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Financing Innovation and SMEs

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FINANCING INNOVATION AND SMES

EXECUTIVE SUMMARY

This Staff Working Document looks at the challenges of financing innovation and SMEs and assesses Commission action and policies addressing these challenges in the period 2005-2009.

Financing innovation requires a funding system that sustains entrepreneurship and drives job creation. Venture capital is an important part of such a framework, but not the only one, as it finances only a very small fraction of businesses. In fact the most common form of external financing to start a business remains bank financing. A well performing financing system provides both types (risk capital and bank financing) and would also include an efficient loan guarantee system to complement bank lending.

The financial market crisis and the ensuing economic recession have seen many banks reduce their lending to SMEs to repair their impaired balance sheets. Debt financing has become more expensive and difficult to obtain. Risk capital financing provided by business angels and venture capital funds has dropped. The availability of mezzanine financing for SMEs has suffered, in many cases, due to its heavy reliance on securitisation. Deteriorating financing conditions can potentially lead to a cut in innovation spending. The actions by EU institutions have mitigated the effects of the financial crisis. This is expected to have a stabilising effect on innovation spending. However further measures need to be considered to limit any long-term negative effects.

The full impact of the financial market crisis on innovation financing depends on several factors. A fundamental issue is the speed at which confidence in the global financial system is restored. This means the speed at which financial institutions resume normal lending activities and equity investors return to the venture market. These developments depend on further action taken by governments and the banking sector to improve banks' equity positions. It is also subject to equity investors increasing their risk appetite. The current economic uncertainty however has put investors and financiers on the defensive. Many angel investors and venture capital funds are shunning new investments and are attending to their current portfolio of companies. This attitude may change only once the economic horizon brightens up.

The European Economic Recovery Plan has aimed to address this situation and mandated EIB to provide €30 billion for lending to SMEs in the 2008-2011 period, of which €15 billion can be spent in 2008-2009. In addition, as part of the Recovery Plan, EIB has earmarked €1 billion for mezzanine financing and given the mandate to EIF to implement the action. Furthermore, EIB aims to mobilise up to €50 billion over the current decade for innovation under the Innovation 2010 Initiative.

The Commission will use the Financial Instruments of the Competitiveness and Innovation Framework Programme (CIP) to improve SMEs' access to guarantees and venture capital. The interim evaluation of the Financial Instruments of the Entrepreneurship and Innovation Programme (EIP) has stressed their effectiveness in addressing a market gap, but there is scope to consider streamlining the decision-making process regarding applications from financial intermediaries in Member States.

The JEREMIE joint initiative of the Commission with EIB and EIF allows Member States to use part of their Structural Funds allocation for the period 2007-2013 to improve access to finance for SMEs. The objective is to stimulate new business creation, innovation activities and investments by SMEs. Furthermore, the Commission and EIB are jointly running the "Risk-sharing Finance Facility" to

increase lending to firms doing research. Ensuring coordination and synergies between these programmes will be crucial for their success.

European venture capital markets remain fragmented and underperforming compared to US. There are bottlenecks at both ends: a continually underfunded early-stage segment and a difficult exit market. The weak performance of the sector and the current challenging exit environment is already affecting fund-raising and investment volumes. This calls for measures to transform the European venture and business angels' landscape in order to ensure adequate funds for innovation in the future.

There is a need to generally revitalise the financing environment for innovation and small businesses and thereby give EU guarantee systems a more pronounced role to balance financial risks. Guarantees play a crucial role in facilitating access to financing for SMEs. By sharing the risk with lenders, they help address the problems of information asymmetry and the lack of adequate collateral often associated with new projects and SMEs. In the current economic environment their counter-cyclical feature is especially useful in helping to maintain the flow of credit to SMEs. Future actions have to be based on an intensified cooperation between the Commission, the European Investment Bank Group and concerned institutions in Member States.

Technology transfer plays a crucial role in the commercialisation of ideas. Measures should aim to network entrepreneurs, investors and the public sector (policy-makers, universities and research institutions) around technology transfer efforts. The involvement of investors at an early stage can make it easier subsequently for the entrepreneur to raise finance as there will be a greater familiarity with the project concerned.

To increase the chances of matching available funding and innovative entrepreneurs, it is important to stimulate the demand side of funding through policies targeted at investment readiness training. Entrepreneurs need to be able to present their projects in ways that respond to the concerns of investors if they want to attract investment. The Member States and the Commission should continue to facilitate networking and the exchange of best practices in the field.

1. EARLY-STAGE

1.1. Introduction

Financing innovation and small businesses requires a funding system that sustains entrepreneurship and drives job creation. Venture capital is an important part of such a framework, but not the only one, as it finances only a very small fraction of businesses.¹ It will remain the preserve of companies that have the potential to grow into large firms and provide investors with adequate returns.

A Eurobarometer Survey of 2005 shows that 79% of small- and medium-sized enterprises (SMEs) use bank loans to finance their operations, while only 2% use venture capital.² In fact the most common form of external financing to start a business remains bank financing. Clearly, a well performing financing system provides both types (risk capital and bank financing) and would include an efficient loan guarantee system to complement bank lending.

Young innovative companies play a crucial role in bringing new technologies to the market in sectors such as biotechnology and information technology. They account for a large part of European innovation and growth. Since innovation involves risk, this has to be reflected in the potential rewards for financiers. Venture capital is the most appropriate form of financing innovation, as it can provide investors with the potential profits that they deem are required to assume the risks involved. In an economic recession it is generally more difficult to find the appropriate financing as lenders and investors reassess potential risks. In particular, venture capital is a cyclical form of financing and can suffer in an economic downturn. A recent study mandated by the Commission shows that venture capital has the longest cyclicity of the various forms of SME financing.³

1.2. The challenges in early-stage financing

Although considerable progress has been made over the last ten years, **European venture capital markets are still functioning below their potential**. This reflects long-standing market failure in early-stage equity finance due to problems, both in the supply of, and in the demand for, risk capital. As a result, potential innovations are not being fully exploited: Europe is losing out on jobs and growth. Very few European early stage companies exploiting innovative technologies have grown into world-class companies.⁴

The venture capital market in Europe seems to suffer from an ‘equity gap’ in early-stage financing.⁵ There is a persistent lack of business angels and other seed investors. Venture capital funds are

¹ A glossary of terms used is annexed:

<http://ec.europa.eu/enterprise/entrepreneurship/financing/glossary.htm>

² “SME access to finance”, Flash Euro Barometer 174, European Commission, 2005.

³ Cyclicity of SME Finance, 23 March 2009, European Commission.

http://ec.europa.eu/enterprise/newsroom/cf/itemlongdetail.cfm?item_id=3157&tpa_id=127&lang=en

⁴ “Investing for Growth and Competitiveness in Europe”, Conference Report on the Risk Capital Summit 2005, European Commission, 2006.

http://ec.europa.eu/enterprise/newsroom/cf/document.cfm?action=display&doc_id=1199&userservice_id=1&request.id=0

⁵ Handbook of Research on Venture Capital, Edited by Hans Landström, 2007.

concentrating on larger deals, often leaving the small and risky early-stage deals aside.⁶ In addition European venture capital funds are not comfortable with cross-border investments given that fund structuring across multiple borders becomes increasingly complex. As a result smaller funds cannot specialise and tend to avoid operating outside their home jurisdictions.

Corporate venturing provides an alternative to more traditional methods of growing a company. It can be defined as a larger company taking a direct minority stake in a smaller, unquoted company for strategic and financial reasons. Corporate venturing can provide not only additional venture capital funds to those deployed by independent venture capital funds, but also help small companies with technology and knowledge transfer as well as marketing and distribution channels. Corporate venturing is well established as a growth strategy in US, but is less widely used in Europe even though there are examples of tax incentive schemes in Europe, which aim to encourage corporate venturing involving equity investment.

The lack of **seed investors** is partly due to low returns that make early-stage investments unattractive. Figures for the year 2008 highlight the underperformance of venture capital against other forms of private equity, such as growth capital and buy-outs. The statistics show that early-stage venture capital investments in Europe, since inception, have suffered 1.3% average annual fall, while returns from later-stage venture capital were better at plus 7.4%. Overall pooled venture capital returns of 3.0% were dwarfed by the 13.0% that buy-outs achieved.⁷

In addition to the gap in investment returns between the various investment stages, there also seems to be a considerable difference in venture capital performance between the EU and US. The 10-year return on overall venture capital investments was 0.2% in Europe compared with 15.5% in US.⁸

Private equity and venture capital are a global business and there is intense competition for investment funds worldwide. The above mentioned rates of return cannot generate the levels of private investment that Europe needs. The failure to develop seed and start-up investments in particular prevents new enterprises from reaching a size where they can attract expansion capital.⁹

To better leverage private sector early-stage finance, some countries have already used or are considering more flexible arrangements than *pari-passu*, as regards investment criteria and profit-sharing.¹⁰ The advantage of such arrangements is that private risk capital is more incentivised to co-invest with the public sector and fund-raising could also be easier. In the current economic environment where investors are avoiding risky asset classes and long lock-in periods this approach could be attractive for private investors. This approach, however, would be at odds with the concept where financial rewards are distributed to investors according to the risk taken. Furthermore, it potentially raises State Aid issues and therefore needs to be looked at carefully. The Commission services will study in detail the implications of such arrangements in the future in consultation with stakeholders.

Business angels are in many cases the only active private seed investors. The visibility of business angel financing has increased over the past years as more and more angels have joined networks that facilitate the matching of angels and entrepreneurs and provide opportunities for syndicated investment. Many Member States have recognised the importance of angels in the seed and early

⁶ “J Curve Exposure – Managing a Portfolio of Venture Capital and Private Equity Funds”, P.-Y. Mathonet & T. Meyer, 2007.

⁷ Final figures for 2008, 17 June 2009, EVCA.
http://www.evca.eu/uploadedFiles/News1/News_Items/2009-06-17-PR_final_perf_data.pdf

⁸ European and US figures up to December 2008. 17 June 2009 EVCA and 27 April NVCA.

⁹ “Financing SME Growth – Adding European Value”, Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions, COM (2006) 349, 29 June 2006.
http://ec.europa.eu/enterprise/newsroom/cf/document.cfm?action=display&doc_id=1181&userservice_id=1&request_id=0

¹⁰ For example the YOZMA programme in Israel, but also there are examples in Ireland, UK and Finland.

stages and have introduced tax incentives for capital gains or started programmes to enhance cooperation between angels and other investors.¹¹ Nonetheless, more needs to be done. A modest increase in informal investment activity is likely to have a much larger impact than an equivalent increase in institutional venture capital given business angels' predominant focus on early-stage investments.¹²

There is a need to increase the pool of business angel finance in Europe which is much smaller than in US. An estimated €20 billion were invested by business angels in US in 2007, while in Europe the figure is estimated at €3-5 billion.¹³ The financial and economic crisis has had a negative impact on the availability of business angel finance in Europe. Many business angels have seen their wealth reduced by the stock market crash and the fall in property prices.¹⁴ They consequently have now less available for investment in young innovative companies. Nonetheless, the above figures suggest that Europe could harness better the pool of equity capital of informal investors. There are good practices available in Europe that aim to use better business angels' capital and contacts. The Commission will facilitate the exchange of such practices.

Technology transfer plays a crucial role in the **commercialisation of ideas**. Europe has a strong science and technology base, but could perform better in commercialising research results. Academic institutions often lack the necessary incentives and management skills to launch spin-outs. The working relationship between entrepreneurs, investors and the public sector (policy-makers, universities and research institutions) is not yet sufficiently developed. The substantially lower early-stage investment figures in Europe - compared to US - confirm this.

Another indication may be the relatively low number of registered patents in Europe. For example, US surpass the EU both in the number of patent grants as well as in the number of patents in force.¹⁵ Yet clarity concerning intellectual property rights is one of the key issues for equity investors during the due diligence process.¹⁶ The Commission will continue in its efforts to facilitate technology transfer in Europe and strengthen ties between key public and private sector stakeholders.

When looking at the financing of innovative SMEs, the supply of funds has often been the subject of analysis and policy work. However to increase the chances of innovative entrepreneurs finding financing, it is crucial to stimulate the **demand side** of the risk capital market. Many entrepreneurs simply lack adequate knowledge of the nature and motives of venture capital and the interests of investors. Entrepreneurs need to be able to present their projects in ways that respond to the concerns of investors if they want to attract investment.

Investment readiness programmes can help SMEs develop in a number of areas by helping with preparing a business plan, explaining the sources of financing, understanding investors' requirements, ensuring that the right management skills are available, and improving the quality of presentations to convince investors. This is particularly relevant given the typical high rejection rate of investment proposals by venture capital funds.

¹¹ "Best Practices of Public Support for Early-Stage Equity Finance", Final Report of the Expert Group, European Commission, September 2005.

¹² "Venture capital and government policy", G. C. Murray, Handbook of Research on Venture Capital, Edited by Hans Landström, 2007.

¹³ Source of data: European Business Angel Network, ACA and Centre for Venture Research.

¹⁴ EBAN Press Release, 6 February 2009.

¹⁵ World Patent Report, World Intellectual Property Organisation, 2008.

¹⁵ http://www.wipo.int/export/sites/www/ipstats/en/statistics/patents/pdf/wipo_pub_931.pdf

¹⁶ "Best Practices of Public Support for Early-Stage Equity Finance", Final Report of the Expert Group, European Commission, September 2005.

1.3. Commission actions in 2005-2009 in support of early-stage financing

The **broad-based innovation strategy** for the European Union has identified innovation finance as one area where further efforts were needed.¹⁷ To meet this challenge and reduce the early stage finance gap in Europe, in the period 2001-2006 the Commission deployed the **Financial Instruments of the Multiannual Programme** (MAP) (2001-2006). The European Technology Facility (ETF Start-up) under the MAP provided venture capital funds through financial intermediaries to high growth and innovative companies in Europe. The venture capital funds have addressed a market gap in the field of access to early stage capital. The Seed Capital Action under the MAP provided grants to venture capital funds investing in seed capital for the long-term recruitment of investment managers, in order to reinforce the capacity of the venture capital industry to cater for investments in seed capital.

For the period 2007-2013, the High Growth and Innovative SME Facility (GIF) under the **Competitiveness and Innovation Framework Programme** (CIP) (2007-2013) will assist in addressing the early-stage equity gap in Europe as well as provide funds for expansion phase venture capital investment. The instruments also support the take-up of environmental technologies, in particular through a higher investment rate in risk capital funds that provide equity for firms investing in eco-innovation. Additional flexibility is offered by supporting side funds linked to business angels. The interim evaluation of the Entrepreneurship and Innovation Programme noted that the venture capital instruments are responding to a strong market failure experienced by start-up and innovative companies and are designed to promote good practice among financial intermediaries. The EU funds managed by the EIF on behalf of the Commission amount to approximately half a billion euros.

These instruments are complemented in some countries by the JEREMIE joint initiative of the Commission with EIB and EIF. This initiative allows Member States to use part of their Structural Funds allocation for the period 2007-2013 to improve access to finance for SMEs. JEREMIE makes available equity, loans, guarantees or their combination to SMEs. The objective is to stimulate new business creation, innovation activities and investments by SMEs.

The **Seventh Research Framework Programme** (2007-2013) supports key areas of research increasing Europe's potential for innovation and competitiveness. Within its budget €1.3 billion is earmarked for innovative actions to outsource SMEs' R&D. Public funding worth €0.4 billion is available for the Eurostars Joint Programme, which supports SMEs performing R&D. Of the €0.4 billion amount, the Community contribution will total a maximum of €0.1bn, the rest coming from participating countries. The Risk Sharing Finance Facility provides additional volume and more risk-taking capacity for Community lending for research, development and innovation investment. Until the second quarter of 2009, the funding share of SME participants in the grant agreements of the Seventh Research Framework Programme was 12.3%.¹⁸ Ensuring coordination and synergies between these programmes will be crucial to achieve maximum benefit.

To establish an international basis for comparison, the Commission had an expert group with the US Department of Commerce to look at various aspects of venture capital financing.¹⁹ Under the presidency of the United Kingdom, the **Risk Capital Summit** in 2005 discussed how risk capital could support Europe as a leader in innovation.²⁰ Under the Portuguese presidency in 2007, the **Estoril**

¹⁷ 2769th Council meeting, Competitiveness (Internal Market, Industry and Research), Press Release, Council of the European Union, 4 December 2006.

¹⁸ 3rd Progress Report on SMEs in the 7th R&D Framework Programme, European Commission, June 2009.

¹⁹ European Commission – US Department of Commerce Working Group on Venture Capital, Final Report, 2005. http://ec.europa.eu/enterprise/newsroom/af/document.cfm?action=display&doc_id=1201&userservice_id=1&request.id=0

²⁰ "Investing for Growth and Competitiveness in Europe", Conference Report on the Risk Capital Summit 2005, European Commission, 2006.

Declaration set out the principles for successful innovation financing.²¹ With the Member States, the Commission made in 2005 an inventory of policy instruments addressing the early-stage funding gap and identified criteria for good practice.²²

Furthermore, the Commission has discussed with private and public sector experts how the **commercialisation of research results** could be improved in Europe through more efficient technology transfer, better intellectual property rights management and enhanced investment readiness.²³ The results were presented to policy-makers to facilitate policy learning and the exchange of good practices. The Commission has improved awareness of investment readiness by funding several pilot programmes (Gate2Growth, EASY, Ready4Equity). A specific project under the Sixth Framework Programme has analysed investment schemes in the field of environmental technologies with a focus on SMEs' needs (FUNDETEC).

The Commission-financed initiatives **Europe INNOVA** and **Pro-Inno Europe** have contributed to enhanced cooperation among stakeholders in the innovation process such as innovation agencies and platforms²⁴, technology transfer offices, business incubators, early-stage financiers²⁵ and cluster organisations. In addition, to strengthen evidence-based policy making in the SME finance field, the European **Enterprise Finance Index** has been set up, which provides periodically updated figures on the development of the SME finance market in the Member States and at European level.²⁶

1.4. Addressing the remaining challenges

The Council Conclusions of December 2006 regarding a broad-based innovation strategy in the EU singled out innovation finance as one area where further efforts were needed.²⁷ This point was further stressed by the Commission Communication on “Removing obstacles to cross-border investments by venture capital funds” in 2007 and the Council Conclusions of 2008.²⁸ Both supply and demand sides of the risk capital market need to be addressed.

²¹ The Estoril Declaration, “Principles and good practice policies on financing the innovation value chain”, October 2007:

http://www.eu2007.pt/ue/ven/noticias_documentos/20071012declarationestoril.htm

²² “Financing SME Growth – Adding European Value”, Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions, COM (2006) 349, 29 June 2006.

²³ Financing innovation and SMEs: sowing the seeds. Main findings of four workshops, March 2007.

http://ec.europa.eu/enterprise/newsroom/cf/document.cfm?action=display&doc_id=1156&userservice_id=1&request_id=0

²⁴ For example the VALOR project. The project coordinates key stakeholders in innovation policy to develop an action plan for the exploitation of knowledge and research results across Europe.

<http://www.proinno-europe.eu/index.cfm?fuseaction=page.display&topicID=74&parentID=74#>

²⁵ For example the EASY project (Early Stage Investors Action for Growth of Innovating Businesses). The project looked at both the supply side and the demand side of equity investment.

<http://www.earlystageinvestors.org>

²⁶ The Enterprise Finance Index can be accessed at

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

²⁷ Council Conclusions on a Broad-Based Innovation Strategy: Strategic Priorities for Innovation Action at EU Level, 4 December 2006.

http://www.eu2006.fi/news_and_documents/conclusions/vko49/en_GB/1165252699841/files/76366008377934671/default/91989.pdf

²⁸ Council Conclusions: A Fresh Impetus for Competitiveness and Innovation of the European Economy, 3 June 2008. <http://register.consilium.europa.eu/pdf/en/08/st10/st10174.en08.pdf>

Venture capital

The financial market and economic crises have had a negative impact on the pool of equity investors. Risk awareness has increased and there could be less equity funding available in the coming years for innovative and high-growth SMEs.

In view of the lack of interest in the Capacity Building Scheme of the CIP Financial Instruments, the Commission is reallocating the funds originally earmarked for this initiative to venture capital support. Expected demand for the venture capital instruments suggests that the market would make better use of these funds. The resources would be in particular destined for investments in funds with a focus on eco-innovation.

Business angels

One of the key elements is to tap more and better business angel financing for early stage companies.

Some Member States have introduced tax incentives for capital gains to increase the pool of potential business angel investors. Good practices in this field should be considered by Member States which have not yet introduced such schemes.

Another option would be to boost public early stage resources through co-investment with business angels. Based on the public-private partnerships between the public sector and venture capital funds, similar models should be devised to harness business angel financing. The size of these co-funds should be such that it should preferably attract institutional venture capital, too. Such investment arrangements exist at European level through the Financial Instruments of CIP.

Member States should actively support contacts between business angels and entrepreneurs to stimulate financing towards innovative SMEs. This could take place, for example, through organising regular presentation forums of business projects. Such events inform about equity finance, raise awareness of angel investors and stimulate demand.

At the same time, Member States should support the efforts of business angel networks to professionalise their operations. Professionally managed business angel networks are in a better position to increase co-investment with venture capital funds. The Commission should continue to provide a forum for the exchange of good practices regarding business angel activity.

The commercialisation of research results

The economic performance of Europe depends to a large extent on how swiftly ideas can be brought to market. Capitalising better on a strong academic research base is one of the remaining challenges for Europe.

The Commission will strengthen funding available for the financing of technology transfer in the CIP Financial Instruments. This would be complemented by developing appropriate links with the European Institute of Innovation and Technology and the Knowledge and Innovation Communities structure. Links between the Framework Programme and CIP actions will be strengthened to facilitate the market take-up of research results, in particular in the field of eco-innovation.

Public sector policy should aim to network entrepreneurs, investors and the public sector (policy-makers, universities and research institutions) around technology transfer efforts. Investors should have a much greater influence on funding decisions made by public programmes. The involvement of investors at an early stage can make it easier subsequently for the entrepreneur to raise finance as there will be a greater familiarity with the project concerned.

Policy makers need to devise more effective systems of evaluation for the use of public resources in early stage financing. The success of a technology transfer finance programme should be evaluated on

how successful the supported projects eventually were in turning a research result into a marketable product. The Commission encourages Member States to develop effective monitoring and evaluation systems to help programme design and implementation and can provide a forum for Member States to share such knowledge. Experience has shown that licensing of product ideas sometimes is a more adequate alternative than starting a new enterprise on the basis of such an idea.

Investment readiness

To increase the availability of early stage finance in Europe the demand for such investments needs to be stimulated. Entrepreneurs seeking innovation finance need to be informed about the motives and interest of risk capital investors. Their projects and proposals need to become investment ready as demonstrated by the results of projects like EASY or Ready4Equity²⁹.

²⁹ The project aimed to identify and address the key issues impeding business angel activity across the European business community. <http://www.readyforequity.eu/>

2. GROWTH PHASE

2.1. The challenges of financing growth

Despite years of efforts, the venture capital sector cannot yet benefit fully from the single market, and its fragmentation and heterogeneity contribute to a low performance that does not attract enough private investment. At present there are divergent national approaches across Member States, which adversely affect both **cross-border fundraising and investing**. Operating across borders is complex and costly. Smaller venture capital funds cannot specialise and tend to avoid investing outside their home jurisdictions. Especially in smaller countries and in those with emerging venture capital markets, venture capital funds have difficulties in expanding and getting a critical mass of deals.³⁰ In addition, the business angel market has not developed as expected.

The **Capital Requirements Directive (CRD)**, implementing Basel II in the EU, has now a crucial bearing on how credit decisions are taken. It has increased the use of rating procedures and credit scoring systems by banks thereby affecting the bank-SME relationship. To ensure a good rating, it is essential for SMEs to be aware of the factors that influence the rating decision. If SMEs can improve the quality of information they supply to banks, they may obtain better credit terms.³¹ The current review of the CRD aims to address the weaknesses identified in the legislation. For SMEs, increased transparency and a constructive dialogue with their banks will remain crucial to ensure the continued flow of credit.

The financial market crisis and the ensuing economic recession have seen many banks reduce their lending to SMEs to repair their impaired balance sheets. The European Economic Recovery Plan has aimed to address this situation and mandated EIB to provide €30 billion for lending to SMEs in the 2008-2011 period, of which €15 billion can be spent in 2008-2009.³² EIB aims to mobilise up to €50 billion over the current decade for innovation under the Innovation 2010 Initiative (i2i) programme. From 2000-2006, loans advanced under i2i had reached close to €45 billion.

Mezzanine instruments combine features of debt and equity financing (for example subordinated loans). Mezzanine financing can help avoid the dilution of ownership while being effective in financing growth. At the same time, it may also help meet the need for stronger balance sheets.³³ Although the use of mezzanine instruments has expanded since 2005, they remain little used compared to normal loan financing. SMEs in some Member States have a choice of a wide range of mezzanine products, but in others there is a lot of ground to make up.

³⁰ Commission Communication, Removing Obstacles to cross-border investments, COM(2007)853, 21 December 2007:
http://ec.europa.eu/enterprise/newsroom/cf/document.cfm?action=display&doc_id=1021&userservice_id=1&request_id=0

³¹ Fifth Round Table between Banks and SMEs, Transparency and Dialogue, Final Report. European Commission, 2007.
http://ec.europa.eu/enterprise/newsroom/cf/document.cfm?action=display&doc_id=1064&userservice_id=1&request_id=0

³² A European Economic Recovery Plan, Communication from the Commission to the European Council, 26 November 2008.
http://ec.europa.eu/economy_finance/publications/publication13504_en.pdf

³³ “Financing SME Growth – Adding European Value”, Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions, COM (2006) 349, 29 June 2006.

The traditional users of mezzanine finance are larger and well-rated SMEs that often require amounts around €2 million. This segment is usually well catered for by the commercial mezzanine market. The overwhelming majority of SMEs however has much smaller individual financing needs. They often do not fulfil the requirements of the commercial mezzanine market.³⁴ Several mezzanine schemes have now disappeared due to the financial market crisis and their reliance on securitisation. Improving the supply of hybrid finance to SMEs will thus need some form of public support until market conditions recover. As part of the European Economic Recovery Plan, EIB has earmarked € 1 billion for mezzanine financing and given the mandate to EIF to implement the action.³⁵

Many start-up businesses and self-employed need small loans, but access to loans under €25 000 can be difficult. Depending on the target group and policy objectives, **microcredit** can be provided by different financial institutions. It can also be a tool for achieving goals like improved social welfare and increased employment while furthering the development and growth of small businesses.

2.2. Financing SME growth - Commission actions in 2005-2009

The key effort in addressing the fragmentation of the European venture capital markets was focused on facilitating cross-border investment. In December 2007 the Commission issued a Communication on “Removing obstacles to cross-border investments by venture capital funds” and advocated a broad partnership with and between Member States to work towards the mutual recognition of national frameworks for venture capital funds either through reviewing the existing legislation or by adopting new laws.³⁶ The short-term approach of mutual recognition as proposed by the Commission was endorsed by the Council in 2008 and has been included in the Small Business Act and the Partnership for Growth and Jobs Programme.³⁷ The European Parliament requested that the measures proposed by the Commission in the Communication be implemented.³⁸ Further to the Council Conclusions, the Commission has consulted independent researchers and continues to encourage Member States to take steps towards the mutual recognition of national frameworks for venture capital funds.

The possible case of double direct taxation for cross-border venture capital investments is being looked at by a Commission expert group. The Commission has also been analysing national frameworks for non-harmonised funds, including venture capital funds; and barriers to cross-border private placement and possibilities for establishing a European private placement regime. The Commission published a preliminary impact assessment report on private placement in 2008, which concluded that further work would be needed to measure the overall costs and benefits of introducing EU level arrangements.³⁹

³⁴ Fifth Round Table between Banks and SMEs, Mezzanine finance, Final Report. European Commission, 2007.
http://ec.europa.eu/enterprise/newsroom/cf/document.cfm?action=display&doc_id=1065&userservice_id=1&request_id=0

³⁵ A European Economic Recovery Plan, Communication from the Commission to the European Council, 26 November 2008.

³⁶ Commission Communication, Removing Obstacles to cross-border investments, COM(2007)853, 21 December 2007.

³⁷ Council Conclusions, A fresh impetus for competitiveness and innovation (2871st Competitiveness), 29 May 2008:
http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/intm/100715.pdf

Council Conclusions, “Think Small First – A Small Business Act for Europe” (2891st Competitiveness), 1 December 2008.

http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/intm/104403.pdf

³⁸ EP Resolution, Annex – Recommendation 1 on VC sector and SMEs (23 September 2008):
<http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2008-0425+0+DOC+XML+V0//EN>

³⁹ Preliminary impact assessment report on Private Placement, 17 July 2008:
http://ec.europa.eu/internal_market/investment/legal_texts/index_en.htm#nonlegis

Furthermore, the European Commission has proposed a Directive on Alternative Investment Fund Managers (AIFMs) with the objective to create a comprehensive and effective regulatory and supervisory framework for AIFMs at the European level. AIFM include the managers of hedge funds and private equity funds. The proposed Directive will enhance the transparency of the activities of AIFM and the funds they manage towards investors and public authorities.⁴⁰

The Commission organised a series of conferences to explain to SMEs the impact of the Basel II accord, more specifically the **Capital Requirements Directive**. It published a **guide** aimed at giving SMEs practical advice on how to adjust proactively to the ongoing changes in the credit process.⁴¹ Moreover, the European Commission organised a **Round Table between banks and SMEs** from 2006 to 2007. It looked at the following issues: (1) transparency and dialogue between banks and SMEs, (2) mezzanine finance and (3) SME loan securitisation. The conclusions and recommendations of the Round Table were presented to Member State policy makers to promote the exchange of good practices and facilitate similar discussions at national level.

Following the entry into force of the Capital Requirements Directive in Europe, the relevance of **guarantee schemes** has grown. Among others, their positive features include mitigating the risk of bank lending as well as counter-cyclicality. In the current economic environment guarantee schemes have assumed a crucial role to help maintain the flow of credit to SMEs. The Commission drew up an inventory of good practices in the use of guarantees and made them available to Member State policy-makers.⁴²

The Commission has continued to focus on developing the markets in **microcredit** in Europe. It has met Member States and market experts in a series of workshops that have reviewed both European and national rules, and provided recommendations for improvements.⁴³ The Communication “A European initiative for the development of micro-credit in support of growth and employment” presented a European initiative for the development of micro credit in support of growth and employment. The Communication identified four priority areas for action: (1) improving the legal and institutional environment in Member States, (2) changing the climate in favour of employment and entrepreneurship, (3) promotion of best practices and (4) providing additional financial capital for new and non-bank micro finance institutions (MFIs).⁴⁴ As a first step in implementing this agenda, the Commission and EIB launched the “JASMINE” initiative which aims to support the development of MFIs/micro-credit providers in Member States and regions.

Since 2007 these have complemented the Microcredit Initiative of the Commission that seeks to allocate ERDF funding to revitalise the European microcredit sector. In addition, the EU will make available €19 billion of planned European Social Fund expenditure to support people hit by the economic crisis. The new EU loans facility will be set up to provide micro-credits for those who would usually have difficulty in accessing the necessary funds to set up a business or micro-enterprise.⁴⁵

⁴⁰ Commission proposes EU framework for managers of alternative investment funds, Press Release, 29 April 2009. http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm

⁴¹ “How to deal with the new rating culture”, European Commission, July 2005.

⁴² http://ec.europa.eu/enterprise/newsroom/cf/itemlongdetail.cfm?item_id=2078&tpa_id=127&lang=en
Guarantees and Mutual Guarantees, Expert Group Best Report, January 2005.

⁴³ The Regulation of Microcredit in Europe, Expert Group Report, European Commission, April 2007.

⁴⁴ http://ec.europa.eu/enterprise/newsroom/cf/document.cfm?action=display&doc_id=538

⁴⁵ “A European initiative for the development of micro-credit in support of growth and employment”, Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions, COM (2007) 708, 13 November 2007

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0708:FIN:en:PDF>

A ‘shared commitment for employment’: Commission initiates new strategy to tackle the employment impact of the crisis, Press Release, 3 June 2009, European Commission.

The EU has introduced **financial instruments** to support its SME policies in the field of access to finance. Between 1998 and 2007 around 365 000 SMEs have benefited from the financial instruments. Approximately 90% of beneficiary SMEs are micro-enterprises and about 99% are either micro- or small enterprises. On average, each SME that obtains a guaranteed loan creates 1.2 jobs. This has resulted in over 200 000 new jobs so far under MAP (2000-2006) and over 400 000 new jobs since the launch of the financial instruments in 1998. The Financial Instruments of the Competitiveness and Innovation Framework Programme (CIP) have been proactively marketed through a series of Finance Days in the Member States and other participating countries in 2008-2009.⁴⁶

While CIP will not solve the financing needs of SMEs in the EU, it has helped to close the gap. Two thirds of the SMEs receiving a guaranteed loan reported that alternative sources of finance would not have been available to them without the loan guarantee facility. Concerning microcredit in particular, 86% of SMEs receiving guaranteed credit via the micro-credit window reported that alternative sources were not available to them.⁴⁷

The interim evaluation of the Entrepreneurship and Innovation Programme (EIP) noted that the Financial Instruments are an efficient form of intervention because they are implemented on a commercial basis and target financially viable SMEs.⁴⁸ The early and expansion-stage venture capital instruments as well as the loan and microcredit windows of the SME Guarantee Facility (SMEG) are expected to reach many SMEs. In addition, SMEs' need for complementary forms of finance has been taken into account. The SMEG provides guarantees to stimulate the provision of mezzanine financing as well as the securitisation of SME debt finance portfolios in order to mobilise additional lending to SMEs.⁴⁹

2.3. Addressing the remaining challenges

Despite action undertaken by the Commission to improve SMEs' access to finance, there remain areas which policy needs to further address. These include reducing the fragmentation of the European venture capital market; the facilitation of an intensive dialogue between banks and SMEs; the use of guarantees and the development of the European mezzanine market; and the provision of micro-finance.

Cross-border investment by venture capital funds

European venture capital funds are not able to benefit from the single market because fund structuring across multiple borders is complex and costly. Commission policies 2005-2009 have sought to facilitate cross-border investment. The Communication "Removing obstacles to cross-border investments by venture capital funds" has aimed to work towards the mutual recognition of national frameworks for venture capital funds, but progress has been slow. Only one Member State has taken concrete steps aimed at facilitating cross-border investment. It is essential that policy-makers recognise potential impediments to venture investment, like administrative regulations about establishment and taxation rules, and take action to facilitate cross-border investments.

Transparency and dialogue between banks and SMEs

<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/859&format=HTML&aged=0&language=EN&guiLanguage=en>

⁴⁶ European Investment Fund.

⁴⁷ European Investment Fund.

⁴⁸ Interim Evaluation of the Entrepreneurship and Innovation Programme, Final Report, April 2009.

⁴⁹ http://ec.europa.eu/enterprise/dg/files/evaluation/final_report_eip_interim_evaluation_04_2009_en.pdf

⁴⁹ Decision No 1639/2006/EC of the European Parliament and of the Council establishing a Competitiveness and Innovation Framework Programme (2007-2013), OJ L 310/15, 09.11.2006.

The Capital Requirements Directive as well as the current economic crisis calls for the continuation and deepening of the dialogue between banks and SMEs, which the Commission is prepared to support.

The use of guarantees to facilitate lending and the development of the mezzanine finance market

Given the current financial and economic crisis, Member States should continue to use guarantees to support bank lending to SMEs, in full compatibility with EU State aid rules.

Although they are limited in financial terms, the evaluation of the CIP Financial Instruments has stressed their efficiency in addressing market needs, but there is scope to speed up the decision-making process.⁵⁰

Member States should encourage the expansion of the market for mezzanine finance. Promotional financial institutions are invited to develop programmes which improve SMEs' access to smaller tickets of mezzanine finance. This should allow access to hybrid finance for companies with more limited financing needs, often smaller than €250 000. The Commission will continue to provide a forum for the exchange of good practices to help the development of the mezzanine market.

Microfinance

National legislation should allow a range of financial institutions to lend, including institutions focusing on microcredit. European banking legislation does not pose problems in this respect. Allowing non-banks to lend can be beneficial in particular for those borrowers that effectively cannot get loans from banks, for example people who are socially or financially excluded.

Microcredit has higher risk and higher administrative costs that need to be reflected in the lending rate. In the long-term, appropriate interest rates on microloans should allow such lending practices to become self-sustainable. At the same time, Member States need to ensure that there are minimum quality standards for the pricing of microcredit. The information provided must be transparent and conditions for microloans need to be easily understandable to prevent predatory lending.

Banks as well as micro finance institutions play an important role in providing micro credit. The banking sector in particular encompasses a large network of local offices and has a substantial capacity to evaluate business projects. One could therefore expect that banks could further develop their interest in the market segment as has been the case in some Member States. Some of the activities in place consist of a close cooperation between regional and local authorities and the banking sector.

⁵⁰ Interim Evaluation of the Entrepreneurship and Innovation Programme, Final Report, May 2009.

3. EXIT PHASE

3.1. Exit markets and business transfers in Europe

Initial public offerings (IPOs) provide a natural exit route for venture capital investors and give valuation guidance for sales to other companies. The **fragmentation of the IPO landscape** in Europe is a major hindrance to deeper and more liquid exit markets. At the end of 2007, there were 16 growth stock markets in Europe, which are dwarfed by the size of Nasdaq in US.⁵¹

Chart 1: Directory of growth markets

Market	Established	Number of companies 31 Dec 06	Number of companies 31 Dec 07	
Australia	Australia Pacific Exchange (APX)	1997	2	3
	Bendigo Stock Exchange (BSX)	2000	62	63
	National Stock Exchange of Australia (NSX)	2000	48	53
Austria	Standard Market	2002	51	45
Brazil	Novo Mercado	2002	52	90
Canada	TSX Venture (TSX-V)	1999	2,244	2,338
	CNQ	2003	63	83
Cyprus	Alternative Market	2004	67	71
	Parallel Market	2004	14	16
	Investment Companies Market	2004	14	18
France/ Belgium/	Alternext	2005	75	125
The Netherlands/Portugal	Marché Libre	2000	256	308
Germany	Open Market Entry Standard	2005	76	112
Greece	Atex Medium and Small Cap Category	2005	174	166
	Special Stock Exchange	2005	22	21
Hong Kong	Growth Enterprise Market (GEM)	1999	198	193
Iceland	ICEX Alternative Market	2001	1	1
India	Indonext	2005	519	517
Ireland	Irish Enterprise Exchange (IEEX)	2005	20	27
Italy	Mercato Expandi	1978	26	35
Japan	JASDAQ	1963	971	976
	Mothers	1999	185	195
	New Market "Hercules"	2002	155	175
Korea	KOSDAQ	1996	963	1,022
Mainland China	Small and Medium Enterprises Board	2004	102	202
Malaysia	MESDAQ Market	2002	128	133
New Zealand	New Zealand Alternative Market (NZAX)	2003	29	29
Nordic	First North Alternative Market	2005	81	126
Philippines	SME Board	2001	3	2
Poland	NewConnect	2007	-	27
Singapore	Catalist	1987	169	157
South Africa	Alternative Exchange (altx)	2003	37	76
	Development Capital Market	1984	9	7
	Venture Capital Market	1989	16	9
Thailand	Market for Alternative Investment (MAI)	2001	42	48
Turkey	New Economy Market	1995	3	3
	Second National Market	1995	15	14
United Kingdom	AIM	1995	1,634	1,694
	PLUS Markets Group	1995	190	228
United States	NASDAQ	1971	3,133	3,069
	OTCQX	2007	-	22

Source: Global growth markets: the changing face of world finance”, Capital Markets Guide 2008, Grant Thornton

IPOs on growth stock markets in Europe picked up in the 2005-2007 period, nonetheless activity in a stronger equity culture would have been at a higher level. With the onset of the financial market and the economic crisis, IPO markets have suffered considerably. Trade sales are now expected to be the top exit route for venture capital investors in the next few years. Trade sales however may not be able to fill the gap left by a weak IPO market.⁵²

A **clogged deal pipeline** can make future fundraising and investment difficult as funds cannot divest themselves of their investments and channel money back to investors. Furthermore, thin IPO markets

⁵¹ “Global growth markets: the changing face of world finance”, Capital Markets Guide 2008, Grant Thornton.
http://www.gti.org/files/2008_gmg_report.pdf

⁵² EVCA Barometer, March 2008.

depress valuations and push young innovative companies – along with many of Europe’s best entrepreneurs and scientists - to other geographical markets such as US.⁵³

Major stock exchanges in Europe and around the globe experienced some consolidation in the 2004-2007 period. Euronext linked up exchanges in France, Belgium, Netherlands and Portugal. OMX, the Nordic exchange, enlarged to unite the stock exchanges of Sweden, Finland, Denmark, Lithuania, Latvia and Estonia. Subsequently NYSE joined forces with Euronext and the London Stock Exchange (LSE) with Borsa Italiana, while Nasdaq teamed up with OMX. As regards high-growth companies, it would benefit all market participants if these exchanges could further increase **liquidity on their growth platforms** and **achieve a critical mass for advisory services**.

Many of the **growth markets** in Europe are **exchange regulated** which take into account the special needs and features of SMEs such as simplified reporting or shorter company history. SMEs need to have easy EU-wide access to growth stock markets.

Business transfers provide a form of exit where ownership of an established business is transferred between parties due to the retirement of the previous owner. It is estimated that in the years ahead over 600 000 SMEs will need to be transferred to the next generation each year. Transfers of business can be expensive as they often require not only the purchase of material and financial assets, but also intangible assets such as goodwill. From a financing point of view the solution is usually not uniform and often the result is a specific mix of equity and debt. Mezzanine instruments are especially useful to finance such transactions.⁵⁴

3.2. Commission actions in 2005-2009 to facilitate liquid exit markets

Building on the conclusions of the Risk Capital Action Plan and aiming to address the persisting weaknesses in exit markets, the Commission analysed with experts how the financial environment could be improved for initial public offerings for high-growth companies.⁵⁵ It was pointed out that the Commission, Member States and stock exchanges should work together to facilitate cross-border operations of exchanges; remove obstacles to the use of competing clearing and settlement systems and apply common rules to trading.

Efficient cross-border clearing and settlement processes are essential to allow market participants to operate effectively in an integrated EU financial market. Cross-border arrangements in the EU have been complex and fragmented, imposing costs, risks and inefficiencies on investors, institutions and issuers. Following the 2004 Commission Communication on clearing and settlement, the clearing and settlement industry put forward a code of conduct in 2006, which aims at ensuring efficiency, integration, safety and soundness of European post-trade infrastructure arrangements.⁵⁶ The Commission has been following up implementation since then. In its report of March 2008 monitoring progress, it highlighted the progress made in the area by the industry.⁵⁷

⁵³ “Feasibility Study: A Pan-European Market for Technology Growth Companies”, Executive Summary, R. Abbanat, MIT, August 2004.

⁵⁴ Fifth Round Table between Banks and SMEs, Mezzanine finance, Final Report. European Commission, 2007.

⁵⁵ Improving opportunities for Initial Public Offerings on growth stock markets in Europe, European Commission, 2005.
http://ec.europa.eu/enterprise/newsroom/cf/document.cfm?action=display&doc_id=1203&userservice_id=1&request_id=0

⁵⁶ Clearing and settlement: Commissioner McCreevy welcomes industry’s new Code of Conduct, Press Release, Brussels, 7 November 2006.

⁵⁷ “Improving the efficiency, integration and safety and soundness of cross-border post-trading arrangements in Europe”, Third Progress Report to Economic and Financial Affairs Council (ECOFIN), March 2008.
http://ec.europa.eu/internal_market/financial-markets/docs/clearing/ecofin/20080311_ecofin_en.pdf

The integration in securities trading structures in Europe has been further strengthened by the implementation of the Markets in Financial Services Directive (MiFID). MiFID gives exchanges, multilateral trading facilities and investment firms a "single passport" to operate throughout the EU on the basis of authorisation in their home Member State.⁵⁸

The **Round Table between banks and SMEs 2006-2007** looked at mezzanine financing also from the business transfer perspective and provided examples of mezzanine programmes that support such transactions.

3.3. Addressing the remaining challenges

Venture capital funds need successful exits to return funds to investors, which is a precondition for raising new funds. A well-functioning IPO market is key to this. The signalling effect of IPOs about successes has an effect on the willingness of investors to allocate funds to venture capital.⁵⁹

A reduction in the fragmentation of growth markets in Europe would serve the interest of high-growth companies. Strategic decisions regarding mergers and acquisitions among stock exchanges however are taken by stock exchanges' management not policy makers. It is clear that without liquid exit markets for venture capital and the critical mass of advisory services around them young companies may move to other geographical markets to raise the capital they need.

A vibrant complementary secondary market for venture capital participation stakes is needed to allow funds to exit investments, repay investors and start a new investment cycle.

The public sector's role remains crucial in facilitating active venture capital markets through an appropriate legal and regulatory framework. Progress has already been made at European level, but more is needed, especially at Member State level.

In particular, the following are essential to increase the depth and liquidity of growth markets in Europe:

A well-established legal system with adequate **investor protection**. At the same time, growth stock markets need to take into account SMEs' special needs to allow them to list easily and their stocks to be readily available to qualified investors from all around Europe.

A **regulatory framework** that allows institutional investors to invest in venture capital across borders.

An enabling **taxation regime** that stimulates the supply of risk capital. A tax regime that favours debt to the detriment of retained earnings and new equity does not encourage venture capital investments. At the same time, the taxation regime needs to prevent cases of direct double taxation when investing venture capital across borders.

⁵⁸ Commission Staff Working Document on Financial Integration, November 2008.

⁵⁹ "Best Practices of Public Support for Early-Stage Equity Finance", Final Report of the Expert Group, European Commission, September 2005.

4. CONCLUSIONS

Financing innovation requires a funding system that sustains entrepreneurship and drives job creation. Venture capital is an important part of such a framework, but not the only one, as it finances only a very small fraction of businesses. In fact the most common form of external financing to start a business remains bank financing. A well performing financing system provides both types (risk capital and bank financing) and would also include an efficient loan guarantee system to complement bank lending.

Guarantees exercise a crucial role to facilitate access to financing. By sharing the risk with lenders, they help address the problems of information asymmetry and the lack of adequate collateral often associated with new projects and SMEs. In the current economic environment their counter-cyclical feature is especially useful in helping to maintain the flow of credit to SMEs.

European venture capital markets remain fragmented and underperforming compared to US. There are bottlenecks at both ends: a continually underfunded early-stage segment and a difficult exit market. The weak performance of the sector and the current challenging exit environment is already affecting fund-raising and investment volumes. This of course can affect available funds for innovation in the near future. To improve the conditions for innovation financing, policy efforts should focus on better leveraging private sector early-stage finance, facilitating technology transfer and helping to improve entrepreneurs' investment readiness.

For an effective policy in access to finance for innovation that supports the wider societal goals there has to be a strong focus on two key policy areas: 1) transforming the European venture capital landscape and 2) generally revitalising the financing environment for innovative and growth oriented small businesses.

For financing innovation, transforming the European venture capital landscape is essential. It requires breaking the vicious cycle of small funds, low returns and lack of investor interest. The Commission's goal is to contribute to a more pan-European orientation of venture capital funds and to provide incentives for funds to grow to a larger average size. Innovative firms in growth markets will provide Europe with jobs and growth, and will contribute to achieving the wider societal objectives like the use of clean technologies, energy efficiency, new transport modes and improved health.

Continuing actions are needed to build a single market in venture capital that provides appropriate conditions for the emergence of larger, pan-European funds. There has been little success in improving the stock market exit scene, and an alternative focus on developing the secondary venture capital market (trading portfolio companies between venture capital funds) is needed. One way of achieving this is by having appropriate financial instruments for the secondary VC market.

In order to transform the venture capital landscape in Europe, specific focus is needed in the beginning (technology transfer), middle (venture capital investment) and end (investor exits) of the financing lifecycle.

To revitalise the credit financing environment for small businesses, the first step is to overcome the effects of the crisis as the cyclical and structural problems reinforce each other. In this, the Commission and the European Investment Bank Group will have to continue to work closely together. A strategic aspect is to evaluate and possibly develop the risk-sharing element in loan programmes.

Furthermore, careful monitoring of the financing environments in the Member States is needed both for cyclical and for structural reasons and the cooperation with national promotional banks needs to be strengthened in particular to enhance cross-border financing programmes.

GLOSSARY

Definitions contained herein are only applied in the context of this staff working paper and are without prejudice to possible existing definitions in the Member States or Community legislation.

Business angel

A knowledgeable private individual, usually with a business experience, who invests directly part of his personal assets in a new and growing unquoted businesses. Besides capital, business angels provide business management experience for the entrepreneur.

Capital Adequacy Directive (CRD)

European implementation of the international rules for capital requirements for banks and investment firms. Globally the rules are often referred to as “Basel II”. They aim to make the international financial system safer by having the riskiness of banks’ loan portfolios to be reflected in the capital charges they need to set aside against unexpected losses.

Early-stage capital

Financing to companies before they initiate commercial manufacturing and sales, before they generate a profit. Includes [seed](#) and [start-up](#) financing.

Equity gap

Exists when there is a persistent [capital market](#) imperfection preventing supply from meeting demand at any price (or at a price acceptable to both sides). An often cited example is the lack of venture capital for a young, innovative firm. See also [risk capital](#).

Exit

Liquidation of investments by a [private equity or venture capital](#) investor. The most common exits are (1) trade sale to another company; (2) public offering (including an initial public offering – IPO) on a [stock market](#); (3) sale to another investor; (4) repayment of the investment (when part of the investment agreement) or (5) the write-off of the investment.

Fundraising

The process in which [venture capital](#) firms raise money to create an [investment fund](#). These funds are raised from private, corporate or institutional investors, who make commitments to the fund which will be invested by the [general partner](#).

Growth stock market

Alternative market for new, fast growing companies. Usually with lighter regulatory load than the main stock markets.

Institutional investor

An organisation which professionally invests substantial assets in international capital markets. Examples include banks, investment companies, insurance companies, pension funds, foundations or endowment funds.

Investment readiness

The entrepreneur's understanding of the concerns of banks, business angels and venture capital funds. In particular, this includes knowledge about communication with investors and about how to structure business plans to secure external finance.

IPO - Initial public offering

The sale or distribution of a company's shares to the public for the first time. An IPO is one of the ways in which a private equity fund can exit an investment.

Mezzanine finance

Also called hybrid finance. Financing with assets that contain characteristics of both debt and [equity](#), covering a variety of instruments tailored to a specific legislative and operating environment. Frequently unsecured, they usually bear interest at a higher rate than secured loans and often give the lender a stake in the [equity](#) of the company.

Private equity

Investment of equity capital in firms not quoted on a stock market. [Venture capital](#) is strictly speaking a subset of [private equity](#), which also includes replacement capital and [buyouts](#).

Private placement

Rising of capital through the sale of securities to a small number of professional investors. Investors typically include banks, investment funds, insurance companies, and pension funds. This allows the transaction to be exempt from many or all of the requirements that would apply in the event of a public offering.

Risk capital (markets)

Markets providing [equity](#) financing to a company during its [early](#) growth stages ([start-up](#) and development). It covers three types of financing, (1) informal investment by [business angels](#); (2) venture capital ; (3) [stock markets](#) specialised in [SMEs](#) and high growth companies.

Seed capital

Financing provided to study, assess and develop an initial concept. The seed phase precedes the [start-up](#) phase. The two phases together are called the [early](#) stage.

Start-up capital

Provided to companies for product development and initial marketing. Firms may be in the process of being set up or may exist but have not sold their product or service commercially.

Technology transfer

Also known as knowledge transfer or knowledge sharing. The process of converting scientific findings from research laboratories and universities into products and services in the marketplace by an enterprise.

Venture capital

Investment in unquoted companies by venture capital firms who, acting as principals, manage individual, institutional or in-house money. In Europe, the main financing stages included in venture capital are: [early](#) stage (covering [seed](#) and start up) and expansion. Strictly defined, venture capital is a subset of [private equity](#). Venture capital is thus professional [equity](#) co-invested with the entrepreneur to fund an [early](#) stage ([seed](#) and [start-up](#)) or [expansion](#) venture. Offsetting the high risk the investor takes is the expectation of higher than average return on the investment.

Venture capital fund

An investment fund that manages money from professional investors seeking private equity and [equity](#)-related securities (such as [quasi-equity](#)) in small and medium-sized firms (investee companies) with strong growth potential. The venture capital fund is usually an unincorporated arrangement such as a [limited partnership](#). A management company that usually has several funds under management can be a limited company, a [limited partnership](#) or a company quoted on a [stock market](#).