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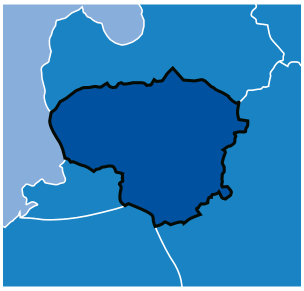
Stocktaking study on financial instruments by sector



Progress to date, market needs and implications for financial instruments

The Lithuanian RDI-specific equity instruments

Case study

European Commission

European Investment Bank
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Abbreviations

Abbreviation	Full name
BA(s)	Business Angel(s)
CF	Cohesion Fund
ERDF	European Regional Development Fund
ESIF	European Structural and Investment Funds
EU	European Union
FoF(s)	Fund(s) of funds
GBER	General Block Exemption Regulation
INVEGA	'Investicijų ir verslo garantijos', or 'Investment and Business Guarantees' (a national promotional institution of Lithuania)
ITS	Intelligent Transport Systems
MTEPI	'Mokslinių tyrimų ir eksperimentinės plėtros bei inovacijų', or 'scientific research, experimental development and innovation activities'
NPI	National promotional institution
PE	Private Equity
R&D	Research and Development
RDI	Research, Development and Innovation
RSI(s)	Research and Scientific Institutions
SMEs	Small and Medium-sized Enterprises
S3	Smart Specialisation Strategy
VC	Venture Capital

In the 2014-2020 programming period, a strategic decision was taken by Lithuania to build on the experience acquired in the previous period and further promote the use of equity financial instruments. In this context, Research, Development and Innovation (RDI)-specific financial instruments were set up and implemented as of 2018. The case of Lithuania illustrates the initiative of a national promotional institution (NPI) developing European Regional Development Fund (ERDF)-supported financial instruments 100% focused on RDI, leveraging and structuring the RDI ecosystem of the country, as well as aligning the strengths and interest of research centres, Venture Capital (VC) and Private Equity (PE) funds, as well as Business Angels (BAs) to specifically finance RDI.

The RDI instruments are being implemented under the umbrella management of the NPI INVEGA which has a long-standing experience in the implementation of European Structural Investment Fund (ESIF)-supported financial instruments, mostly focusing on loans and guarantees. In the current programming period, INVEGA was also entrusted by the State to set up and implement equity instruments.

From a governance aspect, INVEGA has set up a subsidiary entity named UAB Kofinansavimas in the form of a limited liability stock company (with shares owned by INVEGA). This subsidiary operates as an umbrella VC fund, implementing, amongst others, the RDI specific instruments.

1. Description of the financial instrument

1.1 Rationale and objectives

The Lithuanian NPI, INVEGA, was established in 2001 as a guarantee agency providing individual guarantees to Small and Medium-sized Enterprises (SMEs). Building on this experience, it launched additional financial instruments such as a microfinance instrument in 2006, soft loans in 2008, and other financial instruments since. As of now, INVEGA manages four funds of funds (FoFs), all dedicated to corporate financing. In total, INVEGA manages 22 active financial instruments, providing a variety of financial products (loans, guarantees and equity financing).

In the context of equity financing, INVEGA (through its subsidiary UAB Kofinansavimas) has developed three financial instruments dedicated to RDI. Two of these instruments are implemented by the fund, Koinvesticinis Fondas[1]. The latter is a co-investment VC fund that provides equity financing (as a co-investor together with private VC and PE funds, as well as groups of BAs) to start-ups and growing Lithuanian SMEs. The relations it builds with private VC, PE funds and groups of BAs aim to favour the development of the Lithuanian equity market, as well as stimulate BA investments with a view to promote a better access to equity financing for Lithuanian SMEs. The two RDI focused instruments implemented by Koinvesticinis Fondas are 'Koinvest MTEPI'[2] and 'Koinvest II' (their scopes are described in the next section).

1 The fund Koinvesticinis Fondas is also managing two additional instruments:
- 'Koinvest I', which uses EUR 11 million of resources already returning to INVEGA which have been earmarked by the Ministry of Economy and Innovation (non-ERDF) in order to provide equity financing to SMEs of less than five years and not necessarily developing RDI-related projects; and
- 'Koinvest susisiekimui' (*'susisiekimui'*, standing for 'transport and communications'), which uses EUR 4 million of Cohesion Fund (CF) funding earmarked by the Ministry of Transport and Communications in order to provide equity financing to SMEs developing mobility services and products, Intelligent Transport Systems (ITS), and innovative transport technologies reducing CO_2 emissions produced by the transport sector.

2 'Koinvest MTEPI' ('Mokslinių tyrimų ir eksperimentinės plėtros bei inovacijų' – MTEPI, or 'Scientific research, Experimental Development and Innovation activities'). The full official name of the 'Koinvest MTEPI' instrument is 'Ko-investicinis fondas MTEPI, finansuojamas iš ERPF', standing for 'Co-investment Fund for scientific research, experimental development and Innovation activities, financed from ERDF'.

The third instrument is a VC fund managed by a private fund manager, described in the next section.

1.2 Scope

An ex-ante assessment was conducted before launching the instruments. The analysis identified a financing gap and a market failure in the Lithuanian equity market in relation to SMEs developing Research and Development (R&D) projects, and suggested the set-up of dedicated instruments. Looking more closely at the three RDI-specific equity instruments, their scopes are defined as follows:

- The first instrument, Koinvest MTEPI, aims to attract Research and Scientific Institutions (RSIs) and private investors to co-invest in RSIs' spin-offs (i.e. start-ups or SMEs created to commercialise an innovation developed in an RSI). It was set up in 2018 and is managed by the fund Koinvesticinis Fondas. The entire instrument must be invested in SMEs implementing or intending to undertake R&D projects in the areas of the Lithuanian Smart Specialisation Strategy (S3). EUR 5 million[3] of ERDF funding is devoted to this instrument. As at the beginning of November 2019, five investments for EUR 2.2 million in total were already made by this instrument;
- The second instrument, Koinvest II aims to finance SMEs with projects in relation to the S3. RSIs are not required to co-invest with this instrument. In the meantime, at least 50% of the instrument must be invested in SMEs implementing or intending to undertake R&D projects in the areas of the S3. Similar to Koinvest MTEPI, Koinvest II was set up in 2018 and is managed by the fund Koinvesticinis Fondas. EUR 11.6 million of ERDF funding are devoted to this instrument. As at the beginning of November 2019, no investments have been made by this instrument;
- The third instrument, Venture Capital Fund II is a VC fund managed by a private fund manager, Iron Wolf Capital. The budget of this instrument (up to 80%) is intended to be invested in SMEs developing RDI-related projects in the areas of the S3. It was set up in December 2018 and operates as a standard equity fund (as opposed to a co-investment fund, like the first two instruments). EUR 13.76 million of ERDF funding are devoted to this fund (with no national co-financing). A first roundtable aiming to attract co-investors has led to a total available funding of EUR 16 million and, once the current second roundtable is finished (final closing is expected by the end of 2019), the total amount of funding available within the fund is intended to be of EUR 20 million. As of beginning of November 2019, three investments for EUR 1.7 million in total were already made by this fund.

The companies targeted by the three instruments are SMEs:

- Engaged or having the intention to engage in economic activities in relation to the Lithuanian S3 by implementing RDI activities; and
- Whose shareholders include, or will include at the time of investment, an RSI.

3 A minimum amount of EUR 4 million is earmarked for investments under this financial instrument, with up to EUR 1 million devoted to cover management costs.

The instruments also define further criteria for the financing of the SMEs. For instance, as detailed on the specific website[4] of Koinvest MTEPI the instrument invests in SMEs fulfilling the following criteria:

- At the time of investment, the SME must meet all of the State aid requirements (detailed on the website);
- The SME must be an 'innovative enterprise' as per the meaning of Article 2(80) General Block Exemption Regulation (GBER)[5];
- The SME must be implementing or intending to implement scientific research, experimental development and/or innovation projects in areas of the S3, and be in line with at least one action plan of the priorities established in the National Programme for Priority Research and Experimental (Social, Cultural) Development and Innovation Development;
- An RSI is either one of the shareholders of the SME or should become shareholder at the time of investment;
- The instrument can invest in SMEs operating in Lithuania or in another EU Member State, if this investment benefits Lithuania[6]. Investments in companies operating outside Lithuania cannot however exceed 15% of the sub-fund. Also, the total investment made by the instrument in a single SME, including its follow-on investments, cannot exceed EUR 1.6 million.

1.3 2014-2020 Operational Programme

The three ERDF-funded instruments have a combined budget of EUR 30.36 million originating from the 'Operational Programme for EU Structural Funds Investments for 2014-2020' of Lithuania.

1.4 Financial allocation and governance

The two RDI-specific co-investment VC instruments, Koinvest MTEPI and Koinvest II, are fully financed by ERDF funding The ESIF funding is co-invested with RSIs and private investors – private VC and PE funds and/or teams of at least two BAs – in viable RDI-related projects. The RDI investments follow a number of steps:

1. First, any co-investment made by the instruments has to be initiated by a private investor (i.e. an RSI, a private VC or PE fund, or a group of at least two BAs) which provides proposals to the fund manager regarding investments in high-potential companies. It is to be noted that **only** private investors present on the list of the 113 BAs and private VC/PE funds already selected by the fund Koinvesticinis Fondas may submit a request for co-investment with the fund. A start-up/SME cannot do it directly;
2. Second, to request a co-investment, the private investor(s) and the proposed SME must submit a request for investment under a specific form (the information/documents needed in/with the form are easily available/listed on the internet). If the SME has not been founded yet, it must be represented, and documents must be submitted by the author of the idea, its founder;

4 https://www.koinvest.lt/en.

5 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.

6 In that context, the fund Koinvesticinis Fondas has published online a Guideline on the eligibility of costs of its financial instruments. The specific webpage of the Koinvest MTEPI instrument also provides an extensive list of 'ineligible investments': https://www.koinvest.lt/en.

3. Third, when submitting the request for co-investment, the accredited private investor(s) have to justify why, in their opinion, the investment is viable and potentially profitable. They also need to present the terms of their current financing agreement with the SME; and
4. Fourth, as established in the shareholder agreements signed between the instrument and the private investors following a specific negotiation for each deal, the instrument operates as a silent shareholder in the management of the financed start-ups/SMEs.

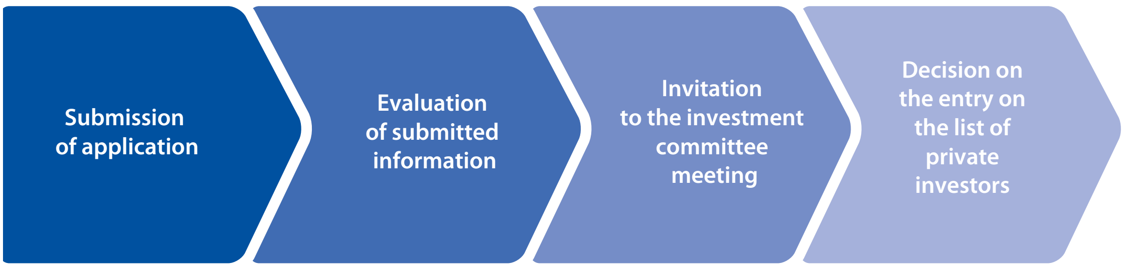
This process, common to all sub-funds under the fund Koinvesticinis Fondas (and so including Koinvest MTEPI and Koinvest II), is illustrated and detailed on the fund's website with the following figure.

Figure 1: Investment process of any sub-fund within the fund Koinvesticinis Fondas

Source: www.koinvest.lt, 2019.

As mentioned, only the selected private investors may submit a request for co-investment. An SME cannot send a direct request. This selection follows specific terms. If the private investor meets these requirements, the Investment Committee decides on the entry of the applicant to the 'list of private investors' on the basis of its assessment of the application. This selection is an ongoing process which will continue until the end of the investment period (expected for 31 December 2020, and can be extended). It is illustrated by the figure below.

Figure 2: Selection process of private investors that may then request co-investment with the fund Koinvesticinis Fondas



Source: www.koinvest.lt, 2019.

Once a private investor (one private VC or PE fund or two BAs together) present on the list sends its request for investment, the latter is assessed. In their request, the private investors have to prove the profitability of the investment and the terms of investment agreed with the SME (under the form of a term sheet). These private investors cannot be current shareholders of the SMEs targeted for investment. The manager of the fund Koinvesticinis Fondas may conduct an additional due diligence. Following this, the Investment Committee assesses the request based on the SME's team, its business model and the private investor(s) involved.

The negotiation and investing phase then starts. Once the Investment Committee agrees to invest in the SME, contracts are negotiated:

- A 'shareholder agreement' between the appropriate sub-fund (such as Koinvest MTEPI) and the private investor(s); as well as
- An 'investment agreement' between the sub-fund, the private investor(s), including the RSIs in the case of the Koinvest MTEPI, the existing shareholders of the target SME, and the target SME.

The investment is made once all the agreements are signed.

Looking more closely at the case of Koinvest MTEPI, the contribution takes the form of new equity financing or of convertible bonds for up to 90% of each specific investment. Also, as mentioned, the total investment from Koinvest MTEPI, including potential follow-on investments, in one single SME cannot exceed EUR 1.6 million. Finally, in parallel, the funding provided by the RSI(s) must represent around 5% of the value of the specific investment or of the authorised capital of the SME. RSI funding is understood as own private funds from the RSI, which would not be financed from public sources (i.e. from State budget). Once the investment is effective, Koinvest MTEPI – as any sub-funds of the fund – behaves as a silent shareholder and transfers the majority of its non-material rights to its private co-investor(s) who represent its interests.

As a general policy of the fund Koinvesticinis Fondas, and as explained on its website, Koinvest MTEPI aims a 4% annual profit on the amount invested for each investment year, which is the maximum return for the fund as a public investor. The remaining profits, after this annual distribution of 4% for the fund, go to the private investors. This set-up helps attract private investors while ensuring a minimum return for the public sector when a very successful investment is supported by the fund. If the profit from the investment does not reach 4%, it is allocated between the fund, and the private investor(s) based on the pro rata to their respective investments in the SME. As a general policy, the fund Koinvesticinis Fondas aims to exit each SME after 5 to 7 years, and not later than the private investor(s) with which it co-invested in the SME. When exiting simultaneously with the private investor(s), the terms of investment disposal must be at least as favourable as those offered to this/these private investor(s).

In parallel, the investment process of Venture Capital Fund II is quite different. First, the selected fund manager has to raise funding from private investors at fund level, in complement to the ERDF funding (as reminder, there is no national co-financing from the managing authority in this VC fund). The first roundtable of this fundraising process has been achieved and the second roundtable is ongoing. Its closure is expected by end 2019. Second, the fund manager selects and invests into innovative SMEs with high-growth potential that are still in their early development and which develop RDI-related projects in the areas of the S3. The fund has already performed three investments for a total invested amount of EUR 1.7 million.

1.5 Financial products

As already mentioned, the contribution of the instruments to the start-ups/SMEs takes the form of new equity financing or of convertible bonds for up to 90% of each specific investment.

1.6 Leverage

Taking the example of Koinvest MTEPI, since the maximum share in each investment may be up to 90%, the minimum leverage to be expected is around 1. This predictable leverage is consequently quite limited, but in line with what is to be expected for such RDI instrument focusing on spin-offs. In the meantime, since the investment share taken by the instrument is decided on a case-by-case basis, and may then be less than this maximum of 90%, this minimum leverage of 1 may be higher on an investment-by-investment level. However, since this instrument has been specifically designed to finance RDI (and considering that spin-offs which are among the projects with the highest risk profile in the RDI sector), it is expected to take higher risks. It is consequently to be assumed that a quite low leverage is expected from the instrument, i.e. around 1.

In parallel, the leverage effect expected for Venture Capital Fund II is between 1.2 and 1.45 (if the fund achieves a total volume of EUR 20 million at the end of its fundraising process by end 2019).

1.7 State aid

The State aid regime applied to Koinvest MTEPI and Koinvest II follows the rules detailed in Article 22 GBER established for aid for start-ups. The State aid regime applied to Venture Capital Fund II follows the rules of Article 21 GBER relative to risk finance aid.

2. Lessons learned

2.1 Results

Since the instruments were created in 2018, as at the beginning of November 2019, their implementation is still at the beginning of their investment phase. In total, the three instruments have performed eight investments for a total invested amount of EUR 3.9 million: five investment for Koinvest II representing EUR 2.2 million, three investments for Venture Capital Fund II representing EUR 1.7 million and no investment for Koinvest MTEPI.

It is important not to undermine the very fact that such dedicated instruments have been actually set up. The willingness of the public administration to conduct the relevant ex-ante assessment, to seek technical support to set up all legal structures, to gradually build capacity in such a technical topic, and to address complex issues such as procurement, reveal a commitment in promoting such instruments. Especially when taking into account that such targeted instruments in more narrow sectors such as RDI usually take up more time to produce results and substantial impact in the market. Even more so in 'small' markets like Lithuania. In addition, such equity related instruments require a very strong knowledge of the market and substantial field work to source the investors and projects. In this context, the timely set-up of the structures and of the procedures should be seen as a positive result.

In parallel to this, it is anticipated that the instruments will also produce tangible results such as to:

- Stimulate the RDI market (notably thanks to agreements with RSIs, private VC and PE funds and groups of BAs at the fund level);
- Focus on projects considered as too risky by private stakeholders;
- Act where a public intervention can add value, share risk with the private sector and incentivise the latter to also invest in SMEs with higher risk profiles; and
- Be complementary with other financial instruments (including loans and guarantee instruments) already available and provided by/through INVEGA to Lithuanian SMEs.

2.2 Barriers and challenges

The first series of barriers and challenges encountered by the instruments relate to the historic nature of RDI financing. Grants remain the most widespread public financing scheme for the RDI sector in Lithuania. They are often perceived as a 'quicker/simpler' financing scheme to implement, in comparison with financial instruments. They may also be perceived as more attractive from a political perspective, as opposed to financial instruments; the latter being often perceived as more time-consuming to develop and to obtain results. In that context, the introduction of financial instruments related to RDI (such as the three instruments set up in Lithuania) needs to be structured in a complementary manner with grants and needs to be supported with communication (i.e. publicity).

Another challenge relates to the innovative nature of these instruments, as well as of the projects to be financed, and consequently their perceived risks. RSIs may be reluctant to invest, due to their historic dependence on grant financing. Simultaneously, spin-offs may experience difficulties in explaining their concepts or purposes in view to commercialise these projects and attract private financers. This challenge is addressed by another entity (Enterprise Lithuania) that directly supports the spin-offs/start-ups/SMEs when developing their business models and plans, making it a key enabling factor for the financial instruments.

Third, still because Lithuania may be considered as a small market, the financial instruments may encounter difficulties in establishing a pipeline of viable projects sufficiently deep to make them viable. Indeed, as mentioned by INVEGA[7], even though there are a lot of ideas in Lithuania, it may be challenging to find investable projects. That is why the instruments have been appropriately calibrated to the Lithuanian market in order to ensure absorption.

2.3 Key enabling factors

As mentioned by INVEGA, there is a need for a shift from grants towards financial instruments when it comes to developing publicly-supported financing mechanisms. This is especially valid for RDI financing**,** where financial instruments providing equity or other types of financing are needed in Lithuania (as observed in the ex-ante assessment). Key enabling factors for the three RDI-specific instruments (developed in parallel, using ERDF funding, and focusing on S3-related projects financing) are:

- Cooperation with RSIs (specifically for Koinvest MTEPI), private VC and PE funds and groups of BAs to raise interest and structure the RDI-financing market as well as to develop an ecosystem of equity investors in Lithuania;
- The awareness raising campaigns initiated by INVEGA and UAB Kofinansavimas; as well as
- The use of public funding (including ERDF) to develop financial instruments specifically aiming to finance RDI, and so bear a part of risks that private stakeholders are reluctant to take, attract private investors, and structure new/niche markets in the country.

Overall, the three Lithuanian RDI-specific financial instruments provide a good example of how public authorities may build on previous positive experience (regarding market knowledge, successful financial products implemented and work with various stakeholders) in order to define and cope with new challenges, such as better structuring the RDI sector with the support of financial instruments.

7 INVEGA representatives were interviewed in the context of this case study.

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