The Globalization of Private Equity and Venture Capital

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What is Private Equity (P.E.)?

Partnerships specializing in;

- Venture Capital
- Growth Capital
- Leveraged Buyouts
- Mezzanine Investments
- Build-Ups
- Distressed Debt

Brief History

- Spectacular growth in the U.S. from 1980 ($4 billion) to today ($300 billion).
- Highly cyclical: large increases and decreases in annual fundraising.
- Primarily concentrated in the U.S. and U.K.
- P.E. has become much more global over last decade.

How does P.E. investing differ from "Public" investing?

- P.E. investors are ***Active*** investors.
- Builds companies in venture capital.
- Changes their direction in buyout funds.
- Distinct from the "active management" of hedge funds or mutual funds in the public markets.

Why is P.E. needed?

- Start-ups starved for capital or
- Large ailing firms that need to restructure

– present risks and uncertainties that discourage other investors.

Risks

- Uncertainty and information gaps -difficult to assess these firms.
- Difficult for the typical investor to verify outcomes
- Difficult to write contingent contracts.
- This makes external financing costly.

Risks

- These information problems can be alleviated by P.E. firms.
- P.E. intensely scrutinizes companies prior to funding and carefully monitors afterward.

What Not Banks?

- Banks usually don't have the skills to evaluate projects with few tangible assets and significant uncertainty.
- Banks unable to take equity positions.
- Banks unable to charge borrowers high enough rates to compensate for the firm's riskiness.
- Banks are unable to replicate the high-powered compensation systems of P.E.

Globalization of Private Equity and Venture Capital

- Do governments welcome P.E. firms?
- Global P.E. is highly cyclical.

Private Equity Int'l Top 50 Global P.E. Firms

(based on capital raised 2005 -10)

- 34 North America
- 9 London
- 2 Sweden
- 2 France
- 1 Holland
- 1 Greece
- 1 Dubai

Europe Experience

- Highly cyclical, early attempts largely failed.
- Buyout firms outperformed venture capital.
- Privatization efforts of national governments and deconstructing inefficient conglomerates. Ex. government owned telecoms.
- P.E. is well developed in the U.K., underdeveloped in Germany.

Why the differences?

- IPO market, labor market rigidities, accounting standards, private pension funds, government programs, tax and legal structures, strong university system.
- Civil law countries (France, Germany) tend to have less venture investing than Contract law countries (U.S. and U.K.).

Developed Asia Experience

- Australia: 13 billion $US in 2009, most all in buyout funds.

- Japan: peak of 10.6 billion $US in 2006 to less than 1 billion $US in 2010, struggles to become established. Management buyouts becoming more common.

P.E. Emerging Markets

Difficulty in becoming established:

- underdeveloped business infrastructure,
- lack of deals of adequate size,
- management culture not focused on profits,
- inadequate legal systems,
- lack of accounting transparency,
- political instability,
- difficult to exit due to lack of IPO market and lack of potential purchasers,
- competition from subsidized state-run enterprises.

P.E. Emerging Markets

- Strong growth rates in P.E. fund raising since year 2000.
- Most P.E. investment occurs in Growth capital – investing in a company that already has a market and a product reduces the intense hands-on supervision needed in a start-up.
- L.B.O.s may be difficult since government approval can be needed and due to lack of adequate debt financing.
- Emerging Asia investment mostly in China and India.

China:

- Still evolving – legal, regulatory, and administrative frameworks for the RMB funds and for joint ventures with foreign funds is not developed.
- Primarily investing in Growth capital.
- Carlyle Group most active P.E. firm from U.S.
- Challenges include finding management comfortable with Western style firms and lack of accounting transparency.

India:

- Continues deregulation of markets.
- Primarily investing in Growth capital.
- Carlyle, Blackstone, Sequoia, 3i, Bessemer Venture Partners, KKR have largest presence among overseas funds.
- Challenges include poor infrastructure and complicated regulatory system.

Vietnam:

Domestic Funds:

- VI Group (Vietnam Investments)
- Mekong Capital
- VinaCapital
- Indochina Capital
- Saigon Securities
- Dragon Capital

Vietnam:

- Overseas Funds:
- KKR (recently closed $200 million deal to invest in Masan Consumer Corp.)
- TPG Capital
- Navis Capital Partners (Malaysia)

Discussion questions:

- Will the P.E. model which evolved in the U.S. likely be successfully translated to other countries?
- Will only Buyout funds make the transition or will other types such as Venture Capital also make the leap?
- How can the tools of P.E. – Active monitoring by P.E. investors, compensation linked to results, and an emphasis on good governance be best adopted in emerging markets?

Discussion questions:

- How will P.E. groups deal with questions of scaling and institutionalization and the disruptive impact of market cycles?
- What makes a country or region more likely to adopt private equity as a funding mechanism?
- What conditions predispose P.E. transactions to success?