

- ERDF
- EUR 13.6 million
- Loans and equity
- SME support
- East Netherlands

*...the Innovation Fund's ability to attract private investors leads to more support for innovative SMEs at their early growth stage...*

# Innovation Fund East Netherlands

Case Study



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The authors of this study are a consortium of five companies: Sweco (lead), t33, University of Strathclyde – EPRC, infeurope and Spatial Foresight.

## Abbreviations

Abbreviation	Full name
ERDF	European Regional Development Fund
EU	European Union
GBER	General Block Exemption Regulation <sup>1</sup>
Oost NV	East Netherlands Development Agency
OP	Operational Programme
PPM Oost	Participatiemaatschappij Oost (Participation Agency East, the regional venture capital company)
SME	Small and medium-sized enterprise
SPV	Special Purpose Vehicle
TRI	<i>Troisième Révolution Industrielle</i> (Third Industrial Revolution)

<sup>1</sup> 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 Text with EEA relevance (OJ L 187, 26.6.2014, p. 1).



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# 1 Summary

This study explains how the Innovation Fund in East Netherlands, co-funded by the European Regional Development Fund (ERDF) in the 2007-2013 programming period, addressed a regional market gap for access to finance. Target recipients were small and medium-sized enterprises (SMEs) in the food, health and technology sectors, with no track record and in the early development stage. The fund manager, Participatiemaatschappij Oost (PPM Oost), provided equity and loans combined with non-financial support such as networking, training and coaching. PPM Oost invested in SMEs like Solmates, described later on, which could not easily obtain finance to test and market their new production process for thin films. Through a fixed-interest loan from the ERDF-supported Innovation Fund, Solmates was able to launch its product and reach out to clients all around the world.

The Innovation Fund succeeded in attracting significant private finance from its network and leveraged its ERDF allocation of EUR 6.14 million by 6.4 times instead of the expected 4.4. So each ERDF euro led to 6.4 euros of SME investment. The fund generated EUR 39.3 million in SME investments and created 325 full-time equivalent jobs, 178 more than expected. Investments were 13% loans and 87% equity products. The managing authority set objectives for both financial products to achieve 50% private co-investment at the final recipient level. The Innovation Fund added value by sharing risks and leveraging finance from private investors for projects that would otherwise not have been supported by commercial lenders. Among other success factors were the clarity of both governance and the investment strategy.

The fund is going to be continued with reutilisation of repayments and the proceeds of equity sales. In addition, there are regional and national financing schemes for SMEs so there is no need for additional ERDF contributions.

## Innovation Fund East in the Netherlands

### THE FINANCIAL INSTRUMENT

#### Funding source

ERDF, Operational Programme (OP) East Netherlands 2007-2013

#### Type of financial products

Loans and equity, in some cases combined with advisory services

#### Financial size

EUR 13.6 million OP resources + EUR 25.66 million private resources = EUR 39.3 million  
(EUR 6.1 million from ERDF and EUR 7.5 million from national and regional public co-financing) +  
at least 50% from private co-investors at project level

#### Thematic focus

SME support

#### Timing

July 2008 to July 2015

#### Partners involved

Provinces of Gelderland and Overijssel (managing authority)  
Participatiemaatschappij Oost - PPM Oost (financial intermediary)

### ACHIEVEMENTS

#### Absorption rate

100% of OP resources: ERDF and national funding (at May 2015)

#### EU leverage

6.4 times<sup>2</sup>

#### Leverage of public resources

2.9 times<sup>3</sup>

#### Re-investment

n.a.

#### Main results

33 SMEs supported, an additional EUR 25.7 million<sup>4</sup> in private investment was attracted and 325 new full-time equivalent jobs created as at May 2015

- 2 EU leverage is calculated as the total amount of finance to eligible final recipients, i.e. EUR 39.3 million (in this case made up of the Innovation Fund's EUR 13.64 million and the investment it triggered from private actors of EUR 25.66 million), divided by the total amount of ERDF allocation to this financial instrument, i.e. EUR 6.14 million. It does not include the reuse of resources returned to the instrument.
- 3 Leverage of public resources is calculated as the total amount of finance to eligible final recipients, i.e. EUR 39.3 million, divided by the total amount of programme allocated to the financial instrument, i.e. 13.64 million. It does not include the reuse of resources returned to the instrument.
- 4 This represents the amount of additional private resources triggered in investment by the Innovation Fund. The fund's own investment is not included in this amount.



## 2 Objectives

The provinces of Gelderland and Overijssel in the east of the Netherlands form a nationally-recognised innovation region. This region aims to strengthen its position at European level. It has a well-developed knowledge infrastructure where public authorities, universities and enterprises cooperate. The region aims to increase competitiveness by fostering growth and innovation in the food, health and technology sectors, where the knowledge economy is especially well-developed.

It was difficult for many young innovative enterprises to fully benefit from the existing knowledge economy infrastructure, especially in the early years of the crisis. Another challenge hampering the region's ambitions is the relatively low survival rate for start-ups compared with other Dutch regions. There was a lack of capital to overcome the so-called 'valley of death', the period of negative cash flow in early development stages, before revenues arrive. Conditions for entrepreneurship needed to be improved to fully benefit from the region's leading universities.

The 2007-2013 ERDF East Netherlands programme aimed to strengthen the knowledge economy, the regional innovation capacity and market position of enterprises in the region. The programme supported this objective by investing in start-ups in the region's main sectors of food, health and technology. The programme's objective was to support young innovative enterprises when bringing their products to market.

Carrying out a full ex-ante assessment was not necessary in the 2007-2013 programming period<sup>5</sup>, as is the case with ESIF financial instruments in the 2014-2020 programming period. Nevertheless, the managing authority assessed the need for a financial instrument in the region. Based on various reports, the Gelderland and Overijssel provinces were aware of a market failure and wanted to financially support innovative young enterprises. An expert group commissioned by the Ministry of Economic Affairs conducted an analysis and concluded that start-ups in particular are important for the innovation potential of the country. This expert group recommended broadening assistance to enterprises by using financial instruments. Various studies found a market gap that prevented young innovative enterprises from accessing private finance since they were considered as high risk. Banks, equity investors, venture capitalists and business angels invested less and less in these promising young enterprises which were considered crucial for the region's innovative character.

Following an assessment of how financial instruments could combine subsidies and venture capital funds to support innovative young enterprises, and a review of the ways to set up a fund, the managing authority decided to establish the Innovation Fund East Netherlands in July 2008. The fund invests primarily in innovative and young enterprises for which access to finance has become increasingly challenging. The fund was set up with support from the regional public venture capital company, PPM Oost.

<sup>5</sup> Carrying out an ex-ante assessment before the managing authority contributes OP resources to a financial instrument has become legally binding only in the 2014-2020 programming period.



Other resources in the region help young enterprises to bridge their financing gap. The managing authority also established the Gelderland for Innovations Fund, an ERDF co-funded financial instrument providing guarantees and microcredits for projects which need smaller investments. In addition, several national schemes increase access to finance for innovative SMEs. The financial instruments supported by the ERDF have inspired other national and regional funds. Whenever these schemes have objectives similar to the Innovation Fund, they still complement one another by addressing different target groups.

### **Solmates: Objectives**

Solmates is a young enterprise in Enschede with a new process supporting thin film, computer chip and innovative display production. Solmates develops and tests machines for the development of thin films that can for example be used in cell phones and cameras.

Developing this particular engineering process and testing new production methods was considered too risky for private financial institutes to finance. A loan from the Innovation Fund helped bring the new process to market by financing testing and the adjustment of the new technology to different environments. The first stage testing and development takes place in-house in Enschede. In a second step the newly developed processes need to be tested in actual production environments. This is done with partners in Asia, helping Solmates improve their products.



## 3 Design and set-up

The Innovation Fund is mainly built on existing governance structures, speeding up the process ahead of implementation and maintaining clarity for the stakeholders. The fund is managed by the region's venture capital company and includes EUR 6.1 million of ERDF co-funding, together with EUR 7.5 million of public funding from regional and national authorities. According to the investment strategy of the fund, an additional 50% private co-investment should be attracted at the level of final recipients. Eventually, PPM Oost managed to attract more private co-investors than originally anticipated, increasing the leverage effect of ERDF resources to 6.4.

### 3.1 Preceding events

The managing authority and regional partners had experience of financial instruments under the ERDF in the 2000-2006 programming period. These instruments combined grants and venture capital to support innovation. The intention to set up a fund supporting young innovative enterprises was laid down in the 2007-2013 East Netherlands OP.

Soon after adoption of the OP, the managing authority supported a fund with clear governance structures and streamlined processes, to fill the financing gap for young entrepreneurs. It started by checking European and national legal requirements and by seeking a strong regional partner with financial instrument expertise. From early on, the managing authority cooperated with the region's public venture capital company, PPM Oost, which has experience of implementing European, national and regional financial instruments. PPM Oost set up the fund and managed its implementation and functions as the financial intermediary.

From November 2007 to March 2008, PPM Oost assessed ERDF requirements for financial instruments and matched them to the objectives of Gelderland and Overijssel provinces as well as those of the Ministry of Economic Affairs. The fund adhered to Community Guidelines on State aid.

The next four months were used to draft investment strategy documents based on the targets of the regional ERDF OP and on other European examples, including a comparable fund in Berlin. The managing authority implemented the financial instrument by directly awarding a public contract to PPM Oost.

PPM Oost as fund manager and receiver of the public contract prepared investment strategy documents for the funding agreement. In order to receive the ERDF allocation, PPM Oost had to present its market assessment, definition of the market failure, organisational structure and detailed information on State aid.

The funding agreement was signed in July 2008 and the first investment was made in April 2009. A change of focus regarding the involvement of private investors had delayed the first investment. Private co-investors were unwilling to invest at the fund level, so the fund manager, in agreement with the managing authority, then looked for investors at final recipient level.





### Solmates: Financing gap

New technology improving production processes for thin films is costly, but with excellent potential in a growing market. Solmates needed to find partners that were willing to invest in high-risk technological development. Private banks were not interested in such developments and were even denying financing to better-known and larger players. The investment from the ERDF supported fund made it possible for Solmates to continue and grow their business.

## 3.2 Funding and partners

The main funding partners are the **managing authority**, the **financial intermediary and fund manager** (PPM Oost), **public investors** (the Ministry of Economic Affairs, the provinces of Gelderland and Overijssel) and **private investors**.

The provinces of Gelderland and Overijssel share the **managing authority** role for the East Netherlands region, which is eligible for ERDF funding.

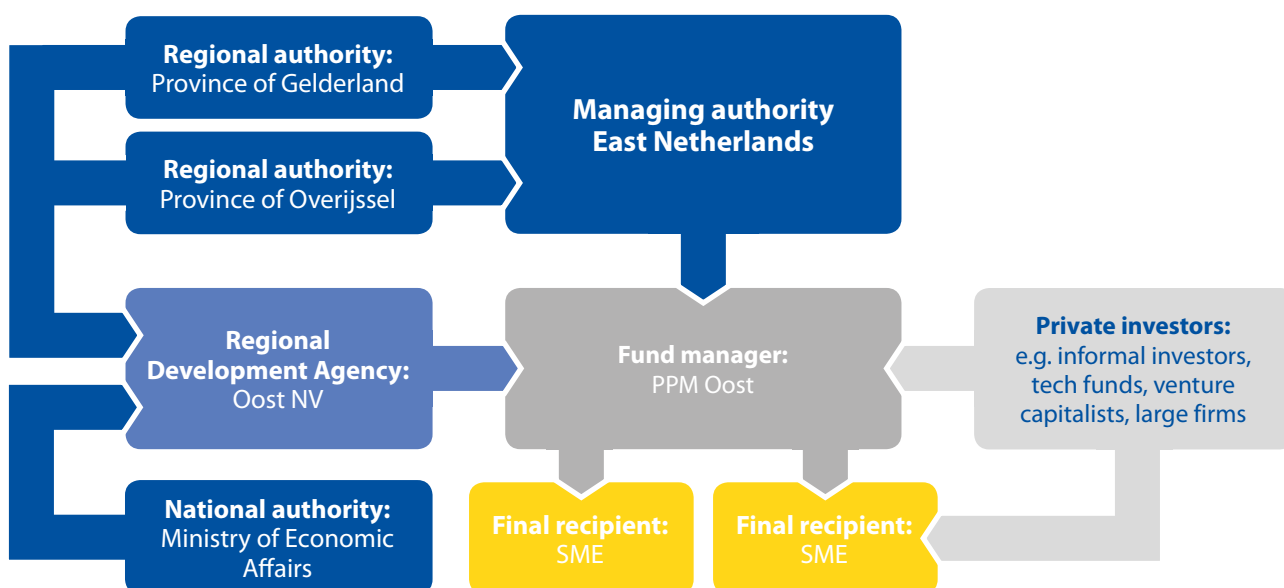
The **fund manager**, PPM Oost, is the region's venture capital company. It is a separate entity within the East Netherlands Development Agency (Oost NV) and administers government funds in the provinces of Gelderland and Overijssel.

In addition to the ERDF that provided EUR 6.14 million, **public investors** are the provinces of Gelderland and Overijssel and the Ministry of Economic Affairs, contributing EUR 2.5 million each. The shareholders in Oost NV, the parent institution of the fund manager, also act as public investors. Dutch regional development agencies like Oost NV help entrepreneurs to access capital, investing primarily in start-ups or enterprises in early stages of development. In addition to financial investments, they also support enterprises by offering training and networking. In this financial instrument, Oost NV monitors and evaluates PPM Oost as an entity within the agency. The two bodies, as publicly-owned entities, pursue public policy objectives rather than just economic objectives. Their main target is helping firms to develop innovative products and services and enabling their successful introduction to the market. Consequently, they support growth and jobs in the regions and contribute to solving large-scale social challenges.

**Private co-investors** provide at least 50% of funding at final recipient level. This is in line with the fund's investment strategy. The SMEs must find private co-investors, but these can also come from PPM Oost's network. Co-investors include informal investors, technology funds, venture capitalists, large firms and banks. Together with each private co-investor, PPM Oost decides on investments in final recipients.



Figure 1: Structure of the Innovation Fund



### 3.3 Investment strategy

The investment strategy documents drafted by the managing authority were in line with programme objectives and formed the basis for the fund, defining its objectives and increasing its impact. The managing authority coordinated the feasibility of their plans with the prospective fund manager on a regular basis. Programme objectives are evident in the fund's target group – food, health and technology enterprises in the early stages of development. Another investment strategy objective was to increase the impact of the fund by attracting private investment and was reflected in the output indicator 'number of SME projects supported'.

In addition to the measures aligning the investment and the regional objectives, the investment strategy includes details of treasury management. All revenues, including interest accrued and revenue from equity sales should flow back to the fund and be re-invested.

The strategic documents include provisions for the managing authority to closely monitor the fund manager. Twice a year the fund manager reports to the managing authority on achievements against programme targets and provides information on final recipients who received funding. In addition, the managing authority can request information from the fund manager.

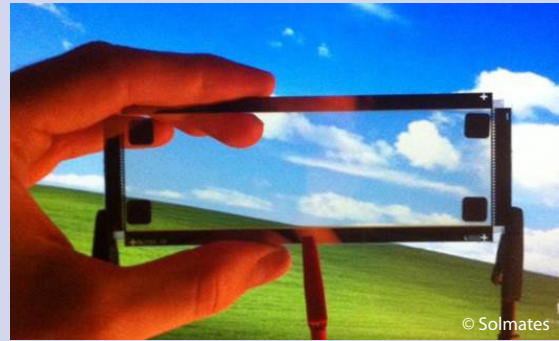
### 3.4 Governance

Decision making processes are partly based on existing structures and partly defined in the investment strategy documents.

The managing authority and the fund manager have clearly separated roles and responsibilities. The fund manager is responsible for the day-to-day management and implementation of the fund as well as monitoring achievements against the investment strategy. The fund manager set up specific systems to follow the ERDF investment. The managing authority is responsible for final evaluation and reporting to the European Commission. Since the managing authority delegated tasks to the fund manager they did not have to change or acquire new skills for implementing the financial instrument. The managing authority was mainly responsible for monitoring and control. For these tasks they could rely on their experience and existing procedures.

#### Solmates: Accessing the Financial Instrument

The founders of Solmates heard of PPM Oost at business events during the start-up phase of their enterprise. PPM Oost is very visible in the region, promoting funds under its management. Prior to applying for the Innovation Fund East Netherlands loan, Solmates had already received support from PPM Oost through another fund supported by regional resources. These established contacts and familiarity with PPM Oost procedures made it easier for Solmates to apply for this ERDF-supported funding.



By focusing on different aspects of bringing the engineering process and newly developed machines to market, both funds facilitate the company's growth, supplementing each other. Private co-investors from the regional fund subsequently made additional investments in Solmates alongside the Innovation Fund loan.



## 4 Implementation

Together with the private co-investors, PPM Oost decides whether to invest through a loan, equity or a combination of these, as well as the terms of the investment. The first transaction was made in April 2009 (Table 1). By the end of June 2015, the fund had invested in 33 SMEs, with 13% of the fund volume in loans and 87% in equity.

Table 1: Timeline related to the financial instrument

Time period	Action taken
March 2007	Adoption of the OP East Netherlands 2007-2013
November 2007 to March 2008	Examining ways to set up the financial instrument, checking procurement law and State aid regulations
March 2008 to July 2008	Drafting the funding agreement, including strategic investment documents
July 2008	Signature of the funding agreement and commitment of public resources to the fund manager
August 2008 – March 2009	Promoting the fund to attract private investors at fund-level, revision of the strategy to the agreement to attract private co-investors at final recipient level
April 2009	First investment signed
December 2015	End of the eligibility period according to the investment strategy of the financial instrument for investment of the EU Structural funds coming from 2007-2013 OP
Onwards	Fund re-investment will be managed by PPM Oost after the end of the eligibility period

### 4.1 State aid

The managing authority made use of exemptions under State aid regulations. As referred to in Decision 2008/C 125/02 Dutch regional and local authorities could grant aid for research, development and innovation compatible with the internal market, the so-called ‘Omnibus Decentraal regeling voor provincies en gemeenten intake de staasteunaspecten van subsidiemaatregelen ten behoeve van onderzoek, ontwikkeling en innovatie’. With the introduction of the General Block Exemption Regulation (GBER) these procedures have been harmonised at the European level. The managing authority made use of internal and external legal advice to comply with State aid regulations which apply at different levels.

The same terms and conditions, *pari passu*, applied for both the fund manager (public body) and co-investors, implying no State aid. Support at the level of the final recipient is covered by the GBER, which allows investment in a target group.

## 4.2 Financial products and terms

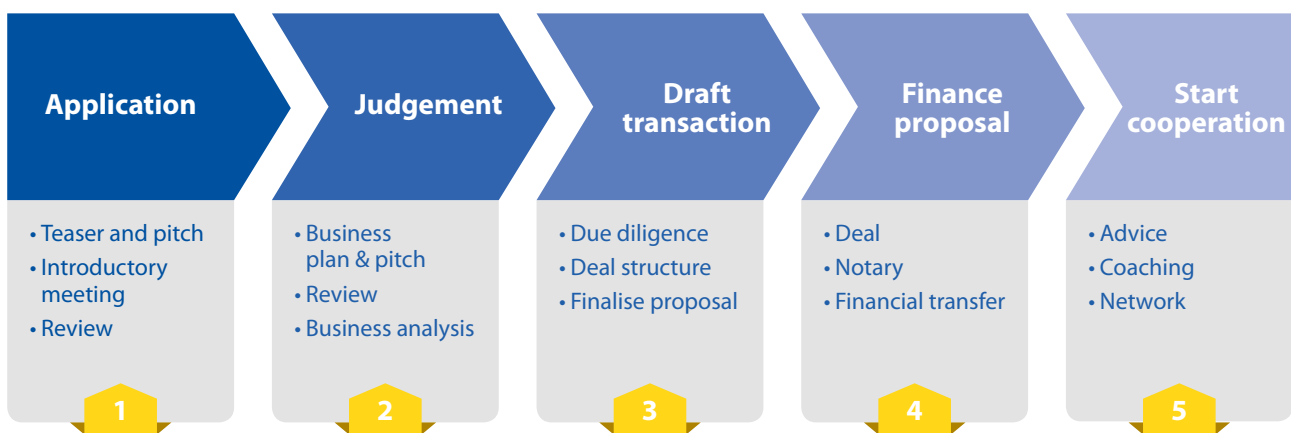
The Innovation Fund East Netherlands invests mainly through equity, but it can also give loans or combine equity and loans. The initial division of the fund's volume was 26% loans and 74% equity. By the end of June 2015 the ratio was 13% and 87%. The fund manager, together with private co-investors, decided on the financial product and its terms case-by-case.

Each final recipient's application is assessed by PPM Oost. Applications include a business plan describing the innovation, a market assessment, perceived profitability and management strengths.

PPM Oost and private co-investors make a proposal to PPM Oost's board and the investment committee, consisting of experts from large firms, research and education. The proposal for investment includes, for example, details on interest rates and a specific exit strategy.

The investment is assessed and approved by PPM Oost's board and investment committee. If the investment exceeds a certain amount it has to be approved by Oost NV as well. Investments are from EUR 100 000 to EUR 2.5 million per year and should be at least doubled by private co-investment.

When all parties agree with the investment terms, contracts are signed and the money is disbursed.



During the investment period, PPM Oost and Oost NV provide 'soft' support such as networking that is free for the final recipient. PPM Oost sometimes employs external experts with relevant business experience and nominates them to the board of directors (supervisory board) of the SME. Here they can advise and influence the SME more directly.

The exit strategy differs in each individual case. If a buyer for the equity is found before the end of the planned investment period, PPM Oost may sell their shares earlier.



### Solmates: Terms of the investment

At the end of 2013 Solmates received a loan via the Innovation Fund East Netherlands for eight years. The fixed interest rate was comparable to market rates, but the advantage was the willingness of PPM Oost to fund such a risky investment.

Solmates benefits from the knowledge and advisory service provided by PPM Oost. For example, PPM Oost provided templates for contracts, helped contact other businesses and facilitated an exchange of experience with other start-ups. The regional knowledge of PPM Oost is highly appreciated.

## 4.3 Final recipients targeted

PPM Oost translated the investment strategy objectives into a checklist for SMEs to assess whether they were eligible for an investment from the Innovation Fund. Enterprises need to be based in the intervention area (Gelderland or Overijssel), be innovative by developing new products or entering new markets, comply with the EU definition of an SME and be active in the food, health or technology sectors. The target group is in line with the East Netherlands OP.

All targeted SMEs have a high innovation profile. In 2011, final recipients spent almost EUR 7 million on research and development and almost EUR 12 million in 2012. In the EU some 70% of SMEs do not engage in formal research, but innovate nonetheless<sup>6</sup>. It is rare (13% of EU SMEs) for them to take major risks such as introducing new products and services, like Solmates did.

Furthermore, the fund manager looks to invest in enterprises with a public policy focus. The fund invested, *inter alia*, in an enterprise developing pharmaceuticals, one developing a way to rapidly identify and locate diseases and one producing food in a sustainable way.

The fund has been marketed by the managing authority, PPM Oost and Oost NV, and also relied to a large extent on marketing through social networks. The managing authority promoted the fund via its website, press releases, reports and personal contacts with entrepreneurs. Oost NV and PPM Oost promoted the fund more actively in the region through events and within its networks. PPM Oost not only advertised the fund to potential final recipients, but also to potential co-investors.

6 [http://ec.europa.eu/research/eurab/pdf/eurab\\_04\\_028\\_sme\\_era.pdf](http://ec.europa.eu/research/eurab/pdf/eurab_04_028_sme_era.pdf)



## **4.4 Changes in strategy**

Initially the fund manager was required by the managing authority to find co-investors at fund level. However, during the early stages of implementation, PPM Oost did not find any private co-investors. Before the first investment took place, PPM Oost further defined the target groups and its communication strategy, as well as the internal procedure for project selection and approval. It also agreed to include co-investors at the final recipient level.

There were no other major changes. The fund is set up to be flexible during implementation. For example, the terms of the loans and the equity investments are made in coordination with private investors and are specific for each deal.

### **Solmates: Advantages and challenges of the financial instrument**

The Innovation Fund East Netherlands invests in young enterprises that have not yet made a profit, so it is difficult for them to get financial support from commercial banks. The main advantage of the loan for Solmates is that it accelerated the company's technological development and growth. The investment strengthened the company's financial capacity, making it easier to bring the process to market. This helped to establish trust in Solmates and their activities, improving their market position and access to other funding.

## 5 Achievements

The fund is still operational and has achieved both financial and social objectives.

The leverage for ERDF co-funding was initially expected to be 4.4, meaning that for each ERDF euro spent the final recipient would receive a total of EUR 4.4, including other public resources at fund level and private co-investment at final recipient level. In reality, PPM Oost has been even more successful in attracting private co-investors. By mid-2015, EUR 39.3 million had been invested in the region, leveraging ERDF funds by 6.4.

By the end of 2012, 33 SMEs had been supported, of which twenty contracts were still running. Two of these 20 investments were considered to be excellent performers. Of the thirteen investments that had been exited, six SMEs repaid their loan, or the equity was bought by another investor. The other seven final recipients were not able to fully repay the investment, e.g. due to bankruptcy. The high proportion of final recipients not repaying the investment is normal given the high-risk of young enterprises; moreover, as the volume of these investments was limited compared to the more successful SMEs, profits outweighed losses. The managing authority and PPM Oost expect the fund to be revolving showing that, despite investing in high-risk projects, the fund had critical mass and is sustainable for a longer period of time.

Beyond the financial performance, the objectives of the OP have been broken down into result and output indicators that measure economic and social outcomes. Through the Innovation Fund, the managing authority aimed to support 35 SMEs, create 147 jobs and unlock EUR 13.6 million of private investment. By July 2015 the targets had been largely met or exceeded with 325 jobs created, 33 SMEs supported and EUR 25.7 million in private co-investment. The increased private co-investment helped the fund to create more jobs than anticipated and increase the innovation capacity in the region.

Table 2: Achievements against targets

Indicator	Target	Achievement
Jobs created (full-time equivalent)	147	325
Number of SME projects supported	35	33
Additional private investment induced in research and development	EUR 13.6 million	EUR 25.7 million

### Solmates: Achievements

Solmates was founded in 2006 and since then the company has grown from three employees to seventeen. The fund's investment created the opportunity to optimise and test the process they have developed for improving the production of thin films in actual production environments. This also allowed the company to find new partners and clients and made it possible to transfer the process to other markets, as the technology is also applicable to LED displays.





## 6 Lessons learned

The Innovation Fund East Netherlands supported access to capital for young innovative entrepreneurs. This helped SMEs to grow and the region to strengthen its innovation capacity.

### 6.1 Main challenges

At first, regulatory requirements for designing and implementing financial instruments seemed discouraging for the **managing authority**. However, with the support of the fund manager and national coordination, the managing authority found a way to set up and implement a financial instrument with no significant administrative burden. The managing authority considers that support from the European Commission has improved since 2007, in particular with documents that guide setting up financial instruments.

The **fund manager** experienced some challenges when implementing the fund and following the investment strategy requirements, specifically for:

(a) **Definition of target groups.** The key features of final recipients were sometimes defined too narrowly, or too broadly. It was difficult to use the definitions as straightforward criteria to assess whether an applicant could be an eligible final recipient. For example, since the fund manager usually invests across all sectors, it was difficult to determine whether an SME fitted within the sectors of food, health or technology.

(b) **Judgment of the innovative nature of the investments.** Looking back, the fund manager would have appreciated a more specific formal definition of this criterion in the strategy.

### 6.2 Main success factors

These challenges illustrate the **need for clarity** during implementation, which the managing authority tried to ensure when setting up the fund. This is visible in the overall strategy and governance structure. The managing authority could rely on **existing structures** and processes to mandate fund manager tasks to the region's venture capital company, while retaining the responsibility to monitor and evaluate the fund's achievements. The managing authority could also benefit from existing State aid exemptions, which reduced delays in setting up the fund. Success was facilitated by the close relationship with PPM Oost and its knowledge and capacity to assist in the set-up, design and implementation of the fund. As PPM Oost is a **public organisation** it was easier for the managing authority to align OP objectives with the objectives of the fund manager.



Another success factor of the fund is the **significant amount of private co-investment**. The requirement to have at least 50% co-funding from independent investors was a challenge in the first year, but was implemented for almost all funds managed by PPM Oost.

Several interrelated, mutually reinforcing, aspects increased the number of private investors:

- the **regional venture capital company** invested in the fund as well;
- PPM Oost made a major effort to **match its network of private investors** with applicants. PPM Oost knows the region and regional investors as well as how to convince them to get involved;
- ERDF co-funding **increased the confidence** of private investors;
- some enterprises managed to receive **additional follow-on investment**, e.g. from banks after receiving investment from the fund. Banks trusted enterprises more after receiving investment from the fund.

### **6.3 Outlook**

The fund is revolving and is using the amounts repaid and returned from exits to make further investments. Most of the investments are still outstanding. In line with the conditions outlined for the financial instruments, the fund manager invested in SMEs usually for five to eight years, though this has sometimes been extended partly due to the crisis, in agreement with the SME and the other private co-investors. The fund continues to use resources repaid and returned from exits. In addition, regional and national financing schemes for SMEs mean there is no identified need for additional ERDF contributions.



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