

# THE JOURNAL OF PRIVATE EQUITY

VOLUME 14, NUMBER 2

SPRING 2011

<b>JAMES E. SCHRAGER</b>	Editor
<b>HARRY KATZ</b>	Production and Technology Director
<b>ANDREW O'DONNELL</b> <b>JOANN LIN</b>	Director of Marketing Associate Marketing Manager
<b>SEGAL BENGIGI</b>	Global Digital Sales Manager
<b>PETER JUNCAJ</b>	Head of Subscription Sales Account Manager
<b>CHARLIE BUXTON</b> <b>TRISTAN EFREMENKO</b> <b>JENIFER HILL</b>	Account Manager Account Manager Account Manager
<b>DEWEY PALMIERI</b>	Reprints Manager
<b>KELVIN LOUIE</b> <b>EMPERATRIZ MIGNONE</b>	Senior Fulfillment Manager Fulfillment Manager
<b>STEVE KURTZ</b> <b>ALINA LEONOVA</b>	Director, Finance & Operations Business Manager
<b>DAVE BLIDE</b> <b>SAMANTHA RALPH</b>	Associate Publisher Group Graphic Designer
<b>JANE WILKINSON</b> <b>ERIC HALL</b> <b>ALLISON ADAMS</b>	President & CEO Publisher Group Publisher

With signs of a slow recovery starting as this issue goes to press, we present a series of articles directly related to the way we see our world, how we calculate values to guide our entries and exits, and the way others see us. Each of these lead ultimately to the way we see ourselves and the way we manage our firms.

Our lead-off article is the third in a series that examines, with the aid of hindsight, a purchase by one of the most famous investors in modern history, Warren Buffett. Joseph Calandro, Jr. analyzes a centerpiece in Buffett's collection, GEICO insurance company. This company, now well known due to a TV saturation advertising campaign, started by insuring only workers of the government ("Government Employees Insurance Company"), of which Buffett first wrote 60 years ago. Calandro lays out the process for valuing the firm and, more importantly, develops a way to track the worth of a "franchise" firm, defined as one operating with a sustainable advantage. All areas of valuation analysis are touched upon here, including strategy, finance, and performance improvement. How good a deal did Buffett get when he bought GEICO?

Ever wonder what sophisticated advisors are telling your limited partners about how to select funds to invest in? J. Christopher Kojima and Daniel J. Murphy take us inside the mind of the investor and offer advice (from Goldman Sachs) on how to judge private equity investments. Starting with a comparison of the wide performance variance between top-tier and bottom-tier venture and buyout private equity funds versus other investment classes, the authors take potential investors through a series of non-obvious risks that the informed investor needs to consider. How many of the tough questions proposed by this article are you prepared to answer?

Now how about those funds of funds and the type of performance these entities claim for their investors? Nathalie Gresch and Rico von Wyss illuminate a large dataset of 1,641 funds, raised between 1979 and 2001, to track returns—which are risk adjusted—among various categories such as buyout, venture, real estate, mezzanine, distressed debt, and others, each of which is compared to the returns for funds of funds. Which do you think achieved the highest risk-adjusted return in this study? I was surprised. My guess is you will be as well.

How is it that we add value to our portfolio companies? This is an essential question every general partner must decide. Lucia Silva Gao considers three types of strategies for evaluation: industry specialization, industry diversification, and complementary networks. Gao uses a dataset of 132,440 financing rounds during the period of 1995 to 2004. We all know which strategy should be the best, right?

As long as we are asking basic questions, ever wonder how entrepreneurs evaluate potential VC firms? Yanfeng Zheng analyzed 4,653 online comments made about 261 venture funds looking for what entrepreneurs were particularly attentive to. He noticed that late responses and concerns with ethical behavior were of special interest as prospective entrepreneurs formed their opinions of VC firms. How do you think you would rate?

Looking at this question a different way, Dave Valiere first posits a theory of the signals venture capital partners send to entrepreneurs, and then tests that with a small sample-size study. He tests two ideas: First, that investing in early-stage deals, rather than later financings, is a signal of deal-screening ability for the VC fund. Second, that making deals with firms overlooked or rejected by other VCs is a sign of independence and special skill. The idea of course is that those VC firms that signal skill in selecting the best deals will have access to the best deal flow. While the data provide only an exploratory study, the results hint at a barrier to entry many VC firms may need to better understand.

Our final piece by Laurence M. Smith discusses one of the toughest parts of the sale of securities by a private company, the scope of indemnification that will be triggered when a breach of representations and warranties has occurred. Of course, the obvious remedy is to be reimbursed for the diminution in value caused by the breach, but there are many reasons why this will most likely result in a “call to arms” by the lawyers on both sides. Read on if you’d like to plan ahead to minimize these kinds of fire-works.

**JAMES E. SCHRAGER**  
Chicago, Illinois  
January 2011