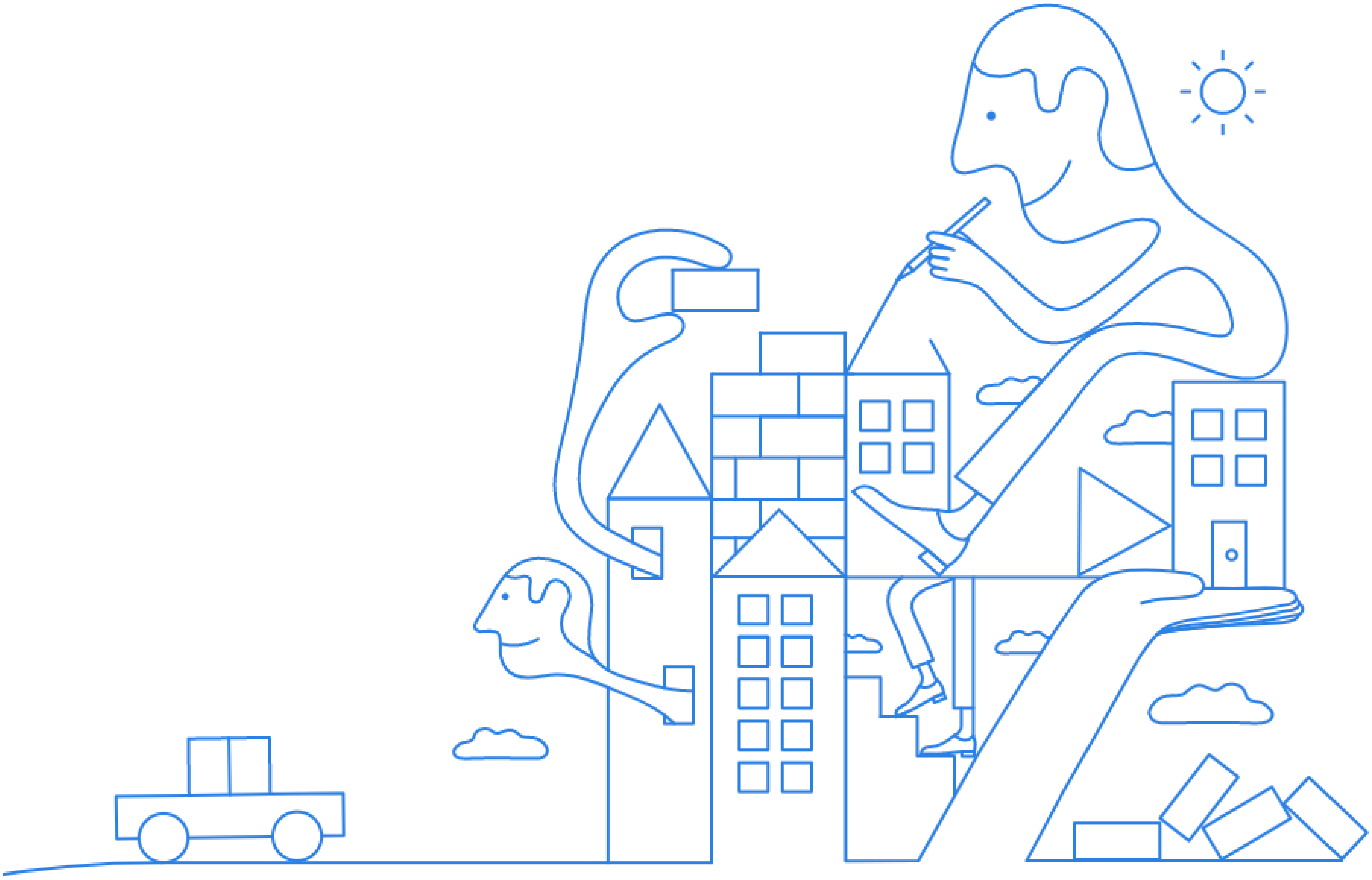
Disrupting Investors' Own Game

What SoftBank's $100 billion Vision Fund means to the future of investing.

By Craig Shapiro and Morgan Housel, The Collaborative Fund



It was hard to fund a startup when Phil Knight started Nike in 1964.

You had to know the right people or come from the right family. Phil Knight didn't, and wasn't. So even as Nike prospered, Knight had to cobble together short-term bank loans to keep the company alive. He wrote in his biography:

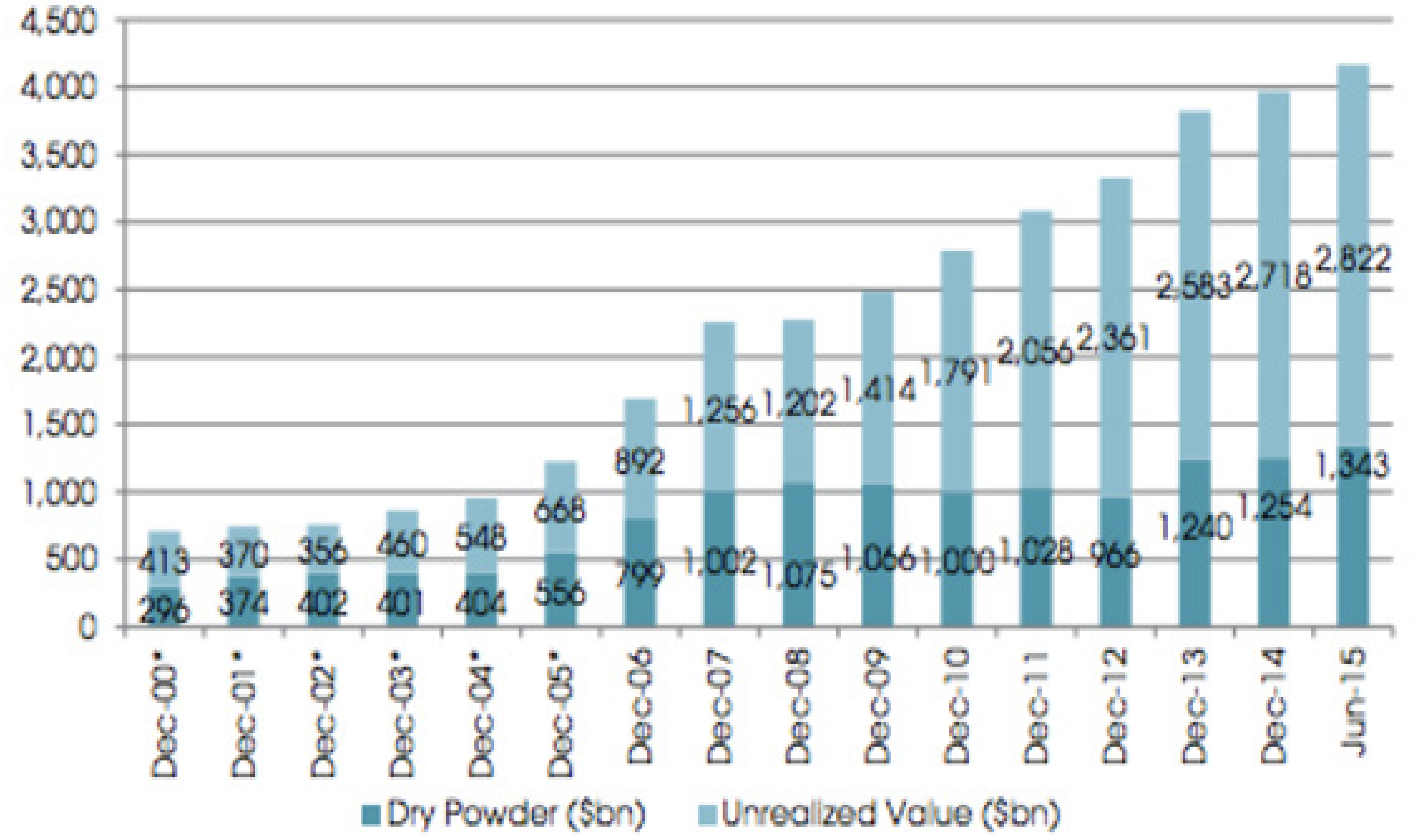
> There was no such thing as venture capital. An aspiring young entrepreneur had very few places to turn, and those places were all guarded by risk-averse gatekeepers with zero imagination. In other words, bankers ... I'd built this dynamic company, from nothing, and by all measures it was a beast— sales doubling every year like clockwork— and this was the thanks I got? Two bankers treating me like a deadbeat?

Funding a business is now exponentially more efficient. Private equity and venture funds control more than $4 trillion. The Phil Knight of today would be turning piles of money away.

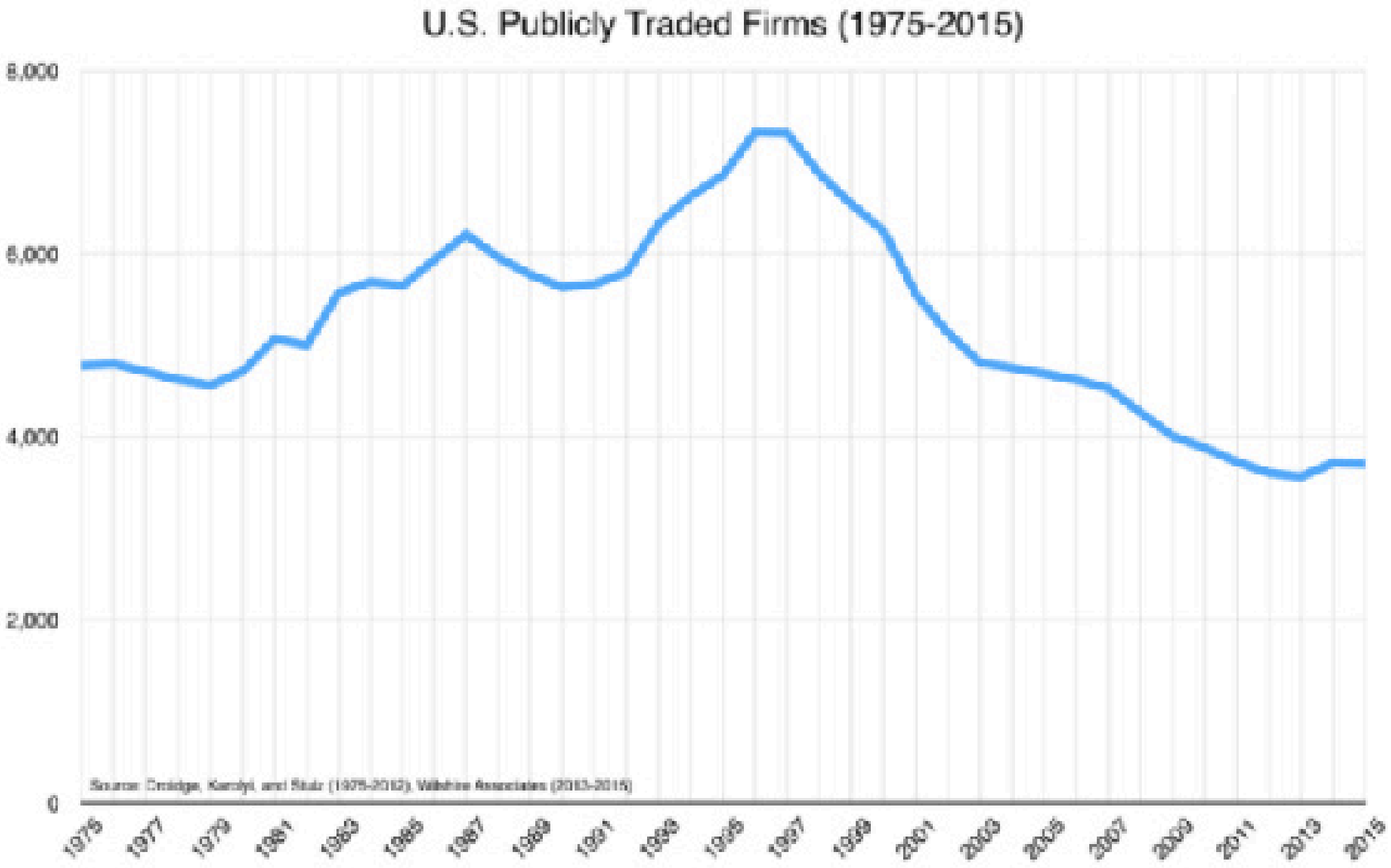
It is hard to exaggerate how much capital markets have changed in the last few decades. From a world where startups relied on bank loans before maturing enough to IPO, we now live in a world where neither of those funding sources are necessary.

This chart, from Preqin, tells one side of the story:

Fig. 5.1: Private Capital Assets under Management, December 2000 - June 2015



And this chart, from the U.S. Chamber of Commerce, tells the other side:



So much private equity capital now exists that it is possible, for the first time in generations, for a large, successful company to remain private indefinitely, without the aid of excessive debt or family money.

This trend happened fast. It blossomed over the last 15 years, when most investors were focused on the fallout of two bubbles. But we think it's one of the most important investing trends of our time, affecting everything from valuations, to exits, to retirement account returns for individual investors.

And the trend has gone into overdrive this year with one development: SoftBank's $100 billion Vision Fund.

It's hard to grasp how much money $100 billion is:

- SoftBank's Vision Fund is larger than all U.S. IPO proceeds in the year 2000, or from 2010-2012.
- It is, on its own, larger than the aggregate assets under management of roughly the bottom 80% of private VC and private equity funds, and more than the combined value of every venture fund raised in the last two years.
- It is more than twice the size of the combined value of the next five largest tech funds in history.

The Vision Fund's success or failure won't be known for years. But the outcome could have a profound impact on capital markets, creating a tipping point where private capital either peaks, or breaks through into a new era of mega-funds that keeps large companies away from public markets for even longer.

This short report will argue:

- Why this is happening now.
- How it impacts the entire capital stack.
- A valiant attempt at predicting how it'll play out.

1. Why This is Happening Now

Investing is based on rules and formulas that were set hundreds, even thousands, of years ago. But the industry has evolved tremendously in the last 50 years.

We break it up into three eras:

Pre-1980: Not technically advanced enough to distribute capital on a large, global scale.

Investing used to be a local affair. With the exception of government bonds, investors didn't have the information or diligence capabilities to make meaningful investments in companies outside their local domain. Capital markets are heavily dependant on communication technology, which by modern standards were archaic just a few decades ago. Bill Bernstein wrote about capital markets before 1900:

> They matched borrowers and lenders only by word of mouth or dumb luck—even though the two parties most often lived in the same city. As a result, both the users and suppliers of capital could not easily ascertain the true cost of capital, and because of this uncertainty, both sides were reluctant to transact.

Things got much better in the 20th Century. But for most of the 1900s information did not flow nearly as freely as it does today. Part of this was technology: The SEC didn't keep corporate documents in electronic form until 1984. Part was regulatory. Interstate regulations kept bank lending at the local level until the 1980s.

The result was a capital system that, compared to today, did not travel far or scale, even if it was liquid. People invested in what they knew and who they knew. This was true even for public stock markets, which as a share of GDP were less than half the size 50 years ago as they are today.

1980-2000: Markets became technologically advanced enough to blossom, but not experienced enough to understand the downside of being exposed to public scrutiny.

The explosion of technology in the 1990s made investing in companies thousands of miles from your home possible. An investor in Shanghai had as much information about Coca-Cola as an investor in Atlanta, which was unthinkable even 10 years before. Technology also made it possible to scale mutual funds, index funds, and 401(k)s.

The embrace of public markets and the surge in IPOs that came with it was, at its core, an embrace of participating in the worldwide community that greater technology enabled, and a belief that the full democratization of information benefited everyone. The goal of most entrepreneurs was to go public as soon as possible. And the goal of most investors was to one day own their shares.

2000-present: Post-bubble realization of the benefits of playing your cards close to your chest.

As public markets grew and became more competitive, they became increasingly short-term oriented, making it harder for investors to participate in games other than trading with a time horizon of a few quarters into the future. As investors became pressured to fit their performance inside of quarterly and annual periods, they began applying pressure on companies themselves to perform in ever-shorter time horizons. (More on this trend here.)

The result was a system that became less productive for almost everyone. Investors became frustrated by public markets that increasingly resembled a casino. Businesses became frustrated by markets that viewed them as gambling chips, with a cynical spotlight on their every move.

So, more people on both sides began staying private.

Staying private reduces both the ticking clock of time pressure, and the public spotlight that can be hard to navigate in endeavors that are governed by uncertainty.

Brain, an AI robotics company that recently took an investment from the Vision Fund, said it was excited to work with SoftBank as "a long-term strategic partner." Not something you often hear public companies say about their investors.

2. What's Happening Now

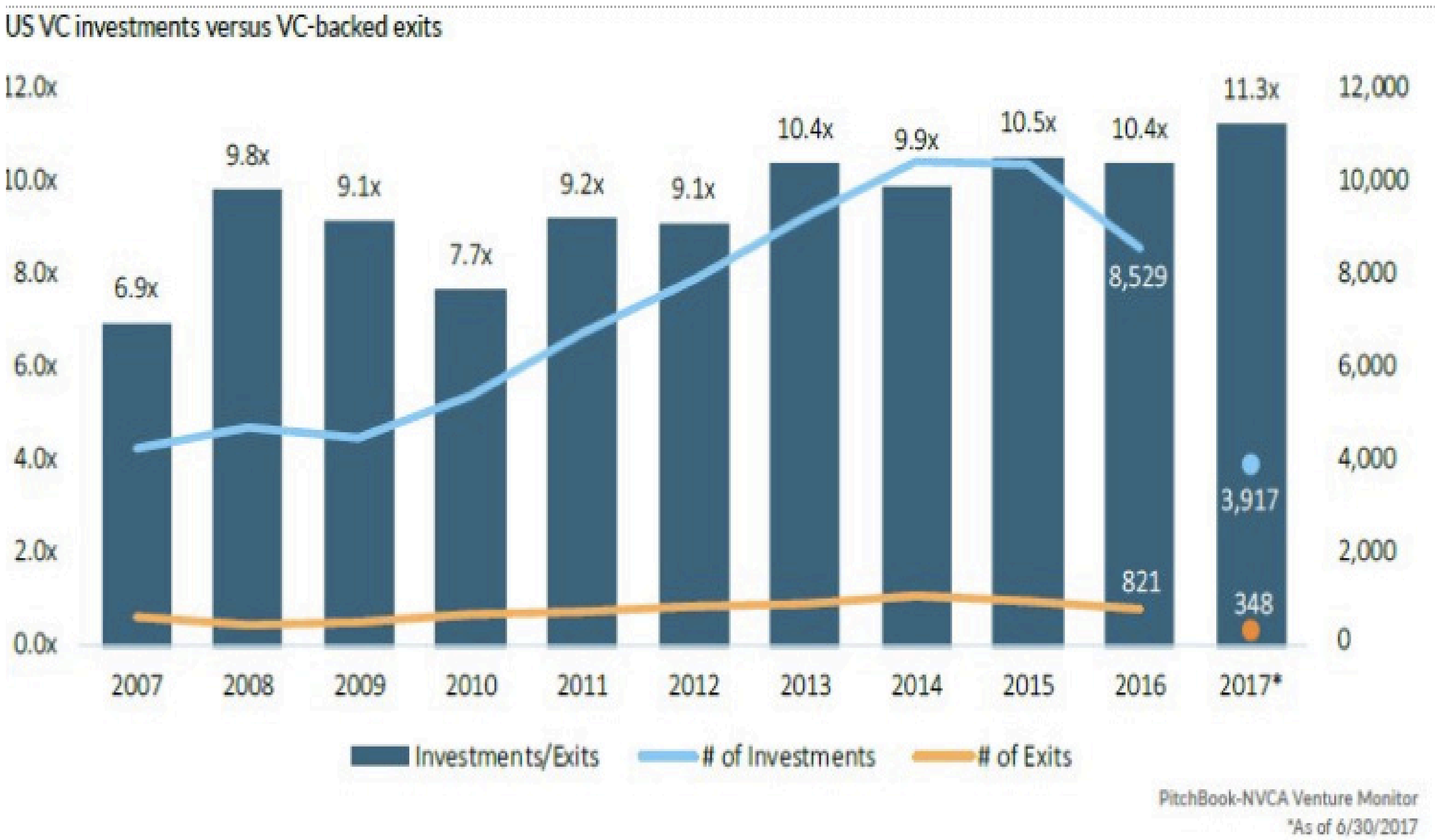
The Vision Fund's size could impact every part of the capital stack, in different ways.

For startups, the impact isn't direct, since the fund has a $100 million minimum check size. But more private capital for later-stage companies can have a trickle-down effect.

Higher valuations and later-stage companies staying private longer creates a high-profile world where formerly reclusive startups are suddenly on the cover of Fortune magazine. That rarely happened in previous decades. Investor Patrick O'Shaughnessy recently mentioned that for being a small sliver of total financial market assets, VC has received a staggering amount of attention from investors and the media. This is a new phenomenon, in part driven by companies like Uber and Airbnb drawing attention to the treasure and glamour of "startups" for companies that, in any other era, were publicly traded and considered mature.

The result, at the early stage, is a proliferation of funded investments. More people want to be entrepreneurs, more people want to be VCs, so the supply of both rises. The number of VC deals funded increased 2.5-fold from 2010 to 2014. Despite a pullback in recent years, funded deals per quarter are still running about double where they were seven years ago.

But an increase in funded investments hasn't translated into an increase in exits. As the number of venture deals rise, the number of exits has barely budged. Even with an expected multi-year lag, there's a disconnect between startups funded and startups exited:



The risk the Vision Fund poses for early-stage startups and investors is vague but real: A system that can sustain successful startups later into their lifecycle will draw more attention and spotlight, which draws more competition, which makes tangible results more challenging for everyone involved.

One public mutual fund manager told us: "Even though our core business is not private capital we've seen a substantial lowering of standards for the types of firms that get funding even at the angel level."

For later-stage growth equity, the Vision Fund's impact is more direct.

SoftBank has shown that it is not terribly valuation sensitive, and is willing to pay premium valuations for prized assets. Combine that with its size, and it's a formidable competitor for existing growth funds.

We asked a few investors in the space what they thought about the Vision Fund. Some of their anonymous comments:

"Valuations will become unnaturally inflated with SoftBank's presence. Whereas late-stage growth investors are valuation sensitive since they are worried about generating a solid multiple on their investment, SoftBank can pay higher prices since their focus is putting a massive check to work. It feels dangerous all around."

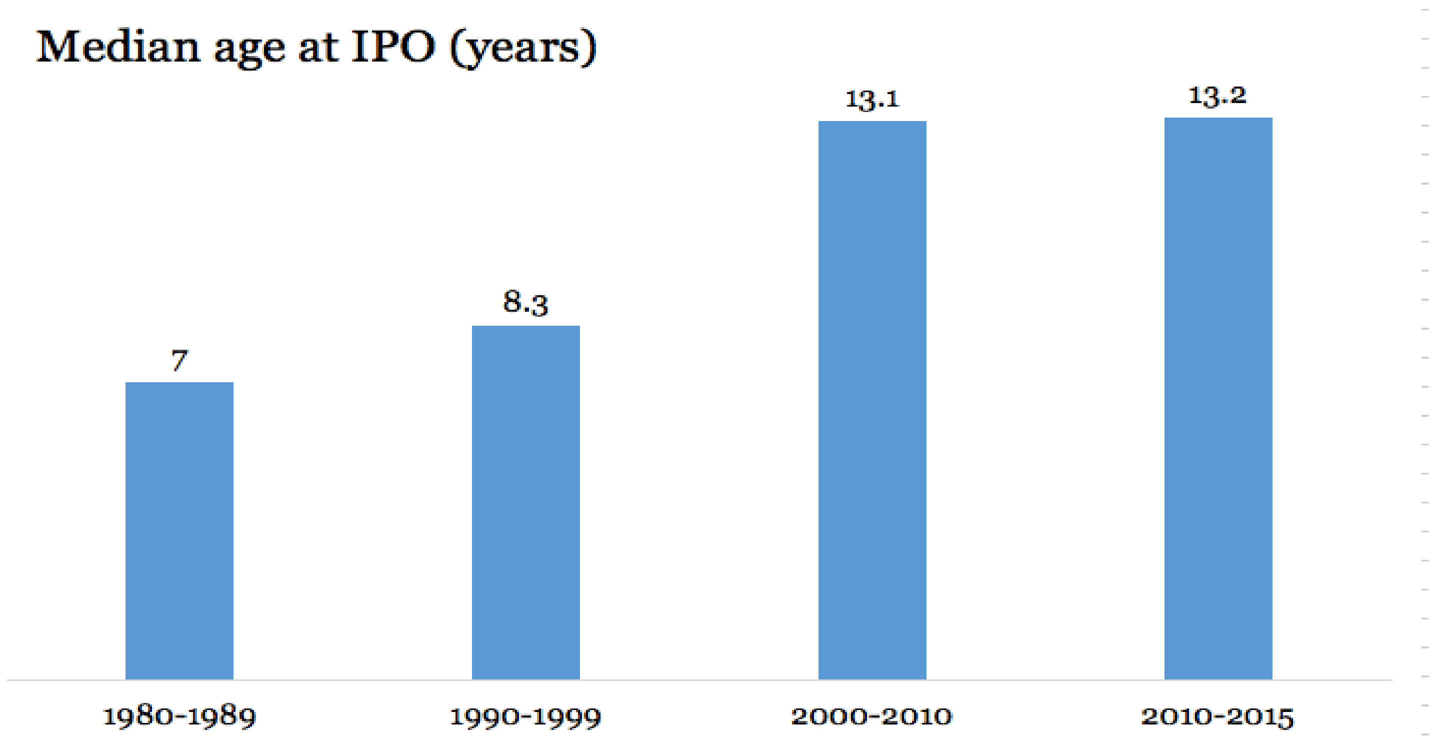
"That amount of capital, with that amount of pressure, in an ecosystem this competitive, with valuations this high...enormously interesting technology will develop as a result, but the net returns on invested capital will probably make the Vision Fund look like more of a philanthropy than an investment fund."

"Valuations in certain companies will become artificially high. We've been seeing this happen over the past few years with growth equity rounds, but this is next level. These high valuations will make exits for the performers that don't have the fundamentals to back it up increasingly difficult."

For public companies and public market investors, the impact might be most severe.

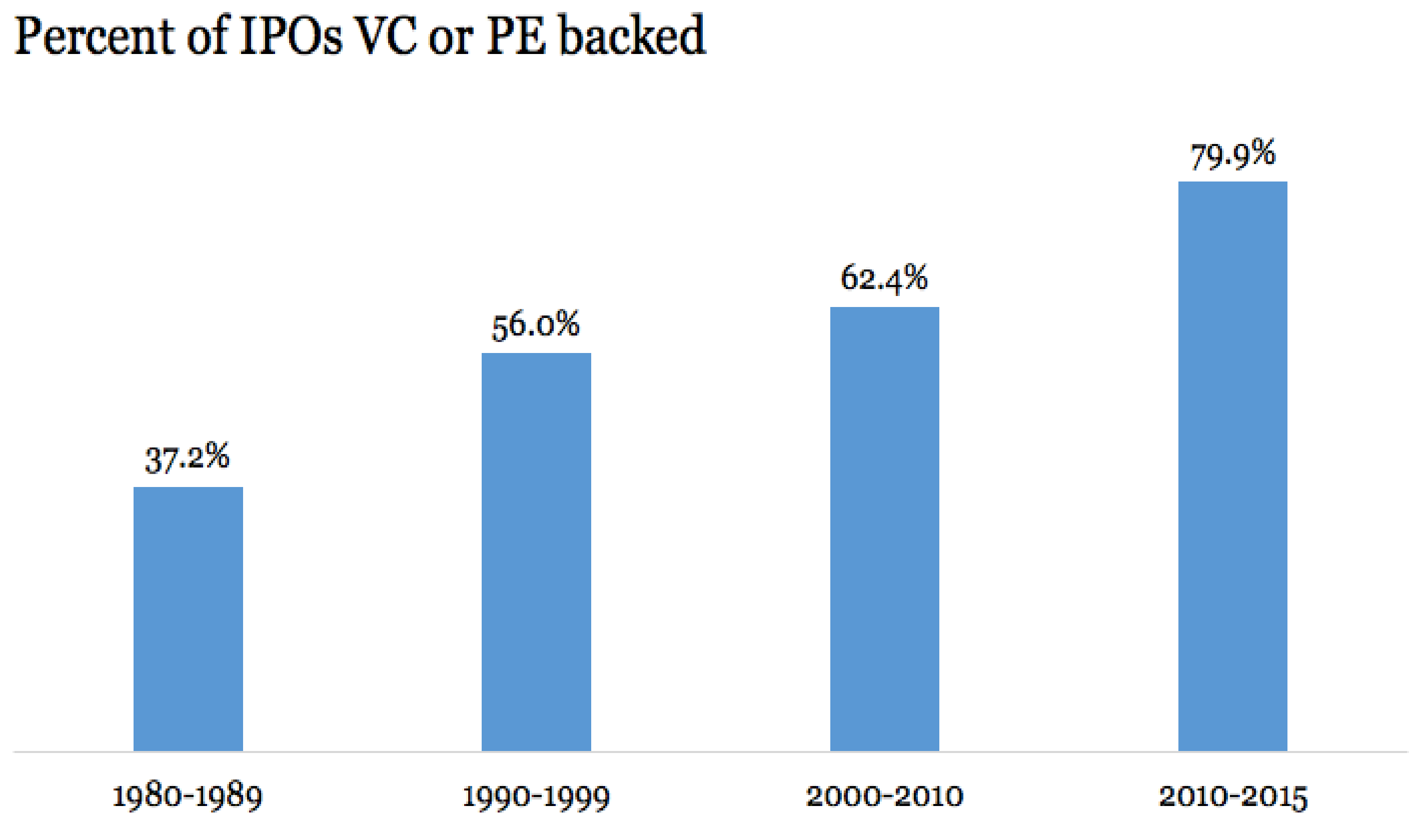
The Vision Fund has more assets than all U.S. IPO proceeds in the bubble year of 2000. It could, single-handedly, add enough capital to private markets to reduce or delay the number of companies going public.

We've already seen this as private-market assets rise. The median age a company goes public at has almost doubled in the last 30 years:



Source: University of Florida School of Finance

The rise has come as the number of companies going public are more likely to have taken VC or private equity financing:



Source: University of Florida School of Finance

Every investor we spoke with said they expect the Vision Fund to reduce or delay IPOs. A few of their comments:

"The existence of such a large private capital source should further reduce the incentive for high quality private firms to tap the public markets and subject themselves to the opinions of a set of investors not of their choosing."

"If SoftBank becomes a permanent capital holding company for start-up exits, they will also accelerate the trend of a decreasing number of public companies.

"I think SoftBank will have a hugely negative impact on exit timelines. Companies will stay private even longer, making it difficult for earlier investors to get liquid within their 10-year fund timelines. Valuations will also become unnaturally inflated with SoftBank's presence."

This could have some strange implications.

By limiting the supply of public equities while more individual investors need public equities to fund their retirement, public market valuations could shift higher. No one should ever use the phrase "permanently higher valuations," but a 50% reduction in the number of public companies combined with trillions of dollars of inflows from retirement investors will have an impact. The number of public fund managers whose returns have suffered over the last 15 years because they consistently saw markets as overvalued is too long to list. The Vision Fund may, by itself, increase that frustration and confusion.

It could also affect corporate governance. Part of the reason IPOs have declined is because the spotlight of being a public company in the age of 24/7 media can be an anchor on making tough, long-term decisions. But there is an upside to public disclosure: It forces honesty and an acceptance of reality in ways staying behind the scenes prevents. Fred Wilson once wrote:

> Being public is about being transparent, accountable, and owning up to the issues and dealing with them. I think it makes companies better. If you are losing your biggest customer, you have to tell the world and deal with the consequences. If you are making a leadership change, you have to tell the world and deal with the consequences.

Public companies are filled with all kinds of misbehavior. But would Uber's culture and previous leadership have maintained as long as it did if there was greater public disclosure on how the company operated? Would it be allowed to burn as much money as it has, or would public markets force it to find a quicker path to profitability?

3. What Happens Next

Size is the ultimate anchor to investment performance, limiting the pool of opportunities. One of the only investment firms to achieve lasting outperformance at over $100 billion of assets is Berkshire Hathaway. One example. And there will be statues built for Warren Buffett.

And Berkshire isn't directly comparable, because Buffett has an unlimited time horizon that lets him wait as long as needed to find opportunities. The Vision Fund has a five-year investment period and a 10-year lifespan.

Those constraints -- huge size and limited time -- are high hurdles to success. We would never count out or bet against any competent investor. But investing is about putting the odds of success in your favor. And the odds do not seem anywhere near SoftBank's favor.

The spotlight on the Vision Fund makes its success or failure particularly important, as it could tilt markets further in the direction of privatizing companies, or set an example of private assets growing too big for their britches, pushing markets back to more IPOs and publicly listed companies.

We'll be watching closely. And we're positioned for several outcomes at Collaborative Fund.

We are a private source of capital. But we've backed several companies that stand to benefit from the industry moving in different directions.

Kickstarter, Crowdrise, and CircleUp, for example, let individual investors back or invest in privately held companies. Public vs. Private markets is not black and white. There could be a new blurring of the two, where "private" companies raise capital from a broad group of public investors. It's more efficient than traditional venture fundraising, but not as public as an IPO.

The Long-Term Stock Exchange is remaking a whole new public stock exchange from the ground up. By aligning both investor and corporate incentives and actions around long-term thinking, LTSE is on a mission to fix public markets rather than see them continue to lose share to private investors.

Whatever happens, the world is changing. Old norms have been broken, and almost certainly won't return.

All investors back disruption and competition. Now it's hit our own industry.

More from the Collaborative Fund:

A look at why bubbles occur, and always will:

The Reasonable Formation of Unreasonable Things

How we responded to the biggest inventions of modern history:

What We Said When the World Changed

Why it's so hard to be a public company these days:

The Bad Side of a Good Idea