THE CHALLENGES OF STRENGTHENING EUROPEAN FINANCING FOR START-UPS

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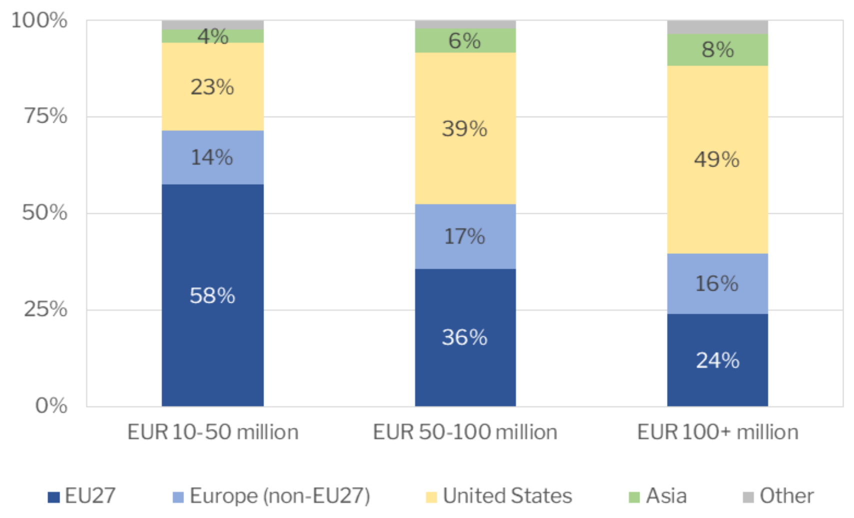
In 2021 and the first half of 2022, European start-ups raised record amounts and 68 of them gained the status of "unicorn". Up to now, this dynamic has relied on the increasing involvement of US and Asian investors, particularly for late-stage funding rounds. This emphasises the need for the European Union (EU) to strengthen its own venture capital industry.

Chart 1: Investor origin by amounts raised by EU27 start-ups (2016-21)



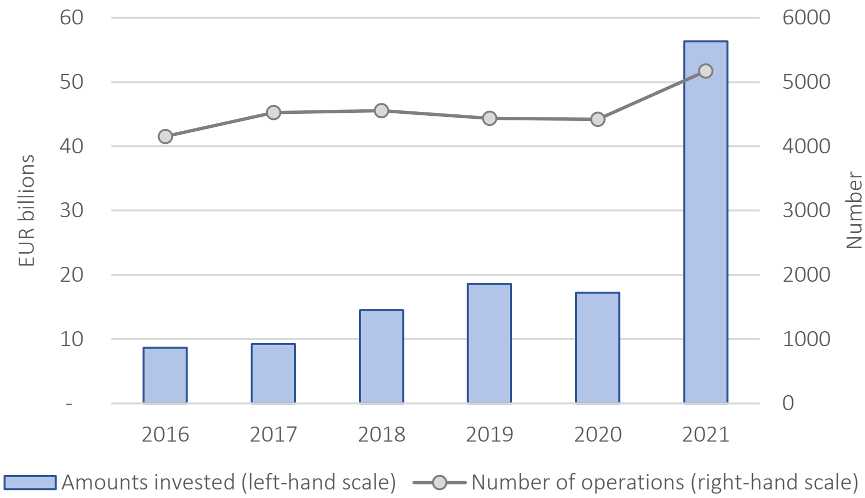
Source: Banque de France calculations, based on Crunchbase data (at 31 July 2022).
Note: The investors considered here are lead investors whose identity is known (see definition below).

European start-ups are raising more funds, and under better conditions

In 2021, venture capital investment in the EU27 amounted to EUR 56 billion (see Chart 2), up 227% compared with 2020. This increase is a global phenomenon (investment rose by 111% and 132% in the United States and the United Kingdom, respectively), but we are witnessing a catch-up effect in the EU, where late-stage fundraising had lagged well behind (there were 131 funding rounds of EUR 100 million and more in 2021, compared with an average of 14 per year between 2016 and 2020). This catch-up effect is illustrated by the fact that 68 start-up unicorns emerged (as their investor valuations exceeded USD 1 billion) in the EU27 in

2021 and the first half of 2022, whereas there had only been 29 new EU27 unicorns over the previous 10 years (Banque de France calculations, based on CB insights).

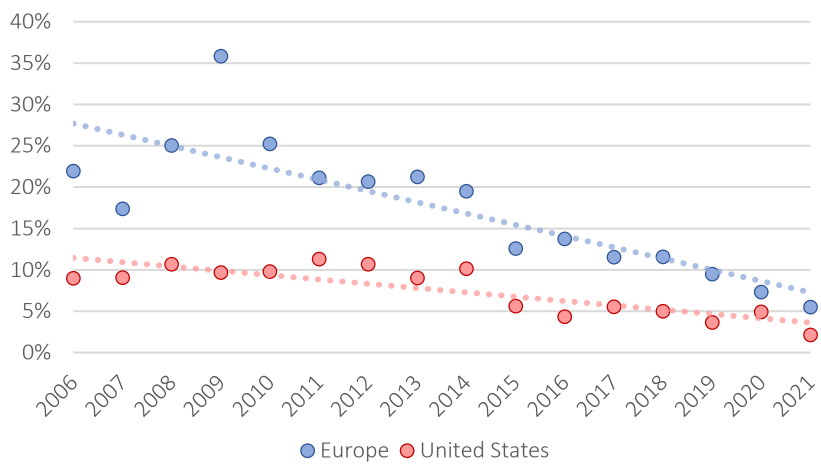
Chart 2: Total venture capital amounts invested in EU27 start-ups



Source: Banque de France calculations, based on Crunchbase data (at 31 July 2022).

At the same time, financing conditions for European start-ups have improved and are now more in line with the United States (see Chart 3). This has led to higher investor valuations for start-ups, and means that in order to obtain EUR 1 million in funding, start-ups yield a smaller share of their capital to investors and founders retain greater ownership. As part of the same dynamic, average operation amounts have increased sharply from EUR 2 million in 2016 to EUR 4 million in 2019 and EUR 11 million in 2021.

Chart 3: Change in the share of capital acquired for an investment of EUR 1 million



Source: Banque de France calculations, based on Pitchbook data.

Note: In this instance, Europe comprises 44 countries, including EU27, the United Kingdom, Switzerland, Russia and Norway.

This dynamic is supported by the increasing involvement of non-European investors

The improvement in European start-ups' access to capital is partly due to greater capital contributions from non-EU27 investors (see Chart 1), particularly for late-stage funding rounds. As the operation amount increases, we see more US and Asian funds among the lead investors (those who manage the financial operation, define key parameters and generally invest the most funds). Between 2016 and 2021, 42% of the lead investors in funding rounds of between EUR 10 million and EUR 50 million were non-European. This proportion rises to 64% for amounts of between EUR 50 million and EUR 100 million and 76% for rounds of over EUR 100 million.

This trend is getting stronger over time. In 2017, for venture rounds of over EUR 10 million in the European Union (EU27), 54% of lead investors were from the EU27, compared with only 46% in 2021. By contrast, the proportion of US lead investors increased from 23% to 31%. Significant differences exist between the EU countries with the most venture capital operations (see Table 1).

Table 1: Proportion of non-EU27 lead investors in European start-ups funding rounds

Country	EUR 10-50 million	EUR 50-100 million	>EUR 100 million
Germany	54%	70%	81%
France	28%	54%	73%
Netherlands	36%	55%	67%
Sweden	43%	50%	59%
Spain	46%	67%	82%
EU27	42%	64%	76%

Source: Banque de France calculations, based on Crunchbase data (at 31 July 2022).
Note: These five countries accounted for 75% of EU27 funding rounds over EUR 10 million from 2016 to 2021.

In this phase of rapid EU catch-up, non-European funds – particularly US funds (Pitchbook 2021) – seek out relatively smaller valuation levels in the EU than in the US (EUR 34 million on average in Europe between 2016 and 2021 compared with EUR 130 million in the United States). It is also worth noting that among these non-EU investors, non-traditional investors (sovereign wealth funds, hedge funds, private equity funds) are becoming increasingly active in European start-ups funding rounds.

These funds fill a financing gap for European growth-stage start-ups that has been recognised for some time (Ekeland et al., 2016; Duruflé et al., 2017; Tibi, 2019). However, the ongoing market correction in the United States might lead to a decline in non-EU capital flows in the second half of 2022.

Exceeding the limitations of European venture capital

Although the EU has a significant savings surplus (an average financing capacity of more than EUR 300 billion per year during the past five years), European financing is still insufficient during the growth phases of start-ups. This is due to the particular characteristics of European investment funds as well as how private savings are structured.

European venture capital funds are far smaller than their US and Asian counterparts and non-traditional funds. For example, the largest venture capital fund created in the United States in 2021 raised a total of EUR 5.7 billion (see the annual report of the US National Venture Capital Association) compared with EUR 1.6 billion in the EU. The necessity for European funds to diversify their exposures thus limits their capacity to invest in large-scale operations.

One reason regularly put forward to explain why Europe lags behind in this regard is that institutional investors have less appetite for this asset class (Hafied et al., 2021). This is based on several main factors. First, there are less pension funds in Europe than in other countries where they play a significant role in financing the growth of start-ups. Second, the prudential regulations applicable to insurers (Solvency II) impose high capital requirements fon holding unlisted equities. Lastly, European households, notably because they are more risk averse than in the US (Bekhtiar et al., 2019), tend to prefer guaranteed investments. In order to offer this type of savings products, institutional investors favour safe, liquid investments, thus diverting them from investing into start-ups.

A strategic imperative that necessitates better channelling of European savings

The development of European venture capital impacts the EU's economy and strategic autonomy. The EU's lack of venture capital capacity, particularly inlate-stage funding, partly explains why it lags behind in developing European alternatives to US or Asian technology companies. Furthermore, the involvement of non-resident investors may weaken the entrepreneurial ecosystem in the long term by encouraging start-ups and talents to relocate abroad (Braun et al., 2019).

The fragmentation of European capital markets presents a barrier to the development of continental-scale venture capital players. The European Commission's action plans for the Capital Markets Union (CMU) aim to encourage an increase in the size of funds and the development of cross-border investments (particularly through the reforms of the EuVECA – European Venture Capital Funds – regulation of 2017 and 2019, the aligning of corporate insolvency regimes and a single European access point to company information). The number of cross-border venture capital deals in the EU thus grew sharply between 2019 and 2021 (Demertzis et al., 2022). Lastly, in order to promote this asset class, it is necessary to develop exit opportunities for investors, through the public listing of start-ups (IPOs) or their acquisition by larger companies.

The deepening and further integration of venture capital will help companies access capital within the EU (particularly companies supporting the green and digital transition), while strengthening the EU's strategic autonomy. While public financial support, such as the European Investment Bank's recent creation of a fund dedicated to scale-ups (companies in their late-stage development), plays an important role, it cannot substitute to private capital (see, for example, the German government's new start-up strategy). Strengthening European venture capital will thus depend on the successful implementation of the CMU, targeted public financial support and, more generally, a more mature entrepreneurial and financial ecosystem.