Gordon Murray’s and Weixi Liu’s Comments on EC Consultation on a New European Regime for Venture Capital

We should perhaps first note that we see greater cross border investment activity by VC funds as a highly desirable activity contributing to both more efficient and more competitive markets for risk capital. In more established national VC industries, investment flows from both institutional investors into VC funds and by the funds themselves in portfolio companies, have always had a strong international component. In line with other globalisation trends, venture capital has become more international with established financial service industries investing in both VC funds and portfolio companies in other developed economies and, more recently, in emerging economies. However, a robust case has to be made for the allocation of public resources for the support of such activity via the employment of specific policy instruments.

1. The Consultation would have benefited from a clear definition of what was assumed to be VC activity at its very start. The supply of finance from institutions to VC funds (which has always been highly international for the more successful VC industries including USA and UK) needs to be clearly separated from the international allocation of finance from VC funds into portfolio companies. Both types of activity are subject to different constraints.

Unlike PE, VC refers to early-stage, risky investment (usually in the form of equity capital) in new/young and unproven enterprises often with innovative products and services for new consumers in new markets in order to build major businesses that will generate substantial value and wealth creation. The early financing of disruptive technologies is an area where venture capital has excelled.\(^1\)

According to the latest (2010) BVCA Global VC survey, of those VC funds which are investing outside their home countries, more than half plan to increase this activity during the next five years. UK-wide\(^2\), 23% of investments made by UK VC/PE funds are in overseas portfolio companies (60% of total amount invested). With respect to the source of funds raised, 56% of total amount raised are from overseas investors, with US as the largest source (25%), followed by EU (7%) and Middle East (4%).

2. We found that this Consultation was a curious document as it suggests a range of major and potentially far reaching policy changes without substantiating any of the alleged problems which the proposed changes were seen as resolving. No attempt was made to address causation issues (which are critical for effective policy analysis and intervention) and thus no rigorous and objective support for the proposals offered was given.

3. Similarly, the Consultation was almost completely bereft of any longitudinal quantitative evidence supporting its analysis, e.g. supply side failure, international fund raising or international VC investment.

4. The Consultation over-emphasised the role of VC for SMEs. In practice, VC is a marginal facility for a tiny minority of new enterprises. While important for some high potential young firms, most innovative firms are formed and grow without any VC support.

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Research by Colombo and Grilli (2007)\(^3\) suggests that the most common source of external funding is commercial (high street) banks. The 2007/08 BIS Annual Small Business Survey (ASBS) finds that only 2% of UK SMEs chose to use equity (including VC) when seeking finance although the percentage slightly increased during the latest economic recession (2.5%) according to a series of ‘Business Barometer’ surveys conducted by BIS from December 2008 to February 2010.

5. Amazingly, the report did not allude to the fact that the returns from VC to institutional investors have been very disappointing in Europe\(^4\). There have been attractive exits but these have been too infrequent to improve sector returns markedly. This is the single biggest reason why VC activity has reduced over time since the ‘bubble years’ of 1999 and 2000. Poorly performing VC funds have been starved of new finances by disillusioned investors. In this context, ECF type hybrid arrangements have been of some effective (see Cowling et al’s 2011 evaluation of the UK Hybrid VC fund programmes)

VC fund performance in both short-term (3-year) and longer-term (10-year) horizons appears to be poor and the strongest returns are observed over the mid-term (5-year). The EVCA Pan-European Private Equity Performance Benchmarks Study suggests that in 2008, the 3-, 5- and 10-year internal rates of return (IRRs) for European VC investments are -0.6, 1.8 and 0.2, respectively. This is in sharp contrast with the US VC fund performance, which has a 5-year IRR of 6.3. Meanwhile European buyout funds (majority PE investments) exhibit much better performance especially over mid- (5-year IRR = 10.8) to long-term (10-year IRR = 11.6).

The performance of the UK VC market shows different patterns than its EU counterpart. Generally, VC fund performance decreases over time. According to the BVCA 2010 Performance Measurement Survey, the industry average IRR for UK VC funds over the 3-year horizon is 1.4 annually. The figure is 0.6 and -2.5 for the 5- and 10-year investment horizons. However the performance of VC investments in the UK still significantly lags that of PE investments. Moreover, the BVCA 2010 Performance Measurement Survey suggests that domestic VC/PE investments underperform non-UK investments, and technology investments show similar performance to VC investments, which is significantly lower than the VC/PE industrial average,

Although to a limited extent, the government invested ‘hybrid’ private-public VC funds have shown improved returns than private VC investments. According to the latest assessment of BIS equity programmes (Cowling et al, 2011\(^5\)), ECF is predicted to generate a higher IRR (3.0) in the 5-year period than the average UK VC market (0.7) and the UK FTSE Small Cap Index (investment return = -1.6). In the case of ECF and the UKHTF, investment returns appear likely to improve in the longer-term and outperform UK PE and VC general and technology investments returns.

6. A strong assumption that there is an adequate supply of attractive portfolio firms for VC finance appears to have been made throughout the Consultation. Such an assumption is likely to be excessively optimistic. (See NESTA 2009 Thin Markets report\(^6\)). This is not to argue

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\(^6\) http://www.nesta.org.uk/publications/assets/features/from_funding_gaps_to_thin_markets
that there is a substantial body of attractive European created, intellectual property from the STEM industries. However, such resources do not automatically metamorphose into attractive new businesses.

The difficulty in firms getting access to finance, including both loan and equity finance, is also a direct result of a ‘demand side gap’. SMEs’ lack of understanding of equity instruments, their poor quality and presentation of business plans and a widespread reluctance by entrepreneurs to cede any control via the sale of common stock are all causes of demand-side gaps. These severely reduce the attractiveness of SMEs to formal VC financing. The need for both supply and demand side conditions is cited in a DG Enterprise Report of 2005.

A 'Thin market' occurs when small numbers of high potential firms and small numbers of investors with the skills to help them grow find it difficult to find one another without incurring unacceptable transaction and/or search costs (NESTA, 2009).

7. Reasons for market failure in VC can legitimately be applied to: information asymmetries, adverse selection, diseconomies of small scale and spill-over effects. The case has still to be made but there are clear structural problems with VCs addressing early stage funding especially at the seed capital stage.

8. Double taxation problems need to be explicitly detailed. Where is this a problem and what is the evidence over time? While more work has been done on the influence of taxation on demand side issues of new firm formation, double taxation is rightly a ‘deal breaker’ for many institutional investors. However, the issue is complex. The legal status of several institutional investors including pension funds is such that they may not pay taxes on their investment returns. Accordingly, it is not appropriate to state that the lack of cross-border investment is due to double taxation unless this can be corroborated.

9. The LLP/LP (general partners/investors) model is adopted by both the USA and the UK as arguably the two most developed and sophisticated national VC industries in the world, accounting for 80 percent of all VC funds. This successful structure should be the benchmark for other nascent VC industries - rather than the creation of an untested European-specific model. Given the importance of inflows of funds into Europe from outside the EU, such a European model could restrict further investors’ interest in VC as an attractive ‘asset class’.

Corporate VCs can be seen as an alternative model to the classic VC fund. They are widely regarded as having performance results that are inferior to limited partnership VCs although

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it is perhaps better to see the two activities as complementary\textsuperscript{12,13}. Three reasons give rise to the better performance of the LLP model: (1) the limited liability partnership structure provides investment managers (general partners) with a larger degree of autonomy during the life of the fund, usually 10 to 15 years; (2) better incentive structures (performance based) among limited liability partnership VCs relative to corporate VCs, and (3) the strategic rationales associated with corporate investing (e.g. investments determined by corporate objectives) versus the purely financial/economic-driven limited partnership VCs. Cumming (2007)\textsuperscript{14} provides another explanation for the prevalence of LLP VCs. He argues that limited liability partnership VCs write contracts that are superior to corporate VC contracts, which in turn improve investment performance through the appropriate allocation of cash flow and control rights.

10. Given the relatively small size of VC as a proportion of total investment activity, new rules and requirements by investors or fund managers are likely to have perverse effects in reducing interest in VC as an asset class. Such greater ambiguity increases market entry and transaction costs in an industry with, presently, a highly variable performance record for investors.

11. The relevance of the initiative AIFMD to VC is acknowledged as limited. Further, independent information is still absent as to the initiative’s effect. Accordingly, there is little logic for immediate action until further information is both collected and analysed.

12. Any scheme would have to define VC in a manner that promotes the additional supply and take up of additional sources of risk capital for new and growing enterprises. It should not encourage the refinancing of existing assets. The latter is the core activity of PE.

The drift from early-stage VC to development capital and increasingly PE activity (e.g. management buyouts) is a trend that appears inevitable given both the historically higher returns, the velocity with which PE investments can be made and then successfully exited, and the considerably larger sums of institutional finance including leveraged debt that can be invested in later-stage deals. Investment ‘style drift’ is especially a concern during the economic downturn as empirical evidence\textsuperscript{15} suggests when market conditions worsen, investors are more likely to shift towards to better (or safer) investment opportunities (e.g. later-stage buyouts).

13. We are skeptical as to the ability of several EU member states to meet the strict compliance code of an EU level framework. VC requires considerable trust given its risky nature. We have clear evidence that some country’s legal frameworks (as well as other environmental conditions) do not support the growth of a VC industry\textsuperscript{16}.

\textsuperscript{13} Maula, M., Autio, E.and Murray, G.C. 2006. How Corporate Venture Capitalists Add Value to Entrepreneurial Young Firms. \textit{Advances in Entrepreneurship, Firm Emergence and Growth}. 9, 267-309
14. It would be helpful for the EC to conduct a literature review of the existing academic VC studies/analyses in the areas under discussion (e.g. cross border transfers, equity gaps, market failure etc.) before embarking on its own studies\(^\text{17}\). The UK’s Rowland Report gives a useful introduction to some of the relevant literature.\(^\text{18}\) Further of particular relevance, the present pan-Nordic, inter-country VC arrangements could be examined for useful policy lessons\(^\text{19}\).

Professor Gordon Murray & Dr Weixi Liu
University of Exeter Business School, UK
gmurray@ex.ac.uk

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\(^\text{17}\) Anna Soderblom completed such a policy focused, literature review of VC economic research for the UK government in 2006 (Söderblom, A. and J. Wiklund, 2006. Factors Determining the Performance of Early Stage High-Technology Venture Capital Funds – A Review of the Academic Literature, DTI: London).
