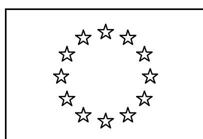

EUROPEAN COMMISSION
DIRECTORATE GENERAL REGIONAL POLICY

Comparative Study of Venture Capital and Loan Funds Supported by the Structural Funds

Final Report

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Contents

	SECTION	PAGE
	Executive Summary	**i**
1.	**Introduction**	**1**
	1.1 Study Aims	1
	1.2 Methodological Approach	1
	1.3 Structure of the Report	4
2.	**Background and Key Issues**	**5**
	2.1 Definition and Rationale for Intervention	5
	2.2 Risk Capital and the Structural Funds	7
	2.3 Existing Information on VCLFs	10
	2.4 EU Framework for Risk Capital 2007-13	11
3.	**Assessment of VCLF Performance**	**13**
	3.1 Overview of VCLFs	13
	3.2 VCLF Funding Models	16
	3.3 Types of VCLF Finance and Other Services	22
	3.4 VCLF Performance	28
	3.5 Regional Development Impacts	35
	3.6 VCLF Legacies	39
	3.7 Management and Costs	41
4.	**Overall Conclusions & Best Practice Recommendations**	**44**
	4.1 Overall Conclusions	44
	4.2 VCLF Strategies and Target Markets	45
	4.3 VCLF Models and Regional Development	47
	4.4 Public and Private Sector Involvement	51
	4.5 Governance and Management Structures	52
	4.6 Information Disclosure, Monitoring and Evaluation	53

Contents

	APPENDICES	PAGE
A.	**Glossary of Terms**	**56**
B.	**List of Interviews**	**59**
C.	**VCLF Fiches and Profiles (Separate Document)**	**61**
	C1: Merseyside Special Investment Fund (UK)	61
	C2: North West Business Investment Scheme (UK)	71
	C3: South Yorkshire Investment Fund (UK)	78
	C4: Scottish Co Investment Fund (UK)	83
	C5: SAS Alyse Participations (FR)	91
	C6: IBB Beteiligungsgesellschaft (DE)	97
	C7: IBG Beteiligungsgesellschaft Sachsen-Anhalt (DE)	103
	C8: Stimulus VCF BV (NL)	109
	C9: Technofonds Flevoland (NL)	114
	C10: MKB Fonds Flevoland (NL)	117
	C11: PME Investimentos (PT)	122
	C12: Change Partners (PT)	127
	C13: Andalucia 21 FCR (ES)	138
	C14: TANEO (GR)	142
	C15: Attica Ventures (GR)	149

Executive Summary

The study 'Comparative Study of Venture Capital and Loan Funds (VCLFs) supported by the Structural Funds' was undertaken in 2007 by the Centre for Strategy & Evaluation Services (CSES) for the European Commission's DG Regional Policy.

1. Study Aims and Background

The objectives of the study were to:

- Provide, on the basis of an examination of a representative sample of venture capital funds, an overview of **achievement and the impact** of the venture capital funds in terms of the objectives contained in VCLF business plans;
- Assess the **contribution of VCLFs in terms of reaching the strategic objectives** contained within the 2000-2006 programmes;
- Assess **potential weaknesses and shortcomings** in the design and functioning of VCLF which impact negatively on cost-efficiency and on cost-effectiveness in terms of their overall contribution to creating and sustaining SMEs the relevant regions, and how such shortcomings can be avoided in future;
- Draw subsequent **lessons of relevance** for the purpose of determining the contents and strategic thrust of future programming rounds for the 2007/2013 programming period.

The main purpose of the study was to provide DG REGIO desk officers and others with guidance on how best to set up and operate VCLFs in the new 20007-13 Structural Fund programming period, drawing on lessons from the previous period. A list of the VCLFs covered by the research is shown below:

List of VCLFs Covered by the Research

	VCLF	Location	Country
1.	IBB Beteiligungsgesellschaft	Berlin	DE
2.	IBG Beteiligungsgesellschaft Sachsen Anhalt	Magdeburg	DE
3.	Andalucia 21 FCR	Seville	ES
4.	SAS Alyse-Participations	Paris	FR
5.	TANEO	Athens	GR
6.	Attica Ventures (Zaitech Fund)	Athens	GR
7.	Stimulus VCF BV	Eindhoven	NL
8.	MKB fonds Flevoland	Lelystad	NL
9.	Technofonds Flevoland	Lelystad	NL
10.	PME Investimentos	Lisbon	PT
11.	Change Partners	Porto	PT
12.	Merseyside Special Investment Fund	Liverpool	UK
13.	North West Business Investment Scheme	Manchester	UK
14.	South Yorkshire Investment Fund	Leeds	UK
15.	Scottish Co-investment Fund	Glasgow	UK

Executive Summary

The VCLFs covered by the research were selected by the Commission following contact with national authorities to establish interest in participating in the study. Taken together, the 15 VCLFs examined in this report received over €300 million of ERDF funding, i.e. some 25% of the estimated total of €1.2 billion allocated from the Structural Funds to these types of interventions during the 2000-06 period.

2. Role of Structural Funds and VCLF Models

2.1 VCLFs are ERDF-supported interventions that are designed to address a market failure in the provision of finance for start-ups and SMEs. Start-ups and SMEs often face difficulties in raising finance because lenders perceive them as high risk Credit can therefore be relatively expensive and only available if demanding collateral requirements are met. Promoting start-ups and SMEs is, however, important to regional development. In this context, risk capital has an important role to play. But on the supply-side, it is usually not profitable for the private sector to provide the relatively small amounts of seed and venture capital needed by start-ups and SMEs because of the overhead costs and risks associated with investments in these companies. On the demand-side, SMEs lack awareness of the different types of finance available to them and with equity funding are often unwilling to accept an outside ownership stake.

2.2 From a purely Structural Funds' perspective, VCLFs also represent a more efficient use of financial resources than non-refundable grant aid because investments can (in theory at least) be re-cycled and used again to support new interventions. Reflecting these and other considerations, there has been a considerable increase in the allocation of Structural Fund resources to VCLFs over the past ten years.

ERDF Allocations to Risk Capital - 1994-99 and 2000-06 (€000s)

Country	1994-99			2000-06		
	Risk capital	SF total*	%	Risk capital	SF total	%
Austria	0.0	338	0.00	0.2	931	0.02
Belgium	3.3	1,159	0.28	35.5	1,058	3.36
Denmark	0.0	123	0.00	7.5	183	4.09
Germany	18.9	17,554	0.11	54.9	23,651	0.23
Spain	61.0	33,541	0.18	230.1	40,757	0.56
Finland	0.0	185	0.00	5.5	1,402	0.39
France	48.1	6,585	0.73	94.4	9,855	0.96
Greece	27.3	13,980	0.20	103.5	20,961	0.49
Ireland	81.2	7,640	1.06	0.0	3,088	0.00
Italy	207.7	18,704	1.11	71.3	24,644	0.29
Luxembourg	0.0	15	0.00	0.0	40	0.00
Netherlands	0.0	828	0.00	24.4	918	2.66
Portugal	45.7	17,857	0.26	274.6	19,029	1.44
Sweden	11.0	178	6.18	6.1	1,128	0.54
UK	66.3	10,412	0.64	360.0	10,946	3.29
Cross border	0.0	n/a	n/a	2.3	n/a	n/a
Total	**570.3**	**129,099**	0.44	**1,270.3**	**158,591**	0.8

Executive Summary

Although the precise amounts are uncertain pending the completion of negotiations over the new Cohesion and Structural Fund programmes, there is likely to be a further increase in the proportion of Structural Fund aid that is earmarked for VCLFs during the 2007-13 programming period. For the first time, there is also support for VCLFs in the newer EU Member States.

2.3 VCLFs provide equity, loans or a combination of these types of funding, together with (albeit with a varying degree of emphasis) mentoring and other business support services. VCLF models can be sub-divided into three basic types:

- **Co-investment schemes** use ERDF resources to make investments directly in companies pari passu with other investors. Such schemes may have active fund management or may act as passive co-investors in deals brought to them. Leverage is obtained at the company level.

- **Co-financed venture capital funds** combine ERDF resources with (pre-matched) funding from other sources. This type of VCLF may be co-financed at the outset to increase fund leverage and will have a fund management capability usually provided by the private sector under contract. Leverage is obtained both at the VCLF and company level.

- **Fund of funds** support one or both of the VCLF models above and provide an overall framework for interventions.

2.4 The difference between the models lies essentially in whether leverage takes place at the VCLF level or on a deal-by-deal basis. Either way, from an investment perspective, there are obvious benefits in being able to leverage additional funding from non-ERDF sources. Some VCLFs have been limited in the past to obtaining co-financing from other public institutions (in several cases the intention is to now to work more closely with commercial sources of funding too). In other cases covered by the research, leveraging private sector funding is a key and distinctive feature of VCLF operations.

2.5 In terms of their objectives, there is a fundamental difference between the VCLFs operating in economically more deprived regions and those in regions with more developed financial markets. In less developed regions, the objective of the 'funds of funds', and certain other VCLFs, is to stimulate demand for venture capital in the regions concerned, addressing bottlenecks in the creation of a market (such as the lack of experienced fund managers, awareness-raising and low quality proposals) and demonstrating that addressing the (latent) demand for risk capital can be profitable. In regions where a more fully developed range of public and private sector financing instruments is already available to start-ups and SMEs, the focus of ERDF-supported VCLFs often lies more on the demand side of the risk capital market.

2.6 Synergies exist between VCLFs and regional development strategies but in some cases these are very limited in practice. Although there are theoretical synergies at a strategic level with Structural Fund programming documents justifying

Executive Summary

financial allocations to VCLFs, from an implementation perspective these synergies have often been rather weak. Many of the VCLFs covered by the research are essentially 'stand-alone' operations and have not been closely integrated into wider regional development structures. However, the research also highlights a number of good examples of where VCLFs have worked closely alongside other regional development initiatives in an effort to integrate the provision of risk capital in the region with wider business support services, innovation and technology transfer mechanisms.

3. VCLF Investment Activities

3.1 There is a considerable variation in the nature and scale of ERDF investment in VCLFs and their funding structures generally. The proportion of VCLF funding contributed during the 2000-06 period by the ERDF ranged from 17% in the case of one VCLF covered by the study to an ERDF contribution of over two-thirds (69%) in another. The mix of national public/private funding for VCLF schemes also varied considerably: An estimated 18% of the funding for co-financed schemes came from the private sector. In comparison, private contributions amounted to 11% of VCLF resources for co-investment schemes, which emphasizes their leverage potential on a deal by deal basis. Overall, in the 2000-06 period, co-investment schemes were the smallest VCLFs with an average €25 million in resources. Co-financed funds were almost twice as large on average with €49 million followed by the 'funds of funds' with €78million. In terms of the breakdown of funding, co-financed schemes were funded to 60% by ERDF grants, compared with 46% for co-investment funds and only 18% for the 'funds of funds' covered by the research. An estimated 13% of the funding obtained by the VCLFs was raised in the form of equity.

3.2 Taken together, the 15 VCLFs covered by this research have so far invested just under half (44%) of the resources available to them. At the time whern the research was undertaken, investment rates ranged from 100% in one case to 7% in another. The extent to which resources have been invested also varies across the different VCLF models. Co-financed schemes had the highest investment rates with an average of 77% of resources utilized at the time of the research. By comparison, co-investment funds had invested a lower proportion - two-thirds of their resources on average and the two 'funds of funds' had invested only 32% on average. Not all VCLFs monitor the volume of applications but where this is so, the ratios range greatly from 100:1 to 1.6:1 in terms of applications to investments.

3.3 Although difficult to verify, there is evidence to suggest that the average size of VCLF investments increases over time. This reflects the fact that start-ups and SMEs go through different stages of growth and as they expand, their financing needs become different too. From the perspective of the VCLF, another consideration – in the case of equity financing – is the desirability of preventing a dilution of investment stakes as SMEs go through refinancing rounds and other investors increase their holdings. Some VCLFs have limits on the maximum amount of funding that can be provided to the same undertaking through successive deals. Other VCLFs do not have constraints of this sort.

Executive Summary

3.4 All VCLFs support their investment strategies by combining financial assistance to SMEs with some degree of 'money with management', i.e. the provision of mentoring and business advice along side risk capital. From the SME perspective, one of the key advantages of VCLF support is that - unlike with grants – such interventions are usually accompanied by other forms of assistance. However, there are varying degrees of emphasis on 'money with management'. Similarly, advice is sometimes given before an investment takes place (help with business planning and 'investment readiness') and/or continuing advice may be provided afterwards ('money with management'). Some of the VCLFs are also engaged in initiatives to develop business support structures more widely in their regions (e.g. support for developing business angels' networks) and not just for the direct benefit of investees.

4. VCLF Performance

4.1 At the beginning of 2007, the 15 VCLFs covered by the research had invested in a total of 1,123 undertakings, i.e. an average of just over 75 investments per VCLF. Reflecting the differing fund sizes and the rate at which they have invested, there is a range in the VCLF portfolios from less than 10 investments at the lower end of the scale to over 400 at the upper end (at this end of the scale, loans account for a significant proportion of deals). The average amount invested by the VCLFs is €427,900 with a range from €51,621 to €1.9 million.

4.2 The extent of financial additionality demonstrated by VCLFs at the deal level is generally high. The survey work undertaken for this study suggests a high degree of 'absolute additionality', i.e. a situation where the firms' plans could not have gone ahead at all without the VCLF investment. Almost two-thirds (64.7%) of the responses fell into this category with the remainder divided between 'partial additionality' (23.5%), i.e. a situation where SME plans would have gone ahead but on a reduced scale and/or on a delayed basis, and 'don't knows' (11.8%). None of the SMEs indicated that in the absence of support they could have gone ahead with their plans anyway using finance from other sources ('deadweight'). Additionality demonstrated at the deal level by VCLF interventions is likely to be highest in the less developed regions where alternative sources of finance, in particular risk capital, are less likely to be available.

4.3 The quality of investments can be assessed in various ways - in purely financial terms, quality criteria for VCLF portfolios include the number of 'successful' investments (interpreted, as a minimum, as being those that are still 'live' or where a successful exit has occurred). For these investments, the likely/actual IIR is clearly an appropriate measure of success. From a broader regional development perspective, quality is to be judged in terms of the survival and growth of SMEs, number and quality of jobs, and contribution to the knowledge base of regions. In this respect, an indication of the quality of VCLF portfolios can be obtained from the sectoral spread of investments. The various VCLFs have differing targets but there is generally a focus on start-ups and SMEs that are innovative and engaged in technology/knowledge-based activities. From a Lisbon Strategy perspective, VCLF

Executive Summary

portfolios of this type clearly promote the aim of creating a knowledge-based economy with 'more [and particularly] better jobs'.

4.4 The VCLFs covered by the research have differing strategies with regard to the ideal duration of their investments. VCLF investment terms vary from 1-2 years to around five years. In the case of a quarter of the VCLF investments, there has now been an exit. The exit rate varies from just one in several cases to over two-thirds of the original number of investments in another. The exits have also involved different procedures and situations. Half of all exits (50%) were successful in the sense that they involved a profitable realisation of the VCLF investment either via a trade sale, IPO or repurchase of equity by the undertakings' owners. The remaining exits are accounted for by situations where the investment returns were not sufficient to generate a profit or the undertakings that received VCLF support ceased trading.

4.5 While it is still too early in most cases for any definitive conclusions, actual and projected investment performance seems to vary substantially across the different VCLFs. Based on the available evidence, projected investment returns would appear to generally lie in the range 10-25%. There are a number of reasons why projections are difficult to establish. The most obvious of these is that there is uncertainty over how investments will perform in the future. But there are also other factors. Thus, some but not all VCLFs distinguish between gross and net returns, i.e. the profit after deducting investment losses, management costs and other overheads. Likewise, some VCLFs make available information on IRRs to date on their investments as well as projections for when the fund closes whereas others do not, providing estimates for only one or in some cases neither of these factors.

4.6 Variations in the (projected) performance of the VCLFs are not surprising given the different environments in which the funds operate and their primary objectives. For instance venture capital funds that focus on market creation are likely to have higher failure rates than their counterparts in the more developed markets. From a different perspective, VCLF (projected) performance is likely to be linked to the way in which target markets are defined. More particularly, where a VCLF has invested in a wide range of businesses, it is usually easier to generate positive returns because the choice of investments is greater. VCLF (projected) performance is also influenced by the type of financing they provide to SMEs. Where VCLFs are gap funders (which is the generally the aim), equity funding is inherently more risky, but offers higher rewards.

4.7 One of the key aims of a VCLF, and an advantage over grant-aided funding, is to generate a legacy fund which can be used for continued investment. Whilst VCLF schemes may be more expensive to administer than loans, if the investment funds can be recycled there is a potentially sustainable financing operation. All of the VCLFs covered by the research have the objective of ensuring that there are sufficient returns from their investments to create legacy funds. The achievement of this aim clearly depends on how the investments made by the various VCLFs perform and, more particularly, the extent to which the gains exceed losses, and management costs and other factors (e.g. in several cases, the servicing of debt). In most cases, it is still too early to forecast investment returns for the VCLFs covered by this research. Very few VCLFs

Executive Summary

(only three of the 15) have provided projections with regard to likely legacy funds. Where information has been provided, projected legacies are generally around 1-2 times the original ERDF investment. Initial estimates of IRRs varied by up to 20%, but such targets are extremely challenging and may not be met.

4.8 Clear aims should be set with regard to legacies when VCLFs are established and progress towards them closely monitored. When a VCLF is set-up, the legal document setting up the fund should make provision for the future use of any legacy and its monitoring. It would be helpful if the document ensures that there is public accountability, for example by means of publication of accounts containing sufficient information so that the process can be easily monitored.

5. Regional Development Impacts

5.1 Based on information available from 10 of the 15 VCLFs, their activities have so far led to a total of almost 7,900 being created at an average overall gross investment of €47,185 per job based on the original investment values (or €17,800 per job for ERDF investment alone). Moreover, the current average gross investment cost per job to the ERDF compares very favourably with the Structural Fund average (for example, in CSES's ex post evaluation of the 1994-99 Objective 2 programmes the average ERDF cost per job was in the range €15,000 to €20,000). Moreover, given the nature of risk capital, the investment cost per job could fall to zero if VCLFs are profitable. As with other VCLF outcomes, there is a considerable variation in the ERDF gross investment cost per job to date. It should also be noted that these estimates take only jobs created' into account and do not include 'jobs saved'. If the survey work is taken as a reliable guide to additionality, then the gross estimate of 7,900 jobs created needs to be adjusted downwards to around 5,200 to provide a net figure (this gives a net ERDF investment to date per additional job of almost €27,000 or just over €65,000 if both ERDF and national public expenditure is taken into account).

5.2 In terms of the VCLF employment effects achieved so far, the 7,900 new jobs created to date represents over half (56%) the original target. This is a very credible outcome and disproportionate to the value of the original VCLF funds actually invested (44%). Several VCLFs have exceeded their original targets for 'jobs created'. The outcomes projected by VCLFs by the time the various schemes close – if fully achieved – will make a significant contribution to Structural Fund programme targets. Furthermore, the quality of job creation attributable to VCLF activities is likely to be higher than average for the Structural Funds generally.

5.3 Overall, there is a question of how some VCLF regional development effects are measured and the reliability of monitoring data, and hence the usefulness of the indicator(s) concerned is doubtful. This applies especially to VCLF employment effects and in particular to the category of 'jobs saved' where the information provided by VCLFs does not make it clear how an estimate is arrived at.

5.4 There is a more fundamental question over the appropriateness of some VCLF performance indicators. In particular, there is a potential mismatch between

Executive Summary

VCLFs investing in technology-based businesses designed to provide long term returns and high quality jobs, and the ERDF measures on job creation during the programming period itself. Most VCLFs are designed to run for between 8 to 10 years and it is difficult to measure success after one or two years. There is also a question over how the cost effectiveness of job creation effects should be measured: while in the short term, when a VCLF investment is still 'live', there is clearly a 'cost per job', in the longer term this cost could fall to zero if a positive IIR is achieved. There are wider regional development impacts that are not captured by the performance indicators typically being used by VCLFs.

6. Key Conclusions and Best Practice Recommendations

6.1 With most VCLFs still at a relatively early stage of their operations, it is not possible to reach definitive conclusions on whether or not they will achieve their objectives. However, performance is so far in most cases encouraging. Taken together, the 15 VCLFs covered by this research have so far invested nearly half (44%) of the €1.4 billion resources available to them. As noted earlier, a total of 1,123 undertakings have been supported with an exit rate of 25%. In half of these cases there has been a profitable outcome. While overall VCLF rates of return are difficult to estimate, all the VCLFs are forecasting a positive gain by the time the funds close. In terms of regional development impacts, the quantity and quality of measurable outcomes (in particular, the estimate of 7,900 gross jobs created so far at an average overall gross investment cost of €47,100 per job/€17,800 for ERDF investment alone) is good and could fall to zero if VCLFs are profitable.

6.2 At the VCLF level, any comparisons in actual/forecast performance need to take into account fundamental differences between the VCLF operating in economically more deprived regions and those in regions with more developed financial markets. More particularly, in addition to purely quantitative financial and physical outcomes, the 'market-making' contribution of VCLFs needs to be taken into consideration in assessing and comparing their performance. To the extent that can be ascertained, most VCLFs covered by this research have contributed significantly to developing a more favourable environment for risk capital at a regional level.

6.3 VCLFs should ensure that their activities are closely aligned with overall regional development strategies. The report highlights various examples of how this can be done, e.g. by aligning VCLF target groups with cluster development strategies. Related to this, VCLF objectives and target groups should be defined in a way that focuses on market failures and longer term development objectives. There is a trade off between VCLF objectives and target markets that are broadly defined and offer scope to select investments that are likely to produce a good return relatively quickly, on the one hand, and more narrowly defined targets that focus on investing in businesses with long term job and wealth creation potential, on the other. Although there is a case for the first approach as demonstrating that VCLFs can operate successfully in regions with under-developed financial instruments, this 'market-making' role should not be limited to simply establishing that interventions can generate a positive return. In time, it can be assumed that the private sector will address market failures if it is profitable to do so.

Executive Summary

6.4 Following from this, in situations where a primary objective is to demonstrate that risk capital instruments can be successfully developed in a region, there should be more emphasis on the wider role that VCLFs can play in creating a favourable overall environment for these types of interventions. Apart from their role in providing SME finance, there is a need for VCLFs to work closely with partners in addressing other demand and supply-side issues - developing investment readiness schemes, networking with other intermediaries (universities, professional advisers, business incubators, etc) to identify projects where risk capital is needed to promote entrepreneurship, innovation and technology transfer; working with business angels and other sources to increase the supply of early stage risk capital; and on the supply side, helping to develop the capacity to provide start-ups and SMEs with high growth potential with specialized business advice and support.

6.5 Given the strengths and weaknesses of the various VCLF models, the choice of which type to establish in a region, should depend on the prevailing regional development circumstances and, in particular, on the sophistication of financial markets. It is not possible to identify a single model that is appropriate in all circumstances. However, in regions with weak or no risk capital financing capacity, the 'funds of funds' model is likely to be an appropriate structure to support new schemes that are unlikely to be able to set up VCLFs with other public and private sector partners without support. In more developed regions, where it is easier to secure public and private sector investment in a VCLF from the outset, the co-financed VCLF model is likely to be more appropriate. In regions with relatively highly developed financial markets, but where there are gaps in the provision of SME funding, the co-investment model is an obvious option, i.e. co-financing at the deal level.

6.6 The type of finance provided by VCLFs - debt, equity or a combination of these (and possibly other) instruments – should depend on the nature of the target market and identified funding gaps. The main use of debt instruments is to improve the availability and terms of working capital loans and short term loans to start-ups and SMEs at an early stage of development and as an alternative to grants. The effect of guarantee schemes is to pool risk, thus making the remaining risk more attractive to a lender. Equity instruments are usually more appropriate for very high risk start-ups or for SMEs that have reached a stage in their development where substantial additional funding is required but is unavailable in the form of debt and/or falls below the investment thresholds for other equity providers. In many respects, an ideal model is where VCLFs offer an in-house combination of debt and equity financing since this means that from an SME perspective, there can be a more seamless progression from one stage in their financing arrangements to another.

6.7 VCLFs should offer 'money with management' services, preferably by networking with other business support providers. As the examples covered by the research show, providing business advice and mentoring is one of the ways in which VCLFs add value compared with grant schemes and other types of SME finance. Being directly involved in advising companies also means that the VCLF is in a better position to monitor its investments and to detect problems at an early stage when there may still be scope to take corrective action. At the very minimum, this 'money with management'

Executive Summary

role should involve VCLF personnel or appointed representatives sitting on company boards. A preferable approach, however, is for the VCLF to network with professional advisers and others with business experience to offer a more comprehensive range of advisory support to SMEs. The costs should be possible to pass on to client companies although in certain circumstances they may be a case for subsidization (e.g. for a time-limited period at an early stage in a VCLF investment).

6.8 VCLFs have differing governance and management structures depending on their funding structures and there is no ideal model. More particularly, whereas VCLFs based on the co-financed model have boards representating the various stakeholders, this does not apply to VCLFs who do not have multiple public and private sector funding sources, i.e. co-investment models. The advantage of the first VCLF model is that it is potentially more effective in terms of partnership building and 'buy-in' with key organisations and investment partners directly involved in VCLF management. The disadvantage is that it means that setting up a VCLF can take longer and, once operational, can make VCLF management more complex and costly to undertake. There is no best practice model and the most appropriate arrangements depend on the nature of the VCLF, national regulations and regional circumstances.

6.9 Likewise, there are different approaches to portfolio management – in some cases this function is undertaken in-house whereas in others it is contracted out. Again, there is no best practice that is applicable to all types of VCLFs. The decision on which approach to adopt may be influenced by regulatory factors, in particular whether or not the VCLF manager is authorised to directly deliver financial services. Beyond this, contracting out portfolio management has the advantage, in theory at least, of securing expertise, ensuring professional standards and independence in investment decisions. A disadvantage is that it may be more costly in terms of overheads than an in-house approach.

6.10 There are very different practices with regard to the disclosure of information on VCLF financial performance and management costs, and a more transparent and standardized approach should be encouraged. Notwithstanding complications in comparing VCLFs and their performance and likely legacies, there is scope for a more standardized approach to providing information on their activities. This is needed to improve transparency and the effectiveness of monitoring by Managing Authorities and the Commission.

6.11 The performance indicators typically used by VCLFs to monitor socio-economic effects are in many respects not appropriate for risk capital interventions and do not shed light on regional development impacts. More emphasis is needed on obtaining qualitative rather than purely quantitative information on VCLF beneficiaries, e.g. on the sectoral characteristics of assisted start-ups and SMEs, the nature of the activities they are engaged in, new products and services developed, job quality. At present, this type of information is collected by very few VCLFs. More generally, it needs to be accepted that the impacts that VCLFs achieve are only likely to be possible to assess in the longer term.

Introduction 1

This document contains the final report that has been prepared by the Centre for Strategy & Evaluation Services (CSES) for the study 'Comparative Study of Venture Capital and Loan Funds supported by the Structural Funds'. The study was undertaken for the European Commission's DG Regional Policy.

1.1 Study Aims

The objectives of the study were to:

- Provide, on the basis of an examination of a representative sample of venture capital funds, an overview of **achievement and the impact** of the venture capital funds in terms of the objectives contained in VCLF business plans;
- Assess the **contribution of VCLF in terms of reaching the strategic objectives** contained within the 2000-2006 programmes;
- Assess **potential weaknesses and shortcomings** in the design and functioning of VCLF which impact negatively on cost-efficiency and on cost-effectiveness in terms of their overall contribution to creating and sustaining SMEs the relevant regions, and how such shortcomings can be avoided in future;
- Draw subsequent **lessons of relevance** for the purpose of determining the contents and strategic thrust of future programming rounds for the 2007/2013 programming period.

The main purpose of the study was to provide DG REGIO desk officers and others with guidance on how best to set up and operate VCLFs in the new 20007-13 Structural Fund programming period, drawing on lessons from the previous period.

1.2 Methodological Approach

The assignment was undertaken in three phases:

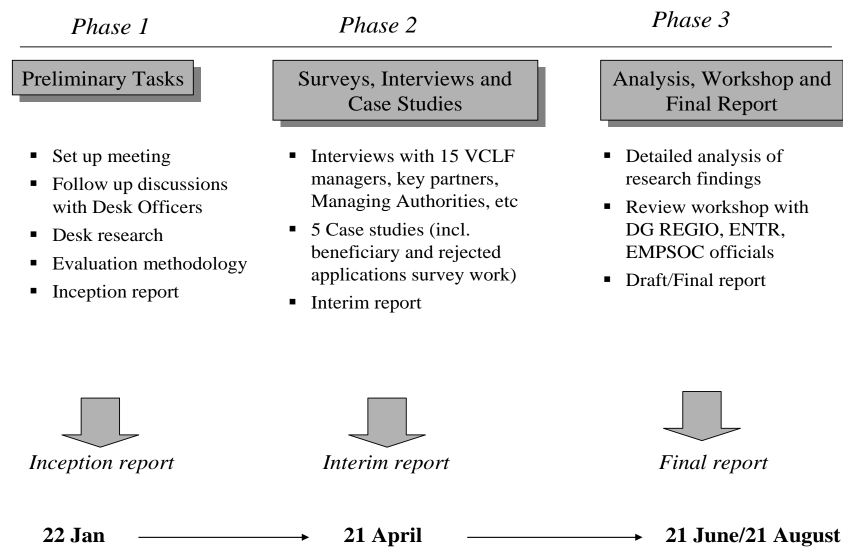
- **Phase 1 – Preparatory Tasks***:* a kick-off meeting and follow-up interviews with Commission officials, review of existing information on the ERDF-supported VCLFs and wider trends with regard to financial instruments, finalisation of the study methodology, and preparation of an inception report;
- **Phase 2 – Surveys, Interviews and Case Studies***:* interviews with a sample of 15 VCLFs with more detailed case study work focusing on five of them, meetings with the Managing Authorities and other key partners

in each of the selected regions, initial analysis of research findings and preparation of an interim report;

- **Phase 3 – Analysis, Workshop and Final Report***:* a detailed analysis of the Phase 2 research and preparation of a draft final report. A workshop with Commission officials to discuss the results of the evaluation took place before the report was finalized.

The diagramme below provides a summary of the overall work plan. The study was undertaken during the first half of 2007.

Figure 1.1: Overview of Methodological Approach



The VCLFs covered by the research were selected by the Commission following contact with national authorities to establish interest in participating in the study. Taken together, the 15 VCLFs examined in this report received over €300 million of ERDF funding, i.e. some 25% of the estimated total of €1.2 billion allocated from the Structural Funds to these types of interventions during the 2000-06 period (see Tables 2.1 and 3.2 in the following sections). The selected VCLFs provide good coverage of different types of interventions, EU Member States and regional development situations. CSES has also drawn on other research carried out by the firm to supplement the VCLF sample.

A range of material on the selected VCLFs was examined as part of the desk research for this study. This included: previous research on VCLFs; Structural Funds programming documents for the 2000-06 period; and information provided by the VCLFs covered by the study (business plans, management accounts and monitoring information, evaluation studies in some cases, etc). CSES also had meetings with DG Regio Desk Officers to discuss key issues

Introduction

relating to VCLFs in the various regions. Towards the end of Phase 1, CSES prepared an inception report.

During Phase 2 of the study, face-to-face interviews were undertaken with Managing Authorities, VCLF management teams and other key partners. Altogether 44 face-to-face interviews were carried out by CSES as part of this study with the Phase 2 fieldwork being conducted across seven EU Member States (Appendix B provides a list of interviews). As part of the Phase 2 research, a survey was also undertaken in three countries of companies that had benefited from VCLF investment. An interim report was prepared midway through Phase 2 of the study summarizing key findings and emerging conclusions.

In the final phase of the study, CSES completed the fieldwork, undertook a detailed analysis of the research findings and prepared a draft final report. This was discussed at a meeting with the Steering Group on 11 July 2007. This session was then opened up to other DG Regio officials to allow a wider exchange of views on the research findings. The final report takes into account the feedback obtained at these meetings and subsequently communicated by the Commission to CSES in writing.

The following table provides a list of the 15 VCLFs covered by the research undertaken for this study.

Table 1.1: List of VCLFs Covered by the Research

	VCLF	Location	Country
1.	IBB Beteiligungsgesellschaft	Berlin	DE
2.	IBG Beteiligungsgesellschaft Sachsen Anhalt	Magdeburg	DE
3.	Andalucia 21 FCR	Seville	ES
4.	SAS Alyse-Participations	Paris	FR
5.	TANEO	Athens	GR
6.	Attica Ventures (Zaitech Fund)	Athens	GR
7.	Stimulus VCF BV	Eindhoven	NL
8.	MKB fonds Flevoland	Lelystad	NL
9.	Technofonds Flevoland	Lelystad	NL
10.	PME Investimentos	Lisbon	PT
11.	Change Partners	Porto	PT
12.	Merseyside Special Investment Fund	Liverpool	UK
13.	North West Business Investment Scheme	Manchester	UK
14.	South Yorkshire Investment Fund	Leeds	UK
15.	Scottish Co-investment Fund	Glasgow	UK

Introduction

1.3 Structure of the Report

The final report is structured as follows:

- **Section 2: Background and Key Issues** – defines the VCLF concept and examines the rationale for intervention, evolution of EU support for risk capital, policy framework and existing research;
- **Section 3: Performance of VCLFs** – examines key features of the VCLFs and addresses the specific questions set out in the Commission's terms of reference;
- **Section 4: Conclusions and Best Practice Recommendations** – overall conclusions and recommendations from the research concerning best practices is setting up and operating VCLFs.

The final report is supported by a number of appendices. Appendix A contains a glossary of terms; Appendix B provides a list of interviews carried out for the study; and Appendix C (a separate document) contains a fiche and profile of each of the VCLFs covered by the research.

Background & Key Issues 2

In this section we define the term 'Venture Capital and Loan Fund' and examine the rationale for intervention. Following this, we examine the role of the Structural Funds in supporting VCLFs and key issues.

2.1 Definition and Rationale for Intervention

Venture Capital and Loan Funds (VCLFs) is the term used to describe Structural Fund interventions to promote the availability of risk capital (equity and/or loans) to start-ups and SMEs, especially innovative undertakings with good growth potential.

VCLF financing is usually divided into four main stages:

- **Seed capital** - financing provided to assess and develop an initial concept.
- **Start-up capital** - financing provided for product development and initial marketing. Firms may be in the process of being set up or may exist but have not sold their product or service commercially (together with seed capital called early-stage capital).
- **Expansion capital** - financing provided for the growth of a firm, which may or may not break even or be profitable. Capital may be used to finance increased production capacity, market or product development, or to provide working capital.
- **Replacement capital** - purchase of shares from another investor or to reduce gearing via the refinancing of debt.

In some cases, the same VCLFs provide these different types of risk capital to SMEs (often via separate but jointly managed funds). However, often VCLFs concentrate on providing one particular type of finance.

The type of finance provided by VCLFs is to be distinguished from private equity which involves leveraging bank finance to purchase an undertaking outright. In contrast, VCLFs usually only take a minority shareholding in companies and they do not assume overall responsibility for management. From a different perspective, venture capital offers a number of advantages over 'traditional' types of finance for SMEs (overdrafts, loans, etc). Banks are often unwilling to lend to start-ups and SMEs because of the lack of collateral and relatively high risks. A consequence is that bank finance is a relatively expensive option for SMEs with demanding collateral requirements.

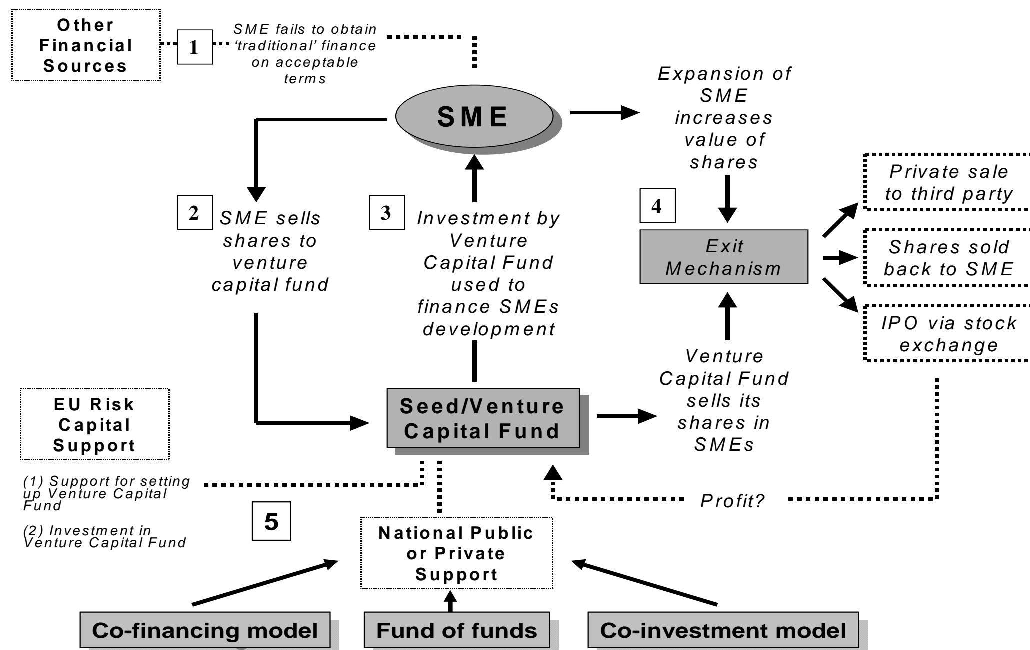
Despite the advantages, according to a Eurobarometer survey in 2005, only 2% of SMEs use venture capital companies to obtain financing.[1] There are a number

[1] Flash Eurobarometer 'SME Access to Finance', October 2005, published by DG Enterprise.

of reasons for this. On the *demand-side*, SMEs lack awareness of the different types of finance available to them and with equity funding are often unwilling to accept an outside ownership stake. In addition, poor investment readiness is a barrier in many cases to using risk capital. But there are also market failures on the *supply-side*. In particular, it is usually not profitable to provide the relatively small amounts of seed and venture capital needed by start-ups and SMEs because of the overhead costs. According to one estimate, while the 10-year returns on overall venture capital investments was 6.3% in Europe it was 26% in the US.[2] A further estimate showed that at the seed capital and start up stages, private VC funds were marginally profitable at best[3].

Figure 2.1 summarises the rationale for VCLF operations and the basic intervention logic.

Figure 2.1: Summary of VCLF Rationale and Intervention Logic



[2] Sources: 'Venture Capital Returns Held Steady At Year-End 2004', NVCA 11.4.2005, and 'Pan-European survey of performance', EVCA 27.10.2005. According to another estimate, early-stage venture capital investment is equivalent to around 0.04% of GDP in the US. In 2004, this level had already been reached or exceeded by Sweden, Denmark and the UK. However, for the rest of the EU to reach it would mean investing about €6bn a year, i.e. a tripling of current levels. Such levels were briefly achieved in the past, but the challenge is to reach them on a sustainable basis (Annual Survey of Pan-European Private Equity & Venture Capital Activity" 2004).

[3] Profitability of venture capital investment in Europe and the US, DG ECFIN, ECFIN/L6/REP/50386-EN, March 2006.

Background & Key Issues 2

In the above diagram, the intervention logic for VCLFs involves:

- **Market failure (1)** - against the background of a market failure, a start up or existing SME applies to a VCLF for support. The undertaking will already have investigated alternative commercial sources of finance but without a positive outcome. Its financing structure will be such that it needs risk capital to develop and to leverage other forms of finance.

- **Equity stake (2)** - the VCLF will acquire equity shares in the company. Typically, this holding will be new shares issued by the company. In some cases, shares may be issued at a premium to face value.

- **VCLF investment (3)** - the proceeds from the sale of equity will be used for the financing of the company. This may be accompanied by the provision of other funding, such as loan finance or hybrid instruments such as convertible loan stock. During the period of the investment, the VCLF will monitor the investment, sometimes providing business advice to the SME to help improve its performance and growth prospects ('money with management').

- **Exit mechanisms (4)** - in due course, the VCLF will attempt to sell its stake in the SME. For successful companies, exit routes may be through the private sale of the investment to a trade investor, or by means of an IPO, and can generate high returns. For less successful SMEs, the exit route for the VCLF may be problematic. In a significant number of cases, the SME may undergo a financial restructuring and the whole of the equity capital will be lost.

- **VCLF funding and legacy (5)** - ERDF financing is used to leverage support from national (public and/or private sector) sources. This may be provided at the regional level ('fund of funds'), VCLF level ('co-financing model') or deal level ('co-investment model). The distinction between these different VCLF models is explained in further detail in Section 3.1. Ideally, the VCLF should generate a positive overall return from its investments thereby creating a self-sustaining, longer-term legacy fund.

2.2 Risk Capital and the Structural Funds

The case for Structural Funds' intervention in favour of VCLFs rests on the existence of market failures and the lack of public intervention at a national and/or regional level to address these failures. In particular, the aim is to increase the supply of early-stage finance to start-ups and SMEs.

From a purely Structural Funds' perspective, VCLFs also represent a more efficient use of financial resources with non-refundable grant aid being replaced by investments that (in theory at least) can be re-cycled and used again to support new interventions. Moreover, the revolving nature of risk

capital should reduce the cost of job creation through the Structural Funds over time. At the same time, the ability to recycle risk capital allows for a longer lasting store of investment capital for the beneficiary region.

Reflecting these and other considerations, there has been a considerable increase in the allocation of Structural Fund resources to VCLFs over the past ten years. Such interventions have formed an important aspect of ERDF Priorities aimed at promoting entrepreneurship, innovation, technology transfer and knowledge-based SMEs generally. During the 1994-99 programming period – the first when risk capital featured in Structural Fund programmes – an estimated total of €570 million was allocated from the ERDF to these types of interventions. As Table 2.1 shows, ERDF allocations to VCLFs more than doubled in the 2000-06 period.

Table 2.1: Estimated Investment in VCLFs in Structural Fund Programmes 1994-99 and 2000-06 (€000s)

Country	1994-99	2000-06 Programming Period			
	EU	EU	Public	Private	Total
Austria	0.0	0.2	0.2	1.1	1.5
Belgium	3.3	35.5	35.7	1.4	72.6
Denmark	0.0	7.5	7.6	0.0	15.1
Germany	18.9	54.9	49.8	3.2	107.9
Spain	61.0	230.1	100.3	0.0	330.4
Finland	0.0	5.5	8.4	6.5	20.4
France	48.1	94.4	165.8	216.1	476.3
Greece	27.3	103.5	50.1	39.7	193.3
Ireland	81.2	0.0	0.0	0.0	0.0
Italy	207.7	71.3	80.2	146.7	298.2
Luxembourg	0.0	0.0	0.0	0.0	0.0
Netherlands	0.0	24.4	38.2	43.1	105.7
Portugal	45.7	274.6	92.9	691.2	1,058.7
Sweden	11.0	6.1	0.0	0.0	6.1
UK	66.3	360.0	110.0	420.0	890.0
Cross border	0.0	2.3	0.8	0.4	3.5
Total	**570.3**	**1,270.3**	**740.0**	**1,569.3**	**3,579.7**

Source: 1994-99 estimates from 'Guide to Risk Capital Financing in Regional Policy', CSES, 2002; 2000-06 estimates from DG Regio based on amounts notified by Member States (2002). The category 'Cross Border' is thought to relate to an Interreg programme between Belgium, France and Luxembourg that included provision for risk capital.

Background & Key Issues 2

As can be seen from Table 2.1, the overall increase in the ERDF allocations to risk capital between the 1994-99 and 2000-06 Structural Fund programming periods masks considerable variations at a national level. In four countries (Austria, Denmark, Finland, Netherlands) the position changed from zero allocations in 1994-99 to modest support for VCLFs in 2000-06. The cross-border INTEREG allocation in 2000-06 was also new. But in Luxembourg the zero allocation to risk capital remained unchanged while in Ireland financial allocations to VCLFs ceased at the beginning of the 2000-06 period and in Italy there was a reduction in commitments to VCLFs between 1994-99 and 2000-06. However, in the other EU Member States, there was a substantial increase in ERDF support for VCLFs ranging from a doubling in France to a more than tenfold increase in Belgium.

Another way of looking at the financial ERDF allocations to risk capital in the 1994-99 and 2000-06 periods is to relate them to total Structural Fund commitments. As Table 2.2 shows, at an EU level, the allocations to risk capital rose from 0.44% of total ERDF commitments in 1994-99 to 0.80% in 2000-06.

Table 2.2: Proportion of Structural Fund Programmes 1994-99 and 2000-06 Allocated to Risk Capital (€000s)

Country	1994-99			2000-06		
	Risk capital	SF total*	%	Risk capital	SF total	%
Austria	0.0	338	0.00	0.2	931	0.02
Belgium	3.3	1,159	0.28	35.5	1,058	3.36
Denmark	0.0	123	0.00	7.5	183	4.09
Germany	18.9	17,554	0.11	54.9	23,651	0.23
Spain	61.0	33,541	0.18	230.1	40,757	0.56
Finland	0.0	185	0.00	5.5	1,402	0.39
France	48.1	6,585	0.73	94.4	9,855	0.96
Greece	27.3	13,980	0.20	103.5	20,961	0.49
Ireland	81.2	7,640	1.06	0.0	3,088	0.00
Italy	207.7	18,704	1.11	71.3	24,644	0.29
Luxembourg	0.0	15	0.00	0.0	40	0.00
Netherlands	0.0	828	0.00	24.4	918	2.66
Portugal	45.7	17,857	0.26	274.6	19,029	1.44
Sweden	11.0	178	6.18	6.1	1,128	0.54
UK	66.3	10,412	0.64	360.0	10,946	3.29
Cross border	0.0	n/a	n/a	2.3	n/a	n/a
Total	**570.3**	**129,099**	0.44	**1,270.3**	**158,591**	0.8

*Source: Analysis of information in 'Ex Evaluation of the 1994-99 Objective 1 Programmes' (ECOTEC, 2003) and 'Ex Post Evaluation of the 1994-99 Objective 2 Programmes' (CSES, 2003). Note: * 1994-99 Objectives 1 and 2 only. The category 'Cross Border' is thought to relate to an Interreg programme between Belgium, France and Luxembourg that included provision for risk capital.*

Background & Key Issues 2

The most substantial increases in financial allocations to VCLFs (expressed as a percentage of overall Structural Fund commitments) were in Belgium (+3.1% percentage points), Denmark (+4.1pp), Netherlands (+2.6 pp) and the UK (+2.6 pp). These were also the EU Member States with the highest proportion in absolute terms of Structural Fund commitments allocated to VCLFs during the 2000-06 period. Conversely, allocations fell most in Sweden (-5.6 pp), Ireland (-1.0 pp) and Italy (-0.8 pp). In all other countries (with the exception of Luxembourg as noted earlier) there were modest increases in the proportion of ERDF commitments for risk capital schemes between 1994-99 and 2000-06.

Although the precise amounts are uncertain pending the completion of negotiations over the new Cohesion and Structural Fund programmes, there is likely to be a further increase in the proportion of Structural Fund aid that is earmarked for VCLFs during the 2007-13 programming period. For the first time, there is also support for VCLFs in the newer EU Member States.

2.3 Existing Information on VCLFs

There is only a limited amount of previous research on EU-supported risk capital interventions.

Earlier studies include an evaluation of the first generation of 'financial engineering' schemes. This study, carried out in 1999, examined four VCLFs in Belgium, Portugal, Spain and the UK.[4] Important conclusions included the need for VCLFs to develop more effective ways of demonstrating the contribution to regional development and the importance of private sector involvement in ensuring professional management.

Otherwise, previous research focusing specifically on ERDF-supported VCLFs is largely limited to the coverage provided in interim and ex post evaluations. However, this coverage is not in-depth or extensive in scope. The ex post evaluation of the 1994-99 Objective 2 programmes included an estimate of the amount of ERDF resources devoted to VCLFs and some examples of interventions.[5] It argued that more emphasis should be placed on VCLF interventions in the future given constraints on providing grant aid. Parallel evaluations of the 1994-99 Objective 1 and 6 Structural Fund programmes did not include any detailed information on risk capital schemes although there were some references to VCLFs in the context of business support measures generally. In the 2000-06 programming period, there is been more research on VCLFs including studies in Germany and the UK focusing specifically on ERDF-supported schemes (considered later in this report).

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[4] Evaluation of Financial Engineering Measures in Regional Policy', Ernst & Young, study for DG Regional Policy, 1999.
[5] Ex Post Evaluation of the 1994-99 Objective 2 Programmes', Centre for strategy & Evaluation Services, study for DG Regio, 2003.

Apart from the (rather limited) previous evaluation studies, the Commission has also produced guidance on risk capital schemes in regional policy.[6] There have also been some studies of other non-ERDF EU-supported risk capital schemes and related initiatives.[7]

2.4 EU Framework for Risk Capital 2007-13

The **Lisbon Agenda** provides the overall policy framework for VCLF operations with its aim of making Europe the most dynamic and competitive knowledge-based economy in the world by 2010. The 'renewed' strategy of 2005 stresses the importance of supporting entrepreneurship and innovation with appropriate financial instruments including risk capital.

The '**Risk Capital Summit'** held in London in 2005 identified a number of priorities. These included: more encouragement of business angel investment; venture capital funds need to become larger and more professional and need to cooperate closely with innovation sources; the need to overcome the fragmentation of the venture capital market and to develop more growth-oriented stock markets; and encouraging entrepreneurs to become more growth-seeking and investment-ready; and Governments rewarding success with their policies.[8]

More recently, the Commission addressed the issue of risk capital financing in its **Communication on 'Financing SME Growth- Adding European Value'** (COM (2006) 349, June 2006). In this, the Commission emphasised the importance of reducing and redirecting State aids to address market failures in order to increase economic efficiency and to stimulate research, development and innovation. It also undertook to reform the State aid rules, inter alia, with the aim of facilitating access to finance and risk capital. Following the Communication, new **EU guidelines on risk capital** were issued.[9] These guidelines adopt a more flexible approach so as to allow Member States to better target their risk capital measures to the relevant market failure. Amongst other things, the guidelines set out a refined economic approach for the assessment of the compatibility of risk capital measures with the EC Treaty.

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[6] Guide to Risk Capital Financing in Regional Policy, European Commission (produced by CSES), 2002.

[7] These include, for example, 'Evaluation of the CRE Seed Capital Scheme' Evaluation of EU-Supported Business Angels Initiatives', and 'Strategic Evaluation of SME Assistance Schemes' for DG Enterprise; and research at a macro level by DG ECFIN, for example, 'Profitability of Venture Capital Investment in Europe and the United States', in European Economy, 2006.

[8] Conference Report on the risk Capital Summit 2005: Investing for Growth and Competitiveness in Europe, European Commission, 2005.

[9] Community Guidelines on State Aid to Promote Risk Capital Investments in Small and Medium-Sized Enterprises (2006/C 194/02), 18 August 2006.

Background & Key Issues 2

As noted earlier, in the Structural Fund regulations for the 2007-13 programming period envisage an even greater emphasis that before on risk capital. A number of other initiatives are planned that are also relevant in this respect.

The **Competitiveness and Innovation Framework Programme** (CIP), through the High Growth and Innovative SME Facility (GIF), will provide some €1 billion through its financial instruments which are expected to leverage around €30 billion of new finance for SMEs.

The Joint European Resources for Micro- to Medium Enterprises (**JEREMIE) initiative**, which is being launched during the 2007-13 programming period, will combine grants from the ERDF with loan capital and other sources of finance to support the creation and expansion of innovative micro, small and medium-sized enterprises as part of EU regional policy. It will also support technology transfer and links between business, universities and research centres, and will improve the availability of micro-credits targeted at those who may not have access to commercial credit. Funding from instruments established through JEREMIE may also be combined with business support and institution-building measures financed by the Structural Funds. Under JEREMIE, the EIB will provide a risk capital mandate of €1 billion to the EIF between 2007 and 2013.

Last but not least, under the **Seventh Framework Programme for Research and Development**, SMEs can participate in projects using the new Risk Sharing Finance Facility (RSFF) to support applied research and the commercialisation of results.

Assessment of VCLF Performance 3

In the terms of reference for this study a number of questions were posed concerning the performance of VCLFs during the 2000-06 Structural Fund programming period (Section 3b of the brief – Key Issues). Key issues are considered under the following headings:

- **Section 3.1**: **Overview of VCLFs** - provides an overview of the VCLFs covered by the study, highlighting their key features;
- **Section 3.2**: **VCLF Funding Models** - examines the different funding models for VCLFs, highlighting advantages and disadvantages;
- **Section 3.3**: **Types of VCLF finance and other SME Services** – examines VCLF portfolios and the amount and type of SME funding and other services, notably 'money with management';
- **Section 3.4: VCLF Performance** – analyses VCLF investment returns;
- **Section 3.5: Regional Development Impacts** – assesses the job and wealth creation effects attributable to VCLF interventions and the contribution to regional development;
- **Section 3.6: VCLF Legacies** – the extent to which VCLFs supported during the 2000-06 period will generate legacy funds for future investment;
- **Section 3.7: Management and costs** – examines management structures and costs.

3.1 Overview of VCLFs

We begin by providing an overview of the different types of VCLFs and then examine their objectives and investment strategies.

3.1.1 Types of VCLFs

The VCLFs covered by this study can be sub-divided into the following categories:

- **Co-investment schemes** using ERDF resources to make investments directly in companies pari passu with other investors. Such schemes may have active fund management or may act as passive co-investors in deals brought to them. Leverage is obtained at the company level.
- **Co-financed venture capital funds** that combine ERDF resources with (pre-matched) funding from other sources. Such VCLFs may be co-financed at the outset to increase fund leverage and will have a fund management capability usually provided by the private sector under contract. Leverage is obtained both at the VCLF and company level.
- **Fund of funds** that are used to support one or both of the VCLF models above.

Assessment of VCLF Performance 3

In each case, the VCLFs provide equity, loans or a combination of these types of funding, together with (albeit with a varying emphasis) mentoring and other business support advisory services. Table 3.1 provides a summary overview of the 15 VCLFs covered by the research. The distinction between the three VCLF models is further explained in Section 3.2.

Table 3.1: Overview of VCLFs

Co-investment schemes			
1.	Scottish Co-investment Fund	UK	Co-investment fund for SMEs in Scotland. 'Passive' investment relying on partners to create deals.
2.	North West Business Investment Scheme	UK	Co-investment fund focusing on the Objective 2 areas in North West England.
3.	MKB fonds Flevoland	NL	Co-investment fund focusing on SMEs in Flevoland, without sectoral focus.
4.	Technofonds Flevoland	NL	Co-investment fund focusing on growth SMEs in Flevoland
5.	PME Investimentos	PT	Co-investment fund focusing on innovative start-ups and SMEs, especially in Biotech and ICT sectors.
6.	Attica Ventures (Zaitec Fund)	GR	Co-investment scheme established with TANEO support and focusing on innovative SMEs across a range of sectors.
Co-financed schemes			
7.	Merseyside Special Investment Fund	UK	Co-financed fund with bank co-financing, subdivided into three funds plus a seed corn fund aimed at different sizes of companies, in Merseyside.
8.	South Yorkshire Investment Fund	UK	Originally modeled on MSIF, a co-financed fund with bank and other co-financing, subdivided into three funds. Covers Objective 1 area of South Yorkshire.
9.	IBG Beteiligungsgesellschaft Sachsen Anhalt	D	Publicly co-financed VCLF offering equity to technology-based SMEs in the Sachsen Anhalt region.
10.	IBB Beteiligungsgesellschaft	D	Equity financing for technology-related and Berlin-based companies in both Objective 1 and 2 areas of the city.
11.	Stimulus VCF BV	NL	Co-financed VCLF. The fund makes investments principally in high tech SMEs located in the region.
12.	Change Partners	PT	Co-financed VCLF which invests in a range of SMEs with no particular sectoral focus. There are two VCLFs operated by Change Partners with ERDF support.
13.	Andalucia 21 FCR	ES	Generalist venture capital fund operated by a private sector organisation and investing in SMEs in the Andalucia region
Fund of funds			
14.	SAS Alyse-Participations	FR	Fund of funds focusing on start-ups and SMEs in the French overseas territories
15.	TANEO	GR	Fund of funds focusing on SMEs in Greece without sectoral focus. Has supported 4 VCLFs so far.

Assessment of VCLF Performance 3

3.1.2 VCLF Objectives and Investment Strategies

In terms of their objectives, there is a fundamental difference between the VCLF operating in economically more deprived regions and those in regions with more developed financial markets. VCLFs in less developed regions that illustrate this include TANEO in Greece and Alyse-Participations in the French overseas territories – in both cases, these schemes are primarily supply-side orientated, i.e. aim to have a demonstration effect by improving the availability of financing instruments for start-ups and SMEs. The objective of the 'funds of funds', and certain other VCLFs, is to stimulate demand for venture capital in the regions concerned, addressing bottlenecks in the creation of a market (such as the lack of experienced fund managers, awareness-raising and low quality proposals) and demonstrating that addressing this (latent) demand for risk capital can be profitable. Reflecting this, traditional regional development objectives such as creating jobs, promoting innovation, etc, are a lower immediate priority for these VCLFs, in the short to medium term at least.

In regions where a more fully developed range of public and private sector financing instruments is already available to start-ups and SMEs, the focus of ERDF-supported VCLFs lies more on the demand side of the risk capital market. Thus, the MKB and Technofunds in Flevoland, and the MSIF and North West Business Investment Scheme in the UK, amongst others, aim to offer risk capital to SMEs in order to help them develop their business, commercialise R&D, enter new markets, etc. Their aim is to address specific shortcomings in the provision of private sector risk capital financing. Typically, this involves focusing on early-stage financial instruments. For these VCLFs, standard regional development objectives relating to job and wealth creation are important. These types of interventions also seek to address supply-side shortcomings (for example, one of the objectives of the co-investment model used in Scotland is to attract other risk capital providers to the country and to develop the local business angel community) but this is generally not their primary aim.

VCLF targets and investment strategies, management structures, the way in which they are funded and their performance reflects differences in their objectives. VCLF target markets are defined in terms of: (a) *geographical location* (i.e. during the 2000-06 period, whether or not an applicant was located in an area that was eligible for Structural Fund support); (b) the *amount and type of financial assistance required* which generally reflects the undertaking's stage of development (start-up, existing SME in a growth phase, etc); (c) *business activity/sector* (here, there is a fundamental distinction between VCLFs, some of which support businesses in any sector while others have a specific focus, e.g. SMEs engaged in the development of particular technologies); and (d) *likely performance*, i.e. VCLFs focus on start-ups and SMEs with good growth prospects and where an investment is likely to match or exceed a 'hurdle' rate of return. Although there are some differences in these factors, all VCLFs of course have investment strategies that seek to generate a

positive aggregate return over the lifetime of the funds, thereby rewarding investors and creating a longer term legacy for future investment.

Synergies exist between VCLFs and overall regional development strategies but from an implementation, these are rather limited. The justification and plans for VCLF interventions during the 2000-06 period was set out in programme documents, usually under Priorities and Measures relating to the promotion of enterprise, innovation and competitiveness. However, although there are theoretical synergies at a strategic level with Structural Fund programming documents justifying financial allocations to VCLFs in terms of the need to address market failures in the financial instruments available for innovative, knowledge-based start-ups and SMEs, at an operational level these synergies have often been rather weak. Many of the VCLFs covered by this research are essentially 'stand-alone' operations and have not been closely integrated into the structures used to promote regional development strategies. That said, the research also highlights a number of good examples of where VCLFs have worked closely alongside other regional development initiatives in an effort to integrate the provision of risk capital in the region with wider SME support services (see Section 4.1).

From another perspective, the geographical targeting of VCLF interventions in accordance with Structural Fund Objective 1 and 2 priority areas that existed during the 2000-06 period has complicated investment strategies. In the case of IBB Beteilingungsgesellschaft (DE), for example, it was originally assumed that Objective 1 areas of Berlin would account for the majority of applications for risk capital and the allocation of funding reflected this (three-quarters of the VCLF's ERDF financial allocations being earmarked for these areas). However, in practice, demand levels have been more or less equal in both parts of the city which has meant a shortage of ERDF funds for the Objective 2 area. As a consequence, some €4 million of VCLF funding has not been utilized. Similar problems arose in the North West of England where the fragmented nature of the Objective 2 eligible areas meant that several good investment opportunities in close-by locations could not be pursued by the NWBIS. 'Zoning' is not of course a feature of Structural fund interventions in the new 2007-13 programming period and this should have benefits for VCLF interventions by eliminating geographical constraints on investment activities.

3.2 VCLF Funding Models

The terms of reference required several questions to be examined – the amounts of co-funding flowing to the VCLF instruments financed by the Structural Funds, broken down by source (public, private) and type (equity or debt); and, secondly, the quantity and quality of actual VCLF investments in SMEs (including social enterprises and other undertakings) during the 2000-06 programming period - both achieved and projected.

Assessment of VCLF Performance 3

3.2.1 Funding of VCLFs

The size of the VCLFs covered by this research varies considerably, as does the way in which they are funded. Table 3.2 provides a summary of funding sources for the 15 VCLFs covered by this research.

Table 3.2: Breakdown of Original VCLF Funding (euro 000s)

	VCLF	ERDF	Public	Private	Total
	Co-investment Funds				
1	Scottish Co-investment Fund	35,000	30,000	-	65,000
2	North West Business Investment Scheme	8,950	25,950	-	34,900
3	MKB fonds Flevoland	1,450	500	1,750	3,700
4	Technofonds Flevoland	2,315	4,115	-	6,430
5	PME Investimentos	6,900	3,100	-	10,000
6	Attica Ventures (Zaitech Fund)	15,000	-	15,000	30,000
	Co-financed Funds				
7	Merseyside Special Investment Fund	60,000	33,000	74,000	167,000
8	South Yorkshire Investment Fund	32,175	44,044	39,325	115,544
9	IBG Sachsen Anhalt	87,400	39,700	-	127,100
10	IBB Beteiligungsgesellschaft	13,750	6,250	-	20,000
11	Stimulus VCF BV	1,467	978	2,722	5,167
12	Change Partners	4,687	1,563	2,750	9,000
13	Andalucia 21 FCR	6,750	2,250	9,000	18,000
	Funds of Funds				
14	SAS Alyse-Participations	3,000	2,000	1,000	6,000
15	TANEO	25,500	19,500	105,000	150,000
	Total	**304,344**	**212,950**	**250,547**	**767,841**
	Percent	**40%**	**28%**	**33%**	**100%**

Note: MSIF includes separate venture, mezzanine and small firms funds, as described later in this report. Figures for a recently established seed corn fund are excluded.

There is a considerable variation in the extent of ERDF investment in VCLFs. The proportion of VCLF funding contributed during the 2000-06 period by the ERDF ranges from 17% in the case of TANEO (GR) to an ERDF contribution of over two-thirds (69%) in the case of the IBB Beteiligungsgesellschaft (DE), IBG Sachsen-Anhalt (DE) and PME Investimentos (PT).

The mix of national public/private funding for VCLF schemes also varies considerably. Some VCLFs have relied mainly on the public sector (e.g. Technofonds Flevoland, Investitionsbank Sachsen Anhalt, Alyse) whilst others have been largely private sector supported (e.g. Merseyside Special Investment Fund, UK and TANEO, GR). Overall, 18% of the funding for co-financed schemes came from the private sector. In comparison, private contributions amounted to 11% of VCLF resources for co-investment schemes, which emphasizes their leverage potential on a deal by deal basis.

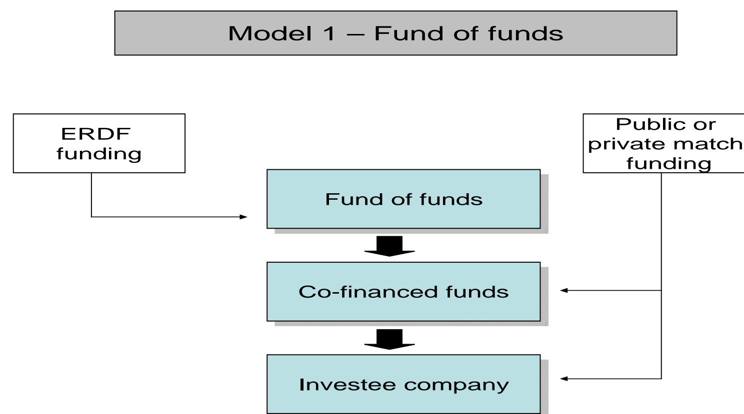
Assessment of VCLF Performance 3

Overall, in the 2000-06 period, co-investment schemes were the smallest funds with an average €25 million in resources. Co-financed funds were almost twice as large on average with €49 million followed by the 'funds of funds' with €78million.[10] In terms of the breakdown of funding, co-financed schemes were funded to 60% by ERDF grants, compared with 46% for co-investment funds and only 18% for the two 'funds of funds'.

The extent to which the ERDF contribution to the VCLFs has leveraged additional funding from other sources reflects more fundamental differences in the models:

Fund of funds - the 'funds of funds' models allow for multiple leveraging of the ERDF contribution: (a) at the level of the 'fund of funds'; (b) at the level of the VCLFs that are supported; and (c) at the level of individual SME investments. In comparison, VCLFs, such as the Dutch MKB or Technofonds allow for double leveraging of EU funds, at the fund level and the level of individual SME investments. Clearly, greater leverage will increase both the level of risk and (potential) returns.

The fund of funds model is more complex than the other models. In that model ERDF funding comes in at the level of the fund of funds, which then invests in other funds (in this example a co-financed fund). Match funding comes in at the level of the co-financed fund, and the investee company. Other models are possible, with match funding coming in as well at the fund of funds level (e.g. TANEO), and ERDF funding also coming in at the co-financed fund level.

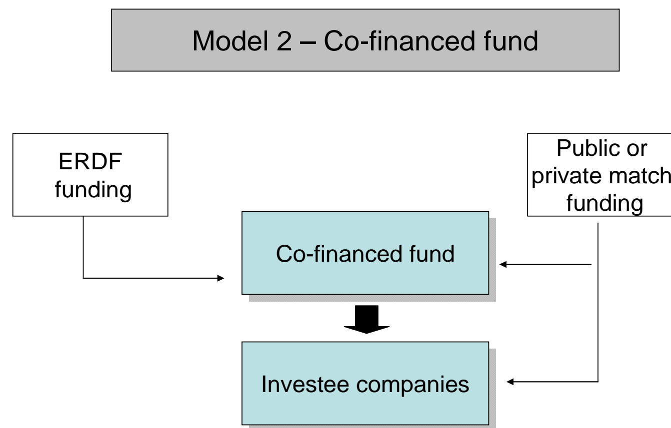


Co- financing – a further model is for the private sector or other public bodies to invest directly in a VCLF, either by means of equity or using loan finance. The VCLF then makes investments in companies, and these investments may generate further leveraging of ERDF funds at the company level. An example of this

[10] It should be noted that the average for the funds of funds in this section is heavily skewed by TANEO, which is much larger than Alyse and funded largely (68%) by private sector debt.

model is the Merseyside Special Investment Fund (UK) where bank funding has been obtained, but on a preferential creditor basis (another example in the UK, modeled on MSIF, is the South Yorkshire Investment Fund. PME Investimentos (PT) and Andalucia 21 (ES) are also co-financed).

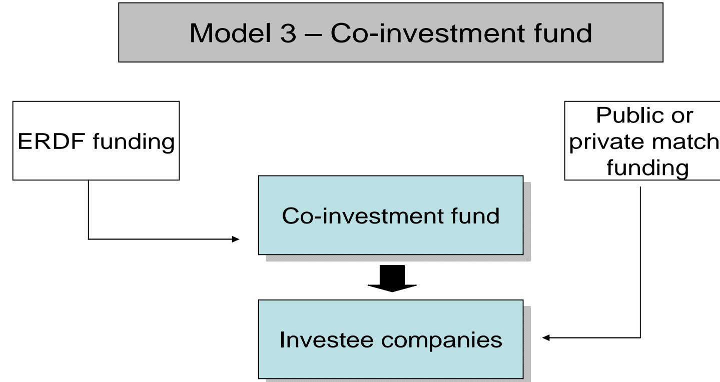
The effect of matching ERDF funds with bank borrowing is to create a leveraged fund. In itself, this approach will work if the VCLF is able to make returns in excess of the cost of bank funds. But if the VCLF is not able to achieve these returns the leverage will work against it leading to losses. Bank borrowing therefore amplifies risks and rewards. The model is also relatively complex to set up and costly to run. This is because of the relatively large number of VCLF stakeholders. The financing flows can be shown in the following diagram.



Co- investment - such VCLFs are inherently simpler. The VCLF may not have an external, private sector investment partner although some are co-financed by national public sources. The VCLF invests directly in companies on a pari passu and a deal-by-deal basis with other investors. Leverage is obtained through a catalytic, risk-taking role, thereby encouraging other investors to provide funding alongside the VCLF.

One example of a co-investment fund is the North West Business Investment Scheme in the UK which employs a fund manager whose role is to put together deals with other financial providers in the area. An even simpler model is the Scottish Co-Investment Fund which has relied on a number of partners (other risk capital providers, business angels, etc) to bring deals to it. These partners take the lead in identifying opportunities and then ask the Scottish Co-Investment Fund to co-invest with them. They do this either because SCF participation increases the size of the deal they can cope with (particularly important for business angels) and/or enables them to spread their investments across more SMEs. Examples elsewhere include the Technofonds (NL). Advantages of co-investment funds are their relatively simple corporate structure, potentially low

management costs and relatively transparent operations. The financing structure of a simple co-investment fund is shown below



The following table summarises the key features, advantages and disadvantages of the three basic VCLF models.

Table 3.3: Key Features of VCLF Models

Issue	Fund of funds	Co-financing	Co- investment
Nature of fund and leverage	ERDF fund invests in another fund or funds with external investors. Leverage obtained at level of the investee fund	Leverage obtained by direct equity or loan investment in the ERDF fund	Often no other investment in the ERDF fund. Leverage obtained at the investment company level, either through equity or loan
Complexity of set up	Requires group of funds to be set up	Obtaining direct external investment may be difficult and lead to a complex structure	Relatively simple. May require appointment of co-investment partners
Where investment decisions are made	Decisions made in investee funds, not in the ERDF fund	Made by ERDF fund, possibly by fund managers	Made by ERDF fund, possibly by fund managers. If investments brought by partners, due diligence may be carried out by those partners rather than the ERDF fund
Management of investments	At investee fund level – ERDF fund not involved	By ERDF fund. May offer significant management input	By ERDF fund or by investment partners
Exit mechanism	Depends on investee funds	Fixed life of fund. Exit of individual investments by ERDF fund when opportunity arises	Fixed life of fund. Exit of individual investments by ERDF fund when opportunity arises

Assessment of VCLF Performance 3

Management costs	Low at ERDF fund level. May not be transparent at level of other funds	Likely to be relatively complex	Likely to be lower, particularly using investment partner model
Public disclosure	Different layers of investment may impede transparency	Transparent, unless corporate structure dos not require disclosure	Transparent, unless corporate structure dos not require disclosure

The difference between the models lies essentially in whether leverage takes place at the VCLF level or on a deal-by-deal basis. Either way, from an investment perspective, there are obvious benefits in being able to leverage additional funding from non-ERDF sources. Some VCLFs, such as IBG in Germany, have hitherto been limited to obtaining co-financing from other public institutions and it is noteworthy that the intention with this fund is to now work more closely with commercial sources of funding too. In other cases covered by the research, such as PME Investimentos (PT), Andalucia 21 (ES), the North West Business Investment Scheme and Scottish Co-investment Fund (UK), leveraging private sector funding is a key and distinctive feature of their operations.

Our research indicates that the successful leveraging of private sector support requires a critical VCLF size. For instance, both the Dutch MKB fund (€3.7m) and the French Alyse-Participations fund of funds (€6m) are not large enough to leverage the active involvement of private institutional investors. As one of the fund managers estimates, a fund of at least €50m would be required for the private sector to become actively interested in the activities of the fund. Several VCLFs covered by the research – MSIF and the SYIF in the UK, IBG Sachsen-Anhalt in Germany – have clearly achieved the scale required to (potentially) secure substantial private sector involvement. With a total size of €150m, TANEO has also been able to leverage its investments in the four VCLFs it has set up with private sector resources.

An estimated 13% of the funding obtained by the VCLFs has been raised in the form of equity. Whilst ERDF and most national public sector funding is provided in the form of grants or equity, private sector contributions include both loans (e.g. in the case of the Merseyside Special Investment Fund and South Yorkshire Investment Fund, UK) and equity (e.g. MKB and Technofonds Flevoland (NL), Change Partners (PT) and Andalucia 21 (ES). Equity funders include banks and other financial institutions, pension funds and in one case (Stimulus VCF (NL) a private individual. Change Partners (PT), Attica Ventures, Alyse and PME Investimentos are entirely funded by equity.

3.3 Types of VCLF Finance and Other Services

VCLFs differ in terms of fund size, the types of finance provided to SMEs, investment thresholds and limits, and the extent to which they are fully invested and the nature of their portfolios. Below we consider these factors and the reasons for differences. Section 3.3.2 then examines the extent to which (and how) VCLFs offer other services, notably 'money with management'.

3.3.1 Types and Amount of VCLF Finance for SMEs

Taken together, the 15 VCLFs covered by this research have so far invested just under half (44%) of the resources available to them. Investment rates range from 100% in one case (Stimulus BV) to 7% in another (TANEO).

Table 3.4: VCLF Fund Size and Investments (Jan 2007)

	VCLF	€m Fund Size	€m invested	% invested
	Co-investment Funds			
1	Scottish Co-investment Fund	65,000	29,627	46%
2	North West Business Investment Scheme	34,900	9,779	28%
3	MKB fonds Flevoland	3,700	3,600	97%
4	Technofonds Flevoland	6,430	6,000	93%
5	PME Investimentos	10,000	9,554	96%
6	Attica Ventures (Zaitech Fund)	30,000	11,500	38%
	Co-financed Funds			
7	Merseyside Special Investment Fund	167,000	53,894	32%
8	South Yorkshire Investment Fund	115,544	42,900	37%
9	IBG Sachsen Anhalt	127,100	120,000	94%
10	IBB Beteiligungsgesellschaft	20,000	10,400	52%
11	Stimulus VCF BV	5,167	5,168	100%
12	Change Partners	9,000	8,410	93%
13	Andalucia 21 FCR	18,000	15,800	88%
	Funds of Funds			
14	SAS Alyse-Participations*	6,000	3,407	57%
15	TANEO**	150,000	10,000	7%
	Average	**51,189**	**22,669**	**44%**

Note: * Investment figures for Alyse refer to investments in regional VCLFs in overseas territories (total in SMEs: €8.5m incl match regional funding); ** Investment figures for TANEO refer to investments in SMEs (total invested in VCLFs: €38m).

The extent to which resources have been invested varies across the different VCLF models. Co-financed schemes had the highest investment rates with an average of 77% of resources utilized at the time of the research (this amounts to a total investment of €202.7 million overall). By comparison, co-investment funds had invested a lower proportion - two-thirds of their resources on average (a total of €70 million) and the two 'funds of funds' had invested only 32% on average (a total of €13.4 million). However, the average for the two funds of funds is heavily

skewed by TANEO's low investment rate. Indeed, at the time of the research, the other 'fund of funds', Alyse Participations, had invested 57% of its resources.

VCLFs have investment thresholds and limits which reflect a combination of factors - the need to operate cost-effectively in terms of portfolio management overheads, to spread risks and to address SME funding gaps. Amongst the VCLFs covered by the research, relatively few have minimum investment thresholds (the exceptions being Attica Ventures, MSIF, SFIF, Alyse-Participations, IBG Sachsen-Anhalt and Change Partners). These tend to be the 'funds of funds' or VCLFs with multiple co-financing sources (i.e. the 'co-financing model referred to earlier). In these cases, the decision to establish a lower investment threshold may be driven as much by considerations relating to cost-effectiveness (i.e. the need to achieve economies of scale by investing relatively large amounts in a smaller number of SMEs) as by an analysis of market gaps in the provision of SME finance. Attica Ventures is the only co-investment fund with a lower investment threshold. Change Partners and IBG Sachsen-Anhalt have the highest thresholds among co-financing schemes at €150,000.

Table 3.5: Types and Amounts of Finance provided by VCLFs

	VCLF	€ Range from	€m to	Notes
	Co-investment Funds			
1	Scottish Co-investment Fund	-	750,000	Max €750,000
2	North West Business Investment Scheme	-	500,000	Max £200,000 in equity
3	MKB fonds Flevoland	-	250,000	Up to €200,000
4	Technofonds Flevoland	-	250,000	Current max of €470,000
5	PME Investimentos	-	1,000,000	Max €99,000
6	Attica Ventures (Zaitech Fund)	500,000	4,500,000	€4.5 is higest investment to date
	Co-financed Funds			
7	Merseyside Special Investment Fund	4,500	6,000,000	Up to £3m in equity and £1m in loans
8	South Yorkshire Investment Fund	15,000	1,000,000	£15-75k loans, £75-250k mezz, £100k-
9	IBG Sachsen Anhalt	150,000	6,000,000	No limit but €1.5m average
10	IBB Beteiligungsgesellschaft	-	750,000	
11	Stimulus VCF BV	-	500,000	Up to €500,000
12	Change Partners	150,000	1,350,000	Average is €700k
13	Andalucia 21 FCR	-	-	No limit but €2.7m is largest investment
	Funds of Funds			
14	SAS Alyse-Participations	40,000	200,000	Up to €200k in SMEs and current
15	TANEO	-	-	Up to €3m in SMEs and up to €15m in
	Range	**0**	**6,000,000**	-

Notes: TANEO has an upper threshold of €15m for its investments in VCLFs; NWBIS: maximum £200,000 in equity; MSIF: up to £3m in equity, £1m in loans; IBG Sachsen Anhalt: €1.5m average; Change Partners: average €700k; Andalucia: €2.7m is largest investment;

Almost all the VCLFs have upper investment limits. For some VCLFs (e.g Andalucia 21 (ES), IBG Sachsen Anhalt (DE)) there are no formal upper limits on investments and the range in the table below indicates the highest investment to date. Upper investment limits range from €200,000 (Alyse) to around €6 million (Merseyside Special Investment Fund). These limits reflect the analysis by VCLF managers of the SME funding gap in their regions as well as the need to ration available assistance and to develop diversified investment portfolios as a way of spreading risks.

Not all VCLFs monitor the volume of applications but where this is done, the ratios vary greatly - from 100:1 to 1.6 in terms of applications to investments. The number of enquiries received by VCLFs is systematically monitored by some VCLFs (e.g. South Yorkshire Investment Fund) but is arguably not as reliable an indicator of demand as the number of actual applications. An analysis of the data on applications and investment approvals made available by seven of the 15 VCLFs shows that the ratio ranges from just over 100:1 (Attica Ventures' Zaitech Fund) to around 1.6:1 (IBG Sachsen-Anhalt). Taken together, the VCLFs covered by this study that provided data had received a total of 3,877 applications since they started operating with 1,123 of these leading to actual investments (a ratio of around 3.4:1).

Table 3.6 provides a summary of the position current position regarding the level of applications and investments for each VCLF.

Table 3.6: VCLF Portfolios (as at Jan 2007)

	VCLF	Date Started/ First Invest	No. of applications	€m invested	% invested
Co-investment Funds					
1	Scottish Co-investment Fund	2002/2003	-	29,627	46
2	North West Business Investment Scheme	2003/2003	582	9,779	28
3	MKB fonds Flevoland	1996/1996	-	3,600	97
4	Technofonds Flevoland	2002/2002	-	6,000	93
5	PME Investimentos	2003/2004	-	9,554	96
6	Attica Ventures (Zaitech Fund)	2004/2005	600	11,500	38
Co-financed Funds					
7	Merseyside Special Investment Fund	1996/1996	1,314	53,894	32
8	South Yorkshire Investment Fund	2001/2002	1,065	42,900	37
9	IBG Sachsen Anhalt	2000/2001	163	120,000	94
10	IBB Beteiligungsgesellschaft	2000/2001	440	10,400	52
11	Stimulus VCF BV	2000/2000	-	5,168	100
12	Change Partners	2003/2003	176	8,410	93
13	Andalucia 21 FCR	1998/2000	242	15,800	88
Funds of Funds					
14	SAS Alyse-Participations*	2003/2004	360	3,407	57
15	TANEO**	2001/2003	-	10,000	7
	Average	-	**277**	**22,669**	**64**

*Note: * Alyse figures based on total investment in VCLFs; ** TANEO figures based on total investment in SMEs by its VCLFs. In some cases information was only available at September 2006.*

In terms of the different types of VCLFs, the two co-investment schemes that provided data had a ratio of applications to investments of 12.6:1 compared with only 2.4:1 for co-financed schemes. This difference may also help explain the greater investment rates for co-financed schemes observed in Table 3.4. The ratios not only vary between VCLFs but also between equity and debt instruments and over time. More particularly, the ratio of 3.4:1 masks a difference between equity schemes where the ratio is typically higher (around 10:1) and loan schemes where it tends to be lower (typically 3:1).[11]

It is clear from the research that the conversion ratio of VCLF applications into investments alters over time. For example, in the case of the South Yorkshire Investment Fund, the earlier years of its operations saw a lower proportion of applications being converted into investments but following a decision to bring the investment management back in-house, the conversion rate increased. Similarly, in the case of the VCLFs set up by TANEO, the fund managers' initially high level of risk adversity is gradually reducing with experience. In other cases, where the investment phase in VCLF operations is coming to an end, the reverse trend is apparent. The fund manager of the MKB fund which is almost fully invested, for instance, is diverting some applications to the Technofund where an increase in capital is planned for the coming programming period.

Although difficult to verify, the average size of VCLF investments tends to increase over time. This reflects the fact that start-ups and SMEs go through different stages of growth and as they expand, their financing needs become different too. From the perspective of the VCLF, another consideration – in the case of equity financing – is the desirability of preventing a dilution of investment stakes as SMEs go through refinancing rounds and other investors increase their holdings. Some VCLFs have limits on the maximum amount of funding that can be provided to the same undertaking through successive deals. Other VCLFs do not have constraints of this sort.

While some of the VCLFs are still in an investment phase of operations, others are now in the process of disinvesting. Six of the VCLFs covered by the research are now either fully invested or approaching this point (IBG Sachsen Anhalt, MKB Fonds Flevoland, Technofonds Flevoland, PME Investimentos, Change Partners and Andalucia 21). There is no direct correlation with the length of time the VCLFs concerned have been operating, i.e. in several cases (notably Change Partners and MKB) they started investing later than other VCLFs covered by the research that have a lower overall commitment levels. There are many factors that are likely to affect the rate at which VCLF funds are invested. Foremost amongst these is demand for support from start-ups and SMEs (or, in the case of funds of funds, from VCLFs), the quality of proposals submitted, the risk adversity of the fund managers and the extent to which the VCLFs adopt restrictive target

[11] These ratios are typical values. There were not enough data to compute ratios for equity and debt instruments among the funds covered in this study.

markets. As noted earlier, geographical constraints have also been a significant factor in several cases.

3.3.2 Non Financial VCLF Support for SMEs

All VCLFs support their investment strategies by combining financial assistance to SMEs with some degree of 'money with management'. However, there are varying degrees of emphasis on 'money with management', i.e. the provision of mentoring and business advice along side venture capital. Table 3.7 provides a summary overview of non-financial support to SMEs.

Table 3.7: VCLF Non Financial Support to SMEs

	VCLF	Summary - non financial support to SMEs
1	Merseyside Special Investment Fund	Advice is provided by the VCLF staff and through networking with business support providers.
2	NW Business Investment Scheme	Advice is provided by the VCLF staff and through networking with business support providers.
3	South Yorkshire Investment Fund	Has a mentor bank of some 480 experts, in-house specialists and administers a 'money with management scheme with is financed separately.
4	Scottish Co-investment Fund	Often, co-investment partners have a board member.
5	SAS Alyse-Participations	Business advice is provided by the fund manager. An expanded advisory service is in the process of being established.
6.	IBB Beteiligungsgesellschaft	Business advice is provided by the VCLF's own staff or through IBB.
7	Investitionsbank Sachsen Anhalt	Business advice is mainly provided by the VCLF's own personnel with support from three external experts.
8	Stimulus VCF BV	No particular provision is available.
9	MKB fonds Flevoland	Business advice is provided by the fund manager.
10	Technofonds Flevoland	Business advice is provided by the fund manager
11	PME Investimentos	Ad hoc business advice is provided by the VCLF's representatives on company boards
12	Change Partners	No particular provision is available.
13	Andalucia 21 FCR	No particular provision is available.
14	TANEO	No particular provision is available at the fund of funds level. VCLFs supported by TANEO do however provide business advice to SMEs.
15.	Attica Ventures	Some advice is provided on an ad hoc basis by the management team to companies.

From the SME perspective, one of the key advantages of VCLF support is that - unlike with grants – such interventions are usually accompanied by other forms of assistance. Advice may be given before an investment takes place

(help with business planning and 'investment readiness') and/or continuing advice may be provided afterwards ('money with management'). This is the case for Alyse, for instance, which maximizes impacts on regional development by providing advice on business plans and investment strategies to companies which then go on to secure funding through other more traditional instruments (e.g. bank loans). MKB and Technofunds have also supported workshops and other initiatives aimed at informing young entrepreneurs in Flevoland about business plans, irrespective of whether they had submitted an application for funding through the VCLF.

After an investment takes place, some VCLFs limit their business advisory support to the role of representatives on SME boards. The VCLFs covered by this research usually have the right to appoint non-executive directors to the boards of the companies they have invested in. While their function is limited in some cases to a monitoring role, i.e. providing feedback to the VCLFs on the performance of companies and acting as an 'early warning system' so that problems with investments can be detected soon enough to take action (e.g. Andalucia 21), in other cases (illustrated by PME Investimentos in Portugal), the role of non-execs goes beyond this and includes providing ad hoc advice on business planning and management issues generally. SCF co-investment partners often have board members on an investee company board.

A few VCLFs have more fully developed mentoring and business support schemes. An example is the North West Investment Scheme (UK) which provides a range of advice to start-ups and SMEs at an early stage in their development, drawing on a network of professionals to match needs with expertise. In some cases (e.g. South Yorkshire Investment Fund) this role is closely linked to publicly-funded business advisory support schemes and covers both the pre- and post-investment stages. With the Dutch VCLFs in Flevoland, workshops have been organized in co-operation with the regional development agency where potential entrepreneurs are given advice on business plans and proposals. Even where not fully developed, it is accepted by all VCLFs that 'money with management' is critical in ensuring successful investments.

Some of the VCLFs are also engaged in initiatives to develop business support structures more widely in their regions and not just for the benefit of investees. For example, Alyse-Participations (FR) plans to provide expanded advisory services using external consultants (e.g. on the island of Réunion). Another good example of a VCLF with an emphasis on pre-investment advisory support is the South Yorkshire Investment Fund in the UK. There are also several examples from the research of where VCLFs go beyond this, e.g. by helping to develop the supply side, particularly the business angel community. Some funding (including ERDF) goes into supporting business angel structures and this is seen as an innovative and important outcome of VCLF interventions. IBG Sachsen-Anhalt in Germany and the two Dutch funds (MKB and Technofonds) are good examples of this wider role.

Assessment of VCLF Performance 3

There are differences in the way that 'money with management' schemes operate from the financial and human resources perspective. The North West Business Investment Scheme in the UK, for example, relies less on its own resources and more on networking with business service providers to ensure that the companies they have invested in receive the necessary advice. A different model has been adopted by the South Yorkshire Investment Fund which has established a 'mentor bank' consisting of 480 individuals who have experience in business and who are available to advise companies. The VCLF pays half the cost of this service up to a limit of £6,000 (€7,500). Another example is PME Investimentos in Portugal which relies on its representatives on the boards of the companies it has invested in to provide advice. Smaller schemes, such as the two Dutch VCLFs, rely on the initiative and sometimes personal connections of the fund manager to attract suitable advisors. Finally, Alyse is hoping that the regions where it operates will be able to use some ERDF funds to support the development of local business consultancy services in the next programming period.

3.4 VCLF Performance

A key question from the terms of reference was to examine the track record of VCLF investments made including portfolio valuations, number of disposals (in the form of sale, stock market flotation or other methods), etc. We begin by examining the extent of financial additionality demonstrated by VCLFs and then consider other aspects of performance.

3.4.1 Financial Additionality and Market Failure

A key issue in assessing VCLF performance is the extent to which they demonstrate financial additionality from the perspective of SMEs. Put another way: to what extent do they address market failures in the provision of SME finance?

The extent of financial additionality demonstrated by VCLFs at the deal level is generally high. To examine the extent of financial additionality, SMEs that had received assistance from a VCLF were asked the hypothetical question in the survey work for this study: what would have happened if the assistance had not been made available? The responses suggest a high degree of 'absolute additionality', i.e. a situation where the firms' plans could not have gone ahead at all without the VCLF investment. Almost two-thirds (64.7%) of the responses fell into this category with the remainder divided between 'partial additionality' (23.5%), i.e. a situation where SME plans would have gone ahead but on a reduced scale and/or on a delayed basis, and 'don't knows' (11.8%). None of the SMEs indicated that in the absence of support they could have gone ahead with their plans anyway using finance from other sources ('deadweight').

Additionality demonstrated at the SME level by VCLF interventions is likely to be highest in the less developed regions where alternative sources of finance, in particular risk capital, are less likely to be available. The survey sample was too small for cross-tabulations to be examined, e.g. between the extent

of additionality and regional characteristics. However, there is some evidence to support the above argument from a comparison between the survey work undertaken for this study and research in the Objective 2 regions of the UK. The UK research points to higher levels of deadweight than in this study where the survey work focused on less developed Objective 1 regions. Comparisons with other studies are, however, arguably more helpful and reliable in pointing to differences in the extent of financial additionality depending on the type of VCLF interventions. In particular, it would seem that the extent of financial additionality demonstrated is higher with equity instruments than with debt financing. [12]

There are of course other factors relating to VCLF beneficiaries themselves that are also likely to influence the extent of financial additionality. In particular, as is well-known, start-ups and businesses at an early stage of development generally face more difficulties in raising finance than more mature SMEs. It follows that VCLF interventions focusing on the first of these target groups are likely to demonstrate higher financial additionality than those that are mainly aimed at the second category.

3.4.2 VCLF Investment Portfolios and Returns

At the beginning of 2007, the 15 VCLFs covered by the research had invested in a total of 1,123 undertakings, i.e. an average of just over 75 investments per VCLF. Reflecting the differing fund sizes and the rate at which they have invested, there is a range in the VCLF portfolios from less than 10 investments (6 in the case of Attica Ventures and 9 for Andalucia 21) at the lower end of the scale to 409 at the upper end (MSIF – in this case, however, the bulk of interventions have been made in the form of loans). On average, co-financed schemes had made 142 investments per fund compared with only 50 investments for co-investment schemes.

The average amount invested by the VCLFs is €427,900 with a range from €51,621 (Alyse Participations) to €1.9 million (Attica Ventures). It is notable that VCLFs set up by 'funds of funds' form both extremes of this range, which could reflect the versatility of this type of model. The average investment for co-

[12] As part of the recent evaluation of VCLFs in Scotland, the survey of SMEs that had received assistance from the Scottish Co-investment Fund (SCF) also suggested a very low level of deadweight (5%) but a relatively high level of partial additionality (70%) and lower absolute additionality (25%) than in the case of the survey for this study (CSES, 2007). In the case of the loan funds in Scotland, deadweight was higher (17% of SMEs surveyed) with partial and absolute additionality estimated at 63% and 20% respectively. The evaluation of VCLFs in England, which focused on a sample of SMEs that had almost all received loans, suggested an even higher level of deadweight with 45% of respondents stating that they could have gone ahead with their plans in the absence of VCLF support (in half these cases, however, this would only have been possible using more expensive alternative sources of finance and/or finance on less favourable terms). The study concluded that 'this raises concerns as to the additional impact that VCLFs have on finance for firms'.

financed schemes was €694 million compared with €552 million for co-investment schemes. These figures include second round investments which have taken place in some cases.

Table 3.8 provides a summary analysis of the status of the VCLF investment portfolios, indicating the number of investments, average values and exits (in absolute terms and as a proportion of the number of VCLF investments).

Table 3.8: VCLF investments and Exits (Jan 2007)

	VCLF	Number of Investments	Average € per SME	Number of Exits	% of Exits
	Co-investment Funds				
1	Scottish Co-investment Fund	82	361	7	9
2	North West Business Investment Scheme	88	111	10	11
3	MKB fonds Flevoland	12	300	5	42
4	Technofonds Flevoland	27	222	5	19
5	PME Investimentos	24	398	1	4
6	Attica Ventures (Zaitech Fund)	6	1,917	1	17
	Co-financed Funds				
7	Merseyside Special Investment Fund	409	132	144	35
8	South Yorkshire Investment Fund	296	145	4	1
9	IBG Sachsen Anhalt	105	1,143	44	42
10	IBB Beteiligungsgesellschaft	14	743	1	7
11	Stimulus VCF BV	21	246	9	43
12	Change Partners	12	701	3	25
13	Andalucia 21 FCR	9	1,756	6	67
	Funds of Funds				
14	SAS Alyse-Participations	66	52	14	21
15	TANEO	13	769	2	15
	Average	**102**	**600**	**18**	**24**

Notes: *MSIF exits are primarily from small business loans (125 exits or write offs). The remaining 21 are from the larger investments; ** Alyse-Participations and TANEO figures refer to SME investments by the VCLFs they support;

The VCLFs covered by the research have differing strategies with regard to the ideal duration of their investments. In the case of a quarter of the VCLF investments, there has now been an exit. The exit rate varies from just one in several cases (PME Investimentos, Attica Ventures, IBB Beteiligungsgesellschaft) to over two-thirds of the original number of investments in another (Andalucia 21). In terms of different types of VCLFs, at the time when the research was undertaken, co-financed funds had exited an average of 31% of their investments compared with only 17% for co-investment funds. The average for the two 'funds of funds' was 18%.

The exits have also involved different procedures and situations. Half of all exits (50%) were successful in the sense that they involved a profitable realisation of the VCLF investment either via a trade sale, IPO or repurchase

of equity by the undertakings' owners. On average, co-financed funds had 70% successful exits whereas co-investment schemes had 65%. There are a number of notable examples of successful exits (e.g. in one case, an investment of €300,000 was realized after only one year with a profit of 25%). The proportion of successful exits ranges from 100% in the case of many of the VCLFs to 21% (Alyse Participations).[13] The remaining exits are accounted for by situations where the investment returns were not sufficient to generate a profit or the undertakings that received VCLF support ceased trading.

While it is still too early in most cases for any definitive conclusions, actual and projected investment performance seems to vary substantially across the different VCLFs. Based on the available evidence, however, projected investment returns would appear to generally lie in the range 10-25%. There are a number of reasons why projections are difficult to establish. The most obvious of these is that there is uncertainty over how investments will perform in the future. But there are also other factors. Thus, some but not all VCLFs distinguish between gross and net returns, i.e. the profit after deduction of investment losses, management costs and other overheads. Likewise, some VCLFs make available information on IRRs to date on their investments as well as projections for when the fund closes whereas others do not, providing estimates for only one or in some cases neither of these factors.

Table 3.9: VCLF Investment Returns (Jan 2007)

	VCLF	Likely investment returns
1.	Merseyside Special Investment Fund	The business plan indicated an IRR of 6.75% for the whole of MSIF. Given the early stage of investment, it is too early to comment whether this IRR will be achieved.
2	NW Business Investment Scheme	Forecast of 16% gross and 10% net
3	South Yorkshire Investment Fund	No estimate available
4	Scottish Co-investment Fund	Although there is a negative return (-8%) of investments to date, an average annual return of 20% is expected over the fund's lifetime.
5	SAS Alyse-Participations*	Projected IRR of 12% on the three VCLFs that were set up
6	IBB Beteiligungsgesellschaft	No estimate is available
7	IBG Sachsen Anhalt	The overall rate of return on the IBG portfolio has not been estimated but the view is that positive returns will exceed negative ones. There is an estimated 8% IIR on IBB's 'silent' capital to date.
8	Stimulus VCF BV	The initial business plan had a target return on each investment of 25% and an IRR of 13%

[13] In the case of Alyse this low share of successful exits is primarily due to a low-quality portfolio legacy from a previous fund managed by public authorities in the French overseas territories

9	MKB fonds Flevoland***	Currently negative. No estimate is available
10	Technofonds Flevoland***	Currently negative but a positive return is expected, particularly due to one large investment with high likelihood of success.
11	PME Investimentos	It is estimated that six of the 21 investments are likely to achieve a positive IIR, 8 are currently projecting a loss and with the remainder it is too early to tell
12	Change Partners	Projected IRR of 12% when fund closes
13	Andalucia 21 FCR	IRR to date is 30% with 25% forecast
14	TANEO**	Projecting a 20% IRR
15.	Attica Ventures	No estimate is available

More fundamentally, variations in the (projected) performance of the VCLFs should not be surprising given the different environments in which the funds operate and their primary objectives. For instance venture capital funds that focus on market creation should, it could be argued, have lower failure rates than their counterparts in the more developed markets. Indeed, the market failure that Alyse-Participations and TANEO address, for example, is a lack in the supply of venture capital. With little private sector competition, these schemes have to assume lower risk in their investment decisions. However, an alternative argument is that in more developed markets, there is generally a higher level of experience and expertise in VCLF operations, and following on from this, an enhanced capacity to manage investment risks.

From a different perspective, VCLF (projected) performance is likely to be linked to the way in which target markets are defined. More particularly, where a VCLF has invested in a wide range of businesses, it would seem easier to generate positive returns because the choice of investments is greater. Thus, Andalucia 21 in Spain, which has invested in existing SMEs from a wide range of sectors, is projecting a relatively high positive overall return on 25% on its investments. In contrast, where VCLFs have narrowly defined target markets, for instance focusing on start-ups in particular technology fields, the overall return is more uncertain but likely to be considerably lower. IBG Sachsen-Anhalt (DE) is a good example of such a case. Other funds, such as the North West Business Investment Fund from the UK, have target markets which tend to lie between these two extremes and their performance (in this case, a projected overall return of 16%) reflects this. In addition, where target markets are narrowly defined in terms of sectors and geography, it is more likely that the VCLFs will find it difficult to find suitable investments thus increasing the pressure to invest towards the end of the period.

VCLF (projected) performance is also influenced by the type of financing they provide to SMEs. Where VCLFs are gap funder (which is generally the aim), equity funding is inherently more risky, but offers higher rewards. VCLFs need to be certain of their risk profile before deciding which route to take. A good compromise in some cases may be a loan with a 'balloon' interest payment if certain company targets are met – this offers some reward to the fund for success,

but does not carry the risk of equity.[14] Another possibility is for VCLFs to adjust the mix of equity and loan financing they provide to SMEs. MKB and Technofonds for instance provide both types of financing depending on the needs of the applicant and the fund manager's risk/return considerations.

3.4.3 Quality of VCLF Investment Portfolios

The quality of investments can be assessed in various ways - in purely financial terms, quality criteria for VCLF portfolios include the number of 'successful' investments (interpreted, as a minimum, as being those that are still 'live' or where a successful exit has occurred. For these investments, the likely/actual IRR is clearly an appropriate measure of success. From a broader regional development perspective, quality is to be judged in terms of the survival and growth of SMEs, number and quality of jobs, and contribution to the knowledge base of regions.

If the failure rate of start-ups and SMEs is taken as a guide, then the investments supported by the various VCLFs can be seen as being of a generally high quality. All the VCLFs have suffered losses on some of their investments but this is inevitable given the nature of their activities, the numbers seem small and in most cases, overall positive returns are projected.

A further indication of the quality of VCLF portfolios can be obtained from the sectoral spread of investments. From a sectoral point of view, the various VCLFs have differing targets but there is generally a focus on start-ups and SMEs that are innovative and engaged in technology/knowledge-based activities. Several VCLFs provide a detailed breakdown of their investments by sector and business activity and in most cases this shows a clear focus on innovative, technology-based SMEs. From a Lisbon Strategy perspective, VCLF portfolios of this type clearly promote the aim of creating a knowledge-based economy with 'more [and particularly] better jobs'.

Sectoral Focus of VCLFs
IBG Sachsen Anhalt – the fund has mainly targeted Life Sciences (25% of investments by number), Electronics (12%), Software and New Media (11%) and other sectors such as Medical and Environmental Technologies (10% combined).
IBB Beteiligungsgesellschaft – Biotechnology and 'Produktionstechnik' account for two thirds of the investments by value that have been made to date.
North West Business Investment Scheme – there is a clear focus on particular sectors – in particular, the Creative Industries (25% of total investments by value), Chemicals (12%), Aviation (12%) Healthcare and Biotechnology (8%), and Financial and Business

[14] This type of loan involves making equal (monthly) payments of principal and interest for a relatively short period of time followed by settlement of the balance in one payment, called a balloon payment.

Services (8%).

Technofunds – focuses on growth SMEs in Flevoland, particularly in the Life Sciences and ICT sectors. One company (also in MKB portfolio) has received a $1m grant from the Bill Gates Foundation to develop its life-science business.

SAS Alyse-Participations - Focus on start-ups and SMEs in the French overseas territories without sectoral limitations. The fund has made investments among others in the Agro-Food sector (5), Mining and traditional industry (7), IT (7), Tourism and other Services (7) and innovative companies in various sectors, including Horticulture.

TANEO – investments are so far mainly in Biotechnology and Health (1), ICT (4), Renewables, Agro-Businesses (5) and Industrial Materials (3)

The extent to which VCLFs focus on particular sectors varies and reflects a number of factors. Thus, neither of the two 'funds of funds' covered by this study have a specific sectoral focus. Alyse's portfolio for instance has a wide sectoral spread which includes investments in mining companies, tourism, ICT, recycling, etc. The lack of sectoral specificity is compatible with the primary objective of the' funds of funds' VCLF model, i.e. to kick-start the development of an active market for risk capital. TANEO's business plan requires it to invest in "innovative" companies. While this is not strictly speaking sector-specific, it is interpreted as referring to IT, biotechnology and life science and similar types of technology/knowledge-based activities. Indeed, TANEO's current portfolio reflects this with more than half of its investments in these sectors. However, the lack of clarity associated with the requirement to invest in "innovative" SMEs has caused difficulties and TANEO fund managers have recently applied for permission to drop the focus on "innovation" in an effort to increase the investment potential of the VCLFs that it has supported.

Amongst VCLFs that are not linked to a larger funds-of-funds system, some have strong sectoral specificities whereas others have no sectoral focus at all. For instance, among the two Dutch VCLFs in Flevoland, the Technofund is limited to high-growth SMEs (interpreted to mean primarily life sciences and ICT) whereas the MKB fund does not have a sectoral focus. This is thought to have affected VCLF performance with the Technofund having performed better than MKB, which attracts fewer companies with lower potential returns. Elsewhere, neither Attica Ventures' Zaitech Fund nor Andalucia 21 have a sectoral focus and in both cases, the investment managers argue that the markets they are operating in are not sufficiently mature for this type of targeting to be feasible. Instead, investment activities need to be spread across the economy as a whole to enable suitable targets to be identified that are likely to generate a good return. In Portugal, PME Investimentos is seeking to strengthen its links with universities in an effort to boost the technology-content of its portfolio, having previously adopted sectoral targets derived from the PEDIP programme.

In terms of overall VCLF portfolio quality, the restrictions imposed by investment periods are an important issue for all funds. Indeed, the investment

period effect creates an incentive for the fund manager to adjust the trade-off between the quality and quantity of investments over time. As a result of such investment pressures MKB for instance acquired a lower quality portfolio towards the end of its first period in the late 1990s. At the same time, from the perspective of Managing Authorities, the requirement to invest available funds within the period also has the effect of raising the activity level of the fund.

3.5 Regional Development Impacts

The terms of reference asked for an estimate of the number of SMEs, sales, jobs created/safeguarded (FTE) through VCLF investments and the reliability of such figures, together with an assessment of the overall contribution of VCLFs to regional GDP.

Whilst there is a more or less standardized framework of VCLF financial indicators, this is far from being the case with non-financial performance. Here, there are varying degrees of emphasis placed on indicators such as new jobs created or jobs safeguarded, number of SMEs assisted, the increased turnover of companies, GVA and other outcomes. Amongst the VCLFs covered by the research, this sort of information is collected in some cases, but in most cases it is far from clear how estimates are arrived at and how reliable they are.

Notwithstanding these considerations, based on information available from 10 of the 15 VCLFs, their activities have so far led to a total of almost 7,900 jobs being created at an average overall gross investment of €47,185 per job based on the original investment values (or €17,800 per job for ERDF investment alone). Moreover, the average gross investment cost per job to the ERDF is lower than average (for example, in CSES's ex post evaluation of the 1994-99 Objective 2 programmes the average ERDF cost per job was in the range €15,000 to €20,000). As with other VCLF outcomes, there is a considerable variation in the ERDF gross investment cost per job to date.

It should also be noted that these estimates take only jobs created' into account and do not include 'jobs saved' (see below for explanation). The inclusion of 'jobs saved' would result in an even lower investment cost per job. Furthermore, it is important to bear in mind that the average investment per job is likely in any case to fall over the remaining lifetime of the VCLFs and, if they are all profitable, there could eventually be a zero investment cost per job. Table 3.10 provides a summary of the regional development outcomes achieved by the VCLFs to date.

Assessment of VCLF Performance 3

Table 3.10: VCLF Regional Development Impacts (Jan 2007)

	VCLF	No. Jobs Created	Investment per job €	SMEs assisted	Sales €m
	Co-investment Funds				
1	Scottish Co-investment Fund	679	43,633	89	-
2	North West Business Investment Scheme	213	45,911	173	174
3	MKB fonds Flevoland	400	9,000	-	-
4	Technofonds Flevoland	410	14,634	-	-
5	PME Investimentos	-	-	-	-
6	Attica Ventures (Zaitech Fund)	253	45,455	6	-
	Co-financed Funds				
7	Merseyside Special Investment Fund	1,682	32,042	415	-
8	South Yorkshire Investment Fund	1,280	33,516	1,439	119
9	IBG Sachsen Anhalt	775	154,839	72	-
10	IBB Beteiligungsgesellschaft	126	82,540	-	-
11	Stimulus VCF BV	-	-	-	-
12	Change Partners	135	62,296	11	7
13	Andalucia 21 FCR	428	36,916	9	-
	Funds of Funds				
14	SAS Alyse-Participations*	1,300	2,621	66	185
15	TANEO**	200	50,000	13	-
	Average	**7,881**	**47,185**	**153**	**32**

Note: Alyse figures based on total investment in VCLFs; TANEO figures based on total investment in SMEs by its VCLFs.

The estimate of gross investment per job above does not take into account additionality, displacement and indirect effects. These terms are defined as follows:

Converting Gross VCLF Outcomes into Net Regional Development Effects
Additionality – the outcomes that would not have been achieved in the absence of VCLF support. Usually, the application procedures for VCLF assistance include an additionality test, e.g. asking applicants to state whether they had sought to identify alternative sources of similar types of financial support.
Displacement – a situation where VCLF support for a business gives it a competitive advantage at the expense of non-assisted firms. In this situation, any positive outcomes achieved through VCLF intervention could be offset by reduced jobs and turnover in other businesses leading to no overall benefit to the regional economy. VCLF target groups should ideally be defined in a way that minimises the risk of displacement.
Indirect effects – where the positive outcomes achieved by VCLF-assisted businesses have multiplier effects. These can be of two kinds: (1) income-related (or consumption) multipliers – where additional jobs in assisted businesses lead to additional spending in local economies which in turn leads wider job creation; (2) supplier effects – where the VCLF-assisted businesses expand and place more orders for goods and services with local suppliers which in turn leads to wider job and wealth creation.

Earlier (Section 3.4.1), we estimated that in approximately two-thirds of cases, the businesses assisted by the VCLFs would not have been able to go ahead with their plans at all without the investment they received. If the survey feedback is accepted as a reliable guide to additionality geenrally, then the gross estimate of 7,900 jobs created needs to be adjusted downwards to around 5,200 to provide a net figure (this gives a net ERDF investment to date per additional job of almost €27,000 or just over €65,000 if both ERDF and national public expenditure is taken into account).[15]

In terms of the VCLF employment effects achieved so far, the 7,900 new jobs created to date represent over half (56%) the original target. This is a very credible outcome and disproportionate to the value of the original VCLF funds actually invested (44%). Several VCLFs have exceeded their original targets for 'jobs created' (North West Business Investment Scheme and Alyse Participations). Although of doubtful value, if the same estimates are made for the combined category of 'jobs created' and 'jobs saved', there is an even more positive position with 59% of the original targets already achieved. Table 3.10 above also includes data for the number of SMEs assisted (generally related to the number of investments although in some cases higher because of pre-investment advice for SMEs that did not subsequently receive investment) and 'increased sales'. Neither of these indicators is considered by us to be reliable enough to justify analysis.

The outcomes projected by VCLFs by the time the various schemes close – if fully achieved – will make a significant contribution to Structural Fund programme targets. Thus, the Merseyside Special Investment's projection of an eventual 12,750 jobs created or saved represents almost a quarter (22%) of the overall 2000-06 Objective 1 target for the region. With the target for net value added, MSIF's potential contribution to programme targets is potentially even more significant (57% of the target for the region) and quite disproportionate to its share of Objective 1 funding.

Furthermore, the quality of job creation attributable to VCLF activities is likely to be higher than average for the Structural Funds generally. As noted earlier (Section 3.4.3), where available, the information on the types of businesses assisted by VCLFs demonstrates a strong focus on start-ups and SMEs engaged in technology/knowledge-intensive activities. Although businesses with good growth prospects can be found in all sectors (including some declining ones), they are likely to be concentrated in parts of the economy that have good long term prospects. If assessed in terms of the skills content of jobs, durability, etc, then the

[15] Although not possible to quantify without more detailed research, displacement is likely to have been negligible (e.g. no more than about 10%) because in most cases the VCLFs have targeted start-ups and SMEs in growth sectors. On the other hand, indirect effects are likely to have been considerable because assisted businesses have generally been smaller local enterprises (which are likely to rely mainly on local suppliers) and the quality of jobs created is generally high (which should be reflected in higher remuneration and therefore higher local expenditure/consumption-related job and wealth creation effects).

quality of employment effects brought about by VCLF interventions can be assumed to be high – much higher than, for example, Structural Fund interventions to help safeguard jobs in declining sectors. A similar argument applies to other outcomes attributable to VCLFs, in particular the contribution to GVA and to the promotion of innovation and regional competitiveness.

Overall, there is a question of how some VCLF regional development effects are measured and the reliability of monitoring data, and hence the usefulness of the indicator(s) concerned is doubtful. This applies especially to VCLF employment effects and in particular to the category of 'jobs saved' where the information provided by VCLFs does not make it clear how an estimate is arrived at. In this respect, the problem is a wider one since previous estimates of 'jobs saved' that have been made as part of Structural Fund evaluations have not been able to distinguish between situations where only the jobs directly at risk in an undertaking are counted as opposed to all the jobs. A similar problem exists with some other indicators used by VCLFs, notably the 'increase in the turnover' of companies that VCLFs invest in (used by amongst others, the North West Business Investment Scheme in the UK). It is far from clear how this indicator is measured and, more particularly, how any increase in turnover is attributed to VCLF intervention as opposed to other factors. Where a VCLF invests in start-ups, the question of attribution is more clear-cut but for established SMEs this is far from being the case.

There is a more fundamental question over the appropriateness of some VCLF performance indicators. In particular, there is a potential mismatch between VCLFs investing in technology-based businesses designed to provide long term returns and high quality jobs, and the ERDF measures on job creation during the programming period itself. Most VCLFs are designed to run for between 8 to 10 years and it is difficult to measure success after one or two years. There is also a question over how the cost effectiveness of job creation effects should be measured: while in the short term, when a VCLF investment is still 'live', there is clearly a 'cost per job', in the longer term this cost could (as noted earlier) fall to zero if a positive IIR is achieved. Similarly, quantification of employment effects does not allow for an assessment of job quality, and yet this is arguably more important given the aim of most VCLFs of investing in knowledge-based activities. Some VCLFs (e.g. IBB Beteiligungsgesellschaft) do, however, monitor gender balance with regard to employment effects whilst others (e.g. NWBIS) analyse the extent to which disadvantaged groups generally have benefited from interventions.

Last but not least, there are wider regional development impacts that are not captured by the performance indicators typically being used by VCLFs. In the Dutch case, for example, the managing authority sees venture capital as being part of the overall SME support programme - not as a standalone project. More generally, risk capital can complement a region's public grant schemes, interact with the business angel network, incubators or other SME support and generally enhance efforts to promote entrepreneurship and innovation.

Assessment of VCLF Performance 3

For the funds of funds, such integration is less straightforward because they only have indirect contact with SMEs through the VCLFs that they have set up or have helped create. Indeed, in many cases, the priority for funds of funds lies in stimulating the supply of venture capital rather than directly supporting individual SMEs. As a result, these interventions can have a large impact on the provision of risk capital through the creation of multiple VCLFs.

External evaluations of VCLF performance and impacts are thought to have only been undertaken in five of the 15 cases examined (IBG Sachsen-Anhalt in Germany and the four schemes in the UK covered by the research). In several cases, these do provide good quality information on VCLF impacts on companies and the wider regions where they operate. [16] The question is whether some aspects of the methodologies used in external evaluations (e.g. obtaining feedback from companies on impacts) could be incorporated into routine VCLF monitoring frameworks or, alternatively, whether the practice of undertaking periodic external evaluations and impact assessments could be extended to all VCLFs as general good practice.

3.6 VCLF Legacies

The terms of reference asked for an assessment of the quality and quantity of VCLF legacies at the end of the 2000-06 funding period.

The concept of a legacy is fundamental to the rationale for using VCLFs as a regional policy instrument. Whilst VCLF schemes may be more expensive to administer than loans, if the investment funds can be recycled there is a lasting financing operation. However, most VCLFs would not expect to realise the proceeds of equity for up to ten years, although loans may be recycled more quickly. In their early stages, it is often impossible to assess the likely outcome of investments by VCLFs. It is to be expected that some investments will fail at an early stage, whilst the successful investments may be held until they mature. Accordingly, at an early stage of a fund, some of the 'losers' will have been identified, but the winners will not yet be known.

[16] See 'Evaluation of ERDF Supported Venture Capital and Loan Funds in Scotland', CSES study for Scottish Executive, February 2007, which included an assessment of the Scottish Co-investment Fund; and 'Study of ERDF Funded Venture Capital and Loan Funds in England and Wales, Regenris Consulting study for Department for Communities and Local Government and DTI, June 2007.

The evaluation of VCLFs in England, for example, identified three main regional impacts in addition to job and wealth creation effects – enhancing financial infrastructures (e.g. links with business angels networks), working with providers from outside the region to ensure the availability of specialist advisory services and co-investors), strengthening links with business support (e.g. SYIF's funding of an officer post in the Business Link to promote a cross-referral of clients), and supporting cluster and sector development strategies. However, it noted pronounced variations in these factors across the different regions in England.

Assessment of VCLF Performance 3

All of the VCLFs covered by the research have the objective of ensuring that there are sufficient returns from their investments to create legacy funds. The achievement of this aim clearly depends on how the investments made by the various VCLFs perform and, more particularly, the extent to which the gains exceed losses, and management costs and other factors (e.g. in several cases, the servicing of debt). A key consideration is VCLF policies with regard to the distribution of profits and these vary in terms of the proportion of any gains allocated to different types of stakeholders and the fund managers themselves.

In most cases, it is too early to forecast investment returns for the VCLFs covered by this research. Very few VCLFs (only three of the 15) have provided projections with regard to likely legacy funds. Where information has been provided, projected legacies are generally around 1-2 times the original ERDF investment. From Table 3.9 earlier, initial estimates of IRRs varied by up to 20%, but such targets are extremely challenging and may not be met.

However, returns from VCLFs might be expected to follow a 'J' curve as losses are identified earlier than gains, A recent report by DG ECFIN based on an analysis of European venture capital and private equity funds demonstrated the 'J effect' which is to be expected as funds mature.[17] The analysis showed the increasing IRR as VCLFs mature and realise investments. For the first few years, IRRs are negative.

Table 3.11: Pooled IRRs of European Venture Capital and Private Equity Funds

Age of fund	1 year	2 years	5 years	10 years	20 years
Years covered	2003	2001-03	1999-03	1994-03	1984-03
Early stage	-13.1	-11.1	-1.8	1.3	1.9
Development	-7.2	-4.8	4.6	10.7	9.1
Balanced funds	-5.4	-10.2	4.2	12.3	9.0

It is important that the future operation of the VCLF, and the potential legacy, are considered when it is set up. Amongst the issues that need to be considered are: whether there is a need to repay any investor (for example, loans to the funds or redeemable equity); the future governance of the VCLF; any restrictions on its use – e.g. to continue to invest with the same objectives of the original fund; and public accountability in the longer term and monitoring

Most of the VCLFs that have been analysed in this report are not yet at a stage where the use of the legacy is a current issue. There is one exception (Stimulus,

[17] Profitability of venture capital investment in Europe and the United States, DG ECFIN, March 2006.

NL) where some of the issues concerning repayment of investors, which had not been finalized when the fund was set up, are now being investigated.[18]

Another issue for many VCLFs, relating to legacy funds, is keeping the management team in place into the next Structural Fund programming period. After 2008 the availability of ERDF funds from the 2000-06 Structural Fund programming period will cease. For future periods it is hoped that VCLF realisations from the current programming period will provide funding, but substantial realisations are unlikely to be available for a number of years. This is particularly an issue where there is a relatively large managed team.

3.7 Management and Costs

Management structures of VCLF and cost implications of such structures; costs of management structures in absolute terms and expressed as a percentage of total investments in venture capital instruments.

VCLF management structures and the organisational set-up of the schemes covered by the research differ significantly, depending on their objectives. However, all VCLF managers emphasise the importance of independence in investment decisions. This reflects one of the main findings from an earlier study which concluded that VCLFs that are independently and professionally managed tend to perform better than those where management is provided by the stakeholder (e.g. public authority).[19]

The number of personnel directly employed by the various VCLFs varies and is not directly related to the size of the funds. The number varies from 18 (South Yorkshire Investment Fund) to 1-3 (MKB/Technofonds, Andalucia 21, North West Business Investment Scheme). A major factor determining the level of human resources is whether day-to-day fund management is undertaken in-house or not, and whether additional ('money and management') services are offered to SMEs. In the case of the South Yorkshire Investment Fund, for example, management of one of the three funds has until recently been externalized but is now undertaken in-house. In addition, a number of the VCLF staff are involved in providing business advice. In other cases, where business advice is provided, this is often undertaken by personnel who are not on the payroll of the VCLFs concerned but rather paid on a daily rate basis as contractors. As a (albeit crude) measure of efficiency, VCLF personnel numbers can be compared with the size of the venture

[18] We are aware of other ERDF-supported VCLFs which are now working on their legacy. One is the South of Scotland Loan Fund, where monies have been recycled three times and where the original documents governing the fund made provision for future loan funds to be ring-fenced to the geographic area supported by the original VCLF. In this case the fund continues to be operated by a public sector body which was involved in the operation of the original funds, and publishes full public fund accounts.

[19] See 'Evaluation of Financial Engineering Measures in Regional Policy', study by CSES for DG Regional Policy, 1999

capital funds under management. This calculation produces a range from 1 person: €30 million to 1:€6.5 million. However, for the reasons explained above, these ratios need to be interpreted with considerable caution.

Different VCLF structures, and other factors, lead to different levels of operational and management costs. The way in which management costs are arrived at varies across the VCLFs, in some cases being based on a fixed fee linked to the value of the fund while in other cases the fee is linked to the investments made or to profits. Additionally, there are issues of comparability between direct VCLFs and fund of funds. For instance, in the case of TANEO, total management costs for the €150 million fund should go beyond the costs of managing the fund of funds to include management of investments in SMEs at the level of direct VCLFs set up by TANEO (see table below for details). As far as possible we have sought to include both the ongoing costs of management, and the initial costs of making investments. Table 3.12 summarises the information that has been obtained on management costs.

Table 3.12: VCLF Management Costs

Merseyside Special Investment Fund: the largest item of management expenditure is the priority profit share paid to the investment managers. The current forecast of this over the life of the Fund is approximately €28m. Based on a total fund of €144m, the originally envisaged fund, the management fee is about 20% of the Fund over the original budgeted period of approximately six years. However, as the fund value has fallen, the management charge is largely fixed, so comprises a higher proportion of fund value
Scottish Co-investment Fund: Scottish Enterprise pays their SCF Partners 2.5% of the investment every time they complete an SCF deal. If the SCF Partner completes a deal in an ERDF area, they are paid 3.5%. Partners are therefore paid between 2.5% to 3.5% of total SCF invested. Payments are made from the allowance for management fees contained in the Fund. A higher fee is paid in ERDF areas with the objective of incentivising Partners to look for investments in those areas. SCF had one of the lowest level of management costs of the funds we reviewed
North West Business Investment Scheme: a separate allocation from the original £23m of ERDF funding has been used to cover NWBIS management costs. Amongst other things, the advantage of this approach is that it has been possible to invest all interest earned in projects rather than using this to cover management costs. Similarly, there has been no need for monthly monitoring to establish whether sufficient returns have been generated from deals to produce the cash required to cover overheads. A fixed fee, equivalent to 2.9% of the initial fund size, is paid to the fund managers. This reduces later in the fund's life. Other costs of the fund include audit and related professional fees which are relatively small, so total annual management costs are of the order of 3% of the fund. These costs occur on an annual basis over the life of the fund. If, for example, an investment is held for six years with an annual cost of 3%, the management cost of that investment (based on its original cost) will be of the order of 18%.
MKB Fonds Flevoland: Management costs were €57,4323 or 3.8% of investments in 2006. In the case of Technofonds Flevoland management costs were €181,095 or 3.9% of

investments in 2006.

Stimulus VCF - Management costs have averaged about €89,000 per annum including professional fees. The annual cost currently represents about 4% of the fund value.

Change Partners: management costs to date are €821,000 which is equivalent to 10% of the amount invested.

Andalucia 21: management costs are 15% on the net investment (€2.4 million to date).

TANEO: In 2006, management fees for the 4 funds that are supported by TANEO exceeded €715,000, which is less than 1% of total fund size but more than 7% of the total amount invested in SMEs thus far. In addition to this, TANEO's own management fees are in the range of 1.5-3% (i.e. €150,000-€300,000). In sum, management costs for the entire TANEO structure is in the region of €800,000-1,000,000 or 8-10% of actual SME investments.

In many cases, there is a lack of transparency in the calculation of management costs for VCLFs. For instance, it is not always clear whether management costs are based on fund size or investment size or whether they are tied to the financial performance of these investments. In the case of TANEO for instance, the setup as a fund of funds complicates calculations because each VCLF calculates its own management costs in addition to the costs of the fund of funds itself. In the case of Alyse, it is not clear whether management costs include the operation of the VCLFs in the overseas territories or whether these should be added to the figures in Alyse's annual report. Transparency is generally better for direct VCLFs where costs are calculated only at one administrative layer. For instance, annual reports for the two Dutch funds provide a clear breakdown of costs by type of expenditure. However, given that both funds are managed by the same fund manager, the allocation of costs to each fund seems somewhat arbitrary and might not reflect actual time spent and expenses incurred.

There is also a more fundamental issue about the definition of management costs, what they should include and what they should be compared to. Alyse defines management costs broadly as "overhead" and provides a breakdown, for instance, of the amortization of establishment costs, taxes incurred, and staff and travel costs. In comparison, other outfits might adopt a more restrictive definition of management costs to include only staff and travel but not establishment costs and other expenses. In addition it is not always clear whether management costs should be compared to overall fund size, irrespective of actual investments made (which penalizes very active fund managers), whether they should be compared to investments under management (which would be more appropriate for costs incurred as part of business advisory services but which favours smaller funds), or whether they should be compared to investment performance.

Overall Conclusions & Best Practice Recommendations 5

This section sets out overall conclusions and highlights a number of best practice lessons and other noteworthy examples of experience in setting up and operating VCLFs.

4.1 Overall Conclusions

There are a number of key overall conclusions from the research. To summarise:

- With most VCLFs still at a relatively early stage of their operations, it is not possible to reach definitive conclusions on whether or not they will achieve their objectives.

- However, performance so far is in most cases is encouraging. Taken together, the 15 VCLFs covered by this research have so far invested nearly half (44%) of the €1.4 billion resources available to them. A total of 1,123 undertakings have been supported with an exit rate of 25%. In half of these cases there has been a profitable outcome. While overall VCLF rates of return are difficult to estimate, all the VCLFs are forecasting a positive gain by the time the funds close.

- In terms of regional development impacts, the information available from 10 of the 15 VCLFs indicates that their activities have so far led to a total of 7,900 gross jobs being created at an average overall gross cost of €47,100 based on the original investment values (or €17,800 for ERDF investment alone). The quality of these and other outcomes is high. Cost effectiveness also compares well with other types of Structural Fund interventions.

At the VCLF level, any comparisons in actual/forecast performance need to take into account fundamental differences between the VCLFs operating in economically more deprived regions and those in regions with more developed financial markets. More particularly, in addition to purely quantitative financial and physical outcomes, the 'market-making' contribution of VCLFs needs to be taken into consideration in assessing and comparing their performance. To the extent that can be ascertained, most VCLFs have contributed significantly to developing a more favourable environment for risk capital at a regional level.

Notwithstanding complications in comparing VCLFs and their performance, there is scope for a more standardized approach to providing information on their activities. This is needed to improve transparency and the effectiveness of monitoring by Managing Authorities and the Commission. There is also scope for a more effective sharing of good practices in setting up and managing VCLF operations. This report highlights a number of key lessons relating to the effectiveness, sustainability and added value of VCLF interventions.

Overall Conclusions & Best Practice Recommendations

4.2 VCLF Strategies and Target Groups

4.2.1 VCLFs should ensure that their activities are closely aligned with overall regional development strategies. As noted in Section 3, some of the VCLFs covered by this research are essentially 'stand-alone' operations and are not closely integrated into the structures used to promote regional development strategies. Although there are theoretical synergies at a strategic level with Structural Fund programming documents justifying financial allocations to VCLFs in terms of the need to address market failures in the financial instruments available for innovative, knowledge-based start-ups and SMEs, at an operational level these synergies are generally weak.

Best Practice Examples – VCLF Aims and Regional Strategies
IBG Sachsen-Anhalt (DE) - the fund works closely with several universities and research institutes in the region to identify spin-offs, usually involving post-doctoral students with good business ideas, and to then provide technology transfer financing. Target sectors include life sciences, optics, chemicals and pharmaceuticals, and instrumentation. IBG's operations are limited to the Sachsen-Anhalt region.
PME Investimentos (PT) - in 2002, PME Investimentos began to diversify into other activities and, in particular, switched from a PEDIP based sector focus with most investment activity benefiting existing SMEs to providing finance for start-ups and early-stage SMEs engaged in innovation and technology-related projects. This has, amongst other things, led to protocols being signed with the main universities in Portugal to help identify innovative projects with commercialisation potential where PME Investimentos can play a role in technology transfer financing. Sectors that are being targeted in this respect are Biotechnology and ICT.
North West Business Investment Scheme (UK) - has target markets that are derived from the Regional Economic Strategy and the clusters it seeks to promote (aerospace, automotives, chemicals, energy, digital industries, healthcare, tourism, etc). Approximately 80% of the investments by number that have been made so far have been start-ups and SMEs from these clusters.
Technofonds (NL) – The fund manager works closely with the managing authority and the regional development agency to ensure that VCLF operations are closely integrated into the wider SME support framework in Flevoland. As a result of this collaboration, the managing authority is well informed about the financial performance and objectives of the fund and the fund manager is aware of regional development priorities. In terms of practical implications, this exchange of information has resulted in collaboration in the creation of a business angel network surrounding the VCLF, the organisation of workshops for young entrepreneurs and promotional and awareness-raising events (newsletters, articles, etc.), some of which together with the regional authorities.

Overall Conclusions & Best Practice Recommendations 5

4.2.2 VCLF objectives and target groups should be defined in a way that focuses on market failures and longer term development objectives. There is a trade off between VCLF objectives and target markets that are broadly defined and offer scope to select investments that are likely to produce a good return relatively quickly, on the one hand, and more narrowly defined targets that focus on investing in businesses with long term job and wealth creation potential on the other. Although there is a case for the first approach based on demonstrating that VCLFs can operate successfully in regions with under-developed financial instruments, this 'market-making' role should not be limited to simply establishing that interventions can generate a positive return. In time, it can be assumed that the private sector will address market failures if it is profitable to do so.

4.2.3 In situations where a primary objective is to demonstrate that risk capital instruments can be successfully developed in a region, there should be more emphasis on the wider role that VCLFs can play in creating a favourable environment for these types of interventions. Apart from their role in providing SME finance, there is a need for VCLFs to work closely with partners in addressing other demand and supply-side issues:

- Developing **investment readiness schemes** and undertaking other promotional activities to promote awareness of risk capital and to ensure a supply of good quality investment proposals;

- **Networking with other intermediaries** – universities, professional advisers, business incubators, etc – to identify projects where risk capital is needed to promote entrepreneurship, innovation and technology transfer;

- Working with **business angels** and other sources to increase the supply of early stage risk capital;

- Also on the supply side, helping to develop the capacity to provide start-ups and SMEs with high growth potential with **specialized business advice and support**.

In some cases, these types of developmental activities can be promoted as part of VCLF deal-making and covered by the management fees associated with this function. However, to be undertaken on a more extensive scale, there is likely to be a need for separate financial provision to cover costs.

Overall Conclusions & Best Practice Recommendations

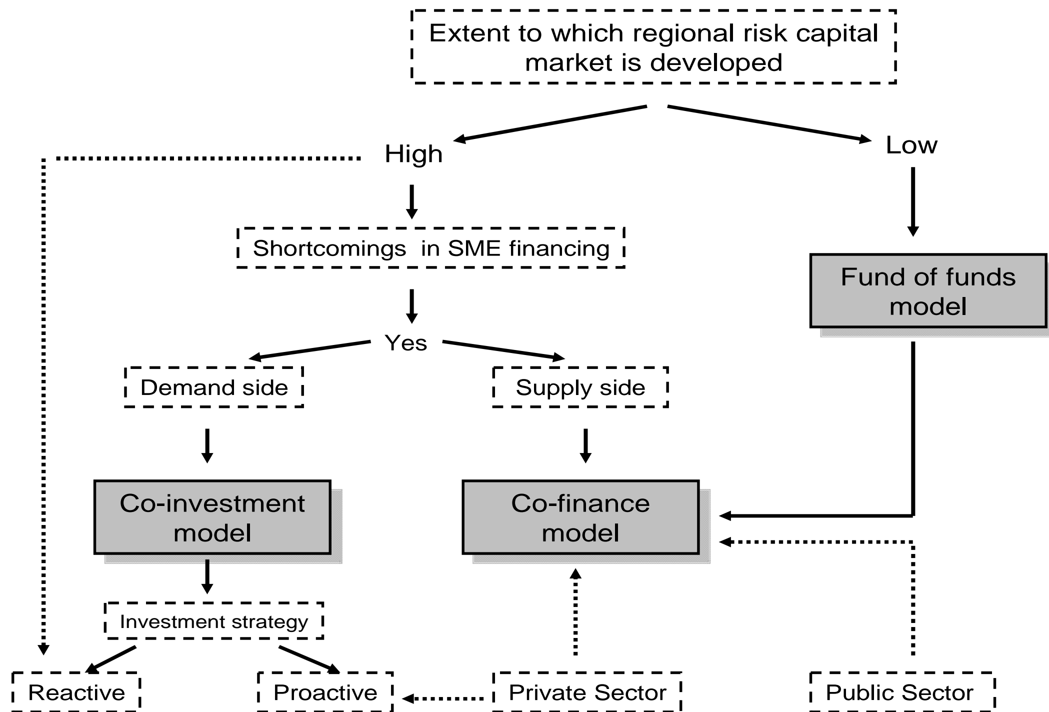
Best Practice Examples – Wider Role of VCLFs
IBB Beteiligungsgesellschaft (DE) – IBB undertakes a number of activities to promote awareness of risk capital in the Berlin area. This includes business plan competitions, workshops and seminars, networking with other organisations (particularly university staff who are able to identify projects), consultants and other banks. Half the 440 applications it has received have been generated in this way.
Technofonds Flevoland (NL) - in addition to providing business advice services, the fund manager in co-operation with the regional development agency has set up a network of 50 business angels, which has been able to close 6 deals to date.
South Yorkshire Investment Fund (UK) – works closely with intermediaries in the region and uses them as a referral mechanism. An analysis of the applications and approvals has established that a significantly higher proportion of successful projects originate in this way. The VCLF now works closely with the Business Link in particular which now accounts for around 20% of referrals. It also pays the Business Link to coordinate financial packages. SYIF sees these and other activities as an important aspect of its role in helping to develop a more favourable overall environment for risk capital.
TANEO (GR) – TANEO has introduced the idea of venture capital in Greece and continues to promote the advantages of this type of financing through promotional activities and awareness raising, for instance through connections with the Greek government, collaboration with the EIF and through the four VCLFs that is has set up.
Alyse (FR) – Alyse provides extensive business advice services in the French overseas territories in order, eventually, to develop a private market for SME finance. The objective is to develop an attractive portfolio of investments and set up a professional and independent management structure which can be handed over to the private sector in the form of several independent fund management companies. This will occur when the level of investment activity covers the cost of professional management and as soon as private partners accept to move in alongside public investors because profitability can be expected. Finally, in order to strengthen the quality of SME proposals, Alyse wants to set up "enterprise foundations" and provides business plan advice to companies which then go on to raise funds through other instruments (e.g. banks). In addition, the fund manager is hoping to use Alyse's economic leverage in the overseas territories to develop the local private business consultancy market.

4.3 VCLF Models and Regional Development

4.3.1 The strengths and weaknesses of the various VCLF models, and the choice of which type to establish in a region, should depend on the prevailing regional development circumstances and, in particular, on the sophistication of financial markets. It is not possible to identify a single model that is appropriate in all circumstances. From a regional development perspective, the diagram below summarises, in a simplified form, the options with regard to different VCLF models.

Overall Conclusions & Best Practice Recommendations

Figure 4.1: VCLF Options



The left-hand side of the diagram represents the more developed regional financial market and the right-hand the less developed situations.

- **Fund of funds** – in regions with weak or no risk capital financing capacity, the funds of funds model is an appropriate structure to support new schemes that are unlikely to be able to set up VCLFs with other public and private sector partners without support. This model enables triple leveraging of the ERDF contriburtion (1) at the level of fund of funds, (2) at the level of the VCLFs and (3) at the level of individual deals. The overhead costs of a fund of funds system are, however, relatively high compared with other models.

- **Co-financed model** – in more developed regions, where it is possible to secure public and private sector investment in a VCLF from the outset, this option may be appropriate. A key advantage is the ERDF-induced leveraging of additional resources to create a VCLF with greater capacity to intervene in its own right than would be possible with ERDF and co-investment funding alone. A drawback is the complexity of managing an

operation with multiple stakeholders. Furthermore, if debt forms an element in the co-finance, there may be high servicing costs.

- **Co-investment model** – in regions with relatively highly developed financial markets, but where there are gaps in the provision of SME funding, the co-investment model is an obvious option, i.e. co-financing at the deal level. Variations on this model are VCLFs which create deals and identify other investment partners, on the one hand, and VCLFs that rely on deals to be referred to them (which should be possible in the more developed regions). The advantage of the co-investment option is relative simplicity and lower costs than other models.

4.3.2 The type of finance provided by VCLFs - debt, equity or a combination of these (and possibly other) instruments – should depend on the nature of the target market and identified funding gaps. The main use of debt instruments is to improve the availability and terms of working capital loans and short term loans to start-ups and SMEs at an early stage of development and as an alternative to grants. Such interventions address a market failure in the provision of loans to SMEs that do not meet normal lending criteria because of lack of track record or collateral. The effect of guarantee schemes is to pool risk, thus making the remaining risk more attractive to a lender. Equity instruments are usually more appropriate for very high risk start-ups or for SMEs that have reached a stage in their development where substantial additional funding is required but is unavailable in the form of debt and/or falls below the investment thresholds for other equity providers.

4.3.3 In many respects, an ideal model is where VCLFs offer an in-house combination of debt and equity financing since this means that from an SME perspective, there can be a more seamless progression from one stage in their financing arrangements to another. From the point of view of the VCLF an advantage of this approach is that diversifies their portfolio investments, spreads risks across different instruments and can create a more even cash flow over the lifetime of the scheme. A combination of financial instruments also creates a self-referral system with undertakings that benefit from early stage debt support then being equity at a later stage in their development. The VCLF will know the businesses concerned which reduces the need for screening.

Overall Conclusions & Best Practice Recommendations

Examples – VCLF Models
IBG Sachsen-Anhalt (DE) - the first round of investment in a company can be undertaken by IBG on its own if the risks are considered too high for other funders. However, in practice, most of the portfolio has involved co-investment by other institutions, in particular the Landesbank and KfV. Over the past 2-3 years there has also been a growing involvement of business angels (at present, IBG is working with around five). The second round of financing usually involves commercial banks investing alongside IBG. However, there is also a growing involvement of other venture capital funds, especially in the field of biotechnology.
Scottish Co Investment Fund (UK) - operates through approximately 24 investment partners who bring deals to SCF. These partners can be institutional investors, professional fund managers, smaller regulated and unregulated fund managers and investors, business angel syndicates and private individual investors. Partners were appointed after an advertisement to meet public procurement rules, and include both Scottish partners and others from the rest of the UK and abroad. SCF enters into deals on a pari passu basis with its partners. It is a passive investor in the deals and SCF relies on its partners, as the lead investor, to monitor the investments.
South Yorkshire Investment Fund (UK) – combines a Small Business Fund (loan scheme) with a Capital and Development Fund (mezzanine and equity). The assumption made in the business plan was that there would be a loss on the debt instruments, breakeven with mezzanine finance and an overall gain with the equity investments. Taken together, this combination is expected to generate a legacy fund of around €33 million by the time the VCLF closes.

4.3.4 VCLFs should offer 'money with management' services, preferably by networking with other business support providers. As the examples covered by the research show, providing business advice and mentoring is one of the ways in which VCLFs add value compared with grant schemes and other types of SME finance. This reinforces a message from an earlier study.[20] Being directly involved in advising companies also means that the VCLF is in a better position to monitor its investments and to detect problems at an early stage when there may still be scope to take corrective action. At the very minimum, this 'money with management' role should involve VCLF personnel or appointed representatives sitting on company boards and offering advice when required (possible with equity investments but not with debt). A preferable approach, however, is for the VCLF to network with professional advisers and others with business experience to offer a more comprehensive range of advisory support to SMEs. The costs should be possible to pass on to client companies although in certain circumstances they may be a case for subsidization (e.g. for a time-limited period at an early stage in a VCLF investment).

[20] See 'Evaluation of Financial Engineering Schemes, study by Ernst & Young for DG Regio, 1999.

Overall Conclusions & Best Practice Recommendations

Examples – 'Money with Management'
IBG Sachsen-Anhalt (DE) – its 13 professional staff specialize in particular technology fields and offer ad hoc in-house advice to companies. In addition, it makes use of three external experts. The initial pre-screening of applications is undertaken by IBG's staff and this is then reviewed by one of the external experts.
Alyse Participations (FR) - has started the creation of 'enterprise foundations' to improve the availability of business advisory services in the overseas territories and to improve the follow-up of its investments. In many cases, Alyse's advisory services are seen as more important than its investments as some companies take on Alyse's advice and then go on to raise the required capital in the private sector.
PME Investimentos (PT) - appoints non-executive directors to the boards of all the companies it invests in. The individuals concerned are recruited from the market and paid a monthly fee for their services. Most have previously worked for banks and undertake the role for PME Investimentos on a part-time basis in their retirement. The amount of time they commit to a particular company is negotiated on a case-by-case basis. As a minimum, however, the non-execs are expected to attend one meeting with the companies each month. Apart from providing advice to the companies, one of their functions is to monitor performance on behalf of PME Investimentos. Monitoring reports are provided on a monthly basis and every six months PME Investimentos organises a meeting with all non-execs to review activities.
South Yorkshire Investment Fund (UK) – offers both pre-investment (investment readiness) and post-investment advice. This is delivered using a combination of in-house resources and by drawing on a 'mentor bank' consisting of 480 individuals. It had originally been proposed that business support services should be provided by the Business Link but instead SYIF decided to establish the 'mentor bank' since it wanted access to individuals who had been/are entrepreneurs and/or specialists in particular fields. SYIF covers half the costs of their time up to a maximum of £6,000 (€8,700) per firm. The 'money with Management' programme' is financed by a separate £8.3 million (€12 million) funding package that includes an interest rebate scheme.

4.4 Public and Private Sector Involvement

4.4.1 The extent of public/private involvement in VCLFs can have implications for risk management and the relative emphasis on regional development/purely financial objectives. The evidence from this study generally suggests that public sector involvement leads to a greater focus on purely regional development objectives. Similarly, because public sector shareholders perceive impact on regional development as one of the most important aims of VCLF interventions, they are often willing to assume greater risks and accept lower financial returns. This can substantially increase deal flow and widen the impact of VCLFs on jobs. In contrast, private shareholders are likely to be more concerned with financial returns and see regional development impacts more in terms of a "demonstration effect" arising from a professionally managed venture capital operation. Public Stakeholders are likely to adopt a "market-taking" as well as a "market creating" role.

Overall Conclusions & Best Practice Recommendations

Examples – Role of Public/Private Sectors
Alyse Participations (FR) - Alyse is a largely publicly run "fund of funds" with 83% of its resources from the ERDF (€3m) and the national and regional public purse (€2m). The remainder (€1m) of Alyse's resources stem from private sources. A large ERDF-financed capital increase has been requested for the next programming period. Alyse's VCLFs can cover a large risk spectrum in their investment decisions. As a result, Alyse has made a large number of SME investments (63) in a very short period of time. Investments widely exceed original targets with 1,300 jobs created or safeguarded and a total turnover of €185m. Additionally Alyse has maximised its leverage potential with a multiplier of 3 at the level of its VCLF subsidiaries and again at the deal level with a multiplier of 5.9 (total deal size: €103m). The total multiplier on the ERDF contribution is 34
MKB fonds (NL) – MKB's mostly private shareholders include 4 major Dutch banks for €1.75m (47%) of fund resources and the regional development agency in Flevoland. ERDF resources played a major role in bringing these partners together behind a regional development agenda. MKB has made only 12 investments and there has been a reluctance by the shareholders to assume greater risk and secure additional deals. The Managing authority and fund manager feel bank shareholders lost interest in the operation of the fund after having depreciated their small initial investments.
Technofonds (NL) – Technofonds has only public shareholders including several municipalities in the province of Flevoland and the regional development agency. ERDF resources have been essential in bringing this fund to a workable size. A further ERDF financed capital increase has been requested for the next programming period.
TANEO (GR) – TANEO is a relatively large, overwhelmingly private "fund of funds", with 70% of its resources raised privately through a bond issue for €105 million. Public partners include the ERDF (17%) and the Greek government (13%). The risk adversity of its fund managers was one of TANEO's primary concerns. At the fund of funds level, TANEO has invested €38m or 25% of its initial resources in 4 VCLFs and they are currently negotiating with an additional 5 potential fund managers.

4.5 Governance and Management Structures

4.5.1 VCLFs have differing governance and management structures depending on their funding structures and there is no ideal model. More particularly, whereas VCLFs based on the co-financed model have boards with representatives of the various stakeholders, this does not apply to VCLFs who do not have multiple public and private sector funding sources, i.e. co-investment models. The advantage of the first VCLF model is that it is potentially more effective in terms of partnership building and 'buy-in' with key organisations and investment partners directly involved in VCLF management. The disadvantage is that it means that setting up a VCLF can take longer and, once operational, can make VCLF management more complex and costly to undertake. There is no best practice model and the most appropriate arrangements depend on the nature of the VCLF and national regulations.

4.5.2 Likewise, there are different approaches to portfolio management – in some cases this function is undertaken in-house whereas in others it is contracted out. Again, there is no best practice that is applicable to all types of VCLFs. The decision on which approach to adopt may be influenced by regulatory factors, in particular whether or not the VCLF manager is authorised to directly deliver financial services. Beyond this, contracting out portfolio management has the advantage, in theory at least, of securing expertise, ensuring professional standards and independence in investment decisions. A disadvantage is that it may be more costly in terms of overheads than an in-house approach.

Examples – VCLF Portfolio Management
IBG Sachsen-Anhalt (DE) - applications are considered by a five-person investment committee (two from the Ministry of Finance, a professor from the Fraunhoffer Institut, a representative from a financial institution, and a tax expert). This process includes an interview with the applicant him/herself. If the application involves more than €1m equity or over €5m of equity and debt, then the decision is referred to IBG's supervisory board. Portfolio management is undertaken in-house by a team of 13 staff.
Andalucia 21 (ES) – is managed by a director, investment manager and an administrative assistant. Its activities are supervised by a 6-member Investment Committee (this includes the Andalucia 21 director and the CEO and several directors from the holding company, Grupo Ahorro Corporation). Portfolio management is carried out in-house.
Merseyside Special Investment fund (UK) - MSIF is managed by Alliance Fund Managers Limited, who is subject to FSA regulation. They are members of the BVCA and are shown as having eight executives, and managing only MSIF. The current fund managers manage all the funds and are therefore able to take an overall view of the fund. Previously, there was separate fund management for each of the tiers of fund.
South Yorkshire Investment Fund (UK) – at the outset, because the holding company was not FSA approved, the management of all three funds was contracted out after public tender. The Small Loans Fund was originally managed by British Steel Enterprises but in 2004 the decision was taken to transfer responsibility to in-house staff and a wholly-owned subsidiary, Finance South Yorkshire, was set up for this purpose. A key reason for this decision was to reduce overhead costs and to increase the level of investment activity.

4.6 Information Disclosure, Monitoring and Evaluation

4.6.1 There are very different practices with regard to the disclosure of information on VCLF financial performance, management costs, and a more transparent and standardized approach should be encouraged. Differences exist in part because of the differing regulatory regimes that VCLFs are subject to at a national level. In general, we have found that a considerable amount of information on VCLF investment activities is reported on a regular basis to

Overall Conclusions & Best Practice Recommendations 5

Managing Authorities – quite enough to provide a good overview of activities.[21] There is less transparency with VCLF costs which (excluding losses on investments and bad debts on loans) generally consist of two elements - management fees and other costs (e.g. audit and related professional fees). Furthermore, different methods are used to determine management fees. For example, in some cases, a fixed fee, equivalent to a percentage of the initial VCLF size, is paid to the fund managers which reduces over time as a transition is made from the investment to disinvestment phase; in other cases, the fee is linked to the level of investments actually made. In yet other cases, the management costs are disclosed but it is not clear at all how they are calculated. The Commission, Managing Authorities and VCLF managers should agree on a more harmonized approach based on the minimum information disclosure required to make these costs fully transparent.

4.6.2 One of the key aims of a VCLF, and an advantage over grant-aided funding, is to generate a legacy fund which can be used for continued investment. It is therefore important that clear aims are set with regard to legacies and progress towards them closely monitored. When a VCLF is set-up, the legal document setting up the fund should make provision for the future use of any legacy and its monitoring. It would be helpful if the document ensures that there is public accountability, for example by means of publication of accounts containing sufficient information so that the process can be easily monitored.

4.6.3 The performance indicators typically used by VCLFs to monitor socio-economic effects are in many respects not appropriate for risk capital interventions. As explained in the previous section, most VCLFs monitor a similar range of non-financial performance indicators (jobs created and saved, SMEs assisted, (increased) SME turnover). Some have gone beyond this (e.g. in one case monitoring the gender of jobs created). The value of these kinds of performance indicators is, however, very debatable (as argued earlier) - firstly, they are difficult to measure accurately and, secondly, they do not fully capture the type of effects that VCLFs are primarily designed to have (promoting innovative, knowledge-based start-ups and SMEs, and more generally, contributing to the Lisbon Strategy aims). More emphasis on qualitative rather than purely quantitative information on VCLF beneficiaries is needed, e.g. on the sectoral characteristics of assisted start-ups and SMEs, the nature of the activities they are engaged in, new products and services developed, job quality. At present, this type of information is

[21] The best examples include details on: the number of enquiries received and their status (accepted, still being reviewed, etc); the portfolio structure broken down into various categories (sector, size of firm, risk category, size of loan/equity investment, etc); details of the amounts invested by period/cumulative, funding source, type of financial instrument, and type of area (Objective 1, 2 - if relevant), etc; details for each investment (amount invested broken down by financial source, repayments, etc); management costs per investment category; jobs created and saved and other outcomes.

collected by very few VCLFs. More generally, it needs to be accepted that the impacts VCLFs achieve are only likely to be possible to assess in the longer term.

4.6.4 VCLFs and Managing Authorities should periodically commission external evaluations to identify the impacts being achieved. In two of the countries covered by the research, external evaluations had been undertaken (in one case as part of the mid term evaluation of the 2000-06 Structural Fund programme and in the other case as an input to preparation of the 2007-13 programmes). However, elsewhere, evaluation activity of this type focusing on VCLFs seems to be the exception rather than the rule. The primary aim of such evaluations, perhaps carried out on a three year basis, should be to help assess regional development impacts by obtaining feedback from the SMEs that have been assisted. This type of information cannot be easily obtained through routine VCLF monitoring activities. External evaluations also provide an opportunity for key stakeholders and others to review the effectiveness of interventions, synergies with other Structural Fund and purely national schemes and programmes, etc, and to adjust VCLF strategies if necessary.

Best Practice Examples – Monitoring and Evaluation
IBG Sachsen-Anhalt - an assessment of IBG was undertaken in March 2006 by the consultants ISW as part of the mid term evaluation of the Operational Programme for Sachsen-Anhalt. This study, which focused on non-financial aspects of IBG's activities and which involved a survey of companies that had received investments, came to broadly positive conclusions but emphasised that it as still too early to judge the ultimate success of the VCLF. A second study, undertaken by the OECD in September 2006, came to similar conclusions, stating that "the company appears to be well managed and performing well.
South Yorkshire Investment Fund (UK) – an external evaluation of its 'Money with Management' scheme was undertaken which involved interviews with beneficiary companies to obtain their feedback on added value. A key conclusion was that most SMEs would be willing to pay market rates given the benefits of the scheme. More generally, there have recently been external evaluations of ERDF-supported VCLFs in Scotland and the UK which were designed to identify priorities for the 2007-13 Structural Fund programming period.
Evaluations of ERDF-supported VCLFs in the UK – towards the end of the 2000-06 programming period, two separate studies have been undertaken in the UK, one in Scotland and the other covering England and Wales, to examine the performance of ERDF-supported VCLFs. These studies were seen as making an important input to plans for the new 20007-13 Structural Fund programming period.

Glossary of Terms

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Business angel	A wealthy private individual who invests directly in new and growing unquoted businesses and provides them with advice. Business angels usually get an equity stake in the business, but may also provide other long-term finance. This capital can complement the venture capital industry by providing finance at an earlier stage, especially at the pre-seed and seed stage.
Buyout	A transaction in which a firm (or part of it) is acquired from the current shareholders. In a management buyout the current managers are the buyers, with the support of private equity/venture capital investors.
Debt	Loans and other funding instruments that provide the investor with mostly fixed minimum return and are at least partly secured.
Early-stage capital	Financing to companies before they initiate commercial manufacturing and sales, before they be generating a profit. Includes seed and start-up financing.
Equity	The ordinary share capital of a company.
Equity gap	Exists when there is a persistent capital market imperfection preventing supply from meeting demand at a price acceptable to both sides. The gap may concern, on one hand, high-tech innovative and mostly young companies with high growth potential and, on the other hand, a wide range of companies of different ages and sectors with smaller growth potential that cannot find financing for their expansion projects without additional external risk capital.
Exit	Liquidation of holdings by a private equity/venture capital investor. Usual ways of doing this are trade sale to another company; public offering (including an initial public offering) on a stock market; write-off of the investment; sale to another investor; or repayment of the investment (when part of the investment agreement).
Expansion capital	Financing provided for the growth of a firm, which may or may not break even or be profitable. Capital may be used to finance increased production capacity, market or product development, or to provide working capital.
Fund-of-fund	A fund that invests in other (venture capital or private equity) funds.
Fund size	The total amount of capital committed by the limited and general partners of a fund.

Glossary of Terms

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General partner (GP)	A partner in a private equity/venture capitalmanagement company who has unlimited personal liability for the debts and obligations of the limited partnership and the right to participate in its management.
Internal rate of return (IRR)	In a private equity/venture capital fund, the net return earned by investors from the fund's activity from inception to a stated date. The IRR is calculated as an annualised effective compounded rate of return, using monthly cash flows and annual valuations.
Institutional investor	Refers mainly to insurance companies, pension funds and investment companies collecting savings and supplying funds to the markets, but also to other types of institutional wealth (e.g. endowment funds, foundations, etc). Usually these have substantial assets and are experienced investors.
Investment readiness	SMEs with growth potential need to understand the concerns of risk capital investors and should have specialist advice on how to structure business plans to secure external equity finance, to make themselves 'investment ready'.
IPO, initial public offering	Also flotation, going public. The process of launching a private company for the first time on a stock market by inviting the public to subscribe in its shares.
Limited partner (LP)	An investor in a limited partnership .
Limited partnership	A legal structure that is used by most private equity/venture capital funds. A partnership is usually formed for a fixed period of time between the investors in a private equity/venture capital funds and the management company making the investments in the underlying portfolio companies. The investors have limited liability and the management company has unlimited liability. The details on management policy and profit-sharing are laid out in a partnership agreement.
Private equity	Investment by private investors taking an equity stake in companies not listed on a stock market. Venture capital is strictly speaking a subset of private equity, where the latter also includes replacement capital and buyouts.
Private equity/venture capital fund	A private equity/venture capital investment fund is a vehicle for enabling pooled investment by a number of investors in equity and equity-related securities (such as quasi-equity) of companies (investee companies). These are generally private companies whose shares are not quoted on any stock exchange. The fund can take the form either of a company or of an unincorporated arrangement such as a limited partnership. In form, a private equity/venture capital fund can be either a company or a limited partnership: a few are also quoted on stock markets.

Glossary of Terms

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Quasi-equity (or mezzanine finance)	Financing that combines the features of debt and equity. The term covers a variety of instruments tailored to a specific legislative and operating environment. Quasi-equity encompasses such instruments as convertible shareholder loans, loan notes, preference shares. These instruments are unsecured and convertible on exit.
Replacement capital	Purchase of existing shares in a company from another private equity investor or shareholder.
Risk capital (markets)	An EU term used to describe markets providing equity financing to a company during its early growth stages (start-up and development). In the framework of the recent Commission Communication(2), it covers three types of financing, (1) informal investment by business angels; (2) VC; (3) stock market specialized in SMEs and high growth companies.
Seed capital	Financing provided to study, assess and develop an initial concept. The phase preceding the start-up phase, which are together called early-stage.
SME - Small and medium-sized enterprise:	Under European rules(4) an SME should have less than 250 employees, an annual turnover not exceeding € 50 million and/or an annual balance sheet total not exceeding € 43 million.
Start-up capital	Provided to companies for product development and initial marketing. Firms may be in the process of being set up or may exist but have not sold their product or service commercially.
Venture capital (VC)	Investment in unquoted companies by venture capital firms who, acting as principals, manage individual, institutional or in-house money. In Europe, the main financing stages included in venture capital are: early stage, covering seed and start up, and expansion. Strictly defined, venture capital is a subset of private equity. Venture capital is thus 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.
Working capital	The liquid assets a company has available to build its business and a measure of its efficiency and financial health. Working capital can be positive or negative, depending on how much short-term debt the company is carrying. A negative working capital means that a company currently is unable to meet its short-term liabilities with cash, accounts receivable, and inventory.

List of Interviews

B

Name	Position	Country
VCLF Managers and Managing Authorities (the latter denoted with an *)		
Dr Dinnies v. der Osten	Director, IBG	DE
Eric Bourgett	Manager, IBG	DE
Frank Jungblut*	Ministry of Economy, Sachsen-Anhalt	DE
Lars Michalak	IBB Beteiligungsgesellschaft	DE
Oliver Bathe*	Senatsverwaltung fur Wirtschaft, Arbeit und Frauen	DE
Manuel Neira Lopez	Sub Director General, Andalucia 21 FCR	ES
Olivier Follin	Executive Director, SAS Alyse	FR
Nikolas G. Haritakis	CEO, New Economy Development Fund	GR
Antigoni Lymperopoulou	Investment Manager	GR
Giannis Papadopoulos	CEO, Attica Ventures	GR
Ioannis Souliotis*	Management Organisation Unit, Ministry of Finance and Economics	GR
Mr Makris*	Management Organisation Unit, Ministry of Finance and Economics	GR
Dr Ruben Baijens	Investment Manager, Stimulus (REDE)	NL
Hans Bloemen	Head of Unit, Advice and Finance, Stimulus	NL
Rene Krijger	Fund Manager, BV Management	NL
Joke van den Brink-Rozendaal*	Programme Manager, Province of Flevoland	NL
Dr ADM Hubers	Consultant, Province of Flevoland	NL
Dr RM Schuitemaker*	Director of Economic Affairs, Prov. Flevoland	NL
Olaf Gahler*	Province of Flevoland	NL
Miguel Goncalves	Board member, PME Investimentos	P
Nelson de Souza*	Chairman, PRIME	P
Fernando Alfaiate*	Coordinator, PRIME	P
Nuno Goncalves	Manager, IAPMEI	P
Jose Furtado	Vice President, IAPME	P
Mario Pinto	Director, Change Partners	P
David Hall	Managing Director, YFM Private Equity	UK
Vivienne Upcott-Gill	Manager, North West Business Investment Scheme	UK
Mark Fuller	Managing Director and Fund Manager Merseyside Special Investment Fund	UK
Lisa Greenhalgh	Finance Director, Merseyside Special Investment Fund	UK

List of Interviews

B

Tony Goldborne	Director, South Yorkshire Investment Fund	UK
Clive Downward	Investment Manager, South Yorkshire Investment Fund	UK
Chris Hubbard*	European Policy and Programmes (EPP), Department for Communities and Local Government	UK
Maria Munoz*	European Policy and Programmes (EPP), Department for Communities and Local Government	UK

European Commission Desk Officers		
Christian Juliusson	Desk Officer, DG Regio (Sweden)	Brussels
De Maistre Nicolas	Desk Officer, DG Regio (France)	Brussels
Stephen Langley	Desk Officer, DG Regio (UK)	Brussels
Frank Elholm	Desk Officer, DG Regio (Denmark)	Brussels
Ulrich Krause Heiber	Officer, DG Regio (Germany)	Brussels
Joao Faria	Officer, DG Regio (Portugal)	Brussels
Miguel Benito	Desk Officer, DG Regio (Spain)	Brussels
Joel-Philippe Tilly	Desk Officer, DG Regio (Belgium)	Brussels
Elina Hakkonen	Desk Officer, DG Regio (Finland, Ireland)	Brussels
Amodeo Francesco	Desk Officer, DG Regio (Greece)	Brussels
Gabriela Hernandez	Desk Officer, DG Regio (Austria)	Brussels