Talking point

Investment grant for business angels: An imprecise instrument to fund startups

July 3, 2013

Germany's new investment grant is a direct subsidy for business angels that is intended to promote the funding of more (innovative) startups. Starting with business angels is an appealing idea, but the instrument runs the risk of producing undesirable windfall gains. What is crucial for the economic impact is ultimately not the number of startups, but rather their success in the market.

There is no doubt Germany needs to catch up with other countries in terms of starting up innovative firms. According to the Global Entrepreneurship Monitor, Germany ranks poorly by international standards in terms of nascent entrepreneurs and new firms. Investments by venture capital funds – a key indicator for particularly innovative and high-growth startups – are reported to be much lower than in the leading regions, i.e. the United States, the United Kingdom and Scandinavia. This gap to the leaders results in measurably lower growth and also explains why German companies do not play a major role in many new business fields. 1)

Need to catch up on innovative startups

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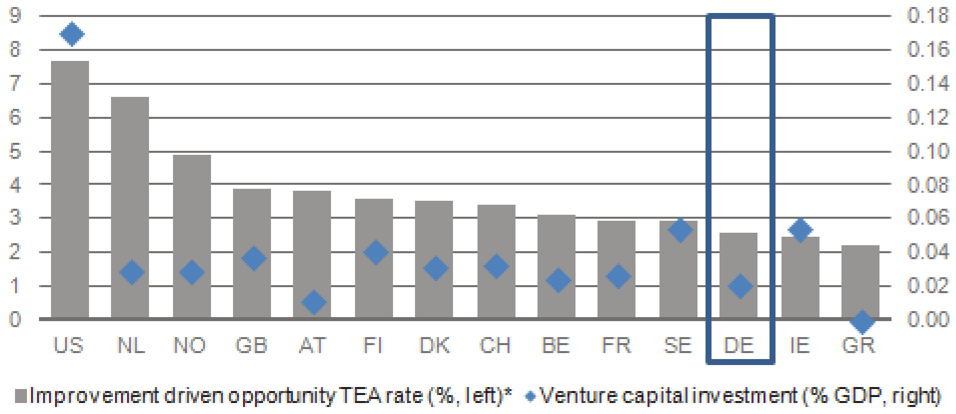

*The TEA rate measures the share of nascent entrepreneurs and new business owners in the total population (TEA = Total Entrepreneurial Activity). Only those startup entrepreneurs are counted who start a business with the intention to commercially exploit an opportunity and thus aim to improve their situation (improvement-driven opportunity TEA).

Sources: Global Entrepreneurship Monitor, EVCA, NVCA, IHS Global Insight, DB Research

It is therefore generally encouraging that the German government is addressing this issue. The new investment grant, which under certain conditions enables business angels to be reimbursed for 20% of the amount invested, became available in May. Only a few weeks have passed since then and the grant has already proved very popular. A total of EUR 150 m has been earmarked for the programme up to 2016. For every startup investments of up to EUR 1 m per year may be eligible for this programme. This is a respectable order of magnitude.

The idea of addressing business angels certainly has appeal. Independent investors, it is hoped, will not only support a startup with capital, but also offer management expertise and establish contact with important business networks. At the same time, they invest with the intention of making a profit. The two aspects should help to ensure that startups are professionally run and tuned to be a commercial success.

Furthermore, boosting the investment clout of business angels has the advantage of relieving the strain on the next stage of the funding chain. Business angels usually play a key role in the early-stage funding of a startup. Later, the startup's capital requirements often exceed the capacities available to informal investors, and that is when other investors, such as venture capital funds, step in. The smoother the functioning of early-stage funding via business angels, the stronger the companies that then receive next-stage funding. Progress is needed here, since venture capital funds in Germany invest only about one-eighth of the amount per company that is invested by US funds, for example. This prevents the emergence of economies of scale, and growth stimuli fail to materialise.

Better to focus on the outcome

The investment grant for business angels is a very imprecise instrument for reaching these objectives, though. It is unable to distinguish between nice but economically insignificant niches and potentially market-moving business models. Nobody can do so in the early stage of an enterprise's establishment. So the grant runs the risk of producing windfall gains to firms not even aspiring to be “the next big thing”, thus wasting resources and distorting the capital allocation.

Startups are not an end in themselves. The economic value does not lie in having the largest possible number of startups, but rather in having several successful companies of market-relevant size emerge from the cluster. They are the ones that establish innovative technologies, create new jobs in significant numbers and bring pressure to bear on longstanding market incumbents.

It is therefore important to consider the outcome of startup promotion: what will have to change so that innovative startups find it easier to succeed in the market? Such a perspective has the advantage of tracking both the macroeconomic aspect and the investment incentive for venture capitalists. After all, the investors reap massively higher gains if, for example, the startup is floated on the stock exchange (IPO).

The relevant package of measures has already often been the subject of debate: migration, education, reduction of bureaucracy and competition policy, but also societal beliefs about nascent enterprises and new businesses are important buzzwords. On the capital market side there is a need, for example, for powerful equity markets: our research shows that the countries boasting the leading venture capital markets also stand out insofar as their research-intensive companies have higher stockmarket valuations than is the case in Germany. This means that IPOs of successful startups can command higher prices. This in turn fosters the incentive to invest in startups.[2)] Of course, it is simpler to offer a small investment grant than to change deeply anchored institutional norms, let alone societal values.

Germany's new investment grant is a direct subsidy for business angels. This is an imprecise instrument for increasing the number of innovative startups. Now it is time to pave the way ahead. After all, it is only when startups can successfully compete in the market that they develop a more pronounced macroeconomic impact. In this respect, much remains to be done.

[1)] See, for example: Meyer, Thomas (2008). Venture Capital: Bridge between idea and innovation? E-conomics 65. Deutsche Bank Research. Frankfurt am Main.

[2)] Meyer, Thomas and Philipp Ehmer (2011). Capital markets reward R&D. E-conomics 83. Deutsche Bank Research. Frankfurt am Main.

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