GreenHills Ventures, LLC.

GreenHills Ventures – “Aligning GP compensation with LP interest breeds trust and good returns for all and that includes our portfolio companies”

The Demise of the Management Fee in Venture Capital

August 29, 2016 J.R. Randall
http://ift.tt/2bLCO69

Since the advent of traditional early stage venture capital in the 1980s, the industry has been dominated by a dual-compensation model: a management fee, to pay for running the firm over its lifetime, and a profit carry, to give upside to the partners for their hard work.

Recently, a new crop of investors – myself included – has been leading by example in the charge to end the dual-compensation model: to drastically reduce or end use of management fees and instead rely on profit carry.

This charge is certainly not absolute, or applicable in 100% of cases. Many traditional venture capital funds – such as FF Venture Capital and Bullpen Capital just to name two I am personally a Limited Partner in – have strong, long track records and have produced excellent returns and the earned right to continue operating under whatever model they see fit.

But many – a majority of funds under management if some analyses are to be believed – do not have such sterling returns. In fact, more than half of traditionally structured VC funds may lose money. Contrast that with the returns of prominent angel investors and individuals, which are far higher, and it’s fair to ask: what gives?

The answer is that, in most cases, there are clear and compelling reasons for investors to push for a profit-carry only compensation model (less limited rights to charge investors for taxes and at-cost admin of course):

1) The 20% Management Fee Itself Can Cut Deeply into Returns

Different funds have different management fees, but if you are taking off a standard 20 cents for every dollar before you even put it to work, that narrows your margins room considerably. For a fund like FFVC routinely performing in the top-quartile (typically defined as 2.5X or above) it hardly matters. But for a hundred-million-dollar fund doing say 1.5X before fees are accounted for, it can make a huge difference in what investors see out of it.

2) Deal Leads Should Be Incentivized Fully by Their Deal Performance

As a deal lead, and an investor who also often serves on the board of his companies, introduces them to other investors, mentors, customers, investment banks, et al, I feel strongly that I should be compensated for strong deal performance. But, I feel equally strongly that taking compensation up front, for deals that may fail, makes little sense. In other words, at the risk of mathematical oversimplification, if I make an investor $100,000 for $25,000 they invested with me, I feel perfectly good about $20,000 of it going to profit carry – because there is still $55,000 in pure profit left. But I don't feel like taking $5,000 out makes sense, because that $25,000 hasn't turned into $100,000 yet.

3) Far Less Risk of Exposure to SEC Violations or Bad Accounting

Venture funds, like other complex investment vehicles, have a certain risk of opacity with the wrong manager. Several name funds, which I feel no need to bash publicly, have recently come under just this sort of scrutiny. By contrast, per-deal, LLC style investments under a carry structure, especially if conducted through a platform such as Angelist, are far more transparent. Investors are viewing these investments and making transaction decisions on a per deal basis, with other expenditures – such as LLC formation costs and taxes – much more explicitly defined and usually quite lean.

About GreenHills Ventures

GreenHills Ventures, LLC., established in 2001 as a private investment holding company and General Partners for GH Fund I and GH Fund II and GHV Wealth Management Holding, LLC. (GHVWMH), a wealth management firm focused on alternative investments for its single and multi-family offices and institutions. For more information visit www.greenhillsventures.com