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When Will Economic Instability and Market Volatility End?

As 2012 begins, venture capital and private equity continue to face several significant uncertainties, which are likely to be disruptive for some time. First, there are expectations of somewhat more modest future global growth rates, which have been substantiated in the recently released IMF, *World Economic Outlook*. Second, financial regulations (Frank-Dodd, Basel III, Volker rule), particularly in the United States and Europe, are making some activities more difficult and more costly. Third, the U.S. election campaign has drawn increased attention to the industry, which could alter how institutional investors, such as pension funds, fund buyouts. Fourth, continued concerns about government budget deficits could increase tax pressures and remove tax breaks, thus hurting returns. Finally, major banks are still not fully recovered to the point that they are supporting private equity activities, especially with respect to those with assets below $1 billion. And if these circumstances are not bad enough, there are questions arising about the actual private equity return being lower than what investors expected, according to a *Financial Times* article referencing studies by Yale and Maastricht Universities.

Despite these negative developments, overall private equity in 2011 matched the 2010 levels, with continued broad improvement in deal flow, fund raising, and exits compared with the 2009 lows. The average time spent on the road fund-raising fell by two months from 2010 (see chart at back of this journal). Private equity secondary deals were very strong particularly in Europe, and were also significant in the United States, accounting for half of all buyouts. The strongest area of activity in the United States was in business products and services, and larger-sized deals (above $1 billion) increased noticeably compared to 2010. Meanwhile, buyout purchase price multiples rose to nine times earnings before interest, taxes, depreciation, and amortization (EBITDA)—up from slightly above seven times in 2010 (see chart in the Market Snapshot section at the back of this journal).

This issue of *The Journal of Private Equity* contains a series of articles about regulation effectiveness, financing issues, and risk management concerns related to venture capital and private equity. A second set of articles examines the development of venture capital and private equity markets in Mexico, India, and selected Eastern European countries. The BRIC (Brazil, Russia, India, and China) countries and many other emerging market countries are undergoing changes in financial market regulations and instruments as countries look to attract development financing as export revenues and foreign investment inflows soften and dampen domestic economic growth.

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K. Vaidyanathan asks what an optimal threshold size is for registration. The Dodd–Frank Act has made it mandatory for all venture capital (VC) funds with assets under management (AuM) exceeding $150 million in the United States to register with the U.S. Securities and Exchange Commission (SEC). Supervising too many VC funds may spread regulatory resources too thin and may dilute the effectiveness of supervision. He argues that keeping the size threshold at $250 million may mean that regulators can optimize their time and effort spent on monitoring and improving supervision effectiveness.

Adrian Horotan argues that unless the discount rate is much higher than what is considered fair, investing in convertible debt with a discount to the next financing round—without warrants, founders' stock, or a conversion price cap—is equivalent to sacrificing most of the upside potential for the early-stage investors.

Gene Barton takes a company's perspective in looking for a private equity investor. He identifies a number of reasons that successful businesses look for private equity investment. Private equity can provide growth capital and some liquidity for business owners while they continue to grow their businesses. While more expensive, private equity also tends to be more flexible in its terms than traditional debt financing. Hence, it may be particularly attractive in today's challenging economic environment where bank and similar debt financing is becoming harder to get and more restrictive in its terms.

Nakhon Kokkaew and Alex Xu write about lenders' concern about credit risk management in infrastructure project financing. Most lenders assume that project debt lenders only invest in one project at a time. However, many project lenders are inclined to be simultaneously involved in a portfolio of assets around the world. This article presents a copula-based model to measure the credit risk of a portfolio of projects by implementing the variance model and the double stochastic intensity model.

David Slifka writes how private fund fee structures typically contain a catch-up, which is a widespread limited partner preference despite the fact that it increases fund fees and misaligns incentives. By estimating carried interest paid based on published histories of real estate opportunity fund returns, he shows that fee structures with no catch-up and a lower hurdle have been roughly 14% less costly to limited partners than structures with a catch-up and higher hurdle.

Manu Sharma and Shikha Kaushal analyze the daily volatility behavior of the S&P Private Equity Index and Private Equity Total Return Index. The results show that the S&P Private Equity Index has more volatility than the Private Equity Total Return Index, and the authors explain why this is the case.

Roberto Charvel writes that private equity activities in emerging markets (particularly Mexico) are experiencing an important change as local institutional investors are coming of age and becoming more sophisticated. He shows how the development of private equity and other alternative assets will have a positive impact on the development of other financial institutions that will create productive growth overtime.

Thillai Rajan Annamalai and Vishal Prasad Kamat examine the recent significant growth in the venture capital and private equity industry in India. Lifecycle analysis provides findings that can impact the long-term growth of the industry. A large proportion of the deals are round-one investments with a dramatic drop in subsequent rounds. Most investments are in late-stage financing and take place many years after the incorporation of the investee firm. They argue that investments should be made in early-stage financing, investors should stay invested for a longer duration, and larger rounds of funding should be made in the portfolio companies.

Darek Klonowski shows that the strong development of private equity in Poland is due to economic stabilization and growth, strong development of the private sector, a favorable business outlook, and continuous improvement to the local institutional infrastructure (laws, accounting regulations, and fiscal regimes). He offers two conclusions: private equity in Poland generates the strongest long-term returns among emerging market countries; and a careful selection of local general partners (GPs) can further enhance returns for limited partners (LPs).

Robert D. Hisrich shows that venture capitalists have a significant impact on both developed and emerging markets providing capital, particularly for the growth of enterprises. Understanding the way they operate and make decisions in emerging markets, such as Southeast Europe, provides insights into the economic development. He explores this by reporting the findings of an in-depth interview with a leading venture capitalist in the region in terms of the five ways to operate and succeed.

F. JOHN MATHIS
Editor