Venture Capital for Knowledge Economy

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<th>Draft text of Recommendations</th>
<th>International</th>
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<td><strong>1</strong> State of Play: VC in Europe and in US</td>
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Comparison of VC flows between EU and US is very clear: due to fragmented European market there is twice as many companies receiving VC investment, but the average size of investment in US is more than 4 times bigger than in EU. In Europe 40% of all VC investment go into start-ups and early stage, while in US this share is less than 25%. Consequently, in US over 75% of VC investment are realized into
expansion and later stage business developments, and in EU this share is 60% - showing that VC is one of the “normal”, mainstream sources of corporate finance.

Consequently in US the VC-backed companies provide 11% of all private sector employment, and 21% of total corporate revenue compared to GDP. This is a clear indication of knowledge economy, and Europe has to make VC an equally important instrument of dynamic growth, by identifying cultural, market, regulatory and other barriers, and urgently introduce measure which will address these barriers.

Concerted and energetic action is needed to create the conditions in which VC will become a powerful instrument of building European Knowledge Economy and help it regain its international competitiveness.

Understanding the mature of VC

The nature and importance of VC is not fully understood and appreciated, particularly in Europe. Though it represents only a small share of total business investment in most economies, and in some even marginal share (in terms of % in GDP in 2008 it was 0.05% in US, and only 0.02% in Europe), it usually contributes essentially to dynamic growth of knowledge economy and deserves much higher priority among policy efforts in order to create conditions necessary for stimulating innovation and mobilising private capital to turn new ideas into sound and sustainable business.

Venture investment takes place in a very inter-personal context, but depends very much on regulatory and fiscal conditions created by government. VC will give its contribution to economic prosperity of a nation only if and when there is sufficient stock of private capital in the hands of rich and experienced business people, who are ready and entrepreneurial and interested to risk their personal money with prospects of high profit, as well as creative innovators seeking financial backing and guidance in return for partnership (usually stocks) in their normally young company. In US they think of and deal with individuals, while in Europe we automatically turn to institutions (and expecting banks to play a role in VC investment). In Europe we lack ambitious, high growth companies, and there are fewer funds available for venture investment.

Authorities, business associations, economists and opinion makers should increase their efforts to put VC into public focus and enhance the appreciation of politicians and government officials of this important instrument of innovation and wealth creation.

Fragmentation of European VC Industry

Barriers to integration of European VC markets:

On the supply side: VC funds face obstacles when investing across borders in Europe, since they are often liable for separate registration or establishment in each Member State, which increases costs and time spent for fund structuring. Some larger VC funds that are nevertheless operating across EU borders have to channel investments through complex and costly parallel vehicles established in other countries. National regulatory frameworks could be more responsive in recognizing the need for VC funds to be able to invest outside their home market without having to establish parallel structures.

On the demand side: many innovative and high-growth firms face difficulties in accessing equity finance. Although external equity capital is an important source of
financing only for a limited number of innovative firms, understanding its importance for growth financing is essential also for entrepreneurs. Improving entrepreneurs' investment readiness is the necessary counterpart for improving the supply of venture capital and providing basis for a rapid expansion of high-growth firms. EU and member states should act decisively to support gradual integration of European VC markets.

Public Private Partnerships

There is room for improvement in public policy for the purpose of strengthening public-private partnerships and boosting initiatives in the early stages of commercialisation and the innovativeness of small businesses more generally. There are good reasons to learn from existing good practice. The US Small Business Innovation Research (SBIR) programme, which specialises in this area, merits careful scrutiny. The varying approaches of the Nordic countries lay the basis for other observations and lessons.

Selecting deals to be supported

Increases Deal Flow and Leads to Market-Driven Funding Decisions in a style akin to Monday morning partner meetings held at venture capital firms across the nation, TechColumbus regularly convenes a unique gathering of venture capitalists, angel investors, domain experts and other commercialization specialists for the Deal Flow Assessment Committee (DFAC). The DFAC brings together local sources of deals and capital for deal sharing, collaboration and enhanced communication. DFAC members evaluate potential opportunities from grass roots and institutional sources and determine the best steps and resources to help an idea or company advance to the next stage of formation.

One of the key responsibilities of the DFAC is to initially screen all startups in contention for TechGenesis and TechColumbus Pre-Seed Funding and to make recommendations to the TechColumbus Investment Committee as to which of these startups represent the strongest promise for yielding high-growth companies. Even those companies who don't receive funding, benefit from the process of presenting before this diverse group of experts. This is a practice worth studying in detail and to learn from.

Motivational environment for risk-takers

It is imperative that the public sector strives to operate so as to compensate for the lack of private capital provision in areas where there is a strong social motivation for investment, but also so as to catalyse better functioning private markets. In addition, the public sector needs to give high priority to ensuring appropriate conditions for the individual entrepreneur and risktaker – in other words, an operational risk-reward ratio for the human being who ultimately stands behind any potential high-growth venture.

There is also a need to push reforms so as to alleviate the distortions that deter risk-taking. The risk-reward ratio confronting the individual needs to be scrutinised and improved in many cases, for example by tax reforms and initiatives to improve societal attitudes towards entrepreneurship. Necessary tax reforms that may be considered include the reduction of capital gains taxes, which could stimulate more
Risk-taking and entrepreneurship. This must be combined with consistent reforms that raise the ability of institutional investors to diversify sources of venture funding. There is also a need to strengthen business angel networks and their links to technology incubators and complementary support services.

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<td>Venture-backed companies also require a reasonable, efficient and predictable regulatory apparatus. Due to the relatively long-term investment horizons (typically five to seven years and often longer) and the uncertainties inherent in new product development, venture capital is already one of the most risk-intensive asset classes in the world. Additional delays and uncertainties caused by swings in regulatory policy, inconsistent guidelines and processes for federal agency approvals and slow-moving bureaucracies can push the risk profile of even the most exciting innovation beyond what a venture capitalist can consider acceptable. A promising company has a greater chance of receiving venture funding if there is transparency around the regulatory approval process through which it will move. National authorities should secure full transparency of the approval procedure.</td>
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<td>Strong investor protection leads to liquid capital markets and deal flow and exit opportunities, which ultimately affects the attractiveness of a country’s VC markets. This ultimately affects a country’s attractiveness for institutional investments in the VC class. However, this discussion reflects the capital supply side only. Without a sufficient entrepreneurial culture and entrepreneurial opportunities, with rigid labor markets, bribery and corruption, there will be no demand for VC. If there is no demand, there is no opportunity to establish a vibrant VC market.</td>
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<td>Most VC investments in emerging markets go to revenue generating or profitable companies rather than early-stage ventures. One important barrier to developing vibrant early-stage investment in emerging markets is the dearth of entrepreneurship education in their engineering and science schools. Early-stage VC investors also shy away from seed or start-up companies when the founders lack an understanding of how to start, build and grow a substantial company. It is simply too much work for investors to engage first-time teams. Building an entrepreneurial curriculum into science and engineering education is as important as building incubators.</td>
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<td>Governments can facilitate forward and backward local linkages from subsidized firms, and they can also foster spin-off entrepreneurship, appropriately constrained by intellectual property protection. Yet, there is a role as well for global governance, particularly (as in the case of high skill migration) with respect to smaller countries that lack the leverage to impose conditions on foreign investors. Global norms and rules need to be devised that would enhance the odds of domestic or intra-regional spillovers.</td>
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### European Stock Market and uniform tax rates

The goal of policy makers should be to support a **single European stock market**, which is appropriate for an **investment exit via IPO** to realize higher investment returns for VC investments in Europe. Imaginable is a European stock market segment like the AIM in UK where investors have essential tax benefits if they invest in companies traded on AIM. Mother instrument to spur early stage investments which follows the same goal is to **implement low tax rates for potential portfolio firms**. This also enhances the value of the firm and makes it more attractive for venture capitalists to invest in Europe. This strategy seems to be more effective than a direct subsidy for innovative SMEs. A **uniform tax regulation for Europe** might enhance transparency, but it impedes competition for a best practice solution and does not account for country specific conditions.

### Enhancing cross-border activity

In recent years, **cross-border venture capital** has become an economically **important phenomenon**. However, while globalisation of VC activity gradually becomes a reality, a number of impediments still exist hindering the convergence of **markets** and the development of a full-fledged global industry. This is true not only between developed and developing regions, but also between venture markets throughout the most collaborative regions such as North American and Europe. The ability of venture capital markets to get involved in flows of investments across borders largely depends on the maturity of the industry. Moreover, the **lack of sufficient infrastructure** prevents crossborder investments from taking place. **Legal structures** which are nation-specific create border-issues that are not easily transpassed, and complicate collaboration between actors located in different countries, especially when in regard to support of high-risk ventures. Where governments are directly involved in transactions, additional issues arise. Countries and regions with **heavy public venture capital involvement** tend to find themselves with certain **limitations in their investment strategies**. Governments should ensure that investment policies are adapted to the ongoing globalisation process, putting in place structures and playing rules which can enable and support cross-border activities and investments.

### Quality of public policies

These policies establish the playing field - they further or hinder VC activity on many levels:

— **Entrepreneurship-friendly regulation** (such as low taxes, little red tape, protection of property rights, a reasonable bankruptcy law) lowers entry barriers. High costs of starting a business, for instance, are a drag on entrepreneurial activity.

— **A liberal immigration policy** designed to attract the best talents from all over the world can spark entrepreneurial activity. Many founders of hightech startups in the US were born abroad.

— **Research and technology policies**: a high level of education and strong technological capabilities are the foundations on which the most interesting startups thrive. Co-operation with academic institutions are important sources of knowledge transfer.

— **The tax and legal framework** governing VC activity itself is a somewhat contentious issue – not least the new AIFM directive (for an industry perspective, see the statements by EVCA). Some rules appear to be geared towards bigger buyout or
hedge funds and put disproportionate burdens on smaller VC funds. All of these concerns should be taken into account in determining instruments of public policies affecting VC.

14 Mutual recognition of venture capital funds from other jurisdictions

A fund should be established and registered only in its home jurisdiction and should be recognised in other Member States and not be liable for separate registration or establishment in each jurisdiction. National authorities could recognise that venture capital funds domiciled in another country and operating in their market are already subject to regulatory and taxation regimes in their country of residence.

Steps could be taken towards mutual recognition of the existing national frameworks that allow VC investments. This should gradually lead towards a regulatory framework that all Member States could adopt if they wish.

15 Creation of co-investment funds through public–private partnerships at European level

This would be essential to develop local financial communities and ecosystems. Moreover, they provide an incentive for investors to remain active in follow-on rounds and continue to make their time and network available to their investee companies. Experience has shown that co-investment funds are an efficient way to leverage private sector participation in the market.

- Encourage Member States to create or increase special fiscal incentives for investments in Young Innovative Companies, thereby stimulating the participation of a higher number of business angels in the market.
- Remove obstacles to cross-border investments by venture capital funds through mutual recognition and a stronger and more transparent regulatory framework to conduct cross-border investments.
- Lighter regulation in the early-stage investment market. Co-investment funds at EU level should be established through public-private partnership.

16 Pan-European trading platform

Creating a pan-European trading platform and quoted market for small cap growth companies is not a trivial exercise. Previous efforts to do so – such as EASDAQ or the emergence of cross-border alliances between fledgling new markets – faltered for a variety of reasons including intense competition from national exchanges, poor timing, and a lack of financial industry support.

EVCA has spent time talking to the various members of the ecosystem, including its own members, the stock exchanges growth companies, regional and global investment banks, and institutional investors. There is a broad consensus that it would be highly desirable to establish a pan-European trading platform and a view that aftermarket liquidity would be significantly enhanced provided that several important steps are taken.
These include:

1. The **harmonization of listing criteria across exchanges**. Specifically, standardised criteria regarding requirements for minimum total assets, years of trading history, and number of independent Directors.
2. The **promotion of the cross-exchange platform** through the marketing of sector indices and their inclusion in the financial press throughout Europe.
3. The **involvement of additional non-domestic market makers** willing to commit capital in the trading of small cap growth company shares.
4. The development of **simple connectivity for investment banks in remote locations**.
5. The implementation of **low-cost settlement systems**.
6. A streamlining of regulatory procedures for IPO filings similar to the “light touch” model adopted by AIM and more recently by Alternext.
7. Discrete and **confidential listing approvals for secondary offerings**.
8. The adoption of **fair acquisition and minority squeeze out regulations and provisions**.

European commission, supported by member states, should create a pan – European trading platform.

### Depth of capital markets

A well-developed **stock market that permits venture capitalists to exit through an initial public offering is crucial for the existence of a vibrant VC market**. This key driver captures the size and liquidity of the stock market, level of IPO and M&A and debt and credit market activity. Venture capital firms provide temporary financial support for young businesses, but must divest their exposure and eventually return the proceeds to their investors.

For that reason, the **divestment conditions must be favorable** — that is, the **M&A and IPO markets should be liquid**. A bank-centered capital market tends to be less effective in supporting an efficient VC infrastructure not only because it lacks a strong stock market, but also because its secondary institutions compromise entrepreneurial activity, given the bankers’ conservative approach to lending and investing and the social and financial factors that reward entrepreneurs less richly and penalize failure more severely.

### Proposal:

#### Human and social environment

National culture shapes both **individual orientation** and **environmental conditions**, which lead to different **levels of entrepreneurial activity** in particular countries. This key driver incorporates the **quality of education and human capital, labor market rigidities**, **levels of bribery and corruption** and **costs of crime** within a nation. In order to foster a growing risk capital industry, **research culture**, especially in universities and laboratives, plays an important role.

**Rigid labor market policies negatively affect the evolution of a VC market.** To allow entrepreneurs and VCs to harvest the fruits of their efforts, the costs and efforts needed to recruit, hire and lay off employees must not be so high as to be discouraging. Finally, the **highest societal barriers and costs for start-ups** in different countries are **associated with corruption, crime, a larger unofficial economy and bureaucratic delay**.

These problems should be addressed more ambitiously at EU and national level.
## Rationalizing national VC support structures

Consequently, **founding entrepreneurs are not driven by extreme growth aspirations**. In result, also due to historic differences in fiscal and social security policy, there is a shortage of high net worth individuals dedicated to business angel activity.

Also, due to the larger role of government in the V2C space, among other reasons, the VC community is not as vibrant as in the USA. Because of the government’s policy to control for the delivery of public resources to the growth ventures, a relatively massive network of various advisory, business development, and incubator organisations – those who live off the growth company process, rather than the success of individual growth companies – has emerged in many EU countries. These institutional arrangements at national level should be rationalized.

## Reconsidering the role of government

Despite significant public involvement in recent years, the **role played so far by governments is highly controversial**. A well-functioning venture capital industry is not guaranteed through public intervention, nor does it necessarily develop by market forces alone. Undoubtedly, there is an urgent need for governments to rethink their positions.

On the one hand, the public sector is responsible for supporting and fostering technological development. At the same time, it should be able to identify and react to market failures in order to justify intervention in venture capital markets. Hence, to be efficient in policymaking, governments must ask questions such as: **why intervene in venture capital markets, and what ways are most effective** when doing so.