Q&A

VENTURING ON

A boom for disruptive sectors triggered by the pandemic fuelled a record year for venture in 2020, but Pantheon's **Brian Buenneke** and **Jack Farr** say long-term relationships hold the keys to success.

Venture capital is generally considered among the higher risk areas of private markets investing, with its focus on smaller companies that have yet to turn innovative ideas into recurring revenues. On the other hand – and as we have written previously – these companies can exhibit strong growth, momentum and, accordingly, there are large potential rewards for investors backing the start-ups of today that go on to become the stellar stocks of tomorrow.

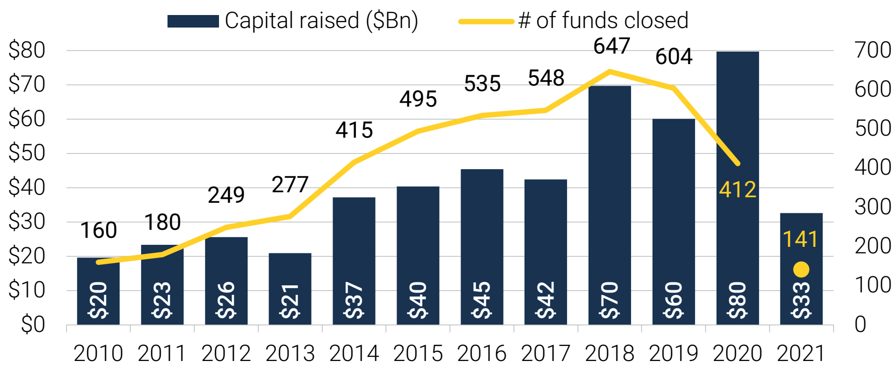
In a low-growth economic environment, and amid a global pandemic that has placed renewed focus on disruptive digital technologies, that allure has brought a raft of new investors – and capital – into the sector. We asked Brian Buenneke and Jack Farr, Partner and Vice President in Pantheon's U.S. investment team, to share their views on why venture has emerged as a winner from the Covid crisis, which sub-sectors are driving investment growth – and why it is important to look past short-term trends to identify the drivers of long-term growth.

Why has venture come into focus during the Covid pandemic?

Jack Farr (JF): There had already been extensive innovation in areas such as consumer e-commerce, technology, and healthcare – and many of these sub-sector trends have been accelerated by the pandemic. The result is that sector-level returns have been strong[1] and the amount of capital flowing into VC has been higher than ever (see Chart 1)[2].

But while venture as a sector has consistently outperformed public markets – U.S. venture returns have outperformed the S&P 500 over 1, 3, 10, 15 and 25 years[1,3] – it has also historically had a much wider return dispersion than other private equity stages. There is a subset of high-quality, blue chip managers that are the hardest to get into, have a proven track record of identifying the success stories of tomorrow, and that generate persistent top-quartile returns. Gaining access to these high-quality, hard to access managers is the key to generating consistent returns[4].

Chart 1: U.S. VC fundraising, 2010-2020



Source: Pitchbook, NVCA Venture Monitor, February 2021.

What did we see in terms of investment trends in 2020?

Brian Buenneke (BB): 2020 was a record year for venture transactions (see Chart 2 on page 2). Given the amount of capital that has flowed into the sector, it is likely that these bullish deal trends are here to stay – for a while at least.

Overall, most of the new money coming into the sector – and as a consequence, the majority of the growth in deal activity – has been concentrated at the later-stage end of the market, targeting companies that are already well commercialized and that have been through a number of fundraising rounds already. The hope with these investments is that a lucrative exit through a stock market listing or trade sale is just around the corner.

On the exit side of things, public markets have been buoyed by global central bank stimulus and so the IPO exit route has remained open – and we have seen a number of big IPO exits in the past year across our underlying portfolio[1].

How does Pantheon's approach differ from deal trends over the past year?

JF: The real cornerstone of our strategy is that we have built great relationships across the venture market, and especially in Silicon Valley, having had a presence in San Francisco since 1987.

In practice the best new ideas are funnelled to – or, equally as often, are actively uncovered by – those managers with recognized names and the most proven track record of success. There is also a brand cache among entrepreneurs. You want to be able to say you raised money from one of those established names. It's a halo effect; a stamp of approval that can bring in further investment, open up new networks, and attract new talent.

BB: Not only have we been local in Silicon Valley over four decades, we have advisory board seats or were founding investors with a number of the most established managers, including spin outs of successful teams from groups we've backed previously. That means

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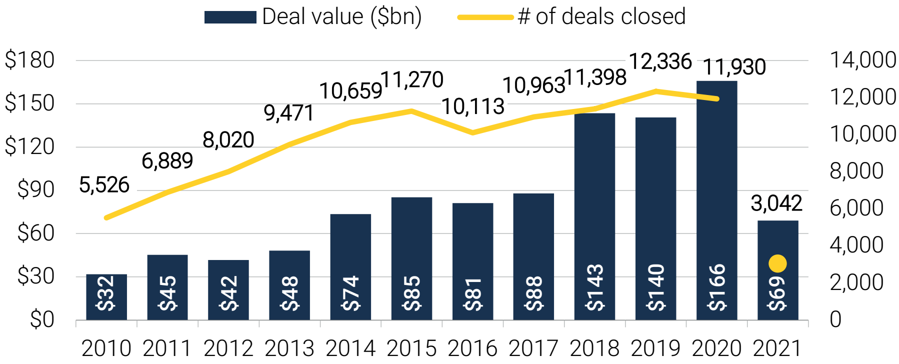
Chart 2: U.S. VC deal activity, 2010-2020



Source: Pitchbook, NVCA Venture Monitor, February 2021.

we have access to those high-quality managers that have consistently generated outperformance.

In many cases we're also backing sector specialists with the tools and experience to generate added value. These managers are often able to identify the more nuanced, niche sub-sectors and emerging trends that are likely to outperform. They're also always looking for new ways to source and assess opportunities – and some managers have developed data analysis tools that use a whole different set of metrics than managers in other sectors, for example using workforce tracking tools to spot specific technological developments based on hires of staff with specialist skill sets.

What are the other key elements you look out for?

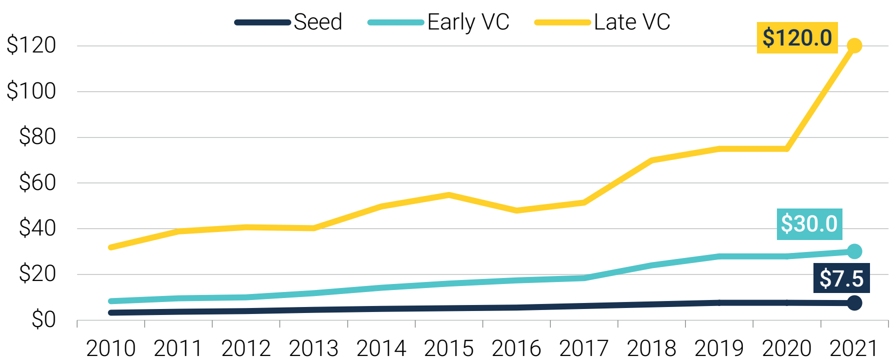
BB: A significant portion of the new money that has come into venture has come from hedge funds and mutual funds. Most of these have been buoyed by global central bank stimulus and so they have capital to put to work – and in turn they've been a disruptive force in some parts of venture, especially at the later-stage end of the market. This new influx of capital has boosted the value of some of our underlying portfolio companies in the short term, but it isn't going to determine the long-term success of the companies we back.

In contrast, our portfolio skews to the early side and towards companies that are in their initial phases of growth, with some exposure to later-stage investments thanks to managers we back supporting portfolio companies through follow-on fundraising rounds. What we don't do is passive, pre-IPO investments that are very much in vogue, but where investment outcomes are often driven by market forces outside of the manager's control. We're not looking for stock pickers or trend riders, we're backing investors and companies that add sustainable, realizable value. That's the best defense against high valuations that are prevalent in some of these sectors.

Finally, turning back to the pandemic, what are the key trends that have come to the fore and that will persist as we emerge from the crisis?

JF: Some of the sector themes that were prominent coming into the pandemic have been magnified, such as artificial intelligence, cloud computing, big data and a fintech (financial

Chart 3: Median pre-money valuations in $m for venture-backed companies, 2010-2020



Source: Pitchbook, NVCA Venture Monitor, February 2021.

technology). These are things venture investors have been interested in for a while and that haven't really been impacted by the crisis.

What Covid has done is bring to the fore a number a themes that were more nascent. Things like distributed workforce, which relates to tools and software to enable more effective, productive and collaborative remote working. There has also been an obvious boost for the consumer internet economy and especially to digital sales and servicing in a number of sectors where online interaction had previously been more niche, such as healthcare and real estate. These are trends that we, and the managers we back, have been tracking for some time and that are now poised to enter a period of sustained growth.

BB: Things constantly evolve in the global economy – and especially in this part of the market. The only thing we're certain of coming out of the pandemic is that the world is not going to go back to the way it was before. For example, we're probably not going to be doing one-day "red eye" flight round trips for a two-hour meeting. These are the sort of efficiencies and productivity gains that are being identified – and that will fuel new technological growth. The strength of the best venture investors is in their ability to take a longer-term view and consistently be ahead of the curve in identifying the companies bringing new ideas and creating real value – and then leaning into them.

[1] Past performance is not indicative of future results. Future performance is not guaranteed, and a loss of principal may occur.
[2] This is no guarantee these trends will continue.
[3] Source: Cambridge Associates US Venture Capital Index and Benchmark Statistics, as of Q3 2020.
[4] Pantheon opinion.

Biographies

Brian J. Buenneke, Partner

Brian is a Partner in Pantheon's U.S. investment team with management oversight of the U.S. primary investment team. Brian is also a member of the U.S. Investment Committee, ESG Committee and Inclusion & Diversity Committee. Prior to joining Pantheon, Brian spent seven years at HarbourVest Partners, Duke Street Capital and Paul Capital Partners. Brian began his career as a financial analyst in Lehman Brothers' Investment Banking Division. Brian received an AB in government from Dartmouth College and an MBA from the Kellogg School of Management at Northwestern University. Brian is based in San Francisco.

Jack Farr, Vice President

Jack is a member of Pantheon's U.S. Investment Team where he focuses on the analysis, evaluation and completion of North American investment opportunities. He was previously at BlackRock on the Aladdin Investment Management Platform. Jack has a B.A. in International Relations from Stanford University and is based in San Francisco.

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