PitchBook

# Shadow Capital in Venture Investing

## Estimating nontraditional investor participation in VC dealmaking

PitchBook is a Morningstar company. Comprehensive, accurate and hard-to-find data for professionals doing business in the private markets.

## Credits & contact


**Analyst**

**CAMERON STANFILL, CFA** Analyst II, VC
**KYLE STANFORD** Analyst, VC
**DAN COOK, CFA** Senior Manager, Data Analysis

**Research**

reports@pitchbook.com


## Contents



### Key takeaways

- **We estimate nontraditional capital availability is approximately $240 billion to $340 billion.** We calculated this figure by using historical values of years of dry powder on hand—which has ranged from 2.5 to 3.5 years over the past decade—and applying that to our estimated $97.4 billion in nontraditional capital investment as of year-end 2018. This is a rough estimation; however, with the increased capital investment we have seen from this non-VC fund group, we believe it's crucial to provide a sense of the potential nontraditional investment force for startups and other investors.

- **The number of unique nontraditional investors participating in global VC deals has outstripped that of traditional venture firms each year from 2013 to 2019.** Together these investors wield incredible influence across the industry, having large stores of capital to put to work. During 2018 and 2019, more than 79.2% of US VC deal value originated from deals with nontraditional participation. While many of these investors participate in fewer deals per year than venture firms, its likely not a coincidence that the growth of nontraditional investors has coincided with rises in deal values globally.

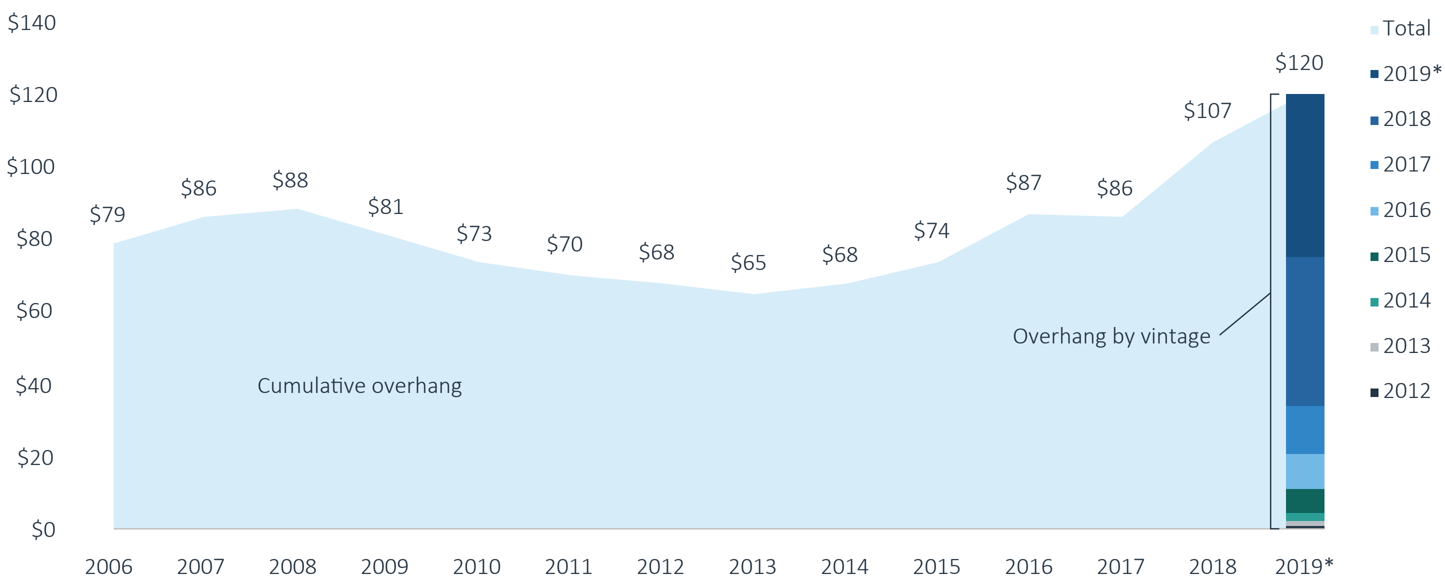
- **Dry powder in VC funds continues to build as of Q3 2019.** There is currently 3.2 years of dry powder on hand given the average of $37.3 billion in contributions. This compares favorably against the era following the global financial crisis (GFC), as this statistic has slowly grown since 2009. However, the years before the GFC boasted a higher figure of years of dry powder on hand given that contribution levels have swelled in the last few years.


Published on June 8, 2020

## Introduction

The VC industry has changed drastically over the past decade in both size and scope, broadening the types of participants in the market. While the CVC strategy has been around for decades, corporates have become more involved and ingrained in the broader VC landscape than ever before. In addition, mutual funds, hedge funds, sovereign wealth funds (SWFs), family offices and other institutions that have historically accessed VC in an LP capacity are doubling down on their direct VC investing practices, contributing to further diversification of the sources of capital available to startups. We have extensive tracking of the deals in which these investors participate; however, we are unable to extract a clean view of the total capital these participants earmark for direct investments. As a result, we have not historically included nontraditional investors in our VC dry powder calculations. To account for the growing cohort of nontraditional VC investors and to better quantify the capital available to startups, in this analysis we incorporate alternative data sources such as VC fund cash flows and nontraditional investor characteristics to generate a comprehensive estimate of nontraditional investors' total capital availability.

**Dry powder ($B) in dedicated VC funds**



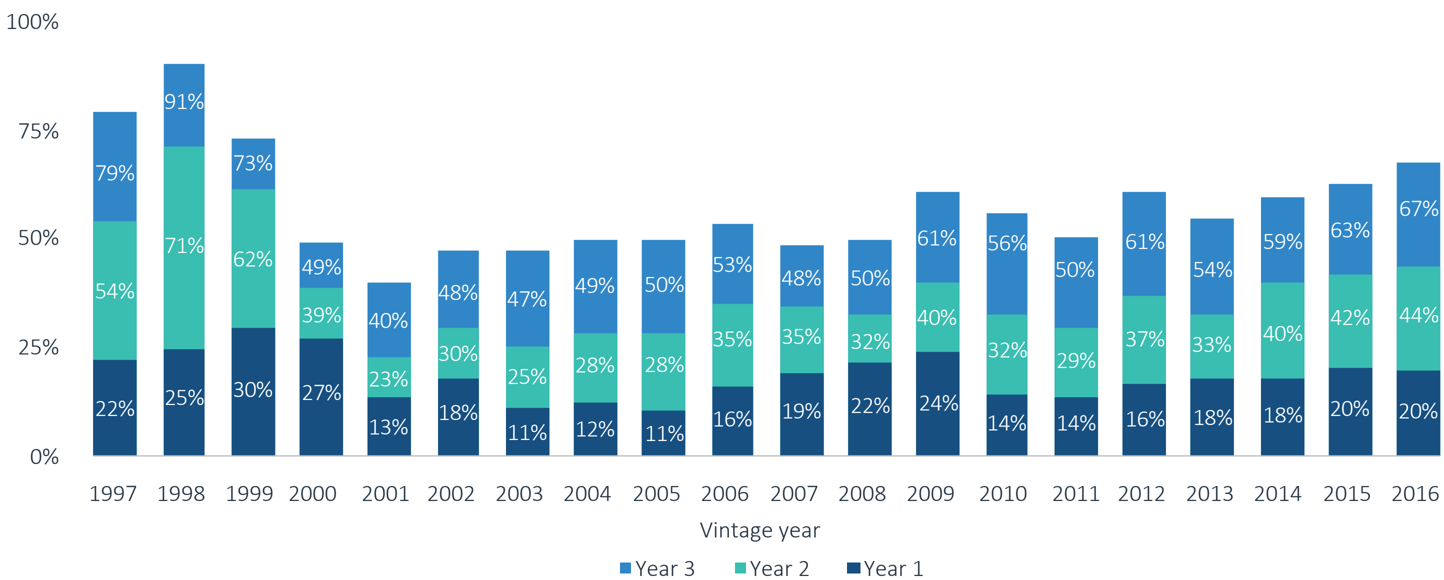

**Source:** PitchBook | **Geography:** US
*As of September 30, 2019

For context surrounding nontraditional investor participation, we first need to observe the traditional VC market. Dry powder is the widely reported on and traditional standard for VC capital availability. As a refresher, this measure only includes capital committed to VC funds, which undoubtedly leaves out a huge portion of the total given nontraditional participation. With that said, VC dry powder still has a significant amount of value given the amount of confidence we can assign to the figure. As of Q3 2019 (the period of our most recent cash flow data) US VC dry powder stood at $120.4 billion. This is an impressive figure in the historical context of VC, but it is key to compare it to the current pace of dealmaking to determine the real capital cushion. This calculation of dry powder divided by the three-year average of cash contributions by LPs into VC funds determines the number of years VCs could continue to invest out of their current funds if all fundraising dried up immediately.

There is currently 3.2 years of VC dry powder on hand given the average of $37.3 billion in contributions. This compares favorably against the era following the global financial crisis (GFC), as this statistic has slowly grown since 2009. However, the years before the GFC boasted a higher figure of years of dry powder on hand, illustrating the strong fundraising at that time, and perhaps the reason that VC firms were able to invest throughout that recovery. The accelerated pace of dealmaking over the last couple years has pushed contributions to all-time highs, which may have depressed the current value for years of dry powder on hand. It will be interesting to see if the market can sustain the capital investment levels we've observed over the past few years through the pandemic-related crisis. The outcome will determine if we have found a new normal for contributions to VC or if the venture ecosystem will return to historically average levels as LPs move to safer assets.

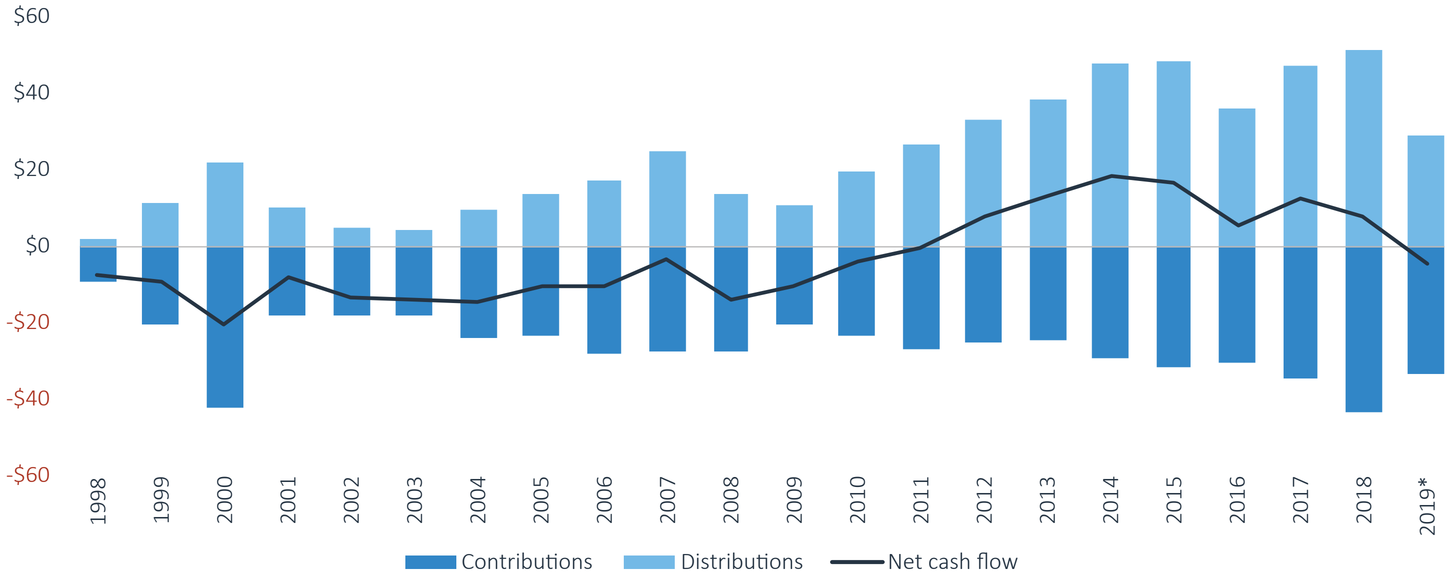
With the spread of COVID-19 shrouding the financial markets in uncertainty, GPs' ability to reserve enough capital to continue to back their portfolio companies will be put to the test. Newer funds are deploying capital more rapidly than in recent years. The average 2016 vintage fund has called down 67% of its fund by the third year, which is quicker than the last couple years but still below the rate we saw in the dotcom era. This heightened pace of deployment has not hindered a buildup of VC dry powder. The recent relative ease of VC fundraising has allowed VC firms to quickly raise subsequent funds to make follow-on investments. If this rapid pace of returning to market is interrupted by the current economic downturn, VC firms might need to rethink the amount of capital they hold back to support existing portfolio companies.

**Average cumulative capital called as a proportion of VC fund size by vintage year***




**Source:** PitchBook | **Geography:** US
*As of June 30, 2019

VC cash flows ($B)



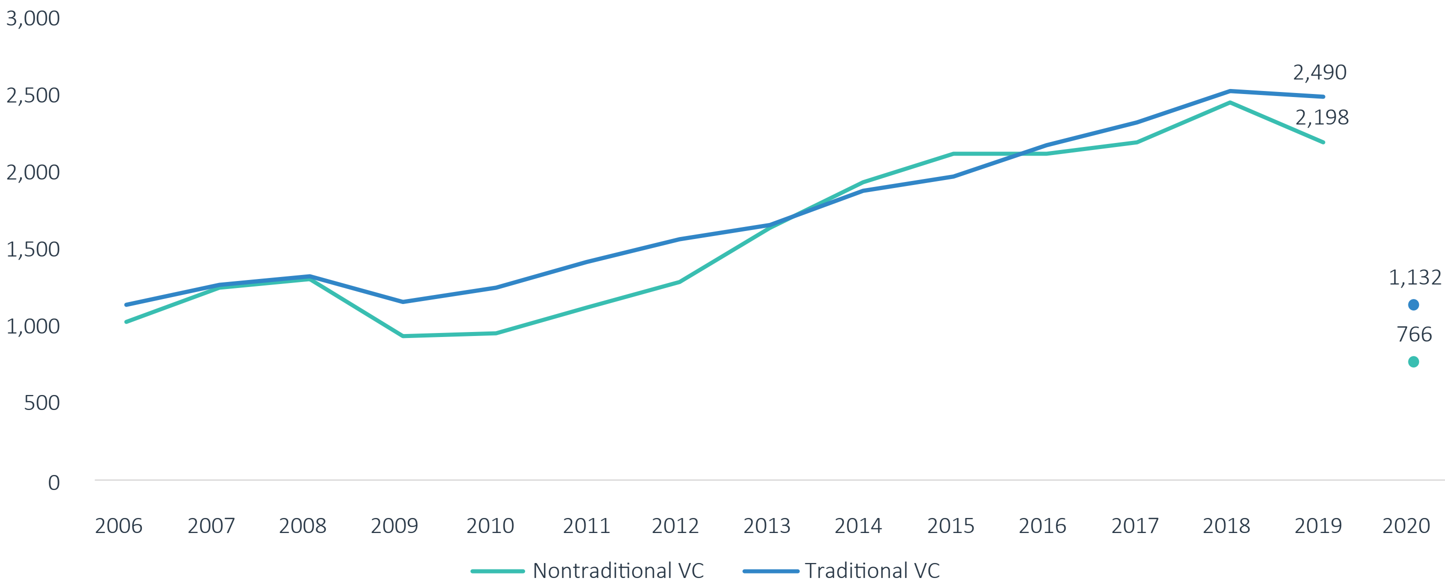

**Source:** PitchBook | **Geography:** US
*As of September 30, 2019

## Nontraditional Investor overview

In addition to VC firms' growing dry powder, capital available from nontraditional investors has become a major piece of the venture industry before, during, and likely after the pandemic-related crisis. These investors have an enormous amount of capital available to them—much higher than classic VC funds. Microsoft, Apple, Intel and Google each have more than $100 billion of cash on hand, and multiple SWFs operate funds with more than $200 billion in AUM. PE firms have amassed their own surge in dry powder—around $1.2 trillion globally—and have increased activity within the venture industry in recent years. These fund types will invest only a small percentage of this capital in venture, but even this modest sample highlights the potential influence nontraditional investors could have on VC. Recent events occurring during COVID-19 highlight this further, with emergency deals such as Airbnb's $1 billion financing and Lime's $170 million round funded predominantly by nontraditional investors. Although the common thought has been that these types of firms would pull back from VC in an economic downturn, the large pools of capital available to them may lead to opportunistic activity.

The number of unique nontraditionals investing in venture deals each year has, surprisingly, largely mirrored the number of active VC firms. Notably, nontraditional investors even outnumbered traditional venture firms within their own market during both 2014 and 2015. That these years were also transformative for industry deal sizes and valuations is likely not a coincidence. It's true, however, that few of these nontraditional investors participate in as many deals on a yearly basis as traditional VCs, both due to a lower focus on startups and the general lack of fully built-out deal sourcing programs. Globally in 2019, VC firms completed an average of five deals, whereas hedge funds participated in an average of four VC deals, growth firms only barely surpassed three and corporate VCs was less than 2.5. Venture is, for many nontraditional investors, a small allocation from their overall investment program or operations business model. Corporations, for example, may invest solely off their balance sheet in emerging companies with technologies that can benefit their own product. Altria (NYSE: MO), the world's largest tobacco company, has participated in just two deals in VC-backed companies over the past few years, although one of these deals accounted for nearly $13 billion in total deal value counted by the industry through its deal into JUUL. These types of large deals highlight how even nontraditionals with low annual participation levels can have outsized impact on the overall market activity figures.

**Unique investors (#) by type**

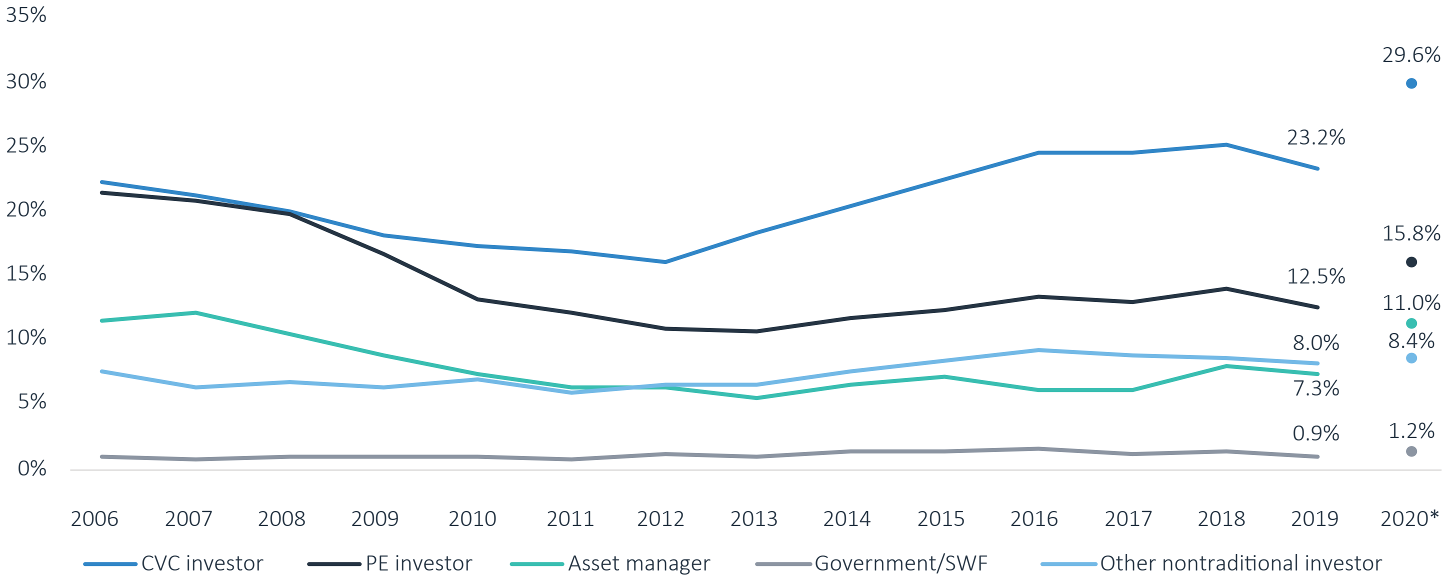



**Source:** PitchBook | **Geography:** Global
*As of March 31, 2020

Not only are these nontraditional investors prominent throughout the venture market, they are notable participants in deals where large sums of capital can be put to work. In 2019, late-stage deals with participation from these investors reached a median size that was $19 million higher than that of late-stage deals with investment from only traditional venture firms, a wide margin for a median size. This spread is exacerbated when averages are considered. The average late-stage VC deal size with nontraditional participation during that year was $60.3 million, more than 4x the average size of deals without a nontraditional investor.

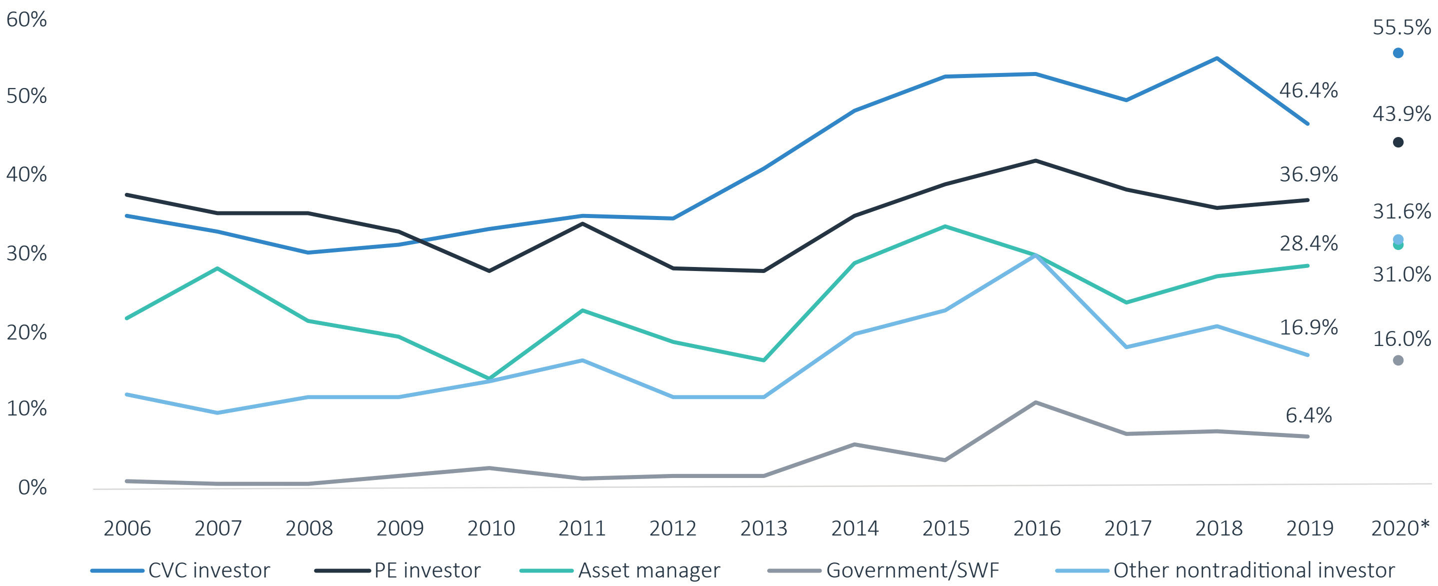
With this in mind, it's not surprising to see the high participation rate of total venture deal value that nontraditional investors hold. So far in 2020, corporate VC investors have participated in 55.5% of deal value despite participating in just 29.5% of completed deals, and SWFs have participated in 16% of deal value in while being present in just 1.2% of deals. Overall, US venture deals with nontraditional participation added $106 billion and $96 billion worth of deal value to market totals in 2018 and 2019, respectively, representing more than 70% of total deal value participation each year by nontraditional investors.

**VC deals (#) with nontraditional investor participation as a proportion of all VC deals by type**




**Source:** PitchBook | **Geography:** US
*As of March 31, 2020

**VC deals ($) with nontraditional investor participation as a proportion of all VC deals by type**

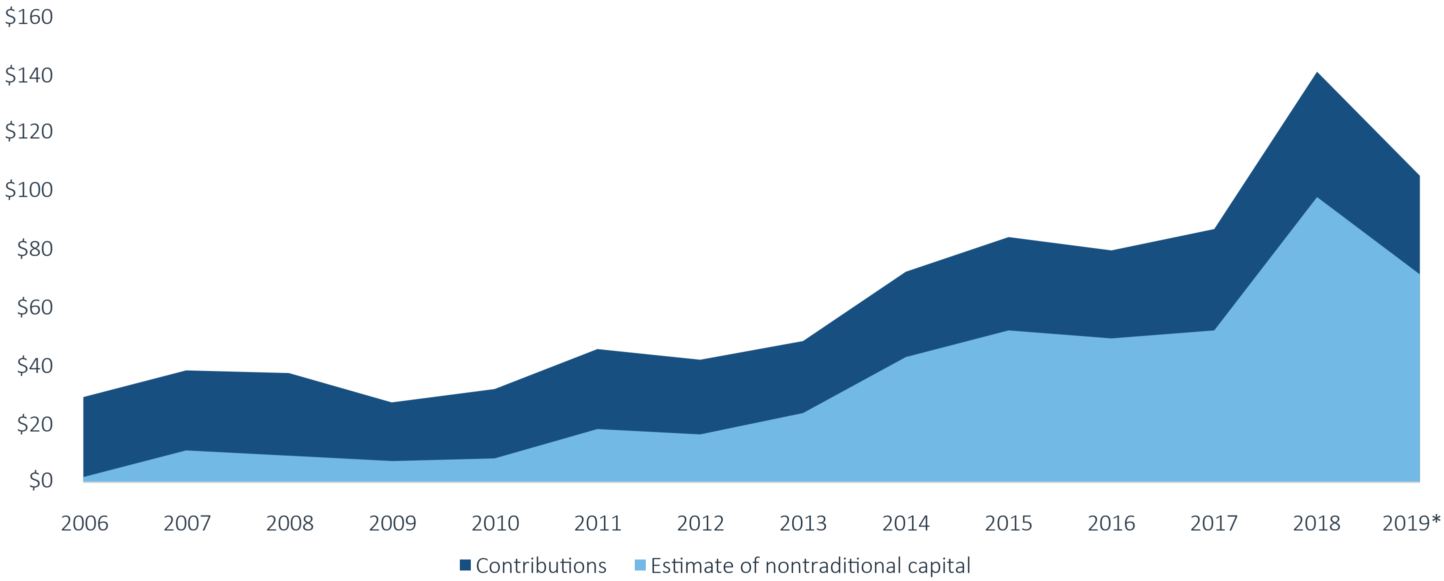



**Source:** PitchBook | **Geography:** US
*As of March 31, 2020

## Nontraditional capital availability estimation

VC dealmaking has been on an exceptional run over the past few years, notching two consecutive years of more than $100 billion of capital invested into startups. Traditional VCs have stepped up and raised more money, but the speed at which that capital has been called down has lagged the huge jumps in deal value. The gap between VC fund contributions and deal value has grown from $23.2 billion to $97.4 billion from 2013 to 2018, a 318.9% increase. This coincides with the previously presented surge in nontraditional investor VC activity. While the difference between these two measures is not a perfect answer for the amount of capital invested by nontraditional investors in a given year, it is our best proxy given most capital called by VC funds is already earmarked for a deal.

### VC deals ($B) overlaid with VC fund contributions




**Source:** PitchBook | **Geography:** US
*As of September 30, 2019

It is helpful to see the amount of capital nontraditional investors have previously invested into the VC strategy; however, this is a backward-looking measure, especially since it utilizes fund cash flow data which lags an extra two quarters. Even still, the 2019 value through three quarters looks almost identically high, a level that we expect the ecosystem to maintain even through the pandemic.

The diversity of nontraditional investor types and the strategies within those groups makes generalizing about the group extremely difficult. With this note, we hope to illustrate the broader potential available capital from these market participants. In that vein, as nontraditional investors have become more sophisticated and strategically more similar to traditional VCs, we assume they could be allocating a similar amount of capital for startup investment.

We estimate nontraditional capital availability is approximately $240 billion to $340 billion. We calculated this figure by using historical values of years of dry powder on hand—which has ranged from 2.5 to 3.5 years over the past decade—and applying that to our estimated $97.4 billion in nontraditional capital investment as of year-end 2018. This is a rough estimation; however, with the increased capital investment we have seen from this non-VC fund group, we believe it's crucial to provide a sense of the potential nontraditional investment force for startups and other investors.

## Conclusion

We live in a much different world than in Q3 2019, which is the period of our most recent cash flow data. All participants in VC have likely had to reevaluate their outlook in drastic ways to cope with economic uncertainty. Nontraditional investors present one of the most complex pieces of that puzzle, as the myriad investor types included in nontraditionals will react differently to an economic downturn, not to mention how individual firm decisions may vary. However, it's clear that players have become integral to what we now recognize as the VC market, making actions throughout this crisis increasingly vital.

If nontraditional investors are really just tourists and this capital dries up, the VC ecosystem will be in for quite a shock given our data around how large the presence this group has become in the market. We do not expect an exodus from VC by nontraditional investors precisely because of how large this group of market participants has grown. Direct VC investing has become a significant part of the strategy of many nontraditional investors over the past decade as the population of companies under VC-backing swelled and represented more of the company lifecycle. As investors could no longer access younger, fast-growing companies in the public equity market, nontraditionals have naturally shifted to gain exposure to VC investments. Further, the control over investments and reduction of fees paid to VC funds has likely enticed some of the nontraditional players to expand across the lifecycle and put more capital behind their VC strategies. Given these changes, we see nontraditional players as much more entrenched in the VC market than before, setting many up to continue investing through downturns and to take advantage of eventual recovery.