Feasibility and market potential study on an INVEST-like support scheme of investments by private individuals in VC funds

Study prepared for the Federal Ministry for Economic Affairs and Energy

Executive Summary

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The study was prepared by SpaceTec Partners and P+P Pöllath + Partners on behalf of the Federal Ministry for Economic Affairs and Energy between spring and winter 2019.

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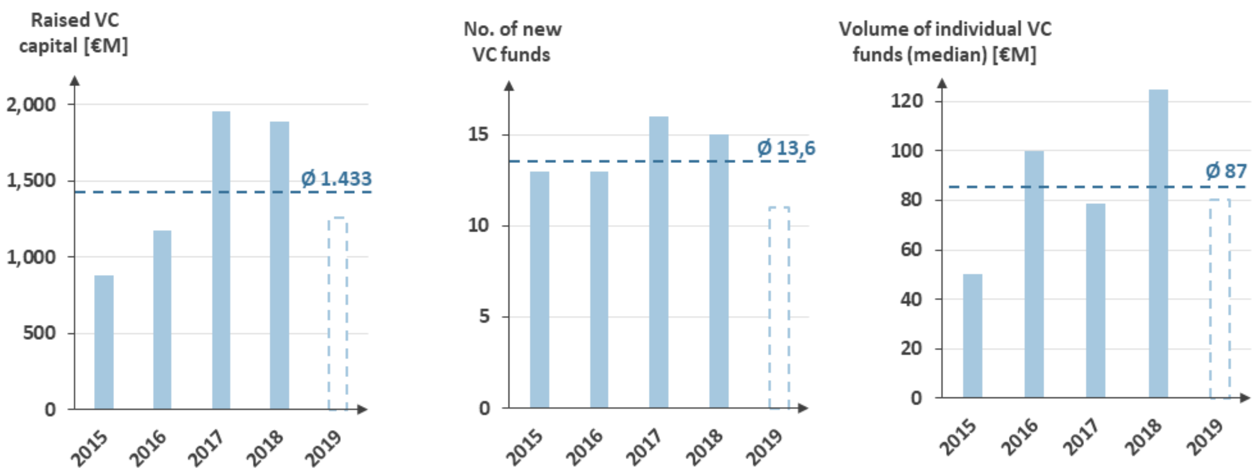
EXECUTIVE SUMMARY

Venture capital funds (VC funds) as providers of risk capital are indispensable for the success of young, innovative companies, which constitute the foundation for growth, innovation, and progress in Germany. Support schemes can help mobilise additional funding to provide young innovative enterprises with sufficient capital. The INVEST programme of the Federal Ministry for Economic Affairs and Energy (BMWi) already successfully supports direct investment by private individuals in start-ups. The programme can therefore act as a model for additional schemes aimed at mobilising venture capital provided by private individuals. To supply additional capital to the market that will also flow to enterprises in their growth phase, the Ministry contemplated to introduce **an INVEST-like passive investment support scheme**. The idea is to subsidise **investments by private individuals** in companies **through VC funds**.

Any such support would have to be adjusted to the characteristics and circumstances of the German venture capital market. Currently, almost all German VC funds are so-called Special Alternative Investment Funds (Special AIF), which are managed by a fund manager registered under the German Capital Investment Code (KAGB) or the European Venture Capital Funds (EuVECA) Regulation. Investing in Special AIF is open to semi-professional and professional investors only. As a result, the range of investors in German VC funds is limited to those investors capable of furnishing the statutory minimum investment amounts of Euro 100,000 (EuVECA) or Euro 200,000 (KAGB).

The capital collected by the German VC funds has been increasing almost continuously since 2015 and has been well in excess of Euro 1 billion per year since 2016. The number of new VC funds being set up is between 10 and 20 each year. The average size of a German VC fund amounts to approximately Euro 90 million.

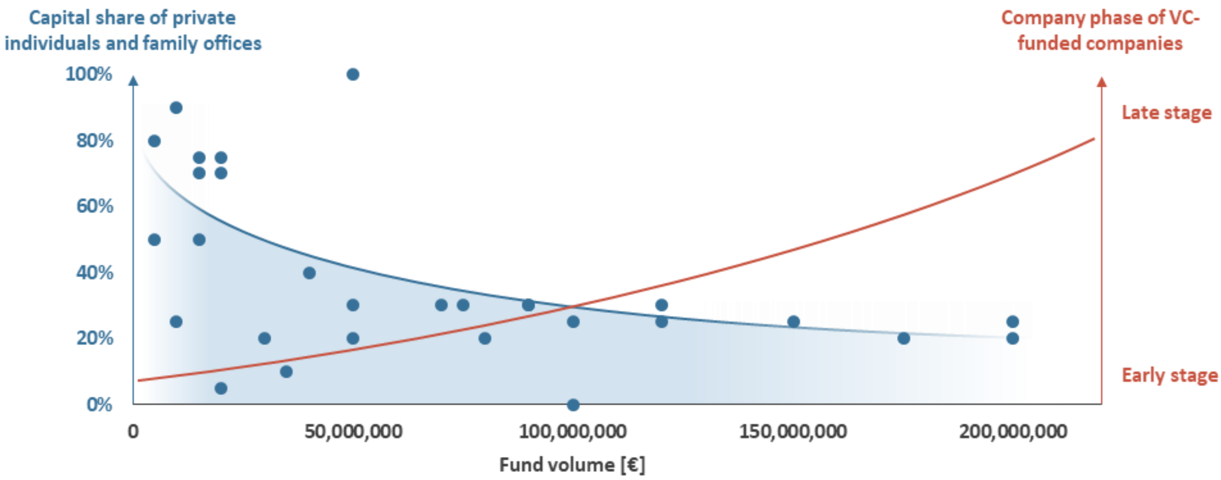
Exhibit 1: Characterisation of the German venture capital market*



The share of capital provided by private individuals varies depending on the size of the fund. As the volume of the fund increases, the share of capital provided by private individuals or family offices declines, since the minimum investment amounts of large funds are usually set at a level of several million euros.

* excluding sovereign and corporate VC funds, as at 09/2019

Exhibit 2: The importance of private individuals and family offices

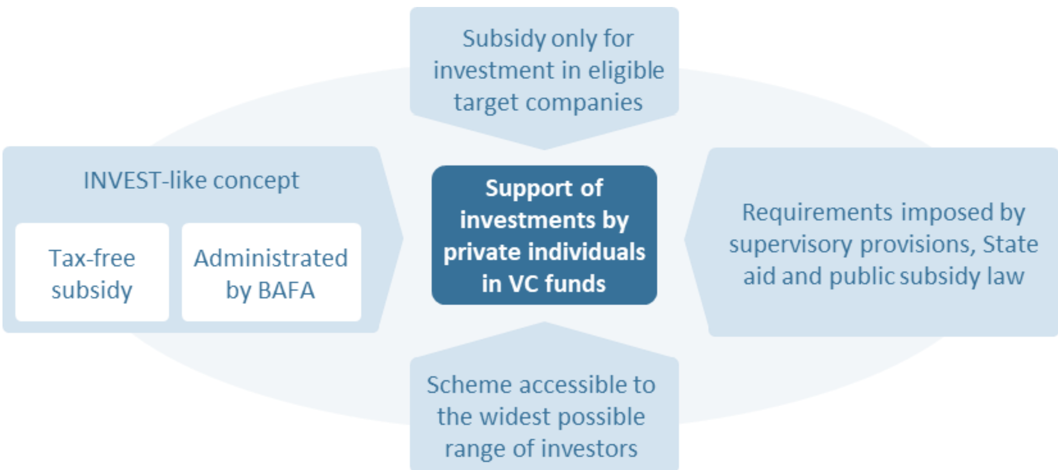


The number of German VC funds that are accessible to small investors (Retail AIF) is negligible. The reason for this is that fund managers in Germany are required to have a license to manage a Retail AIF. Obtaining such a license is time-consuming and expensive. Moreover, the management of a Retail AIF involves a host of statutory obligations and comprehensive investor management.

VC funds and similar structures accessible to private investors partly exist abroad. European countries already provide subsidies for some of these funds, which grant tax benefits or tax reliefs for private investors. Examples include Venture Capital Trusts (VCT) in the United Kingdom and French Fonds Commun de Placement à Risque (FCPR). Both programmes grant investors a pro rata income tax deduction when purchasing shares in special, publicly accessible VC funds. These pre-existing models abroad have already contributed to mobilising significant amounts of venture capital. However, it is not possible to directly apply these concepts to an INVEST-like support scheme in Germany. The fund structures available abroad are often specifically developed for the respective support programmes for retail investors.

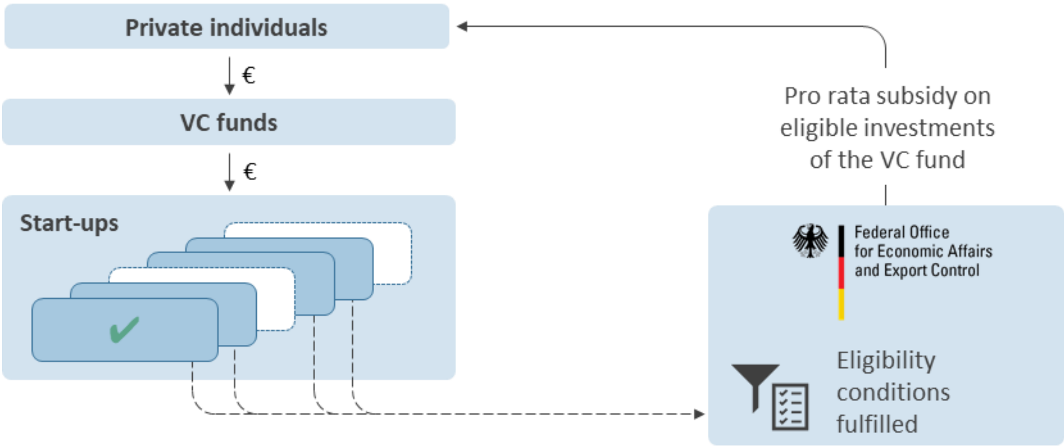
When developing an INVEST-like support for venture capital investments through VC funds, the legal framework of supervisory provisions, State aid law, and public subsidy law must be considered in addition to the economic objectives of the programme.

Exhibit 3: General conditions and objectives of an INVEST-like support scheme



The objective of the contemplated scheme is to mobilise private risk capital and thus achieve a better capitalisation for young innovative enterprises. The objective is not to support VC funds or their investors as such. To ensure this, solely the **investment in the eligible target company** is subsidised and not the mere purchase of shares in the fund. Alternatively, one would have to set a quota for the funds, determining the minimum percentage of enterprises eligible for support. Such a quota, however, would limit the investment strategy of the fund, which is an undesirable consequence.

Exhibit 4: The proposed scheme of an INVEST-like support



The contemplated **passive investment support scheme is, based on the proven concept of the INVEST programme,** supposed to mobilise new investors and to allow investments in VC funds at levels similar to INVEST (as of Euro 10,000). The support should be accessible to a wide range of investors beyond semi-professional and professional investors.

As in the case of INVEST, **the Federal Office for Economic Affairs and Export Control** (BAFA) should be in charge of the **administrative management** of the scheme. The capacities and responsibilities of BAFA provide for the framework in which a potential passive investment support must take place.

The requirements laid out in legislation on State aid and public subsidy must be observed. For instance, Member States must notify the EU Commission of any State aid measure, such as the one represented by the INVEST-like support programme, prior to its introduction. The Commission will subsequently examine its compatibility with the European internal market. The required notification should be based on the EU Commission's Guidelines on State aid to promote risk finance investments (Risk Capital Guidelines). Since the payment of the subsidy also represents an allocation of State funds within the meaning of the Federal Budget Code (BHO), the German provisions governing public subsidy must also be considered.

The basic concept of the previously-described support appears to be a meaningful extension of the INVEST programme. However, the **implementation of the concept entails several problems and challenges**. This includes, but is not limited to, the following aspects:

- **High minimum investment amounts:** For semi-professional investors, the KAGB sets minimum investment amount for Special AIFs at Euro 200,000. In addition, investors must confirm that they have sufficient knowledge and experience in the relevant asset class, and that they are aware of the risks. The high minimum investment threshold limits the range of private individuals to wealthy investors as potential recipients of the subsidy. The pooling of capital in so-called investment clubs cannot be implemented extensively, because such bundling vehicles are themselves not allowed to raise capital in the market.
- **Examination of shareholder agreements:** In order to guarantee that the investments comply with all guidelines of the support programme, the shareholder agreements are to be examined by BAFA, similar to the INVEST programme. The shareholder agreements concluded by the VC funds are significantly more complex than those used by business angels and are written in English. BAFA, however, would only examine shareholder agreements in German language, which requires translation. Most VC funds refuse to provide these translation services and are generally not willing to disclose the shareholder agreements.
- **Payment modalities and process:** Within the passive investment support scheme, the fund would act as an intermediary between investors and start-ups. Therefore, the subsidy can be paid to the fund, which would hold it in trust and forward it to the investors. This option, however, is rejected by VC funds, because they consider this additional effort attached to the management of the subsidies as an obstacle and an additional risk. Therefore, VC funds prefer a direct payment of the subsidy to the investors. However, especially in the case of Retail funds with their significant number of private investors, this model could lead to an administrative overload at BAFA.
- **Risk of possible reclaims:** The legal provisions on State aid would require a minimum holding period for shares in the enterprises within the planned support scheme. Consequently, a failure in complying with this minimum holding period would trigger a recall of the subsidy. The VC funds are in charge of deciding on their holding periods and not the investors themselves. Since VC funds do not wish to be bound by a minimum holding period in their investments, investors may be asked to pay back the subsidy already granted to them.

The German VC funds expressively welcome the efforts to **strengthen the venture capital market** and wish to play a role in the **development of any such support**. The proposed specific INVEST-like support scheme, however, was met with significant scepticism. The **disapproval** can be primarily attributed to the **considerable additional effort** expected, which, from the funds' perspective, is disproportionate to the **small additional capital** that can be mobilised with the support scheme. Market surveys among fund managers show that the following aspects are mainly responsible for the predominant negative attitude towards the support scheme:

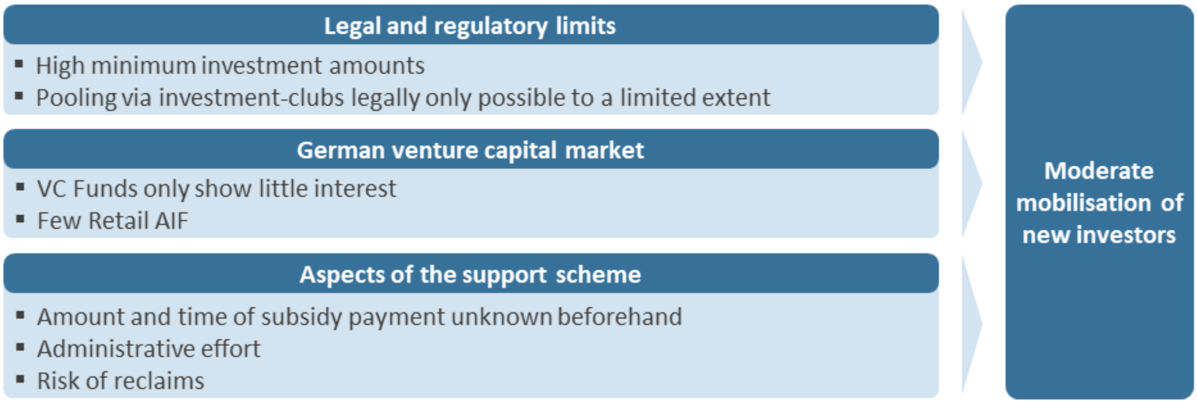
- **Additional effort, and potential for conflicts with private individuals in the fund:** While well-networked, VC-experienced individuals can contribute added value due to their contacts and knowledge of the industry and are therefore often welcome investors, inexperienced private individuals are often rejected as investors. The increase in the number of private individuals as a result of the support scheme and the additional required customer care is not desirable for funds. Moreover, the risk of private investors not meeting their payment obligations is usually higher than with institutional investors. In addition, the support scheme entails the risk of conflicts with the investors due to reclaims or discrepancies between the expected and the actual amount of the support. Finally, investment decisions that are not eligible for subsidy but are taken by the managers in the overall interest of all investors may cause discontent among the private individuals wanting to benefit from said support scheme.
- **Additional administrative effort as a result of the support scheme:** The additional administrative effort involved in the support concept itself, and the resulting increase in the number of private individuals are met with disapproval by the funds. The costs incurred by the new administrative processes would have to be borne by all investors - including those who do not benefit from the support - via the management fee. Moreover, the funds rule out paying for necessary translations of shareholder agreements.
- **Possible drawbacks in the interaction with start-ups:** From the funds' perspective, a support scheme may have a negative impact on negotiations with start-ups. Some funds, for instance, fear that start-ups eligible for support are aware of some investors receiving a tax-free subsidy, and therefore discount the company value by the subsidy amount. The documents to be submitted by the start-ups may also be considered an obstacle, so that the start-ups are likely to prefer capital from funds not using the support scheme.

The additional capital mobilised by the support is not perceived as an adequate incentive for funds to compensate for the additional effort involved. The **market acceptance** of the respective support scheme, however, **varies with the fund volume**. In the explanations described above, the support scheme is consistently rejected by managers of large funds, while managers of small and medium funds with a high percentage of private investors are more open, though still critical towards the support scheme.

The objective of the support scheme is to mobilise capital from investors previously inexperienced in risk capital. Moreover, it is desirable to motivate existing investors to invest more capital. Due to the small number of VC funds that would use the support scheme it is expected that it **will only have a moderate mobilisation effect**. This can also be underlined by the expected behaviour of potential subsidy recipients:

- **Limited capital mobilisation effect in new investor groups:**

  Exhibit 5: Reasons for the limited mobilisation of new investors



  The high minimum investment amounts are one of the main reasons why a passive investment support scheme can only appeal to a few new investors. Furthermore, due to the negligible number of Retail AIF, there are almost no funds potentially eligible for the support scheme. Since the subsidy is granted only for investments in companies eligible for the scheme, the amount and date of the payment of the subsidy are unknown in advance, which diminishes the attractiveness of the scheme. Other issues criticised include possible reclaims and the high administrative effort involved.

- **Deadweight effect and limited interest among VC-experienced investors**

  Exhibit 6: Reasons for deadweight effects and limited interest among VC-experienced investors

  Some wealthy private individuals and family offices are already investing in VC funds to an extent that is considered sensible from an investor's perspective for their asset allocation under consideration of opportunity and risk aspects. This allocation is not expected to change appreciably as a result of the planned support scheme. Therefore, primarily deadweight effects are expected from this investor group, provided the scheme is being used. Some market experts even point out that only a fraction of the current investors would use it. Especially if each investment of the fund in a company were linked to an action by the investors, the investors would be deterred by this administrative effort. Moreover, possible reclaims and the uncertainty about amount and payment date of the subsidy contribute to diminishing the attractiveness of the proposed programme.

In conclusion, a variety of indicators show that the support scheme in its proposed form cannot accomplish the expected results. The reasons are partly attributable to the statutory and regulatory conditions and premises of an INVEST-like support scheme and be partly to market circumstances and the preferences of the market participants. Therefore, **the success of an INVEST-like support scheme** in the envisaged form **is deemed uncertain**.

To achieve a significant mobilisation effect, it will be necessary to adjust the boundary conditions and create structures that would go beyond the current legal and regulatory possibilities and thus would not directly be realisable as part of a support scheme. Apart from the possibility of **examining shareholder agreements in English** at BAFA, bundling a large number of private individuals as investors with smaller amounts through funds of funds or **feeder funds** could help boost the acceptance of the support among funds. This, however, is hardly possible given the regulatory barriers of the KAGB which are currently applicable. To achieve a significant mobilisation of additional venture capital within the current legal framework, it may be necessary to **shift away from an INVEST-like approach** and **considerably simplify the support concept**. Greater acceptance by investors and funds only seems achievable by a generalised subsidy for the participation in a fund and minimum effort for funds. Legal limitations on State aid and subsidies will nevertheless continue to pose a major challenge.

Moreover, in addition to an INVEST-like support scheme, numerous alternative steps could be taken to further **strengthen the venture capital market in Germany**. Successful measures have already been implemented with the High-Tech Gründerfonds, coparion, the instruments of KfW Capital, and the ERP/EIF fund of funds. The market surveys of this study show that the lever for strengthening the venture capital market in Germany consists of **improving the fiscal and regulatory environment** rather than creating another subsidy programme. In order to make Germany more attractive as a VC location and encourage more venture capital, it is essential to **mobilise institutional capital**.

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