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by Cyril Demaria

Is the Enemy, in Fact, Us?

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Among the multiple reports, surveys, white papers and other contributions that regularly hit the shores of the private equity world, "We have met the enemy…" was welcomed with an astounding silence. As my first book publisher told me, it is either a sign that it is really bad (which might have been the case of my first book, but doubtful when it comes to the Kauffman Foundation as an author); or that it is touching such a delicate subject that it becomes untouchable. I tend to think that the latter explanation is the most likely.

After all, it not only criticizes GPs of venture capital funds, but also the LPs (category to which the Kauffman Foundation belongs to). By aiming at the GP and the LP community, the Kauffman Foundation makes few friends – even though its report is most welcomed and salutary. Having practiced frankness and honesty many times myself, there is one little lesson that I learned though: what is written has to be irreproachable. If not, then the criticized take any detail or inaccuracy to cast the shadow of doubt on whatever else is written. I must say that even if I approve the main ideas of the report, it may not be accurate – and this might hurt the cause it supports and the message it conveys.

1. The "golden age" of VC will not "come back"

One of the critics that might be addressed to the report of Diane Mulcahy, Bills Weeks and Harold Bradley is that it assumes that everything remained (and should remain going forward) equal in the venture capital world. This is a problem.

On one side, the report states that the economics of fund management should reflect a better alignment of interest, by switching from the "2%-20% model" to a pre-defined budget. On the other side, the authors expect the VC industry to generate 2x the capital invested and a "3 percent to 5 percent annual returns above the public markets". At the same time, the authors hope that the sector will come back to a pre-1995 situation in terms of amounts collected and invested.

Let's make here a prophecy: the "golden age" of VC (if it ever existed) will never come back – and the Kauffman Foundation, which supports the development of entrepreneurship, should actually celebrate it. Entrepreneurs today find more readily capital (supposedly, given the amounts raised and deployed). Entrepreneur has become a job ("serial entrepreneurs" prove it), not a marginal activity for hotshots. Successful entrepreneurs are

even a source of investments ("super-angels").

There is no turning back, because the VC industry has professionalized and it has become part of the asset allocation of institutions (an approach that the report criticizes heavily). What does it mean concretely? That the 2x capital and 300 to 500 basis points above market returns are no longer a reasonable target.

As much as VC is known, understood, explained, analyzed, documented, structured… it becomes a less risky activity. From an "exotic" activity (such as collecting fine art, classic cars or wine), it is now part of the private equity asset class (itself part of alternative investments). Less risk means lower returns, due to the law of the decline of marginal returns (which applies here as much as anywhere else).

Does it mean that the 2%-20% is untouchable? No, and the authors rightfully complain that this inheritance of the early days of modern venture capital is no longer justified. However, even if the management (and other) fees are going down, they probably will never make it up to the loss of returns.

2. Right sizing: beware of cutting too close to the bone

Let's assume for the moment that the asset allocation of institutions remains the same, and that the amount of capital available is going to drive/maintain low marginal returns in US VC. Does it mean that it is not worth investing in it? One of the conclusions of the authors is that an arbitrage with the Russell 2000 index has lead the Kauffman Foundation to reduce its exposure to some fund managers and go for ETFs replicating this index.

That might first reduce the portfolio diversification of the overall Foundation, which is an important aspect to consider. Beyond this, it is particularly uncomfortable to hear a comparison between listed and non-listed markets. The Russell 2000 is a passive index based on an exception in the financial world: the stock exchange. The authors compare the activity of trading listed shares on a secondary market with the capital increase in early stage companies. Methodologically, that sounds shaky because it assumes that managers in the VC world just pick stocks and shares as an index builder would do and an ETF provider would operate. That does not seem really the case (everyone who tried to negotiate a shareholder's agreement with the management of a portfolio company would agree – and this is a small portion of the job).

Does it mean that GPs of large VC funds ("1 billion+ USD") deserve their fees? Not necessarily. However, when the authors emphasize the necessity to focus on funds with less than 400 million USD under management, the logic is that these management fees will not necessarily go down dramatically. One of the reasons is the fact that doing the job actually requires increasingly more money (and not only to pay hefty salaries and bonuses as the authors appear to assume): compliance with regulations is more demanding, as well as faster and more detailed reporting. This requires manpower and resources.

By going to low on the management fee topic, the authors might risk to push the GPs either to seek their compensation elsewhere (out of the LP radar, for example, by charging the portfolio companies) or simply to cut corners. Pushing the fund size down might have another consequence: having funds with a sub-optimal size (with no critical mass to amortize the fixed costs). Here, an example comes to mind: European VC, which has even more dismal returns than US VC. Part of the reasons is notably that the average fund size is rather low, which means that fees and expenses are actually higher than for their American counterparts.

3. The J-Curve phenomenon exists: I have seen it

There is a strong attack against the J-Curve theory in the report. Inexplicably, the authors assume that the J-Curve is the reflection of the projections of successive IRRs over the life time of the fund. This is totally wrong: it is the projection of cumulated cash-flows of the funds. Hence, not only the J-Curve exists, but this is a permanent phenomenon that can be seen by looking at any private equity fund.

The authors build on this misunderstanding of the basic phenomenon to criticize the "seductive narratives" build by GPs willing to raise the next fund. Said differently, IRRs are inflated by GPs to fund raise and are not reflecting the true value of the funds.

Nobody defends IRRs here, but the authors are probably aware that the valuation guidelines are clear: either a portfolio company is kept at cost by a GP, or it is depreciated if the portfolio company is under budget, or it is appreciated if there was an upward round (ie,

a third party made the new valuation of the company). Except in outright fraud, GPs usually apply these guidelines (and the valuations are audited every year by external auditors).

What to conclude of the "n-shape" curve that successive IRRs of VC funds show?
i) That the authors should use it to challenge the TVPIs of their funds and not to take an investment decision (which is what they conclude at the end of the report).

ii) That their GPs invest in companies that could raise further (upward) rounds. Is it bad? Not necessarily, if the alternative is a write-off of the said portfolio companies. Yes, if the upward rounds are the proof of a bubble, which deflates with the trade sale or a mediocre IPO.

This is actually a consequence of the "too much capital chasing too few cherries" that the authors deplore. That does not mean that the J-Curve does not exist, and that the actual performance of fund, whether the authors like it or not, cannot seriously be analyzed before year 5 to 7 of a given fund's life.

4. Praising evergreen vehicle: beware of what you wish for, it might come true

Against the standard 10 years lifespan of a fund, the authors praise the evergreen structure. It "reduces the impact of cumulative fees and eliminates the time pressure to produce positive returns in time of the next fundraise" (p. 31).

First, it is not clear how an evergreen vehicle might reduce the impact of cumulative fees. Actually, evergreen structures are more of a "black box" than the typical LP-GP relationship. Not only investment and management money are blended, but there is a lot to criticize about the lack of transparency of listed evergreen private equity vehicles (hence their structural 20 to 30% discount to NAV).

Let's compare the two:
i) limited partnerships: management fees limited partnerships are usually calculated on the capital committed (sometimes invested) during the investment period, and then are winding up during the divestment period (and are calculated either on the NAV of the fund or according to alternative formula). The authors fail to recognize this basic rule in their table page 34 when they assume that the management fees are fixed and equal over the 10 years life of the fund.

ii) evergreen vehicle: because there is no investment/divestment period, the fees are calculated as a percentage of the assets under management and usually not obvious to identify. They are in the P&L of the structure and not negotiated with the investors (at least in the listed vehicles). This means that investors in evergreen structures pay more on the overall life of the structure, but also that they actually do not know how much they pay at any given time – and that the management of the evergreen vehicle can increase its compensation at will.

The "time pressure" associated with limited partnerships is actually… a good thing. The worst which can happen to an investor is when a GP falls in love with its portfolio companies (or worse, uses them as personal cash cows to charge "advisory fees" for example). The ten year's time is necessary to force the GP to manage actively its portfolio, to create value and to give the opportunity of LPs to "exit" (if not "voice" their discontent). LPs in evergreen structure have no "voice" (being divided), but they cannot even exit (or in worse conditions than with a standard limited partnership stake).

As a side note, the authors mention an exit window every four years (page 38) which is an even shorter time frame than the usual ten years of a limited partnership. It is difficult to criticize the "short-term approach" of GPs in a standard limited partnership and in the same breath explain that an evergreen vehicle with four-years exit windows should be the solution.

Last but not least: limited partnerships are tax efficient – and distribute profits. Evergreen vehicles do not distribute (they reinvest) and if they do, they distribute dividends (which are not tax efficient).

5. Terms and conditions: the grass is always greener elsewhere… until you get there

The authors criticize the terms and conditions of limited partnerships and the practices associated with it:

i) deal-by-deal carried is (rightfully) excoriated. The fact is that it is more and more an exception. First it is a US-only feature. Then even in the US, only the top VC fund managers

can still impose it. So complaining about it is like complaining that this GP is making too much money. That's why we do not have clawbacks in Europe: we do not have deal-by-deal carry.

ii) the lack of preferred return (or "hurdle") rate. Once again, this is an exception. Almost all European funds have a hurdle rate and only the top US VC firms can skip this feature…

iii) serial fund raising "every twenty-four to thirty-six months". First, it is a good thing (exit possibility for LPs and keep GPs on their toes), and then in Europe and increasingly the US, there are provisions to prevent fund raising before the GP has invested 70% or more of the current fund.

The limited partnership is not perfect, but at the Luxembourgers would tell you, it is difficult to do better: the SICAR took ten years to be engineered and is still not very popular compared to a typical LP. Luxembourg even created the Special Investment Fund to get closer to the LP model… Of course, everyone is listening if there is a better solution – but that will certainly not be an evergreen fund.

Conclusion

This report is full of great ideas and suggestions. It is hence more annoying to find the elements listed above in it. Does it mean that the conclusions of the report should be overlooked? Not at all, but the authors should have gone the extra mile to give their report (and its conclusions) the magnitude that it deserved. One simple example: it is great to support the PME method to benchmark VC funds. However, the way it is applied in the Exhibit of the reports falls under the same critics which were addressed to Kocis & alii, as well as Schoar and Kaplan about the difficulty to deal with selling the index. Had the authors made a bit more research, they might have come across the PME+ (developed by Rouvinez) method which solves this major hurdle. The same applies to the comments above…

*Cyril Demaria is a Professor at HEIG-VD and the author of "**Introduction to private equity**." Opinions expressed here are entirely his own.*

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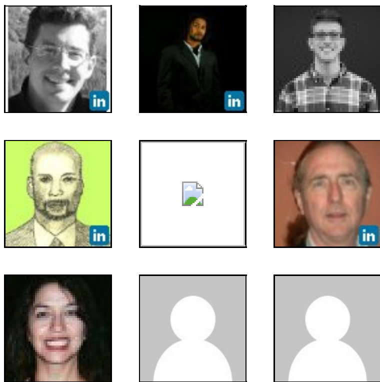

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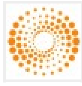

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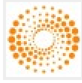

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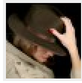

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