LPs share a bright outlook

Six venture-investing LPs share their views in a virtual roundtable on the impact of covid-19, communications, due diligence, diversity and healthtech.

By: Lawrence Aragon

The covid-19 pandemic has turned the world upside down but any fears that it would throw venture capital into disarray have proven to be unwarranted. LPs remain eager investors in VC funds, remembering the opportunities they missed following the global financial crisis.
"We're staying the course, if not leaning in more," says Dana Johns, senior portfolio manager at the $56 billion Maryland State Retirement and Pension System. Johns was one of six LPs in a 90-minute virtual roundtable hosted by Venture Capital Journal on July 17. They included representatives from pensions and insurance companies, which collectively have committed more than $5 billion to venture funds.

"Carpe diem" may best describe the mindset of the participants. Johns says she made five fund recommendations since March, using online tools and Zoom to complete due diligence for four of them.

Her peers are equally enthusiastic about venture. "We believe there is going to be a lot of great innovation that comes out of this time period," says Matt Curtolo, a director of private equity for the $601 billion MetLife Investment Management.

The challenge of covid-19 was just one topic of conversation. Others included how to access the best funds, growing interest in healthcare, manager communications, virtual due diligence and efforts to improve diversity of fund managers. Read on to hear LP perspectives on those topics and more.

Coping with covid-19

LPs say covid-19 hasn't caused them to pull back on investing in VC funds, although they are spending more time scrutinizing their portfolios before they entertain new fund investments.

"Staying the course is so important," says Curtolo of MetLife. "Making a decision based on what's happening in a span of weeks or months is just not the right approach for an asset class that is 10 to 15 years in duration."

In fact, now may be a better time than most to put money to work. "There is plenty of data that says some of the best technology is formed during periods of economic downturn or depression," Curtolo adds.

Johns agrees. "I think everyone learned lessons [from the GFC] and wanted to have the opportunity to take advantage of the market," she says. "We all waited practically 10 years for this."

Funds launched after the GFC have performed particularly well. For example, 2010 vintage venture funds have generated an internal rate of return of 25.36 percent to date, according to a March 31 performance report by Cambridge Associates.

Of course, the LPs are proceeding with caution. “I was involved in some due diligence sessions probably around St Patrick’s Day, March 17, when we realized it was necessary to take a pause as there was a lot of volatility and uncertainty in the marketplace,” says Sean Holland, a director for the $500 billion New York Life Investment Management. “Many of those conversations have resumed.”

LPs have spent a fair amount of time making sure that their existing portfolios are healthy. Many have had detailed conversations with managers about how portfolio companies are doing. “I think covid has caused a lot of people to look at their business model,” says Kevin Schimelfenig, managing partner of McGeever Family Office, which has about one-quarter of its assets in VC.

The pandemic made it clear that how well a start-up manages its burn rate may determine if it survives. “Looking at who in a company is managing the capital is a really important due diligence consideration, whereas in the past you didn’t look at that,” Schimelfenig says.

Early-stage companies have historically operated with a mindset of growth at all costs, but that is not a winning strategy in this environment.

“Many of these companies have had to learn the lesson early that you do have to tighten the belt and think about how you’re going to make it through the next 12 to 24 months,” Curtolo says, and start-ups will be better for it. “For those that survive and have learned how to live a leaner lifestyle, they will be incrementally more valuable and more efficient,” Curtolo says.

Access to funds

Getting into the best funds is an ongoing quest for LPs. Once a firm has established itself as a top-quartile performer, it’s difficult to add LPs without cutting back allocations for those who have been with it from the start. This is especially true for early-stage investors, since their funds are smaller. It’s easier for LPs to find space in late-stage funds, which have grown considerably as companies require more cash and stay private longer.

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Maryland SRPS had challenges with access about five years ago. Andrew Palmer was just named a new CIO and was looking to build out its venture program. Palmer introduced Johns to some top-tier managers he had previously worked with, but when Johns asked if the managers had room in their funds, she heard, “Thanks, but no thanks.”

To get access to high-quality early-stage funds, the state pension system partnered with Tiger Iron Capital in 2016 on a separately managed account. Tiger Iron manages the pipeline, conducts due diligence and negotiates VC allocations for Maryland SRPS and two other pensions.

Maryland SRPS allocated $300 million to the SMA, which Tiger Iron committed on its behalf to 15 GPs (and 24 funds) and five co-investments over three years. The LP allocated another $100 million in 2019 to a second SMA that will ultimately grow to $300 million.

“So far, we’ve gotten exactly what we wanted,” Johns says. “There have been times where we targeted $15 million to $20 million for a commitment and we got $5 million, but in the next fund we’re getting a larger allocation.”

Johns prefers the SMA to a traditional fund of funds. With the SMA, the LPs only pay fees on committed capital and they can veto proposed fund investments. They also get more access to the funds in the portfolio.

Arizona Public Safety Personnel Retirement System has gotten introductions and been invited to conduct due diligence and attend meetings by VC funds of funds, says James Ko, a portfolio manager with the $11 billion retirement system.

LPs understand that they will not gain access to top-tier funds by waiting for an invitation. “You have to develop a program where you are constantly on the hunt for new groups,” Curtolo says. “You have to make sure that the top of the funnel is really big.” MetLife has an innovation office that has been particularly helpful with developing relationships, he says.

A good long-term strategy is to back emerging managers. That has helped British Patient Capital, a British Business Bank subsidiary, identify managers who have become top performers and write bigger checks as those managers have grown, says managing director Ian Connatty. “We are sort of doubling down on those relationships we’ve had for 10 years or more, where we started right at the beginning of their journey,” he says.

Backing spinouts from top-tier firms is especially popular among LPs in our roundtable. “It’s important to keep the door open and talk to people when they spin off,” says Holland of New York Life Investment. “If you look back over the past 10 years, firms like Spark Capital and Union Square Ventures were essentially emerging managers, but now they are red-hot funds and probably access constrained.”

Spinouts can be particularly attractive to small LPs that do not have the weight of a state pension. “When a key fund manager departs, we tend to get some exposure that we wouldn’t usually get,” says Schimelfenig of the McGeever Family Office. “For us, it is a wonderful thing when they step out.”

Manager communications

Despite an end to most face-to-face meetings, LPs are communicating with managers just as much – if not more – than they were prior to the pandemic.

“The cadence has been just as strong and the transparency has been strong,” says Arizona PSPRS’ Ko. “Overall, the experience has been pretty positive in terms of getting information and data that’s required.”

MetLife’s Curtolo also likes what he has seen. “In the last few weeks of March, nearly every GP in our portfolio had a call on the state of their portfolio or about just what’s happening,” he says. Even managers that did not have a great reputation for communications stepped up. “We found it to be a challenging environment to figure out what’s going on, but the communication was really great from our managers,” Curtolo says.

Schimelfenig of the McGeever Family Office considers any reduction in communication during a financial downturn to be a red flag. “We always have good communication if they’re good partners,” he says. “Candidly, if we don’t have good communication, we’re not investing with them ever again.”

The pace of communication from GPs should naturally increase during times of economic distress or uncertainty, Schimelfenig adds. “When you suddenly have a circumstance [like covid-19], they may communicate more and be more specific. The cadence should be a little bit more frequent.”

Being stuck in a home office is challenging, but LPs have found it has upsides. Normally they have crowded calendars and are tight on availability because they are constantly traveling for meetings.

“Previously you were trying to juggle two things: am I available then and am I in the same location as they are?” says Connatty of British Patient Capital. “Now you have only got the one dimension of availability because we are much more accepting of doing it remotely.”

Johns says the decline in travel has given her extra time to meet with more managers. She previously spent a lot more time managing her email inbox and calendar to try to squeeze in meeting requests from new managers. “In the past, they would have to ping me three times” before she had time to figure out if or when she could meet with them, Johns says.

Overall, Johns has been happy with manager communications during the pandemic. “I haven’t had any issues with access,” she says. “If I have made a request to go through the portfolio and understand what impacts are, I have had complete access. I feel like the GPs have done a great job of communicating with LPs and talking about what the impact of covid is.”

Virtual due diligence

Due diligence was a big concern at the start of the lockdown. How would fund investments get made in a business that relies on face-to-face visits? LPs say the virtual meetings enabled by technology have proven to be good enough to get the job done.

“When I did diligence for five investment recommendations over the past couple of months, only one of those was on-site, and that was March 1,” Johns says. “The rest proceeded with due diligence online through Zoom.”

Ko expects the use of Zoom and other online tools to continue after the pandemic. “I think as a result of this, people’s processes and teams’ processes will be more refined,” he says.

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ARIZONA PUBLIC SAFETY PERSONNEL RETIREMENT SYSTEM

“There will be more reliance upon technology when performing due diligence, and all of us will need to be more comfortable in front of a camera going forward.”

"I learned what you have in your background matters, so be careful," jokes Schimelfenig of the McGeever Family Office.

One happy surprise of virtual meetings is that lots more people can be on a single call. "More members of our team can participate in these meetings, which is a terrific benefit from a learning perspective," says Curtolo of MetLife. "We have a team of eight in New Jersey and London. With everybody being on video, it puts everybody on the same footing."

Of course, Zoom cannot replace a live meeting. "You don't have the ability to inspect records on the spot, and you don't have the ability to read body language in the room," Ko says.

Johns has the same concern. "You lose that ability to be in the same room and understand the dynamics between the team," she says. For example, when she goes out to dinner with managers, she typically sits next to an associate to get a perspective she may not get from a partner.

Like his peers, Holland misses the subtleties he can pick up in person. "You don't get the body language," he says. "You can't check the pulse of the person you're talking to that easily. It's a little slower, it's a little different but it's still going to work."

For existing managers, LPs are generally comfortable using Zoom for due diligence. "Because they're in the portfolio or because we already know them, we are able to move through those processes," says Connatty of British Patient Capital. "It is hard to tell whether it is as fast as it was before but it is certainly more effectively than I was expecting."

The jury is still out on whether fully virtual due diligence will work for first-time funds. "The managers that will really be impacted adversely right now are those that are raising their first fund," Johns says. "If they do not have a prior relationship with an investor target, I think it's going to be a hard row to hoe. It is going to take a lot longer, as opposed to mature funds where they opened up their data rooms in February and they were done in early May. It's a tale of two cities."

Healthcare

LPs were already bullish about healthcare before covid-19 hit. As VCJ has reported, healthcare-focused VC funds raised a record $10.7 billion last year.

What's the attraction? "Healthcare is one of those markets where you're going to deal with it whether you like it or not, like death and taxes," says Schimelfenig, who has worked at and invested in healthcare companies for about 30 years.

The pandemic was a grim reminder for anyone who forgot about the importance of modern medicine.

"The responses to the virus have really started a gold rush," says Holland of New York Life Investment Management. "One fund manager was telling me that he knew of over 600 therapies, including vaccines, that are actively being researched. Many of those will not come to fruition and that underscores the importance of having a skilled manager to make the right selection for you."

Another thing that attracts LPs to healthcare is that they can invest in multiple ways in both private and public markets and at various stages of development of a company or product. "We have exposure from early stage all the way through to large buyouts," Johns says. And it crosses industry boundaries. "It's even in our real estate portfolio," she says.

Says Curtolo: "When you think about it in a portfolio context, healthcare and technology are so ubiquitous. You can own the technology within the ventilator, you can own a piece of the production of the equipment itself, you can license the technology."

Even generalist tech funds are investing in the space as they find synergies between technology and healthcare. "We went through some periods where life sciences teams went off their own," Connatty says. "Now you're seeing generalist managers recruiting scientific specialists as opportunities are emerging in these new gaps between all these different disciplines. For example, what happens when AI [artificial intelligence] meets drug discovery?"

Yet another attraction for healthcare is that an investment can succeed even if a company does not. "You can invest in a company knowing that even if it doesn't make it there is a high probability that a large corporation is going to buy it to put it in its research channel," says Schimelfenig.

He adds: "We had a deal where we had both a public position and a private position in it, and it worked out really, really well. Ironically, the company didn't make it but we as investors did well because we were able to get it moved to the next level. It's like a cocktail party: You have to know when it's time to leave."

Diversity

If you want LPs to beat a path to your door, you should invest in a company developing tools that help LPs figure out if they are meeting diversity and environmental, social and development goals. It is a major pain point for participants in our roundtable.

"One of the struggles is just there's not a lot of data" around ESG and diversity/inclusion, says Curtolo of MetLife. "It has always been a subject but it has not necessarily been something that everybody has captured for years and years. I think everybody can agree at a high level that these are important but how do we measure them?"

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MARYLAND STATE RETIREMENT AND PENSION SYSTEM

That has not stopped LPs from pushing their GPs to support diversity and ESG. "We have signaled that these things are important to us, and that helps drive the behavior in the direction that we're looking for," says Connatty of British Patient Capital. "It takes time for that to lead to outputs, to know things like: What is the proportion of female-founded startups that garner investment capital? That kind of output takes time, but it all starts right at the top with us as LPs signaling that this sort of thing is important to us."

LPs in the roundtable say ESG and diversity factor into their manager due diligence.

“It is something that’s discussed around the table,” says Johns of Maryland SRPS. “It’s not a deal-breaker, but it is a recognition that we are the stewards of this capital and we need to be making the best investment decisions possible. Having diversity of thought around the table is really important.”

Johns is heartened to see efforts like those of Lenox Park Solutions, which released a white paper in May saying it had developed a method to measure diversity, equity and inclusion. The method is used to rate an asset manager on DEI, similar to how a consumer is judged on creditworthiness.

Says Johns: “I think they have some mandates with some larger pensions that are tracking this information across the portfolio – not just private equity but all the asset classes – which is kind of attractive to us because we’d like to have that data to understand in our portfolio: what does diversity look like?