The Griswold Center for Economic Policy Studies

Reunions Conversation – May 21, 2021

Venture Capital:

An Insider's Insights

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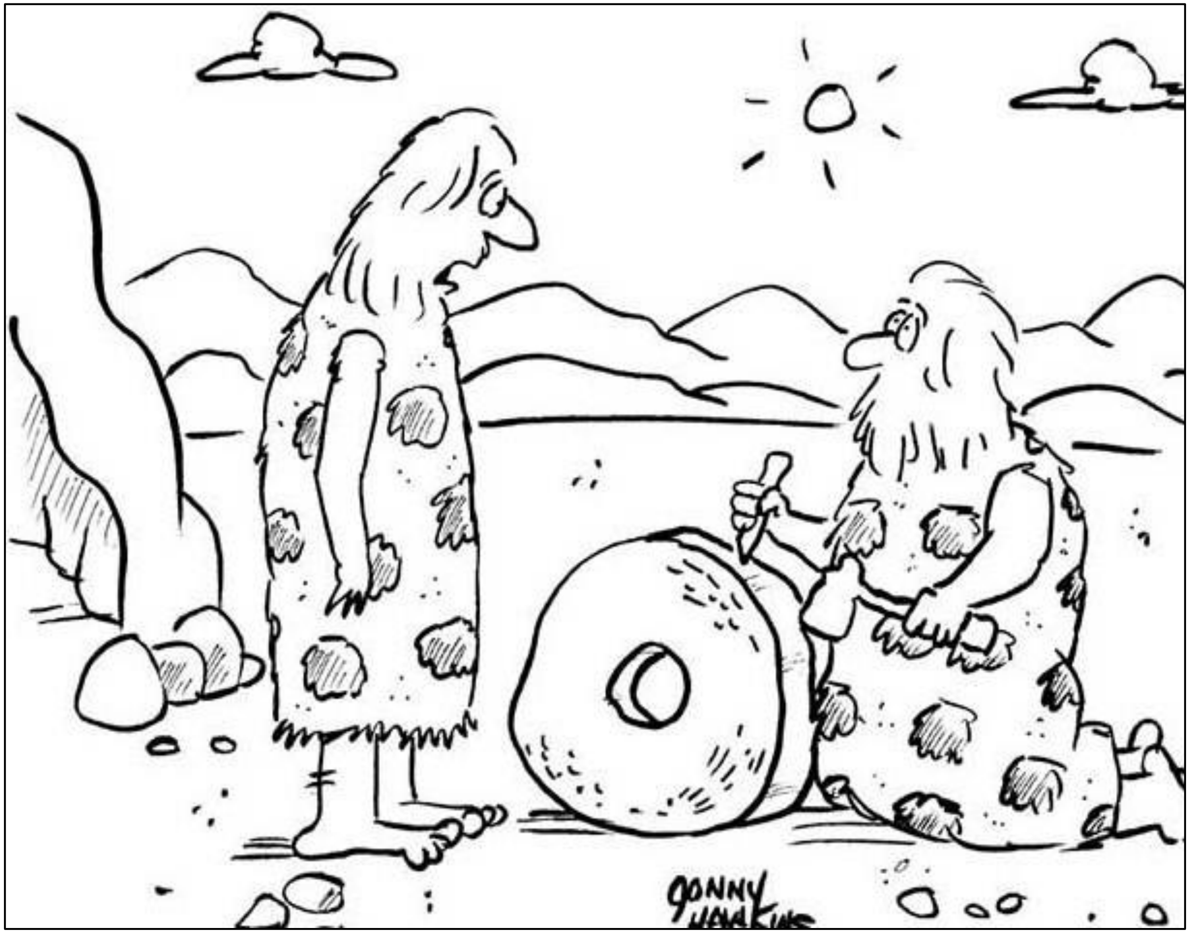
Today's Agenda

We'll focused largely on the US *institutional* venture capital (VC) industry.

1. What is VC and how does it "work"?

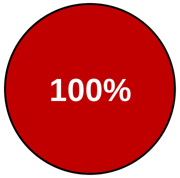
2. Is this a good thing or a bad thing?
   - For transaction participants
   - For our broader society

3. What will the future bring for the VC industry?



"What a cool invention – How about I give you some venture capital, you give me part of the business, and I'll help you create a great big valuable company? We'll both own this together and then we'll take it public. And what a great invention this will be for the world – it will make life a lot easier for humanity."

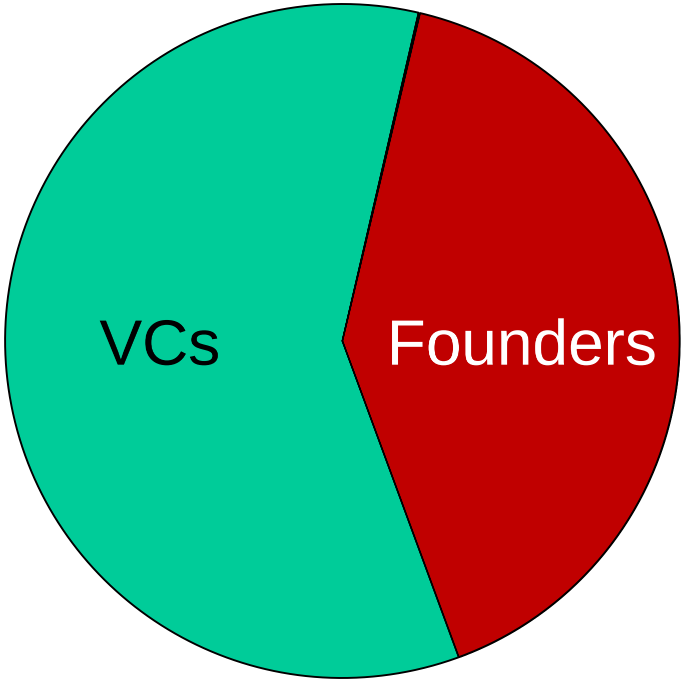
Founders And Their VC backers Must "Make The Pie Larger" For The System To Work



In the beginning, founders own 100% of a **small** start-up.

Founders And Their VC backers Must "Make The Pie Larger" For The System To Work

At the end (IPO or sale), founders typically own substantially less than half and VCs own the majority.



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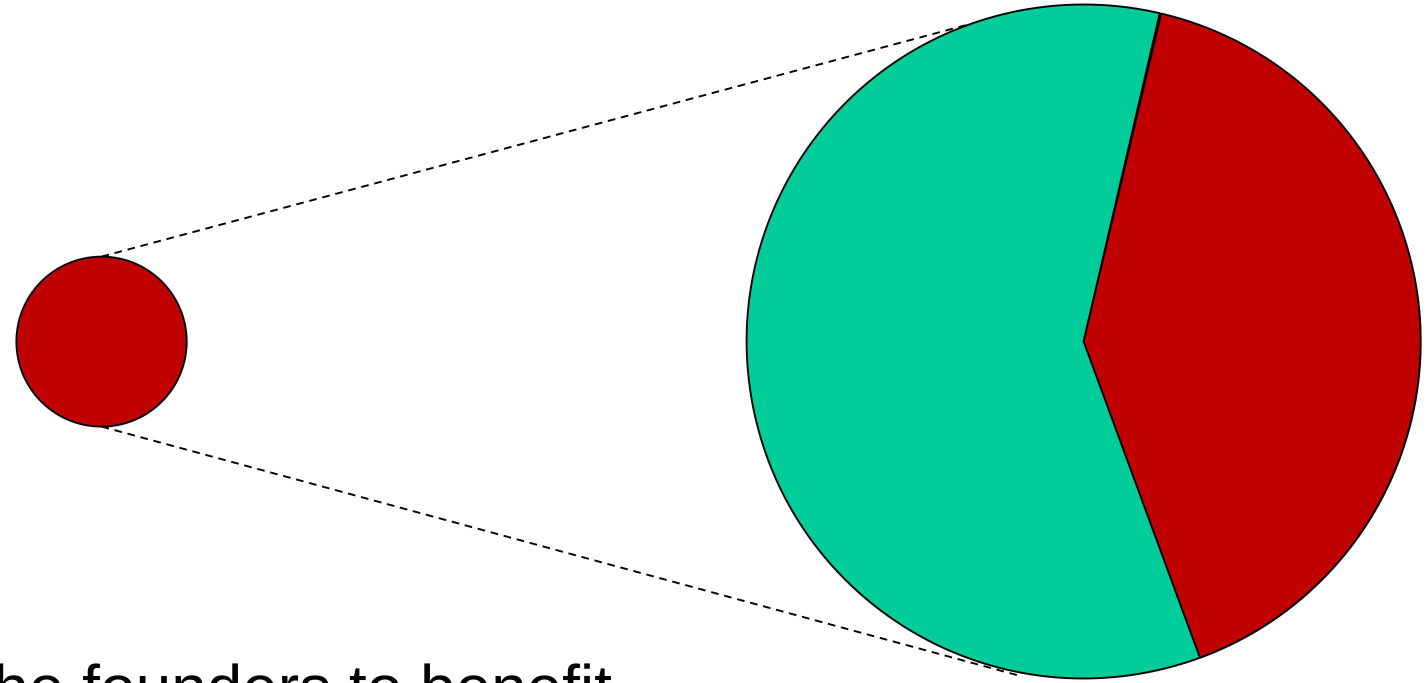


For the founders to benefit, VCs must help them create a much larger pie, so they have more "square inches" of value.

The Institutional Venture Capital Process

(Funds flow from left to right)

INSTITUTIONAL INVESTORS

(Limited Partners – e.g. Endowments, Pension Funds)

- Invest in VC “funds” not “firms” (10-year contract, Capital is “called” slowly, Pay carried interest and fees)
- Need out-sized returns to “pay” for illiquidity; Want access to best firms who consistently out-perform
- Can drive cyclicality with asset allocation
- May “outsource” fund selection via “Fund of Funds”

VENTURE CAPITALISTS

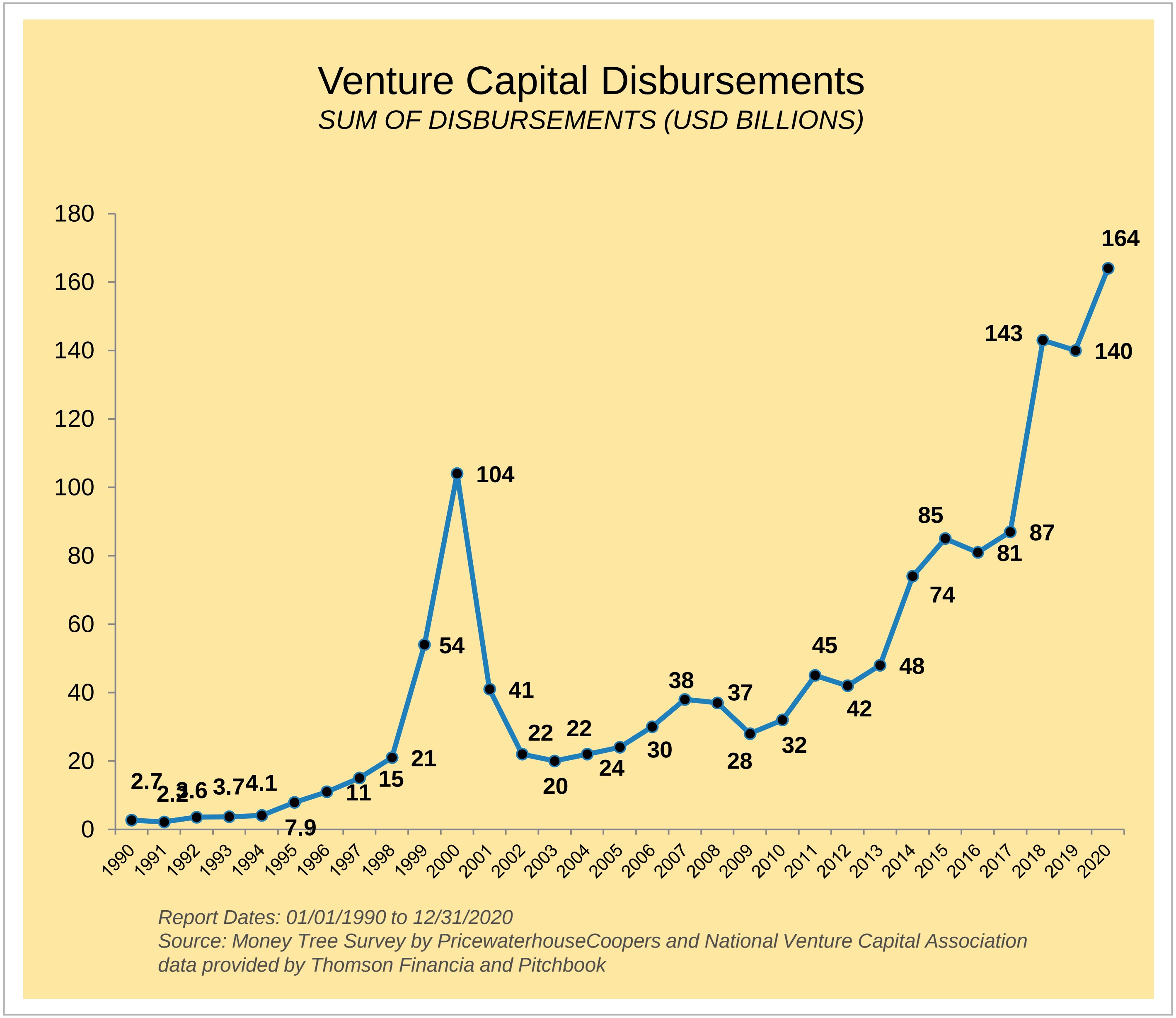
(Finding and Funding Entrepreneurial Companies)

- Equity investors (Not lenders); Strike deals; Valuations; Pitches
- Pick winners *and* add value; wide variety of outcomes – 20% of capital drives 80%+ of returns
- Firms often specialize and have multiple funds
- Long-term funds, but liquidity focused; Buyers *and* sellers
- Perform or Perish; Firm-focused

ENTREPRENEURS

(Starting and Building Companies)

- Find “product-market fit”
- Build organizations quickly
- Attempt to create big outcomes – use capital to make the pie larger
- For more than half the companies VCs fund, the results are not very material to the VC; “Slugging average”, not batting average
- When VCs’ greed overcomes fear, checks get written



Source: 2005-2021 NVCA Yearbook

U.S. Venture Capital Index

Returns for the Period ending 12/31/20 (%)

	1 Year	3 Years	5 Years	10 Years	15 Years	20 Years	25 Years
U.S. Venture Capital	50.10	28.15	18.28	17.22	13.11	7.23	32.41
USVC – Early Stage	55.53	29.65	19.14	18.37	13.37	6.50	56.62
USVC – Late & Expansion Stage	46.45	29.45	19.82	16.02	14.86	9.30	12.28
USVC – Multi-Stage	42.79	24.98	16.17	15.80	12.02	8.09	13.06
DJIA	9.72	9.90	14.65	12.97	10.00	7.95	9.92
NASDAQ Composite	43.64	23.13	20.81	17.12	12.49	8.61	10.54
S&P 500	18.40	14.18	15.22	13.88	9.88	7.47	9.56

Sources: Cambridge Associates LLC, Bloomberg Barclays, Dow Jones Indices, Frank Russell Company, Standard & Poor's and Thomson Reuters Datastream, and Wilshire Associates.

Note: Because the U.S. Venture Capital Index is cap weighted, the largest "vintage years" mainly drive the index's performance. The index is a horizon calculation based on data compiled from 2,006 US venture capital funds, including fully liquidated partnerships, formed between 1981 and 2020. Private indexes are pooled horizon internal rate of return (IRR) calculations, net of fees, expenses, and carried interest. The timing and magnitude of fund cash flows are integral to the IRR performance calculation. Public indexes are average annual compounded return (AACR) calculations which are time weighted measures over the specified time horizon, and are shown for reference and directional purposes only.

Is Venture Capital Good Or Bad…?

…For Those Who Transact?

- Limited Partners → Venture Firms → Entrepreneurs
- Hard to reach the illusive “fair deal” in an inefficient market

…For Broader Society?

- Job creation (~70%+ of VC investment goes to payroll)
- Who gets to participate
- Is favorable tax treatment appropriate?

Where Is All This Headed?

1. Current VC returns will soon decline as they begin reversion to historic means.

2. Within a year or two, institutional interest in VC will temporarily crest.

3. Special Purpose Acquisition Companies (SPACs) will become more heavily regulated and new SPAC creation will decline substantially – but other attempts to “bring VC to Main Street” will continue (eg. tracking stock?).

4. The VC “ecosystem” (both funders and those they fund) will continue to move toward greater inclusivity.

Q&A

Note: For more detailed statistical information please consult the 78-page statistical composite
in the 2021 Yearbook of the National Venture Capital Association (NVCA) available for free online at:
https://nvca.org/research/nvca-yearbook