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MAIN FINDINGS NOTE

THE ROLE OF VENTURE CAPITAL FOR ECONOMIC GROWTH IN THE NORDIC REGION

DVCA, FVCA, NVCA & SVCA

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PREFACE

This report is commissioned by the four Nordic venture capital and private equity associations; the DVCA, FVCA, NVCA and SVCA, and produced by Copenhagen Economics.

The aim of the report is to map out the potential and challenges for the Nordic venture market focusing on four key areas:

- The role of venture capital in the region's economic growth
- The ability of the region to attract capital that help scale Nordic companies and start-ups
- Barriers to further developing the market for venture capital in the region
- Recommendations for the role of the Nordic governments to boost venture capital activity and increase Nordic cross-border cooperation

Methodology

The report is based on desktop research and a survey to venture capital players in the region. The documentation underlying the main findings is in a power point report attached to this note.

BUILDING A VENTURE CAPITAL INDUSTRY TO FUEL GROWTH

Some of the world's largest companies were originally backed by venture capital funds, and venture capital (VC) plays a significant role in countries with high economic growth. In the Nordic region, employment in firms currently backed by venture capital reached some 37.000 in 2016[1].

The Nordic region has a strong industrial position in the high-tech industries, that globally thrive on the back of VC investments, and top rankings in international surveys of competitiveness.

What can the Nordic countries do to ensure that the region has the venture capital needed to scale local businesses to internationally leading companies? This report shows that the answer is three-fold:

1. More large VC funds with sufficient international scale and experience, delivering competitive returns
2. More serial entrepreneurs driving start-ups as founders and business angels
3. Substantial increase in funding from institutional investors attracted by the longer-term return potential from VC

Financing for ambitious innovation

Venture capital funds look for scalable, high-technology companies, with global growth potential. In 2015, two-thirds of the venture capital invested in the EU was invested in ICT and life sciences companies, sectors which benefit from patient capital with a tolerance for high risk.

High growth tech industries account for an increasing share of global economic value and are more dependent on equity funding, notably new equity issuance, than other industries such as retail. Venture capital therefore plays an increasingly important role in the financing of R&D efforts in new companies.

Societal benefits of venture capital

Average annual growth of employment in venture capital-backed companies in Finland, Norway and Sweden exceeds growth in mid-size and large cap companies by 6 and 10 percentage points, respectively. Not only is employment growth higher, companies backed by venture capital funds also have a higher productivity.

In addition, venture capital contributes to innovation and productivity growth, for example studies show: (1) 8% of all US innovations are linked to venture capital-backed companies (2) the return to society exceeds the private returns by a factor of 2 to 3.

Globally, institutional investors represent the lion share of investors in venture capital funds. In the US, the frontrunner in the global venture capital market, the internal rate of return on venture capital investment has matched returns from investing into US blue chip companies included in the S&P 500 Index over the past two decades. Additionally, it has been instrumental in the creation of the top four companies at global level measured by market cap.

THE NORDIC VENTURE CAPITAL INDUSTRY

Despite venture capital investments as share of GDP ranking above the OECD average in three out of five Nordic countries, the region still lags behind Israel and the US. Yearly venture capital investments are roughly 0.04% of GDP in the Nordic region, versus 0.02% in the OECD, 0.36% in the US and 0.38% in Israel.

Still, Nordic venture capital investments have been a key factor in creating 15 growth companies each with a market cap exceeding € 1 billion (a Unicorn). In total, these 15 companies have a market cap equal to 6% of the GDP of the Nordic region and employs roughly 20.000 people.

These success stories are important beyond their own merit, as they provide role models for other potential growth firms, key learnings from scaling internationally, and can help boost the attractiveness of Nordic companies. Indeed, our survey among venture capital funds in the region showed optimism, notably based on an increased number of high growth investment opportunities and some improvement in the availability of funding.

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[11] See main report

The Nordic advantage

The region comes out (near) the top of the class in international rankings with respect to economic stability, innovation capability, skills etc.

Moreover, the Nordic region have strong industrial positions in the industries that dominate global venture capital investments, such as ICT and life science. World class research institutions with decades of experience in private-public research co-operation add to the potential. Entrepreneurs in small open economies have the aim, from the beginning, on conquering world markets.

Weaknesses of the Nordic VC market

Three key weaknesses in the Nordic venture capital environment challenge the development of the sector and its opportunity to contribute to the Nordic economies.

First, while a handful of VC firms deliver high returns and succeed in raising several consecutive funds, the Nordic venture capital industry has historically lacked the maturity and depth to produce investment opportunities in a scale that is sufficiently attractive for investors, not the least pension funds.

Specifically, we have identified the following:

- Several respondents called for more expansion of scale and an international approach to investments. There seems to be an increasing number of smaller venture funds in many of the Nordic markets, but there are still too few larger venture funds, which can provide later stage financing. Consequently, firms must seek capital outside the Nordic region and potentially also move innovation, production and jobs.
- Several studies have shown that experience is crucial for the high returns that US VC-funds deliver, implying that maturity in the market is an inevitable factor. It is therefore crucial to create teams and firms that are able to raise consecutive funds, to create a community of sharing best practices, and to have supporting local LPs (funds investors).

Second, despite the Nordic region ranking in the top in terms of pension assets as a share of GDP, inflows from this group of investors is only on level with European peers and has declined over the last years. In addition to regulatory barriers, the lack of consistent high-level investment opportunities and the relatively small funds sizes, which mean smaller tickets (share of the fund) for investors, are arguably factors in explaining the weak inflow from institutional investors (pension funds, family offices etc).

This is essentially a "chicken-and-egg" dilemma. The US experience shows that developing an effective venture capital industry takes years of funding and investment before competitive returns can be delivered without government assistance. So higher returns tomorrow, require larger inflow of funding now. It also requires a larger interest among institutional investors in building the investment teams that can pick the right VC funds and give them the mandate to hold out for years before returns are coming back.

Third, talent remains a scarce resource. The high-tech industries in which VC funds invest rely on high skilled employees, most often with a natural science background ("STEM"). Yet, the Nordic region struggles with producing enough high-quality candidates to satisfy demand. This is demonstrated with unemployment ratios for person with such education way below average and with firms noting access to qualified labour in these areas as a barrier to growth across the entire region. Moreover, the Nordic region also need more successful entrepreneurs: numerous studies show that they are crucial both as investors and business angels in starts-up providing both finance and advice as mentors, board members and part of the wider start-up and scaleup community.

FROM POTENTIAL TO REALITY: POLICY RECOMENDATIONS

Creating a successful VC industry is a long-term process and the policy framework plays a large role along with the structural industrial characteristics of a region. Experience within the Nordic area proves that taking the right steps are working. For example, there is strong evidence that the creation of Stockholm as a very strong bastion of risk-based capital for small and mid-cap companies is the direct results of policy decisions taken from the early 1990s onwards. For example, tax reforms of personal capital income taxes, investments in broadband infrastructure and so called "Allemansfonder" with the objective to promote savings in funds among the public with lower tax than other capital gains. Allemansfonder is an older reform from the 1970s but an important part of the Swedish "equity culture".

Based on our research, we propose the following action points to address and mend the identified weak points of the Nordic venture capital markets:

I: Transparent, competitive and foreseeable tax environment Uncertainty about the tax treatment of the asset class, can hamper investments our survey showed. This was particularly evident in the answers from the Swedish respondents. Further, uneven and complex tax rules increase cost of investment for institutional investors, thus creating a further obstacle for fund investors looking to back venture capital funds.

In terms of tax levels, the tax regimes vary across the region with some countries struggling with complex systems, others with wealth tax, others again with the level of capital gains tax and the treatment and classifications of the taxable entity.

Recommendation:

- Review tax systems with the aim of increasing the availability of funding for cross-border risk capital, including incentives for entrepreneurs.

II: Creating and incentivising talent. Failure to meet the demand for talent and expertise within tech and life science, will risk hampering growth and slowing the pace of promising scaleups.

Recommendations:

- Increase the number of natural science graduates, engineers by way of educational reforms.
- Review the tax treatment of option and warrants to enable companies to attract international talent.

III: Proportionality in regulation of VC funds. Despite efforts at EU level to ease regulation for venture capital funds, respondents report a high cost of compliance which is not perceived to be proportional to the benefits and objectives intended when the regulation was introduced.

Recommendation:

- Nordic countries to take an active role in promoting a proportionality principle in EU regulation affecting the venture capital industry.

IV: Mobilising the role of institutional investors, notably pension funds. Nordic pension funds represent a largely untapped source of capital for Nordic venture capital funds with a long-term investment horizon. Likewise, the industry needs to mobilise capital from family offices and other professional investors.

Recommendation:

- Identify the specific barriers to investment from the various groups of institutional investors (pension funds/insurance funds/family offices).

V: Nordic co-operation

We also see four specific areas of co-operation and joint action for the Nordic countries since most international investors perceive the Nordics or even the EU as one market:

1. *Learning from best practice*: There is a large divergence in performance within the Nordic countries with respect to the role that the VC and other risk capital markets are playing and have played in creating new firms and boosting innovation. This should provide a source of experience to learn from and adopt best practice.
2. *Creating scale in the Nordic VC market*: Existing programmes to boost innovation and funding to VC firms tend to have a national focus. This may hamper the development of a more Nordic and ultimately international scale of VC companies.
3. *Exploiting comparative advantage*: The Nordic countries and regions excel in different parts of the eco-system around the VC universe. Rather than attempting to replicate all parts of this universe in each region, co-operation and specialisation could help create needed scale.
4. *Joint EU action in areas of common interest*: Creating joint positions could increase impact on EU regulation affecting risk capital and VC markets. The aim could be to ensure that EU regulation focused on financial stability and creating an internal market does not inadvertently lead to high compliance costs for VC firms and related stakeholders out of proportion to the intended benefits. It is also of utmost importance to avoid obstacles for third countries investing into EU-based funds, as LPs, or directly in EU-based companies.

CONCLUSION

The VC industry in conjunction with a strong eco-system supporting risk capital investment has a strong potential in supporting growth and innovation. Countries and regions that can identify and invest in promising but risky firms have experienced higher growth rates in the past and all evidence suggests that this will continue in the future.

The Nordic region has both the potential and need for a stronger VC industry. The policies needed to drive that development are well identified and all the Nordic countries can step up their performance, but it requires long-term commitment.

As a conclusion, we suggest that the focus should be on realising the long-term potential of the Nordic VC markets. We are about to exit the period of easy money and mountains of liquidity and it is likely that evaluations of business cases will be tougher at a global level. A more solid, specialised and diversified VC sector with the ability to scale companies internationally and operating increasingly across borders will be better equipped to meet this challenge and deliver long term gains in line with potential.