The German Venture Capital Market from a U.S. Perspective

I. Introduction

Emerging growth companies in the United States have been benefiting from the sophisticated venture capital market of the United States for decades. Well-known technology companies such as Apple, Compaq, Sun Microsystems and Intel would have probably never become what they are without funding by venture capitalists. The situation is very different in most of Europe where emerging companies have been disadvantaged by a lack of a developed venture capital industry.

While buyout transactions involving private equity companies show impressive growth rates in Germany, the VC investing environment remains depressed and accounts for only 9.4 percent of all new funds raised in 2004, even less than those raised in 2003.[1] On the plus side, the volume of all venture capital investments (seed, start-up, and expansion financings) increased by almost 50 percent in 2004 from €707.9 million to €1,079.4 million.[2]

This increase pales in comparison to the VC investments made in the United States, where according to the National Venture Capital Association, total venture capital investments decreased from $106.4 billion in 2000 to just $18.3 billion in 2003,[3] while bouncing back to $21 billion in 2004.[4]

Although the burst of the tech bubble led to a downturn in VC investments on both sides of the Atlantic the overall investment figures don't even come close. While Germany's venture capital market was even at the height of the dotcom bubble not much more than a cottage industry, venture capital in the United States is a mature asset class whose economic significance

[1] Source: GermanGerman Private Equity and Venture Capital Association e.V. (BVK), *BVK Statistik 2004*, at 4
[2] *Supra*, at 7
[3] Study by the National Venture Capital Association (2004)
[4] *BVK Special- Venture Capital in den USA 2004*, at 3

is out of question. In 2004 the size of venture capital investments in 2004 was still almost 18 times larger than Germany's. Investments made by venture capitalists in emerging growth companies in the Washington, D.C. area (an area with relatively few VC-investments compared to the Bay Area) alone roughly equaled all VC-investments made in Germany.[5]

II. Structural Challenges

There are several reasons for Germany's relatively weak VC market: the capital market with a low number of IPOs and the general lack of viable liquidity events. On the other hand, many founders hesitate to spend the money and time to develop a convincing business plan that might attract interest by venture capital investors. Some entrepreneurs are also worried that the venture capitalist might have too much control in the management of the company. Others are not familiar with the very nature of the venture capital industry.

In addition, the number of startups per capita is significantly lower in Germany than in the United States because there is a deep risk averseness based in German society as a whole and until recently most university graduates would prefer a "safe" government job over setting up their own company. What is true for entrepreneurs is also true for prospective angel and VC investors: They often shy away from early-stage investments because they dread the risk to lose their investment. Another problem is the unfavorable taxation of domestic venture capital funds. As a result, several German venture capitalists have opted in the past to locate their new funds abroad, preferably in tax havens such as the Channel Islands like Guernsey and Jersey.[6] It has to

[5] $866.6 million; Source: National Venture Capital Association, *NVCA Yearbook 2005*
[6] FAZ, *Risikokapitalfonds zieht es ins Ausland*, May 21, 2003

be seen whether the new German government will promulgate more favorable rules in this regard. The coalition agreement seems to indicate that positive changes might lie ahead.

The main structural flaw of the industry is the absence of major local venture capital firms which results in the modest volume of total capital under management. While TVM has €918 million under management, with two funds in the United States and six Germany based funds, most other domestic venture capitalists have less than €400 million under management. Whereas no German venture capitalist was able to close a new fund within two years, American venture capitalists closed 108 funds in 2005 and 116 in 2004.[7] At this time there are no German venture capital companies comparable to American Sequoia Capital or Kleiner Perkins making it more difficult for start-ups to obtain venture capital. While the largest German VC fund was closed with €336 million, New Enterprise Associates recently announced to close a new fund with $2.5 billion.

The main problem is the little interest of institutional investors in venture capital. While fundraising in Germany is hard enough for buyout funds, domestic institutional investors have shown even less interest in committing venture capital. Recent funds could only be closed with the backing of the European Investment Fund (EIF).[8]

As a result of the difficult fundraising environment, the total number of venture capital firms is relatively low. While there are 1,251 active venture capital firms in the United States

[7] Source: VentureOne/Dow Jones Newswires
[8] FAZ, *Lebenszeichen aus der Wagniskapitalbranche* (January 26, 2005)

managing 3,370 funds,[9] there are only around twenty active venture capitalist firms among the 174 private equity firms in Germany.

III. Signs of Improvement

Nonetheless there are signs of recovery of the German venture capital market. Pursuant to a study by FHP Private Equity Consultants, in the second half of 2005, sales of venture capital backed companies have reached the highest level for three years. Above all, venture capitalists benefit from a recovering capital market environment; eight out of fourteen IPO's in 2005 were successful venture capital exits. Even German venture capital companies acknowledge significant improvements in the venture capital environment and are more optimistic for 2006. Although German venture capital firms were unable to close a new fund for two years, new funds were finally closed in 2005.

The German venture capital industry's malaise is not due to a lack of innovation: German businesses are among the most innovative companies in the world and have filed 14,870 patents in 2004 which is equal to 12.4 percent of all patents filed world wide.[10] In fact, German companies rank third in the total number of patent filings behind US companies with 41,870 patent filings (36.8 percent market share) and Japanese companies which filed 19,982 patents (16.6 percent market share).[11] The technological edge of German companies is obvious in the European context. In 2004, French companies filed only 5,281 patents and British businesses account for 5,056 patent filings. Global venture capitalists should keep these numbers in mind since innovative products and assets in form of marketable patents are prerequisites for a

[9] *BVK Special-Venture Capital in den USA 2004*, at 12 (NVCA Yearbook 2005)
[10] Source: WIPO at http://www.wipo.int/edocs/prdocs/en/2005/wipo_pr_2005_403.html
[11] *Id.*

successful exit. Although German companies are innovative, patents are often not commercialized due to a lack of VC funding and an overly cautious approach with bringing new products to the market.

IV. Opportunities for American Venture Capitalists in Europe: Lessons from Skype

Although unknown to many, the German startup and technology scene could be an attractive market for American venture capitalists at a time when many VCs plan to increase their global investments. According to the Deloitte & NVCA 2005 Global Venture Capital Survey, 20 percent of U.S. based VC respondents intend to increase their global investment activity over the next five years, which is up from 11 percent currently investing abroad.[12]

The best example of opportunity in Europe was the successful early stage investment in Luxembourg-based Skype Technologies SA by several smart US-venture capitalists.[13] After less than three years of their initial investment of $20 million, eBay acquired Skype Technologies SA for $2.6 billion in cash and stock plus about $1.5 billion in contingent payments,[14] which was without any doubt a profitable exit.

Another motivation for Silicon Valley based venture capitalists to invest in Germany might result from their own recent fundraising successes. Unlike in Germany, where VC fundraising remains a challenge and funds are small, American venture capitalists are sitting on a significant amount of funds that need to be invested.

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[12] Deloitte & Touche LLP & National Venture Capital Association, *2005 Global Venture Capital Survey* (June 22, 2005)
[13] Bessemer Venture Partners, Draper Fisher Jurvetson, Index Ventures. Mangrove Capital Partners
[14] Source: Mergerstat M&A Database

The main challenge for many VCs is the increasing difficulties to locate promising start-ups that are not “me-too companies.” Since too much money is chasing too few deals, some start ups face the odd problem that they are offered more VC cash than they need.[15] This contrasts starkly with the situation in Europe, where it is very hard for start-ups to obtain venture capital financing at all. Outbound transatlantic venture capital investments would offer Valley based venture capitalists the opportunity to invest their funds smartly, by benefiting from European innovations and a cash-starved market environment. Due to their extensive experience and financial firepower they would be welcomed by German start-ups and would not face fierce competition from local venture firms that are often themselves in an early stage.

Due to relatively weak competition from domestic venture capital firms, innovative and moderately valued startup and emerging companies, as well as a recent recovery of the capital market, Germany offers numerous opportunities for experienced venture capitalists in the years to come.

[15] SiliconValley.com, *Net Start-Ups Face Off Problem: More VC Cash Than They Need* (October 14, 2005)

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