



## Nothing gained?

Is too much venture capital chasing too little return? Has too much enthusiasm led to a bubble? **Jon Moulton** reflects on an excess of investor cash looking for a home

I recently wrote about the limits to the size of the buy-out business. Those limits are within sight. But what about venture capital? It's a very broad term – Softbank, aside from its multi-billion losses, makes multi-billion investments in businesses, often some distance from start up, governments pour money into regions where votes are at stake and, at the other end, you have angels backing tiny businesses just out of the egg.

To keep this to a comment piece rather than a tome, I'll focus on the traditional fund structures of 10-year funds with general partners doing the deals and limited partners putting up the money to enable companies to grow. But the general drift applies more widely.

There has been no shortage of investor capital available in recent years. Most institutions still have a considerable ability to increase their asset allocation to venture. Their willingness to do so is largely a question of chasing return. Historically, venture capital in the UK has underperformed other private equity investment with internal rates of return around 5% lower than the rest of private equity. Median UK venture funds have been taking 10 years to return capital – given inflation, it actually takes longer to get the value of the commitment back.

Investors such as the European Investment Bank and regional government funds were chasing other objectives and were less interested in return – they've been a large component of the investor base for venture capital funds. But a more return-driven minority of investors was willing to bet that the past was no guide to the future and that their selections of jockeys and horses would be superior to the market average. This minority kept the industry going.

However, in recent years, pulled by several factors, more and more mainstream money has poured into venture. These factors included serious successes in the US, with NASDAQ providing profitable exits, low interest rates causing investors to do more risky but potentially more lucrative investments, and very strong returns from US venture capital funds, all of which, and more, attracted cash to the sector.

The stage was set for what we'll doubtless see as a bubble. More money was poured into larger

funds, more funds were launched and homes had to be found for that money. Just as in any other market, the effect was a general price rise in the venture capital world. Valuations of deals rose and good-looking deals were competed for strongly. Quoted returns rose, with those returns rising to unprecedented levels. This attracted more money.

### Uncertain future

While supply of deals rose to reflect that liquidity, it didn't rise in quantity or quality to match the fast-accumulating cash available. There's no evidence that good investments are not getting funded today.

More money meant higher valuations, which meant higher returns, which meant more money...

But returns became dominated by unrealised gains. All might have been well if economies had stayed strong and stock markets buoyant so that these valuations became realised. But they didn't. Markdowns and down rounds are now the norm. And new deals have slowed.

Most of the improved 'return' will vanish and investor interest will decline.

Fewer firms would now seem to make sense. But given the 10-year service contracts that investors give to general partners, this will be slow to happen.

Less money would increase returns in the long run. There's no shortage of venture capital investor staffing. Good pay has seen to that. There's no visible limit there.

Well-meaning government schemes have clearly distorted the market and the excess cash and particularly the funding of weak investors is partly down to these. Is there too much venture capital for the good of the economy? This is a tough question. Clearly a lot of good money, tax breaks and good humans are applied to low- or no-return investments. Would that money be better deployed in other things or by a different route?

It's obvious that there are serious successes in venture capital investment, but they're not the norm. It looks like the industry is currently too large.

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