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There’s a lot of mis-information being shared about VC performance and how it translates into LP returns.

There’s also a lack of understanding about how the VC ecosystem broke the LP ecosystem over the past few years and why this matters A LOT.

Here’s what’s going on:🧵 👇

Most VC funds have a 3-pronged value proposition: Capital, Advice and Support.

But while a VC fund controls the advice and support they give, they don’t own the capital that buys them the right to invest and a seat at the table.

VC Funds have to source the capital they deploy.

So the General Partners (GPs) in a VC fund share their fund’s track record and value proposition with potential sources of capital.

The goal is to convince these sources of capital to become Limited Partners (LPs) and commit capital to their next 2-3 fund cycles.

LPs look for funds that can deliver top quartile returns. Cycles matter, but historically the best funds are able to deliver 3X+ MOIC (Multiple On Invested Capital).

But LPs also care about the timing of inflows and outflows of cash.

This is missed by outsiders looking in!

Historically, a typical fund added new positions during a “deployment period” of 3 years and reserved 30-50% of the fund for follow-ons.

And usually, by year 4 money started to come back through various liquidity events (strategic sales, secondary sales and IPOs).

The cadence of inflows and outflows matters A LOT.

A 3-fund commitment of $20MM/fund requires a LP to commit $60MM of capital but uses only $20MM of initial cash. This example produces a 26% IRR pre-carry!

(Thank our CFO Jamie Loving for the spreadsheet)

	Year																		
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	Totals
Fund I Outflows	(4.00)	(3.90)	(5.80)	(2.40)	(2.40)	(1.20)	(0.30)												(20.00)
Fund I Inflows					6.00	9.00	12.00	12.00	12.00	3.00	3.00	3.00							60.00
Fund II Outflows				(4.00)	(3.90)	(5.80)	(2.40)	(2.40)	(1.20)	(0.30)									(20.00)
Fund II Inflows								6.00	9.00	12.00	12.00	12.00	3.00	3.00	3.00				60.00
Fund III Outflows							(4.00)	(3.90)	(5.80)	(2.40)	(2.40)	(1.20)	(0.30)						(20.00)
Fund III Inflows											6.00	9.00	12.00	12.00	12.00	3.00	3.00	3.00	60.00
Annual Cash Flows	(4.00)	(3.90)	(5.80)	(6.40)	(0.30)	2.00	5.30	11.70	14.00	12.30	18.60	22.80	14.70	15.00	15.00	3.00	3.00	3.00	
Cumulative Cash Flo	(4.00)	(7.90)	(13.70)	(20.10)	(20.40)	(18.40)	(13.10)	(1.40)	12.60	24.90	43.50	66.30	81.00	96.00	111.00	114.00	117.00	120.00	

And it's fairly common for a few VC funds in a vintage to massively outperform the rest. History shows that 5X, 10X and even 20X funds are possible!

Imagine investing in a VC that could produce a 5X, 3X, 3X streak. The 18-year pre-carry IRR is 33%!

	Year																		
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	Totals
Fund I Outflows	(4.00)	(3.90)	(5.80)	(2.40)	(2.40)	(1.20)	(0.30)												(20.00)
Fund I Inflows					6.00	9.00	20.00	23.00	20.00	10.00	6.00	6.00							100.00
Fund II Outflows				(4.00)	(3.90)	(5.80)	(2.40)	(2.40)	(1.20)	(0.30)									(20.00)
Fund II Inflows								6.00	9.00	12.00	12.00	12.00	3.00	3.00	3.00				60.00
Fund III Outflows							(4.00)	(3.90)	(5.80)	(2.40)	(2.40)	(1.20)	(0.30)						(20.00)
Fund III Inflows											6.00	9.00	12.00	12.00	12.00	3.00	3.00	3.00	60.00
Annual Cash Flows	(4.00)	(3.90)	(5.80)	(6.40)	(0.30)	2.00	13.30	22.70	22.00	19.30	21.60	25.80	14.70	15.00	15.00	3.00	3.00	3.00	
Cumulative Cash Flo	(4.00)	(7.90)	(13.70)	(20.10)	(20.40)	(18.40)	(5.10)	17.60	39.60	58.90	80.50	106.30	121.00	136.00	151.00	154.00	157.00	160.00	

But VC funds deployed fast in 2017-2021 and exits aren't coming soon.

If a fund deployed initial capital over 2 years with liquidity pushed out by 2 years, then an LP needs to deploy $50MM to make their $60MM commitment. Pre-carry IRR drops to 18%.

This breaks the system!

	Year																		
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	Totals
Fund I Outflows	(4.00)	(3.90)	(5.80)	(2.40)	(2.40)	(1.20)	(0.30)												(20.00)
Fund I Inflows							6.00	9.00	12.00	12.00	12.00	3.00	3.00	3.00					60.00
Fund II Outflows			(4.00)	(3.90)	(5.80)	(2.40)	(2.40)	(1.20)	(0.30)										(20.00)
Fund II Inflows									6.00	9.00	12.00	12.00	12.00	3.00	3.00	3.00			60.00
Fund III Outflows					(4.00)	(3.90)	(5.80)	(2.40)	(2.40)	(1.20)	(0.30)								(20.00)
Fund III Inflows											6.00	9.00	12.00	12.00	12.00	3.00	3.00	3.00	60.00
Annual Cash Flows	(4.00)	(3.90)	(9.80)	(6.30)	(12.20)	(7.50)	(2.50)	5.40	15.30	19.80	29.70	24.00	27.00	18.00	15.00	6.00	3.00	3.00	
Cumulative Cash Flo	(4.00)	(7.90)	(17.70)	(24.00)	(36.20)	(43.70)	(46.20)	(40.80)	(25.50)	(5.70)	24.00	48.00	75.00	93.00	108.00	114.00	117.00	120.00	

Making matters worse, valuations were much higher during this period which brings into question how many 3X+ funds there will be in the 2017-2021 vintages.

And we're already seeing markdowns and write-offs that highlight the issue.

The short-term pain is being felt by VC funds raising in this environment. The amount of money LPs expected to receive in distributions is far less than their models forecasted which means they have to make tough choices when funds come up for renewal.

But the problem isn't a permanent one.

Many underperforming VCs will have to reduce their fund sizes and many funds with limited track records or undifferentiated strategies will shut down.

But the VCs with solid strategies and track records will be fine.

And companies will have to be built more efficiently and raise at more reasonable valuations. They'll be designed knowing that capital is scarce and scaled with capital efficiency top of mind.

The net result should be vintages that perform better than those from 2017-2021.

TL;DR: It's always been true that the best Funds produce great risk-adjusted returns while average Funds don't. Picking winners matters.

And while the 2017-2021 vintages could underperform VC norms, the ecosystem is resetting in ways that bode well for returns to bounce back.

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