

# THE JOURNAL OF PRIVATE EQUITY

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## Editor's Letter

F. John Mathis

*JPE* 2018, 21 (4) 1-3

doi: <https://doi.org/10.3905/jpe.2018.21.4.001>

<http://jpe.ijjournals.com/content/21/4/1>

This information is current as of October 16, 2018.

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# THE JOURNAL OF PRIVATE EQUITY

VOLUME 21, NUMBER 4

FALL 2018

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The Fall 2018 issue of *The Journal of Private Equity* confirms a pattern of continuing expansion in funding power and investor confidence in seeking new opportunities in private equity markets. (Refer to Market Snapshot, p. 101) The most substantial 10 private equity funds accounted for over 40% of all funds raised through the first half of the year.<sup>1</sup> With record levels of increasing capital, private equity is undergoing several transformations in its business model. *The Economist*<sup>2</sup> recently identified that fear of tax reform that is adverse to private equity has resulted in public companies being taken private, with large companies selling off divisions to private equity firms (e.g., Smucker and GE). Also, the number of limited partners (LPs) with \$1 billion or more invested in private equity has increased to 359 from 304 (quoting Preqin data) and LPs avoid management fees. Finally, the larger private equity companies are undertaking massive takeovers alone, and then, to reduce the risk of a sizeable concentrated investment, are syndicating large shares to LPs as co-investors.

Venture capital is also growing in total deal value, but the number of deals accounted for by North America is declining. This decline is a cause for concern because new start-up companies add to the number of smaller companies, which contribute significantly to the creation of new jobs in the United States. A recent report from Pitchbook<sup>3</sup> quoting a working paper by Martin Kenney and John Zysman, titled “Unicorns, Cheshire Cats, and the New Dilemmas of Entrepreneurial Finance,” questions whether fundraising at breakneck speed and deals getting larger are signs of excess (bubble). Are investors buying into unicorn start-ups bloated by overvaluation and vulnerable to new technological advances, which could cause them to disappear overnight? At the other end of the venture life cycle, exit times have lengthened. Public markets continue to be burdened by IPO-related regulation. Moreover, an earlier article in *The Economist*<sup>4</sup> finds the reduction in the number of U.S. start-up financings is the result of the large tech giants purchasing them to sell under their own brand, or burying them in favor of promoting their own branded technology product or service.

Many U.S. states and major cities have tried to promote new venture start-ups by attracting outside funds to invest in their programs.

<sup>1</sup>Christopher Elvin, “Forward,” Preqin quarterly update: Private equity & venture capital Q2 2018, p. 3.

<sup>2</sup>“Barbarians grow up,” *The Economist*, July 28, 2018, p. 53.

<sup>3</sup>Anthony Mirhaydari, “How venture capital is hurting the economy,” Pitchbook, July 13, 2018.

<sup>4</sup>“Into the danger zone,” *The Economist*, June 2, 2018, pp. 55–57.

Few have lived up to expectations, often because not all of the necessary supporting infrastructure and institutions exist, or they take too long to develop, so the start-up effort fails or is forced to relocate.



In this issue of *The Journal of Private Equity*, several articles evaluate this situation from different perspectives. Joe Milam, in “The Need for Localized Risk (Venture) Capital: *Place-Based Impact Investing*,” details a proposal for Place-Based investment to support a local private equity entity or fund for new ventures. This entity would mobilize legacy capital from local wealthy families or individuals, community foundations, and thought leaders. These groups have resided in or near cities for decades; they consider them their homes and want to leave a positive impact on “their” communities by investing in them and supporting new businesses and employment. Milam details how and why such a so-called “legacy” capital fund would work and the significant tax advantages currently available to help ensure its attractiveness and success. The proposed diversification from the existing three U.S. new venture capital centers could increase the number of new ventures launched and help distribute the employment and income benefits to more states and cities. Milam’s model would provide the more timely, understandable, and meaningful performance data desired by investors. It would lower the fee structure, and the more important management of existing tax opportunities would further boost returns.

In the next article, “Innovations are Coming to the Human Resource” by John Mathis, the author analyzes a new tech trend that is significantly impacting future employment; it could further aggravate a pattern identified in the preceding article of threatening the growth of middle-class unemployment. The new human capital technology (including Artificial Intelligence) currently being implemented in healthcare, transportation, finance, e-commerce, and utilities is paving the way for innovations in talent acquisition, employee management, and leadership development. Significantly, companies in these industries currently account for roughly half of U.S. private, non-farm employment—or almost 78 million people.

The following articles extend and update the investigation of existing venture capital investment public policy in developed and emerging markets and its effectiveness. Gugu Ndlwana and Ilsé Botha examine “Determinants of Private Equity Investments across the BRICS Countries.” They analyze the impact of six macroeconomic and market-related variables and find four to be significantly related: GDP growth and real interest rate are positively associated, and market capitalization and corporate tax rates are negatively correlated. Recommended government policy actions include: Firstly, innovative ways could be explored to reduce taxes in the interest of positively driving PE investments. Secondly, policymakers could promulgate robust regulations and enforcement that seek to protect the rights of investors (domestic and foreign) within a country. Thirdly, governments could incentivize pension funds (of public and private companies) to channel some of their investment funds toward PE firms. Lastly, governments should promote a culture of entrepreneurship. The authors also note that inadequate or nonexistent regulation limits PE investments.

Luca de Angelis, in “When Too Much Is Too Little: *Evaluating the Italian Startup Act*,” shows that start-up ecosystems in developed countries have so far produced mixed results and wasted taxpayer money. The failure of importing policies from other countries results from not understanding the real economic goal of start-up policies, nor how to adopt strategies that have worked elsewhere to the local context. The author uses the Italian 2012 Startup Act to reveal what works best when governments promote start-ups to boost the innovation content of an economy and spur economic growth. First, where start-ups get their funding is of paramount importance; local market funding has to come with strings attached that help start-ups grow to the next stage. The Italian case shows that government guaranteed debt is the wrong type of funding, as it does not force start-ups to evolve, but rather lets them fund ideas regardless of their attractiveness to investors and customers. Second, a good start-up ecosystem must consider the local skills gap and create incentives to bridge it. When it is not paired with experienced and global mentorship, start-ups have a hard time figuring out what works and what does not on their own. Third, innovation germinates

in universities, research centers, and corporate R&D arms. Public start-up policies need to focus capital and incentives around existing innovation centers to increase the innovation content of the economy.

An original and thoughtful article by Mark Anson investigates “Initial Coin Offerings: *Economic Reality or Virtual Economics?*” Digital currencies have grown exponentially since 2009 and are impacting the way start-up companies raise capital. Initial Coin Offerings (ICOs) raised over \$4 billion in 2017. Anson explores the economics of ICOs, and considers their risks, regulatory implications, and placement in the capital structure of start-up ventures.

In the next set of articles the focus shifts to performance management and measurement in private equity companies. Frank Williamson examines “Capital and Financial Strategies for Private Companies: *Lessons from Their Publicly Traded Brethren.*” He argues that the companies with the best governance and risk management also regularly evaluate their capital and financial plans, and think ahead about their needs for liquidity, mix of funding types, and need to return money to their investors. The law requires this for public companies. The author explores how private companies adopt the governance and risk management practices of public companies and overcome the challenge of little visibility into capital markets for their companies.

Slavcho Parushev examines “Putting Private Equity Scorecard Approach (PESA™) to Work,” as introduced in an article<sup>5</sup> in the Spring 2018 issue of *The Journal of Private Equity*. The author discusses the specific characteristics of the internal process and organizational structure of a private equity fund that uses PESA™ in its performance management. He also examines the fund’s approach to investments and the necessary information environment in which the fund operates.

Next, Bradford Cornell and Richard Gerger ask how “Can Private Equity Firms Pay Fair Value for Acquisitions?” and be able to earn returns of 18% for their investors, which is typically higher than the cost of capital for the target firms. They explore the conditions under which private equity firms are likely to be able to

pay fair market value as well as the circumstances when potential targets should say no.

Md. Noman Siddiquee examines “Do Daily Dividends Reduce Stock Return Volatility and Value-at-Risk?” Using data on five stocks listed on the Dhaka Stock Exchange he finds that in most cases the inclusion of daily dividends significantly reduces the volatility of daily returns. Furthermore, the Value-at-Risk (VaR) of the remaining stocks’ returns generally declines, substantially decreasing the maximum expected yield. Extending the holding period also lowers the VaR of the daily returns proportionately.

Shifting the focus to industries, Tay Kin Bee analyzes the “Valuations of Chemical Companies and Distributors: *Comparable Metrics and Precedent Transactions*” Low interest rates are why mergers and acquisitions are at a high pace and why companies’ valuations are essential to determine the value of the deals. Public chemical companies’ comparable metrics and profits from previous transactions can be helpful to potential strategic and private equity buyers.

**F. John Mathis**  
Editor

<sup>5</sup> Slavcho Parushev, “Private Equity Scorecard Approach: *Quality versus Myth,*” *The Journal of Private Equity*, Spring 2018.