PAVILION

POP SONG PORTFOLIO CONSTRUCTION

Dr. William Charlton, Ph.D., CFA
Managing Director & Head of Global Research & Analytics, Pavilion Alternatives Group, LLC

Dire Straits, a 1980's British rock band, combined blues, jazz, and folk influences into a unique lyrical sound. As did many other successful bands, Dire Straits employed a winning formula in the construction of their albums. On each album, they included two or three songs that were potential popular ("pop") hits while the remainder of the album included more artistic or politically oriented songs. The epitome of this strategy was their Brothers in Arms album released in 1985. One song on the album, Money for Nothing, included the famous line "I want my MTV" which virtually guaranteed regular play on the recently formed music video network. The song reached number one in the charts whereas the politically motivated title track Brothers in Arms was not even released as a single in the US. Despite the poor reception of the title track, the pop music strategy worked well and the album reached number one, selling over 30 million copies. The performance of that album contributed to Dire Straits being considered one of the most commercially successful bands of the era.[1]

What does this brief reminiscence of a 1980's rock band have to do with private equity? Put simply, it would serve private equity fund managers well to consider the pop song strategy when they construct their portfolios. That is, give us a taste of what we want, what we really, really want (to paraphrase another British band) – exits. Preferably, more than one and the earlier the better. The combination of the use of blind pool investment vehicles and the lack of true market valuation makes the validation of the fund managers' value creation capability through exits particularly important. Being aware of the importance of generating at least some exits from a portfolio prior to raising a subsequent fund is an indication of a fund manager's appreciation of the circumstances faced by LPs. For emerging managers, early exits can be a strong signal to LPs that the fund managers are transitioning successfully from a deal-shop approach to establishing themselves as an institutional quality fund.

> *"When asked why they have not exited a good company, fund managers will often use the argument that the company is growing well and they do not want a potential buyer to reap the benefits of their hard work.*

For strategies in which holding periods tend to be longer than others, such as for lower middle market buyout and growth funds, developing an understanding of the importance of exits to LPs is especially critical. For these types of funds, it may be worth consciously incorporating some shorter-term investment prospects into the portfolio as a demonstration of the fund manager's ability to create value. Our research has shown that the holding periods for below cost realizations are statistically shorter for smaller investments; smaller lemons ripen earlier. If a lower middle market buyout or growth fund manager has not incorporated a pop song strategy in their portfolio construction, the manager could easily end up in a situation where their portfolio has several impaired companies and no exits. This would make fund raising very difficult and could force otherwise supportive LPs to pass on the next fund.

1 - Mark Knopfler, the lead vocalist and guitarist of Dire Straits, became discontented with the pop music aspect and dissolved the band in 1995. Subsequently, Knopfler has been very prolific and has built a diverse solo music catalog as well as being very active on movie soundtracks. For those interested, his album Sailing to Philadelphia is especially engaging.

When asked why they have not exited a good company, fund managers will often use the argument that the company is growing well and they do not want a potential buyer to reap the benefits of their hard work. Similarly, they may express the opinion that if the company is demonstrating attractive compound growth: "why take money off the table." While both opinions may be valid, within a portfolio management context, the better decision might be to exit if there have not been any previous exits from the fund. It is worth remembering a quote attributed to financier Bernard Baruch: "I made my money by selling too soon." LPs generally will not view a GP negatively for profitably selling a company and subsequently seeing that company continue growing under the next owner. However, they will not view a manager positively if it has passed on an attractive exit offer without a clear path for substantial value creation for the company, especially as this exposes the eventual exit value of the company to future and uncertain market conditions.

Musical purists could argue that Dire Straits "sold out" by employing a pop song strategy. Perhaps they did, but in giving fans what they wanted, the band was able to produce significant personal wealth while also gaining distribution of their non-pop music more widely than they likely would have otherwise. The parallel for fund managers is that by generating exits prior to asking LPs to make their next fund commitment, they can make their fund raising significantly easier while also allowing more time for the other companies in their portfolio to mature. While the term "pop music" is often used pejoratively, pop music stations and artists abound and would not do so without ample demand from listeners. To stretch the pop culture allusions possibly beyond breaking point, the quintessential quote from the 1990's film Jerry Maguire was "show me the money." What fund managers may not fully appreciate is that if they "show LPs the money" (or at least some of it), LPs are much more likely to give it right back to them for their next fund.

Inquiries or comments concerning this article may be addressed to:

Dr. William Charlton, Ph.D., CFA
Managing Director & Head of Global Research & Analytics
Pavilion Alternatives Group, LLC
wcharlton@pavilioncorp.com