The rapid internationalisation of the venture capital market and implications to policy: The case of the United Kingdom

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Abstract

Venture capital (VC) – which we define as independently managed, dedicated pools of capital that focus on equity and equity-linked investments in privately-held, high growth companies (Lerner, 2009) - plays a critical role in technological innovation and regional development (Florida and Kenney, 1988). A study by Lerner et al. (2011) showed that around half of European and one third of US based funds invest abroad. It is often argued that the significant number of VC funds that participate in foreign investment activities is mainly stimulated by demand for quality deals outside theirs borders (Devigne et al., 2013).

This increased foreign VC (FVC hereafter) investment activity has direct implications to both the enterprise receiving foreign investment and the locality in which the enterprise is based. On one hand, international investors add value to private entrepreneurial firms through increased access to capital, knowledge and experience in foreign deals, and access to international network and markets (Tykvova and Schertler, 2014). On the other hand, capital inflow from FVC funds compensate for the shortage of local VC supply (Schertler and Tykvova, 2012) and stimulate domestic markets through the creation of exit opportunities in a foreign market (Makela and Maula, 2005).

This paper has three distinctive objectives. First, it explores whether the regional heterogeneity identified by the literature in terms of the volume and nature of regional VC investments is also reflected on the FVC investments. Second, it investigates what attracts FVCs in a particular region. Third, it questions whether increased level of dependency on foreign venture capital matters for regional development.

This study contributes to the existing literature on the geography of venture capital by empirically investigating the regional distribution of FVC investments and by exploring regional attractiveness to foreign funds, building on the premises of agency and social capital theory. The findings of this research have important implications for practitioners (VC fund managers and entrepreneurs), policy makers and scholars.

Foreign venture capital investments

Various scholars have previously investigated the reasons VC funds invest outside their national boundaries. For example, Schertler and Tykvova (2012) explain that VC funds often invest abroad for the purpose of exploiting differences in risk-adjusted expected returns between their home country and the portfolio companies' country, with deal flow considerations and value-adding activities as additional reasons.

Regional economic development

Florida and Kenney (1988) identified that VC investments are unevenly distributed across regions both in terms of the location of firm/resources and flow of investment. This is also evident in the United Kingdom where VC investments are not evenly distributed across regions (Mason, 2007). Although a relatively even or 'fairer' distribution of FVC investments to UK regions may benefit companies based throughout the country, Makela and Maula (2005) suggests that while FVC investment support with internalisation of backed companies, they tend to drive backed companies towards their home markets, and this could be of disadvantage especially if the target market is different from the home market.

Agency and social network theory

Fried and Hisrich, (1994) posits that FVC funds play the role of information agents through which they certify the quality of their portfolio companies in home markets. Zaheer and Masakowski, (1997) indicates that the presence of FVC investors helps lower the barrier of going public and reduces the liability of foreignness.

Clearly, FVC investments have a positive effect to both portfolio companies and the regional economy but for FVC activity to flourish, social networks, close ties and proximity between VC funds and investment targets seems to be crucial. In this regard, there is a major gap in the existing evidence base of the volume of FVC investments in the UK that research reported in this paper aims to fill.

Methodology

This study uses data from Thomson One database and focuses on a 15 year period, between *2002 and 2017*. Thomson One is one of the largest VC deals database used for accessing information, market data and financial data on VC backed companies (Schertler and Tykvova, 2011).

Results

Overall, the findings of this study suggests that there is a large regional heterogeneity in the UK VC market and while around half of London, East of England and Southeast England based companies attract foreign investors, only a small proportion of companies based in Northern regions and the Midlands do so. In addition, there is a relatively large number of standalone FVC investments (i.e. investments made without a local co-investor) especially in those region which are dominated by public backed investments.

This leads to an obvious concluding question: *what are the implications of FVC investments for regional development?* For the host region, this increase in the supply of VC finance has positive impact such as improving employment, innovation and productivity growth (Brander et al. 2015). However, by being located in another country, a foreign investor lacks geographical proximity with its portfolio companies and this has implications for both the portfolio company and the region the company is based in. First, VC money is smart money (Sørensen, 2007) as investor actively support the company to grow with hands on involvement and regular interaction (Pierrakis and Saridakis, 2017). Due to geographical distance, it is much harder for foreign funds to offer hands on support to their UK based portfolio companies compared with the local funds (Chen et al., 2010). To address this issue, VC suppliers frequently syndicate investments in distant portfolio firms with partners who are more closely located (Fritsch and Schilder, 2008). However, our results show that in several UK regions around half of all FVC investments are stand-alone investments while even when FVC funds co-invest with UK based funds, these funds are often based in London rather than the region where the company is based in.

Venture capital funds are an integral part of the regional innovation ecosystem (Mason and Brown, 2014) as they are able to mobilise different innovation players for the benefit of their portfolio companies (Pierrakis and Saridakis, 2017). However, foreign funds lack local knowledge and connections and their contribution to the local ecosystem could therefore be questionable. In addition, foreign investors may crowd out local investors and this could slow the growth of local VC markets and entrepreneurial ecosystems (Bradley et al., 2019). Local GPs may be considered as second best by the local 'star entrepreneurs' and hence they may ‘lose out’ to the foreign investors in their bid to invest in promising local companies (which are arguably limited in numbers in peripheral regions).

Another important concern is that foreign investor often require that companies relocate to the fund’s country of origin either at the early stage of funding or during the scale up period (Mäkelä and Maula, 2005), as often relocations yield higher returns relative to staying in their country of origin (Cumming et al., 2009). This has significant and negative implications to the host region as it results to brain drain and loss of employment. However, how much relocation of portfolio companies to their investors’ country of origin actually happens, is largely a function of how strong the domestic ecosystem is (Bradley et al, 2019). As Bradley et al., 2019 put it: *“entrepreneurs in stronger ecosystems have more power to negotiate with foreign investors and may find it easier to resist calls for relocation by foreign investors”* (p. 29).

The existence of a vibrant ecosystem in London may balance out the potential concerns resulted from London’s heavy dependency on FVC funds. In contrasts, regions with less vibrant ecosystem are more vulnerable to the risks associated with FVC investments. The above concerns call for a balanced approached when policy makers at the national and regional level explore ways of encouraging FVC investments. A coherent policy approach should not be limited to only attracting foreign investors, but it should also seek to strengthen the domestic ecosystem at the same time (Bradley et al., 2019). The efforts of the regional authorities should focus on attracting FVC investments that are closely linked with the regional industrial strengths and aligned with their regional development strategy. They should also encourage co-investments with local funds at the expense of stand-alone investments by foreign funds.

There are several ways in which national and regional policy makers could approach this matter. At the national level, the British Bank through its Enterprise Capital Fund scheme could encourage industry targeted foreign co-investments with local funds. This can be done either at the fundraising level (e.g. incentives are offered to a foreign GP to raise a fund together with a local GP) or at the deal level (e.g. incentives are offered for local funds to co-invest with high quality foreign funds). In addition, improving the quality of local GPs, which are often publicly backed (Mason and Pierrakis, 2013) will minimise the need of foreign funds to choose London based funds as preferred co-investors. At the regional level, authorities may organise networking opportunities to expose local GPs to international counterparts and improve flow of information between local and foreign based funds as the local investor's international social capital facilitates the formation of cross-border syndicates (Mäkelä and Maula, 2008).