Position Paper

25 January 2022

european association of innovation consultants

EIC Equity Funding Process Roadmap

Summary

This position paper summarizes the opinion of the EAIC (European Association of Innovation Consultants). EAIC comprises 50 members present in 26 European Countries, supporting around 40% of all the companies awarded EIC Accelerator funding in 2021.

We acknowledge that the EIC Accelerator is the most impactful and coveted funding instrument that the EC has at its disposal to fund high-risk deep-tech innovation. The funding decisions made by the EIC in the coming years will durably shape the future of European deeptech, with €7bn allocated to the EIC Accelerator, which will fuel the next European champions in strategic domains such as quantum, bioinformatics, high-performance computing, cybersecurity, cleantech, healthcare, etc.

The companies that we support are highly concerned about how equity investments approved under the Horizon 2020 Pilot have been severely delayed, following a drastic change in the EIC Fund investment policy. Delays are moreover increased as the adoption of the work programme 2022 is currently at a standstill, because there has been no agreement on how to manage and implement the equity component of the EIC Accelerator under Horizon Europe. This is severely impacting the credibility of the instrument.

The Work Programme draft goes one step further by placing the equity investment decisions in the hands of various EIC investment partners including the EIC Fund, the European Investment Bank Group and private venture capital funds, while increasing the administrative **expenses and fees from 4% to 10% of the equity investment budget**, in order to support these new investment partners.

The proposed new approach violates both the spirit and the letter of the EIC legal basis.

The European Commission cannot make the EIC support dependent on the interest of private investors to join, and transform the **objective** to crowd them in, into a **pre-condition**.

The EIC programme was meant to be different from similar programmes run at Member States, where initial co-investment is an obligation. This radically new design led the European Council of Spring 2018 - held in Sofia - to request that the EIC Accelerator be already implemented as a Pilot programme, pending the adoption and entry into force of Horizon Europe.

We believe the EIC should go back to this original mission of **a European sovereign investment mechanism**, as initially foreseen by the European Parliament and European Council. The European Commission should remain the single decision-maker with regards to EIC equity funding. The EIC Fund should only be responsible for the investment implementation modalities and exit strategy, as per the Council Decision.

Moreover, we consider that the **governance** of the current EIC Fund should be opened to stakeholders such as impact investment funds, corporate funds, entrepreneur funds and business angels, in addition to venture capital funds. Finally, the EIC should add considerable resources to actively manage investments and match them with these investors.

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What was the original idea behind the EIC Accelerator?

The proposal for an EIC Accelerator - made by the previous Commission - built on a series of considerations, that were regularly presented to stakeholders starting in the Autumn of 2017:

- Innovation in Europe lags US and China due to multiple factors: lack of flexibility of our traditional industrial planning, weak technology transfer capability from academia to innovators, and risk aversion of European investors. The latter is due to legitimate factors: the single market remains divided between different languages and culture, the uneven development of innovation along a North-West South-East axis does not favour capital mobility and an ageing European population calls for more guaranteed returns investment;
- Disruptive innovation based on breakthrough technology presents very high risk: first a technical risk (at TRL5-8) and then a market risk (at TRL9). However, none of the previous EU-funded instruments for SMEs and innovators were able to address these risks:
    - Whilst the SME instrument was providing grants of 70% until TRL9, SMEs and innovators were too often faced with a lack of funding for TRL9 and market deployment. The possible synergies with the EIB instruments (InnovFin) did not materialize: no SME instrument beneficiary received any investment from the EIB, as processes, criteria and accepted risk levels were not the same;
    - Through the experience of the 2 InnovFin instruments (EDP and IDFF), the Commission was even confronted to the fact that, despite a 95% risk guarantee provided by the Commission, the EIB could not support a single operation, as these were still considered too risky (the Commission had to increase its guarantee to 100% to allow the EIB to invest).

Based on these considerations, the Commission came with a radically new concept: ensure from the onset funding for TRL5-8 all the way to TRL9 and further, so as to provide a funding runway to innovators, in order to reduce risks and attract private investors later. In this context, the funding proposals would not be judged based on the typical criteria used by private markets, but instead, on scientific excellence and project impact, as reflected in Article 48 of Regulation (EU) 2021/695. Of course, in order to avoid affecting competition within the Single Market, the support for TRL9 activities could not be offered as grant, but instead as equity, loan or guarantee to investors, on a tailor-made basis. This led to the blended finance concept: a mix of a grant and equity components **awarded in a single decision-making process.**

> 3. A single award decision shall cover and provide funding for all forms of Union contribution provided under EIC blended finance.
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> Source: Regulation (EU) 2021/695 of the European Parliament and of the Council of 28 April 2021 establishing Horizon Europe (page 44) – Link

Another important idea to bear in mind is that a grant is in fact a “sunk investment”, money that will be lost whatever the outcome of the operation. The new equity approach has the advantage to allow the Commission recover some of its funding, or even benefits in case of success, in addition to offering a sustainable thus more efficient support to European innovators.

The EIC programme was meant to be different from similar programmes run at Member States, where initial co-investment is an obligation. This radically new design led the European Council of Spring 2018 - held in Sofia - to request that the EIC Accelerator be already implemented as a Pilot programme, pending the adoption and entry into force of Horizon Europe.

When the blended-finance scheme was launched in its pilot phase within Horizon 2020, most companies built their proposals and business plans considering investment from the EIC Fund as vital, and being the only equity funding source, to sustain their growth over time. Besides their scientific excellence, these companies were selected for funding based on their difficulty to find adequate investors willing to assume the risk. These companies were therefore under the impression that they would receive the full financial support of the EIC Fund, without being required as a pre-condition to bring on board another unaffiliated investor.

Yet, despite the above-mentioned intentions agreed at the highest level of the Union, and clearly stated by the Director-General of DG RTD, implementation did not meet the promise.

Why has the EIC Accelerator experienced equity delays?

The EIC Fund guidelines highlight four investment alternatives for successful EIC funding recipients, depending on their capability to secure external co-financing in parallel to the EIC investment. Under the "bucket 1" category, the EIC Fund is normally entitled to act as the principal investor (with the goal, but not the requirement, to crowd in external capital later), in accordance with the legal basis:

Bucket 1: low maturity and failure to attract co-investment	Bucket 1 will include cases that are not sufficiently mature for regular investors, due to remaining very high risk despite the awarded EIC Accelerator support. This lack of traction may result from various shortcomings, such as the very early stage of the underlying technology, a too long planned time to market, a too small market compared to the investment needed, the low readiness of the company to absorb additional equity in terms of its team or cap table, etc.

Source: Investment Guidelines 2021 (page 7) – Link

The EIC Fund states publicly that it has now completed to €630m of EIC equity investments, directed to the companies selected for blended finance under the EIC Accelerator pilot program of Horizon 2020 (covering 5 deadlines spanning between October 2019 and October 2020). This figure does not include the companies selected for equity funding in 2021 under the full-blown EIC Accelerator programme of Horizon Europe, who have not started their equity negotiation process yet.

159 companies selected for blended finance	**141** approved investments	**€ 630+ million** invested
75 signed deals	**14** rejected investments	**4** pending decission

Source: European Commission - Link

While this represent a good start, and the result of hard work from the EIC and EIB teams, the reality is that, according to the official information above, not more than 50% of the €630m has actually been invested as of 25/01/2022:

- **Only 31 companies have received a first tranche of equity;**
- another **44 companies have signed deals that include a short-maturity convertible note,** which provides them with funding, but gives them only 12-18 months to raise a formal equity round, or else it will be converted to equity by the EIC Fund at very unfavorable terms;
- but most of all, **66 companies are still waiting for equity or quasi-equity investments from the EIC Fund**, 18-24 months after having been approved for funding, and as their grant funding is now running out, they are now at risk to scale down their operations or even wind down their companies.

The reason for these delays is not only related to a lengthy due diligence and legal processes, but also a direct consequence of the fact that **companies are required by the EIC Fund - against its legal basis - to have a new unaffiliated investor committed to lead the funding round** before they can receive any equity financing from the EIC Fund.

In practice, approved investments are conditioning the EC equity investment to the company raising a significant amount of funding (between 25% and 50% of the total funding round) from a new lead investor, which cannot be an existing shareholder, and which has to be approved as a “qualified investor” by the EIC Fund.

Public statements from EIC Board Members confirm this change of investment policy, in contradiction with the original design - and legal text - of the EIC Accelerator.

> Herman Hauser, EIC Fund Board Member and Founder of Private Venture-Capital Firm Amadeus Capital Partners, commenting on the governance of the EIC Fund:
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> Some tech investors and entrepreneurs raised concerns that Brussels doesn’t know how to spot, support and invest in promising start-ups.
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> Hauser said he had similar concerns: “Of course, the thing that I was immediately worried about was … **don’t let the Brussels guys decide who to invest in or not,**” he said.
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> To get around this issue, **Hauser introduced a rule** that means the EIC fund can only invest in a start-up’s funding round when the majority of the money is coming from private investors.
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> “It needs the VC community because it’s not allowed to make any investment **unless the majority of the money comes from the market**,” he said.
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> Source: CNBC article (Feb 12th, 20021) - Link

This co-funding requirement is in direct contradiction with Council Decision (EU) 2021/764 establishing the Specific Programme implementing Horizon Europe, which clearly state that the EIC is allowed to bear alone of the initial investment risk, with the goal (but not the obligation) to bring in external co-investors at a later stage (“crowding in mechanism”).

Council Decision (EU) 2021/764, combined with the Regulation (EU) 2021/695, provides that, where the EIC Accelerator cannot be **fully** externalised to another body, it is the Commission **alone** that is responsible for deciding on the award the EIC blended finance as a whole (i.e., grant and investment components together) and even with the possibility for the Union to be the sole and hence the lead investor, where market operators do not agree to join, due to the risk level of the operation. The idea of the EIC Accelerator is for the Union to bear the risk alone from the onset, so as to allow risky operations to be launched, and as the risk decrease, to crowd in private investors.

> Available private and corporate financing remains scarce between the late stage of R&I activities and market take-up for high-risk (22), and therefore not 'bankable' or 'investor-attractive', breakthrough and market-creating innovations. In order to bridge the 'valley of death' for any type of high-risk innovation, including in particular breakthrough and 'deep tech' innovations that are key to Europe's future growth, public support must develop a radically new approach. Where the market does not provide viable financial solutions, public support should provide for a specific risk-sharing mechanism, bearing more, if not all, of the initial risk of potential breakthrough market-creating innovations in order to attract alternate private investors in a second stage, as operations unfold and the risk is reduced until the company carrying out the innovative project becomes bankable.
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> (…)
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> While the Union may bear alone the initial risk of selected innovation and market deployment actions, the aim will be to de-risk these and to stimulate, from the outset and during the development of the action, co-investments from alternative sources and even substitute investors. In that event, the objectives and schedule of the co-investment will be agreed with the co-investor(s) and the beneficiaries/supported companies.
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> Source: Council Decision (EU) 2021/764 (page 69-70) – Link

The new proposal for 2022 violates the legal basis

The most recent draft of the Work Programme 2022 (dated January 21) goes one step further on removing the effective decision on the investment component from the hands of the European Union. According to the proposal, the Commission continues to evaluate, select and award the grant component of funding operations. For the investment component however, there are two alternatives based on the investment-readiness of the company:

- For investment-ready operations, the EIB takes the lead, which creates two problems: 1) the EIB has complex decision-making processes that do not match the required pace of start-up innovation where time is of the essence; 2) as indicated in the legal basis, such investments are typically at a level of risk above and should be channelled to the EIB financial instruments at a later stage, once they have been de-risked;
- For other operations, the Commission "offers" the operation to a "new" EIC Fund managed by private operators, with the possibility of refusal. The Commission is hence proposing to give a veto right to a fund managed by private operators that will necessarily operate in accordance to market criteria, away from the applicable criteria and process described Article 48 of the Regulation (EU) 2021/695.

The proposal is also to increase the administrative **expenses and fees from 4% to 10% of the equity investment budget**, in order to support these new investment partners. This could represent up to €500m of management costs over the duration of the Horizon Europe programme.

The argument of the Commission is based on Article 11(3) of the Council Decision that states that, for blended finance, the Commission "shall make use of indirect management" and "if it is not possible, may establish a special purpose vehicle". However, "blended finance" refers here to the grant and the investment component, **as the initial idea was a single and unified decision process for the funding applicants**. Since the Commission has decided to retain evaluation, selection and management of the grant component, then this is - de facto - not indirect management but the application of the Council Decision as its stands, with the EIC Fund implementing the Commission decisions for the equity component, and not substituting to it.

We hence consider that this proposal - if adopted - would constitute **a violation** of Council Decision (EU) 2021/764 which puts the Commission as responsible for investment decisions on behalf of the Union (see page 73).

> The Commission will manage all operational elements of Accelerator projects, including the grant or other non-repayable forms of support.
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> For the purpose of managing EIC blended finance, the Commission shall establish a special purpose vehicle. The Commission shall seek to ensure the participation of other public and private investors. Where this is not possible at the initial set-up, the EIC special purpose vehicle will be structured in such a way that it can attract other public or private investors in order to increase the leverage effect of the Union contribution.
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> The Commission will endorse the investment strategy of the EIC special purpose vehicle. The EIC special purpose vehicle will define and implement an exit strategy for its equity participations, which will include the possibility to propose the transfer of (a share of) an investment operation to the implementing partners supported under the InvestEU Programme, where appropriate and for operations whose risks have been sufficiently lowered so that they meet criteria of Article 209(2) of the Financial Regulation. The Programme Committee will be informed accordingly by the Commission.
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> The EIC special purpose vehicle will perform due diligence and negotiate technical terms of each investment in compliance with the principles of additionality and prevention of conflicts of interest with other activities of the investees and of other counterparts. The EIC special purpose vehicle will proactively leverage public or private investments into individual Accelerator operations.
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> Source: Council Decision (EU) 2021/764 (page 73) – Link

According to the Horizon Europe legal basis, the Commission is responsible for evaluating, selecting and awarding EIC support. According to the Council Decision, the Commission is moreover responsible for managing all operational elements of Accelerator projects. The special purpose vehicle (EIC Fund) is only established to manage investment components of the EIC blended finance, not to decide on any such investment. Its only autonomous power is to define an exit strategy, in addition to perform due diligence and negotiate technical terms of each investment and proactively leverage public or private investments into individual Accelerator operations.

If there is an investment strategy to be "endorsed" by the Commission, it cannot affect the power entrusted to the Commission by Parliament and Council as detailed in the Horizon Europe legal basis.

Why this cannot work for European deeptech start-ups

The EIC was designed (as per the legal text voted by the European Council) to use a single Commission decision based on non-financial criteria, providing a clear commitment to support a project subject to agreed milestones, with the idea to bear all the risks - alone if necessary - until the operation fails or is successful and enough de-risked to crowd-in regular market operators.

The idea was to set up a sovereign fund, not encumbered by complex decision-making processes, and not influenced by other operators that might not be necessarily sharing the same mission and investment policy as decided by the European Parliament and the European Council. This was the initial idea proposed by the Commission and endorsed proactively by Member States with full support from Chancellor Merkel and President Macron, among other.

Indeed, one cannot win over the market's aversion to risk if one leaves it to market to make the final decision.

The Work Programme 2022 contradicts the decision of the European Council by introducing a cumbersome two-stage decision mechanism, with a first decision from the EIC jury and a second decision from an EIC Investment Partner (which could be the EIC Fund, the EIB, or even private venture-capital firms).

This approach gives a de facto "veto right" to the market operators, with no real commitment from the EIC until all the hurdles have been cleared. Since the EIC Fund is currently taking a minimum of 12 months to close a deal, it is unlikely it will improve with the EIB (known for its extremely long decision processes, often 18-24 months) or with private venture-capital firms (who might be faster but absolutely not the right actors to decide how to allocate funding coming from taxpayer's money - and not from their own limited partners).

In practice, companies will never spend the 12 months needed to clear the 3 application steps, only to hear - if they are in the top 5% of selected proposals - that they "may" get the funding in 12-24 months, but that the award letter "does not constitute a commitment", as it is currently the case.

Conclusion and way forward

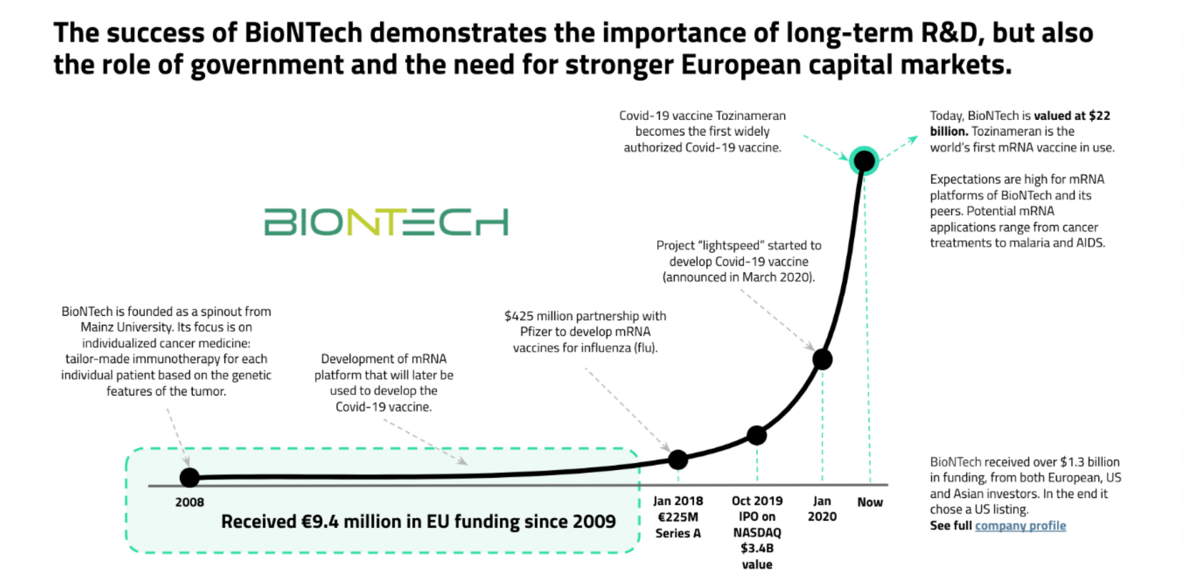
The EIC Fund was originally designed to be an innovative, sovereign financial instrument at the service of the best European start-ups, that could take risky investment decisions where private investors/venture capital firms could not.

> The EIC Accelerator aims at bridging this market failure, known as the "Valley of Death of European Innovation", which significantly affects growth and jobs in Europe compared to its main competitors. The EIC Accelerator targets potential market-creating innovation presenting a too high level of risk for traditional public and private investors, whether based on breakthrough technologies originating from research (deep-tech) or disruptive thinking, but also on impactful incremental and social innovation. Beneficiaries are innovators, start-up and SMEs, and small Mid-caps, eager to bring their innovation to market deployment and to scale-up.
>
> Source: Investment Guidelines 2021 (page 1) – Link

However, in practice, the EIC Fund has become a regular co-investment/matching fund that can only invest in deeptech start-ups if - from the onset - the majority of the money comes from traditional investors and, as per the most recent draft, based on investment decisions from the EIB and private venture capital funds.

This dependency on private investors is at odds with previous success stories where the EC was the only early funding source: for example, the success of BioNTech demonstrates the importance of long-term R&D, but also the role of EC funding at early stages where the private market is not ready to invest.

The EC will not be able to fund the next BioNTech with the EIC Accelerator if it fails to implement its original mission to provide funding where private funding is not available.



Source: Dealroom-Sifted deeptech report (page 5) – Link

The question we have to ask ourselves, as stakeholders, tax-payers and citizens, is the following: do we want to support an investment scheme that selects bold deeptech projects that are very risky but can make, in 10-20 years, a significant impact in our society, or one that simply follows what the private investors are betting on, with a short time horizon of 5-7 years?

The European Council and the European Parliament have made their position very clear in the EIC legal basis.

We hence call the Commission to go back with confidence to its own initial proposal of 2018, as European innovation needs such a powerful and risk-taking EIC. If this is not possible, the French Presidency should request the Commission to submit with no delay a draft Article 187 Decision to provide for full indirect management of the EIC Accelerator by a Union body, entrusted with all necessary powers to implement this essential policy for the future of Europe.

This turnaround towards the original design of the EIC will also require changes in the governance and resources of the EIC Fund, in particular at the Board and Investment Committee level.

- The Board should have a more balanced representation of the European innovation ecosystem (e.g., representative from impact investment funds, corporate funds, entrepreneur funds and business angels, in addition to venture capital funds);
- The Investment Committee is currently severely understaffed and should include a sufficient number of new members, who can support the 150+ new companies that the EC wants to invest in every year.

The debate is not about whether economic development should be wholly planned or exclusively shaped by market competition. It is about which aspects of Europe's economic life should be planned — and above all, who should be allowed to do the planning.

Notice

This position is supported by ACI (Association des Conseils en Innovation).

Appendix – Supporting Documents

- Council Decision (EU) 2021/764 – Link
- Regulation (EU) 2021/695 - Link
- Investment Guidelines 2021 – Link
- Public Statement by Herman Hauser (CNBC article) – Link
- EIC Equity Investment List – Link
- EIC Fund Board – Link
- EIC Fund Investment Committee – Link

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