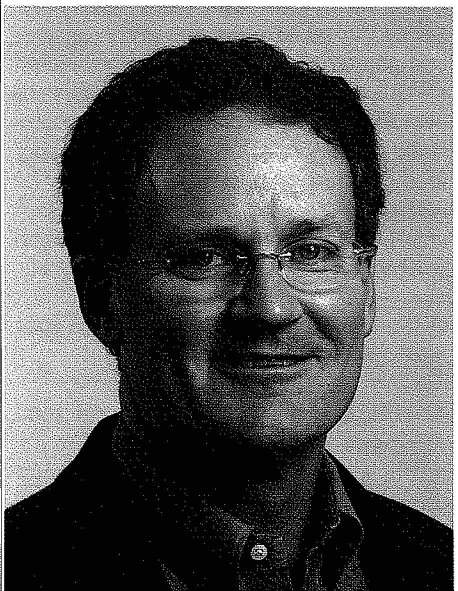
GUEST ARTICLE
HOW TO SUCCEED IN A FLAT WORLD



JIM HUSTON
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Should LPs be happy that their GPs are off to Shanghai or Mumbai several times per quarter to get into the hottest new deal and attend board meetings?

One of the best business books of 2005—or at least the most talked about at tech conferences—is "The World is Flat" by Thomas Friedman. The book offers a well-articulated vision of how a confluence of several events and technologies have already created a "flat" world where outsourcing is the norm, no market is safe from foreign competition and any value-added process that can be digitized—from reading X-Rays to designing drugs to developing software to writing patents to content creation to (gasp) venture capital—can and will flow to the most efficient producer in the world. Schumpeter first described this in 1942 as "creative destruction." But he didn't see creative destruction on such a global scale and brought to you through a broadband pipe on Internet time.

Many VCs are adapting to this new "flat" reality by rushing to create a China strategy or India office. While there are already several examples of winning deals, with Baidu being the most recent example, the risks for a Western VC to invest into an Asian startup (even with the aid of a local partner) remain enormous—including lack of governance and transparency, lack of IP protection (in China at least) and the immense distance. Adding value to a company located 10-12 time zones away is giving new meaning to the word hyperbole. So much for the 30-minute rule! Did we say 30-minutes? We meant 30-hours. And besides, it's not about mentoring entrepreneurs and growing companies, it's about making money, goddamnit. Did you say First Class was sold out?

Should LPs be happy that their GPs are off to Shanghai or Mumbai several times per quarter to get into the hottest new deal and attend board meetings? Or that their GPs are investing in Chinese funds—i.e., becoming LPs themselves? Undoubtedly there will be some great companies created in India and China over the next decade. And any entrepreneur or investor who ignores the implications of a flat world on their supply chain or customer base is foolish at best. But what is less clear is whether the investment upside is likely to accrue to U.S.-based VCs and their LPs, to India-based or China-based investors, or to more geographically-suited investing neighbors like Taiwan or South Korea. It is also less clear if there will be political fallout to pension funds and endowments that profit from investments which are clearly at odds with interests of their constituents due to loss of jobs or the perception of lower environmental and human rights standards. For now, the rush is on.

But is there another way to profit from the global I-want-it-now-and-I-want-it-cheap flat world that we are now living in?

Friedman attributes India's rise to technological prominence to getting the benefits of being the "Second Buyer" for much of the broadband technology created during the Bubble Era. The Second Buyer is an entity that is able to pick up assets on the cheap after someone else has over-invested (like Mr. Potter in "It's a Wonderful Life," who kept his head during the early days of the Depression and bought up most of Bedford Falls on the cheap when everyone else panicked). When the S&L industry was in crisis in the late 1980s and Drexel blew up, firms like Apollo and Blackstone capitalized on Second Buyer merchandise and create liquidity in the distressed debt market. The private equity world has a long track record with a Second Buyer investment thesis with distressed debt funds, including Oaktree Capital, Cerberus, Littlejohn & Company and others.

India clearly benefited from the massive over-investment in trans-Pacific communications infrastructure, allowing engineering, customer support and product development to be done cheaper and more easily in Mumbai or Madras than in Manhattan or Memphis. India was an effective "second buyer."

GUEST ARTICLE

Our firm leverages the benefits of the Second Buyer investment thesis with its focus on early stage corporate IP spinouts. In these deals, Blueprint works with corporations to extract technologies and form new companies. These technologies have the benefit of leveraging someone else's investment before taking their first institutional dollars. In these deals, the parent still benefits from the success of the spinout at a minimum through their equity participation, and in some cases through the market knowledge and relationships developed through their work with the spinout. These technologies become candidates for spinouts because they have been "stranded" inside large organizations that either lack the market capabilities or are strategically impaired from further investment in them. By structuring a spinout, all parties can benefit as a Second Buyer with the parent receiving an opportunity to recover its initial R&D investment through an exit event down the road.

Corporations are a great source for spinouts because they invest so much more than universities or government labs in research. In 2004, U.S. corporations spent about $140 billion on R&D, while all government research funding—both for universities and government labs—was only about $70 billion. The Second Buyer opportunity in spinouts becomes a very clear path of building new companies based on someone else's R&D investment. The disparity in patents is even more marked. The top four U.S. companies on the USPTO list in 2004 were IBM, HP, Micron Technologies and Intel, with 3,248, 1,775, 1,760 and 1,601 issued patents, respectively. Contrast this with the top universities, where the University of California system topped everyone with 424 issued patents in 2004, and Caltech and MIT coming in next with 135 and 132 patents respectively—an order of magnitude difference from corporations. This massive investment in technology by large corporations creates a very ripe opportunity for VCs—and thus their LPs—to capitalize on the Second Buyer opportunity.

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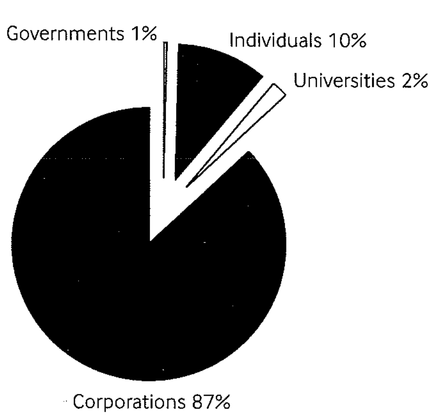
The Patent Pie (2004)



Another emerging private equity space that capitalizes on the Second Buyer thesis is the direct secondary market. In a direct secondary transaction, corporations and financial institutions (and in some cases GPs themselves) sell their interests in still-private companies to better focus their resources on strategic investments, to rebalance their portfolios or to generate liquidity. The direct secondary market has grown from virtually nothing in 2000 to over $500 million today with projections to be over $1 billion by 2008. One of the leading players in the direct secondary market is W Capital. Over the last several years, W Capital has raised a $250 million dollar fund and completed 16 portfolio acquisitions with the world's leading corporations, financial institutions and venture capital firms. Not surprisingly, this is a very "quiet" segment of the private equity universe where most transactions are never disclosed. But it is safe to say that the GPs running these direct secondary firms, such as David Wachter at W Capital, are savvy business people who are able to create deal structures that work for buyer and seller. Mr. Wachter is, effectively, a great Second Buyer.

While Schumpeter's Creative Destruction remains a driver of capitalism, and in fact has accelerated in the "flat" world of Friedman, the world of private equity is working to figure out how best to capitalize on it. We believe that pursuing a Second Buyer strategy in our own back yard is a better way to profit than by jumping on the next jet to Asia. But we'll sure miss those frequent flier miles.

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