FINANCING HIGH GROWTH ENTERPRISES AND THE SCALE-UP GAP

0. SUMMARY

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

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

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

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

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

The European Innovation Council's fund (EIC Fund) is clearly relevant in that it targets initial scale-up financing stages of high-risk deep tech ventures with investments of up to €15 million (which can be part of larger overall investment rounds alongside other co-investors). In principle the EIC Fund could make larger investments (the Horizon Europe legal base does not limit the size of investments), but such possibilities are limited by the overall size of the EIC budget (approximately €500m per year is available for EIC Fund investments in the current period).

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

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

A workable response to the scale-up gap could draw on EIC and ESCALAR while bringing into the picture other Commission initiatives and on-going reflections which have a bearing on this matter, such as the on-going work on the implementation of the 2020 Action Plan on the Capital Markets Union (creation of the SME IPO fund and reviewing listing rules

for companies, especially SMEs, which will also assess the need for a regulatory framework for special-purpose acquisition companies (SPACs) as well as considering what would be the most efficient and fit-for-purpose means of implementation (i.e. managed by EIF or an agency like EISMEA, involvement of NPBs, etc.).

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

Financing high-growth enterprises

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

Justified by market failures, the provision of finance for promising startups and HGEs is a major focus of government support using a variety of instruments, including accelerators, guarantees, participative loans and governmental venture capital programmes. These instruments mostly focus on start-up and early growth stages. However, the financing needs of HGEs are rarely met by a "one shot deal" and so several funding rounds are needed over time. Research indicates that difficulties in accessing later stage finance is a bigger constraint on growth than access to early-stage finance (Aernoudt, 2017; Hoffman, 2016 + a more recent Commission study on the set up of the SME IPO Fund A Public-Private Fund to Support the EU IPO Market for SMEs).

With the European VC market lagging far behind the USA and China, both in absolute terms and relative to GDP, the later stage gap is particularly severe in Europe (Aernoudt, 2017). Overall, the relatively small size of the EU VC market is the reason for European Commission's intervention to provide capital to both VC funds and VC funds-of-funds, through its investments arm, the European Investment Fund (EIF).

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

The scale-up gap

Venture Capital investment in European companies in the EU is about one sixth of the amount it is in the USA (Table 1). Particularly worrying is the funding situation for scale-ups in their growth or later stage phases. Based on 2020 figures, the proportion of total VC in the form of later stage financing is 84% in the US and 71% in the EU (see Table 1).

Other authors using different data sources come to the same conclusion. Duruflé et al. (2017) who analysed the period 2007-2014 using OECD data confirm that the amount and percentage of funding going into later stages is highest in the USA, namely 67% (in 2014), while it was only 44% (2014) in Europe.

Table 1. Amounts of investments by stage (in billions of euro) for EU27, UK, USA and China in 2020

Data source: Dealroom.co[2]

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

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

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

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

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

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

Source: Own calculation based on CB Insights

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

Current EU-level measures and prospects

The EU already has a number of policies and instruments to facilitate the funding of SMEs, start-ups and HGEs more generally under many EU programmes (InvestEU, Horizion Europe, etc.). Also, within the **Capital Markets Union** (CMU) and the **Renewed Sustainable Finance Strategy**, measures are being deployed to improve the framework conditions for investments in the EU and as such will benefit deep and green tech. More specifically, Action 2 of the CMU action plan announced possible simplifications of listing rules. These simplifications would aim to reduce compliance costs and remove a significant obstacle that holds companies, especially SMEs, back from tapping EU public markets. Since a public listing by a company provides for an exit opportunity for venture capitalists and private equity investors, an ability of a company to list also facilitates the access of that company to earlier-stage financing. In the area of competition policy, a revision is underway of the **guidelines on State aid to promote risk finance investments** following a public consultation which closed in July 2021. In addition, the mandated systematic screening of foreign direct investments will permit to flag upfront EU interests in scale-ups. Under the 2020 SME Strategy, a proposed **SME IPO Fund** aims to boost financing for SMEs that are planning a public listing, are already in a public listing process or have just been listed, to fuel the growth of small and high-growth companies.

As of 2021, **InvestEU**, the Commission's main investment programme, will deploy a European budgetary guarantee of €26 billion to mobilise around €372 billion in additional investment. Among its priorities is support to digital start-ups and innovative SMEs with the objective of enabling them to better compete and scale up. The InvestEU Fund will offer direct debt and quasi-equity funding, as well as intermediated equity products to address market gaps and suboptimal investment situations in areas of EU policy priorities and ensure availability of risk capital for early and growth and late-stage equity and debt investments in European SMEs and mid-caps, including throughout the IPO stages.

The European Innovation Council Fund (**EIC Fund**) was established as specific legal entity to provide equity and quasi-equity investments in startups selected by the EIC Accelerator programme. The investments range from €0.5m to €15m[4] and are generally part of a larger investment round, thereby crowding in other investors into high-risk, deep-tech investments in Europe. Since its launched in mid 2020, the EIC Fund has taken investment decisions in

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

4 The limit of €15m is established in the 2021 EIC Work Programme and is subject to amendment in future Work programmes

approximately 140 startups worth over €600m. It is expected to invest approximately €3.5 billion in the period 2021-27 as part of the EIC budget of €10.1 under Horizon Europe.

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

Other EU equity instruments that have supported the growth of SMEs and start-ups include:

- **Equity Financing for Growth (EFG)**[5] under the COSME programme, targets SMEs in their expansion and growth stages. Through EFG, selected funds – acting as EIF's financial intermediaries – provide VC and mezzanine finance to SMEs operating across borders
- The pan-European venture capital fund-of-funds programme (**VentureEU**) was launched in 2016 under EFSI, with the support of Horizon 2020 InnovFin and COSME, to co-invest public resources in a VC Fund-of-Funds targeting innovative start-up and scale-up companies across Europe. The EU provided €410 million of which €200 million were drawn from Horizon2020, €105 million from COSME, and €105 million from the EFSI.

Both these vehicles underscore the importance of attracting institutional investors willing to invest bigger amounts in bigger, high-potential ventures.

Also noteworthy from a thematic/ sectoral approach:

- The **AI&Blockchain Fund Pilot** launched in 2020 to enhance access to funding for innovative AI and blockchain startups and SMEs - the fund is supported by an investment support programme, which is instrumental in developing a portfolio of AI and blockchain companies and crowding-in co-investments from Venture Capital funds and National Promotional Banks (KFW capital) The fund is managed by the EIF and invests through a decentralised, market-based instrument to existing VC funds that focus on deep technologies across Europe. To date, EC funding of €100m has leveraged a total investment of €1.3 bill (through private-sector and EIB investments [€150m through the first EIB/EIF co-investment facility]) and the EIF has signed 13 agreements with private VC funds.
- Following the AI&Blockchain Fund, a Fund of Funds **Investment Platform** focusing on **Digital Strategic Technologies** (i.e. AI, blockchain, 5G/edge computing, microelectronics, quantum technologies, high performance computing, cybersecurity and IoT in line with the EU digital strategy) is planned providing co-investment risk capital to EU VC funds. The ambition is that €250m be contributed from the Digital Europe Programme and combined combined with funding from InvestEU guarantee through blending in accordance with the InvestEU Regulation. The EIF and possibly EIB will then add their funding to the constitute the dedicated fund that will become the marketable product to VCs.

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

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

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