Venture Capital: The Access Class

Stockholm (HedgeNordic) – In the world of institutional investors, the largest pension funds and sovereign wealth funds are often likened to the most popular kid in school that everyone wants to be friends with. This status does not get them far with the top 1% performing venture capital managers, or the VC aristocracy as some call them, who can pick their own play mates.

This is not to say that institutional investors are not welcome, but they will face a hard battle to get into these managers and trying to build a team to rival them would be a huge financial commitment without guaranteed success. Building up such a team will take no less than 3-5 years and even then it is unlikely they will ever come close to the success of the top VC managers.

These top 1% of VC managers often see demand outstripping capacity three or four times each time they launch a fund. Even if the sector is growing, access remains hard as the best tend to have preferential access to funds favouring existing and early investors, leaving only 1-10% to new investors, which is decided on a discretionary basis by the GPs.

Marcel Rafart, founder of Galdana Ventures, an investment advisory firm based in Barcelona, which provides its services to the Altamar Private Equity VC fund of funds (Galdana Ventures I, II and III, “Galdana Funds”), focused on tech companies and amounting to €900 millions, said a very small proportion of VC managers have a solid track record spanning decades. “Out of some 5000 managers in the VC space globally, only 50-70, or just over 1%, have this exceptional track record. They have a structural competitive advantage in terms of preferential deal-flow and as a result they can achieve fantastic results i.e. substantially better than the rest,” he said.

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“Just having the suit and the capital does not give you access. VC has no leverage and its roots are in innovation, the future and growth, unlike buyouts that originated from financial engineering. The whole tech innovation space is very different and requires very different skills – you have to be into technology and part of the ecosystem for it to work, not just bringing in the dollars. These top VC managers are not your typical fund managers. There´s a distinct difference in the way they go about their business, forge relationships and even in how they dress. To appreciate this is key,” Rafart explained.

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Galdana Ventures, itself founded by seasoned entrepreneurs, concentrates its efforts to gain acceptance by the 50-70 players worldwide because of the risk return profile being so attractive. “Risk is lower than you might expect given the returns obtained. You only get this when you have an imperfect industry, and in a way, VC is exactly that. Because a very small group of players dominate the deal-flow they can obtain superior returns. There is an information asymmetry within the VC universe which favours a very small number of players," Rafart explained.

Rafart and his team of 8 are all tech veterans, so the focus on tech innovation that will change our lives in the future the way the internet and the mobile phone have done, is not a surprise.

"The digital revolution is changing the world in such a way and at such a speed that technology needs to be part of any well-diversified portfolio," Rafart argued, adding that VC managers and founders of successful tech companies see the public markets as the end of their journey, where they can sell their shares at a very high multiple compared to when they began their journey years before, when their valuation was much lower.

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This large difference between the valuation at the private phase vs the public phase makes the asset highly resilient to the volatility of the public markets, since a great gain has already been obtained for the existing investors.

"We encourage investing in VC if you can access the top managers . The biggest challenge is access. The Galdana Funds are able to provide access to most of the 1% top managers worldwide, even to new investors. In addition, the Galdana Funds' portfolios are diversified across geographies, stages, vintages and sectors.

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Rafart said that VC managers have been professional and disciplined in dealing with excess demand and while this demand is increasing they remain focused on their principles of only taking a fund to a size where the capital can successfully be deployed to continue delivering for their LPs.

Institutional investors are notoriously cost conscious but for the top 1% of VC managers there is no pressure on fees given that demand outstrips availability several-fold.

"VCs have not tended to take advantage of the excess demand in a way that perhaps managers of other classes did in the past. As an example, in 50-70 managers there is maybe five partners per manager. This is only 250-350 in total, and over the years we´ve been fortunate enough to get to know them and how they tick – not only professionally but also at a personal level. They have been very successful over the past 20-25 years, so 100% of the partners are very wealthy but also 100% of them are incredibly ambitious and curious from an intellectual perspective which creates a different mindset and integrity," Rafart said.

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"They love what they do and love to discover and invest in companies that will change our lives. Their focus is the searching for the amazing founders with great companies, not the amount of money the funds will make them. When meeting these managers very little time and focus is on fees but all about content. They are passionate and want to be part of the revolution and the reason the Galdana Funds have been accepted into these managers is because the Galdana Ventures team shares their passion.

“In the past the excess capital also affected the level of transparency, but things are slowly changing in a positive way. The pressure is now increasing to comply to the level of transparency that more sophisticated and institutional investors require. This also applies to ESG policies where VC has been late to the table compared to many other asset classes but the progress we have seen over the last few years is encouraging and could well catch up with other asset classes in the coming years,” Rafart said.

As VC companies get better equipped to handle institutional capital in terms of transparency and ESG policies, the access issue will remain. However, Rafart maintains that as the digital revolution is also growing and picking up speed there is still room for growth among the top tier of VC mangers; so, it is not too late.

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“If you ranked by market capitalization the top 10 companies in the world, 20 years ago this was the domain of US industry with only two tech companies in the top 10 (Microsoft and Intel) today, the slots are filled by tech companies (8 out of 10) including two Chinese (Tencent and Alibaba). China is no longer the copy-cat of the world. Innovation in China is exploding and in some sectors such as Artificial Intelligence, China is ahead of the West,” he said.

As these new tech companies become increasingly dispersed globally, access becomes even more complex and takes more time and resources to develop close relationships. However, Rafart said that the impact of the digital revolution on the economy and society is only growing so future potential remains. “VC specialises in these future giants while they are still very small or medium-sized but with great potential for growth. The top VC managers are surfing on a positive wave and will continue to grow between 10-15% per year,” he predicted.

Rafart singled out the Nordic region as one of the best hubs and fertile grounds for tech innovation, likening it to Israel in this respect with a small population but a high number of enormously successful tech companies such as Spotify, Klarna and Rovio to name a few. “The most important thing for young people is to see that an idea can become a success, not just locally but globally. The success stories are fantastic examples and what the Nordics have done is to be open minded and feed the ambition of future entrepreneurs, which of course is great for the broader economy, creating a virtuous cycle,” Rafart said.

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The pandemic in 2020 put a stop to what most of us viewed as normal life and the tragedy that ensued will not be easily forgotten. We all got used to working from home and endless video-conference calls. Rafart said that during a normal year at least 50% of his and his team’s time is spent travelling. He also noted that the industry was perhaps in the best position to adapt to this new normal, making use of the latest technology to stay in touch and work from home. “The managers moved rapidly into remote operations and a significant proportion of activity will remain remote because people have understood the value of these new tools and the flexibility they offer even if we do want to get back into face-to-face meetings too. Also, as was the case with investors in innovative tech companies such as Zoom, there was also good news with increased IPOs and M&A activity, despite the dire global situation," he said.

When asked about what innovation we might see in the coming decade that will change our lives as fundamentally, as the internet or mobile phones did, Rafart said it will not be just one thing but a plethora of innovations we cannot even imagine. He remembers a time when mobile phone penetration was 0.5% and estimates by those bidding for contracts forecast 15% penetration in twenty years, which was perceived as very aggressive. The benefit of hindsight tells us it quickly reached beyond 100%.

Rafart is sure that self-driving 'anything' will be the norm, whether it is cars, buses or trucks. He also said that people today underestimate the way we will use these innovations. Looking at the earlier example of mobile phones, the 'phone' part is only a very small part of how we use the device compared to how we used a land-line telephone.

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"Innovations and technology will continue to develop but it is hard to predict what will take off and how it will impact our lives. I am sure it will be much quicker than expected over the next few years and the hurdles will be of regulatory nature rather than technological" he said, concluding that this is not science fiction. For investors like Rafart, and the entrepreneurs who surround them, this future is much more exciting.

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