EUROPEAN COMMISSION

DIRECTORATE-GENERAL FOR ENTERPRISE AND INDUSTRY

Financing SMEs, entrepreneurs and innovators

Investment readiness

Discussion paper for the workshop

Brussels, 28 November 2006

European Commission

This document served as a basis for discussions during the workshop on "Investment readiness".

BACKGROUND

Supporting the creation and growth of innovative small and medium-size enterprises (SMEs) is a high priority for Europe, as they are the main drivers for innovation, economic growth and job creation. At the supply side, although equity funds raised have recently increased, reaching all-time records in 2005, funds actually invested in SMEs remain proportionally low, especially in the early stages. European investors are reluctant to invest in SMEs because of the high risk and overhead costs induced which are not compensated by realised returns. Europe has too few business angels, just as it has too few private venture capital funds that are willing to invest in seed and start-up stages. On the demand side, many entrepreneurs have a limited understanding of the various financing options and they often perceive the loss of control of their company as unacceptable.

Over the years, the EU and the Member States have demonstrated their commitment to bridge the finance gap faced by SMEs, in particular innovative early-stage SMEs. Both have recognised the benefits for entrepreneurship and innovation provided by equity funding and have taken many initiatives to increase the supply of equity finance to SMEs in Europe[1]. Complementary efforts are, however, needed on the demand side. SMEs need to become "investment ready" if they want to satisfy investor needs. In this paper, investment readiness refers to the capacity of an entrepreneur – who is looking for external finance – to understand the specific needs of an investor and to be able to respond to these needs by providing an appropriate structure and relevant information, by being credible and by creating trust to increase the probability of an investor to invest in the project.

The European Commission has acknowledged in its Communication "Financing SMEs Growth – Adding European Value" that "*many entrepreneurs need guidance on the advantages and disadvantages of alternative forms of finance and on how best to present their investment projects to potential financiers. Investment readiness programmes, too, need to build on best European practice*" and before that at the Risk Capital Summit 2005, its chairman David Cooksey emphasised that "*coaching, education and investment readiness programmes should accompany any financial measures*".

In fact, several Member States have already introduced policy measures to identify the gaps and develop investment readiness programmes, helping SME understand the financing options available, assess their business strategy, structure their business plans and manage the raising of equity. The European Commission has also promoted investment readiness programmes through its PAXIS programme, for example.

Good practices should be identified and disseminated. The Member States can learn from each other's experience, and the Commission can act as a catalyst in the process.

---

[1] Commission activities include the Risk Capital Action Plan (RCAP), the Financial instruments of the MAP (2001 – 2006) and CIP (2007-2013); JEREMIE; the 7th Framework Programme; several workshops and conferences aiming at raising awareness on key issues referring to equity finance: the workshop on a European fund structure (2005), the "Risk Capital Summit (2005); the expert group on private equity funds (2006); the expert group on removing obstacles for cross-border investments, the workshop on financing technology transfer and seed finance. All the documents are available on http://ec.europa.eu/enterprise/entrepreneurship/financing/publications_documents.htm.

AIMS OF THE WORKSHOP

The workshop will focus on how **the European Commission** could support and spread good practices in investment readiness. The outcomes of the workshop will provide insights on what impact could be expected from investment readiness programmes, who is best placed to organise them, how to market them and based on the findings, propose a few recommendations.

More specifically, discussions should concentrate on how the European Commission could:

- raise awareness on the need for investment readiness policies in the EU Member States among stakeholders, including policy-makers, business advisers, enterprise agencies, and finance providers;
- identify and promote good practices and success stories;
- identify criteria for the effectiveness of investment readiness programmes;
- initiate networking between stakeholders.

RISK CAPITAL FOR SME GROWTH

Although bank loans remain an important source of finance for SMEs, equity finance becomes necessary at certain development stages of an enterprise. At the early stages, for instance, debt finance may be unsuitable because of the SME's limited income flows and assets that can be used as collateral. Moreover, the payment of the loan principal and interests is a burden for the enterprise, which can be difficult to bear at crucial times as expansion phases. Finally, the usual information asymmetry between entrepreneur and bank is more pronounced because of the skills needed to evaluate the technologies of many start-ups[2]. In addition, for SMEs with growth potential, equity financing provides the advantage of strengthening their balance sheet and unlocking their access to bank loan.

… but a persistent equity gap for SMEs

Over the last ten years, the supply of equity funds increased significantly in Europe. In 2005, funds raised reached € 71.8 billion more than two and a half times than the € 27.5bn in the previous year. The amount invested by European private equity funds reached an all-time record of € 47 billion, investing in 7,207 companies. However, only 3.4% of the funds raised were invested in early-stage SMEs, a lower proportion when compared to the 8.7% in 2004. The number of early-stage SMEs receiving equity funds was approximately 2500 in 2004 and 2005[3]. Risk capital still accounts for a too small number of innovative SMEs, in particular at early-stage, despite that around 25% of SME want to grow[4].

---

[2] Best practices of public support for early-stage equity finance, Final report of the expert group, September 2005 (http://ec.europa.eu/enterprise/entrepreneurship/financing/publications_documents.htm).

[3] Figures from EVCA 2006 Yearbook.

[4] Alun Michael, Risk Capital Summit 2005.

The lack of investment in early-stage SMEs is mainly due to low returns compared to the high risk. Investors' perception of risk is magnified by the often poor quality of presentations they see, making such investments unattractive. A recent study by DG ECFIN showed that in Europe, early stage funds are only marginally profitable. The investment decision is largely based on the subjective appraisal of prospects of the entrepreneur. Therefore it is necessary for an entrepreneur to understand the investor's needs and to provide relevant information to make his business proposal more attractive.

INVESTMENT READINESS GAP

Three main reasons explain why entrepreneurs have insufficient knowledge about finance:

Lack of knowledge about financing

Many entrepreneurs are unaware of the available and suitable options for financing including which sources would be relevant to their adopted business strategy. For many entrepreneurs, bank loans remain the preferred source of external finance. They often do not realise the benefits of a stronger capital structure for survival and expansion.

Fear of losing control

In Europe, some entrepreneurs do not seek for venture capital funding because they are afraid that it will mean giving up control of their business to the investors. However, investors do not only provide funding, but can provide knowledge and advice, becoming partners in the business. Equity investors also require greater disclosure of information about the firm than debt finance. However, entrepreneurs' aversion of giving part of their share is such that some will prefer to keep their business small rather than taking the equity route, although it would mean of giving them the chance to own a more valuable of a much larger business[5].

To achieve growth, entrepreneurs willing to create wealth and value in the business, should in the end be prepared to share that wealth with investors. They should have a better understanding of the implications of giving up an equity stake to motivate them to structure "investable" projects. The private and public sector actors that support entrepreneurs should collaborate to provide expert advice about the benefits of risk capital for growth. At the same time, policy-makers need to be aware of the needs of an equity culture and the economic contribution it makes to society[6].

Information asymmetry

Many SMEs with growth potential do not succeed in raising the finance they need because of the low quality of their presentations. The entrepreneurs are not aware of the key factors that drive the investment decisions of equity investors and are not prepared to answer questions about these or lack some of the capabilities investors are looking for. This wastes the time of all participants in the process and results in a high failure rate. Many business plans and management teams may have quality in them, but are either

5 Paulo Anselmo, Risk Capital Summit 2005, London.

6 Jean-Bernard Schmidt, Risk capital Summit 2005, London.

insufficiently developed or are inappropriately structured and do not provide the assurances equity investors need. This reflects badly on the abilities of the team seeking finance, as it reveals lacking understanding of finance and perhaps business also.

Q1: What other factors contribute to the lack of investment readiness?

OBJECTIVES OF AN INVESTMENT READINESS PROGRAMME

Investment readiness programmes aim to correct failures at the demand side of the equity market. They are designed to assist entrepreneur, especially innovative entrepreneurs that have firms with growth potential, raise external finance, in particular equity finance. The programmes can include training, guidance and advice, mentoring, technical support, and networking. They usually contain tools for:

- assessing a business strategy, explaining the sources of financing and more specifically the advantages and disadvantages of raising equity finance, understanding investors' requirements, and structuring an attractive business plan;
- improving the quality of presentation, negotiating with financiers and managing the fund raising;
- ensuring that the business has an appropriate corporate structure;
- connecting "investable" SMEs with potential investors.

According to a survey carried out in 2004 on European start-up needs with more that one hundred innovative companies[7], top 3 SMEs' most apparent needs are:

- mentoring in source of financing;
- dialogue with and understanding of investors;
- finding business angels.

Q2: What other significant objectives should/could investment readiness programmes target?

INVESTMENT READINESS SERVICE PROVIDERS

There is a plethora of public and private organisations providing business support services to SMEs. Some of them are specialised in advising SMEs on financial management issues, including access to equity finance. The range of advice they offer depends on their nature and specific activities.

Natural providers are:

---

[7] SUN & SUP (http://www.sunsup.org/index.html): the project, which was developed under the PAXIS action, is now finalised. It aimed to improve existing services to support start-up creation and development at EU level.

- business angel and venture capital fund networks;
- incubators and sciences parks;
- national and regional business development agencies;
- accountants and consultancies;
- business schools and universities.

Banks or other financial institutions are not necessarily direct providers of investment readiness programmes but some of them offer financial management information to their SME customers and work with business angel or venture capital networks making referral of SMEs seeking risk capital.

Q3: To what extent does the content of investment readiness support differ from one provider to the other?

Q4: To what extent should the provision of advice be sector or thematic-based?

Q5: Should the provision of advice depend on the size or the type of the SME (i.e. company with international or trans-national focus)?

Q6: Should the provision of free guidance be widespread? To what extent should public support be used to provide investment readiness advice?

Q7: What is the relationship between the equity gap and the provision of investment readiness advice to SMEs?

Q8: How to encourage the spread of good practice between the different providers of investment readiness training?

Criteria of good practices

Many performance indicators could be used to assess the effectiveness of investment readiness programmes and qualify them as good practice. The Sun & Sup project[8] proposed the following criteria:

Qualitative indicators

- Customer satisfaction;
- Advice received by the entrepreneur and leading to the improvement of the business plan;
- Networking benefits for the entrepreneur;
- Level and quality of after-care services;
- Involvement of competent and successful professionals;
- Visibility.

[8] SUN & SUP, Final business plan, October 2005 (http://www.sunsup.org/index.html).

Quantitative Indicators

- Number of enterprises having gone through the programme annually;
- Volume of finance raised by entrepreneurs involved in the project;
- Number of projects having received funding the following months (number of deals);
- Time that it takes for a deal to go through;
- For many service providers receiving public funding: ratio of private money leveraged by public money;
- Number of referrals.

Q9: How relevant is the above list? Do these criteria allow us to identify good practices?

Q10: What further examples of good practice are there in the Member States? See also annex 1.

WHAT IS THE ROLE OF THE PUBLIC AUTHORITIES AND THE EU?

The persistent gap between equity supply and demand is usually used to justify the intervention of public authorities to correct the market failure.

Many actions have already been taken and need to be taken also in the future in the supply side to increase the availability of equity for investments. On the investment readiness side, the possible contribution of the public sector is less clear although there are some initiatives.

Member State level

Creating an equity culture requires a series of tasks, including measures to promote an entrepreneurial climate and a mindset seeking success. In the UK, for example, the government has addressed the need to promote an entrepreneurial environment through a campaign called "Enterprise Insight", which highlights the contribution of enterprises to job and wealth creation and celebrates successful entrepreneurs and growth companies[9].

Public actors could also have a role in investment readiness, in particular bringing together the relevant partners, both private and public.

EU level

- At EU level the possible contributions to investment readiness could be:
- raising awareness of the need to have investment readiness programmes;
- identifying and promoting good practices;

[9] Investment readiness, HM Treasury/Small Business Service consultation document, 30 March 2001.

- encouraging networking among the stakeholders.

Q11: What policies could national or regional public authorities develop to promote investment readiness programmes?

Q12: What is the situation in the Member States? Are there investment readiness programmes? Who is running these programmes? Are these public or private initiatives?

Q13: How to promote public-private partnerships in this field?

Q14: To what extent could financial education in schools and universities help to promote an entrepreneurial culture?

Q15: What measures could the European Commission take to raise awareness and promote investment readiness programmes?

Q16: How to promote cooperation between Commission-financed activities and other networks?

ANNEX - EXAMPLES OF INVESTMENT READINESS PROGRAMMES/GOOD PRACTICES

PAXIS

Managed by the Commission's Enterprise Directorate-General under the 6th Framework Programme, 'Research & Innovation Programme', PAXIS promoted the setting-up and development of innovative companies across Europe – a driving force for employment and economic growth. The PAXIS programme had two major objectives:

- To boost the transfer of local and regional excellence in innovation;
- To have an instrument for the co-operation and the exchange of tacit knowledge and learning among local innovation stakeholders, profiting from each other's experience.

SUN&SUP (www.sunsup.org) (PAXIS) provides pan-European mentoring and support which answers to the real needs of entrepreneurs. In addition to the development of services, the SUN&SUP networks initiated a policy recommendation aiming at facilitating the access of innovative SMEs to public procurement markets in the whole European Union, which would foster the emergence of new large companies necessary to meet the Lisbon Agenda and take up the challenges of globalization. To this end SUN&SUP has launched a petition which raised strong interest and collected more than 1000 signatures all across Europe. Moreover, with the partnership of EURADA/EBAN a toolkit « **Invest Academy** » that still need to be tested has been developed on the basis of an analysis of existing « Investment Readiness » programmes.

Oxford Investment Opportunity Network (OION), Thames Valley Investment Network (**TVIN** - www.tvin.co.uk) **and Oxford Early Investment** (**OEI -** www.oxin.co.uk) (UK) are business angel networks, established to link investors to companies with high growth potential, which are seeking business development funds from £10,000 to £1 million. The networks champion the interests of investors by providing them with a strong deal flow of bankable investment opportunities. This provision necessarily involves careful and comprehensive investment readiness training for the young companies seeking investment, resulting in a win/win outcome for both the investor and the company in receipt of the funds.

Leonardo project « Ready for equity – Training for Business Angels and Entrepreneurs »: the project aims to **develop and test a training curriculum**, on the one hand addressed to business angels networks in order to improve the capacity of informal investors, and on the other hand to prepare entrepreneurs to present their enterprise project to those informal investors.

Ready4growth was an intensive capacity building and support programme for technology based SMEs, led by Greater London Enterprise and operated by oneLondon and **London Business Angels** (UK - www.g2i.org); **Barcelona Activa,** (Spain), and **iVEN** (Greece). Over two years, 450 companies passed through the ready4growth workshop programme which was supported by the European Commission's Information Society eContent programme. The programme is now terminated.

Other examples include:

Fit4finance programme (94% satisfaction): www.exemplas.com (UK).

London Business Angels - The Creative Business Accelerator: www.lbangels.co.uk (UK).

InvestorNet, the "**Master Classes**" concept (G2G): www.gate2growth.com/g2g/g2g_InvestorNet.asp

BAARacademy: www.baar-ev.de (Germany).

BANDacademy: www.business-angels.de (Germany).