The Economist

Warburg Pincus | Start me up

When building companies from scratch makes more sense than buying them

BUY-OUT firms have had a good run recently. The stuff in their inventory—the companies they control—has risen in value over the past few years, if flighty stockmarkets are to be believed. A spate of sales and listings has resulted in bumper returns for investors. But when private-equity firms have to replenish their inventory, they are confronted with the same inflated valuations. One solution arrived at by Warburg Pincus, a New York outfit, is to stop merely buying and selling businesses and to build them from scratch instead.

Why pay a bundle to buy an overpriced African oil-exploration firm, say, when you can hire a team of seasoned industry hands to recreate much the same thing for a lower price? The build-don't-buy trick is one the firm has become adept at, mostly in unglamorous industries. Last year it sold off its remaining shares in Targa, an American gas processor it founded in 2003, reaping $1.8 billion from a $400m investment. It sold ATG, an Indian maker of truck-and-tractor tyres it conceived in 2007, to KKR, a private-equity rival, for $630m.

Building a venture from nothing is fiddlier than picking which company to buy from an investment banker's offerings, the way much of the private-equity industry finds its targets. The process often starts with the hiring of an "executive-in-residence", a veteran of an industry Warburg Pincus sees as promising. It can then take a year or two to refine the investment thesis, or find a company to purchase as a platform for further acquisitions. The executive typically then becomes the day-to-day boss of the new venture, putting up his own money alongside Warburg Pincus's.

Some of the sums can be colossal: Warburg Pincus and other investors have pledged to invest up to $1.1 billion in Venari Resources, which they founded in 2012 to hunt for oil in the Gulf of Mexico. Others start small but may guzzle cash later. Earlier this year Warburg Pincus put up over $100m to buy Source, a European manager of exchange-traded funds, having partnered with a former boss of iShares, the industry leader. It wants to use its original purchase as a base to consolidate a fragmented industry, ultimately selling or listing a larger group.

The model works best in industries in which entrepreneurs would struggle. Anything to do with energy, which requires oodles of capital, is a recurring theme, with dozens of investments across Africa and America. Other ventures, for example in areas where customers are twitchy dealing with startups, such as outsourcing, benefit from the gravitas bestowed by Warburg Pincus's 48-year heritage, 170 staff and $37 billion in assets under management.

Others have tried their hand at the building-from-scratch model, particularly in oil and gas, but it is tricky to replicate. One of the specificities of Warburg Pincus is that its other investments range from venture-capital minnows to conventional leveraged buy-outs, so it can support new companies both before and after they have grown. It was also among the earliest to spread its footprint beyond America and Europe, notably to India, where it is one of the best-established private-equity firms.

Backing entrepreneurs has its complications. The new ventures typically cannot be loaded up with debt, a common source of profits for buy-outs, made all the more alluring by the heaps of cheap money available nowadays. Execution is trickier: growing firms are by their very nature unstable. And the companies need to be nurtured for longer than a typical buy-out, which can depress annual returns even if profits are greater in the end.

The biggest risk, says Chip Kaye, who alongside Joe Landy has led the firm since 2000, is that either the investment thesis ends up being wrong, or that it is right, but hard to act on. "We have a habit of knowing what we want to invest in before it shows up," he says. ■