Mind the gap

The performance gap between US and European venture capital funds has been an under-explored area. Keith Arundale, author of a new report addressing this very issue, speaks to the BVCA's **Tim Hames** and **Tom Allchorne**

Keith Arundale is currently a lecturer on private equity and venture capital at the University of Reading and a doctoral researcher at the Adam Smith Business School at the University of Glasgow, but for the BVCA he carries a special resonance. A chartered accountant, Keith was formerly at PwC, where he led the venture capital and business development programme within the firm's Global Technology Industry Group for Europe. Keith first got involved with the BVCA (and Invest Europe, or the EVCA, as they were then known) when he worked on our annual Performance Measurement Survey for many years. He is also the author of our ever-popular '*Guide to Private Equity*'. And it was here that seeds were sown for his latest project, a qualitative report looking at the differences between venture capital in the US and Europe.

"In looking at the performance data I got interested in the fact that seemed to be showing that European venture capital funds weren't performing as well as US venture capital funds," said Keith. "When I left PwC I decided that I'd like to do a bit more research into this difference in performance, and it became the subject, therefore, of a potential PhD topic."

Under the supervision of Professor Colin Mason at Adam Smith Business School at the University of Glasgow, Keith began his research in 2009, meeting with members of the BVCA venture capital committee and a number of academics. "In 2009, some people were disputing the data to some extent. 'Are we comparing apples with pears?' but since then there has been an acceptance of the performance difference. I decided, rather than looking at loads of data, and doing regression or statistical analysis on it, I would instead look at it in a more qualitative way by conducting semi-structured interviews with venture capitalists and other industry stakeholders in the UK, Europe and the US."

Between September 2012 and September 2014, Keith conducted 64 separate interviews with venture capital firms in Europe and the US. In addition, 40 non-practitioners were interviewed, including LPs in venture capital funds, entrepreneurs with experience of successfully raising venture capital, as well as advisors, corporate venture capital professionals, trade body executives and others involved in the industry.

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The report – which is very much meant to be a discussion paper – is divided into three components: structural differences (fund size, sector focus, partner backgrounds), operational differences (investment process) and wider environmental factors (culture, ecosystem, tech hubs).

Looking for the home-run

One of the key findings was the approach to risk-taking. Keith explains: "Specifically, I was looking at what I call this 'one in 10' approach, where you're looking for the home-run investment which is going to return your fund as a whole, and the really high-risk approach where you're looking for the outliers. There was definitely much more focus on that in the US than in Europe."

The differing attitudes to risk between US venture capitalists and their European counterparts is of course well known. But the reasons behind it are complex.

"I think it's a combination of things. Part of it is just how intensely competitive it is, particularly in Silicon Valley. Just about everybody agreed how competitive it is compared to Europe. And because it's so competitive, it affects a variety of things. One is they tend to invest earlier in a company's lifecycle, which means they've got a better chance of potentially picking up outlier returns. They're probably taking more of a risk ▶

because of the competition, but I think it's also culture. A number of people commented on the cultural aspect there, that they're just more used to taking risks in the States."

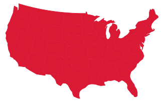
But this does appear to be changing: "With the newer venture capital firms, they are showing a higher engagement with risk. Of course, it's probably too early to say just how those are performing as my research was carried out in 2012 to 2014. It would be interesting, for future research, to know how things have moved on since then".

The report also discovered that US venture capital firms were also more collaborative than in Europe, a finding which, on the face of it, could seem paradoxical in such a competitive environment. "In Europe, they're syndicating largely for monetary reasons. Generally in the US they have the money. Yes, it's nice to have more, but they're looking to syndicate largely to share expertise and to collaborate with each other, whereas in Europe, it's much more of a need to syndicate, because if they don't they are not going to be able to finance the investments all the way through."

The issue of scaling – which relates to both the disparity in fund size and the fragment nature of the European market – is one that comes through in the research and indeed, it has been a hot topic for participants and observers of the early-stage investment community for a number years, most notably through the work of Sherry Coutu and the Scale-Up Institute, and more recently by the Government through its Industrial Strategy, Patient Capital Review and the Business, Energy & Industrial Strategy Committee Inquiry into scale-ups.

Keith agrees that this is where attention needs to be focused: whereas in the past there was concern over entrepreneurship and whether people could even launch a business, there is now a healthy eco-system of investors and investment schemes at the early-stage level. The problems today come later down the line.

"Nobody particularly thinks there's a shortage of early-stage finance. Below



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Further reading

The report can be found at the BVCA website [www.bvca.co.uk/Portals/0/library/Exploring-VC-Difference.pdf] and if you are interested in finding out more about the research or wish to contact Keith to discuss further, please email communications@bvca.co.uk.

the £500,000 level you've got plenty of opportunities with individual business angels, and then between the £500,000 and the £2 million mark, which used to be known as the 'equity gap', you've got syndicates of angels now, you've got crowdfunding. And you've also got some specialist venture capital firms that invest very much in the early seed stages, but it is that later-stage finance, that £5 million plus, where it is more difficult to find the money. I think the UK venture capitalists I talked to would all agree generally about that point."

The next generation

Raising larger funds would of course help address this. Of the firms interviewed, the average size of a US fund was US$282 million. For a UK fund it was US$168 million and in Europe US$128 million. The largest fund interviewed on this side of the Atlantic was US$557 million. In the US, the largest was almost three times that size.

The report makes a number of recommendations, including raising bigger funds, the adoption of a higher risk, 'home run' strategy and less focus on the downside. It is not, however, designed to be strictly prescriptive but aims to encourage debate and discussion, and already there are some signs that the UK and European venture market is starting to change its approach.

Over the last financial year, the BVCA saw 17 newly-established venture capital funds join as members, the largest number since the dotcom boom and bust. What is also interesting is the demographics of the founders. A high proportion of them were not born in the UK, many of them are entrepreneurs, or at least have some hands-on entrepreneurial skills, and the majority have a deep and concentrate sector specialism. Keith's experience is similar.

"I did find a lot more specific specialisation in the UK, particularly with the newer venture capital firms. They're much more focused on digital technology or fintech and so on. A lot of them are in the Tech City area of London, and when I look at those UK venture capitalists that

Keith Arundale, author of the report into European and US venture capital performance

I interviewed, I did find much more of the Silicon Valley, 'one in 10' approach to risk. And their backgrounds were very much more entrepreneurial and operational."

Keith believes this evolution of the market will continue: "It wasn't so long ago that there were only about 20, 25 actually active venture capital funds in the UK. It's now improving, and we've got all these new venture capital firms emerging over the last five, ten years. We will see more supply of money, more later-stage finance, and an increased focus on potential unicorns as part of a new approach to risk".

> **"I found a lot more specialisation in the UK, particularly with new venture capital funds"**

More generally, Keith feels the country has had something of a shift in its approach to enterprise in recent years: "I think there's much more of an entrepreneurial culture now developing in the UK. I see this in the business school, and I know one university intends to make entrepreneurship a core module for every single student, whether they're doing business or whether they're doing agriculture or physics or whatever it might be. Just talking to the students, they are much more interested in entrepreneurial-type careers and forming their own businesses."

In short, and as the report concludes, "the UK/European venture capital environment is improving". What Keith hopes is to stimulate discussion, both within the industry and outside, on the issues raised in the report and encourage the sharing of best practices. As the interviews that make up the paper were conducted between 2012 and 2014, Keith is interested in exploring how traditional venture capital firms have changed their approach in the time since, and whether LP attitudes towards European venture have shifted. ■

Tim Hames is the Director General of the BVCA and Tom Allchorne is the BVCA's Director of Communications.