THE IMPORTANCE OF VENTURE CAPITAL

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Abstract
Created in the United States of America, Venture Capital is an asset class which attracted recently the attention of the policy makers all over the world. But the concept is still not clearly defined and understood. This paper attempts at introducing in the concept, its characteristics, and reviewing some of the benefits Venture Capital investments can bring at both the macroeconomic level, by looking at the correlation with the economic growth, and at the microeconomic level, for the portfolio companies.

Keywords: *venture capital, growth, macro-economy, impact, value-added.*

I. Introduction

Venture capital is a term used intensely in the United States, where it was invented, and where it became an important part of the culture, one of the buzz-words widely used and less understood. The truth is though that the Venture Capital model really worked in the United States: venture capitalists provided financing and added value to start-ups, and in the process contributed significantly to transforming entrepreneurs into rock stars of the start-up world and the companies into world famous multi-billion dollar brands like Microsoft, Google, Apple, Intel, Cisco Systems, Sun Microsystems, Dell Computers, Federal Express, Genentech, Home Depot or Starbucks, to name just a few.

II. Terminological clarifications: What is Venture Capital in Europe vs. United States

The two main organizations dealing with the venture capital industry on the two sides of the Atlantic (European Venture Capital Association in Europe and National Venture Capital Association in the United States) seem to have different definitions in terms of the stages of investment and in terms of inclusion in the category of private equity, which creates more confusion for the rest of the world, which becomes more and more interested in this phenomenon.

For the purposes of this study we will rely on the definition provided by EVCA in its Glossary[1] and understand Venture Capital as being "Professional equity co-invested with the entrepreneur to fund an early-stage (seed and start-up) or expansion venture. Offsetting the high risk the investor takes is the expectation of higher than average return on the investment. Venture capital is a subset of private equity."[2] In the US, private equity is generally equated to buy-outs, referring to investments in later stage deals. In order to avoid terminological confusion, we represented the two approaches in the table below, and for the purposes of this paper the term private equity includes venture capital investments.

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[1] http://www.evca.eu/toolbox/glossary.aspx.

[2] For another definition see for example Lerner 2009 "Venture Capital represents independently managed dedicated pools of capital that focus on equity or equity linked investments in privately held, high growth companies."

EUROPE	Private Equity	
	Venture capital Seed, start-up, Expansion	Buy-outs
United States	Venture Capital Seed, start-up, Expansion	Private Equity (Buy-outs)

The venture capitalists pool together capital for investing in private companies from various private and institutional investors who allow the investment process to be delegated to fund managers with significant experience and proper incentives to screen, evaluate and select potential companies with expected high growth opportunities, companies that develop new products and technologies. After making the investment, the venture capitalists have a hands-on approach and through mentoring and monitoring they add value to the portfolio companies, in order to realize significant capital gains on disposing of the shares during the exit process.[3]

Venture Capital is actually an asset class represented by a medium to long term investment, with a significant element the element of risk, and generally venture capitalists are investing in a portfolio of companies expecting some of them to fail, but hoping that the returns on the successful ones will not only compensate for the write-offs, but also generate significant returns for the investors. Considering this risk element, it becomes clear from the beginning the importance of the expertise of the fund manager in screening and selecting companies, and then in adding value throughout the administration phase and later on sourcing best exit opportunities.

It is generally accepted that Venture Capital is the only alternative for some companies which: (i) cannot be financed otherwise (due to risky growth options plus information asymmetry between the bank and the entrepreneur) or (ii) are founded by entrepreneurs who realize need and appreciate the opportunity to team up with professionals to reach faster to the next level (we refer to those who acknowledge their need for external support with extensive knowledge of the industry and managerial expertise, support brought by the experienced Venture Capitalists).

The table below presents the main characteristics and challenges of the early-stage investments done by Venture Capitalists.

Start-up and early stage investment characteristics and associated risks (adapted from Eggerz 2009)
For the target companies • An interesting idea but generally no income, only uncertain costs; • Customers and competitors are vague; • The technology is commonly high and the due diligence very complex; • Pricing is very difficult;

[3] For a literature definition, see Brander, J., Du, Q. & Hellmann, T., 2010 saying that: "Venture Capitalists are financial intermediaries that seek out and invest in high-potential entrepreneurial ventures, predominantly in high-technology sectors, and that often provide managerial assistance to enterprises that they invest in."

- Generally there is an one person team with “vision”; Hands on involvement of the Venture Capitalists is critical;
- Significant illiquidity;

For the investors

- Research & monitoring costs/deal size ratio is high;
- Historically poor rates of return in Europe compared to the US;
- More investment is needed to spread fund risk;
- Smaller deal sizes so more investment needed and monitoring is more difficult;
- Long term investment horizon;
- Outright failure considerations.

III. Why Venture Capital?

Thomas Friedman was writing in his New York Times Op-Ed (Friedman 2009) that instead of spending the 20 billion on supporting the auto-making industry, the United States government should use the bailout money to give 1 million dollars to each of the top twenty Venture Capital firms in America to fund the best ideas that come their way. But if Venture Capital is so risky as we described above, and it requires so much time and such specials skills, why is it still regarded as the secret sauce by so many people, including more and more governments and local administrations all around the world? The simple answer is that Venture Capitalists bring money but also entrepreneurial know-how to the table, and by using their market savvyness they are screening and selecting ideas and companies, are making educated bets on the most promising ones and are pushing them towards success through hands-on co-management and use their contacts for expansion and exit.

In this section we will have a look at the macro-level effects, as well as the impact at the level of the portfolio companies.

The macro-level benefits

By looking at the history, at its peak, in the year 2000, US VC investing reached the level of 1.1% of the country’s GDP, and today United States of America are still the global leader, with less than 0.2% of its GDP. However, the impact of this small percentage is absolutely astonishing: according to National Venture Capital Association (2009) the venture-backed companies have revenues of 2.9 trillion USD, representing 21% of the gross domestic product of the United States of America, and employ 12.1 million people, which represent 11% of the country’s private sector employment. In Europe as well, even though Venture Capital investments account for a far smaller percentage of the gross domestic product (0.053% in 2008 – information obtained in a telephonic interview with Zornitsa Pavlova, former head of research at the European Venture Capital Association), the impact on job creation is significant. In the absence of more recent studies, it is worth quoting the figures from the EVCA (2005), according to which employment in venture backed companies in Europe grew by an average rate of 30.5% annually over the period 1997-2004, which is nearly forty times the annual growth rate of total employment in the EU 25 member states between 2000 and 2004 and 73% of the surveyed venture-backed companies increased the number of employees by more than 25% on average per year. The same study points to some interesting findings in terms of research and development, showing that venture-backed companies when surveyed spent on average €3.4m per year on research and development activities, their average research and development expenditure by employee being €50,500, which is six times more than the research and development expenditure per employee of the 500 companies in the EU 25 with the highest research and development spending at €8,500. Moreover, every third employee in those venture-backed companies when surveyed worked in research and development with 13% of the employees holding a PhD or equivalent degree. So Venture Capital is not only creating jobs, but it is creating jobs for the best educated people, preventing the brain drain or even generating brain regain.

Another documented effect of Venture Capital is that it tends to promote innovation, as Brander, Du, & Hellmann 2010 conclude after reviewing extensively the literature. Venture Capitalists are steering portfolio companies' innovation strategy towards commercial success and recent studies show that Venture Capital investments improve the absorptive capacity, and have a significant positive effect on innovation itself.

In terms of economic growth, the theoretic model according to which an analysis of the European Venture Capital performed by Deutsche Bank Research reports that an increase in private-equity investments by 0.1% of GDP is associated statistically with an increase of real economic growth of 0.2 pp if the investments are done at the buyout stage, 0.4 pp at the venture-capital stage and 1 pp if investments are done at early-stages – other things being equal (Meyer, 2006). The results of the analysis underline the economic potential of Venture Capital backed entrepreneurship. If Germany's Venture Capital investments were to rise to the European average, economic growth could increase by ¼pp – statistically speaking. However, this would require Germany to more than double the size of its venture capital market from 0.056% of gross domestic product to 0.113% of gross domestic product without compromising on the quality of financing, which is quite unrealistic in the short run.

Impact at the micro level

Besides the overall macro-level impact that has been demonstrated for Venture Capital, it is interesting to look also at its micro-level impact, at how do venture capitalists support the companies in which they invest. And there are two main directions in which their support is focused: providing capital and adding value to the portfolio companies. Providing money for growth is of the essence of venture capital investment. So much so that many still believe that this is all Venture Capitalists do, and this belief has important negative consequences, both for the venture capital industry (which misses out on opportunities due to the fact that its full benefits are unknown) and for the entrepreneurs, who might be in for a big surprise if they expect to be left alone with the money after securing venture capital financing. The reasonable expectation would be for the venture capitalists to be quite involved in the way the money they injected and then the money produced will be spent. And even though at times these "intrusions" of the venture capitalists will be regarded as uncomfortable by the entrepreneur (who by definition is used to decide by himself/herself), it is accepted more and more that good venture capitalists add more value with their mentoring and monitoring than with the money they are contributing as investment. But the entrepreneurs, who psychologically tend to be rather the "I know it all"-type perceive the need of capital far more acute than the need of guidance and mentoring, so they seek the venture capitalists for financing their companies, hoping to minimize the interventions and the rights the venture capitalists will have post investment.

Providers of capital

Many start-ups fail for lack of financing, since the banks are not lending them money and they never make it out of the "valley of death". Start-ups have few tangible assets that could serve as collaterals for bank financing, and the banks do not have the relevant expertise to assess the ideas, or the risk profile required to invest in such promising but incipient ventures. Therefore the Venture Capitalists are supporting entrepreneurs to finance their businesses in exchange of equity in the company, allowing them not only to survive, but also to grow.

Adding value to the portfolio companies

Even if the banks would finance such start-ups, as debt holders the bankers have lower incentives to push for innovation, for taking risks, for a more aggressive business strategy[4], while Venture Capitalists do push for all these, due to their "diversification across portfolio" and "few home runs" strategy (Senor & Singer 2009). And for early-stage investments, the services provided by the Venture Capitalists, their expertise and networks are at least as important as the financing component.

The approach of the Venture Capitalists varies from company to company and also from fund to fund, their contribution ranging from providing business contacts and brand-equity to strategic advice and to, in some cases, even integrating themselves to the day to day operations of the portfolio company and getting involved at all levels.

In an attempt to capture the recipe used by private equity investors to increase the value of their portfolio companies, Gadiesh & MacArthur from Bain Capital identify "six lessons from private equity any company can use", as follows (Gadiesh & MacArthur, 2008):

Lessons from Private Equity any company can use

- Define full-potential – How high is up? Focusing on the right/critical issue
- Develop the blue-print - Who, What, When, Where and How? Emphasis on measurable actions, milestones;
- Accelerate performance;
- Harness talent;
- Make equity sweat – eliminating unproductive and underperforming capital;
- Foster a result oriented mind-set – and developing a repeatable formula, demand accountability.

Source: Based on Gadiesh & MacArthur, 2008 (adapted)

It is important to note that Venture Capitalists are not adding value only during the administration phase, but also during the pre-investment activity (the due-diligence exercise helps entrepreneurs learn a lot about what is important for managing their business and also helps them organize the operations better) and at exit (when the rubber stamp of the Venture Capitalists has significant weight).

Moreover, a review of the literature points to the Venture Capitalists as investors adding value by other means, such as:

- Decreasing substantially the required time to introduce an innovation to market (Da Rin Penas 2007), speeding up product commercialization (Helleman and Puri 2000) and strengthening companies commercialization strategy (Gans, Hsu, Stern 2002, HSU 2006);
- Adoption of HR policies (Helleman and Puri 2000)
- Timing market conditions (Gompert et al 2007);
- Providing certification (Megginson and Weiss 1991);
- Leveraging the network of relationships (Hochberg, Ljungqvist, Lu 2007);
- Promoting export behaviour (Lockett, Wright, Burrows, Scholes, Paton 2008)

Venture capitalists are company builders, who influence innovation as much as they influence professionalization and innovation strategies (Da Rin, Penas 2007), and they have an active role as

[4] This is why the author of this paper strongly believes that entrusting the venture capital operation of a group to the people who have banking experience is a recipe for disaster, as it has been proved in Thailand. The bankers have a completely different risk profile based on their expertise, and would not have the skills to steer the entrepreneur in the right direction.

mentors and monitors of inexperienced entrepreneurs shaping management teams and boards, and giving them more credibility (Lerner 2009).

Impact on innovation

For a long while the literature has confirmed that Venture Capital is essential for bringing innovations to the market. More recently, research has proved that Venture Capital does provide support to the build-up of absorptive capacity. An interesting finding comes from the comparison of the effect of private venture funding with that of public funds. Da Rin & Penas found that venture capitalists selectively push portfolio companies towards choosing innovation activities which result in the accumulation of absorptive capacity, and towards more permanent in-house research and development efforts. They found a clear difference between the role of (private) venture financing and public funding, as the latter relaxes financial constraints but does not provide any additional strategic guidance. This provides novel evidence on the special role of venture funding in driving companies towards successful innovation strategies. (Da Rin, Penas 2007)

VI. Conclusion

Venture Capital continues to be a fancy term, insufficiently understood. In this paper, we made an attempt at clarifying the concept, by reviewing its definitions on both sides of the Atlantic, and we focused then on analysing the impact at the macroeconomic level (economic growth, development of entrepreneurial ecosystems) and at micro level (how the companies are benefiting by receiving not only financing, but also other type of value added services from the Venture Capitalists, and also how Venture Capital is impact positively the innovation capacity). Considering our findings, which lead to the conclusion that Venture Capital is an asset class which can contribute significantly to development, further research should be dedicated to what prevents Venture Capital funds from generating the sought after effects in some parts of the world.

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