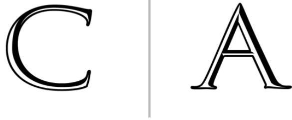

CAMBRIDGE ASSOCIATES LLC

MANAGING POST-VENTURE DISTRIBUTIONS

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MANAGING POST-VENTURE DISTRIBUTIONS

Introduction

As the booming U.S. equity market has spawned a boom in the venture capital industry, whose preferred strategy for realizing profits is to take companies public through the booming market for initial public offerings (IPOs), venture capital investors have been forced to consider how best to deal with *in-kind distributions* (i.e., distributions to limited partners made in the form of newly issued public stock, rather than in the form of cash). Once an afterthought, the question of how best to manage such in-kind distributions has become a topic of hot debate. Our own view is that no one approach is best for all investors, but rather that the most effective distribution management strategy is defined by the investor's goals and current portfolio structure, which should be clearly articulated and understood before a distribution management strategy is implemented.

Background

Many venture capital investments eventually become public stocks, either through a public offering or through acquisition by a public company. Once publicly traded, however, the stock is likely to be subject to trading restrictions prescribed by the Securities Act of 1933, the underwriter, or both. The general partner of a venture capital fund may elect to hold the security until these restrictions have expired, and then either distribute it to the fund's limited partners, or sell it and distribute the proceeds. Increasingly, venture capital firms are distributing the security while it is still partially restricted, transferring the burden of sorting through the administrative issues to the limited partner. In the case of an in-kind distribution, the *fund's* exit price is calculated as of the date of distribution (or, increasingly, using a five-day average trading price). However, the *investor's* exit price depends on when the stock is sold. Some investors sell as soon as possible with a view to realizing a price roughly equal to that realized by the fund (which can prove difficult with small, thinly-traded securities), while others may hold the stock in the hope of realizing a higher price later.

Although it is true that in-kind distributions have constituted a higher *percentage* of total distributions in recent years, the real driver behind their growing volume is the pronounced increase in venture funds' *total* distributions. According to Cambridge Associates data, $16.2 billion was distributed between September 30, 1998 and September 30, 1999. This compares to roughly $11.2 billion in 1997 and just under $2.5 billion in 1991. While the percentage of stock distributions has been steadily increasing, it is worth noting, however, that the 1997 distribution sample is affected by reductions in the Rule 144

holding periods,[1] which went into effect in mid-1997. These holding period changes "liberated" millions of dollars' worth of restricted securities, and thus increased the percentage of stock distributions for the year. On balance, the Rule 144 change has encouraged the practice of distributing securities in-kind, as the stocks are younger and are perceived to have much upside remaining. (One could argue, however, that the stocks of such immature companies are just riskier, since the absence of one year's worth of data on product, management, and markets creates greater uncertainty rather than any basis for appreciation.)

The combination of Rule 144 changes and the willingness of the public markets to purchase immature technology companies have stimulated the distribution of undeveloped "public start-ups." The Bloomberg IPO Index[2] provides evidence of this. Roughly 45% of those companies reporting earnings in the Index have negative EPS estimates for the next 12 months. Overall, the entire Bloomberg IPO Index, with a weighted market capitalization of $156 billion, has a negative price-earnings ratio. Many of these underlying companies flounder or are quickly acquired. Some flourish. Very few investors possess the resources required to analyze them effectively, execute trades, manage custody, and monitor the portfolio. Consequently, those who have decided that actively managing such securities is preferable to selling them at the earliest possible opportunity frequently outsource their distribution management. Some investors have cast the problem solely in these terms–to hire or not to hire a distribution manager. We would suggest, however, that the decision to hire a manager (or manage the distributions in-house) is a decision about how best to *implement* a strategy that the investor should have arrived at by other means, and does not in itself constitute a strategy.

Characteristics of Distributed Securities

The debate on how best to manage in-kind distributions is sometimes confused by investors' reluctance to classify them as part of their U.S. equity fund, because they constitute a sort of involuntary allocation to a small-cap growth portfolio that may be highly concentrated in just a few economic sectors. As indicated below, however, that is exactly how investors should classify these holdings, and if they do not want, or cannot tolerate, a portfolio with these characteristics, they should adopt a policy of retaining in-kind distributions in their venture capital portfolio and selling them as soon as is practicable.

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[1] Rule 144 provides a safe harbor for resales of "restricted" and "control" securities. "Restricted" securities are securities purchased in unregistered private placements. "Control" securities are those held by control persons (i.e., affiliates of the company). Under the revised Rule 144, certain investors can now sell limited amounts of restricted securities after a one-year (rather than a two-year) holding period. Unlimited sale is now permitted after a two-year (rather than a three-year) holding period. These changes became effective on April 29, 1997. (Parallel changes were made to the holding-period provisions included in Rule 145, which governs resales of securities received in connection with mergers, consolidations, asset transfers, etc.)

[2] The Bloomberg IPO Index (US) is a capitalization-weighted index which measures the performance of stocks during their first publicly traded year. It includes all companies with a market value of at least $50 million at the initital public offering.

Correlations (quarterly data from 3Q 1989 through 2Q 1999)

	Distribution Manager X	S&P 500	Russell 2000®	Russell 2000® Growth	H&Q Growth Index	Venture Capital
Manager	1.00	---	---	---	---	---
S&P 500	0.76	1.00	---	---	---	---
R2000	0.82	0.80	1.00	---	---	---
R2000 Growth	0.90	0.83	0.97	1.00	---	---
H&Q	0.96	0.76	0.79	0.90	1.00	---
VC	0.52	0.50	0.52	0.56	0.52	1.00

Risk/Return Data (quarterly data from 3Q 1989 through 2Q 1999)

	Distribution Manager X	S&P 500	Russell 2000®	Russell 2000® Growth	H&Q Growth Index	Venture Capital
AACR	26.09	18.78	12.39	11.39	24.55	28.81
Std Dev	16.46	6.48	9.64	11.11	16.81	7.39
Risk Premium	5.97	3.30	2.13	2.05	5.64	5.47
Sharpe Ratio	0.36	0.51	0.22	0.18	0.34	0.74
M^2	5.32	6.95	3.74	3.34	5.02	9.52
Beta*	1.33	0.48	0.84	1.00	1.35	0.37

* Beta is measured relative to the Russell 2000® Growth Index.

Given the high concentration of venture capital investments in the medical and technology sectors, it is hardly surprising to find that the Distribution Manager Composite exhibits a high correlation with the returns of the H&Q Index, which is an unweighted index comprised primarily of stocks in those industries. More surprising, perhaps, is the high correlation with Russell 2000® Growth Index, which has far broader industry representation. This correlation suggests that, over time, company size is a more dominant influence than economic sector, and argues against the notion that post-venture securities are sufficiently distinctive to warrant their classification as a distinct asset class–these stocks are simply high-beta, small-cap issues that one would expect to outperform strongly in a bull market (like the period illustrated above) and to nosedive when investors shun this sector of the market.

As footnoted, one should set little stock by the correlation of venture capital returns with those of public securities marked-to-market each day–a clear case of apples being compared to oranges–nevertheless, it is worth noting that the total *performance* of the two composites was roughly equal

during the period shown. Since venture capital investments provide superior portfolio diversification benefits, this would suggest that whenever possible venture distributions should be sold and immediately reinvested into the venture capital portfolio.

Crafting a Distribution Management Strategy

The most common mistake investors make when they consider whether to manage or to liquidate their post-venture in-kind distributions is to look at the prospective allocation in isolation, rather than in the context of its impact on the composition of their total portfolio. For example, an investor might dismiss the idea of a post-venture distribution portfolio because it would consist of relatively small and illiquid issues, might be highly concentrated in a few sectors and extremely volatile, be relatively tax-inefficient, and so on. This would be illogical–as with the addition of any new investment to the portfolio, the relevant question is how its inclusion is likely to affect the portfolio as a whole. Thus, an investor already heavily exposed to small-cap growth stocks might be appropriately less inclined to increase the weighting of this sector, while an investor with no such exposure might find that its inclusion actually *improved* the risk/return characteristics of the total portfolio.

In addition, investors should also consider the quality and diversity of the underlying venture portfolio. Clearly, an institution with a small (or immature) venture portfolio will receive a limited universe of distributions, and so end up with an undiversified post-venture portfolio characterized by very high stock-specific risk. Similarly, a large portfolio that is skewed by industry or geography may be highly concentrated despite holding multiple securities. Under these circumstances, investors that still want their distributed securities actively managed might consider granting the distribution manager the discretion to *buy* post-venture stocks, in addition to selling or holding those distributed to the account. This decision would create a larger and therefore more efficient universe from which the manager could select securities.

The strategic options available to investors may be summarized as follows:

	Option 1	Option 2	Option 3	Option 4
Strategy	Sell Everything	Hold Everything (X years)	Sell/Hold	Buy/Hold/Sell
Rationale	Best opportunities for investment are in other parts of the portfolio.	For investment horizon, these securities offer best opportunity for investment; believe in long-term allocation to post-venture as part of a diversified portfolio.	Timing of sale (some company analysis) and best execution will add value over Option 1; Do not believe in long-term allocation to post-venture.	Believe distributions should be actively managed; post-venture universe offers attractive investment opportunities.
Manager Value	• None	• None	• Trading execution • Timing • Some company analysis and valuation	• Trading execution • Timing • Company analysis and valuation • Stock selection
Liquidity	Immediate	None for X years	Partial (spotty over time)	Depends on manager strategy
Benchmark	Locked box measures opportunity cost of *not holding* distributed securities.	Should be determined by distribution reinvestment policy; possibilities include the overall portfolio hurdle, VC benchmark; or emerging growth index.	Should be determined by distribution reinvestment policy; possibilities include the overall portfolio hurdle and VC benchmark; Locked box used to measure manager value-added over Option 4.	Depends on manager strategy and allocation definition; include an emerging growth index or venture benchmark.
Holding Period	Extremely short (less than three months)	Medium-term (X years, usually three to five years)	Short-term (less than one year)	Long-term (strategic allocation)

Option 1: Sell All Distributions

Implementation. All distributions are sold as soon as practicable. The investor may wait a few days or weeks to liquidate the distributions depending on market conditions; but full liquidation is likely to take place within a month. In all likelihood, this approach would be implemented in-house, through the broker/dealer identified by the venture firm at the time of the distribution.

Rationale. The explicit assumption here is that holding distributions is not consistent with the institution's investment goals. For example, an institution might decide that holding the distributions introduces too much volatility into the portfolio or it might have a need for the liquidity this strategy provides. Implicitly, the investor in this "sell all" strategy believes that selling the distribution and investing the cash in other assets is a more attractive alternative than passively holding or actively managing the distributions over a longer time period. The money can be used to rebalance to target allocations or can be deployed in a single asset class to execute a tactical allocation. A logical use of proceeds would be to fund venture capital drawdowns. The main benefit of this option is that it creates liquidity and flexibility.

Primary Issues

- **High Execution Costs.** As a liquidity seeker in what is often a relatively illiquid security, the seller will incur high trading costs. (Here we define trading costs broadly to include commissions, market impact, and unexecuted trades).
- **High Opportunity Costs.** The volume of in-kind distributions will almost certainly be greatest when the public securities markets in general, and the IPO market in particular, are infected with maximum bullishness. In such an environment, *on average*, investors are likely to suffer significant opportunity costs if they sell these securities as soon as they receive them. Conversely, during those periods when it would be most advantageous to unload in-kind distributions as quickly as possible, the volume of such distributions is likely to dry up, since these are conditions inhospitable to IPOs or to any other exit route for venture-backed companies.
- **Bad Timing.** Historically, post-venture stock prices have on average declined after distribution. Some stocks recover, but the recovery typically takes at least several months.
- **Inefficient for Taxable Investor.** This strategy could be problematic for a taxable investor. The other three strategies are potentially more tax efficient.

Performance Evaluation. The "sell all" strategy can be evaluated against several possible benchmarks. To measure the opportunity cost of selling these securities, a locked-box[3] benchmark is an appropriate measure. Alternatively, the price received from the stock sale could be compared to the distribution price. If the actual price received is consistently below the distribution price reported by the venture firm, the strategy should be revisited (or the venture capitalist should be admonished for "dumping" distributions).

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[3] A locked-box is a hypothetical composite calculated by holding each distribution for a specific period of time (usually three years). For example, a distribution of Netscape received on Jan. 1, 1994, would be sold at the opening price on Jan. 1, 1997.

Option 2: Hold All Distributions for X Years

Implementation. All in-kind distributions are held for a finite period of time, typically three or five years.

Rationale. This strategy implies that there is more value to holding the venture distributions for a finite period of time than there is in investing in any other area of the portfolio. In addition, there is an implicit decision that no value can be added by active management of the distributions. Under this strategy, the post-venture allocation's security diversification would be the result of the original venture capital investments and would not necessarily be broadly diversified across industries or geography. Unlike Option 3, the sell/hold strategy, there would be no opportunity to eliminate poorly performing companies. Finally, this strategy provides the portfolio with no liquidity from venture distributions during the course of the defined holding period; consequently it generates no cash flow until such time as the portfolio has matured.

Primary Issues

- **Inefficient Universe.** This passive strategy puts the investor entirely at the mercy of the capital markets, since returns will be dominated in any given period primarily by how well small-cap growth stocks perform, and secondarily by the relative performance of those economic sectors in which the venture portfolio has been most heavily invested.
- **Arbitrary Sell Discipline.** Because the sell discipline for this strategy is defined by a certain time period, the rapid growth (or decline) of venture investments could lead to this unmanaged allocation being a large (or small) percentage of the overall portfolio. In addition, the timing of any security sale would be based on an arbitrary time period, not on the optimal investment period determined by company research.

Performance Evaluation. The cost of this strategy is primarily the opportunity cost of not investing the money in other asset classes and the trading or transaction costs at the end of the holding period. As with Option 2, the benchmark for this strategy should be determined by the reinvestment policy of the institution. In other words, opportunity costs of not being reinvested in the general portfolio or in a specific asset class are the benchmark against which this strategy should be measured. Importantly, the high volatility exhibited by this type of strategy requires that all performance be evaluated on a risk-adjusted basis.

Option 3: Sell and Hold

Implementation. In adopting the sell/hold option, an investor seeks to enhance returns by 1) minimizing market impact through actively managed stock sales; and 2) maximizing returns from attractive distributions ("holds") while quickly eliminating unattractive securities ("sells"). Absent the in-house capability to evaluate specific securities, industry conditions, and the trading environment, the Sell/Hold strategy requires that the investor hire a distribution manager. The holding period for securities deemed attractive is discretionary, while unattractive securities are sold as soon as practicable.

Rationale. In addition to believing that returns can be enhanced through actively-managed trading, practitioners of the sell/hold option believe that the post-venture period is an extension or "tail" of the venture capital investment cycle, and that many securities continue to possess attractive growth prospects after their distribution. Indiscriminate sale of the distributed securities is therefore seen as lopping off this "tail" and unnecessarily sacrificing an opportunity to capture the additional returns a capable distribution manager should be able to generate. Manager selection is an important part of this strategy since performance is highly dependent on the manager's ability to time the sale of each security correctly. (A list of firms experienced in the management of post-venture distributions is given on the last page.) In its purest form, this option generates staggered liquidity that is highly dependent on equity market activity. As a result, the investor cannot be dependent on pre-scheduled liquidity, although some managers will agree to provide a predetermined annual cash flow. In general, a mature and diversified venture capital portfolio will generate more predictable cash flow than a developing or highly concentrated venture portfolio.

Primary Issues

- **Performance Evaluation.** Evaluating *manager* value is relatively straightforward using a locked-box benchmark. (Although the choice of time period on which the locked-box is based is arbitrary). However, evaluating the performance of the *strategy* relative to the total portfolio is difficult. The irregular cash flows generated by this strategy support the use of dollar-weighted performance; however, most indexes are calculated using time-weighted returns.
- **Inefficient for Taxable Investor.** This strategy may be more tax-efficient than the sell all approach; however, it is likely to generate unpredictable tax events that could try the patience of tax planners.
- **Manager Fee Structure.** It is difficult to design a manager fee structure that aligns the interests of the manager with those of the investor. Managers that are compensated based on total assets under management can be motivated to hold (rather than sell) securities. At the same time, using a performance-based fee is expensive, particularly, when one considers that both carried interest and management fees have already been paid to the venture capitalist.

Performance Evaluation. To monitor the value added by the manager's sell or hold decisions, a locked-box benchmark is an appropriate measure. To evaluate performance of the sell/hold strategy over the sell all approach, the distribution manager's performance should be compared to that of those asset classes in which the distributions would have been reinvested. Here, an appropriate benchmark could be the benchmark of the total portfolio or of a separate asset class such as venture capital or global equities. As with each of these options, no single benchmark is perfect. Particularly difficult in this strategy is the issue of cash flow. Most of the broader indexes are calculated using time-weighted returns that immunize the effect of cash flows. The nature of this strategy, however, results in significant inflows of distributions and outflows of cash, requiring the use of a dollar-weighted return to measure manager performance accurately.

Option 4: Hire an active manager to buy, sell, and hold post-venture distributions

Implementation. This "managed" strategy can be implemented in two ways, either through a customized portfolio that provides limited diversification or through a commingled pool that provides broader diversification and prompt monthly liquidity if necessary. Since its success is heavily dependent on the manager's stock selection, timing, and trade execution capabilities, investors must have a high level of confidence in the firm selected. Investors tend either to hire a small-cap growth stock manager with which they have an existing relationship (which can create some conflicts of interest that should be discussed in advance), or to hire a manager specializing in post-venture distribution management.

Rationale. This strategy implies that post-venture stocks present an attractive investment opportunity and deserve an allocation within the portfolio. In addition, the presumption is that active management in this area can add value. The strategy would not necessarily result in predictable liquidity for the portfolio except when the allocation exceeds its target level or a reallocation decision is made. The implication in choosing this strategy is that the allocation would be held for the long-term and represents a strategically targeted percentage of the portfolio which could become self-funding over time.

Primary Issues

- **Asset Classification.** Post-venture cannot be clearly defined as a separate asset class. As a result, this type of allocation can be considered either a small-cap growth allocation, or due to the illiquid nature of many of the holdings and the need to measure performance on a dollar-weighted basis, as part of the alternative assets portfolio. This type of distinction often causes problems for institutions that monitor and report these portfolios separately.

- **Limited Performance History.** The limited history of both post-venture distributions and the active management of them means that we have no objective, statistical basis on which to evaluate whether institutions should expect such portfolios to perform better or worse than the market over time, or whether active management can or cannot add value.

Performance Evaluation. Benchmarking issues are similar to those presented by Option 2. The locked-box provides one possible measure, but a more logical approach is to measure the manager's performance against that of a specialized small-cap growth index like the Hambrecht and Quist Growth index, which captures the volatile nature of these holdings and the returns from which have been highly correlated with those of such actively managed post-venture distribution portfolios. As with each of these strategies, however, the selection of an appropriate benchmark decision should be fully discussed with the manager.

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