

# Differences in Investment Practices between European and US Venture Capital Funds: a frequency analysis

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## Abstract

**Objectives:** To investigate whether differences in practice between the ways in which European and US venture capital (VC) funds go about originating, executing, monitoring and exiting from their investments might go some way to explaining the historical difference in performance between European and US VC funds.

**Prior work:** There are only a relatively small number of studies that seek to explain the reasons for the relative underperformance of European VC funds compared to US funds. Differences in practices between European and US VC funds have been investigated but these are not necessarily linked to fund performance. There are few studies that have employed qualitative interview techniques to investigate VC firm investment practices.

**Approach:** Semi-structured interviews with 65 VC practitioners across industry sectors were carried out (from 25 US, 27 UK and 12 continental European firms). Thematic analysis was used to identify emergent themes. Percentages of recurring themes were calculated.

**Results:**

- US funds (average size \$282m) were considerably larger than UK (\$168m) and continental European (\$128m) funds.
- US firms have around one more partner in total than European firms. They also have proportionately more partners with operational and, to a lesser extent, entrepreneurial backgrounds. US firms tend to have the team working together on a deal more than European firms.
- US VCs use a “theme” approach to identify future areas for potential investment.
- More US VCs do most of their due diligence in house. European VCs are more likely to use external experts for technology, financial, IP and legal due diligence.
- More US VCs wait for the best exit and are proactive in achieving an exit than European VCs.
- More US VCs have “entrepreneurially friendly” terms in their term sheets.
- Whilst most US VCs reach investment decisions unanimously or by consensus, a senior partner could force a decision in some US VCs.
- More US VCs pursue a home run investment strategy than European VCs.

**Implications:** In order to replicate the success of US VC funds, European VC funds could consider raising larger funds, hiring partners with operational backgrounds, taking more risk in effecting and approving deals and holding onto investments until more valuable exits can be achieved.

**Value:** The historic poor performance of European VC funds could lead to a shortage of funding for investment into young, innovative, potentially high-growth European companies. By adopting the investment practices of US funds, European VC performance could potentially be improved leading to increased investment in the asset class.

## 1 Introduction

European venture capital (VC) funds have historically performed worse than US VC funds and, though the gap has narrowed since the collapse of the dot.com/ internet era of 1999 to 2001, there is still a significant difference in performance. This has led to reduced allocations of funds raised for European venture from non-governmental sources, such as traditional institutional investors. This, in turn, could result in a shortage of VC funds going forward for investment into young, innovative, potentially high-growth European companies. Venture capital helps companies grow quickly and successfully (Gompers and Lerner, 2001), is regarded as a key component both in the development of an entrepreneurial economy (Mason and Harrison, 2002) and in the innovation process (Powell et al., 2002). This paper considers whether differences in the investment practices of the European and US VC firms that manage the funds for investment could at least in part explain the difference in performance between European and US funds. By adopting the investment practices of US funds, European VC performance could potentially be improved leading to increased investment in the asset class and subsequently into innovative companies that could contribute significantly to European economic growth.

Venture capital is medium to long term finance that is invested by usually independent, professional fund managers in potentially high growth unquoted companies in return for equity stakes in those companies (Arundale, 2007; Lerner et al 2012). The supply of venture capital is an important component of the so-called funding escalator for business growth (Mason and Botelho, 2013) which includes initial equity finance often provided by the business founder and his team, family and friends, crowd-funding, business angels and some venture capital funds who specialise in seed and start-up finance, and then other early stage and growth finance provided by venture and development capital funds. VCs carry out an intensive screening process prior to investing and then monitor these companies rigorously during the period to exit, adding value by providing advice and contacts to the companies, aiding their success (Bottazzi et al 2008, Gorman and Sahlman 1989, Lerner 1995). Venture capital is a subset of private equity which also includes equity finance for much later stage established businesses often provided to assist management teams to buy out businesses from their existing owners (Gilligan and Wright, 2014).

Low returns by European VC funds has led to reduced funding from institutional investors and hence less money for investment into high-growth entrepreneurial companies. Annual funds raised by venture capital firms in Europe reached an all-time high of some €22.1bn at the peak of the dot-com / internet boom in 2000. Amounts invested by VC funds in underlying high-growth potential companies businesses that year totalled €19.6bn, also a record level (EVCA, 2001). In more recent years both the levels of funds raised and investments have declined and in 2013 were around €4.0bn and €3.4bn, respectively (EVCA, 2014). A key contributing factor to this decline in activity has been the relative poor performance of the venture capital asset class in Europe, resulting in less investment by traditional non-governmental investors into European VC funds. Overall funds raised for European venture were 43% less in 2013 than in 2007. Funds raised by pension funds for allocation to European VC were 8.9% of the total funds raised for VC in 2013 compared to a 42.2% allocation of total funds for buyout investment (EVCA, 2014) by pension funds. Some of the long-standing VC firms have moved away from investing in early stage deals to focus on growth capital and buyout deals where returns have been considerably better. This refocus towards later stage deals could lead to a shortage of funds for investment into young, innovative, potentially high-growth European companies, notwithstanding increased activity by alternative sources of finance in the early stages of the funding escalator such as crowd funding and business angels.

The US also reached a peak in VC activity in 2000 with some \$105.1bn invested, compared to \$29.6bn in 2013 (MoneyTree, 2014). Whilst the overall performance of VC funds in the USA has been disappointing since the dot.com / internet era, European VC returns have been significantly worse than those achieved in the US.

The difference in performance between European and US VC funds was investigated initially by Hege, et al. (2003, 2009) who reported that differences in the amount of funding provided to portfolio companies, the extent of syndication with other VCs and with corporate investors and the degree of specialisation of the VC firms explained some of the performance difference. A significant portion of the difference was however unexplained. Hege et al. found that exits from investments by means of IPO gave similar returns in Europe and US but exits by trade sale performed less well in Europe compared to the US. Factors such as differences in the tax and legal systems or the stock markets appeared to be relatively unimportant to the performance difference.

Investigating UK and US funds for Nesta, Lerner et al. (2011) found that year of formation of fund (vintage year), size of fund, investment stage focus, industry sector focus, fund manager attributes such as prior

experience in the market and strategic choices such as number of companies invested in, amount committed, number of co-investors do not explain the magnitude of the difference in performance between UK and USA funds. They conclude that the historic gap in performance must be due to other characteristics of the funds that have not been measured or indeed to the wider environment in which the funds operate, such as the number of investment opportunities, the drive and ambition of entrepreneurs, cultural issues and other factors.

This paper investigates whether differences in the investment practices of European and US VC firms might go some way to explaining the performance gap, that is differences in the ways in which European and US VC firms go about originating, executing, monitoring and exiting from their investments. Whilst previous research in the area of venture capital fund performance and practices has largely involved the use of regression analysis on large data sets or a questionnaire approach this research adopts a qualitative approach of semi-structured interviews with executives from 64 separate VC firms in Europe and USA. It is also investigating, for perhaps the first time in an extensive manner, the entire investment process from sourcing deals to exiting deals (Tyejee and Bruno, 1984), specifically contrasting Europe and the US in the context of fund performance.

The paper first of all addresses the historic gap in performance between US and European VC funds, reviews existing literature on differences in investment practice between US and European funds and reviews the variables that affect fund performance, explains the methodological approach to the collection and analysis of data for this study, summarises the findings from the research and finally considers the implications for the approach to VC investing in Europe.

## **2 Literature review**

### **2.1 Reliability of performance data**

Several organisations collect and provide data on private equity and venture capital fund performance, including Thomson Reuters, Cambridge Associates and Preqin. Professional associations, such as the BVCA, also collect data as do various limited partners, such as Calpers, and fund of funds, such as Capital Dynamics. Performance data from different sources is often not comparable due to differences in the funds covered by the different providers, valuation bases used for unrealised assets by general partners, and inclusion or non-inclusion of investments outside the home country territory of a general partner (Harris et al., 2010). Despite these differences in data methods and sample selection a difference in performance between European and US venture capital funds is apparent, with European funds performing on average not so well as US funds, although the extent of the difference varies between the data providers.

Recently, Kaplan and Lerner (2014) have reviewed venture capital performance data and conclude that Thomson Venture Economics data (the predecessor to Thomson Reuters) should not be used as they comment that TVE stopped updating performance on around 40% of the VC and private equity funds in their sample. Thomson Reuters is however now providing private equity benchmarking data to Cambridge Associates and EVCA continues to use Thomson Reuters data. Despite any issues that may exist with TVE and / or Thomson Reuters data, as noted above, other data providers confirm a disparity in performance between European and US VC funds.

### **2.2 Performance difference between Europe and US**

Private equity and venture capital returns are traditionally measured by the industry, including practitioners, data providers, limited partner investing institutions and professional associations in terms of the internal rate of return (IRR) and / or the multiple. The IRR is an annualised rate of return achieved over the life of investment which is based upon cash flows from investors and from the realization of assets on exit and on valuations for unrealized assets. The multiple is a measure of the amount returned from an investment compared to the cost of investment; it is not time-sensitive unlike the IRR. Academics often measure performance in terms of PME (public market equivalent) but this is not commonly used by practitioners. This paper, with its practical orientation, uses the IRR as the measurement for venture capital returns.

Clarysse et al. (2009) reported that VC fund returns pooled over the period 1991-2007 were on average 6.9% per annum for Europe and 18.9% per annum for US. The research by Clarysse et al confirmed earlier studies by Hege et al. (2003) and Megginson (2004) which revealed that US VC funds generally report significantly higher IRR performances than their European counterparts.

The performance difference between Europe and US VC funds on average was subsequently further confirmed by Thomson Reuters data provided to the author in 2011 specifically in connection with this

research: the overall pooled average VC returns for 1985 -2010 were 2.5% per annum for Europe and 14.5% per annum for US. The difference in performance was significant in most years, especially from mid 1980s to 1998, mixed through the dot.com / internet bubble period, and in 2002 to 2010 US performance was better for each year than Europe, though by no means as significant as in some of the earlier years. The IRR for the start of the top quartile of funds was much higher in the US than in Europe (except for 2002). There was mixed variability in performance between US and Europe for the very best funds with maximum IRR depending on year. In this Thomson Reuters data some of the best European funds outperformed the best US funds in some years which could be due to some high profile exits in Europe in those years. For seed and early stage funds only, the US upper quartile was generally at a higher IRR than the Europe upper quartile, except for two years pre-bubble and two years in the bubble and immediately thereafter. However, the maximum IRR for Europe for seed and early-stage funds was greater than the maximum IRR for US funds for most years post bubble, reflecting the success of specific European VC funds due most likely to stellar exits, whilst the average performance for Europe is lower than the US.

Looking specifically at UK fund performance compared to the US, research by Lerner et al. (2011) for Nesta indicated that the historic performance gap between the UK and the US was narrowing, with the average performance of funds raised pre-boom 1990 to 1997 being 12.71% for UK and 32.95% for US compared to -1.21% for UK and -0.21% for US for funds raised post-boom 1998 to 2005. However in a later report by Marston et al. (2013) for Nesta, the gap between UK and US was widening with the average IRR for funds formed between 1990 and 1997 being 13.98% for UK funds and 33.34% for US funds and for funds formed between 1998 and 2007 the performance was -0.53% for UK funds and 3.87% for US funds. Marston et al. (2013) explain that this recent better performance of US funds could be driven by a resurgence of successful technology IPOs in the US and lucrative trade sales to cash-rich giant internet companies.

### **2.3 Variables affecting the performance of venture capital funds**

There are many factors which may explain the difference in performance between US and European VC funds. Previous studies have shown significant differences in investment practice between US and European firms though these have not necessarily been linked to performance. These include differences in the contractual relationship between VCs and entrepreneurs, the better capacity of US VCs to screen projects and US VCs investing larger amounts in initial rounds (Hege et al. 2003). Convertible securities are used three times less often in Europe than in the USA (Schwienbacher 2008). Other differences relate to the replacement of former management, stage financing, deal syndication and duration of exit stage (longer in Europe), and VC activity post investment (less in Europe). Schwienbacher (2005) shows that European VCs monitor less than US VCs. Within monitoring he includes the replacement of the entrepreneur as CEO, reporting requirements and stage financing. Schwienbacher (2008) concludes that European VCs are less active investors than US VCs which has implications in terms of how much value they add to the investee company which could in turn lead to lower returns for their portfolio companies.

Hege et al. (2009) observe that US VCs are often more specialised and more sophisticated than European VCs. Hege et al. (2003) argue outperformance of US VC funds relative to European counterparts is due (at least in part) to the superior screening abilities of US based GPs in taking on portfolio companies. Schwienbacher (2005) found that syndication is used more often in the US and also that the average size of syndicates is larger than in Europe. Schwienbacher (2008) found that the time for European VCs to find a trade sale buyer was a mean of 7.2 months compared to 5.1 months in USA, supporting the view that the greater degree of syndication in the US provides a larger pool of contacts when looking for a potential buyer. Manigart et al. (2002) investigated the motives for syndication in continental Europe and found that finance considerations were more of a driver for syndication than the sharing of resources or improving deal flow which appear to be more a motive for syndication in the USA. Less availability of capital due to smaller fund sizes and the desire to share the risk on deals are strong drivers for syndication in Europe; amounts invested in early stage companies are significantly larger in US than UK (Clarysse et al. 2009).

The backgrounds of the VC executives doing the deals has historically been different in Europe compared to the US. Kelly (2011) states that anecdotally it is claimed that European VCs more commonly have a background in finance, while US VCs tend to be scientists and ex-entrepreneurs. Kelly mentions that this difference in backgrounds of European and US VCs has never been tested as a reason for difference in performance. This is specifically investigated in this research.

There are many variables that can affect the performance of VC funds, including such areas as size of funds, track record of VC, strategy (investment stage, sector classification and geographic focus), timing and amount of VC financing provided, number of tranches of financing, capital inflow and vintage years, monitoring and control processes over portfolio companies, how VCs add value, syndication, skills / experience of the VC

partners, valuation of unrealised investments, timing and type of exits, and the general economic environment (Kaplan and Schoar 2005; Lerner, Schoar and Wong 2005; Diller and Kaserer 2005; SVB Capital 2010; Ljungqvist and Richardson 2003; Gottshalg et al. 2003; Aigner et al. 2008; Lerner et al. 2011; Schwiembacher 2008; Phalippou and Gottschalg 2007).

Whilst many of the variables affecting VC fund performance have been subject to academic investigation, as reviewed by Soderblom (2006), there were only a relatively small number of studies that sought to explain the reasons for the relative underperformance of European VC funds compared to US funds at the commencement of this research in 2009 (Hege et al., 2003 and 2009; Dantas and Raade, 2006). Subsequently, Lerner et al. (2011) in their work for Nesta found that various fund characteristics, as mentioned in the introduction to this paper, do not explain the magnitude of the difference in performance between UK and US funds. Later research for Nesta (Marston et al., 2013) also concluded that fund choices and fund characteristics do not explain the performance gap for pre-1998 or post-2003 funds. It did however conclude that the UK has slower and less profitable exits which would certainly impact on performance.

Clearly the US has been involved in venture capital for longer than Europe since George Doriot, a Harvard Business School professor, founded what is considered to be the first venture capital firm in 1946, American Research & Development (ARD) (Blank, 2009) whereas it was the 1970s before independent VC firms started to appear in Europe (other than ICFC formed by the Bank of England and the major UK banks just after the end of World War II. Leleux (2007) comments on the different stages of development of the US and European VC industries in connection with the large differentials between the performance of European and US early-stage VC funds.

The type of exit, duration of exit and influence of VCs on exit process could be key reasons for the difference in performance. Schwiembacher (2008) comments that European VCs face less liquid exit markets than in the USA which forces European VCs to shop around for longer periods when trying to sell their shares. Sapienza et al. (1996) note that trade sales in Europe are the most important means of divestment, unlike the USA where IPOs are more dominant. Europe lacks active IPO markets as exit routes for VC investments (Leleux and Manigart, 1994). If trade sales create less value than IPOs and Europe has more trade sales than the US this could be part of reason for the performance difference. But Kelly (2011) refers to the strong links existing between corporates and the VC community in the US which is held to account for the much greater amounts realised in trade sales. Lerner et al. (2011) showed that both US and UK funds had the lowest share of IPO exits when investing in UK companies, while they achieved the highest share of IPOs in their US investments. Dantas et al. (2006) investigate European performance versus US performance of VC funds for the period 1983 to 2003 and comment that US funds return cash sooner, realising investments quicker than European funds and refer to US VC's skill in identifying potential buyers for their investee companies

Axelsson and Martinovic (2013), in a report for the BVCA "European Venture Capital: Myths and Facts" conclude that venture capital backed exits in Europe and the US has the same determinants of success in Europe and US, with more experienced entrepreneurs and VCs being associated with higher probabilities of exit: IPO exits of deals from the same vintage year have equal success in Europe and US; Europe has a lower probability of exit via trade sales by 8 percentage points.

Following the demise of EASDAQ and NASDAQ Europe there is no pan-European stock exchange for growth companies which has been put forward as a key reason for the underperformance of VC firms in Europe (Oehler et al. 2007). Hege et al. (2009) found no evidence that this caused any difference in performance between European and US VC backed companies. Kelly (2011) also finds no real evidence that portfolio companies have suffered directly due to fragmented exit markets other than indirectly as poorly developed exit markets may discourage investment.

Apart from factors concerning the size and amount of funding in US versus Europe, the stage of development of the industry, the experience and specialization of the VC firms and their executives, the ways in which firms source, structure and grow their deals and how they exit from the deals, there are other wider factors that could contribute to a difference in performance between US and European VC funds. There are of course many different cultures, laws, regulations and taxes in Europe vis a vis USA. But Hege et al. (2009) found no evidence that these areas caused any difference in performance between European and US VC backed companies. Tyabji and Sathe (2011) comment that whilst VC firms in Europe operate in a similar manner to those in the US, there are important differences related to the external environments in which those firms operate, such as differences in culture and customs where Hege et al. (2009) found no causality for the difference.

Axelsson and Martinovic (2013) state that a contributor to the difference in performance is due to serial entrepreneurs being less common in Europe. They also comment as previously mentioned above on European VCs having less experience than the US. They find no evidence of a stigma of failure for European entrepreneurs. Fear of failure is however commonly regarded as one of the reasons why venture in Europe has not yet produced substantial returns (Alt Assets, 2009).

Serendipity and “unmeasured or unmeasurable” factors are mentioned as possible factors for much of variation in returns between UK and USA VC funds (Lerner et al. 2011). Several of the VC practitioners with whom the author has spoken mention “luck” as a key factor to success.

US small technology companies have historically benefited from government support prior to VC investment particularly in terms of R&D procurement through the Small Business Innovation Research programme. Dorte Hoppner, Secretary-General of EVCA commented in 2011 that: “If European venture is to help SMEs achieve their potential, facilitating public procurement for R&D, in a similar way (to the US SBIR programme), would provide a boost”.

Interestingly Hege et al.(2009) found that US VCs investing in Europe do not perform better than their European peers. In fact US VCs do worse when they invest in UK and UK VCs do better when they invest in US implying that it is the wider economic factors, exit routes, the characteristics of the investee companies themselves or the fact that UK VCs investing in the US in syndication with US VCs are benefiting from the US VCs wider experience that are leading to the difference in performance. Lerner et al. (2011) found that the more capital that US based funds committed to UK based companies as opposed to US based companies the worse their performance, though this was only apparent for funds raised before the dotcom bubble; subsequently US funds investing larger amounts of capital in European markets have instead displayed higher returns. Gottshalg et al. (2003) also noted that it is more the proportion of European deals that is related to performance than the fund being European per se.

The above studies indicate that a number of variables known to affect performance of VC funds could have different levels of emphasis with Europe and US funds and these, together with other unmeasurable factors, might explain the difference in performance between Europe and US. The purpose of this research is to investigate the variables surrounding the actual investment practices of VC firms in Europe and the US.

### **3 Research methodology**

Operating within the context of the critical realist philosophical framework (Bhaskar,1975) the author uses a mixed methods approach (Creswell, 2014) with quantitative review of secondary data (the performance data on which the premise for the study is founded) and qualitative, semi-structured interviews using thematic analysis to identify emergent themes (Boyatzis,1998).

Embracing engaged scholarship (Van de Ven, 2007) with the author’s practical experience in the VC industry (gained during a working career with PwC), the approach taken in the research has been to carry out interviews of around one hour’s duration with senior VC practitioners in both Europe and the US using a semi-structured aide-memoire approach. The author covers the entire investment process (origination, execution, monitoring and exiting) in the interviews (Tyejee and Bruno,1984).

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. Muzyka et al. (1996) refer to the VC community’s negative attitude towards such surveys. Sapienza et al. (1996) interviewed US VCs and CEOs as a precursor to completion of survey questionnaires sent to both US and European VCs, largely in connection with the VCs’ monitoring and adding value roles. Haemmig (2003) interviewed 100 VCs in Europe, US, Asia and Israel using a detailed structured questionnaire looking mainly at internationalisation aspects but also covering areas such as investment decision making and syndication. Garbade (2011) carried out 24 short interviews with European and US VCs to elaborate his subsequent on-line questionnaire covering various aspects of the investment process. Whilst not conducting interviews, Schweinbacher (2008) sent questionnaires to US and European VCs covering their investment practices. Tyabji et al. (2011) interviewed VC firms in Europe (number not specified) having previously interviewed 12 players in the industry in Silicon Valley ( including VCs, serial entrepreneurs and fund of fund managers) in connection with the underperformance issue.

The VCs interviewed in this research form a purposive sample drawn from membership of professional VC associations and from the author's and others contacts in the industry. The sample size of VC firms (64 separate firms) utilises the concept of saturation and also allows for the assessment of variation between the distinct VC groups in terms of geographical location. Sanders, Lewis and Thornhill (2012) suggest that where the focus of a research question is wide ranging between 25 and 30 interviews should be undertaken.

The VC firms were sourced from a cross-section of stage and sector specialisms. The majority of the VC firms were focused on early-stage ventures, some were more focused on later stage venture investing and some invested across the venture stages. Firms invested across the broad spectrum of IT and lifesciences, sometimes specializing in one or both of these sectors and sometimes having a narrow focus on specific areas, such as digital media.

Themes were developed using an inductive/ data driven approach, reducing the raw transcriptions to a shortened outline form within categories pre-determined from prior research and following the aide-memoire used to conduct the semi-structured interviews.

Some 65 interviews (64 separate firms) were carried out with senior VC executives from 39 separate European and 25 separate US VC firms as follows:

Europe: UK 26, France 3, Germany 3, Ireland 3, Scandinavia 2, Spain 1, Switzerland 1

US: California 13, Boston 4, Pittsburgh 4 (5 interviews), Baltimore 1, Cincinnati 1, New Jersey 1, New York 1.

36 of the 65 interviews were carried out face-to-face at the VC firms' offices or other suitable venues (the face to face interviews were held in London, Silicon Valley and Pittsburgh). The remaining interviews (continental Europe and elsewhere in US) were conducted over the phone. A number of issues were faced in making contact to secure interviews with the 65 senior practitioners across Europe and US. The author's own contacts in the industry through EVCA and BVCA certainly aided in securing interviews with senior VC partners in UK, Ireland and continental Europe. Personal contacts in Pittsburgh USA facilitated interviews there. Interviews with Silicon Valley and other US regional VCs were more difficult to arrange and involved a mixture of cold calling (principally NVCA and Nesta contacts), introductions from Silicon Valley Bank and contacts made by attending international VC and Global Corporate Venturing conferences. Persistence through a combination of emails, follow-up phone calls and involvement of partners' PAs helped secure the high-level interviews.

Prior to interviewing the VC firm executives in Europe and the US desk research was carried out on the firms' funds using information sourced from firm websites, CrunchBase and data providers including Preqin. The backgrounds of the partners were also checked from firm website biographical details. Partners were categorised as having a financial / investment, consultant, operational or entrepreneurial background depending on their previous work experience prior to joining the VC firm.

All 65 interviews were transcribed and the typed transcripts reduced to 4 to 6 page outlines within theme categories as follows:

Theme categories:

- Size and vintage year of fund
- Geographic focus of VC fund
- Performance of VC fund
- Professional backgrounds of investment executives
- Deal generation
- Approach to due diligence
- Investment approval process
- Terms of investment / use of syndicates
- Monitoring and portfolio review
- Adding value
- Exit process
- Europe / US differences from the perception of the interviewee
- Reasons for success or failure.

Preliminary discussions held with VC practitioners at an early stage of the research revealed other variables, such as the degree of trust between the VC and the entrepreneur, business model of investee company, ability of VC to pick winners and the ability to scale / grow big companies.

The outlines of the transcribed interviews were further summarised onto an Excel spreadsheet. Categories were sub-coded for further themes. The spreadsheet categories were analysed for percentage of recurring themes.

## 4 Findings

### 4.1 Performance data of funds included in sample: confirmation of a returns gap

The US VC firms in this sample had a greater number of funds with top-quartile performance and certainly outlier high performance than the European firms included in the sample. This is consistent with the overall historic difference in performance between European and US VC funds as referred to earlier in this paper.

Independent performance on 26 of the 64 funds was provided on special request by an independent data provider. 15 of these firms had top-quartile performance for their most recent fund (US 7, UK 5, E 3). 19 firms had at least one fund where performance was top quartile (US 11, UK 5, E 3) and 12 firms had two or more funds with top-quartile performance (US 7, UK 2, E 3). In addition 6 US firms, but no UK or E firms had funds whose performance showed an IRR of >50%. Independent performance data was also available from other data providers. 7 of these firms had their most recent fund with top-quartile performance (US 6, E 1), 11 firms had at least one top-quartile fund (US 10, E 1) and 7 firms had two or more funds with top-quartile performance (US 6, E 1). Additionally, 6 firms had funds with outlier performance >50% (US 5, E 1). The findings from these data providers support the first set of data. Only 3 firms showed consistency of top-quartile performance between all their funds (2 US and 1 continental European firm with an office in San Francisco). Venture capital funds have generally been shown to have persistence in performance from fund to fund (Harris et al., 2014).

Firms were also asked about their own views on their performance. Of the 61 firms who responded 46% said that their most recent fund had top-quartile performance (US 60%, UK 32%, E 43%), 64% said that one of their funds had top-quartile performance (US 84%, UK 45%, E 57%) and 33% said two or more funds had top-quartile performance (US 48%, UK 27%, E 14%). This is consistent with the better performance of US funds shown by the independent sources noted above.

### 4.2 Structural differences

The research investigated the size of the funds included in the sample and the backgrounds of the partners, categorized as financial / investment, consultant, operational or entrepreneurial. As explained below, US VC funds in the sample were considerably larger than UK and continental European VC funds. US firms had around one more partner in total than European firms. They also had proportionately more partners with operational and, to a lesser extent, entrepreneurial backgrounds.

#### 4.2.1 Fund size and firm age

US VC funds in the sample with an average size of \$282m were considerably larger than UK and continental European funds, which had average sizes of \$168m and \$128m, respectively. The largest US fund (\$1,515m) was ~3 times the size of the largest UK (\$557m) and continental European fund (\$557m). The larger size of US funds is consistent with previous studies (Lerner et al. 2011) and would better permit US VCs to fund entrepreneurial businesses through to exit. However, larger size funds do not necessarily perform better than smaller funds (Gottshalg et al. 2003). In fact there is an optimum performance level around medium size funds (\$84m to \$365m) according to Lerner et al. (2011) as the very largest funds may not be as selective as more optimally sized funds in their selection processes.

Table 1: Size (and age) of VC funds in sample

	US	UK	Cont Europe
# of firms with fund info in sample*	22	18	14
Av size of funds (\$m)	282	168	128
Smallest fund size (\$m)	12	15	11
Largest fund size (\$m)	1,515	557	557
Vintage year of earliest fund	1981	1987	1994
# of funds before 2000	14	4	5

\* an average size of fund was calculated for the funds pertaining to each of 54 firms. 11 firms were not directly comparable (as listed or VCTs) or did not have information available for some of their funds and are excluded from these calculations.

Not surprisingly, US firms in the sample have been in the VC business for longer, the earliest fund in the sample having been formed in 1981 compared to 1987 for the UK and 1994 for continental Europe. 14 of the US funds had been formed before 2000 compared to 4 in the UK and 5 in continental Europe.

#### 4.2.3 Partners

US firms in the sample had around one more partner in total than UK and continental European firms (US 6.4 per firm, UK 4.9, E 5.3). They also had proportionately more partners with particularly operational (US 2.7 per firm, UK 1.5, E 2.0) and, to a lesser extent, entrepreneurial backgrounds (US 1.0, UK 0.7, E 0.9). Lerner et al (2011) found a positive relationship between the number of partners and fund performance.

Table 2: Background of VC partners

	Whole firm	Financial/Investment	Consultant	Operational	Entrepreneur
By no. of partners in sample:					
US	160 ptrs	39%	3%	42%	16%
UK	117	48%	6%	32%	14%
E	79	32%	14%	38%	16%
By no. of firms:					
US (25)	6.4 ptrs/firm	2.5	0.2	2.7	1.0
UK (24)	4.9	2.4	0.3	1.5	0.7
E (15)	5.3	1.7	0.7	2.0	0.9

US VC firms have more partners with an operational and entrepreneurial background than with a financial / investment and consultant background (60 /40 split). UK firms have less partners with an operational and entrepreneurial background than with a financial / investment and consultant background (46 / 54 split). Continental European firms have more partners with an operational and entrepreneurial background than with financial / investment and consultant background (54 /46 split). Excluding one continental European firm with a particular focus on entrepreneurial partners (8 out of 12 partners) the remaining continental European firms have an equal number of partners with operational and entrepreneurial backgrounds and financial / investment and consultant backgrounds (50 / 50 split). Bottazzi et al. (2004) show that VC firms where the partners have previous business experience provide more support and governance to a venture. The greater concentration of operational partners in US VC funds may well contribute to improved performance, an area that has not been subject to much investigation in the past (Kelly, 2011). Whilst most VC firms have a lead partner responsible for deals from sourcing a deal through to exit, US firms tend to have the team, including different partners, working together on a deal more than UK and continental European firms. 95% of US VCs partners / staff other than the deal lead partner involved at the due diligence or post-investment stages or indeed throughout the deal cf 74% UK and 69% continental European VCs. This would aid greater sharing of expertise on deals contributing to the ultimate success of portfolio companies.

Table 3: Partners “own” deals

Theme category	Themes
Partners “own” deals (US 20, UK 23, E 13)*	<ul style="list-style-type: none"> <li>95% of all VCs had a lead partner responsible for deals from source to exit (three UK firms did not)</li> <li>95% of US VCs, 74% UK and 69% E VCs had other partners/staff involved at due diligence or post-investment or throughout the deal</li> <li>35% of US VCs had two partners on deals cf 13% UK and 15% E</li> </ul>

\*numbers in brackets under theme category on this and subsequent charts indicate the number of VC firms from each region who commented on the specific area.

#### 4.3 Operational differences

The research investigated various aspects of the VC’s investment approach, including their investment strategy in terms of a higher risk, home-run approach as compared to a lower risk, growth approach, how they source deals, whether they invest in disruptive technology, how they carry out due diligence procedures and arrive at their investment decisions, the terms used in the deals, syndication, how they monitor portfolio companies once investments have been made, how they seek to add value to the investments and how they achieve exits. As explained below, the findings show that more US VCs pursued a home run investment

strategy than European VCs, more US VCs do most of their due diligence in house, senior partners can force an investment decision in some US VCs and, more US VCs wait for the best exit and are proactive in achieving an exit than European VCs.

### 4.3.1 Investment strategy

VCs tend to pursue either a home-run “1 in 10” investment strategy when they select deals for investment on the high-risk basis that at least one out of every ten investments they make will return the fund as a whole or they pursue the less risky, and potentially lower return basis of achieving a 2x or 3x return on all their investments (growth strategy). This usually depends on whether they are investing at early stage or later stage. In the sample here it was apparent that more US VCs pursued a “1 in 10” investment strategy (81%) than UK (57%) and continental European VCs (57%) potentially leading to outlier returns:

*“So you have to be absolutely willing and ready to lose companies and to push them really hard on going big. The battle is being won by people who produce big exits”:* US VC.

Table 4: Investment strategy

Theme category	Themes
Strategy (1 in 10 approach) (US 16, UK 21, E 14)	<ul style="list-style-type: none"> <li>81% of US VCs pursued a 1 in 10 investment strategy or at least a 10x expectation cf 57% UK and 57% E VCs</li> <li>43% of E VCs, 38% of UK VCs and just 13% of US VCs stated that they specifically did not pursue this strategy</li> </ul>

More recently established UK VCs in the sample all pursued a 1 in 10 strategy as did those VCs in the UK which are operations of US VCs. One of these US VCs operating in the UK commented that they:

*“Look for huge outliers of 20-30x return in order to return the fund 3-5x”.*

This VC also commented that they are:

*“Paid by our LPs to take risks”.*

These firms all invest at the early stages. Some more established UK VCs which in some cases had changed strategy from earlier stage towards later stage investing pursued a growth strategy:

*“We decide over time how to evolve a company rather than going for broke from day one”:* UK VC.

Of course a “1 in 10” strategy doesn’t suit the risk profile of all early stage VCs, even US ones:

*“Anybody who can tell you they swing for the fences on every single deal that they do and that’s what they go for doesn’t have a snowball’s chance in hell of building a real successful portfolio because you just don’t know”:* US VC.

### 4.3.2 Deal sourcing

VC firms may source deals in several different ways. Some proactively go out into the marketplace and find suitable companies in which to invest. This approach requires an in-depth knowledge of the particular sectors in which the VC firm operates. Other firms might rely on their brand name, profile in the marketplace and track record in working with successful portfolio companies to attract deals; more of a reactive approach. Deals may come via the proprietary networks of the executives in the firms. In the sample of VCs interviewed in this study, more UK and continental European VCs cited a proactive approach to sourcing deals than did US VCs (UK 43%, E 50%, US 26%). More US VCs cited their brand name, profile in the marketplace and track record as the principal means whereby deals are sourced (US 26%, UK 9%, E 8%). This may be associated with the extremely competitive environment in which they operate, particularly in Silicon Valley. This is where having a well-established brand name to attract the best deals certainly helps as confirmed by a US Silicon Valley VC that invested in Facebook:

*“I certainly think a company like Facebook has had wide-ranging global impact on the brand”.*

Personal networks and proprietary contacts were more important to UK and continental European VC firms (UK 52%, E 33%, US 26%). European VCs are more concerned to keep proprietary information to themselves for competitive advantage in contrast to more of a willingness by US VCs, particularly on the West Coast, to share information.

Table 5: Deal sourcing

Theme category	Themes
Deal sourcing (US 23, UK 23, E 12)	<ul style="list-style-type: none"> <li>• More UK and E VCs cited a proactive approach to sourcing deals than US VCs (43%, 50%, 26%)</li> <li>• More US VCs cited their brand name/profile/track record as key for attracting good deals (26% cf 9% UK, 8% E)</li> <li>• Personal networks/proprietary deals were more important to UK (52%) and E VCs (33%) than US VCs (26%)</li> <li>• More US VCs referred to deals being highly competitive</li> </ul>

#### 4.3.3 Focus on disruption

VC firms from all regions like to invest in disruption as this provides competitive advantage for portfolio companies potentially leading to excellent returns for the investors. Disruption could be either in terms of the technology or product being disruptive (the principal approach to disruption), or the business model or the market. The term “disruption” was coined by Prof Clayton Christensen of Harvard Business School and means a new technology that unexpectedly displaces an established technology. For those VCs asked about whether they insisted on investing in disruption, most cited technology (2/3 US VCs, ½ UK and all but one continental European VC), though a third of UK VCs cited business model and a fifth cited markets.

Table 6: Disruptive

Theme category	Themes
Disruptive (US 9, UK 19, E 8)	<ul style="list-style-type: none"> <li>• Technology (US 6, UK 9, E 7)</li> <li>• Business model (US 2, UK 6, E 2)</li> <li>• Markets (US 1, UK 4, E 0)</li> <li>• Not necessary (US 1, UK 4, E 1)</li> </ul>

#### 4.3.4 Due diligence

VC firms may carry out much of the due diligence on potential investments in-house; they will form their own views as to the strengths of the management team, the attractiveness and growth potential of the market and the uniqueness and reliability of the product. Others may also involve external experts to a greater or lesser extent. In the sample tested more US VCs performed most of their due diligence in house; UK and, particularly continental European VCs were more likely to use external experts for technology, financial, IP and legal due diligence (US: 76% in-house cf UK 52%, E 60%).

Table 7: Due diligence

Theme category	Themes
Due Diligence (US 25, UK 23, E 15)	<ul style="list-style-type: none"> <li>• 75% of US VCs do DD largely in-house cf 52% UK and 60% E VCs</li> <li>• Only 20% of US VCs use external experts for tech DD cf 43% UK and 67% E</li> <li>• Only 12% of US VCs use independent accountants for financial DD cf 35% UK and 47% E</li> <li>• Only 12% of US VCs have external advice on IP cf 26% UK and 33% E</li> <li>• Only 12% of US VCs have external legal advice cf 39% UK and 47% E</li> <li>• 48% of US VCs did not mention tech DD cf 26% UK and 20% E</li> </ul>

This reflects the greater technical operational knowledge of some US VCs, again aiding performance, as illustrated by the following comments:

*“We do a lot (of due diligence) in house but no matter how good your own team is technically you can never really understand every product to the fullest extent so we always bring in know-how from our board of advisors...or the networks of those guys”*: German VC;

contrasted with the following comment from a US VC: *“We only invest in areas where we have the expertise in house. If we can’t diligence it because it’s not an area we know and understand we are not going to be helpful to the company”*.

#### 4.3.5 Investment decisions

95% of VC firms in the sample had an investment committee at which potential deals are discussed and eventually approved if due diligence and other enquiries are successful. In general the investment committees were comprised of those partners responsible for making investments. In a UK VC with operations in Silicon Valley the managing partner who operates the business is also on the investment committee. In another UK VC the CFO also sits on the investment committee. In another UK VC the operations director sits on the committee.

Table 8: Investment approval

Theme category	Themes
Investment committee (US 22, UK 24, E 15)	<ul style="list-style-type: none"> <li>95% of VCs had an investment committee (three US VCs were informal)</li> </ul>
Investment decision (US20 UK 20, E 11)	<ul style="list-style-type: none"> <li>More UK and E VCs reached decision unanimously than by consensus; US VCs were equal here</li> <li>In four cases with US VCs (20%) a senior partner could force a decision</li> </ul>

Whilst the partners may comprise the formal committee others can get informally involved. In a UK VC included in the sample the formal investment committee is just the partners but in practice everybody sits round the table and has an equal part in the discussions.

More UK and continental European VCs reached investment decisions unanimously than by consensus. Often the objective is to reach agreement rather than just vote:

*“We would if it came to it have a majority vote but in reality if someone is really uncomfortable we’d like to find out why and we wouldn’t go ahead if someone was violently against something”*: UK VC.

Whilst most US VCs reach investment decisions equally unanimously or by consensus, a senior partner could force a decision at 4 of the US VCs:

*“What we found was that consensus would kill the outliers. Anybody who feels strongly about something can make it happen”*: US VC.

This approach can mean that US VCs are more likely to decide to back very high risk propositions which can potentially lead to outstanding returns.

#### 4.3.6 Investment terms

Some of the various terms of investment included in the formal documentation between the VC and the investee company may impact on subsequent performance. The terms of a VC investment usually include the following areas:

1. amount to be invested, instruments (eg. ordinary shares or convertible preferred shares), valuation, capital structure;
2. liquidation preferences, dividend rights, conversion rights, anti-dilution protection, redemption rights, lock-ups, pre-emption rights, ratchets;
3. board composition, consent (veto) rights, information rights;
4. warranties, vesting, option pool, milestones;
5. confidentiality, exclusivity, fees, conditions precedent.

VC firms differ in their approach to the inclusion or exclusion and the extent of inclusion of many of the terms included in 2 and 4 above such as the use of liquidation preferences or the right to receive a dividend on their shares or whether financing is to be provided based on the company reaching certain milestones. The inclusion of such terms may depend on the stage of investment, the industry sector and whether the VC firm is leading an investment or following on behind others. This largely tracks the VC firm's propensity for risk and also the state of the market and competition to do deals. Several of the terms included at 2 to 4 above may impact on performance, such as dividends helping to increase the IRR on the one hand or reducing retained profits for potential future investment in the business on the other hand.

US West Coast VCs in the sample referred to their terms being more "entrepreneurially friendly" than East Coast or European meaning that valuations offered by the VCs were attractive to the entrepreneurs, often due to the competition involved in doing deals, and onerous terms were not included. In contrast "investor friendly" terms may include full ratchets, multiple liquidation preferences and cumulative dividend streams.

*"If you look at a venture deal structure, it's probably the most lenient here and it gets kind of more onerous as you go east":* US Silicon Valley VC.

*"We tend to have more of a west coast model. The east coast, they're more financially driven, so they have more punitive terms. My experience with European venture capitalists is very similar... a lot of similarities to east coast investors in the US":* US Mid-Atlantic VC.

In the sample, more US VCs had "entrepreneurially friendly" terms in their term sheets than UK and continental European VCs (US 57%, UK 23%, E 14%).

Table 9: Investment terms

Theme category	Themes
Investment terms (US 21, UK 22, E 14)	<ul style="list-style-type: none"> <li>• 57% US VCs used entrepreneurial friendly terms cf 23% UK and 14% E VCs</li> <li>• 23% UK VCs had used ratchets cf 14% US and 14% E VCs</li> <li>• 71% E VCs referred to liquidation prefs cf 36% UK and 29% US VCs</li> <li>• Only UK and E VCs referred to dividend requirements</li> </ul>

*"This is a cultural thing, in California we ask the question, well if everything this guy says is true, how big can the outcome be? In Europe they ask the question, what are all the ways this guy could be lying to me?":* US Silicon Valley VC.

In this VC's view European VCs are looking at every reason to say "No":

*"Europeans are saying how do I not lose and Americans look at the question how do I win?"*

This illustrates the long-held views on the cultural differences between the US and Europe in terms of ambition and propensity for risk which have been acknowledged as possible contributors to a performance gap (Lerner et al., 2011).

UK VCs in the sample tend to use ratchets more and continental European VCs use liquidation preferences more than US VCs. Only UK and continental European VCs referred to dividend streams. In contrast Kaplan et al. (2004) found less use of convertible securities and contingent control provisions in VC contracts with a predominant European component.

*"No American CEO wants a European VC. I worked for a European VC because they do things exactly as you describe. What are our dividends that we're going to get? Questions that American VCs just vomit all over":* US Silicon Valley VC.

#### 4.3.7 Syndication

Most of the VCs in the sample syndicated with other VCs on their investments, usually locally but sometimes internationally. There was more of a tendency to syndicate for monetary reasons in Europe compared to the US, as previously reported by Manigart et al (2002). This may be due to the relative scarcity of funding in Europe for scaling up ventures:

*“We will raise more money to scale production. It’s a very liberating investor to have, saying if you had more capital could you be more ambitious with this? Having X as an investor added value because it gave the company more options”*: UK VC.

*“It’s better to syndicate, better to have other people around you to help you but I think you do that from a position of strength. We syndicate not because we need to (we have the ability to write the whole cheque if we wanted to) but because we want to”*: US VC

Some US VCs also appreciate the additional finance and reduction in risk that syndication provides:

*“We want someone whom we think is rational who we have a personal relationship with who also has a deep pocket as part of our syndicate and so doing things on your own doesn’t make any sense because you don’t know what bad things will happen”*: US VC.

Many VCs commented on the importance of relationships to successful syndication.

*“We’ve had lots of bad experiences (with syndication). So, you’ve got issues of funds of different vintage, you’ve got different mindsets, people may be not as commercial, or just have a different view of life. Disagreements over what should be done with companies, whether there should be more money, or whether there should be a change of management team. We’ve had lots of suboptimal experiences”*: UK VC.

There was no evidence of less syndication activity in Europe compared to the US in the VC firms sampled, in contrast to Schwiendbacher (2005) who found that syndication is used more often in the US.

#### 4.3.8 Monitoring and adding value

95% of UK VCs took a board seat in the sample of VC firms interviewed, compared to 73% in the US and 67% in continental Europe. In contrast to Schwiendbacher (2005) there was no evidence that European VCs spend less time monitoring their investments than US VCs:

*“In our rule book anyway; you should be spending a day a week with the company if you’re doing your job properly”*: UK VC.

Table 10: Monitoring

Theme category	Themes
Monitoring (US 22, UK 20, E 12)	<ul style="list-style-type: none"> <li>• 95% of UK VCs take board seat cf 73% US VCs and 67% E VCs</li> <li>• 30% UK VCs take observer role cf 27% US VCs and 8% E VCs</li> <li>• Four UK VCs said they limit no. of board seats cf one US VC (one US VC said no limit)</li> <li>• Weekly contact with portfolio companies was most popular in all three regions</li> </ul>

VCs review their portfolio companies usually quarterly (or maybe annually) for the purpose of reporting to their LPs. Reviews are also carried out for considering whether to follow on with subsequent rounds of financing and for the level of support that is provided to portfolio companies. This might involve a formal rating of investments (A,B,C) every 6-8 months as reported by one UK VC or an informal rolling review, two to three times per year as reported by an Irish VC. Some VCs review all their portfolio companies each week, not just new opportunities, as reported by an East Coast US VC. One of the purposes of such reviews is to identify and cut off losers as early as possible and to concentrate on supporting the better performing companies in the portfolio.

*“Here’s ten companies, arrange them one through ten in terms of the ones you think are going to make it,” you usually tend to agree on the top three or four and you usually tend to agree on the bottom three or four, alright? So the discussion is really about the two or three in the middle ... but normally, everyone normally can spot the ones that aren’t going to make it”*: UK VC.

In addition to providing finance to their investee companies, VCs usually seek to assist their companies in various ways, seeking to add value to the financial investment and contribute to the success of the company and their investment (Hellmann and Puri, 2002; Bottazzi et al., 2008). In the sample the most common methods of adding value were helping to recruit the CEO (67% of VCs questioned on this), assisting with

further financing (38%), introducing the portfolio companies to useful contacts in their networks for commercial purposes (29%) and assisting with the exit process (28%).

Table 11: Adding Value

Theme category	Themes
Adding value (US 21, UK 24, E 13)	<ul style="list-style-type: none"> <li>• Key activities are recruiting CEO and team members (67%), assisting with financing and bringing in other VCs (38%), commercial connections (29%) and assistance with exits (28%)</li> <li>• 83% UK VCs helped with recruiting of 52% US VCs and 62% E VCs</li> <li>• 48% US VCs helped with financing of 33% UK VCs and 31% E VCs</li> <li>• 48% UK VCs helped with commercial connections of 13% US VCs and 31% E VCs</li> <li>• 42% UK VCs helped with exits of 24% US VCs and 8% E VCs</li> <li>• Assisting with international expansion was not cited as value add by US VCs; only one acted as a sounding board for CEO (both more prevalent for UK and E VCs)</li> <li>• Two US VCs shared best practices with portfolio companies (no UK, E VCs cited this)</li> </ul>

There was less evidence of adding value activities by US VCs, other than sharing networks with other VCs. This may reflect the strong screening skills of US VCs to invest in better quality companies which consequently do not need much non-financial support from a VC:

*“The best companies are the ones where you add the least value”:* US VC.

More UK VCs helped with recruiting, commercial connections and exits than for US and continental Europe VCs. More US VCs helped with financing than for UK and continental Europe VCs, in particular introductions to other financial VCs and to corporate VCs; a reflection of the greater supply of later-stage finance available in the US.

#### 4.3.9 Exits

Despite previous studies showing that the duration of the exit stage is longer in Europe (Schwienbacher, 2008; Dantas et al., 2006), the US VCs in the sample were perhaps more prepared to wait for the most optimal exit rather than cashing out early. Early exits may result from pressure of fund raising activities to show a track record of exits.

*“While in the first year or two after the financial crisis began, we were under pressure to produce cash, that then changed, and our investors are saying the priority is good returns”:* UK VC.

Investor (LP) pressure affects US VCs too:

*“When you get a lot of pressure is when you’re fundraising, because... like, right now, we’re fundraising for our Fund III and people say “Well, we love your Fund II story but we’d love to see a little more liquidity out of it”:* US VC

VCs don’t usually press for an exit unless a fund has not had any returns or there are market concerns:

*“We were increasingly anxious about the market and we were keen to exit sooner rather than later”:* UK VC.

Table 12: Exit process

Theme category	Themes
Exit process (US 22, UK 22, E 13)	<ul style="list-style-type: none"> <li>• 23% of US VCs wait for the best exit of 14% UK VCs and no E VCs</li> <li>• 36% of US VCs take proactive approach, inc appointing investment bankers of 18% UK VCs and 23% E VCs</li> <li>• 32% US VCs state companies are bought not sold of 18% UK and 23% US VCs</li> </ul>

36% of the US VCs took a proactive approach to achieving exits, for example by appointing investment bankers to find suitable buyers, compared to just 18% UK VCs and 23% continental Europe VCs.

*"Somebody doesn't knock on your door that you've never heard of, that you've never spoken to, that you don't know anything about and say "I want to buy your company""*: US VC.

Nevertheless many VCs believe in the concept that for better performing investments "companies are bought not sold":

*"We're working to elicit unsolicited offers by doing business development with companies who might become acquirers"*: UK VC.

#### **4.4 Perceptions of US / Europe differences**

The VC firm executives interviewed were asked to comment on their perceptions of any differences between the environment for funds in the US and Europe and the manner in which the firms and funds operate in the two regions. 55 VCs commented on these differences (US 19, UK 22, E 14).

The most cited differences were:

- Larger funds in US (as reported by Lerner et al, 2011 and confirmed in this study as noted above) and a lack of VC finance in Europe (49% of firms commenting). 59% of UK VCs commenting on this aspect and 57% of continental European VCs cited this cf 32% of US VCs.

*"There's not enough top tier, early stage, series A-focused funds around (in Europe)"*: US VC

- Size and maturity of VC market / fragmented European market / different ecosystem (38%), cited by 64% continental European VCs, 36% UK VCs and 21% US VCs. This has been referred to in previous work (Lerner et al., 2011).

- Cultural issues concerning the VC executives themselves (attitude to risk, lack of confidence, not thinking big enough) (33% of firms commenting), cited by 47% US VCs, 23% UK VCs, 29% continental European VCs. This is perhaps summarised as a "How do I win" US attitude versus "how do I not lose?" European attitude. However this may be due to differences in the relative wealth of US VCs compared to European VCs which may permit a higher level of risk taking by US partners:

*"Because all the partners have made hundreds of millions so far (in US), it's a totally different ball game"*: European VC.

Entrepreneurially friendly vs investor friendly terms (36%), as noted earlier in this study. 42% of US VCs cited this cf 32% UK and 36% continental European VCs.

- Lack of good CEOs, serial entrepreneurs and people with sales & marketing skills (31%) cited by 41% UK VCs, 26% US VCs and 21% continental European VCs, as noted by Axelson and Martinovic (2013).

- An easier exit process in US (via trade sales to large technology companies and IPOs) (23%) cited by 32% UK VCs, 16% US VCs and 21% continental European VCs, as referred to by Schwienbacher (2008).

Other comments referred to the sheer size and scale of the technology sector in the US and the difficulty of scaling up companies in Europe (Coutu, 2014).

VCs also referred to the more open ecosystem in the US, including a willingness to share contacts, talents and information, versus the proprietary networks in Europe (in the interviews 52% UK and 33% continental Europe VCs referred to the use of their proprietary networks for sourcing deals cf 26% US VCs).

#### **4.5 Perceptions of reasons for success and failure**

Participants were also asked about the reasons for the success and failure of investments made by their funds. Sector knowledge, connections within a sector and backing the right management team were cited as more important to success for UK and continental European VCs than for US VCs (perhaps because these are assumed to be in place by US VCs). In contrast, a focus on investigating and establishing an investment thesis or theme was cited as more important to US VCs. In fact all US VCs in the sample who were asked whether they researched future potential investment themes said that they used this approach.

Table 13: Investment theme approach

Theme category	Themes
Investment theme approach (US 11, UK 7, E 4)	<ul style="list-style-type: none"> <li>All US VCs asked about theme approach said they used this approach. One UK VC said follow trend; one said pretend to do it. one E VC said do not do it</li> </ul>

*“We do those ‘prepared mind’ initiatives, so you try to develop a thesis around what you think is going to be a future area of investing and that’s why venture investing is so hard because you don’t really know what you’re investing in”*: US VC

Market timing was cited more commonly as a reason for failure with US VCs than with UK VCs.

*“The biggest question is why now? It turns out that timing is the most critical driver of success and failure of a venture investment”*: US VC.

UK VCs perhaps had more issues with poor due diligence than US VCs (despite UK VCs outsourcing this more).

Surprisingly, more US VCs admitted to keeping on funding poorly performing companies:

*“They (partners) tend to fall in love with their investments and they become a little too emotionally attached to them and it is very hard to then stop”*: UK VC which carries out formal triaging of portfolio 4 times / year in an attempt to prevent over funding.

## 5 Conclusion

The performance of European VC funds on average lags behind that of US VC funds and this has led to less investment into European VC funds by the traditional non-governmental investors which in turn means there are potentially less monies available for investment into high-growth entrepreneurial companies in Europe. This study has investigated differences in investment practices between European and US VC funds which may go some way to explaining the performance difference.

The study has revealed a number of areas where the investment practices of European VC firms differ from those of US firms that have not been extensively addressed in previous research. In particular the adoption of a high risk, “1 in 10”, home run investment strategy by many US firms included in the sample with some US firms pursuing outlier deals at the behest of a senior partner without necessarily the consensual approval of the partner team, the use of “entrepreneurially friendly” terms in the term sheets of US West Coast based VC firms compared to the more “investor friendly” terms favoured by many European and East Coast based US VCs, the more prevalent approach to working together in teams on deals, the “theme” approach to identifying hot areas for investment used by several US VCs, the benefit “brand name” VCs, particularly in Silicon Valley, obtain for deal sourcing and the greater local sector knowledge and deep networks of US VCs that aids in-house due diligence and targeted exits. There is also some evidence that US VCs may hold onto investments until more valuable exits can be achieved, contrary to previous research showing that US VCs exit earlier than European VCs.

Whilst it is not unequivocally possible to link the observed differences in investment practices from this study to the difference in performance between European and US funds it is clear that the sample of VCs investigated does exhibit a clear supremacy of performance overall by the US VCs included in the sample. The different investment practices may well contribute to this difference, along with various cultural and economic differences to which reference has been made by the interviewees (of these the more open ecosystem in the US and a willingness to share talents and information, in contrast to a more proprietary culture in Europe, are particularly noteworthy).

It is well known that US VC funds are on average larger than European funds and employ more partners in their teams, characteristics that are also borne by the funds included in this study. The research confirms anecdotal evidence that US VC firms have proportionately more partners with operational and, to a lesser extent, entrepreneurial backgrounds, than European firms. This may well assist in the screening and value-adding capabilities of US VCs which could contribute to the performance difference.

This study has worked with a purposive sample of 64 separate VC funds in Europe and US, which is satisfactory for qualitative purposes. However it does mean that the findings from this study cannot be extrapolated to the full population of VCs. The current paper is concentrated on an overall frequency analysis

of recurring themes. Further work is being undertaken by the author to analyse the depth of the interviews to bring to light the richness of the data with many more quotes from the participants. The possible impact of stage and sector specialisation amongst the VCs included in the sample is also being investigated by the author, although Lerner et al (2011) found that these and other fund characteristics do not explain the magnitude of the performance difference, nor do differences in tax and legal systems and stock markets (Hege et al 2003, 2009). The 65 interviews with VCs are supplemented by some 40 further interviews with individuals prominent in the industry, including limited partner investors, “grandfathers” of the industry, executives of professional VC associations, corporate VCs and entrepreneurs. These additional interviews are currently being analysed, largely in the context of the wider external environmental factors that might impact on VC fund performance, several of which have been mentioned as differences between the US and European VC environments by the VCs interviewed in the current study as noted above.

Whilst the performance difference may be due in part to differences in wider economic and possibly cultural factors, the drive and ambition of entrepreneurs and the number of investment opportunities pertaining to the different geographies (Lerner et al., 2011), a possible implication of this study for the European venture capital industry is that European VC performance could potentially be improved by considering the adoption of certain investment practices of US VCs discussed in this paper. These practices include a higher risk, home run investment strategy, the pursuit of deals championed by senior, experienced partners, the use of “entrepreneurially friendly” terms, more working together in teams on deals and a “theme” approach to identifying hot areas for investment. European VC firms could also consider raising larger funds, hiring more partners with operational backgrounds, and, depending on market conditions and scaling potential, exiting from investments when the most value can be achieved. Improvement in VC performance in this way could encourage greater investment into the sector by institutional investors leading to improved opportunities for financing the potentially high-growth companies of the future in Europe.

## 6 Acknowledgements

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