

# Conclusions of the National Audit Office

## Private equity investment operations of the state

In Finland, investing in private equity began in the 1980s and since then there has been a rapid expansion of this form of economic activity: In relation to GDP, there were only five EU and euro area countries in which companies received more private equity investments than Finland in 2014. In venture capital investments Finland was second after Sweden. The State of Finland has also become a major private equity investor.

The purpose of the audit was to determine whether the steering of the private equity investments made by the state and the monitoring of the investment performance support the achievement of the investment objectives. The audit was carried out in the Ministry of Employment and the Economy and the following three companies in its administrative branch that invest in private equity: Finnish Industry Investment Ltd, Finnvera plc and Tekes Venture Capital Ltd. Finnvera has decided to end its venture capital investment operations after a transitional period and Tekes only started investing in venture capital in 2014, which means that the focus of the audit was on Finnish Industry Investment Ltd.

## State and public sector account for a large proportion of all private equity investments

The state creates general prerequisites for private equity investments but it is also a major private equity investor: At the end of 2014, the equity of Finnish Industry Investment Ltd alone (EUR 597 million) accounted for about 10 per cent of the total assets managed by Finnish venture capital investment companies (EUR 5.9 billion). In fact, compared with other European countries, vibrant venture capital investment operations and a large proportion of the public sector of all investments are both typical of Finland: According to the evaluation of Finnish Industry Investment Ltd carried out in 2014, the proportion of the public sector of all private equity investments in Finland between 2008 and 2012 was about twice as high as the European average. In Finland, the public sector accounted for a larger proportion in all stages of private equity investments.

The economic performance of the state-owned venture capital investment companies has usually been rather modest. The return on equity of Finnish Industry Investment Ltd was one per cent and return on investment two per cent between 1995 (the year the company was established) and 2014. Of Finnvera plc's subsidiaries, the operations of Veraventure Ltd have been profitable in most years whereas Seed Fund Vera Ltd has never made a profit. Every year, the state has forgiven capital loans that it has granted to Finnvera for strengthening Seed Fund Vera's capital base.

## The need for capitalisation should be carefully considered

A number of recent reports and evaluations discussing financial markets and business funding by the state have suggested that there should only be small increases in private equity investments by the state or no increases at all. It has also been suggested that the investments by the state could distort the market. However, the state has made a large

number of new funding decisions involving sums of different sizes that substantially exceed the need for additional inputs suggested in the reports. Finnish Industry Investment Ltd has accounted for the largest increases even though in the evaluation of the company it was recommended that instead of being provided with additional capital the company should make more efficient use of its existing capital base.

According to the audit results, the additional capitalisation by the state should be based on a comprehensive analysis of companies' funding needs and functioning of the capital market. The inadequacies in these areas should also be specified in the analysis. Any market distortions generated by the state's investment operations and the other non-investment tools for strengthening the capital market available to the state should be reviewed.

### The justifications offered by the Government for its proposals concerning venture capital investments are of general nature

According to the audit results, the legislative proposals concerning state-owned venture capital investment companies and their operations that the Government has submitted to Parliament contain only summary descriptions of the current problems, needs for change and the impacts of the proposals on the capital market and business operations. On the basis of the proposals, it is difficult to get any idea of the functioning of the venture capital investment market and the market failures that are claimed to exist. Typically, venture capital investments by the state are described as the only way to deal with the needs detailed in the proposals. The proposals do not contain any evaluations of the other types of business funding provided by the state or the other instruments available to the state that can influence business operations and the capital market. The proposals are only considered to have positive impacts and there is no mention of any undesirable or negative effects.

### Effectiveness has been evaluated and measures have already been taken

The Ministry of Employment and the Economy has commissioned evaluations of the agencies and companies in its administrative branch on a regular basis. In the evaluation of Finnish Industry Investment Ltd, the company is characterised as having a substantial impact. The usability of the results is negatively affected by the fact that the causal relations between the company's operations and the impacts described in the evaluation cannot be proved with the methods used. A reliable effectiveness evaluation would, in addition to a greater focus on methods, also require that the sustainability of the impacts after the end of the investment activities is assessed and that consideration is also given to the non-desirable impacts of the operations.

The Ministry of Employment and the Economy has considered the recommendations presented in the evaluation in the steering of the company's operations and in this way it has made efforts to improve the effectiveness of the company. The intention is to continue the development work.

The liquid assets of Finnish Industry Investment Ltd totalled 242 million euros at the end of 2014 and according to the company their purpose is to ensure that the company is able to meet its investment commitments. At the end of 2014, the company had a total of 256 million euros in outstanding investment commitments. The company

has paid between 40 and 60 million euros in investment commitments each year and its view has been that these amounts are fairly easy to forecast. According to the evaluation, the company could make much more efficient use of its existing capital base and liquid assets and draw on them when making the new capital investments required. According to the ministry, the recommendation concerning the more efficient use of the company's existing capital base is primarily directed at the sector under the company's management and board of directors and thus it does not require any specific action from the ministry.

### More than half of the target companies of Finnish Industry Investment are in foreign ownership

The main task of Finnish Industry Investment Ltd is to promote small and medium-sized business activities in Finland, which means that the details of the domestic and foreign ownership of the companies receiving funding from it can be considered essential information. According to the annual reports of Finnish Industry Investment and the other information provided by the company, in 2014 it had direct investments in 66 companies, while its target funds had investments in 544 companies. Thus the company had investments in a total of 610 companies. It is not stated how many of the target companies are Finnish-owned and how many are foreign-owned or how the assets invested by Finnish Industry Investment are divided between Finnish and foreign target companies.

According to the information separately requested from the company, of the 610 target companies, 341 (56%) were foreign and 269 (44%) were Finnish.

### Investing in foreign funds requires a Finnish interest

Under the act governing the operations of Finnish Industry Investment Ltd, the company can make investments in foreign funds and target companies provided that their operations help to promote economic growth in Finland. In the rationale of the act, investments in foreign countries were defined as investments outside Finland. Such investment activities across national boundaries were considered to be essential for the development of the capital market. There are no provisions in the act or the Government decree on the company on how a foreign fund is defined even though this is essential for the implementation of the act. In addition to the increasingly international nature of private equity investment operations, the fact that the definition of a foreign fund is not well-established also underlines the role of regulation. Previously, a fund was considered foreign-owned if its management company was registered outside Finland. However, in its most recent opinion, the ministry has stated that in funds located in the Baltic states and the Nordic region, foreign ownership should, for reasons of practicality, be defined in accordance with the type of the investment. The ministry is not planning to apply this definition to other funds located outside Finland.

Investments outside Finland require a Finnish interest and according to the Government proposal, the intention was to issue more detailed Government provisions on this matter. Finnish Industry Investment has also produced definitions of the Finnish interest even though the Finnish interest is specifically used as a justification for state involvement.

## Recommendations of the National Audit Office

The National Audit Office recommends that the Ministry of Employment and the Economy

1. should review and specify inadequacies in the capital market and evaluate which non-investment instruments the state can use for improving the functioning of the capital market
2. should when evaluating the effectiveness of the private equity investment companies pay attention to the reliability of the methods used and examine both the desirable and undesirable impacts and the sustainability of the impacts after the discontinuation of the investments
3. should ensure that the Government issues a decree containing provisions on what is considered an investment outside Finland and what is required of such an investment (Finnish interest).