Survey of the Economic and Social Impact of Venture Capital in Europe

Research Paper
The European Private Equity and Venture Capital Association (EVCA) exists to represent the European private equity sector. With over 950 members throughout Europe, EVCA's many roles include providing information services for members, creating networking opportunities, acting as a lobbying and campaigning organisation and working to promote the asset class both within Europe and throughout the world. EVCA's activities cover the whole range of private equity, from seed and start-up to development capital, buyouts and buyins, and the flotation of private equity-backed companies.
Survey of the Economic and Social Impact of Venture Capital in Europe

This paper considers the role played by venture capitalists in the seed, start-up and expansion stages of an enterprise. It is based on a pan-European survey conducted on behalf of EVCA by Nottingham University Business School (NUBS), Nottingham, United Kingdom (in conjunction with CMBOR\(^1\)) and with the support of Europe Unlimited, Brussels, Belgium.

June 2002

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\(^1\) CMBOR was founded at Nottingham University Business School in March 1986 and carries out bespoke research in the field of venture capital and publishes regular reports on buy-out trends and other relevant issues in its Quarterly Review and annual European Buy-out Review.
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The European Private Equity and Venture Capital Association (EVCA) first undertook investigations to improve general understanding of the economic impact of private equity with independent research back in 1996. The results of this survey are now well documented and prove that venture capitalists contribute positively to the rapid growth of companies to increase sales, employment, investment, R&D expenditure and exports.

5 years later, EVCA set about commissioning a similar investigation into buyouts, a subset of private equity. This found that without the buyout, 84% of companies would either have ceased to exist or would have grown less rapidly.

It is hence, that this year, in spite of the current economic down cycle, the EVCA High-Tech Committee initiated the following independent study, to apply the same methodology to venture capital, the other subset of private equity. The findings of this research bring to light a greater understanding and awareness of the positive impact of venture investment on a growing company.

It should not be forgotten that the involvement of Venture Capital is a long-term support, which goes to those companies, which have at all times, the potential of success and sustainability. There are in Europe, a high number of very promising European companies with great technology and enthusiastic and capable management. Venture capital is there for them, to help them build businesses and grow faster than they otherwise would.

Venture-backed companies harness the entrepreneurial spirit, provide tomorrow’s technologies and create jobs. Regardless of economic cycles, the impact of venture capital investment on the overall economy, is clear.

The latest statistics demonstrate sustained investment levels by European venture capitalists in all sectors, including the suffering high-tech sector. It is certainly the most encouraging response of a mature industry to the expectations, which have been placed upon them.

**EVCA encourages governments and policy makers to look at market facts and re-enforce the support given to venture capital, specifically by easing the regulatory environment both for establishing new companies and for their venture capital partners.**

EVCA would like to acknowledge and give thanks to the members of the EVCA High-Tech Committee for leading this exercise, Europe Unlimited for contributing to the representation of the sample and Nottingham University Business School for their high quality research work.

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Since 1995, Europe has seen a dramatic increase in venture capital investment in companies that are in their seed, start-up or expansion stages. Not only has the total invested in these young companies grown from €2.6 billion per annum in 1995 to €12.2 billion per annum in 2001, but venture capital’s share of total private equity investment has, over the same period, also risen from 47.2% to 50%.

In January 2001, the EVCA report ‘Survey of the Economic and Social Impact of Management Buyouts and Buyins in Europe’ (based on research carried out by CMBOR) was widely welcomed, both as an insight into the nature and operation of buyouts and as an investigation of why this type of investment is important and valuable for the economy and society as a whole.

This current report on the impact of venture capital investment mirrors the buyout survey. It aims to provide a similar analysis of the function and value of venture capital investments in early stage and expansion stage companies.

The study was designed to investigate some of the reasons for the success of these types of investments. Its purpose was to find out more about three aspects of venture-backed companies:

- **Background characteristics** – the nature, size and business sector of investee companies
- **Operation of the venture-backed company** – the internal organisation and strategies adopted
- **Post-investment performance** – indicators showing post-investment achievement in a number of areas.

Questionnaires were sent out between January and March 2002 to a sample of companies across Europe that had, between 1995 and 2001, received venture capital funding during their seed, start-up or expansion stages. This report analyses the 364 replies that were received, representing a good correlation with the relative size of each country’s venture-backed markets (see Appendix 2).

The most significant findings of the study are that:

- Some 95% of the companies replying to the survey stated that, without venture capital investment, they could not have existed or would have developed more slowly
- Almost 60% said that the company would not exist today without the contribution of venture capital
- An average of 46 additional jobs were created by each responding company following the venture capital investment.

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2 Venture capital is, strictly speaking, a subset of private equity and refers to equity investments made for the seed, start-up or expansion of a business. Private equity therefore consists of venture capital and buyout investments.

3 Seed involves funding to research and assess an initial concept; Start-up involves funding to develop and initially market the concept; Expansion involves funding to grow and expand an operating company

4 The Centre for Management Buy-out Research, Nottingham, UK

5 The term ‘early stage’ encompasses the seed and start-up stages of a business.
POST-INVESTMENT PERFORMANCE

The responses of the venture-backed companies prove that venture capital investment is crucial to the existence, feasibility and success of businesses in the seed/start-up and expansion stages.

- Overall, 94.5% of companies responding to the survey said that the venture capital investment had been an essential ingredient in their creation, survival or growth.

- Of companies receiving investment in the expansion stage, 90% said that, without venture capital, they could either not have existed or would have developed more slowly.

- 72% of seed/start-up companies stated that they would have never come into existence without the contribution of venture capital.

Employment

The creation and growth of these young companies has also had a significant impact in terms of new employment opportunities.

- Around 90% of responding investee companies declared an increase in the total number of employees following the venture capital investment.

- A total of 16,143 additional new jobs were created after the investment by the 351 companies who responded to this part of the survey.

- On average, 46 new jobs were created per company. This represents a large percentage increase for both seed/start up companies (two-thirds of whom had fewer than 6 employees at the time of the investment) and expansion stage companies (70% of whom had fewer than 50 employees at the time the investment was made)\(^6\).

\(^6\) See Section 1.1 of the Survey Findings.
Growth strategies

Investee companies use venture capital investment funding to implement a range of growth strategies. The survey shows that increased expenditure on research & development, marketing and training has resulted in significant improvements in turnover and profitability.

Comparison with competitors

Over half the respondents considered that their performance in the post-investment period had been significantly better than that achieved by their competitors. The perception of nearly 80% of companies was that the growth in their EBIT (Earnings before Interest and Tax) had been either the same as or greater than that of their competitors.

■ OPERATION OF THE VENTURE-BACKED COMPANY

Destination of the investment funding

The companies surveyed used venture capital investment to fund long term, value-adding developments such as research & development, marketing, and training. Investee companies reported significantly greater expenditure in all these areas.

■ Seed and start-up companies identified research & development as the area in which the largest post-investment increases in expenditure were made (multiplying factor of more than four for half of the surveyed companies).

■ Companies using venture capital investment to fund expansion stated that the largest increases were in marketing, where expenditure almost tripled for half of the surveyed companies.

Respondents’ perceptions of post-investment increases in turnover and EBIT in comparison to competitors – all responding companies (source: NUBS/EVCA)

Percentage increases in expenditure between the time of the initial investment and the time of the survey – seed/start-up stage companies (source: NUBS/EVCA)
All companies invested heavily in training their employees. Half of the seed/start-up companies increased spending in this area by a factor of more than four, while half the expansion stage companies more than doubled their expenditure.\(^7\)

**Active involvement of the venture capitalist**

The sampled companies reported that the involvement of the venture capitalist is not restricted to financial contributions, and often includes a variety of non-financial inputs.

- It appears that seed/start-up companies value venture capitalists most for their strategic advice.

- Companies receiving investment to fund expansion on the other hand, consider the venture capitalist’s most important contribution to be the provision of credibility.

\(^7\) The definition of ‘median’ (used in the following graphs and elsewhere in the reports) is the value achieved or exceeded by the upper 50% of the sample.
BACKGROUND CHARACTERISTICS

Size

At the time the venture capital investment was made, the majority of investee companies had fewer than 50 employees.

- Two-thirds of companies in the seed or start-up stages employed fewer than 6 employees in the year of the investment.
- 70% of companies in the expansion stage had fewer than 50 employees in the year of the investment.

Sector distribution

Although venture capital investment takes place in all sectors, a substantial majority of reporting investee companies are active in high-tech industries.
1. BACKGROUND CHARACTERISTICS

1.1. The recipients of venture capital investment are typically companies with fewer than 50 employees.

- For all responding investee companies, the number of employees in the year of the initial investment ranged from 0 to 800, with a median value\(^8\) of 6.
- For companies receiving venture funding in their seed or start-up stages, around two-thirds (64.4%) had fewer than 6 employees.
- 70% of companies in the expansion stage had fewer than 50 employees.

1.2. Although venture capital investment takes place in all sectors, almost three-quarters of the companies financed in their seed and start-up stages are active in high-tech industries.

- 74% of companies financed in their seed and start-up stages are in high-tech industry sectors – for example, internet technology, telecommunications, computer hardware, software, IT services and semiconductor, electronics, biotechnology, medical instruments and pharmaceutical activities.
- Slightly fewer companies (62%) receiving investment in their expansion stage are high-tech, with the two main sectors being computer related and communications.

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\(^8\) The median value is the value achieved or exceeded by the upper 50% of the sample.
1.3. The most common stage of development for surveyed companies receiving venture backing is the start-up stage.

■ Just over a fifth were seed companies (22.5%).

■ Over four out of ten (44.8%) of the responding companies were start-ups at the time of the investment financing.

■ Just over a third (32.7%) used venture capital to fund expansion.

2. OPERATION OF THE VENTURE-BACKED COMPANY

2.1. Venture capital investment provides medium to long-term support to investee companies.

■ Around 90% of respondents declared that the planned duration of the venture capital investment was between 2 and 7 years (86% for expansion stage companies, 91% for seed/start-ups).

■ Approximately 70% reported that the planned duration of the venture capital investment was 2 to 5 years.

■ Less than 7% said that no specific time-scale to exit of venture capital investment was planned.
2.2. The survey confirms that venture-backed companies view a healthy cash flow, new product development, market acceptance and highly trained employees as the most important value creation factors.

Respondents were asked to consider how they planned to add value by ranking a number of factors on a scale between 1 (very low importance) to 5 (very high importance). The seed/start-up group and the expansion stage group both identified the same four factors as being of prime importance:

- Ensuring healthy cash flow (liquidity) (score of 4.05-3.96)
- New product development (score of 3.75-3.90)
- Gaining market acceptance (score of 3.65-3.78)
- Employing highly trained personnel (score of 3.5-3.76).

Building brand identity, optimising capital expenditure and cost control were also given high priority by both groups. However, the other three value-adding strategies identified in the ‘top ten’ were different for each group. While broadening the product range and improving business efficiency/reputation were ranked highly by expansion stage companies, seed/start-up firms focused on developing/refining the business model and improving product quality.

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**Fig. 2.2.a: The ten most important value creation factors (rated on a scale of 1-5) – seed/start-up stage companies** (source: NUBS/EVCA)

- Ensuring healthy cash flow (liquidity)
- New product development
- Gaining market acceptance
- Employing highly trained personnel
- Developing business model
- Refining original business model
- Cost control
- Optimising capital expenditure
- Building brand identity
- Improving product quality

**Fig. 2.2.b: The ten most important value creation factors (rated on a scale of 1-5) – expansion stage companies** (source: NUBS/EVCA)

- Ensuring healthy cash flow (liquidity)
- New product development
- Gaining market acceptance
- Employing highly trained personnel
- Broadening product range
- Building brand identity
- Cost control
- Improving business efficiency
- Improving reputation
- Optimising capital expenditure
2.3. The companies surveyed used venture capital funding to achieve significant increases in their budgets for research & development, marketing and training.

■ For all companies, the initial venture capital investment has been followed by a sharp increase in spending on research & development. Half the seed/start-up companies multiplied their efforts in this area by more than four times (median increase 370%)\(^9\), while half the expansion stage companies almost doubled the amount invested (median increase 95%).

■ The median value of marketing expenditure for the seed/start-up companies more than tripled after the investment. For the expansion stage companies, the median value of spending in this strategic area grew by almost the same amount – which makes marketing the type of expenditure with the largest post-investment growth for companies at this stage of development.

■ Median training expenditure after the venture capital funding multiplied by a factor of more than four for the seed/start-up companies and more than two for the expansion stage companies.

\(^9\) The largest percentage increases in these areas of strategic expenditure occur amongst the seed/start-up phase companies – mainly because businesses at this stage of development typically start from a very low base figure.
2.4. Most venture capitalists adopt a hands-on strategy in their working relationships with their investee companies.

- More than 90% of all responding companies reported that they have contact with their venture capital backer on a weekly or monthly basis.

- The percentage of companies having contact with their venture capital backer at least once a week is 36.6% for seed/start-up companies and 28.6% for expansion stage companies.

2.5. Investee companies value the venture capitalist’s strategic input in non-financial, as well as financial, areas.

It is clear that venture capitalists focus on monitoring financial performance and giving financial advice. However, their input often extends beyond these areas.

Two questions focused on this aspect of the investor/company relationship.

- The first question asked the companies to identify the venture capitalist’s level of input in a number of company activities. For each activity, they were asked to estimate the percentage of venture capitalist involvement, ranging from 0% (no involvement by venture capitalist) to 100% (venture capitalist has sole responsibility).
The opinions of seed/start-up and expansion stage companies were very similar on this point. In most companies the involvement of the venture capitalist covers a wide range of non-financial areas. These include monitoring operating performance, formulating strategy, acting as a sounding board for management ideas and helping management to maintain focus. The venture capitalist’s contribution in financially-oriented areas (monitoring financial performance, regular budget reporting, financial advice) is, as would expected, also relatively high.

The second question asked companies to identify what they valued (apart from the provision of investment funding) as the venture capitalist’s single most important contribution. In this question there was a wider divergence between the opinions of the two groups (seed/start-up and expansion stage companies).

- For seed/start-up companies, strategic advice, networking opportunities and focus and support were the most important contributions.
- For expansion stage companies, providing credibility/status, focus and support, strategic and financial advice were the most important contributions.
3. POST-INVESTMENT PERFORMANCE

3.1. The post-investment period is characterised by large percentage increases in turnover.

The annual percentage increase in turnover for companies in their seed or start-up stage is very large for the first year following the investment – around 200%. The average annual growth rate over the first four years is 120%.

Growth rates of expansion stage companies after the initial input of venture capital are, as expected, lower than those for seed/start-up companies – but are nevertheless substantial. The average annual growth rate for the first four years is 33%.

3.2. While venture capitalists may expect expansion stage companies to achieve a growth in profits over the period of the investment, they recognise that it may be some years before a typical seed/start-up company becomes profitable.

For seed/start-up companies EBIT is initially highly negative, as the business generates more costs than revenues. Three years after the initial investment, a majority of companies have still a negative EBIT.

The results for expansion stage companies are quite different, with EBIT increasing steadily from 1.2% of turnover in the year of the investment to 4.4% after three years.
3.3. **Most responding companies reported an improved competitive position in terms of both market share and profits.**

Changes in turnover and profits are, of course, affected by general market conditions as well as by the individual company’s performance. To understand whether or not venture capital is really improving investee companies’ position, we therefore need to analyse their financial performance relative to their competitors.

Almost 90% of the respondents considered that, since the investment, the growth in their turnover had either been the same as or greater than that of their competitors. 57% of respondents reported that their turnover had grown more than that of their competitors.

More than three-quarters (77%) considered that, since the investment, growth in EBIT had either been the same as or greater than the growth in their competitors’ profits.
3.4. Venture-backed companies deploy growth strategies to increase their sales in export markets.

Companies at all stages of development reported an increase in exporting activities following the venture capital investment.

- The number of seed/start-up companies engaged in exporting rose from one-third (37.2%) of companies in the year of the investment to nearly six-tenths (59.7%) in the last year.\(^\text{11}\)

- For seed/start-up companies already exporting at the time of the investment, the share of output exported rose from 17.2% in the year of the investment to 30.6% in the last year – an increase of 78%.

- The number of expansion stage companies engaged in exporting rose from just over a half (55%) in the year of the investment to almost three-quarters (72%) in the last year.

- For expansion stage companies already exporting at the time of the investment, the share of output exported rose from 26.4% in the year of the investment to 36.4% in the last year – an increase of 38%.

3.5. The venture capital investment enabled investee companies to create an average of 46 jobs per company.

Almost all the surveyed companies reported that, as a result of the investment, they had been able to create substantial numbers of new jobs.

- Around 90% of all respondents declared an increase in the total number of employees (92% for seed/start-ups and 84% for expansion stage companies).

- In all, 16,143 jobs were created by the 351 companies who responded to this question (11,633 by seed/start-up companies, 4,510 by expansion stage companies).

- This average of 46 jobs created per company is particularly impressive in the light of the fact that, before the investment, two-thirds of the seed/start-up companies (i.e., the businesses that created 72% of the new jobs) had fewer than 6 employees.

\(^\text{11}\) ‘Last year’ means 2001 (or 2000 if more recent financial data not available).
3.6. **Employees at all levels achieved higher levels of earnings and other forms of remuneration following the investment, with many companies using incentivisation tools such as stock options and performance-related pay.**

- For the surveyed group as a whole, around half (49%) reported that total earnings (including fixed, variable earnings and equity packages) rose for top management since the investment.

- For middle management, remuneration rose in 54% of cases, and for other employees in 50% of cases.

- The largest increases in overall remuneration were achieved by the expansion stage companies, where between 52% and 63% of companies reported increases in remuneration across all three employee categories.

Forms of remuneration such as equity participation and variable (performance-related) pay are becoming increasingly popular as motivation tools for both management and other employees.

- Overall, the number of employees who participated in share option schemes rose from 38% in the year of the investment to 53% in the last year (from 22% to 38% for expansion stage companies and from 46% to 60% for seed/start-up companies).

- For all companies, the number of employees receiving performance-related pay increased from 28% in the year of the investment to 36% last year (from 26% to 37% for expansion stage companies and from 30% to 36% for seed/start-ups).

Many companies also use share options as a recruitment tool.

- Stock options were used to attract new management in 65% of cases (70% seed/start-up, 54% expansion stage).

- In these companies, the percentage of management receiving stock options increased from 52% (58% seed/start-up, 36% expansion stage) at the time of the investment to 79% (82% seed/start-up, 72% expansion stage) at the time of the survey.
3.7. The perception of the responding companies is that the contribution of the venture capitalist has been crucial to the feasibility and success of the company.

A vast majority of all respondents considered that employment (74%), research & development (69%) and investment (72%) were higher than they would have been without venture capital investment in the company. In half the cases, exports were perceived to be higher.

- The views of companies in their seed/start-up stages were that employment (76%), research & development (73%) and investment (72%) were all higher.

- The figures for companies who used venture capital to fund expansion were only slightly lower (employment 69%, research & development 62% and investment 70%).

3.8. Almost three-quarters of seed/start-up companies could not have existed without venture capital.

- Overall, 95% of companies stated that, without the venture capital investment, they could not have existed or would have developed more slowly (90% of expansion stage companies, 97% of seed/start-up companies).

- The majority (almost 60% of all respondents) said that they could not have existed without venture capital (72% of seed/start-up companies, 25% of expansion stage companies).
Appendices

Appendix 1: Survey methodology

The survey was carried out between January and March 2002.

The sample was derived from both the EVCA database and the Europe Unlimited database.

Our sample included all companies who had had venture capital backing (for seed, start-up or expansion) across Europe between 1995 and 2001.

The structure of the questionnaire was based on the framework used for the ‘Survey of the Economic and Social Impact of Management Buyouts and Buyins in Europe’ (published by EVCA, January 2001). However, the survey questions were adapted to take into account the particular characteristics of venture capital investment.

After first making any modifications required to comply with variations in venture capital legislation or practice in each target country, the questionnaire was translated into French, German, Italian and Spanish.

Response to the survey

A total of 364 responses were received from the 2,908 questionnaires sent out, representing a return rate of 12.5%.
Appendix 2: Analysis of responses by country

Figure A.2 shows, for each surveyed country, its share of the total number of questionnaires returned, compared to its share of the total number of European venture capital deals. With the exception of Spain, the Netherlands and Norway (where the response rate was rather low), the proportion of questionnaires returned from each country was much in line with the relative size of that country’s venture-backed markets.

Fig. A.2: Response rate by country compared to total number of venture capital deals (source: NUBS/EVCA)
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