Adaptation And The Shape Of A Deal

5-7 minutes

As an early-stage private market investor, one of the many things I obsess over is how to design and manage the funds we raise and deploy. Ask 100 peers how they do it, and you'll likely get 101 answers back. The problem is, as each fund and network is unique, different strategies and different pairings of variables can both lead to prolific or disastrous results. These conundrum has been swirling around my head, and as I need to do when that happens, I open up this composite box and try to work through it. So here, I am not sure if I'll reach a conclusion by the end of this post. I may, or I may not. And, if you've managed portfolios like this and have a strong opinion, I would absolutely love to hear it.

"Ownership Really Matters" – This is a line often repeated by VCs and their LPs. Why does it matter? A few reasons. One, it's not clear in the early days which company or companies will be the key fund drivers from a results point-of-view. On top of this, most portfolios tend to follow a power law curve, where the company which drives the highest return can be greater than the sum of the returns for the remainder. Given this uncertainty and randomness in distribution, having high ownership in a number of companies affords the fund a chance to return the fund (RTF) and hopefully drive a multiple in returns. Stepping back, ownership is important in early-stage funds because of no one knows which companies will be those fund drivers until years later, and no one knows how big they could be until the time of exit. These uncertainties combine to push many investors to hold high ownership in the companies they invest in, with larger funds needing to justify higher ownership levels.

"Entry Price Is Critical" – Many, but not all, investors will talk about valuation, or entry price as being critical to early-stage portfolios. This is often rooted in understanding how the power law curves look for size of eventual outcomes. It is really hard for a company to get a small acquisition offer. Most new ventures fail, sadly. Public companies can use a mix of cash and stock to buy startups for $100M and not have to publicly disclose those transactions. Acquisitions from $100-$500M in size happen but are significantly less frequent. As we approach billion-dollar exits and higher, those are incredibly rare. And, rarest are the companies that can go public and continue to accrue value — look at Shopify, which very few private investors truly paid attention to, went public a few year ago around $1B and is now almost a $100B company. Put all this together, and the only way to drive any multiple in a fund is to either be in a huge mega-winner early (like Shopify) or to invest early enough with lower prices such that, if there is an exit, the portfolio can benefit from the event. An investor's entry price dictates the multiple early on, and then the ability to continually invest in subsequent rounds (to a point) helps further drive returns if the investor picks the right ones to do so in.

"Company Selection Is The Most Important Thing" – Surely, if an investor isn't selecting good opportunities, all of this is moot. Let's assume most managers are picking good founders — that still doesn't mean those are necessarily good investments. And, the earlier an investor selects, the less data and information they have as evidence to support the investment. At slightly later stages, company selection is a bit more filtered but still uncertain. Those funds can theoretically own more as they can write larger checks, join boards, and participate meaningfully in future rounds. For even earlier funds, where much less is known, it is nearly-impossible to select based on future potential of the company, which is why these early investors focus so much on the prior experiences and technical insights of founders starting new endeavors.

All of these elements make up “the shape” of an investment. When investing early and building a portfolio, all of these elements need to line up. It’s so obvious when you write it out and this will be obvious to many reading this — but I’m writing this for myself as a reminder and for those in the early stages of their investing careers. It has taken a long time for these concepts to gel in my head, and even longer for them to combine into this “shape” analogy. I can only speak to very early-stage investing, that’s what I know. It’s so early, and so uncertain, that it is hard to get company selection right, perhaps impossible; as a result, it can be easier to manage entry price given the risk, yet the early-stage markets are flush with cash from angels all the way up to the platform funds; and as a result, smart founders are rightfully cautious about taking on so much dilution early on — this makes getting proper ownership for a fund quite difficult. And the bigger an early-stage fund, the more of a problem finding the right “shape” becomes. Prior to this pandemic, early-stage investors were comfortable operating in an uncertain environment given how little is known at the time of investment — fast-forward to today, and the process by which we early-stage investors make these “shapes’ and adjust fund sizes and portfolio construction will become even more important. This is the adaptation many of us need to make.