The Journal of
PRIVATE EQUITY
Strategies and Techniques for Venture Investing
VOLUME 9, NUMBER 3 SUMMER 2006

We all know that fund flows into private equity coffers have been brisk of late. Wonder where all that money is going? As we go to press, we reviewed an announcement of the private equity arms of Merrill Lynch, Deutsche Bank, and Stark Investments (a hedge fund) establishing numerous vehicles to invest in one of America's leading exports: Hollywood (and not in a lending relationship, but as an equity player). In deference to the size of the challenge these brave souls are undertaking, in this issue we present a series of articles that might help these pioneers select investments you and I will enjoy at the movie theatre—and will most certainly help the rest of us select and manage investments, that are, shall we say, a bit more conventional.

Parenthetically, I must add that whenever Wall Street has ventured into Hollywood, the outcome has been less than stellar. But hope is eternal. Rather than hope, our mission here is educational.

First up is a further look at our continuing topic of developing rating systems for business plans. Hindle and Mainprize present a new piece of the puzzle in their series of investigations on venture capital screening techniques. Here they distill all VC rating systems into ten basic principles, each with a dozen laws that tie different schemes together. This look at how venture capitalists actually pick deals gets to the heart of what we all do. How many of these principles and laws seem familiar to you? Which among the unfamiliar ones might be of interest?

Alex Proimos and Wayne Murray have a bit of a different take on the same subject, with a compilation of entrepreneurs who have presented deals for funding. Their research looks at both their ideas of readiness and the investors' opinions. The data lead to a number of conclusions, such as the fact that potential teams rarely have a second chance to present a business plan once an investor has said no. This means that potential management teams must be exceptionally well prepared to articulate and defend their ideas the first time.

In thinking about CEOs in entrepreneurial ventures, what are the right role models? Should they behave like Jack Welch? Or given the small size of the company, is the idea of a doer rather than a coach more appropriate? Fried, Bruton, and Kern tackle this question by analyzing a series of activities their research highlights as critical. These ideas help us consider how we manage and evaluate our own CEOs.

The Journal of
PRIVATE EQUITY
Strategies and Techniques for Venture Investing

How do European private equity funds manage risk? Kut, Pramborg, and Smolarski address that fascinating question with data encompassing over 140 firms and an average fund size of about 500 million Euros. Survey data set the baseline for valuation methods, such as IRR, NPV, EVA, and others; how new investments are evaluated; how risks are identified and managed; the identification of portfolio risks; and if macro-risks—such as foreign exchange, interest rate, inflation and business cycle risk—are hedged. Taken together, these data help us understand the inner workings of this large sample of European funds.

Japan is the great lost market of the past fifteen years. It was in early 1990 that the averages hit their highs, and since then, they have lost about 65%. If twenty-five years is a generation, we may see an entire generation of Japanese investors pass by before the Nikkei averages again hit their 1990 numbers—which at that point is just break-even, not including the loss of investment income over the ensuing period. However, things look a bit different in Japan today than in the past. Gerald Hane reviews the structural changes in Japan over the past decade, and cites interesting data supporting his thesis that innovation is growing in Japan. For example, business formation at universities increased ten-fold over the last seven years. Is it time to look at Japan in a different way?

And what of China? From far away, we see reports of substantially increasing private and public market activities. Jay Tannon takes us inside and details some of the data and a selection of the administrative changes that affect private equity in China. His brief piece provides updates on the latest thinking about where this large and exciting market is heading.

In contrast to the two articles above, which write in general terms about big changes overseas, we then present two rather technical pieces for those of you looking for highly detailed information to help take action on these topics. Joseph Bartlett offers his views on the difficult situation when a fund has been promoted at an industry event and, accidentally, the exemption allowed for private placements under the Security Act of 1933 has been compromised. He offers a potential solution for your consideration.

Our final piece, from Ferreira, Brooks, and Girard, analyzes in detail the performance of 240 equity private placements of publicly held companies from 1983 to 1996. The authors evaluate the extent of "abnormal returns" generated by the new information presented by the equity placement. Their data are useful to any of us looking at an equity private placement as a vehicle to raise funds or invest in smaller or medium sized listed firms.

James E. Schrager, Editor
Chicago, Illinois