Venture Capital in the EU: A Warning Tale from Helsing

Introduction

It has been long established that the global hub for venture capital (VC) investments is the US, with California, New York and Massachusetts being particularly strong in this type of alternative investment. Europe, on the other hand, is notorious for lagging in the scene, with tight regulations, limited funding, and a stark contrast in performance to its counterpart over the Atlantic and even China on the other side of the continent. European VC has experienced positive development lately, but the growth is still stunted, and much of the framework in place must be revisited if EU is to ensure a bright economic future for its citizens. While there have been significant jumps in recent years, in particular in the defence tech sector, the general trend is not clear-cut.

Performance

Celonis, N26, Revolut, and Personio all have one thing in common: they are all Unicorns. But not only that, they are all based in Europe and among the current 128 start-ups in Europe with a valuation of above $1bn. What might seem like a strong track record, is quickly put into perspective when looking at 641 Unicorns in the US alone. How does the American country perform so much better against its overseas counterpart in terms of innovation and funding? The numbers paint a clear picture, with the US investing $4.8 per one dollar invested in the EU in investment funds. Also, investments in the VC sector in the EU only average 0.4% of the EU's GDP, a third of the US' share, in 2024. Furthermore, there is 55,079 startups in the US, while there are only 39,668 in Europe. The assets under management show an even more significant difference, with $227bn more funds invested in the US relative to the $44bn in Europe. Finally, there were 2,879 deals amounting to $37.5bn in the US in Q3 2024, compared to 1,750 deals worth $13.8bn in Europe. In 2023, the overall funding was at $138bn against $52bn respectively. It becomes apparent that there is a tremendous financial and structural difference between the two regions, one that is full of many intricacies of the EU.

Europe: Small but Successful?

First, one in five US unicorn founders is European, demonstrating the talent the continent has. Additionally, the gap between the two regions had narrowed between 2017 and 2023, with Europe having grown twice as fast as its counterpart. Record numbers of cash were raised in 2021 and 2022 and a growth of near 200% in investments was recorded in 2022 compared to 2020. Furthermore, an advantage of the emerging VC ecosystem is the increased specialisation of players. Ex-founders that have turned into investors themselves usually tend to invest into their own knowledge area to give better support and thus certain sectors are performing better. Specifically, Germany is leading the revolution in a difficult macroeconomic environment, with record investment into Helsing, followed by Isar Aerospace and joined by other firms in the AI, but also health and biotech sectors. Surprisingly, European funds tend to perform better than their US counterparts, as well. Over the past 10 years, Europe led by 6.24% in net annual returns, as well as by 1.92% and 0.31% over 10 and 20 years respectively. The strong focus on mature businesses with a long but safe growth trajectory seems to have a positive impact on return, even though this might hinder innovation.

The Reality

While Europe is indeed on an upwards trend, neglecting recent slowdowns, the overall picture is still looking grim. The continent has serious structural and policy issues which divided governments are not managing to overcome.

In his latest report for the EU Commission, Mario Draghi, former prime minister of Italy and ex-president of the ECB, outlines a €800bn funding gap in the union, part of it being in venture capital, though not limited to it.

A fundamental issue in the EU are the various regulatory frameworks, such as the AI Act, which materialises in 90% of AI funding being in the US – as well as twice as many of the industry's startups. Additional frameworks, such as GDPR add to this gap, however it is not specific rules but rather the sheer number and variety of rules and regulations that pose issues for founders. The often-complicated legal frameworks lead to cross-border issues when combining all 27 member states to one ecosystem, making founding and funding unattractive. The fragmentations in tax laws, capital raisings, and other regulatory areas lead to funds only investing in their home country due to the high transaction costs elsewhere.

Furthermore, not only the business environment is difficult, but also the investing frameworks. The European finance sector is heavily based on bank deposits instead of private investments into funds, which leads to a heavier reliance on bank financing overall. In return, the increasing minimum capital and collateral frameworks by the EU hinder these banks from investing their cash at hand. Generally, banks do not like the long-time horizon, needed sector expertise or risk profile of VC investing, which makes it an unattractive investment. Also pension or insurance funds often do not have the mandate to invest into early stage or growth startups and funds, due to their flat risk profile, mandated by the Solvency II directive since early 2016. Additionally, there is two regulatory frameworks overseeing investments by funds. One of them is the European Venture Capital Fund Regulation (EuVECA) for funds with AUM below €500m, the other one is the Alternative Investment Fund Managers Directive (AIFMD) for AUM above the threshold. The former mainly targets VCs as they tend to have a lower AUM. While it enables funds to invest EU-wide, it also imposes tight regulations on use of capital, eligible investments and terms of supervision. The latter directive does not regulate investment targets as tight, but it imposes several other restrictions on valuation of assets, transparency, marketing, capital requirements and many more areas. These three legislations and regulations are disadvantaging European funds as they must battle tight restrictions in order to be operative in the first place, unlike their American counterparts.

Additionally, a high fragmentation of capital markets weakens exit opportunities and thus valuations. The less competitive market yields less IPOs and thus weaker exit opportunities to public markets, compared to the US. A possible solution, also proposed by Draghi in his paper, would be a capital markets union, with a unified regulatory framework with the aim of creating easier access and improved exit opportunities which would trickle down to VC investments. Another tremendous issue poses the lack of Series B funding due to very little investors at that stage, which would eventually be bridged by an EU venture investment fund. While government investments are effective, they must be mixed with private investments, otherwise the lack of selection and guidance on the state's side will harm general startup performance.

Overall, the European VC ecosystem is in constant growth and has a bright future ahead. If the governments on both EU and national level can take the needed steps, the union will be able to catch up to its overseas competitor and secure innovation and economic wellbeing.

Defence Tech VC in Europe

Over the past few years, attention and funding towards EU Defence Tech start-ups have starkly increased. Since 2022, in fact, the share of VC funding allocated to the sector has more than tripled, moving from 0.4% to 1.8%. This trend has been mostly driven by the outbreak of conflicts near the EU borders, such as the Russia-Ukraine war and the latest conflicts in the Middle East. Moreover, such recent conflicts have also shown an increasing use of AI and advanced technologies, which further highlight the relevance of the industry.

The overall growth in the EU Defence tech sector shows that the ideas and human capital required to build successful companies are present. In particular, the overall capital raised has increased from around €160m in 2020 to projected €1bn in 2024. In terms of geographies, the three most active countries are Germany, United Kingdom, and France, which accounted for around 87% of the capital raised over the last 6 years.

In general, European VC investors have typically been reluctant to invest in defence technology and dual-use goods' companies due to ESG, ethical, and reputational concerns. The trend slightly changed after the outbreak of the Russia-Ukraine war, as more capital began to flow into the industry. Nonetheless, domestic investors have provided the majority of capital during the past years, averaging 60% of the overall funding allocated to defence start-ups. This composition, though, has shifted, and in 2024 around 66% of the funding came from US VC investors, compared to just 18% in 2023.

With larger seed rounds taking place now, such as the €450m funding for Helsing, a German-based defence start-up, US investors are playing a more prominent role. In particular, EU VC funds typically cannot commit to such large equity tickets, and therefore start-ups turn to non-EU investors, mostly US funds. This holds true not only for the defence tech sector but also for the broader European VC landscape, which is not yet able to compete with US investors.

Helsing

The largest funding round of the year so far has been accomplished by Helsing, the Munich-based start-up, founded in 2021 by Gundbert Scherf, Niklas Köhler, and Torsten Reil. The company focuses on developing AI technology to process large-scale information coming from sensors and systems both on the ground and in the air to provide intelligence to military forces. In particular, the software developed by the firm aims at using data from infrared, radio frequencies and sensors placed on military equipment or drones to create live analysis of the overall situation.

Helsing has closed several partnerships with private companies as well as governments. In June 2023, Helsing and its partner SAAB [STO: SAAB-B] were selected by the German government to develop new technology capabilities for the upcoming model of the Eurofighter aircraft. Moreover, in August 2023, Helsing took part in the consortium of firms winning the contract to provide the AI backbone for the FCAS (Future Combat Air System) program. This is a multinational joint initiative between Germany, France, and Spain to develop the next generation of combat fighter aircrafts. In addition to the above-mentioned contracts, the strong interest from investors came also from the fact that Helsing's technology has been actively used in the Ukraine-Russia war since 2022.

Over the past three years, Helsing has been able to raise almost €800m across different rounds, the latest of which valued the company at around $4.5bn.

The first significant investment in Helsing was received from Daniel Ek, the founder of Spotify. Back in 2021, the Swedish entrepreneur invested around €100m through his Prima Materia fund. The company had an implied valuation of around €400m. The funding came a month after Helsing had announced the beginning of a partnership with Airbus.

The Series B round took place in 2023 and was led by the US venture capital firm General Catalyst along with the Swedish defence group SAAB. Helsing raised €209m at a valuation of around €1.5bn. In particular, the Swedish group disclosed that it had acquired a 5% stake in the German company for around €75m, with the rest of the capital provided by the US venture capital firm. The investment from SAAB strengthens the partnership among the two European defence companies and highlights the relevance of making strategic investments across EU defence groups to build long-lasting relationships between firms.

The latest round of funding was closed in July 2024 and saw the Munich-based firm raising €450m. The Series C financing was led again by General Catalyst along with Elad Gil, Accel, Saab, Lightspeed, Plural, and Greenoaks. The implied valuation is around $4.5bn, three times the one reached in the previous year through the Series B funding. This valuation places Helsing among the most valuable start-ups in Europe, along with the French AI start-up Mistral, which this year raised €600m, with an implied valuation of around €6bn.

Domestic investors were a minority in the capital raised by Helsing this year, in line with the overall trend in the VC defence space. Although the stronger availability of capital makes the growth of such companies easier, it also raises possible implications in terms of the ownership of critical assets for European countries. While established defence companies tend to be controlled by government-related agencies, as they play a peculiar role within the respective countries, sometimes the major shareholders in European defence tech start-ups are US VC funds. This result might not be in the best interest of the European countries going forward, but probably more structural changes are required to invert the trend.

Europe's Potential

So far, it is obvious that there are various hurdles in place in the EU's VC space. However, the current pessimistic picture can be overturned, albeit with significant efforts both from the EU and its Member States. First, a true Single Capital Markets Union would reduce the cross-border barriers for investors and allow start-ups to access capital easier. This would facilitate investment into foreign entities, as well as improve IPO opportunities for late-stage start-ups. To bolster growth of start-ups, the EU could also create incentives for large tech companies to acquire innovative start-ups, which is a major deviation from its current anti-trust policies. Moreover, a regulatory reform, harmonizing laws for investors across Member States, would decrease the costs associated with foreign investment. If regulations overseeing investment into VC were streamlined, pension funds and insurers would be keener to allocate capital to VC funds via more accessible bureaucratic and research processes. Furthermore, the EU must focus on its people. There must be more investment in STEM education, assistance in attracting global talent, encouragement of entrepreneurship. The EU must adopt a risk-taking culture, transform failures into learning opportunities and promote success stories. Perhaps, the Union could balance its investment into mature businesses with safe trajectories and new, bold start-ups.

Considering the trends in defence tech VC in Europe, it becomes clear that the Union has the potential to be at least on par with the US and China. While we are just at the beginning of the road, sensible policymaking and a transformative approach of the Member States could definitely bring back the glory to Europe's human capital, innovations, and strategic strength.

TAGS: VC, venture capital, defence, defence tech, Helsing

