Unicorns: legendary returns, harsh realities

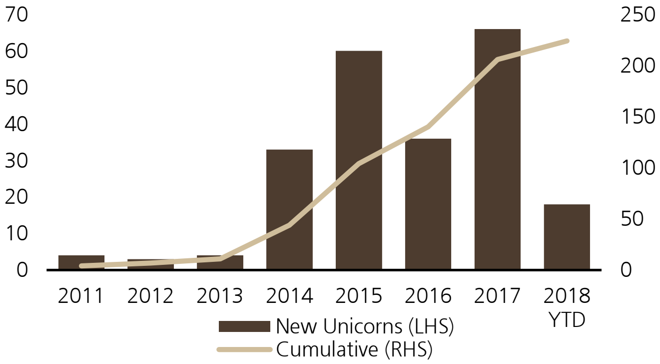
Market updates from UBS Asset Management

Unicorns are the Holy Grail for investors. Though they are becoming more common, the challenges and risks associated with identifying and investing in them are considerable, making it a nigh-on impossible task for the individual investor. However, a systematic, diversified approach of investing with top-quartile venture capital managers can meet these challenges and reduce risks, and has a proven track record of delivering exposure to unicorn companies.

Unicorns are ubiquitous

Unicorns are supposed to be rare, but they are becoming more common. Sixty-six new unicorns were minted in 2017, according to CB Insights, compared with 36 in 2016, and 30, on average, per year since 2013. E-commerce, fintech, internet services, and healthcare sectors stand out, accounting for 106 of the 224 unicorns minted since 2013, with most of the total unicorns being located in US (115) and China (70).

Exhibit 1: New Unicorns, 2011-2018 YTD



Source: UBS Asset Management, Real Estate & Private Markets, July 2018, data from CB Insights, July 2018.

Unicorns are changing the world

Many unicorns are involved with businesses or concepts that are rapidly driving social change. The internet (GitHub, Dropbox, Slack), e-commerce (Wish, Flipkart, Houzz, Delivery Hero, Fanli, Kuodai), on-demand (Didi, Grab, Uber, Ofo, Mobike) are sectors that stand out, as well as hardware (Xiaomi, Jawbone), fintech (u51.com, Klarna, Transferwise), and social networks (Pintrest, Pinduoduo, Snapchat). Most of these have emerged quickly and have had a massive global impact in how we interact with others and spend our time and money – in short, how we live our lives.

And as the transition to a tech-driven future continues, if not accelerates, we'll expect to see more unicorns emerge in the coming years. Notable sectors to watch include artificial intelligence, virtual reality, augmented reality, smart transportation, and robotics.

Unicorns are emerging because of the relatively abundant availability of capital which allows many startups to stay private for longer rather than pursue an IPO. Add to this the increasing connectivity of the world through the internet, and the huge domestic user-bases in India and China alone are bound to lead to more unicorns as both these economies continue to digitize and consumers become increasingly affluent.

> "Unicorns used to be rare, today they travel in herds"

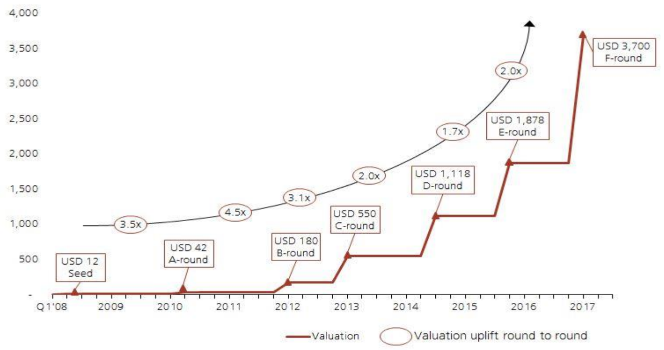
Unicorns can deliver excellent returns

But for all that unicorns are giving society, they are also generating excellent returns for investors. Take

Appdynamics, the US-based app management and analytics company, for example.

Appdynamics took 10 years to grow from a valuation of USD 12m to an exit of USD 3.7bn in 2017 [1]. An investment in the A-round would have delivered an 88x return, while an investment in the B-round would have delivered a 20x return, and a 3.3x return on a D-round investment.

Exhibit 2: Appdynamics valuation history, Q1 2018-Q2 2017 (USDm)



Source: UBS Asset Management, Real Estate & Private Markets, July 2018, data from CB insights July 2018.

But unicorns are (really) hard to find

But while there are more unicorns emerging, they're really hard to find at an early stage, even for seasoned VC investors.

Furthermore, the odds of becoming a unicorn are very long - research by CB Insights, a US-based data firm, shows that only 1% of 1,098 US start-ups kicked off between 2008 and 2010 went on to become unicorns with a USD 1bn+ valuation,. Among these were Airbnb, Slack, and Uber, i.e. not a bad cohort.

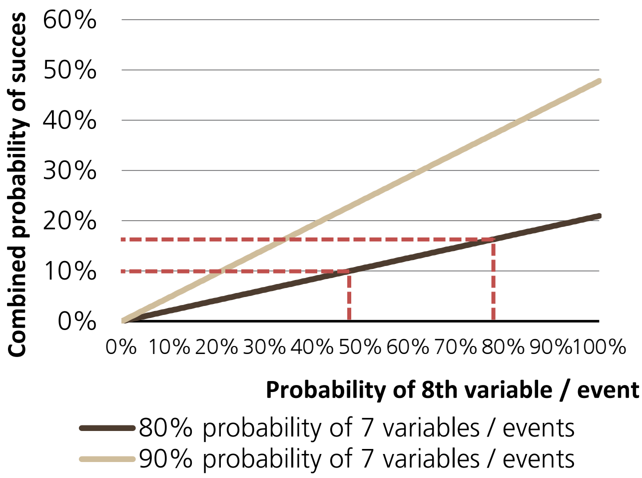
There are many reasons why it's hard to identify unicorns, but here's three in particular: firstly, it's hard to look seven-to-eight years ahead and predict whether a business will work; secondly, it's challenging to develop a great idea into a viable business, even if there's a mass market for it over time; and, finally, businesses suffer not through a lack of capital but a lack of knowhow and execution.

“Trying to pick a unicorn early on is a like trying to pick a winning lottery ticket”

To quantify this, we take a look at eight business-critical events[2] for any startup in Exhibit 3.

Applying a relatively high probability of a successful outcome of 80% on each event, nonetheless leads to only a combined probability of success of only 17%. Illustrating just how critical these factors can be for success, if just one variable drops to a 50% probability, the combined probability of success falls to 10%.

Exhibit 3: Probability of a successful business outcome



Source: UBS Asset Management, Real Estate & Private Markets, July 2018.

And investing in unicorns isn't easy

It also becomes even harder to invest in firms with unicorn potential even as seed start-ups grow into fully-fledged companies.

Two reasons stand out for this. Firstly, prior investors have pro-rata follow-on rights giving them an option for the next round and making a hurdle for outside investors to get over.

Secondly, new investors need to be approved, often by the founder, and investors need to bring other sources of value, e.g. industry knowhow and knowledge networks, as well as investment capital.

Beyond venture capitalists, for who this is also not easy, very few purely financial investors, no matter the depth of their pockets, are well placed to do this.

Risks are considerable

There's lots of the upside to unicorn investing that is attractive, but the downsides are considerable, making it incredibly challenging to do on your own.

[1] Appdynamics was bought by Cisco Systems for USD 3.7bn in January 2017 while finalizing its IPO.

[2] Eight events: Sufficient capital, capable management, product development, supply chain, competitive environment, customer interest, product pricing, enforceable patents.

In the early rounds, where the upside by far is greatest, there is often considerable technology and business model risk and failure rates reach 65%[3].

At this point it also takes a lot of investment to establish a venture capital type of capability to search for, research into, negotiate with, and structure investment deals in would-be unicorns.

At later rounds, when the company is revenue positive and business model and technology risks have been overcome, young companies still face risks in the form of market competition, consumer demand, management execution and more. At this point, there is by no means a guaranteed positive outcome let alone the certainty the company will become a unicorn.

"When you reach later rounds money is a commodity – thus just bringing money is very unlikely to get you a seat at the table"

At later stages or so-called "pre-IPO rounds" where friends and family with big checkbooks are welcomed as purely financial investors to support continued rapid growth there is, contrary to common belief, still quite some risk.

Firstly, a pre-IPO round supposes an actual future event – and IPOs might be even more fickle than unicorns. Secondly, investors in a pre-IPO round will often have the least remaining upside, (see Exhibit 2 as an example), while at the same time being the most exposed to any form of market correction (see 'Snapdeal: a unicorn stumbles').

But there is a way……..

The complexity of selecting and developing unicorns on your own is daunting, if not close to impossible, but relying on experienced managers can significantly simplify the process.

There are a number of experienced managers who have an excellent track record of identifying, investing in, and developing seed companies into fully-fledged unicorns (see Exhibit 4). They can do that because they have the expertise to not only invest in long-term growth opportunities, but bring the knowhow and contacts that fledgling companies need to fulfil their potential.

Importantly, even these well-established venture managers don't rely on an innate ability to pick and develop unicorns.

They are acutely aware of 1) the long odds of becoming a unicorn, 2) the failure rates of individual companies, and 3) the loss rates even within their own portfolios, where 30% for early-stage investors is not uncommon.

To compensate for this, they construct well-diversified portfolios, often with 30 or more high potential within well-defined sector where the partners will have deep experience, networks and domain expertise. They combine this with mentoring, operational value added and more, thus increasing the probabilities of success.

And even with all this, very few of these VCs would be audacious enough to assume a unicorn winner when building their portfolio, but rather look to do this over multiple vintages.

Snapdeal: a unicorn stumbles

An example of down /pre-IPO round risks is the e-commerce company Snapdeal - one of the first Indian unicorns.

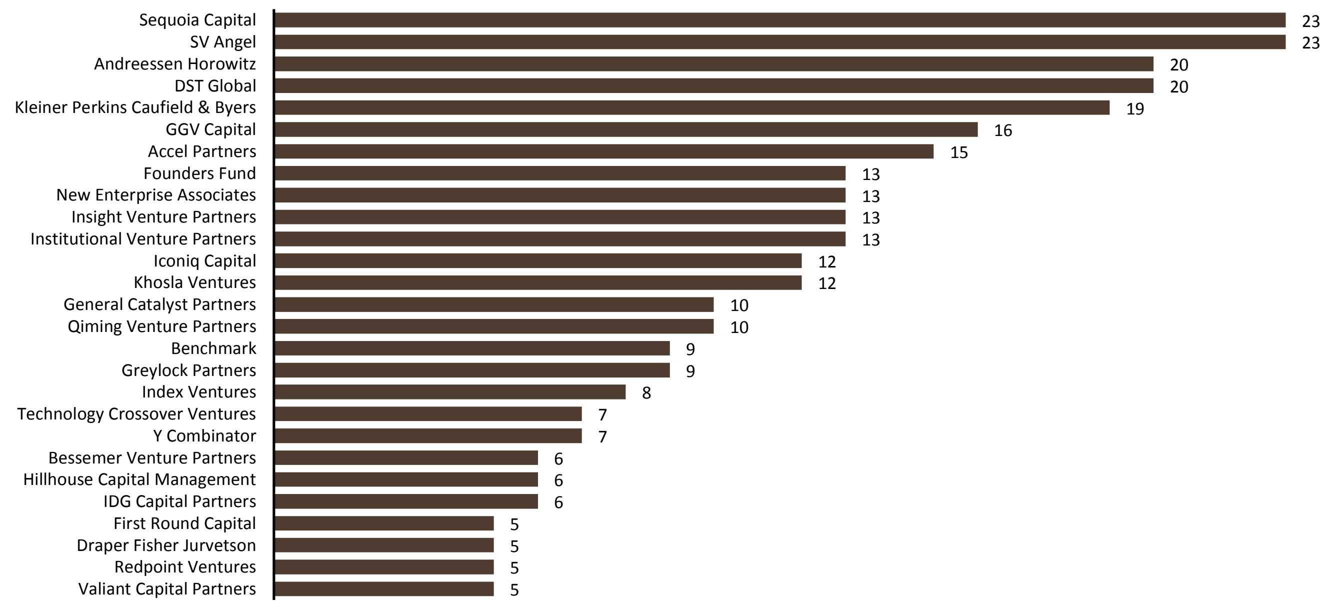
Backed by early-stage investors such as: Nexus Venture Partners, Kalaari Capital, Bessemer Ventures, and later stage investors such as Alibaba, SoftBank, Temasek, BlackRock and Ontario's Teachers Pension Plan, Snapdeal in 2016 reached a peak valuation of USD 6.5bn as it was heading towards an "inevitable" IPO.

However, continued high cash burn, increased competition from both Amazon and Flipkart, declining market share, disagreements in the investor base, and questionable management decisions led to and almost equally "inevitable" down round in early 2017 valuing Snapdeal at USD 2.5bn – which has continued down since.

While the early-stage investors certainly took a hit, they will all still make money on Snapdeal. It is however very unlikely that the later-stage predominantly financial investors, punting on a pre-IPO round will recover more than fractions of their original investments.

[3] From the point of view of a financial investor, failure rates for start-ups necessarily include both business failure and failure to secure any follow-on financing, which even if not a failure for the company may not be a good outcome for the investor

Exhibit 4: Top unicorn catchers (by # of unicorns)



Source: UBS Asset Management, Real Estate & Private Markets, July 2018, data from CB Insights February 2017.
PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS

Access is all-important

So one (obvious) way for investors to get exposure to unicorns, even if not investing directly in them, would be to invest in one, or to increase the hit rate, preferably more of these managers.

However, knowing who these managers is one thing, investing with them, as any serious VC investor will tell you, is quite another.

There are many reasons for this, but top among them are that venture fund sizes are small[4], existing investors have grandfathering rights, and the funds can be very picky with any new investors.

In regard to the latter, VCs have a preference for stable sources of capital, experienced venture investors, professionalism, and long standing relationships where it is not unusual that new investors often have queued for a long time, at times developing the relationship for several fund generations before being admitted.

Private investors, even those designated as Professional Investors, may additionally find access becoming increasingly challenging. This is due to more regulation and greater scrutiny of fund managers potentially making investments from private individuals less attractive to them.

For an investor it is also worth bearing in mind that even if access is possible, picking a “winning” fund vintage of one of these managers, while at better odds than picking unicorns, is also difficult. An investor would be better off developing a well-diversified portfolio across vintages and managers.

Why a systematic, diversified approach works

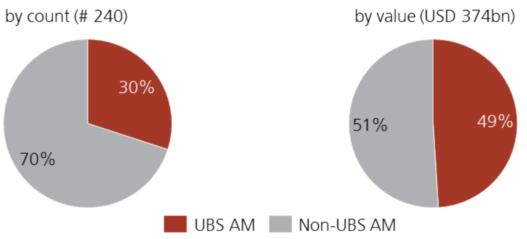
But by utilizing long-standing relationships with top-quartile managers, investing in a diversified way across a selection of these with demonstrated track records of assessing and building companies, and getting access to high-potential companies, a fund-of-funds strategy can effectively overcome the challenges of unicorn investing and deliver a high-potential portfolio, while mitigating risk.

This is how UBS Asset Management since 2000 has developed our venture investment programme. Our approach has not only delivered strong overall venture returns year on year but has also given our investors exposure to unicorns across vintages and regions.

Looking globally, our venture portfolio has exposure to 30% of the total 240 unicorn companies, but with 49% of the value represented by the unicorn group – i.e. our managers seem to be better than average at picking unicorns. And, for the curious reader, we are in fact invested in most of the unicorns mentioned above.

[4] While some managers will raise funds above USD 1bn, this is more the exception than the rule, and these managers will also admit that outsized returns and funds size tend to be inversely correlated

Exhibit 5: UBS Asset Management unicorn exposure



Source: UBS Asset Management, Real Estate & Private Markets; July 2018.

Conclusion

So, while investing in unicorns is the Holy Grail for investors, the challenges involved and the risks of failure are considerable.

But a systematic, diversified approach to investing that utilizes top-quartile managers with knowhow and a track record of unicorn investing can overcome these challenges and reduce risks, and is a proven strategy for realizing the undoubted upside from identifying companies with unicorn potential.

Sources:

CB Insights: Has The Market Stopped Making New Unicorns? Not Really

CB Insights: Unicorn Trends Webinar, 2017

Times of India: What led to the SoftBank-SnapDeal fallout, May 1 2017

Livemint: Snapdeal: Rise and fall of an Indian unicorn, April 28 2017

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