STEPSTONE

VENTURE CAPITAL

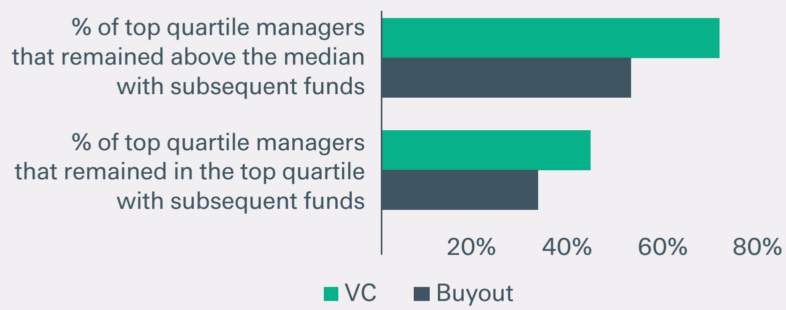
Shedding the "access class" label

JANUARY 2024

Historically, access to top-performing managers was considered the most important factor to building a successful venture capital allocation—so much so that venture capital was sometimes jokingly referred to as an "access class."

This was largely due to the higher persistence of performance of venture capital managers compared with other asset classes, driven by factors such as information asymmetry, access to proprietary deal flow, smaller fund sizes relative to other asset classes and path-dependence stemming from successful past investments **(Figure 1)**.

FIGURE 1: PERSISTENCE OF TOP QUARTILE MANAGERS BY STRATEGY



Source: Becker Freidman Institute for Economics at UChicago, "Has persistence persisted in private equity? Evidence from buyout and venture capital funds" Journal of Corporate Finance, volume 81, 2023, 102361. ISSN 0929-1199 (includes Venture Capital fund data from Burgiss, including vintages from 1984–2015).

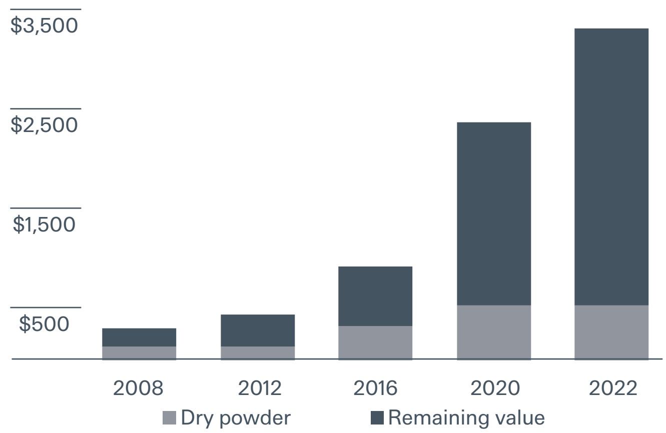
As a result of higher persistence, it became a generally accepted principle to invest only in established, top-quartile venture managers or to avoid the asset class altogether. Simply put, the playbook for venture capital investing was to get access to blue-chip managers, re-up each time they raised new capital and (hopefully) capture a disproportionate share of all returns generated in the asset class. However, this “wash, rinse, repeat” approach to venture capital investing, which worked mostly for investors with inside connections to select managers, has become outdated; it is no longer the only way to strive for outsized returns.

From a cottage industry into a fully institutional asset class

While access is still paramount, success in venture capital today is heavily dependent on manager selection, due to the impressive growth and maturation of the industry over the past 15 years. Since 2008, venture assets under management have grown from $300 billion to $3.5 trillion, bringing VC’s share of total private capital assets to 25% (**Figures 2 and 3**). In addition, the number of active venture capital funds has increased by more than 3.5x over the same period.

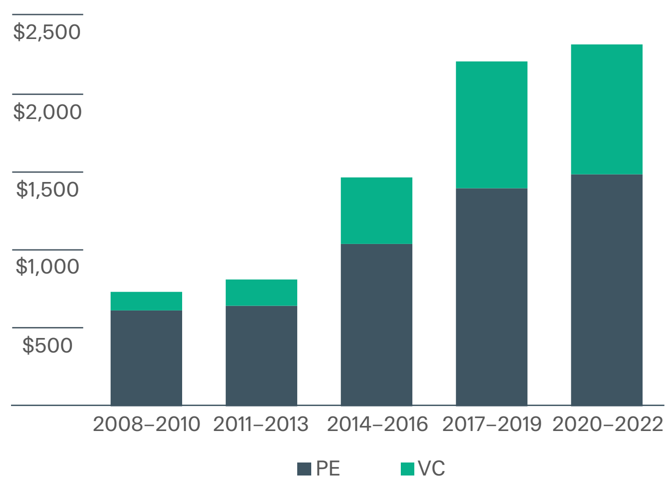
This growth is attributable to factors such as the prolonged low interest rate environment, lower cost of company creation, increased capital efficiency of startups, expansion of the ecosystem beyond traditional geographies, new exit routes, including the maturation of the venture secondary market, and the emergence of investable sectors such as artificial intelligence and climate technology. In addition, the increased regulatory burden on public companies has resulted in startups remaining private longer, which has given rise to

FIGURE 2: VC AUM ($B)



Source: PitchBook Q1 2023 Global Private Market Fundraising Report, data as of March 31, 2023; global geography.

FIGURE 3: SHARE OF PRIVATE CAPITAL RAISED BY STRATEGY ($B)

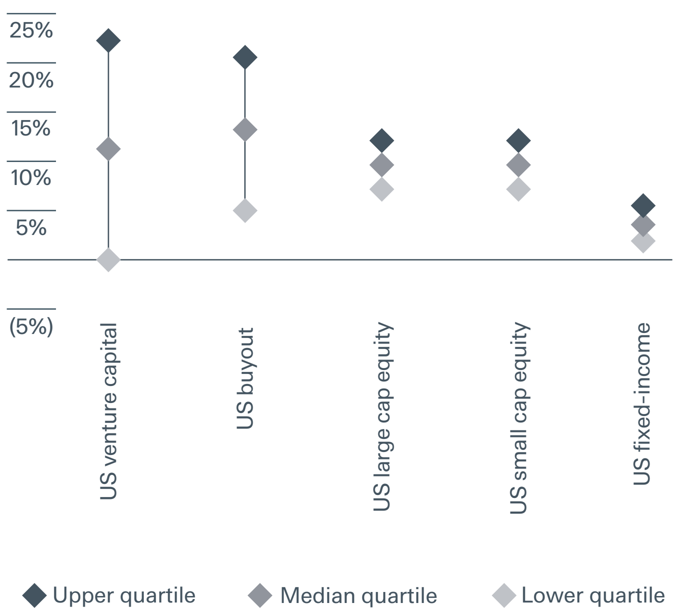


Source: PitchBook Q1 2023 Global Private Market Fundraising Report, data as of March 31, 2023; global geography.

the late-stage category and enabled venture capital to capture a larger proportion of company growth and value creation.

Meanwhile, venture capital managers have historically exhibited the widest dispersion of performance between and across quartiles relative to any other asset class (**Figure 4**). This return distribution also features positive skewness—demonstrating that a small number of positive outliers drive returns in a given vintage . The flood of capital into the industry and the proliferation of new funds has only exacerbated the variability of outcomes and underscored the increased importance of manager selection.

FIGURE 4: RETURN DISPERSION
15 YEAR RETURN—QUARTILE ANALYSIS
(1981–2018 VINTAGES)



Source: Burgiss, March 31, 2023.

A closer look at the expanding emerging manager landscape

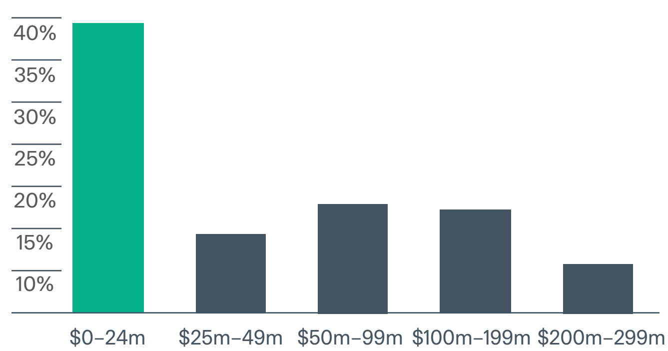
Unsurprisingly, the growth in number of venture capital funds is more pronounced at the lower end of the market. Our analysis shows that approximately 3,000 US-based funds, or 1,600 unique managers, less than $300 million in fund size, have been raised since 2018 alone. Of those funds, 38% were less than $25 million and 53% were less than $50 million (**Figures 5 and 6**). Due to the short performance history of most of these funds, investors interested in supporting managers during their development years are forced to rely

FIGURE 5: <$300M VC FUNDS RAISED IN THE US SINCE 2018

Fund size	Managers	Funds
$0–49m	876	1,868
$50m–99m	302	469
$100m–199m	283	429
$200m–300m	185	225
Total	1,646	2,991

Source: StepStone Group, August 2023.
Note: Fund size for managers is determined by the largest fund raised during this period.

FIGURE 6: PERCENTAGE OF MANAGERS BY FUND SIZE



Source: StepStone Group, August 2023.

on a more qualitative evaluation framework. To convince allocators to place a bet on them, emerging managers often highlight prior startup or "big tech" experience, education at a prestigious university, and/or the diversity of their team and networks. However, many such attributes that were once considered differentiated when venture capital was still a niche industry, have become more commonplace, making it harder for managers to raise capital based on those characteristics alone.

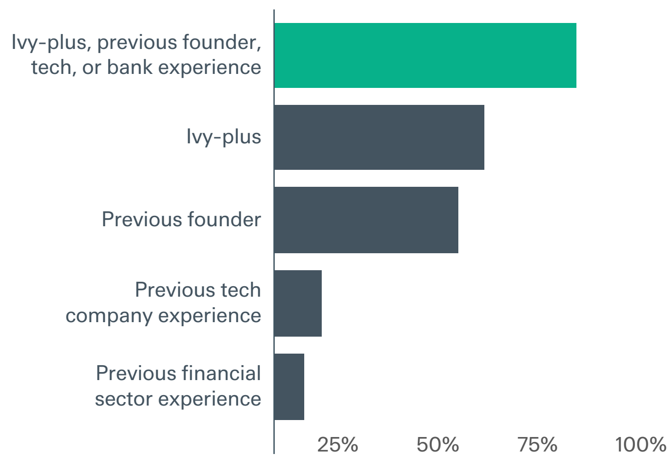
Of the 3,000 funds raised since 2018, 85% of them had at least one partner who either obtained an "Ivy League Plus" degree,[1] founded a startup or had prior experience in big tech or investment banking at companies such as Google, Amazon, Goldman Sachs, or J.P. Morgan. In addition, approximately half of the funds in this dataset had at least one ethnically or gender-diverse partner (**Figures 7 and 8**). While diverse teams, degrees from world-renowned academic institutions, founder/startup experience and previous operational roles at reputable firms remain extremely valuable credentials, we believe they are not sufficient criteria to allocate capital to a particular manager.

The explosion of capital and new funds, increasingly similar education and prior experience, combined with the nascent institutional track records of new entrants, has made the job of allocators more complex and challenging than it has ever been.

Manager selection in VC is equal parts art and science

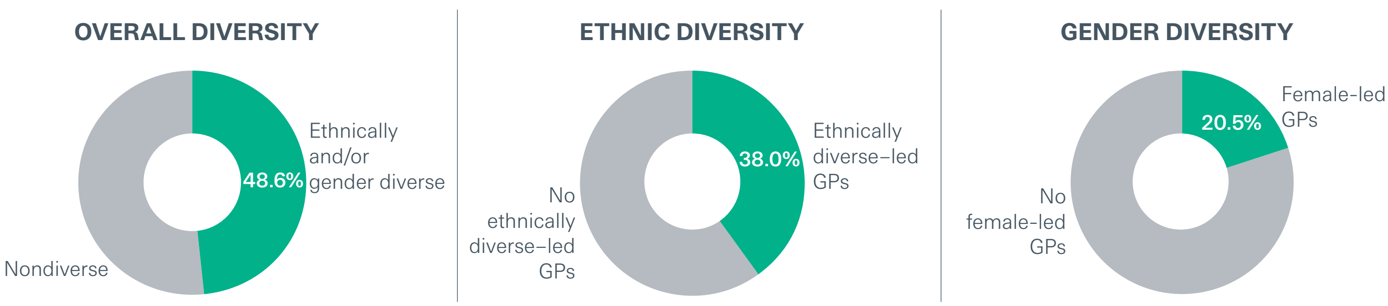
The process of manager selection in venture capital requires both qualitative and quantitative considerations across three distinct due diligence workstreams: investment, operations and legal.

FIGURE 8: EMPLOYMENT BACKGROUND & EDUCATION OF LEADING MANAGERS



Source: StepStone Group, August 2023.

FIGURE 7: DIVERSITY OF LEADING MANAGERS



Source: StepStone Group, August 2023.

[1] Includes Harvard, Princeton, Yale, Brown, UPenn, Columbia, Dartmouth, Cornell, University of Chicago, Stanford, MIT and University of California, Berkeley.

On the investment front, we believe the role of a venture investor includes four components: **sourcing, judging, winning,** and **impacting** portfolio companies.[2]

- Sourcing entails knowing which ponds to fish in and who to fish with and requires a constant pruning of one's network.
- Judging opportunities at the narrow intersection of exceptional founders and exceptionally large markets is what we believe is the most difficult part of the job, in addition to taking the longest amount of time to determine success.
- To win competitive deals, venture capital firms need to offer a tangible value proposition to founders that goes beyond basic advice and a typical network, supported by a list of experienced and referenceable founders.
- Finally, venture capitalists should clearly articulate what they bring to the table, aside from capital, and how they plan to support founders post-investment.

Based on our experience, it is a tall order to excel at all four parts and is not necessarily required to generate outsized returns. That said, we see less differentiation in managers within the "sourcing" and "impacting" parts of the job, since most firms boast large and similar networks and tend to offer similar services. In contrast, there tends to be greater variability in investors' abilities as it relates to "judging" promising early-stage companies and "winning" competitive deals, which we believe are competencies that subsequently manifest as top-quartile fund performance.

To supplement this framework, we also believe the managers that generate the best performance demonstrate a keen understanding of firm and fund management, sound portfolio construction and a focus on returning capital to limited partners (LPs).

In terms of firm and fund management, we look for managers that prioritize building a strong brand, attracting and retaining top talent across the organization, and ensuring that the firm is best-in-class in its operational setup and legal structure. In addition, an understanding of venture math (e.g., concentration, ownership, reserves management, recycling) and disciplined execution of portfolio construction strategy is critical for a manager to achieve its return target over multiple fund cycles. Finally, while many emerging managers reported impressive unrealized performance in the years leading up to the 2021 market top—a period broadly characterized by high multiples and frequent up-rounds—few have returned meaningful, if any, capital to LPs. This reality, combined with the reduction in LP demand for risk assets and illiquidity as interest rates have risen, has created an even more challenging environment for emerging managers to raise new capital.

More managers, more complexity, more opportunity

Constructing a successful venture capital program has become more challenging and nuanced over the last 15 years. To do well in venture, we believe it is important to have a large and specialized team with a deep understanding of the market to sift through the thousands of funds in existence and identify the small subset that may be able to generate top-quartile returns.

In order to select these managers, it is essential to look beyond the information that is easily obtained, such as that which is provided in a data room. Some examples of deeper diligence that we perform include:

- Performing back-channel reference checks on GPs with: founders, other investors who have served on boards with the manager, former colleagues at former firms, former employees of the current firm and other members of our vast network within the broader innovation economy who may have experience with the GP in the past.
- Leveraging our network and data to properly assess deal-level attribution and partners' individual track records, including investments they sourced and led at prior firms. This is particularly important since, as they say, "success has many mothers/fathers/parents/guardians." On a related

[2] Based on a framework popularized by Nakul Mandan, Founder & GP at Audacious Ventures.

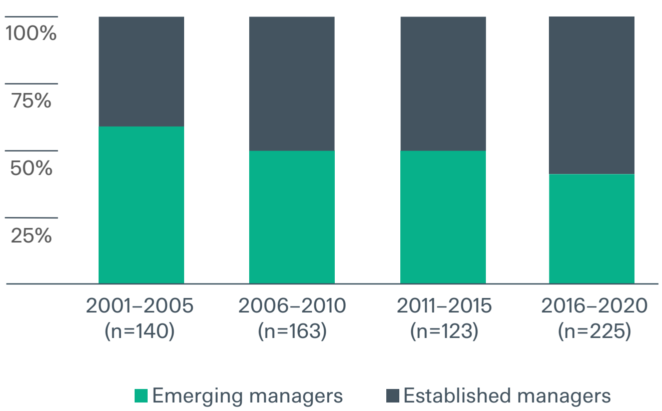
note, firms often attribute less successful deals to departed partners while also reassigning responsibility for the deals of departed partners that are going well to current partners; unearthing which GP sourced value-driving or struggling companies is not as simple as it might seem on the surface.

- Using our direct investment expertise, position as an LP in many funds across our platform, and knowledge of individual portfolio companies to better understand portfolio quality and—if required—calibrate valuations and reported fund performance.

Some of the managers we invest in are established organizations, while others are lesser-known or emerging firms that we believe have differentiated models capable of generating outperformance. Despite the added challenge posed by the expanding manager universe, we believe that exposure to emerging managers is an important complement to a core allocation consisting of "brand name" firms with more established performance histories. Looking at the composition of the top ten managers by vintage cohort since 2001, approximately half have been emerging managers, defined as firms that have raised three funds or less (**Figure 9**). In addition, data from SPI Research, our proprietary private markets library, shows that smaller funds, defined as less than $500 million in size, on average tend to outperform, but with more variability in outcomes (**Figure 10**).

Regardless of their characterization, we strive to partner with managers that possess deep sector-level expertise and hands-on experience operating early-stage companies. We believe that our 24-year history of investing as a venture platform across primary fund commitments, direct investments, and secondary investments, combined with our data advantage and breadth and depth of relationships with investors and entrepreneurs within the venture capital ecosystem, allow us to capitalize on informational asymmetries and execute on a model capable of identifying and accessing top-performing and high-potential managers. While this is more nuanced and labor-intensive than simply targeting the top-quartile venture funds of the past, this strategy is more aligned with today's multi-faceted industry.

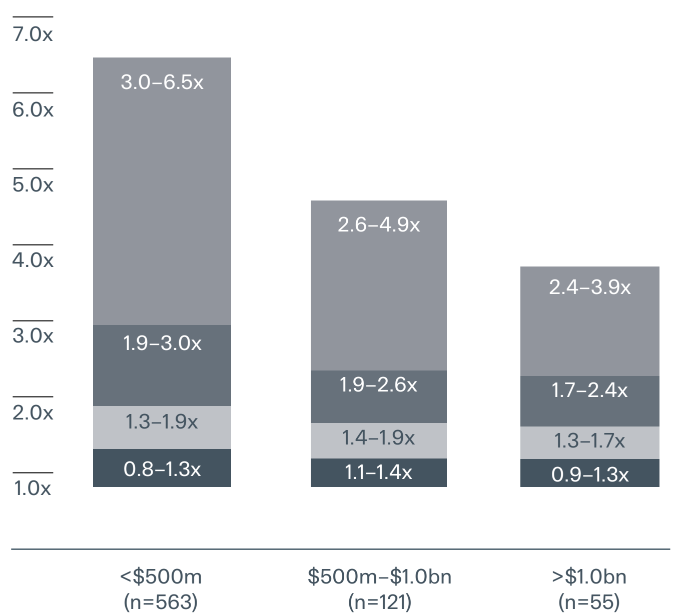
FIGURE 9: % OF EMERGING MANAGERS IN TOP-10 FUNDS BY VINTAGE COHORT



Source: Preqin as of September 20, 2023.

Note: Represents US VC funds greater than $50 million. Emerging managers defined as Funds I–III.

FIGURE 10: PERFORMANCE QUARTILES BY SIZE COHORT 2001–2020 VINTAGES[3]



Source: SPI Research.

Note: The top and bottom 5% are excluded from the 1st and 4th quartiles, respectively.

[3] For illustrative purposes only. All information provided is at an industry level, no StepStone investments are included in any of the above metrics. All information provided here is based on research related to third party managers.

We are global private markets specialists delivering tailored investment solutions, advisory services, and impactful, data-driven insights to the world's investors. Leveraging the power of our platform and our peerless intelligence across sectors, strategies, and geographies, we help identify the advantages and the answers our clients need to succeed.

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