Capturing Venture Innovation Across Market Cycles

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Executive Summary

Great products and companies are founded and backed by great early-stage venture capital managers at times that may not correlate with broader financial market trends. Startups are impacted by the macro environment – but are more influenced by factors specific to company founders and the VC investors who partner with them. These include:

- the quality of the founding team
- the underlying fundamentals of its business, and
- the value-enhancing capabilities of its VC investors, who can maximize ownership and influence at company formation

How does an investor harness and potentially monetize the value created by founders and early-stage VC investors? We believe manager selection is a key driver of venture program success, so we detail the critical importance of:

- Differentiated access to managers that we believe to be top tier
  - Outperformance tends to persist over multiple funds
- Strong sourcing capabilities
  - Established and promising emerging managers are difficult to identify, and scarce capacity is often only available in the earliest funds
- Deep due diligence
  - The presence of a strong team and a replicable investment process increase the likelihood of continued investment success
- Diversification by number of venture relationships
  - The wide range of possible outcomes across managers and vintage years calls for thoughtful portfolio construction to offset the inevitable lumpiness of returns

Investors who pause venture programs in a challenging exit environment can miss opportunities for exposure to the innovation that early-stage venture managers are skilled at finding and harnessing.

Introduction

Don’t believe the headlines about the death of venture capital (“VC”): Innovation persists through periods of higher rates and negative market sentiment. As history has shown, great companies are founded and backed by great early-stage venture managers in good times and in bad. Investors can’t predict when the next Google will be founded or what the exit environment for that company will be when it’s ready to IPO in 10 years.

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Sadly, the past few years in venture may have conditioned investors to view venture as easy, quick money. The reality is that successful venture investing is complex and difficult, requiring a consistent strategy, a regimented sourcing and due diligence process, access to top-tier managers, and a great deal of patience. Investors with those attributes will be able to navigate the winding path in venture capital in the coming years, and the long-term returns will likely make it a path worth following. Those who really stand to lose in tough exit environments aren't the venture capital managers – but rather the investors who take a break from venture in discouraging markets.

Today's challenging venture market

If you've read a headline about venture capital in the past two years, you know that the market is facing stiff headwinds. Higher rates make long-dated, cash-flow–negative companies less attractive to investors – particularly public ones. The IPO market for late-stage VC-backed companies is effectively closed. Since the start of 2022, IPOs that have occurred have had generally poor results, and companies accessing public markets through a SPAC merger have tended to fare even worse. A VC-backed company would still likely receive a lower valuation at IPO today than it would have received from late-stage venture investors in the private markets a couple years ago.

Pitchbook IPO and DeSPAC Indices Total Return

(January 1, 2022 to December 31, 2023)[1]

[1] Pitchbook Q1 2024 Quantitative Perspectives: US Market Insights, FactSet.

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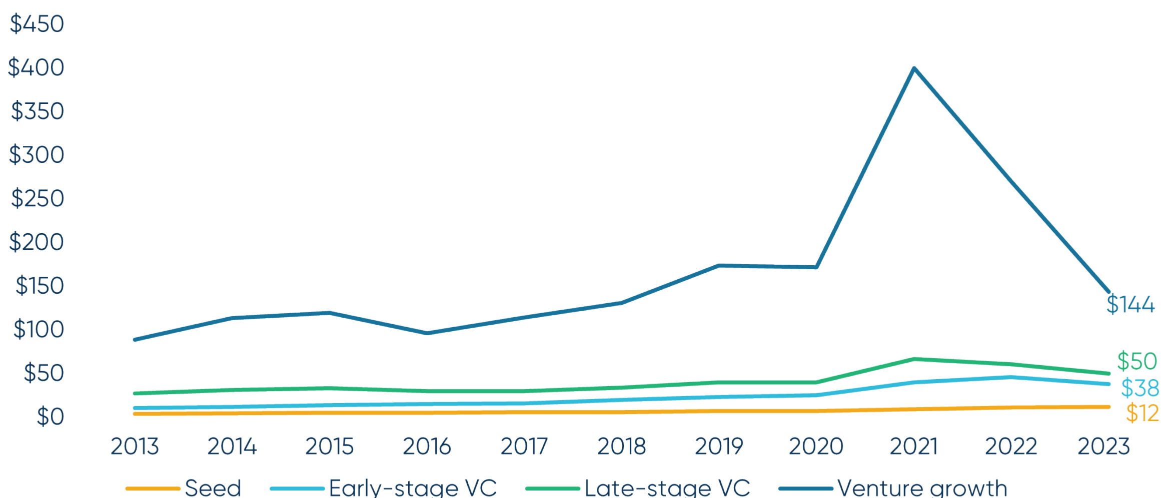
Valuations in venture capital have declined across stages very slowly – but are potentially still not at the low level suggested by today's market. With the exception of the largest venture growth deals, median pre-money valuations – the estimated value of a company before it goes public – have yet to revert to pre-COVID levels.

Median US VC Pre-Money Valuations by Stage ($mm)

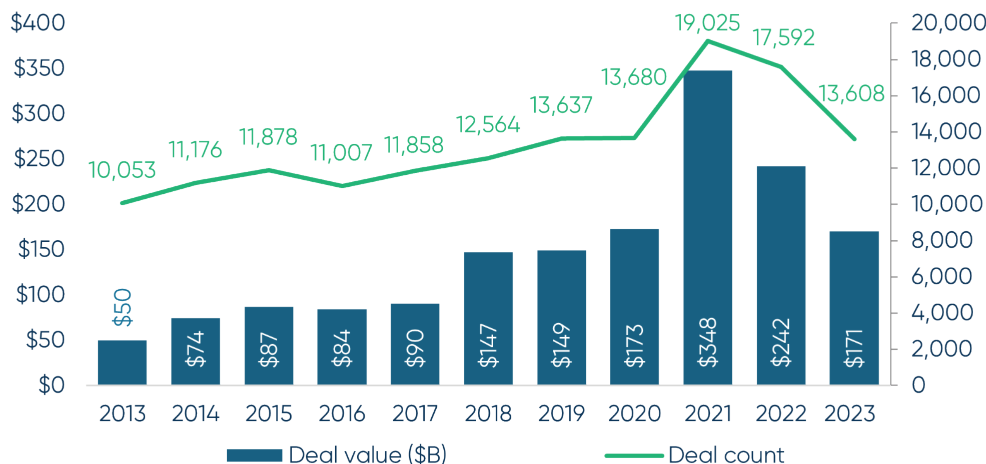
(January 1, 2013 to December 31, 2023)[2]



Understandably, the overall pace of venture investment has slowed dramatically, with firms cautious on new investments and focused on reserving capital to support existing portfolios. US VC deal value has declined more than 50% from its 2021 peak, coinciding with a reduction in growth rates for SaaS businesses, down more than 40% from their peaks.

US Venture Capital Deal Activity

(2013 - 2023)[3]



[2] Pitchbook Q4 2023-NVCA Venture Monitor. 2023 is as of 12/31/2023, but not a final estimate.
[3] Pitchbook Q4 2023-NVCA Venture Monitor. 2023 is as of 12/31/2023, but not a final estimate.

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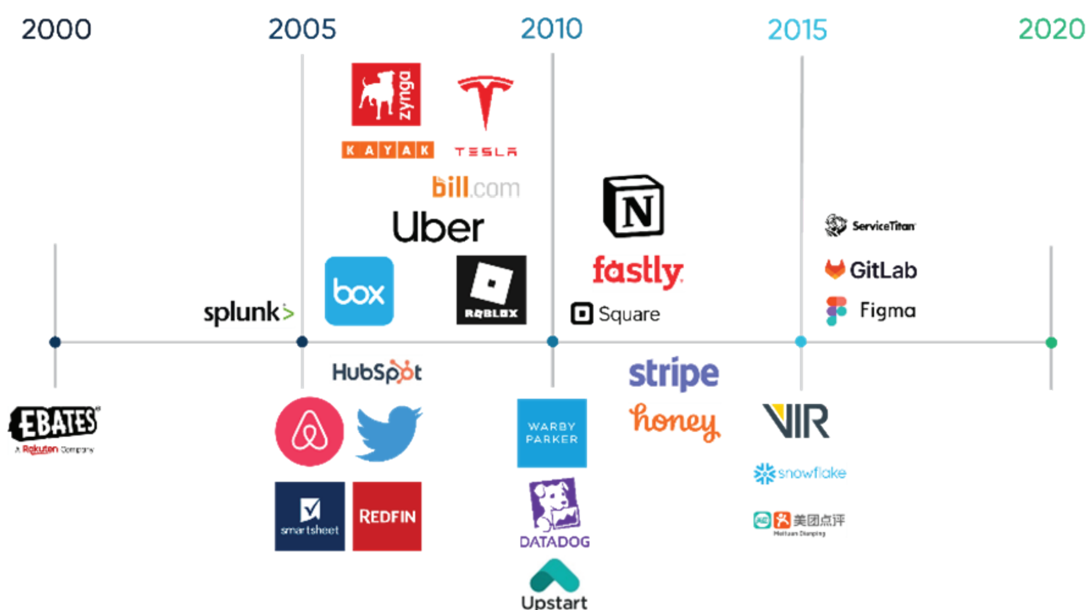
Given that backdrop, why do we still believe in the long-term attractiveness of early-stage venture capital? Because the next great companies are being founded *now*.

Companies founded across market environments

Historically, tech innovation has persisted in the US and abroad, driving wave after wave of company formation. Apple, Microsoft, Oracle, and Genentech were founded in the stagflation of the 1970s. In the aftermath of the global financial crisis, Uber, Airbnb, and other currently iconic technology companies raised their first significant VC financing rounds.

Early-Stage Venture Growth and Innovation Across Market Cycles

(2000 to 2020)[4]



Great products and companies are created and funded at times that may not correlate with broader financial market trends. A startup can be impacted by the macro environment, but will be much more influenced by the quality of the founding team, the underlying fundamentals of its business, and the value-enhancing capabilities of its VC investors, who can maximize ownership and influence at company formation.

Is this cycle different? Is innovation slowing? Is venture so over-funded that the risk/return math no longer works for LPs? Although there is no way to consistently predict

[4] TIFF. Time horizon represents transactions that have been given an opportunity to reach a degree of growth and maturity. This exhibit is included for illustrative purposes only.

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which vintage years will be better or worse than others, our view is that one would need to answer "yes" to each of those questions to conclude that "yes, this cycle is different – venture is dead."

We do not believe that the end of innovation in technology and biotech is in sight. Artificial intelligence is the latest technology theme for businesses and consumers, and we will continue to see the adoption of this and other new and existing technologies. The world's ability to predict the next big thing and its magnitude is mixed at best; the hottest technology themes attracting the most venture dollars have not always yielded the most valuable companies. Top early-stage venture managers outperform by investing in themes before they are obvious. For example, although "sharing economy" companies attracted significant venture dollars in the mid-2010s, the early-stage venture managers who first backed Uber and Airbnb captured the most value. The next big technology wave might surprise us all, but innovation persistence will not.

The pace of venture funding has already seen a strong – and healthy – pullback. Tourists who dipped their toes into venture when it looked easy, in 2021 and 2022, have left the market, shown by an almost 60% decline in annual "non-traditional VC investor" deal value from 2021 to 2023.[5] Undifferentiated VC firms will fail to raise new funds, and some firms that grew too large will be forced to scale back. Gradually, the venture market should reach a new equilibrium. As power dynamics shift back toward investors from founders, venture capital firms will have more time to conduct due diligence on companies and founders, improving investment decision-making.

Truly innovative companies won't have to contend with an overfunded landscape of me-too competitors, making their path more capital efficient – and early investors' returns that much greater. Founders should once again become more thoughtful about which VCs to partner with, and more concerned about who can help build great businesses than who will assign the highest pre-money valuations. We believe this will benefit high-quality venture firms, both emerging and established.

Although the venture market is still in the midst of these adjustments, we believe that the attractive long-term risk/reward of a *high-quality* early-stage VC program remains intact.

[5] Pitchbook Q4 2023-NVCA Venture Monitor.

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Manager selection, the perpetual challenge in early-stage venture

In almost any multi-year period during the past 25 years, the Cambridge Associates Venture Capital Index would have beaten a comparable US public equity benchmark by a significant margin, and the US Early Stage Index would have performed even more strongly.

Horizon Pooled Return Net to Limited Partners

(1981 to 2023)[6]

Index (%)	1 Q	YTD	1 Yr	3 Yr	5 Yr	10 Yr	15 Yr	20 Yr	25 Yr
Cambridge Associates LLC Venture Capital Index[1]	-2.36	-3.84	-8.89	14.85	17.24	17.18	13.42	12.52	20.36

Sadly, you can't buy a venture capital index fund – and historically, venture returns have exhibited a power law distribution, where a small number of startups massively outperform all others and capture the vast majority of returns in any given year. Recent analysis shows that fewer than 4% of dollars invested into US VC-backed companies exiting over the past decade generated more than a 10x return, but 37% lost money.[7]

In the past several years, the influx of capital into venture, particularly later stage dollars, inflated the value of leading startups and me-too companies beyond what could be justified by business fundamentals. This dynamic was never sustainable.

We expect that valuations will continue to contract and that category laggards will go out of business while category leaders accelerate growth. The power law in venture never actually went away; rather, it was just in hiding for a few years. We believe that a handful of startups will continue to drive venture returns in any given year, and that the funds with early exposure to those companies will drive that vintage year's returns.

These dynamics make venture manager selection one of the most critical aspects of an institutional portfolio. Venture returns follow a power law distribution, not a normal distribution, so those who can invest in the best managers and best companies will likely experience VC returns that are well above average, and those who can't will

[6] Cambridge Associates LLC. As of September 30, 2023. The index is a horizon calculation based on data compiled from 3,106 venture capital funds, including fully liquidated partnerships, formed between 1981 and 2023. [1]Private indexes are pooled horizon internal rate of return (IRR) calculations, net of fees, expenses, and carried interest. The timing and magnitude of fund cash flows are integral to the IRR performance calculation. Cambridge Associates provides these benchmark statistics "AS IS" and at no cost to managers that participate.
[7] Source: Correlation Ventures. "Venture Capital – We're Still Not Normal." David Coats. July 13, 2023. Published by VC By the Numbers, medium.com.

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dramatically underperform. Because more managers and LPs will underperform in early-stage venture than outperform, investors should be cautious about entering without a partner or experience and clear process and access edges.

Competitive advantages in early-stage venture

To win over the long haul in early-stage venture, an investor needs rigorous sourcing and due diligence processes, differentiated access, and the resources and experience to create a diversified portfolio of premier established and emerging venture capital managers.

Differentiated access

Differentiated access is crucially important in venture. Unlike other areas of the investment world where a top performing manager in one year can be the worst the next year, venture capital managers have exhibited persistence in returns.

Fund Persistence by Quartile Performance at Fund End

(Vintage Years 1984 to 2014)[8]

Previous Fund Quartile at Fund End	Current Fund Quartile / No. of Funds: 1	2	3	4
1	44.7% 98	24.2% 53	18.7% 41	12.3% 27
2	22.9% 47	27.3% 56	31.2% 64	18.5% 38
3	16.8% 31	33.7% 62	29.3% 54	20.1% 37
4	9.3% 11	18.6% 22	26.3% 31	45.8% 54

For vintage years 1984 to 2014, top quartile venture managers in one vintage had a 45% chance of remaining in the top quartile with their next fund. Even more importantly, with their next fund, top quartile venture managers had an almost 70% chance of being above median and just a 12% chance of being in the bottom quartile. Bottom quartile venture managers had a greater than 45% chance of remaining at the bottom in their next fund.

[8] "Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds." National Bureau of Economic Research, November 2020, page 32, by Robert S. Harris, Tim Jenkinson, Steven N. Kaplan, Ruediger Stucke.

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Although we believe top quartile persistence will likely slowly erode over time, there are real dynamics that help keep top venture firms on top. Premier venture firms can easily attract LP capital, allowing them to focus on investing and making the best long-term decisions for their firms. VCs who have succeeded in the past tend to attract founders who believe these VCs can help their companies grow. In turn, if a top VC backs a startup, founders will have an easier time attracting talent and other sources of capital.

By the time a venture firm is perceived to be premier, its funds are closed to almost all new investors. As an LP, if you don't already have access to top-tier firms or a way to access them, your venture capital program will have a hard time succeeding. Early access to a top venture firm is a true asset that can lead to years or, in some cases, decades of partnership with and commitments to that VC. If you're a seasoned venture investor, with existing access to some of the top firms and a network – existing managers, board or alumni connections, etc. – to access additional top firms, your venture program will be well positioned to win.

Strong Sourcing Capabilities

Strong sourcing is also vital to long-term venture success - persistency in venture isn't fool proof, and short-term returns aren't especially meaningful. A company that has a big up-round today might go out of business in a few years. Valuation methodologies vary widely, leading the same company to be held at different valuations by different firms. Finally, it can take a decade for a company to exit, so the ultimate quartile ranking of a venture fund might not be fully baked for many years. You can't just look at recent, unrealized returns and assume that a venture firm will continue to generate outsized returns.

The top venture firms aren't a perpetually static roster. Generational transition, team turnover, AUM and product growth, and strategy drift can knock a high-flying venture firm to the ground. An LP investing in venture has to have the ability to find, underwrite, and gain access to emerging firms who may not have realized track records to analyze. By the time it's obvious to the world that a new great venture firm has emerged, LPs who aren't already investors are likely too late to access that firm. The ability to source and select – or be selected by – top emerging venture managers is possibly the hardest task for any institutional investor.

The best early-stage venture firms are highly selective in who they add to their investor base, rarely marketing broadly. Investors must have unique networks within the venture ecosystem and must systematically mine them to discover the best new early-stage

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investors before everyone else. Having multi-year – sometimes multi-decade – relationships with established VC managers gives existing investors a first look at high-potential spin outs. Referrals from top-tier early-stage VCs and founders in an investor's network can add a consistent stream of qualified opportunities to the pipeline. LPs with strong reputations and history in early-stage venture investing will often receive direct inbound opportunities worth pursuing.

Deep Due Diligence

Given the sheer volume of early-stage venture funds, it is paramount to have a rigorous, consistent, and comprehensive diligence process to be able to select top managers.

As is true with backing early-stage companies, the quality of the team should take center stage when evaluating venture capital firms. It is critical to spend significant time with GPs and the teams that they manage (sometimes over many years) to truly understand their backgrounds, investment process, leadership capabilities, and team dynamics. Speaking with founders of their portfolio companies, their VC co-investors, and their other LPs can shed light on their competitive differentiation, their value-add capabilities, and their partnership orientation. Keeping in mind the challenges of interim valuations and performance evaluation noted earlier, investors must maintain rigor when analyzing a manager's track record and their go-forward strategy. We weight recent and unrealized performance much less than we do our analysis around portfolio construction, ownership targets, and exit outcomes necessary to achieve our target returns. Relatedly, funds must be sized appropriately to reflect the opportunity set in the market, and incentives must be aligned to reward superior performance over generating management fees.

Investors must have a disciplined process to distill that information into the best investment decisions possible. Here, the importance of experience, pattern recognition, a rigorous manager selection framework, and a well-defined investment strategy become clear.

Diversification by Venture Firms

Adding just one new high-quality venture firm is hard enough, but an institutional investor needs to build an entire roster of such managers.

Investors have differing views on the right number of venture managers in a portfolio. We tend to have 10 to 15 venture firms active on our roster. A number of those – typically

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Fund I's – are sized as "starter" positions; we look to scale up firm exposure over time as firms prove themselves. We consider sector and geographic diversification, ideally creating a portfolio where our venture managers have non-overlapping networks and areas of expertise so that we gain access to the greatest breadth of startups. We think about creating a balance between shots on goal (the greater the number of shots, the higher the chance we get exposure to the winning companies in that vintage) and concentration. Too many small commitments dilute any winners, but too few commitments can reduce your chances of hitting winners in that vintage to an unacceptably low level. At the end of the day, we only want to invest in high-conviction managers who we think are great partners and have a differentiated position in the market. As a result, the size of our venture roster will likely move up and down within that 10 to 15 range.

Conclusion

From our vantage point, fears about the death of venture capital are misplaced. Venture capital always has been and will continue to be a challenging market to navigate. We firmly believe that technology innovation will continue, despite where we are in the financial market cycle. The excesses of the venture industry over the past several years are in the midst of a correction that we believe is good for the long-term health of the early-stage ecosystem.

Successful venture investing requires strong and resource-intensive active management. For those investors with differentiated access, strong sourcing and due diligence processes, and a disciplined approach to portfolio construction, we believe the potential to generate superior long-term returns is certainly worth the time and effort.

Past performance is no guarantee of future results and the opinions presented cannot be viewed as an indicator of future performance. There is no guarantee that any particular asset allocation or mix of strategies will meet your investment objectives.

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