CLEARPOINT

MIKE MCLELLAND, CFA, CAIA, DIRECTOR, ALTERNATIVE INVESTMENTS, CLEARSTEAD

A PRIMER ON VENTURE CAPITAL AND CURRENT MARKET DYNAMICS

BY MIKE MCLELLAND, CFA, CAIA, DIRECTOR, ALTERNATIVE INVESTMENTS, CLEARSTEAD

Private market asset classes have experienced a sharp divergence in performance since the beginning of 2022, when slowing macroeconomic conditions, geopolitical instability, and reactive and restrictive central bank policy flipped the script from economic exuberance to a period of ambiguity. This inflection point has helped beneficiaries of a higher-for-longer interest rate cycle (e.g., private credit), while weighing on risky, rate-sensitive companies. This is especially true with venture capital, which is often defined as early-stage investing in nascent high-risk, high-return companies with disruptive, innovative, and scalable concepts, products, technologies, and solutions. Although public comparables for many VC-backed companies have rebounded from sharp underperformance in the risk-off environment throughout 2022, we continue to see atrophy across the venture space as companies attempt to manage cash burn and hold off from raising new capital at, what would be expected to be, a step down from the prior financing round. Many venture companies are facing existential crises as sales cycles have extended and customer bases pare back spending given an ambiguous macroeconomic environment. That said, not all is doom and gloom in the world of venture capital. Valuations have declined considerably over the last few years and innovation is still taking place. Thematic verticals such as artificial intelligence and machine learning are changing a perpetually evolving venture landscape with

CLEARSTEAD CONTINUES TO BOLSTER TEAM WITH NEW TALENT

We are pleased to announce that we have added talent to the Private Client team with Caitlin Monahan and Theresa Stuckart.

Caitlin Monahan has joined Clearstead as a Managing Director. Caitlin was previously employed with UBS where she was a Vice President of Wealth Management. She also spent 11 years at Fidelity working with corporate executives and 401(k) participants on education, financial planning, and investments. Caitlin brings experience and knowledge on partnering with executives, particularly in publicly traded companies in assisting in complex benefits packages.

Caitlin is currently pursuing her CFP and Chartered Advisor in Philanthropy designations. She is a graduate of Beaumont and serves on the Alumni Engagement and Advancement Committee. She also serves as a First Tee Cleveland Ambassador Committee member.

Theresa Stuckart has joined Clearstead as a Senior Client Service Associate. Prior to joining Clearstead, Theresa was a Client Relationship Associate at Key Private Bank.

These changes underscore the firm's commitment to building its investment consulting practice, promoting the next generation of leadership, and maintaining a rigorous investment process.

the expectation that those technologies will help optimize even the most antiquated of industries. With any widespread dislocation in a particular asset class, there could be a strong entry point for investors. Understanding the history and dynamics within venture capital is paramount to success as an investor, especially due to the riskier (and often binary) nature of early-stage companies.

INTRODUCTION TO VENTURE CAPITAL

Venture capital is a subset of private equity and refers to providing equity to help nascent businesses launch, develop, or expand innovative products and services. It may be surprising to some, but venture capital investing has roots well before the 1990s and 2000s when shifts to networking and desktop internet took place. The origins of the modern venture capital industry can be traced back to the Industrial Revolution when wealthy industrialists began seeding entrepreneurs and start-ups with capital for innovative concepts and products. After World War II, the American Research and Development Corporation ("ARDC") was founded to help garner private capital to back businesses run by veterans returning from the war. ARDC had an early win with its 1957 investment backing Digital Equipment Corporation ("DEC"), a nascent computer start-up that was incubated at MIT. ARDC, after an initial investment of $70,000 for 70% equity ownership and a $2 million loan, made multiples on their money after DEC went public in 1966. At the time of the initial public offering ("IPO"), ARDC's stake in the business was valued at $38.5 million. This, along with the establishment of the Small Business Investment Company Program around the same timeframe, helped mark a turning point for venture capital as an institutionalized asset class for allocators globally and helped set the precedent for future deal marking in the asset class.[1,2]

The foundation set in the post-World War II era enabled significant growth and innovation driven by the rise of the technology sector in the 1980s and 1990s with the backing of dedicated VC firms. Institutional capital began flooding into the asset class after Congress amended the Employee Retirement Income Security Act ("ERISA") in 1979 which relaxed the "prudent man" provision that essentially could hold institutional investors liable for gross negligence performed by venture funds. Additionally, individual taxable investors demanded more access to VC strategies as the maximum tax rate on long-term capital gains declined from 40% in the late 1970s to 20% by 1982.[3] These events helped fuel significant demand to access the venture market and flood the asset class with copious dollars at scale. During this time, Silicon Valley emerged as the epicenter for venture-driven innovation, investment, and technological advancement. This served as a global hub for continuous innovation as best-in-class venture capitalists, start-ups, and founders set up shop in the area.

The enthusiasm that followed a rapidly growing VC market, extreme absolute returns, inflated valuations, low barriers to entry, lax regulation, and significant hype led to the formation of a large bubble across the VC landscape. The "fear of missing out," or "FOMO," drove speculators to pour capital into the asset class with little (or no) investment thesis under the hood. From the beginning of 1995 through February 2000, the Bloomberg IPO Index (a proxy for the publicly traded formerly venture-backed companies) returned over 77% annualized and 1815% on a cumulative basis. Over the next twelve months, the index would decline by over -74%.[4] There were too many dollars chasing companies that offered similar capabilities which led to a mass exodus of laggards and the emergence of a few top-tier providers of select services. In case you need a reminder—think about how many internet browsers used to exist before the millennium.

As the dust settled in the aftermath of the dot-com bubble, strong founders with innovative ideas persevered. The VC market, benefitting from shifting technological trends and globalization, fueled a substantial portion of global economic growth well into the 21st century. Companies such as Facebook and YouTube emerged as market leaders during the shift from desktop to mobile internet. In the 2010s, cloud computing and SaaS ("software-as-a-service") implementation helped drive a new era of future innovation with companies such as Salesforce and Snowflake leading the charge. Lastly, the current shift to generative artificial intelligence and machine learning has fostered a new regime of innovative companies despite turbulence across the VC ecosystem. While the venture market goes through a resetting of valuations and investor expectations, it is important to note that innovation occurs agnostic of current business cycle. Some of the world's most innovative companies were incubated from the venture capital market through a variety of market environments. The term “unicorn” is used by the VC community to describe companies that eclipse $1B in valuation. All five of the “FAANG” stocks (aka Facebook, Amazon, Apple, Netflix, and Alphabet/Google) were funded by venture capitalists. Six of the ten largest publicly traded companies in the world came from the venture space.

Examples of VC-Backed Unicorn Exits

Source: Google (various company logos).

SEGMENTING VENTURE CAPITAL AS AN ASSET CLASS

When assessing the venture capital market as a whole, it is important to segment opportunities based on the financing stage. As a risky and esoteric asset class, garnering investment dollars is a unique challenge for start-ups in the venture world. Capital is needed for product development, market penetration, and working capital requirements for operational continuity and liquidity. The venture capital market can be segregated into several different stages based on maturity of the underlying company.

- **Pre-Seed / Seed Stage**
    - Pre-revenue ideas or concepts requiring validation
    - Initial research and development
    - Enough usability to generate feedback from a small sample of potential consumers
    - ~$12M median pre-money valuation for seed rounds raised in 2023 (slightly positive growth on a year-over-year basis)[5]
    - Investor base includes angel investors and seed-focused VC funds

- **Early Stage**
    - Nascent companies with high levels of revenue growth
    - Focus on acquiring new customers and reducing cash burn
    - Start scaling commercial production and marketing efforts
    - $36M median pre-money valuation for early-stage rounds raised in 2023, representing a decline of -20% year-over-year (“YoY”)[5]
    - Includes Series A and B rounds

- **Late Stage**
    - Companies tend to have proven products or services
    - Sustainable revenue streams
    - Focus on market expansion and product development
    - Breakeven or slightly negative profitability
    - $50M median pre-money valuation for late-stage rounds raised in 2023, representing a decline of -17% YoY[5]
    - Series B+ and C rounds

- **Expansion / Venture Growth Stage**
    - Companies have added some blue-chip companies to their customer base
    - Increased involvement from growth equity and thematic buyout managers
    - Managing customer churn, garnering additional whitespace (total addressable market or "TAM"), contractual revenue base
    - Breakeven profitability or slightly positive
    - Highly correlated to publicly traded growth-oriented and formerly VC-backed companies
    - $144M median pre-money valuation for growth-stage rounds raised in 2023, representing a decline of -47% YoY[5]
    - Series D+ rounds

Traditional VC investors have focused the bulk of their time on seed and early-stage companies while backing their winners in later rounds. In early-stage venture financing, it is paramount to thoroughly evaluate the key personnel within each company. Companies with clear product-market fit but have yet to scale need strong leadership to maintain the growth trajectory at each inflection point for the business. As such, finding and backing best-in-class entrepreneurs is critical for venture capitalists and increases the probability of success in a relatively binary industry. By the time a company reaches late- or expansion-stage status, the management team is largely set, and the company has experienced de-risking from its underlying financial performance. Late-stage VCs and growth equity managers are tasked with maturing companies at scale for a future exit, either by strategic acquisition, special purpose acquisition company ("SPAC"), or IPO.

Relative to strategies that target profitable opportunities in buy-and-build or operations-heavy, value-add private equity, VC-backed companies tend to have high growth rates and return targets, but substantially higher cash burn and expected losses. That said, VC-backed companies have historically used little-to-no leverage unlike traditional leveraged buyouts in the private equity world. As unprofitable entities, and in the aftermath of the Silicon Valley Bank crisis in March 2023, credit availability is predominately constrained to private credit funds at 20%+ all-in rates.

PRIVATE MARKET STRATEGY COMPARISON[6]

Stage	Early-Stage VC	Late-Stage VC	Venture Growth	Growth Equity	Growth Buyout	Buyout
Profitability	Very high cash burn	High cash burn	Modest cash burn	Breakeven+	Modest EBITDA	EBITDA+
Growth Rate	>100%	>75%	>50%	>30%	>20%	<20%
Return Target	>10x+	>5x	>5x	>3x	>2.5x	>2.5x
Expected Loss Ratio	40-50%	25%	25%	<20%	<20%	<15%
Leverage	None	None or modest	None or modest	0-3x EBITDA	2-4x EBITDA	>4x EBITDA
Revenue Multiple	>20x	>10x	>8x	>5x	>4x	N/A
Strategy	"Find product-market fit"	Scale business	Market leadership	Profitable growth	M&A	Operational Improvements, M&A

Source: StepStone Group.
*Venture capital stages are boxed in blue.

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When evaluating venture strategies, allocators should understand the risk/return profile of the asset class. Investing in venture is not for the faint of heart as the dispersion of outcomes can be vast. Prospective limited partners of VC funds should expect multiple underlying investments to be fully written off. To put it in baseball terms, the venture game is all about slugging percentage, not batting average. Venture presents the opportunity to return the entire fund by realizing just a few investments with outsized exits via initial public offering, strategic acquisition, or sizable up round financing. According to Industry Ventures, ~65% of seed and early-stage VC realizations from 2004 to 2013 returned below 1x cost. This dynamic is less dramatic in late-stage VC, with 30% of realizations yielding less than 1x cost, although these companies are much more tied to the health of public markets.

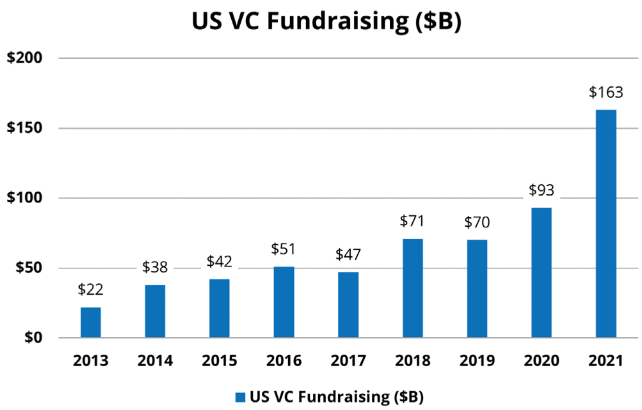
Given the heightened risk/return profile of VC investments, fund manager dispersion is larger than other traditional private and public asset classes. The gap between top and bottom quartile performing venture capital funds is nearly 24%, noticeably greater than the ~2% difference in global public equity funds. Based on the ten-year horizon internal rate of return ("IRR") for global venture funds, the top quartile performing strategies have returned approximately 20% while bottom quartile yielded a net IRR of -4%.[8] Clearly, the overall investor experience in venture can be different which magnifies the importance of manager selection amongst allocators of capital.

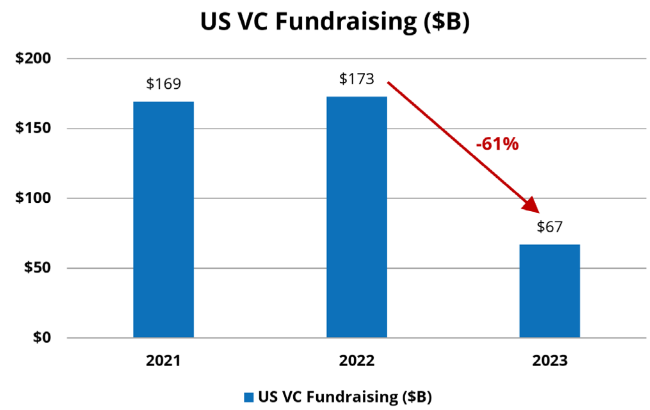
THE STATE OF THE VC MARKET: WHEN THE WELL RUNS DRY

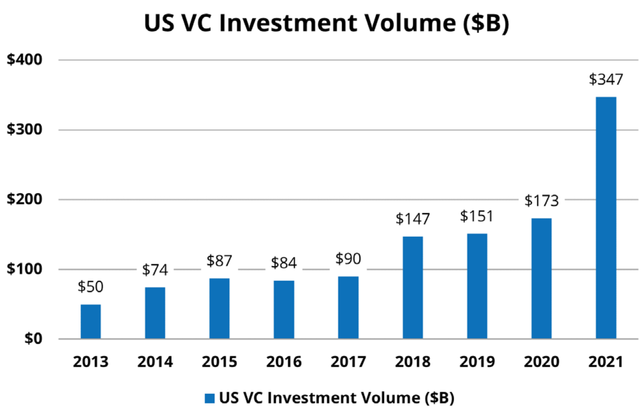
In prior ClearPoint articles, we have illustrated how public market volatility directly affected the flow of institutional capital into private strategies during the sharp drawdowns experienced in 2022. Allocations to privates increased as public markets declined, resulting in a "denominator effect" where investors paused future commitments to private funds as allocations deviated outside of investment policy guidelines. While public markets have transparent pricing and liquidity, private investments are valued infrequently and do not trade regularly. This created a valuation gap during sharp public market drawdowns throughout 2022 as investor portfolios ended up having more exposure to private alternatives than allowed per policy guidelines. Additionally, private fund managers with substantial levels of dry powder left to deploy have extended the runway for declining valuations to enter in at better pricing. This directly impacts sluggish dealmaking activity and indirectly impacts distributions back to investors in adverse fashion. The dynamic is especially true in private market asset classes where most distributions occur towards the end of a fund's term, such as traditional private equity or venture capital.

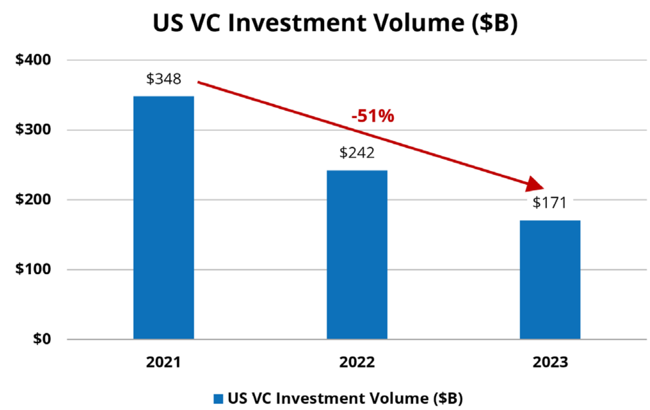
In the venture world, realizations via IPO are directly correlated with the health of capital markets. The same is true for subsequent venture rounds (higher cost of capital). This phenomenon has persisted throughout multiple business cycles, leading to a lack of distributions back to investors which weighs on their ability to fund future commitments. When capital markets froze during the Great Financial Crisis ("GFC"), venture distributions as a percentage of beginning net asset value ("NAV") declined to ~4.2% by Q2 2009, after peaking at 24.1% approximately 18 months prior. Post-GFC, exuberant capital markets helped propel this figure to 32.0% in the middle of 2021. Current venture-backed IPO activity has fallen off a cliff, declining from $676 billion across 309 listings in 2021 to $33 billion (80 total listings) in 2022 and $29 billion (84 total listings) in 2023. Over the last few years, the lack of exits via IPO, strategic acquisitions by corporations, and new follow-on financings has shuttered investor distributions in the VC world to levels not experienced since the GFC at 5.8%.[5] You need to go back nearly 10 years for the DPI (also known as "distributions-to-paid-in-capital") of top and median quartile performing VC funds to eclipse 1.0x.[9] At an investor conference in March, a partner for a respected venture firm stated "DPI is the new TVPI" meaning limited partners are laser-focused on the pacing of historical realizations (and therefore distributions) when assessing new and existing, open VC funds.

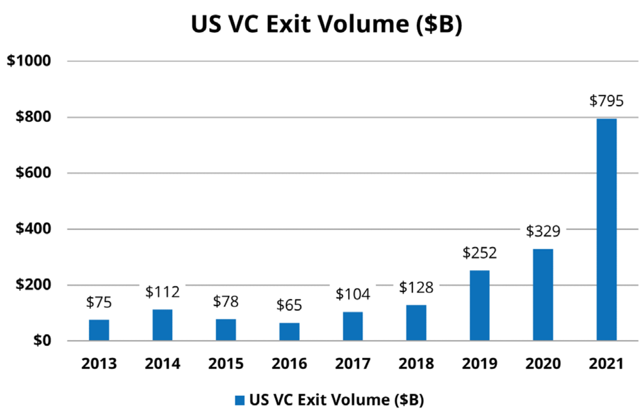
The frigid exit environment will inherently extend the holding period across venture-backed companies, which hopefully have enough cash on hand to withstand an economic slowdown or minimize cash burn. That would prevent venture-backed companies from raising additional funding at, what is likely to be, lower valuations. The trend should persist as fund managers have a copious amount of dry powder available for investment and are effectively on the clock to allocate within a preset investment period per fund terms. Raising new equity rounds in VC-backed companies was more costly to investors versus waiting for capital markets to reopen and managing cash burn conservatively. As such, dealmaking activity collapsed over the last few years, with investment dollars declining by -51% and exits drawing down by over -90%.[5,7]

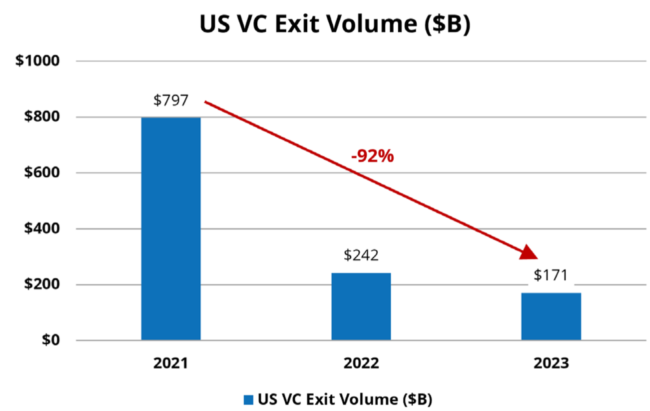












Source: PitchBook Q1 2024 NVCA Venture Monitor Summary, StepStone Research: Venture Capital State of the Market (March 2024).

Step-ups in valuation for subsequent financing rounds have evaporated. During a recent discussion with an established venture capital manager, a partner described the impact of the resetting of valuation expectations on new financings as "raising a flat-round is the new up-round." Down-rounds accounted for nearly 20% of equity rounds raised in 2023.[7] While founders and VCs may hold out for a better period to raise capital, a recent study estimates that nearly 50% and 80% of VC-backed companies will run out of cash by June 2024 and mid-year 2025.[10]

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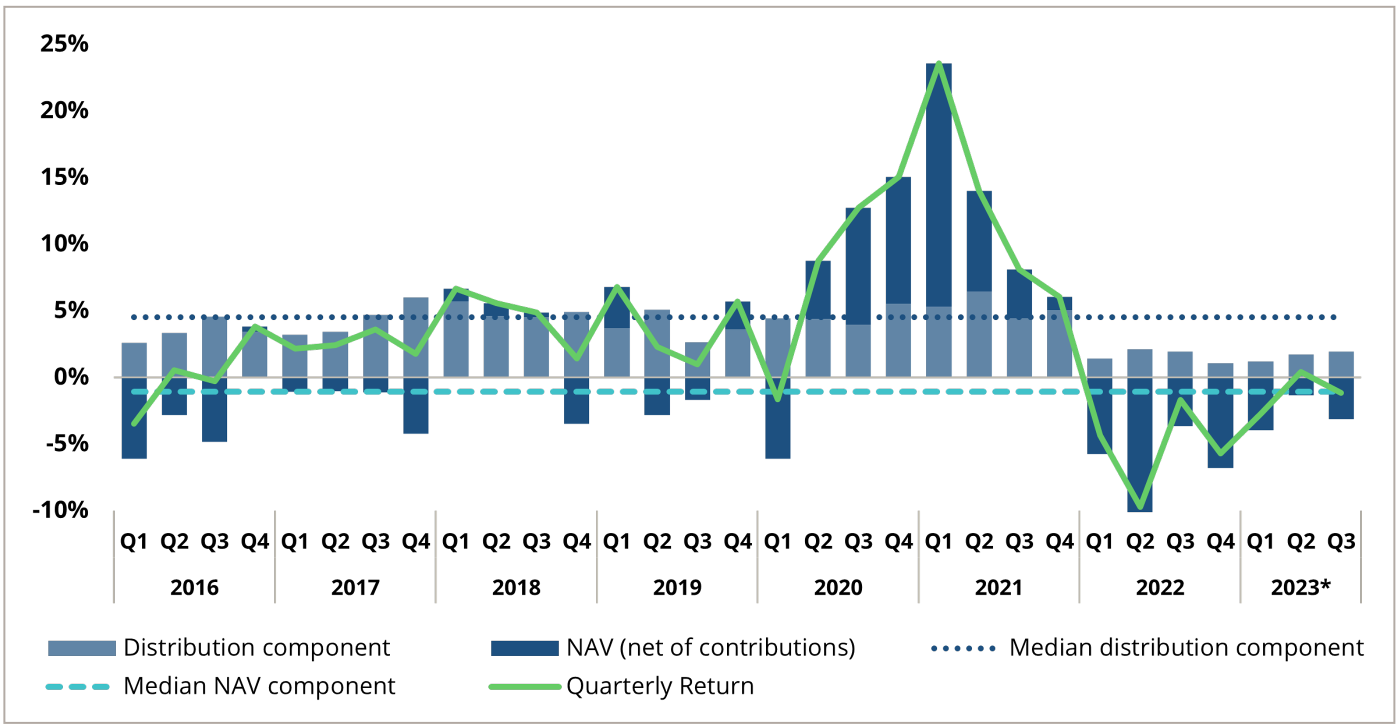
Over time, venture capital funds have accumulated a lofty amount of unrealized value after capitalizing from historically low interest rates, strong macro tailwinds, and an attractive exit environment (notably via IPOs). Recent PitchBook data estimates that U.S. venture funds held over $900 billion of unrealized value at the end of 2023. While publicly traded growth companies have whipsawed from 2022 lows, venture capital funds have experienced slow yet sustained atrophy from a valuation and returns perspective. Venture-backed companies have attempted to curtail extreme levels of cash burn amidst an opaque outlook for future financing. They also have faced slowing sales cycles with new customers and increased churn from existing clientele. Company valuations are gradually reflecting economic reality, and as such, funds have marked unrealized positions lower. Funds with elevated levels of unrealized gains would like to capture these returns at current valuations, but with a shuttered capital market environment and weakening company financials, expectations have met reality in the form of lower marks and negative performance. When capital was cheap and readily available to risky endeavors, venture-backed companies grew substantially. From Q2 2020 through Q4 2021, U.S. venture capital strategies returned over 88% on a cumulative basis. Removing distributions from the equation, underlying company appreciation in the form of NAV returned over 53% during that timeframe. The drawdown impacting VC markets began in Q1 2022 and has continued today, resulting in a -25% peak-to-trough decline through Q3 2023. The underlying NAVs of venture-backed companies continue to fall and have decreased by over -36% since the beginning of 2022.[5]

US VC QUARTERLY RETURNS BY SOURCE (% OF BEGINNING NAV)[5]



Source: PitchBook as of September 30, 2023.

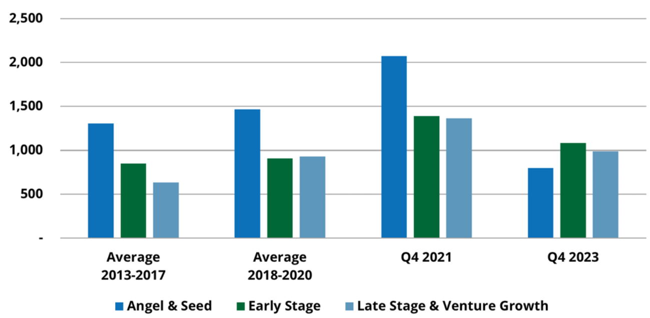
PEAK DISLOCATION OFTEN PRESENTS GREAT ENTRY POINTS

Given the higher-octane nature of venture investing, stagnant dealmaking and exit environment, and greater importance on manager selection, some may question whether the juice is worth the squeeze. Technological innovation and advancement have persisted through multiple business cycles and the current market environment bodes well for the future innovators and disruptors to form high quality products and solutions. Despite a general slowdown of VC deal activity, the sheer volume of venture-backed deals has exponentially increased over the years, nearly quintupling to 54,780 since the end of

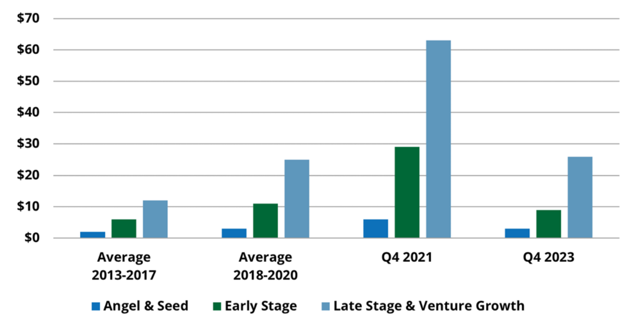
2010. This has primarily been driven by an exponential increase in the volume of seed-stage deal activity, which has jumped over 11x since 2010.[11] It has never been easier to form a start-up than it is today, especially outside of traditional venture markets (e.g., Silicon Valley). There has been a plethora of strong venture capital firms formed in non-traditional markets to target non-coastal opportunities, often at lower pre-money valuations than their Bay Area counterparts. For example, early-stage VC rounds raised in the Mountain West region were valued at a 41% discount versus deals backing companies based in California.[10] The technological platform shift to generative AI and machine learning has fostered an era of potentially market-leading companies incubated globally. While there is plenty of risk associated with new and emerging verticals, AI enablement and implementation across all industries is estimated to create $3.5-5.8 trillion of value on an annual basis.[7,12] The estimated productivity gains are too fruitful for companies to ignore, which should lead to a broad implementation of AI capabilities agnostic of sector.

Another silver lining in the broad dislocation impacting the venture landscape is, what appears to be, a normalization of deal value, transaction volume, and pre-money valuations across all stages. The total value in early and late-stage VC deals has fallen by -69% and -59% from peak levels reached in Q4 2021. From a valuation perspective, late-stage (Series D+) rounds are tracking public markets closely, down -70% from their peak while earlier stages (Seed – Series C) are down -28% on average. This does not mean later stage VC-backed companies are necessarily undervalued relative to early-stage counterparts—look at the late-stage parabolic growth during the run up to the market stress. Series D valuations traded up by over 13% from Q1 2020 to Q2 2022, while Series A rounds were priced higher by ~66%.[5,7] This broad repricing across all venture stages is **healthy** for the asset class and a re-rating presents solid opportunities to find high quality investment opportunities.

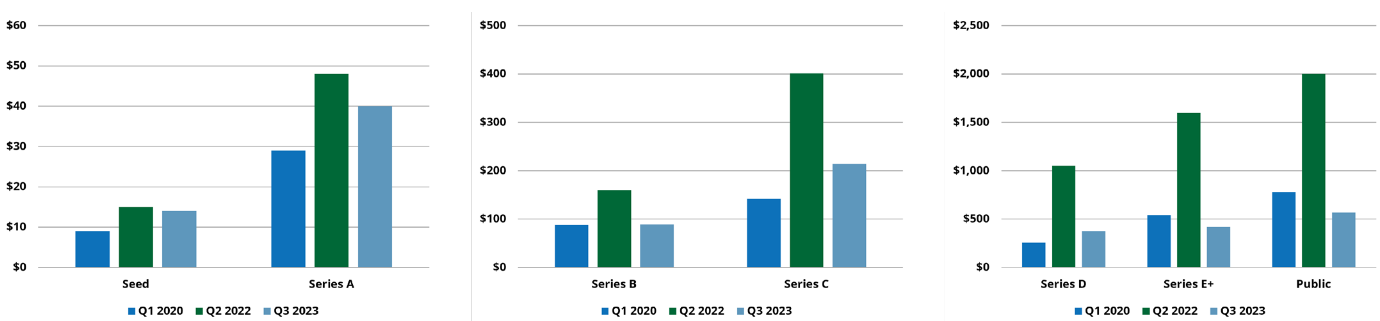
Deal Count by Period



Deal Value by Period ($B)

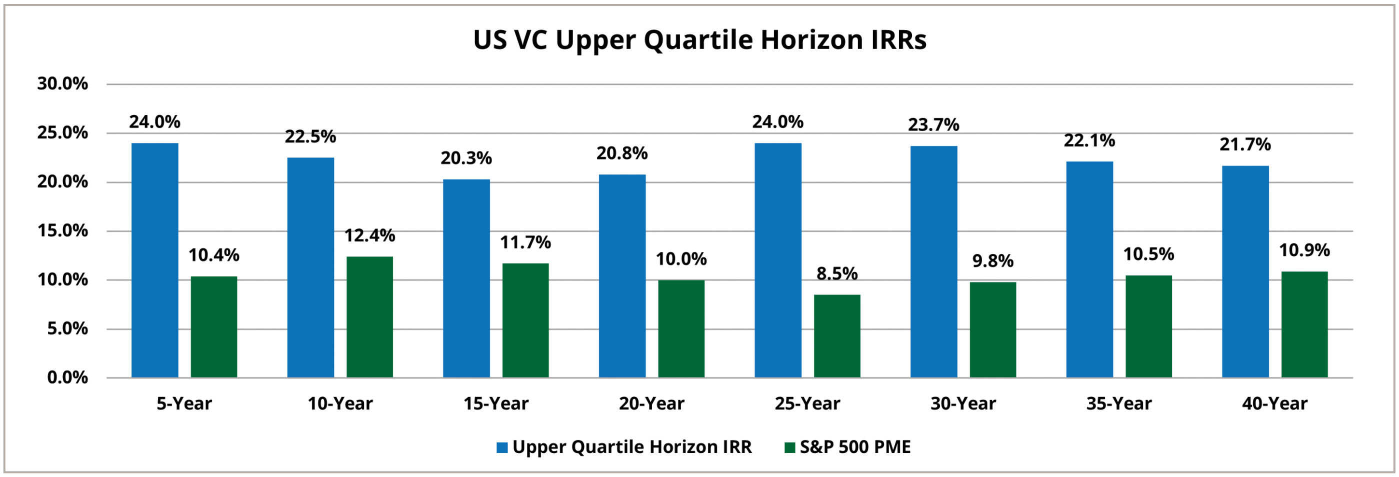


Median Pre-Money Valuation by Funding Round ($M)



Source: PitchBook Q1 2024 NVCA Venture Monitor Summary, StepStone Research: Venture Capital State of the Market (March 2024).

Despite a prolonged period of declining valuations and negative returns, venture capital has generated strong outperformance relative to public markets over several trailing periods and through some business cycles.[13] While it may feel uncomfortable to commit to a new strategy given the current state of the VC market, allocators should also understand how critical maintaining a disciplined commitment schedule is to overall portfolio returns. Investors are risking missing out on potentially strong outperformance when they try to market time new vintages in venture capital. Based on research conducted by StepStone, skipping a commitment to the top five vintage years for venture capital funds would be detrimental to an investor's total return over a market cycle. Investors would miss out on an additional 4.48x MOIC over the past 15 years on a cumulative basis, returning a 1.19x instead of 5.67x had they stayed the course on a commitment program.[7] Additionally, PitchBook estimates that the number of pent-up VC-backed IPOs has increased to the highest levels since 2010. Backlogged IPOs going public not only should help overall returns, but investor optimism should rebound as well.



Source: Cambridge Associates as of 9/30/2023; includes 1981–2019 vintage years.

Manager selection is critical when investing in venture capital strategies. There can be a glaring dispersion of returns between top and bottom quartile managers, especially during periods of market stress. Our focus has always been on finding high-quality strategies backed by best-in-class investors that can generate strong performance independent of where we are in a market cycle. We look for managers that have unique or proprietary sourcing capabilities, a strong operational value-add focus, a culture of rigor and alignment with our clients, strong historical performance, and do not rely on generating the bulk of prior returns from market beta. While it may be difficult to stay the course, opportunity presents itself during times of trial. The venture capital game has changed dramatically in a higher interest rate environment and there will be winners and losers when the dust settles. Innovation is still occurring while pricing has repriced substantially. With the current platform shift to generative AI, investors have an opportunity to participate in a trend with significant global whitespace across industries. It may be a great time to back capable venture capitalists, especially with the guidance of an experienced, trusted advisor.

Sources:

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(6) StepStone Research: Growth Equity and Venture Capital Outlook (February 2024).
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(8) J.P. Morgan Asset Management Guide to Alternatives, Lipper, NCREIF, HFRI.
(9) PitchBook Benchmarks – North American Venture Capital (September 2023).
(10) Silicon Valley Bank: "State of the Markets: SVB's Innovation Economy Outlook".
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(12) McKinsey: Economic Potential of Generative AI June 2023.
(13) Cambridge Associates.

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MARKET BENCHMARK RETURNS

April 30, 2024		1M	3M	12M	YTD
US Large Cap	S&P 500	-4.1%	4.3%	22.7%	6.0%
US Small Cap	Russell 2000	-7.0%	1.7%	13.3%	-2.2%
Developed Intl	MSCI EAFE	-2.6%	2.5%	9.3%	3.1%
Emerging Intl	MSCI Em Mkt	0.4%	7.8%	9.9%	2.8%
Real Estate	NAREIT	-7.8%	-4.4%	-0.3%	-9.0%
Core Fixed	BarCap Agg	-2.5%	-3.0%	-1.5%	-3.3%
Short Fixed	BarCap 1-3Yr	-0.3%	-0.3%	2.8%	0.1%
Long Fixed	BarCap LT G/C	-5.5%	-6.3%	-7.2%	-7.7%
Corp Debt	BarCap Corp	-2.5%	-2.7%	0.8%	-2.9%

Source: Bloomberg

The performance data shown represents past performance. Past performance is not an indicator of future results. Current performance data may be lower or higher than the performance data presented.