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Green shoots of venture show through in Europe
By Ayesha Javed

High-profile venture capital-backed companies such as Facebook, Groupon and Twitter have attracted eye-watering valuations in the US and the industry is seeing green shoots of recovery in Europe.

The venture capital industry, which was hit by lack of funding during the financial crisis, has been slower to bounce back than other sectors in the private equity bracket, but the industry in Europe is showing signs of recovery.

In Europe, 94 VC funds are currently on the fundraising trail, with an aggregate target of €10.3bn, according to data provider Preqin. The number of funds raised fell dramatically during the financial crisis. Last year, 35 VC funds were raised in Europe, totalling €4.5bn, compared with 98 funds in 2008 raising €10.4bn, according to Preqin.

David Waserstein, director of investments at VC and clean technology-focused asset manager I2BF said: “As capital starts to chase things like private equity, less falls into venture.”

But the industry in Europe is showing signs of improving. Trade body the British Private Equity and Venture Capital Association recently hailed 2011 the “year of venture” in an effort to promote investment in the sector.

Mike Chalfen, a partner at Advent Venture Partners, said: “Now is a good time for venture investment, the question is how many people in the market recognise that.

“Venture funds need to show that they are disciplined. People talk about consolidation, but it is more important that the fund size is appropriate for the opportunities.”

Chalfen said the number of investment opportunities would continue to rise. “The cost of creating companies has reduced because of commoditised infrastructure, the internet and cloud mobility. Company formation is more and more possible. There are fundamental reasons to believe that will improve.”

Instability in emerging markets could steer further investment towards Europe, according to Waserstein.

“I would expect to see more capital flowing into the US, UK and Europe in the long term because there is more stability. If there is a riot next door, that is not an environment you want to work in.”

Confidence is returning to VC funds previously reluctant to re-enter the market.

Sophie McGrath, an associate at law firm Morrison Foerster said: “Over the last few years, many venture firms who had money to spend wanted to hold tight and see if the companies they had invested in could weather the storm before making new investments.

“Towards the end of 2010 and into 2011, we have seen a renewed interest from venture funds looking at new investment opportunities rather than simply follow-on rounds or restructuring opportunities.”

US venture funds are also increasingly viewing Europe as a source for better returns, according to McGrath.

She said: “We have seen a greater willingness for US funds to look towards Europe as a place for investment. Generally speaking, venture funds prefer to be geographically close to their portfolio companies, but an increasing number of US funds seem prepared to come over to Europe to look at potential investment opportunities and to meet potential portfolio companies.”

Waserstein, whose firm focuses on VC and public equity activities in the US, Europe and the Asia-Pacific region, noted that some firms had a competitive advantage in Europe. “The dearth of capital means I get better pricing on deals I make because it is harder to raise a fund in this environment.”

Despite the noise around technology and renewable energy, life sciences remain a key sector in the European venture space.

Healthcare remains the most dominant sector in terms of VC equity investments, with 22% of investments in biopharmaceuticals and 20% in medical devices in the fourth quarter of last year, according to Dow Jones VentureSource. Information technology deals accounted for 29% of VC equity investments, while the renewable energy sector accounted for just 8%.

McGrath said: “There is lot of hype about cleantech as a new asset class, but it is interesting that in terms of total VC spend in Europe in 2010, only 8% went into renewable energy.”

But there are factors that could boost investments in the cleantech space this year.

Waserstein said: “The price of oil spiking over $100 a barrel is beneficial for alternative fuel, especially renewable energy.”

But he added that limited partners (investors) remain wary of venture and prefer the stability of having assets backing venture investments. “Limited partners want asset-backed deals, for example they want a wind farm rather than wind technology,” he said.

McGrath said: “There is no question that interest in cleantech will continue to grow. It will be interesting to see some of these investments exit over the next few years and see whether cleantech can outperform other asset classes in terms of the rates of return achieved on these investments.”

Developments in the technology sphere are putting pressure on infrastructure, driving a new generation of infrastructure development, according to Chalfen. He said while deals such as social networking sites Facebook, Twitter and Zynga, as well as online coupon provider Groupon, had created a “bubble-type environment”, those companies had high value-creation potential. “They are producing tremendous cashflow,” he said. “There is a bubble but it is not as exaggerated as people say.”

Regulation and government policy could play a role in how the VC industry develops, but regulation is not an immediate cause of concern.

McGrath said: “Obviously the adoption of the Alternative Investment Fund Managers Directive in November 2010 by the European Union Parliament has big implications for the private equity industry.

“Having said that, member states have two years from the date of publication to transpose the directive into national law, which means we will not see the practical impact of the directive until early 2013. Further, there is an exemption for smaller funds, which means many VC funds will fall outside the scope of the directive.”