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The Private Capital Research Institute

Is a Private Partnership Greater than the Sum of Its Partners?

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What happens when PE partners move or leave?

Exclusive: Tim Draper is leaving DFJ

FORTUNE

By Dan Primack November 19, 2013: 3:20 PM ET

Venture capitalist Tim Draper is stepping back from the Silicon Valley firm he created 28 years ago.

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Ajay Shah will not lead the next Silver Lake Sumeru fund.

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Gray Shines in Blackstone's Succession Plan

Head of Firm's Property Business Is Top Candidate Should the Current President Depart in the Next Few Years

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By CRAIG KARMIN and MIKE SPECTOR CONNECT

Questions

In spite of rarity of investment success, evidence of return persistence:

- Kaplan and Schoar (2005) and Harris et. al. (2013)

We ask:

To what extent are the important attributes of performance part of the firm's organizational capital or embodied in the human capital of the people inside the firm?

Specifically:

- Is there performance persistence at the partner-level?
- What is the relative importance of the partner and firm in the cross-section of investment performance?

The VC industry

Venture capital excellent area to study these issues because partners $\rightarrow$ projects:

- Typical entrepreneurial firm board has 3.3 VC investor board members
- Most investors take board seat at their first major investment
- Most remain on the board through investment exit (e.g. IPO or acquisition)

$\Longrightarrow$ have a VC-partner-level track record of investments and outcomes.

Data: financings, entrepreneurial firms and partners

The major dataset contains VC financings and exits:

- 1987 - 2012, near-perfect coverage of investment activity
- 19,053 financings in 11,885 entrepreneurial firms
- includes
  - exit valuations for large subset of firms
  - entrepreneurial firm characteristics: founding date, industry, capital raised, etc.

Current and former board members of all entrepreneurial firms:

- 1,573 VC firms with 5,324 VC partners.

Panel of individual VC partner board seats, their firms, the dates, investment characteristics and outcomes.

Partner performance persistence

Investment performance persistence has been challenging to find in public equities and mutual fund managers.

- Should the same hold in PE?

Compute a VC partner's past investment success – average exit valuation, IPO rate – and ask whether it predicts their next investment outcome:

- 1 sd increase in past success $\implies$ 17% higher probability of IPO.

Can also show for other outcome measures:

- <u>Exit valuation</u>: top quartile past performance $\implies$ 14% higher probability of remaining top quartile
- <u>Acquisition rates</u>: VC partners who produce acquisitions, do so repeatedly

What about the PE fund?

PE partners likely consider their funds and firms assets, so we now "control" for the firm:

- Compare partners investing at the same firm at the same time
  - e.g. all partners in Sequoia XI

We find:

- Persistence remains within-fund
- $\implies$ there is *rank* persistence with VC funds
  - the best partners at a fund remain the best

What's missing?

Both the firm and partner help explain variation in investment outcome persistence.

- The *relative* importance of the two, however, is still unknown

  How much can the partner and firm fixed characteristics explain the distribution of investment performance?

Exploiting movers

Venture capital partners who sit on multiple boards over their career allow us to infer their movement across VC firms:

- We observe board members – current and former – for each entrepreneurial firm
  - 2114 total partners of interest: at least four investments, worked at a VC firm (rather than a corporate VC or PE firm)
  - 603 movers: 15% of all “active” partners, 30% of sample of interest

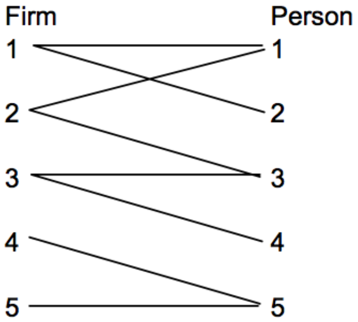
Separating the importance of firm and partner

This estimation separates three pieces of investment performance:

- firm, person and year (of investment)

Connectedness algorithm ensures that we can separate them all:

Firm	Person	Group
1	1	1
1	2	1
2	1	1
2	3	1
3	3	1
3	4	1
4	5	2
5	5	2



Here, there are two connected groups.

Relative Importance of Partner vs Partnership

Estimate the relative importance of partner and firm in over 20,000 investments:

Partner explains 2 - 4 times more of the exit valuation variation than the firm.

- holds across several performance metrics
  - IPO rate
  - Successful acquisition rates
- Suggests that partner's have some time-invariant skill – both good and bad – that can explain the top vs. bottom PE firms

Does this guide investment choice?

What did Tim Draper take?

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Implications

- Asset allocation and past performance:
  - increased focus on the partner-deal history
- Why don't we see a few huge VC firms with many partners?
  - There are huge PE funds $\Longrightarrow$ more scalable assets
- Why don't we see M&A between VC firms?
- Surprising to many LPs - did partners who set up a new firm leave the 'secret sauce' behind?

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