PRIVATE EQUITY, VENTURE CAPITAL AND GLOBAL ECONOMY

Trajanka Makrevska
International Slavic University "Gavrilo Romanovich Derzhavin" makrevska_art@yahoo.com

Abstract: The world today is marked by economic, political, and social uncertainties. The economics speaks for them: massive deleveraging, a fall in consumer demand, and a freeze in bank lending are all apparent.
Although global economies are already on the mend, the story of the meltdown provides a backdrop for private equity and venture capital today and a lesson for all in the future. Much has already been written, much more will be written. It's a remarkable story. Behind the scenes, however, is a relatively simple story.
When the Bubble burst in 2008, the result was the massive destruction of wealth by systemic repayment. Consumer demand has dried up and corporate revenues have fallen. The financial world has gone from a period of extreme liquidity to extreme illiquidity.
In theory, private equity and venture capital can exist anywhere that an individual can raise money, invest it, and then dispose of the investment at a profit. Each has its own structures and communities.
They run on ambition, greed, talent, and the challenge of finding new ways to finance and run a company.
Financially, private equity and venture capital may well be one of the only institutions left standing.
Do private equity and the investment industry provide a model for successful corporate behavior?
Despite the current reliance on government intervention, private equity and venture nominally solve the problem of modern corporations by aligning the interests of owners and managers.
Their capital and investment horizons are premised on future goals. They are flexible in their approach to potential opportunities. Though resting on an illiquid base, they offer higher returns to their investors in good times. Although their portfolio companies are suffering from the same downturn afflicting the rest of the economy, the owners control both the balance sheet and the business.
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.
Now that we have listed the players and described the playing field, there's one final question worth asking: What is the purpose of private equity and venture capital? Why do it? The answer depends on whom you ask.
Keywords: private equity, venture capital, global economy

1. INTRODUCTION

One of the many problems that venture capital, to some extent, and private equity, to a greater extent, has 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. And the most recent turmoil in the venture capital and private equity worlds has no doubt exacerbated this general lack of understanding.
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. 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.
Three principal parties inhabit the private equity world: general partners (GPs), limited partners (LPs), and debt providers (banks and mezzanine—mezzanine debt is subordinate to but earns more interest than the bank debt). Two other groups—management and service providers—play important but ancillary roles. Among the general partners are the global funds, those firms that have evolved into asset managers, and the pure play, those who invest opportunistically in deals. The global funds have offices around the world and invest locally. The global funds have dedicated funds that invest in specific transactions, but they also engage in other activities such as hedge funds, real estate, and capital markets.
Private equity and venture capital use similar plays in running their businesses. How they execute makes all the difference between the top 10 percent and those whose next fund will be a nonstarter. The first step is to establish a fund, generally a limited partnership. The individuals who set up the fund are the key to its success: prior experience, particularly successful deals, is the main criterion. Where do general partners get that experience? Almost invariably they earn their stripes by working for another fund, though corporate executives, lawyers, and

investment bankers have also been successful. Next, the general partners get funded. The suppliers of capital are the LPs. Fund raising is a difficult and torturous process.

What is a ‘‘good deal’’? Private equity and venture capital general partners diverge in the nature and size of the transactions they undertake. Private equity invests in large deals and has traditionally used anywhere from 50 to 90 percent debt. The hallmarks of a good private equity deal are solid cash flows, moderate growth, and unrealized profit potential. Stable cash flows are extremely important, as these transactions tend to be highly leveraged. For private equity, deal structure is also important in determining final returns. That is a function of the debt structure.

In venture capital, what matters? Skill or luck? Venture capital boils down to the ability of picking winners. Still, no book can teach you how to pick winners or be a successful VC. At best, this is an attempt to develop and identify the framework for thought and action. Findings from academic research papers have also been summarized. Even as we live in the era of big data, nothing about venture capital investments is predictable or persistent. The correlation/causation debate continues.

As soon as the fund-raising process is complete, VCs are under pressure to deploy the capital. During this investment period, any fund actively seeks Facebook-like opportunities to generate target returns. Investment periods can be three years to five years. In this period, the start-ups come in— the mating dance begins. The pitch deck, term sheets, valuations, and boards are negotiated. A venture fund has to build a portfolio of companies that promise strong returns. Each portfolio company should demonstrate the potential to generate a return that equals a multiple of 8 to 10 times the capital invested. On a portfolio-wide basis, venture funds target a 20 percent annualized rate of return or a minimum of two to three times the invested capital. A typical portfolio size for any fund can be 10 to 30 companies, based upon the sector and stage of investment. In technology sectors, the capital needs are lower, risks are deemed higher, and growth rate of companies is faster. In comparison, life science companies need larger amounts of capital and time to reach maturation. Hence, a technology venture fund may have as many as 30 companies in its portfolio, whereas a life sciences fund may have a dozen companies.

Fund returns, measured by internal rate of return (IRR) are a function of two factors: time and capital. The faster a portfolio company is sold, for as high an amount, the higher the IRR. This is often where things can get tricky. A speedy exit involves selling a start-up, and this can clash with the realities of market conditions and lofty entrepreneurial ideals. Ideally, the exits should occur within three to four years from the date of investment, but only very few follow this hyper curve. Exit horizons are six to eight years, possibly longer based on market conditions. Delays create immense pressures on the fund managers as future fund raising can be jeopardized if the timing is not aligned. The graveyards are littered with plenty of start-ups, as venture capitalists fail fast and move on. If a start-up cannot achieve liftoff quickly, it often ends up in the “living dead” section of the portfolio.

VCs only make money after their investors make money: A venture capitalist makes money in two ways: a base salary and a percentage of the profits (called “carry” or “carried interest”). Typically, funds make 20 percent of the profits generated on any exits. Some funds, thanks to their performance and brand, command as much as 30 percent. Most funds are structured so that the profits are distributed after they have covered all the previous losses in the fund. A successful firm raises multiple funds over time: those who cannot perform are relegated to the annals of history as unfortunate victims of Darwin’s laws.

For those seeking financial gain primarily, this path may not be optimal, at least in the short run. Venture capital is an “antfragile” career with fundamental asymmetry. In his book Antfragile, author Nicholas Naseem Taleb defines asymmetry to be when you have more upside than downside and tend to gain from volatility, randomness, stressors, errors, time, and uncertainty. Venture capitalists flourish on information asymmetry. They have a ringside view of the technological future, and the companies they have funded are often the ones to become the next-generation behemoths. Financial gains are expected as a by-product of value creation, but only after asymmetry is identified and realized within a short span of five to seven years.

Those who have had a successful entrepreneurial journey often see the venture as a pathway of imparting their lessons to the next generation.

The VC business is subject to pressures from multiple ends: the supply of capital, the availability of investment opportunities, liquidity time frames, and regulatory dynamics. As they say, the business of venture capital is not for the faint of heart. At its core, venture capital is truly an apprenticeship business. It takes years of mentoring to learn how to assess investment opportunities, set pricing and strategy, build and motivate management teams, deal with inevitable and unpredictable threats to the businesses, source additional capital and strategic partners, and finally, divest (for better or worse) these illiquid investments.

Venture capitalists (VCs) hunt institutional investors (called limited partners, or LPs), and entrepreneurs hunt VCs. If VCs understand the universe of LPs and the constraints and drivers of various LPs, the fund-raising process may become less boring for the hunter and the hunted. Potential investors in venture funds, or LPs, include institutional

investors (e.g., pension funds, foundations, endowments, banks, and insurance companies) and family offices, including high-net-worth individuals (HNWIs).

All LPs aim to minimize risk and aim for a target financial return. For any venture fund, targeting the right mix of LPs is a bit like matchmaking; understanding the array of potential investors and their decision-making process is the first step in raising the fund in an efficient manner.

The four major asset classes are stocks (public equities), bonds (sources of fixed income), alternative assets (private equity, venture capital, hedge funds, real estate), and cash. Based on global economic trends, investors establish asset allocation strategies to adopt optimum allocation percentages in each of these asset classes. Asset allocation, a prudent method to manage risk and returns, is driven by each investor's appetite for risk, rewards, and liquidity. Venture capital is a subset class of private equity and falls under the alternative investment asset class, and for most LPs, it is a smaller fraction of the overall portfolio. Alternative assets are alternatives to equity and include a growing array of options.

Certain types of alternative assets, such as private equity/venture capital, are illiquid and do not provide the same advantages as do equities and hedge funds. Investor capital remains locked in for longer periods, which can be as long as 10 years in private equity and venture capital, and interim resale is not efficient. The concept of liquidity affects allocation outlays, and often investors seek an illiquidity premium, a higher return from this asset class.

Liquidity creates fickleness and generates infidelity, which hurts long- term asset classes such as private equity and venture capital. "The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only," writes John Maynard Keynes. Unfortunately, neither marriage nor investment is treated as permanent in current times.

Despite these drawbacks to alternative assets, market surveys affirm that alternative assets are an attractive and growing asset class. Enhanced returns, improved diversification of their investment portfolios, and a hedge against inflation risk are primary advantages of this asset class. Investors see alternative investments as a way of lowering the overall risk of their portfolios without giving up the opportunity for substantial returns. Average allocation to alternative assets is about 20 percent, with private equity and venture capital approximately at 7 percent.

Placement agents not only advise venture capital funds seeking to raise a new fund, but also broker much of the crucial interaction with institutional investors and key players in the private equity community. Expanding the investor base and accelerating fundraising efforts, placement agents often act as advisors and sounding board. Emerging managers as well as more established firms look to placement agents to gain access to new institutional investors and to streamline the logistics of the fund-raising operations. Beyond opening new doors for funds, agents also influence fund terms and offer advice on market terms and conditions.

Market intelligence and social capital: Placement agents offer connections and a solid base of contacts for their clients. Rather than serving as a static database of names for private equity funds, the best placement agents are aggressive trackers, watching the shifts in personnel, sniffing out sector trends, and monitoring investment appetite in the allocations of private equity. In hiring placement agents, funds gain more efficiency in their fund-raising efforts by benefiting from the agents' targeted approach rather than by relying on shallow leads and marketing plans. Agents keep a constant check on the pulse of the market, honing long-term insight and an instinctual know-how on what relationships work or don't work. Placement agents also provide access to new investors and sources of capital. As one fund manager pointed out, when trying to raise a larger fund, you have to talk to new investors—strangers—and a placement agent can simplify this process.

The only measure of venture capital success is performance. The ability to pick the right companies that generate superior returns is paramount to any professional's success in this business. The investment process—sourcing, due diligence, negotiation of investment terms, board roles and supporting entrepreneurs—is important, yet secondary. Investors primarily care about strong financial returns.

Most venture practitioners would agree that "a pioneer deserves 30 percent to 40 percent profit for his risks and foresight," although they may not necessarily agree with Conrad's style of due diligence. Yet due diligence in venture investments seldom follows a structured approach and often is conducted in a free-flowing manner. Due diligence is the art of sizing up an investment opportunity—its potential and risk. Entrepreneur and venture capitalist (VC) Peter Thiel is the cofounder of companies like PayPal and Palantir. "Great companies do three things. First, they create value. Second, they are lasting or permanent in a meaningful way. Finally, they capture at least some of the value they create" he points out. According to Thiel, durable start-ups create something new, or go from 0 to 1, instead of replicating an existing model, or going from 1 to n. Once a novel idea has been launched, the goal is to monopolize quickly and eventually, spread that monopoly into other parallel domains.

Identifying value creation and estimating its sustained advantage is the core of due diligence activity. Good due diligence process helps a practitioner find the top risks and the upside of any opportunity. Steeped in shades of gray, any due diligence process offers some answers, but not all: Practitioners need to be comfortable with some degree of ambiguity. If you had all the answers, the opportunity would cease to exist.

In any investment opportunity, most venture capitalists concur that the jockey, or the management, matters more than any other criteria. The horse, or the technology, is another factor. Yet others believe that a large, growing market is the primary criteria. While this remains a much-debated subject, practitioners gravitate toward a combination of the three, and it all starts with a growing market.

2. CONCLUSION

Venture capital is a catalyst for job creation, innovation, technology advancement, international competitiveness, and increased tax revenues. Venture capital is the DNA upon which our very successful capitalistic economy is based .As a template for other economies, both developed and emerging, VC is also growing in importance and has become a key catalyst in driving GDP growth, employment, personal income, and industrial production.

Whereas entrepreneurs focus on identifying and solving burning pain points, venture investors try to find those extraordinary entrepreneurs who are trying to solve potentially huge problems in a meaningful way. Venture investors tap into their tremendous network of contacts and “pattern recognition”—the art of leveraging lessons drawn from past successes and failures to identify a combination of factors and behaviors that may point to promising markets, entrepreneurs, products, business models, and so forth. Together, these build a “prepared mind” or “gut feel” about the emerging market opportunities created by the tectonic shifts in customer behavior and the enabling technologies that can be successfully applied to those shifts. Entrepreneurs are true visionaries, and venture investors are great pattern recognizers with an experienced toolkit of how to build companies—and how not to build them. Successful start-ups are created when a trusted relationship and line of communication is established between the visionary (entrepreneur) and the pattern recognizer (investor) for two-way knowledge transfer.

Over the past several years the private equity market has continued to grow into a global industry, both in terms of where funds are investing and in the profile of the Limited Partners (LPs). Pools of capital have also become more sophisticated, with PE firms adding new asset classes to their stable of investment vehicles (some added fixed-income, hedge fund, and other products).

It’s not surprising that as the size and scope of private equity funds have expanded over the years, so, too, have their hiring habits. Although we’ve seen some effects from recent market turbulence, the pace of hiring and the corresponding demand for highly capable professionals remains strong. In any given year, we continue to see many firms bringing on multiple new hires.

The private equity market has gone through a major transformation over the past two decades, with many of the most dramatic changes occurring over the past few years. As you are likely aware, you are attempting to enter one of the highest profile sectors of the financial markets—one that is wielding significant influence on the economy while at the same time creating great wealth for its investors. The wealth that has been amassed has played a significant role in increasing the attractiveness of the sector and thereby further fueling the competitive environment to enter.

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