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EUROPEAN MARKET COMMENT

NAVIGATIONAL AIDS FOR THE EUROPEAN VENTURE SECTOR

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Navigational Aids for the European Venture Sector

In the past few weeks you have sat through a presentation from a Parisian IT venture firm excited about backing a serial entrepreneur from Grenoble in his latest chip venture; a German biotechnology manager has been attempting to convince you that, behind the depressing headlines of a sclerotic German economy and its floundering body politic, talented people are propelling biotherapeutics companies with excellent science through clinical trials; and a U.K.-based early-stage investor rolled in spouting about "Delaware flips" (the latest fad of grafting a Delaware holding company onto a European start-up, better to position it for an exit in the United States), and waving a set of slides purportedly placing his fund's seemingly unremarkable performance comfortably in the upper quartile. But it is obvious to you that none of these managers really has a tangible track record; they fiercely disagree about the routes for exit for venture-backed companies, and there seems to be precious little consensus as to what levels of return they are targeting, let alone what sort of companies they are attempting to build. Welcome to European venture capital.

Since 2001 the industry has been dusting itself off following a fierce kick in the teeth administered by the bust of the late 1990s technology bubble—delivered just as the sector in Europe seemed finally, after many years of disappointed promise, to be blossoming at least into adolescence. Last year firms in Europe collectively raised just €2.5 billion for investment in high technology, from a total of €27 billion secured by the European private equity industry at large, according to the European Private Equity and Venture Capital Association (which does not break down fund-raising figures into venture and buyouts). Now, perceiving a moderate improvement in the climate, and perhaps more significantly, having held off as long as they can before bumping up against the expiry of bubble-era funds' investment periods, a number of firms are now either in the market (where some have been for some while), or preparing to hit the fund-raising trail. They need to convince investors that this time around, after two false starts (in the early 1980s with just a handful of participants, and in the late 1990s), European venture can deliver.

The industry is facing dramatic consolidation, shaking down from some 400 firms at the height of the bubble, to between 20 and 30 serious participants, excluding the numerous also-rans eking out an existence on dwindling management fees and unwilling or unable to face the prospect they will not raise another fund. Even with the winnowing, investors still face a fairly formidable task as they attempt to determine which firms could be positioned to succeed this time. Amid the cacophony of murky, incomplete track records and conflicting strategies, limited partners (LPs) could perhaps do with a bit of GPS equipment to find their way about.

No one is going to be persuaded to invest in European venture based on historical returns. According to preliminary results from the Cambridge Associates database, drawn from data supplied by a meaningful and growing, but still incomplete set of firms, the ten-year pooled mean for Western Europe is 12.8% (compared with 7.1% for Western Europe plus Israel, which is quite another story). Even those few firms that have been around for a couple of decades seem only to be investing a fourth or fifth fund, not least because entry and exit conditions were so tough for so long that they endured exceptionally long gaps between fund raisings. Not unlike the category of so-called emerging managers in the United States, the more typical profile is that of a firm with one or two past funds, maybe a late 1990s bubble-era fund from which the team may or may not have achieved exits and a 2000 or 2001 fund that is too young to be showing its true colours.

Given the murkiness of the data, LPs should only commit if they believe they have identified promise—the promise of a team that can capitalise on the strengths of European technology, benefit from a relatively uncrowded market (at least compared with the United States today), and take advantage of the wider improvements in the ecosystem (e.g., more serial entrepreneurs, a more favourable tax and regulatory backdrop, more educated professional service providers) of the last few years.[1]

More specifically, it is about finding a certain sort of company-building nous, combined with the basic ambition to set sights high enough, evidence of which LPs will have to unearth by forming judgments about the quality and development of companies in largely unrealised existing portfolios. After all, one of the central attributes of the best venture capitalists (VCs) anywhere, after quality of deal flow, is company building ability. In Europe, lacking a leading single cluster and handicapped by the absence of a vast homogenous domestic market, these skills are at even more of a premium.

After extensive analysis of the market, Cambridge Associates has come up with three broad categories of European venture firms in today's market, as one way of helping sort through the miasma.

The Local Parochials

Sadly, the largest proportion of the European venture industry falls into this category of local players building local companies: French software for France, Swedish medical devices saving lives in Sweden, to be sold to local strategic buyers, etc. Even if they have offices or are operating in more than one European country, these VCs have an outlook that is essentially parochial. As ambition is limited, so the potential "upside" in their performance will by definition be equally limited. Such managers are liable also to spend a good deal of their time worrying about attempting to return capital on almost all their investments, rather than shooting for home runs, which they argue simply does not work in Europe because of the lack of exit markets. The limitations of their vision and ambition will result in a self-fulfilling prophecy. One almost feels that if they happened to stumble on a piece of excellent technology—quite possible given the dispersed nature of the European market—they might inadvertently strangle it at birth by not knowing what to do with it, or by dint of their confined experience, send the company's founders off down the wrong path. The bottom line is that few will be "institutional quality" and attractive to sophisticated investors, because they will be capping their potential returns at buyout like levels, but taking a lot more risk.

[1] We plan to publish a full report on European venture capital in the fall, which will explore these changes in depth.

The Local Opportunistics

This bracket houses those investors who have the ambition, but not the resources, to build global companies. Their broader perspective relative to local parochials will allow them to spot opportunities with real potential, but they will not have the network, particularly in the United States, to propel their portfolios to meet these lofty goals on their own. However, they will be valued local partners of firms that do have such resources, serving as "feeder" funds, and hence they will be able to attract either a U.S. firm or one of the VCs in the global opportunistic category below into at least some of their investments. They are also likely to have part of their portfolio in local parochial investments. A select few, likely not more than one in each country (although the United Kingdom, France, and Sweden may be exceptions), will be suitable investment candidates. However, beware those that for one reason or another will not extract value from those global ambitions, perhaps because they have inadequate stakes in their companies and are unable to preserve their positions as the investment progresses through later stages of syndication.

The Global Opportunistics

VCs in this group (a small and select bunch) have the ambition and ability to build global companies. They have the look and feel of the best U.S. firms; indeed some are European offshoots of Sand Hill Road firms. They have superb international contacts and networks, and the vision and strategic skills to help their companies achieve tough goals. Theirs is a clear "home-run" mentality. They will sustain their own strong series A deal flow, but as mentioned above, will also derive later-stage opportunities from the best of the local firms, who will bring them in to inject their brand of international rocket fuel. While there is a lot of hype in Europe at present about the "Israeli" model, referring to the notion of taking local research and development, but developing the company itself in the United States to position it for a Nasdaq IPO or U.S. strategic sale (which is where the Delaware flip comes in), the global opportunistics recognise this is simply too prescriptive; appropriate perhaps for some software companies, but quite wrong for a wireless or fabless chip start-up with predominantly European or Asian customers. By contrast with the local parochial firms, which will (and should) struggle to raise funding, investors will find they face access constraints getting into the best of the groups in this category.

Finally, it is important for investors to take something of a portfolio approach in European venture. The high-quality technology for which Europe is rightly lauded may in fact arise in more or less any corner of the Continent, given the lack of centripetal force of any single cluster. Therefore, it is necessary to pick a small handful of firms rather than a single fund, with an eye to building in geographic diversification, in addition to seeking the more familiar forms of balance between information and communications technology and life sciences. Most importantly, the GPS will need to remain finely tuned only to those firms that are positioned to extract real value from genuinely global networks, or else investors will all too easily be in for yet another round of bitter disappointment.