THE JOURNAL OF PRIVATE EQUITY

JPE.IIJOURNALS.COM | VOL. 21, NO. 2 | SPRING 2018

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www.iijournals.com

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Notwithstanding the media attention given to the high-profile startups and the investors supporting their success, the conventional wisdom surrounding both the venture industry's historical returns, and the success/failure rate of startups, contradicts the research. The Kauffman Foundation's analysis of the Foundation's venture returns summarizes well the "false narrative" surrounding venture investing (Mulcahy, Weeks, and Bradley [2012]:

- The average venture capital (VC) fund fails to return investor capital after fees.
- Many VC funds last longer than 10 years—up to 15 years or more: "We have eight VC funds in our portfolio that are more than 15 years old."
- Investors are afraid to contest general partner (GP) terms for fear of "rocking the boat" with general partners who use scarcity and limited access as marketing strategies.
- The typical GP commits only 1% of partner dollars to a new fund while limited partners (LPs) commit 99%. These economics insulate GPs from the personal income effects of poor fund returns and encourages them to focus on generating short-term, high IRRs (internal rates of return) by "flipping" companies rather than committing to long-term, scale growth of a startup.

Examining the structure and incentives of the conventional venture firm and model is instructional as to why this is the case.

"TYPICAL" VENTURE FIRM STRUCTURE

Although some firms are altering their structure and processes to more closely resemble portfolio management firms; starting with a portfolio strategy, then a security selection process, then individual company selection (see, e.g., Social Starts, Social Capital, 500 Startups), most venture firms adhere to the traditional model: assemble a collection of individual transactions based on a (presumed) thematic expertise. Within this model, each venture partner is incentivized to "hunt" for ideas that make it into the portfolio, as the partner/source of the idea will retain an outsized share of any "carry" created by a successful exit.[1]

This traditional model creates perverse incentives at the *portfolio level*, as each "hunter" can be less concerned about portfolio returns and more concerned with getting one of their holdings in the portfolio. Heads (profit/carried interest), the hunter wins, tails (subpar portfolio returns), the LPs lose. This results in firms in name only.

The reality is a collection of partners with their singular portfolio of companies they care about, with firmwide processes and practices to screen, select, monitor, and service portfolio companies suffering.

When combined with some of the observations of the aforementioned Kauffman Foundation study, historical returns predictably underperform highly correlated indexes in the public markets (Mulcahy [2014], resulting in "negative alpha."

Aside from the obvious incentives as illustrated in the *Harvard Business Review* article by Mulcahy [2014], why would thoughtful, highly educated, well-intended VCs continue to replicate a model that consistently delivers such poor results for investors? Is it that they don't know better, or are they simply willing to offer the (LP) market what it will bear?

Kahneman and Tversky's work would suggest that it is obvious when viewed from the lens of behavioral finance popularized by Michael Lewis' book *MoneyBall*. VCs are "anchored" in explicit or implicit biases that validate their status and role,[2] much like the traditional baseball scouts that populated Major League Baseball before Sabermetrics (empirical analysis of baseball).

Or, as stated by Clayton Christensen [2013]:

> … in certain domains, where entrenched world views, attitudes and values are deeply woven into societal values, innovation can come to a grinding halt. This is particularly noticeable with multiple stakeholders whose identities and livelihoods are being challenged by the threat of innovation.

PERPETUATION OF CONVENTIONAL WISDOM

Returns

The conventional wisdom on the venture asset class is that to provide a compelling return for the investors, VCs need to have a big winner in the portfolio. This is often called the "Law of the Power Curve."[3]

This is partially right.

Due to the typical 2/20 fee structure and the subsequent impact on the capital account for the limited partners, the J-curve will graphically illustrate the economic hole dug by the high fees and the lack of any meaningful early returns.[4] The need to reach for sizable-enough returns to "get out of the J-curve hole" often leads investors to take undue risk—to make inappropriately risky investments in individual companies at the expense of the overall risk metrics of the fund/portfolio.

The high "friction costs" create perverse incentives, while success is perceived and measured through the unique prism of the high fees/Power Law model.[5]

High Failure Rate of Startups

Simply expanding the definition of success beyond the venture model (high fees/Power Law prism) and incorporating more of a Moneyball strategy—batting for a high average and not swinging for the Power Law fence—the reality of startup failure rates looks quite different, as proffered by Erin Griffith, formerly of *Fortune Magazine*/Term Sheet Blog:

> Cambridge Associates, a global investment firm based in Boston, tracked the performance of venture investments in 27,259 startups between 1990 and 2010. Their research reveals that the real percentage of venture-backed startups that fail—*as defined by companies that provide a 1× return or less to investors*—has not risen above 60% since 2001. Even amid the dotcom bust of 2000, the failure rate topped out at 79%.
>
> But startup failure isn't a natural law like gravity. It's not a given. Normalizing the failure narrative only conceals the truth, misleads founders, and in certain cases, *explains away bad behavior.*

To put it another way, when "success" is defined by a minimum threshold of 100% return of investors' capital (1× return), historically 40% of startups that have raised outside capital are successful. In contrast, the popular belief is that only 15% of startups deliver a return for investors.

If a theoretical venture portfolio were constructed with this more accurate failure rate, combined with the historical returns as represented in the work done by 500 Startups,[6] a clearer picture of an optimal, alpha producing, venture fund materializes.

Venture Funding as the Preferred Funding Path for Startups

There is no question that there are venture firms that improve the odds of success for startups fortunate enough to source capital and value-added resources/advice from those firms. But research proves those companies—and those firms—are the exception, not the rule.

Transactional Pitch

Unfortunately, the media attention surrounding the exceptions defines and dominates the conversation in entrepreneurial communities, again "anchoring" the conventional wisdom and perpetuating the swing-for-the-fences mentality.

In addition, the construct of most angel groups, accelerators, and sources of funding advice fuels a transactional mentality, hoping to stimulate "animal spirits" among the audience—often in lieu of objective, measured insights prior to any "pitching" or funding.

As a result, the perception of success remains anchored in a transactional mentality, startups trumpet big funding rounds (often at unrealistic valuations), while investors boast inclusion in these (likely) overfunded party rounds.

LACK OF TRANSPARENCY

Venture Fund and/or Partner Performance

There is a remarkable lack of transparency given the hundreds of billions of dollars invested in the venture asset class over the decades. Performance track records published by most venture firms typically lack the standard statistical metrics applied to public market managers, such as the Sharpe ratio, the information ratio, the up-market capture ratio, the downside capture ratio, and batting average.

The historical track records of the individual partners are absent, or if referenced, lack the complete record of both successful *and* unsuccessful investments. Also absent is any time-weighted or money-weighted return computations.

Why don't they exist today? One of the arguments for the lack of any standard statistical metrics is that no firm (nor the industry itself) has defined a way to track standardized metrics.

A more cynical interpretation could be that the industry *does not want transparency* so they can benefit from the inefficient flow of information, to continue collecting their "rent seeking" returns.

Entrepreneurial Transparency and Performance

Discussions with former partners at venture capital firms confirm the lack of information supporting many portfolio investments. Although all speak to the thoroughness of their due diligence process, or their thematic expertise, often investments are made as co-investments in party rounds. Additionally, few expectations are placed on the startup companies themselves when such investments are made. Unless there is a lead investor with a board seat, many holdings within portfolios are held with little information availed by the startups until additional funding is requested.

Performance metrics for VC firms and standardized operational transparency from startups can be available. It simply needs to become an *expectation*—for both the startups seeking capital and the investors/fiduciaries seeking to allocate capital.

NEED FOR GREATER VELOCITY OF INVESTING

Expanding Entrepreneurism, Concentrated Investing

Although entrepreneurial activity is spreading outside Silicon Valley/San Francisco and across the country, funding for startups continues to be concentrated in few entrepreneurial communities.[7] The number of total dollars invested continues to rise, but the number of companies getting funded is declining, with first-time fundings flat with levels from four years ago.[8] Investors are funding larger rounds in later-stage companies, with more than 70% of total dollars committed in just two regions: the west (CA/OR/WA) and mid-Atlantic (New York/Boston).

This funding gap outside the coasts has not gone unnoticed. Steve Case, the founder of AOL, now of Revolution Ventures, has been travelling around the country drawing attention to the opportunities outside the coasts, launching a $150 million fund to take advantage of the arbitrage in valuations and relative lack of competition.

But this is far short of the capital need to create greater equilibrium between startups looking for capital and the available sources.

Expanding Interest in Impact Investing

There is clear evidence there is a growing interest in impact investing (investments made with the intention of generating social and/or environmental impact),[9] with trillions of dollars forecasted to move into early-stage companies that offer the prospect of not only positive financial results but also of delivering products or services to the market that will improve the human condition in some way.[10]

What is often hindering more capital flowing into such companies are instruments that satisfy the fiduciary/prudent man requirements but also present a more transparent experience for the impact investors, which are largely family offices.

MODERN, BEST PRACTICES VENTURE FUND

What would a more modern venture fund look like that applies the many insights proffered previously, one that would avoid the structural flaws and perverse incentives that results in such poor risk-adjusted returns?

To oversimplify:

"Typical" Fund	Modern Fund
• High fees/little capital risk	• Low fees/high hurdle rate
• Concentrated portfolios	• Diversified portfolios[11]
• Subjective/opaque selection process	• Transparent/disciplined process
• Power Law–incented portfolio decisions	• Managed risk/"buy beta" strategy
• Indifferent tax implications	• Emphasize after-tax returns

Lower fees. This has multiple impacts on performance besides the obvious. High fees require greater returns (and associated risks) to get out of the negative J-curve hole. An LP wouldn't know for multiple years if this were to happen, while the VC firm has already collected substantial fees without taking any risk. In addition, the larger the fund, the more likely the outsized fees alter the incentives and activities of the venture firm.

Diversified portfolios. This, too, is fairly obvious. Early-stage private equity has greater risk than public securities, yet the typical VC fund is less diversified than the typical mutual fund or exchange-traded fund (ETF), with the need for a "unicorn" to compensate for the high fees. Again, VCs have perverse incentives without capital at risk—again, "heads, I (VC) win; tails, you (LP) lose."

Transparent/disciplined process. This is probably the hardest to execute, and the most uncomfortable for most VC firms. The "black box" of process and outcomes is similar to the hedge fund world and insulates the VCs from accountability and competitive analysis. The best ones have this, but research would suggest that is but a fraction of firms today.

Managed risk/"buy beta" strategy. All the company-specific due diligence or co-investment activity does nothing to manage risk at the portfolio level. Buying beta as is done in the public markets would put pressure on the 2/20 fee structure. Again, there are clear perverse incentives that keep VCs from volunteering a migration to this strategy.

Emphasize after-tax returns. While few VCs actually track the after-tax implications of their portfolio activity for their taxable LPs (qualifying Sec. 1244 transactions allow for losses to be deductible against ordinary income, while Sec. 1202 transactions allow for profits to be tax free), simple utilization of these laws would create after-tax alpha for their individual investor/high-net-worth/family office LPs immediately. Most will suggest they don't give tax advice, but in fact the venture firms either don't know about these laws or are unwilling to capture the information and report it on the funds' K-1s.

CONCLUSIONS

Given the historical performance track record and the growing need for more capital sources for early-stage companies, there is clearly a need for the venture capital funding model to evolve to deliver alpha for the growing legions of investors.

With the simple application of some well-tested risk management techniques, a more sustainable security selection/portfolio construction process, lower friction costs, and increased transparency from both investors and startups, entrepreneurial funding can become more efficient, more capital will be available to startups, and investors will have an improved experience.

ENDNOTES

[1]Typical 2/20 fee structure: 2% annual management fee and 20% carried interest in calculated profits.

[2]Anchoring bias is the common human tendency to rely too much on potentially irrelevant information.

[3]See J. Neumann's blog post, "Power Laws in Venture" (June 25, 2015): http://reactionwheel.net/2015/06/power-laws-in-venture.html.

[4]See M. Roth, "What GPs Need to Know about the Private Equity J-Curve (and Why LPs Care)," January 25, 2017: https://www.cobaltgp.com/what-gps-need-to-know-about-the-private-equity-j-curve/.

[5]See Root [2017].

[6]For more information, see Lerner [2017].

[7]See "Venture Monitor 3Q 2017," PitchBook, National Venture Capital Association, 2017. https://files.pitchbook.com/website/files/pdf/3Q_2017_PitchBook_NVCA_Venture_Monitor.pdf.

[8]See "Bloomberg U.S. Startups Barometer," www.bloomberg.com/graphics/startup-barometer/.

[9]For more information, see the Global Impact Investing Network website: https://thegiin.org/impact-investing/.

[10]Family Wealth Report: The Growing Momentum of Impact, Sustainable Investment.

[11]See Lerner [2017].

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