Summary

# Government measures in venture capital provision (RiR 2014:01)

SWEDISH NATIONAL AUDIT OFFICE

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# Government measures in venture capital provision

The Swedish National Audit Office has investigated if the government measures for venture capital provision meet the objectives that the Government has expressed in bills and other written communications to the Riksdag.

## Audit background

*Reasons:* Several state-owned companies and foundations are tasked with improving the provision of capital for private companies. In total there is around SEK 10 billion in government funds intended for investments in ownership capital, of which half has been added in the last five years. These numbers do not include the investments in the venture capital market made by the Sixth AP Fund.

This system of various government actors has grown over time and has been criticised for having insufficient transparency and overlapping operations. An important principle of government venture capital management is that the government measures should supplement the market rather than crowding out private services and companies. At the same time, several government actors have market-based required returns, either directly or indirectly through requirements for co-financing on equal grounds with private actors. This potential for conflicting objectives with the State's market supplementing role has caused the National Audit Office to reason that an audit is required. Another reason for the audit is that is can be questioned if it is efficient for several government actors to offer similar services.

*Aim:* The aim of the audit is to determine if the government venture capital provision is designed in a way that meets the objectives expressed by the Government in bills and other written communications to the Riksdag. The object of the audit is the Government.

*Implementation:* The audit has been conducted based on observations of how the government capital provision measures work in practice. The work has included interviews with key persons among the relevant government venture capital actors and with industry representatives, as well as document studies of bills, owner directives, annual reports etc.

The objectives, required returns and operations of the government actors have been compared to the Government and Riksdag's general principles for government company financing.

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## Audit results

The National Audit Office's overall conclusion is that the system for government venture capital provision that has been developed over the years is difficult to grasp in its entirety and that it fails to meet the overall objectives expressed by the Government. The principle behind government measures intended to promote company development is to compensate for shortcomings in the market that may impede the industry's development capabilities and competitiveness. When it comes to providing additional ownership capital, the State's market supplementing role should primarily consist of increasing the supply of venture capital in early investment phases where private actors are not participating to a sufficient degree. The Government's actual steering of the state-owner venture capital actors does now, however, primarily focus on the capital reaching this segment. Instead, the Government has placed great emphasis on the capital being allocated to certain geographical areas and sectors. Industry and sector-limited actors such as Inlandsinnovation, Fouriertransform and Almi Invest constitute upwards of 60 per cent of the government venture capital supply, which in total amounts to around SEK 10 billion.

The audit is limited to venture capital operations conducted with government funds, but should be seen in a wider context of political tools that the State can use to increase the supply of financing for new and growing companies, such as tax relief, grants, loans and guarantees. Broad measures that aim to create more stable framework conditions for industry or improved human capital to increase the demand for capital are also included in these tools.

### *The state-owned venture capital actors' required returns cannot be reconciled with the State's supplementary role in the market*

The National Audit Office notes that there is an inherent conflict of objectives in the Government's guidelines for company financing. In Bill 2009/10:48, the Government states that the required return for state-owned market-supplementing financing actors shall be set at a low level. At the same time, when it comes to ownership capital they are to operate on the same terms as private actors, which in practice means that individual investments have market-based required returns. According to the Government, risk sharing on equal grounds with private actors leads to the total financing supply being easier to direct towards early or sensitive investment phases. However, the National Audit Office notes that a relatively large share of the public venture capital is invested in the parts of the venture capital market where private actors are most active and in companies that have reached a fairly advanced stage of their development. Information about new investments that the National Audit Office has collected from the biggest state-owned actors shows that companies still in their start-up phase received 27 per cent of the government venture capital during the audited period (excluding the Sixth AP Fund). Companies in the seed stage only received 0.2 per cent. Over 40 per cent of the government capital was invested in companies in expansion phases and in mature companies.

The various government measures that aim to supplement the supply not met by the private market can generally be divided into two categories. One includes direct investments in very early stages of a company, where the State must be prepared for its capital to be diminished over time. The other category consists of various ways of stimulating private capital to direct itself towards earlier stages. This can either be done by joint investments with private actors, through indirect government investments via private funds or through subsidies in the form of deductions or guarantees for private investors. If the State wants to stimulate investments in earlier stages through joint investing or investing in private funds, the National Audit Office believes that this cannot be done on the same terms as for private actors. Instead the State's terms should be adjusted in favour of the private investors, for them to be willing to expose themselves to greater risk. In theory, the State subsidies to private investors shall be offset by the public economy gains that the State expects from the deal. This must be reflected in the state-owned actors' missions and objectives.

*Indications that government measures are crowding out private capital*

It is impossible to decide on empirical grounds to what extent government venture capital is crowding out private venture capital, but there are indications that this is the case. The National Audit Office notes that over 40 per cent of the state capital (excluding the Sixth AP Fund) is invested in companies that are in expansion phases or in mature companies. The risk of crowding out capital increases when state-owned actors are active in the same arena as private actors. The fact that the boards of some state-owned actors have wished to avoid losses in individual investments also speaks in favour of the state capital crowding out private capital to some extent. However, we do not believe that we have enough data to estimate the scope of these effects.

*The government capital provision measures can become more efficient*

The audit shows that there are several cases of overlapping operations in the government venture capital provision measures. The government venture capital measures have been based on various factors at different points in time, which has resulted in today's complicated system. The National Audit Office has also noted that the system of having several state-owned actors who have received major initial capital from the State means that the system has a very high degree of total liquidity. In total, the various units that are primarily working with venture capital investments in companies not quoted on the stock exchange have around SEK 6.5 billion allocated for short-term capital placement as liquidity reserve for its regular operations. If we, as an experiment, assume that the state-owned actors have a total need for liquidity of SEK 5 billion (50 per cent of the total reserved capital for venture capital investments), the annual borrowing cost for this reserve is

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around SEK 150 million. The National Audit Office believes that it would be more cost efficient, and allow for more effective economising of government funds, to borrow and add any new capital as the need for capital arises, i.e. when the state-owned actors carry out their investments. From a budget technical standpoint, this cannot currently be done as each new investment decision would affect the State's need to borrow money. A new approach therefore requires regulations to be revised.

Finally, the National Audit Office notes that the administration costs vary significantly between the various state-owned actors. As the actors have partially differing focus and are at various stages, it is hard to draw any general conclusions regarding the scope of the costs. To be able to determine what is a reasonable level for administrative costs, an individual audit of the operations is needed for each of the actors. Only Industrifonden and the ownership capital that Sweden invests within the scope of the EU's structural fund programmes currently have cost-efficiency objectives. The National Audit Office believes that all state-owned venture capital actors should have specific objectives regarding the size of administration costs, based on the operations being conducted.

## The Swedish National Audit Office's recommendations

The National Audit Office recommends that the Government review the system of state venture capital and clarify what the system is to achieve and the forms in which this should be done.

*The Government should:*

- Review the number of state-owned venture capital actors and clarify the various actors' internal roles so that the Riksdag's intentions are fulfilled both regarding general company financing and regional and sector policy.
- Adapt the state-owned venture capital actors' terms in joint investments or investments in private funds, so that private actors are motivated to direct their funding at earlier stages in companies' development.
- To ensure cost-efficient operations, the Government, directly or indirectly via the boards, should introduce specific objectives for administrative costs for the various state-owned venture capital actors.
- If the Government wishes to issue new capital to existing or future funds, this should be done by issuing the capital as the need for investment arises.