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. Jessica Duong examines the drivers of this success, and the impact of this on LP attitudes to the asset class.

A Chequered Past

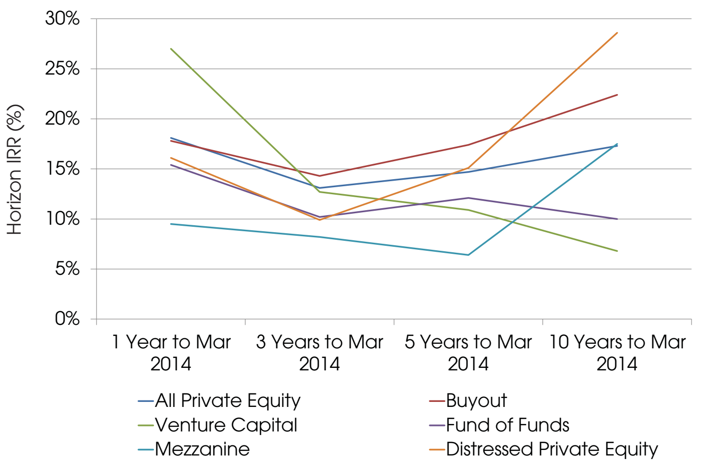
Following a rapid reversal of fortunes at the turn of the millennium, the venture capital industry has experienced largely lacklustre returns which have led to tough fundraising conditions for all but a select group of top-tier managers. However, more recently there have been some encouraging signs across 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 past. 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.

Fig. 1: Private Equity Horizon IRRs (As at 31 March 2014)

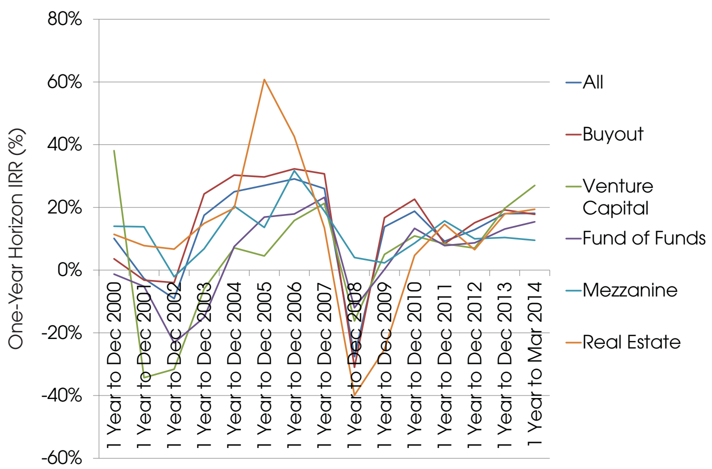


Source: Preqin Performance Analyst

Post Dot-Com Performance: 2001 – 2007

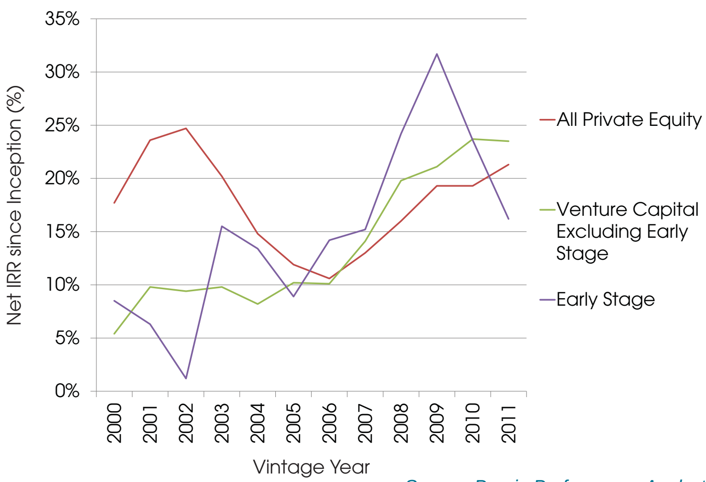
To provide an insight into how venture capital performance has progressed over time, we can assess horizon IRR figures at year/quarter ends (Fig. 2). In the one-year period to December 2000, venture capital was still riding high on the dot-com boom with a horizon IRR of 38.1%. Following the subsequent 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.

Fig. 2: One-Year Rolling Horizon IRRs by Fund Type



Source: Preqin Performance Analyst

Fig. 3: Top Quartile Boundary Net IRRs by Fund Type and Vintage Year



Source: Preqin Performance Analyst

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. 4, 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.

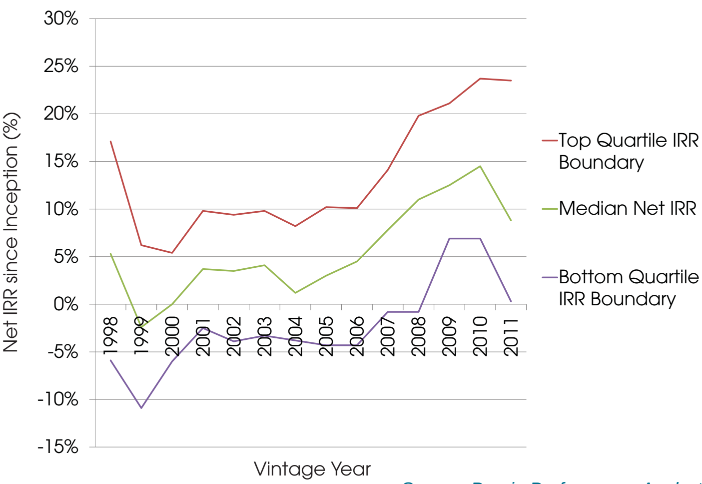
Where is the Money Going?

The record distributions that investors are currently seeing, which Preqin described 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 ($38bn) 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.

When analyzing funds closed split by primary geographic fund focus, North America consistently continues to account for the largest proportion of total capital raised by venture capital funds, while 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.

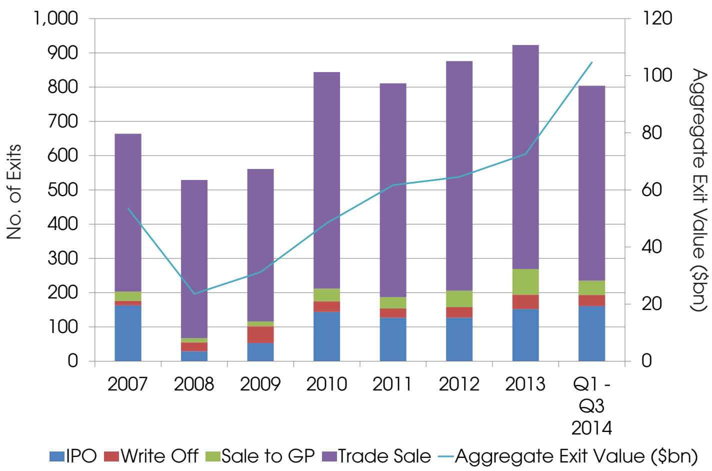
These fundraising statistics should be considered alongside venture capital deal activity. Fig. 7, which uses data from Preqin's Venture Deals Analyst, shows a significant overall rise in annual deal numbers and aggregate value since 2009. Significantly, aggregate deal value for the first three quarters of 2014 has already reached $60bn, eclipsing full year total values since 2007.

Fig. 4: Venture Capital - Median Net IRRs and Quartile Boundaries by Vintage Year



Source: Preqin Performance Analyst

Fig. 5: Global Number and Aggregate Value of Venture Capital Exits by Type and Aggregate Exit Value, 2007 - Q3 2014



Source: Preqin Venture Deals Analyst

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.

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, 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%.

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.

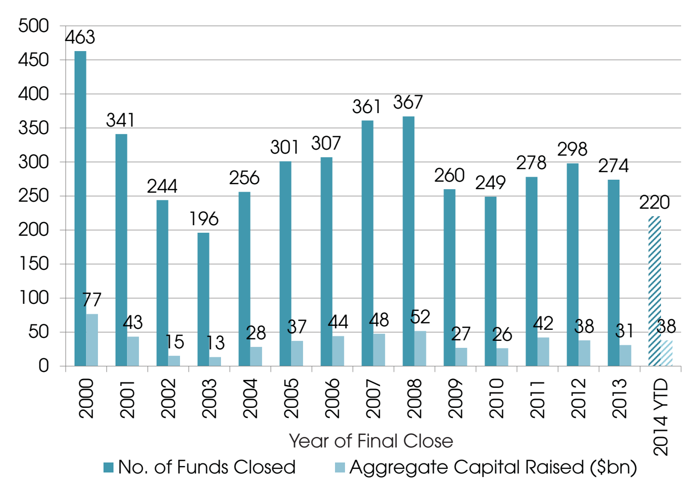
Encouragingly for those seeking capital or planning to launch a new vehicle, the results from previous Investor Outlook surveys show a small but sure growth in appetite for venture capital commitments. When asked the fund types that they are seeking to invest in over the next 12 months, 18% of LPs surveyed 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.

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.

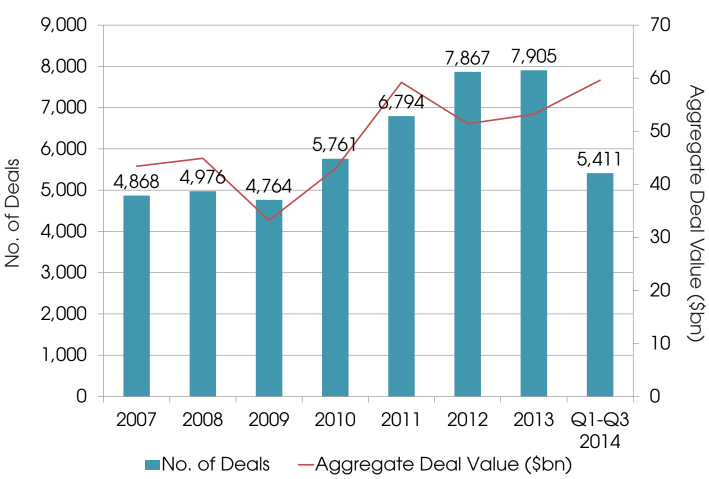
Overall, the global venture capital landscape is currently seeing favourable conditions that are pointing to a healthy fundraising market and a strong deals environment. However, fund managers still face challenges in securing capital as investors are wary of the asset class, given the largely disappointing 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.

Fig. 6: Annual Venture Capital Fundraising, 2000 - 2014 YTD (As at 14 October 2014)



Source: Preqin Funds in Market

Fig. 7: Number and Aggregate Value of Venture Capital Deals, 2007 - Q3 2014



Source: Preqin Venture Deals Analyst