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CONCEPT PROPOSAL FOR FUTURE JEREMIE VENTURE CAPITAL PROGRAMS

JEREMIE programs were started in 2009, and they made a major impact on the domestic venture capital market. As a result of the programs, significant private funds have been involved in financing early-phase companies, and many of these companies have been financed on this equity basis. The programs were started in an environment in which capital was only available in isolated streams, and it was only available to companies at certain phases of development. JEREMIE programs have already produced perceptible results, however, real economic stimulus can only be achieved if the program continues. On one hand, portfolio companies that have already received financing can continue to grow with assistance from the programs. On the other hand, any company (at whichever phase of development) that has not yet received financing from JEREMIE programs would benefit from these venture capital related funds.

The economic stimulus effects of venture capital may be obvious to everyone, but only few are aware of its effect on economy recovery. Statistical data demonstrate that a 0.1% increase of GDP results in a 0.3% GDP increase in the volume of venture capital (Deutsche Bank Research, Thomas Meyer, 2010.09.14). Therefore, each Hungarian Forint invested in venture capital will produce a threefold increase in GDP. This prominent multiplier helps to understand the economic stimulus effect. As the data also indicate, it is in the interests of the country and the market participants to have an appropriate source available for venture capital investments, and these investments should be made as soon as possible in order to ensure the effect on economy recovery.

Based on the experience of the last five years, we would like to sum up the following suggestions regarding the timing and structure of the venture capital programs that will be launched in the future.

There are currently four overlapping programs that were launched successively, and because they all share the same investment period, they are manageable as a single unit. The cornerstones of the programs are as follows:

- **Co-financing:** co-funds have been established in which the proportion of the EU funds cannot exceed 70%
- **Geographic limitation**: with only one exception, the investment of funds can only be performed outside the region of Central Hungary.
- **Time limitation:** if the company was established earlier than five years, it cannot raise its capital.
- **Sectorial limitation:** due to applicable EU regulations, certain activities cannot be financed from the available sources, and therefore are excluded from the financed investment categories.

Given the experience we have gained, we are now able to reconsider the JEREMIE programs' previous cornerstones. Furthermore, we can explore how to adapt the programs so that they can continue to succeed in a corporate ecosystem with changed market conditions. In the following, we have listed our thoughts in light of past cornerstones, as well as the structure and the timing of the programs.

1. Co-financing

Beside private market investors' yield stimulation, the EU's co-financing system being the first cornerstone of the program significantly contributed – e.g. through the maximization of the yield expected by the EU and the assumption of first loss – to the success of all JEREMIE programs generating considerable interest as a result of which significant private funds have been involved in the financing of early-phase companies.

In light of such success, the system of incentives should be maintained; however, the system can be fine-tuned in response to input from domestic and international experience.

First, the proportions and incentives should be adapted to the lifecycle of the corporate segments that are to be financed by venture capital. The earlier the phase of investment, the greater the probability of bankruptcy; therefore, the risk to investors is also increased.

In the early phase of investments, providing a higher rate of EU co-financing (currently 70%) would help to prompt innovation and generate ideas. We have the following suggestions as regards the proposed differentiation:

Second, the so-called co-investment structure can be enabled and extended, which could increase the rate of the co-investment funds. There had been only one such fund in the JEREMIE's domestic program.

This type of co-investment fund would avoid widespread risk, limiting it to only one private investor rather than the whole portfolio. Furthermore, small private capital could also participate in the program, and this would increase the liability base when financing early-phase companies. Importantly, co-investment funding would readily allow investors with knowledge of a given sector to enter into more funds at the same time. Such knowledgeable and dedicated investors would also be able to directly support management with "deal-by-deal" enters. However, such direct participation by senior industry professionals (as angel investors) is often missing from domestic, emerging companies. Note that companies in any stage could benefit from these funding sources.

2. Geographical limitation

Out of the twenty-eight winning funds, twenty-seven received GOP-sourced funding; therefore, investors should recognize the funding's geographical limitation (i.e., the European Union).

The Hungarian economy's particularity cannot be ignored. First, a significant portion of domestic production focuses exclusively on Budapest and Central Hungary. Second, suitable skilled labor force is not evenly distributed or everywhere available in Hungary. Third, the portfolio companies often encountered difficulties in serving customers from the countryside. In light of these features of the Hungarian economy, many companies funded by JEREMIE programs were based in Budapest; however, their registered seats were variously listed as being in other parts of the region as a whole. The EU's examination of the JEREMIE program criticized this latter practice.

With respect to this issue, we cannot assess whether the government's room for maneuver will increase over time. However, special attention should be paid to the transfer of funds from EU sources, as well as any attempts by the Hungarian government to use some of these EU funds for its own budgetary purposes. Even if Budapest's metropolitan region—the nation's hub of economic innovation and activity—were to be excluded from analysis, outsourcing is currently an unrealistic option for Hungary.

3. Time limitation

The current program's funds can only be invested in new companies (i.e., those founded no more than five years ago). We believe that lifting this age restriction would be an effective step for the program. First, innovation often requires founders with considerable experience and knowledge of a sector. Second, for new companies founded on the basis of existing intellectual property, the transfer of this IP can be a sizeable expense and constraint to management capacity. In this respect, rather than devoting time and effort to IP transfers, management should be free to focus on a new project's launch. Third, requiring companies to transfer IP sometimes weakens the companies' management and founders. Fourth, existing activity and income from it can assure investors; thus, continuity with previous activity can reduce investment risk and improve a fund's returns. In our proposal for certain investment categories, the scope of the companies that can be funded is not defined by the date of companies' respective foundations, but rather the scale of their operations and revenues.

4. Value limitation

Venture capital typically builds on itself—multiple sources of venture capital may be provided for a single company. Co-investment of this sort allows undercapitalized or out-of-capital companies to access a larger number of capital streams. Domestic JEREMIE funds receive the greatest amount of venture capital and the greatest number of venture capital sources. As such, additional and future JEREMIE funding is all but assured at the domestic level.

Current regulations limit investment in the above-described funds (i.e., those in which the same company is financed by multiple sources). Regulations stipulate that a company's available capital cannot be increased by such co-financing. Although these regulations pose no problems during a company's seed phase, domestic financing can be hindered by such regulations during a company's growth phase (i.e., when a company's financing needs often grow rapidly). Therefore, regulatory constraints on co-financing and co-investment should be re-evaluated and (potentially) removed, at least with respect to the growth-phase hindrances that they pose.

5. Structure of the program, Distribution of life cycle

Growth funds were the first JEREMIE programs to be created. Seed funds were started as part of the JEREMIE II program. The Gazelle program, which is distinct from the JEREMIE program, was announced next. Due to a number of conceptual errors, the Gazelle program began haltingly; thus, support from the Gazelle program was not entirely consistent (i.e., some companies experienced an abundance of resources, while others were met with a relative lack thereof).

For future programs, it would be best to calibrate funding to the companies' respective life-cycles. All funding would be phase-specific—seed (angel), startup, and growth. Given that the respective phases indicate different needs of the companies and degrees of investment risk, it would be reasonable to distinguish the programs in accordance with an equivalently distinct framework and set of rules. Such an arrangement would better enable the programs to address the particularity of companies' growth phases.

Of course, there may be significant differences between the different sectors (e.g., biotechnology and information technology), and such differences will be reflected in the overall investment approach to a given sector.

Without being exhaustive, here are the following recommendations for each stage:

Appendix presented in tabular form in (a), (b) and (c) layers.

(a) **Seed stage:** this stage is intended to equip entrepreneurs with the necessary entrepreneurship knowledge, and involves the building of teams, the finding of the adequate partners, the development of the prototype and the surveying of market opportunities. At this stage the chances of failure are much higher and companies generate revenue only sporadically.

  (i) **program participant:** a business incubator / accelerator with a small fund, the maximum of 2-4 licenses in the market

  (ii) **seed stage period:** 3-12 months

  (iii) **typical capital requirement:** EUR 30,000-100,000

  (iv) **number of undertakings per incubator:** high, between 20-50

  (v) **potential amount of fund:** EUR 2-6 million

(vi) **exit:** typically 5-7 years, including next stage financing

(vii) **assumption of first loss from private investors (risk reduction):** amount of first loss: first 25%

(viii) **proportion of co-financing:** 10% from private funds

(ix) **provision of tax benefits:** In view of the extremely high risk involved in the financing of this lifecycle, we propose the introduction of tax benefits for the private investors of the fund. There are several examples of such benefits even in more developed VC markets (e.g. UK, South-Africa). Possible structure: 75% of the amount of investment into the seed fund is deductible from the private investor's tax base. This would be a significant incentive for private equity to invest also into funds other than those focusing only on later stages.

(x) **note:** It is to be achieved that the operation of seed stage funds is based on economies of scale. Providing business development services to seed stage companies require substantial expert capability, moreover, these funds make the most investments. Even in the case of the recommended maximum fund size (EUR 6 million) the 3% fund management fee may not be sufficient to cover the costs of the services. Therefore, the financing of business incubators is somehow to be supplemented, e.g. by providing non-returnable subsidies.

(b) **Startup stage:** this phase is intended to ensure entry to the market for the undertakings and launch revenue generation. The purpose is to acquire customers and ensure that the product is marketable and the company is capable of continuously generating revenues.

(i) **program participant:** the venture capital fund manager/capital fund supervised by MNB

(ii) **startup stage period:** 12-24 months

(iii) **typical capital requirement:** EUR 100,000 – 500,000

(iv) **number of undertakings per fund:** between 10-15

(v) **potential amount of fund:** EUR 3-10 million

(vi) **exit:** typically 4-6 years, including next stage financing

(vii) **assumption of first loss from private investors (risk reduction):** amount of first loss: first 20%

(viii) **proportion of co-financing:** 20% from private funds

(ix) **provision of investor tax benefits:** 50% of the amount invested into the startup fund is deductible from the private investor's tax base

(x) **note:** co-investments funds may result in substantial efficiency gains at this stage

(c) **Growth stage:** this stage is intended to confirm that the company is capable of producing continuous revenue generation and growth. In this stage it is worthwhile for undertakings to enter foreign markets and prepare for next stage, even international capital injection. Companies may even be provided with several growth capital injections, since growth stage investors frequently cooperate with each other.

(i) **program participant:** the venture capital fund manager/capital fund supervised by MNB

(ii) **growth stage period:** 24-60 months

(iii) **typical capital requirement:** EUR 500,000-7,500,000

(iv) **number of undertakings per fund:** between 10-20

(v) **potential amount of fund:** EUR 10-50 million

(vi) **exit:** in 3-5 years (occasionally, following the next stage capital injection)

(vii) **assumption of first loss from private investors (risk reduction):** amount of first loss: first 10%

(viii) **proportion of co-financing:** 30% from private funds

(ix) **provision of investor tax benefits:** 30% of the amount invested into the startup fund is deductible from the private investor's tax base

(x) **replacement capital:** in addition to capital and debt financing, we propose that replacement capital financing is also made available to the fund to the extent of such investment, in the maximum proportion of 50% of fresh capital and debt capital and 50% of replacement capital. This would in part give an incentive to founders and management owners for business development and a possibility for the more flexible buyout of funds financing the earlier stage, which would in turn create liquidity for repeated investment.

(xi) **note:** the risk for an individual fund may be reduced by consecutive investments by several funds, or significantly larger funds could be raised with the coordination of several funds. At this point it is essential to reconsider investment limits. Maximum 20% of the resources of the fund should be dedicated resources for follow on investments. Permitting the acquisition of shares to the extent of 30% of the amount of the fund (and/or) 30% of the given investment, for the purpose of the direct enforcement of sanction purchase rights (in the case of transactions also involving capital increase)

It is to be noted that at the earliest stage of the market there exists a financing niche at the so-called pre-seed stage preceding seed financing, the management of which may result in the growth of the venture capital market. Nevertheless, such niche does not necessarily fall within the scope of the JEREMIE program or the venture capital industry. In this segment the financing of research results and scientific innovations generated by knowledge bases, predominantly at publicly financed universities and research institutions, is to be ensured, as such innovations may have significant economic potential. However, the results achieved by basic research cannot be directly utilized for business purposes. As their market financing remains unresolved under the present circumstances, the chances of their market entry is minimal. By providing so-called pre-seed/proof of concept resources the analysis of the market applicability, patentability (e.g. prior art search), technical and technological feasibility of the research results achieved at publicly financed research institutions could be ensured.

6. Timing of programs

The JEREMIE I funds launched in 2010 were for a while the only funds of their type. The JEREMIE II funds commenced their investment activity at the beginning of 2013, while simultaneously the investment period of the funds established firstly was also extended. These funds were followed by those established within the framework of the JEREMIE III and IV programs. Thus at present there are altogether 28 funds operating in Hungary within the framework of the JEREMIE program.

Opinions are divided as to whether there are too many or too few funds. However, it is beyond question that the conclusion on December 31, 2015 of the investment period for all JEREMIE funds so far established is unfortunate. As no new program has been announced, the current resource abundance may be followed by acute shortage of capital. This may result in a stop-and-go system, which would pose considerable difficulties for undertakings in terms of resource planning. Moreover, if no new resources are available for venture capital investments during a certain time period, such lack of resources may undermine economic growth due to the previously referenced multiplier effect.

It would be advisable to set up a long term calendar providing precise information to fund managers planning fund raising on the dates when the state plans to launch new funds. Such predictability would be of significant help to undertakings and ensure that resources for venture capital investments are continuously available and provide continuous support to economic growth.

7. Old participants vs. new participants

In terms of the stability of the system it is also of significance whether fund managers and business incubators which are already present at the market, have gained substantial experience and accumulated social capital in Hungary and abroad are given a chance to launch new funds upon the closing of previous funds. Hungarian venture capital investors are typically generalists. Due to the size of the market they cannot specialize in a particular sector. However, there are only a limited number of such qualified experts in Hungary. Therefore, it seems expedient to keep the number of fund managers within reasonable limits. Naturally, such limitation should not entail the restriction of competition; nevertheless, it is an inefficient solution that the 28 JEREMIE-funds are managed by 24 fund managers. In addition to maintaining competition, the stability introduced into the system would provide significantly more clarity for undertakings and also make their planning easier. Therefore, it does not seem appropriate to maintain the previous restriction, which excludes fund managers that already acquired resources in one JEREMIE round from participating in the next round.

8. Transparency

It is the legitimate interest of market participants that the program operates in a transparent manner as far as possible. On the other hand, it may promote fund raising outside the scope of the JEREMIE program, if the market conditions of a given sector in a given country are transparent for potential investors. This is why sectoral statistics play a key role.

However, it is also to be considered that it may harm business interests and ultimately be disadvantageous even for the company receiving the funds, if too much information is required to be disclosed by the participants on a particular transaction, since such information could occasionally be obtained by competitors, suppliers and customers.

Due to the foregoing, we propose that in addition to the notification of transactions by the fund managers, aggregate statistical data be collected and published from time to time. HVCA also prepares quarterly and annual reports on the Hungarian market. However, not all JEREMIE fund managers are HVCA members, thus the data published by HVCA are limited. Similarly, it would not provide an overall picture, if only JEREMIE statistics were considered to be the market. Therefore, we offer to cooperate in the setting up of an overall common database, which satisfies the data needs of those interested and also ensures that the interests of companies are not harmed.

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