



Governmental venture capital in Europe: Screening and certification



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ABSTRACT

This paper investigates the screening and certification abilities of government-managed venture capital (GVC) firms in Europe. Using a sample of European high-tech entrepreneurial companies, we show that GVC funding increases the likelihood that companies will receive private venture capital (PVC). Moreover, GVC-funded companies that have received a first round of PVC are at least as likely as other PVC-backed companies to receive a second round of PVC or to be listed or acquired. After ruling out alternative explanations, we interpret these results as positive evidence of GVC firms' abilities in selecting promising companies and certifying them to PVC investors.

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1. Executive summary

The creation of an active VC market has become a priority on the agenda of European policy makers (Da Rin et al., 2006; European Commission, 1998). To achieve this goal, many European governments have established governmental-managed VC (GVC) funds to complement the small supply of private VC (PVC) to high-tech entrepreneurial companies.

Recent studies have shown that the effect of GVC on the performance (i.e., growth, innovation and efficiency) of their portfolio companies is somewhat limited (e.g., Grilli and Murtinu, 2014; Bertoni and Tykvová, 2015; Alperovych et al., 2015), which raises doubts regarding the effectiveness of this type of financing (e.g., Lerner, 2009). However, another potential source of added value that is associated with this initiative is that financing by GVC firms may facilitate the access of their portfolio companies to PVC. If GVC firms can *screen* the market and identify promising entrepreneurial companies, the receipt of GVC financing acts as a “stamp of approval” (Lerner, 2002, p. F78). This endorsement *certifies* the entrepreneurial company's potential to outside investors (including PVC firms), which facilitates the company's access to the PVC market.

Overall, little is known regarding whether GVC firms can screen the market, select promising entrepreneurial companies and certify them to private investors. Several studies at the country and/or industry level have found mixed evidence concerning

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whether the direct provision of public financing to the VC industry increases or crowds out the aggregate pool of PVC investments (e.g., del-Palacio et al., 2012; Jeng and Wells, 2000; Leleux and Surlemont, 2003). However, at the micro level, no studies have specifically investigated whether the alleged positive effect of GVC in stimulating PVC investment can be ascribed to a certification effect.

In this paper, we intend to reduce this gap by investigating whether obtaining GVC financing facilitates a high-tech entrepreneurial company's access to PVC financing because of a certification effect. Our hypotheses also address the GVC's *screening ability*, i.e., GVC's capacity to select promising entrepreneurial companies with the potential of resulting in good investment opportunities for PVC. By offering a better understanding of these issues, this paper attempts to join the important policy debate regarding the effects of governmental efforts to stimulate the PVC industry in Europe (e.g., Cumming, 2013; Da Rin et al., 2006; Lerner, 2009).

The empirical analysis in this study is conducted by using a unique, company-level longitudinal sample of 8277 European high-tech entrepreneurial companies that are extracted from the VICO dataset, which was created as part of the VICO research project, promoted by the European Commission (see www.vicoproject.org). In our sample, 183 companies received their first round of financing from 81 different GVC firms that operate in seven European countries.

Our results show that receiving GVC funding makes an entrepreneurial company three times as likely to receive a first round of PVC. Second, entrepreneurial companies that are selected by GVC investors and then invested by PVC investors have at least the same likelihood to receive a second round of PVC or to have a successful exit as the companies that are directly selected by PVC investors. We interpret these results as positive evidence of GVC firms' abilities to screen the market, select promising companies and certify them to PVC investors.

The implications of our analysis are important for policy makers who are interested in designing effective GVC initiatives. Our work supports the importance of government interventions in the form of direct investments in high-tech entrepreneurial companies. We find that the bulk of value that GVC adds is the result of GVC firms' screening abilities. This finding can have important implications for the design of GVC funds, which should attempt to certify high-potential companies, not enhance the companies' value without the intervention of PVC. Our work has also implications for practitioners. Our results indicate that PVC investors can use the fact that an entrepreneurial company has received GVC as a screening criterion to select good investment opportunities. Finally, entrepreneurs should consider GVC a valuable source of finance that can improve the entrepreneurial company's chances to raise additional funds from private investors.

2. Introduction

Venture capital (VC) is an important source of financing for high-tech entrepreneurial companies (Denis, 2004; Gompers and Lerner, 2001). Moreover, VC investors complement their financial resources with a series of value-added activities – including financial, administrative, marketing, strategic and managerial support (Gorman and Sahlman, 1989; Sahlman, 1990) – that have an overall positive effect on the performance of companies in their portfolios (for a survey, see Da Rin et al., 2011). Although VC has been beneficial to the creation and development of many companies in the U.S. that have grown to employ thousands of people in a few years (e.g., Genentech, Google and Facebook), the VC market in Europe is less developed. Kelly (2011) notes that in Europe VC investments as a percentage of GDP are only one-fourth of the corresponding figure in the U.S. Typically, European high-tech entrepreneurial companies finance new investments with internal funds (Revest and Sapio, 2012) and their growth is threatened by financial constraints (Carpenter and Petersen, 2002a). This observation is troublesome because high-tech entrepreneurial companies are drivers of innovation, efficiency and growth of the countries where they operate (e.g., Audretsch, 1995; Audretsch and Thurik, 2001; Stam and Gamsey, 2008).

The creation of an active VC market has therefore become a priority on the agenda of European policy makers (Da Rin et al., 2006; European Commission, 1998). To achieve this goal, many European governments have established government-owned and managed VC (GVC) funds to complement the small supply of private VC (PVC). Examples of this type of government intervention include GIMV in Belgium, SITRA in Finland, BPI France in France, Piemontech in Italy, Scottish Enterprise in the UK, and Axis Participaciones Empresariales in Spain. Recent studies have shown that the effect of GVC on the performance (i.e., growth, innovation and efficiency) of their portfolio companies is somewhat limited (e.g., Alperovych et al., 2015; Bertoni and Tykvová, 2015; Grilli and Murtinu, 2014), which raises doubts regarding the effectiveness of this type of financing (e.g., Lerner, 2009).

However, another potential source of added value that is associated with this initiative is that financing by GVC firms may facilitate access to PVC for their portfolio companies. Lerner (2002) argues that a rationale for GVC is the *certification hypothesis*. Specifically, if GVC firms can *screen* the market and identify promising entrepreneurial companies that are otherwise neglected by PVC firms, the receipt of GVC financing acts as a “stamp of approval” (Lerner, 2002, p. F78). This endorsement *certifies* an entrepreneurial company's potential to outside investors (including PVC firms), thus facilitating the company's access to the PVC market.

Studies at the country and/or industry level have found mixed evidence concerning whether the direct provision of public financing to the VC industry increases or crowds out the aggregate pool of PVC investments (e.g., del-Palacio et al., 2012; Jeng and Wells, 2000; Leleux and Surlemont, 2003). However, no studies have specifically investigated whether the alleged positive effect of GVC in stimulating PVC investment can be ascribed to a certification effect. To the best of our knowledge, Brander et al. (2015) conducted the only study that provides cross-country evidence regarding the relation between GVC financing and a portfolio company's additional fundraising. However, the study by Brander et al. (2015) is based on a sample that consists exclusively of VC-backed companies and lacks an adequate counterfactual of non-GVC-backed companies. In evaluating the certification role of GVC, we attempt to examine instead whether the companies that receive GVC would have attracted PVC had they not received

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