CIO Academy

Introduction to Venture Capital Investing: Why Now?

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Marketing Communication. For Professional Clients.

Dave Lowery
Head of Alternatives Research, HSBC Asset Management

Trisha Mayr
Principal, Private Markets, HSBC Asset Management

Patrick Sixsmith
Managing Principal & Head of Co-Investments, Private Markets, HSBC Asset Management

Thibaut Charron
Private Markets Investment Specialist, HSBC Asset Management

- Venture Capital (VC) is a financing method where capital is invested in startups or young businesses in exchange for ownership shares. VC firms, also known as General Partners (GPs), raise funds from Limited Partners (LPs) to invest in companies with high growth potential, particularly in innovative sectors like software, fintech, and biotechnology.
- VC differs from private equity buyouts in terms of company types, ownership stakes, risk profiles, and investment strategies. VC investments are typically higher risk but offer the potential for outsized returns, often relying on a few successful investments to drive the overall portfolio performance.
- The VC industry has seen significant growth, with assets under management (AUM) projected to reach $3.8 trillion by 2028. North America remains the dominant region for VC activity, although interest is growing in emerging markets too.
- The fundraising market has slowed since its peak in 2021, with a notable decrease in deal values. But the number of deals has relatively stabilised now, indicating a focus on smaller investments. The exit market has also contracted, but successful IPOs suggest potential recovery.
- However, we believe that for knowledgeable and experienced investors with the appropriate risk tolerance, we believe now is an opportune time to invest in VC, as valuation corrections may allow access to top-performing managers and high-quality companies at favourable prices.

Source: HSBC Asset Management.
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Venture capital – what's important to know?

Whether you're booking a holiday through Kayak, grilling a plant-based burger from Impossible Foods or buying groceries through Instacart, you are likely to use services and products from venture capital-backed companies – they are all around us.

Venture capital ("VC") is a form of financing where capital is invested into a company – generally a start-up, young business or a small business – in exchange for an ownership share in the company. VC firms (General Partners – "GPs") will raise funds from investors called Limited Partners ("LPs") to invest in emerging companies that they believe have exceptional long-term potential. Beyond providing capital, GPs will support companies through their networks to building their teams and develop the product. Both the GP and the LP benefit if the company does well. The companies receiving the capital will generally invest it into their business in a variety of ways to help support the growth: for example, add on new teams to target a new market, or invest in sales, technology or product development.

VC-backed companies exhibit high growth potential and aim to offer highly innovative products or services within high-potential, highly scalable industries such as software, fintech, digital infrastructure, and pharmaceutical/biotechnology, although the reach of venture has expanded over time. Despite this, start-ups face significant challenges, including product development, customer adoption, market evolution, and financing risks, which is why many fail in the early stages. Venture strategies seek to offset these losses through well-diversified portfolios with outsized returns from a core of highly successful investments.

There are many prominent VC firms with experienced teams and a long-term track record of successfully selecting winning and high-profile investments.

The difference between VC and Buyouts

Both VC and Private Equity Buyouts share the same goal: to increase the value of companies they invest in before selling their stake for a profit; however, they differ in the following ways:

- Types of companies
- Ownership stake
- Risk profile
- Team construction
- Holding periods
- Fund fees

VCs seek start-up companies, or those in their relative infancy; the company can be as early stage as a small team with a business plan and no assets or cashflow. VC funding gives them access to vital capital and GPs can also share expertise, experience and network, informally or via a board seat, to support companies and improve the chances of success.

VC managers often take minority stakes - 50% or less - when making an initial investment in order to gain access to the most attractive companies and potential 'pro-rata' rights in subsequent rounds. Although there's no "controlling" investor as seen within PE, the VC managers with the biggest ownership positions typically sit on the company board and are part of strategic and growth discussions.

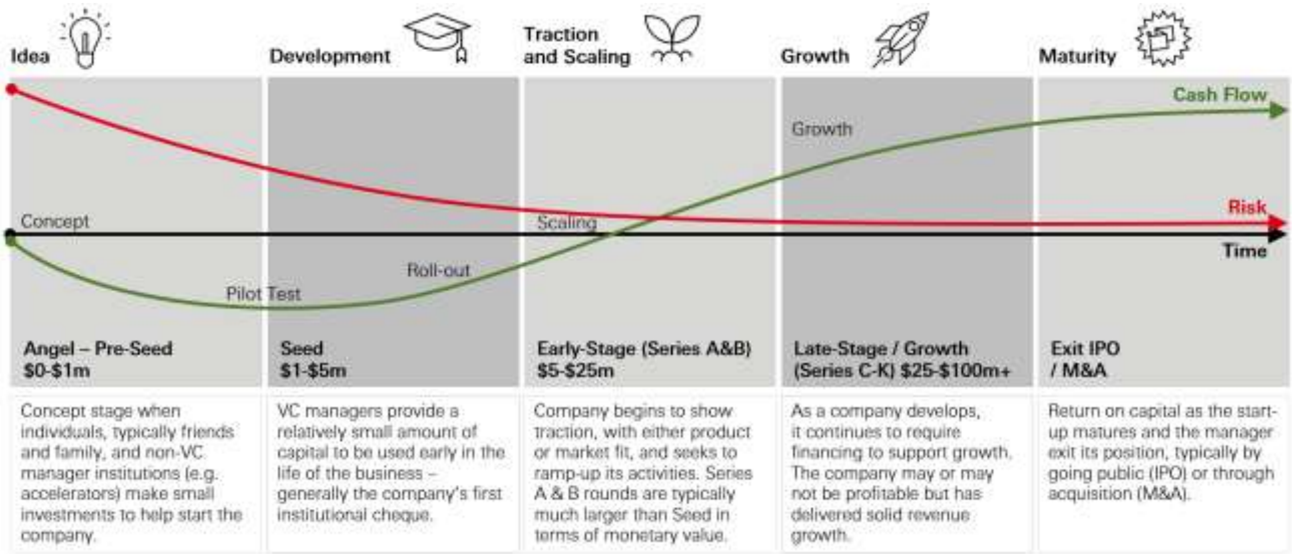
Another notable difference between Buyouts and VC is the risk profile. VC investments are generally higher risk, with both the potential for higher relative returns and an increased chance of failure. As such, the loss ratios are higher in VC than in Buyouts. There is increased risk in VC investment as young companies are often still developing products or services, which might need refinement, they may be in immature or new markets and could be operating at the cutting edge of a technology. Given these characteristics, while risks to the downside are greater, so is the potential upside. As a result, venture portfolios tend to be well-diversified with managers typically seeking a handful of 'home run' investments that alone generate the majority of fund returns, this is commonly referred to as the "Power Law."

In terms of team construction, VCs are much smaller and nimbler, allowing them to move quickly. Investors typically employ a thesis-driven sourcing approach and are encouraged to take calculated risks to uncover outliers, often without the need for formal voting processes. Unlike Buyouts, where operational efficiency is key to value creation, VCs focus on offering access to networks, strategic guidance and mentorship to help fuel growth.

Given VC managers invest in less mature companies, holding periods are typically longer than Buyouts; however, the potential for outperformance makes it worth the wait with compounding returns. Successful VC-backed companies are typically exited through the public markets via IPO or through a sale to a larger, strategic company.

Finally, VC fund managers operate in the same way as other private market fund managers, in that they charge management and performance fees; however, they can be higher than the Buyouts industry standard 2% management fee and 20% performance fee (over a specified hurdle rate) – due to expected outperformance. Management fees are typically calculated as a percentage of assets under management (AUM) within a fund and performance fees are calculated as a percentage of the profits from investing. These performance fees incentivise managers to deliver greater returns and are generally paid out to employees to reward their investment successes.

The Venture Capital cycle



Source: HSBC Asset Management, HSBC Global Private Banking, November 2024. Note: Conceptual illustration based on industry data and statistics.

The stages of VC fundraising

As start-ups grow and develop, they will require financing from VC fund managers to support the growth. This happens through fundraising rounds across different stages from angel, pre-seed, seed to late stage, as described below. After the seed round, fundraising rounds are called "Series" and are labelled alphabetically, e.g., Series A, Series B, etc. With each Series, the fundraising rounds typically increase in size as well as the valuation of the company. In a fundraising round, companies may seek new VC fund managers to diversify the investor base and seek investors that can provide additional support e.g., through their networks. The new fundraising round will also provide an opportunity for existing investors to provide additional or follow-on capital to the company. Some VC fund managers may specialise in specific stages, and some may invest across all (known as multi-stage managers).

Angel & Pre-Seed Stage

This is the initial concept stage when individuals, typically friends and family, and non-VC manager institutions (e.g. accelerators) make small investments to help start the company.

Seed stage

When a VC fund manager provides a start-up company with a relatively small amount of capital to be used early in the life of the business, it is referred to as seed funding. The seed round is generally the recipient's first institutional cheque. The initial investment can be in a range of formats and is often in the form of convertible notes, equity or preferred stock options in exchange for an investment in the company.

Early stage

Early-stage is generally intended for companies that have started to show some traction either with the product or services, or customers, and are seeking to ramp-up their activities. As such, this stage of financing is usually larger, in terms of the monetary value, than the seed stage. Within early-stage, fundraising rounds are generally labelled as Series A or Series B.

Late stage / Growth

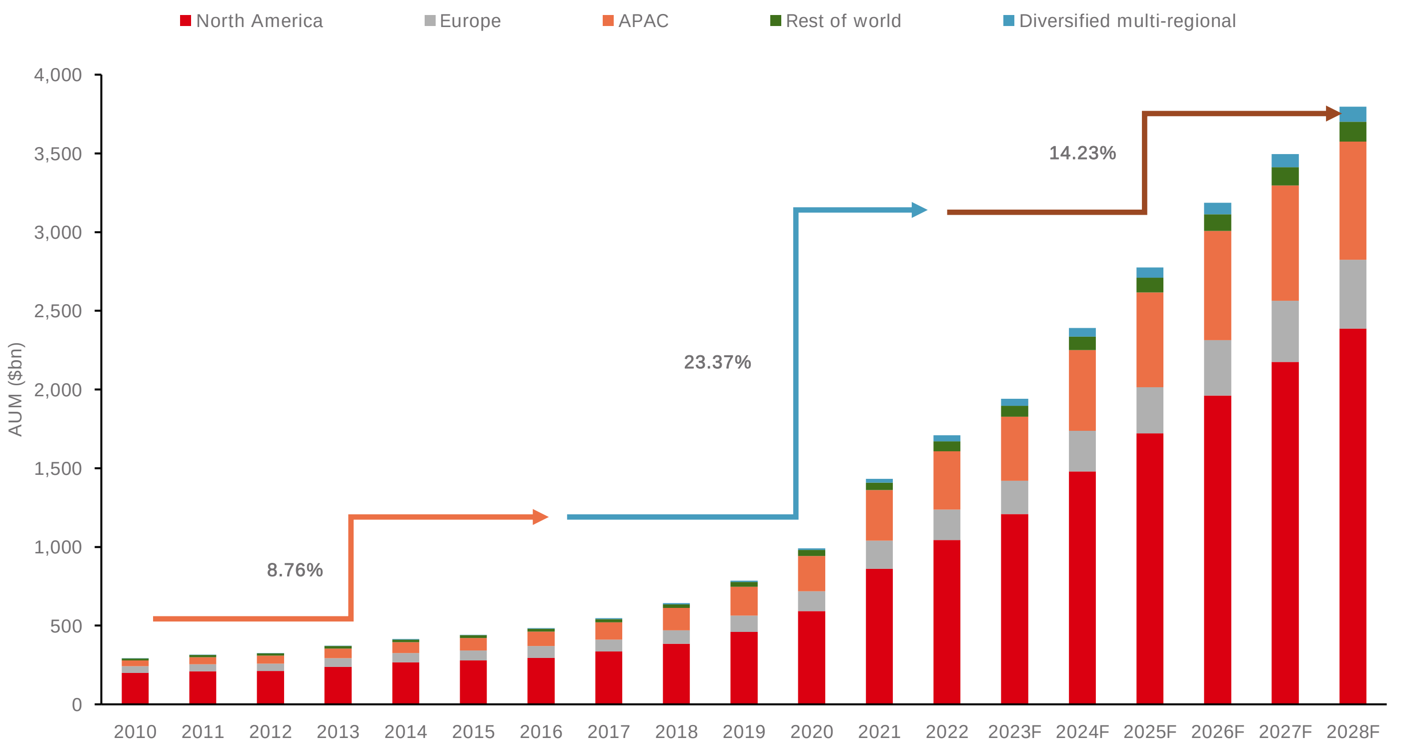
As a company develops, it will continue to require financing to support its growth. Late-stage funding is targeted towards more mature companies than start-ups (but less mature than PE), which may or may not be profitable but have delivered solid growth and are typically revenue generating. Within late-stage, fundraising rounds are labelled as Series C, Series D etc. up to Series K usually.

The broader venture capital market

The VC industry has been a major beneficiary of the growth in private capital markets, particularly in recent years. Between 2010 and the end of 2022, VC AUM increased from $293bn to $1.7tn, according to Preqin report on Future of Alternatives 2029. Their forecasts suggest that while the rate of growth in the asset class will slow, it will remain the fastest growing asset class within private capital markets. Over the forecast horizon, which runs from 2023-2028, Preqin expects VC AUM to reach $3.8tn – equal to a compounded annual growth rate of 14.2% between the end of 2022 and the end of 2028. VC is expected to dwarf that of both infrastructure and real estate, which should reach AUM of $1.7tn and $2.2tn in 2028, respectively. Among the attractions driving interest in VC markets are access to cutting-edge technology and market disruptors while they are in the nascent stage, something traditional asset classes cannot provide until much later in a company's lifecycle.

The vast majority of VC activity is located in North America. Of the expected $3.8tn in VC AUM in 2028, 63% is forecasted to be in North America, compared to 11.5% in Europe and 19.8% in APAC. That said, VC fund managers are expanding their horizons beyond traditional technology hubs such as Silicon Valley: there is growing interest in emerging markets and secondary cities that offer promising opportunities for innovation and growth (i.e. London, Berlin, Singapore, Tel Aviv).

Venture capital AUM* by primary region focus



Source: Preqin Future of Alternatives 2028, HSBC Global Private Banking, November 2024. Past performance does not predict future returns. Note: *AUM figures exclude funds denominated in Yuan Renminbi and data is as of November 2023. This information shouldn't be considered as an investment advice.

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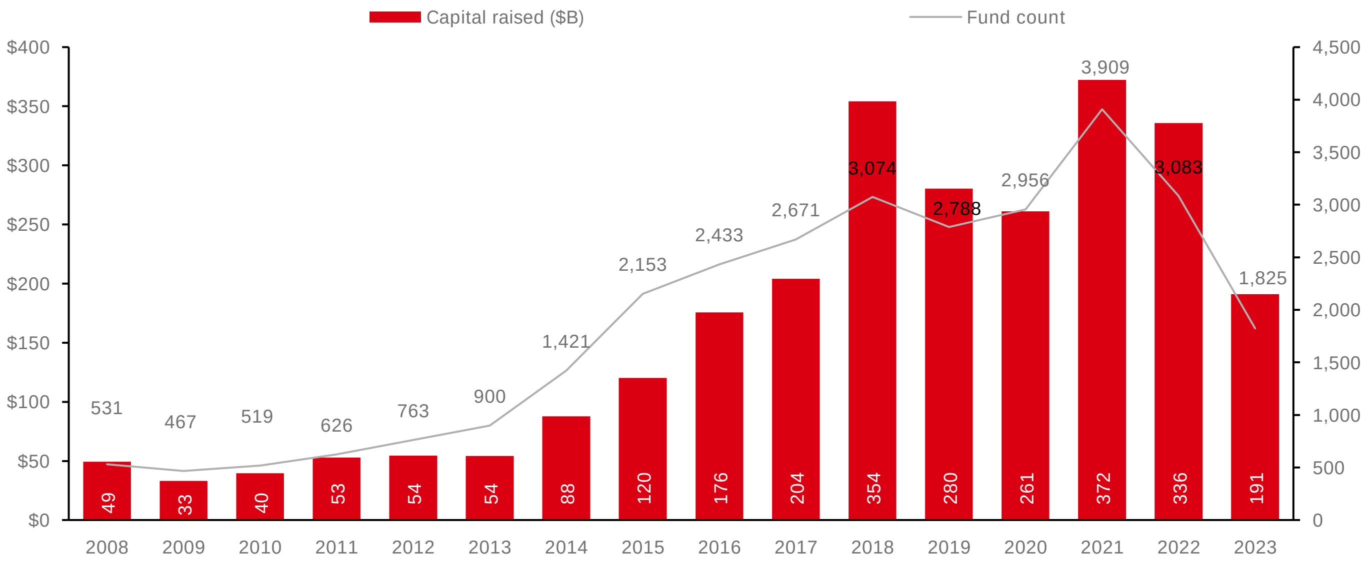
As a result of this growth, the composition of the VC industry has changed. There are now more and larger participants in the VC market, as the industry has evolved and increased in size. VC markets are primarily (but not entirely) focused on technology investments of some kind, and eight of the ten largest companies in the world are now technology companies, initially funded by VC (Source: Companiesmarketcap.com). In 2015, it was only one (Source: PWC). Indeed, VCs are increasingly prioritising sectors that, in their view, demonstrate more resilience and long-term potential, principally in areas such as AI, healthcare IT, climate tech and fintech. Generative AI, specifically, continues to dominate the VC landscape. Large language models continue to see the majority of AI funding, along with AI development tools.

Fundraising markets slow from the 2021 peak

The global venture capital fundraising market has slowed since the peak in 2021. During that year, almost 4,000 VC funds closed, raising a combined $372.3bn, according to Pitchbook data. This had fallen to just over 1,800 funds closing in 2023, raising $191.2bn – the quietest year since 2017. The slowdown has been driven by the contraction in valuations, which, due to the denominator effect, has resulted in a number of LPs reducing overall allocations to fund managers (across private markets). This provides a potential opportunity to gain access to top-performing managers that may otherwise have been difficult to access. That being said, the top performing venture capital funds will continue to raise funds, even in tougher fundraising environments. In fact, these environments tend to lead to outperformance as the best managers can choose the best opportunities at more attractive valuations. In the first quarter of 2024, global VC funding grew by around 16% quarter over quarter. In addition, there was $89 billion distributed over 4,600 deals as the market continued to see ongoing activity.

Global venture capital fundraising activity



Source: Pitchbook, data as of June 2024, HSBC Global Private Banking, November 2024. Past performance does not predict future returns.
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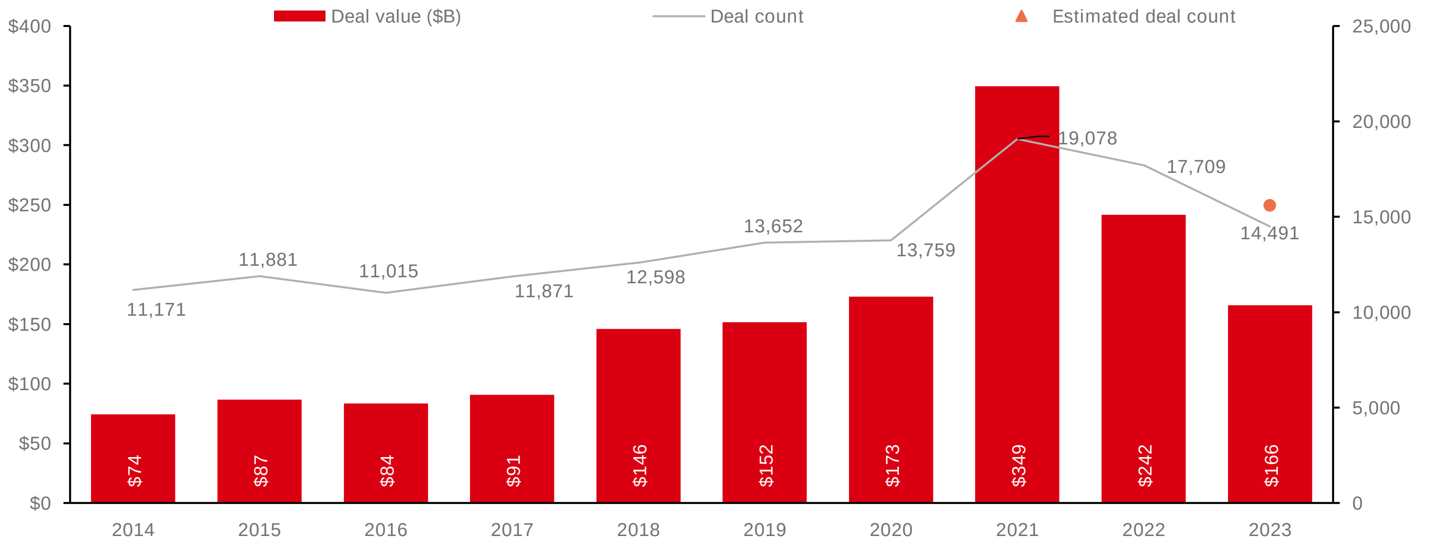
In contrast with some other asset classes, VC has remained a relatively robust asset class for the emergence of new fund managers. Whereas private credit, infrastructure and PE fundraising is often dominated by a small number of large-scale mega funds, VC remains an asset class with greater diversity. While there are some fluctuations across years, first time funds are able to secure a solid proportion of capital raised within VC markets.

Deal values fall but the market remains active

As with capital raising, VC deal activity also peaked during 2021. In the US alone, more than 19,000 deals were completed during 2021, with an aggregate deal value of almost $350bn. While the value of deals had fallen by the end of 2023, with aggregate deal values less than half the level witnessed in 2021, the number of deals fell by a far smaller amount (24%, compared to 53%). This suggests that activity was focused more towards smaller deal sizes, rather than a wholesale retrenchment of activity, with a particular dearth of mega deals.

US venture capital deal activity



Source: Pitchbook, data as of June 2024, HSBC Global Private Banking, November 2024. Past performance does not predict future returns.
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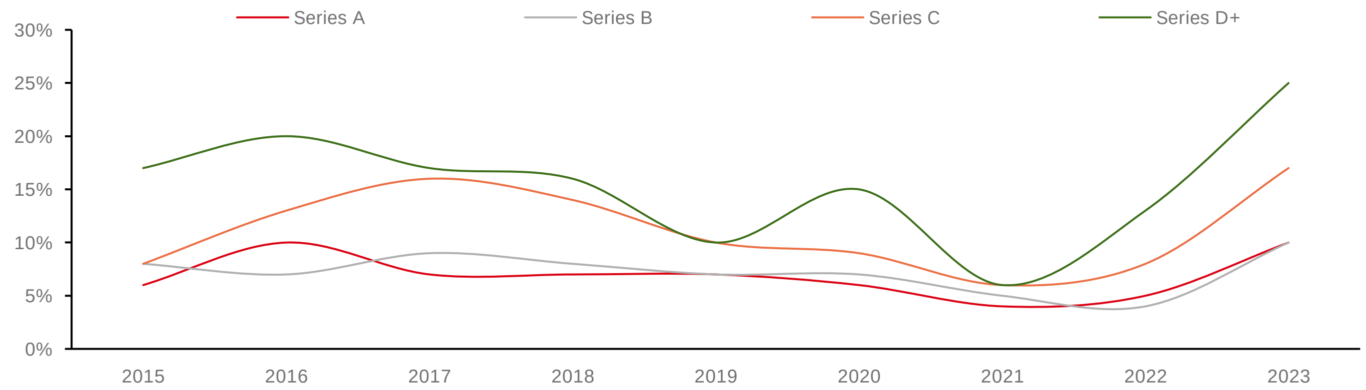
When assessing US VC deals further, it is clear that valuations have fallen. The proportion of firms raising capital at lower valuations than they have in the past is currently the highest it has been for many years. In 2023, down rounds became a reality, with nearly a quarter of later-stage (series D and later) deals raising rounds at valuations below their previous round. Firms will aim to avoid down rounds (new fundraising rounds at lower valuations than the prior round) when they can, as they can negatively impact sentiment, both among existing investors and employees, who might have their own stake in the firm through equity options. That being said, while down rounds are generally unavoidable in many instances, there are two benefits:

- Companies have become more efficient with the use of funding, focusing on profitability rather than growth at all costs, resulting in a longer time between fundraising rounds.
- The lower rounds offer a chance for some VC fund managers to buy into solid businesses at far more attractive valuations than may have been available in the past. Those funds with dry powder to deploy, particularly more recently closed funds, may be able to take advantage of the current market and gain exposure to high-quality companies at favourable prices.

Down round by series for US start-ups



Source: KPMG Venture Pulse, data as of Q1 2024, HSBC Global Private Banking, November 2024. Past performance does not predict future returns.
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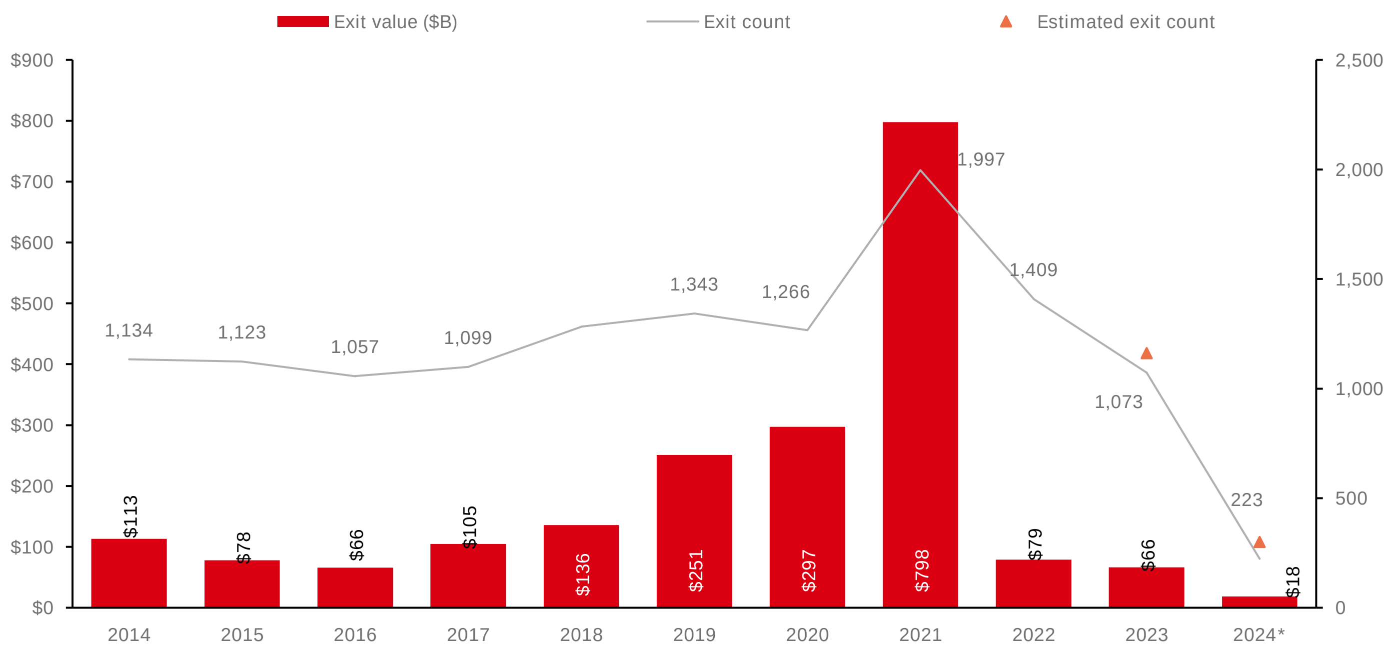
Lower distributions in recent years

While deal activity peaked in 2021, a similar story was evident when it came to exit activity. The peak in 2021 of almost $800bn in exits was followed by a sharp pullback in both 2022 and 2023, driven by the weaker IPO markets, a typical exit route for VC-backed companies. A record backlog of exit-ready unicorns has formed. It is estimated that the aggregate valuation of unicorns with high pressure to exit, based on company age, is $1.2tn. Data for Q1 in 2024 suggests the exit market remains weak, but when the data is assessed more closely, there may well be some room for optimism. While the $18.4bn in aggregate in exit values remains low so far in 2024, this figure was delivered with a relatively small number of

exits, including the high-profile IPOs of Astera Labs and Reddit. These successful IPOs point towards the potential re-opening of the IPO market.

In addition, VC fund managers are increasingly seeking creative ways to provide liquidity to their LPs, including through secondaries or continuation funds. The VC secondaries market has only recently started to open up and we expect these types of deals to generate strong returns, similar to the early secondaries in PE.

US venture capital exit activity



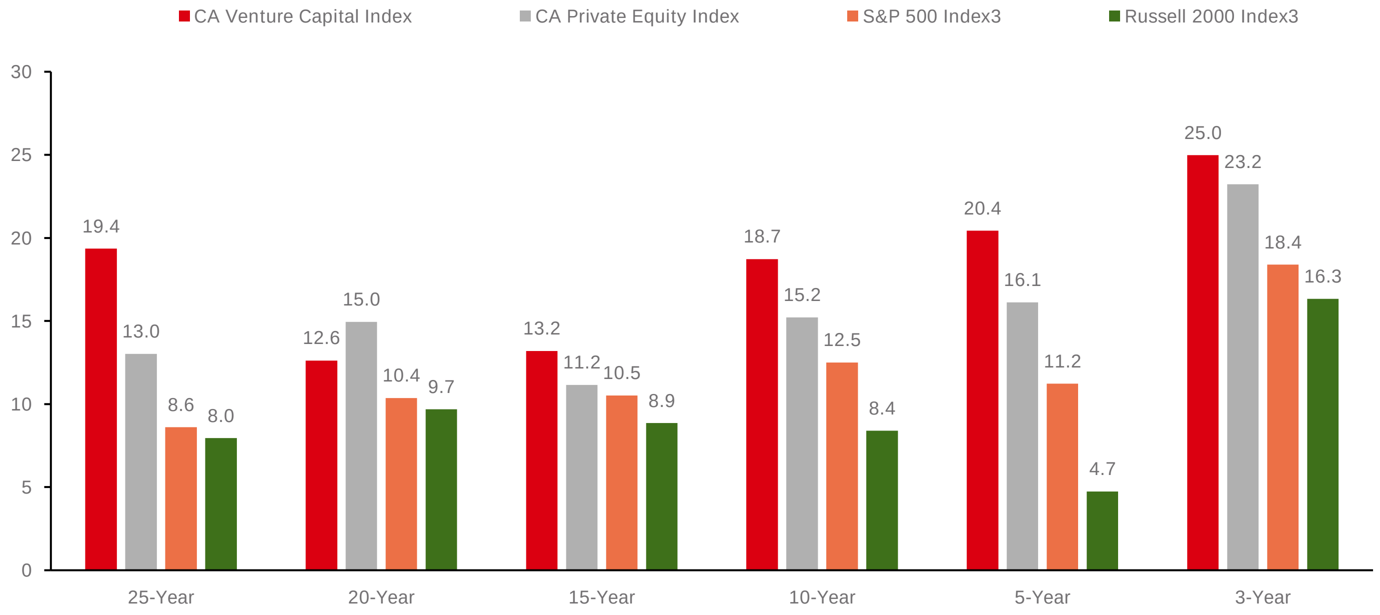
Source: Pitchbook, data to end Q1 2024 as of May 2024, HSBC Global Private Banking, November 2024. Past performance does not predict future returns. For illustrative purposes only. There is no guarantee that the trend illustrated by the chart above will continue.

Wide performance dispersion in VC highlights the importance of manager selection

There is an increasing body of evidence to highlight the benefits of adding VC assets to a multi-asset class portfolio. Research suggests that adding VC investments to the portfolio mix not only helps with diversification, but also enables investors to demand higher returns from their portfolios. What's more, this is also true when performance benchmarks are unsmoothed, to reflect a more realistic movement in values over time. These benefits are increasingly accepted by investors and have been an additional driving force behind the VC industry's growth in recent years.

The inefficiencies that exist in private markets, particularly in the venture part of the market, expand the opportunity spectrum and, we believe, make the asset class a viable long-term, high-return solution for those able to tolerate its inherent illiquidity. These traits also highlight the need to select the 'right' managers, as the dispersion of returns between winning funds and those less successful has been widening in recent vintages. Clearly, manager selection is incredibly important in maximising the benefits of an allocation towards VC.

Global VC Periodic Rates of Return (%)



Source: Cambridge Associates LLC, Frank Russell Company, MSCI, Thomson Reuters Datastream, and Pitchbook, as of 31 December 2023, HSBC Global Private Banking, November 2024. Past performance does not predict future returns. Performance provided is of an index and not a fund. You cannot invest in the index directly.

We believe that now is an attractive time to invest in VC

VC is a growing asset class and provides access to cutting-edge technology and market disruptors while they are in the nascent stage. These businesses are often exited via IPO and so, historically, there is little overlap between VC-backed businesses and those backed by PE firms. As such, it is an important portfolio diversifier as part of a multi-asset portfolio and can generate risk-adjusted returns superior to what is achievable from Private Equity Buyouts alone. With the valuation correction and pullback of LPs due to the denominator effect, now is an excellent time to invest in venture capital and access top performing VC fund managers.

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