Polynomial Ventures

Evergreen Funds: The Future of Venture Capital

By Steve Valentor

We are all familiar with open-ended fund models. They are the most common structure for mutual funds and exchange traded funds (ETFs). Investors can purchase and sell shares in the fund with minimal limitations. These flexible investment vehicles, often referred to as *evergreen*, have not been widely available in hedge funds, private equity or venture capital (VC). That may be changing — and for good reason.

The graph below compares a typical $100 million fund in two scenarios. The evergreen fund, with all other terms held constant, generates a **+23% better result** for the investor and a **+27% increase** in carried interest for the fund manager.

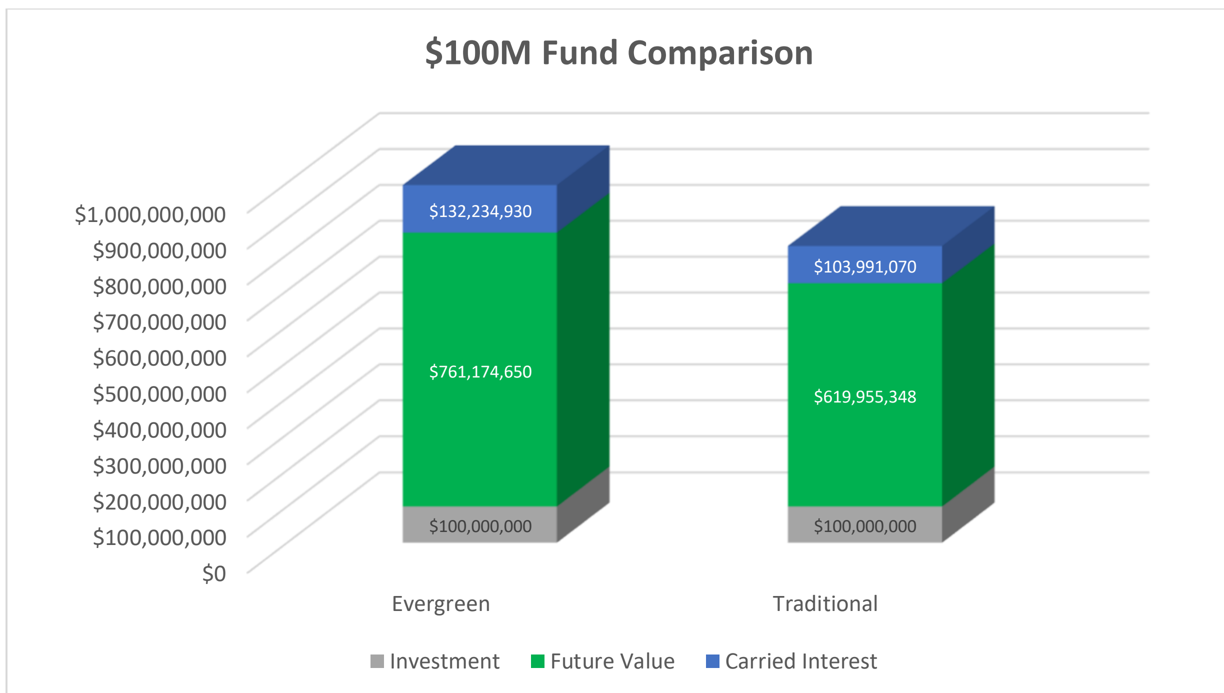

Figure 1

With traditional venture capital, the portfolio assets held in the fund are generally illiquid. It would be difficult for the fund manager to support withdrawals if they are not aligned with portfolio liquidity events — even if they were allowed. The Investment Advisers Act of 1940 (The Act) requires that investment advisers (fund managers) register with the SEC or their home state's securities regulation authority. This process can be difficult and expensive, and requires considerable overhead, oversight, and reporting to maintain compliance. The Act imposes fiduciary duty on advisers, which is the highest legal standard of care for investors and includes

a duty of loyalty. Those who achieve registration are designated as Registered Investment Adviser (RIAs). The result is that RIAs are the most trusted asset managers.

The Act does include exemptions for certain types of advisers to stimulate business investment. These exemptions allow private fund managers to avoid registration and be treated as Exempt Reporting Advisers (ERAs). Among the criteria for exemption is that ERAs cannot offer redemption rights to their investors. This means that investors cannot withdraw their investment or any returns (with a few exceptions) until the fund is closed and ceases to exist.

Other criteria for the exemptions include limiting the type of securities that fund managers can invest in and the duration of those investments.

RIAs are not restricted and may choose investments that are appropriate for the funds they manage. This aligns particularly well with evergreen funds. RIAs may act as financial advisers with full discretion for the investment of the assets under management AUM). RIAs who manage evergreen funds can mix the AUM to provide sufficient liquidity to support partial withdrawals. Evergreen funds also can accept additional investments at any time.

A major benefit to investors is that an evergreen fund can accept the entire committed investment amount immediately. With traditional funds, ERAs must first secure capital commitments, then call capital from their investors only when they actually make investment in qualifying portfolio companies.

The catch is that the fund managers charge management fees on committed capital even before it is called. It is easy to imagine the frustration of an investor who must hold their committed capital in short-term assets until the fund manager calls for it. What's worse is that they must manage their own assets (or pay someone else to do it) while simultaneously paying management fees on the not-yet-invested committed funds. This double-expense is eliminated with an RIA offering an evergreen structure. The interim returns generated are then automatically invested in the portfolio at much higher return rates.

Managers of evergreen funds are not limited to fixed fundraising cycles at the initiation of the fund, as they would be with a traditional fund. They may raise capital continuously, or whenever it is most optimal.

Yet another advantage that an RIA can offer with an evergreen fund is that assets can be held after major liquidity events.

One example of this benefit is the case of Spotify (SPOT). The day it went public in 2018, shares closed at $160, yielding a market capitalization of $29.5 billion. This represented a great return for the VC and their investors.

Three years later, the stock was trading for $364 at a market cap of nearly $72 billion. Sure, the investors could have held the shares on the open market or with a different manager. But there

is a case to be made that the VC who shepherded the company through its IPO and remains involved in the company's oversight may be the best qualified to manage that ongoing investment.

SPOT is now trading at about $100 with a market cap of less than $20 billion. Again, the argument can be made that the VC who was involved from before the IPO is best qualified convert the fund's position at the optimal time.

The carried interest portion of the fee structure in an evergreen fund is also different. The fund manager must be compensated similarly to a traditional fund. However, since the fund will not be liquidated at a predetermined date, the net asset value (NAV) must be calculated any time that investors will make deposits or withdrawals.

With a mutual fund or an EFT, this calculation is easy because the underlying assets are publicly traded and are priced continuously. When the portfolio is predominantly privately held assets, a mutually agreed audit process and net asset valuation process is required.

Certainly, one of the most important considerations for investors is when and how they can access liquidity. Evergreen funds maintain policies for this. Investors may enter and exit the fund at regular times, under certain conditions.

In a traditional fund, a limited partner (LP) investor has very few options and may have their funds committed for at least 10 years. In an evergreen structure, they have options.

Many LP investors have mandates in their fund charters that limit the percentage of their assets that can be committed to particular asset classes, such as VC with liquidity options.

Evergreen fund structures with periodic liquidity opportunities make it possible for investors to allocate larger portions of their assets to these traditionally high-return classes. The following table, used to generate Figure 1 above, illustrates the potential advantages of an evergreen fund structure.

	Evergreen	Traditional	Improvements
Investment	$100,000,000	$100,000,000	
Future Value	$761,174,650	$619,955,348	23%
Carried Interest	$132,234,930	$103,991,070	27%
Returns	$508,939,720	$395,964,278	

RIA managed evergreen funds, also called permanent funds, truly represent a win-win for investors and managers. With all things being equal — including the amounts invested, period of investment, effort, and the manager's ability — both earn more!

Steve Valentor is a 30-year technology industry veteran who has worked in computer engineering, semiconductor R&D and software development for companies ranging from startups to the Fortune 200. He has held positions from entry level engineer to senior technical management, CEO and board chair. Currently the managing partner of Polynomial Ventures and an adjunct professor at DePaul University, Valentor holds an M.B.A. in finance and a bachelor's degree in math, both from the University of Illinois at Chicago.

Polynomial Ventures invests in early stage technology companies outside of Silicon Valley and Boston. The Chicago-based firm is an emerging, registered investment adviser (RIA) operating an evergreen fund.