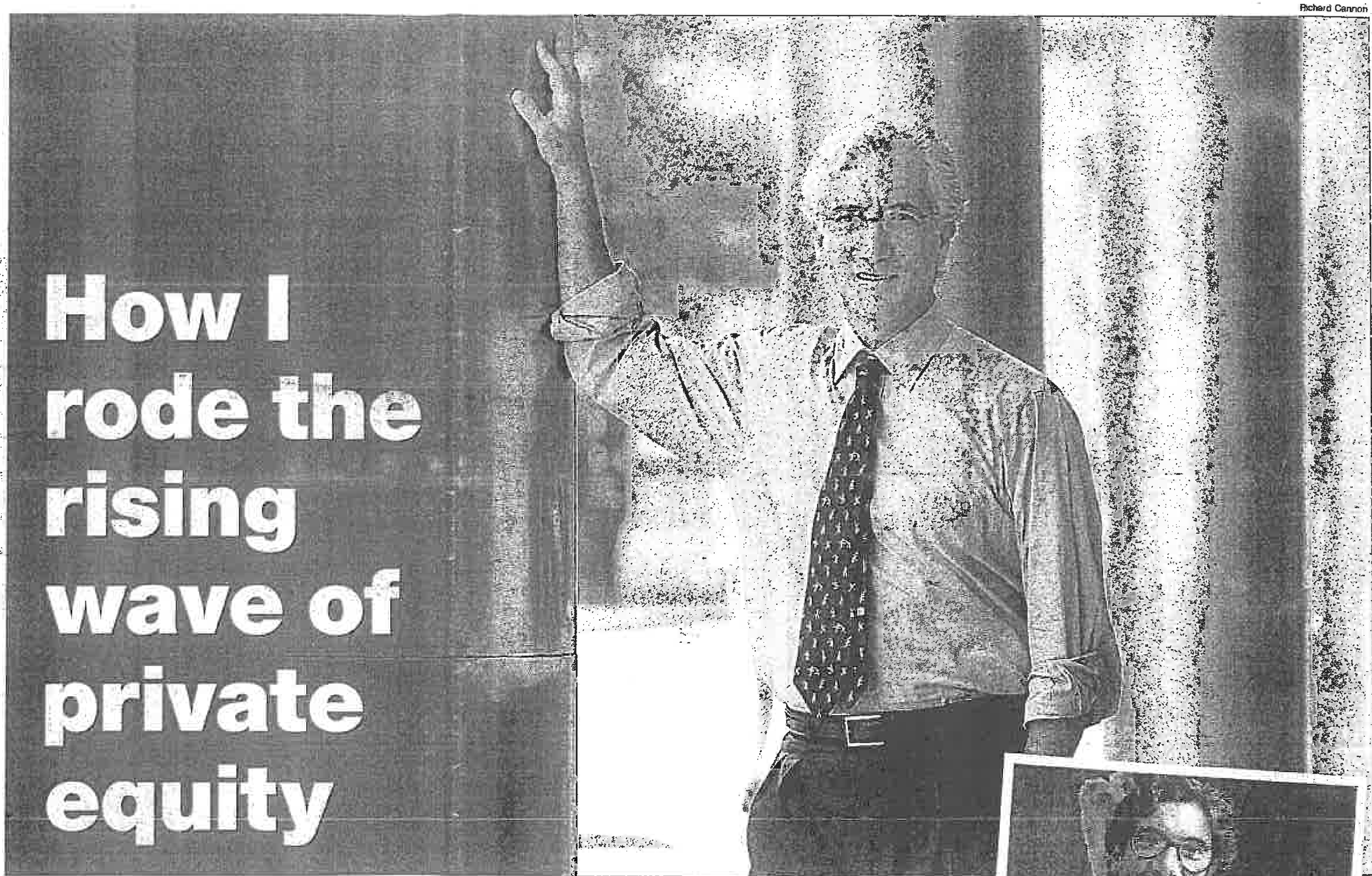
In his new book **Sir Ronald Cohen** explains how he latched on to private equity in its infancy and then rode it to the top with Apax Partners

How I rode the rising wave of private equity

Richard Cannon



WHEN do you discover that you are cut out to be an entrepreneur? To answer this question, it might be useful to look at the example of my own career.

I was born in Cairo. As a child I spoke French at home. Arabic was my second language; I did not speak English at all. Then, when I was 11 years old, President Gamal Abdel Nasser's reaction to the Suez crisis made the life of a Jewish family like ours very difficult.

Because my mother carried a British passport, we were forced to leave. We were allowed to take 10 Egyptian pounds and a suitcase each; we had to leave everything else behind. I left clutching my stamp collection and remember worrying that somebody might take it away from me. We moved to London.

Once we settled in, I went to a state school in northwest London. I started with the disadvantage of not speaking the language. Even so, I performed reasonably well in my first year, especially in those subjects where mastery of English was not required. By my second year, I had grasped the language sufficiently to move up to the top of the class.

I studied politics, philosophy and economics at Oxford. Again, I was an active and ambitious student and in my third year opted for what might be called public life by standing for — and winning — the presidency of the Oxford Union.

The high point of my presidency was Robert Kennedy's acceptance of an invitation to speak. There were crowds when he arrived; he stood on the roof of a car to speak to them in the street before going in to address the students in the debating hall.

At Oxford, I did not really think about the road beyond. My father, Michael, forced to start all over again in Britain, did quite well in business at first, but my parents' financial future was not assured. Providing some measure of security was an obligation of which I was very aware.

By the time I left Oxford in 1967, my father was 54 years old. At the age of 30 he had

box. In the first year of our professional partnership, 1972, we considered what would have been one of the first private-equity buyouts in Europe, of the French crane manufacturer Potain. For the deal to make financial sense, the equity investment had to be leveraged with a significant amount of debt (just as one mixes equity and debt when one raises a mortgage to buy a house). But in those days it proved impossible to raise the debt that was needed for that kind of transaction. We had the idea, but not the means. We were a decade too early.

To complicate matters further for me, in 1973 there were 3m unemployed in Britain, a global oil crisis and a British coalmin-

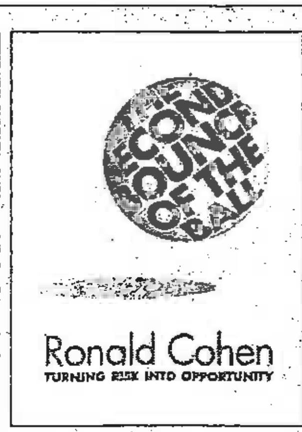
THE SECRET LIES IN ANTICIPATING THE 'SECOND BOUNCE'

IT was our first chairman, Maurice Schlogel, who used to encourage us to anticipate "the second bounce of the ball", as he called it.

Where and when will it bounce next? If you really understand your market, you will get to the correct answer. You will be able to take advantage of the next bounce of the ball, the one that is hard to judge.

In the private-equity industry the first bounce of internationally in 1988 or 1990, as we did at Apax, instead of waiting until the multi-country bounce took place in 2000, you would have gained an advantage and raised and invested larger funds than strictly national competitors.

The current bounce of the ball is the global one: funds that are not limited to particular territories but can be invested anywhere — in America, Europe, Japan,



companies that had a significant demand for computer power and tailored software — such as insurance companies — and said: "You are spending so much on your mainframes. We can shift you to PCs and you will be able to do all these things much more cheaply than you can today."

Computacenter invested in a sophisticated, IBM-style sales force to address business clients. It became

By the time I left Oxford in 1967, my father was 54 years old. At the age of 30 he had moved from working for a bank to setting up his own trading business in Egypt, importing and exporting goods. Perhaps it was from him that I picked up the idea of working for myself.

I was a product of the 1960s: idealistic and wanting to make a difference. But I would have to make money somehow. My father suggested that I would be better prepared for employment if I completed my education by going to Harvard Business School.

It was at Harvard that I made my first real contact with the world of business and money. In those days ambitious business-school graduates looked forward to careers in big business, not enterprise. But, as luck would have it, I arrived, in 1967, just in time to witness the beginning of two waves that, over the next three decades, changed the shape of business around the world.

The first was the wave of entrepreneurship in new, high-tech industries such as information technology and life sciences. The second was the wave of venture capital that financed the high-tech entrepreneurs.

As expected, Harvard made me eminently employable, and I got an offer from McKinsey, the management consultancy firm. But my nature is not to advise but to do, and to lead. I left McKinsey after about two years to reconnect with my Harvard colleagues and to launch the company, Multinational Management Group (MMG), that was eventually to become Apax Partners.

We launched MMG to provide advisory services to entrepreneurial companies. We knew we wanted to create a firm that was advising and, later, investing in growth businesses, but young companies, by definition, are not able to pay big advisory fees.

So we focused on advising larger entrepreneurial companies on international expansion, raising capital through private placements, and advising on mergers and acquisitions (buying and selling companies or divisions of companies), especially where the transaction involved parties on both sides of the Atlantic.

It was, however, seemingly the worst time to start a venture like MMG, and successes were hard to achieve. The entrepreneurial wave that had started to form in America had not yet reached Europe, where there was no venture-capital or private-equity industry at all; rates of income tax were high (in Britain, the addition of a surcharge on investment income meant that the highest marginal rate of personal taxation was 98%); and there was little entrepreneurial activity.

We tried to think out of the box for me, in 1975 there were 1m unemployed in Britain, a global oil crisis and a British coalminers' strike that led to a nationwide three-day working week. In 1974 there was the secondary banking crisis, in which several smaller London banks went to the wall. And from 1974 to 1978 there was a deep recession.

Sure enough, we struggled, and in 1975 two of the founding partners pulled out. I had a conversation with my father about what to do. He advised me to stick with it. I knew that developing an international firm advising and, more especially, investing in young, growth companies was the right thing to go for and, with my father's encouragement, I persevered. I had not turned my back on a career at McKinsey only to quit at the first obstacle.

I thought it was crucial formally to maintain the partnership even if two out of the original four were leaving.

With (chairman) Maurice Schlogel's moral support, Maurice Tchénio and I stuck with it, albeit in more of an arm's length relationship than before. Neither of us was in for an easy journey. For the next nine years, every time I finished one corporate-finance transaction I had to start another, just to earn the fees to cover my overheads. But by sticking with it, Maurice and I eventually derived the advantages that came from being among the first movers in the fast-growing and highly profitable new field of private equity.

The term "private equity" has come to be applied in imprecise ways, sometimes to include venture capital and at other times to be almost synonymous with buyouts. As I use it, it takes in the whole spectrum of investment in unquoted shares: venture capital in new and early-stage companies; expansion capital in more established firms; buy-ins of under-managed firms requiring an injection of new management; and buyouts of profitable companies of every size.

There have always been privately financed companies. Private equity existed in 14th and 15th century Italy, where merchant bankers would fund enterprise and trade. In the 16th and 17th centuries, when European traders were travelling to the New World and the Far East, voyages were funded by private investors, each of whom took a share of the risk and a share of the profits in proportion to his or her investment.

By custom, the captain of the ship took 20% of the value of the cargo. That rule still applies: private-equity firms generally take a carried interest of 20% of the capital gain made by the funds under their management. Then in the 19th century there were the private banks — Barings, Rothschilds and others — which were funding private businesses.

'Tony Blair's Labour government, which came to power in 1997, gave the sector its biggest boost'

The difference today is that the private-equity industry is not run by ship captains or bankers but by firms for whom private-equity investment is a profession. Our skill lies in our long-term professional approach to taking business risk.

We raise funds, almost entirely from pension funds and institutional investors; we identify companies in which to invest those funds; we take large-enough shareholdings to have real influence over the companies' affairs; we have a clear strategy in view for growth and for exit; we strengthen the boards and executive teams of the companies in which we invest and we make resources available for strategic initiatives.

Unlike the public-company model (that is, the model of companies listed on a public stock exchange), in which shareholders are a long way removed from operational and even strategic issues, the private-equity model is one of close involvement by empowered, expert investors.

I wanted to raise large funds from institutions — funds that we could invest at our discretion in a number of ventures over a long period of time, in the process earning management fees and a share of the increase in the funds' values (the 20% interest, which investors in the fund "carry" for the fund's managers). That was what was already happening in America. It was the business model to aim for.

In stark contrast to America, however, conditions in Europe did not favour entrepreneurship. Entrepreneurship requires an enabling environment, including low rates of tax on capital gains, supportive stock markets and policy initiatives to support enterprise and small businesses, such as only governments can provide. There was no such environment in Britain or any other European country.

Conditions improved when Margaret Thatcher became prime minister in 1979. Her administration brought down the highest rate of personal taxation to 40%, which led to a significant change of sentiment in Britain, away from a "nine-to-five" mentality and towards an appreciation of the value of hard work.

However, for all the pro-entrepreneur sentiments of Thatcher's successive chancellors of the exchequer, they did little actually to promote entrepreneurial investment. Certainly, the Thatcher era left Britain with a far better business culture than before, and with lower levels of income tax, but we were still saddled with high rates of capital gains tax and an unclear position about the role and status of entrepreneurs.

It was Tony Blair's Labour government which came to power in 1997, that gave the sector its biggest boost. Blair spoke up in favour of institutional investment in private equity.

In 1998, chancellor of the exchequer Gordon Brown reduced capital gains tax on business assets from 40% to 10%, which gave an immediate positive signal to enterprise. He appointed the respected City figure Paul Myners to look at institutional investment in private equity, resulting in a positive transformation of British institutions' understanding of the sector.

Brown did this as part of a clear strategy to make the British economy more entrepreneurial, competitive and capable of steady growth and full employment.

Today, private-equity funds account for about $1,500 billion (£720 billion) of investment capacity (if we include debt, leveraged to equity at about 2:1), compared with more than $40,000 billion of stock-market value across the world. So private equity represents less than 4% of the value of quoted shares.

By every significant measure — growth, employment, investment, productivity and profitability — private equity has outperformed the publicly quoted market by a substantial margin. If that margin is reduced in future, it will be because private equity has provided a new yardstick by which to measure performance.

In private equity, the interests of the company, its management, the private-equity fund managers and the private-equity fund investors are all in alignment. In the public-company model, the interests of management and shareholders are all too often in conflict.

Anyone old enough to remember the economic climate in the 1970s will know that there has been a massive improvement in the world of enterprise and business since then, and that the benefits have been widely, if not universally, shared. Private equity can be proud to have been a significant contributor to that improvement.

Extracted from The Second Bounce of the Ball: Turning Risk into Opportunity by Ronald Cohen, to be published by Weidenfeld & Nicholson on November 8 at £20. Available from The Sunday Times Booksfirst for £18 (free p&p) on 0870 165 8585

Pillar of the sector: Cohen today, top, and in 1986 when buyouts were taking off

In the private-equity industry, the first bounce of the ball in America and, later, in Europe, was venture capital, backing start-up or early-stage companies.

The second bounce of the ball was buyouts, where private-equity firms bought established, generally private companies that were not achieving their full potential.

The next bounce of the ball was funds that could be invested in a number of countries, not just one.

If you saw these bounces ahead of time, you could be ahead of your competitors. If you opened offices be invested anywhere in America, Europe, India, China or the rest of Asia.

We have seen a sequence of bounces in all industries. A bounce often follows a change in the trend or a turn in the cycle.

In the computer industry, for example, at the time when the switch from mainframe to personal computers was about to occur, some thought that the second bounce of the ball would be that businesses as well as consumers would buy PCs from retail outlets.

Apax made an early-stage investment in a company called Computacenter that thought differently. The insight that Computacenter had was that if businesses were going to buy a large number of computers, they were not going to do it by queuing in line at a retail store. They were going to need — and they would expect — a sophisticated supplier.

Computacenter, which correctly anticipated the second bounce from mainframes to PCs in the business world, went to big sales force to address business clients. It became a trusted supplier in a new field because it anticipated the second bounce correctly and invested to take advantage of it.

Later on, as the market developed, Computacenter realised that there was a further opportunity in the marketplace to buy back all the computers it had installed in its clients' offices — because the clients were struggling to manage their PC networks — and to run them on the clients' behalf. Instead of companies buying their own computers and having their own IT people, Computacenter offered: "We'll take all this burden off your back."

This is an example of anticipating the bounces of the ball in the market trend. If Computacenter had not taken advantage of these opportunities, somebody else would have.

Computacenter floated on the London Stock Exchange in 1998, achieving a value of just over $2 billion (£960m). It was a successful investment for us; we made more than $500m.

EGOTISTICAL TECHNOLOGISTS WHO ARE BOUND TO FAIL

IN the early 1980s, I sat on the board of Sir Clive Sinclair's company, Sinclair Research. He was identifying market opportunities on the basis of his remarkable, imaginative grasp of the possible impacts of convergent technologies.

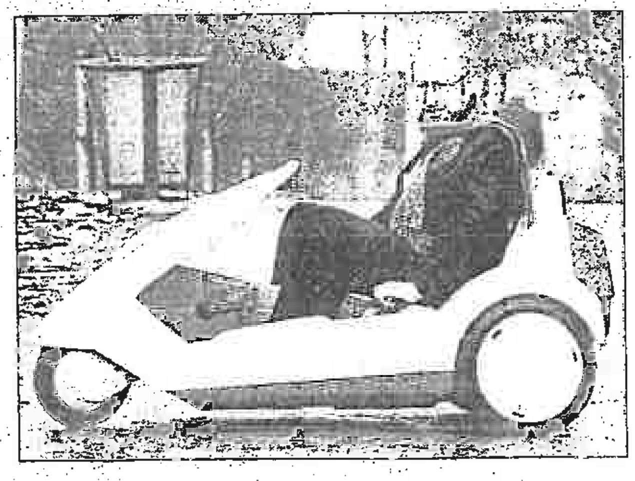
Identifying market opportunities was crucial for the high-tech entrepreneurs of the 1980s and 1990s. While Sinclair had a brilliant understanding of technology and technological convergence, and enjoyed success with his electronic calculators, computers and portable televisions, management was not his strength.

When you look at high-tech ventures, the people who had the vision were often technologists who could not manage. Those who went on to be successful were the ones who realised this, brought in good management and allowed the management to get on with it. The ones who failed tried to do everything themselves.

Clive Sinclair tried to do everything himself. In addition, he insisted on the infallibility of his own personal reading of the market. He wanted to revolutionise the car industry with his diminutive C5. He thought he could do it because he believed he was the man who could revolutionise everything. He designed the C5 in secret, with little input from outside, and the car was a failure as a result.

Ego let Sinclair down in his relations with his investors. You cannot pour all your energy, against everybody's advice, into a car rather than a computer. You must stick to the plan investors backed, or else get their approval for change. In the event, we succeeded in keeping the C5 car out of Sinclair Research.

But I and two other non-executive directors eventually resigned from the board because we felt that, despite his undoubted talent, it would be impossible for Sinclair to succeed.



Sir Clive Sinclair and his C5 in 1985: he wouldn't listen