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# Venture Capital: Investing Insights During the Economic Dislocation



Jeff Diehl, Managing Partner & Head of Investments, recently moderated a Q&A with Brijesh Jeevarathnam, Partner & Co-Head of Global Venture Fund Investments, and Fred Wang, Partner, Growth Equity Investments, in which they shared perspectives on the impact of the economic dislocation on venture and growth investing. They explored dynamics at fund and company levels, and innovation themes that will be positively and negatively impacted by the crisis.

**Q: How do you think the healthcare sector will compare to other venture capital sectors?**

**BJ:** We think there are compelling opportunities in the healthcare sector that the COVID-19 pandemic will accelerate. One is healthcare providers leveraging technology for new delivery mechanisms. The second relates to the innovation and speed in drug discovery.

We've seen strong innovation in healthcare delivery already, primarily as it relates to telemedicine. Given the stay-at-home orders in many states, patients are avoiding clinical settings and healthcare providers have ramped up their use of telemedicine. We think that virtual care/telemedicine will become more widely adopted over time. Anecdotally, our portfolio companies that planned to roll out telemedicine budgeted 6+ months to do so. The pandemic accelerated this timeframe and providers have launched telemedicine capabilities in a matter of weeks.

As it relates to the innovation and speed in drug discovery, we believe there will be tailwinds because of the pandemic, as the current situation has exposed the lack of preparedness in the healthcare system. We believe there will continue to be significant innovation in the sector, particularly as it relates to responding to the coronavirus (e.g., vaccines, serology tests, and COVID-19-specific tests). We also believe that the speed of drug discovery could accelerate as there is heightened awareness by many constituents, including the FDA and healthcare providers, of the need to be more prepared to respond to global health issues. While our biopharma portfolio continues to perform well through this cycle, the one area we are seeing softness is early-stage companies that are running clinical trials. Clinical trials have generally been delayed by a quarter due to the inability to enroll patients (particularly for trials completed in the hospital setting).

Overall, we think that the pandemic has brought to light the lack of preparedness of healthcare systems around the globe which will create opportunities for healthcare investors in the future.

**Q: What do you expect in the way of capital calls and investment activity over the next 12 months for your Growth Equity practice, and is this faster or slower than originally anticipated? For older vintage Growth Equity funds, do you expect exits and distributions to be slower than originally expected?**

**FW:** We anticipate the team's investment pace, which drives our capital calls, to remain consistent. We are actively seeing a very high level of quality deal flow right now. In many cases, valuations haven't adjusted much. In a few cases, it is difficult to forecast where these companies will come out post COVID-19. So, we are being cautious but also actively looking for opportunities. As for exits and distributions, we think in the short term, liquidity will be hard to come by, but that acquisitions will accelerate later this year and into 2021, particularly as strategic M&A transactions are the largest source of exits for our portfolio companies, and companies in general in the technology and healthcare sectors.

**Q: Have you been able to move public stock in the Growth Equity portfolio recently to provide some distributions?**

**FW:** Yes. The markets were down in the first quarter, but they have since rebounded quite a bit. In fact, year-to-date the markets are up slightly. The Nasdaq is modestly up compared to where we started and so we are taking advantage of our public companies and public positions to get liquidity where we can. In fact, we just had a recent liquidity event and distribution for a company in our portfolio.

**Q: Are you able to conduct adequate due diligence on managers new to Adams Street, particularly with groups outside the US, during the lockdown? If so, how are you altering your process if face-to-face meetings are not possible at the current time?**

**BJ:** We've had a busy pipeline in 2020. While the majority of our commitments to date have been in managers with who we were previous investors, we are still having conversations with, and have invested in, new managers. For those managers that we had not invested with before, we typically have met with the managers over time and tracked their progression over several years. This enables our team to operate with a prepared mind when conducting due diligence in the current environment.

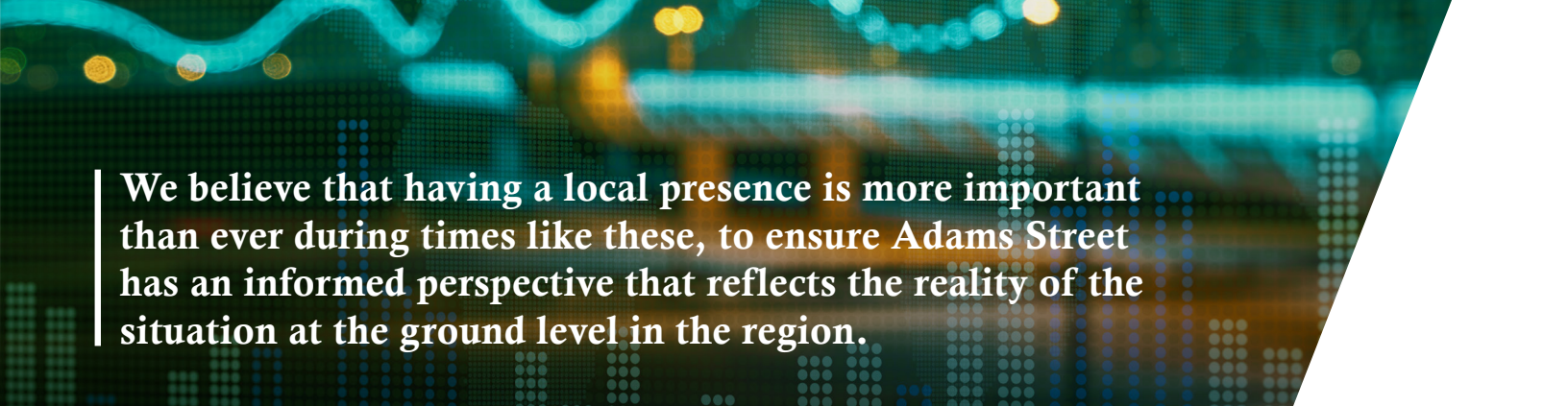
Each investment opportunity continues to go through the same due diligence process as deals completed pre-COVID; the only difference being that we have replaced in-person meetings with video conferencing. We have adapted to this environment by (a) making more extensive reference calls and (b) meeting with GPs over a series of virtual meetings to offset the lack of in-person meetings.

**Q: What's changed in terms of the due diligence process for the Growth Equity Team?**

**FW:** We are spending more time with management teams than we might have in the past, because people are spending more time engaging in conversation around various business aspects overall. We are actually finding that working remotely hasn't impacted us as significantly as we might have guessed going into this. Also, a lot of the companies that we're looking at do have a fair amount of substance to their business and there are things we



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can evaluate financially with customers that are beyond just the face-to-face team meetings. Overall, we've been able to manage the due diligence process extremely well.

**Q: Are you concerned at all about any potential regulatory issues that may change what can be done in terms of investing in or holding investments in Chinese venture funds? Have you changed your fundamental view on the attractiveness of the opportunity set in China?**

**BJ:** From a regulatory perspective, there is a lot of rhetoric on both sides, but nothing has changed fundamentally with respect to where we can invest, where we can divest, and then bring dollars back on shore. We are watching it very closely, and we are in constant discussion with our Chinese venture GPs and our Adams Street team members based in Beijing. We believe that having a local presence is more important than ever during times like these, to ensure Adams Street has an informed perspective that reflects the reality of the situation at the ground level in the region.

We haven't changed our view on the long-term attractiveness of our China investments. It's a strategically important though small part of our overall geographic allocation.

**Q: What is Adams Street's view on venture-backed companies (and private equity companies in general) accepting government funding through the CARES Act and other legislation?**

**JD:** We don't expect a lot of private equity-backed companies to access government funding. Let's start with the private equity or venture capital firms taking money for their own operations, i.e., the general partnership. We have not seen that occur and would be shocked if it did.

As for portfolio companies, the government funding has some stipulations in terms of qualifications - for the Paycheck Protection Program, which is for small businesses, there is a guideline known as the affiliation rule. This is long-established guidance from the Small Business Administration, which generally provides that if you effectively control a company, all the companies that you control are aggregated in terms of the employee headcount for calculation for whether you qualify as a small business. While interpretations and rules under the CARES Act continue to evolve, it is likely that, as a result of needing to aggregate employee headcount, a portfolio company backed by a buy-out firm would be disqualified from accessing the PPP. As a result of this and other aspects of implementing the PPP, we would expect private equity-backed companies to encounter barriers in accessing PPP assistance.

There is also the main street lending program in the United States, which has been made available for low cost loans that are not forgivable. Those are subject to EBITDA multiple caps, so to the extent that a company already has debt to EBITDA over a certain level, that would exclude them as well.

**BJ:** Based on our conversations with Adams Street managers, the number of companies that are eligible, actually apply, and feel it's defensible to take that funding, is a very small number.

**FW:** That is consistent with what we've seen on the direct side as well. Ultimately, what the PPP was in put place for is to protect employees - to keep people employed and active as consumers. We have seen a small number of companies take the PPP loan if they can honestly say that if they didn't have this loan, they would have to lay off a significant number of people.

**Q:** **What was the performance of venture capital during the Global Financial Crisis (GFC) and how does that compare to what we're expecting to see now?**

**BJ:** Market dislocations have historically generated good vintage years for venture capital investment. The performance of venture funds was strong following the Global Financial Crisis. Based on information sourced from Burgiss, the top quartile VC funds in 2009, 2010, and 2011 generated 20%+ net IRRs (25%, 22%, 25% net IRR, respectively).

**Q:** **Specifically, on the direct portfolio, what are you seeing, and how do you expect the portfolio to perform?**

**FW:** The broad portion of our portfolio appears to be in good shape. It's unfortunately difficult to project how the rest of the year will turn out, but we do

anticipate that our portfolio companies will emerge from the downturn more quickly than many other companies.

More specifically, we are seeing companies with some slowdown in revenue growth; maybe 20% from what they had originally planned. These are companies that are still growing, but perhaps a bit slower than projected earlier in the year. There are some extreme cases where companies are seeing a much more difficult headwind, and in other cases they are actually seeing a tailwind. On average, our portfolio continues to grow at a healthy clip. Our portfolio companies have, for the most part, cut their burn rate back and so from a capital risk standpoint, a very small percentage of portfolio companies are seeing the combination of direct business impact coupled with a relatively low amount of cash flow. We're spending quite a bit of time with those management teams trying to make sure those companies survive.

**Q:** **Online education and remote working are some sectors that are actually benefiting in the current environment. Are there any other sectors or industries that may experience tailwinds that are not as obvious?**

**BJ:** With all the time spent at home, there's an emphasis on education, of course, but also entertainment, and we've seen some of our online gaming companies continue to do really well. The downside of so much time on the internet is, unfortunately, more cyber-attacks, spamming, phishing, etc. As a result, our cybersecurity companies are seeing their business pick up in this environment.

It's also interesting to see companies in the community category gain momentum as people band together. NextDoor, as an example, the website and app through which you can



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coordinate with your neighborhood on anything - helping a neighbor or just asking questions in these pandemic times – has had a significant increase in usage. GoFundMe, which many local businesses (restaurants, hair salons, etc.) are using to raise funds to stay afloat, has seen activity pick up.

The last example I'll give is exercise. People aren't going to the gym anymore, and companies focused on "stay-at-home" fitness (e.g., Peloton) are doing really well.

**Q: What sectors or industries are you putting in the "Do not touch" pile?**

**FW:** We are obviously avoiding sectors experiencing a direct impact from COVID-19; travel, entertainment, and things related to the restaurant vertical, for example. There are certain sectors where we think it will take quite a bit of time for companies to emerge out of the pandemic, even though technology adoption in many cases can help these companies. Their IT budgets will be quite constrained. There are a handful of vertical markets that we've avoided. That also applies to some broader horizontal enterprise companies that might have a heavier reliance on some of those vertical markets. Lastly, I would say that we do have some caution around the small and medium-sized business sector. Those companies are getting hit the hardest right now. If you are a software provider to a lot of small and medium-sized businesses, we suspect that you will see quite a bit of headwind as you try to scale your business over the next 6-12 months.

**BJ:** Most of the funds that we look at are diversified funds investing across multiple sectors or sub-sectors. Our playbook remains the same: focus on high-quality managers who we believe can weather the storm. We may place emphasis on managers who have seen a cycle or two before, which describes the vast majority of the managers we invest with today. The experience to know when to act and when not to act is what we are focusing on, which is true for our very high-quality venture GPs. ■

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