

### ELEMENTS OF EXCELLENCE SYMPOSIUM *REVIEW*

Fairview Capital hosted its bi-annual Elements of Excellence Symposium on November 18<sup>th</sup>, 2010 at the Mandarin Oriental Hotel in New York City. We thank all those who took part in what proved to be an extensive and insightful examination of the venture capital and private equity markets. The event featured panelists representing funds in the Fairview portfolio, as well as a unique perspective on the pharmaceutical industry from Kenneth C. Frazier, President and Chief Executive Officer – elect of Merck & Co. The following is a comprehensive review of each session and panel discussion.



### GUEST SPEAKER

#### Kenneth C. Frazier, Merck & Co., Inc.



Kenneth C. Frazier



To commence the Symposium, Fairview was delighted to have Mr. Kenneth C. Frazier, the President of Merck & Co., as a keynote speaker. Mr. Frazier leads Merck's three major divisions: Global Human Health, Merck Manufacturing, and Merck Research Laboratories, and has been instrumental in Merck's success since joining the company in 1992. Mr. Frazier spoke to symposium attendees about topics relevant to the healthcare industry, including the results of the midterm elections, innovations in biotechnology, and the drug development cycle. Less than one week after the symposium, it was announced that Mr. Frazier had been appointed to the position of Chief Executive Officer effective January 1, 2011.

With healthcare reform a hot topic, Mr. Frazier discussed how the 2010 midterm elections may have further polarized healthcare politics. He pointed to the fact that there are partisans on both sides in favor of, and opposed to, healthcare reform. This combination of differing viewpoints is expected to disrupt the presidential agenda and may result in a change to current healthcare reform legislation; however, Mr. Frazier doesn't expect this to materially alter the final outcome.

On the topic of biotechnology, Mr. Frazier stressed the importance of the sector in unlocking new discoveries in the pharmaceutical industry. Continuously replenishing the research and development pipeline is a difficult challenge for companies of Merck's scale, so collaboration between small, entrepreneurial biotechnology firms and "Big Pharma" is an area of focus that he believes will continue to be fruitful. Ideas occur at every level and Merck, at core an innovation company, will continue to seek out important innovation. Mr. Frazier cited focus, depth, and accountability as the fundamental principles of pharmaceutical development.

Critical to Merck, and other large pharmaceutical companies' growth, are drugs with large sales, also known as blockbuster drugs. With Merck's revenue base of approximately \$46 billion, blockbusters are key drivers of revenue growth. There is still significant residual opportunity to improve health above the current standard, and traditional therapeutic areas are benefiting from research and development efforts. Merck's goal is to come to market with new drugs that have tangible outcomes data that demonstrate meaningful progression towards the treatment of ailments such as heart attacks, strokes, and cardiovascular disease. Individuals who suffer from common conditions such as asthma and osteoporosis stand to benefit most from Merck's efforts in the traditional therapeutic space.

Healthcare reform is poised to provide access to healthcare for over 32 million Americans who previously were un-insured. The ultimate test will be whether policy can allow for the innovation needed to meet the challenge of adequately providing healthcare to Americans. Reform is often synonymous with cost-cutting, and Mr. Frazier cautions against efforts that might stifle innovation in favor of short-term economics. On the whole, he is optimistic about the future growth of the healthcare industry, much of it being driven by innovation.

**PROLIFERATION OF DIGITAL MEDIA**

**New Business Models and Successful Venture Investing In an Evolving Market**

**Moderator**



Rebecca Connolly



**Panelists**



Alex Finklestein



Ran Harnevo



Alan Patricof



Tommaso Trionfi



The first session of the symposium, moderated by Fairview partner Rebecca Connolly, featured two general partners from leading digital media-focused venture capital firms and two digital media entrepreneurs. Each panel member discussed his firm’s approach towards investing or developing products and services within digital media – an area experiencing rapid growth. Consider the following: the amount of digital content now created every two days surpasses the amount created from the dawn of civilization up to 2003; 1 in 13 people on the planet is a Facebook user; Twitter processes 90 million updates per day and 1 billion queries per day; and over 35 hours of video are uploaded to YouTube every minute. The growth figures are undoubtedly overwhelming and tell us technological convergence and ubiquitous internet connectivity are empowering more and more individuals to produce and consume content of ever-increasing quality.

Alex Finkelstein, a General Partner at Spark Capital, first outlined his firm’s thesis for investments in digital media. Spark Capital was founded in 2005 with the belief that digital media was at an inflection point and would soon be disrupted by a variety of trends including ubiquitous broadband, changing social behavior, innovative new devices, and the emergence of real-time data. In order to gain exposure to the explosion of digital media, Spark invests across the entire value chain including infrastructure and content.

Spark’s investment thesis for digital media led the firm to invest in 5min Media, a video syndication company specializing in educational and how-to videos. According to Mr. Finkelstein, the firm thought “how-to videos would be the most monetizable videos on the internet, given that someone watching a how-to video is a super-defined, niche demographic right around a purchasing decision and has intent.” 5min Media was an ideal match for Spark Capital. The company’s primary offering caters to small, niche publishers on the web, e.g. a website dedicated to golfing. 5min Media allows these small, niche publishers to match, for example, their own article about golf strategy with a third-party how-to video about golf technique. The value to the user of each component, article and video, is greater in combination. Currently, 5min Media’s network sees 47 million unique visitors with an average of 31 minutes of monthly engagement per user. The company was acquired by AOL in September of 2010.

The second General Partner featured in the session was Alan Patricof of Greycroft Partners. Greycroft Partners is an early stage venture capital firm focusing on digital media. The firm was founded on the realization that large venture funds tend to over-capitalize early stage companies, which eliminates many likely exit opportunities. With seemingly all firms striving towards ever-increasing fund sizes, Mr. Patricof sought out opportunity in the vacated space with a \$75 million fund in 2006 to focus investments solely on products delivered over the internet or to mobile devices.

Greycroft’s investment in Ixtens is demonstrative of the firm’s digital media focus. Ixtens’ mission is “to power the emerging wave of online marketplaces for retailers and media companies.” More specifically, Ixtens’ products power multichannel ecommerce marketplaces. For example, if a retailer wants to sell multiple products across multiple online destinations, Ixtens would be an ideal solution provider. Ixtens provides the software needed to manage a complex, online-retail strategy. It is Greycroft’s belief that the developments in digital media are so compelling that merchants will continue to pursue retail opportunities online for years to come.

As digital media continues to grow, we continue to reach unthinkable milestones in terms of content production and consumption. This rapid development of digital media shows no signs of slowing. Today’s firms are emphasizing business models with tangible revenues, and as long as development continues at a healthy rate and users continue to derive utility from consumption, opportunities should be plentiful.

**SUCCESSFULLY ACHIEVING LIQUIDITY****Perspectives from Growth Equity and Lower Middle Market Veterans****Moderator**

Edwin Shirley

**Panelists**

Tom Crotty



Bruce Eatroff



John Hayes



In the second session of the conference, moderated by Fairview partner Edwin Shirley, three experienced general partners with track records of successfully harvesting investments – Tom Crotty of Battery Ventures, Bruce Eatroff of Halyard Capital, and John Hayes of Great Hill Partners – shared their perspectives on achieving liquidity. For the past several years, growth equity and lower middle market investors have faced unprecedented liquidity challenges as the recession limited exit paths for many companies. Nonetheless, against this difficult macroeconomic backdrop, skilled investors have adapted and found creative ways to produce meaningful liquidity. Successful exits *can* be attained, as long as investors remain cognizant of, and astutely navigate, the challenges and opportunities the market presents.

For much of the last three years, traditional exit opportunities have been difficult to access. Private equity investors have had to work extremely hard to achieve major asset sales and, due to the reduced number of selling opportunities, investors have been forced to extend portfolio company holding periods. Although the exit market has improved in 2010, Mr. Eatroff described the investment environment as being “at best – choppy.” While strategic buyers have emerged when acquisition targets offer synergies with existing portfolio companies, many companies that have been put up for sale recently have been received with lackluster interest. Mr. Eatroff pointed to the fact that “a number of assets hit the market in the second half of the year triggered by the tax law changes and a number of them did not clear.”

One key area where private equity fund managers may want to focus is closely aligning the interests of all members in a particular deal syndicate to take advantage of opportunities when they are presented. Mr. Crotty recounted that, in the past two years, four deals occurred in which an offer was received; however, syndicate members disagreed as to whether or not to accept the offer price and sell the portfolio company. “A lot of times, decision-making on exits in our industry has little to do with the product/market situation and far too much to do with what’s going on within these funds,” added Mr. Crotty. Investors should take steps to insure that potential syndicate members will be aligned for the life of the investment.

Subdued buying interest and increased scrutiny of transaction terms over the last three years have also created a large inventory of ready for sale private equity-backed portfolio companies. Mr. Hayes and Mr. Eatroff agreed that 2011 will be an active year for private equity-backed exits. Many firms will be looking to sell companies as they trim down their portfolio. Mr. Hayes acknowledged that with so many firms looking to sell, there may be a ‘crowding out effect;’ however, he offered reassurance that good companies will not be overlooked: “If you have a good company, it’ll rise to the top. It will get the attention it needs to get a good multiple and if the company needs more development, we always feel like we have the flexibility to keep it within the portfolio and continue to let it grow and develop to the point where it’s really ready to move on to its next stage in the hands of a new set of owners.”

The recent macroeconomic environment has also changed seller expectations. Mr. Eatroff highlighted the fact that entrepreneurs have become more aware of risk. Consequently, entrepreneurs are more willing to consider selling a stake in their companies as opposed to a full outright sale of all equity in the company. Even though entrepreneurs might be bullish on their business or sector, many entrepreneurs are using liquidity events as an opportunity to de-risk personal wealth. Mr. Crotty added that the tightened liquidity environment has popularized earn-outs among entrepreneurs who are reluctant to accept low valuations. Reduced liquidity has made it difficult for investors to meet entrepreneurs’ asking price and many deals are being transacted with significant earn-out provisions.

Looking ahead, there seems to be plenty of reason for optimism. Mr. Crotty believes the level of activity is trending in a positive direction and sees considerable momentum going into 2011. Mr. Eatroff cited the significant amounts of cash on the balance sheets of large technology companies coupled with the inventory of PE-backed companies as a source of optimism for 2011. Mr. Hayes added that he believes the increasing availability of leverage will lend to a stronger deal market in 2011. Keeping lessons learned from the last three years in mind, perceptive private equity managers should be well positioned to provide meaningful liquidity to their investors.

## PRIVATE EQUITY IN EMERGING MARKETS

## From the Exotic to Mainstream

## Moderator



Kola Olofinboba  
FAIRVIEW  
CAPITAL

## Panelists



Tom Barry



Vispi Daver



In the final session of the symposium, Kola Olofinboba, a Partner at Fairview, discussed Emerging Markets private equity with Tom Barry, CEO & Founder of Zephyr Management and Vispi Daver, Partner at Sierra Ventures. The compelling macroeconomic and demographic trends driving growth in emerging markets make for an attractive opportunity for private equity investment. For example, by 2014 the GDP of emerging economies is forecast to surpass that of developed economies and by 2030, the labor force in emerging economies is expected to grow by over 75%, while the labor force in Western developed economies is expected to remain at 2010 levels.

According to Mr. Daver, robust emerging economies are characterized by strong GDP growth coupled with high purchasing power parity; a transition from export-driven growth to growth fueled by domestic consumption; and growth in the size of the middle class. China and India are two emerging market countries that exemplify these characteristics with expanding middle classes driving domestic consumption growth. Each has about 60 million middle class households – constituting 25% of each nation’s population. The US currently also has about 60 million middle class households, but this constitutes 70% of the national population. In the next 10 years, there will be “over 100 million households each in China and India that are middle class and that will still be less than 40% of the total population, so headroom is pretty phenomenal in terms of domestic consumption,” said Mr. Daver. These middle class populations will be poised to purchase financial, travel, and hospitality services, in addition to autos, and many of the other goods and services enjoyed by middle classes worldwide.

Emerging market countries traditionally begin their economic development exporting natural resources and low labor cost goods to more developed markets. The current shift away from export-driven growth, to growth driven by domestic consumption is building sustainable economies that are less reliant on international trade for economic viability. As economic growth brings more and more people into the middle class, these individuals enjoy goods and services previously unavailable to them. “There is a very rapid J-curve of expenditures once a family gets above subsistence level with regards to food and housing,” Mr. Barry added.

The robust growth in domestic consumption has provided several attractive private equity investment opportunities across various emerging market sectors. Mr. Barry pointed out that his firm is bullish on a number of sectors in emerging markets, such as retail banking, mobile phones, and insurance. Mr. Daver added two areas his firm has invested in are the travel and auto space through MakeMyTrip.com, an online travel agency, and CarWale, an online shopping utility for car buyers. While economic activity is growing rapidly in emerging markets, Mr. Daver commented that the current trend is for business models to focus more on organic growth versus disruptive growth; in emerging markets firms face less competition from incumbents and thus are less likely to need to

disrupt the business models of others in order to carve out market share. In the future, Mr. Daver expects this trend to reverse as sectors in emerging markets mature and market participants are forced to depend more on innovation to remain competitive.

While a booming macroeconomic environment is positive for investment returns, corruption and other risks are a constant threat to investments, particularly in emerging markets. Mr. Barry acknowledged that certain risks are more prevalent, but that these risks are largely avoidable. His firm, Zephyr Management, values transparent pricing: “If there is competitive pricing in the marketplace, there isn’t room for economic rent and that’s all corruption is – economic rent where someone arbitrages the access to a business. We carefully study businesses to make sure they are fully transparent and fully competitive, so there isn’t room for anyone to charge ‘rent.’”

Many institutional investors have begun investing in emerging markets solely through public equity markets. Mr. Barry encouraged diversifying exposure beyond public equity markets largely due to the fact that most exchanges have few listed companies and even fewer securities which are traded on a daily basis. Public equities typically do not represent a very considerable fraction of gross national product in emerging markets and thus are not well correlated to the growth in domestic consumption.

Given rising interest in the emerging markets by institutional investors, questions concerning optimal portfolio exposure naturally rise. Currently, emerging markets constitute 37% of global GDP and are forecast to grow to 59% of global GDP by 2030. However, the MSCI Global Index has an emerging markets component only equal to 13%. Mr. Barry propositioned, “If 40% of the world’s GDP is in developing countries, why wouldn’t one have 40% of his portfolio in these countries because of their rapid growth rate – even if you reduce a little bit for liquidity, it’s very substantial.” Emerging markets private equity undoubtedly presents a substantial opportunity for investors, who, if prudent in their approach, can access one of the greatest growth stories of our time.