North Sky
CAPITAL

Fourth Quarter 2014

Quote of the Quarter

"For Series A rounds, $12 million pre-money is the new $6 million pre-money."

– prominent venture capitalist at a recent annual meeting we attended

Yearend Wrap-up

Overall, 2014 was another very good year, with significant exit activity across our more mature funds and additional distributions to investors. Our more recent funds also made tremendous progress:

- **Alliance Fund I** – energy infrastructure, 2010 vintage, multiple liquidity events, on track to hit a 12% net IRR
- **Clean Growth Fund III** – cleantech secondaries, 2013 vintage, significant new investment activity, several earlier than expected exits, currently 20+% net IRR
- **PEP V** – small buyouts and growth equity, 2014 vintage, fund manager selection nearing completion, first co-investment completed, a very strong start

We believe these three funds are well-positioned for the current investment environment.

In contrast, we remain cautious about some other private investment areas, namely mega buyouts (priced to perfection/too much leverage) and early stage venture capital (volatile/wide dispersion of potential outcomes). In the USA, valuations have been rising steadily across private and public equity markets, perhaps to extremes in certain segments. We have seen early stage venture rounds move sharply up in price over the last 18 months, and the same is true for large buyouts and late stage rounds of buzzworthy venture-backed companies like Uber, Box and Theranos. History is repeating itself as hedge funds are now crossing over again to invest in private companies in "pre-IPO" rounds. Interestingly, a few late stage VCs are also crossing over into the public market to invest in fallen angels. In this tumult lies opportunity.

So-called "Private Equity" Funds that Offer Liquidity

From time-to-time, we receive inquiries about building a liquidity option into our funds. These inquiries ebb and flow, but we have experienced a spate of recent inquiries recently and thought it worthy of commentary today.

Private equity is inherently illiquid, and it is this trait that allows private equity funds to invest with a multi-year time horizon and generate a better-than-public-equity return. Examples of this are (a) investing in a startup company that is developing a promising cancer drug, which will take 4-7 years to be developed, clear its drug trials, receive FDA approval and be accepted by the medical community and (b) investing in the #1 or #2 manufacturer in a highly-fragmented industry and using that company as an acquisition platform to roll-up 5-10 competitors, thus creating a more formidable, efficient and valuable company. Creating that value takes time, but it also delivers outsized returns.

Any product marketed as a private equity fund with liquidity simply is not a private equity fund. Rather, such a fund is a hybrid of private equity investments mixed with something else (usually Treasuries and/or investment grade bonds) which will produce a hybrid (lower) return. Hybrid funds often keep at least 25% of investment capital in highly-liquid, AAA-rated securities, earning perhaps 30-300 bps. This allows the fund manager to meet occasional redemption demands from investors. Of course, it would not allow the fund manager to meet all such demands if all investors run for the exit at the same time—the nightmare scenario where the investor thinks he had a liquidity option but in reality only 25% of the investment is available immediately. In this event,

the fund manager is then faced with selling illiquid assets under fire sale conditions unless the manager can calm the investors and stop the run on the fund.

It also should be noted that liquid securities may comprise a much greater percentage of invested capital in the first few years as private equity investments are being identified and selected—especially if all the capital is called upfront, rather than called as investments are made. Even giving such a fund the benefit of the doubt, the math exposes the problem very quickly. Assuming (absurdly) that all the private equity investments could somehow be made immediately at the inception of the fund and were held until the final liquidation of the fund, that would mean 25% of the fund earns 0.3-3% via the liquid securities and the remainder earns something like 15% via the real private equity investments. Even in this best case scenario, you should expect a sub-standard private equity return like 11-12% (and that is before deducting the additional fees!). A more likely scenario—where the private equity investments are scaled up in the first few years and exited over the last few years of the fund's life—would magnify the impact of the low return earned on the liquid securities.

The fees of a hybrid fund are higher too, given the additional custody, trading, legal and other related costs of administering this complexity. Often such products are marketed to retail clients through wealth management platforms, adding yet another layer of fees (upfront loads and ongoing commissions), further reducing the net return to the investor compared to real private equity funds. Additional fees also may apply upon an early exit. So, when you step back to objectively review this concept, you see upfront fees, a higher annual fee, an exit fee if you invoke your liquidity rights and a lower expected gross return due to mixing bonds and private equity. All of which signals a lower net return compared to the real thing. Such hybrid products therefore tend to have a narrow target audience, usually wealth management clients of big Wall Street firms.

We understand the simple psychological allure of having ALL of your investments liquid. We in fact created a hybrid structure—part bonds, part private equity—in 2000 to meet the specific needs of a large institutional client. Since then, we have regularly considered, analyzed and uniformly dismissed variations on this theme because the outcome is always the same. You can have a private equity return or you can have liquidity but you cannot have both. Adding an element of liquidity always reduces the return profile of the fund. And the more certain you are of liquidity, the lower the expected return. The development of a secondary market for private equity interests in recent years has helped but still compromises must be made due to additional transaction costs and, more importantly, the 10-20% discount to Net Asset Value that a seller normally must accept upon early exit (or worse if the buyer knows a sale must be made because there is a run on the fund). Secondary sales also tend to take weeks or months to be negotiated and closed. The discount to NAV would be bigger and the time to close would be longer in the event of another significant stock market downturn. In that event, the liquidity described in the glossy marketing brochure becomes illusory.

For most of us this is an academic discussion. Rational investors recognize that they can afford to keep some portion of their assets illiquid in order to achieve greater portfolio diversification and a higher overall return. That is the reason most investors allocate only 5-20% of their portfolios to illiquid investments, leaving the rest of their portfolios available to draw upon as needed.

Over the years, we have seen numerous attempts at providing liquidity within a private equity fund, with modest improvements in recent years in terms of cost and tax reporting. But in the end the result is the same: lower returns, higher fees/complexity and potential disaster should all investors run for the exits at once.

Impact Report

We have now posted our 2014 Impact Report to our website and encourage you to check it out. In addition to previous private equity investments, several of the infrastructure projects from Alliance Fund I are shown starting on page 14.

Upcoming Events

We are regular speakers and attendees at key industry conferences. We hope to see you at these events in 2015:

January 18-20 — **Made in America – 12th Annual Conference**
Las Vegas, NV www.frallc.com/conference

February 18 — **Scott Barrington speaking at CFA Insight Series: Impact/ESG Investing**
Minneapolis, MN

April 13-15 — **Intergrowth 2015**
Orlando, FL http://intergrowth.org

May 4-6 — **US SIF – 5th Annual Conference**
Chicago, IL www.ussif.org/conference

November 3-5 — **SRI Conference 2015**
Colorado Springs, CO www.sriconference.com

November 8-11 — **61st U.S. Annual Employee Benefits Conference**
Honolulu, HI www.ifebp.org

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