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INVESTMENT PERSPECTIVES

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Unicorns: Beyond the Myth

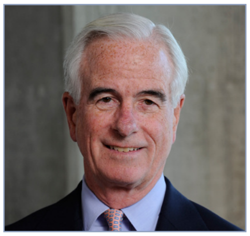
According to legend, the unicorn is a large, horse-like beast with a spiraling horn protruding from its forehead. Numerous writers, particularly in ancient times, have described it, but contrary to popular belief, most accounts occur in the literature of natural history rather than mythology. Whatever the case, the animal possessed unusual powers to heal the sick and purify water, and it was considered extremely rare.

Aileen Lee, founder of Cowboy Ventures and former strategic advisor at Kleiner Perkins Caulfield & Byers, is believed to have been the first person to invoke the term *unicorn* in a financial sense. In 2013, she applied it to the small number of privately held companies with a market value over $1 billion to denote their rarity. Since then, the population of unicorns—unlike their legendary namesakes—has multiplied to the point where sightings are almost an everyday occurrence. Thus, some might associate the name with a spike in value rather than a spike in the forehead.

Research firm CB Insights calculates that there are 145 unicorn companies with an aggregate value over $500 billion as of this writing. And they're not just an American phenomenon, as more than a third are headquartered outside the U.S. Most have achieved their unicorn status rather recently, and in fact nearly all did so in just the past five years. **Uber**, arguably the best known, first became a unicorn in mid-2013, about the time Ms. Lee coined the term. It's now worth an estimated *$51 billion* just two years later.

RAPID GROWTH

What is behind this sudden surge in the unicorn population, and are some of these valuations "spiraling" out of control? To a certain extent, the Federal Reserve's zero-rate monetary policy has fueled the flow of money into higher-risk asset classes, since "safe" assets have been priced to yield only meager returns. While a decision by the Fed to withdraw record stimulus could foreshadow a shift in the appetite for risk assets, several other forces have contributed to the growth of unicorns over the last couple of years.



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- *Bull market for public equities:* Certainly, the run-up in public market valuations over the past few years has spurred gains in private market values over the same period. Small-cap growth stocks, particularly in technology and biotech, have been among the market leaders during the post-crisis recovery.
- *Favorable exit opportunities:* Low interest rates have created an environment in which private companies have been able to attract strategic buyers at premium valuations. Demand for initial public offerings, while declining in number this year, has also facilitated exits at favorable prices.
- *New private market entrants:* In contrast with earlier market cycles, hedge funds and several of the largest emerging growth mutual funds have committed meaningful resources to investing in late-stage private companies over the past several years. By way of example, Black Rock, Hartford Insurance and Fidelity Management, among others, have participated in recent private financing rounds for Uber.
- *Less need to tap the public markets:* Many of the largest private companies find that they have more options for financing in today's markets, as the flow of funds into late-stage venture funds has provided ample equity capital to meet private

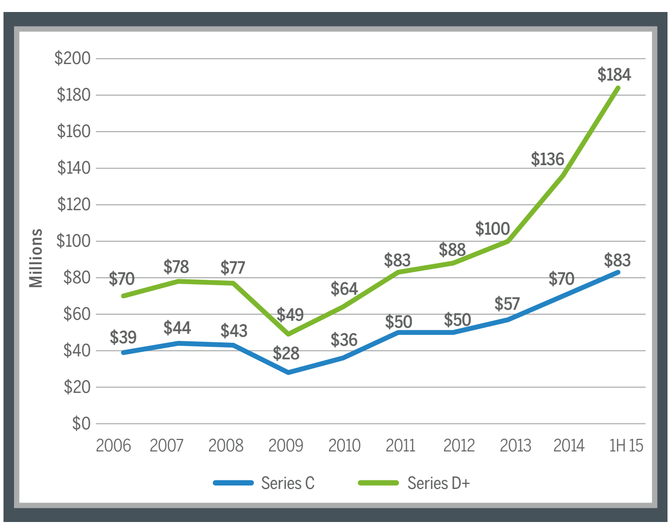
company needs. Moreover, the need for capital in many cases is less urgent today than in previous market cycles because of the evolution of business models. The growth of outsourcing has allowed many companies to tap outside operational and technological resources rather than create them in house with their own capital.

- *Resistance to being public:* As has been widely reported in recent years, the increased regulatory burden of SEC filings, the Sarbanes-Oxley Act and other legislation has tended to make the IPO route to liquidity less attractive. At a minimum, the new rules have raised the bar on the effective economics of being public. Further, many companies are reluctant to subject themselves to the perceived short-term mentality of Wall Street. Partly for these reasons, the median elapsed time from a company's founding to its IPO has increased by about one-third to more than 10 years, according to Pitchbook data. Interestingly, only one technology company went public in the third quarter, and the future offering calendar is relatively light. It appears that 2015 will go down as the slowest year for technology IPOs since 2009, according to Renaissance Capital.

Taken together, these factors have benefited early-stage investors. Since companies are typically waiting longer to go public, a much larger proportion of their gain in value has been accruing to those institutions that own private securities—mostly venture capital firms, a few hedge funds and mutual funds, and a handful of large companies that back new technologies largely for strategic reasons.

By the same token, public market buyers are realizing a lower proportion of the returns. In some cases, highly publicized companies such as **Alibaba, Box Inc.** and **Twitter** are even trading below their IPO prices. Interestingly, the IPO of **Square Inc.** was priced at about half the valuation of the most recent venture round of financing, but it traded up significantly in its public market debut. Presumably, the company's management and investment bankers decided to leave some money on the table so that early buyers in the public market could make a profit.

EXHIBIT 1: Late-Stage Venture-Backed Company Valuations By Year



Source: Pitchbook.

PARTICIPATION

If much of the return associated with unicorns occurs before going public, how can private clients participate? There are several ways, depending on one's appetite for risk and need for diversification and liquidity. Probably the least "pure" option is through small-cap, emerging growth mutual funds that maintain an allocation to private companies. Even in funds active in these markets, the size of the allocation is not normally sufficient to make a significant difference in performance, and it adds to risk. Moreover, most funds that invest in this space are participating in late-stage rounds of financing after much of the private market gain has occurred. And, of course, the values of these investments don't always appreciate. In a November regulatory filing, Fidelity Management, for example, reduced the value of its holdings in **Dropbox**, **Snapchat**, **Zenefits** and a few other privately held companies as of September 30 despite their continued growth.

Various services are emerging that allow individuals to invest relatively small amounts of money in start-ups alongside venture capital firms. Some, like SeedInvest, claim to have vetted each situation, and investments can be made online. "Crowdfunding" has also become a way for investors to link up with very early-stage enterprises through intermediaries. Finally, some investors may be approached directly by would-be entrepreneurs with the opportunity to be a so-called angel investor. In all of these cases, investments are made at a very early (and thus speculative) stage and are focused on one company at a time.

For qualified investors, the best option is probably to invest in venture capital funds. Since most funds require a relatively high minimum investment ($1 million to $25 million depending on the fund), it's usually more palatable to participate through some sort of "feeder fund." Brown Advisory, for example, has created a series of partnerships that allow clients to invest below-minimum amounts in selected venture funds. These investments are typically available for Qualified Purchasers or Accredited Investors only. In a slightly different twist, our Private Equity Partners program consists of "vintage year" partnerships that each invest in five or six underlying funds—including venture, buy-out and energy—in order to achieve a degree of diversification across fund types. We have also participated in Savano Capital Partners, whose strategy is to buy interests in mid- to late-stage venture-backed companies from existing shareholders, as opposed to injecting new capital into a company's balance sheet. By purchasing shares at a discount to recent rounds of financing, the fund attempts to benefit from both the growth of the company prior to IPO or sale and the elimination of the discount when the shares are ultimately sold.

GOVERNANCE AND OTHER IMPLICATIONS

Regardless of the means of investor participation, there are subtle but important implications of the unicorn phenomenon that go to the root of capitalism and corporate governance. In essence, the rise of the unicorn highlights how the ownership of companies has evolved and, with it, their responsiveness to stakeholders. Growth and change in the securities markets over the past 100 years or so has resulted in management's becoming more and more distanced from the ultimate owners of public companies—individuals. According to the Bogle Financial Markets Research Center, individuals have gradually reduced their ownership of public equities from about 90% in 1950 to 30% today, while institutional investors have filled the void and now control about 70% of public shares. Institutions, of course, represent the interests of millions of individual investors, whether through mutual funds, retirement plans, insurance companies or other investment accounts. In practice, however, these extra layers, together with regulations governing how funds must conduct their business, mean that individual investors have relatively little influence over corporate affairs. Many institutions don't devote much thought to voting their shares on corporate matters or electing directors, sometimes even farming out this function to consultants. Also, the growth of passive investing in the form of index funds and ETFs (exchange-traded funds) means that voting can be perfunctory rather than a result of careful analysis of management's performance.

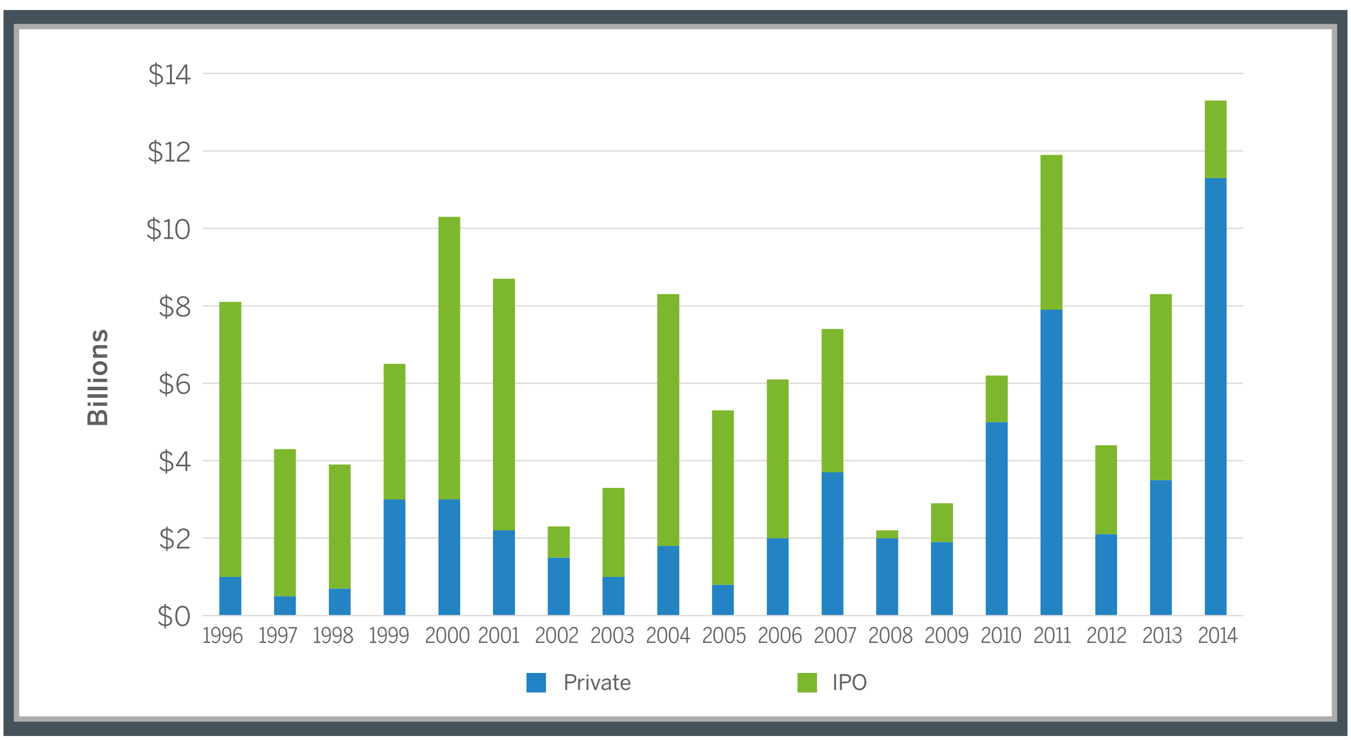
Under these conditions, management is at greater liberty to pursue its own agenda. While corporate boards establish guidelines for awarding incentive compensation and stock options, management's actions to earn those incentives can often be focused on short-term results rather than building value over the long haul. It can be argued, for example, that the growing practice of repurchasing shares to improve return on equity and earnings per share is occurring at the expense of long-term value creation through research and development or capital investment.

The increasing role of institutional investors in public markets may also have contributed to the rise of so-called activist investing. A few high-profile investors like Carl Icahn, whose funds are themselves largely institutional (although his own money is on the line), make headlines by establishing major positions in companies they perceive to be underperformers and pushing for change to improve shareholder value. Others, like ValueAct (in which we have invested on behalf of clients who meet the Qualified Purchaser requirement), work more quietly behind the scenes to effect change, but with the same goal: to better align management's interests with those of shareholders in creating value.

ALIGNMENT OF INTERESTS

Consider a continuum of ownership/management structures: On the one hand, the owner-operator of a small business has complete alignment of interests between investors and management since he or she is one and the same. At the other extreme, as we've suggested, are large public companies whose ownership is primarily institutional, allowing management to pursue its own agenda with little direction from outside owners. In between are smaller, less institutionally controlled public companies and private companies with multiple owners. This is also where unicorns fit in. (Brown Advisory falls into this category, as our shares are owned by a combination of our colleagues and a relatively small number of outside stockholders, a structure that we feel aligns our interests with those of our clients.)

EXHIBIT 2: Aggregate Funding For Top 20 Technology Deals By Year



Source: Andreesen Horowitz.

Private companies have the freedom to determine exactly how to align the interests of ownership and management. These arrangements, moreover, are the result of contractual agreements, unlike the loosely defined relationship between shareowners and management in publicly traded companies. Even in the start-up phase, management is able to decide with shareholders who owns what and how management's performance will be evaluated. In the world of venture capital, such decisions are typically the result of negotiations between founders and their venture backers. As the company grows and more investors are added, the ownership structure evolves, but it's still the subject of close interaction between the two parties. To the extent that capital is an important ingredient, shareholders should (and do) have a major say in governance issues, thereby keeping interests aligned.

Is this alignment of interests a major driver of the unicorns' success? It's hard to know for sure since so many other factors play a role, notably the ability to leverage today's technology. Still, one cannot ignore the number of private companies that have achieved meaningful size and scale in today's relatively sluggish economy.

LESS NEED FOR CAPITAL

As we've noted, the flow of money into venture capital funds has been more than enough to supply capital to a huge number of start-ups, not to mention unicorns. And many such companies are able to meet their growth targets without consuming capital at the same rate as earlier generations of companies. Not so long ago, for instance, semiconductor companies required enormous amounts of capital to build sophisticated foundries, but today they can outsource manufacturing while focusing on design and leveraging technological expertise rather than capital. Other start-ups reduce the need for capital by accessing the cloud for data storage or software and outsourcing other functions. In short, the technology revolution, including growth in the Internet, cloud computing, mobile devices, big data, etc., has been a major unicorn enabler. The growing number of start-ups attests to the ability of entrepreneurs to get a company up and running with minimal capital. If larger amounts of capital are eventually required, it can sometimes be raised in the public debt markets while a company remains privately owned. Companies pursuing such a strategy are often referred to as "hybrids."

Another factor that could dampen some companies' interest in being public is the emergence of secondary markets for private securities. Many founders and senior executives are content to keep their companies private as long as they have the opportunity to sell a few shares from time to time to meet their cash requirements. Early funders and former executives, however, may have a greater interest in selling as their priorities and needs change. Occasionally, if a company is meeting its growth targets, venture investors may want to add to an existing position by purchasing shares, but would-be sellers cannot count on such potential buyers. As a result, embryonic secondary markets are attempting to address these needs for liquidity. One example is SecondMarket, recently acquired by NASDAQ, which has been active in the stocks of late-stage venture-backed companies, including **Facebook**, prior to its IPO. While these markets are still relatively undeveloped and inefficient—partly because of the need to meet compliance requirements—they do provide limited liquidity for sellers.

A NEW MODEL?

In light of these factors, it seems plausible that a new model is evolving in the corporate world. The improving alignment of interests between investors and management appears to be at least partially responsible for the success of a growing number of privately owned companies. When these companies can tap private sources of capital and sometimes even the public debt markets, they have little need to be public to fund their growth. Further, many of today's business models require less capital in the first place. Finally, if new market mechanisms can provide shareowners with a limited outlet for their shares, the need to be public for liquidity purposes is less urgent. It's little wonder, then, that some companies choose to remain private, free of the need to cater to shareholders with little connection to management and of the scrutiny of regulators, who add to compliance requirements and expense. For these reasons, the number of public companies may continue to shrink, and some of the more dynamic investment opportunities may be veiled from public view, at least for a time.

In closing, we'll take this opportunity to wish our clients and friends a healthy, happy and prosperous New Year.