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Groups That Cut Teeth in Mid-'90s Return To Market Showing Promise

Are they Just One-Hit Wonders, Or Can They Remain Rising Stars?

Erica C. Bushner knew something about name-dropping.

So when Steven D. Arnold, back when he was trying to get **Polaris Venture Partners, L.P.**, off the ground, mentioned he had worked closely with Bill Gates at Microsoft Corp., she wanted to find out just how closely.

"I said, 'I want to talk to him,'" recalled Ms. Bushner, then the director of alternative assets at the **Pennsylvania State Employees' Retirement System**.

It must have been the last time she doubted Mr. Arnold's connections.

"Bill Gates was kind enough to spend 25 minutes talking with me," said Ms. Bushner (who can now do a little name-dropping of her own). "It was just a very good, straight-up due diligence, and he spent as much time as I needed."

Pennsylvania ended up taking a \$15 million flyer on Polaris—a good move, as it turned out. The firm, which recently wrapped its second fund at \$175 million, went on to back a hit-parade of companies, including **Allaire Inc.**, the Boston software developer that saw its market capitalization swell to more than \$600 million after a January IPO.

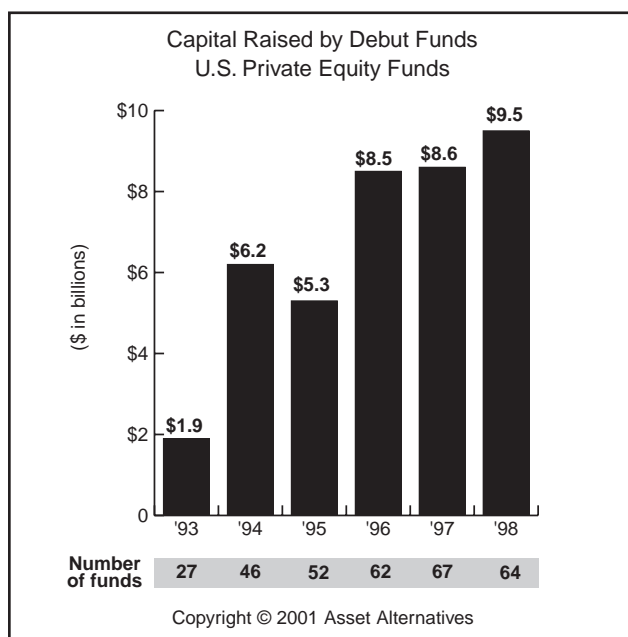
Polaris's story parallels that of many private equity firms during an era when the capital raised by debut groups soared—from 27 new groups raising \$2 billion in 1993 to 64 raising \$9.5 billion last year. The partners who made up these new firms relied on the strength of references, track records at other firms (two of Polaris's founders had been venture capitalists at Burr, Egan, Deleage & Co. before its breakup), and whatever else it took. Many of these firms got off to strong starts, and have since returned to market to raise more substantial sums.

Their names often aren't widely recognized, and some still take a year or more to get a fund raised. One big rea-

son to know about them is the growing number of partnerships that simply don't have the space, or the desire, to bring in new investors. Many newer firms still offer the chance for institutional investors to invest directly in their funds, as well as to co-invest alongside of them.

A survey of young firms inevitably falls short of covering the waterfront. In preparing this report, *The Private Equity Analyst* relied on financial advisors, placement agents and institutional investors to point out some of their top finds from the latest crop of private equity newcomers. The sources were asked to pass along information about the firms that were under-hyped or over-achieving, and, if possible, those that were still open to new investors.

The firms that were mentioned include **Carousel Cap-**



Young Firms Returning to Market

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ital Co., a Charlotte, N.C. buyout firm that recently struck up a strategic alliance with heavy-weight **Forstmann Little & Co.**, New York; **Convergence Partners**, Menlo Park, an early investor in iVillage Inc., whose market capitalization recently broke the \$2 billion mark after a successful IPO; and **HIG Capital Management**, a Miami buyout firm that makes a specialty of acquiring small companies that dominate their fields. (For a list of selected private equity firms that were launched in the mid-'90s, see pages 40 and 42.)

A Good Time to Be Born

Luck has played its part in the early success of these firms. All have benefited from having begun investing capital during a seemingly endless U.S. economic expansion, which in turn has fueled a runaway bull market. Some, like **Flatiron Partners**, New York, **Idealab Capital Partners**, Pasadena, Calif., and **Softbank Technology Ventures**, San Jose, had the additional good fortune of betting big on the Internet just before the Internet became the next big thing on Wall Street.

These firms have a little more pressure than they ordinarily might, given the boom times they're operating in, to keep the successes coming. "The spotlight is particularly on you in those early years," says Philip B. Pool Jr., managing director at the Private Funds Group of **Donaldson, Lufkin & Jenrette Inc.**, New York. "Your early deals have to be successful or you damage your franchise right out of the blocks."

In addition, that times have been so good could prove a liability for these firms when the going gets tough. With so many investments turning into home runs, for example, firms find it that much more difficult to say no to high valuations.

All-weather Strategies

Nonetheless, many partners, despite never having invested in a bear market while at their current firms, say that they have taken the steps to build a franchise that will perform well across economic cycles. They maintain that their early progress, aided by a head wind or not, is no fluke. Indeed, many have converged on a similar set of strategies for trying to stay ahead of the pack:

- *Finely tuned focus:* Young firms almost always define their niches tightly. Staying within a small investment sphere has several advantages, one being that the firm can quickly gain a reputation as having the best connections in a particular field, and of therefore being best able to recruit

managers and win strategic partners. Consider the strategy of **InSight Capital Partners**, Greenwich, Conn., which is to provide expansion-stage capital to companies that have \$5 million to \$15 million in revenue and that specialize in helping other businesses make better use of information technology.

- *Heavy Networking:* A reliance on strategic investors, advisory boards and other communities of experts to provide deal flow, due diligence, and portfolio company management is a hallmark of many young groups. Having an advisory board paid off for **Polaris Venture Partners**, Waltham, Mass., when member Robert Langer helped to build a company around technology he had developed at the Massachusetts Institute of Technology. In less than a year, Polaris's \$2 million investment in Advanced Inhalation Research Inc. ballooned to \$22 million following the sale of the Cambridge, Mass., company earlier this year.

- *Industry-first approach:* Young buyout firms, in particular, say they don't wait for deals to come to them. Rather, they first decide on a field that seems promising, then go out and find the best company that they can to acquire. Carousel Capital last year decided that it wanted to cash in on a craze for motor-car racing in the Southeast. Several of the firm's individual limited partners—a collection of 60 former and current CEOs—pointed to Simpson Performance Products as a likely target. The Mooresville, N.C., company held 50 percent of the market for motor safety equipment, but lacked a strong management team needed to press its advantage. Last April, Carousel took a 60 percent stake in the company, then found it a president, chief financial officer and chief operating officer.

- *Emphasis on recruitment:* Recognizing the importance of management team recruitment, many young firms have taken special measures to find the people they need. Take Convergence Partners, which has struck up an strategic alliance with **Geneva Group International**, a San Francisco executive recruitment firm. Convergence last year sponsored an \$8.5 million seed fund managed by Geneva, and gained, in effect, a right of first refusal to back any companies that Geneva incubates. Geneva also helps Convergence find management teams for its other portfolio companies.

- *Image Counts:* Young firms are particularly conscious of the importance of reputation and image in winning deals. **Willis Stein & Partners LLC**, the four-year-old Chicago buyout firm, in January hired a public relations firm to raise its profile—still an unusual move among private equity firms, better known for cultivating an aura of secrecy. "The idea is to create and enhance our local image, and our national image," says Avy H. Stein, managing director.

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Many of the newer firms still offer institutional investors the chance to invest directly in their funds, as well as to co-invest alongside of them.

Bootstrapped Beginnings

Several of the firms established in recent years relied on the deep pockets of one or two backers to get started, then approached institutional investors after having logged some gains.

Such firms include Convergence Partners, with early backing from **NEC Corp.** and **Sumitomo Bank**; Idealab Capital Partners, the Pasadena, Calif., venture firm bankrolled early on by **Moore Capital**, the \$6 billion hedge fund based in New York; and **Vector Capital**, the San Francisco venture firm backed by **Ziff Brothers Investments**, New York and Menlo Park.

Convergence got its start in 1997 with a \$60 million pool—\$45 million from NEC and \$15 million from Sumitomo Bank (whose parent company is a major shareholder in NEC). The firm used the capital to build a portfolio of 12 companies, most of them in the applications services sector.

Convergence recently began trumpeting this track record to institutional investors as it tries to raise a second fund of \$100 million. It is not a long track record, by any means, but given the accelerated pace of venture investing today, it's long enough to show ample early promise.

One of Convergence's early deals involved iVillage—the online Web site for women that went public earlier this year. The firm's 3.5 percent share of iVillage, purchased for \$4.5 million over a two-year period, at press time was valued at \$73.7 million—enough to return NEC and Sumitomo's entire commitment to the firm's first fund, and then some.

Should Convergence succeed in marketing its fund to institutional investors—and Partner Eric Di Benedetto says that so far they have responded well—the firm will be following in the footsteps of both Vector Capital and Idealab Capital Partners.

Vector invested a \$40 million pool supplied in 1995 by Ziff Brothers Investments in eight software and communications companies. Encouraged by results, Ziff Brothers made an early commitment of \$30 million to Vector's second fund, **Vector Capital II, L.P.**, which the firm began marketing early in 1998.

Ziff's re-commitment "gave other investors a lot of confidence," says Managing Partner Alexander Slusky—as did the firm's two IPOs to date. Vector already has realized substantial gains on the two offerings: NetGravity Inc., the San Mateo, Calif., provider of online advertising software; and RealNetworks Inc., the Seattle provider of data streaming software for the Internet.

Vector ended up closing Vector II at \$150 million last month, ahead of its \$100 million target, with backing from **GE Capital**, Stamford, Conn., **General Motors Investment Management Co.**, New York, and **Massachusetts Institute of Tech-**

nology, Cambridge, Mass.

Idealab Capital Partners, which evolved out of the Internet company incubator started by Bill Gross, used an early \$30 million commitment from Moore Capital to start investing. "As we got to month seven or eight of our fund-raising, we had a good story to tell," says Managing Director William S. Elkus.

Idealab's Starting Five

Indeed, the firm's first five investments today would appear on almost any list of the most highly anticipated IPO offerings of 1999. Those in registration at press time include Goto.com Inc., the Pasadena, Calif., search engine provider, and Etoys.com Inc., the Internet retailer based in nearby Santa Monica. Should shares of Etoys.com trade at the low end of the offering price—and Internet stocks have a habit of doing much better than that—Idealab's 8 percent stake would be valued at \$81.3 million.

California Public Employees Retirement System and the **Michigan Department of Treasury** anted up for Idealab's debut fund, which held a final close at \$105 million in February. Both **Harvard University** and MIT, meanwhile, opted to sit Fund I out—although they both asked the firm to keep them in mind for their second.

Harvard and MIT may get their chance shortly: Idealab plans to begin raising its second fund this summer, having invested about \$50 million from Fund I in 17 deals. The second time around promises to be a cakewalk: Based on phone calls received from current and prospective investors, Mr. Elkus says, "I have a second fund that's substantially sold already. I don't even have a term sheet available for them."

The firm anticipates having room for some new investors, since it plans to raise a larger fund. "But I feel obligated to satisfy the appetite of existing investors," Mr. Elkus says. "They took a chance on us when we weren't well known."

Can They Keep it Up?

One danger for many young firms is that they may have chosen too specialized an industry. Even if the industry continues to grow rapidly, it may not always find favor on Wall Street.

Alan E. Salzman, managing partner of **VantagePoint Venture Partners**, San Bruno, Calif., observes that "single-sector funds who get the sector and the timing right have historically been the best-performing funds in any given year. If you were a biotech fund in 1991, you outperformed everyone else."

VantagePoint itself invests only in information technology. However, Mr. Salzman says that his

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In an industry better known for cultivating an aura of secrecy, some young firms are conscious of the importance of public relations

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firms tries to stay diversified within the broader field by investing in data networking, advanced telecommunications services, the Internet and related enabling technologies. The firm also tries to stay diversified by risk, as well as by stage of company development.

Other firms remain unapologetic about their concentrations.

Charles R. Lax, general partner with Softbank Technology Ventures, acknowledges that sector funds may tend to be the best performers. However, he also believes that the opportunity presented by the Internet is “not just a three-and-a-half-year play. We believe it’s going to radically change how all business is done.”

Preparing for Change

Another danger is that the early strategies of new firms won’t prove adaptable.

“Obviously, I can’t sit here and tell you that a strong economy hasn’t helped us,” says Anthony (Tony) Tamer, managing director of HIG Capital Management. “The question becomes, what happens to our business model, versus other models, in a down economy?”

Mr. Tamer says that part of HIG’s answer is to keep its purchase prices down, and to rely on boosting company performance, rather than on exiting at higher multiples, for its returns. As an example, Mr. Tamer says, his firm was able to more than double profit margins at Exceltec International Corp. through operational improvements. HIG purchased the Houston manufacturer of waste water treatment equipment for \$20 million in February 1997.

Mr. Tamer declined to discuss what specific actions his firm took. However, he says, “It is not unusual for HIG professionals to work on task forces with management, focusing on reducing cycle times at manufacturing plants, or putting together a plan for integrating two manufacturing plants into one.” In less than two years, HIG’s \$4

million equity investment in the company grew to some \$48 million after the sale of the company to U.K.-based **Severn Trent PLC**.

Such results have impressed HIG’s backers: The firm last year had to turn down more than \$500 million in raising an oversubscribed \$255 million middle-market buyout fund, its second. Investors in the fund include **Bankers Trust, Teachers Insurance and Annuity Association** and **Yale University**.

High Equity Content

Mindful of tough times ahead, some young buyout firms are taking care to avoid over-leveraging their portfolio companies.

Peter Lamm, president of **Fenway Partners**, the New York buyout firm that specializes in consumer-brand companies, says that in the last four years, the firm has averaged putting in about 45 percent equity toward the purchase of its 15 portfolio companies. Fenway wants the equity to represent at least 30 percent of its deal, he says. While they dilute returns, such high equity contributions bolster a company’s resistance to economic downturns, and free up more capital in the short run to invest in growth.

A case in point is Fenway’s \$110 million equity investment late last year toward the acquisition of **Simmons Bedding Co.**, Atlanta. Co-investors chipped in another \$70 million to take the equity contribution to 36 percent.

Mr. Lamm points out that one reason the bedding industry remains so fragmented is that the industry leaders were so heavily leveraged in the 1980s and early 1990s. Now that Simmons is well capitalized, Mr. Lamm says, the company can begin to think about snapping up some of its rivals.

Such recession-resisting strategies by Fenway, HIG and other young firms should help them stand the test of time—at least in theory. Rest assured, however, that limited partners will remain hard on these young groups, particularly when the next downturn finally hits. After all, says Donaldson, Lufkin & Jenrette’s Mr. Pool: “The true test of a good firm is the ability to make money across cycles.”

By David M. Toll

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One danger for young firms is that they may have chosen too specialized an industry.

Select Young Firms Launched in Mid-1990s

Firm	Key People Include	Fund-Raising Plans / Key Backers
<p>Carousel Capital Co. Charlotte, N.C. (704) 372-2040 <i>Middle-market buyouts in Southeast</i></p>	<p><i>Erskine Bowles:</i> Co-founder, best known as former White House Chief of Staff and founder of Bowles Hollowell Conner & Co. Splits time between Forstmann Little and Carousel. <i>Nelson Schwab III:</i> Co-founder and former CEO of Kings Entertainment Co., operator of theme parks.</p>	<p>Carousel plans to begin raising its second fund, a follow-up to the \$163 million Carousel Capital, L.P., in the next 12 months. \$200 million is a good estimate of the target. <i>Backers:</i> First Union Capital Partners, Liberty Life Insurance Co., NationsBank Capital Investors</p>
<p>Convergence Partners Menlo Park (650) 854-3010 <i>Early-stage information technology</i></p>	<p><i>Eric Di Benedetto:</i> Founder and general partner, previously the managing director of U.S. venture capital funds managed by Banexi, the merchant banking arm of Banque Nationale de Paris. <i>Paul C. Dali:</i> Founder and general partner, previously a venture capitalist at Nazem & Company.</p>	<p>The firm recently launched Convergence Ventures II, L.P., seeking capital from U.S. institutional investors for the first time. <i>Backers:</i> Convergence already has lined up more than \$45 million in commitments from prior backers NEC Corp. and Sumitomo Bank.</p>
<p>Fenway Partners New York (212) 698-9400 <i>Under-performing middle-market buyouts</i></p>	<p><i>Richard C. Dresdale:</i> Co-founder and president, previously a principal at Clayton, Dublier & Rice. <i>Peter Lamm:</i> Co-founder, chairman, and CEO, previously managing director at Butler Capital Corp.</p>	<p>The firm believes commitments to Fenway Partners Capital Fund II, L.P. will shortly take it into the \$850 million to \$900 million range. <i>Backers:</i> First-time investors in the fund include the state pension funds of Oregon, Rhode Island and New York.</p>
<p>Flatiron Partners New York (212)228-3800 <i>Early-stage Internet</i></p>	<p><i>Frederick R. Wilson:</i> Co-founding partner and previously a venture capitalist for 10 years with Euclid Partners. <i>Jerry Colonna:</i> Co-founding partner, and previously the editor of InformationWeek magazine.</p>	<p>Flatiron originally was funded with \$150 million through a joint agreement with Chase Capital Partners and Softbank Technology Ventures. Chase last summer signed back on with Flatiron, committing \$300 million.</p>
<p>HIG Capital Management Miami, Fla. (305) 379-2322 <i>Lower middle-market buyouts</i></p>	<p><i>Anthony (Tony) Tamer:</i> Founder and managing director, previously a partner at Bain & Co. <i>Sami Mnaymneh:</i> Founder and managing director, formerly a managing director at The Blackstone Group.</p>	<p>HIG last year closed its second fund at \$255 million, and has since used it to acquire four companies. <i>Backers:</i> Fund of funds run by Goldman Sachs Asset Management, and the endowments of Massachusetts Institute of Technology and Yale University</p>
<p>Idealab Capital Partners Pasadena, Calif. (626) 535-2880 <i>Early-stage Internet</i></p>	<p><i>Bill Gross:</i> Chairman and founder of idealab!, incubator of Internet businesses. <i>William S. Elkus:</i> Managing director, previously founding partner of Iacocca Capital.</p>	<p>The firm plans to begin raising its second fund this summer, having closed its first at \$105 million in February. <i>Backers:</i> Moore Capital, SunAmerica Inc., Times Mirror Co.</p>
<p>Insight Capital Partners New York (212) 681-7292 <i>Information technology companies with revenue</i></p>	<p><i>Jeffrey Horing:</i> Co-founding partner, previously with Warburg Pincus. <i>Jerry Murdock:</i> Co-founding partner, previously with Aspen Technology Group. <i>Ramanan Raghavendran:</i> Partner, previously partner with General Atlantic Partners.</p>	<p>The firm began raising its third fund in 1998 and closed on \$225 million this spring. It expects to close on another \$50 million by the end of this month. <i>Backers:</i> Fund of funds run by Goldman Sachs Asset Management, Hewlett Packard, Microsoft Corp.</p>

Select Young Firms Launched in Mid-1990s *(continued from page 5)*

Firm	Key People Include	Fund-Raising Plans / Key Backers
Peninsula Capital Partners LLC Detroit, Mich. (313) 877-9960 <i>Mezzanine funding</i>	<i>Scott A. Reilly:</i> Co-founder and president, formerly co-founder of Northstar Capital	The firm on March 31 brought its second fund to \$128 million. <i>Backers:</i> State pension funds of Wisconsin and Michigan
Polaris Venture Partners Waltham, Mass. (781) 290-0770 <i>Early-stage information technology and health care</i>	<i>Stephen D. Arnold:</i> Co-founder and general partner, previously a vice president of broad-band media applications at Microsoft Corp. <i>Jonathan A. Flint:</i> Co-founder and general partner, previously a venture capitalist at Burr, Egan, Deleage & Co.	The firm closed its second fund in 1998 at \$175 million. <i>Backers:</i> Pennsylvania State Employees' Retirement System, Pantheon Ventures Ltd., Wilshire Associates Inc.
Softbank Technology Ventures Newton, Mass. (617) 928-9300 <i>Early-stage to pre-IPO Internet</i>	<i>Charles R. Lax:</i> Managing director, previously a partner with VIMAC Partners LLC. <i>Gary E. Rieschel:</i> Executive managing director, previously in executive positions at nCube and Cisco Systems.	The firm closed Softbank Technology Fund IV last summer at \$320 million. More than half of the fund is committed in more than 35 deals. <i>Backers:</i> Chase Capital Partners, First Chicago Investment Corp., GE Capital
VantagePoint Venture Partners San Bruno, Calif. (650) 866-3100 <i>Early-stage information technology</i>	<i>Alan E. Salzman:</i> Managing partner, previously partner of Canaan Partners <i>James D. Marver:</i> Managing Partner, previously head of worldwide technology at Bear Stearns.	The firm raised \$205 million for VantagePoint Communications Partners, L.P. , its second fund, last year. The firm plans to come back to market in May. <i>Backers:</i> Amoco Corp., Southern Co., Natwest Bank
Vector Capital San Francisco (415) 293-5000 <i>Software and communications companies with revenue</i>	<i>Alexander R. Slusky:</i> Managing partner, previously a product manager with Microsoft Corp. <i>Val E. Vaden:</i> Managing partner, previously founding partner of Benchmark Capital	Vector last month wrapped up its second fund, Vector Capital II, L.P. , at \$150 million <i>Backers:</i> General Motors Investment Management Co., GE Capital, John D. & Catherine T. MacArthur Foundation
Willis Stein & Partners LLC Chicago (312) 422-2400 <i>Rollups and buyouts</i>	<i>Avy H. Stein:</i> Managing director, previously co-head of investments at Continental Illinois Venture Corp. <i>John Willis:</i> Managing Director, previously co-head of investments at Continental Illinois Venture Corp.	Earlier this year the firm closed its second fund fund at \$840 million. <i>Backers:</i> Iowa Public Employees' Retirement System, Princeton University

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