A Rise in Good Deals, but an Investor Drought

The State of European Venture Capital

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AT A GLANCE

By some measures, the European venture capital (VC) ecosystem is thriving. VC investments are on a healthy upward trend, returns and money multiples are growing, innovation hubs are emerging, and serial entrepreneurs are flourishing. But European fund-raising has steadily slowed.

A Surplus of Small Funds, a Dearth of Returns

The constraints on European venture investments include the European VC-fund ecosystem, which consists of some 800 VC funds that average €70 million in capital and generally post substandard returns. Many are nationally or regionally focused, which limits their diversification and boosts their risk.

Toward a Pan-European VC Ecosystem

The timely option is to ease the regulatory restrictions on pension funds, insurers, and other private investors. Tax incentives for private investors encourage the supply of funds. As an interim step, a funds-of-funds layer could leverage public capital to scale up quickly. Large investment opportunities managed by experienced private talent would help make the European VC market more accessible to private investors. This arrangement would endure until private investments have scaled up enough to establish a European VC ecosystem supported by private capital.

THE COMPLAINTS ARE OLD and familiar. Returns on venture capital (VC) aren't competitive with those of other asset classes. The investor mix is skewed far too heavily toward government entities whose main objective is to build up regional or national champions rather than to earn financial returns. The general partner (GP) landscape is opaque and highly fragmented, with many subscale VC funds.

Such criticisms have some foundation in fact. But a closer look at the European VC market reveals that many of the criticisms are based on outdated assumptions and incomplete information. In this report, The Boston Consulting Group and IESE Business School closely examine the health of the European VC ecosystem and pinpoint root causes of and potential responses to the private-investor shortage.

Our analysis is unavoidably constrained by the limited availability of data on deals, market participants, and entrepreneurs. Thomson ONE was our main source of information, supplemented with data from the European Investment Fund (EIF)—a public-private partnership that is majority owned by the European Investment Bank with 30 financial institutions as shareholders—as well as Preqin and Invest Europe, which was formerly known as the European Private Equity and Venture Capital Association. We also conducted more than 20 interviews with limited partners (LPs) in the public and private spheres, GPs managing VC funds and funds of funds, and entrepreneurs. Their insights helped us evaluate the the current VC market and develop suggestions for ways to make it more appealing to private-sector investors. A timely and efficient option is to ease the regulatory restrictions on private investors. Tax incentives for private investors offer an effective mechanism for encouraging the supply of funds. We conclude by describing the requirements of an interim solution that could mitigate the historical shortcomings of the European VC market and enable it to transition to a structure more responsive to private investors.

Contrary to conventional wisdom, VC investments in Europe are at a secular peak.

Performance and Investment Flows Trend Upward, but Fund-Raising Slows

Our analysis of the European VC market revealed that contrary to conventional wisdom, it is in good shape. (See the sidebar, "A Snapshot of Europe's VC Market.") Returns on European VC investments are on a healthy upward trend. Returns on the EIF grew at a 7 percent compound annual rate from 2011 through 2014. Money multiples have increased continually since 2011, with a strong rise in 2015. (See Exhibit 1.)

Again contrary to conventional wisdom, VC investments in Europe are at a secular peak. They surged strongly from 2012 through 2014, growing by 73 percent, nearly

A SNAPSHOT OF EUROPE'S VC MARKET

These are the facts.

- VC performance is trending upward, and there is a steady increase in money multiples.
- VC investments are up—driven by high U.S. investments in EU ventures—yet VC fund-raising in 2014 was at a multiyear low.
- Because of the absence of private investors, government investors—with roughly 30 percent of the market—have become the largest LPs in Europe.
- The average fund size of Europe's more than 800 VCs is typically small, and smaller, nationally focused funds, in particular, underperform.
- Venture hubs are emerging, and the deal flow is trending upward, benefiting serial entrepreneurs.

matching the growth rate of VC investments in the U.S., which increased by 78 percent. (See Exhibit 2.) Investment levels now stand at their highest point since the bursting of the dot-com bubble: since the third quarter of 2013, each quarter has surpassed the year-earlier period.

The main source of growth is investment in Internet-specific and software ventures. Investments in these companies account for more than half the current VC investment volume in Europe and the U.S., doubling in volume from 2013 to 2014 alone.

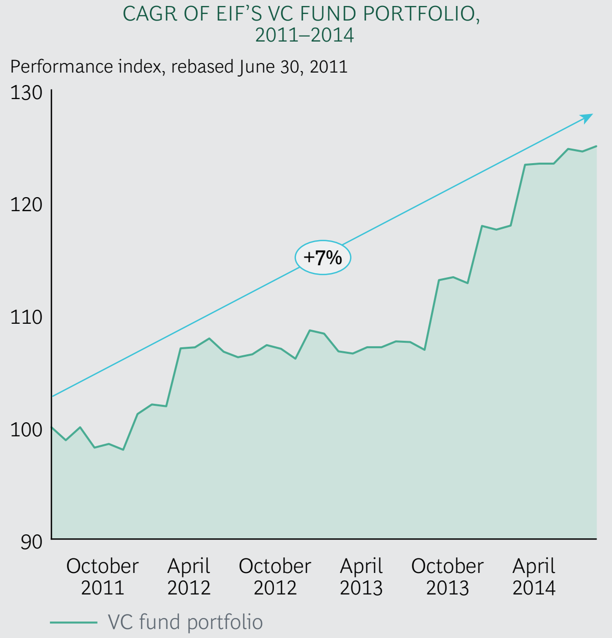
European fund-raising has traced a path that is the opposite of the growth in investment. According to Thomson ONE, since 2012, European fund-raising has plunged by 33 percent, while U.S. investment has increased by 45 percent to approach a ten-year high. In consequence, the gap between U.S. and European investment widened to about €21 billion. (See Exhibit 3.) However the momentum in 2015 is encouraging. Each of the top ten funds raised more than €100 million, and three of them raised more than €300 million.

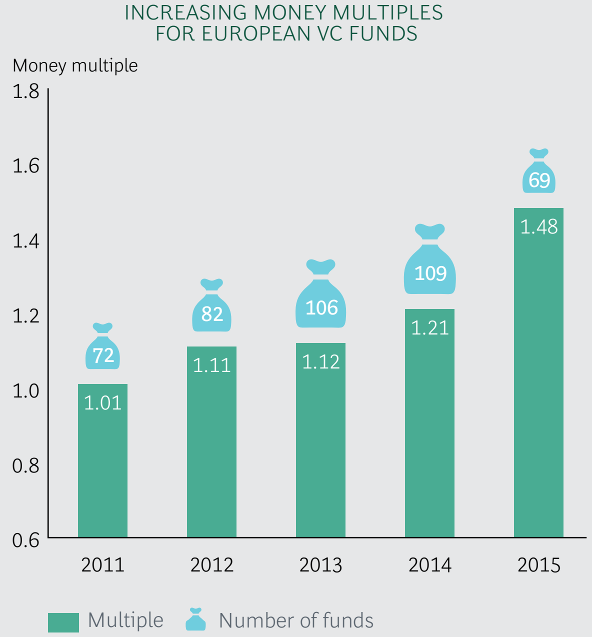
Experts we interviewed mentioned that the strong uptrend in U.S. fund-raising has produced a highly competitive U.S. market. Now, U.S. managed capital is starting to spill over into a comparatively undervalued European VC market, offering large opportunities as the fund-raising gap widens. U.S. outbound venture investment in Europe has more than tripled in the past ten years, accounting for more than a quarter of total VC investment in Europe in 2014 and posting disproportionate growth during the past few years.

A Shortage of Private Investors, a Surplus of State Capital

Our analysis of the role of European LPs in the VC landscape reveals several salient facts: European institutional investors (including, for instance, pension funds, academic endowments, and family offices) constitute a smaller share of the population

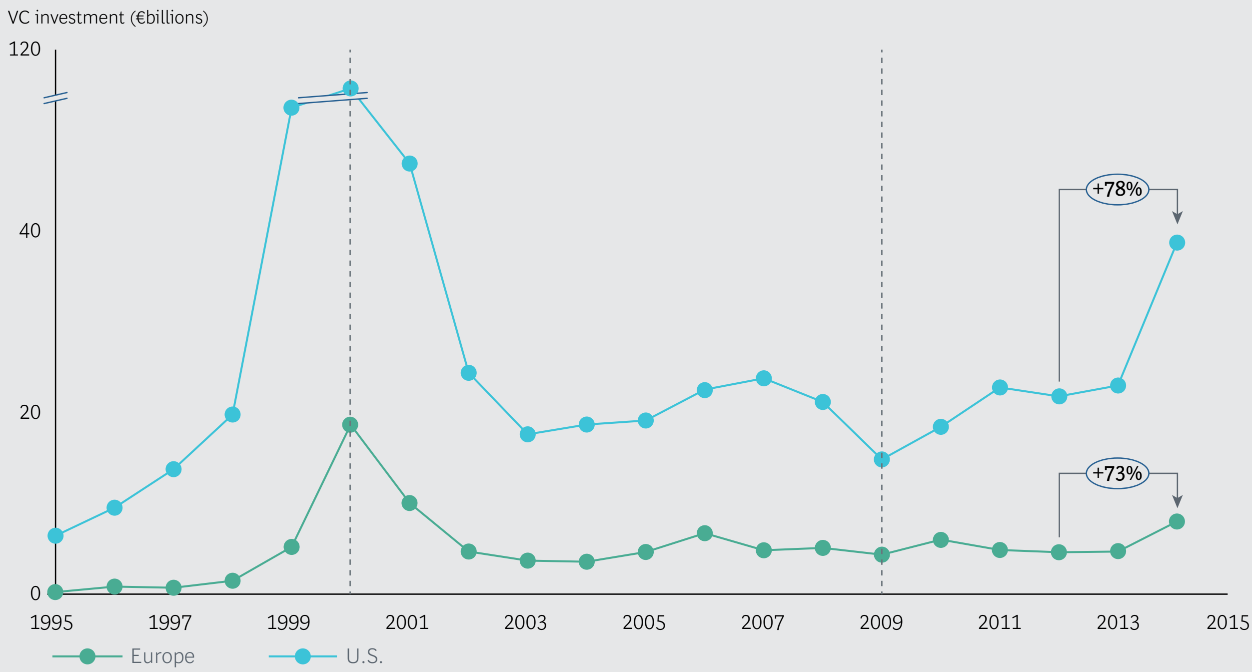
EXHIBIT 1 | VC Performance in Europe Is Trending Upward





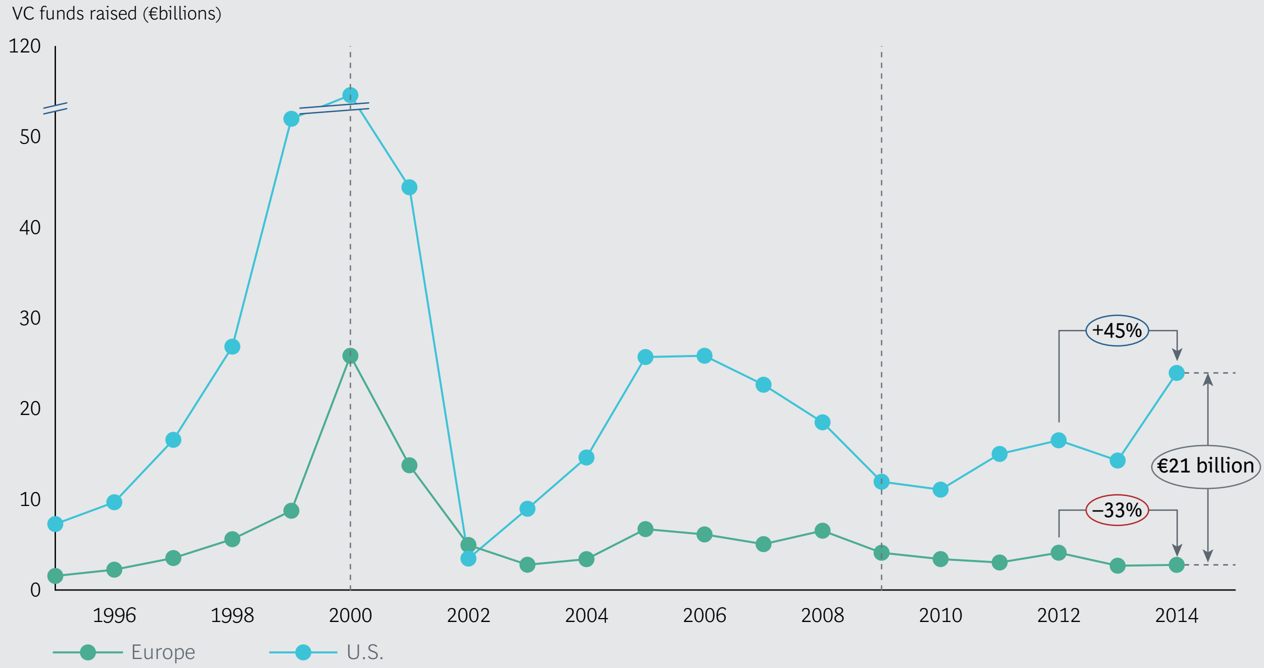
Sources: European Investment Fund (EIF), Preqin, BCG analysis.
Note: CAGR = compound annual growth rate. Valuations, as of March 31, 2015, are based on the average of all nonliquidated funds with year-end performance data.

EXHIBIT 2 | VC Investments in Europe and the U.S. Show Strong Momentum



Sources: Thomson ONE; BCG analysis.

EXHIBIT 3 | VC Fund-Raising in Europe Shrinks as U.S. Fund-Raising Swells



Source: Thomson ONE.
Note: By calendar year.

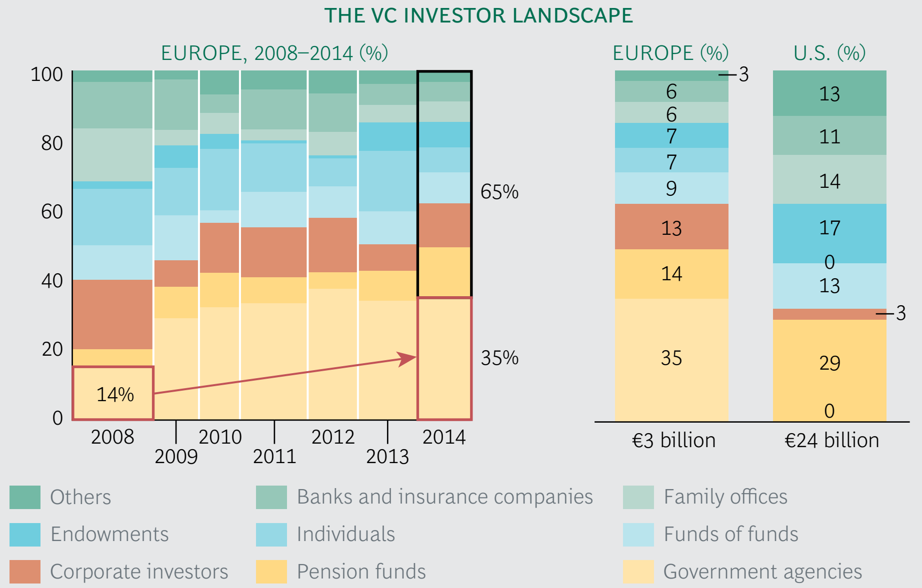
of LPs in VC funds than do U.S. institutions. For example, pension funds make up 14 percent of all private VC LPs in Europe, compared with 29 percent in the U.S. (See Exhibit 4.)

Making the situation worse, since 2008, private investors have slashed their VC investment in both relative and absolute terms. The shortfall in private investment has been covered by government agencies, which stepped in to fill the breach and ensure that European startups obtain at least minimal funding. As a result, the government share of investment in VC funds more than doubled from 2008 through 2014. But government-controlled investments often come with strings attached and tend to favor local or national ventures, to the detriment of cross-border activity and the growth of cross-border funds.

Several common themes emerged during our interviews with GPs and LPs. They noted that the current European financial-regulatory regime's discouragement of equity investing has contributed to the low historical performance of many VC funds.

The market is also highly opaque, which complicates decision making and demands a heavy investment of time and money to build expertise and form networks. All interview subjects agreed that the European VC market is too fragmented and is marked by a large number of small, nationally focused funds, making it difficult for institutional investors to write large investment tickets. A closer look at the GP landscape reveals the extent of the imbalance.

Exhibit 4 | Government Stakes in Europe Have More Than Doubled Since 2008



Sources: European Private Equity and Venture Capital Association; Thomson ONE; BCG analysis.
Note: “Others” includes GP contributions, sovereign-wealth funds, discretionary advisors, and other asset managers.

Most European VC Firms Are Subscale, and Many Underperform

One of the most striking features of the GP landscape is the glaring absence of data transparency. For example, because most information is produced voluntarily and based on self-evaluation, the performance of a VC fund can be reliably determined only at the end of its lifetime, which can span ten years or more.

Europe’s GP landscape consists of more than 800 VC firms that average €70 million in size. The number of European VC firms actively engaged in fund-raising shrank by about 40 percent from 2012 through 2014, which indicates robust market consolidation. The average VC fund’s size decreased by 13 percent—from €85 million, an all-time high, to €74 million—during the same period, widening the distance to the average U.S. fund’s size by 30 percent.

Furthermore, compared with their U.S. counterparts, European VC investments as a percentage of GDP are not gaining ground. In 2009, European VC investments equaled 0.03 percent of EU GDP, and U.S. venture investments were 0.14 percent of U.S. GDP. In 2014, Europe’s ratio grew to 0.05 percent, while the U.S. ratio more than doubled to 0.29 percent.

Looking at performance, we begin to see why. Many European funds don’t have the sort of records that attract flocks of new investors. According to Cambridge Associates, from 2005 through 2014, European VC funds turned in an overall net internal rate of return (IRR) of 7 percent, while the top quartile of European funds turned in an average IRR of 14 percent. Low-performing funds have trouble closing fund-raising, while a handful of large, successful funds are oversubscribed and crowded with well-connected investors.

Our analysis revealed that top funds were characterized by their global investment expertise and strategies, large fund size, and concentration in a few industries.

Our analysis revealed that top funds were characterized by their global investment expertise and strategies (most invest in ten or more countries), large fund size (on average more than €130 million), and concentration in a few industries. Low-performing funds were marked by their narrow regional focus and small size (roughly €60 million on average).

Performance data from Preqin on the ten best-performing VC funds from the vintage years 2006 through 2012 reveals that seven of the funds were based in the U.S. and averaged US$139 million in capital. Three of the seven had fund sizes of US$3 million, US$5 million (focused primarily on seed and early-stage funding), and US$50 million.

Of course, small can be beautiful, as the strong performance of many U.S. microfunds illustrates. In addition, the one European fund that made it onto the Prequin list of the ten best-performing VC funds was capitalized at €14 million. The GP landscape needs differentiation, and no single fund profile ensures optimum performance.

The need for differentiation was also evident when we analyzed the EIF performance data on 78 funds launched from 2008 through 2012. The funds were pan-European with no regional focus. The larger funds slightly outperformed their smaller peers. Thirty-five percent of funds with €50 million or less in capital posted IRRs greater than 10 percent. This compares with 43 percent of the funds with €100 million or more in capital, which racked up IRRs greater than 10 percent. Given the vintage years and times to maturity of the funds in the sample, all return figures are interim IRRs.

Our analysis of the relationship between fund value and net multiples shows that there is on average a positive correlation between fund size and performance, which suggests that the larger the fund, the lower the risks and the higher the performance. In particular, the national focus of many small, largely government-funded VC funds further discourages private investors, who are wary of the lack of scale effects and the increased risks that stem from low regional diversification. Another important feature of the landscape is that small funds are limited in their fee budgets, and, therefore, many of them struggle to attract and retain top management talent and to conduct thorough due diligence. Such small funds are also unattractive to large institutions, many of them global, whose minimum investment amounts can easily exceed the size of a single European VC fund (of which approximately 80 percent manage less than €100 million in assets).

Furthermore, as we describe below, many European VC funds rely on U.S. capital for support. It is especially challenging for smaller VC firms to develop transatlantic footprints, experience, and expertise.

The Entrepreneurial Landscape Has Matured

Today's Europe is not short of so-called unicorns—private companies valued at $1 billion or more. As of August 2015, 13 of 129 global unicorns, or 10 percent, were based in Europe. Their ranks include well-known global names such as Shazam and Spotify. Moreover, Europe boasts established venture hubs such as London, Paris, Berlin, and Stockholm, where capable entrepreneurs with solid track records are building on their repeated successes and sharing their experience and expertise with their counterparts and colleagues. Some regions have developed sector-specific ecosystems, such as Cambridge's medical-technology cluster for biotech.

Looking at the current deal flow, we can also see an ongoing positive trend: the number of companies receiving seed investments grew by 19 percent from 2011 through 2014. Many of these companies can be expected to require additional capital, thereby offering interesting investment opportunities as they grow.

There is, then, no current or anticipated shortage of European entrepreneurs and ventures. But if they want to compete with U.S. companies, they will need a lot of capital to grow, especially in later development stages.

To date, European entrepreneurs have been able to attract capital at every funding stage. But some entrepreneurs are already turning their backs on European funds, many of which are too small to support startups as they grow through later stages. This accelerates the shrinkage of European private capital and drives European entrepreneurs to seek funding in the U.S., where VC investors stand ready to write large checks—fast. This trend is amplified by the regional agnosticism of today's entrepreneurs. They are willing to launch their ventures wherever the environment is most welcoming. Much—and a growing share—of their capital originated in the U.S. in recent years, accounting for 25 percent of total capital raised in 2014, with a slightly higher focus on expansion (27 percent in 2014) and late-stage funding (26 percent), compared with seed and early-stage funding, which accounted for 17 and 22 percent of total capital raised, respectively.

Moreover, when U.S. investors are involved, European startups can raise two to five times more money. That multiple increases with each successive funding stage.

Toward a More Investor-Friendly European VC Market

How can European entrepreneurs attract European private investors? It's a steep challenge. Several conditions are necessary to draw in private capital. Most important, investors must be confident that they can earn competitive returns. Investment structures have to aim for returns on equity of at least 20 percent. However, performance will depend on further development of the European VC ecosystem. The following few points are mission critical:

- To attract institutional investors accustomed to writing tickets of €50 million or more, the market has to feature investment opportunities with a pan-European focus.

- There must be funds that are large enough—potentially with capitalizations of €350 million or more—to invest in startups at all stages of development, especially the late and growth stages.

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- VC funds and managers need transatlantic expertise and networking to support the growth of ventures in the U.S.
- Governments can act as catalysts and be the first movers, but they cannot lead private investors in new fund vehicles.
- Market performance must be sufficiently transparent, trustworthy, and timely to enable efficient investment decisions.

How to Develop a Universe of Privately Managed Funds of Funds

In a nutshell, we see two ways to reshape the GP landscape by attracting a diverse mix of large, private LPs and restoring private fund-raising levels. The timely and efficient option is to ease the regulatory restrictions for pension funds, insurers, and other private investors. Tax incentives for private investors offer an effective and timely mechanism for encouraging the supply of funds.

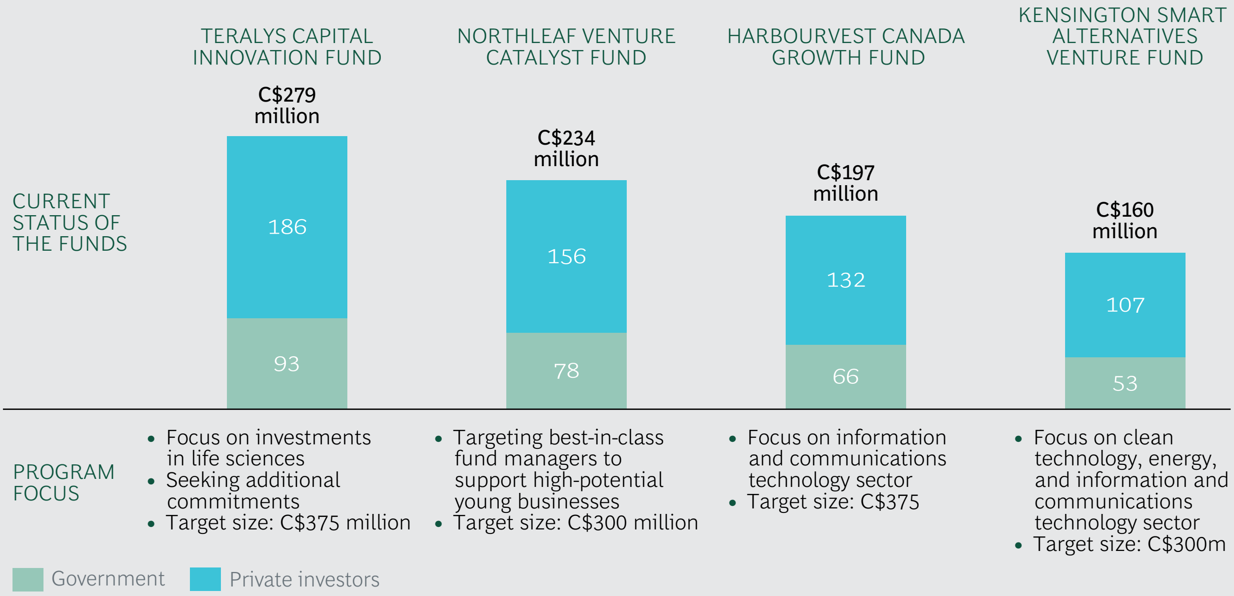
A second alternative will take more time. As a potential interim step, market players should consider setting up a funds-of-funds layer that could attract both private and public money. Such a structure could leverage public capital as a catalyst to scale up quickly. And it could help make the European VC market more accessible to private investors—not just by offering larger investment opportunities but also by increasing data transparency by, for example, encouraging the sharing of VC-fund performance data.

Market players should consider setting up a funds-of-funds layer that could attract both private and public money.

A successful example of this approach has been implemented in Canada as part of its Venture Capital Action Plan. (See Exhibit 5.) The initiative's objective is to increase private-sector investment in innovative businesses. The Venture Capital Action Plan has made available as much as C$350 million to establish up to four large-scale private-sector-led funds of funds in partnership with institutional and corporate investors. The role of the government consisted in defining the structure of the action plan and providing financial support to the funds of funds in the form of loans. These funds of funds are active investors in VC funds as well as innovative, high-growth companies, and they are managed by leading private-investment firms.

Europe could follow this example. Five to ten such sector-focused funds of funds would be sufficient to cover the most important high-growth sectors, such as software, Internet and mobile communications, life sciences and health care, energy and clean technology, hardware, electronics and robotics, and business-to-consumer and business-to-business commerce. VC funds focused on these sectors could be selected on the basis of their track records or future performance expectations, because of the management team's expertise and experience. Fund strategies should privilege and encourage cross-border investment. The funds of funds could be equipped with a mandate to invest in both pan-European VC funds and to make direct investments (for greater and faster generation of scale and returns) in attractive startups across the entire deal-size spectrum. Such funds-of-funds investments could be supplemented by other asset classes, such as private equity, to scale up capital faster, gain diversity, and reduce risk.

EXHIBIT 5 | Canada Shows How Government Money Attracts Private Money



Source: Company disclosures.
Note: Due to rounding, not all numbers add up to the totals shown.

To overcome the hurdle of additional fees for the funds of funds and their lack of performance history, the funds of funds could use a distribution model with asymmetric return structures. Public investors would receive a return equivalent to speculative-grade bond returns (currently around 5 percent). All remaining surpluses and losses would fall to the private investors. Risk levels should remain unchanged to avoid distortions in resource allocation. Private investors could also have the option of buying out public funds-of-funds positions. Such a funds-of-funds structure should be outlined and initiated by public bodies such as the European Commission, but management should be in private hands. Other barriers, such as regulations—including Basel III, Solvency II, and Alternative Investment Fund Managers Directive—that historically have discouraged equity investment, should also be adapted.

Changing the European LP Landscape in Venture Capital

Such a funds-of-funds structure would, over time, significantly increase private investors' share of VC investments. Several sector-specific funds of funds could support various VC funds. Of course, this capital requires sufficient European investment opportunities—which should be ample, judging from the profusion of seed- and startup-level ventures in Europe. Such a structure could deepen the European VC pool and finance several hundred companies that would create jobs and drive incremental growth.

We emphasize that the structure we have outlined would be an interim arrangement that would endure until private investments have scaled up sufficiently to establish a robust European VC ecosystem supported mainly by private capital. At that point, Europe's VC market would be a largely private affair, and Europe's status as a healthy, well-funded hub of innovation would be assured.

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