December 22nd, 2024
Koko Xs

Venture Company Masterplan (v0)
The following is an excerpt from my inaugural LP letter for year 2024.

Venture Capital's Existential Problem

When I was seriously considering venture as a career, I made a list of reasons why I would regret it in retrospect and set out to speak with more experienced investors about my concerns. I especially wanted to know how they reconciled my top worry - venture returns have been on a continuous trend of decline since the 1970s - with their personal long-term career plans. I presented my observation on why venture returns will continue to crunch:

IRR is determined by three variables: buy-in price, holding period, and exit price.

- Buy-in price is determined by the inflow of capital and inflow of investable opportunities.
    - Inflow of capital depends on regulatory stimulus (ERISA 1974, Reaganomics 1980s, ZIRP 2010s, etc) and market cycles (1967-1972, 1982-1987, 1994-1999, 2012-2017).
    - Inflow of investable opportunities is determined by the inflow of backable founders under the "Great Man Theory" of venture worldview.
        - *The result: the inflow of capital is more liquid than the inflow of investable opportunities, thus the former outpaces the latter, leading to higher and higher buy-in prices each decade.*
- Holding period is determined by the exit opportunities and availability of downstream capital.
    - Exit opportunities are cyclical and depend on regulation (Glass-Steagall repeal 1999, "Amazon's Antitrust Paradox" 2017, etc).
    - Availability of downstream capital is determined by the general appetite for private equity.
        - *The result: the exit opportunities have dried up with the death of the Four Horsemen (IPO) and the Lina Khan effect (M&A), while more downstream capital has entered the market (HF, PE, CVC, etc), leading to longer and longer holding periods each decade.*
- Exit price is determined by earnings and market optimism on tech.
    - Earnings of technology companies are determined by the value creation and value capture of technology.
    - Market optimism in the technology industry is cyclical.
        - *The result: earnings of technology companies have grown significantly as core technology improves in tandem with their market penetrations, while the market optimism in the technology industry has increased on average, leading to logarithmic growth in exit prices.*

I observe that:

- Empirically: every decade in the last 50 years, the buy-in price has increased by 2-3x, the holding period has increased by 5 years, and the exit price has increased by 10x.
- Mathematically: when holding the buy-in price constant, a linear increase in the holding period cancels out any IRR gains from a logarithmic increase in exit price.
- Therefore: when accounting for the increase in buy-in price, venture returns will continue to crunch.

I concluded that if venture does not evolve, then even the top 5%, Midas-list, genuinely talented investors will be only doing high-teens IRR by the 2030s simply from alpha erosion.

From my conversations, I found these categories of responses (in order of frequency):

1. Denial: uneducated about venture history and not aware of this trend.
2. Acceptance: "It's outside of our day-to-day control, we can only focus on being the best at what we do." - Mike Moritz, Alfred Lin, Keith Rabois, etc.
3. Bargaining: "Yes, it is a shrinking pie, but here's why we'll capture more of it." - Marc Andreessen, Josh Wolfe, etc.

I wasn't satisfied with what I learned from these conversations and was especially disappointed by the overall defeatist undertone. So I began building my own thesis and solution.

The Paradox

I became fascinated by this apparent great paradox: while the asset class seems to have declined, the underlying asset has appreciated dramatically. In the last 50 years, technology has truly eaten the world in global GDP share:

- 1974: technology was a loose collection of semiconductor, computer, and electronics sectors in global GDP and was not recorded categorically. Global GDP was ~$5.4T.
- 1994: technology was <5% of the $28T global GDP.
- 2024: technology accounts for ~20-25% of the $110T global GDP.

As an asset class, venture punches far above its weight: American venture-backed companies started in the last 50 years are now 7 of the top 10 largest companies in the world with a combined market cap of $20 trillion; 10 of the top 15 wealthiest people in the world built fortunes off of American venture-backed companies with a combined net worth of $2 trillion; most of this tremendous wealth has emerged in the last 10 years, since 2014. If we linearly extrapolate this trend to the next 20-30 years, we will soon live in a world where technology becomes over 50% of the global Gross Domestic Product. Given that 55-60% of the global GDP today (~$60T) are labor industries that are increasingly replaced and automated, we can see a very realistic path to that future.

I began forming three core hypotheses that laid the foundation of my thesis:

1. Technology will become over half of the global GDP in the next 20-30 years.
2. Venture investors are the best at understanding and underwriting the future of technology.
3. There are more interesting ways to monetize venture alpha in a post-50% tech GDP world than purchasing small dollar volumes of high-risk, illiquid, private equity.

I see this as a tremendous uncaptured opportunity. Over the last few decades, the innovation economy has grown from a niche frontier of the economic system to one of the dominant drivers of global productivity. However, the venture business model is still reliant on a single product: equity financing. This product has become so competitive that a simple extrapolation from the past 50 years predicts uninspiring returns in the next 30. Venture capital's existential problem is chasing the finite game of ever more competitive startup equity financing at the expense of missing the grand opportunity to become the main provider of financial products in the technoverse.

Adventure capitalists live at the very edge of the capital risk curve and act as humanity's window into the future. A vertically integrated venture asset manager that leverages strong muscles in underwriting the future of technology to build a diverse portfolio of financial products is best positioned to fill this market gap.

Studying Asset Management

I studied the product roadmaps of other legendary asset management firms to understand how they evolved over time - in particular, I wanted to understand private equity and hedge funds, which emerged alongside the venture industry:

- KKR: $130B market cap
    - LBOs (1976) → Credit (2004) → Infrastructure (2008) → Energy & Real Assets (2009) —> Real Estate (2011) → Hedge Funds (2012) → Insurance (2014) → Growth Equity (2019) → Retail Wealth (2021)
- Blackstone: $200B market cap
    - M&A Advisory (1985) → LBOs (1987) → Real Estate (1991) → Hedge Funds (1994) → Credit (2002) → Infrastructure (2008) → Tactical Opportunities (2011) → Insurance (2017) → Retail Wealth Management (2018) → Growth Equity (2019) → Energy & Climate (2020)
- BlackRock: $160B market cap
    - Fixed Income (1988) → Risk Management Advisory (1994) → Equities (1999) → Risk Management Technology (2000) → ETFs (2009) → Alternative Assets (2010) → Wealth Management (2019) → LBOs (2019) → Digital Assets (2023)
- Citadel: $70B hedge fund net profit + $20B Citadel Securities market cap
    - Convertible Bond (1990) → Equity, Fixed Income, Commodities, Global Macro (1994) → Statistical Arbitrage (1998) → Quant Research (1999) → Energy (2001) → Credit (2002) → Equities Market Making (2005) → Options Market Making (2006) → Systematic Macro (2011) → Fixed Income Market Making (2014) → Retail Brokerage (2020) → Digital Assets Market Making (2021)

In Private Equity, all of the large platforms have (1) diversified into other assets since the 1990s and (2) gone public in the 2000s. Furthermore, after Dodd-Frank and thanks to ZIRP, Everything Is Private Equity Now. Private equity has captured markets that used to belong to banks, and they're starting to look like them too.

In Hedge Funds, single-manager shops have been increasingly swept up into large multi-asset multi-manager platforms (Citadel, Point72, BAM, etc) with complex technology infrastructure and risk management tools. Whereas the 1990s Tiger and Quantum model emphasized the star trader, the 2020s pod-shop model emphasizes the platform. Hedge funds have never looked more like large-scale asset managers.

In Venture Capital, platform firms have grown larger by an order of magnitude in the last cycle, consolidating their positions as the founders' most desirable partners while pricing out even the best boutique funds like Benchmark. LP capital is increasingly concentrated in the largest firms, and they're branching out into tangent businesses like private credit, wealth management, public equities, and buyouts. This trend has been termed the PE-tification of venture capital.

What used to be clear boundary lines between asset classes are now blurred - PE in HF, HF in VC, VC in PE, not to mention credit, real estate, indices, insurance - and all of this has happened in the last 15 years.

To me, these secular tailwinds all point in one direction for the future of asset management: a few mega platforms at war with each other to conquer every financial products market, each dominating a major category as their home base. The next 15 years will see wet cement turn into dry cement: Blackstone as the central asset management platform for real estate and infrastructure; KKR as the central asset management platform for retail brands and credit; BlackRock as the central asset management platform for ETFs and wealth management; Citadel as the central asset management platform for quantitative arbitrage and market making.

When all is said and done, there will be one central asset management platform built on the innovation economy. This player will have strong muscles in technology, venture capital, growth equity, and all things Silicon Valley.

Venture Company Thesis

The core muscle of our firm will be:

Identifying, structuring, and investing in assets correlated to technology trends.

We'll gradually build out each area of expertise:

1. Identifying
   This is our core intel and research muscle - through our home base in Silicon Valley, information about the future of technology passes through us first. We combine this major alternative data source with hedge-fund-trained research analysts to systematically turn our venture insights into venture alpha.
2. Structuring
   This is our stable services business - having the infrastructure to quantitatively determine the correlation between legacy assets and new ones (like startup equity) allows us to create new financial instruments tailored to our client's needs. We act as the liaison between Silicon Valley and the rest of the financial services industry.
3. Investing
   This is our volatile discretionary craft - starting with traditional venture investing, we monetize our venture alpha via thematic trading strategies in all assets affected by technology. We grow our footprint alongside the global penetration of technology and bring a piece of Wall Street to Silicon Valley.

In the next 10-15 years, I see these skills translating to the following core business lines:

1. Venture & Growth
   Meat-and-potatoes early-stage venture and venture growth businesses, our initial foothold and the foundation of our alpha factory. Key challenge here is brand and network building.
   Ex. traditional preseed to pre-IPO financing, global markets coverage.

2. Venture Macro
   Monetizing our venture alpha via a thematic macro hedge fund fluid across public equities, bonds, currencies, and any other asset that will be influenced by technology. Key challenge here is generalist, interdisciplinary research talent and trading infrastructure.
   Ex. ecommerce and retail REITs, cleantech and energy, AI and chips pair trades.
3. Venture Indices
   Building baskets of correlated assets for each major technology trend, specific sectors, corporate clients, sovereign governments, and retail investors. Key challenge here is sales, marketing, and distribution to find the capital demand pools.
   Ex. AI100, Stripe50, SF200 ETFs.
4. Venture Consulting
   Becoming the main expertise provider to legacy industries when it comes to technology-related topics. Supplying customized solutions for corporate clients. Key challenge here is building products tailored to customer's needs.
   Ex. technology consulting for agriculture, manufacturing, construction industries.
5. Venture Credit
   Providing non-equity financing to venture startups and venture-backed high-net-worth individuals, including wealth management services. Key challenge here is bootstrapping a strong and loyal client base.
   Ex. heavy machinery convertible debt financings, equity-collateralized founder and employee "secondaries loans", portfolio founders wealth management.
6. Venture Buyouts
   Leveraged rollups with a buy-and-build model, using automation to increase margins or using venture insights to buy assets in high-growth sectors before they break out. Key challenge here is finding undervalued assets before traditional buyout players.
   Ex. AI and data centers (Blackstone QTS 2021), cleantech and batteries (John Doerr Enphase 2017), Twitter Elon 2022.

This product portfolio includes a mix of stable cash flow services businesses and volatile discretionary investing revenue streams. Our goal is to assemble a revenue base that's diverse across liquidity, year-to-year volatility, growth rate, and risk profile. We'll need a large pool of interdisciplinary talent, consistently great execution, strategic foresight, and a nontrivial dose of luck to accomplish this.

Now Or Never

We're at an interesting point in the supercycle: it's early enough to see low-hanging fruits everywhere but late enough to see the industry begin to cement.

Private markets have raised more money than public markets since 2012, yet retail investors still do not have access to this asset class. This leads to pent-up demand for exposure to the innovation economy, and the dam has started to break: the first startup equity ETF listed in March of this year, and BlackRock's Bitcoin ETF listed in January. The people want a piece of the future, and asset managers are waking up to this opportunity.

The “feast or famine” nature of venture capital fundraising is rapidly killing off mid-market firms that can’t compete with post-reflection brand shops, yet are too awkwardly large to survive on crumbs of local alpha that micro-boutiques like myself live on. This eventually leads to a “megas and minnows” industry structure in venture. Thus, the window to build a de novo brand in venture that makes it past the funds 3-5 mid-market valley of death is closing quarter by quarter.

In my short time in the industry so far, I’ve seen legacy platform venture firms raise record amounts, register to become RIAs, and launch alternative product lines. From my conversations with the founders and architects of these platform firms, it’s clear that everyone is circling the same idea space. It feels like the time to build is now or never.

Looking Ahead

Today, I spend most of my time improving my craft as a venture investor, building out the capital base with long-term partners, and iterating on the Venture Company thesis. Over the coming decade, we’ll turn words on these pages into revenue-generating products. In the next five decades, we’ll build an enduring financial franchise. The competition will be fierce, but the prize is too compelling.

We will build the central asset management platform for technology.

PS: I’ve written over 100 pages on this thesis this year, which you can find here.