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Beyond Venture Capital: An Innovative Approach for Investment in New Ventures and Projects

Manuel Stagars, CAIA
Entrepreneur and Economist

How Venture Capital Works

To prototype his vision and receive feedback from the market, an entrepreneur raises seed capital from a business angel or venture capital firm. When the market confirms that the idea has room to grow, the startup raises further rounds of capital, scaling the business up from round to round. At some point, the early-stage venture capitalists start selling their shares in the second market to realize a profit. Finally, in an initial public offering (IPO), founders and later stage investment firms sell shares to the public to realize their profits.

Venture capital firms usually strive for at least a 10X multiple (1,000 percent return) over the investment period. The desired average lies somewhere around a 30X multiple. The investment capital is concentrated and dependent on the success of a single venture. To hedge their bets, venture capitalists invest funds in more than one startup at the same time, hoping that roughly one in ten will end up in a lucrative exit and more than cover the costs for those that did not work out as well. See Exhibit 1.

In this article, the term "investors" describes the investors in the venture capital fund, not the venture capital firm itself. Venture capitalists rarely invest their own money. They draw their capital from venture funds, which hold money that has been raised from high-net-worth individuals and institutional investors. The size of these venture funds is usually around US$200 million. Investments funds are locked up for 7-10 years and the investors receive their principal plus (presumably) a profit upon liquidation of the portfolio. The venture capital firm manages the venture fund by allocating it across several portfolio investments.

Assimilation Funds Enable Network Effects

Assimilation funds offer a fresh perspective on venture capital funding. Instead of concentrating on single companies and their management, the approach allows investors to buy strategic building blocks of a growth story right from the beginning. By investing in both the startup and its value chain partners, assimilation funds "assimilate" strategic investments early on. Not only does this diversify risk and cap the downside of the project, it also enables synergies that may accelerate profits if investee companies take off. If unexpected tail events happen, such as total failure of a business or an unexpected windfall, the strategy may achieve superior returns compared to traditional venture capital investment. This is possible because the portfolio contains several tangible assets in addition to startup equity. Their value may decrease, but it is not likely that it will go to zero. Conversely, when one asset in the basket takes off, it may lift the others as well.

While venture capital firms commonly diversify across several investments, they do not always consider the potential network effects they create. If one startup in a portfolio becomes successful, it could boost other assets as well. This may occur if it lowers the cost of certain components that other companies use, or if the companies share innovations rapidly and freely. In reality, successful startups use every advantage to beat the competition, not to support it. However, if one investor controls large parts of the value chain that several startups depend on, the situation changes. Advantages can spread to other companies more easily. Further, control of supply and distribution channels keeps competitors out and gives portfolio companies an added boost. Venture capital investors can do this with an assimilation fund.

Comparison to Conventional Venture Capital

Assimilation funds run differently from venture capital funds. Taking into account the strategic value chain of a small group of portfolio companies gives them a better chance at becoming successful. Such an approach takes a more sustainable view on startup investments. It verifies that they have enough potential to scale well into

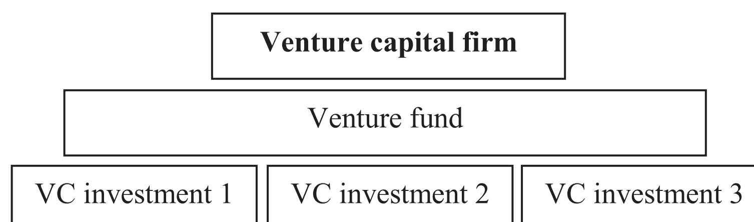

Exhibit 1 Conventional venture fund

Source: Author

the future. It also introduces hard assets as collateral earlier into the investment portfolio, reducing the risk for financial investors.
Exhibit 2 outlines the main differences between the two approaches.

Introducing a Long-Term View

Spreading investment over strategically linked assets and asset classes moves the focus away from chasing a 10-30X return with a startup relatively quickly. Instead of trying to identify the next "big thing," an assimilation strategy realizes profits from the entire supply chain over the longer term. This shift in focus serves as an additional filter when evaluating portfolio assets. It goes one step beyond the obvious market that startups may play in. The bigger picture becomes more important.
Just as venture capital firms hedge their bets with investments in several startups, assimilation funds spread their capital across more than one core company. If the venture capital firm selects its portfolio companies wisely, there will be overlap in the strategic partners. The stronger this overlap is, the stronger the potential for network effects. When selecting investments, the fund manager should seek out complementary assets. Exhibit 3 shows how clusters of portfolio companies and their value chains overlap.

Investment Style and Characteristics

In terms of portfolio companies, assimilation funds have a narrower focus than venture capital funds. They follow a solid investment thesis and purchase stakes in partners in the value chain of the startups, often established companies in their own right. The fund achieves this through convertible debt, private equity invest-

	Venture capital	**Assimilation funds**
Use of funds	Purchasing a stake in a startup (investment size depends on stage)	Purchasing a stake in complementary startups and their upstream and downstream partners in the value chain
Term of investment	Short/medium-term view, exit pre-IPO or at IPO	10+ year horizon, long-term view, exit at IPO, or later
Size of the capital pool	Up to US$ 200 million for the entire venture fund	Up to US$200 million per assimilation fund, several are possible per VC firm
Objective	Realizing 10-30X return fast	Realizing 100X return over the long term
Investment thesis	"The startup quickly exploits a highly lucrative market opportunity, profit through IPO"	"The startup addresses a long-term need, which will take time to monetize. When that happens, large profits come from the startup and its partners in the value chain"
Investment theme	None, other than a sector focus, based on expertise of the firm	Strong themes, such as impact investment, sustainability, clean air, etc.
Fund manager	Venture capital firm	Venture capital firm together with dedicated fund manager
Business model for fund manager	Annual management fee, performance fee ("carry") at liquidation	Annual management fee, performance fee ("carry") at liquidation – but on a larger capital base than conventional VC funds
Return characteristics for investors	Option-like returns	Blended: Fixed income and equity from value chain investments; option-like on the upside, capped on the downside for startups

Exhibit 2 Comparison between venture capital and assimilation funds
Source: Author

ment, or purchases of publicly traded equity. Currency and interest rate hedges are also included in assimilation funds. This blend of asset classes diversifies risk and transforms venture capital into a less risky asset class. Compared to conventional venture capital, assimilation funds outperform as soon as investee companies deviate from normal performance. See Exhibit 4.

The dashed line in the figure represents classical venture-style returns. They have the characteristics of a call option. If investee companies do well and their share price exceeds the cost of the options premium, investors will realize a return. Otherwise, their entire investment is lost. The option expires worthless when investee companies are shut down or go bankrupt.

Investment performance in an assimilation fund follows a different pattern. It has the combined return characteristics of equity, a put option, and a call option. The strong line in the figure represents the return from a blended strategy. If investee startups perform poorly, collateral from value chain investments and hedges pad the loss. When startups are successful, network effects potentiate their benefits and boost not only the direct investment in those companies, but also the value chain assets. In these events, assimilation funds outperform conventional venture capital funds. However, diversification comes at a price. When startups perform as ex-

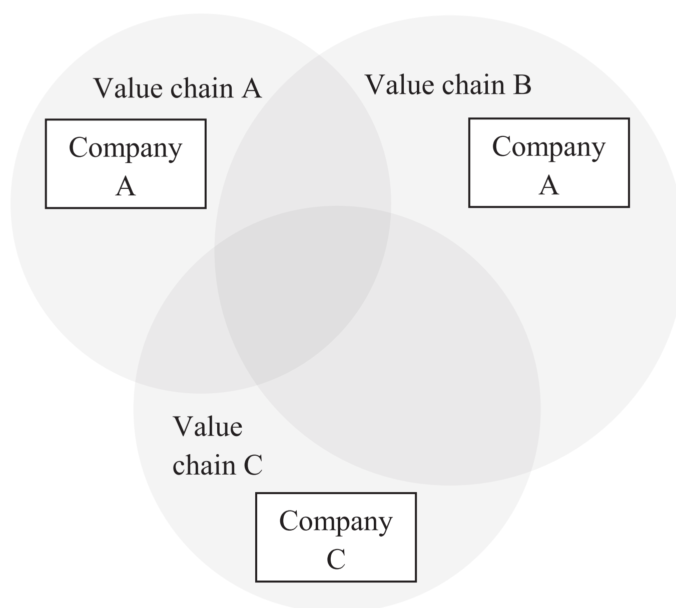

Exhibit 3 Synergies through overlapping value chains
Source: Author

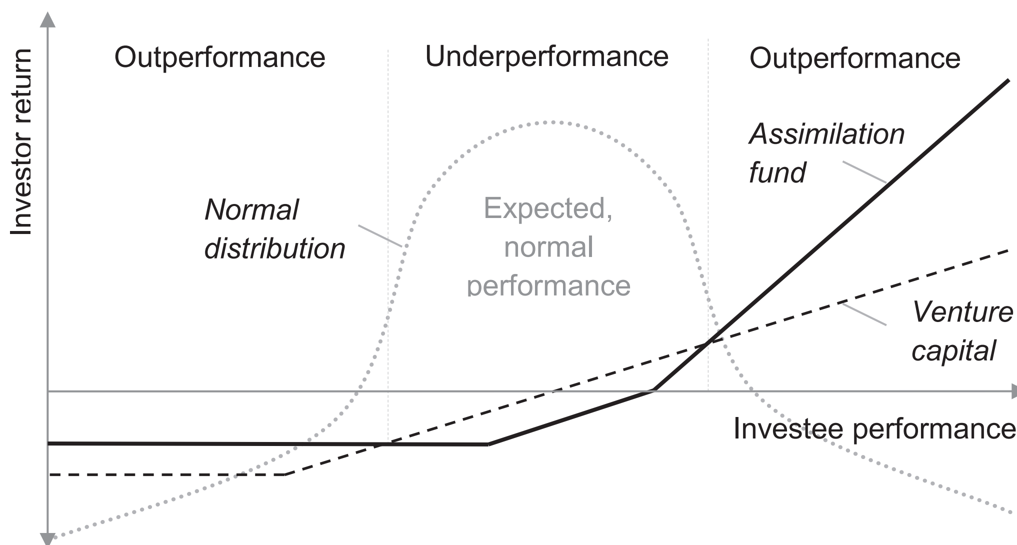

Exhibit 4 Investor return with conventional venture capital and assimilation funds
Source: Author

pected by achieving medium returns, the costs of the put and the call option outweigh these returns. With normal performance, the strategy underperforms traditional venture capital investment.

Venture Funds Become Hedge Funds

Venture capital firms enjoy an additional benefit when using assimilation funds to capitalize startups. As the total assets under management in these funds are larger than those of traditional venture funds, they generate higher annual management fees. Venture capital firms may do better with assimilation funds than funds operated under the old model, both in the event of success, and in the event of failure. Their business model becomes more like that of a hedge fund.

Application

Similar to traditional venture funds, assimilation funds allow venture capital firms to allocate capital from third parties to promising investments. However, these funds impose some additional constraints on investment selection that conventional venture capitalists may not be familiar with.

- Startups must follow a certain thesis and theme, e.g. SRI, sustainable transport, etc.;
- Startups must allow for scale and must involve an investible value chain;
- Startups must benefit from synergies by using the same value chain companies;
- Asset allocation.

Necessary Skills

Venture capital firms must carry out the assimilation approach consistently to take full advantage of the assimilation strategy. It is essential that interested venture capital firms familiarize themselves with the intricacies of these financial instruments and understand their implications. In particular, identifying complementary value chain assets may not be intuitive to conventional venture capital firms right away.

Since assimilation funds are blended funds and not pure venture funds, the fund manager has a dual role. On one hand, he is responsible for directing the venture capital investments in the portfolio. This is the expertise already native to venture capital firms. Additionally, he must also oversee the value chain assets and other financial instruments in the portfolio, such as private equity stakes in supply partners, publicly traded equity,

	Investment	Size (US$ millions) and % AUM	Stake
Venture capital (45%)	Electric car company	60 (30%)	60%
	Traffic flow software	20 (10%)	30%
	Regenerative breaking technology	10 (5%)	50%
Private equity (30%)	Electronic motor manufacturer	20 (10%)	5%
	Assembly plant	20 (10%)	5%
	Windshield projector manufacturer	20 (10%)	10%
Public equity (20%)	Manufacturer of charging stations	5 (2.5%)	
	Battery manufacturers	10 (5%)	
	Motor manufacturers	5 (2.5%)	
	Component manufacturers	20 (10%)	
Hedging instruments (5%)	Currency USD/CNY	5 (2.5%)	
	Put options on public equity	5 (2.5%)	

Exhibit 5 Asset allocation in an assimilation fund
Source: Author

and hedging instruments.

Asset Allocation
In addition to venture capital, assimilation funds include several other asset classes. Imagine a hypothetical assimilation fund of US$200 million with the theme "sustainable transport." It may consist of the following investments and asset classes, as seen in Exhibit 5.

Allocating the raised capital over about twenty investments in different asset classes helps to reduce the risk. The collateral of the hard assets in the value chain serves as a cap on the downside. At the same time, when the venture allocations outperform, their success may stimulate network effects that make the value chain companies more valuable. Their strategic ownership may help position the startups even more strongly in the market. Alternatively, when network effects kick in, investors may wish to realize capital gains.

Fund Structure
A venture capital firm can (and should) have several assimilation funds to increase its assets under management and benefit from larger scale in its operations. To do that, it will have to integrate new skills into its operations to manage the funds, comply with regulations, and regularly report to investors. A support structure and stronger banking relationships will be crucial in order to attract a more potent investor base and achieve scale. Just as other investment funds, assimilation funds are domiciled in a designated fund jurisdiction. The paper Themed Investment Funds (Stagars, 2014) explains their setup in more detail.

Exhibit 6 shows an example of a fund structure and its most important stakeholders.

Performance Modeling
Since assimilation funds are not pure venture capital funds, their returns have different characteristics from conventional venture capital funds. According to portfolio composition, fund managers need to find adequate benchmarks against which they compare their performance. Comparability is equally important when investors and their advisors evaluate assimilation funds against other investments.

When investments have a long performance history and trade on public exchanges, data is often freely available. However, in the case of startup investments and unproven investment theses, fund managers must construct a hypothetical portfolio and calculate model performance. They should back-test this portfolio over a certain time horizon, perhaps three to five years, and project returns into the future with several scenarios. Of course, accredited investors know that model performance does not ensure actual performance. Nevertheless, extra care to follow disclosure guidelines is important, perhaps more so than in a conventional venture fund. The CFA Institute recommends the following best practices when disclosing model performance.

- Clearly label all theoretical results as such (e.g.,

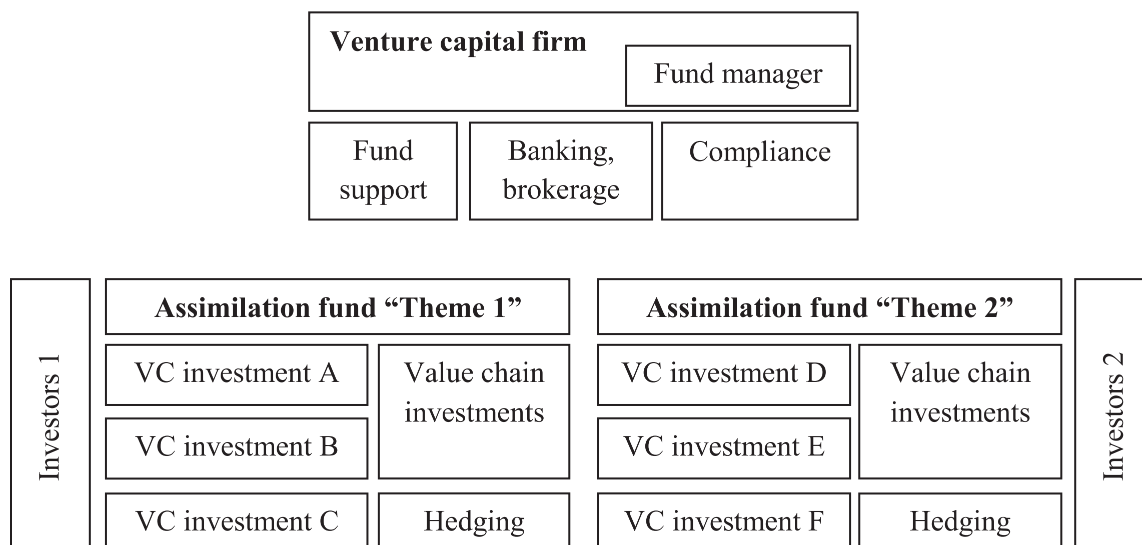

Exhibit 6 Structure of an assimilation fund funds
Source: Author

Backtested Global 130/30 Strategy).

- Do not link theoretical performance with actual performance in any way. This means more than just not linking the returns geometrically. If you must include theoretical and actual performance in the same presentation, then show them on separate pages, and label them clearly.
- Do not state that "past performance is not indicative of future results." Even though we are accustomed to this language, in the context of model performance, it implies that what is being shown is actual performance.
- Provide clear and prominent disclosure that the returns are theoretical, and describe all of the assumptions that have been made and their limits.
- Theoretical results should be shown only to consultants and sophisticated clients or prospects that have sufficient experience and knowledge to assess the product, presentation, and risks.
- Maintain sufficient records to support calculations and presentations.
- Consult with attorneys and your compliance department regarding applicable laws and regulations.

Such disclosures are more common in investment banking and private banking than in venture capital. To implement assimilation funds, venture capitalists need to adjust their approach to disclosures and compliance slightly, in order to include new practices and vocabulary.

Advantages and Disadvantages

Assimilation funds offer many advantages for investors, investment companies, family offices, foundations, and asset owners. The main benefit for venture capital firms lies in the larger pool of assets they manage. This may give them access to bigger deals, which results in larger revenues from management and performance fees. However, assimilation funds are more complex to manage than conventional venture funds.

Investors profit from blended exposure to venture-style returns. As venture capital is still the dominant asset class in assimilation funds, they may fulfill their allocation requirements with less downside risk and a stronger thematic investment thesis. However, if they wish pure exposure to venture capital, including its well-known risk-return profile, they may wish to allocate capital to more conventional funds instead.

Exhibit 7 summarizes some of the most important advantages and disadvantages from both perspectives.

Conclusion

This article gives an overview of assimilation funds and assimilation strategy. It introduces them as an innovative approach to financing new ventures and projects. This technique goes beyond venture capital investment, as it considers not only startups by themselves, but their strategic value chain as well. Investments follow a theme and have a longer-term investment horizon. This approach has the potential to offer superior risk-return characteristics to investors, especially lower downside risk. Blending several asset classes may attract more risk-averse investors, such as large institutions and endowments.

Venture capital firms benefit from assimilation funds as well. They gain access to larger pools of capital that

	Venture capital firm	**Assimilation fund investors**
Advantages	• Access to larger investor group • More assets under management (AUM) • High management /performance fee • Higher profile	• Blended venture capital exposure • Leveraged investment with capped downside risk • Larger secondary market, better liquidity during the investment term
Disadvantages	• More complex to set up and administer • Fund requires detailed reporting, compliance • Venture capital firm needs to find agreement with the board of the fund/fund manager	• Not "pure" venture capital exposure, if that is desired • Boundary to entry, as funds may impose higher investment minimums

Exhibit 7 Advantages and disadvantages for venture capital firms and assimilation fund investors

Source: Author

would otherwise not find their way into venture capital. The larger account size generates higher management fees, which allow venture capitalists to source new assets more aggressively.

Assimilation funds are new territory for both venture capitalists and financial investors. Because of their more complex structure, investors should familiarize themselves thoroughly with the risk-return characteristics of the approach. When venture capital firms introduce these financial products, they may find them complementary to conventional venture capital. However, it is possible that a new breed of venture firms will emerge that uses structured finance more audaciously. This may reinvent the traditional business model and make venture capital more palatable for a larger investor base.

Important note: This article contains information on portfolio management and wealth management principles and is for informational purposes only. It should not be construed as investment advice. In particular, it is not intended as a recommendation that any investor pursue investment strategies involving listed options, high-yield bonds, venture capital, or other alternative investments.

Author Bio

Manuel Stagars is a serial entrepreneur and economist. He founded companies in Switzerland, the United States, and Japan and holds certifications as a Chartered Financial Analyst (CFA), Chartered Alternative Investment Analyst (CAIA), and Energy Risk Professional (ERP). Mr. Stagars is supporting and consulting startups and companies in terms of business development, strategy, and platform thinking since 2007. This wide background enables him to blend creative entrepreneurship with the perspective of investors and venture capitalists. To read more about Mr. Stagars' work, visit: www.stagars.com.