European venture capital: a misunderstood but very attractive asset class

By *Harry Geels*

The great appeal of venture capital is the combination of both high financial returns and impact. However, it is American investors that are profiting from our flourishing, European startup ecosystems. There is an educational challenge in regard to VC in Europe which should be addressed: we try to make a start with this Mini Roundtable on VC, with Joost Holleman of Prime Ventures, Ross Morrison of Adams Street Partners and Juul Vaandrager of NVP.

What is venture capital (VC) and what is the difference between venture capital and buyouts?

Juul Vaandrager: 'Let's first start with the similarities: they are both forms of private equity as opposed to public equity. With regards to the differences, VC funds invest primarily in innovative startups with a limited track record, whereas buyouts occur later in mature companies. Furthermore, VC companies are primarily financed with equity, whereas buyouts use a combination of debt and equity. So, leverage is important. The third difference relates to the risk profile. VC investments are typically riskier than buyouts as there is little track record and the product/market combination is not yet fixed. Fourth, institutional investors, at least the Dutch ones, tend to invest a significant percentage of their portfolios in buyouts and only a very little in VCs. Fifth, VC invests in innovative companies that have new business models or new technologies. Hence, VC is ideally positioned to generate not only a financial return but also a societal impact.'

Joost Holleman: 'Regarding the different risk profiles, VC is indeed riskier. Startups have little or no revenue. You will probably lose money on most of them, and this needs to be compensated for by the few startups that become unicorns. There is a very asymmetrical payout. Another difference between VC and buyout is that the latter can only come about through a change of ownership – normally in the form of a majority investment – whereas VC investors and entrepreneurs can become partners with VC firms and hold minority stakes with founders and management. Finally, VC is a long-term asset class with a longer probable horizon than buyouts. This long horizon fits actually very well with pension funds.'

What is 'the case for' VC and why should Dutch institutional investors invest in it?

Vaandrager: 'Foremost, it's the combination of potentially high returns and making an impact that is needed now more than ever. We face so many challenges in respect to healthy aging, climate change, and the demand for strategic autonomy for medicines, food, and energy. Global problems require global solutions and proper funding. This is where big institutional investors, I think, should step in, because they can make a difference and could provide substantial funding. Unfortunately, they are not yet very invested in VC. That needs to change.'

Ross Morrison: 'In the long run, venture has disproportionately outperformed all asset classes. Unfortunately, the appeal of VC does not appear to be well understood in Europe, and this is a big systemic problem. Europe has a flourishing venture ecosystem, but American and even Asian fund managers, or LPs, are primarily the ones enjoying the benefits because they invest in VC globally. US institutional investors have historically understood the case for venture much better than their European counterparts, and their typical allocation to VC amounts to 20% to 30% of their overall, private markets allocation. The US has a flourishing venture capital market that has greatly benefited the country. Look at all the great IT companies listed on the Nasdaq and included in the S&P 500, for example.'

That is quite a statement: European institutional investors don't understand VC!

Morrison: 'It is indeed, but it needs to be said because we believe the venture ecosystem could be the life blood of Europe and therefore could be a significant determinant of its future growth. Yet many European institutional investors have decided not to invest in it. And that needs to change.'

Holleman: 'Correct, and it's kind of strange that they don't because we can easily demonstrate that the risk-return profile of the portfolio increases with an allocation to VC, and that's not just over a short period of time. It's over decades and through all economic cycles. Even if an investor is not susceptible to all the other arguments, this return argument should do the trick, I would say.'

Why do Dutch institutional investors invest relatively little in venture capital?

Vaandrager: 'Let's first correct one point. There is some allocation by Dutch institutional investors to VC. However, that is mostly not invested in the Netherlands, but in the US. With insurance companies there are some positive exceptions. For example, Achmea and Menzis have invested in a European VC life science fund. The same also applies to some banks that invest in VC impact funds. There are a number of misconceptions that explain why Dutch pension funds are reluctant to invest. These misconceptions can easily be countered. One of them is that the large capital of our pension funds cannot be deployed. This is not true anymore, for already quite a few years. For instance, the life sciences branch of EQT (formerly called LSP) has just raised a 1 billion fund, offering the possibility to do large tickets.'

Morrison: 'The dominance of US institutional investors as LPs in European VC funds is due in large part to a bad experience during the dot-com era, when a lot of European institutional investors stepped into the market at the worst possible time. There was too much capital chasing too few deals in an ecosystem that scarcely existed, and there were some quite big losses when the bubble burst. That eroded confidence in the space, which has persisted for about 20 years, but European investors need to get over the hangover and start investing in VC. It's important for Europe so that people across the continent benefit from the wealth created by European unicorns.'

Holleman: 'Indeed, it seems to be a matter of once bitten, twice shy. It's also not an easy asset class to understand and therefore not an easy one to invest in either. It's about new companies with no cashflow in a market that does not exist. It's actually about investing in a vision. This can be learned and understood. The Americans have been doing it for fifty years and look what it has brought them.'

How do we get Dutch pension funds and other institutional investors to invest in our flourishing VC ecosystem? Any show cases yet?

Holleman: 'There are three necessary ingredients for a flourishing VC industry. One is innovation in technology. Europe is leading here, considering the number of scientists and PhD's that are graduating every year. The second ingredient is entrepreneurship, which has really developed in the last ten years. Ten years back, those graduates wanted to work for Shell and Unilever. Now, they want to start their own company. Founders of successful

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Juul Vaandrager

Juul Vaandrager is Director Venture Capital at the NVP. In this role she represents the interests of VC funds in the Netherlands. Prior to this, she held senior positions in corporate finance/financial advisory and worked as an investment professional for Rabo Private Equity and ABN AMRO. She is also a member of various advisory committees.

Joost Holleman

Joost Holleman, Managing Partner at Prime Ventures, joined this company in 2009. He is responsible for all aspects of the operations, including investor relations. Before joining Prime Ventures, he was with AlpInvest Partners in Amsterdam. As of 2001, he has led a large number of fund investments on behalf of AlpInvest in buy-out, mezzanine and particularly in venture capital. Before AlpInvest, Holleman was a Senior Consultant at PricewaterhouseCoopers (1997 – 2001).

Ross Morrison

Ross Morrison, Partner at Adams Street Partners, focuses on the primary portfolio within the UK, Nordic Region and France. He also covers pan-European managers, the large cap space, and is responsible for Venture Capital in Europe and Israel. Prior to joining Adams Street, he was an Investment Associate with Horsley Bridge and was in the Private Equity Group at Ernst & Young.

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companies are also breeding other successful entrepreneurs. The third ingredient is capital. Most of it is indeed coming from outside Europe or from angel investors: friends and family or family offices. There have also been many unicorns – a great example is Adyen, a very successful multi-billion Dutch payments company. There are actually no arguments against investing anymore.'

Vaandrager: 'Look for instance at the LP base of Adams Street. They have about five hundred pension funds globally in their client base. About 40% of them are European, but there are hardly any Dutch ones. The Dutch funds that do invest in the asset class invest in American VCs. There are exceptions. Some pension funds have dipped their toes into the European VC impact water, such as MN, PME and PMT. They invested in Innovation Industries, a Dutch VC that is active in impact Deeptech and in the later-stage life science fund of Forbion. These pension funds have realized attractive returns in VC. I hope that other funds will follow suit. Maybe the growing popularity of impact investing can do the trick, because, as mentioned before, VC lends itself very well to impact investing. For instance, a company such as BioNTech that is funded by international VCs and pension funds. It developed the first successful mRNA Covid vaccine. Maybe the political mood shift to investing more locally will also help. A final point to mention is that it helps to make decisions based on the right data on the markets, sectors and realized financial returns: the NVP puts a lot of effort into making this information publicly available.'

Is there an optimal allocation between VC and buyouts?

Morrison: 'In Adams Street's 50 years of building portfolios, we see that a 20% to 30% allocation to venture within a largely buyout-focused portfolio enhances the risk-return profile of the overall private equity allocation. One challenge is that, because many investors are sensitive or don't want to pay the fees, they try to do it themselves. I would advise against that, because in a properly diversified VC portfolio you generally need to have a large dispersion of companies. By the way, we are increasing our focus on European startups in our funds because, as I said, there are so many opportunities here.'

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Holleman: 'It's indeed not easy to do it correctly. You not only need the dispersion, but also the expertise, networks and, maybe most importantly, the patience. It can easily take ten years to see the returns. Also, commitment - or maybe better, consistency - is needed. That is, invest every year, not just as a one off. I recognize the point that some pension funds shy away from the fees, but that's an unwise decision. Good VC fund managers more than make up for their fees.'

What is the outlook for VC? What is the short and long-term impact on the VC industry of the significant decrease in valuation of listed tech companies?

Morrison: 'We believe the recent market dislocations and valuation resets make this an excellent time to start investing in European venture. In our view, all of the ingredients for success appear to be there. The VC ecosystem in Europe is robust and in good shape.'

Vaandrager: 'Indeed, and we need to watch out that US investors are not eating our lunch. VC is not a short-term investing strategy; you need to have a long-term horizon. If there is one lesson to be learned from the past, it is that you need to be consistent in your investment strategy, whatever the economic tide may be, both as a GP but also as a LP.'

Holleman: 'We have seen quite a big correction in the technology markets in the public markets, and that now also leads to a correction in the private markets. These lower valuations make it a better time to step in and reap even better returns in the future.' ■

SUMMARY

VC is ideally positioned to generate both a financial return and societal impact.

It is mainly American investors that are profiting from the flourishing European startup ecosystems.

The dot-com crisis has made European investors more hesitant about investing in VC.

Innovation, entrepreneurship and capital are the necessary ingredients for a flourishing VC industry. Europe has all of them.

The recent market dislocations and valuation resets make this an excellent time to start investing in European VC.