Adams Street

# Powerful Long-Term Trends Boost Venture Capital Outlook


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**KEY TAKEAWAYS**

- We believe we are in the early stages of a decades-long innovation supercycle
- Venture capital has a disproportionate influence on backing innovative, technology-focused startups, and some of the best VC outcomes have resulted from investments in companies created during sub-optimal market conditions
- We expect an increased focus on capital efficiency to boost demand for cost-efficient technologies, especially enterprise software. We think healthcare, next generation AI and machine learning also offer compelling opportunities
- Venture capital is recalibrating after the market correction caused many non-traditional investors to exit the market, kickstarting a mean reversal in deployment pacing, valuations, and terms, which we believe makes the environment more compelling for investors
- Our research shows that approximately 9% of VC-backed companies produced 100% of the investment gains going back to the 1970s. As such, it is important to select and access managers with strong sector expertise and a record of producing attractive risk-adjusted returns through market cycles
- We believe venture capital will continue to outperform its public market equivalents over the long run

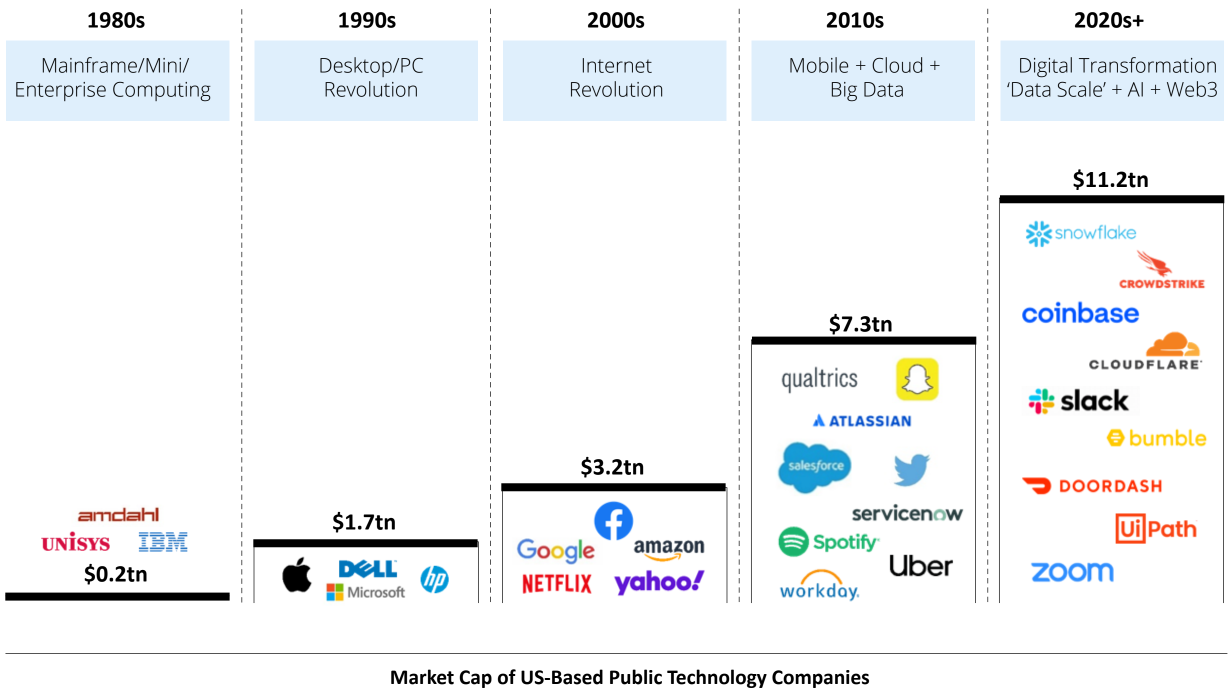
If there's a single word to describe the first two decades of the millennium, it may well be innovation.

The pace of technological development is accelerating exponentially. The formation of Lyft, Snap, Spotify, and countless other global mobile-first platforms would have been inconceivable prior to the era of fast, high-capacity wireless networks, the proliferation of powerful, pocket-sized connected devices, and the emergence of cloud computing.

Each wave of innovation eclipses its predecessor in a virtuous cycle that encapsulates the compounding nature of technology. Chris Dixon, General Partner at Andreessen Horowitz, summarizes this by saying "the core growth process in the technology business is a mutually reinforcing, multi-step, positive feedback loop between platforms and applications." This dynamic has led to more significant value creation for technology-focused companies and their investors, over subsequent decades.

**Figure 1: The Compounding Nature of Technology**[1]

Continuous Innovation Cycles Expand Scale of Each Subsequent Wave




## Venture's Value Creation

Venture capital firms have a multi-decade history of facilitating innovation. Four of the five largest public companies by market capitalization at the end of 2022 trace their roots to VC funding. According to the National Venture Capital Association, half of all US public companies benefited from venture investment, while VC-backed businesses make up about 77% of US public market capitalization, 81% of total patents granted by the US Patent and Trademark Office, and 92% of research and development (R&D) spend.[2] Since 2001, 53% of all initial public offerings (IPO), and 70% of tech companies going public had VC backing, according to Professor Jay Ritter at the University of Florida.[3] Still, venture accounts for less than 1% of total capital market assets.[4]

Investing in innovation has generated strong returns for top-performing venture capital funds. The top quartile of global venture capital funds generated a 28.2% internal rate of return from 2001 to 2022. However, not all venture capital is created equal, as there is a wide dispersion in returns due to a relatively small number of investments driving most value creation in any given vintage year — the median performance of global venture capital funds is 13.2% over the same period.[5] An analysis by Adams Street going back to the 1970s shows that 9% of VC-backed companies produced 100% of the investment gains. This is driven by top venture funds being able to generate 100 times or even a 1,000 times multiple on invested capital in a single company.[6]

Having a stake in the companies within each fund cycle that have the capability to become next-generation category leaders means VC investors need consistent allocation across time. Being on the right end of such a wide range of return dispersion means selecting managers with sector expertise, trend awareness, venture and tech community relationships, access to deal flow, and the ability to negotiate terms and close deals that look attractive.

## Adversity Creates Opportunity

Economic uncertainty, characterized by factors including rising interest rates to combat inflation, is putting pressure on margins and global growth. Organizations of all stripes are therefore seeking to boost productivity through cost-efficient technologies, especially enterprise software. As Microsoft Chief Executive Officer Satya Nadella told investors in an earnings call in April 2022, “In an inflationary environment, the only deflationary force is software."[7]

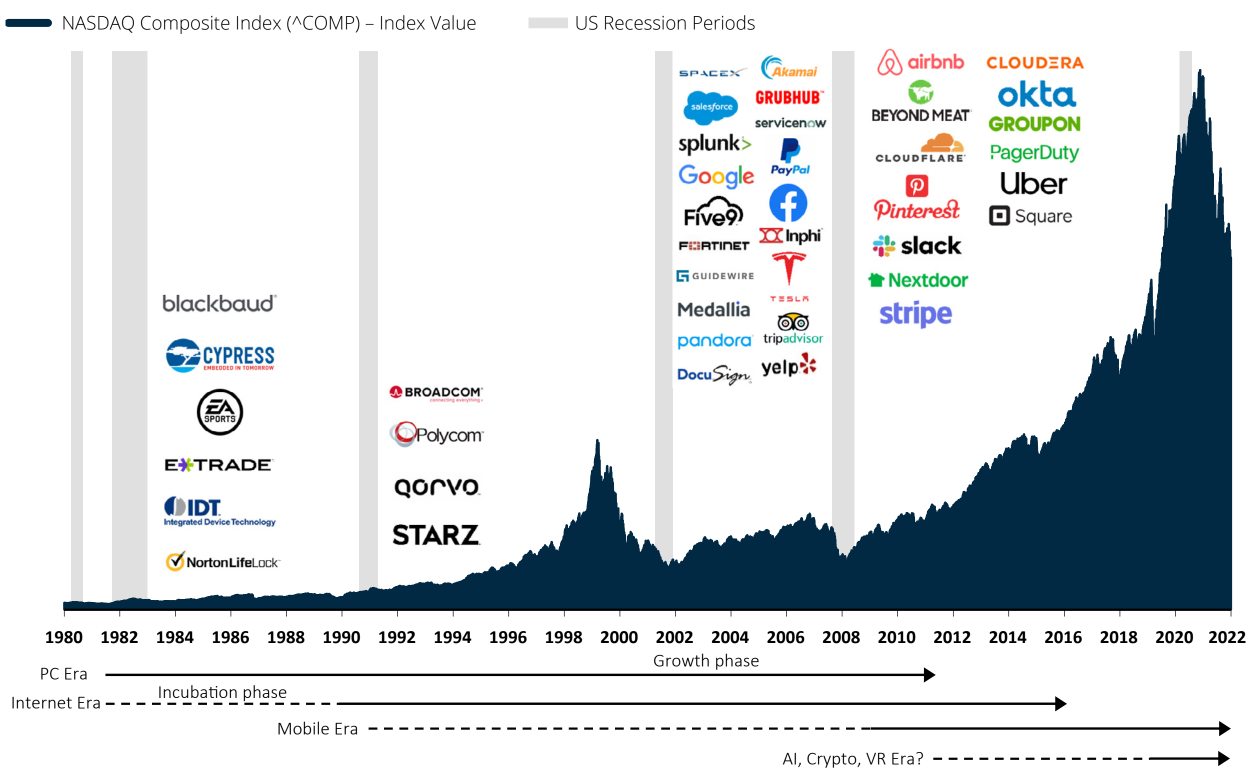
In our view, crises can promote robustness in the startup ecosystem. Perhaps the clearest recent manifestation of this phenomenon was the COVID-19 pandemic, which drove increased use of solutions such as remote working and telemedicine.

"Innovation and disruption are constant and not subject to the whims of the overall economy," Bill Gurley, General Partner at venture capital provider Benchmark, wrote in December 2008 in the midst of the Global Financial Crisis.

Benchmark was an early investor in Uber, Snap and Elasticsearch, which were founded during this time. All are now public companies with market values from $5 billion to $60 billion. This illustrates how some of the best venture capital outcomes can result from investments in companies that are created during sub-optimal market conditions.

**Figure 2: Innovation Does Not Mirror Financial Cycles[8]**

Select US Companies Founded Around US Recessions (1980-2022)



## Market Reset

While the cohort of traditional investors serving early and mid-stage companies has remained relatively stable, many non-traditional venture investors have withdrawn after deploying capital at historically high valuations in recent years. This has helped to reverse distortions and kickstart the normalization of conditions.

As investment pacing, valuations, and terms revert toward historical means, we believe the environment will be more compelling for traditional investors. Furthermore, we think competition will be reduced (both from fewer startups, but also lower R&D budgets at tech incumbents), talent availability will be more abundant, and capital efficiency will be at the forefront of every company's mind.

## Rocketship for the Mind

We see particular opportunities for disruptive and innovative technologies that stand to benefit from the digital transformation of the global economy, which is in its early stages and is likely a decades-long trend.

For example, an estimated $1 trillion of unproductive spending in the US healthcare system is being targeted by novel software applications. Telemedicine is expanding the reach and efficacy of care. Artificial intelligence (AI), advanced devices and robotics are improving diagnostics, surgery and the overall standard of care, while minimizing or even eliminating redundant workflows.[9] All of these represent solutions provided by VC-backed companies in our portfolio.

Next generation AI and machine learning offer many compelling potential use cases. Generative AI allows machines to "create" via writing, coding or drawing through human initiated prompts, and has the capability to significantly improve productivity in the knowledge-based economy, which currently employs about a billion people globally.

In addition, because AI is not a "one size fits all" solution, we expect companies to emerge that focus on applications specific to certain use cases. If personal computers are “bicycles for the mind”, as Steve Jobs quipped, we expect the next generation of AI and machine learning to represent something akin to a rocketship for the mind.

**Humankind faces countless predicaments and we believe our best chance to unravel these conundrums is by being investors in human ingenuity and perseverance**

## Elements of Success

Having invested directly into companies since 1972, and as a limited partner in venture capital funds since 1979, Adams Street is a long-term optimist in the potential for technology. Humankind faces countless predicaments in areas such as healthcare, education provision, workforce reimagination, and financial services, to name a few. We believe our best chance to unravel these conundrums is by being investors in human ingenuity and perseverance.

Entrepreneurship has experienced strong tailwinds over the past decade from improved horizontal technology infrastructure. This has reduced startup capital expenditures, allowing companies to operate with more flexible and dynamic cost structures as they scale their business, improve distribution through tech platforms and app stores, and seamlessly embed payment capabilities in applications.

Iconic companies are built in all market cycles, and we believe that venture capital is one of the primary avenues to invest in this innovation while generating attractive risk-adjusted returns. Companies are staying private longer and are achieving greater scale than in prior cycles, both of which improve the potential for value creation in private markets, all while market fundamentals and terms are improving.

Building a company from zero to one and scaling it to commercialization continues to require significant work, skill and, of course, some luck. The core tools for value creation by venture capitalists that help improve the chance of success — domain expertise, networking, strategic guidance, governance — remain vitally important to startups, especially in today's environment.

We think the need has never been greater, and the potential has seldom been so compelling. As Bill Gurley noted in September 2022, "If you're going to build something from scratch, this might be as good a time as in a decade."[10] ■

1. Source: World Bank & Adams Street Analysis, as of October 2022. Note: Market capitalization calculated by averaging the total market cap of US-based public technology companies at the beginning and end of each decade. '2020s+' market cap reflects the market cap at just the beginning of the decade.
2. Source: National Venture Capital Association Yearbook 2023.
3. Source: Initial Public Offerings: Updated Statistics, Jay R. Ritter, University of Florida, March 8, 2023.
4. Sources: Preqin, as of December 2021. McKinsey & Company Global Private Markets Review March 2022 "Private Markets Rally to New Heights". Global listed equities and global listed bonds: Securities Industry and Financial Markets Association (SIFMA) Capital Markets Fact Book, July 2021.
5. As of September 30, 2022. IRR reflects Internal Rate of Return. Sourced from Burgiss as of January 20, 2023, and numbers are subject to updates by Burgiss. Burgiss is a recognized source of private equity data and the Burgiss benchmark is based on a global set of venture capital funds. Burgiss results are net of fees, carried interest and expenses to limited partners.
6. The returns achieved by a single investment are not necessarily representative achieved by the overall portfolio and past performance is not a guarantee of future results.
7. Source: Microsoft.com Press Release & Webcast, Earnings Release FY22 Q3 April 26, 2022.
8. Source: US Recessions Data from Federal Reserve Bank of St. Louis (Accessed April 2023). NASDAQ Composite Returns from CapitalIQ. Adams Street Analysis.
9. Source: Jama Network "Waste in the US Health Care System: Estimated Costs and Potential for Savings", October 7, 2019.
10. Source: McKinsey & Company Quarterly September 26, 2022.