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New Directions for European Private Equity

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Does the venture capital industry need to develop a new private equity model if it is to continue to attract investor funds in the future? It is a question that must be occurring to more and more venture capitalists these days because it is certainly a hot topic amongst institutional investors increasingly disappointed at the returns they have seen from private equity. But if venture capital is currently struggling to legitimize itself as an asset class, what if anything, can be done about it?

The initiative of the European Venture Capital Association to measure performance is certainly a step in the right direction. By hopefully providing institutions with an index of venture capital performance we can at least know what our starting point is as we think about the future of the industry.

But missing from any debate so far is a self-analysis of the private equity model, and its ability to satisfy institutions' demands for better returns and improved liquidity at lower cost. Partnerships are not alone in facing the critique; senior bank officials controlling the flow-of-funds to internal venture staff are likewise questioning the wisdom of the private equity model.

THE PROBLEM

Investments structured as private equity presume high growth companies and efficient capital markets. Yet the high growth required to generate equity gains can't be predicted with precision or certainty; investee companies are plagued by unforeseen events that erode IRR and extend time-to-exit.

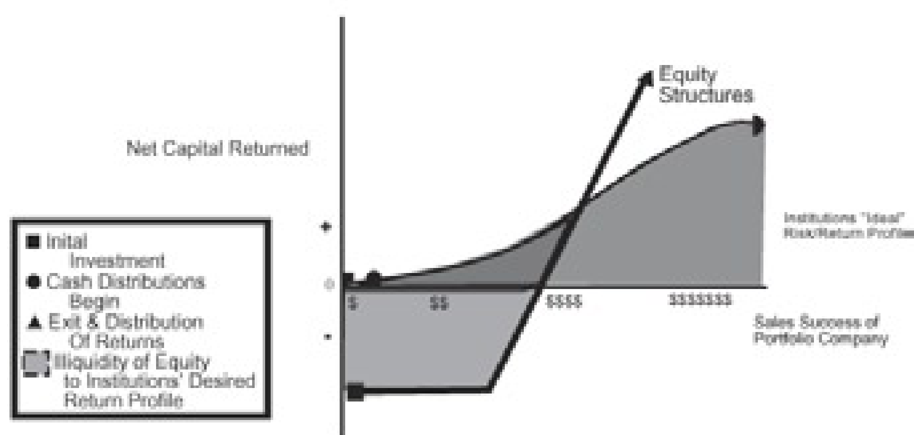
Uncertain capital markets compound liquidity risks even when buy-backs dominate the exit strategy. Valuations are affected by public market P/E ratios for companies in-like industries (e.g., US biotechnology hot in 1991, not so hot in 1992 with valuations down 40%+). Volatilities in the financial markets erode total returns, delay termination or dilute holdings in future financings. Changes in the corporate growth process will postpone liquidity.

INSTITUTIONS AS CHANGE AGENTS

The balance of power shift to institutions that invest in funds compound the investment challenge. Institutions seek strategies and structures that create early and more certain returns over multiple investment outcomes. Yet investments structured as equity produce neither early nor certain rewards. This illiquidity, expressed as an inefficiency to

Figure 1

RISK / RETURN PROFILE: EQUITY



institutions' 'ideal' risk/return profile is graphically portrayed in Figure #1.

Dividends or debt as fixed returns do not satisfy institutions' expectations for uncapped gains (Figure #2). Dividends can be reduced or eliminated if investee company profitability falls below levels established by finance ministers in countries like France.

Ratchets imposed by fund sponsors expedite the need for model review. Hurdle rates of return, level of carried interest compensation as a function of IRR received, and declining fees lead to new contradictions: Higher cost of funds are transferred to SMEs as more expensive capital; operating costs and entry prices rise as the process to find and nurture super-winners becomes more selective, and clever entrepreneurs with the best projects bypass the industry in favor of cheaper alternatives such as wealthy individuals, corporate partners and government funds.

PARADIGM SHIFTS

This vicious circle intensifies as the industry ends up sponsoring the second rate. Loss ratios increase and more pressure is applied to find and finance the one-in-one hundredth SME with a hockey-stick sales curve. Total return is a function of winning SMEs earning breathtaking rewards to compensate for the failures. This ratio of winning vs. losing investments is called the 2-6-2 distribution of returns rule (out of ten investments properly researched, two produce extraordinary gains, six yield nominal returns, and two are write-offs). As the low loss ratio of development capital catches up to its North American 2-6-2 brethren, asset class pessimism leads to new ratchets.

Technology investors will recognize this phenomenon as a shift in the 'S' curve. The 'S' curve governs the speed by which one technology, standard, or way of doing business (i.e., model) is superseded by another with, more customer benefits and less constraints.

Paradigm shifts occur in all industries. Sometimes they obsolete the status quo; witness automobiles for buggies, digital for analog, and solid-state electronics for vacuum tubes. In other cases, vulnerability leads to self-denial and confusion to the long-term outlook. Reforms fail to yield the performance gains commensurate with the resource inputs. Under siege, the model regains viability with a different focus and often at a lower level; carbon paper, typewriters and mail delivery overcome by xerography, word processors and fax machines respectfully. The leadership void remains until innovation revitalizes the industry (e.g., Polaroid's entry into Kodak's core markets).

NEW LEADERS WITH A FRESH APPROACH

European development bankers, government planners in the EC and EFTA countries, and economists openly discuss the inflexibility of private equity to

Figure 2

RISK / RETURN PROFILE: DEBT

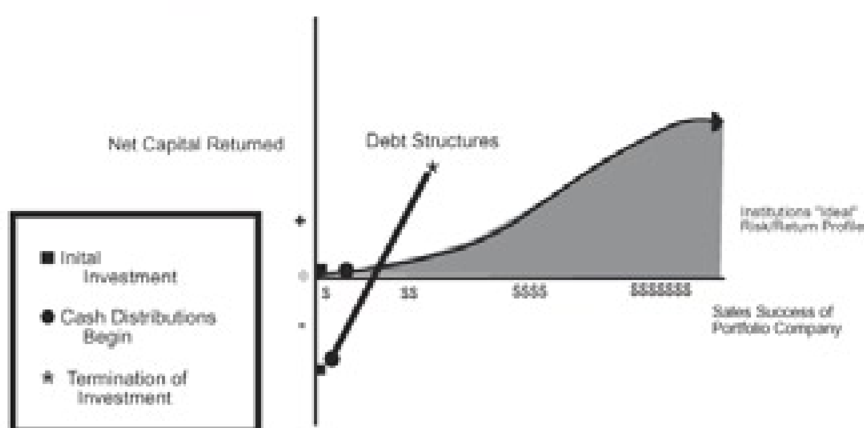
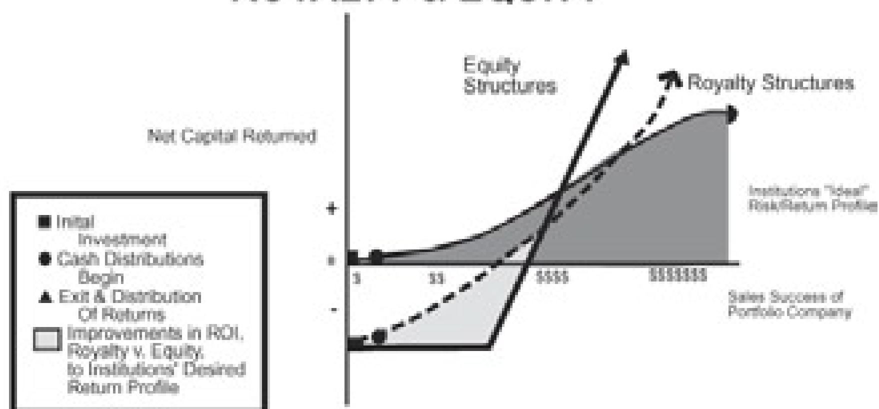


Figure 3

RISK / RETURN PROFILE: ROYALTY & EQUITY



serve but a handful of fast growth SMEs. Forward thinking venture capitalists recognize structural inefficiencies too. At the EVCA Symposium '92 in Madrid, Kevin Landry of the US venture fund TA Associates wondered why only 5% of the US' 500 fastest growing private companies had been backed by venture capital. In his excellent article (EVCJ, Sept/ Oct 1991), Mr. Leendert I van Driel of Gilde Investment Funds articulated the deal flow problem as too many investors looking at the same market segment as sources of opportunity, not too much money chasing too few deals.

New initiatives to serve underserved companies like the European Commission's SPRINT and Seed Capital scheme, and Germany's BITU represent grass roots movements to correct inefficiencies with complimentary schemes. The Federal Business Development Bank of Canada implemented a quasi-equity programme in consultation with us (IVI) to bridge the gap separating private equity and term loan clients, and finance threshold and medium growth companies. These entrepreneurs drive economic growth in Europe, Canada and the US, yet are spurned or choose not to accept our money. Inefficiencies that impede capital from reaching these mainstream sectors of wealth and job creation also frustrate the flow-of-funds to E. Europe, L. America and Asia.

NEW DIRECTIONS

Breaking the cycle requires a new scheme that conforms to institutions' desired return profile (Figure #1). New directions are not limited to just deal structures. Forging new channel alliances with other distributors of capital is mandatory to reduce operating overheads and cost of funds. A lower cost product attracts price sensitive entrepreneurs: the 95% of high growth SMEs that Mr. Landry spoke of, and the threshold and medium growth companies targeted for help by governments and development banks. The basis for a new direction should be a quasi-equity scheme that integrates the best features of share ownership and a term loan to generate equity-like gains on a cash receipt schedule paralleling debt. The closest we have got to this in the past is the overlooked mechanism of royalty deal structures. As a levy on sales, royalty deal structures generate liquidity independent of the capital markets to create early and more certain returns over multiple investment outcomes (Figure #3). Implemented as a quasi-equity strategy to make the initial investment and build the relationship with the entrepreneur vs. simply a deal structure, it provides the opportunity to better time the equity risk and improve total return. Moreover they are compatible with a growing feeling within European venture capital that yield based schemes make the most sense.

Royalty structures have a long history as a niche investment vehicle. The British Technology Croup headquartered in London with offices in the US and Japan, shares royalties with

companies, universities and inventors. Corporations have established internal intellectual property offices as profit centers to license technology with returns received as royalties, e.g., Texas Instruments reported US$124,000,000 in 2ndQ1992 royalty returns, compared to US$95,000,000 in 1stQ1992 and US$74,000,000 in 2ndQ1991.

These strategies meet the economic aims of their sponsors. Transplanted to the European scene, they 'sweeten' returns. But investors would still be subject to the same risks of equity, and with lower IRR. Investors can protect returns when a company grows slower-than-expected, and reduce risks when external events beyond our control impact P/E valuations as the following example demonstrates.

IMPROVE TOTAL RETURNS

In 1987 we at IVI invested US$700,000 in a US$1,400,000 financing of a supplier of machine vision products to US and European OEM's (investors included six other venture capitalists and two Fortune 500 firms. An existing investor co-invested the remaining US$700,000 as equity). The company was three years old and marginally profitable on total sales of US$1,600,000. Capital was used to launch their second-generation product, build inventory and launch the European marketing effort. We received 5% royalties on sales of this product line and enhancements, bundled software, royalties on the firm's two existing product lines and 7.5% of all licensing fees.

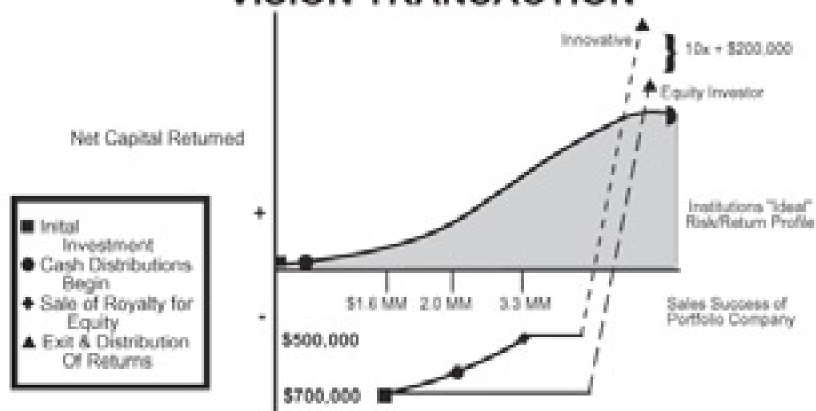
Anatomy of a transaction (see box) shows how the investment returned US$200,000 on the US$700,000 investment despite the fact that the company's sales took a slower-than-expected course. Such early gains frontload IRR to satisfy institutions' early return desires.

Unforeseen events that impact total returns are inevitable in private equity investing, and this company was no exception. It struggled in 1988 and 1989, and its valuation dropped for several reasons: Volatile sales growth (from 40% to 0% as employee morale sunk from the turnover of three sales VP's in 2 years, a Guinness world record?) depressed conditions in the US equity markets, and consolidation in the US venture capital industry. Dilution reduced one equity co-investor's ownership from 20% to 1%.

In March 1990, IVI sold the royalty claim back to the company for US$1,000,000 in equity (vs. the buyout price of US$1,000,000 in cash) representing 10% ownership. The equity risk was assumed once progress was demonstrated by the investee in factors that govern high growth; executive camaraderie, effective pre-selling process, cultivation of a new bellwether customer and a hit ratio of sales success to sales prospecting. In December 1990, the company consummated product contracts with two new US Fortune 500 customers

Figure 4

RISK/RETURN PROFILE: MACHINE VISION TRANSACTION



valued at US$25,000,000 over three years. Shifting from cash flow to equity after a one-time investment enabled IVI to improve total returns by a factor of 10x (Figure #4). The inflexibility of equity to recoup gains due to uncontrollables eroded our co-investor's IRR. Investment models that protect IRR to improve total returns simplifies future fund raising efforts. New risks in the 1990's provide another reason to consider alternatives.

MANAGING HEW UNCERTAINTY

The 1980's corporate growth model was based on attacking large markets with technology and a 'going it alone' strategy; companies controlled research through production to marketing. 100% ownership of the revenue stream rewarded investors and lenders with superior gains.

The 1990's corporate growth process is a blend of new strategies with new risks. More capital to launch new technologies, compressed product life cycles and increased sales volatility all make returns more uncertain and volatile. Strategic partnering, co-manufacturing and collaborative agreements limit a company's revenues as several participants share sales rather than the total rewards going to the innovator. Companies will therefore peak at a sales size too low per invested capital to generate target valuations. This illiquidity will fuel new pessimism for the asset class.

Managing these risks after investment requires strategies and structures that generate returns more independently of the swings in a company's fortunes and quirks in the capital markets. We have all seen high-flyers fail, early achievers peak into 'life-style' investments, while others never take off. One can never take all the volatility out of the path of an SME, but royalty structures help investors to manage IRR risks after investment.

NEW INVESTMENT OPPORTUNITIES

Threshold and medium growth companies miss market opportunities due to lack of capital. Their growth rates and projected P/E ratios are unattractive to generate the public market or strategic buyer interest required for equity. Lenders reject them (or provide only a fraction of requirements) because of a limited operating history or a balance sheet full of intangible assets. Royalty capital is a financing solution since returns are generated from revenues, not the sale of stock.

Threshold companies create customer value through technical know-how in software,

ANATOMY OF A TRANSACTION

The figures below compare total returns to IVI and a co-investor from the initial investment in the machine vision transaction. The co-investor received no income, nor did it participate in subsequent financing at substantially lower pricing. Valuation reflects dilution from 20% to 1%. All numbers are expressed in US$ per thousand except share amounts.

INCOME RETURNS

	1988	1989	1990	TOTAL
INNOVATIVE VENTURES (invested US$700k in 1987)	US$90k	US$110k	Sale of royalty interest for US$1MM in equity @US$2/share	US$200k

TOTAL RETURNS & VALUATIONS

	Investment	N+	$/Share	Valuation	TOTAL RETURN*
INNOVATIVE VENTURES	US$700k	500,000	$2.00	$1,000	$500k
EQUITY INVESTOR	US$700k	13,461	$2.00	$27	($673k)

*Total return is the sum of income received plus unrealized net gains or losses

new materials, communication, and biotechnology. IVI's USS200.000 investment in a software/peripheral SME is an example of one such transaction. Formed around a small market (<50,000,000 ECUs) and high margin products, this investee is generating equity-like gains on a cash receipt schedule paralleling debt; a 12% royalty as sales increased from US$250,000 to US$5,000,000 in the past four years through increased market penetration and European distribution.Competitive advantage and returns are ensured since intellectual assets receive fifteen years of protection under the US legal system, and the courts of Europe provide safe haven too. Compounding fifteen-year income streams satisfies institutions' desire for long-term gains (Figure #3) distributed early and at predictable intervals throughout the investment cycle. Modeling to institutions' desired return profile eliminates skepticism toward the private equity asset class.

Medium growth companies enjoy strong customer franchises, stable revenues, and depth of cash flow afforded through protective status as a sole supplier. They sell into the manufacturing, basic and infrastructure industries. Since these segments cut across all sectors of Europe, diversified investments reduce volatility of returns and risk. Equity investors ignore these companies because of liquidity risks and debt returns are capped to the interest rate.

As this financing gap grows due to the new forces of the changing corporate growth process and bankers' continuing retreat from SME lending, new markets emerge for investors. Niche companies cap revenue growth to the size of the market that unintentionally reduces equity flow-of-funds. Lenders reduce debt commitments since the balance sheet has insufficient equity. As brick and mortar is replaced with intellectual assets to increase value-added, the lack of hard asset collateral to secure debt forces entrepreneurs to seek other sources of capital.

ENTREPRENEURS' ACCEPTANCE OF THE MODEL

While US & European entrepreneurs have traits that distinguish one from the other, each have similar motives, and acceptance of the scheme has more similarities than differences. Royalties are non-dilutive and solve the ownership/ control paradox. They create an environment for the entrepreneur/ investor relationship to flourish, and build new client skills to augment value-added activities such as nurturing investments or acting as the temporary CEO. Establishing trust in the initial investment leads to future equity participation as exemplified in the machine vision transaction. Overcoming entrepreneur resistance quickly expedites the investment process to reduce transaction costs. Reduced costs improve total returns.

Clever managers shy away from managed equity pools because the uncertainty of returns as a function of the entire portfolio demands that capital be priced to compensate for failures (the 2-6-2 rule again!); in contrast royalties create more certain returns over multiple investment outcomes since success is a function of SME sales only. Certainty of returns reduces the financing demands on any single investment to compensate for failures and removes one of the sources of entrepreneurial ill will for private equity. Shifting from cash flow to equity at an acceptable valuation occurs because the risk built into the price of equity is reduced, and dilution to earnings is less onerous than the drain on cash flow as perpetual royalties cause the costs of capital to converge.

CREATE NEW CHANNEL RELATIONSHIPS

Capturing new investment opportunities and transacting deals profitably with the new class of entrepreneur in the 1990s mandates a lower cost infrastructure and new liquidity solutions. Streamlining the investment process by cutting staff or corners will not make the hurdle rate competitive. Price reductions only erode IRR.

New partners performing private equity functions are needed. For alliances to work, fund managers must specialize in their core distinctive competencies and spin off value-added, but tangential activities (to distinctive competencies) to others.

There are four basic private equity functions, and any of them are candidates for divestiture: 1) deal origination; 2) analyzing, structuring and negotiating investments; 3) value creation through portfolio management; or 4) terminating investments through exit strategies.

For example, the exit barriers that inhibit investors from financing threshold and medium growth companies can be overcome; structure returns as royalties and pool the income streams into a portfolio for sale to purchasers of private placement securities. Pooled investments diversifies risk and yields the equity-like gains that institutions seek (Figure #3), but without the liquidity constraints or the extended holding periods required of convertible debt, loans with conversion features or equity kickers. Securitized with a solution to control vs. own assets makes the income stream saleable to a new class of institutional investor too risk adverse for private equity. Liquifying assets vs. holding investments to perpetuity opens the banking network as the intermediary to originate investments.

Bankers are well positioned to participate as partners. They're skilled at delivering customer value at low cost. Moreover W. European lenders are acquiring new talents through quasi-equity, project financing schemes. TPF (Technology Performance Financing scheme) launched under the SPRINT initiative of the European Commission is one example.

The intent of TPF is to accelerate the adoption of new technologies or products by traditional industries resistant to change. Banks provide the capital to bridge suppliers (of technology) with users (of technology). The investment is unsecured and bank profits, expected to yield a higher rate of return than debt, is contingent on project success.

Success in quasi-equity requires a blend of term loan and private equity skills. Without collateral as protection, quality of the client's revenue stream (or cost savings as the determinant of product demand by customers) provides IRR security.

Techniques that help lenders verify certainty of returns is one contribution that private equity can make to an alliance; IVI is involved in such an effort; we are under contract to train lenders in techniques to improve total returns in the TPF scheme. Modeling the deal structure mix to the value creation process of an SME is not the only input that private equity can make to the new channel. In the upcoming autumn 1992 TPF symposium, IVI's 'silent lien™' is a second training subject since it creates investment security by controlling vs. owning assets in unsecured financing schemes.

Royalty payments are expenses and appear as tax deductible dividends to reduce a company's cost of capital and leverage stockholders equity. Channel efficiencies reduce the cost of capital even further to make transacting small investments economically viable as quasi-equity. Bridging this equity gap releases capital normally reserved by seed investors for follow-on portfolio financings to finance new start-ups.

Development bankers are receptive to such solutions that finance the equity gap, but for different reasons. The IFC, EBRD, the EIB, and the EC have advisor and investor roles to catalyze private sector development and create new financial institutions in the former Warsaw Pact countries. Impediments to achieving these objectives include inefficient capital markets and the scarcity of high growth companies.

CENTRAL & EAST EUROPE INTIATIVES

The Central and East European capital markets are simply too young to provide meaningful P/E valuations or liquidity for private equity investors. Unproven entrepreneurs and the lack of significant high growth role model companies to propagate opportunities inhibit capital flows.

Project investments structured as royalties in mission critical, ready-to-sell products of medium growth and threshold SMEs provide an alternative. Mission critical investment secures the preferred position to influence company direction, rather than being pigeon holed as a minority investor. Ready-to-sell products yield early and certain returns while funds disbursed to a milestone-financing schedule reduce risk. Banks employed as the delivery mechanism in this pre-venture capital initiative time compresses implementation vs.

Western-style solutions.

Financing projects provides other opportunities to attract development bankers as potential fund sponsors. Entrepreneurs in Central & Eastern Europe are known to possess better skills in managing projects compared with creating high growth companies. Company building practices used by Western managers to attract equity capital are too nebulous for these entrepreneurs to grasp. But by making the initial investment in a project and adding value to their project talents, the investor creates the environment for entrepreneurs to learn the more sophisticated and esoteric management skills required of high growth companies.

Investments must be made in companies that generate sales receipts in a convertible currency; financing exports, e.g., provides the means for investors to repatriate returns. Development bankers and finance ministers will co-finance such cross border schemes since exports create foreign exchange earnings to improve trade accounts.

Generating investor rates of return from export driven SMEs attracts new capital as success begets success. Pooled income streams sold in the secondary market liquefies illiquid assets for re-investment. Recycling gains accelerates capital turnover, and increases in the capital stock encourages the entrepreneur pool to expand. More risk taking is an essential input to the birth of growth companies, and a prerequisite for the capital markets to flourish in Central and Eastern Europe.

RECOMMENDATIONS TO DEVELOPMENT BANKS & GOVERNMENTS

ERM, EMU disappointing economic growth and the command economies' sudden transition to capitalism are forces of a new era with no role models charting future directions. The private equity asset class faces equal perils.

The US was the innovator that investors emulated. But the US has relinquished its leadership position with grave consequences to Europe. Sophisticated investors historically followed the US' lead in types of deals financed by stage and industry focus, and pointed to US successes as evidence to the merits of the asset class. US venture capitalists and its institutional supporters also absorbed the experimentation costs of trial and error.

With the US industry totally confused, and financing later stage deals with abnormal selectivity, one can expect reductions in flow-of-funds to companies that are the engines of European economic growth, threshold and early stage SMEs. Europe's relative fund raising success in 1991 may not be repeatable in the near future. Unless new entrants enter the industry, capital inflows will drop once allocations are satisfied.

Development banks and governments are ideally suited to assume the leadership role in the private equity asset class. Each is implementing creative niche schemes and it's time to move mainstream. Strategic solutions do exist that can make private equity more responsive to fund sponsors' needs and the requirements of SMEs:

1. Finance quasi-equity schemes to accelerate its adoption as an asset class equal in status to debt, guarantees and share ownership. Provide capital to six new funds with articulated corporate missions and strategies to model institutions' 'ideal' risk/return profile. Paralleling fund sponsors' desired return profile is crucial if new funds are to raise co-investment monies to initiate operations. Otherwise more government help (spelled capital) may be required to fund shortfalls placing diversification or social rate of return goals at risk or reduce the number of recipients receiving funds to a sum fewer than planned. Give these funds the option of operating in either W. or E. Europe.

While institutions are weary of private equity's illiquidity, their desire for early returns does not mean they've replaced the long-term perspective with a shortsighted mentality. For example, while royalty structures create early and more certain returns, they can provide a fifteen-year income stream from intellectual assets. Institutions embrace royalty structures because they provide both short and long-term gains. This refutes the notion that their focus is out of step with the long-term nature

of this asset class.

Institutions' need for early and more certain returns reflects economic reality in their world; an exploding number of alternatives, which provide equity-like IRR, but without the high cost volatility and liquidity constraints of pooled funds.

2. Support private equity funds that demonstrate investment strategies and deal structures that better control IRR when an SME grows slower than expected or the capital markets depress valuations or extend time-to-exit. Better management of the risk factors improves total returns, and attracts institutions to the asset class. Updated operating procedures, new channel relationships and alternative liquidity mechanisms should be bundled into the funds' overall game plans.

Without solutions to these problems, public monies will only subsidize the losses inherent in new schemes; once capital is exhausted, managers will revert to past behaviors thereby abandoning the investment segment worked so hard to make appealing and rewarding. Forgiveness or deferral of debt payments, limiting investor losses, or risk-sharing features can be effective short-term solutions, but they are not the long-term answer to create a new and permanent market mechanism. Similar approaches implemented by the US Government and several US State Governments failed.

3. Establish mechanisms that change fund managers' behavior and attitudes toward risk don't encourage simply taking more risk. Successful implementation of new models mandate a paradigm shift in the mind set of investors toward private equity decisions; early stage investing and early returns are not mutually exclusive, investing in threshold and medium growth SMEs is financially lucrative, returns can be protected, costs required to operate a fund can be reduced, etc.

4. Organize funds as corporations, not as limited partnerships. A corporate structure gives fund sponsors more control and influence over deployment of capital.

CONCLUDING REMARKS

The private equity business has become so focused on its own economic recovery that it has become blinded to global realities that go well beyond the current cycle. The industry has plateaued and successes in fund raising are a function of capturing market share from competitors and geographic regions rather than new growth. Reversing this trend requires investors to re-think the status quo, and adopt new models (not just deal structures) to better serve our institutional and SME customers.

Ideas to provide new sources of value-added have been discussed in this article. Other ideas are limited only to the creativity of the reader: For example, investors can purchase the illiquid equity interests in European life-style companies from venture partnerships caught in the industry consolidation, and structure the new investment as a royalty as IVI is doing in the US.

We only need to look at the demise of industries and companies to realize the perils of past success. Private equity investors are no different than entrepreneurs who get stuck on the single model that made them successful, and lose the youth to regenerate themselves. The carbon paper manufacturers condemned themselves when they universally rejected xerography as a new model for creating copies and customer value. Ed deCastro, the forced out founder of US Data General, is another case in point. Started in 1968, the company peaked at US$1.4 billion in sales twenty years later and began its terminal decline as the company missed the wave in new computing models as PCs and workstations replaced Data General's computers. In retrospect Mr. deCastro articulated the problem as the status quo drowning out innovators, and companies and people sticking with one successful idea, forgetting what made them successful, the process of creating new ideas. Superior ideas don't stay better for long.