NAVCS Public Policy Forum

Quebec City, October 27, 2008

Main Conclusions

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December, 2008

Introduction

These few paragraphs do not pretend to reflect all the richness of the 11 presentations made by the speakers, the intense discussions around these presentations and the debate around some of the conclusions of the LP Forum at the end of the day.

They would just like to highlight the main points of convergence of the day and can be read as an introduction to the presentations which have been joined in annex.

Based on these proceedings and many one to one conversations we had during the Forum, we have added some suggestions on next steps to build on the momentum of this day.

POINTS OF CONVERGENCE

1. A consensus around the case for government intervention but difficulties to correctly assess the need for this intervention, its size and its target

There was a large consensus around the following themes developed by Josh Lerner. Venture Capital is a very young and relatively small industry but it is "high powered money". Collectively it spurs technological innovation and has a huge impact on the economy which goes well beyond its size. However, it is not an efficient market and generates positive externalities. Therefore it justifies public intervention and government can play a catalytic role.

On the other hand, several speakers underlined the fact that it is not always easy to assess correctly the size and the specific domains of the need for intervention. Examples were cited of public interventions trying to create a market where necessary conditions were not present or over dimensioned interventions forcing into the market too much money given the size of the opportunities.

These remarks led to a couple of recommendations:

- Recognize the indigenous comparative advantage of the market you are targeting
- Seek input from interested parties
- Invest along the private sector
- Work not only on the supply side (supply of capital) but also on the demand side (investment readiness, commercialization of research, incubation, international collaborations)

2. There was also a large consensus around major reasons why many government interventions failed

- Lack of understanding of how VC markets work and will to force money into the market
- Multiplying constraints and objectives leads to conflicting objectives, increased risk, poor returns and unsustainable programmes
- Top down approaches: unawareness of risk and short circuit of normal risk assessment processes
- Mixing policy writers and investment decision makers: not the right people and expertise
- Distorting the market and being unable to syndicate efficiently with private sector teams: not the right people, the right approach or different return expectations

3. This consensus around the causes for failure led to consensus around a set of generally accepted recommendations for government interventions

- First and foremost, set the environment right: cultural (risk tolerance), fiscal, legal, tech transfer, possibility for pension funds to invest in the asset class, etc. This is the main lesson of the US experience and was also underlined by most speakers.
- Do not run against the market but with the market
- Define clearly the goals and objectives of the programs – Programs should be profit motivated
- Be ready for a long term commitment
- Adopt private sector best practices: skills and expertise, compensation schemes and alignment of interest, return expectations
- Invest alongside the private sector
- Diffuse best practices: role modeling, mentoring, circulating standard information on best practices
- Evaluate your programs and your failures

4. However, given the poor returns in most places outside specific states in the US, the pari passu approach with the private sector might not be sufficient. Return incentives may be required as well

There have been discussions around the accuracy of performance data which may minimize the coming of age of performing funds outside of the US. However, there was no real disagreement that average VC performance remains poor outside the US and that returns are very concentrated. Moreover, hints given by speakers on their ongoing programs point to the fact that these programs are having positive effects on building the industry but that returns are still below expectations.

In most places outside the US, private sector investors tend to find VC investment and especially seed and start-up investment too risky and there is a constant drift of VC funds toward later stage and buyout.

Under these circumstances, it appears that the pari passu approach will not be sufficient to attract private sector money and reduce market gaps such as:

- Facilitating investment in segments of the markets which most teams in the private sector tend to consider too risky but where there are positive externalities (e.g. technology seed and start-up stages)
- Maintaining a certain level of activity in the VC financing chain at a time when, outside of the US, most institutional investors tend to withdraw from the asset class for lack of performance.

  This question of lack of returns in most places outside some US States has surfaced time and again during our meeting. Josh Lerner's position was that there is no reason to consider that there is an "American exception" and that with time, big winners should emerge in other parts of the world as well. As he mentioned, it took more than 3 decades in the US to come to a performing and sustainable asset class. If this is true, there is a good case to keep providing incentives to invest in that asset class until there is a critical mass of experienced tech. entrepreneurs and investors and the asset class becomes self sustainable.

Therefore, to complement the supply of capital by the public sector to match private sector funding, it appears important to consider some return enhancement. This has been stressed by ECF, Yozma, the Ontario Venture Fund, the New Zealand Venture Investment Fund, and the Russian Venture Fund.

Some criticism has been raised concerning some schemes used in the past:

- Government taking first loss, which appeared to be a self fulfilling prophecy, very costly and non sustainable
- Direct tax credits to investors, which tend to induce a reduction in return expectations and a distortion in the market.

Experiences where there is an asymmetry in the water fall of profits (SBIC, Yozma, New Zealand fund, ECF, Russian Venture Fund) seem to have more positive effects. It has been underlined as well that formulas that include a buy-out option (Yozma, New Zealand Fund, Russian Venture Fund) are a good way to limit the involvement of government: if the option is exercised, it is an exit for the government; if it is not, it is a signal of failure and the government should not go on.

5. Do we need to find another model? LPs and GPS should work together on this issue

This question of concentration of returns and underperformance of the VC asset class in most countries or regions has led to a debate which has gone through the whole day around the following question: do we need to find another model?

More specifically, the “American model” seems to have delivered good returns only for a few VC firms based in very specific environments (Silicon Valley, some places on the American East Coast). Is it replicable elsewhere? Many people in the audience seemed to doubt it and to conclude that we need to find “another model” to be able to build large successful companies and self sustainable VC industries.

Interestingly, in three “peripheral countries” (Canada, Israel, New Zealand) and even more broadly for Europe in the biotech sector, it has been noted that the ability to obtain high returns has been hampered by the small size of the funds and the fact that these countries had to rely on the US market for exits. They are more building technologies than building companies, which does not seem to be enough to deliver great returns. These two types of constraints may become even more challenging in the present situation.

As already mentioned, Josh Lerner was in disagreement that there should be an “American exception”. His guess was that if we had data for VC returns in the US between 1946 and 1976, it would show a “pretty ugly” picture. With the globalization of VC and the progress on the learning curve in other parts of the world, he sees the potential for big winners outside of the US. Several remarks suggested that we may be at the beginning of experiencing this in some places or sectors in Europe, (though there was no hard data yet to support this). In his views, this industry has to be very selective to be successful and there should be a very rigorous sorting out process to attract the most talented people.

(This could be one of the important recommendations for any public intervention: it should not slow down or prevent the selection process to attract and retain best managers.)

This being said Josh mentioned that encouraging other models as corporate venture funds for instance is very valuable.

David Quysner approached this question of the “right model” from another angle when he presented the ECF model. He underlined the fact that sixty years later, “we are still testing the market”, meaning that there is no clear model on how to support the industry until it reaches the self sustainable mainstream or Silicon Valley model but that we have to keep testing and experiencing.

The model proposed by ECF innovates in many respects:

- Flexibility in terms of fund’s structure in order to facilitate the involvement of Entrepreneurs and Angels
- Flexibility in terms or fees, carried interest and distribution of profits structure in order find the proper incentives
- Flexibility in terms of linking the funds to other sources of capital (angel networks, more established VC funds) for follow on investments.

So far it seems to have been able to attract new sources of skills and capital, notably from the angels’ networks to invest in this underserved market.

Interestingly enough, the issue of “the right model” was at the centre of what the LP Forum presented for discussion to the Public Policy Forum. Their main conclusion was that LPs were not satisfied by risk adjusted returns obtained by the GP/LP model and not really interested in participating in this model anymore as returns are so concentrated in so few funds which, most of the time, they cannot have access to. However, they mentioned that they were not ready to throw the towel for two kinds of reasons: fiduciary duty as they think that technology could eventually deliver good returns and, also, a responsibility to invest in innovation to ensure that there will be a vibrant economy for their retirees and their grand children.

One of models they were considering was a model of in house Life cycle investing developed by APG: investing on the whole life cycle of companies from “peep” (one step before seed) to exit which could go up to 12-15 years. It was proposed that this would be a better way to develop the infrastructure, the leadership, the staying investment capabilities, the collaboration and the operational expertise required to invest in technology companies.

APG is developing on these principles an innovation fund to which it will allocate up to 2% of its 200 billion Euros under management.

Some comments praised this initiative, notably mentioning that it could help avoiding Europe to be an incubator to the US by being able to invest enough patient money to build the companies and not sell them too early to US buyers.

Others expressed a strong scepticism on the ability of such an in-house program (or what was perceived of it through the very rapid presentation that was made) to attract the right skills and talents to build and exit successful technology companies.

Though the APG program does not include any government incentive, Michael Nobrega mentioned that some coordinated (federal/provincial), consistent, clear and long term government incentives might be necessary for such a scheme to work in Canada and to bring back Canadian institutional investors to the VC asset class.

The general conclusion was that this question of “the right model” was crucial and that LPs and GPs should keep working together to test various possible solutions.

NEXT STEPS

There has been a request directly formulated by David Quysner and echoed by others to keep developing networks around these issues. Beyond informal networks, is there a case for something more organized? How?

Many people, even among those who had been working in the field for a long time, mentioned that they learnt a lot about programs they did not know. This shows the interest of a platform such as the PPF to share this information. Several countries which were not present were mentioned as interesting experiences on several occasions: Scandinavia, Australia, France.

However, several people mentioned that given the broad convergence of the presentations and discussions which followed, keeping the same format might become somewhat redundant. We would have to go deeper. Three kinds of ideas were mentioned:

- Select a more focused theme, like “Evaluation” for instance which seems to be so important and neglected
- Organize workshops on more technical issues, like incentives for investors to invest in VC funds
- Organize case studies (which would suppose that some programs would be ready to open their books and share more information…)

Should we develop one or the other of these suggestions or should we rather keep the same format as this year?

Another idea was to try and reach a more political level. Several ideas were put forward in that direction:

- Develop from the Forum some advocacy papers which could be circulated and influence decision makers
- Attract to the Forum a more political level so that we could communicate to them what comes out of our experiences (format to be determined)

Some policy government officials mentioned that they would be interested to discuss not only about program implementation but more about policy design and justification. How could this be done?

Last but not least, what should be done to keep working with LPs on the “right model”?