

Bringing down the barriers to SME finance

Innovative SMEs in Europe face significant problems in accessing the funding and expertise needed to help them grow. As part of its continuing efforts to address this issue, the European Commission held four specialist workshops and set up an expert group to identify the key problems and suggest solutions. The results will now be taken up by the Commission and disseminated to policy-makers and financing institutions across Europe.



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The four workshops⁽¹⁾ were held in Brussels in November 2006, and examined the following issues: seed finance, financing technology transfer, intellectual property, and investment readiness.

For each workshop, the Commission invited a broad range of experienced people to come together to discuss what works, what does not work, and what needs to be done. The participants included experts from the investment and technology-transfer communities, those running investment training programmes and dealing with intellectual property as collateral for finance.

Some findings were universal to all the workshops. Vesa Vanhanen, from the Financing SMEs, Entrepreneurs and Innovators Unit in the Enterprise and Industry DG, reports that a key theme the Commission will take on-board is the need for experienced business people to be involved in assessing ideas and considering their prospects in the market.

"This cannot be done by professors or bureaucrats. You need experienced practitioners, and there seems to be a lack of this kind of experience being used to advise SMEs in Europe," says Vanhanen. He emphasises that even if the actual funding is provided by public authorities,

the decisions on investment should be made by private investors with business experience.

Preparing for investors

"Another crucial finding is that many European SMEs are not properly prepared to look attractive for the investors that are there for them," says Vanhanen.

On the issue of 'investment readiness' he points out that investors look out for very specific things when they assess requests for funding. For example, equity investors look for market and growth opportunities and also appropriate exit opportunities from their investment. Banks, on the other hand, have some different priorities, including more sensitivity to risks.

"It is clear that entrepreneurs must be made aware of the needs and concerns of particular types of investor," Vanhanen notes, and the workshops indicate this is an area where training and communication might bring big results.

Another area where training and dissemination of good practice might have a big impact is in the valuation of intellectual property rights by SMEs. The workshops revealed that few innovative SMEs in Europe are properly aware of the value that their intellectual property rights will have for potential investors. They often regard their patent portfolio as simply a legal protection issue, rather than being able to quantify its financial worth and present it in an attractive way when seeking funding.

Wider recommendations

Other main findings of the workshops include:

- Public funding is needed to address shortcomings in seed capital provision and to develop the market
- Larger funds are needed to support SMEs, to create economies of scale and attract professional fund managers
- In addition to equity funding and grant financing, more flexible schemes should be considered, such as lending on a contingency basis with repayment only if commercial success is achieved



- National tax incentives for investors could improve the flow of funds to SMEs
- The Commission should work to boost the networks of those involved in early-stage financing
- More could be done to identify and promote good practice in protection of intellectual property, including licensing guidelines, standard forms of agreement and checklists to avoid common pitfalls
- Greater sharing of good practices at European level could increase the quality of business proposals.

Part of a process

“Overall, I think the workshops have provided us with many useful ideas to build on,” Vanhanen concludes. He explains that the Commission plans to incorporate the results into its many activities directed towards financing innovation in SMEs.

He adds: “All of these workshops are part of a longer process. We have been looking at the problems in seed and start-up finance for quite some while now. The issue is not so much about new funding, because quite a lot of EU funding is already available from the Competitiveness and Innovation Programme and Structural Funds. The issue is more about using this funding intelligently, so we will continue trying to spread good practices at all levels, from the national and general level down to the regional level and specific industrial sectors.”

Removing barriers on cross-border VC investments

The four workshops were mainly intended to establish general good practice, rather than looking in detail at the considerable variations in the state of play in the 27 Member States and associated countries. The variation between countries was a major issue, however, for the work being done by the Expert group on removing obstacles to cross-border investments by venture capital (VC) funds.

“The expert group focused on venture capital funds from the SMEs’ perspective,” says Ulla Hudina, a colleague of Vanhanen’s in the Enterprise and Industry DG.

The traditional sources of funding for SMEs are banks and grants, but VC funds are becoming increasingly important for those with the best innovations which are most suited to fast and profitable exploitation. Europe lags significantly behind the US in providing venture capital to SMEs, and this is one of the key problems the expert group was set up to investigate.

Tackling market fragmentation

The group has looked at ways to encourage the development of a truly European VC market for SMEs, with funds able to flow freely across national borders. A major problem identified as needing to be resolved is the market fragmentation caused by having 27 sets of regulations for registration of funds, operating procedures, taxation, etc.

“Perhaps the new Member States will be able to leap more quickly over some of the problems that older Member States have experienced.”

Having to deal with these issues in each country they wish to operate in imposes administrative, financial and time burdens on funds, which goes a long way to explaining why the funds do not flow across borders to the extent needed to exploit the opportunities that are available within Europe’s SMEs.

“Perhaps the main conclusion was that in the short term, the only possible way to improve things is through mutual recognition of VC funds across borders, so that if a fund meets the regulations of the country it is based in it could operate in other countries without having to go through separate registration and regulation processes,” says Hudina.



Successful funding

Specific initiatives considered by the workshops include these examples of good practice:

Seed finance – the High-Tech Gründerfonds

The German federal government, the KfW banking group and the firms BASF, Deutsche Telekom and Siemens joined together in 2005 to form High-Tech Gründerfonds (HTGF) with an initial capital fund of €262 million.

HTGF invests venture capital in young, high-opportunity technological companies implementing promising research results in an entrepreneurial manner. In addition to start-up capital of between €0.5 and 1 million, HTGF provides their chosen companies with management supervision and support.

More than 90% of HTGF's capital comes from public authorities, and the remainder from large private-sector firms. The private sector provides much of the crucial advisory support.

The fund specialises in the ICT and biotech sectors and its main aim is to prepare start-ups for a second round of VC funding. Seven of the 43 companies supported so far have successfully moved on to receive second-phase funding.

A key factor in HTGF's operations is the standardisation of investment procedures, reducing transaction costs by making the same offer to all potential investees.

<http://www.high-tech-gruenderfonds.de/>

Technology transfer – Weizmann Institute

The Weizmann Institute's technology-transfer section has 17 staff working to identify and support R&D projects with commercial potential. Each year they manage around 50-70 patents, 20-30 licensing agreements and two to five spin-offs.

Unlike many similar organisations, the Institute takes a royalty on the sales generated by licences rather than an equity stake. This tends to produce a higher level of income, although the full benefit can take longer to materialise.

The Institute is believed to have one of the highest levels of licensing income of technology transfer organisations anywhere in the world. This income is reinvested in R&D projects and related activities such as the cost of filing patents.

A key to the Weizmann success is the close physical proximity of the TT and R&D operations. This promotes personal interaction and networking more effectively than maintaining contacts at a distance.

<http://www.weizmann.ac.il/>

Investment readiness – Greater London Enterprise

The London Business Angels service of Greater London Enterprise (GLE) provides an introduction service for innovative entrepreneurial businesses seeking growth capital of between about £100,000 and £500,000. It draws on a network of over 170 private investors with a total of €73 million to invest.

The organisation does not charge for its services but is very selective about which organisations it helps. It has developed a range of training modules available both in print and on-line. The UK's venture capital community recognised London Business Angels as the 'Private network of the year' for both 2005 and 2006.

GLE is also coordinating the EU-funded early-stage investors action for growth of innovating business (EASY) project. This brings together 17 European partners, including banks, venture-capital providers and government, to look at the crucial issue of harmonisation of investment finance. Specific issues being tackled include the problem of cross-border investment, taxation regimes and legal structures.

<http://www.gle.co.uk/>

<http://www.earlystageinvestors.org/>

In the longer term, the expert group accepts that harmonisation of VC fund regulations at EU level would be an ideal solution. As Ulla Hudina points out, however, "the group recognises that the industry itself does not want more EU regulation".

Preferred features

The expert group has also identified specific preferred features of VC funds and management companies if the flow of investments across borders is to be facilitated.

The group encourages funds to avoid a country-centric perspective in what should ideally be a single market of 27 Member States. On the other hand, there should be no need for management companies to establish a permanent presence outside their home states and regions.

Taxation issues are being addressed in detail by other Commission initiatives, but the group did emphasise that double taxation should be avoided by a transparent tax structure, with taxation occurring only at the level of the final investor.

The way ahead

With the expert group's findings now published^(?), the Commission will be integrating the conclusions into the wider range of groups and initiatives focused on these and related issues.

"We have to report on the conclusions to the Member States via the Council in November 2007," explains Hudina. "It will then be up to the Member States to go in whatever directions they choose."

She accepts that it is inevitable that some states will move faster than others, with the Nordic and possibly Baltic states perhaps ready to move ahead most quickly.

"In the new Member States there is probably a particular need to work quickly on raising awareness among SMEs of alternative sources of finance, such as venture capital funds in other countries," Hudina comments.

On that issue, and all other aspects of assisting SME funding in the new Member States, Vanhanen points out: "If we can use these results to spread knowledge to the new Member States then perhaps they can leap more quickly over some of the problems that older Member States have experienced, and try to implement good practices as fast as possible. In general, everything we are doing is focused on trying to speed up the process of taking innovative ideas from universities, research institutes and other innovators and bringing them successfully to the market."

Few innovative SMEs in Europe are fully aware of the value that their intellectual property rights will have for potential investors.

(1) Financing Innovation and SMEs: sowing the seeds – main findings of four workshops:
http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/financing_smes_workshops_2006/workshops_main_findings.pdf

(2) Report of expert group on removing obstacles to cross-border investments by venture capital funds:
http://ec.europa.eu/enterprise/entrepreneurship/financing/publications_documents.htm

Contacts

Vesa Vanhanen, European Commission
Enterprise and Industry DG

Tel. +32 2 299 2151

vesa.vanhanen@ec.europa.eu

Ulla Hudina, European Commission
Enterprise and Industry DG

Tel. +32 2 295 3864

ulla.hudina@ec.europa.eu

http://ec.europa.eu/enterprise/entrepreneurship/financing/index_en.htm