PitchBook

Nontraditional Investors in VC Are Here to Stay

“Tourist” investors have become an entrenched participant in the US VC industry

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Key takeaways

- Nontraditional investors contributed to nearly 3,000 US VC deals in 2018, the highest annual total in our dataset. Those deals amounted to over $100 billion and comprised 81.5% of total US VC deal value. As a group, nontraditional investors control pools of capital that are orders of magnitude larger than VC funds in aggregate, which will allow them to continue influencing VC investment trends, particularly at the late stage.

- Nontraditional investors operate under diverse investment mandates that dictate how they can access VC investments and benchmark their returns.

- While some types of nontraditional investors have been dubbed “tourists” because of their seemingly fickle investment in VC, we believe that these investors are more entrenched in the current venture industry and are likely to be around for the foreseeable future.

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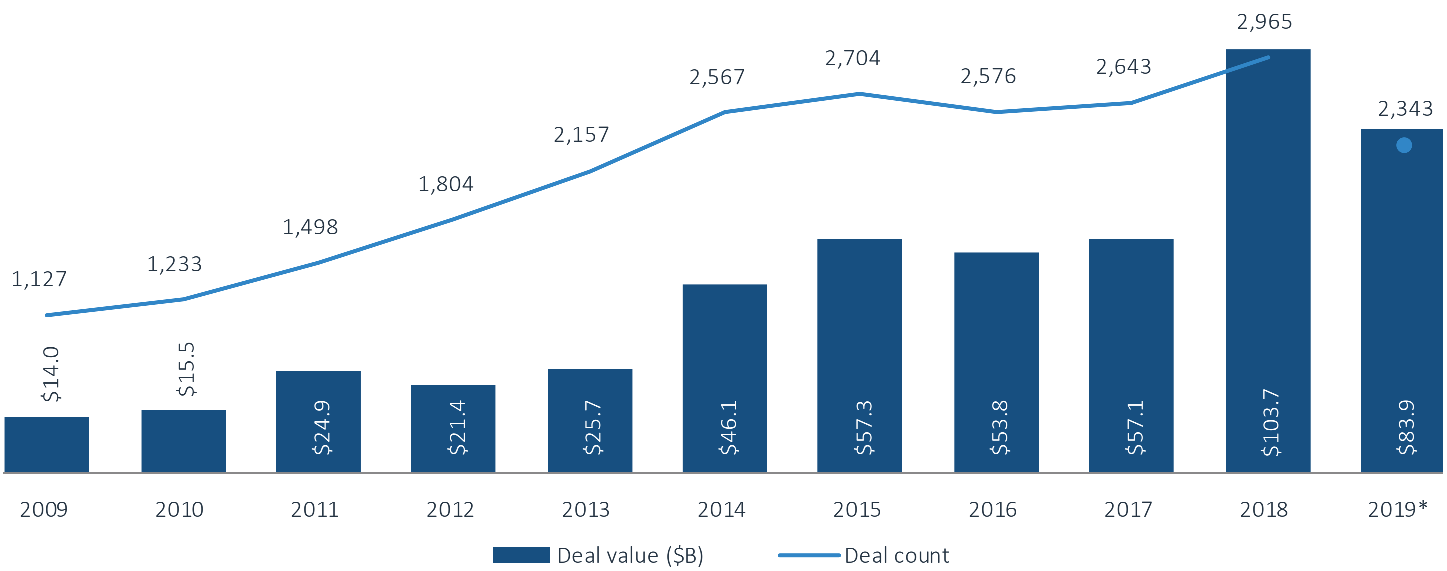
Introduction

Over the past several years, the venture industry has increasingly attracted capital from investors and pools of capital that don't focus exclusively on VC investments. These "nontraditional investors" contributed to nearly 3,000 US VC deals in 2018, the highest annual total in our dataset. Those deals amounted to over $100 billion and comprised 81.5% of total US VC deal value. The influence of nontraditional investors began to intensify in 2014, when the annual value of deals with nontraditional investor participation jumped $20 billion YoY, a growth of 80%, which coincided with a huge spike in the number of unicorns. Today, several nontraditional investors from that influx sit atop the list of those backing unicorns. This sudden increase in activity is a major reason why certain nontraditional investors are seen as "tourists" that are changing the venture industry by misunderstanding its fundamentals.

VC deal activity with global nontraditional investor participation

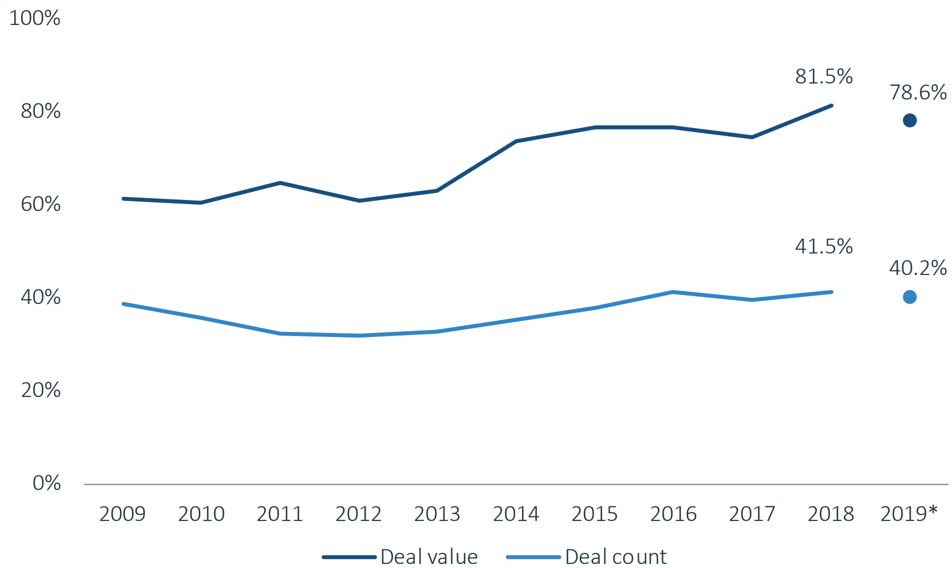


Source: PitchBook | **Geography:** US
*As of October 31, 2019

Corporations, PE firms, mutual funds, hedge funds, sovereign wealth funds (SWFs) and family offices all fall under this umbrella of nontraditional investors in VC. While all of them are seeking some combination of diversification and alpha potential from their venture investments, their primary motivations differ. Hedge funds and mutual funds look to capitalize on the diversifying effects and idiosyncratic opportunities presented by VC, as well as the potential for outsized absolute returns. Corporations often are diverting some R&D budget or extra cash on the balance sheet into startup investment, acting on both strategic and financial initiatives.

PE firms are set up as pools of capital similar to VC funds, but by participating in these non-control deals, they are forgoing the use of leverage to which they are accustomed in the search for superior growth potential. The differing nature of investment theses changes how each nontraditional investor carries out its venture deals and therefore shifts where each has the highest influence on the broader industry.

Proportion of VC deal activity with global nontraditional investor participation



Source: PitchBook | **Geography:** US
*As of October 31, 2019

Nontraditional classifications

Nontraditional investors enjoy certain benefits because they are not registered as pure-play VC funds. When operating under the VC fund structure, firms are allowed to make non-startup investments depending on their LP agreements, but the SEC has limited capital availability for these investments to 20% of a fund's total. VC firms are also restricted in other ways, such as in their use of leverage. To gain more flexibility, some traditional VCs have even chosen to shed their formal VC distinctions with the SEC (although we continue to classify them as such). For example, Andreessen Horowitz recently transitioned into a registered investment advisor (RIA) in large part to make investments outside the permitted venture scope, such as in public equities and crypto assets. By not registering as pure-play VC funds, investors have the benefit of using the strategy as a smaller proportion of their overall portfolio. In this section, we summarize the various types of nontraditional investors that have allocated to venture as part of their private market strategies.

Mutual funds

Unlike other pooled investment funds, mutual funds are able to solicit investments from retail investors and certain retirement plans. This broadens the potential investor pool but requires these funds to provide daily liquidity as a requirement of the 1940 Act. To ensure they are able to meet this requirement, funds that are subject to 1940 Act laws are restricted to investing no more than 15% of their net assets in illiquid investments such as venture.

Fidelity is one of the more active mutual funds in VC and possesses more than $2.5 trillion in AUM across all of its vehicles. It has recently participated in rounds for Convoy ($400.0 million), Riskified ($165.0 million) and Wheels Up ($128.0 million), which are considered large by VC standards but relatively small for Fidelity. For perspective, if it were to invest 15% of its total mutual fund AUM in VC, it would amount to over $375 billion in available capital—roughly three times the annual VC deal flow in the US. Total exposure to VC for mutual funds tends to be extremely low, however, often comprising only a percentage point or two of a given fund's AUM. As such, the impact of VC investment tends to be relatively immaterial to a mutual fund's overall returns. With less need to directly monitor and work with the company to have an impact on returns, mutual funds have been found to participate in deals with less board representation,[1] acting more simply as a financial partner.

Accessing venture through an underlying portfolio provides mutual funds the benefit of diversifying their holdings beyond public stocks with exposure to private companies, even if the holding is relatively small. The number of registered mutual funds has grown almost continuously over the past decade, adding to the competitiveness in attracting new investors. Diversification into high-growth private companies can also be a potential source of alpha.

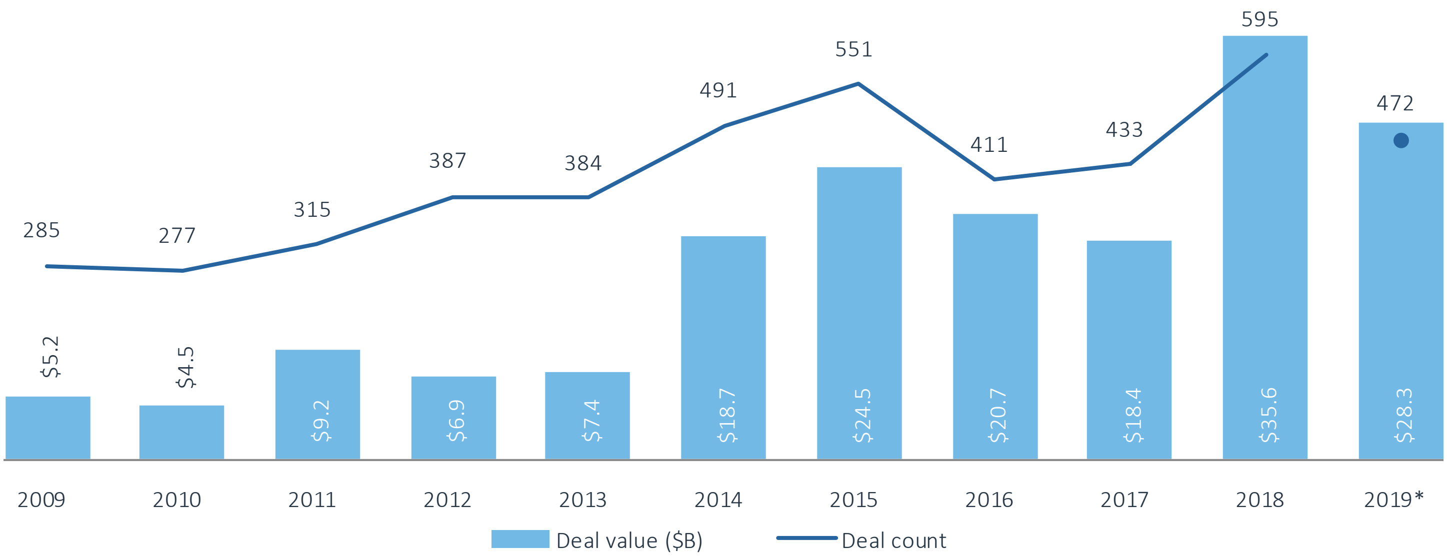
Hedge funds

Hedge funds have much more regulatory leeway than mutual funds, in part because investors in these vehicles must meet specified accreditation characteristics. Because of this, many hedge funds have a higher risk tolerance than mutual funds. This structure is similar to that of venture funds, which also cannot accept capital from non-accredited investors, but hedge funds diversify their holdings across public equities, fixed-income and structured products, and other asset classes well beyond venture. Also unlike a venture fund, which typically locks up capital for at least 10 years, hedge funds usually have redemption periods on a quarterly or annual cadence, which means they must keep capital relatively liquid to satisfy investor redemptions.

1: "Mutual Funds as Venture Capitalists? Evidence From Unicorns," Sergey Chernenko, Josh Lerner & Yao Zeng, October 2017

According to Ernst & Young's 2019 Global Alternative Fund Survey, investors are increasingly looking to PE (which includes VC in E&Y's survey) when allocating capital at the expense of alternative strategies such as hedge funds.[2] Similar to mutual funds, by participating in venture deals, hedge funds can potentially differentiate themselves with positions that cannot be replicated as those in public equities can. Some hedge funds, including Tiger Global Management and Coatue Management, have gone as far as opening VC-focused investment vehicles to help boost returns from venture.

VC deal activity with global open-end fund manager participation



Source: PitchBook | **Geography:** US
*As of October 31, 2019

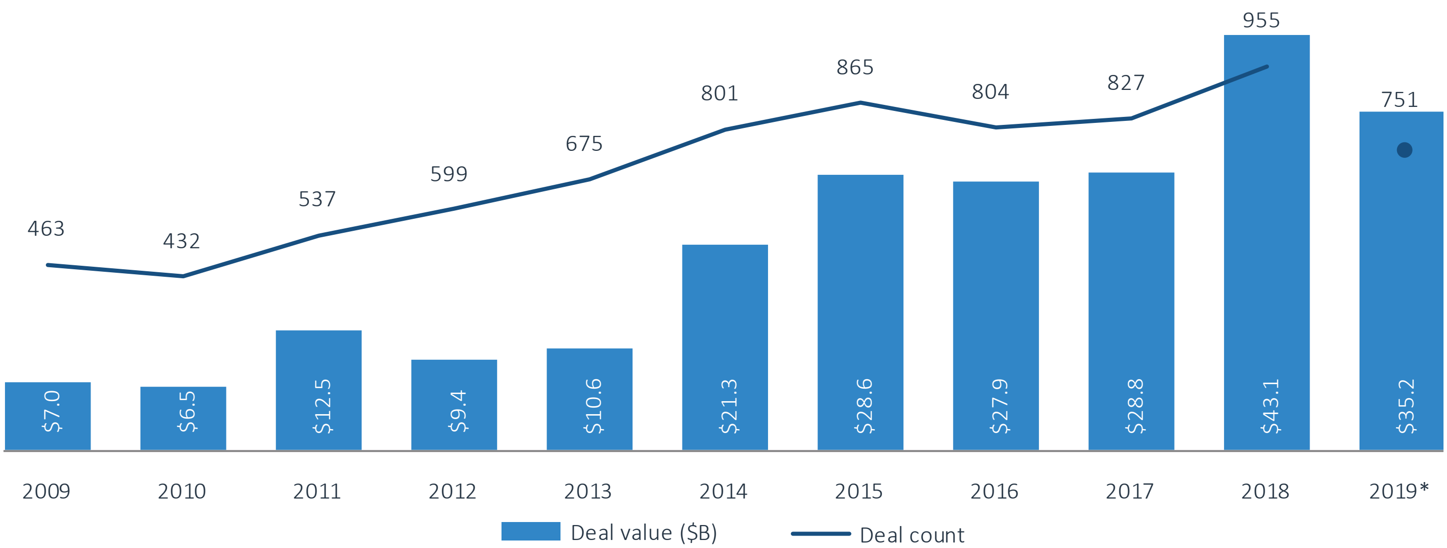
Hedge funds, mutual funds and other asset managers participated in just 8.3% of deals in 2018, but those deals contributed more than $35.6 billion to the industry, $26.7 billion of which was funneled into the late stage. Pursuing late-stage investments provides several benefits to asset managers. For one, they are theoretically illiquid for a shorter period than investments made in younger startups, providing relatively quick returns. The second benefit is that with these private investments, the asset managers typically investing in IPOs and public stock secondaries gain a window of insight into potential IPO candidates, as well as emerging market dynamics. With investors looking for alpha, any information asymmetries that they can collect can help shape their future strategies.

2: "2019 Global Alternative Fund Survey," Ernst & Young, 2019

PE funds

PE funds fall into the pooled capital fund manager category along with mutual funds and hedge funds, but PE firms are structured most like their VC counterparts. LPs commit capital that is subsequently called down as GPs make investments, generally with restrictions that are laid out in the LP agreement. PE funds do not have to register as an investment company under the Company Act of 1940, meaning there is no set regulation on what percentage of its holdings must be illiquid. Though many PE funds are set up to provide growth-stage capital, traditional buyout firms such as KKR and Warburg Pincus have recently participated in VC rounds. The distinction between PE and VC has converged over the past few years as VC-backed companies stay private longer and raise more capital, albeit through non-control investments.

VC deal activity with global PE investor participation



Source: PitchBook | **Geography:** US
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Competition among PE firms for buyout targets has intensified driving deal prices up and lowering the expected future returns for the industry. High-growth startups command lofty valuations, but the median EV/EBITDA multiple for PE buyouts has surpassed 12x in 2019, the highest figure we've tracked for this metric. Venture investment is a different way for PE funds to put capital to work. While PE firms have increased their interest in early-stage deals in recent years, 53% of their deals have been made into the late-stage during 2019. VC deals with PE participation reached a decade high in 2018 with 955 closed.

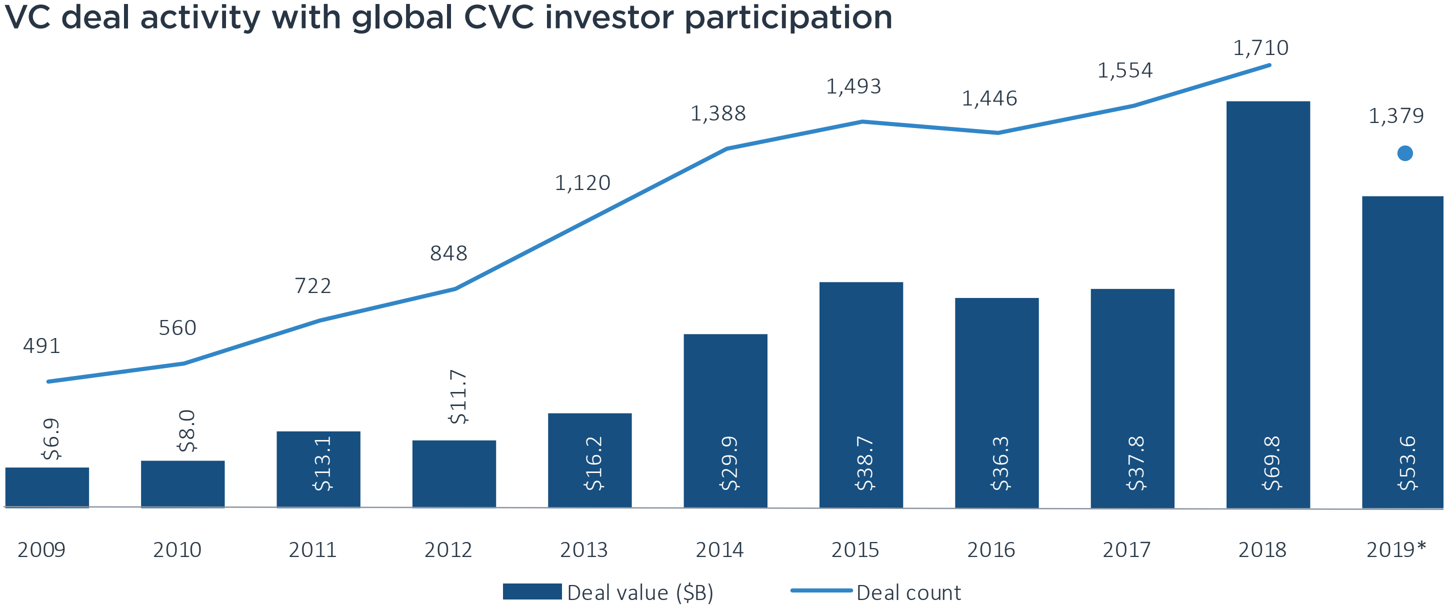
The maturation of the tech industry has been one of the reasons for increased interest in venture from PE firms. Tech-focused funds have accounted for 20% of all capital raised across North American and European PE funds YTD, and PE sponsors acquired a record 202 VC-backed companies in 2018. VC-backed tech companies have been a major beneficiary of PE as the industry continues to mature, especially as companies realize large returns even for late-stage investors.

Corporate venture capital

There is a wide spectrum of how CVC is deployed, ranging from strategic to more strictly financial motives. That strategic corporate development can motivate investment into a startup is a stark difference between CVC investment and that of traditional VC funds. Corporations seeing their industries disrupted by new technologies have a major incentive to invest in VC, with many viewing investment as a supplement to traditional R&D. Partnering with young companies can provide market data and access to technology that can help the corporation build out its moat and future business plans. Corporate distribution channels can be a huge assistance to the growth of a startup's product, making corporations a sought-after investor as well.

Amazon's Alexa Fund and Slack's VC fund are two examples of incumbents investing in startups to improve their own products by incorporating new technology into their existing platforms. In many cases, this approach provides faster returns for Slack and Amazon than they would otherwise achieve through internal R&D programs.

VC deal activity with global CVC investor participation



Source: PitchBook | **Geography:** US
*As of October 31, 2019

Recent years have shown corporate investors increasingly participating in the earlier stages of the venture lifecycle. We believe this is partially due to startups gaining traction more quickly, providing a better window into their technologies. CVCs' position under a corporate umbrella means there is a strategic benefit to identifying targets and new technologies early because the corporation can then partake in the growth of the technology. As corporations continue to build out their VC investment teams, their dealmaking initiatives will likely occur earlier in the venture timeline.

SoftBank

If any single investor deserves its own category, it's SoftBank. The Japanese telecommunications conglomerate was an active investor in venture deals even before raising its $100.0 billion Vision Fund, but the firm has become a major disrupter since. The fund operates with a unique dual-class share structure; 40% of the shares are preferred and pay a 7% coupon annually, while the other 60% are common. The preferred class was structured as such to entice certain investors into committing the large sums needed to reach the $100.0 billion target.

Vision Fund's investments are virtually tantamount to a list of the largest deals in recent years. The investor has participated in or fully funded deals of more than $1 billion with WeWork, Uber, Fanatics, Flexport and Katerra and more than $500 million with Nuro, REEF Technology, DoorDash (twice) and SoFi, among a litany of other mega-deals. Despite its scale, the fund's strategy reads like that of a much smaller venture fund, claiming that it strives to invest in companies and help founders navigate growth at every step to reach their full potential. SoftBank's Vision Fund has come under intense scrutiny recently due to several of its portfolio companies failing to grow into sound businesses.

In many ways, SoftBank has become the antihero of VC, muscling its way into deals and promoting a winner-take-all approach to investing. This aggressive approach to venture dealmaking—investing massive sums with less regard for the ultimate price paid for the stake—has put upward pressure on valuations across the industry, which is a reason many VCs have labeled nontraditional investors as "tourists." The way in which the fund goes about dealmaking has also raised eyebrows. It was reported that SoftBank offered $4.4 billion to WeWork just 10 minutes after meeting with founder Adam Neumann; and its $300.0 million investment in dog-walking app Wag was 4x the size of the round that the company had initially set out to raise.

SoftBank's top deals*

Company name	Close date	Deal size ($M)	Post-money valuation ($M)	Deal type	Industry group
The We Company	October 31, 2019	$6,550.0	-	Corporate	Commercial services
Uber	May 24, 2016	$5,600.0	$66,600.0	Series G	Transportation
The We Company	January 8, 2019	$5,000.0	$47,000.0	Corporate	Commercial services
The We Company	August 24, 2017	$1,700.0	$21,200.0	Series G	Commercial services
Uber	December 28, 2018	$1,250.0	$69,575.0	Series G	Transportation
SoFi	August 20, 2015	$1,000.0	$3,575.0	Series F	Other financial services
Fanatics	September 6, 2017	$1,000.0	$4,500.0	Late-stage VC	Retail
Flexport	April 22, 2019	$1,000.0	$3,200.0	Series D	Commercial services
Katerra	September 20, 2018	$998.9	-	Series D	Commercial services
Nuro	February 11, 2019	$940.0	$2,700.0	Early-stage VC	Transportation

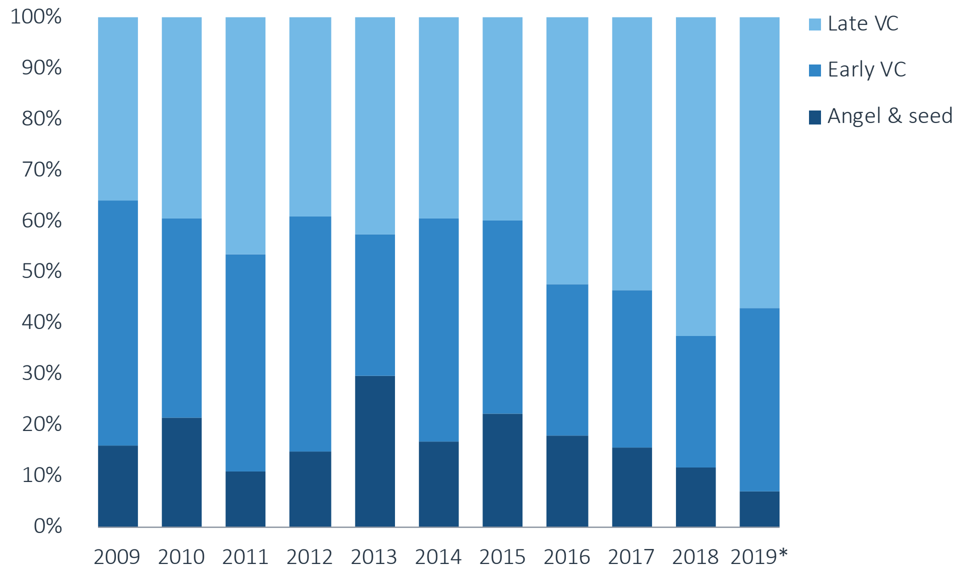
Source: PitchBook | **Geography:** US
*As of October 31, 2019

Sovereign wealth funds

SWFs tend to exercise more patience in their investment strategies. They are the largest allocators to private markets, typically drawing upon natural resource reserves as their base of capital. SWFs generally have one of three goals: stability, savings or local development, with long-term gains and asset accumulation serving as a major part of their general strategy. This timeline fits well with VC investment as near-term returns aren't necessary for SWFs. The size of a typical SWF's AUM limits direct investments mostly to large, late-stage deals. Some of the more active SWFs in VC are Temasek (Singapore, $230.0 billion), Australia Future Fund (Australia, $75.0 billion) and Mubadala (UAE, $229.0 billion).

VC firms have historically targeted SWFs as LPs in the past, but SWFs have been increasingly investing in VC directly. For example, Singapore's Temasek Holdings and Government Investment Corporation (GIC) have directly invested in nearly 100 VC-backed, US-based companies combined, closing 49 in the past two years alone. Direct investment allows SWFs to enhance returns with wins while risking relatively little of their substantial AUMs. Giving more credence to SWFs' commitment to the VC strategy, Qatar, United Arab Emerites and Saudi Arabia have each opened a Silicon Valley office location to give their funds more visibility within the US VC industry.

VC deals (#) with global SWF participation by stage



Source: PitchBook | **Geography:** US
*As of October 31, 2019

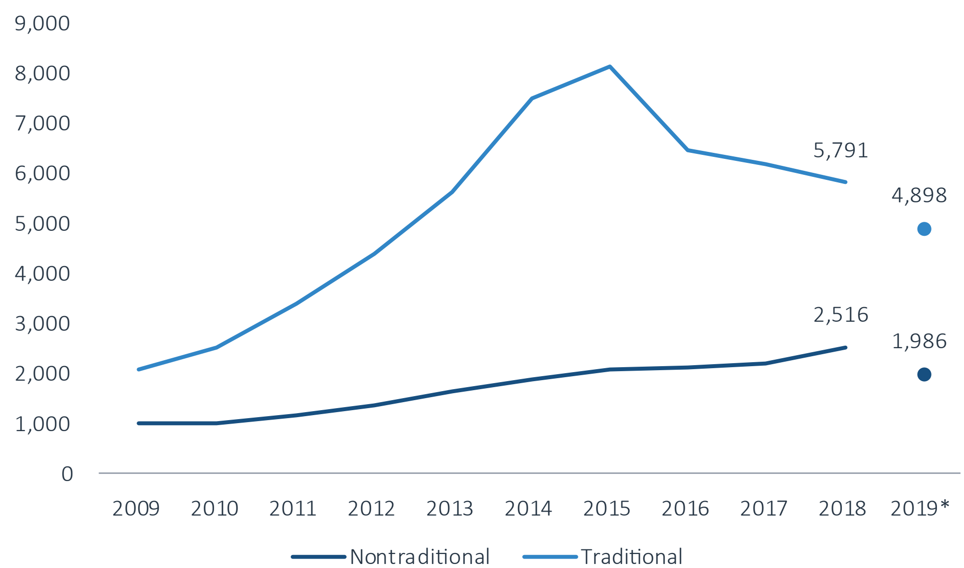
Family offices

Family offices are another nontraditional investor type that has participated in the venture industry for a long time, but mainly as LPs. Family offices investing directly into venture is a relatively new trend, at least at the levels seen today. There is also a wide range of family office sizes and investment strategies. For example, Bezos Expeditions is the family office of Amazon founder Jeff Bezos, who is himself worth more than $100 billion, but there is no size requirement to open a family office, and each operates to service the individual needs of the family. Investment experience also varies widely and likely determines the level of exposure to alternative private investments. Family offices can afford to be patient in terms of capital return schedule since these entities are set up for multi-generational wealth accumulation, though this depends on how the family intends to use returns. Seed- and early-stage investment represented 69% of deals for these investors in 2014. Particularly for family offices, which often access VC via fund commitments, the elimination of fees can be a major motivating factor. Venture has performed the highest of any private market fund strategy over the past year and compares favorably to other private strategies over five- and 10-year horizon IRRs. But VC funds carry hefty fees that can be circumvented via direct investing.

The effect nontraditional investors have on the VC industry

Tourists, nontraditional investors, alternative sources of capital—whatever this group may be called, it is now an important and transformative part of the venture industry, commanding a substantial source of capital. Nontraditional investors control significantly more capital than VC firms in the US, which conversely have averaged around $40 billion raised over each of the past five years. There are over 1,000 more US mutual funds in 2018 than there were in 2009,[3] harboring net assets that have grown by some $7 trillion.[4] Corporate profits continue at record levels,[5] and US wealth has reached the highest figure to date.[6] More than 2,500 unique nontraditional investors from around the globe participated in a US VC deal in 2018; this compares to fewer than 1,000 at the height of the financial crisis a decade ago. Not only are nontraditional investors large in aggregate, but the individual players are formidable in size: Saudi Arabia's Public Investment Fund controls $320.0 billion in AUM; Fidelity has over $1.5 trillion in equity and multi-asset mutual fund AUM; SoftBank has invested out of a $100.0 billion multi-asset-class fund over the past couple years and is in the process of raising its successor. This disparity plays into nontraditional investment trends and, more importantly, explains how influential these firms are over the industry.

Unique global investors (#) investing in VC deals



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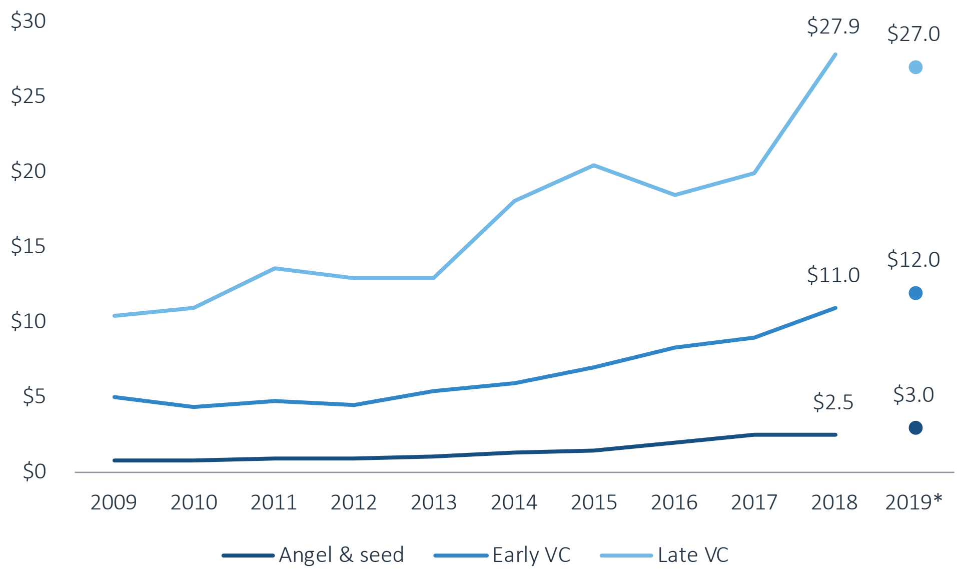
3: "Number of mutual funds in the United States from 1997 to 2018," Statista, 2019
4: "Total Net Assets of US-registered Mutual Funds Worldwide From 1998 to 2018," Statista, 2019
5: "United States Corporate Profits," Trading Economics, n.d.
6: "B.101.g Balance Sheet of Households (1)," Board of Governors of the Federal Reserve System, June 6, 2019

Nontraditional VC investment has followed a similar trajectory to the overall venture market over the past decade: up and to the right. From 2009 through 2018, nontraditional investors increased their deal activity by a CAGR of 11.3%, actually surpassing the growth rate achieved by the US VC industry overall (10.5%). That momentum has only continued recently, with 2019 likely becoming the second-consecutive year in which the value of deals with nontraditional investors participation surpasses $100 billion.

As companies stay private longer and raise more cash while private, the need for nontraditional investors has also risen. The lofty deal sizes of late would not have been possible without nontraditional investors. Since 2015, mega-deals have pumped almost $196.2 billion into VC-backed, US-based companies; during that same timeframe, US-headquartered VC funds have raised a total of $210.5 billion. While traditional VC funds have trended larger in recent years, they have not kept up with the demand for ultra-late-stage deals. Nontraditional investors have filled the void, particularly in the largest transactions. The median late-stage deal with nontraditional investment is more than 4x the median size of deals without. The need for this capital is only growing. More than 230 VC mega-deals have been completed in the US in 2019 alone—a new record—and more than 85% of those deals included nontraditional investment.

Median VC deal size ($M) with global nontraditional investor participation by stage



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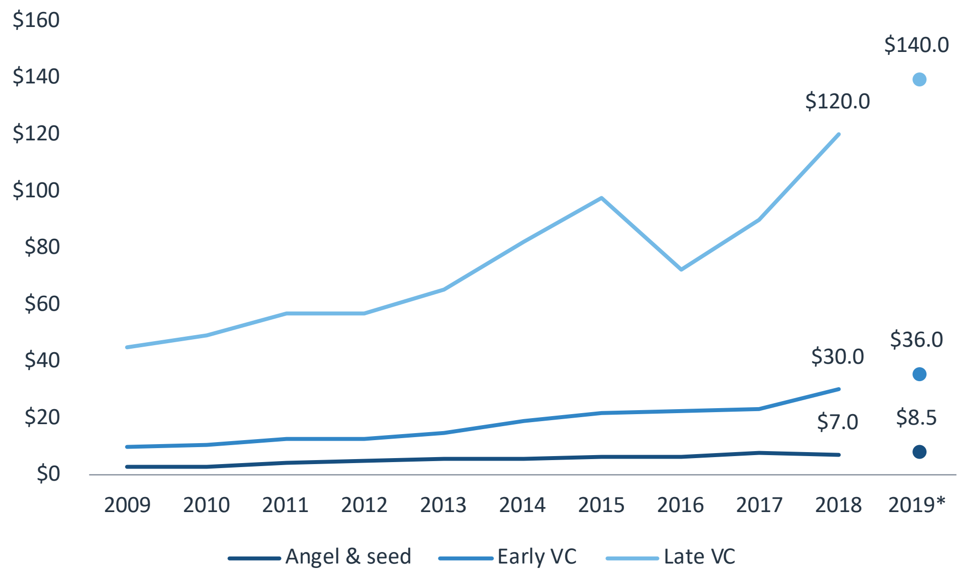
As this data would suggest, VC investments by nontraditional investors have been typically focused on the late stage, where deal sizes allow them to put enough capital to work to make a difference in their returns—though for some of the largest firms, even these outsized deals may be immaterial. Regardless, as a result of nontraditional investors primarily participating in larger, late-stage venture deals, the median VC deal size and pre-money valuation have subsequently risen substantially in the past decade.

Median pre-money valuations ($M) with global nontraditional investor participation by stage



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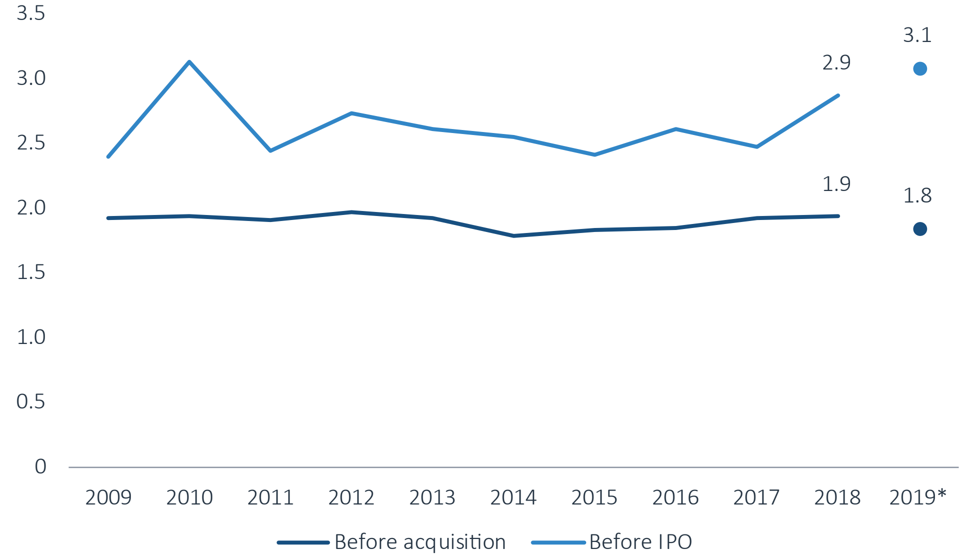
Conclusion

We believe nontraditional investors will continue to play a prominent role in the venture industry, and there is some evidence that their influence may grow even further. Many nontraditional investors have willingly taken a backseat when it comes to direct investment, often jumping on the bandwagon late to score quick financial wins. But as their investment teams mature and become more comfortable with venture dealmaking, we're seeing more nontraditional investors move up in the venture lifecycle and take stakes earlier. For example, Goldman Sachs has opened an in-house accelerator, and Coatue Management has closed a $700.0 million early-stage VC fund.

Average number of rounds with global nontraditional investor(s) prior to exit by exit type



Source: PitchBook | **Geography:** US
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These new avenues for investment show that not only are some nontraditional investors becoming more comfortable with VC investing, but that they have worked to professionalize their involvement, building dedicated investment teams to implement their venture strategy. In 2019, the average number of rounds that nontraditional investors have made into companies that have exited has risen to nearly 3.1, underscoring how they are working more to develop these companies and are increasingly engaging in VC as more than just flighty tourists.