FrontLine Research Paper

Are the "good old days" back in venture capital?

Were the 1990s the golden decade of venture capital? Listening to veteran investors of that time, it would be easy to reach that conclusion. In the collective memory, that decade remains associated with stellar returns, meteoritic entrepreneurial successes and a certain ease of doing business. The advent of the Internet and the World Wide Web triggered a wave of business innovations and of start-ups. Information technologies were a new frontier: start-ups could colonise entire new markets that had no incumbents. Once on their feet, start-ups could easily list themselves and their investors could reap the reward of their effort.

Fast-forward to today and venture capitalists complain of competition to attract the best investment opportunities and of the high valuations for start-ups. Entrepreneurs complain about the breakneck speed of innovation, the difficulty to recruit well and fast enough, the high level of salaries and the costs of developing a viable business. Fund investors lament about the difficulty of accessing good funds and crucially about longer holding periods.

Conventional wisdom has it that in the 1990s, returns from venture capital funds were higher and cash was returned faster.

Is it really the case that it was relatively easy to do venture capital business in the 1990s, and that returns were higher and cash was returned faster?

Thanks to the high quality of data provided by eFront Insight, we can put this to the test. Specifically, by exploring the relationship between holding periods and performance we can draw empirical conclusions that will help frame the evolution of VC investments over the years and answer the questions: were there any "good old days" in venture capital? If so, are they back?

The poster child of VC: US early-stage

US early-stage VC funds are probably the best starting point to assess the question of performance and time-to-liquidity (used as a proxy for holding periods), for multiple reasons. First, the US provides the longest time-series and the highest number of funds in the sample of early-stage VC funds. Second, early-stage VC funds are less affected than later-stage funds by sudden surges in valuations, adverse events such as the sudden closure of IPO windows or, until recently, by the increased competition of alternative sources of financing such as corporate venture capital.

Looking at Figure 1, the 1990s can indeed be singled out. In fact, conventional wisdom is right on one point: that decade witnessed a shorter time-to-liquidity. The 1990s recorded an average time-to-liquidity for US early-stage VC funds of 3.62 years, compared with 5.82 years for the previous decade (prior to 1991) and 6.7 years for the next (2001-2010). The latter still includes a substantial number of active funds, which means that the time-to-liquidity could still increase further.

However, performance does not look particularly good, especially when compared with the other two decades. If a few vintage years made a strong impression on investors, the overall decade appears fairly poor in terms of pooled average total value to paid-in (TVPI). In fact, a direct link between higher returns and longer time-to-liquidity looks likely. It could be coincidental. Whether this link would apply to the current decade remains to be seen, notably

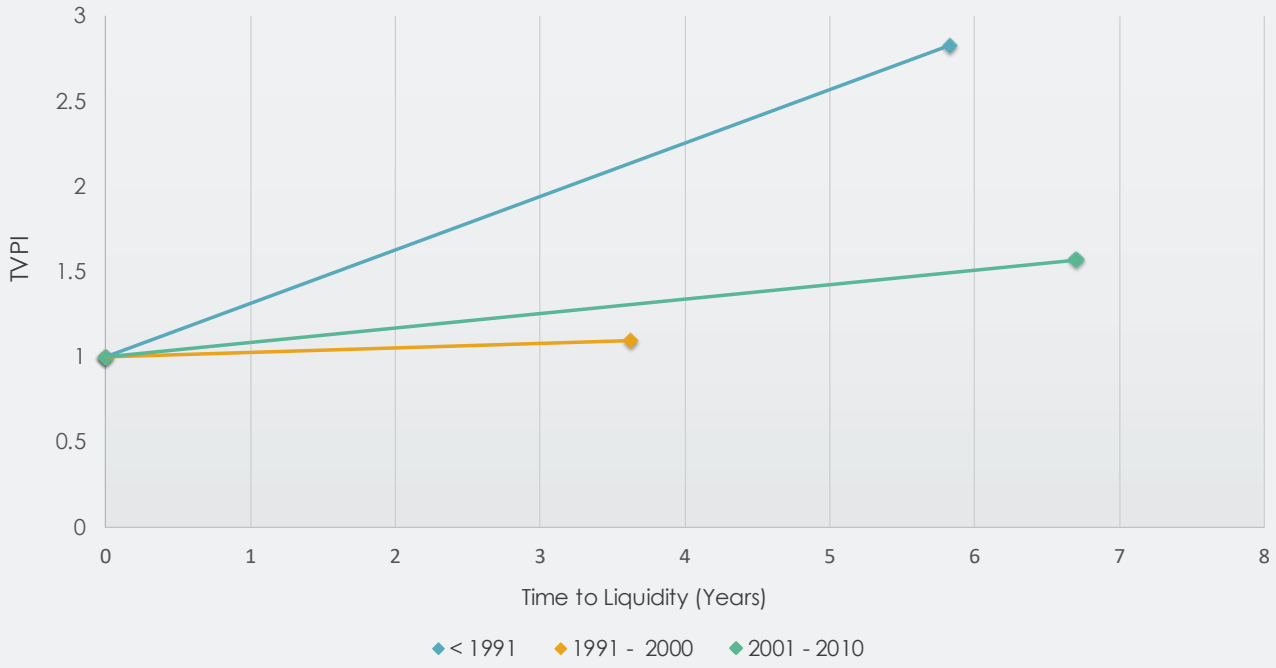
The 1990s can be singled out for its shorter time-to-liquidity, but not for higher returns.

as the VC market has developed fast and reached an increased level of maturity. It could hint at possible higher returns for the decade 2001-2010 once funds are fully realized.

Nevertheless, if anything, the shorter time-to-maturity of the 1990s seems to have hurt the performance of funds, not supported it. Beyond the aggregate figures, a more detailed analysis by vintage years shows that there is, in fact, a tale of three successive and distinct periods in 1990: one with high TVPIs and short time-to-liquidity in 1993-1996, then one with low TVPIs and short time-to-liquidity in 1997-1998 and a final one with negative returns and long time-to-liquidity in 1999-2000.

Therefore, less a golden decade, the 1990s appear more as a period of transition in which observers can find data supporting the conclusion that please them. Conventional wisdom probably focuses on the first part of the decade. The following decade 2000 is more consistent over time both in terms of fairly high TVPIs of 1.5 to 2.5x (except in 2001) and longer time-to-liquidity (4.8 to 6.4 years).

Figure 1 – Performance and time-to-liquidity of US early-stage VC funds, by decade



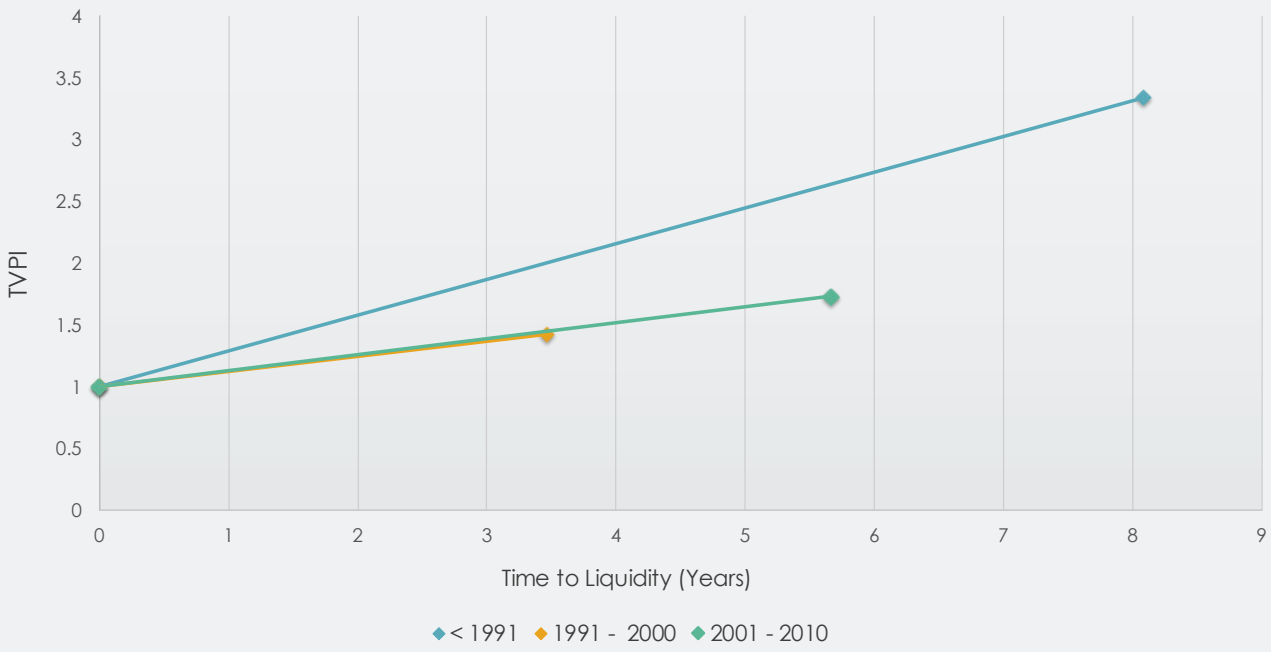
Source: eFront Insight, as of Q1, 2018.

The confirmation: later-stage US VC

How does US later-stage VC, which tends to be more opportunistic when it comes to exits, handle performance and time-to-liquidity? The answer is, mostly in line with the conclusions drawn above for early-stage funds (Fig. 2), with two notable differences. First, US later-stage VC funds generated consistently higher TVPIs than early-stage funds. Second, with the exception of vintage years prior to 1991, the time-to-liquidity was shorter for the decades 1990 and 2000. This confirms that later-stage VC funds hold on average assets for a shorter period of time.

A more detailed analysis shows that there are in fact three successive and distinct periods in the 1990s, which marks a transition for venture capital.

Figure 2 – Performance and time-to-liquidity of US later-stage VC funds, by decade



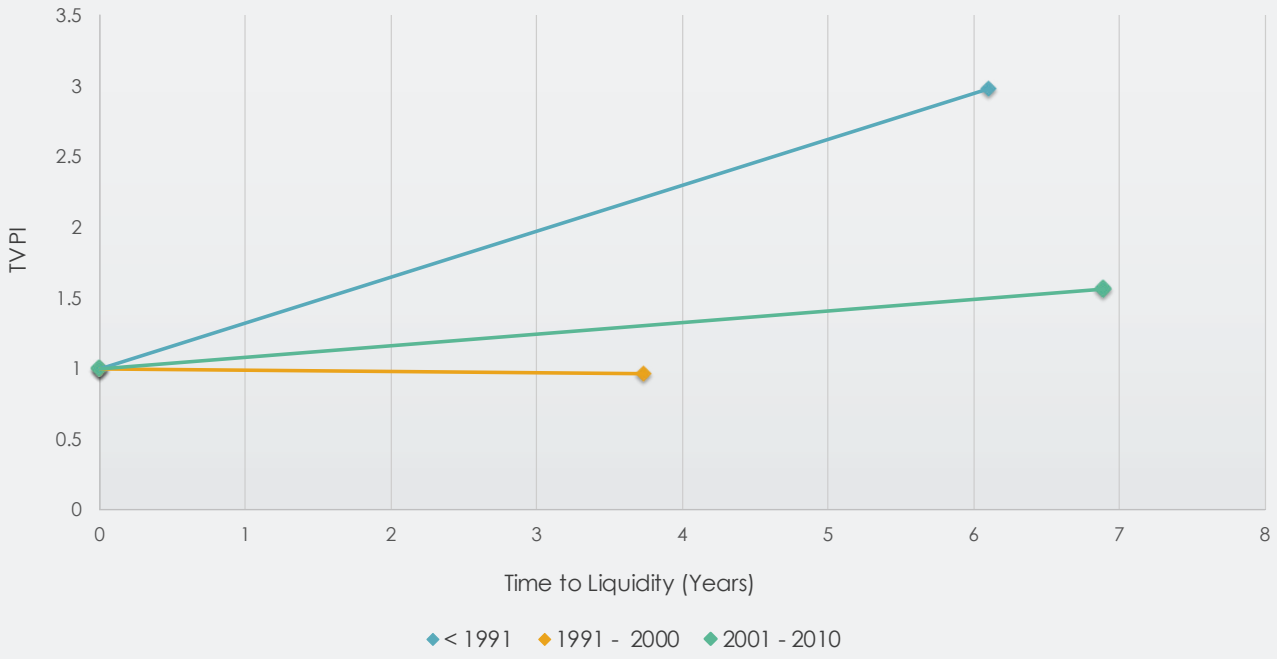
Source: eFront Insight, as of Q1, 2018.

Testing the findings: Western European VC funds

Could this phenomenon be shared across the Atlantic? Looking at Figures 3 and 4, the answer is yes: the picture is rather similar for Western European VC funds. In fact, early-stage VC funds of the 1990s record the same three periods as in the US. Along these lines, the 2000s for Western European early-stage funds reflects the US experience.

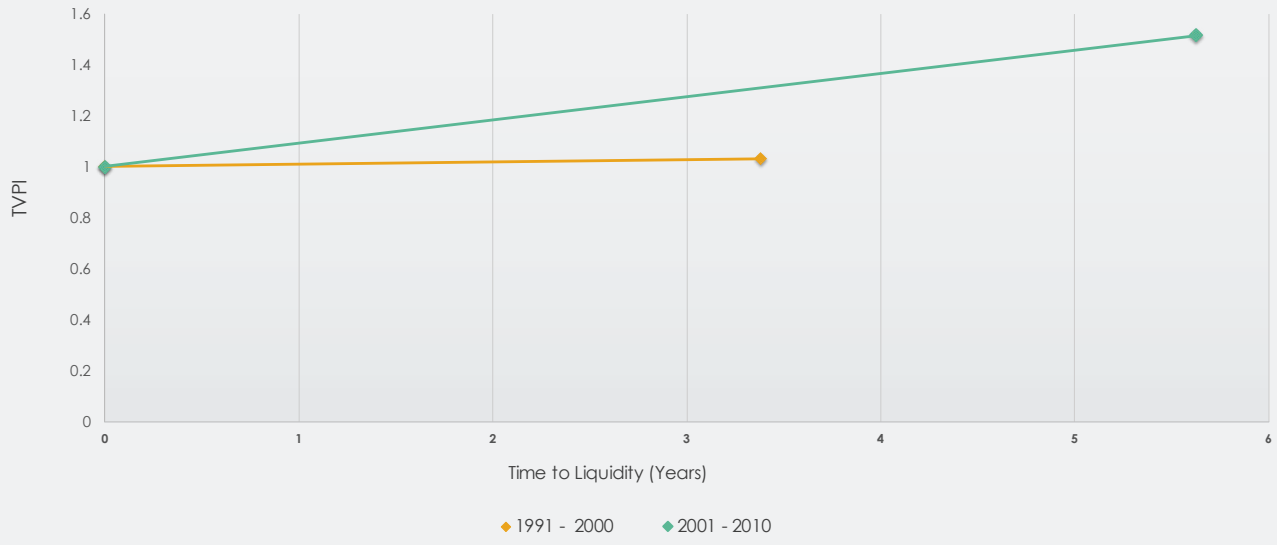
Likewise, Western European later-stage VC funds, just like American ones, have shorter time-to-liquidity than early-stage VC funds. However, they differ from American funds in the sense that their performance is overall equivalent to those of early-stage funds.

Figure 3 – Risk and return profile of private equity funds by location



Source: eFront Insight, as of Q1, 2018.

Figure 4 – Performance and time-to-liquidity of Western European later-stage VC funds, by decade



Source: eFront Insight, as of Q1, 2018. Note: there is no data for the period prior to 1991.

Conclusion

A few exceptional years have marked a decade and an asset class. The venture capital boom years of the 1990s have left investors with, at the least, a feeling of nostalgia. However, our analysis shows that the decade was unusual more for its shorter time-to-liquidity than its returns. Since any aggregate outperformance of that decade was subsequently wiped out by the ensuing stock market crash, investors should be 'careful what they wish for'.

The following decade 2000, still partially in the making, contrasts with the 1990s in surprisingly positive ways. First, the decade seems rather homogeneous, if the vintage year 2001 is excluded (as it could arguably be associated with the previous two years to the recession). Second, funds show more consistent and attractive pooled average returns. Third, they have rather longer time-to-liquidity, which tends to be more in line with the pattern of the 1980s.

The 2000s show higher returns and longer holding periods, but falls short of catching up with the 1980s.

Thus, longer time-to-liquidity observed in VC over the course of the decade 2010 is not only in line with the past, but might also be the expression of potentially high performance. However, this relies on the assumption that current VC funds invest under the same conditions as during the decades 1980 and 2000.

Note

The aim of this newsletter is to provide readers with elements of analysis and understanding of the private finance universe, based only on data collected by eFront Insight. It does not intend to draw any definitive conclusion, nor judge the performance of fund managers. By providing a guided reasoning, FrontLine hopes to contribute to the overall progress of understanding of the asset class in a short monthly format, with all the limits that this entails.

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