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THE ATTRACTIVENESS OF DACH FOR LIMITED PARTNERS

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A Bird-eyes View to Global Allocation in VC and PE Assets

Investors in Venture Capital and Private Equity (VC/PE) funds have one key objective: performing transactions with satisfying risk and return ratios. They look globally to achieve their goals, and often set their sight on emerging regions, attracted by high growth expectations. However, building an international Venture Capital and Private Equity program often means venturing into the unknown, where one meets unfamiliar political, legal and economic environments, difficulties to find general partners, and potentially illiquid exit markets alongside different cultures and languages. Although the expected economic growth, and advantages of diversification might appear favorable, the risk of investing in remote regions must be considered. Academic literature submits that vibrant Venture Capital and Private Equity activity exist in countries within a broad institutional context defined by prevailing liquid capital markets, sound economies, and a stable political and socio-economic structure. Further, each country's risk capital market is conditioned, amongst other criteria, by administrative and regulatory burdens, the flexibility of labor markets, and by the legal protection of investors. Clearly, these institutional characteristics vary strongly over countries and regions, and over time. However, the differences are important for the analysis of long-term perspectives in institutional investors' asset allocation processes.

Where to best invest is the motivation of our research project conducted at IESE Business School - Barcelona, sponsored by Ernst & Young and DLA Piper. The purpose of this project is to calculate a composite measure that benchmarks all relevant countries of the world (= 66 countries) with respect to their attractiveness for institutional investors in terms of their international VC/PE asset allocation decision factors. The idea of the composite measure is to take into account all components that determine VC/PE market activity. We observe, especially in many emerging regions, that capital enters quickly, anticipating high economic growth rates. However, the economic development might not be mature enough to secure sufficient quality deal flow, without speaking about exit opportunities. Therefore, VC/PE returns do not match the expectations. Returns might be further sacrificed by week legal protection and legal enforcement possibilities, and we should not forget about cost of corruption. Altogether, we observe that experienced VC/PE managers, banks, M&A boutiques, and deal supporting institutions found branches in emerging countries. Hence, the supply of venture capital and private equity is established. However, quality deal flow does not materialize as hoped, and therefore, the demand for capital lags the supply. With this in mind, we address the attractiveness of 66 countries for limited partners with respect to the financial market infrastructure, and the countries' "ability to absorb the committed capital" hence, the expected deal flow.

For the construction of our composite measure, we need to determine the criteria for vibrant VC/PE markets, and to detect appropriate data to measure them. Further, we need to aggregate the data to the composite measure, which we call "The Global Venture Capital and Private Equity Country Attractiveness Index". We comprehensively review the academic literature for the determination of relevant criteria. Additionally, we run a survey asking 1,079 institutional investors world-wide about the most important factors affecting the attractiveness of countries for their asset allocation decision. We identify six key drivers determining institutional investors' international VC/PE allocation decisions:

1. ***Economic activity:*** *Economic size, prosperity and growth, as well as low inflation and unemployment create deal opportunities in general.*

2. ***Depth of the capital market:*** *Size and liquidity of the public stock market and the M&A market, IPO activity, and bank lending volume are proxies for the state of professionalism of the deal supply side, and likewise determine exit conditions.*

3. ***Taxation:*** *Low taxation, differences between corporate and income tax rates as proxy for incentives for self employment, and implementation of tax rules facilitate any commercial, and also VC/PE activities.*

4. ***Investor protection and corporate governance:*** *Property rights, corporate governance rules, regulation, ease in seeking legal recourse and disclosure requirements keep the financial market transparent.*

5. ***Human and social environment:*** *Literacy, labor market policies, crime, degree of corruption and bribery influence the cost of doing business.*

6. ***Entrepreneurial culture and deal opportunities:*** *Ease of starting and doing business, innovation, bureaucracy and degree of administrative burdens influence the rewards from entrepreneurial activities.*

In principle, we measure the attractiveness of a country by the aforementioned six main criteria using 66 different data series from several data providers like the Global Market Information Database (GMID), World Bank, Heritage Foundation, etc. and aggregate the data with a certain weighting scheme to the overall index. The reviewed literature, our methodology, the data, and the weighting scheme are comprehensively described on our website www.vcpeindex.iese.us. We encourage you to download our report on 66 countries (free of charge).

We find a world-wide ranking of country attractiveness as presented in Figure 1.

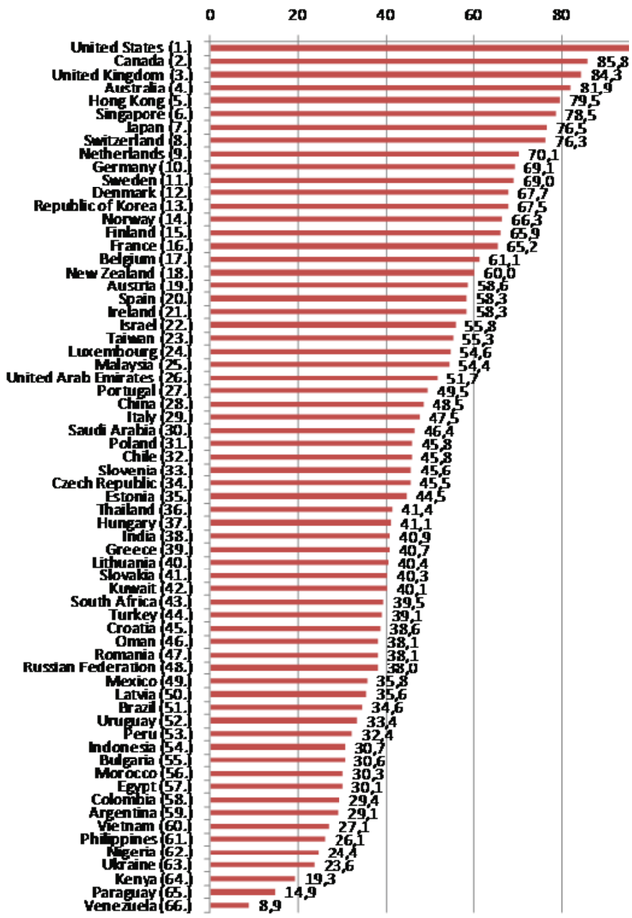

Figure 1: The Global Venture Capital and Private Equity Country Attractiveness Index

It is not a big surprise that the US receives the highest index score. Any other result would be doubtful, considering the origin of VC and PE, and the actual size of the US risk capital market. Therefore, we chose the United States as the reference, and assign 100 points to them for every criterion. Hence, a score higher than 100 for a country implies stronger performance in a particular factor relative to the United States.

Table 1 shows the attractiveness of 8 aggregated regions in terms of their aforementioned characteristics. The global risk capital market can be separated into three parts: developed, transition, and emerging markets.

	Economic Activity	Depth of Capital Market	Taxation	Investor Protection & Corporate Governance	Human & Social Environment	Entrepreneurial Culture & Deal Opportunities
North America	100,3	82,0	100,8	101,1	106,3	99,9
Australasia	95,5	29,7	104,1	107,4	114,5	85,8
Western Europe	93,8	23,3	121,1	90,5	93,3	80,2
Asia	73,9	27,3	116,5	68,1	74,0	37,4
Middle East	72,2	13,8	133,3	66,6	76,4	35,5
Eastern Europe	72,6	9,6	123,6	64,8	69,0	39,8
Latin America	73,6	10,0	112,6	45,8	48,2	29,1
Africa	53,9	10,9	103,6	53,6	48,5	22,2

Table 1: Performance of Regional VC/PE Markets (USA=100 Index Points)

The North American region (including the US and Canada) is characterized by a sound economy, a strong capital market with remarkable distance to its followers, a legal system which protects investors and allows flexible and efficient VC/PE contracting, and a liberal culture which focuses on and encourages commercial activities. There are good reasons why the roots of Venture Capital and Private Equity are in the United States.

Even if Australasia (Australia and New Zealand) and Western Europe hold the economic development status of North America, the lack of liquidity and depth of the capital markets bears one of the major impediments for more risk capital activity.

The (average) capital market infrastructure of Asian countries ranks higher than Western Europe's. However, the region lacks with respect to its institutional framework and human and social environment, according to our index outcomes.

Despite the low scores for their capital markets, Latin American and African countries have strong difficulties to foster an entrepreneurial culture and to strengthen the legal and corporate governance structure. It should be noted however, that while our index covers Latin America almost completely, Africa is represented by only four countries, due to the poor data availability. The average of those four countries certainly biases the African score positively, and hence, lacks representativeness for the whole continent.

The Competitiveness of Western European Countries

Table 2 shows the ranking and the scores of the six key drivers for the Western European countries. Indeed, low liquidity and little sophistication of the capital market (compared to the US) is still an obstacle for more vibrant Venture Capital and Private Equity activity.

	Economic Activity	Depth of Capital Market	Taxation	Investor Protection & Corporate Governance	Human & Social Environment	Entrepreneurial Culture & Deal Opportunities
United Kingdom (rank: 3)	95,8	49,9	115,7	101,6	97,9	90,0
Switzerland (rank: 8)	101,6	28,3	144,6	78,2	119,0	96,5
Netherlands (rank: 9)	101,2	22,1	118,0	93,5	95,6	95,7
Germany (rank: 10)	97,1	23,6	126,6	94,2	90,0	85,1
Sweden (rank: 11)	91,6	20,0	113,7	96,1	103,4	97,8
Denmark (rank: 12)	92,3	14,3	120,5	106,0	120,8	100,1
Norway (rank: 14)	104,6	16,1	115,0	101,0	97,7	93,8
Finland (rank: 15)	90,7	14,5	116,3	102,9	107,4	102,3
France (rank: 16)	95,0	28,8	106,1	83,9	78,3	69,2
Belgium (rank: 17)	91,1	15,2	102,8	92,0	101,8	79,4
Austria (rank: 19)	96,3	11,8	114,7	93,0	103,9	76,1
Spain (rank: 20)	87,7	26,6	104,1	76,4	66,5	57,6
Ireland (rank: 21)	84,4	10,7	143,3	101,6	99,6	78,1
Luxembourg (rank: 24)	92,4	10,1	136,4	94,7	81,1	74,6
Portugal (rank: 27)	81,3	13,2	121,0	72,1	73,0	52,8
Italy (rank: 29)	89,7	17,7	101,6	53,1	52,0	56,3
Greece (rank: 39)	88,5	12,8	120,9	54,2	47,7	36,7

Table 2 : Index Scores of the Western European Countries (USA=100 Index Points)

It is redundant to comment on the excellent ranking of the UK due to the parallels with the US, especially with respect to their legal system. Academic literature comprehensively discusses the influence of legal origins on the state of financial markets and concludes that common law systems historically developed much stronger capital markets. Our Index further submits that Switzerland and Germany rank overall on the 8th and 10th position. The excellent ranks result from the economic activity, well developed capital markets, the transparent legal framework, high innovation capacity, and a strong socio-cultural environment in these countries. The third DACH country Austria ranks overall on the 19th position, primarily caused by its small public capital market, which scores only half of Germany. However, its economic performance as well as the entire institutional and socio-economic framework bears sufficient potential to spur risk capital activity.

Strengths and Weaknesses of DACH, France, and the UK

We disaggregate the six key drivers into their sub-components and show in Figure 2 the performance of more granulated data on DACH, France and the UK. For example, we split the key driver "depth of capital market" in its subcriteria: stock market, IPO market, M&A market, debt and credit market, and the overall sophistication of the financial system.

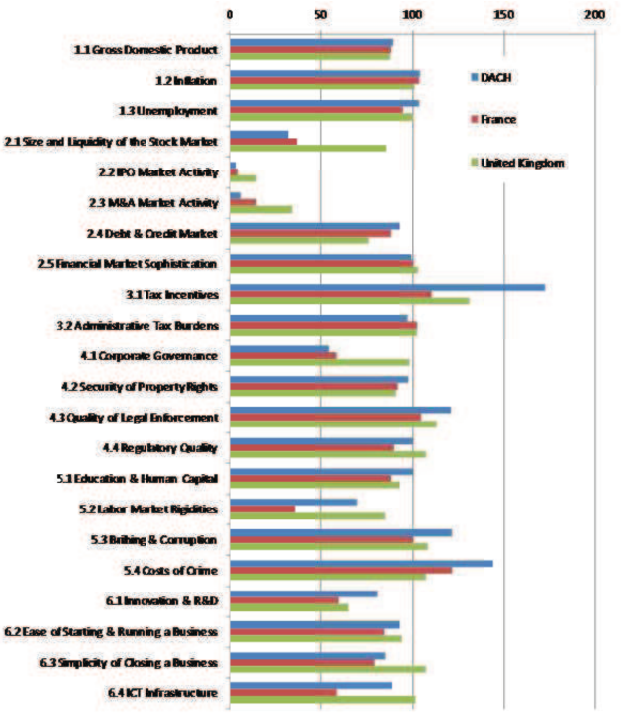

Figure 2: Second Level Data Comparison: DACH, France and United Kingdom (USA=100 Index Points)

The Figure points to the gap with respect to the elements describing the financial market infrastructure and the corporate governance culture between the UK and continental Europe. The causality is obvious: good corporate governance culture establishes investors' confidence, trust, and security, and therefore spurs the development of capital markets.

The strengths of DACH are often characterized by a strong infrastructure and reliable administration, as well as by a cultural attitude towards performance and diligence with low corruption and crime. The data presented in Figure 2 reveals the favorable socio-economic environment and institutional framework with strong legal protection and enforcement, excellent human capital and capacity for innovation. France lags behind with respect to the latter criteria. The French capital market has advanced to the second largest in Europe, though. However, rigid labor market policies, less capacity for innovation, and more difficulties of starting, running and closing businesses (compared to DACH and UK) push France below DACH's rank.

Conclusion

Our composite measure presented above indicates how institutional investors might judge about countries for their international allocation decisions in VC/PE assets using publicly available data. Our proposed index measures six key drivers that affect the attractiveness of national or regional VC and PE markets. We refer to our research study on the internet, www.vcpeindex.iese.us, where we provide detailed information on the data, their aggregation, and much more analyses. In this article, we focus on the DACH region and elaborate its strengths and weaknesses compared to its peers.

The DACH region shows a favorable socio-economic environment and institutional framework with strong legal enforcement, excellent human capital and high capacity for innovation. The financial market infrastructure is not as strong as in France, or in the UK. Its growth expectations are not as high as in emerging markets. However, limited partners consider many more aspects for their allocation decisions, and neither economic growth nor the public capital market infrastructure is the exclusive driver of VC and PE returns. Only countries with top scores in all the key driving forces are able to achieve leading ranks. The DACH region has well-balanced good scores among the six key drivers, and this underlines its strength and high attractiveness for limited partners.

Source: Global Venture Capital and Private Equity Country Attractiveness Index, www.vcpeindex.iese.us

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