



PRIME MINISTER'S OFFICE  
ECONOMIC COUNCIL OF FINLAND



20 September 2006

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## Risk capital for growing world-class companies: challenges for European policy

This paper is a contribution to the project *Globalisation Challenges for Europe and Finland* organised by the Secretariat of the Economic Council. The project is a part of Finland's EU Presidency programme and its objective is to add momentum to the discussion in the European Union on globalisation, Europe's competitiveness policy and the Lisbon strategy.

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## EXECUTIVE SUMMARY

The availability of risk capital in all its variants is a critical resource for a modern and adaptive economy. The effective exploitation of new knowledge requires a commercialisation process that is conditional on informed, skilled and risk accepting investors both as individuals (Business Angels) and professionals (Venture Capitalists). Similarly, the restructuring and reinvigoration of large established corporate businesses, often on an international or global scale, has been materially assisted by the advent of a finance industry focused on Management Buy-Out activity.

In Europe, the provision and use of equity-based financing is both patchy across countries and materially lags behind the levels of development seen in the USA. Both inefficiencies in the supply of venture capital and in the demand from informed and growth-oriented entrepreneurs has resulted in parochial and nationally focused risk capital industries that are individually and collectively weaker than their US competitors.

Global trends in both the provision by and demands of institutional finance seeking more and larger management buy-out opportunities, as well as the increasingly borderless identity of new technology paradigms, is threatening the relevance of Europe's current, predominantly country-based model of private equity. There is a real need to develop a more pan-European private equity industry.

In creating an Entrepreneurial Europe, policy makers need to recognise that:

1. Business Angels are a fundamental and early building block of an innovative and adaptive enterprise community. For early-stage ventures, they are collectively more important than venture capital. The national fiscal environment should incentivise and reward risk taking by entrepreneurs and their early-stage financial backers.
2. The fiscal environment should allow inter-country tax transparency. The costs associated with avoiding multiple taxation by private equity firms are a material barrier to a European market for risk capital.
3. Government should work to encourage the involvement of private and commercial investors rather than seeking to substitute for their unique skills by acting as a direct investor of public monies into new enterprises. Where government supports 'hybrid' venture capital funds by co-investing, it should stipulate that such funds must be of a commercially viable scale.
4. Governments themselves can be highly entrepreneurial. Yet, inter-country learning from both good and bad enterprise policy initiatives is poor and should be addressed by greater international contact between policy makers and academic experts.



## 1 INTRODUCTION

In this summary report we seek to give an informed view of two important roles of risk capital markets in Europe. First, we look at the region's ability to provide risk capital for high-potential start-ups and young growth-oriented firms. Secondly, we examine the region's ability to restructure, refinance and grow established firms into strong international firms capable of competing globally.

The key roles of venture capital in the identification and growth of new enterprises are described, including present weaknesses in Europe. Similarly, the increasingly dominant influence of the European private equity industry on company (and increasingly industry) restructuring via management buy-out activity will be charted. Given the European policy perspective of this document, we will emphasise, where possible, means by which current market constraints or limitations may be resolved in order to ensure that high-potential businesses secure the appropriate finance and support to realise global opportunities.

The terms 'venture capital' (VC) and 'private equity' (PE) are notoriously easy to confuse. We will therefore follow the convention of the European Commission's Expert Group (European Commission 2006b). VC investors seek to identify and finance the rapid growth of high-potential young firms that embrace innovative products, processes or technologies, thereby generating substantial rewards from successfully overtaking existing business paradigms. In parallel, a separate but closely related management buy-out (MBO) industry seeks to identify established (but under-priced and/or inefficiently managed) target firms that may be purchased by professional investors prior to significant restructuring, refinancing and the eventual re-sale of the 'revitalised' businesses. Essentially, venture capital describes the provision of risk capital and managerial expertise to new enterprises while MBOs concern the commercial transformation of existing (and increasingly very large) businesses. Both sectors of the PE industry seek to make their investors' medium-term returns substantially above the quoted market in order to reflect the substantial risks in these investments.

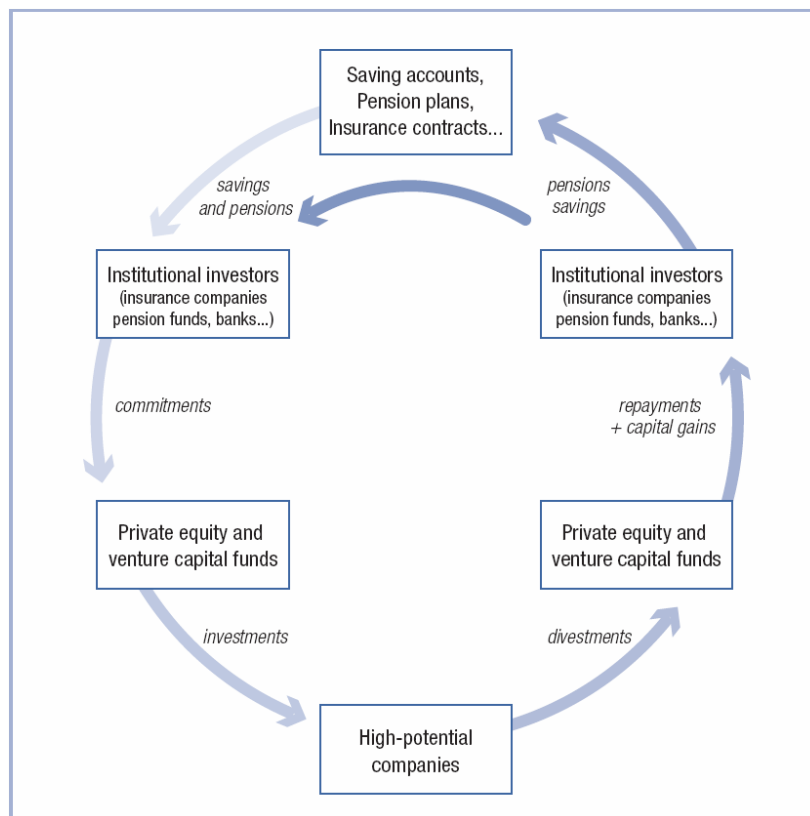
## 2 THE 'VIRTUOUS' VENTURE CAPITAL CYCLE

In order to understand the PE industry, it is necessary to recognise the dynamic cycle of risk capital investment and realisation. PE is an 'alternative asset' that institutional investors, including pension funds and insurance companies, may introduce to diversify their portfolios of established investments. Fixed term funds are created and run by professional management companies. These highly experienced executive teams, acting as the agents of the investors, invest in a portfolio of rigorously selected enterprises. The skill with which the

professional managers of VC or MBO funds can identify, add value to, and sell their chosen portfolio firms will determine their ability to raise future funds. Profitable exits are the single most important driver of the venture capital cycle.<sup>2</sup>

The stages of this investment cycle also suggest the wide range of variables that influence the growth of a successful PE industry. As well as requiring informed providers of capital matched with experienced and professional investors, there needs to be a ready supply of attractive target portfolio firms able and willing to accept the strict commercial obligations of new sources of equity. These entrepreneurial firms must also accept the rigorous managerial governance such speculative investment demands. Venture activity needs to be undertaken within a transparent legal structure that is conducive to high risk, new enterprise and corporate transformations in a dynamic entrepreneurial environment. The institutional pre-conditions for a successful PE industry are not trivial.

**Figure 1** The virtuous financing cycle of private equity investment.



Source: EVCA 2005a.

<sup>2</sup> E.g. Black & Gilson (1999) Gompers & Lerner (1999), and EVCA (2005b).



### 3 NEW AND OLD WORLD DIFFERENCES

The differences between Europe and the USA are simply put. America has built an innovation financing system, i.e. the 'classic' VC industry, which has managed to link world class scientific effort to the continuous production of novel, technology and knowledge-enhanced products and services. VC firms have facilitated the commercialisation of novel ideas and thereby have directly assisted in the creation of new sectors and industries of huge economic wealth. At the same time, the US innovation system has acted as a magnet for entrepreneurial talent from all over the world in addition to its home-grown entrepreneurs. The American model remains unique and is an exemplar admired by the rest of the world. While Europe has a number of centres of technological excellence it has not been able to replicate the US experience in VC. With a few exceptions, the investment returns to early-stage European VC investors and their ability to identify, nurture and grow a stream of world class companies has been consistently disappointing over the long run.<sup>3</sup> However, Europe can be rightly proud of a growing MBO industry which, at its best, is world class.

However, it would be a mistake to assume that future VC returns will inevitably mirror Europe's brief and disappointing history. PE is a highly sophisticated investment activity with a significant learning curve for its professional participants. Further, the industry standard structure of 10-year closed funds has a strong 'legacy effect'. A poor performance in the early years of an industry is likely to be similarly reflected in depressed performance figures for several subsequent years. Some recent evidence indicates better capital efficiency figures in 2004-5 exits in Europe compared to the United States.<sup>4</sup> Thus, the widespread pessimism in Europe as to its ability to conduct successful early-stage VC investments may be misplaced as a future prognosis.

### 4 BIG IS BEAUTIFUL

Small scale, country based PE operations are only stable so long as there are few benefits associated with the international or global scale. But the nature of professional financial services with its increasingly high levels of fixed costs - for example, the building of professional support networks or establishing a back office to ensure compliance with regulatory agencies - demonstrates very significant scale and scope economies. These imperatives operate both in the raising of new funds or in the realisation of attractive deals (this process is repeating the rapid global consolidation seen in industries as diverse as car production, banking and advertising).

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<sup>3</sup> See e.g. Dantas & Raade (2006).

<sup>4</sup> See e.g. Fricke (2006).

There exists significant empirical evidence to support the performance benefits of size across the investment cycle including:

- New fund raising
- Key management recruitment
- Management remuneration
- Deal selection
- Investment structuring
- Investment syndication
- Portfolio company support
- Investment exits

Yet, the single largest pressure on fund size has been the investment success of the PE industry itself and, above all, the exceptional performance in Europe (and latterly the US) of large management buy-out funds. Both median and upper quartile statistics have continuously shown very considerable margins over public stock performance. Only rarely have European VC funds been able to provide a performance comparative to their MBO peers. The consequence has been a continued and very marked preference by institutional investors world-wide for later-stage funds.<sup>5</sup> In Europe, this growth has been at the expense of VC investment.

**Table 1** European private equity performance (combining all data since records began).

	EU total return pooled, IRR	Top Quarter*, IRR	Upper Quartile, IRR	Morgan Stanley Euro Index, IRR	HSBC Small Company index, IRR
Early-stage	0.1	13.6	2.3	4.2	10
Development	9.2	18.8	9	8.4	10.3
Balanced	8.3	23.7	8.5	6.3	9.9
All venture capital	6.3	17.1	6.2	6.4	9.8
Buy-outs	13.7	31.8	17.8	2.7	8.7
Generalist	8.6	10.3	8.8	7.4	9.7
All private equity	10.3	22.9	10.6	2.3	9.7

Source: European Commission 2006b.

<sup>5</sup> See e.g. Collier Capital (2006).

## 5 GLOBALISATION OF THE PRIVATE EQUITY INDUSTRY

There is, as yet, no European PE industry but rather a set of more or less country-based venture capital and management buy-out partnerships operating within their national borders and entrenched in domestic law and regulation. The absence of pan-European risk capital markets reduces both the growth opportunities of entrepreneurial firms and the effectiveness of local investors in relation to their international competitors. Yet, institutional investors are highly informed and have a large and growing choice of countries, sectors and management partnerships in which to invest. They have a preference for established funds and known markets with continuing attractive deal flow. As a consequence, the dominance of Anglo-Saxon economies in private equity (notably the US and the UK) is likely to continue for the foreseeable future.

However, the integrity of this parochial, nationally defined structure is eroding. The single most significant driver of this change is the emerging globalisation of the PE industry driven by the implacable search for new and more investment opportunities.<sup>6</sup> Internationalisation is important to both the VC and MBO industries but for quite separate reasons. We know that the best technology or knowledge-based young firms will rapidly seek to expand beyond national borders early in their growth trajectories. Increasingly, inputs or outputs in technologically demanding markets have little or no local characteristics or identity. The relatively short periods before new technologies are superseded further increase the urgency of internationalisation.

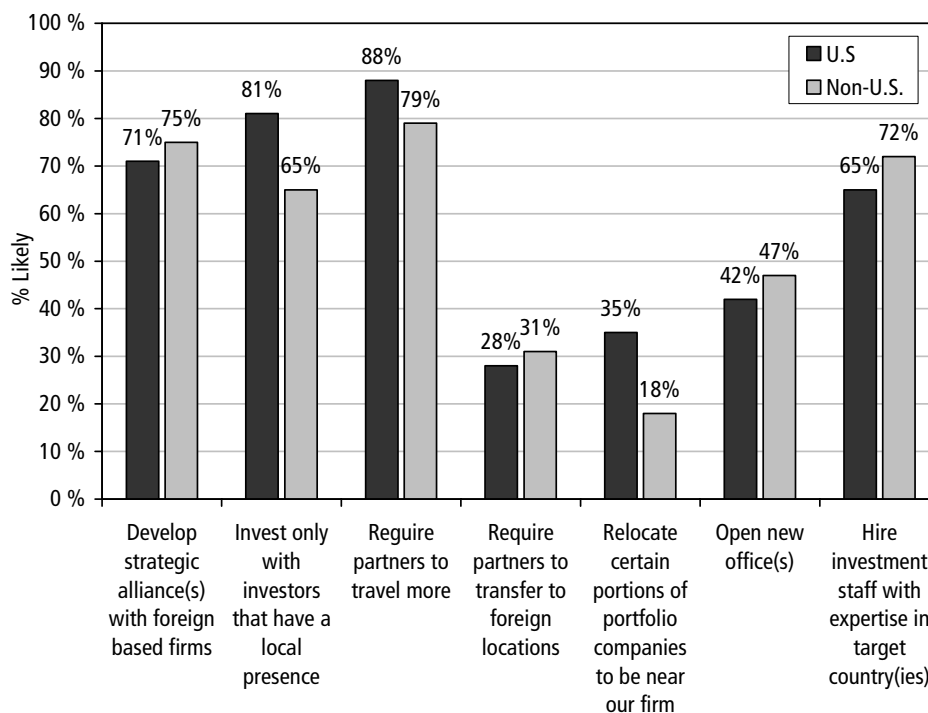
This imperative to access wider markets for growth is particularly important for small and/or peripheral economies, e.g. Finland. Such decisions for aggressively expansionist young firms may raise tough choices about future ownership and legal identity. Research evidence suggests it is far more advantageous both for the firm and its host economy if subsequent growth is not frustrated by artificial legal constraints that block increasing international share ownership.

In order to support the rapid growth and success of these expansionist firms, their VC investors must also be internationally located. This has seen the transformation of some investors into multi-national VC firms with offices in the key centres of enterprise activity. Other firms have encouraged international partnerships creating a network of co-investors and collaborators. Both demand and supply side factors are promoting a more global identity for VC firms and industries.

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<sup>6</sup> See e.g. Deloitte (2006).

**Figure 2** Business practices forecast to be deployed for global expansion.



Source: Deloitte 2006.

The driving force behind the global expansion of PE lies in the huge increases in finance resulting from the recent investment successes of the management buy-out sector. The search for under-performing corporate assets does not stop at national borders despite institutional and legal complexities. PE houses have increased their global reach in a search for more and larger deals. However, frictions in the functioning of the European single market based on the imperfect integration of national legal systems (many of which take little cognisance of PE activities) still hinder cross-border acquisitions and mergers. These barriers exist despite the quantified benefits of management buy-outs as a vehicle for increasing the growth, productivity and international competitiveness of European firms.

As the PE industry has raised greater funds it has also had to be far more creative in the design of investment products in order to ensure the sufficient flow of productive investment opportunities. Investment managers combine portfolio companies from different local markets to achieve global scale benefits. 'Buy and build' strategies in which cross-border transactions play an important role have become commonplace. MBO funds have sourced new partners at the highest level of executive talent in order to gain deep insight and industry knowledge in targeted sectors. From the original and rather passive buy out

product, professional investors are now capable of restructuring entire industries - on a trans-continental or global scale - given their purchasing power. With 19 new funds over US\$ 5 billion raised since 2000, the creation of \$25 billion or even \$100 billion funds is not inconceivable within the foreseeable future (Apax Partners 2006). Companies from the S&P large-cap market will no longer be immune because of size alone if performance is regarded by existing shareholders or entrepreneurial and knowledgeable investors as capable of improvement. There are fewer and fewer hiding places for poor managers under-utilising valuable corporate assets.

## 6 BUSINESS ANGELS – INVESTORS OF *FIRST* RESORT

Both in the US and Europe, there has been a long-run increase in the size of initial investments that VC firms are prepared to make. Accordingly, accessing small amounts of seed capital for new and speculative enterprises remains very difficult in the so-called 'equity gap' area of EUR 0.5 to 2 million. As one US venture capitalist put it: "We do not do pocket money". With more money to invest, the attractions of large, later-stage investments have grown. In 2005, according to industry statistics, the US and UK, the two largest PE industries in the world, undertook only a few hundred seed and start-up stage VC investments. Collectively, the two economies created over a million new firms in the same year.

**Table 2** US Comparison of business angel and venture capital investments.

	2002	2003	2004	2005
VC investment (BUSD)	21.8	19.6	22.0	22.7
Angel investment (BUSD)	15.7	18.1	22.5	23.1
VC investee companies (#)	2 608	2 409	2 559	2 626
Angel investee companies (#)	36 000	42 000	48 000	49 500

Source: (Sohl 2006) and VentureXpert/PwC Moneytree as of September 2006.

Thus, the reality is that professional VC investors are not going to resolve the equity gap. Yet, the US has continued to be an outstandingly entrepreneurial economy despite professional investors' widespread disinterest in start-up firms. This is because of the existence of large numbers of experienced business angels and their huge impact, especially in early-stage deals (See Table 2). In the same year that US venture capitalists invested in 192 seed and start-stage companies (PwC/NVCA Moneytree 2006), US business angels invested in nearly 50,000 companies, the vast majority being start-up and early-stage businesses (Sohl 2006). In the US, 227 000 active business angels were actively looking for investment opportunities and developing their portfolio companies in 2005 (Sohl

2006). Bygrave et al. (2003) argue that policy makers concerned with encouraging investments in new enterprises should redirect their energies from promoting venture capital to removing the barriers to informal investing. This advice is equally true in Europe. The encouragement and incentivisation of business angel activity should be a priority policy goal.

## 7 THE ROLE OF GOVERNMENTS IN THE PRIVATE EQUITY INDUSTRY

There is substantial evidence that, in the earliest and most challengingly uncertain areas of risk capital investment (i.e. seed and start-up finance), the PE industry has increasingly abandoned the field. Faced with this reality, the state has felt unwilling to leave a highly strategic area of policy interest to the vagaries of individual fund managers' or private investors' preferences. Accordingly, encouraging early-stage finance has become a major programme interest at both national and European government levels.

Government has to be wary of intervening in a free market where its actions may 'crowd out' or frustrate commercial interests. The history of governments' direct involvement in modern economies suggests strongly that public agencies should rarely intervene in commercial activities where they have little experience or skills. However, at the earliest stage of new ideas in advanced technological environments there may be a somewhat clear role for government support through, for example, meritocratic grants schemes. Pre-commercialisation stages of investment in areas of new knowledge are often so uncertain and delayed in their outcomes that exclusively commercial investment models may be inappropriate.

Mindful of the disadvantages of displacing private activity, governments have become increasingly interested in the 'equity enhancement' or 'hybrid' model of public and private co-investment. The involvement of government as one of the limited partners in such an early-stage fund may, through public finance leverage, assist the fund in achieving a minimum viable scale. However, the state has no executive role or influence on the operational autonomy of the fund managers. It sees its role as temporary and only valuable during the initial stages of infrastructure building. There is presently considerable interest in these hybrid models based on programme experience in several countries including the US, the UK, Germany, Australia and New Zealand. However, evidence of programme success is still limited, with little public evaluation. Nevertheless, it is very clear that the first and foremost role for governments in developing the private equity markets is to ensure a conducive and predictable

tax and legal framework that encourages the commercial operations of private equity investors.<sup>7</sup>

## 8 CHALLENGES IN EUROPE

We know from a recent review of research literature on the determinants of VC performance that both macro (economy wide) and micro (firm level) variables are important (Söderblom 2006). Macro level factors including stock market liquidity, sympathetic taxation regimes, pension fund rules, flexible and high quality labour markets, IPR protection and a flourishing Informal Investor/Business Angel community each have a positive and complementary impact. Similarly, at the VC firm (partnership) level, empirical studies suggest that fund size, managerial experience, stage and geographic focus, industry specialisation and syndication each have an effect on investment performance. We also know that when compared to the best US funds, European VC funds are generally too small, too generalist and too local in market ambitions. They are also frequently managed by investors with less specialist industry-technical experience than their US peers who are also more aggressively growth oriented.

Despite the conspicuous success of the European MBO industry, its wider international penetration remains 'patchy'. Major structural impediments still exist for institutional investors wishing to invest in European opportunities in several countries. The European Commission's 2006 Expert Group on Alternative Investments noted that "national regimes do not interlink and are heavily fragmented". Similarly, the 2006 Apax Report termed European regulation "a patchwork" of poorly integrated national legislation that seriously restricts the cross-border investment opportunities of PE firms and their institutional investors by increasing both the complexity and cost of such activities (Apax Partners 2006). A direct consequence of this absence of an integrated single European market for private equity is that the US continues to receive the majority share of new institutional investment in the private equity market despite growing investment opportunities across Europe. The lack of a European agreement on the principle of the mutual recognition of each nation's fiscally transparent PE fund structures for capital gains (similar to that pertaining to public equity investments) is particularly singled out as a serious barrier to further investment. The spectre of institutional investors being vulnerable to multiple taxation liabilities in several national domains rather than solely in the home state of the investor was, in the opinion of the Expert Group, a major constraint on the growth of cross-border activity (European Commission 2006b).

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<sup>7</sup> See e.g. EVCA (2004, 2005a).

## 9 WHAT'S TO BE DONE? EVIDENCE-BASED POLICY RECOMMENDATIONS

In this concluding section, we attempt to make some sense and order out of the information, trends and analyses cited. We look at the major stumbling blocks in arriving at well-functioning markets for entrepreneurial finance and cross-border growth. Particular attention will be paid to policy prescriptions to improve the functioning of the European single market for risk capital and efficient corporate control. We conclude that coherent national policies in support of a vigorous and growing entrepreneurial economy in Europe should include the following elements.

### 9.1 Create tax incentives to stimulate informal risk capital

*Promote business angel investments to fill gaps in the supply of early-stage finance and support.* There is a clear and persuasive argument for the greater promotion of business angel activity in all member states<sup>8</sup>. These informal investors remain one of the biggest competitive advantages of the entrepreneurial US economy. Their role is particularly important in supporting the genesis and growth of high-potential young firms, and as a complement for early-stage professional VC activity.

*Promote tax incentives to stimulate informal risk capital.* Personal tax incentives have been shown to influence the investment behaviour of high net worth individuals.<sup>9</sup> Revised legislation to enhance personal tax incentives is currently under discussion in several European countries and in the US Congress.<sup>10</sup> Several European countries and US states currently have such programmes.<sup>11</sup> The Pan-European "Young Innovative Company" (YIC) status allowing tax incentives to both young companies and their investors in member states is a European initiative that should be aggressively supported.<sup>12</sup>

*Complement tax incentives with other measures to stimulate informal venture capital.* In addition to tax incentives, further support for infrastructure including the education and support of angels and the continued promotion of regional and national business angel networks (BANs) is needed. Existing network

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<sup>8</sup> See e.g. European Commission (2002).

<sup>9</sup> See e.g. the evaluation of the Enterprise Investment Scheme in the UK (Boyns et al. 2003).

<sup>10</sup> H.R. 5198, the Access to Capital for Entrepreneurs Act of 2006 submitted to Congress in April 2006 (See <http://www.govtrack.us/congress/bill.xpd?bill=h109-5198>). The proposed scheme would give a 25% tax credit for "accredited investors" up to USD 500k qualifying investment per year with a limit of max USD 250k qualifying per company per year. See also Manzullo (2006).

<sup>11</sup> See e.g. CDVCA (2004) and EBAN (2006).

<sup>12</sup> See e.g. European Commission (2006a) and EVCA (2005a).



programmes should be reviewed and examples of excellence replicated (Sohl 2006).

## 9.2 Dismantle the barriers to cross-border investment

*Improve inter-country tax transparency.* If a single pan-European fund structure is not presently feasible, then in the shorter term the mutual recognition of other European structures as tax transparent vehicles by member states is urgently required to facilitate further cross-border investment.<sup>13</sup> Regulatory barriers for cross-border investments, mergers and acquisitions should be removed to reduce fragmentation of the European markets. The existence of such barriers represents a major hurdle to increased investment both within and into Europe, and reduces the growth potential of European businesses.

*Develop pan-European exit markets.* PE and M&A industries cannot exist without attractive and open exit routes. Efficient, informed and large volume markets are a key driver of investment.<sup>14</sup> Therefore, the development of such mechanisms is of crucial importance. National stock markets frequently fail to provide sufficient liquidity or the sophisticated investor base needed by many specialised technology-based companies. Therefore, more pan-European exit routes are needed including both IPO and trade sales channels.<sup>15</sup> Regardless of its political sensitivity, Europe must provide unequivocal support for (at least) one European 'small cap' market of international importance in terms of the volume and value of transactions.

## 9.3 Ensure that publicly supported funds are commercially viable

*The default public investment policy should be indirect.* In the near absence of professional VC fund interest, and with several countries having under-developed business angel activities, the state is often obliged to intervene in the earliest stages of the VC process. Evidence indicates that this can be accomplished most effectively if the state acts indirectly via the incentivisation of private and commercial early-stage fund managers to undertake more early-stage investments. The 'default' policy stance for the state should be to fund co-investment without direct operational involvement i.e. the financial support of professionally managed funds or fund of funds rather than the state assuming responsibility itself for direct investment activity.

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<sup>13</sup> See e.g. European Commission (2005b, 2006b).

<sup>14</sup> See e.g. Black & Gilson (1999).

<sup>15</sup> See e.g. European Commission (2005a) and EVCA (2005b).

*Only support commercially viable funds.* The state should also be mindful of the need for a sufficient scale of finance under management in publicly co-financed funds in order to ensure the best possible chance of a fully commercial operation.<sup>16</sup> The setting up of state supported funds for other than strictly commercial objectives has been shown to result in few permanent benefits. Supported funds should be of a size capable of financing a portfolio of investments through successive rounds of growth finance to the exit stage. Any prospective fund seeking government support should be prepared to provide a testable business case supporting its commercial viability.<sup>17</sup>

*Incentivise larger funds to invest at earlier stages.* The US experience shows that some of the largest, very early-stage (seed) investors are large and established VC funds. Such support for nascent firms in interesting new technology areas is seen as a necessary market intelligence and knowledge building requirement by fund managers. Large funds can invest in seed enterprises more cheaply than small, specialist early-stage funds as they incur only marginal costs. Accordingly, it is suggested that governments look at how later-stage European VC investors may be incentivised to invest in some early-stage deals like their US counterparts. One further benefit of involving established VC funds is that it will also enable the industry's most competent and experienced investment professionals to participate more actively in order to support the rapid development of early-stage ventures.

## 9.4 Educate entrepreneurs, investors and policy makers

*Develop 'investment readiness' training.* Improvements in the supply of finance to entrepreneurs are conditional on the growth of genuinely attractive investment opportunities i.e. professional and growth-oriented entrepreneurs. Investors repeatedly argue that the money would be available if sufficiently interesting investments were identified. 'Investment readiness' programmes seek to improve the quality of entrepreneurial proposals by educating inexperienced entrepreneurs. These initiatives directly address the major information imbalances between professional investors and those companies seeking their finance.

*Encourage inter-country programme learning.* Advanced economies have continuously experimented in new policy initiatives to address age old problems in support for young firms. Yet, the means by which extant knowledge and experience is communicated between countries, both within and outside Europe, are limited. Inter-country learning often remains serendipitous and ineffective. We suggest that channels be set up between policy makers and specialist

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<sup>16</sup> See e.g. Murray & Marriott (1998).

<sup>17</sup> The UK's Enterprise Capital Funds have to meet this requirement in a competitive appraisal.

academic researchers, whereby existing policies and their outcomes may be identified, appraised and the ensuing lessons communicated to other interested groups internationally. The Norface Entrepreneurship Policy Research Seminar series is one current (and rare) example of such an academic/policy initiative<sup>18</sup>.

*Think internationally, act internationally.* In the area of VC and PE activities where governments are expected to have a role or to offer support, responsibility should be placed on stake holders to address the implications of globalisation on present and future activities. Government departments involved in entrepreneurial finance, as well as VC and PE Industry Associations, and small business and entrepreneurial interest groups that seek government support should each be able to illustrate how they are responding proactively to the implications of globalisation on new enterprise formation and growth.

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<sup>18</sup> See website  
<http://www.norface.org/norface/publisher/index.jsp?1nID=93&2nID=94&3nID=201&nID=203>

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