Kamco Invest: Venture Capital becomes key component in wealth creation investment strategies

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While the outcome of the pandemic was unpredictable, it not only fast-tracked the shift towards digitization, but has become a defining moment for digital transformation. What began as a questionable year for Venture Capitalists, with investments in the startup and innovation ecosystem expected to significantly drop, soon became a transitional point in the Venture Capital realm with new opportunities available across various industries.

The unexpected circumstances global economies are facing due to the pandemic led to the rise of industries that were overlooked by analysts. The cloud computing industry, for example, boomed since the onset of the pandemic witnessing a drastic increase in the demand for cloud-based technology. Performing at a level far exceeding analyst predictions, the industry is now considered a key and necessary component in streamlining the path to the new normal. Lockdowns and social distancing accelerated the adoption of a decade's worth of digital technology into one year, driving traditional businesses to shift online and digitize their operations. This shift in return has increased the demand for such solutions, increasing revenue levels of suppliers exponentially to reach record highs.

The impact triggered by the pandemic led most Venture Capital firms to halt spending and fund-raising activities. This however rapidly changed in a matter of 3 months, when they witnessed retailers achieve significant revenue growth due to strong online sales. On one hand, countless employees were losing their jobs due to cost-cutting, and on the other, small to medium sized enterprises (SMEs), including mom-and-pop stores were suffering due to lockdowns and social distancing. Retailers with strong online platforms, however, witnessed a surge in sales and higher demand for such services. Quarantine and isolation proved to have a positive effect on the technology sector, and hence Venture Capital activities witnessed a strong return in Q3-2020 with companies lined up to go public.

The transition was documented in the latest study released by Abe Othman, Chief Data Science at AngelList, revealing that Q4-2020 was the best quarter on record for early-stage startups. More than 80% of the startups that changed valuations in Q4 were marked up, according to AngelList investments into 3,449 active startups.

Large-cap technology stocks, led by Apple, Amazon and Netflix, drove major U.S. stock indexes to record highs in 2020, capitalizing on the larger shift towards digitization. The rise in e-commerce spending sent Amazon surging 76%, while Apple became the first-ever USD2 trillion company. Lockdowns and social distancing spiked the number of subscribers to online streaming services, increasing Netflix shares by almost 62%.

The 'big four', Apple, Amazon, Alphabet and Facebook, now worth approximately USD5.9 trillion in total - roughly one-fifth of the S&P 500 SPX, reported record revenue reaching USD718.55 billion over three quarters.

Returns

Based on the findings of Cambridge Associates, venture capital has generated compelling returns relative to the public markets, both in recent years and over the long-term.

	1-Year	**3-Year**	**5-Year**	**10-Year**	**15-Year**	**20-Year**	**25-Year**
USA Venture Capital Index	8.67%	13.96%	**10.52%**	**14.34%**	**10.93%**	4.95%	36.41%
Bloomberg Barclays Capital Government/Credit Bond Index	9.82%	5.17%	3.54%	4.15%	4.49%	5.18%	5.57%
Dow Jones Industrial Average Index	-13.38%	4.42%	6.86%	10.00%	7.73%	6.07%	9.37%
Nasdaq Composite Index	-0.38%	9.21%	9.46%	12.37%	9.41%	2.64%	9.39%
S&P 500 Index	-6.98%	5.10%	6.73%	10.53%	7.58%	4.79%	8.85%

Source: Cambridge Associates US Venture Capital as of 31 March 2020

The index is a horizon calculation based on data compiled from 1,955 US venture capital funds, including fully liquidated partnerships, formed between 1981 and 2020

Venture capital is currently outperforming other assets classes in the US. According to the 2019 NACUBO-TIAA Study of Endowments, venture capital was the highest-performing asset class for university endowments with 13.4% in 10-year average annual returns, bringing in more than U.S. equities (8.2%).

With the potential to generate attractive returns while making a significant and positive impact, venture capital has become a critical component of long-term investment strategies. Cambridge Associates considers venture capital as a key component in wealth creation investment strategies, for both financial institutions and HNWIs to sustain future generations. As such, top performing institutional investors understand the importance of venture capital and its positive impact on their portfolios. This has been a key driver in increasing venture capital allocations, reaching a mean of 15% of their portfolio.

Risk profile

Venture Capital has always been considered high risk, some had claimed in the past that almost 90% of companies end up going bankrupt. Studies however showed a loss ratio of 50% in the 1990s which decreased to 20% within the last two decades, as per the Cambridge Associates Venture Capital Positively Disrupts Intergenerational Investing report.

Loss ratios by investment strategy	**Global Venture Capital**	
Vintage Year	1991-2001	2002-2015
Loss Ratio	51.5%	**20.0%**
Impairment Ratio	65.6%	40.9%

It is important for investors to understand how the risk profile of venture capital investing has changed considering that today's market is not the same as it was 20 years ago. The industry has evolved, and fund managers have learned from their mistakes. Before the 2000 tech bubble, venture capitalists relied on capital and luck, since then, they started implementing a more rigorous risk management approach. They focus on how to add value and scale their portfolio companies. This involves surrounding themselves with advisors and incubators, while setting aside capital for follow-on investments to increase exposure in wining portfolio companies or mitigate any potential risks. This has had the effect of reducing the impairment and capital loss ratios of the underlying companies. To further reduce the risks associated with single startups, investors are considering venture capital portfolios or funds that include several investments, allowing more opportunity for growth and diversification.

Highest fund-raising in 2020

Despite uncertainty from the pandemic, US venture fundraising activities in 2020 were strong and witnessed the highest fund-raised amount during the last decade. The total raised amount in 2020 was USD73.6 billion, higher than the previous record in 2018 which was USD68.1 billion. Some of the main factors that led to the record raised amount were the shifts in industry dynamics, accelerated technology adoption rates, and role of technology in enhancing life during the pandemic, in addition to a strong IPO market. In 2020, Venture capital firms raised 44 mega-funds, consisting of USD500 million or more, nearly double the 24 funds closed in 2019.

Increasing liquidity for exits

The US VC liquidity market exceeded expectations in 2020 witnessing some of the largest tech IPOs ever. A major concern with the ongoing pandemic was the impact it would have on exits from VC-backed companies. Not only did high-profile exits continue in 2020, but they also increased liquidity to new levels. The total exit value in 2020 amounted to USD290.1 billion, exceeding the total value in 2019 over a similar number of exits (around 1,101 exits). IPOs, M&As and buyouts were active, however, the enormous IPOs drove the record exit value. Public listings in 2020 included Snowflake, Unity, Root Insurance, Palantir, and Asana. The IPOs of Airbnb and DoorDash in December were the largest VC-backed IPOs of the year, each raising over USD3 billion with a market capitalization between USD55 billion and USD100 billion. The largest VC-backed acquisition was Intuit purchasing Credit Karma for USD7.1 billion.

Number of US Venture Capital exits by size

As shown below, large exits expand to new levels with unicorns no longer considered rare and elusive.

The push for new investing avenues comes as GCC investors seek alternative asset classes, such as venture capital, to further diversify their portfolios beyond real estate, fixed income, and listed equities. Ultra-high-net-worth individuals and family offices are setting on the same path as Sovereign Wealth Funds by investing in tech-based companies abroad.

Kamco Invest issued a report on the importance of Venture Capital as a key asset class for investors seeking diversification and wealth creation. As modern-day technology continues to evolve and drive innovation, the shift towards digitization was well underway prior to the pandemic.