diffuse*tap*
Virtual Event Series

Fund Modeling Finesse

Guest Speaker:

Taylor Davidson

Managing Director/Founder
Foresight

Hosts:

Kenny Estes
CEO and Founder
Diffuse

Ayla Kremb
Chief of Staff
Diffuse

DiffuseTap: Fund Modeling Finesse

Last time on DiffuseTap, **Taylor Davidson, Managing Director and Founder of Foresight**, talked about why the perfect fund structure simply does not exist, and how the rolling fund structure is, surprisingly, not so different from the traditional fund structure we all know, save for a thing or two.

Want to make friends from the Diffuse Fund Ecosystem? Email contact@diffusefunds.com.

DiffuseTap

This networking session is part of our weekly virtual events series. Networking (you'll bump into at least a dozen high caliber fund managers) meets purposeful (you'll tap into brand-new sources of ideas) … straight from your armchair like a boss.

Meet the Speaker

Taylor Davidson is Founder and Managing Director at Foresight, a solution that helps entrepreneurs and investors build operational and financial forecasts. More than 28,000 entrepreneurs have used a Foresight template for forecasting, fundraising, valuations, and financial and operational analytics, and over 450 venture funds and investors for venture portfolio tracking and forecasting. An experienced investor, Taylor sits as advisor at companies worldwide, including Diffuse. LinkedIn: @taylordavidson

About Diffuse®

We are an alternative fund platform offering differentiated investment products. From digital assets to VC funds and beyond, we identify green field investment opportunities we feel will have market beating returns and turn them into professionally managed funds.

For more information, visit www.diffusefunds.com.

© 2021 Diffuse Inc

KENNY ESTES: Today's speaker is none other than Taylor Davidson. Taylor, would you mind unmuting yourself to talk a little bit about what you're up to?

TAYLOR DAVIDSON: Sure. So, I'm Taylor Davidson. I run Foresight, which is a product and services firm that builds financial models and protections for startups, as well as venture funds. Around 80% of what I do is with startups, 20% with funds and venture capitalists working in seed and direct investing into ad tech and marketing tech. I've worked with hundreds of emerging managers over the last five years, creating projections for funds, creating models for investments, proceeds distributions, and helping them understand cash flow to help with the mechanics of fund operations, and helping them out with their investment thesis. And I'm also in the process of finalizing a fund called Possibilian Ventures, to invest into transformative societal innovations.

KENNY: Thanks, really appreciate that. And a little fun tidbit for everybody in the audience, Diffuse is a paying customer of Mr. Davidson over here, and we appreciate his work very much. I'm joined for the fireside chat session with my partner in crime - who does most things better than me - Ayla Kremb. Ayla, do you want to kick off the first question?

AYLA KREMB: Yeah, I'd love to. So, one of the things we chatted about with Taylor was, AngelList kind of pioneered this concept of the evergreen fund or made it more popular and more well known. We'd love to have you dive a bit into what is the difference between just a standard VC fund and something that's more evergreen, or a rolling VC fund model.

TAYLOR: Yeah. So, what I found is that everybody's familiar with a true traditional fund. There's been some investments, some efforts some time ago towards building evergreen style funds, where we can accept and redeploy capital from proceeds back into investments, rather than into distribution back to the LPS.

Then, one of the newest innovations in fund structures we've seen in the last year is the rolling fund structure that AngelList has popularized, which I'm sure a lot of people here are familiar with, so we could talk a lot about it. I've worked with a number of emerging managers who are creating rolling funds. Possibilian Ventures is a rolling fund as well, so I've been through that process and setting it up. And what's interesting about it is that a lot of the mechanics of how you budget and forecast call capital, committed capital fees, all of those things, is structurally the same as rolling funds.

So, it takes some degree of rethinking on your own terms and thinking how the structure works. Also, the education part of the LP is taking them through some of the complexities about it and making it clear and crisp so they can understand how it fits within their methodologies. How detailed would you like me to get into that?

AYLA: It's a pretty good starting point.

KENNY: Yeah. Specifically, the mechanics. How does it work between quarters? So, they have the quarterly call, but is the next quarter a different one, or is it all the same? Are there different tranches? How do they allocate the economics? Does that create any kind of conflicts concerns, questions for LPs down the road?

TAYLOR: Yeah. That's a great question. So effectively, the way it works is LPs sign subscriptions. So normally, in a traditional fund, you're deploying a certain amount of capital to be called over a certain period of time. In a rolling fund, LPs essentially do the exact same thing except that there's a subscription, and the actual call period is shorter, and is subject to renewal. So instead of an LP committing a million dollars over four years, they're actually committing to a subscription, and the term of the rolling fund can vary. Some people will choose subscription amounts from one quarter up to four years, for example.

So, it's a variable on the path of the fund manager in terms of how they want to structure that, or even how they want to do it. There's some variability there in terms of how fund managers and LPs want to define a certain term. Essentially, if you agree to a four-quarters subscription, you're committing a certain amount of capital that will be called over the time period. And the way it works in the backend is, each quarter of the capital is its own fund. So mechanically, on the back end, it's its own fund, making its own investments, and having its own set of LPs. And so, an LP ends up being an LP into a number of different quarterly funds.

So, your exposure to the investments is determined by your subscription terms. That creates some variability in terms of what a fund is, and what the returns and investments are, versus what your particular investments are, based on finding your actual subscription time period around it.

On the fee side, you're charging a fee over to LPs making capital calls with pay management fees or any fees. In addition to that over time, in a rolling fund structure, all those fees are called up front, so effectively, all the fees are called in the first quarter.

AYLA: What have you noticed with people that come to you that start a fundraising, but never take that model fully? Because when you see certain general partners, they start fundraising without having their models fully baked. What are some of the dangers of doing that but not having thought that through?

TAYLOR: Yeah, it's interesting. I say this all the time. I build models, but I don't think the models are the most important thing in the fundraising process. In many ways, it's like a check on your understanding. In many cases, it's more valuable for a GP than it is for an LP. When you're building a model for an LP, you're trying to show how you're going to invest to return 3x net back to their investors. And so, you're going to basically modify your assumptions to get to a 3x.

To some degree, the actual model itself is not necessarily the most important thing for an LP, but it's a really important check to show that your strategy for the fund can work. Do the numbers in your

investment strategy qualitatively fit your strategy? Are you properly budgeting for your capital calls over time to be able to do follow-ons? Are you probably budgeting your structure in terms of your management fees to run the company to provide your value-adds to your portfolio companies?

And so, those are general questions and checks that kind of come up in the process. I think it's most helpful to first understand how the mechanics work.

KENNY: In your experience, how baked does the model need to be before the general partner can actually go out and start talking to LPs? For those first conversations, do you basically want to be more or less ready to go? So that if somebody is warm and they want to invest, do you have a spot for them to invest rather than wait two months? Or are you more of an advocate of the conversational, let's get together and figure it out, kind of collaborative manner?

TAYLOR: Well, I mean, I think it's going to depend upon your fundraising strategy. And I'm not an expert in terms of that — I'm raising my first fund at the moment. And so, I'm still learning this on myself on the fly. But you know, it depends on who you're talking to. If you're talking to an institutional LP, I think it's pretty important to have a baked understanding of the mechanics when you can have a conversation with them, because they're going to be looking at your metrics and looking at how you approach that and much more in a quantitative manner. I think if you're talking to a high net worth individual or family office, I think there's a little bit of different expectations around there.

The same way as when a startup talks to an angel investor. Most times, you will have those conversations about the financial model, right, and your ideas. The important thing is your thesis, your team, and what you're doing. The model becomes a secondary thing in terms of those conversations., I don't think it's the most important thing.

In terms of mechanics, and whether you fully understand what's going on, I don't think you have to have a fully baked model during the first couple conversations. But probably, what's important is to get smart about it pretty soon.

I do see that there is a difference in approaches to understand, in terms of levels of complexity. There's a way to build a simple model, which basically says I'm going to invest a certain amount of dollars, I'm going to get a certain amount of dollars back, and here's the committed capital, capital fees, proceeds, those sorts of things, and your own model and the overall perspective of the fund.

And that can be a fairly simple model. I can make a one sheet model, which basically describes overall returns. I think that's an important thing to understand from the beginning. But what I often have to deal with is taking one step beyond that, which says, okay, what does it actually mean in terms of cash flow over time? An overall model may not really show how the fund changes over time in terms of unrealized gains, residual value, write offs, call capital schedule, scheduled proceeds, and distributions, etc. Getting that detailed into it is not necessarily the first thing to do. I'm a proponent of building something simple first and understanding the mechanics, and then getting into more detail as you go.

AYLA: To kind of dig into one of those more detailed level two questions, in a rolling fund, how do you actually handle internal portfolio valuations and the subsequent profit distribution, given that each investor is going to join at a different time?

TAYLOR: There’s actually a lot of hard record keeping and math against it. But mechanically, it’s not as hard because each fund is its own fund. And so, it's just about keeping a record of what investments are made in that fund and what proceeds return to that fund. So, in terms of the idea of returning funds back to the capital, you don't have to return the total investment capital, you just have to return it for that fund.

So, in many ways, it works almost like an American waterfall where distributions and carry can come back to LPs and GPs faster. Fundamentally, the important part is record keeping and the infrastructure to support knowing what funds invest in and what LPs are invested in.

KENNY: I’m going to pick up a point that you might be in a good position to expand on, and that's how to handle portfolio evaluations between different investors. In a rolling fund, it's relatively straightforward because it's every quarter, right? You do a quarter, and then there's a new challenge of investors. If those first quarter investments are killing it, the second quarter investors might not be terribly happy because they don't participate.

But if you're on a three-year or five-year capital call fund, often you can have investors coming in a year, two years after the first close and there's a portfolio, and you've got to worry about dilution and all those things that generally always come up in alternative assets. What are your thoughts on that topic recommendation? Innovative solutions?

TAYLOR: Really two separate questions there. The rolling fund is actually a simpler way to address those concerns. In a traditional fund you have multiple closes over time. You have to have a mechanism to bring new investors into the fund. And oftentimes, you're going to have requirements for them to effectively buy into previous investments at the same kind of basis as past investors. And so, effectively creating a schedule for them, to bring them on the same footing at the same time.

All funds work a little bit differently, because oftentimes, you're going to actually have an actual kind of NAV, right? So, you'll have an NAV for the fund, and you'll have shares for the fund. And people will buy different NAVs essentially. But rolling funds, it's actually simpler in that sense, because each one is its own fund. And so, the bigger question is are there investors actually in that fund?

Rolling funds, especially AngelList’s rolling fund structure itself is a fairly new thing. I think there's a number of things we just haven't seen in the industry yet. We haven't actually seen a big exit come out of a rolling fund yet. So, what happens when the first exit comes out is a bunch of LPs are going to be like, okay, well, was I an investor in that investment or not?

And some will be happy about that. Some won't be happy about that. And we haven't had that conversation in the marketplace because we haven't had that exit yet. But it will happen.

Every rolling fund has different positions in terms of how they want to go to market in terms of their subscription periods. I've seen subscription amounts from one quarter to 16 quarters.

Subscribing for one quarter and giving the LP a chance to choose to continue on a quarter-by-quarter basis is good, but it also exposes a lot more risk to an LP in terms of where they actually get access to the investments that the fund makes over time.

Back to one of the earlier questions I saw on the chat, the structure is actually kind of a hard thing to discuss for a lot of LPs, and we try to find a way to bring the structure back to a way that they're used to thinking about it, in terms of traditional funds, and then tell them the details that are different.

AYLA: And that kind of tees up to another question around insights you've learned while working with various different clients. What is something that you wish you had known early on before you got started in business, or something you wish you'd known three, four years ago about the complexities of putting together these models? For instance, what is the interplay between fund one and fund two, and how those things change, etc. What are some of the key learning lessons you've taken away?

TAYLOR: I've been building models for funds for about five years, in different based approaches in terms of how to actually do it. And so, I constantly rethink the best way to attack building models and things, cause' there's always different ways to approach things. I've changed my base approach to doing things based upon reflections or feedback from other people over time.

And so, I try to take learnings from the market in terms of where the best approach is. So, I've changed my approach to how I think about following allocation. I've changed approaches based on individual investments, or a basket of individual investments, versus a broader portfolio allocation. I revamped the actual model itself. I think I'm on version four at the moment.

I've made massive changes to the model for deploying capital and thinking about how the value of the capital goes up. But the biggest thing I've tried with the model is building more flexibility into it to deal with the different approaches. If someone has their own frame that they want to approach, to modeling out their investments, I try to make the model more flexible to adapt the different frames of thinking, rather than having to only do one specific thing.

That's kind of like a technical answer to your question. But basically, that's what I've learned in how to build models over time, by building different fund structures across different geographies and regions. I work with funds across the world, and there are always going to be vastly different terms or structures necessary for European early-stage ventures, to European late-stage ventures, to American ventures, to different areas, and so on. And so, adapting for the different terms and needs for different focuses is really important.

Thank you for downloading this DiffuseTap event transcript.

Sign up for upcoming sessions and check out past features and event transcripts.

Dennis Chookaszian
Corporate Director, CME Group

DiffuseTap: Institutional Grade Governance

Sharing his decades-long expertise on corporate governance, Dennis discussed how to avoid a co-partnership going sour, the problem with overly idealistic CEOs, and the importance of keeping your board in check. Read on

Susan Brazer
CEO & Founder, LionShare Media

DiffuseTap: Media Metaverse 2022

Susan talked about the 2020 digital media landscape; the evolution of media distribution; how converging, emerging technology points to the metaverse; and the prospect of having an open, decentralized, and free Web 3.0 marketplace. Read on

Raj Mukherjee J.D.
VP/Global Head of Tax, Binance.US

DiffuseTap: Crypto Taxes Decoded with Binance.US

Raj explained the complexities of the US crypto tax landscape, how he built a dynamic tax information system for Coinbase and Binance from scratch, and how investors can profit from crypto without getting caught in a taxation mess. Read on

JOIN US

© 2021 Diffuse Inc