Problems and prospects of venture capital

Venture capital is a type of private equity which provides funding for businesses which are newly started with high potential growth. Venture capital is very important to countries; this is because it creates job opportunities, advance technology, which in turn increases economic growth of the country. (Mason, C. Pierrakis, Y. 2009)

What distinguishes between venture capital and private equity is that private equity is usually involved in investing in large company where as venture capital invest in small start up companies. These small and young businesses generally have high level of uncertainty, thus making them more risky. In additional, these businesses generally don't have many tangible assets making it extremely difficult for them to secure bank loans, therefore making venture capital a very good option for them. VC firms are not interested in companies that are trying to create a market, or companies that are in a mature market, instead they look for markets that have a large number of potential users. (Mason, C. Pierrakis, Y. 2009)

A typical venture capital investment usually lasts from 3 to 7 years, and the standard sequences of venture capital investment are the following: The founder of an idea or product will try and persuade the venture capital firm that their idea/ product is sensible and profitable. If the venture capital firm is happy with the founder's proposal, it will provide funding for the founder to set-up; this includes management team, development of a fully functional prototype, marketing research. In return the VC firm will get an equity stake of the invested company. Once the setting-up is finished, the VC firm will provide funding and support on promoting and selling the product. If the

product is successful, reaching the targeted market shares, the VC firm will exit cashing in its investment. (The Smart Set-Up 2008)

The first VC firm was found in 1946 by MIT President Karl Compton and General Georges F. Doriot named American Research and Development (ARD) which was structured as a close ended fund. ARD was extremely successful since it turned an investment of $70, 000 in Digital Equipment Corporation to a value of $355 million after the company's initial public offering. A number of VC firms which was structured as close ended fund was established after ARD, but it wasn't until 1958 the first VC limited partnership was established by Draper, Gaither and Anderson. Limited partnership became more common in the 1960s and 1970s; however the majority of VC firms are still structured as close ended fund. (Gompers, P. Lerner, J. 2001)

Today, Venture Capital has been affected by the recession. Not as much money is being invested as 5 years ago during the height of the technology bubble. Currently Venture Capitalists are decreasing there overall amounts invested but are moving towards allocating more to later-stage investments. Currently there are fewer young entrepreneurs with great new ideas who are willing to risk building and sustaining a business. However this downturn is not expected to continue forever and it is China that will lead the way as the new most exciting venture market with 1. 3 billion potential consumers. Yet, it is not only China who will rise from this downturn, UK along with other traditionally strong venture markets will re-emerge, but the question remains whether or not it will attract as much venture capital as it once demanded. Although China is set to become the biggest venture capital market, it can

without a doubt learn an awful lot from past experiences of the UK market to assist its development. (Deloitte. 2009)

UK Venture Capital Industry Overview

Introduction: importance of the UK venture capital industry

Although the private equity industry in the UK founded its roots back in 1940s, it started to take off and grow rapidly from the mid 1980s, and now is second only in importance globally to the USA. In Europe the UK private equity market is regarded as the most mature (Tannon et al. 2005 cited in Soderblom 2005). 40% of the European PE industry is shared by the UK funds. As of % of GDP, the UK is the most significant private equity investor in Europe at a level of 1. 10% (Figure 1), but out of this only 0. 21% goes into venture capital financing while the rest is invested in the buyout sector (EVCA, 2005b cited in Soderblom 2005). It is important to note that in Europe the terms “ venture capital” and “ private equity” or “ risk capital” are often used interchangeably, as European private equity funds typically include three main sub-categories: venture capital for start-up businesses and early stage companies; later stage expansion capital; and management buy-outs and management buy-ins. This terminology differs from the one in the US, where private equity funds are considered as separate institutions from those managing venture funds (European commission 2006). That is why in UK venture capital is regarded as an integral part of private equity, but as the riskier part of the whole portfolio of PE funds.

The UK VC Industry has been always compared to the US VC Industry in its performance and main development drivers. However, Richard, chairman of Library House (2007), argued that instead of benchmarking each European

country against the whole US, it is more reasonable to explore the difference in VC performance between separate states, and then compare them with countries in Europe. Thus, Library House has produced a league table, which put the UK a third in this ranking in 2006 with 515 minority stakes worth €1. 78bn. California was first with 1, 367 deals worth €9. 1bn, followed by Massachusetts with 338 deals worth €2. 1bn.

Development of Venture Capital Industry in UK and recent trends

VC Industry in the UK started from 1945, when Industrial and Commercial Financial Corporation (ICFC) was created (Clarysse et. al. 2009) to provide capital to growing independent businesses, which later became a global private equity firm, with €8bn of assets under management (3i 2009). However, in 1970s availability of experienced VC managers proved to play an important role in taking-off the industry and developing it to the most successful in Europe. From early times of the development, the UK VCs were concentrated on leveraged buyouts and expansion type deals, as start-up opportunities were weak and not promising (Clarysse et. al. 2009). This is still the case in a current VC industry in UK making investments in established companies traditionally more attractive. Nevertheless, the UK VC Industry has shown a radical increase from £26m invested in 1983 to £1, 048 in 2008. High-technology companies made more than 50% of those investments (Clarysse et. al. 2009).

Over the last decade, the UK has been maintaining the average level of VC investment in early stage development of new ventures between 20% and 30% of total VC (BVCA 2009).

VC Industry in recession

Business XL (2009) reports that investments in ventures have decreased since 2006: 2 billion compared to estimated 750 million in this year. This suggests that venture capital industry was affected by the financial crisis. In the face of the recession that has challenged their existing portfolio companies, VCs are trying to secure more money to support those companies. Thus, most of the emerging opportunities are passing by without being considered by venture capitalists. Even though lower valuations of ventures seem to be a good deal for opportunistic VCs, according to Deloitte Research (2009), global trends indicate that large VC firms ($ 500million or more) have cut their investments more than small investment firms ($99 million or less).

As the figure shows after the “ dot-com” bubble in early 2000s the value of VC investments was falling gradually. But then, according to BVCA (cited by Mason et al. 2009) private equity and venture capital investments tripled in value between 2003 and 2007 from £4bn to almost £12bn. However, the value of investments fell by 28% in 2008 as the financial crisis took place. These trends indicate thatinvestment activities in Venture Capital Industry are very cyclical and fairly dependent on the general state of the economy.

Source: BVCA Report on Investment Activity (various years)

Importance of VC industry for growth of the UK economy

According to BVCA (2009), companies backed by venture capital are more efficient and grow faster: VC-backed firms compared to those that do not receive venture capital backing are more innovative and produce more patents (Kortum et al. 2000), they develop and launch their products to the

market faster (Hellmann et al. 2000), and have faster managerial professionalization (Bruton et al. 2005).

In the UK during the time 2002-2007, the annual growth in number of people employed in VC-backed companies was 6%, sales growth was 12% annually, and exports were 14% annually (BVCA, 2009). Research undertaken by IE Consulting (2008) implies that venture capital funding plays a crucial role in making the whole UK economy more productive and competitive. VCs provide seed capital for new businesses helping them to develop the new high-tech products, market them, and to grow further to set-up their manufacturing and sales operations. Even though VC's contribution to growth of national economy is indirect, through funding new venture companies, this role is indeed the cornerstone of increasing innovation activities and development of advanced high-technology based firms in the country.

The survey among 1013 VC-backed businesses (IE Consulting 2008) in UK identified that 86% of respondents have grown their businesses " organically" since receiving venture capital funding.

91% of the surveyed venture companies confirm that " venture capital was responsible for the existence/survival of their businesses and allowed them to grow more rapidly" (IE Consulting 2008). Moreover, there are also tax implications from the growth of VC-backed firms: public revenues increase as a result of growth in sales of those firms, and consequently more taxes are received by the government (including not only corporate taxes, but some other taxes resulting from growing venture firms' operations). All these facts

underlie the positive impact of venture capital industry on the overall economically important factors of the country such as job creation, growth of small and medium-sized businesses, investments in innovation and high-technology firms.

Problems of Venture Capital industry in the UK

Although UK is considered to be a world leader in Private Equity and Venture capital sector, second only to the US (IE Consulting 2008), still there are problems to be resolved as there are concerns that UK lags behind in the growing of ‘ new high-tech based economy’ and innovation activities. The figure below taken from the report by Think Play Do Group (2009) prepared for BVCA, comparing VC industry development to US and Israel, the world-leaders in VC, shows that VC investments in the UK as a % of GDP are much lower than those in the US and Israel (Figure 3). This confirms the concerns that underinvestment in VC industry should be resolved and underlying problems identified and treated appropriately.

Supply and Demand drivers for Venture Capital in the UK

Since Venture Capital is so important for the economic development of the country, it is necessary to gain insight into how VC Industry is driven by supply and demand determinants. Moreover, the problems in the development of this industry can be identified through the closer look into both sides of it.

Main demand side determinants of VC performance in the UK

The demand for venture capital is drawn by the quantity and quality of innovative companies looking for funding and that are able to produce particular rates of return on those investments (Clarysse et. al. 2009). So,

first of all, demand for VC is highly driven by early-stage entrepreneurial activities in the country.

According to GEM Global report (2008), which explores the relationship between entrepreneurship and economic development, and particularly investigates “ Entrepreneurial Attitudes, Activities and Aspirations” across 43 countries worldwide, in the UK 41% of adult population agreed that there are good opportunities to start a business in the next half of the year, and 52% considered entrepreneurship as a desirable career choice. However, only 5% expected to start a business in the next three years. All of these resulted in a very low rate of entrepreneurial activity, especially at the early stage which is just 5. 9% of the whole population. Compared to the US (10. 8%), this entrepreneurial activity is quite low, and might be a result of high percentage of respondents (38%), who believe that fear of failure would prevent starting a business.

Clarysse et. al. (2009) explain that with bankruptcy laws that are more entrepreneur-friendly in the US compared to the UK, where there is high correlation between company and personal bankruptcies.

One of the most important factors affecting the demand of VC is a stock of knowledge, which can be gathered through universities or national laboratories. Strong R&D culture and easier spin-outs from those universities proved to have very positive effect on formation of new companies. It is also commonly considered that due to the lack of a culture of commercialising research in most of the European Universities (including the UK), these conditions are less effective in facilitating the commercialization of business

ideas compared to countries where universities are normally private and dependent on commercialising research in order to increase revenues. Thus, indications of technological opportunities, such as growth rate of R&D investments, availability of patents and access to university spin-outs seem to have a great impact on the demand for venture capital funding mainly through increasing number of new start-up firms exploiting those available opportunities.

Statistical data (Worldbank 2008) indicate that between 1996 and 2006 R&D expenditure in the UK as a percentage of GDP was stable between 1. 5% and 2%.

Fairly low capital gains taxes in the UK have had favourable effect on demand for VC in the UK, as it makes more people willing to start their own company. CGT rate has been reduced since 1988 from 40% to 10% for higher-rate tax payers for long-term investments. Though in 2008 this rate increased again from 10% to 18% in 2008, it is still low enough to encourage new business start-ups. (Clarysse et. al. 2009)

According to statistical analysis conducted by Clarysse et. al. (2009) entrepreneurial activity is an important determinant of VC investments in the UK, so in order to enhance VC activities in thecountry policy makers should work on increasing entrepreneurial activity.

Main Supply side determinants of VC performance in the UK

There are different factors identifying the level of supply of VC, such as the situation on the exit markets, regulation policies, the fiscal environment and wider economic situation.

The main problem is that the amount invested in early stage company is still low in the UK. The investors in the country are more interested in established businesses rather than in new innovative small companies, which is evidenced by the dominating buyout sector. According to Martin et al. (2003) and EVCA (2005) cited by Soderblom (2006), over 70% of all private equity goes into buyouts. For the last few years the early stage investments have substantially decreased in the UK, where VC allocations to seed and start-up phases account for only around 5% out of total PE investments (EVCA, 2005b cited by Soderblom 2006). Even with the fact that between the early 1990's and 2001 the volume of investments in high-technology companies in the UK increased tenfold (Martin et al., 2003) the VC investments in high- tech firms as a percentage of GDP was only 0. 21% in 2005 (EVCA, 2005b cited by Soderblom 2006). The Figure 4 below illustrates these trends during the last decade.

These low investments in early stage firms can be explained by the notion of " short terminism" which is the prevalent attitude towards returns on investments in the Capital market in the UK (Oakey 1995). It is evident that new high-tech based firms (NTBFs) have had a bad reputation among investors for being unreliable due to their inability to meet " fast return" demand and other " milestones" predicted in their business plans (Oakey 1995).

Even more recent studies (Lockett et al. 2001) on " whether or not the UK VC industry has become less biased against investment in new technology-based firms" conclude that, although, investment in new high-tech based firms have increased by 2000s, the investors do not appear to be lowering

their target rates of return for technology-based investments compared to non-technology-based investments at the same stage. So, even with higher acceptance rates for NTBFs, technology still proves to be a more important risk factor than stage of investment. Especially, the survey by Lockett et al. (2001) indicates that venture capitalists believe that many of NTBF proposals continue to be riskier than non-technology projects due to issues in management quality, intellectual property protection and potential market size.

So there comes the problem of equity gap for the NTBFs. These firms are unable to get investments from either business angels or venture capitalists. The reason is that the small private Investors have limited financial resources and generally invest relatively small amounts of equity that is not enough for the new ventures and at the same time venture capitalists invest in bigger projects and the minimum sum they provide is higher than that the company asks for. According to the 2004 Bridging the Finance Gap report, the equity gap affects businesses seeking to raise between approximately £250, 000 and £2 million of equity finance, and that this gap is most severe for sub-£1 million investments and for innovative businesses at an early stage of their development.

Exit strategy for investor. On the supply side, stock market activity and the availability of trade sale opportunities were found to be important elements. VCs think in milestones but dream of exits. Visible exits such as stock market introductions are important for VCs to raise funds. It does not really matter whether these companies are introduced on local or international public markets as long as the stock market is liquid.(source)

Ideally, investments are realised through an IPO, an industrial trade sale, or a secondary sale (Söderblom 2006). However, deep and liquid stock markets and favourable conditions to realize trade sales tend to be the most important factors for VC industry to flourish. Bringing a company to IPO indicates the quality of the VC and is important for investors in considering subsequent funding rounds, even though IPOs only account for less than 5% of total exits. A secondary market in for stock exchanges in the UK was created with AIM (Alternative Investment Market founded in 1995, and has grown significantly, from having a capitalisation of £82. 2 million in 1995 to nearly £40 billion at the time in 2008. Furthermore, the London Stock Exchange launched techMARK to help promote existing quoted technology stocks and attract new ones to the exchange. However, according to BVCA there is a slow development of early stage VC in Britain and the whole Europe because of the absence of a functioning pan-European stock exchange for early stage ventures. The problem is that the European second-tier markets are fragmented (as several second-tier markets were launched) which resulted in limited capitalisation and liquidity of individual markets. Thus, reforms in capital market regulations may be needed to allow the creation of a single stock market for growth companies (including the UK markets) promoting economies of scale (Clarysse et. al. 2009). The sizes of public funds in the UK have not enabled the industry to reach a sufficient critical mass and the limited availability of follow-on financing has resulted in a “ second equity gap”. To address this, the government could cornerstone an investment into a fund-of-funds that would attract private capital from institutional investors which would invest in venture capital funds able to demonstrate a track record of strong performance. (source)

The Importance of balance between private sector and public sector investors in VC industry

Since the early development of venture capital industry till late 1990s venture funds were primarily publicly-funded and supported by Business Expansion Scheme, which was replaced in 1994 by the Enterprise Investment Scheme (Mason et al. 2009). At the beginning of 20th century Many of these funds became ' hybrids', involving a combination of public money and private investors, with incentives which enhance the risk-reward profile to attract private investors. Although free-standing private sector investments increased in numerical terms from 2002 until 2006, they have declined as a proportion of total investment activity from 81% in 2001 to 56% in 2008. In the UK the increased involvement of the public sector is even more apparent in the early stage venture capital market (Mason et al. 2009) accounting for the majority of such investments. In 2001 public sector funds were involved in 36% of investments. By 2003, as the various funds established by the Labour Government came on stream, this had risen to 51% and by 2008 accounted for 68% of all investments. The proportion of public sector investments in the form of co-investment schemes has grown from 28% in 2001 to peak at 56% in 2007, falling back to 45% in 2008. (source)

Nonetheless, emerging evidence from a NESTA/BVCA study (Nightingale et al, 2009 cited by Mason et al. 2009) indicates that companies that have received funding from public sector venture capital funds have not performed significantly better than those firms that did not receive funding from such sources. One interpretation is that public sector venture capital funds may not be able to add value to the companies they manage, because

there is a “ necessity to attract, reward and hold together experienced and committed venture capital executives to manage public funds.” In other words, the individuals running public sector funds are highly rewarded and incentivised to make the best possible returns. On the other hand, public sector venture capital funds may not be able to attract capable investment managers, and consequently they are unable to make good investments (quality of deal flow, domain knowledge, effectiveness of their due diligence). Thus, dominating position of publicly funded VC funds especially in economically lagging regions resulted in inefficient performance of regionally based funds in the Midlands and north of England, along with Scotland, Wales and Northern Ireland due to lack of entrepreneurial eco-system and necessary networks with expert VC managers and external investors, and this in turn resulted in the VC industry in UK being concentrated and limited in traditionally active centres as London and Cambridge.

Analysis

Such a market would have two crucial benefits; first, it would greatly improve the ability VC-backed companies to raise large sums of capital required for global expansion and secondly, it would help to increase the average valuations of M&A transactions. Further research should be conducted to fill the gaps and update the existing literature on the feasibility of a Pan-European stock exchange.

A briefly description of development of VC industry in China

How it originated and developed?

China's venture capital business started from the middle of 1980s. For about twenty five year's development, China's venture capital has made a great improvement, especially in the recent four or five years. However, there are still a lot of difficulties and problems facing China venture capital. For example, lack of appropriate regulations and policies, inflexible venture capital investment mechanism, lack of diversity of funding sources or lack of effective exit mechanism and so on.

In 1983, the State Science & Technology Commission (SSTC) (now the Ministry of Science & Technology or MOST) set up a Research Group of Countermeasures to the Influence of the New Technology Revolution in order to carefully study the international technology situation. (This was the first time for China to truly face the implications that were taking place in the development of the global economy. After that from 1985 to 1995, the Central Government and some local governments financed and set-up investment institutions that intended to pursue the venture capital business. (Jack C. Fensterstock, Aimin Li 2001)

In the year 1999, lots of government funding were lost, because of not deeply and really understand VC. After that both government and private started to change, for example, make some polices and gave better conditions for those who is good at VC.

Since 2006, VC is on its boom in china, with the government supplying majority of it, however the amount of both private funding and the funding from abroad has developed significantly,

More, VC in china is paying more and more attentions on new technologies.

(Jack C. Fensterstock, Aimin Li 2001)

Policy support in China

Venture capital as a risk investment, it is highly risky but also highly profitable. More integrated laws or regulations are needed for China's venture capital development.

In China, to protect and regulate the VC markets, Chinese government had made some National laws and some local laws duo to its own background. (As the graph shows below) In China, there are several different business activities of Venture capital. However, it is not permitted for VC enterprises to invest in guarantee services or real property business activities.

Venture capital investment business;

Venture capital investment business carried out on behalf of other organizations such as VC enterprises or individuals;

Venture capital investment consulting business;

Venture capital investment management services provided to VC enterprises;

Participations in VC enterprises and venture capital management consultancies.

(China: Venture Capital Regulations Published January 6, 2006 – Hong Kong)

With the development of policy, technological and understanding of VC, both organizational and institutional elements in China are becoming more and more complex. The system that has emerged so far is highly complex in terms of variety and number of organizational actors.

Although the result has been dramatic, the series of changes are best seen as evolutionary and primarily driven by China's larger objective of national technological and economic development. As such, key changes in China's science and technology policy and business system structure during the transition era can be linked to the emergence and nature of China's venture capital industry. In this context, venture capital is simultaneously an extension of prior policy trajectories, as well as a potential answer to problems that other policy initiatives have not been able to solve.

Balance between private and public

For the venture capital industry in China, unlike other countries, it has been promoted not as a means to private gain; it is a critical mechanism to connect among scientific, technological capabilities and output. one hand, with national and regional economic and social development on the other which includes the total set of related actors and institutions, has undergone a dramatic transformation over the last two decades.

The source for fund is very single, most of them are from government, or mixed by both private and government. Also, for Chinese government, it is always believed that both science and technology are the most significant parts of its search for economic development. (Steven WHITE, 2008)

Most venture capital funds have a fixed life of 10 years, with the possibility of a few years of extensions to allow for private companies still seeking liquidity. The source for fund is very single, most of them are from government, or fixed by both private and government, and government takes the risky, compared with others, this kinds of fund do not want to take high risk investment.

The national and local governments may establish venture capital investment guidance funds. The funds are to support the establishment and development of VC enterprises by taking equity participations and providing financial guarantees, etc. The state shall use beneficial tax policies to support the development of VC enterprises and to encourage them to invest in small and medium size enterprises, in particular in the high tech sector. The foregoing preferential policies shall be set forth in regulations to be drafted by the relevant authorities.

Exit mechanism of Venture capital in China

China’s venture capital business started from the middle of 1980s (2). For about twenty five year’s development, China’s venture capital has made a great improvement, especially in the recent years. Yet there are still a lot of difficulties and problems facing China venture capital. Compare to developed countries, China venture capital still lagging far behind. Exit mechanism as

the major process of making profit from investment, it is very important to Venture capital. However, Because of the lack of appropriate laws, regulations or market structures and so on, exit become extremely difficult for China venture capital industry.

Exit mechanism of venture capital mainly including four methods, initial public offering (IPO), mergers and acquisitions¼Œrepurchase¼Œwrite- off (10). In China, about 15% of venture capital exit mechanism is by IPO in recent years, this is higher than in developed countries, this is not good because over half of listed companies are overseas-listed; over 37% of venture capital exit from mergers and acquisitions which is the highest compare to the other exit mechanisms (Qisong Wang, 2004), and this is still increasing. Both numbers are proving that china's venture capital exit mechanism lacks of flexibility, the reasons lead to exit inflexibility can be described as follow: lack of appropriate laws, policies or regulations; inadequacy of a well organized market structure; absence of a efficient intermediate service system; limitation on enterprise ownership structure, and so on.

One big very important element should be taken into consideration is that the Chinese government involvement. Most domestic venture capital institutions in China carry a government background or were once state owned enterprises, this deprive them of the capability of adapting to the high marketization, ardent competition, high intelligence, and high-responsiveness of the venture capital industry (Gongmeng Chen, 2005). The inflexibility of venture capital investment mechanism and lack of competitiveness is another problem to China venture capital development. If

they do not thoroughly press forward with the marketization and globalization reform, even though they can have some development it will not be a long-term intrinsic development. No matter the market or policy environment in China, both have limited the adjustment of venture capital development. What the government can do is to build a more specific regulation system to rule the whole venture capital market. The Chinese market is attractive to foreign venture capitalists because of large domestic demand, rapid economic development (Chang Sun, 2006). Government itself can do investing but the more important thing is to encourage private equity and other forms of capital to involve into venture