

Position paper of BIO Deutschland

Financing innovation with venture capital

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1. Biotechnology companies in Germany lack the venture capital needed during the growth stage

Germany has structural weaknesses when it comes to key areas of innovation financing. BIO Deutschland has already examined this issue in detail in two previous position papers, one on innovation financing in Germany and the other on how to improve the financing of innovative small and medium-sized enterprises (SMEs).¹ Direct state financial support is valuable, whether it comes in the form of tax incentives for research and development or in the form of tax-funded government grants. Here the “INVEST – Venture Capital Grant” programme should be expanded. SMEs are burdened in particular by the lack of clarity in the government support programmes at the state, national and EU levels. ***It would, however, be more effective in the long term and make more sense fiscally to attract more private capital for innovation financing.***² The Federal Ministry for Economic Affairs and Energy (BMWi) was correct in its assertion that “despite the international awareness of Germany’s start-up scene, the German venture capital market is too small – both in an international comparison and in relation to Germany’s economic strength”.³ The German government has therefore introduced various funding instruments in order to make Germany more attractive to venture capital. The measures that support the start-up stage can, for the most part, be assessed as positive. Measures targeting the growth stage, however, put research-intensive biotechnology companies at a disadvantage, because such companies have high capital requirements in the long term. Only the ERP/EIF Venture Capital Fund of Funds, ERP Venture Capital Fund Financing and KfW Capital address the industry’s needs in their initial form. What is still lacking in the funding instruments introduced by the BMWi are incentives capable of attracting larger volumes of capital for innovation financing.

2. From R&D to the market

The swift commercial exploitation of research findings is an important pillar of a society’s innovative capacity. Breakthrough innovations must become marketable in a globally competitive time frame. New start-up companies in the United States and China are able to successfully translate their research findings into marketable products in a significantly shorter period of time. In particular when it comes to markets that are heavily regulated by the government, the barriers to market entry are high, which means higher risks for investors.

¹ <https://www.biodeutschland.org/de/positionspapiere/positionspapier-zum-thema-innovationsfinanzierung-in-deutschland.html>;
<https://www.biodeutschland.org/de/positionspapiere/positionspapier-zur-verbesserung-der-finanzierung-des-innovativen-mittelstandes-in-deutschland.html>

² An extensive discussion about critical aspects can be found in the EY biotechnology report “Sprung nach vorne! Modell Deutschland: Von der Biologie zur Innovation”, 2018.

³ https://www.bmwi.de/Redaktion/EN/Downloads/financing-start-ups-and-growth-overview-of-funding-instruments.pdf?__blob=publicationFile&v=9

3. Other regions have far better conditions for innovation financing

Unlike in Anglo-American countries, Europe lacks for the most part an innovation financing ecosystem due to there being little equity capital available for development and growth financing. The paradigm-shifting business models of companies such as Google, Facebook, Amazon and Tesla, and in the biotechnology sector Genentech, Kite, Bluebird, Amgen, Gilead, Biogen, and others, are inconceivable in the absence of large sums of private venture capital for development financing. Such companies are financed through private equity (also known as venture capital, VC) provided by investors; the investors become partners or co-founders of the company. The only possible way to level the playing field is by creating a more favourable environment for venture capital and/or for initial public offerings (IPOs) in early stages of company development.

4. Options for action

Pension systems in Europe are usually financed on a pay-as-you-go basis, which means a key source of capital accumulation is lacking. This very source of capital accumulation provides the foundation for a very productive venture capital financing ecosystem, especially in the United States. Such an ecosystem involves traditional venture capital in the early stage and institutional investors that invest in innovative development through listed companies. These forms of financing open up the possibility for active VC investors to recoup their investment and make a profit through early-stage IPOs, and enable growth companies to be financed through the stock market up to market readiness or market penetration.

There is a huge amount of capital and assets in Germany and Europe looking for investment possibilities. Insurers, pension funds and private individuals could contribute to innovative capacity by providing extensive inflows of capital. Possible strategies include:

4.1. Incentives for VC investment

State support is needed in order to make private investment in venture capital more attractive. Suitable measures could, for example, convert private assets into venture capital. The financial assets of private households totalled around €5.875 billion at the end of the first quarter of 2018.⁴ Here we see two possible approaches:

- Establishing a legal framework for German/European capital-collecting institutions to invest in venture capital. This relates both to investments in private companies via VC funds and investments in listed companies by institutional investors. **In the post-2008 era, funds are in many cases prohibited from investing in such classes of venture capital.**
- Introducing tax incentives, especially ones that allow private investors to set off capital losses against other income or to exempt future profits when they invest in the VC asset class. Such incentives should apply to both the VC segment (pre-IPO) and investment via the stock market (development and growth financing). In addition, the “INVEST – Venture Capital Grant” programme could be expanded to create more incentives for VC investment.

4.2. Creation of suitable capital-collecting institutions

The core idea is that the high level of economic cash flow is utilized to shape – and thus safeguard – the future. It will be implemented to support young, innovative companies through the following models: Innovation Norway (income from natural gas and oil sales),⁵ Australia’s Future Fund (accumulation of trade surpluses),⁶ US health insurance companies,⁷ CalPERS in California (the pension fund of the state’s public employees, which manages US\$ 300–400 billion),⁸ TIAA (US pension fund for teachers and professors),⁹

⁴ Statista 2018

⁵ <https://www.innovasjon Norge.no/en/start-page>

⁶ <http://www.futurefund.gov.au/>

⁷ <https://divisionofresearch.kaiserpermanente.org/>; <https://medcitynews.com/2015/10/mckesson-blue-cross-top-digital-healths-most-trusted-corporate-vcs/>

⁸ <https://www.calpers.ca.gov/>; <https://www.calpers.ca.gov/page/investments/asset-classes/private-equity>

⁹ <https://www.tiaa.org/public/index.html>

Swiss Entrepreneurs Foundation (foundation supporting young companies)¹⁰ and the Dansk Vækstkapital fund in Denmark.¹¹

Alongside the size of the fund, it would be possible to provide state support or guarantees like those in the Danish fund model in order to provide market participants with a better tie-in with previous structures.

4.3. A promising route for Germany: establishing a “Germany/Europe Future Fund” as a third pillar of pension provision

In order to supplement the pay-as-you-go system consisting of employee and employer contributions as well as the low-yielding second pillar of self-provision (based on contributions to the Riester pension scheme and similar instruments), a third pillar with a stronger orientation to capital markets could be established. The aim would be to pool assets from voluntary employer/employee-financed programmes in an innovation fund that invests in a broad range of new technology areas, either by taking a private equity stake in start-up companies or by investing in the development and growth financing of mature listed companies. It would, for example, be conceivable to place occupational pension schemes on an even broader basis and allow them to make such investments. An appropriate diversification in different sectors and companies would ensure a sound risk profile. Such a possibility has already been realized in the United States by pension funds for public employees and other groups.

This position paper was prepared by BIO Deutschland's Working Group on Finance and Taxation.

As the sector association of the biotechnology industry, BIO Deutschland has set itself the objective of supporting and promoting the development of an innovative economic sector based on modern biosciences. The association currently has over 330 members. Dr Peter Heinrich is Chairman of the Board of BIO Deutschland.

BIO Deutschland's supporting members and partners are AGC Biologics, Avia, Bayer Pharma, BioSpring, Boehringer Ingelheim Pharma, Centogene, Clariant Produkte (Deutschland), CMS Hasche Sigle, Deutsche Bank, EBD Group, Euronext, Evotec, Exyte, EY, Isenbruck | Bösl | Hörschler, Janssen, KPMG, Merck, Miltenyi Biotec, MorphoSys, Neuwert, Pfizer, Phenex Pharmaceuticals, PricewaterhouseCoopers, Qiagen, Roche Diagnostics, Sanofi-Aventis Deutschland, SAP, Thermo Fischer, Vertex and VWR.

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Further information about the activities of BIO Deutschland can be obtained upon request from the association's headquarters or at www.biodeutschland.org.

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¹⁰ <https://www.handelszeitung.ch/digital-switzerland/swiss-entrepreneurs-foundation-mit-promi-stiftungrat>

¹¹ <https://www.danskvaekstkapital.dk/>