



Rethinking Private Equity Structures to Leverage Returns in Resource Productivity & Efficiency

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What was Broken with Sustainable Investing?

▪ Poor Branding

- “CleanTech”, “GreenTech” and “Sustainability” are too environmental or climate-change focused;
- Need clearer financial connection between resource risks and economic returns

▪ Misunderstood Risks

- Capital formation, scalability and bankability were the big risks; few deal structures addressed them;
- Government policies and large governmental investments skewed results, both accelerating and decelerating returns, but in unpredictable ways

▪ Wrong Investment Model

- The industry applied a post-1995 IT venture model (“your winners will pay for your losers”) instead of an early 1980’s paradigm (“can’t take risk of loss of capital”);
- The post-1995 model assumes capital light, short-term outcomes based on inefficient markets and preferential deal access. To succeed, it requires companies to achieve significant near-term revenues and 40X+ net income multiples.
- The right model was a small number of syndicated club deals supported by deep industry expertise and capital to scale what they were building

▪ Too Many Undercapitalized Deals

- The industry applied a model suited to Internet investments – make lots of early bets, rely on the companies for sector expertise, look for Black Swans, and hope that you either don’t need much capital or that someone else’s capital can be used to scale the business – it didn’t work.
- Limited Partners spread their capital across too many funds that then spread that capital across far more companies than the capital ecosystem could support.
- Family offices compounded the problem by adding more sub-scale funds, lacking domain expertise that often led to yet more small investments.
- Corporations compounded the problem, adding yet more \$100M in size funds doing early stage deals

Additional Issues re Private Equity

- **Fees are Too High and Too Little Transparency**
 - Fees too high, particularly management fees that can be earned regardless of outcome
 - Most LPs don't know exactly where their fees are going – GPs require far greater compensation transparency of their portfolio companies than they are willing to provide to LPs about their own
 - As a result, costs can be out of proportion to the value the private equity/venture personnel actually provide
 - Add overlay of consultants and other advisors and fee load can approach 40%
 - GP's can do their bit to enhance the environment in which their companies operate--but, they shouldn't get paid as if they created the environment themselves
- **Funds are Too Big or Too Small**
 - Big funds tend to mean big fees because management fees are charged whether the fund does well or poorly, but small funds increase administrative load and transaction fees
 - VC-backed companies are encouraged to swing for the fences (statistically correct, but generally misapplied)
 - Fewer, bigger relationships is preferred model, but really hard to do in a sector where there are virtually no GP's with the track record to justify that type of relationship
 - But, small funds lack scale to get to the finish line, lack sector expertise in complex areas
- **Brands matter**
 - Brand loyalty is high both among LPs and potential portfolio companies, so innovation is hard for newcomers and institutions getting in unless you can really establish instant credibility
 - Best performing VC firms view their roles in terms of business development, recruitment, executive coaching rather than just investment; but those roles are easier to talk about than earn
 - The skills needed to provide that level of assistance are scarce and not cheap, most LPs are hugely under-resourced to provide those skills themselves, but due to lack of transparency most also fail to recognize what good talent could be accessed for

Why is Resource Investing so Hard to Fix?

- **Investors still misunderstand technology development cycles**
 - They attempt to apply capital light software models to industries still in the inventive, infrastructure and factory building stage, capital light only works where adoption rates are in exponential growth
- **Institutional Investors want to pursue direct investments but tend to fall short**
 - Current institutional direct investment model has theoretical access to scale, but rarely deploys it; it often lacks strength and depth of team and, frequently plays the role of late stage capital for still nascent companies
- **New Strategic Directions Must be Set at the Top/Fear of Failure Remains High**
 - A strategic investment commitment of this nature must originate at the top. Only the CIO, the CEO and Board typically can envision, craft and execute such a new strategic direction.
 - No LP really wants to act as the Guinea Pig for significant change, so real change probably requires a consortium approach involving a number of large LPs acting together
- **New Structural Models Would Enhance Outcomes Significantly**
 - The typical 2/20 and ten year fund model is simply not an optimized vehicle for the task at hand. It will require a longer term, more nimble, and more collaborative investment vehicle.
 - Investing in resource transitions straddles several conventional asset classes, rendering the traditional venture, private equity, infrastructure, and debt categorizations obsolete.
- **Investment Models must address capital risk involved and produce the returns that once characterized oil and gas investments**
 - The best new models combine infrastructure investment in yield with equity investments in capital growth, but separate the yield pool from the growth pool while overlaying a combined investment management philosophy

Potential Solutions

- **Shrink:**
 - Number of decisions, number of relationships managed, and number of people to oversee
 - BUT, implies fewer bigger firms (see problems)
- **Be More Direct:**
 - Hold a concentrated set of assets you understand deeply on a direct basis
 - Do it yourself – hire your own world-class team (either internally or by sponsoring captive entity)
 - Go indirect, but focus on a handful of world class people and let them find the best opportunities
 - Automate the decision and investment process through better information
- **Be More Opportunistic**
 - Find opportunities where the target companies cannot rely on PE managers alone to reach commercial scale, i.e. in capital-intensive industries, such as energy innovation.
 - Understand sector tipping points more clearly and structure investment vehicle to withstand systemic delays and risks that can be overcome with capital and scale
- **Bet on Inevitability**
 - “We believe that a subset of the green energy and technology companies of this generation will go on to be the most profitable companies for generations to come.”
 - BUT, understand that the biggest risk to inevitability is delay, so focus on areas where adoption curve for technology is beyond 1% of addressable market and growing exponentially
- **Team up**
 - Don't go it alone, find ways to collaborate more closely with other LPs facing same challenge of capital deployment into this yet not fully understood sector

Structural and Team Opportunities

- ***Assemble an All-Star team.*** Now is the best opportunity in a decade to pull together a great team of the highest individual capabilities. We believe this opportunity has a short shelf life.
 - Note: Most experienced venture capitalists know better than to create their own companies when the outside companies they are investing in fail to produce results; our core skill is identifying investments not running companies
 - Therefore, the desired structure must attract the best talent that would otherwise have created its own firm, if you can't attract and retain that level of talent don't bother
- ***An Increasing Number of Technologies are Producing Earnings and Growth Now.*** Therefore, although this is the toughest of times to create and back a new team, it is also likely the best of times.
- ***A New Team can establish itself as the Category Leader.*** It is now possible for a new entrant to establish itself at the top of the food chain and obtain preferential access to the best of deals – because existing brands have struggled a major new player has credibility.
- ***Heightened Risk re Fossil-Based Energy, Divestiture Movement Gaining Ground and Investors are struggling with Correlation Risk in their Portfolios.*** For those who act, they benefit because the asset classes at risk are too large and the asset classes to which one might want to migrate too small to allow the majority of investors to safely transition.
- ***Sustainable Investing is an Industry Ripe for Investment Vehicle Innovation.*** Transformational changes are easier in a world of flux than in a world of comfortable stasis. Flux is favorable way to describe the disarray that reflects the sustainable investment community today.

A Structure to Address the Opportunity

- *Allow for success:*
 - *The issue isn't about GPs getting rich, its about unsuccessful people getting rich on fees. Focus on novel structures that address long-term objectives and retain L.P. influence over increasing success, with off-ramps to allow LP's to match their commitment to actual success;*
 - *Start with budgeted fees, LP's should have same influence on fund compensation as GP's have on their portfolio company compensation;*
 - *Provide the necessary upside – successful portfolio CEO's get fabulously wealthy, it's ok for GP's to get meaningful carry on success;*
- *Manage to Limit Failure:*
 - *Negotiate long term financial arrangement that allows for fewer, bigger, more meaningful relations, but also allows you to walk away from failures;*
 - *One method is to focus deployment of capital on set of clearly defined investment themes able to generate returns today, each of which is agreed upon before capital is invested.*
 - *Provide theme-specific GP upside to attract highest level talent specific to that theme;*
- *Be a Real Partner:*
 - *Make capital deployment a vastly more partnered and collaborative model in which the investment themes are vetted by the limited partners and relevant corporate participants.*
 - *Incorporate a defined set of on and off-ramps to manage risk over time as the investment team proceeds against the approved investment themes.*
 - *Allow Fund management to exist as an independent team, in order to favorably compete for best talent, but tie them to a longer-term orientation and an organizational structure that permits individual success but only to the degree it is fully consistent with overall economic performance and the longer terms interests of both GP and LPs.*
- *Treat your holdings like Berkshire Hathaway:*
 - *Focus not on quick liquidity but on building long term holdings*
 - *Create liquidity where needed structurally, but hold liquid positions for long-term gain;*