APPLICA

ISMERI EUROPA

European Commission

Expert evaluation network delivering policy analysis on the performance of Cohesion policy 2007-2013

Year 2 – 2012

Task 1: Financial engineering

Sweden

Version: Final

Jan-Evert Nilsson

JENA

A report to the European Commission
Directorate-General Regional Policy

Contents

List of abbreviations

- EEN Expert Evaluation Network
- FEI Financial Engineering Instrument
- OP Operational Programme
- SEF Sydsvensk Entreprenörfond

Executive summary

The only Financial Engineering Instruments (FEIs) in Sweden co-financed by the ERDF are regional co-investment funds. The main reason for establishing the funds was the existence of an imbalance between the financial resources provided by the market and the demand for funding from firms. SMEs in the start-up and expansion phases especially are considered to have problems in meeting their need for finance.

There are only small differences between the way that the investment funds co-financed by ERDF and private ones are operated. The co-financed funds invest on terms similar to private funds though they are obliged to obtain finance from private participants like venture capital firms or business angels.

The main complaint from those managing the funds concerns the extent of EU bureaucracy and the regulations which they need comply with, some of which are considered to be inappropriate.

The funds were established in 2009 and have invested in about 70 companies. So far, due to the short time period involved, it is impossible to assess how far they have achieved their goal of speeding up growth in owner-led limited companies at the beginning of their expansion phase.

1. Use of financial engineering instruments

The first co-investment funds, co-financed by the ERDF started as a response to a report from the European Commission in which Sweden was highlighted as one of only four countries that still only used non-refundable grants and subsidies in ERDF programmes. Three pilot co-investment funds, based on a model developed in Scotland, were established in 2005. These pilot funds were closed in 2008 and replaced by a more permanent structure.

Since 2009 Sweden has had twelve regional co-investment funds with nationwide coverage that are run in the form of projects co-financed by the ERDF and the regions. The project period is from January 2009 to December 2014 and the funds have to submit a final report on the use of ERDF support by end-March 2015. The ERDF contribution to the funds is EUR 75 million, which corresponds to 8% of the total ERDF available. In addition to the ERDF contribution different national authorities contribute another EUR 75 million making a total of EUR 150 million available for investment. Five different intermediaries manage the 12 funds. Ten of the funds are governed with the same formal requirements. These funds are public venture capitalists that normally make equity capital investments of around EUR 0.1-1.1 million in SMEs in the start-up and expansion phases. The funds are co-investment funds that operate with private commercial participants on equal terms, which means that the ERDF and the national public agency each contribute 25% of the total funding and private investors 50%. Each fund is only allowed to invest in its own region. Two funds differ in that they operate with loans alongside equity capital.

2. Rationale for using financial engineering instruments

The initial reason for starting to use FEIs was the report from Commission pointing out Sweden as one of four Member States that did not use FEIs. The arguments presented in the Operational Programmes (OP) for the use of FEIs vary. In the OP for Smaland and the Islands a reference is made to a statement from the Commission that FEIs are considered to be more cost efficient than grants.[1] In the OP for North Central Sweden it is argued that there is a need for public venture capital in order to increase the flow of private capital to the region.[2] Otherwise the most common argument used for public co-investment funds is that of market failure. The phrasing of this argument varies between the regions. Some focus on the problem of small businesses to obtain loans from banks, other on the difficulties faced by knowledge-based firms without fixed assets or firms in the very early stage of development. The market failure argument has some support in research. According to some studies there is an imbalance between the finance offered by the market and the demand of companies.[3] SMEs in the start-up and expansion phases are considered to have particular problems satisfying their financial needs.

The problem is worsened by the fact that Sweden has a history of an under-developed equity capital market. Access to venture capital funds and business angels has been limited. However this situation has gradually improved since the 1990s. An assessment undertaken in 2007 concluded that venture capital is developing well in Sweden, though large regional disparities

[1] Tillväxtverket Regionalt strukturfondsprogram för regional konkurrenskraft och sysselsättning i Småland och Öarna, 2007-2013. Stockholm 2011, page 52.
[2] Tillväxtverket Regionalt strukturfondsprogram för regional konkurrenskraft och sysselsättning i norra Mellansverige, 2007-2013. Stockholm 2011
[3] Tillväxtanalys Staten och riskkapitalet. Rapport 2010:01 Stockholm 2010 and S. Avdeitchikova ”On the structure of the informal venture capital market in Sweden: developing investment roles, Venture Capital. An International Journal of Entreprenewurial Finance, 10 (1), 2008, pages 55-85.

exist. Despite the improvements a persistent gap between the demand for equity capital and supply was identified.[4] Due to the very limited micro-financing schemes there is a significant financing gap between demand and supply as regards financing for micro enterprises. The market failures identified appear to exist in both the provision of debt finance to start-up companies and to existing growth companies.

The funds were in operation one year after they were set up. Several factors delayed the start of the funds - difficulties in arranging co-financing agreements, a longer time than planned for recruiting staff, board members and investment committees. Another initial problem was that the funds considered the regulatory framework unclear, which created uncertainty about the interpretation of the rules and delayed the investment process. According to the regulations the administrative cost should not exceed 3% of the capital base of the fund. The relative overall costs of setting up and administer the funds in relation to non-refundable grant schemes has not been assessed and, in any case, grants and equity capital are not considered to be comparable measures. The major purpose of the co-investment funds was to offer SMEs capital adjusted to conditions on the market.

Swedish policy makers are convinced that the lack of venture capital is one important factor that limits the growth of SMEs. In recent years the Swedish government has established a number of public venture capital funds focusing on different industries and geographical areas. The FEIs created an opportunity to follow this strategy by setting up venture capital funds for each NUTS 2 region. One argument for these funds is that as co-investments funds they share the risks with private investors. It seems to be difficult to get private capital to invest in projects financed by grants, making them heavily dependent on public financing and their long-term survival uncertain. The venture capital fund model ensures that the investments are consistent with market forces. In Sweden many national policy makers, based on the results of impact evaluations undertaken, distrust the efficiency of grants as a tool for regional development. The venture capital funds represented an opportunity to test another more market-oriented approach, but there was no discussion comparing the advantages and disadvantages of the two.

From a Swedish perspective, FEIs and grants are complementary rather than competing measures and the choice between them depends on the purpose.

3. The effectiveness of financial engineering instruments: selected examples

In contrast to many private funds that are specialised in technology or a particular line of business, the co-investment funds co-financed by ERDF invest in a broad spectrum of industries. On the other hand, in contrast to private funds, they are not allowed to invest in businesses outside their own region.

A discussion of the differences in objectives and the way they operate between these funds and private investment funds is complicated by the fact that views on these differ.[5] The differences between the operation of co-investment funds and private ones in practice seem to be small. The co-investment funds cooperate with private venture capital firms, business angels or other investors in unlisted companies and they invest on the same terms as their private sector partners. One reason for this is that the funds are revolving, but it is still unclear if they should be profitable or not. Neither the Commission nor the Swedish government has demanded any

4 European Investment Fund JEREMIE, Interim report for Sweden. SME Financing Gap Assessment. 2007
5 Tillväxtverket Start av regionala riskkapitalfonder. Uppdrag och lärdomar. Rapport 0072 Rev B. Stockholm 2010

return on investment. One of the twelve venture capital funds emphasises the need for a return on investment due to the fact that the major Swedish contributor to the fund is a state pension fund with strict yield requirements. The funds are told to operate in way that complements the market, but it's unclear what kind of action this entails. The funds' role is to co-invest with private investors on principles adjusted to the conditions on the market. What this means in practice was unclear at the beginning and a common understanding has gradually been clarified in the implementation process.

In two respects there is a clear difference between these FEIs and private investment funds. The co-investment funds are expected to take notice of some horizontal criteria – the funds impact on and handling of gender equality, social integration and the environment- included in the National Strategy. These horizontal criteria have created some confusion among the fund managers. The lack of clarification about how the funds are expected to deal with them has resulted in each fund developing its own strategy. *Almi Invest*, representing 8 funds, says that they are not looking solely at the return on investment when evaluating investment proposals. They also assess proposals in terms of sustainable development and they cooperate with the Board Academy to increase the number of women on the boards. The investment funds not owned by *Almi Invest* make a purely financial evaluation of the investment proposals. For them the horizontal goals are not considered in the choice of investments. It is only an aspect of relevance in monitoring their activities and is reported in the yearly reports they have to send.

The other major difference between the co-investment funds and private venture capital firms is administrative. The co-investment funds have less money at their disposal than most private funds and all of them except one are obliged to find matching private financing. The exception is an investment fund owned by a state pension fund. The money from this pension fund is considered as belonging to future pensioners and it is therefore classified as a private capital fund, which means that it does not need to find matching external private financing. The fund managers, who are fewer than in most private funds, are employed by the co-investment funds and do not invest money of their own in the fund. The normal situation of private funds is that fund managers are employed in a separate company which is responsible for the management of the fund and that they invest money of their own in the fund and obtain a return on this.

Almi Invest is responsible for 8 funds organised in 7 separate regional venture capital funds. Each fund employs a small team of Investment managers, normally with a background in the business or managing private companies, who have solid knowledge of the local business community. The aim of these funds, which so far have invested in 55 companies, is to invest in companies which:

- are owned and led by committed entrepreneurs,
- are limited companies, which have come through the early establishment phases and are in the expansion phase,
- have a scalable business model and an opportunity for long-term growth,
- are profitable,
- can attract another investment partner willing to invest alongside *Almi Invest,*
- have the qualities to become an attractive acquisition target.

The single most important criterion is that the companies are led by committed entrepreneurs with the drive to achieve exceptional results. These regional investment funds invest money, contribute knowledge and offer access to their networks and expect to have representatives on the board in return. A first-round investment from *Almi Invest* is usually in the range EUR 200,000-450,000. Over the lifetime of an investment in a company they can invest up to around EUR 1.1 million. The overall aim of the investment is to create a high yield in order to be able to sell the shares for a good profit. Up till now they have made in three such sales.

In each separate round of investment, there must be a co-investor investing at least as much as *Almi Invest*. These should be reputable and experienced investors in un-listed companies and have an understanding of, and willingness to work actively for, investments in early-stage companies. The co-investors are also expected to provide relevant industry knowledge and have the capacity to make follow-up investments.

Scania-Blekinge is the only NUTS 2 region without an investment fund managed by *Almi Invest*. Instead, the region has three venture capital funds, *Sydsvensk Entreprenörfond* (SEF) *1+2+3*, which are funds in which *Industrifonden*, a state owned venture capital firm, has replaced *Almi Invest*. The three funds have in practice been merged into one. The ERDF also contributes 50% of the capital in this case and the regions and the state, the other half. It is a revolving fund aimed at stimulating the creation of new firms and the growth of existing ones, increasing employment and strengthening the regional system of innovation in order to improve the competiveness of the region. SEF's task is to invest in SMEs, with less than 250 employees and EUR 50 million in turnover, which have a need for external capital. SEF has so far invested in 9 SMEs of which five are in the life science and medical instruments sector reflecting the importance of the University of Lund in the region.

In *Mid Norrland* there are two venture capital funds co-financed by the ERDF - *Saminvest*, belonging to the *Almi Invest* group and *Mittkapital*. The latter is a venture capital firm, owned by a Swedish state pension fund, with a capital of EUR 22 million, of which 50% is from the ERDF, investing in SMEs in the region. Investments by *Mittkapital* are made on commercial grounds in long-term sustainable growth companies primarily focused on the wood, energy, tourist and food industries. Investments are made in stocks and convertible bonds. Expected time to exit is 3-7 years. *Mittkapital* has up until now invested in 5 SMEs, two in tourism, one in wood and two in other industries, and has not yet exited from any of the firms.

The co-investment funds report each year how many investments they have made and the number of new firms and new jobs created as a result. (The new firms' indicator seems strange since the funds invest primarily in firms already in operation.)

The target of the ERDF co-financed investment funds are limited companies, owned and led by committed entrepreneurs, which have come through the early establishment phase of development and are in the expansion phase. The funds are revolving though it is unclear whether the Swedish government and the Commission expect any return on investment. The funds have invested in about 70 companies and so far, due to the short time period, have exited from only a handful making it impossible to assess how they will succeed in speeding up growth of the selected companies.

4. Main problems in using financial engineering instruments

The main complaints from the managers of co-investment funds concern the EU bureaucracy and regulations, some of which are considered inappropriate. An example is that the co-investment fund can take a seat on the board of a company in which they have invested only if they own less than 20% of the capital. This rule creates problems, especially for the venture capital fund, which does not need matching private capital, while funds normally demand representation on the board in exchange for their investment. In practice, to be able to take a seat only when the fund owns a small share of the capital seems counter- productive for a profit making investor. For an investment fund taking responsibility for its investments, it is more important to have representation on the board the more the fund owns of a company. In order to overcome this problem, they have to contract people they do not employ and place them on the board.

5. Evaluations of financial engineering instruments

As part of the preparation for the creation of the 12 investment funds, the pilot projects, which preceded them, were evaluated.[6] In total the three pilot projects invested EUR 12.6 million together with 49 private co-investors. Most of the firms invested in were micro firms with less than 10 employees. The evaluation concluded that the pilot projects had achieved their aims. They increased the volume of venture capital to SMEs in the regions and they helped to increase the interest of private investors in investing in SMEs because they created an opportunity for them to double the capital going in. They also attracted private investors from other regions to invest in the three regions. The conclusion was that the investment funds had met a demand that the market was not able to meet.

The model used in the pilot projects was considered successful. It corresponded to the real needs and was appreciated by the various stakeholders involved. From the evaluation it also became obvious that regional conditions in terms of the structure of the economy and the number of private investors greatly affect the ability of funds to invest. Knowledge of the region, geographical proximity and close ties to the area are prerequisites for successful investments in small firms in the early phases of development.

The 12 regional co-investment funds launched in 2009 are monitored by an on-going evaluation which has produced a mid-term evaluation report.[7] The purpose of the evaluation is to provide national authorities, the investment funds and other stakeholders with early indications of progress in relation to defined goals and to highlight difficulties of implementation.

The evaluation reported that the composition of the portfolio of venture capital funds largely consisted, as intended, of shares in small firms at early stages of development. Several investment funds reported that interest from companies has exceeded expectations with relatively high quality firms spread across a range of industries applying for capital. The companies receiving funding have used the capital primarily for the development of products and markets and the acquisition of skills and in general consider that the funding received has contributed to faster expansion, more opportunities to obtain other external financing and increased professionalism among directors.

The mid-term evaluation did not produce a final answer to the question of whether the capital market situation has improved as a result of the initiative, although it found indications that it has helped to reduce the equity gap in the companies that have received funding.

[6] Tillväxtverket Utvärdering: Pilotsatsning på regionala investeringsfonder. Stockholm 2011.

[7] Tillväxtverket Halvtidsutvärdering av regionala riskkapitalfonder. Implementering och lärdomar. Rapport 0108. Stockholm 2011. The 'Growth Analysis" agency has been tasked with evaluating FEIs co-financed by the ERDF in Sweden.

6. Concluding remarks

The idea behind the co-investment funds differs radically from most projects financed by grants. The aim is to strengthen the growth capacity of firms. The regional objective is not to change the path of development determined by the market but to speed it up. Projects financed by grants are in many cases aimed at achieving results which differ from what the market would produce, such as increasing the production of renewable energy.

The large interest from companies in different sectors indicates the need for venture capital Funds. The fact that they are co-investment funds that need to attract private capital ensures that investment proposals are subject to professional appraisal. From this point of view, there are strong reasons to believe that the investments made by the funds will have a positive effect on regional growth. However, the relevant question from an evaluation perspective is not whether growth is generated by the funds but what would have happened without the funds. Without the FEIs, other means of filling the financial gap may have been activated. In a situation where all regions have their own venture capital fund this is a counterfactual question impossible to answer. If the policy makers were interested in learning about the impact of the FEIs they should have started with an experiment where the eight NUTS 2 regions were divided into four pairs of comparable regions. A venture capital fund should have been established in one of the regions in each pair with the other region acting as a control. By comparing differences, using a sample of indicators, between regions with a venture capital fund and those without opportunities for a knowledge-based discussion of the impact of FEIs would have been created.

References

Literature

Avdeitchikova S. ”On the structure of the informal venture capital market in Sweden: developing investment roles, Venture Capital. An International Journal of Entreprenewurial Finance, 10 (1), 2008, pages 55-85.

European Investment Fund JEREMIE, Interim report for Sweden. SME Financing Gap Assessment. 2007

Tillväxtanalys Staten och riskkapitalet. Rapport 2010:01 Stockholm 2010

Tillväxtverket Start av regionala riskkapitalfonder. Uppdrag och lärdomar. Rapport 0072 Rev B. Stockholm 2010

Tillväxtverket Regionalt strukturfondsprogram för regional konkurrenskraft och sysselsättning i Småland och Öarna, 2007-2013. Stockholm 2011

Tillväxtverket Regionalt strukturfondsprogram för regional konkurrenskraft och sysselästtning i norra Mellansverige, 2007-2013. Stockholm 2011

Tillväxtverket Utvärdering: Pilotsatsning på regionala investeringsfonder. Stockholm 2011.

Interviews

Per Aspemyr, CEO, Sydsvensk Entreprenörfond

Jan Bengtsson, CEO, Almi Invest

Susanne Olofsson, CEO, MitKapital