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Interest has been quickening recently in the benefits of fostering private equity investment in emerging markets, building on the concept of venture capital investing as it has evolved in the US. One result of this has been a representative resolution that was adopted at the UN sponsored meetings of the world’s heads of state, finance ministers and NGOs in Monterrey, Mexico, in January 2002, stating in part that:

“We will support new public/private sector financing mechanisms, both debt and equity, for developing countries and countries with economies in transition, to benefit in particular small entrepreneurs and small and medium-size enterprises and infrastructure.”

As a follow up to the above, an action proposal was also tabled at the meeting, to the effect that: “The international development community should designate a significant component of its aid program to risk-ventures and work with local public entities, using similar programs as the Small Business Administration (SBA) in the US, in the emerging economies to implement such programs. Such funds can be engineered to attract some limited foreign funds over time, but not necessarily now. To do so, an international fund can be set up and allocated on a regional basis among four or five regions, e.g., Latin America, South Asia, the Middle East, and Africa. The Fund can enter into a “master agreement” with one or more US private managers with proven skills. … To be successful, the international community should benefit from the experience of VC and other capitalists by attracting such managers to help install managerial skills into such companies and to make this work along the way VC managers work.”

The time is ripe, it seems, to start thinking about the issues, questions and possible solutions one is likely to encounter in attempting intelligently to invest capital in emerging markets. This must include, although not be limited to, those investments styled as venture capital opportunities.

The framework

If one thinks of private equity investment in terms of ‘traditional venture capital’ (as it has historically been applied in the United States), the threshold problem is apparent. Venture investing is high risk/high reward, the risks having to do with questions such as the viability of technology, the existence of a genuine market for the same, the adequacy of the firm’s capital resources over a relatively a long period of time and the all important question of management. As VCs like to say, you have to “bet the jockey and not the horse.” Venture investing in the United States is, according to researchers, a difficult business since the top performers routinely, and by wide margins, outperform the middle and the lower tier venture investors. The evidence suggests that there is a very real art to venture investing: the disparity between the top and bottom decile is wider than any other asset class currently under review.
VC-backed companies employed 5.9 per cent of the US workforce and accounted for 13.1 per cent of US GDP

This is a business, in other words, for people who have a real knack for it. And part of that knack is to minimize unnecessary risk, an imperative which (while obvious) questions the wisdom of investing in emerging markets. If the risks for all but the top players in venture capital in the U.S. are such that median performance lags the S&P index, how much more difficult will it be for investors in emerging markets to achieve competitive returns? The challenge seems daunting.

To be sure, emerging markets present opportunities: new entrants will, for example, not face such stiff competition. Moreover, the ability to release pent up demand and take advantage of underutilised skills should pay dividends. However, emerging markets entail a number of risks not directly related to the particular value proposition under consideration. If unchecked, these factors could render any investment a loser. These have nothing to do with management, market, product or the business model but with, among other things, the lack of appropriate infrastructure in the LDCs.

The US venture capital experience

There are various estimates of the current magnitude of venture investing in, and its impact on, the US economy, in part depending on when one measures the activity. It is fair to say that, currently, professionally managed venture funds (650 in number, more or less) invest on average (leaving aside the 1999/2000 bubble) about $10bn per quarter in domestic emerging growth firms, a total of $40bn annually.

The impact on the domestic economy is not susceptible to precise calculation but, if one averages the returns on investment typically achieved by the pros, a four multiple seems plausible. This suggests an impact of $160bn in new wealth creation over the succeeding five years. An annual infusion of $40bn may not be sustainable *ad infinitum*, given the 11 September, 2001 tragedy, so that the National Venture Capital Association number for 2001 of $45bn invested may be high. But we are still talking about many billions of dollars in professional venture investment. To that figure must be added capital committed to entrepreneurial funds by strategic investors (no precise data, but in the billions), angel investors ($10-$30bn) and government assistance (mainly from SBA). All in all, one gets to some big numbers. And those numbers produce interesting results.

The National Venture Capital Association’s 2000 report says that VC-backed companies employed 5.9 per cent of the US workforce and accounted for 13.1 per cent of US GDP; over the last 30 years, VC investments have created 7.6m jobs in the US.

Further, as Harvard scholars Paul Gompers and Josh Lerner have written, “[t]he increase in innovative outputs can be seen through several measures, probably the clearest indication is in the extent of patenting. Patent applications by U.S. inventors, after hovering between 40,000 – 80,000 annually over the first eighty-five years of this century, have surged over the past decade to over 120,000 per year. This does not appear to reflect the impact of changes in domestic patent policy, shifts in the success rate of applications, or a variety of alternative explanations .... Rather, it appears to reflect a fundamental shift in the innovative fecundity in the domestic economy. The breadth of technology appears wider today than it ever has been before. The greater rate of intellectual innovation provides fertile ground for future venture capital investments.”

These numbers, as approximate as they may be, translate into some real bottom line, macro-economic effects. Jill E. Fisch has stated in her article *Can Internet Offerings Bridge The Small Business Capital Barrier?* that “small businesses [not only venture-backed, of course] make up 47 per cent of the gross national product (GNP) of the United States.”

What is more, there are approximately 23m small businesses in America (again not, by any means, all venture-backed) and it is these small businesses that are the principal source of new jobs in the US economy. They employ 53 per cent of the private workforce and, more importantly, they provide 67 per cent of workers with their first jobs and initial on-the-job-training in basic skills. Small companies also lead large corporations in
the amount of innovation produced: recent research actually suggests that small companies provide 55 per cent of all innovations in the US.

Obviously, in a number of regions (including emerging markets) small business is the strength, sometimes the only strength, of the local economy. However, for the world’s economic superpower to be as small company-oriented as it is, venture capital is a significant contributing factor.

What makes a robust venture capital environment?

Opinion, both empirical and academic, varies on the necessary elements for a robust venture capital environment. There are to be sure, certain fundamentals. One is the availability of first class educational institutions which generate research at the graduate and post-graduate level. Were this the only necessary element, however, any number of places around the world would qualify.

Access to capital accustomed to and comfortable with taking significant risks is another obvious element of the equation; what is not so obvious is the problem of legal strictures on capital deployment.

The funding of venture-backed companies in the United States did not really begin to take off until a couple of little known events coincided, the first being the advent of modern portfolio theory, which dictated that large pools of capital could enhance their returns by diversifying their investments over a variety of asset classes. Venture capital in and of itself might be deemed too risky for a given pension fund manager; however, theorists revealed that, if the manager were to take a discrete pool of capital and allocate a certain percentage to bonds, another percentage to publicly traded stock and the remainder to so-called alternative investments (real estate, buyouts and venture capital), superior returns would result, all other things equal.

Coincident with the arrival of modern portfolio theory as an asset management imperative, in 1979 the Department of Labor (after years of importuning) enacted the Plan Asset Regulation, which released pension fund managers from strict application of the so-called “prudent man rule” and protected them from liability if they were to invest capital in professionally managed venture capital funds.

Simply having capital available is not enough

These two factors combined with the fact that most US states and municipalities shifted in the post war period from pay-as-you-go backing of their retirement obligations to fully funded pension funds. The pension funds, both private and public, swelled into the trillions of dollars, managed by competitive professionals who used modern portfolio theory to maximize their results.

The key message from this is that simply having capital available is not enough. It must be capital which, from a legal and economic standpoint, is painlessly and naturally oriented in the direction of, among others, venture capital as an asset class. If the capital is not assembled under professional management, if it is subject to legal, ethical or cultural restraints, and/or if it is not managed by individuals who see the virtue of this asset class as a necessary portfolio construct, then it is essentially sterile and cannot be counted.

Beyond the science and capital, the third ingredient is, of course, people: energetic and optimistic risk takers who are willing to sacrifice near term income and leisure time in order to take the plunge as entrepreneurs. This implies, although not exclusively, individuals with adequate education plus some ability to keep one’s head above water (and feed one’s family) during the lean years, which entrepreneurship often implies.

The ability to sustain one’s self while drawing little or no salary is a function, in the United States at least, of a combination of factors. Personal savings, including the equity in one’s home, are the principal source of capital for a typical business at the pre-seed stage. (In fact, there have been from time to time theories that attempt to tie entrepreneurial activity to the average levels of home equity, the latter being an indicator of the amount of capital available for the pre-seed round when the entrepreneur is financing the initiative themselves.)

Another factor is the domino effect. This is to say, a Hewlett Packard or a Litton Industries in a given locality will spin off talented people, whether they leave with a financial parachute or simply with a store house in their minds of useful commercial information. Thus, there has
always been a “breeder effect” in, for example, the Route 128 area of Greater Boston. Digital Equipment, Prime and Data General were founded by refugees from the likes of IBM and in turn spawned additional enterprises.

If one looks at the US economy closely it also becomes clear that good public schools are an essential element. Entrepreneurs often have families and, in the early stages at least, are not in a position to pay private school tuition. They are highly educated and expect, accordingly, a first class education for their children at public expense. The Palo Alto, Newton, Wellesley, etc. high schools have had a great deal to do with the rise of entrepreneurial activity in both Boston and Santa Clara County.

Next, and crucially, government regulation plays a key part. A jurisdiction which does not protect intellectual property, for example, is not one that technology entrepreneurs will find sympathetic. On the other hand, protection of intellectual property can go too far. Stanford Professor Ron Gilson among others, has advanced theory to explain why the center of gravity of the venture capital industry, initially sited in Boston in the ’60s, segued to the peninsula south of San Francisco. Certainly, Harvard and MIT are the equals of Stanford, Berkeley and CalTech. What tipped the balance, in Gilson’s view, was the restrictive attitude the Massachusetts courts and legislature had developed towards departing employees. Massachusetts tended to uphold constraints on employees who departed from the mother ship and wound up competing on the basis of information (if only theoretical and abstract) they had acquired in their prior employment. Equitable relief was available to the employer; Prime Computer, indeed, was one of the most active litigants, attempting to keep its alumni out of the computer businesses. California, on the other hand, has historically been unfriendly to restraints on competition, the liberal view in California being that a man or woman had a right to make a living. On the west coast, the conversion of intellectual property had to be pretty rank before an injunction would issue.

Whether this theory is objectively demonstrable or not, it is clearly the case that a balanced, well-developed code of law governing a number of subjects (including employer/employee relationships, intellectual property and like items) is of critical importance. Both Massachusetts and California have such well-developed rules and active bar association committees in touch with the appropriate legislative committees to revise the law when glitches appear.

Curiously, evidence would suggest that personal income tax rates have not appeared to play a major role in attracting venture capital activity in the US. Both California and Massachusetts have, historically, been high tax states. The important tax number to the entrepreneur, of course, is not the tax on ordinary income but that on capital gains. And it does not appear that the lure of tax holidays in a New Hampshire or a Florida has been sufficient to tip the scales.

Finally, there is a critical mass issue. According to most surveys, more than half of all venture investments go to just two regions of the country – California’s Silicon Valley and New England’s high-tech corridor. The most plausible explanation is that “birds of a feather flock together.” It’s certainly the case that both venture capitalists and entrepreneurs gain sustenance (and economic advantage) from networking. Why not, therefore, locate the firm where the networking opportunities are most robust?

It is not easy to generalise about emerging economies around the world because each has special characteristics, of course. But, in the more advanced states, one assumes the existence of at least one first class university with the resources to conduct groundbreaking research. Moreover, an educated and inspired workforce is often available. Consider the graduate students in scientific and technological disciplines at U.S. universities to see the raw material, in people terms, for a valid entrepreneurial initiative. A good university with an active research component is a first pre-requisite if not the sine qua non.

A second fundamental is the availability of capital. Many emerging economies lack investment capital, particularly that portion of an asset manager’s portfolio...
5 per cent or so) that, in the US is allocated to venture capital. Capital deployed in an emerging market is, by definition, itself high risk, particularly given political and currency risk. There is a question, therefore, whether it is within the bounds of prudence for the investor to add the additional risks which early stage enterprises entail. Presumably, such risk capital can and must be supplied by some form of government stimulus. For purposes of this analysis, I will assume that the availability of capital per se is not the problem but, more importantly, how it is deployed.

If learning and capital is available indigenously, the outcome in any given country is likely to vary directly with the quality of the managers appointed to oversee the investment process. This precept is echoed in the words of the overseer of US efforts (the Enterprise Fund initiative) to foster entrepreneurial enterprises in Eastern Europe. As John Birkelund has put it: “Nothing can compensate, in contrast, for deficiencies in the quality of fund management; boards must exercise vigilant oversight and correct problems promptly, just as they would in the private sector. Despite its virtues, therefore, the Enterprise Fund concept is successful only when care is taken in selecting both board members and management. When selection has been driven by political considerations rather than merit, the result has been disaster.”

Essential technicalities to emerging market VC

Several commercial technicalities are essential, in concert with these fundamentals if venture capital is to take root in an emerging market.

1. It is central that a well-developed code of commercial law be enacted, respected and reliably interpreted and enforced by an independent judiciary. This is the rule for any type of economic activity, of course, but it is particularly important for investors in fragile enterprises, e.g., start ups, to understand what might be the legal consequences of their activities. Are investors protected from liability if the enterprise fails? In that connection, I would stress the importance of a realistic bankruptcy code. If the cost of failure is disgrace and ruin, then nobody is going to take the risk in the first instance.

2. Can employees be laid off at any realistic cost or is lifetime employment assured? Again, the costs become too great if the manager cannot respond to a downturn in an economically efficient fashion.

3. Are contracts enforced? Is intellectual property protected? A whole list of items, which practitioners in the United States take for granted, need to be implemented if a venture capital industry is to flourish in an emerging market.

4. It is highly likely that the most promising venture capital hot spots will grow up around the world in areas where both of the typical exit and/or liquidity events are open to entrepreneurs and VCs, meaning both company sale and initial public offerings. The latter is particularly tricky. Many emerging markets enjoy the existence of at least a notional stock exchange, which in turn would imply that an IPO in the host country is a real possibility. However, in all but a very few cases the local stock exchange is not IPO functional. Typically there is not enough trading activity to make an IPO interesting. Few if any of the listed companies are followed by competent analysts and the pools of capital necessary to make up an adequate buy side do not exist. A company sale, of course, is an adequate exit opportunity; in fact, in the US it is the only exit opportunity when the IPO market is in one of its periodic swoons. Israel is an interesting example here; several VC-backed Israeli companies have gone public on NASDAQ (and the Neuer Market) and in some cases successfully. However, leaving Israel aside, it is hard to bring an offshore company public in the US, particularly one from a less-developed country, unless the company itself has significant business ties in the US.

Do emerging economies have the right stuff to nourish venture capital? And what should a realistic action plan to nurture emerging market VC look like? Part 2 of this article will be in the next issue of Private Equity International, out in early September.

Joe Bartlett is a senior partner at Morrison & Foerster LLP in New York. He is also the Founder Chairman of VCExperts.com, the leading US website for entrepreneurs and professionals in the venture capital industry.