Mastering Private Equity

INSEAD Professor Claudia Zeisberger

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Private equity is breaking fundraising and divestment records, creating an unprecedented number of private-equity backed billion-dollar ventures, and attracting new entrants like never before, according to INSEAD Professor Claudia Zeisberger.

Speaking to a packed conference room at an INSEAD alumni event in May in Zurich's Au Premier, she said that the term "private capital" is more apt than "private equity". The growth of private equity, driven by its success, has caused it to expand and diversify. Today, its practitioners invest capital in a larger variety of privately- owned assets, such as infrastructure, real estate, distressed and secondaries.

Breaking Records

Private equity's assets under management (AUM) is growing rapidly, and that goes for buyouts, emerging market funds, venture capital, mid-market, and growth funds. It is 6.7 times what it was 2000, up from USD 704 billion in 2000 to USD 4,712 billion last year. "No other asset class has grown like this asset class," said Zeisberger.

The median deal size is significantly higher than anytime in the last 10 years. Dry powder, or uninvested capital from funds raised in recent years, is at an all time high. The volume is "forcing the hand" of fund mangers, driving them to look at larger deals.

There is an increasing number of mega-funds being raised globally, driven by PE funds returning cash to LPs. This elite group receives about 75% of the total funds raised. The size of some of these funds is unprecedented. Mega funds, or very large amounts of capital being allocated to a select group of top fund managers, is driven, at least in part, by LP strategies. LPs are following a trend set by two influential California-based fund managers who several years ago publicly announced they were managing too many relationships and had made a decision to work with fewer managers.

Whereas in Europe and in the US buyouts represent the largest pools of private equity assets under management, in Asia it is still growth capital that represents the largest pool.

The European private-equity scene is specifically undergoing change. European buyout fundraising is breaking all-time records. It used to be known as the mid-market region and the US was known for its large buyouts. But that's changing. Today there are mega funds being raised by European fund managers. European secondary buyouts are on the increase as well.

Venture Capital Trends

It is a great time to be selling companies and raising funds. But it is not necessarily a great time to be investing. A heated market leads to higher valuations. This exacerbates the "dry powder" issue. It is not only buyout funds that have a lot of dry powder. VC funds have it too. They are returning cash to LPs steadily since 2010 after almost 10 long dry years where capital was invested and very little was returned. The more capital returned, the more LPs have to invest in venture, resulting in ever larger funds.

Corporate venture investment activity is at an all time high. Companies like Intel have been doing VC investment for a long time, but many newcomers are active now. "I am a bit worried about the after-party," she said, referring to the losses that may be incurred as a result of uninformed corporate venture activity. There is the basic VC rule of thumb to keep in mind. Only 2 out of 10 investments in a venture capital portfolio, or a particular fund, will return money. The rest of the companies will make no money or merely return cash invested. Returning the cash invested is not enough to be able to raise a new fund. The average successful investment has to achieve a 40 to 70% internal rate of return (IRR) in order to "live" to raise another fund.

VC Exits

Venture valuations are getting higher. Money is chasing deals. Startups are not going public as the favored exit strategy, or if they do they are taking much longer. For example, it took Spotify eight years to do an IPO. Amazon went public after 4 years.

Buyout funds acquiring mature venture-backed companies accounted for close to 20% of all venture capital-backed exits in North America and Europe. "We have never seen a proportion like this before," commented Zeisberger.

Corporates, even non-technology companies, are acquiring VC-backed companies at high valuations too. The two trends that encourage these kinds of acquisitions are 1) corporate investment in R&D in general is falling, and 2) cash on corporate balance sheets has grown. When companies like Unilever and Walmart, non-tech companies buy VC-backed companies, the implication is that venture capital is a way to do R&D.

Red Unicorns

Professor Zeisberger presented a slide illustrating how venture capital created some of the largest and most successful companies in the US, such as Apple, Google, Microsoft, Amazon and Facebook, according to Bloomberg data. This sets the stage for some of the data she presented about Chinese venture capital trends.

China's venture capital ecosystem has grown tremendously. A study of venture capital deal activity based on the company location shows that China already dominates the Asian venture capital market, far ahead of India or any other Asian country.

China rivals the US as a hub of venture capital investment. It is in fact on a trajectory to outpace US and Silicon Valley's level activity by mid-2019. A group within Professor Zeisberger's department at INSEAD in Singapore looked at records of deals involving China-based companies (looking at data published in Mandarin not in English). The initial figures indicate USD 62 billion raised by over 1441 companies. China's VC growth rate is 20% CAGR, compared to the US venture growth rate of about 6%.

There has been very little analysis of the size and rate of growth of mainland Chinese VC activity. Part of the reason for that is language but also that the two venture hubs are very different. The American venture capital ecosystem was and is still driven by stand-alone venture capital funds. In China, it is driven by corporate venture capital, particularly Alibaba and Tencent, along some well-funded family offices. "China's private wealth has few other investment options," she observed.

Globally, unicorns, startups with valuations over a billion, have become more common. Everyone knows about Uber and AirBnB, but Chinese unicorns are on the upswing too. Four out of the 10 highest valued unicorns, globally, are Chinese. (For example, Xiaomi and Didi Chuxing).

Professor Zeisberger said that an analysis of emerging market unicorns revealed 164 unicorns in China valued at USD 628 billion. She has an article about "Red Unicorns" coming out soon.

China's Entrepreneurial Prospects

China's ability to benefit from venture capital investment and create global tech giants looks good. It can rely on access to talent and government support. There is an ample supply of talent. For example, there are six million university graduates in China each year. They want white collar jobs. Youth unemployment has been an issue in the past but government programs both formal and informal are encouraging entrepreneurship.

To support and speed up entrepreneurial endeavors, China has 420 startup incubators. Some focus on particular technologies, like artificial intelligence and robotics. Some are regionally-focused. That does not mean they are tiny little incubators. A third-tier city has a population of 12 million, suggesting there is a significant pool of talent and significant industrial cluster.

Speaker Bio

	**Claudia Zeisberger, Senior Affiliate Professor of Decision Sciences and Entrepreneurship & Family Enterprise & Academic Director, Global Private Equity Initiative (GPEI) INSEAD Professor.** Professor Zeisberger is a Senior Affiliate Professor of Decision Sciences and Entrepreneurship & Family Enterprise at INSEAD, and the Founder and Academic Director of the school's private equity centre (GPEI). Her PE course has been awarded the "Dean's Commendation for Excellence in MBA Teaching" annually since 2008. She launched 'Managing Corporate Turnarounds' a popular MBA elective known for its intensive computer-based simulation involving an iconic car brand and its struggle with bankruptcy. As a natural extension, she teaches INSEAD's Risk management elective. Before joining INSEAD in 2005, she spent 16 years in investment banking in New York, London, Frankfurt, Tokyo and Singapore.

Impressions