VENTURE CAPITAL

# Funding to reach €3 billion

*With a combination of funding available to Irish venture capital (VC) companies and internatic the next five years, says Michael Donnelly. He argues that with the right legislative interventi*

Going into 2008 the outlook for venture capital funding remains positive. Irish venture capital companies are on track to have up to €1.4 billion available for investment in Irish industry. These funds are likely to attract international co-investment of €1.6 billion during the course of their four to five year investment cycle, making about €3 billion in total over five years. Having in excess of €500 million a year available for investment is very positive news for anyone looking to raise investment capital.

**Michael Donnelly**

And this funding is essential if Ireland is deliver on the Government's objective of creating a knowledge-based economy. This has been brought into even starker perspective as the country's overdependence on property and the impact of a slowdown in the construction industry as repercussions on taxation revenue and employment.

In the last year we have also seen the continuing haemorrhage of jobs into low cost centres in Eastern Europe, India and China. So the goal of creating our own indigenous knowledge-based economy becomes even more of a priority.

Research conducted by the Smurfit Graduate School of Business at UCD (Economic Impact Study IVCA, Feb 2007) has found that the Irish Venture Capital Associtaion (IVCA) backed companies mirror the requirements of a knowledge-based economy. The Economic Impact Study showed that expenditure by IVCA backed companies represents 23 per cent of the total Irish indigenous spend on research and development. The UCD study, showed that in venture capital (VC) backed companies, graduates represented 74 per cent of the workforce, increased revenues in the Republic of Ireland by 81 per cent, increased exports year on year by 6 per cent and had total revenues €1.95 billion.

High technology companies accounted for 84 per cent of all investment. This is the highest weighting in Europe, where the average is 17 per cent. Thirty four per cent of this capital was invested in start-up and early stage companies compared to a European average of 23 per cent. The EIS is unique in that it is not a survey which only gives indicative results but is a census of all VC backed companies.

VC and private equity (PE) funds provide cash to develop and grow unquoted companies. PE investment funds draw down monies on a deal by deal basis, whereas VC funds are a subset of overall PE where the VC fund's limited partners (LP) participate at 'arms-length' in all investments made by the VC fund.

The VC fund sources its LP investors from banks, pension funds, Government agencies and private individuals. The VC fund takes a stake in the business in return for the cash invested. The VC investment is unsecured and is fully at risk. VC is typically the only source of funding for knowledge-based business which does not have revenues to service debt.

The majority of the thousand plus knowledge-based businesses which have grown successfully in Ireland over the last 10 years were financed by VC. VC backed companies start out as the 'embryos' which ultimately become the companies which attract institutional investors to become major international players in their sectors.

In comparison to the US and the rest of Europe, we have a relatively young but successful VC industry in Ireland. The IVCA, which represents Irish VC members, was established in 1985. There were only a small number of investments made prior to the establishment of the first generation '1994 funds' which had combined commitments of €118 million. Most of this was invested between 1995 and 1999.

In an analysis of the performance of these funds over the period of 1994 -2005 by Frank O'Brien and Brian O'Loughlin of Investment Faculty Ireland these '1994 Funds' generated an internal rate of return (IRR) of 15.7 per cent (according to Investment Faculty Ireland, November 2006). This is well above the 9.4 per cent IRR of all European venture funds during the same period.

Currently the IVCA has 19 full members which represents 95 per cent of the €1.2 billion invested between 2000 and 2006. While there is no published IRR available yet for these funds, the fact that the majority of these funds are completing next generation funds reflects the confidence of their existing LP's. These new second and third generation funds are targeting to close at the €1.4 billion level.

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# lion in Ireland in 2008

*and international co-investemnt, the VC industry in Ireland could have €3 billion available over ive intervention and tax regime, Ireland could become a world leader in the sector.*

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has become a very active lobbying organisation for the industry and has had direct influence on policy development. It has also undertaken a number of analyses of its portfolio companies. The Economic Impact Study initiated in 2005 clearly provided strong evidence of the contribution which VC is having on the development of the knowledge-based economy and to the achievement of public policy objectives.

The massive investment in infrastructure, which began with the PRTLI awards and Enterprise Ireland's support of research and development programmes and innovation facilities on the campuses of all third level colleges, coupled with large awards from the newly established Science Foundation Ireland, is now starting to yield results with commercial potential. The significant increase in the number of US patents issued to inventors with an Irish address who do not work for a multinational is clear evidence of this. Although coming from a small base, the annual rate of increase in US patents since 1998 has been 200 per cent. During the same period, the US and the UK were static with India at 400 per cent outstripping Ireland, Israel and Finland who are all pursuing similar economic trends at 50 per cent.

Another key indicator that we have the potential to take full advantage of this research investment is the annual US National Science Foundation (NSF) analysis of which countries are developing the capabilities to be the new high-technology exporters. The study assesses a country's potential to become important exporters of high technology products during the next 15 years. The indicators are:

- National orientation - evidence that a nation is taking action to become technologically competitive, as indicated by explicit or implicit national strategies involving cooperation between the public and private sectors
- Socio-economic infrastructure - indicators include the existence of dynamic capital markets, upward trends in capital formation, rising levels of foreign investment, and national investments in education
- Technological infrastructure - the social and economic institutions that contribute directly to a nation's ability to develop, produce, and market new technology. Indicators include the existence of a system for the protection of intellectual property rights; the extent to which research and development (R&D) activities relate to industrial application, competency in high-technology manufacturing; and the capability to produce qualified scientists and engineers
- Productive capacity - the physical and human resources devoted to manufacturing products and the efficiency with which those resources are used. Indicators include the current level of high-technology production, the quality and productivity of the labour force including the presence of skilled labour

In the most recent study by the NSF, published in 2006, Ireland ranked third behind Israel and China.

The VC industry has seen steady annual growth with first generation '1994 funds' placing around €25 million, second generation '2000 funds' moving to a level of over €200 million and the third generation '2007 funds' expected to reach a level of over €300 million. With the participation of international co-investors we can expect to see a very vibrant indigenous pool of business finance to become international players in their markets.

We can expect to see further increases to the development of strong Irish based international companies who can fill the potential gap created by fall-off in the levels of foreign direct investment in our economy, wth the developing pipeline based on infrastructure investment by Government and the next generation of VC funds with resources to take companies to the international stage.

We should consider at Government and the private sector level, how appropriate changes in legislation and the tax regime could set the stage for Dublin and Ireland to become /the/ hub for the European VC industry. Ireland has been successful in achieving world class status in financial services in the IFSC and in medical devices and pharmaceuticals across the entire island by taking strategic views and putting executable plans in place. There is no reason why in 15-20 years we can't have the same recognition for VC.

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