April 14, 2019

<u>Kirenaga Observations:</u> Lyft *Off*?

Two weeks ago, the ride-sharing company Lyft had its IPO, raising ~$2.3 billion in fresh capital and valuing the company at $23 billion. Since then, derision has set in. Lyft's stock price has traded down to $59.90 from its $72 IPO price (down 16.8%), while during the same time, the NASDAQ has gained 4.0%.

But here's the deal: investors who think Lyft has been a failure are <u>missing the game</u>. Quite simply, investment alpha is no longer being generated by the public markets. Rather, investment alpha is being generated and captured in the private markets, and those investors who fail to realize that the game has changed are suffering poor portfolio returns as a result.

Last week, Mike Milken spoke at the Credit Suisse America's Credit Forum, and mentioned two unstoppable macro themes:

- First - the rise of AgTech and movement of food production from outdoor farms to indoor facilities. We won't dive into that theme in this newsletter, but our investors know that Kirenaga is well-positioned with our investments in Plenty and Violet Gro.

- Second – the fact that <u>all major pools of capital are moving to the Private Markets</u>. Look at Softbank which raised over $100 billion from the likes of Saudi Arabia. Mike mentioned that Japan has something like 120% of their GDP sitting in cash. That $6 trillion needs to be invested somewhere. That trend is everywhere, from the size of CalPERS to the Yale Endowment. These pools of cash need to be invested, and the vast majority of money is not going to public stocks.

So the **<u>new, new thing is the rise of venture capital</u>** from a boutique, early-stage business-creating craft to a large-scale diversified industry, deploying massive amounts of capital.

In the following few pages, we dissect some trends in the overall marketplace and the specifics of the Lyft transaction. We focus on <u>who gets paid</u> and the implications for individual investors and their investment portfolios.

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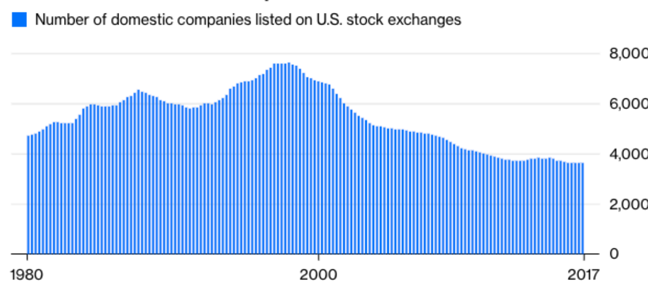
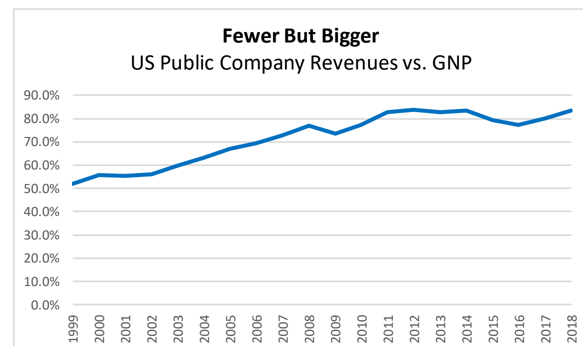
Observation 1: Public-Market Investors Have Fewer and Fewer Opportunities to Generate Alpha, as There are Fewer and Fewer Publicly-Traded Companies

We start by noting that the sheer number of publicly-traded companies in the US has declined dramatically over the last 20 years. During the tech boom at the end of the 1990s, there were ~ 7,500 publicly-traded companies. Today we are at around half of that number, with the number of publicly traded companies falling to ~3,600 by the end of 2017, and the trend looks to be continuing downward.





First Chart from: Bloomberg Article: *Where have all the Public Companies Gone* April 9, 2018

While the number of publicly-traded companies has declined precipitously, the overall economic contribution of these companies has continued to increase substantially over time. This means each company is, on average, much larger, and economic concentration is greater than ever.

So with fewer companies available and these companies more correlated with overall GNP as well as each other, the opportunity for differentiated returns among public companies has decreased. This inevitably makes long-short equity and stock-picking strategies much more difficult. In other words, the opportunity for individual company out-performance (i.e. alpha) has decreased, while overall market risk (i.e. beta) dominates the public market investor's expected return.

For investors concerned with where to allocate their money for future returns, the question is what's behind this trend, and will it continue?

Observation 2: **Mergers & Acquisitions has Replaced IPOs for Venture-Backed Monetizations – Public Investors Never Get a Chance to Participate**

Several factors have contributed to fewer, but larger public-companies:

- Massive increase in regulatory obligations with Sarbanes-Oxley and Regulation FD
- Increased regulatory costs in their respective industries, which creates protective moats for the largest and best companies
- The often counter-productive decisions needed to manage to analyst's quarterly expectations
- The costly burden of dealing with activist investors and short-sellers

And none of these above factors are going away. But in our view, the largest contributing factor is the nearly wholesale reorientation of larger corporations regarding the most effective means for Research & Development. As these companies grow larger, they need to devote more and more resources to work (by dollars deployed) to keep their growth engines moving (at acceptable percentage rates). They also have constant pressure to keep costs down and margins high.

From food to pharma to tech, publicly-traded companies consistently find that the acquisition of new companies as outsourced research and development is far more efficient than running large-scale internal R&D organizations. Most companies have concluded that it's easiest to buy a company with innovative properties than invest in the development of new products or services directly. In other words, large companies evolve to become integrated platforms with wide-distribution capabilities, with much less focus on research and development.

Since large companies have found that buying companies with new technology is much more efficient than running their own R&D and also having to compete with the new competitor in the marketplace, large corporations are willing to pay significant premiums to acquire new companies.

Because of the premiums paid, most venture-backed companies seek to be acquired by larger companies, and therefore don't need the public markets for a successful exit, as illustrated in the chart below. Rather than IPOs (which dominated in the 1980s and 1990s), most exits today occur via a merger or acquisition, so public investors never get to participate in these innovative companies. Even to the extent that these newly acquired companies benefit the larger acquiring companies, the stock price differential is quickly arbitraged - leaving public investors with market returns. We'll go into this point in more detail later.

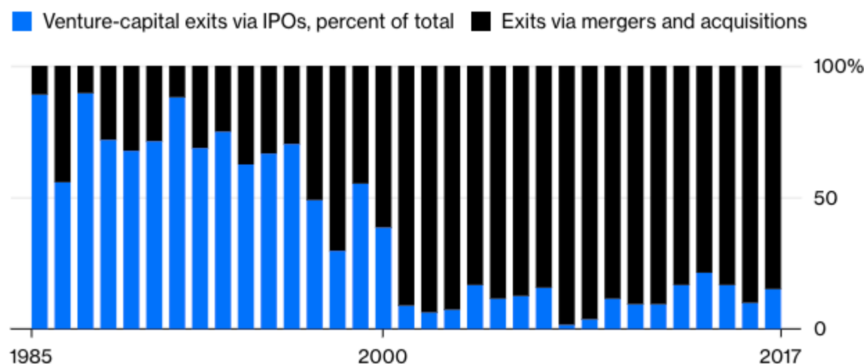


Chart from: Bloomberg Article: *Where have all the Public Companies Gone* April 9, 2018

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Observation 3: **The Venture Capital Industry is Evolving to Meet the Demand of Corporations and Institutional Investors. . .**

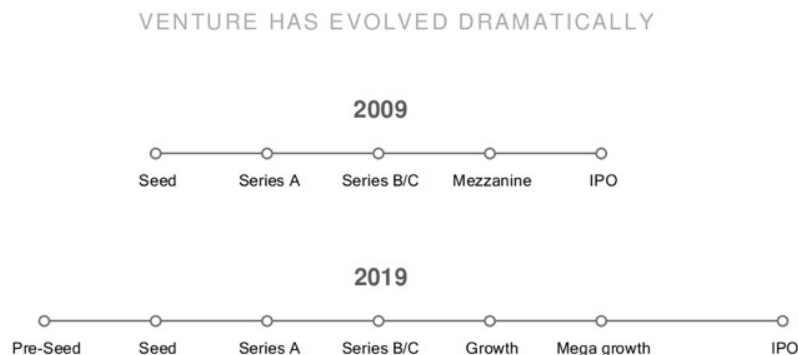
Two trends are converging:

(1) Institutional Investors have more and more cash to invest

(2) Corporations are willing to pay large premiums for innovative technologies, and their premium becomes even higher as the technology has more clients. (A simple example would be 1 user * 1x multiple = $1 premium paid vs. 2 users * 2x multiple = $4 premium paid vs. 3 users * 3x multiple = $9 premium paid. So a 3x increase in users may lead to a 9x increase in premium)

So, venture-backed firms have an incentive to keep companies private longer and have the readily-available capital to make it happen.

We borrowed the following chart from the folks at Kleiner Perkins to help articulate the expansion of the venture capital marketplace to meet the desire for companies to stay private longer. Ten years ago, venture capital investing was a straight-forward process with relatively few steps. Today, because many venture-backed companies are staying private for longer, the Growth and Mega growth rounds have replaced traditional IPO funding.



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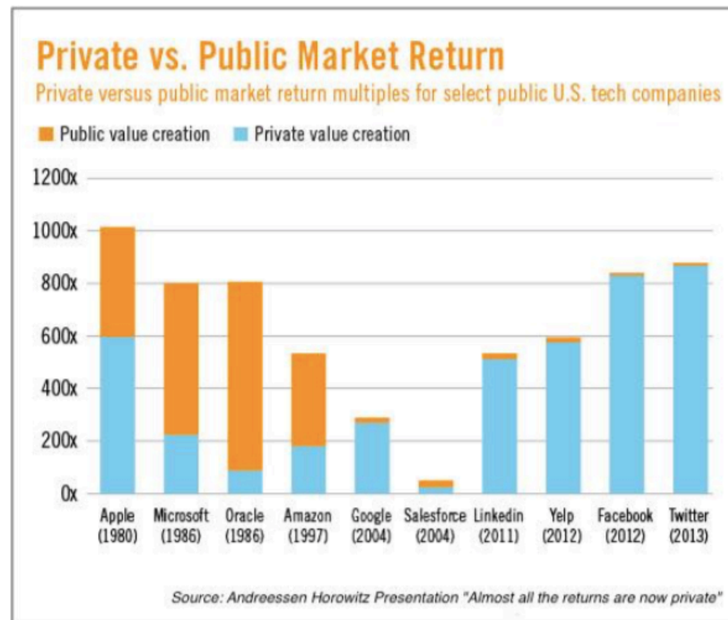
Observation 4: **. . . And Venture Capital is Now Capturing What Used to Be Public Returns, Even When Companies Do Go Public**

The venture firm Andreessen Horowitz provided the chart below a few years ago. It shows that much more value creation is captured by private investors than ever before. An IPO used to be a step in the process of growth for new companies, allowing for significant upside for public-market investors, but now it is largely just an exit strategy after the venture-firms have captured as much value as possible.



For venture-backed firms, the choice is simple:

(1) Get big-enough to be acquired by a larger firm and cash-out

(2) Stay private for as long as possible, and go public simply as means to monetize earlier investors

In either scenario, the value is captured by the founders, the venture firms and the institutional investors. Meanwhile, those investors seeking outperformance in the public-markets will not be realizing it.

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Observation 5: **Lyft's Early Investors Benefitted Tremendously by Staying Private Longer**

Here is a quick summary of Lyft's funding rounds with information provided by Pitchbook:

Round	Date	Price	Raise Amount	Pre-Money	Post-Money	IPO ($)	Years to Exit	IRR	Gain (x)
IPO	Mar-19	$72.00	$ 2,340,000,000	$ 20,000,000,000	$ 22,340,000,000				
Series I	Jun-18	$47.35	$ 999,900,000	$ 14,000,000,000	$ 14,999,900,000	$72.00	0.8	69%	1.5x
Series H	Mar-18	$39.75	$ 1,700,200,000	$ 10,000,000,000	$ 11,700,200,000	$72.00	1.1	72%	1.8x
Series G	Jul-17	$32.15	$ 600,000,000	$ 6,900,000,000	$ 7,500,000,000	$72.00	1.8	57%	2.2x
Series F	Feb-16	$26.79	$ 998,300,000	$ 4,500,000,000	$ 5,498,300,000	$72.00	3.2	36%	2.7x
Series E	Mar-15	$19.45	$ 916,100,000	$ 2,000,000,000	$ 2,916,100,000	$72.00	4.1	38%	3.7x
Series D	Apr-14	$10.13	$ 250,000,000	$ 750,000,000	$ 1,000,000,000	$72.00	5.1	47%	7.1x
Series C	May-13	$4.25	$ 61,500,000	$ 215,000,000	$ 276,500,000	$72.00	5.9	62%	16.9x
Series B	Jan-13	$2.10	$ 14,800,000	$ 95,000,000	$ 109,800,000	$72.00	6.3	75%	34.3x
Series A	Sep-11	$0.76	$ 6,200,000	$ 22,900,000	$ 29,100,000	$72.00	7.6	82%	94.7x
Seed	Aug-10	$0.23	$ 1,400,000	$ 5,400,000	$ 6,800,000	$72.00	8.7	94%	313.0x

In the pre-2000s era, LYFT would likely have gone public before it hit $1 billion in valuation – somewhere between their Series C & D rounds. But, because of the availability of mega growth capital, Lyft had five (5!) more venture capital rounds, raising an additional $5 billion before going public.

Round	Date	Price	Raise Amount	Pre-Money	Post-Money	IPO ($)	Gain (x)	Years to Exit	
IPO	Mar-19	$72.00	$ 2,340,000,000	$ 20,000,000,000	$ 22,340,000,000				
Series I	Jun-18	$47.35	$ 999,900,000	$ 14,000,000,000	$ 14,999,900,000	$72.00	1.5x	0.8	<---50% Gain in Price

Even less than 1 year ago, Lyft raised $1 billion at a $14 billion valuation (7% dilution). With this new cash, Lyft doubled their revenue to $2.2 billion in 2018, but increased its burn rate to a loss of $919 million. Lyft essentially spent the entire $1 billion raise on marketing initiatives to increase ridership, but it worked out great for them as they were able to raise their exit price by 50% in less than one-year!

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<u>Observation 6</u>: **Early-Stage Investors Earn Huge Returns. Late-Stage Investors Deploy More Capital.**

For private-market investors, there is a massive difference in returns between early-stage and late-stage fundraising rounds. Those investors willing to be 'illiquid' for longer realize much greater returns. For a 7-8 year holding period, the return was nearly 100x the invested capital, while those invested for 1-year only realized a 1.5x return:

Round	Date	Price	Raise Amount	Pre-Money	Post-Money	IPO ($)	Years to Exit	IRR	Gain (x)	
IPO	Mar-19									
Series I	Jun-18	$47.35	$ 999,900,000	$ 14,000,000,000	$ 14,999,900,000	$72.00	0.8	69%	1.5x	<-- One Year Hold Period
Series H	Mar-18									
Series G	Jul-17									
Series F	Feb-16									
Series E	Mar-15									
Series D	Apr-14	$10.13	$ 250,000,000	$ 750,000,000	$ 1,000,000,000	$72.00	5.1	47%	7.1x	<-- Five Year Hold Period
Series C	May-13									
Series B	Jan-13									
Series A	Sep-11	$0.76	$ 6,200,000	$ 22,900,000	$ 29,100,000	$72.00	7.6	82%	94.7x	<-- 7-8 Year Hold Period
Seed	Aug-10									

This difference is consistent with what we would expect, given the nature of value creation, risk at each stage, and the compounding of the high returns for close to a decade.

The early-stage investors earn huge returns with massive compounding effects, but the rounds are smaller and therefore limited dollars can be deployed and the capital must be tied up for 7-10 years. These investors also face the risk of companies that don't make it. Luckily, a good early-stage venture firm can source a diversified portfolio of great companies and can deploy as much capital as most investors will want to allocate.

The later-stage investors earn good returns and can deploy large amounts of capital in later rounds to more established and less risky companies, and without having the capital tied up as long. Importantly, the expected return for later-stage investments over time (like a decade) is much lower because there are only a limited number of companies available for such large rounds, and therefore returns are lessened by having the capital sit uninvested between deals. For most investors, however, the biggest problem will be gaining access to later-stage managers.

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Observation 7: **Early-Stage VC's and Late-Stage VC's Both Get Paid.**

What the Lyft history highlights is how Venture Capital is evolving into two worlds – those who find and build companies from the early stages and those who are primarily focused on asset gathering for large late stage rounds. Let's look at how the GP's did:

Round	Date	Price	Raise Amount	Pre-Money	Post-Money	Gain (x)	Years to Exit	Gain (Round)	To Investors	To GP	
IPO	Mar-19	$72.00	$ 2,340,000,000	$ 20,000,000,000	$ 22,340,000,000						
Series I	Jun-18	$47.35	$ 999,900,000	$ 14,000,000,000	$ 14,999,900,000	1.5x	0.8	$ 520,548,446	$ 416,438,756	$ 104,109,689	<-- Asset Gathering
Series H	Mar-18										
Series G	Jul-17										
Series F	Feb-16										
Series E	Mar-15										
Series D	Apr-14										
Series C	May-13										
Series B	Jan-13										
Series A	Sep-11	$0.76	$ 6,200,000	$ 22,900,000	$ 29,100,000	94.7x	7.6	$ 579,135,891	$ 463,308,713	$ 115,827,178	<-- Business Building
Seed	Aug-10										

Notice how <u>the VC firms made about the same total amount of money in the Series A round as they did in the Series I round</u>.

- The Series A VCs made all of their money because they identified something before anyone else and took the leap (the more traditional VC investor). The Series A VC only had to raise and deploy $6 million, but had to find the proper idea to back and spend 7-8 years nurturing the company.

- The Series I VCs made their money, because they could deploy lots of capital that would normally have come from the public markets, and they made their money in less than one year. It's easy to see why many venture firms have re-orientated themselves to serve the largest of institutional investors. Their core competency becomes raising large amounts of capital and deploying it into well-established, but growing companies. This latter VC group is the reason why public investors, and all but the highest of high net worth individuals and family offices, will never get to participate in that value capture.

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For investors, one conclusion is clear: strong portfolio returns require an increased allocation to private markets away from public markets, regardless of whether that investor is seeking alpha or beta. The Yale Endowment now allocates over 19% of their portfolio to venture capital and has been decreasing their exposure to real estate and private equity. Cambridge Associates has suggested that the best performing family offices will allocate 40% or more of their investment portfolio to private market investing

The more challenging decision is how to best deploy capital to the private markets. The very largest investors can choose between early-stage, business-building venture firms and the later-stage asset-gathering venture firms, but the vast majority lack the capital and professional networks to have this freedom. Instead, most investors should focus their efforts on identifying quality, early-stage venture capital managers with access to a diversified pool of the best companies and the skills to guide those companies to success.

The good news is that the evolution in the venture capital industry creates a great opportunity for early-stage venture firms like Kirenaga, as we focus on opportunity identification and business creation to the benefit of the founders, the investors and the community at large. The 'name-brand' firms are raising larger and larger amounts of cash to replace the IPO markets, which means that certain early-stage companies, particularly those in non-prime venture markets, will struggle to raise capital because they need to be further along with much bigger rounds for the 'asset gathering' venture firms to be interested.

We hope you find this information enlightening and helpful, and as always, please reach out to us with any questions or comments. We love to hear from you.

Stay Sharp,

David Scalzo Terrance Berland

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