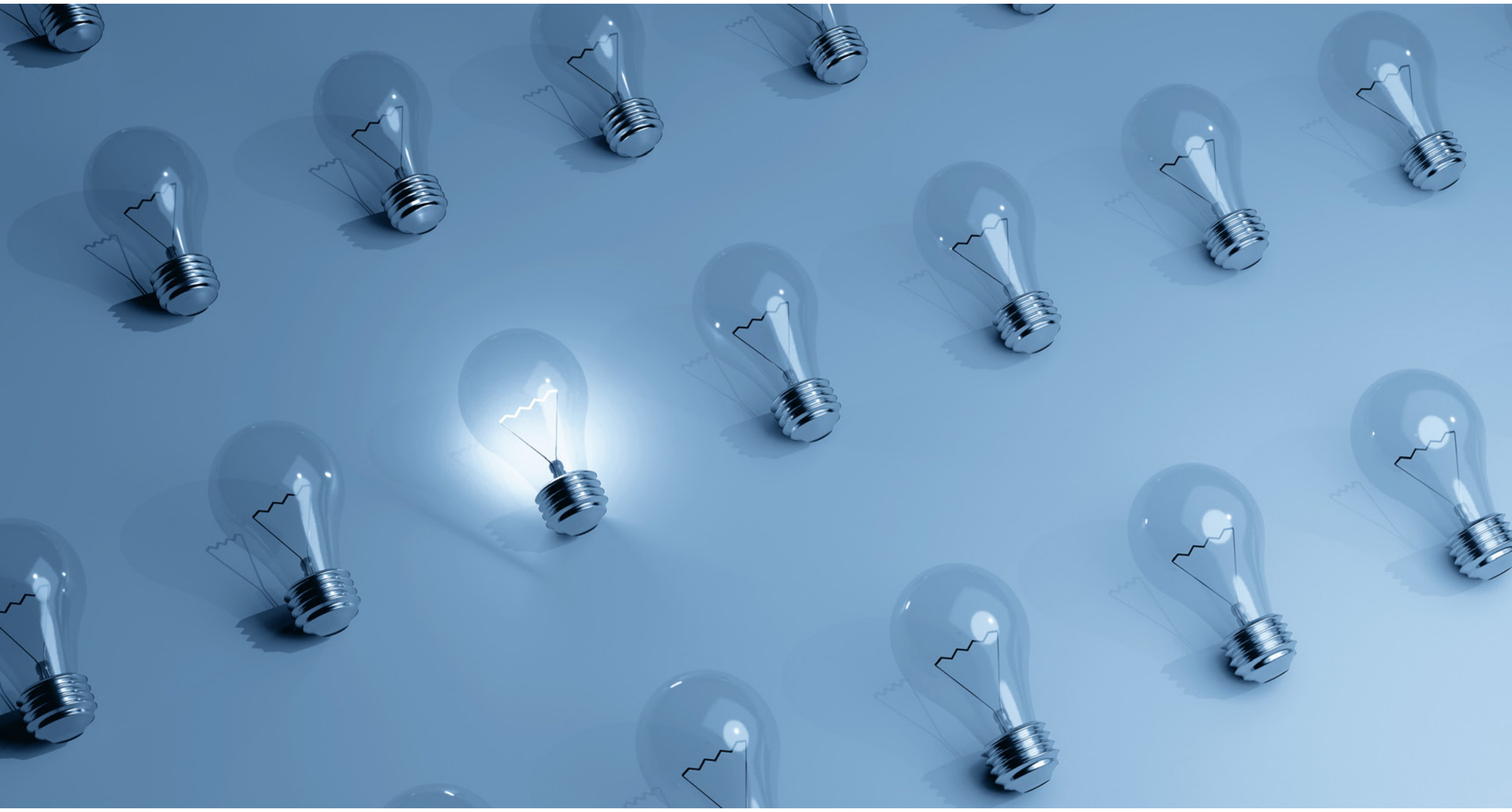
Technology, Media & Telecommunications Practice

Hard choices: How Europe's fastest-growing start-ups become unicorns

Just one in ten start-ups valued at $100 million grows to $1 billion within four years. Here are five trade-offs they made to get there.

by Kim Baroudy, Giacomo Dolci, Sid Ramtri, and Harry Schiff



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Earning a $100 million valuation is an exceptional achievement. In all of Europe, only about 850 start-ups reached this milestone between 2010 and 2017. Yet these "centaurs" have little time to celebrate. The venture capital (VC) firms that invest in them expect their value to reach $1 billion or more—and to do so quickly (Exhibit 1). Less than one in ten of them manage this feat in under four years.

Why is it so hard for already successful start-ups to maintain their rapid pace of growth?

Earlier this year, we surveyed and interviewed dozens of founders, top executives, and board members of 100 scale-stage European start-ups to understand the strategic decisions and best practices that differentiated the fastest growers from their peers (see sidebar "About our research").

What quickly became clear was that scale-up leaders struggle with making trade-offs. When we asked founders and executives to name their biggest mistakes, 39 percent (the largest group) described a failure to focus attention and resources in the right places—or a failure to focus at all.

In recent years, excess liquidity has allowed scale-ups to put off making such trade-offs, but fundamental value creation has always required tough decisions among competing priorities. This is a universal lesson that applies across business types, economic cycles, and capital environments.

Through our research, we have identified principles to guide leaders of European scale-ups through some of the critical trade-offs and decisions that mark this period in their development, even if it takes longer than four years to reach the elusive milestone.

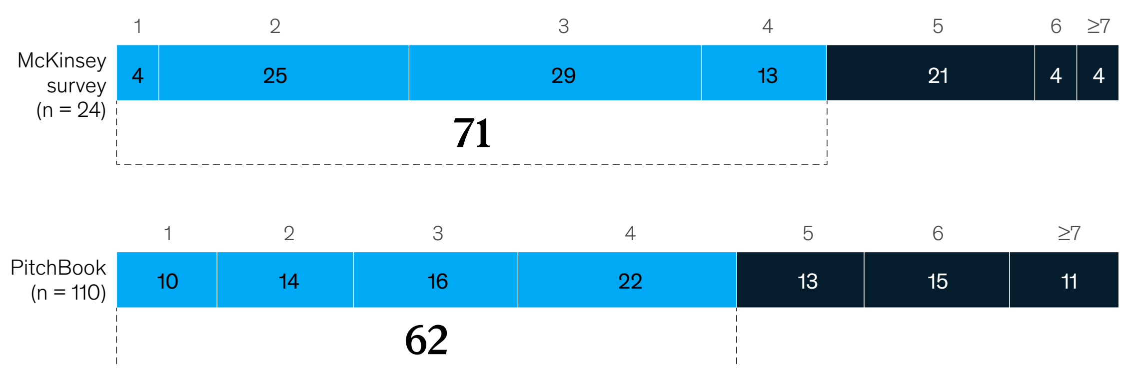
1. Strike the right balance between growth, efficiency, and moat building

Almost all scale-ups agree on three strategic imperatives: to succeed, they must drive growth, increase efficiency, and build a moat to protect their market position. Yet in our analysis, we found

Exhibit 1

Most European scale-ups that made the leap from a $100 million to a $1 billion valuation have typically done so in fewer than four years.

Number of years from $100 million to $1 billion valuation,[1] % of companies



Note: Figures may not sum to 100%, because of rounding.
[1]Question: In what year did the start-up first achieve a valuation of ~$100 million? In what year did the start-up's valuation reach or exceed $1 billion?
Source: Dealroom; PitchBook; McKinsey European Scale-up Growth Journeys Survey, May–June 2022

About our research

To identify best practices for European scale-ups, we mined venture capital (VC) databases to identify 846 European start-ups estimated to have reached a $100 million valuation between 2010 and 2017. We surveyed founders, top executives, and board members from approximately one hundred of these companies and interviewed 50 founders (some who had also been surveyed and others who had not). We also interviewed select VCs. The companies represented a wide range of industries, from biotech and cybersecurity to consumer products and travel, with finance/insurance accounting for nearly a quarter of the total. Based on quantitative and qualitative data, we identified the strategic decisions and practices of the fastest-growing scale-ups.

that 40 percent of companies struggle to balance efficiency and growth.

Deciding where to focus can be a function of two things.

The first is a company's strategic play. In a previous article, we described the overarching strategic plays pursued by scale-stage companies.[1] Scale-ups in our research identified themselves with regard to these plays based on their core business drivers:

— *Network plays* (such as ridesharing services, social media, and communication platforms, and other advertising-based businesses) benefit from network effects and can focus on growing users and usage, as this naturally enhances their value proposition. Former scale-ups that applied this approach include Airbnb and LinkedIn.

— *Product plays* (such as software companies) are often vulnerable to copying or commoditization and thus focus on continuously enhancing or expanding their offering to maintain differentiation, increase customer-switching costs, or develop a one-stop-shop value proposition. Examples include Revolut and Stripe.

— *Scale plays* (such as e-commerce and delivery companies) have high fixed or marginal costs and have to focus on generating revenue and improving operational efficiency. Examples include Picnic and Zalando.

The second factor that can drive how a scale-up allocates effort and resources across growth, efficiency, and moat building is the macrofunding environment. This should be no surprise; scale-ups tend to be cash-flow-negative and are thus highly sensitive to changes in the availability of capital.

When capital is abundant, as it was for much of the past ten years, scale-ups can lean more heavily into growth. In this environment, not being aggressive enough can be a fatal mistake. As one executive warns, "We made decisions that capped growth to reach profitability, but competitors growing faster than us attracted more money, better investors and, ultimately, better unit economics

1 The three strategic plays are discussed in more detail in our previous article "Winning formula: How Europe's top tech start-ups get it right," McKinsey, August 18, 2021. Earlier analyses included a fourth category: the deep-tech play, pursued, for example, by firms that develop biotechnology, deep-learning models, and advanced manufacturing solutions. These companies have value propositions and competitive advantages founded in unique intellectual property (IP) based on scientific or technological breakthroughs, and thus focus on developing this IP. We have excluded deep-tech plays from this analysis because at comparable valuations, it's arguable as to whether deep-tech companies are actually in the "scale stage" of their development.

The fastest-growing scale-ups began geographic expansion more than two years later than their slower-growing peers.

too." This perspective is supported by our research: profitability, efficiency, and cash flow were cited as top three priorities by just 12 percent of the scale-ups that made it to $1 billion in four years in the period between 2010 and 2021.

When capital tightens—for example, as it has in 2022—scale-ups may want to focus more on efficiency.

2. Pursue product expansion before geographic expansion

Geographic expansion is the most common strategic priority among scale-ups: 61 percent of the companies we surveyed included this among their top three. However, more than half of these companies came to regret that prioritization. In fact, the fastest-growing scale-ups began geographic expansion more than two years later than their slower-growing peers,[2] and 20 percent of our respondents cite overly rapid expansion as their single biggest mistake.

"We were pushed to expand because we had raised all that money, and that was expected," said an executive at a German scale-up. "But we weren't ready, and we ended up leaving some of those markets a few years later."

In contrast, product expansion provides a clearer path to value creation, in part because it can drive *all three* strategic imperatives of scale-stage companies:

— *Drive growth.* New products can open new customer segments or increase spend from existing customers.

— *Increase efficiency.* New products that target existing customers drive revenue with low (or no) acquisition costs.

— *Build a moat.* Broadening product touchpoints with customers increases switching costs.

The fastest-growing scale-ups in our sample were twice as likely to cite product improvement as a top three priority, compared with slower-growing peers—and none expressed regret for that decision.

The benefits of product extensions are especially relevant for scale-ups pursuing two strategic plays:

— For companies pursuing scale plays, new offerings that increase revenue per customer can help overcome high fixed costs or low margins. For example, a meal-kit deliverer added luxury meals to its offering, increasing the average basket size while leveraging its existing distribution network.

— For companies pursuing product plays, product extensions can increase differentiation from

[2] Relative to the investment round that gave them their initial, estimated $100 million valuation.

competitors and broaden customer touchpoints, raising switching costs. For example, a data intelligence company added products and governance services to become a one-stop shop for customers' data management needs.

Network-play scale-ups stand out as exceptions to this principle of focusing on product extensions before geographic expansion. Because first-mover advantages are especially valuable to business models with network effects, network-play scale-ups often have more to gain from rapid expansion than companies pursuing other strategies. As such, a more aggressive approach to expansion may be worth the risk (Exhibit 2).

3. When embarking on geographic expansion, prioritize accessibility over size

At some point, scale-ups do need to look beyond their borders to find growth. When they do, many are tempted to target the biggest market they can find, but this is often a mistake.

That's because expanding is hard, but it gets easier with practice. Beginning with an accessible, familiar market nearby—rather than the one with the largest revenue pool—reduces the degree of difficulty and helps companies develop a playbook for achieving sustainable operations and positive unit economics in other markets. Trying to build this playbook while battling strong competitors, wooing customers whose tastes and habits are shaped by a different culture, and managing a team several hours and time zones away is rarely a recipe for success. As one founder told us, expanding to unfamiliar markets is "95 percent like starting a new company; there are almost no synergies" (see sidebar "US expansion: Go all in or don't go at all").

A successful online grocer provides a better example. It launched its first expansion into a neighboring country with a similar culture and no dominant competitors. The company refined its playbook and optimized operations before tackling larger and more competitive markets farther away.

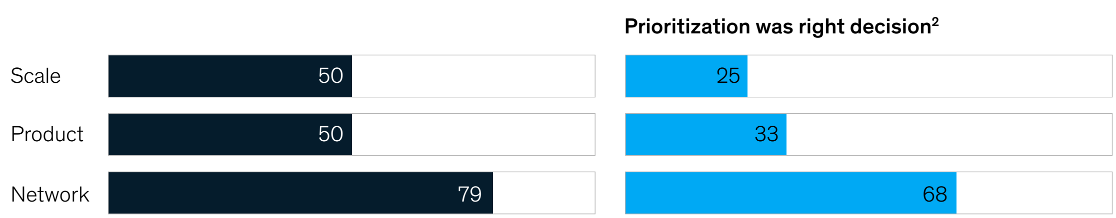
Variations on these approaches can be more or less appropriate, depending on a scale-up's overarching strategic play:

— Scale-ups pursuing scale plays (such as delivery or e-commerce companies) may want

Exhibit 2

Network-play scale-ups are more likely to prioritize geographical expansion, and less likely to regret it, than other European scale-up types.

Share of scale-ups citing geographic expansion as a top 3 priority,[1] % of respondents (n = 70)



[1] Question: At the time of the [SCALE ROUND] in [SCALE YEAR], what were your top 3 strategic priorities?
[2] Question: Reflecting back, were those the right strategic priorities for the company to focus on at the time?
Source: McKinsey European Scale-up Growth Journeys Survey, May–June 2022

US expansion: Go all in or don't go at all

A US expansion can be tempting for European scale-ups, for understandable reasons. It's a large, unified market with customers that often adopt new technologies quickly and investors with big checkbooks. But many European scale-ups fail to commit fully enough to gain a foothold in what is not only a very large but a very competitive and culturally different market.

European scale-ups planning a US launch would do well to gather three critical components beforehand:

1. A significant American investor, or a customer that can act as a true partner, helping to navigate local dynamics or regulations.

2. An expansion playbook that has been thoroughly battle-tested in other markets.

3. A commitment from a top leader (such as a founder or CEO) to relocate to the United States for several years to oversee the business and signal commitment to customers, suppliers, and staff.

to give even greater preference to cost and ease of entry when selecting initial expansion markets, given the high cost of setting up local infrastructure and logistics.

— Scale-ups pursuing product plays (such as software companies), by contrast, can be more bold in targeting larger markets, even if more distant, simply because the cost and complexity of launching a new market tend to be lower. In many cases, these businesses can launch with no physical presence at all.

4. Acquire companies for their products, people, and intellectual property—not their presence in other markets

Buying another company can be an effective mechanism for rapid growth, and scale-ups with tens of millions of dollars in VC capital are—often for the first time in their existence—in a position to do so. However, many scale-ups get their first acquisitions wrong.

One clear pattern from our data suggests that the *goal* of acquisitions heavily influences their likely outcome: acquisitions undertaken for the purpose of launching in a new market are more than five times more likely to fail than those aimed at acquiring products, people, or intellectual property (Exhibit 3). Absorbing a new company is difficult enough, but layering on differences in culture, distance from management, and technical integration of highly redundant product components increases the difficulty substantially.

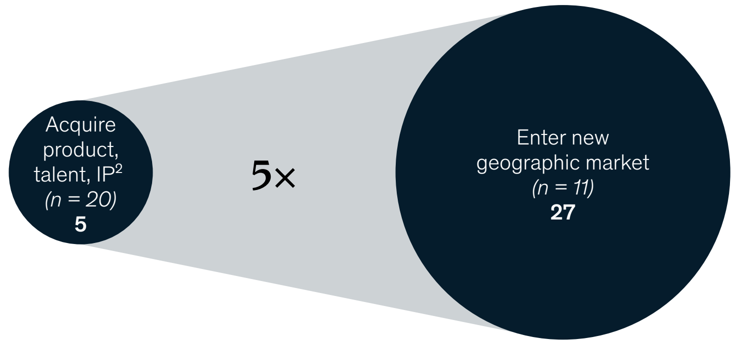
One executive put it this way: "Most of our acquisitions aimed at entering new markets failed. They were just too far away from the team, there was too little management oversight, and we couldn't execute."

In contrast, bolt-on product acquisitions present fewer challenges—94 percent of the companies that attempted these considered them successful. "When we bought for product, we were much more successful," adds the same executive. "We could co-locate people and integrate fast. When

Exhibit 3

Acquisitions for territorial expansion are five times more likely to fail than those for products, people, or intellectual property.

Acquisitions reported as unsuccessful, by acquisition purpose,[1]
% of respondents



[1]Question: How many companies had the start-up acquired in the 4 years following the [SCALE ROUND] in [SCALE YEAR]? What were the primary purposes of these acquisitions? Would you consider these acquisitions successful?
[2]Intellectual property.
Source: McKinsey European Scale-up Growth Journeys Survey, May–June 2022

something goes wrong you know it, and you can react right away. The synergies that exist in your Excel—you can make sure they actually happen."

There is one principal exception to this lesson. Scale-ups pursuing network plays often face a chicken-and-egg problem in each new market: How do you attract users from one side of a marketplace (such as buyers, riders) before securing a critical mass of users on the other side (such as sellers, drivers)—and vice versa. For these companies, acquiring a company with an existing user base can provide a shortcut to achieving critical mass in new markets. A ridesharing player employed this strategy to quickly expand to cities across Europe. Notably, this approach tends to work best when the acquired company itself already has a critical mass before the deal. Buying a company that is still fighting its own chicken-and-egg battle offers little benefit, with all of the aforementioned risk.

5. Don't shy away from making changes to the leadership team

The scale stage is not like the seed stage, and the leadership team that was successful in the former may not be in the latter (Exhibit 4). Nearly one in five scale-up leaders we surveyed claimed their biggest mistake was acting too slowly to replace people in the wrong roles. Companies should try to be honest about roles that are outgrowing their current occupants.

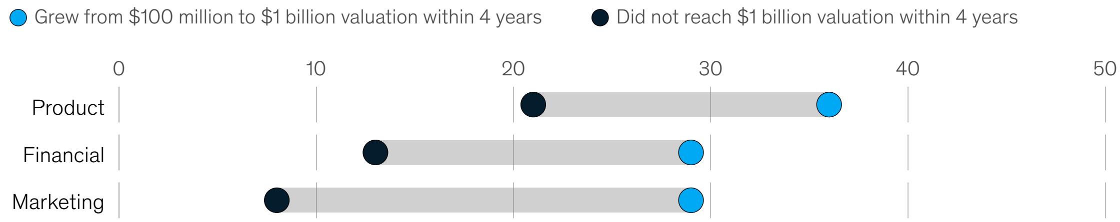
This includes founders, who may need to take a hard look in the mirror.[3] Those who successfully create a scale-up from nothing may not have the full skill set or mentality required to grow a scale-up into an enterprise. In some cases, a strong CFO or chief human resources officer (CHRO) can serve as a counterweight to founders and address weaknesses or blind spots in the original leadership team.

[3] For more on the transition thinking among founders, see the recent McKinsey podcast interview "Giving developers a leading role in cybersecurity" with the cofounder (and former CEO) of Snyk.

Exhibit 4

The fastest-growing European start-ups are more likely to replace people in key roles after their first scale round.

Top 3 C-level roles replaced after the first scale round,[1] % of scale-ups (n = 52)



[1]Start-up's 1st investment round with an estimated valuation of $100 million. Excludes deep-tech-play scale-ups.
Source: McKinsey European Scale-up Growth Journeys Survey, May–June 2022

In other cases, founders may realize that they don't actually enjoy the day-to-day work demanded by their evolving role and may prefer to step back from their executive position while retaining their board and shareholder roles. One founder told us, "As a founder, I did not want to run the business at that size, it did not excite me. I'm a zero-to-one guy. So, I left and just remained as a shareholder."

Start-ups that reach the $100 million valuation milestone have already outperformed scores of their peers, but the growth imperative only gets harder. As a result, scale-ups are forced to make hard choices among competing priorities. Sometimes (as with a US expansion), the decision may be all or nothing. Other trade-offs (such as in allocating resources across initiatives that drive growth, increase efficiency, or reinforce moats) may require a more balanced approach. The common thread among all is that leaders should be ready to embrace the challenge full on, understand the ramifications of various options, and be bold in plotting a path forward.

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