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What makes a country attractive to VC investors?

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In the past few years, the venture capital industry has been globalizing at a dramatic pace. Increasingly, funds are being raised internationally and invested globally. Company managers are increasingly looking to venture capital investors to provide the capital, advice and strategic partnerships they need to bring their plans to fruition. Another trend has been the professionalization and maturation of the venture capital industry. Its investment policies, procedures and systems have become refined, formalized and structured over decades of experience. Therefore, it is no surprise that many nations are making greater efforts to encourage venture capital activity, with an eye to boosting innovation and entrepreneurship and to counteract the recessionary impact of the global economic crisis on growth.

As venture capital commercializes innovation, a country's VC market is becoming a cornerstone for its international competitiveness. A vibrant VC market not only provides investment opportunities, it is a key to a nation's survival in a globalized economy. The commercialization of innovative products and ideas contributes to a country's quality employment, economic growth and wealth.

According to our *Global Venture Capital Country Attractiveness Index Study 2009–2010*,[1] the six key factors that shape a country's VC markets and its relative attractiveness are:

- Economic activity
- Entrepreneurial culture
- Depth of a capital market
- Taxation
- Investor protection and corporate governance
- Human and social environment

Economic activity

The economic size and growth of an economy, as well as the wealth of its citizens, influence the number of start-ups. This key driver captures the state of a country's economy (i.e., the GDP, inflation levels and unemployment levels), all of which, intuitively, affect its VC attractiveness. An economy's size is an indicator of the number of corporations and deal flow opportunities. Economic growth should lead to demand for finance. If the economy is growing quickly, more attractive opportunities exist for entrepreneurs.

Entrepreneurial culture and deal opportunities

Access to viable investments is one of the most important factors for the attractiveness of a regional VC market, especially for early-stage or start-up deals. This key driver reflects a country's capacity for innovation and R&D, as well as the ease of starting and running and closing businesses in terms of time, costs and administrative requirements, and the quality of the IT infrastructure. Industrial and academic research and development (R&D) expenditure significantly correlates with VC activity. The innovative capacity of a country and the technical sophistication and literacy of its people affect the need for venture capital.

Depth of capital markets

A well-developed stock market that permits venture capitalists to exit through an initial public offering is crucial for the existence of a vibrant VC market. This key driver captures the size and liquidity of the stock market, level of IPO and M&A and debt and credit market activity. Venture capital firms provide temporary financial support for young businesses, but must divest their exposure and eventually return the proceeds to their investors. For that reason, the divestment conditions must be favorable – that is, the M&A and IPO markets should be liquid.

A bank-centered capital market tends to be less effective in supporting an efficient VC infrastructure not only because it lacks a strong stock market, but also because its secondary institutions compromise entrepreneurial activity, given the bankers' conservative approach to lending and investing and the social and financial factors that reward entrepreneurs less richly and penalize failure more severely.

Investor protection and corporate governance

In general, a strong legal infrastructure, the protection of investor and property rights, robust corporate governance and the presence of deal-supporting institutions, (such as banks, auditors, lawyers and consultants) are important to facilitate VC investments and influence the attractiveness of a VC market. This key driver takes into account the level of corporate governance, security of property rights, quality of legal enforcement and regulatory quality within a country. The legal environment strongly determines the size and extent of a country's capital market and local companies' ability to receive outside financing. Furthermore, experienced law firms, and even more important, a high-quality legal system and law enforcement possibilities are required to handle potential issues in VC contractual obligations.

1 Groh, Alexander and Liechtenstein, Heinrich, *The Global Venture Capital and Private Equity Country Attractivemess Index 2009–2010*, IESE Business School, University of Navarra

Taxation
Lower corporate taxation, more tax incentives and fewer administrative burdens are also crucial for a vibrant VC market. This key driver assesses a country's tax incentives and administrative tax burdens. Corporate tax rates strongly affect entrepreneurship. Greater entrepreneurial activity takes place in countries with lower corporate taxes. Indeed, some countries create start-up incentives by taxing personal income higher than corporate income. On the other hand, less entrepreneurial activity emerges from countries where the government poses substantial hurdles that increase administrative efforts and start-up costs for entrepreneurs.

Human and social environment
National culture shapes both individual orientation and environmental conditions, which lead to different levels of entrepreneurial activity in particular countries. This key driver incorporates the quality of education and human capital, labor market rigidities, levels of bribery and corruption and costs of crime within a nation. In order to foster a growing risk capital industry, research culture, especially in universities and laboratives, plays an important role. Rigid labor market policies negatively affect the evolution of a VC market. To allow entrepreneurs and VCs to harvest the fruits of their efforts, the costs and efforts needed to recruit, hire and lay off employees must not be so high as to be discouraging. Finally, the highest societal barriers and costs for start-ups in different countries are associated with corruption, crime, a larger unofficial economy and bureaucratic delay.

Our study demonstrates that, not surprisingly, the United States is the most attractive country for VC, and maintains the highest level of VC activity in the world, largely because it harbors the conditions most conducive to vibrant national VC markets.

In order to facilitate direct comparison among all the countries, the US was chosen as the benchmark, with its index score set to 100. Such a ranking may be open to debate. Nonetheless, the index is a result of high-quality, commonly available, aggregated, current socioeconomic data. Our ranking can be traced to the level of the individual data series and hence, can be confirmed.

A typical pattern emerges in that the US VC market dominates all others. We then benchmarked the US with three other countries noted for their innovativeness, namely, Germany, Finland and Israel. (Even when other countries were chosen, the pattern still more or less remains the same, with the domination of the US.)

Figure 2 reveals that the US ranks ahead of all other countries except Finland with respect to all key drivers except taxation. (Finland leads the world and scores higher than the US in its entrepreneurial culture, its human and social environment, its investor protection and corporate governance system and its entrepreneurial culture and resulting VC deal opportunities.)

Nonetheless, the criterion that most affects the level of VC activity and explains the dominance of the US venture capital industry is the general depth of its capital markets, so crucial for the establishment of a deal- and exit-supporting infrastructure, and the strength of its legislation and enforcement with respect to investor protection and corporate governance.

Methodology
The Global Venture Capital Country Attractiveness Index assesses the key drivers shaping national VC markets. Specifically, it benchmarks countries with respect to their attractiveness for institutional investors and the key criteria on which they base their international VC allocation decisions. This research project was undertaken at IESE Business School in Barcelona, Spain, with support from Ernst & Young.

The most important principle of our index is to measure the attractiveness of a country by these six "latent drivers." The choice of these criteria is based on our own experience, an extensive review of academic literature and a survey undertaken among limited partners.

Since none of the key drivers is directly measurable, to express them, we disaggregated them, found the best possible proxies, aggregated 60 different data series and created one single index score. Next, a composite measure that takes into account all relevant aspects for national VC markets and extracts a country ranking was calculated. For as many countries as possible, a data series with appropriate proxies for the key drivers shaping national VC markets was sought. Data that shared common characteristics and determined the key driver values via these groups were grouped together.

Our index has two caveats: unfortunately, we cannot include small regional clusters simply because of the unavailability of the required data. In addition, we do not focus on the competition among VCs because it is too vague to estimate.

Figure 1 presents a ranking of the 20 countries covered. The selection of our sample countries is purely driven by the availability of data. More details of the approach, the exact index structure, the weighting scheme and descriptions of the data series used can be downloaded from *www.vcpeindex.iese.us*.

Our analysis can be broken down to a more granulated data level to provide further details to support the detected pattern.

Figure 3 points, once more, to the wide lead that the US holds over other countries in the strength of its capital markets. While there are many economically strong nations with vibrant entrepreneurial cultures, human capital and social environment, again, the most decisive drivers are the depth of the capital markets, and level of investor protection and corporate governance. Common law countries dominate all others with regard to these variables. All strong countries show high scores for investor protection and corporate governance, which likewise spurs the development of a national capital market – so crucial for the establishment of VC and PE deal-supporting institutions.

BRIC countries lack the strong entrepreneurial culture and investor protection necessary for strong VC markets

Currently, much institutional capital flows into emerging VC markets, notably to India and China. Without any doubt, the expected economic growth and the resulting opportunities justify exposure there. China and India have developed strong capital and M&A markets recently, which creates encouraging prospects for VC activity. Figure 4 provides the key driver scores for the BRIC countries – Brazil, Russia, India and China – to provide more insight into the prospects for VC activity in the largest emerging regions.

Figure 4 benchmarks the BRIC countries and also implicitly benchmarks the US, which represents 100 points in every individual key driver. The results show the strength of India's and China's capital markets (relative to the German market, for example, from Figure 2). In these BRIC countries, a wide variety of market opportunities have arisen as a result of rapid economic growth (measured in recent growth rates, overall economic size, wealth, inflation and unemployment), depth of talent and capital markets.

Figure 1. Country rankings: the US leads the world in the vibrancy of its VC markets by a wide margin

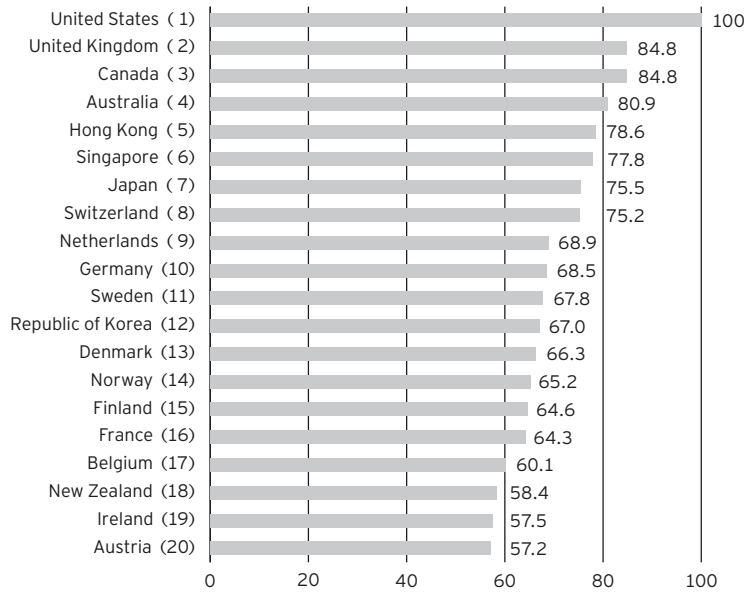
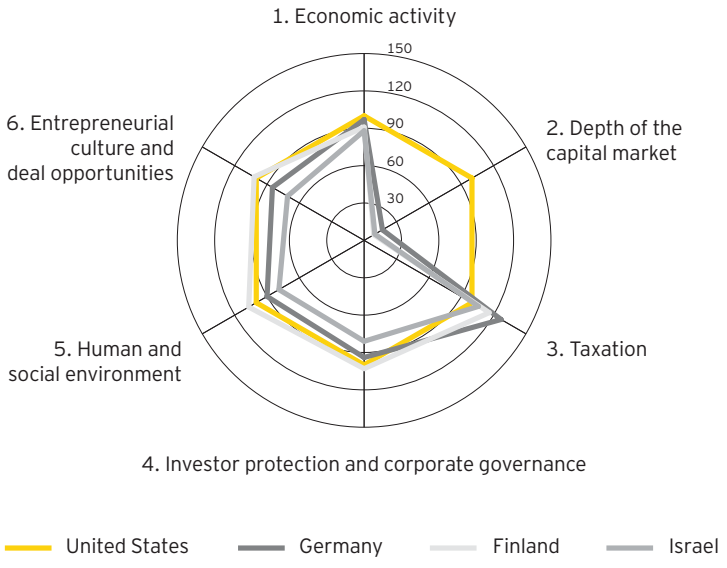
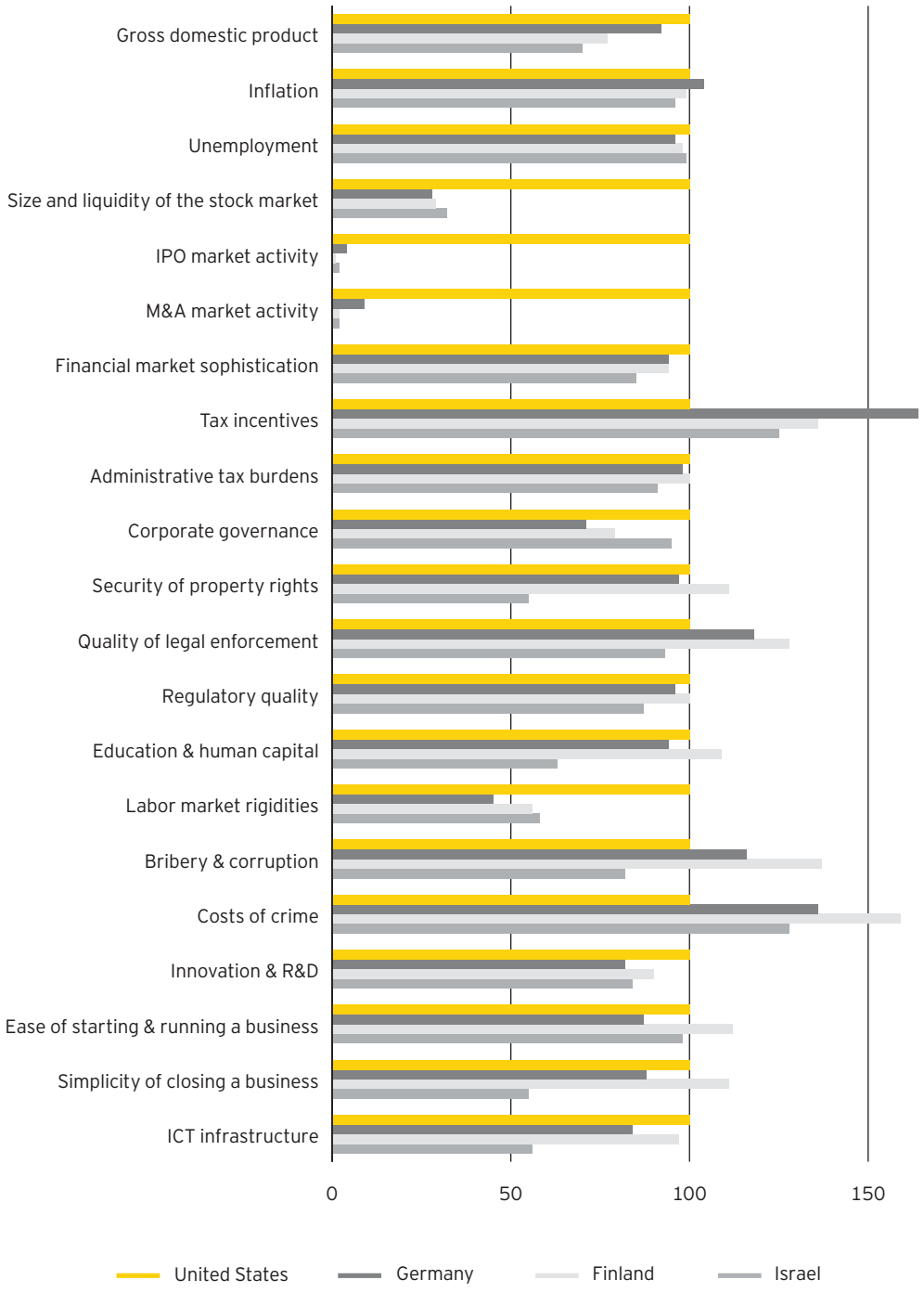


Figure 2. Six key driving forces: comparison of the US, Germany, Finland and Israel. Deep capital markets and strong investor protection and corporate governance levels are the two key drivers for VC attractiveness



Source: Global Venture Capital and Private Equity Country Attractiveness Index 2009–2010

Figure 3. Level 2 criteria: comparison of US, Germany, Finland and Israel



Source: Global Venture Capital and Private Equity Country Attractiveness Index 2009–2010

However, despite their relatively strong economic activity, some important ingredients for a vibrant VC market are lacking in BRIC countries – namely, entrepreneurial cultures and investor protection/corporate governance. BRIC countries achieved disappointing scores for the key driver, entrepreneurial culture, which mainly captures countries' capacity for innovation and the ease of starting and running businesses. In other words, few disruptive technologies and little intellectual property from VC-backed corporations are likely to emerge from these countries. Rather, investors focus on capitalizing the expected growth of established business models or on infrastructure requirements.

Additionally, the scores for investor protection and corporate governance also remain disappointing. Unlike strategic investors that form joint ventures and contribute managers to their remote partners, VC funds usually rely fully on their investees' managers and need a reliable domestic partner and a management team that is attuned to the demands of government. Without a proper protection of VC fund rights, and with weak law enforcement and a lack of legal measures to control investees, VC investments can be challenging.

Conclusion: strong investor protection leads to liquid capital markets and deal flow and exit opportunities, which ultimately affects the attractiveness of a country's VC markets

We can conclude that strong investor protection leads to liquid and efficient capital markets, and these establish the necessary environment to secure deal flow and exit opportunities for VC funds. This ultimately affects a country's attractiveness for institutional investments in the VC class. However, this discussion reflects the capital supply side only. Without a sufficient entrepreneurial culture and entrepreneurial opportunities, with rigid labor markets, bribery and corruption, there will be no demand for VC. If there is no demand, there is no opportunity to establish a vibrant VC market.

Figure 4. Comparison of BRIC countries

Source: Global Venture Capital and Private Equity Country Attractiveness Index 2009–2010