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Private Equity: Today America, Tomorrow the World

The Irresistible Rise of Global Private Equity

by Ray Maxwell

No man is an island, entire of itself
Any man's death diminishes me because I am involved in mankind
And therefore never send to know for whom the bell tolls;
It tolls for thee.

John Donne
Devotions upon Emergent Occasions 1624

Although the above piece is somber, it reflects the point that mankind is interconnected—a fact even more apparent in today's world of mass communication and interdependent economies.

Stock markets dominate the investment landscape. Because of this, the role of private companies, as a major agent for growth and change, is frequently overlooked. Private equity has a sustainable global dimension.

The Private Equity Solution

Invariably behind all NYSE-, FTSE- and DAX-quoted companies is a supply chain of small, privately owned firms providing products and services. The automotive industry is an example where major brands such as General Motors, Ford, Toyota and Renault/Citroen no longer manufacture, but subcontract virtually all elements of production. In Europe, the creation of the single market has led to rapid consolidation that is imposing profound change on Small to Medium Sized Enterprises (SME). Up to 1999, Europe had 40 battery manufacturers and 50 tractor manufacturers compared to 3 and 5 respectively, in the U.S.[1] The companies supplying these industries either have to acquire other complementary activities, expand organically or pass control from owners to managers who are capable of meeting the new challenges. In all of these situations private equity can provide the appropriate solution.

The supply chain is no longer limited to being solely domestic, but may be regional (e.g., the automotive industry) or global (e.g., technology companies such as Intel, Cisco and Nokia). Intel, often regarded as a

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"Silicon Valley" company, is a global business with locations in 40 countries. Apart from the U.S., these include large-scale design and development facilities in Ireland, Israel and China.

Although the U.S. has been Intel's major market, 59% of the company's 2000 revenues were derived from sales outside the country.[2] This is a reflection of the globalization trend that is helping economies to move from being resourced-based to knowledge-based. A recent Global Competitiveness Report (GCP) noted that, "As economies move from low to middle income status, global competitiveness becomes investment driven, as economic growth is increasingly achieved by harnessing global technologies to local production. Foreign Direct Investment (FDI), joint ventures, and outsourcing arrangements help to integrate the national economy into international production systems, thereby facilitating the improvement of technologies and the inflow of foreign capital and technologies that support economic growth."[3]

In the report, Finland—closely followed by the U.S.—was listed as being the most competitive economy with the best prospects over the next five years. Sweden, the UK, Ireland, Germany, Israel and Poland were all well placed.

In a supplement to the GCR, published after the events of September 11, sentiment remained positive that the world economy and the globalization process would continue.

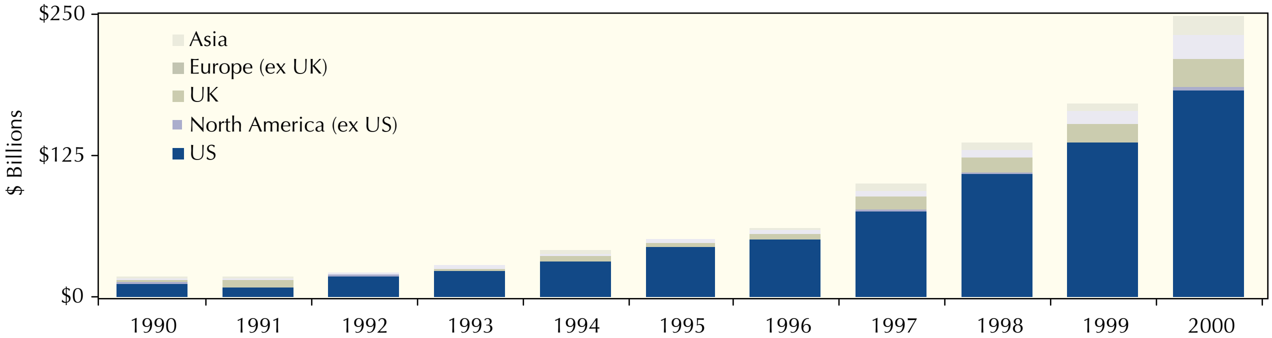
The Economist Intelligence Unit endorsed this in their survey, where they noted globalization continues to gain momentum and that the FDI is its most potent method.[4]

The globalization trend is helping economies move from being resourced-based to knowledge-based.

However, we are currently enduring a downturn in the economic cycle with a noticeable reduction in transaction volumes. The depth of the current malaise is evidenced in a recent report by KPMG. It showed the total value of global M&A activity fell from $3.3 billion in 2000 to $1.6 billion in 2001[5]—a decline of 52%. As business confidence gradually recovers, private equity opportunities will re-emerge across the globe. The KPMG survey suggests the M&A markets are at their nadir.

Trying to predict when recovery will take place is not easy, since confidence is built on the stability of global stock markets, the state of world economies and corporate earnings meeting analysts' expectations. *The Wall Street Journal Europe*,[6] in an article entitled "European Deals Could Acquire New Life" was more sanguine, noting that the European forces driving consolidation are stronger than ever and companies, especially in the debt-burdened sectors of telecommunications, media and retail, are looking to restructure. The article observed that there is a substantial pool of private equity available to spend "if the right deal comes along."

Exhibit 1
All Private Equity Commitments



Source: Venture Economics

Private Equity is Not Unique to the U.S.

It is often thought that private equity is an American phenomenon, stimulated by the creation of the Small Business Investment Company (SBIC) Program in 1958. However, 13 years previously, in the UK, the Bank of England and other major commercial banks formed "Investors in Industry" with the objective of funding small enterprises and supporting reconstruction.[7]

The entity, now called 3i, is a FTSE 100 company with over $8.4 billion (£5.8 billion) of assets under management operating out of 42 offices of which 15 are in the U.K., 23 in Continental Europe and 2 each in the U.S. and Asia. Year ending March 31, 2001, 3i invested approximately $2.9 billion (£2.0 billion) of which 14% was allocated to start-ups and the rest to buyouts and growth situations. In terms of geography, the UK accounted for 51% of the investments, Continental Europe 39%, U.S. 7% and Asia 3%.[8]

The reason for focusing on 3i is to show that private equity has not been the sole preserve of the U.S. Going back further, it can be argued that the Tulip and South Sea Island Bubbles, of the 17th and 18th centuries respectively, were the precursors of the Internet boom.

Private equity really came of age during the 1990s with global fund raising growing from approximately $18 billion in 1990 to $250 billion by the end of the decade as demonstrated in Exhibit 1.

The increase in funds was a reflection of a buoyant global economy led by the emergence of new technologies in the realms of communications and life sciences. Of equal importance has been the increasing use of buyout deals as a restructuring tool, helping corporations improve their efficiency by divesting themselves of non-core businesses.

The growth in funds was led by the U.S., however, it has to be noted, a significant number of domestic groups such as Carlyle, Hicks Muse, Texas Pacific, KKR, Clayton Dubilier & Rice, Benchmark, Crescendo and Accel have set up operations in Europe. Sequoia, a company focused exclusively on Silicon Valley transactions, took the radical step of opening an office in Israel.

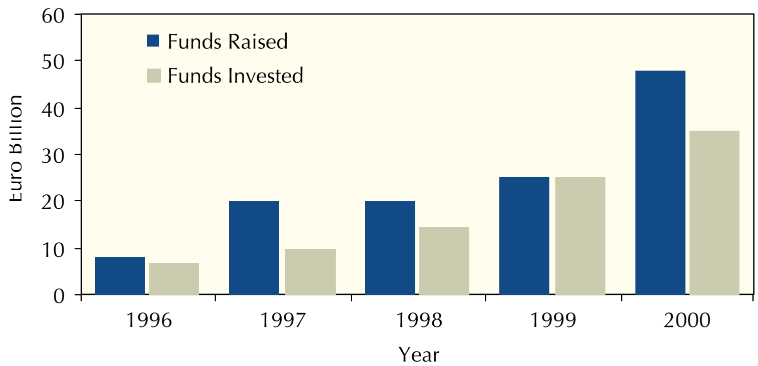
Expansion of The European Private Equity Market

The growth of the European private equity market has been spectacular, rising to euro 47.2 billion between 1996 and 2000 as shown in Exhibit 2. American sources of capital have been significant and consistent supporters of European private equity, committing 20% (euro 9.7 billion) of the aggregate funds raised, up from 16% in 1999.[9] In Europe, the European Venture Capital Association's (EVCA) membership has increased from 43 members in1983 to currently over 850—an illustration of the solidity of the European market.[10] The most active private equity market, however, is in the U.K where the British Venture Capital Association (BVCA) now has over 150 full members.[11]

Though the European marketplace has developed strongly over recent years, private equity is only a third of the U.S. GDP figure of 1.01%.[12] An indication there is further scope for European private equity development.

According to a recent survey, U.S. investors have steadily increased their allocation to international private equity from 6% in 1995 to 17% in 2001, the majority of which is focused in Europe. Public pension and corporate plans were also shown to have allocated between 20% and 21% of their private equity portfolios to international with over 50% allocated to Europe.[13]

Exhibit 2
Funds Raised in Europe

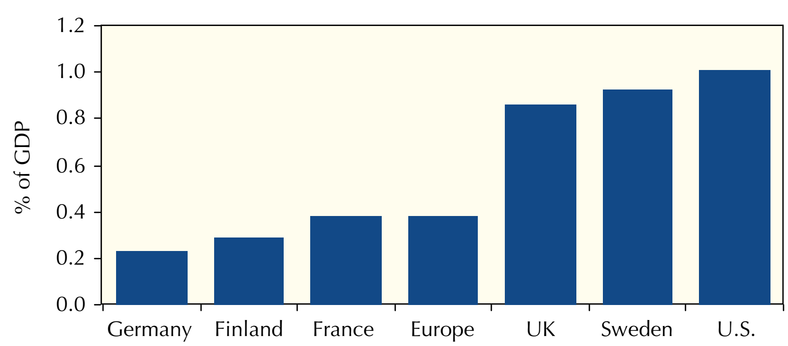


Source: EVCA Yearbook 2001

Centers of Innovation and Development

Over the past decade, a number of factors have contributed to the growth of venture capital and private equity. A key ingredient was the remarkable advance both in mobile telephony and in the usage of optical fiber to deliver broadband services. The emergence of the Internet (combining

Exhibit 3
European Private Equity as Percentage fo GDP—2000



Source: EVCA Yearbook 2001/3i Group plc Report and Accounts technological advances in computing and communications) will eventually be recognized as being as significant as the printing press in broadening the dissemination of information and improving business efficiency.

In the area of life sciences, the completion of the human genome project is the beginning of a medical revolution that has given birth to new technologies such as bio-informatics, proteomics and pharmacogenomics. These new technologies are creating the next generation of diagnostics and therapies. Although economic activity has slowed down and stock markets have retrenched, technology continues to touch us all and there is no discernable reduction in the pace of innovation.

In terms of development, the Israeli venture market has had no peer.

Although the U.S. has been at the forefront of technological development, over the past decade, there has been a critical shift with the emergence of centers of innovation in line with globalization. Across Europe, in Israel and in India, hubs of technology have been established, commercializing innovations emanating from universities and research centers.

Examples include the Cambridge Science Park, in the U.K., which has been the home to 1,200 or so start-ups since 1990. Cambridge pre-dates MIT and Stamford as a center of excellence, but until recently has not been as adept in commercializing innovation. Cambridge has focused exclusively on "hard science" and counts among its recent successes ARM (advanced micro processor design), Virata (software and semi conductors for broadband network equipment) and Cambridge Silicon Radio (single-chip bluetooth wireless system).[14]

In Cambridge, and other university cities such as Manchester, Edinburgh, Lyons and Munich, technology hubs have been built around centers of academic excellence. The Scandinavian telecommunication giants Nokia and Ericcson have been responsible for a large proportion of innovation in mobile networks and handsets. However, around these companies have grown clusters of start-up companies creating the services accessed over the mobile networks. A prime example is Iobox, a wireless portal launched in 1999 to create and exploit opportunities for connecting the Internet with mobile communications. The company has over 4 million subscribers across Europe and was sold to the Spanish telephone operator, Telefoncia, last year.

In terms of development, the Israeli venture market has had no peer. In 15 years it developed into the world's second-most important hi-tech cluster after Silicon Valley. In 2000, Israeli hi-tech start-ups attracted $3.2 billion invested in 3,000 companies.[15] The emergence of Israeli technology can be attributed to the combination of government incentives, a highly educated scientific labor force, military investment in technology, high levels of FDI and a positive attitude to risk-taking. Like Cambridge, the main focus is on core technologies particularly in the areas of communication infrastructure and life sciences. Companies such as Amdocs, Checkpoint and Comverse Technology have become global leaders in their respective fields.

Since 2001, Israeli venture capital groups found it difficult to raise funds due to economic conditions and perceived political risks in the Middle East. However, as Roger Abravanel has observed, Asian and European companies such as Nokia and Deutsche Telecom are filling the void by investing both directly and into Israeli venture partnerships. He noted that U.S. companies have shifted their focus from seeing Israeli technology as a cheaper substitute, to making Israeli innovation and innovators an integral part of long-term corporate R&D strategy.[16] This is further evidence of the significance of globalization.

Restructuring and Consolidation Provide Growth Opportunities

Early-stage innovative companies have been the recipients of funding from local venture capital sources. This reflects the acceptance of the venture model nurtured in the U.S., coupled with a growing tide of entrepreneurship.

Through the 1990s, the buyout markets of the U.S. and Europe enjoyed substantial growth as companies restructured to improve their competitive position. In Europe, the major driver was the advent of the "single market" and the introduction of the euro replacing 11 European currencies. On January 1, 2002, euro notes and coins became legal tender.

The process of consolidation has been felt in fragmented industries such as financial services and engineering. Large companies began the process at the end of the 1980s, but mid-sized and smaller companies are only now recognizing the need to restructure or perish. Over the coming decade the opportunity for private equity will be sponsoring consolidation in the mid market.

Early-stage innovative companies have been the recipients of funding from local venture capital sources.

During the past few years, European business culture has shifted from being corporate-minded to becoming more entrepreneurial. This is due to a general reduction in the rates of capital gains taxes coupled with an appreciation of the concept of shareholder value. Tax changes taking place in Germany in 2002 should encourage founders of "Mittelstand" companies to dispose of their interests without incurring punitive taxes. It has to be noted, not all owners want to sell to private equity houses. A recent article in *The Economist* pointed out that many German owner bosses are used to being masters in their own houses.[17]

Within Europe there has been a debate on whether the EU should be deepened or widened. Those supporting widening have won the argument and a number of the Eastern economies including Poland, Hungary and the Czech Republic will join the EU within the next five to ten years. To bring eastern European companies up to EU standards has required a massive injection of capital including a significant amount of private equity. Because these economies were sclerotic under Communist rule, the process of modernization will take a significant amount of time and create a continual flow of opportunities for private equity.

The emerging markets of Latin America and Asia are in a state of flux, but opportunities for private equity still exist on a selective basis. For instance, companies enhancing their competitive position within local and overseas markets. The current economic and financial plight of Argentina highlights the fact that private equity investment thrives in a stable economic environment. It is enough to worry about business risk, let alone try to manage uncontrollable economic risks.

Future International Prospects

International private equity is alive and well and U.S. private equity groups, corporations and institutional investors are confidently investing overseas, particularly in Europe and to a lesser extent in Israel. There are two reasons for institutional investors to consider an exposure overseas: 1) prospective rates of return and 2) diversification. At this juncture, it is extremely difficult to predict future outcomes due to a period of uncertainty where there are no clear trends. Throughout the 1990s, venture capital and private equity experienced rapid growth and attractive rates of return, partly due to active world stock markets with a strong appetite for new issues and to substantial levels of M&A. As we moved into the 21st century, stock markets are not receptive to new issues and M&A volumes have dropped.

However, the change in market perceptions does not invalidate the principle of private equity. Economies operate in cycles and stock markets' sentiment can change in an instant. The critical point is private equity investment opportunities are abundant at lower valuations than during 1999 and 2000. The holding period for private equity transactions usually ranges from three to five years. It is not inconceivable, during this time, stock markets will recover and M&A volumes will improve. Although the economic climate appears to be weak, this is an ideal time to commit to private equity and within the mix there should be a meaningful allocation to international markets exhibiting the potential to deliver high-quality returns.

Notes

1 "Small but perfect for reforming", *The Economist* January 21, 1999

2 Intel—Corporate Overview

3 Michael Porter, Jeffrey Sachs and John McArthur, *Global Competitiveness Report, Executive Summary: Competitiveness and Stages of Economic Development*

4 "The Cutting Edge", *The Economist*, February 22, 2001

5 "Corporate Finance", KPMG, December 18, 2001

6 "European Deals Could Acquire New Life", *The Wall Street Journal Europe*, January 3, 2002

7 Harry Rijnen "3i is Here," *Upside Magazine*, October 2000

8 3i Report and Accounts, 2001

9 EVCA Yearbook, 2001

10 EVCA Directory, 2001

11 BVCA Directory, 2001/2002

12 3i Report and Accounts, 2001

13 "Alternative investing by Tax Exempt Organizations 2002", Goldman Sachs & Co and Frank Russell Company

14 "Silicon Fen Strains to Grow", *The Economist*, April 12, 2001

15 Abravanel, Roger, "The Promised Economy," *The McKinsey Quarterly*, 2001, Number 4

16 Abravanel, Roger, "The Promised Economy," *The McKinsey Quarterly*, 2001, Number 4

17 "Slipped Disc," *The Economist*, December 13, 2001

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