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International Trade Administration

European Commission
Directorate-General for
Enterprise and Industry

Working group on venture capital

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About this report

This report is based on the work of group of experts from the US Department of Commerce and the European Commission, who were advised by representatives of the industry and the academia.

The contents of this report do not necessarily reflect the opinion or position of the European Commission or of the United States Government.

Further information about the working group can be obtained from:

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1. Recommendations

The Directorate-General for Enterprise and Industry of the European Commission and the United States Department of Commerce believe that more policy-makers all over the world should be familiar with the potential benefits of a vibrant venture capital market, and that adopting policies favouring growth that is driven by venture capital could have considerable benefits. The following actions intend to contribute to this goal.

1. Policy cooperation on venture capital

The venture capital and private equity industry is a global one. Leading players are competing globally for funds and investing where return potential is high. The benefits for economic growth that venture capital brings make it essential that policy-makers recognise impediments, like administrative regulations about establishment and taxation rules, to venture investment and take action to facilitate cross-border investments. This policy process should take place in a global context, learning from best practices irrespective of their provenance.

For its part, the European Commission will continue to work with its Member States towards a more beneficial environment for venture capital. Furthermore, the parties believe that beneficial work could be undertaken at other forums on policy cooperation. To this end, the parties fully support the work of bodies like the OECD and the United Nations Economic Commission for Europe (UNECE), both of which have been active in developing policy cooperation in venture capital. As the work progresses, its results could be adopted by other international forums, as appropriate.

2. Venture capital handbook for policy-makers

The cyclical nature of the venture capital industry makes consistent long-term policy development essential. To facilitate policy learning and development, the parties believe that editing and publishing a handbook on venture capital for policy-makers would be useful in this context.

This handbook should be forward-looking in nature, exposing industry trends and potential, with a specific focus on the interaction between economic policy-making and venture capital investments. The contributors to the handbook should be the leading experts in the field, with the resulting handbook being easily accessible for non-technical readers. The parties will continue their discussions about the practicalities of drafting and publishing the handbook.

3. Resource centre for policies on venture capital

To facilitate venture capital investments and to spread information about investment conditions, the parties believe that the venture capital industry and the public sector could cooperate to provide information about the prevailing rules, regulations and documents on venture capital on a country-by-country basis.

In order to gather and disseminate such information, the parties believe that further coordinating work would be useful. To this end discussions could be held among stakeholders in a suitable international forum in order to create an internet-based resource centre, accessible for both policy-makers and the industry, which are interested in prevailing practices on venture capital investments. The aim would be to gradually develop this resource centre into a global one and the parties will review ways to achieve these goals.

2. Reasons and aims

Entrepreneurship and innovation are the two keys to success in economic development providing for wealth creation and a rising standard of living. Furthermore, the commercialisation of innovation and the growth of entrepreneurial firms require that risk capital is available, in particular at the early stages of firm growth. To promote the competitiveness of small and medium-sized enterprises (SMEs), the Directorate-General for Enterprise and Industry of the European Commission and the United States Department of Commerce established a working group on venture capital, which also forms part of their *Innovation and Entrepreneurship Initiative*.

The group's aims were:

- To improve the understanding of policy makers of the private equity and venture capital industry's role is in the economy;
- To review the standards on transparency, data, definitions and the valuation methods used by venture capital funds;
- To understand the current structure and emerging trends of the venture capital fund sector;
- To review the tasks of the public sector.

The availability of venture capital is essential to allow innovative firms to grow in their home location. This keeps the benefits of innovation, growing wealth and employment, in areas which created them and prevents brain drain towards environments that provide better financing conditions. Venture capital investors make a valuable contribution to growth, and need a reward for the risks taken – a fact that should be recognised in policy-making. This is even more important when investors across the world are risk averse and the markets are failing to provide initial capital for new firms.

Public awareness about venture capital is different in the United States from that in the European Union. In the United States, the entrepreneurial and equity-oriented culture makes venture capital a well-known and well-regarded financing alternative, at least in the key cluster regions. In Europe, the clusters tend to be smaller and the presence of venture capital more limited, holding back the possibilities of wider public recognition of the benefits of venture capital investments. Besides public policy initiatives to enhance the operating environment of venture capital investors, a sustained further effort from the part of the venture capital industry might be useful to raise public awareness about the benefits of venture capital.

For its part, this group has tried to build a transatlantic dialogue between the venture capital industry and policy makers. The group has been working in the wider policy context under the "*European Union and the United States Initiative to Enhance Transatlantic Economic Integration and Growth*" and "*Innovation and Entrepreneurship Initiative"* as agreed in the bilateral summits of 2004 and 2005. In particular, the initiatives have noted that increased venture capital investments contribute to the goals of stimulating open and competitive capital markets; and to facilitating investment flows that contribute to sustained economic growth.

The working group held two meetings, the first on 22 March 2005 in Brussels and the second on 6 June 2005 in Washington, DC. The group was co-chaired by Mr. Mario Cardullo from the Department of Commerce and Mr. Vesa Vanhanen from the European Commission. Representatives of venture capital funds, industry advisors and associations, academic world, and other key stakeholders were invited to participate in the discussions. The participants of the meetings are in annex 1.

3. Global industry

The working group discussions emphasised the global nature of the venture capital industry. For natural reasons, large funds are in the forefront of international investments, but even smaller funds often look for opportunities to raise funds and invest all over the world. Globally, competition for venture capital investments is intensifying and investment in China has grown to $1.3bn. Total venture capital investment in the US was $20.5bn and in Europe $13.4bn.

The global nature of the venture capital industry is also reflected in the various groups that follow the development of the industry and seek to facilitate an exchange of views and establish good practices in public policy. Besides the EU-US working group, other policy-oriented groups with focus on venture capital include:

- OECD Working Party on SMEs and Entrepreneurship;
- United Nations Economic Commission for Europe (UNECE) Working Party on Industry and Enterprise Development;
- United States – United Kingdom working group on venture capital;
- United States – Australia working group on venture capital.

Other actors like the World Economic Forum (WEF) core group on venture capital can play a role in increasing the understanding of venture capital among policy-makers. In addition, many stakeholders are doing valuable policy-oriented work. One example is the Ernst and Young focus group on global venture capital and another is the PriceWaterhouseCoopers contribution to the data collection effort on venture capital.

These forums contribute to policy development and exchange, which the EU-US working group considers essential in creating favourable conditions and in implementing good policies that can lead to significant increases in venture capital investment. Many countries have achieved excellent results in venture capital investment per capita, which for example in Israel was $191, in Sweden $94, in United Kingdom $83, in the US $69 and in Denmark $65 in 2004.

The discussions made it clear that each country needs to develop its own approach to venture capital, suitable to its market conditions. The policy goal, however, is common: providing growing companies with the benefit of large liquid venture capital markets.

4. Key results from discussions with advisors

Small firms need investment capital but the market has failed to provide it — public sector support is needed

The work of the group confirmed that there is a fundamental market failure in the provision of early-stage financing in both the US and the EU. Venture capital funds are concentrating on larger and larger deals, leaving the small and risky early-stage deals aside. This is due to the more attractive returns and lower risks available in later-stage investments to more established firms, and in buyouts of larger companies. This can become a self-reinforcing cycle: because few venture capital funds are active in the seed and early stage area, they don't have any longer the necessary knowledge to operate there. The few remaining seed funds and the business angel investors cannot by themselves cover the demand for equity investments.

The recognised benefits from the birth and growth of innovative small firms to the economies are such that public sector measures are justified to overcome this market failure in seed and early-stage investments.

However, any public sector action to stimulate investment should contribute to the efficiency and long-term sustainability of the venture capital sector. Such action should aim for programmes that work with the markets but do not crowd out private investment, and do not contribute to the proliferation of small funds. Small funds cannot benefit from the possibilities for economies of scale; their ability to provide advice to the companies they invest in is limited; and so are the possibilities of investment diversification; they can have difficulties recruiting experienced managers; and consequently they are likely not to provide the management quality that investors are looking for. Allocating public funding to substandard venture capital funds would work against the development of the market by prolonging the life of underperforming funds without improving the overall situation of the industry.

The best results are achieved when the public sector invests in well-managed venture capital funds, where only part of the funds raised come from public sources. To provide equal access and promote quality, such funds are best selected competitively, based on quality criteria.

Common standards on valuation and transparency are essential for venture capital funds

The group reviewed the performance figures of the EU and US venture capital funds over the last years and noted the diverging calculation methods and varying results. In particular, problems about definitions, investment classification and valuation make performance figures subject to considerable uncertainty. The discussions confirmed that to reliably assess the performance of the industry, basic standards on common definitions, classification and valuation would be helpful.

As outlined above, public sector participation as an early-stage investor in venture capital funds is necessary. This requires that the industry becomes more transparent because it is managing more and more taxpayer money. Common standards for data collection and performance evaluation would help in this respect. Furthermore, to reliably compare EU and US venture capital industries, consistent definitions and valuation concepts, as well as uniform data are necessary. Transparency on risks taken and returns achieved would also help the industry to justify its fees.

The emerging industry standards on asset valuation as developed by the European Private Equity and Venture Capital Association (EVCA), together with other associations, were presented to the group, and the group recommended that venture capital funds should adopt these on a global basis.

Think locally, act globally — combining the benefits of a global industry with local growth

Venture capital is an attractive form of financing for high-growth companies and its availability allows them to grow. A vibrant venture capital industry promotes local development and the growth of companies. The group concluded that venture capital funds should be more visible at policy-making level to be able to influence their operating environment.

The venture capital industry is both global and local. Fundraising and investments in buyouts and later-stage investments take place in a globalised environment, without much regard for borders. In contrast, seed and early-stage investments are very local and there is a home bias in the activities of many stakeholders. Considerable benefits could be had from expanding links between local and global investors. In particular, links between venture capital funds and business angels should be encouraged. If the activities of business angels, who are active in seed and early stages, could be better integrated into the mainstream of venture capital, for example through co-investment schemes where angel financing is complemented with venture capital fund investment, this could help to overcome the market failure in early-stage funding. The profile of business angel financing has become higher as angels have been able to extend their investment reach by acting together in syndications and by extending their reach into cross-border investments.

The group concluded that strengthened cooperation and networking of investors like business angels and venture capital funds is essential to connect the local and global dimensions of risk capital markets and in this way provide benefits of more liquid funding markets for innovative firms.

Economic and regulatory policies make a difference

The group noted that economic policies and macroeconomic conditions influence investment decisions, and that administrative obstacles and taxation can hinder cross-border investments and small business growth. The group concluded that for those countries that want to increase venture capital investments, it is vital to remove obstacles that hamper the growth of that market.

This is especially critical for cross-border investments, as in many cases they in any case face additional hurdles that stem from economic culture and traditions. In particular, countries that have a weak tradition of equity culture and limited asset mobility should ensure that administrative and regulatory obstacles are minimised to enable innovative companies to get the financing they need.

Based on industry presentations, the group noted the industry practice of classifying countries according to their friendliness as an environment for venture capital investment. Such rankings have an effect on investment behaviour and should influence policy-making.

Industry development needs a supportive environment

The quality of the fund management company is a decisive factor for investors in venture capital. Successful teams are able to raise funds more easily, which implies that management companies with such teams tend on average to be larger than others. The structure of the venture capital industry is evolving, becoming in many ways more global, which expands the demand for high-quality investment managers.

The group concluded that raising the average quality of investment managers is a task that could have large external benefits for the whole industry, and it commended the efforts that venture capital associations have undertaken to do that. To provide further incentives for funds to raise the quality of their managers, suitable conditions might be attached to public sector investments in venture capital funds so that new managers get the training that they need.

5. Conclusions

The discussions essentially confirmed many of the policy recommendations on venture capital that has been made over the years. For example, the European Commission has worked to complete the single market in risk capital and the OECD has regularly issued policy recommendations for public authorities. The main elements of many recommendations are common, like focusing on the early stage; aiming at leverage with private investors; strengthening regional cooperation; increasing the expertise of fund managers; benefiting from existing stock markets; reviewing regulations that hamper investment; and developing the treatment of intangible assets.

Taking into account the discussions with the industry and academic advisors and the existing policy recommendations, policy-makers would benefit from resources that would help them to expand their knowledge of recent developments in venture capital, both in policy-making terms and academically.

It is essential that the benefits of venture capital be widely understood among economic policy-makers because this would facilitate the implementation of favourable policies. To this end further resources should be available so that the exchange of good practices can take place. To achieve progress towards the goals that the group's discussions identified as hampering venture capital investments, the following resource elements would be helpful:

1. Economic growth can be enhanced if economic policy-makers cooperate widely to enhance the availability of venture capital;
2. Policies on developing venture capital markets can benefit from research on policies and practices of other countries;
3. Policy-makers can benefit from readily available resources that contribute to the development of public policies for areas of risk capital where the market can not provide solutions.

These elements form the basis of the concrete recommendations outlined in chapter 1.

6. Follow-up

The working group believed that it is important to continue to build global awareness of the merits of equity funding for emerging growth enterprises. Several opportunities for this are provided at global level.

First, the "Risk Capital Summit 2005" organised by the European Commission and the UK Presidency of the European Council in London on 4 and 5 October 2005 will address the need to unleash the dynamism of financial markets and increase the availability of risk capital across the European Union. The conference aims to underpin this work by sharing international good practice and innovative approaches to improve access to risk capital for innovative and growing small enterprises.

The working group welcomed the initiatives that the governments of United States and Australia have made under the auspices of the OECD to clarify definitions in the area of venture capital. In particular, technical work on data and definitions with the objective of gaining agreement to a standard set of definitions for collecting statistics on private equity has global significance in developing industry standards and comparability. Global standards and valuation methods are particularly important in countries where the development of venture capital investment is at its early stages.

Further progress on a global level will be assessed at the OECD conference "Better Financing for Entrepreneurship and SME Growth" on 27 to 30 March 2006 in Brazil. The conference is jointly organised by the Brazilian Ministry of Development, Industry and Foreign Trade and the OECD. The objective of the conference will be to gather evidence relating to difficulties for SMEs in gaining access to equity finance, to report on policies and programs to address these difficulties, the lessons learnt in applying policies and programs and to provide practical guidance to governments on the options for intervention to improve SME equity financing. The conference will also provide an opportunity to review progress towards the agreement on standard definitions and valuation methods in private equity and on a proposed program for countries to present data along these lines.

These forums will provide valuable opportunities to raise the profile of venture capital investments as drivers of growth, and can feed the policy-making process on venture capital at all levels.

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