Once the preserve of Silicon Valley, Internet incubators are now rapidly expanding in Europe. The question: Will they survive?

Incubators in Europe

A Tough Egg to Hatch

New Ventures: A Special Report

by Des Dearlove

Photography by Holly Lindem

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It's London in late June 2000, and David Hart is conducting a tour of the headquarters of Brainspark PLC, an Internet incubator. Housed in a refurbished five-story warehouse in Clerkenwell, London's dot-com heartland, Brainspark crackles with youthful expectancy and entrepreneurial energy. The atmosphere is informal but intense, more reminiscent of a business school campus than a traditional office.

On the fourth floor, Mr. Hart, a former marketing executive at *The Economist* and now Brainspark's marketing supremo, introduces members of the 70-strong team of MetaPack, an Internet-based logistics company. MetaPack, launched last year, offers end-to-end physical delivery to e-tailers; the company is celebrating having secured second-round financing of £2.6 million ($3.9 million). In another corner of the warehouse is LeisureHub.com Ltd., a 28-person firm offering online B2B services to the leisure industry through a series of trading communities centered on segments such as theme parks, pubs and clubs, and fitness centers.

In total, Brainspark — which was founded in late 1999 by a former Goldman Sachs banker and two colleagues and which follows the incubator model established by U.S.-based firms such as Idealab and Internet Capital Group (ICG) — has in its one-time warehouse 12 fledgling Internet businesses that share a need for seed finance, office space, and help setting up their ventures. In exchange for equity stakes, Brainspark gives its "cubs" a suite of startup services, including support in IT, legal matters, accounting, marketing, public relations, and recruitment. Its core management team of 28 also provides much-needed mentoring for the e-startups' management teams, and guidance as they tread the difficult path to IPO.

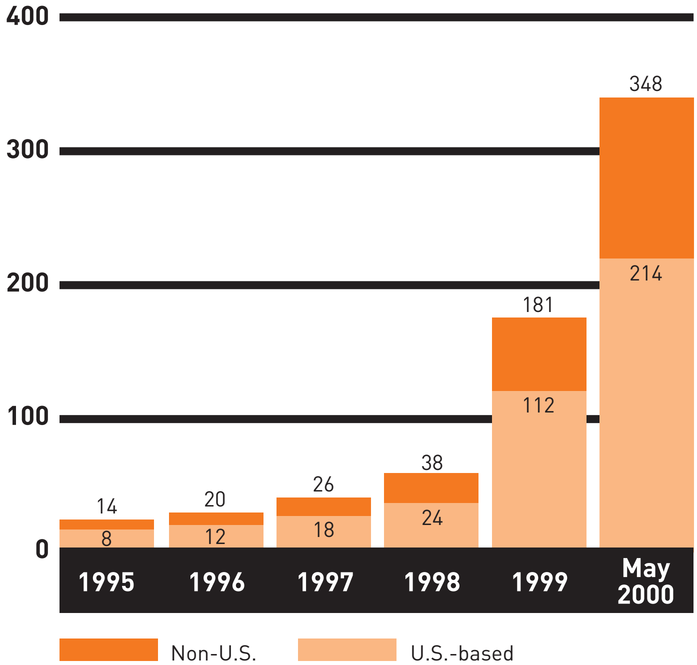
Growth worldwide of such Internet business nurturers has been nothing short of spectacular. (See Exhibit 1.) A study conducted last year by a team from Harvard Business School showed the number of incubators rising globally from 14 in 1995 to 348 as of May 2000. Between November 1999 and May 2000, Internet incubator startups more than doubled worldwide, according to the Harvard report.

While the U.S. is the leader, the study confirms that incubators are spreading rapidly in Europe and Asia. The U.K. in particular is a hotbed of homegrown incubator activity, with companies such as Brainspark, NewMedia Spark PLC, Antfactory, GorillaPark, and Ideas Hub. Other incubator hot spots include Germany, France, Sweden, and the Netherlands. Incubators are also emerging in Ireland, Italy, Austria, Belgium, Finland, Spain, Norway, Switzerland, and the Czech Republic.

French businessman Bernard Arnault, whose Internet investment vehicle Europatweb currently has a portfolio of approximately 40 Internet investments, modeled it after another well-known U.S. incubator, CMGI Inc. Mr. Arnault, chairman of LVMH Moët Hennessy–Louis Vuitton SA, was an early backer of eBay in the U.S., and his European successes include LibertySurf, the French Internet service provider.

Others in the European incubator arena include CMGI and Idealab, and major American management consulting firms like McKinsey & Company, Bain & Company Inc., and Booz-Allen & Hamilton. Blue-chip European corporations are setting up incubation operations, an activity otherwise known as corporate venturing. (See "Europe Ventures Forth," page 130.) Even business schools like the U.K.'s London Business School and Cranfield School of Management have incubator units to

Exhibit 1: **Growth in Internet Incubators Worldwide**



Source: The State of the Incubator Marketplace, Harvard Business School, June 2000, and "The Industry Standard"

help MBA students launch Internet businesses.

Despite this explosion of activity, incubators in the U.S. and Europe, like their young dot-com wards, have felt the recent pain of plummeting stock prices and failed Internet businesses. In the U.S., the stocks of public incubators CMGI and ICG have tumbled in recent months. In October, Idealab canceled a long-planned IPO shortly after two of its "incubatees" went out of business. Lately, Idealab CEO Bill Gross and CMGI chairman and CEO David Wetherell have said they prefer for their companies not to be called incubators at all.

The positive buzz surrounding incubators has not dissipated entirely in Europe, but it cannot disguise a sense of uncertainty. Share-price corrections dampened enthusiasm for the IPO markets on both sides of the Atlantic at a time when many European incubators were hoping to graduate their first classes of Internet companies. Having planned to flip young companies to an IPO within a few months, many European incubators find their exits are barred. And as with their U.S. counterparts, the volatility in Internet stocks has hit incubator share prices hard. Among the European investment companies that floated during the boom, valuations were down by as much as 90 percent as of June 2000.

Still, for Europe, which has a poor track record in e-startups relative to the U.S., Internet incubators are one way entrepreneurial finance is coming to a region that has traditionally been less than fertile ground for any new ventures. "Incubators are a reaction to Europe's lack of experience with early-stage finance," says Phil Fernau, program director at the John H. Foster Center for Private Equity and adjunct associate professor of business administration at the Tuck School of Business at Dartmouth College in New Hampshire.

Indeed, especially in Europe, incubators have exposed a need for new kinds of business funding and development mechanisms beyond traditional corporate R&D and venture capital. As the authors of the Harvard incubator study note, "Although the effectiveness and worth of these incubators remains open to debate, they appear to represent a new organizational model for wealth creation."

Incubators: Old and New

Today most people think of incubators as an Internet phenomenon. Yet in the U.S., incubators date back to the 1950s, when nonprofit organizations set them up to encourage commercial development. Local governments created incubators to stimulate regional business activity. Universities used incubators to capitalize on patentable technologies developed through academic research. Europe has followed a similar pattern, with growth in industrial parks created to foster economic revival in areas of high unemployment.

Today, the vast majority of incubators are for-profit enterprises developing for-profit ventures. Commonplace in the technological ferment of Silicon Valley, incubators — some prefer the term business accelerators — aim to speed the time-to-market for startup businesses and reduce the number of failures.

The new incubator breed, started in Silicon Valley, specializes in e-business startups. Most provide seed funding, physical space, and operational support, including the typical incubator suite of functional services (e.g., IT, legal, accounting, marketing). Some charge fees for these services, but most take an equity stake — usually between 15 and 50 percent — in lieu of fees, and use their contacts with venture capitalists (VCs) to help fledgling businesses attract later-stage funding.

Benoît Leleux, professor of entrepreneurship at IMD, the business school based in Lausanne, Switzerland, categorizes four complementary roles incubators can play to help fledgling companies achieve success:

1. Parents bring developmental skills that are stronger than those of the entrepreneur. They provide guidance, shelter, and support, both technologically and emotionally.

2. Facilitators provide diagnostic help and expert sounding boards.

3. Investors provide capital in exchange for equity stakes, just like venture capitalists. But they differ from VCs in that they are willing to fund small seed rounds (those below the VC radar screen), they take a more active role, and they usually are willing to stay in longer.

4. Country clubs provide opportunities for entrepreneurs to come together with deal-makers and other key industry players who otherwise would be inaccessible.

The classic funding sequence for a startup begins with seed finance, traditionally from angel investors. A first round and a second round of private funding follows, in which VCs might get involved. After this there may be a third round, fourth round, or more rounds of private funding, depending on the state of the IPO market, the type of business, and other factors. Mezzanine-stage funding — typically raised within six months of a planned IPO as a contingency against a delay — is optional. And finally, there is the exit strategy via an IPO. Alternatively, a trade sale could occur at any point.

Although reluctant to offer a typology of incubators, the Harvard study distinguishes four types by their origins. *Startup incubators* are new companies dedicated solely to providing the incubator services described earlier. This is the fastest-growing category and accounted for 58 percent of the incubators in the Harvard survey. *VC incubators* are run by venture-capital firms and made up 31 percent of the survey's sample. In addition, a small number of incubators (5 percent of the survey) are run by *holding companies,* typically new companies set up to develop, acquire, and manage Internet ventures. The fourth category of corporate venturing groups exists within *established corporations,* and these made up 6 percent of the survey's respondents.

The rise of the holding companies might be significant. The Harvard study found that many incubators combine a strategic mix of "built to hold" and "built to flip" companies. Conventional wisdom is that incubators flip companies as soon as their equity stakes can be sold for a profit. The survey found that 44 percent invest to liquidate. But 56 percent invest to hold, meaning they maintain their stakes after the companies turn profitable via IPO or sale. The intent is to create a portfolio of successful companies that can aid another generation of startups.

The surprise is that 60 percent of VC-based incubators claim they invest to hold. Traditionally, VCs have sold their equity stakes as soon as the investment has become profitable. This change lends credence to claims that incubators could be a new organizational model for wealth creation.

Increasingly, the talk among incubators on both sides of the Atlantic is of symbiotic networks of companies, similar to the Japanese *keiretsu.* A number of U.S. Internet incubators see themselves as holding companies, with a stated aim of creating a keiretsu-like community of synergistic businesses. For example, CMGI, which started life as College Marketing Group and went public in 1994, is a network of about 65 Internet businesses, plus affiliated companies and venture investments. Under Mr. Wetherell, CMGI, which he describes as "an Internet operating and development company," has pioneered this symbiotic structure, known in Internet parlance as economic networks, or EcoNets. U.S. firms HotBank, eCompanies LLC, and Divine InterVentures Inc. have followed a similar model.

In Europe, besides Europatweb, ci4net.com Inc. is an EcoNet, with more than 40 partner companies. The Harvard report identified such institutionalized networking as a key dimension of value creation, with networked incubators offering superior value to "incubatees."

But not everyone has confidence in the EcoNet model, and public investors in the U.S. in particular lost confidence during the last half of 2000. Divine InterVentures had a rough ride in the run up to its IPO in July, with flagging investor enthusiasm for incubators forcing the company to postpone its offering seven times. As of November 2000, Divine InterVentures had yet to launch an IPO for any of the startups in its portfolio. CMGI's share price had also fallen from a high of $165 at the start of 2000 to about $12 by early December 2000. Surviving bearish cycles is a challenge for all incubators on both sides of the Atlantic.

Reluctant Entrepreneurs

Regardless of the state of the financial markets or the dot-com sector, there are good reasons for incubators to flourish in Europe, the most significant being that they fill a huge financing void in the investment market for early-stage companies.

A typical tale comes from three 27-year-old entrepreneurs, Ollie Cornes, Alfie Nwawudu, and Damien Webster. Little more than a year ago, Mr. Nwawudu, a Cambridge University graduate, worked at an investment bank; Mr. Cornes and Mr. Webster were employed at a marketing agency, where they worked on Web sites for clients that included Tesco, Saab, and Microsoft. They took the idea for their company Hobomedia.com Ltd. — an online information service for the music, film, and

Incubator hot spots include Germany, France, Sweden, and the Netherlands. The U.K. alone hosts Brainspark, Antfactory, Ideas Hub, and more.

television industries — to 10 venture capitalists. "The venture capitalists told us to go and get our hands dirty, as we hadn't run a company before," Mr. Cornes recalls. "Others said come back when we had raised £300,000."

Instead, Hobomedia found a willing partner in Brainspark. Brainspark, which went public in March 2000 and now employs 260 people, focuses on developing U.K. and European B2B, infrastructure, and enabling-technology Internet startups. It incubates companies that it believes have the potential to reach a market capitalization of about £200 million within two years. The incubator invested £500,000 ($750,000) of seed funding in Hobomedia, which was launched in May 2000 with a team of 20 people. "We believed in the three founders, and we felt that their lack of management experience could be balanced with support and guidance from Brainspark," says Mr. Hart, explaining why they were prepared to back Hobomedia when the VCs would not.

Backing for high-risk startups is par for the course in Silicon Valley, but in Europe, which has lacked both the entrepreneurial culture and a full equivalent to the Nasdaq stock exchange, private equity markets are only just beginning to come to grips with the technological revolution.

Unlike American venture capitalists, European VCs have been reluctant to provide seed funding or early-stage finance, especially when it means backing an inexperienced management team. Until recently, the European VC industry was geared not to startups but to management buyouts, as these often offered the best returns. Startups were funded mostly by entrepreneurs, with the backing of angel investors, individuals with family money, or friendly bank managers. Fledgling companies then struggled to establish themselves before receiving a cash injection.

Venture capitalists generally arrived at the second or third round of funding, prior to a firm's seeking a listing on a market like the Alternative Investments Market, London's market for small, young, and growing companies, or Ofex, the unregulated market established by stock brokerage firm J.P. Jenkins Ltd. These markets were often the only alternative for companies too new to meet the stringent criteria for a full listing on the London Stock Exchange. This is changing, though, with the arrival of Germany's Neuer Markt and other planned markets that could offer a European equivalent of Nasdaq.

While Europe has a few major high-tech success stories to its credit, such as Finland's Nokia Corporation and Sweden's Ericsson, it has nothing to match the meteoric rise of companies like Cisco Systems Inc., the Dell Computer Corporation, and the Microsoft Corporation. Some believe the legislative environment in European countries is to blame for inhibiting the fast-paced entrepreneurial activity that spawns major high-tech players. Entrepreneurs and VCs face more red tape in Europe's highly regulated markets, which slows the flow of capital to startups. Large differences between the tax systems, company laws, accounting procedures, and business cultures of the different European countries are also obstacles to pan-European investment.

One 1999 study by the venture-capital firm 3i Group PLC and INSEAD, the international business school in Fontainebleau, France, noted how the European government's high taxes, including capital gains tax and other charges, reduce entrepreneurial competitiveness in the region. The study found that the U.S. offered a much better environment for entrepreneurs and VCs, and it proposed that governments simplify regulations and reporting requirements and review tax policy to "improve the European climate for entrepreneurship."

At the same time, Europeans are debating the role of government in supporting incubation and other funding of entrepreneurs. Some European governments are getting directly involved (see the profile of Roel Pieper and the Twinning Network, page 142), while others maintain their distance. Sue Birley, professor of entrepreneurship at the University of London's Imperial College School of Management, is skeptical about government involvement with for-profit incubators. "When I was teaching in Indiana, there was a lot of interest in incubators at the U.S. state government level," she says. "The same thing was happening in Northern Ireland when I was there 20 years ago. But when governments meddle with for-profit incubators, they tend to make a mess of it. Government's really useful role is in championing the concept."

Brainspark cofounder Stewart Dodd, too, is unconvinced that more government intervention is good. "The incubator model doesn't work in a governmental framework in Europe any more than it would in the U.S. It's too radical for governments. You have to be at the cutting edge, and you can't do that if you're involved in politics. I'm a slave to market forces. I think incubators have to be, too."

The American Invasion

Established U.S. incubators, sensing opportunity, are now coming to Europe to test the waters. For the Americans who can make their model work, there is everything to play for in Europe. The region is widely acknowledged to have a lead in wireless technology and could be the epicenter of the next wave of mobile commerce.

CMGI has established its European headquarters — or "campus" — in Maidenhead, U.K., which also acts as a European base for other companies in the CMGI group, including AltaVista Europe and Engage Inc. It regards Europe as an expanding two-way market, with a presence on the continent to incubate local entrepreneurs and a launch pad to help successful U.S. firms expand into Europe. Establishing a transatlantic bridge could enable startups to go global on day one, offering huge potential to entrepreneurs on both sides of the ocean.

The question is whether the Americans will succeed in colonizing notoriously fragmented European markets, or whether the homegrown European incubators, with their local networks and knowledge, will be more effective. One argument against the Americans says if the strength of Silicon Valley lies in its closely interwoven networks of personal relationships, then expanding into Europe, where Americans don't have this network, should be difficult.

Meanwhile, European incubator leaders are confident their relationships with the local business and financial community give them the edge. "ICG and Idealab have set the model for incubators, but they don't have the European expertise, or the supplier networks and goodwill of European incubators to cooperate with them," asserts Dafna Israeli, CEO of ismartlab.com, a U.K.-based incubator launched in May 2000 by ci4net.com.

As yet, there is no distinctively European incubation model, although a transcontinental approach is emerging among the larger, most established incubators. However, whether this will lead to Dutch or U.K. incubators incubating Spanish e-startups, for example, is unclear.

Antfactory, founded in September 1999 by a group of Internet entrepreneurs and investors, bills itself as a pan-European accelerator with special emphasis on helping established companies launch new online business activities. Key movers include CEO and chairman Harpal Randhawa; Rob Bier, a former director with the consulting firm Monitor; and ex-McKinsey partner Geoff Crossley. Antfactory has more than 100 employees and offices in London, Munich, Paris, Milan, Madrid, Stockholm, and Amsterdam. It also owns Techubator in Denmark, and is backed by the Internet investment fund JellyWorks PLC and venture capitalist J.H. Whitney & Company. A number of European VCs are Antfactory investment partners, and it now has an investment fund of $350 million. With enthusiasm waning for B2C startups, Antfactory is pursuing B2B opportunities: It has a portfolio of 13 B2B companies and interests in media, retail, IT, and software.

GorillaPark, headquartered in Amsterdam, is another pan-European player with transatlantic aspirations. It is the brainchild of Jerome Mol, whose previous successes include Tornado-Insider.com, which provides a range of services for Internet entrepreneurs. GorillaPark provides startups with mentoring support and access to the networks of experienced executives.

There has been talk of a number of leading U.K. incubators, including Antfactory, Brainspark, Ideas Hub, NewMedia Spark, and iCocoon, forming an alliance. The idea would be to create an incubator network to further share resources and contacts. Insiders play down the significance of the move, but such an alliance could strengthen the position of the homegrown European incubators, and even create a platform for a pan-European rollout.

Sink or Swim

A few early incubator success stories, like the U.K.'s lastminute.com, a Web site backed by NewMedia Spark that offers last-minute deals on holiday travel and theater tickets, have led some business experts on the continent to speak of incubation as a new "European model" for e-startups. But such talk may be premature.

"I get the sense that most are being set up by service providers and entrepreneurs who don't have a track record of tech startups," says Tuck's Phil Ferneau. "All the European incubators I'm running into have a lot of traditional service people around them. I haven't seen many with operational experience and track records as angel investors, as in the U.S."

Corporate experience in human resources, marketing, and the like, Mr. Ferneau suggests, does not necessarily translate to the real needs of the embryonic Internet companies. "An incubator with networks or where the management team has real experience is valuable," he says. "But I've seen too many incubators with no 'value-add.' " In some cases, he says, the incubators may be destroying value rather than adding it. In the worst case, they divert scarce financial and human resources to weaker startups, losing investor capital, squandering entrepreneurial zeal, and undermining the profit models of otherwise viable rivals.

Further, the collapse of the original Boo.com, a leading pan-European e-commerce site funded by Europatweb, and other high-profile dot-com casualties, including the Belgian travel site Leisureplanet.com and U.K.-based natural health Web site Clickmango.com, have shaken European confidence. This and the attendant fall in technology share prices means that many startups housed in European incubators have been unable to fly the nest, forcing the incubators to dig deep into their financial reserves. This has already spurred consolidation among fledgling incubators.

In May 2000, NewMedia Spark acquired Danish rival Softechnet.com PLC to reassure investors, it said; the prize was Softechnet's £23 million war chest. Smaller incubators and those that have invested heavily in B2C startups look especially vulnerable. Harvard University's Jeffrey Berger believes the forthcoming months could be sink-or-swim time for many European and U.S. incubators. "Incubators need to prove themselves along two dimensions — graduation rate and outside financing for incubated companies," he says. "If these two numbers do not improve markedly during the next year, the vitality of the entire incubator market space will be called into question. Some will consolidate and some will cease to exist."

For those that survive on their own, or in an alliance, Brainspark's Mr. Dodd says the incubator concept will keep evolving. To a large extent, the incubators aimed just at startups have already moved on. According to Mr. Dodd, "in the U.K., Antfactory is moving toward large-company e-business spin-offs rather than working with new companies, and Brainspark is thinking about it."

While more realistic Internet valuations have cooled incubator ardor, they are unlikely to extinguish it. Incubators simply have to take a longer-term view of their progeny, relying on cash reserves to carry their portfolios. In Europe, where early-stage investment in technology startups has been lacking, incubators are likely to be a stepping stone to freer private equity markets, rather than the all-encompassing solution to the e-startup problem. +

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Resources

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Laura M. Holson, "Hard Times in the Hatchery," *The New York Times,* October 30, 2000

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