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WHY IS CEE A VC **FUNDING HOTSPOT** RIGHT NOW?



A fast-changing landscape

It may not seem like an optimal time for investment. High interest rates, rising inflation, the increasing cost of capital and geopolitical unease have conspired to create a downturn. Experts in North America speculate a recession could come soon; while China is already in the grip of an economic downturn, on the edge of possible deflation.

But amongst so much gloom, one region seems to continue to be making economic headway: Central and Eastern Europe. There are a number of reasons for this: the popularity of bootstrapping in this area, making it better placed to weather financial turbulence; growing interest shown in the region by foreign investors (especially those from North America) and the abundance of entrepreneurial and tech talent found there, amongst other reasons.

There is also evidence to suggest that the challenging monetary climate is creating more robust startups, with evidence that companies are restructuring, optimizing costs and extending runways.

hubraum investment expert Cezary Iwan has delved into the facts and figures to try and unravel the complicated success story of CEE. In the following report, he explores:

- Why the current situation in the European VC market is a correction more than a downturn
- How CEE is the fastest growing region for investment in Europe
- The role international investment plays
- The rise of the unicorn in CEE
- How funding is split between CEE countries
- Popular sectors in the region
- Reliance on public funds in the startup ecosystem
- Why CEE is so successful



Cezary Iwan

hubraum investment expert

The current context: challenging market conditions

According to the latest report in VC investments in Europe published by PitchBook (European Venture Report – Q2,2023), European VC dealmaking dropped significantly in the first half of 2023, with deal value down 60.8% compared with the first half of 2022 and 34.2% lower than the second half of the year. Experts attribute the decline to higher interest rates, high inflation, low IPO activity, and tough fundraising conditions.

With overall difficult market conditions, the figures from the second quarter of 2023 come as no surprise to anyone. The question everyone is scrambling to answer is whether we have already hit the bottom and if so, when can we expect a recovery?



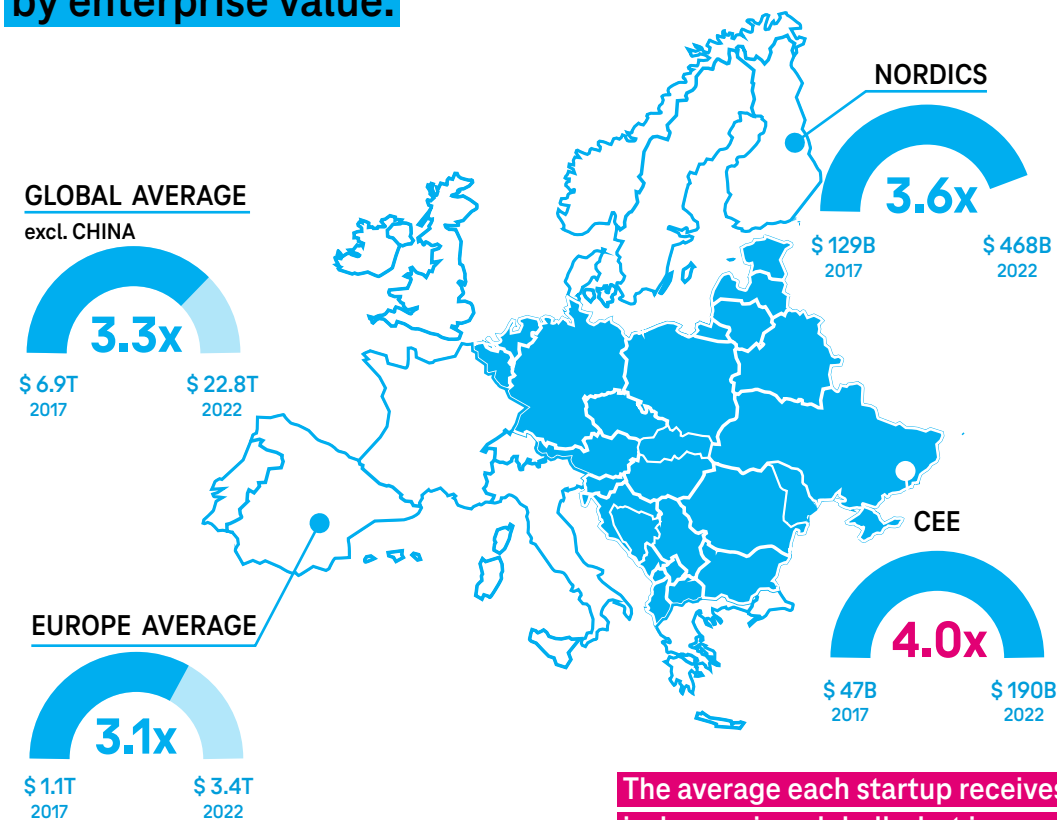
There are no clear answers to these questions. However, based on the signals from the market and the trends we've seen taking place for several quarters in the European VC and startup community, it's possible to draw some conclusions. It's also possible to predict the earliest time we might reasonably expect a recovery.

Firstly, we should stress that not all of the reactions caused by the overall depression are bad. Some are welcome and positive changes! The market is adapting very quickly to the new normal. Founders are beginning to focus on being more efficient in terms of spending. The valuations of technology companies are adjusting to the new conditions, returning to healthier levels, and creating great opportunities for investors.

Secondly, according to a recent report from VC firm Atomico, European startups are on track to raise \$51B this year, down 39% from 2022. Many experts say the current situation in the European VC market is a correction more than a downturn. The extraordinarily high VC investment volumes in 2021 and 2022, clear outlier years, should be considered anomalies. Investment volumes and valuations are now returning to long-term averages.

Looking across Europe and the first half of 2022 vs. the first half of this year in terms of VC investment activity, this slowdown is visible in almost all countries, with a 57% fall in the UK, 55% in France and 44% in Germany. A comparison of these time periods, investment values, however, shows signs of stabilization.

CEE is ALSO one of the fastest growing regions in Europe by enterprise value.



The average each startup receives in funding is decreasing globally, but increasing in CEE



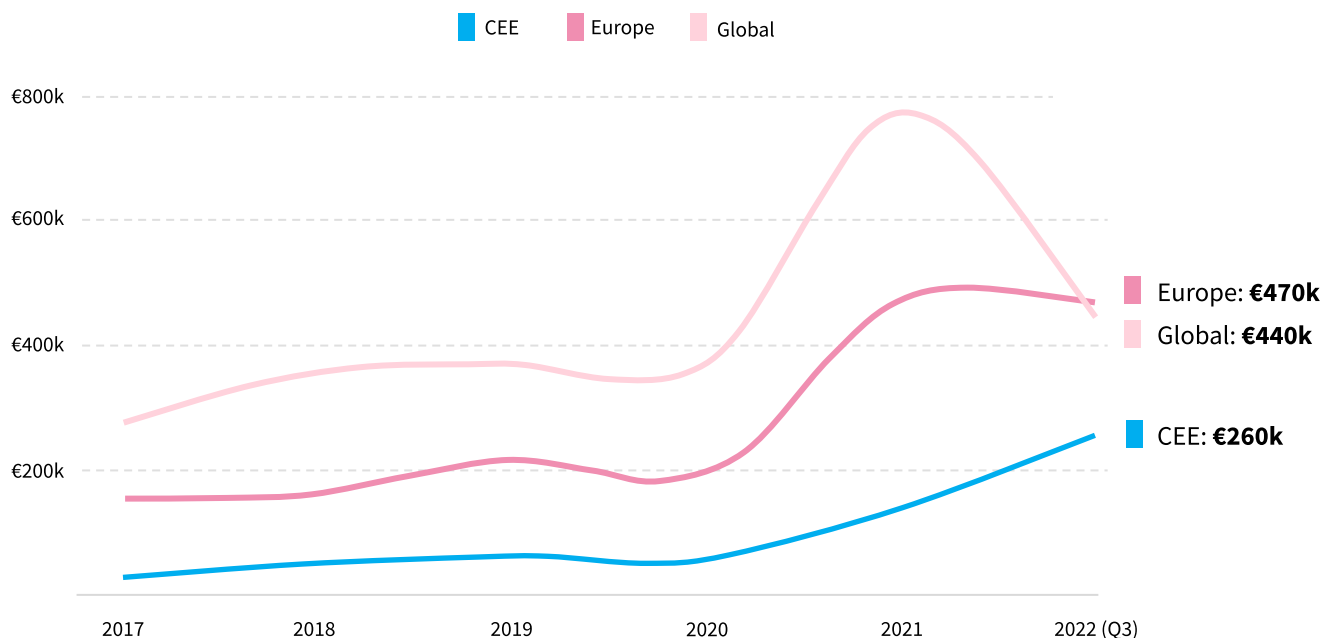
In a global downturn, where to invest?

Given these trends, let's return to the question of where in Europe is the greatest opportunity for a rapid return to growth and where to look for investment opportunities in the near future.

Logic tells us that it makes sense to look at regions and countries where the VC market had the highest growth rate before the European and global VC market downturn started, and those with the greatest availability of tech talent. And that brings us to... Central and Eastern Europe.

According to Vestbee data, combined VC investment in CEE has increased from €2.2B in 2020 to €5.9B in 2022. Although in terms of the investment volume it is still a relatively small market compared to areas like the DACH region (€18.1B in 2022, Source: Pitchbook), CEE is by far the fastest growing region for VC funding in Europe, growing 7.6x in the 2017-2022 time period. The growth rate in the same period for the whole of Europe (excl. CEE) is 3.8x, 3.8X for the Nordics and 2.9x for DACH region (Source: "CEE startups 2022", Dealroom, Google for Startups, Atomico, Credo). In 2021 and 2022 average funding per startup was decreasing globally, but it was increasing in CEE (see figure 1).

Fig. 1. Average funding (combined 5-year activity) per startup, 2017-2022.



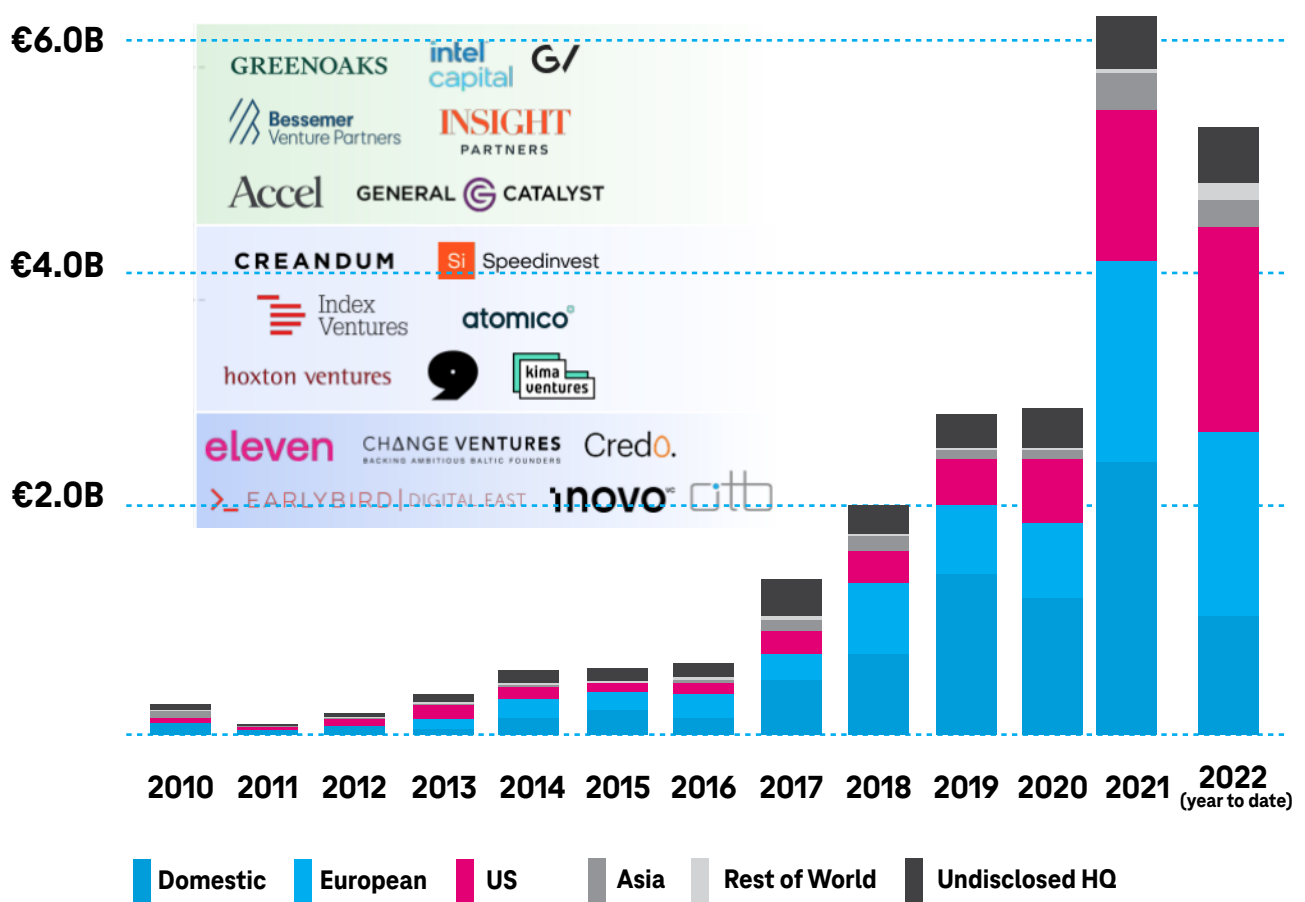
Source: "CEE startups 2022", Dealroom, Google for Startups, Atomico, Credo.



In a global downturn, where to invest?

In the last few years, international investors have increased their activity in CEE startup funding significantly. Around half of the value of VC deals in CEE in 2021 and 2022 are investments made by VC funds outside of Europe. One noteworthy trend is the rapid increase of investments in the CEE region made by US VC funds, including top firms such as Intel Capital, Bessemer Venture Partners and Accel. In 2022, US VCs allocated €1.9 billion in funding in CEE, which accounted for roughly a third of the total value of VC investments in this region (See figure 2).

Fig. 2. Investment into companies founded in CEE by investor origin.



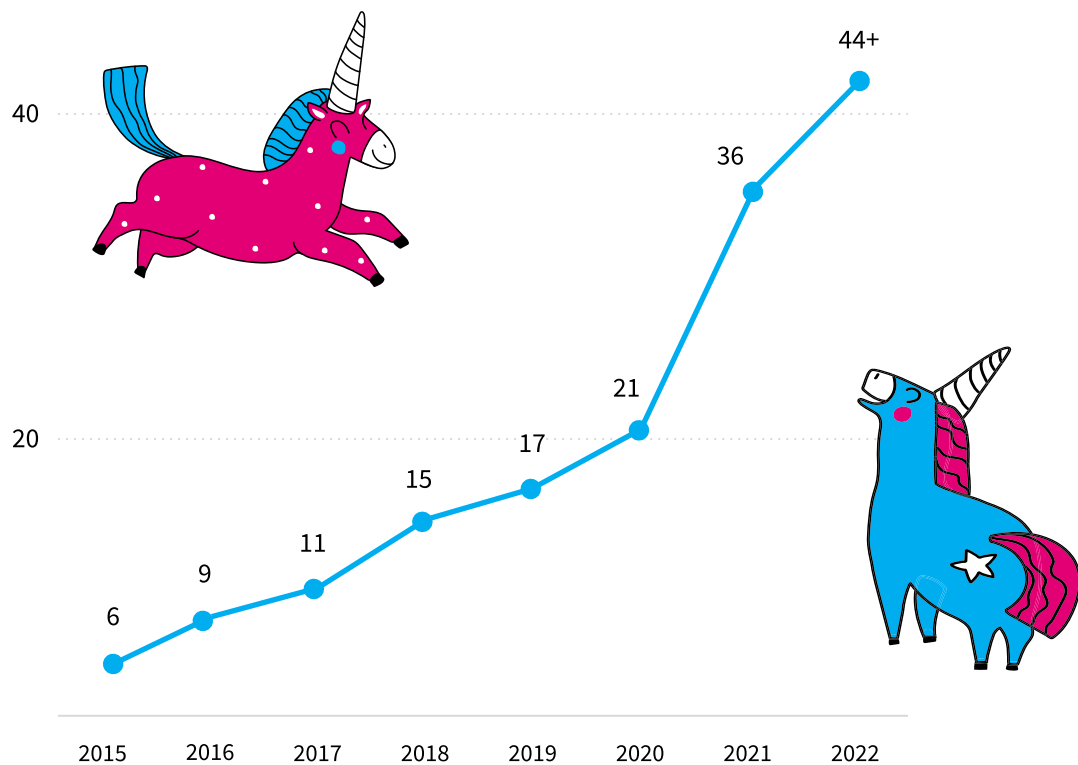
Source: "CEE startups 2022", Dealroom, Google for Startups, Atomico, Credo.

Unicorns on the up

The strongest years for unicorn creation in CEE so far were 2021 and 2022, with the number of unicorns more than doubling since December 2020 (See figure 3). Examples of new unicorns from CEE include AirSlate (SaaS/Legal, Ukraine), Nord Security (Security, Lithuania), Payhawk (Fintech, Bulgaria) and more.



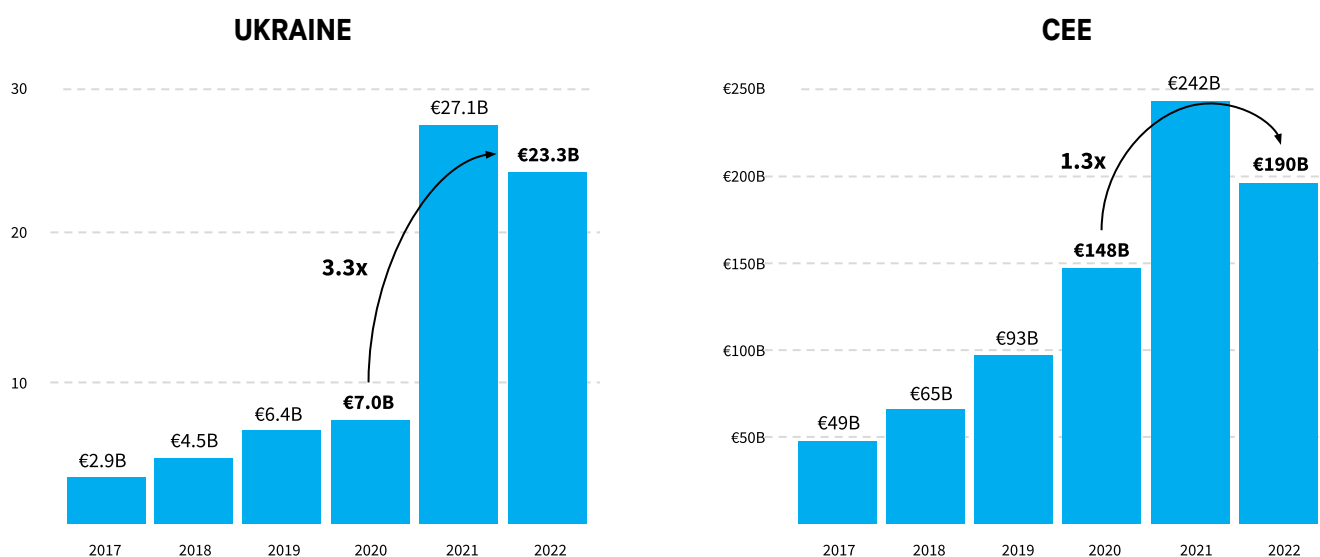
Fig.3. Cumulative number of CEE unicorns.



Source: “CEE startups 2022”, Dealroom, Google for Startups, Atomico, Credo.

It is important to note that bootstrapping plays a prominent role in CEE’s late-stage successes. Almost a quarter of unicorns born in CEE are not VC-backed.

Fig. 4. Total combined enterprise value of Ukrainian and CEE startups.



Source: “CEE startups 2022”, Dealroom, Google for Startups, Atomico, Credo.

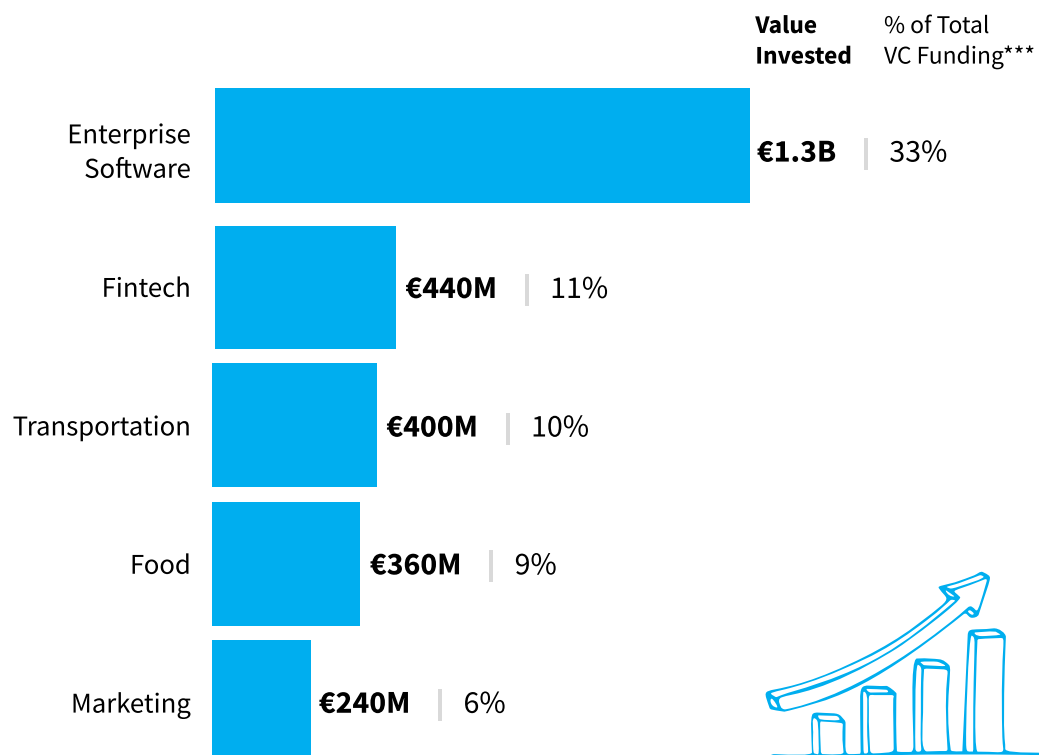


Taking a closer look

Megarounds aside, Poland, Estonia and the Czech Republic see the bulk of VC funding in the region. 52% of CEE's VC funding (cumulative 2017-2022), excluding megarounds, was concentrated in those three countries. Ukrainian startups are showing incredible resilience in spite of the war and recession, with enterprise value growing 3.3x since 2020 (See fig. 4). Total value growth of CEE startups in the same time period was 1.3x (from €148B in 2020 to €190B in 2022).

Enterprise software, fintech and transport were the most popular verticals among VC investors active in the CEE region between 2015 and 2021 (see figure 5). In 2022, little has changed — the only detail that differs is that marketing has left the top five verticals and the security sector has taken its place.

Fig. 5. Biggest industries 2015-2021 by VC funding



Source: “CEE startups 2022”, Dealroom, Google for Startups, Atomico, Credo.
In the last few years, CEE has created a streak in Gaming.

Over the course of 1990-2019, the combined value of exits from CEE gaming startups amounted to €1.3 billion. The corresponding figure for exits in 2020-22 is €2.3 billion! The biggest CEE gaming exits since 2020 include Huuuge (€445M, IPO 2021), Nordeus (€378M, Acquisition 2021), Coolbet (€176M, Acquisition 2021), Nanobit (€148M, Acquisition 2020), Flying Wild Hog (€137M, Acquisition 2021) and Melsoft (€100M, Acquisition 2020).



The secret to growth

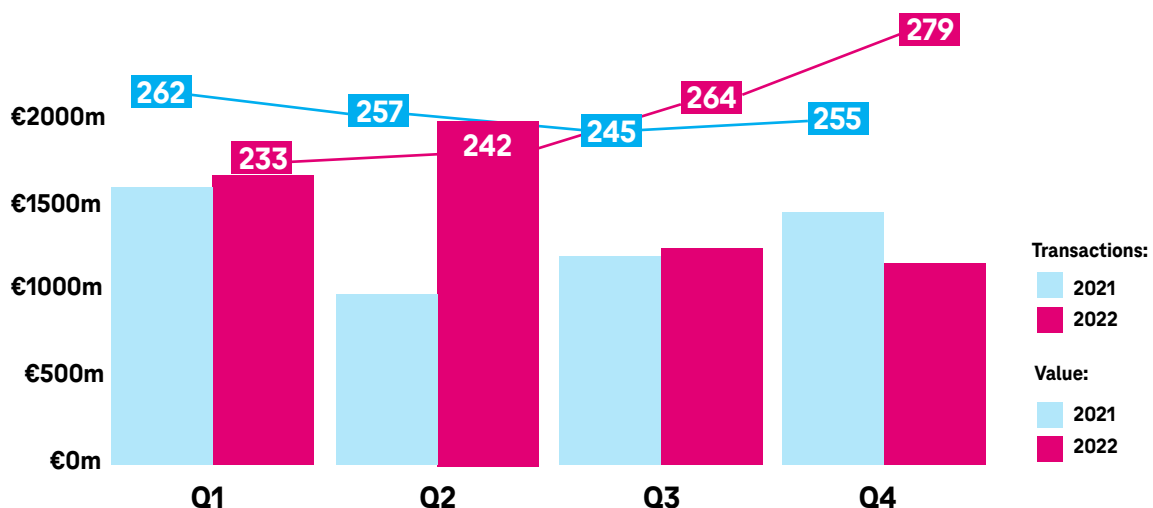
Why has the VC market in CEE grown so significantly over the last few years?

- 1) high activity (more investments, higher sums being invested) of the rapidly growing number of domestic VCs, with many benefiting from the support of public (EU) funds
- 2) an abundance of entrepreneurial and tech talent – according to various estimates there are 1M developers in CEE
- 3) a significant increase in the activity of foreign investors in the region, encouraged by
 - a) the growing number of global successes of startups with a CEE-origin and b) access to plenty of software and engineering talent.

The global crisis hits CEE

Despite all the positive trends and developments in the CEE VC market in recent years, the global crisis of the VC market has also affected the CEE region. Total funding delivered to CEE startups increased from €5.4B in 2021 to €5.9B in 2022. In the second half of the year, however, a clear slowdown of VC activity could be observed (See figure 6).

Figure 6. VC Investments in CEE, 2021 vs 2022

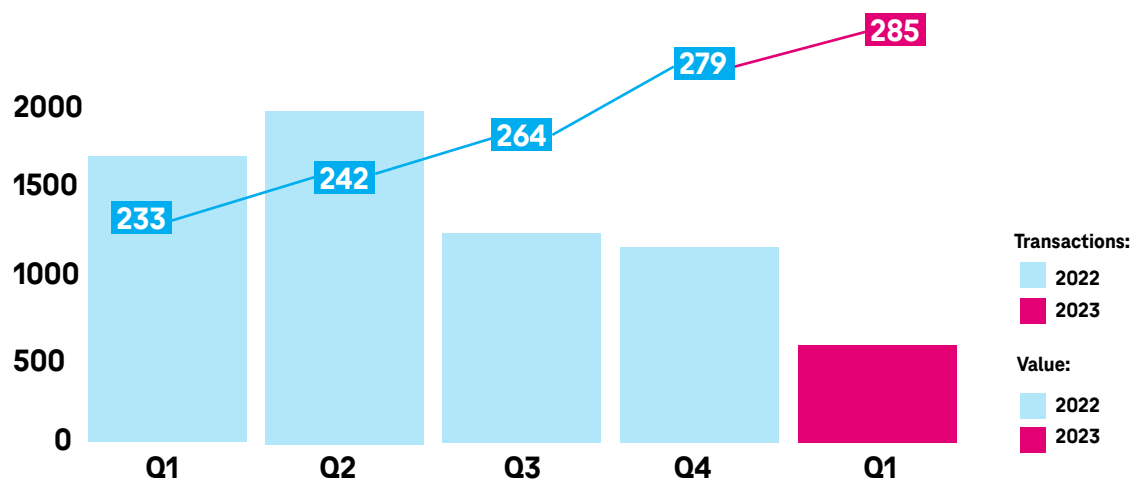


Source: <https://www.vestbee.com/blog/articles/vc-transactions-in-cee-report-2022>

Figures for the first quarter of 2023 showed a significant decline in the value of VC investments in CEE — from €1.1B in the final quarter of 2022 to only €600M in the first quarter of 2023 (See figure 7).



Figure 7. VC Investments in CEE 2022 vs 2023



Source: <https://www.vestbee.com/blog/articles/vc-funding-in-cee-report-1q-2023>

Further issues

The main reasons for this decline are the same ones that contribute to reduced VC activity the world over — a sluggish economy, high inflation, high interest rates and the resulting increasing cost of capital. In the case of the CEE region, one contextual detail that's also unfavorable to the growth of VC investments from abroad is the war in Ukraine.

Moreover, in recent years, many VCs active in CEE countries have benefited from public funds. These funds are now running out, and it is unclear when new funds will be available. In this situation, a big question mark is the future of many local VC investors once they are disconnected from the drip of public money.

For startups, this could mean problems with fundraising. Many of them will be under strong pressure to spend less (decrease burn), cut costs and increase the runway. Data on VC activity in CEE for the second quarter of 2023 is not available yet, but partial data from individual countries of the region and latest information coming from VCs and startups provide a hint of what to expect.



Conclusion

We hear from every corner of the ecosystem that startups are restructuring, focusing on operational excellence, optimizing costs and extending runways. On the other hand, we see that companies that have a strong value proposition are still able to close quite large financing rounds (e.g. Eleven Labs raised €17.5M Series A round from Andreessen Horowitz, Concept Ventures, Credo Ventures and angel investors; FlowX.ai from Romania raised \$35M for its AI-based approach to application integration).

The same can be said about VCs. Recently, the launch of new funds was announced by several well-known and experienced investors from CEE, e.g. Inovo (Fund III, €100M), Market One Capital (MOC II, (€60M), ff Venture Capital (€60M), Movens Capital (Movens Fund 2, €60M).

Data on VC transactions in the second quarter of 2023 in Poland, the largest investment market in the CEE region, show that investment value in the first half of 2023 decreased by 70% in comparison to the first half of 2022. At the same time, the number of transactions remained high (116 in Q2'23 vs. 92 in Q2'22) and consisted mainly of seed-stage investments.

The 116 companies that raised money got €94 million from 69 VC funds. This shows that early-stage activity has not been impacted as much as later-stage transactions. Investors seem to be reluctant and play a waiting game regarding later-stage investments, given the amount of uncertainty in the market and the lack of exit opportunities.

The VC market in CEE, like the industry around the world, is currently going through difficult times. Some startups and investors will fall out, but everything indicates that the market as a whole will emerge stronger from the crisis.

Most importantly, difficult times do not mean the end of technology creation. And in this context, the potential of the CEE market remains excellent. The CEE region is currently one of the two largest talent pools in the world in software and engineering next to Silicon Valley. Every year, more and more of these people work in startups. And this is the main reason why, despite the current and potential future turbulences in the local and global VC industry, CEE will certainly be one of the VC funding hotspots in the coming years.

