

External sources for financing innovation

External sources of finance are critical for firms' innovation as firms typically lack internal sources (e.g. retained earnings and profits) for financing their innovation projects. They critically depend on how financial markets operate and on the rewards they provide to innovators (see [Markets and rewards for innovation](#) [1]).

External sources for financing innovation include:

- [Debt financing](#) [2], which refers to opportunities for firms to secure public and private credit to start and develop their businesses (i.e. loans from banks and public institutions), is used as one of the most common tools for access to finance.
- [Stock market financing](#) [3], which refers to raising capital by issuing shares or common stock in stock markets can also be used to obtain financing. Yet, it may be of limited relevance for financing innovation whose outcome is uncertain and for innovative new venture, which often have, at least initially, negative cash flows, untried business models and uncertain prospects of success.
- [Business angels](#) [4]: wealthy individual investors, typically with business experience, who act as a source of equity and provide start-up capital (as well as expertise and access to networks) to smaller firms in exchange for either convertible debt or equity. In recent times, business angels are establishing networks in order to better link firms with investors. Business angels attempt to identify firms which seem promising but lack the necessary funds to implement innovative strategies. As a result, angel investors play a key role in providing finance to younger firms.
- [Venture capital](#) [5]: venture capital funds can be defined as pool of capital which is managed professionally and is invested in private ventures using preferred stock or similar instruments. Venture capital funds have developed significant expertise on how to undertake due diligence for high-risk innovative firms as well as how to structure the contracts and stage the funding provided in order to reduce the impact of informational asymmetries.
- [Other types of finance](#) [6], such as subsidies and grants from governments and international organizations can also be critical given innovative businesses' limited access to financial markets.

Related Link: Key actors for financing innovation

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Financial market development

Financial market regulation

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Links

[1] <https://www.innovationpolicyplatform.org/content/markets-and-rewards-innovation?topic-filters=12050>

[2] <https://www.innovationpolicyplatform.org/content/debt-financing?topic-filters=12217>

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[4] <https://www.innovationpolicyplatform.org/content/business-angels?topic-filters=12205>

[5] <https://www.innovationpolicyplatform.org/content/venture-capital?topic-filters=12161>

[6] <https://www.innovationpolicyplatform.org/content/other-types-finance?topic-filters=12110>