

## The Long Tail of the Private Equity Secondary Market

By Wm. Blake Winchell

Hits Business? Blockbuster Mentality? High Inventory Cost? Lockstep Culture? In his book 'The Long Tail', Chris Anderson uses these terms to characterize the historical structure of (mostly) media and retail businesses, and how changes in the fundamental characteristics of those businesses has lead to 'long tail' opportunities for companies like Amazon, NetFlix and Rhapsody. Sounds a lot like the private equity industry to me, and the same arguments that apply to books and music apply to the nascent and exploding venture capital and leveraged buyout secondary markets for all of the same reasons.

While there are multiple factors that have contributed to the 'long tail' phenomenon in media and retail, Anderson cites four in particular; the decline of the blockbuster, the increasing cost of holding inventory, the ubiquity of data and the emergence of aggregators. All of these trends are very evident in private equity and have contributed to the rise in the secondary market.

### *The Decline of the Blockbuster*

Just like the movie, music and book businesses, historically, the venture capital business has been a 'hits' business. The time honored formula for a venture capital portfolio of 10 companies is that 3 will be 'zeros' (shut down or sold for scrap), 4 will be 'misses' (returning <1x capital), 2 will be 'hits' (returning 2x – 3x capital) and one will be a 'home run' (returning 5x plus). The hope has been (and historical performance would support that) hits and misses cancel each other out, and the 'home run' is big enough to fill the holes left by the 'zeros' plus generate enough of



a profit to return LP capital plus a 20% IRR and reward the GPs with millions of dollars in carried interest.

Because of this dynamic, the private equity business has long had a ‘blockbuster mentality’, with the venture capitalists looking for the next Google or eBay (or money losing but return producing CommerceOne) to make their portfolio and help them renew their Net Jets subscriptions. Like the music and movie business, an entire venture capital ecosystem developed to deliver these blockbusters, beginning in the 1970s and gaining momentum through the 1990s. Garages throughout Silicon Valley and all along Route 128 teemed with entrepreneurs, fresh out of Stanford and MIT with engineering and biology degrees in hand and visions of sugar daddies dancing in their heads.

A venture capital community bloomed to provide millions of dollars in multiple alphabetic series, the life blood of these young companies. Venture investment syndicates formed and reformed to move investments from startup phase to ‘escape velocity’ and ultimately to exit, facilitated by the law firms and investment banks that incorporated them, documented the financings, wrote the red herring, orchestrated the roadshow, built the book, managed the initial public and secondary offerings and then published reams of research on these mini-businesses to keep the stock price up long enough for the initial investors (and the banks and law firms themselves) to meet the lock-up requirements and then sell out at fabulous profits. Just as the record industry had payola to insure that the next big hit got heavy rotation and a lot of on-air hype to listeners who would then go out and buy the record or see the band in concert, the

investment banks were paid hefty banking commissions and fabulous greenshoes if they would write research promoting the companies they marketed to the public.

The ‘Lockstep Culture’ referenced by Anderson as a key contributor to the blockbuster mentality in media also characterized the private equity investment business as well, as firms moved from one favored investment sector to another – microprocessor, personal computers, hard drives, biotech, internet, telcom and cleantech. Each of these investment themes generated higher amplitude (larger valuation fluctuations) and increased frequency (from several years for the microprocessor phase to several months for the communications bubble to form, peak, and burst. As funding flooded into the ‘new new thing’ all of the players were looking for the next big hit.

The same phenomenon played out in the LBO world, albeit with different players – instead of Kleiner Perkins, Wilson Sonsini, and Montgomery it was KKR, Simpson Thacher and Goldman Sachs taking companies private, leveraging their balance sheets, improving their operating margins and then either taking them public again or ‘recapitalizing’ them by taking on even more debt and dividending cash out to the fortunate partners of those firms. Life was good.

But then the music stopped.

The four horsemen (Montgomery, Alex Brown, Robertson Stephens and Hambrecht & Quist) that were the drivers of the venture capital mezzanine funding, M&A and IPO markets were decimated by the move to electronic trading on the NASDAQ coupled with the 2001 implementation of decile quotation, reducing the trading margins (which had long supported

their research effort) by 75% in one fell swoop. Adding insult to injury, the passage of Sarbanes Oxley legislation the following year effectively raised the IPO bar by adding an average of \$2 million in pre-IPO SOX compliance cost followed by an additional \$1 million in annual compliance expense after going public. With no marketing machine and a much higher revenue/profit hurdle to 'get out', the IPO market began to dry up, a dehydration process that continues to this day, made worse by the market crash in the fourth quarter of 2008 when there were no venture-backed IPOs at all. That market crash effectively stopped M&A exits as well, as the traditional acquirers of young technology companies began hoarding cash and did not want to use equity at depressed levels to purchase largely non-accretive small businesses.

In the buyout world it has been much the same story. Reams have been written about the 'credit crisis' and the constipation of lending markets worldwide that has resulted in a total halt to the LBO business; no L, no B. And even if debt could be found, bid prices have fallen dramatically from the auction-fest of 2007, and sellers haven't all gotten the memo. The hit parade came to a screeching halt.

### *The Increasing Cost of Inventory*

As exits have evaporated, holding periods for venture and buyout investments have steadily lengthened – the average holding period for a venture investment from inception through exit is now over seven years (up from four years in 2001) and that is only for those companies lucky enough to exit. Many venture investors have 2000 vintage funds with a dozen or more

companies in them, and few of those companies have any real possibility of reaching a liquidity event in the near future.

The cost of holding these companies for such a long period of time is enormous. Most venture funds have partners or managing directors on the boards of their portfolio companies. Longer holding periods increase the number of years a partner must dedicate to a single company which either reduces the number of new investments the venture fund can make or forces them to increase the number of partners in the fund. The longer a company is private, and as the prospects of a profitable exit continue to dim, the more likely it is to have increased employee turnover, particularly in its leadership team. That requires boards to expend additional resources (both time and money) to recruit new leadership, and that fresh leadership often comes with expensive severance agreements and will not be interested in joining unless investors commit new capital to the enterprise. Finally, and most importantly, because these small venture companies almost all lose money year after year, the longer they are held, the more capital is required to keep them alive.

The forces of longer holding periods, extended fund boardpower, higher management turnover and more capital funding combine to significantly increase the inventory cost of each investment in a private equity portfolio.

### *The Ubiquity of Data*

When Kleiner and Sequoia were founded in 1972, and continuing on through the mid 1990s, venture investing was a word-of-mouth and relationship business; it was largely about who you knew and what they told you. It was difficult for budding entrepreneurs to even find venture capital firms, much less submit a business plan or secure a meeting. Similarly, venture capitalists tracked down entrepreneurs using shoe leather and a land line. The same firms tended to invest together deal after deal as the oral tradition of investment promotion was based on familiarity and trust. Due diligence, too, was conducted by foot and phone – a trip to Jackson Library at Stanford and days in the stacks trying to determine market size and characteristics, or calls to friends in an effort to assemble an accurate vision of a nascent market and emerging competitors. Central to all of this communication was the land line with its evil siblings, voice mail and facsimile machines. Days could go by in the effort to reach a potential investor or entrepreneur, talk to a due diligence interviewee, present a pitch or turn a set of documents.

The internet revolution, in addition to providing a target-rich environment for funding new technology companies, changed forever the closed system that characterized earlier venture investing by putting tremendous amounts of data into the hands of entrepreneurs and investors alike. VC firms published websites touting their distinguishing strategies and soliciting business plans to be electronically submitted complete with Word formatted text and Excel spreadsheets showing monthly forecasts at impossible levels of detail. Powerpoint presentations could be made to remote audiences using Webex, and email allowed entrepreneurs to assemble teams and market themselves to investors.

A search engine-enabled World Wide Web put a universe of data at everyone's fingertips. Want to know how large the market is for iPhone applications - \$1.2 billion (in .32 seconds, thank you Google). Competitive profiles can be built in a few minutes, business plans assembled in a few days. Potential investors can find out more about a company in 24 hours that they could just a decade ago in as many weeks.

All of this data can be collected, stored, analyzed, sliced-and-diced and accessed in a moment's notice in a way that was never before possible, enabling the analysis of whole portfolios of private equity investments that would have been overwhelming in earlier times. Anderson refers to the 'curves within curves within curves', positing that the long tail is made of many mini-tails, each of which is its own little world. He uses examples from the media world of music types, artists, genre, and labels. Similarly, the long tail of private equity can be sliced into ever more narrow segments, by general partner, investment sector, geography, syndicate makeup and company stage.

### *The Emergence of Aggregators*

In the same way that the decline of the 'hit machine', the increase in carrying cost and the explosion of data and connectivity led to the birth of eBay and Amazon, the same forces in venture and buyout have led to the emergence of the Private Equity Secondary Market. The future world of private equity is looking very different from the past. With the IPO marketing machine dismantled, it will be extraordinarily difficult for venture portfolios to rely on a big bet producing a 'ten bagger' result to make up for losses in the balance of the portfolio. Instead,

portfolios are going to have to rely on many more, smaller investments that result in singles and doubles. Just like the 100-million copy selling album ‘Thriller’ released in 1982 has devolved into 2008’s biggest grossing album by ‘Lil Wayne (selling less than 3 million copies), so to will the outsized returns of many 90s vintage IPOs be replaced by the more common ‘double your money after 8 years’ sales of today.

The higher cost and increasing risk of holding large stakes in venture investments is leading some funds to take a radically different approach – rather than purchasing 15% in each of 20 early-stage companies in a portfolio and then investing massive resources into that portfolio over a 10 year fund period, some partnerships will prefer to hold 2% – 4% of each of thousands of companies that are monitored from afar annually rather than managed aggressively every week. In the same way that inventorying a song in iTunes is a fraction of the cost of carrying the CD at Tower Records, inventorying a small piece of a venture company as part of a highly diversified secondary portfolio has none of the cost involved in traditional VC management.

Finally, the ubiquity of data will allow these companies and the resulting portfolios to be analyzed and evaluated much more systematically than they have been before. Private equity secondary firms have developed sophisticated databases that track the performance metrics of hundreds of companies, many of which they already have pieces of in their portfolio. As their investment portfolios grow, they are able to aggregate even more data on the companies, thus spinning the wheel of this virtuous cycle.

### *Private Equity Secondary Markets*

Anderson states that ‘The key supply-side factor that determines whether a revenue distribution has a Long Tail is the cost of inventory storage and distribution. Where inventory storage and distribution costs are insignificant, it becomes economically viable to sell relatively unpopular products; however, when storage and distribution costs are high, only the most popular products can be sold.’<sup>1</sup>

Traditional venture capital and private equity business models are limited in their ‘inventory’ by their available ‘shelf space’ – or the bandwidth of partners to identify, diligence, document and monitor and monetize their investments. Historically, venture capitalists have had to commit enough funds so that their ownership in ‘hits’ is sufficient to make up for all of the ‘losses’ and compensate them for the high carrying cost. In the private equity secondary market, the low acquisition cost per unit, the low carrying/storage cost per unit and the large number of individual units purchased at the right price can potentially yield a return that is equal to or greater than the primary market itself. Stated a different way, purchased at the right price, the value of secondary private equity portfolios consisting of many ‘tails’ can appreciate to more than the value of the ‘head’.

For venture capital and private equity investors, once the ‘hits’ are identified, the ‘misses’ can be off loaded for a fraction of the cost, as the expense of ‘inventorying’ them is outweighed by the opportunity cost of finding another potential hit. These companies become the long tail – and while they might only be ‘worth’ in aggregate .5x invested capital, if they can be purchased in

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<sup>1</sup> Footnote reference

aggregate for .25x invested capital with little or no storage/carrying cost, they can be a profitable investment.

Several funds are capitalizing on the trends and opportunities presented by this long tail in private equity. Lexington Partners, Collier Capital, Paul Capital, Pantheon Ventures, Landmark Partners and VCFA Group have all made significant and increasingly sophisticated secondary purchases of Limited Partner positions in General Partnerships. W Capital, Industry Ventures, Saints Capital and Ally Capital have all been formed to purchase secondary investments directly in companies rather than in the partnerships that hold them. And just like Amazon has come to dominate the bookselling world, so may the size, value and returns of these secondary private equity partnerships eclipse their primary investor brethren as they ride the Long Tail.

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