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THE U.S. INSTITUTIONAL PRIVATE CAPITAL MARKET: A TURBO TOUR

James T. Bartlett*

I. INTRODUCTION

From its origins as a loose federation of informal private investors and partnerships established in the early 1970s, the Institutional Private Capital (IPC) industry has emerged as a major force fueling the growth of private enterprise in the United States. Approximately 250 billion dollars of institutional capital has been assembled to invest in promising companies ranging from start-ups to large, mature businesses. The robust growth of the domestic IPC industry has spilled over into international markets. Virtually all of the major industrial nations now support, to some degree, an IPC infrastructure of firms and funded pools of private capital.

IPC has become an established asset class with validated returns and sophisticated management deeply experienced in private investing. As a result, U.S. pension funds, endowments, and corporations no longer hesitate to commit a significant percentage of their assets to IPC (ranging in some cases up to twenty percent of managed assets). The reason is simple. IPC has developed a proven track record of delivering superior returns over long cycles, even taking into account the risks inherent in private investing. In a few short years, it has moved from being a curious phenomenon pursued by a small fraternity of individual investors and eclectic firms to an institutionalized business with a powerful impact on the U.S. economy.

II. THE IPC MANAGERS

IPC is controlled by several hundred private partnerships in the United States.1 These partnerships are delineated by: a) the amount of capital under

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1 Exclusions to this generalization are domestic and foreign bank holding companies and corporations with private equity subsidiaries (e.g., Intel, GE, IBM). Often, however, these investors look and act like private partnerships in their management structures and compensation practices.
management, b) their particular style of investing, and c) the specific industry sectors and/or geography they cover.

The largest firms are typically categorized as Leveraged Buyout Funds (LBO funds) and may have as much as several billions of dollars (U.S.) under management. These firms tend to concentrate on a few large transactions per year, typically seeking to buy control of divested divisions of public companies, to purchase large private companies, or to take private heretofore publicly traded companies. They may commit from under 100 million dollars to well in excess of one billion dollars to a single transaction. LBO firms are typically the most astute financial engineers in the industry, relying on innovative financing structures and terms to shape their prospects for superior returns. Typically, they use leverage (high debt-to-equity ratios) and are riveted on cash flow management in their portfolio companies. Often they are able to generate returns not by growing enterprises, but by raising cash to retire debt through rigorous control of operating costs, current assets, and capital expenditures. LBO funds are quite catholic in their tastes for specific industries or geographical settings, seeking first and foremost companies that can support leverage and that are well-managed. Most important to them is a sound management team that knows its markets and can generate cash flow, not a specific industry.2

Next in line are the smaller private equity investors, often referred to as middle market firms. They concentrate on smaller companies and smaller transactions than those sponsored by the larger LBO funds. The same formula applies, however: invest in well-managed businesses with predictable cash flows that can be leveraged. Some of these smaller firms have concentrated on a relatively new investment phenomenon, the so-called “roll-up strategy.” The basic premise is to find a stable base company, preferably with industry leadership and sound management, operating in a market that is highly fragmented and characterized by under-managed “mom and pop” businesses. Using creative financing techniques and an aggressive acquisition model, they “roll up” a series of like companies then manage them as a streamlined, centrally controlled enterprise. Recent examples of roll-ups in the United States include the consolidation of auto body repair shops, funeral homes, pet food stores, beauty salons, insurance agencies, and automobile dealerships.

At the more speculative end of the market, defined by the amount of capital typically under management and the nature of the companies in which they invest, are the venture capital firms. The entire range of IPC investing is

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2 There are exceptions. Some LBO firms are now beginning to concentrate their efforts by industry, seeking to capitalize on special relationships, management contacts, or industry expertise to enhance performance.
at times referred to as venture capital, but this is a misnomer. Venture capitalists invest in a wide spectrum of opportunities, from early-stage companies, often pre-revenues, up to companies with established products and markets seeking the private equity needed to accelerate growth. Rarely does a venture capital firm invest in an already publicly traded company. Further, a venture-backed company in the early going typically avoids debt save for modest working capital lines. Every capital dollar is earmarked for product or market development and assembling the necessary organization to manage growth. Debt is anathema to most venture investors; paying interest is considered a misallocation of precious capital needed to fuel growth.

In contrast to buyout firms, venture capitalists tend to specialize by industry sector or, in some cases, focus on a geographic market. Specialization forces a concentration of talent and experience, where successful investing requires deep technical expertise to accurately assess trends and evaluate the odds of a new product's success. Biotechnology and medical devices are two sectors where a deep understanding of the specific science and the needs of the marketplace distinguish the successful investor from a gambler. The geographically focused investor covers the ground intensively, seeking to dominate the sources of investment opportunities in its region. At times, the two forms of specialization—industry and geography—converge in a single firm. The declared focus of one successful venture investor I recently visited in an active Western U.S. market was to invest only in telecommunications companies within 100 miles of Denver.

Most firms in the IPC industry are organized as partnerships, both in legal form and management style. Competition for good investment ideas is particularly keen in the U.S. market and is getting more so with each passing year. To companies needing capital, a swift response ahead of competition often makes the difference between a winning firm and one with modest results. Swiftness translates into streamlined decision-making and the ability to shift resources on a moment's notice. This environment is ideally suited to the partnership model of management: flat structures, bare bones administrative reporting, team decisions (as opposed to a chain-of-command), and the ability to re-balance staff resources weekly or daily if necessary.

IPC industry compensation is attractive by most standards, with a heavy emphasis on sharing realized gains with limited partners, who are the source of capital put to work by IPC firms. The owner-managers of IPC partnerships are motivated to generate attractive returns for their limited partners because those returns in turn translate into a big payoff for the managers. This aligning of interests—you win if I win—has been one of the drivers behind the growth of IPC in the United States. The potential financial rewards for managers are such that IPC has become one of the two or three most sought after...
careers for top-flight business school graduates and first rate managers from other financial sectors. At the same time, by producing stellar returns for their limited partners, these same firms have satisfied their “clients” by proving over a long period that they can deliver outstanding results net of all fees and expenses.

III. THE IPC INVESTOR: PROFILES AND TRENDS

Who are the investors in IPC? Three decades ago the answer was simple: they were wealthy individuals, an occasional insurance company, some corporations, and a scattering of bank holding companies. Pension funds, most international investors, foundations, and college and university endowments were conspicuously absent. At that time the “prudent man rule” and the legal restraints imposed upon trustees compelled to act as fiduciaries deterred all but the hardiest institutional investors from playing the game. There were few managers with established track records, and therefore little hard evidence to support a recommendation to invest in an IPC fund. Until the late 1970s and early 1980s, relatively few investors understood the arcane legal and financial issues embedded in most private equity transactions.

The 1980s changed all that, as did the working through of ERISA regulations and rules governing the investment policies of pension funds. As more firms became visibly successful and could demonstrate consistent performance over a series of funds, larger amounts of capital were allocated to them. A classic example is the New York firm of Warburg, Pincus & Co. They raised their first fund in the early 1970s with what seemed a princely sum of fifty million dollars in committed capital. In 1988, Primus collaborated with Warburg in an investment where they ultimately committed sixty-five million dollars to just one portfolio company. Warburg’s most recent fund, closed late last year, was five billion dollars. Our experience, although on a smaller scale, illustrates the same point: our first fund raised in 1984 was thirty million dollars, our most recent fund, in 1997, is 165 million dollars.

The appeal of IPC investments in a balanced portfolio has become increasingly apparent. These investments are longer term in nature, offering the prospects for returns in the range of 500 basis points above the Standard and Poors 500 Index. They add risk to a portfolio, but since most IPC investment vehicles (primarily investment partnerships) have a large number of high potential companies in a portfolio, the odds of losing money on an IPC investment are relatively small. In most endowments or pension funds, the amount of capital committed to IPC as an asset class can also be controlled to

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whatever level the trustees or managers deem appropriate depending on the special needs of the institution. Thus, not only has the management of IPC in the United States become institutionalized, but so has the asset class for investors. These two conditions point to a continuing demand for IPC investment vehicles operated by seasoned fund managers.

Back up this statement, in 1982 $1.8 billion of new institutional money was committed to IPC in the United States. At the end of the 1980s, between eight billion dollars and fourteen billion dollars was being committed annually to IPC-managed funds. In the past three years, 1996 to 1998, thirty-seven, fifty-four, and eighty-five billion dollars, respectively, was committed. In twenty years there has been a staggering increase in the availability of IPC in the United States, with a significant percentage of it going into LBO or acquisition funds. It is estimated that over 250 billion dollars of capital is currently lodged with all categories of IPC managers. What better measurement to underpin the statement that IPC has become a major force in the U.S. economy?

IV. VENTURE CAPITAL, A TRUE ENGINE FOR GROWTH

An impressive percentage of IPC funds under management resides with the venture capital firms, but it is nowhere near the amount of capital managed by LBO firms. Does this mean that venture capital has less of an impact on the economy and on wealth creation? I believe the opposite can be argued.

First, a quick tour of the facts is in order. Venture capital funds at the end of 1997 in the aggregate controlled roughly forty-six billion dollars of IPC in the funds under management.\(^4\) I estimate this number is presently well more than fifty billion dollars. Putting that number in perspective, at the beginning of the 1980s, seven to ten billion dollars was under management. By the end of the 1980s, that figure had grown to thirty to thirty-five billion dollars. Correspondingly, this huge increase in the amount of venture capital under professional IPC management has meant that the number of firms managing venture funds has increased dramatically. So has the average size of venture funds; in the early 1980s, a fifty million dollar fund was considered large. Today, funds that are a multiple of 100 million dollars are commonplace.

As one would expect, disbursements out of venture capital funds into private companies have also increased dramatically. In the early 1980s, a record year would have chalked up two to three billion dollars of new portfolio company commitments. In 1996 through 1998, eight billion, eleven billion, and fourteen billion dollars, respectively, was committed to new

\(^4\) 1998 statistics are not yet available. Normally they are released well into the second quarter of the following year.
ventures or supporting existing companies. Over that same period, approximately twenty billion dollars of funding through Initial Public Offerings (IPOs) was added to the privately funded capital invested in venture-backed enterprises. These sums are truly enormous when one considers that most of these companies did not exist five years ago, and that many of them have yet to achieve revenues in the 100 million dollar range, let alone significant profits.

How productive is this floodtide of private capital? Judging from the recent phenomenal growth in the value of Internet-related companies, substantial wealth has certainly been created, at least on paper. But what about job creation, growth in research and development dollars, and other measures of lasting contributions to the economy?

VentureOne Corporation, a database management company reporting on private capital transactions, completed a study two years ago on the impact of venture-backed companies on the U.S. economy. The results were quite revealing, and included the following conclusions about venture-backed companies: 1) They grew at thirty-eight percent compounded in 1991-1995 versus 3.5% for the Fortune 500 companies and 4.2% for the U.S. economy. 2) Their research budgets compounded annually at thirty-three percent versus twelve percent for the Fortune 500. 3) On average, the survey companies added over 150 employees each in their first eight years of operations. Looked at in another time frame, during 1991-1995 their employment grew at a thirty-three percent compounded average. The Fortune 500 had a negative growth rate in employment of -3.6%.

These are compelling statistics that speak to lasting economic impact. Not only is wealth being created for investors and other owners, but jobs are also being created that underlie the long-term health of the U.S. economy. For the most part, these are highly desirable jobs. When one looks at the industries in which venture capital is investing, they have the following common characteristics: they grow rapidly and they attract educated and well-trained employees. They are largely service-based, and they have little or no environmental impact. These industries include software and information technology, telecommunications, healthcare services, business services, and biotechnology. What developed or developing nation would not covet such newly created employment opportunities for its own workforce?


6 For more information, see generally Nat’l Venture Capital Ass’n, The Seventh Annual Economic Impact of Venture Capital (1999).

7 These are ranked in order by the amount of private capital invested in 1998.
Venture capital has become a powerful force driving some of the most rapidly expanding sectors of our economy. Perhaps most relevant, it has been the capital juggernaut funding the swarm of companies that are riding the Internet wave and its closely aligned, skyrocketing world of E-commerce. Very few of these companies that have made it from start-up through to public ownership have done so without professional venture capital support. In the Internet area, household names such as Netscape, Yahoo!, America Online, Excite, Lycos, Cisco Systems, Sun Microsystems, GeoCities, and Broadcast.com are just a few that spring to mind. In E-commerce, Amazon.com, eBay.com, E*Trade Group, Buy.com, Mail.com, and iVillage.com are just a few of the billion-dollar-plus market capitalization companies that attracted early investors from the venture community. The list goes on, and it is increasing daily as a flood of new ideas and companies find venture sponsorship.

It is rare in the United States today that any economic sector relying on the development or application of technology is not touched by the venture capital community. Based on the trends in funding and the willingness of institutional investors to place increasingly larger bets on venture capital managers, it is unlikely the impact of venture capital will diminish anytime soon. Indeed, all IPC markets are apt to continue expanding as long as there are decent opportunities in which to invest and investors who believe.

V. A SNAPSHOT: WHAT’S HAPPENING IN TODAY’S IPC MARKETS?

In addition to understanding the broad trends at work in the U.S.-based IPC markets, we should explore briefly the state of those markets today. I have already indicated the size of the capital pool available to invest and the rate of investment, particularly in the venture capital sector. But what are some of the other current trends that are impacting IPC managers and their investment activities?

LBO funds and their middle-market counterparts are active, but they are not as fully committed as they were two to three years ago. During the recent run-up in the U.S. stock market, valuations for public companies of all kinds have soared. This trend has had the effect of causing large company or divisional spinout transactions to rise in price, a direct “trickle down” effect of

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8 Companies classified as “Internet” in the venture capital world are those that provide the infrastructure and tools for using the Internet. “E-commerce” companies are those that provide products or services over the Internet to both consumer and business customers.

9 No reliable statistics are published on the rate of investment by LBO and middle-market funds.
the public markets' rising multiples over the past five years. To quantify this shift in values, transactions that were valued in 1994-95 at four to five times Earnings Before Interest and Taxes (EBIT) are now being valued at nine to ten times EBIT, or roughly a doubling in five years. Since entry prices, or what one pays for a company, are a key determinant in the ultimate return potential on the investment, this change has dampened some of the enthusiasm for LBO transactions that existed in the late 1980s to mid-1990s.

The unprecedented amount of capital now residing in LBO funds is another factor contributing to an upward price spiral in the buyout sector. Estimates as high as 200 billion dollars of available capital for buyouts suggest there may be too much capital chasing a finite number of transactions. If this is the case, and I believe it is, the effect on pricing in the LBO market is obvious: continuing upward pressure.

In addition to pricing, the competitive landscape has also shifted. Many corporations, in their role as strategic buyers, enjoy high multiples on stock that they can exchange for the assets or stock of privately held companies. Corporate cash flows are also near all-time highs, with many companies enjoying relatively low debt-to-capital ratios and high liquidity. As a result, these competitors can "pay up" in either cash or stock for businesses possessing strategic relevance. They are clearly fueling the price spiral in LBO transactions. If this trend continues, the returns for LBO fund investors may well drift downward; high entry prices almost invariably result in lower returns when an investment rolls over.

The venture capital sector is experiencing similar pressures. Traditionally, pricing for early-stage or growth equity financings has not been as closely linked to multiples in the public markets. Recently, however, the trends appear to be converging. One reason may be the outlandish public market multiples being accorded Internet or e-commerce companies. Their market capitalizations, now measured as a multiple of revenues, not profits, have reached historic proportions. As of late March 1999, the following companies were trading at the indicated multiples of revenue: Amazon.com (sixteen times), eBay.com (147 times), and E*Trade Group (seventeen times).

Any entrepreneur establishing an Internet company is well-aware of this phenomenon. In fact, he or she cannot help but notice it, given the extensive

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10 "Multiple" is shorthand for the Price-to-Earnings or P/E ratio paid for the equity securities of traded companies.

11 "Market capitalization" is determined by multiplying the sum of all shares outstanding times the price per share. For companies with multiple equity securities outstanding (e.g. Preferred and Common stock), the market capitalization is the sum of all equity securities times their respective prices per share or per unit.
press coverage on the Internet and its more visible players. Entrepreneurs and promoters of start-up investments are, therefore, demanding correspondingly higher valuations for their ideas (the company is yet to take form in most instances) in raising an initial round of venture capital.

Offsetting this trend in the venture capital sector, there is no shortage of new ideas or technologies in which to invest. Again, the Internet and its related E-commerce world have provided a burgeoning stream of investment proposals. As a proxy for the robustness of the flow of ideas in the Internet/E-commerce sector, in a single two-week period this spring, BT Alex Brown reported in its *E-Tailing Review* fourteen completed IPOs and forty more pending. To feed this public financing activity, ten to twenty times the number of transactions were probably being completed in a like period earlier on.

Other industries are also attracting huge amounts of private capital, among them information technology and telecommunications. Information technology opportunities come from the demand for data management tools to cope with the information needs of our society at all levels. It is difficult to imagine any institution, whether it be a school system, a corporation, or a healthcare complex, that is not either overhauling or updating its information system. I serve on the board of trustees of an art museum and a liberal arts college, and I am a director of eight companies, both private and publicly held. Every one of these entities is currently heavily invested in information systems upgrades or a total overhaul.

Aside from the highly publicized Y2K problem, these needs are ongoing. Unless an organization updates its management information systems every two to three years, it will likely fall behind in its field. At the beginning of the 1990s, the relevant time interval was probably closer to seven or eight years. This fundamental rate of change attracts entrepreneurs with better ways of coping with data management and systems issues, which in turn translates into a need for growth capital.

A similar trend is emerging in telecommunications, where the demand for ever-increasing amounts of bandwidth is being driven by a global explosion in both voice and data transmission. Tying these trends together, the use of the Internet for transmitting data is having a huge impact on the telecommunications industry and the demand for Internet protocol (IP) capacity. This fact is fueling a surge in private financings for telecommunications companies seeking capital to expand their high-speed data networks worldwide.

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12 *E-Tailing Review* is a bi-weekly report issued by BT Alex Brown, Inc. on financing activity in E-commerce.

13 IP is the standard format for transmitting data over the Internet.
The recently initiated overhaul of the worldwide regulatory telecommunications framework is another force spawning a new generation of companies eager to compete with the monopolistic Poste Telephone & Telegraph Telecommunications companies (PTTs) in most foreign countries, calling for private capital to get them started. U.S.-based IPC managers are participating in, if not leading, private investment in these companies, recognizing that the same wealth creation surge is apt to occur in the foreign telecommunications markets that took place here during the 1980s and early 1990s. Taken together, these developments point to an almost boundless demand for private capital. It is not likely that venture capitalists and other private equity sources will be facing a shortage of new ideas to fund in the coming two decades.

VI. A MICRO VIEW OF ONE VENTURE FIRM, PRIMUS VENTURE PARTNERS

For the reader not familiar with the workings of a venture capital firm, it might prove instructive to examine one firm in some depth to develop a better understanding of how IPC investors approach their work. My firm, Primus Venture Partners, based in Cleveland, Ohio, is a case example I obviously know very well. Let me share some insights into our firm, including how we are organized, where we concentrate our resources, and how we go about selecting investments.

We established Primus in 1983 as a venture capital firm with a geographic focus. Our chosen marketplace was Ohio and the upper Midwestern states. At the time, there was little venture capital managed in formal pools between New York and Chicago; thus the Midwest (excluding Chicago) was considered virgin territory. Our investment thesis was that, by establishing our presence here, we would attract investment proposals from owner/managers who preferred working with the home team rather than turn to a major money center partner for capital.

Our first venture fund was thirty million dollars in size with exclusively institutional investors, all from the Midwest area. We followed our early strategy and maintained a tight geographic focus, not really identifying industries that were a priority. This strategy worked for a number of years, but at the same time, we were building experience in four or five industries where we had realized first-tier returns and were developing a following among those industries' entrepreneurs. As more IPC capital began to flow into our region, we knew competition would become keener within our core

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14 This phenomenon occurred in the United States, beginning with the breakup of AT&T mandated by the Justice Department in the early 1980s.
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market. Hence, we concentrated on developing expertise that would ultimately lead us to a national focus.

In 1987, we raised our second fund of approximately seventy-five million dollars, and followed that fund with a third fund of like size in 1993. Our presently active fund (from an investing viewpoint) was raised in 1997 with 165 million dollars of committed capital. In one decade, Primus moved up approximately fivefold in fund size under management, reaching a total of 340 million dollars under management for all funds. During this period, we moved away from geographic focus to concentrating nationally and internationally on five industry sectors, all proven money-makers: medical/healthcare, information technology (including telecommunications), consumer/retail (now almost exclusively concentrated in E-commerce), financial services, and for-profit education and training (largely over the Internet). All of these industry sectors share some common themes: rapid growth, serving very large and dynamic markets, and managements that provide the necessary entrepreneurial firepower to build successful companies.

Primus has also shifted its focus in terms of company stage at the point of initial investment. We have always done early-stage investing; we are a venture capital firm, and that is part of our work. But in earlier times, we also invested in mature businesses operating in slow-growth industries as well. Now that pricing pressures and competition in this arena more typically covered by the middle-market firms are much more intense, we have moved “down market” in our focus, exclusively investing in early and growth-stage smaller and younger companies.

Our evolution from a geocentric, all-stages investor to an industry-focused firm doing early to growth-equity investing typifies the pattern of development for successful competitors in our industry. The fast pace of change occurring in the markets where we invest has spilled over into our way of doing business. You either adapt swiftly or you die.

When Primus makes an investment, we invariably key on four core elements that must be present if we are to commit capital:15

Proven management – There must be a team in place that has a track record of successfully building companies in the specific industry where we seek to invest.

Significant management ownership – We insist on management having an equity stake in the business. If they succeed, they will build considerable personal wealth for themselves. Their incentives must be parallel with ours, that is, focused on building shareholder

15 Primus has invested in over eighty-five companies in fourteen years.
equity. We are proud of the fact that our managements in Primus companies that have either gone public or been merged in the past ten years have accumulated personal wealth in excess of three-quarters of a billion dollars.\textsuperscript{16}

*Proprietary advantage coupled with market leadership potential* -- We look for unusual if not unique product and market opportunities that, if successfully managed, have the potential to create an industry leader of significant size. A good example is STERIS Corporation, now the world leader in infection prevention systems for hospitals. We invested in STERIS when it had three employees. It now has revenues approaching 800 million dollars.

*Superior market opportunity* -- We invest only in companies that are serving, or plan to serve, large and rapidly growing markets. In order to build significant value in a company, it must have size and large profit potential. We will not invest in companies whose prospects are limited by the size of the markets they serve. In passing, one of the inherent appeals of E-commerce and Internet-related investments is the enormous potential for companies that "get it right" in terms of a business model and market focus. Demand will ultimately sweep them to a very large revenue base if they can find the right service or product niche.

On the reverse side, we have a set of time-tested and painfully developed negative screens as well. For example, we will not invest in technologies where there is no management to take a proven idea to market. We do not invest behind consultants or staff persons as CEOs. And we do not favor commodity or cyclical businesses that lack linear growth potential.

How do we organize for making investments, then follow them through to a profit for our limited partners? We are a partnership and follow the model discussed earlier. We have a flat organization of six partners with seven others doing the investment work of the firm (out of seventeen total employees). Each week, we meet to discuss current investment proposals circulating in the firm and assign priorities. For the most promising, we pack resources into due diligence or negotiation of terms in order to ensure we have the best prospect for completing the investment. If priorities shift because of new opportunities that arise weekly, we will re-allocate staff to con-

\textsuperscript{16} This figure is measured at the time of an IPO, sale, or merger of their companies. We have no records on the after-market activities of our managers or their personal investment programs.
centrate on the ones we want to win. We operate as teams. There are no line reporting relationships at Primus in the usual corporate sense. Once an investment is on the books, we then follow it through board representation, with the original team on call in case a major opportunity should present itself (acquisition, new product initiative, etc.). In short, we are a fleet organization, highly flexible, and geared to rapid response.

Primus is not unlike scores of like firms in the venture capital segment of the IPC market. We periodically re-create ourselves by adapting to changing conditions or taking advantage of long-range market trends. We are quick-responders by nature and in our way of doing business. But at the same time, we are patient and willing to work with our portfolio companies to build long-term value for all shareholders over many years.

VII. CONCLUSION

Closing out my comments on the bigger picture, the IPC market in the United States is booming. In two-plus decades it has moved from an informal club of shirt-sleeved investors to a sophisticated, professionally managed industry. Nothing else in modern times rivals the speed with which this industry has reached such an important position in its impact on the world’s largest economy. The U.S. market was the industry’s seedbed and its laboratory. Now that many proven patterns of successful investment and management strategies for IPC have been validated, this phenomenon is spreading internationally. Hopefully, IPC will ultimately have the same lasting effect on growth and prosperity in the rest of the world as it has had in the United States.