

VENTURE CAPITAL: DON'T CONFUSE BRAINS WITH A BULL MARKET

HOW TO POSITION YOUR PORTFOLIO TO SURVIVE THE NEXT MAJOR DOWNTURN

David Clark
Investment Director
VenCap International plc



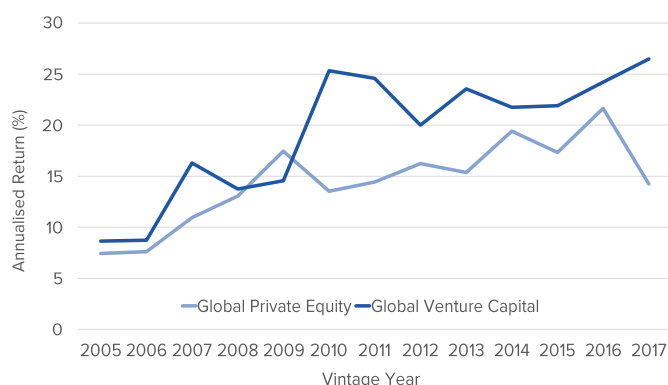
1. OVERVIEW

For investors in venture capital it's very easy to get caught up in the frenzy of recent exits, rapid markups on deals and sky-high IRRs. However, these times do not last forever. This was a lesson painfully learned in 1999/2000 during the dot-com boom and bust. And then again nearly 10 years later during the Financial Crisis. More than a decade on from the last major bear market in venture capital, how do investors ensure they are not repeating the mistakes of prior cycles? Or is this time truly different?

2. TODAY'S LANDSCAPE

The period since 2010 has been a golden age for venture capital. As Marc Andreessen predicted back in 2011, software and technology business really have taken over large portions of the economy. It has resulted in many of the leading VC-backed companies now becoming household names – Zoom, Airbnb, Spotify, Uber – and provided exceptional returns for their VC backers. And with these technology companies disrupting large parts of the traditional economy, venture capital has significantly outperformed private equity in every vintage year from 2010 to 2017.

Figure 1 - VC Outperforming Since 2010



Source: Cambridge Associates Investment Benchmarks to 30 September 2020

However, VC returns are not the only thing that have been rising over the last few years. According to data from Pitchbook, there are now as many investors writing cheques to VC-backed companies as there are VC backed companies raising capital – over 26,000 globally. This represents a three-fold increase in the number of active investors in VC companies since 2010. While the range and scale of venture investment opportunities have increased massively over this period, it does mean that at a minimum, two-thirds of active cheque writers have never seen a protracted bear market.

The relative inexperience of many venture investors should be an important consideration when thinking about how to allocate to the asset class. In a rising market, aggressively committing to newer managers can be a successful strategy. These managers are typically early-stage investors, with relatively small funds. A few companies raising follow-on rounds at higher valuations can drive strong interim performance, particularly for IRRs.

Unfortunately, however, markets do not rise indefinitely. Despite the strong long-term outlook for venture capital, there are likely to be plenty of ups and downs along the way. As such, it is essential that investors understand how quickly market conditions can change and how resilient their managers are likely to be when this happens.

3. LESSONS FROM THE PAST

If the dot-com bust and Financial Crisis of 2008/09 tell us anything, it's that investors must remember the Golden Rule. Namely, whoever has the gold, makes the rules! In today's VC environment, seed and early stage investors can rely on deep pocketed growth players such as Tiger Global, Coatue, Altimeter and many more to fund the later-stage rounds of their startups at ever-increasing valuations. While this is a major benefit in rising markets, it presents a major risk in downturns. What will happen to portfolio companies dependent on regular cash injections for survival once the growth capital firehose is turned off?

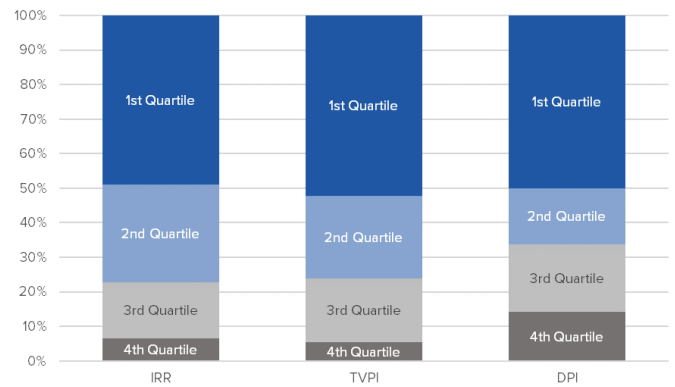
Effective management of capital reserves is one of the most under-rated attributes of the most successful VC firms. In good times, these managers are able to funnel additional capital into their most successful companies. In downturns, it can potentially make the difference between a company's survival or failure. VC funds with adequate reserves also become price makers, not price takers, with investors who cannot participate seeing their ownership positions being washed away. And don't think that VC firms can simply go back to their LPs to raise additional capital when markets correct. LPs are fighting their own fires in these situations and are often unable or unwilling to make significant new commitments.

Experienced investors in venture capital understand the importance of building a strong and resilient core to their portfolio. They look to back managers with the experience and wherewithal to successfully navigate through the good times and bad. Managers who have proven their ability to deliver consistent top-quartile performance across all stages of the market cycle. They are then able to commit to some smaller, early stage, emerging managers, safe in the knowledge that a major correction will not wipe out their entire portfolio.

4. THE CORE MANAGER STRATEGY

At VenCap, the vast majority of capital we commit goes to just 14 Core Managers, including many of the most successful VC firms in the industry. Since 1995, there has never been a single vintage year in which our investments in Core Manager funds have failed to exceed the Global VC median return and they have beaten the Global VC top quartile benchmark in 73% of vintage years. Around 50% of all mature Core Manager funds backed by VenCap rank in the top quartile by IRR, TVPI and DPI, capturing the upside that investors expect from the VC industry, while avoiding the worst of the fallow years that are part and parcel of the venture capital cycle.

Figure 2 - Core Manager Benchmarking



92 funds raised by Core Managers from 1995 to 2015 (inclusive). Benchmark is Cambridge Associates US Venture Capital. All data to 30 September 2020.

5. SUMMARY

The next few decades are poised to be an exceptional time for venture capital as technology companies continue to disrupt and innovate. For investors to benefit from this, they must ensure that the downturns that will invariably come along the way don't prove fatal to their VC programmes.

ABOUT VENCAP

VenCap is an independent investment firm focused on investing in top-tier venture capital funds in the US, Europe, China and India. Since its inception in 1987, VenCap has been an investor in funds that have offered investors early exposure to many of the most significant companies that have been formed in the last 30 years, for example Facebook, Google, Netflix, NVIDIA, Spotify and Zoom.

To find out more about us, please click [here](#). To see our latest fund offering, please click [here](#).

VenCap International plc is authorised and regulated by the UK Financial Conduct Authority. VenCap (Channel Islands) Limited is registered and domiciled in Jersey, Channel Islands and is regulated by the Jersey Financial Services Commission for the conduct of Fund Services Business, Investment Business and AIF Services Business.

This article was originally published on 28 May 2021 in VentureCapital Magazin [vc-magazin.de](#)