McKinsey & Company

Technology, Media, and Telecommunications Practice

Europe's start-up ecosystem: Heating up, but still facing challenges

More ventures are achieving unicorn status, and at a faster pace, but many more still aren't realizing their full potential. What's holding them back, and what can change that?

This article was a collaborative effort by Kim Baroudy, Jonatan Janmark, Abhi Satyavarapu, Tobias Strålin, and Zeno Ziemke, representing views from McKinsey's Technology, Media, and Telecommunications Practice.

October 2020

In recent years, Europe's start-up ecosystem has seen a surge in the number of unicorns and the pace at which they are created. Of the 99 venture-capital-backed European unicorns, 14 were added in 2019 alone.[1] These include Germany's neobank N26, France's healthcare scheduling service Doctolib, and Lithuania's online used-clothing marketplace Vinted. Despite this accelerated activity, European start-ups still lag in achieving successful late-stage outcomes when compared with other start-up ecosystems.

To better understand the forces at work behind the outcomes of European start-ups, we conducted a cohort analysis that examines Europe, India, and the United States, using the latter as a benchmark for a healthy start-up ecosystem (see sidebar, "About our analysis"). We also assessed the trends and challenges affecting those ecosystems and interviewed start-up founders and investors to add context to our findings. Though our data is historical and conditions are definitely changing for the better, our analysis of Europe's start-up ecosystem illustrates the ongoing underlying issues that entrepreneurs face.

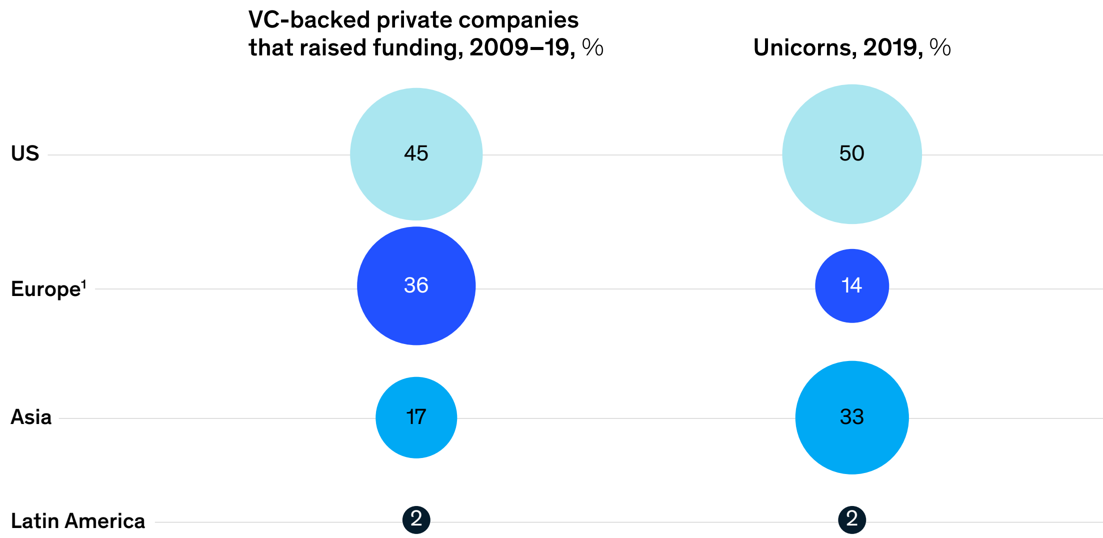
A startling disparity

Although change is happening quickly, according to our analysis Europe's start-ups are still fewer in number, raise less money, and have a lower likelihood of success (which we defined as start-ups that reach Series C funding, go public, or are acquired). While Europe generates 36 percent of all formally funded start-ups, it creates only 14 percent of the world's unicorns (Exhibit 1). Adjusted for population and GDP, the number of seed-stage start-ups that Europe generates is only 40 percent of that generated by the United States.

[1] *The state of European tech,* Atomico, 2019, stateofeuropeantech.com.

Exhibit 1

Europe produces about 36 percent of global start-ups but only about 14 percent of the world's unicorns.



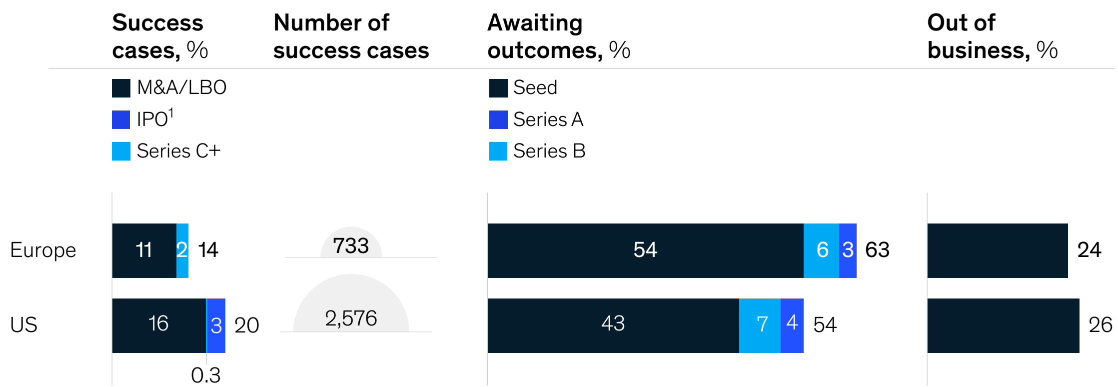
Note: Figures may not sum to 100%, because of rounding.
[1]Data from Europe, the Middle East, and Africa used as a proxy for Europe.
Source: PitchBook; McKinsey analysis

Historically, Europe's ecosystem has been less effective than that of the United States at turning start-ups into late-stage successes. To analyze the steps between the seed stage and success, we looked at start-ups that received seed or angel funding between 2009 and 2014. For example, European start-ups were 30 percent less likely to progress from seed to a successful outcome (also defined as securing Series C funding or beyond, going public, or being sold), as compared to start-ups that raised seed funding during that time in the United States (Exhibit 2).

Exhibit 2

European start-ups have an approximately 30 percent lower likelihood of success relative to start-ups in the United States.

Start-up outcomes, % of total companies that raised a seed/angel round of funding from 2009–14



Note: Based on a cohort of companies that received angel or seed funding 2009–2014; Europe = 5,417, US = 12,891; data range chosen to capture lead time from seed to success. Figures may not sum, because of rounding.
[1] Companies that reached IPO 2009–2014: Europe = 27, US = 44.
Source: PitchBook; McKinsey analysis

About our analysis

To assess the health of the start-up ecosystems in Europe, India, and the United States, we conducted a cohort analysis. We viewed the US start-up ecosystem as a benchmark; we included India because India's start-up ecosystem, like Europe's, is also heating up significantly. For each region, we sampled start-ups that raised a seed or angel round from 2009 to 2014, a timeframe that deliberately excludes younger start-ups that haven't yet matured through the usual funding round timeline. This allowed us to get a clear picture of outcomes. We tracked the performance of this set of companies from the moment they raised seed funding to the present day and noted performance from the seed round all the way to either Series E or an exit such as an IPO, merger, or acquisition. We defined "success" as reaching Series C or a favorable exit. We also tracked the number of start-ups that didn't advance or went out of business.

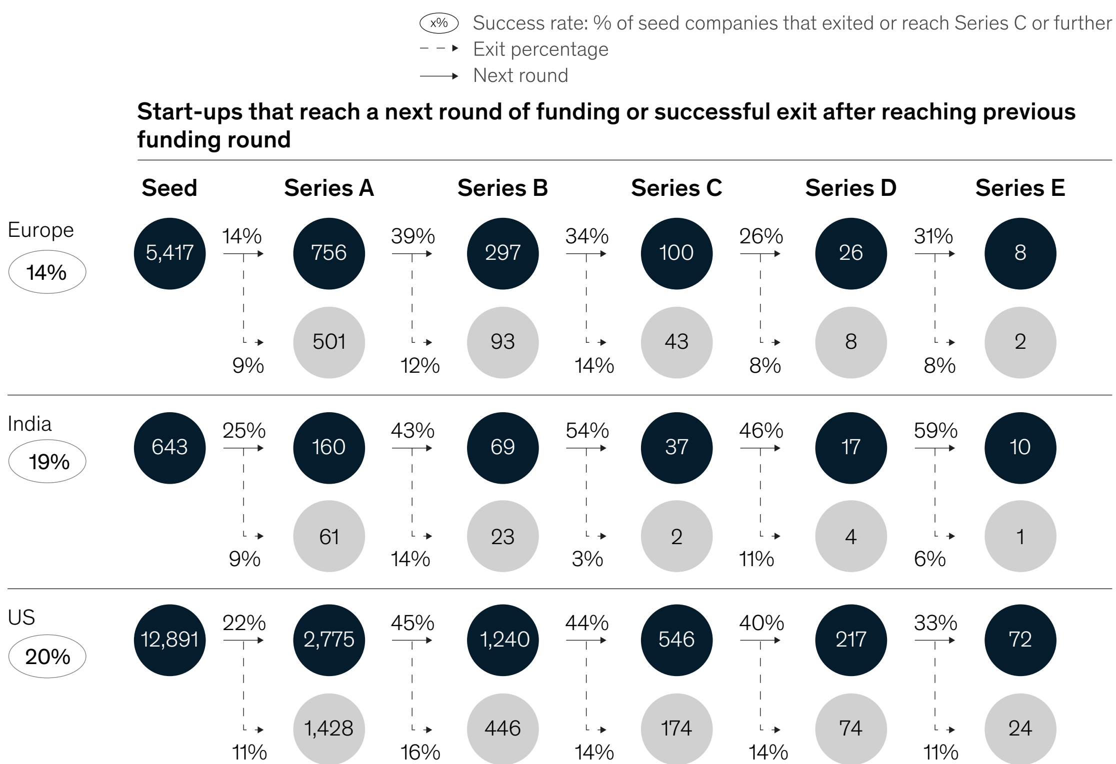
This cohort analysis enabled us to assess success and failure rates between various rounds of funding, and compare, with a large enough sample size, across regions. We recognize that this provides a historical view—the European start-up ecosystem has developed considerably over the last five years, as, for example, governments have actively sought to promote entrepreneurship. Start-ups launched in Europe during that time may have performed better than those included in our analysis, but since they have not yet reached the maturity level needed to objectively assess their outcomes, we omitted them from this analysis.

Further, European start-ups have consistently lower total success rates and show less progress through all series rounds when compared to US and Indian start-ups in aggregate (Exhibit 3). For instance, for the cohort of start-ups raising seed or angel funding between 2009 and 2014, the US and Indian ecosystems are almost twice as effective as Europe's at moving start-ups from Series C to Series D funding rounds, or even Series B through Series C. For the same cohort, European start-ups experience lower success rates than those in the United States progressing through subsequent funding rounds.

Being less successful at progressing through this funnel, however, doesn't mean that Europe's start-ups are outright failures. In fact, as measured by bankruptcy rates across rounds, European companies don't fail more often than US companies (Exhibit 4). Rather, European companies are more likely to stall after a fundraising round, meaning they simply don't advance to the next stage of funding or don't manage a successful exit in the form of an IPO or some sort of acquisition. This happens to 10 percent more European start-ups than US start-ups after securing series A funding. While these companies may actually be growing and profitable, and thus self-funding, they could be sacrificing further growth potential. This effect may dampen the appetites of venture capitalists (VCs), for whom operating at a profit is not enough—as they tend to rely on big sales or IPOs to get high returns on their investments.

Exhibit 3

US and Indian start-ups have greater success than European start-ups at progressing through funding rounds.

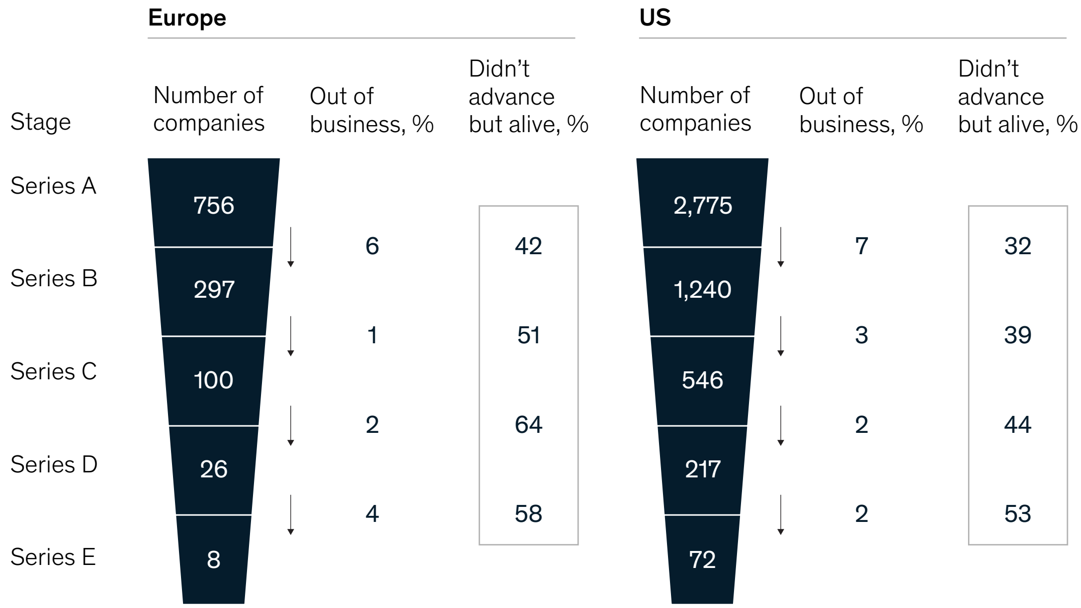


Note: Funnel based on companies that raised seed or angel funding between 2009 and 2014.
[1]Successful exit is defined as a merger, acquisition, initial public offering, or leveraged buyout.
Source: PitchBook; McKinsey analysis

Exhibit 4

European start-ups don’t fail any more frequently than US start-ups do, but they tend not to advance as often.

Start-up progression by stage, with % rates between funding rounds



Note: Funnel based on cohort of companies that received angel or seed funding 2009–2014; Europe = 5,417, US = 12,891.
Source: PitchBook; McKinsey analysis

What holds Europe’s start-ups back?

These striking numbers highlight the key challenges that work in concert to create drag on European start-ups. Five in particular have the greatest effect on nascent companies.

The domestic value pool is fragmented. At the most basic level, the fact that Europe is not a single market has profound effects on what start-ups must focus on in their early years. Europe may have lowered its borders and opened its markets, but it is still a collection of dozens of different countries with their own languages, cultures, and governments. For example, customer behaviors vary between countries, which can require brands to be rebuilt for individual markets. Distribution and marketing channels can be similarly challenging. Even accommodating languages and payment methods alone requires a greater investment of developer time than would usually be required of a start-up in the United States, for example. Further complicating matters is Europe’s regulatory landscape, which, though being streamlined, is both stricter and more fragmented than that of the United States. Depending on the industry and vertical, regulations also have wide variability.

Yet internationalization is unavoidable for Europe’s start-ups—to achieve valuations typical of US start-ups, European companies must expand quickly and early across many countries. For a European start-up to address a market that is similar in size to that of the United States, it would need to enter 28 heterogeneous countries (Exhibit 5).

Exhibit 5

The value pool of the European Union (plus the United Kingdom) is similar in size to that of the United States but is highly fragmented among 28 heterogeneous countries with different languages and cultures.

GDP distribution by region, %

Source: Eurostat 2019; International Monetary Fund

The limitations of the domestic value pool, and what start-ups have to do to compensate for them, are also reflected in the geographical footprint of unicorn companies. Our analysis of start-up website traffic shows that about 70 percent of European unicorns had to establish a global or partly global geographical footprint to reach unicorn stage, as compared with just 50 percent of US unicorns.[2]

Our data show that most European unicorns have had to expand not just beyond their individual countries but beyond Europe as well, whereas only half of US unicorns have expanded outside the continental United States. This means that European start-ups have to focus on wider internationalization earlier in their journey than do US start-ups.

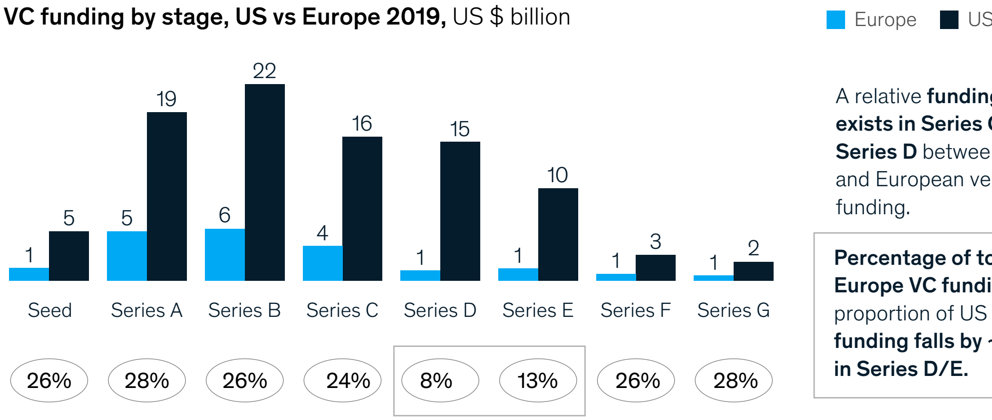
Large funding rounds can be challenging. Historically, it has been more difficult for European companies to raise large funding rounds due to a lower supply of late-stage capital. As a result, it is harder for those companies to compete with significantly better-funded US competitors. We found that the problem was especially pronounced in the Series D and E stages (Exhibit 6). In our interviews with industry insiders, this difference was partially attributed to European investors' risk aversion.

[2] Our analysis of unicorn start-ups' web traffic as a proxy for the location of their customer base defined "global" web traffic as being less than 60 percent of web traffic coming from a start-up's home region, and "partly global" as being 60 to 80 percent of web traffic coming from the home region; we found that 70 percent of European start-ups had web traffic that was global (55 percent) or partly global (15 percent), whereas 50 percent of US start-ups had web traffic that was global (32 percent) or partly global (18 percent).

Exhibit 6

European start-ups have historically had greater difficulty raising late-stage rounds of funding.

VC funding by stage, US vs Europe 2019, US $ billion



European funding as % of US funding

A relative **funding gap exists in Series C and Series D** between US and European venture funding.

Percentage of total Europe VC funding as a proportion of US VC **funding falls by ~50% in Series D/E.**

"The single biggest risk for UK and European start-ups is that only 1 in 5 companies receive further financing from the same investors. **Many European VCs do not have the finances available to follow on with their initial investments."**

— Adviser

"I know several cases of US companies that are **less successful and one-third the size** of European counterparts that raised money at 10x higher valuations."

— Former head of product

"We **expanded into 80 cities in 16 countries within six months.** We sold too early, but as a European company, one of our main concerns was **raising sufficient capital fast enough."**

— Former COO and cofounder

"There are **very few European VCs that have deep enough pockets for late-stage rounds.** We mainly spoke to US investors and SoftBank."

— Cofounder

Source: PitchBook; McKinsey analysis

In recent years, as US funds have expanded their presence in Europe, European VCs have raised more money, and more private-equity funds have begun European growth-equity investing arms, European founders of leading start-ups report that they have more access to late-stage capital from global and local investors. Still, US businesses in comparable industries, with similar success metrics, are able to raise funding at significantly higher valuations than their European counterparts. One factor that could account for Europe's historically lower supply of late-stage capital is the mix of funding sources: the biggest funders of European VCs tend to be governments and corporate investors, which have a different set of interests and goals from the biggest funders, such as large retirement and pension funds, of US VCs (Exhibit 7).

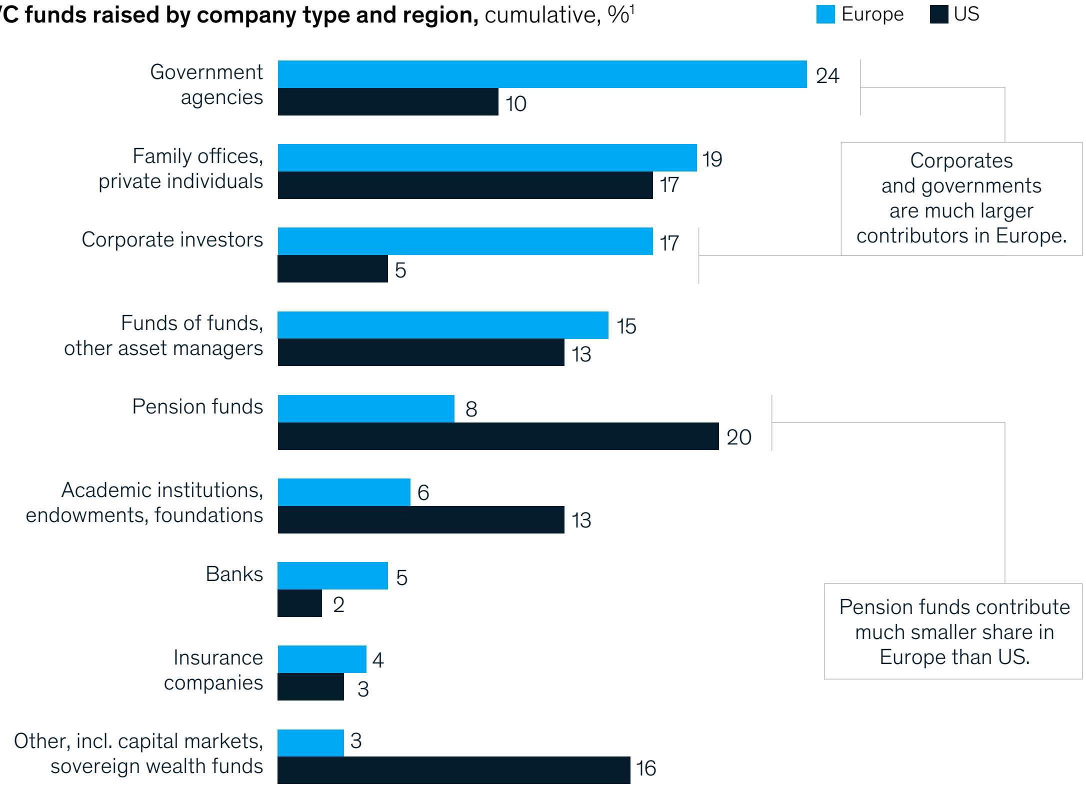
However, as Europe's venture capital ecosystem matures and catches up to that of the United States, which has had several more decades to evolve since its emergence in the second half of the 20th century, the funding proportions are starting to change. As VC returns have gained additional momentum in recent years, pension-fund investments in Europe have significantly increased: 2.3 times more pension funds were committed to European venture capital in 2018 compared with the four previous years.[3]

[3] *The state of European tech,* Atomico, 2019, stateofeuropeantech.com.

Exhibit 7

The sources of venture capitalists' funds differ in Europe from those in the United States, which may affect investing styles.

VC funds raised by company type and region, cumulative, %[1]



Note: Figures may not sum to 100%, because of rounding.
[1]Data based on funds raised between 2012 and 1H 2017; all percentages are only calculated on known LP allocation; unclassified allocations extrapolated; US VC LP allocation based on data from Preqin.
Source: Invest Europe/EDC; Preqin; *State of European tech* 2017 & 2019; McKinsey analysis

In 2019, capital invested in rounds of $100 million and more in Europe was four times that of 2014. The continent also saw an increase in megafunding rounds of $100 million and more, and even six $500 million–plus rounds, in 2019.

Despite such signs of progress, founders and funders told us in interviews that the relative gap in ease of raising large funding rounds has not yet fully closed, making it more difficult for European start-ups to compete with significantly better-funded US competitors and to become leading global players.

These issues can make European start-ups more inclined to limit risk when pursuing exit strategies, including by spending too little on expansion. In some cases, rapidly growing European start-ups may have factored concerns about their abilities to raise large amounts of follow-up capital into the decision to be acquired by US competitors instead of trying to become global players on their own. For example, the German collective-buying platform CityDeal was acquired by Groupon after just six months in operation,[4] and the Swedish payments company iZettle had been preparing for an IPO when it sold to PayPal.[5] Of course, every case has its particulars,

[4] "Breaking: Groupon acquires German clone CityDeal," TechCrunch, May 16, 2010, techcrunch.com.
[5] Amy Lewin, "Are European start-ups sell-outs?," sifted, June 24, 2019, sifted.eu.

European start-ups face much greater pressure to perform, and to do so earlier, than start-ups in the United States.

but for the highly profitable Finnish mobile-gaming company Supercell Oy, the founders stated clearly that they sold a majority stake to foreign investors (first SoftBank and GungHo Online Entertainment, and now Tencent) because they felt a "responsibility to pay out venture investors sooner rather than later."[6] These concerns can lead to missed opportunities: The former CEO of Booking.com, the Dutch hotel reservation company that sold to Priceline in 2005, has said that had other options been available at the time, they might have held out longer for a next funding round. Today Booking.com generates an estimated 80 percent of Priceline's revenue.[7]

Cultural values play a role. European start-ups face much greater pressure to perform, and to do so earlier, than start-ups in the United States, where having a failure in one's past is typically seen as a badge of honor (or at least a rite of passage critical for gaining the lessons needed to ultimately succeed). We heard these sentiments echoed repeatedly in our interviews with founders and venture capitalists, and sentiment analysis of media coverage has shown, for example, that only about 17 percent of press coverage in Germany portrays entrepreneurship in a positive light, as compared with 39 percent in the United States.[8]

This lack of a "risk culture" in Europe can also drive some founders to take other, more conservative approaches that sacrifice growth potential. For example, they might narrow ambitions to merely building a sustainable business and regional disruptor. This could partially be driven by the stigmatization of start-up bankruptcy in several European countries, incentivizing founders to be more risk-averse in pursuing growth opportunities. This would put European start-ups at a stark disadvantage to their US peers, which more often aim for global dominance.

However, an increasing number of recent European success stories, such as Delivery Hero, Auto1, or N26, that focused on hypergrowth at the expense of short-term profitability, has shifted this culture. According to our interviews with founders around Europe, such success stories appear to be inspiring other European start-ups to follow a similar path.

Attracting the best talent can be difficult. While Europe has a tech talent cost advantage compared to the United States—salaries for software developers are as much as 50 percent lower in Europe than those in the San Francisco Bay Area or New York City[9]—the continent's start-ups often lack the tools to attract the best talent. Most notably, in many European countries unfavorable equity and stock-option rules make start-ups less appealing to potential employees. For example, more than 75 percent of the EU countries' stock-option rules analyzed by the European VC firm Index Ventures lagged behind those of the United States.[10]

6 Jeremy Kahn, "Why can't Europe do tech?," August 17, 2018, Bloombergquint.com.
7 Jeremy Kahn, "Why can't Europe do tech?," August 17, 2018, Bloombergquint.com.
8 Matthias Jacobi, *Media judgment of entrepreneurial failure–implications for founders,* Technical University of Hamburg, 2018, semanticscholar.org.
9 Salary data from *2019 Global startup ecosystem report*, 2019, startupgenome.com.
10 Dominic Jacquesson, "Rewarding talent: A guide to stock options for European entrepreneurs," Index Ventures, 2017, indexventures.com.

At the same time, the significantly lower number of leading tech companies and successful hypergrowth start-ups in Europe reduces the pool of experienced executives and other talent that have hands-on background in building IPO-sized companies. The type of operational knowledge that comes from deep experience launching and exiting from successful start-ups is key to scaling companies through the late stages.

Innovation 'superhubs' are not as densely packed with resources as those in the United States. "Superhubs" such as Silicon Valley and New York City, which have a high concentration of entrepreneurs, tech talent, and investors, have played a very important role in the success of the US start-up ecosystem. Although London, Paris, Berlin, and Stockholm can be considered the leading hubs in Europe, they have not achieved the same concentration in terms of capital, knowledge, and talent. As a result, only about 30 percent of European start-ups have located their headquarters in a tech superhub—where they might have an easier time attracting talent and funding—versus almost half of US start-ups (Exhibit 8). Furthermore, surveys show that more than 60 percent of founders start their companies where they live or where they have family and support systems.[11] Of course, relocating within the United States is not the same as relocating within Europe, given that in the United States the language and culture will generally be the same. However, if COVID-19 means that working

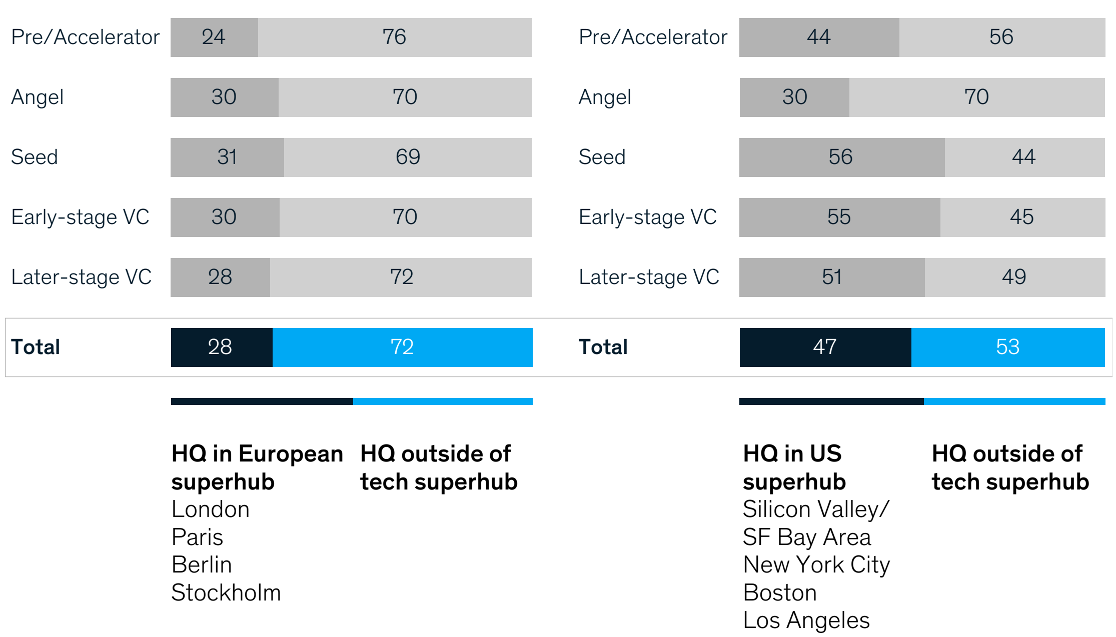
[11] "Picking places," *The state of European tech*, Atomico, 2019, stateofeuropeantech.com.

Exhibit 8

Start-ups in Europe are less concentrated around top hubs compared with those in the United States.

Distribution of European start-ups[1] with HQ in a tech superhub vs outside of superhubs, %

Distribution of US start-ups[1] with HQ in a tech superhub vs outside of superhubs, %



[1] Active VC-backed companies that raised any VC round in last 3 years (since January 1, 2017).
Source: PitchBook; McKinsey analysis

remotely or from home becomes more common, this disparity might become less problematic and potentially could lessen the importance of superhubs.

Even though conditions are improving, the challenges facing Europe's start-up ecosystem remain significant. To overcome them, there are three key areas in particular to consider. The first among these is harmonization and active policy making. Europe could continue to streamline its regulatory frameworks, which remain complex for start-ups to navigate easily. Many European start-ups are seeking to expand operations to multiple regions early on. Similarly, legal frameworks could be reassessed to allow European start-ups to attract and retain the necessary talent to build and scale new companies. Underpinning all of this could be a vision that aims both to defend Europe's existing strengths and to build and support areas of potential growth.

Second, leveraging Europe's assets, which include its public sector and its relative strength in the B2B arena, is critical to growing the start-up ecosystem. As large contractors, governments are key drivers with the power to support innovation. Through this lever, Europe can actively promote its start-up ecosystem. The B2B sectors offer particularly fertile ground here, as the continent's entrepreneurs have already established a solid foundation of innovation by digitizing the activities that serve other businesses—and even more so now, as the coronavirus crisis has created an expectation that more business will be conducted digitally. Europe could also build on another relative strength, sustainability, as the business opportunities around the growing conversation of stakeholder responsibility continue to expand. Europe is a leader in this area and is well positioned to capitalize on this asset.

Third, Europe could look at how to support the culture and capital needed to further grow its start-up ecosystem. Entrepreneurs could take advantage of the improving conditions for start-ups to broaden their ambitions and aim for global leadership. Governments could further this through more risk-willing capital, and considering allocating more semi-public funds toward growing the ecosystem, as well as fostering collaboration between ventures, academia, and industry. It could also prove beneficial to improve conditions for capital and funding—for example, by leveraging European and global partnerships with aligned incentives to allow them to scale faster.

Kim Baroudy is a senior partner in McKinsey's Copenhagen office; **Jonatan Janmark** is an associate partner in the Stockholm office, where **Tobias Strålin** is a partner; and **Abhi Satyavarapu** and **Zeno Ziemke** are consultants in the San Francisco office.