COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 29.6.2006
SEC(2006) 842

COMMISSION STAFF WORKING DOCUMENT

ANNEX III to the

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE EUROPEAN PARLIAMENT, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS

Implementing the Community Lisbon Programme:

Financing SME Growth – Adding European Value

{COM(2006) 349 final}

ACCESS TO FINANCE: THE WAY FORWARD

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1. SUMMARY

(1) Improving SMEs' access to finance is one of the key factors for business expansion, job creation and economic growth. To increase competitiveness and to ensure that new ideas get a chance in the market, European Union and the Member States should create better conditions for accessing finance and contribute to overcoming market failures.

(2) To implement the Community Lisbon programme[1] and to complement the modernising of SME policies[2], new approach is needed in developing policies helping SMEs to access finance.

(3) Policies facilitating access to loan finance are essential because it is the most important source of external financing for most European enterprises. New approaches are needed to deal with hybrid instruments combining features of loans and equity, which are likely to become more widely used.

(4) Banks have differentiated their loan pricing based on the riskiness of clients, partially as a consequence of the new capital requirements (Basel II). This requires that SMEs are capable of presenting a convincing case, including strong balance sheets that can improve access to lending.

(5) Risk capital is the best financing alternative for rapidly-growing new innovative SMEs, but it is more difficult to access risk capital in Europe than in the United States. To unleash the growth potential, improved policies, fully using the single market and public-private partnerships to overcome market failures are needed.

(6) In particular, the aim is to reduce the fragmentation of the European risk capital markets by extending the benefits of the single market.

(7) To overcome market failures, the financial instruments of the Competitiveness and Innovation Programme and the Joint European Resources for Micro to Medium Enterprises (JEREMIE) of the structural funds should be used employing effective and good practices.

(8) Developing the demand side of finance in Europe requires widespread financial literacy, investment readiness and growth orientation. To achieve this, Member States should adopt good practices in implementing investment readiness programmes and in strengthening cooperation between networks that provide advisory and financial services for SMEs.

(9) Fully exploiting the potential of strengthened partnerships can effectively spread best practices and lead to improvements in SMEs' access to finance.

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1 Commission Communication "Common Actions for Growth and Employment: The Community Lisbon Programme", COM(2005) 330 final of 20.7.2005.

2 Communication "Implementing the Community Lisbon Programme - Modern SME Policy for Growth and Employment", COM (2005)551 final of 10.11.2005.

2. INTRODUCTION

Improving access to finance for enterprises and especially SMEs is crucial in fostering entrepreneurship, competition, innovation and growth in Europe. European contribution to overcoming the market failure in early-stage finance been carried out through instruments such as the MAP financial instruments[3], structural and cohesion funds, and activities of the European Investment Bank (EIB) Group. Improving SMEs' access to finance is one of the key factors for business expansion, job creation and economic growth.

This was confirmed by the conclusions of the spring 2006 European Council, which invited the Commission to bring forward specific provisions to encourage SME growth and development. The European Council emphasised that a fully integrated financial market and sufficient access to finance is crucial for the growth of small and medium sized enterprises. It concluded that if not properly addressed, the lack of finances will continue hindering innovation in SMEs. Furthermore, the Council paid particular attention to the importance of using the Community financial instruments to leverage funding for SMEs, In addition, the Council called on Member States to fully utilise the potential of structural funds, through traditional and new funding instruments such as JEREMIE, and to fully implement the single market legislation for the benefit of SMEs.[4]

As the Community Lisbon Programme noted, the limited availability of finance is an obstacle to set up and develop businesses in Europe. Enterprise financing in Europe is heavily oriented towards lending at the expense of equity, which makes the firms riskier in the eyes of the banks. In addition, in their early stages firms do not usually have either the income stream or the collateral required by banks. This makes risk capital investments necessary in the early stages of firm development and more investors should be active in providing early-stage risk capital, including business angels and seed funds.

Europe can increase risk capital investments by changing the operating environment of investors. For example, venture capital funds have difficulties investing across borders and improving the functioning of the single market in this respect would generate benefits in terms of fund size, fund liquidity and risk diversification. This would contribute to the full integration of financial markets, increasing output and employment by allowing more efficient allocation of capital. Another area where obstacles have been identified is opportunities for initial public offerings (IPOs) on growth stock markets in Europe.

Europe needs to work on both the supply and the demand side of finance. Improving access to finance of innovative SMEs is also a question of enhancing the cooperation of advisers and support providers that can help entrepreneurs with the questions of growth and finance. Because many entrepreneurs need guidance on how best to present their investment project to investors, good practices in investment readiness programmes should be disseminated throughout Europe. For this, a key element is the mobilisation and commitment of all relevant actors, both public and private, at regional, national and European levels.

A Eurobarometer poll published in 2005 showed that many SMEs find it more difficult than previously to obtain a bank loan[5]. To improve the chances of SMEs adapting to the more risk-

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3 Multiannual programme for enterprise and entrepreneurship, and in particular for small and medium-sized enterprises (SMEs) (2001-2005), 2000/819/EC of 29.12.2000.

4 Brussels European Council, 23/24 March 2006, Presidency conclusions.

5 http://europa.eu.int/comm/enterprise/entrepreneurship/financing/surveys.htm

oriented financial environment with its focus on transparency and financial reporting, SMEs and banks need to work to increase mutual understanding. One reason for the new environment is the revision of capital requirements for banks (the Basel II process) that has aligned capital requirements more closely with risks leading banks to more widespread use of rating systems[6].

The need to provide concrete public leverage to private investors to overcome market failures has led the Commission to a long-term commitment to use the financial instruments for this purpose. These instruments are managed by the European Investment Fund (EIF) and are specifically targeted at improving the financial environment for businesses, focusing on early-stage finance, where the market gaps are most evident.

Of the financial instruments, the SME Guarantee Facility has provided co-, counter- and direct guarantees to European guarantee schemes and banks providing loans to smaller enterprises in the Member States. The Seed Capital Action has provided support for the long-term recruitment of additional specialised investment managers by seed capital funds. The ETF Start-up facility has provided risk capital to specialised venture capital funds for investment in SMEs in their early years. The external evaluation report commissioned by the Commission found the financial instruments to be an effective way of addressing the financing problems of SMEs and efficient in their implementation.[7]

The new Competitiveness and Innovation Framework Programme (CIP)[8] is a coherent and integrated way of contributing to the objectives of the renewed Lisbon strategy and provides the framework for the financial instruments for the period 2007-2013. The financial instruments provide increased flexibility and new possibilities, including the option for co-investment funds with business angels, securitisation of banks lending, and supporting capacity building in the financial sector.

The Commission's Communication "Cohesion Policy in support of growth and jobs, Community Strategic Guidelines 2007-2013"[9] underlined the importance of improving access to finance for SMEs also at the regional level, in particular enhancing support for start-ups and micro-enterprises. Regional policy focus should be on technical assistance and on instruments such as venture capital and guarantees. Accordingly, Commission services and the EIB Group have launched a joint initiative to improve access to finance for SMEs in the regions. This is the Joint European Resources for Micro to Medium Enterprises (JEREMIE).

The Seventh Research Framework Programme[10] (FP7) will support key areas of research increasing Europe's potential. Under FP7, the Commission and the European Investment Bank (EIB) are developing a new dedicated facility for the financing of innovation, the Risk Sharing Finance Facility (RSFF) expanding existing EIB risk funding capacity. The RSFF

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6 More information on capital requirements: http://europa.eu.int/comm/internal_market/bank/regcapital/index_en.htm.

7 "Strategic Evaluation of Financial Assistance Schemes to SMEs", Final Report, Deloitte & Touche, July 2003.

8 Proposal for a decision of the European parliament and of the Council establishing a Competitiveness and Innovation Framework Programme (2007-2013), COM(2005) 121 final of 6.4.2005.

9 Communication "Cohesion Policy in support of growth and jobs, Community Strategic Guidelines 2007-2013, COM(2005) 0299 of 05.07.2005.

10 Proposal for a Decision of the European Parliament and of the Council concerning the seventh framework programme of the European Community for research, technological development and demonstration activities (2007 to 2013), COM(2005) 119 final of 6.4.2005.

will be targeted to projects eligible under FP7, supporting all types of organisations participating in multi-partner consortia, including SMEs. Close cooperation between the Community institutions in developing SMEs access to finance is crucial in identifying the most appropriate products in various situations, reflecting the conditions at national and regional level but also the specific needs of the financial intermediaries, maximising the value added for SMEs.

Excellence and attractiveness of the European science base are essential preconditions for the birth of new ideas. But Europe needs to pay attention to the full innovation chain, promoting also the commercialisation of research. Using financing mechanisms appropriate to each step of the chain will make the use of public funding more efficient and will improve the investment cooperation of private and public actors. The EIB has a key role in research financing, as the new "Risk sharing finance facility"[11] aims to improve access to debt finance for participants in large European research actions. This will allow a larger volume of loans for research projects and the financing of bankable projects with a higher risk that would otherwise be possible for the EIB.

Finance is a strategic resource for enterprises because investments are the way of new ideas to become products and services in the market. There is a market failure in the provision of early-stage financing, and the public sector needs to act in cooperation with private investors to overcome this. To be able to compete, Europe needs to provide investment opportunities that are attractive and therefore European policy should focus on a regulatory and fiscal environment that promotes growth. However, without returns that are competitive in global competition, private investors will not invest in European venture capital but in other asset classes offering better returns.

3. ACCESS TO FINANCE FOR SMEs: THE ROOTS OF THE PROBLEM

3.1. The SME viewpoint

Small and medium-sized enterprises (SMEs)[12] make up the largest portion of the employment base in the European Union. There are around 23 millions SMEs providing around 110 million jobs and accounting for 99% of all enterprises.

To increase access to finance that facilitates business investment and leads to higher growth is essential for European SMEs – and for Europe. In the Eurobarometre[13] survey, 40% of SMEs indicated that they needed easier access to finance, which was the third obstacle after simpler social and fiscal regulations and better availability of qualified people. Whilst the financial situation of many businesses is healthy, the survey also reveals large differences between countries.

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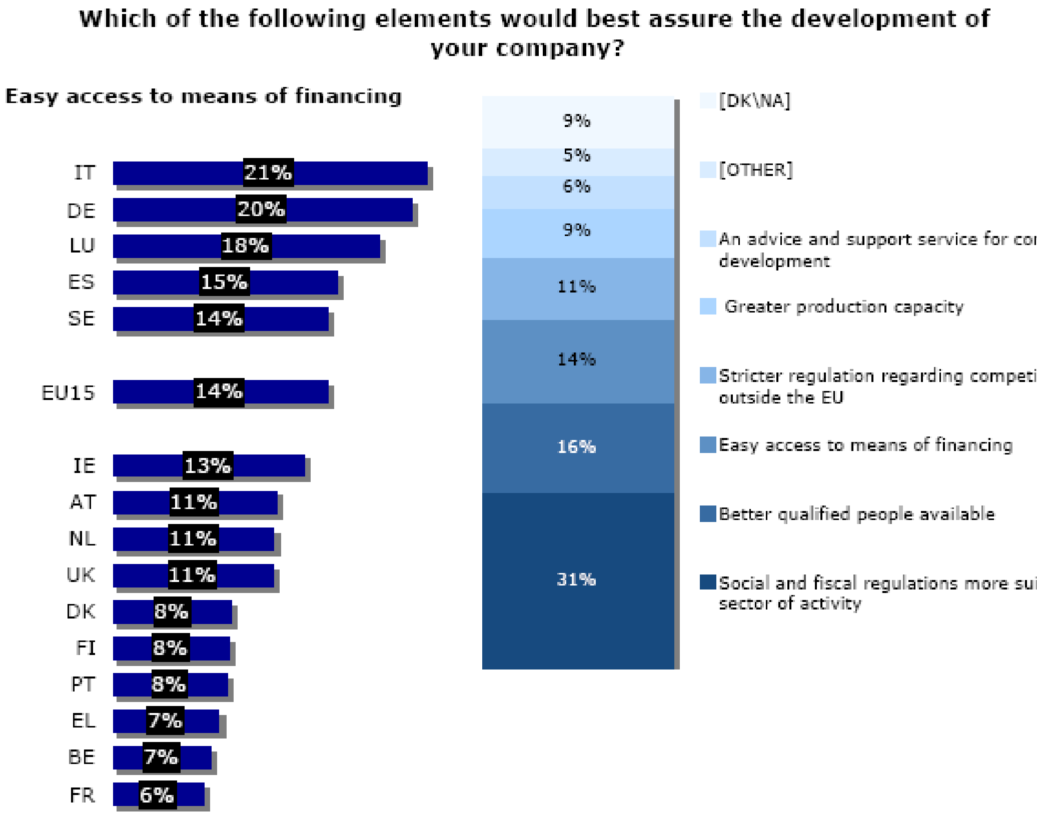
[11] Proposal for a Council Decision on the Specific Programme: "Capacities" implementing the 7th Framework Programme (2007-2013) of the European Community for research, technological development and demonstration activities COM(2005) 443 final of 21.9.2005.

[12] http://europa.eu.int/comm/enterprise/enterprise_policy/sme_definition/index_en.htm

[13] Flash Eurobarometre 174, TNS Sofres/EOS Gallup – October 2005.



Banks are looking more and more closely at the capacity of their borrowers to pay back loans[14]. Banks' assessments of the risks associated with loans are increasingly related to the characteristics of the individual borrower. Banks use rating systems to identify the different individual risk levels of their loan obligations and ensure that they earn a return appropriate to the risk they undertake. These changes have a direct impact on business relations between SMEs and banks. While the consequences for large corporations are relatively small, as they are accustomed to being rated, many SMEs face more significant changes. SMEs will be internally assessed (or rated) more and more thoroughly by banks, even when applying for small loans. In consequence, SMEs are likely to encounter a widening range of credit prices and overall borrowing conditions[15].

3.2. Diversity and policy learning

Many Member States provide a world class financing environment for enterprises, but in many others, SMEs have problems accessing of both bank lending and venture capital. While respecting the diversity of European financing systems, it is clear that there is room for improvement and that policy learning between Member States could provide considerable benefits.

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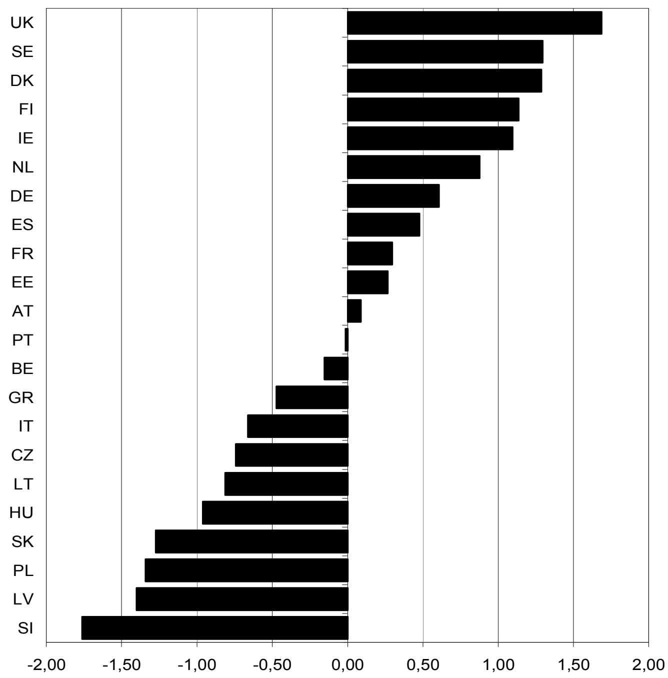
14 Abut European Commission efforts to inform SMEs about the changes, see the guide and seminar material on Basel II at http://europa.eu.int/comm/enterprise/entrepreneurship/financing/basel_2.htm.

15 33% of SMEs feel it is today easier to obtain a bank loan but 42% fell that is less easy than a few years ago. 71% of SMEs think that the banks do not want to take risks in lending to firms.

Capital access index (deviation from EU average) (No data available for CY, LU, MT) [16]



According to the Global Entrepreneurship Monitor[17], high-expectation entrepreneurial activity (expectations of over 20 employees in five years) is highest in the USA, with Germany and the UK at less than half the US levels. Globally, start-ups expecting to employ 20 or more employees are responsible for almost 75% of total expected jobs in all entrepreneurial activity.

Facilitating spin-offs from knowledge-intensive and research organisations may increase high-expectation entrepreneurial activity. The insufficiently growth-oriented financing of innovative enterprises is one of the causes for the EU's inferior performance in the last two decades. To improve competitiveness and economic performance of the European Union in this respect, focus needs to be in technology transfer and financing innovative SMEs, in particular with risk capital.

Improving access to finance is an important aspect of fostering entrepreneurship in Europe. Public sector should primarily improve the general framework conditions of finance and take direct action only when market failures warrant it. Experience has shown that best results in corporate finance are achieved when the public sector works with the markets and act as a catalyst to encourage their development. Because successful innovation promotes structural changes and leads to improved welfare for the whole Europe, the European Union and the Member States have to make sure that the right incentives are in place for a flow of ideas to have financing so that they can develop into services and products.

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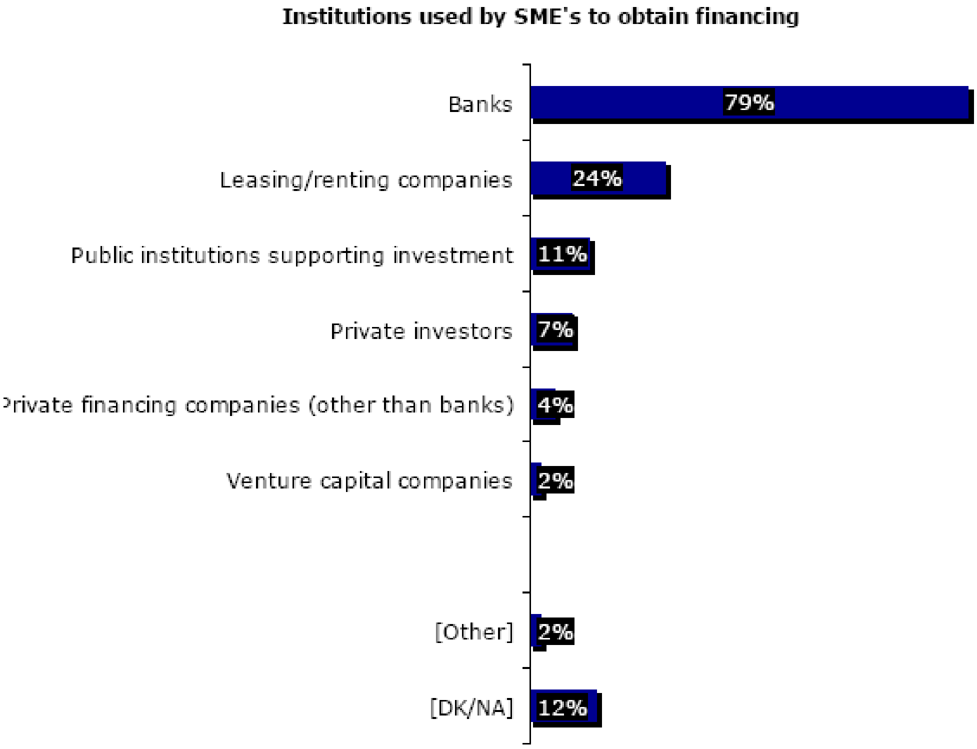
16 The index is based on 56 indicators on macroeconomy, institutions, finance and banking. James R. Barth et al. "Best Markets for Entrepreneurial Finance: 2005 Capital Access Index. Securitization in Financing Economic Activities". Milken Institute, October 2005, http://www.milkeninstitute.org/research/research.taf?cat=indexes

17 Global Entrepreneurship Monitor: High-Expectation Entrepreneurship 2005, Summary Report.

4. ANALYSIS OF THE SITUATION: MAINSTREAM FINANCE SOURCES

4.1. Bank loans: a major source of external finance

Both the Commission Staff Working Document on access to finance[18] and the Flash Eurobarometre survey confirm that banks continue to be the most important source of external finance for most European enterprises[19].



The banking sector will continue to be the most important source for business finance in Europe. Lending can, however, take several forms. Between a simple loan and pure equity there is a broad range of instruments which could be used to help to finance specific parts of the enterprise life cycle.

Banks usually require collateral against their lending and for SMEs that are investing in intangibles and that do not have collateral, the availability of external guarantees will be essential in securing access to loans. In addition, many SMEs' own funds are inadequate and the resulting undercapitalisation is one of the most important sources of business failures.

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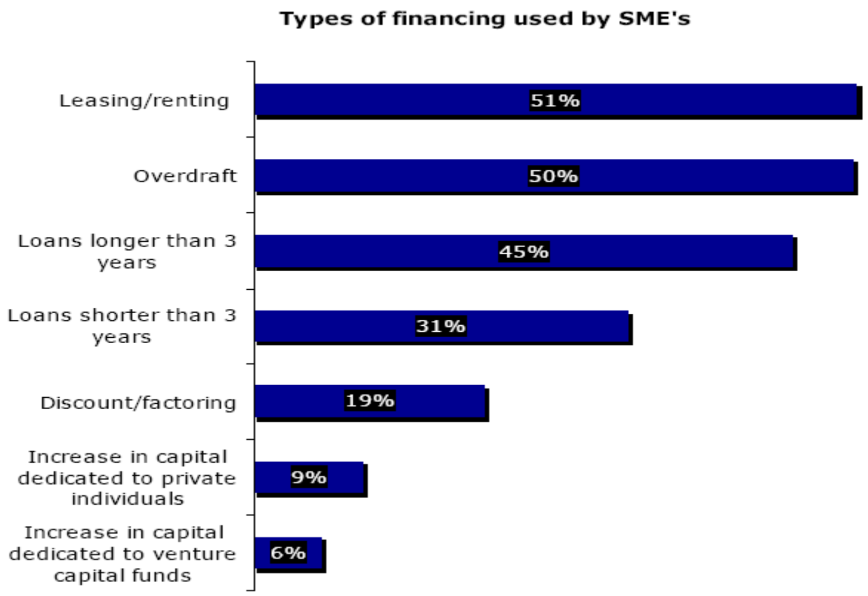
18 Communication from the Commission to the Council and the European Parliament: Access to finance of small and medium-sized enterprises, COM(2003) 713 final of 1.12.2003.

19 For more detailed information on developments in bank lending for the euro area, see: http://www.ecb.int/stats/money/lend/html/index.en.html.



The good experiences from the previous Round Tables between banks and SMEs[20] have encouraged the Commission to launch another one that intends to review recent developments and pay particular attention to the changes in the financial markets.

4.2. Financing business transfers

According to the expert group report published in 2002[21], roughly one-third of all EU companies will change hands over the next 10 years (between 25 and 40%, depending on the Member State). This means an average of 610 000 small and medium-sized enterprises will change hands each year potentially affecting 2.4 million jobs. Thousands of economically sound businesses can disappear every year if they fail to overcome the difficulties involved in the transfer of ownership.

Many Member States need further measures that can facilitate the transfer of business ownership and support growth and employment in the European Union. First, banks are an important source of financing for business transfers[22] and providing public co-guarantees with banks for business transfer loans is an example on how policy can improve the situation.

20 For the results, see http://ec.europa.eu/enterprise/entrepreneurship/financing/round_table.htm

21 Final report of the expert group on the transfer of small and medium-sized enterprises, May 2002.

22 In 2003, a French bank launched a scheme granting loans without personal guarantee of up to €25 000, repayable over a maximum of three years. In 2005, another scheme for the same purpose in the form of a loan of maximum €100 000 subject to the fact that the entrepreneur has to provide 25% of the loan with a personal guarantee.

Furthermore, hybrid instruments combining the features of debt and equity can be effectively used in financing business transfers and their use should be promoted more widely.

4.3. Guarantees: lowering risks

Guarantees are an effective way of lowering the risk of bank lending to SMEs and their importance is increasing because banks are becoming more and more risk aware in their lending[23]. The increased risk sensitivity of banks is partly due to the new capital requirements, but the trend is reflected differently. In Germany, 95% of SMEs agree completely or partially that banks are unwilling to take risks, whereas in Ireland and Denmark only 45% think so[24].

The leverage effect of partial public guarantees can have a large effect on the lending volume available for SMEs. Importantly, guarantees can also be countercyclical, helping to maintain banks' lending volumes also in a downturn. Effective use of guarantees is especially important for Member States where SMEs believe that access to bank lending has become more difficult, such as in Germany, Luxembourg and the Netherlands.

Improving access to finance can not be separated from the administrative environment. Developing guarantee provision requires a favourable regulatory framework both at European and at national level, and considerable progress has been achieved in taking guarantees into account in European and national legislation.

Supporting an increasing use of innovative financial instruments for SMEs is also one of the objectives of the European Investment Bank (EIB). Asset-based securitisation and covered bonds instruments are illustrations of the use of such new instruments. In parallel, an increased attention will be given by the EIB to SMEs active in research and innovation, in particular through dedicated global loans also including a risk-sharing component. Support to innovative SMEs will involve national banks specialised in this domain, thereby accelerating know-how at European level.

4.4. Social inclusion and microenterprises

For social inclusion and small-scale entrepreneurship, the supply of microloans is a major issue[25]. Support for microcredit is a policy option that can be powerful for self-empowerment by enabling the poor, especially women[26], to become economic agents of change. Worldwide, micro-credit and related self-employment promotion schemes have been identified as a way of enabling those at risk of poverty and social exclusion to participate in the economic and political processes of society through self-employment.

Commercial banks are often reluctant to lend small amounts and it is important that Member State legislation allows competition from microcredit institutions. This can be achieved through specific legislation for microcredit institutions or by enabling, for example, non-bank lenders to raise funds from the banking sector. To reduce the risks of microcredit, business

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23 See "Guarantees and Mutual Guarantees Best Project", http://europa.eu.int/comm/enterprise/entrepreneurship/financing/publications_documents.htm

24 See the 2005 Eurobarometer.

25 Microcredit for small businesses and business creation: Bridging a market gap – Report of the Commission – November 2003.

26 Best report on "Good Practices in the Promotion of Female Entrepreneurship" http://europa.eu.int/comm/enterprise/entrepreneurship/craft/craft-women/bestproject-women.htm

support services like mentoring and peer reviews are often an important part of microcredit provision to increase the probability of success.

Of the EU 15 countries, Portugal (27%), France (19 %), Italy (18%) and Austria (18%) are those in which the use of and interest in microloans is highest among SMEs, whereas in Denmark (3%), Finland (4%) and the Netherlands (5%) this form of financing is less prevalent.

Supporting microloans is therefore not only an issue of entrepreneurship and economic growth but also of social inclusion[27]. Microcredit provided by NGOs[28], primarily for social inclusion, are therefore important in some Member States as they contribute to the promotion of enterprises as a tool to fight social exclusion and unemployment[29]. Microcredit is also an efficient tool, as public support has been on average between €2000 and €5000 per microenterprise created, whereas unemployment allowances are about €18 000 per year for one person.

Promoting entrepreneurship among groups like women and minorities can be enhanced by good access to financing sources like microcredits, and national legislation should facilitate their provision. The EIB has dedicated some global loan operations to micro-credits and new actions are foreseen to increase further the volume of EIB global loans targeting micro-credits.

5. INVESTING IN TECHNOLOGY AND GROWTH

5.1. Business angels

Seed capital is the stage of firm development where significant amounts of time and money are invested prior to the creation of a commercially viable product or service. Because there is little guarantee that the investment will result in a commercially successful product or service, the investment decision is based on subjective appraisal of the prospects of the entrepreneur.

Europe has very few private investors in seed and early stage, which is driving the best and brightest entrepreneurs elsewhere. It is necessary to seek ways to encourage seed investments, for example, through leveraging existing investments and creating the conditions for new investors to emerge. Business angel investments in Europe are estimated to be less than 10% of those in the United States, which achieve a level of €20 billion[30].

The Member States should adopt good practices when using publicly funded co-investment schemes that invest with business angels and seed-oriented venture capital funds[31], and the Commission will identify and spread good practices in creating the right conditions for business angel investment. Such schemes could effectively increase the amounts available and spread the risks, but they should only invest on equal terms with angels and should not

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27 Promotional banks such as Fonds de participation and ICO have products with specific social purposes.

28 See Association pour le droit à l'initiative économique www.adie.org and The Prince's Trust http://www.princes-trust.org.uk/

29 Legal and political conditions for credit extension for social purposes by non banks in the EU-Analysis: final study Part 1, by IFF, DG Employment and Social affairs.

30 Estimate from the European Business Angle Network (EBAN).

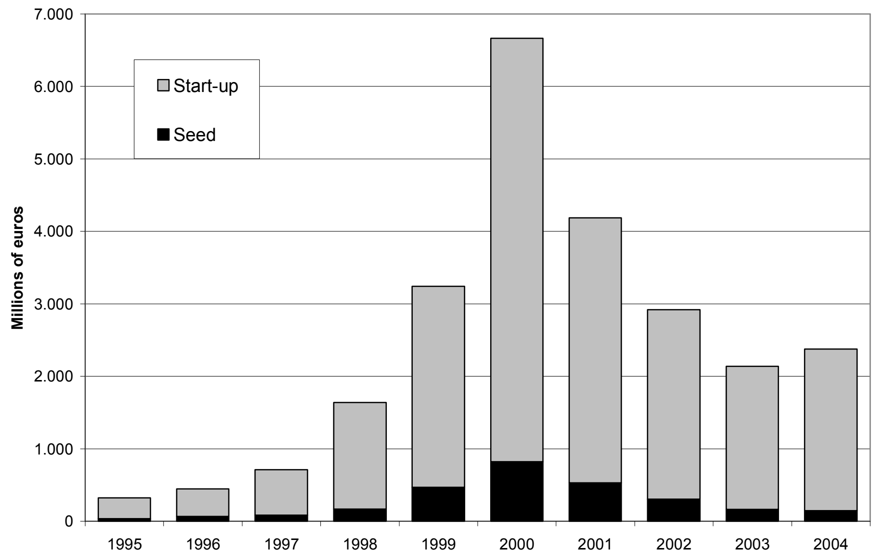
31 Source: EBAN. Good results have been achieved on co-investment eg. in Scotland. See http://www.scottish-enterprise.com/sedotcom_home/services-to-business/businessfinance/equity.htm

contain any subsidy elements. As the venture capital markets develop, larger funds are likely to increase their seed investments, including co-investments with business angels, as the presence of angels is a signal of quality, and of due diligence being already done.

5.2. Towards a more dynamic venture capital industry

Overall, investment in private equity and venture capital in Europe has grown over the last few years, after the bursting of the technology bubble in 2001. The statistics[32] show that for the third consecutive year, investment exceeded fundraising and almost €10 billion more was invested than raised in private equity in 2004. However, the solidity of the US venture capital industry has allowed it to recover much more quickly from the bust of 2001 and the weak point of Europe remains investment in seed and start-up SMEs.

Seed and start-up investment by venture capital funds in Europe 1995-2004[33]



The overall amounts invested in buyouts and venture capital increased as a percentage of European GDP in 2004, although venture capital increased only to 0.10% in 2004 from 0.08% in 2003. However, development in investment has been uneven. Start-up investments increased in 2004 by 13% by amount to €2.2 billion compared to €2 billion in 2003. The amount invested in high tech-companies increased by 6.5% to €7.4 billion compared to €7 billion in 2003. The proportion of expected allocation of funds to venture capital increased to 32% of the total raised (€8.8 billion) in 2004 from 21% (€5.7 billion) in 2003.

Successful fundraising for venture capital in Europe also requires a long-term and solid investor base. Increasing the diversification possibilities of pension funds[34] and insurance companies could lead them to marginally increase their investments in private equity and venture capital, where the impact of these increases could be substantial. Currently many

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32 All investment figures are from the European Private Equity and Venture Capital Association (EVCA) Yearbook 2005.

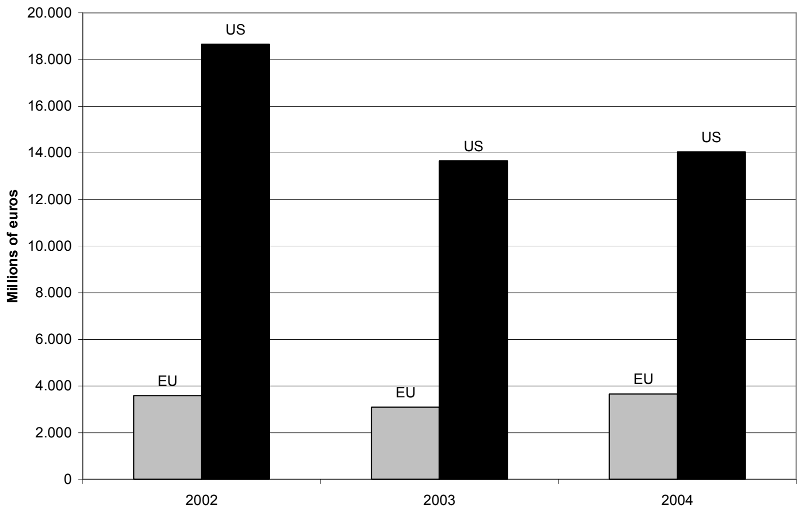
33 See "Annual Survey of Pan-European Private Equity & Venture Capital Activity", years 2000-2005.

34 See eg. E. Philip Davis, Pension Funds, Financial Intermediation and the New Financial Landscape, http://www.pensions-institute.org/workingpapers/wp0010.pdf

Member States lack substantial pension funds but the demographic changes in Europe's population are likely to increase long-term saving and the number of funded pension systems.

Despite the improved figures, the gap between the US and the European Union remains large. In particular, investment in technology has remained low in Europe although it grew by 19% in 2004. For many reasons the European venture capital industry plays a lesser role in the transfer of technology from research to industry than its US counterpart, where the average investment in a technology company was €6.1 million as opposed to just €0.9 million in Europe.

Investments in technology by venture capital funds, 2002-2004[35]



Some of the reasons for lower investment in Europe are clear. First, there is a difference between the profitability of US and European venture investment. Venture capital funds need to raise their funds from institutional investors who are interested in the risk-return trade-off available. Assuming roughly comparable risk levels for technology investments in the EU and the US, the return figures of European venture capital funds have been disappointing.

The failure of European early stage investing has been subject to some recent research by Commission services[36] as well as the Member States. Results suggest, inter alia, that for lack of suitable funding too many projects are financed by venture capital before being ready for the demands that come with commercial financing. This could be linked to the looseness of ties between innovation centres and the risk capital market that generally characterise the European innovation systems in comparison to the US. Closer and more structured co-operation between universities and research organisations on one hand and providers of risk capital, including venture capital funds and business angels, on the other could make deal sourcing more efficient and increase the impact of public support instruments. Examples of innovation networks already exist from leading knowledge centres in Europe and, in particular, the US.

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35 Source: Money for Growth, The European Technology Investment Report 2004 and 2005, PriceWaterhouseCoopers.

36 "Profitability of venture capital investment in Europe and the United States", European Economy series of Economic Papers, no 245.

When comparing returns across countries, it should be remembered that the calculation of venture capital returns is wrought with pitfalls, and the only fully reliable way to do it is to wait until investment exit has been done and count the realised return on a cash-on-cash basis. However, this takes a long time as the average investment periods are between five and ten years, so valuation of investments in the portfolio is needed despite different valuation methods. Looking at the published returns does not inspire confidence in the average performance of the European venture capital industry despite the fact that past returns are no guarantee of future ones and that there are considerable return differences between good and bad funds.

Ten-year horizon returns of EU and US private equity[37]

Per cent	**10 year horizon returns to 31.12.2004**	
	Europe	**US**
Venture capital	6.3	26.0
Buyouts	12.5	8.4

Under these circumstances it is no wonder that investment in venture capital in Europe is low because investors wishing to have private equity in their portfolios could realise much higher returns by investing in the US venture capital markets – on average. For investors wanting European private equity opportunities, the attractive alternative is to invest in buyouts, which are less risky and provide better returns than venture capital investments. The immaturity of the European market can be seen in the greater difference between the good and the bad fund returns than in the US.

The number of projects receiving venture investments is much higher in Europe than in the US, leading to smaller investments and less attention to each investment. In 2004 European venture funds made more than 4200 investments in technology whereas in the US the number was 2300. The contrast between the shotgun European approach and the more targeted, large investment and good profitability US approach could not be starker.

Successful US funds are increasingly specialist in their focus, large in size, often syndicated early with other funds, had experienced managers and made much larger investments per investee firm. Often the most successful investment model was a long-term one, "first in, last out" because only that way could returns be maximised. By contrast, EU funds tend to have insufficient funds under management to properly support investee firms, have inexperienced managers and have relied too often on soft public money.

Clearly, economies of scale and scope are very important in venture capital investing and public policy needs to recognise that investors need to ruthlessly identify and select the very best, irrespective of region or sector. In particular, small seed funds have had difficulties in achieving a sustainable level of operations. Larger funds and management companies would bring with them several benefits, including spreading the overhead costs between a larger number of deals, being able to make larger deals, being able to recruit quality personnel, and being able to provide more comprehensive services to the SMEs they invest in.

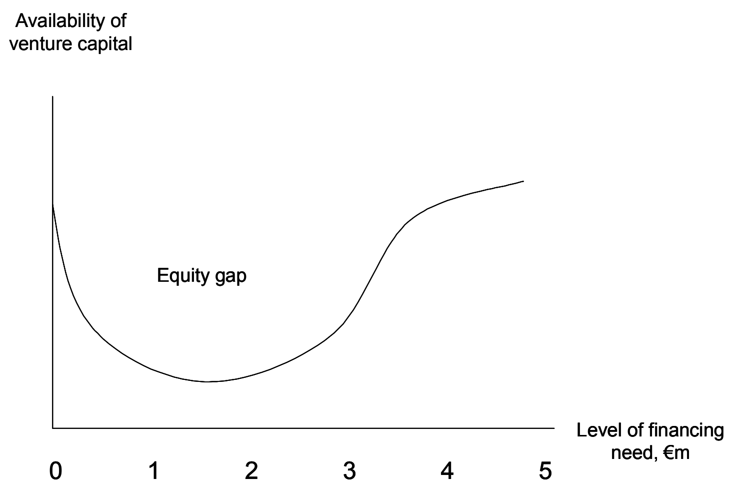
[37] Sources: EVCA, NVCA.

Seed investments in Europe fell slightly in 2004 and represented 0.4% at €148 million compared to 0.5% at €150 million in 2003. Overall, European early stage venture investment continues to rely on funding from public sources. The private funds are more interested in investing in later stage, as expansion stage took 45% of the total number of investments. The Commission financial instruments have been used to correct this market failure[38], but more needs to be done.

Looking at the new Member States, fundraising picked up in 2004 to a total of €496 million raised, which represents a 59% increase compared to 2003. The vast majority of fund raising for venture capital in these countries comes from foreign investors and goes into buyout transactions, with some expansion and replacement investment. There were no seed and little start up investments. Although this represents a normal development in building a venture capital market, it still leaves an equity gap that is much more severe than in countries with a mature venture capital industry.

Cyclical and structural factors have led to a venture capital market that focuses heavily on expansion and buyouts, where the returns have been commensurate with the risk taken. In the seed and start-up phases venture capital finance is not really available in many places. This has left it for the national and regional public actors to maintain the flow of finance to innovative start-ups, but to build a sustainable investment environment for the long term, private sector sources need to be built up, including business angels and seed funds.

Equity gap



The *Financial Services Action Plan (FSAP)* that was achieved in 2005 laid the main legal foundations for a stable, integrated and more efficient EU capital market.[39] The Financial Services Action Plan was delivered in full and within the timeframe set by the Lisbon agenda and the focus is now in the implementation and enforcement of the new legislative framework in order to ensure that the full benefits can be captured.

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38 The CREA pilot programme sought to increase the supply of seed capital. See the evaluation report at http://europa.eu.int/comm/enterprise/entrepreneurship/financing/publications_documents.htm. The "Growth and Employment" action and the "Multiannual Programme for Enterprises and Entrepreneurship (2000-2006)" have also focused on early-stage finance.

39 "Financial Services: Turning the Corner – Preparing the challenge of the next phase of European capital market integration", 2.6.2004, http://europa.eu.int/comm/internal_market/en/finances/actionplan/index.htm

5.3. A fragmented market

The European venture capital funding process has deficiencies throughout the investment chain, from technology transfer to investment exits. The weaknesses in venture capital have led to a string of public initiatives aiming to overcome these[40]. In order to promote good policies on venture capital, policy-makers need to pay attention to the overall framework conditions of small business finance and adopt good practices in a wide range of issues. The stakeholders agreed on the policy lines concerning an improved venture capital market in the "Risk Capital Summit 2005"[41].

Europe has already done a great deal to improve the integration of the financial markets. The Prospectus Directive[42] has simplified and standardised the rules for capital-raising across Europe for securities admitted to trading on a regulated market. The forthcoming Markets in Financial Services Directive[43] will bring much closer integration of trading of securities and a range of allied activities such as investment advice and reception and transmission of orders. Much rests with the quality of the implementation of this cornerstone piece of legislation by the Member States and individual firms, which the Commission will be monitoring closely. The Commission has the clearing and settlement issue under very close review.

To encourage the wide adoption of good practices in state aid, the Commission has made recommendations on state aid for risk capital[44] that are being reviewed in 2006.

However, concerning venture capital markets, the fragmentation of markets is evident because there is no effective way for investing and raising funds across borders with 25 sets of operating conditions. Venture capital funds are often liable for separate registration or establishment in each Member State, which is both expensive and time consuming[45]. Existing investment vehicles are not recognised outside their local jurisdictions, foreign investors are discriminated against local investors, and legislative and administrative practice tends to prefer local structures. Large venture capital funds that are operating cross borders invest through complex and costly parallel vehicles, something that many funds, especially smaller ones, choose not to do. To draw full benefit from the single market requires actions that facilitate venture capital investment across borders[46].

In a single market worth its name, professional venture capital managers should be able to raise capital from investors in other Member States. They should be able to invest in venture capital investments in other Member States without incurring unfavourable tax treatment.

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40 See eg the report "Best practices in early-stage equity finance", http://europa.eu.int/comm/enterprise/entrepreneurship/financing/publications_documents.htm

41 See http://europa.eu.int/comm/enterprise/entrepreneurship/financing/publications_documents.htm, and the Aho report "Creating an innovative Europe: Report of the independent expert group on R&D and innovation appointed following the Hampton Court summit" at http://europa.eu.int/invest-in-research/

42 Directive 2003/71/EC, which came into force on 1 July 2005.

43 Directive 2004/EC/39, now due to come into force on 1 November 2007.

44 State aid and risk capital, OJC 235 of 21 August 2001, available at: http://europa.eu.int/comm/competition/oj_ extracts/2001_c_235_08_21_0003_0011_en.pdf

45 In most Member States, a limited partnership (LP) structure is the one established for the fund. There is no standard definition of LP. In addition, only in some Member States is limited partnership treated as a legal personality. This means that a fund raiser in one jurisdiction cannot expect the same treatment as in local jurisdiction.

46 See "Merits and Possibilities of a European fund structure for venture capital funds" – Report from a workshop held in Brussels on 21 June 2005

This is currently not the case. Concrete and pragmatic answers are now needed to the many legal, regulatory and tax barriers which prevent professional venture capital managers from structuring operations on a cross-border basis.

On the taxation front, the Commission will invite the Member States to identify in an expert group, in consultation with industry representatives, the cases of double taxation and to reflect on ways to overcome them. The Commission is also working to remove tax obstacles which companies face when investing across border[47]. Efforts to provide EU-wide recognition for nationally regulated venture capital funds have met with little success to date.

An industry expert group[48] will report in June on the legal and regulatory barriers which stand in the way of cost-efficient market access for venture capital fund managers to investors and projects in other Member States. It will also draw the lessons from successful national experiences in cultivating VC markets and how these could be put to work on a European scale. This will serve as the starting-point in the search for effective solutions to single market failures which hold back the development of this type of VC financing structure. Every effort will be made to ensure full engagement of all relevant national authorities with this agenda - from both regulatory and competitiveness perspectives. As part of this process, the Commission will invite representatives of Member States[49] to discuss further steps.

The Member States are responsible for most of the legal and regulatory environment of risk capital markets, in particular taxation. Some Member States have started to develop specific schemes for Young Innovative Companies[50], providing fiscal and social benefits for entrepreneurs, employees, investors and companies for investments in early stage companies. To complement such national developments, all Member States are invited to reflect the costs and benefits of the current arrangements for cross-border investments, in particular to the emergence of new, rapidly growing European technology SMEs.

On the fund raising side, the Member States should develop investor interest in venture capital. One element in this is the national implementation of the *Occupational Pensions Directive*[51] and its ‘prudent person rule’, which allows occupational pension funds to make a professional decision on their exposure to venture capital investment.

One point in the venture financing chain where the fragmentation of the European market has attracted attention is the exit market. In some industries like software, even trade sales of equity positions to other companies are difficult, as there are few large European software companies that could act as buyers. This increases the importance of secondary market in private equity, where in particular seed funds could exit from their investment through a sale to another venture capital fund.

Although the most common exits are trade sales and secondary sales of investments to other venture capital investors, the market for initial public offerings (IPOs) is an important

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47 The Common Consolidated Corporate Tax Base.

48 “Expert Group on Alternative Investment Funds”, http://europa.eu.int/comm/internal_market/securities/ucits/index_en.htm

49 “Expert group on obstacles to cross-border investment”, see http://europa.eu.int/comm/enterprise/enterprise_policy/mult_entr_programme/programme_2001_2005_annualprog.htm

50 See eg. the “Young innovative company statute“ www.france-biotech.org/LOAD.asp?ID_DOC=543

51 Directive 2003/41/EC.

indicator of valuation even for other methods of exit. Europe has no liquid market for small growth stocks[52]. The lack of critical mass and liquidity leads also to a lack of advisory and support services for listing small stocks, although one market has shown signs of developing its liquidity.

Each stock exchange has its own set of listing criteria, disclosure requirements, and IPO market practices, which leads small capitalisation growth companies having serious problems accessing investors across borders. This leads to a lack of demand for shares in these companies, which is exacerbated because there are few specialists of small stock investment in Europe.

Moreover, local banks that are likely to take on smaller offerings often lack the research expertise needed to attract institutional investors on an international basis[53]. The lack of sector-focused research on high-growth companies reduces investor interest and leads to a lack of comparability. This is a self-reinforcing phenomenon as research on growth companies must be financially worthwhile and therefore research is primarily conducted on those companies that could expect sufficient trading volume. Furthermore, cross-border clearing and settlement remains very costly which made cross-border investing expensive for investors. Obstacles to the use of competing clearing and settlement systems should be removed and by applying common rules to trading[54]. Fragmentation lowers both IPO valuations and aftermarket trading liquidity of growth company stock in Europe as long as the liquidity of growth markets is not solved.

Although the link from weak early-stage investments to weak exit mechanisms is not evident, these are connected by the venture financing gain. Being able to raise investment, invest for the long term, and exit from these investments with fair valuations are all necessary links of the chain. An efficient venture capital market is only possible when there is enough volume and liquidity in each link of the chain, and in a Europe of 25 mostly small Member States achieving this requires cross-border activities.

Innovative growth-oriented SMEs at their early stages often do not have internally generated funds and require large amounts of financing. External equity investments are the most appropriate source of funding for them, and the information asymmetry problem that plagues all early-stage investment can at least partially be alleviated through the management skills of the venture capitalists. However, performing due diligence of high-technology companies requires both experience and specific technology expertise from the venture capital funds. Public policy can only create the framework for successful operations of venture capital funds, the actual results depend on the funds themselves.

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[52] See the report from the "Risk Capital Summit 2005" and "European Stock Market Financing for High-Growth Companies". EVCA, January 2004.

[53] See the workshop report "Improving opportunities for Initial Public Offerings on growth stock markets in Europe". The VC industry emphasised the lack of available research data on high growth companies.

[54] Communication from the Commission to the Council and the European Parliament: Clearing and Settlement in the European Union – The way forward. COM(2004) 312 final of 28.4.2004; and the reports "Cross-border clearing and settlement arrangements in the European Union" (2001) and "Second report on EU clearing and settlement arrangements" (2003), http://europa.eu.int/comm/economy_finance/giovannini/clearing_settlement_en.htm

5.4. Improving financial literacy and investment readiness

Growth entrepreneurship requires the potential, the willingness and the knowledge to grow. Achieving growth and wealth implies that entrepreneurs have a willingness to share ownership with equity investors, but many lack this willingness and want to keep control of their business. Even if the potential and the willingness are there, many entrepreneurs need knowledge about financier needs to succeed in convincing them to invest.

The inability to present high-quality projects to investors and failure to address their concerns results in a high failure rate when seeking risk capital. Although the entrepreneurs and their business plan might have inherent merit, if they does not address issues important to investors like management competencies, they are likely to fail.

To be ready for seeking investment, entrepreneurs should be able to identify appropriate sources of finance for their business. They have to be able to identify the concerns of their preferred financing source and address these concerns before seeking finance. In many Member States investment readiness programmes have helped SMEs to increase their knowledge on investor concerns, and many organisations have worked together in providing project screening and development advice. Identifying and spreading good practices from these programmes and encouraging regional authorities to run similar initiatives is a key element to foster access to finance for SMEs.

At European level, networks within several initiatives are developing a number of actions in support of access to early stage finance in terms of instruments, support to authorities and public private-partnerships and sector specific activities. Instruments include coaching tools[55] for start-ups, hands-on coaching schemes and new investment schemes to be used by risk and debt capital investors. Measures in support of authorities and public-private partnerships include funding of programmes at MS and sub-national level, based on the instruments to design policies and to spread good practices in the Member States. Sector specific activities include networks of entrepreneurs, incubators, investors and policy makers to analyse, validate and implement good practices in access to early stage finance. Member States are invited to replicate the most successful measures, notably using the structural funds. To validate these best practices Europe INNOVA[56] communication platform will insure a permanently open communication channel with the relevant Member States. Developing networks focusing on the problems of specific industries is important for competitiveness eg. in biotechnology[57]. Tools and good practices for early stage finance should be taken up by other networks and promoted by the Member States[58].

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[55] Such as the Gate2Growth Self Assessment Tool, www.Gate2Growth.com

[56] The aim of Europe Innova is to produce data and recommendations for policy making on the factors of innovation proper to each industrial technology sector, including access to finance. Europe Innova is launching specific networks to find new innovative financial schemes based on credit and risk capital and Member States will be invited to endorse the sectoral policy recommendations and implement them through national and European initiatives. The aim of the projects is to build pan-European networks of incubators, venture capitalists, and business angels together with sectoral seed and start-up communities and large businesses. See http://www.europe-innova.org/ .

[57] Europe and the United States have about the same number of companies in the biotech sector but the US biotech industry spends three times as much on research, raises three to four times as much venture capital and has access to four times as much debt finance. See EuropaBio: Biotech in Europe, 2005 Comparative study, Critical I comparative study for EuropaBio.

[58] See “More Research and Innovation - Investing for Growth and Employment: A Common Approach”, COM(2005) 488 final, 28.10.2005.

But the problem is not only at the entrepreneur side. The expertise of the analysts at a venture capital fund, their understanding of technology, is crucial for a successful investment. As investment analysts seem to learn most of their skills on the job[59], experience about previous investment projects would seem to be the key determinant in developing expertise. This requires that the fund employing the analyst is big enough to provide such experience through sufficient investment volume and length of operations.

Financial literacy is important also in bank relationships. As regards the relationship between banks and SMEs, in particular concerning lending[60], Commission services have focused their attention to identifying good practice, making recommendations for the improvement of the relationship, and developing, refining and combining financial products and services that facilitate growth, and, furthermore, reducing the legislative, administrative and fiscal burden on businesses and strengthening existing policies in favour of SMEs.

6. RISING TO THE CHALLENGES BY TARGETING POLICIES

6.1. Reforming state aid rules for risk capital

Competition is the most effective way to guarantee business innovation because it creates natural incentives for companies to come up with new ideas and products; it makes them adapt to change; and sanctions those that stay put or lag behind.

Effective state aid control maintains a level playing field for free and fair competition in the single market, the key to competitiveness. But efficient and equitable state aid can also stimulate competition and support the economic reform process in new ways, acting as a driver for the virtuous circle of economic growth, better standards of living, and more and better jobs.

State aid should promote overall growth in the size of the economic cake, by targeting the gaps that markets alone will not fill. State aid rules should also guide Member States in getting the best value for money for their taxpayers, making sure that scarce state resources are used where they can have most impact. State aid rules and procedures must be transparent, and as simple, user-friendly, clear and predictable as possible.

To help the Member States to overcome market failures in early-stage finance, the Commission is reviewing the state aid rules for risk capital. The aim of the review will be to further stimulate investment in the form of risk capital, in particular in favour of start-ups and young, innovative SMEs, where this can properly address identified market failures.

In particular, the Commission will focus on the need to further increase the flexibility of the current rules. The Commission is considering adapting them to better reflect the different and time-varying levels of equity gaps in the Member States, as well as to streamline the procedure for the assessment of cases notified to it. The new rules should also ensure that risk capital funds (partly) financed through State resources should aim to maximise their profits and be run on a commercial basis to the greatest extent possible. The Commission aims to complete the revision of the rules before the expiration of the current rules in August 2006.

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[59] Less than one-fifth have studied a technical discipline such as engineering. See Training needs of investment analysts, 2001. http://www.cordis.lu/innovation-policy/studies/fi_study3.htm

[60] http://www.europa.eu.int/comm/enterprise/entrepreneurship/financing/round_table.htm.

6.2. Supporting growth, employment, social inclusion and regional development

European governments seek growth, employment, social inclusion and regional development when supporting entrepreneurship and access to finance. Not all of these goals can be achieved with the same tools and it is important to select the right policy tools for each objective. For example, promoting microcredit and guarantees can be effective tools combating social exclusion and enhancing regional development, with venture capital being the appropriate tool for rapid growth.

Supporting growth requires strict focus on the essential. The fast-growing SMEs with the best potential are likely to be located in metropolitan or cluster areas, where traditional venture capital is also concentrated because they provide a constant deal flow. Despite European clusters becoming more competitive, the best US regions have four times the venture capital available (per head) than the best European regions, Stockholm, London, and Ile de France[61].

Experience has shown that in supporting growth best results can be had when the public sector invests in private venture capital at arms' length, leaving the investment decisions for the private investors. Growth can only be effectively financed when investment decisions are driven by profit orientation, not by political considerations.

Small venture capital funds can have difficulties covering their fixed costs and producing competitive returns, and consequently, policies should not contribute to their proliferation. Small funds lack the possibilities for economies of scale, have difficulties recruiting experienced managers, and have conflicting objectives. Subsidising small and inefficient funds can attract poor managers to them and reduce the quality of screening and monitoring of deals. Allocating public funding to substandard venture capital funds would then work against the development of the market by prolonging the life of underperforming funds without improving the overall situation of the industry.

Although the question is at times hard to answer, assessing the overall effect of the public programmes in terms of companies and growth created is essential for efficient policy development. It is also important for the overall sustainability of the venture capital industry, as the public sector policies need to develop in step with the industry and they need to have an exit strategy when the policies do not any more add value to the economy.

Experience has pointed out that regional development funds can be used to achieve sustainable development. When regional development funds are used to improve small firms' access to finance, this has an impact on the wider community that will foster local and regional long-term growth.

Partnerships between national and regional authorities with the private sector intervention in SME finance will be a key factor leading to competitiveness and growth. Best results in early stage finance can be achieved when the public sector work in partnership with the private sector and create incentives for funds to improve performance. The level of venture capital market development has an impact on the public sector instruments used so that at a capacity-building stage the schemes support the growth and the sustainability of VC funds. However, when governments invest to overcome the market failure in early-stage, they should do so at

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61 World Knowledge Competitiveness Index 2005, Robert Huggins Associates.

arms' length so that investment decisions are solely driven by private funds using market discipline[62].

The Joint European Resources for Micro to Medium Enterprises (JEREMIE) will offer the Member States and European regional authorities the possibility to substantially increase funding for small businesses and long-term sustainability becomes particularly important. Practices that combine regional development and the tools of venture investing have emerged over the last years, like the Bridges Community Ventures in the UK. Community development venture capital funds focus on both the financial returns and the social returns for the communities in which they are located. Although such funds seek market rates of return, they target regions where few investments are made, or industry sectors that do not allocate capital efficiently. This often leads to investments in companies with managerial shortcomings, implying a need for intensive assistance. To ensure the spread of good practice, cooperation of regional funding organisations that are active in risk capital funding is essential.

Access to finance especially in the New Member States should be facilitated by the diversification of banking counterparts in the framework of the EIB global loan strategy. It should contribute to the development of financial markets and improves the framework conditions for SME finance, and complement actions implemented by the Commission through capacity-building part of the Competitiveness and Innovation programme (CIP).

In conclusion, policy on access to finance needs to focus on goals and effective tools to achieve these goals. The key task at the European level is to create conditions for the single market to function also in risk capital, in particular in the new Member States. There SMEs face difficulties accessing most forms of financing and the capabilities of the financial system merit special attention, as otherwise the underperforming financial markets will severely hamper entrepreneurship and growth.

Public intervention on different levels can be important in bringing together various actors networks that are active in research, innovation and finance to leverage finance for corporate development. Dissemination of best practices and expertise can also increase the commercialisation of ideas that support entrepreneurship thus job creation and economic development.

7. FINANCING SMEs: CORNERSTONE OF LISBON STRATEGY

7.1. SME financing policy towards economic growth and job creation

The European Union and the Member States can provide a framework for action in access to finance for SMEs, as good policies are important in creating the right incentives for the flow of ideas from universities and research institutions to find financing so that they can develop into services and products. However, tangible progress can only be achieved through the involvement of all stakeholders at national, regional and local level.

Europe is competing for investments in the world and China and India can provide investors with unparallel growth opportunities. Europe needs to leverage its strengths by effectively

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62 See the report "Best practices in early-stage equity finance", http://europa.eu.int/comm/enterprise/entrepreneurship/financing/publications_documents.htm

commercialising its world-class research, which requires effective availability of finance in the growth phases of an innovative SME.

The Community Lisbon Programme[63] provides the overall framework for European action and implementing it in the area of SMEs' access to finance is the Communication. The key policy issues that have been identified in access to finance are:

- Creating an environment that will improve the functioning of venture capital markets and increase the availability of venture capital.
- Promoting the benefits of the single market also in risk capital.
- Providing leverage to private investment to overcome market gaps by using the financial instruments and the structural funds.
- Keeping debt finance accessible to SMEs by reinforcing the use of guarantee and mutual guarantees schemes, in particular for microloans.
- Setting up improved tools for policy learning and exchange of good practices.
- Creating incentives for technology transfer between universities and enterprises facilitating the birth of new enterprises

For their part, Europe's 23 million SMEs see a changing environment where access to both bank lending and risk capital requires increasing financial sophistication. To provide SMEs with the tools that they need when dealing with banks and risk capital investors, the Communication highlights the importance of sharing good practice.

7.2. Competitiveness and Innovation Framework Programme (CIP)

The Competitiveness and Innovation Framework Programme (CIP)[64] will extend the scope of the existing financial instruments in several areas. The CIP will contribute to support those market segments where SMEs face difficulties, such as early stage venture capital or microlending. The goal is also to provide additional resources to attract private investments in risk capital funds. On the equity side, the new GIF 2 window will provide capital for enterprises in the expansion phase, thereby complementing GIF 1, which will focus on seed and early stage investments.

On the guarantee side, a new securitisation window will support the packaging and selling of portfolios of SME loans, thus releasing capacity for banks to do new SME lending, Securitisation shall enable banks to provide further SME loans through capital relief and attractive funding conditions. The same goes for guarantee schemes: their capacity to issue guarantees in favour of SMEs could considerably increase via securitisation structures. The current equity guarantee window will be refocused more towards mezzanine finance. Finally, as regards technical assistance, the Seed Capital Action will have its scope broadened, while a

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63 Commission Communication "Common Actions for Growth and Employment: The Community Lisbon Programme", COM(2005) 330 final, 20.7.2005.

64 Proposal for a decision of the European parliament and of the Council establishing a Competitiveness and Innovation Framework Programme (2007-2013), COM(2005) 121 final of 6.4.2005.

new Partnership Action will help banks in countries with low banking intermediation to improve their credit appraisal procedures and thus stimulate the supply of loans to SMEs.

The financial instruments of the CIP will also be a transversal instrument supporting the implementation of the Environmental Technologies Action Plan, which aims at removing the obstacles so as to tap the full potential of environmental technologies to protect the environment while contributing to competitiveness and economic growth, ensuring that over the coming years the European Union takes a leading role in developing and applying environmental technologies, and mobilising all stakeholders in support of these objectives.

7.3. The JEREMIE initiative

Under the JEREMIE initiative, specialised financial institutions, notably the EIF and other IFIs, in co-operation with the managing authorities of programmes supported by the European Union under the Structural Funds, would be able to:

- Provide improved conditions for, and adequate levels of, funding for new business development in the form of loans (including microcredit), equity, venture capital, and guarantees as well as organisational and technical assistance as appropriate;

- Contribute to better co-ordination at national and regional level in this field, as well to the transfer of good practices;

- Contribute to more effective use of scarce public resources under EU programmes. In addition, it would have a revolving character leading to the sustainability of this initiative over the longer term.

8. CONCLUDING REMARKS

(1) SMEs are the backbone of European economy and creating an environment that enables easier access finance is crucial in achieving more growth and employment. Direct public action is needed to overcome market failures in partnership with the private sector.

(2) Banks continue to be the most important source of external finance for most European SMEs. Loans, overdraft and leasing are common used by most SMEs but for many reasons that are only partially linked to the new capital requirements for banks (Basel II accord), banks are attaching more attention to the relative riskiness of their clients. For this, they need more information than before and SMEs need to demonstrate their financial health. If they can do so, they can expect to benefit with lower interest rates and better access to loans.

(3) Growth and business continuity can be also facilitated through the use of hybrid instruments combining the features of debt and equity. This can be particularly important in financing business transfers as thousands of economically sound SME disappear every year because they fail to overcome the difficulties involved in the transfer of ownership.

(4) Microfinance has proven to be an efficient and effective tool for promoting entrepreneurship, a key catalyst for individuals willing to create and develop their own business. Microcredit should be seen as a more accessible instrument to facilitate

European growth, competitiveness and cohesion. Public policies have to take into account microfinance instruments by improving their regulatory framework and by disseminating best practices.

(5) Many European SMEs suffer from legal or financial red tape, including unclear bankruptcy laws, slow justice systems and weak creditor rights. Thus, financing growth depends also on the legal environment and on macroeconomic policies that create demand for new services and products.

(6) Young and innovative SMEs are dependent of the availability of risk capital in their early stage phases. In particular the new Member States need to improve the functioning of their risk capital markets and need to tap global best practice. The goal is to enable all Member States to draw the benefits of the single market while respecting the diversity of European financing cultures.

(7) Whether in venture capital, microcredit, or financial system development, the policy goals of the Member States should include sustainable development for the long term, providing only temporary public funding to build up the private investment market and the required support services so that these can gradually become self-sustaining.

ANNEX: Glossary[65]

Arm's length

The relationship between persons or organisations that interact on purely commercial terms without the influence of other factors (like common ownership, parent/subsidiary relationship, political or family considerations).

Basel II

Reform of the capital requirements for banks, drafted by the Basel Committee on Banking Supervision. Aims 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. Implemented in the European Union for credit institutions and investment firms through the Capital Requirements Directive that has been approved by the European Council and European Parliament.

Business angel

A wealthy private individual who invests directly in new and growing unquoted businesses and provides them with advice. Business angels usually get an equity stake in the business, but may also provide other long-term finance. This capital can complement the *venture capital* industry by providing finance at an earlier stage than most venture capital firms want to invest.

Buyout

Purchase of at least a controlling percentage of a firm's equity from the current shareholders, taking over its assets and operations. In a management buyout the current managers are the buyers. In a management buy-in a group of outside managers are the buyers.

Capital market

A market in which long term capital is raised by industry and commerce, the government and local authorities. *Stock exchanges* are part of the capital market.

Competitiveness and Innovation Framework Programme (CIP)

Brings together several existing EU activities that support competitiveness and innovation for the period 2007-2013. The combination of programmes gives synergies like a common toolbox and synchronisation of calls for proposals. The subprogrammes are the "Entrepreneurship and Innovation programme", the "ICT Policy Support Programme" and the "Intelligent Energy Programme".

65 Based on Commission work (see the Risk Capital Action Plan at http://europa.eu.int/comm/internal_market/securities/riskcapital/index_en.htm) and EVCA industry definitions..

Debt instruments

Loans and other funding instruments that provide the investor with mostly fixed minimum return and are at least partly secured.

Early-stage capital

Financing to firms before they initiate commercial manufacturing and sales, prior to generating a profit. Includes *seed* and *start-up* financing.

Equity

Ownership interest in a company as represented by the shares issued to investors.

Equity gap

Exists when there is a persistent capital market imperfection preventing supply from meeting demand at a price acceptable to both sides. The gap may concern, on one hand, high-tech innovative and mostly young companies with high growth potential and, on the other hand, a wide range of companies of different ages and sectors with smaller growth potential that cannot find financing for their expansion projects without additional external risk capital.

Exit

Liquidation of holdings by a *risk capital* investor. Usual ways of doing this are trade sale to another company; public offering (including an *initial public offering*) on a stock market; write-off of the investment; sale to another investor; or repayment of the investment (when part of the investment agreement).

Expansion capital

Financing provided for the growth of a firm, which may or may not break even or be profitable. Capital may be used to finance increased production capacity, market or product development, or to provide *working capital*.

Factoring

Selling a company's accounts receivable, at a discount, to a financing company that assumes the credit risk of the account debtors and receives cash as the debtors settle their accounts.

Fund-of-funds

A fund that invests in other (*venture capital* or *private equity*) funds.

Growth stock markets

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

Hybrid finance

Also called mezzanine 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. These are typically used in a management buy-out to achieve the desired risk/return profile for investors. 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.

Institutional investors

Refers mainly to insurance companies, pension funds and investment companies collecting savings and supplying funds to the markets, but also to other types of institutional wealth (e.g. endowment funds, foundations, etc). Usually these have substantial assets and are experienced investors.

Investment readiness

SMEs with growth potential need to understand the concerns of risk capital investors and should have specialist advice on how to structure business plans to secure external equity finance, to make themselves 'investment ready'.

IPO, initial public offering

Also flotation, going public. The process of launching a public company on a stock exchange for the first time by inviting the public to subscribe in its shares.

Limited partnership

A legal structure that is used by many venture capital funds. A partnership is usually formed for a fixed period of time between the investors in a venture capital fund and the management company making the investments in SMEs. The investors have limited liability and the management company has unlimited liability. The details on management policy and profit-sharing are laid out in a partnership agreement.

Microcredit

Small loans, usually smaller than €25 000, granted most often by specialised institutions.

Private equity

Provides equity capital to enterprises not quoted on a *stock market.* Private equity includes *venture capital, replacement capital* and *buyouts*.

Prudent man rule

Obligation of pension fund managers to invest as a prudent investor would do when investing on his own behalf, in particular by carrying out sensible portfolio diversification but with no formal limits to portfolio distribution.

Quasi-equity

Instruments that have a return to the holder mostly based on the profits or losses of the firm. These are usually unsecured in the event of default and can be convertible into ordinary equity. Includes instruments like convertible loans and preference shares. Part of a wider class of hybrid instruments.

Replacement capital

Purchase of existing shares in a firm from another private equity investor or shareholder(s). Also called secondary purchase.

Risk capital

Equity and quasi-equity financing for firms during seed, start-up and expansion phases. Risk capital financing includes (1) informal investment by *business angels*; (2) *venture capital*; (3) stock markets specialized in *SMEs* and high growth companies.

Secondary sale

The sale of private equity holdings to other investors.

Seed capital

Financing provided to study, assess and develop an initial concept. The phase preceding the start-up phase, which are together called *early-stage*.

Small and medium-sized enterprise (SME)

Under European rules[66] an SME should have less than 250 employees, a turnover at most €50m or balance sheet total at most €43million.

Start-up capital

Financing provided to firms 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. Together with *seed capital* called *early-stage capital.*

Stock exchange (stock market)

A market in which securities are bought and sold. Its basic function is to enable public companies, governments and local authorities to raise capital by selling securities to investors.

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[66] Commission Recommandation 2003/361EC, OJ L 124 p. 36 of 20 May 2003.

Technology transfer

Also known as knowledge transfer or knowledge sharing. The process of converting scientific findings from research laboratories into useful products by the commercial sector.

Venture capital

Investment in unquoted companies by venture capital funds who, acting as principals, manage individual, institutional or in-house money. Venture capital includes *seed*, *start-up* and *expansion* financing, but does not include *replacement* and *buyout* stages. However, in European statistics it is not always possible to separate *private equity* from venture capital.

Venture capital fund

A vehicle for enabling pooled investments by a number of investors in *equity* or *quasi-equity* of a firm. In form, a venture capital fund can be managed either by a company or a *limited partnership* but only a few of these are quoted in *stock markets*.

Working capital

The liquid assets a company has available to build its business and a measure of its efficiency and financial health. Working capital can be positive or negative, depending on how much short-term debt the company is carrying. A negative working capital means that a company currently is unable to meet its short-term liabilities with cash, accounts receivable, and inventory.

Young Innovative Company schemes

National scheme(s) providing fiscal and social benefits for entrepreneurs, employees, investors and companies for investments in early stage companies.