An introduction to Venture Capital

Ruhr-Universität Bochum

June 2, 2022
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03 The VC decision making process & valuation drivers

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Cusp Capital – VC for companies on the cusp of global relevance

→ As a team we started in 2009 and were repeatedly ranked as one of the Top 10 backers of European unicorns by GP Bullhound in their annual Titans of Tech reports.

→ In 2021, we have started Cusp Capital and raised an independent early-stage VC fund.

→ We follow a thesis driven investment approach.

→ We work with entrepreneurs in scaling their businesses by supporting to shape their strategic narrative and operational excellence.

→ With Cusp Capital, we have partnered with 9 companies so far – more to come.
We invested *crossed in many category defining categories over the last 12 years.*

Investments in European champions

- **Zalando**: Invested in Series A
  - DAX 30
  - Private with €38bn last valuation

- **Klarna**: Invested in Series C
  - DAX 30

- **Delivery Hero**: Invested in Seed
  - DAX 30

- **Westwing**: Invested in Series B
  - Public

- **OFG Global Fashion Group**: Invested in Seed
  - Public

- **Scalable Capital**: Invested in Series A

- **SumUp**: Invested in Seed
  - Private with €4.5bn valuation

- **DataArtisans**: Invested in Series A
  - Acquired by Alibaba

- **Stylight**: Invested in Seed
  - Acquired by Pro7Sat1

- **eKomi**: Invested in Seed
  - Sold shares to PE

- **Wunderlist**: Invested in Seed
  - Acquired by Microsoft

- **Lazada**: Invested in Series A
  - Acquired by Alibaba
A new generation of companies changing the way millions of people live or enabling other businesses to master this change.
02 Venture capital – a small asset class with high impact
02 Venture capital – a small asset class with high impact

Venture capital is a growing asset class ...

The European technology ecosystem reached $100B of capital invested in a single year for the first time in 2021.

Source: State of European tech
02 Venture capital – a small asset class with high impact

... but still tiny compared to other asset classes.

Allianz third-party portfolio of asset allocation

<table>
<thead>
<tr>
<th>Third-party assets under management</th>
<th>€ bn</th>
<th>As of 31 December 2021</th>
<th>As of 31 December 2020</th>
<th>Delta</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business units’ share</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PIMCO</td>
<td>%</td>
<td>76.8</td>
<td>78.1</td>
<td>-(1.3) %p</td>
</tr>
<tr>
<td>AllianzGI</td>
<td>%</td>
<td>23.2</td>
<td>21.9</td>
<td>1.3 %p</td>
</tr>
<tr>
<td>Asset classes split</td>
<td>%</td>
<td>10.4</td>
<td>9.5</td>
<td></td>
</tr>
<tr>
<td>Fixed income</td>
<td>%</td>
<td>75.4</td>
<td>78.3</td>
<td>-(3.0) %p</td>
</tr>
<tr>
<td>Equities</td>
<td>%</td>
<td>10.5</td>
<td>9.4</td>
<td>1.1 %p</td>
</tr>
<tr>
<td>Multi-assets</td>
<td>%</td>
<td>3.7</td>
<td>2.7</td>
<td></td>
</tr>
<tr>
<td>Alternatives</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Investment vehicle split¹          | %    |                        |                        |       |
| Mutual funds                       | %    | 58.5                   | 57.9                   | 0.5 %p |
| Separate accounts                  | %    | 41.5                   | 42.1                   | -(0.5) %p |

| Regional allocation²               | %    |                        |                        |       |
| America                            | %    | 55.5                   | 54.8                   | 0.8 %p |
| Europe                             | %    | 32.4                   | 32.8                   | -(0.4) %p |
| Asia Pacific                       | %    | 12.1                   | 12.4                   | -(0.4) %p |

VC is part of the Alternatives asset allocation

- Hedge Funds
- Buyout funds
- Real estate
- Infrastructure
- Venture Capital
Some of the world’s most successful companies have been funded by venture capital in their early days.
Venture capital is defined by asymmetric returns – a high probability of default with an (almost) unlimited upside.

> 40% of investments of a typical VC

*loose money*

Returns are driven by

*home runs*

Source: Chris Dixon (a16z). Performance Data and the 'Babe Ruth' Effect in Venture Capital.
To achieve a 3x return on the fund, every investment needs to have home run potential.

The Babe Ruth Effect

Frequency vs. magnitude

“Building a portfolio that can deliver superior performance requires that you evaluate each investment using expected value analysis.

What is striking is that the leading thinkers across varied fields—including horse betting, casino gambling, and investing—all emphasize the same point.

We call it the Babe Ruth effect: even though Ruth struck out a lot, he was one of baseball’s greatest hitters.”
02 Venture capital – a small asset class with high impact

**Summary:** In the VC fund model non-profitable investments are overcompensated by fund returners.

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### Example of a fund model for a € 100m VC fund

<table>
<thead>
<tr>
<th>Company</th>
<th>Investment</th>
<th>Money Multiple</th>
<th>Exit proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10</td>
<td>0,0x</td>
<td>0</td>
</tr>
<tr>
<td>2</td>
<td>10</td>
<td>0,0x</td>
<td>0</td>
</tr>
<tr>
<td>3</td>
<td>10</td>
<td>0,0x</td>
<td>0</td>
</tr>
<tr>
<td>4</td>
<td>10</td>
<td>1,0x</td>
<td>10</td>
</tr>
<tr>
<td>5</td>
<td>10</td>
<td>1,0x</td>
<td>10</td>
</tr>
<tr>
<td>6</td>
<td>10</td>
<td>1,5x</td>
<td>15</td>
</tr>
<tr>
<td>7</td>
<td>10</td>
<td>1,5x</td>
<td>15</td>
</tr>
<tr>
<td>8</td>
<td>10</td>
<td>1,5x</td>
<td>15</td>
</tr>
<tr>
<td>9</td>
<td>10</td>
<td>11,5x</td>
<td>115</td>
</tr>
<tr>
<td>10</td>
<td>10</td>
<td>12,0x</td>
<td>120</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
<td><strong>3,0x</strong></td>
<td><strong>300</strong></td>
</tr>
</tbody>
</table>

**Metrics**

- Loss ratio: 30%
- Fund returner: 20%
- DPI: 3x

This example follows the assumption that investments are equally distributed among companies. In reality the fund manager also has to manage allocations of follow-on financings etc. In doing so, opportunity costs need to be considered.
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Investment decisions are guided by the goal to *hit home runs*

<table>
<thead>
<tr>
<th>Market size</th>
<th>Team</th>
<th>Product (market fit)</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>The TAM narrative</em></td>
<td><em>The ambition &amp; execution</em></td>
<td><em>The metrics</em></td>
</tr>
</tbody>
</table>
03 The VC decision making process & valuation drivers

Investment decisions are guided by the goal to hit home runs

Market size
- The TAM narrative

Team
- The ambition & execution

Product (market fit)
- The metrics
The “so what” question in Venture Capital

- “The team is great and the product is superb, but so what if the market is not big enough?”

- “Companies can succeed in great markets with mediocre teams but great teams will always lose to bad markets”

But what is the market? The addressable market narrative

- How would you estimate the market size for Uber?
03 The VC decision making process & valuation drivers

Addressable market narrative – the case of Uber

The taxi market narrative by Aswath Damodaran: *Uber is not worth USD 17bn*

### Uber: Intrinsic valuation - June 8, 2014 (in US $)

<table>
<thead>
<tr>
<th>Year</th>
<th>Overall market</th>
<th>Share of market (gross)</th>
<th>Revenues as percent of gross</th>
<th>Annual Revenue</th>
<th>Operating margin</th>
<th>Operating Income</th>
<th>Effective tax rate</th>
<th>After-tax operating income</th>
<th>Sales/Capital Ratio</th>
<th>Free Cash Flow to the Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$106,000</td>
<td>3.63%</td>
<td>20.00%</td>
<td>$769</td>
<td>7.00%</td>
<td>$54</td>
<td>31%</td>
<td>$17</td>
<td>5.00</td>
<td>-$57</td>
</tr>
<tr>
<td>2</td>
<td>$112,360</td>
<td>3.52%</td>
<td>20.00%</td>
<td>$1,173</td>
<td>10.67%</td>
<td>$125</td>
<td>33%</td>
<td>$40</td>
<td>5.00</td>
<td>$4</td>
</tr>
<tr>
<td>3</td>
<td>$119,102</td>
<td>3.41%</td>
<td>20.00%</td>
<td>$1,528</td>
<td>14.33%</td>
<td>$219</td>
<td>33%</td>
<td>$85</td>
<td>5.00</td>
<td>$81</td>
</tr>
<tr>
<td>4</td>
<td>$126,248</td>
<td>3.31%</td>
<td>20.00%</td>
<td>$1,846</td>
<td>18.00%</td>
<td>$332</td>
<td>34%</td>
<td>$147</td>
<td>5.00</td>
<td>$71</td>
</tr>
<tr>
<td>5</td>
<td>$133,823</td>
<td>2.98%</td>
<td>20.00%</td>
<td>$2,123</td>
<td>21.67%</td>
<td>$463</td>
<td>35%</td>
<td>$219</td>
<td>5.00</td>
<td>$64</td>
</tr>
<tr>
<td>6</td>
<td>$141,852</td>
<td>2.90%</td>
<td>20.00%</td>
<td>$2,408</td>
<td>25.33%</td>
<td>$561</td>
<td>36%</td>
<td>$301</td>
<td>5.00</td>
<td>$58</td>
</tr>
<tr>
<td>7</td>
<td>$150,363</td>
<td>2.87%</td>
<td>20.00%</td>
<td>$2,666</td>
<td>29.00%</td>
<td>$773</td>
<td>37%</td>
<td>$301</td>
<td>5.00</td>
<td>$54</td>
</tr>
<tr>
<td>8</td>
<td>$159,385</td>
<td>2.84%</td>
<td>20.00%</td>
<td>$2,916</td>
<td>26.67%</td>
<td>$953</td>
<td>38%</td>
<td>$390</td>
<td>5.00</td>
<td>$52</td>
</tr>
<tr>
<td>9</td>
<td>$168,948</td>
<td>2.81%</td>
<td>20.00%</td>
<td>$3,163</td>
<td>30.00%</td>
<td>$1,149</td>
<td>39%</td>
<td>$487</td>
<td>5.00</td>
<td>$49</td>
</tr>
<tr>
<td>10</td>
<td>$179,085</td>
<td>2.78%</td>
<td>20.00%</td>
<td>$3,582</td>
<td>34.00%</td>
<td>$1,433</td>
<td>40%</td>
<td>$591</td>
<td>5.00</td>
<td>$84</td>
</tr>
</tbody>
</table>

**Terminal Value** = $793 (0.08-025) = $14,418

Based on the investment of $1.2 billion made by investors, the imputed value for Uber’s operating assets, in June 2014, was $17 billion.

### Value of operating assets = $6,595

Discount back the cash flows (including terminal value) at the cumulated cost of capital.

<table>
<thead>
<tr>
<th>Year</th>
<th>Value of operating assets</th>
<th>Cost of capital for first 5 years</th>
<th>Cost of capital declines from 12% to 8% from years 6 to 10.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$6,595</td>
<td>$6,595 (39)</td>
<td>$6,095 (85)</td>
</tr>
</tbody>
</table>

Source: Aswath Damodaran, https://aswathdamodaran.blogspot.com/2014/06/a-disruptive-cab-ride-to-riches-uber.html

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03 The VC decision making process & valuation drivers

Addressable market narrative – the case of Uber

The car ownership alternative narrative by Bill Gurley: 25 times higher than Damadoran’s original estimate

"Sizing the market for a disruptor based on an incumbent's market is like sizing the car industry off how many horses there were in 1910”


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Investment decisions are guided by the goal to *hit home runs*
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To win, founders need to have high ambitions, execute under pressure & inspire others – *this takes a special character*

Examples of outstanding entrepreneurs (you might have not heard about)

- **Born in Koblenz**
  - Freelance software developer
  - Built an e-commerce shop for snowboards
  - CEO of a USD 45bn company

- **Started to develop websites at age 13**
  - Managed a team of 15 by the age of 18
  - Founded several companies
  - CEO of a USD 21bn company

- **Born in Romania**
  - Worked for Microsoft in Seattle, U.S.
  - Returned to Romania to build the UiPath
  - CEO of a USD 9bn company
03 The VC decision making process & valuation drivers

Your personal ambition test

What would you do?

You have founded a company 3 years ago. The journey so far has been tough but you see great developments over the last year. The opportunity is huge and you are excited that things are finally moving in the right direction.

A competitor comes along and offers you €50m for your company. Sell or not sell?
Investment decisions are guided by the goal to hit home runs.

Market size

Team

Product (market fit)

The TAM narrative

The ambition & execution

The references & metrics
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Being in a good market with a product that can satisfy this market – *product market fit*

What do industry experts / customers think about the product?

- Expert calls
- Customer calls

Are relevant metrics pointing to product market fit and growth?

- User / customer growth
- Recurring revenue growth
- Net revenue retention
- Churn of customers
- ...

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Funding volumes & valuation boomed over the last 3 years – 
irrational exuberance?
In 2021, more companies than ever before reached unicorn status.
Funding volumes & valuation boomed over the last 3 years – irrational exuberance?

- Hedge Fund turned VC based
- Invest out of a USD 12.7bn VC fund
- Have done almost one deal per day in 2021 across the globe
Driven by inflation, increasing interest rates & economic uncertainty we are in a tech bear market—*the drought*?
Driven by inflation, increasing interest rates & economic uncertainty we are in an epic tech bear market – *the drought?*
Driven by inflation, increasing interest rates & economic uncertainty we are in an epic tech bear market – *the drought*?

**TIGERGLOBAL**

Tiger Global hit by $17bn losses in tech rout

Hedge fund suffers ‘breathtaking’ drop as speculative stocks sink from pandemic peaks

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**CNBC DISRUPTOR 50**

**Klarna to lay off 10% of its workforce as souring economy hits buy now, pay later space**

Published Mon, May 23 2022-11:16 AM EDT | Updated Wed, May 25 2022-10:23 AM EDT

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**TECH**

**Sequoia coaches start-ups to cut costs or face a ‘death spiral’ amid stock market slump, bleak economic backdrop**

Published Thu, May 26 2022-11:16 AM EDT | Updated Thu, May 26 2022-11:21 PM EDT

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The upside of a downturn – *time to build*

Progress in technology continues *throughout market cycles*. 
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