VENTURE CAPITAL: WHAT EXACTLY IS IT AND HOW SHOULD YOU INVEST?
A GUIDE FOR INSTITUTIONAL INVESTORS

David Clark
Investment Director
VenCap International plc

1. VENTURE CAPITAL OVERVIEW

Venture capital has been responsible for funding many of the largest companies in the world. The six largest companies by market capitalisation - Microsoft, Apple, Google, Amazon, Facebook and Alibaba – all began life as venture-backed startups. Unlike private equity, which typically invests in established and profitable businesses, venture capital focuses on young and rapidly growing companies intent on disrupting established sectors and creating entirely new industries.

Over the last decade we have seen companies such as Uber, Spotify, Airbnb and Zoom all emerge as major forces within large and established markets. Early-stage investors in these and many similar companies are also benefiting from the fact that companies are staying private for much longer than their predecessors and ultimately exiting at substantially higher valuations. As shown below, this has meant that investors in venture capital have enjoyed significant outperformance relative to both private equity and the public markets over the last decade.

Comparative VC Performance

	1-Year	3-Year	5-Year	10-Year
Venture Capital	**9.10%**	**14.62%**	**11.29%**	**14.85%**
Private Equity	1.98%	11.40%	11.42%	13.19%
Nasdaq Composite	-0.38%	9.21%	9.46%	12.37%
S&P 500	-6.98%	5.10%	6.73%	10.53%

Source: Cambridge Associates. Data to 31 March 2020.

Not only has venture capital outperformed in recent years, it is also able to provide increased diversification to an investor's portfolio. Over the 12 months to 31 March 2020, venture capital has generated solid positive performance. This is in marked contrast to the losses experienced by the public markets.

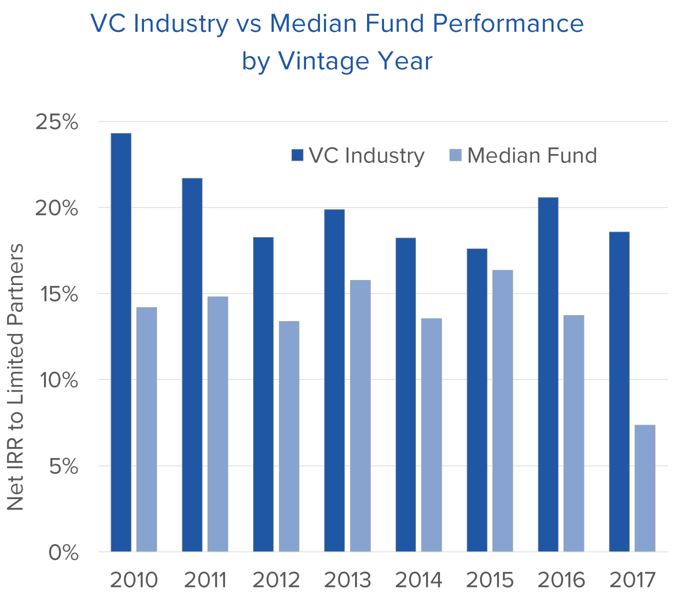
2. CHARACTERISTICS OF VENTURE CAPITAL

Any institutional investor thinking about building a venture capital programme needs to appreciate the subtle differences between VC and other asset classes. There are three key distinctions that investors need to consider.

Firstly, the bulk of the value created by the VC industry comes from a handful of leading companies. Over the last decade, the 20 largest VC-backed exits each year accounted, on average, for 50% of the total liquidity value generated by the entire industry. Additionally, 94% of funds VenCap has backed between 2000 and 2016 that are generating a 3x net return or greater has at least one "fund returner" – ie a company that generates proceeds greater than the total committed capital of the fund.

Secondly, there is a concentrated group of venture firms that have shown they can consistently gain early-stage access to these leading companies. Firms such as Accel Partners, Andreessen Horowitz, Index Partners, Kleiner Perkins, Lightspeed Venture Partners and Sequoia Capital have been responsible for funding many of the most significant businesses to have emerged from the VC industry in recent years.

Finally, as shown in the chart below, the returns generated by the VC industry overall are significantly higher than the returns generated by the median venture fund. This is due to a small number of high-performing funds in each vintage year that are the main contributors to the overall industry return. Any investor looking to replicate the strong performance of the overall venture industry must be able to access a number of these high-performing funds.



Source: Cambridge Associates. Data to 31 March 2020.

3. BUILDING A VC PORTFOLIO

The good news for investors looking to build a VC programme is that identifying the leading venture firms is not too difficult. Unlike other asset classes, there is a high degree of serial correlation within the VC industry. Simply put, if a manager has one fund in the top quartile, there is a higher probability their next fund will also be top quartile. Similarly, if a manager has a fund performing in the bottom quartile, it is more likely their next fund will also be bottom quartile. This serial correlation is one of the reasons why VenCap focuses its investments in a concentrated group of Core Managers which consistently outperform not only the median VC fund, but also the upper quartile benchmark.

The ability to invest in these leading managers, however, is significantly more challenging as access to their funds is usually limited to a small number of investors. Therefore, investors must consider how best to solve this access challenge prior to embarking on a VC investment programme. Investors must also be aware of the risks involved in investing in venture capital and how these can be mitigated through careful portfolio construction.

4. SUMMARY

Given the ongoing technology-led disruption of traditional industries, together with the best companies staying private for longer, it is clear that venture capital is becoming a strategically important asset class for institutional investors. However, the unique characteristics of VC mean that accessing the potential outperformance from the industry is not straightforward. Being able to build a portfolio that is highly concentrated around the most successful VC managers is the best way of ensuring consistent access to the next potential Apple, Amazon or Alibaba.

ABOUT VENCAP

VenCap was founded in 1987 and is one of the longest-established venture-capital focused funds-of-funds active today. VenCap has raised over $2.4 billion across multiple funds and client accounts and has developed a proven and highly successful investment strategy focusing on a small number of the leading VC firms globally.

This article was originally published in Finanz und Wirtschaft's Institutionelles Anlegen supplement in October 2020. It has been translated from the original German. The original article can be found at https://www.fuw.ch/wp-content/uploads/2020/10/fuw_institutionellesanlegen_10-2020.pdf