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European VCs may be better prepared for a downturn than their US peers

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By **David Bogoslaw** - 19 hours ago

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GPs and LPs say there are a variety of reasons to be optimistic about the European venture market even as a growing number of economists forsee a recession for the world's largest economies. Venture Capital Journal's David Bogoslaw examines this and other issues with insight from major stakeholders in the industry including Forbion Managing Partner Sander Slootweg. Article follows below.

Europe’s venture market faces choppy waters in the year ahead, but its VCs and start-ups may get through the downturn with less pain than their US counterparts.
Both GPs and LPs in the European market point to a host of reasons for optimism even as a growing number of economists foresee a recession for the world’s largest economies.

First, start-up valuations did not get as out of hand in Europe as they did in the US. Second, most of the investments made in Europe have until recently been in early-stage start-ups, whose capital needs are generally much lower than those of late-stage companies and therefore less vulnerable to a projected capital crunch in the event of an extended market downturn.Third, higher-quality funds and portfolio companies have been socking away capital in preparation for periods of market volatility.Finally, Europe has matured into a key part of the global venture market. More and more VCs in the US and elsewhere recognize they must stay engaged in Europe so as not to lose out on compelling talent and investments.

Lower valuations

One factor that prevented valuations in Europe from getting as inflated as they did in the US is a smaller and less enabling IPO market that provided far fewer opportunities for high-priced exits than in the US. That’s kept investments in European start-ups relatively less expensive than those in the US. The number of VC exits in the US spiked 67 percent from 1,123 in 2020 to 1,875 in 2021, with almost 90 percent of those in 2021 achieved through public listings, according to PitchBook’s Q4 2021 Venture Monitor report. That’s a far larger IPO market than in Europe and Israel, where 142 European and Israeli start-ups went public through December 6, PitchBook noted.

Europe’s less mature capital markets and less available liquidity actually work to its advantage during economic downturns, said Oliver Kahl, a principal at Munich-based MIG Capital, which focuses on early-stage investments in deep-tech companies. “When the markets are in a downturn, the capital markets are the ones that react more strongly and immediately,” he said. “And that’s something that is not felt here in Europe so much.”

Jessica Archibald, managing director of Top Tier Capital Partners, a San Francisco-based fund of funds with an office in London that focuses on European VC investments, agrees European venture funds and start-ups won’t be as adversely impacted by the volatility in public markets.Many of Europe’s VC funds are newer, having launched just five to 10 years ago, with portfolio companies that aren’t yet mature enough to be raising pre-IPO or even late-stage rounds. “It still feels like the good funds are getting raised very easily, regardless of location,” she said.

The entire fundraising process, from announcing a new fund to limited partners, going through due diligence, having one close and admitting only a few new investors, is still being completed relatively quickly, she said. “That’s a sign that there are plenty of investors out there willing to invest in the top part of the ecosystem, whether it’s in the US or Europe.” In the first year of the pandemic, the median pre-money valuations for late-stage and early-stage companies in the US were already more than triple and four times, respectively, those of their European counterparts, and the valuation gap has widened over the past year and a half.

The median pre-money valuation for late-stage companies in Europe doubled from about €14 million in 2020 to €28.1 million in Q1 2022, while the median pre-money US valuation doubled from about $50 million to roughly $100 million over the same period, PitchBook reported. For early-stage companies, the median pre-money valuation in Europe nearly doubled from more than €6 million in 2020 to €12.2 million in Q1 2022, compared with a near-tripling in the median US pre-money valuation from $25 million to roughly $70 million, according to PitchBook.

Sustained investor appetite

LPs currently have attractive opportunities in Europe because there are fewer of them than in the US. Although some VC funds remain hard to access, LPs like the fact that if they’re willing to take a little more risk, they can scale with those that are still growing in fund size, and reap the benefits, which is harder in the US, said Archibald of Top Tier.

More reasonable valuations in Europe have likely already attracted US investors hunting for bargains as well as a way to diversify their portfolios, and because it remains relatively early in a more mature, competitive European venture market. LPs see better opportunities to get their preferred allocations, whereas access to the best US funds has become harder, much less the allocations that LPs want.

Archibald suspects other LPs such as endowments and pension funds are investing in Europe for the same reason as Top Tier. “You have a belief that innovation is global. So I don’t care where the apps on my smartphone have been created,” she said. “That became so much clearer through the pandemic. You don't know and you don't care where people are working."

Combine that with 30 percent lower valuations for tech start-ups than in the US and a growing track record of exits and realized performance over time, and global investors that already have exposure to the US and Asia are saying, "Let's make sure we have all three legs" of the stool and are "not excluding a large part of the venture ecosystem," Archibald added.

This is not to say fundraising will be easy for European funds. What capital is available will go to funds that are performing well, whether measured by multiples, IRR or distributions. Emerging managers, on the other hand, will have to struggle more to attract funding, Archibald said.

Vital Laptenok, a general partner at Flyer One Ventures, which has offices in Kyiv and London, has a brighter outlook for new managers. He said there's still room for emerging venture funds to get in the game, especially if they focus on just one industry, or a narrow area like sustainability, and are able to support their portfolio companies with specific knowledge and relationships. This has not traditionally been the strength of European VC funds managers, which tend to be generalists, Laptenok said.

Best funds have reserves

Higher-quality VC funds have been socking away cash in preparation for periods of elevated market volatility and have urged their portfolio companies to do the same, said Ross Morrison, a partner in the London office of Adams Street Capital, a fund of funds manager with about three quarters of its assets invested in early-stage funds.

He believes the best funds have amassed enough capital to enable their portfolio companies to weather the volatility until the public markets rebound, which could take up to two years. They can also use the cash they've accrued to acquire struggling companies as private markets consolidate, he added.

In downturns like the current one, MIG's focus – and that of VCs and investors in general, Kahl suspects – is that the portfolio comes first. “When it’s harder to raise money, VC funds want to make sure the [companies] you have invested in do well and will survive” before considering new investments, Kahl said. And when they do show interest in new start-ups, the ticket sizes are sure to be lower.

MIG, which has been able to raise nearly one fund a year since 2004, is currently reserving 20 percent to 30 percent of its total assets to be able to keep funding portfolio companies if fundraising headwinds persist for an extended period. That’s more than the firm would have set aside in prior years, Kahl said.

Funds with reserves will also be well positioned to take advantage of lower valuations on new deals, which slowed dramatically this year, just as they did in the US. An excess supply of start-ups should bring down the price of equity.
While it’s still early days for declining valuations, Kahl hears from companies raising rounds that they are no longer able to dictate a price to VC funds as they could previously. “These days, we hear statements like ‘let the market decide,’” he said.

The number of venture deals across all funding stages tumbled by 23 percent from 2,908 in Q1 2021 to 2,228 in the first quarter of this year, PitchBook reported. Early-stage and angel/seed investments posted far bigger declines – 31 percent and 29 percent, respectively – than late-stage investments, which were down 7.2 percent, according to PitchBook’s latest Euro VC Deal Activity report.

“Many of the late-stage transactions take time to put together so there were some processes that started in Q4 and closed in Q1,” said Morrison of Adams Street Capital. “The expectation is that late-stage deal activity has slowed down and hence not captured in Q1 figures, but expect to see the slowdown in Q2 figures.”
Some late-stage investments may continue to thrive due more to the structural evolution of certain sectors like biotech during the 10-year VC boom than to greater confidence in the inherent ability of late-stage over early-stage funds to ride out a potentially prolonged bear market.

Abundant talent and FOMO
A vast amount of regional talent is drawing capital from the US and Asia to Europe’s VC funds. Over the past several years, 350

unicorns have emerged from Europe, noted Morrison.The growing availability of venture capital in Europe in recent years showed fund managers they no longer needed to go to Silicon Valley to raise late-stage funding, said Archibald of Top Tier. She pointed to how much software development is being done, particularly in Central and Eastern Europe. Since the start of the Russia-Ukraine war, there may not be many venture-backed companies still based in Ukraine, but a lot of development teams remain there.

Investors from outside Europe are realizing they need to be actively investing in the region if they want to stay abreast of the talent and unique mini-industries emerging in countries like Ukraine, Archibald said. Many of the people starting companies are “not going to come to the US for capital,” she explained. “They’re going to stay in Europe.”

That has spurred major VC firms such as Battery Ventures, Sequoia and General Catalyst to open offices in Europe in recent years. Just as specific cities in the US have become identified with certain kinds of start-ups, regional specialization has emerged within Europe, Archibald said. When it comes to unicorns, Scandinavia is now known for its gaming and communications companies, including Angry Birds, Candy Crush Saga, Skype and Spotify, while London has gained a reputation as a fintech hub.

US investors are increasingly disinclined to ignore any of these varied regions in Europe, just as several years ago nobody wanted to ignore emerging startups in China or India, Archibald continued. “I don’t know whether it’s a fear of missing out, or a portfolio diversification, but I think that’s driving some investors to Europe.” Flyer One Ventures’ portfolio includes Mate Academy, whose innovative business model consists of providing a free four-month programming course to students in exchange for students who then find it easier to get tech jobs paying roughly 15 percent of their salary to the company for the first two years of their employment, Laptenok explained.“They are profitable and grow fast and are much more successful than US startups working on same model,” he said.The rise of partnerships between VC firms like MIG and academic centers such as Technical University of Munich is also helping to identify talent worthy of investment. Numerous tech companies have been spun out of such universities as Delft in the

Netherlands that have developed innovative technologies, said Kahl.

Pent-up demand

While public listings in Europe account for a fraction of exits for European VCs, the M&A market is quite robust. In fact, some big sectors rely almost entirely on acquisitions for new products and innovations. For example, European drug companies have “made themselves fully dependent on buying innovation from the outside,” with about 80 percent of approved drugs currently originating from smaller biotech companies, **said Sander Slootweg, a managing partner at Forbion**, a Dutch VC firm with about €2.3 billion in AUM that invests across all stages of life sciences development. “That is quite difficult to reverse.”

Because pharma companies still have strong balance sheets, “there is a large group of willing buyers for the best innovation out there,” he added. He estimates big pharma has roughly €500 billion in reserve for acquisitions over what could be a very fallow period for capital.

Forbion has raised nearly €470 million for its Growth Opportunities Fund II and aims to close on €600 million sometime this summer. “That shows there’s still plenty of interest with our LPs in this strategy,” Slootweg said. “But I can imagine across the board that LPs will have to think through the new market circumstances and will have to prioritize where they will still play and where not.”

Despite minimal change so far in acquisition valuations, Archibald said she expects the number of acquisitions to climb in Europe and elsewhere. “Especially with the public markets the way they are, there’s a lot of potential acquirers sitting on a lot of cash. Usually what we see is when the public markets go down, the number of acquisitions goes up.”

The extent to which target companies’ acquisition prices hold up “depends on the vintage year of the VC Funds,” Massimiliano Magrini, co-founder and managing partner of United Ventures in Italy, said in an email. “There will be a tradeoff with funds with good portfolio companies that need to exit despite suboptimal market conditions, but traditionally funds starting to invest in a period dominated by ‘bear’ markets historically have been the best performers.”