Nesta...

UNCHAINING INVESTMENT

Barriers to US venture investment in UK Internet and digital businesses

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1 INTRODUCTION

The UK still lags behind the US in VC investment and performance

Venture capital investment in the UK was $2.3 billion in 2012, compared to $41 billion in the US. This means UK venture investment was 6 per cent of that in the US, despite having 20 per cent of the population and 16 per cent of the GDP. When measured as a proportion of GDP, UK venture capital is less than half the size of the US industry.

Returns of UK venture funds are also worse than those of their US counterparts. Nesta's research report *Atlantic Drift* published in 2010[1], showed that this gap was very large in the 1990s but had narrowed in the 2000s. The new evidence presented in this report shows that this gap is starting to grow again.

Venture capital forms a very small part of the market for business finance, yet it plays an important role in supporting innovation and risk in early-stage companies. A wide range of research has shown that venture capital helps firms to invest more, grow more quickly, sustain long-term performance,[2] obtain higher valuations at exit[3] and bring radical innovations to market faster.[4]

Forthcoming research[5] from Nesta confirms that UK VC-backed firms are larger and have higher growth rates when compared to similar aged non-VC backed companies. While only 7 per cent of UK firms achieve high growth* over a three year period, 20 per cent of VC-backed firms do.

The UK venture market has struggled for years with the perception of being a smaller, less successful cousin to the US market. The UK and Europe missed out on the outsized returns of the late 90s but participated fully in the excesses of the bubble. And so they acquired a reputation for poor returns that has been hard to shake. This has contributed to a perceived shortage of risk capital available to UK start-ups.

About this report

Attracting investment from the US brings the joint benefit of access to new pools of capital as well as the experience of the investors that disperse them. This report examines which factors influence US funds' decisions to invest in UK start-ups, with a particular focus on the role that regulation might play in encouraging or discouraging US venture investments in the UK.

Using a unique venture fund database, Section 2 describes the current state of UK venture capital investment and its recent performance, while Section 3 briefly examines the role of US investors.

Section 4 outlines the possible explanations for the performance gap between UK and US funds. From this analysis, exit markets and the environment for start-ups emerge as the most important factors.

We then examine the perceptions of US and UK investors on the regulatory environment within which UK digital start-ups operate. We look particularly at investor views of regulation as a contributor to their decisions to invest. We have restricted the review of regulations to Internet and digital start-ups only, which represent 33 per cent of recent venture capital investments in the UK. Other significant segments, such as biotech and energy, have different regulatory environments from other industries, and therefore have been excluded from this analysis.

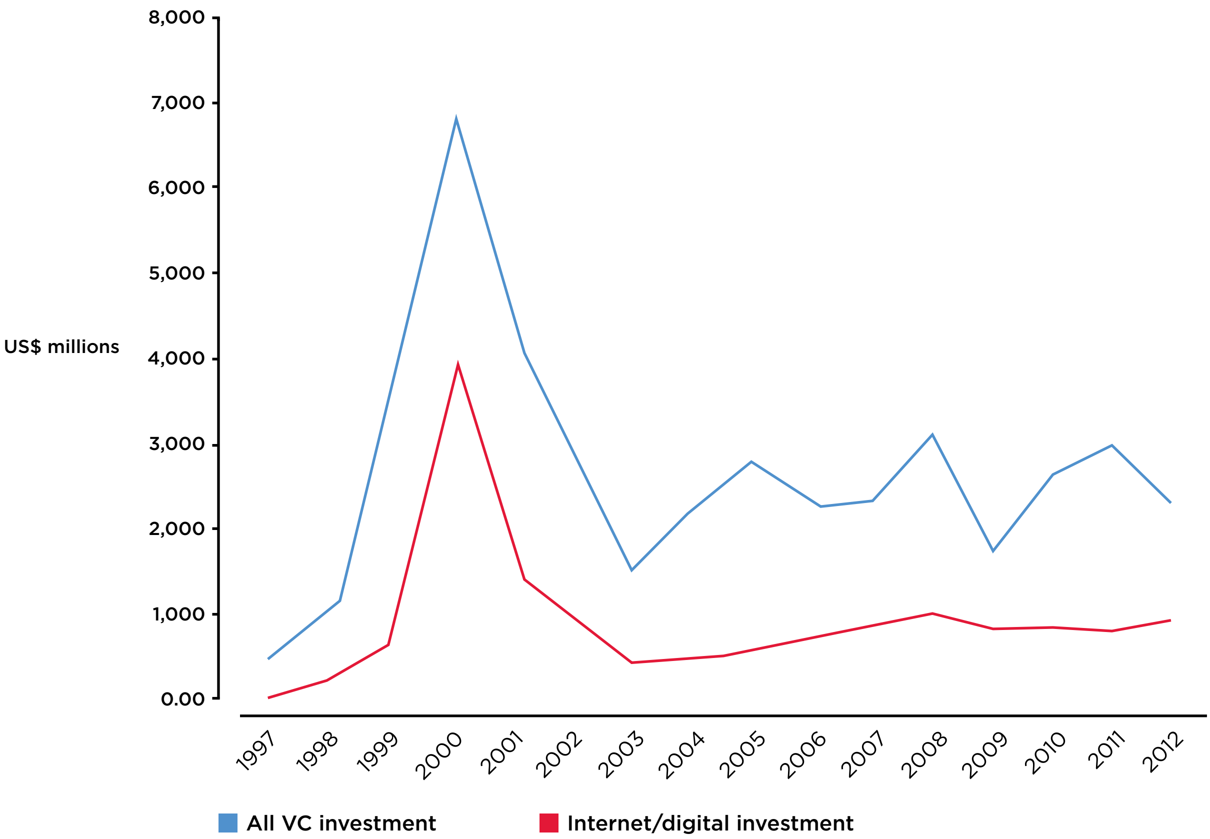
*Achieved an annual growth in employment of at least 20 per cent.

METHODOLOGY

This report combines quantitative and qualitative analysis to understand the causes for the UK–US investment and performance gap. First, it updates the regression analysis of venture capital performance undertaken in our previous report, *Atlantic Drift*,[1] with more recent data. The data is drawn principally from Thomson One and Preqin, with some other supplementary datasets. For a full explanation of the data and methods used for this analysis, please see the original report.

Second, we conducted interviews with 27 investors, start–up companies and accelerators to understand their perceptions and views on the US–UK divide, and their experiences of regulation. Their views are quoted from transcripts of the interviews throughout the report, and attributed wherever possible.

Figure 1: **Trends in UK venture capital investment into UK companies**



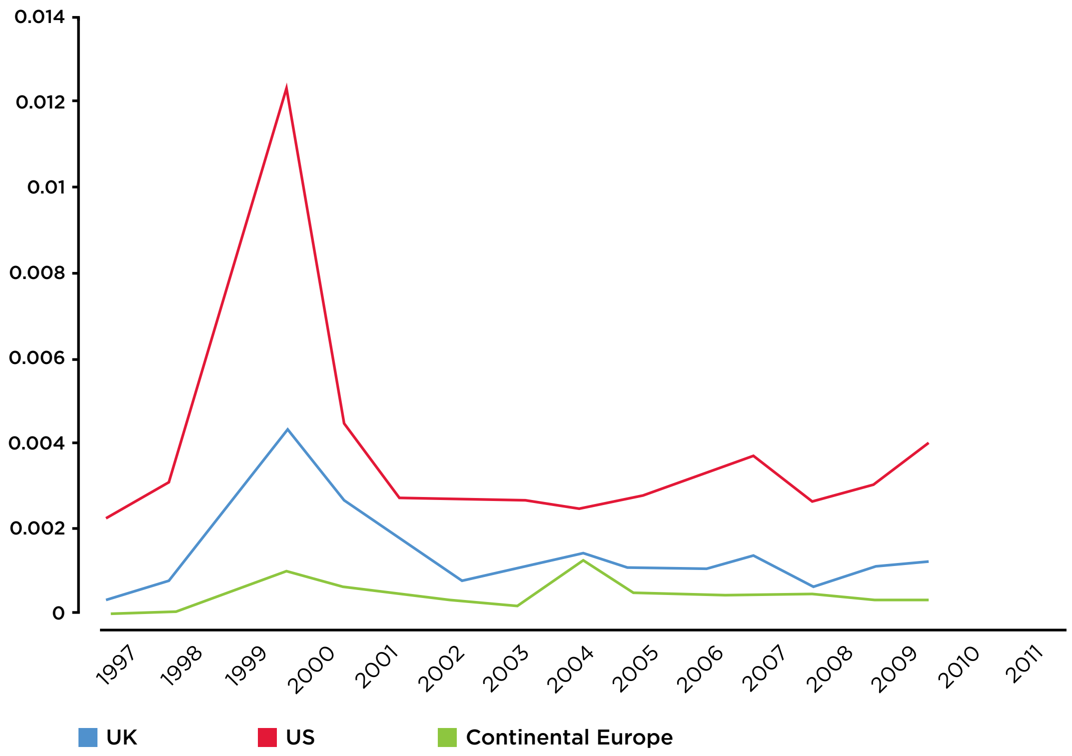
2 PERFORMANCE AND INVESTMENT DATA

What is the investment gap?

UK venture capital investment amounts to around 0.1 per cent of GDP, as compared to around 0.2 per cent in the US (Figure 2). If it were possible to raise UK venture investing to the same level as the US, VC investment in the UK would be $2 billion higher every year.

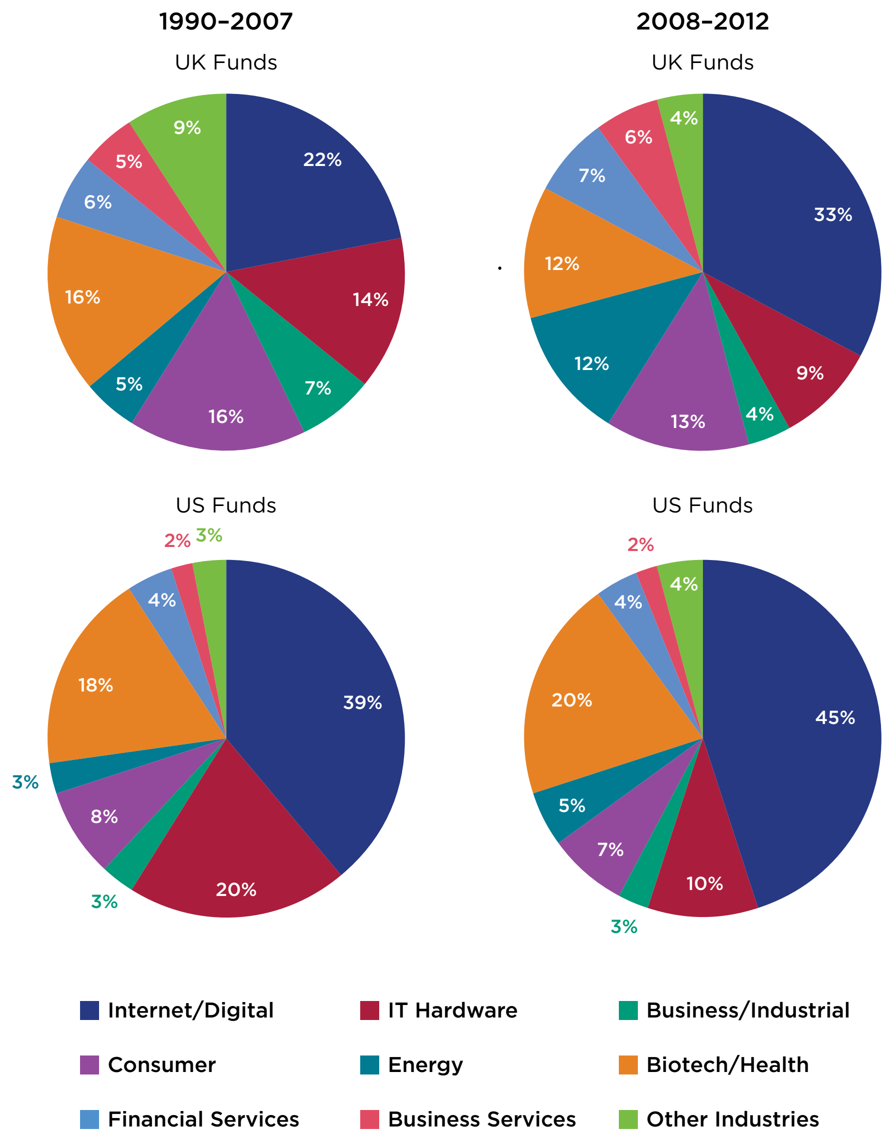
The opposite appears to be happening. While UK and US venture investment as share of GDP have followed a similar trend over the last decade and a half, they have started to diverge in the most recent years. As a result, the investment gap is widening rather than narrowing.

Figure 2: **VC investment in the country as per cent of GDP***



There are also differences in the sectoral focus of UK and US venture capital funds (Figure 3), but these have converged over time. Both US and UK funds have increased their proportion of investment in Internet and digital companies, with a larger percentage increase by UK funds. In contrast, IT hardware investment has decreased in both markets. UK funds have also reduced their exposure to biotech, while US funds have increased it.

Figure 3: **Amount invested by sector**



What is the performance gap?

UK funds' average returns have consistently underperformed in comparison to US funds. Average net IRR was close to 20 percentage points higher for US funds raised prior to the dotcom bubble than for UK funds (Figure 4).

As Fred Wilson of Union Square Ventures[6] recently commented, average venture returns even in the US have been very lacklustre in the past decade, failing to beat stock market investments over the same period.

For funds raised just before and during the Internet bubble, average returns on both sides of the Atlantic have been very poor, but they continued to be lower in the UK (four percentage points below the US average). The gap is wider when restricting the analysis to funds which invest in Internet and digital businesses, with the net IRR for UK funds raised since the Internet bubble being five percentage points below their US counterparts on average.

Figure 4: **Average performance of UK and US venture capital funds**

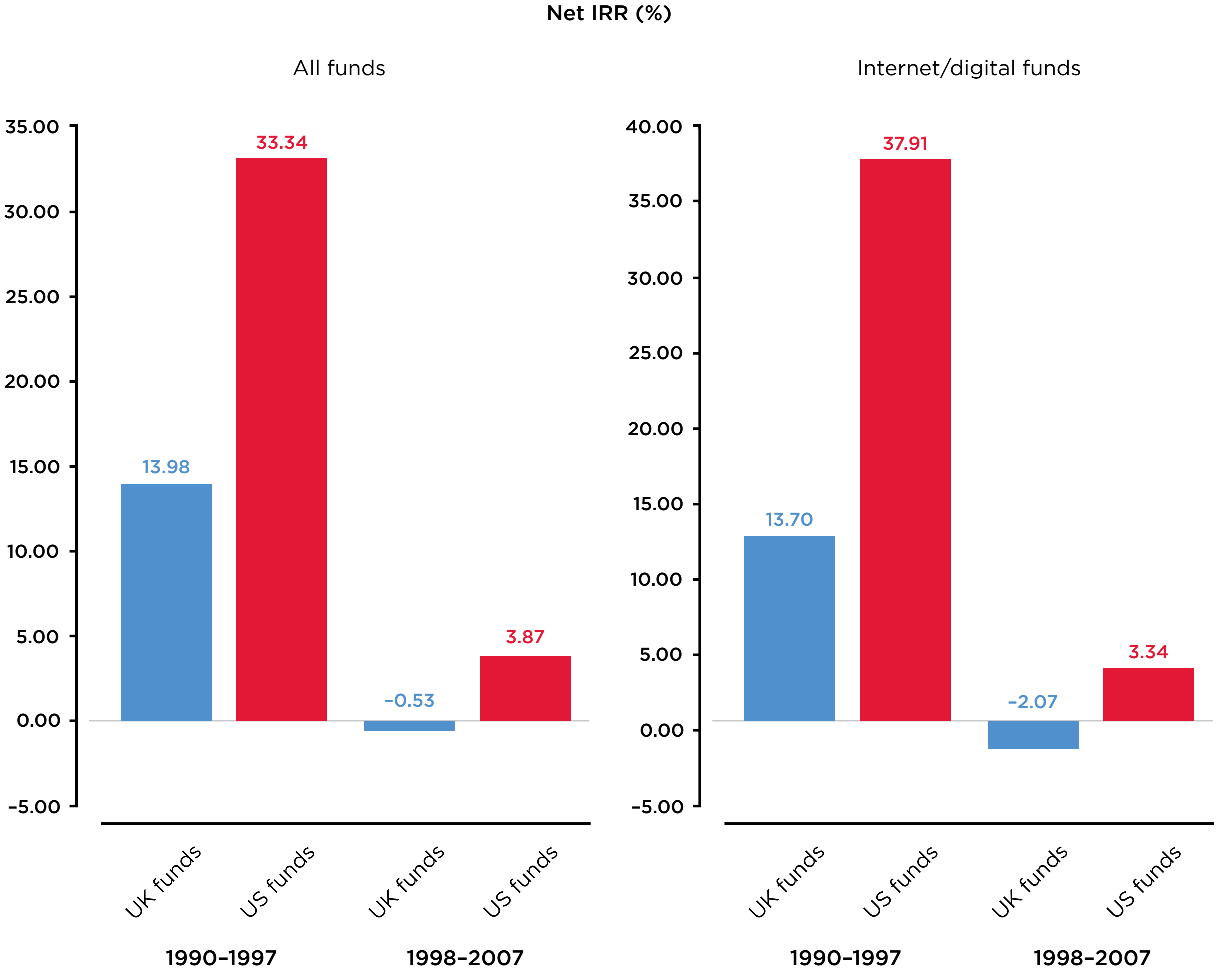
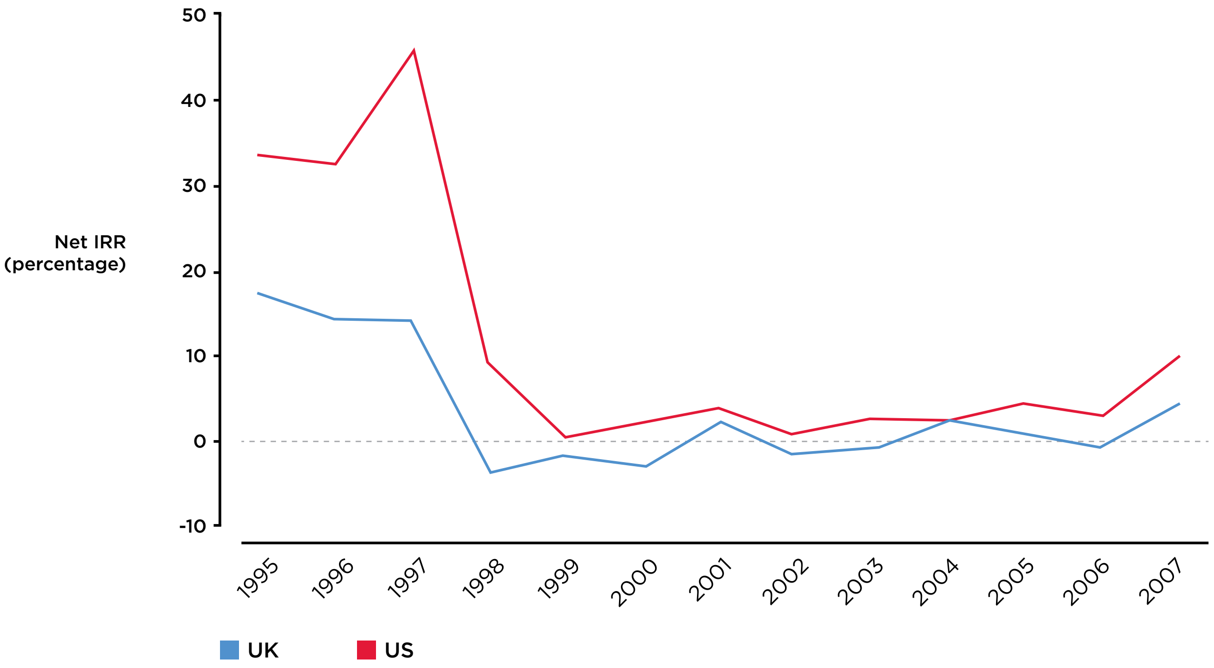
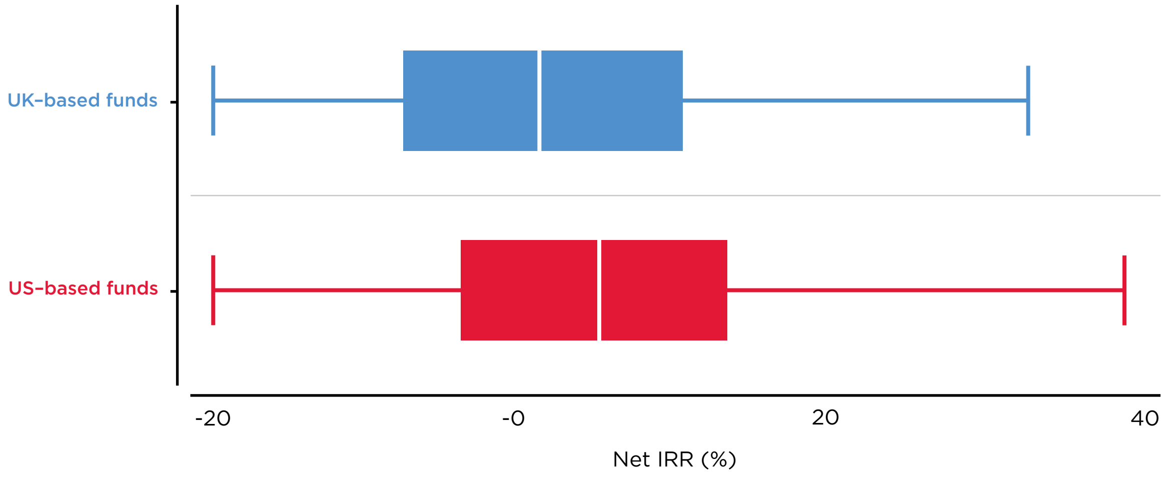


Figure 5: **Average US and UK fund performance by vintage year**



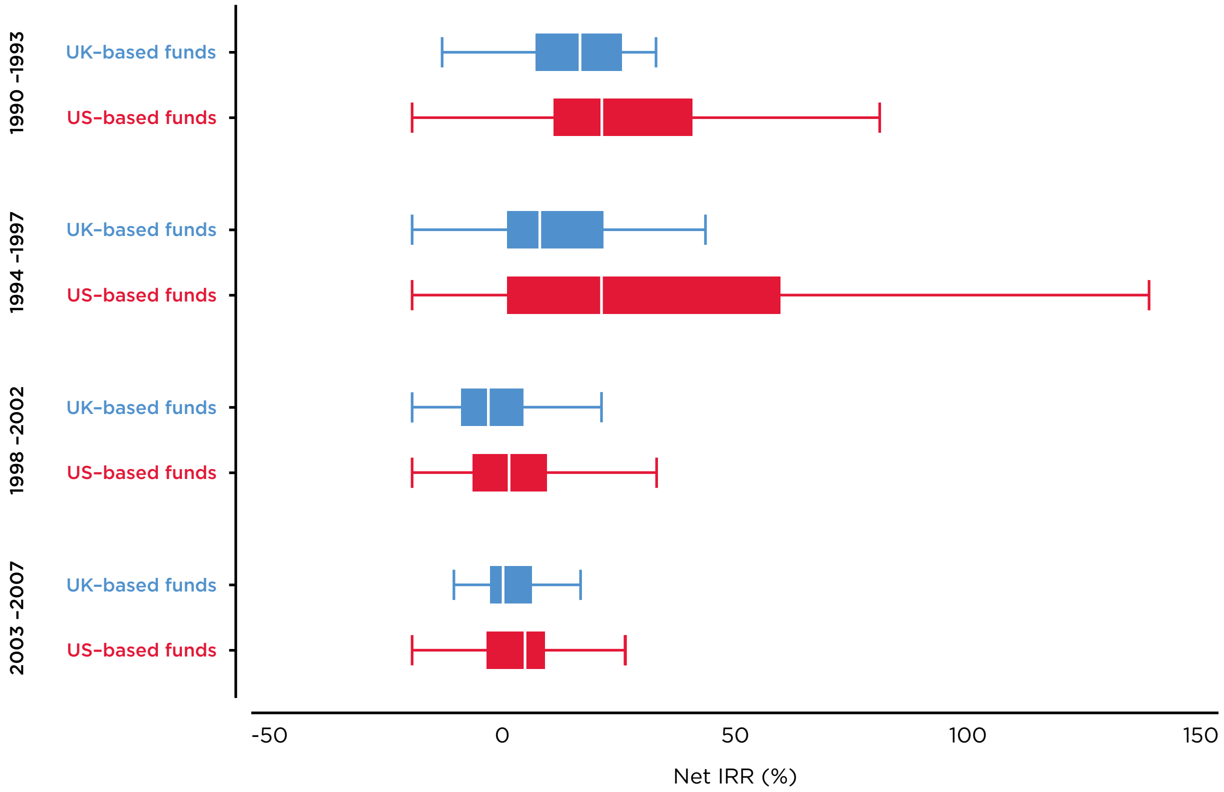
Looking at performance year–by–year shows that, while the UK–US performance gap had closed for much of the 2000s, it has started to diverge again as performance on both sides of the Atlantic begins to improve. This is likely driven by the recent resurgence of successful tech IPOs in the US, and the increasing cash balances of the Internet giants, leading to more frequent and more lucrative trade sales. Looking at average performance can be problematic in an industry where the top performers are the main drivers of returns and industry reputation. The best UK funds are competitive with the top quartile of US funds, and both countries have good and poor performers. The distribution of funds by performance shows the high degree of variation between the top and bottom performers, a span which dwarfs the gap in average performance across countries. However, while some UK funds clearly perform very well, the gap in performance is present not just in the median values, but also in the top and bottom quartiles (Figure 6).

Figure 6: **Distribution of UK fund and US fund returns 1990–2007**



Excludes outside values

Figure 7: **Distribution of returns by fund vintage period**



Excludes outside values

Figure 7 above separates the distributions by vintage period, and shows the significant gap in top–end performance that came just ahead of the bubble. Since then, the distribution has been much more similar (consistent with the average return figures), although the UK funds show a smaller degree of variation between the top and bottom performers. For the most recent vintage years, US funds have both more high performers and more very poor performers – a finding consistent both with the idea that US funds take bigger risks with their investments or that the US environment is more conducive to fast–growth portfolio companies (these ideas are discussed further in Section 4).

3 THE ROLE OF INTERNATIONAL INVESTORS

Given the substantial performance and investment gap between the UK and US, what advantages might US investment bring to the UK market? There are a number of roles US funds can play, in addition to providing a supplementary source of capital for UK start-ups. These might include bringing additional expertise and experience; providing routes to access the larger US market; and making it easier to access US exit markets. Some interviewees referred to US investors, especially West Coast funds, as being more willing to invest in speculative business models, and having fewer requirements for immediate revenues and profits. Others cite better expertise in their industry or market, or the need for a network of contacts to enable expansion into the US market.

From the VC perspective, international investment provides the opportunity to pick the best companies to invest in regardless of their location, as well as to identify opportunities that other funds may have overlooked in less crowded markets. Therefore, many VCs do seek out investments overseas, either through a satellite office or simply by being willing to travel further for a good enough opportunity.

EXAMPLES OF US INVESTMENT INTO THE UK

Hailo – This taxi-hailing smartphone app has seen rapid growth in London, and is now expanding into the US, with Tokyo coverage planned. US investment was provided by New York-based Union Square Ventures, alongside investors including Wellington Partners, Atomico, Accel Partners and Felicis Ventures. They most recently raised $30 million in series B funding at the end of 2012.

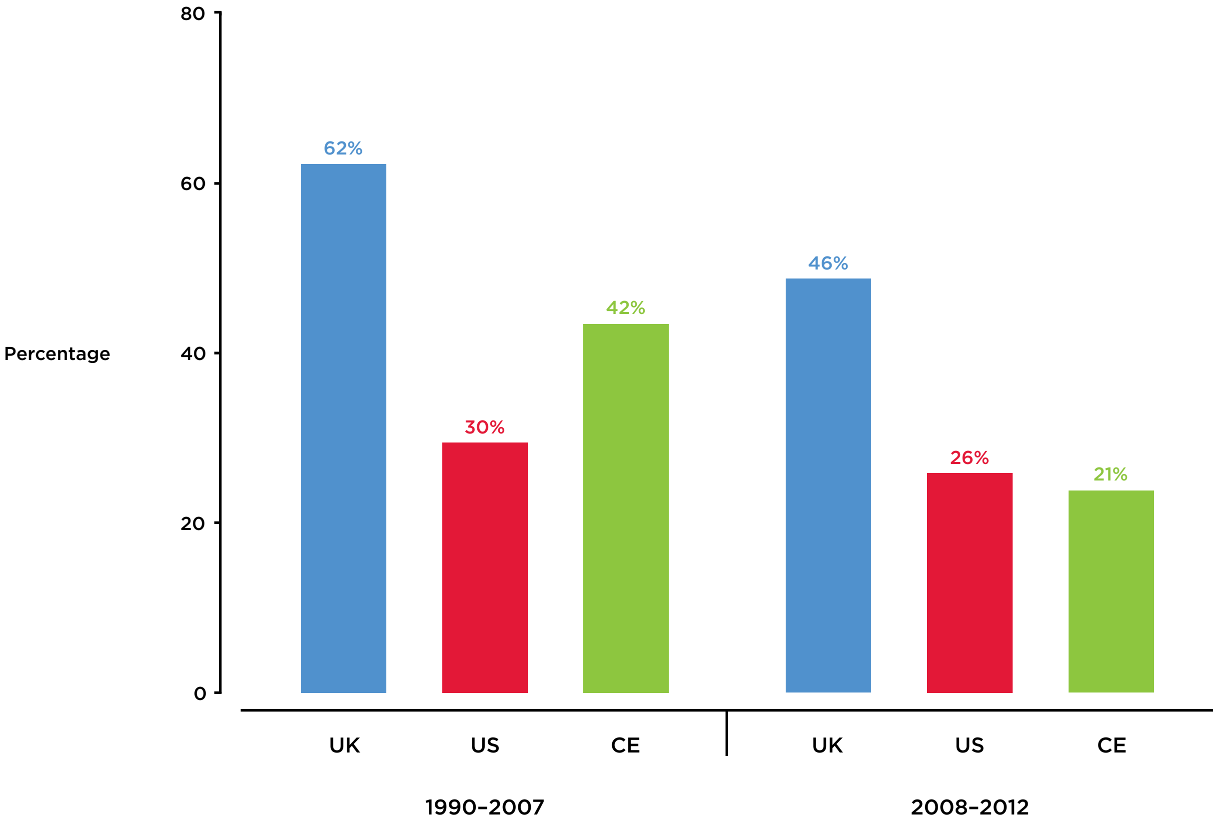
Mimecast – This secure email and archiving provider, based in London, has received backing from Insight Venture Partners (US) and Dawn Capital (UK), raising $62.5 million in series C funding in 2012.

Huddle – This cloud-based software platform supports collaboration and content management for businesses. The company raised seed and series A funding in the UK followed in 2010 by series B and C from the US. They now have dual headquarters in San Francisco and London.

Alfresco – This UK open-source content management software company is currently planning a US IPO and has appointed a new CEO who will be based in the US. They received venture investment from Accel Partners, Mayfield Fund and SAP ventures between 2005 and 2008.

However, the trend we see in the investment data is that funds are becoming less and less international in their outlook, not only in the US but also in the UK and Europe. Where once almost a third of US funds invested outside their home region, now the figure is closer to a quarter (Figure 8).

Figure 8: **Proportion of funds investing outside home region***

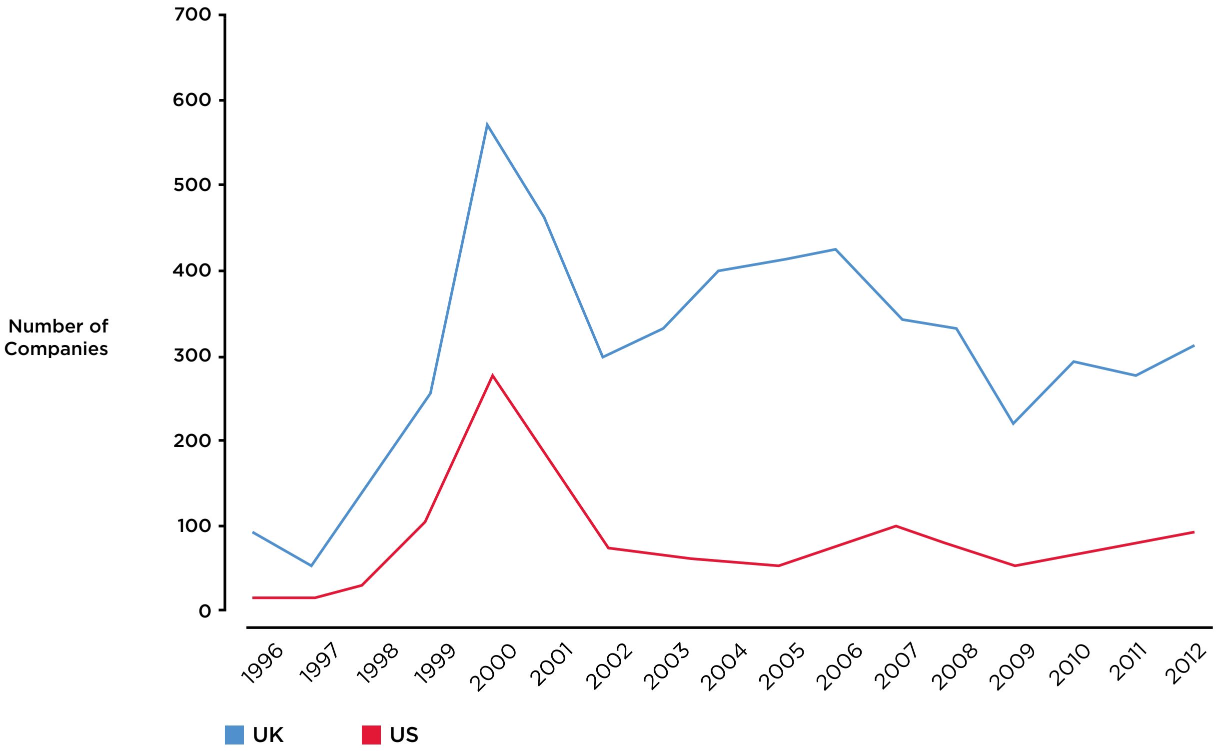


*CE = Continental Europe. For these funds, the figures show proportion invested in Europe; for UK and US funds it shows proportion invested in the home country.

What are the barriers to US investment into the UK?

The number of UK companies receiving US investment fell after the bubble, but has remained relatively stable over the last decade. Specifically, it grew somewhat prior to the financial crisis, and after the fall that followed it, it is now increasing again (Figure 9). Investments in digital and Internet business follow a very similar trend.

Figure 9: **Number of UK companies receiving finance by fund location**



There will be limits on how much investment can realistically be attracted but, as some firms such as Union Square Ventures have shown, some of the top US funds are still willing to invest overseas for the right companies. Israel succeeded in becoming an attractive location for overseas venture capital, having successfully attracted more than 30 foreign-based VCs to operate there.[7]

With regards to the UK, the interviewees were generally very favourable about the UK as a location for deals, even if they have to reach a higher standard to overcome the additional costs of remote investing. These costs include both money and time needed for travel, and additional effort that may be involved in transacting with an overseas jurisdiction (some of these are also present when making out-of-state investments within the US).

The main barriers to remote investing expressed by the investors in interviews were:

- **Distance** – the need to be close to the founding team, especially at the earliest stages, to provide mentoring and guidance, to attend board meetings, to keep in touch with what's going on at the firm. Venture capital investors generally prefer to be located close to their portfolio companies, within two hours travel. More UK branch offices of US firms would help, (and they would need to see enough dealflow to make them sustainable).

> "*Our concerns about investing in UK companies are predominated by the fact that you are eight time zones and a ten or 11 hours flight away... it has to be a very, very compelling opportunity.*"
> **Patrick Chung**

- **Negative past experience** – as the data shows, UK VC has historically lagged behind in performance. The gap in fund returns (net IRR) between the average US and UK fund has fallen from nearly 20 percentage points before the dotcom bubble (funds raised in 1990–1997) to four percentage points afterwards (funds raised in 1998–2007). Some interviewees cited particular bad experiences, which ensure they set a higher bar for future investments.

- **Fund agreement restrictions** – agreements with the limited partners providing finance may specify that some or all of the investments are made domestically to fulfil their own asset allocation requirements.

- **Lack of familiarity with overseas tax arrangements** – a general lack of experience with international investments and markets can mean more work in due diligence (and more lawyers) to understand the relevant risks.

- **Expensive place to set up** – especially London. A perception that companies based here will struggle against higher rents, higher salaries and a generally higher cost of doing business, meaning the investment won't go as far in growing the business. However, London is viewed as having made a lot of progress in raising its profile and developing its ecosystem:

> "*London has raised its profile as a city in the US, I think it's done a good job of selling itself*"
> **Edward Goodmann**

> "*I think (London has) a pretty good eco-system that will be vibrant enough to help develop the next generation of entrepreneurs and start-ups, because that's the one thing which is always missing in all the European countries: having enough established entrepreneurs, willing investors and venture capitalists to actually take companies through the early stage to exit.*"
> **Jeff Clavier**

4 BREAKING DOWN THE POSSIBLE EXPLANATIONS OF THE US–UK GAP

Understanding the causes of the UK's underperformance can provide some answers on how it can be improved, making it easier to attract additional investment for UK start-ups.

Regulation is one part of this puzzle, although as it is very directly influenced by policy, it is an important area when considering how the gap could be closed. Other potential explanations of the gap help provide context and identify other possible concerns that could be addressed in attracting additional investment.

This section considers a range of possible explanations of the performance gap. There are three ways to explain the gap (and the right explanation may include some combination of these factors):

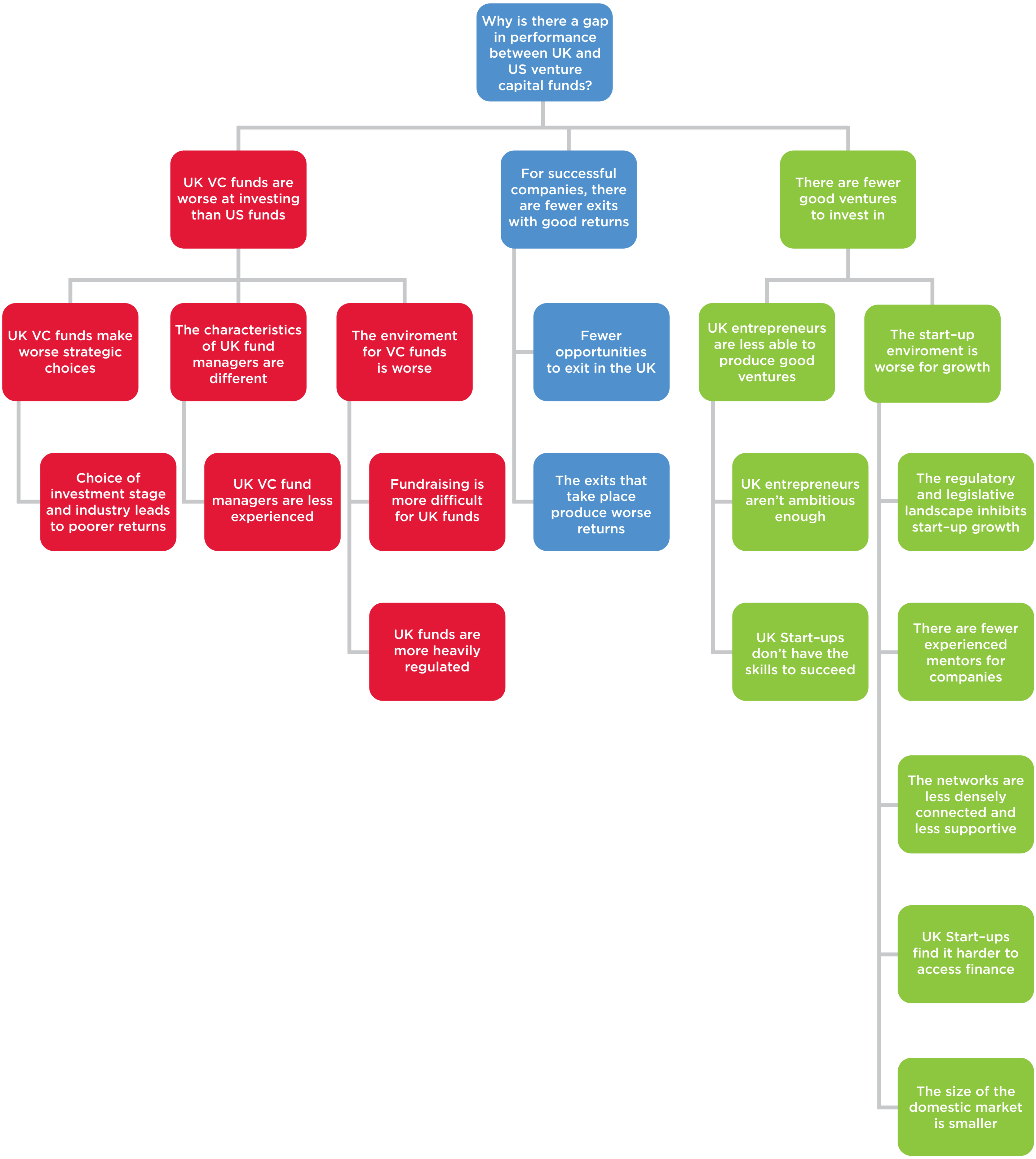
1. **Less successful VC fund managers** – UK venture capital funds are worse at investing than US venture capital funds – something about their approach to investing produces lower returns.

2. **Lower returns when exiting successful companies** – The UK is a worse place to generate good returns on VC investments through IPO or trade sales.

3. **Fewer good companies to invest in** – The UK produces fewer, less valuable ventures to invest in, either through lack of good talent or other resources, or due to a poor environment for venture growth.

It is worth exploring each of these areas further, to see which are plausible given the data we have about this industry, and therefore where efforts to close the gap might be focused.

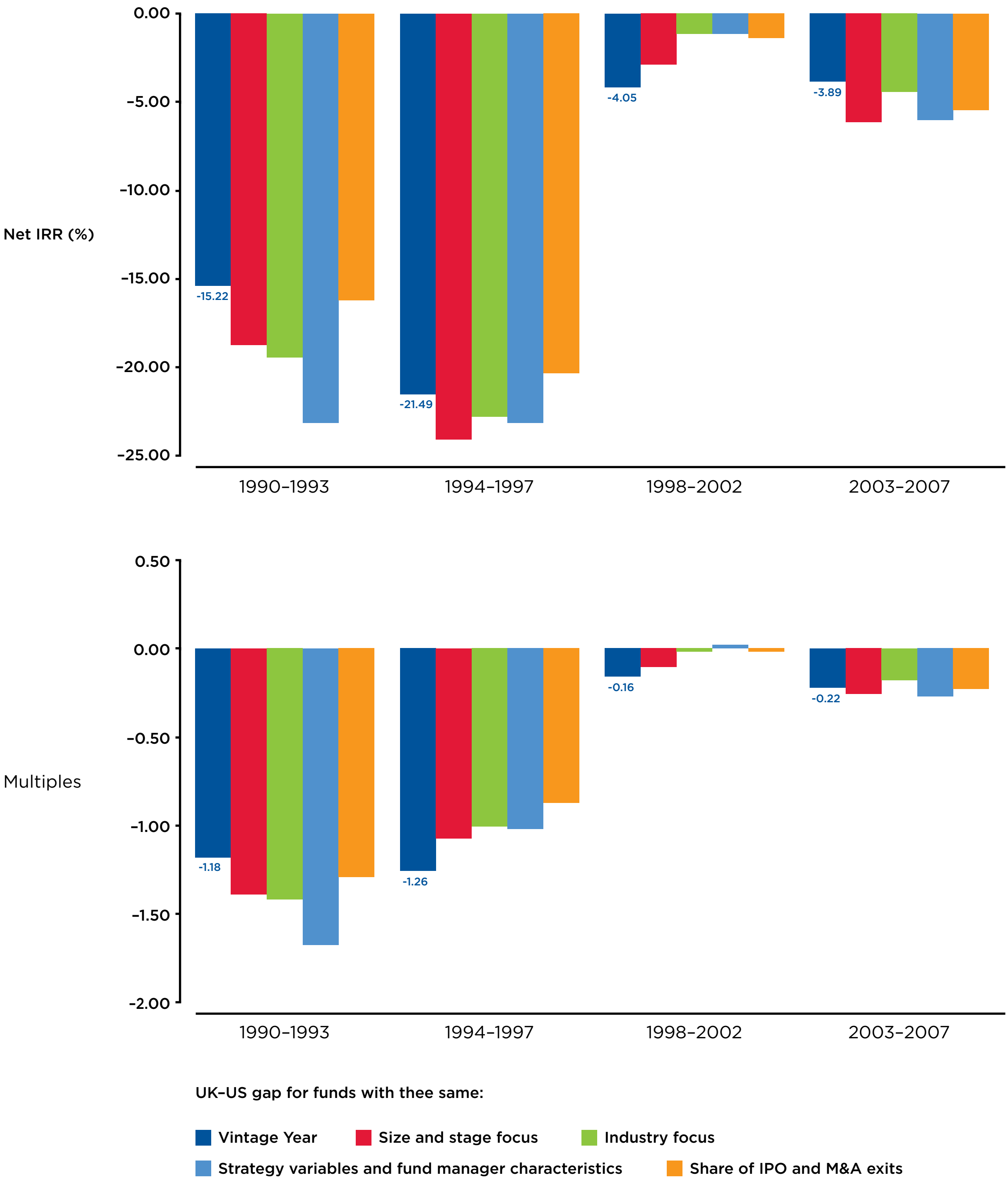
Figure 10: **Explanations for the UK–US performance gap**



1 LESS SUCCESSFUL VC FUND MANAGERS

The first potential explanation is that there is something about UK venture capital funds and the investment choices they make that leads to lower returns. Some of these factors can be examined using a regression analysis that explores whether the performance gap still remains after controlling for a number of characteristics of the funds.

Figure 11: **UK–US performance gap by vintage period***



*Strategy variables and fund manager characteristics controls for: experience of fund manager, industry specialisation of fund manager, average round at which first investment into a company is made by the fund, average size of first investment by the fund into a company, number of companies the fund has invested in, whether investor is located in an investor hub and the average number of other firms co-investing in deals with the fund.

Figure 11 updates the regression analysis conducted for *Atlantic Drift* in 2010 incorporating more recent data. It shows how the returns gap changes when we control for factors including the characteristics of the fund, its managers and its investments. Splitting the sample into four periods helps to smooth the year–on–year fluctuations in returns. Each bar represents the size of the UK–US returns gap for each period, when a set of cumulative controls has been applied.

Are the characteristics of UK VC funds different?

By controlling for VC fund characteristics in the regression analysis, including experience of the fund manager, size of the fund and location in a hub, it is possible to identify whether these fund characteristics can explain the difference in performance. As seen in Figure 11, none of these factors can explain the performance gap.

Do UK funds make worse strategic choices?

In the same regression analysis, some of the basic choices that funds can make, including industry and stage of investment, industry specialisation, number of companies invested in, average round at which first investment is made, average size of first investment, and average number of co–investors, were also controlled for. As with the fund characteristics, these factors have little explanatory power.

What this illustrates is that, so far as they are controlled for, neither the choices the funds have nor the fund characteristics appear to explain the gap for the most recently raised funds. For the 1998 to 2002 vintage funds, these variables accounted for almost the entire performance gap (admittedly a very small one to begin with), but controlling for size of investment, stage and industry focus, experience and specialisation of the investor, and share of exits leaves the performance gap virtually untouched for funds raised after 2003 (or for funds raised prior to 1998).

However, these controls do not cover all the behavioural characteristics in VC funds.[8] The interviews revealed that there is a consistent perception that UK, and European investors more generally, take a different approach to risk, with European investors tending to focus on earnings rather than growth.

Several interviewees suggested that West Coast investors place a premium on high growth rates, as compared to the value they place on current revenues or margins. On the East Coast this tendency is less, and for UK and European investors, revenue and margin have much greater importance in establishing a valuation:

> *"On the West Coast, (what) they will pay for something growing 50 per cent or more is higher regardless of the EBITDA (earnings), as an example. I find that on the East Coast, unless it's over 50 per cent, they're certainly going to want it to be EBITDA positive or neutral. When I get to the UK, the curve looks almost linear. So I find that people, and I'm slightly exaggerating here, are almost willing to trade off 10 per cent (percentage points of) growth for 10 per cent of EBITDA margin."*
>
> **Larry Handen**

The explanation for this approach varies – some attribute it to a lower risk tolerance, some to a lack of foresight, and some to a more prudent approach that derives from smaller fund sizes. This might have a knock–on effect on success, for instance by affecting willingness to invest in certain types of talent or technical skills.

Some UK companies and accelerators also cited a view that there was sometimes a desire by investors to see a start–up already generating revenue and profit before investing, whereas they are seeking investment before the model becomes profitable. This view is consistent with a recent report[9] that suggests that a higher proportion of VCs in Europe invest in revenue generating and profitable start–ups than in the US.

Several people interviewed for this report implied that European VC in general is in a vicious circle. The hypothesis is that past good performance makes raising more and larger funds easier in the US, which makes those funds more willing to take large and risky bets, which in turn leads to better performance. On the contrary, European funds not only haven't achieved good returns in recent years but, unlike the US, don't have a good track record for earlier periods. And therefore make more conservative choices, which lead to lower performance on average. This would have a knock–on effect on the likelihood of funding break–out successes, and on the ability of start–ups to scale fast early on (in terms of hiring talent and marketing spend).

Another view is that the investment size is appropriate for the smaller UK and European markets – you need less cash to address these in terms of, for example, marketing spend. Where US investment has been secured by UK start–ups, it has often been in order to fund an expansion into US markets.

The analysis and comments above suggests that the explanation for the narrowing of the performance gap is not that UK VC funds have changed in size, experience or investment strategy. Instead, it is more likely that the gap is explained by the underlying quality of the companies that are invested in and the environment in which they operate, including the regulations that they are subject to.

Is the environment for the funds worse?

A final aspect of the venture funds that has not been discussed here is whether the regulatory or talent environment for the funds themselves seems to produce different outcomes. Some aspects of fund manager talent and experience were included in the regression analysis, but by no means all. One example of a possible environment impact might be having to deal with multiple legal environments across countries within one fund portfolio.

2 LOWER RETURNS WHEN EXITING SUCCESSFUL COMPANIES

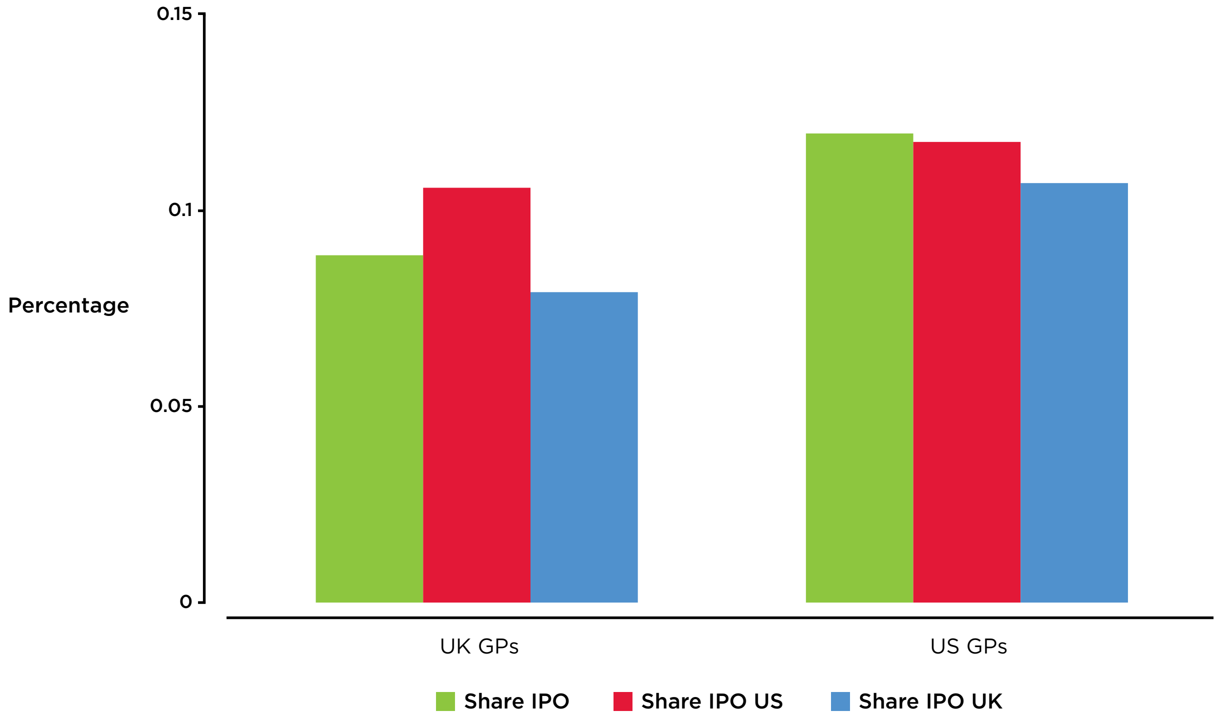
The second potential explanation of the performance gap may be the different abilities to secure a successful exit for a portfolio company. This is fundamental to the performance of a VC firm; it is only at the point of exit, either through an initial public offering (IPO) or trade sale that the value of the equity stake becomes realised, and the returns are made.

Are there fewer opportunities to exit in the UK?

According to recent research published by the BVCA,[10] the IPO success rate is virtually identical for US and European companies in the last decade when time effects are taken into account, although trade sales remain much more likely in the US.

Our analysis of historical IPO success rates for funds that invest in both the US and UK indicate that funds, regardless of their origin, have more success achieving IPO exit with US portfolio companies than with UK portfolio companies[11] (Figure 13).

Figure 13: **Share of portfolio companies with IPO for US and UK investors***



Do UK company exits produce poor returns?

Research has suggested that a lack of liquidity in equity markets goes some way in explaining the gap between EU and US venture capital performance. The causes are thought to be: EU institutional investors tend to concentrate their investments in larger capitalisation stocks, and small company exchanges being under the same management as larger markets, resulting in under-promotion of smaller exchanges (in contrast, NASDAQ is independent).[12]

Consistent with that, the regression analysis shows that the UK–US performance gap remains even after controlling for the number of IPO or acquisitions that the fund achieves (Figure 12). This suggests that the size of exits being achieved is more of an issue than the number of exits.

Some interviewees emphasised that factors outside the control of regulation are harming the dynamism of the UK's public markets, especially the lack of analyst coverage and an investment base with an appetite for tech companies:

> *"If you list on the London Stock Exchange or the AIM as a tech company, good luck trying to get good research to cover you and basically help you build up an institutional investment base. You're much better off doing that in the US. You have to replicate everything that the US has done, and by the time you're done with that you might as well list the company in the US in the first place. The same way if you're a mining company, you'd be silly to list in the US, you'd be much better equipped listing in London."*
>
> **Hussein Kanji**

*This data is based on all funds associated with UK general partners (GPs) – an overlapping but slightly different set to UK based funds.

> *What does cause us more angst (is) the lack of analyst coverage in Europe, so that when you do have mature companies and you want to take them public, you get a better reception on NASDAQ in New York, than you do in London"*
> **A UK VC**

Several interviewees posit that if several large IPOs occurred in the UK, this would accelerate the growth of the ecosystem:

> *If you had three decent exits, tech company IPOs on the LSE (London Stock Exchange), the floodgates would start to open."*
> **A US VC**

> *It's probably a time solved issue… the more exits that do occur in Europe the more high net worth individuals, more entrepreneurs are going to come back into the market and seed it … we've had a few, Skype and the likes, who have come back in and are doing those type of things, but there's just not enough of them, not enough big ones for us to find the exit partners …. If you're looking at really big exits then yeah, the US is probably the only market, but I'm sure that's going to change"*
> **Simon Jenner**

A survey of VC firms found that 88 per cent of US respondents cited difficulties in achieving successful exits as being among the most important factors in creating non-favourable climates for venture capital, compared with 72 per cent of all respondents.[13] It is commonly thought that NASDAQ, the US's large independent equity market, provides faster, larger and more frequent exit opportunities. European companies, lacking an equivalent exchange, are more likely to exit via trade sale, which are generally less lucrative than IPOs.[14]

Interviewees confirmed that the NASDAQ in particular is the exit market of choice, including UK entrepreneurs actively seeking IPOs in the US. Poor exit market conditions have led some US investors to persuade companies to reincorporate in the US:

> *Sometimes we require UK start-ups to reincorporate in the United States, but I think that's more because eventually the hope is to have them go public on markets and exchanges that we have more experience in and probably influence over."*
> **A US VC**

Opinion was divided on whether this in itself was damaging. Some argued that successful UK companies moving to the US harms the UK's ecosystem, removing companies from UK Plc. On the other hand, some argue that in the long run, having UK entrepreneurs with experience of developing companies in optimal conditions will be a net benefit:

> *The good news is in the long run people do come back. When they come back they bring all of that DNA back with them. If enough of it starts circling back, you can actually jumpstart an economy or an ecosystem. That's what we're starting to see here in the UK, there are people who've gone out to California and they're slowly returning back."*
> **Hussein Kanji**

In general, exit markets seem to be an important factor in the UK-US performance gap, in particular a much less developed stock market for tech companies and the relative shortage of large local companies able to participate in a trade sale exit. It is not yet clear whether the start-ups that relocate to the US for these reasons will create problems or opportunities for the UK.

3 FEWER GOOD COMPANIES TO INVEST IN

The third potential explanation of the gap in returns may be that, even if UK venture funds are equally good, the pool of companies they have access to isn't as high quality as the US pool. This could be because the companies themselves have less successful characteristics, or because the environment in which the companies operate creates greater barriers to growth.

This is certainly a view expressed by several of the interviewees for this project. Almost everyone interviewed was clear that great companies and great founders can be found in the UK, and cited companies such as Hailo and Songkick. However, the general view was that the average firm pitching for venture capital was less likely to be successful than a US counterpart.

Are UK start-ups less able to produce good ventures?

The first reason cited for this is a perceived lack of ambition amongst UK entrepreneurs, or a sense of risk aversion. A contrast was made between companies that seek to be the leader for their country, rather than a global industry leader.

Some suggested that larger investment sizes in the US enabled US companies to be more ambitious. Others say that it's less common to find European start-ups that want to change the world – a level of ambition necessary to address even the domestic market in the US.

> “*The number one challenge that all European start-ups have is that it's difficult to see the same interest in changing the world that you've seen in US entrepreneurs, where they always think big .... It's rare that someone starts a company in Europe thinking the world is my oyster and I'm going to go for the global opportunity.”*
> **Jeff Clavier**

A shortage of experience and entrepreneurial skills, including fewer serial entrepreneurs, was also mentioned as a distinction between US and UK start-ups. BVCA/VentureSource data[15] also suggests that relative experience levels are staying static and are still below the US. The figures indicate that the proportion of firms with a founder with an entrepreneurial background is around 35 per cent in the US and around 15 per cent in Europe, with small variations, since 1995.

Do UK start-ups operate in a worse environment?

The environment in which the start-ups operate includes factors such as the population of other start-ups; the availability of mentors and advice; the willingness of people to share their contacts; the culture; and the regulations and legislation affecting them; access to finance.

Some of these factors are closely linked to the resources directly available to the start-up firms: finding technical and executive talent is easier in a more connected ecosystem. Understanding the sources of funding available is easier when there are more mentors around who have done it before.

Linked to ambition and entrepreneurial skills, a culture that is perceived to punish failure and reward short-term profitability can discourage risk-taking.

A number of interviewees would like to see recent changes to promote entrepreneurship as a career option extended, to further shift the culture in the UK.

> *There's more that can be done around educating UK entrepreneurs on having a less parochial view of serving our domestic market and that's it, which then goes back to the earlier point about British entrepreneurs tend not to be quite as ambitious."*
> **Ian Merricks**

> *On the west coast, if you started a business then it failed ... and if you learned something from it then you weren't a failure, you were an experienced entrepreneur. So I think that whatever the government can do to try and encourage that mindset would be valuable."*
> **David Hornik**

Scott Sage at DFJ Esprit suggests that the ecosystem of support is improving in the UK:

> *Early on in the valley, both technical and business operators who had been made financially independent from an exit event at a startup, invested back into the ecosystem. They gave back by investing into, mentoring and going to work at the new crop of startups. Given the tech market is much younger in the UK than in SV, we are just moving into that second phase where we have repeat entrepreneurs who are putting back into the ecosystem."*

Hussein Kanji expresses concern about the depth of the technical talent pool:

> *One of the big strengths in California and Silicon Valley is there is a cadre of people who are not founders of businesses, and may not even be the first ten or 20 employees, but know how to join a company either as employee number 30 or 50 or 100 and help take the company to 1,000 people, 10,000 people, 20,000 people. ... If you happen to hit a good idea, there's no poaching ground for great talent in Europe. New York has the same exact problem and New York is slowly building this up."*

Hoxton Ventures advise people to move to the best location to build their business, even if that's in the US. This might be bad for the UK in the short term, but in the long term, if those people are successful, that should start to trickle back to build up the UK.

An important contributor to the start-up environment is access to finance. Opinion on the role this currently plays was divided. Some claimed that this isn't an issue, and that broadly, the good ideas can get funded. Others instead claimed that there is still a shortage of funding in the market, and that this is constraining growth. However, several emphasised recent progress, which wouldn't yet be visible in the fund performance data.

Some also suggested that it wasn't lack of capital as much as lack of awareness about where best to look for funding amongst UK entrepreneurs and an appreciation for the different roles that angel and venture capital investment can play.

There was also a view that the UK ecosystem is improving and the UK Government is generally doing positive and helpful things – with particular praise for the EIS and SEIS* schemes.

> *In terms of early-stage capital, I just don't think there's a shortage. I really do, and I think the UK is, from a policy perspective, like high level as good as it gets. The US is behind on the Founders Visa, the US is behind on Capital Gains Tax, and the US doesn't have the same incentives on SEIS."*
> **Saul Klein**

A major aspect that differentiates the UK environment from the US is regulation, which is explored more thoroughly in the next section.

*Seed Enterprise Investment Scheme – this scheme offers tax breaks to investors who put money into small start-up businesses, and is a complement to the successful EIS scheme for larger investments.

5 REGULATION AND UK DIGITAL START-UPS

We have conducted interviews to understand US investors' perspectives on one of the issues that may drive underperformance in UK venture capital, via its effect on the start-up environment, namely regulation affecting Internet and digital ventures.

There are three possible routes for regulation to impact venture investment decisions:

1. Regulation that affects the willingness of venture capital funds to invest in companies, which they believe will face increased friction.

2. Regulation that affects start-ups, creating barriers to growth that could in turn reduce their ability to attract investment.

3. Regulation affecting exit markets, which would in turn affect fund performance

Using these interviews, this section addresses the views that VC funds and some entrepreneurs and accelerators have on regulation across these different routes. However, investor perceptions of the effect of regulation may not necessarily represent the real effects that different types of regulation have on the start-ups. For instance, there may be some issues that occupy the management team, but which the investors aren't aware of. On the contrary, investors might be more concerned about some regulations than the managers themselves, if they already know how to navigate them. Other effects may also be unseen – it is not possible to interview investors for the companies that didn't form or didn't survive to seek investment as a result of regulatory barriers.

Regulation is only one component of the start-up environment and our interviews indicate that its importance differs among those we spoke to. It is, however, an aspect of the environment for start-ups that government is in a good position to address, and so worth examining for potential opportunities for improvement.

Is it plausible that the perceptions that investors have of regulations affecting digital start-ups could influence investment decisions?

Certainly some interviewees indicated that regulation was not something they spent much time thinking about. They cited other factors such as the quality of the team, and the business idea itself as being much more important to a given decision to invest.

> “*There are so few regulations that will have a meaningful impact on the likelihood of success of any given company. Little companies live and die on all sorts of other things.*”
> **David Hornik**

However, some interviewees indicated that regulation may dissuade investors from examining some types of investment. Others suggested that it might increase the amount of 'friction' and raise the bar for some companies, making it harder to secure funding than for companies in a different segment or location:

> “*I don't think it is that much worse (in Europe). I guess it's just there's certain doors or roadblocks that maybe don't exist in other markets that exist here. That you feel like you have to jump through hoops, whereas maybe in the US you don't have go through so many hoops.*”
> **Mattias Ljungman**

We asked specifically about regulation that affects UK Internet and digital companies, whether that regulation originates in the UK, or from the EU. Some attributed the 'friction' generated by regulations to the complexity of dealing with many different jurisdictions, rather than any specific country's regulations.

This is particularly the case for companies addressing the European market, which in addition to regulation that affects the company's main office, need to deal with the complexity of 27 different regulations and the fragmentation this creates.

> *There is no EU wide regulation for start-ups, you know. Start-ups are regulated by national laws and regulations, if any, because there is no difference between a normal start-up in technology and the start-up of a mom-and-pop shop, in the legal form of a company."*
> **Georges Noel**

IMMIGRATION

Previous sections highlighted the importance of both founder and technical talent as essential resources for building start-ups. Consequently, visa and immigration regulation might shape the UK's capacity to offer investment opportunities. Evidence suggests that being a migrant to the UK corresponds with an increased likelihood of engaging in entrepreneurial activity in general.[16] A study of venture-backed start-ups in the US found that over a quarter were founded or co-founded by immigrants.[17]

Immigration regulation was indeed emphasised by interviewees as being a crucial constraining factor on the development of a strong UK ecosystem. The UK Government has introduced the Entrepreneurs Visa and the Graduate Entrepreneurs Visa to ensure that the UK is competitive in this respect. Interviewees praised this development:

> *You guys have been very, very supportive of start-ups and that's fantastic. And the fact that you guys have the Entrepreneurs Visa before the US, by like six to nine months. I applaud what your Government has done."*
> **Jeff Clavier**

Nonetheless, there were concerns about immigration regulation restricting the supply of talent required to grow digital companies, especially technical talent from outside the EU:

> *This might be the biggest issue for our companies…the biggest complaint is always on the visa issues, getting a visa for an Eastern European developer. If they're not from EU, it's really difficult to get them in. It just takes too long and time is your enemy at a start-up because there is someone else doing what you're doing and you have to execute, you work six, seven days a week and pretty crazy hours. So if you're held up hiring a python developer for six months, you could be toast."*
> **Scott Sage**

There remain concerns that prospective immigrants still find the process off-putting, immigrant entrepreneurs face uncertainty on their resident status, and that sponsoring bodies find the process excessively bureaucratic.[18]

Interviewees also suggested that the US faces a similar, if not worse, situation with respect to visas:

> *There are occasionally issues around entrepreneur visas and getting good talent into the right country, but I think that sounds like it's an equal problem on both sides of the Atlantic."*
> **Ian Merricks**

EXIT MARKETS

Exit markets have a crucial role in enabling a return on venture investments, as well as providing growth capital to develop companies. Exits are achieved either through a trade sale or through an IPO on a stock exchange. As regulation has a greater role to play in IPO markets, this section focused on that exit route.

A majority of investors believe that IPO activity in their country is too low.[19] The probability of exit via an IPO has gone down in recent years, and the time taken to achieve this has gone up[20] – even if a recent survey showed that a majority (65 per cent) of investors and entrepreneurs expect IPO activity in the US to increase in the next year.[21]

Regulatory restrictions on digital companies' ability to seek an Initial Public Offering on a public equity market – for example through prohibitive listing requirements – might place a bottleneck on their development. However, as discussed earlier in the report, regulation is not the only factor affecting local equity markets.

Whilst exit market regulation itself was not particularly cited as a barrier by the interviewees, macro exit market conditions were emphasised as being crucial in supporting the UK's tech ecosystem:

> *I've got a couple of companies that we're considering taking public and we're having huge debates about whether we take the company to the UK or the US… both of them are going to end up going public in the US just because I'm sure that it's easier, we feel like the markets are more open and more receptive. I don't know how much of that is regulation but it's definitely just a sense of the way things are."*
> **A US VC**

Consistent with that, in a survey of investors and entrepreneurs only 11 per cent cite compliance requirements as being an obstacle to more IPO activity, far behind other factors such as volatility of public markets and fallout from poor IPOs.[22]

The London Stock Exchange (LSE) and its AIM market have been the main markets in the UK for IPOs, although they have seen very few digital and technology companies listing in recent years. The LSE has recently announced a new High Growth Segment to combat this issue. Aimed at companies with valuations in the £300–£600 million range, this market will be more accommodating in terms of its free float (minimum portion of tradable shares).

Whilst the new High Growth Segment was generally welcomed, there was some doubt as to whether this would solve the issue. Interviewees welcomed measures that soften admissions criteria:

> *I think it tries helpfully to address one aspect, but in an incomplete way… It comes back to my same question, how are you going to get the analysts to spend their time looking at these companies and understanding them? That said, anything that softens the admission criteria I think is helpful."*
> **A UK VC**

Marketing the exchanges to build a bigger investment base with better analyst coverage would be the ideal remedy for respondents:

> *There's probably a lot of marketing that needs to be done… in order to have the listing markets available in Europe you need people to invest in those markets. So it's a question of [companies] choosing to go with the US or with something (developing) in Europe."*
> **Will Vizard**

However, some expressed doubt that these exit market conditions can be significantly improved by regulation alone:

> *"I don't even know if the Government could intervene, I think it's also a matter of the investor base becoming educated and as a result the analysts would then follow, the banks would follow. It's more than just opening up the public markets."*
> **A US VC**

CASE STUDY: ALFRESCO, A UK SOFTWARE COMPANY SEEKING A US IPO

Alfresco is a UK-based software company that has received venture capital investment from both UK and US funds. They recently announced their intention to go public with an IPO in the US, and a new CEO who would be based in the US.

> *"In the last ten years, rather than the Internet dispersing expertise it's actually made it focus more and more on the valley in particular, and the US market. So all the people that would follow a company like us over the years have relocated from New York and they're in the valley now, all the financial analysts are going there. So it's sort of a vicious circle, if the expertise and analysis of our type of company are not there.... Given the route we took and then with our backers having US backers as well it's virtually inconceivable that we'd do an AIM exit."*
> **John Powell, Alfresco**

COPYRIGHT

Copyright is one area of increasing focus with respect to online innovation. As the recent Hargreaves review noted, while copyright plays an essential role in encouraging creativity, it also *"can constrain third parties wishing to access or innovate on top of this protected knowledge or content, with potentially serious economic and social costs."* As with all forms of regulation, there is the need to balance the benefits and incentives it generates, with the potential costs and obstacles it creates.

It has been argued that much copyright law is inappropriate for the digital age, as it fails to take into account the transformative nature of copying; it doesn't differentiate between large-scale copyright violation and incidental violation; and it punishes otherwise innovative companies who are 'mere conduits' for violators.[23]

Recent research suggests that the lack of clear and flexible limitations on copyright can have an impact on digital innovation in the EU. For example, research has shown that court decisions relating to cloud-based services that stored copyrighted material in France and Germany – decisions that were viewed as creating uncertainties and expanding the scope of copyright protection – were followed by a drop in investment in companies in this sector.[24] Conversely, court decisions in the US that clarified the law with regard to the position of cloud-based services were correlated with an ensuing increase in investment.[25] Some interviewees indicated that copyright-based businesses can experience a higher barrier to investment:

> *"If ever there is a company in Berlin or in London, the company has to be so good that it would make it worth clearing the copyright hurdle. And if it's streaming involving copyright material, other materials or whatever, it has to be even better. But if we think it's a gem, then we'll take the risk."*
> **Jeff Clavier**

Several interviewees confirmed that dealing with Europe's multiple jurisdictions is a pain point for start-ups, especially if it involves taking risks to pursue high growth:

> "*I think there are major chilling effects particularly in the EU, because of the patchwork regulatory scheme that's been set up. If you want to build a product that's got a strong consumer base in Europe it's a lot more difficult to tap into the 450 million consumers, who do still have a lot of buying power, and do buy stuff."*
> **Edward Goodmann, Hattery Labs**

> "*Even Apple have found it really, really hard to roll out iTunes across 26 different markets, it's not a single market. That is due to the complexities associated with content and rights holders on one side, and also the payment systems on the other side."*
> **Jon Bradford**

Separate to the issues surrounding the nature of copyright regulations, some interviewees also described problems with licensing copyrighted content. Some focused on difficulties in licensing content efficiently.

> "*Any start-up dealing with trying to develop a platform for distributing copyrighted content, obviously has problems, not just when you get into technical details around data and text mining, and all those quite niche areas of copyright, and format shifting, but then also around licensing and having to deal with collecting societies."*
> **Sara Kelly**

This problem is exacerbated by the fact that licensors will have to repeat these sorts of negotiations with multiple parties.

Some interviewees pointed to a lack of clarity around legitimate uses that do not need to be licensed, and indicated that they may avoid such businesses altogether.

> "*We're actually pretty careful about it, so we avoid businesses that provide other people's copyrights. We don't want to get in to that complicated structure."*
> **Mattias Ljungman**

DATA PROTECTION AND PRIVACY

Increasingly, innovations in the Internet space are driven by the deployment of user data. The online world offers hitherto unknown opportunities to understand consumer behaviour, including those engaged in online marketing and advertising. But as a result it also gives firms access to massive amounts of data on the actions, preferences and beliefs of private individuals, and so requires adequate regulation to guarantee individuals' fundamental right to privacy. Striking the right balance can be a difficult task. Data protection regulations that aim to safeguard consumer privacy place barriers to collecting or accessing user data which may hamper business models built around data. This may limit the development of sectors that rely on online marketing and on advertising revenue to provide online services as well as companies that parse user data to improve the operational efficiency of their platforms:[26]

> *Certainly running the largest video ad-tech company in Europe in that environment is kind of painful without doubt. It would be great if there were privacy laws that both protected the consumer but understood that if you put some barrier to business that is especially bad and business will suffer, but that's not how European leaders think."*
> **Jeff Clavier**

The EU is generally viewed as being more restrictive than the US on matters of data protection: the US tends to rely on self-regulation rather than government regulation to protect privacy. Research suggests that the EU Privacy and Electronic Communications Directive 2002 was correlated with an ensuing decrease in venture capital investment into online advertising companies of approximately $249 million in the eight-and-a-half years since its implementation, compared with the US.[27]

Although the UK was not picked out in particular by respondents as being problematic, several investors identified more stringent privacy regimes as being restrictive on innovative start-ups and their concomitant attractiveness as investments:

> *The problem is government thinking wrongly about how companies monetise the data that's shared by consumers, and the way that consumers derive value from data exchange...there are seriously amazing companies that are doing great things with data and I don't think they can survive a German style privacy regime."*
> **Edward Goodmann**

Moreover, companies in the EU have faced a period of uncertainty following the implementation of the 2009 Data Protection Directive (often referred to as the cookie law), which obliged online companies to obtain the explicit consent of users before collecting information from user's devices. European investors identified the EU cookie law as a source of frustration for start-ups, for example:

> *This EU cookie law was a pain. Advertising tech companies for about six months had to double check this cookie stuff ... this added friction, as they had this extra level of checking."*
> **Hussein Kanji**

Although the uncertainty receded as the deadline approached, there were reports that it interfered with aspects of site design and therefore business models, as well as diverting time and resources from business development.

There were indeed some concerns about the prospect of Data Protection Directive and the feasibility of its proposals.

> *(the Data Protection Directive) presents a lot of problems for businesses for whom data is essentially their product. They provide a lot of their services for free but then use the data to build upon the service or deliver advertising or things like that... [data-driven companies] are worried about the possibility that a lot of their business is going to be withdrawn at the click of a finger."*
> **Sara Kelly**

Some felt that legislators do not have good insights into how businesses in this sector function. The need for more European start-ups to have a proactive attitude to self-regulation was identified as being important:

> *"The right thing is for there to be an on going, active debate between a self-regulated or a self-aware business community that is clearly putting the interests of consumers, not just the business opportunities, at the heart of what they're doing."*
> **Saul Klein**

It is also vital that regulators have a thorough knowledge of the sector. In general, companies say they are aiming to stay ahead of the requirements of UK regulation, and believe that this is sufficiently stringent that most companies are likely to be compliant elsewhere if they meet these standards.

> *"You have to start to think about those things from day one and you have to think, not about the lowest common denominator of privacy and data protection, you absolutely from the beginning have to think about the highest common denominator."*
> **Christopher Lukezic**

Provided that regulation does not compromise the functionality of the service, taking a responsible approach to protecting users' privacy makes good business sense:

> *"It's a bit like financial regulation, you're better off following the regulations of the toughest area because you know then you can do business anywhere. But the problem is if the service is not a good service because of privacy and it becomes too rigid, and, say, we can't do that or we can't do this, it's going to be a big problem."*
> **Mattias Ljungman**

BANKRUPTCY

Differing attitudes to the failure of businesses have often been claimed to be symptomatic of the contrasting entrepreneurial cultures of the US and Europe. Conventional wisdom says that while the US is tolerant, if not welcoming, of entrepreneurs whose businesses have failed and the value of that experience, European countries are more likely to punish failure. Consequently, appetite for taking risks that are inherent in entrepreneurialism may shape start-up culture and the growth of dynamic businesses. Interviewees from both sides of the Atlantic attested to the contrasting cultural attitudes to risk and bankruptcy. However, several interviewees also speculated that this attitude is beginning to change in the UK.

Whether bankruptcy regulation has a causal relationship with such attitudes, or indeed is a reflection of them, is open for debate. Research suggests that less punitive bankruptcy laws stimulate entrepreneurial demand for venture capital[28] and that bankruptcy laws need to be more employer-friendly to encourage start-ups.[29] Several (UK-based) interviewees felt that the UK's bankruptcy regulation is supportive in instances of failure, and that the problem is cultural rather than legal:

> *"I don't think the law's a problem, I think it's pretty straightforward, I think the culture's an issue around bankruptcy."*
> **Simon Jenner**

However, one US respondent did perceive European bankruptcy laws to be more burdensome:

> *"What I would say is that I think that bankruptcy laws in Europe are much more onerous than they are in the United States, at least by our perception. So it again has a lot to do with this challenge of how do you build a business quickly, grow it and shrink it. It's about being able to hire and fire people, it's about being able to go out of business without it following you past the failure of that business."*
> **David Hornik**

According to others in the US, the lack of Chapter 11 protection and ability for founders to quickly bounce back doesn't affect ability to do deals, but in some cases, a higher price might have been achieved with Chapter 11 in place.

One US investor was overburdened with paperwork following the failure of a portfolio company in the UK:

> *"On the downward spiral, the Government did not make it easy and then to have these random things turn up at my house every few months is probably not very good marketing for enterprise in the UK… honestly it leaves a very bad taste in your mouth for the company to have totally liquidated, for the accounts to be closed, for everything to be totally done and then for years later you're just constantly reminded of this by the British Government in the post….It constantly reminds me of a bad experience."*
> **A US VC**

LABOUR AND EMPLOYMENT

Evidence suggests that high-risk innovation sectors are smaller in countries with restrictive employment protection legislation because the cost of shedding workers is higher.[30] Inherently risky enterprises might be at a competitive disadvantage if regulation stops them from having a flexible workforce. US investors particularly emphasised that an agile labour force is critical to the success of start-ups:

> *"We had a huge amount of difficulty being agile enough, because you couldn't let all that many people go quickly. The company, feared litigation from (the employees) and so it saved a few jobs in the short run, but ultimately collapsed the company"*
> **A US VC**

This was commonly thought to be a significant issue in other parts of Europe, particularly France, rather than the UK. Nonetheless, for those who have experienced both, UK regulations are thought to be more onerous than the US:

> *"Employment law in the US is far more favourable for business owners than it is in the UK, it's slightly harder to let go of people in the UK. You've got a lot more legislation to follow, but that's only with the benefit of hindsight. Whilst I was still running my UK company, I just thought that's the way things are and it was something you dealt with."*
> **UK entrepreneur**

Some claimed that employment regulation is not a high priority for early-stage start-ups:

> “*Most of the other red tape and stuff really doesn't affect start-ups; they'll get away with not having to worry about any of that stuff. It becomes more of an issue as you start employing staff and you grow, so I think for these early-stage start-ups, actually legislation is not a limiting factor.*”
> **Simon Jenner**

Several interviewees recommended that restrictions on early-stage companies should be lightened for their first few employees:

> “*It's a binary process, you move from being self-employed and it's your idea to make a commitment to run a start-up, and then all of a sudden you've got the move to administering the PAYE scheme, which few of these entrepreneurs would have had any experience of and it's quite burdensome.*”
> **Ian Merricks**

Another interviewee speculated that the ERR (Enterprise and Regulatory Reform) Bill is likely to help in this respect.

TAX INCENTIVES FOR INVESTMENT

The UK operates several schemes to incentivise investment in digital companies, and start-ups more generally. Research suggests that these schemes are important to investors: a survey of VC firms found that 35 per cent believe that effective tax policies that encourage risk-taking and investment are among the most important factors in creating a more favourable climate for venture capital.[31]

Both the Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS)* – established to make investment in small unquoted companies more attractive – were widely praised by UK respondents:

> “*The entrepreneurs relief is fantastic, people love that. EIS is amazing; it's really been driving investment.*”
> **Scott Sage**

However, schemes like EIS were not thought to be decisive in securing US investment:

> “*Those are things which are sort of interesting, but similarly it doesn't solve the issue of showing me someone who's going to try and disrupt education, create a world class high-tech company. And if it's genuine and they're worth it, we'll give it a shot. But we'll try to invest in the US as a first order of priority.*”
> **Jeff Clavier**

There was some unease around whether these schemes result in investment for the wrong reasons:

> “*I don't know enough about the specifics of US angel tax breaks as opposed to the early VC but I don't think they're as attractive as they are in the UK. However, that points at a much bigger problem which is a large part of early-stage angel investing in the UK is driven by tax breaks as opposed to venture returns, which comes back to this point of that's a pretty bad thing, that's the tail wagging the dog, is people's investing to get a tax break as opposed to investing to see those companies grow.*”
> **Ian Merricks**

*EIS and SEIS can both provide investors with Income Tax relief, Capital Gains Tax deferrals and Capital Gains Tax exemptions.

The UK Government also offers R&D tax credits to SMEs. Digital companies are often engaged in activity that qualifies them for this scheme, including several interviewees:

> *We've benefited a lot from participating in the R&D tax credit scheme which I didn't know of before being advised of its existence by our auditors…that was very helpful. It is somewhat bureaucratic to justify the rebate and it's always a bit of a slog explaining that we do R&D to HMRC. I'm sure that puts off some valid claims as well as provides nice consulting fees for the audit firms, a simpler method would go a long way to encourage more R&D investment I'm sure, but it's a good foundation and HMRC does need to prevent abuse of the scheme."*
> **John Powell**

Several noted that awareness of both SEIS and R&D incentives was deficient. One interviewee said:

> *Tax advantage is great … we're still educating angel investors about SEIS, never mind teams from Italy, to know that actually the UK is a great place to come because it's easier to get investment. So I think we do have an advantage there, I just don't think anybody knows about it yet, outside of the UK."*
> **Simon Jenner**

Some have posited that, whilst support for earlier-stage companies is strong, there needs to be more incentives for later-stage companies to set up offices in the UK,[32] and better support for the follow-on funding that is needed after the EIS stage.

TAXATION AND OTHER ISSUES

Taxation can affect the extent to which VCs and entrepreneurs can derive profit from digital companies (via personal income, capital gains and corporation taxes). This can shape both the fund's appetite for investing in companies subject to a particular tax regime, as well as an individual's risk tolerance for undertaking entrepreneurial activity in the first place. High levels of income tax and low levels of capital gains tax are associated with a higher incidence of entrepreneurialism.[33]

Amongst those based in the UK, taxes were generally thought to be competitive in the UK and not an issue:

> *The taxes are actually comparable with the US once you include California state income tax, but it's things like, if they have a family the schooling is a lot more expensive. They would probably complain about the healthcare because they don't get the same benefits, although as someone who's lived in both, it's better here. Capital gains tax, I've never heard anyone complain about CGT, except for private equity investors."*
> **Scott Sage**

One US investor agreed that that UK is in a strong position compared to other parts of Europe:

> *Taxes are horribly difficult and labour laws are just downright challenging outside of the UK in Western Europe, I mean really, really challenging. That's probably our biggest issue… We've found our experiences in the UK to be positive. I mean tax and the things that we're complaining about aren't wholly different than what we're complaining in the US."*
> **Larry Handen**

One interviewee suggested that the tax implications of investing outside the US were not well understood, and were therefore off–putting for US funds. This raises the possibility that perception of taxation in the UK is as important as the reality.

The use of employee stock options is far more common in the US than the EU.[34] The UK has implemented Enterprise Management Incentives to encourage the uptake of employee stock options: those who had used this scheme found it useful, if bureaucratic. Some interviewees emphasised the importance of driving up interest in employee stock options:

> “*In Europe we're still not too familiar with employee share options, convertible loans etc., but it's slowly, slowly improving. I think a lot of start-ups today recognise the need to give shares to co-founders and probably also the next round of people that they hire.*”
> **Carsten Kølbek**

Several interviewees discussed how governments here and in the US could use tax instruments to better distinguish between what they see as the positive social impact of venture investment, as compared to other forms of investment activity.

In the UK, similar points were made around the prospective abolition of capital gains taper relief and the failure to differentiate entrepreneurs who have committed years to building companies from other beneficiaries of this policy.

Interviewees had a range or recommendations on this topic, reflecting the range of issues that were discussed.

From a US perspective, having reciprocal tax regimes was recommended:

> “*Making sure that the tax regimes are reciprocal. Ideally, you want the UK to be the headquarters and I don't have to dump something in the Antilles or somewhere else, so that means I'm going to be able to repatriate my cash, which is very difficult for us to do in the United States, I think that would be helpful.*”
> **Larry Handen**

6 CONCLUSION

This report has updated figures on venture capital performance and investment for the UK and US, as well as reviewing perceptions from both UK and US investors on the UK market. In an industry where average returns even in the US are failing to beat stock market returns, the average UK fund is even further behind, with returns four percentage points below the average US fund. However, from both the figures and the interviewees, there are early signs that things may be improving in the UK venture capital market.

US returns have started to improve in the last few years, and although this has started to widen the gap again with the UK, London in particular is viewed very positively as a location with significant potential for further start-up investment. While distance will always make it a challenge to invest from the West Coast into Europe, the rise of East Coast funds, especially those based in New York could be helpful in providing a source of investment that is closer in both geography and temperament to London.

In examining the range of causes of the persistent gap in performance between UK and US venture capital, this research shows that two of these factors may be more important. One is the role of exit markets: It appears that the slower, less profitable UK exits may be both driving down performance of UK funds, and persuading the best UK companies to incorporate in the US to take best advantage of more favourable IPO markets.

The other component, confirming our previous analysis, is the wider environment in which start-ups operate, composed of the regulatory environment, as well as culture, talent pool, access to advice and information, amongst other components.

Internet and digital companies often operate in fast-moving areas of regulation, where legislators and regulators are trying to track an ever-changing technological landscape. The uncertainty created as appropriate responses are formulated can create problems with funding, and slow down the speed that start-ups operate at – an essential component of success.

However, regulation is necessary and important, not least in these rapid areas of technological change. There are few that argue that we need no protection from abuses of privacy or stealing intellectual property. A balance is needed to encourage innovation and exploration.

This research has also approached these questions from a specific perspective: that of the investor and their perceptions of the market. The interviews did not take account of the views of regulators, government policymakers, and took only a limited set of views from start-up companies themselves.

There are several questions arising from this work that should be further explored. These include:

- How does regulation affect the start-ups themselves and the decisions they take.
- How can we learn from examples where the regulatory regime has supported entrepreneurship and how can those be replicated?
- Can regulatory changes be used as a policy lever to increase venture capital investment proactively?

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