INVESTMENT INSIGHTS

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A Growing Institutional Market for Venture Capital

As the innovation economy continues to evolve, so does the outlook for the venture capitalists who are funding its expansion and the resulting economic growth. This means potential opportunity for institutional investors.

Several trends point to a promising 2020 for venture capital, according to Jim Lim, a managing general partner at Greenspring Associates, a venture capital investment platform. He pointed to "tremendous return potential" in tech-based industries that are still early in terms of maturity.

Among those industries: software as a service, cloud, cybersecurity, e-commerce/internet and digital health care. While much of the focus in those industries has been on companies in the United States, globalization means there are significant and growing opportunities beyond those borders.

"Given that China is the second-largest venture capital market, if you don't have approximately 20% in China, you're actually shorting the market," Lim said.

Greenspring Associates also sees opportunities in other regions of Asia, such as Korea and Southeast Asia; as well as in several European countries and Israel.

"The globalization part of venture, we think, is really exciting," Lim said. "The next Facebook or Uber or Airbnb could be found outside the United States."

BEYOND THE PUBLIC MARKETS

Venture capitalists are also benefiting from a trend in which companies in the U.S. are choosing to stay private longer, waiting an average of seven years before they go public. Lim said that time period may continue to expand, creating even more opportunity for VCs. The longer companies remain private, the greater the value and return captured by private investors when compared to public investors.

Given all of those trends, institutional investors have been increasingly looking at the venture capital space. Greenspring Associates has historically targeted a net-of-fee return of 300-500 basis points above public equity markets, a strategy that is garnering increased interest as pension plan sponsors seek to increase their allocation to private markets in an effort to meet return targets and improve their funded status.

"There's a lot of demand for early-stage venture funds in particular," Lim said. "As companies stay private longer, investors are searching for ways to access compelling investment opportunities earlier, invest at lower valuations and have multiple ways to realize value."

One of the factors driving interest may be the spate of recent venture-backed IPOs like Uber, Pinterest and Peloton. Venture-backed IPOs set a record in 2019, and while some of these high-profile IPOs have struggled in the public markets, earlier-stage investors in these companies have reaped high returns because they were invested at such low valuations.

GETTING STARTED

Depending on the investment committee members and staff, there may be a learning curve involved in coming up to speed on the fundamentals of venture investing. For a committee and staff with more sophisticated experience in the venture-investing space, the discussions may get more in-depth from the outset.

"It is critical for investors to choose venture partners carefully. The returns generated by the best VC managers and the worst-performing is wider than the gap in other asset classes," Lim said. "Furthermore, the number of VC firms has grown exponentially in the last decade."

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"It's hard to really capture the number of VC funds, but they're definitely in the thousands. And if you look at the types of venture funds, it's staggering. You have pre-seed and seed funds, traditional early-stage funds, expansion-stage funds, growth equity funds and sector-only funds, and then you've got global funds," Lim said. "For this reason, you see institutions partnering with firms like Greenspring to navigate fund manager and company co-investment opportunity identification and access."

Even before selecting the appropriate partners, the first step for institutional investors considering a VC allocation is to determine both their risk appetite and liquidity profile.

"Venture capital should have a role in a portfolio, as long as your portfolio liquidity requirements support it," Lim said.

Beyond that, institutional investors need to think about how to diversify a venture capital allocation. That diversification might reflect not only industry sectors, but vintage year, geography, stage, funds and co-investments on a primary and secondary basis.

"It's often been said that like wine, there are good years and bad years in venture," Lim said. "By being a long-term platform-oriented investor, you plant the seeds across various years and you can put yourself in a position to capture strong vintages. The last thing you want to do is try to market-time and pick one or two vintages."

Once they've created a diversified venture capital allocation, institutional investors might consider further expanding their allocation by making co-investments, considering secondary funds or looking at very-early stage investments via seed/micro managers and ex-U.S.

MONITORING FUNDS

Before making an allocation to venture capital, institutional investors need to have the staff to monitor the funds they've chosen or make sure that they have a reliable partner in the venture ecosystem who can do so on their behalf.

"It's really, really hard with a thinly staffed team in venture capital to monitor these venture funds properly," Lim said. "Venture managers raise funds every two to three years, so a limited partner will often have to re-up with a manager in three or four successive funds before knowing if the manager is good or not. This places a huge premium on an LP to figure out if the team and strategy is working, often with imperfect and ambiguous information."

While venture capitalists have the luxury of not worrying about the typical gyrations of capital markets, Lim said that if interest rates were to rise, it could be good for the industry.

"If there's a transition away from risk," he said, "I do think that overall the reduced levels of venture capital raised will result in lower entry valuations and less hot money going into the category." •

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