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.

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.
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...
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 Zuckerberg’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 success in the long run. Zynga’s share price has dropped by 75% since its IPO in 2011 and Groupon has had similar struggles, giving

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 vintage year. Other portfolio companies that Union Square Ventures has invested in include Twitter, 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.

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

<table>
<thead>
<tr>
<th>Firm</th>
<th>Initial Investment Date</th>
<th>Initial Exit Type</th>
<th>Exit Date</th>
<th>Exit Value ($bn)</th>
<th>Acquiror (Exit)</th>
<th>Primary Industry</th>
<th>Location</th>
</tr>
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<tbody>
<tr>
<td>Facebook</td>
<td>Sep-04</td>
<td>IPO</td>
<td>May-12</td>
<td>16.0</td>
<td>-</td>
<td>Internet</td>
<td>US</td>
</tr>
<tr>
<td>SuccessFactors, Inc.</td>
<td>May-06</td>
<td>Trade Sale</td>
<td>Dec-11</td>
<td>3.4</td>
<td>SAP</td>
<td>Software</td>
<td>US</td>
</tr>
<tr>
<td>ExactTarget, Inc.</td>
<td>Jul-04</td>
<td>Trade Sale</td>
<td>Jun-13</td>
<td>2.5</td>
<td>Salesforce.com</td>
<td>Internet</td>
<td>US</td>
</tr>
<tr>
<td>3PARdata</td>
<td>Jun-99</td>
<td>Trade Sale</td>
<td>Sep-10</td>
<td>2.4</td>
<td>Hewlett Packard</td>
<td>Hardware</td>
<td>US</td>
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<tr>
<td>Isilon Systems</td>
<td>Aug-01</td>
<td>Trade Sale</td>
<td>Nov-10</td>
<td>2.3</td>
<td>EMC</td>
<td>Software</td>
<td>US</td>
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<tr>
<td>Data Domain</td>
<td>Oct-02</td>
<td>Trade Sale</td>
<td>Jul-09</td>
<td>2.1</td>
<td>EMC</td>
<td>Software</td>
<td>US</td>
</tr>
<tr>
<td>Kayak Software Corporation</td>
<td>Jan-04</td>
<td>Trade Sale</td>
<td>Nov-12</td>
<td>1.8</td>
<td>Priceline.com</td>
<td>Internet</td>
<td>US</td>
</tr>
<tr>
<td>Omniture</td>
<td>May-04</td>
<td>Trade Sale</td>
<td>Sep-09</td>
<td>1.8</td>
<td>Adobe Systems</td>
<td>Marketing</td>
<td>US</td>
</tr>
<tr>
<td>Liberty Dialysis</td>
<td>Apr-10</td>
<td>Trade Sale</td>
<td>Aug-11</td>
<td>1.7</td>
<td>Fresenius</td>
<td>Healthcare</td>
<td>US</td>
</tr>
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Source: Preqin’s Performance 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.

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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