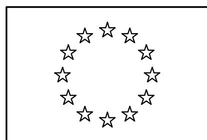

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 29.6.2006
COM(2006) 349 final

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

{SEC(2006) 841}
{SEC(2006) 842}
{SEC(2006) 856}

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1. SUPPORTING THE LISBON PROCESS

The partnership for growth and jobs is the flagship policy of the European Commission. Its success depends on Europe's small and medium-sized enterprises (SMEs) achieving their potential, for they are crucial in fostering the entrepreneurship, competition and innovation that leads to sustainable growth and development. Further, the conclusions of the spring 2006 European Council emphasised that a fully integrated financial market and sufficient access to finance are crucial for the growth of small and medium sized enterprises. The Lisbon process offers a framework within which to improve access to finance, through reforms at national and EU levels.

This improvement is needed despite the fact that the features of a world class environment for SME finance can already be found in many Member States. In the recently published world top 20 ranking on capital access, half are Member States[1]. One of the main challenges is therefore to spread good practices across the EU.

In improving access to finance, the diversity of European SMEs is an asset. They are as different in their cultures as in the ways they innovate. Some provide cutting-edge technology, while others make incremental adaptation of processes and products or develop new marketing strategies. Still others hardly innovate at all, yet their contribution to society is indispensable. This diversity entails different financing needs of individual SMEs. It also creates potential for Member States to improve their policies by learning good practices from each other, so making access to both risk capital and debt finance easier.

Europe needs to work on the availability of risk capital to SMEs with high growth potential. After a strong decrease from €4.2 billion in 2001 as a result of the bursting of the technology bubble, European venture capital investment in early stage firms has stagnated at around €2 billion. If the increase in the number of investments in companies in their expansion phase since 2004 gives cause for some encouragement, European stock markets appear to fall short of providing a passage to the next stage for a significant number of successful companies whose continued growth is so important for the EU.

A recent survey[2] has shown that 14 per cent of the 23 million SMEs registered in the European Union need better access to debt finance, for they can still encounter difficulties in seeking a loan or a microcredit for their next project.

On the demand side, many entrepreneurs need guidance on the advantages and disadvantages of alternative forms of finance and on how best to present their investment projects to potential financiers. Investment readiness programmes, too, need to build on best European practice.

Overall, Europe needs to develop a mindset in which entrepreneurs and financiers alike are more willing to take and to share risk.

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[1] Best Markets for Entrepreneurial Finance, Milken Institute, 2005 Capital Access Index, October 2005

[2] Flash Eurobarometer 174 survey, September 2005

Solving this problem is crucial, for SMEs are essential sources of innovation and job creation, the engines of European growth, whose activities promote structural change and improved welfare for the whole of Europe.

Complementing the Communication on modern SME policies, this Communication presents a set of actions on financing innovative SMEs. It builds on the Commission's work to improve the functioning of the single market, to foster investment in research and in its commercialisation, and on previous Communications on SMEs' access to finance.

2. A BETTER ENVIRONMENT FOR RISK CAPITAL INVESTMENT

The future of European competitiveness depends on an integrated, open, and competitive financial market that also covers risk capital, and in particular, that part of risk capital markets that is generally referred to as venture capital[3].

For growth-seeking entrepreneurs, external financing becomes necessary when their initial funds have been exhausted. Knowledgeable private investors are critical for the launching of entrepreneurial businesses, but there is a serious and persistent lack of business angels and other seed investors in Europe. Business angel investments in Europe are estimated to be less than 10% of those in the United States.

The seed investment decision is based largely on subjective appraisal of the prospects of the entrepreneur. Accumulated experience is important in making such judgements, which is why individuals with a successful track record as entrepreneurs are often best-placed to evaluate and back new opportunities. They should be encouraged to become investors – business angels. Europe has too few business angels, just as it has too few private venture capital funds that also invest in the seed stage.

The lack of seed investors is partly due to low returns that make such investments unattractive. The 10-year return on overall venture capital investments was 6.3% in Europe compared with 26% in the US[4]. These low rates of return clearly cannot generate the levels of private investment that Europe needs. Yet the failure to develop seed and start-up investments in particular prevents new enterprises from reaching a size where they can attract expansion capital. Rigidities in product and labour markets reduce returns, and gaps in the financing chain prevent many start-up firms from achieving their growth potential.

The lack of private funding sources in seed and start-up phases is partly compensated by public investors or public-private partnerships. The financial instruments of EU programmes have also been used for such purposes and the new state aid rules will help in targeting state aid to overcome the market gap. Yet effective public investment needs to form partnerships with private investors and lack of private investors prevents many start-up firms from achieving their potential.

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[3] Risk capital markets cover informal investors (business angels), venture capital funds and growth stock markets. For a full glossary, see annex II.

[4] Figures up to the end of 2004. There are methodological and data differences behind these figures, but this does not change the conclusions concerning the low European figure. Sources: "Venture Capital Returns Held Steady At Year-End 2004", NVCA 11.4.2005, and "Pan-European survey of performance", EVCA 27.10.2005.

The Member States are invited to create incentives for private investors that are willing to invest in enterprises, including by using public funds to target co-investment with business angels. The Commission will identify and spread good practices that can help improve the conditions for business angel investment.

Tripling early-stage investment by venture capital funds

The gap in early-stage financing inhibits SME growth in the EU. United States early-stage venture capital investment stands around 0.04% of GDP. This level has already been reached or exceeded by Sweden, Denmark and the United Kingdom in 2004[5]. For the rest of the EU to reach it would mean that the EU would be able to invest about €6bn a year. This would amount to a tripling of current levels. Such levels were briefly achieved in the past, but the challenge is to reach them on a sustainable basis. Some of these investments may hold the key to Europe's future.

Reforms outlined in this Communication, such as removing obstacles to cross-border investments, and the efficient use of funding sources, would help to achieve this target.

Comparison with the United States reveals a large scope for improvement, especially in technology. In the US, total venture capital investment in technology is four times that of Europe. Further, the average investment in Europe is €0.9m against €6.1m in the US, limiting the potential for growth.[6] To enhance its competitiveness on a global scale, Europe needs both a substantial increase in venture capital funding and in the scale of investments.

In Europe, venture capital seems to fund projects earlier and with smaller amounts than those in the USA, and, as already noted above, it also produces lower returns.[7] This might partially reflect the fact that European venture capitalists more than their US counterparts fund projects before they are ready for the commercial pressures that come with it. This could be linked to the shortfall in appropriate sources for very early stage investment.

Further problems are caused by the fragmentation of the market. As a result, many funds cannot become sufficiently specialised and their management teams cannot develop the special sectoral expertise required for successful investments. The result is a venture capital market that is far less efficient than in the US. Yet the differences between the returns of the top and the bottom European venture capital funds are large. The top funds can consistently provide appropriate returns and attract private investors.

Europe is also risk averse and lacks a growth culture. Neither firms nor funds are aggressive enough in pursuing growth.

In the single market, professional venture capital managers should be able to raise capital and invest across borders without incurring unfavourable tax treatment or extensive legal documentation. This is not yet the case in Europe.

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5 "Annual Survey of Pan-European Private Equity & Venture Capital Activity" 2004.

6 See "Money for Growth: The European Technology Investment Report 2005", PriceWaterhouseCoopers.

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

A key aspect of any successful venture capital investment is the exit strategy – the point at which the venture capitalist can transfer their investment to others, releasing funds to be recycled to new ventures. Unfortunately the European market is also weak at this stage. Easier EU-wide access to growth stock markets is needed, for firms to be able to list easily and for stocks to be readily accessible to qualified investors from all around the EU. Such easier access to financing through stock markets could provide opportunities for the flotation of firms seeking to broaden their capital base on competitive terms. Initial public offerings of stock provide a natural exit route for venture capital investors and give valuation guidance for sales to other companies. Although initial public offerings in Europe have picked up recently, activity in a stronger equity culture would be at a higher level. There are alternative listing opportunities established by European stock exchanges that allow growth companies to raise capital. It would, however, clearly benefit all market participants if these exchanges could develop further by operating across borders, providing liquidity and achieving a critical mass for advisory services.

The fact is that without liquid exit markets for venture capital, with a critical mass of advisory services around them, venture capital funds will always face difficulties. Their weakness strangles the growth of key SMEs. The Commission, the Member States and the exchanges should therefore work together to ease the cross-border operations of financial exchanges, to remove obstacles to the use of competing clearing and settlement systems and to apply common rules to trading. Otherwise, expected returns will be reduced and growth opportunities put at risk. Promising small firms miss opportunities to grow into medium-sized and large ones, reducing the dynamism of the European economy.

To achieve the Lisbon goals, the Commission and the Member States have to work with other stakeholders to transform the face of risk capital investment in Europe. The "Risk Capital Summit 2005" in London identified the following key areas for action:

- Business angel investment needs to be encouraged;
- Venture capital funds need to become larger and more professional and need to cooperate closely with innovation sources;
- Europe needs to overcome the fragmentation of the venture capital market;
- Europe needs liquid growth-oriented stock markets;
- Entrepreneurs need to become more growth-seeking and investment-ready;
- Governments need to reward success with their policies.

The EU needs to create an environment that, despite the cyclical nature of the industry, achieves sustained growth in the level of venture capital investment. This needs a favourable regulatory environment for the whole financing chain, from pre-seed through to investor exits. Further, public intervention needs to be targeted on building the commercial market. Public investment to compensate for market failure should as far as possible be at arm's length, so that investment decisions are solely driven by market discipline, and in partnership with the private sector. The Commission and the Member States need to work in partnership to achieve this aim.

3. MORE DEBT FINANCE FOR SMEs

European banks and guarantee societies are experienced in financing later stages of firm development. This strength needs to be leveraged to ensure growth and employment. The new capital requirements for banks ('Basel II') have reinforced the trend for banks to emphasise the need for thorough risk assessment of their clients. This has created a changing environment in which European SMEs need to maintain a close dialogue with financial institutions. The Commission continues to support this dialogue.

Effective competition in the financial markets improves access to finance by lowering the cost of capital. The Commission has launched inquiries in the financial services sector, examining whether competition is working in these markets. These actions complement the Commission's initiatives to remove regulatory barriers from the single market.

Member States are invited to implement good practices in the use of guarantees to support bank lending in full compatibility with EU State aid rules. In particular, guarantees should be used to help innovative SMEs finance research and innovation (including eco-innovation), and for business transfers. Loan guarantees lower the risk of bank lending, and partial, well-targeted, public guarantees can have a large effect on lending to SMEs. Guarantees can also be countercyclical, helping to maintain banks' lending volumes in a downturn.

Member States are also invited to ensure that national legislation facilitates the provision of microfinance (loans of less than €25 000). Such loans offer an important means to encourage entrepreneurship through self-employment and micro-enterprises, in particular among women and minorities. This instrument favours not only competitiveness and entrepreneurship, but also social inclusion.

In different phases of their life cycle, SMEs may encounter specific financing needs, such as strengthening their balance sheet or financing business transfers. Mezzanine finance (hybrids of loans and equity) offers scope for innovative solutions to such problems. For example, mezzanine instruments can avoid the dilution of ownership while being effective in financing growth; they may help meet the need for stronger balance sheets to address banks' expectations in the new financial environment; they may also help finance business transfers (this is all the more important since, as entrepreneurs retire, over 600 000 SMEs every year are expected to change ownership[8] and many transfers require financing that is attractive for all participants).

Member States should therefore encourage the expansion of the hybrid market, keeping in mind that these are not soft loans, that it is critical to avoid crowding out private financing, and that they should ensure that government programmes are sustainable and do not distort the market. The Commission will identify good practices in the use of hybrid instruments.

Dialogue and healthy capital structure

Capital structure that has too much debt and too little equity makes firms riskier and is a barrier to investment. Taxation that favours debt to the detriment of retained earnings and new equity has been recognised as an obstacle to building stronger balance sheets. The Commission invites the Member States to consider the possibilities for a more neutral taxation

[8] Final Report of the Expert Group on the Transfer of SMEs, July 2002.

of the different forms of financing.

To enhance the dialogue between banks and SMEs, the Commission's Round Table provides opportunities to discuss and adopt common views. The Commission invites Member States to replicate such forums at national level.

4. THE EU CONTRIBUTION TO SME FINANCING

The main EU instruments to promote entrepreneurship and innovation, and to improve SMEs' access to finance, are the *Competitiveness and Innovation Framework Programme (CIP)* and the *Joint European Resources for Micro to Medium Enterprises (JEREMIE)* of the structural funds. The *Seventh Research Framework Programme* will include measures to help SMEs meet certain research-related financing needs.

The CIP will provide some one billion euros through its financial instruments, which are expected to leverage around 30 billion euros of new finance for SMEs. The new programme will offer flexibility in its venture capital investments, enabling it to be used in support of side-funds linked to business angels. At the same time, it will provide support for banks to package and sell off portfolios of SME loans, thus releasing lending capacity. The CIP will support the take-up of environmental technologies, in particular through co-investment in risk capital funds that provide equity for firms investing in eco-innovation. It will also provide guarantees for debt finance, mezzanine finance and microcredits to SMEs. In all, 350 000-400 000 SMEs are expected to benefit from these facilities between 2007 and 2013.

The JEREMIE initiative will combine grants from the European Regional Development Fund with loan capital and other sources of finance to support the creation and expansion of innovative micro, small and medium-sized enterprises as part of EU regional policy. It will also support technology transfer and links between business, universities and research centres, and will improve the availability of micro-credits targeted at those who may not have access to commercial credit. Funding from instruments established through JEREMIE may also be combined with business support and institution-building measures financed by the Structural Funds.

The *Seventh Research Framework Programme (2007-2013)* will support key areas of research increasing Europe's potential for innovation and competitiveness. Opportunities for SMEs are provided by the *Cooperation* and *Capacities* programmes. *The Risk Sharing Finance Facility* will provide additional volume and more risk-taking capacity for Community lending for research investment.

The Commission will closely cooperate with the European Investment Bank (EIB) and the European Investment Fund (EIF) when implementing its financial instruments and in using JEREMIE. From its own reserve, the EIB will notably provide a risk capital mandate of one billion euros to the EIF between 2007 and 2013. To reach the full potential, the Commission invites the Member States to increase the funds flowing to risk capital by making efficient regional use of JEREMIE.

To enhance pre-seed and seed financing, the Commission will also promote cooperation between Commission-financed activities like *Europe INNOVA* and *PRO-INNO Europe* and networks such as the *European Business Angels Network (EBAN)*. The widest possible use

should be made of the lessons of good practice, whether by the Member States, the Commission, or non-governmental operators.

The Commission is currently reviewing the state aid rules for risk capital to allow additional flexibility for Member States, notably higher thresholds and possibility to allow follow-on investments. In addition, state aid rules for research, development and innovation, including rules to support young innovative companies both directly and through support services are being reviewed.

On the taxation obstacles to venture capital fund investments, the Commission will convene an expert group to identify 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 borders.

Building long-term policies on SME access to finance requires policy evaluation based on quantifiable results. Improved data make it easier to evaluate policies and their results at EU and national levels. This is essential to select the best approaches, to avoid red tape, to create a stronger equity culture and to increase asset mobility. The Commission sees the importance of having solid data on SME finance and to use such data to monitor the impact of the new financial environment on SMEs access to finance and thus to ensure a follow-up of this communication.

Support from the EU financial instruments
an example of success

A company focusing on smart cards that was founded in 1991 received business angel backing in 1995. As the company got off the ground, it received venture capital funding in 1999 through a prominent venture capital fund with backing from Community funds.

The venture capital fund sold its share in December 2004, returning over 18 times the original funds invested. Freed funds could be returned to the available pool of funds for investment.

The company is now a leading independent supplier of components and technology in the semiconductor market and operates worldwide logistics services.

5. BETTER GOVERNANCE AT NATIONAL LEVEL

Despite the quality of some aspects of the financial environment in many Member States, SME access to debt finance and venture capital remains difficult in others. Based on the concrete proposals outlined above, mutual policy learning is essential to help Member States to improve the performance of their financial systems. Microeconomic conditions, such as labour market rigidities, can affect the return on investments. The Commission therefore welcomes the commitment of the Member States to implement reforms in the Lisbon National Reform Programmes.

SMEs suffer from unclear bankruptcy laws, slow justice systems and weak creditor rights. Member States are therefore invited to improve their legal systems and judicial processes affecting capital markets and continue their efforts to reduce red tape and improve the regulatory environment for SMEs. In particular, the new Member States have an opportunity to rapidly improve their financial systems by adopting global good practices.

Member States are invited to study schemes that provide fiscal and social charge advantages for entrepreneurs, employees and investors in innovative SMEs in full compatibility with EU State aid rules. However, it is important that such incentives are carefully balanced so that they do not create thresholds (like a sudden need to pay much higher social charges) that make it more difficult for small firms to grow to medium-sized or large ones.

Because investments, in particular in risk capital, are made for long periods, Member States should aim for stable policies that provide certainty for investors. This lowers the effectiveness of short-term policy measures and argues for long-term solutions.

Both the Member States and the venture capital industry need to work to increase the attractiveness of venture capital as an asset class for institutional investors. Venture capital investments that promise to generate appropriate returns may fit well the long-term strategies of pension funds and insurance companies. Member States should not prevent institutional investors from diversifying their portfolio to venture capital investments. National implementation of the *Occupational Pensions Directive* and its 'prudent man rule' should allow occupational pension funds to make a professional decision on their exposure to venture capital investment. This and the identification of remaining obstacles would help reap the benefits of the single market.

Easier cross-border investments in venture capital

In a single market, professional venture capital managers should be able to raise capital and to invest across borders, without incurring unfavourable tax treatment or encountering heavy bureaucratic burdens. This is currently not the case in the EU. With 25 sets of operating conditions, raising venture capital funds and investing across borders is complex and expensive. As a result, European venture capital markets are fragmented and can miss growth opportunities.

Concrete and pragmatic steps are needed to overcome the legal, regulatory and tax barriers in the way of cross-border venture capital funds.

Efforts to provide EU-wide recognition for nationally regulated venture capital funds have so far met with little success. An industry expert group will shortly report on the legal and regulatory barriers to cost-efficient market access for venture capital fund managers.

The Member States need to engage with this issue. To this end, the Commission will invite the representatives of the Member States to discuss further steps.

On the demand side, European entrepreneurs are too often unaware of, or insensitive to, investor concerns. This prevents them from presenting their projects to potential investors in the most convincing way. Professionally-run investment readiness programmes can prepare entrepreneurs both to understand the benefits and constraints of different forms of finance and to make the best presentation of their projects. The Member States are invited to implement such investment readiness programmes, in cooperation with local organizations such as networks of investors and advisors with expertise that could be used more widely.

To support the Member States, the Commission will organise exchanges of experience, specific round tables between financial institutions and SMEs, expert groups on best practice, reports and studies. In doing so, it will pay specific attention to the single market for risk capital.

6. CONCLUSIONS

Better access to debt and equity finance will help all SMEs to achieve their potential. The policies outlined in this Communication offer a solid basis for this improvement, leading to more jobs and growth. In particular, if finance for innovative, growing firms is not available, the EU will be unable to achieve its ambitious growth and jobs targets.

The Lisbon partnership offers a framework within which the Member States can improve access to finance for SMEs, not least by identifying and exploiting good practice.

The challenge is now to make this happen and the Commission will monitor progress on SME finance and provide a first report in 2009 that will feed into the reporting on progress with the renewed Lisbon strategy.

For growth and jobs, Europe needs:

1. More growth through risk capital investments. To this end the Commission will:

(1) Work towards a *single market for venture capital funds* that allows investments across borders without red tape.

(2) *Enhance investor cooperation in seed investment, paying particular attention to business angels,* by identifying and spreading good practices.

(3) *Favour the emergence of more professional* venture capital funds making larger investments, also when implementing Community instruments (CIP instruments, JEREMIE).

The Community institutions and the Member States should create the conditions that allow the sustainable tripling of investment by venture capital funds in seed and start-up companies by 2013.

2. More bank finance for innovation. To this end the Commission will:

(4) Organise a *Round Table between banks and SMEs* to review the current situation and to suggest ways to improve the scope for long-term banking relationships;

(5) Use Community instruments to *leverage lending programmes* targeting innovative SMEs;

(6) Invite experts to evaluate the *advantages of tax relief systems* for young innovative companies.

3. Better governance. To this end the Commission will:

(7) Invite stakeholders to implement *good practices when using public funds* for venture capital investment;

(8) Develop tools and indicators to *evaluate the effects of policies* on SME financing across Europe;

(9) Identify and spread good practices in investment readiness programmes.