EUROPEAN DIGITAL FORUM

digital insights

From Startup to Scale-Up

Growing Europe's Digital Economy

By Sergey Filippov and Paul Hofheinz

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Europe's performance in terms of new business creation is much better than many people think. According to Eurostat, the European Union's flagship statistical agency, 2.3 million new enterprises came to life in the EU in 2012 alone, creating around 3.5 million new jobs. And in 2014, the latest year for which statistics are available, there were more enterprise births than deaths in Europe, a key measure of entrepreneurial drive.[1] Many policymakers across Europe have embraced entrepreneurship and put in place ambitious programmes to help local entrepreneurs start new businesses.[2] And entrepreneurs have responded in kind, uniting to launch a host of viable new initiatives and teaming up into an astonishing array of new startup-driven advocacy groups and associations.[3]

However, increasing the number of new firms is only part of what might or might not eventually count as success.[4] And while Europe can rightly report progress in some areas, there is still one place where Europe lags rather severely behind: not nearly enough companies move decisively from the "startup" to the "scale-up"

1 Eurostat, *Business Demography Statistics* (Luxembourg: Eurostat, 2014). http://ec.europa.eu/eurostat/statistics-explained/index.php/Business_demography_statistics

2 Visit the European Commission's European Small Business Portal for an overview of national support programmes in Europe: http://ec.europa.eu/small-business/index_en.htm

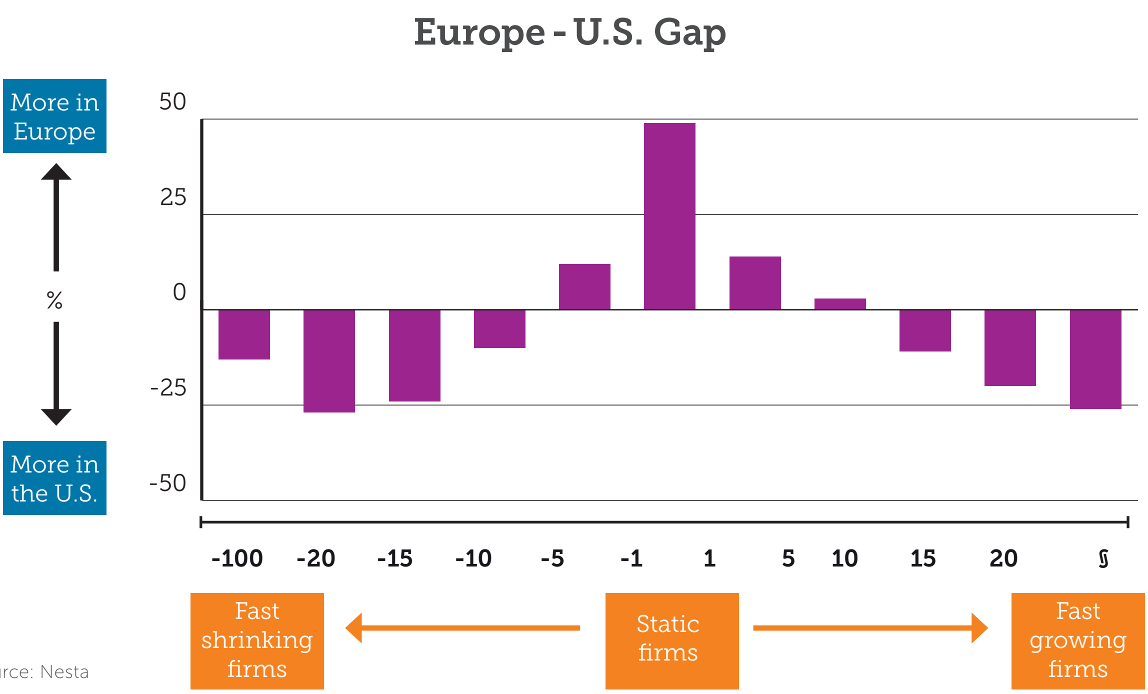
3 See David Osimo, Sergey Filippov, Paul Hofheinz, Katarzyna Jakimowicz and the Startup Manifesto Policy Tracker Crowdsourcing Community. *The 2016 Startup Nation Scoreboard: How European Union Countries are Improving Policy Frameworks and Developing Powerful Ecosystems for Entrepreneurs* (Brussels and London: The Lisbon Council and Nesta, 2016). http://www.lisboncouncil.net/publication/publication/132-the-2016-startup-nation-scoreboard.html For a list of innovative European ventures in this realm, see Sergey Filippov, *Data-Driven Business Models: Powering Startups in the Digital Age* (Brussels and London: Lisbon Council and Nesta, 2014). http://www.lisboncouncil.net/publication/publication/119-data-driven-business-models-powering-startups-in-the-digital-age.html

4 Michael Moritz, "Europe Should Forget Google and Investigate Its Own Shortcomings," *Financial Times*, 22 April 2016. http://www.ft.com/intl/cms/s/0/6425979e-07b0-11e6-9b51-0fb5e65703ce.html

phase, taking on the size and scale to become global champions, and ultimately driving the growth and creating the jobs Europe so badly needs.[5] One study shows that European countries have both fewer growing and fewer shrinking firms than the U.S. In contrast, Europe has a much larger share of firms that remain static.[6] See Chart 1 below.

What's more, 69% of European startups do not achieve unbroken revenue growth between years two and three of their existence, according to a World Economic Forum report.[7] And results like these have a sobering effect on both economic growth and employment.[8] In Europe, for example, the average firm size is 14 employees.[9] In the U.S., it's 30 – a sign that for whatever reason U.S. startups have an easier time moving from the garage to the High Street, taking on employees as they expand and delivering important wealth to the community.

Chart 1. Growth of firms in Europe and in the U.S.



Source: Nesta

5 A startup is commonly defined as an entrepreneurial venture designed to search for a repeatable and scalable business model. These newly created companies are usually highly innovative, typically based on ideas, technologies or business models that didn't exist before. By contrast, a "scale-up" company is one that rapidly expands and grows in terms of market access, revenues or number of employees. High-growth companies are generally defined as those having annual turnover growth of 20% on average in the past three years. Some studies have shown that – whatever the give and take of "creative destruction" at the heart of the capitalist system – new, high-growth firms are the principal source of job creation. According to by Octopus, a UK-based fund management business, 22,470 high-growth small businesses in the UK generated one in every three new jobs and almost 20% of economic growth in the country in 2014. In other words, they generated 4,500 new jobs each week. And these high-growth companies constitute just 0.6% of over 3.5 million firms on the UK business register. See Octopus, *High Growth Small Business Report 2015* (London: Octopus, 2015). http://www.highgrowthsmallbusiness.co.uk/HGSB-report-2015.pdf

6 Albert Bravo-Biosca, *A Look at Business Growth and Contraction in Europe* (London: Nesta, 2011). https://www.nesta.org.uk/sites/default/files/a_look_at_business_growth_and_contraction_in_europe.pdf

7 World Economic Forum, *Enhancing Europe's Competitiveness: Fostering Innovation-Driven Entrepreneurship in Europe* (Geneva: World Economic Forum, 2014). http://www3.weforum.org/docs/WEF_EuropeCompetitiveness_InnovationDrivenEntrepreneurship_Report_2014.pdf

8 Recent economic data in Europe show an uptick in Q1 2016. The challenge for policymakers will be to deepen and secure this expansion. See Eurostat, "GDP Up by 0.6% in the Euro Area and by 0.5% in the EU28," *Press Release 86/2016*, 29 April 2016. http://europa.eu/rapid/press-release_STAT-16-1634_en.htm

9 Albert Bravo-Biosca, *Growth Dynamics: Exploring Business Growth and Contraction in Europe and the US* (London: Nesta, 2010). https://www.nesta.org.uk/sites/default/files/growth_dynamics.pdf

To be sure, the reasons for this dichotomy are complex and multifarious. But attention is increasingly focusing on one area where progress is urgently demanded in Europe: a lack of investment and capital-raising opportunities at the key growth phase. Put simply, the European "funding escalator" is broken. A perfectly operating funding escalator would seamlessly "transport" a new business from startup through seed-capital investment to growth finance and several rounds of venture-capital funding and eventually exit – either through acquisition or a stock market flotation via an initial public offering (IPO). See Chart 2 on page 4 for a schematic rendering of a well-functioning funding escalator.

'Europe's performance in terms of new business creation is much better than many people think.'

The amount of capital available to businesses in Europe is actually shrinking despite the evident need. Invest Europe, the association representing Europe's private equity, venture-capital and infrastructure sectors, estimates the total amount of venture and other forms of growth capital raised in 2015 at €47.6 billion.[10] Venture capital, so important to growth companies, accounted for €5.3 billion, only 11.1% of the total annual amount. Nonetheless, this was the highest level reached since 2008. In 2015, fundraising for early-stage-focused funds increased to €2.7 billion, up by 13%, while later-stage fundraising nearly tripled to €870 million. Actual venture-capital investments increased by 5% but still constituted a mere €3.8 billion, even less than the venture capital raised that year.

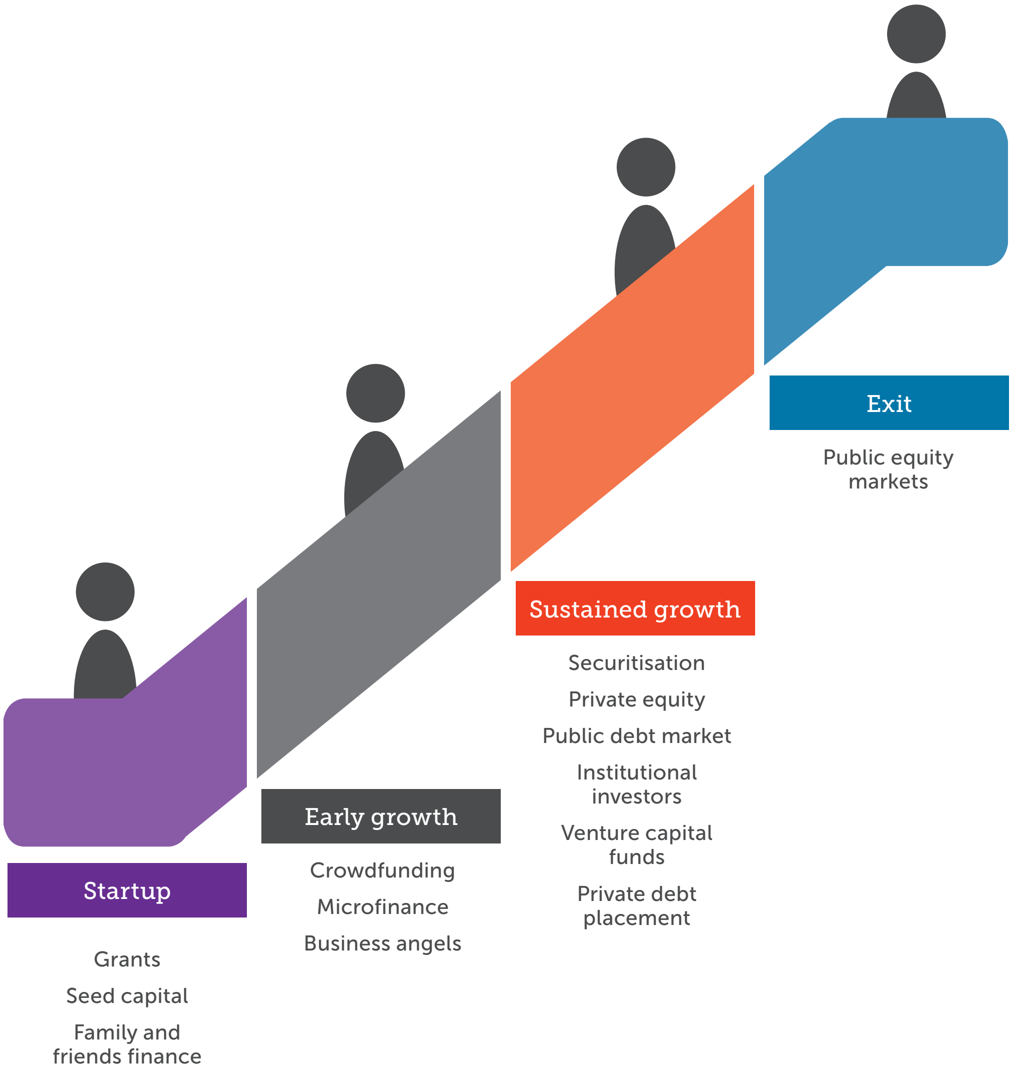
And this is posing an increasingly large strategic problem for Europe – for startups and policymakers alike. In this Digital Insight, we will analyse the places where company-growth financing breaks down in Europe and propose a ten-point plan for fixing the European funding escalator. In this way, we hope to contribute useful ideas and important context to the Investment Plan for Europe proposed by European Commission President Jean-Claude Juncker as a way of increasing investment and unlocking growth, as well as the soon-to-be-formed European Innovation Council, which will complement and expand it.[11]

To be sure, there is no silver bullet to solve the problem of scaling up and unlocking private investment in European growth companies. But concerted efforts from policymakers and the business community – and a strategic combination of soft policies and hard legislation – could bring vital change. We believe the winning formula is a combination of strategic initiative, imaginative funding vehicles, legislative reform, awareness-raising schemes, public advocacy and a strong contribution from the European Fund for Strategic Investments (EFSI), a €21 billion fund made up of European Union guarantees and European Investment Bank capital (managed by a steering board of European Commission and EIB representatives). Over time, EFSI could play a decisive role, but – now that the instrument has been made permanent – policymakers must move decisively to ensure that EFSI does not become a redundant, pro-cyclical subsidy

10 Invest Europe, 2015 *European Private Equity Activity*. Statistics on Fundraising, Investments and Divestments (Brussels: Invest Europe, 2016). http://www.investeurope.eu/media/476271/2015-European-Private-Equity-Activity.pdf. The report provides data on more than 1,200 European private-equity firms, covering 91% of the €564 billion in capital under management in Europe. Next to venture capital, other categories included in funding are growth and buyout. "Growth investment" stood at €6.5 billion in 2015, reaching their highest level since 2008. This is a type of private equity investment – most often a minority investment but not necessarily – in relatively mature companies that are looking for capital to expand operations, restructure operations or enter new markets.

11 The plan aims to inject €21 billion of public money in the European economy, through the European Fund for Strategic Investments, to unlock over € 300 billion of private investment. The European Innovation Council is intended to introduce and develop "disruptive market-creating innovation" in the words of European Commissioner Carlos Moedas. See the box on page 10 for more information.

Chart 2. Funding escalator



for going-nowhere projects with powerful backers. It must remain what it was intended to be: a strategic instrument that corrects genuine market failure and a tactical vehicle for helping the most innovative ideas attain scale and make it to market.

We recommend the following ten-step programme:

1. The European Union and the European Investment Fund should increase investment alongside EU member states in a large public-private venture capital funds of funds.

2. European initial public offering markets need to become significantly more accessible to promising, high-growth firms. Creating dedicated high-growth segments of European stock exchanges, tailored to the needs of these firms, as well as more flexible alternative segments, could have great impact and become part of the solution.

3. Corporate and institutional investors should channel more finance into venture capital and other growth-based funding. This could be done through greater public-private partnership, using state guarantees to encourage co-financing on key projects from sources

as multifarious as pension funds, sovereign wealth funds and social investments. This would require a better national and European-incentive structure, including improved information about opportunities.

> ‘The amount of capital available to businesses in Europe is actually shrinking despite an evident need.’

4. The European Commission should improve communication and public awareness of Europe’s rising stars. One good initiative could be a “Future 100 Europe” programme, modelled on the United Kingdom’s Future 50. In this programme, European companies would compete to receive funding and mentoring from larger, more established firms.

5. End tax discrimination for equity investment. EU member states should drop punitive front-loaded taxes on equity options – not just because “Europe” asked them to but because it’s in their interest that they do so. Tax systems should be adjusted to treat the choice between debt and equity more neutrally. Startups should be able to use “stock-option” packages to attract and retain talent.

6. At the European level, the European Commission and EU member states should work jointly to complete the single market and the capital markets union. A good starting point would be improved business insolvency legislation. A harmonised regulatory framework should allow quick bankruptcy, making it easier for those in need to “fail fast” and offering a second chance to many worthy entrepreneurs.

7. Give a stronger role to EFSI, and to digital startups within it. Regarding EFSI, we believe it could serve as a model in future EU budgets, helping the EU move from a traditional grant-based method of funding projects to a more effective investment-led model, which would “crowd in” funds around well-vetted projects. The EFSI has been a success in that regard, bringing funding into relatively risky areas that might easily have been overlooked.

8. Set up a platform-based information hub and database of promising companies, integrated with the European Investment Advisory Hub (EIAH) and the European Investment Project Portal (EIPP).[12] Its core element would be a pan-European database of EU high-growth firms in different sectors, chosen on objective and transparent criteria, allowing cross-company comparison and benchmarking. In particular, the hub would include a list of companies in their pre-IPO phase.

9. Build a broader investment tool kit to promote and stimulate growth-stage investment. Among the options that should be considered are greater use of so-called “asymmetric funds,” which deliver varying returns to different classes of asset holders (widespread on the Israeli tech scene) and alternative finance vehicles, such as crowdfunding.

10. Startups should themselves be more vocal, banding together to provide better, more coherent recommendations to policymakers at the national and European level. A good place to begin would be with a “Scale-Up Manifesto,” a hard-hitting set of policy proposals written by leading entrepreneurs. It should look at the concrete problems of scaling small companies and propose concrete solutions for resolving the bottlenecks.

12 European Investment Advisory Hub: http://www.eib.org/eiah/index.htm. Information about the European Investment Project Portal: http://ec.europa.eu/priorities/jobs-growth-investment/plan/eipp/index_en.htm

Any attempt to kick-start growth by stimulating new business creation will remain futile without mobilising additional sources of growth financing. And that's where the problems begin. The fact is, scale-ups are infinitely more threatening than startups. No one can object to a tiny operation with a small market footprint. But scale-ups are a different matter; they often encroach on the territory of economic incumbents as their new business models attract customers with new and better products and services. But this is precisely why a European "scale-up" initiative is needed. Without evolution and innovation, the European economy will struggle to remain at the forefront of global economic development.

Take the case of Denmark, a relatively successful country with a €270 billion economy. A comprehensive set of startup programmes and policy reforms in the last decade led to a dramatic increase in the number of new businesses formed. However, the vast majority stayed at the level of just a few employees, and a recent study showed that fewer than 1% could be considered "growth" ventures.[13] Put simply, to gain the impact and scale, to get the growth and jobs and not least to attract and retain the innovative young companies Europe needs, the broken "funding escalator" must be fixed.

This Digital Insight is divided into three parts. Part I explores the current investment landscape in Europe and identifies bottlenecks and challenges that need to be tackled in order to enhance the investment ecosystem and attract private investment – both domestic and foreign – into fast-growing startups. Part II proposes a comprehensive "Scale Up Europe" plan consisting of six key elements, in which we believe the EFSI and the soon-to-be-launched European Innovation Council should take a central role. We have organised those proposals into a six-part "Growth Wheel," whose recommendations are summarised in Table 1 on page 8. Part III concludes with a brief look at the revolutionary role of digital technologies to drive business growth.

'The situation is posing an increasingly large strategic problem for Europe – for startups and policymakers alike.'

Where the funding escalator breaks down

Europe has traditionally been more reliant on bank finance, with bank lending playing a significantly larger role in the financing of the corporate sector than the issuance of debt securities in the market. This greater dependence on bank lending makes the European economy, especially young dynamic firms, more vulnerable when bank lending tightens.[14] Many traditional banks, especially in the current climate of economic uncertainty, tend to stick to tried-and-tested solutions and classic models of lending. As startups are by definition temporary organisations designed to search for a repeatable and scalable business model, they naturally represent riskier investment projects for banks. On top of that, valuation of these businesses is a huge challenge; and it is even more problematic in the case of digital companies that have few material assets or collateral – companies such as BlaBlaCar, Shazam Entertainment Ltd. and Skyscanner, Ltd. among others.

13 Daniel Isenberg, "Focus Entrepreneurship Policy on Scale-Up, Not Start-Up," *Harvard Business Review*, 30 November 2012. https://hbr.org/2012/11/focus-entrepreneurship-policy

14 European Commission, *Building a Capital Markets Union, Green Paper*, 18 February 2015. http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52015DC0063

The incontestable success of U.S. digital scale-up companies and technology giants points to a different financing model – one fuelled by venture capital, private equity and multibillion exits through IPOs.[15] Below, we analyse how this model works in Europe. It is beyond the scope of this Digital Insight to provide a comprehensive statistical review of the financial performance of the startup/scale-up ecosystem across Europe.[16] Rather, we concentrate our analysis on the bottlenecks and weak spots – identified through a series of roundtables, a comprehensive literature review and more than a dozen interviews with leading financial professionals, entrepreneurs, startup leaders, industry experts and venture capitalists.

'Many policymakers across Europe have embraced entrepreneurship and put in place ambitious programmes to help local entrepreneurs start new businesses.'

Venture capital for growth

At its heart, the challenge Europe faces is an insufficient amount of venture capital available for high-growth scale-ups. European venture capital funds are financing too many startups with too little money. And dedicated growth venture capital funds are too few in Europe. As a consequence, companies at the scale-up stage cannot call on deep and sophisticated capital markets to raise the capital they need.

The main problem is the high fragmentation of the EU venture-capital industry along national borders. At around €60 million, the average European venture capital fund is only half the size of the average firm in the U.S., and around 90% of EU venture-capital investment is concentrated in only eight EU member states – Denmark, Finland, France, Germany, the Netherlands, Spain, Sweden and the UK.[17] Because of the diversity of rules in EU member states, venture-capital managers bear high costs in raising funds across Europe. The result is EU venture capital funds are relatively small, and thus have less capital to support growing businesses. The European Commission estimates that if Europe's venture-capital markets were as deep as in the U.S. as much as €90 billion of additional funds would have been available to finance companies between 2008 and 2013.[18] High geographic localisation in Europe make the funds extremely exposed to endogenous shocks in their respective home economies. Potential risks and rewards are not shared across borders. This home bias of venture capital may be less of a problem for startups that start their business operations locally and rely on capital raised locally too. But the problem becomes acute at the growth stage.

Also problematic is the insufficient involvement of private investors. Over the last decade, the European venture-capital sector has become increasingly reliant on public-sector institutions. At the onset of the global economic crisis in 2007, government agencies contributed 7.9% of the venture

15 The U.S. venture-capital model has come under recent criticism – mostly from critics inside the U.S. – who argue that the system is over-compensating winners and under-valuing otherwise promising companies. But the fact is, whatever problems it has, the U.S. venture-capital system has produced 101 unicorns, as startups with market valuations of more than €1 billion are known. See, especially, William D. Cohan, "Silicon Valley's $585 Billion Problem," *Fortune*, 01 February 2016. http://fortune.com/silicon-valley-tech-ipo-market/

16 An excellent study for the UK has been prepared by Sherry Coutu. Sherry Coutu, *The Scale-Up Report on UK Economic Growth* (London: The Information Economy Council, 2014). http://www.scaleupreport.org/scaleup-report.pdf

17 European Commission, *Building a Capital Market Union, Green Paper*, op. cit.

18 Ibid.

Table 1. The growth wheel: Key recommendations

1. Embrace growth as a model and goal

- Celebrate high-growth digital businesses, define success in terms of business growth
- Embrace the transformative power of digital technologies
- Advocate growth-friendly policies through a "Scale-Up Manifesto"

2. Create new financial mechanisms to support digital businesses

- Design innovative non-debt, non-equity financial vehicles
- Develop cost-effective and standardised approaches to capture and process information on intellectual property and intangibles

3. Foment dedicated programmes to promote scaling up

- Establish a Future 100 Europe programme
- Create a dedicated portal integrated with the European Investment Advisory Hub (EIAH) and the European Investment Project Portal (EIPP)

4. Pass legislation to facilitate scaling up

- Implement policy proposals and initiatives in the digital single market, capital markets union and upgraded single market strategies that create an environment supportive to scaling up

5. Enhance the contribution of the European Fund for Strategic Investments (EFSI)

- Encourage EFSI involvement in a pan-European venture capital fund of funds
- Establish a digital investment platform benefiting from the EU guarantee within EFSI

6. Replicate success; build on what works

- Scale up the European Fund for Strategic Investments as a model for future public funding, starting with the next EU Multi-Annual Financial Framework

> 'Increasing the number of new firms is only part of what might or might not eventually count as success.'

capital raised that year. In 2015, this number grew to 31% – €1.6 billion out of €5.3 billion overall.[19] State-sponsored funds are now the biggest investors in European venture capital. While justified during the economic slowdown, this trend, however, should be reversed. The aim should be not less public money, but more private money. The investor base must be expanded and diversified if the industry is to become self-sustaining in the long-term – with banks, pension funds and insurance companies, hedge funds, corporate investors, foundations and endowments, serial entrepreneurs, wealthy families and individuals all playing a part.

Even more decisive engagement of pension and insurance funds into the venture-capital ecosystem would be a game-changer. In 2015, pension funds constituted 7% of the total amount of European venture capital raised; and insurance companies – 3%. In general, insurance and pension funds typically pursue long-term, conservative strategies, tending to avoid risky investments such as venture capital. In many instances, the regulation in place encourages this. For instance, the new insurance directive (Solvency II), inspired by the prudential one for banks, establishes the amount of capital that EU insurance companies must hold to reduce the risk of insolvency.[20] Policymakers should make sure for insurance companies that Solvency II does not discourage investment in venture and growth capital. A possible solution would be to encourage their investment alongside European states in large public-private funds of funds.

A new category of non-traditional investors could also be brought in – the sovereign wealth funds, such as Norway's Government Pension Fund, UAE's Abu Dhabi Investment Authority, China's SAFE Investment Company, China Investment Corporation or Saudi Arabia's SAMA Foreign Holdings. In 2015, they contributed fully 13% of the total amount raised by private-equity firms, but their share in venture-capital fundraising was close to zero. Considering the multibillion resources they control, the potential of sovereign wealth funds in the venture-capital ecosystem is enormous.

Taking into account the special – sovereign – status of these funds, bilateral funds with local financial institutions need to be established. The case of Ireland deserves special attention. Jointly with China Investment Corporation, the Irish National Pension Reserve Fund established a bilateral fund to invest in rapid-growth technology startups. Created in 2014 with a total of $100 million [€80.1 million according to the December 2014 exchange rate], the China Ireland Technology Capital Fund provides investment to Irish startups seeking to expand into Asia and set up a base in China, and vice versa.[21] In a similar fashion, Italy has put together bilateral funds with Kuwait and Qatar to invest in medium-size companies and provide expansion capital to help them grow in international markets, including the Middle East. France has done the same thing with sovereign wealth funds from Qatar and the United Arab Emirates.[22]

Another development picking up speed in the investment industry is corporate venture capital, such as Telefónica Venture, Telefónica Open Future, Siemens Venture Capital, Unilever Ventures,

19 Invest Europe, *op. cit.*

20 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=celex%3A32009L0138

21 Department of Finance, "NPRF and China's CIC Establish $100 Million China Ireland Technology Growth Capital Fund," *Press Release*, 17 January 2014. http://www.finance.gov.ie/news-centre/press-releases/nprf-and-china%E2%80%99s-cic-establish-100-million-china-ireland-technology

22 Javier Santiso, *Sovereign Wealth Funds 2014* (Madrid: ESADE, KPMG, Invest in Spain, 2014). http://itemsweb.esade.edu/wi/Prensa/SWF2014_ENG.pdf

New ideas for 'disruptive market-creating innovation'

One new idea to emerge from European policymaking circles is the proposed "European Innovation Council." Apparently modelled on the European Research Council (ERC), a European funding agency which manages a €13 billion budget to stimulate the pursuit of excellence in scientific research, the somewhat oddly named European Innovation Council would contain a mandate to develop and fund "disruptive market-creating innovation" in the words of Carlos Moedas, European commissioner for science, research and innovation, who first proposed the idea in February 2016. So far, concrete proposals for how the "council" should be run are vague, but if it is anything like the ERC upon which it is modelled, it would be set up with a bifurcate structure: at the ERC, a body of eminent scientists gives expert advice on where the cutting edge of research lies, while another panel administers the funding. Commissioner Moedas has also called for a "fund of funds" not unlike the one proposed in this paper. In this scenario, the fund of funds would provide matching funds in the venture-capital arena, looking to stimulate private investment in more ambitious, market-bending business ideas. Says Commissioner Moedas: "This is what is needed to turn our best ideas into new jobs, businesses and opportunities." The specific remit and responsibilities of the proposed innovation council are still being debated. For more information, visit https://ec.europa.eu/research/eic/ and read Éanna Kelly, "Exclusive: EU Moves toward European Innovation Council Pilot Plan," *Science|Business*, 28 May 2016. http://sciencebusiness.net/news/79795/Exclusive-EU-moves-toward-European-Innovation-Council-pilot-plan.

Google Ventures, Intel Capital and Qualcomm Ventures. Large companies are setting aside funds for external investment in fledgling companies or startups.[23] They are looking for quicker, cheaper and better sources of innovation than research and development. In return, the startups they invest in benefit from their capital, expertise and connections.[24]

Despite some of the successful examples of European corporations creating their own corporate venture capital funds, the overall contribution of the European corporate sector to the venture-capital pool remains modest. In a submission to the UK government, the British Private Equity and Venture Capital Association (BVCA) noted that some £488 billion (€580 billion) in cash and equivalents is sitting on the balance sheets of UK corporations.[25] By contrast, across the whole of Europe, corporate investors dedicated only €742 million for venture capital funds in 2015 – representing only 14% of the venture-capital formation that year.[26] The potential of the corporate sector as a source of venture capital is enormous; and it is set to grow as a key player in the sector.

A perfectly functioning pan-European venture-capital space for European digital scale-ups offering those companies the same opportunities as the U.S. venture capital offers to investors may seem like a far-fetched expectation. In order to achieve it, a common European regulatory framework encouraging the participation of various groups of investors is needed today.

23 Rami Rahal, "Will Corporate Venture Capital Disrupt the Traditional Investment Ecosystem?" *Entrepreneur*, 16 December 2014. http://www.entrepreneur.com/article/240904

24 The Economist, "If You Can't Beat Them, Buy Them," *The Economist*, 22 November 2014. http://www.economist.com/news/finance-and-economics/21633883-fear-being-displaced-startups-turning-firms-venture-capitalists-if

25 British Private Equity and Venture Capital Association, *BVCA 2014 Budget Submission* (London: BVCA, 2013) http://www.bvca.co.uk/Portals/0/library/documents/BVCA%202014%20Budget%20Submission.pdf

26 Invest Europe, *op. cit.*

Huis clos. No way out

'Not enough European companies move decisively from the 'startup' to the 'scale-up' phase.'

The modest functioning of Europe's venture capital in supporting scale-ups is intimately related to challenges at the exit stage. By definition, venture capital funds expect higher returns, compensating for higher risks. And these higher returns need to be realised at the exit stage. More successful, high-valued exits from the startup-scale-up – through mergers and acquisitions (M&A) or IPO – could generate more capital that would flow back to venture capital funds. This may explain why European venture capital funds are on average half the size of those in the U.S.; they can't raise high amounts of capital if they don't expect correspondingly high exits.

Compared to an IPO, acquisition represents by far the more popular form of exit, both in Europe and in the U.S.[27] In Europe, the iconic – and largest – venture-capital exit to date is the purchase of Skype by eBay for $3.1 billion (€2.6 billion at the then-prevalent exchange rate) in 2005.[28] By contrast, a study produced by the Startup Europe Partnership found that out of 990 digital scale-ups in the five biggest EU countries (France, Germany, Italy, Spain and the United Kingdom) there were 350 M&A deals and only 24 IPOs over a period of 2011-2014.[29]

Out of these 24 IPOs of digital scale-ups, 20 became listed on European stock exchanges with an average valuation of $184 million (€168.3 million). The smaller IPOs of European companies backed by venture capital mean less capital flowing back in the venture capital funds. Unless we see bigger exits – on the magnitude of €500 million – the European venture capital funds will remain small on average. And this is a vicious circle. Underfunded venture capital funds fail to support the growth stage and force ambitious entrepreneurs to sell out prematurely, before reaching the highest possible market valuation.[30]

Europe's IPO systems are not as well developed as their U.S. competitors, resulting in fewer IPOs and fewer dynamic companies benefiting from broad investor participation.[31] More IPOs by technology companies would be beneficial both for the companies financed and the investors investing in them.

One reason why more IPOs do not happen is equity-hostile regulation in Europe. There is a strong bias in the tax system towards debt at the expense of equity. Under most corporate tax systems, the interest paid on a loan is deductible from a company's taxable base, while the dividends paid to equity investors are fully taxable.[32] This tax discrimination between debt and equity originates from accounting principles that traditionally considered interest as a cost of doing business and

27 Martin Zwilling, "Ten Reasons Why IPO Is No Longer a Good Startup Exit," *Forbes*, 10 September 2013. http://www.forbes.com/sites/martinzwilling/2013/09/10/10-reasons-why-ipo-is-no-longer-a-good-startup-exit/

28 E-bay, subsequently, sold Skype for $8.5 billion [€7.5 billion] to Microsoft Corporation, which is the owner today.

29 Startup Europe Partnership, *SEP Monitor: From Unicorns to Reality. A Five-Country Comparison of European ICT Scaleups* (Belgium: Mind the Bridge, 2015) http://startupeuropepartnership.eu/wp-content/uploads/2015/07/SEP-Monitor-From-Unicorns-to-Reality.pdf

30 But a push for an IPO too early can also be damaging. See Markus Gentner, "Windeln.de-Börsengang: Aktie bricht am ersten Handelstag ein," *Finanzen.net*, 06 May 2015. http://www.finanzen.net/nachricht/aktien/Schwaches-IPO-Windeln-de-Boersengang-Aktie-bricht-am-ersten-Handelstag-ein-4324854

31 Recent data shows a slump in high-tech IPOs in the U.S. too: just 30 tech deals priced in 2015 – about half the previous year and the smallest number since the crisis in 2009. Market volatility is cited as one of the reasons. Nicole Bullock, "Technology 'Unicorns' Stay Shy of IPOs," *Financial Times*, 09 February 2016. http://www.ft.com/intl/cms/s/0/85bd0034-cb2b-11e5-a8ef-ea66e967dd44.html

32 Serena Fatica, Thomas Hemmelgarn and Gaëtan Nicodème, "The Debt-Equity Tax Bias: Consequences and Solutions," *European Commission Taxation Papers / Working Paper* 33-2012. http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_33_en.pdf

> 'For whatever reason, U.S. startups have an easier time moving from the garage to the High Street.'

returns on equity as a reward for the owner. However, in the age of publicly-held companies and an economy increasingly dependent on taking startups to scale through a cornucopia of financing mechanisms, this discrimination no longer serves a useful purpose or has a clear rationale.[33]

Some countries have designed schemes to reduce the tax discrimination between debt financing and equity financing. In Belgium, a so-called "notional interest deduction" enables all companies subject to Belgian corporate tax to deduct a fictitious interest from their taxable income calculated on the basis of their shareholder's equity (net assets).[34] In Italy, Decree 201 introduces a new tax incentive allowing a nominal deduction computed as a percentage of "new equity," i.e. equity generated after 2010. It grants the tax benefit only to the new equity issued after the reform and includes a stricter anti-avoidance framework. In July 2015, Cyprus implemented a tax deduction on new equity coming into the company for all companies (foreign and local), irrespective of the nature and domain of their activities, and Luxembourg has promised a similar scheme.[35] Initiatives like these could be studied and replicated in other EU member states.[36]

Likewise, individuals who receive share options in a company often have to pay ordinary income tax on these options, reducing their attractiveness as a mechanism for attracting talent and rewarding risk-taking.[37]

The cost of listing fees can be prohibitive for many companies, too. A recent EU IPO task force estimated the cost of fees in IPOs below €6 million to be 10-15% of the overall deal value. In comparison, for larger deals (€50-100 million) these fees are roughly half as large – about 5-8%.[38] For many SMEs, these initial (and ongoing) listing costs outweigh the benefits of going public.

A possible solution is sub-markets with more flexibility, tailored to the needs of smaller, dynamic companies, such as London's Alternative Investment Market (AIM), Frankfurt's *Neuer Markt*, Paris' *Nouveau Marché*, or Madrid's *Mercado Alternativo Bursátil* (MAB). One way of providing flexibility is by dropping requirements for capitalisation or number of shares issued. London Stock Exchange's AIM is the most successful growth market in the world. A wide range of growing businesses including early-stage, venture-capital backed as well as more established companies join AIM seeking access to growth capital. Since its launch in 1995, over 3,600 companies from across the globe have chosen to join AIM. The available evidence shows that listing on the AIM is rather

33 This is one of the conclusions of a high-level conference on corporate debt basis convened by the European Commission and the International Monetary Fund on 23-24 February 2015. http://ec.europa.eu/taxation_customs/taxation/gen_info/tax_conferences/corporate_debt_bias/index_en.htm

34 Learn more: http://finance.belgium.be/en/ondernemingen/vennootschapsbelasting/belastingvoordelen/notionele_interestaftrek

35 See Action 3.2.4 on the Startup Manifesto Policy Tracker, which tracks progress towards fulfilling the goals of the 2014 Startup Manifesto. http://www.europeandigitalforum.eu/startup-manifest-policy-tracker/country/CY-32

36 Several EU member states – including Finland, Slovakia and the UK – have also made debt and equity financing more tax neutral through changes in the statutory rate, according to a European Commission study. European Commission, "Tax Reforms in EU Member States: 2015 Report," *Taxation Papers*, Working Paper No. 58 – 2015. http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_58.pdf

37 See Daniel Ek and Martin Lorentzon, "We Must Act or Be Overtaken," *Medium*, 12 April 2016. https://medium.com/@SpotifySE/vi-m%C3%A5ste-agera-eller-bli-omsprungna-383bb0b808eb

Authors of the Startup Manifesto (http://www.startupmanifesto.eu) propose taxing share options offered by companies in Europe as capital gains, not ordinary income.

38 European IPO Task Force, *EU IPO Report. Rebuilding IPOs in Europe: Creating Jobs and Growth in European Capital Markets* (Brussels: European Issuers, EVCA and FESE, 2015). http://www.fese.eu/images/documents/speeches-reports/2015/Final_report_IPO_Task_Force_20150323.pdf

Tech City UK's upscale programme

On 12 November 2015, Tech City UK announced the launch of Upscale, a new programme to support the next generation of UK scale-up digital businesses. Upscale is designed to provide scale-up tech businesses with expertise from a set of world-class Scale Coaches – who have been influential in the growth of some of the world's most successful digital companies. Some 25 UK tech founders will be chosen to join the programme. The programme consists of a range of curated workshops, mentoring and panel sessions designed to provide the selected founders which the knowledge to scale their companies past the growth barriers they may face. The Scale Coaches include, among others, Niklas Zennström (Skype, Atomico), Brad Feld (Techstars, Foundry Group), Alex Chesterman (Zoopla) and Saul Klein (LoveFilm, Kano, Seedcamp). Upscale builds on Tech City UK's commitment to support UK digital businesses at every stage of their lifecycle and growth trajectory from the Digital Business Academy for very early stage entrepreneurs to Future 50. To participate in Upscale, businesses must be UK-headquartered, growing at 40% month-on-month for the last three months and be funded up to Series A. For more, visit http://www.techcityuk.com/blog/2015/11/powering-the-next-generation-of-uk-tech-businesses-upscale/.

successful. Companies listed on the AIM market have shown on average a turnover growth of 37% and an employment growth of 20% in the year following the IPO.[39]

But this same flexible regulatory system can be a double-edged sword. On one side, small companies have easier access to the stock exchange to float shares. On the other side, the climate can prove hazardous for unsophisticated investors who lack the knowledge and resources to conduct proper inquiries into a firm's prospects and activities.[40]

Another idea worth exploring could be greater use of "sub-markets" for high-growth high-technology companies. In 2013, the London Stock Exchange launched the High Growth Segment in an effort to compete with Nasdaq – the U.S. stock exchange for high-technology companies. It is meant for companies valued between £300 million and £600 million (€420 million to €840 million) and will act as a "stepping stone" for businesses seeking full listing on the main market.[41]

Companies should be encouraged to develop and grow at different stages of development. This may require different markets to suit those needs. The examples of the alternative investment markets show that companies should be able to choose the markets most appropriate to them, and then to opt in to more stringent global regulation at a later stage as they grow.

39 ECSIP Consortium, *Improving the Market Performance of Business Information Regarding SMEs* (Rotterdam: ECSIP Consortium 2013). http://ec.europa.eu/DocsRoom/documents/5570/attachments/2/translations/en/renditions/pdf

For an overview of the 10 top IPOs on AIM, read: David Prosser, "The Top 10 IPOs on Britain's Alternative Investment Market," *Forbes*, 04 April 2014. http://www.forbes.com/sites/davidprosser/2014/04/04/the-top-10-ipos-on-aim

40 The story of Let's Gowex SA, a provider of wi-fi in public spaces, is a example of what can go wrong. Listed on Madrid's *Mercado Alternativo Bursátil* (MAB) in July 2010, the company was tapped in 2013 by the Federation of European Stock Exchanges as the "best new listed company" for its meteoric growth, which was in fact driven by falsified accounts. In July 2014, Let's Gowex declared bankruptcy, which was devastating for other MAB-listed companies. Their shares fell sharply and several companies and members announced their intention to leave the exchange. Tobias Buck, "WiFi Provider Gowex Goes Bankrupt and Admits Falsifying Accounts," *Financial Times*, 07 July 2014. http://www.ft.com/intl/cms/s/0/851d118c-0516-11e4-b098-00144feab7de.html

41 Rupert Neate, "LSE to Launch High Growth Segment Market to Lure Next Google to London," *The Guardian*, 13 February 2013. https://www.theguardian.com/business/2013/feb/13/london-stock-exchange-high-growth-segment

The growth wheel: Six components for driving investment

Europe's 35 "unicorns" – companies with valuation of more than €1 billion – are vivid testimony to the fact that growing and scaling up in Europe is indeed possible.[42] But to kick-start economic growth on the continent, it will be imperative to unlock more private capital and connect investors with high-growth businesses. The good news is there is considerable scope to encourage more corporate and institutional investors into venture capital – tapping into pension funds, corporate venture capital and social investments in order to channel more finance into high-growth businesses.

But growth will not be the outcome of any one set of reforms. It will come about when a series of factors are brought together at the right time in the right place. We like to think of it as a wheel, revolving continuously and effectively, moving the vehicle forward because all parts are strong and functioning well. No one part is more important than any other; to the contrary, the important thing is that all of the necessary elements are there and they all work well together. To illustrate this, we created a six-point growth wheel, containing all of the broad-stroke reforms and innovations for powering European startups into the next era. See the Growth Wheel on page 15 for more.

The growth mindset

Newcomers and disruptors will increasingly power future economic growth. "Creative destruction" is unavoidable.[43] In fact, it has been a defining feature of all market economies for the past century. What is distinctively new is the rapid acceleration of its rate at the onset of the 21st century due to the transformative power of digital technologies.

> 'A strategic combination of soft policies and hard legislation could bring vital change.'

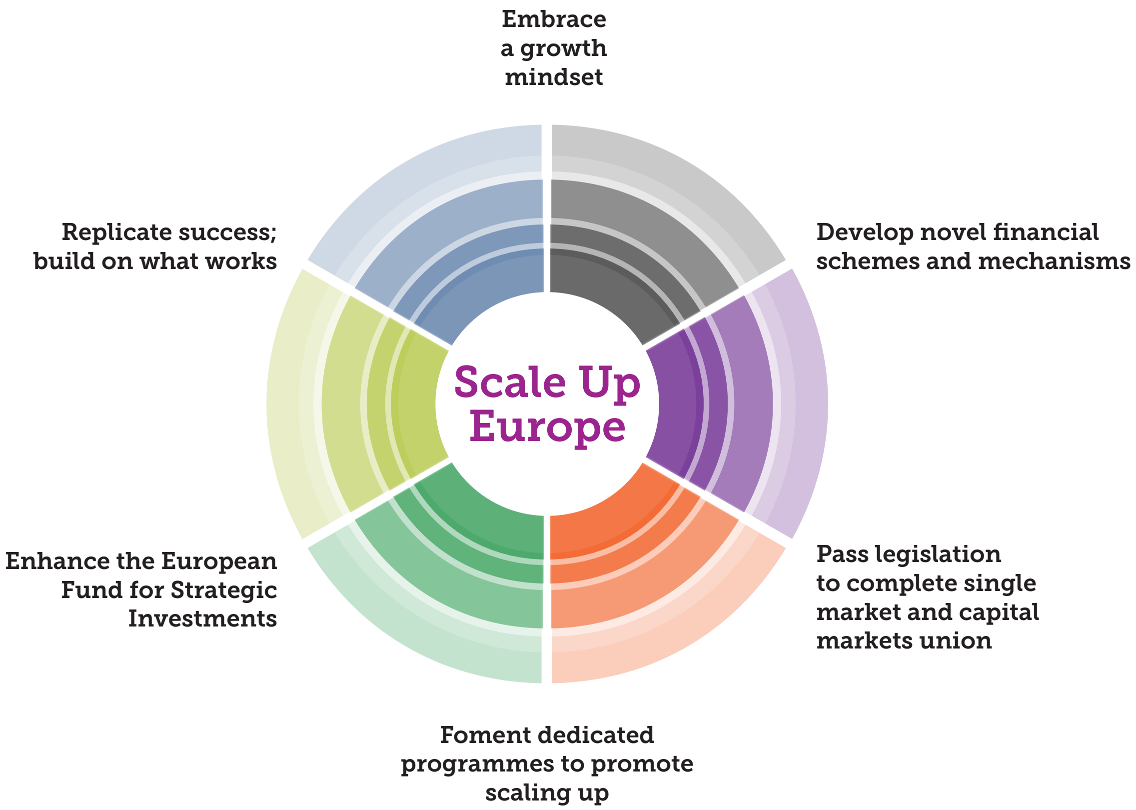
Many visionary business leaders have already embraced this change. They reengineered business models, invested heavily in digital transformation and turned around their companies to be fit for the 21st century. Others have not been that successful. And too often, the focus of policy intervention has been on protecting the past rather than looking positively at the future. Saving the static incumbents that are at risk of being swept away by revolutionary economic and technological developments is unsustainable in the long run. High-growth companies create new jobs and contribute to economic growth and better standards of wellbeing.[44] This growth mindset should drive a wider policy agenda.

42 Unicorns are geographically distributed throughout Europe in an interesting way. In the United Kingdom, there are 17; in Sweden, six; in Germany, four; in France, three; in Finland, two; and in Ireland, Italy and the Netherlands, one each. See GP Bullhound, *European Unicorns: Do They Have Legs?* (London: GP Bullhound, 2015). http://www.gpbullhound.com/wp-content/uploads/2015/06/GP-Bullhound-Research-Billion-Dollar-Companies-2015.pdf

43 The term popularised by Austrian-American economist Joseph Schumpeter, particularly in his book *Capitalism, Socialism and Democracy*, first published in 1942.

44 Ian Stewart, Debapratim De and Alex Cole, *Technology and People: The Great Job-Creating Machine* (London: Deloitte, 2015). http://www2.deloitte.com/uk/en/pages/finance/articles/technology-and-people.html

Chart 3. The growth wheel



Finance plays a crucial role for high-growth businesses. Here, a common understanding needs to be nurtured. It is not the amount of capital that defines economic prosperity; it is the amount of active and productive capital that propels the economy. Money needs to work and to be invested in promising high-growth firms and projects. In particular, the participation of retail investors – individuals – needs to be encouraged. The available data shows that over the years, small investors have been reducing their investment in shares; the proportion of retail investors among all shareholders is less than half what it was in the 1970s.[45] An equity culture should be created and promoted in Europe, including educational and non-legislative initiatives. The European financial system needs to develop investment products that are suitable to retail investors and liquid for them to invest in innovative small businesses.

In particular, we believe startups themselves have a responsibility to address this problem. Specifically, they should team up to produce a Scale-Up Manifesto similar to the well-known Startup Manifesto, written by nine successful European tech entrepreneurs.[46] The Scale-Up Manifesto should capture and convey the importance of startups in powering economic advancement in Europe. And it should address the specific needs of scale-up companies, in particular access to finance.

45 Jonathan Hill, *Speech at the Conference: "Next Steps to Build a Capital Markets Union,"* Brussels, 08 June 2015. http://europa.eu/rapid/press-release_SPEECH-15-5137_en.htm

46 A manifesto for entrepreneurship and innovation to power growth in the European Union: http://www.startupmanifesto.eu. Track its implementation in 28 EU member states at the Startup Manifesto Policy Tracker: http://www.europeandigitalforum.eu/startup-manifest-policy-tracker/

iMinds takes Belgium global

iMinds, the region of Flanders' digital research centre, combines the forces of its 850+ researchers at five Flemish universities for conducting strategic and applied research on key digital technologies.

iMinds designed the Go Global internationalisation programme specifically to support expansion plans of digital startups in key markets, such as Asia and North America. The programme is open to any tech startup in Flanders or Brussels, the Belgian capital. The organisation also welcomes innovation-driven SMEs with a proven business model and concrete internationalisation objectives. Ideally, the participating company already has revenues in its home market and is looking for international opportunities. Internationalisation should be part of the company's strategy, as well as building a network of commercial and financial relationships in foreign markets.

iMinds offers many types of support and guidance – leveraging its worldwide network of business coaches and international professionals. Programme participants receive up to 32 hours of hands-on coaching by an experienced entrepreneur or business developer abroad, access to startup ecosystems and co-working spaces in other countries and pre-paid credit to cover part of the housing and travel expenses.

Tailored to the needs of the participating company, it can benefit from business development, market research, opportunity assessment and introduction through events.

As is traditional, Go Global's geographic focus is the U.S., with hotspots in San Francisco, New York and Boston. But other targeted regions include Asia, with Singapore as a business hub. Additionally, its São Paulo offices offer support in the South American market. For more, visit https://www.iminds.be/en/services/go-global.

New financial mechanisms to support digital business

The classic understanding of venture capital is private equity capital provided as seed or growth funding; and thus the traditional *modus operandi* of venture capital funds is based on taking equity or control in the businesses they invest in. Many successful founders, however, are wary of giving up any equity or diluting existing shareholders and management teams.

Digital technology itself has enabled many alternative mechanisms, such as crowdfunding and peer-to-peer lending. The alternative finance market, virtually unknown a decade ago, is expected to reach the €7 billion-a-year mark in Europe alone in 2015. Digital technologies connect investors and entrepreneurs and make more capital available for investment.[47]

Is it feasible to design non-debt, non-equity financial vehicles? There are some examples of that. A newly established UK-based investment company Draper Oakwood Royalty Capital offers "royalty

47 Sergey Filippov, *Financial Services in the Digital Age: Leveraging Technology and Regulation to Achieve a Stronger Capital Markets Union* (Brussels and London: Lisbon Council and Nesta, 2015). http://www.lisboncouncil.net/publication/publication/125-financial-services-in-the-digital-age.html

capital." Under this scheme, businesses receive an alternative form of growth capital in exchange for a share in future revenues.[48]

> 'Over time, the European Fund for Strategic Investments could play a decisive role.'

In the era of the data-driven economy, the competitive advantage of many modern disruptive companies is underpinned by intangible assets (patents, copyright, industrial design rights and trade secrets). Traditional financing mechanisms are ill-prepared to take into consideration the idiosyncrasies of such businesses. Europe also needs to develop financing routes for intangible-asset-rich firms.

Intangible-asset-rich firms represent a large risk for traditional investors. The UK's Intellectual Property Office has examined ways of stimulating investment into this class of firms, and came up with a set of recommendations helping old and new economy businesses identify and communicate their intellectual property and its relationship to cash flows.[49] Mainstream lending needs cost-effective and standardised approaches in order to capture and process information on intellectual property and intangibles. Unsecured lending in general, and applications to the UK's Enterprise Finance Guarantee scheme in particular, are places for banks to start gathering experience in dealing with intangible asset-heavy companies. Germany, for one, has pioneered the *Wissensbilanz* – an audit of an individual company's intellectual capital in order to capitalise on the capital already within the company and to identify opportunities to increase it.[50]

Asymmetric funds are another innovative idea, whose success can be widely seen in Israel, where these funds originated. An asymmetric-fund is a venture capital fund where different investors are given different terms based on their diverging investment goals – e.g., public investors might get their returns in the form of tax income, while private investors would receive preferred dividends. The funds can also be used to incentivise public-private partnership, recognising the different interests of partners in diverse collaborations. Funds of this type have popped up in several European countries, including Finland, Greece, the Netherlands, Poland and the UK. Notably, the ministry of economy and employment in Finland has adopted an asymmetric fund model to attract private funding through ventures like the Northern Startup Fund I managed by Butterfly Ventures. The fund invests in early stage startups either located or planning to locate in Finland's Northern Ostrobothnia region. Under the unique pay-out structure, the city of Oulu will receive its revenue in the form of tax income. Private investors, by contrast, can receive preferred returns on invested capital and distributed profits.

Dedicated programmes to promote scaling up

Improving access to finance for growth is only one part of a big story. Simply pouring more capital into the market can hardly solve the problem. Many promising high-growth businesses need dedicated support to realise their potential.

Inspiration can come from programmes like the Future 50, an initiative led by Tech City UK that is tailored to the needs of scale-ups and supporting the United Kingdom's top 50 growth-stage

48 BusinessWire, "Draper Oakwood Launches in the UK," *BusinessWire*, 24 November 2015. http://www.businesswire.com/news/home/20151124006011/en/

49 Martin Brassell, and Kelvin King, *Banking on IP? The Role of Intellectual Property and Intangible Assets in Facilitating Business Finance* (London: Intellectual Property Office, 2013). https://www.gov.uk/government/publications/banking-on-ip

50 The research group "Arbeitskreis Wissensbilanz" http://www.akwissensbilanz.org/

digital companies. The UK offers appealing economic conditions for technology businesses, including a big domestic market, widespread online shopping and high rates of the Internet and smartphone adoption. Even in this favourable situation, by effectively cutting red tape, government support is extremely helpful and can make a difference for potential high-growth companies. The programme has already delivered tangible results, with four IPOs and four "unicorns" in particular (see the box on page 27 for more).[51] Another initiative of Tech City UK is its Upscale programme launched on 12 November 2015, which will offer digital startup businesses access to expertise and advice from top European and U.S. entrepreneurs to scale (see the box on page 13 for more).

We propose that the European Commission launch a pan-European programme for growth-stage digital companies, capturing the benefits of the single market. The first intake should be limited to 100 companies, and hence, "Future 100 Europe" could be its name. And this number can be increased over time. Considering the utmost importance of scale-ups for the continent's economy, this programme should fall under the direct responsibility of Elżbieta Bieńkowska, European commissioner for internal market, industry, entrepreneurship and SMEs, and Carlos Moedas, European commissioner for research, science and innovation, and the strategic supervision of Jyrki Katainen, European Commission vice-president for jobs, growth, investment and competitiveness.

'European initial-public-offering markets should become significantly more accessible particularly to mid-sized technology companies.'

Through a transparent selection process, using objective criteria, the programme would identify high-potential companies and nurture them to reach greater scale, exploiting the benefits of Europe's single market. The support – in terms of guidance, counselling and networking – provided to Future 100 Europe companies would be uniquely designed and driven by the particular needs of these companies, with no "one-size-fits-all" solutions. High-growth digital businesses would be incentivised to join this top-notch "executive MBA programme for companies."

Similar to the Future 50 programme, which is now welcoming non-UK native companies with intentions to grow their business in the UK, Future 100 Europe should not discriminate against non-EU businesses. While the focus is obviously placed squarely on promising EU scale-ups, this programme could potentially offer a launching pad for non-EU ventures (with already established operations in Europe) to benefit from the single market, create jobs and contribute to economic growth on the continent. This Future 100 Europe programme would be a "quality mark," and the companies participating in the programme would shine for investors and customers, contributing to brand awareness.

Another inspiration may come from ELITE, a programme of structured engagement developing and supporting ambitious private companies through their next stage of growth. Offered by the London Stock Exchange in partnership with Imperial College Business School, ELITE delivers a three-part service of education, business support, mentoring and access to an ecosystem of professionals fostering growth and innovation.[52] European stock exchanges may collaborate on a voluntary basis to design and deliver a similar programme at European level.

51 The four Future 50-mentored IPOs were AO.com, Horizon Discovery, Just Eat and Zoopla. The four unicorns are Farfetch, Funding Circle, Shazam and TransferWise.

52 Learn more about ELITE programme http://www.lseg.com/elite

Telefónica Ventures, Telefónica Open Future

Open Future is Telefónica's global programme of entrepreneurship and investment, aimed at attracting innovative products, services and talent to the organisation, with the goal of integrating them into its value proposition for customers. It includes several initiatives of proven success, such as the Telefónica Ventures and Amérigo investment funds, the startup accelerator Wayra and the Think Big and Talentum initiatives. Telefónica Ventures aims to maximise the venture-capital portfolio value within the group, enhance Telefónica's relationship with startups and identify tomorrow's opportunities in the sectors like future communication, video, cloud, advertising, HTML5, big data, financial services, security, M2M, and e-health. Telefónica Ventures is based in Mountain View, California and has offices in Madrid, Spain and Jerusalem, Israel. To date, Telefónica Ventures has realised 20 investments in 16 companies. For more, visit https://www.openfuture.org and https://www.crunchbase.com/organization/telefonica-ventures.

Legislation to facilitate scaling up

Few measures could do more to help European companies scale up than completion of the single market, the EU's flagship initiative, which alone would give European entrepreneurs access to a dedicated market of 508 million consumers. This is why the Juncker Commission has launched a series of ambitious new policy initiatives to advance the creation of the single market, helping to bring its provisions more squarely into the digital age and to overcome blockage in key areas.

The landmark proposals include the digital single market, the capital markets union, the single market and the Investment Plan.[53] All these policy initiatives have one thing in common – making a single 508 million-people market work. Broadly supporting these plans, we identify several critical proposals and initiatives that should be treated as a priority for the creation of an environment supportive to scaling up (See Table 2 on page 21). We believe simple and effective cross-border contract rules for consumers and businesses are a priority in the digital single market strategy, and it is gratifying to witness two recent policy proposals, both adopted on 09 December 2015: on the supply of digital content (e.g. streaming music) and on the online sale of goods (e.g. buying clothes online). The two proposals are meant to tackle the main obstacles to cross-border e-commerce in the EU: legal fragmentation in the area of consumer contract law and associated high compliance costs for businesses and low consumer trust when buying online from another country. The European Commission estimates that the removal of barriers due to contract law differences will boost consumption in the EU by €18 billion and EU gross domestic product will increase by €4 billion from its current level.[54]

In the capital markets union plan, revision of the European Venture Capital Funds (EuVECA) regulation and modernisation of the prospectus directive, as well as a study on tax incentives for venture capital and addressing the debt-equity basis are of prime importance. Changes to the prospectus directive should speed up and ease the requirements for small- and medium-sized

53 The Digital Single Market: http://ec.europa.eu/priorities/digital-single-market/index_en.htm. The Capital Market Union: http://ec.europa.eu/finance/capital-markets-union/index_en.htm. The Single Market: http://europa.eu/rapid/press-release_MEMO-15-5910_en.htm

54 European Commission, "Commission Proposes Modern Digital Contract rules to simplify and promote access to digital content and online sales across the EU," *Press Release*, Brussels, 09 December 2015. http://europa.eu/rapid/press-release_IP-15-6264_en.htm

Pitch@Palace

In the United Kingdom, Prince Andrew, Duke of York, founded Pitch@Palace to support entrepreneurs with the amplification and acceleration of their business ideas by connecting them with potential supporters including angels, mentors and key business contacts.

The first Pitch@Palace event took place on 02 April 2014. To date, five editions of Pitch@Palace have taken place, with the latest edition – on 07 March 2016. Pitch@Palace takes place twice a year at St. James's Palace and between 12 and 15 UK entrepreneurs pitch to an audience of around 300 CEOs, angel investors, mentors and key business partners. In due course, the aim is to develop a digital platform to encourage and promote continued dialogue after the pitch events.

Startups participating in Telefónica's Wayra accelerator are regularly selected to join Pitch@Palace. At Pitch@Palace 3.0 in March 2015, two Wayra startups reached the final. All previous winners of the "Best Pitch" award joined Wayra directly afterwards. Four Wayra startups also ran for People's Choice award, which was open to a public vote.

Importantly, Pitch@Palace programme allows to promote British entrepreneurs overseas and to connect them with businesses and investors abroad. The Duke of York invited companies to join him on an economic mission to Saudi Arabia, and at the World Economic Forum in Davos. Learn more at http://www.pitchatpalace.com/.

enterprises (e.g. with a market capitalisation of up to €10 million) and high-growth firms to raise capital throughout the EU.

We also believe a legislative initiative on business insolvency – proposed in both the capital market union plan and in the upgraded single market – could make a big difference for entrepreneurs. As Chart 1 on page 2 shows, seen from the point of view of society, growth on one part of the economy is often coupled with a fall in another, as resources get reallocated towards more effective models and services. The goal is to make this process smoother and less painful. New business models and digital innovation magnify these risks. A harmonised regulatory framework fit the 21st century should allow quick bankruptcy, offering a second chance for honest, hard-working, experienced entrepreneurs.[55]

But there are other areas where the Juncker Commission and EU member states could do more still, including:

- A pan-European legal entity. European law offers an option of the European company (also known by its Latin name *Societas Europaea* or SE) – a public, limited-liability company regulated under EU law.[56] Introduced in 2004, this law has been only modestly successful, with 2,563 established SEs as of 02 June 2016.[57] Recently, the European Commission proposed to institute

55 The Insolvency Regulation (EC) 1346/2000 is an EU regulation concerning the rules of jurisdiction for opening insolvency proceedings in the EU. It determines which member states' courts have jurisdiction. The Insolvency Regulation does not seek to harmonise insolvency laws between the different member states.

56 Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE)

57 SEs are mostly large industrial and financial companies, including Airbus Group SE, Axel Springer SE, Allianz SE, BASF SE, Deutsche Börse, Porsche Automobil Holding SE, SAP SE, Schneider Electric SE. Visit the European Company Database: http://ecdb.worker-participation.eu/

Table 2. Juncker Commission proposals

Digital Single Market	Legislative proposals for simple and effective cross-border contract rules for consumers and businesses
	Legislative proposals to reduce the administrative burden on businesses arising from different VAT regimes
	Initiatives on data ownership, free flow of data (e.g. between cloud providers) and on a European cloud
Capital Markets Union	Proposal for pan-European venture capital fund of funds and multi-country funds
	Revise EuVECA and EuSEF legislation
	Study on tax incentives for venture capital and business angels
	Proposal to modernise the prospectus directive
	Review regulatory barriers to SME admission on public markets and SME growth markets
	Address the debt-equity bias, as part of the legislative proposal on common consolidated corporate tax base
	Assessment of the prudential treatment of private equity and privately placed debt in Solvency II
	Proposal on simple, transparent and standardised (STS) securitisations and revision of the capital calibrations for banks
	Legislative initiative on business insolvency, addressing the most important barriers to the free flow of capital
Upgraded Single Market	VAT action plan
	Legislative initiative on business insolvency, including early restructuring and second chance
	Initiatives to facilitate the use of digital technologies throughout a company's lifecycle and cross-border mergers and divisions
	Initiatives to modernise the intellectual property rights (IPR) framework, including a review of the EU IP enforcement framework

a single-member private limited liability company – *Societas Unius Personae* (SUP), with online registration and a symbolic capital requirement of one euro as its main elements.[58]

- A tax regime that offers incentives to grow and scale up a business rather than selling it. An enabling regulation needs to end tax discrimination of equity towards debt and other forms of investment, and make the choice between equity and debt neutral. A healthy mix of equity and debt is more important than prioritising one over the other. The capital markets union plan seeks to address the debt-equity bias as part of the legislative proposal on a common consolidated corporate tax base. Overall, taxation belongs to national competence. EU member states can work together, creating business-friendly environments.

58 Proposal for a Directive of the European Parliament and of the Council on single-member private limited liability companies / COM/2014/0212 final - 2014/0120 (COD) http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2014:212:FIN

- Harmonisation of accounting standards and systems so that investors can make reliable comparisons of companies across Europe. There is a need to ensure that listed companies are not obliged to report the same results twice in two different ways – a national set of accounts for fiscal reporting and an International Financial Reporting Standards (IFRS)-based report for financial markets. This creates yet another burden for companies, especially SMEs considering listing. And it frequently confuses all but the most sophisticated investors.

All in all, measures should encourage the development of markets in the venture capital and dedicated public equity space.

Contribution of the European Fund for Strategic Investments

The EFSI, a flagship initiative of the Juncker Commission, seeks to address the growth slowdown in the EU and contribute to bridging the investment gap, which is estimated to be about 1.7% of GDP for the EU and 1.9% for the eurozone.[59]

The Investment Plan embraces three interlinked policy areas and objectives – mobilising finance for investment, helping finance reach the real economy, and improving the overall investment environment. The EFSI uses a total of €21 billion from the EU budget and EIB funds to provide guarantees, with the purported goal of unlocking an estimated €315 billion in 2015-2017 by leveraging private investments.[60]

> ‘The main problem is the high fragmentation of the EU venture-capital industry along national borders.’

If successful, the EFSI would cover up to a third of the EU investment gap and provide a short-term boost to aggregate demand and increase long-term economic potential. The EFSI is meant to be "additional" *vis-à-vis* other EU-level interventions, or national interventions. Normally, the EFSI should be used to finance high-risk projects that cannot be financed by the EIB, the EIF or the EU through their normal activities. Article 5 of EFSI Regulation states that EFSI projects "shall typically have a higher risk profile than projects supported by EIB normal operations and the EFSI portfolio shall have overall a higher risk profile than the portfolio of investments supported by the EIB under its normal investment policies."

And the programme is – so far – a big success. As of May 2016, 64 infrastructure and innovation projects had been approved with EIB/EIF approved financing of €9.3 billion. The new agreements enable fund managers to invest in promising startups, SMEs and midcaps, benefitting from early-stage to growth capital investments. As of May 2016, 185 project agreements have been signed through the EFSI SME Window, with the EIB/EIF approved financing of €3.5 billion (roughly €2 billion of those funds – 57% of the amount committed – goes to finance research and development). The projects are operational in 26 EU member states (the exceptions are Cyprus and Malta).[61]

59 European Political Strategy Centre, "The European Fund for Strategic Investments (EFSI): Maximising its Potential," *EPSC Strategic Note*, Issue 11, 06 April 2016. http://ec.europa.eu/epsc/pdf/publications/strategic_note_issue_11.pdf

60 The EFSI is based on three pillars – improving framework conditions and removing regulatory barriers to investment at national and European level; expanding advisory services for project preparation and implementation and the establishment of a pool of viable projects; and accelerating investment by kick-starting risk-taking among market players for viable investment projects.

61 European Commission, The Investment Plan for Europe State of Play, May 2016. http://ec.europa.eu/priorities/publications/investment-plan-eu-wide-state-play-may-2016_en

By their nature, digital scale-ups have a higher risk profile, and this is one of the stumbling block preventing private investment in their growth. It is here that the EFSI can make a huge difference.

> ‘Startups are by definition temporary organisations designed to search for repeatable and scalable business models.’

There are no restrictions on the size of projects eligible for EFSI support for the operations conducted by the EIB or the EIF via financial intermediaries (Art 6.2. of EFSI regulation). The risk might be that the EFSI will tend to support large-scale projects, as promoters of small-scale digitally-led projects do not have the technical capacity and expertise to structure sound projects to the EFSI. The focus on digital scale-ups should be clearly and directly incentivised in the EFSI, and one way of doing that is to create a special platform inside EFSI – which is permitted under existing rules – for digital investment.[62]

Enhanced cooperation and complementarities in terms of competence and expertise between the EIB and national and regional promotional banks are seen as a key condition for success. The involvement of these financial institutions will take place through co-financing of individual projects and through investment "platforms," defined as "special purpose vehicles, managed accounts, contract-based co-financing or risk-sharing arrangements ... to finance a number of investment projects."[63] Investment platforms can either be a national or sub-national platform that groups together several investment projects on the territory of a given member state; a multi-country or regional platform that groups together partners from several member states or third countries interested in projects in a given geographic area; or a thematic platform that groups together investment projects in a given sector. Thematic platforms provide scale benefits by pooling resources and expertise.

We suggest focusing on the digital sector by establishing a digital investment platform, benefiting from the EU guarantee. It would group small- to mid-size investment projects aimed at supporting growth of digital scale-ups, reduce transaction costs and provide a more efficient distribution of risks.

We should also explore the feasibility of EFSI involvement in a pan-European venture capital fund of funds, proposed in the capital markets union.[64] This fund of funds will hold a portfolio of other investment funds rather than investing directly in stocks, bonds or other securities. Investing in a fund of funds may achieve greater diversification and lead to the reduction of volatility. Thus, the fund of funds would be especially attractive for pension funds, endowments and other institutions that tend to pursue a conservative investment strategy. To make sure, such a fund should be private sector-led, but with incentives provided by the EU to reduce risks, such as guarantees or asymmetric profit-sharing providing upside to private investors. This would help in creating needed critical mass, or larger funds, in the European venture-capital industry.

62 In a recent interview, European Commission Vice-President Jyrki Katainen stressed that if one sector could be identified due to its horizontal impact and huge potential, that would be research and development related investment in digital and energy areas. Jorge Valero, "More Needs to Be Done to "Sell" Juncker Plan, Confesses Katainen," *EurActiv.com*, 11 December 2015. http://www.euractiv.com/sections/euro-finance/more-needs-be-done-sell-juncker-plan-confesses-katainen-320340

63 Article 2.4 of the EFSI regulation. Regulation (EU) 2015/1017 of the European Parliament and of the Council of 25 June 2015 on the European Fund for Strategic Investments, the European Investment Advisory Hub and the European Investment Project Portal. http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L_.2015.169.01.0001.01.ENG

64 Carlos Moedas. *Financing Ideas from Europe, Speech at the Innovative Enterprise Conference*, 31 March 2016. http://ec.europa.eu/commission/2014-2019/moedas/announcements/financing-ideas-europe_en

> ‘Without evolution and innovation, the European economy will struggle to remain at the forefront of global economic development.’

Last but not least, given the optimistic initial results of the programme, we support the decision to extend the EFSI’s mandate and operations beyond the original 2015-2017 term and increase its size.[65] We believe the EFSI should continue to be developed and pursued, offering, as it does, a unique way of using public funds to “crowd in” private-sector investment in areas that could make Europe vastly more competitive, providing the jobs and growth our social model needs to sustain itself. We believe that EFSI should become a model for a new form of EU financing, helping the 28-member bloc move away from a grant-making model of public funding to a unique investment-driven format, where the risks worth taking get made, and public finance plays a more helpful role in building the economy of tomorrow. The upcoming mid-term review of the Multi-Annual Financial Framework – the EU’s multi-year budget – would be a good place to begin this discussion.[66]

‘Invest in Europe’ platform: Correcting information asymmetry

Information asymmetry is a central concept in economics. Information asymmetry – where one party has more or better information than the other – creates an imbalance of power in transactions and even market failure in the worst case. Information asymmetry is in stark contrast to perfect information, which is a key assumption in neo-classical economics. The great relevance of information asymmetry in the context of modern information economics was acknowledged by the Nobel Prize Committee when it awarded the Nobel Prize in Economics in 2001 to three U.S. economists – George Akerlof, Michael Spence and Joseph E. Stiglitz – for their “analyses of markets with asymmetric information.”[67]

Information asymmetry is yet another reason why Europe doesn’t produce enough high-growth firms. Investors – from inside and outside Europe – do not have a perfect overview of all investment opportunities. Particularly, non-EU investors face problems understanding the specifics of different national markets on the continent and facing linguistic problems.

And Europe’s high-growth companies also have trouble knowing where to find private and public funding. Particularly, the multitude of financing available and the fragmented nature of pan-European support measures often make it difficult for firms to access funding opportunities.

We suggest creation of a dedicated portal tentatively dubbed “Invest in Europe,” integrated with the European Investment Advisory Hub (EIAH) and the European Investment Project Portal (EIPP).[68]

65 European Commission, “Europe Investing Again: Taking Stock of the Investment Plan for Europe and Next Steps,” *Communication*, COM(2016) 359 final. http://ec.europa.eu/priorities/sites/beta-political/files/1_en_act_part1_v11.pdf

66 The mid-term review of the Multi-Annual Financial Framework will begin at the end of 2016, though formative change in the EU budget will need to await the next MFF, which begins in 2021. Visit http://ec.europa.eu/budget/mff/index_en.cfm.

67 Nobel Prize, “Markets with Asymmetric Information,” *Press Release*, 10 October 2001. http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2001/press.html

68 European Investment Advisory Hub: http://www.eib.org/eiah/index.htm. Information about the European Investment Project Portal: http://ec.europa.eu/priorities/jobs-growth-investment/plan/eipp/index_en.htm

European Startups: More dependent on savings than angels

The European Startup Monitor, an initiative of the German Startups Association, offers a detailed depiction of the state of play among European startups – and a picture of how much more needs to be done to create and sustain these vital innovation engines through their needy, early-stage funding period. More than 2,300 startups were surveyed, representing over 31,000 employees. The Monitor finds that most European startups are internationally oriented and already heavily present in the digital economy. More than half serve international markets, with eight out of 10 planning further internationalisation in the next 12 months. With regards to financing, most founders indicated that their major capital source was their own savings, followed by support from friends and family. In the third place, founders relied on governmental funding and subsidies. Business angels came only fourth. Learn more at http://www.europeanstartupmonitor.com/fileadmin/presse/download/esm_2015.pdf.

Among its core elements would be:

A pan-European database of EU high-growth firms in different sectors, based on objective and transparent criteria, allowing cross-company comparison and benchmarking. Local public and private organisations can identify, target and evaluate their support to scale-up companies. The *Scale-Up Report*, written by Sherry Coutu, cites data available from the UK Office for National Statistics (up to 9,000 scale-ups in the country). If this is already done in one EU member state, why can't it be done at European level? National statistical offices and business registers need to start providing the same data, underpinned by a common methodology. This work can be coordinated by Eurostat, which would accumulate the data and make it available to the portal.

A pan-European database of companies considering their IPO – a "pre-IPO." As well as a pan-European database of all listed SMEs to make them more visible to local, regional, European and non-European investors as an asset class. In particular, this would help mid-caps become more visible to institutional investors who are less close to them geographically.

A pan-European database, or an index of venture capital funds, providing a comprehensive overview of investment opportunities into digital scale-ups for prospective private and institutional investors. The European Investment Fund, which is in possession of reliable data on most European venture capital funds, could take the lead in this undertaking.

All of that would contribute to higher visibility, promotion and even celebration of European scale-up and growth success. In addition to connecting investors with businesses in need of investment, the portal would also build solutions to finance high-growth firms through the critical phases of growth.

> 'At its heart, the challenge Europe faces is an insufficient amount of venture capital available for high-growth scale-ups.'

EuVECA: First steps and assessment

One of the recent initiatives to promote effective cross-border venture capital is the Regulation on European Venture Capital Funds (EuVECA) that took effect on 22 July 2013. The aim of the EuVECA is to make it easier for venture-capital-fund managers that are below the Alternative Investment Fund Managers (AIFM) Directive thresholds – €100 million if the fund uses leverage, or €500 million if not – to raise funds across Europe. It sets out a new "European Venture Capital Fund" label and includes new measures to allow venture capitalists to market their funds and raise capital across the EU and grow based on a single nation's rules, without having to comply with 28 different national standards. Every fund using the label will need to spend a high percentage of investment (70% of the capital received from investors) in supporting young and innovative companies. At this stage, it is still hard to estimate the extent to which the EuVECA will work. The European Commission has already proposed revisions to the regulation in the framework of the capital markets union plan. For more, visit http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0345.

Digital technologies power the rise of scale-ups

At the end of the day, there is no substitute for creating the enabling conditions – such as the digital single market – that would allow ambitious European firms to seize the growth they seek. However, impactful actions could be launched right now to unlock private investment in digital growth and make Europe a prime place for digital business.

Technology makes possible "exponential organisations," which perform 10 times better than their peers thanks to advanced accelerating technologies – 3D printing, industrial robots, drones, solar energy, sensors, neurotech, nanotech, biotech and the like.[69] This is the biggest transformation in business the world has seen in over a century. Over a short period of time, digital technologies have moved from simply allowing businesses to do what they've always done to enabling businesses to completely change not only what they are doing, but also the business models they use to create value. The list of "exponential organisations" includes companies like AirBnB, Inc.; GitHub, Inc.; Google; Netflix; Quirky; Tesla Motors, Inc.; Uber Technologies, Inc.; Valve Corporation and Waze.

Regrettably, many investors unconsciously perceive digital technologies as a threat, reminiscent of the so-called "dot-com bubble" that collapsed in the course of 1999–2001. But this time is different. Fifteen years later, the Internet itself is more mature and ubiquitous, and in advanced economies, digital technologies are interwoven in and underlie most physical processes and operations. Companies in traditional sectors reinvent themselves, becoming more digital. In contrast to the late 1990s, today virtually every citizen in advanced economies is digital, using computers, tablets, smartphones and other gadgets routinely. Digital is not an isolated sector. Today, the economy is digital.

The problems and solutions discussed in this Digital Insight are valid for most scaling up companies, and they are even more pronounced in the age of the Internet, when digital

69 Salim Ismail, *Exponential Organizations: Why New Organizations Are Ten Times Better, Faster, and Cheaper Than Yours (and What to Do About It)* (New York: Diversion Books, 2014).

technologies power scale-ups. Put simply, despite the unparalleled opportunities for high growth, scaling up remains hard. But the Internet offers the opportunity to turn that challenge into hope. Concretely, it offers the chance that Europe can find the growth and jobs it needs to sustain our way of life and restore social cohesion after nearly a decade of stagnation. But the solution lies not in stubborn rejection of the new but in passionate commitment to the modern. And the investment sector has a key role to play in getting us there. This Digital Insight is intended as a small contribution to that reflection and debate.

How the UK makes its stars known

One of the key initiatives promoted by the UK government is Tech City UK, an organisation whose main objective is to foster the technology ecosystem in the United Kingdom and to make it the best place in the world to imagine, start and grow a digital business. Future 50, a flagship business programme originating from Tech City UK, is specifically designed to support growth stage technology companies to scale rapidly and reach their full potential in the UK and globally. Chancellor of the Exchequer George Osborne and Joanna Shields, then Tech City UK Chair and Digital Advisor to the UK Prime Minister, launched this programme in April 2013; and an open competition for the UK's most promising growth-stage companies commenced. Objective financial indicators were set for companies in order to be eligible for the programme, namely, annual run rate revenue of at least £10 million [€11.8 million at the April 2013 exchange rate], increasing by 30% year-on-year over the last two years. In the most recent intake, the requirement for annual revenue was defined as a range of between £3 to 30 million [€3.5 to 35 million].

While enjoying a strong political support by the UK government, the programme is spearheaded by the UK business community, not by government officials. On a daily basis, a dedicated Future 50 Programme team works continuously to provide bespoke services tailored to the Future 50 companies' specific needs. This is accomplished by enabling unique access to and leveraging the expertise from the UK government and private sector as well as in-house knowledge and expertise. The programme also aims to significantly boost visibility and exposure of the companies to the institutional investor community.

At present, Future 50 supports the UK's top 50 growth-stage digital companies, collectively employing around 17,000 people. Since joining the programme, a number of the Future 50 companies have announced major milestones, including initial public offerings (IPOs), growth capital raises, expansion via strategic acquisitions, opening international offices and expanding presence overseas. To date, Future 50 companies have raised £791 million [€1.13 billion]. Four Future 50 companies – Farfetch, Funding Circle, Shazam and TransferWise – have turned into "unicorns," being valued at more than €1 billion.

There have been four IPOs representing the key primary capital markets activity in the broader technology sector in the UK: Ao.com, Horizon Discovery, Just Eat and Zoopla. In fact, the Future 50 programme corresponded with reforms introduced by the UK government and the London Stock Exchange to make UK equity markets more attractive for British companies who would have turned to NASDAQ or other global markets for listing otherwise. For more information, visit http://futurefifty.com.

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About the European Digital Forum

The **European Digital Forum** is a think tank dedicated to empowering tech entrepreneurs and growing Europe's digital economy. The initiative is led by the Lisbon Council, a European think tank based in Brussels, and Nesta, the United Kingdom's innovation foundation, in collaboration with the European Commission's Startup Europe initiative. The European Digital Forum was launched at the World Economic Forum in January 2014 as a vehicle to intellectually accompany the 22-point action plan put forth in the **Startup Manifesto** (www.startupmanifesto.eu) written by the Leaders Club, an independent group of founders of world-leading technology companies based in Europe, including Atomico, HackFwd, Rovio, Seedcamp, Spotify, Tech City Investment Organisation (TCIO), Tuenti and The Next Web. In the manifesto, which was drafted to spur discussion on improving Europe's startup ecosystem and digital-era performance, the European tech leaders proposed establishing a permanent independent think tank to explore and elaborate a more decisive approach to startups, an invitation which was seized and carried forward by the Lisbon Council and Nesta in 2014. Among the founding partners of the initiative are the European Investment Fund (EIF), Banco Bilbao Vizcaya Argentaria (BBVA) and Telefónica. Accenture is a partner. Follow the European Digital Forum on twitter at www.twitter.com/edf_eu.

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