



WILEY FINANCE

THE FUTURE OF FINANCE

*How Private Equity and Venture Capital
Will Shape the Global Economy*



DAN SCHWARTZ

With a Foreword by David Rubenstein, Cofounder and
Managing Director, The Carlyle Group

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Venture Capital Will Shape
the Global Economy*

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John Wiley & Sons (Asia) Pte. Ltd.

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Published in 2010 by John Wiley & Sons (Asia) Pte. Ltd.
2 Clementi Loop, #02-01, Singapore 129809

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Wiley-VCH, Boschstrasse 12, D-69469 Weinheim, Germany

Library of Congress Cataloging-in-Publication Data

ISBN 978-0-470-82511-2

Typeset in 10/12 pt Sabon by Thomson Digital
Printed in Singapore by Toppan Security Printing Pte. Ltd.
10 9 8 7 6 5 4 3 2 1

*For my daughters, Allison and Dana, and to Karen,
who took care of them while I was away.*

Foreword

From embryonic starts in the United States in the 1960s and 1970s, the separate, but inextricably linked investment disciplines of venture capital and private equity grew, by the early part of the twenty-first century, into a significant, global (and at times controversial) industry managing trillions of dollars and employing tens of millions of workers.

The good times for these firms—and their ever-growing set of institutional and individual investors—seemed likely to extend for many years, if not decades, into the future.

And then came the Great Recession of 2008–2009, with its devastating effects on so many of the largest, most vibrant economies in the world.

Although the venture capital and private equity industries were generally not blamed for causing the Great Recession, they were nonetheless severely and adversely impacted by it—to the point that many serious observers openly wondered whether these once seemingly infallible investment forces might become a relic of the past.

Their magic was gone. Their investor allure had waned. Their images had been impaired.

How had this happened—and so quickly? Could venture capital and private equity recover, perhaps by reinventing themselves as they had following previous, though far less severe, economic downturns? And what if they did not? Who in the future might provide entrepreneurial capital for innovation or enhanced corporate productivity?

The answers to these questions and related ones are still unknown, for the Great Recession is only beginning to recede, and its full, and perhaps permanent impact on the world of investing—especially in the higher-risk but higher-return areas of venture capital and private equity—is difficult to accurately predict.

To be sure, many of us who have worked through prior ups and downs in the investment cycle believe that venture capital and private equity will indeed return, and in many ways stronger than ever—chastened by earlier excesses and focused anew on helping entrepreneurs, managers, and investors achieve their goals. But that is admittedly a biased perspective.

To those who have not lived in the trenches of venture capital and private equity, but would nonetheless like to have answers to the key questions about the future of venture capital and private equity, a less biased—but fully informed—perspective might be in order. And that is precisely what Dan Schwartz has provided in *The Future of Finance*, a book that, because of the author's clear objectivity and unquestioned knowledge of the subject, is certain to be widely read and thoroughly commented on.

One of the many problems that venture capital, to some extent, and private equity, to a greater extent, have faced in recent years is the general public's general lack of understanding of these disciplines: how they work, why they have grown, what they achieve, and who they impact. Regrettably few works by well-informed writers have appeared in recent years to provide answers to these basic questions. And the most recent turmoil in the venture capital and private equity worlds has no doubt exacerbated this general lack of understanding.

Dan Schwartz has therefore provided a real public service by not only carefully researching and skillfully writing this book, but by doing so in a way that can truly inform the layperson, as well as investment professionals, about what has happened, is happening, and is likely to happen in the increasingly important—but rapidly changing—worlds of venture capital and private equity.

And the author has done this while holding down a day job of running a business he headed for more than 15 years—the *Asian Venture Capital Journal*, which has grown from its modest beginnings to a position of enormous influence in the burgeoning Asia venture and private equity worlds.

That perch has put Dan Schwartz into frequent contact with the leading professionals in both the Asian and the global venture capital and private equity industries. This is made abundantly clear in *The Future of Finance*, for the author has been able to obtain many frank (and invaluable) observations and insights from those professionals.

Stated simply, a nonprofessional interested in learning about the seeming mysteries—and likely future—of venture capital and private equity would be hard pressed to find a more useful, up-to-date primer than *The Future of Finance*. But, to the author's credit, he has also written a book that provides a great deal of information likely to be unknown to even the most seasoned of venture capital and private equity professionals. And they are therefore likely to benefit as well from reading *The Future of Finance*. I already know one who has so benefited.

David Rubenstein
Cofounder and Managing Director
The Carlyle Group

Acknowledgments

As anyone who has done so will tell you, writing a book is no small feat. It has occupied the greater part of my attention for the past year, and I have enjoyed the process. A number of people who assisted with the project have made it easier, and I wish to thank them profusely.

First, I would like to thank those who agreed to share their thoughts for the book. Not only did they spend time speaking with me, but they checked quotes, found photos, and signed forms. Despite busy days and hectic travel schedules, their time on the phone or in person discussing and describing the industry was most appreciated. You were great. I hope the book meets your expectations.

Most of those with whom I spoke or met had personal assistants, secretaries, or significant others who made it all happen. Your names do not appear in the book, but you know who you are. And so do I. Thank you!

Next, I would like to thank David Rubenstein for writing the Foreword. He is a busy man. His taking the time to write a substantive introduction is much appreciated. Those who know David and are familiar with his reputation as a hard-working and insightful man would, of course, expect no less.

I would like to thank my associate at the *Asian Venture Capital Journal*, Harmony Heung, for her assistance in putting this book together as well as everything else she has taken care of for me in Hong Kong over the past 18 years. You have been invaluable. Many others at *AVCJ* have also helped, including Allen Lee, Anil Nathani, Paul Mackintosh, Ying Jiang, Amelie Poon, and Helen Lee. I would also like to thank Jonathon Whiteley and his Incisive Media colleagues. They purchased the company in 2006. Good luck, and don't forget us in Asia!

I wish to extend my appreciation to the many others for your indulgence over the past year as I lugged my laptop around the world to talk, gather information, and to write. That includes my family, girlfriend(s), and friends from all over who graciously allowed me the time and space to think and write.

Finally, my sincere appreciation to Nick Wallwork and the crew at John Wiley & Sons (Asia) in Singapore, who have agreed to publish this book. May it be a winner!

The book contains a lot of information and facts. I have done my best to ensure that they are correct and timely. Mistakes will happen, though, and for these, please accept my sincere apologies. They are my own.

Dan Schwartz
Hong Kong
January 2010

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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

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 make-over 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 make-over? 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 health-care 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*