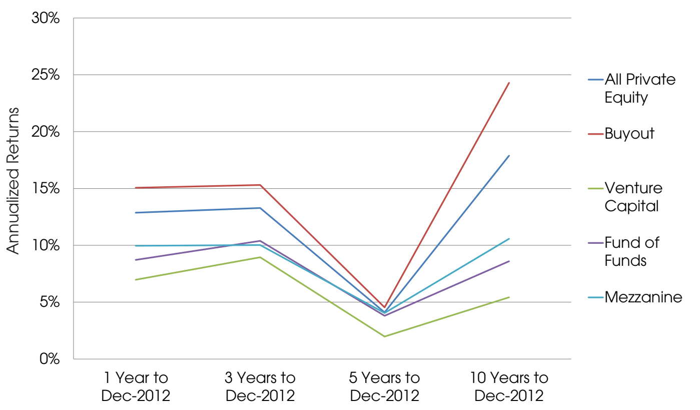
The Venture Capital Conundrum

Investor appetite for venture capital funds remains high and new funds keep on being launched into the space. However, overall returns are low in comparison to other funds and there is a feeling that the industry won't return to the heyday of the 90s. Ignatius Fogarty looks to answer the venture capital conundrum and understand what drives investor appetite?

Venture capital provides an important function in today's economy in assisting the growth of new and young companies. The goal of the venture capitalist is to identify new companies that they feel have potential and provide equity to these firms at an early stage of their existence, with the overall goal of growing these companies and generating a return. There is the opportunity to make high returns when investing in a venture capital fund, but there is also the opportunity to lose a significant amount of money as well. The 1990s saw the venture capital industry attract significant publicity, as venture capitalists invested in internet start-up companies, but when the dot-com bubble burst many of these companies lost value very quickly and folded. One of the most notable of these was Pets.com, which raised $82.5mn in an IPO in 2000, but folded nine months later. However, companies did survive the bubble and continue to thrive; one of these, Amazon.com, continues to be at the forefront of e-commerce today.

Fig 1: Private Equity Horizon IRRs as of 31 December 2012



Source: Preqin Performance Analyst

Performance of Venture Capital Funds

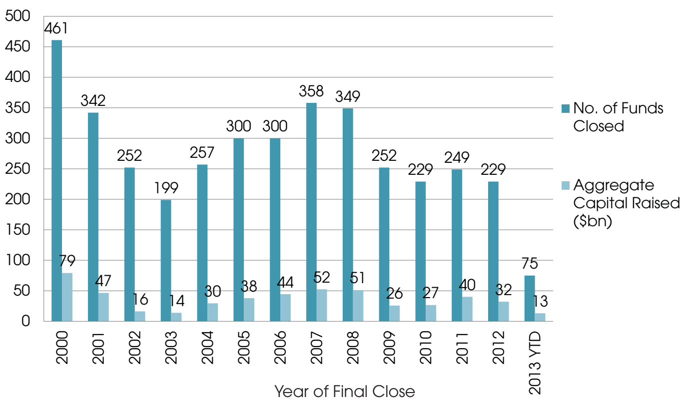
Compared to other private equity funds, venture capital funds as a group have more recently produced lower average returns for investors; Fig. 1 shows Preqin's horizon IRR data. Ten-year horizon IRR data to 31st December 2012 indicates that for all strategies, private equity generated a return of 19.0% and for buyout funds this was 23.4%; however, venture capital funds only generated an average return of 4.4%.

Investor Appetite for Venture Capital

Despite other private equity strategies recently outperforming venture capital, investor appetite for this fund type remains strong and fund managers are responding by launching new funds. As of July 2013, there were 397 venture capital funds seeking to raise an aggregate $47bn in capital commitments. In 2012, 229 venture capital funds held a final close, securing an aggregate $32bn from investors as displayed in Fig. 2.

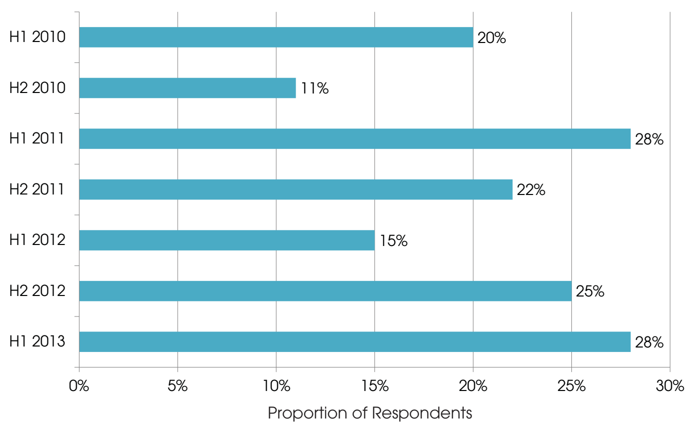
Investor appetite for venture capital funds has also increased over time. Twenty-eight percent of the LPs Preqin spoke to for its Investor Outlook: Private Equity, H1 2013 that are looking to make new fund commitments in 2013, expected to commit to venture capital funds, as shown in Fig. 3. Furthermore, over 60% of investors tracked by Preqin's Investor Intelligence online service have expressed an interest in, or have previously invested in, a venture capital fund, which further demonstrates how widespread investor appetite for this strategy is.

Fig. 2: Annual Venture Capital Fundraising, 2000 - 2013 YTD (As at 03 July 2013)



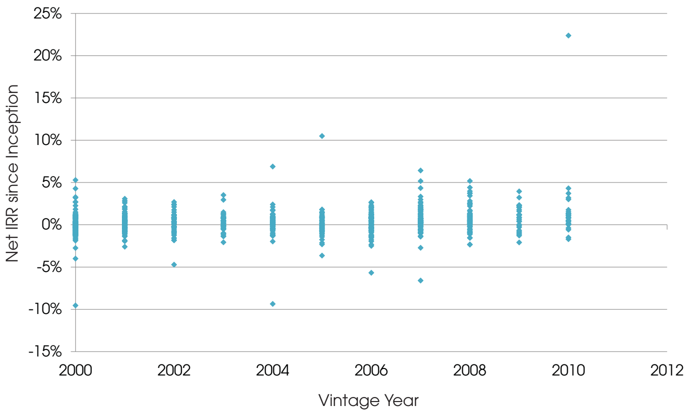
Source: Preqin Funds in Market

Fig. 3: Proportion of Investors Planning to Make New Commitments to Venture Capital Funds in the Next 12 Months, 2010 - 2013



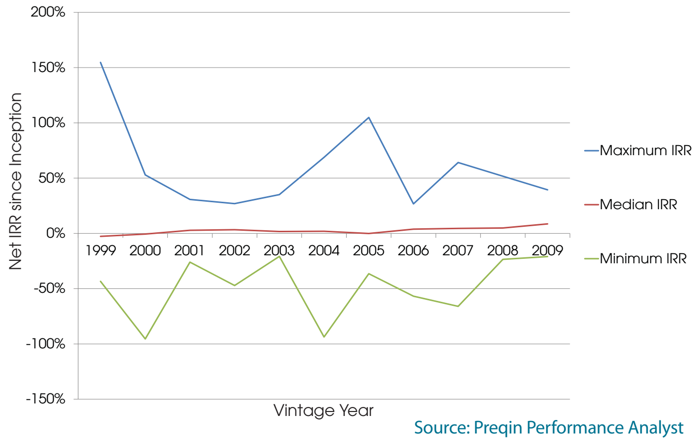
Source: Preqin Investor Interviews, 2010 - 2013

Fig 4. Venture Capital Net IRR Dispersion by Vintage Year



Source: Preqin Performance Analyst

Fig 5. Venture Capital - Minimum, Median and Maximum IRRs by Vintage Year



Source: Preqin Performance Analyst

The Big Draw

So what attracts investors to the venture capital industry when it appears that, overall, the industry has not been performing as well as other fund types such as buyout? Looking further into the numbers, we can see that even though the overall benchmark may indicate that, as a group, venture capital funds may not have performed well, individually there are some great performing funds, which drives overall investor sentiment. Fig. 4 shows the IRR dispersion of venture capital funds, highlighting the difference in performance of this fund type. The majority of funds are clustered around the median; however, there is the occasional fund that performs significantly higher than the rest. These are the "home run funds" that drive investors to commit to venture capital funds.

Fig. 5 compares the minimum, median and maximum IRRs of venture capital funds by vintage year, illustrating the difference between the top performing managers and the lowest performing fund managers. For funds with a 2005 vintage, the best performing venture capital fund delivered its investors a return of 104.9%, whereas the worst performing fund generated a return of -36.5%. The best funds of each vintage year are performing very well; however, the worst performing funds have negative IRRs, clearly demonstrating the importance of selecting the best fund managers. Fig. 6 shows the Preqin Venture Capital Benchmark and demonstrates that the majority of Q3 IRR quartiles are in the negative. In the 1990s the industry was performing very well; looking at vintage 1997 funds, the median IRR was 29.8% and the maximum was 267.8%. Preqin has identified over 164 venture capital funds with an IRR of over 30%.

Venture Capital Exits

In recent years, venture capital exits have once again become significant publicity events, the largest of which can be seen in Fig. 7. When a tech start-up is exited by its founders, these individuals and their backers are celebrated widely, and stories of the growth of their personal wealth dominate not just the financial press, but the mainstream media as well. The story of tech savvy students building tech products in their dorm rooms, which then go on to

Fig. 6: Preqin Venture Capital Benchmark

Vintage	No. Funds	Median Fund			IRR Quartiles (%)			IRR Max/Min (%)	
		Called (%)	Dist (%) DPI	Value (%) RVPI	Q1	Median	Q3	Max	Min
2010	37	45.0	0.0	101.8	18.5	11.0	1.4	223.7	-13.6
2009	36	64.4	5.8	102.5	18.0	9.9	-5.7	37.4	-21.0
2008	91	71.8	12.7	87.9	14.9	5.9	-3.6	72.2	-23.3
2007	104	84.9	12.3	96.9	14.8	5.7	-1.3	62.0	-66.0
2006	98	91.3	20.2	80.9	10.8	4.1	-4.6	26.5	-56.8
2005	71	95.0	27.1	68.2	8.6	1.3	-6.4	104.9	-75.3
2004	62	98.7	33.7	64.7	6.8	2.0	-3.5	68.8	-21.0
2003	50	99.4	36.6	48.1	8.5	2.0	-3.8	35.1	-19.7
2002	61	100.0	58.2	28.8	9.0	2.8	-6.1	26.9	-47.2
2001	94	100.0	70.3	28.8	9.5	2.4	-4.6	30.4	-26.0
2000	144	100.0	61.0	19.3	5.8	-0.8	-6.3	52.9	-95.5
1999	82	100.0	62.0	8.9	5.7	-2.6	-12.3	154.7	-43.4
1998	71	100.0	108.7	0.5	17.9	6.3	-6.8	1015.7	-46.1
1997	69	100.0	181.4	0.0	71.9	29.8	4.8	267.8	-30.0

Source: Preqin Performance Analyst

be companies worth billions of dollars, is this generation's story of the self-made man. When Facebook issued its IPO, it was reported that Mark Zuckerburg's personal wealth escalated to around $24bn, and those venture capital firms that had backed him from the start generated significant returns for their investors. Accel Partners invested in Facebook in 2005 and 2006 and now has approximately a 10% stake in the company, which as of June 2013, is valued at around $5.2bn. Instagram, another high profile tech start up, was bought for $715mn by Facebook; it received funding from firms such as Andreessen Horowitz, Benchmark Capital and Greylock.

There has been speculation recently in regards to Twitter, estimated to be valued at $11bn, going public in 2014, which would generate significant returns for backers such as Benchmark Capital, Charles River Ventures and Union Square Ventures. There is a view that the recent increase in investor appetite for venture capital has been driven by these highly publicized events, which have made the asset class more attractive to investors. However, not all exits are successful in the long run. Zynga's share price has dropped by 75% since its IPO in 2011 and Groupon has had similar struggles, giving the thought to many industry commentators that there potentially could be a "web 2.0" bubble in the not so distant future.

Consistent Performance

Investing with a successful venture capital fund manager can deliver an investor high returns. An example is Union Square Ventures, one of the venture capital fund managers that provided financing to Twitter. All of the funds that it has raised historically are in the top quartile for their respective vintage years, based on data from Preqin's Performance Analyst. Its first fund, Union Square Ventures, which has a 2004 vintage, significantly outperforms the benchmark for funds with the same vintge year. Other portfolio companies that Union Square Ventures has invested in include Tumblr (which in turn was recently bought by Yahoo.com for $1.1bn in cash), Foursquare and Bluefin Labs.

These successful fund managers are able to continually attract capital from institutional investors for their vehicles. Insight Venture Partners, a firm which has four of its six funds in the top quartile in their respective vintage years, secured $2.57bn for its latest fund, Insight Venture Partners VIII, surpassing its target of $2.5bn. Among its investors were Washington State Investment Board and Los Angeles City Employees' Retirement System.

However, it is not just the high profile fund managers that can generate significant returns for their investors. Jerusalem Partners,

Fig 7: Top 10 Venture Capital Exits by Exit Value, 2008 - 2013 YTD (As at 03 July 2013)

Firm	Initial Investment Date	Investors	Total Known Funding ($mn)	Exit Date	Exit Type	Exit Value ($bn)	Acquiror (Exit)	Primary Industry	Location
Facebook	Sep-04	Accel Partners, DST Global, Elevation Partners, Firsthand Capital Management, General Atlantic, Goldman Sachs, Greylock Partners, GSV Capital, Hercules Technology Growth Capital, Meritech Capital Partners, Microsoft, T Rowe Price, The Founders Fund Management, TriplePoint Capital	2,617	May-12	IPO	16.0	-	Internet	US
Pharmasset, Inc.	Jun-01	Burrill & Company, CDIB BioScience Venture Management, Horizon Technology Finance Corporation, Lumira Capital, MPM Capital, TVM Capital	70	Nov-11	Trade Sale	11.2	Gilead Sciences	Pharmaceuticals	US
SuccessFactors, Inc.	May-06	Canaan Partners, Cardinal Venture Capital, Emergence Capital Partners, GGV Capital, Greylock Partners, Lighthouse Capital Partners, TPG	45	Dec-11	Trade Sale	3.4	SAP	Software	US
ExactTarget, Inc.	Jul-04	Battery Ventures, Greenspring Associates, Insight Venture Partners, Scale Venture Partners, Technology Crossover Ventures	193	Jun-13	Trade Sale	2.5	Salesforce. com	Internet	US
3PARdata	Jun-99	AllianceBernstein, Amerindo Investment Advisors, Integral Capital Partners, Mayfield Fund, Menlo Ventures, Open Field Capital, Oracle Corporation, Oracle Venture Fund, Sun Microsystems, Van Wagoner Capital Management, Veritas Software, Worldview Technology Partners	178	Sep-10	Trade Sale	2.4	Hewlett Packard	Hardware	US
Isilon Systems	Aug-01	Atlas Venture, Focus Ventures, GGV Capital, Madrona Venture Group, Sequoia Capital, Tenaya Capital	69	Nov-10	Trade Sale	2.3	EMC	Software	US
Data Domain	Oct-02	Greylock Partners, New Enterprise Associates, Sutter Hill Ventures	26	Jul-09	Trade Sale	2.1	EMC	Software	US
Kayak Software Corporation	Jan-04	Accel Partners, AOL Inc., General Catalyst Partners, Gold Hill Capital, Lehman Brothers, Norwest Venture Partners, Oak Investment Partners, Sequoia Capital, Silicon Valley Bank, Trident Capital	229	Nov-12	Trade Sale	1.8	Priceline. com	Internet	US
Omniture	May-04	Attractor Investment Management, Hummer Winblad Venture Partners, Scale Venture Partners, WPP	80	Sep-09	Trade Sale	1.8	Adobe Systems	Marketing	US
Liberty Dialysis	Apr-10	Bain Capital, Ignition Venture Partners, KRG Capital	-	Aug-11	Trade Sale	1.7	Fresenius Medical Care AG	Healthcare	US

Source: Preqin Venture Deals Analyst

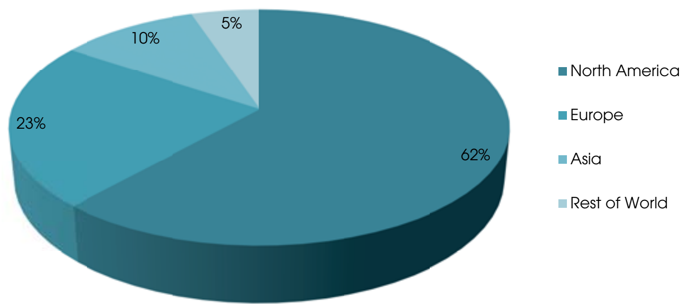
based in Israel, is another consistent performing manager; three out of its six funds are in the top quartile for their vintage years with the other three funds in the second quartile. It invests in technology companies based in Israel and the US. The increasing globalization of the asset class has seen investors being attracted to opportunities outside of the traditional private equity hubs of North America and Europe. So far during 2013, Asian venture capital deals have accounted for 10% of all deals globally, as shown in Fig. 8.

With so many venture capital funds on the road, it is important that investors are able to distinguish between the opportunities available because as demonstrated in this article, while there are some funds that can offer excellent returns, there are many that will not. A key part of due diligence is understanding a fund manager's track record, as it is clear that there is a relationship between a fund manager's predecessor fund and successor fund. Fig. 9 shows that 40% of fund managers with a top quartile fund go on to have their next fund also ranked in the top quartile. In turn, 70% of top quartile fund managers go on to achieve above median-fund performance with their next fund. In comparison, only 33% of fund managers with a bottom quartile fund then go on to exceed the median benchmark with their next fund. Past performance should be a fundamental consideration for investors when looking at a new opportunity; however, it is important to note that past performance is no absolute guarantee of future performance.

The Outlook

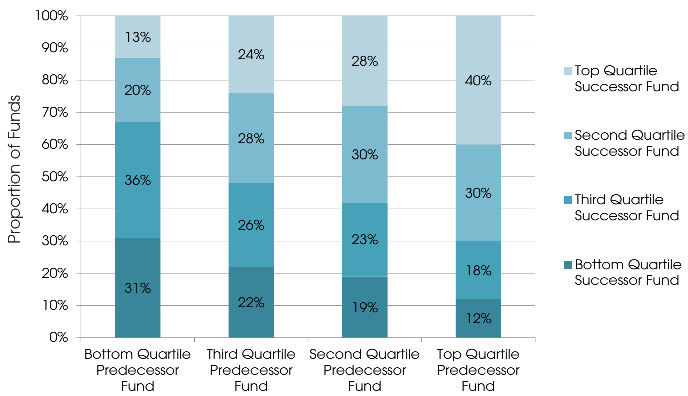
For an institutional investor, venture capital is a key component of a balanced and diversified investment portfolio. The venture capital industry will continue to generate interest, as fund managers continue to look for the next big thing, the lottery winning investment, and many institutional investors buy into this story. We are in an exciting time of technical innovation and growth, and there is a definite buzz around the industry. Looking at Preqin's Performance Analyst, it is clear that there are many great fund managers out there that have the ability to spot good deals and excellent opportunities; however, there are many out there that will not be as successful, as demonstrated by the low returning investments and the poor performance of the overall benchmark. For every Facebook, Instagram and Tumblr, there are other companies and ideas that will not turn a profit and will fold. However, this is the nature of venture capital investment, and it is what makes it a compelling story as investors look for that "home run" investment.

Fig. 8: Proportion of Number of Venture Capital Deals in each Region, 2013 YTD (As at 03 July 2013)



Source: Preqin Venture Deals Analyst

Fig. 9: Venture Capital - Relationship between Predecessor and Successor Fund Quartiles



Source: Preqin Performance Analyst

Data Source:

Preqin offers a complete resource for those looking for intelligence on the venture capital market.

Venture Deals Analyst has over 44,000 venture capital deals. Fund Manager Profiles has intelligence on over 3,300 venture capital firms. Performance Analyst has detailed performance for 1,600 venture capital funds. Using Investor Intelligence you can gain access to over 3,500 LPs with an interest in venture capital.

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