European Commission

BACKGROUND DOCUMENT FOR THE WEBINAR ON:

FINANCING HIGH GROWTH ENTERPRISES AND THE SCALE-UP GAP

5TH OCT 2021

0. SUMMARY

The capacity for transforming Europe's innovation and entrepreneurial potential into high growth / high employment-creating firms is constrained by shortcomings in financial markets, particularly regarding large equity financing deals which such firms typically need when they move from the early start-up phases into the crucial later high growth and expansion (scale-up) phases.

Not only is such scale-up financing a smaller proportion of VC in Europe than in the US, in addition, overall VC in Europe is one-sixth of what it is in the US.

The disproportionally low number of European unicorns (start-ups having reached an estimated valuation of >$1 billion) is an indicator of this problem as is the phenomenon of European scale-ups relocating to the US to access adequate financing.

The proposal to the Commissioner by a group of EU Unicorn CEOs to set up, *inter alia*, a €100 billion megafund to fill this financing gap serves as a stimulus to the Commission to look at what it is already doing and planning for the 2021-27 period and to assess the appropriateness/ feasibility of the type of megafund proposed as well as alternatives.

A key issue is the source of financing as there are no readily-available EU resources for a fund of this size. Moreover, any solution should rely on a large leveraging of private investments, but a sizable public contribution would still be needed in particular if the risk levels of the investments are above normal commercial practice.

The European Innovation Council's fund (EIC Fund) is clearly relevant in that it targets initial scale-up financing stages of high-risk deep tech ventures with investments of up to €15 million (which can be part of larger overall investment rounds alongside other co-investors). In principle the EIC Fund could make larger investments (the Horizon Europe legal base does not limit the size of investments). However, this would be difficult with the current budget of the EIC as it would mean a large concentration of the overall annual budget in single companies (countries), except if an additional budget is made available for this initiative (as has been the case for EFSI).

For subsequent stages requiring larger financing volumes, commercial funds (including those supported by InvestEU) are relevant, but only if the risk levels are acceptable.

The EIC Fund and InvestEU instruments invest on equal terms with other investors ("pari passu"). One way of attracting more private investors would be for the EU investment to be on non-equal terms (e.g. accepting more potential losses or less potential gains). A pilot initiative using this approach by DG GROW is presently underway - European Scale-Up Action for Risk Capital (ESCALAR). ESCALAR is inspired by a similar Small Business Investment Company (SBIC) initiative run by the US Small Business Administration for decades. This approach is at the level of funds, not at individual investments, while the EIC Fund provides direct investments.

A workable response to the scale-up gap could draw on EIC and ESCALAR as well as bringing into the picture other Commission initiatives and on-going reflections which have a bearing on this matter, such as the SME IPO fund, aspects of the Capital Markets Union (e.g. possible regulation of special-purpose acquisition companies (SPACs)), as well as considering what would be the most efficient and fit-for-purpose means of implementation (i.e. managed by EIF or an agency like EISMEA, involvement of NPBs, etc.).

Whatever the response, it must be based on the best available scientific, economic and financial knowledge and evidence. In this regard, DGs RTD and JRC, in close consultation with relevant services, and drawing on top level external and internal expertise, undertake to: 1. Better quantify the scale-up financing gap mapping both knowledge as well as gaps in the available instruments/ policy response; 2. Establish what is known about the causes of the gap and its negative economic consequences; and 3. To identify how best to address the gap.

A first workshop involving a range of Commission services, EIB/EIF and representatives of the Unicorns Group which took place in 06 July 2021, included a session which discussed the scale-up megafund idea in the context or existing instruments and other relevant on-going developments.

Next steps include:

1. An initial informal consultation with concerned DGs and EIB/EIF to test and measure level of interest in working on this issue and initiate mapping of scale-up financing knowledge/ policy gaps (Sept 2021). Additional meetings will be held as necessary.
2. A seminar involving the best internal and external expertise and key stakeholders (e.g. EU Unicorns Group) to discuss, test and validate views on different possible solutions (Oct 2021)
3. Reinforcing on-going JRC research in collaboration with external experts and consider a preparatory study/expert group to be financed by the 2022 EIC Work Programme.
4. Providing real-time input to work on a new EU innovation strategy (Summer/ Autumn 2021)
5. Preparing input on the topic for presentation at a French EU Presidency conference early in 2022.

Financing high-growth enterprises

The economic importance of high-growth entreprises (HGEs)[1] comes from their disproportionally high contribution to employment, innovation and growth (Acs, Parsons & Spencer, 2008; Flachenecker, et al., 2020; Shane 2009). Their innovative and often high-tech characteristics make them more likely to suffer from financial constraints (Carpenter and Petersen, 2002). In instances where HGEs do not have verifiable commercial track records, or tangible assets to pledge as collateral, and where uncertainty, information asymmetry and agency problems typify their innovative commercial potential, they rarely qualify for "traditional" bank loans (Berger and Udell, 1998). Professional investors, such as venture capitalists (VCs), private equity managers or professional business angels, have the screening skills to overcome information asymmetries and use well-designed contracts to manage agency conflicts with the firms they invest in (Kaplan, and Strömberg, 2001). However, VCs invest in only a handful of rigorously selected HGEs, often in narrow sectoral niches (Lerner, 2002) and geographical areas (Colombo, D'Adda, and Quas, 2019) and within selective professional and educational networks (Gompers, Mukharlyamov and Xuan, 2016).

Justified by market failures, the provision of finance for promising startups and HGEs is a major focus of government support using a variety of instruments, including accelerators, guarantees, participative loans and governmental venture capital programmes. These instruments mostly focus on start-up and early growth stages. However, the financing needs of HGEs are rarely met by a "one shot deal" and so several funding rounds are needed over time. Research indicates that difficulties in accessing later stage finance is a bigger constraint on growth than access to early-stage finance (Aernoudt, 2017; Hoffman, 2016). With the European VC market lagging far behind the USA and China, both in absolute terms and relative to GDP, the later stage gap is particularly severe in Europe (Aernoudt, 2017). Overall, the relatively small size of the EU VC market is the reason for European Commission's intervention to provide capital to both VC funds and VC funds-of-funds, through its investments arm, the European Investment Fund (EIF).

The scale-up gap

Venture Capital investment in European companies in the EU is about one sixth of the amount it is in the USA (Table 1). Particularly worrying is the funding situation for scale-ups in their growth or later stage phases. Based on 2020 figures, the proportion of total VC in the form of later stage financing is 84% in the US and 71% in the EU (see Table 1).
Other authors using different data sources come to the same conclusion. Duruflé et al. (2017) who analysed the period 2007-2014 using OECD data confirm that the amount and percentage of funding going into later stages is highest in the USA, namely 67% (in 2014), while it was only 44% (2014) in Europe.

1 For Eurostat, HGEs experience employment growth of >10% per annum for at least three years and have at least 10 employees at the start of the growth period. Such HGEs account for between 7 to 11% of business economy firms in EU Member States. Other definitions specify > 20% annual growth in revenue or employment for three years or more. The term 'gazelles' is employed for 20% HGEs that are < 5 years old

Table 1. Amounts of investments by stage (in billions of euro) for EU27, UK, USA and China in 2020
Data source: Dealroom.co[2]

	USA	EU27	UK	China
Seed stage	2.6	1.5	0.7	0.1
Early stage - Series A	16.4	4.6	2.8	3.3
Later Stage - Series B, C, D + later	97.2	14.9	11.2	30.4
Total VC	**116.2**	**21.0**	**14.7**	**33.8**

This lack of scale-up money is one of the reasons – not the only one – why Europe is lagging behind regarding the number of unicorns.

Of the current cohort of 702 unicorns (data June 2021), only 77, or 11% are based in Western Europe (EU + UK). For EU27, the number is 48 representing 6.8% of the total. Based on valuation (data June 2021) the 77 EU+UK Unicorns represent 9.4% of the world value, and the 48 EU27 unicorns represent only 5%. So, the EU is underrepresented in unicorns and the EU-based unicorns have a lower average valuation. The same picture applies to decacorns (companies valuated at > $10 billion): there are 32 decacorns in the World: 15 in US, 8 in China 2 in the UK and 1 in EU-27 (Klarna, a Swedish online bank).

Table 2: Summary of Unicorn figures (Data June 2021)

Jan 2020	US	EU27	UK	China	Rest of the World	World
Unicorns	370	48	29	138	117	702
Value unicorns (in B$)	1,165	118	95	549	328	2,255
New unicorns 2021	127	14	6	3	32	182
Decacorns	15	1	2	8	6	32

Source: Own calculation based on CB Insights

Against this backdrop, the so-called 'EU Unicorns Group'[3] proposed to Commissioner Gabriel in April to set up a €100 billion EU sovereign tech fund and a €10 billion EU sovereign green tech fund. The idea behind these 'mega-funds' is to maximise the extent to which European (deep) technology and innovation-based start-ups with high growth potential can avail of the necessary large amounts of investment capital which they need to grow (typically in the form of equity-based venture capital deals in the several tens of millions to a hundred million euros range). Given that VC deals of such a large size are presently not readily available in Europe as they are in the US, this increases the likelihood of many high potential firms relocating to the US with attendant losses in jobs, knowledge, revenue streams, etc. (Braun et al., 2019).

2 According to Dealroom experts, this data is very representative of European startup and Venture Capital activity. Dealroom captures more European deals than any other provider (L. Rodriguez Bernate, P. Petitcollin, O. Browne, personal communication 19/02/2022)

3 https://unicornsgroup.eu/wp-content/uploads/2021/05/Next-Innovation-EU-FINAL-REPORT.pdf

Current EU-level measures and prospects

There is broad consensus on the funding gap for very large investment deals, highlighted by the EU Unicorns Group. The EU already has a number of policies and instruments to facilitate the funding of SMEs, start-ups and HGEs more generally under many EU programmes (InvestEU, Horizion Europe, etc.). Also, within the Capital Markets Union and the Renewed Sustainable Finance Strategy, measures are being deployed to improve framework conditions for investments in the EU and as such will benefit deep and green tech. From a competition policy point of view, adjustments could be made to the General Block Exemption Regulation (GBER) which is presently under review, to create more favourable conditions for risk finance aid schemes. In addition, the mandated systematic screening of foreign direct investments will permit to flag upfront EU interests in scale-ups. Under the 2020 SME Strategy, a proposed SME IPO Fund aims at simplifying fund-raising to finance the growth of small and high-growth companies, particularly in strategically important sectors.

Note however, that even though funding for seed and early-stage companies in Europe is easier to set up/ more readily available than for late-stage growth, it is not a matter of simply putting more funds into existing instruments. The EIC[4] for example, targets stages prior to scale-up and investments are for the time being capped at €15 million. Legally speaking higher amounts are possible (by removing the limit[5] in the EIC annual work programme) though in practical and budgetary terms it may be challenging as it would require the agreement of Member States (Comitology with EIC Programme Committee). Another limitation is that InvestEU does not allow risk levels as high as those which national promotional bank and institutions in some Member States allow.

European Scale-Up Action for Risk Capital (**ESCALAR**) managed by EIF involves a new innovative investment approach inspired by the US SBA's SBIC scheme in which a flexible quasi-equity instrument is used to catalyse private investment flows to increase the investment capacity of private funds to finance European scale-ups.

Other EU equity instruments supporting the growth of SMEs and start-ups include:

- **Equity Financing for Growth (EFG)**[6] under the COSME programme, targets SMEs in their expansion and growth stages. Through EFG, selected funds – acting as EIF's financial intermediaries – provide VC and mezzanine finance to SMEs operating across borders
- The pan-European venture capital fund-of-funds programme (**VentureEU**), was launched under EFSI, with the support of Horizon 2020 innovFin and COSME, in 2016 to co-invest public resources in a VC Fund-of-Funds (FoFs). The EU provides €410 million of which €200 million are drawn from Horizon2020, €105 million from COSME, and €105 million from the EFSI, and which are supposed to generate €2.1 billion. In turn, this is expected to trigger an estimated €6.5 billion of new investment in innovative start-up and scale-up companies across Europe. These vehicles are traditionally larger than direct VC funds. Hence they could attract institutional investors willing to invest bigger amounts in bigger, high-potential ventures.

[4] The EIC Accelerator, which supports high-risk, high-potential small and medium-sized enterprises and innovators. Beneficiaries receive funding, optional equity and are offered business coaching and mentoring to scale up

[5] This limit is inherited from the EIC pilot under Horizon Europe.

6 EFG is a successor to the High Growth and Innovative SME Facility (GIF), implemented under the Competitiveness and Innovation Framework Programme (CIP) in the period 2007-2013

Still, an EU-level instrument commensurate with the size of the scale-up financing gap for later stage high-risk investment in companies is lacking.

While there is ample consensus on the need to close the financing gap, there are doubts whether a sovereign megafund of the type advocated by the EU Unicorns Group would be an appropriate way to retain EU champions and attract other such internationally-mobile entrepreneurs. A €100 billion EU sovereign tech fund would distort the VC market. It would give rise to an "elephant-in-the-room" situation where a single large public sector dominated fund would dwarf other market players. Such a fund would further increase the share of governmental-backed VC, which in the EU is currently estimated to be in the order of 39%. In addition, there are legal and practical considerations to assure the effective operation of such large fund either by the public hand or in collaboration with private actors.

We believe that firstly, a single mega-fund *per se* will not solve this complex issue, unless it is part of a mix of actions aimed at supporting innovation ecosystems. Also, the Unicorns Group proposal does not specify how the fund would be constituted, nor does it give details on eligibility criteria and other implementation aspects, such as funding rounds. Finally, as pointed out in the present note, a public fund might crowd-out private investments.

Interestingly, in the recently published report from Scale-Up Europe, to which some members of the Unicorns Group contributed, a sovereign megafund is not among the 21 recommendations for scaling European tech. Instead, the report recommends:

- "Increasing the EIF investment capacity to seed 10-15 funds larger than €1bn each, via the creation of a sovereign funding structure leveraging private capital (structures that could include layered funds and/or a mix of equity and debt)"
- "Developing national public banks and EIC/EIF action plans dedicated to deeptech funding, by injecting money into private VC funds"

Therefore, instead of creating a sovereign super-fund *ex novo*, it is worth exploring how current EU initiatives via the EIF and EIC Fund could be adapted to better address the scale-up financing gap, for example by:

- Investing into existing private/VC funds.
- Supporting late-stage investment finance.
- Allowing higher investment amounts, above current caps (e.g. removing the limit of EUR 15 million in the EIC WP).
- Using the existing EIC Fund in (a) specific compartment(s) as a basis for the Sovereign Tech Fund

Rather than increasing further the high share of governmental venture capital, the policy objective should be primary to increase the supply of private (especially late stage) venture capital in Europe. A significant increase of private funds would remove the risk of a possible market distortion and set a better base for a long-term sustained VC industry in Europe. In reality, private money is available in abundance (particularly in times of low interest rates of funds looking for investment opportunities). The challenge is rather to design adequate financial instruments that enable the direction of financial flows, enabling a range of institutional investors (e.g. insurance companies, asset management companies) to provide funds to support growing and scaling companies.

European VCs should consider raising larger funds for follow-on funding and up-scaling. The potential of the EIC Fund and the new ESCALAR instrument is worth exploring in this regard.

A first dedicated discussion of some of the above issues took place in one of the sessions of a workshop on 06 July 2021 with the Unicorns Group organized by DG RTD together with the JRC, DG EAC and EISMEA, in which all the flagship actions proposed in the Unicorns' report "A Lean Canvass for #NextInnovationEU" submitted to the Cabinet in April were discussed. This full day event brought together over 60 participants including sherpas from a number of unicorns[7], as well as representatives from the European Investment Fund, the EIT, and different Commission services (DGs COMP, CNECT, FISMA, GROW, HOME, REGIO) and gave rise to fruitful discussions. The main points retained from the session addressing the proposed sovereign tech funds were:

- A fully publicly-funded fund would not have the catalytic role required to de-risk private investments, and
- Existing instruments, such as the EIF and EIC Fund, could be refined to better increase access to finance for scale-ups, for example, by increasing the ticket size they are able to provide.

[7] Aimotive, Bitpanda, BlaBlaCar, Bolt, Booking.com, Brainly, Cabify, Collibra, FacilityLive, Geneplanet, Gtmhub, Hellas Direct, HMD Global, Hotjar, Immedis, Indigomed, Innovafeed, Iobiotech, Klarna, Mintos, Neuron Soundware, Northvolt, Photoneo, Rimac Automobili, Skeleton Technologies, Spotawheel, Supercell, Twino, UiPath, Vinted, Zalando.

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