

Venture Capital & Private Equity

A Changing Model Requires Changes in Practice

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The VC and Private Equity model is changing. Most would agree that the industry has matured to the point of commoditization, forcing those that wish to compete on a high level to make better decisions faster. Not unlike other maturing industries, those that wish to compete in a commodity-like market are forced to operate on increasingly thin margins while at the same time adding more value to their customer in order to differentiate their firm from a sea of competitors. Like the distributor that innovates to provide cost-effective packaging and pre-paid freight to induce customers to look their way, the VC or equity manager must seek opportunities to add value to a product or service that may otherwise be perceived as a commodity and discounted accordingly. Forward thinking VCs and Private Equity Fund managers are looking *outward* to identify strategic big picture opportunities while at the same time turning their attention *inward* to innovate and improve business processes that add more value to the firm. Indeed, history shows that failure to respond and adapt quickly to changes in the business environment eventually leads to an irrelevant and outdated business model. This article puts forth several *inward* looking change opportunities and offers a framework of ideas that help add value to the VC and Private Equity model.

Dramatic change is currently underway-

One only needs to read the Wall Street Journal or other relevant news sources to get the idea that considerable change is underway in the Venture Capital and Private Equity investment industries. New models such as InsideVenture sponsored by Silicon Valley Bank that offers matchmaking services between start-up companies and institutional investors represents one of many examples of innovators seeking to change the current model. A recent video presented at Harvard Business School by Adeo Ressi titled, "The Canary is Dead" argues that the current model is broken and change is needed. Whether or not the proposed models work or whether the model is entirely broken to begin with may be a matter of perspective or a matter of opinion. However one thing remains very clear; change is indeed underway.

As with most maturing industries, VC managers are under increased pressure to compete on a higher level. In clear terms this means offering more value to the customer, making more intelligent decisions and doing it faster and better at a lower cost. In the VC or Private Equity world this means identifying solid investment opportunities on the front end, making judicious follow-on secondary investments and holding portfolio company executives accountable to deliver as expected. In short, this means conducting the front-end investment analysis with added rigor, monitoring monthly portfolio-company performance with more diligence, and finally, contributing value-added management expertise when performance drifts astray.

Systematizing non-value added tasks, leveraging technology-

Embracing tools that leverage technology is vital to managing this process with a higher degree of skill and efficiency. In addition, reducing internal costs associated with acquiring, aggregating, analyzing and reporting monthly portfolio company performance data represents a major opportunity to add profit to the bottom line. This otherwise inefficient task can be transformed into a systematic process that leaves fund managers free to focus their effort on tasks and opportunities that generate rather than consume important company resources.

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Increase reporting transparency for decision makers and stakeholders-

Clear and transparent financial and portfolio company performance reporting to all relevant decision-makers up and down the stakeholder chain represents a major opportunity to maximize perceived value. The need for transparent financial reporting to stakeholders including board of directors, investors, executive team members and lending institutions has increased dramatically in the recent past and especially so in light of the current global financial crisis. PriceWaterhouseCoopers (2008) in a recent white paper that reviews current practices for the private equity industry states, “investors want regular and robust information and may exit funds if this is not made available”. Clearly this statement underscores the need to provide stakeholders with reliable financial performance data and further illustrates that financial transparency is no longer a requirement for public companies alone. Perhaps more important is the need for fund managers and analysts to have easy access and insight into portfolio company performance to monitor trends and identify value creation opportunities in order to manage and mitigate risk. Clearly, investment professionals can no longer rely on powerpoint slides backed up by unreliable spreadsheets to communicate performance, justify valuations and meet auditing requirements.

FAS157 and IFRS requirements will change the game-

Meeting auditing requirements and meeting the challenges associated with the impending convergence to IFRS standards will dramatically impact the need for consistent and reliable source of historical financial data. In particular, valuation methodologies that include a DCF component or earnings multiple require solid justification based on prior performance and historical variance to plan. Marking debt values that reflect a default premium may require a rigorous analysis of the company’s financial position, underscoring the need for timely and reliable access to portfolio company performance data.

Conclusion-

No less than four significant trends are driving major change with respect to front and back-office management strategies employed by Venture and Private Equity capital firms. Some will see emerging problems while successful managers will see the opportunity to differentiate and add value.

Driver

Opportunity

- 1) Inevitable Commoditization** – Leverage technology to add value & improve decision making.
- 2) Inefficient Data Management** – Leverage technology and tools to economize the process of portfolio company performance data management.
- 3) Transparency** – Turn growing need for financial performance and investment data into a value added asset that inspires and mobilizes management while building confidence among investors and other stakeholders.
- 4) Auditing Requirements IFRS and FAS** – Implement strategy that facilitates consistent and reliable access to historic performance data to meet auditing requirements and standards.

Successful leaders will innovate with new strategy that leverages technology to retool and replace non-value added processes and activities with management tools that enable better and faster decision making. Traditional modes of operation with respect to portfolio company performance management, valuation, and financial reporting can no longer support the demands placed upon the industry by investors nor can they meet the challenges of today’s competitive environment.