# B 4–2 Venture capital

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## Importance of venture capital for innovation

Venture capital is an important source of financing for young innovative enterprises, without which they are unable to create and market their innovative products or business models.[228]

Financing represents a major challenge for many companies – not only in the early start-up stage, but also during the growth phase. Particularly in the case of highly growth-oriented businesses, the financing requirements can quickly rise to several million euros[229]; this is why external financing is often essential at the beginning of business operations. The typical form of financing is to borrow external equity capital from business angels or venture capitalists. As a rule, debt financing is not an option, since young companies are usually unable to provide the collateral required by banks.[230]

Despite some improvements over the past few years, only a limited amount of venture capital is available in Germany. Many venture capital funds are too small, especially for the particularly capital-intensive financing rounds during the growth phase. Nor is this gap closed by foreign funds. The lack of capital means that many promising start-ups in Germany only grow slowly compared to start-ups in other countries. Furthermore, no stock-market segment is currently available to allow a transition to a share-based form of financing. As a result, IPO exits by German start-ups are rare; German start-ups with excellent chances of success are often taken over by foreign firms.[231]

An international comparison shows that the venture capital market in Germany is much less developed than in the USA or in other European countries. In 2015, about 0.027 percent of GDP was invested in young growth companies in Germany; approximately 0.333 percent of GDP was available in the USA.[232] Even by European comparison, Germany only ranks about mid-table. The frontrunners in Europe – Finland, Switzerland and Sweden – have figures of 0.051 percent, 0.043 percent and 0.036 percent respectively.[233] In the United Kingdom, venture capital amounting to 0.034 percent of GDP is available to young companies.

In Europe, the largest number of former venture-backed companies whose current value exceeds a billion US dollars are based in the UK and Sweden; Germany follows in third place. The cumulative value of these so-called unicorns amounts to 39.6 billion US dollars in the United Kingdom, 31.1 billion in Sweden, and 20.8 billion in Germany.[234]

## Framework conditions for venture capital financing

In order to overcome the weakness of the German venture capital market and turn Germany into an internationally competitive investment location, the Federal Government has initiated a whole series of improvements for venture capital investment over the last few years.[235] In 2013, for example, the programme 'INVEST – Zuschuss für Wagniskapital' (Subsidy for Venture Capital) was launched to mobilise more capital from private investors in Germany.[236] The programme was extended to INVEST 2.0 with effect from January 2017. Investors receive a subsidy of up to 100,000 euros per year for investments in young innovative companies. In addition, the tax on capital gains is refunded.[237] EXIST funding for start-up teams from tertiary education institutions was increased, and the regulations – in particular the prospectus requirements – for crowdfunding with a volume of up to 2.5 million euros were relaxed.[238]

Many venture capital funds have been newly launched or topped up. KfW returned to the market as an investor for venture capital funds in 2015 with a budget of 400 million euros.[239]

In addition, the BMWi, the European Investment Fund (EIF) and the KfW set up the 'ERP/EIF-Wachstumsfaszilität' (Growth Facility) and the Coparion fund in March 2016, two new instruments for financing venture capital with volumes of 500 and 225 million euros respectively.[240] Coparion succeeds the ERP-Startfonds (Start Fund), which had – as part of KfW – previously invested in small, innovative technology companies.[241]

In July 2016, an extra billion euros in funding was made available to the ERP/EIF-Dachfonds (Fund of Funds), established in 2004, topping it up to 2.7 billion euros.[242] The purpose of these measures is to close the gap in supplying follow-up financing for young businesses in the growth phase.[243] The ERP/EIF-Dachfonds provides 270 million euros for the European Angels Fund, which was launched in 2012.[244]

Furthermore, in July 2016, the Federal Government announced the launch of a new fund with a volume of 10 billion euros. This so-called Tech-Growth-Fund is to grant founders one additional euro of credit on favourable terms for every euro of venture capital.[245]

In addition to the measures for improving the financing situation, the Federal Government set up accelerators for young companies in the field of information and communication technology (ICT) and life sciences between 2012 and 2016. The BMWi-supported German Accelerator in Silicon Valley, New York and Cambridge (Boston) makes it possible for founders of start-ups to spend several months accompanied by mentors in the environment of the USA's great ICT and life-sciences cluster.[246] The aim is to encourage business development in the USA, which is still the largest international market for innovative products and services.

## Law for the improvement of loss carryforward regulation

In order to overcome a further obstacle for venture capital investment, the Federal Government submitted a draft Act on the Further Development of Tax Loss Carryforwards for Corporations (Gesetz zur Weiterentwicklung der steuerlichen Verlustverrechnung bei Körperschaften) in September 2016; it was passed by the Bundestag and adopted by the Bundesrat in December 2016.[247] The restrictive tax regulations on the treatment of loss carryforwards[248] (section 8c of the Corporation Tax Act [Körperschaftsteuergesetz, KStG]) had repeatedly been named in the past as the reason for the weak venture capital market in Germany by international comparison.[249]

At present, carried-over losses cannot be deducted from tax if an investor acquires shares in a company above a certain level. Yet innovative companies in particular spend large sums on research and development (R&D) in the first few years, which can then be posted as carried-over losses. If these loss carryforwards for R&D expenditure can no longer be deducted from tax after a takeover, the companies are less attractive for potential investors.[250]

The new regulations launched by the Federal Government (new section 8d of the KStG) aim to ensure that unexploited losses (loss carryforwards) can still be used despite a change in shareholders. The precondition is that the entity's business operations are maintained after the change of shareholders and any other use of the losses is excluded.[251] The Commission of Experts warns that this condition must be interpreted flexibly enough, since start-ups often change their business model, customer target group or technology.

## Taxation of capital gains and the remuneration of fund initiators

In 2014, within the framework of a Bundesrat initiative, the Länder called on the government to introduce a general taxation on capital gains realised on the sales of free-floating shares in corporations. The Federal Government has not taken up this initiative.[252] The Commission of Experts welcomes this decision because it would have made small-scale investments by venture capitalists and business angels less attractive and thus reduced incentives to invest in young, innovative enterprises.[253]

Similarly, the Federal Government has not agreed to calls by the Länder for an increase in the taxation of fund-initiator remuneration – known as carried interests.[254] However, it is not clear whether the discussion might be resumed at a later date. This ongoing uncertainty reduces long-term planning security for the initiators of venture capital funds.[255]

Another locational disadvantage is that – unlike in many other European countries – the administrative services of fund managers in Germany are subject to turnover tax.[256] Building up and administering venture capital funds in Germany is therefore relatively unattractive.[257]

## Restrictions for anchor investors

Not only changes to overall tax conditions are necessary in order to revive the venture capital market. Major institutional investors, e.g. pension funds, are also important. In countries with funded pension schemes, such funds often act as anchor investors that send important signals to foreign investors on investment opportunities on the domestic market. Since the pension system in Germany is largely financed according to the pay-as-you-go principle, these anchor investors are missing here. This makes it all the more important that other institutional investors – e.g. insurance companies – can become active in this field. However, institutional investors are often hesitant to invest in venture capital funds because of stringent regulatory requirements. The Commission of Experts regards it as a positive initial signal that the KfW returned to the market as a fund investor in 2015 (cf. p. 85) and can thus contribute to winning over further domestic and foreign institutional investors.[258]

## Importance of liquid secondary markets

In the long run, liquid secondary markets are also needed to improve incentives for investors. The availability of flexible exit options increases the incentive for investors to invest in venture capital funds.[259]

Since it has not been possible to create a separate stock-market segment for young companies in the past, due to the small number of exits, in December 2014 the BMWi opened a dialogue process aimed at reviving the stock market as a source of financing for young growth companies and as an important exit channel for investors.[260]

In June 2015, the first result of the dialogue became visible with the founding of the Deutsche Börse Venture Network.[261] This network acts as a pre-trade matching platform to bring institutional and private investors together with young, growth-oriented companies, and to give support in setting up rounds of financing.[262] As a further step in November 2016, Deutsche Börse (the German stock exchange) announced the introduction of a new stock-market segment for young growth companies and SMEs.[263] The new segment is to be launched in March 2017.[264]

## Encouraging final spurt

The Commission of Experts expressly welcomes the improvement in the framework for start-ups and venture capital financing initiated at the end of the current legislative period. The reorganisation of loss carryforwards and the creation of a stock-market segment for young growth companies represent important milestones on the road to making Germany competitive in the field of venture capital funding. The continuation of the High-Tech Gründerfonds and the INVEST programme will provide important support in this context.