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Venture Capital Takes Centre Stage: Exploring Its Role in Today's Financial Ecosystem

Kunjana Malik & Sanjay Motwani

Problem of practice:

As an institutional investor, or family office manager, you may be familiar with the recent trend of increasing 'dry powder'. In private equity speak, dry powder refers to "the amount of committed, but unallocated capital a firm has on hand".[1] In other words, it's an unspent cash reserve that's waiting to be invested. To put dry powder to use, investors may wish to navigate the private equity (PE) landscape, encompassing both venture capital (VC) and buyout strategies. While all investors focus on top-performing funds, consistent performers are sometimes overlooked due to recency bias. Hence, a key question arises: How can investors recognize skillful PE managers with a proven track record? Is there an easily discernible pattern that investors should look for? Recent research by Robert S Harris, Tim Jenkinson, Steven N. Kaplan, and Ruediger Stucke provides a much-needed answer[2]

[2] Featured in the Volume 81 of the *Journal of Corporate Finance*, authors Robert S. Harris, Tim Jenkinson, Steven N. Kaplan and Ruediger Stucke in their article: 'Has persistence persisted in private equity? Evidence from buyout and venture capital funds' talk about performance persistence for private equity (buyout and venture capital) funds

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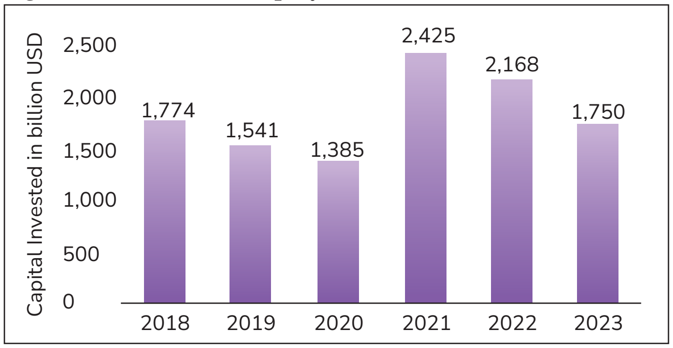
Private equity landscape

Investment in PE has been declining globally since 2022 (*see Figure 1*). The benefits of low interest rates and increasing investment values seen for the last decade are no longer helping. Now, private market managers need to work harder on growing revenues and profits to improve investment returns in this new era.

Figure 1: Global Private Equity Investments, 2018-23

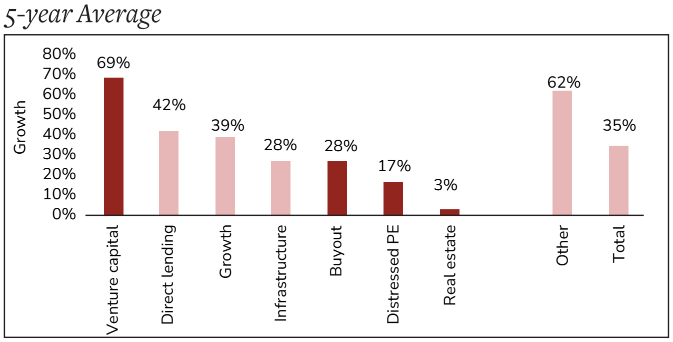


Source: Created by the authors based on data from Statista Research Department. "Global Private Equity Capital Invested Annually 2023", March 27, 2024

Buyout and venture capital, the two biggest types of private equity, have followed different paths over the last 18 months. Despite a 19% drop in the number of deals in 2023, buyout's performance improved to a 5% net internal rate of return (IRR) through September 30, 2023.[3] Though it is still not high as compared to venture capital. On the other hand, VC fundraising fell by nearly 60%, matching its lowest level since 2015, and the number of deals also decreased by 36%.[4]

Though fluctuations in PE are not uncommon, what stands out in the recent downturn is the rise in the **dry powder**. As of 2023, a large portion of this unspent capital is getting old and needs to be invested soon (*see Figure 2*). This unspent capital, combined with the prospects of easing or unchanged interest rates, has created expectations that investments will rise in 2024. Nearly 50% of all global buyout companies in the portfolios have been held for at least four years.[5]

Figure 2: Global Growth in Dry Powder in 2023 compared to 5-year Average



Source: Created by the authors based on data by Bain & Company. "Dry Powder: Global Growth by Fund Type 2023" March 2024[6]

The solution: How to pick winners?

The study by Harris and team explores the performance consistency of the US buyout and venture capital funds managed by the same general partners across different funds.[7] The results of the study indicated that VC funds had higher performance consistency and using the interim data available at the time of fundraising, instead of final data, might be a better indicator of performance persistence.

The researchers utilized extensive cash-flow data from a broad group of institutional investors, analysing the persistence of fund performance before and after the year 2000 (until 2020). Three metrics used to measure the PE fund performance[i] are: a) Average Internal Rate of Return or IRR[a], which is a financial metric used to measure the profitability of an investment, b) Multiple on Invested Capital[b,ii] and c) Public Market Equivalent Return[c,ii]. Key findings of the study were:

1. **Performance persistence across funds**

- VC funds exhibited robust performance persistence in both pre-2000 and post-2000 periods, with previous fund performance significantly predicting future performance, especially for top quartile funds.
- Buyout funds' performance persistence declined for funds raised post-2000. Specifically, top quartile funds raised post-2000 show less persistence in maintaining their quartile ranking compared to those raised pre-2000.

2. **Impact of the timing of performance measurement**

- Utilizing interim performance data (available at fundraising), instead of final data, resulted in a significant drop in persistence for buyout funds raised post-2000, for which almost no persistence was observed contradicting the common strategy of selecting funds based on their past success.
- VC funds showed some persistence using interim data, although it weakened for funds formed post-2000.

3. **Effects of fund strategy and size changes**

- VC funds did not exhibit significant negative impacts from increased fund sizes or changes in fund strategies, suggesting a more stable performance profile across different operational scales and strategic shifts.

In practice, Sequoia Capital, a California-based venture capital firm, has a reputation of picking successful investments at an early stage.[8] Its investment portfolio includes some of the marquee names such as Google, WhatsApp, Apple, Oracle, Paypal, Instagram, LinkedIn, and YouTube, among others.[9] In India, it has backed start-ups such as Flipkart, Paytm, Zomato, OYO, OLA, and Meesho. Sequoia uses a performance persistence strategy effectively to identify and invest in new ventures that have similar potential for high growth and success.

Kalaari Capital, a leading early-stage VC firm in India, employs a similar performance persistence strategy.[10] Some of its notable investments include Myntra, Dream Sports, cure.fit, along with others.[11]

Softbank Vision Fund, established by the Japan-based Softbank Group, is an example on the buyout fund side, albeit with a mixed track record.[12] Launched in 2017 with a massive $100 billion corpus, the fund made substantial investments in high-profile startups such as Uber, DoorDash, and WeWork. Unlike the consistent success of Sequoia and Kalaari, Softbank Vision Fund experienced significant setbacks, particularly with its investment in WeWork, which became a high-profile failure due to mismanagement and unsustainable business practices.[13] This highlights the risks associated with buyout funds and large-scale investments in potentially overvalued start-ups.

History repeating itself

The post Covid-19 landscape indicates that history is repeating itself, with the entire private equity space, including both buyout and venture capital, experiencing a decline in deal activities. Therefore, it is reasonable to anticipate that the post-2020 return data may resemble the patterns observed in the pre-2000 period. However, considering that the post-2000 period included the years of the global financial crisis, these results are likely to remain applicable in the post Covid-19 environment as well. Additionally, the market is expected to rebound in 2024, with a significant amount of capital ready to be invested.

Weighing your options

As a PE investor weighing the options between investing in early-stage versus more mature businesses, understanding the ability of managers to replicate success across different funds becomes crucial. Research by Harris and team offers valuable insights, suggesting that VC funds, despite their higher risk, tend to yield higher long-term returns compared to buyout funds. When selecting a VC fund to invest in, it is important to consider interim performance data, which can offer significant insights into the fund's potential future performance. For investors, this means prioritizing VC funds where managers have demonstrated the ability to sustain performance across cycles, which can be discerned from historical interim results. On the other hand, buyout funds, which generally involve more mature business profiles, may be better suited for investors seeking investments with shorter horizons.

Glossary of technical terms used

[a] Internal Rate of Return or IRR is a financial metric used to measure the profitability of an investment, which takes into account the time value of money.

[b] Multiple on Invested Capital or MOIC is a financial metric used to measure the performance of an investment relative to its initial cost. It is the ratio of the total value realized from an investment to the initial amount of capital invested or the total investment amount.

[c] Public Market Equivalent Return or PME is a metric used to compare private capital fund performance to public indices.

Notes

i. It is to be noted that the data on actual returns was net of fees and carried interests in the entire study.

ii. The terms Multiple on Invested Capital and Public Market Equivalent Return are commonly abbreviated to MOIC and PME respectively.

*Kunjana Malik is Assistant Professor with SPJIMR's Finance & Economics department. You can reach out to her at **kunjana.malik@spjimr.org***

*Sanjay Motwani is student at IIT-Mumbai. You can reach out to him at **motwanisanjay123@gmail.com***

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