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# Association News

# IVCA Article: Highlights of the NVCA/IVCA Luncheon, including Professor Mitchell Petersen on 'The Real Impact of Venture Capital and Private Equity'

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CHICAGO – The annual NVCA/IVCA Luncheon was on May 2nd at The Chicago Club, a historic setting which has been a center for the business community in Chicago since 1869. Membership of the IVCA was there to get a perspective on the state of the venture capital and private equity industry, through the presence of the National Venture Capital Association (NVCA), the Small Business Investor Alliance (SBIA) and Professor Mitchell Petersen, with the Kellogg School of Management at Northwestern University.

Professor Petersen spoke on the subject "Beyond the Soundbites: The Real Impact of Venture Capital and Private Equity Investing in America." His remarks were an answer to public perceptions of media's coverage in the current presidential campaign.

The NVCA/IVCA Luncheon began with an opening statement from IVCA Executive Director Maura O'Hara, who also introduced the representatives of the event sponsors, Bill Chapman of accounting firm Baker Tilly and James Lidbury of law film Ropes & Gray. Also in attendance – from Washington, D.C. – was the President of the NVCA, Mark Heesen, and Brett Palmer, the President of the Small Business Investor Alliance (SBIA). They answered general questions about national issues from the attendees after the presentation from Professor Petersen.

The Chairman of the IVCA, Jim TenBroek of Wind Point Partners, also updated the association membership on IVCA's recent activities. In keeping with the the subject of the luncheon, Mr TenBroek said, "Success means growth, not contraction. When we're successful, everyone wins. Jobs are created and local economies grow, plus a wide variety of constituencies benefit by being investors directly or indirectly in our funds – pension recipients, insurance company customers, college students, the list goes on. That's our role, and we need to embrace it more fully."

Below are some of the highlights of Professor Mitchell Petersen on "Beyond the Soundbites: The Real Impact of Venture Capital & Private Equity Investing in America"

On academic research of Venture Capital and Private Equity industries...

"Part of what you want to hear are the facts, and part of what you want to hear is the context – without context the facts aren't terribly useful. This is an industry that potentially can create value. I find this a fascinating industry to study, and to think about the role it plays in funding good projects. And as you get deep into it you see the opportunity in a market economy where people 'pursue their own interests,' there are many collateral benefits. I think there is a positive role to play, I don't think that's always been clear."

What is the objective of the Venture Capital and Private Equity industries...

"The objective is to make money for our shareholders. We think about who those shareholders are, they're pieces of society we think are very important. As a result, we need to think about how we create value. Piecing together the industries to understand how value is created in them is difficult. I'm going to talk about returns, the difference between firms in a private context versus a public context and two areas of investment – the effects of employment and innovation. Some of this message will come out of the academies, but much of it must come out of the industries."

The Returns

"Private Equity isn't just a source of capital for firms, it's also a huge fraction of the portfolios of many investors. When I think about foundations, endowments, private and public pension plans, that is about 64% of capital in 2010 that goes into the industry. How goes the industry, so goes these institutions in society."

"The first study looks at the PE or buyout industry. Depending on how they weighed the data, they found excess returns of about 3.8 through 4.5 percent, on a risk adjusted basis. If you buy a stock, you get a higher return, but you take more risk. What we're interested in, that if you hold the risk constant, how much better do you do? In the last two or three decades, **you're beating the market on a risk-adjusted basis by two or three percent**. That's not how much an individual makes in the industry, that is how much income flows out in general, and somewhere value is being created."

"The Venture Capital industry is a little more nuanced. Over the same two to three decade period, the class has outperformed the market on a risk-adjusted basis, but it's very concentrated. It happened through the 1990s, but after 2000 you don't see that performance. So it's about the time pattern, as well as the magnitude.

In VC, it was an interesting ramp up, then a collapse. Part of it is the hangover from the dotcom era, and several bad years will live with the industry for a long while. At the peak, it was a 30-40 percent return, and the market wasn't doing that. In the last decade it hasn't been great, but the market has also been poor during the last three or four years, and the sample for the last three or four years doesn't take into consideration that some funds have not cashed out. You'd have to look at those separately and they would be more positive in returns."

"The message I take away from this data is this. Both industries for long periods of time have outperformed the markets, both have returns that are highly cyclical and both seem to be declining over time. Can we think about how this can come back? To predict the future I want to understand how to take capital, employees and natural resources to create a product, and then how the limited partners walk away with extra money.

Mathematically, it's pretty simple. You put money in today and you take money out in five or seven or ten years. The first place value created is the present value of that piece you sell in the future minus today. The second place value can be created is that you get to buy low. The third place is you sell it for more than you paid. And then there is the difference between the value when you secure it between the value when you release it. Those three are going to be the sources of value."

Private Capital versus Public Capital...

"What is unique about the private source of capital that you provide that others cannot? One is where the returns come from, if you can provide something that others can't provide, you can capture some of that value. Secondly, that creates value for society. Because if you can provide capital where others can't, that means ideas will be converted to products that wouldn't otherwise happen. So think about how private capital is different, and in this discussion we're going to argue how it's unique and better."

"Let's start with the image of how Private Equity comes in and strips a company, and is only short term focused. Really? If you were going to describe a set of firms that are short-termed focused, you'd pick the private ones, not the public ones? Jeff Bezos of Amazon once said, 'If you have a short term focus, so does all your product competitors, and they'll compete with you. Our focus is going to be long term, because it limits who we have to compete with...' What is clear about that quote, if you like it come on board, if you don't, don't listen. In essence, short term earnings might not be as good, but for the long term we think it's going to be a good investment, all up and down the company. Public markets don't like to hear that, because they're in it for the short term."

"In a anonymous survey of public companies, the question was, 'would you sacrifice long term goals for short term gains?' What they found was the majority of these public firms do. That's an issue when you have that pressure."

"There is a difference in companies that go public in IPOs, between those backed by the VC/PE industries versus those that are not. The set that are backed by VC/PE outperformed by several percentage points. If because of competition you can't buy cheaply and sell expensively, the fact that returns are still being made is the central piece. That feeds back to the actual value created by limited partnerships. It represents not just a gain for the individual, but a gain to society at large."

Employment...

"In census data, the study we looked at had to connect all factory and office employment data to which ones are associated with Private Equity and Venture Capital firms. If in that comparison, if you take a Private Equity takeover versus any random other firm, my guess is that the PE data is going to be bad. And the reason is, especially with firms in buyouts, is that the takeover does not occur because the firm thinks the company is being run excellently, and they just want to own it, but because there are unexploited opportunities or it really needed a severe fixing."

"The story in the newspaper will not be about employment loss in a company relative to comparable firm buyout, it's just going to be about the job numbers lost. Great for a headline, not great for understanding what is really going on. In comparison, the net figure is minus one percent, not a huge number."

Innovation...

"Part of the reason the VC/PE industry remains persistent, is that it fills a hole. It allows firms and companies that do not have a lot of history or do not have a lot of cash to fund projects that would not otherwise happen. The advantage to society is these projects are in drug research, services, products that exist if and only if someone is willing to take a huge risk with their own money. So it should be that Private Equity is able to finance innovation in ways other firms can't."

"Another study looks at private firms, in industries where there is lots of innovation, that innovation drops 50 percent when the firms go public. That is not the number of patents, that is flat, but it's the novelty of patents. It's patent citations. When private, the research is interesting and innovative, when public it basically is more pedestrian. That's a dramatic fact, a 50 percent drop is huge."

"What is behind that fact? It's evolution. When you're young you innovate, when you're mature you don't need to do as much innovation but you still need the money to maintain what you have."

"There is an advantage to being private because you can keep it quiet, there is an advantage to private because you're talking to very sophisticated set of groups. And if you think innovation is valuable, it is clearly being captured by the VC/PE industries, society lives much better because of the products and services created by companies backed by VC/PE industries."

"The end result is that the objective at the end of the day has got to be creating value for the limited partners. The other piece is that explaining why, in a capitalistic economy, people doing what is good for them has collateral benefits, and these are industries that has incredible opportunities in this long term. If the choice is to stay a small family business or the choice is to be a public firm, if you don't have an initiative in between there are a lot of goods and public services that never get developed."

Professor Petersen then moderated a Q&A panel with the President of the NVCA, Mark Heesen, and Brett Palmer, the President of the Small Business Investor Alliance (SBIA), and took questions from the attendees.

**What are we seeing in Washington, especially in association with the Jobs Act and the Dodd-Frank legislation, and how will that affect taxation?**

**Mark Heesen:** A couple things from the Venture Capital perspective, the SEC registration was important to the industry as a whole. The vast majority of Venture Capital firms do not have to register under Dodd-Frank, we now have for the first time a definition of Venture Capital in the law, and that will play into many different areas of the law in years to come. Unfortunately for many of the Private Equity folks in the room, there is no definition of Private Equity, and PE firms will have to register. A lot of that has to do with the fact that the Private Equity Growth Capital Council came out in favor of registration, and hurt the cause of the smaller buyout shops who could have been exempted if given that opportunity to have that debate from the get-go.

In the Jobs Act, the NVCA played an integral role on pushing the IPO on ramp and developing that proposal. We think the on-ramp will fundamentally change how companies go public. We've already seen quite a number of companies filing confidentially. Mostly in my mind, a cloud has been lifted from entrepreneurs and they are now thinking that going public is a good thing to do. It is no longer something they feel they have to do, and that maybe they'll do unless an acquisitions entity comes along. What the Jobs Act does is shift the industry. Their companies are going 90 percent to the acquisitions route, and this will get it down to 60%, with the other 40% going public. We're optimistic to where the Jobs Act will take the industry as a whole, it all comes down to returns at the end of the day, and some powerful IPOs will help the industry as a whole.

**Brett Palmer:** Those are critical points, especially on the SEC side. At the time, we were the National Association of Small Business Investment Companies, the SBIC, and you're right, the larger Private Equity Association was pushing for registration, which complicated your life and my life. SBICs were exempt from SEC registration, Venture Capital was exempt from SEC registration, and there is a whole range of issues out there, and we were also pushing for broader exemptions. You're going to see more of the SEC affecting your daily lives, because it's a structure not designed for public equity but public companies, and it doesn't merge very well.

Taxes are also going to affect the bottom line very intensely, whether it's carried interest, the venture funds or the buyout funds. That story has to be told. It really has to come from having a seat at the table and telling your story. On the venture side that's been a spectacularly good job, and the NVCA and IVCA has done that. The rest of the Private Equity story is just represented by just the giant funds, and that's a problem. There is no sympathy for a 15 billion dollar fund.

**What are the kind of things that members of the industries can do to help the lobbying situation?**

**Palmer:** Congress legislates by anecdote, not analysis. You guys have great stories, and you have to tell them. You don't have to hire a public relations firm or do the lobbying yourself, but collectives like the IVCA do get together with members of government to tell the stories. It does have an impact, and you have to engage. Find a broader group like the NVCA, SBIA or IVCA and tell your story.

**Heesen:** I think what we've seen over the last several months, you have to understand who is writing the articles on Private Equity today, more so than you've had in the past. You used to have only economic writers on this space, but now you have political writers. Economic reporters may have an understanding about PE issues, the political reporters have none. The Mitt Romney issue has made these political reporters become writers about business, and that's been difficult. One thing we do, is every time we see a story about Venture Capital or Private Equity that is written incorrectly, we actually write that reporter and tell them what the proper definitions are. We don't do it in a condescending manner, and most reporters thank us, and tell us the next time they do a story, they will do it right. It's actually quite helpful to them. The more you educate them, the better off you are.

**Why are the social implications of buying low, selling high – which essentially puts more money into the system to reinvest – not touted as highly as the value that was talked about earlier?**

**Mitchell Petersen:** If you sell and come away with more money, the good news is that you have more money to invest, but on the other side is that person has less money to invest, so in some sense it's a zero sum gain, which might not be a value to society. Let's go back to the beginning when you buy, is it a value to you or a value to the person you're buying from? Because you are able maybe to do things that they couldn't, that is the piece I'm putting in the middle, because in some sense you do create value.

**What do you think the regulatory environment will be in raising 'crowd funding' on the internet, and raising early stage Venture Capital from individuals in that fashion?**

**Heesen:** The NVCA did not take a position on that portion of the Jobs Act. We're happy to see the changes, it's less like the Wild West in the proposal. It's going to be extraordinarily limited, with only a million dollar cap and audited finances and that narrows the arena. From a venture perspective, I don't see a biotechnology company going out and getting crowd funding, but it could happen in the IT area. But having said that, I think most IT folks would rather go to angels and super angels than use the crowd funding platform. The SEC is not happy with crowd funding, and will drag their feet on it to allow the statutory timeline to lapse.

**Palmer:** You hit the nail on the head. I was surprised when it came up a year ago, and the SEC was generally saying nice and soft things about crowd funding, but when it started to develop the SEC took an institutional approach, as in if you can regulate it, regulate it. They do have a full plate going forward, but that it's relatively small and yet to be seen how it will play out.

**How much do you think the SEC's fundamental mission is to protect the investor, and how much of it is regulatory risk aversion, given some of the difficult events of the past four years?**

**Palmer:** My personal opinion, is they want as much documentation and information so they can go after you, after the problem is found. They're not going to find it on their own, and they're collecting information that they cannot possibly analyze and review. They just want to say if there's a problem now, then we've got you. As new advisors will find out when they register, that most SEC reviews will find some type of problem, which would say that the overall system is failing. When most people are trying to do right and are making good faith efforts, and are still running into issues, that's the failure of the regulatory structure.

**What is the update on the carried interest taxation issue?**

**Heesen:** Carried interest is not an issue if there is no distinction between ordinary income and capital gains. There is a much more basic issue that is being debated. That is going to be at the forefront of the tax debate, you are already seeing politicians line up on one side of the aisle or another as to whether there should be any distinction between ordinary income and capital gains.

Also, there are already hearings set on the whole idea of partnership taxation. Why are there so many partnerships, LLCs and 's corporations' out there, why aren't these folks paying under the corporate tax structure. When eight million returns come in on that partnership side, and only two million on the corporate side, tax writers are looking at that and saying there's something wrong. For raising tax revenue, they'd like to see a lot more folks under the corporate structure. That will alter many buyout and Venture Capital shops who suddenly will have to fall under the corporate structure. Those are much more fundamental issues that go to the heart of these industries and entrepreneurs than carried interest. Carried interest is a blip when it comes to the hostile amount of revenue raised, and I don't see it as a debate with all those other issues out there.

**Palmer:** Fundamentally, we're looking at a system that is failing. We have trillions of dollars of tax provisions that are expiring this year, and taxes will go up, if Congress does nothing. It really comes to an ugly head at the end of this year, but there may be an opportunity if enough pent up energy and enough fear occurs about what might happen to the economy if taxes are raised, that there might be an opportunity to take a chunk out of the tax code and address a piece of it. Going after carried interest is a losing issue both politically and financially, but you have the potential in the lame duck sessions for something big to happen, or if nothing happens at all you still get something big.

But even if those things happen, there is a broader long term, multi-year tax process, so if you don't tell your story now, once the actual bill is proposed, it's too late and you've lost. If the images and expectations are such that one sector is good and one is bad, and if they start picking winners and losers, you don't want to be on the bad side of that ledger.

The next IVCA event is the Crosstown Classic on June 20th, 2012 – Chicago Cubs vs. Chicago White Sox – in the Miller Lite Extra Base Lower Terrace Suite at U.S. Cellular Field. Click here to buy your ticket!