Proskauer

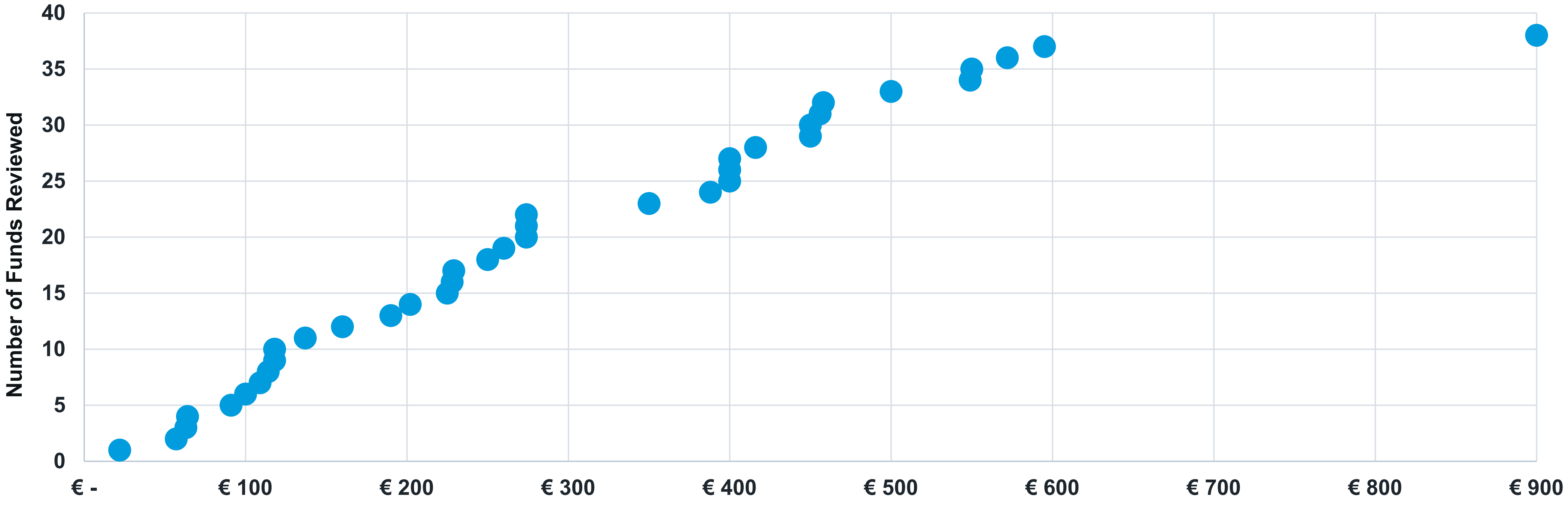
Under the Microscope

Fundraising Terms and Trends in European Venture Capital Funds

March 2024

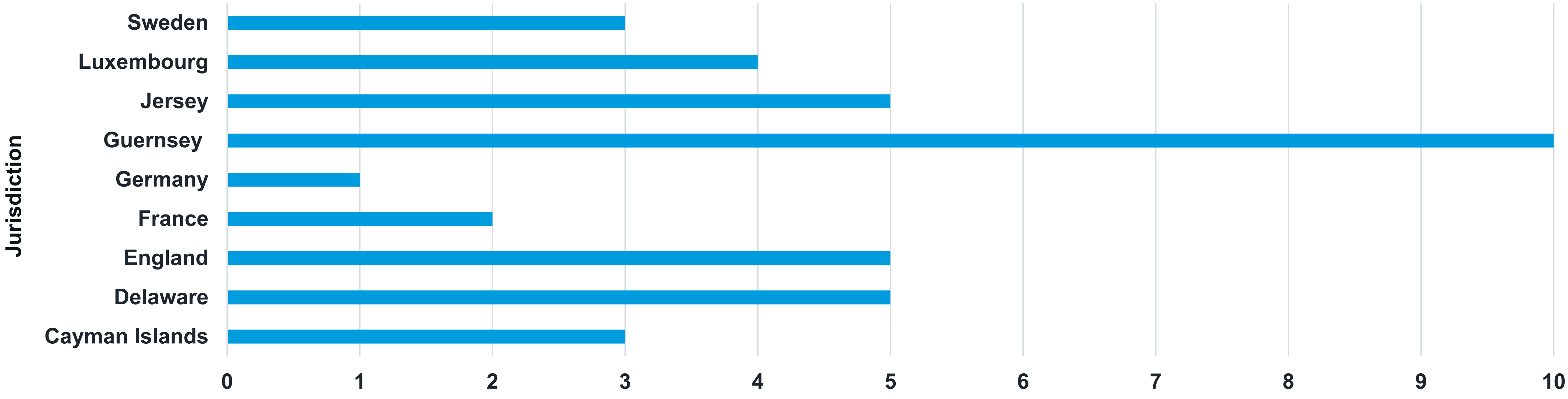
Data methodology

Our sample contains 38 European venture capital funds raised in 2022 and 2023. We reviewed 32 data points from these funds. The funds were all either specifically focused on Europe, were primarily European-based or had Europe as the primary geography in their investment strategy. The target size of the funds reviewed ranges from €22 million to €900 million, representing in aggregate approximately €11.393 billion of capital.



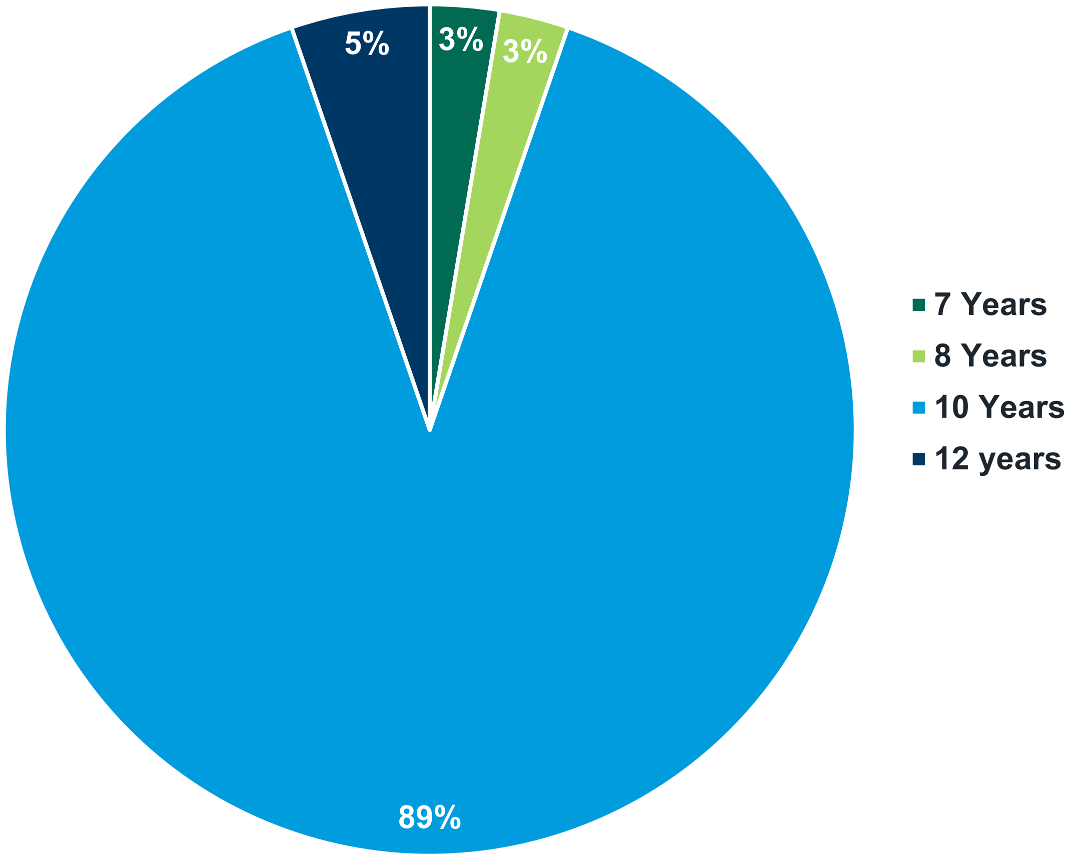
Jurisdiction of formation

Results in this year's report are similar to previous years with venture capital not having made the same shift to Luxembourg that we have seen in private equity funds and certain other asset classes. While four of the funds are Luxembourg based, we note 15 funds are based in the Channel Islands (five in Jersey and ten in Guernsey), five funds based in each of England and Delaware and then the remainder of our sample across other jurisdictions. The difference in jurisdiction is driven by a multitude of factors, including the fact that European venture capital funds tend to be, on average, smaller than European private equity and credit funds and therefore favour jurisdictions which are considered as familiar, lower-cost and less administratively burdensome than Luxembourg. Consistent with prior data, US-based sponsors seem ready to deploy meaningful capital in Europe as the European venture capital market continues to mature and the trends observed may indicate that sponsors do not consider obtaining an EEA marketing passport to be integral to their ability to raise capital.



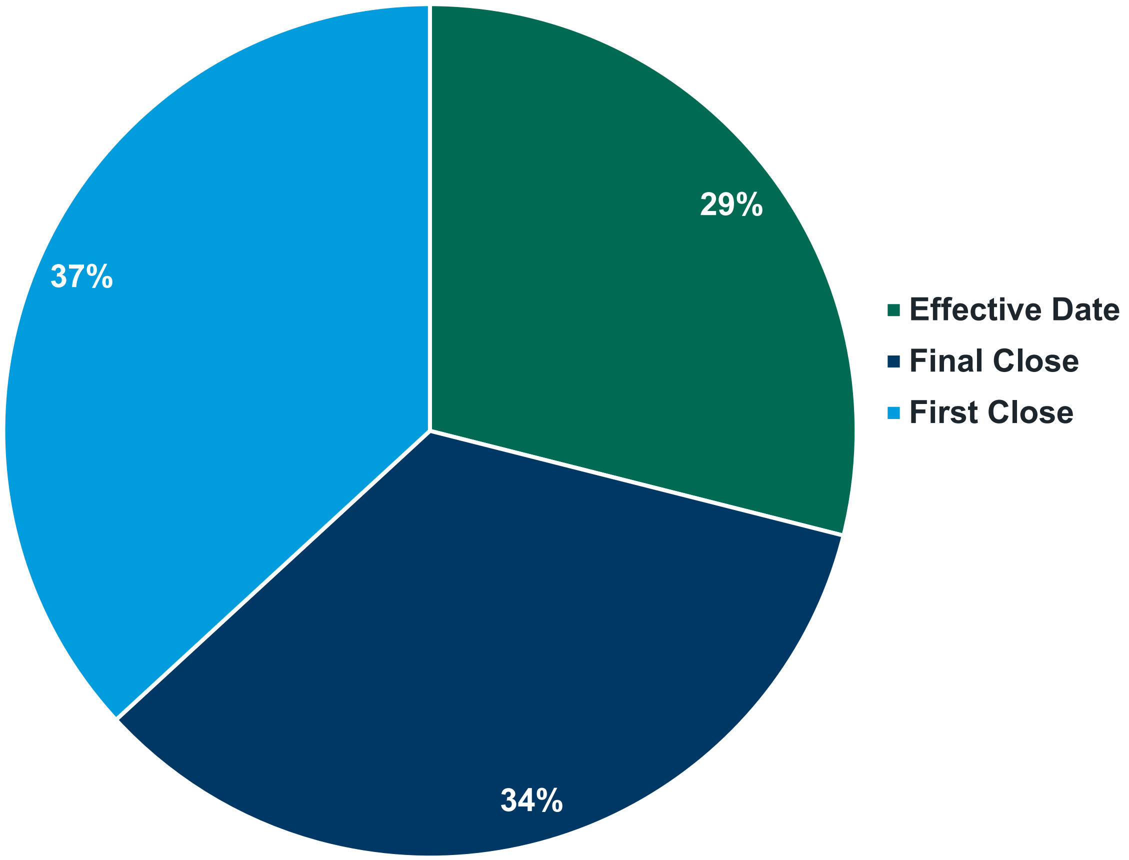
Initial term

Notwithstanding that a typical venture capital investment may take longer to mature than a buy-out transaction, as they are made earlier in the lifecycle of a company, we continue to see the initial term of almost all venture capital funds being set at 10 years: 89% of the funds in our sample set, which represents an 8% increase on the previous sample set. Despite a relatively small percentage of the funds sampled (5%) having an initial term of 12 years, we are seeing more venture capital sponsors exploring a longer term or evergreen fund strategy to sustain portfolio companies through a more prolonged period of growth.



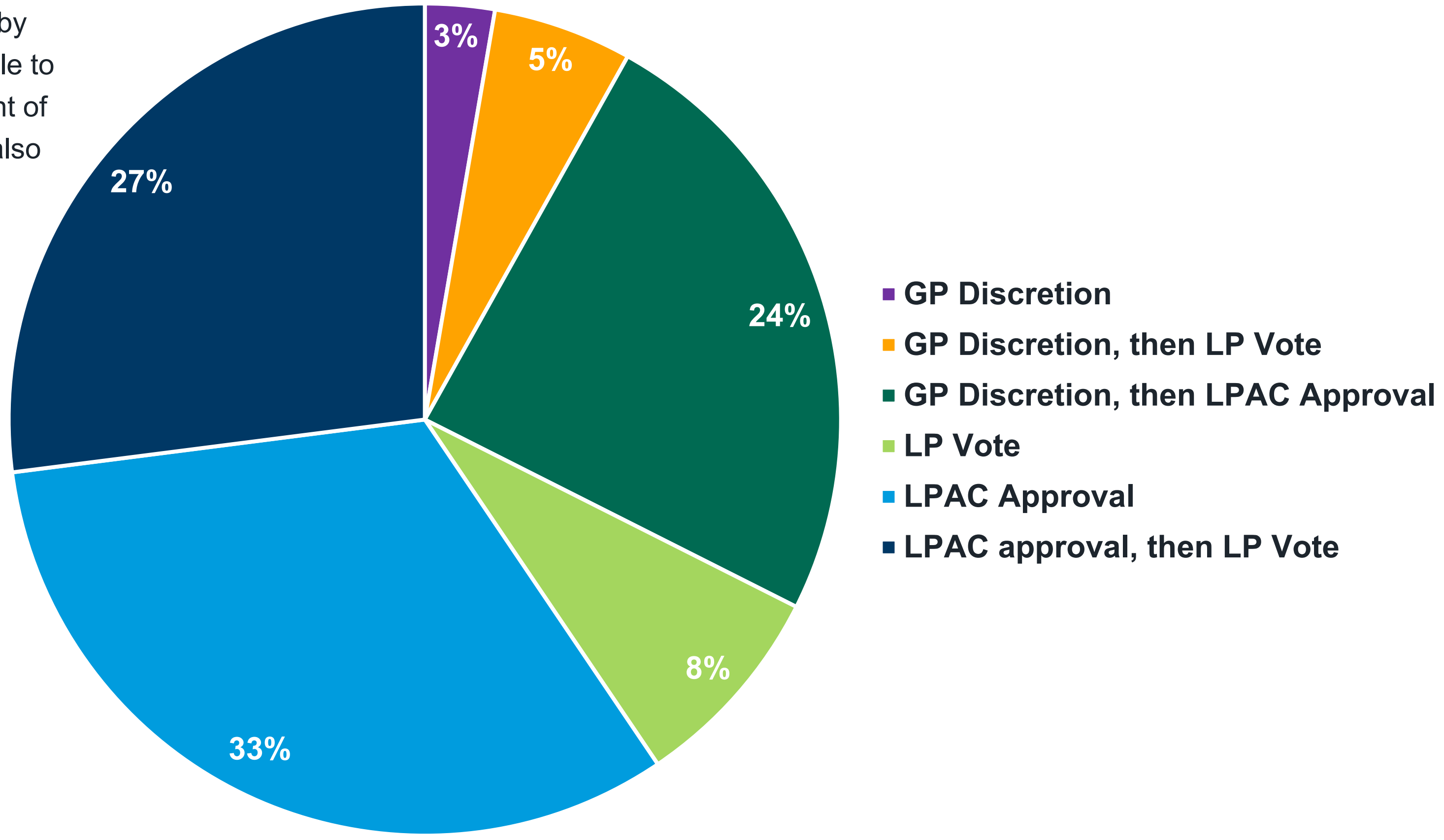
Initial term begins from

This year's data shows 29% of the funds sampled have an effective date mechanism (i.e., being the date determined by the sponsor, typically linked to the end of the investment period of the prior fund or the date of the current fund's first investment) as the from which the expiry of the initial term is calculated, whilst 37% and 34% of funds pin this date to their first close date and final close date, respectively. This is a relatively even split between the funds sampled. In prior years we had seen a gradual move towards the effective date concept (and the final closing date), giving venture funds additional time to deploy capital into new investments.



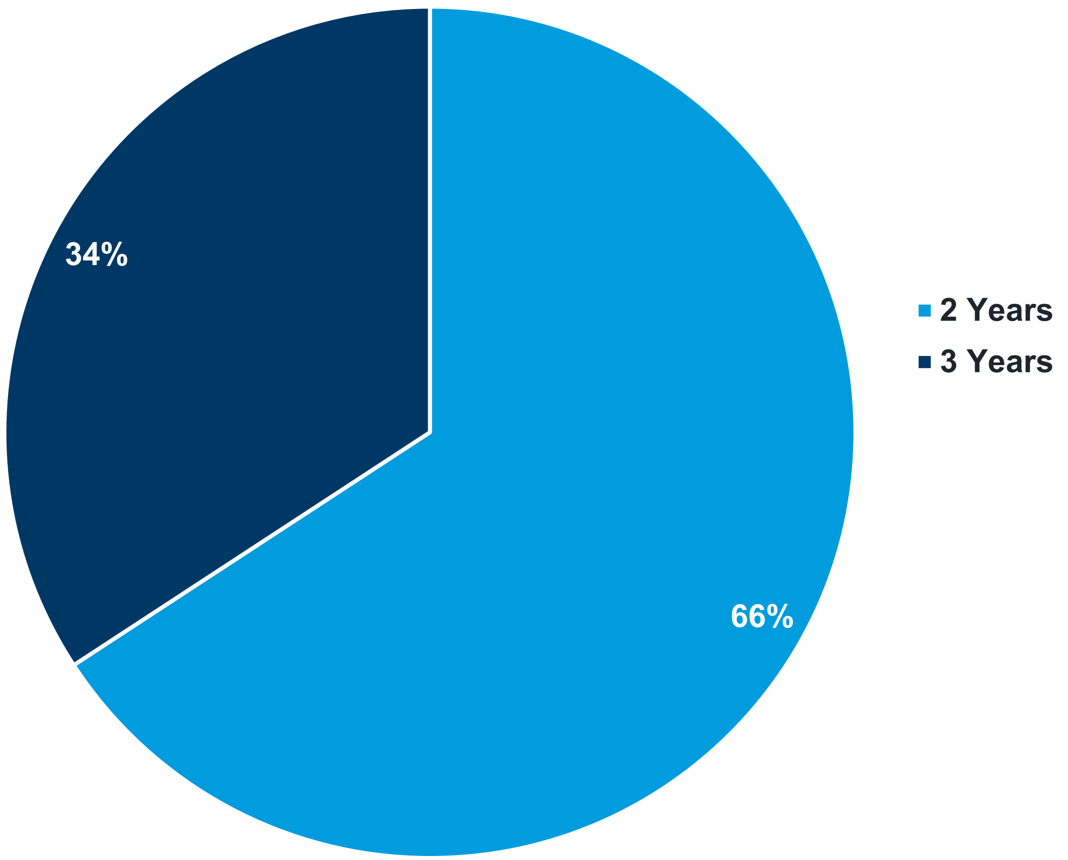
Approval required for extension of term

We observe that LPAC approval is required for at least one extension of the term in 60% of the funds comprising the sample set. Conversely, 33% of funds in the sample set see the sponsor having the ability to exercise its discretion for such an initial extension, down from 73% in prior data. This suggests that investors are being increasingly focused on wanting oversight of any extension, thereby seeking to ensure that the reasons for the extension are acceptable to them (typically to maximise the value of residual assets on account of the longer holding periods of investments in venture capital) and also to check the continued management fee that this may entail.



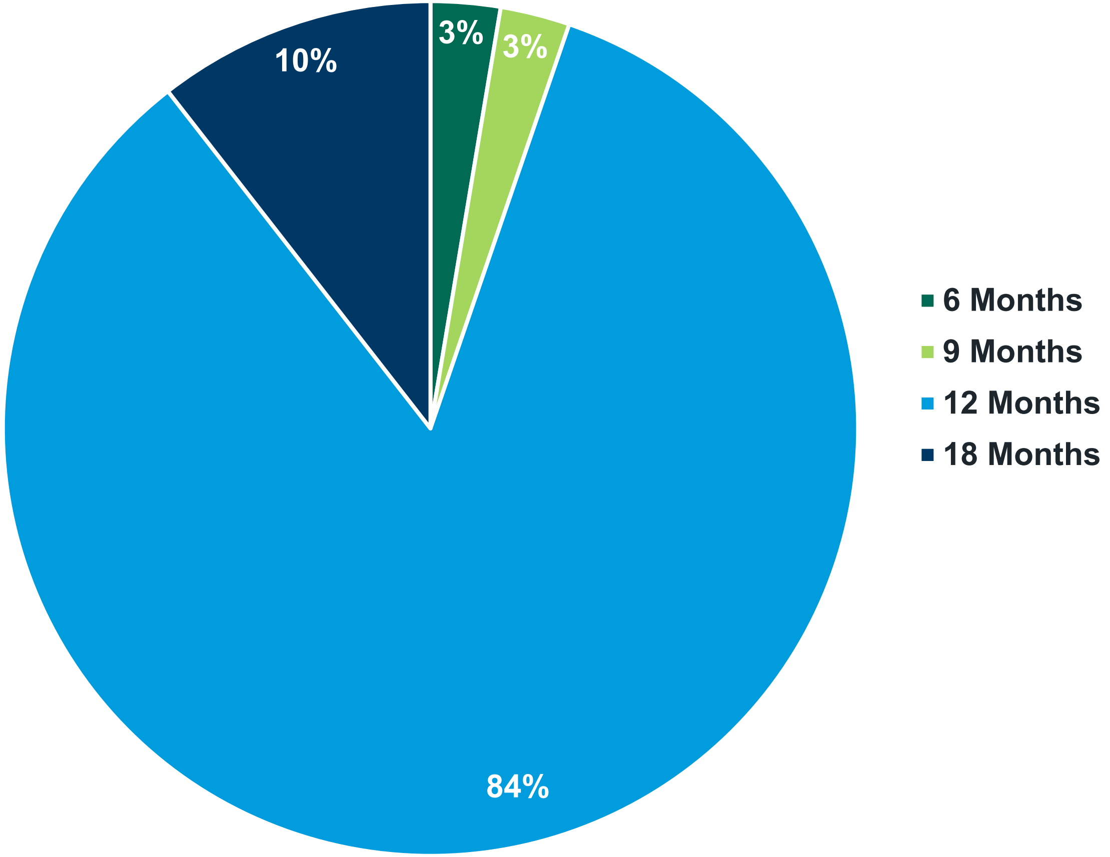
Maximum period of extensions of term

Consistent with the prior data, the significant majority of funds continue to provide for a two-year extension only. We anticipate longer hold periods for investments observed in venture capital to make this a continued hot topic of debate between sponsors and investors as well as it potentially prompting certain sponsors to look to raise fund products with longer terms or that are evergreen. Extensions beyond the periods provided for the in the agreements would require amendments to the fund documents and therefore typically investor consents.



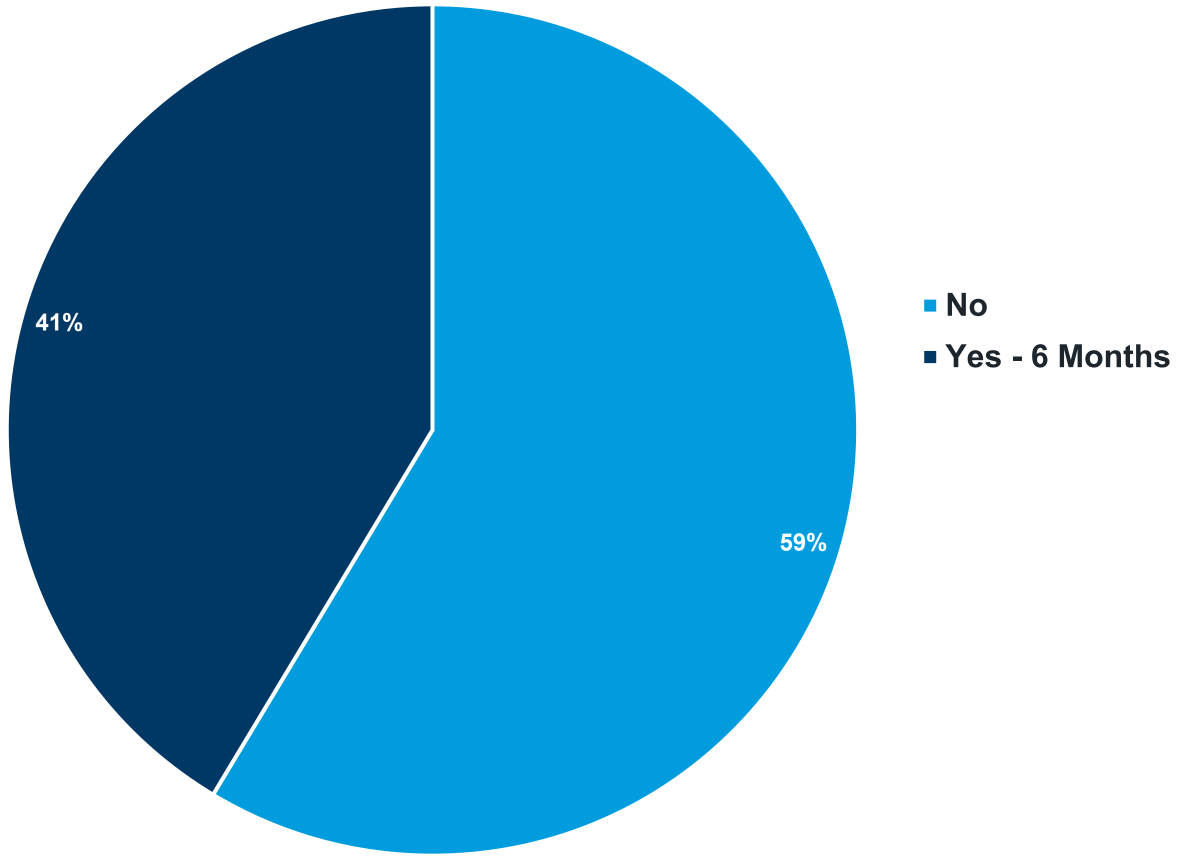
Fundraising period

12 months remains the common permitted fundraising period at 84% (increased from 73% in the previous data set). We then observe a variety of other time limitations, suggesting particular negotiations and situations which may be individual to the fund products being raised. Fundraising periods are the maximum stated period in the fund documents during which capital may be accepted into the fund, subject to any permitted extension to such periods – see next page. They may not reflect the amount of time that it takes in practice to reach final closing, but we have observed a general trend of fundraisings taking longer within the last 12/18 months than in prior years. This means sponsors are typically looking to utilise more of maximum stated period in which they are able to raise capital.



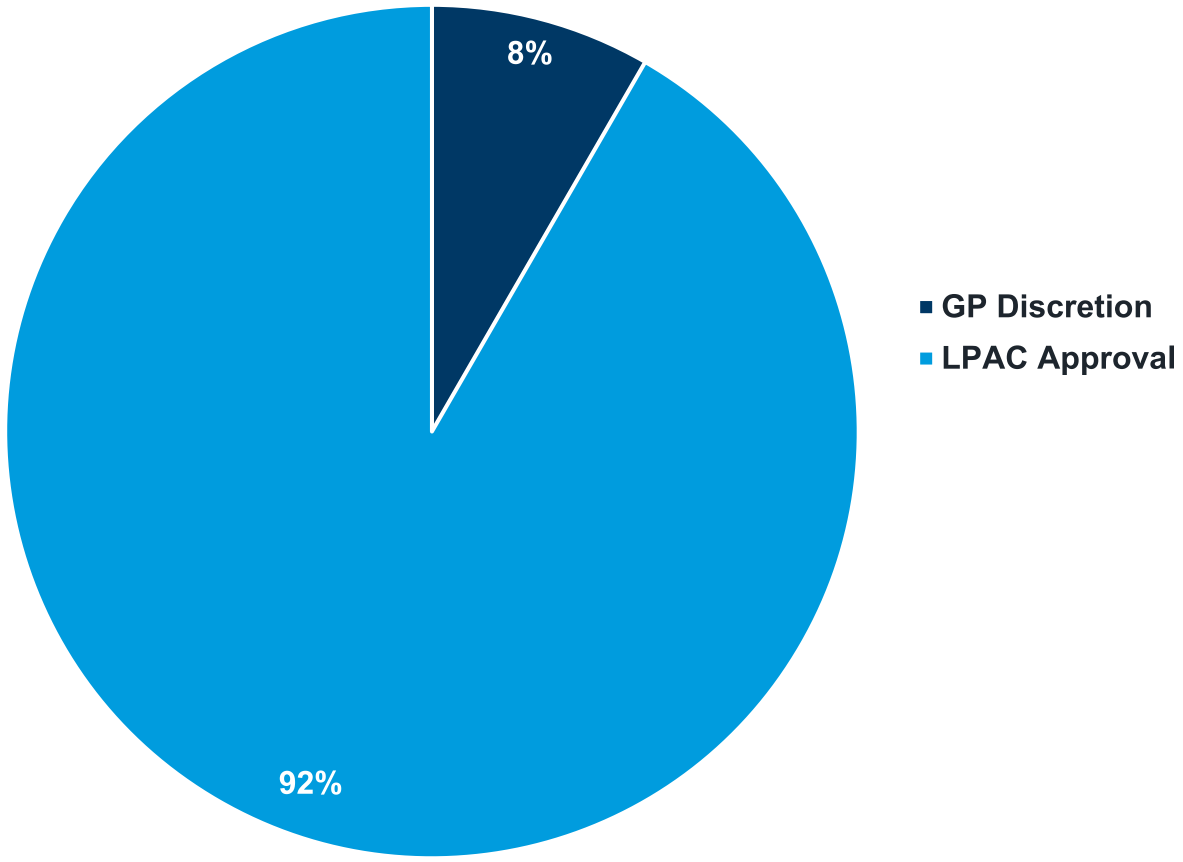
Extension of the fundraising period permitted

In light of the observations made on the prior page, we have sought to capture a new metric in this year's sample set of funds, whether or not an extension to the fundraising period is permitted. 59% of the funds sampled allowed for an extension of six months. We anticipate this figure increasing in the coming year, given current market conditions.



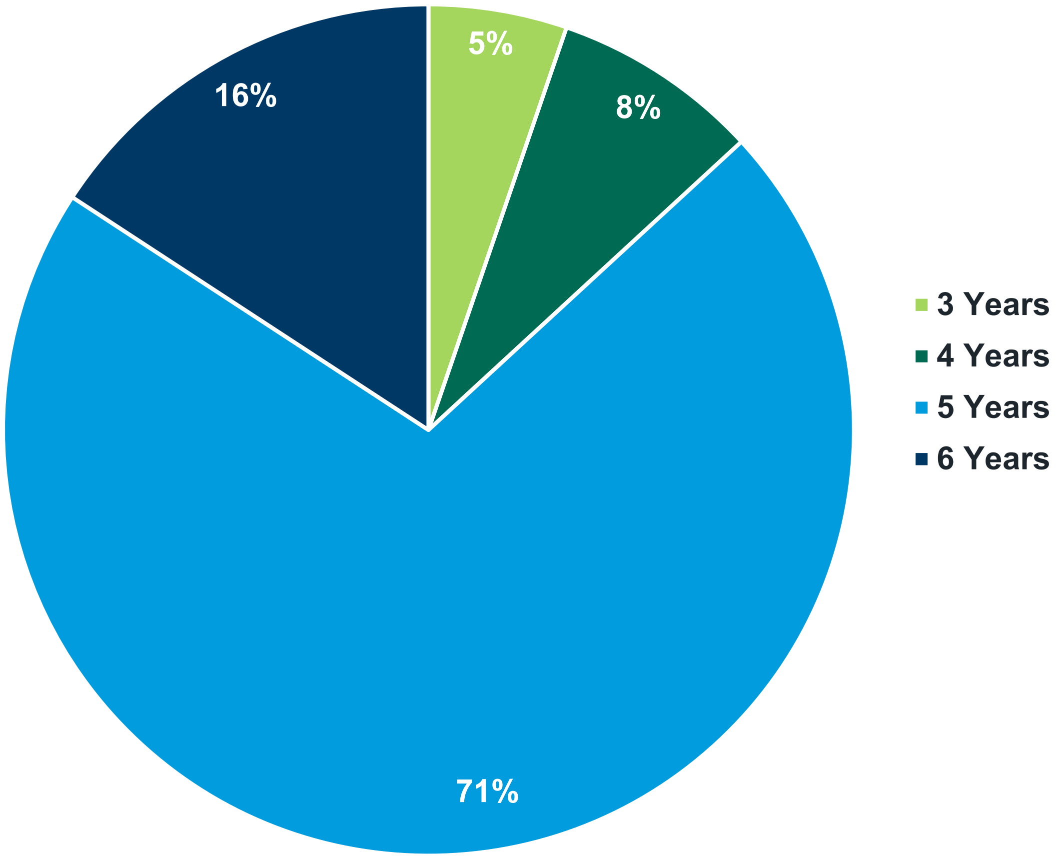
Approval required for extension of fundraising period

From the funds within our sample set with the ability to extend their fundraising period, the overwhelming majority (92%) required LPAC consent to be able to trigger such an extension and the residual proportion (8%) can do so at the sponsor's discretion. We note that none of the sampled funds have the requirement to obtain a broader LP consent, which most sponsors would like consider to be too onerous and time consuming if requested by investors when a relatively quick decision is usually required on whether or not the extension will go ahead.



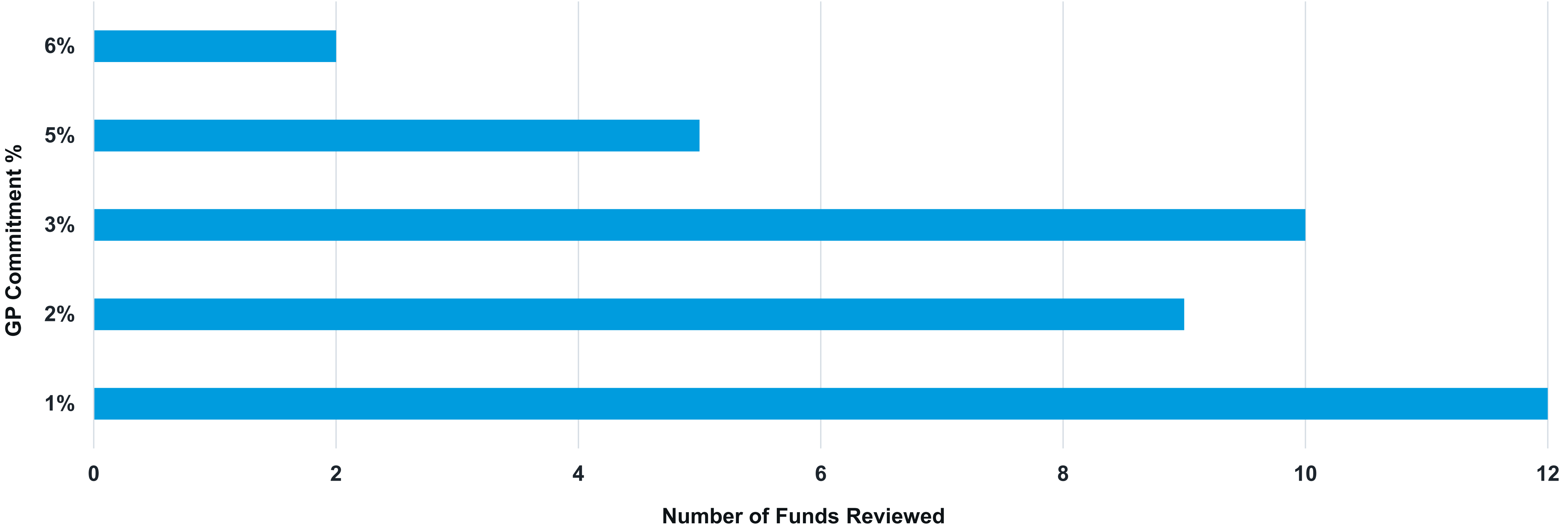
Investment period

Five years remains the most common investment period, representing 71% of our sample set (markedly close to the 68% observed previously). As with prior years, we have not seen a push to increase the length of investment periods in venture capital in the same manner we have seen a push in certain other asset classes. We expect that this is mostly because venture capital investment periods tend to end earlier than their full potential duration given a relatively quick initial deployment of capital coupled with more capital reserved for follow-ons to ensure that the fund can participate in later stage funding rounds to augment the value of prize assets.



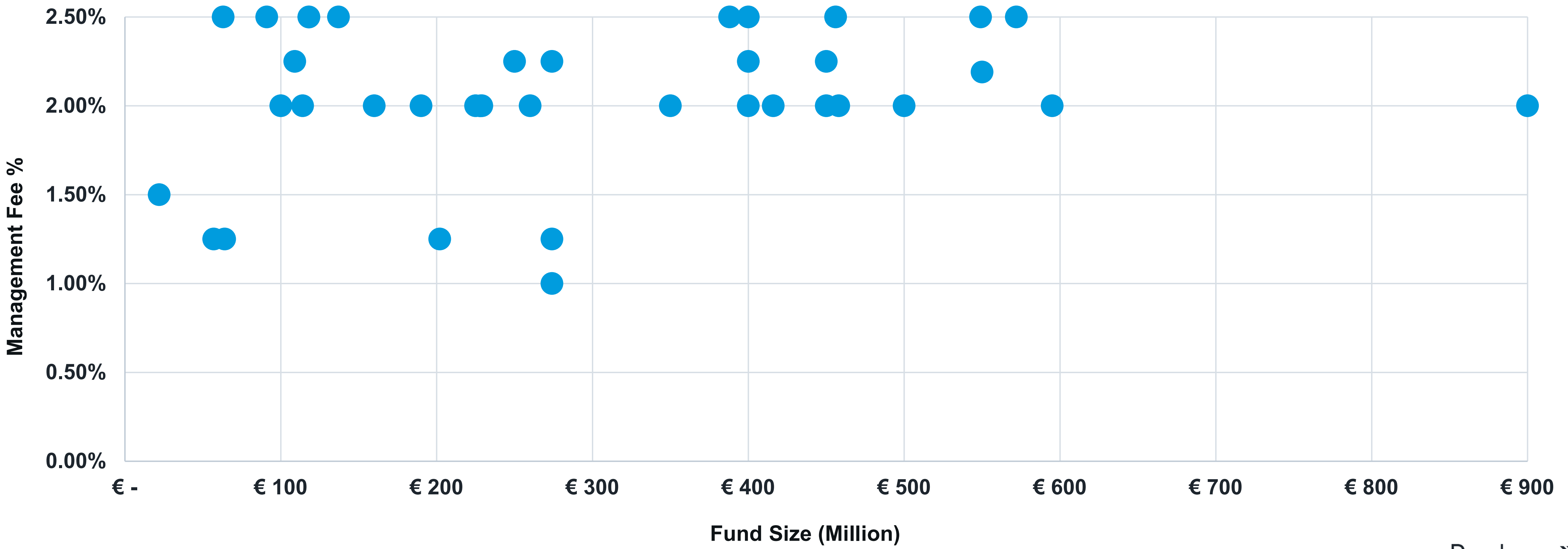
GP commitment (% of commitments)

Consistent with prior years, the data from our sample set demonstrates that a GP commitment of 1% remains the most common in venture capital with most funds typically falling in the 1-3% range. This is likely to be a result of venture capital teams often being smaller than private equity and, also, there being more first-time or less established fund managers without significant prior fund returns to re-invest as GP commitment. The personal circumstances of the team and how many executives participate in the GP commitment will be relevant factors discussed with prospective investors in the fund when this matter is negotiated.



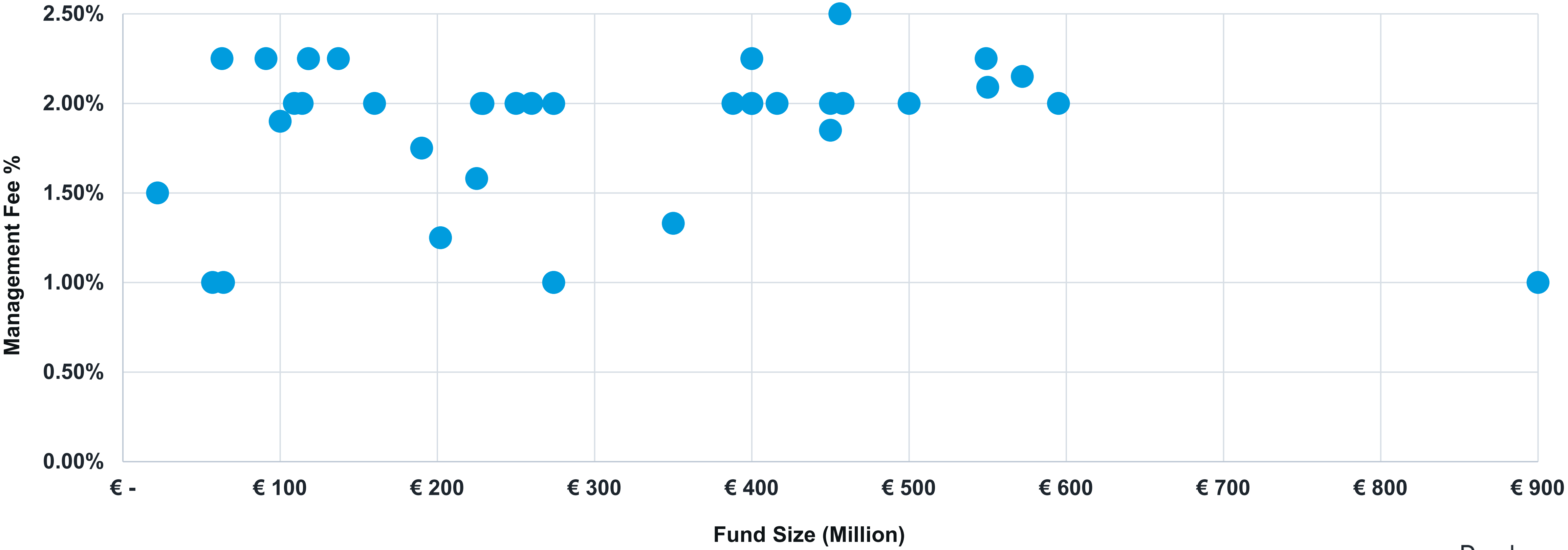
Annual management fee rate – Investment period (% of base)

The management fee percentage during the investment period for the funds comprising our sample set generally ranged between 2% and 2.5% with few exceptions. All such management fees are calculated based on total commitments of the funds. This is broadly consistent with the prior data. We again note that most venture capital funds with fees of 2.5% or close thereto raised £500 million or less, suggesting that this smaller size of fund has allowed sponsors to justify a higher percentage fee. In addition, many European venture capital sponsors do not have multiple fund products generating fees (although that may be changing). That said, the average percentage fee observed in venture capital remains higher than other asset classes, suggesting that investors remain willing to pay a premium to the sponsors that they back or which otherwise have a strong track-record.



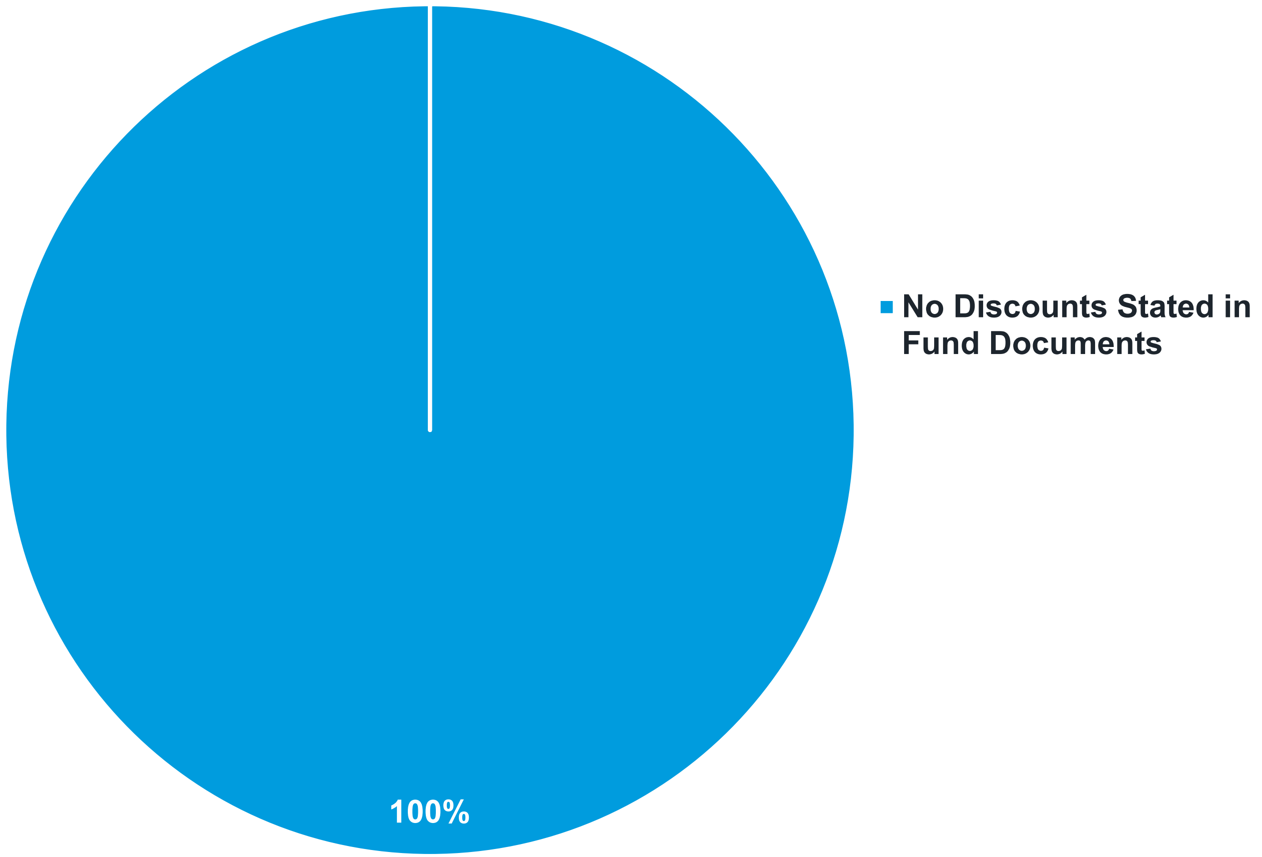
Annual management fee rate – Post-investment period (% of base)

Several of the funds in the sample set step down their management fee after the expiry of the investment period. This stepdown is most pronounced in funds which charge a management fee of 2% or above during their investment period, with the reductions (as applicable) ranging from 0.25 to one percentage point. We would note that it is common for venture capital funds to continue to base their post-investment period management fee on total commitments rather than switching to a calculation made on invested capital which is the most common base for calculation in private equity. There are various reasons for this with the most predominant one being that a significant amount of capital may be retained for follow-on investment investments in future funding rounds which take place after the investment period. This means that an immediate switch to invested capital would put the sponsor at risk of a significant drop in fee income upon the expiry of the investment period. This could cause the sponsor to be incentivized not to reserve capital to back the prized assets in its portfolio in their later rounds, thereby potentially diluting future returns for investors. By continuing to use a fee based on commitments, rather than invested capital, both sponsors and investors are granted greater predictability and can be more assured that management fee concerns do not influence the pace of investment. Another reason for this fee structure is because venture capital has a larger number of nascent sponsors relative to their more established private equity counterparts which require this certainty when it comes to fee income to be able to grow their business and attract the best talent on a predictable basis.



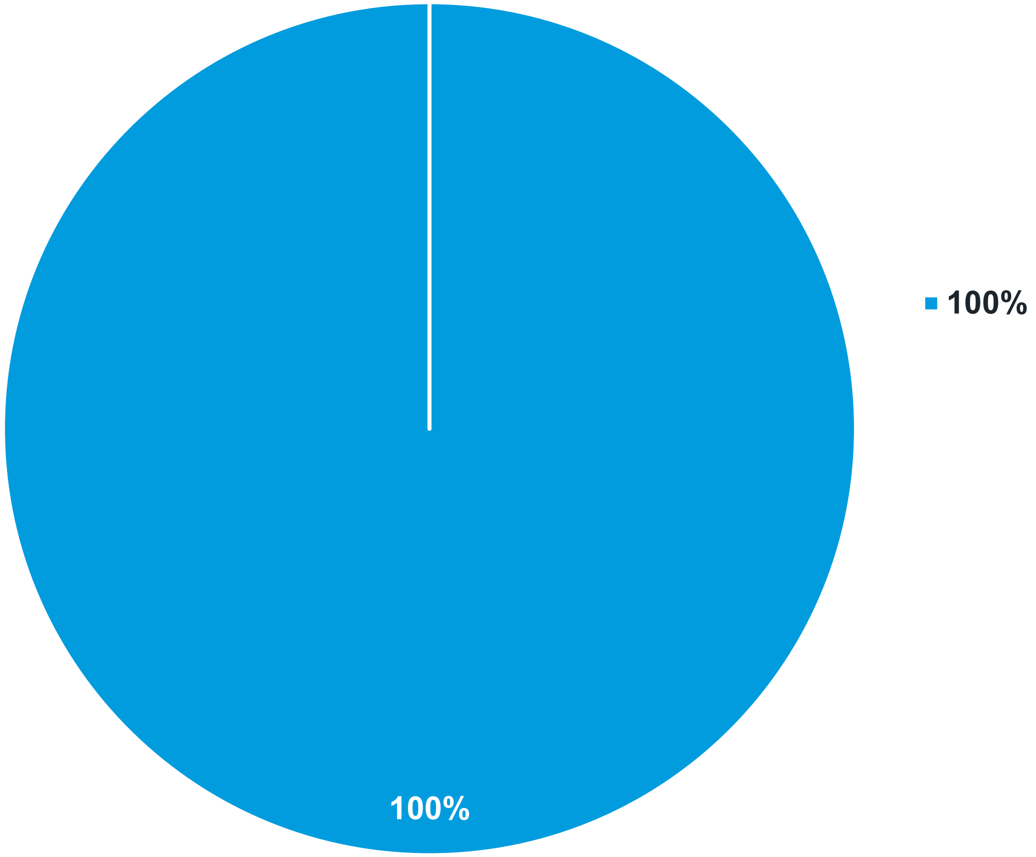
Management fee discounts

As with prior years' data, management fee discounts are not a common feature of venture capital fundraisings. None of our sample set of funds offer a form of fee discount on the face of the constitutional documents of such funds, whereas this was the case for 97% of the funds comprising the previous sample set. We are aware that certain forms of discounts may be offered outside of the fund constitutional documents, such as in side letter. This could, for example, include large investor, early bird or friends and family discounts. These would not be picked up in our data, but we appreciate that they can sometimes be a key negotiation point for a sponsor when it comes to strategically important investors.

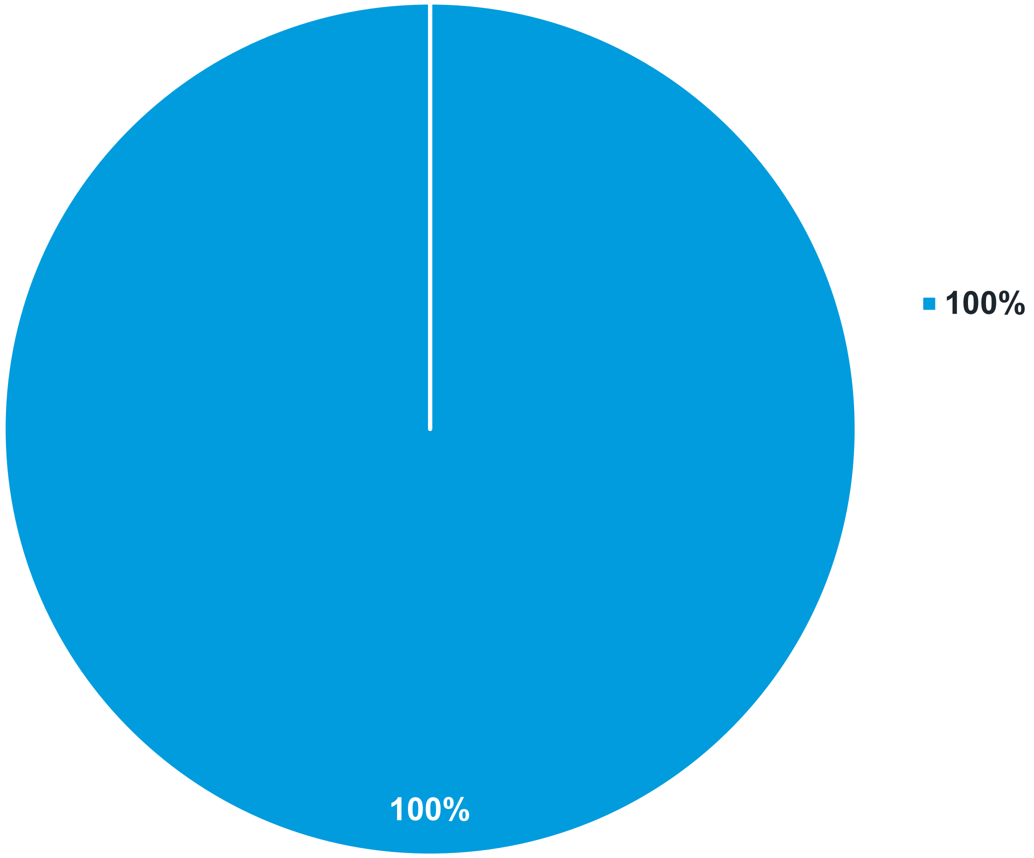


Management fee offset – Directors' fees

Consistent with previous data, all the funds in our sample set provided for a 100% offset of fees against the management fee. Venture capital managers do not typically receive transaction, directors or other fees and so this is less a focus in negotiations. However, we have observed the fund documents of certain sponsors seeking to include carve outs so that certain fees for services provided by venture partners and other advisers to portfolio companies are not subject to such fee offset – for example, the performance of services that would otherwise be provided by consultants on an in-house basis, provided that the fees charged are determined on an arm's length basis.

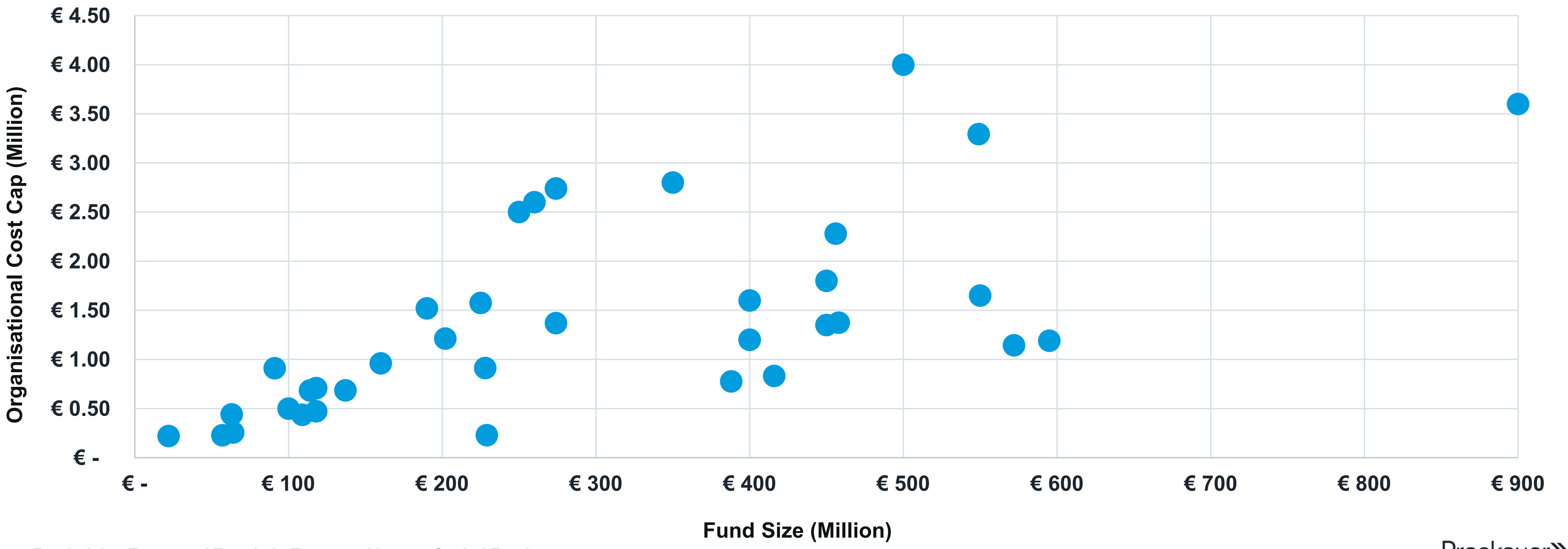


Management fee offset – Other fees



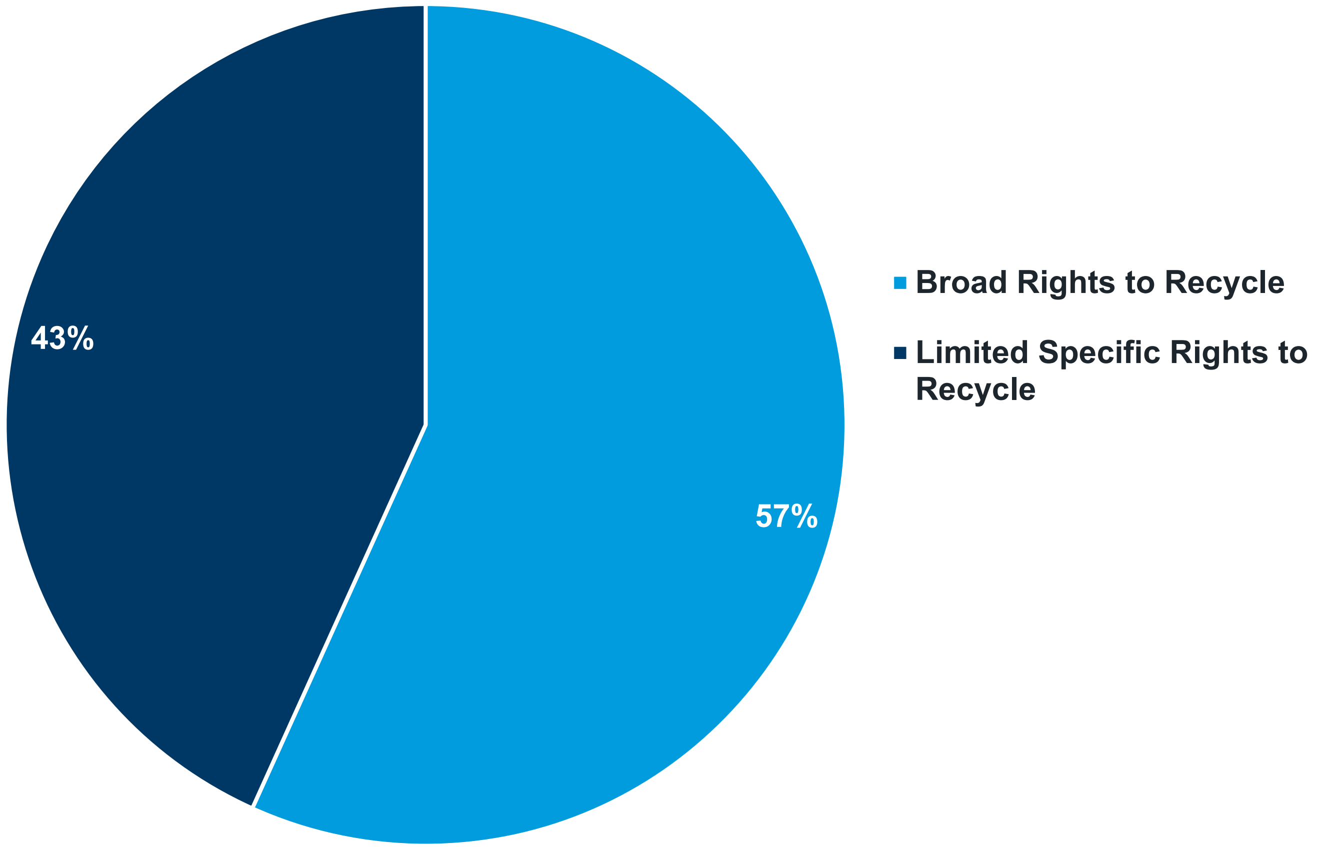
Organisational cost cap

As you would expect, the graph shows a general trend that the size of the organisational costs cap increases with the size of the venture capital funds being raised. We noted in past data that most of the funds had organisational costs caps of between €0.5-1.5 million and that there were three outliers at €2.25 million and above. This year's data demonstrates an upwards shift with most of the funds surveyed having caps of between €0.5-2.75 million. This could be due to several factors, including larger fund sizes, more complex negotiations of legal documents and more established asset managers wanting to gain exposure to venture capital as an asset class.



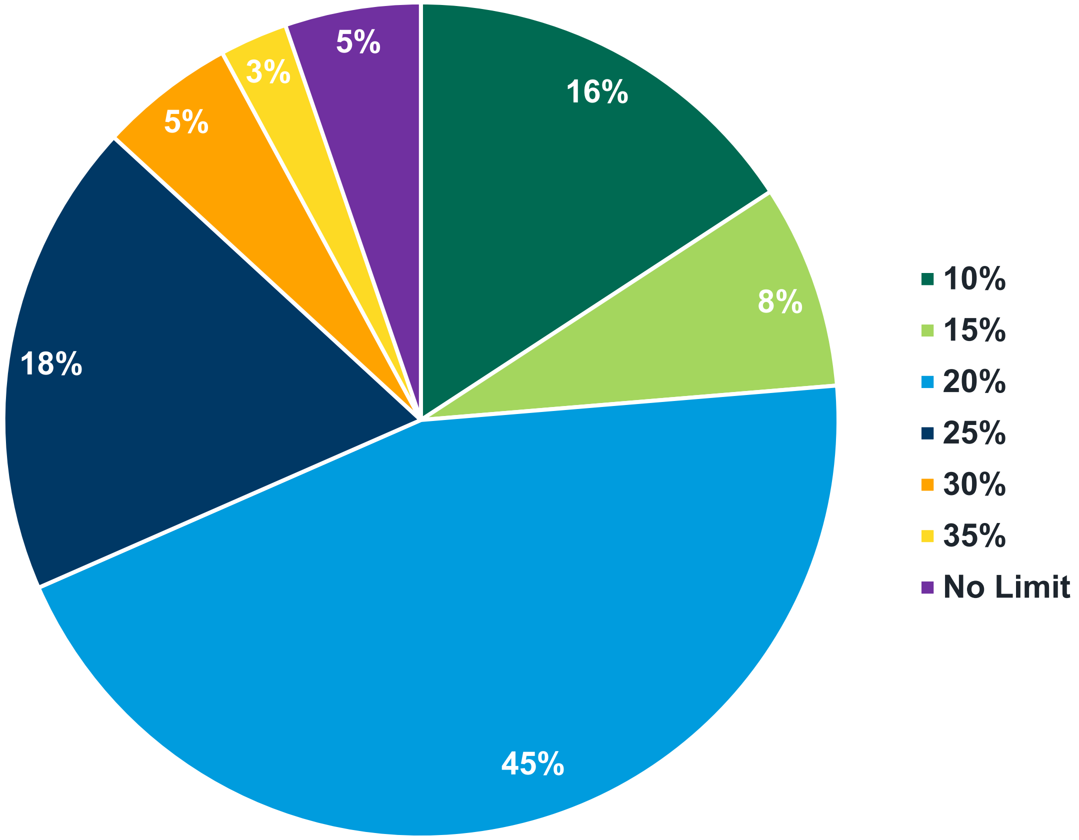
Recycling

Our sample set of funds shows that there has been an increase in the percentage of funds with a broad ability to recycle relative to those with a more limited recycling ability compared to the prior data: 57% of the funds sampled this year relative to 51% of the funds sampled previously. By broad recycling rights, we typically mean that sponsors can recycle proceeds from investments during the investment period of their funds in addition to having the right to recycle proceeds equal to fees and expenses. The funds with more limited or specific rights would be subject to restrictions such as only being able to recycle proceeds received from investments realised within 12 to 18 months of acquisition. We expect broader recycling rights to continue to grow in prevalence in the coming years. Venture capital sponsors should consider how important such recycling rights may be in the context of their overall investment strategy as this could allow them to participate in subsequent funding rounds of portfolio companies with the benefit of minimising the dilution of the investment in such portfolio companies and making investors' commitments to the fund work harder.



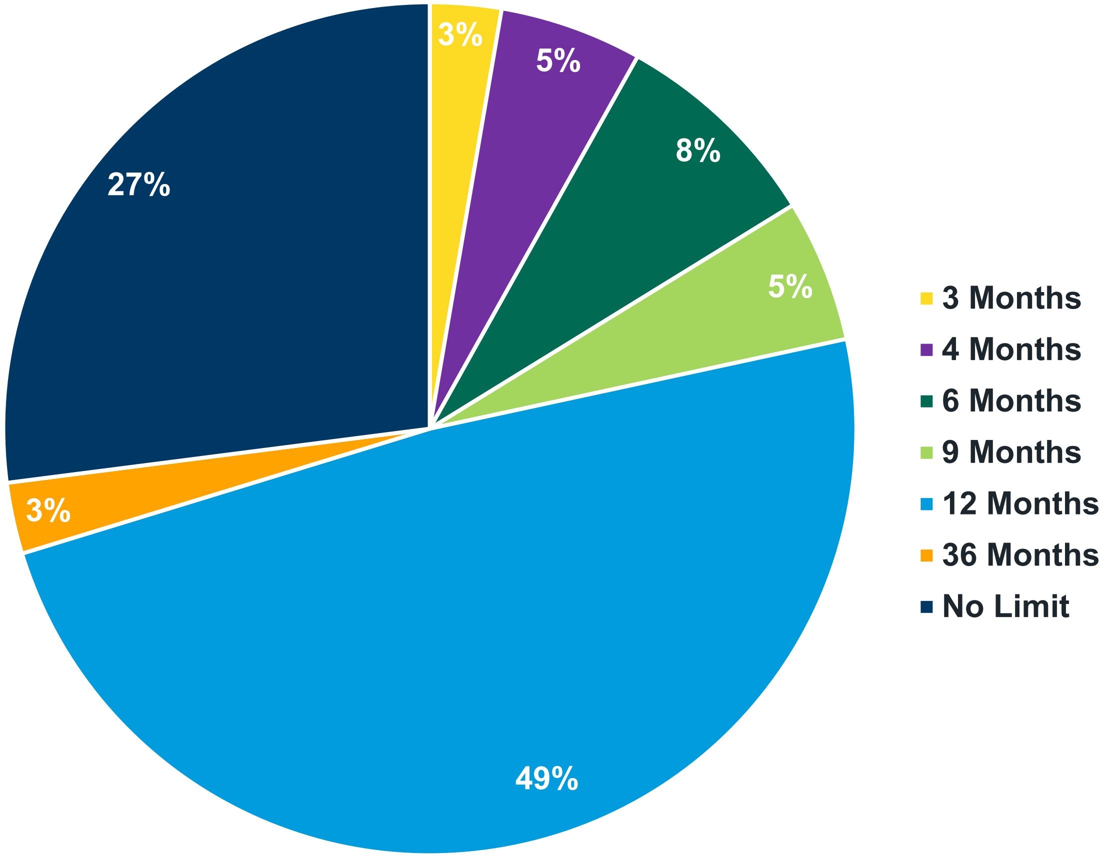
Limits on bridge facilities and other fund-level borrowing (% of commitments)

Given the expenses involved in setting up and operating bridge facilities, we see fewer of these facilities implemented in European venture capital relative to private equity. However, as the market continues to develop, we expect these facilities will become increasingly common as they can be a useful tool for sponsors to be able to better manage and coordinate cash flows, drawdowns from investors and the execution of portfolio transactions. As this happens, investors may become more focused on such limitations. Our data shows that 84% of funds in our sample set have permitted fund-level borrowing of 15% or more of commitments, up from 76% in the prior data. As with previous surveys, a limitation set at 20% of commitments is the most common.



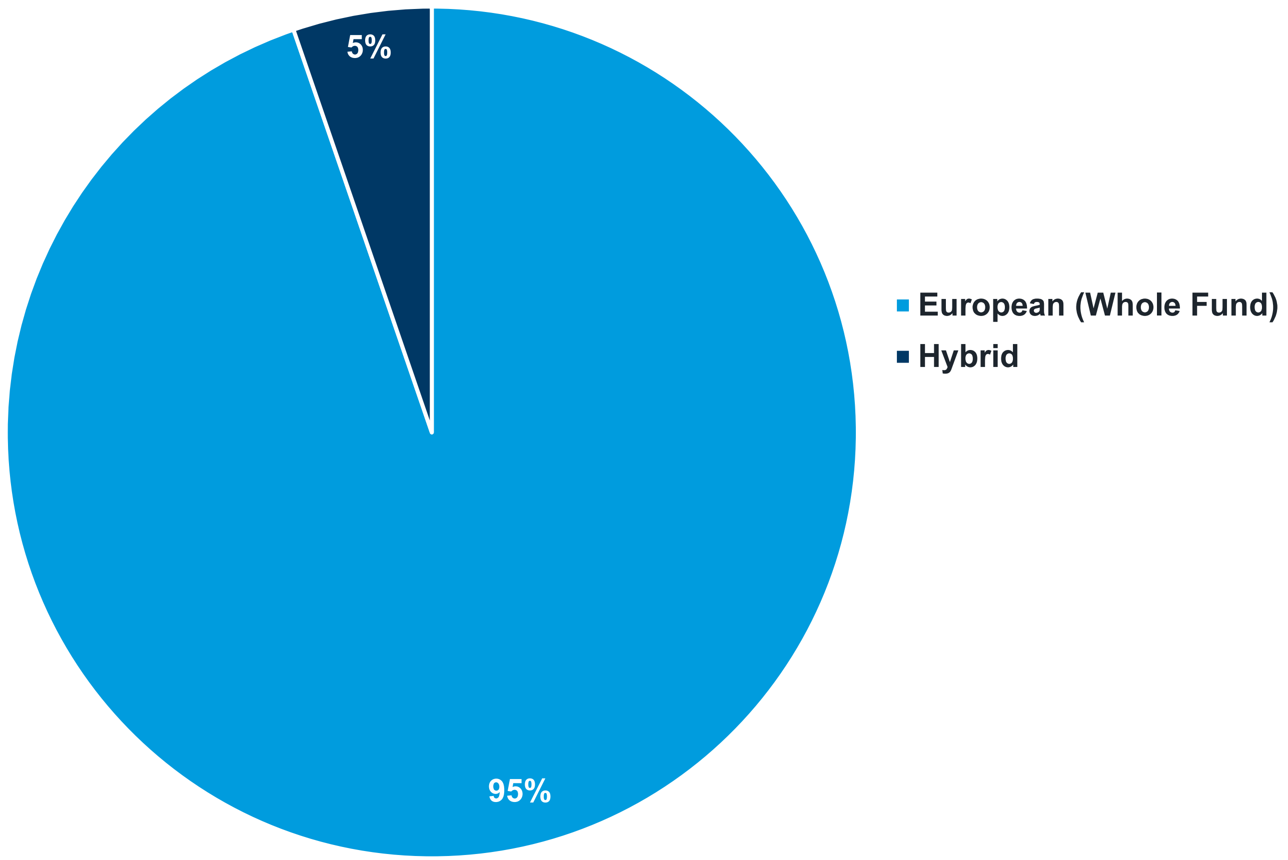
Time limits on borrowing

49% of the funds from our sample set are subject to a 12-month time limitation of fund-level borrowing (up from 40% in the prior data). This compares to 27% of funds being subject to no specified time limit (down from 46% in the prior data). We consider this to point to a general trend of most institutionalised borrowing practices among venture capital sponsors as the 12-month time limit follows what is the norm in private equity. This is also likely to be driven by certain European regulations concerning borrowing, which venture capital sponsors are paying closer attention to as they look to have the ability to implement fund-level borrowing strategies.



Distribution waterfall – Type of waterfall

Almost all the funds in our sample set used a whole-fund distribution waterfall, which required the sponsor to return at least all drawn commitments before carry is generated. There were two hybrid waterfalls which account for 5% of the sample.

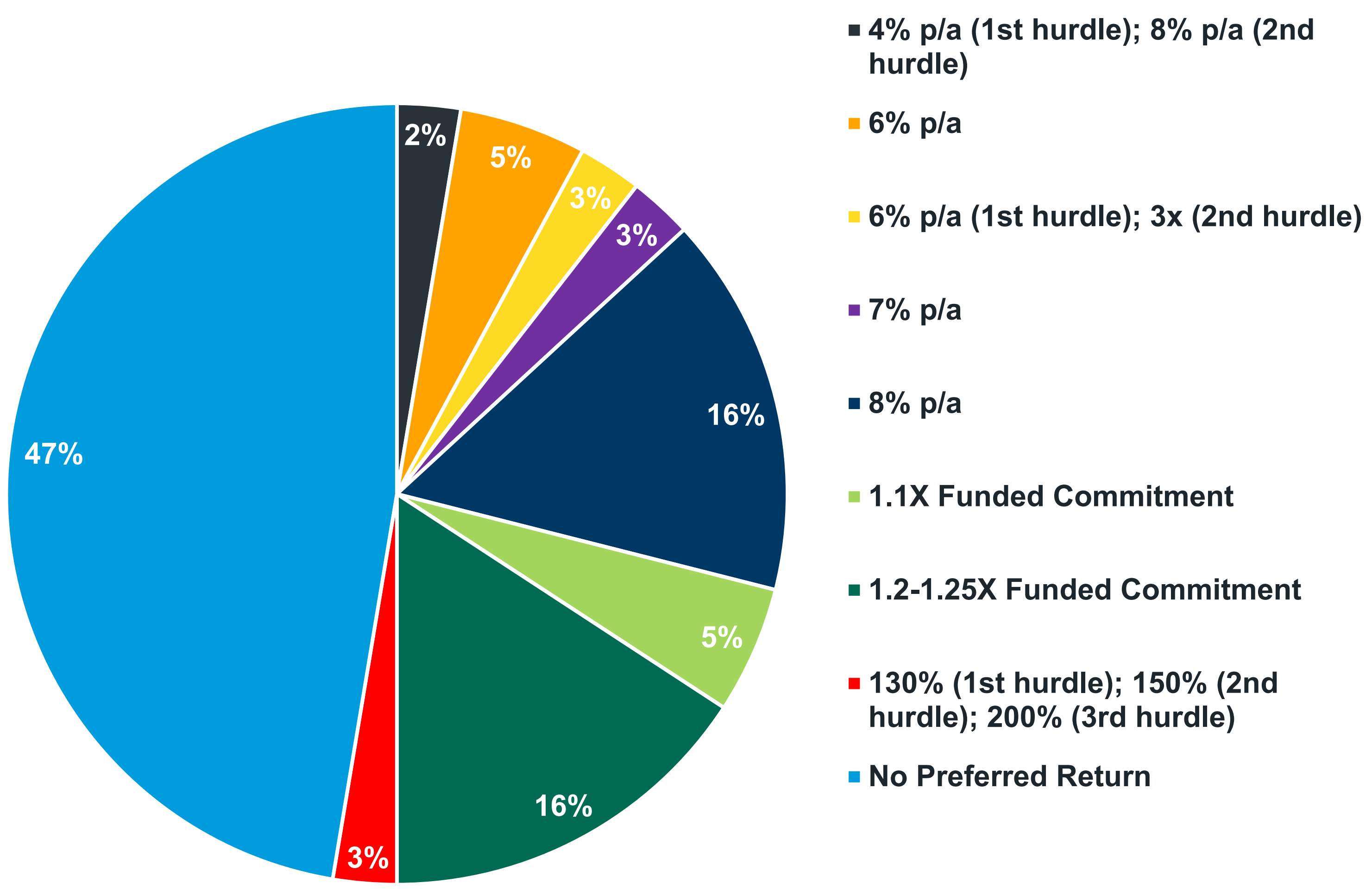


Distribution waterfall – Preferred return (%)

47% of the funds from our sample set do not have a performance hurdle going straight from the return drawn commitments to a split in the profits between the sponsor and investors. This is down from 68% of the European venture capital funds surveyed previously, which perhaps points to sponsors needing to concede slightly on economic terms within the last year in a tougher fundraising environment than that which was observed in the couple of years prior to that.

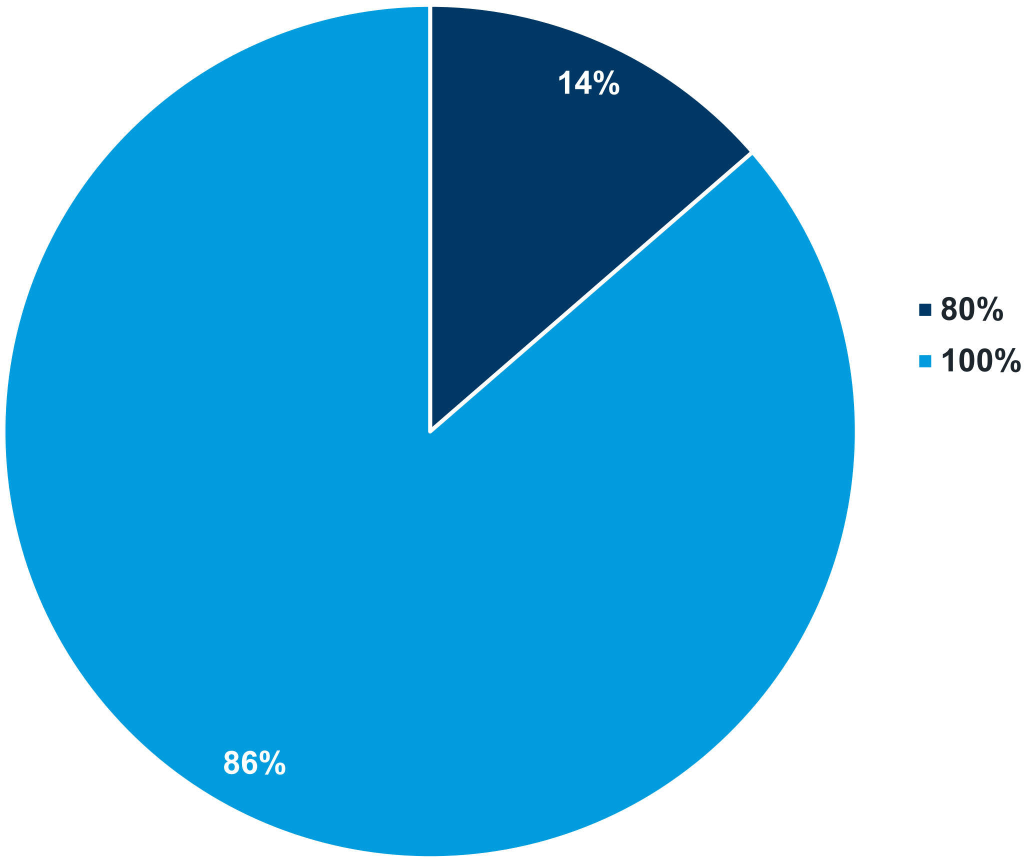
29% of the funds from our sample set have a percentage based preferred return, ranging between 4-8% with the remaining funds operating with a preferred return calculated on a multiple of invested capital before carried interest may be distributed to the sponsor. Three of the funds surveyed had waterfalls containing secondary hurdles.

It will be interesting to see whether this year's increased prevalence of European venture capital having a preferred return represents an anomaly (due to the broader macroeconomic considerations) to the general trend that we have seen in previous years of the industry seeking to align itself more with the US venture market where we see an increasing trend away from annually accruing preferred return. The best returns on venture capital assets can often require holding an investment for a significantly longer term than a buy-out fund given the time it takes for early-stage companies to grow into their potential. Removing the pressure of annually accruing preferred return can mean sponsors are less incentivised to make fast exits and allows them to achieve premium returns for their investors.



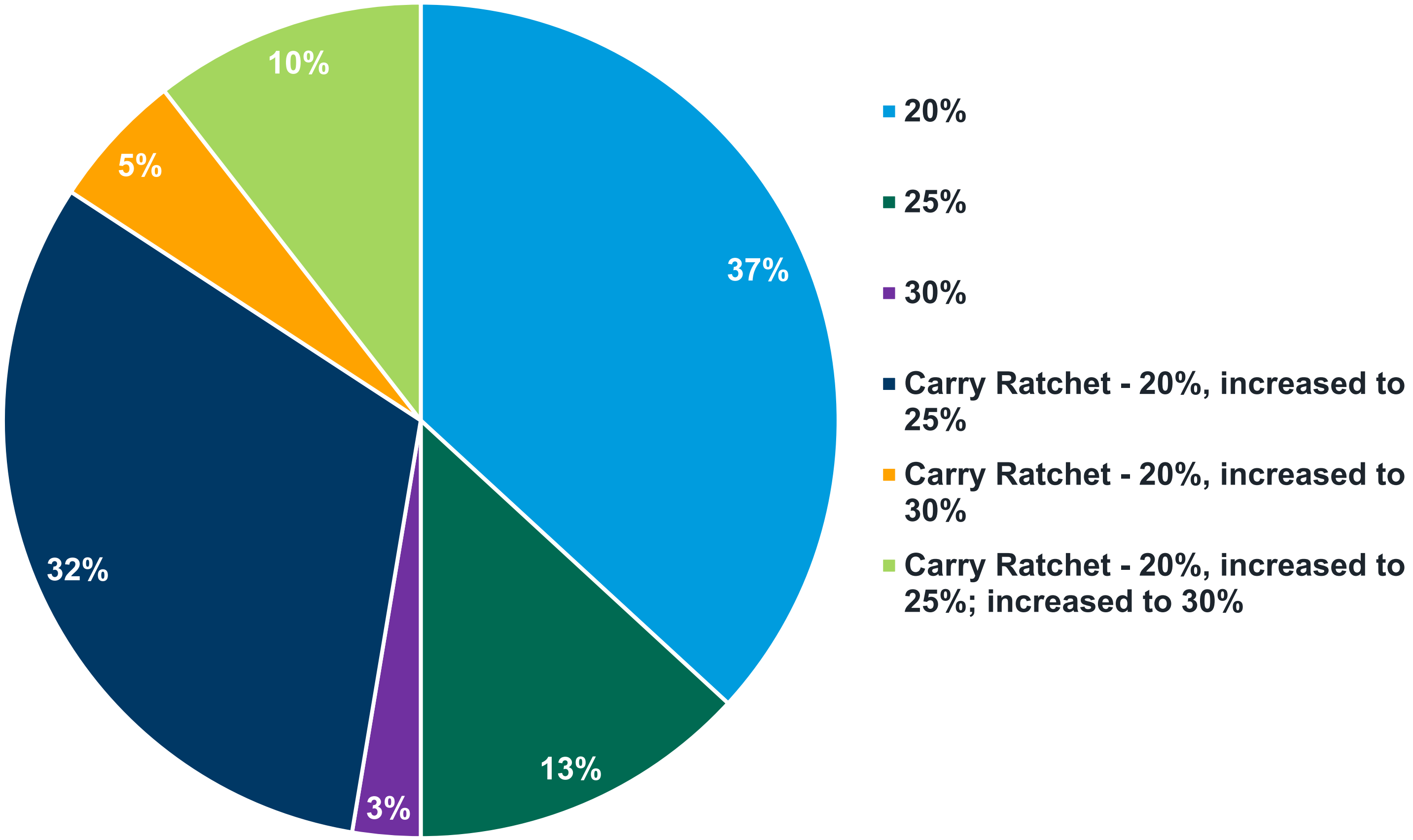
Distribution waterfall – Carried interest catch-up (% after preferred return)

Of the funds in our sample set that have a preferred return (and therefore give rise to the need for a carried interest catch-up), 86% of the funds had a 100% catch-up (up from 83% based on prior data).



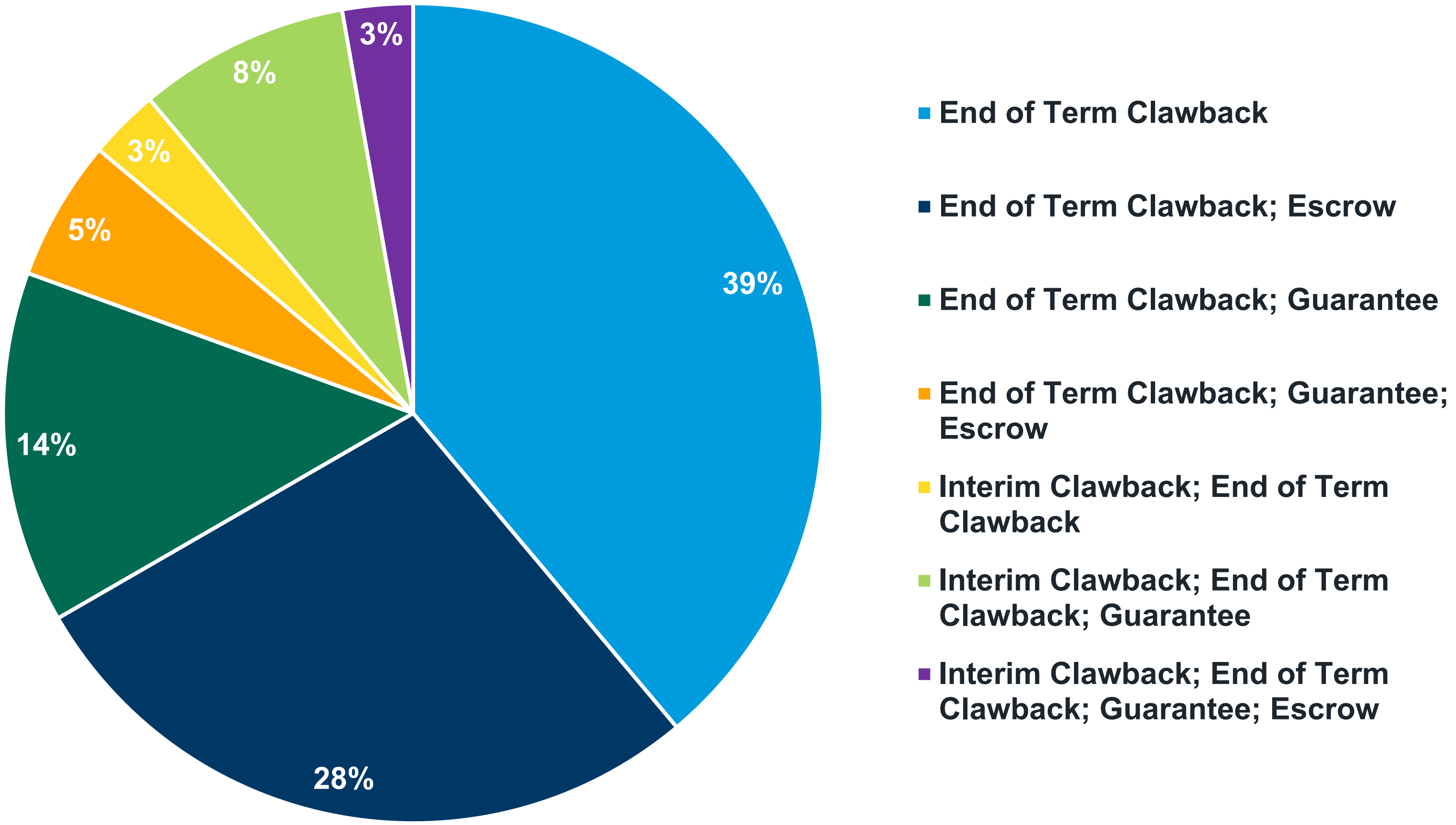
Distribution waterfall – Carried interest percentage

37% of the funds from our sample set have a fixed carried interest percentage of 20%, similar to the 35% of funds in the previous sample set of funds. A substantial proportion of funds (32%) operate with a carried interest rachet, which can see the entitlement to carried interest for the sponsor increase from 20% to 25%. A further 15% of funds operate with other forms of ratchet mechanics leading to the possibility of the sponsors being able to participate in up to 30% of the profits. The variety that we observe in both preferred returns and the calculation of carried interest entitlements from within our sample set points to venture capital investors continuing to be willing to be flexible on fund economics to incentivize sponsors to attain premium returns.



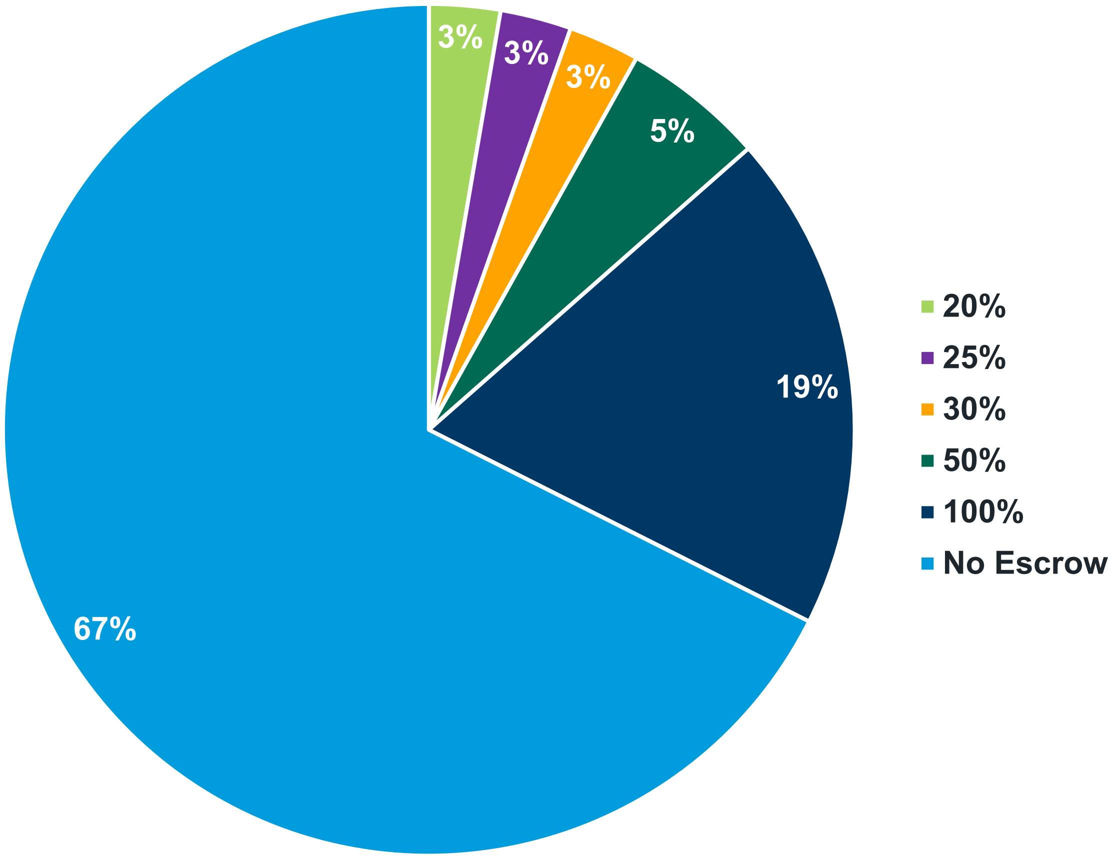
GP clawback and related investor protections

The variety of distribution waterfalls observed in our sample set has meant that we observed several different approaches to carried interest clawback and related investor protections. The three most popular mechanism used are: simple end of term clawback (39% compared to 43% from prior data), end of term clawback combined with an escrow (28% compared to 11% from prior data) and end of term clawback combined with a guarantee (14% compared to 21% from prior data). While simple end of term clawback remains the most prevalent mechanism, we would expect more robust investor protection terms and whether there is an interim clawback test to be increased points of negotiation between sponsors and investors.



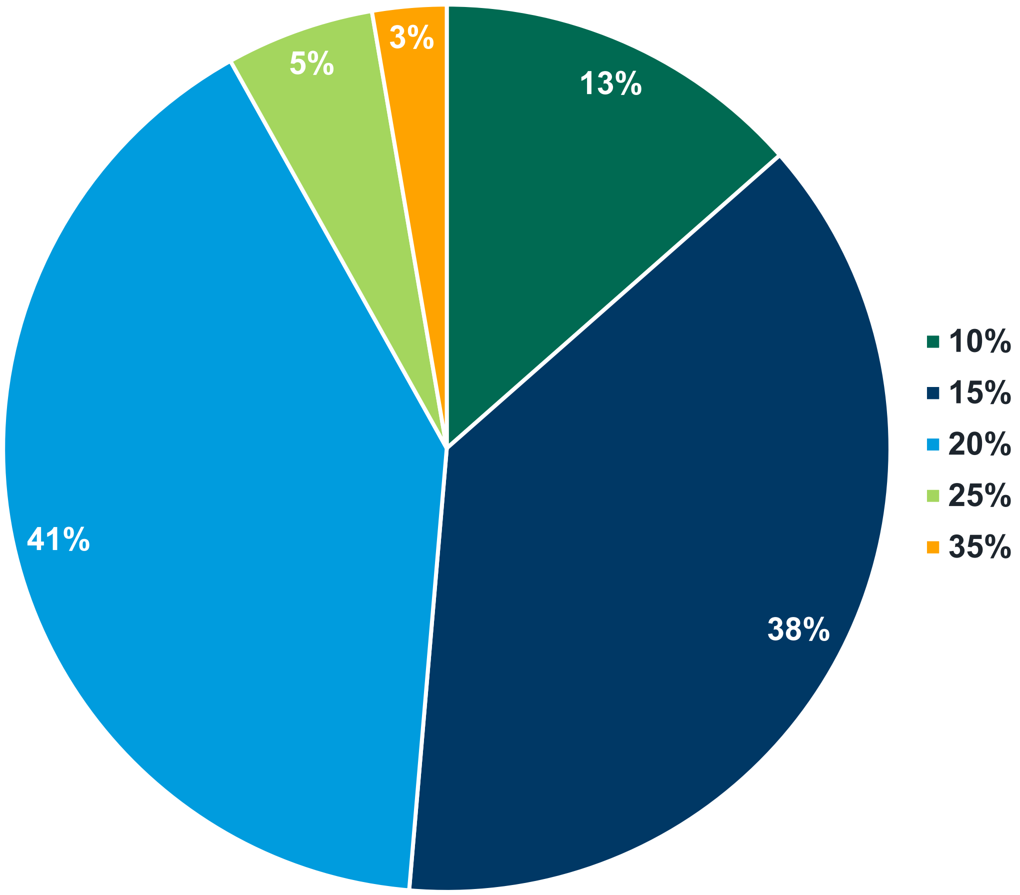
Escrow (% of carried interest)

Building on the trends observed on the previous page, 67% of the funds comprising our sample set do not contain any escrow mechanics. For those that do, 19% have escrow mechanics in their constitutional documents which require an amount equal to 100% of carry proceeds to be retain in escrow until the third-party investors have received amounts equal to their undrawn commitments and drawn commitment to the Fund plus any preferred return hurdle. A range of other escrow mechanics requiring sponsors to retain a lower percentage amounts of carry proceeds in escrow are then used.



Investment restriction – Diversification limit (% of commitments)

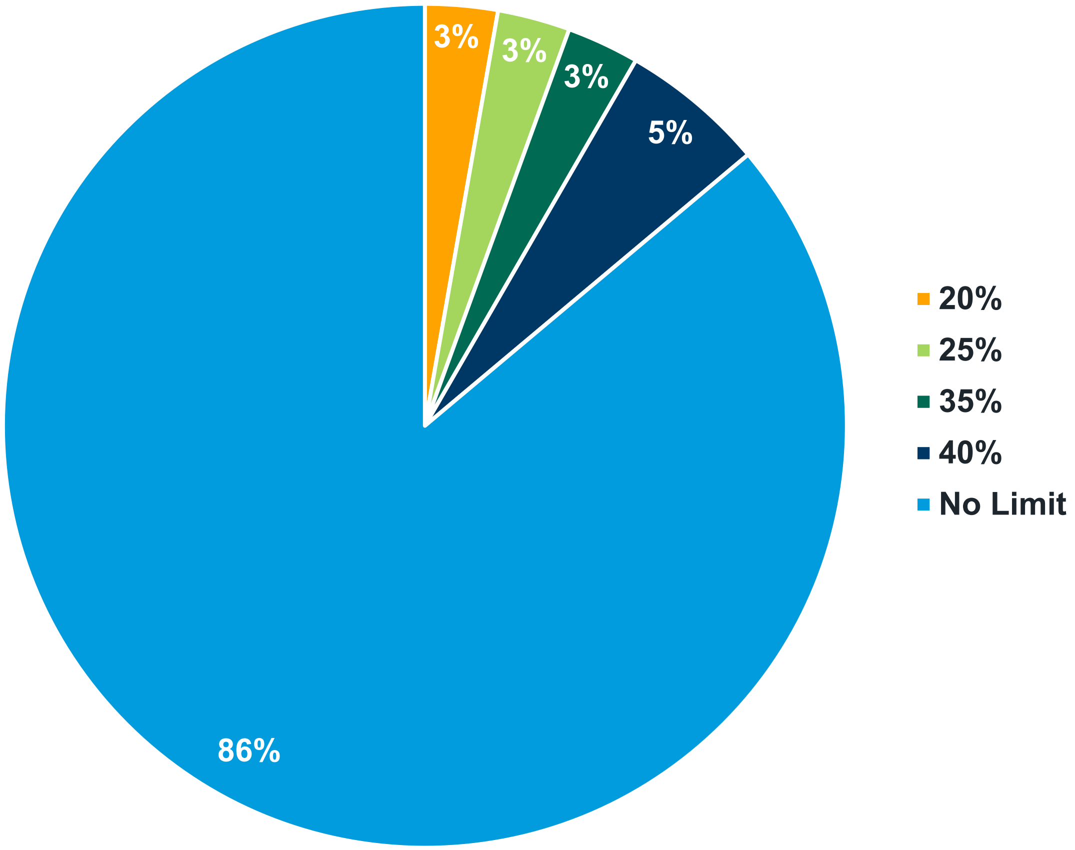
41% of the funds from our sample set have diversification limits for single portfolio investments set at 20% of aggregate commitments of investors (relative to 30% of funds in the previous data set). As predicted in our previous paper, this represents a trend where sponsors are pushing for higher diversification limits given that 15% was the most prevalent limitation we saw at the time: represented by 40% of funds in the previous data set and 38% of funds this year in the respective sample sets. Diversification thresholds are generally lower than in buy-out funds because of the greater risk being taken when investing in early stage enterprises, which is inherent with the nature of venture capital. Investors and sponsors therefore look to strike a balance between the fund being overly exposed to a single investment and allowing the relevant sponsor to back one or more prize assets, so that the fund can maximise returns.



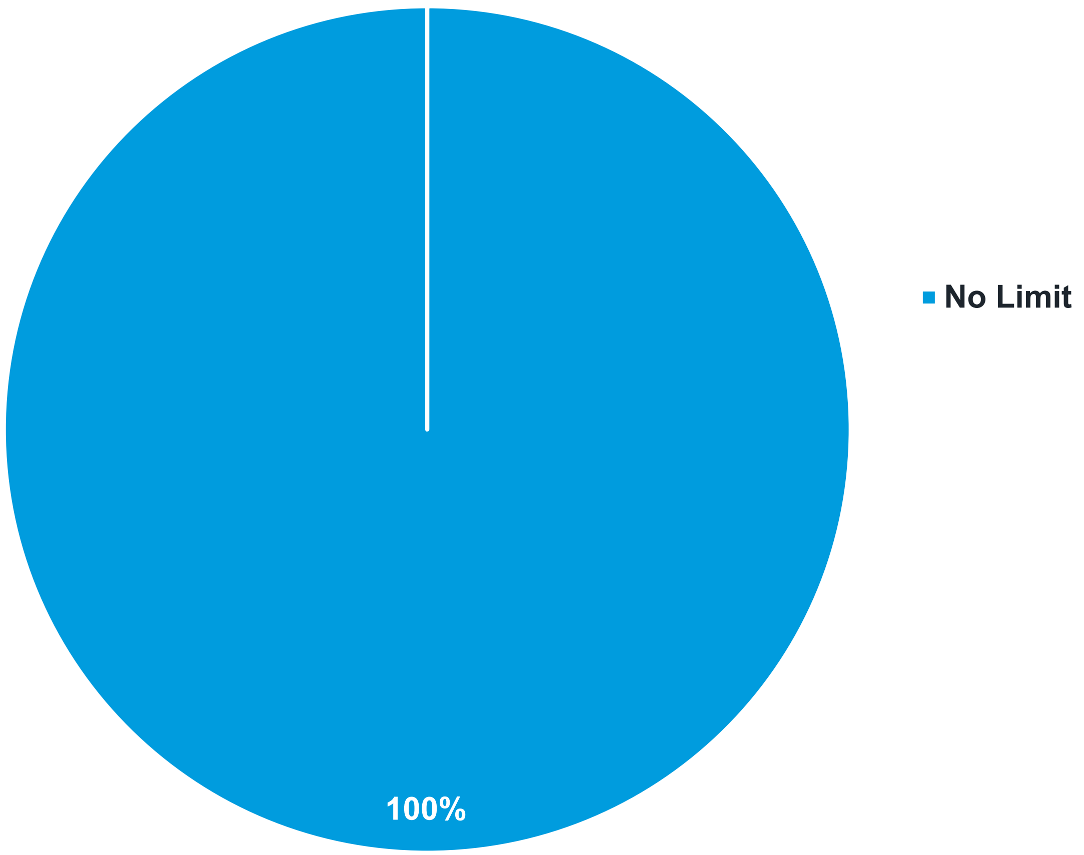
Limit on follow-on investments post-investment period (% of commitments)

We observe that 86% of the funds comprising our sample set have no percentage limitation on the amount of commitments that may be used for follow-on investments after the end of the investment period. This represents a slight decrease on our prior survey where 100% of the sampled funds had no such limitation. The other limitations that we see from this year's data are likely to have been as a result of the rate at which the relevant sponsors anticipate deploying capital towards the outset of their respective funds' lifecycle and/or negotiations with investors who want clarity on how much capital they may still be required to advance later on in the life of the fund.

As with the prior data, the next chart shows that no fund in our sample set had a time limit on making follow-on investments. Collectively, these data points are in keeping with the observations that we have made on prior pages that sponsors typically want the flexibility to keep more capital reserved for follow-ons to ensure that the fund can participate in later stage funding rounds to augment the value of prize assets.

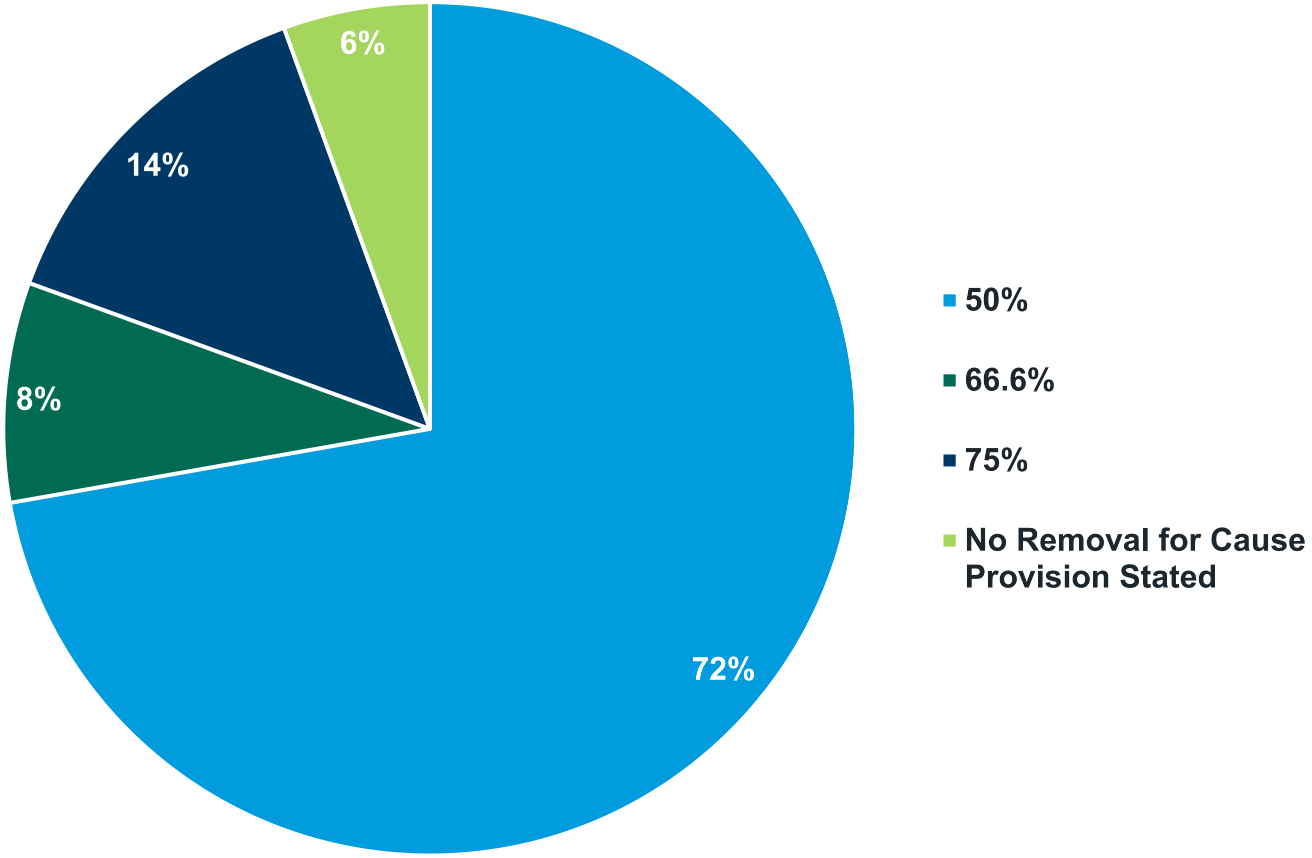


Limit on follow-on investments post investment period (months post investment period)



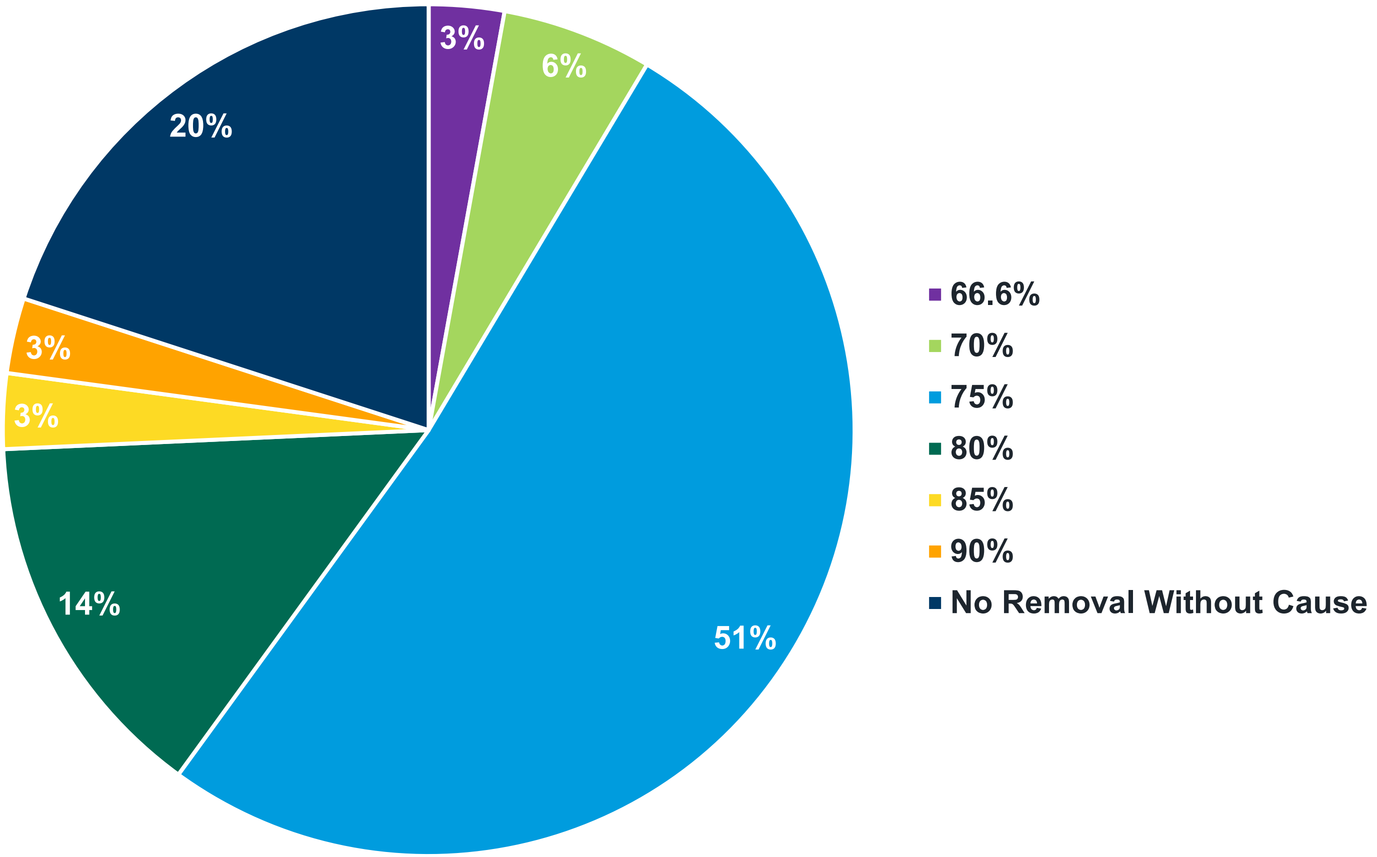
GP ‘for cause’ removal – Investor voting threshold (% of interests)

72% of the funds comprising our sample set require a majority vote to remove the sponsor following a cause removal even, markedly similar to the 75% observed in our previous survey data set. 22% of funds require a higher threshold of either two-thirds or 75% of commitments to vote for such removal, whilst 6% of funds do not allow for cause removal. Again, these latter three data points are substantially similar to the trends observed in the prior data set.



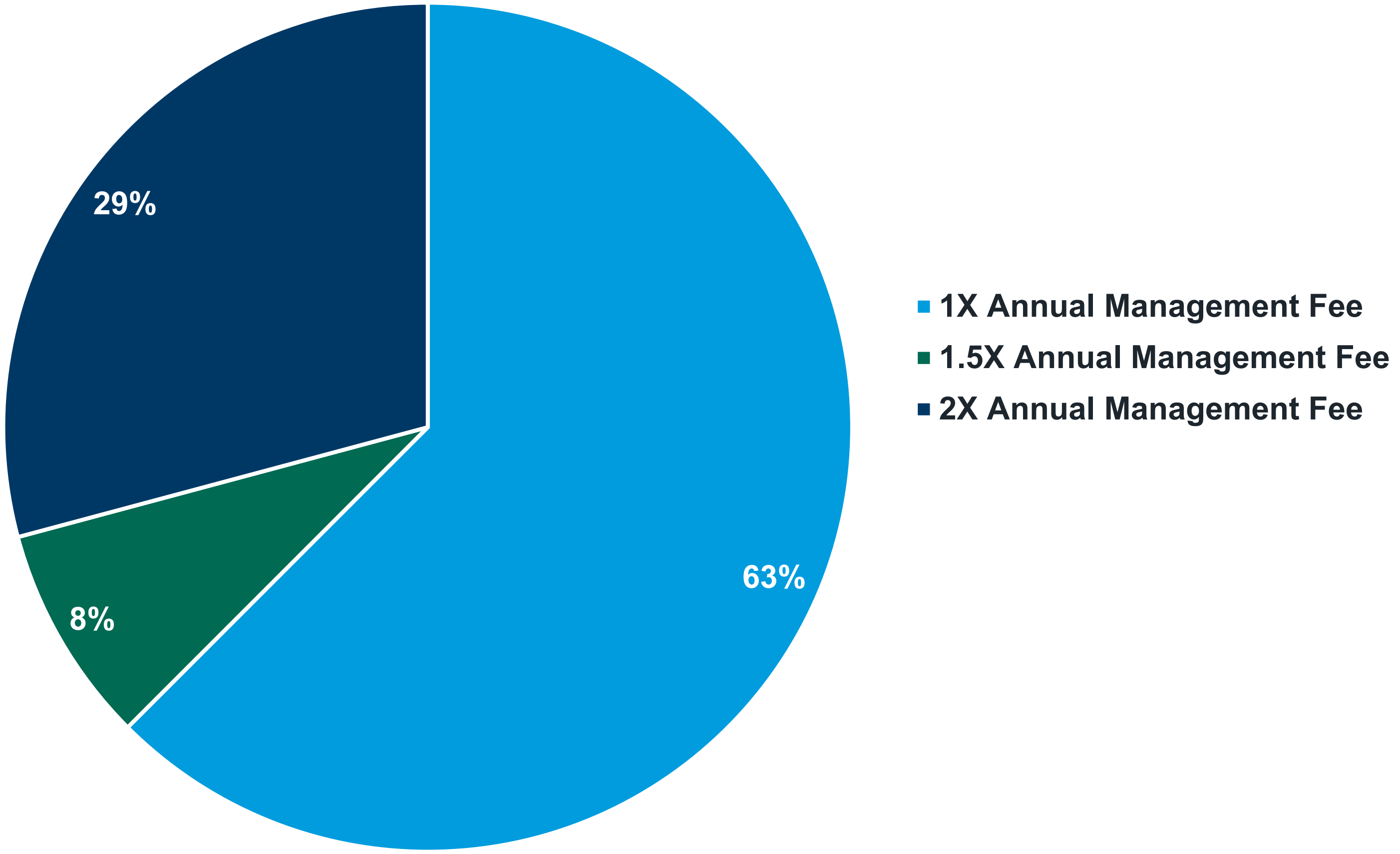
GP ‘without cause’ removal – Investor voting threshold (% of interests)

Where a no-fault removal provision was present, the most common voting threshold was at least 75% of commitments: 51% of the sampled funds which represents a noted increase of 38% of previously sampled funds. We then observe a variety of other voting thresholds up to an including one based on at least 90% of commitments and the fact that 20% of the funds from our sample set do not give investors the right to remove the sponsor without cause at all. Those funds that do not provide for such removal do, in some instances, still give the ability to terminate the fund early without cause.



GP ‘without cause’ removal – Manager termination payment

Where funds have a no-fault removal provision, most of the funds forming our sample set provide for a compensation payment equal to one year’s management fee – 63% of funds (relative to 68% in the prior data). As with the prior data, no funds provided for zero compensation. 8% of the sampled funds provide for 1.5x management fee (relative to 9% in the previous survey) and 29% of the sampled funds provide for 2x management fee (relative to 23% in the previous survey).



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