

Driving Growth with Big Ideas: Private Capital & Global Innovation

Summary of Discussions

On April 1, 2015 the Private Capital Research Institute and the Brookings Institution co-sponsored a conference focused on private capital's role in fostering global innovation. The event was hosted by GSV Asset Management in its Silicon Valley-based GSV Labs. The conference was attended by more than 400 investors, business leaders, policy maker, journalists and academics.

Keynote

The conference opened with Founders Fund Partner Peter Thiel's provocative keynote address on the condition of the venture capital industry. Thiel stated that the current approach to venture capital investing is obsessively micro focused: for example, venture capital tends to be overly concerned about customers and the personalities of people. Instead, Peter challenged the private capital industry to adopt a much broader vision for the private capital industry.

Thiel urged VCs to seek out business models with monopoly pricing power, which results from having sharply differentiated and innovative products and services. He argued that venture capitalists frequently exhibit a "perverse attraction to competition," a desire to win over a small share of large markets rather than competing with large market shares of smaller markets. This mentality has led to the oversaturation of many sectors, such as clean-tech. Lastly, he emphasized the need for VC fund managers to look beyond common trends and buzzwords, such as "Big Data", "Educational Software", "Health Tech Software", and "Cloud Computing." His key theme was a call for VC firms to concentrate on sectors that are underappreciated and where there is an unmet need.

Micro, Macro, Cosmo

Kate Mitchell, co-founder and partner of Scale Ventures, led a discussion about the sweeping changes the VC industry has undergone over the past 20 years. Michael Moe, Founder of GSV Asset Management, began by



discussing the structural changes in the industry. He noted that the holding time of VC investments has nearly quadrupled as managers work to build fundamentally strong and sustainable enterprises. He also pointed out that while the number of VC firms has decreased significantly, new sources of capital have proliferated. Stanford Professor Shai Bernstein echoed the point citing new funding sources, such as AngelList and crowdfunding.

Peter Bell, a partner at Highland Capital, described current investing market conditions as “frothy” and predicted an inevitable correction in which “a lot of the tourists will go away.” However, he added that this environment has spurred a great deal of technological growth and innovation, which he believed was at an all-time high. Entrepreneurs also have today more time to build sustainable businesses, given that they are not expected to exit for more than 10 years and there is sufficient late stage capital to support private company growth. Even though entrepreneurs now have many more financing choices, Bell cautioned that it is still a challenging time because selecting the right partner with compatible values has never been more challenging.

The panel went on to discuss the emergence of big data as a new way to value companies and to measure fund performance. Bernstein posited that VCs could be much more analytical with their own data to value companies and measure performance. Bernstein’s collaborative study with AngelList demonstrated the power of data and how sharing of information provides powerful analyses. Moe agreed that data analytics could prove to be a useful tool especially for early stage filtering of opportunities, pointing out that quantitative due diligence processes will increasingly transform industry investment evaluation practices. However, he cautioned that VC investing would never be completely reduced to a science. He noted that while data “increases the probability of success”, the most common errors still lie with business execution and management talent. Bell agreed with Moe about the importance of data analytics and mentioned that his firm like many others, has invested heavily in bulking up on internal research capabilities to data mine.



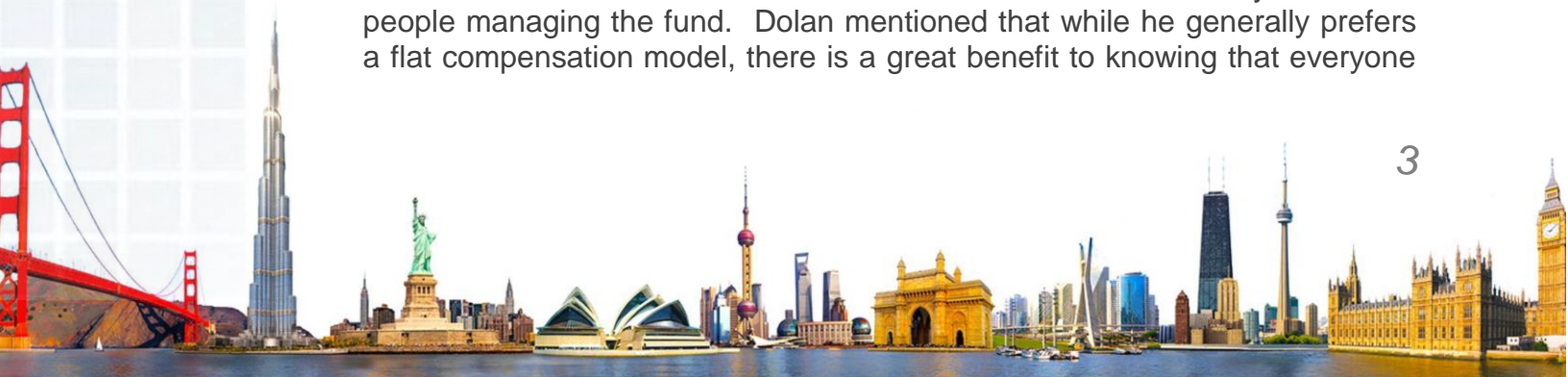
Is the VC Partnership More than the Sum of its Partners?

Professor Michael Ewens of Caltech presented his ground-breaking study that suggests that while strong economic persistence exists at both the firm and partner level, more of the value-creation generated by VC managers is derived from the individual partner. By tracing the history of partners who move to different firms, Ewens provides compelling evidence those individual partners explain two to four times more of the performance of venture deals than the identity of the venture firm.

Tom Keck, CIO of Stepstone, led a panel discussion on organizational dynamics. Sandy Miller, a partner at IVP, took the view that, regardless if one partner is doing better than the other, having a team model is preferable because it eliminates internal politics and conflicts that undermine internal alignment and ultimately undermine the ability to drive value creation. For Miller, a strong team culture that promotes diversity of opinion is the foundation for sound investment decision-making. Peter Dolan, a Managing Director at the advisory firm, Makena, pointed out that sometimes, if you have a strong deal rainmaker at a firm, it can present issues in terms of maintaining an egalitarian culture where give and take is welcomed.

The panel discussed investment performance persistence in venture capital. Aileen Lee, Founder of Cowboy Ventures, maintained that the combination of the increased amount of capital for a typical investment and the needed skills sets have put pressure on the VC industry. Dolan observed that while persistence has been strong, it is definitely weakening. Moreover, the industry is more transparent as a result of the explosion of knowledge in recent years. Dolan also added that since persistence is limited to selected firms, it is getting increasingly difficult to access the top performing brand-named firms. Lee pointed out that may be an opportunity because it could potentially accelerate allocations to promising new firms that have a fresh outlook. Dolan concurred, adding that that sometimes you need to make many bets knowing that some may not work out.

The panel concluded with a discussion about how VC firms think about dividing economics— flat or equal partnership, hierarchical, or a hybrid. The consensus was that there is no one structure that has always proven successful. However, they agreed that unless there is a meaningful tie of compensation to performance, the compensation structure would fail. Sandy Miller said that the economics of the fund should reside entirely within the people managing the fund. Dolan mentioned that while he generally prefers a flat compensation model, there is a great benefit to knowing that everyone



has to be a producing partner or else they are out. Importantly, Dolan forcefully argued that whatever the compensation structure, investors in particular needed to understand it.

Invisible Fuel

Stefan Heck, Stanford University Law professor and co-author of *Resource Revolution*, began with a talk about the 3rd industrial revolution that is taking place in the energy sector: taking lessons from IT software and data analytics and applying it to resources. As the world stands, he argued, we are not running out of anything, but resources are more expensive to obtain. Heck explained that we need to look for industries that are at the turning point of the learning curve: if we use these assets more efficiently, we can increase productivity. As an example, he explained how owning a car is a bad investment because most of our cars sit parked for 94% of the day. However, with new apps like Flight Car and UBER, it may make economic sense for people to get rid of their cars.

The follow-up panel led by Carter Bales, Managing Partner of New World Capital, further explored productivity and innovation in the energy sector. First, the panelists commented on what is going to happen in the solar industry. Mike Wingert, CEO of Solixel commented that there is a considerable room for innovation. Wingert stated that adoption of solar grew by over 30% over the past 10 years. John Creyts, Managing Director of Rocky Mountain Institute, predicted that by 2050, solar would be the most used source of energy. Heck added that there are plenty of examples out there of how to improve energy efficiency.

Bales asked the group why the energy sector, which had little innovation for 50 years, is now seeing a change. John Denniston from GSV explained that a large part has been driven by the explosive growth of the middle class world-wide creating an upshift in demand and a resulting resource crisis. Also, a growth in innovation has enabled efficiency and productivity changes. Looking globally, all the panelists had a positive belief that there is considerable potential in the energy sector.

The PCRI Agenda

Joe Rice Chairman of the PCRI and Founder of Clayton, Dubilier & Rice, in his remarks identified private capital's ability to nurture and support innovation as one of the most important, and often overlooked, components of its wide-ranging global economic impact. He noted that the increased size and scope of private capital, its global presence and the extent to which



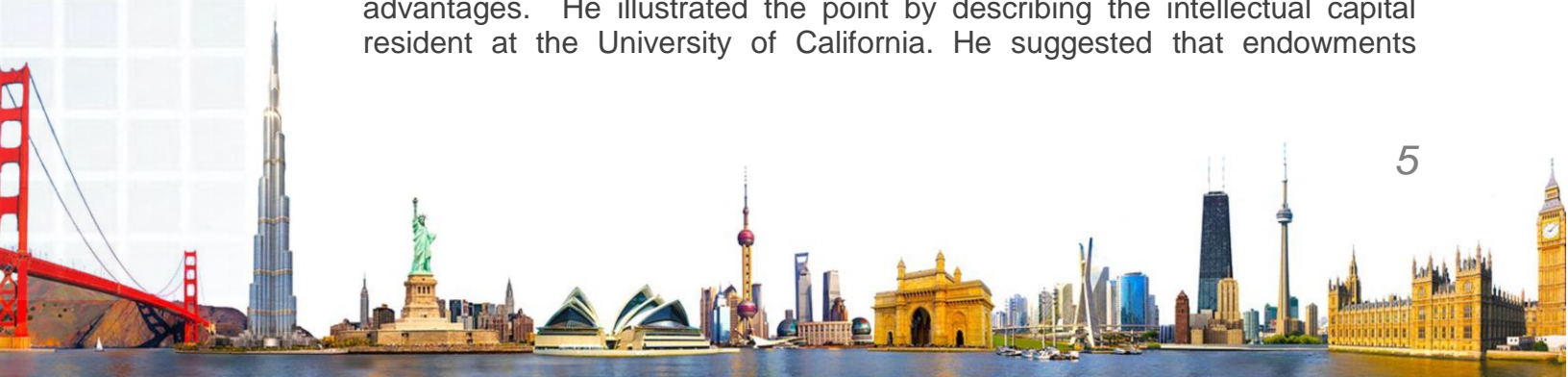
institutional investors rely on private capital returns have necessitated a deeper understanding of the positive role that private capital plays in the economy.

He provided perspective on the formation of the PCRI as an outgrowth of an effort that began with the World Economic Forum to study the global economic impact of private equity. As it became apparent that the data available for research in this area were inadequate and often misleading, the PCRI undertook the development of an extensive database with accurate, complete and unimpeachable data that would permit better understanding and new insights about private capital's economic impact.

Rice noted that today, over 40 private capital firms are in the process of voluntarily transferring fund performance and portfolio company data to the PCRI which is housed at the National Opinion Research Center at the University of Chicago, completely anonymized, and open to all qualified researchers. In addition, he described the partnerships that the PCRI has established with a number of recognized commercial performance data providers including iLevel, Thomson Reuters, Unquote, and the Emerging Markets Private Equity Association.

Shifting Priorities: Changing Institutional Investor Perspectives on Venture Capital

HBS Professor Josh Lerner led a discussion on institutional investors' views on the current state of VC investing with John Powers, CEO of Stanford Management Company and Jagdeep Singh Bachher, Chief Investment Officer of the University of California Board of Regents. A central topic was whether the VC industry would still be able to get outperformance or whether the industry had matured to the point where returns would revert to the mean. Powers stated that the band of outperformance has shrunk over time and that there were signs of risk going forward, especially at the high and low ends of the industry. However, he acknowledged that there are still exceptional investment opportunities to generate alpha. Bachher noted that, with the globalization of capital, the VC industry is being saturated with demands for investments. To Bachher, every asset seems to be over-priced. He added that to invest in the VC space, endowments and other institutional investors need to the extent possible exploit their own competitive advantages. He illustrated the point by describing the intellectual capital resident at the University of California. He suggested that endowments



control resources to leverage which can be repurposed for the GPs they back, thus making them a value-add investor.

Powers stated that even though there is still residual value in brands, LPs should turn their attention to new funds. At the low end of the VC market, a willingness to experiment is required. For example, Powers felt that one strategy might be to make several small bets and hope to get a few winners, with an eye to scaling the successes over time.

Finally, the conversation ended on the topic of economic alignment between limited partners and general partners. Currently, both Powers and Bachher felt that VC funds are not as economically fair to limited partners as they might be, reflecting the hyper demand for the best funds. Newer funds tend to be more cost efficient, but they are riskier. Co-investments were also discussed as a means for LPs to lower fees. However, Powers noted there is evidence of selection bias in the co-investment deals offered LPs.

Fireside Chat Keynote

The program concluded with a conversation between Martin Baily, Senior Fellow at the Brookings Institute, and David Kappos, former Director of the U.S. Patent and Trademark Office, over the current state of intellectual property protection in the United States. Kappos gave a positive outlook on the US patents system, highlighting efforts to crack down on patent trolls. Furthermore, he underscored the importance of patent laws as providing the key incentive for innovation in today's capital-abundant environment. Patents may be a large component in creating the monopoly power that Thiel earlier described. Apart from a firm's brand, the major defining characteristic of a monopoly is often its intellectual property portfolio.

Shifting to an international focus, Kappos was asked to evaluate the strength of the China's patent system and its ability to foster innovation. Drawing from his experience as a consultant for the Chinese government, Kappos stated that China is in transition and has improved on patent enforcement over the years. Furthermore, Kappos added that China invests more money on innovation than the US. However, despite the large volume of patents awarded over the past few years, China has severely lacked in innovative output. Kappos emphasized that patents clearly do not measure innovation. He cited the example of the Chinese drug industry, in which there were many patents awarded, but not a lot of new drugs produced.

Addressing the entrepreneurs in the audience, Kappos outlined some key points when it comes to intellectual property. First and foremost, a start-up

company must be able to identify its trade secrets and determine what needs to be patented for protection against copycats. Kappos warned not to overreach, but to instead, have a few meaningful patents, which support a firm's core business model. Lastly, he said that it is critical for senior executives of start-ups to know and to be able to articulate their company's value proposition.

Conclusion

The importance of venture capital to the economy cannot be understated. But many important questions remain poorly understood. It is the hope that the work of the Private Capital Research Institute—and the discussions, like this one, that it will inspire—should lead to greater transparency in this area.

