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CREATING LASTING VALUE

Accelarating Innovation:
Using Public Sector Capital to Attract Private Sector Investors to the European Venture Capital Industry
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Executive Summary

European innovation has a problem: the lack of private sector investors in venture capital. In 2007 Government agencies accounted for less than 10% of investment in European venture capital; by the first half of 2011 this had grown to over 55%.

During this same time period venture backed companies performed significantly better in terms of sales and employment growth than other, non-venture backed, high-tech companies[1]. The overall venture capital industry has not, however, delivered competitive financial returns compared to other private equity investment stages.

Venture capital in Europe is now characterised by a reliance on public sector institutions such as the European Investment Fund ("EIF"). It is essential that programmes managed by the EIF and other institutions at a national level are continued. It is also crucial they are built upon and complemented. The investor base must be expanded and diversified if in the long-term the European venture capital industry is to become self sustaining.

In March 2010 EVCA proposed a scheme[2] to complement the EIF and stimulate the demand for high quality venture funds. This would be a multi-annual programme for private sector managed pan-European funds of funds with a high commitment to venture capital.

This programme would enable the European Commission to invest in typical private sector managed private equity funds of funds to:

- Incentivise private sector institutional investors to venture capital
- Create a level playing field with other private equity investment stages
- Scale up the European venture capital industry by increasing the number of high-quality European venture capital funds
- Overtime reduce the requirement for public sector support to venture capital

Challenges for raising venture capital funds

Venture capital, although strategically important, accounts for only approximately €5 billion on an annual basis. This is tiny in comparison to other asset classes. Many institutional investors such as banks, pension funds and insurance companies generally consider the market too small to allocate expertise or resources.

The low performance of the venture capital industry in recent years in comparison to other illiquid asset classes, coupled with tightening EU regulation has compounded the challenge.

Pension funds, insurance companies and banks have fallen from 35% of funds raised to just 5% in the first half of 2011. Government agencies now account for over 55% of venture funding. The changing investor base is illustrated in Fig 1.

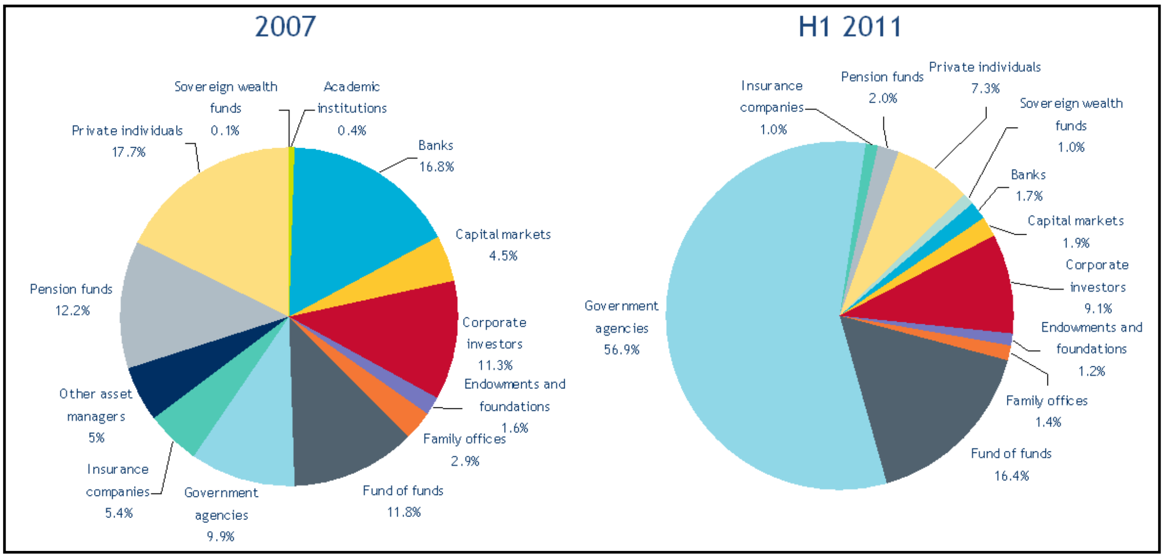

Fig 1. *The changing source of investors in European venture capital* (Source: EVCA)

The use of private sector managed funds of funds

A fund of fund can provide instant access to venture capital, enabling investors to allocate capital without the need to understand the intricate details of the asset class. Overtime the investor will build up knowledge and expertise by monitoring investments.

The private sector manager is required to market the fund of funds to institutional investors, building expertise and knowledge in the institutional investor community. European venture capital fund managers themselves are not inexperienced , just under capitalised.

Funds of funds will also serve to diversify the investor base. Governmental agencies will not be sufficient without co-investors in venture capital funds.

Creating a level playing field for investors in venture capital

In addition to structural issues in the investor base venture capital fundraising has been challenged by low returns to investors in recent years.

Unlike other asset classes such as property or later stage private equity, venture capital investors can not reduce the cost of their equity investment by blending it with cheaper bank financing. This is because innovative, pre-profit companies can not generally access debt financing. This increases the risk to venture capital investors and reduces the equity return. Equity investing is expensive.

This means that venture capital firms have to generate a higher return on their equity investment than other asset classes in order to compete. This is one factor depressing returns to investors in innovation. The funds of funds could be structured to level the playing field.

The European Commission could invest on a non-pari passu basis in the fund of funds. The profits could be distributed in favour of the private sector investor. A number of structures have been used successfully in the past at a fund level - The Yozma scheme in Israel is one example - and a number of scenarios are possible.

- There is a low-fixed, preferred return to the European Commission. After this return has been met the private sector investors capture the rest of the upside and boost the returns of the fund.

- A similar structure to the low-fixed preferred return can be designed with an additional boosting mechanism: the private sector investors also have the option to buyout the European Commission at a fixed low rate capturing all the upside of the fund. This buyout option could be exercised at a certain point in the life of the fund.

These are just examples of how the scheme could work to offer an incentive to the private sector. It is essential the European Commission work with private sector fund of fund managers to create flexible, market appealing, schemes.

General design principles of the scheme

The scheme should be based closely on existing private sector fund of funds following typical market characteristics.

- The scheme should be based on incentives to attract investors and enhance performance: the private sector can not be ordered to invest in venture capital.

- A limited partnership is a negotiated agreement not a product that is bought or sold. The fund of fund needs to work with the public sector investor to develop a compelling strategy to the market - a one size fits all approach will not work.

- The funds of funds should be able to invest across all industry sectors:

  - Different sectors have different funding cycles - directing capital to certain themes or sectors without an accompanying market driver can distort the market

  - The fund of funds manager needs to have the flexibility to develop an investment strategy which will attract private sector investors to deploy capital in a ten year investment programme. A themed approach would reduce the ability to attract private sector investors.

  - Innovation can not be produced on demand. Channeling capital to certain sectors is counterintuitive to how venture capital works in practice and limits the success of public support. This programme aims to create a thriving venture capital industry with its celebrated externalities of job creation and growth.

- The targeted commitment to venture capital should equal, but preferably exceed, the public sector investor's commitment to any funds of funds.

- The funds of funds are pan-European. The venture funds in which they invest should have a high target allocation to European companies.

- The scheme is a multi-annual programme over the next EU Budget period, gradually building capacity in the market with a number of funds of funds.

- The scheme should have a mechanism that creates a level playing field for investors in innovation and venture capital and thereby improve returns - this can be achieved by a non-pari passu fund structure.

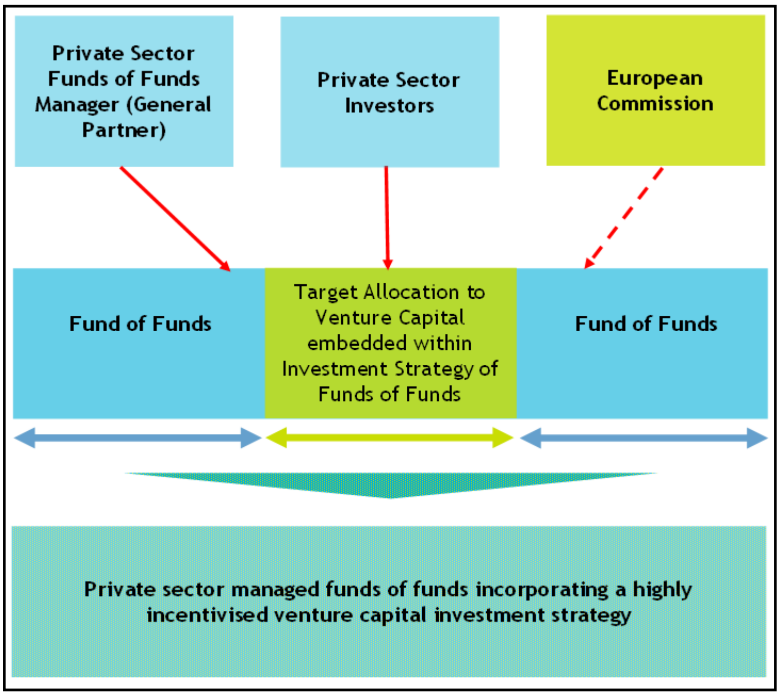

Fig 2. *The Basic structure of a fund of funds*

1. The European Commission is an investor in a private sector managed funds of funds

2. The investment strategy must envisage at least as much investment to venture as the Commission's investment

3. The private sector manager has the responsibility to develop an investment strategy that is compelling for the private sector investor

4. There are a number of mechanisms that can be deployed to "leverage" the public sector commitment

Summary

The European Commission is committed to making "an efficient European venture capital market a reality"[3]. This can not be done without bringing the private sector back to venture capital. The proposals outlined in the document are not a request for subsidies, grants or protection mechanisms such as guarantees, just the smart use of public sector capital to enable institutional investors either to re-engage with, or start, investing in European innovation and high technology growth companies.

1. Venture Capital: policy lessons from the VICO Project. 30/09/11
2. EVCA Venture Capital White Paper. Closing Gaps and moving up a gear: the next stage of venture capital's evolution in Europe. 2/03/10
3. Communication from the Commission "EUROPE 2020 A strategy for smart, sustainable and inclusive growth" 3/3/2010