Provocative Panel on Private Investing

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All Generalizations Are False: Private Investing circa 2000

The cooperative has received much favorable feedback from the many representatives of charitable organizations who attended TIFF Forum 2000 on May 9. The Forum ended on a high note indeed: a stirring address by famed strategist Michael Porter on two subjects near and dear to his heart — inner city revitalization and philanthropy — was followed by a lengthy and lively discussion about the evolving environment for private investing among four distinguished panelists: John Childs, founder of the Boston-based private equity firm J.W. Childs Associates; Steve Graham, founder of the Wayne, PA-based private equity firm Graham Partners; Steve Jurvetson, principal of the Redwood City, CA-based venture capital firm Draper Fisher Jurvetson Associates; and Professor Porter, the author of dozens of books and articles on competitive analysis and strategic planning and a long-time member of the faculty of Harvard Business School. For the benefit of readers who did not attend the Forum, we are publishing below an excerpted transcript of this concluding panel discussion, which was moderated by David Salem, TIFF's founding president and CEO. To make the discussion as productive as possible, Mr. Salem distributed to each of the panelists in advance of May 9 a series of opinionated statements about various issues germane to private investing, all focusing in one way or another on the Internet's impact on private investing broadly defined. These statements, which Mr. Salem read aloud as a means of stimulating discussion, fell into three broad categories: (1) the Internet's impact on corporate strategy and tactics, (2) the Internet's impact on institutional investment strategy and tactics, and (3) the Internet's impact on public policy formulation and implementation.

The Internet's Impact on Corporate Strategy and Tactics

Issue #1 — Who Benefits Most from the Internet?

Moderator: History suggests that the only parties that truly derive lasting gains from technological revolutions are consumers, who ultimately benefit in the form of real wage gains caused by falling real or inflation adjusted prices for goods and services. Years from now historians will agree that the so-called Internet Revolution served as the catalyst not for a material or sustained increase in corporate profits but rather for a massive and sustained decline in corporate profits with so-called new economy companies undergoing a massive shake out relative to their population as of today and with so-called old economy companies also undergoing massive profit deflation as the Internet puts more and more information, including competitive price data, into their customers' hands.

Porter: Well, first of all, let me say that all of the statements David plans to lob at us are quite sophisticated, and I doubt that we're going to be able to exhaust the answers to them here today, but let me try to react to the first one. We all probably understand that much of what's happening on the Internet in terms of e-commerce is uneconomic. It's driven by pricing below cost; it's driven by supplying things that are supplied at lower than their true cost. However, make no mistake, the Internet is a very, very powerful enabling technology. It will have a stunning impact on the effectiveness of how business processes take place all across the value chain, and we're just seeing the beginning of that impact.

We haven't yet seen tangible signs that the Internet's impact on corporate profitability is indeed going to be similar to previous technological revolutions, but they're coming, and this is where the essence of David's statement is actually correct. I believe the Internet is quite threatening to profitability. Profitability is driven by two things: one is the structure of the industry in which a company competes and the other is the ability of a company to gain a competitive advantage that it can sustain over its rivals in its industry. The Internet does tend to make industry structure less attractive. It does indeed shift power to the customer, it makes the customer better informed, it tends to increase the threat of substitution — alternative means of performing the same function — and it also tends to lower barriers to entry. It makes it easier to enter fields that were unassailable previously because new entrants needed costly sales forces or wide distribution channels and the like. This is going to vary a lot across industries but on average I think the effect on corporate profitability will be quite negative. I also find in my own work that it is very difficult for most businesses to use the Internet as a sustainable competitive advantage. The problem is that you can't keep the Internet proprietary, you can't capture it, you can't own it, and most Internet applications are relatively easy to copy. Therefore, it is very hard for a company to actually gain an advantage just because of the Internet, and this is particularly an issue for dot-coms that basically are built on the Internet.

There has been a lot of talk that the Internet is going to create barriers arising from high switching costs: if you can get there first, if you can be a first mover, you'll derive network effects that will protect you from subsequent entrants. I believe that most of this is merely wishful thinking. Switching costs for customers using the Internet are much lower than they were with previous generations of technology. Indeed, the Internet is destined to become a neutral competitive weapon in the following sense: everybody's going to have access to the Internet; everybody's going to use the Internet; every company, old or new, is going to be involved with the Internet, using it in every imaginable way. This is already happening on a massive scale. Therefore, the Internet per se cannot possibly provide a sustainable competitive advantage for corporations, individually or in the aggregate. In fact, the Internet is going to force corporations to migrate back to seeking more traditional types of competitive advantage. Your Website won't give you a competitive edge; as was traditionally the case, your edge will be found in proprietary products, proprietary content, personal relationships, and superior knowledge and skills. In other words, the so-called old economy advantages will resurface. This means that Internet-only companies are at risk because at the end of the day most successful companies will be those that integrate the Internet with traditional ways of competing. The customer will almost always prefer to have a choice between dealing with a company over the Internet or dealing with it in other, more traditional ways. The customer almost always wants to have the option of talking to a human being and of picking up products at a physical location.

There will be inherent efficiencies of combining Internet'based modes of commerce with more traditional modes. These various modes are not cannibalizing each other, and in many cases they are actually complementary. Therefore, traditional companies can and will prosper as a result of the Internet. This is not the end of the old economy. The old economy and the new economy are going to merge, and there is going to be one economy. Let's call it the post-Internet economy — the economy where all companies are using this relatively new technology. And, on average, that may cause a diminution in average profitability because David's provocative statement is correct: the customer will be better informed. But traditional competitive advantages will remain robust. They will reassert themselves and support profitability at an attractive level in some industries. The firms that are at risk right now are the pure dot-coms that lack conventional advantages like logistical networks or personal relationships or brand images that have been developed over time. These are the firms that are at the greatest risk as more established firms come roaring into the Internet age.

Childs: First, I'd like to note for the record that you're quite right, David: as you noted when you introduced Mike's luncheon talk, speaking **after** Mike Porter has addressed an audience is indeed quite a challenge! I mean, he's just given the definitive lecture on our topic here! But I wanted to make a couple of comments since my firm is heavily rooted in the old economy. I do agree with Michael that the Internet is basically an enabling technology that allows you to do differently some of the traditional things you do in business. It will make companies, whether they are new economy companies or old economy companies or merged economy companies, sensitive to the fact that you really don't want to be competing on the basis of price alone. You want to exploit aggressively all of the other advantages that companies have traditionally sought to exploit. On the Internet, which does provide a vast amount of information, the **quality** of content may provide a big competitive advantage. Now, someone will say, well, anyone can go on your site and replicate or plagiarize your content. What I have found in my own exploration of the Internet is that there's an awful lot of old information on it, so keeping content up-to-date could be a huge competitive advantage if one can do it. Obviously, customer service can be a competitive advantage; one of Amazon's great strengths is extraordinary customer service. For the retailers in our portfolios that aspire to be e-tailers, we seek to develop Amazon-like customer service. Our approach is to avoid head-on price competition and identify other basic strengths and then use the Internet as an enabler to gain advantage.

Jurvetson: We're primarily Internet investors, and I disagree with many of the things that have just been said. But I do agree with Mike's conclusion. That said, I don't think that old companies are going to benefit nearly as much as new companies will from the Internet revolution. If you think about today's most exciting brands and products, with a handful of exceptions, they are controlled by companies that didn't exist five years ago. What you're going to see happen is similar to how Dell took business from Compaq. It's not that Compaq was stupid, it was a structural problem with a major channel conflict that Compaq was unable to resolve. They weren't willing to go cold turkey and walk away from their existing business franchise and reinvent themselves. Similarly, in almost every instance of new channel development, disruptive technological dislocations or paradigm shifts in industries, it's new entrants that benefit, not incumbents. So, again, limiting my comments purely to technology businesses and particularly to the Internet, I don't think any of these statements that we've heard so far are true other than customer empowerment. I think that's absolutely the case, that customers are empowered as they've never been before, that barriers to entry are lower than they've ever been before. While profit margins may decline as you gain efficiencies from the Internet because things are being done more efficiently than ever before, there is also an expansion of the market. It doesn't matter if you shrink profit margins if you grow the market tenfold. If you talk to any one company or any one industry and draw a very rigid line around it, it may not be indicative of the overall economic wealth creation for the economy as a whole. The Internet and information technology revolution that we're in is going to be a boom, profits in the economy, in general, will boom but it will be in entirely new companies.

Issue #2 — E-tailers vs Traditional Retailers

Moderator: The massive correction in so-called e-tailing stocks not withstanding, Wall Street continues to overestimate the future profitability of firms engaged in electronic commerce and underestimates the future profitability of firms engaged in more traditional modes of selling. Traditional retailers such as Wal-Mart, Kmart, and the like can easily and economically exploit the Internet-related business opportunities that e-tailers, such as Amazon, were created to exploit. But e-tailers cannot so easily or economically recreate or exploit the competitive advantages that established retailers have long enjoyed — namely, extensive distribution and logistics networks and experience, negotiating leverage with suppliers, and most important, a powerful brand name. Indeed, one could go further and argue that, contrary to popular wisdom, e-tailing will never capture a meaningful share of certain important consumer markets that many observers think it will penetrate robustly, such as new car or clothing sales. So, I invite each of you gentlemen to comment on retailing in general and perhaps on the aforementioned industries in particular. Steve Jurvetson, why don't you go first on this one.

Jurvetson: Sure. It's somewhat baiting because I notice that the binder for today's Forum includes two columns that I wrote for Red Herring magazine. With the affectionate title 'Amazon is an Anachronism,' the first starts with the somewhat provocative statement that the whole concept of an online retailer is an outdated and quaint notion that really has no place on the Web. [1] To summarize my argument, companies like Wal-Mart, Toys—R—Us, Target — companies whose brands stand for physical goods fulfillment in your local economy — are being rendered obsolete by the Web. Of course buying patterns change at a glacial pace, but if we jump forward say 10 years, why would any of these brands stand for the same thing that they do today? Retailing is an industry that's evolved over hundreds of years with very little change. It's evolved with a fairly static set of requirements, which is, how do we get products into the hands of customers in the physical world? With the Internet, the entire retailing playing field has changed. If you think about it in the abstract and say, "I want to design a retail concept from scratch," how should I proceed when people are accessing my products from wherever they may be located? I don't need a neighborhood store, I don't need to be physically located like Wal-Mart in suburban and rural areas. And, in fact, many of the logistical benefits that were alluded to earlier become an albatross in the new domain. If you have inventory and confront shipment logistics, well — these are not exactly valuable assets when you are making drop shipments directly to your customers.

What we think of as a retailer is a carryover from the old medium, that being physical space or meeting space — as we sometimes affectionately call it in the 3D world in which we live. You go to the neighborhood store because you have to go there to buy certain products. In the case of multi-line or multi-product retailers, the only reasons you find multiple offerings under one roof is because customers don't like to shuttle around town pursuing each of these distinct activities. These distinct activities include figuring out what you want to buy, paying for it, taking fulfillment, and getting customer support. Today these are all provided by a physical world retailer because it would be inefficient to move your body around town to obtain all of these services. But on the Internet they can all be provided by separate companies — whether integrated through partnership or not. Each company can specialize in one of these areas and, as we've seen in almost every industry, when a vertically integrated industry goes horizontal, innovation is much more rapid at each layer. Vertically integrated companies can't possibly keep up with horizontal competitors as long as consumers have unfettered access to each point in the distribution chain and it's not a lockup or monopoly kind of situation, which it isn't in retail. What you could and will no doubt soon have is unbiased companies helping you locate what you want to buy. These will not be retailers: retailers want to sell you their specific products. Other companies will get to know you and will also get to know how you like to pay for things. Another company will provide fulfillment, thereby solving the problem of how to get products to people within, say, three hours, which wouldn't be possible if every retailer tried to do it on its own.

What I'm describing is a world 10 years from now where the average size of each company is much smaller, the focus is much narrower, and each company does one thing and one thing very well. The transaction costs of partnering on the Web are much lower than they are in the physical world so the scope of each company will be much narrower. Companies will partner for everything in order to provide a coordinated bundle of services. To the consumer, it may look like a single point of purchase, but actually the services are being provided by a variety of companies tied together via one interface. When you design logistics networks and supply chain fulfillment systems, the issues of where information resides, where product resides, and how you get it from place to place — these can all be resolved much more efficiently with a clean slate than they can by trying to adapt existing retailers. These existing retailers have other albatrosses, other problems they must deal with, such as existing locations, compensation structures, option plans, channel conflicts, pricing pressures from the physical world versus the online world, all of which make it difficult to be aggressive first movers in a new world where none of their existing attributes are, in fact, assets. So, at the end of the day, I don't see a role for retailers as we think of them today. I see retailing going through a profound shift where it's actually a combination of many new entrants and not some offline or established company that benefits in the online world.

Childs: I'd like to take issue with some of what Steve has just said. There's still an aspect of retailing that the Web in its current incarnation can't replace. I'm referring to the tangible experience of shopping, the desire to touch things, to be able to return things without going down to the post office and doing it. There are many transactions that the Web doesn't lend itself to doing very well. You may be right that it'll change way beyond my ability to imagine 10 years from now, but at present traditional retailers have an advantage over the newer dot-coms: they don't have to spend hundreds of millions of dollars to establish a brand name; they already have one. The other advantage of many traditional retailers is that they have a large market cap and when anyone comes along that might threaten them, they can acquire them. So, I would still be a proponent of saying that the dot-bams, as they're called, which refers to online companies that also have brick and mortar locations, will have a significant role going forward and those that are asleep at the switch will get Amazon-ed, if you will. But those that are paying attention to what is happening and look at the Web as a legitimate supporting channel to what they're doing today have significant assets that the pure dot-coms do not have.

Moderator: Other comments on retailing before we move on?

Porter: I take strong exception to Steve Jurvetson's view that the physical assets of existing retailers constitute a disadvantage. My view is that a combination of an Internet site and physical assets are compellingly better than either one alone. Moreover, I don't believe there's actually much cannibalization occurring in retailing at the present time. The evidence is growing that Web-based sales opportunities actually feed sales through physical stores, and the presence of physical stores makes e-commerce more effective. This is true not just in retailing; it's also true for a lot of distribution businesses — like W.W. Grainger — and for many other types of companies also. It's wishful thinking to believe that a company that has a national distribution system designed to efficiently move goods to many points via a carefully planned warehouse network is going to somehow be less efficient than a company that **must** use UPS or recreate such a network from scratch. It's a mistake to argue that existing retailers will be hobbled and will be unable to exploit these advantages and that they'll somehow disappear. What's going to happen is that e-tailers are going to end up becoming more and more physical over time, and they'll start looking more and more like conventional retailers. In short, there's going to be a merger. This distinction between e-tailing and traditional retailing will become increasingly blurred over time and will ultimately disappear.

Jurvetson: I was not implying that physical stores will disappear. My comments were aimed at a separate question, namely — can the assets of a strong offline retail business be leveraged into creating a strong online retailer? I just don't see firms with lots of physical stores willing to go through the profound changes they need to undertake in order to become effective online competitors. So I think these two different types of retailers are indeed going to become segregated over time. After all, the idea of using physical stores to facilitate product returns isn't really as compelling as it may first seem as a reason to keep sales and customer support integrated via physical stores. In fact, it's actually more of a logistical minefield to accept returns for online purchases at physical stores than it seems at first blush.

Issue #3 — Business to Business (B2B)

Moderator: I'd like to turn our attention to so-called B2B exchanges. B2B means business-to-business, and I'll introduce it as follows: The bloom is clearly off the so-called B2C rose, meaning firms whose stock prices got pumped up due to inflated expectations of the profits they could ultimately derive from facilitating commerce between business and consumers. In recent months, the bloom has come off the B2B rose also, with shares of such poster children for the business-to-business concept as Ariba and Commerce One falling dramatically in price. This is as it should be, because viewed through the prism of industrial structure and strategy, many if not most B2B firms cannot possibly generate large profits on a sustained basis. Indeed, it is hard to identify any industries which are structured in a manner that will enable B2B or B2C firms to earn profits exceeding those earned by the oldest and largest B2B exchange the world has ever seen; namely, the New York Stock Exchange. Last year, the Big Board processed transactions with a face value exceeding $7 trillion and generated a net profit of $177 million for its owners, equivalent to a net profit margin of less than two 100ths of one percent. That's better than a loss, of course, but it's pretty hard to "make it up on volume" with net margins hundreds of times smaller than those enjoyed by your average grocery store. As we're in the realm of B2B and Steve Graham and his team are doing some really interesting things trying to help their "old economy" companies exploit B2B innovations, I thought Steve might want to comment first on this issue.

Graham: Well, I'll comment on a couple of things. We're an old economy private equity fund buying middle market manufacturing businesses. But these businesses, fortunately or not, are going to have to address the fact that the new economy is developing, and they're going to have to change the way they do business if they want to remain profitable. To facilitate this process, we are creating a loose consortium of buyout firms to work with a major online procurement entity to try to deliver value to our portfolio companies by aggregating their purchasing power.

Most of our portfolio companies are pretty inefficient at buying some secondary materials. As an example, a plastics molder may be able to buy resin very, very efficiently but it might not buy parts and office supplies and things of that nature very efficiently. Many manufacturing businesses incur an extraordinary amount of needless hard and soft costs in procurement, creating big opportunities to reduce expenses.

We spend time thinking about how the Internet will impact potential investments, not only from a procurement standpoint, but also from a distribution standpoint. We try to stay away from businesses that are subject to significant risks from the Internet in terms of selling their products. That's why we prefer businesses that have highly customized, highly tooled products that don't lend themselves to being distributed over the Internet. To me, many of the pure B2B plays are basically like agents, consultants, or middlemen, and, ultimately, these types of companies are going to make the types of relatively low returns that agents or middlemen typically make. Now, there may be certain companies that grab a huge chunk of a given market and, consequently, are able to earn a very high return, but on average, I wouldn't be placing bets on which of those companies are going to be successful because I think there's going to be a huge shakeout in the B2B sector. It's going to be very tough. I would rather try to buy quality manufacturing companies that are still going to be around in 10 years than guess which B2B companies will ultimately survive.

Jurvetson: I think it's somewhat unfair to pick the purely crossing function that the New York Stock Exchange provides, in one of the most efficient markets the world has ever seen, as an example of what B2B firms might look like. One could pick many other examples, like the classified ad market that generates the vast majority of profits for most newspapers and say, "Hmm, why is it that this market is so different?" If you consider the ancillary services that stock exchanges entail, including brokerage, research, everything involved with a trade, you realize that there's actually quite a bit of profit sloshing around most exchanges. My point is that B2B is not synonymous with exchange and an exchange is not just a crossing function. In fact, there's a lot of value created around a trading exchange, making it quite interesting. We have steered away from B2B verticals largely because we think they're niche industries at the end of day, and a niche is still a niche. We applied the same rule in the B2C arena, avoiding the most notorious dot-coms. If you're just selling pet food on the Web, that's just not going to be a great business; it's not going to grow the market for pet food 10 times over merely because pet food is being sold on the Web.

So, the way we look at this problem of B2B exchanges is quite simple: every company communicates, and what the Internet provides is a way to structure automation and furnish real time information feeds which is all very powerful but has nothing to do necessarily with running a commercial exchange. We've made a lot of money investing in the basic elements or infrastructure of commercial exchanges. But these exchanges have nothing to do with the example we're discussing [the New York Stock Exchange], so I won't spend too much time on them other than to say that there are plenty of trading exchanges where you have information asymmetries, information inefficiencies — and frankly, great margins being earned.

Moderator: Anyone else on B2B? Mike, are you going to jump in?

Porter: I think there are a couple things that have so far been unstated that we're all agreeing on. First, firms that make things which allow people to use the Internet — if they have proprietary technology — are going to make a killing because it doesn't matter to them which one of us is right. This is the safest investment play of all provided one picks the company wisely. Second, the impact of the Internet on competition and profitability is going to be a business by business thing; no generalization is possible. Just because a company is an exchange doesn't mean it's good or bad. Similarly, just because a company is a retailer doesn't mean it's good or bad. In fact, I find phrases like B2B and B2C completely meaningless. I don't think they communicate anything particularly relevant. They tend to be shorthand that is actually distracting, just like classifications such as "manufacturing" and "services." These labels don't tell you much about whether or not something is a good business.

On the exchange issue in particular, I find myself agreeing with Steve Jurvetson. I think that the interesting question is not whether there are going to be efficiencies created by Internet turbo-charging of some of these exchange functions. That's a given. The question is who's going to capture the value. Will it flow to the transactors? Right now, big auto companies and others are forming their own exchanges, and they're capturing a lot of the value of the technology. But there will be other industries in which there are fragmented players on both sides, where there is imperfect information, where I think that somebody that actually gets in the middle and does a really good job making a market will make a lot of money. I entirely agree that there's going to be a kind of economic growth effect; that is, costs will go down and purchasing power and productivity will increase, but I think that the question that we really have to struggle with, particularly for many of you who are investors, is which of these many things that are all going to work and boost efficiency are going to actually be good businesses? And that's where we have different points of view.

The Internet's Impact on Institutional Investment Strategy and Tactics

Issue #4 — Venture versus Buyout Investing

Moderator: We're going to shift to the Internet's impact on institutional investment strategy and tactics. Mike said a second ago that he finds certain labels used in discussions of business strategy useless or worse than useless. Well, this is emphatically true in institutional investing. Something as simple as the distinction between growth and value often does more harm than good in trustee discussions, and we work very hard at TIFF to be really clear about language. My next question is going to focus at least in part on this ongoing challenge. What I will try to do is elicit our panelists' thoughts on what's going on in the private equity arena from a customer's perspective, by which I mean the viewpoint of a limited partner or institutional investor.

The opinionated statement that I'd like to read to stimulate this discussion runs as follows. Institutional investors and their consultants have tried to do to the private equity business what they long ago succeeded in doing to marketable securities investing, with dire consequences: sort managers into artificial pigeonholes for asset allocation and benchmarking purposes. In a marketable securities context, pigeonholing of this sort has failed spectacularly in recent years, and so-called value managers intent on retaining an ever-shrinking pool of clients have abandoned their traditional purchase criteria in favor of more growth-oriented names. The same phenomenon is occurring in the private equity arena, with many buyout managers who used to insist that purchase candidates display low technological risks plus stable revenues and cash flows now throwing money at ventures that entail high technological risks and negative cash flow. In addition to hopelessly messing up consultants' efforts to pigeonhole and benchmark private equity managers, this morphing of buyout mavens into venture investors is destined to end in tears because the skills needed for success in buyout investing are not readily transferable to, nor necessarily helpful in, technology-oriented venture investing. Of course, in light of recent events in the public market, it is probable that certain venture firms now sitting on mounds of uninvested cash are going to find it appealing, if not irresistible, to become buyout artists themselves, investing money that was originally earmarked for new business concepts in more mature ones. You want to react, Steve Graham?

Graham: I do agree that some private equity firms that have perhaps wandered off the reservation in terms of classical LBO investing are starting to do venture investing, which is a pretty risky proposition. We believe that businesses run by people that have a focused strategy have the best chance for long-term success. So, as a private equity player, we believe in having a fairly narrow focus in industries where we have some past relevant operating experience, knowledge, contacts, resources, something of this nature. That's not to say that there won't be an opportunity in a classic LBO fund to make a winning venture investment, but as a general rule we would prefer for our investments to remain focused in industries in which we have a distinct competitive advantage.

My family has investments in about 30 private equity funds, and some of the big funds, which we thought were LBO-focused, are now off doing a substantial number of venture investments. With a private equity manager you're locking up your capital, depending on how you want to look at it, for five or ten years and you're effectively investing in someone else's judgment, so you would like your private equity managers to focus their investing where they have competitive advantages. There are really four things that a private equity manager can bring to the table: (1) they can source investments, (2) they can analyze and negotiate investments, (3) once they own a company, they can add some value to it, and (4) they can sell it. At Graham Partners, we focus on middle market manufacturing companies. We know how to find these types of investments, we know how to evaluate and negotiate deals, we know how to work with a company to add value once we own the company, and we know how to exit. We're very comfortable in this arena. If, all of a sudden, we changed our stripes and tried to play the venture game with significant dollars from our fund, we wouldn't know how to source deals, we wouldn't know how to discriminate between good and bad ones, and we wouldn't necessarily know how to negotiate. In the LBO game, there's a whole process of doing due diligence and negotiating deals that is more or less standard. Venture investing requires a very different approach. In terms of adding value to a business, in our game we understand that you're buying a basic manufacturing business, you're putting a little bit of leverage on the balance sheet, and you're trying to grow a firm's EBITDA [2] at perhaps eight to ten percent annualized over a five-year holding period. If you adopt the right capital structure and exit the investment at about the same multiple you paid for it, you're going to generate a 30 percent compound return, which constitutes success in the game that my firm prefers to play. In their very different world, venture capitalists are often buying businesses that have little or no revenue, and it's a whole different picture in terms of how outside investors work with their companies. That game is not for us.

We think private equity managers should stick to what they know best and limit their risk in non-core investment opportunities by placing very small bets. So, as institutional investors go about their work of evaluating funds and fund managers, I think that one important criterion to consider is, 'Are these folks going to stick to what they're supposed to do — to what they say they're going to do up-front?'

Childs: I'm going to add a few thoughts to what Steve just said. I agree almost completely with what he said. To me, venture capital and leveraged buyout investing, which are the two arms of private equity, are fundamentally different approaches to generating high returns. In venture capital, you're basically taking an extraordinary business risk which you've evaluated and you're financing it with equity. In my business, which is leveraged buyouts, I'm really taking very little business risk, if I can manage to do so, and creating high returns by artificially leveraging the balance sheet and minimizing the equity input. I would argue that if you try and cross the boundaries and take high business risks and leverage them, you are either going to have one of the most spectacular investments in the world or a total meltdown. I can't predict which, but you're going to have a high volatility asset, that I guarantee you. So, I think there are different ways of making outsized returns starting from fundamentally different premises, which almost certainly demand very different skill sets.

But I would make one other comment: when things change in a given industry, a savvy investor must be somewhat opportunistic. Not a total opportunist, mind you, but somewhat opportunistic. For example, my firm backed a small Internet incubator with the specific mandate of looking at the traditional, old economy companies in our portfolio and asking, first, is there an Internet opportunity waiting to be exploited in this bricks and mortar thing we've bought and, second, is there an Internet threat coming down the pike that we should be aware of that perhaps because we're too focused on our traditional economy operations we haven't adequately considered? So we've dabbled a little bit in the Internet sector, if you will, but it has been for defensive reasons as much as anything, trying to be a good fiduciary.

Jurvetson: The aspect of David's statement that struck me the most is the notion being advanced by some private equity firms that buyout investing and early stage investing can somehow be integrated effectively and profitably under one roof. I agree with David that these disciplines are about as diametrically opposite along the investment spectrum as you can get. As we think about all the people who compete with us, the LBO investor is the one we worry about the least because everything that one learns in LBO investing is diametrically opposite to what one wants to do in early stage investing. My point is not merely that what one learns in buyout investing is not relevant to early stage venture investing — it's actually quite harmful. I would be a horrible LBO investor due to everything I've learned by rule of thumb as a venture capitalist and, judging from what's been successful over the last few years, I think the converse is true as well.

As venture investors, we are trying to help build companies, making intuitive decisions on markets where there's no market research, where there's no study that one can rely upon, where in fact you can't even build financial models because all you have is an entrepreneur who has a certain vision of the world and it could be just as good as the next guy's or not. There is also much less time for decisionmaking in early stage investing.

And the choice of a specific deal structure is almost completely irrelevant. We use the same boiler plate term sheet for every deal that we do. It's entirely a question of one, how much of the pie can you get; two, do you think this is the pie you want to eat; and, three, is the market opportunity large enough?

What we do as early stage investors is counter-evolutionary in many ways. I look at Tim Draper, the founder of our firm. The way he lives his life personally and the way he invests almost certainly would have gotten him killed off in almost any other society in human history. His would not be a set of survival traits in any selection environment because he openly states that everyone he hires in the company should be a risk-seeking missile — if we aren't losing enough companies, we're not taking enough risks. Tim is always thinking of ways to inject more speed of decisionmaking and risk-taking than we've displayed in the past, which is intriguing. It's not exactly the LBO mindset, and it's certainly not the dividend investor's mindset!

What we find ourselves discovering time and again is that companies that are changing the world, the ones that enable investors to make a thousand times their money, are uniformly **not** regarded as sound business ideas. I can't tell you how many people chided the VCs that invested in Yahoo! or eBay. At the time these types of winning investments are made, it is not at all clear which companies will change whole industries — which companies will, in fact, change the world. In retrospect, we all have very powerful rationalization skills that enable us to conclude, "Oh yes, of course, I would have invested in such-and-such a company." But I find this is never really the case. In fact, what we must do is trust our judgment and employ a counter-phobic investment style which asks not how low is low but rather how high is high? What if an entrepreneur has actually underestimated his forecast? What could go phenomenally right for this company if everything goes not according to plan but better than anyone anticipates? So it seems to us as we look at buyout firms, on every dimension that we think is important in early stage investing, the rules of thumb, the feedback, the methodologies, everything that we see them doing lies at the opposite end of the investment spectrum. There is more of a debt mindset than an equity mindset and more of an emphasis on financial engineering than on breaking truly new ground in the product design or marketing sense.

Issue #5 — Private Equity Fees

Moderator: Moving along and trying to get even harder hitting — we've been focusing on institutional investment strategy and tactics, what we at TIFF live and breathe in deciding what to do with the money that TIFF's members have committed to our private investment program. The next issue I'd like our panelists to address is what I call the fallacy of composition. In 1999, new commitments to venture capital funds exceeded $41 billion, more than a five-fold increase from 1995 levels. When added to the massive sums that corporations of all stripes have committed to their own internal venture capital operations — an estimated seven billion dollars in 1999 alone — these fresh commitments are of a size that essentially assures failure, by which I mean the production of returns far below the expectations of the parties furnishing such capital. Logisticians ascribe such perverse behavior to a mental error known as the fallacy of composition, which in an investment context means the unfortunate tendency of investors to ignore the fact that an excessive number of like-minded people are acting on precisely the same assumptions. Alas, the root cause of the problem runs deeper than a mere error in logic. The root cause of the problem is perverse fee structures that put today's generation of venture capitalists into the enviable position of lottery entrants holding multiple tickets purchased on their behalf by others. Given the large pools of money that leading VC firms have raised recently, many venture capitalists are guaranteed to earn very large annual incomes from management fees alone regardless of whether the portfolios they assemble perform well enough to generate capital gains for their clients. Playing the lottery is a bad idea because the probability weighted payoff is usually less than the cost of the ticket — unless, of course, the ticket is essentially free. No wonder venture capitalists are scrambling to raise as much money as they can as quickly as they can.

Jurvetson: In the list of statements that David distributed to the panel ahead of time, I was tagged as the initial respondent to this one. You in the audience don't know this, but David has re-ordered the statements when reading them, and until he read this particular one I've been sitting here hoping he was going to skip it! But now he's come back to it. I admit, it's hard-hitting. It's a very accurate description of what I see happening in the venture capital market. It's easier to talk about other firms so maybe I'll start by talking about other firms that are falling prey to this phenomenon, and then talk about my own firm and how my partners and I look at this. The bottom line is that there's clearly a trade-off being made in the venture industry between short-term greed and longer-term wealth accumulation.

Over the last 10 years, more and more capital has become available for venture capital through the relaxation of prudent investor rules. Because the returns have been spectacular, a lot of people have been jumping into the venture business. From a supply and demand perspective, there's been a more than ample supply of capital. From a management perspective, the gut-wrenching decision that venture capitalists face whenever they go to raise a new fund is where to draw the line. I have a lot of respect for firms that consciously pursue a strategy of drawing a line and sticking to it with respect to asset size. The trade-off, as I'm sure you're well aware, is that in the short term when you raise larger funds you can make more current income off the management fee. Longer term, presumably, your returns will suffer. You will also be forced to migrate into a later stage of investment and the carried interest proportion of your compensation is likely to fall as a consequence. In fact, some of the best-known VCs in Silicon Valley had their best performing venture funds when they were early stage investors, and they earned laurels and reputations off those funds and haven't matched their first or second fund performances since. What we're seeing is that capital under management has gone up an average of about five-fold in the last few years. I doubt that the head count has gone up anywhere that much, so the average capital per partner has gone up hugely as a result.

When a bunch of money pours into any market you're going to see returns suffer. The key question is, are you starting with an enormous opportunity set? I would argue that the Internet is the largest investment opportunity the world has ever seen, vastly exceeding that of the industrial revolution or any other major turning point in business history. And, if you compare it to a lottery, I think that Internet-related investing is a game of chance where your odds of winning are a heck of a lot better than the typical state-sponsored lottery. It's a game I'd rather play any day of the week. The argument that the odds are stacked against you investing in Internet ventures is simply wrong. In fact, this is a lottery where the odds are tilted sharply in favor of entrepreneurial ventures — where new ventures enjoy an unfair competitive advantage over incumbents.

Also, David's reference to the fallacy of composition presumes reasonably efficient markets, which simply don't exist in the venture community today. You don't have perfect competition. What you have instead is perhaps the least efficient capital market the world has ever seen. It's just rife with information asymmetries, not only with respect to investment decisions but also with respect to product development and labor markets. You also have an element of free will, which is to say that in my business investors tend to make their own luck. Against the backdrop of economics that are generally tilted in an investor's favor, you see vastly different performance among venture funds. There are plenty of firms that have managed to not make money in the current environment. But I think the Internet does favor the start-up with huge upside potential relative to other types of businesses we've invested in over the last 15 years. And there are more entrepreneurs than ever before. You don't need a PhD in electrical engineering to start an Internet company. The relevant labor pool to start a chip company or datacom company is quite restricted. But business model companies — companies that are re-engineering the way that industries are structured and function — these types of companies can be led effectively by entrepreneurs with a wide variety of backgrounds, including marketing, so at the same time that the supply of venture capital is expanding so too is the pool of available entrepreneurial talent.

The other systemic effect I will mention is that these companies are growing faster than ever, yet the costs of raising capital haven't fallen that dramatically. Sure, money's more available but it's generally a painful, risky, and unpleasant experience to raise capital. Companies are raising more money because they're growing more quickly. That's about the only good reason I can give for why the average start-up is consuming more capital. There are plenty of bad reasons, like they're all competing for inflated media buys and investing in over-funded product niches, but savvy entrepreneurs sense that they had better be well funded if they are going to compete with other well-funded start-ups. In fact, we almost never think about an incumbent as a competitor. It's the 20 other start-ups down the street that we worry about when we invest in new ventures.

So, I think it's true that the venture industry's typical fee structure is indeed causing larger and larger funds to be raised. It's the only way that some VCs can concoct to grow their franchises. Just about every other lever that can be pulled has been pulled: VCs are no longer syndicating deals; they're putting larger amounts of money into the typical deal — doing multiple rounds all at one go. And now, as venture firms raise larger funds — when they move from a hundred million dollar fund to a billion dollar fund, they inevitably change what they do. They end up investing in mezzanine rounds.

As for my firm, we have scaled our head count and expanded horizontally as our capital under management has increased so we can stick to early stage investing. When I joined the firm, it had two full-time partners. Now we have eight partners plus one associate plus two venture partners plus a much larger support staff. And we turned down more than twice as much money as we took in for our last fund. Deciding where to draw that line was a very painful decision internally. It raised the sort of soul-searching questions every venture firm has to ask itself these days, namely, what do we do for a living? Do we enjoy what we do? Why do we do it? And if you're just out to make a buck, you're going to make the fund as big as you can and run away with the proceeds. If, instead, you live to build companies and the reason you show up at work each day, excited and invigorated, is because you love technology and you love business, you're going to take the more prudent approach and raise only the amount of money it takes to do what you do well but not more.

Childs: I'd add that raising more money than you can effectively put to work, and effectively means good investments made over a specified period of time, is a prescription for raising your last fund, at least if TIFF and the other institutional investors of the world discipline themselves as to who they'll give money to. So the discipline is self-serving in the sense that if a private equity manager wants to raise another fund beyond the one that he's currently raising, he wants to size the new fund to both the market niches in which he's going to invest and his available skill set.

I also want to highlight one attribute of private equity firms that I would encourage LPs such as TIFF to look for. My firm as well as many firms like it make a substantial co-investment in our funds. In other words, we eat our own cooking. An interesting way to assess a prospective manager's mindset is to analyze how much of the management fee over and above the expenses of running the firm will be invested by the firm's partners in the deals that it proposes to make. This is not a difficult measurement to make. In our case, we co-invest about twice what one might call our excess fee — our total fees less what it costs us to run the firm. So just trying to live off fees would not be a very smart trade-off for us. There is one other factor to consider — one that appeals to my low tax sentiments. You have to pay ordinary income tax on fees. If a manager invests his LPs' capital wisely, he'll get his money back at capital gains rates and that's a much more efficient way to grow wealth than trying to do it with a marginal federal rate of 40 percent plus state and perhaps also local taxes on top of that.

Moderator: Steve Graham, do you care to follow up?

Graham: Putting my LP's cap back on, I'm very uncomfortable when a manager raises so much capital that its management fees greatly exceed the firm's ongoing overhead costs. When we at Graham Partners sized our own buyout fund, we set a target that reflected (a) the amount of capital we thought we could invest prudently over a few years and (b) the amount of capital that would generate fees that would cover but not exceed the firm's overhead. We like to see a situation where if one could segregate management fees from the carried interest, the vast majority of the present value of the manager's expected income stream reflects carry as opposed to annual management fees. But this has been a very good market in which to raise capital for private equity funds, and there are many firms that have raised lots more money than they ever expected to raise.

I think there's likely to be a real shakeout in some sectors, because there's too much capital out there. I suspect that this will be the case in venture investing. In the LBO market, whether it's large deals or small ones, too many firms are showing up to compete for attractive acquisitions. One of the problems when you're competing against a lot of firms with lots of cash is that those firms are going to rationalize certain things during the due diligence process. Some of the assumptions that they're going to make are going to be more optimistic than would be the case if there were fewer investors with less capital. We're seeing surprisingly high prices being paid for basic, middle market manufacturing companies.

Moderator: We're nearing the end of our allotted time. I do want to turn to the third set of issues that I asked our panelists to think about, which is the impact of the Internet on public policy formulation. As a segue, Jeremy Hosking of Marathon-London made a point this morning that may not have hit home sufficiently and that I'd like to emphasize. It's something that we at TIFF think about a lot and is directly germane to what Steve Graham just said. Steve said that successful private equity investing entails essentially four steps, with the third step being a private equity firm's ability to add value to the companies in which it has invested. Of course, most public securities managers like Jeremy Hosking typically don't seek to do this — to add value to portfolio companies — but another phenomenon to which Jeremy alluded underscores a weird if not downright perverse trend in money management today. It's the curious tendency of institutions to fire value-oriented managers because they are upset with their performance, and then to use the proceeds to invest via private equity firms or buyout firms that, in turn, buy essentially the same shares of underperforming old economy firms that the institutional LPs in question have just sold, but at a 20 to 40 percent takeover premium. You pay the typical marketable securities manager, at most, one percent a year, to buy and hold these shares, with no carried interest, and you pay the typical buyout maven two percent a year plus at least 20 percent of the ultimate capital gain. Obviously, it makes no sense whatsoever to shift capital from the first type of manager to the second and end up owning essentially the same companies. I mention this because I think it's an appropriate cautionary note for trustee groups and those of you serving on investment committees wrestling with these questions.

The Internet's Impact on Public Policy Formulation and Implementation

Issue #6 — Competition and the Government's Case against Microsoft

Moderator: The long battle between the Justice Department and Microsoft appears to be nearing an end, with many observers predicting that Uncle Sam's probable victory will, in the fullness of time, be seen as a Pyrrhic one at best — a costly and needless effort to achieve by government fiat what the free market would have produced on its own in due course, namely the erosion of Microsoft's alleged monopolistic control over key aspects of the PC industry. This line of argument is appealing to those of us who think that that government is best which governs least, but in Microsoft's case, it happens to be dead **wrong**. Unlike the epic lawsuit against IBM, which was a colossal waste of both public and private resources, the effort to discipline Microsoft has been crucial in preserving meaningful competition and innovation in the computer industry.

Porter: Finally, I have something else to contribute! The issue David has just raised is a very controversial one.

I've been working in the field of strategy and competition for 20-plus years. I've worked in many countries and worked with virtually every type of company, including a bunch of dot-coms where I'm an advisor or on the board. What I've learned is something very simple: competition really does matter. There is nothing more powerful in producing good things for society than having a lot of competition, competition that's really unfettered by distortions, by government intervention, by any kind of artificial barriers. The second thing I'd underscore is that businesses seek monopoly positions. That's what they're trying to do: they're trying to create an unassailable position with the strongest possible advantages. They tend to use any means available to do this. And, in some countries, unlike the United States, they use means that we would all immediately label corrupt, like bribing government officials. When you work in the developing world as I do a lot, you witness many boldface efforts to create monopolies in a corrupt or uncompetitive way. But I think it's also demonstrably true that in any economic system, very few managers truly welcome competition. They're trying to gain competitive advantage; they're trying to achieve as strong a position as possible in any way they can. Therefore, in any economy that's healthy, we've got to set some rules on what kind of competitive tactics are appropriate and what kind are more likely to entrench companies or give them unnecessary advantages that really don't map directly or even indirectly into true consumer or social benefits. You've got to have rules of the game and that's why we need to have an antitrust policy.

I'm now the co-proprietor of the Global Competitors' Report, which is an annual in-depth study of the competitiveness of countries all around the world. What we've found is that one of the most powerful determinants of growth in per capita income is whether a country has an effective antitrust policy. Countries that step to the plate and really believe in competition and have a serious antitrust policy grow more rapidly: they have higher per capita incomes. Countries that allow cartels — monopoly and collusion and domination of markets — don't do as well. So, there have to be rules of the game.

The most obvious area where there needs to be rules of the game is with respect to mergers. Mergers are fraught with danger. Mergers generally don't require innovation, they don't require a better idea, they don't presuppose any value added — all they require is a checkbook. We in this country are appropriately suspicious of mergers that substantially concentrate markets because these deals are hugely risky: what we know from studying mergers is that most of them simply don't succeed. They don't live up to their expectations. So, there's not much of a social benefit to mergers, but there can be very real social costs.

Turning to Microsoft in particular, I have no problem with how Microsoft got to where it got in terms of a 90-plus percent share of the operating systems market. But I believe that once a company gets into such a privileged position, it has to be held to a higher standard of behavior than the standard applied to firms with less dominant shares. Indeed, I believe that the burden of proof should actually shift. If you have 30 percent of a market and you do something to sharpen your competitive position, the burden of proof ought to be on the government to show that there is something really bad about what you're doing. But, if you have 90 percent market share, I believe the burden of proof should flip and the burden of proof should be on the 90 percent market share company to prove that what it's doing is really valuable — that it outweighs whatever risk the economy will bear if the company in question continues down its present path. Bundling the browser into the operating system may have provided some benefit, but the effect of this tactical choice made it harder for independent entrepreneurs to compete in important segments of the software industry.

Moderator: Steve Jurvetson, would you like to comment on the impact of a successful conclusion to the Microsoft litigation — from the government's point of view — on the types of business plans that you would fund or not fund?

Jurvetson: That's an interesting question. We haven't thought it through fully because we think that a final resolution of this dispute is so many years off that it's not relevant over our investment time horizon. We've gotten so used to not worrying about Microsoft by investing in niches where it doesn't compete effectively — areas where one needs a direct sales force, like enterprise software — that I have only some ill-formed thoughts on this topic. But I'll share them anyway!

It seems to me that the underpinnings of much of antitrust law as it relates to technology is antiquated and inappropriate. The whole basis for antitrust law is rooted in the trusts that dominated the economy at the beginning of the 20th century. It's predicated on a government grant of monopolies and, in fact, in the early going business trusts and monopolies were essentially synonymous. Monopoly meant something that the government gave you as a franchise, which is very different from a natural monopoly — monopolies that arise in markets like the one now dominated by eBay, monopolies that arise spontaneously in certain technology niches. In fact, a tipping point gets reached in many technology niches where a standard takes root, often at an early stage, with no ill-intent on anyone's part. It simply becomes the standard.

That said, I do think Microsoft is evil. There's something in its genetic code that makes it so. But nevertheless, I would hesitate to reprimand it in any way because the only institution for which I have less respect than Microsoft is the government. As an investor in start-ups, I welcome the challenge to try to unseat Goliath by funding the Davids of the world rather than having Zeus step in and regulate things through government intervention. Having the government involved is, in my judgment, a less likely path to success than is simply financing the next revolution in niches that are prone to reaching these important tipping points. Sure, you can try to cripple the company that is strong and you may cripple it for a period of time, but what replaces it will not be a new and vibrant array of spreadsheet competitors or operating system competitors, it will be something from left field, whether it's Linux or some Web-based business that doesn't rely on Windows or a new information appliance that's coming out of Larry Ellison's workshops at Oracle or something else. I bet that even though none of these possibilities particularly excite me right now, something like what I've just described is going to have a better chance of dethroning Microsoft than trying to regulate what Microsoft itself does because a new entrant will deliver important technological benefits to consumers.

Moderator: Thanks, Steve. Speaking of genetic coding, as those of you who've participated in face-to-face presentations by TIFF know, we try to finish every presentation on time, if not early. We adopted this mindset because in over a dozen years of working with trustee groups prior to starting TIFF, I was never once ushered into the room to begin my presentation on time, and it drove me crazy. So we try to help trustee groups stick to their schedules, and we're going to stick to our schedule here today by wrapping up on time, if not a few minutes early. I know that some of our panelists and many of you in the audience have a long way to travel tonight so let me thank all of today's speakers and panelists, as well as the TIFF staff who worked so hard to make today's Forum a success. Thanks to all of you for joining us today. We hope to see you again soon.

Endnotes

1. The articles cited can be obtained via Draper Fisher Jurvetson's Website at www.drapervc.com.

2. Earnings before interest, taxes, depreciation, and amortization.