

KEYNOTE INTERVIEW

The evolving investment opportunity in private tech



*Even in choppy markets, big opportunities remain for tech investors, say Adams Street partner and co-head of global venture fund investments **Brijesh Jeevarathnam**, and primary investments partner **Saguna Malhotra***

Q With tech companies now staying private longer, how is additional value being created in private markets?

Brijesh Jeevarathnam: Venture-backed companies are typically staying private longer; the average time from first venture funding to exit is now approaching nine years. That is partly because the total addressable markets these companies are going after are much larger than they used to be 10 to 15 years ago. For example, leading consumer internet companies in the 2000s decade might have counted monthly active users in the hundreds of millions. Today, category-leading consumer

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internet companies have monthly active users numbering an order of magnitude larger. So, we have seen many venture-backed companies prefer to remain private longer, while they address this larger market opportunity, and eventually emerge as much bigger companies, in terms of revenues and enterprise value, when they pursue an initial public offering or get acquired.

The obvious downside for investors in such companies is that the illiquidity period is longer. The question is – are

companies compensating their investors for this longer lock-up (longer time to liquidity)? The answer in many cases appears to be yes and the top quartile venture capital returns data shows that.

As well, if you look at the average IPO size (for a venture-funded company) back in the 1990s, it was typically in the hundreds of millions of dollars (in enterprise value at time of IPO). Now, IPO valuations for venture-backed companies can be in the tens of billions of dollars. In other words, for the best venture-backed companies, the longer time gestating in the private markets frequently results in bigger absolute outcomes.



Q How is current public market volatility impacting tech valuations and the VC landscape? Can we draw any insights from previous periods of market disruption?

SM: If you look at the peak to trough declines in the public markets over prior cycles, we are in the third worst correction ever. But we believe tech is defensive and has proved resilient through prior cycles. A lot of our GPs are adopting the ethos of never letting a good crisis go to waste, and so are we. Price discovery is taking longer, which is why deal pace has slowed down, but we believe there could be compelling buying opportunities in the short to medium term.

If you look at the pipelines of many of our tech buyout managers today, more than half of their deals are take-privates. Those are hard to get done but over time we feel this could create great entry points for our tech buyouts managers. There appears to be less opportunity in growth because most of what they are doing is in the private realm. While we haven't seen a private market correction yet, we are starting to see early indications of pricing starting to soften.

BJ: When we think about venture investments, we have to think about the capital markets cycle and the technology cycle. The capital markets cycle matters, of course: we have had a remarkable run of robust capital markets around the world for the past decade and venture has been a big beneficiary. Now, the IPO window has closed temporarily and in our view is likely to remain that way for a few quarters, plus M&A activity is hard to predict. So, this year will not look like 2020 or 2021.

In terms of the tech cycle, though, we are in the middle of a multi-year, multi-decade innovation supercycle, with the transformation of multiple industries driven by everything from smart phones to cloud computing and artificial intelligence. The pace of tech innovation and high-quality company creation continues unabated. Historically, periods of macro decline have been great times for the creation of enduring new companies, and that is part of our thesis: to keep investing in early-stage venture through this environment.

Importantly, that pre-IPO value creation and those outcomes are not accessible to public market investors; they are only accessible to private market investors (venture and growth, in this case) in these venture-backed companies. So there appears to have been a shift in the way value is created for many tech companies over the last few decades, with a significant amount of growth occurring during the period of time the company is privately held.

Saguna Malhotra: We've seen a real dichotomy in hold periods between venture versus the growth and buyouts space. In the last six years, we have witnessed the hold period in growth and buyout portfolios shrink quite meaningfully, driven by multiple factors including strong growth in companies, more successful add-on acquisitions and much more capital chasing companies. GPs are getting to their underwriting case in two-and-a-half years rather than four or five.

With hold periods coming down, internal rates of return with respect to investments in these companies can be quite high, though that could shift given the recent drawdown in the public markets. We have seen a meaningful slowdown in dealflow in 2022. Last year was incredibly busy on all fronts but the competitive dynamics are now shifting, and price discovery is more challenging.

Q How are managers making decisions on when to exit investments, and what opportunities do longer hold periods create?

SM: If you are underwriting at 3x in five years and a 25 percent IRR, then 2x in three years gives you the same IRR. GPs today have multiple opportunities to exit, and in the growth and buyouts space that is typically to strategic and financial buyers. When companies achieve tremendous scale, outside of late-stage venture, you can see a path to IPO, but that is not the norm in our experience.

Now there is a whole new avenue to exit via sponsor-led continuation vehicles, where Adams Street, as primary investors, have the opportunity of taking liquidity. We also have a large and experienced secondary practice as well as a co-investment practice, so often they are looking at these buying opportunities where we have opportunities to sell. On the primary side, our default for the most part has been that if the GP wants to sell an asset, for example at 4-5x, and they see an opportunity, we are generally supportive of that.

BJ: In early-stage venture, the median hold time has gotten longer, as discussed earlier, and the ultimate exit route of an IPO or M&A is driven by the CEO and the management team in conjunction with the board. The view of external shareholders is important, but it is not a unilateral decision.

Still, venture managers have a few avenues to take capital off the table along the way. It was once unusual for venture funds to sell part of their investment in a secondary sale or exit in any way before an IPO or M&A event, but that has been changing. We are seeing more and more early-stage venture managers taking some money a few years after their initial investment; they might take some of their stake off the table, realizing a few turns on their initial investment in the company while still retaining the bulk of their position. That sale can be to a dedicated secondary buyer or, through a secondary sale when the company raises a follow-on round from a later-stage investor.

Q What are you currently focused on when identifying tech funds?

SM: Broadly speaking, our portfolio sticks to our belief that managers need an edge with specialization because they have real pattern recognition and understand how to underwrite growth.

At Adams Street, we believe we are still in the early days of a multi-decade digital transformation across the global

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economy, and we seek to leverage those tailwinds. We feel the specialist funds in this space understand the dynamics better than the generalists, and the data around returns dispersion speaks for itself. So, we focus our relationships on the highest quality specialist managers.

BJ: In venture, we have seen more specialization in terms of stage, sector and geography. We see specialist early (ie, seed, Series A, Series B), later stage and growth investment managers, and we see sector specialization in everything from agtech to crypto, gaming and biotech, and so on. That reflects technology shifting from being a vertical to a horizontal across all industries and touching every part of GDP. We are also seeing specialist firms emerging in pretty much every geography.

Our approach in venture has been to favor tech generalists, with a few exceptions. We like venture firms that specialize in technology, but which consider themselves generalists within that space because technology evolves rapidly and having a broad aperture lets their funds evolve with that. Plus, we think the most interesting companies tend to emerge at the intersection of sectors and therefore, as investors we believe that venture managers need to be able to have a broad lens, to see multiple trends, to increase their chances of backing tomorrow's winners.

There are exceptions in certain

domains that are so technical and fast-evolving – like crypto/blockchain – that you can argue a specialist approach is needed. Fintech is another area that is so specialized that a successful play-book in the space tends to be applicable across multiple geographies.

Q How are PE and venture firms currently creating value and driving growth in their tech portfolio companies?

SM: At Adams Street, we like to invest in growth and buyout managers that are specialists, with sector focus and knowledge, but also with really strong operational capabilities as part of the suite of services they can offer portfolio companies. In our view, strong returns can be generated across cycles only by focusing on the fundamental growth of those companies.

Today's leading growth equity firms are focused on driving profitable growth, which means growing executive teams, investing in sales and marketing, and thinking about how to increase wallet share from existing customers. We also still find expanding the product roadmap is important, and of course M&A, which could be really interesting at a time when smaller businesses might struggle in the tougher environment.

BJ: On the venture side, we look at value-add services in the context of companies staying private longer and becoming much larger before exit. On that journey, we believe venture capital has to play a part in building the business, and today's consummate venture firms do everything from team building (eg, helping the founders hire key engineers or heads of marketing), to finding product market fit, finding marquee customers or helping the company scale up with co-development opportunities.

Firms now often have sizeable teams of non-investment professionals to help companies do all these things, and that is a meaningful part of the venture play-book and has become table stakes in helping companies cross the chasm. ■