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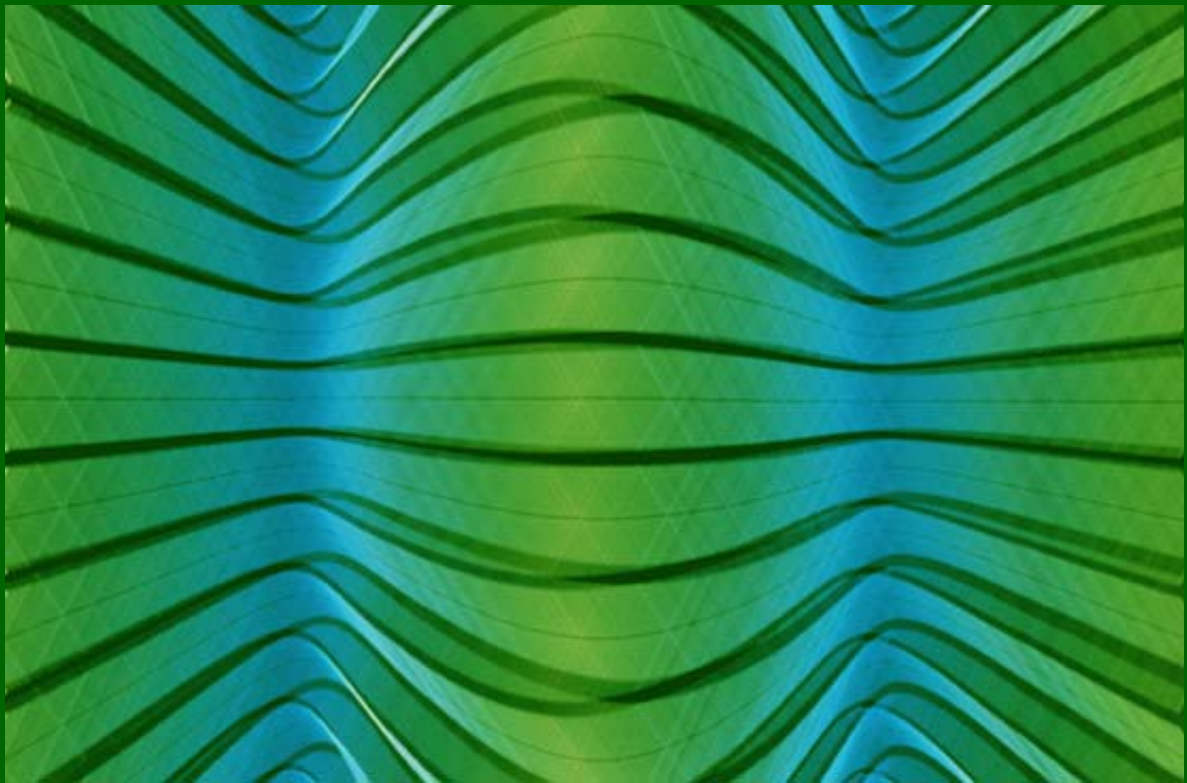
DIRECTORATE-GENERAL FOR ENTERPRISE AND INDUSTRY

Financing SMEs, entrepreneurs and innovators

Seed Finance

Summary report of the workshop

Brussels, 21 November 2006



European Commission

This summary is based on the work of experts attending a workshop in Brussels on 21 November 2006 on seed finance. The workshop was designed to assess how the European Commission could support SMEs' access to seed capital in Europe. It identified key problems and possible solutions. A list of participants is provided in the appendices to this report¹. The workshop was organised by Directorate-General for Enterprise and Industry of the European Commission.

¹ The document does not contain the complete and verbatim text of all presentations and interventions during the workshop. Likewise, the contents do not necessarily reflect the opinion or position of the European Commission. Neither the Commission nor any person acting on behalf of the Commission is responsible for the use, which might be made of the information contained herein.

BACKGROUND

Although Europe has a strong R&D base, there is a failure to exploit this potential fully and inadequate provision of seed capital is a major contributing factor in this respect. Transforming R&D projects - and innovation generally - into successful business start-ups depends heavily on appropriate early stage finance. The shortage of seed capital can be largely attributed to the high risk associated with early stage financing coupled with relatively low rates of return. However, equity-based financing is preferable to alternative debt-based instruments which are more expensive and rely on collateral which start-ups are often not in a position to provide.

Whilst the amount of private equity has risen in Europe in recent years, there has been a decrease in the levels of seed capital investment. This trend is highlighted by the EVCA amongst others² At the end of 2003, the performance of early stage investments appears particularly disappointing with five and ten year investment horizon with Internal Rates of Return (IRRs) as low as -1.8% and 1.3%. The performance gap between European and US funds is striking with US early stage funds showing IRRs of 54.9% and 37% for five and ten year horizons. These low rates of return clearly cannot generate the levels of private investments that Europe needs. The lack of seed and start-up investments prevents new firms from reaching a size where they can attract expansion capital. The overall profitability of European venture capital market is also low, as shown in a recent study by the European Commission³.

KEY OUTCOMES OF THE WORKSHOP

Workshop participants identified a number of factors relating to a lack of good quality investment opportunities and the need for exit mechanisms which act as constraints on the availability of seed finance.

The question of whether or not there really is a market failure in the provision of seed capital finance was debated. It was argued that in Member States where financing structures are well-developed, the shortage of seed capital to some extent simply reflects the fact that there is a lack of good quality investment opportunities, the challenge therefore being to stimulate the demand side and generate deal flow. As a rough guide, it was pointed out that today only one in every 12 investment proposals actually receives support. Professional preparation of the entrepreneur for an investment is crucial. Various measures of investment readiness support can provide solutions.

² According to EVCA, the volume of private equity investments in Europe has shown a sharp increase, whereas the share of early stage investments is still declining. Private equity investments increased by 27% from €36.9 billion in 2004 to €47.0 billion in 2005. However, seed financing was not able to pick up on the growth of private equity. Seed investments fell by almost 34% from €148m in 2004 to €97m in 2005. This decline is reflected in the sharp decrease of the share of seed investments of the total from 0.4% in 2004 to 0.2% in 2005. Start-up investments (following the seed phase) increased slightly from €2.2 billion in 2004 to €2.3 billion in 2005.

³ DG ECFIN, "Profitability of venture capital investment in Europe and the United States", March 2006.

The fact that there may be high risks associated with an investment is not the main issue – what business angels are looking for are good projects that offer the possibility of a high return with the possibility to exit the investment when desired. It was generally accepted that business angels and other providers of seed capital are willing to accept high risks as long as their investment offers has the potential to provide a good return in a relatively short period of time. But a major problem for business angels is the lack of exit mechanisms to ensure that the return is realised. Apart from selling the equity stake back to the company and a trade sale, the most common exit is via a venture capital investment. It is preferable to have a single (or a few) investors at the seed capital stage because if equity stakes are too diluted, this can deter VCs from providing second round financing given the need to negotiate with a lot of different parties.

A key question is stimulating deal flow. A number of possible ways of doing this were identified. The aim should be a sufficient deal-flow as far as both quantity and quality are concerned. Thus, in Spain, amongst other countries, an effort is being made to raise awareness of and interest in entrepreneurship in schools, to create a culture of entrepreneurship. In Belgium, the problem is not so much one of a lack of ideas but rather a lack of well-structured companies (i.e. with appropriate financial and management structures) that are capable of achieving high growth. There is also a lack of growth ambition amongst many start-ups and smaller firms. In Italy, there are a large number of small firms with growth possibilities but the number is declining. In Germany, the High-Tech Gründerfonds (HTGF) works closely with a network of technology transfer offices to help generate deal flow. Ultimately, the quality of projects is just as important as ensuring that there is good pipeline of deals from a quantitative point of view. Market pull rather than technology push is the key to ensuring high quality deal flow. Following on from this, it is essential that there is an early involvement by potential investors in projects so that they develop into sound business propositions.

There is a need for a more professional approach to managing existing business angel and seed capital fund networks. Ideally, this role should be undertaken by people who have personal experience of setting up and running businesses. The role does not necessarily have to be full-time. It requires skills in sales and marketing, and is more to do with an instinctive feel for a good business proposition rather than formal assessment of business plans, etc, or having specific financial expertise.

A key factor in successful seed capital operations is being able to network with existing entrepreneurs and business people who can provide mentoring support to new start-ups. Innovators often have the necessary technological know-how but lack business skills. Filling key management positions in start-ups is a critical success factor and sometimes it may be necessary to identify external candidates to fulfil this role. These should ideally be people with experience of starting up and running a business rather than simply VCs. As such, there is a need for experienced entrepreneurs on the investor side (and not just investment professionals). Business angels have an especially important function in this respect.

Several factors were identified that are specific to R&D spin-offs from universities with regard to the provision of seed capital finance.

A key problem as far as generating university spin-offs is concerned is a lack of business leadership – those engaged in R&D are often willing to consider the idea of setting up a company to commercialise their ideas if somebody else takes the lead.

Research is currently underway in Finland to investigate this issue in more depth. Workshop participants agreed that more needs to be done to develop a culture of entrepreneurship in universities and other sources of R&D. Team building in a way that combines people with R&D and business expertise is the key to successful start-ups.

There is a need to improve the business support services available to R&D spin-offs. Seed capital financing should be supported by other types of assistance and this is especially important for R&D spin-offs where the technological know-how exists but there is often a lack of business skills. Whilst existing business support and technology transfer services often meet basic requirements, more could be done to improve available assistance, especially with regard to advice on Intellectual Property Rights (IPR) issues. Often the way in which IPR issues are dealt with in new start-ups leads to problems. For example, if R&D is carried out by a consortium (as is often the case with EU-funded projects) it is frequently not clear who owns the IPR and this can complicate the process of attracting external investors.

It was agreed that an important question is what happens to proposals for seed capital financing that are rejected. Here, there is a need to consider further efforts to develop some R&D projects (again, for example, through investment readiness' support) so that 'dormant' potential is not lost. But at the same time, projects that are unlikely to succeed despite further assistance should be 'killed off' sooner rather than later in both the interests of the potential investor and (would-be) entrepreneur.

Business angels are a key source of early stage financing but more needs to be done to develop this market.

There is an important distinction between pre-seed and seed capital finance. Pre-seed ('proof of concept') finance is generally provided from public sources. Difficulties in raising finance are therefore often not so much a manifestation of market failure but rather associated with the transition from grant financed research to a commercially-funded project. Partnership working between public authorities, business angels, and other providers of seed and venture capital finance is critical if R&D-based start-ups are to make this transition successfully.

Business angels are one of the most important sources of seed capital but the situation with regard to its availability varies. During the workshop, several presentations were made to illustrate differing practices and situations in Europe – The Spanish Business Angels Network, ESBAN, the HTGF (Germany) and Lewiatan Business Angels, a venture conducted by the Polish Confederation of Private Employers Lewiatan in Poland. Appendix A provides a summary of these presentations.

More emphasis should be placed on communication – in particular, raising awareness of opportunities to become a business angel. There are a number of different approaches that can be adopted to this, e.g. getting existing business angels to share their experiences with networks that draw in potential investors. There is a considerable amount of existing experience, and good practices need to be identified, shared and replicated.

There is a need to maintain a balance between the number of projects/investment opportunities coming forward, on the one hand, and the number of business angels and other investors, on the other. There is a danger if this balance is not maintained and the number of projects far exceeds the number of business angels, then potential investors will lose interest. This is partly because if there are a large number of projects relative to the number of potential investors, the

perceived quality of investment opportunities may be adversely affected. Maintaining this balance is a key function of the 'gatekeeper', i.e. the intermediary between entrepreneurs seeking finance and those who are in a position to provide it.

There were mixed views on the merits of business angels' registration systems. Many business angels do not want the publicity that inevitably comes with a registration system. This is reflected by experience in the UK where culture is more one of self-assessment/regulation. Thus, only a very small proportion of those who have put money into the UK Enterprise Investment Scheme were known to be business angels. The fact that few people invested more than once in the scheme is also an argument against having a formal business angels register. In Spain, on the other hand, it is felt that a formal registration system needs to be developed as a way of creating transparency and reflecting the legal environment of the country. Overall, the conclusion was that what is appropriate for one country is not necessarily suitable for another.

There is a need for hands-on involvement by business angels and other early stage investors in projects. The involvement of potential investors at an early stage in a start-up contributes to success by bringing in business expertise at a critical stage in a company's development. This can also help ensure that unviable projects (e.g. ideas that are unlikely to find a market) do not proceed, thereby saving all concerned time, effort and money. It was agreed that the early involvement of investors can help to speed up investment returns).

A number of other critical success factors in the development of business angels and seed capital operations generally were highlighted.

Companies with high growth potential have the same requirements, irrespective of their location, as far as seed and capital finance is concerned – what varies is the capacity of the supply side to respond appropriately. Workshop participants agreed that the financing needs on the demand side do not vary and that because of the perceived risks, it is difficult for many start-ups with an innovative idea and high growth potential to raise early stage funding. Although there are variations (e.g. extent and nature of regional specialisation and clusters), the diversity of EU Member States and regions within them applies mainly to the supply side, i.e. in the availability of seed and venture capital schemes. Action is therefore needed at an EU and national/regional level to address supply side weaknesses.

Ideally, there should be private sector 'stewardship' of seed capital schemes. However, it was noted that whilst this is desirable, it is difficult for the private sector to make money from such operations and public sector support is therefore often necessary. That said, the private sector may be motivated by other considerations, e.g. the HTGF involves large private companies who participate in the scheme mainly to gain information about new technologies.

Seed capital funds should have sufficient capacity to achieve economies of scale. Workshops participants suggested that a minimum size of €40-50 million is needed to for seed capital funds to achieve economies of scale and to justify the appointment of a professional management team.

In seeking to develop business angels and seed capital networks, there is a need to build on existing structures including business incubators. At a regional and national level, this includes professional business advisers, technology transfer specialists, and other business support organisations. At a European level, the EIF is, for example, working with incubators in Scandinavia. Creating integrated networks of

this kind is important to the success of business angels and seed capital networks and provides a more seamless support system for new start-ups.

Overall, the workshop concluded that public-private sector co-operation in the development of business angel and seed capital financing is vital but this is not primarily because of lack of finance.

It was agreed that public sector intervention is justified, whether there is sufficient private sector financing or not, because of the public interest in matching high quality demand with the provision of seed capital. More particularly, the role of the public sector need not necessarily be to provide finance but rather to help prepare the entrepreneur for private sector investment (e.g. through the provision of investment readiness support or by ensuring adequate signposting to sources of private sector finance). That said, in some countries where private sector seed capital funding is not yet well developed (e.g. the new EU Member States), the public sector may still have an important role to play as a provider of finance as well. Eventually it can even be the case in countries where seed capital markets are well developed. For example, the HTGF in Germany uses large amounts of public money along side private sector contributions.

KEY RECOMMENDATIONS - EU AND NATIONAL AUTHORITIES

Because of the lack of private sector involvement, the EU and national authorities have a particularly important role to play in the seed capital financing field. At a very early stage in a company's development, an appropriate structure for private sector financing may not be in place and this is where public sector involvement can be critical, e.g. providing early stage finance but also in stimulating the greater availability of private sector seed capital finance. On the demand-side, there is a need for more emphasis on investment readiness support (e.g. helping entrepreneurs to prepare a business plan, ensuring that company structures are in place that are suitable vehicles for external financing, information and matching of entrepreneurs and potential investors).

There are a number of ways in which the EU and national authorities can support the development of seed capital schemes. At a national level, this includes developing a favourable fiscal environment for business angel and seed capital financing activities, particularly tax incentives⁴; at both a EU and national level, there is scope for additional initiatives to provide public funds for the pre-seed financing of projects; and more generally, supporting the development of business angels networks and/or new seed capital funds, e.g. through co-investment schemes, training of network managers, studies to map out seed capital and business angel provision, coaching schemes and networks, etc. Clarity is needed with regard to the aims and tools of public interventions.

Specifically with regard to business angel financing, EU Member States should ensure that an appropriate overall framework for such operations is in place. This might include, again, introducing fiscal incentives. It will not be appropriate to register

⁴ EBAN has published a 'Survey of Tax Incentives available to Private Informal Investors or Business Angels in Europe' (September 2006). See www.eban.org.

business angels except in those jurisdictions where the commercial code requires this, because informal investors often are not eager to be included in registers.

Publicly-supported co-investment schemes could have an increasingly important role to play in encouraging private sector investors to come forward. One example of this is 'France Investissement' which provides financial assistance from the public sector to help leverage/support business angel investment activity, together with guarantees). At an EU level, it is envisaged that the CIP will also support co-investment schemes. Although co-investment schemes can help to stimulate the provision of business angle finance, they are mainly suitable at the second stage in the market's development, i.e. once a business angel sector has already been developed.

Managing the relationship between the public and private sectors is critical in the development of successful seed capital funds. Too often, however, the person performing this role comes from the public sector – there is a need to attract more private sector involvement by people with business experience since this function should be undertaken by somebody with entrepreneurial drive.

More generally, there is distinction to be made between investment decisions where the private sector is best placed to take a lead, on the one hand, and development decisions with regard to seed capital, on the other, which is the role of the public sector. At the level of individual seed capital operations, the private sector is best placed to provide the expertise required for efficient and effective management, even if the funding is (partly) provided by public authorities. However, public authorities have a clear leadership role in develop decisions, i.e. deciding how best to allocate public funding that can be used to address shortcomings in seed capital provision and to develop the market.

The role of the Structural Funds has been critical to stimulating the provision of seed capital in many EU Member States. The example of the UK was highlighted in this respect. Here, the Structural Funds have been especially important in helping to develop seed capital schemes at a regional and sub-regional level. The risk capital market in the UK tends to be otherwise dominated by London-based fund managers who have relatively high investment thresholds. In most other countries, there are also essentially micro-markets as far as seed capital is concerned and a key role for the EU and national authorities is to help reduce this fragmentation. A good example, independent from EU-Structural Fund support, is in Germany where the HTGF performs this role by reinforcing regional seed and venture capital markets through a national scheme. However, it needs to be borne in mind that that what works in one country does not necessarily work in another and models such as the HTGF need to be adapted to suit regional and national circumstances.

It was agreed that there needs to be a continuing EU policy commitment to developing seed capital funds in the new 2007-13 programming period. This should combine support for early stage financial instruments with loans and other interventions such as guarantees for start-ups. There is considerable support available from the 2007-13 Cohesion and Structural Funds (including the JEREMIE initiative), EIF (Technology Transfer Accelerator), the new Competitiveness and Innovation Framework Programme, and other EU programmes, for seed capital schemes. This reflects the aim of shifting the emphasis in EU funding away from grants in favour of financial instruments that involve recycling funds and are therefore more sustainable. However, although much can be done at an EU level, national authorities need to take the lead in helping to create a favourable environment for the development of seed capital financing.

Public intervention needs to take place in a way that avoids the risk of crowding out the private sector. In particular, there is a danger that if the public sector provides subsidized seed capital (and/or other types of financing for start-ups) in market

segments where there is no lack of finance but a different type of market imperfection (such as low-quality demand), this will make it difficult for private sector providers to compete and to enter the market. Linked to this, there is also a need to avoid 'contaminating' companies with inappropriate (public sector) financing tools - for example, an excessive dependence on grants - which can also result in deterring private sector investors.

APPENDIX A – EXAMPLES DISCUSSED DURING THE WORKSHOP

ESBAN (Spain)

ESBAN, the Spanish Business Angels Network, was established two years ago. It has three main objectives:

- Developing business angels in Spain;
- Providing an interface between business angels and the public authorities (e.g. to help develop a legal framework);
- Providing a means of sharing experience and ideas, and for capacity building (e.g. training for network managers).

A study was carried out in 2005 to map out business angel activity in Spain. This confirmed that Spain lags behind other major EU Member States with regard to business angel activity. It also highlighted the need to develop regional networks. These are already quite strong in some Spanish regions (Madrid, Catalonia) but otherwise generally weak and under-developed.

A key priority for ESBAN is to establish a legal framework for business angels. The first step is to set up a register so that business angels can be identified and thereby made eligible for tax incentives. To this end, ESBAN is working on the development of a code of conduct that can be used as a basis for the proposed register. Other initiatives include discussions with major banks in Spain to provide loans to business angels (e.g. loans of up to euro 150,000 on preferential terms including a three-year grace period). Another scheme being worked on by ESBAN is a proposed Innovation Financing Programme.

In addition to weaknesses on the supply side, one of the biggest problems in Spain in seeking to develop business angel finance is the reluctance amongst SMEs to accept an external interest in their financial structures, especially if this has implications for ownership.

High-Tech Gründerfonds (Germany)

The HTGF was established 15 months ago to invest seed capital in new technology based firms. It draws on some 25 years of experience in this field and against the backdrop of relatively modest venture capital investment levels in Germany.

The HTGF has invested €262 million since August 2005. Most of this (€240 million) has come from the public authorities with the remainder coming from large private sector companies (e.g. Deutsche Telekom). Although the private sector's financial contribution to the HTGF is relatively modest, it makes other important inputs including the provision of advisory support to new companies. From the perspective of private

sector investors, access to technology rather than financial returns is the key driver. The HTGF concentrates on providing:

- Seed capital of between €500,000 and €1 million to companies that are less than one year old;
- The HTGF takes a 15% equity stake for a fixed investment of €5,000 (there is no valuation. The €5,000 investment the form of a convertible loan with interest rolled up and then, together with the principal, being converted into equity);
- Investments with a lifetime of 5 years plus a reinvestment period of 7 years.

Since August 2005, the HTGF has received 1,400 proposals of which 480 were examined in detail leading to 43 investments and a further 15 commitments (the HTGF's investments account for most – 43 of the 49 – VC investments in Germany in 2005/06). The target group of the HTGF is 200-300 technology-based firms, mainly in the ICT and Biotech sectors. 16% of the Fund has been invested so far in Saxony, one of the new 'Länder'. It is envisaged that the Fund will invest in up to 50 of these p.a. Other conditions are that the IPR must be owned by the company and the owner must be prepared to make an investment of at least 20% in the firm's equity.

The aim of the HTGF, and main success criteria, is to prepare start-ups for second round VC funding (so far, 7 firms have received VC funding) and to return a profit to investors. In addition to seed capital, it provides advisory support via networks consisting of technology transfer organisations, the VC and business angels sector, large companies, and a regional pool of 50 coaches and mentors (often a business angel).

A key factor in the HTGF's operations is the standardization of investment procedures, the same offer being made to all potential investees. This helps reduce transaction costs (currently below 2% of capital invested)

There are relatively few seed capital funds in Europe like the HTGF. One is a seed capital fund that was established in 2003 in the North West of England with Structural Fund support although this is available to existing SMEs with growth potential as well as start-ups. One complication highlighted was that according to Structural Fund regulations, the intervention should be closed by the end of 2008. However, given the nature of the investments, full-scale returns from the seed capital fund will only materialise over the period to 2018.

Lewiatan Seed Capital Financing in Poland

Poland has a still under-developed VC market with few investors and only one organisation providing seed capital financing. This is partly because real estate offers better investment returns and therefore a more attractive alternative to investing in new companies.

The Lewiatan seed capital fund is run by the Confederation of Private Employers. It is supported by around 50 business angels. Most VC funds have thresholds of €5 million plus. The seed capital fund offers:

- Seed finance of between €50,000 and €1.5 million;
- Funding for a period of up to three years for seed phase companies based on R&D;

- Companies are required to declare that they are not making use of Government funding (this requirement will be dropped soon) and have paid all taxes and social security contributions.

Since it began operating in 2005, there have been 230 project proposals leading to 7 seed capital investments. It is anticipated that there could be up to 10 investments p.a. in coming years. The fund currently has €18 million available and a substantial increase is anticipated after 2007 once the new Structural Funds become available.

Support is also being available for the establishment of new funds. It is anticipated that between 3 and 5 new start-up VC funds will apply for an injection of capital of between €5 and €10 million each.

APPENDIX B – LIST OF PARTICIPANTS

Experts

- Mr Henri-Francois Boedt**, European Investment Fund
- Ms Virginie Goupy**, Vigiecom, Europe (FR)
- Mr Mats Enegren**, Startinvest (SE)
- Mrs Emma Fau**, European Private Equity and Venture Capital Association (EVCA)
- Mr Denis Marnane**, Enterprise Ireland (IE)
- Mr Michael Brandkamp**, High-Tech Gründerfonds (DE)
- Mr Peter Gombert**, Dr Neuhaus Techno Nord GmbH (DE)
- Mr Peter White**, YTKO, St John's Innovation Centre Cambridge (UK)
- Ms Vivienne Upcott-Gill**, Techinvest (UK)
- Mr Risto Kalske**, Finnish National Fund for Research and Development (FI)
- Mr Christian Saublens**, EURADA
- Ms Claire Munck**, EBAN
- Mr Bernard Surlemont**, Liege University (BE)
- Mr Bart De Smet**, PMV-kmo (BE)
- Mr Jerry Kanhai**, Technopartner Seed Capital – Seed Facility (NL)
- Mr Luigi Amati**, META Group (IT)
- Mr Michał Olszewski**, Lewiatan Business Angels (PL)
- Mr Jordi Rodríguez**, ESBAN, Red Española de Business Angels (ES)
- Mr Boris Pfeifer**, Slovene Enterprise Fund (SI)

Observer

- Christian Lossgott**, Austria Wirtschaftsservice, (AT)