A different ballpark

Technology investing in Europe has long fallen short of the returns reaped by US venture firms. **Michele Appendino** of **Net Partners** says European VCs should stop competing on pure technology plays, and play to their own strengths.

PHOTOGRAPHY: ROBERTO GRAZIOLI

Early-stage venture capital in Europe has historically yielded sporadic and scattered results. Although it is hard to make straightforward comparisons with the US, in the medium term European early-stage venture capital has consistently produced lower returns than in the US.

There are a number of well-known reasons for this. For one, European VCs have typically focused on the same areas as their US counterparts, namely technology plays. However, there are few areas of European technology excellence. European VCs are always competing with US VCs, which are better-funded and closer to key customers and R&D centres. In addition, buyers are still mainly US-based, and generally prefer buying US companies – or at least look at US targets first.

The European public markets are also much less keen to attract fast-growing tech businesses and, despite the promises of euro integration, remain very fragmented. Listed tech companies generally suffer from this lack of liquidity.

In addition, given the fact that there was never a prolonged growth period for European tech start-ups, the overall infrastructure did not fully mature: the boom times of 1999-2000 were too short to produce enough serial entrepreneurs. Managers from blue-chip companies that experimented with the entrepreneurial life were burned, and people from the corporate world are less likely to make the move these days.

Even advisers that became more experienced in helping early-stage companies pulled out after the market downturn and are now mainly focused on private equity investments.

So is European venture capital destined to have a medium-return future and always have to look to the higher return private equity businesses?

Not necessarily. But European venture capital needs to look beyond investment in pure technology plays to grow. Focusing on innovative, technology-enabled services in sectors such as financial, retail, healthcare and wireless services is key.

The rationale for this move is simple: there are several under-penetrated areas throughout Europe in these sectors, and local markets are indeed large enough to build sustainable business models. Exploiting the local opportunity should be the mantra for European early-stage ventures – exits are also easier, as buyers typically come from within Europe. Take financial services as an example: a successful specialist finance provider will always have several local established institutions queuing up to get a piece of the action: no US buyer needed, no Nasdaq IPO – just a traditional trade sale to a local buyer. Doesn't this sound better?

Although it may be difficult to build multi-billion euro companies following this model, returns can be achieved at a much lower risk. Service-based companies can re-adjust their strategy more easily, and their break-even point is lower – pure technology plays present a much higher risk. This is why we have preferred to invest in companies of this kind.

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One of our portfolio companies, for example, is Yoox, an online fashion retailer which sells discount designer clothes and accessories. Based in Italy, the company has forged excellent relationships with fashion houses, and is exploiting this local knowledge and opportunity to deliver discount designer wear throughout Europe. It is also heading for expansion into Asia and the US. Gross margin is almost 50 per cent and the company has reached break-even. Fashion houses have revenues totalling several billions of euros and the share of the end-of-season clothing market is growing. Yoox, having positioned itself as a preferred supplier, could easily end up getting a large share of this expanding market.

Freever is a good example of a company exploiting European opportunities in the wireless sector. It partners with European mobile operators to provide wireless functionality, such as chat. Mobile technology and infrastructure is one area where Europe really does excel. And because communities are not confined to one carrier, Freever provides a significant amount of traffic that the operators would not normally have. It is service creation companies like these – ones that take advantage of Europe's core competencies – that are worth investing in. Other interesting ventures are those that improve or enable the existing technology infrastructure.

However, one of the most interesting areas for investment is financial services. This is the only area where the euro has really created a single market, which for many other sectors is still an illusion.

MutuiOnline is an Italian financial services venture in our portfolio. It focuses its on- and off-line brokerage service on the booming domestic mortgage market. A foreign mortgage issuer partnering with MutuiOnline has all of its back-office taken care of and an important distribution channel is already established.

Bfinance is another company providing technology-enabling services to financial institutions across Europe. A pan-European online broker, it helps corporates secure financing lines. It also helps institutional investors better select their fund managers through an extremely thorough process.

One of the reasons for Europe's lack of investment in service companies is that they require a host of different skills to those needed for straight technology investments. Knowledge of consumer marketing and marketing spend can be very important, for example. Fulfilment and logistics are also important. In some cases, such as in the financial services market, knowledge of underlying regulations is crucial.

During the bubble, many service companies failed because they spent too much on marketing. On many occasions, this was partly the fault of the investors that were unable to properly audit marketing plans and assumptions.

It is possible to develop successful start-ups in Europe and to have a successful VC sector. It is, however, important for Europe to stop imitating the US. Instead, it must develop its own growth model based on its core competencies and existing assets and market opportunities. Therein lies the recipe for parallel success.

MICHELE APPENDINO is co-founder and managing director of Net Partners Ventures, a pan-European venture capital firm. He can be contacted at appendino@net-partners.com