The Growth of European Venture Capital

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On May 11, 2022, a panel of academic researchers and practitioners met to discuss the rebirth of the European venture capital industry. The European venture capital scene has experienced extraordinary growth and maturation in recent years, with a number of entrepreneurial hubs and successful unicorns emerging. At the same time, the enthusiasm about this growth must be tempered by memories of the sharp decline in European venture activity after the "dot com bust" of the early 2000s. This session explored what has been behind the extraordinary surge of European venture activity, and how it will fare in the challenging months and years ahead. The panelists were **Niklas Adalberth** (Norrsken Foundation), **Thomas Hellmann** (University of Oxford), **Nenad Marovac** (DN Capital), and **Diane Mulcahy** (Kauffman Foundation). **Josh Lerner** (HBS) presented some empirical evidence on the state of the European venture capital industry. The discussion was moderated by **Reiner Braun** from the Entrepreneurial Finance Group at the Technische Universität München.

The European venture capital industry has gained much attention of late. There has been a tremendous growth in deal activity (shown in Figure 1), with transaction volume more than doubling over the previous decade. This growth is understandable given the outperformance of European VC over U.S. VC over the past three years (See Figure 2)[1].

Despite this success, the European venture market is still relatively young and small. The percentage of VC capital invested in Europe as a fraction of total global VC dollars invested is far less than Europe's share of global GDP (10% vs. 22%, respectively). By way of contrast, the global share of VC capital invested in the U.S. is more than twice its share of global GDP (50% vs. 24%, respectively)[2]. Moreover, the European VC ecosystem is clearly going through a period of rapid change and is evolving in substantial ways.

[1] Performance is measured using the internal rate of return and the Kaplan-Schoar public market equivalent measures. State Street data through the third quarter of 2021.

[2] Capital invested by relative weight of global GDP and population. State of European Tech 2021, Source: Atomico,

Figure 1

European Venture Capital Deal Activity*

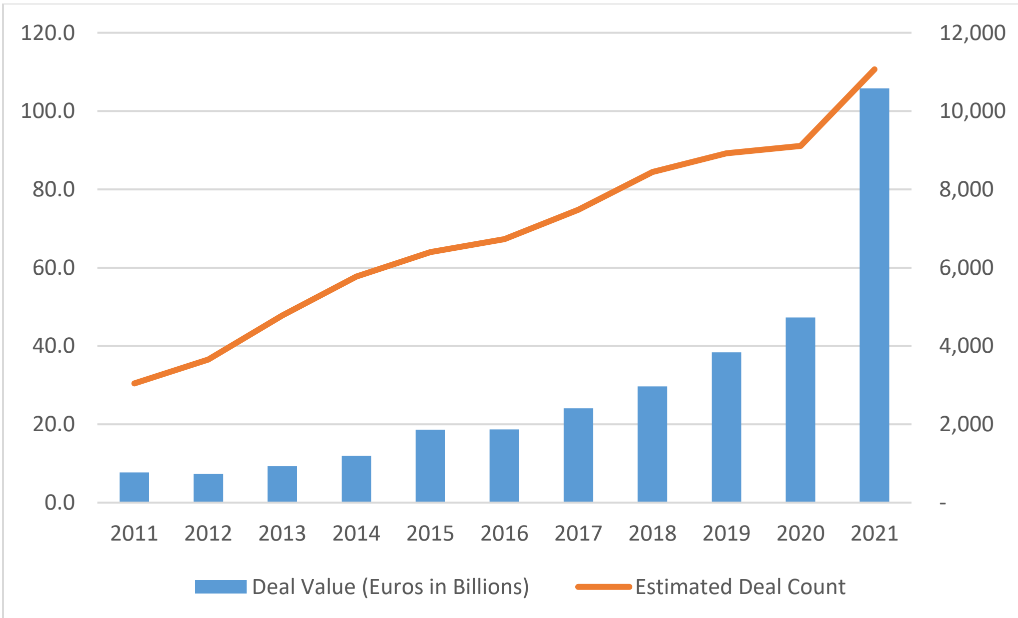
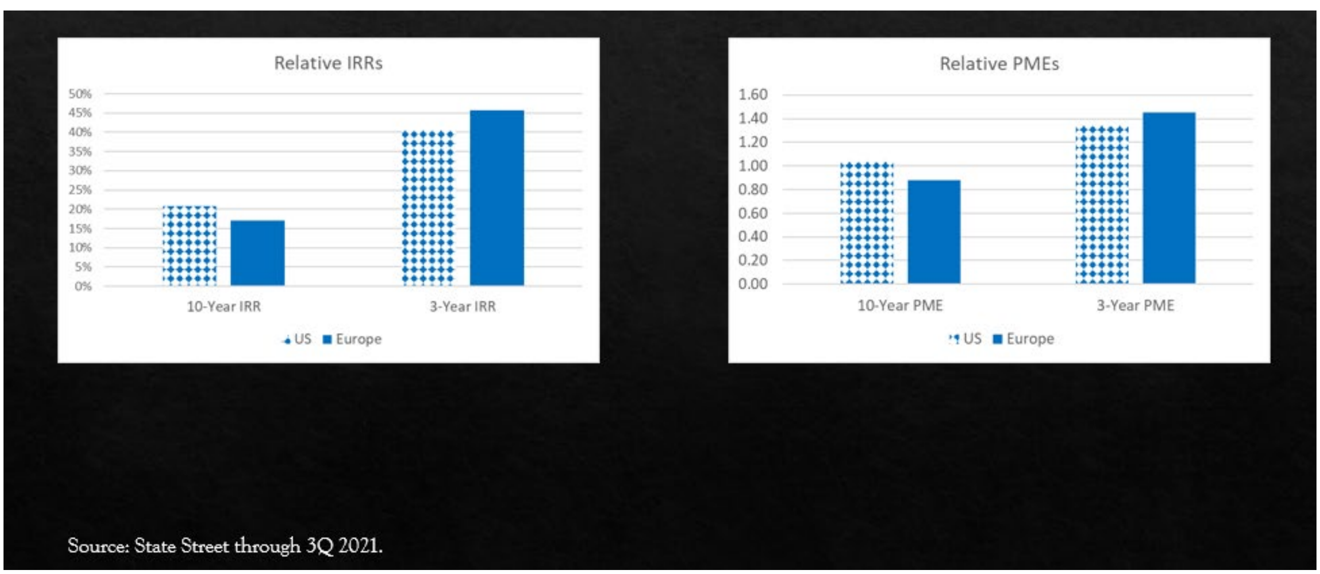


*Figure adapted from Pitchbook's Q1 2022 European Venture report as of March 31, 2022, https://pitchbook.com/news/articles/q1-european-venture-capital-trends-five-charts

Figure 2

Performance of European Venture Capital vs. U.S. Venture Capital



Characteristics of the European VC Market

The panelists highlighted several defining characteristics of the European venture market:

- ***Fragmented European Ecosystem:*** One of the features of the European VC ecosystem is its highly decentralized nature. Unlike the U.S., where more than 60% of the money comes from three major hubs[3]: Boston, Silicon Valley (San Francisco Bay Area, San Jose), and New York City, there is a more diverse mix of where capital originates. Historically, London, Paris, and Munich dominated the market in Europe, but now there are hubs in places like Berlin where there was relatively limited activity back in 2000. Companies now can originate from nearly anywhere in Europe. Last year, the largest IPO in Europe was UiPath, a $35 billion deal out of Romania. Similarly, there have been a few unicorns (Bitpanda and GoStudent) coming out of Vienna which has historically had little venture activity. The ability to find great opportunities all over demonstrates the adaptability and strength of European VC. However, the panelists pointed out that the decentralization of European VC does have a downside in that it is harder to put investment teams together because of cultural and language issues. Unlike Silicon Valley, where a deal could originate in a single day, negotiating a transaction in Europe requires more time and patience.

- ***Local-Market Focus:*** The European venture industry is a hyper-local market with domestic funds largely invested in small domestic transactions. For instance, in transactions ranging from $10-$20 million, more than 50% of the capital comes from domestic sources and another 25% come from other European countries. However, the larger transactions tend to be globalized. Looking at deals greater than one quarter billion, we see about 60% of the capital coming from outside of Europe.[4]

- ***Favorable Industries in Europe:*** Like most places, the software industry is "eating"[5] Europe and is the dominant industry for European VC investing.[6] However, the panelists noted several other sectors in Europe that could see more activity in the future, including Fintech, Life Sciences, and Climate Tech. The regulatory environment, particularly in the U.K., is favorable to Fintech, making it an interesting sector to explore opportunities. Life Sciences in Europe is not as well-developed as the technology industry, but there is world-class scientific discovery coming out of leading European universities.

[3] Florida, Richard, "The Post-Pandemic Geography of U.S. Tech Economy," Bloomberg U.S. Edition online, March 9, 2022, https://www.bloomberg.com/news/articles/2022-03-09/where-venture-capital-and-tech-jobs-are-growing.
[4] Share of capital invested (%) in Europe by round size and geographic source region, 2017 to 2021. State of European Tech 2021 Report, Source: Atomico.
[5] Andreessen, Marc, "Why Software is Eating the World," *The Wall Street Journal*, August 20, 2011.
[6] Lerner, Josh, "The State of European Venture Capital" webinar presentation May 11, 2021. Data source: Pitchbook as of December 31, 2021.

Emerging climate tech companies also show a lot of promise, with favorable regulation in Europe to reach net zero.

Evolving Venture Capital Ecosystem in Europe

The panelists highlighted a number of steps that are necessary for the European venture sector to continue to experience growth and success:

- ***Building Generations of Entrepreneurs:*** The relatively young VC market in Europe lacks multiple generations of successful serial entrepreneurs, who can inspire the next generation of entrepreneurs and give back by funding new companies themselves as angel investors. There is also a need for a stronger culture of successful entrepreneurs investing in the next generation of startup companies. This deficiency, however, is slowly changing as more success stories come out of Europe. Young workers are seeing entrepreneurial success, even in small cities, and are quitting their jobs to start their own companies. In addition, the caliber of founders in Europe increasingly matches that of the U.S.

- ***Reducing Brain Drain:*** There is a tendency for start-ups to relocate outside of Europe during their growth stage. Historically, Europe has been an excellent place for generating new ideas, but not as good in growing those concepts into commercial use. This is partially a result of the fragmented financing system mentioned earlier, which makes it more difficult to finance domestically rapidly-scaling firms that require large sums of capital. As successful European start-ups begin to seek their next round of funding, they often need to look globally for financing, as well as for experienced scale-up managers. Foreign investors and especially foreign acquirers may pressure target start-ups to relocate from Europe. For example, this has often occurred in the life sciences industry, where good ideas are generated in Europe but move to the U.S. to scale up and commercialize. Some companies are mindful of the pressure to move and negotiate explicitly to stay in Europe. For instance, DeepMind negotiated with Google to be acquired on the condition of staying in London. The acquisition turned out to be a good deal for both Google and DeepMind and has helped the firm retain talent.

  Similar to limited availability of venture capital, at least when compared to the U.S., exit markets in Europe still seem somewhat underdeveloped. The panelists agreed that Europe needs to find ways to foster acquisitions by its corporates to keep start-ups from leaving. Also, perhaps the changes in the way people work may reduce the brain drain problem (e.g., remotely or Digital Nomad Visas that allow individuals to work in different countries). Lastly, if more start-ups are able to stay in Europe, local managers will gain experience in scaling up and commercializing businesses thereby enabling future businesses to stay local.

- ***Evolving Sources of Finance:*** The sources of funding for European VCs have historically lacked diversity. Most of Europe's funding had come from three primary sources: pensions, public funds, and larger family offices. Recently, more sophisticated LPs such as endowments, foundations, and fund-of-funds have invested in European VCs. The benefit of these sophisticated investors, who have a deeper understanding of the riskiness of venture investments, is that they tend to be more stable sources of capital. Rather than looking for a single "big hit," these groups tend to diversify across different GPs and vintage years.

  The panelists also noted over the years, the sophistication of the government as an investor has also increased. For instance, the European Investment Fund plays a vital role in the VC industry, taking a sizable stake in funds (approximately 10%).

  Lastly, there has been a growth in participation by non-traditional investors in venture financings, such as private equity groups, hedge funds, and sovereigns. These non-traditional investors only represent around a third of the deals a few years ago but three-quarters of the value in 2021 (see Figure 3). How the participation of these investors will evolve in light of the recent venture capital downturn remains to be seen.

Figure 3*

VC Deal Activity with Nontraditional Investor Participation

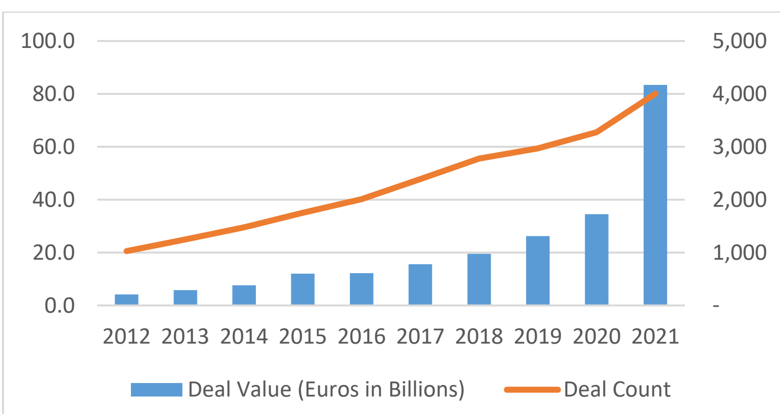


*Figure adapted from Pitchbook's Q1 2022 European VC Valuation Report, May 16, 2022, https://files.pitchbook.com/website/files/pdf/Q1_2022_European_VC_Valuations_Report.pdf

- ***Development of Deeper Public Markets in Europe:*** At present, the availability of a domestic initial public offering (IPO) in Europe as an exit strategy for venture capitalists varies across countries. There are potential limitations based on the size of the deals – some local markets are unable to handle large IPOs. Thus, larger companies will likely resort to multiple listings, often with a primary listing in the U.S. Also, the general lack of good equity research coverage in Europe can present a problem, particularly for complex companies like life sciences or companies with unique technology. For a successful IPO, companies need analyst research to get investors excited about their businesses. In some cases, European companies decide to go public in the U.S., where the public markets tend to be more developed. Along with the growing European VC industry, the European public markets will need to grow and adapt to the changing environment.

Conclusion: A Resilient European VC Ecosystem

The European venture capital ecosystem should be more resilient should another pullback like the dot com bubble occur. Unlike in 2001, when VC funds were predominantly supported through public funding, the European VC funds of today are more sustainable, with stable and diverse sources of capital from sophisticated investors. Furthermore, there is far more of a track record of success among European ventures today than was the case in the early 2000s. These changes should give European VCs more staying power than they had in earlier years.