CLOSING THE INNOVATION GAP IN THE EU

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Revitalizing Europe's innovation: Private capital & pension funds

The case for a Savings and Investments Union to channel more capital into innovation in Europe is clear. But time is of the essence to proceed. That's why private capital as an instrument and pension funds as a vehicle could provide valuable support.

Since the creation of the EU single market the capital intensity of the European economy has grown three times less than in the United States. Europe is not only underinvesting. There is a broad consensus that its investments are not sufficiently focused on innovation, with most R&D spending concentrated in large companies operating in mature markets. As a result, Europe is missing new champions and is largely absent in key disruptive technologies. Europe risks losing its technological edge and falling into the middle technology trap, which could translate into a further erosion of its position in global trade and, ultimately, a loss of economic welfare for every citizen.

The investment paradox is twofold. First, Europe doesn't lack savings to invest. Foreign markets attract European savings. In his report published last year, Christian Noyer estimated that one euro in five saved by Europeans is invested in foreign debt securities. Savings exceed investment by four percentage points of national income. By channelling these excess savings into a domestic use, most of the investment needs identified by Mario Draghi as necessary to restore competitiveness could be met without further burdening public balance sheets. The second aspect of this paradox is that Europe doesn't innovate enough because it lacks ideas or great minds. Europe is absent from many disruptive technologies, even though many of the patents for these technologies originate from research in European universities.

Mario Draghi's report made it clear that the roots of this double paradox run deep. Resolving it will require a deepening of the single market, and the financial industry has a role to play in this. Let's face it: Europe has ample savings and great minds, but capital costs and risk aversion hinder innovation. A large body of literature suggests that equity is the holy grail of funding innovative start-ups, not least because they have no tangible assets to offer as collateral for bank loans. Unfortunately, European equity markets are underdeveloped. The market capitalization of the European economy is about a third of that of the US economy, and even lower in the eastern part of the EU. As a result, the cost of equity is much higher than the cost of debt or a bank loan for a European company - currently around 200 basis points higher - and not lower than the cost of U.S. equity, despite lower interest rates in Europe. In other words, the equity risk premium is much higher in Europe than in the US. Again, 200 basis points higher. At the same time, bank lending standards in Europe are so high, not least because of the regulation framework, that micro-businesses less than 2 years old consistently report a financing gap. All this shows that Europe faces more hurdles to scale up young companies than the US. Empirical evidence suggests that this is particularly true in the later stage of their development, when the focus is on expansion, entering new markets and becoming market leaders, what is typically when financing needs exceed EUR 50 million.

It is essential to take forward the Savings and Investments Union in all its three dimensions: developing pan-European capital market infrastructure, ensuring better access to finance for companies, and broadening investment opportunities for EU citizens. Unfortunately, Europe has been trying to make progress within the CMU framework for ten years. It has taken a few important steps, such as the introduction of legislation on European long-term investment funds in 2015; the creation of a European single access point for financial disclosure, which should become operational in 2027; and the recent decision to have a consolidated tape for stock markets. While all these measures are welcome, we, like many other observers, must acknowledge that they have not had a transformative impact.

> **Europe has savings and great minds, but capital costs and risk aversion hinder innovation.**

Time is of the essence, however. Baseline credit conditions are benign for now, despite a high degree of political and geopolitical uncertainty. So, what else can be done? First, we should consider that private capital is and will be a critical tool to support innovation, as we are currently seeing in the US with data centers. Second, pension funds could be a suitable vehicle to provide more private capital to the European economy, as is the case in some Nordic countries. In Sweden, pension funds account for almost a third of domestic venture capital. Capital deepening in the Swedish economy has been significantly stronger than in the Eurozone since creation of the single market.

Examples like this show that the innovation Europe needs is taking place but at a scale that's too small. Europe can be faster to recognize inventive solutions but must not wait for a completed Savings and Investments Union to act.

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The relationship between innovation and investment: Creating an EU that fosters innovation through investment

Innovation and investment are two fundamental pillars of economic growth and competitiveness. A well-structured investment environment can significantly enhance a member state's ability to foster innovation, leading to technological advancements, increased productivity, and overall strengthened economic resilience. Creating successful innovation clusters requires a combination of economic, institutional/educational, and societal factors – which all need to work in symbiosis.

In his report on the future of European competitiveness, Mario Draghi highlights a significant innovation gap between the European Union (EU) and the United States (US). He emphasizes that this gap is largely due to Europe's failure to capitalize on the digital innovation and on emerging technologies. Draghi points out that only four of the world's top 50 technology companies are European. To address this challenge and increase the pace with economic competitors globally, Draghi argues that coordinated industrial policies, accelerated decision-making processes, and investments of €800 billion per year are required to close the gap.

From my perspective there is no "silver bullet" or "moon-shot" strategy to close this gap. Rather, the EU needs a strategy where all member states collectively take individual action to close and finance the innovation gap. Inspiration could be found by observing the successful development of innovation in smaller economies such as Sweden, Taiwan, Israel, and South Korea can be attributed to a combination of strategic governmental policies, robust educational infrastructures, active public-private partnerships, and the effective deployment of financial resources targeted at fostering innovation ecosystems. These economies have successfully bridged the gap between research and commercialization, a challenge that remains across Europe.

Further, strategic government support plays a significant role. Countries like Sweden and Israel have invested extensively in both public and private research and development (R&D) and start-ups through governmental agencies, offering grants, subsidies, and investment to stimulate private sector innovation – especially through the defense industry. The proactive role of public-private partnerships cannot be overstated. Israel's Yozma program, which co-invested alongside private venture capital (VC), significantly boosted its high-tech ecosystem. Sweden's public investment funds such as Industrifonden and ALMI benefit from close collaboration between academia, industry, and public sector institutions creating strong innovation clusters. Swedish public pensions funds have also had a broad mandate for non-public investment, contributing to large investments in innovative companies.

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By learning from successful small economies, Europe can not only develop more dynamic funding mechanisms, expanding pensions funds mandates thereby improving access to private equity and venture capital, and enhance public market incentives; but also give people the confidence to become entrepreneurs. The Commission and member states need to take collective action to close the innovation gap by creating incentives for both private and public sector investments in innovation. To achieve this capital, needs to be allocated to academia and start-ups whilst actions to further strengthening the Single Market and the Capital Markets Union. Member states also need to act by creating incentives for citizens to invest by creating tax-incentives and investment accounts like Sweden's Investment Accounts (ISK).

Summing up, a society that fosters innovation through investment requires a multi-faceted approach, involving strategic R&D funding, broad array of investors, incentives to increase cross-border business, and strong public-private collaborations. This requires coordinated action both on member state and EU-level. The European Commission's Competitiveness Compass will play a vital role in ensuring coordination and exchange of best practice between member states. It should be accompanied by a new Juncker Plan, where we can activate private investments in innovative companies with public guarantees. By addressing these structural challenges, Europe can bridge its innovation gap and reestablish itself as a global leader in technological advancements.

DAVID SERRERO

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Promising European Tech IPO candidates will successfully meet financial markets

Why do many European unicorns choose to list in the US rather than in Europe?

The attractiveness of the US is structurally linked to the depth of its investor base, which is larger, wealthier and more specialised, as well as to its larger pool of listed companies, which offers greater comparability. Finally, the US is the largest market in the world for certain industries such as pharmaceuticals, biotech, and software.

Delving into the details, since 2018, only 50 European companies have gone public in the US, accounting for less than 5% of the total number of listings of European companies. Among these, 60% are from the Healthcare sector.

For which results? Euronext-listed issuers achieve higher valuations than US-listed European issuers. Liquidity in Europe and the US is at par for mid and large cap equities.

What explains the lack of attractiveness of IPOs for young, innovative and successful companies?

Innovative start-ups often offer a risk/return profile that is in line with the mandates of venture or growth investors. In addition, venture and growth investors raise far more funds than European SMID funds and specialise in technology. IPOs should ensure continuity of funding at more mature stages, when the innovation has demonstrated that it can create a new market or replace an obsolete one. But Europe's financial markets face headwinds.

Firstly, the shortage of tech investors is illustrated by the very low allocation of European funds to the tech sector: only 4% ($0.1T) is directed towards software and another 4% ($0.1T) towards hardware, compared with 16% ($2.7T) and 13% ($2.2T) for U.S. funds, which limits Europe's capacity to finance tech.

Secondly, the financial performance of Tech IPOs over the last 5 years has been very poor, declining by an average of 49% among the 15 French Tech IPOs examined, with only two out of the 15 showing a positive return.

When examining the total amount raised though IPO transactions over the past five years, European IPOs have raised $156 billion, which is three times less than the $436.5 billion raised in the United States during the same period."

How can we boost the financing of innovation through IPOs in the EU?

To improve the attractiveness of IPOs, we need to attract stock market investors to IPOs in Europe. This can be achieved by offering them high-quality companies with a risk profile that align with their investment mandates: companies with strong customer validation of their products and able to demonstrate their profitability in the short term. Most importantly, valuations should accurately reflect the IPO risk, offering a discount of approximately 20% compared to listed peers or M&A transactions.

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At the same time, on the demand side, investors need to create specialised vehicles dedicated to investing in tech IPOs in order to make the market attractive to companies. This is precisely what we have accomplished with CDC Tech Premium. The Fund was created two years ago by CDC Croissance with the support of Group Caisse des Dépôt and Bpifrance. CDC committed 300 M€, supplemented by an additional 50 M€ from a leading insurance company. We received the Tibi approval in 2023.

What exactly are we financing? We finance Innovation and growth, we provide liquidity to venture capital and private equity and we facilitate post-IPO financing and liquidity.

How do we invest? We invest at the IPO or post-IPO stage through capital operations such as accelerated book building or follow-on offering. Our focus is on French and European companies within the Eurozone, with a preference for listings on Euronext and a priority (but not an exclusivity) on France. CDC Tech Premium targets strategic Tech companies with global market potential, across all sectors including energy, marketplace, robotic, medtech, biotech... We select companies with a market capitalization between €300 million and €7 billion as we seek firm with a certain level of maturity.

Last but not least CDC Tech Premium is a Cornerstone Investor taking a significant part of the free float. What are the benefits of this strategy for the market? We work on a fair valuation reflecting the IPO risk, we give advice on the equity story and the guidance and we ask for ESG practice improvement. How do we benefit from it? By receiving 100% of the shares we request, regardless of the book coverage. Additionally, as a cornerstone investor, our name is mentioned in the prospectus, enhancing our reputation in the market.

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Strengthening the EU's attractiveness for scale-ups and innovation

Europe has long been a hub of technological innovation and research, yet it continues to struggle with the retention of high-growth companies and the concentration of financial resources on the most promising sectors of the future. By comparison, the U.S. economy and its current exceptional equity market performance in 2023 and 2024 was in large part driven by its digital and technology companies, the so-called Magnificent 7. Their outstanding profitability and earnings-per-share (EPS) dynamics have contributed to roughly a third of the market capitalization of the S&P500 and around 60 percent of the S&P500 performance.

This allows these companies to invest billions of US dollars into research and development, thereby fortifying their global leadership position. For Europe to gain competitiveness and becomes less dependent on the U.S. and China in technology and digital services, policymakers at both national and EU levels must create an ecosystem that fosters technological and digital innovation, provides adequate funding, and reduces bureaucratic and talent hurdles for scale-ups.

To enhance the European investment ecosystem, an important first step is to strengthen venture capital and private investment. One of the primary reasons why European scale-ups relocate to the U.S. or Asia is the relative scarcity of late-stage venture capital. To counter this trend the EU should expand initiatives like the European Investment Fund (EIF) and European Innovation Council (EIC) Accelerator, focusing on later-stage funding. The EU should also encourage pension funds and institutional investors to allocate more capital to high-growth European start-ups by providing tax incentives or reducing regulatory constraints. It should promote cross-border investment funds that enable investors to support companies regardless of their country of origin within the EU.

A second key initiative is the creation of a unified European IPO market. European scale-ups often list on the NASDAQ or the New York Stock Exchange instead of European stock markets. To change this, Europe needs to develop a single, harmonized European IPO framework that reduces red tape and makes listing in Europe more attractive. The EU should offer financial incentives for European stock exchanges to support high-growth technology firms and to improve the liquidity in European financial markets to ensure competitive valuations compared to U.S. exchanges.

Europe should expand public-private partnerships and embark on more government-backed initiatives to de-risk investments in key sectors. This could take the form of launching co-investment programs where governments match private venture capital funding for innovative projects or establishing technology-specific investment funds focused on key areas as identified in the Draghi Report: AI, quantum computing, biotechnology, and clean energy.

> Europe needs to strength its digital and technological sovereignty.

Europe also must streamline regulations for scale-ups. The EU's fragmented regulatory landscape is a major deterrent for growing companies. To ease this burden Europe needs to harmonize key regulations across Member States, especially in data privacy, digital taxation, and labour laws. Introducing a "scale-up visa" to enable fast-track hiring of talent from outside the EU would help ease qualified labour bottlenecks. Simplifying tax structures and offering targeted tax incentives for R&D-intensive businesses would also help. Many start-ups struggle with complex bureaucracy when scaling across multiple European countries. Europe needs to move to implementing a single digital platform where companies can manage compliance requirements across all 27 Member States. It needs to standardize corporate tax reporting procedures and reduce the administrative burden associated with receiving EU funding.

To gain competitiveness, Europe needs to both retain its highly skilled workforce and attract global talent. Many European start-ups struggle to hire the best global talent due to restrictive immigration policies. Europe must implement a pan-European "Tech Talent Visa" for high-skilled workers in key industries. It needs to offer tax incentives for highly skilled foreign workers who relocate to the EU and work on improving mobility programs that allow researchers and innovators to work seamlessly across Member States.

Finally, in an increasingly hostile era of tariff threats aimed at reducing international trade dependencies in goods and services, Europe needs to strength its digital and technological sovereignty. To reduce dependency on foreign technology providers, Europe needs a quantum leap in increasing its investment in EU-based cloud computing, AI, and semiconductor industries. The EU and national governments should support European alternatives to major U.S. and Chinese tech giants and develop a unified European strategy for critical technology supply chains.