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EU Commission should pick and back winners to grow €1B unicorns

Éanna Kelly, Science|Business

A UK programme set up in 2013 has already produced four high tech companies with valuations of €1B. The European Commission should set up a similar scheme, says the European Digital Forum

The European Commission should handpick 100 mid-size technology companies and back them to grow rapidly, **says the think tank, European Digital Forum (EDF).**

The programme – suggested name Future 100 Europe – should take its inspiration from the UK's Future 50, a government-backed, industry-controlled body launched in 2013 to promote Britain's digital economy.

"This Future 100 Europe programme would be a 'quality mark', and the companies participating in the programme would shine for investors and customers," says EDF.

The idea is consistent with much of the thinking behind the proposed European Innovation Council (EIC), a new instrument being pushed by EU Research Commissioner Carlos Moedas to help companies grow quickly and significantly, by increasing the funding options for medium-sized companies with growth potential in Europe.

The UK Future 50 initiative combines several features the Commissioner says he would like to see in the EIC, including mentoring for companies, introductions to investors and advice on international expansion opportunities.

Future 50 has generally been recognised as a success and four Future 50 companies, Farfetch, Funding Circle, Shazam and TransferWise, have turned into ‘unicorns’, with valuations of more than €1 billion.

US-inspired ideas

The difficulties of scaling up matter because the rate of formation of new start-ups in Europe is, “better than most people think”, says EDF. According to Eurostat, the EU statistical agency, 2.3 million new firms came to life in the EU in 2012.

This indicates the feedstock is there to grow €1 billion companies, if only there was more ready access to capital. EDF, which is led by the Lisbon Council and the UK innovation body Nesta, in collaboration with the European Commission's Startup Europe Initiative, suggests several other financing options the EU should explore, most of which are inspired by the funding scene in the US.

“The incontestable success of US 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,” EDF’s report says.

The Commission could use a type of fund known as the “asymmetric” model, which offers unique pay-outs to different investment groups.

Finland’s ministry of economy and employment, for example, has adopted this fund model to attract private finance. The fund invests in early stage start-ups either located or planning to locate in Finland’s Northern Ostrobothnia region. Under the scheme, the city of Oulu will receive its revenue in the form of tax income. Private investors, meanwhile, can share future profits.

EDF points to sovereign wealth funds as another untapped source of cash for helping companies to scale-up.

“Considering the multibillion resources they control, [their potential] in the venture capital ecosystem is enormous,” EDF says.

As one case in point, the China Investment Corporation has teamed up with the Irish National Pension Reserve Fund on a fund to invest in rapid-growth technology start-ups.

The China Ireland Technology Capital Fund, created in 2014 with around €80 million, provides investment to Irish start-ups seeking to expand into Asia and set up a base in China, and vice versa.

Venture capital shortage

“At its heart, the challenge Europe faces is an insufficient amount of venture capital available for high-growth scale-ups,” EDF says, recommending the Commission should work with the European Investment Fund (EIF), to raise a new venture capital funds of funds that would match private sector financing with public money.

At around €60 million, the average European venture capital fund is only half the size of the average fund in the US, and almost all EU venture capital investment happens in only eight EU states, Denmark, Finland, France, Germany, the Netherlands, Spain, Sweden and the UK.

Bank lending plays a significantly larger role in the financing of corporate Europe than the issuance of debt securities and this becomes a problem during a downturn in the economy, when bank lending traditionally slows to a drip. Traditional bank lending is also largely unsuitable for modern digital companies with few material assets or collateral.

To give equity financing a boost, policymakers should strip away, “equity-hostile regulation in Europe,” says EDF. “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. Tax systems should be adjusted to treat the choice between debt and equity more neutrally.”

Despite urging the Commission to take on a bigger role in VC, EDF acknowledge part of the problem in Europe is an over-reliance on state-sponsored funds, in particular the EIF, which is the industry’s biggest player.