Europe venture capital The road ahead in 2024

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Market Overview

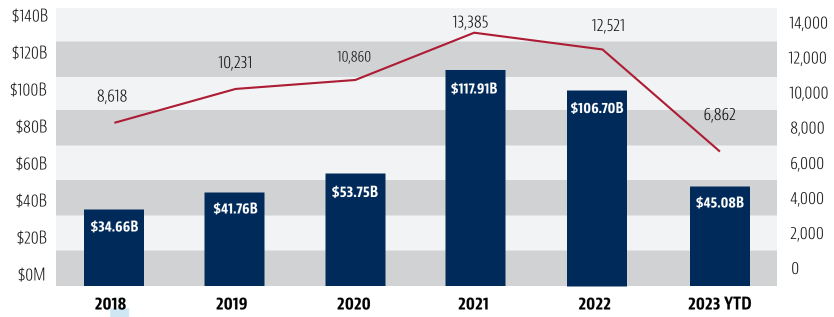
First signs of spring

European venture capital funding took a dive in 2022 and has not recovered since then. With rising interest rates, money is no longer free. This has massive implications for fundraising and deal activity. Financial sponsors have slowed down their deployment of capital which in turn has caused less competition for deals resulting in lower valuations, lower round sizes and fewer deals. Despite significant dry powder to deploy, financial sponsors are expected to continue to be highly selective.

Further, investee companies are facing multiple challenges. Not only must they cut cash burn to survive while looking for new equity financing, the exit environment and the prices worsened significantly in 2023. Together with fundraising, this has become the biggest challenge in the European venture capital market. While the current market environment is challenging, we see first signs of hope for a turnaround in Europe.

In this regional market overview, we look at a number of the key themes in 2023/24 across the venture capital market in Europe.

European venture capital – deal activity

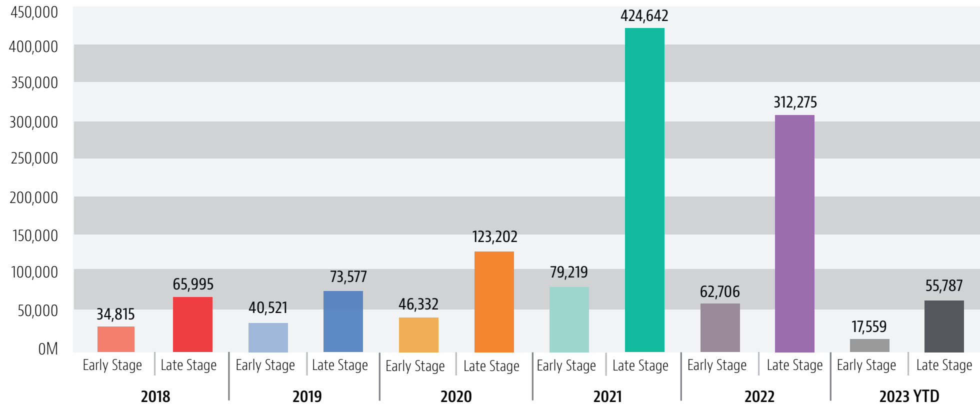


Capital Invested (USD billion)
Deal Count

Source: PitchBook Data, Inc

Deal activity by value and volume retreated again in 2023, closely aligned with 2018-2020 historical averages.[1]

European venture capital - valuations

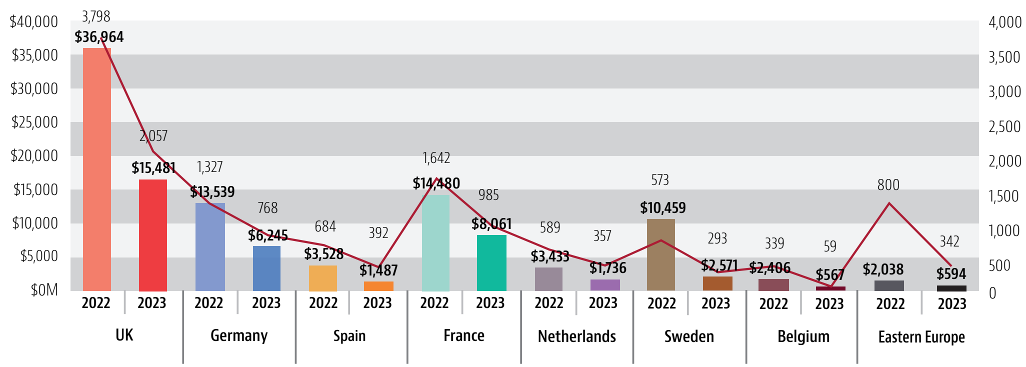


Pre-money valuation (USD million)

Source: PitchBook Data, Inc

A decline in valuations in 2023 had a greater impact across the late stage market (relative to the early stage market).[1]

European venture capital – geographical comparison



Capital Invested (USD million)
Deal Count

Source: PitchBook Data, Inc

Across various European markets, venture capital investment declined further consistently against record deal activity in 2022.[1]

1 Figures have been rounded up or down to the nearest whole number; figures for 2023 include Q1-Q3.

10 Key European Venture Capital Themes in 2023/24

1 Fundraising environment

Fundraising is currently one of the biggest challenges for investors in the European venture capital market. Expectations for the coming year, however, appear to be more positive.

2 Finding co-investors

Less competition for deals has made it harder to find co-investors. This often contributes to lower valuations and lower round sizes.

3 Due diligence and investor-friendly terms

Investors are seeking greater levels of comfort, ensuring that the investee companies' house is in order and supports the valuation. The funding timetable should allow for sufficient time for investor's due diligence to increasingly test founders across a range of financial, legal and compliance areas. In addition, investor-friendly terms are expected to continue in Q4 2023/24 with a greater emphasis on more favourable preferred equity rights and governance terms. A breakdown of some of the emerging trends is set out in Schedule 1 – *Key Deal Terms Unpacked*.

4 Convertible and SAFE-like instruments

Convertible notes are increasingly being used to defer challenging valuation negotiations and/or as a bridge between equity financing rounds. Some European jurisdictions have also implemented SAFE *(Simple Agreement for Future Equity)*-like instruments. Instead of raising new equity financing rounds, many companies are turning to existing investors for equity extension financings. A breakdown of some of the emerging trends is set out in Schedule 1 – *Key Deal Terms Unpacked.*

5 Venture debt

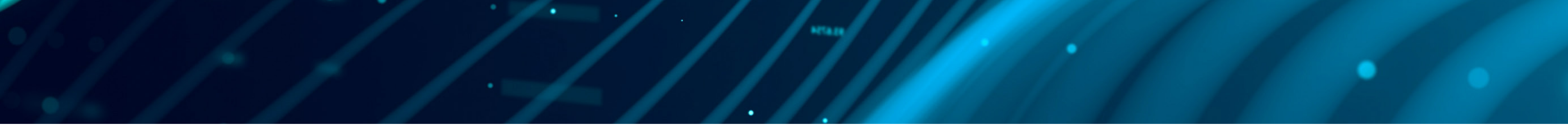
Investee companies seeking to raise capital on a down round will potentially trigger existing anti-dilution protections and complicated readjustments of equity structures. Venture debt can provide investee companies with preferred funding terms, particularly when faced with valuation pressures. Yet, along with the rising interest rates, venture debt is also getting more expensive. Investee companies considering venture debt facilities face a general tightening in funding requirements within the venture debt market. Venture debt lenders are expected to proceed cautiously.

6 Employee incentive plans

With a focus on reduced cash burn, investee companies increasingly look to employee incentive plans to retain, motivate and attract employees. The dilutive effects of such incentive plans continue to play an important role in valuation discussions. Depending on the jurisdiction, employee incentive models in Europe range from direct equity to virtual participations.

7 ESG / supply chain scrutiny

We anticipate an increased emphasis on environmental, social and governance (ESG) and supply chain scrutiny in European venture capital and expect to see more financial sponsors and companies including metrics in their investment policies / performance criteria.



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Insolvencies

The number of investee company insolvencies is increasing. Often, there is personal liability for members of the management who fail to file for insolvency. In some jurisdictions, there are even criminal penalties. In some countries, like Germany, insolvency is not only triggered by illiquidity, but also by "over-indebtedness". A German company is over-indebted if the company's assets no longer cover the existing liabilities unless, considering the circumstances, the continuation of the company is likely over the next twelve months. The latter is a challenge for many investee companies in light of their funding needs and the current funding environment.

9

Exits

The exit environment and exit valuations worsened significantly in the first three quarters of 2023. With the European IPO market being virtually closed and few potential buyers, exits have become one of the biggest challenges. The need for market consolidation has already resulted in a number of share for share deals. Going forward, liquidity requirements are likely to continue weigh heavily on financial sponsors and will force them to compromise on valuations.

10

Hot sectors and markets to watch in Europe

Technology and innovation remain in the spotlight as key drivers for growth for financial sponsors and corporate venture capital investors alike, featuring, in particular, Artificial Intelligence, Bio Tech, Health Care / Health Tech, Renewable Energy and Climate Tech.

Key growth markets in the region are expected to remain a focus for investors. In particular, the UK, Germany, France, Spain, Italy, and Switzerland continue to be markets of high interest for investors.

Navigating the Headwinds

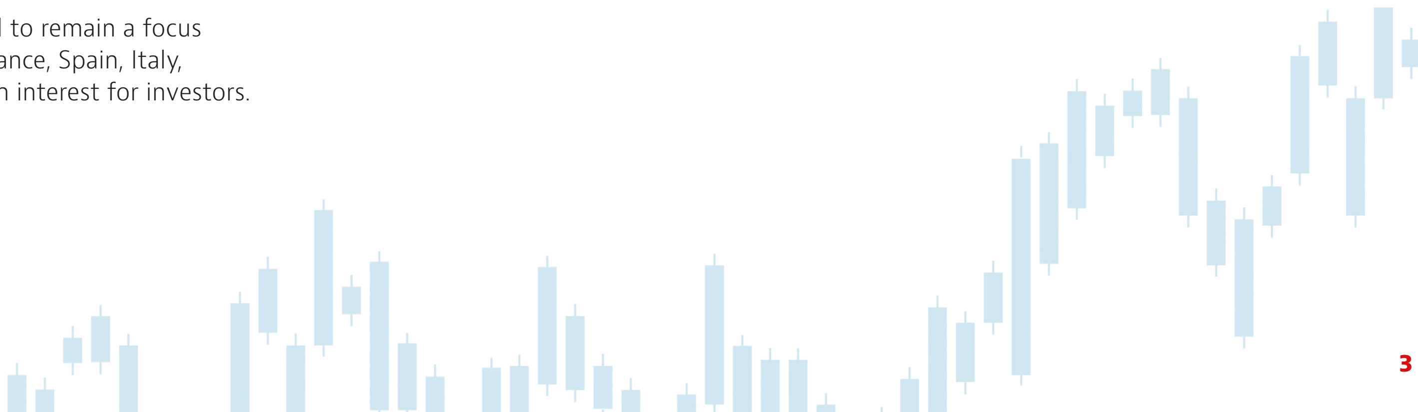
According to an analysis by Crunchbase, European investee companies raised $16.4bn (€15.6bn) in funding in the third quarter of 2023 — a 28% increase quarter over quarter. The fresh capital has mostly favoured late-stage rounds. In contrast, funding for seed and early-stage companies hit its lowest points since Q3 2022. European
investee companies have managed to raise a bigger proportion of global venture capital compared to last year. Their share reached approximately 23%, while VC funding in North America remained flat.

The investment conditions will continue to present challenges for financial sponsors and investee companies. For Q4 2023 through 2024, we anticipate that deal terms for venture capital transactions across the region will continue to evolve with investors remaining selective.

Investee companies are working hard to streamline or reduce cash burn, and extending the runway before the next raise. Founders must navigate their way through the current challenging environment, accept financing rounds at lower valuations and more preferential terms for preferred equity investors.

Liquidity concerns remain a key issue for investors, and we expect investments to increasingly be structured providing more flexibility for investor-driven exit requirements.

Looking forward, as inflationary pressures eventually ease and markets stabilise, we see a gradual increase in venture capital deal flow return to the region. 2024 might bring a European venture capital spring.



Schedule 1 - Key Deal Terms Unpacked

Recent market conditions have led to a shift in deal terms sought by investors for venture and growth deals. While there are notable variances in certain jurisdictions, we set out a selection of general trends emerging in 2023 across:

- more favourable terms for preferred equity;
- convertible notes; and
- SAFE instruments.

Preferred equity

Preferred equity terms
▪ *Liquidation preference multiples and participation.* Investors are increasingly seeking liquidation on preference multiples of up to 1.5x to 2x and, in some cases, potentially 3x, with an option to participate in the remaining proceeds following receipt of a liquidation or preference.
▪ *Redemption and other exit rights.* More favourable redemption rights are increasingly prevalent in addition to drag-along rights, rights of first refusal and other exit rights (including pre IPO lock-up periods).
▪ *Information flow and board rights.* Investors are increasingly seeking greater oversight and influence at the board level coupled with veto rights via progressively stringent reserved matters.
▪ *Pre-emptive rights.* Investors may request enhanced pre-emptive rights which rank ahead of other shareholders by up to 1.5x to 2x the investor's ownership interest in some cases, subject to local regulatory requirements.
▪ *Deferred vesting of founder interests.* Increasing requests from investors to defer or restrict founders' equity interests with vesting schedules linked to performance are expected.
▪ *Founders' warranties and covenants.* Investors may increasingly call for founders to stand behind company warranties and other covenants.

Convertible notes

Convertible note terms
▪ *Higher liquidation preference.* Liquidation preference multiples of up to two times in the event of an exit or liquidation are increasingly being sought.
▪ *Conversion discounts.* Investors may seek greater conversion discounts of up to 30% of the issue price at the relevant equity financing round up, from 15% - 20% (conversion discounts may vary, depending on the perceived risk / return profile)
▪ *Cash requirements and financial covenants.* Some investors may require higher minimum cash requirements, leading to potentially slowing down a company's growth / investment plans. Investee companies may also be required to maintain certain financial ratios during the term of the instrument.
▪ *Operational covenants.* Investors are increasingly requiring additional undertakings from investee companies to restrict certain business activities and certain corporate actions without the investors' consent.

SAFE-like instruments

The use of SAFE instruments in Europe used to be rather uncommon. In light of the current market conditions, SAFE-like instruments are now more frequently used, in particular to postpone valuation discussions. They are available, inter alia, in Austria, Germany, France (BSA Air), Sweden (WISE) and the UK (SeedFast).

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[APAC Venture Capital: The Road Ahead]

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