Venture Capital

Traditional approaches to venture capital by GPs in Europe and the USA.

Presented by:

Arif Harbott
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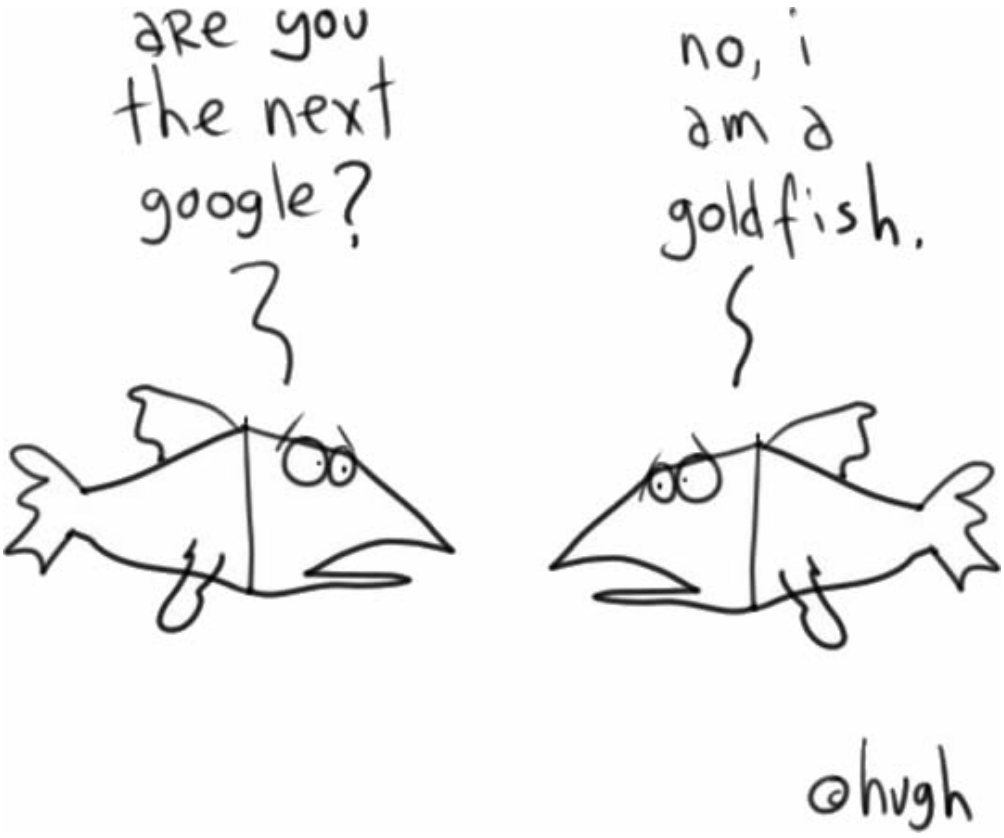

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Executive summary

US Venture Funds have outperformed European Venture Firms by a large margin when looking at both capital weighted average and upper quartile returns (Fraser-Sampson, 2010). Some argue that this outperformance is due to market and labour conditions, however most experts agree that the US approach to venture capital (VC) has largely driven these superior returns.

The traditional US approach is characterised by a home run mentality, investing in early stage companies and using entrepreneurial experience to add value to portfolio companies. In contrast the Europeans adopt a risk-adverse mentality, invest in later stage companies, often lack start-up/ entrepreneurial experience, operate in a fragmented market and have no stockmarket equivalent of the Nasdaq.

However in recent years, newer European funds have started modelling themselves on the successful US firms; investing in earlier stage companies and adopting a home run mentality (huge exits such as Skype, Betfair, MySQL). These success stories have created a new breed of entrepreneur who now has the ability to add value to portfolio companies. There are other changes as well, VC in Europe is also maturing with more fund managers managing repeat funds, relative undervaluation of Europe companies, coupled with better capital efficiency means that Europe may outperform over the next few years. The US could also be a victim of its own success with large amounts of capital flooding the market, driving up valuations and increasing the number of inexperienced US Venture Firms.

This leads us to ask the question of how relevant are historical returns comparisons if the markets have changes post-credit crunch and European funds are adopting the US model.

European VC firms seem to be closing the performance gap, but whether upper quartile returns in US and Europe narrow still remains to be seen.

Investment is about risk-reward trade offs, and the risk-reward profile of venture capital is not uniform across all sub-categories. Generally speaking, the earlier the stage, the riskier the investment, but the greater the potential payoff in case of success. As US VC adopts a more early stage approach there is a higher probability of extreme (positive and negative) returns. By comparing Europe VC to the US, a naïve conclusion might be that European venture performance would have been better had investment been undertaken in greater volumes, with more of a focus on early stage, and more of a technical focus. However, correlation does not indicate causality (Kelly, 2011).

Ultimately US and European capital and labour markets are very different so trying to compare VC firms on either side of the Atlantic is very difficult.

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1 US and European venture performance

US Venture Funds have outperformed European Venture Firms by a large margin when looking at both capital weighted average and upper quartile returns (Fraser-Sampson, 2010).

Figures 1 and 2 show that not only has US venture significantly outperformed European venture, but also the best performing US funds have dramatically out-performed their European counterparts.

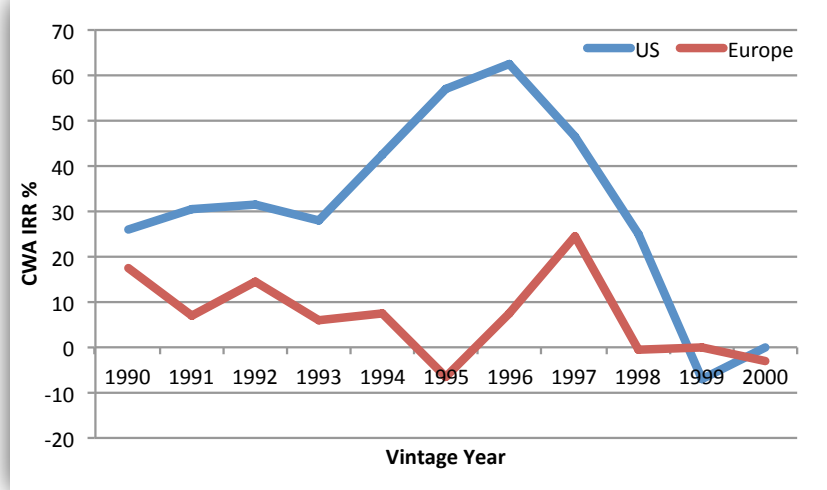

Figure 1 - CWA Venture IRR (Source: Thompson One)

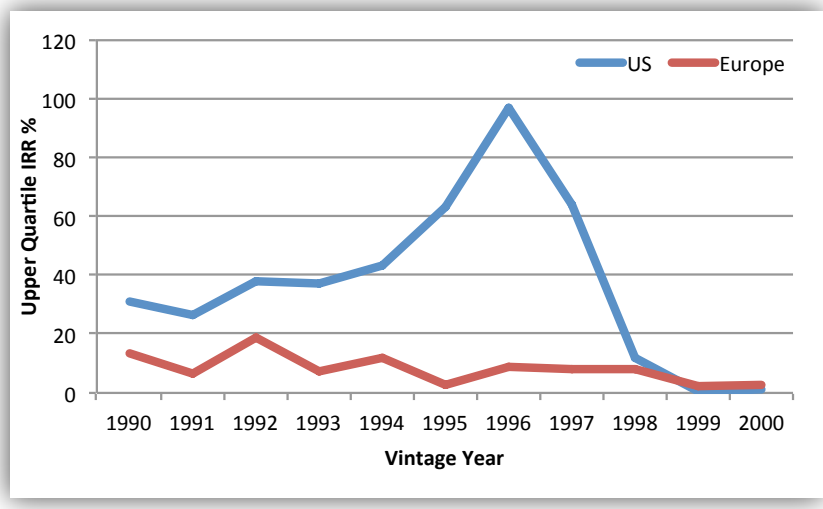

Figure 2 - Upper Quartile Venture IRR (Source: Thompson One)

On average VC firms in Europe: (1) hold their investments for a longer (3.6 years in Europe vs. 2.9 years in America), (2) use convertible debt and convertible preferred stock less frequently (17% vs. 59%), (3) replace management less frequently (19% vs. 34%), and (4) co-invest with other VCs less frequently (56% vs. 81%) (Schwienbacher, 2008).
Available theory predicts this might lead to lower performance in Europe because: (1) longer holding periods signal a reluctance to cut unpromising ventures and "shoot the wounded", (2) less use of convertible securities may indicate weaker control rights and less downside protection, (3) less frequent replacement of management may imply greater patience with underperforming managers, and (4) less frequent co-investing may imply that the benefits from syndication are not being exploited (Tyabji & Sathe, 2011).

2 Traditional approaches to venture capital

2.1 US approach

2.1.1 Home run mentality

To understand why US firms outperformed European funds by such a large margin we need to know what drives venture fund returns. Figure 3 suggests a connection between higher money multiples and higher IRRs, thus the ability to achieve high money multiples appear to drive high IRRs. This introduces the concept of home runs.

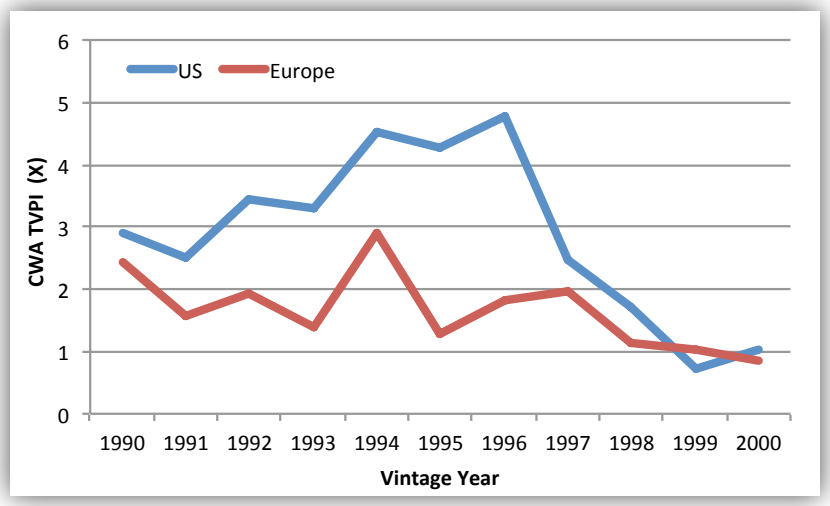

Figure 3 – Venture CWA TVPI
(Source: Thompson One)

US Venture returns have been dominated by a small number of very large winners (Fraser-Sampson, 2010); these home runs can make or break a fund.[1] Horsley Bridge Partners published their internal database, which showed that although a home run costs less than 5% of the fund it could return 80% of the fund value; thus a fund only needs one home run to deliver significant fund performance.

US Venture Firms have recognised the importance of this and adopt a home run mentality, which mean they focus heavily on a small number of high potential businesses and very quickly cut funding in businesses that they do not think will become home runs. Developing a home run is very difficult and even the best venture firms are unlikely to achieve a home run in every fund but you might expect them to develop three home runs for every five funds.

2.1.2 Early stage investing

The younger the company the higher the risk of failure, even with this additional risk we have seen that a fund only needs one home run to generate a great fund return.

US Venture Firms focus on investments in early stage companies because higher money multiples can be achieved (because valuations are lower), where as Europeans focus on later stage companies. The reason for this difference is early stage investing requires a very different set of skills and a different network for deal flow.

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[1] A home run is an investment that returns the whole of the capital of the fund at least once. This is usually accepted as a 25x return.

A big differentiator in the US is the 'EIR programme'. An entrepreneur in residence (EIR) is a successful entrepreneur (ideally one that was venture-funded and had an exit) who is looking to start another business. The EIR co-locates with the venture fund and is on hand to mentor the portfolio teams and potentially lead one if they like the business enough. This incubation process is very hands on and is done with the full support of the fund GPs.

Recently the EIR concept has been extended to create a new breed of early-stage accelerator funds. The pioneer, Paul Graham developed the Y Combinator fund using a new model of funding. Twice a year Y Combinator invests a small amount of money (average $18k for approximately 6% of business) in a large number of start-ups (most recently 63). The start-ups all co-locate in the same office space in Silicon Valley for three months, during which time a network of experts, mentors, investors and entrepreneurs work intensively with the company to improve/ build the product and refine the pitch to investors. At the end of three months there is a Demo Day, when the start-ups present to a large audience of investors to get follow on funding (Y Combinator, 2011). Since Y Combinator there has been many similar funds started e.g. Techstars, Seedcamp, Launchbox, DreamIT Ventures, all with varying degrees of success. These accelerators have created a very strong ecosystem of start-ups, investors and blue-chip companies that creates a strong cycle of potential acquisitions and seemingly high investment returns.

2.1.3 Value add

US funds take a strong added value approach to their portfolio. Their portfolio companies are likely to leverage the GPs contacts and operating experience as well as gain from working with the funds EIRs (Fraser-Sampson, 2010). We have already seen how accelerator funds, such as Y Combinator, take this added value approach to extremes.

John Frankel of FF Venture Capital argues that before the dot.com bubble technology start-ups needed racks of servers and lots of engineers. Today with low server costs are advances in programming languages mean start-ups are typically one or two founders and a handful of employees. This lean staff structure means that there are often intellectual capital gaps e.g. no in-house accountants or marketing teams. John believes VCs can add a lot of value by plugging these intellectual capital gaps (Frankel, 2011).[2]

In addition to operating experience, an investment by a reputable VC fund is an important signal of quality. David Hsu, from Wharton School, estimates VC funds with a high reputation can buy equity at a 10-14% discount and that their offers are three times more likely to be accepted compared to funds with an average reputation (Meyer, 2006).

2.1.4 Market size

The US has the advantage of a larger internal market than Europe, which makes scaling a company easier.[3] Unlike the single language in the US, Europe has different languages, laws and cultures which makes it difficult to treat the whole continent as one market.[4]

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[2] See timestamp 13:46 of video.

[3] USA has a population of 312,540,000 people, where as the largest European country has just 81,724,000 people (Source: Census information).

2.2 European approach

2.2.1 Risk mentality

In contrast to the home run mentality, European VCs take a more risk adverse approach.

Halstead (2011) argues European VCs are too risk adverse; spend too long looking at financials and want to see 3-5 year projections. They also require a proven model and revenues where as in America there are plenty of companies with $3-4 million funding rounds that have a lot of traction but no revenue. "It's almost like a bank loan. It's as if VCs think of themselves as giving you loans, rather than being risk takers." (Halstead, 2011).

Cultural differences regarding the stigma of failure also play a role. In Europe struggling companies are not killed off quickly and even worse these struggling companies can take up excessive GP time as they try to turn them around. Contrast this with the US approach of killing off under-performing companies quickly so that the majority of time and resources can be spent nurturing potential home runs.

2.2.2 Lack of seed stage investments

European VCs have avoided early stage investments instead waiting until a business has customers or a proven business model before they will invest. This could be because early stage businesses are seen as too risky or that European venture funds do not have enough first-hand business operating experience. Some experts argue that there are almost no independent, professional seed-focused venture firms in Europe (Fraser-Sampson, 2010).

2.2.3 Lack of value add

US Venture Firms get their hands dirty and use their skills and network to help their portfolio companies, whereas European Firms tend to take a back seat and focus solely on providing financial capital. One reason for this could be that traditionally European GPs tended to be bankers and lawyers with little operational experience and less appetite for risk. This is perhaps why they have focused on more mature companies rather than on start-ups.

Speaking to some venture-backed founders in London they corroborated that their investors take a very hands-off approach and only engage with them at infrequent board meetings.[5]

Another argument is that there is a lack of entrepreneurs in Europe who have the skills required to add value to start-up businesses. This could be because Entrepreneurs have an enviable image in the US so there is more encouragement to start a business even if you have previous failed. Le Meur (2004) argues that entrepreneurs in Europe have a bad image where as in the US they are considered heros.

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[4] Assumes that companies do not go global on day one and build their brand in their local market first. This is becoming less relevant in an increasingly Internet connected World.

[5] I spoke informally with the founders of three European venture-based companies (who all preferred to remain anonymous). This is obviously a small biased sample but it is indicative of this point.

2.2.4 Available funding is spread too thinly

VC backed firms that receive too little money perform worse than innovative companies that develop their business model without VC involvement; thus insufficient availability of funds clearly impacts overall VC performance (Kelly, 2011).

It is difficult to establish whether VC backed firms in Europe have received 'too little' money, but Figure 4 shows European funds invest much less in aggregate than in the US and support nearly twice as many companies (Kelly, 2011).[6]

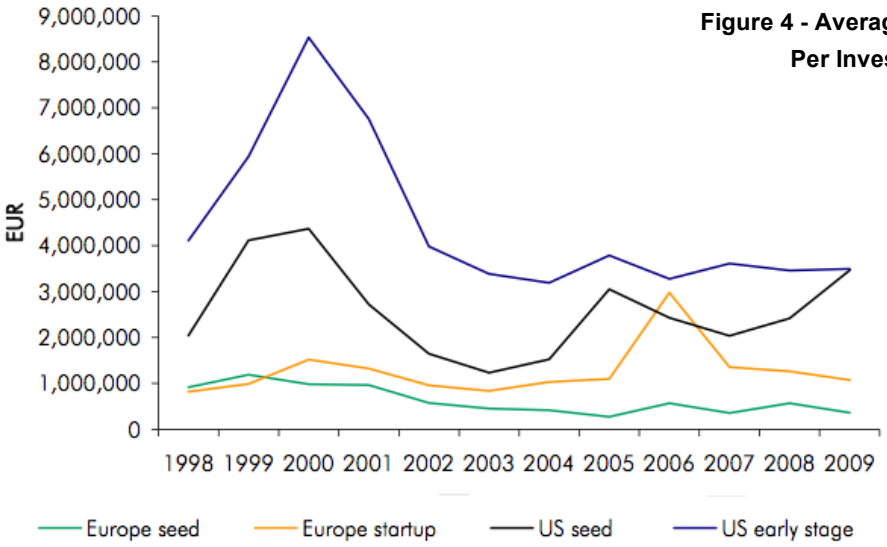

Figure 4 - Average Venture Investment Per Investee Company

2.2.5 Lack of eco system

A number of researchers (Clarysse, Knockaert, & Wright, 2009) have suggested that successful venture investing occurs within an ecosystem; the geographical proximity of VC funds to other funds with which they can co-invest, and the presence of experienced, skilled legal and financial advisers (Kelly, 2011).

Silicon Valley gives US Venture a big advantage over the rest of the World as it is a thriving ecosystem for start-ups and gives businesses access to talent, role models, and creates a success mentality. More importantly Silicon Valley provides a captive audience of companies that can be targeted as trade buyers. It is no coincidence that many of the golden circle venture firms are located very close to Silicon Valley. As yet a thriving technology ecosystem has not emerged in Europe.[7]

2.2.6 No NASDAQ equivalent in Europe

The fact that Europe (since the failed EASDAQ index) has nothing to rival the NASDAQ has had a definite impact on returns.[8] European VC firms rely heavily on trade sales or main market listings, which make exits harder and typically, take longer (Gregoriou, 2006).

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[6] Another argument could be that European Venture Firms are more efficient with their capital.

[7] Although the UK government is investing heavily trying to create The Silicon Roundabout in East London

[8] The EASDAQ was created to be a pan-European market aimed at entrepreneurial, high growth companies.

3 Are the traditional approaches still valid?

Evidence suggests that European VC is starting to model itself on the US model and some other factors such as lower European valuations and a maturing base of European GPs may lead to future European outperformance.

3.1 Younger European VC funds develop a more early stage focus

In 2001, a survey found European firms had portfolios of 38% early-stage investments compared to 50% for American firms.[9] However, the difference was greater for older VC firms (those established prior to 1997; 31 percent for Europe vs. 48 percent for America) than it was for younger VC firms (45% for Europe vs. 53% for America) (Schwienbacher, 2008). This implies that the younger European firms are adopting an early stage focus more inline with their US counterparts.

In addition early stage accelerators have arrived in Europe, which means more early stage investment. US accelerators such as Techstars have opened UK operations and copycat funds such as Seedcamp, Startupbootcamp and Springboard have emerged. These funds are slowly starting to build the competencies for early stage investment in Europe.

However Figure 5 challenges the notion that seed/ early investments lead to higher returns. Returns by stage have narrowed between 2000 and 2009. This implies that the stage focus of a fund will have less impact on performance in the future.

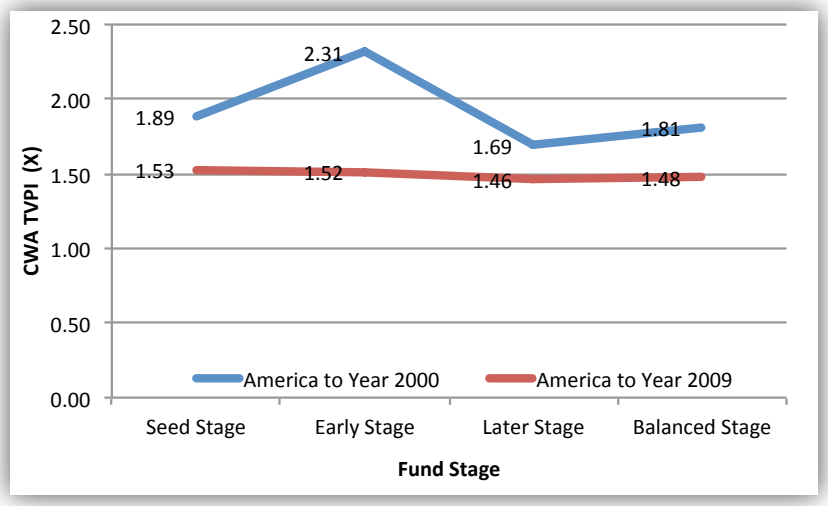

Figure 5 – US CWA TVPI by Stage (Source: Thompson One)

3.2 Europe wakes up to value add

Although European funds still focus too much on financial modelling over proven operating experience there are signs of change.

[9] Comparing the practices of 104 VC firms in Europe with 67 American VC firms (Schwienbacher, 2008).

One example is Atomico Ventures founded by Skype co-founder Niklas Zennström, Atomico. As well as the knowledge from Niklas they also have an EIR, Jamie Murray Wells who founded Glasses Direct (Atomico, 2011).

Another example is PROfounders Capital with Brent Hoberman (Lastminute.com), Michael Birch (Bebo), and Mike Danson (Datamonitor) as investment partners (PROfounders Capital, 2011). These entrepreneurs have a lot of experience building successful businesses and can add huge value to portfolio companies.

3.3 Home run mentality crosses the Atlantic

An increasing number of European Venture Firms (especially the newer ones) are embracing the home run mentality. This has led to the successful exits of Betfair, Skype, MySQL and Autonomy which provided huge home runs for the funds that invested early.

As we have discussed some of these successful entrepreneurs have since started their own venture funds, following the US model of value add. Success breeds success.

3.4 European VC maturity catches up

The US was the creator and world leader of the venture capital industry. As such they had the most experienced GPs who have raised the most repeat funds, which allowed US GPs to hone their approach over many funds.

Funds Raised	*Europe*	*US*	*Ratio*
>= 2	73	334	4.6x
>= 3	58	202	3.5x
>= 4	28	132	4.7x
>= 5	8	94	11.8x
>= 6	4	65	16.3x
Time since early growth of VC industry (years)	10-15	50-60	4-5x

Table 1 – VC Teams Maturity by Number of Funds Raised Up To 2010[10]

Although the European venture market is younger, Table 1 shows that European GPs have a growing number of repeat funds, which is allowing them to learn from their mistakes and with this added experience they have more potential for outperformance.

[10] Source: Dow Jones Venture Source

4 Recent comparative returns

In 2009/2010, European venture-backed companies had $15 billion of liquidity events, compared to $30 billion in the US. However the European ventures used one-fifth the venture funding $6 billion, versus $25 billion in the US (Earlybird Venture Capital, 2011).[11] This data implies that European VCs have higher capital efficiency even if their exit values are smaller.

This outperformance is largely driven by the over proportion of successful exits and home runs. Figure 6 shows that in 2004 with just 18% of the capital invested Europe achieved 26% of home runs and 41% of total exits (Earlybird Venture Capital, 2011).

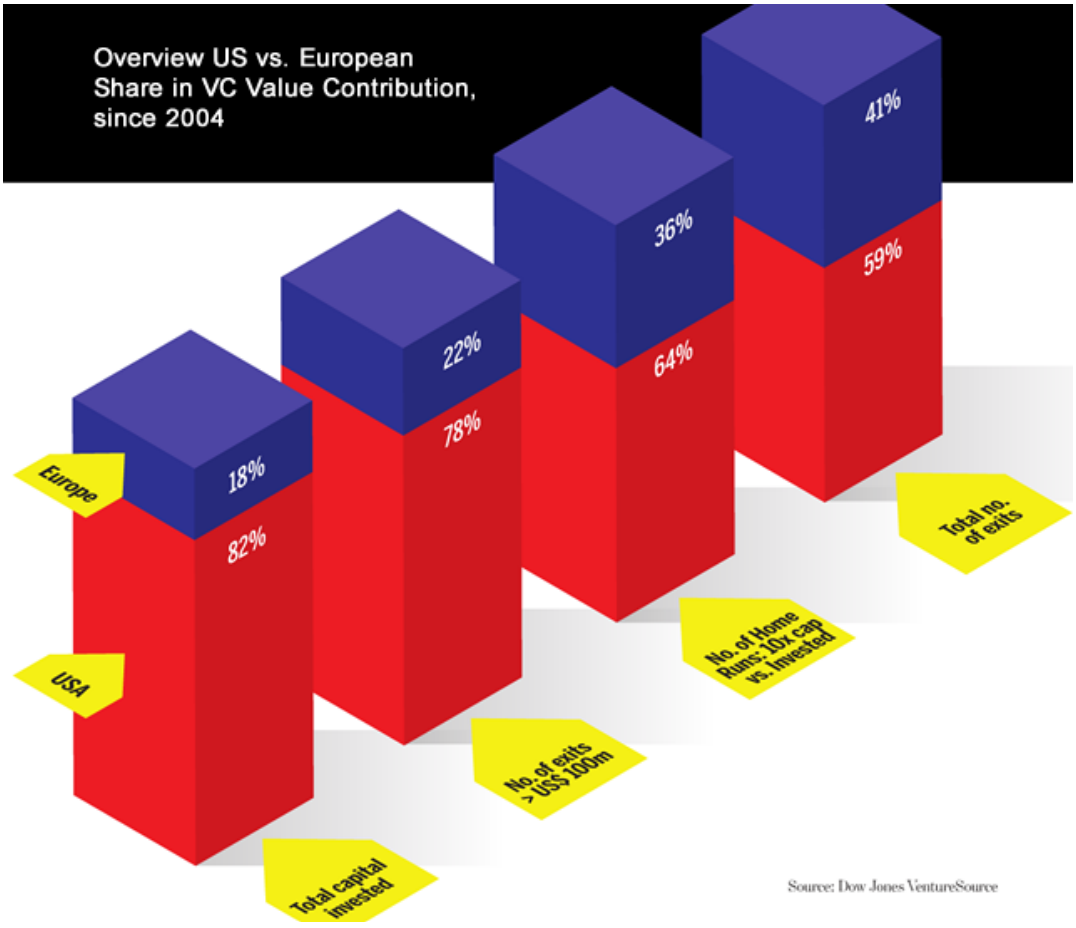

Figure 6 - US vs. European Share in VC Contribution, since 2004.
Source: Dow Jones VentureSource (Earlybird Venture Capital, 2011)

Figure 7 shows the large supply gap between the supply and demand of capital in Europe, which is caused largely by the lack of pension and endowment fund investment (Earlybird Venture Capital, 2011). This creates a buyers market and has a downward pressure on European entry values.

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[11] See bibliography for Earlybird Venture Capital Report. Their source data was compiled from Thompson Reuters, NVCA and EVCA data.

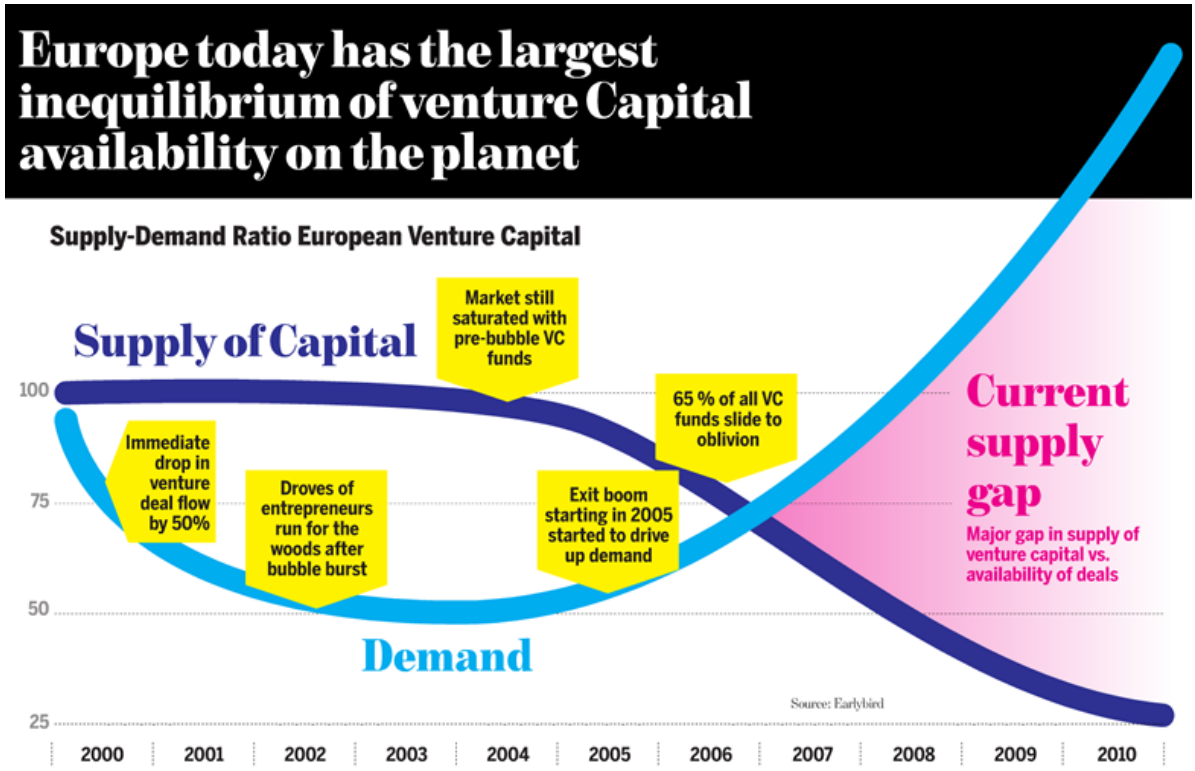

Figure 7 - Capital Supply Gap (Earlybird Venture Capital, 2011)

"The scarcity of VC money in Europe not only has led to low entry valuations, but has also driven up capital efficiency (roughly 70 percent higher than in the US) and yield (hit rate) because the scarcity of money allows the very few investors to simply be more selective." Uli Fricke, EVCA Chairwoman 2010-2011.

4.1 Is the US a victim of its own success?

The success of US Venture Firms has seen a huge rise in invested capital over the last ten years (Figure 8 puts this into perspective). This increase means quality firms increase their fund sizes but also new inexperienced firms enter the market. This leads to more money chasing the same number of deals, inflating valuations and reducing returns.

As more deals are sought the quality control of investments is lowered so more lower grade investments are made. The higher valuations combined with lower quality investments will likely drag down US returns in the future. Fraser-Sampson (2010) suggests that the less money that is in the system leads to better returns and that the fund size sweet spot is around $150m which is small by US standards.

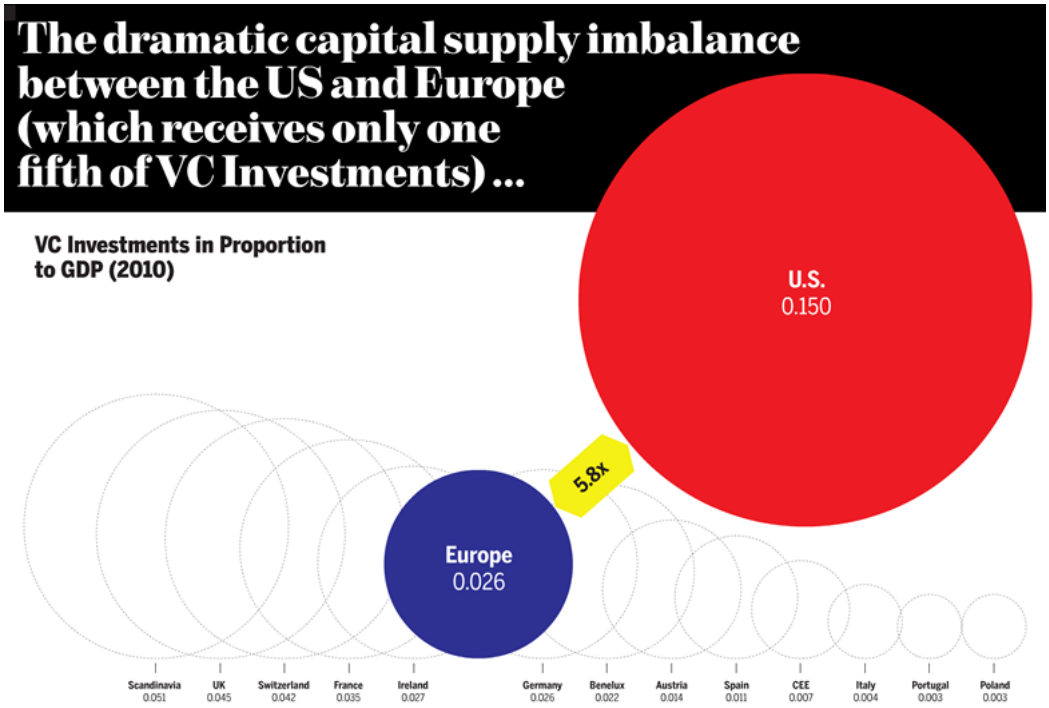

Figure 8 - Supply Imbalance Between Europe and US.
Source: EVCA, Eurostat (Earlybird Venture Capital, 2011)

4.2 European post-IPO outperformance

Figure 9 shows that European VC-backed IPO performance from March 2004 to July 2011 matches or exceeds US performance post-IPO. This dramatic outperformance will increase the returns of European VC firms that retain an equity stake post-IPO.[12]

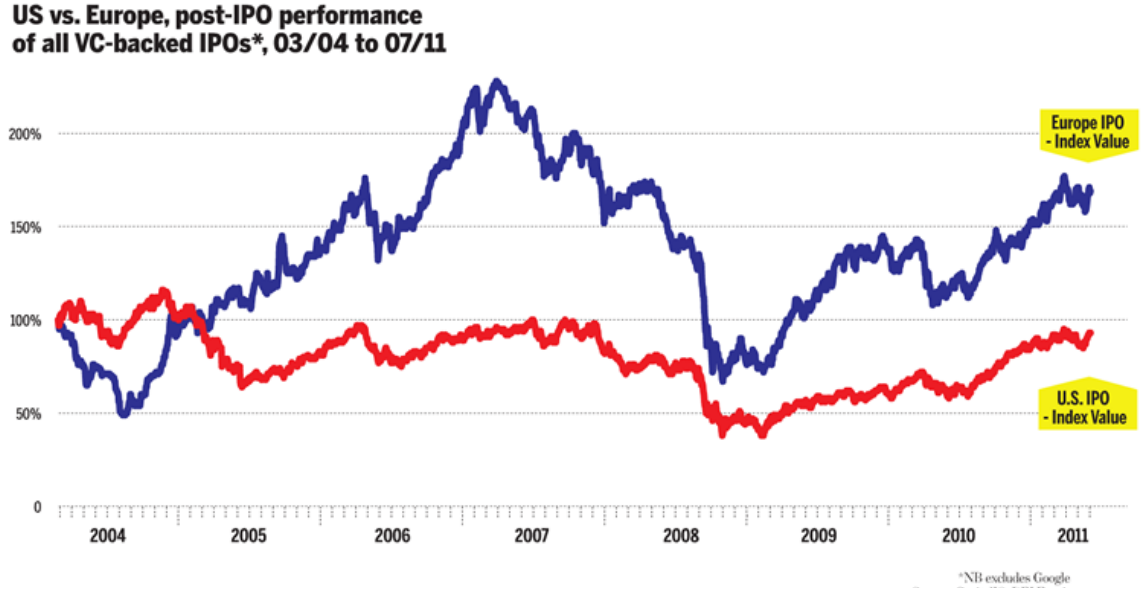

Figure 9 - US versus Europe Post-IPO Performance. Source: Capital IQ

[12] However it should be noted that VC firms often sell a large proportion of their stake in an IPO so this may only have a small impact on returns.

5 How valid are historical returns?

The changes in the European approach along with the devastating worldwide credit crunch mean that historical performance is probably not a valid predictor of future performance.

5.1 Are European returns as bad as they seem?

European data includes many quasi-development funds (e.g. academic, localised, or government funds) and funds run by banks, media corporations and industrial groups, which would not be considered by sophisticated LPs.[13] Conversely US returns are not as good as they appear, as poor performing funds may simply stop submitting data. Figure 10 shows when comparing the maximum returns from US and European funds the difference is not as pronounced as it first appeared.[14]

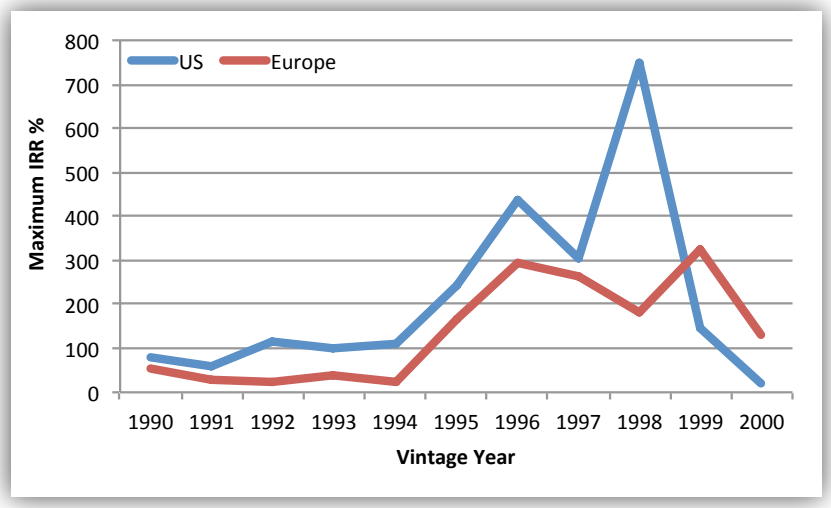

Figure 10 - Maximum Venture IRR (Source: Thompson One)

5.2 Comparing like with like

We have seen that US VC has outperformed European VC, however the data does not capture the differing risk profiles between the US and Europe. US funds tends to invest in earlier stage companies (with inherently more risk) so they will exhibit a higher probability of extreme (positive and negative) returns.[15] If the European and US venture industries both had the same structure (i.e. both invested in the various stages of venture in equal proportions) they would have the same return probability distribution, and we would be comparing like with like. If not, performance differences should be expected (Kelly, 2011).

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[13] Sophisticated LPs only invest in independent funds

[14] The US tends to invest in earlier stage companies, which carry more risk. This may explain why the European 1999 and 2000 vintage years were less affected by the dot com crash as they had less exposure to early stage.

[15] The earlier the investment stage the fatter the probability distribution (in technical terms, they exhibit higher kurtosis compared to the normal distribution; this is similar to saying they have larger standard deviations)

5.3 Shifting leaders in technology

Historical returns may not predict future performance due to changing trends in technology, which arguably will be led by Europe. Cook (2010) argues Europe has become a leader in many high growth industries:

- Biopharmaceuticals, UK
- Medical devices and equipment, Germany
- Clean-tech and renewable technology, Germany
- Semi-conductors, UK and Germany
- Advanced energy sources, CERN

US firms have failed to recognise venture is a global business and take a geographically insular approach (Fraser-Sampson, 2010). If European companies drive the technology of tomorrow, and US firms have difficulty-entering Europe, their chances of home runs will reduce along with their returns.

5.4 As technology matures diversity becomes more important

The US has had an advantage due to it large homogenous market but in the future it may be Europe's diversity that wins.

Danny Reimer of Index Ventures points out, "People from different countries are good in particular roles. Germans tend to excel at business development, Russians at developing software, the French at user interfaces. As the Internet becomes less dominated by American tastes, European skills in design and branding are becoming more valuable (Economist, 2010).

European VCs should capitalise on these advantages even as they learn from their peers across the Atlantic.

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