Venture Capital

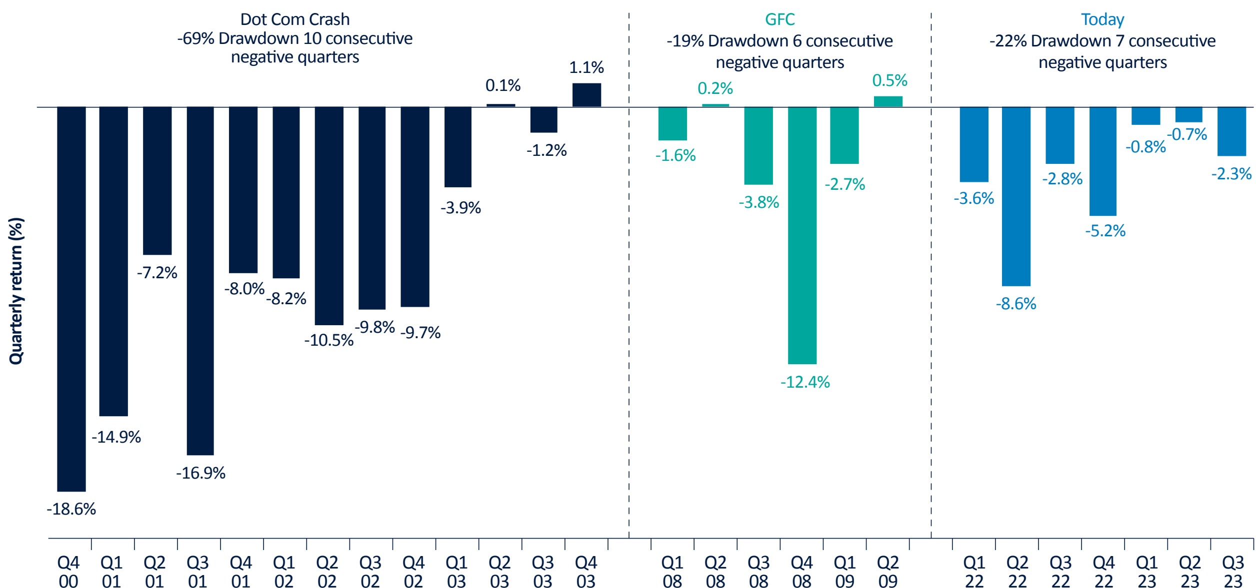
Major Trends

Global venture capital markets continued their slide in 2023, but at a decelerating pace. As of September 2023, venture capital markets recorded negative performance for seven consecutive quarters (Exhibit 1), marking the longest correction since the Dot-com Crash of the early 2000s. This translates to a -22.4% loss for the Venture Capital Index since the correction began at the end of 2021[1]. Current losses are primarily the result of interim mark-to-market valuation adjustments, with most portfolio companies yet to formally reprice through new funding rounds. In 2023, the index showed a modest decline of -2.0% during the first three quarters[2]. This suggests that asset managers believe their adjustments to holding values in 2022 adequately capture the prevailing market conditions. A comparison with publicly traded companies reveals a contrasting story; since the end of 2021, high-growth cloud software companies and post-IPO venture-backed companies declined by -43.4%[3] and -49.3%[4], respectively. The performance disparity between private and public high-growth technology companies suggests that venture capital portfolios may experience further losses when companies return to market for new funding.

Startups that have raised additional capital are doing so at lower valuations. The valuations investors are applying to startups in new funding rounds have declined since the market peak in 2021, with the extent of the correction varying across venture capital "stages". Median valuations for late-stage U.S. startups have fallen by c. -65% since 2021[5]. Companies at this end of the market tend to exhibit the highest sensitivity to changes

Exhibit 1

Venture capital markets have declined for seven consecutive quarters, the most significant correction since the Dot-com Crash



Source: *Partners Capital Analysis*

1 State Street Global Venture Capital Index, Q4 2021 through Q3 2023
2 Ibid
3 BVP Nasdaq Emerging Cloud Index, Q4 2021 through Q3 2023
4 PitchBook VC-backed IPO Index, return calculated by Partners Capital for the period Q4 2021 through Q3 2023
5 Q4 2023 PitchBook-NVCA Venture Monitor. Late-stage represents the median valuation for "Venture Growth" companies in PitchBook's data set.

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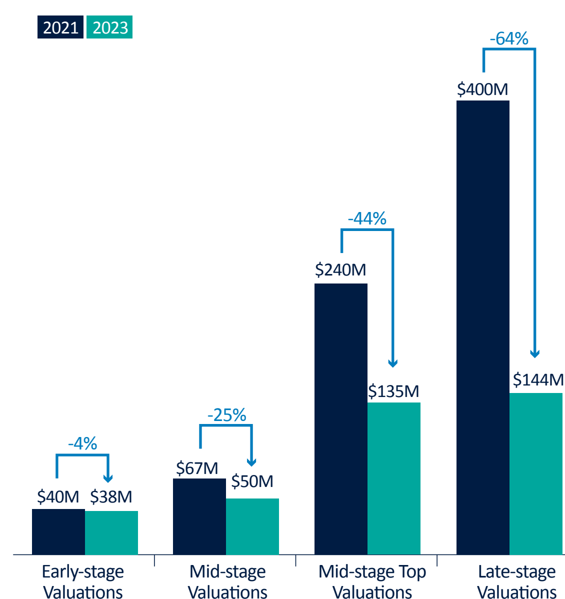
in public market valuations, which is attributable to the maturing financial profile of the companies and the participation in funding rounds from both public and private market investors. Mid-stage startups saw median valuations fall by approximately c. -25% since 2021, with highly valued startups at this stage experiencing a more substantial decline of c. -44%[6]. As a result of these trends, nearly 20% of 2023 funding rounds were down rounds[7]. Even some of the most sought-after startups in recent years, including Stripe, Shein and Ramp raised capital at significantly lower valuations in 2023. In contrast, early-stage startups have continued to raise capital at valuations comparable to those observed in 2021[8]. In the aftermath of the market correction, many investors shifted their focus from mature startups to early-stage opportunities. This move aimed to maintain investment activity while avoiding additional exposure to highly valued assets. This activity drove up the valuation of early-stage funding rounds through the first half of 2022, postponing the correction by several quarters. Investment activity in early-stage rounds has since normalised and valuation data from recent quarters indicates that pricing has started to correct at this end of the market as well.

Exhibit 2

Average valuations have reset across mid- and late-stage funding rounds



Source: *Pitchbook*

Capital scarcity is reshaping the balance of power in the industry. In 2023, global venture capital fundraising amounted to $105B, marking a year-over-year decline of -56%[9]. The market backdrop suggests that investor interest in venture capital is likely to remain subdued over the near term, with the prevailing higher interest rate environment steering investors towards safer assets. Additionally, exits of venture-backed companies amounted to $144B in 2023, down c. -69% from 2021 and the lowest aggregate exit value since 2014[10]. The decline in realisations limits limited partners' ("LPs") capacity for new commitments, particularly after several years of rapid fundraising. Investment activity has also declined across all regions, falling -40% year-over-year and by -61% since 2021[11]. These trends are shifting the balance of power in the industry. While leading asset managers still hold considerable influence over their LPs, many are choosing to introduce LP-friendly changes in the current environment, such as reducing their fund sizes and extending fundraising timelines. The funding environment is also tilting the balance of power from founders back to venture capitalists after more than a decade of founder-friendly dynamics. In addition to more favourable valuations, venture capitalists are benefiting from extra time to evaluate investments. Anecdotally, due diligence timelines have shifted from 'days to weeks' for early-stage opportunities and from 'weeks to a month or longer' for late-stage opportunities between the

6 Q4 2023 PitchBook-NVCA Venture Monitor. Mid-stage represents the median valuation for companies in PitchBook's data set on series C-E funding rounds. "Highly valued" represents the top-quartile in the same data set.
7 Carta State of Private Markets, Q3 2023.
8 Q4 2023 PitchBook-NVCA Venture Monitor. Early-stage represents the median valuation for companies in PitchBook's data set on seed-series B funding rounds.
9 Preqin, January 2024.
10 PitchBook Data, Inc.
11 Ibid.

market peak and today. There is also a resurgence in investor-friendly deal terms, such as liquidation preferences and participating preferred stock. While dry powder currently stands at $660B[12], an all-time high for the venture capital industry, we expect investors to continue to approach deployment conservatively and for current power dynamics to persist over the near term.

Startup austerity is beginning to weigh on growth. In early 2022, the startup landscape experienced a rapid shift in mentality from "growth at all costs" to austerity. Companies sought bridge rounds from investors to bolster their balance sheets. They implemented measures to reduce spending and optimise resources, resulting in several waves of headcount reductions that peaked in Q1 2023[13]. Startups reinforced these efforts in the wake of the Silicon Valley Bank collapse in early 2023. As a result, many startups have successfully extended cash runway beyond the typical 18 months between funding rounds. While these changes have had a positive impact on capital efficiency for many companies, the impact on growth has been less favourable. In 2023, the industry's top 100 cloud software startups forecasted +55% year-over-year revenue growth, a -45% decline in growth rate compared to the prior year[14]. Companies beyond this distinguished group experienced even more pronounced adjustments. Many startups are now growing at rates that fall below investor expectations. Companies that have allocated capital judiciously may sidestep the need for additional financing or have enough dry powder to reaccelerate growth when market dynamics become more favourable. Others lack the financial profile to justify further funding. As a result, we anticipate a significant resurgence in the dispersion of outcomes within the industry, accompanied by an increase in startup failures.

Artificial Intelligence ("AI") emerges as the next major innovation cycle. Amid the bubble bursting in the technology sector, the development and public availability of large language models marked a fundamental shift for AI from analysis and prediction to content creation. Google's 2017 breakthrough with its Transformer architecture paved the way for larger AI training sets. These advancements enabled a leap forward in the functionality of generative AI models and made them accessible to a broader range of users. OpenAI, an AI startup founded in 2015, released its large language model, ChatGPT, to the public in November 2022. ChatGPT gained over 100M users in just two months[15], reaching this milestone faster than any software application in history. Many have described this event as the "iPhone moment" for generative AI, sparking renewed interest in artificial intelligence. During 2023, as capital investment in U.S. startups fell by c. -29% broadly, investment in artificial intelligence startups grew by +15%[16] (Exhibit 3). AI-related investments now represent approximately 37% of the U.S. venture capital market compared to 21% five years ago[17]. Venture capitalists are exploring opportunities across the three core layers of the generative AI technology stack: 1) the infrastructure layer, 2) the model layer and 3) the application layer. Investors pursuing opportunities at the infrastructure (e.g. specialised chips) and model layers face substantial funding requirements and a "winner-take-all" dynamic. Leading startups OpenAI, Anthropic and Inflection AI, which operate at the model layer, collectively raised $7.9B through traditional venture capital funding rounds in 2023[18]. Including the value of multiyear cash and cloud computing commitments, the capital raised by these three startups alone increases to

12 PitchBook Data, Inc. Global VC Capital Overhang, Q2 2023.
13 layoffs.fyi, January 2024.
14 Bessmer Venture Partners, The Cloud 100 Benchmarks Report 2023.
15 Reuters.
16 Q4 2023 PitchBook-NVCA Venture Monitor.
17 Ibid.
18 The Q4 2023 PitchBook Analyst Note: Generative AI VC Trends.

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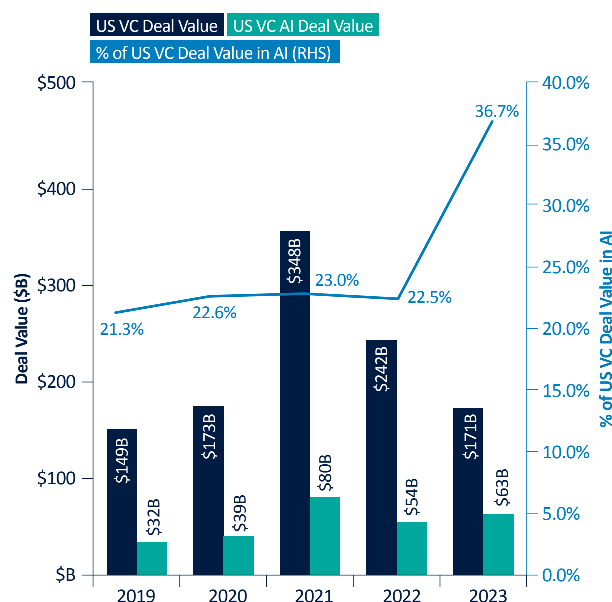
$23.2B[19]. These companies are experiencing rapid adoption, with OpenAI and Anthropic projecting annualized revenue run rates of $1.6B[20] and $850M[21], respectively, in 2024. Considering the capital intensity and competitive dynamics of the initial two layers of the technology stack, most venture capitalists are directing capital toward the application layer. Their goal is to secure an early stake in what could be the next-generation Adobe or Salesforce. We are still in the early phases of exploring generative AI's potential. To achieve success, startups and investors must navigate rapidly evolving technical, competitive, and regulatory landscapes. Despite these challenges, generative AI's potential to disrupt and transform industries will remain in focus for many venture capitalists for the foreseeable future.

Exhibit 3
US VC investment in AI startups grew by +15% in 2023, defying the broader market contraction, and now constitutes c. 37% of the total US deal value



***Source:** Pitchbook*

Golden Rules

- Prioritise manager selection, as venture capital has greater performance dispersion than any other asset class.
- Focus on skilled investors with a demonstrated proficiency in sourcing, selecting, accessing, and supporting startups poised for venture-scale outcomes.
- Construct a portfolio that allocates capital to established and emerging managers. Aim to capitalise on the persistent outperformance observed in funds managed by market leaders and the alpha potential of smaller, more specialised funds.
- Invest across early- and late-stage funding rounds to concentrate capital in companies with potential asymmetric outcomes and to leverage the informational advantages inherent in multi-stage investing.
- Maintain a steady commitment pace given the ineffectiveness of market timing strategies and the lack of correlation between innovation and macroeconomic cycles.

19 Ibid.
20 The Information.
21 Reuters.

Sub-Strategy Attractiveness

By Stage:

- **Early-stage:** Favourable view. We expect early-stage investments to exhibit lower correlation with macroeconomic risks, as outcomes are dependent upon innovative technologies and product-market fit, rather than interest rates or the corporate earnings cycle. History has shown that successful companies can be founded in virtually any environment. Recent advancements in the application and accessibility of artificial intelligence should also act as a positive force for entrepreneurs aiming to disrupt the offerings of established incumbents. Finally, investment information and access are opaque at this end of the market and these inefficiencies create a compelling opportunity for alpha generation. Persistently high valuations remain a concern, but pressures are beginning to ease as investment activity normalises.

- **Late-stage:** Neutral view. Short-term challenges persist, including a lingering excess of overcapitalised businesses and an uncertain exit environment. The late-stage market is expected to show signs of improvement in the latter half of 2024, with a growing cohort of companies compelled to seek their first new round of financing since 2021. Investors will need to carefully navigate this opportunity set, as many of these companies have overinflated valuations and/or broken business models. We are also mindful that our long-term outlook on interest rate volatility is a potential headwind for late-stage investors. We favour multi-stage investment platforms in this environment, which benefit from clear information and access advantages and tend to skew towards earlier entry points.

By Geography:

- **U.S.:** The U.S. remains the largest venture capital market globally with the deepest pool of founder and investor talent. The regulatory environment in the U.S. also remains supportive of innovation and entrepreneurship. We see compelling opportunities to invest in both established and emerging managers in the region and expect it to remain a core focus of our program. Competition and valuations are likely to remain at a premium to other markets, underscoring the significance of manager selection despite the favourable backdrop.

- **European:** Neutral view. The European market has evolved over the past decade and now commands a larger share of global funding and startup value creation. Greater support for entrepreneurship in the region and increased interest from investors overseas have contributed to the market's maturation. Key considerations for investors in this region include the distribution of opportunities across countries with distinct cultural and language barriers and the limited pool of managers with evidence of persistent outperformance.

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- **China:** Cautious view. China remains a global technology leader; however, 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. We have significantly reduced our commitments to the region and concentrated our relationships in the region with a small number of proven market leaders.

By Subsector:

- **Enterprise technology:** Favourable view. We continue to view enterprise technology as a core allocation within our venture capital program. Historically, there are more realisations at valuations greater than $1B in enterprise technology compared to other segments of the market. Furthermore, the transition to the cloud and the growing adoption of artificial intelligence have driven a need for new infrastructure and presented an opportunity to develop innovative new applications. Key challenges for this segment include persistently high valuations, particularly in categories such as applied and generative artificial intelligence, and low barriers to entry. Favour investors with deep domain expertise and the ability to support product commercialisation.

- **Consumer technology:** Neutral view. The consumer segment has produced many of the largest outcomes in the venture capital market over the last 20 years; however, value tends to be concentrated in a smaller number of companies making it a more challenging category for generating consistent outperformance. Many consumer businesses are experiencing a slowdown in growth, as conditions that propelled growth in 2020/21 have diminished. While the category faces headwinds, the opportunity set has expanded into healthcare, financial services, and real estate in recent years, significantly expanding the value creation opportunity for investors. Advancements in generative AI may also catalyse new, or more efficient, business models and consumer experiences.

- **Life science:** The rapid pace of innovation and the strong demand for new assets from large pharmaceutical companies support investments in start-ups developing novel therapies and infrastructure. However, the capital requirements of drug development, combined with the funding pullback and the prolonged time to exit, pose imminent challenges for investors in this market. We also remain cautious given the weaker performance relative to technology-focused venture capital funds historically[22].

- **Deep technology:** Cautious view. Industry participants broadly categorise opportunities that carry a greater level of technological and market risk as "deep tech" investment. Our definition of this market segment includes opportunities in hardware (e.g. robotics, semiconductors, computing), climate technology and blockchain technology. We are approaching opportunities across these categories with caution, given the incremental technology risk and the capital requirements associated with scaling many of these technologies. We have selectively backed specialists in climate

22 Source: PitchBook Data, Inc.

and blockchain technology in the past and we will continue to support a limited number of investors in these categories, as long as the end market and potential return dynamics remain favourable.

2024 Strategic Priorities

Past performance is not indicative of future returns, your capital is at risk and you may not get back the full amount invested.

- **Continue to expand exposure to early-stage venture capital:** Our venture capital strategy seeks to combine the persistent outperformance of established venture capital platforms with the alpha potential of smaller and more specialised investors. Many of these specialised funds concentrate on early-stage funding rounds. We continue to view this as an attractive segment of the market, due to the sustained trend of accelerating innovation and the inherent inefficiencies within this space. Furthermore, we believe the key drivers of performance in early-stage venture capital are less correlated with macroeconomic cycles, as previously discussed. We aim to allocate c. 30%-40% of our venture capital focused pooled investment vehicle to early-stage specialists. We reserve another c. 50%-60% of the vehicle for multi-stage managers which allocate c. 50% of capital to early-stage investment strategies. The vehicle's approach to portfolio construction results in c. 55%-70% total exposure to early-stage investments.
- **Opportunistically develop new relationships with preeminent established venture capital platforms:** We believe the current environment presents an opportunity to increase our exposure to managers historically closed to new investors. The increased pace of fundraising in recent years and strong performance of the asset class over the past decade have left many limited partners overallocated relative to their long-term targets. The weak exit environment is likely to exacerbate this issue over the near term. Partners Capital is uniquely positioned to take advantage of this opportunity, considering the depth of our industry network and our recent decision to increase long-term target exposure to the asset class. We have had notable success over the past 24 months, both in increasing our exposure to existing partners and accessing new platforms. We are working to source one or two new relationships for 2024.
- **Leverage commingled pooled investment vehicle to scale program and facilitate client exposure to venture capital:** In 2022, Partners Capital raised its first venture capital focused pooled investment vehicle which has facilitated the expansion of key manager relationships by strengthening our negotiating leverage through the aggregation of client commitments. Access to previously approved venture capital managers increased by c. +40% since launching the vehicle in 2022[23]. For investors, many of whom lack the scale needed to create a suitably diversified venture capital program, the vehicle plays a crucial role in optimising portfolio

23 Compares Partners Capital's latest total commitment to total commitment to a manager's previous fundraise for venture capital investments made since 2022. Excludes new manager relationships and terminated relationships during that time.

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construction. Moreover, investors who commit to venture capital managers directly are more likely to be under-allocated to early-stage managers, emerging managers and co-investments. This vehicle provides investors with exposure to these investments across a range of themes, many of which would be inaccessible directly due to capacity constraints and other investor restrictions.

Long-Term Expected Return

We expect our clients will earn an average 13.5% annual return over the long term from private equity: 7.5% beta return (based on an equivalent net equity beta of 1.0), 4% driven by the illiquidity premium and 2% of additional manager alpha.

Exhibit 4

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

	Venture Capital
Risk-free Rate	4.0%
Risk Premium	3.5%
Illiquidity Premium	4.0%
Manager Alpha	2.0%
Total Return	**13.5%**

Venture Capital expected returns reflect +7.5% p.a. beta returns modestly above public equity markets, plus +4.0% asset class excess return reflecting the longer "illiquidity premium" and +2.0% alpha from our strategy and manager selection.

Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.