Diary Jon Moulton

A few top performing funds are obscuring the generally weak performance of much of the VC industry

There is a real concern developing over venture capital returns.

The British Business Bank has produced a report *UK Venture Capital Financial Returns 2021* which, though it does rather lean to optimism, is a good source of data.

One chart shows, if you go back to 2002/3 funds, that VC funds have only paid back 20% over paid-in capital to their investors – in nearly 20 years. This is very different from the cheerful valuations and statistics of recent years that we have all got used to.

According to the report, as of 2021, UK venture funds for 2014-2019 vintages showed distributions for the median UK venture funds of near nil – this is said to "highlight the importance of patience with VC investing". It occurs to me that there is another possibility – weak performance.

The median fund showed a total return (all of which is unrealised valuation) of 25% of paid-in capital. To the extent that subscription bank lines are used instead of paid-in capital these total return numbers will be flattered.

'Would a VC industry with fewer players and less money deliver better and more solid returns?'

Remarkably, the pooled fund returns exceed the top quartile returns, illustrating the skewed nature of the data due to a relatively small number of very large successes, with top quartile funds reporting 22% of paid-in capital as distributions and another 70% chunk of unrealised valuation gains for this cohort.

Similar numbers apply to US and European venture funds.

The industry's return averages really depend upon the validity of those valuations. And those valuations reflect the weight of money pricing venture capital deals.

The seriously high valuations are concentrated in a few sectors including internet, cryptocurrency, AI, US Spac transactions, mega scale deals featuring investors such as Softbank and fast-growing but loss-making concept plays – often in fintech.

Most of these sectors have generally seen big value reductions in public, and recently private, markets. I really can only guess what that 70% of valuation gains would be if sensibly marked to market but I would not be surprised if it dropped by half.

Recently one of the funds my family office has invested in wrote to the LPs saying that they had not adjusted their valuations to the latest round prices where they felt the new investors were "overly" irrational.

This is concerning – but more so was that the fact that our GP had reviewed their valuations, and made very little change, in the light of revenue multiples and annual growth rates.

Fundamentally doomed business models that will never generate a profit can grow quickly! Indeed, growth has, generally, to lead to cash positivity to be genuinely valuable.

Valuations will be slow to drop, and, to an extent, are at the option of the GPs, but drop they will.

We have seen a bubble, lots of VC money has driven investment values up and returns look good which means more money sucked in. And so on.

Valuation drops will hurt reported returns for the great majority of VC funds. The attractiveness of the sector will decline, especially as inflation now puts more pressure on for greater nominal returns. Bubbles burst.

These skewed fund returns beg questions.

Why do we need the lower performing funds? Would a VC industry with fewer players and less money deliver better and more solid returns for investors?

Would the economy actually do better if less venture capital was around? Putting good cash into mediocre or bad businesses does not lead to economic growth and clearly it's been a substantial activity.

It rather looks like market pressures will answer these questions over the next few years.

I'm already longing for the return of a bull market!

Veteran financier Jon Moulton has been involved in buyouts, turnarounds and venture capital since 1979 with firms such as CVC, Permira, Apax, Alchemy and, most recently, Better Capital, where he has been the chair since 2009

Valuations have been high during the bubble and attracted more money, but now they are expected to deflate and fall

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