Flying High

It was 2013 and Marc Lore, co-founder of Diapers.com parent Quidsi, was anxious for a new venture. He had recently left Amazon, which had purchased his company for $545 million in 2010 after an escalating price war that Lore ultimately concluded he couldn't win. He was in New York, having lunch with an investor from the well-known venture firm Accel Partners, when he pitched his new idea – an online shopping club where the company would utilize membership fees as its primary source of revenue. A pricing algorithm would squeeze costs from every possible source – shipping, transaction fees, order size – and pass along these savings to the consumer. Lore's theory was that online companies like Amazon and Walmart.com were catering to the wealthier-than-average middle-class shopper, and that nobody was catering to the just average middle-class shopper, the one that could wait a few extra days for a product in order to save a few extra bucks.

It was certainly a bold and audacious plan. Amazon and Wal-Mart are companies that are well-capitalized, have massive infrastructures, and, most importantly, know how to deliver a positive user experience. Amazon in particular is rabid about customer service, which is reflected in the company's immense popularity and customer loyalty. But Lore exuded the entrepreneurial confidence of someone who had built a successful business before and could do it again, and at the end of the lunch Accel was sold, writing him a check for $1 million, which would prove to be merely a drop in the financial bucket. Before Lore's new company, Jet.com, had sold even a single product, it raised $194 million in equity, by far the greatest amount of equity raised by an e-commerce startup in its first year.[1] All of the other start-ups in the top ten were founded in 1998 or 1999, during the height of the 'dotcom' frenzy, when almost any idea with a pulse could get funding and valuations skyrocketed well beyond the point of rational.

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On the great ideas/bad ideas continuum, private equity (which includes buyouts, growth equity, and venture capital) has staked a claim on the former. This area of the investing universe offers potentially higher rewards than traditional public equity, albeit at a cost of illiquidity, and over time this asset class has certainly earned its stripes. As with all successful asset classes, they're great only until they're not, but that tipping point usually occurs silently, and before excited investors have stopped allocating to the area. The risks of coming to any asset class late can be quickly erased by exiting the area, but in private equity, such an option doesn't exist, at least not without taking a dramatic haircut on price via a secondary market sale. Of course, identifying the peak of any investment area is impossible, but it isn't impossible to make a reasonable determination of whether the environment for attracting capital is strong or weak. For private equity firms, the environment has not only been strong, it's been booming.

[1] Dow Jones Venturesource

According to a new study by McKinsey[2], private equity firms received $625 billion of new capital in 2016, bringing assets under management – which includes both commitments and the unrealized value of actual investments – to $4.7 trillion worldwide. For the fourth year in a row, distributions outstripped capital calls, implying that the fruits from previous labors are blossoming at a more accelerated pace than the industry's ability to plant new seeds. Although year-on-year growth has been modest for the last four years, fundraising has been nearly as high as in 2006–2007, the period immediately preceding the Global Financial Crisis.

As assets have ballooned, so has dry powder – the available capital with which private equity firms make deals. According to the McKinsey study, private equity dry powder in 2016 increased to an all-time high of $869 billion, a staggering amount of capital that doesn't even consider the inclusion of "shadow capital" – the limited partner commitments to separate accounts, co-investments, and direct investments – which totaled another approximately $188 billion.[3] Eventually, all this dry powder must find a spark, and whether that leads to an explosion of gains or an explosion of losses (or a combination of the two) has yet to be determined.

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Prior to the company's official launch in 2015, Lore was blunt about the task he had ahead of him, but also supremely confident. He told the Wall Street Journal that he expected the company to endure heavy losses in the first couple of years, but by 2020 it would reach profitability on the back of $20 billion of products sold per year[4], a total that, according to eMarketer, precisely one company – Amazon – reached in 2015 (Walmart.com was number two, with $13.5 billion in sales). Lore stated that Jet's business model is "100% proven viable at scale. You just have to get to scale." By scale, Lore meant 15 million paying customers, which would generate about $750 million based on the current $49.99-per-year membership cost, the company's primary source of potential profits, as it planned to undercut rivals on price and offer free shipping on orders of more than $35, as well as free returns.

Profitability, according to Lore, was expected, but it would cost a lot to get there. Advertising costs were expected to be $100 million over the next twelve months, and Jet projected that it would spend $100 on average to sign up each customer, a number that implied $1.5 billion in marketing spent to sign up all those customers in the first five years. Not surprisingly, Lore was ready to absorb all the capital that willing investors were ready to provide. "People want to put money to work," said Lore. "I get a call and people say: 'Hey, can we talk?' Yeah, I'll listen."

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2 "A Routinely Exceptional Year" McKinsey Global Private Markets Review, Feb 2017

3 "Triago Quarterly" Triago Capital, December 2016

4 "Frenzy Around Shopping Site Jet.com Harks Back to Dot-Com Boom" Wall Street Journal, July 19, 2015

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While the calls are going out from private equity firms to potential investments, calls are coming in from limited partners anxious to put money to work. According to the McKinsey study, "The prospect of sub-par public market returns over the next two decades has led a broad array of investors to see private equity as offering the opportunity to achieve absolute return goals such as preserving purchasing power for endowments or meeting pension obligations for defined benefit plans… driven largely by their increasing liability gaps. In the United States, for example, the Federal Reserve estimates that the gap in pension liabilities across federal, state, local, and private pensions grew 3% from 2015 to 2016, reaching $4.3 trillion. For many sovereign-wealth funds, demand has been created by the strain that lower commodity prices have put on national budgets."

Although neither a pure pension nor a sovereign wealth fund, the University of California system provides a good example of the nature of the mindset of investors as they seek to earn adequate overall returns. Last month, the Regents or central investment office for the ten-campus system announced plans to almost double its private equity allocation, from 11.5% to 22.5%, along with a reduction in its target for public equities from 42.5% to 30%. CIO Jagdeep Bachher said that his office will look for venture capital investments and opportunities like co-investments to expand its private equity portfolio, focusing on long-term results and managing risk. He is much more heavily invested in public equity than private equity, and the staff is trying to change the asset allocation so the endowment can compete with its peers. "If you look at the best performance of the last decade, you don't have to look too far to notice something very striking," Bachher said. "We've been much slower at going into private assets."[5]

One can sympathize with Bachher's conundrum. He requires a certain rate of return to support spending and knows that private equity has historically been able to offer it, but increasing his allocation to the area requires identifying top firms, accessing them, and hoping that pumping more money into an industry that is awash with capital will lead to a portfolio largely allocated to good ideas. Otherwise, the base case should be for lower future returns. And therein lies the all-important question: With all of this buying power, will there be enough deals to satisfy investor expectations going forward, or will private equity firms be tempted to invest in more and more long shots where the likelihood of success is far worse than in more rational times? Sub-par or exceptionally risky businesses are certainly always out there, but they haven't always had such an accommodating environment for raising money. Furthermore, investors don't want to wait forever for their capital to be called, a factor that could lead to private equity firms investing in businesses that they otherwise might have avoided for one reason or another, like a business run by a talented but optimistic CEO whose projections may be unrealistic.

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[5] "University of California Fund to Double Private Equity Holdings" Bloomberg, March 15, 2017

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The trial run leading up to Jet.com's launch did not go well. Chief Revenue Officer Scott Hilton had told investors a few months earlier that the company had signed up 420,000 people for free trial memberships, but Lore clarified the statement, reporting that the number was actually only 100,000[6] (420,000 was the number of emails that the company collected during a promotion to add members). In addition, Jet was absorbing steep losses on many of the filled orders, largely because Jet hadn't yet established partner relationships for much of the merchandise listed on its website. If a Jet customer bought one of these items, it meant that a Jet employee would go online, purchase this item elsewhere, and have it shipped directly to the customer, a wildly expensive proposition given the fact that Jet would not only have to pay the high shipping costs necessary for fast delivery, but it would have to cover the difference between its advertised price and the amount charged by the outside website from which it was purchased.

To show how this "concierge approach" worked, and how expensive it could be, the Wall Street Journal bought 22 items from Jet at a total cost of $275.55, and reported that Jet's total cost, including estimated shipping and taxes, was $518.46. While insisting that this approach would be phased out (after spending $300 million over the next five years on it) as the company reached scale, Lore was adamant that the membership fee/low price strategy would work. "I have 100% confidence that these prices you're getting now are fully sustainable." he said. "Forever."[7]

Three months later, the company got rid of the annual membership fee.

As it turns out, Lore's business plan didn't fully incorporate the sentiment of merchants, those whose products his customers were buying, and some of these companies preferred a site without a membership fee. "The paradox of Jet's pitch is that the low prices it needs to attract customers can drive away product suppliers who don't want their products discounted, limiting the availability of merchandise." [8] But Lore remained undaunted, telling potential investors in a slide presentation that the company would still be worth $40 billion in five years. It commenced plans to raise its next round of funding at a valuation of $4.8 billion, but investors were not quite as optimistic. They didn't turn the capital spigot off, but they did adjust the flow. Jet ultimately settled for a quarter of its intended amount at a valuation of $1.35 billion, still an impressive sum for a company bleeding money in a competitive industry.

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With all this dry powder in the industry, prices only seem to be going in one direction, a challenge for investors usually accustomed to being disciplined on price. This is

[6] "Behind the Numbers of Jet.com's Audacious Plan to Attack Amazon" Wall Street Journal, July 20, 2015

[7] "Jet.com Eyes an Exit Short of Its Audacious Goal" Wall Street Journal, August 3, 2016

[8] "Shopping Site Jet.com Abandons $50 Membership Fee" Wall Street Journal, October 7, 2015

especially important as industry players are keenly aware of how long the bull market in private equity has continued. As Bain and Company put it in a recent report, "Every month brings us closer to what many consider an inevitable next recession. Assumptions that GPs now build into any deal model for market beta—future multiple expansion, GDP expansion, leverage—have turned more bearish. GPs find it increasingly difficult to pencil out how assets bought at prices today will achieve targeted returns."[9] According to S&P Capital IQ, purchase multiples for buyout transactions are currently higher than they were in 2007, and 42% higher than they were in 2009.

McKinsey also presented an interesting way to look at valuation by measuring the percentage of Russell 3000 stocks that are trading below the median buyout multiple[10]. Only about 25% of public companies in the Russell 3000 Index were valued below the median buyout multiple at the end of 2016 (which was 9.3), down from 68% in 2008, when the median buyout multiple was 8.1.

This is the case across almost all industries. It's expensive to make public market acquisitions today, and for public companies struggling in their respective industries, the private market can be an important place to find short term solutions.

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On August 8th, barely a year after its official launch, Jet.com was sold to Wal-Mart in what the Wall Street Journal called "one of the largest e-commerce acquisitions in the US in years and the second time Mr. Lore has sold a startup to a retail giant, quite a feat… A sale would also mark a premature end to what was one of the most audacious e-commerce experiments since the dot-com boom: underpricing mighty Amazon on millions of items, all from a standing start."

Whether to stave off another competitor or to make a more aggressive push in e-commerce (or, more likely, both), Walmart.com paid $3.3 billion in cash and stock for Jet.com. As for Marc Lore, he agreed to join Wal-Mart as CEO of e-commerce and be responsible for both Walmart.com and Jet.com, which would be run as separate front-facing platforms. At the end of the day, the man who looked to upend the system became part of it.

That's hardly an indictment of Lore. He had an idea, found an extraordinary amount of capital willing to get behind it, and even after eliminating a central component of the company's fundamental strategy, still managed to find a buyer to ensure that everyone made money on the deal. Everyone, that is, except Wal-Mart shareholders. It will take time to see if spending $3.3 billion in cash and stock was worth it.

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9 Global Private Equity Report" Bain and Company, 2017

10 The buyout multiple equals the multiple of EBITDA (earnings before interest, taxes, depreciation, and amortization) paid for an acquisition.

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Is there a moral to this story? Hard to say. Had Wal-Mart not bought Jet.com, this might have been remembered as an example of late stage irrational exuberance that typified the final pre-burst moments of the internet bubble. But Wal-Mart did purchase it, and that's an important part of the narrative. It underscores an increased measure of unpredictability that accompanies investing in this environment. This is not to say that the firms that provided capital to Jet were undisciplined or even flat-out lucky. These were (and are) smart, successful, experienced investors, and they understood that if Jet was to make some noise, develop a brand, and chip away, even a little bit, at the e-commerce dominance of the top companies in the category, the company could position itself as a threat, and an acquisition target for a well-capitalized organization. Which is exactly what happened. They likely concluded that the extraordinary amount of capital looking for deals made this particular deal more likely than not to be a winner. And they were right.

Does the fact that an investment area is popular make it a poor place to invest? Not necessarily, but one should never lose sight of the fact that the odds of a disappointing outcome are quite high. Capable contrarian investors are few and far between simply because it is difficult to chart a course that differs from what others are doing. Complicating the situation further is the fact that no one has the ability to know when the laws of finance will emerge and reward those who walk the road less travelled, and it is that period in between, where one is both wrong and alone, that can be unbearable.

Anyone making allocations to private equity today is most definitely not alone, but if one agrees with the idea that extended periods of rising prices are more likely than not to produce richly valued investments and that markets and attitudes are ultimately cyclical, what are the odds that the great ideas will continue to be superior over, say, the next seven to ten years? Defenders of private equity as a great idea for the next ten years will rightly point to the structural advantages this group possesses. Yet structural advantages can take a long time to clearly establish their importance, a factor that is exacerbated when one begins with high prices and/or poor supply/demand dynamics. Will today's decision-makers patiently wait for the current crop of popular ideas to prove their mettle if the figures three, five, or seven years out suggest a different conclusion? Forgive our skepticism, but years of observing many, many investors have taught us that patience is quite rare and chasing returns is not.

To be clear, we do not think that private equity is doomed, nor do we think that one can make sweeping statements regarding a heterogeneous and fragmented industry. However, it would be foolish to ignore the fact that the headwinds are considerable, and any outcomes that are less than well-above-average to exceptional are likely to lead to disappointing results that are only marginally stronger than those produced by public equity markets. This makes manager selection enormously critical, and investors should not bemoan a commitment pace that falls short of one's goals. When articles begin appearing about why private equity is not the return engine it once was, that will perhaps be the time when one can get away with being less selective, but not now. The climate may not be as rewarding for the next Jet.com and private equity managers should not be blamed for their reluctance to put capital to work.

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