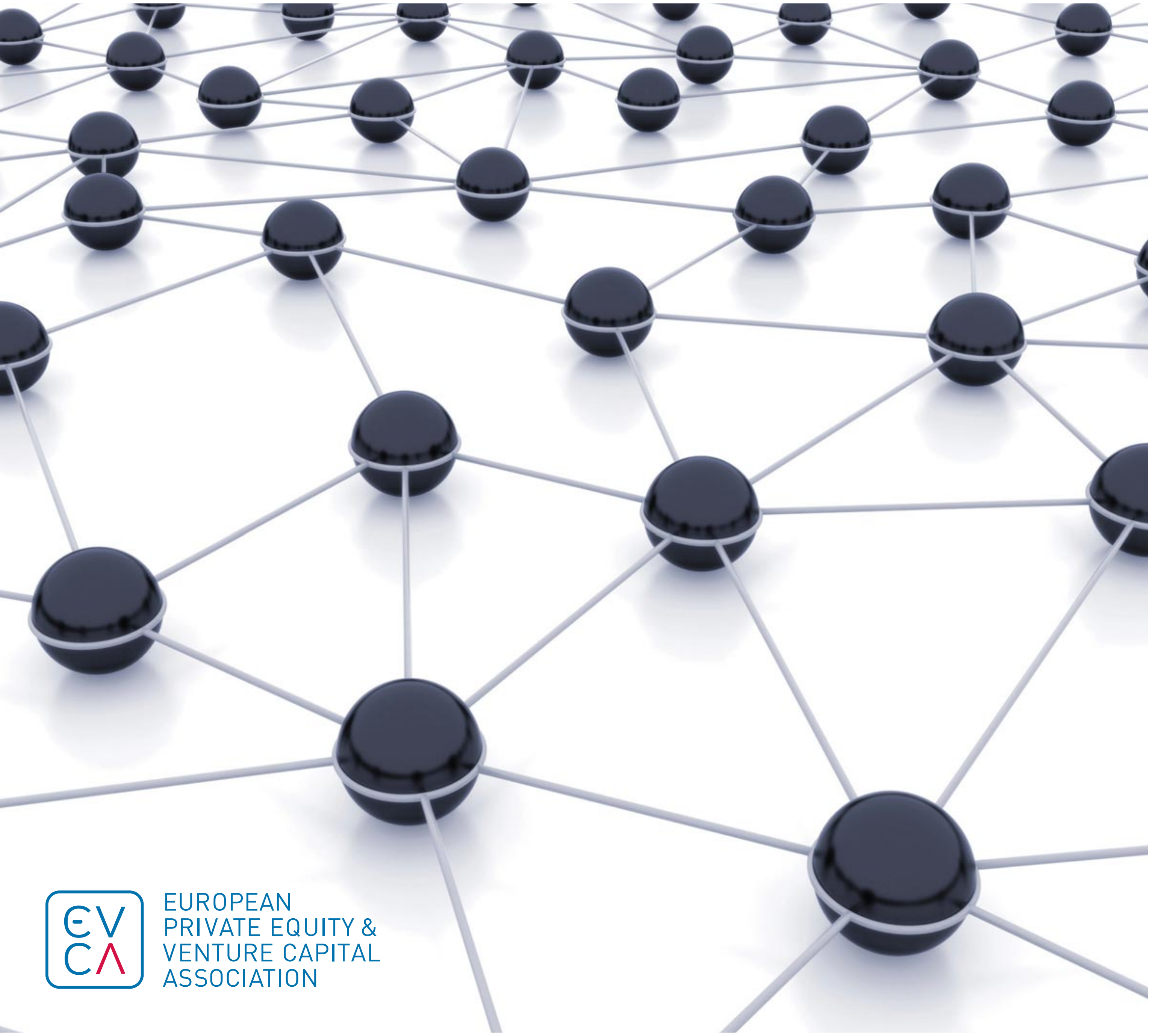
EVCA Venture Capital White Paper

Closing gaps and moving up a gear: The next stage of venture capital's evolution in Europe

Brussels, 2 March 2010



EUROPEAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION

EVCA

The European Private Equity & Venture Capital Association

EVCA is the voice of European private equity and venture capital. We promote and protect the interests of close to 1,300 members, thereby ensuring they can conduct their business effectively.

EVCA engages policymakers and promotes the industry among key stakeholders, including institutional investors, entrepreneurs and employee representatives. EVCA develops professional standards and research reports, as well as holding professional training and networking events.

EVCA covers the whole range of private equity, from early-stage venture capital to the largest buyouts.
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Executive Summary

The European Private Equity and Venture Capital Association (EVCA) believes that the time has now come to adapt and refine the existing structures of public support for venture capital. This will allow the policy successes of the last decade in stimulating venture capital, achieved most notably through the execution of the European Investment Fund, to be built upon and allow the European venture capital industry to move, to a new stage of development. This should increase its competitiveness, attract private investment and also lead to a phased reduction of its dependence on public money at national and at European level. EVCA believes that the lack of investment by private investors in venture capital is not a cultural issue or a reflection of the fact that European institutional investors might be overly risk adverse but rather a structural problem and can therefore be resolved. In this White Paper EVCA makes recommendation as to the next steps which the European Commission and other EU policymakers should undertake.

Specifically, EVCA calls on the European Commission and the other EU institutions to convene an expert group to analyse the existing barriers to the further expansion of the venture capital industry in Europe (many of which are already being highlighted by this White Paper) and to propose concrete, phased policy actions which should feed into a new Venture Capital Action Plan 2010-2020 for the European Union. EVCA believes that a gear change is required in EU policy if the development of venture capital markets is to be brought to a new level. Part of this will involve rethinking the funding model for venture capital in the EU.

Against this backdrop, this White Paper looks at the strategic long-term viability and financing of the venture capital industry in Europe; and at the contribution which this industry can make to the promotion of European growth and innovation. It does not address the immediate pressing concerns arising from the financial crisis. In a separate communication to the European Commission EVCA called for short-term measures to help the industry survive the ongoing crisis. These measures are already available within the existing framework for public support for the venture capital industry.

1. Introduction

The EU adopted its original Risk Capital Action Plan in 1998 (RCAP) ([1]). This plan was directed at raising political awareness for this important part of the economy and at highlighting its importance for financing innovation and growth in Europe. The RCAP became one of the main backbones of the EU's 2000 Lisbon innovation strategy. Much has since happened to help build a sustainable foundation for a venture capital industry in Europe. The RCAP contributed to strengthen the European venture capital industry, it was instrumental in creating a large number of fund management teams, and allowed them to gain significant skills and experience.

Structural failures and the changing environment

Despite the progress made, the venture capital and growth sectors remain vulnerable to financial and economic shocks. Global venture capital performance has suffered in recent years and has not met investors expectations, which has lead to a significant lack of appetite from institutional investors across the globe, not just in Europe. This underperformance is a worldwide phenomenon, and in many cases is related to macro-economic conditions. In addition Europe is facing a specific structural issue in its institutional investor community and as a result, the European venture capital industry is in deep crisis. Private institutional investors are leaving the market just at the time when Europe needs to redouble its efforts to stimulate the economy and stimulate growth. As a consequence public investors like the EIF/EIB Group are playing an even more important role, and in turn the continuation of these programmes is vital. This situation has, however, not just been caused by the current economic downturn. Long term public support, reinforcing and complementing current initiatives is required to address the structural issues that we identify in this paper.

The European market is not only still highly fragmented, but also the funding gap, compared to the US, remains high. As venture is part of a wider risk capital market, its size is difficult to assess, but according to EVCA's data, venture capital in Europe accounts for just €5bn to €6bn a year on average. This is tiny compared to most other asset classes. As a result, Europe's large institutional investors (pension funds, asset managers, banks and insurers) generally consider venture capital too small to justify allocating investment expertise or resources to this asset class. Europe currently does not have a community of institutional investors that fit the profile of long term partners for venture capital. Such institutions would embrace innovation, be committed to building the necessary experience in the sector, have the right 'investment-size' to make venture commitments economically meaningful and be willing to accept the inherent risk associated with this investment. By comparison, this class of investor does exist in the US, in particular in the form of university endowments, who are having significant successes with their investments in venture capital.

In fact, entry barriers into venture capital are steadily going up and it is less and less seen and accepted as a "cottage industry". There is a general increasing risk awareness on the institutional investor level which is also reinforced by regulation at all levels. Institutional investors require a wide range of expertise, skills and systems for risk management, regulatory reporting or compliance. Investment management is becoming far more sophisticated and the learning curve is much steeper than a few years ago.

The (1) absence of institutional investors whose objectives and profile are aligned with the venture industry, the (2) complexity and costs associated with the set-up of in-house venture teams, and the (3) small share venture capital activities can achieve within the typical European institutional investors' programs imply the need for outsourcing and greater intermediation. However, in Europe there are too few funds-of-funds that operate in this space.

([1]) http://ec.europa.eu/internal_market/securities/docs/risk_capital/sec98_552_en.pdf

The need to adapt

Ten years after the publication of the RCAP, EVCA believes that the time has come for the EU to rethink its policy on financing innovation and pave the way for a new Venture Capital Action Plan. This new focus on venture capital should become part of the EU's Innovation Strategy and also part of the EU's broader review of its Lisbon objectives 2010-2020. A new Venture Capital Action Plan should also contribute to the EU's drive for meeting its environmental commitments by investing in green technologies.

Providing adequate, continuous and sustainable capital for the venture capital industry forms the foundation for promoting this industry's long-term success and global competitiveness, however other conditions will also need to be met. These include the creation of an appropriate European regulatory and fiscal framework for venture capital, the promotion of entrepreneurship and research, and the ability of inventors to bring new commercial ideas and patents to the market.

With this White Paper EVCA intends to stimulate debate in the European Union on the role of venture capital in society, the industry's role in addressing Europe's policy priorities of today, and to set out a number of concrete recommendations as to how the EU can stimulate the venture capital market over the next five to ten years. The RCAP was instrumental in the creation of Europe's venture capital industry but EVCA believes that it is now time to review these policies and shift a gear to adapt these policies to today's circumstances. The aim should be to develop a self-sustaining and significantly larger European venture capital industry which can compete globally both for investors and for new innovative investments; while at the same time in the medium- to long-term reducing the industry's dependence on public finance.

EVCA calls on the European Commission and the EU to carefully consider the recommendations of this White Paper in defining the policy priorities for the next five to ten years. As an initial measure EVCA calls upon the European Commission to convene an expert group on the subject of venture and growth capital. This will be an immediate and welcome move to facilitate progress. The group would be able to bring together representatives of the industry, its investors, innovative companies and research institutions, and other relevant representatives of society. The group would be mandated to help identify current barriers to venture capital investments in Europe and to propose appropriate policy responses. These barriers could in turn be removed by the European Union by means of a new Venture Capital Action Plan 2010-2020.

2. European Venture Capital – Part of the Jigsaw Puzzle of Innovation

Investors in venture and growth capital funds provide high-risk finance for promising entrepreneurs and early-stage businesses with the aim of creating world-class companies (see Figure 1).

The ancillary benefits of venture capital investment, such as innovation, potential job creation and economic growth, mean that correctly fostered over the long-term, venture capital has the ability to promote an economy's growth and competitive position. A thriving venture capital industry is a precondition for exploiting Europe's rich potential for innovation and entrepreneurship.

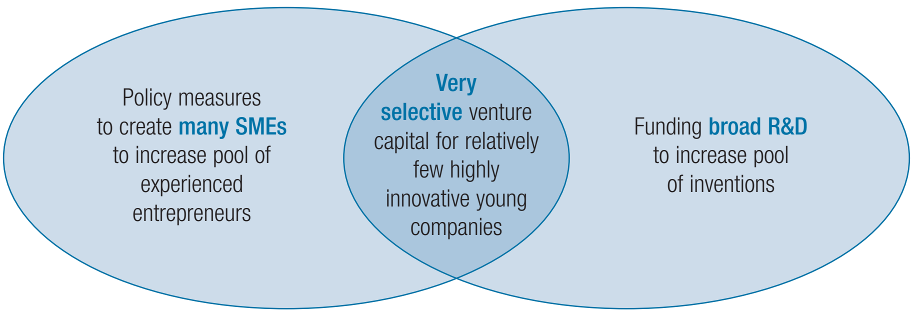
As recently as December 3rd 2009 the European Competitiveness Council stressed the importance to encourage venture capital in Europe when developing future policies for research-based innovation at EU level ([2]).

Too often the debate around venture capital has been highly popularized. Venture capital is not a panacea for achieving all of the current and future economic aspirations of the EU. It is however, a fundamental part of a larger risk capital ecosystem.

A detailed discussion of this risk capital system – comprising of business angels, technology transfer accelerators, guarantee schemes, tax incentives and other agents – is beyond the scope of this paper. We do, however, suggest a clearer differentiation between measures that support entrepreneurship and measures to promote innovation: while often seen as synonymous, in practice they demand different treatment. Entrepreneurship does not always require innovation, in most cases this would be better achieved with other tools than venture funding, and should be promoted in all European regions.

Of course, some entrepreneurs are also highly innovative, and a deep pool of such individuals are a precondition of innovation. It is important to recognise that venture capitalists must be extremely selective to be successful and therefore can only fund a small fraction of investment proposals.

Figure 1: The role of venture capital – accelerating the growth of highly innovative young companies



([2]) http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/intm/111732.pdf

To create a healthy environment for innovation and growth the venture capital industry and a widespread spirit of entrepreneurship must be developed in tandem. Both these objectives require different approaches.

A pervasive entrepreneurial culture must be developed at both national and regional levels with a range of financial instruments being deployed to ease the access to finance. Not just venture capital. As an example business angels or hybrid funds could closely cooperate with the banking sector and asymmetrically share risks and rewards between public and private investors.

The venture capital industry requires a wider, pan-European and global approach without allocations or restrictions related to geography. It is more the quality of innovation and its far reaching impact on future competitiveness that makes venture capital so important for all economies. It certainly has well-documented spin-off effects on job creation, patent applications and economic growth but the way in which it contributes to these objectives is often misunderstood. The provision of the capital itself is only one, though very important, element in the success of venture capital. The availability of investment acumen, i.e. specific knowledge of the market in which funds are investing, the existence of entrepreneurs willing to commercialise new ideas, the pool of investment opportunities available through research and development, and the existence of a supportive regulatory and fiscal environment; are all of equal importance.

The European Commission has appropriately described this combination of factors as the venture capital ‘ecosystem’. Imbalances or the lack of availability of any or all of these factors will have a detrimental effect on the overall contribution which venture capital can bring to the economy. All of these factors need to be looked at in conjunction with one another. This makes venture capital a unique and complex financial asset class. Any policy intervention in this market most also be given due consideration to the context in which public policies are being applied.

3. Significant Public Support was Required to Kickstart the Industry

The European venture capital industry has come a long way since the mid-1990s. It not only survived the dot-com crash but also generated success stories such as Skype, Cambridge Silicon Radio and Q:Cells. MySQL, often perceived to be a US success, in fact originated as a Swedish start-up. Public finances clearly have played a critical role in this process. In fact, in many European countries, public sector financing provided the kickstart to get the industry moving while providing support to many venture capital players in the aftermath of the dot-com crash.

The international experience, from Silicon Valley to the more recent growth of the Israeli venture industry, has been no different showing that public funds and well considered intervention is critical for the venture industry. Initially the venture 'ecosystem' has needed external support in order to get going and consequently, European policymakers have dedicated significant funds to what has now become the foundation for the European venture capital market. These vital interventions have succeeded in establishing venture initiatives in parts of Europe where it may well have not otherwise have taken hold.

It should of course not be forgotten that the European regulatory environment also opened up the possibility for established institutional investors (insurance companies, pension funds, collective investments and others) to invest a small part of their capital in such funds in the interest of diversifying their investments, potentially increasing their returns and to generally grow the venture capital industry in Europe. Contrary to initial expectations however, private sector capital has not entered the industry to the same extent, and more recently – as an effect of the crisis – has increasingly left this market.

To fill the gap caused by the lack of institutional investors in venture capital, over the last decade several European public institutions have also been operating as funds-of-funds operating on pari passu commercial terms aiming to bring in private investors to co-invest in venture funds. This intervention proved to be very successful: a commitment by these public institutions has now become essential for venture capital fundraises. It is therefore vital that the investor base is broadened to further support and build upon this platform while addressing the structural issues currently hindering private sector investment in venture reaching the critical mass required to avoid this type of intervention reaching diminishing returns.

But public funding, in its current form, is reaching its limits

There has been a recent convergence of public sector support to commercial approaches that have sought to avoid market distortion, however at the other end of the spectrum broadly delivered public support schemes have tried, with a single policy tool, to achieve several, simultaneous, policy goals including SME creation and the establishment of a sustainable venture capital industry. As a result there has been a wide proliferation of venture capital funds directly leading to a lack of competitiveness in the European venture industry; something which the European Commission recognised in its fifth and last Progress Report on the RCAP [3].

While Europe is home to a handful of globally successful venture capital firms, the goal of establishing a fully-fledged venture capital 'ecosystem', able to exploit the Continent's innovative capabilities and its skill base, remains elusive. On reflection, while public sector initiatives operating on commercial terms have managed to "professionalise" the venture capital industry in Europe, a self-sustainable industry, relying on private sector investors for the bulk of its funding, has not emerged.

(3) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2003:0654:FIN:EN:PDF

Clearly, producing a business case that is sufficiently appealing for private sector investors cannot be the purvey of public funding support schemes alone. The current European venture capital landscape, after more than a decade of public support, suggests public support schemes provide crucial, non-market distortive funding to the VC industry. This is still not a sufficient tool to make the European VC industry self-sustainable. It needs to be complemented with ladditional policy measures that seek to incentivise private sector investors to deploy capital at scale into this asset class alongside public sector funding programs.

Innovation cannot be organised by decree

Venture capital by its nature invests in new businesses and technologies. The venture capital's much-celebrated externalities in promoting innovation and economic growth do not occur quickly or in a predictable fashion.

In many instances public financing is linked to political objectives, preferences for certain technologies or tied to particular geographic regions. We fully understand the political rational for such thinking but it is counterintuitive to how venture capital works in practice and limits the potential for success of public support. It is impossible to predict in advance the success of particular research or the emergence of a new discovery. This is exactly the reason why venture capital investments are perceived to be more risky than most other forms of investment. On the upside it potentially renders higher returns for its successful investors.

Therefore, and contrary to political aspirations, venture capital schemes should not be devised back-to-front: determining a particular policy outcome first and then working back to designing the appropriate venture capital market to raise the appropriate funding to meet this policy objective regularly fails.

Instead, public support should contribute to the creation of a competitive venture capital market, the promotion of qualified and informed investors, and create the appropriate fiscal and commercial incentives for promoting research and development in line with policy priorities. These policy objectives could then be met in time through the venture capital's commercial and technological spin-offs.

4. An Overreliance on Public Funding is a Structural Weakness

Some initiatives at national and European level, notably the selective investment approach applied by EIF pursuing policy objectives through the creation of a viable infrastructure, need to be enhanced to fulfil their policy objectives in a non-distortive way. Therefore public finances remain essential to the future success of the European venture capital industry, for both, the attraction of new investors but also for the continued support of the existing venture capital industry. The use of these support mechanisms does need to be carefully reassessed.

Public finance that disregards market forces can potentially upset the delicate ‘ecosystem’ of the venture capital industry and restrict its ability to flourish unassisted. European venture capital funding is thinly spread across a large number of funds and projects. Too many public finance schemes have also created political expectations which the venture capital industry cannot meet and created incentives for investment which are not in line with commercial realities. Together, this has lead to a situation where public money has increasingly, and in many cases even exclusively, become the main source of financing for venture capital. This has, to a large degree, contributed to the sector’s uncompetitive state and reduced the ability of some of the best performing funds to differentiate themselves to both investors and SMEs, diluting the ability of the market’s best performers to thrive.

EVCA believes that in order to allow venture capital to deliver many of the expected economic externalities, any public financing schemes in support of Venture Capital not only need to be made systematically compatible with private sector market logic, but also paired with initiatives aimed at mobilizing additional private sector capital for the VC industry in order to make it less dependent on public sector support in the long run.

Aligning public policy and private sector goals

EVCA urges policy makers to start to rethink the way in which they view venture capital. The first priority of policy makers should be to assist in the establishment of an EU-wide large and sustainable venture capital market bringing together both public and private sources of financing, as well as more technology oriented investment acumen and know-how.

Investment decisions need to be taken primarily on commercial considerations rather than in response to a predetermined and wide ranging set of policy objectives. Public policy can assist in developing properly designed incentives and ensure an alignment of interests of investors. This is the ‘glue’ that binds the venture capital ‘ecosystem’ bringing many different players together and giving it its driving force. Ideally, public funding should stimulate venture capital markets, help bring in private investments and in time make these markets self-sustainable. The EIF approach has demonstrated how public support can be deployed in line with a private sector market logic. Now is the time for public support to evolve in step with the development of the market, otherwise these efforts could potentially be wasted and the venture capital market could head into terminal decline.

One of EVCA’s motivations for preparing this White Paper is to introduce means by which the funding for venture capital can be rebalanced and private institutional investors can be enticed to invest more readily into this sector; like in the US market. Innovation, in the sense of taking new ideas and translating them into commercial successes, would benefit from a far stronger private sector involvement. This is crucial if Europe is to successfully compete on the world stage.

Ability to raise funding depends on match with investors' profile

The scale of the European venture industry is mismatched with what potential private institutional investors find commercially viable. As a consequence, institutional investors have either turned away from venture capital as an asset class or were never incentivised to invest in the first place. More importantly, they had insufficient incentives to develop specific investment expertise in venture capital. Building or rebuilding this investment know-how is critical for the future success of the European venture capital industry.

As it stands, and due to its relatively limited scalability, venture capital is mainly attractive for smaller and medium sized institutional investors which are more willing to specialize in this market segment. But their size also makes them more vulnerable to the risks associated with venture capital.

To manage these risks and grow the venture capital market over time it is imperative to bring private institutional investors to the market. Given the multitude of financial instruments they invest in, of which venture capital is only one asset class, and through their diversification of investments these institutional investors are much better placed to absorb the potential risks associated with venture capital and thereby complement the role currently being provided by the public financial support. This requires that private institutional investors are given the freedom to pursue early stage investments within the context of broader investment themes and strategies.

5. Now is the Time to Shift Gear

If the EU wishes to take venture capital to a new level it will and to a much larger extent have to involve European and international private institutional investors. These can provide a more diversified source of funding while creating knowledge spill-over and network effects. It is essential that policy makers trust the private sector to invest in those companies that really have a chance to become global powerhouses, large employers and future tax payers.

EVCA believes that in recent years European policy makers have given too little prominence to the fact that the success of the European venture capital industry ultimately depends on its ability to attract private funding. The critical yardstick of the industry's success and competitiveness should be the number of IPOs, M&A transactions and, companies which year on year emerge as new world class champions.

Softly but decisively

As we have already observed European venture capital is currently in a very critical condition, but its fundamentals are good and the European innovation system is viewed as highly attractive. With a number of world-class venture capital firms that happen to have chosen Europe as their base – Amadeus Capital Partners, Balderton Capital, Index Ventures, Northzone, Healthcap, TVM, and Sofinnova Partners to name but a few – we believe in the asset class' rich potential to deliver attractive financial returns. Particularly in the cleantech area which has gained investor attention worldwide and one which Europeans are seen as leading. There are already examples of fund-of-funds managers who have created interest for investments in European venture capital within the context of a diversified portfolio strategy.

EVCA does not suggest a radical break from the current public funding model for the venture capital industry as this could further destabilise the fragile venture capital 'ecosystem'. EVCA therefore extends its backing to the short-term stabilizing measures taken by the public authorities in several member states and certainly endorses the long-term role of EIF that in today's environment constitutes a key component in providing support to the European venture capital market. However, we call for thinking on a longer-term strategy that would lead to the stronger engagement of private investors, a prerequisite for the emergence of a self-reliant European venture capital market. This market will play a crucial part in providing the finance required for stimulating research and technology for Europe's companies of the 21st Century.

6. Policy Recommendations

This White Paper sets out two sets of policy recommendations:

1. A set of proposed actions aimed at improving the regulatory and commercial environment for the venture capital industry in Europe. These actions are aimed at stimulating the market while reducing and eventually overcoming its current fragmented state.
2. A far reaching, and essential set of proposals, that directly address the fundamental flaws currently preventing the deployment of capital into the market by private institutional investors. These proposals need to be seen in addition to the continued and further enhanced support by the EIF/EIB Group and not as a substitution of existing funding schemes.

EVCA hopes these recommendations stimulate public debate on how public policy can best help the European venture capital market to thrive and attract global capital inflows, lead to a reorientation of European policy on venture capital while continuing to recognise the strategic importance of this form of finance for innovation and economic growth in the EU.

As previously stated, EVCA urges the European Commission to convene an *expert group on the subject of venture and growth capital*. This group should consist of the appropriate experts and should bring together representatives of the industry, its investors, innovative companies and research institutions, and other representatives of society relevant to the sector (NGOs, trade unions). This expert group will be able to assist the European Commission in identifying the existing barriers to venture capital investments in Europe and make concrete policy recommendations as to how the European Union could establish a self-sustaining and growing venture capital market. In turn EVCA hopes the European Commission will convert these Recommendations into European policy and adopt a new *Venture Capital Action Plan for 2010 to 2020*.

Continue working towards a single venture capital market

Venture capital in Europe is highly fragmented. Funds have to be structured around 27 national operating environments. This creates significant obstacles and diseconomies of scale for venture capitalists and adversely affects fundraising. The European venture capital industry does not benefit from the fact that its market is, in theory, as large as the US market, if not potentially larger.

Improving the tax and regulatory environment for venture capital and the removal of all unnecessary impediments to attract international institutional investors to venture capital funds is therefore a key priority.

We welcome current efforts by the EU to create a single market for the European venture capital industry (see the Alternative Investment Fund Managers Directive([4])) but we have serious concerns about many of the proposed provisions which are not tailored to the venture capital industry. Europe-wide regulation is only helpful if appropriately tailored to the business, its practices and the risks of this industry. A number of further steps should be taken to achieve this objective:

- The improvement of the fragmented European stock market environment: A well-functioning innovation ‘ecosystem’ must include a stock market for innovative companies. Lowering the hurdles, at least initially, for high-growth companies that aspire to list their stock would greatly improve the attractiveness of the venture industry. This also supposes the existence of a large number of financial institutions with the expertise and willingness to make such investments and an equally large number of financial analysts capable of producing technology related investment research.

([4]) http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf

6. Policy Recommendations

- Extend tax reliefs: The EU's current definition of small and medium size enterprises ("SMEs") poses obstacles to venture backed companies benefiting from a variety of tax reliefs.

- Remove obstacles to cross border investments by venture capital funds: All EU Member States should agree to mutually recognise each others' fund structures for venture capital. A clearer cross-border regulatory framework will lower operating costs and risks, raise returns, increase venture capital flows and improve the functioning of venture capital markets. Stimulating cross-border operations will help venture capitalists to specialise, increase their returns and diversify their portfolios as they gain access to increased deal flow. In turn, SMEs will have access to a wider pool of venture capital and sector specific market expertise. This is particularly important for smaller funds and allows smaller countries to benefit from larger venture capital markets.

- Lighten the burden of social charges, taxation and red tape for young innovative companies: An example is the French Young Innovative Company ("YIC") scheme launched in 2004 that has provided temporary tax breaks and relief from social charges to more than 2,000 companies. Such schemes incentivise risk taking by rewarding benefits right from the early stages of a company's development.

- Provide an integrated, clear and efficient system of intellectual property rights: The costs and the time spent in obtaining patents must be reduced. Industry ministers met in Brussels this year and reached a political agreement on setting up a single EU patent to replace multiple national patents. However, the agreement did not resolve the issue of the high cost of translating patents into all European languages.

- Review international accounting standards: A thorough examination of current standards and their implications and practical use for venture capital firms (e.g. consolidation) is crucial.

- Review regulation related to financial risk: Banks, pension funds and insurance companies are subject to Basel II, Solvency II or comparable regimes. These increasingly discourage investment in higher risk asset classes, like private equity and specifically venture capital. More appropriate methods need to be found to integrate such asset classes into the regulatory framework. It is important to note that pension funds and insurance companies account for 25% and 10% respectively of the €370 billion raised by the industry in Europe over the last 5 years.

- Integrate commercialisation into current funding programmes: Innovative entrepreneurs have to overcome significant obstacles and find it difficult to develop a client base for their first products or services. Public procurement for R&D is largely inaccessible for SMEs. In the US, the expansion of venture capital benefited from the Small Business Innovation Research ("SBIR") scheme that was established in 1982 and that was largely motivated by the concern that insufficient financing was available to innovative small firms. The European Union has no comparable budget line to the SBIR and such schemes might firmly belong into the national domain. Several Member States have in fact already introduced such schemes. Nevertheless, the European Union might want to consider whether it could promote greater coordination among Member States in this area and could possibly even reserve parts of its research budgets for contracts and grants to small businesses.

- Move away from overly restrictive and constraining public intervention: By definition public intervention aims to focus on correcting market failures and is therefore associated with increased risks. Instead of focusing public support on specialised vehicles – which are more risky by definition and thus increase exposure to the market failure – support should allow intermediaries to be more flexible and diversified over stages to bring risks down to a level acceptable to the private sector.

Multi-annual programme for private sector asset managers

As previously mentioned, we argue that untargeted public sector finance will impede the inflow of private funding into the European venture capital market.

The current stage of the market's development implies that while existing policies can be enhanced, new approaches are also required. The EU should consider developing a new, additional, and specifically dedicated scheme for stimulating the demand for high-quality venture funds by launching a multi-annual programme for private sector asset managers. The scheme's objective would be to demonstrate that a properly managed portfolio of European venture funds can be attractive to private investors by generating appropriate financial returns. It would propose to do so by promoting funds-of-funds with a significant allocation to European venture capital.

Europe's main weakness is the lack of suitable intermediaries that firstly have the expertise to select the best venture capitalists and in turn allocate capital effectively to innovative entrepreneurs with the highest potential; and secondly can bridge the gap caused by the limited scalability of venture capital and the asset allocation needs of institutional investors.

Under this proposal public sector funding would act as catalyst to provide a competitive market and deliver the appropriate incentives for private sector investors to be able to select and invest in the best funds. Ultimately, the measures would aim to attract international institutional investors by raising the overall quality of the European venture capital industry.

Public money under this scheme would only be invested into venture capital in such situations where experienced investors have undertaken due diligence, taken significant stakes in the selected venture capital funds and have strong incentives to monitor these investments. EVCA believes that this approach would contribute to an alignment of public and private interests.

- The scheme will help to create a true "venture culture": For this purpose the scheme aims to create several funds-of-funds over a time period of 10 years.

- The scheme has to target and attract private sector investors: The main condition imposed by EU policy makers would be that managed by the private sector (mandates for fund management would be assessed by a body like the EIF/EIB group) asset managers match the EU funding with a minimum of private funding. For this purpose they would have to develop and market a convincing investment strategy to appropriate European and global institutional investors. This strategy would have to include European venture capital as a major component and public support should never exceed the size of this component.

- The funds-of-funds' investment strategies need to have an appropriate risk and diversification strategy: The investment strategy should include a suitable diversification over stages and geographies within a fund-of-funds.

- The scheme has to be long-term oriented: It should be in place over several years and returns stemming from the various funds-of-funds should be reinvested into the scheme over this period.

The scheme should be designed to create European funds-of-funds or comparable vehicles with a clear and sizable commitment to European venture capital. This would also allow smaller institutional investors to remain engaged or become active in this asset class. The scheme aims to establish a 'Champions League' of European venture funds that will set the standard and serve as a role model. The model should be designed in such a way that it will support the best and most promising venture fund managers rather than spreading pre-allocated public funding around a wide universe of fund managers. It is thought that this 'Champions League' will spin-out teams of trained and experienced venture capitalist that over time will bring their know-how to other underserved niches in the European venture capital market.

Clearly the scheme proposed in this White Paper should not be seen as a substitute but as complementary to other public sector actions.

Will it work?

The number of responses from private sector fund-of-fund managers for the Request for Proposals for the UK Innovation Investment Fund (UKIIF) has confirmed that – provided that public co-funding is available and that there are no extensive political obligations attached – the high level of interest in managing such mandates. To raise the matching funding from the private sector, fund-of-funds managers are marketing their funds Europe-wide and globally to convince investors of the European venture industry's attractiveness.

Further benefits could be derived from coordinating national risk capital support programs at European level or establishing common best practice guidelines, drawing on the European Investment Fund which has a longstanding track record in supporting the venture capital industry.

7. The Strategy for the New European Commission: A New Venture Capital Action Plan 2010-2020

Venture capital is an integral part of an innovation policy. Attaining and sustaining competitiveness in the global economy requires Europe to work towards the creation of a robust and self-sustainable venture capital industry able to support tomorrow's creative ideas. The existing Community funding programs were critical in placing the European venture capital industry on the map, but the policies must now evolve to meet the goal for the next stage of the European venture capital market's development: to make it globally competitive and self-sustainable.

For this purpose EVCA proposes that within the EU Innovation Strategy 2010-2020 the European Commission incorporates some, if not all of the recommendations set out in this White Paper. If implemented, these recommendations would help to optimize the allocation of resources to Europe's high-potential innovators and to tackle the existing regulatory and non-regulatory barriers to the provision of venture capital.

Structural intervention is necessary to create an EU venture capital market that can play its potential role in supporting economic recovery and competitiveness. It is critical that both public and private sector join forces in an integrated approach as outlined in the recommendations of this White Paper. EVCA calls for political attention and commitment at the European level to adopt a set of coherent, focused and long-term-oriented policies that will promote the growth and achievement of a robust and self-sustainable EU venture capital industry.

This White Paper does not claim to have all of the solutions. Many of the observations made in this Paper will need to be studied in more detail before concrete policy actions can follow. It is for this reason why EVCA urges the European Commission to convene a specific expert group on this subject and call on these experts to report back on their findings within a clear timeframe. This timeframe should be set in order to provide meaningful feed into the EU's Innovation Strategy for 2020.

The experts work should form the basis for a political programme to be implemented by the EU institutions during the terms of the incoming European Commission and this European Parliamentary term. It should also enable the European Commission to assess the progress made at EU level and by Member States towards putting in place measures favourable for the development of venture capital in Europe.

Appendix: What is Venture Capital?

Venture capital is a subset of a larger private equity asset class which includes seed, start-up, expansion, growth, buyout, bridge and mezzanine investments. A venture capital investment is a form of professional equity which is invested in unlisted companies together with the entrepreneur in order to provide seed or start-up capital, or to fund an expansion of the business. Such investments are also made by private equity firms, when expanding their respective horizons in order to capture new opportunities.

Institutional investing in venture capital is mainly through funds that fulfill a number of functions. Firstly, they allow pooling of capital for investing in private companies. Secondly, they allow the investment process to be delegated to fund managers with significant experience and the proper incentives to screen, evaluate and select potential companies with expected high growth opportunities. They have the necessary expertise to finance companies that develop new product and technologies and to foster their growth and development by controlling, coaching and monitoring these companies' management. Finally, the fund managers source exit opportunities and realize capital gains on disposing portfolio companies.

Venture capital funds are generally structured as limited partnerships. While terms and conditions and investor rights and obligations were initially defined in specific non-standard partnership agreements, the limited partnership structure – or comparable structures used in the various jurisdictions – has evolved over the last few decades into a "quasi-standard".

- Investors – mainly long-term oriented institutions such as pension funds, endowments, funds-of-funds, banks or insurance companies, high net worth individuals or family offices – are the limited partners and commit a certain amount to the fund. They have little or no influence on the day-to-day management of the fund. However, limited partners are given some oversight of the fund, i.e. by allowing them to sit on advisory boards or on investment committees while still being protected from general liability. Often there is a minimum amount that makes the fund only accessible to professional and institutional investors.

- The fund usually has a contractually limited life of seven to ten years. The fund manager's objective is to realize all investments before or at the liquidation of the partnership. Often there is a provision for an extension of two to three years. The main part of the capital is drawn down during the "investment period", typically three to five years, where new opportunities are identified. Sometimes there is a provision for an extension of one year. After that, during the 'divestment period', only the existing and successful portfolio companies will be further supported with some follow-on funding provided to extract the maximum value through exits. The manager's efforts during this time are concentrated on realizing or selling the investments.

- The management fees depend on the size of the fund and on the resources required to implement the proposed strategy. They generally range from 2.5% of committed capital for funds of less than €250 million to 1.5% for the largest funds. The fees are often scaled down once the investment period has been completed and adjusted according to the proportion of the portfolio that has been divested. There are, however, considerable differences from one fund to the next, particularly relating to what the managers do with income and expenses from their investment activity, such as directorship fees or transaction costs. These can have an impact on the returns and often account for material differences between gross and net returns.

- The fund managers' main incentive is the 'carried interest' of, typically, 20% of the profits realized by the fund. Usually carried interest is subject to a "hurdle rate", so that it only applies once investors have received their capital back and a minimum pre-agreed rate of return. They also often invest a significant share of their personal wealth into the fund to put themselves at risk in case of under-performance and to thereby signal their belief in the fund's success. These incentives motivate fund managers to take large risks when they believe that the potential returns are high, and thus align their interests with those of the limited partners.

- Commitments are drawn down as needed, i.e. "just-in-time" to make investments or to pay costs, expenses or management fees. Because private equity funds typically do not retain a pool of un-invested capital, their general partners make capital calls when they have identified a company to invest in. Therefore, the main part of the drawdowns is invested immediately. If no suitable investment opportunities are found, funds may even end up returning some of the capital back to the limited partners.

- When realizations are made, or when interest payments or dividends are received, they are distributed to investors as soon as it is practical. Thus the fund is "self-liquidating" when the underlying investments are realized. However, limited partners typically have no right to demand that realizations be made, and these returns mostly come in the second half of the fund's lifetime.

Market practices for fund structuring are continuously evolving driven by competition in international private equity and venture capital markets and adjusting to changing economic conditions. Among other points, funds need to be attractive from a tax point of view, provide for alignment of interest and investor protection. Institutional investors build up geographically diversified portfolios and therefore compare European funds against proposals worldwide: they will only in a venture capital fund if it is seen to be competitive within an international peer group.

The future of a venture capital firm depends on the success of its fundraising. If it fails, the lack of a new source of management fees will force the firm to reduce its cost base – until eventually it has to fully liquidate – in parallel with the decrease in the management fees received from the old funds under management.

During the fund's life, venture capital firms maintain clear disclosure and communication of relevant and material information to their investors. There is regular communication to investors in accordance with the industry standard Reporting Guidelines and Valuation Guidelines. These include substantial details about each of the portfolio companies and valuation of the fund's portfolio at fair value. The periodical liquidation of venture capital funds is essential for investors, because the exit and re-investment cycle allows them to withdraw capital from less competent fund managers or managers whose industry expertise has become obsolete. The fund management team's track record and reputation is critical for the successful raising of follow-on funds.

A private equity management company can act as a 'group', managing several such partnerships in parallel. Typically, limited partnership agreements do not allow follow-on funds with the same strategy by the same manager within a certain investment period.

A significant part of venture capital is invested in technology related areas such as new information and communication technologies, life science and health care, electronics and new material industries. In recent years, the sector has also been an important driver in the financing of "green" and "cleantech" environmental technologies.

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