CHAPTER 1

Tomorrow Will Be Different than Today

Private equity is a people business. Some people you love to hate. But most are smart, work hard, and deliver the goods. They live in New York, Hong Kong, and London. They complete transactions ranging from large buyouts of public companies to restructuring failed banks to funding dorm-room start-ups. They run on ambition, greed, talent, and the challenge of finding new ways to finance and run a company.

Over the past 17 years, I have managed the *Asian Venture Capital Journal* in Hong Kong. In 1992 we started with one monthly, one conference, and one guidebook. *AVCJ* now boasts a weekly and two other magazines, organizes 11 conferences on four continents, and offers online directories, databases, and consulting services. This growth took place in the same period that saw the print magazine industry implode, as ad revenues dried up and titles folded.

It was a period in which the Internet was born and exploded onto the world scene, China and India grew from remote destinations to pillars of the global economy, and an expanding debt bubble in the West finally burst, leaving the world looking for answers. It was a time in which private equity and venture capital grew out of offices on Park Avenue and Sand Hill Road to become a global phenomenon.

AVCJ was there. We watched it from the front porch and inevitably became part of it. We survived the 1997 Asian financial crisis and rode the Internet boom and bust. We watched as the trickle of U.S. and European firms setting up shop in Asia became a torrent. We saw the private equity world explode in size with come-and-get-it debt, and then freeze-frame when the lending markets imploded. And we kept asking for more, as a nonstop stream of crises played out in front of us. I vividly recall peering over the chasm of SARS and thinking it was all over, as people and businesses bolted out of Hong Kong in April 2003. Some never came back.

This story is about what happened then and what will happen in the future: private equity and venture capital's people, their firms, and their customers—billion-dollar pension plans, endowments, and sovereign wealth funds. It is also a story about the stage on which they play: the world's economies—chiefly the United States, Europe, and Asia. You'll see where the industry is today and where it will be tomorrow, and you'll look into the possibilities that lie ahead. The story is about the many challenges the industry faces: the plunge in distributions, looming government regulation, and the issues of succession and business models, among others. The story is also about the opportunities—from overleveraged companies to what's happening in alternative energy, digital media, and new markets. The words are mostly those of industry leaders: a global story about an important industry.

For all the many hurdles that private equity and venture face, however, I think the industry has a bright future. It is testing a new corporate norm, one that aligns the interests of owners and managers and alters the way in which they report corporate earnings. It's a future that offers a superior form of corporate governance—one that ultimately, I believe, leads to superior performance.

Accordingly, this drama is framed by a larger context—the global economy and the role these two communities will play in it. The system is on the mend, but the credit market collapse in the United States and Europe has taken its toll on both the general economy and private equity in particular: portfolio companies are struggling, new investments have been stymied, and all important exits are nonexistent. The IPO and M&A markets are slowly reviving but remain largely closed, with three exceptions: corporate acquisitions, bankruptcies, and fire sales. The recovery will be different in different places, reflecting each country's financial infrastructure, government policies, and corporate dynamics.

The relationship between general partners (those who invest) and their limited partners (those who supply the money to invest) is sure to change. The limiteds like the asset class, but there's a problem: returns on their investments have dried up. Many are facing large write-downs. Although they may be "in disarray," they are starting to talk to each other for the first time. And the financial arrangement that has governed the relationship between the two parties for the past 25 years is being questioned. As one economist notes, "We can show that private equity has outperformed public markets over a long period of time. There is an issue, though, in terms of distributing excess returns."

It's easy to point the finger at the United States as the origin of the economic maelstrom. The country's easy mortgage policies, toxic securities, and consumer spending lit the fire. (Its political shouting matches and fractured decision-making processes didn't help.) But a lot more happened around the world: the push toward global free trade meant that national markets were no longer isolated, China's emergence as a global power called into question its exchange rate policies, and the inflated asset bubble that gripped places as diverse as Dubai and London points to causes on a much broader scale.

Wilbur Ross, Jr., chairman of WL Ross & Co., says, "Historic modeling implicitly assumed that tomorrow would look a lot like yesterday. But the truth is, major credit crises come about when tomorrow turns out very different from yesterday." Howard Marks, chairman of Oaktree Capital Management, notes, "There's a lot of discussion now on models which have small tails. Most everything takes place within two standard deviations. But everything interesting takes place outside of two standard deviations."

Of any recovery, Ross says, "We will do well to be out of this recession by the second quarter of 2010, and even then the recovery is likely to be slow because of the permanent change in consumers' ability and desire to spend. This is not like the V-shaped recoveries from recessions that had been caused mainly by inventory reductions and tight money. The question is whether it will be a wobbly 'W' or more 'L' shaped." Marks agrees: "I see a saucer-like recovery, not a V-shaped recovery. Eventually, things will get better."

The world's economies are in a transition period. The public equity markets have rebounded from their lows in the period from late 2008 to early 2009. Many U.S. and European banks have reported better profits; multiple technology and consumer-driven companies are also making money. But collapses in the number of jobs, housing prices, and consumer credit markets have yet to be repaired. Western governments have taken many of the losses and defaults and put them on their own balance sheets. That's surely helpful, but now the same governments must begin to unwind the massive flows of capital they have pumped into the system. Whether these programs will alter fundamental purchasing decisions, reverse wealth destruction, or delay the shift of economic growth from West to East remains to be seen. Like many others, I also believe that we are seeing a delinking—a separation of high-cost, older, and mature economies from low-cost, younger, and growing markets. Tomorrow will be different from today for many reasons. The consequences for global economies are serious and far reaching.

A CHANGING WORLD

The numbers alone tell us that the world will change. In October 2009, U.S. unemployment rose to 10.2 percent—over 15 million jobless. Eurostat reported a September 2009 unemployment rate of 9.7 percent or 22 million in the 27 countries of the European Union. That's 37 million people without jobs on a workforce of about 385 million. Reemploying these people will take years. And many factory doors will not reopen. In Chapter Seven's discussion of new technology, I suggest there are still areas of innovation and new products. Though the great ideas may happen in the West, the products will be built elsewhere. The reasons are not hard to discern: lower manufacturing costs, growing demand, and the ability to pay for—not borrow—the costs.

The U.S. consumer will be less hardy than before, if for no other reason than they will have less money to spend. Without jobs, with retirement savings depleted, and with their home values deflated, American consumers will be doing what they should have been doing all along—saving. That's the good news. The bad news is that consumption accounted for close to three-quarters of U.S. GDP. One industry executive estimates that if U.S. consumer activity drops from 72 percent to 65 percent of GDP, $1 trillion of purchases will be lost from the economy. Two-and-a-half billion consumers in India and China will not replace them in the near future. Many banks have exited consumer lending, the mainstay of America's consumption-driven economy. And those funding the country's spending habits have likely learned their lesson. Securitizations that provide funding for credit cards and car loans remain moribund.

Corporate lending will revive, but on different terms and pricing. Western governments will pass regulatory legislation enabling them to tinker with important swatches of the industrial landscape. The United States will have a national debt whose $500 billion annual interest payments will consume 15 percent of an already inflated national budget.

The financial community has changed dramatically from two years ago. Gone are stand-alone U.S. investment banks. Hedge funds have fallen victim to redemptions, and securitization markets have yet to reopen. What started out as a crisis in the subprime mortgage market has infected the financial system and global economy as a whole—the downside of free trade, which is oblivious to national boundaries. And although the United States is slowly coming to its feet and Europe by and large remains static, the Asian economies are reporting robust growth. Their financial systems were largely unaffected by toxic securities, and their domestic demand has nowhere to go but up.

ENTER PRIVATE EQUITY AND VENTURE CAPITAL

What seems most likely to happen is also the most obvious possibility: for now, the global economy will shrink. An economic surge won't happen

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overnight, because the means to that boom—the credit markets and consumer demand—have also contracted. The progress of private equity and venture capital will reflect these macro conditions. The industry will have to deal with its own excesses, but it potentially has a tool in its arsenal to work through the downturn: a new model that combines accountability, focus, and financial structure to succeed. If you are unfamiliar with how the industry works, you can jump to the next chapter for a brief introduction.

There will be fewer billionaire private equity fund managers. The days of $20 billion funds are over until the industry better understands its needs and the new model evolves. The venture industry is in for a profound makeover as well: despite venture's inherent optimism about new technologies and new businesses, "institutional venture" is not funding the same technology businesses that it did in the 1980s and 1990s. Its investment profile has already become far more sophisticated. It will develop a new profile and new leaders.

This book looks at private equity and venture from a global perspective. Asia, Australia, and the Middle East have all begun to develop nascent industries on the back of growing economies. Though the larger private equity firms have grown global through the interdependence of free trade and industry expertise, by its very nature private equity remains local in terms of deal sourcing and portfolio company management. European and, to a lesser extent, American firms have had a hard time breaking into new markets. That will change over time, and the Western firms will learn to adapt.

What forces are driving global and national economies? What is the purpose of private equity? Why is venture capital facing an historic makeover? Who are the world's principal private equity and venture players? What issues does the industry face? Where are the opportunities? How could the industry alter the way in which corporations are governed and operated? Once the economy returns to "normal"—whatever that is—what will the world and, in particular, the private equity and venture worlds look like? Read on!

The World in Which We Live

Today's world is marked by economic, political, and social uncertainties. The economics speaks for themselves: massive deleveraging, a fall in consumer demand, and a freeze in bank lending are all apparent. Politically, many eyes have been on the United States—that is, on the Obama administration and Congress. There was considerable optimism as the new president took office in January 2009, but there remained a number of unknowns: administration policies and their effectiveness, the rate of U.S.

consumers' spending and banks' willingness to lend to them, non-U.S. investors' appetite for U.S. borrowing, and the fate of corporate America.

More seriously, the epicenter of global capitalism, Wall Street, is no longer held in the same esteem as it was before the meltdown. Many of its practices and relationships are being questioned. Certainly, other nations have looked at the salaries, bonuses, and options that many American corporate CEOs and financial executives have received and wondered whether the United States got its money's worth. The bailout of financial institutions seemed more a function of the Treasury Department's choices than of economic necessity. A popular ''cash for clunkers'' program spent \$2.88 billion, while Goldman Sachs received \$13 billion from the AIG bailout, \$10 billion under the Troubled Asset Relief Program (TARP), and multiple regulatory benefits. Goldman partners and alumni count among the richest people on the planet, whereas most of those receiving their \$4,500 rebates are, by definition, just able to afford a new car. Whether valid or not, other nations have looked at the numbers and decided to try it their way.

In March 2009, China's Prime Minister Wen Jiabao publicly wondered about the safety of holding U.S. government securities: ''We have lent a huge amount of money [\$1 trillion] to the United States. Of course we are concerned about the safety of our assets. To be honest, I am definitely a little worried.'' Whether that was intended as a joke or signaled a policy change is still an open question. The U.S. treasury secretary made a trip to China in May 2009 to confirm that the Chinese prime minister was only kidding. Secretary Geithner's assurances aside, my opinion is that he was not kidding. The Chinese intend to make their yuan a global currency as well as foster trade settlements in other non-dollar script. Socially and culturally, the disparity between the haves and have-nots has not gone away. The selection of *Slumdog Millionaire* as the Best Picture of 2008 by Academy Awards voters was more than a Hollywood moment: it was a profound symptom of these changes. But this is an economics book, so we will leave these and similar issues for others to resolve.

Prolonging the government guarantees and backstops that have been handed to financial and industrial corporations will be tough because of the deficits. Reversing them will be equally hard because companies have come to depend on them. Moreover, the sums may be insufficient to the task at hand, while disbursement potentially floods the United States economy with currency. For now, these amounts will live mostly on bank balance sheets or pay for small fixes or transfer payments—reimbursement for healthcare, highway repairs, or unemployment compensation. Instead of building an interstate highway system, the United States will paint bridges and fill in potholes. Despite the promise of a more comprehensive healthcare plan, the country will struggle to keep up with ballooning Medicare and Medicaid entitlements. Whether U.S. consumers can actually save is an open question. But as they do, with the national debt at $12 trillion and budget deficits expected to reach a further $10 trillion over the next decade, the private investments needed to rebuild the industrial infrastructure and to provide jobs will stall. Loading up the government's balance sheet with debt could simply kick the can down the street.

Is inflation inevitable? Not necessarily, if the economy remains depressed. But with the cash poised precariously for disbursement, it is difficult to see how it can ultimately be avoided. A dynamic and decentralized U.S. economy may rebound in other ways, but the late William Seidman, former chairman of the FDIC and the Resolution Trust Corp., said, "One of the great problems is that when we start to reduce these guarantees, how the private sector will react? We have so many programs, the results will be different."

Europe has built an enviable infrastructure and can look toward the East for new markets and manufacturing capacity. Education is solid and living standards high. But governments will bicker over work weeks and termination benefits rather than encouraging entrepreneurs and risk-taking corporations. In the United States (and in Asia), an entrepreneur loses, but then gets up and tries again. In Europe, he loses and he's out. Maybe that is inevitable in a region where personal wealth tends to be inherited and an easy lifestyle has become the ultimate objective. Brussels will expand, but without the cultural impetus to innovate and grow, it remains to be seen how the underlying economies will keep pace with global expansion.

Asian markets may well fare the best of all. Their economies will feel the impact of lower exports, but their financial institutions remain solid, their citizens solvent, and their economies growing. Clearly, the commodities markets were hit by the recession, as were export-driven economies. But commodities have rebounded. As one Chinese economist pointed out, "There is no financial crisis in China." Nor is there one in India. For several reasons, including government regulation, Asian banks did not buy the toxic assets or engage in risky lending that affected major banks in the United States and Europe. As a result, these economies seem to be emerging more quickly from the downturn than others.

Toward a New Corporate Norm?

At the end of the day, corporations conduct business; governments do not. Stephen Diamond, a law professor at Santa Clara University in California, writes, "The arrival of a potentially new stage in the history of capitalism is, without doubt, an unusual and perhaps perplexing event. The last such moment was marked 75 years ago by the publication of *The Modern*

Corporation and Private Property in 1932 by legal scholar Adolf Berle and economist Gardiner Means. Their book is now recognized as a critical, if flawed, study of the publicly traded corporation, which was then still a relatively new and little understood institution.''[1]

To a large extent, as Berle and Means predicted, the modern corporation has become a captive of management. The fault lies largely with distracted boards of directors and dispersed shareholders. Nominally, the board of directors represents the shareholders. Sometimes that works; many times it doesn't. All too often, the board's members are nominated by the CEO. He or she remains the person in charge. Directors are reluctant to buck the chief. Other factors also affect management behavior. These include activist institutional shareholders, who are increasingly vocal, and security analysts, whose forecasts are tuned to quarterly earnings. The all-important, albeit invisible, third man—''better than expected'' or ''worse than expected''—also shapes stock market reaction.

Are the accepted divides between shareholders, managers, and employees still viable? Does the private equity and venture industry provide a model for successful corporate behavior different from that of Berle and Means? The answer, I believe, is yes—from both a financial and an operations standpoint.

Financially, private equity and venture capital may well be one of the only institutions left standing. With investment banks operating as bank holding companies, and bank holding companies dominated by a handful of giants, the field looks increasingly bare. Capital markets' trading has driven their profits, but banks' core lending activities remain frozen. Advisory houses and hedge funds will endure, but few with institutional funding or a ''hundred day plan'' to lead the financial field will be around.

By contrast, private equity firms have a robust funding structure: ''long-term deposits''—investments—from their limited partners. Their capital and investment horizons are premised on future goals. They are flexible in their approach to potential opportunities. Though resting on an illiquid base, they offer higher returns to their investors in good times. Although their portfolio companies are suffering from the same downturn afflicting the rest of the economy, the owners control both the balance sheet and the business. General partners can perform their own triage on companies that will succeed, those that need help to survive, and those that should be left to fail. Many private equity houses have losses in their portfolios, but they are also sitting on large amounts of uninvested capital.

Operationally, that underscores the most profound reason why I believe the industry will change but the art form will remain: accountability and the alignment of interests. As private equity (in its saner moments) has shown, aligning business ownership with business management produces profitable results. Separating ownership and management doesn't always produce a debacle, but many of the recent busts in the financial, automotive, and retailing sectors have proven exactly that. Venture will be different as well, but the fundamental reason for its existence remains: sourcing institutional capital, investing in new ideas, and bringing them to market.

Despite the current reliance on government intervention, private equity and venture nominally solve the problem of modern corporations by aligning the interests of owners and managers. By demanding accountability to the owners of the business, these firms provide incentives to operate in today's highly competitive global economy. At the same time, successful general partners are involved in the businesses they fund. As a result, private equity could well emerge as a model for corporate governance and as a weathervane for the underlying economy. If large, centrally controlled companies are breaking down, then the answer could be an economic model based on more flexible entities, direct links between ownership and management, a corporate structure that is less leveraged, the input of banks and LPs, and recognition of the role played by motivated employees. Private equity and venture may have formalized the interdependence of owners, managers, debt providers, and labor. They work as a team to ensure a profitable and successful corporation. If that's the case, then issues of accountability, ownership, and ultimate rewards should be revisited by the corporate community as a whole.

Will private equity and venture save the western world's economies as we know them today? No. As successive chapters show, the industry must first save itself before it can save others. The model for the past 35 years, with few if any modifications, has been unchanged. Investors (LPs) have seen their returns dwindle, whereas fund managers (GPs) have watched their bank accounts soar. That may or may not change, but there will be questions about how "excess returns" are rewarded. There are regulatory and tax hurdles to be overcome. And there are serious structural questions—including succession issues, the dearth of credit and exits, and choice of business model—that the funds will have to address soon. If not, then Boston Consulting Group's 2008 study[2] could well prove true. They reckon that as many as 40 percent of the private equity and venture partnerships that began in 2003–2007 will go out of business in the next two to three years because they cannot get funding.

Private equity and venture are approaching the end of their first generational life cycle. What current leaders leave behind and how they handle the transition will determine the industry's contribution to the financial system and ultimately to the future global economy. As the book suggests, the potential is large.

The intent here is not to lionize private equity or venture capital, but to recognize their strengths for what they are: in their finest hour, they provide generally successful ways to rehabilitate companies or build businesses through a more efficient means of corporate governance. Many wealthy people have made their money though private equity and venture. They don't own oil wells, they didn't get it from Dad, and they are not in jail. A lot of public and private institutions have given them money to invest—state pension funds, private endowments, and corporate bankers. These dollars represent the retirement savings and pensions of millions of people. There must be something to it, and that something is the story this book tells.

American-Anglo Institutions

Although my experience at the *Asian Venture Capital Journal* in Hong Kong begins in Asia, it has required a global perspective. That's because in their formative years in the 1970s and 1980s, Asia's financial and legal institutions had just begun to develop. As such, the Tokyo or Hong Kong offices of Western institutions were effectively run out of New York and London. That began to change in the 1980s as overseas firms rented offices in Tokyo, and continued in the 1990s as they sent managing directors to Hong Kong and Singapore. At the same time, Asians schooled in the United States, United Kingdom, and continental Europe came home to run local operations. Thus to understand Asia required an understanding of events in the United States, United Kingdom, and Europe. Today the Middle East and parts of Africa and South America should be added to that list.

It is my opinion that private equity and venture capital in their modern guise are largely American-Anglo institutions that have been brought to and adapted by Asian markets. The reasons for their U.S. and U.K. origins are straightforward: they rely on a partnership structure that has its foundations in American and English common and statutory law; they are funded through widely held capital pools that had previously existed only in the United States and United Kingdom—public and private pension funds, endowments, and foundations—and they earn their returns through highly liquid public securities and M&A markets whose existence is facilitated by Western institutions. That is not to say that Asia and the Middle East don't have similar activities through the role played by prominent families and nascent funds. They do. But the industry's hard edge, legal structure, and financial distributions are all Western at heart.

Beyond that, the structure of private equity and venture capital reflects American-Anglo free markets. Private equity has enabled individuals with little more than their smarts and a good name to borrow and build vast financial empires. Venture capital as we know it depended on cultural, educational, and legal foundations that were initially found only along Route 128 (Boston) and in Silicon Valley (San Francisco Bay Area). The model has been brought to and adapted by European and Asian markets. Much has certainly changed on these continents. They cannot be the same there. But the concept survives largely intact. That testifies to private equity's and venture's underlying strengths, which are explored in this book.

The book is divided into eight chapters. After this Introduction, the next chapter is a primer on private equity and venture capital. Not necessary for those in the business, useful for those who aren't. It also asks the question, "What is the purpose of private equity?" The third chapter discusses the private equity and venture capital industries in the context of the macro/economic forces that affect how they operate. Economists, general partners, and limited partners provide their thoughts. This chapter also discusses the banks, sovereign wealth funds, and the limited partners. The economic crisis has given added impetus to their concerns, and the market may well be looking at some fundamental changes in the agreements between the general partners and their customers. Issues and opportunities in venture capital are also discussed. The venture focus is mostly on Silicon Valley and China, though important markets in Australia, India, and Europe are also covered.

The fourth chapter surveys today's private equity and venture capital landscape by looking at the league tables. Although they capture only a small segment of the industry, that's probably the best way to see who's doing what. The fifth chapter looks at private equity and venture capital through the prism of world markets. It covers the United States, Europe, and countries in Asia (including Australia) and discusses issues and opportunities in the venture community. The emphasis is mostly on Silicon Valley and China, with a look at Europe as well. If private equity will need to rescale and rethink its internal dynamics, then venture capital may well be looking at a different organizational model altogether.

The sixth chapter covers industry issues. There are many, among them tax, regulatory, and internal questions. Internal issues involve publicly held partnerships, succession, the public face of private equity, business models, and the split between private equity and venture. And then there are the issues that venture capital firms must resolve. These center mostly on returns—improving the IPO process, for starters.

The seventh chapter gazes into the crystal ball. It is about the new landscape, the model for private equity and venture capital. It discusses investment opportunities for private equity and its partners—pension funds, endowments, and high-net-worth individuals. It looks at opportunities in distressed and secondary markets as well as the many ideas and emerging industries in which venture capital can invest. The chapter concludes with a sobering thought: however private equity and venture capital invest, their new technologies and energy-saving devices may not be made in the United States or Europe under current conditions. There will be some relief if the United States and Europe devote more dollars to research and development. But the underlying trend will be hard to change: Asia's cost, population, and financial attributes will increasingly make it the world's manufacturing and consumer center. The United States and Europe will hold their own, but future growth will narrow to certain sectors, leaving governments with the problem of what to do with persistent structural unemployment.

The final chapter proposes a new model for corporate governance. If private equity and venture capital offer a path superior to the large corporation as it exists today, what are the implications for Western corporate culture? What lessons does this hold for more traditional European and Asian companies? Do we need to think in terms of an incentive-driven management and workforce accountable to involved ownership and directors, rather than the traditional corporate pyramid with an all-powerful CEO, passive board, and dispersed shareholders? The answer is undoubtedly yes. But no one knows whether or when that will happen.

This is not a casebook, a "how to," or a "confessions of" book. Nor is it a social commentary. This book highlights one important corner of the financial world. My purpose is to consider the world's economy and financial backdrop on a global scale, to suggest what may lie ahead, and to outline a role for private equity and venture capital among the many changes that will occur in the years ahead.