SPUR THOUGHTS ON DPI

Distributions to Paid-In Capital (DPI) can prove to be a useful tool when assessing interim performance of private equity. Investors' focus on this measure is understandable as they anticipate return of and return on investments. However, when over-emphasized and used out of the context of broader investment goals, such as end-of-life multiples and IRRs, DPI can lead to less than ideal results. Investors who vociferously object to "J-curves" and the paucity of early-year returns risk adversely impacting manager behavior to the detriment of long-term results.

Regulatory changes, as well as the Great Recession of 2008-2009, have meant that investments have gestated longer within venture capital portfolios in the last decade. While the dearth of returns (and reduced DPIs) during this period is generally viewed as a significant failing of the venture industry, in fact, the lengthening of time to exit may lead to proportionally greater value being captured by the venture partnerships. Traditionally, much of the appreciation of great venture capital-backed companies happens in the public market after the venture capitalists distribute shares (e.g., Cisco, Microsoft, Google). Recent valuation of long-held companies indicates that there may be a shift to capture more of the value by the partnerships and limited partners (e.g., LinkedIn and Facebook). Of course, not all partnerships benefit from a lengthened exit horizon; familiarity with the underlying portfolio of companies will be useful in properly assessing interim measures.

Investments in early-stage venture capital inherently should have the longest time to maturation across the private equity spectrum. Early-stage investments can be lengthy, uncertain and daunting, but those companies that execute well and persevere in bringing innovations to market can provide outsized returns for patient investors. Unfortunately, some managers have responded to investors' preference for shorter cash cycles by allocating a portion of committed capital to investments that may have earlier "pay-off" than the managers' primary mandate. We view this as an unfortunate development as managers are in effect insinuating themselves into the LPs' asset allocation decision.

The skill, capital requirements and market knowledge needed to pursue growth, buyout or PIPE investments effectively are distinct from those needed for early-stage venture investing, with its reliance on operating abilities. In addition, time-weighted portfolio diversification benefits are not necessarily optimized by such mixed-strategy venture capital firms. For example, failure of a later-stage investment that consumes a greater amount of capital than early-stage investments can have a significantly adverse impact on a fund's performance, and the ability of a manager to raise a successor fund. With the typical fundraising cycles of three to four years, the natural temptation might be to allocate even more capital to later stage investments in an effort to backfill losses, corrupting the original investment mandate.

Nor does one size fit all when applying performance measurements. In the initial years, earlier-stage investments will generally have, ceteris paribus, smaller DPI's than later-stage investments of the same vintage. Moreover, within early-stage investing, some industries, such as life sciences, have a more established horizon to liquidity (owing to regulatory oversight) than other industries. Although end-of-life returns and multiples may be equally attractive, interim benchmarks such as DPI unfortunately will penalize such areas of investment focus.

Finally, DPI has the potential to present false positives on fund performance. Venture capitalists often say that "the lemons ripen in 2 1/2 years while the pearls take seven or eight". It is not unusual for managers to sell companies that are not meeting expectations for modest returns. Unfortunately, a cursory review of DPIs from two managers with similar strategies and industry focus, one with a portfolio of undervalued pearls and the other with a basket of well-marketed lemons can lead to unintended consequences. It is our view that DPI analysis can be helpful as long as it is thoughtfully applied and benchmarked within venture firm strategies and industry cohorts.