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Assessing the Potential for EU Investment in Venture Capital and Other Risk Capital Fund of Funds

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Executive Summary

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1. EXECUTIVE SUMMARY

This document contains the extended version of the Executive Summary in respect of the study "Assessing the Potential for EU Investment in Venture Capital and Other Risk Capital Fund of Funds"[1]. The assignment was carried out between January and September 2015 by the Centre for Strategy & Evaluation Services ("CSES") and Oxford Research, supported by Panteia and New Frontier Services.

This external study provides an independent technical input to the European Commission's policy development in respect of equity-based financial instruments. The views expressed in the Executive Summary to the report are the sole responsibility of the authors and do not necessarily reflect the views of the European Commission.

1.1 Study aims

The study aims and objectives are, in summary, to:

- Examine whether there is a need for further EU public intervention in the European Venture Capital market in order to attract the private sector back to the VC asset class.
- Assess the rationale for using fund of funds ("FoF") as a delivery mechanism for equity investment.
- Analyse the scope for EU investment in FoF, either by setting up a pan-European Venture Capital Fund or by investing in one or more public-private, cross-border FoF.
- Identify and review alternative configurations of a possible pan-European or multi-country, cross-border FoF during the set-up, operational and exit phases.
- Examine the possibility of the EU investing in *existing* regional, national or transnational FoF, and also consider the scope for setting up a pilot FoF.

The ideal outcome from the assessment is to determine a possible way forward for subsequent EU interventions. The 'Access to Risk Finance' component of the 2014-2015 Horizon 2020 work programme contains provision for (and an outline description of) a study to assess the potential for EU investment in fund of funds (FoF)[2]. The study was steered by DG RTD, supported by a Steering Committee that includes interested other European Commission DGs (DG CONNECT, DG GROW), and experts from the Horizon 2020 Expert Group on Access to Risk Finance.

1.2 Study scope

The geographic scope of the study is pan-European. However, the benchmarking analysis of existing public-private partnership FoF initiatives focusing on their set-up, operation and performance includes an analysis of the situation in Europe and internationally (with a focus on publicly-backed FoF).

Given the global nature of the VC industry, international benchmarking comparisons have been carried out to examine how the VC market operates in countries such as the US, Canada and Australia. Worth noting that the US is still the benchmark for successful risk capital activity (as measured in investment returns) and so its practices must be reviewed to understand the industry. Examples of international initiatives to attract investors and globally-leading, professional fund managers to VC have also been analysed, such as the VCAP fund of funds programme in Canada.

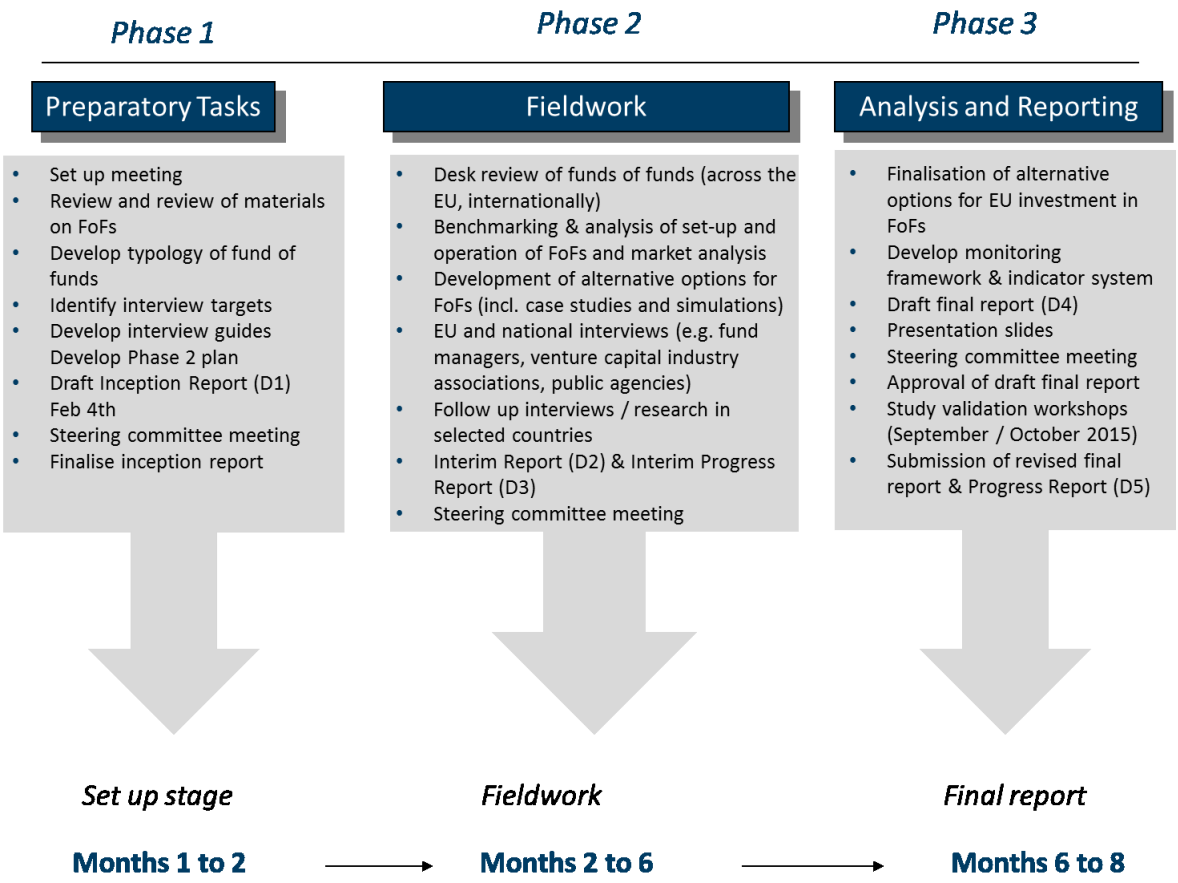
[1] The study is part of the Framework Contract for the provision of services to the Commission in the field of evaluation of research and innovation programmes and policies" (Framework Contract: 2012/s 144-240132).

[2] Action 10 in http://ec.europa.eu/research/participants/data/ref/h2020/wp/2014_2015/main/h2020-wp1415-finance_en.pdf

1.3 Methodological approach

The methodology is summarised in the following figure:

Figure 1 – Methodological overview



The assignment was undertaken over three phases, (i) a structuring phase, (ii) the core fieldwork and data collection phase and (iii) an analysis and report writing phase. The study findings were presented at a workshop for the Commission services.

The following aspects of the research should be highlighted to demonstrate that the findings are evidence-based:

- An extensive literature review was carried out, supported by an assessment of key industry data on trends and developments in European VC.
- An extensive review of performance data of the VC asset class in Europe and in competitor countries outside the EU was undertaken (see Appendix E - performance data and benchmarking).
- A mapping exercise was undertaken to identify and benchmark existing publicly-backed FoF in order to inform the demand and supply-side assessment of EU equity-based and other risk capital financing instruments.
- The focus of the analysis on current financing supply was on: identifying the relative importance of different sources of investment in the European VC asset class by investor type (e.g. high net-worth investors, business angels, single family offices, pension funds) and on reviewing how great a share the public and private sector respectively have of FoF.

- The focus of benchmarking FoF was to gain an understanding of key characteristics relating to their set-up, operation and performance. Among the key parameters that were assessed were their duration, size, financing sources, investment stage and sectoral focus.
- In addition, a review of the managerial set-up, rewards structure and incentives for FoF managers was also carried out.
- An interview programme was undertaken with 105 stakeholders active in (or with an interest in) the European VC ecosystem and in supporting innovative start-ups and SMEs, such as FoF managers, VC managers, national VC associations and investors to obtain stakeholder feedback.
- A detailed assessment of the different policy options and sub-options was conducted drawing on stakeholder feedback. Practical considerations relating to the set-up and operation of a possible future pan-European FoF were analysed, such as the procurement mechanism for appointing a FoF manager, the extent to which there might be competition and state aids issues, depending on the management incentives and returns structure for FoF managers and investors (e.g. asymmetric returns vs. pari passu[3]).
- In order to help advise the Commission in "operationalising" a pan-EU FoF, relevant EU legislation for setting up new financial instruments has been reviewed in detail, notably:
    - Art. 21 of the revised General Block Exemption Regulation (GBER) from 2014[4]
    - Title VIII of the EU Financial Regulation, which addresses financial instruments (applicable to the general budget of the Union and its rules of application).

2. EU POLICY CONTEXT

2.1 Policy context

2.1.1 Overall EU policy context and policy objectives

The European Commission *"aims to make the European VC industry more self-sustainable and globally competitive by reducing its dependence on the public sector and encouraging more investment from institutional and private sources back into VC, especially into early and growth-stage funds"*[5]. During the study, DG RTD further elaborated on the above policy objectives and has defined key policy objectives in relation to this possible initiative as being to:

- Attract the private sector back to the European VC asset space in order to:
    - Improve the supply of, and access to, seed and early-stage VC for firms undertaking research and innovation (R&I);
    - Maintain an adequate supply of risk capital finance to start-ups and SMEs that offer exceptional growth potential so as to counteract cyclical fluctuations during the economic cycle and to serve as a buffer during periods of economic downturn, when access to VC has historically been severely constrained;
    - Encourage more investment from institutional and private sources back into VC, especially into early and growth-stage funds that invest in firms undertaking research and innovation (R&I);

[3] Describes a situation when public and private investors invest on an equal footing and carry the same rights.
[4] Aid for access to finance for SMEs Risk finance aid (Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Art. 107 and 108 of the Treaty.
[5] Source - terms of reference for study.

- Encourage the expansion of existing VC funds and FoF across Europe.
- Increase the average size of VC funds, given that lack of critical mass is a major challenge in attracting international capital.
- Where appropriate, encourage the creation of new market entrants at both the FoF and the underlying funds levels.

A further consideration is the need to ensure that if a FoF programme were set up in future, this is embedded within a package of support measures, to include technical capacity-building measures for GP and investment professionals[6]. The broader relevance of a FoF initiative is that it would help contribute to achieving the aims of the Europe 2020 strategy of smart and sustainable growth. The *Action Plan on Building a Capital Markets Union*[7] 2015 emphasised that if Europe's VC markets were as deep as their US equivalent, more than EUR 90 billion would have been available to finance companies between 2009 and 2014. EU R&I policy emphasises the importance of ensuring support for innovative SMEs with high-growth and internationalisation potential. There are in parallel well-established EU policies relating to strengthening access to finance for SMEs in general to facilitate the growth and development of start-ups and SMEs.

2.1.2 Relevant EU policy and other developments

The origins of this study stem from a number of relevant EU policy and other developments relevant to the setting up of a pan-European fund of funds over a five year period. In March 2010, Invest Europe (formerly EVCA, the European Private Equity & VC Association), issued a position paper on VC[8] that included a recommendation for the EU to promote FoFs with a significant allocation to VC. This was followed up by further position statements in November 2011 and November 2014[9]. In the conclusions of the European Council of February 2011[10], the European Commission was invited to present a proposal for putting in place an EU-wide VC scheme building on the activities of the EIF and other appropriate financial institutions, in cooperation with national operators. In October 2011, DG Enterprise & Industry held a workshop on VC FoFs[11]. The legal bases of the 2014-2020 COSME and Horizon 2020 programmes adopted in December 2013 contain provisions for EU investments to be made into FoFs[12].

The Action Plan on Building a Capital Markets Union[13] (CMU) of 30th September 2015 notes that "public sector risk sharing can help to increase the scale of VC funds in Europe and the industry's footprint across all 28 Member States, as well as acting as a catalyst for private sector investment, helping to promote scale, diversification and geographical reach. The promotion of FoF could in particular help broaden private investment in venture capital by attracting additional investment by institutional investors. A commitment has also been made to launch a package of measures to support VC and equity financing in the EU in 2016, including catalysing private investment using EU resources through one or more pan-European FoFs.

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[6] Any intervention by the EU led by the EC must help to foster the experience of those operating VC funds and FoF. Any new initiative should not undermine the acquisition of such skills, which appear to have a large element of "learning by doing".

[7] COM(2015) 468 final) Brussels, 30.9.2015

[8] http://www.evca.eu/media/27397/evca-venture-capital-white-paper.pdf

[9] Invest Europe position statements: http://www.scribd.com/doc/213369256/EVCA-FoF-Position-Nov-2011 and http://www.investeurope.eu/media/340371/141109_EVCA_FOF_scheme.pdf

[10] EUCO 2/1/11 REV 1, para 22: https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/119175.pdf

[11] Summary report of the FoFs workshop: http://www.scribd.com/doc/213367902/Workshop-VC-FoFs

[12] For COSME, see Art. 18 4. (b) and Art. 5 of Regulation (EU) 1287/2013 - page 43 of http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:347:0033:0049:EN:PDF.
For Horizon 2020, see Council Decision 2013/743/EU (Specific programme) — p. 996 of http://ec.europa.eu/research/participants/data/ref/h2020/legal_basis/sp/h2020-sp_en.pdf

[13] Brussels, 30.9.2015 COM(2015) 468 final

2.1.3 Rationale for using fund of funds as an equity investment delivery mechanism

The rationale for the use of public-private FoF structures to deliver equity investments in order to maintain adequate supply of seed and early stage VC to SMEs in Europe is first considered. The research suggests that:

- FoF fulfil an important intermediary role, which would allow large investors to deploy a small percentage of their total capital allocation into European VC, which would otherwise be reallocated to alternative asset classes and market geographies. Since larger investors need to deploy significant minimum ticket sizes (€25 - €100 million), a FoF structure is more appropriate than investing in individual funds[14].
- Presently, only a small number of globally-competitive private FoF managers continue to invest in European VC as part of their total asset allocations. Many FoF managers have exited the market over the past 15 years due to a lack of interest in European VC among investors due to poor performance returns and concerns about the double layer of fees characteristic of a FoF structure.
- If the EU could encourage the return of the private sector as FoF managers, then the European VC sector would be better placed to access international capital markets by tapping into investor networks of globally-leading fund managers through a FoF approach.
- Public sector actors, notably the EIF, but also the EBRD and national FoF, have stepped in to address market failures in the provision of seed capital and early-stage VC. The public sector accounts for a significant percentage share of the European VC market in general (35%) and particularly in FoF (estimated at over 50%).
- Although there are other mechanisms through which the public sector can invest in European VC to ensure that start-ups and high-growth SMEs continue to have access to innovation financing, such as direct co-investment with VC funds, FoF are a useful mechanism for investing in a diversified portfolio of different VC funds.
- From a public sector perspective, a FoF structure has the advantage of providing a mechanism to increase financing supply to VC funds without taking direct stakes in underlying businesses. The public sector also gains access to highly skilled investment professionals which are not necessarily available to governments.
- For the private sector, one advantage of a FoF structure is being able to spread risk across a diversified portfolio of underlying equity funds, specialising in different sectors, investment stages and geographies spreading risk, whilst retaining exposure to high-growth potential seed, early stage and expansion phase firms[15].

2.2 Possible EU funding sources

A review of existing support for equity instruments through the current and previous EU programming periods was carried out. This covered:

- **Financial instruments supported in 2007-2013 –** e.g. the Entrepreneurship and Innovation Programme (EIP) Competitiveness and Innovation Programme (CIP), the ERDF and;
- **Financial instruments supported in 2014-2020** – e.g. the Single EU Equity Financial Instrument supports European enterprises' growth, research and innovation (R&I) from the early stage,

[14] Since large investors do not generally take stakes in individual VC funds (or fund of funds) of more than 10% for risk management reasons, this makes investing in individual VC funds prohibitive for investors that have a minimum investment ticket size, irrespective of the prospective returns.

[15] However, whilst a risk diversification is an attraction for some investors, for some professionals, the attraction of VC is the high risk/high reward nature of the investment.

including seed, up to expansion within Horizon 2020 (InnovFin SME VC) and COSME (Equity Facility for Growth)."

In terms of **EU funding sources** for a possible new initiative to set up a pan-European FoF programme, among the possible funding sources could be either of the two following sources (or a combination of both):

- **The Single EU Equity Financial Instrument within Horizon 2020 and COSME** – the Regulation for both programmes mentions the possibility of providing support to equity-based FoF.
- **The European Fund for Strategic Investments**[16] **–** under the SME Window, this mentions the possible scope for supporting equity and quasi-equity instruments, with possible scope to support fund of funds (depending on the final text of the Regulation).

In order to ensure that a possible new initiative does not duplicate existing provision, an assessment of existing funding available through the European Investment Fund's Risk Capital Resources (RCR) mandate and through the EBRD was also undertaken. National and regional FoF schemes, both those that have received cornerstone funding support from the EIF and those that operate using national public funding sources alone were also analysed. Among the findings were those:

- The EIF already invests significant resources into European VC both through co-investment and fund of funds (upwards of €2.5bn through an existing FoF programme).
- In addition, the EBRD and national financing agencies have supported the establishment of FoF that invest in underlying funds (the latter, often EIF-backed).
- However, although a small number of the EIF's FoF have attracted private sector backing, generally, these are not fully commercially oriented since the EIF also pursues public policy objectives as part of its various mandates.
- A clear challenge for public policy is whether economic or other aims determining the allocation of investment recipients should be pursued.
- Comparisons of target IRR and / or intended investment multiple over the investment lifecycle between EIF FoF and other FoF are difficult to make due to the lack of publicly available performance data. Nevertheless, the limited data available[17] suggests that the IRR typically acceptable is much lower than would be the case among private FoF operators.
- At the regional level, although significant EU funding has already been invested in VC through the Structural Funds (now ESIFs), this has mainly been at the VC fund level. VC funds at regional level have been driven by a combination of EU and national public funding. However, political and social goals often override economic performance goals and hence the distrust of many private investors.

[16] Regulation 2015/1017 - on the European Fund for Strategic Investments. (http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2015:169:FULL&from=EN)

[17] Data is not generally publicly available on the IRR of EIF FoF programmes. However, documentation on the Polish Growth FoF suggests a target IRR of between 2% and 5% and for BPIFrance FoF schemes of circa 5%. In contrast, many private FoF managers aim for 20%-25%, even though some accepted that 15% was more realistic.

3. PROBLEM DEFINITION

3.1 Problem definition and assessment of baseline situation

Before considering the different policy options, it was necessary to define the problem and to map out the intervention logic that a possible future initiative would seek to address and to assess the baseline situation. Among the findings from the research were those:

3.1.1 Demand-side issues

1. Although equity finance is only appropriate for a small percentage of the total stock of European start-ups and SMEs[18], innovative firms with high-growth potential need access to seed and early-stage risk capital to support their accelerated growth and internationalisation.

2. Although demand for VC from entrepreneurs fluctuates during the economic cycle, demand remained high during the economic and financial crisis, necessitating the intervention of the public sector to ensure continued supply through the setting up of counter-cyclical FoF[19].

3. Banks are more reluctant to invest in start-ups and SMEs because of higher perceived risks and the tightening of EU regulation through Basel III (banks) has made them more risk-averse. This has made it more likely that innovative firms embrace alternative financing forms, including external equity. Previous experience of other EU funded equity instruments suggest that demand for equity finance among start-ups and SMEs is likely to remain strong.

4. There is evidence from previous programmes of high demand for EU financial instruments schemes (e.g. the GIF under the EIP).

5. One feature of innovative young firms is that the returns to innovative behaviour tend to occur at later stages of the investment cycle. The timescale that gains are realised is critical and requires a more 'patient' approach by investors.

3.1.2 Supply side issues

- Since the early 2000s, there is strong evidence that many **private sector investors have exited the European VC asset class**. This trend began with the "dot com crash" (early 2000s) and accelerated during the economic and financial crisis (2007-2009) and the sovereign debt crisis of 2011-2013. Fluctuations in the supply of risk capital have become more frequent and pronounced, although the industry has only really existed since the early 1980s and there were fluctuations then.

- **Many private investors remain wary of the European VC asset class because of low profitability and historical under-performance.** Private pension funds and institutional investors remain largely absent from the market. GPs instead attract investment from private equity groups, high net worth individuals and from the EIF and other public investors at national and regional level.

- **Among the further obstacles to investment include the lack of appropriate framework conditions.** Examples are the lack of tax incentives for institutional investors to reflect the higher

[18] An economic analysis to support the September 2015 Capital Markets Communication suggests that equity finance is used by 4% of micro firms and 6% of small firms. http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-economic-analysis_en.pdf

[19] Examples of counter-cyclical FoF set up during the economic and financial crisis to boost access to equity capital for start-ups/ firms with high-growth potential are UKIIF (UK), the national seed capital fund (FR) and ICEO (ES).

level of risk associated with seed / early stage investments and the introduction of new more stringent EU financial services regulations, which has further deterred institutional investors.[20]

- **However, the situation for private equity overall may be beginning to recover from the economic and financial crisis:** in 2014, Invest Europe data shows that 40% of the funds raised from institutional investors came from outside Europe.[21] This suggests that awareness about improved performance returns in the European VC asset class in the past 2-3 years have begun to have an impact in stimulating investor interest.
- Following the recent economic and financial crisis, Invest Europe has noted[22] the **changing investor base in European VC and the lack of private sector investor participation, with increasing dominance of public sector funding.** Between 2007 and 2012, "pension funds, insurance companies and banks fell from 35% of funds raised to just 15% in 2012. Over the same period, and as a result of these steep declines, contributions by government agencies grew considerably. While in 2007 government agencies accounted for less than 15% of investment in European VC, by 2012 their share had increased to 40%". The relative shares of public vs. private investment naturally shift over the economic cycle, but the scale of the post-global financial crisis shift is of concern particularly at the earliest stages of the enterprise investment cycle.
- Although there is evidence of reduced supply of VC compared with pre-crisis levels, this is **not automatically a market failure if the portfolio companies or funds seeking investment are unattractive.**
- The **public sector has stepped in to address gaps in the provision of equity finance, especially in seed and early-stage VC by serving as cornerstone investors.** This played a central role in ensuring that access to equity capital was maintained during the economic and financial crisis. The public sector's role in smoothing fluctuations in equity financing supply should not be underestimated.
- The **EIF and national operators have played a crucial role in tackling supply-side problems during the crisis** by setting up FoF and serving as cornerstone investors. For instance, the EIF has now established 12 FoF, including one that has private sector participation (PT) and a cross-border FoF (in the Baltic States).
- **There is evidence that many private FoF managers have also largely exited the market.** This is due to a combination of low performance returns and the problem of the "double fees"[23] structure, which has deterred investors (especially institutional and Sovereign Wealth Funds). The issue of developing a sustainable base of talented FoF managers has been exacerbated by these changes and currently remains unresolved in Europe.
- **There is a question mark as to whether the EIF and other public FoF can go on indefinitely supporting the European VC sector.** Moreover, there is an issue as to whether public support is a temporary intervention to address and resolve a market problem or, conversely in many regions, governments are subsidising innovation activities, recognising that the risks and uncertainties are too high for the majority of professional investors.

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[20] Examples are EU laws relating to capital adequacy (e.g. for banks and pension funds), the regulation of alternative investment fund managers and requirements to ensure that institutional investors carry out risk assessments (which are difficult in VC given uncertain levels of returns);

[21] Invest Europe, 2014 European Equity Activity. Statistics on Fundraising, Investments & Divestments. P. 6

[22] http://www.investeurope.eu/media/340371/141109_EVCA_FOF_scheme.pdf

[23] There is a double layer of fees associated with fund of funds structures i.e. at the level of the underlying funds for the fund manager (GP) and for the fund of funds manager. However, the research found some evidence of downward pressure on FoF fees. Moreover, the more significant scale individual FoFs are, the greater the scope for competitive fee rates.

- **Invest Europe data shows that a disproportionate amount of seed and early-stage VC activity is concentrated in eight Member States.** Those countries where VC is more advanced include the UK, France, Germany and Scandinavia. There is also a reasonable level of activity and deal-flow in southern European countries, such as Italy and Spain, boosted since the economic and financial crisis by EIF and state-backed fund of funds. An unequal distribution of equity funding across Europe might be expected in favour of the richer and more developed economies. However, we note that this unequal geography of VC investment is even more marked in the US.
- **If a FoF initiative is driven by return on capital considerations rather than fairness or other social objectives then the FoF should not be prescriptive about the geographic focus of investments.**
- **Overall, the scale of VC activity in Europe is lower than in the US.** Data sources[24] show that the total level of VC activity in the US is significantly higher than in Europe. In 2015, a report by BCG[25] notes that "European VC investments equalled 0.03% of European GDP whereas US investments equalled 0.14% of US GDP. In 2014, the share increased to 0.05% in the EU whereas it almost doubled to 0.29% in the US, demonstrating the dynamics of the US VC market". The percentage of GDP in EU28 was 0.05 or below in 25/28 EU Member States (exceptions being IE, FI and SE).
- However, the scale of investment in VC as a proportion of private equity investment is not that different in Europe (9% of total private equity (PE) investment) and the US (7% in in 2013).
- **Invest Europe data clearly shows that European VC funds lack scale and that the European VC market is highly fragmented.** The table below shows the relatively small size of average VC funds in EU28. At around EUR 60 million, the average European VC fund is only half the size of that in the US[26]:

Table 1 - Average size of a European Venture Capital Fund (2007-2012)

	Amounts in € millions	Number of funds	Average (in € millions) Fund size	Median (in € millions) fund size
Early-stage	7,488	126	59	25
Later stage venture	3,091	41	75	36
Balanced	7,018	120	58	28
Total Venture	17,597	287	61	27

Source: EVCA/PEREP Analytics

- **The lack of critical mass has deterred large institutional investors and pension funds from investing in the European VC asset class.** Institutional investors need a minimum ticket size of €25m or €50m for it to be viable for them to invest[27].
- **There are opportunity costs for Europe of the lack of sufficient scale in not being able to unlock international pools of capital.** According to the September 2015 Capital Markets Union, if European VC markets were as deep as they are in the US, more than EUR 90 billion of funds would have been available to finance companies between 2009 and 2014.
- A further difficulty is **the inability of many European GPs to provide sufficient funding across all**

[24] Sources: Invest Europe 2014 yearbook, MoneyTree Report, Data: Thomson Reuters, Pitchbook PE Breakdown 2014 Annual Report

[25] BCG & IESE. 2015. A Rise in Good Deals, but an Investor Drought. P. 7

[26] However, broad-brush geographic comparisons can be misleading since there is a need to compare key innovative regions in Europe and the US to look at specific eco-system level characteristics.

[27] The minimum "ticket size" or level of investment that large investment funds (LPs) will consider investing varies widely and is difficult to generalise. The range cited was from €25m to €100m, with €100m not unusual for instance in the case of Sovereign Wealth Funds.

investment stages, such that European SMEs seeking later stage Series C and D expansion funding often seek funding from international investors. This means that the EU misses out on the economic and growth potential of high-growth 'gazelles', which often relocate to the US. In a sense, European GPs bear a much higher proportion of the risk and a much lower proportion of the realised gains due to their inability to fully fund follow-on investments.

- However, a **counterargument is that as in the US, there are many later-stage buy-out funds in Europe with access to significant funding.** Some European SMEs may **relocate for other reasons such as more conducive framework conditions in the US** (e.g. proximity to markets and to other high-tech start-ups, culture of entrepreneurship, favourable tax treatment on share options etc.).
- **A further challenge is that the European VC market is characterised by fluctuations in the level of activity depending on the stage in the economic cycle.** Invest Europe data shows that the amount of funding going into European VC more than halved during the economic and financial crisis, although it has subsequently recovered to some extent.
- **Moreover, the European VC industry is spread across many different geographies with differences in the state of development of the VC market.** However, it is difficult to make a direct comparison with the US since there is a high level of concentration of VC activity in two US states (California, Massachusetts and Texas).
- **The VC ecosystem is generally less developed in newer Member States**. However, countries in Central and Eastern Europe and in Southern Europe have seen growth in VC activity, albeit on a more limited scale than in countries where VC has reached maturity. Although there are emerging fund managers (GPs), the investor base lacks depth, the private sector as investors (e.g. LPs) are generally absent and to achieve fund closure, GPs have to rely either on the EIF, the EBRD and / or other public sector support.

3.1.3 Performance returns and types of investors present in the market

1. Seed and early-stage VC in Europe have **generated lower performance returns over the previous 15 years compared with alternative asset classes.** This has deterred investment. This feature was also true for the US VC market across even longer time periods.
2. **Performance returns in the early late 1990s and early 2000s were affected by over-supply of equity capital** concentrated in the ICT and technology sectors**,** leading to a lack of quality deal-flow. The subsequent dot.com crash in Q1, 2000 led to returns in the VC asset class globally being decimated over most of the first decade of the 21st Century.
3. Many pension funds and institutional investors have **consequently stopped investing in the European VC asset class.** These investors have not subsequently returned following the economic and financial crisis, with supply of VC in 2013 remaining below 2007 levels.
4. Many GPs have exited the market as FoF managers, since **investors were reluctant to invest in the European VC asset class generally**, and, given median poor returns, were further wary of the additional double layer of management fees associated with FoF structures.
5. **Tax breaks in a small number of EU countries** (e.g. France, the UK) play an important role in attracting and retaining angel and other individual investors in European VC. However, there are no such tax breaks for institutional investors, in spite of the higher risks associated with investing in seed/ early stage VC.
6. There are however a number of **high-performing private equity GPs that remain active in European VC, along with angel investors/ syndicates and family offices.** The role of formal and informal angels is particularly important in the seed and early stage VC market[28].

[28] However, the returns for BA investors in Europe are more variable than for privately-managed FoF/VC funds.

7. The research identified **performance improvements in investment multiples in the asset class** in the past 2-3 years. This has been underpinned by success stories in European start-ups that received staged injections of equity capital (e.g. Shazam, Spotify and Rocket Internet). According August 2015 data, 13 out of 129 global unicorns[29] (circa 10%) were based in Europe.
8. The performance returns for FoF varies greatly, but industry data suggests that **the returns are better than is commonly perceived, and comparable with some asset classes**:

Industry data from 2014 on the performance of FoF was obtained from VC managers in the industry[30]. Based on a sample of 582 FoF globally, the index shows an end-to-end pooled return of 21% over one year, 10% over 3 years, 13% over 5 years, 10% over 10 years, and 9% over 15 years. For comparison, this level of returns is lower than that of the Standard & Poor Index over a 1, 3 and 5 years' time horizon, but higher than the S&P index when running over 10 years and longer. Looking at data for the past 10 years, the one-year rolling returns appear to be highly volatile – ranging from -21% in 2009 and 2% in 2012 at the low end to 27% in 2007 and 26% in 2011. Again looking only at data for the past 10 years, data from 571 FoF formed between 1986 and 2012 suggests that the total value paid in capital multiple to LPs ranged from 0.27 in 2008 to 1.42 in 2007 with the median moving between 1 and 1.41.

9. There is **evidence of the emergence of global VC hubs**, such as in London, Berlin and Stockholm, with some evidence of **growing professionalism in the European VC industry**. However, the continued dominance of public money in the market suggests that more needs to be done to attract private investors to invest in European VC.

4. PRESENTATION OF OPTIONS AND ANALYSIS OF FEEDBACK ON OPTIONS

4.1 Presentation of the options

A number of policy options have been drawn up which take into account different models of existing FoF structures and performance data. It should be stressed that **the different options and sub-options are not necessarily mutually exclusive.** The options were structured based on the level of ambition, with Option 1 – "no action" being the least ambitious and Option 4 - "setting up a pan-European seed and venture capital Fund of Funds" the most ambitious. There are a series of alternative sub-options as to how each option might be configured, as shown in the table on the following page:

Table 2 - Options identification (overview)

Definition of options	Description and sub-options (where appropriate)
Option 1 –No further action at EU level (counterfactual).	There are already a number of equity instruments being implemented in the 2014-2020 EU financing period, including several VC FoF programmes run by the EIF. Given these existing public sector VC investments, the case can be made that no further action at EU level is required.

[29] Unicorns have been defined as start-ups that have a market capitalisation of US€1 billion.

[30] The data is still being prepared for a proprietary industry report. The source cannot be revealed at this stage.

Definition of options	Description and sub-options (where appropriate)
Option 2 – Increase funding for existing EU-financed equity instruments and / or EIF fund of funds	Funding to these programmes could be increased to enhance their effectiveness. • Sub-option 2.1 – increase funding for existing equity instruments e.g. the Single EU Equity Instrument under the Horizon 2020 and COSME programmes. • Sub-option 2.2 – increase funding to the EIF to expand the size and scope of its FoF portfolio. • Sub-option 2.3 –increase funding for other pilot equity instruments for innovative SMEs (e.g. pilot facility for technology transfer, Fast Track to Innovation Pilot).
Option 3 – The EU could invest in existing publicly-backed national and / or regional fund of funds	• Sub-option 3.1 - EU investment in national (public) FoF operators to encourage them to cooperate with FoF in other countries through cross-border, multi-country FoF. • Sub-option 3.2 – EU investment in setting up new regional VC FoF, building on existing regional VC funds not yet operating cross-border (as per the Vanguard Initiative[31]).
Option 4 – Set up a pan-European seed and venture capital fund of funds.	• Sub-option 4.1 - set up a FoF programme with multiple, public-private FoF to be operated by private sector fund managers selected following a call for proposals. These could focus on different sectors, investment stages, investment volume, or geographies. • Sub-option 4.2 - set up a single pan-European public-private, EU-wide FoF covering the whole EU managed by public or private sector FoF managers following a call for expressions of interest. • Sub-option 4.3 - set up a pilot FoF to test the feasibility of going ahead with a public-private pan-European FoF programme. • Sub-option 4.4 – set up an EU funding pot to support privately backed FoF that are still at the investor-search stage in order to encourage private FoF back into the European VC market (gap funding approach).

4.1.1 Feedback on the different options

Feedback was received on the different options and sub-options from stakeholders interviewed (a representative sample of VC and FoF managers). The feedback both in favour and against particular options and sub-options is first summarised:

Option 1 – No further action at EU level (counterfactual).

The key arguments made in favour of not taking any further action, i.e. the status quo option, can be summarised as follows:

- The EIF already *de facto* acts as a pan-European FoF. Any further EU intervention risks duplicating existing instruments without adding discernible value.
- There is no market failure but rather low investment in European VC reflects problems in the European VC ecosystem. The problem therefore is not a lack of funding but that the framework conditions need to be improved.

The key points made in favour of taking further action are:

[31] http://www.s3vanguardinitiative.eu/

- There is a clear market failure when VC investment is decreasing while returns are improving. This makes public intervention in one form or another necessary to reinvigorate the market.
- The market needs to be diversified given the current dominance of the EIF both as a cornerstone investor and FoF manager.

Option 2.1 – Increase EU funding for existing equity-based financial instruments and FoF for innovative SMEs

The main points made in favour of this option were:

- The EIF who manages many existing EU financial instruments are experienced, well regarded in the market and have a successful track record. The other existing equity instruments have proven themselves, too (all sub-options).

The counterarguments can be summarised as:

- This will foster the EIF's dominance and may not attract additional private investment – better to have multiple cornerstone investors (all sub-options).
- There was not seen to be firm evidence that lack of scale is a central issue for the EIF, since its FoF programmes has already been increased in scale in the past 5 years and it has been continuing to invest in individual VC funds.

Option 2.2 – increase funding to strengthen capital available to the EIF to expand the size and scope of its FoF portfolio.

Key points in favour of this sub-option were:

- The EIF is already performing its role in increasing the supply of VC both in more mature markets (e.g. successful EIF-backed FoF in the UK and the Netherlands) and in less well developed markets (e.g. the Baltic States, Poland).
- It could therefore relatively easily scale up the size and scope of its existing FoF programme compared with other actors.

The counterarguments can be summarised as follows:

- Increasing funding through an expansion in the size of the EIF's programmatic mandate from the Commission could reinforce the EIF's dominance and may not attract additional private investment (especially larger international investors seeking large ticket size and higher commercial returns).
- Plurality in the market would be better served by having multiple cornerstone investors, rather than being over-dependent in the EIF.
- The EIF plays a valuable role in providing funding to the VC ecosystem overall. However, it is difficult to assess whether increase funding should be given to the existing FoF programme since the financial performance of the FoF programme is unclear since there is no data publicly available. It would need to be determined whether the EIF's programme is likely to be sufficiently commercial (either now or in future) to attract private and international capital before the size of the programme (which was in any case recently expanded through the Risk Capital Resources mandate should be further expanded.

Option 3 – The EU could invest in existing publicly-backed national and / or regional fund of funds to foster the transnational dimension and to promote cross-border VC.

The key points in favour of this option were:

- A pan-European FoF scheme benefiting national FoF operators would encourage the setting up of cross-border, multi-country FoF, which are important for achieving critical mass (Option 3.1).
- Strengthening publicly-backed national FoF operators could help to stimulate competition and ensure that underlying VC funds were less dependent on securing EIF funding (Option 3.1).
- Supporting regional FoF could help to encourage cross-border VC investment and help to address underserved markets (Option 3.2).

Conversely, some stakeholders maintained that there were several disadvantages, such as:

- Supporting existing instruments might increase public sector dominance (all sub-options).
- Publicly-backed FoF are not currently attractive to private investors, either because they pursue at least some public policy objectives and are not sufficiently focused on return on capital or because they operate in European regions with little VC activity (all sub-options).
- Several European countries are too small for national or regional FoFs (all sub-options).
- Private sector investors made it clear that they were unlikely to invest in a FoF programme or in individual FoF if geographic or other constraints are imposed on the FoF managers (Option 3.2).
- Absence of a sufficiently clear market failure at regional level - there is already considerable extensive provision of seed and early stage VC through the European Structural and Investment funds and national funding schemes. Often regions have excessive investment funds and the quality of enterprises supported has suffered (Option 3.2).

Option 4 – Set up a pan-European public-private seed and venture capital Fund of Funds.

The key points made in favour of Option 4, which was supported by a majority of stakeholders, can be summarised as follows:

- Provided that FoF are privately managed, it would be easier to attract private investment, due to a more commercially-focused approach compared with existing EU-backed instruments.
- Setting up a pan-European FoF structure would enable the **minimum ticket size to be increased, thus allowing larger investors to be brought in (including international investors).** Such investors would be attracted by the ability to spread risk across a diversified portfolio.
- The importance of **reducing dependence on the public sector.**
- A FoF investing in the European VC asset class could **perform a signalling function** for private investors and encourage them to follow suit.
- Provided that FoF have a **clearly defined scope,** this should **reduce the risk of duplication with existing schemes.**
- Many stakeholders were generally in favour of the EU setting up a pan-European FoF programme, but did not express a strong preference as to whether this should **consist of multiple individual FoF or a single pan-EU FoF** (Options 4.1 and 4.2).
- Sub-option 4.4 could be combined with Option 4.1 whereas one or several of the FoF to be set up would actively support new VC funds.
- It was also stressed that a success factor would be to maintain right balance between resources allocated and the pool of underlying SMEs in order to maximise return and be able to compete with private FoF operating in the European VC market.

The key points made against this option are:

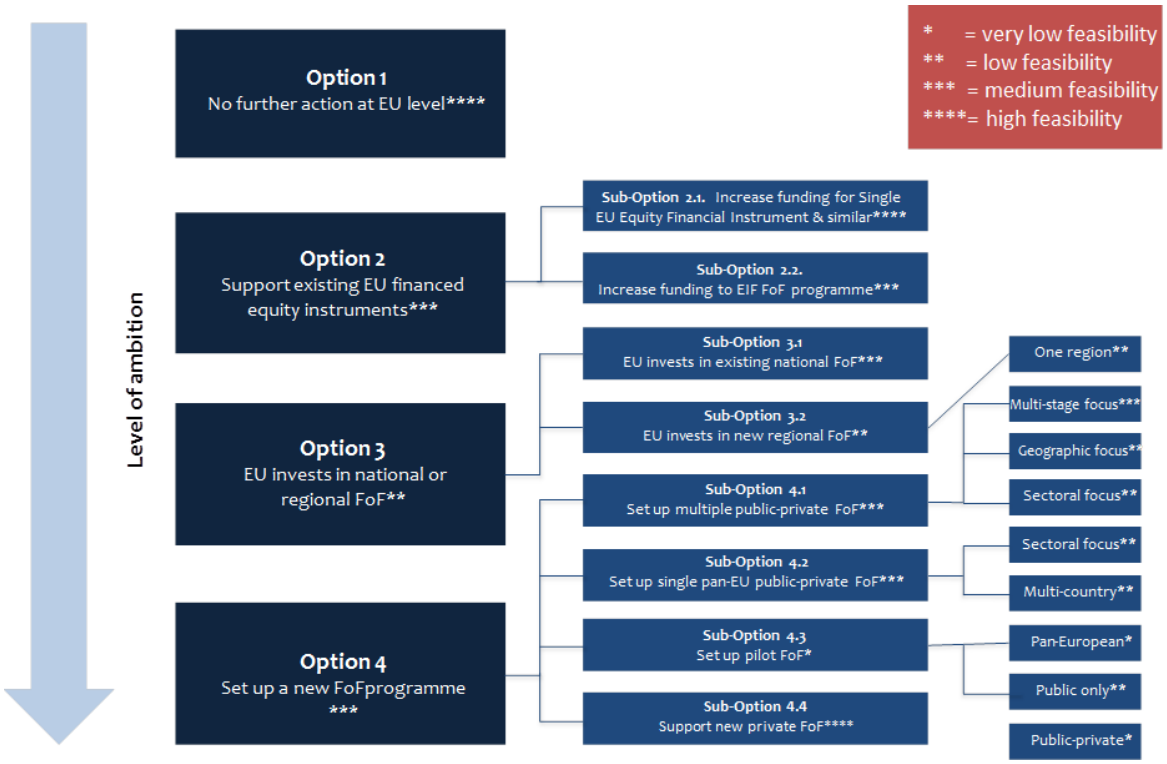
- Risk of duplication with existing EIF-backed schemes, especially since the level of EU funding for equity instruments is significant. A new initiative would have to be differentiated from existing instruments to add value and/or designed to complement them. (Option 4.1 and Option 4.2).
- However, there may continue to be some barriers to attracting large investors either to a FoF or to invest in individual VC funds since they may be concerned about the legal position of being the largest investor in the event of fund or portfolio failure (Option 4.1 and Option 4.2).
- A drawback of setting up a single, pan-European public-private FoF is the challenge of determining who would administer / operate the scheme.
    - If this were to be the EIF as an entrusted entity, it was pointed out that this would reinforce its dominant position.
    - If a single financial intermediary were appointed as a FoF manager, it would not achieve the objective of diversifying supply and tapping into the different investor networks that different FoF managers have (Option 4.2).
- Low additionality and risk of crowding out investments – FoF managers will not be willing to invest in inexperienced but promising new VC managers but will invest in the best performing underlying VC funds that can already raise capital under the current setup.
- Sub-option 4.3 – setting up a pilot FoF – was not perceived as being viable by most stakeholders, since it would take at least 7-10 years to gain sufficient experience and before clear conclusions can be drawn as to its effectiveness. Also, the pilot's performance will be influenced by other variables such as the period in the economic cycle when the pilot was launched.

4.1.2 Assessment of the feasibility of the different options and sub-options

An assessment of the feasibility of the different options was carried out taking into account technical difficulties, as well as potential execution and reputation risks. The extent to which particular options/ sub-options have a high level of feasibility or conversely a low chance of being viable was assessed.

This required forming an evaluative judgment based on extensive interview feedback and desk research. The detailed rationale behind the rankings should be implicit from the detailed assessment of stakeholder feedback provided in the main report. The results are presented below.

Figure 2 - The options and sub-options ranked by feasibility



Option 1 is feasible since it would not require any further action at EU level. Options 2 and 3 (and their respective sub-options) are generally feasible since these would not require setting up new instruments or funding programmes. However, they could risk reinforcing the dominant role the public sector already plays in European seed and VC. Moreover, increasing funding to existing EU financial instruments would be difficult to justify in some cases because the instruments themselves are relatively new, such as the pilot project for technology transfer within Horizon 2020. However, increasing funding for the EIF's FoF programme (Option 2.1) could be highly feasible, since it has been underway for a number of years and would help to continue to address supply-side challenges in some under-served markets for VC. This would however have to be subject to a thorough demand-side analysis to test absorption capacity.

Option 4 had more stakeholder support than the other options, on the basis that although Options 2 and 3 are credible approaches, they would not address the underlying structural problems facing the European VC ecosystem, namely the absence of sufficient private sector participation to ensure its longer term sustainability.

4.1.3 Synthesis of findings on policy options

Having examined the stakeholder feedback and the feasibility of the options, the overall findings were that:

1. Most stakeholders were not in favour of Option 1, the "no policy action" scenario, on the basis that structural problems remain in European VC. However, approximately 20% of stakeholders and questioned the value of additional public intervention on the basis that the EIF already provides sufficient investment into seed and early stage VC, especially in market geographies where VC was non-existent or under-developed.
2. Option 2.1, to increase funding for the Single EU Equity Financial Instrument (funded by COSME and Horizon 2020's Access to Risk Finance Programme) was viewed as feasible. If additional funding is available, this could be used to expand existing equity schemes. However, since these

have only just got underway, it is too early to evaluate their effectiveness.

3. Some stakeholders maintained that Option 3.1 could help to generate additional critical mass and ensure that underlying VC funds were less dependent on EIF funding. However, working through existing national FoF and encouraging a cross-border approach may help to increase critical mass, but there are no guarantees that the private sector would be attracted, given that existing schemes do not operate on a purely commercial basis, at least according to published IRR/ target multiples data available. This could risk continued public sector dominance.
4. Option 3.2 did not receive much stakeholder support, mainly because concerns that existing regional FoF have suffered from particularly poor performance and are not considered commercially viable investment targets for private investors.
5. An advantage of Options 3.1, 4.1 and 4.2 is that private sector leverage would be achieved at two levels, the FoF level, rather than only through underlying VC funds. This 'double leverage' effect would be in accordance with the aims of the European Fund for Strategic Investment (EFSI), where a multiplier effect of 1:15 is anticipated.
6. Under Option 4.1, the EC could differentiate itself from existing EIF FoF provision through a FoF structure/programme through a requirement for FoF managers (either public or private) selected to manage the FoF to raise the additional private capital needed to achieve first and subsequent fund closures.
7. Option 4.2 was viewed positively by many stakeholders but some cautioned that it would be difficult to manage a FoF with such a wide scope and that it would be easier to diversify risk under a programme of multiple FoF (Option 4.1).
8. Option 4.3 was not viewed as a realistic option based on the assumption that the results of a FoF structure could only be assessed after several years. However, the EC could pilot the call for expression of interest and have preliminary discussions with investors in order to further gauge the potential interest in and success of such a programme.
9. There was support among some VC stakeholders for Option 4.4 on the basis that the EU should support new market entrants[32] to ensure that there is an adequate flow of talented new VC managers. It takes 10 -15 years to develop a new generation of high-performing and experienced VC fund managers.
10. A combination of options could be implemented in parallel. The EU should set up a pan-European FoF programme but also, subject to EU funding availability, could channel more funding into existing financial instruments schemes such as the Single EU Equity Instrument under the Horizon 2020 and COSME programmes).
11. Option 4.1, to set up a pan-European public-private seed and VC Fund of Funds, was identified as the policy option preferred by a majority of stakeholders. This was supported by influential industry representatives, notably Invest Europe[33].
12. Option 4.1 also has the potential to encourage private capital back into the European VC asset class and attract as yet untapped international capital. It also has the greatest likelihood of contributing towards the achievement of the key EU policy objectives defined by DG RTD. This option was also selected on the basis of its potential feasibility since there is legal provision under Horizon 2020's InnovFin SME VC product to support fund of funds.
13. Supporting Option 41 could also be done in conjunction with Option 2.1, as Horizon 2020's InnovFin SME VC product can also support fund of funds, legally speaking.

[32] Although the EBRD and the EIF already play an important role in supporting new managers, the research identified some new managers that still could not secure funding.

[33] Invest Europe position paper, November 2014, Accelerating Innovation & Delivering Growth: Using the Jobs, Growth and Investment Package to Attract Private Sector Investors to the European Venture Capital Industry.

4.2 Preferred policy option and suggested configuration of a FoF programme

Feedback on the configuration of a pan-European FoF programme

1. There was broad support for a possible EC-led initiative to set up an EU-financed, pan-European VC FoF programme to invest in the European VC asset class. However, there was not universal support, given concerns about the risk for clear differentiation to avoid duplicating the work of the EIF and the risk of further dependency on (EU) public funds.
2. A pan–European FoF programme could help investors to achieve diversification and offset risk through a balanced investment portfolio[34] in individual VC funds that invest in start-up and early-stage firms across different investment stages. Focussing on multiple investment stages would address the problem of the EU missing out on the significant jobs and growth creation potential of high-performing, innovative European SMEs.
3. There were divergent views among stakeholders as to how a FoF should be set up and made operational and the stage of investment on which it should focus. These have been incorporated into the development of the different options/ sub-options.
4. A number of the alternative options identified are feasible, but a final decision as to which one to go ahead with depends on securing agreement on the primary objectives of the intervention. This in turn will influence the configuration of the FoF.
5. Stakeholders strongly emphasised the need for a possible future pan-European FoF programme to be flexible in defining the investment strategy for the selected FoF managers in terms of geographic coverage, sectoral targeting and the balance between investment stages. A prescriptive approach should be avoided since this would deter investors.
6. Individual FoF should be managed by a commercially-oriented public or private sector GP since this would alleviate private investor's concerns about the commercial orientation of the FoF and the alignment of interest between the GP and LPs. The European Commission should, however, play an active role in the selection and oversight of the FoF manager(s).
7. One means of incentivising the private sector would be to adopt an asymmetric returns model in which the private sector captures the upside once the capital has been repaid with interest plus an agreed level of profits. Although many existing public sector-backed FoF operate on a *pari passu* basis with other investors, these have not generally attracted private investment. Overall, there was a slight majority in favour of asymmetric returns.
8. There were concerns however among some stakeholders about the acceptability of asymmetric returns to the public. Many argued that investors could be attracted under a pari passu approach on the major caveat that the FoF would have to be fully commercially-focused. Whilst many existing FoF structures are pari passu, the EIF is often present as a cornerstone investor.
9. The EC would need to make a significant long-term commitment to a European VC FoF in order to ensure its success. The duration of an EIF FoF is a minimum of 16 years and a private sector FoF up to 12 years (the widely known so-called "10+2 model"). However, there are examples of private FoF of shorter duration (8 – 10 years).
10. Although there are examples of FoF of shorter duration, there is a question as to whether value for investors can be fully realised if the time period for divestment is insufficient. The optimal timeframe for the duration of individual FoF supported within a FoF programme may also need to vary depending on the proposed sectoral focus by prospective FoF managers.

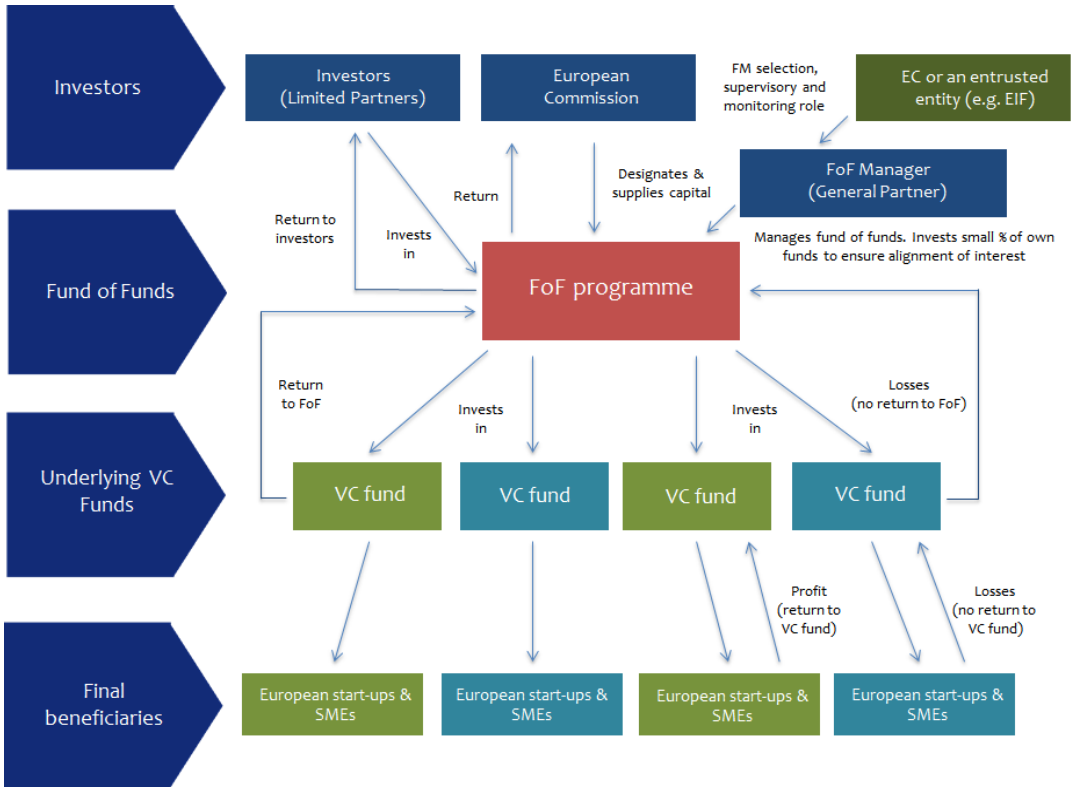
[34] Previous research shows that modelled return and risk profiles of FoFs using Monte Carlo simulations with real VC fund return data. The risk of a FoF losing any capital was small (<1%) when investing in a minimum of 20 VC funds. See Weidig and Mathonet (2004, "The risk profiles of private equity") and Risk in Private Equity - New insights into the risk of a portfolio of private equity funds - BVCA and Montana Capital Partners, 2015.

11. Funding commitments could however be spread over an initial 5 year investment period, which would reflect the multi-annual programming period of EU programmes, and would leave scope for gradual disbursements to be made to underlying VC funds.
12. A future possible FoF would have to be set up in a way as to ensure there is no conflict of interest for the EIF being involved given that they already invest in both FoF and through direct co-investment in the same asset class in many Member States.

The selection of this option does not preclude the EC from giving consideration to supporting other options either in parallel or in future subject to EU funding availability. Several sub-options were identified as being feasible and enjoyed at least some stakeholder support (notably Option 2.1 (increasing funding for the EIF's existing FoF programme) and Option 3.1 (setting up a FoF funding scheme for existing national FoF).

The way in which a public-private FoF model managed by top professional fund managers might operate is summarised below:

Figure 3 – Option 4.1 – Setting up a pan-European FoF Programme



Option 4.1 would involve setting up a pan-European FoF programme in which 4-5 individual FoF were established. Although the focus would be on early stage (seed and venture capital), there may be strong arguments in favour of having a multiple investment stage approach. The rationale for this would be several fold:

- Focusing on multiple investment stages (e.g. *early-stage, late-stage, expansion/ growth*) would allow Europe to capitalise on the full entrepreneurial and innovative potential of high-growth gazelles and be able to provide follow-on financing.
- This could over time help contribute to ensuring the EU shares the benefits for jobs, wealth creation and competitiveness through innovation, rather than the upstream benefits from later stage VC investments and buy-outs being captured in the US.
- Not limiting the investment focus to early stage VC could help avoid the perception among the private sector investors that publicly backed fund of funds are more concerned with addressing

structural market failures in a high-risk, low returns asset class. Blended returns across different investment stages would not only help to diversity risk but also improve performance overall.

4.3 Asymmetric returns vs. pari passu

Among the issues examined relating to Options 3.1, 3.2, 4.1 and 4.2 were the question of asymmetric returns vs. pari passu. There were different views among stakeholders as to whether asymmetric returns were necessary to attract private, non-EIF capital. Whilst private equity LPs and GPs were in favour and said that this would make a significant difference as to their likelihood of investing, many public sector FoF managers, public authorities and representatives from the EIF had concerns about the EC putting in funding (and acceptability among the public) unless this was on a pari passu basis.

However, whilst existing national public and EIF-led FoF are pari passu, EIF funding is classified as private. It was argued by many other private stakeholders and representative organisations that it would be difficult to attract genuinely private sector funding to invest in seed and early stage without asymmetric incentives.

If a FoF programme adopted a pari passu approach, an EU-led FoF initiative may be unsuccessful, since FoF have had a mixed performance track record. Asymmetric returns between public and private investors (LPs) may be needed to attract investors, since they might otherwise be deterred by additional layers of fees. A key finding was that it will be difficult to attract private investment in highly uncertain emerging and hear to market technologies and early-stage businesses with high failure rates, without significant and long-term incentives for private investors.

4.4 Downside protection and / or upside

Among stakeholders interviewed, there was not widespread support for downside protection, which in the current political climate was not seen as realistic (even by private VC managers and FoF managers). However, there are examples of successful FoF schemes that have put in place a downside protection mechanism to attract private investors, such as VCAP in Canada.

There was however support for structuring the FoF in a way that would allow investors (either public or private) to **capture the upside.** If the objective is to attract private sector investors and fund managers on a sustainable basis, then the problem of poor perception of returns in the marketplace needs to be addressed. The EC could then utilise funding received through an "early exit" to support a second generation of a FoF programme. Early exit would only be realistic in the event of the FoF achieving successful performance.

The EC should however maintain the right to retain its investment until the end of the FoF lifetime, given that performance returns may improve during the latter stages of the divestment period (see detailed analysis of the J Curve performance of VC investments).

4.5 State aids considerations, intervention rates and competition issues

In examining the different options, especially those relating to setting up a new financial instruments scheme, it was important to take into account state aids considerations, intervention rates and competition issues. Relevant EU regulations were reviewed, in particular:

- **Title VIII of the EU Financial Regulation[35] –** sets out the EU's rules on financial instruments schemes. It addresses state aid and competition issues.
- **Art. 21 of the revised General Block Exemption Regulation (GBER), 2014[36]**, which addresses aid for access to finance for SMEs - Risk finance aid.

[35] http://ec.europa.eu/budget/biblio/documents/regulations/regulations_en.cfm

- **The 2014 Guidelines on State Aid to promote Risk Finance Investments**[37] **-** these set out guidelines on aid to investors, including when a pari passu approach is appropriate and when asymmetric returns may be justified when there is a demonstrable market failure.

Overall, the findings from the review of the legal framework for EU financial instruments and state aids did not find any major obstacles to going ahead with a pan-EU FoF programme. State aids (e.g. to final beneficiaries, to financial intermediaries, to investors), may be eligible provided that the aid fulfils the eligibility requirements provided for risk finance aid under the revised **General Block Exemption Regulation (GBER).** If any elements of the FoF programme fell outside these requirements, then they would have to be notified (they may still be eligible).

The **maximum public intervention rates by category of undertaking are set out in Art. 21** of the GBER. These put in place a sliding scale for the maximum public intervention rate, and the corresponding minimum private leverage requirements depending on whether the underlying undertakings supported are start-ups, established firms of up to 7 years or firms set up >7 years ago. If the anticipated cumulative level of private sector leverage is achieved, then the requirements under the GBER (calculated based on a weighted average) should be met relatively easily. Only in the eventuality that there were difficulties for FoF managers in attracting private finance would difficulties arise.

The **investment strategy for selecting firms and the size of investment in eligible undertakings** would need to be specified upfront in order to check that it complies with the GBER on Risk finance aid. **Remuneration arrangements** would have to be along commercial lines, but there is a strong emphasis in both the GBER and in the Guidelines on State Aid to promote risk financing on avoiding overly generous management fees and putting the stress on performance-related incentives packages for financial intermediaries.

The extent to which the EC could provide **private investors with upside or downside protection under the state aid rules** was also examined. Provided that the asymmetric incentives structure is proportionate to the level of market failure, there do not appear to be particular challenges from a state aids perspective in allowing investors to capture the upside. However, the proposed structure will need to be checked by DG COMP to ensure that it is compatible with the state aid rules on risk finance for SMEs laid out in Art. 21 of the GBER. Although downside protection was not widely favoured, this would nevertheless be compatible with the GBER under Art. 21 (13c), which states that "in the case of asymmetric loss-sharing between public and private investors, the first loss assumed by the public investor shall be capped at 25% of the total investment". Art. 21 (14c) states that financial intermediaries shall receive "remuneration linked to performance, or shall share part of the investment risks by co-investing own resources so as to ensure that their interests are permanently aligned with the interests of the public investor".

4.6 Assessment of risks and proposed mitigation measures

The research identified a number of different types of risks, such as **technical execution risks, financial risks and reputational risks.** The main risks - and possible mitigation measures - are outlined below.

1. Risk 1 - Reputational risks associated with going ahead with a pan-European FoF initiative *(e.g. due to under-performance of individual FoF or of the programme overall, level of public acceptance of performance incentives for FoF managers or asymmetric returns for investors).*

Mitigation 1 – the EC should ensure that in drawing up the selection criteria for the Call for

[36] Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Art. 107 and Art. 108 of the Treaty.

[37] http://ec.europa.eu/competition/state_aid/modernisation/risk_finance_guidelines_en.pdf

Expression of Interests, criteria are put in place that will ensure that only top-performing, commercially-focused FoF managers with access to high-quality deal-flow and investor networks are selected.

2. Risk 2 - The extent to which a FoF programme can be set up using different EU funding sources or combined EU funding sources is uncertain and could affect the configuration of a FoF programme and of individual FoF.

Mitigation 2 – the EC will need to clarify as early on as possible in the finalisation of the design and structure of the FoF which EU funding sources will be utilised and then clearly spell out how this will affect the design and configuration of a FoF programme.

Mitigation 3 – if EFSI funding is used in addition to H2020, then seed and early stage may need to be separated from later stage FoF, since the EFSI Regulation foresees the delegation of implementation to the EIB group (EIB + EIF).

It remains uncertain however whether the use of a combination of H2020 and EFSI funding would require separate FoF to be set up focusing on specific investment stages to reflect the funding source, or whether funding sources could be combined so as to enable a single individual FoF to operate on a multi-investment stage. COSME and H2020 provide an example where funding sources have been combined through the Single EU Financial Equity Instrument. This is an important issue as it could confound optimal commercial practice and structures *(see main report – balanced investment funds diversifying risk across different investment stages are common).*

3. Risk 3 – The need to maintain the initiative's political momentum to ensure that it is a success through ongoing EU policy and funding support.

A central learning point from VCAP in Canada is the importance of long-term political commitment to ensuring the success of a FoF initiative. There is a risk of a lack of ongoing political commitment from the European Commission beyond the political life of a particular Commission.

Mitigation 4 – a long-term approach should be embedded into the finalisation of the design and configuration of a FoF programme.

Mitigation 5 – the EC should organise investor roadshows in both Europe and internationally in order to promote the initiative to investors and the wider public in order to ensure the continued high visibility of a FoF programme and to get the initiative off to a successful start.

Mitigation 6 – appropriate resources should be put in place – and maintained during the operation of the FoF programme to ensure effective monitoring – to ensure that the initiative is a success.

4. Risk 4 - there are risks that the EC cannot commit to EU funding support beyond the lifetime of the current multi-annual programming period.

5. The EC should ensure that given the high level of ambition of setting up a FoF programme and the high level of skill and technical expertise in managing the design and set-up phase and in carrying out subsequent monitoring that it procures appropriate technical assistance support.

This could be in various alternative forms, such as launching a contract for independent, specialist consultants that specialised in advising the fund management industry, inviting external experts to participate in an advisory panel, etc.

6. *Mitigation 7 - it should be made clear to potential investors that the EU cannot guarantee future financing, since there is a requirement within multiannual programmes to review the budget annually. Secondly, although the rules set out in the EU Financial Regulation require annual approach of the budget within the frame of a multi-annual programming period, the EC could send a strong political commitment that it intends to provide funding support throughout the*

initial lifetime of a programming period to ensure that it can fulfil its role as a cornerstone investor in the FoF programme.

Although the financial profile for a multiannual programme is usually known at the outset of a 7 year period (as detailed in the expenditure profile), there are no cast-iron guarantees of future commitments, since the budget and work programme has to be approved annually. Although previous experience of EU FI schemes suggests that the risks of EU programmes being discontinued are small, it will nevertheless be important to mention these in technical documentation associated with the Call[38], given the legal implications of not identifying all material uncertainties.

The EC should put in place appropriate mitigation measures to overcome risks relating to **the set-up and design phase,** such as:

6.1 Ensure that there are adequate human resources within the EC to manage the setting up of a new FoF initiative.

6.2 Give consideration to supporting 2-3 year secondments to promote knowledge transfer in the setting up and design of FoF e.g. two or three officials from the EIF and / or national FoF operators could be seconded in to the Commission.

6.3 Encourage FoF managers to set ambitious fund-raising targets for first fund closure to ensure that investments can be made during the investment period so as to mitigate the risk of future subsequent years' EU budget not being guaranteed.

7. The EC should put in place appropriate mitigation measures to overcome risks relating to **the operation of the FoF programme and the exit phase,** such as:

7.1 Ensuring that the divestment period is sufficiently long – a minimum of 3 years – to ensure that successful exits can be achieved (recognising under the J-Curve that a disproportionate percentage of value is crystallised during the growth and maturation stages of gazelles' development).

7.2 Setting a requirement that each FoF should invest in a minimum of 20 underlying VC funds in order to spread risk and so minimise the chances of losing any capital (unless the FoF manager can provide sufficient justification for an alternative approach investing in <20 GPs.

[38] The legal terms of investment agreements between investors in an LP are strict. A "default" by the EC or any other investor within an LP would be unlikely because it would be costly. There would be legal difficulties if the EC had to pull out prematurely of an LP agreement, e.g. if the EP decided to terminate a programme mid-way through its implementation or an annual budget commitment was not approved.

5. CONCLUSIONS AND RECOMMENDATIONS

The conclusions section focuses on the rationale for setting up a pan-European Fund of Funds programme and the overall potential benefits of going ahead with the preferred option (or subject to EU funding availability, a combination of FoF options). It should be noted that conclusions relating to the set-up and operation and the configuration of the FoF are incorporated within the subsequent recommendations and implementation roadmap section.

5.1 Conclusions - rationale for setting up a pan-European FoF programme

The rationale for setting up a pan-European FoF programme to support individual commercially-focused, public-private fund of funds is centred on a number of arguments.

Firstly, if EU funds are invested as a cornerstone investment in a pan-European FoF programme of sufficient scale, then this should have **important signalling effects** and help to **attract large private investors**, such as institutional investors and Sovereign Wealth Funds. Attracting international "flagship investors" could have a strong catalytic effect in attracting new investors to European VC.

Larger investors do not typically invest directly in small VC funds in Europe, since their minimum ticket size is too large (in the order of €25 million - €100 million) to invest directly. Moreover, a general rule of thumb is that for risk management reasons and legal considerations, they cannot usually invest more than 10% in any one FoF (or underlying VC fund). Attracting larger investors back to European VC through a FoF mechanism should therefore help to **tackle structural inefficiencies in the European market for FoF and help to boost the average size of European VC funds.**

Secondly, a new FoF scheme backed by the EC should focus on **achieving optimal return on capital to attract the private sector back to the European VC asset class**. Many existing publicly-backed FoF pursue at least some public policy objectives and lead to a combination of economic and social returns. Whilst these objectives may be commendable, sub-optimal returns from publicly driven FoF and the historical under-performance of the asset class have been insufficient to attract private sector investors.

Thirdly, there is a need to ensure that innovative, start-ups and SMEs with high-growth and internationalisation potential have **continued access to external equity capital through staged fund-raising rounds** in order to accelerate their growth at key development stages. The research identified funding gaps within the European VC ecosystem that extend beyond the seed and early-stages, where public intervention has been focused in the previous 15 years to the growth phase (especially between €5m to €15m). It was mentioned by at least 20 of the 105 stakeholders interviewed that this has led to many promising gazelles with strong potential relocating to the US[39].

Fourthly, a FoF should provide a useful **counter-cyclical tool at the ecosystem level** to overcome VC supply fluctuations during economic downturns. Although reduced supply of VC does not necessarily mean under-supply of capital, given that it could equally reflect a lack of high-quality projects (e.g. demand-side weaknesses), nevertheless, there was a major reduction in VC activity during the economic and financial crisis.

Fifthly, FoF could be an effective mechanism to **achieve a significant leverage effect on EU funds through multipliers at both the fund of funds level and the underlying fund level.** The leverage ratio is the ratio between total investment in VC and EU investment as a cornerstone investor (excluding fees). Previous EU equity instruments schemes such as the GIF within the Enterprise and

[39] Whilst recognising that the reasons that high-growth European firms move to the US extends beyond access to finance issues and relates equally to framework conditions (e.g. tax and incentives, regulatory environment), strengthening the European VC ecosystem through more commercially-oriented FoF able to provide support at all stages of their growth and expansion would represent a major step forward.

Innovation Programme achieved significant leverage of ca. 4 EUR for every 1 EUR of EU funding. Attracting new sources of (largely) private capital to the fund of funds level is a clear differentiator of a pan-European FoF initiative backed by the EU compared with existing FoF provision through the EIF's FoF programme, and similar schemes run by national FoF operators, where leverage is typically achieved at the underlying funds level.

Last but not least, many stakeholders noted **the opportunity costs for Europe of high-growth European SMEs ("gazelles") moving to the US** and the benefits forgone for the European economy in terms of the non-contribution of firms relocating outside the EU to the jobs and growth agenda. Convincing European start-ups to remain in Europe will however remain an upwards struggle. The research found that at every investment stage, **European start-ups can raise between two and five times[40] the amount of capital at the equivalent investment stage in the US**.

There is therefore an argument for EU support through a FoF mechanism at multiple investment stages throughout the equity financing lifecycle, not only focusing on identified market failures (e.g. seed, early-stage VC), but covering the expansion stage, where many smaller individual VC funds are unable to fund Series C and Series D expansions.

5.2 Potential benefits of the establishment of a pan-European FoF programme.

It is important to emphasise the **potential benefits** of the establishment of a pan-European FoF programme. These include, *inter alia*:

1. Attracting international capital that could not otherwise be accessed, due to structural barriers associated with the lack of critical mass in VC fund size and over-fragmentation.
2. Increasing the supply of capital available within the European VC ecosystem generally.
3. Increasing the average size of European VC funds in order to help them compete globally to attract investment.
4. Strengthening competition among the VC sector by encouraging greater diversity in financing supply for underlying VC funds. Lessening dependency on the EIF should help to strengthen the longer-term sustainability of the European VC industry.
5. Delivering significant *cumulative* leverage effects on public funds by attracting private investors at both the fund of funds and the underlying VC funds levels.

The combined leverage effect on EU funds is difficult to quantify[41] since it will be dependent on factors such as the stage in the economic cycle when the funds are launched, the prevailing market conditions and crucially, the returns structure for investors, which will be determined by the EC at a later data, should a FoF programme be established.

6. Generating significant leverage through the effective use of EU funds is a policy goal of the European Fund for Strategic Investments (EFSI)[42] Capitalising on the economic and growth potential of high-growth 'gazelles', which have major potential to create high value added employment, promote innovation and greater efficiency in key sectors of the economy and should generate high tax receipts.

The above benefits are only likely to materialise in full if there is a strong focus on the commercial orientation of the individual FoF supported whose primary objective should be securing optimal return on capital and on professional management. Although this implies that the private sector should play a leading role in the FoF programme, there is no particular reason why public or quasi-

[40] This is confirmed in recent literature e.g. BCG & IESE. 2015. A Rise in Good Deals, but an Investor Drought.

[41] The leverage achieved will depend on a multiplicity of factors. Previous experience suggests that the leverage achieved could be in the order of 4:1 to 5:1 (combined leverage) and between 2:1 and 1:1 at the FoF level.

[42] EFSI Regulation (EU) 2015/1017

public FoF managers should be excluded, provided they can attract private investment, demonstrate a strong fund management track record and are able to deliver commercial returns.

5.3 Recommendations - setting up and operating a pan-European FoF programme

5.3.1 Structure and set-up of a pan-European FoF programme

8. A pan-European FoF programme should be set up with the European Commission ("EC") serving as a cornerstone investor in order to kick-start the first generation of FoF.

9. The EC should ensure that in finalising the design of the overall FoF programme, one of the following alternative sub-options for Option 4.1 is adopted so as to ensure that large ticket investors can invest in the pan-European FoF programme:

   9.1 Alternative 1 - a dedicated investment vehicle (DIV) could be established at the level of the FoF programme overall to enable large investors[43] to invest alongside the EC as a cornerstone investor.

   9.2 Alternative 2 – instead of targeting individual FoF of €250m-€300m in size, large investors could be attracted directly by increasing the size of the FoF to €400m - 500m+[44]. Under this scenario, a DIV at the level of the FoF programme overall would not be necessary.

10. Between four and five individual FoF should be selected as part of the first generation of fund of funds. The target size of each FoF (including private sector funding) should be circa €150m in the case of seed and €250m-€300m[45] in the case of a balanced venture fund (investing in a combination of early-stage, later stage and expansion stage).

11. Consideration should be given to a staged approach during the first generation of the FoF programme. For instance, two individual FoF could be launched in Year 1, and a further two or three in Year 2, to allow time for monitoring (in line with a piloting approach).

Although this would imply running two Calls for Expressions of Interest, this could help to mitigate some of the initial set-up and design risks.

12. The FoF programme should cover multiple investment stages (seed, early and later stage), to help support high-growth, innovative European SMEs ('gazelles') with world-class potential throughout the equity lifecycle and reduce the number of such firms relocating to the US.

However, it should not cover the European buy-out stage, where the private sector is already very active (both European buy-out funds and through US buy-out funds already operating in the EU).

5.3.2 EU funding sources

13. The FoF programme could be financed using a combination of EU funding sources, namely Horizon 2020 funding (seed and early stage), and the SME Window within the European Fund for Strategic Investments (EFSI) for later-stage investments (late stage, expansion).

14. Funding commitments made should be spread over a 5 year investment period, with funding disbursements made over the course of the multi-annual programming period. This would spread risk by avoiding over-dependence of individual FoF performance and the FoF programme overall on a particular vintage year.

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[43] Among the potential benefits are that large investors would gain exposure to an entire asset class but through a number of individual FoF which in turn would invest in a diversified portfolio of VC funds. This would achieve risk diversification, but a problem could be that it may create an additional layer of fees.

[44] However, the feasibility of this approach will need to be checked through consultation with leading private FoF managers to ensure that the target fund size set is realistic – see VCAP case study.

[45] The size of individual FoF may vary. There is nothing to prevent a prospective FoF manager from creating a larger FoF of for instance €500m+ if they are able to attract significant scale additional private investment from large ticket investors.

15. In order to ensure the success of a FoF programme, the EC will need to make a long-term commitment to a European VC FoF (at the minimum 12 years, under the 10+2 level to reflect private sector FoF typical duration)[46].

5.3.3 Selecting individual fund of funds

16. In setting up a new financial instruments scheme, the rules laid down in Title 8 of the EU Financial Regulation must be respected. These relate to the implementation of financial instruments schemes by financial intermediaries (i.e. FoF managers) selected "on the basis of open, transparent, proportionate and non-discriminatory procedures, avoiding conflicts of interests".

17. The most appropriate instrument for selecting fund of fund managers, who would subsequently set up individual FoF, is a Call for Expression of Interests.

18. There is scope in the EU Financial Regulation to delegate the management of a FoF programme to an entrusted entity. The EC (or its entrusted entity acting on behalf of and under instruction from the EC), should manage the design and initial set-up directly, supported by expert external technical input[47].

19. However, if the EC's choice of financial support mechanism makes this approach difficult or impossible, a key requirement should be that the investment strategy, as far as the use of the EU budget is concerned, should be prepared by the EC. The same applies to the validation / sign-off of the content of the call for expression of interest for fund managers.

20. FoF managers appointed to manage individual FoF within the FoF programme overall should be required to raise capital from private investors. The capital raising requirements will need to be determined through a negotiation process between the EC and the selected FoF managers. This should be at least a 1:1 ratio[48].

Private sector leverage achieved could potentially be much higher, but this will depend on the asymmetric returns structure put in place for investors by the Commission. It should also be noted that FoF achieve additional leverage through the underlying funds level.

21. Subject to being able to combine different EU funding sources, FoF should be allowed to propose a balanced investment approach across several investment stages. However, there should be a requirement that this should include a minimum of 40% in seed and early stage VC.

Allowing too much flexibility for selected fund managers of individual FoF could otherwise risk them investing only in more profitable, later-stage investments where although there is some evidence that further financing supply is needed, there is less evidence of clear market failure. In addition, this would avoid the risk of the EU "crowding out" existing market participants.

22. FoF managers appointed to manage each individual FoF programme should be required to raise capital from investors.

    22.1 This should be in the order of at least a 1:1 ratio (at the FoF level).

    22.2 The precise level will need to be determined through negotiations with prospective FoF managers.

23. *The level of private leverage that is achieved at the FoF level could potentially be higher, depending on the asymmetric returns structure devised by the Commission for investors.*

[46] However, reference should also be made to the risks and mitigation measures Section 4.6 given the EC cannot make cast-iron financial commitments into the future).

[47] An external advisory panel could be used by the EC to advise on finalising the design of the FoF programme and to provide impartial advice during the selection process.

[48] It should be noted that the minimum 1:1 ratio refers only to the FoF level. The 4:1 ratio mentioned earlier relates to the cumulative leverage effects.

Typically, FoF achieve significant leverage through private investment at the underlying funds level.

24. Although the focus should be on attracting private capital into VC, subject to interest, public sector investors could also be targeted in marketing the initiative as part of investor roadshows, since some public pension funds manage significant assets and could be interested in investing[49].

25. The drafting of the Call for Expression of Interests by the EC should be non-prescriptive in setting investment criteria to ensure that prospective FoF managers have the flexibility to determine how best to achieve optimal risk-reward and to demonstrate their track record and experience.

As with EIF equity funding, some limited geographical restrictions could be required, for instance requiring that two-thirds of total investment in underlying VC funds should be within the EU. However, extending limits on the size of investment, industry sector or imposing limitations on investments by geography within the EU would be counter-productive.

26. In responding to a Call for Expression of Interests, prospective FoF managers should be asked to provide a clear enunciation of their investment strategy.

FoF managers should be asked to propose for instance whether they will adopt a sectorally-focused approach or remain generalist, the proposed balance between different investment stages, etc.

27. In raising capital mainly from private investors at the FoF level, due attention should be given to ensuring that funding attracted is genuinely additional. Any new financial instruments scheme does not displace capital that would already have been invested in European VC (e.g. directly in underlying funds). It should also not detract from existing EU equity-based programmes.

28. Investing in the FoF programme should be open to all types of investors, although the relative weight of individual institutional investors, especially those from third countries, should be monitored.

29. In order to maintain the momentum of the first generation of a new FoF programme

    29.1 A second generation FoF programme should be considered, subject to an external evaluation being carried out of the first generation FoF programme (see monitoring and evaluation).

    29.2 The EC should give consideration as to how subsequent generations of FoF programmes will be funded through subsequent multiannual programmes to ensure continuity.

5.3.4 Management and operation of the FoF programme

30. The EC should either manage the FoF programme itself, or delegate the management to an entrusted entity (or to a group of entities) through an EC mandate. Currently, however, the EIF is the only formally legally-nominated entrusted entity.

31. However, the EC should consider this aspect very carefully in order to avoid a situation in which the EIF faces a perception of conflict of interest[50].

32. The EC should set up an expert advisory panel to guide the EC's DG RTD during the finalisation

[49] For instance, public pension funds have invested alongside the EIF at the fund of funds level in a number of southern European countries.

[50] The EIF could potentially be asked to serve as an entrusted entity. However, it could equally potentially apply to manage one of the individual FoFs (by competing alongside other public and private sector participants).

of the design and set-up process[51]. They could advise on the selection of individual FoF within the first generation of FoF.

The panel could be comprised of independent experts (such as ex-EIF personnel working in the private sector, ex-fund or FoF managers, consultants with the requisite technical expertise).

33. FoF managers of individual FoF programmes should be recruited from top-performing fund managers via an open Call for Expressions of Interest.

34. Although the initiative should have an emphasis on attracting professional fund managers from the private sector, public sector fund managers should not be precluded from participating (since they may also have the requisite skills to operate a commercially focused FoF if they are not hamstrung by political constraints).

35. The FoF manager should commit capital of their own (circa 5%) in order to ensure alignment of interest but should be incentivised through a combination of fees and carry.

5.3.5 Exit and returns

36. The EC should give consideration to the need to strike a balance between offering attractive potential returns to private investors (to attract the private sector back to European VC and to generate high leverage on EU funds) and the need to ensure public acceptance on the other hand.

37. If an asymmetric returns structure is agreed, the precise returns arrangements could be varied based on the characteristics of individual FoF e.g. a FoF proposing to invest in less mature markets in under-served geographies could be given a higher level of upside.

38. Incorporating downside protection was not regarded as realistic, due to concerns regarding the risk of moral hazard.

39. Early exit mechanisms should be incorporated into a FoF structure to allow the European Commission and possibly other public sector investors to withdraw their capital early, either once specific performance hurdles have been met, or at particular time junctures in the FoF's duration (e.g. after a minimum of 5 years).

40. In defining an appropriate returns structure for investors, the state aid rules laid down in the GBER Regulation on risk finance aid (Art. 21) will need to be fully respected.

5.3.6 Attracting investors and achieving a successful fundraising

41. In order to attract private sector investors back to the European VC asset class and to attract new, large-scale international investors, the FoF programme should:

    41.1 Ensure that the FoF programme is commercially-oriented and not subject to political constraints.

    41.2 Adopt as non-prescriptive an approach as possible in determining the requirements in the Call for FoF managers, especially with regard to the investment strategy (sectors, geographies). Only basic minimum requirements should be set e.g. setting a ceiling on investment outside the EU of up to one-third[52].

42. The EC should launch a series of investor roadshows both within the EU and internationally in order to promote participation in the FoF programme.

[51] In Canada, the Canadian government has had the support of a Venture Capital Expert Panel. The VCAP scheme has been implemented by BDA Development in Canada which has brought in people with a fund management background to advise in the design and set-up phases in the selection of High-Performing VC funds.

[52] This criterion appeared to be broadly accepted by stakeholders and would be consistent with EIF practice.

Experience from the Canada VCAP scheme suggests that it takes time to build the momentum of a FoF programme and to prompt interest and to secure funding from private investors. This requires patience and political commitment on the part of the cornerstone investor.

43. The EC should set a realistic timeframe to achieve first fund closure and to complete the subsequent fundraising rounds. This might be in the order of 6-12 months for first fund closure, but 12-24 months to achieve target fund size.

Fundraising timetables are markedly different in the private sector. Whereas an EIF-backed FoF seeking funding contributions from other public sector co-investors may succeed in raising the target FoF size within 3-6 months, this could take 12 months to first fund closure and up to 24 months to achieve target FoF size. There is a need to allow FoF managers selected to operate individual FoF sufficient time to carry out investor roadshows, to tap investor networks and to conclude negotiations on fees.

The research shows the timeframes for fundraising are very different from publicly backed FoF[53].

44. If one of the FoF were to be geographically focused, then additional performance incentives could be provided to FoF managers. In addition, more generous asymmetric returns could possibly be provided to private investors to generate interest in under-developed VC markets within the EU, although arguably the EIF's FoF programme and the EBRD's funding schemes are already addressing geographic market failures.

5.3.7 Governance and transparency

45. The FoF programme should be set up and its operations supported by an appropriate governance framework to ensure good governance and transparency. The existing governance arrangements for the Single EU Equity Financial Instrument in 2014-2020 represent a potential model.

46. At the design phase in setting up a FoF programme, it will be necessary to set out requirements that ensure alignment of interests between the FoF manager, public and private investors.

47. The EC or its entrusted entities (or alternatively a group of entrusted entities) should assume lead responsibility for managing the first generation of a FoF programme and should then provide regular feedback and monitoring data on implementation to a Monitoring Committee (comprised of representatives from the EC and selected invited experts).

48. Individual FoF managers appointed to operate each individual FoF should be made contractually responsible for providing regular monitoring and reporting data to the EC Monitoring Committee. This should include basic information about investee companies[54].

49. In line with Art 21 (15e) of the GBER, investors should be allowed to be represented in the governance bodies of the investment fund, such as a supervisory board or advisory committee. Large investors could make a valuable input to ensuring effective monitoring of the investment strategy, FoF performance, etc.

[53] For instance, the Baltic Innovation Fund, backed by the EIF as a cornerstone investor and three national financing agencies achieved fund closure within 3 months. However, the funding was all public sector.

[54] A model is provided as to the type of information required in the Canadian VCAP scheme - Appendix C – Profiles of Investee Companies

5.3.8 Monitoring and evaluation

50. Ongoing monitoring should also be carried out of the FoF programme's implementation and the performance of FoF managers.

51. The EC as the overall manager of the FoF programme should collect monitoring data regularly on implementation, such as basic information on the number of VC funds invested in by year.

52. An overall evaluation and monitoring framework and robust methodology should be put in place for the future FoF programme. Providing appropriate monitoring and performance data should be a condition agreed upon by all recipients (i.e. underlying VC funds) for receiving public funds.

53. Performance data should be collected from FoF, but is it unlikely that this will present a clear picture for the first five (and possibly 10) years, given the J-Curve effect[55] whereby returns occur during the latter stages of a FoF's existence, reflecting the long-term investment nature of VC as an alternative asset class.

54. Monitoring data should be made publicly available at periodic junctures. However, due caveats should be added to avoid misinterpretation of the FoF programme's performance, given the J-Curve and long-term investment and divestment strategy needed to achieve success in FoFs.

55. The EC should periodically commission external evaluations of the performance of the FoF programme overall to inform strategic policy developments. An initial evaluation should be carried out of the performance (and extent of contribution towards EU policy objectives) of the first generation FoF programme. This should ensure that lessons learned[56] are fed into the development of subsequent generations of FoF.

5.3.9 A broader support package to promote a sustainable European Venture Capital industry and ecosystem.

56. Any future possible European Commission initiated scheme to set up a pan-European VC FoF programme should not be presented as an isolated initiative, but be incorporated into a new holistic policy Communication setting out a package of measures to support the development of a more globally competitive and sustainable European VC industry.

57. The future EU policy Communication should include any new measures envisaged, such as:

    57.1 Setting up a first generation, pan-European VC FoF programme to attract globally-leading, high-performing fund managers to manage each of the individual FoF and to attract the private sector back to the European VC asset class.

    57.2 Technical capacity-building measures should be put in place in less mature markets for VC managers (GPs), and if appropriate also for FoF managers (LPs) to help develop a new generation of quality fund managers in emerging VC markets.

    57.3 Awareness-raising seminars about VC as an asset class for prospective investors (LPs) could also be organised in less mature markets, since there appears to be demand for such events. The participation of representatives from the EIF and the EBRD in such events will be crucial to their success.

    57.4 Giving further consideration to a possible new small dedicated funding scheme (see Option 4.4) to encourage new VC fund managers by providing gap funding.

58. The future EU policy Communication should then summarise existing EU support to help foster

[55] Exposed to the J-Curve: Understanding and Managing Private Equity Fund Investments, Uli Grabenwarter, European Investment Fund; IESE University of Navarra, February 2005

[56] Even though they are at an early stage in their implementation, evaluations have been conducted of some existing FoFs, such as the UKIIF in the UK and of the Danish Growth Fund.

the European VC ecosystem and the important role player by the EIF, the EBRD and national financing of fund of funds.

There is already a wide range of existing EU financial instruments that help to ensure the supply of VC within the European Union, especially in less developed market geographies. It is important that existing initiatives, including the size and scope of the EIF's FoF programme and direct co-investment activity are summarised so as to delineate the scope (and possible limitations) for further EU intervention.

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This study examines the potential for EU investment into venture capital (VC) funds-of-funds operating at EU level. It makes a strong case for supporting several such multi-country funds in order to help address Europe's equity gap, remedy the fragmentation of the VC market, and improve the performance of European VC funds in raising finance from major institutional and other private investors. The study advocates that such a programme of pan-European VC funds-of-funds should not be an isolated initiative, but one accompanied by a package of measures such as a capacity-building scheme for VC fund managers in less mature markets, and an awareness-raising initiative promoting VC as an asset-class to prospective investors.

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