Issue 3 – December 2007

RICAFE2 Newsletter

Welcome to the second edition of RICAFE2 newsletter. This newsletter aims to keep you informed of the recent developments in the RICAFE2 project.

http://www.lse.ac.uk/RICAFE.htm

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RICAFE2 - Regional Comparative Advantage and Knowledge Based Entrepreneurship

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Second RICAFE2 Conference - Review

RICAFE2 Second Conference

5 & 6 October 2007

Baltic International Centre for Economic Policy Studies
Stockholm School of Economics in Riga

The second annual RICAFE2 conference was held on 5 and 6 October at the Baltic Centre for Economic Policy Studies (BICEPS), Stockholm School of Economics in Riga, Latvia. The conference covered both theoretical and empirical studies on entrepreneurship in its various dimensions and on the role of policies, namely taxes, competition, knowledge protection and the level of financial development. The conference was organised into four sections, including a policy panel dedicated to the role of venture capital (VC) in the new European Union states.

The opening and welcome remarks were given by **Alf Vanags** (BICEPS), who briefly commented on the RICAFE2 programme and presented the organizing institution – The Baltic International Centre for Economic Policy Studies (BICEPS). This first session of the conference included three papers. The first paper, presented by **Wolfgang Bessler** (Justus-Liebig-University Giessen) was entitled 'Innovation and the Performance of Technology Firms: Evidence from Initial Public Offerings in Germany' (co-authored with Claudia Bittelmeyer, Justus-Liebig-University Giessen). This paper demonstrated how patents, as a measure of innovation, affect the performance of firms by looking at Initial Public Offerings (IPO) in Germany. The data included German IPOs at the 'Neuer Markt' from 1997 until 2002, and also patents information from the 'Dewent Innovation Index' (Thomson Financial). Using a model of buy and-hold-abnormal returns (BHAR), a three-factor Fama-French asset pricing model and cross-sectional regressions, the authors tested the impact of patents in firm abnormal performance, both in the short term and long term. While implementing these tests they also consider the impact of 'hot' versus 'cold' issues. The paper was discussed by **Jorg Rocholl** (European School of Management and Technology), who suggested a cross-sectional regression for underpricing and a detailed analysis of the IPOs' characteristics. He also suggested alternative measures of firm performance, as the likelihood of survival or operational performance.

Katrin Tinn (SITE/Stockholm School of Economics) presented her paper on 'The speed of technology adoption with imperfect information in equity markets'. **Katrin Tinn** offered possible reasons for the differences in the speed of technology adoption across different countries, namely the development of the stock market, labour characteristics, commitment problems, credit constraints and institutions. She focused particularly on the importance of the equity markets imperfections to facilitate the transfer of ownership between entrepreneurs, who invest in the fi rst stage of technology adoption and subsequent shareholders. Her model predicts that a low expected and uncertain selling price has a negative impact on incentives to adopt a technology, due to the fear of unstable markets and information asymmetry. She concluded that, in fact, the level of development of equity markets impacts on how fast technology is adopted and that foreign investors might not participate in projects that would be optimal in more developed equity markets. Finally, she analysed the role of policies that facilitate access to information. The discussant of the paper was **Arina Nikandrova** (University of Cambridge). Her main comments on the model were the lack of dynamics, namely with respect to the speed of technology adoption and the possibility of investors and entrepreneurs choosing their roles. She also suggested that the model should offer more heterogeneity in risk aversion and in the firms in the intermediate market.

The last paper of the first session presented by **Marina Di Giacomo** (Università di Torino) was entitled 'Firm entry dynamics and the taxation of corporate profits: Evidence from European firm-level data', co-authored with **Marco Da Rin** (Tilburg University, ECGI and IGIER), and **Alessandro Sembenelli** (Università di Torino). This paper focused on the impact of different levels of income taxation at the firm level on the entry rates of companies across different European countries. The primary database used is Amadeus, (by Bureau Van Dijk Electronic Publishing), containing financial information for firms in 38 Western and Eastern European countries. Data on tax rates was obtained from Ernst & Young's yearly Publications 'Worldwide Corporate Tax Guide' and 'The Global Executive'. The authors also used a second set of variables from the Index of Economic Freedom published by the Heritage Foundation and the Wall Street Journal in order to characterise the business environment in the different countries. The paper analysed a panel of 17 countries from 1997 to 2003 and despite its preliminary stage presented some interesting findings pointing to a significant effect of corporate taxation on entry rates that are robust to alternative tax measures, other macro-economic

controls and endogeneity issues. This paper was discussed by José Mata (New University of Lisbon) who commented on the lack of comparability across countries, namely with respect to the definition of the firms and measurement issues regarding the entry of new firms and taxation variables.

The second conference session which brought together a Policy Panel on 'The role of venture capital in the new member states' was chaired by Alf Vanags. The panel consisted of the following speakers: Dairis Calitis (Latvian Venture Capital Association), Krisjanis Zarins (Latvian Guarantee Agency), Marcus Svedberg (East Capital) and Tarvo Tamm (Connect Estonia).

Marcus Svedberg (East Capital) opened the panel discussion by introducing East Capital, an independent asset management firm specialising in Eastern European financial markets, with circa EUR 5.1bn in assets under management, both in public and private equity. The speaker emphasised the importance of information for the venture capital firms and focused on the Baltic region countries. He regretted the lack of business information available in these countries and emphasised the role of venture capital (VC) companies as providers of, not only, financing, but also know-how and information about markets and companies to other entities. Marcus Svedberg also shared his view about the relation between academia and industry. His major concern focused on the use of out-of-date information by academics and the consequent difficulties to apply it to real business situations. A suggestion was made that academics should try to go a step further in the implications of research although he recognised the trade-off between the required rigor of academic conclusions and the impact (or precision) of implications for practitioners.

An outline of the activities of the Latvian Guarantee Agency was presented by Krisjanis Zarins (Latvian Guarantee Agency). This agency is part of a state aid program to promote the development of small and medium companies by facilitating the access of investment management companies and private investors to Latvian companies, and helping to create new VC funds. The program started in 2004 and by 2006 three investment management companies were selected to create three VC funds with a value of approximately 10 million lati. The expected time frame for these investors to exit is around 2013.

Dairis Calitis (Latvian Venture Capital Association) started by introducing the Latvian Venture Capital and Private Equity Association, an organization that includes six of the largest VC companies in Latvia. Dairis Calitis relating his experience in the venture capital sector in Latvia, said that venture capital and risk capital are still something new for these new members, bringing difficulties for companies and investors operating or wanting to operate in the industry. Policy makers on one hand and banking people on the other hand are not completely familiar with these concepts and therefore, the role of the association has been also to create awareness among business people and to work as an intermediate in negotiations between its members and the public sector. He concluded by outlining some policy concerns and implications for the VC sector in Latvia.

The last speaker of the panel was Tarvo Tamm (Connect Estonia) representing Connect Estonia, a network organisation, including start up and growing companies but also investors and service providers. Tarvo Tamm began his presentation with an analogy for VC in Estonia: 'the chicken or the egg' dilemma, suggesting that without good projects and companies there is no room for venture capital, and that without financing there is a very small possibility for these companies to subsist. He then summarized a set of characteristics of the new members that he believes may enhance entrepreneurship and strengthen venture capital investments. Particularly with respect to Estonia he pointed out the main positive and negative aspects of the recent VC trends, emphasising existing stories of success and the availability of public funding and support. After presenting the state of the art of venture capital in Estonia, characterised by four to five venture capitalists or business angels in stage and between 12 to 15 deals, he gave his vision for the future of this sector, estimating a total of seven to ten players and 50 to 60 deals by 2011. Finally, he left some open questions for discussion regarding the role of the public sector, the difficulties to achieve economies of scale and critical mass in these small countries, globalisation and the barriers to entry in the global markets.

The presentations by the policy panel were then followed by a lively discussion between the panelists and the academics, and a session of questions and comments from all the participants in the conference. The main issues debated were, the importance of information for the development of the venture capital and risk capital sectors and the existence or not of an entrepreneurial culture in these countries. There was an exchange of views about whether it is money or ideas which are scarce in transition countries, with policy-makers expressing a view that it is money for the very early stages which is missing, while venture capitalists claimed that they often find it difficult to scout good projects. It became clear that an important issue is the dissemination of information. It is much more difficult for a venture investor to find reliable information about new companies and new projects in transition countries than elsewhere, and in Latvia, policy certainly has a role to play. This conclusion was fully shared by the academics. However, it was also noted that previous RICAFE work has shown that public subsidies do not appear to help attract private money into investing, and therefore policy-makers should look more at structural policies like the creation of stock markets attractive for entrepreneurial companies. In this context, the importance of seed capital, the

role of the public sector, namely the Guaranty Agency and the rate of success/failure of these projects were also debated. It was pointed out that guarantees are a valuable policy tool, but their design is very important. Only if guarantees manage to attract additional money into play are they useful. Otherwise they risk turning into a subsidy to private investors, with the negative effect of lowering these investors' effort in selecting promising companies.

The final session of the first day of the conference comprised two papers. The first paper presented by **Stefan Wagner** (INNOtec, LMU Munich) co-authored with Iain Cockburn (BU, NBER) was entitled 'Patents and the Survival of Internet-related IPOs'. In this paper the authors attempt to quantify to what extent internet start-up companies benefit from patenting their core-business ideas, and if this benefit is observed in terms of survivorship of these companies after the IPO. The data includes 365 internet-firms with IPOs on the NASDAQ from 1998 to 2001, including internet services, internet software and computer software. The authors use this data in order to test the existing Cox Proportional Hazards Model of survivorship and their results confirm previous findings for non-internet based firms. When they extend this model to incorporate the effect of patent holdings they find that firms who do not protect their competitive positions have a higher risk of failure. They find poor results for traditionally used measures of patent value or quality and some evidence for market inefficiency (negative impact of assets and stock market level when going public). The discussant **Fabio Bertoni** (Politecnico di Milano – DIG Dipartimento di Ingegneria Gestionale) focused on endogeneity problems of the model, namely on the impossibility to distinguish if the relation between patents and firm performance was due to a real economic effect or simply a signaling effect (the market perceived quality of the firm). Additional suggestions were made with respect to the use of a more dynamic measure of patent activity and to the actual meaning of exiting the market (exit may not mean bankruptcy).

The last paper of the day was entitled 'Entrepreneurial Innovations, Competition and Competition Policy' presented by **Lars Persson** (Research Institute of Industrial Economics – IFN). The paper, co-authored with Pehr- Johan Norbäck (Research Institute of Industrial Economics – IFN), studied the impact of increased product market competition on the incentives for patenting and innovation (considering different choices: sell the innovation or enter the market). The model was presented in four stages: a first stage where the level of competition is chosen by the nature, a second stage where the entrepreneur chooses the effort to innovate (increasing the probability of a successful innovation), a third stage where the acquisition/entry game occurs (if the innovation is successful its value will depend on the exit strategy of the entrepreneur) and finally at stage four the product market interaction (the intensity of competition will affect the sale price, when the choice is selling the innovation, or the profit when the choice is entering the market). The main predictions from the model are that the incentive for innovation for sale relative to innovation for entry tends to increase when competition increases, and also that changes in competition levels and policy have a different impact on incentives and innovation for entry and innovating for sale. The model was discussed by **Catherine Casamatta** (Toulouse University), who suggested the incorporation of an interaction between the level of effort chosen to innovate and the subsequent choice of exit. Another suggestion was made to endogenise the level of competition and to incorporate some frictions at the innovation stage, for instance some financial constraints or competition between innovators.

On the second day of the conference, the opening presentation was given by **Javier Suarez** (CEMFI) on 'Financially constrained innovation, patent protection, and industry dynamics', a paper co-authored with Gerard Llobet (CEMFI). This work aimed to assess the role of intellectual property protection in promoting innovation and increasing welfare, in a model of industry dynamics where innovations are produced by financially constrained entrepreneurs. The model incorporated some specifi c features in its analysis, namely industry dynamics with endogenous innovation, financial constraints at the innovation stage and the distinction between intellectual property protection against imitators and against innovators. The setup of their model can be summarized as follows: there's a continuum of business niches operating under competition/monopoly, these niches are challenged by both imitating and new products (a successful imitations leads to a Bertrand competition, a successful innovation leads to monopoly), new products result from development of patented invention and finally, intellectual property grants monopolists random protection against new entrants. The main ingredients of the model are the entrepreneur entry decision, by equating entry costs against profits from innovation, the determinants of this profit (probability of success, the market value of the innovation and the severity of the moral hazard and the entrepreneur rent) and the industry conditions that will determine both the probability of success and the market value of the innovation. The main findings are that protection against innovative entries is counterproductive for innovation and welfare, while some level of protection against imitation is positive in both dimensions. The discussant **Catherine Casamatta** (Toulouse University) questioned the need of financial constraints in the model as determinants of the main results and suggested that they should be included in the innovation stage as well, following the standard literature. Finally she suggested the application of the model to alternative ways of public intervention as subsidies and taxes, and she also referred the shortage of links with the existing mixed empirical evidence on intellectual property protection and innovation.

Giovanna Nicodano (Università di Torino and Collegio Carlo Alberto) presented 'Firm scope, debt and value: a structural model of business groups', a joint paper with **Elisa Luciano** (Università di Torino and Collegio Carlo Alberto). This paper presented a comparison in terms of total value, equity and debt between stand alone, conglomerates and business groups in a world free of agency costs, suggesting that financial synergies explain the emergence of business groups despite the value destruction for shareholders. The authors extend the Leland (2007) model to incorporate the distinction between business groups and conglomerates. The model presented is a structural model including exogenous operating cash flows, bankruptcy costs and non-neutral taxation that is solved for an optimal joint capital structure (in the case of the business group) in order to maximise the tax shield and minimise bankruptcy costs. The paper concluded that business groups can be more valuable than stand alone firms and conglomerates, in terms of total firm value, even when destroying shareholder value. The discussant **Julia Hirsch** (CFS), suggested alternative features for the model, namely a further limitation on internal capital markets and restrictions on cash transfers within the business group.

The next paper 'Success Breeds Success Locally: A Tale of Incubator Firms' was presented by **Eren Inci** (Sabanci University). This work analysed the role of networks during the pre-establishment period of start-up firms in industrial districts. More precisely, it explains how these networks are formed and the relations between established firms, network entrepreneurs, and local financiers on the market prices of loans, predicting different outcomes for network members and stand alone entrepreneurs. The main finding of this research is that networks provide a better match of capital to ideas within its members. In addition, **Eren Inci** finds that in general, markets overvalue bad start-ups and undervalue the good ones, but that networks attenuate these errors. The role of networks consists basically in generating information that will mitigate adverse selection problems. Discussing the paper **Sudipto Bhattacharya** (LSE) focused on the lack of externalities in the model and suggested the author incorporate a higher level of heterogeneity across firms. He also suggested a greater clarification of the relation between the hub-firm and the rest of the network members.

The final session of the day commenced with the paper 'Valuing University based Firms' by **Silvio Vismara** (University of Bergamo), co-authored with Damiano Bonardo (University of Bergamo) and Stefano Paleari (University of Bergamo). In this paper the authors aimed to study the impact of university connections on firm value. They used European IPO data during the period 1995-2002 from the EURIPO database including 143 university based firms. They found that university-linked firms show a higher market-to-book values and a lower under pricing at the IPO. They also found no significant evidence that patents are determinants of firm value for this type of firms or that they outperform the control group of non university based firms in the long run. The discussant **Eric Nowak** (University of Lugano and Swiss Finance Institute), pointed out that the definition of university-linked firm was not very clear and suggested a set of alternative methodologies to evaluate long run performance.

Jan Bena (FMG/LSE)

The final conference paper was presented by **Jan Bena** (FMG/LSE), 'Which Firms Benefit More from Financial Development?' co-authored with Stepan Jurada (CERGEEI). This paper established a link between information asymmetries across firms and the level of financial development across countries. More precisely, the authors tested if small and young firms, being size and age proxies for the level of information asymmetry faced by firms, benefit disproportionately from the financial system being more efficient. In terms of methodology the authors applied the Rajan-Zingales strategy at the firm level on European data. They found no differences in the effect of financial development across firms with different sizes, but they did find an inverted u-shape effect of financial development with respect to firm age. In addition they provided evidence that firms entering the market in lower financially developed countries do it with an extra equity endowment. The results were shown to be robust to alternative econometric methods, alternative variable definitions and additional controls at the firm, industry and macro level. **Jan Bena** concluded by pointing out some policy implications of these results, namely in relation to the support of young firms. The discussant, **Yishay Yafeh** (Hebrew University), questioned the two main assumptions of the paper: that European integration has generated equal growth opportunities for firms in all the 15 EU countries, and that whereas the integration of product markets was complete, the integration of financial systems did not mean that firms still depended on the financial system and institutions of their own individual countries.

RICAFE2 Working Papers

The following working papers were included in the RICAFE2 Working Paper Series

RICAFE Working Paper No. 041

Title: Foreign vs. domestic listing: an entrepreneurial decision

Authors: Yuan Ding(China Europe International Business School -CEIBS), Eric Nowak(University of Lugano - USI and Swiss Finance Institute - SFI) and Hua Zhang(China Europe International Business School - CEIBS)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP41-Ding.pdf

RICAFE Working Paper No.042

Title: Fighting for Talent: Risk-Taking, Corporate Volatility, and Organizational Change

Authors: Guido Friebel (University of Toulouse (EHESS and IDEI) and CEPR) and Mariassunta Giannetti (Stockholm School of Economics CEPR and ECGI)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP42-Friebel.pdf

RICAFE Working Paper No.043

Title: Success Breeds Success Locally: A Tale of Incubator Firms

Authors: Eren Inci (Sabanci University).

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP43-Inci.pdf

RICAFE Working Paper No.044

Title: Patents and the Survival of Internet-related IPOs

Authors: Iain Cockburn(BU, NBER) and Stefan Wagner (INNOtec, LMU Munich)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP44-Cockburn.pdf

RICAFE Working Paper No.045

Title: Valuing University-based Firms

Authors: Damiano Bonardo (University of Bergamo), Stefano Paleari (University of Bergamo) and Silvio Vismara (University of Bergamo)

Web address: http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP45-Bonardo.pdf

3rd RICAFE2 Annual Conference

The Third conference of RICAFE2 will take place in October 2008 at the University of Amsterdam. The call for papers for this conference will be published soon in the RICAFE2 website:
http://www.lse.ac.uk/RICAFE.htm

Presentations of RICAFE2 research

During the last 6 months the members of our nodes presented their research under RICAFE2 at the following meetings:

Title: Venture Capital Performance: The Disparity Between Europe and the United States
Date: 19 December 2007
Author: Ulrich Hege, Frederic Palomino and Armin Schwienbacher
Where: Conference, Innovation & Venture Capital, Paris (organised by University of Evry and Institut Europlace).

Title: Competing Through Business Design
Date: October 2007
Author: Christoph Zott
Where: presented at the 27th Annual International Conference of the Strategic Management Society in San Diego, USA

Title: Financially Constrained Innovation, Patent Protection, and Industry Dynamics
Date: Dec 4, 2007
Author: Javier Suarez & Gerard Llobet
Where: Boston University

Title: Financially Constrained Innovation, Patent Protection, and Industry Dynamics
Date: 13-15 December 2007
Author: Javier Suarez & Gerard Llobet
Where: Annual Congress of the Spanish Economic Association

Title: Global Entrepreneurship Monitor 2006 Latvia Report
Date: June 2007
Author: Vyacheslav Dombrovsky and Olga Rastrigina
Where: Riga, Latvia- presented in many local newspapers

Title: Family Interactions in the Making of Entrepreneurs in Latvia
Date: August 2007
Author: Vyacheslav Dombrovsky & Olga Rastrigina
Where: Global Development Network (GDN) Regional Research Competition VII Conference (Prague, Czech Republic)

Title: Family Interactions in the Making of Entrepreneurs in Latvia
Date: November 2007
Author: Vyacheslav Dombrovsky & Olga Rastrigina
Where: BICEPS/SSE Riga Seminar Series (Latvia, Riga)

Title: Family Interactions in the Making of Entrepreneurs in Latvia
Date: December 2007
Author: Vyacheslav Dombrovsky & Olga Rastrigina
Where: 2nd All China Economics (ACE) Conference, session “Labour Markets, Migration and Entrepreneurship” (Hong Kong)

Title: Leverage and Firm Scope
Date: September 2007
Author: Giovanna Nicodano
Where: Workshop on Internal Capital Markets, Antwerp, presentation

Title: Leverage and Firm Scope
Date: October 2007
Author: Giovanna Nicodano
Where: Ricafe2 Conference, Riga, presentation

Title: Leverage and Firm Scope
Date: September 2007
Author: Giovanna Nicodano
Where: Collegio Carlo Alberto, Turin, presentation

Title: Entry dynamics and the taxation of corporate profits: Evidence from firm-level data
Date: October 2007
Author: Marco Da Rin, Marina Di Giacomo and Alessandro Sembenelli
Where: RICAFE2 Conference, Riga, presentation

Title: The role of trust for investment: evidence from venture capital
Date: August 2007
Author: Marco Da Rin
Where: European Finance Association (Ljubljana), presentation

Title: The role of trust for investment: evidence from venture capital
Date: November 2007
Author: Marco Da Rin
Where: the National Bureau of Economic Research Corporate Finance Fall Meetings (Boston) presentation

Title: The effect of venture capital on start-ups’ innovation strategies (preliminary draft)
Date: September 2007
Author: Marco Da Rin
Where: National Bureau of Economics Research ‘Entrepreneurship: Strategy and Structure’ project Conference in Jackson Hole

Title: [A preliminary version of a paper on the role of disclosure in the initial stock pricing of entrepreneurial companies]
Date: June 2007
Author: Marco Da Rin
Where: Third C6 Symposium on Economics and Institutions (Anacapri)

Title: [An initial draft of RICAFE2 WP53 on the role of barriers to entrepreneurship on entry]
Date: October 2007
Author: Marco Da Rin
Where: RICAFE2 Second Conference (BICEPS, Riga)

Title: Fighting for Talent
Date: June 29, 2007
Author: Mariassunta Giannetti
Where: Society of Economic Dynamics Conference, Prague

Title: Favouritism in Capital Allocation
Date: August 27 2007
Author: Mariassunta Giannetti
Where: European Finance Association, Ljubljana