An Anglo-German Foundation Report

Regional Venture Capital Policy UK and Germany Compared

Ron Martin, Christian Berndt, Britta Klagge, Peter Sunley, Stephan Herten

Executive Summary

Over the past two decades considerable interest has focused on the importance of venture capital in funding new, especially innovative enterprises. Concern has been expressed that the scale and dynamism of the venture capital market in Europe has lagged far behind that in the United States, and debate has consequently highlighted the role that public policy can play in stimulating and supporting venture capital activity in European countries.

Views have differed over the aims of policy. Some see its role in fostering critical mass in major geographical clusters of venture capital, of the sort found in the US. Others believe the aim of policy should be to promote a more geographically dispersed pattern of venture capital in order to fill what are perceived to be regional gaps in the market.

This study examines these issues by comparing the venture capital market and its regional impact in the United Kingdom and in Germany. It uses information gained from an original survey of venture capital firms and from interviews with key policy actors in the two countries, as well as data from the two national venture capital associations. The UK and Germany afford interesting comparison: they not only differ in the size and maturity of their venture capital markets, but also in the extent and nature of their institutional set-ups and policy interventions.

The study finds that in both countries venture capital investment has been distinctly uneven geographically. In the UK a disproportionate share of venture capital investment (both general and high-technology) has gone into London and the South East and relatively little into northern and peripheral regions of the country. In Germany investment has been more evenly distributed, although Baden-Württemberg and Bayern have dominated investment in high-technology industry.

Our study reveals considerable evidence of venture capital gaps in both countries, especially in the lower levels of the market (seed, start-up and early-stage projects), but relatively little evidence of a perception of regional gaps by venture capital firms.

However, the evidence does point to significant spatial proximity effects in the investment behaviour of venture capital firms, so that the regional incidence of investment shows a strong positive correlation with the geographical location of the venture capital firms themselves. In the UK this helps to explain the concentration of investment in London and the South East, where the vast bulk of venture capital companies are themselves located. In Germany venture capital firms are more evenly spread across the country, in six major urban centres. Nevertheless proximity effects are just as pronounced, and venture capital firms also tend to restrict much of their investment to their local region. In both countries regions without major clusters of venture capital firms tend to have disproportionately low rates of investment.

Venture capital policies have evolved in quite different ways, and with quite different regional impacts, in the two countries. In Germany the prevalence of public and semi-public actors and the dominance of public financial support – via the programmes of the Reconstruction Loan Corporation (*Kreditanstalt für Wiederaufbau*, KfW) and the Technology Participation Company (*Technologie-Beteiligungsgesellschaft*, tbg) – virtually created a venture capital industry from scratch during the 1990s. The UK, by contrast, already had a large venture capital industry, so it was not until the late 1990s that central government decided to try to directly increase the supply of venture capital to small firms via the new Regional Venture Capital Funds (RVCFs). Its intervention has been on a much smaller scale than in Germany and aimed at demonstrating to the private sector the potential profitability of investment in the (small firm and start-up) 'equity gap'.

Distinctive institutional environments and different aims have shaped the instruments and mechanisms used. German reliance on guarantees and on the supply of capital via refinancing loans and silent capital (co-)investment seems to stem from the traditional means of providing support to small and medium-sized enterprises (SMEs) through loans and guarantees. In the UK, in the case of the RVCFs, the adoption of a fund-of-funds approach run as limited partnerships with a 10-year limit, and the delegation of investment decisions to private managers, demonstrate a stronger market orientation within venture capital policy.

The development of regional venture capital policies has also involved significant interactions between central governments and local and regional authorities. German *Länder* governments initiated their own venture capital policies during the 1990s, and these regional initiatives have been designed to draw down the increasing amounts of national finance available. The precise form of these regional policies has varied significantly between different *Länder*, reflecting fiscal disparities, institutional relations between decision-makers and commitments to other complementary technology initiatives.

In most UK regions specialist 'gap' regional fund managers, often created by local and regional development agencies, have existed since the 1980s. Their ability to capture and manage private enterprise (particularly the Midland Enterprise funds) and European public funds suggested possible means of public intervention that could reconcile economic development goals with a market-conforming style of operation. Such schemes demonstrated the potential value of public–private partnerships in the regions. Recent central government policy has been designed with these models in mind and, indeed, is partly aimed at ensuring that such local partnerships prosper.

Recent UK policy is not as decentralised as in Germany. The RVCF model is clearly a central initiative delivered regionally, but it is essentially the same in each of the English regions.

However, decentralisation is much less pronounced in Germany than one might expect. The national institutions of the KfW and tbg are key actors in national as well as regional venture capital policies because of the competition of various actors, including regional public policy initiatives, for their funds.

In Germany guarantees appear to have had a particularly strong impact in encouraging investments, and their extensive use clearly helped to leverage in a large amount of private investment. However, the recent ‘technology crash’ resulted in large guarantee pay-outs, and the costs have increased to such an extent that the guarantee programme is unlikely to continue in its present form. In the UK only ‘public co-investment in fund’ has had a noticeable motivational effect, which reflects the ‘fund-of-funds’ approach used by both the DTI and European agencies. The dominant, though not unanimous, view among the UK venture capital industry is that policy should demonstrate that commercial returns can be made from small firm funding and can then be withdrawn, leaving private-sector venture capital firms to take over the funding role.

Another key difference in policy mechanisms is the much more extensive use of ‘project-by-project’ co-investment in Germany. In the case of the English RVCF single private manager approach, the agency risk is probably higher in that the performance of each fund will depend primarily on the performance of each nominated manager. The RVCF fund managers are under pressure to demonstrate good returns and, simultaneously, to invest a sufficient number of small deals in target firms.

The German experience supports the view that public programmes can be important in stimulating and supporting the development of regional venture capital markets under certain conditions. A long-term perspective may well be needed in fields where commercial viability is not easily achieved (e.g. the seed stage). At the same time more reliance on, and delegation of responsibility to, private or public regional actors within ‘fund-of-funds’ approaches could help to reduce the bureaucratic problems associated with large public or quasi-public institutions.

This study also examines the regional outcomes of venture capital programmes by comparing the ratios between public venture capital support expenditure and stocks of firms across the regions. In the UK the size of the RVCFs shows no evidence of a systematic trend either towards ‘market-strong’ or ‘market-weak’ regions. Unequal regional outcomes have emerged as an unintended result of the variable experiences of fund creation. In Germany national venture capital policy does not have explicit aims in terms of the regional distribution of support. The influence of market demand is therefore mediated and either amplified or muted by the ‘bottom-up’ organisational capacity and initiative of regional actors. Proactive venture capital policies coupled with innovation and technology policies at the *Länder* level are able to capture and divert public venture capital money. With the exception of the Eastern programmes, rather than offsetting regional imbalance as might have been expected, the sizeable national public funds going into venture capital investment have tended to follow the market and to some extent have reinforced geographical differences.

The main policy conclusions from the research are:

- UK actors appear to prefer temporary and commercially-based public intervention, aiming at a short-term demonstration effect. German venture capital players, by contrast, seem to be more willing to accept longer-term subsidies, justifying intervention in terms of beneficial spillovers from high-tech start-ups to the whole economy.

- In both countries most venture capital policies do not have explicit regional objectives and are best viewed as national interventions with a degree of regional administration and implementation.
- In both countries national polices have regionally differentiated outcomes. This is due to the way that these national policies are delivered through, intersect with, and are tapped by regionally based institutions and actors, and the fact that such local capabilities vary from region to region.
- Each country has policy lessons for the other. The German 'open-ended' policy model supports the view that public programmes can be important in stimulating the development of regional venture capital markets. At the same time, however, the UK regional 'fund-of-funds' approach is less bureaucratic and avoids the risk of large-scale public losses at times of severe market downturn.

For more information please contact:

Annette Birkholz
Anglo-German Foundation/Deutsch-Britische Stiftung
34 Belgrave Square, London SW1X 8DZ
Tel +44 (0)20 7823 1123, Fax +44 (0)20 7823 2324
E-mail ab@agf.org.uk, Website www.agf.org.uk

Professor Ron Martin
Department of Geography, University of Cambridge
Downing Place, Cambridge CB2 1RL
Tel +44 (0)1223 338316, Fax +44 (0)1223-338340, E-mail rlm1@cam.ac.uk

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The authors of the report are:
Professor Ron Martin, Department of Geography, University of Cambridge; Dr Christian Berndt, Department of Geography, Catholic University of Eichstätt; Dr Britta Klagge, Department of Geography, University of Hamburg; Professor Peter J. Sunley, Department of Geography, University of Southampton; Diplom Volkswirt Stephan Herten (Research Associate), Department of Geography, University of Cambridge; Professor Rolf Sternberg (Research Advisor), Department of Social and Economic Geography, University of Cologne