Marketing material for professional clients only.

IN FOCUS

Navigating times of volatility – the five secrets of successful venture capital investing

June 2022

In times of volatility, it is more important than ever to have a focused strategy. Schroders Capital highlights the 5 key points institutional investors need to consider when investing in venture capital.

Michael McLean
Senior Investment Director Private Equity

We are currently experiencing a significant public market correction, especially in high growth technology stocks. Public markets have experienced high volatility so far in 2022 and the Nasdaq is down 26% year-to-date (as of 15 May 2022). High growth software-as-a-service ('SaaS') stocks have been hit harder, with the Bessemer EMCloud index[1] down 44% year-to-date. There have been a number of factors driving this, including 1) the U.S. Federal Reserve raising interest rates to fight rising inflation, 2) concerns around a potential recessionary environment, 3) the war in Ukraine, 4) waning 'covid boosts' for tech companies, 5) a return from historically high multiples, as well as other factors.

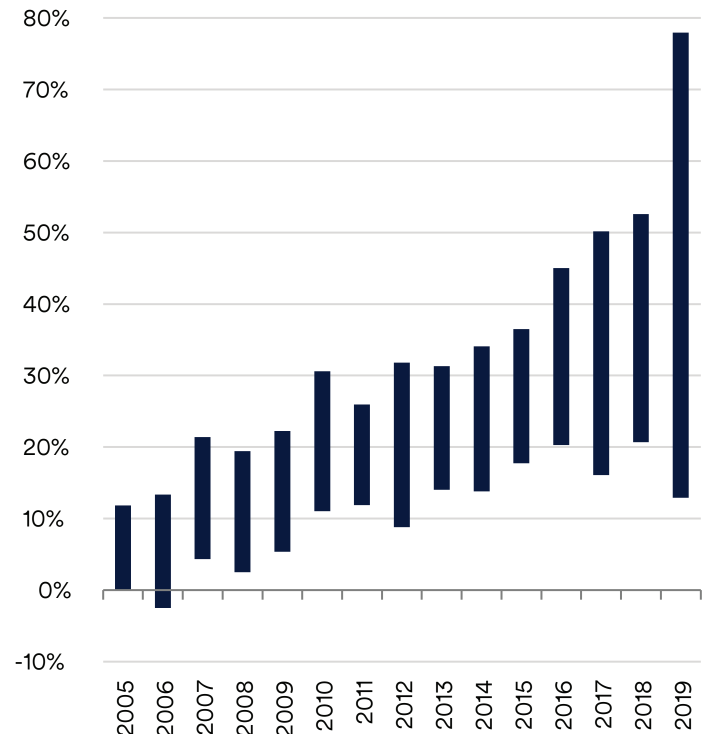
Despite all these macro-economic headwinds, we are still long-term believers in venture capital and the strong returns the asset class is able to drive. The venture capital industry has produced a 10-year pooled return of 21%, with top quartile funds outperforming that by a wide margin[2]. Figure 1 below shows the strong performance of top quartile venture capital funds over the last 15 years, with the top quartile fund managers earning net IRR of over 25% between 2010–2019 (sometimes significantly above that)[3]. Between 2005–2016 vintage years (the more recent years excluded as it typically takes five years for a venture capital portfolio to develop), top quartile venture capital funds outperformed bottom quartile funds by 18% a year, on average. On a compound basis over the 10–12 year life of a venture capital fund, the difference in performance is even starker.

1 As of 12 May 2022. Source: Bessemer Venture Partners Emerging Cloud Index, Yahoo! Finance, Schroders Capital. See the Bessemer Venture Partners Emerging Cloud Index website for more details.

2 Cambridge Associates, Schroders Capital. As of Q3 2021 (latest available data from Cambridge Associates). See Cambridge Associates report for more details.

3 Cambridge Associates Global Venture Capital Benchmark, Schroders Capital, 2022. Data as of 30 September 2021 (latest available).

Figure 1: Interquartile range for Venture IRR by vintage year (% IRR)[3]



Schroders capital

Private company valuations have also started to come down. As such, we believe it is an exciting time to invest in private companies. Innovation continues even in times of uncertainty and some of the best companies are created and scale during periods of public market pullbacks (e.g. Stripe in 2010, Facebook in 2004, and others). Venture capital has financed some of the biggest successes in technology of our time. In fact, when you look at the top 10 market cap companies today, six of them are previously venture-backed (Apple, Microsoft, Alphabet/Google, Amazon, Tesla, and Meta/Facebook)[4]. Access to the best funds, and companies, is essential for success in venture capital. The importance of asset selection shines through in the performance figures above.

We recommend a strategy focused on the early-stage and early-growth part of the venture capital market[5]. This is due to more favourable valuation dynamics for the early-stage and early-growth markets vs. the late-stage pre-IPO market. Over the past five years (2016 to 2021), the median pre-money valuations in pre-IPO late-stage venture deals increased over 2.4x faster than in early-growth deals[6]. This was driven by the inflow of capital from hedge funds and cross-over investors, which have since largely pulled back from the venture capital market. Early-growth companies are typically younger in their life cycle and likely to remain private for an additional 3–5+ years, which allows them to continue to compound at their high growth rates. Pre-IPO late stage companies on the other hand were typically financed under assumptions of going public within 6–18 months. That exit timing now doesn't seem realistic given the IPO window appears to be closed today. Innovative tech and healthcare companies with high growth, high gross margins, well-funded balance sheets, at newly reset valuation levels look to be the best companies to potentially thrive in this market.

4 As of 12 May 2022. Source: Companiesmarketcap.com, Company websites, Pitchbook, Schroders Capital, 2022.

5 Early-stage defined as Seed to Series A rounds and early-growth as Series B-E rounds. Late-stage pre-IPO rounds defined as Series F and beyond rounds.

6 Source: Pitchbook, CBInsights, Schroders Capital, 2022. Pre-IPO late-stage and early-growth as defined above.

Investors tend to think venture capital is risky due to single deals having a high risk profile. However, in a sufficiently diversified venture portfolio, the individual company idiosyncratic risks cancel each other out. This is why venture capital isn't as risky as investors think. It is also possible to get access to top funds/companies. With all that in mind, how do you build a successful venture capital portfolio? Here are the five secrets of successful venture capital investing:

1. A global approach is critical. When you look at the total number of 'unicorns' globally, only ~50% are based in the U.S., with the other half coming outside the U.S[6]. There is a high concentration of 'unicorn' companies in regions like Europe and Asia. It is crucial to have a global focus when investing in venture capital.
2. Focus on topics of the future. Artificial intelligence (AI) and machine learning (ML) are disrupting multiple industries. Other recent trends like 'low-code/no-code' software are enabling business line managers without coding experience to build and use exciting software products. These technologies have the power to not only disrupt markets but create new markets as well.
3. Finding the right balance between selectivity and diversification is key. You want to maximise 'portfolio quality density' since the top 20% of companies drive about 80% of total venture capital market returns (which has remained the same for several decades)[7]. Schroders Capital study of venture portfolio companies going back to 1994. However, it is also crucial to have a diversified portfolio of venture investments, typically over 15–20 in a built-up portfolio. 'Not every company will be a winner, and you need a diversified portfolio to cancel out the individual company risks.
4. Do not get over-excited and be cautious about frothy parts of the market. As previously discussed, we recommend focusing on the early-stage and early-growth parts of the market and avoiding the late-stage pre-IPO market, where valuations have been overheated.
5. Mix of co-investments, primaries, and secondaries. Given the significant dispersion in returns, we think that a portfolio approach spread across multiple companies and GPs can help mitigate risk and give more certainty over returns. Investments in secondaries (funds which buy stakes in existing funds from LPs) and co-investments (where an LP invests in specific deals alongside a GP rather than via a fund structure), both also have the potential to add considerable value.

7 Schroders Capital study of venture portfolio companies going back to 1994.

Important Information

Marketing material for professional clients and qualified investors only. The views and opinions contained herein are those of the authors as at the date of publication and are subject to change due to market and other conditions. Such views and opinions may not necessarily represent those expressed or reflected in other Schroders communications, strategies or funds. This document is intended to be for information purposes only. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument or security or to adopt any investment strategy. The information provided is not intended to constitute investment advice, an investment recommendation or investment research and does not take into account specific circumstances of any recipient. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice. Information herein is believed to be reliable but Schroders does not represent or warrant its completeness or accuracy. No responsibility or liability is accepted by Schroders, its officers, employees or agents for errors of fact or opinion or for any loss arising from use of all or any part of the information in this document. No reliance should be placed on the views and information in the document when taking individual investment and/or strategic decisions. Schroders has no obligation to notify any recipient should any information contained herein changes or subsequently becomes inaccurate. Unless otherwise authorised by Schroders, any reproduction of all or part of the information in this document is prohibited. Any data contained in this document has been obtained from sources we consider to be reliable. Schroders has not independently verified or validated such data and it should be independently verified before further publication or use. Schroders does not represent or warrant the accuracy or completeness of any such data. All investing involves risk including the possible loss of principal. Third party data are owned or licensed by the data provider and may not be reproduced or extracted and used for any other purpose without the data provider's consent. Third party data are provided without any warranties of any kind. The data provider and issuer of the document shall have no liability in connection with the third party data. www.schroders.com contains additional disclaimers which apply to the third party data. Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested. Exchange rate changes may cause the value of any overseas investments to rise or fall. This document may contain forward-looking information, such as forecasts or projections. Please note that any such information is not a guarantee of any future performance and there is no assurance that any forecast or projection will be realised.

Note to Readers in Switzerland: Schroder Investment Management (Switzerland) AG, Central 2, CH-8001 Zürich, Postfach 1820, CH-8021 Zürich, Switzerland. Enterprise identification number (UID) CHE-101.447.114, reference number CH02039235704. Authorised and regulated by the Swiss Financial Market Supervisory Authority (FINMA).

European Union/European Economic Area: Issued by Schroder Investment Management Limited,1 London Wall Place, London, EC2Y 5AU. Registered Number 1893220 England. Authorised and regulated by the Financial Conduct Authority.

Note to Readers in Hong Kong: Schroder Investment Management (Hong Kong) Limited, Level 33, Two Pacific Place 88 Queensway, Hong Kong. Central Entity Number (CE No.) ACJ591. Regulated by the Securities and Futures Commission.

Note to Readers in Indonesia: PT Schroder Investment Management Indonesia, Indonesia Stock Exchange Building Tower 1, 30th Floor, Jalan Jend. Sudirman Kav 52-53 Jakarta 12190 Indonesia. Registered / Company Number by Bapepam Chairman's Decree No: KEP-04/PM/MI/1997 dated April 25, 1997 on the investment management activities and Regulated by Otoritas Jasa Keuangan ('OJK'), formerly the Capital Market and Financial Institution Supervisory Agency ('Bapepam dan LK').

Note to Readers in Japan: Schroder Investment Management (Japan) Limited, 21st Floor, Marunouchi Trust Tower Main, 1-8-3 Marunouchi, Chiyoda-Ku, Tokyo 100- 0005, Japan. Registered as a Financial Instruments Business Operator regulated by the Financial Services Agency of Japan. Kanto Local Finance Bureau (FIBO) No. 90.

Note to Readers in People's Republic of China: Schroder Investment Management (Shanghai) Co., Ltd., RM1101 11/F Shanghai IFC Phase (HSBC Building) 8 Century Avenue, Pudong, Shanghai, China, AMAC registration NO. P1066560. Regulated by Asset Management Association of China.

Note to Readers in Singapore: Schroder Investment Management (Singapore) Ltd, 138 Market Street #23-01, CapitaGreen, Singapore 048946. Company Registration No. 199201080H. Regulated by the Monetary Authority of Singapore.

Note to Readers in South Korea: Schroders Korea Limited, 26th Floor, 136, Sejong-daero, (Taepyeongno 1-ga, Seoul Finance Center), Jung-gu, Seoul 100-768, South Korea. Registered and regulated by Financial Supervisory Service of Korea.

Note to Readers in Switzerland: Schroder Investment Management (Switzerland) AG, Central 2, CH-8001 Zürich, Postfach 1820, CH-8021 Zürich, Switzerland. Enterprise identification number (UID) CHE-101.447.114, reference number CH02039235704. Authorised and regulated by the Swiss Financial Market Supervisory Authority (FINMA).

Note to Readers in Taiwan: Schroder Investment Management (Taiwan) Limited, 9F, 108, Sec.5, Hsin-Yi Road, Hsin-YI District, Taipei 11047 Taiwan, R.O.C. Registered as a Securities Investment Trust Enterprise regulated by the Securities and Futures Bureau, Financial Supervisory Commission, R.O.C.

Note to Readers in the United Arab Emirates: Schroder Investment Management Limited, 1st Floor, Gate Village Six, Dubai International Financial Centre, PO Box 506612 Dubai, United Arab Emirates. Registered Number 1893220 England. Authorised and regulated by the Financial Conduct Authority.

Note to Readers in the US: This communication and its related content(s) are for distribution to Institutional clients, Consultants or investors who have been vetted and 'qualified' as 'accredited investors' under SEC Rule 506 of Regulation D. Distribution of this communication and its contents to any other audience is prohibited. For use with North American audience only. Not all funds are available to US investors.

605280