THE TRANSATLANTIC VENTURE CAPITAL DIVIDE

DR KEITH ARUNDALE INVESTIGATES DIFFERENCES IN APPROACH BETWEEN EUROPEAN AND US VENTURE CAPITAL FUNDS

"While working in my former career at PwC, I became intrigued with the apparent underperformance of European venture capital (VC) funds compared to their counterparts in the US. I decided to undertake doctoral research – under the supervision of Professor Colin Mason at the Adam Smith Business School, University of Glasgow – to investigate the difference in performance between UK/European and US VC funds.
I conducted a series of in-depth interviews with venture capitalists from 64 different VC firms on both sides of the Atlantic. I supplemented my VC interviews with 40 further interviews with other stakeholders in the sector, including limited partner investors, entrepreneurs, VC-related individuals, advisers to the sector and corporate VC firms."

Dr Arundale's thesis, with a comprehensive bibliography, is published on the University of Glasgow website at theses.gla.ac.uk/30827

Historically, there has been a long-standing difference in performance between European and US VC funds, though returns do now appear to be improving and the gap between Europe and the US is narrowing. For example, the ten-year VC returns data to 2017 show that UK VC funds achieved a 6.6% pa return, according to a performance measurement survey by the British Private Equity & Venture Capital Association (BVCA) and PwC, while US VC funds achieved a 9.0% pa return (Cambridge Associates). Earlier data from Invest Europe show that the ten-year returns for VC funds to 2013 were 5.03% for the US but just 0.84% for Europe. This historical difference in performance has led to reduced allocations of funds raised for European VC from non-governmental sources, such as the traditional institutional investors, and a reliance on government agencies, particularly the European Investment Fund, for the funding needed for investment into high-growth entrepreneurial companies in Europe. In 2017, government agencies contributed 27% of the total European VC fundraising amount, though this fell to 18% in 2018 (Invest Europe).

So what explains the performance difference? Are US VC firms simply better at investing in potential high-return investments? Previous studies have not fully explained the performance gap between European and US VC funds, attributing some of the difference to "unmeasured fund characteristics or the environment in which funds operated".

The study sought to ascertain if there are generally agreed factors that may give rise to the performance difference between European and US VC funds for the sample of firms investigated. Potential factors may be of three types, as depicted in figure 1 below.

First, they may be structural, resulting from characteristics of the funds themselves, for example the size of the funds, their strategic focus or the backgrounds of the investment executives who manage the funds. Second, they may be operational, such as the investment practices of the VC firms which manage the funds. Third, they may reflect wider environmental factors, such as culture and attitude to risk and the wider ecosystem in which the funds operate.

The principal findings of the research are summarised below. The aim is to communicate to institutional investors that the UK/European environment for venture capital is improving and, as UK and continental European VC firms adopt more best practices (some of which are based on those of the US VC firms sampled in this research), the performance of UK/European VC funds should improve even further, encouraging increased institutional funding for the sector.

METHODOLOGY: A PRACTICAL APPROACH

Embracing engaged scholarship with practical experience in the VC sector, the approach taken in the research was to carry out interviews of around one hour's

FIGURE 1: OVERVIEW OF CONCEPTUAL FRAMEWORK

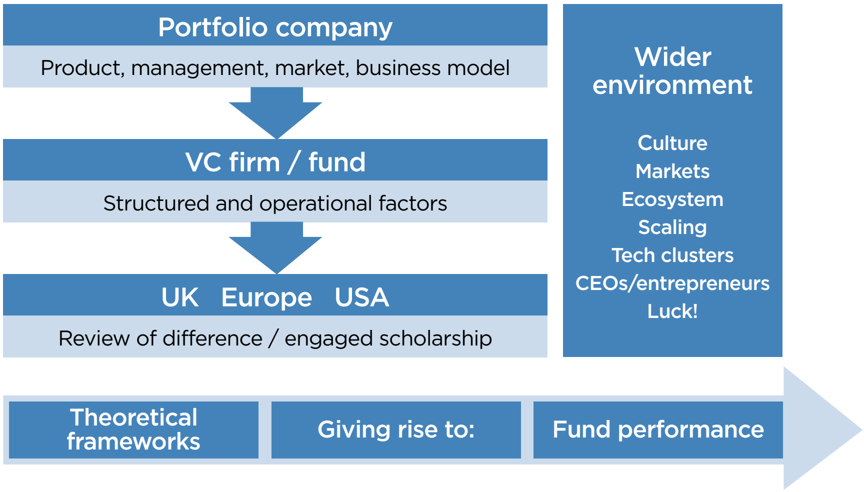

TABLE 1: SIZE OF FUND, SECTOR AND STAGE STRATIFICATION OF VC FIRMS IN SAMPLE

Number of firms	US	UK	Cont. Europe
Size of fund			
Small (<US$84m)	3	9	8
Medium ($US84m–US$365m)	12	13	6
Large (>US$365m)	10	2	1
Sector			
IT	10	8	2
Life S§ciences	3	2	1
Mixed	11	8	10
Focused	1	6	2
Stage			
Seed / early	11	11	9
Venture (including early)	12	13	6
Growth	2	–	–

duration with senior VC practitioners and other stakeholders in both Europe and the US, using a semi-structured aide-mémoire approach. The interviews, which took place in 2013 and 2014, covered the entire investment process (origination, due diligence, approval, execution, monitoring and exiting). There are relatively few studies that have employed qualitative interview techniques to investigate VC fund performance and VC firm investment practices. The majority of the existing studies use quantitative techniques on large data-sets applying regression analysis of variables and/or survey techniques involving questionnaires sent to a large number of participants for completion.

The VCs interviewed in the research formed a purposive sample drawn from membership of professional VC associations and from personal and other contacts in the sector. The sample size of VC firms (64 separate firms) uses the concept of saturation and also allows for the assessment of variation between the distinct VC groups in terms of geographical location. The VC firms were sourced from a cross-section of stage and sector specialisms, as can be seen in the table above.

Half the VC firms were focused on early-stage ventures, the others invested across the venture stages, with two firms focused on growth deals. Firms invested across the broad spectrum of IT and life sciences, sometimes specialising in one or both of these sectors and sometimes having a narrow focus on specific areas, such as digital media.

Some 70 interviews (at 64 separate firms) were carried out with senior VC executives from 39 separate European and 25 separate US VC firms as follows:

Europe: UK 24, France 3, Germany 3, Ireland 3, Scandinavia 2, Spain 1, Switzerland 2, Netherlands 1.

US: California 13, Boston 4, Pittsburgh 4, Baltimore 1, Cincinnati 1, New Jersey 1, New York 1.

Interviews were also held with 40 other stakeholders, including limited partner investors, entrepreneurs, corporate finance and other advisers and corporate VCs, comprising 19 from Europe (15 UK, 4 continental Europe) and 21 from the US. The ensuing thematic analysis involved over 2,500 pages of interview transcripts. While the research comprises some 110 interviews in total, which is certainly comprehensive for a qualitative study, the findings cannot be extrapolated to the full population of VCs.

FINDINGS

Several differences were found between UK/European and US VC firms and the structural, operational and wider environments in which they operate, as summarised here.

STRUCTURAL FACTORS

US funds in the sample (average size US$282m) were considerably larger than UK (US$168m) and continental European (US$128m) funds. There is a shortage of finance, particularly of later-stage finance, for growing and scaling companies in Europe.

> There's a massive inefficiency in the UK because you haven't got scale of funds; you're forever having to look to raise another round of funds and then another, and at each break point for the next fundraising, there are valuation and allocation disputes. It's hugely inefficient, a huge drain on management time.
>
> **UK limited partner**

The larger size funds in the US allow VCs to follow through with their initial investments which, in turn, better permits investee companies to scale.

US VC firms have proportionately more partners with operational and entrepreneurial backgrounds than European firms, which may well assist in the screening and value-adding capabilities of US VCs. European VC firms have a greater proportion of partners with a financial, investment or consultancy background.

> People who are good entrepreneurs are often the folk who end up becoming venture capitalists here.
>
> **US entrepreneur**

US firms have around one more partner in total than European firms. The research also reveals that US firms share responsibility for deals more than UK and continental European firms, often having two partners working together throughout the life of an investment. Additional knowledge and experience gained by two partners working together reduces information asymmetries which could lead to better investment and consequent better fund performance.

There is also evidence of US VCs clubbing together to make relatively small investments in very early, seed-stage investments in order to 'test the water' and thereby reduce the risk of missing out on potential outlier investments which have the potential to contribute disproportionately to the overall returns of a fund.

OPERATIONAL FACTORS

For the sample of VC firms included in the study, there are a number of operational areas where the investment practices of European VC firms differ from those of US firms. A theme approach to identifying 'hot' future areas for potential investment is adopted more by US VCs than by European VCs, with the latter tending to follow the trend. US VCs put considerable resources into researching and developing innovative new areas for investment. Getting ahead of the competition in this way and investing at the earliest stages of new technologies could contribute to the better performance of US VC funds.

> About ten times per year, partners decide where to put resources to try and identify an investment thesis, and present it to the group with respect to: is there an investable idea behind that?
>
> **US VC**

In addition, more US VCs have pursued a home run, 'one in ten' investment strategy than European VCs, perhaps due to the intensely competitive environment in which US firms operate, where taking a middle ground approach does not work, compared to Europe where there are constraints with funding and scaling.

> When we speak with one of our LPs in particular, their constant push is "are you taking enough risk in your portfolio?"
>
> **UK VC**

With a one in ten investment strategy, it could be that one or two stellar-performing investments achieve outlier returns of 10x or more and return the fund as a whole, compared to more of a growth strategy where several investments might achieve more modest 2x or 3x returns.

The brand strength of US VCs has an impact on attracting quality deal flow, whereas European VCs have more of a proprietary approach to generating deals.

> I can't think of European VC-backed firms that would have the same kind of brand franchise for a start-up that would be as attractive as some of the Silicon Valley groups here in North America.
>
> **US limited partner**

While most US VCs in the sample reach investment decisions unanimously or by consensus, a senior partner could force or 'railroad' the decision in some US VCs. Consensus may 'kill' the outlier deals which may produce outlier returns.

More US VCs, particularly West Coast based VCs, have 'entrepreneur-friendly' terms in their term sheets as opposed to the 'investor-friendly' terms found with European VCs and with some East Coast based US VCs. This again demonstrates US VCs' focus on the upside of investment growth as opposed to the European concern to protect the downside risk.

> Europeans are saying "how do I not lose?" and Americans look at the question "how do I win?"
>
> **US Silicon Valley VC**

There is perhaps a greater use of milestone-based financing/drip-feeding by European VCs.

> American CEOs think that European VCs just want to drip-feed them; the European VCs under-capitalise companies.
>
> **US Silicon Valley VC**

US VCs focus on the metrics portfolio companies need to manage to determine how much money to continue to invest at subsequent rounds.

> The US VCs know exactly what metrics they're willing to fund. The reason they're willing to put another US$X in is because they've seen that happen before.
>
> **UK corporate VC**

European VCs syndicate with other VCs, often for monetary reasons. US VCs may not need additional finance but collaborate to pool expertise and know-how.

> We syndicate not because we need to, but because we want to.
>
> **US VC**

European VCs appear to keep poor-performing investments going for longer than US VCs. On the other hand, more US VCs wait for the best exit than European VCs, who tend to exit early, perhaps due to fundraising pressures from their investors or issues with scaling in Europe. US VCs appear more able to achieve optimal exits for their investments as a result of their wealth of contacts with potential trade buyers, such as large technology companies, and an overall easier exit process in the US, including a stock market that is more receptive to technology companies. European VCs achieve less than optimal realisations for their investments, which result in less profitable exits and lower returns for their funds.

> You've got to take the best offer on the table for the money that you've got so you're maximising your return within the capabilities you have of limited fund sizes, and that is a big issue for the UK.
>
> **UK limited partner**

WIDER ENVIRONMENTAL FACTORS

There are several differences in the wider environments in which European and US VCs operate.

European VCs have a lower propensity for risk and do not 'think big enough' with their investments.

> There are just as many smart people with good ideas in Europe, [but there's] a lack of entrepreneurial capital and mindset.
>
> **US adviser**

US VCs' risk approach is perhaps exemplified in their one in ten0 home run investment strategy, noted above. There is also more of a willingness to share contacts, talents and information in the US, particularly in the unique environment of Silicon Valley, versus more of a proprietary approach in Europe.

There is a relative lack of experienced CEOs and serial entrepreneurs in Europe compared to the US.

> I think Europe is getting there but we don't have that large enough base yet of entrepreneurs and CEOs that have done it before.
>
> **UK corporate VC**

The difficulty of scaling by investee businesses in Europe is well known, largely due to a relative shortage of funds and the fragmentation of the European markets.

> In Europe we don't have big enough home markets to build great home run returns, so companies need to be international from day one.
>
> **UK VC**

There is also complexity due to copyright law in Europe.

> While there is now a unitary patent system and copyright across Europe, the issue is who licenses it for which territory. This puts off US VCs from investing in the UK.
>
> **Patent expert at Silicon Valley based tech company**

There are difficulties of exiting in Europe with less receptive stock markets and poorer connections with large corporates.

> You don't IPO your company in London unless there's something wrong with it usually. Because it's not an exchange that's going to value a high-tech company.
>
> **UK corporate VC**

Overall there appears to be a more open and sharing approach in the US, contrasted with a more proprietary, protectionist, hierarchical approach in Europe.

Silicon Valley was specifically highlighted with its unique open but tightly networked ecosystem.

> The investments, the CEOs and their teams are surrounded by a phenomenal ecosystem [in Silicon Valley]: connected advisers, connected partners. The Valley is just unique.
>
> **UK VC**

CONCLUSION: THE WAY FORWARD?

The different structural aspects of European and US VC firms and the differences in their operational investment practices may well contribute to the historical difference in performance between European and US VC funds, along with various cultural and economic differences as noted above and summarised in figure 2, right. The differences that have been identified in this study make an important contribution to explaining some of the unmeasured differences in performance between UK and US VCs referred to in earlier studies.

The implication of this research is that the solution to the funding gap in the UK and continental Europe is not simply a matter of increasing the supply of finance. Rather, there is a need for fundamental changes in both the practice of European investors and in the wider ecosystem in which they operate. European VCs could consider adopting more of a higher-risk, 'home run' investment strategy if considered practical and rational, the pursuit of outlier deals championed by senior, experienced partners, the use of 'entrepreneur-friendly' terms and less focus on the downside, and a 'theme' approach to identifying hot areas for investment. European VCs could also consider raising larger funds, if practical, for follow-on funding and scaling, hiring more partners with operational and entrepreneurial backgrounds and exiting from investments when the most value can be achieved, depending on market conditions and scaling potential.

A less proprietary approach, more networking and sharing of information, including dissemination of best practices, and building collegiate syndicates could also be encouraged. In the wider environment there is a need for more receptive public markets for technology companies, together with a ready supply of good CEOs and entrepreneurs willing to form serial ventures.

As noted at the beginning of this paper, European VC returns do appear to be improving. There are many excellent features about the VC sector in Europe. For example, in the UK we generally have an adequacy of start-up finance with business angel syndicates and crowdfunding, as well as some VCs willing to take the risk of investing at the very early stages. We have much technological innovation from the universities, centres of excellence in artificial intelligence, fintech and other areas and more people studying entrepreneurship and joining entrepreneurial companies. However, there is more that we can learn from the US VC sector. US VC firms are more aggressive. UK/European firms are more timid. This is not a cultural issue. It is due to real economic factors, including a more competitive environment in the US and issues with scaling, fragmented markets and a relative lack of later-stage finance in Europe.

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FIGURE 2: DIFFERENTIATING FEATURES OF US VENTURE CAPITAL FUNDS IMPACTING ON FUND PERFORMANCE GAP