Chapter Seed Money & Venture Capital

Technology and science are changing our world more profoundly than ever. Innovation cycles become shorter and new products penetrate markets faster with high transformative dynamics. These developments provide a fertile ground to startups and entrepreneurs who are taking advantage of these opportunities in growing numbers. Among many factors, they need capital to start, grow and flourish. This capital is provided by Angel and Venture Capital investors.

VC funds

Venture Capital investments are no passive investments. The manager of the Venture Fund strives to further improve the chances of success of each portfolio company through active support in every aspect, especially through strategic backing. The risk of this asset class thus results from the entrepreneurial risk each company bears, which is according to the early investment phase. Consequently, Venture Capital funds strategically keep the risk moderate by spreading it over a sufficient number of diversified portfolio companies.

The holding period of such a stake is approximately 6 years in average. During this time, the company can develop from a start-up to a leader in the respective sector or can achieve a "proof of market" or "proof of technology". Thus, with regard to an entire portfolio, this results in a fund lifetime of a Venture Fund of at least 8-10 years.

Venture Capital funds are typically organized as limited partnerships, whereby the General Partner invests the managed capital of the investors (Limited Partners) as private-equity stakes in start-ups. Generally, a part of the managed capital is invested by the General Partner himself (General Partner Commitment). VCs finance new companies with strong growth potential, take board positions and add value to the company through active support of the companies. Returns are generated through the divestment of stakes (exits), mainly via trade sale (90% of all exits) and secondary transactions, as well as occasionally via IPOs. Besides a high-risk/high-return profile, Venture Capital investments exhibit further principal properties:

- 100% of the investments go to the company (and are invested directly into research, personnel, marketing, etc.).
- Normally, a clear minority stake is acquired, which is secured with extensive minority safeguard clauses.
- Venture stakes are supervised very actively. Generally, there is one of the Venture Fund partners in the board of a portfolio company.
- Over the development cycle of a technology venture, there are several necessary financing rounds and steps. With growing maturity of the company, the requirements with regard to the investors change.

VC Stands out as an Asset Class

- Low correlation with stock market: Private equity has performed well despite the financial crisis and its aftermath, with significant VC-backed exits even during the Internet and housing crises. Independent of the strategy, private equity regularly outperforms the return of public equity and according to Preqin, showed a return of 4.7% annually between 2008-2013. This represents an annual outperformance over public equity of more than 700 basis points, compared to the MSCI World Total Return Index, which lost 2% in value during the same period.[1,2]

- Performance Comparison: Historically, Private Equity and Venture Capital have proven to be a consistently high performing asset class, outperforming other asset classes. When comparing performances of asset classes over a 30-year horizon, there is significant value-contribution by Venture Capital compared to common bond- and stock indices.[3-5]
- Current environment and outlook: General performance expectations for traditional asset classes are modest, with by far more potential in alternative asset classes, such as Venture Capital. As an example among many others, Credit Suisse expects: "Looking forward, we think zero real returns for bonds and 4% to 6% for equities would be a good assumption, with trend returns on a typical mixed portfolio of stocks and bonds down to only 1% to 3% p.a. [...] In a world of diminished beta, necessity will likely drive a renewed search for alpha. This could, for example, take the form of [...] in-corporation of alternative risk premia into multi – asset portfolios [...] ".[6]
- European VCs drive the best exit multiples globally: While Europe and especially Switzerland are global innovation leaders, there is a significantly lower Venture Capital availability per head compared to many other regions.[7] This is highlighted by the fact, that the Bay Area (US) alone has almost a 100 times higher Venture Capital availability than the DACH region.[8-10] In light of the importance of this asset class for the development of any start-up into a market-leading company, this capital imbalance is dramatic. Already today, the immense impact of Venture Capital on the US economy is obvious. Over the past 30 years, Venture Capital has become a dominant force in the financing of innovative American companies. Despite the young age of the VC industry, already one fourth of the largest public US companies are VC backed (e.g. Apple, Amgen, Intel, Google, Facebook, Skype, Ebay, Genentech, Fedex and many more) and make up around 25% of the S&P index, while additionally accounting for up to 40% of the R&D spendings by US public companies.[11] Since 2007, VC investment has amounted to approximately 0.2% of US GDP, while generating 21% of the GDP, underlining the economic importance of this asset class.[12] Furthermore, US startups are responsible for over 30% of all jobs created in the past.[13] At the same time, there are hardly any large public companies in Europe that are venture-backed, with leading European stock indices, like e.g. the DAX, without a single venture-backed company.
- This market situation has created a unique opportunity for investors focusing on Europe today. With only a fraction of start-ups receiving VC funding, VCs can be very selective. The insufficient number of private investors and the lack of pension and endowment funds, which account for roughly 65% of the US VC industry, created a buyer's market in Europe.[14] Significantly lower entry valuations than in the US, lower costs of growing businesses and a tighter control of cash invested are guaranteeing the highest efficiency. Thus, although average exit values are around 25% smaller, European VC funds are proportionally generating higher exit multiples, while investing only half the capital to build the winners. In addition, the high innovative strength of European start- ups and the high selectivity by VCs have led to an over proportional share of successful exits.[15]

The SECA Chapter

The aim of the SECA Chapter for Seed Money and Venture Capital is the general representation and to inform and educate its members, the public, corporates and investors about all matters related to seed investing and venture capital. A long-term goal is to improve the general conditions in Switzerland to set up and run VC funds.

References

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Dr. Michael Sidler
Founding Partner

Redalpine Venture Partners AG
Pfingstweidstrasse 60
8005 Zürich

michael.sidler@redalpine.com