



HELSINKI UNIVERSITY OF TECHNOLOGY
Institute of Strategy and International Business



International Research & Policy Seminar Series on Venture Capital 2006-2007

The objectives of the Norface Research seminar series are simply stated.

We believe that contemporary and future policy making in the financing of early-stage entrepreneurial and innovative firm activity can be assisted by closer reference to the growing international corpus of academic research. Further, we believe that both policy makers' and academics' professional interests can be furthered by a closer association between the users and providers of research activity. Policy makers can contribute important and insightful research questions and the resources to assist academic analyses. Similarly, academics with international research experience can be useful agents in both in the dissemination of current knowledge as well as the analysis and future design of national programmes.

In order to realise the above objectives, Professor Gordon Murray (Exeter) with his co-sponsors, Professor Markku Maula (Helsinki University of Technology) and Professor Dietmar Harhoff (LMU Munich), have initiated a series of three research policy seminars involving both senior academics and policy makers from several countries. These seminars are designed to communicate existing policy-focused research activity and to influence future research programmes. They have to date been financially supported by the UK and Finnish governments, the European Investment Fund as well as by NORFACE, the Europe-wide partnership of twelve national research councils.

The first seminar was held in London on the 4-5th April 2006 and was co-hosted by the Small Business Service of the DTI. Approximately 55 senior policy makers and academics were represented from ten European Union countries plus policy delegates from the European Commission, the European Investment Fund and the Australian and New Zealand industry ministries.

The first seminar agenda and discussions re-iterated from a both policy and academic perspective:

1. the manifold difficulties associated with equity-based new ventures investment.

Given that long run performance statistics clearly show that European early-stage venture capital has on average resulted in lower investment performance than US funds, the question is how we can significantly improve the returns of European VC funds. A significant body of research has shown that VC fund performance is largely influenced by fund size (positive effect), industry specialization (positive effect),

narrow geographical focus (negative effect), early stage focus (negative effect), syndication (positive effect), and experience (positive effect). Despite the ample research evidence supporting the superiority of larger and more professionally managed VC funds, governments have continued to create and sponsor small funds that have very little chance of achieving their desired commercial or policy goals. In addressing market failures, VC policies should focus on pragmatic policy measures and instruments that lead to a sustainable and better performing European venture capital market.

- 2. the critical role of scale and scope economies on the viability of early stage VC funds.** From the overall discussion of performance determinants and the long run performance gap in early stage investing between the United States and Europe, an important area for deeper focus was considered to be the importance of achieving scale and scope economies in venture capital partnerships. Public-supported VC funds directed at areas of market failure are particularly likely to be too small. If the management fee of the partnership is to cover the fully commercial operating costs of a fund, the fund must be of sufficient size to be able to employ professional managers and to attract professional (institutional) investors. The high fixed costs of a small fund, relatively inelastic transaction costs in relation to the investment size, limited opportunities to diversify investments, and insufficient finances to follow-on invest in rapidly growing ventures make the successful operation of a sub-optimally sized fund extremely difficult.
- 3. the limitations of ‘equity enhancement programmes’ to correct for underlying poor fund returns.** Based on earlier US experience, various types of equity enhancement schemes have been developed and tested in several countries. The Enterprise Capital Funds model in the United Kingdom is one of the most recent examples. However, such schemes do have important limitations. In specific circumstances where the causes of the market failure are very intractable and institutional investors remain highly pessimistic based on historic experience, the economic incentives created by asymmetric profit sharing arrangements may not be compelling enough to attract sufficient amounts of private investment. (Furthermore, the notification process related to the EU state aid regulation has until recently also impeded the introduction of such schemes.) However, despite these limitations, such programs can under certain circumstances be effective in encouraging private investment into market failure areas where, in the absence of government support, it would otherwise be difficult to attract competent general partners and investments. Some of the key findings concerning equity enhancement schemes are that it is important to design them to create unambiguous commercial incentives that reward good performance and thereby attract talented and experienced investment managers. Research has shown that upside incentives – via increasing the rewards for performance but not limiting the risk - are more effective than downside guarantees that compensate investors for the consequences of adverse selection. Furthermore, the fund operators should be selected through an open and informed, competitive bidding process in order to avoid market distortions and the selection of inappropriate management (general partner) teams.
- 4. The tendency of early-stage programmes to ‘drift’ away from the targeted recipients, e.g. nascent businesses.** As a direct result of the difficulties of managing small VC funds, history has shown in Europe a pronounced and consistent trend. Over successive fund raisings, the best managed small VC fund managers have rapidly

increased the total value of funds under their control. These subsequent funds have been invested predominantly in later stage, more established businesses rather than in start-ups or young firms. Many such venture funds have metamorphosed into 'private equity' investors focused exclusively on buy-outs and the purchase and leveraged re-financing of mature businesses. For venture capital policy makers, this finding and the underlying research suggests that small, early stage funds may not be viable economic entities in the long run. Conversely, rather than supporting the creation of such transient funds, the state should find incentives that will encourage the management of larger and well established VC funds to invest a percentage of their finances in earlier stage deals including start-ups.

5. **the universality of these issues regardless of context and geography.** Despite local differences between participating countries, many of the issues in venture capital policy appear to be universal. For instance, although it is difficult to measure the exact magnitude and location of market failure areas in different markets, there exists a largely uniform view in each of the participating countries concerning the problems in availability of professional private risk capital for early stage ventures. For example, there is a Europe wide dearth of 'seed capital' from professional VC firms. Given that these problems appear 'generic', this might provide optimism that identified policy solutions will also have a wider international relevance.
6. **the continuing commitment of government to support early stage VC programmes despite current difficulties.** Given the accumulating evidence of the importance of a functioning venture capital market for entrepreneurship, innovation, and growth of the economy, it is important that governments continue to support the development of early stage venture capital markets. In so doing, it is also important for the governments to learn from past initiatives in order to develop an increasingly effective mix of risk capital policy measures. Such learning should be international in scope given the myriad VC policy experiments across developed economies. The challenge remains to encourage both the supply of risk capital from professional investors as well as the flow of high quality ventures that are 'investment ready'. Of considerable importance, such public initiatives should attempt to intervene cost-efficiently and with minimal disruption to existing capital markets.
7. **our still partial knowledge of the key factors influencing programme outcomes and the limited tools presently employed in making robust comparative analyses.** Collective experiences and empirical evidence of effective policy measures are still quite fragmented. Such information that does exist often remains poorly communicated and, in consequence, often under-used. Policy makers have little time to read academic articles, and academics have not always done their best to make their analytical conclusions clear and easy to grasp. There is also a need in policy evaluations for increased use of comparative analyses and deeper investigations of the causal factors that may influence the success of policy measures. The achievement of such goals would be materially improved by greater international collaboration between academics, consultants and policy makers. Overall, there is a clear need for improvement both in communication and intent between academia and policy makers in Europe and elsewhere in order to facilitate learning from past experiences. The utilization of such knowledge is arguably an important pre-condition for better venture capital policy. Several London delegates commented on the timeliness and

importance of the objectives of the NORFACE Venture Capital Policy Research seminars.

Policy makers and practitioners have strongly expressed their interest in the sharing of rigorously appraised findings on the availability and feasibility/value of alternative policy interventions to stimulate the genesis and growth of high potential young firms. Such comprehensive support for the Norface seminars is an indication of the potential value of co-ordinated policy/academic work.

The first London seminar was very much an opportunity to learn effective ways of managing future debate between two different sources of expertise. Automatic and frictionless communication between two informed and interested groups cannot be assumed. Processes need to be employed to 'extract' and place in a coherent context the deep levels of experience and analysis held by the delegates to the seminars. Accordingly, it is important that future seminars in Helsinki and Berlin address the following issues:

1. the formation of precise and relevant policy/research issues for discussion
2. the collection and management of diverse but relevant information from both practitioners and academics (including pre-seminar preparations)
3. the engineering of an active debate to clearly specified and communicated objective(s)
4. the effective dissemination of research/policy findings including a summary of what is know and not known to all interested parties
5. the identification of collaborative (multi-country?) interest in the commissioning of future research activities to address present 'unknowns'

The next seminar will be hosted in Helsinki on October 17-18, 2006, with the support of the Finnish government (MTI), the European Investment Fund and Norface. Preparations are already under way to ensure that the widespread enthusiasm engendered in London from all parties can be built on to ensure more tangible outcomes from the next two seminars. Accordingly, the Helsinki seminar will focus on three identified important themes: (1) ways to encourage informal investment in entrepreneurial ventures, (2) cross-border venture capital and progress towards a single market for entrepreneurial finance in Europe; and (3) identifying an agenda for future research on VC policy. The third NORFACE seminar to be held in Berlin in Fall 2007 will cover demand-side issues such as the improvement of quality and quantity of deal flow. (The Berlin seminar focus will be determined in part by the outcomes and interests of the delegates to the Helsinki seminar.) Further information on the forthcoming Helsinki seminar will be circulated in the near future.

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4th May 2006