STEPSTONE
inside private markets

History Doesn't Repeat Itself… But It Rhymes

Venture Capital's Unique Ability to Navigate Volatile Markets

Venture capital (VC) has performed extremely well over the last 5, 10, and 15 years, beating the S&P 500 by more than 700 basis points on average.[1] Across market cycles, we have witnessed certain vintages reward investors with truly outsize returns, and we feel confident that current conditions, no matter how dire the noise around markets can seem, could lead to similarly high-returning vintages. We believe investors with the flexibility to overweight exposures to VC when conditions are ripe can be disproportionately rewarded. As we enter a period that we believe will be defined by less capital raised, smaller fund sizes, slower investment pacing, fewer market participants, and lower valuations, perhaps the time to overweight is now. In this short paper, we'll seek to explore which of these factors create the environment for an outsize vintage and why the next 24 to 36 months, in our view, could provide just the right mix of market dynamics.

VC FUNDRAISING: STRONG BUT SLOWING

VC funds had a banner year in 2021, raising more than $138 billion (**Figure 1**). While VC fundraising has remained robust in the first six months of 2022, the sustained momentum is due in part to the fact that several large platforms, including a16z and Accel, completed their capital raises in the first half of the year and collectively secured approximately $15 billion in capital commitments.

[1] Cambridge Associates, PME S&P 500 Index, March 31, 2022.

September 2022

While we fully expect well-known VC brands to continue to complete oversubscribed fundraises in excess of $1 billion, we believe a number of economic factors will converge to create a much more challenging fundraising environment in the coming quarters.

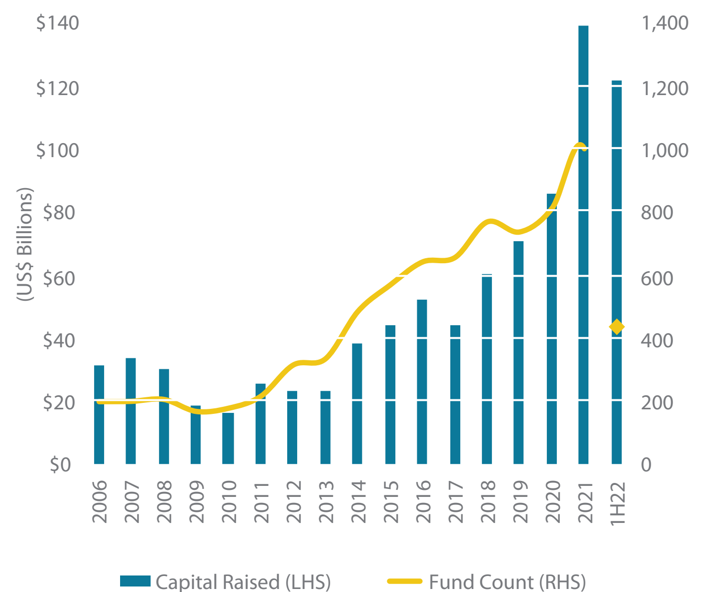
» **The denominator effect**—In general, performance in other, more liquid, asset classes (e.g., public markets and fixed income) has declined more rapidly and materially than in VC. This phenomenon may leave many plans overallocated to VC relative to targets. As such, these plans may be forced to halt or scale back future commitments to managers in the asset class. In a nutshell, the denominator effect decreases the available pool of capital from which VC firms can raise.

» **Limited liquidity**—The current volatility and re-pricing of higher-growth public companies have temporarily closed the IPO window. While large corporates and even private equity buyout funds may opportunistically seek to acquire public companies whose market caps have materially declined, it is unclear how keen they will be to acquire private venture-backed companies. In general, the expectation is that the average time to liquidity for venture-backed companies will extend in the coming years.

» **Extended fundraising cycles**—In an environment where valuations are declining and could continue to fall in a manner consistent with public markets, most venture-backed companies are choosing to delay capital raises to focus on execution. And they have the cash to do it. In 2021 alone, $340 billion was invested into venture-backed companies, leaving companies with healthy balance sheets and long cash runways. Further contributing to the capital deployment slowdown is the fact that VC firms are seeking to better understand where valuations will ultimately settle as opposed to attempting to "catch a falling knife." Rather than deploying a fund in 18 months, we expect most VC firms to return to a two-to-three year average cadence.

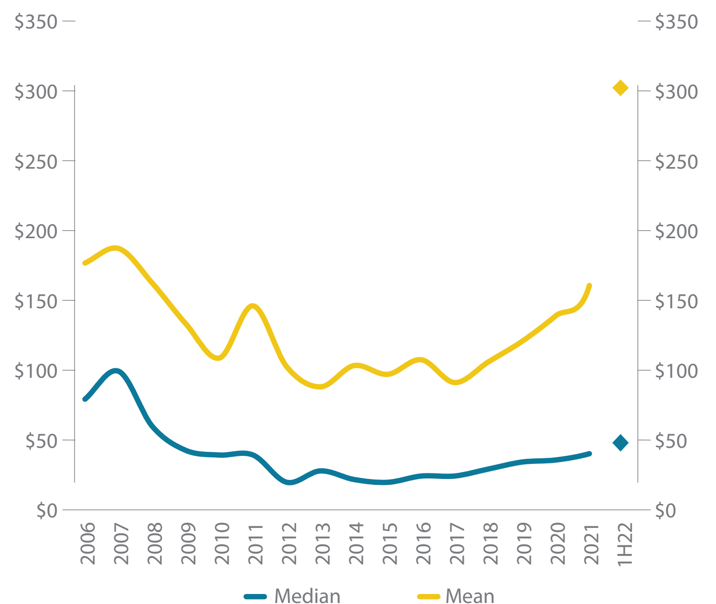
» **Smaller median fund sizes**—When the capital available to allocate to an asset class declines, we have found it is disproportionately harder for smaller, less established managers to raise funds. Between 2009 and 2013, when venture fundraising totals fell below pre–Global Financial Crisis (GFC) levels, the median fund size for the industry declined even more rapidly (**Figure 2**). We expect a similar phenomenon to occur in the coming years.

FIGURE 1 | ANNUAL US VC FUNDRAISING



Source: PitchBook-NVCA Venture Monitor, July 2022.

FIGURE 2 | MEAN AND MEDIAN US VC FUND SIZES (US$ MILLIONS)



Source: PitchBook-NVCA Venture Monitor, July 2022.

The only time in recent memory when fundraising totals declined was during and just after the GFC. While the underlying economic conditions are very different now than in 2009, we believe 2009–2013 could offer some insight into what lies ahead. Fundraising totals fell more than 50% from pre–GFC levels in 2007 to an all-time recent low in 2013. Given the conditions described above, a similar slowdown could be on the horizon. There is good news in all this noise: In general, when capital is scarcer, the asset class tends to perform better.

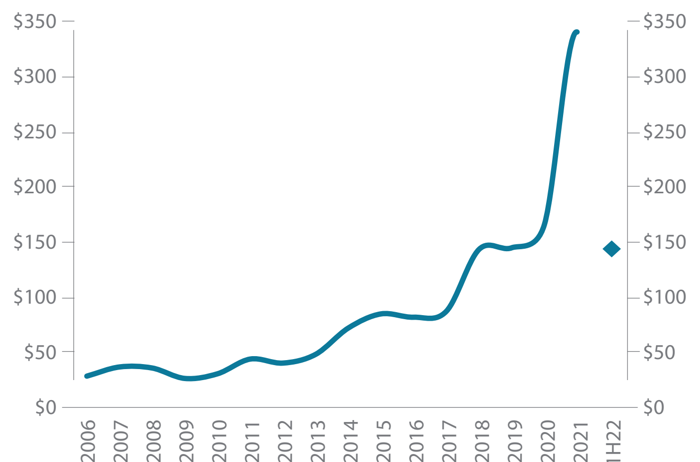
GREAT COMPANIES ARE BORN OUT OF ALL MARKET CYCLES

Recessions have not historically impeded startup activity. In 2006, fewer than 1,000 companies raised capital in seed and angel rounds.[2] In 2012, during the aftermath of the GFC, more than 3,500 companies were financed by institutional angel and seed investors. Fast-forward to the current market: The pandemic accelerated technology and innovation trends that had been quietly brewing for decades. In the past 24 months, we have witnessed the most rapid acceleration of technology adoption and digital transformation in history. This period shined a spotlight on innovation and technology adoption in areas such as supply chain disruption, health care, cybersecurity, artificial intelligence, ecommerce, Web3, blockchain and web infrastructure. We firmly believe that the supply of high-quality companies seeking to raise capital will grow irrespective of market conditions. This, coupled with less capital available for investment, may bode well for VC.

INVESTMENT PACE HAS DECLINED AND WILL CONTINUE TO DO SO

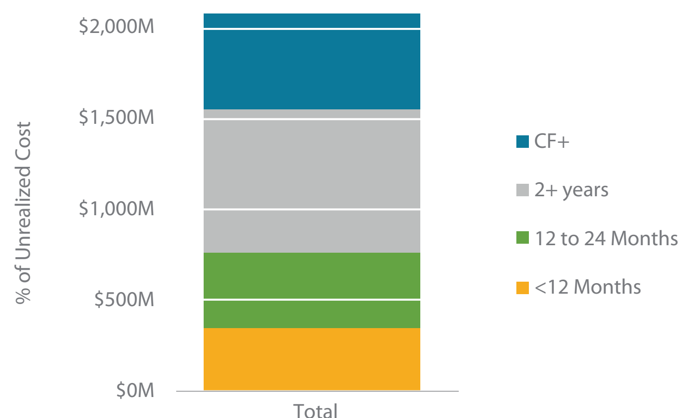
VC fund managers' and entrepreneurs' mentality in the first half of 2022 can be best described as "wait and see." Firms were reluctant to aggressively deploy capital into a rapidly evolving (and potentially improving) valuation environment, while entrepreneurs found it less necessary to pursue financing rounds with already healthy balance sheets. With the exception of a few large outliers, we expect to see fewer rounds raised with less capital invested in the medium term (**Figure 3**). We believe the investment pace slowdown will be underpinned by the factors outlined below.

FIGURE 3 | US VC INVESTMENT ACTIVITY—DEAL VALUE (US$ BILLIONS)



Source: PitchBook-NVCA Venture Monitor, July 2022.

FIGURE 4 | STEPSTONE VC DIRECT PORTFOLIO RUNWAY



Source: StepStone Portfolio Analytics & Reporting. Total unrealized direct investments made as of March 31, 2022. Excludes Spectrum assets and public companies.

The robust private company financing environment over the past 24 months has resulted in well-capitalized businesses with strong balance sheets. Drawing on data from StepStone's own portfolio companies as a proxy for the broader market, over 60% either are cash-flow positive or have two or more years of runway (**Figure 4**). As a result, our portfolio companies, and

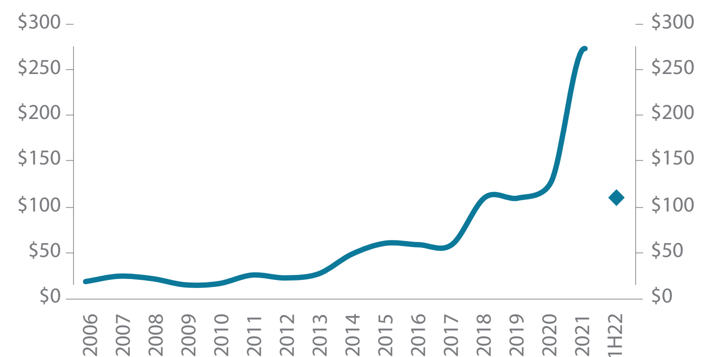
[2] PitchBook-NVCA Venture Monitor, July 2022.

many in the broader market, are forgoing financing rounds. Not only does this approach ensure that optimal execution is front and center, but it also helps avoid founder dilution, down rounds and other headline risks. With fewer companies in need of capital infusions, it's unsurprising to see fewer rounds of financing coming together.

Like the supply side of the equation (the number of companies seeking to raise new financing rounds), the demand side is waning. Not surprisingly, nontraditional VC investors are participating in far fewer deals than in years past.[3] Seasoned VCs pejoratively refer to these groups as "tourists" for a reason—they tend to be sporadic participants in the ecosystem driven by short-term upside rather than developing all-weather strategies to invest across multiple market cycles. With the IPO window temporarily closed, and the public markets no longer rewarding high-growth businesses, fewer tourists are looking to VC for arbitrage opportunities. The first half of 2022 featured the lowest participation rate of nontraditional investors since 2018 (**Figure 5**). We expect a similar trend in the years to come as "tourists" retreat to core competencies.

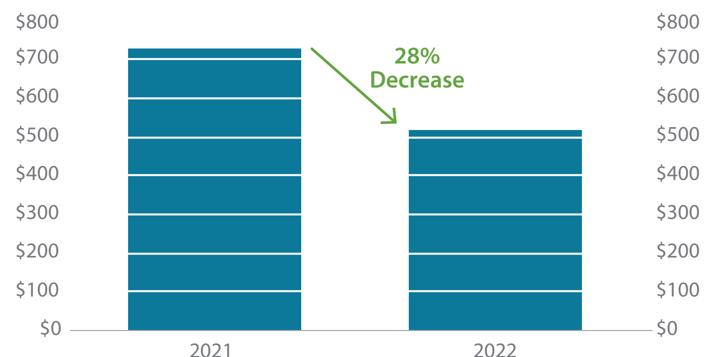
Historical data suggest that VC tends to absorb the impact of public market dislocation at a lag. For the year to date, BVP's NASDAQ Emerging Cloud Index is down 41%. While private company valuations have declined materially as well (see **Figure 6**), we believe we are in the first stages of a private market valuation reset, best presaged by the aforementioned slowdown in investment pacing. This belief is grounded in

FIGURE 5 | NONTRADITIONAL US VC INVESTMENT ACTIVITY—DEAL VALUE (US$ MILLIONS)



Source: PitchBook-NVCA Venture Monitor, July 2022.

FIGURE 6 | AVERAGE LATE-STAGE VC PRE-MONEY VALUATIONS (US$ MILLIONS)



Source: PitchBook-NVCA Venture Monitor, April 2022.

[3] We define non-traditional investors as hedge funds, crossover funds, mutual funds, traditional private equity firms, sovereign wealth funds and corporate venture capital.

data from the GFC. **Figure 7** illustrates that post-GFC stresses were not fully reflected in private market valuations until the second half of 2009. Our expectation is that a similar pattern will repeat with the full impact of the correction not priced until several quarters in the future.

VC HAS PERFORMED WELL DURING DOWNTURNS

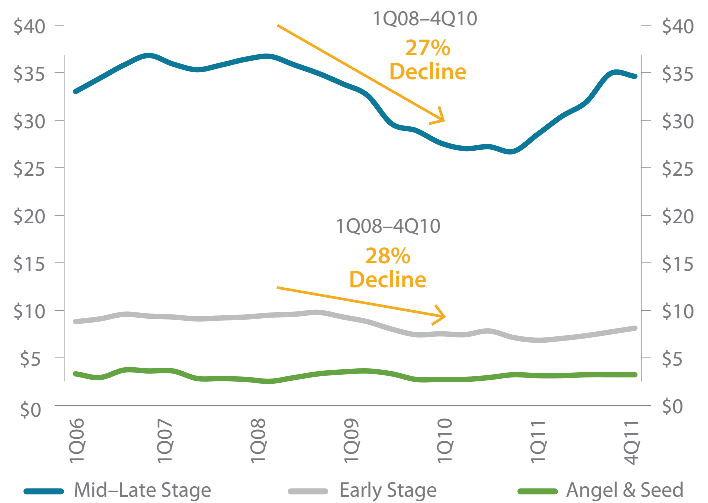
As Warren Buffett famously quipped, "Only when the tide goes out do you discover who's been swimming naked." Similarly, we believe the market correction we're witnessing will be a healthy recalibration of the venture ecosystem that will reward skilled VC investors. As pacing slows, valuations reset and nontraditional VC entrants retreat to their comfort zones, we expect the next 12 to 24 months to present a prime window for top VCs to enter high quality companies—of different stages—at very attractive prices. Historical precedent (**Figure 8**) suggests vintages that coincide with recessionary periods often outperform. For example, the 2010, 2011, and 2012 vintages years, which immediately followed the GFC, are three of the five best performers in the past 15 years, all with upper-quartile net multiples in excess of 3.8x. We believe current conditions match the factors that created the foundation for those outperforming vintages; likewise, we expect the coming years to be high-performing VC vintages.

Conclusion

The years emerging from the GFC were some of the best vintages in VC history. The current market correction is a healthy recalibration for the venture ecosystem, and we believe it presents a compelling opportunity for experienced VCs who can successfully navigate challenging market environments. Some investors will take a pause, and some will dive in headfirst. The nature of the market has fundamentally changed, and we believe now is an opportune time for investors to get off the sidelines and into the game.

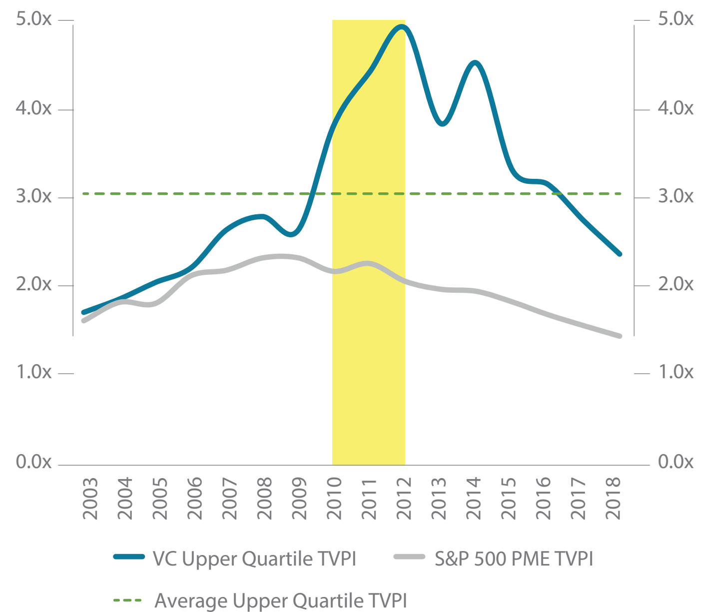
With everything we've outlined in this paper, we think that it's never been more important for managers like StepStone to rely on what's always driven our success, using the relationship advantage we gain from investing in top-performing VC funds to power our investment platform flywheel. In challenging investment cycles, it is critical to use all the tools available such as relationships, data and deal flow advantages to ensure one is positioned to capture the coming upside.

FIGURE 7 | PRE-MONEY VALUATIONS BY STAGE—ROLLING FOUR-QUARTER MEDIAN (US$ MILLIONS)



Source: PitchBook, "Venture capital in the Great Recession," April 2019.

FIGURE 8 | VC RETURNS FOLLOWING THE GREAT RECESSION



Source: Cambridge Associates, September 30, 2021. Past performance is not necessarily indicative of future results, and there can be no assurance that the investment will achieve comparable results or avoid substantial losses. IRR and TVPI for certain vehicles may have been impacted by StepStone's or the underlying GP's use of subscription-backed credit facilities by such vehicles. Reinvested/recycled amounts increase contributed capital.

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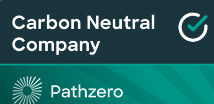

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