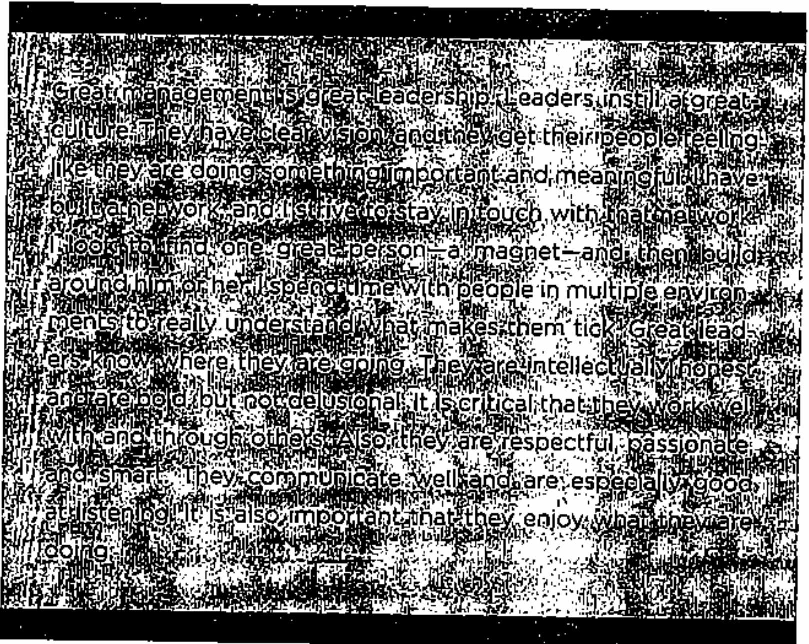
enable a higher level of comfort for companies to open their networks. With this final bottleneck broken, however, business users, consumers, and suppliers will expect or demand that information be available to them anywhere, anytime, and as a matter of necessity.

The convergence of communications is the emerging key to the "electrification" of the network, bringing computing power into the real world, closer to where business decision making, job functions, and consumer and social interactions take place. The initial applications of the converged network and technologies such as VoIP and tags will deliver value through replacing today's technologies, but will ultimately help to define how business is conducted tomorrow. Again, underlying the drive toward convergence is the goal of wider collaboration and the increased recognition that linked knowledge is of far greater value than disconnected knowledge. Investors should be looking for smart and integrated technology that solves problems and delivers return on investment that is made possible only through convergence.

STAR GAZER

DAVID SPRENG
founder and managing general partner of
Crescendo Ventures

David's global venture capital investment firm Crescendo Ventures has more than $1 billion under management and offices in Palo Alto, Minneapolis, and London. He is a core team member of the World Economic Forum Working Group on "Nurturing the Early Stage Investment Climate in China" and a member of the board of the National Venture Capital Association (NVCA). He has been named to the Forbes Midas list of top venture capitalists. I asked David about the importance of management. (To read my full interview with David Spreng, visit www.findingthenextstarbucks.com.)



→ MEGATREND 6: CONSOLIDATION—MAIN STREET VERSUS WALL STREET

"History doesn't repeat itself, but it rhymes." —MARK TWAIN

The story goes like this: Boy gets out of high school, maybe a state university, and goes to work at the first job he can get. He realizes quickly he is pretty good at business and hates working for somebody else, so he starts a business by getting a second mortgage on his house, borrowing from his in-laws, maxing out his credit cards, and/or raiding his children's college fund.

He works around the clock—six, often seven, days a week. His wife takes care of the house, but also helps out at work, doing whatever needs attention. After surviving a number of near-death experiences, the business is going pretty well. He's not taking any big salary, but he can pay all the bills and is expanding the business. Excess profits are plowed back into growth.

Despite the fact that he went to public schools, he sends his three

children to private schools. He joins the country club but rarely uses it. However, his kids love it and are good golfers and tennis players.

Business clicks right along. The company becomes prominent on Main Street, and he's also been able to expand to other cities within the region. Numerous local and regional awards attest to the company's achievements.

He sends his kids off to elite colleges. He tells anybody who will listen about his children's success. During summers, he offers his children opportunities to apprentice in different parts of the business, but they always travel to Europe instead.

The company has become a money machine, but he has trouble retaining the top talent. Most people at the company assume (because the CEO has said so) that he expects his children to take over the company from him when he retires. Given these circumstances, it's impossible to keep a strong number two at the company.

The kids finish college and grad school. After bumming around for a few years, they convince their dad that it would be better for the business if they got some experience at another company or in another industry before they come back.

To begin their careers, the kids move to New York City, Chicago, San Francisco, and London, where, remarkably, a lot of their friends from school are living.

Dad still works six days a week, but he finds he actually is starting to enjoy going on vacation and playing golf. His kids have been promising him for 10 years that "next year" they are going to move back to join the family business.

New technology is coming into the industry. Dad doesn't really understand how it works, but fears if they don't use it, he could get left in the dust. ABC, a company he has known for years through the industry association (he's a former president), just went public at a huge multiple. Now with a public stock, they are buying up everybody.

Having seen ABC's IPO, some of his longtime customers start asking questions. A few even start to do some business with ABC on its e-commerce site (something his company doesn't even have yet). All sorts of issues start arising, such as China, India, and outsourcing. Things were a lot simpler when all he had to do was make the customer happy and keep his costs low.

ABC is getting more and more of his business. They are charging 20% less, which he thinks is insane. When he talks to his lost customers, though, they say a combination of factors attracted them to ABC—doing business with them is cheaper, faster, and better. He looks at ABC's public financial statements and can't believe his eyes. Despite charging less, they have higher margins!

His health is starting to concern him. His doctor has told him he needs to slow down—at the time his business needs him to speed up! He calls his children to see if they are ready to come back. They each tell him no, adding that it wouldn't be fair to *their* kids, but they do thank him for setting up his grandchildren's trust funds and paying for their private schools—it really helps.

Reluctantly, he calls the CEO of ABC and says they should have that dinner. They talk, they dance, they merge.

ABC's stock goes up as the acquisition is accretive. He leaves after six months as he disagrees with decisions being made at the top. Sealing his frustration was a phone call with the CEO, in which the response to his complaints was "Last time I checked, we bought you."

Sound like a unique story? It isn't. This happens every day on Wall Street.

Consolidation occurs when a business grows through buying other businesses in its industry. In a classic fragmented mom-and-pop industry, the consolidator typically gets advantages of scale that give it ongoing competitive advantage. Couple that with cheap currency provided by Wall Street and you get the makings of a consolidation story—Main Street versus Wall Street.

One of the key abilities investors need to form is to be keen observers of society, business, and politics. By being able to see the whole field, an investor can anticipate a future opportunity before it becomes obvious. Being able to see where consolidation of products and/or services may emerge is critical to investing in the stars of tomorrow and avoiding being run over by a truck.

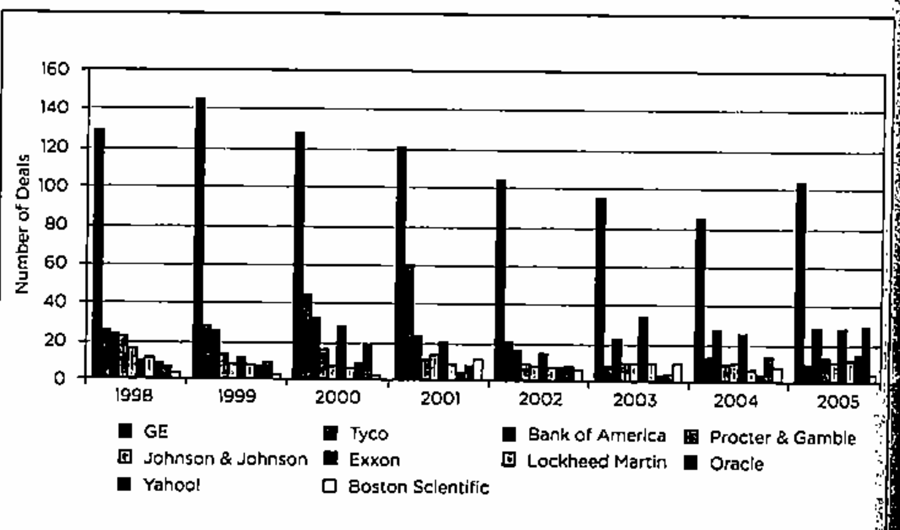
The obvious consolidation opportunity is like the general situation described at the beginning of this chapter. The classic recipe for a consolidator is where there is a wildly fragmented industry that is dominated by mom-and-pop businesses.

As an industry starts to consolidate, the consolidator benefits from scale and service advantages that make it increasingly difficult to compete against. Where a public company buys a private company, there is also often the boost of public-market versus private-market arbitrage.

For example, a leading public-company consolidator may have a P/E of 25x but be able to buy a private company at a P/E of 12x. Shareholders benefit not only from the strategic synergy in the combination, but also from the arbitrage in valuation. The arbitrage in the public and private multiples results in the merger being accretive to earnings, which will likely result in an even higher stock price. The "currency" often used for a consolidation strategy is the consolidator's stock.

An interesting irony in a consolidation investment thesis is that the higher the valuation of the consolidator, the more attractive its stock theoretically should be for an investor. The reason is that its rich stock "currency" will be able to buy more earnings for less and therefore be that much more accretive. It's tough to get your brain around that concept, but once you do, it's pretty powerful.

Consolidators



Source: FactSet, ThinkEquity Partners.

While consolidation is a megatrend and can be a very attractive component of an investment thesis, there are a lot of pitfalls. The biggest warning flags for consolidations are mergers based solely on public/private arbitrage or those that lack strategic logic.

A second issue to understand is integration. Consolidation always makes sense on paper, but from cultural issues to systems and communication, the biggest failures occur where an acquisition wasn't integrated well.

Another issue to understand is the broader global concern impacting an industry. Often you see consolidation in maturing industries where merging parties might be sensing their own vulnerabilities. Just like people on a date often don't bring up all their faults and insecurities, merging companies have incentive to show themselves in the most positive light.

Looking in a very narrow silo, it may have seemed really smart for the facsimile industry to consolidate, but then came the Internet, which made such mergers completely unattractive from a growth standpoint because the industry was going to move away from facsimile altogether.

Consolidation Rules

1. Have a good strategic rationale.
2. Have a solid integration plan.
3. See the broad picture.
4. Use conservative accounting.
5. Verify that it is accretive to earnings.

Beyond the classic roll-up of an industry, where many small companies roll into one large one, some of the most interesting opportunities can be found when companies buy companies that develop services or technologies that give the consolidator an unfair advantage in its industry.

When eBay bought the start-up online payment processor PayPal for $1.5 billion, everyone thought eBay was nuts. It turns out that was a brilliant move because it created a competitive moat around eBay that seems almost insurmountable. More recently, eBay bought VoIP-

provider Skype for $2.6 billion, and the critics are out in full force again. We shall see.

Similarly, Internet leaders Google and Yahoo! have been actively acquiring businesses and technology to enhance their competitive positions.

In biotechnology, there are hundreds of publicly traded products—consolidation will occur to leverage distribution networks and marketing cost. Companies with a single blockbuster product will be better able to market that product if they partner with a larger company complete with an established customer base and marketing arm.

The consolidation wave in software is in full swing, which will result in an industry that looks a lot like the medical device industry—a barbell—with one end being the Goliaths and the other end the innovative emerging companies.

Consolidation Plays

- Medical devices
- Software
- Biotechnology
- Consulting
- Insurance
- Education software
- Asset management
- Oil services
- Financial services
- Internet

STAR GAZER

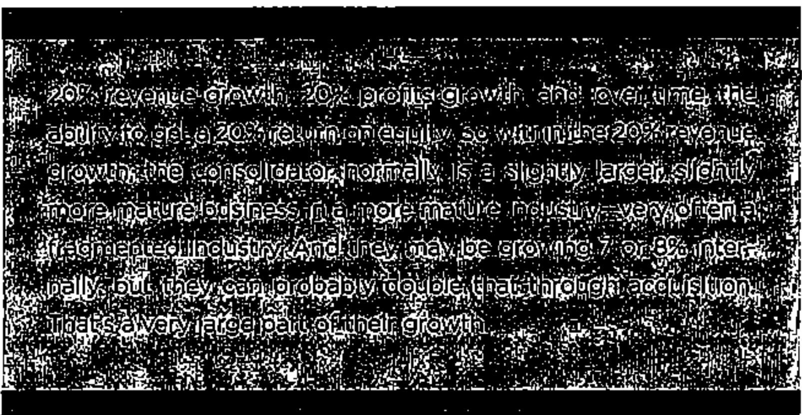
DUNCAN BYATT

co-founder and president of London-based Eagle & Dominion

Duncan Byatt began his investing career in Edinburgh, Scotland, in 1984 as a graduate trainee at Ivory & Sime, where he gained experience with U.S. and European investments. He went on to work as a corporate finance analyst in London, started a fund management operation for a major Japanese insurance company, and spent time in both Japan and the Pacific Rim. From 1991 to 1998, he ran the U.S. Emerging Growth Funds for Gartmore Investment Management in the UK, which were among the largest and most successful funds of their type in London and were AAA-rated by Fund Research. I asked Duncan what he looks for in a company that he is thinking of investing in. (To read my full interview with Duncan Byatt, visit www.findingthenextstarbucks.com.)

Typically, to assess people we sit down and spend quite a lot of time talking with the management team. Very often, we'll go and visit the company on the ground as well and meet with the guys who are actually running the operation. You immediately get a sense of it. Is it buzzing? Is it very busy? Do the people look as though they're really enjoying what they're doing? Or is it kind of quiet? Are people looking a little glum, like they really wish they were somewhere else? You pretty rapidly get a sense of whether the business is ticking positively or not.

Typically, companies that we invest in fall into two camps: consolidators and innovators. We're looking, ideally, for a company that I call a 20-20-20 company. A 20-20-20 company is


20% revenue growth, 20% profits growth, and over time, the ability to get a 20% return on equity. So with the 20% revenue growth, the consolidator normally is a slightly larger, slightly more mature business in a more mature industry—very often a fragmented industry. And they may be growing 7 or 8% internally, but they can probably double that through acquisition. That's a very large part of their growth.

→ MEGATREND 7: BRANDS— THE GIFT THAT KEEPS ON GIVING

"A brand for a company is like a reputation for a person. You earn reputation by trying to do hard things well." —JEFF BEZOS

Raymond Babbitt was right—Kmart sucks. Fourteen years after Dustin Hoffman's autistic savant character muttered those lines in 1988's Oscar-winning *Rain Man*, Kmart filed for bankruptcy.

If Raymond had said, "Wal-Mart sucks," or "Target sucks," the line would have fallen like a lead balloon. It resonated with audiences in a perverse way because most people hated shopping at Kmart. The Kmart brand meant low-quality products, nonexistent service, and a horribly bad shopping experience. Kmart sucks!

Starbucks started with a promise of delivering exceptional-quality coffee and friendly service. The brand equity the company created through its performance against expectations allowed Starbucks to expand its offering to everything from alternative drinks to music. Because Starbucks has established this connection with its patrons, it has been able to expand the relationship. In fact, investors anxiously await the introduction of Starbucks' next product or service because they expect the customer to like it.

Apple has always been a cult brand, but has now been able to expand into the masses. Macintoshes, iPods, Video, iTunes, Shuffle, iSight—

everything Apple makes, we want. It's a badge of coolness to have your Apple Notebook out on the plane. The Apple stores, which didn't exist five years ago, do more than $2 billion in revenue, or more than $20 million per store. For comparison, the gigantic Best Buy superstores do around $30 million per store! Not bad for a new boutique.

We have become a culture where one arm extends to hold a Starbucks cup, and our ears reveal neon-white iPod earphones.

Intel Inside is a brilliant brand. It gives consumers confidence in the technology and gives Intel a higher margin. Is AMD's chip as good as Intel's or better? Perhaps, but Intel has the brand.

Ralph Lauren's Polo is another incredible brand. For two or three times what a consumer would pay for a comparable product, he or she can get the pony as an outsourced endorsement of good taste and fine lifestyle.

Google is the brand for Internet searches. While there are numerous other search engines and sites, when you need to know, you go to Google. It stands for being powerful, accurate, efficient, and simple.

Most of Dell's components and services are provided by somebody else, but because Dell's products have the Dell name attached, consumers have confidence in buying.

Harvard, Stanford, and Princeton are educational brands. It is presumed that people who graduate from these schools are smart because of it. Goldman Sachs is *the* brand in investment banking. You could probably find equally smart people at other places and have your transactions done more cheaply, but if you are going to sell your business or take it public, you want the Goldman stamp of approval.

On the flip side, ill-will brands like Kmart seldom overcome the negative stigma associated with them.

A brand is a promise between the company and the consumer about what to expect from the relationship. It takes years to build brand goodwill, but once it's achieved, it gives the company permission to introduce other products and services consistent with that promise.

General Motors has a huge upside battle ahead of it. Radio Shack is a bad brand. In a global marketplace and Internet economy, having a powerful brand is more important than ever before because a brand provides the shortcut that time-pressed consumers and executives need