High Valuations, Higher Returns

Returns spur nontraditional investors to ramp up deal activity

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Contents

Key takeaways

- As the US venture market has expanded, non-VC investors have jumped at the opportunity. In 2020, these nontraditional venture investors not only participated in 77% of the US market's deal value, but also in around 95% ($285 billion) of the total exit value. While a large portion of this capital will go back to traditional venture firms, the exit values of the companies with existing nontraditional investors (NTIs) show these firms are searching out and investing in the largest of VC-backed companies.

- NTIs have seen strong returns, regardless of where in the venture lifecycle they invest. Annualized returns from NTIs at Series A have surpassed 30%, while investments into later series have realized annualized returns of between 10% and 15%.

- One of the high risks NTIs take when investing in venture is liquidity risk, especially since many of their vehicles are not set up to sustain elongated periods of illiquidity. Our data shows that, while liquidity risk is still present, NTIs hold companies in their portfolios for a median of just 3.7 years, considerably lower than the median time from first investment to exit for companies in the US.

Introduction

NTIs have ramped up activity in venture-backed companies over the past several years. In fact, Q2 2021 was the highest quarter in our dataset for activity from these institutions. Nearly 1,800 deals (around 41.5% of the market total), representing a whopping $57 billion+ of capital invested (more than 76% of the market total), received participation from this group. While the activity of these firms has often been discussed, the returns being generated—which are vital for determining whether their activity has continued or declined—have received significantly less coverage.

NTIs, which PitchBook categorizes as any investor type falling outside a classic VC firm, accelerator, angel group, or solo investor, have become impactful participants in the venture market. NTIs include, but are not limited to, private equity investors, mutual funds, sovereign wealth funds, hedge funds, corporate investors, and family offices. The wide variety of investor types in this group makes analysis and trend attribution somewhat cumbersome, but many trends we see today—such as private companies raising more capital than ever before and extending growth while private—can be traced to heavy involvement by these investors.

One reason this is the case is that NTIs control a much greater pool of capital than traditional VC firms. While much of that capital is earmarked for other investment types, our estimations have put the range of capital available from these investors for the global venture market at between $250 billion and $350 billion. For comparison, global venture funds controlled roughly $280 billion in dry powder in 2020. We believe nontraditional capital effectively doubles the capital available to VC-backed companies worldwide.

What is interesting about the wave of activity is that these firms doubled down on venture, surpassing the pace of pre-pandemic investment more quickly than expected. These investors use venture as a supplement to other strategies, whether they be public equity investment or corporate R&D. The sums of capital being aggressively invested have confounded the market, increasing competition for deals and helping boost deal prices ever higher.

Venture isn't likely to become the "bell-cow" investment thesis for many of these institutions, but the increased activity does indicate the strategy has succeeded in creating large enough returns to keep NTIs dipping into the venture market. This note looks to quantify those returns to better understand the increased activity within the space.

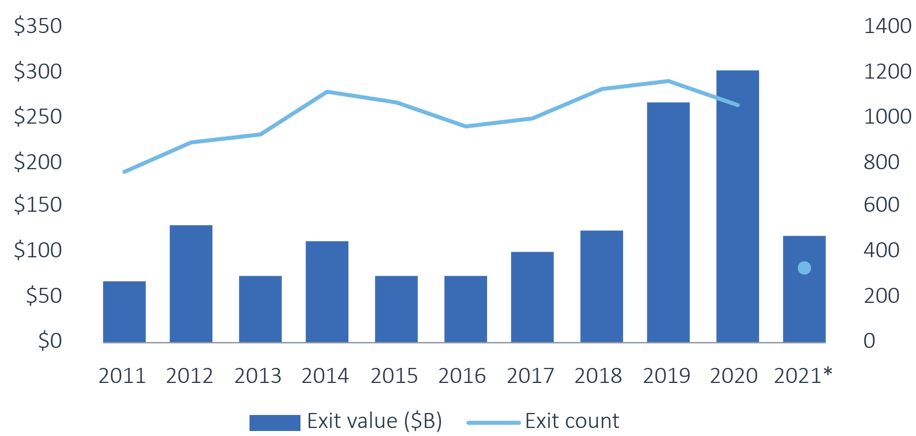
Nontraditional exits

The risks taken in venture investing necessitate higher returns than other types of investments. LPs need the incentive to continue pushing capital to investors evaluating companies that could go under quickly. GPs require high returns so their portion of the carry matches the time and risk they put into the market. While heightened focus has been on social impact (non-cash) returns, and some corporate investors have claimed synergistic returns, the reality is that the venture market is fueled by the cash-on-cash returns it creates, which are then recycled into the market through future LP commitments. Risk-taking investors look for high compensation, and when that compensation does not materialize, then—at least in theory—those investors will stop taking those risks and move on from that strategy.

The venture market has generated massive returns in recent years. Exit value in 2020 surpassed $300 billion, and through just the first quarter of 2021, more than $118 billion in exit value has already been created, marking 2021 as the fifth consecutive year to surpass the $100 billion mark. Most of the total exit value in the last three years was created by IPOs; therefore, true returns cannot be realized until investors finish liquidating their shares, which could take years.

Cash flows back to venture LPs—that is, the net value of the distributions minus contributions for the year—have been positive each year since 2012, even as investment into the market has skyrocketed. According to our recent report, venture has been the highest performing private capital strategy over recent horizons and is just below private equity at the five and 10-year horizons.

VC exit activity

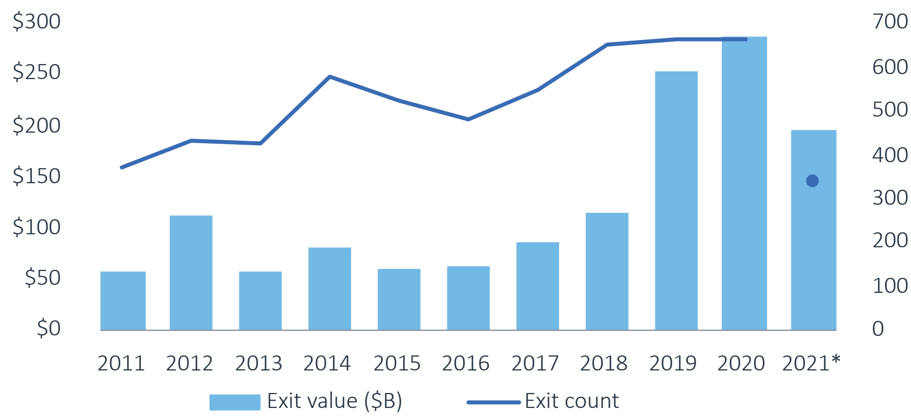


Source: PitchBook | **Geography:** US
*As of March 31, 2021

NTIs have generally preferred to invest at the late stage in recent years, where there is less risk a portfolio company will fail, compared to the seed or angel stages. The large capital sums being put to work, however, increase risk for these institutions, as does their relative inexperience with the venture asset class. Therefore, the rewards should be proportional.

An extraordinary $285.0 billion (95%) of the $301.4 billion in exit value created in 2020 came from companies in which NTIs had invested, which makes sense since NTIs have participated in a high percentage of late-stage mega rounds in recent years. This is possible because of the growing concentration in the venture market. For instance, the 10 largest exits in 2020—all companies that had raised a nontraditional-participating mega-round ($100 million+)—generated $162.0 billion of the total exit value. More than 50% of the record exit value was created by just 10 companies, a highlight of venture's power law of returns and also an indicator of how mega-round strategy plays into some nontraditional venture investment theses.

Exit activity of companies that contained a nontraditional investor



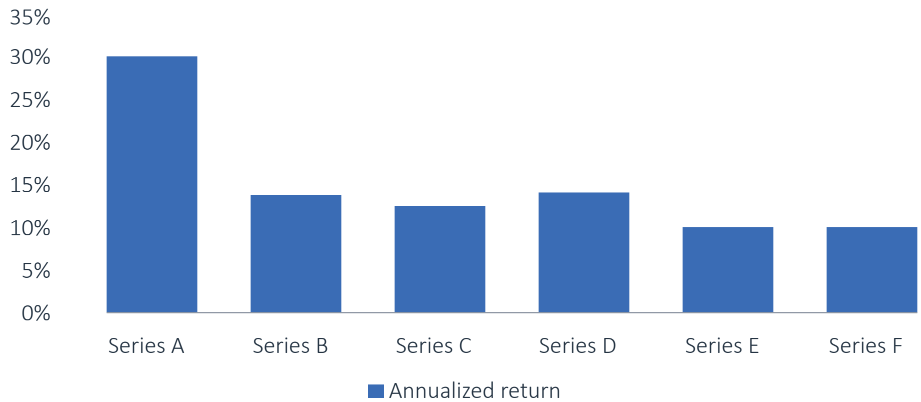
Source: PitchBook | **Geography:** US
*As of March 31, 2021

But such data does not tell the full story of nontraditional returns. Looking at exits by companies with NTIs heavily skews the notion that these investors have generated equally high returns. A company with a cap table of 100 investors—just one of which is nontraditional by our methodology—will show up in the data even though a relatively small proportion of the company's exit value would return to the single investor.

Analysis of nontraditional returns

VC investments by nontraditional firms have done well on returns, regardless of when during the venture lifecycle the investment is made. On an annualized basis, the returns generated by NTIs have been surprisingly consistent—with the exception of Series A investments—across the venture lifecycle. Series B through Series E investments have generated annualized returns between 10% and 15%. The net payout for these investments within this case study is $85.5 billion. NTIs' annualized returns are highest at Series A, where investments have generated a return of more than 30%, for a total net payout of nearly $32 billion.

Annualized returns of nontraditional investor-involved deals



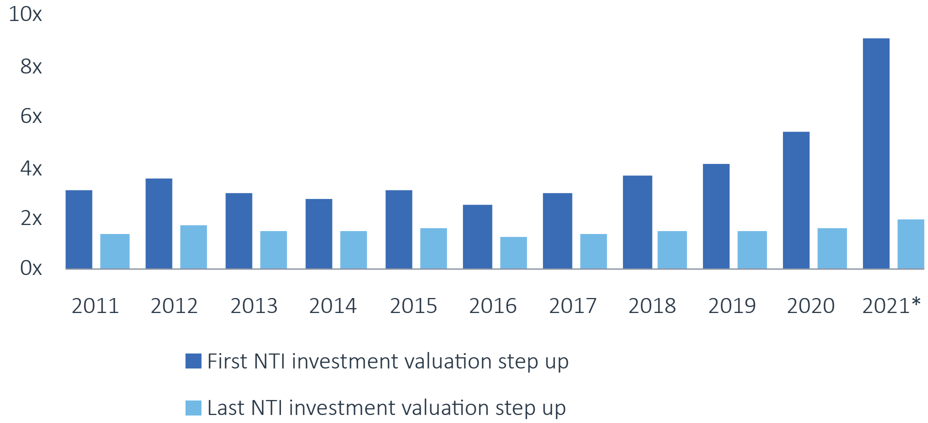
Source: PitchBook | **Geography:** North America
*As of June 6, 2021

The data shows that the returns of NTI deals are more or less in line with—and even exceed in some series—those seen by the broader VC investor base. Annualized returns for NTI Series A investments outpace broader market annualized returns by 5.0%, a reason it is likely more experienced NTIs, especially CVC groups, will shift to investing earlier in the venture timeline.

In 2020, the valuations of companies raising with nontraditional investment rose by a median of 5.4x from the first NTI investment to exit. The average figure is much higher, a massive 33.9x, skewed by outlier exits that typically return much of the industry's exit value. Even when looking at the NTI investment immediately prior to exit, the median step up was 1.59x.

There is a lot of nuance that goes into these figures, however. For one, most NTIs are likely not investing in every round before an exit and can, therefore, see their stakes diluted by the time an exit occurs. There is also survivorship bias with the sample as it includes only companies that have exited, disregarding failed investments and companies that have yet to exit, whether currently in a strong position or not. But the step-up multiples highlight the potential high returns NTIs can see in venture, even when they are not traditional foundational VC investors.

Median step ups of first and last nontraditional investor deals before exit



Source: PitchBook | **Geography:** US
*As of June 5, 2021

With respect to late-stage and growth equity activity by NTIs, the valuation step-up between a company's final round and exit may be the most important. 77 out of the 135 companies that publicly listed in 2020 had raised an NTI in their last private round. These companies saw a median step up at IPO of 1.49x, with the average surpassing 2.0x. Assuming investors in the final round had nonparticipating terms and received their pro rata share of the exit, the average return was double the initial investment.

Investments this late in the company lifecycle are typical of crossover investors who have begun to plow billions into venture after previously focusing their investments on IPO rounds. Exchanging private for public equity just one round after an investment not only relieves liquidity concerns, but in essence provides a discount to IPO shares and likely secures an IPO allotment, if desired.

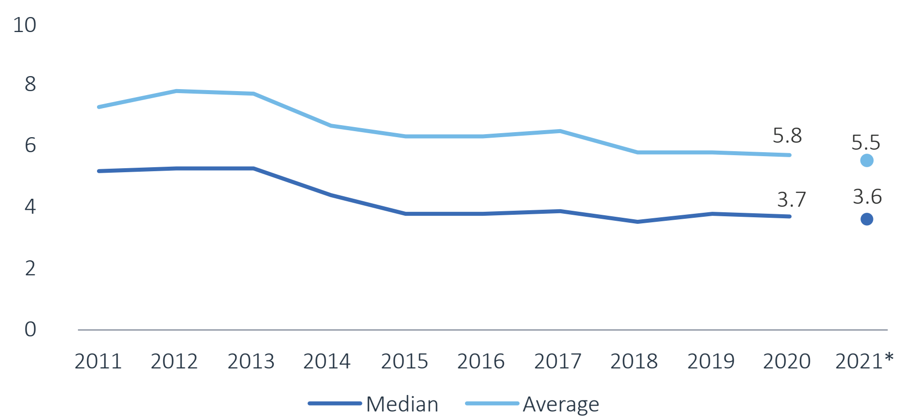
It should also be noted that the success rate—successful exits vs. failure—for nontraditional investments has been very strong, showcasing the lower relative risk of these NTI investments. At the late stage (Series C and beyond), NTI investments are successfully exiting at a rate of 8.9 exits per failure. There is a selection bias at work, however, as many NTI investments are in companies that are already financially strong and on track to exit in the near term.

Hold times and their impact on NTIs

Hold times factor into nontraditional returns for several reasons beyond IRR. For one, NTIs have different liquidity constraints and investor payback schedules than venture funds, and most importantly, different return needs, so the time spent holding portfolio companies is important for understanding the cash-on-cash returns.

These institutions also generally hold their venture investments for much shorter periods of time than the average venture fund because most NTIs do not participate in the earliest venture series; therefore, even successful investments do not drag on portfolios. As for median hold time, companies exited in 2020 were held in an NTI portfolio for just 3.5 years, less than half the median time from first VC round to exit for the broader industry.

Average hold time (years) from deal close to first exit for nontraditional investors



Source: PitchBook | **Geography:** US
*As of June 5, 2021

Unlike other investment firms, strategic corporate investors are able to return benefits throughout the company hold time by gaining insights into markets and realizing the synergistic benefits of partnering with a startup. Longer hold periods reduce risk, as non-financial returns can also be a target of any investment.

The wide variety of NTIs makes analysis of this data difficult. Corporate investors have invested more heavily in early-stage deals over longer horizons, while larger institutions and asset managers have typically leaned toward late-stage deals, an area of venture that lends itself to shorter hold times. The relatively short median hold time highlights the approach to lower liquidity risk these investors take, fashioning their venture theses to realize exits more quickly than the high-risk, high-reward strategy of seed- and early-stage venture firms.

NTIs such as hedge funds, mutual funds, or other open-end funds, require a certain degree of liquidity to service redemption requests, among other liabilities. Per SEC regulations, mutual funds may only invest 15% of their holdings into illiquid investments. Venture capital is one of the most illiquid investments, although secondary exchanges are looking to help alleviate this pressure. Other NTI types have fewer constraints, yet liquidity risk is still high within venture investments, which could pressure NTIs to fund other obligations should immediate liquidity needs arise.

Several factors affect the ability for mutual funds to stay within liquidity regulations. For one, these funds are multitudes larger than traditional venture funds, even the largest in the market today. The largest VC fund to date is Sequoia's $8.5 billion fund, although Tiger Global is reportedly looking to raise a $10.0 billion venture fund in the coming year. Equity-focused mutual funds alone manage $24 trillion worldwide, which makes the size of the venture market seem almost trivial. Individual fund liquidity can be a concern, but overall, nontraditional funds can properly manage cashflows to continue high activity in venture while keeping liquidity concerns low.

NTI investment moving forward

The past few years have shown that NTIs have had an increasing impact on the trends of the current venture market. Not only have we seen more of these institutions participating in VC rounds, but they have increased their activity leading rounds and moved earlier into the venture lifecycle.

It is easy to see this increased activity as a blip, or that these investors are simply opportunistic. Even so, one would expect them to remain opportunistic until returns from the strategy are no longer within their risk-return tolerance—which would likely mean the entire venture market is no longer a winning strategy for a broad spectrum of investors, including VCs.

The fact that the core investment for NTIs of Series C and later generated an annualized return above 10% in our dataset showcases why the strategy has become so popular with this group. 10%-15% per annum may not satisfy a venture firm's expectations, but typical NTIs do not operate with the same risk profile, so they can justify relatively lower returns. Generalizing NTI liquidity risks using historical venture market investment data drastically overestimates the risk taken by NTIs through direct venture deals.

It is our belief that this group of investors will continue to increase their involvement in the VC market—as long as current VC exit and return trends are sustained—regardless of other macro trends or shifts. We have seen NTIs lean further into venture, which we also expect to continue. The market trends have opened opportunities for large investors to participate in materially beneficial ways and be involved in large rounds that can validate the drift from more core strategies. Venture capital has become a strong investment strategy for both diversification and on an absolute basis for NTIs.