The Alpha Algorithm For Micro-VC Managers

Historically, limited partners (LPs) seeking alpha have typically looked to access allocation in the brand-name venture capital (VC) firms while avoiding emerging or smaller managers given the potential risks. However, what is seemingly unknown to many is that the tide appears to be turning, with Micro-VC funds increasingly representing a sizable portion of achievable alpha.

Put simply, this venture return equation should not be ignored.

The Alphabet Is Changing and Making Room for Micro-VC

The traditional VC financing continuum has broadened over the past several years. Companies staying private longer, the horizontal integration of technology and innovation across industries, and a friendlier environment for company creation are a few reasons for this shift. Compared with a decade ago, early-stage technology companies are now raising nearly three times as many institutional financing rounds prior to a Series A round. The increased expectation for companies to exhibit stronger traction and operating metrics has led to raising the bar for Series A deals, resulting in larger checks and funding rounds, further enlarging the Seed category. The idea of a single financing round has been replaced, and Seed itself is no longer one category. Institutional Seed has displaced angel investors,

January 2022

with Micro-VC funds emerging as a new venture sub-category to accommodate these new rounds of pre-Seed, post-Seed and small series (**Figure 1**).

Once a company reaches Series A, brand name matters. The venture managers that have built reputable names over a long period have a huge advantage in accessing and winning deals. Often, these managers choose not to enter pre-Seed rounds, given their larger fund sizes and the number of portfolio companies they are already managing. This opens the window and provides an opportunity for Micro-VC managers that are raising smaller funds and often seek a more hands-on approach with their investments.

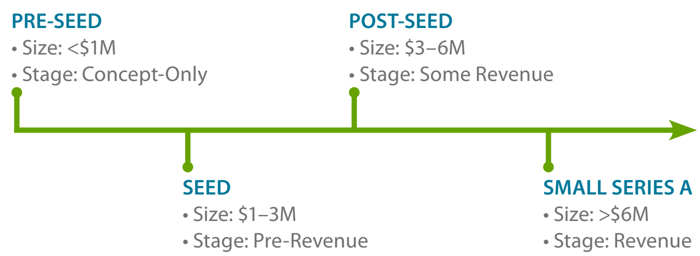
» They invest earlier than Series A–focused managers where it becomes more competitive, without sacrificing ownership.

» The universe of these managers has grown over the last five years, typically raising fund sizes between $40 million and $250 million.

» Micro-VC managers tend to benefit from being early movers, as they are able to set the tone, gain higher ownership and develop strong engagement and relationships before the Series A groups get involved.

Institutional Seed has displaced angel investors, with Micro-VC funds emerging as a new venture subcategory to accommodate these new rounds of pre-Seed, post-Seed and small series.

FIGURE 1 | 2021 Seed VC Landscape



Source: StepStone Group, 2021.

Ultimately, the ability to garner an information and relationship advantage results in optionality for subsequent financing that would ordinarily be difficult to access as a new LP.

Multiple Ways to Win

As we think about the extended financing continuum wherein Seed has become the new Series A, the risk-return profile has proven to be similar. The perception that investing in unproven, high-loss strategies is a binary proposition is a misconception when considering the evolving VC landscape with Seed and Early Stage being far more versatile. The historical lottery approach to constructing a VC portfolio has since evolved and been replaced with a more thoughtful, measured and risk-adverse approach. This methodology has best been afforded to scaled platform investors that possess the informational, resource and relationship advantages to assist with sourcing and diligence. In the 1990s, the typical venture fund had a loss ratio of more than 50%, but since then, this figure has decreased considerably to roughly 20%.[1] The time and capital involved in determining whether a company is viable has also fallen over the past few decades, further contributing to venture's attractive risk-return profile.

Emerging managers are also known as "first-time funds;" however, these funds are often led by investors who are either spinning out of brand-name VC firms or entrepreneurs with strong track records of investing and creating companies.

[1] Cambridge Associates LLC Private Investment Database, 2019.

Micro-VC managers are made up of a subset of individuals and groups that are innovative and have a clear vision of market opportunities. The multifaceted approach has led to far-reaching opportunities to pursue strategies that have historically been overlooked or are still emerging. We believe this dynamic has materialized in such a way that there are multiple ways to win within Micro-VC funds. This is evident in the distinct players listed below who represent different niches, ultimately building diversification while remaining one-dimensional.

» **Manager spinouts**—high performers departing venture firms to start their own fund. Spinning out of a brand-name firm often attracts LP attention; therefore relationships, experience, individual track records and using the right platform can help an LP be a spinout's first call.

» **Venture studios**—investors looking to play a pivotal role in company formation by providing access to their unique skills, experience and networks. This can lead to large ownership stakes due to their active involvement in company creation.

» **Unloved geographies**—geographies outside the mainstream global venture centers can lead to accessing differentiated deal flow and avoiding crowded, competitive markets like New York or San Francisco.

» **Subsector expertise**—deep expertise, networks, and experience in individual sectors.

» **Solo general partners**—the best solo GPs often come with solid track records and, importantly, strong personal brands with entrepreneurs. Because they have increasingly become disruptive to more bureaucratic organizations, it is important for a VC portfolio to consider solo GP exposure while balancing the key-person risk.

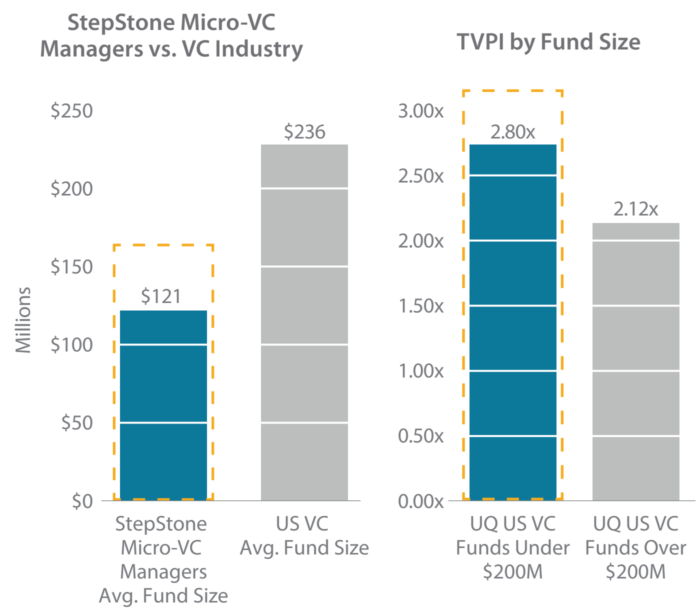
The Venture Return Equation You Shouldn't Ignore

Early, lower valuations and higher levels of ownership sum up the potential for micro funds to achieve alpha. We believe this is a venture return equation that should not be ignored. Because it is harder to generate net level returns as a fund increases in size, Micro-VC funds are often well-positioned to provide attractive economics for investors because they are inherently smaller.

Early, lower valuations and higher levels of ownership sum up the potential for Micro-VC funds to achieve alpha.

Simple math supports the case when considering that a $500 million fund seeking a 3x return on invested capital needs to return $1.5 billion, and with an average ownership level of 10% in each company creates a market cap of $15 billion. Conversely, if you are a Micro-VC manager raising a $50 million fund, the expected value creation to achieve a 3x return is evidently more achievable. **Figure 2** illustrates Micro-VC managers' ability to garner high ownership levels in smaller funds, often allowing for outsize impact.

FIGURE 2 | FUND SIZES



Sources: StepStone Group, August 2021 and Preqin, March 2021.
Note: Preqin data represent vintages from 1982–2017. Preqin data are continually updated; historical values subject to change.

Despite the complexity of yielding higher returns at scale, this is not the general rule given the number of large funds that continue to outperform smaller funds. However, when creating a thoughtful and diversified venture portfolio, including exposure to micro funds for outsize returns should be considered.

The case for micro funds becomes even more compelling when considering the opportunity to capitalize on strong ownership levels. As shown in **Figure 3**, Micro-VC managers are averaging about 12% ownership on an average deal size of $3.7 million, compared with the average Series A deal size of about $17.2 million and an ownership percentage of 13.6%.

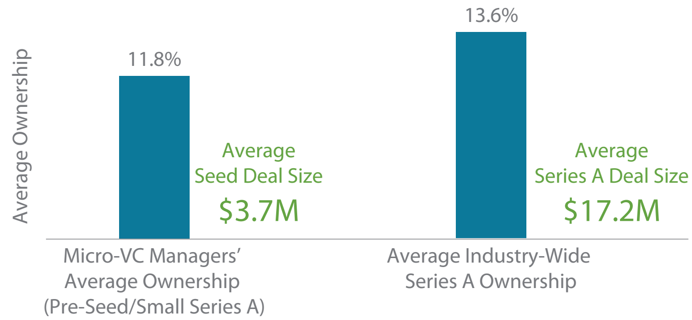
The volatility in the valuation market has affected all asset classes, and while prices continue to increase, Seed valuations have remained flat. Similarly, **Figure 4** shows that while there is a short time frame between Seed and Series A, a material jump between entry valuations makes it that much more appealing to invest at a lower valuation with higher ownership.

Compelling Opportunity Presents a Crowded Market

On a stand-alone basis, the compelling investment dynamic of a strategy that includes micro funds is rarely sufficient for investors looking to generate alpha. Micro-VC as a subcategory has exploded over the past five years, arguably making it the most crowded VC category. The battleground has shifted to be the investor at earliest point of entry as allocators realize the inherent risk in waiting out the financing continuum due to the high valuations in the later rounds. The 1,000-plus

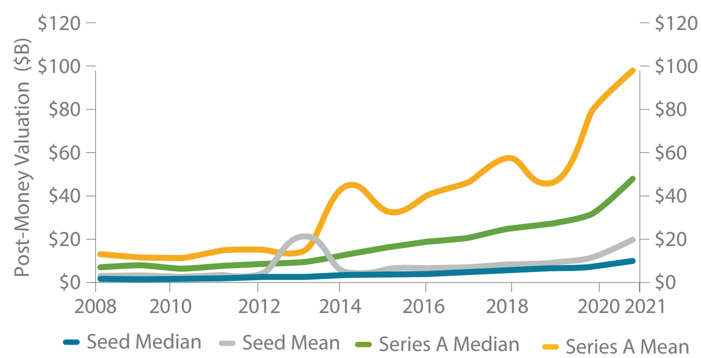
We believe a venture platform fueled by a flywheel of strategies is critical to navigating this multifaceted category of venture investing.

FIGURE 3 | STEPSTONE'S MANAGERS' OWNERSHIP VS. THE INDUSTRY



Source: StepStone Group and Preqin, August 2021.
Note: Preqin data are continually updated; historical values subject to change.

FIGURE 4 | MEAN AND MEDIAN POST-MONEY VALUATION, SEED AND SERIES A ROUNDS



Source: Pitchbook, December 2021.
Note: Pitchbook data are continually updated; historical values subject to change.

Micro-VC firms present a challenge to those investors seeking allocation. In 2020, there were 23,000 Seed-funded companies in the US, a 30% increase from 2016. This surge has put Seed in line with the significant growth we have seen in Series A during that same period.

As with all venture, the spread between the highest- and lowest-performing managers is material, and only a portion will succeed given the skewed nature of returns in venture capital.

While the crowded market reflects venture across the continuum, the key challenge for the micro fund manager comes down to diligence. Similar to vetting a pre-revenue start-up, the same challenges can be present when evaluating a Micro-VC fund manager if there is a limited track record and a newly formed team within a somewhat saturated market.

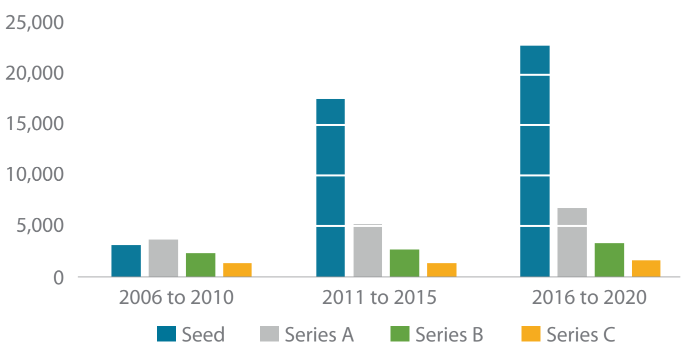
A Venture Flywheel Platform Is the Key to Solving the Equation

The key to solving the equation is finding a partner who can filter through this crowded universe. Outside the brand-name VCs, the alpha that resides with the emerging Micro-VC managers is difficult to identify given the complex nature of sourcing and diligence. The right investment partner can not only provide access to brand-name VCs but also work to identify managers with the potential to generate outsize returns. It can be difficult even for experienced institutional investors, family offices and consultants to filter out the noise. Often, internal venture teams are small, which means they don't have the ability, time or information advantage to churn through the large number of funds to identify the best Micro-VC fund managers.

The combination of access and ability to identify best-in-class micro fund managers is rare but possible. To achieve this, we believe a venture platform fueled by a flywheel of strategies is critical to navigating this multifaceted category of venture investing. This starts with an institutional-quality platform of primary, direct and secondary deal flow. This leads to the real art of triangulating deep GP relationships, proprietary data and information from their underlying portfolio companies as well as the underlying individual track records. The ability to access and understand the value of unrealized assets both current and on a projected basis is ultimately the key opportunity for a scaled-platform investor to source alpha. Micro-VC firms are inherently limited to smaller teams, which leads to greater key-person risk. We firmly believe that such risks can easily be mitigated when long-term trusting relationships are core to manager selection.

The multitiered connections lead to preemptive and broad industry insights across the venture ecosystem. Platform investors are well-positioned to use tools across the platform to identify early spinouts and emerging micro funds. And, as you overlay the unique access to historical individual track records coupled with close relationships, the effect is incredibly powerful to source, access, rapidly vet and filter through the crowded Micro-VC universe.

FIGURE 5 | US VC ROUNDS RAISED BY STAGE PER PERIOD



Source: Crunchbase, October 2021.

A Scaled Platform Leads to Being the LP of Choice

The best Micro-VC fund managers tend to have a similar mindset to the best portfolio companies, which seek to be highly strategic about the investors they are targeting. Typically, these managers are looking for reputable and institutional-quality investors who can develop and grow with them from both a relationship and capital financing perspective. As such, working with a platform at scale provides the ability to grow with the manager over time through the support of future fund iterations with the potential to graduate them into the broader platform if larger funds are raised in the future. Similarly to how founders regard their Seed investors, micro fund managers often consider their earliest institutional investors as an influential anchor and their biggest believers. Micro-VC managers often benefit from referrals and access to LPs who initially invest via the platform but then choose to go direct simultaneously or after. These are relationships with a high level of engagement and collaboration. Ultimately the support leads to long-term trusting relationships, which can drive better access, stronger deal flow, networks and strategic introductions, culminating in a never-ending flywheel.

Conclusion

Micro-VC fund managers present a compelling opportunity to establish high ownership levels at lower valuations with favorable fund economics for their investors. However, despite the appealing investment dynamics, it is a complex universe to navigate alone. Allocators recognize that an institutional platform can identify and provide access to the top managers of tomorrow.

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