Venture capital

A UNIQUE ASSET CLASS WHICH IS HERE TO STAY

Klaus Hommels, founder of a leading European venture fund, explains his approach to investing in tech start-ups, the qualities he looks for in entrepreneurs and how he identifies new opportunities

As one of Europe's leading business angels, Klaus Hommels has established a remarkable success record with investments in some of the largest European and worldwide internet start-ups. They include Skype, Facebook, Airbnb, King, QXL/Tradus, Xing and Spotify (where he is a board member). He has also been named European investor of the year by several organisations over the last ten years.

Lakestar, the venture capital firm he founded, makes investments ranging in size from EUR500,000 to EUR50 million which gives him the utmost freedom in an inefficient asset class where assets are not accurately priced. What he looks for when making investments is the quality of the entrepreneurs.

'It's the people who make the difference. Ideally, I want someone aged between 23 and 34 with a tech background, who has discovered a problem in daily life and is totally passionate about solving it with technology. Because it is difficult to be a lone wolf, I like there to be a co-founder to share the grief and the belief. And the product must be scalable for a bigger market and doable in a clear way.'

The outstanding markets in Europe are London, Berlin and Stockholm, he says, with Paris catching up at London's expense. He has no specific industries he prefers, believing that all of today's great companies were unorthodox in their early days. 'Fixed rules about sectors are a recipe for missing out on those companies. You have to meet the founders, get infected by their passion and see how they solve problems.'

He got into the venture capital business by a process that he attributes largely to luck. It started when he was 16 and his grandmother gave him USD20,000 to invest in stocks, warning him to be sceptical of banks. If he made a profit he could keep it, and she would cover any losses.

'It was when Puma was launching its IPO, and as a member of a soccer team I knew their football shoes. So I decided to buy the shares, and since grandma would bear any losses, I went in fully leveraged. And at a time when I was getting DM10 pocket money a month, I made DM100,000 in three months. At the age of 16, I discovered a passion for investing in equity markets!

After graduating with an MBA, he started working for the chief financial officer of Bertelsmann, where his next lucky step was become one of the first employees of a joint venture between the German media group and AOL. As a board member of AOL Germany, he built up its

European operations before deciding to become self-employed in the first two weeks of March 2000. In the second two weeks of March, however, he became unemployed as the tech bubble burst.

'I couldn't invest and for three years, I struggled to keep my head above water – an experience that helped me understand how difficult it is to be an entrepreneur. But in mid-2004, the markets were recovering and I started to invest. Only a few funds had survived the bursting of the tech bubble, and they had had to invest in a market which felt like it was like trying to catch falling knives. I was by then one of the last men standing in venture capital, a lucky coincidence that has allowed me to pursue my passion ever since.

'I was on my own until I formed Lakestar in 2011, with a shared office, shared secretary and shared printer – a low-cost operation for high-energy activities. Venture capital in Europe was an underdeveloped sector at the time, but I had decided that it was the most attractive asset class.

'All the other asset classes correlate to interest rates these days but venture capital doesn't because it builds from nothing, detached from externalities such as interest rates. It is a pretty pure bet if executed thoroughly in a way that is helpful to entrepreneurs and keeps losses to a minimum.'

Lakestar keeps a low profile in the market, with no phone number or email address on its website. 'High visibility and a big brand bring in so many proposals that you lose half the morning every day declining those which are unsuitable. Most approaches come to us through recommendations from trusted referees. For sectors we regard as promising, we go to universities to learn about them and identify companies in the sweet spots. Then we meet everybody in those sweet spots and make deals with them.

'We're very appealing to entrepreneurs: when choosing a venture fund, they are picking the board representative who will steer them through the hard times. We are the fund in Europe that has probably been involved with the most companies that have reached 10-digit valuations, and we have had valuable experience that is rare to get from venture capital.

'US venture funds expect to write off 60 per cent of their investments and make the losses back from those that are superstars. But in the early 2000s, there were not enough of those superstars to compensate, so the strategy had to be different. Our careful choice of companies has meant that we have written off only four over 15 years.'

Klaus Hommels says that family offices are investors he likes to work with, especially those whose principals are still involved in business. 'Successful entrepreneurs always bring something valuable to an investment opportunity, because they understand how much can be changed by technology. And as well as wanting to invest their liquid assets, they also hope to identify threats to their businesses.'

It can be hard for investors tap into venture capital, he says, because it is an inefficient asset class. 'The best way is to team up with a reputable private bank which gets allocations from top venture funds and has access to the businesses they invest in. Doing it on a deal-by-deal basis makes it hard to distinguish good from bad opportunities – one reason why family offices were burnt in the early 2000s.'

Lakestar has been through two fund-raising rounds since 2011. The first raised EUR135 million in 2013 which is fully invested, while around half of the second round of EUR350 million raised in 2015 has been invested.

'So far, I'm very happy that Lakestar has been able to mimic the performances of the companies we invest in,' he says, 'making us one of the strongest venture performers in Europe. The second fund was three times oversubscribed, and I am pleased that we have been able to fulfil the expectations of the investors who put their trust in us.'

The asset class has matured, he adds. There are now a lot of second- or third-time entrepreneurs, more knowledgeable venture capitalists and more investors ready to embrace new technologies. He believes that venture capital is here to stay, and that it will have a big impact in the years to come.

'The US system is 25 years older than Europe's, and 38 per cent of listed companies founded since 1974 have been venture-financed. They employ 38 per cent of employees in that group and account for 63 per cent of market capitalisation. If the same happens in Europe, we will have a several hundred billion market-swing triggered by venture investments in the next 20 years.

'Combined with its low correlation as an asset class, this makes it absolutely essential to be in venture capital as an investor. In the US, endowments and pension funds typically allocate more than 20 per cent of their funds to venture capital which has outperformed the market. I would suggest that an allocation of between 10 and 20 per cent is a good place to start.

'And I practise what I preach. I don't invest in stocks, bonds or hedge funds – only technology and cash.'●

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