March 2022

Turning start-ups into scale-ups

Incentivising the role of early-stage investors

This paper was prepared by Business Angels Europe (BAE) and Invest Europe at the occasion of "Startup to Scaleup in Europe: The Role of business Angels" event, which was co-organised with France Angels. It follows up on the joint efforts made by these associations in the context of the Scale-Up Europe Initiative to foster the development of European innovative businesses. In this paper, both associations argue that specific changes - from the EU sophisticated investors' treatment to tax incentives and marketing passports - could unleash the potential of tens of thousands of investors across Europe.

While the right focus has been put recently on the creation of scale-ups that have the potential to become unicorns, it is essential that EU policymakers continue developing initiatives focusing on start-ups at the lower end of the spectrum – as these remain the basis of the innovation pyramid.

These initiatives should specifically focus on facilitating private investments, such as venture capital investors and business angels deliver. Investing in the earliest stage of a business growth path requires an astuteness to risk assessment, an agility in strategy and a flexibility in execution, that are rarely matching the standard conditions of lenders or public funding.

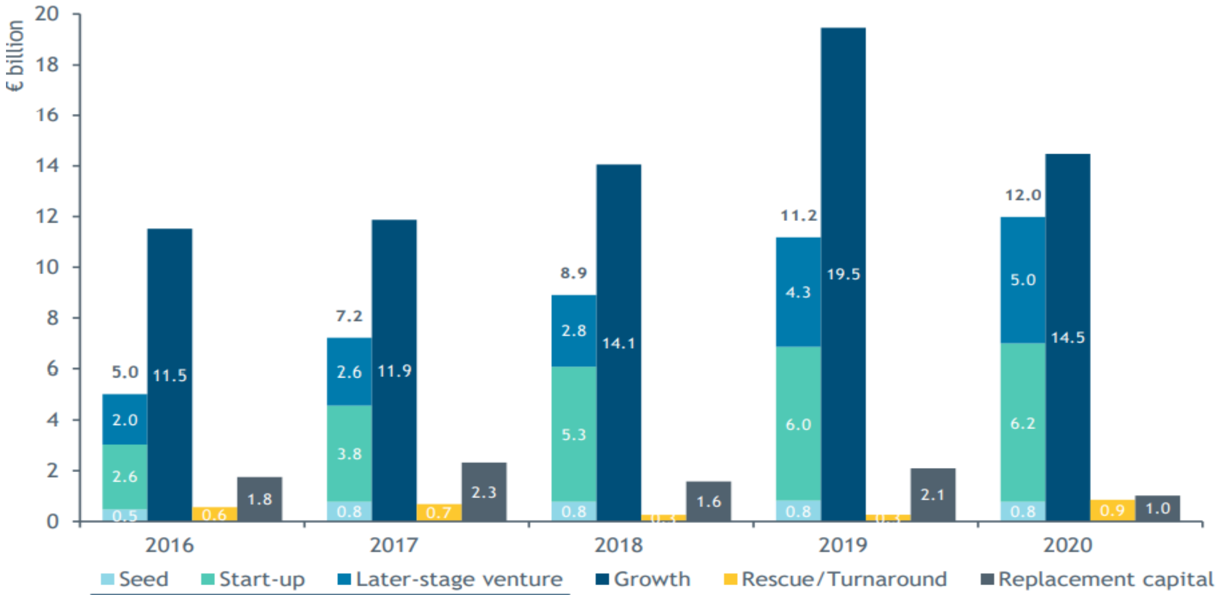

Fig. 1: Amount of private equity capital invested by investment stage[1]

As can be seen in figure 1, the (significant) increase of venture in the past few years has mostly occurred at the larger end of the market while seed investments have remained relatively low.

[1] Investing in Europe: Private Equity activity 2020 (Invest Europe/EDC, May 2021)

From that perspective, and as was well recognised by the Commission in its Retail Strategy, Europe needs an economic environment that incentivises private investors, whatever their size, to commit capital into equity projects – and hence help EU innovative businesses get off the ground.

The benefits could be tremendous and ultimately drive the creation of new unicorns at a time where Europe is, despite improvements, still lagging the US.

As can be seen below, there were still 4 time less unicorns in Europe in 2021 than they were in the US.

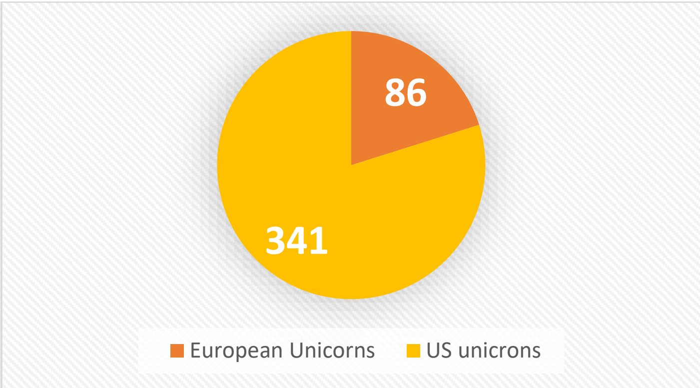

Fig.2: European & US unicorns in 2021[2]

Business angels and venture capital are the two cornerstones of early-stage equity investments and are particularly effective when acting in partnership.

Business Angels (BA) are individuals who directly invest their own money and dedicate their time and expertise into promising ventures in return for equity, while venture capital fund managers pool capital from a range of investors (see figure 3 below) and inject equity into businesses.

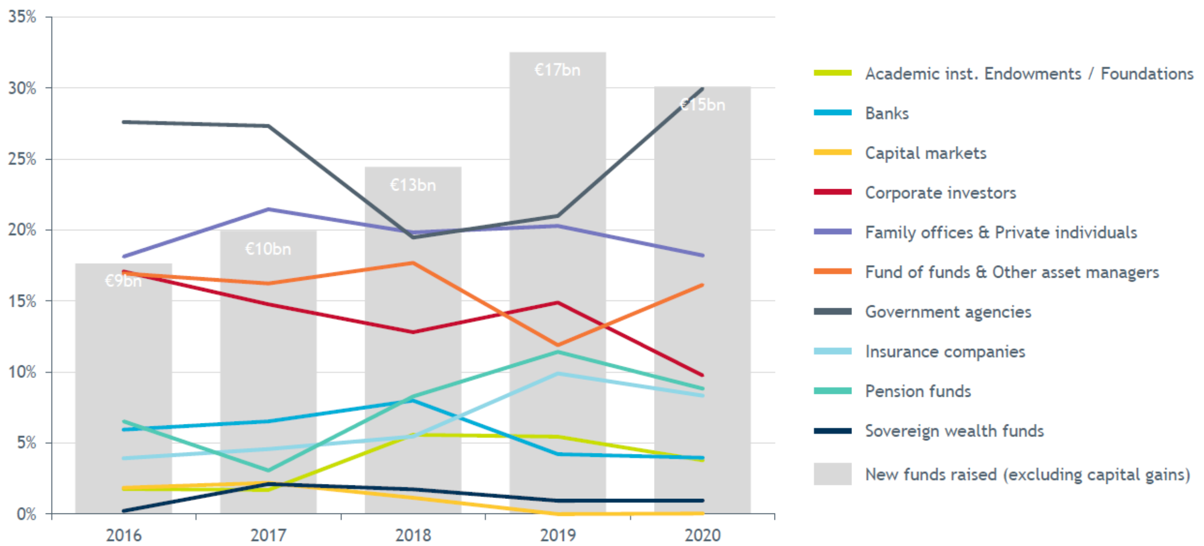

Fig 3: Amount of capital raised by European VC funds in 2020[3]

[2] Crunchbase Unicorn Board, 2022
[3] Investing in Europe: Private Equity activity 2020 (Invest Europe/EDC, May 2021)

Lawmakers across Europe should pursue instruments to promote direct or indirect investor participation in start-ups and scale-ups, whether by increasing these investors' access to expertise, developing financial literacy, promoting tax incentives or improving single market conditions.

To that purpose, we put forward the following ideas:

✓ **A more appropriate treatment of sophisticated investors**

Despite their level of understanding of the market in which they invest, investors with large tickets and a great understanding of the innovative ecosystem, whether business angels or venture investors, are currently often categorised as "retail" clients due to the idiosyncrasies of the MiFID definition, which is very specific to listed markets.

We argue that these "sophisticated" investors should be able to qualify as professional clients. Without this, fund managers will continue to be prevented from marketing to them under the AIFM Directive or forced to prepare documentation that is inappropriate to these investors' level of sophistication.

This would ultimately lower these long-term investors' ability to invest into EU start-ups and established companies.

Introducing amendments to the MiFID investor categorisation ("minimum size of investment" criterion, integration of expertise beyond financial markets) will more appropriately reflect the professional nature of large and sophisticated investors and enhance the EU sophisticated financing ecosystem.

As there are more than 13 trillion of net investable assets held by European high net worth individuals[4], only a minor shift in these investors' allocation of assets could represent a significant difference for the business angel and venture ecosystem.

✓ **Encouraging taxpayers to acquire company shares anywhere in Europe**

While tax remains primarily a national issue, good practices could be fostered as has been indicated in the European Startup Nation Standard.

An initiative to particularly highlight is the French Madelin instrument, a tax scheme offered to all taxpayers, which provides French citizens investors the opportunity to benefit from an income tax reduction by subscribing either directly to the capital of companies or by subscribing to units or shares of venture capital funds.

One of the key advantages of the Madelin instrument is that it does not restrict investments to French businesses, as opposed to its equivalents in other EU countries, making it an essential tool to foster cross-border investments.

Such a measure is also contingent on the "cap/ceiling" of the incentive and on how much actual percentage of the investment can be deducted, something that numerous national governments have so far failed to appreciate.

Promoting this instrument as a "private investor sandbox", and both of its characteristics, would hence strongly incentivize investors cross-border investments in innovative businesses. We therefore

[4] EY study on Wealth Management Outlook, 2018

encourage EU policymakers to support the Madelin Instrument as a “best practice” and national policy makers to integrate it in their legislation.

- ✓ **Creating the right conditions for managers to set up EU retail funds**

If EuvECA allows marketing to larger sophisticated investors, smaller retail investors are not always able to invest their capital into EU venture funds. These funds’ managers are indeed only allowed to market to this type of investors at national level – when such a flexibility is given – or if they are setting up a European Long-term Investment Fund (ELTIF).

As ELTIF is the only opportunity for investors to access long-term asset classes such as venture and growth funds, its ongoing revision is highly welcomed.

ELTIF indeed needed several adjustments, from portfolio diversification rules to operating conditions, to make it a relevant label for fund managers.

We encourage EU policymakers to integrate the suggestions included in the Commission proposal and to make the ELTIF a viable retail passport for long-term managers across Europe, giving retail investors the opportunity to commit capital to the sustainable and growth-enhancing projects they want to support.

As we did with the “Scale-Up Europe” initiatives, our two associations stay at the disposal of European policymakers, not least the French Presidency of the Council, to share good practices and regulatory solutions that could drive retail and sophisticated investments, directly or indirectly, into the companies that will be the face of tomorrow.

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