

PART

One

Setting the Foundation

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CHAPTER 1

Background

“There is always a critical job to be done,” said Doriot. “There is a sales door to be opened, a credit line to be established, a new important employee to be found, or a business technique to be learned. The venture investor must always be on call to advise, to persuade, to dissuade, to encourage, but always to help build. Then venture capital becomes true creative capital—creating growth for the company and financial success for the investing organization.”

—Georges Doriot quoted in Ante, *Creative Capital*, p. 173

This chapter introduces private equity by tracing some of the history and evolution of one of its earliest forms, venture capital. We then explain some of the major forms of private equity investing. We present some unsolicited advice about how to start a program of private equity investing and then let you in on a big secret.

OWNING COMPANIES

On December 12, 1980, Apple Computer, owned by its employees and a few venture capital firms, went public (Apple n.d.). From that day forward, Apple was a public company and was required to comply with the regulations of the U.S. Securities and Exchange Commission. With that event, early investments in Apple by venture capitalists paid off. Since then, Apple has been required to have external audits, comply with government filings, and invite public scrutiny. Further, Apple’s officers had increased liability and were subject to rules that made public their compensation and personal transactions involving the company.

If you buy a single share of Apple today, you instantly own a piece of the company. As a shareholder, you receive financial reports, have voting and other rights, and are invited to the annual meeting. Most importantly, by owning that share of Apple, you have standing—you have equity. Yet you can leave this all behind with one electronic order—it's as easy as selling that share.

Private companies are an entirely different matter. What do you own when you have put some of your hard-earned cash into a private company? As your transaction was private, it was largely unregulated. Need to cash out your private equity in that company? Good luck. Who will you sell it to? Will anyone buy it? And so, realistically, what is it worth? What rights do you have?

VENTURE CAPITAL'S BEGINNINGS

Investing in private companies, whether through sweat equity or with money, is as old as business. Venture capital is but one form of private equity investing and is generally understood to be the business of investing in new or young enterprises with innovative ideas.

WHAT WE CALL PRIVATE EQUITY

Owning equity in a private company led to the obvious and simple term *private equity*. We like that broad term and will use it throughout this book. It is common to see this term used to describe the world of buyouts. We like two other terms, *venture capital* because it describes itself; and, to describe everything in private equity that is not venture capital, including buyouts and mezzanine, *corporate finance*.

A broader term, *alternative investments*, is used to describe many types of investment, including venture capital, corporate finance, hedge funds, distressed debt, timber, energy, and real estate investments.

Some historians mark the beginning of venture capital to the 1930s and 1940s, when wealthy families, such as the Vanderbilts, Rockefellers, and Bessemers began private investing in private companies. These so-called angel investors have a following still. One of the first venture capital firms, J. H. Whitney & Company, was founded in 1946 (J. H. Whitney n.d.). They

are still in business today, having raised their sixth outside fund, for \$750 million, in 2005 (Hsu and Kenney 2004).

Many people credit General Georges F. Doriot, an influential teacher and innovator at Harvard, for helping institutionalize venture capital after the Second World War. Doriot is perhaps best known for his role in the formation of American Research & Development Corporation (ARDC). With ARDC, Doriot raised outside capital solely for investment in companies. In its 25-year history, ARDC helped fund more than a hundred companies. Its most notable financial success was Digital Equipment Corporation, which turned a \$70,000 investment into \$355 million.

In 1958, early venture capital got a boost from the U.S. government when the Small Business Administration was authorized to license businesses as Small Business Investment Companies (SBICs). This license gave these finance companies the ability to leverage federal funds to lend to growing companies. SBIC companies became very popular in the 1960s.

In the United States, the big boosts for venture capital came in the 1970s. The first was the reduction of the capital gains tax. This was of little concern to tax-exempt institutions, but was of profound importance to encourage venture capitalists (Bushner et al. 1994, p. 7). The second was from the U.S. Congress in 1974, when it enacted the Employee Retirement Income Security Act (ERISA), a set of pension reforms designed to help goad U.S. pension managers into more balanced custodianship. Unfortunately, this act was a source of confusion and a damper on venture investing until it was clarified in 1979 to explicitly permit pension funds to invest in assets like venture capital. In effect, the U.S. Congress said: "It is your responsibility to meet the pension obligations to which your organization has committed. Do not be foolhardy, but as well, do not be completely risk-averse. Take risks commensurate with rewards. Balance your portfolio. Diversify. We will be watching."

U.S. pension funds paid heed. In the late 1970s and early 1980s, a few added a small amount of venture capital to their pension portfolios. A few endowments joined in. It is easy today to view this start as timid, but this was uncharted territory. Fund sizes were small. Players were few or had no track record. Pension funds worth hundreds of millions or billions were at that time known to make mere \$500,000 commitments to \$10,000,000 first-time venture capital funds. You might not blame them. What investment professional wanted to own more than 10 percent of a new and "extremely risky" venture? Better to stand side by side with a few other brave souls. However small these amounts were, they were a start. With confidence gained by experience, pension funds, endowments, and foundations began to commit larger sums to bigger funds. Today, it is not uncommon for these same institutions to commit \$50 million or more to a fund.

This start was tentative for a number of other reasons as well. Compared to more traditional investments, such as public equities and government and corporate bonds, an investment in a fund is always more difficult to buy, sell, or even value. These funds are, by design, long-term investments: most have a 10-year initial term. Many are not fully liquidated for 12 or more years. This illiquidity posed further complications to traditional investment managers. And to these managers, venture capital seemed a messy business with a language and practice all its own. To top it off, standards were lacking, there were few participants, and business systems and best practices were nonexistent.

Yet, in a way, the small size of the industry contributed to its early success. This community of investors and fund managers was close-knit. With much of the early activity centered in Boston and Silicon Valley and with money rather scant, general partners (GPs) from different firms collaborated on deals. Practices evolved. Supporting services, particularly in the legal and investment banking areas, grew or expanded alongside. Specialty firms emerged. Periods of retrenchment weeded out the tourists.

So, by fits and starts, the industry grew. Extraordinary monetary returns in the early 1980s attracted new investors and new capital at the wrong time. Industry-wide returns fell, and many first-time investors got cold feet and dropped out. Yet the industry grew, in part because those who stuck with it were rewarded for their persistence. This cycle was repeated in the early 1990s, when returns suffered and another set of investors bailed out. Those with patience hit the jackpot with the sky-high returns of the mid-1990s. Along the way, many of these pioneering investors quietly increased their allocations to this asset class from a modest 2 percent or 3 percent to 5 percent, 10 percent, or more. To some, the rebalancing of their asset allocation targets came through gain and reinvestment in their own portfolio, without having to commit additional capital. For others, gains from pension assets due to private equity were well above pension funding obligations, adding significantly to their bottom line.

Recent history is bubble created, bubble deflated, and beyond. The world went crazy with IT spending in the run-up to the Y2K computer software panic and the advent of the World Wide Web. Venture capitalists became, for a time, masters of the universe. The downturn that followed chastened for a time, but did not fundamentally change the practice of private equity. Despite excesses and carelessness, many investors in private equity made money. Lots of it. But after the boom, the IPO market vanished and the record level of investing in private equity of 2000 was followed by an unexpected and dramatic drop in 2001.

THE VERY RECENT PAST

Despite this cyclical nature, venture capital continues to attract new investors. In many ways it has become institutionalized. Taking advantage of this trend, some experienced investment teams have left the larger institutional investors and formed their own funds of funds. Meanwhile, a continuing crop of investors, having started their portfolios with funds of funds, are beginning to make their own investments directly in funds.

Some suggest that alternative assets may come to dominate the portfolios of some very long-term investors. David Swensen (2000) at Yale University has championed aggressive strategies that emphasize alternative investments over more traditional investments. Where timidity and lack of understanding have kept institutional investors from allocating more than 5 percent of a portfolio, we are now in an age where some institutions have over 50 percent of their portfolios in these assets. Many institutions have reaped the benefits of these aggressive strategies, but in light of the events of late 2008, may now be facing challenges associated with the illiquidity of this asset class.

WHAT MAKES A VENTURE CAPITALIST?

Whatever your preference for this narrative, it is at least agreed that something changed in the marketplace when, with relatively modest investments, these investors helped create a process. This process has become known as venture capital investing and the people behind it, venture capitalists or VCs.

What makes a venture capitalist? Money, of course. Sometimes lots of it. But money is often the least of it. A venture capitalist has got to think he has the stuff that can help make an enterprise work: experience, contacts, knowledge, perseverance, and wisdom. A venture capitalist measures success day by day, by building great companies.

Although many pioneering venture capitalists used their own money, not all did. Venture capital funds, in which money from many investors is pooled, helped change the scale of the process. What had been self-limiting suddenly had the potential to do bigger things. Over time, the venture capital process was applied to a broader set of private investments, and so a more general industry term arose: private equity. Over the past 50 years, private equity has fueled the fortunes of thousands, launched worldwide enterprises, and helped shape whole industries.

PRIVATE EQUITY IS OWNERSHIP OF A COMPANY

Apple Computer is a particularly successful example of venture capital investing. But there are hundreds of companies that benefited from venture capital backing. Netscape, Google, eBay, Cisco, Sun Microsystems, Amazon, and Genentech are also notable companies that were backed by venture capital. That venture capital is associated with these firms and their success is a good thing, but these companies are more the exception than the rule. For every company that makes it big, there are dozens of venture-backed companies that never made their investors a cent. In fact, it is the nature of the business that many venture-backed companies lose all of the money investors put into them.

In its broadest context, private equity is simply a stake, large or small, in a private company. Buying into a company is interesting for a variety of reasons, not the least of which is that a small stake can turn into a big stake as the company grows. In 1985, Merrill Lynch bought a stake in a company called Innovative Market Systems (IMS), which had created an electronic information network (Bloomberg 2004). IMS was later renamed Bloomberg. By 1990, Merrill had invested a total of \$39 million for a 30 percent stake in Bloomberg (*New York Times* 1996). In 1996 Merrill sold back to Bloomberg a portion, and Merrill booked a \$155 million gain. In July 2008, Merrill finally sold their remaining 20 percent interest for \$4.5 billion (Clark 2008). Not a bad investment.

To have the interest and attention of institutional investors, a company or an idea has to have large-scale potential. No private equity investor is interested in acquiring partial ownership of the independent dry-cleaner that does your shirts and blouses. Yet they might express interest in a new idea for cleaning everyone's laundry using nanobots, proving the technology, growing a business around it, and taking it public or selling it for a big profit.

Venture capital may help create household names, but private equity isn't all about venture capital. The buyout, a form of corporate finance, can be used to change the ownership or the type of ownership of a company through a variety of means.

In one of its most common forms, the leveraged buyout (LBO) takes a public company private through a combination of debt and equity financing. One of the central ideas behind this form of restructuring is that the addition of substantial amounts of debt to the balance sheet of the company helps create changes that unlock hidden value.

Once the company is private and freed from some of the regulatory and other burdens of being a public company, the central goal of buyout is to discover means to build this value. In many cases, this work has included

refocusing the mission of the company, selling off noncore assets, freshening product lines, streamlining processes, and often, replacing existing management. A happy conclusion to this disruptive process is that the company, reinvigorated, is brought public again or sold at a profit to a strategic buyer. This process may take years. For example the buyout of Kinko's by Clayton, Dublier & Rice took seven years and it was sold to Federal Express for \$2.4 billion in cash (Clayton, Dublier & Rice 2004).

But such happy endings aren't guaranteed.

There are variations on the theme of buyouts, including Leveraged Buyout, Management Buyout, Management Buy-In, Employee Buyout, Institutional Buyout, and Buy-In Management Buyout. These have the acronyms LBO, MBO, MBI, EBO, IBO, and, of course, BIMBO.

COMMON FORMS OF PRIVATE INVESTING

There are many ways to acquire interests and develop the value of private companies. In general terms, two of the determining factors are how much work you want to do and how close you want to be to the daily operations of the company.

1. Hands On, Hands Dirty Ownership

So you want to be really close to the action? Buy a company and run it. There is no better way to understand that the application of both hard work and money is only a start, and by no means is it a guarantee of success.

2. Hands On Ownership

If you have the appetite to acquire ownership in a company without intermediaries, you can buy into what is called a direct investment. Your capital is exchanged for securities in the form of debt, equity, or some hybrid instrument in the company. With this cash infusion and some guidance, the company expands, increases its market share, finishes the development of a product, or brings a new product to market.

Direct investing usually takes substantial resources, only one of which is money. Young or growing companies need all kinds of advice, management, discipline, and simple moral support. Your connections could come into play, bringing in a key hire, getting the legal help when needed, mentoring staff. Building companies is hard work—pursuing this type activity is the very definition of a venture capitalist or buyout professional.

You get out of a direct investment by selling your position when it makes sense. The upside? A significant return on your money and the

satisfaction that comes from creating something of value. The potential downside? You lose all the time, money, and personal commitment you invested.

3. Hands Off Ownership

As you get further from the action, you have less responsibility. You can have ownership in companies without any operational responsibility in two ways: a co-investment and as a limited partner in a fund.

A co-investment is as a kind of silent partner alongside a direct investor, who may be a fund manager. In this case you are called a co-investor and your responsibility is usually limited to supplying capital.

The most common investment vehicle, a private equity fund, is a legal entity formed to invest in companies. This is the way that most investors get exposure to private equity. These funds are generally set up in the form of a limited partnership and have a fixed term. As a limited partner, you commit money to the fund, the fund manager calls your capital to make investments in companies, and so you come to indirectly own positions in portfolio companies.

The managers of the fund, the general partners (GPs), charge management fees to run the fund. Their principal role is to find, negotiate with, and dedicate themselves to improving the operations, products, or strategies of the companies they invest in to increase their value. When the time is ripe, the partnership then sells its position in these companies and passes on the majority of the profits to its limited partners.

By investing in private equity partnerships, you get the benefit of ownership without as much involvement, liability, or control. As a limited partner in a fund, you are more of an observer than a participant. The general partners choose the companies in which to invest and monitor their progress. Private equity firms use other resources they deem appropriate to help make these companies succeed, including money, time, and talent. The general partners earn a fee for this work, and this fee includes a portion of the profits.

4. Arm's Distance Ownership

You commit to a private equity fund of funds. This is a good alternative for those without the resources to directly invest in individual funds. Investing in a fund of funds has similarities to investing in a fund, in that you are investing in a team that will make decisions for you.

In general, the closer you are to the direct ownership of a company, the more control you have and usually, the more work involved. If you

are buying a direct position in a company, you assume a higher degree of responsibility for the success or failure of the venture and may end up committing much more than money to assure this success. The risk of loss is higher but so is the potential reward. With an investment in a fund as a limited partner, you are privy to the details of the company investments that the fund makes. Limited partners with significant positions or expertise are often asked to be on the advisory board of a fund. Finally, when you invest through a fund of funds, your active involvement is even less.

Successful private equity investing depends on personal relationships, trust, carefully crafted agreements, compensation, and a host of other hard and soft factors. Put all of these things together and it is most easily and often described as an alignment of interests between GP and LP.

WHY INVEST IN PRIVATE EQUITY?

When you're telling these little stories, here's a good idea: have a point. It makes it so much more interesting for the listener.

—Steve Martin to John Candy in *Planes, Trains and Automobiles*

When you bring a private equity opportunity into an institution for the first time, think of yourself as bringing an exotic animal into the boardroom. You will need to explain yourself. “Here is what the private equity animal looks like. It has special needs. It cannot live on its own. It requires special handling and feeding. We don’t know everything we need to know about it quite yet. We are going to have to learn how to take care of it.” And then you’d better be ready to explain to them why you’ve brought it into the boardroom. Have a point.

It may not always be about a golden egg. Diversifying a portfolio and seeking returns above the market may be enough, but getting into private equity should be a deliberate act. You may have a host of reasons. Corporate venture groups may invest in private companies for their strategic fit. Governmental institutions may emphasize employment or regional development. Endowments and foundations are perpetual investors, with a natural tolerance for the illiquid nature of private equity investments.

Most importantly, know that the commitment to build a private equity program relies on consistency that must bear up under the weight of uneven monetary rewards. If it is just money that you are after, being in the game at the right time may make all the difference. Get cold feet, skip a year, and you may destroy all of your hard work. We will discuss this more in depth in Chapter 13, The Concentration of Wealth.

FINALLY: THE BIG SECRET

Today, the business of investing in private equity is an industry unto itself, employing tens of thousands of people across the globe, from dedicated sales forces to specialized legal firms. Even though it has its focus on private transactions, private equity is in the public eye and is subject to a great deal of scrutiny, press, and curiosity. With private equity firms' indirect employment of millions of people, the public offering and notoriety of firms like Blackstone, and attempts by the U.S. Congress to regulate and tax private equity in new ways, its shadow looms large. Also within this mass of activity, private companies are being taken public or are being acquired by public companies and public companies are taken private only to be taken public again: eBay buys Skype; Intel buys a manufacturing division split off by a buyout. As a result, the portfolios of most limited partners are likely to contain a significant amount of transitory undistributed public assets.

The big secret is that the business of private equity isn't that private.

CONCLUSIONS

Although investing in a company can be a casual affair, the business of private equity investing requires substantial resources and a long-term horizon. This chapter briefly looked at the history of private equity investing, described its common forms, and presented some general background.