BEING GREEDY WHEN OTHERS ARE FEARFUL - THE OUTLOOK FOR VENTURE CAPITAL IN 2023 AND BEYOND

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1. OVERVIEW

"***Be fearful when others are greedy, and be greedy when others are fearful"*** **- Warren Buffett**

For the last few years we have been feeling increasingly nervous about the state of the venture capital industry. Venture capital is hard. Most VC-backed companies fail to return capital. Average industry performance is lacklustre - the majority of value is created by just a handful of companies each year and the funds that back them.

In recent years, many investors lost sight of the fundamental nature of venture capital and were seduced by the lure of exceptional returns, driven largely by paper gains.

Over the last 12 months, it has become clear that normality is returning to the VC industry. Fundraising has once more become challenging, valuations are down significantly, and a large percentage of the unrealised markups are disappearing.

These changes in the market are making many investors nervous about allocating future capital to the asset class. We believe they could be missing out on the best new investment environment for venture capital in more than a decade.

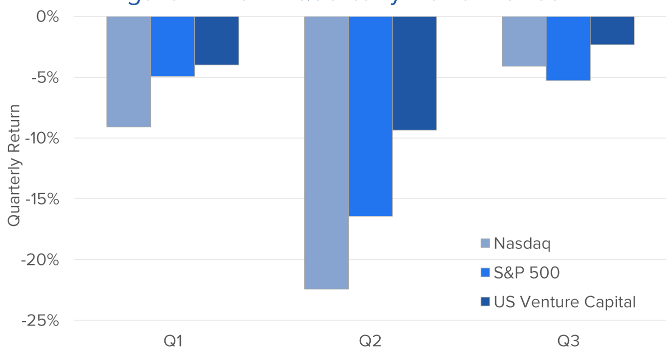
However, not all venture capital funds are created equal. There is a wide dispersion of returns between the best performing VC funds and the rest of the industry. As such, it is not sufficient for investors simply to allocate to the VC industry broadly. They need to have access to the small group of VC firms that consistently produce top quartile performance and are able to back the top 1% of companies.

2. WHAT CHANGED IN 2022?

Simply looking at the industry data for 2022 doesn't really convey the seismic shift in investor sentiment that we have seen in venture capital over the last 12 months.

Figure 1 shows the performance of US VC industry relative to the S&P 500 and Nasdaq indices over the first nine months of 2022. While all three posted negative performance over the period, the public markets fell much more sharply than venture capital.

Figure 1 - 2022 Quarterly Performance



Source: Yahoo Finance, Cambridge Associates. US VC Q3 return is still preliminary.

Typically, it can take 6-12 months after a public market correction for valuations in the venture capital industry to properly adjust to the new reality. With many VC-backed companies raising large rounds in 2021, very few have yet been forced to come back to the market and test their prior valuations. When they do, we think they won't like what they will hear. Investors are no longer rewarding companies that have a "growth at all costs" mentality. Instead, they are looking for businesses that can still generate growth, but with capital-efficient business models capable of producing strong profit margins.

3. EXPECTATIONS FOR 2023

Many existing VC-backed companies will find it impossible to adjust rapidly enough to the new climate of capital efficiency and will run out of money. This is likely to include some previously very high-profile and highly valued businesses.

Similarly, there will also be a large number of VC firms that will be unable to raise new funds. This will partly be due to a major deterioration in performance as portfolio companies are written down or written off. However, they will also have to contend with many LPs, either by choice or necessity, reducing their exposure to venture capital.

All of this means that investors should brace themselves for another 6-12 months of negative news and negative performance from existing investments. In short, we believe that the worst is still to come.

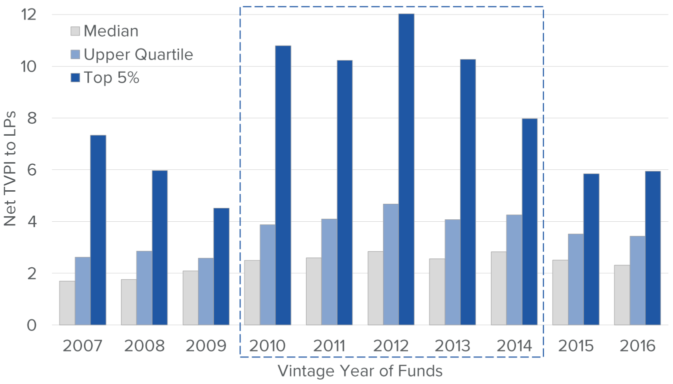
4. SO WHY ARE WE FEELING POSITIVE?

Given the negative outlook for 2023, it may seem strange that we are actually feeling positive about the prospects for deploying new capital into the VC asset class. However, it is the very conditions that make it challenging for existing investments that are the most advantageous for new capital being deployed. New investments made in 2023 will have the benefit of several major tailwinds including:

- Significantly lower entry valuations and higher ownership percentages.
- More time to build relationships with founders and undertake diligence.
- Fewer competing companies around each potential opportunity.
- Greater capital efficiency from investee companies
- Increased ability to attract high quality employees to startups.

These factors very often result in the vintage years following a major correction producing the strongest performance across the whole of the venture capital cycle. Figure 2 below shows the median, upper quartile and top 5% VC fund performance before and after the last major correction in 2008/09.

Figure 2 - VC Vintage Year Returns



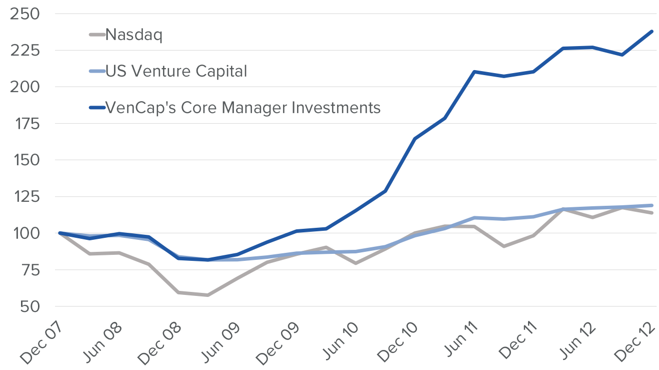
Source: Cambridge Associates Global Venture Capital Benchmarks as of 31 March 2022.

In addition to the increasingly attractive environment for new investment, VC continues to benefit from the multi-decade trend of technology adoption. Technology-enabled companies are disrupting large parts of the traditional economy and this trend is only likely to accelerate in the coming years. For example, we have recently seen major advances in artificial intelligence with products such as ChatGPT. Over the next few years, we would expect to see a major rollout of AI-powered products across industries such as healthcare, finance and transportation that will create significant opportunities for venture-backed startups and form the basis of the next major wave of innovation and disruption.

5. CORE MANAGERS AND CORRECTIONS

Since 2010, 90% of all commitments made by VenCap have gone to funds raised by just 14 VC firms. These 14 Core Managers are comprised of many of the most successful VC firms in the industry. Figure 3 below shows the performance of VenCap's Core Manager fund investments during and immediately after the 2008 Financial Crisis compared to both the Nasdaq and US Venture Capital.

Figure 3 - Core Manager Performance



Source: Cambridge Associates, www.investing.com

Like the rest of the VC industry, VenCap's Core Manager fund investments were not immune from the market downturn in 2008 and early 2009. However, these funds recovered strongly over the subsequent three and a half years and significantly outperformed both the US VC industry and the Nasdaq. These Core Managers have a number of characteristics that makes them particularly resilient during challenging periods and allows them to recover more sharply as markets bounce back. These characteristics include:

- Significant experience within the firm of managing through prior downturns.
- The capital and confidence to support their best companies in challenging markets.

- The willingness to continue making new investments despite negative market sentiment.
- A strong and supportive Limited Partner base that ensures their ability to raise future funds.

As we saw through the last major downturn, we feel highly confident that our Core Managers can navigate the current correction successfully. The funds they raise and deploy over the next few years could prove to be some of their most profitable for many years.

6. HOW SHOULD INVESTORS REACT?

There are many good reasons why investors may choose to pause their VC investment programmes during periods such as these. They may already be overweight private assets due to the denominator effect. The shutdown of the exit markets may mean a lack of liquidity to fund new commitments. There may also be a desire to commit to more liquid investments or asset classes that are perceived as being lower risk.

However, as investors in the venture capital industry for over 35 years, we believe that investors, where possible, should apply the following principles:

- Maintain a consistent commitment pace to the asset class irrespective of the prevailing macro outlook.
- Focus on experienced managers who have a proven track record of backing the top 1% of companies.
- Recognise the long-term nature of VC and don't allow day-to-day events to distract from the bigger picture.

In order to capture the long-term outperformance that venture capital can offer, it is essential for investors to remain "in the market" during challenging times. Missing out on exposure to just one or two vintage years over the course of a cycle can dramatically impact the overall performance of a VC programme.

There is an old adage in financial markets that investors should not try to "catch a falling knife" - ie don't try to second guess markets on the way down, but wait until things have stabilised before committing new capital.

This approach makes sense when you are dealing with established companies listed on public markets. However, it makes less sense when looking at backing new startups. Many of the most successful venture-backed companies were founded during or immediately after major market corrections. For example Airbnb, Uber, WhatsApp, Slack, Groupon and Freshworks were all founded between 2008 and 2010. Collectively these six companies exited for a combined value of $176 billion. We fully expect that a similar cohort of companies will be founded and raise VC funding over the next couple of years. These are the companies that will ultimately drive the performance of the VC industry over the next decade and beyond.

7. SUMMARY

The VC market is in the midst of a major correction which will result in significant value destruction for many investors who lost sight of the fundamental nature of the asset class. However, these periodic resets are essential to ensure the long-term health of the industry. They shake out many of the marginal market participants and ultimately set the foundations for the next major period of value creation.

However, in order to participate in the next wave of growth and innovation, it is essential that investors continue to commit new capital during these challenging periods. VenCap's Core Managers have shown during prior downturns their ability to recover quickly and then to significantly outperform both the broader VC industry and the public markets.

Buying low and selling high sounds very straightforward in theory. It is much harder to consistently achieve in practice. The next few years will really differentiate those investors who have the experience, confidence and capital to be greedy while others are fearful.