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Investment Strategies in European Venture Capital: The Trade-Off Between Growth and Profits

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Abstract

Venture Capital (VC) is characterized by a high-risk, high-reward dynamic, and a plethora of investment strategies along the spectrum of “growth at all costs” versus sustainable growth. This paper investigates the critical trade-off between these two approaches, with a particular focus on how VC firms evaluate their investment strategies in varying economic conditions and cycles. Using semi-structured interviews with prominent European VC and growth investors, the authors explore how factors such as macro conditions, firm-specific characteristics, and investor background affect these decisions. The findings reveal that while the potential rewards and benefits of “blitzscaling” are recognized by market participants, there is a growing emphasis on sustainable growth and profitability metrics. The qualitative analysis highlights that European investors in the sample of this research favour a disciplined approach and that their investment strategy has not evolved with economic cycles – they do not strongly adhere to the power law of returns. Instead, they have a more balanced portfolio approach, aiming to minimize the percentage of failed startups and not relying on outliers to achieve their fund's return. This paper contributes to the age-old question of assessing the growth at all costs vs. sustainable growth debate by providing insights into how European VC investors navigate economic fluctuations and adapt their investment strategy.

***Note**: Financial metrics mentioned in this paper are defined in the annexe.*

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List of Acronyms

Abbreviation	Explanation
AI	Artificial Intelligence
ARPU	Average Revenue Per User
ARR	Annual Recurring Revenue
AuM	Assets Under Management
B/O	Buyout
B2B	Business to Business
CAC	Customer Acquisition Cost
EBITDA	Earnings Before Interest, Taxes, Depreciation & Amortization
ESG	Environmental, Social & Governance
FCF	Free Cash Flow
G&A	General & Administrative
GE	Growth Equity
GenAI	Generative Artificial Intelligence
GRR	Gross Revenue Retention
IPO	Initial Public Offering
IVC	Independent Venture Capital
LPs	Limited Partners
LTV	Lifetime Value
M&A	Merger And Acquisition
MRR	Monthly Recurring Revenue
NRR	Net Revenue Retention
PE	Private Equity
R&D	Research & Development
S&M	Sales & Marketing
SaaS	Software as a Service
SG&A	Sales, General & Administrative
US	United States
VC	Venture Capital

1. Introduction

In VC, there exists a long-standing debate between proponents of growth at all costs and advocates of sustainable growth. Scholars remain divided on the optimal approach. One faction believes in the power law and supports blitzscaling, endorsing rapid and inefficient growth to achieve market dominance. This strategy has led to notable successes such as Google, Facebook, Uber, and Amazon, where initial unprofitable growth eventually turned profitable at scale (Sullivan, 2016; Bradshaw, 2022; Kirchner et al., 2022). Conversely, an increasing body of research contends that excessive VC funding and blitzscaling can be detrimental to firms. These scholars advocate for sustainable growth with healthy unit economics, pointing to failures like WeWork as cautionary examples. They argue that sustainable growth strategies reduce financial risks and promote long-term success (Christensen et al., 2006; Kang, 2020; Griffith, 2023). This ongoing debate underscores the need for VCs to find a balance between rapid expansion and financial sustainability.

While both academic camps acknowledge the advantages and disadvantages of blitzscaling and sustainable growth strategies, little is known about the investors' perspective on the trade-off between growth and profits, and how the macroeconomic environment influences their decision-making.

So, what is the investor's perspective on the trade-off between growth and profits in their portfolio firms and which unit economics and financial metrics do investors consider in their investments? Further, how does a change in the macroeconomic environment impact investors' preferences between pursuing growth at all cost strategies and prioritizing sustainable growth with healthy financial fundamentals?

Addressing these questions is essential for both founders and investors. For investors, understanding the trade-off between growth and profitability metrics during due diligence can enhance the allocation of capital, especially in volatile economic environments. For founders, insights into investor preferences for growth metrics

versus a clear path to profitability can refine their pitching strategies, empowering them to articulate a compelling equity story that aligns with investor expectations.

To bridge the gap between academic research and practical applications in the VC industry, this research conducted a qualitative analysis involving interviews with European VC investors across various investment stages. The research shows that European investors in the sample of this research, regardless of the economic environment, prioritize financial discipline and follow a more balanced investment approach compared to their US peers (Giuliani, 2022) due to their smaller fund sizes and investment professionals' backgrounds in Private Equity (PE). Early-stage investors focus on metrics like contribution margin, burn rates, burn multiples, and Annual Recurring Revenue (ARR) growth, while growth investors have raised their minimum requirements for ARR in response to the macroeconomic environment. Moreover, Revenue Retention metrics and benchmarks (GRR and NRR) are also essential for growth investors but have remained stable despite the economic downturn – the number of companies that reach these GRR and NRR benchmarks today has decreased, however.

Chapter 2 provides a comprehensive literature review that explores perspectives from both academic camps: proponents of growth at all costs and advocates of sustainable growth strategies. It further examines macroeconomic influences on investment decisions in VC. Research questions are derived from gaps identified in this review. Chapter 3 details the methodological approach employed in the study, outlining the qualitative analysis methodology used to interview European VC investors. Chapter 4 presents the findings of these interviews, focusing on investor perspectives regarding the trade-off between growth and profitability, and adjustments in investment criteria in response to the macroeconomic environment. Finally, Chapter 5 discusses the implications of these findings, considers the limitations of the study, and suggests angles for future research.

2. Literature Review

2.1. The Venture Capital model

VC firms invest in early-stage startups, particularly in high-technology sectors. Apart from investing in startups with outstanding business ideas and founders, VCs mainly focus on industries experiencing more rapid growth compared to the overall market (Zider, 1998). For instance, the hardware sector with major victories such as Apple and Intel were the main focus of VC investments in the 1980s (Devani, 2019), whereas today, investors focus more on AI and Climate Tech (Atomico, 2023).

VC investment stages

In the early stages of VC investments, investors target startups that typically generate little to no revenues as they focus on developing a minimal viable product (MVP), testing the market, and preparing their market launch with a go-to-market strategy (ProductPlan, 2019). Investors in this stage rely heavily on the founders' managerial capabilities due to the absence of financial metrics, making the risk of failure high but with relatively low investment volumes, typically ranging from $500k - $20m. Conversely, in the later stage of VC investment, startups generate revenues and concentrate on institutionalizing their business as well as scaling it. Investors in this phase can use financial indicators to assess the investment risk, leading to larger investment amounts often exceeding $50m (Dukes, 2024).

VC investor types

In the VC landscape, two predominant types of VC funds are the Independent VC (IVC). Corporate VCs and Government VCs play also a significant role but are not in scope of this research. IVCs are driven by financial performance, as the compensation for employees in these funds is heavily performance-based. This focus on financial returns attracts top talent to IVCs, who are motivated to maximize investment outcomes (Bertoni & Tykvová, 2015). The investors in IVCs, known as limited partners (LPs), are typically institutional investors such as pension funds and university endowments and seek high returns for their risky investments, often expecting annual returns between 25% and 30%. To meet these high expectations, VCs encourage their portfolio firms to secure substantial funding to acceler-

ate growth at an unprecedented pace. This rapid expansion is typically followed by even larger investment rounds, ultimately leading to the sale or IPO of the firm that yields substantial returns for early investors (Zider, 1998).

VC returns

In VC, the returns are distributed according to the power law principle, meaning a small fraction of investments account for the majority of returns. These few successful investments, or “home runs”, can generate returns that cover the entire fund's value or more. VC investors rely on these outliers to achieve significant returns on their portfolios. Startups that succeed often do so exponentially, rather than incrementally, leading to substantial gains for early backers. This approach contrasts with conservative investing such as PE, which does not tolerate failures. The power law allows VCs to endure many failed investments, as the exceptional returns from the few successes compensate for the losses (Attar, 2024a).

However, some geographies more believe in the power law than others. Giuliani (2022) compared the investing behaviours of American and European VC by examining whether their investments follow a power law distribution. Her findings suggest that American VCs are more likely to make significantly larger investments in individual startups compared to their European counterparts. This indicates a stronger inclination among American investors to seek out and fund potential high growth “moonshot” opportunities, aligning with the power law principle where a few successful investments generate the majority of returns.

2.2. Growth vs. Profits

To achieve these high returns for their LPs, VCs constantly face the challenging trade-off between prioritizing profits or growth at all costs in their portfolio firms. They can opt for a blitzscaling strategy, which aims to establish rapidly a dominant market position through inefficient growth, potentially backing a future monopoly. However, it carries significant risks as high-speed growth without sustainable financial fundamentals led to substantial losses for investors (Kuratko et al., 2020). Alternatively, VCs can adopt a more sustainable growth strategy, focusing on achieving profitable unit economics from the outset. While this approach mitigates the risk of financial losses, it may also result in missing out on the next industry-

defining “moonshot” opportunity, especially if competitors leverage their first-mover advantage to capture market share and scale more rapidly (Sullivan, 2016; Bradshaw, 2022; Kirchner et al., 2022).

The ongoing debate among scholars is marked by a division between those advocating for growth at all costs and those supporting the principles of sustainable growth.

Growth at all costs

Some of the most outstanding VC success stories, such as Google, Facebook, Uber, and Amazon, achieved market dominance through growth at all costs, also called unprofitable growth. Unprofitable growth implies not that these companies are not profitable but rather that their unit economics are initially negative but turn positive when the start-up reaches scale (the concept of unit economics will be elaborated in-depth in the unit economics chapter). Another term that is connected to “growth at all cost” is blitzscaling, which describes “funding a venture for extremely fast growth and prioritizing speed over efficiency in an environment of uncertainty” (Kuratko et al., 2020).

Blitzscaling is acceptable if companies can change customer behaviour after establishing monopolistic power through global scale and first mover advantage, allowing them to increase prices and turn unit economics profitable (Sullivan, 2016). These companies leverage network effects to build strong barriers to entry and make it exceedingly difficult for competitors to challenge them, eventually enabling these monopolies to increase prices and realize substantial profits (Bradshaw, 2022; Kirchner et al., 2022).

An illustrative example is Uber, which needed 14 years and nearly $32 billion of cumulative losses to become profitable and generate significant cash flow in 2023 (Green, 2023). This substantial financial backing allowed Uber to offer prices lower than taxi services, sustaining losses for extended periods to outlast its traditional competitors. Once Uber achieved market dominance, it could increase prices and generate large profits, especially for its investors. For example, Founder Collective, a seed-stage fund, invested $100,000 in Uber in 2010. Nine years later at

initial public offering (IPO), this stake was worth $300 million, yielding an extraordinary return of nearly 300,000 percent for the firm even before Uber turned profitable, showcasing another argument for blitzscaling. However, the success of this approach depends on the market cycle and investor sentiment. VCs and Uber crafted a compelling equity story, persuading public investors to invest and remain patient for another four years to see profits materialize in 2023. Uber's history exemplifies aggressive VC investment followed by unprofitable growth (Madhav, 2019). Uber has demonstrated its ability to turn its core businesses into profits and generate substantial cash flow. This transformation underscores why VCs are willing to invest heavily in potential monopolies, aiming for long-term market dominance and profitability (Bradshaw, 2022; Kirchner et al., 2022).

Prior research found that blitzscaling is most effective under certain conditions. Apart from having access to early-adopters and maintaining a healthy organizational culture, it is crucial that startups have access to adequate funding to navigate unforeseen challenges (Kirchner et al., 2022). Nevertheless, firms must avoid overfunding to prevent wasteful spending, fostering a culture of inefficiency as pointed out in multiple prior studies (Paley & Flaherty, 2016; Paley, 2017; Kang, 2020).

One can also today observe blitzscaling strategies, especially in the GenAI space. GenAI funding surged 5x in 2023 compared to the previous year, with deals increasing by 66%. Already, 36 GenAI companies have achieved unicorn status (CB Insights, 2023). Notably, European company Mistral raised nine-digit seed funding and recently raised a €600m Series B. Investors are eager to invest in the next Google in this emerging sector and accept a long period of cash burn until these firms can become market leaders with high margins (Lomas, 2024).

To summarize, VCs make risky bets on startups in fast-growing markets with the hope of turning them into monopolies through blitzscaling. VCs are willing to accept unprofitable growth with unhealthy unit economics initially, betting that their investments will scale rapidly and establish monopolistic power. Once a company achieves market dominance, it can adjust its unit economics to become profitable, leveraging its monopolistic position to generate substantial returns. However, there

has been growing research that suggests a contrasting perspective. It indicates that VC investments may be significantly negatively related to firm performance, and investors should invest in more sustainable growth strategies.

Sustainable growth

The opposite strategy to the one described above consists in adopting a more disciplined approach to investing by focusing on what is known as efficient or sustainable growth (Attar, 2024b; Paley & Flaherty, 2016). Definitions when it comes to sustainable growth typically vary from person to person, however it typically refers to the ability of a venture-backed firm to grow its revenue and market share while maintaining or improving its financial and operational efficiency. The key with this approach is for founders to have a clear understanding of unit economics of the business, and to ensure that they are positive, or that a clear path to positive unit economics is underway. The company should have a clear path to profitability with a business model that can efficiently scale. Based on the interviews conducted, and the available literature (Attar, 2024b, Bharat et al., 2007), there is no clear-cut definition of what metrics investors use when referring to “a path to profitability”. Indeed, investors may use different metrics of profitability including EBITDA, FCF, and Contribution Margins. However, the common denominator is that VCs and growth funds want companies to convincingly demonstrate that they have a feasible plan to becoming profitable in the future (time horizon will depend on the type of investor). Sustainable growth is summarised in the following quote by Clayton M. Christensen: “Managers must be patient for growth but impatient for profitability” (Christensen et al., 2006).

Voicing a strong critique to the growth at all costs approach, Vinod Khosla of Khosla Ventures articulates that “some percentage that’s substantially larger than 95% of VCs add zero value. I would bet that 70-80% add negative value to a startup in their advising” (Cutler, 2013). While Khosla states as a reason the lack of VCs' operational experience in startups, others share the view that VCs can drive companies into premature scaling—a frequent precursor to startup failure. This forced growth is driven by the intense pressure to meet the high-performance expectations tied to large funding rounds. In many cases, the primary performance metric imposed by VCs is revenue growth rate. While seemingly appropriate for as-

sessing customer interest and market potential in the early stages, this metric can lead to short-term decision-making that neglects sustainable business practices (Paley, 2017).

One example of this inefficient growth is the WeWork case, which led to tremendous financial losses for its investors. The firm was valued at $47bn in April 2019, based largely on its growth potential rather than actual profitability. During its IPO process, WeWork was revealed to be overvalued as the company incurred a net loss of $1.3bn in the third quarter of 2019, losing more than two dollars for every dollar of sales (Platt, 2019). The problem with WeWork's business model was that the company was growing too fast, opening new locations at an astonishing rate without adequately vetting them. This rapid expansion led to problematic leases, and many locations ended up being unprofitable since they could not generate enough sales from renting them out to their customers who were startups. Thus, WeWork's business model was fundamentally unsustainable, and it relied on continuous growth to mask the fact that it was losing money on every lease they signed. This financial instability led to the failure of its IPO (Accountancy Cloud, 2023). The Japanese conglomerate SoftBank, which had invested approximately $16bn in WeWork, saw one of the most significant losses in VC history when WeWork went through severe financial distress (Griffith, 2023).

Blitzscaling failures are not exclusive to the US; a notable European example is Gorillas. With a mission to revolutionize grocery shopping, Gorillas quickly became the fastest-growing unicorn in Germany, renowned for promising “groceries in 10 minutes” and leveraging dark stores to disrupt market standards. However, this rapid ascent was short-lived. Despite its initial hype, Gorillas' business model proved unsustainable. Reports indicate that the venture was a significant cash burner, failing to achieve profitability. By 2022, just two years after its founding, Gorillas had opened over 200 dark stores but exhausted the $1.3 billion it had raised, losing more than €1.50 for every €1 in net revenue. The company's marketing spend averaged €8 per order, an unsustainable figure for a grocery delivery service. Leadership's emphasis on hyper-growth over profitability ultimately led to investor scepticism, drying up funds and resulting in the company's downfall (Lewin & Pratty, 2022).

Further supporting the camp that VCs have a negative impact on their portfolio firms, a study examining the performance of 71 tech IPOs found that well-capitalized companies did not significantly outperform their lightly capitalized peers up to the IPO event and even underperformed post-IPO. The finding suggests "that too much capital over time creates a culture that substitutes cash for creativity and operational discipline". In contrast, capital constraints force companies to confront inefficiencies early on, fostering a culture of efficiency that often translates into long-term success (Paley & Flaherty, 2016).

A study by Kang (2020) on Korean startups reveals that VC investments have a significant negative impact on the profitability of startups, aligning with the growing perspective that VCs often drive startups towards rapid and unsustainable growth. Specifically, the research found that both the presence of VC investments and an increasing share of VC investments correlate with lower profitability for startups, with higher VC investment percentages linked to reduced profitability metrics. VCs typically push startups to prioritize short-term revenue gains over building sustainable business models, leading to increased operational costs and investment in expansion strategies that do not yield immediate profits.

To conclude, increasing research suggests that excessive VC investment can lead to inefficiencies and unsustainable growth, often resulting in significant financial losses and business failures, as seen in cases like WeWork and Gorillas. Studies indicate that well-capitalized companies frequently underperform compared to their less-funded peers, as an abundance of capital can stifle creativity and operational discipline. Conversely, sustainable growth strategies tend to yield better long-term results for investors by promoting efficiency and stability. But how does the changing macro environment influence the investors' choice between growth and profits?

2.3. Change in global macroeconomic environment

The recent shift in the global macroeconomic environment has recently influenced an alteration in investor focus, particularly within the venture capital sector. Rising

interest rates and tightening capital availability have led to more selective investment behaviours, pushing a transition from prioritizing high-speed growth to emphasizing sustainable growth – profitability being at the core of the latter.

The decade following the 2008 financial crisis was marked by a period of quantitative easing by most central banks which resulted in incredibly low interest rates prevailing in historical terms. Indeed, the average monthly US Federal funds effective rate from January 2008 to February 2022 was of 0.61% while it has been of 3.85% on average from February 2022 to today (end of April 2024). The rate today stands at 5.33% and the expectation of it going down has reduced in previous weeks (Statista, 2024). Moreover, most academics and practitioners agree that the age of "free-money" which characterized the 2008-2022 period is over. For instance, during the authors' interview with a growth equity managing partner, the latter stated that "when it comes to the statement about the "end of free money", I believe it is absolutely right. Our interest rate expectations align with the prevailing sentiment that they will not return to the low levels of 1 or 2% in the near future. Instead, we anticipate that interest rates will stabilize in the 3 to 5% range for the next few years". Consequently, ability for firms to borrow money, and for investors to raise money is reduced.

Moreover, fundraising has significantly reduced in the VC space, as US VC fundraising has reached its lowest point in 6 years in 2023 according to Pitchbook ($67bn) – a 60% decrease when compared to 2022. 2024 looks to be even worse in terms of fundraising with US VCs raising only a mere $9.3bn in Q1 2024 according to Pitchbook (Temkin, 2024). At this pace, 2024 will be the worse fundraising year for US venture capital since 2013, with $37.2bn raised. As a result, start-up and venture backed firms expect to receive less funds from VCs, and their ability to get bridge loans is reduced due to higher interest rates. As such, profitability, and bootstrapping, while it has always been very important, is paramount today – as seen with the WeWork example.

The cyclicality of VC investment is in line with the findings of Ning and Wang (2015), who found that VC activity is closely tied to economic conditions. During periods of economic expansion, characterized by higher GDP growth rates, a

greater industry production index, and lower unemployment rates, the VC industry experiences increased investment volumes, more deals, and higher average deal sizes. Additionally, strong stock and bond markets boost VC activities. However, VCs become more cautious and risk-averse following economic downturns, such as the 2000 dot-com bubble and the 2008 financial crisis, resulting in fewer deals and a shift toward later-stage investments. The same pattern can be observed today in a high-interest rate and inflation environment.

Inflated valuations from the 2020-2022 period entails that exit strategies are more complex, and that down-rounds are now much more prevalent (Wilhelm, 2023). As seen in figure 1 of the annexe, global growth capital invested, by investment stage, has significantly reduced between 2021 and 2023 from $910bn in 2021 to $470bn in 2021, a c. 48% decrease (Bain & Company, 2024).The number of down rounds quadrupled in Q1 2023, when compared to Q1 2022. This not only explains slower deal activity in venture capital, as current investors don't want to incur a loss, but also why profitability is increasingly important as valuation methodologies are now more engrained into fundamentals. For instance, VCs, not only invest in a firm based on revenue multiples, but now also incorporate profitability in the analysis much more than they used to. This is an interesting finding as VC is "something of a self-reinforcing cycle" (Wilhelm, 2023): during a period of exuberance, VCs need to act quickly and will omit key due diligence steps and focus more on growth rather than profitability. In down cycles, even though revenue growth is still more important in explaining valuation, the weight of profitability in total valuation is higher. Empirically, GP Bullhound's (2023) European SaaS report states that as of October 2023, "profitability's correlation with explaining valuation has increased 10-fold compared to the market high of October 2021". It has to be noted that this report refers to SaaS valuation and not VC overall, but based on the current literature, and the interviews conducted by the authors, there is reason to believe that the increased importance of profitability in valuations is a phenomenon that can be generalized to the VC ecosystem in general (the magnitude cannot be assessed at this time).

Finally, due to the abrupt slowdown in IPOs and merger and acquisition (M&A) deal activity by strategic buyers, it is expected that purchases of VC portfolio com-

panies by private equity funds as an exit will increase, which reinforces the importance of profitability. Indeed, for the full year 2023, the global M&A deal value fell by 16% to $3.1 trillion (Henry & Van Oostende, 2024), when compared to 2022 – 2023 total deal value was lower than during the pandemic year of 2020. As such, a lot of practitioners believe that the share of exits through sales to private equity buyers will increase. This is one of the key takeaways from the interview of Mark Suster (2024), Partner at Upfront Ventures, by Harry Stebbings from 20VC. This is a capital finding as private equity funds, typically invest in more profitable companies when compared to VCs (Lattanzio et al, 2023). Indeed, the authors state that "growth equity (GE) and buyout (B/O) funds also similarly invest in profitable (or nearly so) companies, unlike VC funds which on average invest in young cash-flow negative firms" (Lattanzio et al., 2023, p.20). As such, it is hypothesized that VC portfolio companies will need to demonstrate current profitability, or a clear path to profitability in the near future, in order to maximize potential interest from a buyout fund.

VCs face a trade-off between prioritizing profits or growth at all costs in their portfolio firms. They can opt for blitzscaling to quickly dominate the market, risking substantial losses as seen with WeWork, or focus on efficient growth with profitable unit economics, potentially missing out on industry-defining unicorns if competitors scale faster. In a tougher macro environment, VC volumes have decreased, forcing investors to be even more cautious and consider various metrics when assessing investment opportunities.

2.4. Research Questions

Whereas scholars agree that sales growth is the preferred metric compared to profits to measure start-up success (Ardishvili et al., 1998; Delmar, Davidsson, & Gartner, 2003), the authors identified a research gap regarding investors' preferences and considerations when deciding between pursuing growth at all costs vs. sustainable growth with healthy unit economics. With this research, the authors want to shed light on the trade-offs investors are facing when deciding between growth and profits by answering the following four sub-questions:

1. *What is the investor's perspective on the trade-off between growth and profits in their portfolio firms?*

Despite extensive literature on the negative impacts of VC on their portfolio companies, such as premature scaling leading to poor performance or even startup failures (Paley, 2017; Kang, 2020) and the inefficiencies spurred by too much capital (Paley & Flaherty, 2016), there is also significant research highlighting the benefits of aggressive growth strategies. In industries where first-mover advantage is crucial, investors often support growth at all costs to help companies achieve global scale and monopolistic power, which can ultimately lead to profitable unit economics through increased pricing power (Sullivan, 2016; Bradshaw, 2022; Kirchner et al., 2022). However, there is a notable research gap concerning the investor's perspective on the balance between growth and profits. Specifically, existing studies do not adequately address the motivations of investors when deciding between growth at all costs and sustainable growth. Furthermore, they lack insight into how these considerations differ across various investment stages. This research aims to fill this gap by exploring the perspectives of investors at different stages, from early to growth stages.

2. *Which unit economics and financial metrics investors consider in their due diligence?*

Understanding unit economics of startups is a critical step for VCs, during the due diligence process, that is often overlooked or not sufficiently understood by both investors and the companies themselves. There are extensive articles and publications available (Attar, 2024b; Bradshaw, 2022) that explain and detail different types of metrics that can be used such as the LTV/CAC and the ARR growth rate. However, there is a gap in the literature regarding how these metrics are prioritized and evaluated under different economic conditions. Financial metrics and unit economics are a cornerstone way of understanding, and assessing, whether VCs adapt their investment philosophy through down cycles. It also enables to have data points and benchmarks to assess the difference between economic periods, but also as to how valuable profitability and growth is in the eyes of investors.

3. *How does the macro environment impact investor's preference for growth vs. profits?*

Most academics and practitioners agree that the age of "free-money," which characterized the 2008-2022 period, is over due to high interest rates. Consequently, fundraising in the VC space has significantly reduced. While it is well-documented that VC activity is closely tied to economic conditions (Ning & Wang, 2015), there is a research gap regarding how much VC investors' preferences shift towards profitable growth during a recession. The research aims to explore this shift in investor preferences, examining how economic downturns influence the balance between pursuing growth at all costs and prioritizing efficient growth.

4. *What is the VCs' outlook? Is efficient growth here to stay or neglectable as soon as interest rates fall again? (Bonus question)*

During periods of low interest rates, many businesses with poor unit economics received massive funding, leading to numerous mega-round investments despite their unprofitable growth models (Griffith, 2023). This raises the question: will these mega rounds be seen again for unprofitable growth businesses once interest rates drop? Today, AI startups such as MistralAI already raise 9-figure funding rounds again without showing a clear path to profitability (Dillet, 2023). The research aims to investigate the future behaviour of VCs in response to changing interest rates, specifically whether they will revert to funding high-growth as soon as interest rates fall again. It is important to acknowledge that these outlooks are speculative and influenced by subjective opinions within the industry. Therefore, this part is considered as a bonus question rather than a core focus of this research.

3. Methodology

The methodology section of this research outlines the approaches used to examine VCs' trade-off between growth at all costs and sustainable growth. The authors conducted semi-structured interviews to gain detailed insights from industry experts. Huffcutt et al. (2013) underscore the significance of using structured or semi-structured interviews for a more consistent and systematic data collection process. This qualitative method is utilized to address the research question and

sub-questions as it provides a richer and more thorough understanding of the topic in practice. Further, it allows the authors to explore different perspectives that can lead to further research in this field. This method can effectively bridge the gap between academic research findings and real-world applications in the industry.

This approach not only adds to the existing body of knowledge on VCs' balance between growth and profitability but also offers practical insights for industry stakeholders facing the challenges and opportunities associated with blitzscaling.

3.1. Data Collection

Data triangulation involves the use of multiple methods, theories, data sources, or investigators within a single study, all focusing on the same topic or phenomenon. This approach significantly enhances the reliability of research findings by cross-verifying information obtained from different angles. The ultimate goal of data triangulation is to gather results from various approaches, each with its own potential biases, to provide a more comprehensive and accurate understanding of the subject under investigation (Lawlor et al., 2017). Triangulation offers several benefits, including increased confidence in the research results and a richer, more robust data basis.

Applying the triangulation method, the authors utilized a combination of primary and secondary data sources. The primary data was gathered through interviews with investors from the European ecosystem, while the secondary data included a comprehensive review of company websites, business publications, and other materials provided by the informants.

The primary data source was 8 semi-structured interviews with individual respondents, conducted over 3 months. These interviews, typically lasting 30-60 minutes, were preceded by a detailed briefing in which the topic and purpose of the research were thoroughly explained to each informant. The authors of this research focused on European VC investors because they tend to believe less in the power law compared to their US counterparts in a sense that they follow a more balanced portfolio approach (Giuliani, 2022). This provided a unique opportunity to under-

stand their perspectives on the trade-off between growth and profits and whether their approach to investing in startups has shifted in response to macroeconomic changes. Five pilot interviews were conducted before the main data collection effort to provide preliminary insights into the VC landscape and test potential interview questions. The pilot informants were individuals with significant experience in VC, including investors and advisors. Findings from these pilot interviews were used to develop separate interview guides for two informant groups: early-stage and growth-stage investors. These guides consisted of open-ended questions that allowed the informants to share their experiences.

The interview guide for both early- and growth-stage investors started with broad questions about the factors they consider when investing in startups and gradually delved into the trade-off between growth and profits. Whereas the interview guide for early-stage investors mainly focused on how much they value if the target startup can show a clear path to profitability, the interview guide for growth-stage investors emphasized which metrics were considered and how the economic environment influenced their considerations.

In preparing for each interview, the authors reviewed notes from prior interviews about the same segment. However, to protect the anonymity of the informants and encourage honesty, information from prior interviews was not shared with subsequent informants. When clarification was required, follow-up questions were asked via phone or email.

The informants were reached through two primary sources: the author's network and LinkedIn, after an examination of their profiles. A small overview of each interviewee as well as an overview of the most relevant financial metrics in VC can be found in the Annexe.

3.2. Data Analysis

As is typical in inductive research, the authors analysed the data by first examining individual case studies within the informant segments, specifically the views of early-stage and late-stage VC investors, and then comparing these cases to construct

a conceptual framework (Eisenhardt, 1989). Upon completing all of the interviews for a particular segment, the interview transcripts and archival data were synthetized into individual case histories. Each case study represented the perspectives of one investment professional from either early- or growth-stage.

These different cases were utilized for two types of analysis: within-case and cross-case analysis (Miles & Huberman, 2020). Within-case analysis focused on describing the trade-offs that early-stage and late-stage investors consider in the growth versus profits debate. The analysis and data collection proceeded iteratively, refining interview questions to pursue emerging themes within each case. While similarities and differences were not among cases, further analysis was deferred until all case write-ups were complete to maintain the independence of the replication logic. Cross-case analysis began after all cases were completed. Using methods suggested by Miles and Huberman (2020) and Eisenhardt (1989), the similarities and differences between early-stage and late-stage VC investors regarding their considerations of growth versus profits were examined.

From this process emerged a set of insights explaining the trade-offs investors face when deciding between growth and profits, allowing us to build a robust conceptual framework grounded in detailed and comprehensive case analysis.

4. Results

For each case study, the aim is to address each of the research questions:

1. *What is the investor's perspective on the trade-off between growth and profits in their portfolio firms?*
2. *Which unit economics investors consider in their due diligence?*
3. *How does the macro environment impact investors' preference?*
4. *What is the VCs' outlook? Is efficient growth here to stay or neglectable as soon as interest rates fall again?*

An overview of the informants and results can be found in the Annexe.

Company 1

About the firm: Early and Growth-stage VC, sector agnostic, <€500m Assets under Management (AuM), European focus

Trade-off Growth vs. Profits: The VC is overall cash conscious and likes profitability, but it depends on the funds strategy. For early-stage investments, the focus is more on the team, market potential, and competition, with less immediate concern for profitability. The informant mentioned, “For us it's not a problem if the company is burning in the next 10 years as long as they show improvements”. For their growth fund, however, they are more cautious and emphasize showing a path to profitability within a reasonable timeframe. Despite this preference for profitability, they do not push against founders who want to pursue aggressive growth, provided they have a compelling equity story and can demonstrate a clear path to profitability. Furthermore, the team’s background plays a significant role in their focus on sustainable growth. Many team members have previous experience as investors in PE funds, which naturally influences their preference for strategies that balance growth with long-term profitability. Lastly, there is a notable preference for profitability in markets that are being consolidated by PE firms engaging in buy-and-build strategies.

Metrics: In the early stages, the focus is on the burn rate and how much revenue is generated relative to the cash being spent. For growth stage investments, there is a more cautious approach, with a detailed analysis of the burn rate and cash efficiency to ensure sustainable growth and financial health.

Macro shift: The VC has consistently focused on efficient growth and maintained a strong awareness of valuation multiples, particularly EBITDA, as PE firms typically acquire companies based on EBITDA multiples. They noticed, however, that companies which previously focused solely on growth while pitching now also emphasize their plans to achieve profitability. Additionally, firms in 2021 could raise funds in about a month, but now it takes approximately six months. Demonstrating profitability therefore has become crucial as it provides firms the time needed to raise funds under favourable conditions.

Outlook: For early-stage funds, the approach will largely remain unchanged. These funds need to identify fund returners and are willing to pay high valuations for these opportunities, with little focus on profitability at this stage. In the growth stage, however, most funding rounds will likely be smaller as investors become more cautious. Despite this, there will still be a few large outlier rounds where significant investments are made in standout opportunities.

Company 2

About the firm: Ealy-stage VC, sector agnostic, <€500m AuM, Global focus

Trade-off Growth vs. Profits: This fund is known for its disciplined investment approach, summarized by the principle: “Small capital is patient for growth and impatient for profits”. Their best investments have been in pre-revenue companies, indicating a strong focus on early potential. However, they primarily assess a firm's path to profitability to assess whether the founders possess the necessary financial knowledge and can establish a feasible business plan.

Metrics: Investing primarily in Seed and Series A stages, this fund focuses on testing product-market fit. Key metrics include user growth, engagement, and the number of clients onboarded. The fund agrees that excessive VC funding can harm firm performance, so they analyse the burn rate versus user growth to determine if follow-up funding rounds are necessary.

Macro shift: The macro environment has not altered their investment approach. This fund has always prioritized traction and maintained a disciplined strategy, regardless of broader market conditions.

Outlook: The fund believes we are in a cyclical phase and anticipates a return of massive funding rounds. However, they view the current high valuations in artificial intelligence (AI) as indicative of a bubble. Smaller funds, including theirs, will maintain discipline and avoid betting on overly hyped companies, instead focusing on sustainable and realistic investment opportunities.

Company 3

About the firm: Early-stage VC, sector agnostic, <€250m AuM, European focus

Trade-off Growth vs. Profits: The fund firmly opposes a growth at all costs mentality and will not invest in firms with negative contribution margins. This stance is partly due to the fund's DNA, with many team members having prior experience in PE, who had seen into different economic cycles in the past. Additionally, the fund's size influences this approach; those who invest in growth at all costs often overpay, either backing the next unicorn or facing the risk of never exiting. “It’s easier to return 10x at a €10m entry valuation than at a €100m valuation. If the fund notices a culture of inefficiency in a portfolio firm, they step in and challenge hiring sprees to ensure operational discipline. Furthermore, they optimize for profitability in markets consolidated by PEs engaging in buy-and-build strategies.

Metrics: The fund considers the LTV/CAC ratio based on 18 months of historical data, recognizing that most firms raise funds after a strong quarter. They also examine the monthly burn rate versus monthly growth to identify any inefficiencies.

Macro shift: The macro environment has not altered their investment approach. This fund has always maintained a disciplined strategy, regardless of broader market conditions.

Outlook: In the near future, the fund anticipates two types of funding rounds: “Companies raise $100 million rounds simply because they have AI in their name, or they have boring business models but with solid metrics”. Overall, the market is returning to large rounds with potentially inflated valuations. There is a collective hope that these investments will uncover the next Google, but there is also concern about whether it is just a dot AI bubble.

Company 4

About the firm: Early-stage VC, sector agnostic, <€1b AuM, European focus

Trade-off Growth vs. Profits: The fund aims to invest in innovation, which often requires substantial capital in the early stages. The informant says that European funds typically do not believe in the power law principle. They rather follow a more balanced portfolio approach in which they seek decent returners, with little tolerance for “garbage”. They should evaluate each portfolio company to determine its potential and decide whether it should pursue further growth through burning cash or aim for profits. There are very few VCs who can adopt a growth at all costs strategy, as only those with significant capital raised can afford to deploy it aggressively.

Metrics: The fund assesses the team and the significance of the problem the company aims to solve. They prioritize companies demonstrating 3x topline growth year over year and expect founders to outline a clear path to achieve EBITDA profitability. They further consider gross and contribution margin and “sales should be at least 4x the founders’ salary”.

Macro shift: Post-COVID, the fund raised the ARR required for Series A investments because their Series B peers shifted their expectations to higher revenue. Consequently, Series A expectations now include a $2 million ARR minimum. However, at the seed stage, the need to take calculated risks and place bets remains essential.

Outlook: If interest rates decrease in the future and returns for funds increase, the market becomes more liquid and less risk-averse, creating a cyclical effect. But “when markets are more constricted, you think twice about your investment”.

Company 5

About the firm: Series A&B VC, software focus, <€3b AuM, European focus

Trade-off Growth vs. Profits: The fund has consistently favoured disciplined, efficient growth companies. They reject the power law model, stating, “We don't believe in the power law; we don't want to have any company that goes to zero. We have to be 100% sure that they reach $50m ARR”. Unlike the American VC

model, which embraces the power law, the informant say that European funds aim for zero underperforming investments. The fund prioritizes profitability to facilitate exits to PE firms, although this focus on profits is influenced by many investment managers' backgrounds as former PE investors, creating a “chicken and the egg” scenario.

Metrics: The fund closely examines how much capital firms need to raise to achieve their ARR growth targets. They also evaluate the ARR profile and compare it to the EBITDA profile, implementing a variation of the rule of 40 by comparing ARR growth and EBITDA margin.

Macro shift: In 2021, companies could raise Series A rounds without any revenue. “Rounds were totally decorrelated with revenue; they were just correlated with intangible traction”. Investors now have less access to capital and therefore invest in companies that show actual traction through ARR growth in Series A rounds.

Outlook: There is a GenAI bubble, partly because pre-seed funds still have capital available and get pressured by their LPs to invest in this emerging technology. Beyond this bubble, the focus for funds without unlimited access to capital remains on profitability. This cyclical nature, coupled with evolving interest rates, indicates that larger funding rounds in the future will likely be seen.

Company 6

About the firm: Pureplay growth investor, Business to Business (B2B) tech focus, <€1b AuM

Trade-off Growth vs. Profits: The firm places a strong emphasis on healthy unit economics over mere growth. While it is important for founders to outline a path to profitability, the firm prioritizes efficiency metrics such as Net New ARR per Sales & Marketing spend, LTV/CAC ratio, and CAC Payback. In high cash-burning segments like logistics, this focus is even more critical. The fund believes that excessive valuations and unnecessary VC funding can be detrimental to startups, align-

ing with the view that financial discipline and sustainable growth is key to long-term success.

Metrics: The firm evaluates potential investments using a range of metrics, including ARR growth rates, Gross Revenue Retention (GRR), Net Revenue Retention (NRR), LTV, and CAC. For enterprise models, they expect GRR of 90%+ and NRR of 110%+, whereas for smaller and medium sized models, the benchmarks are GRR of 80%+ and NRR of 105%+. These benchmarks have remained stable despite economic downturns, though the number of companies achieving them has decreased. Net dollar retention is deemed critical as it indicates growth without needing new customer acquisition. An LTV/CAC ratio of 3x after three years is considered good, and they use a gross margin-adjusted metric for LTV/CAC.

Macro shift: Interest rate changes have not significantly affected the firm's overall investment approach, although they acknowledge a slight decrease in LTV/CAC expectations due to higher CAC levels. The interviewee noted that while companies like Mistral AI can still raise seed rounds at high valuations without clear paths to profitability, this is more a reflection of speculative VC cases rather than growth-driven cases. The firm highlights the importance of GRR and NRR for European startups to successfully fundraise in the current market, emphasizing customer satisfaction and solving real customer pain points.

Outlook: The focus on efficient growth is expected to persist even with potential future rate cuts (as announced by the European Central Bank on June 6th, 2024). The fund sees the biggest challenge for the European startup ecosystem in the next 12-18 months as the difficulty for companies that have done bridge rounds in the past two years to raise new funding. To prepare portfolio companies for successful exits, whether through IPOs, acquisitions, or other routes, the firm works on environmental, social and governance (ESG) related topics and aims to secure downside protection while maximizing upside potential. This approach includes making companies more profitable and showing a clear path to profitability.

Company 7

About the firm: Pureplay growth investor, B2B SaaS focus, <€3b AuM

Trade-off Growth vs. Profits: In 2021-2022, there was a clear focus on growth amongst growth investors, which often came at the expense of profitability. Today, the landscape has changed, and the focus very much is on efficient growth. Growth remains paramount but the impact on valuation has balanced – with a valuation ratio of growth to profitability of around 3.0x today. It is important to note that this investor highlights how the fund has not changed its investment approach through cycles and that it has always had efficient growth, or at least a clear path to profitability, in mind when assessing investment opportunities. The importance of efficient growth and a path to profitability is inherently linked to the fund's strategy given both founders previously worked for later-stage private equity funds.

Metrics: The fund evaluates opportunities using a broad range of metrics, but the speaker strongly emphasised the importance of the LTV/CAC ratio. He argued that it is the best ratio for understanding a business's long-term profitability – if the parameters used for its calculation are accurate, and the cost base of the firm well understood. While the generally accepted benchmark for a good SaaS LTV/CAC ratio is of 3.0x, the fund aims for companies with a ratio > 4.5x since it looks for top performers.

Macro shift: The speaker acknowledges that the current market environment is challenging due to significant geopolitical risk and economic uncertainty. However, this fund has always adopted a disciplined investment strategy and is not adapting its investment criteria. The only difference is that less firms now meet this criterion.

Outlook: In the next couple of years, the fund expects private equity buyers to play a more prominent role in VC exits which does emphasise the importance of having portfolio companies that are either profitable, or on track to profitability. Moreover, the market is undergoing a cleansing process, with numerous privately owned companies and startups that are expected to be acquired or to go bankrupt in the short run. This presents a lot of opportunities for funds that have dry powder.

Company 8

About the firm: Family office growth equity arm, technology focused, <€2b AuM

Trade-off Growth vs. Profits: The firm highlights the importance of having a balanced approach between growth and profitability. Growth is essential, especially in the fast-moving technology sector (particularly for AI), but firms need to demonstrate a clear path to profitability. Compared to other growth investors of their scale, the fund can invest in less profitable companies, but it needs the assurance that the path to profitability is clear. The key is ensuring that unit economics and contribution margin make sense so that the firm can turn very profitable once it scales massively – It is believed that the firm can scale.

Metrics: The fund uses several different metrics such as LTV/CAC, ARR growth, contribution margin, and gross margin. Contribution margin and variable costs are essential for them as they only invest in asset light businesses that have a clear potential to scale enabling them to benefit from significant economies of scale. Minimum LTV/CAC ratio of 3.0x when looking at SaaS businesses, and a minimum ARR growth rate of c. 15%, which needs to be higher if the business is not profitable (at least c. 20-25%+ year on year ARR growth).

Macro shift: The investment strategy, considering the current macro environment characterized by high interest rates and tight capital availability, has not changed. The fund does advertise the importance it places on financial rigor for portfolio companies to LPs more than was previously the case, however. The speaker also adds that the shift in investment strategy and increased “tightness” is in his experience more prevalent in the United States (US). He argued that funds in the US were on average more inclined to underwrite riskier bets, which were not anchored in fundamentals as much.

Outlook: The focus on efficient growth and ensuring a path to profitability will be here to stay in the future, even if macroeconomic conditions improve – which they will. Indeed, the speaker believes strongly that private equity actors will increasingly play a role in VC exits, which will naturally force the industry to increasingly val-

ue profitability. Deep tech companies will continue to raise “obscene” amounts of money without any fundamental financial metrics that rationally validate that decision. However, it is understandable as backing the few companies that will emerge as leaders in their field will yield returns unmatched by any other strategies or investments.

5. Discussion

Through this research, the data collected contributes significantly to the ongoing debate about growth at all costs versus efficient growth in VC. By focusing on leading European VCs across both early and growth stages, valuable insights were gained into why European investors in the sample of this research tend to maintain financial discipline regardless of the macroeconomic environment. Further, the findings reveal what financial metrics are prioritized by European VCs, shedding light on their investment criteria and decision-making processes.

5.1. Trade-off Growth vs. Profits

European VCs maintain financial discipline at every stage of funding. While some are strict, investing only in firms with a positive contribution margin, others are more flexible and willing to support companies burning cash if the burn ratio (cash burn to ARR/revenue growth) aligns with their standards and there is a clear path to profitability. This approach is consistent in both early- and late-stage VCs, though requirements become stricter at the growth-stage funds.

There are several reasons for this more disciplined approach. Firstly, European VCs generally have a different mentality than their US counterparts as they do not believe in the power law. They tend to avoid “crazy” moonshot bets, favoring a balanced portfolio where they aim for 10x returners without significant losses. This skepticism is evident in their prudent stance towards the current GenAI bubble, which they perceive as overhyped. European funds attribute this bubble to the large volume of capital early-stage funds still have access to and pressure on early-stage funds from their LPs to invest in this trending technology despite the associated high risks. GenAI entails the potential to invest in the next Google or

Meta, but this bet can be played only by a few large VCs that are mainly located in Silicon Valley.

Secondly, the size and access to LP funding of European funds, ranging from $250 million to $3 billion AuM in the case of the funds that were interviewed, limit their ability to pursue moonshot investments. A 9-digit entry valuation at the seed stage makes it impractical for these funds to sustain a company's growth until an IPO or trade sale. As one informant noted, “It's easier to return 10x at a €10m entry valuation than at a €100m valuation”.

Lastly, PE significantly influences European VC investment strategies, and “it is the chicken and the egg”. With the IPO window closed for the past two years due to macroeconomic changes, PE exits have become more attractive, albeit less lucrative, as PEs tend to pay less than strategic and institutional investors. Additionally, many European VC teams are comprised of former PE professionals who favour a more cautious and financially disciplined investment approach. This PE influence reinforces a preference for sustainable growth over growth at all costs.

5.2. Metrics

Overall, it is interesting to notice that earlier stage funds rely on very few metrics, if any. Indeed, the key elements for them is mostly linked to the founding team, the product, the product market fit, and the future growth plan the company is setting up. If metrics are used, they are usually limited to contribution margin, burn rates, burn multiples, and ARR / MRR growth – some investors did not even properly know what the LTV/CAC metric is. Notwithstanding, it has been highlighted by several early-stage investors that founders need to have a solid understanding of the cash they are burning and the viability of the business model as the company scales. For instance, it is essential for a SaaS start-up to have a high contribution margin and the ability to scale at very little cost when it increases its client base – once the costs of getting set up have been borne. This has been highlighted as one of the main reasons why startups with successful and attractive products with high demand fail.

Growth investors, spend a lot more time analysing financial metrics and the unit economics of businesses as they invest at a later stage – firms are typically EBITDA positive, close to becoming EBITDA positive, or show exceptional revenue growth rates for a negative profitability deemed acceptable. The main finding from the interviews conducted with growth stage investors is that all have different thresholds for metrics, and that all investors have their preferred metrics and ways of interpreting results. However, the common denominator is that financial metrics are used as a way of assessing where on the growth at all costs vs. efficient growth spectrum, companies are. Some investors define it as a "checklist" that companies must validate to fit the investment characteristics of a given fund.

Finally, another interesting statement made by several interviewees is that financial metrics are used as a way of understanding how literate founders are in some more financial and technical aspects of their company and products. Indeed, metrics can be used not only to gauge the financial position of a firm, but also to assess how deeply founders have considered their products and the firm's revenue-generating potential. Investors, by definition, are interested in selling their stake in the future at a higher price to generate returns which is typically very different from the incentives of a founder (at least for the ones that are not solely driven by financial gain). As such, when discussing metrics with the start-up, investors can assess whether the founders are aware of the viability of their product and company.

5.3. Macro shift

Overall, the macro shift did not change European VCs' perspective on the growth vs. profits debate, as they have always favoured sustainable business models over growth at all costs, regardless of the macro environment. What has changed is that founders, who previously focused solely on growth while pitching, now emphasize their plans to achieve profitability. This shift is crucial as it takes longer to raise a round, and profitability helps bridge this time.

Furthermore, VCs have increased their minimum investment requirements. One sarcastically mentioned that in 2021, it was possible to raise a Series A without any revenue, and “rounds were totally decorrelated with revenue; they were just correlated with intangible traction”. Now, the standards have changed, initiated by growth-stage Series B+ investors who raised their bar for minimum ARR investments. As these investors raised their standards, early-stage funds had to adapt to avoid a significant time gap between Series A and Series B rounds. However, in the seed and pre-seed stages, the focus remains on actual traction in terms of user growth, and revenue is not required.

Therefore, the change in macro conditions did not alter the views of European investors in the sample of this research on the growth vs. profits debate, as they have always been disciplined. However, the minimum investment requirements regarding top-line figures have increased because “when markets are more constricted, you think twice about your investment”.

5.4. Outlook

VC is cyclical, and as more capital becomes available, larger rounds with higher valuations and less risk-averse investors are likely to emerge. In the early stages (pre-seed/seed), investments in moonshots will persist, while later-stage investors, particularly Series B+, are expected to maintain a cautious approach, despite occasional outlier rounds. According to the investors we interviewed, the current high valuations in the GenAI sector represent a bubble, with only a few US investors expected to continue participating as they have the financial fire power to make these bets.

European VCs will maintain their financial discipline, as they always have. Additionally, as institutional investors increasingly demand this information, ESG factors will remain a critical focus for investors, particularly in the later stages when preparing firms for IPOs as institutional investors demand ESG data.

5.5 Limitations and Future Research Directions

The first limitation of this study is that it is based on a relatively small sample of eight interviewees, which may not adequately represent the wider population's perspectives and experiences. Moreover, this research focused on European VC investors to understand their perspective on the growth vs. profits debate. While this provided valuable insights, it would be interesting to explore the views of US investors, who are often strong proponents of the power law (Giuliani, 2022). It is hypothesized that US VCs, frequently founders or operators turned investors, prioritize different factors compared to their European counterparts, who often come from a PE background and emphasize strict financial metrics. Perhaps due to their backgrounds as former operators, US VCs are more likely to invest in moonshot opportunities. Access to more capital from LPs and a more mature entrepreneurial ecosystem are also critical factors that weigh in the geographical comparison of pursuing a sustainable growth strategy or not.

Furthermore, a qualitative research approach was employed to capture the nuanced perspectives of investment professionals on the trade-off between growth at all costs and efficient growth. Conducting a quantitative analysis of how investment strategies and portfolio compositions have changed due to the macro environment was beyond the scope of this research. However, such an analysis could be an exciting direction for future research, cross-checking the qualitative statements that were collected from European VCs.

6. Conclusion

This research has explored the perspectives within the VC industry regarding the trade-off between growth at all costs and efficient growth strategies. Through a comprehensive literature review and qualitative analysis of European VC investors, key insights into investor preferences and decision-making processes were identified.

The findings of this research reveal that while there is recognition of the potential rewards of blitzscaling for achieving market dominance, there is also a growing emphasis on sustainable growth and profitability metrics, especially in response to

economic fluctuations. The qualitative analysis finds that European investors in the sample of this research demonstrate a preference for financial discipline across all funding stages, influenced by their professional backgrounds in PE and the relative constraints of smaller fund sizes compared to the US market. They are not strong believers in the power law regardless of the macroeconomic environment.

Based on the interviews, European founders should focus on demonstrating clear paths to profitability while articulating their equity story to attract funding. Meanwhile, investors should remain vigilant in balancing risk and reward, adapting strategies to capitalize on emerging opportunities while safeguarding portfolio stability. Looking forward, European investment professionals agree on a cyclical nature in VC investments, anticipating larger funding rounds with higher valuations as capital availability increases. Early-stage investors will continue to support moonshot endeavours, while later-stage investors, particularly Series B and beyond, are expected to maintain a cautious approach despite occasional outlier rounds.

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Annexe

	Investment stage	Sector Focus	AuM	Area of focus	Level of Seniority
Company 1	Early and growth stage VC	Sector agnostic	<$500m	Europe	Principal
Company 2	Early stage VC	Sector agnostic	<$500m	Worldwide	Associate
Company 3	Early stage VC	Sector agnostic	<$250m	Europe	Analyst
Company 4	Early stage VC	Sector agnostic	<$1b	Europe	Associate
Company 5	Series A&B VC	Software focus	<$3b	Europe	Associate
Company 6	Pureplay growth investor	B2B Tech focus	<$1b	Europe	Associate
Company 7	Pureplay growth investor	B2B SaaS focus	<$3b	Europe	Managing Partner
Company 8	Family office growth equity arm	Technology fo-cus	<$2b	Europe & US	Investment Manager

Table 1: Overview of the informants

	Investment stage	Key Metrics Used
Company 1	Early and growth stage VC	Early stage: Burn rates and burn multiples Growth stage: Burn rates and EBITDA margins
Company 2	Early stage VC	Product market fit, user growth, and clients onboarded
Company 3	Early stage VC	LTV/CAC ratio and burn multiples
Company 4	Early stage VC	3x topline growth year over year, gross and contribution margins
Company 5	Series A&B VC	ARR growth, EBITDA margins, rule of 40
Company 6	Pureplay growth investor	ARR growth, GRR, NRR, LTV/CAC ratio

Company 7	Pureplay growth investor	LTV/CAC ratio
Company 8	Family office growth equity arm	ARR growth, LTV/CAC ratio, gross and contribution margins

Table 2: Summary table of key metrics used

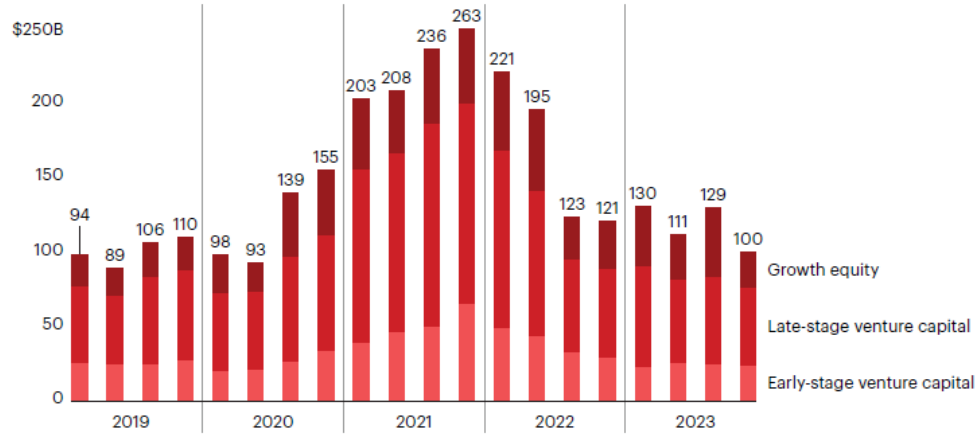

Figure 1: Global growth capital invested, by investment stage, quarterly

Source: Bain & Company Global Private Equity Report 2024 p.14

The key efficient growth metrics are the following:

i. **Customer metrics**: (MRR / ARR, Customer Retention Rates and Churn, Net Dollar Retention Rate, LTV and CAC, CAC Payback).

ii. **Profitability metrics**: (Rule of 40, Contribution Margin, Cash Burn, and Burn Multiple).

Both customer metrics and profitability metrics are critical in assessing investment opportunities for VCs. Customer metrics mostly focus on market traction, customer engagement, and the sustainability of growth through unit economics. Profitability metrics focus on financial performance and operational efficiency. VCs should use both in helping them assess the growth at all costs vs. efficient growth question.

i. Customer Metrics:

Monthly / Annual Recurring Revenue (MRR / ARR): defined as the predictable revenue earned from customers each month. This revenue is predictable and will occur with a relatively high level of certainty. This type of revenue, and metric for that matter, is particularly relevant for subscription-based models such as Software

as a service (SaaS). Recurring revenue is highly valued by investors as it entails a low level of risk regarding the future of the firm – for instance, this is why One Peak solely invests in SaaS, as they believe it is the business model with the least risk due to the high recurring nature of revenue. ARR refers to the same metric, but it is annualized.

Customer Retention Rates and Churn: To track growth in startups, one of the most popular metrics among practitioners is customer retention rates. The initial measure, gross customer retention, assesses the count of existing customers at the start of a period who are still present at its end. Conversely, churn measures the proportion of customers lost compared to those remaining. Additionally, net customer retention builds on gross retention by including new customer acquisitions during the period. Below, a more detailed explanation of how to calculate each with a numerical example is provided:

- **Gross Customer Retention**:

$$Gross\ Customer\ Retention = \frac{(Beginning\ Customers - Customers\ lost)}{Beginning\ Customers}$$

- **Churn Rate** is always the inverse of the gross customer retention: 1-gross retention
- **Net Customer Retention:**

$$Net\ Customer\ Retention = \frac{(Total\ Ending\ Customers)}{Beginning\ Customers}$$

- **Numerical Example:**

	Year 2	Year 3
Beginning Customers	1,000	1,200
Customers Lost	10	60
Customers Added	210	300
Total Customers	1,200	1,440
Churn Rate	**1%**	**5%**
Gross Retention	**99%**	**95%**
Net Retention	**120%**	**120%**

Table 3: Numerical example for customer retention rates and churn

Customer retention rates and churn provides a valuable insight into the health of a business and its viability in the long run through its customer base growth trajectory. However, this metric also suffers from several limitations, including the assumption that customer value is identical, and that it does not provide insights into the nuances of customer churn which are essential to understanding the strengths and weaknesses of a business. To better understand these nuances, practitioners often like to look at net dollar retention.

Net Dollar Retention Rate: As companies start to scale, more emphasis is placed on the actual dollar brought in by the business, as opposed to solely the customer count. This metric calculates the net growth by adding any increases from revenue expansion to existing customers and subtracting losses such as down-sells and customer churn from the existing customer base. This metric is calculated in the following manner:

$$Net\ Dollar\ Retention = \frac{Beginning\ Revenue + Expansion\ Revenue - Downsells - Churn}{Beginning\ Revenue}$$

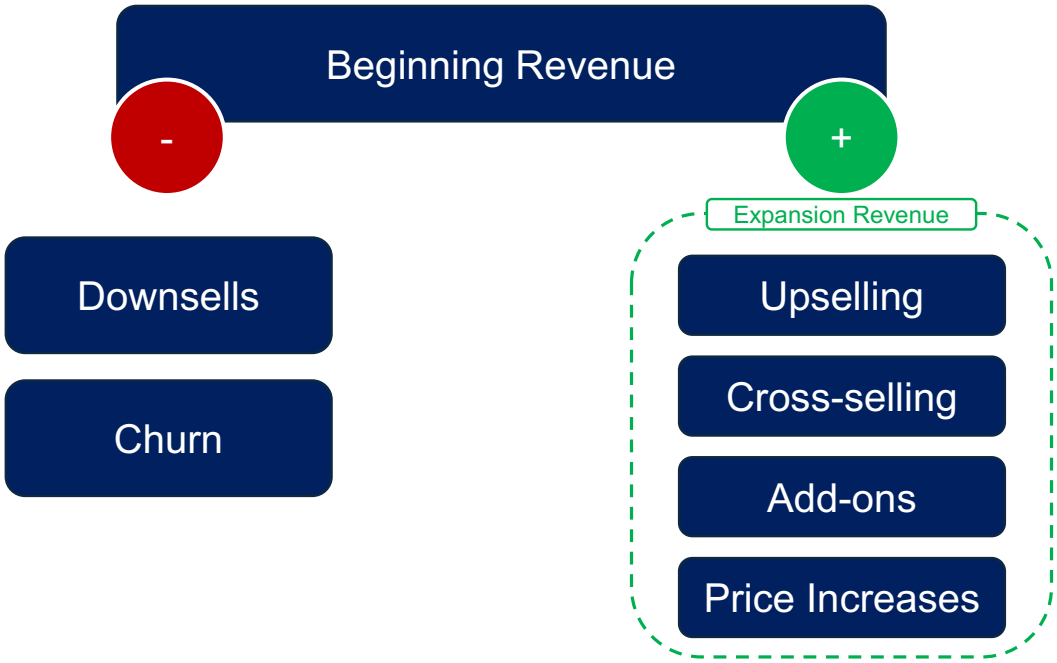

Figure 2: Net dollar retention calculation

Expansion revenue is composed of the following elements:

- **Upselling**: refers to the practice of selling a more expensive, advanced, or premium version of a product or service to existing customers. This could help offset customer churn and is a key strategy of the sales & marketing teams in companies across all stages of growth.
- **Cross-selling**: refers to the practice of offering existing customers additional, complementary products or services to existing customers. It is distinct from upselling as it does not entail the sale of a higher end version of a product or service, but rather the sale of another product or service.
- **Add-ons**: customers can also opt in for recurring supplementary features or services that complement an existing product or service. This differs from cross-selling as these are generally closely related to the original product and are typically an optional feature. Add-ons aim at increasing the value and functionality of an initial purchase.
- **Price-increases**: increasing the price of a product or service year on year will also mechanically increase net dollar retention as the value brought in by each customer increases all else being equal. Some types of products are often subject to yearly price increases such as SaaS products that are deeply embedded within a company's technology stack (Detweiler, 2022).

The main benefit of net dollar retention rates for VCs, is that it provides significantly more information than customer retention metrics as it considers all actions of existing customers. Moreover, it also shows a "hard dollar" metric as opposed to customer retention rate. Indeed, a company could have a positive customer growth trajectory but could lose money if low value-add customers are joining the business while the big revenue generators are churning. This information would be captured by the net dollar retention metric but not by the customer retention metric. As such, it is a capital metric used by venture capitalists.

It is important to highlight that while the two previous metrics mentioned, customer retention rates & churn, and net dollar retention rates, do not focus directly on the profitability of a firm, they are essential in understanding the growth vs. profitability

trade-off in venture capital. Indeed, for a company to grow sustainably, is it essential to understand the costs associated with the actions taken by the firm to grow the customer base / revenue retention metrics. For instance, if net revenue retention grows 10% year on year but the costs associated with this growth are higher than this 10% net revenue gain, the firm is essentially burning cash and focusing much more on growth rather than profitability.

Lifetime Value (LTV) and Customer Acquisition Cost (CAC): these two metrics help to assess the economic benefit that a customer brings to the firm in relation to the cost that the firm incurs to prompt the customer to buy. The LTV estimates the total revenue that a business can expect to generate from a single customer account during the length of the business relationship. The basic LTV metric is calculated in the following manner (this formula is based on the LTV metric developed by Aram Attar at the VC factory, (Attar, 2024b):

$$LTV = Average\ Revenue\ Per\ User\ (ARPU) * Average\ Customer\ Lifespan$$

Where ARPU is equal to the Monthly Recurring Revenue / Number of Users, and the Average Customer Lifespan = 1 / Churn Rate. As the names indicate, the CAC is a metric that measures the cost associated with the acquisition of a new customer. It is calculated by dividing the total costs spent on the acquisition of new customers (including sales and marketing (S&M) expenses) by the number of new customers acquired during a specific period.

The main derivation from the two metrics is the LTV/CAC ratio, which is a crucial metric used in VC and the start-up ecosystem to assess the efficiency of a company's growth and customer acquisition strategy (Silverberg, 2022). Essentially, in the context of this analysis, it is an essential metric to ensure that a start-up is not burning too much cash in the acquisition of customers. The expected ratios will significantly vary based on the industry in which the firms operate, and their stage of growth. For instance, according to the interviews the authors conducted, software businesses use an LTV/CAC ratio of 3.0x as a benchmark.

Moreover, as argued by Blair Silverberg (Silverberg, 2022), it is “imperative for growth financing” to add a layer of complexity to the LTV/CAC calculation by calculating it on a gross margin basis rather than on a plain revenue basis”. Indeed, for companies with high gross margins, the difference between revenue and gross profit might not be significant (this is typically the case for high performing SaaS businesses). However, for companies with lower margins, the costs of serving their customers can be what separates a capital-efficient business from one that's losing value. To make that distinction, it is essential for venture capitalists to look further down the income statement of firms at the gross margin level, as to have some insight into the profitability of companies, and therefore the viability of the firm as it scales. The LTV on a gross margin basis is calculated in the following way:

$$LTV\ (Gross\ Margin\ Basis) = \frac{ARPU * Gross\ Margin\ (\%)}{Revenue\ Churn\ Rate}$$

It is important to note that one of the main drawbacks of the LTV/CAC metric, even when calculated on a gross margin basis, particularly in a VC ecosystem that is increasingly valuing profitability when compared to previous years, is that CAC ignores some key operating expenses. Indeed, in the LTV/CAC calculation, most VCs only include the sales and marketing operating expenses and although it is the major cost source when acquiring customers some other costs are also essential to factor in. For instance, Research and Development (R&D) is also key in developing an attractive and innovative product or service that incentivizes customers to purchase it. In addition, general & administrative expenses also play a role in attracting customers.

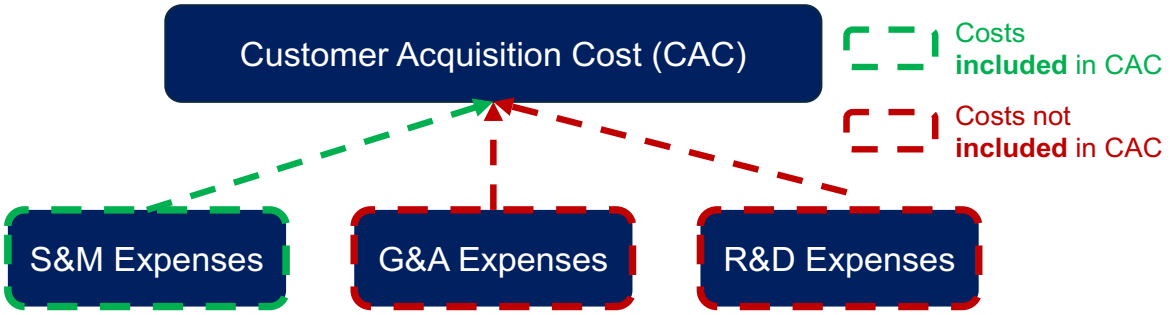

Figure 3: CAC omits some key operating expenses

Another drawback of the LTV/CAC metric is that LTV assumes that inputs are constant. Indeed, it assumes that inputs that tend to move are stable over time while, gross margin and churn can fluctuate significantly between different time periods. As such, the LTV is calculated based on assumptions that can vary significantly throughout the lifetime of a customer.

CAC Payback: this metric adds a time aspect to the previous LTV/CAC metric which is a critical element in assessing when a company will essentially generate a positive return on investment from each customer it acquires. The metric highlights the amount of time that is needed for a company to recoup its CAC. It is calculated in the following way:

$$CAC\ Payback = \frac{CAC}{ARPU * Gross\ Margin}$$

Once again, it is possible to calculate the CAC payback period on a revenue basis but it suffers from the same drawbacks as mentioned previously. It should be calculated on a gross margin basis. Besides giving an indication of time, the other main advantage of this metric is that it provides insights into cash flow needs of the firm. In essence, a business must recover its CAC before it can start acquiring more customers and drive further growth in revenue. The CAC can be replenished either through the business's operations or through additional funding sources such as debt or equity offerings. Therefore, a precise understanding of the CAC payback period can illuminate the working capital needs required to sustain the business's market expansion efforts. Obviously, the shorter the CAC payback period, the better – the benchmark will vary from industry and business models to another but a benchmark according to the VC Factory is 12 months or less. Graphically the CAC payback can be represented as a linear equation seen in figure 3 below:

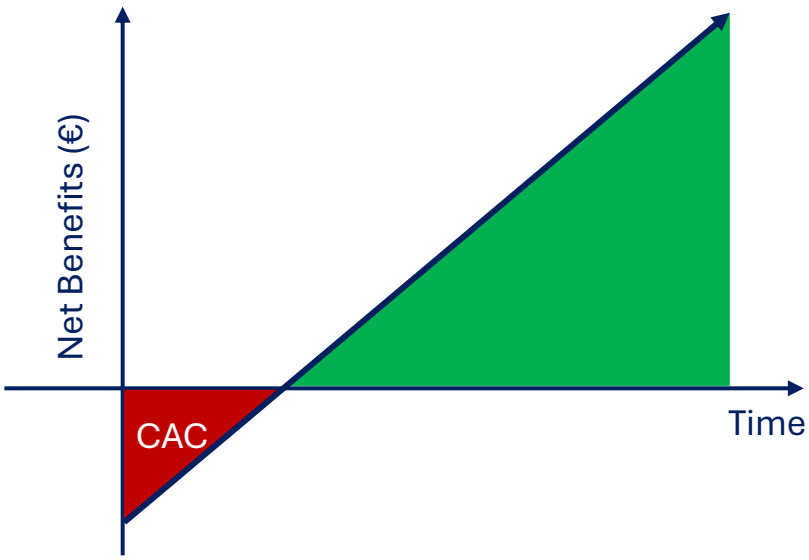

Figure 4: CAC payback visual representation

i. Profitability Metrics:

Rule of 40: some of the previous metrics mentioned above give some insight into the profitability of a firm but mostly serve as a customer metric analysis. The rule of 40 is an excellent bridge into the profitability section as it encompasses both profitability and revenue growth in its calculation. The metric adds the percent of revenue growth of a business (ARR, MRR, Revenue, etc.), and the percent of profitability margin of a business which can be chosen at the discretion of the investor (earnings before Interest, taxes, debt and amortization (EBITDA), Free Cash Flow (FCF), Unlevered Free Cash Flow Margins, Cash Conversion margin etc.). The rule implies that the sum of both parameters should be greater than or equal to 40. The main positive of this metric is the broad applicability and flexibility of its use, as it enables investors to have a very quick KPI to look at when screening through company financials. It is important to note that this metric is very elementary and as discussed with a partner of a growth equity fund, suffers from two main flaws:

- Firstly, the rule of 40 gives an equal weight to growth and profitability which completely overlooks the fact that growth is often valued more than profitability by investors – even in today's market which focuses on efficient growth. Therefore, the lack of a different weight applied to profitability and growth fails to accurately reflect the realities of the market. Data provided

by Meritech Capital confirms the informant's analysis as seen in the figure below which shows the relative importance of revenue growth vs FCF margin in valuation. What is interesting to note is that since June 2021, the valuation gap between revenue growth and FCF margin has narrowed significantly. In June 2021, revenue growth was valued 11.2x more than FCF margin. By March 2024, the ratio decreased to 2.8x. The shift highlights the increased emphasis on profitability and efficient growth compared to the technology boom of 2021.

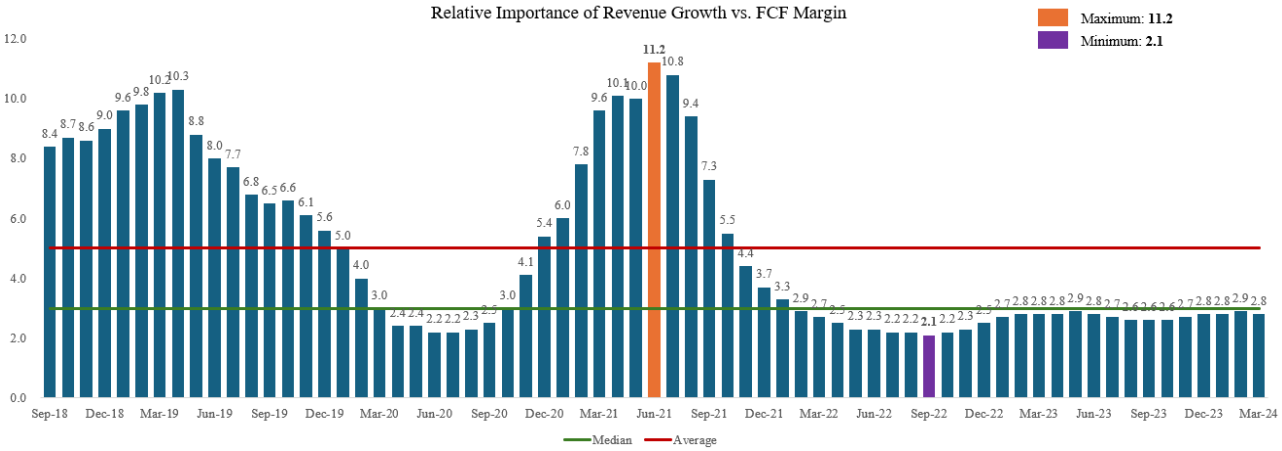

Figure 5: Relative importance of revenue growth vs. FCF margin

- Secondly, the rule is more relevant for larger businesses (defined by a partner of a growth equity fund as businesses' with over $100-$200m of ARR). Indeed, smaller businesses have R&D and Sales, general and admin (SG&A) expenses that have not reached a steady state which is maximised with scale. As such, these expenses represent a larger proportion of revenue for small businesses when compared to larger ones. This makes the rule a lot less relevant for smaller companies.

Contribution Margin: is a metric that can be stated on a gross or per-unit basis, but the latter seems to be the favored method in the VC space. It is calculated by subtracting variable costs per unit to the revenue per unit:

$$Contribution\ Margin = Revenue\ Per\ Unit - Variable\ Costs\ Per\ Unit$$

It is an essential metric to understand the cost split between fixed and variable costs and gives a clear indication into the ability of the firm to sustainably generate profits as sales grow. For instance, a high contribution margin indicates that a start-up can efficiently scale as it will be able to split fixed costs over a larger number of products sold. On the other hand, a small contribution margin means that the ability to scale efficiently is limited in nature as each new product sold requires a large base of variable costs.

Cash Burn / Burn Rate: is a more fuzzy metric for which the definition varies depending on the person. However, the generally accepted consensus is that the burn rate is the speed at which a start-up burns through its cash reserves. It is particularly relevant in the context of VC as it essentially tells investors how quickly an unprofitable company goes through the money it has raised to finance its operations. It enables to calculate what is known as the runway which is the amount of time the company can operate before it runs out of cash.

Burn Multiple: is an essential metric that enables the assessment of the statement that was given to us during an interview which states that “not all growth is created equal”. This metric measures the cash that a start-up is burning to generate incremental ARR – how cost efficient it is in increasing ARR. The lower the burn multiple, the less the company spends to grow – it is growth efficient.
It is calculated in the following way:

$$Burn\ Multiple = \frac{Net\ Cash\ Burn\ for\ a\ Period}{Net\ New\ ARR\ Added\ for\ a\ Period}$$