

Special Report

# Centrally managed EU interventions for venture capital: in need of more direction



EUROPEAN  
COURT  
OF AUDITORS

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## Executive summary

**I** Venture capital focuses on funding small, early-stage and innovative firms that are deemed to have high growth potential. It is often considered a catalyst for job creation and economic growth. For over 20 years, the European Union (EU) has been providing small and medium-sized enterprises with venture capital to help get their businesses off the ground. The EU also fosters a sustainable European venture capital ecosystem.

**II** We decided to look at venture capital markets because of the EU's increasing involvement in this policy area which we have not covered before. We audited the way the Commission has been implementing the centrally managed venture capital interventions. We assessed whether the design of these interventions had been underpinned by impact assessments and evaluations and whether they had been properly implemented. We also considered whether there was a comprehensive investment strategy.

**III** The audit covered the six centrally managed interventions that have been set up since 1998, and also considered the proposals for a successor instrument under the next multiannual financial framework (2021-2027). We reviewed relevant documentation, and interviewed Commission and European Investment Fund (EIF) staff, stakeholders from the public and private sector, and academics. In addition, we conducted surveys among venture capital fund managers.

**IV** We found that the Commission increased its support to the venture capital market without fully assessing market needs covering all instruments and absorption capacity. We also found limited evidence of the impact of its support.

**V** The Commission's investment strategy was not comprehensive, and less developed venture capital markets and sectors of activity benefited little from the centrally managed EU interventions.

**VI** The Commission and other investors (public and private) participate on an equal footing in venture capital funds, sharing the same profits and losses (i.e. according to the *pari passu* principle). The low rate of return on their investment is one of the reasons for private investors' low level of interest in EU venture capital. While the Commission already allows non-*pari passu* investments for social investments, it has not yet analysed the possibility of relinquishing the EU's return on investments to private investors.

**VII** The EIF manages funds primarily for the Commission, the European Investment Bank and national bodies. It has become an important player in the EU venture capital market. However, its procedures require streamlining, as it can take more than 12 months for fund applications to be approved. The EIF's deal allocation policy needs updating and improvement. We found that the EIF has faced difficulties in closing expired mandates.

**VIII** Lastly, the Commission does not gather information on the actual costs the EIF incurs in implementing EU-backed instruments. We found that the start-up fees paid by the Commission to the EIF for launching new instruments increased over time, and that there were no savings from any synergies or know-how the EIF might have built up over the last two decades. We also found that fees were not fully tailored to incentivise the pursuit of the overall objectives of the funds.

**IX** We make a number of recommendations for the Commission to improve the added-value of EU interventions in the venture capital market. We recommend that the Commission:

- (i) perform the necessary analyses to improve the evaluation of the EU interventions;
- (ii) develop a comprehensive investment strategy;
- (iii) engage with the EIF to streamline its management of the EU interventions.

# Introduction

**01** Venture capital can catalyse innovation, job creation and economic growth. As a result, a vibrant venture capital market may bring direct economic benefits. Indeed, experts and stakeholders in the EU, including the Commission, recognise the link between innovation, entrepreneurship, venture capital and economic growth.

## Venture capital: a type of private equity

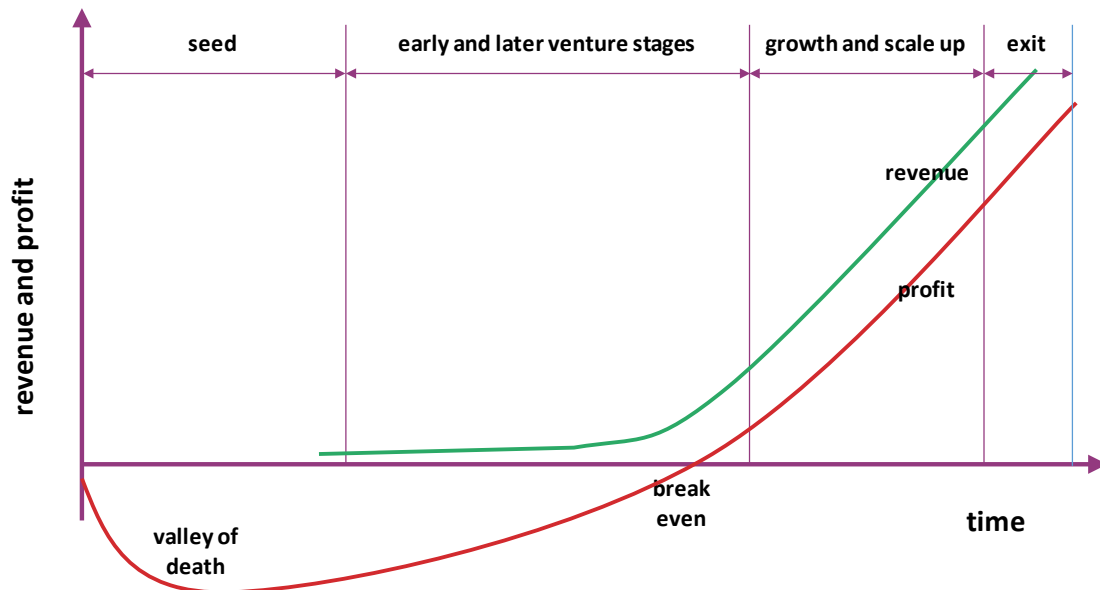
**02** Venture capital is a type of private equity focusing on funding small, early-stage, innovative emerging firms or start-ups that are deemed to have high growth potential. These companies often start with just an idea and an untested business model, meaning there is a substantial element of risk. However, if the idea and business model turn out to be a success, these companies can eventually generate high returns, allowing the long-term returns of venture capital and private equity to outperform traditional investments.

**03** Innovative emerging firms and start-ups need funding to develop their new technology/innovation. At the same time, they have little initial income to report. Therefore, because they can struggle to provide the required levels of collateral, these firms may face difficulties accessing sufficient funding from banks. Venture capitalists fill this financing gap because they are willing to accept more risks than banks on account of the return opportunities or for strategic reasons.

**04** New companies go through different development stages, as [Figure 1](#) illustrates.

- The seed stage: seed capital supports preliminary activities such as market and product research or business plan development. It comes mostly from the business owner(s), business angels and/or family and friends.
- The early and later venture stage: more capital is needed to develop and implement the business model. It is mainly at this stage that venture capitalists come into play. Towards the end of this phase, successful companies slowly start becoming profitable.
- The growth and scale-up stage: successful companies will increase revenue and profits. If venture capitalists have invested in such companies, they will start seeking to sell (or “exit”) these companies to get a return on their investment.

**Figure 1 – Start-up phases and evolution of revenue and profit**



Source: ECA.

**05** Venture capital investments are typically made through a fund, which is a pool of capital from multiple investors (limited partners) that is managed by a fund manager (general partner). Venture capital funds rely on the principle of diversification: they have broad exposure across a diverse portfolio (typically from 10 to 20 investment deals), which helps better manage the risks (see [Box 1](#) for the main characteristics of a venture capital investment in Europe). [Annex I](#) presents the typical structure of a venture capital fund.

**06** Venture capital funds can also offer expertise, which is regularly sought by entrepreneurs looking to grow their company. This valuable service can cover topics such as refining a strategy and commercialising innovation, new product and service development, or bringing a business to the global market. A refined strategy and early visibility on the global market are vital to the success of high-tech companies and other start-ups.

**Box 1****Main characteristics of a venture capital investment in Europe**

- Average investment of €2 to €3 million
- Long-term financial investment (10-15 year horizon)
- Illiquid investment (difficult to exit as there is no transferable market)
- Active ownership to help growing start-ups
- Expectation of high return on investment due to high risk and/or a strategic interest
- Fee payable to investment manager (20 % of investment)
- Specialised skills and dedicated management team

**07** A venture capital fund earns a return once it sells (or “exits”) a company. Exiting takes place through either an initial public offering (IPO) on the stock market, or a sale of the company to either an industrial investor (trade sale) or another venture capital fund or private equity firm. When a portfolio company has no remaining value, its book value is written-off according to applicable accounting standards.

**Commission involvement in the venture capital market**

**08** The Europe 2020 strategy is the EU's current agenda for growth and jobs. It emphasises smart, sustainable and inclusive growth as a way to overcome the structural weaknesses in Europe's economy, improve its competitiveness and productivity, and underpin a sustainable social market economy<sup>1</sup>. As venture capital is a catalyst for innovation, job creation and economic growth, the EU provides money to improve access for European businesses in the start-up and growth stages. The EU also fosters a sustainable European venture capital ecosystem in Europe<sup>2</sup>.

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<sup>1</sup> Communication from the Commission, EUROPE 2020 - A strategy for smart, sustainable and inclusive growth (COM(2010) 2020 final of 3.3.2010).

<sup>2</sup> [http://www.eif.org/what\\_we\\_do/equity/venture/index.htm](http://www.eif.org/what_we_do/equity/venture/index.htm).



**09** EU interventions mobilise additional private and public funds in financial support to maximise the effectiveness of the EU budget. These direct investments in venture capital funds come from different parts of the EU budget.

- Centrally managed interventions are financed from various budgetary areas, such as enterprise, industry and research. The Commission is directly involved in designing and developing these instruments, their investment strategy and determining the scale of the EU contribution.
- Shared management<sup>3</sup> interventions, used in cohesion policy, are financed by the European Structural and Investment Funds (ESIF). Each intervention must be implemented within the framework of an operational programme managed by a managing authority in a Member State. The managing authority is responsible for designing the financial instrument and determining its financial size.

**10** Many of the structural factors that can either boost or restrict venture capital across Europe are still largely the preserve of the Member States. For instance, national fiscal laws may hinder venture capital market development<sup>4</sup>, corporate and labour laws may obstruct the hiring of staff, and the regulatory environment could dampen investors' risk appetite and constrain fundraising<sup>5</sup>.

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<sup>3</sup> The Commission acts in cooperation with the Member States.

<sup>4</sup> Double taxation issues, tax-related administrative obstacles, uncertainty of tax treatment.

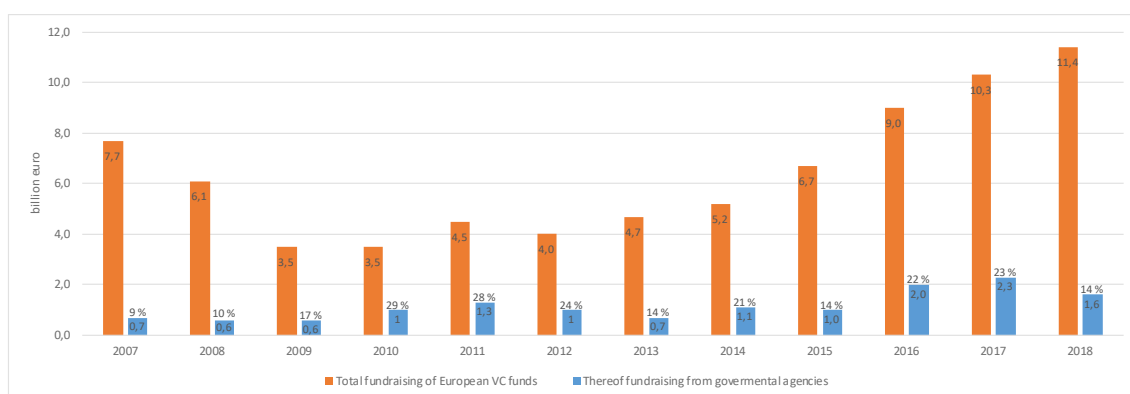
<sup>5</sup> <https://www.investeurope.eu/policy/key-topics/investor-regulation/insurance/>  
<https://www.investeurope.eu/policy/key-topics/investor-regulation/capital-requirements-forbanks/>

## The venture capital market in Europe

**11** Since 2012 there has been a continuous increase in fundraising by European venture capital funds. Total fundraising reached a ten-year peak of €11.4 billion in 2018. The current level exceeds the pre-crisis level in 2007. By 2022, the Commission is due to have allocated more than €3.3 billion to venture capital investments since 2014.

**12** As shown in [Figure 2](#), from 2015 to 2017 government agencies<sup>6</sup> significantly increased their support for European venture capital funds. Support fell in 2018. In relative terms, 2010 and 2011 saw the highest rates of government agency funding. In 2018 governmental agencies provided 14 % of overall fundraising, which is a significantly lower share compared with the two previous years, but still higher than the pre-crisis level of 2007.

**Figure 2 – Share of public funds in total funds raised by European venture capital funds (in billion euro and as percentage)**



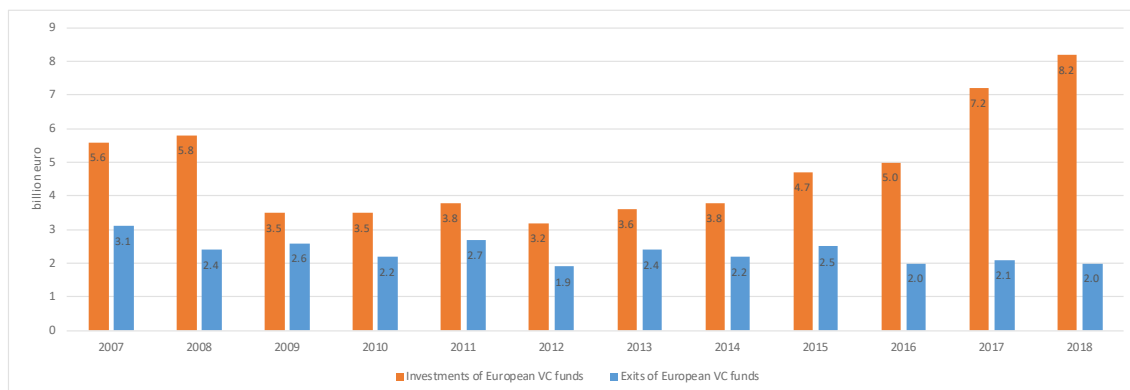
Source: Data provided to the ECA from Invest Europe.

**13** [Figure 3](#) shows a similar trend in investments in companies. In the last decade, investments by European venture capital funds have increased, peaking at €8.2 billion in 2018. Furthermore, the current level of investment exceeds the pre-crisis level of 2007.

**14** Since the financial crisis, the value and number of exits by European venture capital funds have been relatively stable. In 2018, venture capital funds exited 1 193 start-ups, for a value of €2.0 billion, yet there has been no return to the pre-crisis level of 2007, when 1 629 start-ups were exited for a value of €3.1 billion. See [Figure 3](#).

<sup>6</sup> Including the EIF and the EIB.

**Figure 3 – Investments and exits by European venture capital funds (in billion euro)**



Source: Data provided to the ECA from Invest Europe

**15** Over the 20 years that the Commission has been supporting venture capital funds through the centrally managed EU interventions, it has committed €1.7 billion in 140 funds, of which €0.9 billion had been disbursed by mid-2018. On average, these venture capital funds invested €3 million and created 48 jobs per company. These companies employed around 74 000 people at the time of investment.

### How the centrally managed EU interventions work

**16** The Commission mandates the European Investment Fund (EIF)/European Investment Bank (EIB) to implement venture capital interventions for an agreed remuneration. The Commission retains overall responsibility, except in one case where responsibility is shared with the EIB Group and other bodies. EU interventions have supported a large number of start-ups, and some have become important players in their sectors. **Box 2** provides examples of the risks and rewards of the EIF's investments under the Commission's mandate.

## Box 2

### Examples of the risks and rewards of the EU's venture capital investments

The EIF invested €15 million in one venture capital fund focusing on information and communication technologies. So far, the fund has returned €76 million to the EIF following company sales. In mid-2018, the remaining interest (i.e. companies still in the portfolio of the fund) was valued at €35 million. This high return was mainly due to an investment in one successful start-up. At the end of 2018 this company employed approximately 3 600 people, of which 43 % were in the EU.

The EIF invested €17 million in another venture capital fund with the same focus. From 2005 to 2007, this fund made 11 investments in start-ups. Later, owing to low performance, the fund had to write down or sell seven of these below cost. By mid-2018 the fund had only returned €4 million and the EIF's remaining interest was valued at €0.5 million. Thus, as at mid-2018, the loss on this investment stood at €12.5 million.

**17** The amount invested by the centrally managed EU interventions with a venture capital focus has increased significantly over the last decade, climbing from €33 million per year (average 1998-2000) to €458 million per year (average 2014-2020).

**18** These EU instruments are designed on a demand-driven basis, meaning that they provide funding when venture capital funds request them, as long as they fulfil the eligibility criteria and pass the due diligence and approval process. [Table 1](#) shows the six EU interventions with a venture capital focus that are managed centrally in this way<sup>7</sup>.

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<sup>7</sup> For this report we understand as centrally managed EU interventions the financial instruments (ESU 1998, ESU 2001, GIF, IFE and EFG) and the budgetary guarantee for EFSI SME Window Equity Product as mentioned in [Table 1](#).

**Table 1 – Centrally managed EU interventions with a venture capital focus**

Financial instruments/budgetary guarantee	Programme	Programme Period	EU funding (in million euros) as of 31/12/2018
European Technology Facility Start-up (ESU 1998)	Growth and Employment Initiative (G&E) <sup>8</sup>	1998-2000	101
European Technology Facility Start-up (ESU 2001)	Multiannual Programme for Enterprise and Entrepreneurship (MAP) <sup>9</sup>	2001-2006	209
High Growth and Innovative SME Facility (GIF)	Competitiveness and Innovation Framework Programme (CIP) <sup>10</sup>	2007-2013	625
Equity Facility for Growth (EFG)	Programme for the Competitiveness of Small Enterprises and Small and Medium-sized Enterprises (COSME) <sup>11</sup>	2014-2020	325 <sup>12</sup>
InnovFin Equity Facility for Early Stage (IFE)	Horizon 2020 – the Framework Programme for Research and Innovation <sup>13</sup>	2014-2020	488
EFSI SME Window (SMEW) Equity Product	European Fund for Strategic Investments (EFSI) <sup>14</sup>	2014-2020	1 270

Source: ECA adapted from the legal basis.

<sup>8</sup> 98/347/EC: Council Decision of 19 May 1998 on measures of financial assistance for innovative and job-creating small and medium-sized enterprises (SMEs) – the growth and employment initiative (OJ L 155, 29.5.1998, p. 43).

<sup>9</sup> 2000/819/EC: Council Decision of 20 December 2000 on a multiannual programme for enterprise and entrepreneurship, and in particular for small and medium-sized enterprises (SMEs) (2001-2005) (OJ L 333, 29.12.2000, p. 84).

<sup>10</sup> Decision No 1639/2006/EC of the European Parliament and of the Council of 24 October 2006 establishing a Competitiveness and Innovation Framework Programme (2007 to 2013) (OJ L 310, 9.11.2006, p. 15).

<sup>12</sup> This amount reflects the budgetary allocation as at 31 December 2018. The budgetary allocation may have since changed as the EFG is part of an overall budget line under the COSME Regulation.

**19** In 2015, the EU legislators adopted a regulation setting up the European Fund for Strategic Investments (EFSI) (see *Annex II*). The Commission entrusted the EIB with management of the EFSI, and then the EIB delegated part of it to the EIF<sup>15</sup>. The EFSI was launched to provide risk-bearing capacity, facilitated by a €16 billion guarantee from the EU budget and €5 billion from the EIB's own resources in order to enable the EIB Group (the EIB and EIF) to supply additional financing. EFSI will provide venture capital funding of €2 320 million, making it the largest of the six programmes.<sup>16</sup>

**20** In April 2018, the Commission launched the pan-European fund-of-fund programme. Together with the EIF, it selected six European fund-of-funds, of which two have already signed agreements. A fund-of-funds is a pool of capital provided by multiple partners to invest in venture capital funds, which in turn invest in start-ups. This structure allows for broader risk diversification, but adds an additional layer of administration. Up to €343 million are available from the centrally managed interventions, with a further €67 million from the EIF's own resources. The six fund-of-funds are expected to raise a further €1.7 billion from other (public or private) investors, with the aim of catalysing €6.5 billion of investments in start-up companies.

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<sup>12</sup> This amount reflects the budgetary allocation as at 31 December 2018. The budgetary allocation may have since changed as the EFG is part of an overall budget line under the COSME Regulation.

<sup>13</sup> Regulation (EU) No 1291/2013 of the European Parliament and of the Council of 11 December 2013 establishing Horizon 2020 – the Framework Programme for Research and Innovation (2014-2020) and repealing Decision No 1982/2006/EC [Horizon 2020 Regulation] (OJ L 347, 20.12.2013, p. 104).

<sup>14</sup> Regulation (EU) No 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 and amending Regulations (EU) No 1291/2013 and (EU) No 1316/2013 — the European Fund for Strategic Investments [EFSI Regulation] (OJ L 169, 1.7.2015, p. 1). Adopted in 2015, this regulation does not cover the entire 2014–2020 period.

<sup>15</sup> EFSI changed the EIF's role by binding it contractually to contribute funding to the two sub-windows of the EFSI SMEW equity product (see *Annex II*).

<sup>16</sup> The ECA published an opinion on EFSI: "Opinion No 02/2016 – EFSI: an early proposal to extend and expand", and special report 03/2019 "European Fund for Strategic Investments: Action needed to make EFSI a full success".

**21** In June 2018, the Commission published its proposal for the successor intervention called “InvestEU”<sup>17</sup>, as part of the package of proposals for the next multiannual financial framework (2021-2027).

## The role of the European Investment Fund

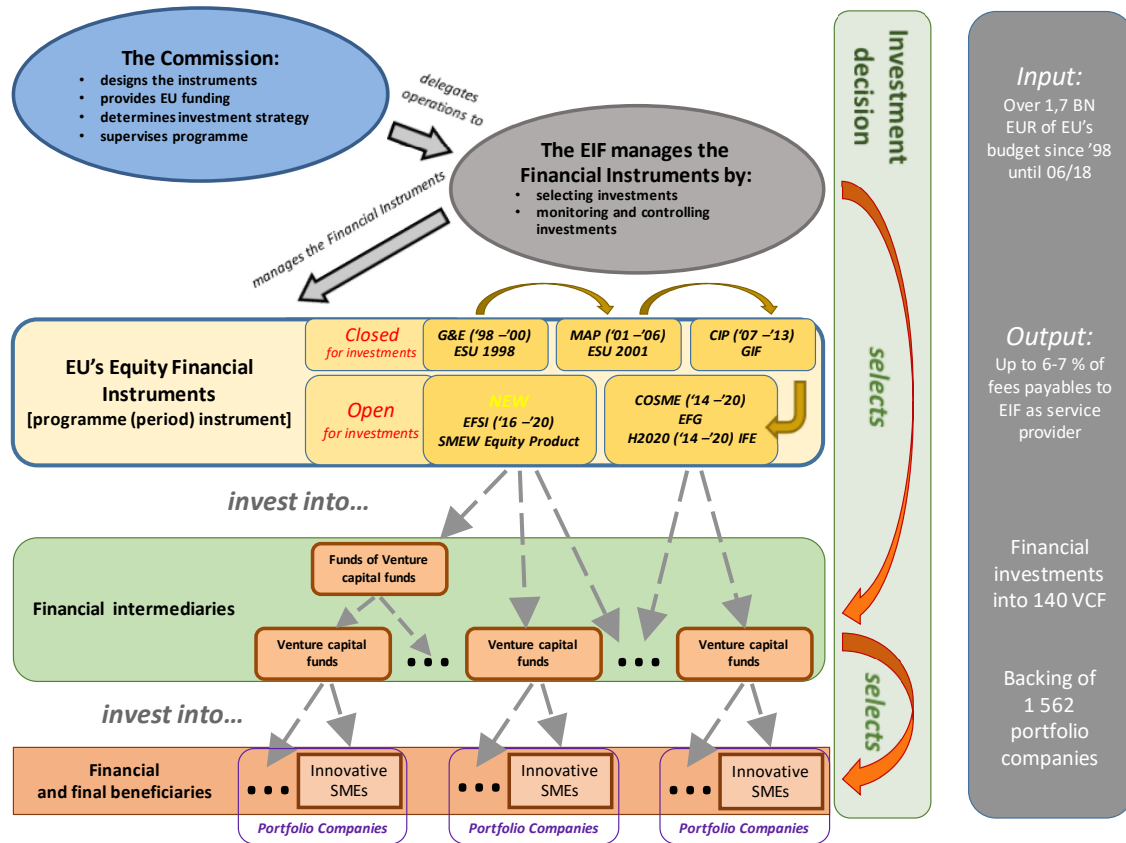
**22** The EIF supports financial intermediaries providing finance to SMEs across Europe. Its main shareholders are the EIB (58.6 % of capital), the EU represented by the Commission (29.7 %), and other stakeholders, including public and private banks and financial institutions<sup>18</sup>. It implements venture capital interventions primarily on behalf of others, such as the EU, the EIB (under the Risk Capital Resources (RCR) mandate), national or regional authorities, and private investors. *Figure 4* gives an overview of how EU-backed venture capital instruments operate and the role of the EIF.

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<sup>17</sup> Proposal for a Regulation of the European Parliament and of the Council establishing the InvestEU Programme (COM(2018) 439 final of 6.6.2018).

<sup>18</sup> [http://www.eif.org/who\\_we\\_are/index.htm](http://www.eif.org/who_we_are/index.htm)

**Figure 4 – Operational structure for EU-backed venture capital instruments**



Source: ECA based on EIF data.

**23** The EIF has become one of the biggest players in the European venture capital market. In 2018, the EIF alone signed agreements with venture capital funds committing to invest €1.4 billion.



## Audit scope and approach

**24** We decided to look at venture capital markets because of the EU's increasing involvement of the EU in this policy area which we have not covered before. We assessed whether the Commission was making good use of its venture capital instruments by examining whether:

- (a) the Commission has carried out good quality of the ex ante, interim and ex post evaluations;
- (b) the investment strategy with which the EU delivered its assistance was comprehensive;
- (c) the EU instruments have been properly implemented by the EIF.

**25** We expect our report to help the Commission to implement its policy more efficiently and effectively. We focused on the 2014-2020 period when assessing the appropriateness of the interventions' design. For the other aspects, we took into account all centrally managed EU interventions since 1998. Where applicable, we also considered the draft InvestEU programme for the 2021-2027 period.

**26** To collect audit evidence, we reviewed relevant documentation, including a sample documenting the EIF's process for selecting venture capital funds. We also interviewed staff from the Commission, the EIF, France's Banque Publique d'Investissement, and Invest Europe<sup>19</sup>, as well as academics and fund managers. Furthermore, we visited venture capital and start-up associations, promotional banks, ministries and venture capital funds in Denmark and Italy. Lastly, we conducted two surveys among venture capital fund managers.

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<sup>19</sup> Invest Europe is an association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

# Observations

## Weaknesses in ex ante and ex post evaluations

**27** Before launching a new intervention, the Commission has to carry out an ex ante evaluation and/or impact assessment, including an analysis of market needs. The evaluation and assessment should also analyse the structure and financing needs of companies' targeted by the instrument, and available sources of funding. Using this information, the Commission can estimate the funding gap and determine the appropriate scale of its support to the venture capital market.

**28** The main objective of all EU interventions since 1998 has been to improve access to finance for businesses, in particular SMEs, by supporting entrepreneurship and innovation. For each intervention, the Commission is expected to carry out interim and/or ex post evaluations to assess the intervention's effectiveness.

### Interventions were not based on a proper assessment of market needs

**29** We examined whether and how the Commission had determined and quantified the funding gap for the interventions in the current programming period (2014-2020). We also looked at whether this had been done at both an aggregate EU level and Member State level. Lastly, we analysed whether a funding gap had been established for the different phases in a company's lifecycle (see [Figure 1](#)).

**30** We found that although the Commission had carried out ex ante evaluations and impact assessments and analysed market needs by looking at supply and demand, the quantification of the funding gap was not comprehensive. This was mainly due to the lack of data. The Commission also noted "no consensus in the academic literature on whether the low levels of venture capital investments compared to GDP in most EU Member States are predominantly a supply or a demand-side problem, i.e. whether there is insufficient venture capital supply or whether there are insufficient companies to invest in"<sup>20</sup>.

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<sup>20</sup> JRC Science for Policy Report, "Improving access to finance: which schemes best support the emergence of high-growth innovative enterprises?", p. 12.

**31** For example, in 2011 the Commission carried out an ex ante evaluation and an impact assessment of the centrally managed Equity Facility for Growth (EFG). We found that the underlying study carried out on behalf of the Commission did not explain the reasoning behind its estimate of the funding gap<sup>21</sup>.

**32** For another centrally managed instrument, the InnovFin Equity Facility (IFE), we found that the 2013 assessment was only carried out after the legislative proposal had been made and an indicative budget had already been discussed among the Commission, the Parliament and the Council.

**33** We also found that when EFSI was launched in 2015, the Commission did not perform a comprehensive ex ante evaluation or an impact assessment of the funding gap or market needs. Nor did it conduct such an assessment in 2017, when the EU guarantee was increased by €10 billion (to €26 billion) and the investment period extended from 31 July 2019 to 31 December 2020<sup>22</sup>.

**34** Also in 2015, a specific assessment was carried out on behalf of the Commission to explore the possibility of using a fund-of-funds structure<sup>23</sup>. Based on interviews with 105 venture capital fund managers, it showed that opinions were divided on the state and needs of the venture capital market. The assessment neither quantified the funding gap nor addressed the issue of absorption when recommending the financial size of the fund-of-funds to be created.

**35** The Commission has already carried out its ex ante evaluation/impact assessment for the successor venture capital interventions under the future InvestEU programme for the upcoming 2021-2027 period. However, once again, the funding gap has not been quantified.

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<sup>21</sup> Annex A to the 2011 report prepared by Economisti Associati srl in collaboration with EIM Business & Policy Research, the Evaluation Partnership, the Centre for Strategy and Evaluation Services, and the Centre for European Studies, p. A.13.

<sup>22</sup> ECA Opinion No 2/2016, “EFSI: an early proposal to extend and expand”, paragraph 26, and ECA special report 3/2019, “European Fund for Strategic Investments: Action needed to make EFSI a full success”, paragraph 17.

<sup>23</sup> Oxford Research Centre for Strategy & Evaluation Services, “Assessing the Potential for EU Investment in Venture Capital and Other Risk Capital Fund of Funds”, October 2015.

**36** In our view, increasing budgetary resources for venture capital funds (see [Table 1](#)) without properly quantifying the funding gap may lead to the risk that such funds cannot be absorbed (see [Box 3](#)).

### Box 3

#### **Increase of public funds without a proper assessment of the market size may lead to a risk of non-absorption**

The substantial increase of public funds in the venture capital market can lead to a risk of non-absorption if there is a lack of: (i) venture capital funds to invest in; (ii) interested private investors; (iii) SMEs with growth potential to invest in.

A 2011 study<sup>24</sup> revealed that it would be challenging for the EU to invest more than €300 million a year over the 2014-2020 period due to non-absorption risks. However, the funds allocated by the EU to venture capital are already close to this amount. For the period 2014-2020, the average annual investment by the EU interventions totals around €285 million per year (i.e. €1 989 million over 7 years). Moreover, the funds allocated to the EFSI SMEW equity product were increased by €1 050 million (see paragraph [07](#) of [Annex II](#)).

The pressure to absorb carries knock-on risks. An ambitious amount may create pressure to commit funds quickly. Since first-time funds or virgin markets require more time for development, this time pressure may lead to a concentration of funds on the “usual” markets or operators, as mature markets and established funds are given priority. Moreover, the 2011 study said “pressure to commit funds may result in the provision of funding to ‘sub-standard’ investees which in due course would inevitably depress returns on investments”.

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<sup>24</sup> 2011 report prepared by Economisti Associati srl in collaboration with EIM Business & Policy Research, the Evaluation Partnership, the Centre for Strategy and Evaluation Services, and the Centre for European Studies.

## Insufficient evidence of the impact of the EU interventions

**37** We examined whether previous interim and ex post evaluations had demonstrated the effectiveness of EU support to venture capital. Proper interim and ex post evaluations provide valuable information for the design of new instruments.

**38** Since it began supporting venture capital, the Commission has presented six mid-term and two final evaluations. Typically, the evaluations reported on outputs and results, such as the number of venture capital funds supported or the number of companies in which the EU-backed venture capital funds had invested. However, the evaluations did not analyse the EU intervention's impact on the venture capital industry or its economic effects (such as growth, innovation, or jobs maintained and created).

**39** Both ex post evaluations were carried out too early. For example, the final evaluation covering the High Growth and Innovative SME Facility was issued in 2011. However, the EIF could approve limited partnership agreements with venture capital funds up until 2013 – leaving them around five years to invest in companies.

**40** The interim evaluation of GIF and ex post evaluations of ESU 1998 and ESU 2001 were weakened by the limited availability of data.

- The early instruments European Technology Facility Start-up 1998 and European Technology Facility Start-up 2001 had no performance indicators. The ex post evaluation of these instruments recommended the use of well-designed performance indicators.
- Although the legal basis of the GIF instrument set indicators and targets, these mainly related to outputs. The interim evaluation covering the GIF instrument therefore again recommended developing results and impact indicators to allow for a final evaluation of effectiveness. The Commission added indicators, but the final evaluation could not draw on them as it was carried out within a year of the mid-term evaluation.

**41** The evaluations relied mostly on qualitative methods such as interviews and surveys. While the information gathered was useful, it was not corroborated by quantitative methods.

**42** The interim and final evaluations carried out by the Commission did not analyse the counterfactual scenario. Evaluators did not assess how many jobs were created or

maintained by the companies that had benefited from the venture capital funding compared with the theoretical number that might have been created in the funding's absence.

**43** In 2011, an EU-funded research project<sup>25</sup> performed such a counterfactual analysis, which considered venture capital from all sources (not only from the EU), and companies from seven Member States and one non-EU country. The analysis concluded: “Findings generally supported the view that venture capital investors had a considerable positive treatment effect on firms’ growth, productivity, as well as investment and innovation performance. Venture capital investors helped their portfolio firms to outperform firms not backed by venture capital even during the financial crisis in 2008-2009. They provided their portfolio firms with the resources and competencies necessary to rapidly readjust their product/market offer during the global crisis.”

**44** On a positive note, the EIF published a series of working papers on the economic contribution of EIF-backed investments and the performance of supported start-ups<sup>26</sup>, including a counterfactual analysis. The only caveat is that the papers examined all EIF venture capital investments – not only those backed by the EU.

**45** As far as the instruments in the 2014-2020 programming period are concerned, the Commission has set results and impact indicators for EFG, IFE and EFSI. For EFG and IFE, targets have been set for all indicators except turnover and the number of employees of the beneficiary companies (see [Table 2](#)). Moreover, the targets for IFE do not only relate to venture capital but combine venture capital and debt financing support, making it difficult to evaluate the performance of each instrument.

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<sup>25</sup> VICO project, “Final Report Summary – Financing Entrepreneurial Ventures in Europe: Impact on innovation, employment growth, and competitiveness”, September 2011 (<https://cordis.europa.eu/project/rcn/88431/reporting/en>).

<sup>26</sup> EIF working paper 2016/34 (Helmut Kraemer-Eis, Simone Signore, Dario Prencipe), “The impact of EIF on the Venture Capital ecosystem”, Volume I of *The European venture capital landscape: an EIF perspective*, 2016.

**Table 2 – Indicators for the EFG and IFE**

Instrument	Indicators	Target
EFG	Number of venture capital investments	360 - 450
	Overall volume invested	from €2.6 billion to €3.6 billion
	Leverage ratio	4 - 6
	Additionality of the EFG	Increase in the proportion of final beneficiaries that consider the EFG or the LGF to provide funding that could not have been obtained by other means compared to baseline
IFE	Total investments mobilised via venture capital investments	€25 billion together for VC and debt financing
	Number of organisations funded	5 000 organisations funded via VC and debt
	Amount of private funds leveraged	€35 billion of private funds leveraged (VC and debt)
	Company turnover and number of employees	To be developed

Source: ECA based on legislation and Commission documents.

**46** The EFSI interim evaluation recommended clarifying the impact of the initiative on the financial market and, in particular, the effect on market failure and possible crowding-out by using counterfactual scenarios. The interim evaluation recognised the EIB Group’s current efforts in testing such approaches for EFSI products, particularly in setting up the necessary data infrastructure<sup>27</sup>.

### The Commission lacked a comprehensive investment strategy

**47** Improving access to finance for businesses through a pan-European venture capital market requires a coherent and comprehensive policy and investment strategy which, inter alia, aims to support less developed markets, decrease dependence on the public sector and simplify interventions.

<sup>27</sup> European Commission, “Independent Evaluation of the EFSI Regulation. Final Report”, June 2018, p. 140.

## **Demand-driven approach does not favour the development of less developed venture capital markets or sectors**

**48** To assess the Commission's investment strategy, we analysed the current state of play in terms of the countries where the EU-backed venture capital funds and beneficiary companies were domiciled, development stages and sectors of activity.

### **Underdeveloped venture capital markets benefited little from the EU's centrally managed interventions**

**49** Since the Commission began its venture capital activity in 1998, its funding allocation has been on the basis of projects' merit and has not been driven by geographic location of venture capital funds or the investment sector.

**50** In the absence of a strategy ensuring that adequate investment is channelled to underdeveloped markets, they may receive less support. This risk is confirmed by the Commission's ex ante evaluations/impact assessments on its interventions in the 2014-2020 period (IFE and EFG), which pointed to a high concentration of venture capital investments in certain Member States.

**51** We found that, at the end of June 2018, the two Member States with the highest registration of EU-backed venture capital funds were France and Italy, with 20 % and 14 % of the total number of funds respectively. These countries were followed by Luxembourg, the United Kingdom, the Netherlands, Germany and Finland. No EU-backed venture capital funds have invested in funds registered in 12 Member States (see [Figure 5](#)).

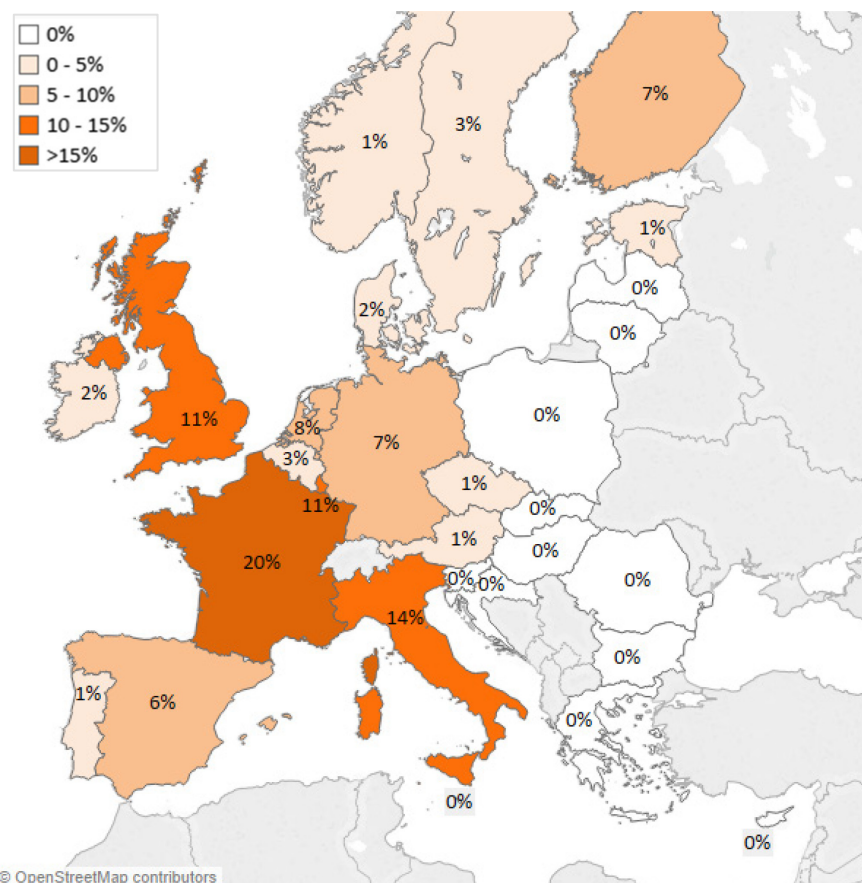
**52** One of the factors that fund managers take into consideration when deciding where to register a venture capital fund is the applicable regulatory regime. According to a survey<sup>28</sup> carried out by the EIF, "the fund managers called for supporting pan-European funds, more cross-border investments, and a harmonisation of legal frameworks and tax systems".

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<sup>28</sup> EIF Working Paper 2018/48, "EIF VC Survey 2018 – Fund managers' market sentiment and views on public intervention", April 2018.



**Figure 5 – EU-backed venture capital funds per country of registration as at 30 June 2018**



Source: ECA based on EIF data.

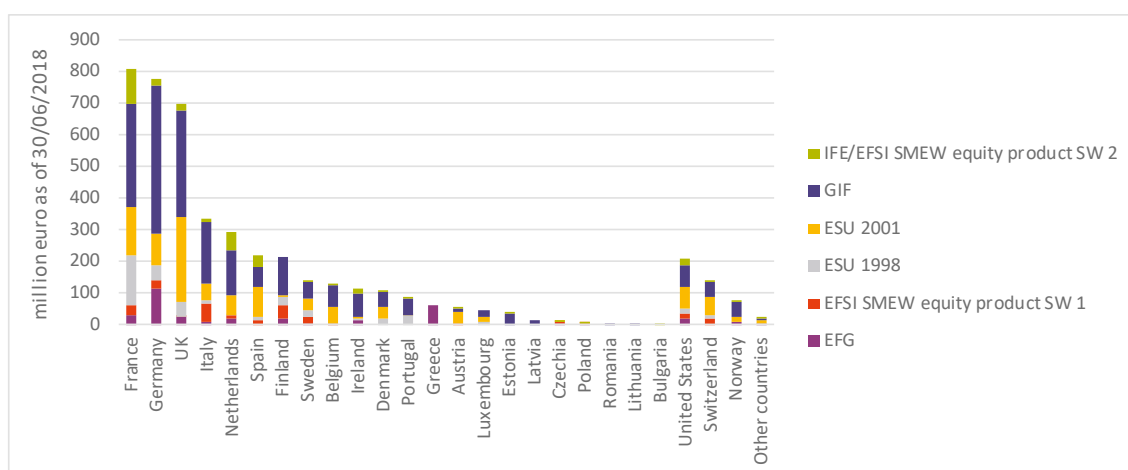
**53** Venture capital funds may either invest only in companies in their country of registration or have a multi-country focus. As at 30 June 2018, 42 % of the EU-backed venture capital funds had a multi-country focus.

**54** In terms of the amounts EU-backed venture capital funds had invested in companies, *Figure 6* shows that the Member States which were attractive to venture capital<sup>29</sup> benefited the most from the EU interventions. France, Germany and the United Kingdom stand out since they account for 50 % of these investments. Since these Member States are the largest EU economies, concentrating on them does not help foster a European venture capital market.

<sup>29</sup> Venture Capital & Private Equity Country Attractiveness Index (<https://blog.iese.edu/vcpeindex/>).

**55** As at mid-2018, none of the centrally managed EU-backed venture capital funds had invested in Cyprus, Malta, Slovenia or Slovakia, and only limited investments (totalling €29 million) had been made in Bulgaria, the Czechia, Hungary, Poland or Romania.

**Figure 6 – Investments in companies by EU-backed venture capital funds as at 30 June 2018**



Source: ECA based on EIF data.

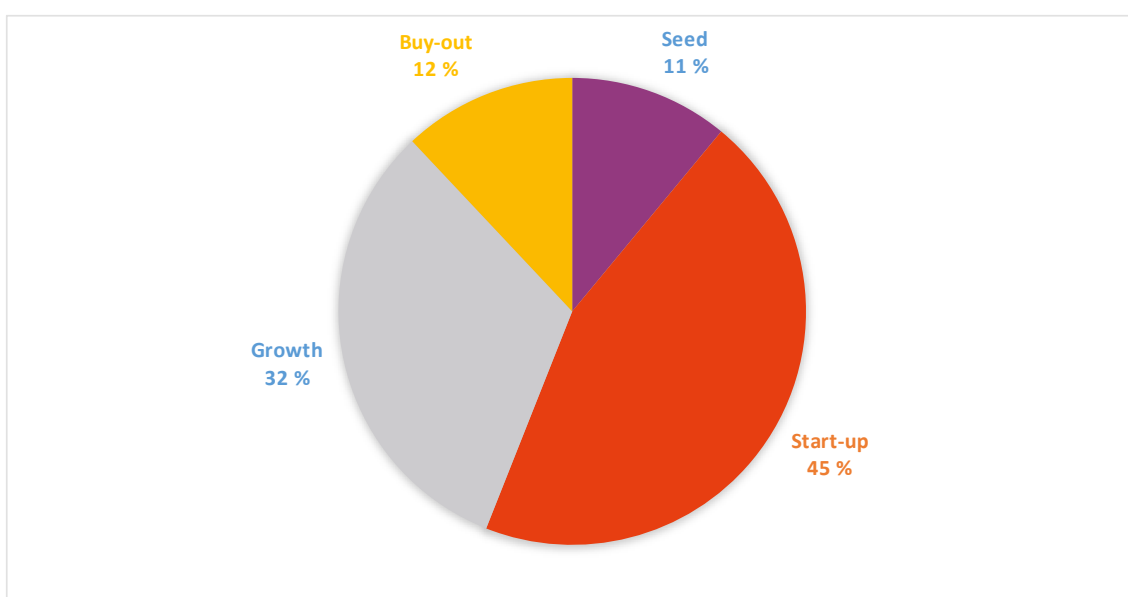
**56** Our data analysis suggests that allocating assistance on the basis of demand favours the most developed venture capital markets. This does not contribute fully towards the EU's stated aim of fostering a pan-European venture capital market as well as to some of the priorities mentioned in the delegation agreements. For example, for the three most recent equity instruments (i.e. EFG, IFE, EFSI) the legal base always makes reference to supporting the development of EU level venture capital. In addition, Article 2 of the GIF's mandate agreement states that one objective of the facility is to reduce the equity and risk capital market gap with a view to improving the EU venture capital market. Several evaluations of the EU interventions carried out by or on behalf of the Commission have criticised the demand-driven approach and recommended that it give way to a more proactive approach.

**57** For instance, the 2018 impact assessment for the successor programme InvestEU (2021-2027 period) recommends balancing the demand-driven approach at the level of individual operations by more rigorously verifying compliance with policy objectives. The Commission has not specified how this balance would be achieved in practice or how it would affect the demand-driven approach.

### Funding needs were not quantified by development stage or sector of activity

**58** Over the 20 years in which the Commission has been supporting venture capital funds through its various centrally managed interventions, it has invested in SMEs at different development stages. **Figure 7** shows how much of the €4.6 billion invested by the EU-backed venture capital funds in this period was used at each company development stage.

**Figure 7 – Investments of the EU-backed venture capital funds per SME development stage**



Source: ECA based on EIF data.

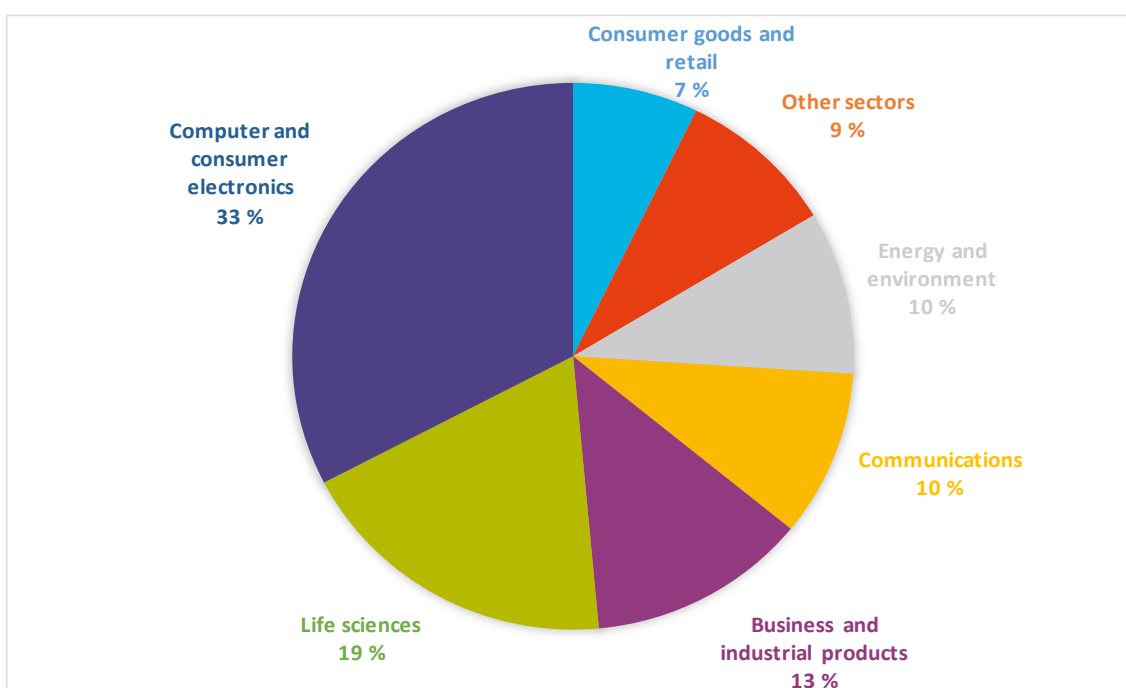
**59** Early stages (i.e. seed and start-up) represent 56 % of the total investment. Typically, venture capital funds invest in more companies in an early growth stage rather than in the later stages. Nonetheless, the average amounts invested per SME are lower in the early stages. The EU-backed venture capital funds have invested, on average, €1.36 and €2.56 million per SME in the seed and start-up stages respectively, while the average investment in the growth and buy-out stages<sup>30</sup> per SME were €4.82 and €7.16 million respectively.

<sup>30</sup> Investment stage classification used by the EIF on purchasing the majority or controlling stake of an company, typically in an advanced development stage, such as the growth or scale up stage.

**60** In our survey, 68 % of the venture capital fund managers who responded considered that public participation in venture capital was most needed for investments in the seed and start-up stages.

**61** As far as the sectoral distribution is concerned, companies operating in computer and consumer electronics and the life sciences sectors represent more than 50 % of the total investments made by the EU-backed venture capital funds (see [Figure 8](#)).

**Figure 8 – Investments of the EU-backed venture capital funds per sector**



Source: ECA based on EIF data.

**62** Although the EU has invested in different development stages and sectors of activity, the allocation of funds was not based on a thorough analysis of supply and demand on the European venture capital market. The Commission’s ex ante evaluations lacked data on the funding gap for the different development stages or sectors of activity (see paragraph [36](#)).

**63** We note that in its impact assessment for InvestEU (period 2021-2027), the Commission suggested that equity instruments could be targeted “on a sectoral basis

[...] and a company life cycle basis (on the basis of a funding gap analysis)”<sup>31</sup>. The assessment makes no mention of targeting or analysis by Member State.

### **The EU venture capital market is not attractive enough to private investors**

**64** EU-backed interventions should address market failures or, more specifically, those which – to observe the subsidiarity principle and achieve added value – Member States cannot address themselves<sup>32</sup>. The ultimate objective of public intervention is to attract private investors in order to develop a sustainable venture capital market. We examined whether the Commission managed to encourage other public and private investors to provide funds alongside the EU. The 2013 ex ante evaluation of IFE highlighted low returns as one of the main reasons for private investors’ mute interest in venture capital. “Apart from the dot.com bubble period from 1997-2000, the average annual return to European venture capital funds has been below 10 %, and for the past ten years or so, negative, with not even the performance of the best-managed funds high enough to deliver the returns sought by institutional investors”<sup>33</sup>.

**65** In order for the EU's intervention to be consistent with state aid rules, the Commission set minimum targets for the share of private investors in the EU-backed venture capital funds. These targets were fixed at 50 % for the early instruments such as ESU 1998 and ESU 2001, but were then dropped to 30 % by the 2014-2020 interventions. This is even more important since the Commission considers own-risk investments by the EIF/EIB and by promotional banks as independent and private. Otherwise, the Commission did not set any targets for private sector participation.

**66** The Commission did not set attaining high returns as an objective for its interventions, nor did it ask the EIF to make a profit with EU funds. However, the EIF is required by the legislation and the delegation agreements to apply the *pari passu* principle, according to which public and private investors participate on an equal

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<sup>31</sup> Commission Staff Working Document, Impact Assessment, SWD(2018) 314 final of 6.6.2018.

<sup>32</sup> Article 209 of the Regulation (EU, Euratom) No 2018/1046 of the European Parliament and of the Council of 18 July 2018 on the financial rules applicable to the general budget of the Union (OJ L 193, 30.7.2018, p. 1).

<sup>33</sup> Commission ex ante evaluation, “Financial instrument facilities supporting access to risk finance for research and innovation in Horizon 2020”, 2013.

footing in venture capital funds, sharing the same profits and losses. Attracting private investors, which is essential for a sustainable venture capital market, is only possible if investments generate high returns.

**67** According to the 2017 financial statements, ESU 1998 has invested €101 million and posted a global net loss of €12 million since its inception. A similar picture emerges from the ESU 2001 and GIF realised portfolios (those already written off or sold). ESU 2001 reported a realised net loss of €82 million on the €207 million invested, and GIF a €88 million loss on €470 million<sup>34</sup>. These last two instruments still have a significant part of their investment left in their portfolios (ESU 2001: 31 %; GIF: 64 %). It is too early to provide meaningful data for the more recent EU interventions [see [Table 3](#)].

**68** Some of the Commission's final and interim evaluations of the centrally managed programmes declared the *pari passu* principle a failure or a barrier to stimulating private investment. Another evaluation (the 2011 ex ante evaluation of the EFG) came to no conclusion on whether to deviate from the *pari passu* principle, deferring the decision until after a detailed market assessment. The Commission had not performed such an assessment at the time of the audit. The Commission allows for non-*pari passu* investments only in the case of social investments under the EFSI SME Window.

**69** One of the arguments the Commission uses for applying the *pari passu* principle is that otherwise there is a risk of the investment being considered as state aid. Incompatible state aid given by Member States distorts competition and can be recovered by the Commission. However, Commission guidelines<sup>35</sup> and EU law<sup>36</sup> clearly set out under which circumstances asymmetric profit-sharing does not contravene state aid rules.

**70** For example, a public investor can increase the return for private investors by relinquishing part of its own return (under an asymmetric return structure). This would

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<sup>34</sup> According to the instruments' 2017 financial statements, the value of the companies that were still in the funds' portfolio backed by ESU 2001 and GIF (unrealised profits) amounted to €97 million and €79 million respectively.

<sup>35</sup> Commission guidelines on state aid to promote risk finance investments (2014/C 19/04), paragraphs 108-109.

<sup>36</sup> Article 21(13) of Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty (OJ L 187, 26.6.2014, p. 1).

mean that the public investor would not invest under the same terms as other investors, contrary to the *pari passu* principle of equality.

**71** The 2015 assessment on the fund-of-funds states: “Most interviewees from private equity and venture capital fund managers argued that if the EU is serious about encouraging the private sector back to European venture capital, it should allow the private sector to capture the upside in return for investing in higher-risk investment stages. Asymmetric returns were regarded as potentially helping to overcome barriers to attracting private investors at the fund-of-fund level.”

**72** Before the establishment of the European fund-of-funds programme, the Commission set up a working group for its analysis. The group suggested providing for asymmetric returns in the call for interest, although venture capital funds with *pari passu* terms should be favoured. It proposed balancing this against investing in countries with less-developed venture capital environments. Contrary to this recommendation, the call for interest did not allow for asymmetric returns.

**73** Another way for public investors to foster a self-sustaining venture capital market is to allow for a gradual withdrawal, i.e. early exit, from venture capital funds. However, neither the limited partnership agreements signed between the EIF and venture capital funds, nor the two fund-of funds agreements signed so far by the EIF, included provisions for early exit. We note that the 2015 assessment of fund-of-funds suggested incorporating early exit mechanisms.

## Complexity resulting from using more than one intervention to deploy EU support to the venture capital market

**74** While, in previous periods, the Commission channelled its support to the venture capital market through one instrument, in the 2014-2020 period it is using three interventions to this end (i.e. EFG, IFE and the EFSI SMEW equity product). We examined whether the Commission had ensured coherence among these three interventions.

**75** The EFG aims to improve SMEs' access to equity in their expansion and growth stage, while the IFE targets early-stage investments. The respective governing regulations both allow for cross-investments at different stages. The two instruments were intended as two components of a single Union equity financial instrument.

**76** With the launch of the EFSI SMEW equity product in mid-2016 (see [Annex II](#)), complexity increased due to the combination of a budgetary guarantee together with a financial instrument, plus the involvement of the Commission, the EIB and the EIF.

**77** To avoid this new product overlapping with the existing EFG, in 2016 the Commission decided to refocus the EFG to target mostly venture capital deals in non-EU participating countries<sup>37</sup>, which the EFSI SMEW equity product cannot cover.

**78** Having three instruments with similar objectives, managed by three different services within the Commission, meant multiplying the governance, reporting and monitoring efforts. According to the various legal provisions, the EIF is required to prepare separate operational reports for each of the instruments, at least biannually.

**79** Currently, the EIF's operational reporting on the EFSI SMEW equity product does not provide sufficient clarity on the different sub-windows, and it is difficult to obtain a comprehensive overview of the structure of the combined interventions.

**80** We note that the Commission has recognised the inefficiencies and overlaps and proposed a greatly simplified structure for the future (2021-2027) InvestEU programme. The proposal is to have one sole instrument instead of three (the EFG, IFE and EFSI) providing a single budgetary guarantee.

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<sup>37</sup> The COSME programme is open to third-country participants, which must agree on arrangements with the Commission.



## The EIF is a cornerstone investor but its management of EU interventions can be streamlined

**81** The Commission has channelled its centrally managed venture capital interventions through the EIF ever since their inception in the late 1990s. Therefore, the Commission needs to ensure that the EIF is properly implementing the EU interventions.

### The EIF is an important player

**82** The funds raised by the EU venture capital industry from public investors doubled between 2015 and 2016 and, in 2018, still exceeded the 2007 pre-crisis level (see [Figure 2](#)). The EIF, which is managing an ever-growing number of mandates (see paragraph [22](#)), has become one of the biggest players in the European venture capital market. In 2018, the EIF alone signed agreements with venture capital funds committing to invest €1.4 billion, including €214 million by the EU-backed instruments. We examined whether the EIF managed the instruments efficiently.

**83** The EIF carried out a survey in 2018<sup>38</sup>, which showed that its participation was considered important as it played the role of a cornerstone investor and helped to attract private investors by strengthening the fund's credibility. EIF participation in investments was generally viewed positively by the fund managers concerned.

**84** Most of the venture capital fund managers who responded to our survey valued the EIF's thorough due diligence process; its quality means it is often seen as a "seal of approval". However, respondents also claimed that the EIF was formalistic and compliance-oriented, and that the fund application approval process took too long. According to the survey, 45 % of fund managers said that the EIF took more than one year to approve an application, and 41 % reported that it took between 6 months and one year. Most respondents (66 %) said that they had been in contact with three to five interlocutors at the EIF during the application process, with some interlocutors not always familiar with national particularities.

**85** The 2015 assessment on the fund-of-funds emphasised "the counter-cyclical role played by the EIF in ensuring that innovative start-ups and SMEs continue[d] to have

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<sup>38</sup> EIF Working Paper 2018/51, "EIF venture capital Survey 2018 – Fund managers' perception of EIF's Value Added", September 2018.

access to capital during periods of economic downturn”. But it also stated that “a number of stakeholders, especially venture capital funds, venture capital associations and some national fund-of-funds operators, [had] expressed the view that the EIF’s dominant role as a cornerstone investor in the European venture capital market and as a fund manager of fund-of-funds raise[d] longer-term sustainability questions”.

### **EU-backed instruments overlap with others managed by the EIF rather than supplementing them**

**86** The EIF developed a policy for allocating funds from the different mandates (i.e. a deal allocation policy). We examined whether the EIF had implemented it properly, considering the nature of its different mandates.

**87** The EIF has to decide in which venture capital fund to invest and under which mandate. The respective legal bases and delegation agreements of the centrally managed EU-funded instruments either permit or not co-investment with funds under other mandates.

**88** Under ESU 1998, co-investments with the EIF or with EIF-managed facilities were expressly prohibited<sup>39</sup>. This is because ESU 1998 was designed to complement the EIF-managed mandates by addressing “those SMEs which neither the EIB nor the EIF could support because of their statutory higher risk criteria<sup>40</sup>”.

**89** The concept of higher risk criteria was repeated for ESU 2001 and the GIF, although co-investment was allowed. At the end of 2017, 30 % of the venture capital funds backed by these instruments had co-investments from other EIF mandates (mostly from the EIB’s RCR mandate<sup>41</sup>). This shows that the selected funds were not targeting a different risk segment from the EIF’s other mandates.

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<sup>39</sup> Although prohibited, we found one co-investment using the EIF’s own resources.

<sup>40</sup> European Commission, Proposal for a Council Decision on Measures of Financial Assistance for Innovative and Job-Creating Small and Medium-sized Enterprises (COM(1998) 26 final of 21.01.1998).

<sup>41</sup> The EIB has mandated the EIF to invest €9.5 billion in risk-bearing capacity to support technology and industrial innovation. With the RCR mandate the EIB targets early to lower mid-market funds that specifically focus on Europe.

**90** The legal basis covering the EFG, IFE and EFSI no longer refer to the concept of higher risk criteria. All three specify that the instruments should complement financial instruments funded by national or regional programmes. While the legal basis for EFSI also specifically encourages complementarity with existing EIB operations and activities, the legal basis for the other two is silent on this aspect.

**91** The EFSI regulation calls for guidance on combining the use of EU instruments with EIB financing under the EU guarantee to ensure complementarity. The Commission issued guidance on complementarities between EFSI and ESIF. No guidance exists regarding co-investments with other EIF-managed mandates, e.g. the EIB's RCR mandate.

**92** Due to the multiplication of mandates under the EIF, the interim evaluation carried out for the Commission on the GIF intervention recommended that the EIF develop a deal allocation policy<sup>42</sup>. The EIF has had such a policy since 2009. Following a few updates, the policy remained unchanged from the end of 2011 until 2018, when an overhaul took place.

**93** The 2011 deal allocation policy saw no noteworthy overlap between the various mandates. Yet, for the GIF intervention, co-investments took place, i.e. the EIF invested funds from several mandates into the same venture capital fund<sup>43</sup>. The 2018 allocation policy drew no conclusions on any potential overlap. However, considering the mandates' preferences (for specific sectors or a certain performance, for example) and their geographical focus, there is overlap between the centrally managed EU interventions and other mandates.

**94** While the initial policy (valid until 2018) left deal allocation decisions entirely to the EIF's professional judgement, the new policy includes criteria for a quantitative<sup>44</sup> and qualitative assessment to decide which mandate best suits which venture capital

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<sup>42</sup> European Commission DG Enterprise and Industry (GHK and Technopolis), "Interim evaluation of the Entrepreneurship and Innovation Programme", 2009, p. IV.

<sup>43</sup> The EIF used funds from other mandates for 41 % of the GIF-backed venture capital funds.

<sup>44</sup> A ranking is compiled based on, for example, the venture capital fund's strategy, the sectors or stages it wants to invest in or its geographical focus. There are also knock-out criteria such as the criterion "first-time managers", as some non-EU mandates do not allow first-time managers.

fund. The EIF provided us with no evidence of the guidance it gives staff on how to apply these criteria.

**95** The EIF tested its new policy by applying it to the deals made in 2017 and 2018. The results of this back-testing exercise showed that, based on the quantitative assessment alone, for some investments made using the centrally managed EU interventions, the EIF could have used other public mandates because the later received equal or higher scores than those backed by the EU. The EIF did not provide us with detailed evidence showing how the individual scores were calculated.

### **The EIF had difficulties exiting EU-backed funds**

**96** A venture capital fund realises a return once it sells (or “exits”) a company. Exiting takes place through either an IPO on the stock market, or a sale of the company to either an industrial investor (trade sale) or another venture capital fund or private equity firm. When a portfolio company has no remaining value, its book value is written-off according to applicable accounting standards. We examined the exit strategy of the funds to maximise the return on investments. In addition, we examined the strategy for closing the mandates under review.

**97** In 2018, the three main exit routes on the European venture capital market by amount were: (i) trade sales at 35 %; (ii) IPOs at 22 %; (iii) write-offs at 12 %<sup>45</sup>. European venture capital fund managers see exiting investments and the IPO market as their biggest challenges<sup>46</sup>.

**98** A 2017 paper from the Start-up Europe Partnership concluded: “Only 2 % of European scale-ups go public and approximately 15 % of the overall amount raised in Europe has been collected through IPOs [...]. This poses a problem, because IPOs, beyond simply providing growth capital, offer exit opportunities to the venture capital funds. Without exits, the venture capital engine risks being flooded.”<sup>47</sup>

**99** *Table 3* shows the number of exits and remaining investments for all centrally EU-backed interventions as at 30 June 2018.

**100** The duration of a fund is set in the limited partnership agreement. The EIF has faced difficulties closing two of the Commission’s mandates (ESU 1998 and ESU 2001) because venture capital funds failed to sell all the companies in their portfolio over their lifetime. When assessing the funds in which to invest under ESU 1998 and ESU 2001, the EIF paid limited attention to the capacity of the funds to manage the divestment phase. This exit problem was addressed late and the two early instruments (ESU 1998 and ESU 2001), which had already expired, had to be extended to allow the EIF time to find ways to divest.

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<sup>45</sup> Invest Europe, 2018 European Private Equity Activity Report. Other exit routes include repayment of preference shares, sale to another equity firm, sale to a financial institution, management/owner buy-back, and other means.

<sup>46</sup> EIF Working Paper 2018/48 (Helmut Kraemer-Eis, Antonia Botsari, Salome Gvetadze, Frank Lang), EIF venture capital Survey 2018: “Fund managers’ market sentiment and views on public intervention”, 2018.

<sup>47</sup> Start-up Europe Partnership, SEP Monitor: Scale-up report, June 2017.

**Table 3 – Exits of centrally EU-backed venture capital funds**

As of 30/06/2018	Number of Investments made (A)	Write offs (B)	Totally sold (C)	Total number of exits (D)=(B)+(C)	Number of remaining investments (E)=(A)-(D)	(E) / (A) % Rounded	End date of the mandate (month/year)
ESU 1998	315	135	168	303	12	4 %	Jul-14
ESU 2001	317	103	116	219	98	31 %	Dec-18
GIF	623	89	138	227	396	64 %	Nov-26
EFG	69	1	1	2	67	97 %	Dec-34
IFE/EFSI SMEW equity product sub window 2	195	1	2	3	192	98 %	Dec-42
EFSI SMEW equity product sub window 1	43	0	0	0	43	100 %	Dec-42
Sum	1 562	329	425	754	808	52 %	

Source: ECA based on EIF data.

**101** As a result, in mid-2018, ESU 1998, the mandate of which ended in July 2014, was still participating in funds with ongoing investments in 12 firms, representing 4 % of the companies invested. Similarly, in mid-2018, ESU 2001 was still participating in funds with an ongoing interest in 98 companies, representing 31 % of investments.

### EIF's fees not fully transparent or designed to meet policy objectives

**102** The Commission pays the EIF management fees to implement the EU venture capital interventions on its behalf<sup>48</sup>. The Commission also reimburses the EIF some costs deemed eligible for the implementation of the EU funds (other management costs). We examined whether the management fees paid by the Commission were justified and whether they pursued policy objectives.

**103** The delegation agreements cap the fees at between 5.7 % and 8.5 % of the EU intervention. (See [Table 4](#) for details on fee thresholds per intervention).

<sup>48</sup> The Commission also pays the EIB fees for the venture capital guarantee related to EFSI.

**Table 4 – Management fee thresholds per intervention**

	ESU 1998 ESU 2001	GIF	EFG	IFE	EFSI
Administrative fees (A)	Not defined	Not defined	2.8 %	2.8 %	2.8 %
Policy-related incentive fees (B)	Not defined	Not defined	3.2 %	3.2 %	2.9 %
Total ceiling for management fees (C) = (A)+(B)	8.5 %	6.0 %	6.0 %	6.0 %	5.7 %
Treasury management fees and other management costs	-	-	1.0 %	1.5 %	-

Source: ECA based on delegation agreements.

**104** In addition to the management fees the Commission pays the EIF, the fund managers of the EU-backed venture capital funds also charge management fees. These generally correspond to 2 % of the committed amount annually. Furthermore, the launch of the pan-European venture capital fund-of-funds programme has added another administrative layer (see paragraph 20). The manager of each fund-of-funds also charges management fees, which can vary from 8 % to 12 % of the EU contribution committed over the lifetime of the fund (often around 12 years).

#### **Lack of transparency over the justification of start-up fees**

**105** The delegation agreements between the Commission and the EIF require payment, as part of the administrative fees, of a start-up fee at the beginning of the implementation period (*Annex III*). These fees are intended to cover: i) the preparation of the call for expression of interest (which includes detailed terms and conditions as well as reporting requirements); ii) the set-up of the EIF's internal processes and IT systems, including the website; iii) the creation of standardised legal documentation.

**106** Given that the EIF has been managing the EU-backed instruments for 20 years, one might expect it to have developed synergies and know-how which could result in savings, notably in the start-up phase of new instruments. However, this is not the case, and the start-up fees paid by the Commission to the EIF have been increasing over time. For the GIF instrument, the Commission paid €0.3 million in start-up fees (0.8 % of the total maximum fees). Looking at the more recent instruments, the start-up fee has increased to €2.5 million in the case of the EFG instrument (13 % of the

total maximum fees), €4.0 million for IFE (14 % of the total maximum fees), and €5.0 million for the EFSI SMEW equity product (7 % of the total maximum fees).

**107** The Commission does not gather information on the actual start-up costs the EIF incurs. We commented on the fee negotiation process between the Commission and the EIF in our special report 20/2017 on loan guarantee instruments<sup>49</sup>. We found that the conclusions of the report also applied to venture capital instruments, particularly the finding that the Commission did not have detailed information at its disposal on the actual costs of previous schemes.

### **Policy-related incentive fees are not fully fit for purpose**

**108** The incentive fees in place do not motivate the development of a European venture capital market. For example, the EIF is paid an incentive fee for each contract signed with a fund manager, of which the amount varies depending on how many contracts are signed. However, the incentive fees are structured in such a way that there is no link between the incentive fee and any fixed target in terms of the number of funds in which the EIF should invest. Moreover, we observe that this fee does not increase progressively in accordance with the number of contracts signed. In the GIF and EFG instruments, the EIF receives a flat fee, and in the case of the IFE instrument, the highest fees are paid for the first four contracts signed.

**109** The incentive fees are not fully tailored to the achievement of the targets established for the interventions. For example, in the case of the EFG, the Commission has set as a minimum target of supporting at least 360 eligible companies. However, it pays part of the incentive fees to the EIF even if this target is not met (see [Table 2](#)).

**110** Policy-related incentive fees do not fully encourage investment in the EU's less developed venture capital markets or sectors of activity. The ESU 1998/2001 instruments provide no incentive for the EIF to invest in new markets. Other instruments do at least contain an incentive – although the amounts are low compared to other types of incentive – but priority is not given to less-developed venture capital markets.

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<sup>49</sup> ECA Special Report 20/2017 “EU-funded loan guarantee instruments: positive results but better targeting of beneficiaries and coordination with national schemes needed”.



## Conclusions and recommendations

**111** The EU has been involved in the venture capital market for over two decades. During this time, the Commission has greatly increased its support to the venture capital market. Significant EU funding has been made available to strengthen the EU venture capital market, but challenges remain.

### Evaluation of the EU interventions

**112** We found the decisions determining the scale of EU intervention to be poorly informed, either because there had been no ex ante evaluation or impact assessment, or because evaluations were prepared once the budgetary decision had already been taken. The funding gap analysis lacked various dimensions, with no analysis at Member State level or of activity sectors or venture phases (see paragraphs 29 to 36).

**113** When designing future interventions, the Commission is required to carry out timely and meaningful interim and ex post evaluations, taking into consideration lessons learnt. The ex post evaluations that were conducted were generally done too early, often before the programmes had even ended. Moreover, these evaluations lacked analysis based on quantitative data and overlooked counterfactual scenarios. Thus, despite a 20-year history of venture capital support, the Commission has so far provided only limited evidence of the impact achieved (see paragraphs 37 to 46).

### Recommendation 1 – Perform the necessary analyses to improve the evaluation of the EU interventions

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The Commission should improve the information base for its decisions. Specifically, it should:

- (a) carry out a thorough analysis of market failures or sub-optimal investments at the EU, Member State and sectoral level, as well as at the different development stages, in order to allocate appropriate financial resources to venture capital interventions.

**Timeframe: by the signature of the delegation agreements with implementing partners (end 2022).**

To improve its evaluations, the Commission should:

- (b) ensure the collection of relevant data for the evaluators to focus on the effectiveness of support, using counterfactual analysis where appropriate;
- (c) conduct retrospective evaluations a certain time after the investment period for ESU 1998, ESU 2001 and GIF, to allow for a meaningful conclusion on the impact of the interventions.

**Time frame: as soon as possible, but by the end of 2021 at the latest.**

### Development of a comprehensive investment strategy

**114** The Commission did not put in place a comprehensive investment strategy to develop a pan-European venture capital market. The EU interventions did not prioritise less-developed venture capital markets or sectors of activity. The EU market is still very dependent on public sector involvement and there was unnecessary complexity deriving from using various instruments.

**115** The Commission's interventions in the European venture capital market have been underpinned by a demand-driven approach, according to which the support is provided for projects based on merit, and has not been driven by geographic location or sector. However, we found that this approach clearly favours the most developed venture capital markets, leading to a concentration of investments, which does not contribute fully towards a pan-European venture capital market (see paragraphs [49](#) to [63](#)).

**116** The Commission did not set the attainment of high returns as an objective for its interventions. Generally speaking, attracting private investors, which is essential for a sustainable venture capital market, is only possible if investments generate high returns. ESU 1998 has invested €101 million, posting a global net loss of €12 million since its inception. A similar picture can be observed in the ESU 2001 and GIF realised portfolios. So far, the Commission has only been providing support on a *pari passu* basis, without relinquishing part of its return to private investors or assuming more losses (see paragraphs [64](#) to [73](#)).

## Recommendation 2 – Develop a comprehensive investment strategy

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To develop a pan-European venture capital market, the Commission should:

- (a) take further concrete measures to support investments in less developed venture capital markets and sectors of activity.

**Time frame: in time for the preparation of the new programming period (end 2020).**

To reduce the dependence of the EU venture capital market on public sector involvement, the Commission should:

- (b) fix appropriate targets at the instrument level to crowd in private investors, taking into account the specific policy objectives, and the development of the different local venture capital markets and sectors of activity;
- (c) explore the option of introducing gradual exit clauses;
- (d) explore the use of asymmetric profit-sharing or asymmetric risk-sharing in the event of acute market failure, whereby the Commission would relinquish part of its return for the benefit of other investors, or assume the first losses where returns are negative.

**Timeframe: before the negotiation of the new delegation agreements (end 2022).**

### Implementation of the EU interventions

**117** The EIF has become one of the biggest players in the European venture capital market, managing an increasing number of mandates. Its due diligence process is thorough; its quality means it is often seen as a “seal of approval”. That said, the process was often seen as too long and formalistic, with 45 % of fund managers reporting that the EIF took over one year to approve an application. Furthermore, throughout, managers had to deal with numerous interlocutors with varying degrees of familiarity with their case.

**118** The centrally managed EU interventions overlap with a number of other public interventions also managed by the EIF. The Commission received little information on how the EIF decided in which venture capital fund to invest and under which mandate (see paragraphs [86](#) to [95](#)).

**119** The EIF has faced difficulties closing two of the Commission's mandates due for winding-up (ESU 1998 and ESU 2001) because venture capital funds failed to sell all the companies in their portfolio over their lifetime. Because attention was only paid to this issue later on, these two instruments, which had already expired, had to be extended to allow the EIF time to find ways to divest (see paragraphs 96 to 101).

**120** We found that the Commission has paid significant start-up fees for the launch of each new instrument. We see no savings resulting from synergies or know-how that the EIF might have built up over the two decades it has been managing EU-backed instruments. Moreover, the Commission was uninformed about the actual costs the EIF incurred (see paragraphs 105 to 107).

**121** The policy-related incentive fees are not fully tailored to the achievement of the targets established for the interventions, nor were they designed to fully encourage investments in countries with a less developed venture capital market or in less developed sectors of activity (see paragraphs 108 to 110).

### **Recommendation 3 – Streamline EIF management of the EU interventions**

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To increase efficiency, the Commission should engage with the EIF to:

- (a) streamline the project approval process by shortening the current timeline;
- (b) ensure that it applies a deal allocation policy ensuring complementarity between the EU interventions and the other mandates managed by the EIF;
- (c) ensure that it identifies sufficient exit options when approving investment in a fund.

**Time frame: in time for the negotiation of the new delegation agreements (end 2022).**

The management fees paid by the Commission to the EIF should:

- (d) correspond to the reimbursement of actual start-up costs incurred when setting up new interventions;

- (e) be designed in a way to incentivise pursuit of the overall objectives of the interventions, notably the development of a European venture capital market, gradually increasing once agreed minimum performance milestones are met.

**Time frame: in time for the negotiation of the new delegation agreements (end 2022).**

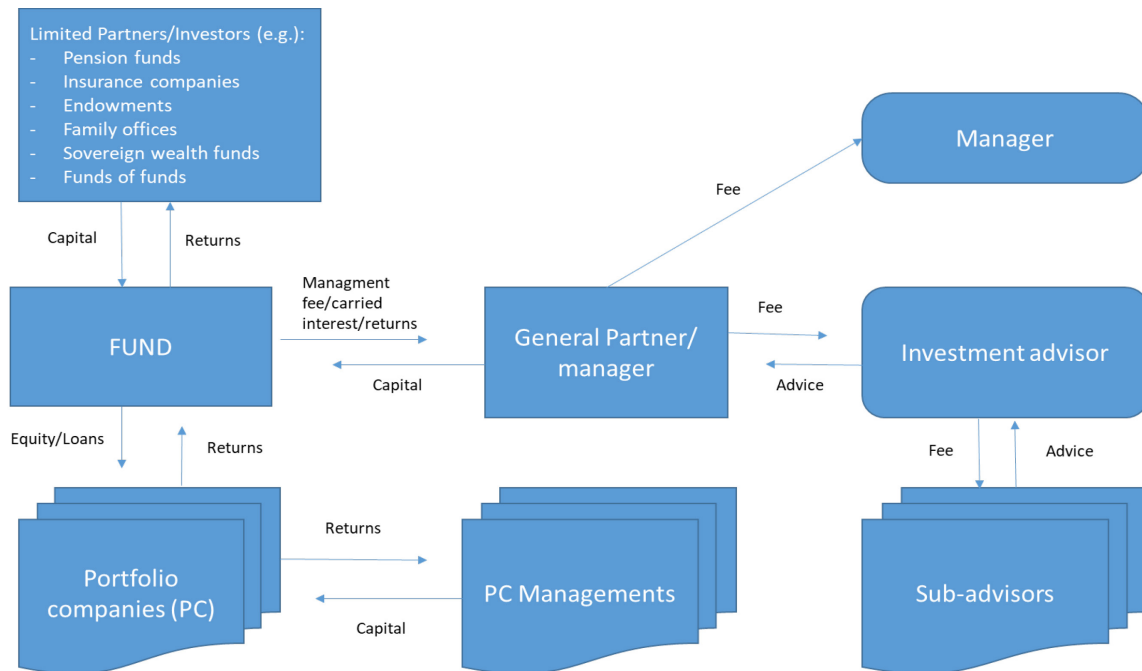
This Report was adopted by Chamber IV, headed by Mr Alex Brenninkmeijer, Member of the Court of Auditors, in Luxembourg at its meeting of 17 September 2019.

*For the Court of Auditors*

Klaus-Heiner Lehne  
*President*

# Annexes

## Annex I — Typical structure of a venture capital fund

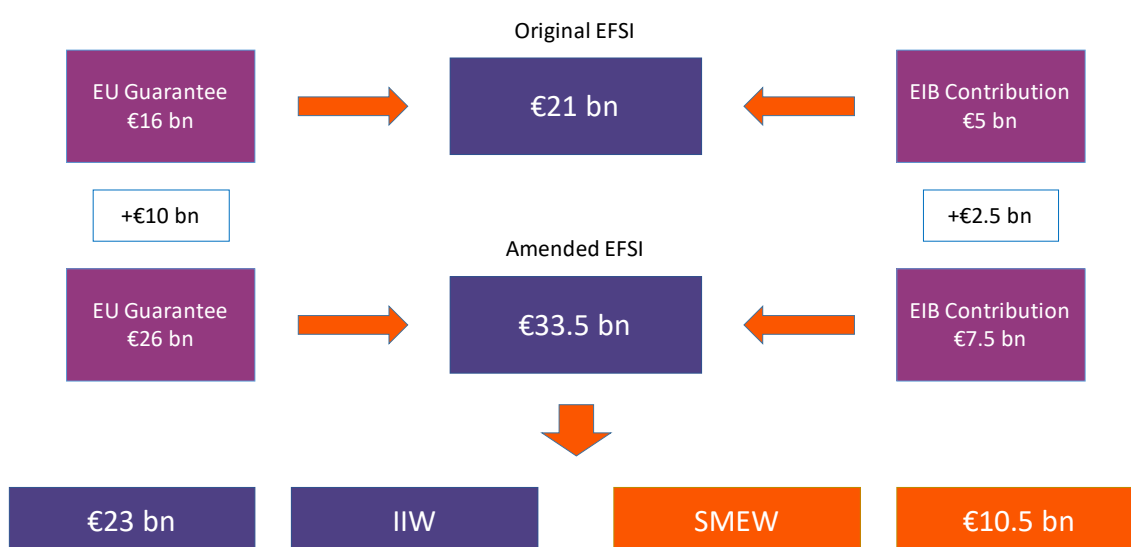


Source: Adapted from 2018 Professional Standards Handbook – Invest Europe.

## Annex II — The EFSI SMEW equity product

**01** In June 2015, the Parliament approved the EFSI regulation with an EU guarantee of €16 billion. Together with the EIB Group's contribution of €5 billion, this makes a total of €21 billion. In December 2017, the Parliament approved an extension of the EU guarantee by €10 billion to €26 billion. The EIB Group also increased its contribution by €2.5 billion to €7.5 billion. Overall, €33.5 billion has been budgeted. *Figure 9* illustrates this development.

**Figure 9 – Development of the EU EFSI guarantee**



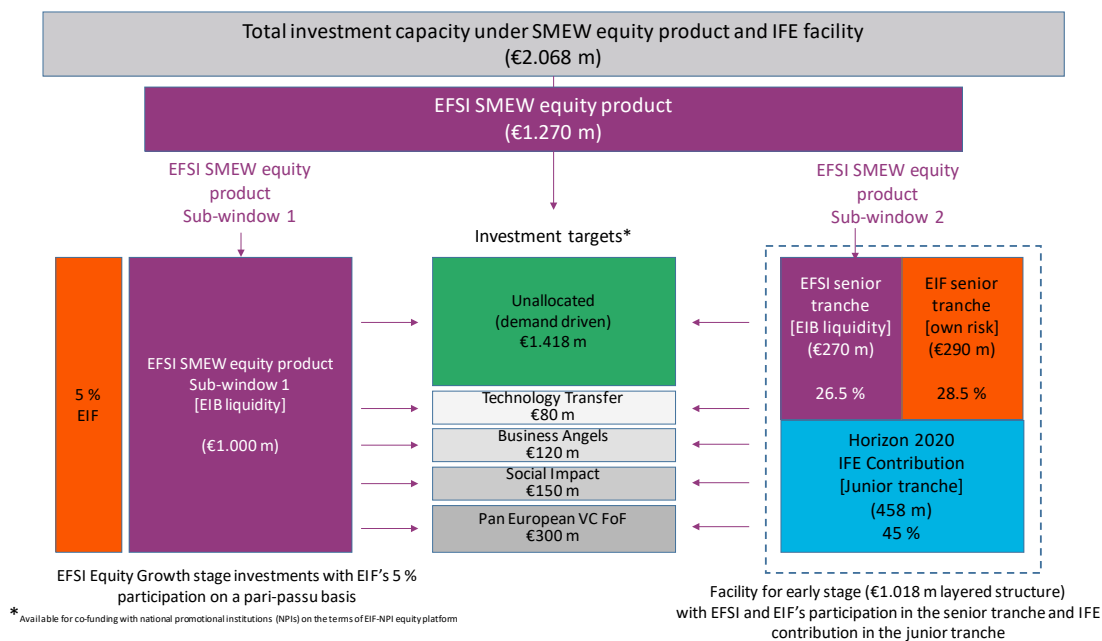
Source: EIB's/EIF's 2017 report.

**02** The €33.5 billion total is distributed under two windows: (i) the infrastructure and innovation window; (ii) the SME window. Following the EU EFSI guarantee extension, the SME window was increased by €5.5 billion to €10.5 billion, of which the EU budget will cover €6.5 billion.

**03** The EFSI SMEW equity product is a part of the SME window. It comprises two sub-windows. Under sub-window 1, the EIF provides equity investments in: (i) expansion and growth-stage VC funds; (ii) multi-stage VC funds; (iii) social impact. The maximum EU guarantee covers €1 billion and the liquidity is provided by the EIB. In addition, the EIF has to fund €50 million at its own risk.

**04** Sub-window 2 is a senior tranche to IFE. Together with the EIB senior tranche, it was added as a top-up to the already existing IFE instrument (Horizon 2020). *Figure 10* gives an overview of the EFSI SMEW equity product before the extension of the EU EFSI guarantee.

**Figure 10 – Structure of the EFSI SMEW equity product before the extension of the EU EFSI guarantee**



Source: EFSI Steering board SB/16/16.

**05** An investment of €100 under sub-window 1 would be funded with €95.2 from the EIB and guaranteed by the EU, with €4.8 from the EIF's own participation. The risk would be shared *pari passu* pursuant to the ratio 4.8/95.2.

**06** Looking to sub-window 2, each investment is funded according to the percentage of the tranches. Taking a €100 investment, €45 would be funded from the junior IFE tranche, €26.5 from the EIB senior tranche (guaranteed by the EU budget via the EFSI SMEW equity product), and €28.5 from EIF's senior tranche. IFE would cover a loss up to €45; above this threshold, the loss would be borne *pari passu* by the EU budget and the EIF's senior tranche at a ratio of 26.5/28.5.

**07** As a consequence of the extension of the EU EFSI guarantee, the EFSI Steering Board decided to increase the EU guarantee for the EFSI SMEW equity product by €1 050 million to €2 320 million in October 2018. Of this top-up, €950 million was intended for sub-window 1 and €100 million for sub-window 2.

**08** Owing to the risk-sharing arrangement shown in [Figure 10](#), the EIF will be required to co-invest a further €47 million (4.8 %) in sub-window 1. An additional increase in the EU guarantee for EFSI sub-window 2 of €100 million also means an



increase of EU's IFE contribution by €170 million and of EIF's senior tranche by €108 million.

**09** The total investment capacity of €2 068 million, as shown in *Figure 10*, will then increase by €1 375 million to €3 443 million. This figure comprises €2 948 million from the centrally managed programmes and €495 million from the EIF's own-risk tranches.

**10** The intended increase required a further amendment to the EFSI delegation agreement, which was not signed until mid-December 2018.

### Annex III — Composition of the management fees paid by the Commission to the EIF per instrument

		ESU 1998 ESU 2001	GIF	EFG	IFE	ESFI
Administrative fee	Start-up fee	√	√	√	√	√
	Signature fee	√	√	√		√
	Yearly monitoring fee		√	√		√
	Basic fee		√		√	
	Operation termination fee					√
Policy-related incentive fees	Number of funds	√	√	√	√	
	Number of new countries where final recipients have received financing			√	√	√
	Achieved leverage			√	√	
	Number of eligible final recipients		√	√		
	Amount invested in eligible final recipients		√	√	√	√
	Number of BA or TT operations				√	√
	Commitments with/to BA or TT operations				√	
Treasury management fees			√	√	√	

Source: ECA based on delegation agreements.

# Acronyms and abbreviations

**CIP:** Competitiveness and Innovation Framework Programme

**COSME:** Programme for the Competitiveness of enterprises and SMEs

**EFG:** Equity Facility for Growth

**EFSI:** European Fund for Strategic Investments

**EFSI SMEW equity product:** European Fund for Strategic Investments Small and Medium-sized Enterprises Window equity product ([Annex II](#))

**EIB:** European Investment Bank

**EIF:** European Investment Fund

**ESU 1998:** European Technology Facility Start-up of the multiannual planning period starting in 1998

**ESU 2001:** European Technology Facility Start-up of the multiannual planning period starting in 2001

**G&E:** Growth and Employment Initiative

**GDP:** Gross domestic product

**GIF:** High Growth and Innovative SME Facility

**IFE:** InnovFin Equity Facility for Early Stage (IFE)

**InvestEU:** Draft programme for the multiannual planning period 2021-2027

**IPO:** Initial public offering

**MAP:** Multiannual Programme for Enterprise and Entrepreneurship

**SMEs:** Small and medium-sized enterprises

**VC:** Venture capital

## Glossary

**Budgetary guarantee:** A legal commitment to back investments made by financial partners by providing funds from the EU budget under certain circumstances to meet a payment obligation on a supported EU programme.

**Centrally managed intervention:** An investment either funded or backed by the EU budget and managed by the Commission.

**Cornerstone investor:** A trusted investor that purchases a significant share of a venture capital fund. They play an important role by guaranteeing that a certain proportion will be sold and by stimulating demand owing to the credibility they bring to the investment.

**Ex ante evaluation:** An assessment conducted before implementation of an intervention, considering, for example, needs, scale with regard to the funding gap, the EU added value and potential synergies with other financial instruments.

**Financial instrument:** Financial support from the EU budget in the form of equity or quasi-equity investments, loans or guarantees, or other risk-sharing instruments.

**Fund-of-funds:** A pooled investment fund that invests in other funds rather than investing directly.

**Initial public offering:** The process of launching the sale or distribution of a company's shares to the public for the first time.

**Impact assessment:** The collection and analysis of information to determine the likely advantages and disadvantages of planned action in order to support decision-making.

**Pari passu:** The principle by which all investors invest on the same terms and enjoy the same rights.

**Private equity:** An investment in an unlisted private company in exchange for a medium to long-term interest, which is later sold. The capital injection acts as start-up or development funding.

**State aid:** Direct or indirect government support to a business or an organisation, putting it at an advantage over its competitors. The EU has rules governing state aid to prevent distortion of the single market. The Commission oversees compliance with these rules.

**Venture capital:** Money invested, in exchange for a holding, in start-ups or innovative emerging firms carrying a substantial element of risk and requiring expert help in growing their business.

**Venture capital fund:** An investment fund that manages money from professional investors seeking to invest in small and medium-sized firms with strong growth potential.

## **REPLIES OF THE COMMISSION TO THE SPECIAL REPORT OF THE EUROPEAN COURT OF AUDITORS**

### **“CENTRALLY MANAGED EU INTERVENTIONS FOR VENTURE CAPITAL: IN NEED OF MORE DIRECTION”**

#### **EXECUTIVE SUMMARY**

I. The primary objective of the six audited instruments is to improve access to equity financing for small businesses, between the years 1998 and 2036. Launched in several successive generations, the investment strategy of these instruments naturally developed over time, in reaction to changing market situation and policy priorities.

While not primarily focussing on the impact on financed companies, the report makes a number of observations on whether these instruments help develop the venture capital market in the EU, and especially underdeveloped markets, which is only an ancillary objective of some of the audited instruments.

Other Commission interventions – in the regulatory and cohesion remits – may also have an impact on market development in individual Member States, including those with underdeveloped markets. These were outside the scope of the audit.

IV. The Commission relied on ex-ante assessments and available market studies. The instruments relied on structural in-built mechanisms to react to potential changes in absorption capacity.

The Commission produces publicly available reports to the Budgetary Authority every year, such as the report under Article 41.4 of the Financial Regulation. In addition, the Commission has reporting, which includes, *inter alia*, details on the impact on mobilised investment and employment.

V. None of the programmes in question has, as an objective put forward by the legislator, “funds being invested in underdeveloped venture capital markets or activity sectors.” The Commission assesses the programmes and their investment strategies against their stated objectives rather than other criteria.

The Commission has put in place a rather comprehensive approach to supporting access to finance for Small and Medium-sized Enterprises (SMEs) through the venture capital market. It uses a set of measures that can contribute, directly or indirectly, to supporting venture financing: regulatory intervention, intervention through shared management and centrally-managed programmes. The audited instruments constitute only a subset of these measures.

A number of Member States with underdeveloped venture capital markets benefitted significantly from these instruments.

VI. The Commission has analysed the possibility of giving part of the EU’s return on investments to private investors. This possibility was analysed in the design phase of several instruments.

In fact, non *pari-passu* investments are already explicitly allowed for social investments under the EFSI Equity Product. In addition, the Commission is further examining the modality of non *pari-passu* investment under the SME window of European Fund for Strategic Investments (EFSI).

VII. The Commission notes that an European Investment Fund (EIF) investment in a fund is often considered as a seal of approval. Many categories of investors rely on EIF’s

involvement in order to make their own investments in the same fund. Thus, EIF's commitment is catalytic and market-making. Such a reputation can only be maintained through a high-quality assessment and due diligence process, which inevitably takes time.

EIF's deal allocation policy was overhauled throughout 2018. It was presented to the Commission and the EIF committed to discuss any updates of the system with the Commission. The system is based on objective and pre-defined criteria, combining analysis of quantitative and qualitative factors. The process is coordinated by an independent service and all allocation decisions are appropriately recorded in the EIF's systems.

Currently, the whole market suffers from a "tail-end" problem, i.e. difficulties in closing old funds.

A comprehensive strategy has been agreed to close the mandates, in line with the legal basis.

VIII. As also highlighted in the context of a similar audit observation in the Commission replies to the ECA's special report No 20/2017 on EU-funded loan guarantees and in particular paragraph 40 therein, the Commission considers that it is useful to have cost data from the implementing partner before entering into fee negotiations. For this reason, the Commission obtains cost estimates whenever possible and also regularly analyses the EIF's financial statements to understand EIF's fee income and its contribution to overall EIF profitability and, more generally, continues to make efforts to obtain further relevant detailed data on the costs of running financial instruments. Such data, however, may not come from directly comparable instruments. Nonetheless, even in the absence of such data, the Commission should be able to finalise negotiations on the basis of available information.

Start-up fees are designed to compensate the implementing partner for the detailed negotiations leading to the set-up of the instruments, for the need to develop new standardised legal agreements for new or revised instruments, to launch calls for expressions of interest and to adapt reporting and audit systems. The Commission would like to recall that the legal framework governing the implementation of financial instruments has developed significantly over time (e.g. the provisions of the Financial Regulation governing financial instruments have become very sophisticated and detailed, which in turn requires more efforts and know-how on the side of the implementing partner).

Therefore, the payment of start-up fees is justified and their size appropriate.

In addition, the incentive fees of the instruments correspond to their stated objectives.

IX. For the reasons set out in the replies to the recommendations, the Commission is not in a position to fully accept all of them.

## **INTRODUCTION**

10. EU legislation already includes harmonised rules on private European label funds in risk capital projects, namely European venture capital funds (Regulation 345/2013 on European venture capital funds), European infrastructure funds (Regulation 2015/760 on European long-term investment funds) and European funds investing in social economy (Regulation 346/2013 on European social entrepreneurship funds). The Regulations allow for the easy identification of the European risk capital funds with defined common features and thus make it easier for managers of alternative investment funds, investors and invested companies to identify them as possible investment vehicles, investment targets or institutional investors

respectively. Tasks undertaken by the European Securities and Markets Authority also foster convergence.

12. The evolution of fundraising for the whole period since 2007 shows a more comprehensive picture. According to *InvestEurope*<sup>1</sup> data, the governmental share of venture capital funding rose from 2007, peaking in 2011 at 34.7%, and then was very volatile, rising and declining until 2018 to 18%.

In addition, it should be noted that this data also includes other public entities besides the EU. The share of the reviewed EU mandates in the overall fundraising was approx. 1.9% in 2018.

Box 2. Current valuations show that the investment portfolios are likely to be profitable overall, making it an efficient way to deliver on policy objectives. The venture capital instruments supported funds that have provided access to finance to hundreds of innovative companies in key stages of their development, including major breakthrough innovators such as Skype, Spotify or start-ups developing products on the basis of graphene for which the 2010 Nobel Prize in physics was awarded.

17. The increase of the budget available to these instruments was driven by the fact that these instruments have become an established support mechanism, following the pilots of late 1990s and early 2000s. In addition, EFSI introduced a major increase in support as a mechanism to boost investment following the financial and economic crisis.

18. In addition to fulfilment of eligibility criteria, award is based on the verification of policy consistency and the assessment of value added achieved by supporting the given investment – i.e. if the value added is not provided, the investment will not materialise.

20. The Commission notes that, indeed, up to EUR 343 million is available for investments in funds-of-funds, but these resources can also be automatically used for other types of investments under the facilities, if the investments in funds-of-funds fail to materialise.

23. It is important to point out the relative role of the EIF on the European venture market.

The EUR 1.4bn committed by the EIF in 2018 should be compared with EUR 11.4 billion which was overall 2018 fundraising for venture capital in the EU. Therefore the EIF in 2018 represented 12% of fundraising in the EU in this market segment. In addition, the EIF uses many mandates for this activity, including commercial ones and the EIF's own resources. The investments EIF channels to the market with the support of EU budget represent only approx. 1.9% of overall EU venture fundraising. The role of EU-supported mandates is therefore to focus on market gaps where public support is needed the most.

## **OBSERVATIONS**

30. Common reply to paragraphs 30 to 36:

The Commission carries out ex-ante quantifications of market needs – and, more importantly, financing gaps – and absorption capacity through the best market intelligence made possible by standard statistical techniques and available advisory. However, strong data limitations

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<sup>1</sup> *InvestEurope*, 2018 European Private Equity Activity. <https://www.investeurope.eu/media/811517/invest-europe-2018-european-private-equity-activity.pdf>.



exist due to the very nature of venture capital financing, as private information is not released by the investee on its business prospects and financial solvency.

In the absence of reliable and sufficient data, the Commission believes that surveys and qualitative analyses are a valid method to assess the market gap.

Using a similar approach, the European Parliament writes: "In summary, Europe suffers from a low supply quantity, i.e. low fundraising from private institutional investors. In addition, Europe suffers from a low supply quality, reflected in the low number of qualified, experienced, and sufficiently large venture capital funds. These problems are obviously closely interrelated: a higher venture capital fund quality would attract institutional investors and result in a larger venture capital quantity." [Source: 'Potential of Venture Capital in the European Union', European Parliament Directorate General for Internal Policies, 2012]

Virtually all Commission documents on the topic acknowledge the existence of an SME financing gap (including for venture capital), which implies that in the EU there is insufficient venture capital supply.

33. The Commission relied on market studies. Several documented the investment gap, both inside the Commission (e.g. Buti 2014a<sup>2</sup> and 2014b<sup>3</sup>), and outside (e.g. Barkbu et al. 2015<sup>4</sup> and EIB 2013<sup>5</sup>). The gap has been operationalised in internal documents. As for venture capital financing gaps for SMEs, studies based on European Private Equity and Venture Capital Association (EVCA) and *InvestEurope* data were available (e.g. ESRI 2014<sup>6</sup> or Lopez de Silanes et al. 2015<sup>7</sup>), showing both the gaps and the underdevelopment of the venture capital market.

36. The risk that funds cannot be absorbed is addressed structurally: all the instruments have allocations that are not fixed, but rather have maximum ceilings, and include embedded flexibility of redeployment to other actions. In addition, five of the six analysed instruments relied directly on annual budgetary contributions and their size can be modulated. Therefore, in cases where the market gap was fully addressed, further resources would not be provided to the facilities. Hence, the Commission has so far successfully managed this risk.

Box 3. The 2011 study was based on the market reality at that time. As the size of the venture capital market more than doubled since, the Commission is of the opinion that the conclusions of that study may not be fully applicable to today's reality. The study was not

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<sup>2</sup> Marco Buti and Philipp Mohl: "Lacklustre investment in the Eurozone: Is there a puzzle?" *Vox*, June 2014. <https://voxeu.org/article/raising-investment-eurozone>

<sup>3</sup> Marco Buti: "Lacklustre investment in the Eurozone: The policy response" *Vox*, December 2014. <https://voxeu.org/article/lacklustre-investment-eurozone-policy-response>

<sup>4</sup> Bergljot B. Barkbu, Pelin Berkmen, Pavel Lukyantsau, Sergejs Saksonovs and Hanni Schoelermann: "Investment in the Euro Area: Why Has It Been Weak?" *IMF Working Paper* No. 15/32, February 19, 2015. <https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Investment-in-the-Euro-Area-Why-Has-It-Been-Weak-42717>

<sup>5</sup> EIB: *Investment and Investment Finance in Europe 2013*, 14 November 2013. <https://www.eib.org/en/infocentre/publications/all/investment-and-investment-finance-in-europe.htm>

<sup>6</sup> ESRI: *Access to External Financing and Firm Growth*. Background Study for the European Competitiveness Report 2014, May 2014. [https://www.google.be/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&ved=2ahUKEwjY\\_475pujeAhVQKuwKHTn6AI4QFjABegQIAxAC&url=https%3A%2F%2Fec.europa.eu%2Fdocsroom%2Fdocuments%2F8786%2Fattachments%2F1%2Ftranslations%2Fen%2Frenditions%2Fpdf&usg=AOvVaw2SPzw1L4aRoQVrA\\_MZ19Y8](https://www.google.be/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&ved=2ahUKEwjY_475pujeAhVQKuwKHTn6AI4QFjABegQIAxAC&url=https%3A%2F%2Fec.europa.eu%2Fdocsroom%2Fdocuments%2F8786%2Fattachments%2F1%2Ftranslations%2Fen%2Frenditions%2Fpdf&usg=AOvVaw2SPzw1L4aRoQVrA_MZ19Y8)

<sup>7</sup> Florencio Lopez de Silanes Molina, Joseph McCahery, Dirk Schoenmaker and Dragana Stanisic: *The European Capital Markets Study. Estimating the Financing Gaps of SMEs*. Report sponsored by the Dutch Ministry of Finance and the EBRD, July 2015. [https://web.archive.org/web/20161213054417/http://www.dsf.nl/wp-content/uploads/2015/09/European-Capital-Markets-Study\\_2015\\_FINAL-15-7.pdf](https://web.archive.org/web/20161213054417/http://www.dsf.nl/wp-content/uploads/2015/09/European-Capital-Markets-Study_2015_FINAL-15-7.pdf)

able to anticipate market developments and as evidenced by current achievements, the Commission's mandates do not have any problem with implementing the budgets allocated to the venture capital interventions. In 2018 the share of the audited venture capital interventions in overall fundraising in the EU was 1.9%.

38. The Commission would like to point out that i) the economic effects and impact on employment (for instruments since 2007) are sufficiently covered in the reports produced by the EIF, and ii) naturally, the studies did not primarily analyse the impact on the venture capital industry as the audited facilities often did not have market development or impact on the industry as an objective at all, while others had it only as one of the ancillary objectives.

39. The timing of ex-post reports and evaluations is clearly set out in the underlying legislation adopted by the Council and European Parliament.

Even if the Commission could influence their timing, there is a clear trade-off between usefulness and availability of comprehensive data. To be able to take into account the recommendations of an evaluation, the results need to be known before the design of the new programme. A later evaluation may rely on more data, but will come too late to be taken into account in the next programme.

40. Second indent: High Growth and Innovative SME Facility (GIF) financial instruments were only one segment of the Competitiveness and Innovation Framework Programme. The timing for conducting evaluations was prescribed in the legal basis and therefore, the timing for evaluation could not have been changed.

41. Qualitative methods, interviews and surveys are a relevant source of information, especially in situations when extensive and detailed statistical data is not available. Moreover, more recently, since 2015 the EIF has been performing economic impact assessments; these analyses include as well venture capital (including EU mandates) and the Commission analyses these closely.

42. A counterfactual analysis can only be carried out a few years after the financial end of the programme, which can sometimes come more than two decades after its launch. Data on jobs created and maintained were reported regularly as part of standard reporting and can be easily compared with employment developments in the overall economy.

43. The ECA reference to the VICO projects as examples of programme evaluation, in fact, confirms the Commission's point on a stringent trade-off between timeliness and comprehensiveness of ex post evaluations. Indeed, the VICO projects were carried out by a consortium of nine universities and research centres over three years, an undertaking which can hardly constitute a blueprint for timely and specific evaluations of individual programmes. More importantly, the VICO projects are not evaluations of specific programmes, deployed over time; rather, the VICO projects simply compare a cross section of venture capital-backed firms with non-venture capital-backed firms, and among the former they consider firms backed by governmental venture capital – whether national, EU central, EU structural or not, whether recently financed or not, whether financed by Growth and Employment Initiative (G&E), Multiannual Programme for Enterprise and Entrepreneurship, (MAP), High Growth and Innovative SME Facility (GIF) or not. In essence, this different perspective entailed the use of a methodology that cannot be carried over to the case of programme evaluations.

45. While no target has been set for the number of employees of beneficiary companies, the impact of the intervention on jobs created and maintained is tracked and reported.

47. Commission's reply to paragraph 47 and the heading above

The Commission has put in place a rather comprehensive approach to supporting access to finance for SMEs through the venture capital market. It uses a set of measures that can contribute, directly or indirectly, to supporting venture financing: regulatory intervention, intervention through shared management as well as centrally-managed programmes. The audited instruments constitute only a subset of these measures. The primary objective of EU interventions was supporting jobs and growth as well as innovation, not creation of the venture capital markets.

48. The Commission considers the fund domiciliation country of little relevance. Not all EU Member States offer appropriate regulatory environments for venture capital funds. This is especially important for multi-country funds, which are usually established in only selected EU Member States, those with developed and tested legal frameworks. Ultimately, the fund domiciliation country does not often provide a clear indication of the actual geographic coverage of the funds' investments.

50. All audited instruments require a geographic diversification and encourage the EIF to operate in as many EU Member States as possible, clearly motivating the EIF to intervene also in Member States with underdeveloped markets.

Within the policy boundaries established for a given financial instrument, the uptake of the instrument is 'market-driven'. As the ECA has pointed out throughout its analysis, absorption capacity plays a significant role in the implementation of the instruments. If no quality applications (i.e. applications adhering to minimum standards) are received from underdeveloped markets, it is not possible to invest. Equal access to the instruments is ensured, as applications are received on the basis of open calls for expression of interest.

51. Please see the Commission's reply to paragraph 48.

52. The Commission has proposed a variety of measures to render the cross-border distribution of investment funds, including the European venture capital funds more efficient (simpler, quicker and cheaper).

In line with the Capital Market Union Action plan, these initiatives aim to facilitate the penetration of private risk-capital investment funds in the Union, further mobilise and channel capital to innovative, small and medium-sized enterprises, harmonise diverging national requirements and render them more transparent and less burdensome.

Targeted amendments of Regulation 345/2013 on European venture capital funds were introduced in 2017 and have applied since 1 March 2018 (Regulation 2017/1991, amending Regulation 345/2013). Further specification of applicable rules for the European venture capital funds has been adopted by the Commission in February 2019 (Delegated Regulation 2019/820) and will apply as of 11 December 2019. Additional initiatives, facilitating cross-border distribution of European venture capital funds have been adopted by the co-legislators in April 2019 and will enter into force in July/August 2019.

The above legislative initiatives were pending at the time of the preparatory works of the EIF survey (the survey was published in April 2018). Furthermore, these initiatives aimed at facilitating cross-border distribution of European venture capital investment and further streamlining the applicable rules to address also the concerns raised by the EIF survey.

As regards the tax systems though, currently the tax system is largely a preserve of Member States and any EU level approximation initiative would require a unanimous decision by the Council.

54. The largest concentration of investments is seen in the biggest EU economies. France, Germany and the United Kingdom had the biggest economies based on their share in EU GDP in 2017 and together accounted for 51.4% of EU GDP. Therefore, this situation is perfectly natural and does not suggest an overconcentration in these Member States. It simply reflects economic reality.

56. The Commission would like to point out that development of underdeveloped markets is not the primary objective for the audited facilities, with the exception of GIF, which mentions it after the objective of contributing towards the establishment and financing of SMEs, while some mention it as an ancillary objective. Both eligibility under the policy requirements of a given mandate and value added elements need to be warranted in order to justify the investment.

The Commission also uses other interventions that could contribute to “fostering a European venture capital market”, which were not the subject of this audit.

EU-backed venture capital funds invested in many Member States, also thanks to shared management instruments. Member States may decide to invest their European Regional Development Fund (ERDF) allocations via loans, bank guarantees and equity / venture capital. The Commission actively promotes the use of such instruments. In the 2014-2020 period, some Member States, in particular Poland, Hungary and Bulgaria, allocated substantial amounts of their ERDF allocations to equity / venture capital (approx. EUR 1.2 billion, 480 million and 340 million respectively).

In addition, as an example of such investment initiatives which are managed by the EIF, the Central Europe Fund of Funds (fund-of-funds created in partnership with the national authorities of Austria, the Czech Republic, Slovakia, Hungary, and Slovenia) and the Baltic Innovation Fund can be mentioned.

62. Please see the Commission’s replies to paragraphs 30-36.

63. The EU-level intervention always targets all Member States and funds need to be accessible to applicants from all Member States on equal terms.

64. The Commission considers that subsidiarity or value added can be achieved when action at EU level can be more efficient or effective than action at the level of Member States.

65. In addition to the need to ensure consistency with state aid rules, the Commission aims to attract private investors to the venture capital industry.

COSME (Programme for the Competitiveness of enterprises and Small and Medium-sized Enterprises), InnovFin (EU Finance for Innovators) and EFSI all have ambitious overall targets at portfolio level, as evidenced through target leverages, agreed multipliers or tracking of overall volume of mobilised investments. In reporting on these objectives, investments by EIF/EIB or promotional banks are not considered private.

However, for individual investments, the Commission needs to allow also for investments of high policy value that require significant public intervention and cannot attract a large volume of private resources. For example, social impact funds or other impact funds, technology transfer funds, or funds focusing on the seed and start-up phase of the company lifecycle need more public intervention than large expansion-stage private equity funds. It is for this reason that other requirements for the participation of the private sector are not set for individual investments.

66. The Commission did not set profitability targets, as the instruments follow policy objectives rather than maximisation of profitability and are complementary to other instruments, which pursue financial return. But even while focusing on policy returns the audited instruments are also set to generate a financial profit, according to EIF reporting, and do invest in funds that attract private investors. While, according to the Commission's assessment, the *pari-passu* principle has been adequate for most of the investment activity, the Commission also already does allow for non *pari-passu* investments, in the specific case of social investment.

The Commission does not share the opinion that attraction of private investors is possible only with generation of high returns. While private investors will seek positive returns, they may be driven by factors other than the pursuit of 'high returns', e.g. geographic diversification within the asset class, scouting for the latest technology developments, venture philanthropy, social investments, etc.

67. It is too early to provide meaningful data for more recent EU interventions. Nonetheless, EIF data indicates that, as of end-December 2018, the EU equity financial instruments and EFSI SME Window equity product are set to generate a profit of 3.6% per annum.

This means that overall, the investments could even deliver a profit to the EU budget, while at the same time delivering on the policy objectives, supporting jobs in innovative companies and mobilising private investment.

68. The Commission has assessed the possibility to deviate from the *pari-passu* principle. In fact, the Commission already allows for non *pari-passu* investments for social investments under the SME Window of EFSI. This possibility was introduced in the EFSI Agreement on the basis of a Commission Decision. Furthermore, the Commission is examining the modality of non *pari-passu* investment the SME window of EFSI.

69. See reply to paragraph 68.

73. Opinions vary as to how the self-sustainability of the market can be fostered by public investors exiting funds earlier.

Limited partnership agreements signed for the operations generally do allow for early exits of individual investors, e.g. through secondary sales. This is standard practice accepted by the market.

The EIF analyses each fund's exit strategy as part of its due diligence. More recently, the Commission and the EIF have planned to implement a more systematic exit from fund holdings, through sales on the secondary market of fund interests.

75. Cross-investments for a limited amount are allowed as a specific lesson learnt from the predecessor programme.

79. The Commission points out that the operational reporting on the EFSI SME Window equity product produced by the EIF does provide the necessary details. It may, however, indeed be seen as complex, due to the fact that the underlying reality is also very complex.

82. According to *InvestEurope* data, the share of funds from public investors rose from 2007, peaking in 2011 at 34.7%, and then dropped and was very volatile, rising and declining until 2018.

The EUR 1.4 billion committed by the EIF in 2018 should be compared with EUR 11.4 billion which was overall 2018 fundraising for venture capital in the EU. Therefore the EIF in 2018 represented 12% of fundraising in the EU in this market segment. In addition, the EIF

uses many mandates for this activity, including commercial ones and EIF's own resources. The EUR 214 million which the EIF channelled to the market in 2018 with the support of the audited instruments represented only approx. 1.9% of overall EU venture fundraising. The role of EU supported mandates is therefore to focus on market gaps where public support is needed the most.

84. The Commission notes that an EIF investment in a fund is often considered as a seal of approval, a quality hallmark of the deal. Many categories of investors rely on EIF's involvement in order to make their own investments in the same fund. Thus, EIF's commitment is catalytic and market-making. Such a reputation can only be maintained through a high quality assessment and due diligence process, which unavoidably takes time.

In addition, the length of the process is bound to differ from applicant to applicant (e.g. under the European programmes first time managers are eligible for which the due diligence process is more complex than for established management teams). Delays can also arise due to an applicant's slow response to EIF's requests for information, a factor that is outside EIF's control.

89. Complementarity of the mandates derives from other criteria than simply being able to target different risk segments, especially as all venture capital investments can be considered very risky. Mandates can complement each other in situations of restrictions on investable amounts, scarcity of resources, geographic coverage, etc.

For each High Growth and Innovative SME Facility (GIF) investment, the resource allocation was described clearly in the request for approval the EIF submitted to the Commission, and the Commission carefully considered this combination and finally approved it or requested modifications.

Therefore, for the 30% of investments identified by the ECA, the instrument explored its complementarity with other mandates. It seems that for the remaining 70% of the GIF investments complementarity with other mandates was ensured automatically, as there was no co-investment with other mandates.

91. The appropriate level of complementarity referred to by the EFSI regulation is ensured via the policy positioning of the Risk Capital Resource mandate and the EFSI mandates, and reflected in the EIF's deal allocation process.

93. In the Commission's view the 2018 deal allocation policy clearly takes into account the focus of individual mandates and tries to identify the best investment source for each opportunity. The policy was presented to the Commission, and the EIF committed to regularly discuss any updates of the policy with the Commission.

The choice of sectors is mostly based on market needs – e.g. innovation is a cross-sectoral characteristic – therefore EU mandates do not have a sectoral "preference" as such. Geographical distribution is the result of the applications received and assessment of policy fit and eligibility, where bigger and more developed markets tend to create more investment opportunities.

94. The policy describes the two phases of the analysis, both quantitative and qualitative. Additionally, the policy indicates in detail what the possible criteria to be used by EIF staff during the qualitative assessment are.

The policy was presented to the Commission, and the EIF committed to regularly discuss any updates of the policy with the Commission.

95. The Commission understands from the EIF that the back-testing showed that 2 out of 31 investments (under various mandates, not only those of the EU) would have been allocated differently under the new policy. However, even for these two allocations, no breach of mandate requirements was identified and the investments are fully eligible under the mandates to which they were allocated.

The relevant detailed information is internal to the EIF.

100. The lifetime of each investment fund does not end automatically. It can be extended several times through the decision of the (majority of the) fund investors. As the EIF is a minority investor in all the funds under the EU's centrally-managed instruments, it cannot decide on its own to end a fund's lifetime, liquidate the remaining investments and dissolve the vehicle. Furthermore, it could be legally liable or negatively affect EIF's reputation in case it acts against the commercial interests of the fund investors.

While exit strategies were not described in great detail in requests for approval of the European Technology Facility Start-up (ESU) 1998 and ESU 2001 instruments, this does not mean that the EIF paid only limited attention to it during due diligence.

Currently, the whole market suffers from a "tail-end" problem, i.e. difficulties in closing old funds.

The Commission and the EIF already paid attention to this exit problem in 2014 and undertook timely measures in 2015/16 to divest the ESU funds. However, the market was not interested in buying them. A comprehensive strategy has been agreed to close the mandates, in line with the legal basis.

101. An agreed process to terminate these mandates exists, in line with the legal basis. The EIF and the Commission have already been trying to address the termination of the ESU 1998 and ESU 2001 mandates since 2014 and attempted a sale of the portfolios on the secondary market. Unfortunately, the timing for the submission of offers coincided with the United Kingdom's Brexit referendum and, given the ensuing market uncertainty, no offers were submitted. Another attempt to dispose of the holdings is planned for 2019/2020.

103. It should be stressed that the higher percentages were used in the 1998 and 2001 instruments that served as pilots, and the fee ceiling was subsequently lowered in the next generations of instruments.

The maximum fees under the EFSI SME Window Equity Product were lowered to 5.7%.

106. The overall fee levels have been considerably decreased between the initial pilot instruments to the more recent ones. In fact, under EFSI, the EU budget only serves as a contingency for fee payments, as the EIF is remunerated from reflows from EFSI.

Within the overall comprehensive remuneration package, start-up fees are only a small fraction. They are designed to compensate the implementing partner for the detailed negotiations leading to the set-up of the instruments, for the need to develop new standardised legal agreements for new instruments, to launch calls for expressions of interest and to adapt reporting and audit systems. The Commission would like to recall that the legal framework governing the implementation of financial instruments has developed significantly over time (e.g. the provisions of the Financial Regulation governing financial instruments have become very sophisticated and detailed, which in turn requires more efforts and know-how on the side of the implementing partner). Therefore, the Commission considers the payment of start-up fees as justified and their size appropriate given the increasing level of required checks and balances.

107. The Commission obtains cost estimates whenever possible and also regularly analyses the EIF's financial statements to understand EIF's fee income and its contribution to overall EIF profitability and, more generally, continues to make efforts to obtain further relevant detailed data on the costs of running financial instruments. However, even in the absence of such detailed data, the Commission should be able to finalise negotiations on the basis of available information.

108. The Commission takes the view that the incentive fees of the instruments correspond to their stated objectives. As recognised by the ECA in paragraph 28, the primary objective of these instruments is not the development of the European venture capital market, only some have it as an ancillary objective. As a result, for only some of the instruments under review there are incentive fees that remunerate the EIF for contributing to the development of the European venture capital markets, e.g. through specific bonuses or incentives for a broad geographic diversification.

Overall and for all instruments, it is therefore absolutely correct that the EIF is not remunerated for something that the instruments are not required to do.

109. The Commission takes the view that the incentive fees of the instruments correspond to their stated objectives. It would be unreasonable to start paying any incentive fees to the EIF only once the ultimate final targets are achieved since significant activities are performed in order to work towards achievement of the overall targets. Therefore, incentive fees are paid gradually upon achievement of negotiated milestones, as the EIF works towards achieving the overall targets.

110. The Commission considers that an objective similar to “investments in the EU’s less-developed venture capital markets or sectors of activity“ was an ancillary objective for only some of the mandates so it would be logical that this is covered by incentive fees only under some mandates.

The statement concerning ESU 1998 and 2001 is correct, as these instruments did not have investment in less developed market as an objective.

Furthermore, venture capital focuses on companies in sectors with significant potential growth over a short period of time. Throughout the recent past, this implied almost always technology-related investments. Thus, venture capital is only suited to a limited number of sectors of activity. One of the instruments had a specific sector target; for the more recent instruments, sectoral diversification is discussed at steering committees giving strategic guidance. In addition, the Commission clearly defines excluded sectors that cannot receive investment.

## **CONCLUSIONS AND RECOMMENDATIONS**

112. The Commission carries out ex-ante quantifications of market needs – and, more importantly, financing gaps – and absorption capacity through the best market intelligence made possible by standard statistical techniques and available advisory. However, strong data limitations exist because private information is not released (e.g. business prospects and financial solvency of individual investee companies). Market data is also not always fully reliable due to the small size of the venture capital market, which makes any statistical projections based on actual transactions not representative.

113. The timing of ex-post reports and evaluations is clearly set out in the underlying legislation adopted by the Council and the European Parliament.



Even if the Commission could influence their timing, there is a clear trade-off between usefulness and availability of comprehensive data. A fully-fledged impact assessment on the additionality of a programme can only be carried out once the beneficiary SMEs have acted upon their equity financing, but this is too late to provide lessons learnt for the design of successor programmes. On the other hand, an earlier evaluation, which could be useful for the design of successor programmes, will inevitably be less insightful.

Details on impact on mobilised investment and employment are included in the reporting for these facilities. In addition, the Commission produces publicly available reports to the Budgetary Authority every year.

### **Recommendation 1 – Undertake necessary analysis to improve the evaluation of the EU interventions**

(a) The Commission partially accepts recommendation 1 (a).

The Commission accepts the view that the financial allocations for venture capital operations should be based on a thorough analysis of market failures or sub-optimal investment situations, whenever a relevant legislative proposal is made.

However, the Commission does not accept that such analysis would necessarily include data broken down by Member State, sector of activity or size of the market (absorption capacity), due to limited availability and incomparability of data. Therefore, the Commission may selectively use such data with caution when establishing the overall envelope and will use structural means to address the risk of insufficient absorption.

(b) The Commission accepts recommendation 1 (b).

It will further develop the collection of data for evaluators.

In addition, the Commission will consider using counterfactual analysis for individual equity instruments if this will be appropriate and feasible at reasonable cost.

Relevant data will be made available to evaluators at the time of evaluations foreseen in the relevant legislation.

(c) The Commission does not accept recommendation 1 (c).

The timing of evaluations is not a decision taken by the Commission. Such timing is clearly set out in the underlying legislation adopted by the Council and the European Parliament.

Nonetheless, the Commission, in addition to formal evaluations, does look at lessons learnt and results of legacy programmes, even decades after their launch, through regular analysis of reporting.

114. The Commission has put in place a rather comprehensive approach that contributes to the development of a pan-European venture capital market. It uses a set of measures that can contribute, directly or indirectly, to supporting venture financing: regulatory intervention, intervention through shared management as well as centrally managed programmes. The audited instruments constitute only a subset of these measures.

115. Equal access to the instruments is ensured as applications are received on the basis of open calls for expression of interest. Therefore, investments are offered to all eligible proposals, regardless of the market where they come from. Furthermore, through incentive fees, the EIF is motivated to achieve as broad a geographic distribution of the support as possible.

It is to be stressed that the EU instruments for venture capital investments are not demand-driven in the sense that EIF would simply respond to demand. First and foremost, all

investments need to fulfil eligibility criteria of a given mandate (i.e. policy consistency needs to be warranted). In addition, all private equity investments are subject to the assessment of value added achieved by supporting the given investment – i.e. if the value added is not provided, the investment will not materialise.

Steering committees for the current instruments provide strategic guidance to the EIF on geographic and sectoral distribution. All instruments also have clear rules on excluded sectors and geographies (such as jurisdictions not cooperating with the EU on tax matters).

116. The Commission did not set profitability targets, as the instruments follow policy objectives rather than maximisation of profitability and are complementary to other instruments which pursue financial return. But even while focusing on policy returns the audited instruments are also set to generate financial profit according to EIF reporting, and do invest in funds that attract private investors. While, according to the Commission's assessment, the *pari-passu* principle has been adequate for most of the investment activity, the Commission also already now does allow for non *pari-passu* investments, in the specific case of social investment.

The Commission does not share the opinion that attraction of private investors is possible only with generation of high returns. While private investors will seek positive returns, they may be driven by factors other than the pursuit of 'high returns', e.g. geographic diversification within the asset class, scouting for latest technology developments, venture philanthropy, social investments, etc.

### **Recommendation 2 – Develop a comprehensive investment strategy**

(a) The Commission partially accepts recommendation 2 (a).

The Commission takes a wide range of concrete measures to support investments throughout the EU including through the Capital Markets Union (CMU) action plan as well as through the Structural Reform Support Service.

In addition, instruments under shared management may undertake investments in Member States with less developed venture capital markets.

The Commission will continue exploring whether further measures could be undertaken.

(b) The Commission partially accepts recommendation 2 (b).

The Commission agrees with the ECA that attracting private investors is important for the development of the EU venture capital market. The Commission already has ambitious targets to attract investors at mandate level, as evidenced by leverage and multiplier requirements and reporting on overall mobilised investments. The Commission will consider enhancing these requirements, with regard to private investors, where appropriate.

(c) The Commission accepts recommendation 2 (c).

While gradual exits are already possible under existing instruments, the Commission will further explore possibilities of gradual portfolio exits, in particular through sales on secondary markets.

(d) The Commission accepts recommendation 2 (d) and is already implementing it.

Asymmetric risk and revenue structures are already explicitly allowed for social investments under the EFSI Equity Product. In addition, the Commission is examining further asymmetric risk and revenue sharing under the SME Window of EFSI.

In addition, the application of asymmetric models is also allowed in ESIF financial instruments to target specific regional or sectoral market gaps.

117. The Commission notes that an EIF investment in a fund is often considered as a seal of approval, a quality hallmark of the deal. Such a reputation can only be maintained through a high quality assessment and due diligence process, which unavoidably takes time.

In addition, the length of the process is bound to differ from applicant to applicant (e.g. under the European programmes first time managers are eligible for which the due diligence process is more complex than for established management teams). Delays can also arise due to other, objective factors beyond EIF's control.

118. The Commission approved each investment in the period 2007-2013, including possible combinations with other mandates, on the basis of sufficient data from the EIF. Subsequently, the Commission has relied on the EIF's deal allocation policy, as updated in 2018, which reflects the mandate requirements defined by the Commission. The policy was presented to the Commission, and the EIF committed to regularly discuss any updates of the policy with the Commission.

119. Currently, the whole market suffers from a significant "tail-end" problem, i.e. difficulties in closing old funds.

A comprehensive strategy has been agreed to close the mandates, in line with the legal basis.

120. The Commission would like to stress that the overall fee ceilings have decreased over time, and the start-up fees are only a fraction of the overall fees payable. Also within the overall fees, incentive-based fees have gained prominence. In addition, the instruments may well generate a profit for the EU budget.

Start-up fees are designed to compensate the implementing partner for the detailed negotiations leading to the set-up of the instruments, for the need to develop new standardised legal agreements for new instruments, to launch calls for expressions of interest and to adapt reporting and audit systems. The Commission would like to recall that the legal framework governing the implementation of financial instruments has developed significantly over time (e.g. the provisions of the Financial Regulation governing financial instruments have become very sophisticated and detailed, which in turn requires more efforts and know-how on the side of the implementing partner).

Therefore, the Commission considers the payment of start-up fees as justified.

121. The Commission takes the view that the incentive fees of the instruments correspond to their stated targets. Only some of the instruments had dedicated support to less developed markets and sectors as an ancillary objective. As stated in paragraph 28 of this report, the main objective of the instruments is to improve access to finance for businesses. It is therefore absolutely correct that the EIF is not remunerated for market development activities where the instruments are not required to do so.

### **Recommendation 3 – Streamline EIF management of the EU interventions**

(a) The Commission does not accept recommendation 3 (a).

The EIF already has a standardised project approval process in place. Fund managers that are in the process of fund raising apply for funding by presenting their investment strategies. To determine whether the fund manager (and his/her team) has the required expertise, experience, access to deal flow, capabilities to invest and manage the portfolios, etc. a comprehensive and sound due diligence process needs to be applied. The length of the

process is bound to differ from applicant to applicant (e.g. under the EU programmes first time managers are eligible, for which the due diligence process is more complex than for established management teams). The selection of fund managers and the required due diligence process has to be thorough in order to be robust, also in view of sound financial management.

(b) The Commission accepts recommendation 3 (b) and considers it already implemented.

A comprehensive deal allocation policy that aims to ensure a complementary use of sources of their funding available to the EIF is in place since 2018 and the Commission was informed about it. The EIF is required to apply this policy under the existing contracts and committed to consult the Commission on any future modifications of the policy.

(c) The Commission accepts recommendation 3 (c).

The Commission accepts that plausible potential exit options need to be identified when the EIF invests in a fund with the support of the EU budget.

(d) The Commission does not accept recommendation 3 (d).

The Commission uses a streamlined system of compensating the EIF on the basis of pre-agreed milestones and performance targets. This system has been improved over time, is in line with the Financial Regulation and follows internal guidance ensuring consistency for all financial instruments. The overall fee ceilings have decreased over time.

The recommendation suggests that one particular element of these fees, the start-up fees, should follow a different process, on the basis of reimbursement of costs. This would introduce administrative complexity and expose the Commission to the risk of asymmetry of information.

More generally, the remuneration of the EIF cannot be based only on costs incurred but should include an incentive component to motivate the EIF to pursue the achievement of objectives of the instruments. This is a requirement enshrined in the Financial Regulation. In addition, as required in its own Statutes, EIF cannot operate third party mandates on a pure cost reimbursement basis.

(e) The Commission partially accepts recommendation 3 (e).

The Commission accepts that fees will continue to be linked, *inter alia*, to the achievement of performance targets whereby the performance payments will be structured according to milestones achieved.

However, the Commission will consider linking fees to the development of the European venture capital market only in cases where the instruments would have such stated objective and if an appropriate indicator could be found.

## Audit team

The ECA's special reports set out the results of its audits of EU policies and programmes, or of management-related topics from specific budgetary areas. The ECA selects and designs these audit tasks to be of maximum impact by considering the risks to performance or compliance, the level of income or spending involved, forthcoming developments and political and public interest.

This performance audit was carried out by Audit Chamber IV Regulation of markets and competitive economy, headed by ECA Member Alex Brenninkmeijer. The audit was led by ECA member Baudilio Tomé Muguruza, supported by Daniel Costa de Magalhães, Head of Private Office, Ignacio García de Parada, Private Office Attaché and Simon Dennett, Analyst; Ioanna Metaxopoulou, Director Chamber IV; Marion Colonerus, Principal Manager; Helmut Kern, Head of Task. The audit team consisted of Christian Detry, Ezio Guglielmi and Natalie Hagmayer. Hannah Critoph provided linguistic support.



*From left to right:* Daniel Costa de Magalhães, Christian Detry, Baudilio Tomé Muguruza, Ignacio García de Parada, Ioanna Metaxopoulou, Helmut Kern, Ezio Guglielmi.

# Timeline

Event	Date
Adoption of Audit Planning Memorandum (APM) / Start of audit	12.12.2017
Official sending of draft report to Commission (or other auditee)	29.4.2019
Adoption of the final report after the adversarial procedure	17.9.2019
Commission's (or other auditee's) official replies received in all languages	17.10.2019

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The EU provides money to venture capital funds for investment mainly in start-ups and innovative emerging firms. This audit assessed six centrally managed interventions that have been implemented since 1998. The EIF manages these interventions on behalf of the Commission. We found that the Commission increased its financial support over the years without fully assessing market needs or absorption capacity. Its investment strategy was not comprehensive, and less developed venture capital markets benefited little. The EIF's procedures also require streamlining and improvement.

ECA special report pursuant to Article 287(4), second subparagraph, TFEU.



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