How can we improve access to risk finance in Europe?

The aim of this workshop, which was organised as three sequential panel discussions, was to help the European Commission refine the design of a new generation of financial instruments — one for debt, and one for equity — to overcome market deficiencies and attract a major increase in private finance for research and innovation.

Brussels, 13 July 2011

SUMMARY

NOTE As the workshop was held under the Chatham House Rule[1], the summary does not identify who said what.

1) Improving Framework Conditions for Debt and Equity Financing in Europe

1. What are the main problems impeding access to risk finance in Europe?

Five main problems were identified during the workshop:

- A **fragmented market**, leading to very few truly pan-European venture capital (VC) funds (stemming from national borders, different languages and cultures, and varying fiscal and legal frameworks).
- A **market that is unattractive to investors**, with insufficient and unclear opportunities for exits. Larger institutional investors do not perceive VC as a lucrative asset-class, based on its past performance.
- Compared to the US, the EU, generally speaking, has **less favourable cultural attitudes to entrepreneurship and innovation**, and in particular, **little tolerance of failure.**
- Not enough attention paid to **supporting and fostering clusters** and attracting local seed investors.
- **Poorly designed and uncoordinated regional, national and EU policies and support schemes**, and not enough **State aid** targeted on research, development and innovation (RDI) and SMEs.

2. What should the European Commission be doing to improve matters at framework level? And national administrations?

Panellists and workshop participants expressed strong support for **building on successful EU schemes** (such as the RSFF under FP7 and the GIF under CIP), improving them, including via greater cooperation and dovetailing with regional and national schemes and actors, and **significantly up-scaling** them. The techniques used by **successful national schemes**, such as the High-Tech Gründerfonds, those under the wing of TEKES, and the Dutch Innovation Credit Facility, should be analysed and their best practices considered for deployment at EU level.

Other suggestions for action attracting widespread support in the meeting were:

- **Coordinated support for enterprises all along the value-chain and at each stage of the company life-cycle**, with no gaps in the "funding escalator" and

[1] For details, see http://www.chathamhouse.org.uk/about/chathamhouserule/

making use of all types of support (grants, public procurement, debt and equity instruments, etc).

- **Specific attention paid to innovative SMEs and mid-caps** — a need for an EU SBIR scheme (learning from the UK and Dutch experiences).
- Concentrate on stimulating the **creation of large VC funds** — not "bonsais".
- **Schemes to improve the investment readiness of enterprises** and, in particular, improve the understanding of start-ups about the different forms of finance available. As part of this approach, a much wider use of case-studies as an educational tool.
- A more **innovation-friendly State aid framework** for RDI.
- **Facilitating relationships** between banks, venture capitalists, business angels and equity markets.
- More support and incentives for **cluster creation and growth.**

At the regional and national level, national authorities should ensure coherence and complementarity **between regional and EU policies** and work on creating framework conditions that encourage private sector investment in technologies and industries that will give them a competitive advantage. Fiscal policy, in particular, should be tuned to attract private investors.

3. How much faith should we put in financial instruments anyway?

The panel drew attention to the success of the RSFF as a counter-cyclical debt instrument for funding RDI, cited several examples of successes stemming from equity financing (Skype, research on graphene) and gave **several reasons why financial instruments are worthy of increased attention and effort**: at a time when pressure on public finances is particularly high, their leveraging of private funds is of great benefit; they are well positioned to help tackle the societal challenges identified by Europe 2020; and they are an efficient mechanism for disbursing public funds. However, successful deployment at EU level requires the identification of clear market gaps; excellent governance and management; the alignment of the interests of the financial intermediaries implementing financial instruments with the goals of the instruments themselves; and an intervention of a scale sufficient to have an impact but not so as to distort competition.

2) LOANS AND GUARANTEES

1. What relative weight should we give to loans compared to other forms of debt finance?

Panellists and participants pointed out that the guarantee facilities of the RSFF under FP7 and the GIF under CIP had been comparatively little used.

Regarding large companies, the point was made that access to finance, per se, was normally not a problem. Loans of the RSFF type did not, typically, stimulate such firms to undertake riskier research. **What was more attractive were loans that could be converted into grants if the project concerned did not work out**.

However, in particular circumstances such as the most recent economic and financial crisis, **risk-sharing loans for RDI purposes had been a very important source for companies to keep their level of RDI investment and to maintain their competitiveness.**

Panellists underlined that for SMEs and mid-sized companies ("mid-caps"), the lack of debt finance — which also includes mezzanine type of finance — for RDI investments was still a key constraint. Financial instruments at EU level would need to address this market failure.

There was also agreement among panellists that **risk-sharing** and **the mitigation of financing risks through public intervention were crucial to encourage private-source finance for RDI investments**. In this context, it was pointed out that future EU financial instruments for research and innovation should be flexible enough to support and leverage national funding schemes for RDI.

2. **How sensible is it to have targets for loans to particular sectors crucial to competitiveness and/or to tackling societal challenges (climate change, energy security, etc)?**

   The general view was that loan finance can support investments for tackling societal challenges, but that **it would be prudent to take a "technology neutral" approach** as much as possible. The policy goal should be to generate business opportunities (by appropriate regulation; by governments becoming first or early-adopter customers, etc).

   Further to that, it was the common view of panellists that too narrowly focused support schemes aiming at addressing a single policy goal should be avoided in order to allow research and innovation needs to emerge bottom-up, according to demand.

3. **How can we best continue with loans for "research infrastructures" while also developing loans for "innovation infrastructures" (clusters, science parks, incubators, etc)?**

   There is high potential for supporting **innovation clusters** forming around research infrastructures and for supporting enterprises contributing to the creation of or benefitting from the output of research and innovation infrastructures.

   However, for purely public research infrastructures without sufficient revenues, debt finance requiring repayment and debt servicing was regarded as an inappropriate instrument.

3) Equity and Quasi-Equity Instruments

1. **What should be done to expand the venture capital market?**

   Panellists stressed that as a consequence of the financial crisis there is a lack of capital on the market; in particular, institutional investors have turned away from the VC sector. Investing and funding have decreased, **average returns continue to be low**; while investment opportunities and a significant number of entrepreneurs with interesting business proposals do nevertheless exist. However, many investors, such as pension funds, turn to other asset classes instead.

   In comparison to the US and as a percentage of GDP, more companies are started in Europe but there is a **problem with financing their growth,** as many VC funds do not have enough resources**, and there is a lack of scale in the EU venture market.**

   As an urgent step, **shortages of capital on the VC market** have to be addressed first by facilitating more **patient capital**, while taking into account the absorption capacity of the market and the availability of experienced management teams.

Although the VC industry currently experiences difficult times, it has significantly professionalised and gained in experience over the past 10 years. The best teams are on a par with their US peers, and these teams are producing significant returns for their investors. At the same time there is an ongoing consolidation, with less successful teams leaving the field.

In order to facilitate success for VC funds and investments, the **scaling-up of successful VC funds** should be supported but **investments should be made on a very selective basis**.

Regulation needs to be smart and simpler. Negative impacts for the industry might be expected from Basel III and the implementation of Solvency II. Possible negative impacts should be reduced and the regulatory environment should be made **more predictable**.

As a consequence of the financial crisis, governments have introduced stricter regulation causing higher overhead costs for LPs, thereby creating pressure to increase fund sizes to absorb higher costs. Governments should introduce incentives (i.e. tax incentive schemes already in place in a limited number of Member States), less bureaucratic schemes (i.e. for young innovative firms) and **reduce the national focus** since innovation and the VC industry are global.

The European VC market is fragmented along national lines, caused by different national regulatory and tax regimes. The ongoing Commission consultation on a new European VC regime is a step in the right direction. **Strengthening cross-border operations** and **reducing fragmentation** are essential for reaching scale and scope on the equity market. Fragmentation has been evident also in the existence of relatively small funds, but this trend has started to change. Cross-border VC operations need to be strengthened.

The common view of panellists and participants was that the European Investment Fund (EIF) has played a significant role and **should thus continue with its activities as a cornerstone investor**, i.e., acting as a long-term, private investor on the VC market. EIF knows the European venture market very well and works very professionally. Therefore, the European Commission should continue with its VC investments through the EIF.

2. How can seed, early-stage as well as growth stage financial instruments best work together with the business angel community and the venture capital sector?

VC is most suitable for growth-oriented firms with unique business models, products or services Seed and early-stage phases are more likely to be financed through business angels and family offices. Panellists stressed the recent positive trend of **strengthened cooperation and co-funding of VC funds and business angels**. Therefore, the Commission and the EIF should:

- **facilitate capital flow for investments together with business angels;**
- leverage these investments in order to ensure longer presence of angels in firms;
- ensure that instruments are suitable for the specific nature of business angels' business models.

Furthermore, the mixing of VCs and business angels should be further encouraged as well as with corporate VC, and the **business angels market should be further built**

up through awareness campaigns, investor-readiness programmes and sharing of success stories. To have a better understanding of the underlying dynamics of this market and its participants, a regular EU-wide survey to gather evidence on business angel investments should be carried out.

3. **What appetite is there for funds-of-funds with or without a thematic focus?**

   The panel agreed that in order to attract institutional investors to the market and to allow for larger investments, suitable vehicles should be established. **Funds-of-funds schemes** were seen as **useful** to provide such a vehicle, provided that their **number is limited** and that they are able to **attract existing experienced fund managers**. The latter do exist, but they need to be incentivised to step into the fund-of-funds market. Encouraging new fund managers to manage such a vehicle would be sending a wrong signal to the market.

   Many existing fund-of-funds work in low gear and consider that there are very few VC funds with good prospects. Therefore, investments in such a fund-of-funds vehicle by the **EIF as a "lighthouse" investor** could provide the required impetus and draw the required capital from private investors. Furthermore, the vehicle could be structured to **incentivise private investors to participate**, i.e. by moving away from *pari passu* clauses. It was suggested that incentives may also be created by allowing a hybrid fund structure which could cover fund-of-funds investments alongside direct investments to enhance the return profile.

4. **How can we promote exit markets?**

   Exit markets are important to pull companies through the full development cycle (different stages of funding) as the business grows and matures. Further incentives should be provided to promote the listing of firms on alternative markets.

   An **IPO event is today not only an exit event** for the investors but **also a fundraising event** enabling firms and funds to attract more capital. In addition, other avenues should be supported, as currently only a few top performers make successful and rewarding IPOs.

Summary prepared by DG Enterprise & Industry and DG Research & Innovation.

For information on EU-level financial instruments supporting research and innovation, see:

RSFF: http://www.eib.org/products/loans/special/rsff/index.htm

CIP Financial Instruments: http://ec.europa.eu/enterprise/policies/finance/cip-financial-instruments/index_en.htm

and http://ec.europa.eu/cip

This workshop was dedicated to the memory of **Diogo Vasconcelos**, Chair of SIX (Social Innovation eXchange) and driver of the Social Innovation Europe Initiative, Distinguished Fellow of Cisco Systems International and former chair of the Commission's Business Panel on Future EU Innovation Policy, who died on 8 July 2011.