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How Did Venture Capitalists Thrive Amidst A Global Pandemic?

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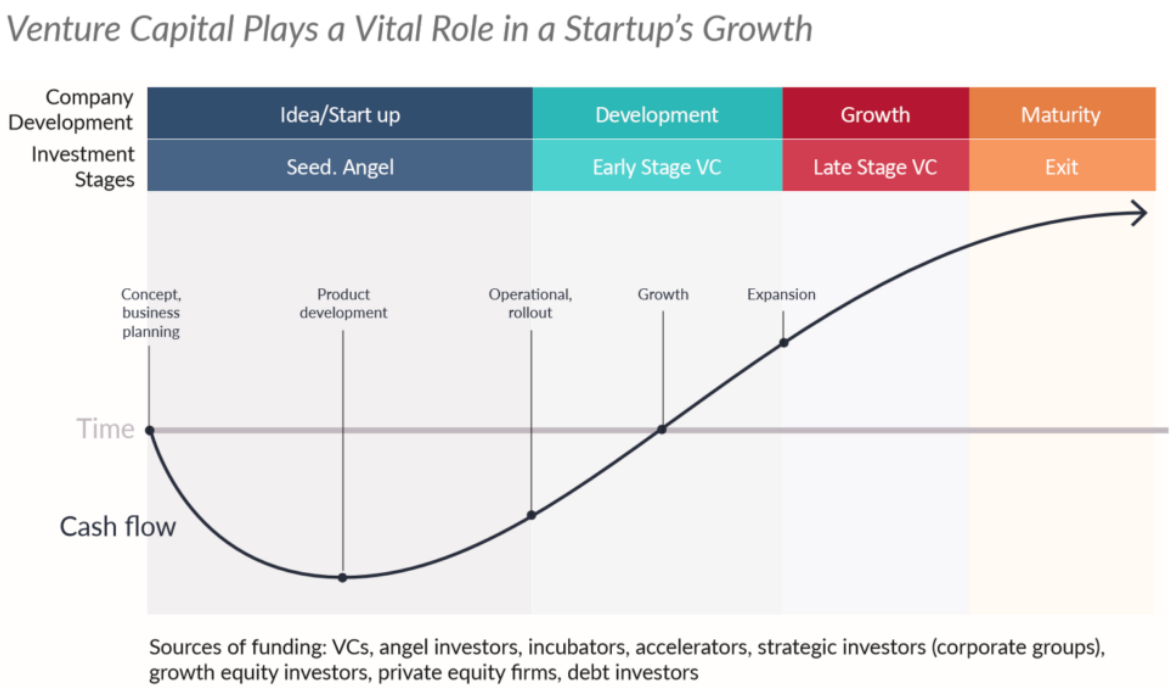
The world of business is vast and expansive, as it branches into numerous sectors, each pertaining to their specific and unique traits. However, if there is one word to describe it, it would be persistent because, time and again, businesses ranging from large to small have shown constant progression and adaptation despite major setbacks throughout history. They are undoubtedly the heart of the world's economy. However, if that's the case, then venture capitalists are the soul. After all, as Bob Zider from the Harvard Business Review astutely states, "Invention and innovation drive the U.S. economy" (Zider). And who facilitates that process more effectively than venture capitalists? A phenomenon that has garnered significant attention is how certain venture capitalists managed to thrive amidst a global pandemic.

RQ: How did venture capitalists withstand the effects of the COVID-19 Pandemic so well?

What is Venture Capital?

Venture Capital (VC) is a form of financial investment in startup companies or small and unheard-of businesses. Most commonly performed by investors from the higher end of the economic spectrum, its primary goal is to seek those early companies with a projected bright future and, in a way, nurture them through three direct tactics. The most notable method involves providing substantial capital to bolster the infrastructure. Another is giving personal insights and strategies to the entrepreneurs, and lastly, providing companies with networks, as the investors will have much larger connections and can use that to help entrepreneurs. What separates venture capitalists from other investors is their outstanding ability to strategize and follow the patient route, which is why many choose "businesses that are believed to have long-term growth potential"(Hayes). But, more importantly, it is integral to note that the word 'patient' doesn't necessarily translate to venture money being long-term money. This is expressed explicitly by Zider, as he says, "the idea is to invest in a [company…] until it reaches a sufficient size and credibility so that it can be sold to a corporation" (Zider). But, of course, that period in which the company is still growing can differ tremendously depending on the industry and the ever-changing environment surrounding each one.

VCs can be classified by the stages they decide to invest in, typically including pre-seed fundings, early stage, and late stage. It is obvious that the earlier you invest capital, the higher the risk of losing it is, which means that the startups will compensate for that by giving a higher percentage of equity. Therefore, VCs in the later growth stage face a lower risk of losing capital but receive less equity.



This is known as the Startup J Curve, which serves as a trendline that reflects a startup's "initial loss immediately followed by a dramatic gain" (Kenton). Investors expect the initial drop, but what follows isn't always the same. The "dream" scenario is for the outcome of the fall to be a steep incline, hence the name J curve.

In the next part, I will be taking a look at different studies carried out by business professors and report their findings, attempting to create a final conclusion using the data collected from the said studies.

NBER

In the first quarter of 2020, many financial institutions, more notably the International Monetary Fund, predicted that the COVID-19 virus would cause the worst economic recession the world has experienced since the Great Depression of the 1930s. This made a significant number of venture capitalists cautious, and rightfully so. VC investments, being both cyclical and unstable, often mirror the economy's trajectory. Consequently, the volume of investments tends to increase as the economy grows and decrease as it contracts. 2020 was an extremely rough and dark year for businesses worldwide, including a portion of venture capitalists. "Despite the economic uncertainty, 91 percent of venture capitalists expect their investments to outperform major equity indexes going forward"(Kost). Paul Gompers, a professor at Harvard Business School, in collaboration with "Will Gornall of the University of British Columbia, Steven N. Kaplan of the University of Chicago, and Stanford University's Ilya A. Strebulaev is to survey more than 1,000 venture capitalists at 900 firms from late June to mid-July"(Kost). Their research findings state that the pace of VCs has dropped by 29%, meaning they were spending more time and resources guiding portfolio companies they already owned through the pandemic. The VC firms the professors worked with said that "52% of their portfolio companies are positively affected or unaffected by the pandemic; 38% are negatively affected; and 10% are severely negatively affected"(Gompers et al. 1). Furthermore, many VCs report that the pandemic has only slightly impacted internal rate of return (IRR) which is a metric "used in financial analysis to estimate the profitability of potential investments" (Fernando). An IRR of 20% or above is considered good and the data provided by the study shows that it only dropped by 1.6%.

Referring back to the J-curve, the survey indicates how both late and early stage investors have a harder time evaluating deals. With the hindrance of COVID-19 preventing the majority of face-to-face team meetups, this is to be expected. In the early stage section of the curve, communication is of utmost importance because the exchange of knowledge between the VC and the portfolio company is what can really impact their future success. Owing to the continuously expanding digital realm of the internet, communication remains readily accessible, explaining why previous recessions impacted the VC world more profoundly.

It is clear that the venture capitalists were affected by the pandemic, but not nearly as badly as other industries. This is evident in a study done by a multitude of business professors from prestigious schools in the US.

Analysis

The Stanford Graduate School of Business published an article in September of 2020 regarding the current state and future predictions of the VC landscape, titled "VCs and COVID-19: We're Doing Fine Thanks". The title alone echoes sentiments similar to those found in the earlier study led by Paul Gompers. The author of this article is Lee Simmons, a senior at Hoover Institution in Stanford. In the second quarter of 2020, the National Venture Capitalist Association (NVCA) announced that "investment in the startup ecosystem is expected to drop significantly" leading to investors from around the world opting out of illiquid and slightly risky portfolio companies. In addition to that, they said "Fasten your seatbelts" as it was going to be a "Bumpy ride". Contrary to the NVCA's predictions, the ride was not, in fact, bumpy but rather smooth, at least when you look at the rest of the world. A survey of more than 1000 VCs was conducted to see not only how they were impacted, but to also reveal what the VCs themselves thought of their current situation. The survey itself was conducted in June of 2020 by a mix of alumni from Stanford and Chicago Business Schools. With numbers that resemble that of the research explained previously, the pace at which new investments were done dropped to 71% of their prior numbers. Looking at the past two recessions and how much they slowed the pace, the dot com crash of 2000 and recession of 2008, 71% is amazing. The survey, which was expected to take weeks to even months, was completed in a span of 10 days because of such extraordinary response rates. Ilya Strebulaev, a professor of finance at Stanford Graduate School of Business, had talked to a handful of venture capitalists from Silicon Valley, reporting that many of them said "this may be the best time to be around — there are so many interesting investments right now. People are sitting at home coming up with new entrepreneurial ideas." (Simmons). The article also mentions the impact of modern technology and how it can possibly cushion the effects of the pandemic.

Cristiano Bellavitis

Cristiano Bellavitis, a professor at Syracuse University, collaborated with Christian Fisch of the University of Netherlands and Rob McNaughton from the University of Auckland to publish an article reporting on the impact of the COVID-19 pandemic on venture capital (VC) investments. Using a dataset of 39,527 funding rounds occurring before and during the pandemic in 130 countries, they documented a significant decline in investments. (Bellavitis). The goal of this paper was to provide "a global and more nuanced assessment of how VC investments respond to the pandemic in terms of characteristics such as the stage of investment and syndication behavior" (Bellavitis). Through their extensive research, the authors created a claim that shared some similarities but also differences with the previous two studies.

The team's first hypothesis revolves around the central idea of how the unpredictability and uncertainty of the pandemic affect earlier stage ventures. Because the portfolio companies understand the heightened risks, they give more discount rates for the long-term prospects, therefore leading to a less justifiable reason to invest in the seed stage. Understanding that both pre-seed and seed stage ventures will most likely be impacted more than late stage ventures, the team split their first hypothesis into two.

- Hypothesis 1a (H1a): As the number of COVID-19 cases increase, VC investors are less likely to invest in seed-stage ventures.
- Hypothesis 1b (H1b): As the number of COVID-19 cases increase, VC investors are more likely to invest in late-stage ventures

It is important to understand that the pandemic affected industries unequally, meaning that some actually benefited from it. The perfect example of this is the medical and biotech industry. With companies racing to create vaccinations and treatments, "Spikes in companies' stock prices undertaking COVID-19 research or developing treatments" (Bellavitis) became more common. On the other hand, travel-related businesses were predicted to take a massive blow. Because of this, the research team's second hypothesis can be split into two different ones.

- Hypothesis 2 (H2a): As the number of COVID-19 cases increase, VC investors are less likely to invest in travel ventures.
- Hypothesis 2 (H2b): As the number of COVID-19 cases increase, VC investors are more likely to invest in biotech ventures.

Unsurprisingly, both hypotheses are spot on. As COVID-19 cases increased at an exponential rate, the sheer volume of early stage ventures dropped. Another trend found by the team was that biomedical-related ventures far exceeded companies in the travel industries. However, this was almost certain to happen, because "several studies find that investments in early-stage ventures are more heavily affected by crises than later-stage investments" (Bellavitis).

Analysis

After analyzing three research papers published by institutions and schools worldwide, it becomes apparent that there are some common themes and trends among them. The first two articles share striking similarities in their conclusions and claims. Both studies indicate that the venture capital (VC) industry is performing well overall. According to the Harvard study, the data suggests that the industry is thriving holistically. Similarly, the Stanford article reveals that not only are many VCs faring well, but they are also optimistic about the future. Paul Gompers, the lead professor on the Harvard research team, notes that the success of the VC world tends to follow the global economy, which explains why the International Monetary Fund (IMF) predicted a hit to the industry. Despite this, the world was proven wrong, and no clear reason or cause is ever stated once by any of the three studies. However, by examining specific trends in the data, particularly in the study conducted by Bellavitis, certain inferences can be drawn. These inferences are robust enough to be considered causal relationships. Notably, the venture capital industry stands out due to its exceptional adaptability, as it encompasses a vast and diverse range of investment opportunities. As such, damages to individual parts of the industry do not significantly impact the sector as a whole. Consider, for instance, Hypothesis 2a from Bellavitis' research, which states that as COVID-19 case numbers increase, investments in travel and international relations tend to decrease. However, the same investors who withdrew from these sectors subsequently redirected their funds into the biotechnology industry, which has experienced remarkable growth due to external factors such as the quest for vaccines and COVID-19 treatments. In essence, when one segment suffers, another flourishes, effectively offsetting the impact. Yet another example of this is the decrease in early seed stage investments. Yes, the amount of seed ventures decreased, but it also means the number of late game ventures increased. This is one likely cause as to why the pandemic barely slowed down the industry. Another probable factor is the integration and normalcy of technology usage in the venture capital industry. Technology was already an integral part of VCs' operations even before the pandemic, so most VCs and VC firms were able to leverage their familiarity with it to mitigate the pandemic's impact. However, this does not diminish the reality that the pandemic still created significant challenges for the industry. For instance, the number of solo ventures (also known as non-syndicate) has noticeably declined. This is because COVID-19 has made it more difficult and time-consuming to conduct thorough research and evaluate

potential deals. Additionally, the surge in syndicate investments has led to a slower overall pace of VC investments. As previously mentioned, the initial impact of the virus resulted in a 30% drop in investment activity.

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