



Competent capital?

Three countries, three attempts

Summary

The Swedish regional venture capital funds – a few reflections at mid-term

The Swedish regional venture capital fund endeavour formally began in 2009. At the time, conditions did not permit full operations. Through the funds' own work and with constructive support from "the on-going evaluators" (Ramböll) and the Swedish Agency for Economic and Regional Growth (Tillväxtverket), the efforts have increasingly taken shape. Knowledge and understanding of the regulations have grown, structures have been developed and the rate of investment has gathered speed.

In 2011, the *rate of investment* has gained increased attention with the aim of avoiding repayments to the European Commission. All indications are that the funds have managed this in volume. The most recently available figures (September 2011) indicate that 127 investments have been made thus far. In total, SEK 957 million has been invested, including both public and private capital. Of the available European Regional Development Fund (ERDF) financing, around one third or SEK 178 million has been utilised.

Expectations on the *levels of return* differ between the funds and the private co-investors. It is likely that the funds' lower expectations, at least partially, reflect the broader target structure to which they must relate.

The issue of *additionality* is methodologically difficult to manage. From the material available, a cautious interpretation may be that the endeavour to-date appears to have constituted leverage for private investments that have thereby shifted up. Additionality appears to exist for a bare majority of the investors. Potential displacement effects cannot be assessed, but nor can they be ruled out entirely. The Swedish Agency for Growth Policy Analysis (Growth Analysis) believes that it is important that these studies are done regularly and with as good underlying data as possible.

The accuracy of the funds in terms of investments at an *early phase* is considered to be well within the intentions of the effort.



The arrangement with regional venture capital funds tied to a specific programme area makes the *geographical dimension* important. The conditions for every individual fund are far from identical.

Experiences from Norway and the previous Swedish pilot study indicate some deficiencies in terms of *collaboration* between the funds themselves and other stakeholders. Consequently, it is important that cooperation and experiential exchange in the current effort are both encouraged and actually take place. A shared vision is important in order to facilitate cooperation, but not easy to achieve.

One of the increasingly important issues over time is *exit opportunities*. This may be a concrete issue where experiential transfer between the funds may play a significant role.

In general, there is a shortage of *systematic evaluations* of national efforts on the capital supply market. The Swedish effort has the potential to contribute much experience. This naturally requires high quality data. It is therefore very important that the conditions for such data collection are secured.

The mid-term report produced by Ramböll in its capacity as the procured "on-going evaluators" includes many relevant aspects. It is hoped that the stakeholders involved earnestly study the report and that the initiated cooperation will continue to be developed.

International case study

The main purpose of this study has been to map experiences with hybrid seed funding models in Finland, Norway, and Scotland. More specifically, overarching goals, organization, effects, incentives, and geographical distribution have been under scrutiny.

In *Scotland*, the Scottish Co-Investment Fund (SCF) was established in 2003. Based on an already established initiative that aimed to develop business angel networks (BANs), this program established a co-investment model where the Scottish Enterprise approves the partners that will take part in the program. The program partners (typically investor networks and venture funds) are responsible for identifying, evaluating and negotiating deals with potential portfolio companies. When investing, SCF will co-invest up to 50 percent of the investment amount at the same conditions as the private actors. Therefore, the decision to invest is made by the program partners. There is no other risk-reducing elements in the program, but one has to bear in mind that the United Kingdom has very attractive individual tax incentives both on invested capital (*front end*) and realized returns (*back end*). Studies have shown that this program has been important in building robust investment networks that invest in early stage of a firm's life cycle. Moreover, these investors often take on a strategic role, and sometimes even an operational



role, in the companies that they invest in. The economic effects of SCF are as of today uncertain, because only a couple of companies have been exited at a reasonable rate of return. This must be viewed in light of the financial crisis, and the fact that it take between seven and ten years to develop new, profitable growth companies. However, it is reasonable to question whether the emphasis on exit has been large enough, and if the investment networks have the necessary experience in facilitating successful exits.

The *Finnish* government has experimented with different programs to stimulate the population of growth ventures. Examples of such programs are: different types of monetary contributions to potential growth ventures, programs for stimulating the creation of new ventures, and different types of governmental seed funds. Realizing that high-potential projects need more capital, the VIGO-program, highly inspired by the Israeli Yozma-program, was established in 2009. This program intended to provide a fast track to financing and competence for high-potential companies. A key component in this program is the use of incentivized business developers. The program began by choosing six specialized accelerator networks (VIGOs) consisting of serial entrepreneurs, investors, and business developers with international experience. The rationale behind the establishment of the VIGOs was that the competence, experience, and network inherent in these networks could contribute to the realization and survival of high-potential ideas. The VIGO program is still in an early phase, but several projects has already succeeded in attracting significant amounts of capital from international venture capital funds. At the same time, however, several of the VIGOs have expressed frustration with the fact that the public actors Seed Vera Venture and Tekes make independent assessments of each project in addition to the evaluation conducted by each VIGO network.

In *Norway*, two rounds with regional and national seed funds have been set up by the Norwegian seed capital program. The program has been organized as a traditional venture capital model with general and limited partners. The government has committed liable loan capital equal to the private capital infused. Additionally, a fund that is subject to claims from realized losses has been established, where 25 percent of the loan capital can be amortized (maximum percent of the loss in each project). The first round of seed funds, established in 1998, has given a non-satisfactory rate of return, and only a few of the investments have given a reasonable return. When evaluating the first round, the following explanations were found for the non-satisfactory return: insufficient risk-reducing mechanisms, lack of competence among the fund managers, too small funds, and a non-satisfactory liable loan capital model. In the second round of seed funds, established in 2006, a total of nine regional and national seed funds were established. By learning from the first round, the focus in this round was: more attention to the choice of fund managers (requiring competent fund managers),



larger funds, and facilitating the sharing of experiences between the different fund managements. Moreover, the liable loan capital had slightly better conditions. Still, however, the private actors must bear the cost of management, making the fund management expensive seen from the private actors' side. As a consequence, the funds have been criticized for not making “real” seed investments. According to the funds themselves, this is due to lack of stable governmental regulations. The seed program in Norway is not a permanent model, and as of today the fund managements are waiting for signals from the Ministry of Trade and Industry of whether or not the program will be continued. This uncertainty implies lack of dynamic and makes the seed program a modest contributor to the development of sustained, robust networks of fund managements.

All of these three programs try to *involve private capital* in order to increase the emphasis on investments in companies with a real growth potential. This illustrates the following dilemma between the main objectives of the programs:

- *First*, the governments wish to engage private actors in order to ensure that investments are made in projects that have a large growth potential.
- *Second*, the programs' intentions are clearly to invest in projects in a very early phase, where the uncertainty is large and genuine. Examples of such projects are research-based spin-offs from universities. However, this intention is not always aligned with the risk-profile of private investors.
- *Third*, it is clearly a wish to develop “thin” capital markets, so that the strength of these markets increase with the supply of additional capital and competence (especially when considering phase and industry, but also to some degree when considering regions).

It is clearly demanding to address all of these goals in one program. In the three programs explored in this report, the goals are weighted differently, and as a consequence, the programs have different characteristics. The VIGO-program puts the strongest weight on the *competence dimension*. It is emphasized that the VIGO-accelerators should be involved in a very early phase of a company's life. The partners are almost expected to involve themselves in operational matters in the companies, in order to position them for domestic as well as foreign investments after a period of one to two years. A key objective in the Scottish program is to engage BANs that can supply strategic and operational competence to the portfolio companies. The competence dimension is also important in the Norwegian model, but the involvement from the general partners in each seed fund is more strategic than operational.

In addition, this study shows that the *historical context* needs to be taken into account when introducing and developing different programs. For instance, the SCF in Scotland would not have been as successful without the existing tax



incentives and investor networks. In absence of this infrastructure, actors would not have been able to exploit the possibilities presented by the program. In this case the introduction of the program enhanced the effect of existing means. On the other hand, Finland has experienced difficulties when trying to operationalize the program with respect to the current set of means.

Another central finding in this study is that the focus on hybrid seed capital models must have a *long-term perspective*, and the government must enhance *stability* in order to maintain the interest from private actors. Lack of stability can make private actors terminate their investments, behave more risk-averse, or reduce their planned investment activity. To have a long-term perspective is difficult for the government, because the government wants to see quick results in order to ensure that public money are invested in a satisfying way. Bearing in mind that it could take 15 years before a satisfying evaluation of these programs can be undertaken, this is an obvious dilemma. Moreover, it is difficult for evaluations of such programs to measure the economic effects of the public money spent to develop capital markets. However, it is possible to undertake partial evaluations underway. Such evaluations should be conducted in close cooperation with fund managers in these programs, since these managers often collect data for internal use. By using this data, it is possible to conduct follow-up evaluations that can support the decision-making process when the government is going to adjust existing programs or developing new programs in a much better way than today.

The Swedish model is in many ways similar to the Norwegian seed model. However, the regional dimension is even more evident. With this study and previous research in mind, it should be questioned whether this model is a good solution for Sweden. Several studies have shown that regional seed funds struggle to succeed commercially. When a regional model has been chosen, it is important that the program is flexible and can be tailored to the regional context. It is not likely, however, that a regional program without some kind of risk-reducing mechanisms will deliver a reasonable rate of return to its private and public owners. At the same time, it is clear that these funds could play an important role for regional development, because the fund managers gather competence and experience that is not present in the regions. Another question is if the establishment of such funds engages serial entrepreneurs in the different regions. It is serial entrepreneurs that in many cases can provide the operational and strategic competence that is invaluable in the early phases of a company's lifetime. The operational as well as strategic advice from serial entrepreneurs could be determining for whether or not a prospective high-growth company will realize its potential.



Policy discussion

In the three efforts studied, the experiences of the involved stakeholders and the structures are described. In all three cases, the government is trying to involve private capital in various ways.

From an evaluation perspective, notable deficiencies can be confirmed in *systematic evaluation attempts*. Few evaluations have been done and they provide more of an impression of individual studies than parts of a cohesive, long-term evaluation system.

Sørheim and Rasmussen's study emphasizes the significance of *long-term* playing rules and *predictability*. Government efforts at irregular intervals, uncertainty regarding extensions and possible changes in structures and terms are at risk of influencing the stakeholders' desire to invest (in volume and phase) and making the building of competent environments more difficult.

One lesson that can be learned from the above is to shift the efforts from short, direct policy measures to more long-term, indirect and system-impacting venture capital strategies, such as incentive structures and regulatory changes. The long-term challenge is, however, to build up and maintain an institutional structure that is stable and long term on one hand, but stimulates learning and innovation on the other.

The three case studies clearly indicate *the significance of the context*. An overwhelming majority of the issues we face in Sweden are internationally applicable. This means that methods and solutions from other countries are highly relevant to us as well. The challenge is to take in these foreign experiences and, at the same time, take into account the context in which they developed. In this case, efforts in the area of the supply of capital must be interpreted based on such factors as history, the nature of the financial market and differences in the business structure.

With this in mind, it can be noted that the Scottish experiences point to the existence of business angels and tax incentives as two crucial, contextual factors for the Scottish Co-investment Fund's (SCF) successful implementation in Scotland. In Finland, business angels do not play as distinct a role, but a national business angel network does exist – Investor Extra. In Norway, capital from business angels has constituted a small part of total investments, but is still judged to have played an important role when mobilising institutional capital. The question of tax relief for investors in an early phase was also posed in Finland, but has not yet found sufficient political support. In Norway, the issue has, however, not been discussed to any mentionable extent.

Historical heritage also influences how new efforts are perceived and succeed in their implementation. In Finland, a structure is being tried that markedly deviates



from previous handling. The strived for rapid decision process is based on the VIGO accelerators' valuation being adequate and public stakeholders automatically complying with their decisions. This is an entirely different way of working for Seed Vera Venture and TEKES than before. This has also initially resulted in a significantly more sluggish decision process than envisioned.

The now working Corporate Income Tax Committee in Sweden will probably propose possibilities of tax relief for natural persons for venture capital investments. In the future, we might possibly see an *incentive structure* in the Swedish tax area with elements reminiscent of the Scottish system.

On a general level, it can be asked what the *actual goal* is of the government's actions? Is there a long-term ambition to develop the capital supply market to the furthest extent possible so that need for government market intervention and selective measures can be reduced over time? Or should the goal be viewed as more short term where the promotion of a smaller number of growth companies in specific efforts is in focus? Although both aspects can naturally be said to be significant to a country, how they are prioritised and communicated plays a role.

In very simple terms, some differences can be identified in the overall objectives of the three cases studied. Finland is making a stake on few selected growth companies at a very early phase, with business development, rapid access to financing and international connections as main points. Norway has a traditional venture capital model where the government participates by contributing lending capital. The emphasis is on innovative growth companies, and a clear geographical dimension is added through regional funds. Scotland's SCF seeks more to develop the market by increasing capacity and competence among private investors. All efforts concern an "early phase".

Geographic delimitations or objectives have been included in various ways in the three countries. Finland's VIGO system is entirely divided by industry and consequently only has an indirect geographic dimension. In Scotland, there are no express geographic considerations. However, at the same time, it can be noted that the stimulus of business angel networks has meant that investors in rural areas organised and entered the market. Norway has a clear geographic character in its efforts with four national and five regional funds. The objectives of the latter are challenging: contribute capital, expertise and networks to knowledge companies with considerable growth potential in the areas characterised by depopulation and a weak economy. In practice, these funds can reasonably be considered to be more regional development actors than distinct seed financing funds and should perhaps also be judged based on this.



Investors prefer to invest in their local geographic area and have portfolio companies within “reach”. The reasons are intuitively easy to explain – it is easier to find cases and easier to take care of and monitor them.

If the political objective is to improve the supply of venture capital nationwide, the above experiences provide an interesting background. Two conceivable policy implications can be noted. The first alternative is to assign venture capital funds strict geographical delimitations to ensure where investments are made. The second alternative is to work with national funds and supplement with non-financial promotion efforts directed at the actors, so-called, *investor/investment readiness* programmes. Well-implemented efforts increase the likelihood of investment action, increase expertise and reduce the search costs in both groups. The likelihood that active informal investors meet investment-ready companies in their local area thereby reasonably increases. Growth Analysis deems the latter alternative to be significantly more attractive than the former.

Informal investors appear to be an important group, particularly in terms of early efforts and a geographic presence. Unfortunately, this also coincides with an unclear statistical situation. Growth Analysis therefore proposes an *in-depth international study* where experiences of promotional measures directed at this group are studied more closely.

The report in its entirety:

http://www.tillvaxtanalys.se/sv/filer/publikationer/rapporter/Rapport_2011_05.pdf