anthemis

WHITEPAPER

Sector Funds & Specialization

JULY 2020

Contents

Introduction
P. 2

I
Sector-Specific Funds and Outperformance
P. 3

II
Driving Value in Fintech
P. 4

III
Why Anthemis?
P. 8

APPENDIX A
Historical VC Context Relevant Today
P. 9

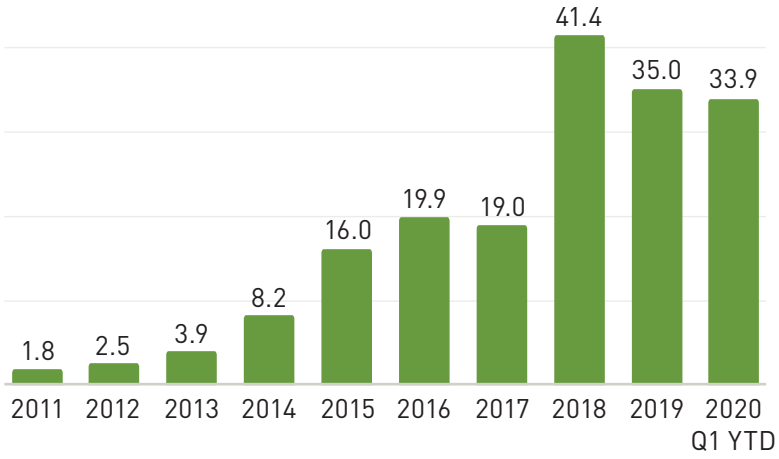
APPENDIX B
Declaring a Major: Sector-Focused Private Investment Funds (Cambridge Associates LLC Reprint)
P. 10

Introduction

As a thesis-driven, sector-focused investor, specialization and expertise lie at the heart of Anthemis' investment process. This research was completed in support of that thesis, taking into account broader market trends and available data. In this paper, we examine sector specific funds and outperformance, as well as specialist expertise in fintech and why it matters.

On average, available data shows that sector-focused managers have outperformed the market;[1] we believe that this trend paves the way for an enduring venture capital (VC) model as competition for deal flow and capital continues to rise.

Global VC Investment in Fintech Growing Rapidly ($ billion)

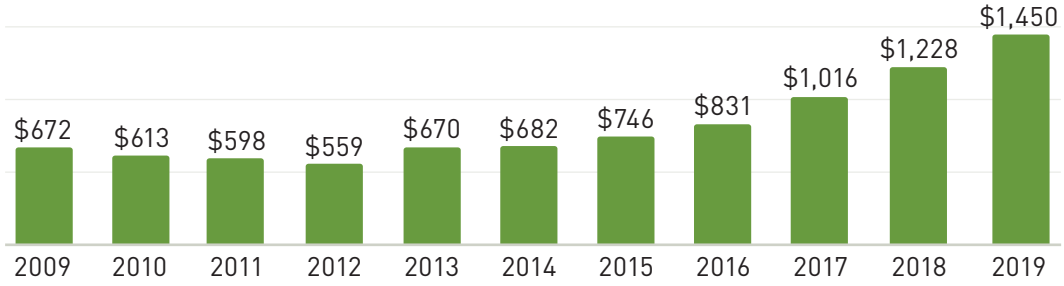


Sources: CB Insights; McKinsey & Company

I. Sector-Specific Funds and Outperformance

A topical refrain in private markets focuses on the "historically high" levels of dry powder currently allocated to fund managers. This statement is timely as it is intriguing given the critical stage for deployment private investors enter over the next 3–5 years. Adding further complexity to the environment, a trifecta of persistent low interest rates, late credit cycle and economic slowdown due to COVID-19 signal that there is no shortage of uncertainty for the direction of asset prices.

Global VC and PE Dry Powder Reached Historic High in 2019 ($ billion)



Source: Preqin

Not long ago, pre-COVID-19, the track for private companies indicated a ballooning market for prices and likely multiple expansion in fintech. We believe that recent events have accelerated the fintech market opportunity and we expect to see continued consolidation and M&A activity in the near term. Alongside this activity, the short-term environment is expected to remain volatile and uncertain and, thus, the margin for error for venture investors remains narrow. On a positive note, fintech has performed very well during recent market down periods (see Appendix A). Like most everyone, Anthemis' view continues to evolve alongside updated global policy actions and virus data.

A non-mainstream strategy for institutional investors to consider, supported by a 2014 research paper titled "Declaring a Major: Sector-Focused Private Investment Funds,"[1] conducted by Cambridge Associates (CA) identifies sector specialists in venture capital and private equity as outperformers both in terms of risk and return. CA writes:

> *While it seems clear that a sector specialist should outperform a generalist within their sector of focus, in this paper we introduce data to show that, on average, sector-focused managers do in fact outperform…sector specialists have a number of competitive advantages that we believe drive this outperformance: sourcing/portfolio company selection, post-acquisition value add and exiting investments…in reviewing the drivers of outperformance, the sector specialists demonstrated a greater ability to minimize capital loss while still achieving significant upside potential.*

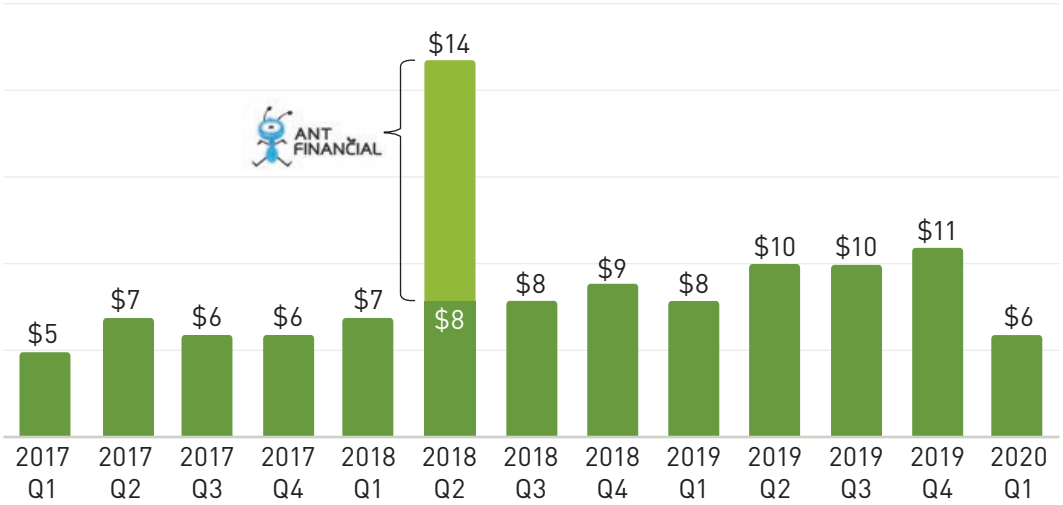
CA's report dates to 2014 but the data tells a compelling story and outlines a sector-specific venture capital allocation to be simultaneously outperforming aggregate VC on the upside, while better protecting on the downside. In other words, a sector-specific VC allocation can be just as effective (if not better) than a generalist one. At a minimum, the data suggests that a 'sector specific VC allocation' can play the role of a 'general or core VC allocation' in terms of performance and risk.

Additionally, the report provides superb reference points and a detailed analysis of the unique value drivers that sector VC funds bring to investment due diligence, deal access and portfolio company future success. Inspired by CA's research, the information gathered throughout this report leverages similar themes updated to the present, where possible.

II. Driving Value in Fintech

Largely due to data availability, competition, Modern Portfolio Theory and asset allocator's ability to identify optimal uses for capital, specialization and expertise have taken the structural center of the investment industry. As such, sophisticated, large public and private fund team structures provide a useful reference model for VC. Largely, public fund managers focus their investment teams by industry sector(s), a nod to the diversity and complexity of businesses as well as expertise required to evaluate investment opportunities on a relative company-by-company basis. We expect the VC investment landscape to continue to evolve in this direction. At the same time, we foresee asset allocators in the form of institutional gatekeepers and fund of funds playing a major role to further encourage this evolution through manager selection.

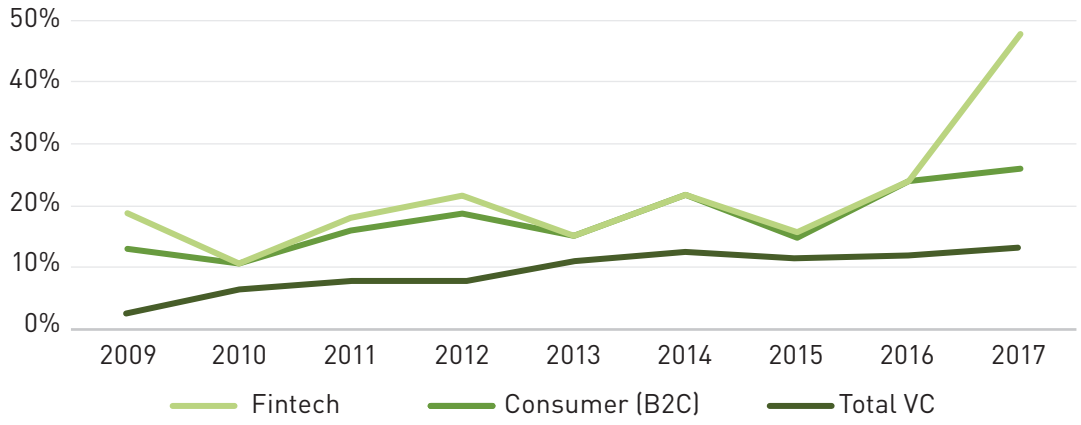
Global Fintech Funding Steadily Climbing ($ billion)



Source: CB Insights

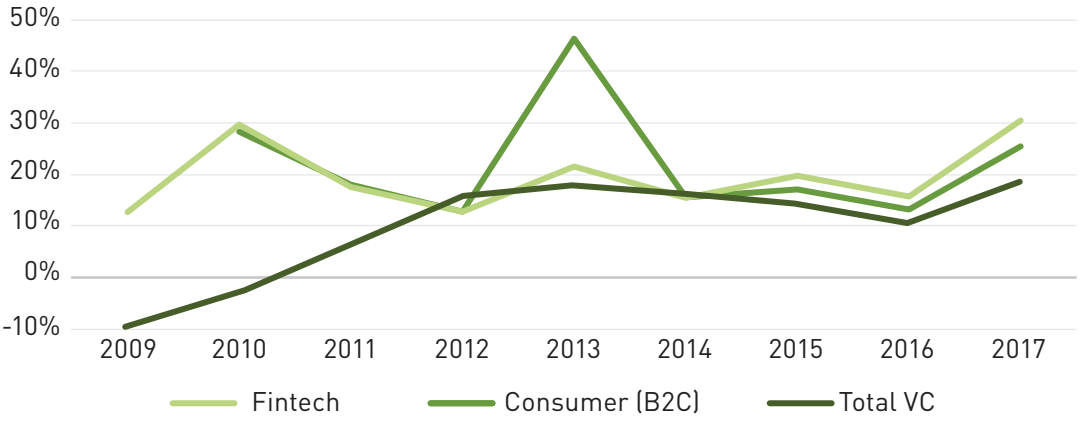
If past performance is a useful guidepost, investors will expect compounding annual returns in excess of 15 percent on the substantial pools of capital highlighted in the first section. We believe that the VC landscape will need to evolve and improve in order to continue to meet those high watermarks. Critical components to process evolution and improvement are efficiency and specialization. And in the venture world, an increasingly segmented and competitive environment, the ability to differentiate through industry knowledge and access has become even more critical—as investors seek to provide more than financial capital to founding teams.

Early Stage VC Investments Average IRR by Vintage Year



Sources: PitchBook; Cambridge Associates US Venture Capital

Later Stage VC Investments Average IRR by Vintage Year



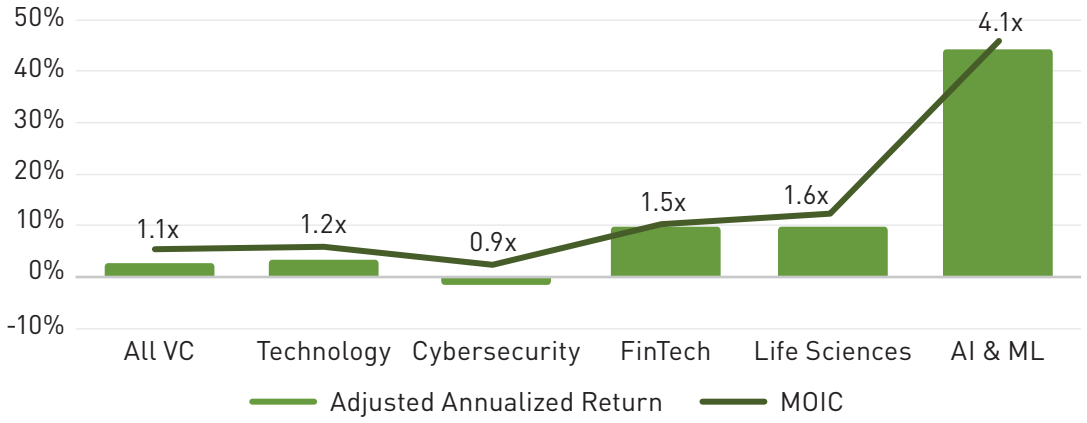
Sources: PitchBook; Cambridge Associates US Venture Capital

Alongside broader technology trends, fintech will continue to be shaped by removing complexity and friction, while simultaneously increasing customer transparency and safety. In many cases, these innovations require know-how from veterans.

Technical proficiency and depth of experience within a founding team enable founders to form ideas and develop solutions discerning between major and minor business opportunities. Similarly, on the investor side of the table, the ability to notice a high potential solution, meet the founding team at their level and evaluate founder assumptions is best executed with peer-like credibility and a deep network. It has been Anthemis' view for some time that the wave of low hanging fruit in fintech has run its course. Thus, digitizing and upgrading existing systems and processes necessitate a comprehensive understanding of the problem and its component parts. This is understated. Specialization is at the core of creating a more resilient financial services market.

While many of the best-performing and well-known venture funds have been enormously successful with a generalist structure, increasingly founders are seeking specific networks, tailored advice, and in-depth expertise from their investors. In this way, venture capital firms that are positioned—either through sector specialization or deep expertise—to provide operational value will be able not only to win deals but help catalyze performance for LPs. The massive rise in vertical allocation of capital in venture, particularly in fintech, virtually mandates the specialization we have described.

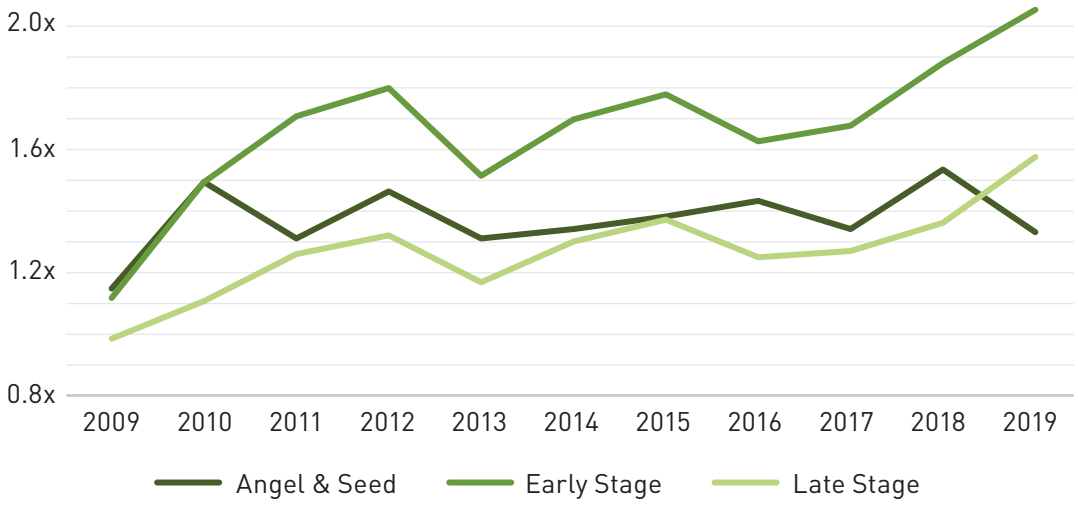
VC Series A Investments in Emerging Technology Sectors Outperform Market (2009-2019)



Source data: PitchBook

Sector-specific funds, although less common in VC, offer specialization and expertise in addition to vertical market exposure. Criticism around 'buying the market' and excessive concentration is unsubstantiated.[2] Financial services as a 'sector' is a relatively large and broad category with disparate business models and embedded complexity where expertise matters. Possessing a comprehensive understanding of sub-sector structure, operations and participants inherently provides a competitive advantage in evaluating an emerging business or new player. It also enables the informed manager with a sound basis for forecasting industry evolution.

Median Step-Up Multiples for All VC by Investment Stage



Source data: PitchBook

At the same time, the investment risk that startup businesses pose is not comparable to those of public companies as early stage companies are not long established, profitable businesses. As investors, understanding the financial services sector in which target companies operate is one part but equally critical is appreciating the commitment and execution ability of the team, alongside the product and market opportunity.

Sean Park, Anthemis Founder and Chief Investment Officer offers, "Financial services is like an iceberg: most of the mass and opportunity is 'below the water', invisible to the casual observer." Two illustrative examples are Anthemis' portfolio companies, Truelayer and CurrencyCloud. The founding teams, both led by technical industry experts, develop and market API solutions. Their products are not obvious or even visible to the consumer. In many ways, they are invisible. Yet, CurrencyCloud has done $50 billion in cross-border payments and recently taken on a major investor, Visa. Truelayer, operating in Europe, is competing in a similar space to Plaid which was recently acquired by Visa for $5.3 billion. As an investor, understanding the market opportunity requires looking beneath the surface to appreciate enormous potential. These are just two examples but they are emblematic of a forward-looking view that specialists may be well positioned to formulate.

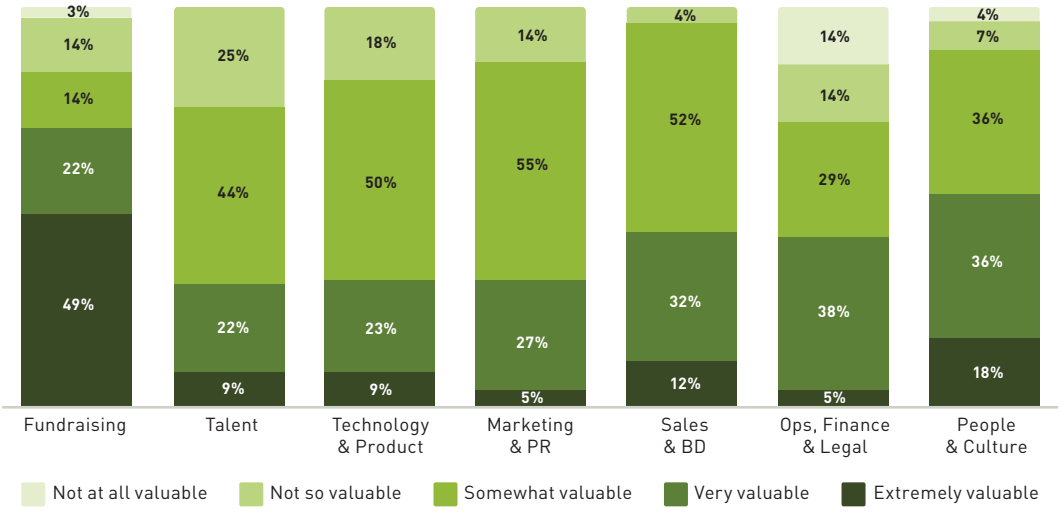
III. Why Anthemis?

Anthemis was founded on three guiding principles: authentic collaboration, virtuous cycle outcomes, and diversity, equity and inclusion. We are committed to cultivating change in financial services by investing in, supporting and building businesses. We are thesis-driven investors that have a strong track record managing capital across a wide range of financial services businesses around the world, from early stage to growth for over 10 years. Anthemis' platform was built on a belief that the transformation of the financial sector would come from a diverse group of inside and outside industry players creating more efficient and resilient digital business models.

Anthemis seeks founders who share our philosophy of reinventing financial services for the digital world. We recognize and appreciate that passionate, thoughtful, and dedicated founders are the engine of our business. Our entire team, including members of the ecosystem, work on behalf of our 100+ portfolio companies. Although less common among early stage venture investors, our contribution extends beyond an initial capital commitment. To help maximize returns, we continue to invest in portfolio companies post initial investment.

Anthemis' dedicated Portfolio Success Team, a diverse group with differentiated product, design, technology, network, and business skill sets, play a quarterback role in driving these efforts. Results from the Annual Founder Survey indicate we have been able to help in key areas and will continue striving to ensure we are offering portfolio companies the most relevant value add services.

Rating Anthemis Support Across Key Verticals (2019)



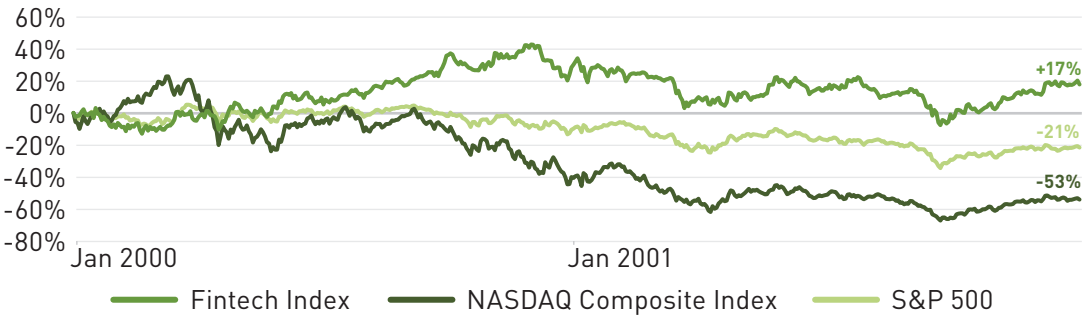
Recent events in the economy have increased our long term conviction in the market opportunity, accelerating the themes of Anthemis' thesis and, simultaneously, providing investors with impactful, high potential return opportunities.

APPENDIX A

Historical VC Context Relevant Today

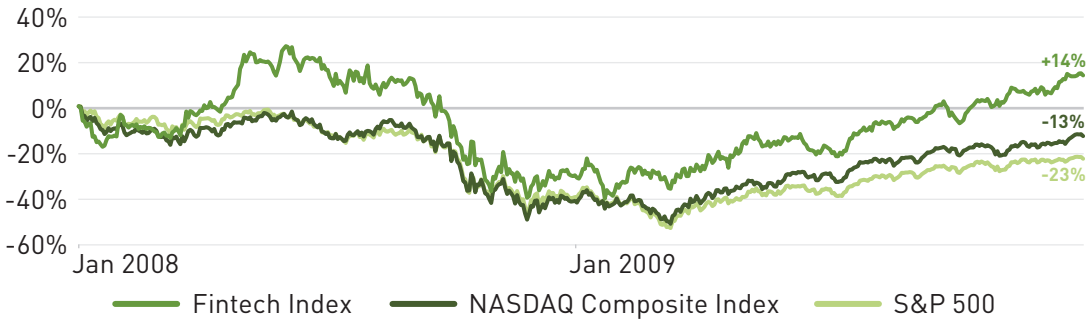
From recent prior crises, fintech showed outstanding resilience. A pool of fintech companies during down periods of the 2000 dot-com bubble and 2008 financial crisis revealed strong public market performance and resilience.

Public Fintech Companies Outperformed S&P 500 and NASDAQ Index after Dot Com



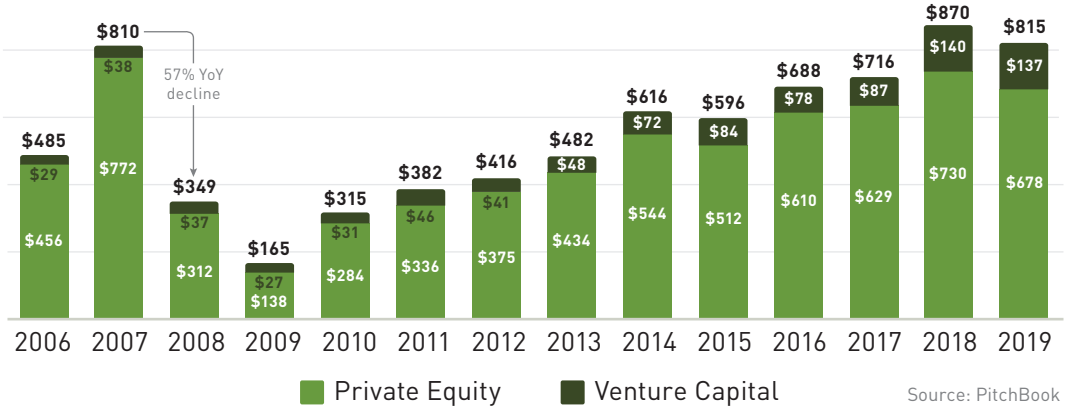
Sources: CapIQ, FT Partners
Note: Fintech Index aggregates share price movements for a composite of qualifying public companies, including Fiserv, Alliance Data Systems, ADP, Paychex, Total System Services, Global Payments, First Data, Bisys, Ceridian, Certegy, CheckFree, DST Systems, National Processing, and Sungard.

Public FinTech Equities had Relatively Strong Resilience during 2008 Financial Crisis



Sources: CapIQ, FT Partners
Note: Fintech Index aggregates share price movements for a composite of qualifying public companies, including Visa, Mastercard, Western Union,Total System Services, Global Payments, CyberSource, WEX, Euronet, Heartland Payments, ACI Worldwide, MoneyGram, and Online Resources.

U.S. VC and PE Deal Volume Rapidly Declined during 2008 Recession ($ billion)



Source: PitchBook

APPENDIX B

Declaring a Major: Sector-Focused Private Investment Funds (Cambridge Associates LLC Reprint)

You Wouldn't Ask Your English Professor for Help on Your Science Project

So what is driving this outperformance?

Sector specialists have a number of competitive advantages that we believe form the basis of the demonstrated outperformance:

- Sourcing/portfolio company selection
- Post-acquisition value add
- Exiting investments.

The deep domain knowledge, industry contacts and sheer number of repetitions in a sector leads to higher quality and increased volume of deal flow and better pattern recognition for sector specialists. The focused and dedicated resources that sector specialists can deploy within a sector allow them to be closer to industry participants, trends and themes that can lead to more attractive and differentiated investment opportunities that generalist firms may overlook, creating at least an advantage and possibly even leading to the elusive proprietary opportunity. These opportunities can be sourced proactively through long-standing and consistent relationships with industry participants.

In addition, sector specialists are better equipped to sift through a deal pipeline to identify attractive investment opportunities and avoid the bad ones. The lower impairment ratios of the sector specialists support the view that much of the outperformance generated by specialists is driven by simply avoiding marginal investments. Sidestepping the marginal investment is easier when a manager has the knowledge to discern risk factors to a greater degree than competitors.

Once an investment is targeted, a sector specialist's reputation of deep domain expertise should provide greater credibility with the seller and management team—that the manager will understand the business and market, be able to evaluate the investment efficiently and have an edge in post-investment value add. All of these factors should combine to enable the sector-focused manager to develop higher conviction and demonstrate that conviction to all parties involved in the transaction, resonating with key constituencies, possibly creating that angle to prevail.

Post-acquisition, it has become essential to know what to do with a company beyond just the capital structure. Industry-specific operating and strategic skills are equally important drivers of value creation. Sector specialists are better positioned to establish strategic and operational goals to improve company performance; recruit top executives, boards of directors and industry advisors; develop and monitor key operating metrics; and position a company for sale. In terms of deciding when to exit an investment, sector specialists should be better able to determine the right time to sell based on underlying company and market level fundamentals and can more effectively identify and court potential buyers, both strategic and financial.

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Endnotes

1 Cambridge Associates. (2014, September). "Declaring a Major: Sector-Focused Private Investment Funds." p.1.

2 Cambridge Associates. (2014, September). "Declaring a Major: Sector-Focused Private Investment Funds." p.11.

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Anthemis cultivates change in financial services by investing in, growing and sustaining businesses committed to improving the world.

We were founded on three guiding principles—authentic collaboration, virtuous cycle outcomes, and diversity and inclusivity—and our deep understanding of markets and models, passion for emerging technology and values inspire everything we do. By creating fertile ground for a diverse group of startups, investors, entrepreneurs, institutions, academics and visionaries to converge, we believe we can solve the financial services world's most pressing challenges faster, better and for the benefit of all.

For the latest on the Anthemis ecosystem, visit: anthemis.com/insights/

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