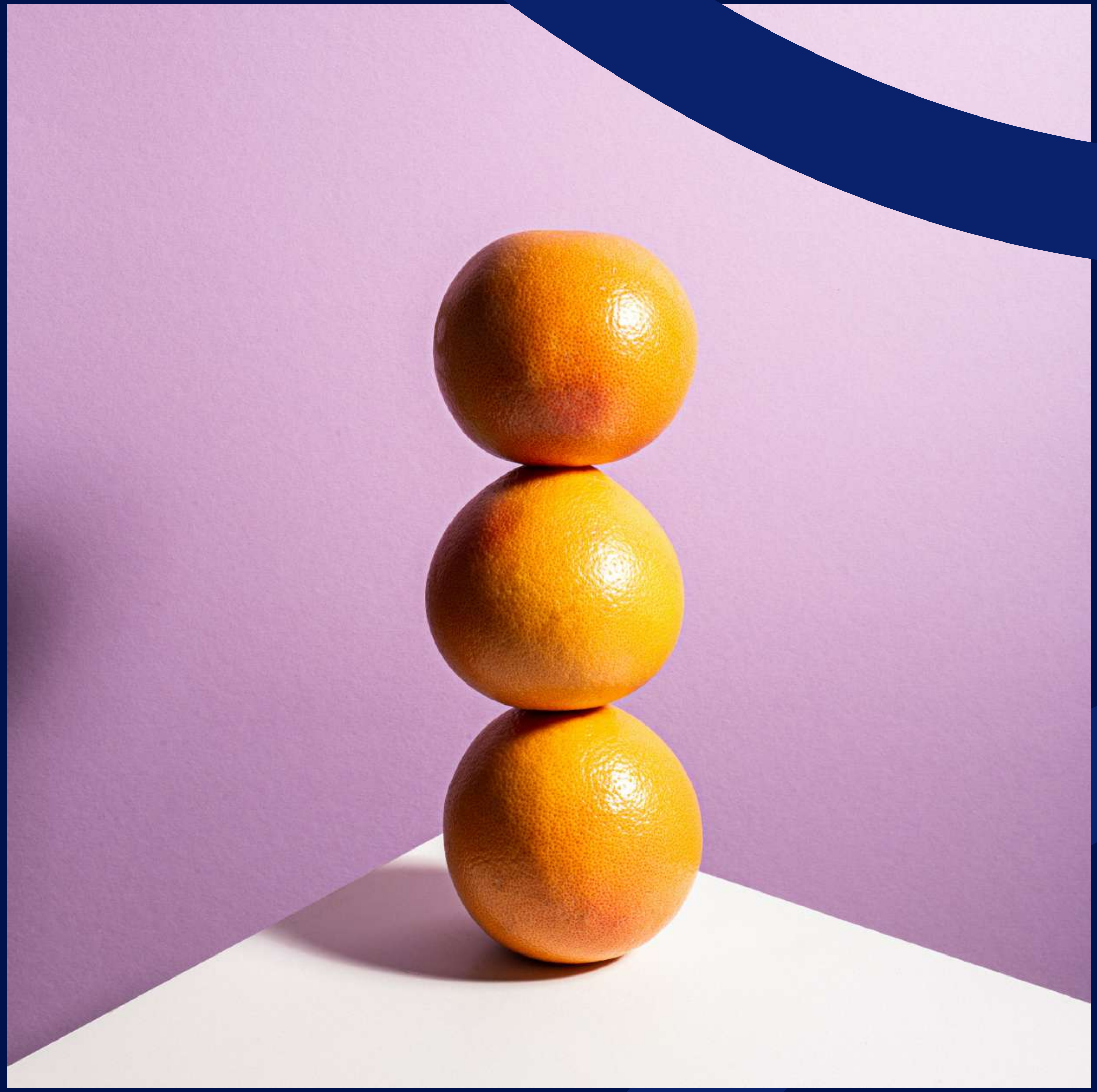
VENTURE CAPITAL By David Struthers

Family Office Venture Capital Review 2023



&Simple

Family offices play a significant role in the world of venture investing, being uniquely equipped to provide funding, as well as guidance and support to their VC partners and often investing in sectors where they have expertise, interest, or a desire to drive innovation. This review takes a closer look at the venture capital landscape through a family office lens, examining the unique value that family offices bring to the table, the role that venture investments play in a family office portfolio, and the strategies that family offices use to achieve their desired level of exposure to the asset class.

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1. Introduction

The immediate uncertainty ignited by the collapse of the Silicon Valley Bank (SVB) subsided as the FDIC stepped in to guarantee all deposits and took steps to secure funds for other mid-sized banks. Questions about oversight, capital requirements, and moral hazard came to the fore in the United State. Potential weaknesses in the banking sector spread to Europe, which saw UBS purchase its longtime rival Credit Suisse. For many of us who lived through the 2008 global financial crisis, this brought up vivid memories of that difficult period.

For startups and VC investors, the trouble at SVB highlighted the role of venture debt and the immediate banking needs of startups to meet payroll and pay vendors so they can continue to operate and grow. As examined in this review, VC is a high-risk asset class and these events draw that out in sharper relief. But if SVB's collapse is indeed chilling start-up funding, then perhaps this is a time of opportunity for family offices in this space.

2. The Venture Capital Landscape

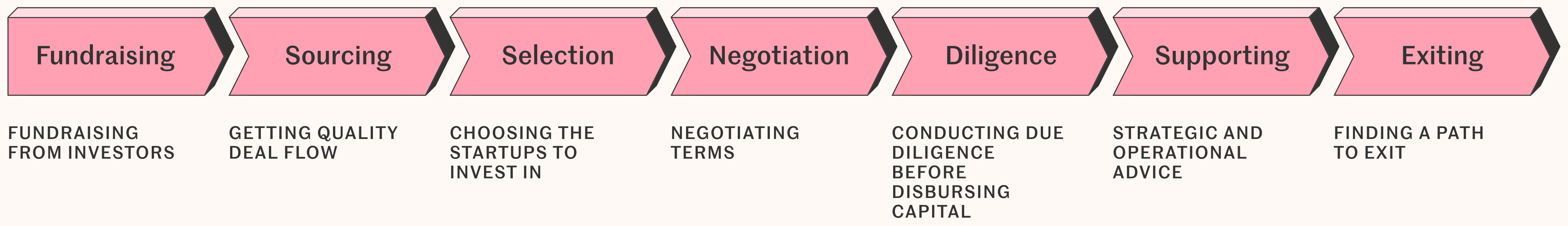
The talented entrepreneurs bringing their innovations to market are at the centre of the venture capital world. Startups need access to the capital, of course, and that's the raison d'etre of VC investing, but most startups also need mentoring and support in areas such as business development that family offices are ideally positioned to provide either through their own internal capacity or through their networks.

Investors accept the risks inherent in venture capital investments because they seek returns greater or uncorrelated to listed equities or other asset classes. Many VC investors are also driven by their desire to fund innovative solutions to societal problems. The nature of investing in early funding rounds of a startup attempting to bring an innovative new solution to market requires understanding the technology and service landscape of the industry in addition to the business prospects of the new firm. The world is not static and an extended product development cycle brings technological and market changes, increasing uncertainty. It is often repeated that 90% of startups fail. This statistic serves as a caution by highlighting the significant risk of investments being complete losses in this asset class. However, VC investing is not just about avoiding risk but identifying opportunities that many seasoned VC investors miss.

Venture investment is a competitive landscape where major VC funds with deep connections and technical expertise dominate in terms of total capital raised and deal flows. Tiger Global and Sequoia Capital stand out in this regard as does the SoftBank Vision Fund.

Exhibit 1: The VC Landscape

The Venture Capital Value Chain



Source: Innosight "The Future of Venture Capital"

The factors in favour of the large VC firms maintaining their position are their brand, track record, a strong pipeline of potential new deals, significant non-monetary resources such as connections and advising, and, lastly, interest from entrepreneurs themselves.

The funding cycle bookended by the 2008 economic crisis and the covid era was marked by the incredible amount of money poured into VC. These two era-defining events unevenly impacted the VC landscape. Recent challenging macroeconomic conditions have focused attention on the potential headwinds faced in the VC space, though differentiated across business and technology sectors.

In recent decades the focus of much VC funding has been on potentially disruptive innovations. However, there are focused critiques on the limitations of VC, especially of institutional VC investors, to "advance substantial technological change" across society because of the "narrow band" of potential technology they choose to invest in. Additionally, as noted above, identifying the most disruptive firms at an early stage that will succeed is a difficult task.

Of the large VC funds, Tiger Global made waves over the past few years for the amount of capital it invested around the world and the speed at which it did so. It reportedly outsourced due diligence and inked deals in a matter of days. It is debatable if Tiger Global Management truly ate the VC world, but the difference in approach from family office VC investing is striking. Most family offices choose to allocate their resources differently than these super-funds, which brings us a discussion about what family offices bring to the VC table, what function VC investments have in a family office portfolio, and what paths family offices take to achieve their desired exposure to the asset class.

3. Family Offices and Venture Capital

Venture capital is one of the most demanding asset classes for investors. Deal sourcing and due diligence require deep networks and experienced team members or trusted external capacity. The extended time horizon of illiquidity needs to be accounted for and managed. VC sits squarely on the high-risk/high-potential returns side of possible investments. VC is a highly specialised area where it takes time to develop expertise. Family offices, of course, function to both protect and grow wealth, which leads them to follow comprehensive wealth management strategies that may tolerate significant risk in part of their portfolio.

Simple's six family office archetypes differ significantly in operating capacity and orientation, which influence how they chart their paths to VC investing. The demands of VC require an interest in the asset class and team members to source, do diligence, and manage the investments at a minimum. Providing continuing business support takes an even larger staff commitment. A startup family office may have deep connections to the VC space, while a legacy family office may be more comfortable delegating this part of their portfolio to a trusted investment fund.

Across the archetypes, rationales for investing in the asset class, or avoiding it altogether, hinge on risk/reward calculations and the toleration of illiquidity.

Average allocations flatten these different journeys, but they do evidence the significant interest of family offices in VC.

Exhibit 2: Family Office Archetypes

Archetypes

Startup Family Office

Newly established family offices with the freedom to create agile organisations at their point of origin.

Legacy Organisations

Family offices that have fulfilled their mission with success and diligence for decades, perhaps lagging behind in their use of technology.

Best in Class

An elite selection of family offices is leading the way in organisational efficiency, management structure, and reach.

Single to Multi-family Office

These are single family offices joining forces to increase efficiency and effectiveness.

Banker to Multi-family Office

When a banker steps clear of their prior wealth management work to start a new multi-family office.

Commercial Multi-family Office

High staff-to-client ratios are the norm as meeting the bespoke needs of clients takes top priority.

Source: Simples Family Office Software & Technology Review 2022

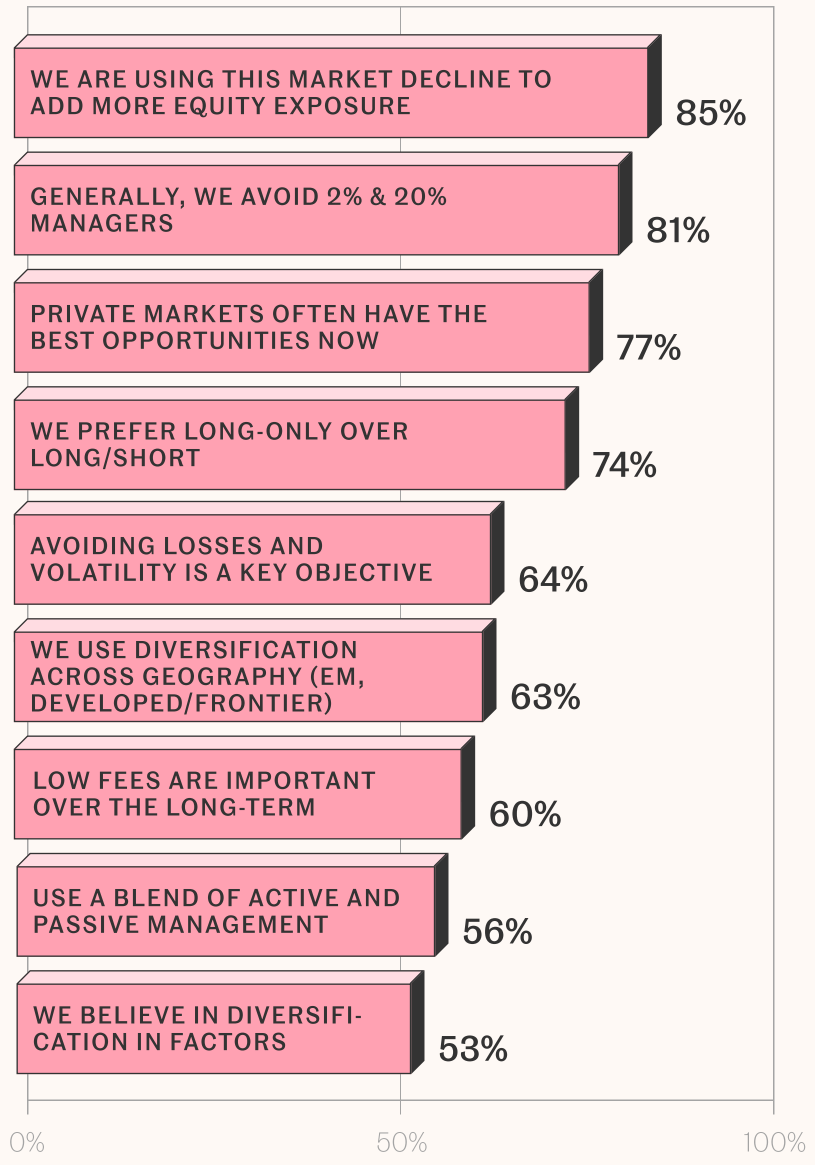
Portfolio allocation

Most family offices believe in diversifying factor exposure for their direct investments (see Exhibit 3) and they average about 6% of their total wealth in VC investments (see Exhibit 4). Family offices seem intent on increasing or maintaining their exposure to the asset class in the current turbulence (see Exhibit 5).

Clearly, family offices are significant players in venture investing within their geographical spheres and globally with this level of committed capital in their portfolios. Family offices have the capacity to be ideal VC partners with startup firms through their ability to manage the long time horizon of their investment and to leverage their other intangible assets to assist growth in the startups they invest in. If we flip this view to think about what VC looks like from the perspective of a startup, it might be tempting for a startup to want a blank check, but experienced hands know that this does not bring as much value as the fleet of resources that best-in-class VC investors provide.

Exhibit 3: Family Office Investment Beliefs

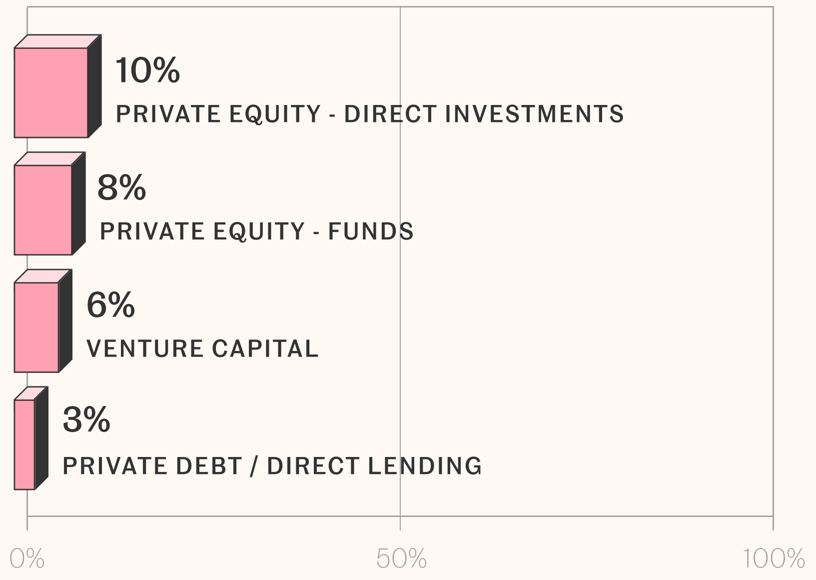
To what extent do you agree with the following statements regarding the family office's investment beliefs?



Source: Dentons Family Office Direct Investing Survey, October 2022

Exhibit 4: Private Equity & Debt

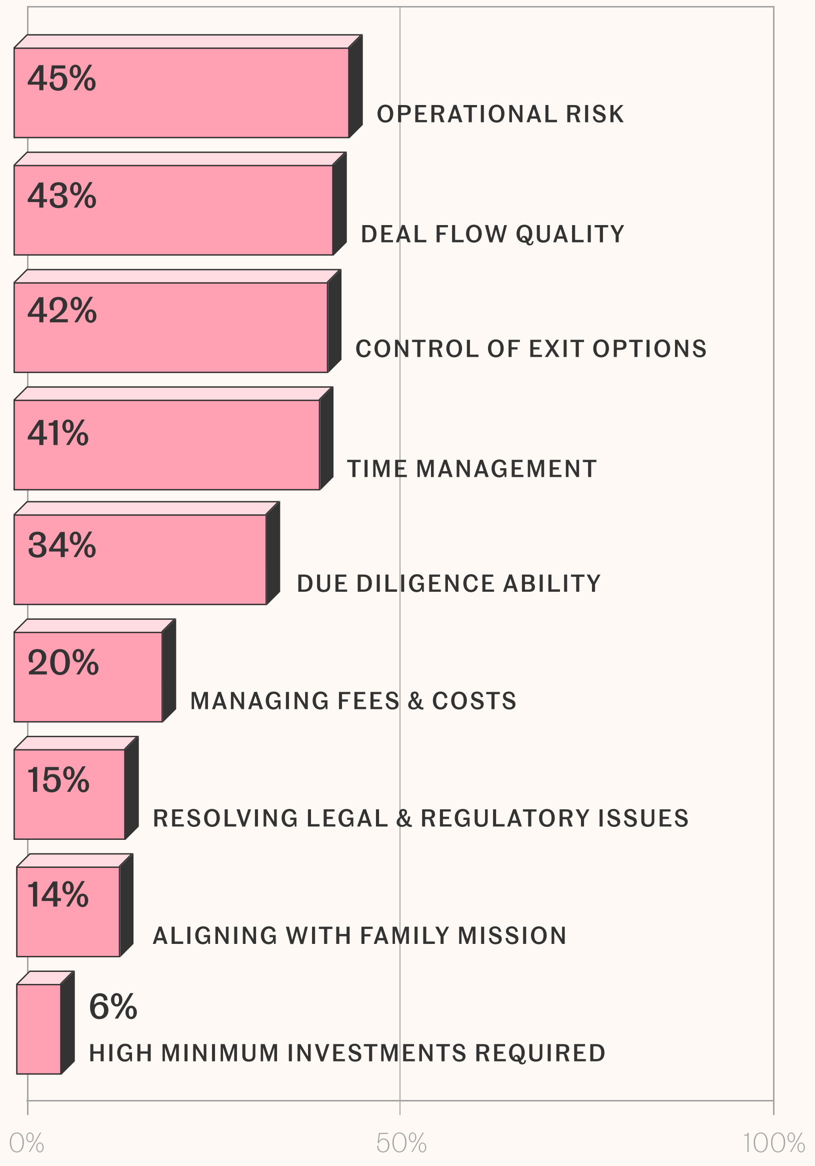
Family Office Venture Capital Allocation in 2022



Source: Campden Wealth, "The European Family Office Report 2022"

Exhibit 6: Direct Investment Challenges

What do family offices see as the biggest challenge when making direct investments?



Source: Dentons Family Office Direct Investing Survey, October 2022

Family offices are increasing their influence in the VC space by shifting the ecosystem because:

> "Family offices possess several key ingredients for venture capital success: capital, patience and commercial history"

– Kjartan Rist, Founding Partner, Concentric

The Function of Venture Capital in Family Office Portfolios

From a purely financial perspective, family offices are attracted to venture investments for similar reasons to other investors: they seek returns not readily available in other asset classes and are willing to accept the risk for this portion of their portfolio. The goal is to make investments uncorrelated with equities markets over the near term and that provide greater returns over the long term. However, venture capital for many family offices is more than purely financial. Many family offices invest in areas in which they have particular expertise and interest or in sectors where they want to drive innovation. The opportunity to move the needle in important business areas is a strong motivation.

Family offices commonly view VC as part of their illiquid alternatives portfolio allocation and a mechanism to play certain investment themes. Across the board, family offices design this portion of their portfolio for the long term by managing its liquidity–often through laddering–while remaining mindful of the high failure rate. Venture capital is about managing risk and portfolio construction.

One family office principal noted:

“Venture investing can be binary, so one should only invest money one can afford to kiss goodbye to.”

Family offices have the option of making direct VC investments, going through funds, and funds of funds. VC investments can also provide exposure to new technologies that have yet to reach maturity in listed firms. One example might be investing in a fund of funds to tap into the potential of a broad suite of blockchain startups, recognising the high attrition rate of technology startups, but still potentially capturing some of the gains of the surviving firms. The downsides of this approach are the high fees and that large funds of funds rarely offer the opportunity for close relationships with fund managers.

Family offices have clear distinctions from large funds, but they also face specific challenges. Many family offices are highly opportunistic when it comes to investing. The downside of being opportunistic is that family offices might not take a structured approach to their venture capital investments. Some lack the internal resources and time to fully diligence each investment. Additionally, family offices often gravitate to investing in sectors in which their wealth originated, which can economise their knowledge resources, but lead to a lack of diversification.

4. Paths to VC Exposure

Direct? Funds? Funds of funds? What model is best for family offices?The answer to that question lies in the family office itself influenced by its interest, knowledge, capacity, available capital, and other factors. When Simple spoke with family office principals and fund managers, one often repeated observation was that opportunities and risk management come through your internal capacity and network. Family offices lacking in either might be best served, at least initially, by investing through VC funds, before making co-investments and eventually investing in a fund's general partnership to gain experience, expand their network, and gain a presence in their targeted VC ecosystem. Drawing on years of experience in the highly competitive technology sector in Silicon Valley, California, one well-placed VC investor put it simply:

"Access is the key"

What they were stressing is just how strong the competition is among investors for the best investments, the startups that they believed had the greatest potential for success.

Direct

The freedom of family offices to take advantage of opportunistic investments should not substitute for a well-defined VC strategy. All but the best-connected family offices will find that access is the first hurdle to clear when making direct venture investments. Another way of putting this is to question why each investment opportunity is being presented to your family office. Competition is high for firms to carve out space in existing markets or create entirely new markets for their goods and services, but that competition also extends to VC investors in well-developed VC ecosystems. There are a limited number of startups and over the prior decade or so VC funds invested an enormous amount of capital. Why did the startup decide to pitch your family office, rather than a fund or a different family office? Of course, there are many good answers to this question: your geographic location, personal connections, and probably most important, the startup may value your family office's ability to help them grow their business in additional, non-financial ways.

Globally, the family offices we spoke to tend to have geographical areas of expertise with concomitant networks and long histories where they concentrate their direct VC investments. One way they leverage these advantages is by connecting with other family offices both informally and formally by creating investing syndicates. This can raise family office profiles in a local VC ecosystem, increase deal flow pipelines, and spread out the costs and time of doing diligence on potential opportunities across multiple investment partners. Another advantage of joining syndicates is that they can be a way to extend the reach of family offices into new VC markets. Globally, a common economic development strategy is attempting to bring the IP created on university campuses to market through dedicated startup support infrastructure. Adjoining VC syndicates near world-leading universities may offer value for family offices looking to increase their VC opportunities.

Another aspect of direct VC investing by family offices looks beyond financial resources. Principals can look past the strategic and diligence requirements of funds to invest in companies and ideas in which they believe in. One of the strengths of family offices in this sense is having the freedom and the financial flexibility to back innovative, yet overlooked ideas. This can also blend into impact investing by putting money into causes they care about. Of course, these startups may still fail.

Family offices understand the complexity and challenges of direct investing. See their response when asked about what they view as the biggest challenge of making direct investments (including PE) in Exhibit 5.

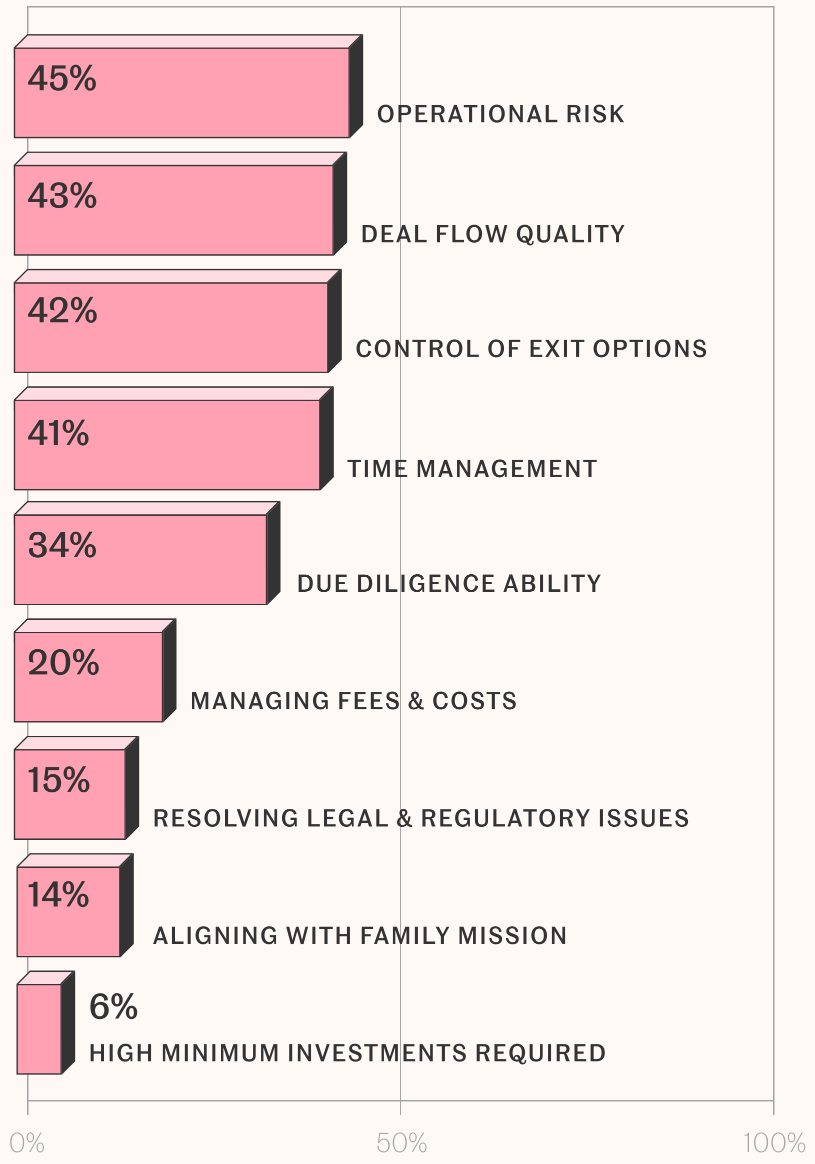
Funds

Funds offer the easiest and quickest way to achieve desired VC portfolio allocations. Best-of-class VC funds have distinct advantages in their professional management, deal flows, financial, and technical expertise. They also spread risk (netting) across a large pool of investments. VC funds often target specific sectors or themes though, so this should not be confused with proper diversification.

After completing a diligence process on the fund, family offices can allocate the capital and account for the expected time horizon without further involvement. Funds, of course, charge handsomely for these services.

Exhibit 6: Direct Investment Challenges

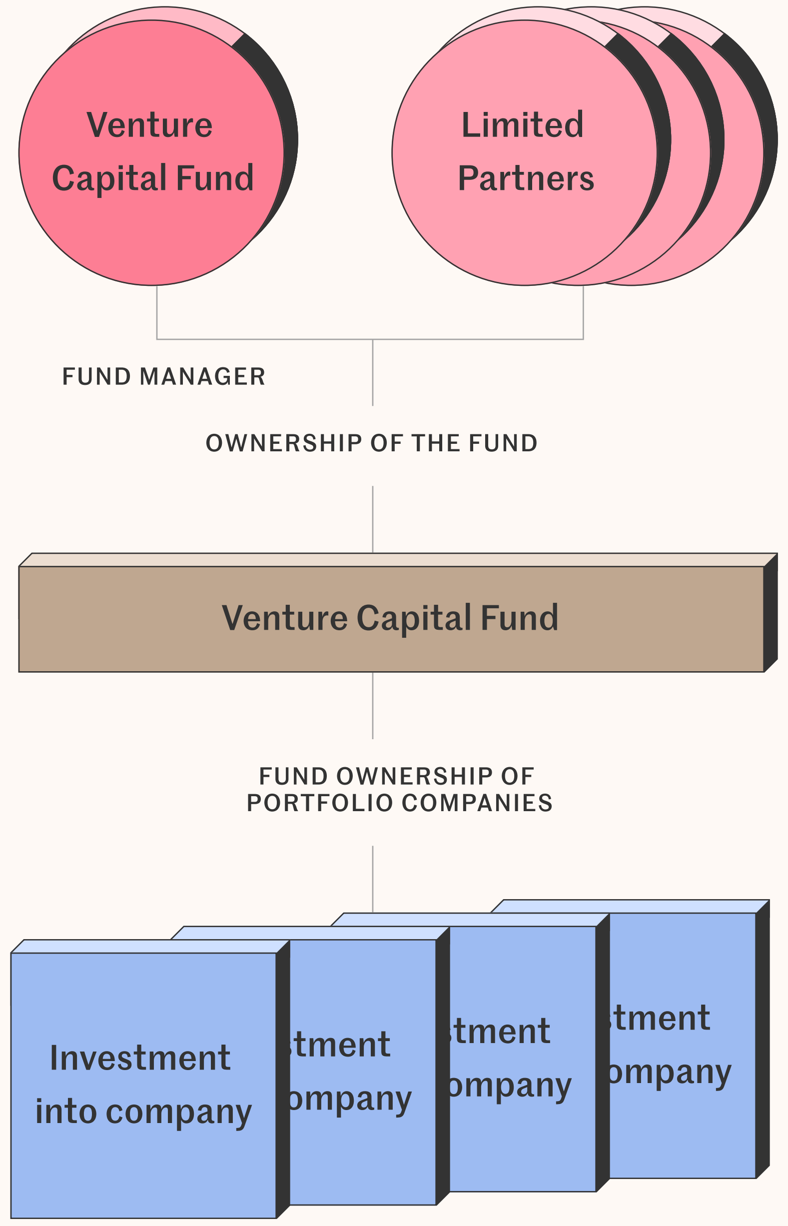
What do family offices see as the biggest challenge when making direct investments?



Source: Dentons Family Office Direct Investing Survey, October 2022

Exhibit 7: Venture Capital Funds

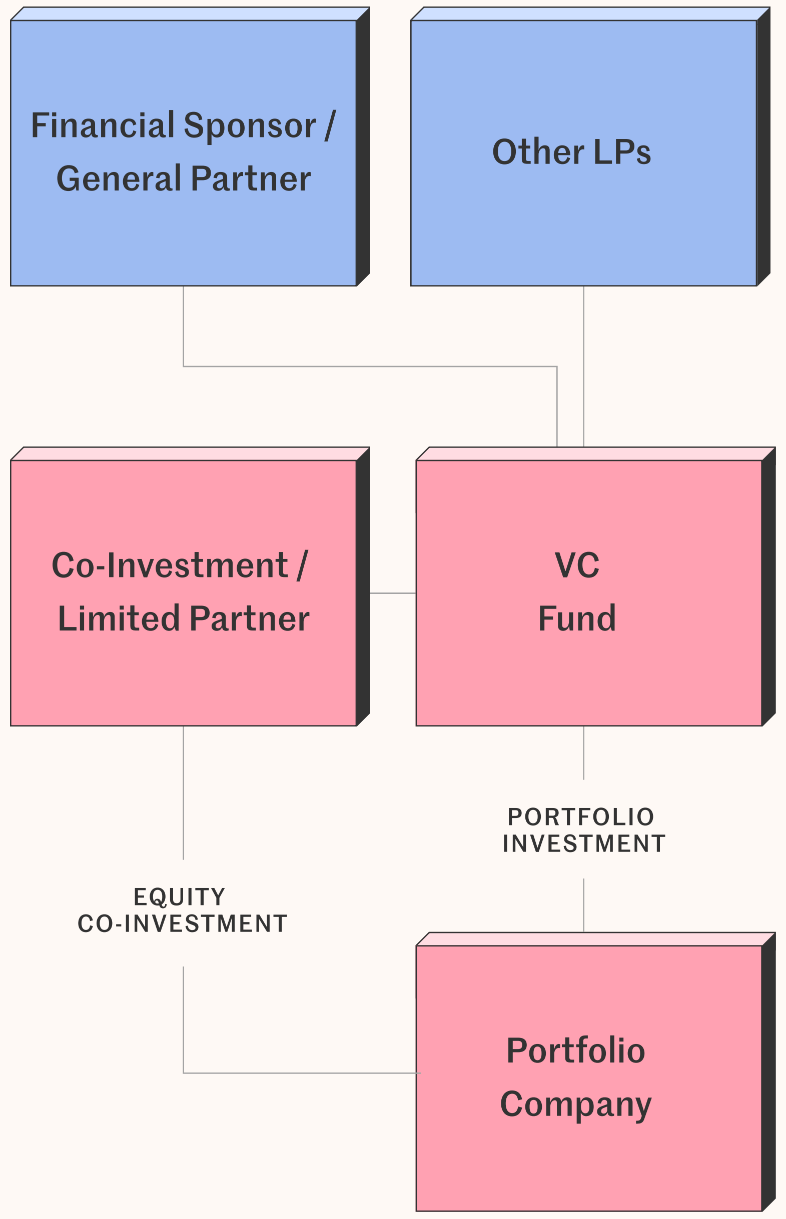
The VC Fund Structure



Source: AngelList

Exhibit 8: Co-investment

Equity Co-Investment & Direct Fund Investment



Source: Laconia Capital Group

Many family offices want to nurture relationships with the managers of the funds they chose to invest in. The availability of managers and their chemistry with them can also factor into the evaluation process.

Funds themselves vary considerably in the services and support that they provide to the startups they invest in. Given the high failure rate of startups, this should factor strongly into evaluations of VC funds by family offices. If the startups invested in fail, you will be writing off your investment and VC funds are still high-risk investments.

Funds present additional opportunities for family office investors than buying into the main investment pool. First, family offices can inform fund managers that they are interested in co-investments. There is some evidence of fund LPs earning higher returns on their co-investments than their fund investments. The family offices we spoke to are active in pursuing these opportunities, viewing it as a way to increase their venture capital allocation through pre-vetted opportunities with funds with which they have existing relationships. Co-investments are typically only offered to existing LPs so the initial investment is key to gaining access. Second, family offices can invest in a fund's general partnership, gaining a seat at the management table. This can be advantageous to increase total VC allocation, target specific sectors, and raise profiles in the VC community.

Funds of Funds

Investing in funds of funds is the aggregate of venture investments. The family offices we spoke with view funds of funds as a way to gain exposure and spread risk in emerging market sectors such as blockchain and biotechnology. The downsides are high fees and less potential gain. Ease and time of entry are similar to funds, but unpacking the risk across a fund of funds' portfolio does present distinct diligence challenges. Advantages include diversification, potentially balanced returns, access to exclusive VC funds, and additional management expertise.

6. Venture Capital and Private Equity

The family offices we spoke with commonly viewed their venture capital and private equity investments as a continuum in their portfolio allocation of alternative assets. Considerations of the amount invested, timeframe, and potential returns skewed toward the long term reveal a spectrum and the considerations at each stage of a company's growth. Nonetheless, VC and PE are distinct asset classes in their structure and financing. For example, PE investments are often leveraged, which increases their sensitivity to macroeconomic conditions and interest rates.

Exhibit 9: Venture Capital and Private Equity

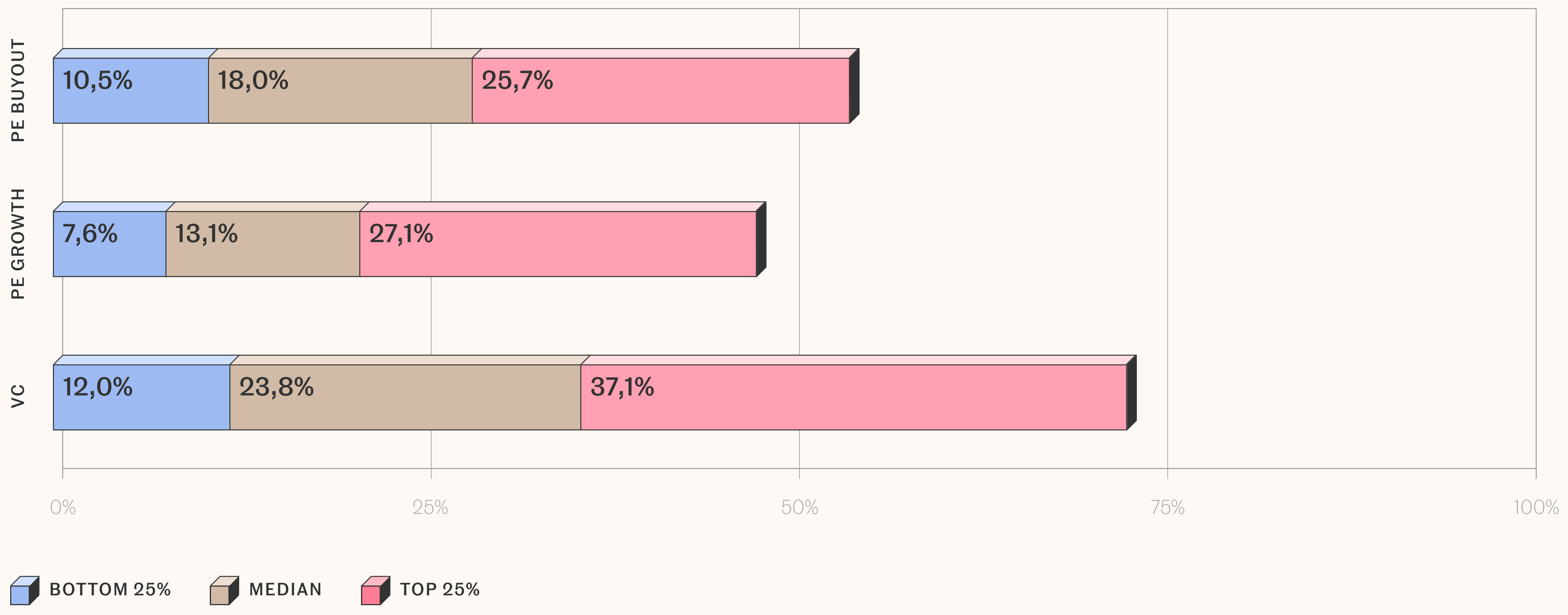
Venture Capital vs. Private Equity: What is the difference?

STAGE OF INVESTMENT	INVESTMENT SIZE	HOLDING PERIOD	RETURN EXPECTATION	INVESTOR TYPE / STAGE
Angel	US$ 10K – US$ 250	8 – 10 years	>75% IRR or +10x	Individuals or group of Individuals
Seed	US$ 250 – US$ 2M	6 – 8 years	>60% IRR or +10x	First institutional check
Growth	US$ 10M – US$ 50M	5 – 7 years	>40% IRR or +7x	Series A Through C
Crossover	US$ 50M – US$ 100M	>5 years	≈25% to 35% IRR or +5x	Series C Through IPO
Late Stage / Buyout	Depends: could be millions to billions	3 – 5 years	>18% IRR or +3x	Majority control / debt financed

Source: Ken Shih via LinkedIn

Exhibit 10: Global PE Performance

Private Equity and Venture Capital Returns in 2022



Source: Private Markets Rally to New Heights: McKinsey Global Private Markets Review 2022

In aggregate VC returns have been greater than PE returns in recent years despite their higher risk, though the data below reflects a funding cycle that saw strong economic growth. Timing is crucial in VC investments.

7. Market Insights: Promising Sectors in Turbulent Times

Venture capital went through an incredible spending cycle between the 2008 economic crisis and the current period. One well-placed VC investor views the present period as one for reflection and to double down on the need for a clear understanding of the purpose of VC investments in a family office portfolio today.

"Think through what family office direct VC investments look like in an up cycle and a down cycle. Are you searching for yield? What about your need for liquidity over the long and near term? What are the ramifications for putting money in private tech now at this point in the cycle?"

Currently, family offices are focusing their VC investments on core growth industries:

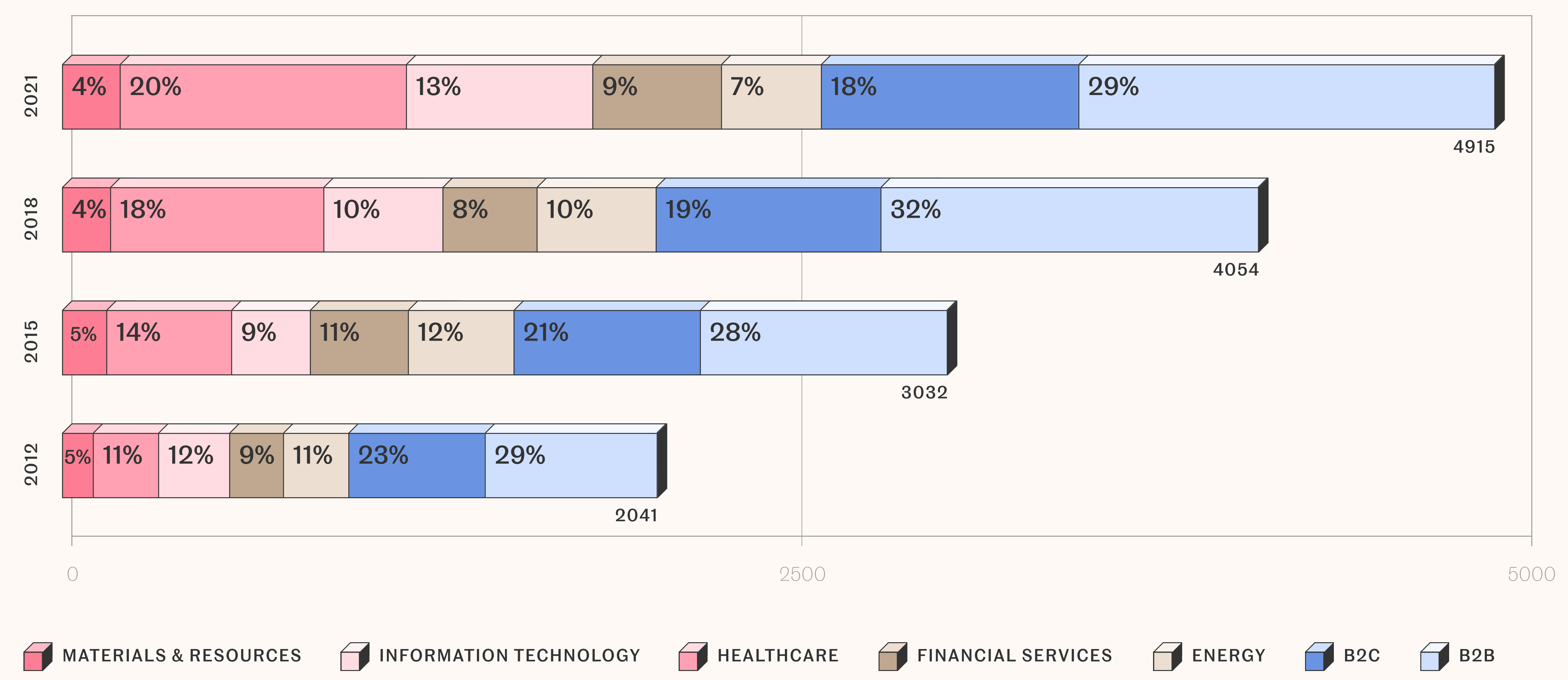
- Healthcare
- Blockchain
- Gaming
- Space
- Climate Tech

Healthcare

If we look briefly at healthcare, core forward-looking sectors are attracting the most interest from family office venture capital investments. The interest in healthcare and IT hold true for PE investments as well.

Exhibit 11: Global PE deal volume by sector

The Fastest-Growing Sectors for Private Equity



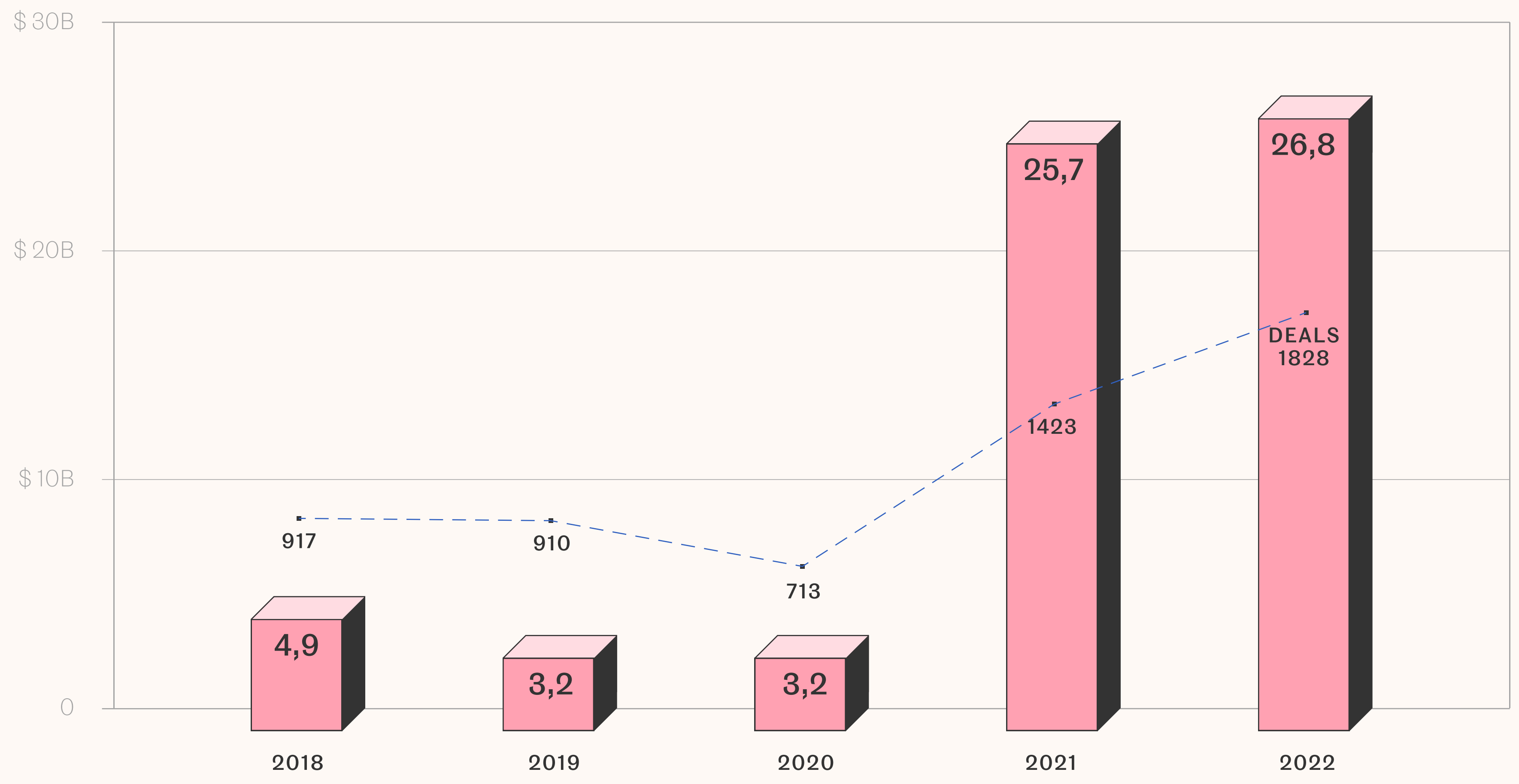
Source: McKinsey

Blockchain

In spite of the recent collapses of key crypto firms, blockchain startups continue to raise funds.

Exhibit 12: State of Blockchain

Global Blockchain Funding and Deals in 2022



Source: CB Insights State of Blockchain 2022 Report

8. Conclusion

Often the simplest advice is the best advice. Across our interviews with family offices and VC funds, we heard guidance about the risks and the extended period of illiquidity inherent in this asset class. The surprising success that came from the buyout of a company that the investor had nearly written off was matched with stories of failed investments. Even the best minds with patient capital get it wrong. Family offices looking to move into venture investing have options to move slowly and build networks, capacity, and experience as part of an extended learning process to maximise the potential for returns.

9. Acknowledgement

Simple would like to thank Kjartan Rist, co-founder of Concentric, for sharing his invaluable insight in assisting with this review.