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European venture capital: a model is born

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The gloom affecting financial markets seems to put a certain pressure on European venture capital investors. Even though out of reach of the credit crunch, venture capital will face difficult times with regard to the development of portfolio companies in a recession, says financial journalist Cyril Demaria. Sequoia Capital, in a widely commented presentation, has drawn drastic conclusions and advises its portfolio companies to radically cut their expenditures.

If these conclusions are valid for the American context, this might not be true for the European. Not that the continent will be immune from the recession, but its specific configuration should at least trigger a step back to reflect on the consequences.

European VC is born out of a recession

Boom years such as the ones that Sand Hill Road firms have experienced were limited to the US, and we should even say to the West Coast. European venture capital, as a contrast, really emerged on the aftermath of the 2001-2003 technology bubble burst. This has conditioned a certain number of reflexes, and among them to measure wisely capital expenditures, limit valuations inflation and focus on trade sales as a way of exit. As a consequence, the structure of current portfolios differs substantially from the ones built by American VCs.

Another consequence is that managements of European companies are trained to work in a capital scarcity context. This provides certain resilience in a recession. Studies have shown that continental start-ups, for example in Switzerland, fare better with less capital than British start-ups: they have a better survival rate and are also providing better returns on average.

When market fragmentation becomes a protection

The financial Dust Bowl which is affecting the US will not have the same consequences in Europe. Markets are fragmented and it takes longer for companies to go to market in each country. In a recession time, this tends to insulate each of these markets at least partially from others. Having built patiently local operations, with a staged roll-out plan, is therefore rewarded in difficult times for start-ups.

This does not imply that European VC will not be affected negatively in terms of returns, but that the impact will probably be more mitigated. Whether this impact will materialize on a longer timeframe remains to be seen yet.

Having a "Plan B"

Testing times are interesting, because they highlight the qualities of people. We have met countless over-inflated egos in the venture capital industry, unable to listen and sure to succeed only in their way. Growth times are a blessing to such attitudes. This will no longer be the case. This is why investors likely to succeed will slow down, reduce some of the pressure on management and set a hierarchy of priorities. A "plan B" may help.

This Plan B is for example about organizing consulting practices on the side to pay wages and manage this consultancy/advisory/market study practice aside from the main product/service (which is the motivation and the innovation part of the venture). This will of course nurture the main product line through introductions, contacts and feedback.

As a consequence, it is also likely that venture capital investors will have to develop paradoxically an alternative to their "pure equity" model to venture lending and/or predefined returns and commitment times for their investments (see "Venture Capital 2.0").

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