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PRIVATE EQUITY AND VENTURE CAPITAL – A PRIMER

A short primer on the private equity and venture capital industries (and how to get in!)

THE private equity and venture capital industry has been getting much press recently – BusinessWeek, Forbes and The Economist have all carried articles on this sizzling industry in the past six months. And sizzling it is – the industry controls $800B[1] in capital (5.5 times India's foreign reserves), raising $174B in 2005 alone. So, what is the VCPE (as it is commonly called) industry?

Broadly, the term private equity refers to investing in a firm's equity privately – not via the public markets. A VCPE firm invests in the equity of a firm, owns it for a period of time, then sells the equity to another buyer or to the public (via an IPO), hopefully making good on its original investment.

A rough segmentation of the industry – venture capital, growth equity, "deep value" or late-state investing and distressed investing – doesn't explain all its nuances, but is a starting point. Venture capital refers to investing in early-stage companies, think Kleiner Perkins and fabled investments like Amazon, Yahoo and Google. Growth equity refers to investing in growth, usually resulting from macroeconomic factors or changes in industry structure – discontinuities of one type or the other. Recall the $300M Bharti Telecom investment by Warburg Pincus. Deep value investing refers to investing in firms that are sold at prices below their "true value", or, in other words firms whose operational value can be unlocked therefore creating equity value. These are often firms that could be run better; consider the $5.1B buyout of Nieman Marcus by Texas Pacific Group (TPG) and Warburg Pincus. Finally, distressed investing refers to buying distressed (firms unable to pay up their debt obligations) on the cheap, and either turning them around or making money off their assets. Wilbur Ross may be the most notable recent example; he has made a fortune investing in left-for-dead business and industries in the US.

In recent times, hedge funds, which traditionally invest in the public markets and could have a fundamentally different set of investors, have also begun investing in private equity. An illustrative deal that has seen much press is ESL Investments purchase of 52% of Kmart. 2005 also saw the birth of funds that would be pursuing dual strategies (public and private equity), a marquee launch was that of Eton Park Capital Management founded by Eric Mindich, who had been the youngest partner at Goldman Sachs at age 27. Not to be outdone, top tier PE funds grew hedge fund subsidiaries, Blackstone started a $9.5B hedge fund arm and TPG launched TPG-Axon with $2.8B in capital. This convergence between hedge funds and private equity is very real, and was one of the most talked-about industry trends in 2005.

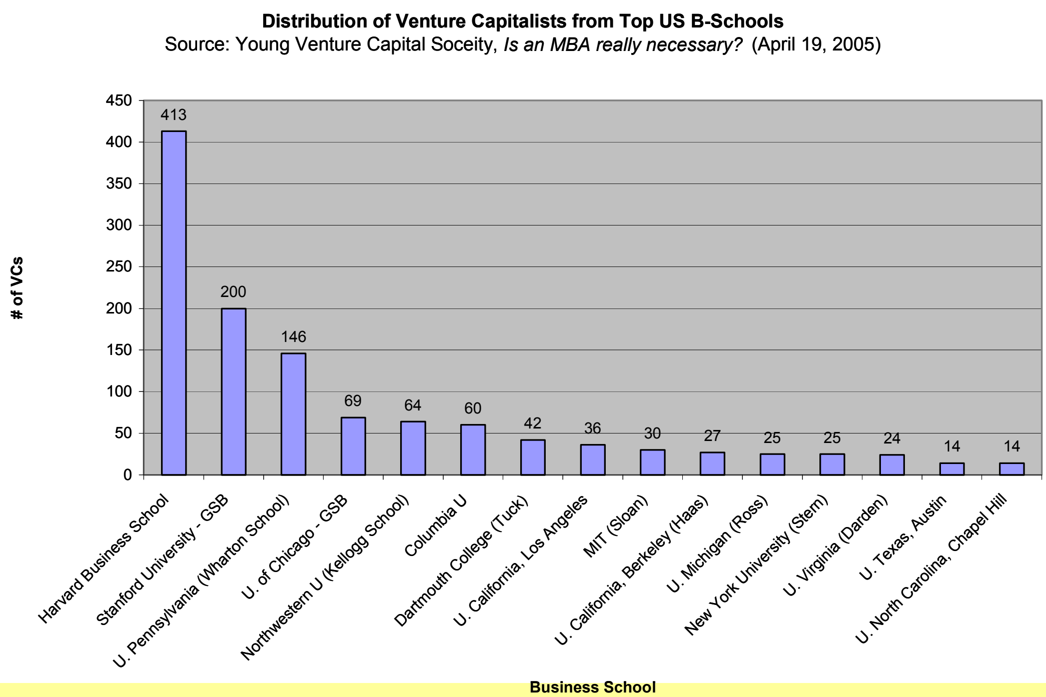
Note that these segments form a continuum, essentially reflecting stages in the evolution of a firm from startup to (perhaps) distress. Historically, these segments of the industry began somewhat differently. Venture capital, some would say, began with Arthur Rock's investment in Fairchild Semiconductor in 1957. This is a fascinating tale of 8 scientists (dubbed the "traitorous eight") walking out of the legendary Shockley Semiconductor, and seeking investment in their new venture. Rock, a visionary New York banker visiting the west coast, met with and invested in them, eventually helping create Silicon Valley. The invention of late-stage investing is less clear,

[1] BusinessWeek, 26th February, 2006

but its popular techniques – including the leveraged buyout (LBO) were known on Wall Street in the 1960s, preceding the creation of well known speciality firms such as Kohlberg Kravis Roberts (KKR), Forstmann, Little' and Clayton, Dubilier & Rice.

There are 3 ways for an investor to create value – growth, leverage and operational improvements. (For the finance-geeks, this would translate into revenue, WACC – Weighted Average Cost of Capital and ROA – return on assets respectively). Investments are made in one or more of these – VCs invest in growth for most part, while later-stage investors often create value via a combination of leverage and operational improvements. Roughly speaking, that combination describes an LBO or "leveraged buyout", where a private equity firm buys a firm for an amount equal to a sum of (a) capital from their own fund and (b) debt raised from the markets. The debt is carried on the balance sheet of the acquired firm, and is paid down through cash generated via operations.

Getting into private equity may interest BITS Pilani graduates. You're not alone; this is a hot topic on most business school campuses. There is no single path to private equity (see interview with Vivek Paul), but knowledge of specific skills for the investing business that might help the more recent graduate. Refer again to the segments described earlier – skills vary by segment. The VC industry is usually interested in operational experience (have you run anything?), so BITSians who are either entrepreneurs or product managers (better still, have significant P&L responsibility) could be well positioned. The VC industry also tends to focus mostly on IT and life sciences/healthcare, so experience in these industries helps. Growth equity requires both strategic (to identify discontinuities and for operational value-add) and financial acumen (to work with valuations), so firms tend to look for former consultants and bankers. Late-stage investing is similar to growth in its requirement, noting that banking experience is essential at junior levels, even when you have been a consultant. Finally, distressed investing tends to look for people who can combine financial savvy with law, no surprise



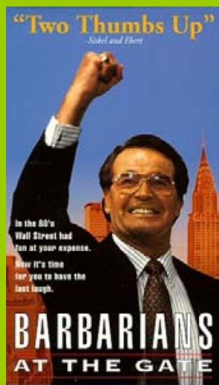
Is an MBA necessary?

Is an MBA really necessary to break into venture Capital? While not a necessity, the list below demonstrates that a large constituency of current venture capitalists pursued an MBA. Moreover, the list highlights the power of going to a highly ranked school such as HBS, Stanford and Wharton.

To find out more information on where VCs worked or went to school (Undergrad, MBA, Masters in Engineering, Law or Ph.d), visit the YVCS website and check out the VC database (www.yvcs.org)

Source: *Young Venture Capital Society, April 19 2005.*

The RJR-Nabisco LBO



Perhaps the most discussed private equity transaction ever is the $25B 1989 leveraged buyout of RJR-Nasbisco by Kohlberg, Kravis, Roberts & Co (KKR). There is a book (“Barbarians at the Gate”) and a movie on that deal, which has never been surpassed in size.

The process began with a bid from Ross Johnson, then head of RJR-Nabisco, and the Shearson Group, a PE firm, to take the firm private. At the outset, this group was offering a 34% premium on the market price of the shares. The negotiation and counter-bidding that followed ended with shareholders getting a 97% premium on the market price at the start of the process!

Within four days of Ross Johnson’s proposal, bidders started to appear on the scene. KKR and Ross Johnson also met to consider a joint deal, which didn’t eventually work out. Next, the firm announced an open auction with a deadline for bids. Multiple extensions of the deadline followed, with bidders coming in and falling out at each step. At one point, KKR indicated they may walk away, but eventually returned with the highest bid.

This example illustrates how transactions could begin with management intent to sell all or part of a firm. The $11B 2005 Sungard LBO began as an attempt to sell a division.

considering the legal wrangles in bankruptcy.

There are a few other things to consider when looking for a VCPE job. First, these firms are hugely selective, and hire very few people on an annual basis. Second, firms tend to hire when they close funds, which is something you can know of from trade publications. Third, the depth of a PE market could determine the type of people – for example, India is a relatively young PE market, so no one sector merits having specialist professionals dedicated to that sector. Consequently, most PE firms hire generalist consultants or bankers. In the US, where the market is mature enough to merit industry specialists, the profile of people at a firm tends to reflect more vertical specialization. Further, you almost always need a business or law degree, except for venture capital and at very senior positions, where degrees count for a lot less. Even if you are at business or law school, VCPE firms tend not to show up on campus for hiring, and you will need to network on your own to find a job. Finally, some business schools have better alum networks in the PE world; Harvard Business School is clearly the leader when it comes to alumni in the private equity industry. Stanford and Wharton are the other two business schools that, together with HBS, have a large alum base in the VCPE community.

There are BITSians in all segments of the industry, and you should reach out to them if you are seeking a VCPE career. Many VCPE firms have very detailed websites, spend time looking through them to understand what they do and who they employ. Further, there are a vast variety of websites and trade publications that can help you keep up with current state of the industry. For an overview, there are many books you could read – consider reading “The New Financial Capitalists”, which traces KKR history in detail and is a good primer on the buyout industry. On the venture side, try a subscription to Dow Jones’ Venture Capital Analyst, which has different editions for technology and healthcare. On the web, use www.altassets.com in general, and http://ventureintelligence.blogspot.com/ for India related VC information. Finally, if you are at business school, you are likely to have access to paid databases and news-services focused on VCPE (for example, VentureXpert), use those extensively.

I will end with the same exhortation I have at the end of every message to BITSians on the bits2bschool list. Dare mighty things in whatever you do; stretch yourself beyond your limits, and the rest, VCPE jobs included, will follow. Good Luck !

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