DG COMP Workshop

State aid to support SME access to risk capital

11 December 2012

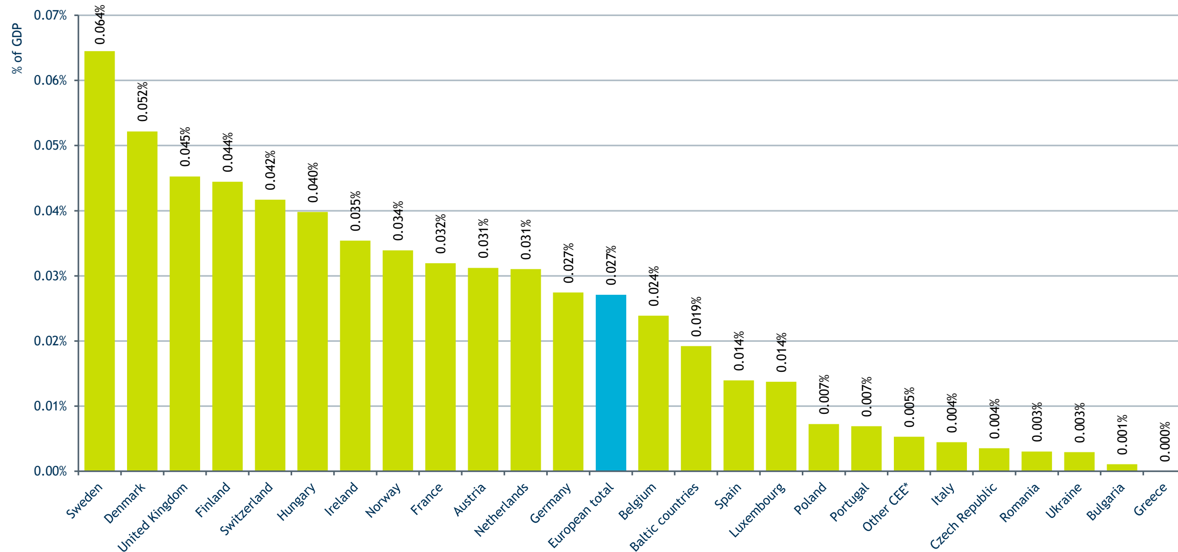
CREATING LASTING VALUE

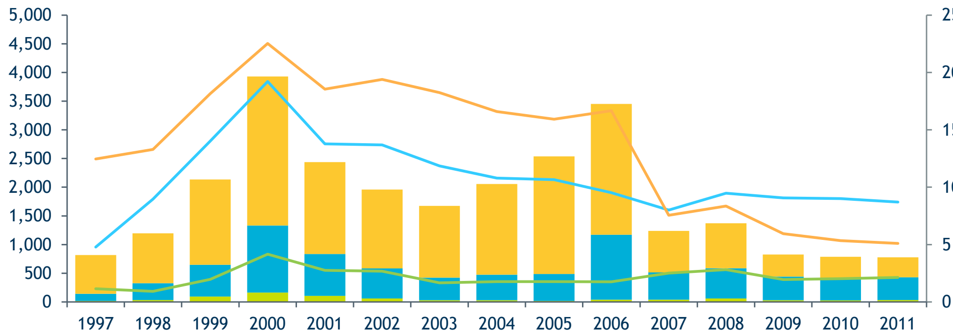
EUROPEAN PRIVATE EQUITY AND
VENTURE CAPITAL ASSOCIATION

Statistics: Venture capital in Europe

Venture Capital as % of GDP (2011)

Source: Thomson Reuters / EVCA (1997-2006) & EVCA / PEREP_Analytics (2007-2011)





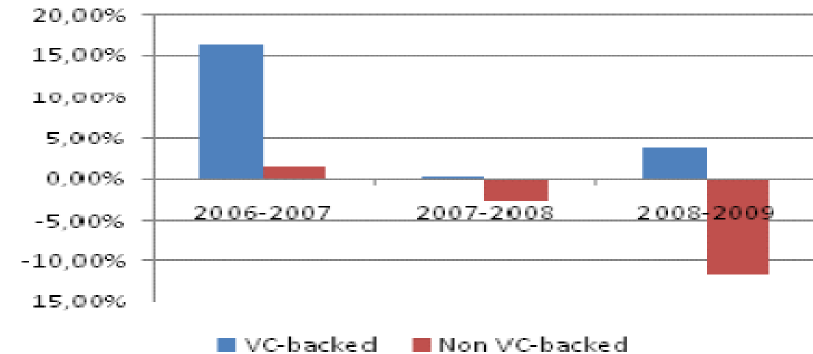
- Every euro invested in early stage VC is statistically associated with 10 euros of GDP growth[1]
- Every euro invested in later stage VC is statistically associated with 3 euros of GDP growth[2]
- Over 45% of venture investment is in high-tech companies[3]

1, 2: Deutsche Bank Research
Venture Capital Adds Economic Spice (14.9.2010):

3: EVCA "A company that has exclusive ownership of certain intellectual property rights such as design rights, patents, copyrights, etc. which are critical elements in adding value to the products and business of a company and which are being developed in-house by the company's permanent staff."

The positive economic impact of venture capital

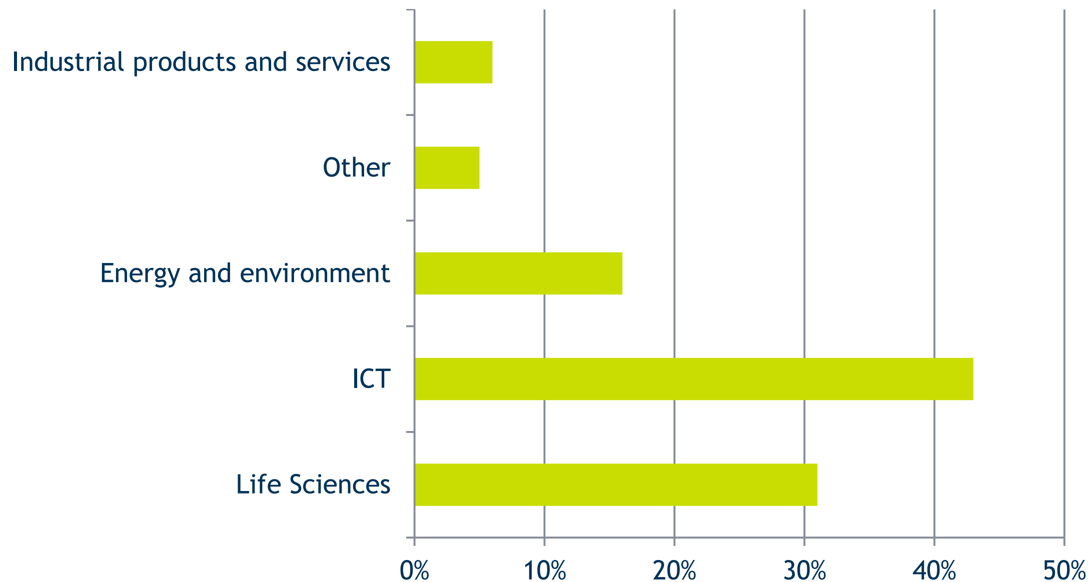
- **VC-backed companies grow at a higher rate – also during economic crises**
- **VCs select companies with more patents**
- **VC-backed companies can raise more equity and debt finance**
- **VC-backed companies receive added value from:**
  - Changing the management team
  - Board members
  - Exit orientation



Source: www.vicoproject.org

- **VC Impact on the Economy** (Source: Deutsche Bank Research)
  - An increase in VC investments of 1‰ of GDP is statistically associated with an increase in real GDP growth of 0.30 percentage points.
  - Early-stage investments have an even bigger impact of 0.96 percentage points

Why is venture capital important in Europe?

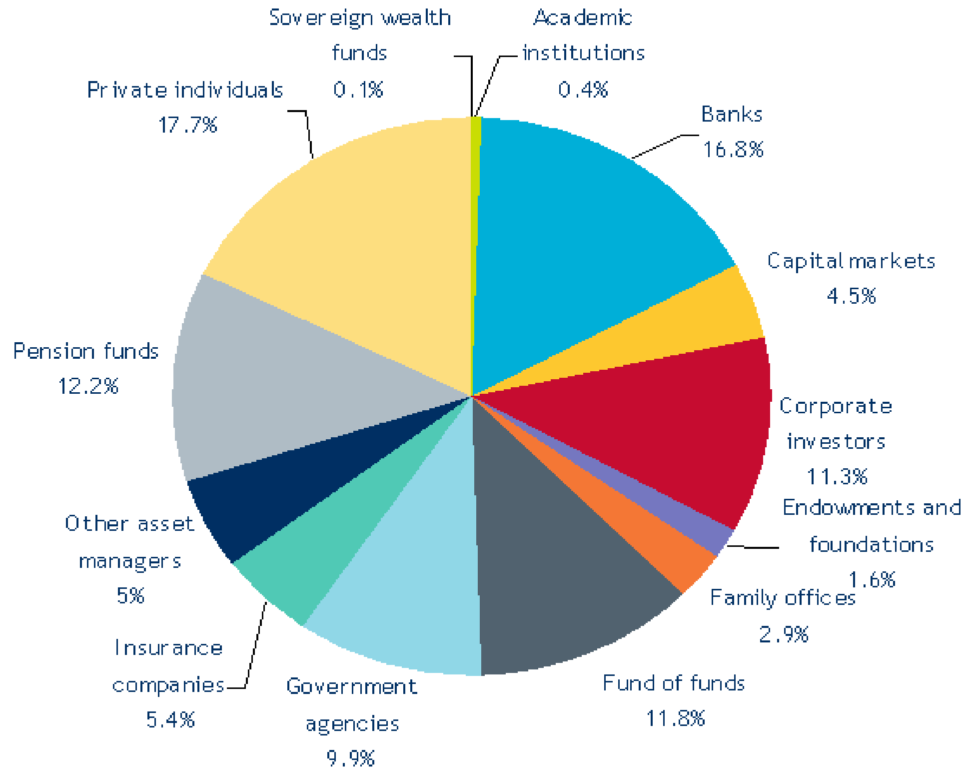


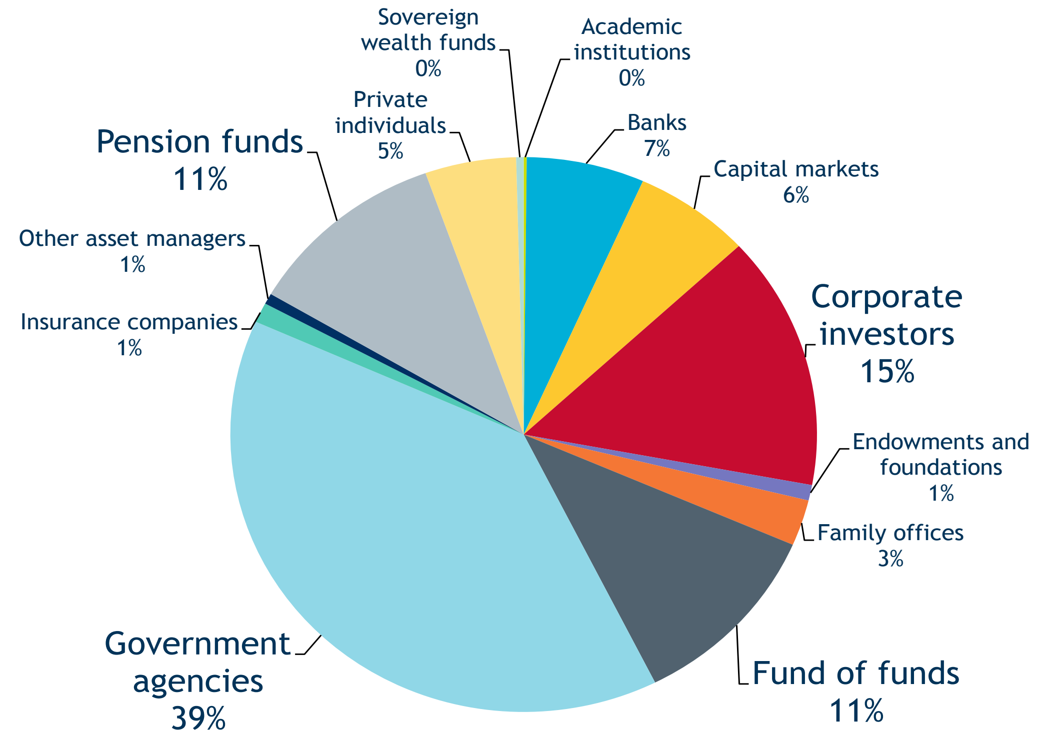
- Since 1975, only three new EU companies have entered the FT Global 500[1]
- This compares with 26 companies from the US of which two-thirds were backed by venture capital at some stage in their development[2]
- To grow these world-class companies, it needs a ready supply of venture capital[3]

1, 2,3: EVCA Briefing, Autumn 2012

Source: EVCA / PEREP Analytics

The investor base of European venture capital





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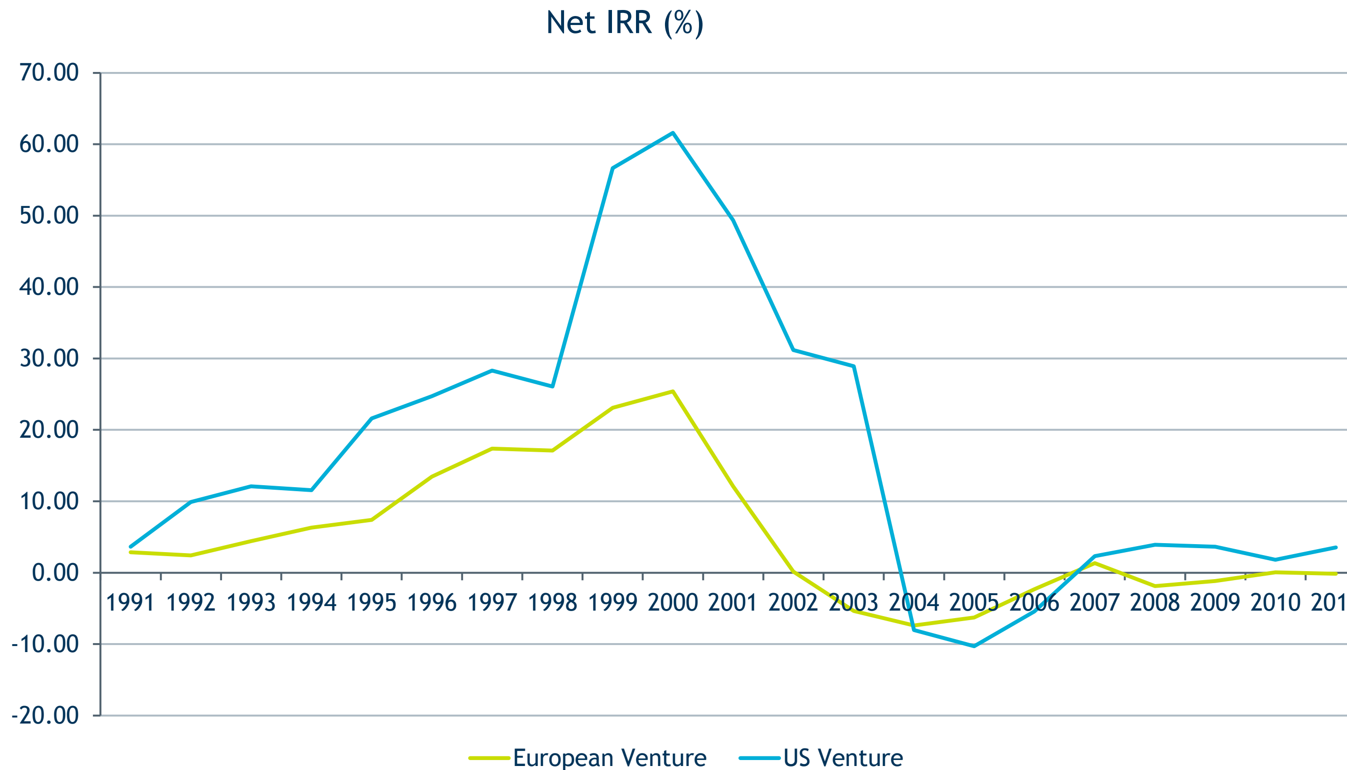
Source: EVCA/PEREP_Analytics

The failure of the EU internal market: Comparison of EU / US returns

Five-year rolling IRRs for US and European Venture Capital



Source: Thomson Reuters

The failure of the EU internal market: Fund raising challenges

- **Macro environment (-)**
  - Fragmentation of the market
  - Flexibility in the financial structure
  - Economic recovery likely to be muted, restricting earnings growth
  - Adjustment of earnings expectations, as in public equity
  - « Credit crunch »
  - No European-wide passport

- **Regulation (-)**
  - AIFMD
  - Solvency II
  - IORP Directive
  - Basel III/CRD IV
  - Dodd-Frank Act

- **New Liquidity Pools (+)**
  - New type of LPs (Corporates, FOs, SWFs, State Funds,….)
  - Emerging markets investors (e.g.: Latin America)

- **Exit perspectives:** the capital market environment for IPOs is weak (-)

- **As acknowledged by the Commission in the explanatory memorandum to the VC Regulation proposal, compared with the United States, the European venture capital industry is fragmented and dispersed.**

EVCA calls for the **simplification and rationalisation** of the Risk Capital Guidelines:

1. Broaden the scope of the block exemption so as to include cases subject to standard scrutiny;

2. Extend the RCG threshold to EUR 6 million, with support for follow-on investments and replacement capital, for all stages, including expansion and growth in non-assisted areas;

3. In any case, the definition of start-up capital should also be improved and made more coherent;

4. Facilitate the use of non-pari passu structures and Funds-of-funds.

These changes would help attract more private investors, address the equity gap and remedy information asymmetries.

Broaden the scope of the block exemption

- Currently, there is a limited use of the General Block Exemption Regulation (GBER): The scope of the GBER only covers the constitution of investment funds in which the State is a partner, investor or participant.

- No investment by funds without first fund raising. **Venture capital is a chain**:
  - Investors -> funds -> SMEs

- Therefore, State aid must:
  - Facilitate Investment from funds into SMEs (downstream), and
  - Contribute to attract private investors into venture capital funds (upstream).

- Given the experience gained, EVCA would suggest an extension of the scope of the GBER, so as to include additional measures which fall under the standard scrutiny.

Extend the RCG threshold to EUR 6 million (1/2)

- The 2,5 million threshold is **counterproductive and insufficient** to cover the needs of companies:
  - The actual equity gap is not rigidly fixed at EUR 2,5 million. It is much higher: up to EUR 10 mil. in capital-intensive sectors.
  - Studies show that in the UK, there is a lack of large deals (above €3,5 million) in comparison with the US VC market. On such deals, the UK only enjoys 20% as much venture investment as compared with the US.
  - The EUR 2,5 million creates a pressure on the size of investments (limit to success). In the words of Google's executive chairman: "***The UK does a great job of backing small firms and cottage industries, but there's little point in getting a thousand seeds to sprout if they're then left to wither or get transplanted overseas***."

Extend the RCG threshold to EUR 6 million (2/2)

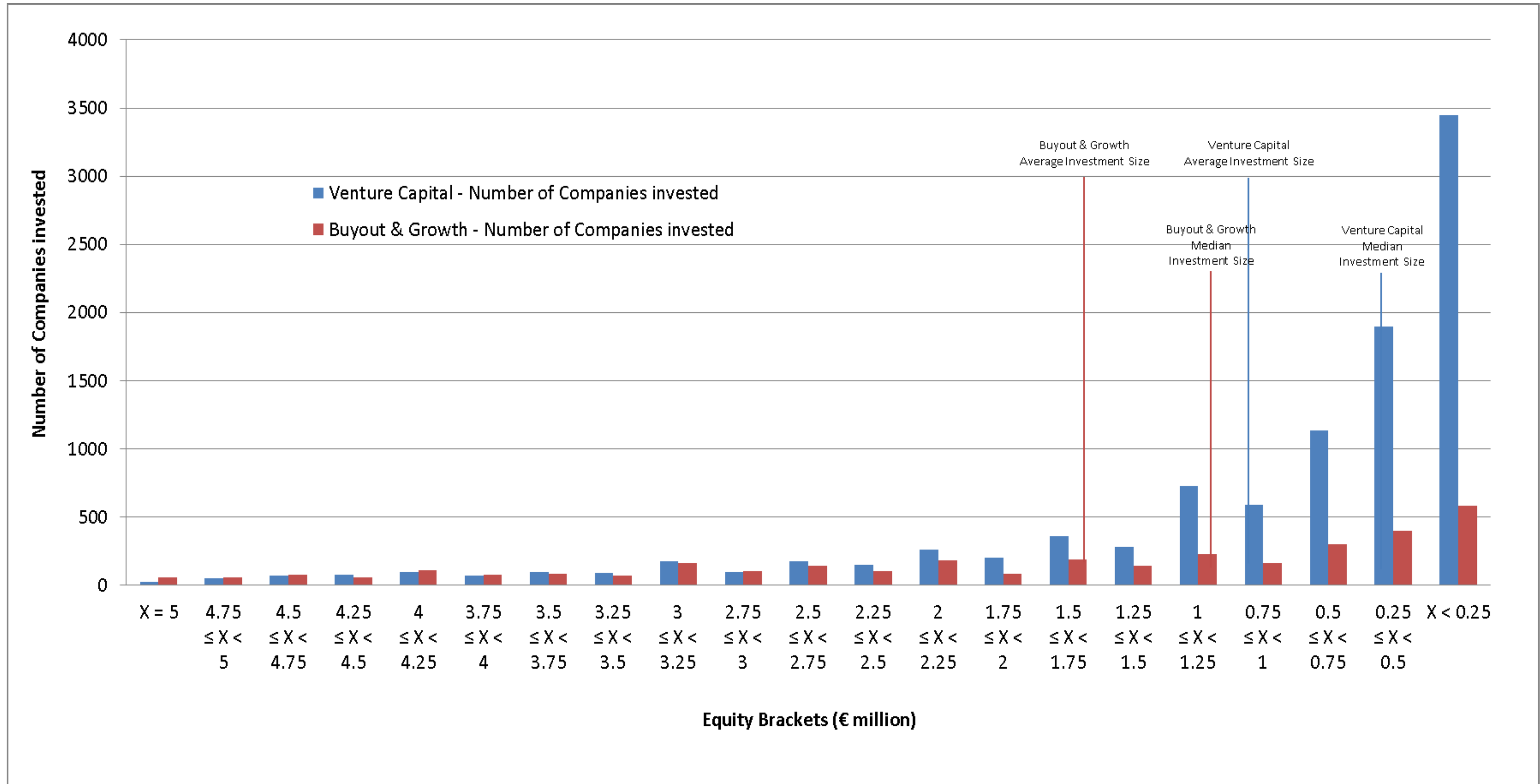
- **Success takes time**: a company may remain a start-up for several years before being successful.

- A higher threshold is needed for **tax schemes to effectively attract investors** to projects with a low aid content.

- **Frequency of investments**: companies in capital intensive sectors require significant investments in the year the company starts, whereas other need rather smaller recurring investments.

- Raising the threshold would decrease the **risk of dilution** for investors in case of follow-on investments hitting the EUR 2,5 million ceiling.

European equity gap or equity cliff ?



Improve the definition of start-up capital

- The start-up phase, as currently defined, ends at the first commercial sale where no profit is yet generated.

- This potentially discriminates between companies depending on the sector in which they are active.
  - For instance, from its creation, an Internet company will be able to engage in commercial sale and make profits, which would exclude it from the start-up phase; whereas biotech companies may not do so for years.

- The definition of start-up capital / stage should be made more coherent and more flexible, to ensure that such a discrimination does not deprive SMEs from access to risk capital measures.

Facilitate the use of non-pari passu structures and Funds-of-Funds

- Non-pari passu structures could be used to address both the structural and the conjectural issues which affect fundraising in the venture capital industry.
- Importance of VC FoFs: 10% (average for the 2007-2011 period)
- Venture capital investors can not reduce the cost of their equity investment by mixing it with cheaper bank financing.
- This increases the risk to venture capital investors and reduces the equity return. This means VC firms need a higher return in order to be competitive and attractive.
- Funds-of-funds could be structured to level the playing field. There should be a provision allowing the public sector to invest on a **non-pari passu basis** but so as to **enhance returns** (no downside protection).