PARTNERS CAPITAL

Insights 2023

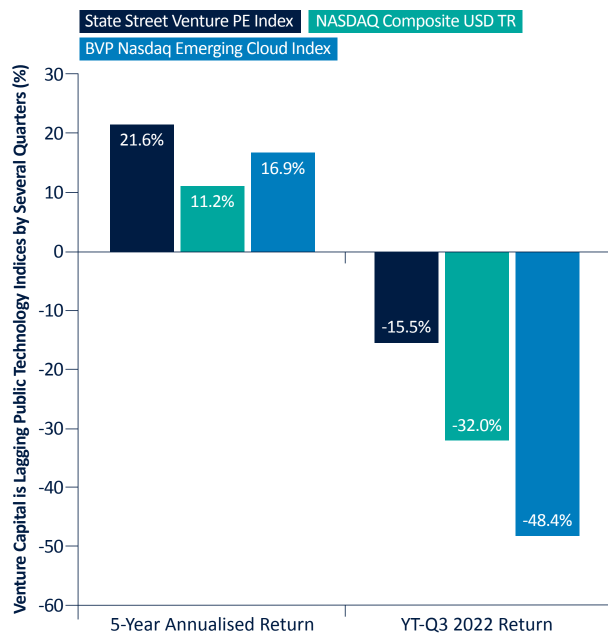
Asset Class Investment Strategies

Venture Capital

We are for the first time breaking out Venture Capital from Private Equity as a separate asset class. Venture Capital represents private investments to fund the founding and growth of startup companies. We primarily invest through partnerships with venture capital firms who have built differentiated founder sourcing, business evaluation and management advisory capabilities in their target investment areas. Our investments range from seed stage and early institutional funding rounds ("early stage"), where the product-market fit is often unproven, to later institutional funding rounds ("late stage"), where companies are refining their business models and growing into their addressable markets. Our focus tends to be on technology-driven and US-based companies though we invest outside these areas at times. Venture Capital has become an important and strategic allocation in most client portfolios, with a different risk/return profile than buyouts and other private equity investments.

Exhibit 1

Venture capital is lagging public technology indices by several quarters



Source: *State Street US Venture Capital Index, 30 September 2022*

Major Trends

We are in the midst of a major tech sector valuation correction which is impacting venture capital: The valuations of publicly traded unprofitable technology and life sciences companies were among the hardest hit by rising interest rates, exposing over-exuberant pricing in the sector. The NASDAQ Composite declined by −32.0% and high-growth cloud software companies declined by −48.4% YTD through Q3 2022.[23] Despite the precipitous correction experienced in the public markets, private market valuations are lagging by several quarters. For comparison, the State Street Venture Capital Index was down −15.5% YTD through Q3 2022, capturing less than half the downside of similar, publicly traded companies, as shown in Exhibit 4. While venture-backed companies that need to raise capital today are doing so at lower prices, with valuations of certain late-stage funding rounds down as much as c. −60% on the year, well capitalised companies have sufficient cash to delay fundraising until at least the end of 2023.[24] In the interim, valuations for many of these companies will continue to reflect the pricing set in the last funding round, causing the venture market valuation lag to persist in the near-term. This dynamic may result in significant uncertainty around valuations for several quarters. While the broader tech correction is a major headwind for existing venture capital vintages, it should also present an opportunity to deploy new capital into high-quality assets at favorable prices when companies need to raise additional funding.

Steep decline in investment activity throughout the course of the year: Global venture capital investment totaled $505 billion in 2022, the second most active year for venture capital since the dot-com bubble.[25] While investment activity remains elevated, we note that total deal value declined by c. −36% relative to the record setting year in 2021.[26]

23 High-growth cloud software represented by the BVP Nasdaq Emerging Cloud Index
24 Carta, Data Minute January 2023 and SVB State of the Markets 2022, top quartile cash runway for US venture-backed technology companies, assumes funding is raised c. 6 months prior to end of runway
25 Preqin

Furthermore, total deal value fell significantly in the second half of the year. Global investments dropped to $86 billion in Q4 2022, down c. −63% from the market peak in Q4 2021, as shown in Exhibit 5, and c. −25% below the trailing 5-year quarterly average.[27] We have observed a similar decline in activity within our own portfolio, with venture fund capital calls within the Condor series declining by c. −63% in the first half of 2022 compared to the first half of 2021.

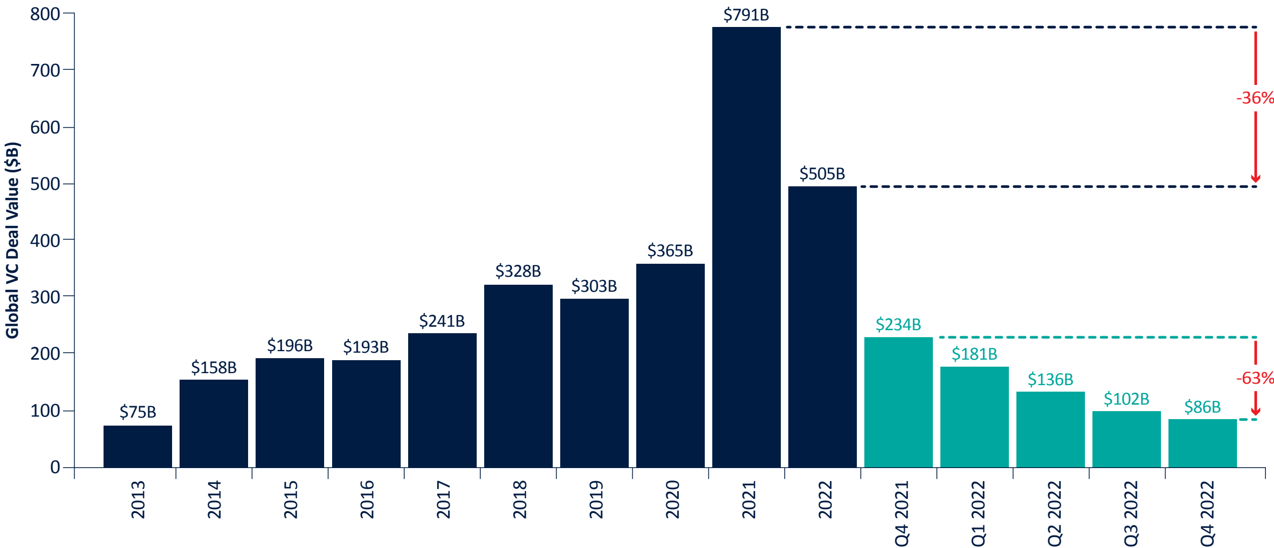
Exit activity drops by -90% following a record year in 2021. The total exit value of venture-backed companies amounted to $753 billion in the US alone.[28] This was the strongest year for VC distributions since the height of the dot-com bubble. Given the new valuation environment for high-growth technology companies, most of the venture-backed companies that exited through the public markets last year have not fared well. An index tracking the performance of venture-backed companies post-IPO was down c. −73% from its peak in February 2021 through December 2022.[29] Companies that went public through SPACs have performed even worse, off c. −81% from the index peak through December 2022.[30] Given the poor performance of VC-backed companies in the public markets and declining demand for unprofitable high-growth companies from investors, exit activity fell to multi-year lows in 2022. Total exit value in the US declined by c. −90% to $71 billion, falling below $100 billion for the first time since 2016.[31]

Start-ups cut costs and headcount to extend cash runway: The new valuation environment and lack of exit options is forcing start-ups to revisit their growth plans. Many VCs started calling for founders to slow their 'burn rate', a reference to the pace at which a start-up is depleting its cash, in Q1 2022. By Q2 2022, the number of tech companies reporting reductions in workforce had grown by c. +38x compared to Q2 2021.[32] Many high-quality companies also raised 'extension rounds' in the first half of 2022, reopening recent funding rounds at similar valuations to raise additional financing. These

26 Ibid
27 Ibid
28 PitchBook-NVCA Venture Monitor, Q4 2022
29 Pitchbook VC-Backed IPO Index
30 Pitchbook DeSPAC Index
31 PitchBook-NVCA Venture Monitor, Q4 2022
32 SVB State of the Markets H2 2022

Exhibit 2

Global VC investment dropped to $86 billion in Q4 2022, down -63% from the market peak in Q4 2021



Source: *Preqin*

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actions are intended to extend fundraising timelines and avoid the dreaded 'down round', raising capital at a lower valuation compared to the prior funding round. While start-ups generally have stronger balance sheets compared to prior cycles, these actions are likely to only delay fundraising timelines by 6-18 months. We expect to see companies that last raised funding in 2020 or 2021 to start to return to market in 2023 resulting in a material increase in the number of down rounds. We also expect to see deal structures with investor-friendly terms, such as liquidation preferences and conversion discounts, become more prevalent.

Golden Rules

- Manager selection is critical in venture capital, as the difference between top and bottom quartile funds is greater than most other asset classes.
- Target managers with a proven ability to source and attract the most talented founders, as we believe these attributes are associated with performance persistence.
- Target experienced operationally-oriented investors with clear domain expertise in a select set of subsectors.
- Invest across stages to capitalise on the information advantages associated with multi-stage strategies and to diversify investment duration.
- Maintain a consistent commitment pace as timing strategies are ineffective and innovation is uncorrelated with macroeconomic cycles.

Sub-Strategy Attractiveness

By Stage:

Early-stage: Positive view. Returns are driven by identifying the small set of companies that will disrupt and capture a disproportionate share of their target markets over the course of a 7-to-10-year hold period. As a result, this segment of the market should be less correlated with near-term macroeconomic risks. Furthermore, we believe the valuations of early-stage funding rounds, while elevated compared to past years, remain low relative to late-stage rounds and still allow for investors to achieve target returns.

Late-stage: Neutral view. The valuations of late-stage private technology companies do not yet broadly reflect the correction experienced by public technology companies. Additionally, many high-quality companies are well capitalised on the back of large funding rounds in 2021 and do not require additional capital at this time. Exit opportunities will be limited over the near term, as public market interest in high-growth, unprofitable companies has declined. The opportunity set may improve in the latter half of 2023 and may present opportunities to acquire premier assets at discounted valuations.

By Geography:

US venture capital: Positive view. The US remains the largest venture market globally and is home to the deepest pool of founder and investor talent. The funding and regulatory environments in the US remain supportive of entrepreneurship. We see opportunities to back both established and emerging managers in this region. Competition and valuations remain elevated and may presents headwinds over the near-term.

Europe venture capital: Positive view. The European market has matured over the last decade and has produced returns similar to the US during that time. Greater support for entrepreneurship in the region and increased interest from investors overseas, including many established US venture platforms, have contributed to the market's expansion in recent years. While valuations have risen significantly, there is still a valuation discount relative to the US market. We note that there is a smaller universe of managers with persistent outperformance in the region.

China venture capital: Negative view. While the market size and demographics remain favourable, regulatory actions on both sides of the Pacific squeeze China's technology industry and create uncertainty for investors. VCs in the region have shifted their focus away from consumer internet towards sectors such as energy transition, enterprise software, healthcare, and consumer services that better align with China's stated policy objectives. Our strategy has shifted to concentrate capital with a small number of proven managers in the region.

By Sector:

Enterprise software: Positive view. We continue to see broad-based opportunities in enterprise software, as the shift to cloud and adoption of AI/machine learning is creating demand for new infrastructure and there are still significant opportunities to develop applications to drive efficiency and task automation across industries. Valuation risk should abate for new companies but will cause lingering headwinds for companies that raised financing in recent years.

Climate tech: Positive view. There is clear demand for new technologies and services to accelerate the path to net zero global emissions. Climate tech companies are less dependent on government subsidies compared to the Cleantech 1.0 era. Technological advances over the past decade are also allowing start-ups to reach proof of concept with less capital. Opportunities exist across power, transportation, industrial segments, and agtech. We favour specialists in this segment of the market, given the scientific, regulatory, and end market risks associated with these opportunities.

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Consumer technology: Neutral view. Consumer technology has evolved beyond commerce to address a broader range of unmet consumer needs in financial and healthcare services. This shift has expanded the total addressable market opportunity for consumer start-ups and investors. Potential headwinds include declining consumer spending and valuation headwinds, as healthcare and financial technology companies have experienced greater valuations corrections over the past 18 months compared to other technology sub-sectors.

Life science: Neutral view. The increasing pace of innovation and strong near-term demand for new assets from large pharma companies support investment in start-ups developing novel therapies and infrastructure. However, we remain cautious given the lacklustre historical performance relative to technology funds and opportunity to generate attractive returns by investing in public biotech companies with better liquidity.

Blockchain: Negative view. Anticipate further volatility in this space as exuberance and leverage in the market continue to unwind. We maintain limited exposure to this opportunity through a specialist given the transformational potential of the technology.

Deep tech: Negative view. We are approaching opportunities in emerging technology and hardware with greater caution, given the incremental technology risk and greater capital requirements associated with many of these investments.

2023 Strategic Priorities

- **Increase exposure to early-stage VC:** We continue to see a significant opportunity to generate alpha in early-stage VC through manager selection, given the wide dispersion of outcomes. Returns are also enhanced by the smaller average fund sizes in this end of the market. Furthermore, we believe that the key drivers of performance in early-stage VC are less correlated with macroeconomic cycles and that the record amount of dry powder sitting with late-stage funds will be a tailwind for early-stage performance.
- **Increase exposure to premier established firms:** We believe the current environment presents an opportunity to increase our exposure to premier established managers. The 'dominator effect' has meaningfully reduced the ability of certain investors to commit to venture capital. The weak exit environment is likely to exacerbate this issue over the near term. We are actively engaging with a short list of managers to create an opportunity to access or increase exposure to managers that have long been closed to new LPs.
- **Leverage commingled vehicle to improve manager access:** Partners Capital raised its first venture capital focused pooled investment vehicle in 2022. The pooled investment vehicle will enable increased access to premier managers via aggregating client commitments and simplifying legal negotiations. The vehicle also provides clients with greater exposure to sub-strategy focus areas compared to what most clients are able to access through a direct program, given the diversification requirements associated with these higher risk segments. Focus areas include emerging managers, early-stage managers, and co-investments. Partners Capital will close the second vintage of its venture capital pooled investment vehicle in March of this year.

Long-Term Expected Return

Exhibit 3

Based on our 10 year forecasts, we target the following long-term expected returns for Venture Capital

	Venture Capital
Risk-free Rate	3.5%
Risk Premium	5.0%
Illiquidity Premium	4.0%
Manager Alpha	2.0%
Total Return	**14.5%**

Venture Capital expected returns reflect +8.5% p.a. beta returns modestly above public equity markets, plus +4.0% asset class outperformance reflecting the longer “illiquidity premium” and +2.0% alpha from our strategy and manager selection.

Hypothetical return expectations do not represent actual trading and are based on simulations with forward looking assumptions, which have inherent limitations. No representation is being made that any investor will or is likely to achieve returns similar to those shown. Such forecasts are not a reliable indicator of future performance.

Your capital is at risk and you may not get back the full amount invested.

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