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The British Private Equity and Venture Capital Association

The role of *entrepreneurs* and *SMEs* in **driving the recovery**

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Introduction

The UK economy has not performed strongly since exiting recession at the end of 2009. In the past, recessions have often been followed by periods of relatively strong growth, as the economy to some degree 'makes up for lost time'. But, at the end of March 2011, UK GDP was still around 4% below its pre-recession peak at the start of 2008 (Figure 1). In contrast, US GDP has already regained all the ground it lost, and national income in the euro area as a whole was around 2% below its pre-recession peak (although that headline figure masks significant divergences within the euro area).

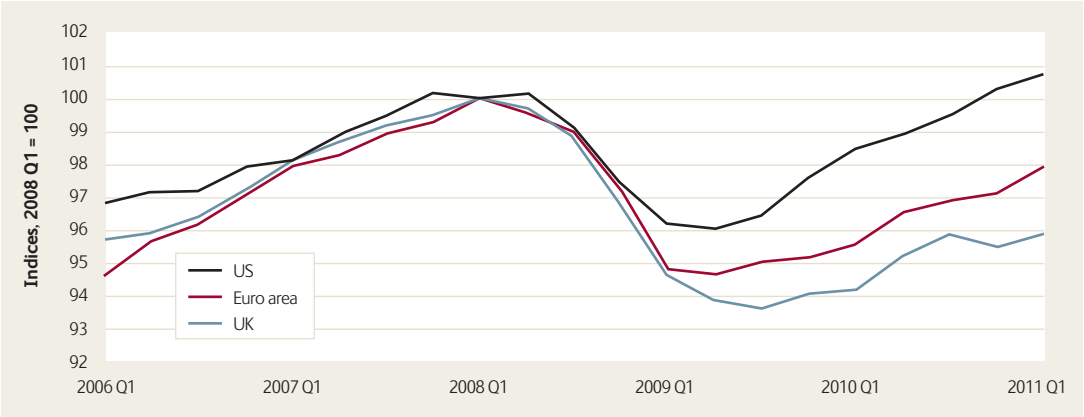

Figure 1:
GDP indices

Source: Bloomberg and BVCA

Unfortunately, the relatively weak recovery coincides with a prolonged period of fiscal tightening. While the UK came into recession with a modest structural deficit in the public finances, most of the 12% deficit that opened up during the downturn reflected the public sector supporting the overall level of activity as the private sector retreated, rather than the public spending actively crowding out private growth. As the deficit is necessarily cut in the years ahead, and at an increasing pace from this financial year, that support to the level of economic activity will be withdrawn (Figure 2). A key question is therefore whether the private sector will be able and willing to pick up the baton of growth and help achieve the required rebalancing of the economy that policymakers desperately want. A particular concern here relates to the labour market, where private sector job creation in the past decade has not been particularly pronounced (Figure 3).

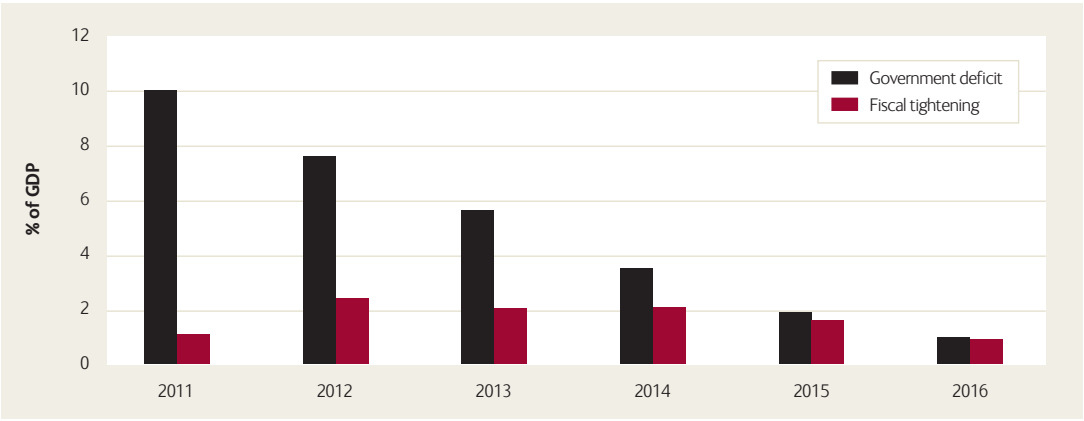

Figure 2:
UK deficit forecast

Source: OBR

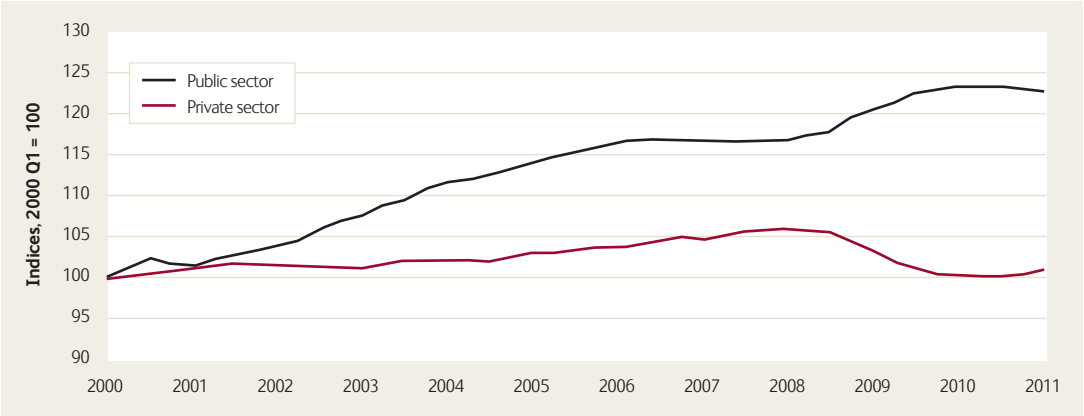

Figure 3:
Estimates of workforce jobs

Source: ONS and BVCA

A central plank of the Government's strategy has been to encourage new businesses and start-ups to fill the void left by the public spending cuts, and for small and medium-sized enterprises (SMEs) more generally to boost activity and jobs. Venture capital (VC) has an important role to play here, which was reflected in the changes to Venture Capital Trusts (VCTs) and the Enterprise Investment Scheme (EIS) that were announced in the 2011 Budget. Against this backdrop, this article examines the role that entrepreneurs and SMEs can play in the recovery. First, we examine how attractive the UK is as a place to do business, on the basis of global comparisons, before looking at how the recent recession has affected entrepreneurial attitudes. Following this, we then examine the role of SMEs and entrepreneurs in generating increases in national income over the long term, and the particular role that they can play.

How attractive is the UK as a place to do business?

As the sixth largest economy in the world, the UK clearly has an important role to play. Yet at the same time, its small size overall – the UK accounts for less than 4% of world GDP – means that it is rarely the driver of global trends in trade or investor sentiment, but instead is subject to them: the UK is often characterised as a small, open economy. As such, the most appropriate way to assess the attractiveness of the UK as a destination to do business is to compare it against other advanced or developing economies.

There are a number of institutes and organisations that are active in this area, compiling statistics and rankings across a broad range of economies. For brevity, we will report only a sub-sample of these indicators here, which are broadly representative of our wider research in this area.

A first point to note is that the UK's underlying economic framework is very strong. Figure 4 shows framework conditions and entrepreneurship from a pre-crisis study by the National Agency for Enterprise and Construction (NAEC) in Denmark. Framework conditions are measured here in terms of market demand, the supply of capital and skills, and working culture and incentives. On this basis, the UK is second only to the US. At the same time, entrepreneurial activity – measured here on the basis of revenue and employment growth for new businesses – is perhaps not as robust as the UK's strong framework would imply. However, across all the countries in the sample the relationship is not especially strong, with an R^2 of 0.22.[1]

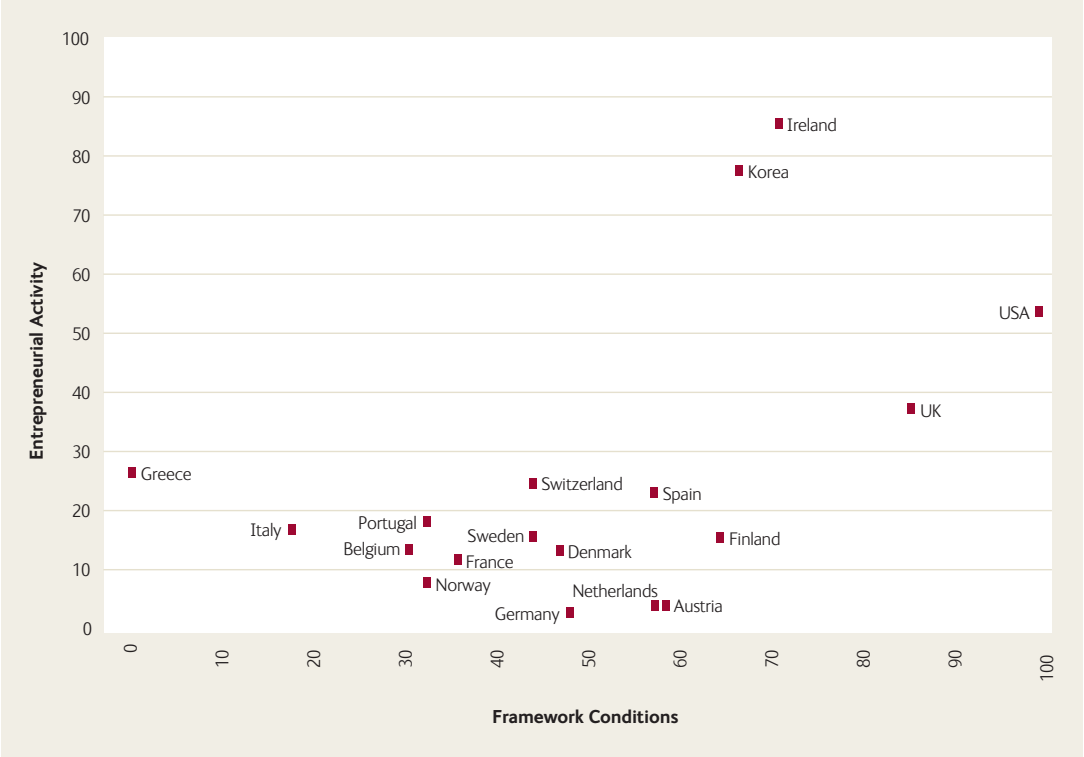

Figure 4: Framework conditions and entrepreneurial activity

Source: NAEC (2006)

1 An R^2 measures the closeness of fit in a relationship between two series, with 1 representing perfect fit, and 0 indicating no statistical relationship.

If we examine alternative measures, a similar picture emerges. Figure 5 reports measures of economic freedom from The Heritage Foundation, which looks at business freedom alongside trade, fiscal and monetary conditions. Figure 6, meanwhile, reports a measure of global competitiveness from the World Economic Forum (WEF). This index is broader, looking at health and education, infrastructure, and technological readiness, among other factors. In both instances the UK performs strongly.

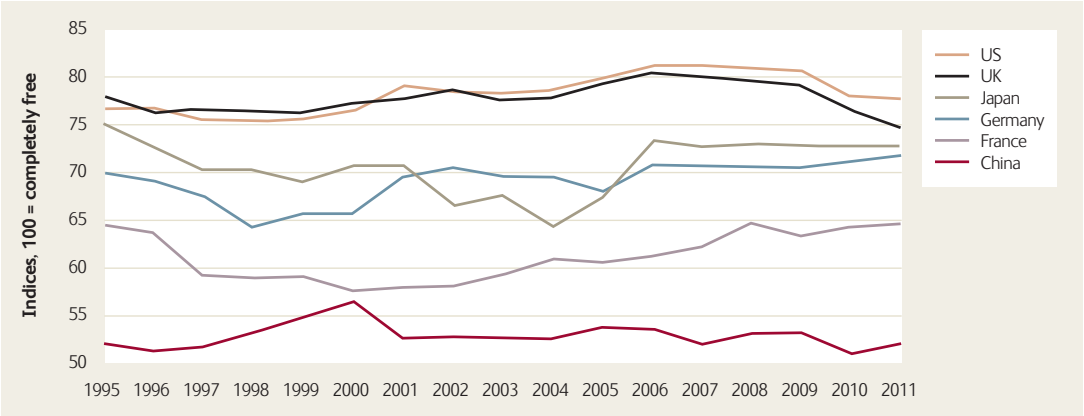

Figure 5:
Economic freedom in selected countries

Source: The Heritage Foundation

Country	GCI 2010		GCI 2009
	Rank	Score	Rank
US	4	5.43	2
Germany	5	5.39	7
Japan	6	5.37	8
Canada	10	5.30	9
UK	12	5.25	13
France	15	5.13	16
China	27	4.84	29
Italy	48	4.37	48
India	51	4.33	49
Brazil	58	4.28	56
Russia	63	4.24	63

Figure 6:
Global competitiveness indices (GCIs)

Source: WEF

One key issue is the burden of regulation that UK companies face when doing business. In common with other advanced economies, it is likely that more time and cost is spent on issues ranging from health and safety to trade permits than in some lower-cost developing nations. But the burden of regulation may be lower than is commonly thought. Figure 7 presents results from an OECD study (Wölfl *et al*, 2009) that looked at the broad burden of regulation across different OECD economies. Under this broad metric, regulation captures administrative burdens for corporations, but also the pervasiveness of state ownership across sectors of the economy, barriers to entry and to foreign direct investment (FDI), and the use and control of regulation. On this basis, the UK economy is far from one of the most over-regulated, and instead enjoys a relatively liberal framework.

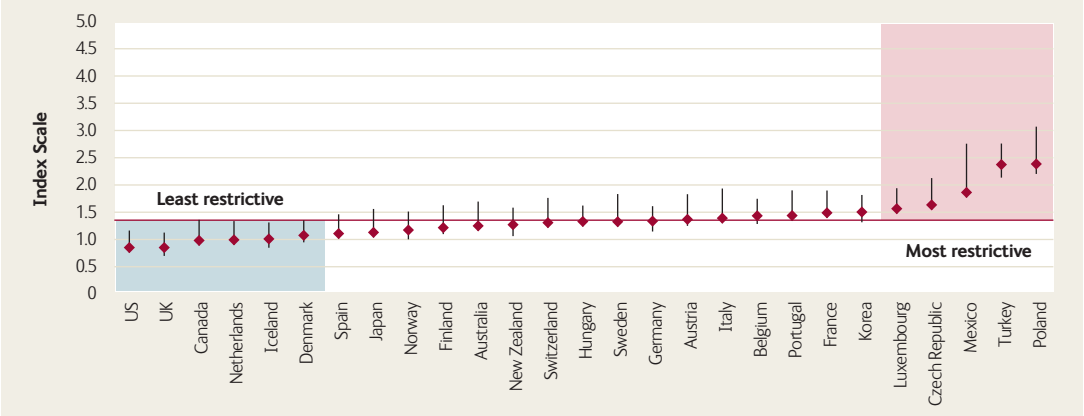

Figure 7: Product market regulation across countries

Source: Wölfl et al (2009)

Note: diamonds represent point estimates, lines represent 90% confidence intervals

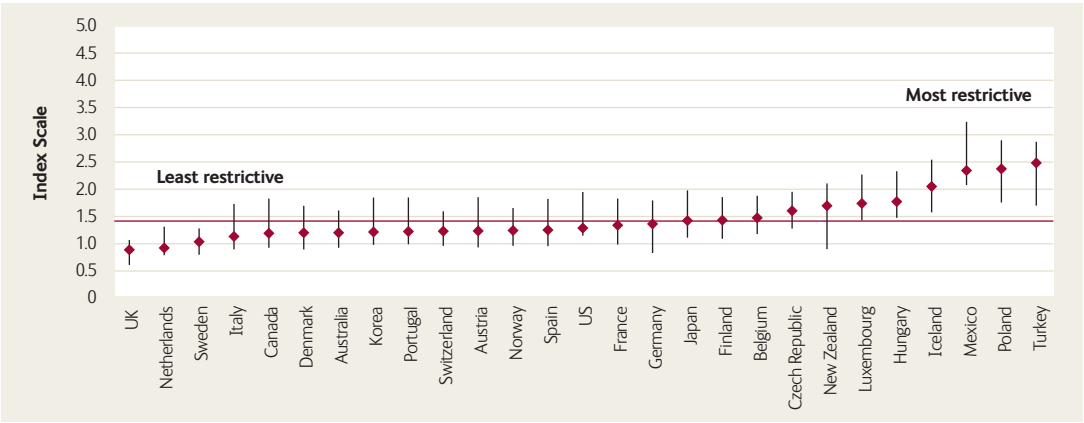

Figure 8: Barriers to entrepreneurship

Source: Wölfl et al (2009)

Note: diamonds represent point estimates, lines represent 90% confidence intervals

The picture is very similar if we consider barriers to entrepreneurship, which were also addressed in the OECD study. These were gauged in terms of traditional barriers to entry such as legal requirements, licensing and permit systems, but also the communication and simplification of rules and procedures. This time the UK emerged at the top of the pack (Figure 8), again reaffirming the UK as a good place for entrepreneurs and companies to do business. In fact, on the basis of the latest World Bank and International Finance Corporation (IFC) figures, the UK is currently the fourth best country globally to do business (Figure 9), behind only Singapore, Hong Kong and New Zealand.

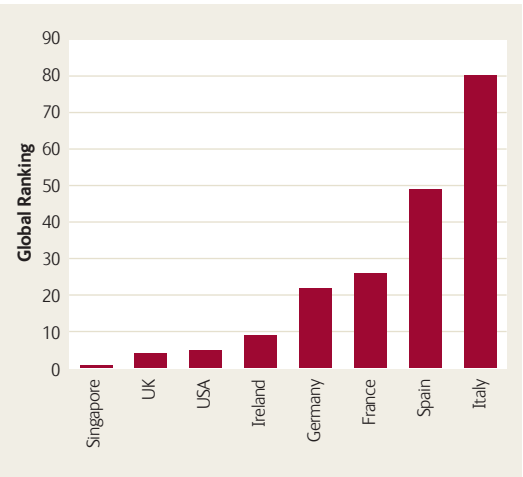

Figure 9: Ease of doing business in 2011

Source: World Bank/IFC (2010)

The impact of the recent recession

The data highlighted above clearly confirm the UK's attractiveness as a business destination. However, entrepreneurial attitudes are perhaps not as pronounced as the economic framework would merit (consistent with the earlier evidence from NAEC).

Figure 10 shows survey results on attitudes to entrepreneurship from the Global Entrepreneurship Monitor (GEM). While UK respondents are relatively bullish about their ability to set up a business, and not overly worried about the possibility of failure (though still more cautious than US respondents), it is striking that only around a quarter of people think that there are good opportunities for start-ups where they live. Figure 11 plots UK responses over time: the impact of the recession is clearly visible, with fewer people believing there are good opportunities in their area than in 2007.

% Agreeing with statement	I know someone who has started a business in the last 2 years	There are good start-up opportunities where I live in the next 6 months	I have the skills, knowledge, and experience to start a business	Fear of failure would prevent me starting a business (for those who agree there are good start-up opportunities)
UK	31.1	26.8	47.2	36.0
France	45.6	31.9	33.8	43.2
Germany	27.9	27.0	36.6	38.6
Italy	29.9	24.6	39.4	39.1
Japan	14.0	5.0	9.4	37.7
USA	24.9	32.3	54.0	31.7
G7 Average	28.9	24.6	36.7	37.7

Figure 10: Global attitudes to entrepreneurship

Source: Hart & Levie (2010)

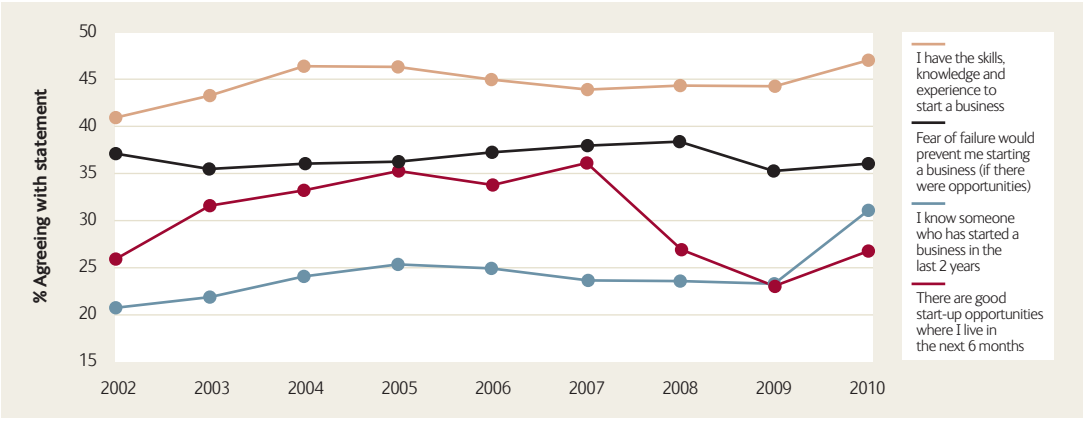

Figure 11: UK attitudes to entrepreneurship

Source: Hart & Levie (2010)

More generally, GEM data suggest that it is not just entrepreneurs who are more cautious about the outlook and opportunities for business following the downturn. Figure 12 splits results for new entrepreneurs and more established business owners. It is striking that both groups think that it is now more difficult to start a business than it was before the recession, and in particular that fewer opportunities exist.

% Agreeing with statement	New entrepreneurs and business owners		Established business owners	
	2009	2010	2009	2010
Starting a business is...				
More difficult	64.4	53.1	75.8	61.7
About the same	23.8	32.4	16.5	29.0
Less difficult	11.8	14.5	7.7	9.3
Expectations for growth are...				
Lower	43.8	24.7	49.8	23.2
About the same	35.8	47.9	34.3	44.0
Higher	20.5	27.4	15.9	23.2
The economic slowdown created				
More business opportunities	20.3	18.7	14.2	10.8
No impact	28.6	37.2	32.2	41.8
Fewer business opportunities	51.1	44.1	53.5	47.4

Figure 12: Attitudes of new and established entrepreneurs

Source: Hart & Levie (2010)

This finding is striking, given the ongoing rebalancing of the UK economy and deficit reduction plan. Past recoveries from recession have been characterised by relatively strong growth as new opportunities are seized. And with 2.5 million people unemployed – and a total of around 6.5 million underemployed, if we include the inactive who want a job and those forced to take temporary or part-time jobs – there are clearly spare people and resources in the economy for entrepreneurs to employ, as well as lots of potential entrepreneurs.

One factor that is likely to have influenced entrepreneurs' views is the marked tightening in credit conditions during the recession. The global banking crisis hit the UK especially hard, given the relatively large scale of its banks, with Lloyds and RBS having to fall back on taxpayer support and other institutions having to raise significant funds from external sources. One consequence is that banks have tightened their lending criteria, which is particularly a concern for UK SMEs as they do not have the same access to capital markets as larger companies. This tightening in credit standards has not just been a feature of the UK, however, with European SMEs more generally also facing a higher hurdle than they did before the downturn (Figure 13). And although credit conditions may now have stopped tightening, there is little sign that they are set to ease any time soon, let alone return to pre-crisis levels. At the same time, BVCA members have been committing more capital to established firms that want to expand and develop (so-called 'growth capital') rather than earlier stage investments including seed and start-up funding (Figure 14). And despite business angels increasing their provision of funding to new businesses in the most recent data (BBAA, 2011), this has not fully offset the funding shortfalls elsewhere. Entrepreneurs are likely to find it more difficult to find financial backing than they did four or five years ago. This remains a critical issue for policymakers.

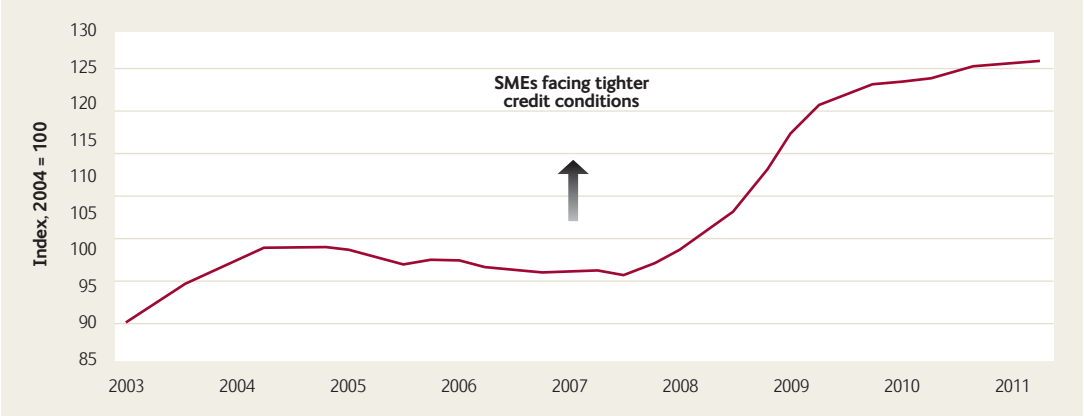

Figure 13: Credit standards for SMEs

Source: ECB and BVCA

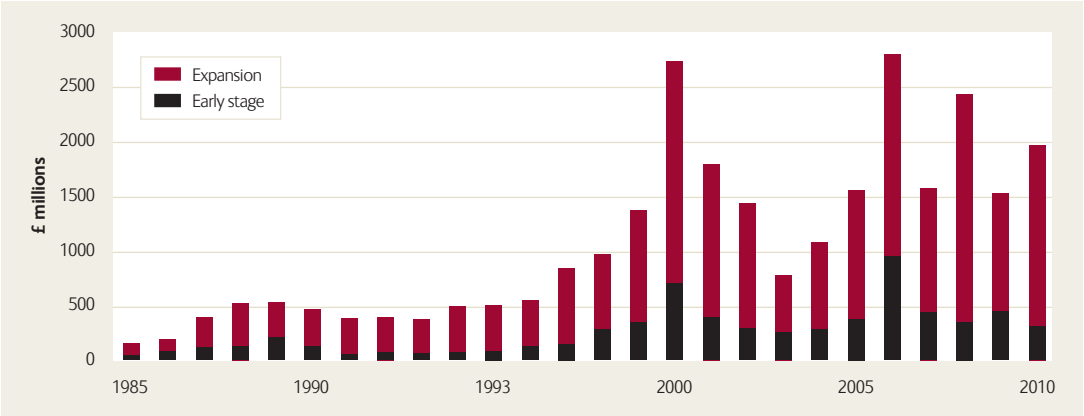

Figure 14: Expansion and early stage VC funding

Source: BVCA

How do entrepreneurs and SMEs affect long-term growth?

This analysis suggests that there is a clear risk that a lack of access to finance could stunt the formation and expansion of UK SMEs. In turn, that suggests that the economic recovery would be (even) weaker than it would otherwise have been. Implicitly, this asserts a link between new businesses, SMEs and growth, but that link is rarely discussed in any depth. As such, in this section we will examine the impact of entrepreneurs and SMEs on UK GDP over the long term.

It is important to take a long-term perspective because developments in the SME sector can otherwise be dominated by cyclical conditions. A common way to analyse GDP over the long-term in this way is to use a 'growth accounting' framework, where changes in national income are linked to different factors of production.[2] The precise accounting framework can take many forms, but for simplicity we consider two explicit factors, namely labour (people) and capital (machinery, equipment, vehicles, premises etc.).

Over the past 30 years, UK GDP has risen by around 80% (Figure 15). At the same time, labour input – measured here using total hours worked – has been relatively unchanged, as increases in employment have been offset by declines in average hours worked. In contrast, capital – measured here in terms of its use in production, rather than the asset value of investments[3] – has outpaced both labour and GDP. In large part, that reflects the declining relative price of investment, which has been well documented elsewhere (Ellis and Groth, 2003).

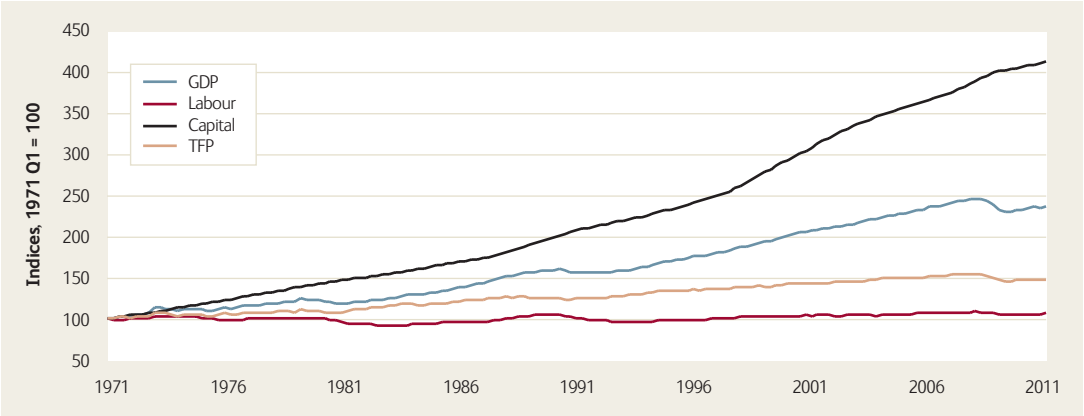

Figure 15:
UK GDP and factors of production

Source: ONS, BoE and BVCA

However, in a standard growth framework labour and capital cannot account for all of the increase in GDP; there is a lump of growth left over. This unexplained growth is often referred to as total factor productivity, or TFP.[4] This accounts for everything that is not included in labour and capital – including innovation, efficiency and entrepreneurship (as well as the economic cycle).

2 See for instance Swan (1956) and Kendrick (1961).
3 See Oulton (2001).
4 It is also known as the Solow residual, reflecting the author's critical contribution in this field: Solow (1956), Solow (1957).

We can examine the likely impact of entrepreneurs and SMEs on each of these factors of production in turn. In terms of capital, small businesses' investment plans were hit every bit as hard as larger firms' spending during the recession (Figure 16), suggesting that any recovery in SME investment may also keep pace with larger players. However, in terms of the level of UK business investment, SMEs account for a relatively small share: only 10% of business investment is from firms with less than 50 employees, despite these same firms accounting for around 45% of total employment. Small businesses are simply not very capital intensive in an economic sense,[5] and as such it would take a large number of new businesses to have a significant impact on the overall level of business investment and hence capital. We are unlikely to see a significant boost to growth via this channel.

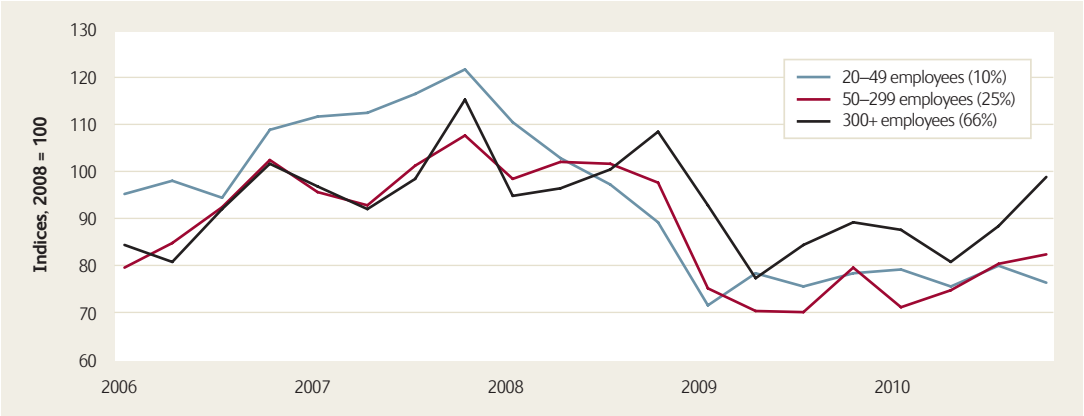

Figure 16: Investment by firm size

Source: BoE

Note: figures in brackets are shares of capital expenditure in 2010

In contrast, various studies have found that SMEs can have a significant impact on employment. One note of caution here is that some reports tend to focus only on one part of the employment distribution, so there is an element of cherry picking. A recent example was a study from NESTA,[6] which looked at the relatively small number of companies that had seen strong employment growth during the sample period in question. Essentially, the study focused on the 6% of firms at the top of the employment distribution (Figure 17) that had seen exceptional growth in employment, accounting for over half of all jobs created at that time.

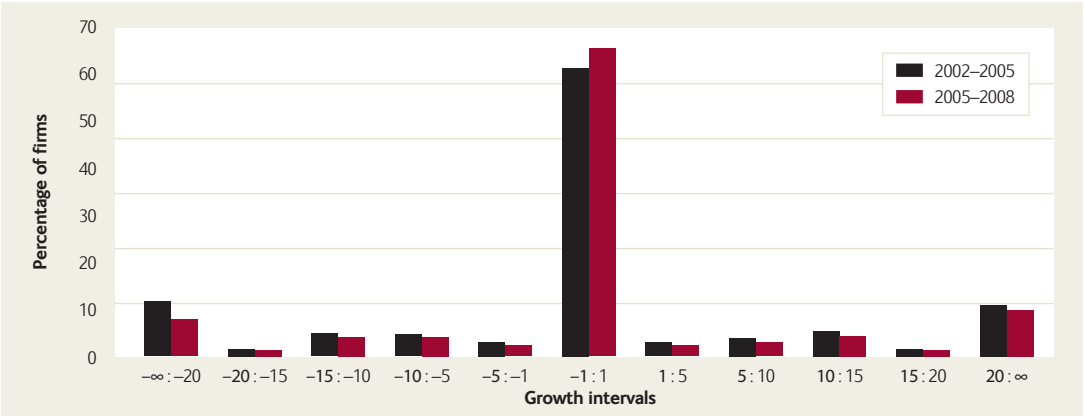

Figure 17: Distributions of changes in employment

Source: Anyadike-Danes et al (2009)

5 Although it is important to note that they may be capital dependent – a new IT firm may struggle to do business without any computers. At the same time, however, the cost of those computers will typically be small.

6 Anyadike-Danes *et al* (2009).

In the NESTA study, small firms accounted for the greatest share of those high-growth firms by number; yet, in proportional terms the role of small firms was not significantly different from their larger cousins. Roughly 6% of small firms were high-growth firms; but so too were 6% of large businesses (Figure 18). The potential for strong job creation is not limited to SMEs.

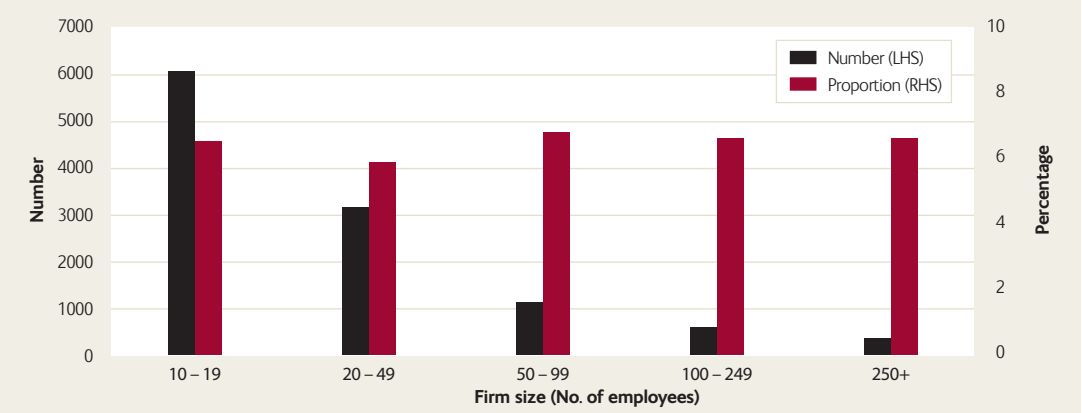

Figure 18:
Number and proportion of high-growth firms

Source: Anyadike-Danes et al (2009)

At the same time, focusing on just one part of the employment distribution in this way is not representative, from a macroeconomic perspective. While there are SMEs that have generated many jobs in the past, SMEs are also inherently riskier, not least because they do not benefit from the same economies of scale or access to capital markets as larger firms, and therefore are more likely to go bust. ONS data show that of all new businesses that started in 2004, fewer than half were still trading in 2009. Clearly the recession has had an impact here, but even by 2007 a third of those 2004-vintage businesses had already shut down. As most high-growth firms are at least five years old, this indicates that many new businesses fail to have a lasting impact on job creation.

It is important to acknowledge that, as much as SMEs can and do generate jobs, jobs are also lost when SMEs shut down. A recent study for the Small Business Administration (SBA) in the US found that, over a 15 year period, net job creation across all small businesses was broadly comparable with that of larger firms (Figure 19). The key difference that was evident in the data was not the net change in employment, but instead the relatively high numbers of job gains and losses from small businesses opening and closing.

Millions of jobs		Job gains from:		Job losses from:	
Size of firm	**Net change**	**Openings**	**Expansion**	**Closings**	**Contractions**
less than 20	4.6	54.8	104.5	51.8	102.9
20 - 499	8.7	11.5	150.6	12.6	140.8
500 +	7.5	1.0	93.9	1.3	86.0

Figure 19:
US job creation by firm size, 1993-2008

Source: Headd (2010)

These job losses, and indeed SME failures more broadly, should not be viewed as overly negative. Part of a normal, thriving market economy is the chance that businesses will fail – indeed, it is an essential feature of well-functioning private markets, as the recent banking crisis has demonstrated. But, at the same time, it may be optimistic to expect UK SMEs to disproportionately generate lasting increases in employment during the recovery. Indeed, despite a general increase in the total number of businesses in the UK over the past 15 years, and a reversal of the downward trend in self-employment since 2000, the overall proportion of people employed in the SME sector has remained broadly steady (Figure 20).

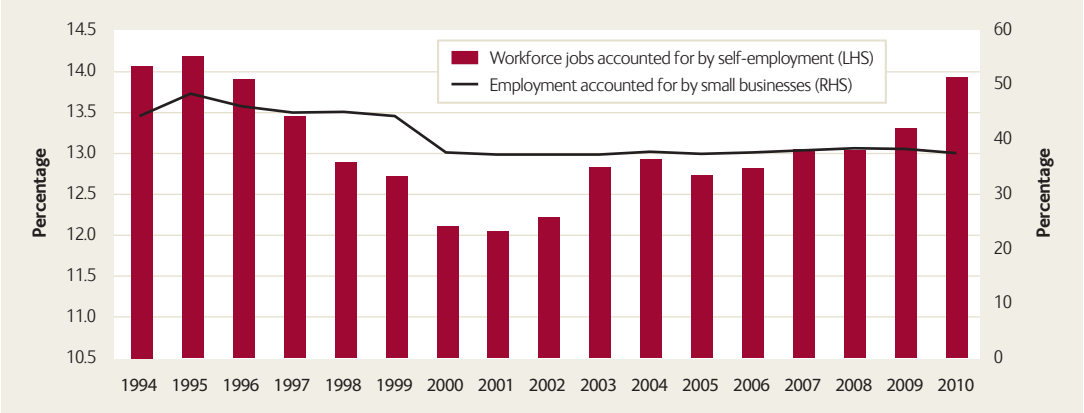

Figure 20: Self-employment and SME employment

Source: BIS, ONS and BVCA

In our view, entrepreneurs and SMEs are unlikely to disproportionately contribute to growth via capital or labour. But they can influence total factor productivity (TFP). The Government's current focus on innovation is very welcome here, as the UK is not particularly innovative at present (Figure 21), and there is evidence that innovative firms generate more jobs than their counterparts (Figure 22). But entrepreneurship can also play an important role with and alongside innovation.

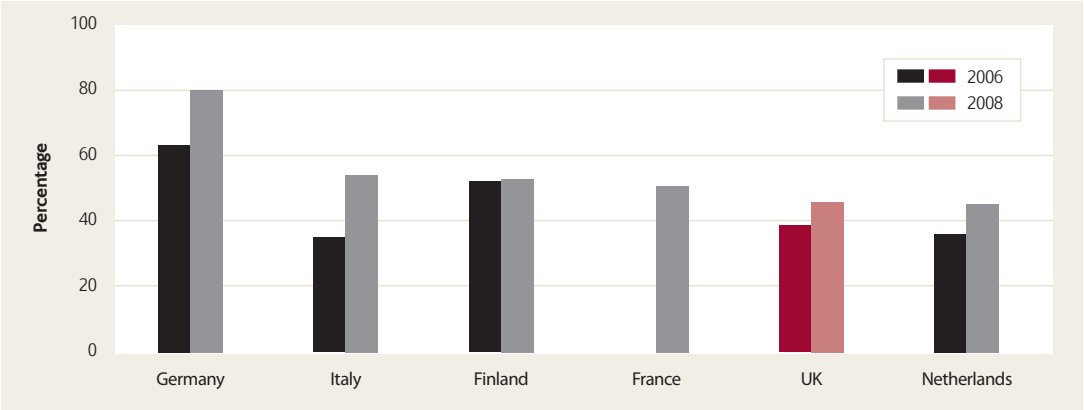

Figure 21: Innovative firms by country

Source: BIS (2011)

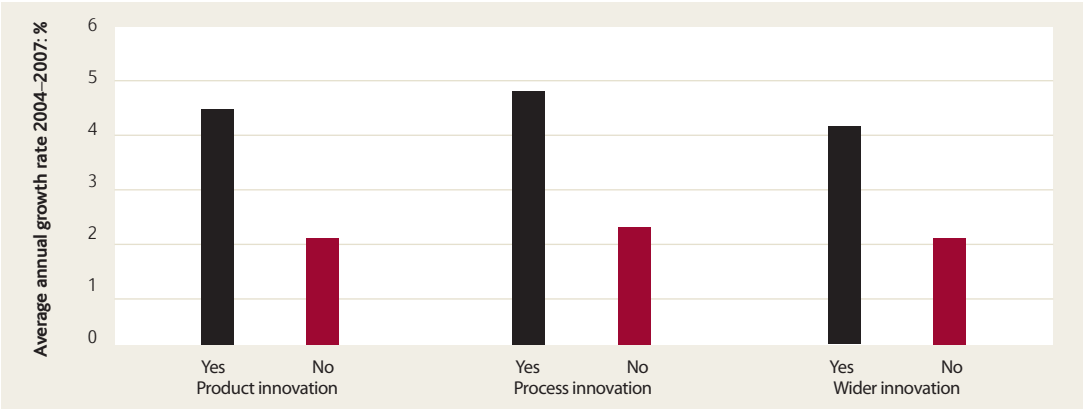

Figure 22: Innovation and employment

Source: NESTA (2011)

Recent research has examined the impact that entrepreneurs can have on national income via TFP, building on past work by Kortum & Lerner (2000), Audretsch & Fritsch (2002) and Disney *et al* (2003). In particular, Erken *et al* (2009) and Bjørnskov & Foss (2010) look at the relationship between entrepreneurship and TFP across OECD countries. The first paper finds evidence that entrepreneurship, proxied by the business ownership rate, significantly boosted incomes via TFP in the 1970s and 1980s, but in most instances made less of a contribution in the pre-crisis period (Figure 23). The second paper also finds evidence of a positive impact from entrepreneurship (measured using self-employment) on TFP across the OECD, albeit one that declines with a rising tax burden (Figure 24).

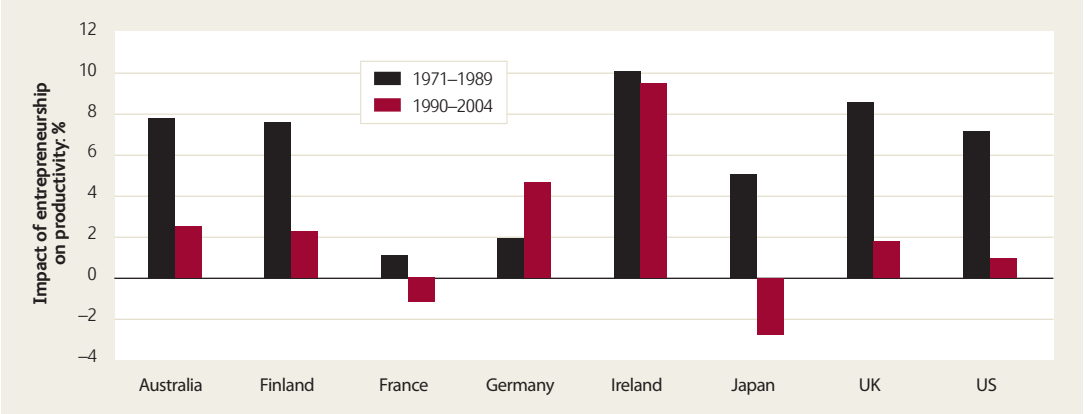

Figure 23: Entrepreneurship and TFP across countries

Source: Erken et al (2009)

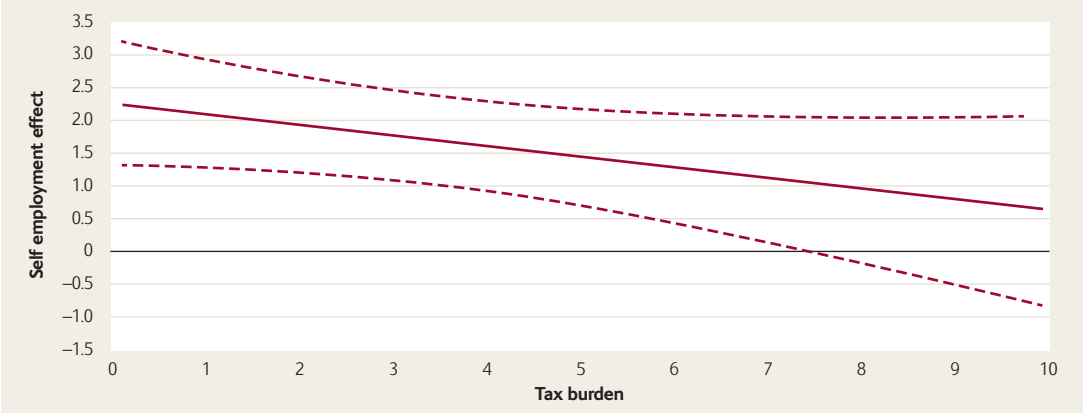

Figure 24: The impact of entrepreneurship and the tax burden

Source: Bjørnskov & Foss (2010)

Note: Dotted lines denote conditional confidence intervals.

Two other studies are also very relevant here. Audretsch and Keilbach (2007) examine the impact of entrepreneurship alongside knowledge across local regions in Germany, measuring entrepreneurship via business start-up rates, and knowledge by employment in research & development (R&D) industries. While capital still has the biggest impact on labour productivity (Figure 25), the contribution from entrepreneurship is more than three times the size of the boost from R&D, illustrating the critical role that it can play.

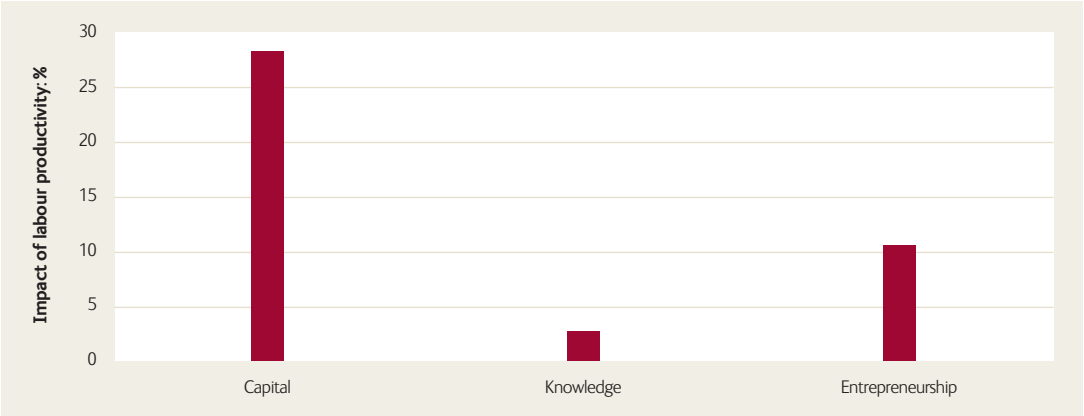

Figure 25: Drivers of labour productivity across German regions

Source: Audretsch & Keilbach (2007)

Finally, Chemmaneur *et al* (2011) look at the relationship between VC investment and TFP across a panel of US manufacturing firms. Two results in particular are very interesting. First, the typical VC-backed firm has higher TFP than a non VC-backed firm, even prior to investment, which suggests that VCs correctly identify companies that are performing strongly. Second, following investment from VCs the TFP gap between VC-backed firms and other companies increases, consistent with VCs genuinely adding value to businesses (Figure 26).[7]

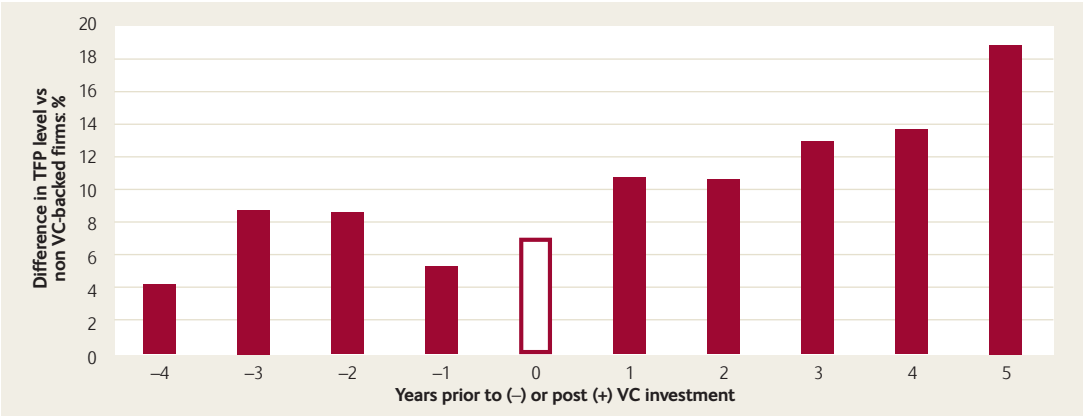

Figure 26: TFP differences in VC-backed US firms

Source: Chemmanur et al (2011)

This evidence suggests that, if entrepreneurs are going to make a disproportionate and lasting difference to the UK economy, we may be more likely to see the impact in productivity gains rather than in job creation or investment. However, those productivity gains are no less important, representing as they do a genuine and lasting increase in national income.

7 This is consistent with qualitative evidence reported in Ellis (2010).

Summary

After the deepest recession that most people can remember, the UK has seen a relatively lacklustre pace of recovery in the past 18 months. Unfortunately, the recent loss of momentum in growth also coincides with an acceleration in the prolonged period of fiscal tightening that is necessary to get the public finances in order.

A key part of the Government's economic strategy is to promote the UK as a place to do business, and encourage entrepreneurs and SMEs to locate and grow here. Our analysis suggests that the UK does enjoy strong advantages as a destination and location for business, although access to funding remains a key concern for many entrepreneurs and SMEs. In terms of the likely impact these new and growing businesses will have on growth, it may not be directly evident in lasting job creation or higher levels of business investment. Instead, much of the benefit will come through productivity gains; recent research suggests that this is an important channel via which entrepreneurs and SMEs can raise national income, thereby boosting activity, earnings and employment across the country as a whole.

Colin Ellis & Devash Tailor

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cellis@bvca.co.uk
dtailor@bvca.co.uk

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For further information contact the BVCA

1st Floor North
Brettenham House
Lancaster Place
London WC2E 7EN

T: +44 (0)20 7420 1800
F: +44 (0)20 7420 1801
E: bvca@bvca.co.uk

bvca.co.uk

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