Have venture capital returns turned a corner? Venture capital outperforms private equity according to the latest one-year horizon IRR data.

Exclusive survey results reveal LP sentiment towards venture capital investment.

Venture capital fundraising on the rise: latest statistics.

Venture capital deals and exits see record highs in 2014 YTD.

**Plus** Special Guest Contributors: Ariadne Capital
Key Facts

Venture Capital Fundraising by Primary Geographic Focus, 2014 YTD

North America $22.2bn
Europe $4.2bn
Asia $9.5bn
Rest of World $1.3bn
Diversified Multi-Regional $4.7bn

One-year rolling horizon IRR to March 2014 data shows venture capital outperforming all private equity.

59% (3,214) of LPs are interested in venture capital investments.

56% of venture capital investors surveyed intend to make a commitment to a venture capital fund before the end of 2015.

Aggregate quarterly venture capital deal value reached an all-time high in Q2 2014, at $23bn.
Venture capital is a core part of the global private capital universe, both in terms of its longevity and also the sheer scale, reach and impact of its activities. Out of a total of 8,256 PE/VC firms profiled on Preqin’s databases, no fewer than 4,754 are venture capital firms, 57% of the total; nearly 4,000 venture funds have closed over the past decade, or are currently on the road fundraising; and with over 50,000 VC deals listed on Preqin’s databases over the past seven years, the impact of venture capital funds and firms in funding start-up and growing businesses is profound. The industry has also become increasingly global, expanding outside its West Coast US roots to develop clusters of venture capital firms and activity across the US and internationally.

The Achilles Heel for venture capital funds since the turn of the millennium has, of course, been performance, lagging well behind other private equity strategies. Despite this, many LPs have “stuck with the program” – with over 3,000 of the 5,500 active private equity LPs listed on Preqin’s databases either having invested in venture capital funds, or having an interest in doing so. Put simply, the argument for venture capital over this period has been: sure, average returns have been disappointing, but the performance of the best funds has been excellent, so if you can identify and get into those funds, you can do well; plus, venture capital gives the investor access to a segment of the economy that you cannot invest in through any other route, so brings vital diversification/efficient frontier benefits. These arguments are valid, but can start to wear thin after so many years in which the asset class as a whole has under-performed.

Is this now changing? Has venture turned the corner?

Starting in 2011, there has been a marked improvement in venture capital fund returns, so much so that the net returns they have delivered to LPs are now on a par with the ‘All PE’ benchmark over three years, and the best-performing strategy over one year. Whether this improvement persists does, of course, remain to be seen – but the arguments for venture capital are starting to resonate ever more strongly with LPs: diversification + average returns looking attractive + opportunity for significant outperformance through good fund selection. As a result, LP attitudes are starting to turn more positive towards venture capital (see page 6), boding well for the 581 venture capital funds currently on the road looking for capital.

The turnaround in venture capital fortunes is both welcome and highly significant for the industry, and especially for LPs looking for opportunities to deploy capital. Preqin will be following developments over the coming months through all the key metrics showing the state of the venture capital industry – capital raising, deals, exits, fund performance and LP interest.

Thank you,

Mark O’Hare
The Turning Point for Venture Capital?

Although much maligned for sub-par performance since the dot-com crash, venture capital returns for more recent funds have picked up significantly – one-year horizon returns are among the best in the entire private equity industry. Preqin’s latest special report examines the drivers of this recent success, and uncovers the impact of improved performance on LP attitudes towards the asset class and the prospects for future fundraising.

A Chequered Past

Following a rapid reversal of fortunes at the turn of the millennium, the venture capital industry has experienced largely lacklustre returns which have led to tough fundraising conditions for all but a select group of top-tier managers. However, more recently there have been some encouraging signs across the industry, with market conditions becoming more favourable, returns improving and fundraising picking up as investors take note. Is this the turning point for venture capital?

Why Invest in Venture Capital?

The venture capital asset class has long featured in many investors’ portfolios for a variety of reasons, including portfolio diversification, fulfilling mandate objectives, the chance to capitalize on the emergence of promising start-up companies and to boost local economies. In certain jurisdictions, the existence of a favourable legislative environment and policies is also a draw. In a survey of 100 venture capital investors conducted by Preqin in October 2014, we found that 51% of respondents commit to venture capital funds primarily for outsized returns.

So what kind of returns have venture capital commitments produced? Fig. 1 shows the private equity horizon IRRs of the main strategies over one-, three-, five- and 10-year periods. The horizon IRRs are calculated using the fund’s net asset value as a negative outflow at the beginning of the period, with any cash paid or received during the period and the fund’s residual value as a positive inflow at the end of the period. The pattern for venture capital returns shows clear underperformance relative to other strategies over 10 years, with an improving picture more recently. Most notably, the last three- and one-year periods show venture capital horizon IRRs improving from 12.7% for the three-year period to March 2014 to 27.0% for the one-year period to March 2014, outperforming all other strategies.


To provide an insight into how venture capital performance has progressed over time, we can assess horizon IRR figures at year/quarter ends (Fig. 2). In the one-year period to December 2000, venture capital was still riding high on the dot-com boom with a horizon IRR of 38.1%. Following the subsequent bursting of the internet bubble at the turn of the millennium, the one-year horizon IRR of venture capital plummeted to -34.3%, and did not recover into the black until 2004. Performance peaked again in 2007 before tumbling once more into the negative, as with all other fund types bar mezzanine, this time as a result of the global financial crisis.

It is important to note that some funds, in the face of wider industry underperformance, still generated exceptional returns and multiples. Examples include Union Square Ventures (vintage 2004, net IRR 70.6%); Avalon Ventures VIII (2007, 58.1%); Emergence Capital Partners II (2007, 52.9%); Grotech Partners VII (2007, 46.5%) and CHAMP Ventures Investments Trust No. 5 (2002, 42.7%).

More Recent Performance: 2008 – 2011

Fig. 3 uses top quartile boundary net IRR data taken from Preqin’s Performance Analyst module, and outlines the improvement in venture capital returns for more recent vintage funds following the dot-com slump. Fig. 3 illustrates the reversal of fortune for venture capital returns. In stark contrast to the venture capital
funds of vintage 2002, which have a top quartile margin that lags far behind all private equity, 2011 vintage venture capital funds (excluding early stage) surpassed the top quartile boundary net IRR of all private equity by 220 basis points.

Preqin’s data further demonstrates that this improvement is not just reserved for top performing funds. As shown in Fig. 3, bottom quartile venture capital funds have also seen a marked improvement, recently moving into the black for the first time. This was unseen even at the height of the dot-com boom and serves as further evidence of the turnaround seen in industry performance. Vintage 2010 venture capital funds have the highest top quartile IRR boundary (23.7%), while the median net IRR for vintage 2008 - 2010 vehicles has risen to between 10% and 15%. Given the precarious economic conditions of the time, the metrics for vintage 2008 venture capital funds are very encouraging.

A Surge of Exits

The improvement in performance reflects the high portfolio valuations and the favourable exit opportunities that are evidently being found by venture capital fund managers. It is also testament to the ability of these GPs to strategize and source companies with good potential to generate outsized returns and exceed public market equivalents. Fig. 5 shows the annual statistics for venture capital exits from 2007 to 2014. The rise in both number of exits and aggregate exit value is clear, with particularly strong momentum for exit value in the periods 2008 to 2010, and 2013 to Q3 2014. A breakdown by exit type shows that trade sales consistently comprise the majority of all venture capital exits. There has also been a steady rise in initial public offerings with year-on-year increases from 127 in 2011 to 161 in the first three quarters of 2014, reflecting the strength of public equity markets of late.

Where is the Money Going?

The record distributions that investors are currently seeing, which Preqin describes in the September 2014 issue of Private Equity Spotlight, should bode well for future venture capital fundraising. Preqin’s latest fundraising figures reveal that the total amount of capital secured by venture capital vehicles in 2014 YTD ($36bn) has already outstripped the total secured in 2013 ($31bn), and looks set to eclipse the total raised for a number of years (Fig. 6). The split between types of venture funds shows that 50% of funds closed in 2007 to 2014 YTD invest generally across all rounds, 11% are focused on expansion/late stage venture capital and the remaining 39% are specialized in early stage, encompassing seed and start up investments.

Analysis of funds closed split by primary geographic fund focus is provided in Fig. 17 (page 10). While North America consistently continues to account for the largest proportion of total capital raised by venture capital funds, the share represented by Asia-focused vehicles has shot up in the past year. Of all venture capital funds closed in 2013, 11% were primarily targeting Asian investments, but in 2014 YTD, this proportion more than doubled to 25%, thus indicating that Asia has overtaken Europe to become the second most popular investment destination for venture capital.

These fundraising statistics should be considered alongside venture capital deal activity. Fig. 7, which uses data from Preqin’s Venture Deals Analyst, shows a significant overall rise in annual deal numbers and aggregate value since 2009. Significantly, aggregate deal value for the first three quarters of 2014 has already reached $60bn, eclipsing full year total values since 2007. The internet, software, healthcare, telecoms and...
media industries are the sectors which have seen the highest level of investment in 2014 YTD. As expected, North America comprises the biggest proportion of global venture deal value by a significant margin; however, other markets such as Israel and India are also showing positive signs of growth. See page 11 for further analysis.

Effect on LP Attitudes

As venture capital performance improves and translates into higher returns for LPs, investor confidence in the venture capital industry has started to return. October 2014 saw the highest number of funds in market in the period 2007 - 2014 YTD (Fig. 16, page 10), in addition to the fact that the proportion of venture capital funds failing to meet their targets is currently at a record low of 30% (Fig. 18, page 10).

Although sentiment has been improving, investor confidence in the asset class is still mixed and returns will need to prove to be more consistent before attitudes change fully. Preqin’s October 2014 venture capital investor survey still found that over half of investors (53%) named performance as a key issue for the industry in 2014 and the year ahead. Nonetheless, anecdotal evidence demonstrates that investors’ attitudes to venture capital performance have improved in recent times, with one US-based investor specifying: “The past has been disappointing but our current active portfolio is mostly living up to expectations.” In fact, for 62% of investors surveyed, venture capital fund investments in the past 12 months have met expectations, while 16% had their expectations exceeded, compared to 22% that felt that their investments in the sector had fallen short.

Comparing these statistics to those revealed in Preqin’s latest Investor Outlook survey, a biannual study of LPs across all private equity, shows that a larger proportion of venture capital investors felt their fund investments exceeded expectations (16% vs. 12%) and a larger proportion felt their commitments fell short (22% vs. 14%) compared to all other private equity fund types. This conveys the more extreme polarities that exist in the venture capital industry, hinting at those ‘home run’ investments that can generate outsized returns at one end of the spectrum, and those ‘strike outs’ that perform poorly with very small or even negative IRRs at the other. The high standard deviation of venture capital fund performance, particularly within early stage-focused vehicles, demonstrates the mixed performance the industry has seen over time and reinforces the importance of good fund selection in venture capital.

Encouragingly for those seeking capital or planning to launch a new vehicle, the results from previous Investor Outlook surveys show a small but sure growth in appetite for venture capital commitments. When asked the fund types that they are seeking to invest in over the next 12 months, 18% of LPs surveyed in H2 2013 stated venture capital, 25% in H1 2014 and 29% in H2 2014. In terms of specific favoured areas for investment, the US and information technology emerged as the front runners. Pages 8 and 9 of this report provide further analysis of the survey results, including intended timelines for next venture capital commitments.

A Brighter Future?

A recovery is well underway for the venture capital industry and investors are exhibiting signs of increased confidence, as reflected in the rising amounts of capital secured by venture capital funds, and deal and exit activity is growing. However, conditions are still tough, and venture capital fund managers seeking capital commitments need to continue to demonstrate to prospective investors that they have a strong strategy and deal pipeline, and a good alignment of interests. Fig. 11 (page 8) provides a breakdown of factors that investors surveyed consider the most important when looking for a venture capital fund manager.

Overall, the global venture capital landscape is currently seeing favourable conditions that are pointing to a healthy fundraising market and a strong deals environment. However, fund managers still face challenges in securing capital as investors are wary of the asset class, given the largely disappointing returns in the past 10 years, and will need to see more consistent performance over time. The recent uptick in venture capital performance confirms the market is at a real turning point. Should these trends continue, more investors will take notice and we could see a rejuvenated market.
They are essentially looking to identify the best entrepreneurs, and Most European venture capital partners’ play book is relatively thin. In short, what’s the end game for the European venture capital world?

Most European venture capital partners’ play book is relatively thin. They are essentially looking to identify the best entrepreneurs, and figure out how to sell them to a US technology platform firm as soon as possible. Or they sell their positions early or strangle the companies they back.

Legend has it that the VCs that backed Racal Telecom (which became Vodafone) sold their position due to the end of their fund’s life – perhaps understandable, but short-sighted nonetheless. So, as a European technology entrepreneur, you hear around you the call to Palo Alto for your funding – ‘it’ll be so much easier out there’, but if you don’t go to Palo Alto at the beginning you go to Palo Alto at the end.

And a large sucking sound of value across the Atlantic westward doesn’t seem to bother too much the general partners of European venture capital funds. They pocket their cash, forget to incentivize the associates who did all the work on the portfolio anyway, and move to Switzerland.

Should it? It is critical to understand how companies are being built right now and how technology is a layer driving growth across all industries to make sense of the fork in the road.

The platform companies are cleaning up. The Gang of Four (Amazon, Apple, Facebook and Google) are the biggest winners here. They organise the economics for their sectors, and compete ruthlessly with each other. Crucially, they use the infrastructure of others without really paying a toll, or negotiating terrific rates. Indeed, this is what the entire net neutrality debate is about.

So, if you are an infrastructure firm, a bank, a telecommunications company, a hospital, a school – with assets that touch ground, with regulation and taxes, and with legacy issues, you must migrate upwards and open up to becoming a platform. This is not easy. You must rethink how you engage with your industry and you must be concerned about the growth and profits of your industry, not just your business. You will have smaller margins, with more players in your business model, but your revenues will grow, and the growth will move from linear to exponential. You will by definition be a company leveraging cloud technology with application platform interfaces (APIs) with strong data analytics capabilities.

What does this have to do with the European venture capital industry? We haven’t created many platform companies in Europe. In key sectors like those occupied by Amazon, Apple, Facebook and Google, there simply won’t be a European equivalent. Notwithstanding the rise of Rocket Internet, whose operational abilities are exceptional, the underlying thinking of the business model is very 2007. Value is accruing to the mostly US-based platform companies because they are providing the dominant ‘highway’ for US and European digital entrepreneurs to go to market. So European start-ups go to Palo Alto once again for their distribution, scale, audience and reach and do a deal with an App Store to put their car on the highway.

So, does it matter if we just make the toppings of the pizza, and not the pizzas or ovens themselves? Actually it does! You have to look hard and consider deeply the ‘successes’ of the European venture capital scene. Elaia Partners backed Criteo, a leader in predictive advertising, which listed on Nasdaq, now with a market capitalization of more than $2bn. I’ll bet it gets taken out by Google within a year. Autonomy, which wasn’t backed by venture capitalists anyway, had the capacity to be a platform company, and we all know what happened there. Despite being able to offer their shareholders’ liquidity, Autonomy’s management did a deal with HP which is mired in controversy, and a once great player has disappeared in a mist.

Ebuzzing, a $100mn revenue video advertising company, has acquired nine businesses, and might go public in 2015. Led by Pierre Chappaz, the entrepreneur who built Kelkoo and sold it to Yahoo, he won’t stop for small change. DN Capital has raised a new $200mn venture fund recently, and had seven exits in their last fund. They have emerged as a significant homegrown venture capital fund in Europe, but their companies are not creating ecosystems or becoming platforms, they are being sold. Again, it is great for the limited partners, but not for the capacity for European economies and societies to disproportionately reap the benefits and profits of the intellectual capital of its talent.

The future of European venture capital lies in integrating established corporates with the digital “enablers”. This will help the corporates build their digital P&Ls and would give start-ups a “highway” to accelerate their growth.

Ariadne Capital
Ariadne Capital is an investment firm founded in 2000 by Julie Meyer which has a portfolio of digital technology investments in retail financial services and media. It is backed by leading entrepreneurs and pioneered the ‘Entrepreneurs Backing Entrepreneurs’ model of financing entrepreneurship syndicating more than £350mn of investments over the past 14 years.

www.ariadnecapital.com
Venture Capital Investor Survey Results

In October 2014, Preqin interviewed 100 investors that have a current interest in investing in, or have previously committed to, the venture capital asset class.

56% of respondents are looking to make a commitment to a venture capital fund by the end of 2015.

75% of venture capital investors view information technology as having the most attractive opportunities at present.

Fig. 8: Key Issues the Venture Capital Industry Faces in 2014/2015

Fig. 7: Regions Investors Are Targeting for Venture Capital Investments

Fig. 9: Timeframe for Investors’ Next Intended Commitment to a Venture Capital Fund

Fig. 10: Industry Sectors Venture Capital Investors View as Having the Most Attractive Opportunities at Present

Fig. 11: Factors Investors Consider to Be the Most Important When Looking for a Venture Capital Fund Manager

Source: Preqin Venture Capital Investor Survey, October 2014
North America accounts for the majority (56%) of venture capital investors, followed by Europe (25%) and Asia (11%).

Two out of every three institutional investors in venture capital have assets under management of less than $5bn.

**Fig. 13: Breakdown of Venture Capital Investors by Assets under Management**

- Less than $250mn: 9%
- $250-999mn: 19%
- $1-4.9bn: 21%
- $5-9.9bn: 15%
- $10-49.9bn: 9%
- More than $50bn: 9%

**Fig. 12: Investor Attitudes towards Different Fund Types at Present**

- Small to Mid-Market Buyout: 31%
- Large to Mega Buyout: 31%
- Fund of Funds: 31%
- Distressed Private Equity: 29%
- Growth: 25%
- Mezzanine: 16%
- CleanTech: 15%
- Venture Capital: 13%
- Other: 12%

**Fig. 15: Sample of Investors Looking to Commit to Venture Capital Funds in the Next 12 Months**

<table>
<thead>
<tr>
<th>Investor Type</th>
<th>Location</th>
<th>Investment Plans for the Next 12 Months</th>
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<tbody>
<tr>
<td>MAHLE</td>
<td>Corporate Investor</td>
<td>Germany</td>
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<tr>
<td>Multilateral Investment Fund</td>
<td>Government Agency</td>
<td>US</td>
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<tr>
<td>Nanjing Venture Capital</td>
<td>Investment Company</td>
<td>China</td>
</tr>
</tbody>
</table>

Source: Preqin Investor Intelligence
Venture Capital Fundraising

Highest number of funds in market than any year in the period 2007-2014 (As of 23 October 2014).

Proportion of venture capital vehicles closed at or above their target in 2014 YTD.

Preqin's Funds in Market module contains detailed profiles on all 5,903 venture capital funds closed historically. Profiles include capital raised, interim closes and geographic focus. For more information, please visit: www.preqin.com/fim

Fig. 16: Venture Capital Funds in Market over Time, 2007-2014 YTD (As at 23 October 2014)

Source: Preqin Funds in Market

Fig. 17: Aggregate Capital Raised by Venture Capital Funds by Primary Geographic Focus, 2007 - 2014 YTD (As at 23 October 2014)

Source: Preqin Funds in Market

Fig. 18: Fundraising Success of Venture Capital Funds, 2007 - 2014 YTD (As at 23 October 2014)

Source: Preqin Funds in Market

Fig. 19: Top Five Venture Capital Funds in Market by Target Size (As at 23 October 2014)

<table>
<thead>
<tr>
<th>Fund</th>
<th>Firm</th>
<th>Fund Type</th>
<th>Target Size (mn)</th>
<th>Location Focus</th>
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<tbody>
<tr>
<td>Invention Investment Fund III</td>
<td>Intellectual Ventures</td>
<td>Early Stage: Seed</td>
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<td>US</td>
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<td>Riverwood Capital</td>
<td>Venture (All Stages)</td>
<td>1,000 USD</td>
<td>China, Emerging Markets, US</td>
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<tr>
<td>India Inclusive Innovation Fund</td>
<td>National Innovation Council</td>
<td>Venture (All Stages)</td>
<td>55,000 INR</td>
<td>India</td>
</tr>
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</table>

Source: Preqin Funds in Market
Preqin’s Venture Deals Analyst online service provides comprehensive information on over 72,000 venture capital deals, including deal date, size, industry, stage and much more. For more information, please visit: www.preqin.com/vcdeals

*Figures exclude add-ons, grants, mergers, venture debt and secondary stock purchases

**Fig. 20:** Number and Aggregate Value of Venture Capital Deals, 2007 - Q3 2014*

**Fig. 21:** Aggregate Value of Venture Capital Deals by Region, 2007 - Q3 2014*

**Fig. 22:** Proportion of Number and Aggregate Value of Venture Capital Deals by Industry, 2014 YTD (As at 14 October 2014)*

**Fig. 23:** Global Number and Aggregate Value of Venture Capital Exits by Type and Aggregate Exit Value, 2007 - Q3 2014 YTD

**Fig. 24:** Five Largest Venture Capital Deals in 2014 YTD (As at 14 October 2014)
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