Venture Capital:
Industry Trends and Investor Appetite

With the launch of Preqin's new office in Silicon Valley, Nicholas Jelfs explores the latest trends in fundraising, performance and deal activity across the venture capital industry, as well as investor attitudes towards venture capital, both over time and for the future.

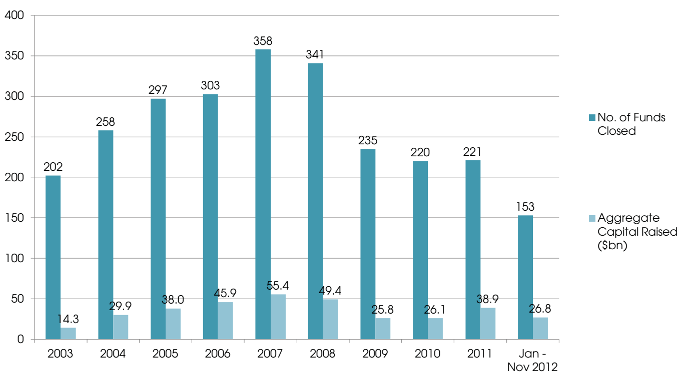
Investment in young, high-risk, high-potential companies by venture capital fund managers has historically been an important part of the private equity industry. In addition to promoting innovation and significant growth within many companies and industries, it is also an important component of many investors' portfolios and a key investment strategy for many general partners. Despite challenging economic conditions following the onset of the financial crisis in 2008, the number of venture capital funds closing each year has remained stable since the post-financial crisis drop from 341 funds closed in 2008 to 235 funds closed in 2009, Fig. 1 shows. Additionally, the aggregate capital raised by funds saw a notable increase in 2011, with 221 funds raising an aggregate $38.9bn in 2011 compared to the 220 that raised an aggregate $26.1bn in 2010.

Investors generally commit to venture capital funds as part of a wider diversified private equity portfolio, but also to pursue the larger returns the strategy has the potential to offer. However, venture capital funds have produced lower returns for investors over recent years compared to other private equity fund types, particularly buyout. Preqin's ten-year horizon IRR data to 31st March 2012 indicates that for all strategies, private equity generated a return of 12.8%. For buyout funds specifically, this return was 19.9%, yet for venture capital funds the horizon IRR was 1.6%. However, Fig. 2 shows a recent improvement in general venture capital performance, with the median and top quartile IRR for venture capital funds with 2007 and 2008 vintages significantly higher than those of previous years.

Investor Appetite for Venture Capital

Despite lower returns, private equity investors still demonstrate interest in venture capital investments. Sixty-three percent of

Fig. 1: Venture Capital Fundraising, 2003 - November 2012

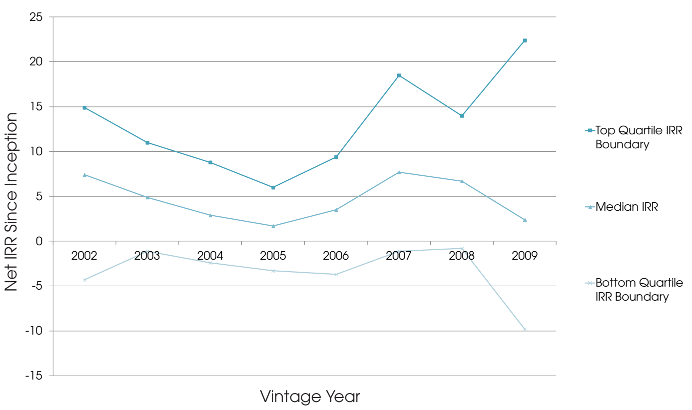


Source: Preqin Funds in Market

investors currently listed on Preqin's Investor Intelligence database have either expressed a preference for, or have previously invested in, venture capital. Fig. 3 provides a breakdown by investor type of LPs that have specified a preference for investing in venture capital funds. Foundations make up the largest proportion of investors, representing 13% of the total universe; endowment plans and public pension funds account for 12% and 11% respectively.

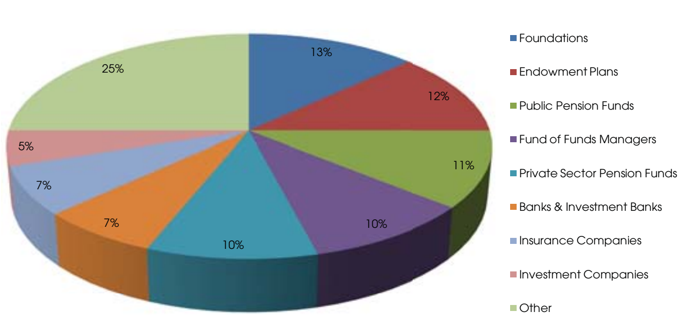
Additionally, investor interest in venture capital investment has grown recently. Preqin surveys private equity investors every six months in order to gauge investor sentiment towards the asset class and explore investor appetite and the outlook for specific fund types and geographies going forward. Fig. 4 shows investors' attitudes towards investing in venture capital over time, from H1 2010 to H1 2013, compiled from the results of these surveys. There has been a notable increase towards the end of 2012 in

Fig. 2: Venture Capital Median Net IRRs and Quartile Boundaries by Vintage as of 31st March 2012



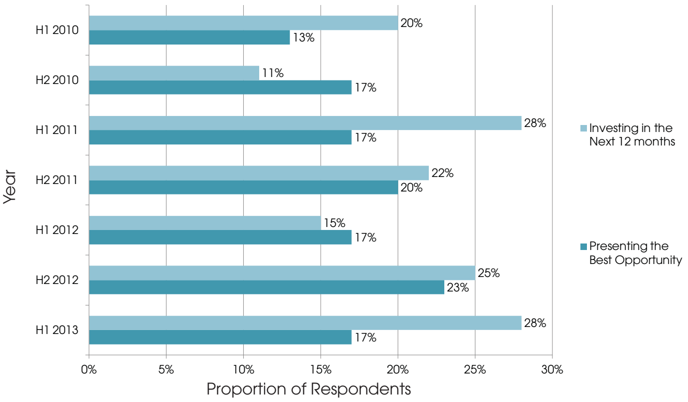
Source: Preqin Performance Analyst

Fig. 3: Make-Up of Private Equity Investors With an Appetite for Venture Capital Funds by Investor Type



Source: Preqin Investor Intelligence

Fig. 4: Private Equity Investor Attitudes Towards Investing in Venture Capital



Source: Preqin Investor Surveys - December 2009 - December 2012

the proportion of LPs looking to invest in venture capital over the following 12 months, with a quarter of respondents specifying an appetite for the fund type midway through 2012, up from 15% at the end of 2011. This is a significant jump in appetite; however, it may have been influenced by the number of high-profile venture capital exits in the first half of 2012, such as Facebook, Instagram and Zynga, Inc., which helped publicize the strong returns available to venture capital investors. These exits also drove particular interest in early stage venture capital investments, which have the potential to produce larger returns than late stage investments. Investor interest has since grown further, with 28% of investors interviewed by Preqin at the end of 2012 planning to invest in venture capital over the next 12 months.

Fig. 5: 10 Largest Venture Capital Fund Managers by Funds Closed, 2010 - 2012 YTD

Fund Manager	GP Location	No. of Funds Closed	Aggregate Capital Raised ($bn)
Kleiner Perkins Caufield & Byers	US	7	2.9
Tiger Global Management	US	2	2.7
New Enterprise Associates	US	1	2.6
Sequoia Capital	US	2	2.4
IDG Capital Partners	China	4	2.2
Andreessen Horowitz	US	2	2.2
Institutional Venture Partners	US	2	1.8
Bessemer Venture Partners	US	1	1.6
Insight Venture Partners	US	1	1.6
Yunfeng Capital	China	1	1.5

Source: Preqin Fund Manager Profiles

Growing Prominence of Top Managers

Investors looking for strong returns are often looking to only commit to funds being raised by top managers, which have demonstrated a strong and consistent track record in venture capital investment. Preqin has witnessed greater amounts of aggregate capital being raised by larger fund managers in recent years. The top 20 largest venture capital fund managers by aggregate capital raised throughout 2012 account for 60% of the total capital commitments raised by venture capital funds closing during the year. Throughout 2010 and 2011, this proportion was 44% and 53% respectively, indicating that the biggest firms are accounting for a significant proportion of total capital raised by venture capital funds. Fig. 5

provides a list of the top 10 fund managers by total capital raised for funds that closed throughout 2010, 2011 and 2012. Five of these 10 fund managers have consistently had funds ranked in Preqin's 1st and 2nd quartiles for their specific fund types; New Enterprise Associates' transition, for example, from early stage vehicles to all stage venture funds in 2004 has produced two top quartile funds and one second quartile fund, according to Preqin's Performance Analyst. Institutional Venture Partners have produced two top quartile expansion/late stage fund since 2000.

How are Venture Capital Fund Managers Investing?

Since the beginning of 2008, there have been over 23,000 venture capital deals completed globally, with an aggregate value of almost $210bn. Fig. 6 displays how the annual number of announced venture capital financings has changed since 2008, excluding venture capital-backed add-on deals and venture debt funding.

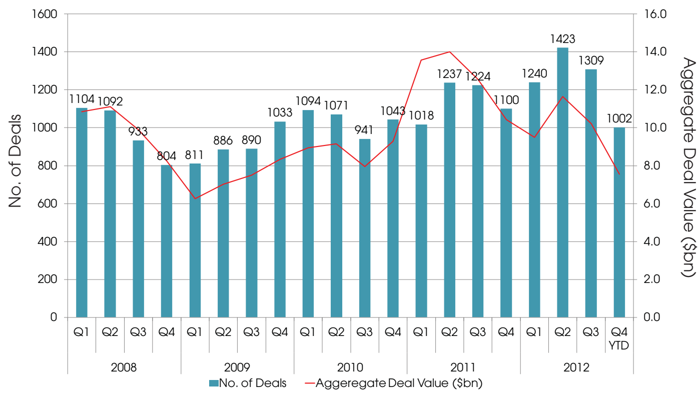
There was a significant increase in venture capital deal activity at the start of 2012 compared to previous years, reaching a peak in Q2 2012, when 1,423 deals were announced. Overall, the number of venture capital deals announced each year has risen year-on-year since 2009; 2012 YTD continues this pattern, with the number of deals announced already surpassing the number announced in 2011. The value of these deals, however, still remains at subdued levels, with $38.9bn in venture capital financings made in 2012 compared to $50.6bn in 2011.

Focusing on Specific Sectors

The technology and healthcare industries have generally attracted the greatest level of investment from venture capital fund managers. Technology especially has remained at the forefront of innovation and development in a growing digital culture. Throughout 2012, $8.2bn and $3.2bn was raised for venture capital funds with a primary focus on technology and healthcare respectively. Together, these sector-specific funds accounted for 43% of the aggregate capital raised between January and December 2012. In general, sector-specific funds account for a greater proportion of the venture capital fundraising market than diversified funds. Out of the $52.1bn currently being sought by venture capital vehicles in market, $31.6bn is accounted for by funds with a specific sector focus.

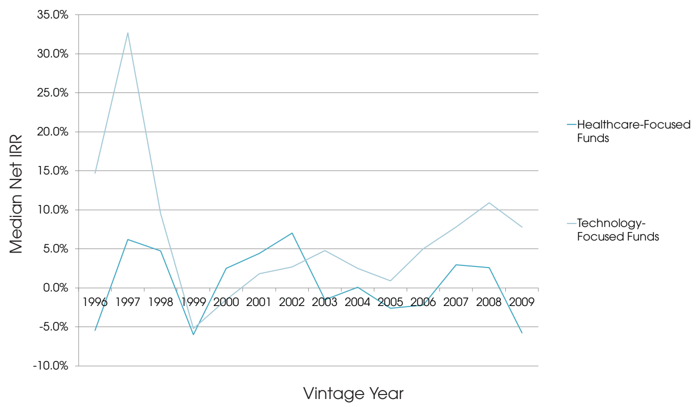
The previously mentioned surge in the value of deals in the first half of 2011 was predominantly led by investments in technology companies. This was largely due to the popularity of social media and internet companies, such as Groupon, Inc., Facebook and Rovio, being invested in at expansion/late stages following successful early stage rounds. This has also encouraged a significant increase in the number of seed stage technology deals, as firms are looking to invest early with these sorts of companies. Seed and angel stage deals accounted for 26% of the number of all technology deals made so far in 2012, compared to 8% of healthcare deals. As such, the average size of technology deals has generally been notably lower than that of healthcare deals. In 2012 to date, the average size of healthcare deals was $11.4mn compared to $8.4mn for technology deals.

Fig. 6: Number and Aggregate Value of Venture Capital Deals Globally, Q1 2008 - Q4 2012 (as of 7th December 2012)



Source: Preqin Venture Deals Analyst

Fig. 7: Venture Capital - Median Net IRRs: Healthcare vs IT Funds



Source: Preqin Performance Analyst

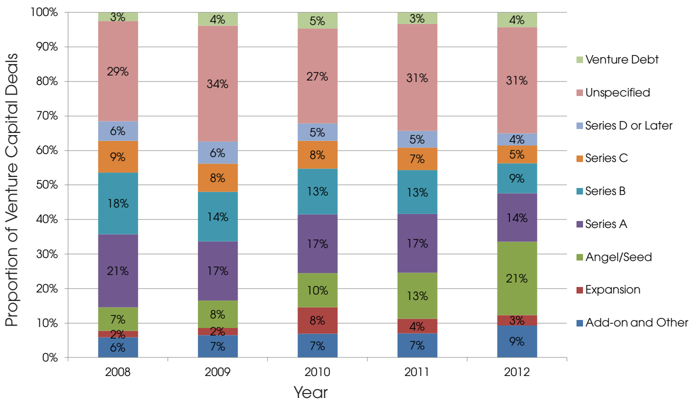
Technology-focused funds have generally outperformed healthcare-focused funds. Fig. 7 shows the median net IRRs by vintage year for venture capital funds with a primary focus on the healthcare industry compared to the equivalent for technology-focused funds. Following the dot-com bubble, healthcare funds briefly outperformed technology funds, but since 2003, funds predominantly investing in the technology sector have performed better; funds with a 2008 vintage currently have a median net IRR of 10.9% compared to a return of 2.6% for healthcare-focused funds.

As previously noted, Preqin has seen a significant increase in the number of seed deals being made by venture capital firms in recent years. Fig. 8, a breakdown of all venture capital deals made globally by investment stage, shows growth in seed stage deals, increasing from 8% of the total number of deals in 2009 to 21% of deals made throughout 2012, as well as a notable drop in mid-stage financing. This perhaps suggests a general growth of interest among investors in investing earlier on in a company's life cycle in the hope of maximising potential longer term value and returns.

Outlook

The venture capital industry experienced some positive growth in recent years, with the number of venture capital deals completed in 2012 increasing in comparison to 2011. Investor sentiment towards venture capital still remains buoyant and the recent uptick in performance may demonstrate the potential for improved returns going forward. There has been a slowdown in the number of large late stage technology deals seen throughout 2011; these deals seem to have been replaced by a surge in seed stage deals. The technology sector remains at the forefront of the venture capital universe, attracting larger levels of fundraising and deal activity, and managing to generate better returns than specific healthcare-focused funds. Venture capital continues to provide young companies with financing and support, and with recent performance improving, fundraising and deal values may continue to pick up throughout 2013.

Fig. 8: Breakdown of Venture Capital Deals by Stage, 2008 - 2012 (as of 7th December 2012)



Source: Preqin Venture Deals Analyst

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Subscribers to Preqin's Funds in Market can click here to view all 383 venture capital funds currently in market, and subscribers to Investor Intelligence can click here to access all 3,028 institutional investors that have a preference for, or previously invested in, venture capital funds. This article draws on data and analysis from Preqin's Private Equity online databases, including Venture Deals Analyst, Funds in Market, Investor Intelligence and Performance Analyst.

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