DIFFERENT STROKES: US AND EUROPEAN VENTURE

Eight years ago VC consultant and academic Keith Arundale set about trying to get to the bottom of why US venture funds have consistently outperformed their UK counterparts over the years. After interviewing more than 100 venture capital managers, advisers and entrepreneurs on both sides of the Atlantic, he came away with some intriguing observations.

By *Nicholas Neveling*

The gap between the returns of US venture capital (VC) firms and their European counterparts has long been a feature of the venture market in the West, and it has shaped the way the industry has been funded and grown.

Yet although this returns discrepancy has had a major impact on European managers, who have received reduced allocations from institutional investors over the years as a result, no-one has been able to pinpoint the exact reasons for the differing performance.

The BVCA and Harvard's Josh Learner, among others, have all looked at the issue, but have never been able to reach complete answers. Lerner concluded that there could be no full reason for the discrepancy, as it was partly determined by "unmeasured fund characteristics or the environments in which the funds operated".

FINDING ANSWERS

A recent paper by academic and researcher Keith Arundale, titled *"Exploring the difference in performance between UK/European venture capital funds and US venture capital funds"*, however, offers some intriguing insights into possible reasons for the returns gap.

Arundale's interest in the subject emerged when he was a director in PwC's global technology industry group, where he was involved in the compilation of VC performance data for the BVCA.

"The seed for my research was sown when I was with PwC. The historical difference between European and US venture was always apparent, but there was never a clear explanation for why this was the case," Arundale tells *Real Deals*.

At the start of the decade Arundale left PwC to build a career in academia and started teaching at Henley Business School and the University of Reading. It was then that he began reading for a PhD on a part-time basis under the supervision Colin Mason, an expert on angel investing at Adam Smith Business School, University of Glasgow. In order to understand why US and European VCs delivered such different performance, Arundale decided to adopt a qualitative rather quantitative approach to the conundrum.

"I did an extensive literature review and there was a lot of work that had been done in this area using quantitative methods. I wanted to look into influences that couldn't be measured by doing a data regression," Arundale says. So rather than crunching through the numbers, Arundale decided to interview LPs, GPs and entrepreneurs in the US and Europe instead, and explore how they worked in order to shed some light on why one side had outperformed the other. Arundale interviewed 70 VC managers in the US and Europe, and 40 LPs, entrepreneurs and advisers.

Arundale's research reviewed the entire investment process, from sourcing to exiting deals, and he spoke to his interviewees about investment culture, attitude to risk and the wider ecosystem in which firms operate.

"I didn't go into the research with any preconceived ideas, but what was surprising and noticeable was differing risk appetite," he says. "US investors generally have a much higher risk threshold than those in Europe. If they take nine losses for every home run deal they will be relatively happy. European investors tend to have a more growth capital mindset, where they will make 2x or 3x money, but there is lower risk. In a US firm the attitude will be: 'Let's grow this company as fast as we can', whereas in Europe the mood will be: 'What can we do not to lose money on this deal.'"

It is a subtle but important difference in mindset that informs much about how firms set up their processes and build firm culture.

In the US, for example, Arundale found that it was not unusual for a senior partner to have the authority to push through a deal that he or she was convinced would deliver value, but that the rest of the investment committee opposed. In Europe, by contrast, Arundale found that decision-making was consensus driven, and that it was highly unusual for a senior dealmaker to override a view widely held across the rest of the firm.

Arundale also found that US VCs were much more proactive when it came to identifying and researching "the next big thing", whereas European houses would take a more cautious approach by following the market.

Arundale's series of interviews also showed that US investors were more proactive about weeding out under-performing portfolio companies; would hold assets longer if they believed a bigger exit could be secured down the line; and would accept terms that were less investor friendly than those European VCs were willing to swallow. With respect to skill sets, US venture houses generally have more people with an entrepreneurial and operational background, as opposed to the staff from financial and consulting backgrounds on the books of European VCs.

Arundale says the interconnectedness of the VC ecosystem in the US, especially in Silicon Valley, was another notable differentiator.

"European VCs are proprietary with respect to their deals, but in the US VCs are much more collaborative. The interconnectedness in Silicon Valley in particular is quite remarkable. People are meeting and sharing information about their deals 24/7."

Although he points out that given the qualitative nature of his research the findings can't be extrapolated, Arundale believes the work does identify the key differences between the two venture ecosystems and provides a basis for understanding why the one has performed better than the other.

"After doing this work what I am really interested in finding out is whether anything has changed, and whether there are any characteristics from US firms that European firms have adopted and benefited from," Arundale says.

This question, he adds, is particularly timely as recent EIF and other data show that the returns gap between European VCs and US VCs has narrowed significantly.

Is this a result of European managers learning from their US rivals, or has Europe carved out its own methods for scaling companies and delivering returns for investors?

"It would be very interesting to see what people thought," Arundale says.