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Hybrid (public/private) Venture Capital Programmes: *how was it for you, darling?*

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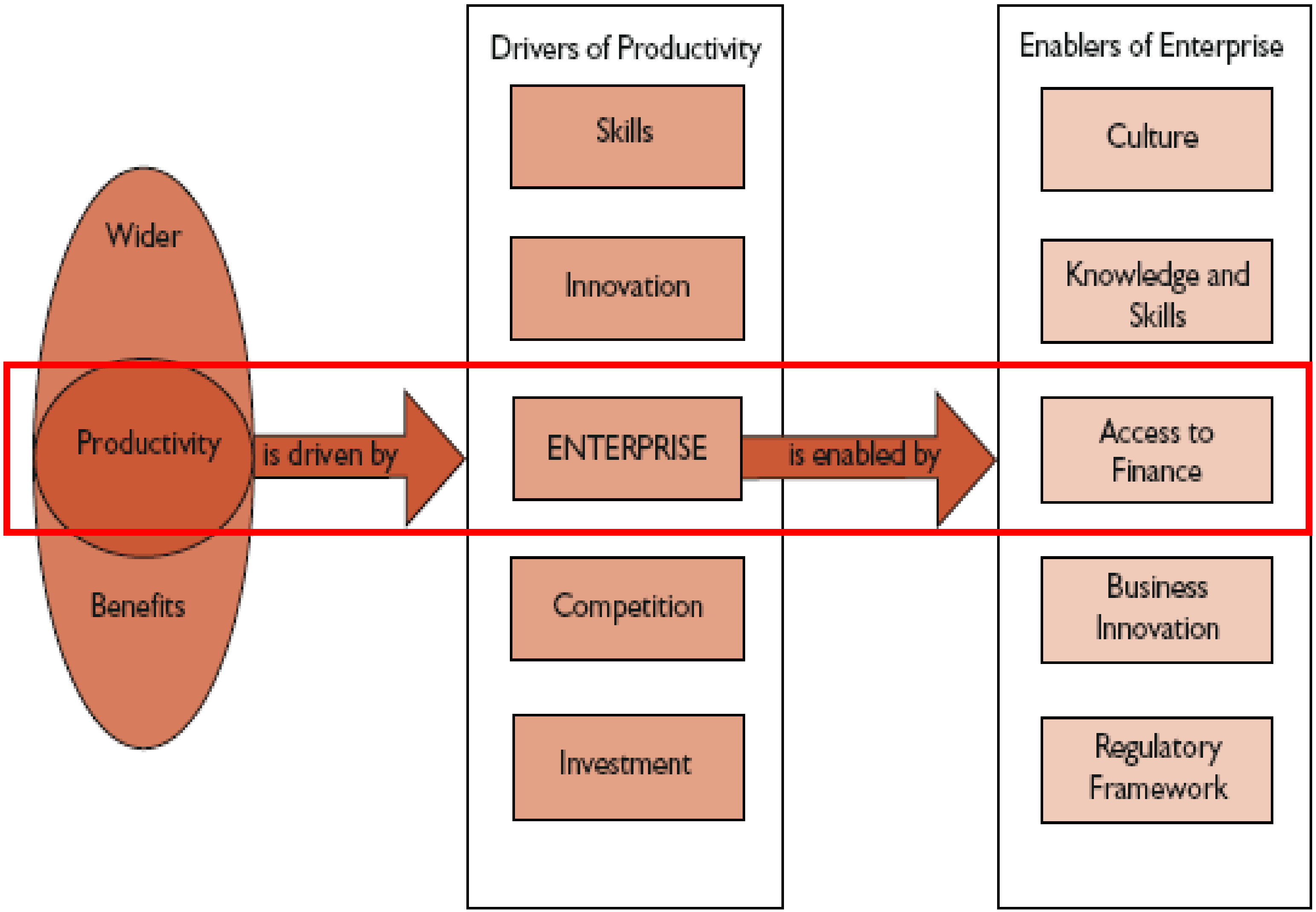
UNIVERSITY OF EXETER

UK Policy, 2008 but still current

Enterprise enablers and productivity



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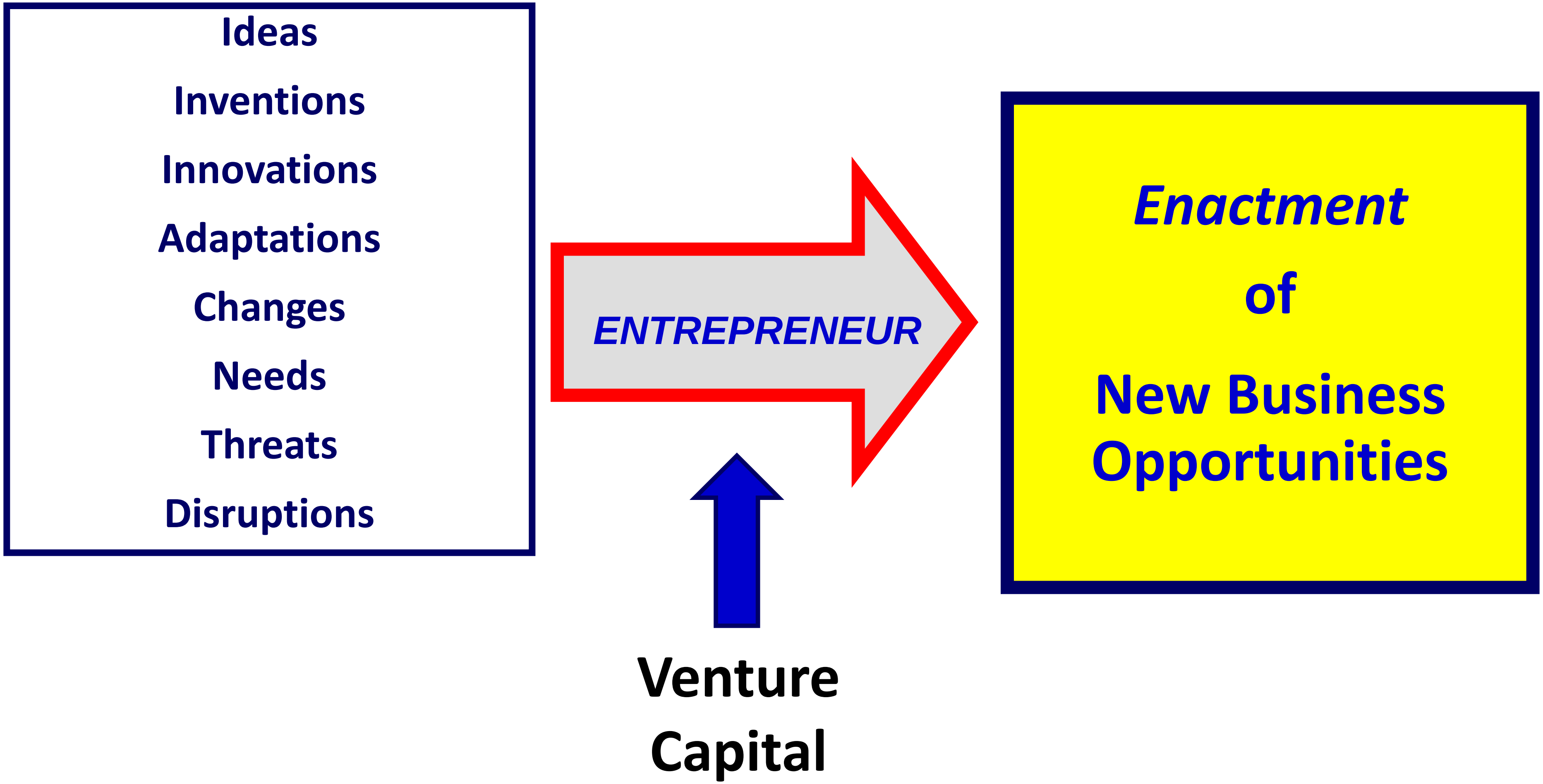
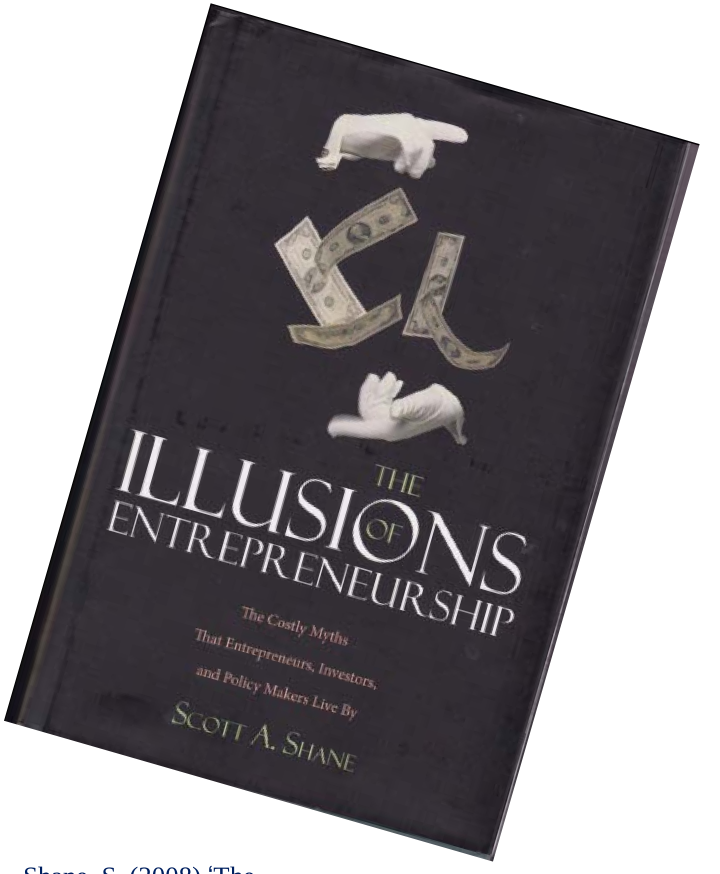
ENTREPRENEURS + VC are seen as key *catalysts* in economic transformations

Audretsch & Kielbach, ETP, 2004



Venture Capital - *the only game in Town?*

“since 1970, venture capitalists have funded an average of 820 new companies per year. These VC supported start ups – a tiny proportion of the more than two million attempted business entries every year – have created enormous economic impacts. By 2003, companies that had been backed by VC employed 10 million people, or 9.4 per cent of the private sector labour force, and generated $1.8 trillion in sales... In 2000, the 2,180 publicly traded companies that had received venture capital backing between 1972 and 2000 comprised 20 per cent of all public companies, 11 per cent of sales, 13 per cent of profits, 6 per cent of employees, and one third of total market value, a figure in excess of $2.7 trillion dollars... In short, a very significant proportion all of the value generated by start ups in the USA has comes from this handful of VC backed firms”.



Shane, S. (2008) ‘The illusions of entrepreneurship: the costly myths that entrepreneurs, investors and policy makers live by.’ New Haven: Yale University Press. p.162.

Model of VC Industry/Government relations

Amorous
VC industry

Je t'aime ... Je t'aime!

Willing
government

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“Houston, (or London, Stuttgart, New York, Stockholm etc. etc.) we have a problem ...”

*Over the past few years, there has been **a movement away from early stage venture capital** from the private sector towards larger, less risky, and often leveraged investments. Many respondents have therefore commented that publicly supported funds are “the only game in Town”.*

***Shortages of equity capital represent a key constraint on innovation for companies**. The situation has grown worse as a result of the current crisis. There remains a need for a long-term improvement in the framework conditions for the provision of company equity. Important incentives for innovation would also be provided by improvements to the framework conditions for business angels and **venture capital** investors.*

*Innovation can be financed in multiple ways, of which the supply of external risk capital, that is, capital from outside of firms whose investors are willing and able to take the risks involved in technology innovation, is a special issue. The **venture capital** industry emerged to meet the need for external risk capital. **The supply of such capital to innovative firms is a bottleneck of the existing financial system.** The way forward is for the government to invest more in improving the support system, or ecosystem, for the domestic VC industry.*

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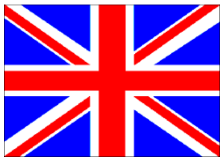
VC Supply: a *generic* Policy Challenge



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HM Treasury & BIS. 2011. Financing business growth: The Government's response to "*Financing a private sector recovery*"

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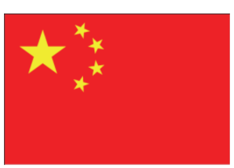
EFI. 2011. "*Research, innovation and technological performance in Germany*"



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Zhang et al. 2010. "*Promoting Enterprise-Led Innovation in China.*" Tsinghua University and World Bank

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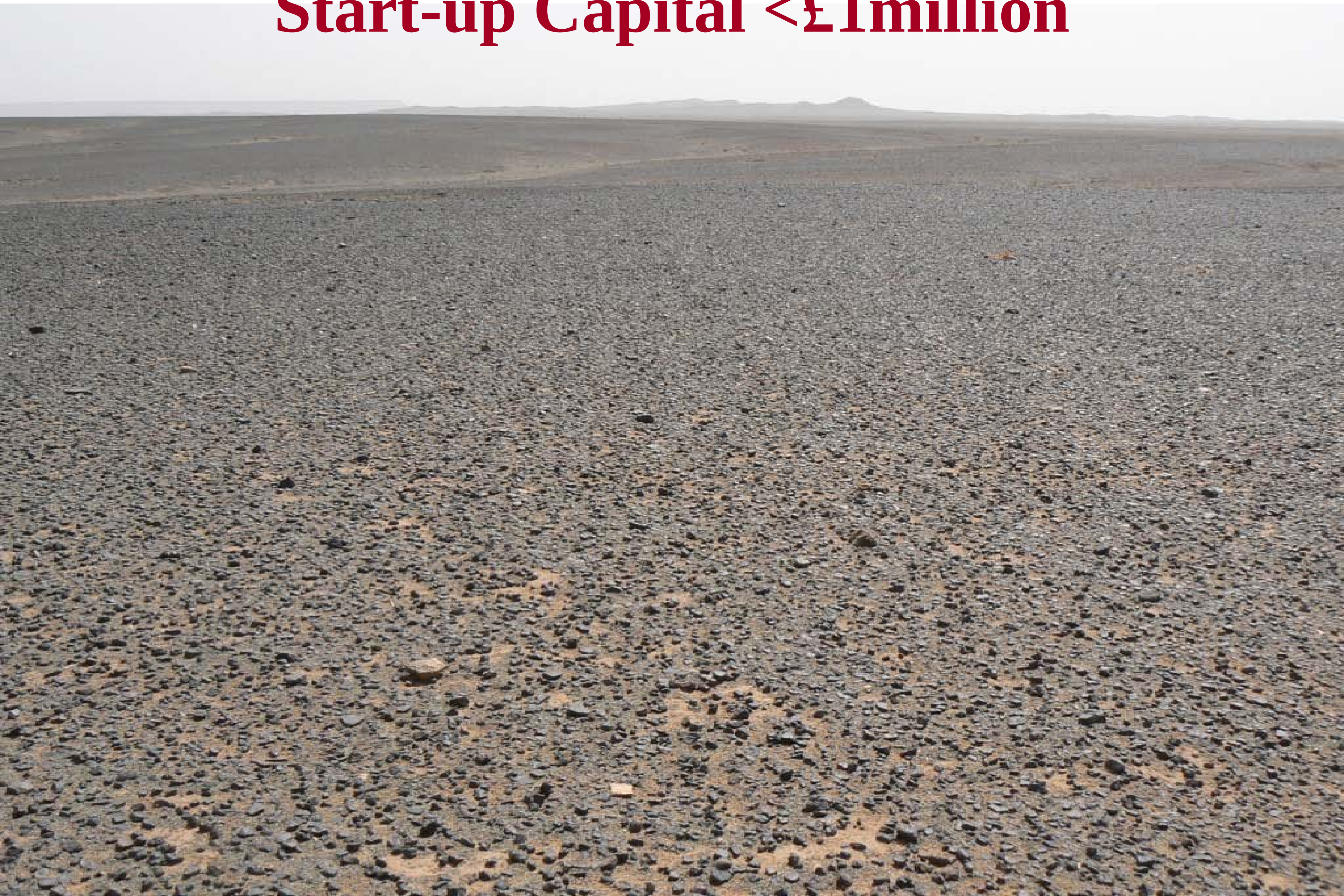
Annual Convention of private VCs offering Start-up Capital <£1million



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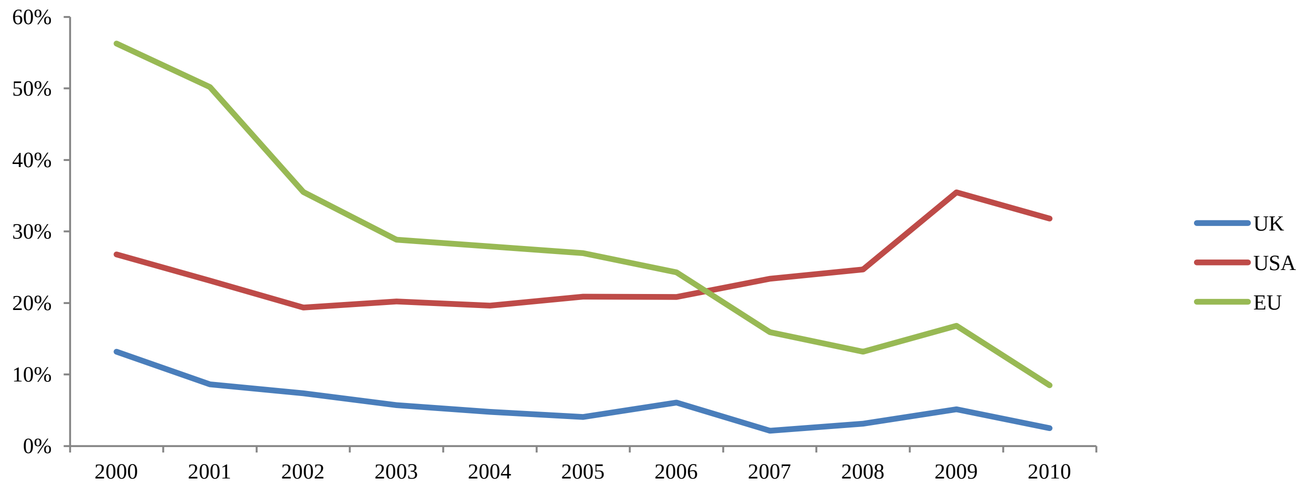
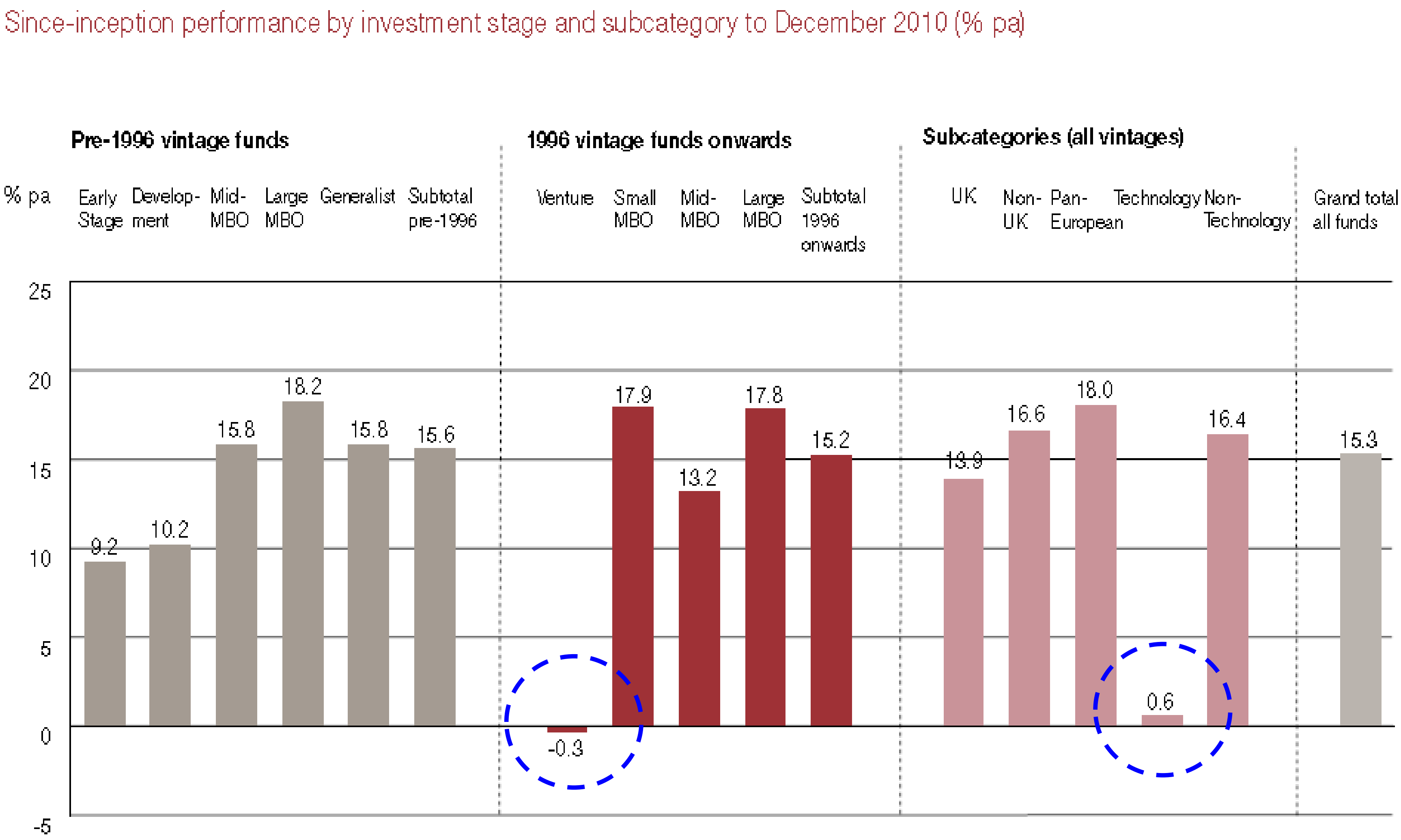
Early-stage Venture Capital investment as a percentage of total Venture Capital and Private Equity investment



The reasons why … British VC Assoc., 2011



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The State has little choice but to intervene *directly* in order to stimulate VC activity

Government rationale based on economic arguments of:

- **"market failure"**
- **information asymmetries**
- **spill-over effects**
- **scale effects**
- **short-termism**
- **national strategic interests**

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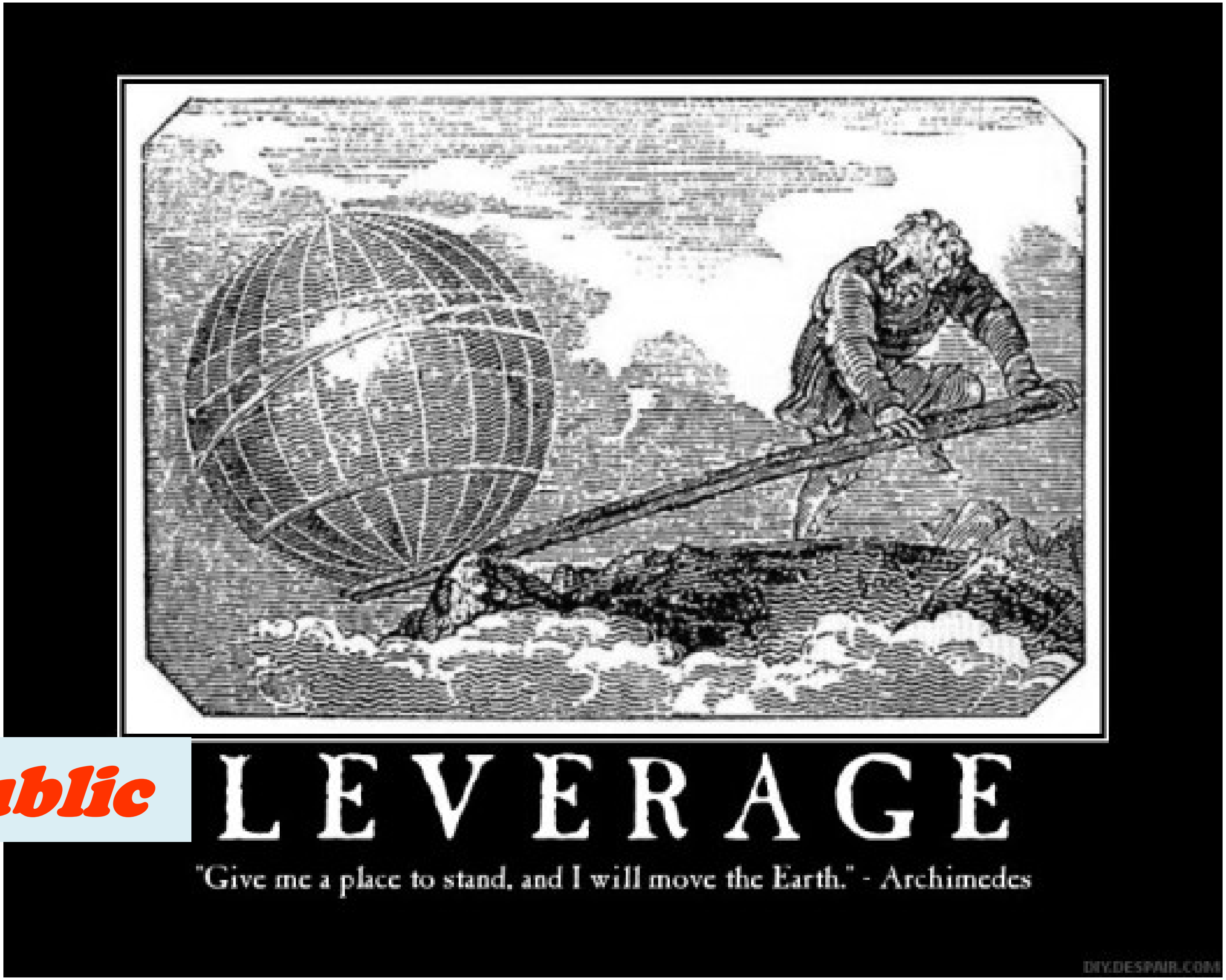
But how do you make a VC *really* amorous?

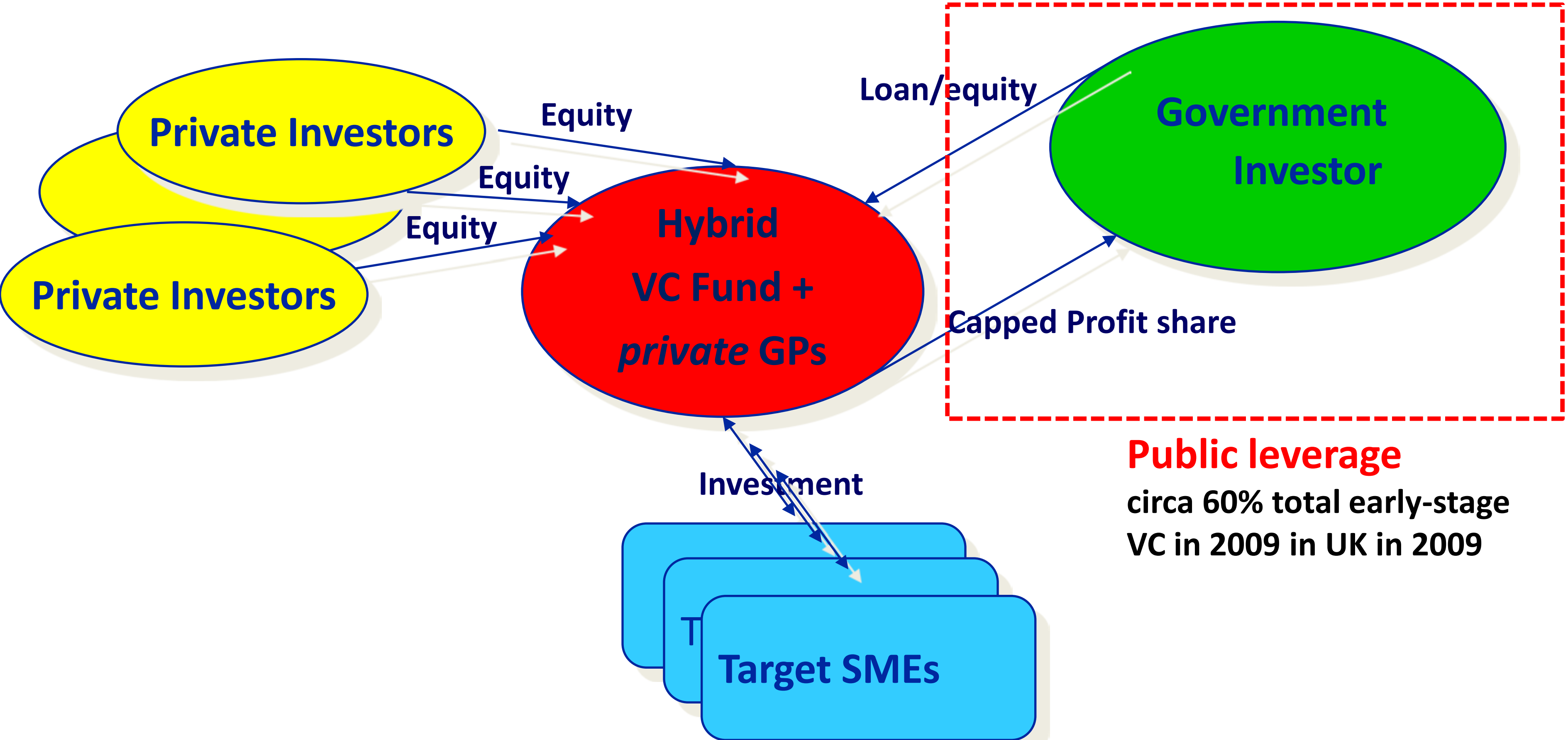


+ public

Generic 'Hybrid' VC Model Structure

Based on US SBIC 'leveraged' model but adapted by several countries:

- ✓ **Government investment as a subordinated loan to fund**
- ✓ **No downside protection – instead addresses risk-return issue with enhanced return for investors.**
- ✓ **State uses *commercial* VC managers to pursue public policy goals**

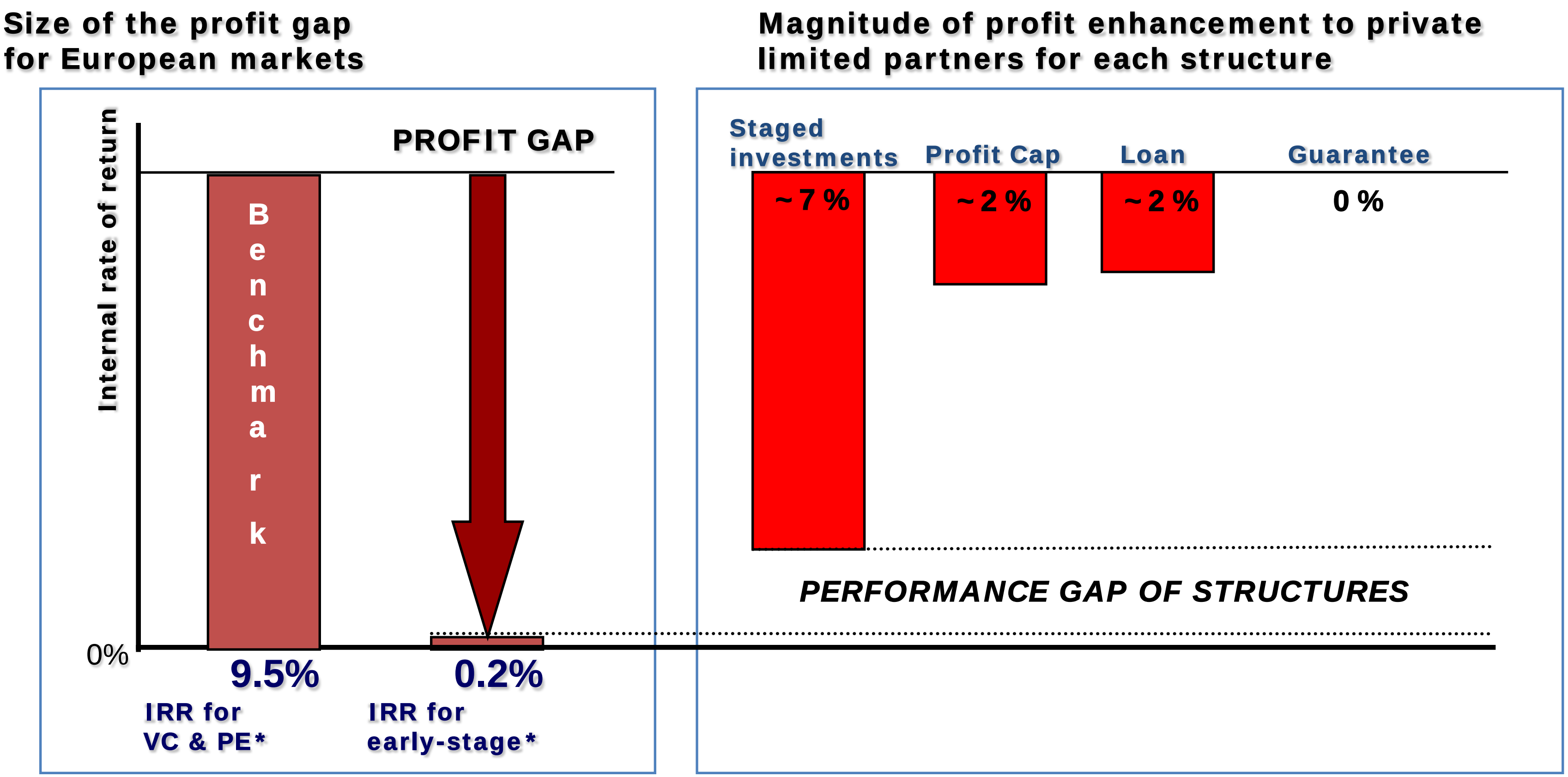


Public leverage

circa 60% total early-stage VC in 2009 in UK in 2009

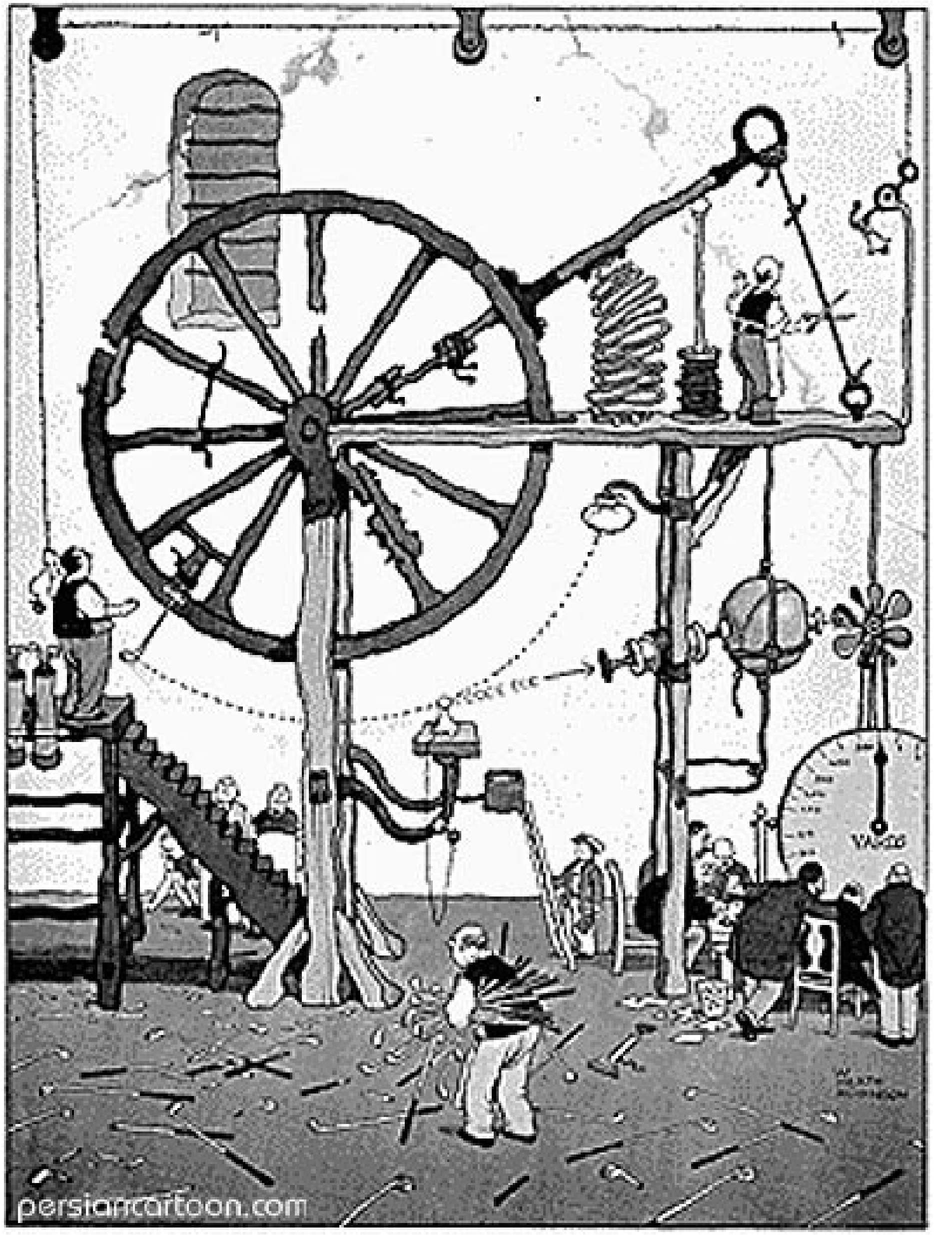
Limits of the 'Asymmetric' Incentive Structures

(Jaaskelainend Maula and Murray 2007)



None of the examined structures produces high enough profit enhancement to 'bridge the gap'

*EVCA 2004 average returns



Available policy levers are rarely direct, immediate ... or fully understood *ex ante*

There is a critical need for robust LR evaluation studies of extant, enterprise and innovation finance programmes and policies

Pros & Cons of Hybrid VC Programmes

- Follows established LLP model
- Focused on early-stage
- Managed exclusively by professional managers
  - Public leverage increases LP & GP incentives
  - Increases fund size
- Increasingly public knowledge & skills re HVCFs
- Addresses element of the ‘funding escalator’

- Requires considerable VC knowledge
- Often used to address non-commercial issues
- Leverage cannot correct for adverse selection
- Does not address demand side weaknesses of SMEs
- Little informed governance or evaluation

UK Hybrid VC Programmes under scrutiny: BIS evaluation 2011

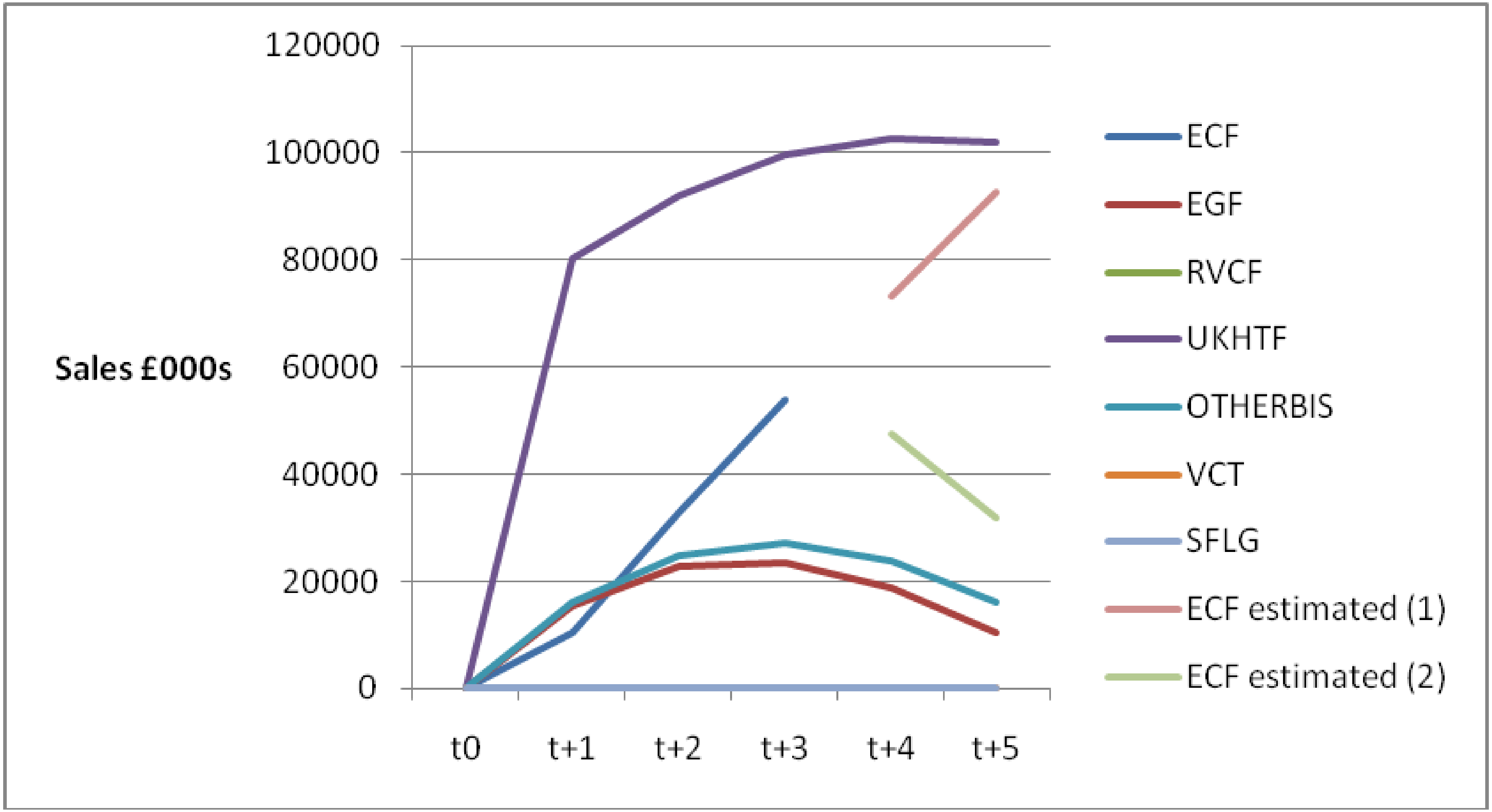
1. Regional Venture Capital Funds (RVCF) — <£500K to locals
2. Enterprise Capital Funds (ECFs) — <£2m. to growth firms
3. UK High Technology Fund of Funds — £124m. to 9 VC funds
4. Early Grow Funds (EGFs) — <£50K to entrepreneurs
5. Bridges Funds — <£500k to disadvantaged communities
6. The Aspire Fund — <£1m. to women entrepreneurs
7. Capital for Enterprise Fund — <£2m. to over-geared SMEs

Key findings I

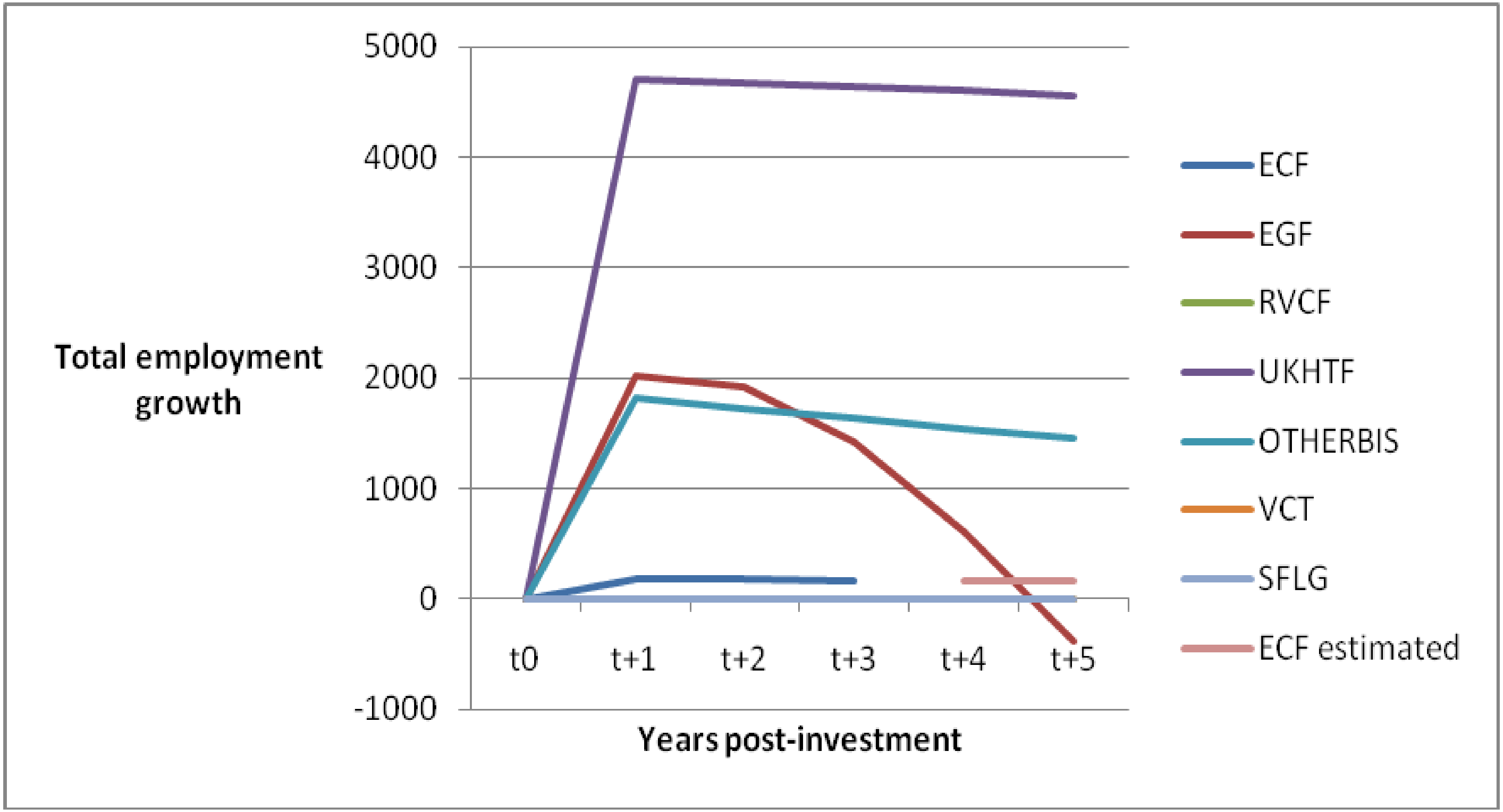
- Sales growth – Investee firms across all schemes, with the exception of RVCF, showed growth in (real) sales in the immediate post-investment period. Typically, this increase in sales peaked in the second or third year after investment and then diminished. The exception to this general pattern was the ECF, where there was a slow increase in sales in the first year post-investment followed by accelerated sales growth in the second and third years post-investment.

- It is estimated that each £1 of government backed equity across all schemes there was an increase in sales of £3.60 after netting out losses. Excluding the RVCF, this average figure rises to £3.97 per £1 of government investment

Post-investment *sales* growth by programme



Post-investment *employment* growth by programme

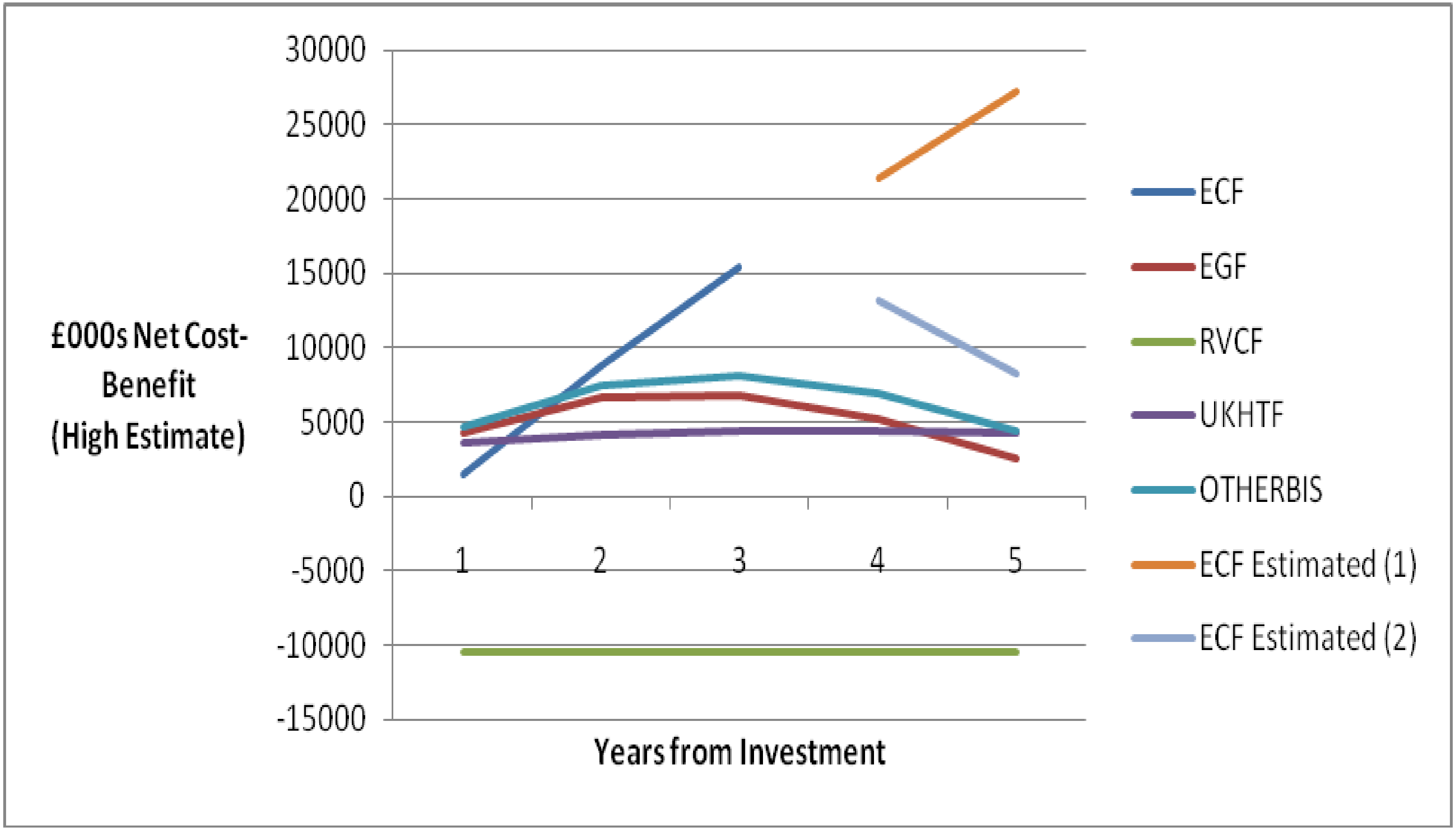


Key Findings II

- Valued added – The general economy wide contribution to value added from the SME sector is £0.33 per £1 of sales. It is estimated that for every £1 of government backed equity invested across all of these schemes £1.19 of value added is created after netting out losses.

- In total, it is estimated that the net value added contribution of Gov VC programmes is between £160m and £184m

Net Economic Cost-Benefit by programme



What has UK Government done *relatively* well ...?

- ✓ Has provided substantial funds over the long term (signalling effect)
- ✓ Has used private VC general partnerships as agents (knowledge effect)
- ✓ Has largely insisted on the commercial focus of the funds (pragmatism)
- ✓ Has provided consistent incentives for private investors (alignment)
- ✓ Has sought to understand the VC industry by recruiting appropriate advisers and researchers (market knowledge)
- ✓ Has build up specialist VC governance unit (transparency/professionalism)
- ✓ Has operated exclusively in the early-stage investment area (relevance)

Lessons for Governments from Current HVCFs Experience in UK

- ✓ **Do your home work !!!**
- ✓ **Recognise VC is often about regions not countries**
- ✓ **Experiment, analyse and learn (internationally)**
- ✓ **Plan for the Long Game**
- ✓ **Apply realistic programme goals**
- ✓ **Recognise that VC is a minority and specialist source of funding**
- ✓ **Address the environment, *NOT* the symptoms**

And the Future for European VC?

- VC returns will not improve until a significant economic upturn
- PE will continue to eclipse VC performance
- European government will continue to fund – *they have no choice*
- Government VC action will be justified on innovation spill-overs
- A few (largely US GPs) will continue to produce the lion’s share of LP returns
- VC opportunities in growth markets (BRICS, Turkey, parts of Asia and Africa) will attract investors away from Europe

Questions? – please feel free to disagree