

**JERRY GALLAGHER'S
UNIVERSITY OF CHICAGO
ENTREPRENEURIAL EDGE CONFERENCE
KEYNOTE LUNCHEON SPEECH**

November 18, 2005

Thank you Scott. It was my pleasure to have worked with Scott while he was a venture capitalist.

I am pleased and honored to be part of this conference. It is particularly meaningful to me that it is student run.

My years as a student in the business school were very satisfying. Lots of hard work. Many great teachers including George Schultz, Bob Hamada, Sidney Davidson, Myron Scholes, Art Laffer and Milton Friedman. Those years prepared me quite well for my career. In addition, I had a lot of fun.

Strong, lifelong friendships were formed. Five of us and our spouses try to get together on a regular basis. Last August in Tahoe and next June in New York City.

When we gather, our conversations certainly cover lots of regular stuff like kids, grandkids, golf and work. But it also goes to the same things we enjoyed 35 years ago such as monetary policy, efficient markets and interesting research. That curiosity that was nurtured here keeps burning in all of us.

My second year I helped design and conduct the first course evaluation which I understand is still done. We wanted to make sure that there was the right balance between research and teaching.

Those years (1967-69) on the south side of Chicago, were exciting and somewhat scary. I saw smoke rising from fires started by rioters after Martin Luther King was assassinated (April 4, 1968.) The radical student organization called SDS occupied the Administration Building and shut down part of the University. As one step in the process of resolving the crises, a meeting was held in which SDS members and the Business School students exchanged ideas. As student representative, I co-hosted that event with George Schultz and had enough sense to keep my mouth shut and let him use his diplomatic skills.

Gang related violence happened in and around Hyde Park quite regularly. One evening when I was studying in the Law Library, I heard gun fire close by. The next day the papers reported that four people were killed.

Those years were truly interesting and formative for me.

My remarks today are divided into four sections. The first will be a brief response to my host's request for a discussion of my "life's journey." Next will be a description of some habits that have helped me throughout my career and particularly during the last 18 years as a venture capitalist. Third is a somewhat more detailed discussion of certain elements of the venture

capital process. Finally, if you are still awake, you will hear my thoughts on some trends in other parts of the world.

When they made the request for a life journey description, they probably were hoping for the type of compelling story that Steve Job's told this year as the commencement speaker at Stanford. It was one of the most interesting speeches I have ever read. He truly has had a fascinating life journey. Unfortunately for you, my story is much less interesting. Born into an intact family that worked hard and went to church. Close to all three of my siblings, as well as my parents before their deaths. Loved sports and played a lot of them with mixed results. Found school very appealing, almost from the first day. My strong curiosity has always led me to want to know how things work and what places look like.

A strong independent streak led to starting my own grocery delivery business at age 8 and organizing a little league baseball team at age 10. We were the only team in our league that was not started by parents. Catholic schools through high school, but decided in the 9th grade there was no such thing as the "one true church." One of my favorite books is the *True Believer* written by Eric Hoffer and published in 1951. True believers really scare me.

Lots of student government positions. Hitchhiked everywhere, including to and from high school and college. Majored in engineering at Princeton to learn about deductive reasoning and to be comfortable with things technical. Took extra courses so I would be exposed to subjects like poetry and sociology. Earned my own way through undergraduate and graduate schools with the help of scholarships. Started working at age 16 at Sears and discovered that retailing fascinated me. Served four years in the submarine service, which both my wife, Ellen, and I enjoyed. Chose Chicago over Harvard because of the reputation of the faculty and a disappointing experience I had with a Princeton course taught with the case study method. Retail analyst at DLJ for 8 years. Manager at Dayton-Hudson for 10 years in both staff and line positions. Venture capitalist for the last 18 years doing retail and restaurant projects. Married for 41 years with three children and three adorable grandchildren. Family and work define my life because those are the things I really care most about. Ski and golf a bit. Travel lots of places for both work and pleasure. At age 64, still enjoying my work. Might write a book someday on human behavior.

Moving on to section II, I will describe some habits. There happen to be eight of them, but Stephen Covey has nothing to fear. Of course if Ellen were present, she would be thinking that I am conveniently avoiding talking about some of my other habits that she finds annoying.

There are so many ways to get a job done. In no way am I going to be so presumptuous to assume that others should do what I have tried. I will simply outline a few concepts that I have followed and have been important to me. If any of them are useful to you, then the time I spent writing these remarks will have been well spent.

Behaving in an ethical manner is a core of my life. Most of the time it has been easy to do what was right, but there were a few times when I felt that I was giving up something of significant economic value by doing so. In the early 1970's, for example, I was offered the opportunity to join the Nixon White House staff in a key position that would work directly with the business community. After spending a day at the White House being interviewed and watching them work, I declined the opportunity despite the fact it would have been a terrific career building step. My reasoning in deciding to decline was that I did not respect how they

made decisions. They did not ask what was right, everything seemed to be decided by what I call situational ethics. A few years later when Watergate occurred, I realized that not only had I followed my conscious, but I had also unknowingly made the better decision for my career. Sometimes that has proven to be the case. But regardless of what I did or did not give up in a particular situation, what is most important is that I can look at myself in the mirror and know that I tried to do the right thing. Perhaps that is a reason why I sleep so well.

Another concept I have pursued is to be willing to take a chance. Ask a question in class that might seem dumb. Speak up in a meeting not to show off, but make things better. Challenge the way something is being done, in a nice way. Be willing to be embarrassed. Invest in a company that looks risky if I believe in the concept and the management. If most people are pointed in one direction, look in another. Go down a different road. My pastor in high school told me I would lose my soul if I went to Princeton rather than a Catholic college. I am pleased to report that has not happened, as of yet. Perhaps I still go to church to prove him wrong.

I love to learn from my mistakes. This is fortunate since I make a lot of them. After a presentation, I want to know what can be improved. At mass, I review how I could have treated people better that week. When an investment is bad, I want to know where I went wrong. If I am not making mistakes, I am not taking enough risk.

I have tried hard to neither curse the darkness nor be distracted by guilt when luck has played a major role in my career. Partly, because it seems to balance out.

A few examples. Shortly after becoming the retail analyst at DLJ, 35 years ago, the three or four most prominent retail analysts on Wall Street either retired or self-destructed with really bad recommendations. A handful of young people, including myself, were able to quickly ascend to the top of our profession to fill the void that had been created. Right time, right place.

On the other side of the coin was the death of one of my companies named iMotors. If the bubble had lasted a little longer or the largest investor had not panicked just before closing on a financing, I believe it would today be a highly profitable company with sales measured in the billions. Wrong time, wrong place.

There is a third example that I was not directly involved in, but rather observed as an interested bystander. In the 1970's, Sears, Roebuck had a brilliant, creative merchant who was in line to be CEO. He had started a number of highly successful house brands, much like Target is doing today. He and I discussed the idea that they should create a Roebuck home improvement chain. This was a few years before Home Depot was founded. A serious illness sidetracked his career and he never became the CEO. In my opinion, Sears would be a much more successful company today if he had not become ill. Wrong time, wrong place.

Protect the downside. Bubbles can be interesting and rewarding. My net worth is much higher than it would have been because of the internet bubble. At the same time, a friend of mine went bankrupt when a real estate bubble in his area popped. What I have tried to do is participate, but limit my risk by only exposing a predetermined portion of assets and holding additional funds in reserve in case of a hiccup. Oak, for example, kept our e-commerce investments to about 6% of our funds during the 1998 through 2002 period. There may be bubbles going on now in private equity and real estate. Frankly, I am not sure. Once again I am participating, but only at a level where life will still be fine if they pop. This reminds me of a

toast one of my Oak partners, Bandel Carano, made in March of 2000 at our annual strategy meeting retreat. In retrospect, we now know the date of that dinner was close to the peak of the bubble. His toast was “to the good old days, TODAY.” A locked up Oak position in Internap that night was worth well over \$1 billion. By the time we could distribute it, the value was down to nearly \$100 million. One has to keep things in perspective because even at less than 10% of the peak, it still turned out to be a very good investment. I have tried to not be scared, but still be prudent.

For me, critical thinking has always been more important than knowing facts. Perhaps that is because I have a lousy memory. As a junior in high school, a friend of my Father’s guided me away from applying to some renowned universities because they were focused more on their graduate programs than teaching an 18 year old kid how to think. I used the same concept in selecting a graduate program. Boy, has that been useful in my venture capital world. So many people are blinded to the obvious by their tendency to see things in patterns that were established by others.

Picked jobs that I really liked. One fortunate decision I made near the start of my career was to concentrate on an industry I love, retailing. Even today, there are few things I would rather do than visit stores and restaurants. Last week, for example, was spent visiting stores, restaurants and companies in five cities with two gentlemen who will be the general partners for a fund Oak is sponsoring in India. Long days passed quickly as we covered many of the most interesting places to shop and eat in this country. People in my office can tell when I am in the field, just by the happy tone in my voice.

I have tried to be persistent until I understand issues that I feel may be really important. As a securities analyst, I applied this approach to my analysis of W.T. Grant, which in 1970, was a large, rapidly growing retailer. My store visits in combination with a review of their numbers caused me to wonder how their older stores were doing. Sales were growing, but not as fast as they were expanding. Their CFO tried to stonewall me by saying they did not separately compute sales for stores opened more than a year and he did not believe the number would be of any value to me as an analyst, even if I did know it. That led directly to the creation of the concept of same store sales. My initial estimate was that W.T. Grants same store sales were declining at a double digit rate. I also did estimates for other companies which I began to publish monthly. They were based on when stores were opened, and how fast I thought they matured. After a few years, retailers started to publish their actual same store sales data, rather than have investors depend on my estimates. By the way, if my memory serves me correctly, W.T. Grant became the second New York stock exchange company to go bankrupt since WW II. It was fairly shortly after a leading Wall Street investment bank had underwritten a securities offering for them.

Now I am going to shift gears and talk about my third topic, the venture capital process. Venture capital is about company building. Entrepreneurs build companies and if we are doing our jobs right, we help them do that. Working with entrepreneurs is a lot of fun. The good ones are smart, focused, confident, hard working and resourceful. All of them have a strong sense of urgency. Often, their company is the most important thing in their lives. Sometimes their work puts a lot of stress on their family relationships. Few people have spouses who have been as cheerfully accommodating as Ellen.

Clearly picking the right leader is critically important for a successful venture. It is one of the four basic ingredients. The others are a strategy that serves customers exceptionally well, an attractive market that has size, growth and acceptable competition and finally a robust profit formula that will absorb surprises while still providing a good return. Reviewing the bidding, it is management, strategy, market and profit formula. All four need to be present or attainable.

In evaluating a consumer strategy, I always start with the question as to what value is provided to the customer. Value for me has seven ingredients; convenience, entertainment, fashion, price, quality, selection and service. The right blend of these depends on what is being sold and to whom. For a cup of coffee on the way to work, convenience and service dominate the purchase decision. When I was on the Board of Directors of Caribou, we learned that not only did the store have to be on the right road, it also had to be on the morning rush hour traffic side. In contrast, many people will drive out of their way and wait a long time for a dinner at P.F. Chang's, primarily because the quality and the price are so good. Many of our successful investments have been considerably better than the competition on four or more of the seven components. Two of my current companies are Chicago based Ulta and Potbelly. Both are quite promising. Ulta has great selection and fashion, while Potbelly excels at price and service.

There is nothing more important in the due diligence process than evaluating a management team. Starting with the CEO, you need to know them well. Field work and the financial reports often tell you if they can translate ideas into reality. That needs to be supplemented with other things. I want to meet each member of the senior management team one-on-one, in addition to a group meeting. Having a meal, meeting in their office and visiting stores with the CEO should be done. A CEO of a potential investment seemed uncomfortable with my suggestion to visit his store about two blocks from the corporate office, but I convinced him to do it with me. When we walked in the door, it became obvious that the store staff didn't even know who he was. In addition, his interactions with the clerks were awkward. His previous statements about liking to visit his stores proved to be false.

Reference checking is both art and science. We do at least ten on a CEO and at least five for a CFO or COO. Go beyond their list. Ask the names they provide, who else you should talk to who might have a different view of the person.

Use a standard form. Talk to former bosses, peers, subordinates and competitors. Cover all time periods even if the person is older. I remember reading that a British businessman, who stole many millions of dollars, had also done seriously unethical things much earlier in his career, but none of his later investors apparently checked out that earlier period. We have done as many as 25 reference checks on a person. One of my CEO's told me that I knew more about him than his wife of 15 years did. Don't paper the file, really probe. Once I didn't make an investment because my last reference check hesitated on a question about ethics. It took many additional calls before we found out the CEO was dishonest. The company failed because of him, despite a great strategy.

There is a trait I look for in CEO's that I call incisiveness. It involves the ability to select the few critical variables that will make a difference in a given situation. Successful entrepreneurial CEO's are incisive. Talking about a wide range of subjects from politics, to health care, to sports, etc. gives insight on how the person reasons. Challenges to opinions can reveal things like backbone and openness.

Governance leads my list of company building responsibilities. I try not to miss any board meetings. It is very difficult to anticipate when something important will emerge, even when the advance agenda is quite detailed.

Normal Board responsibilities include reviewing and approving financial plans, evaluating the CEO, finding a new CEO as necessary, reviewing and approving expansion plans, and making sure the compensation plans are appropriate. Service on either the audit committee or compensation committee is the norm. Try to keep your board focused on the big picture rather than slipping into endless discussions of details that, unfortunately, are more frequent even in private companies now that Sarbanes Oxley exists. It is hard to be strategic after a five hour audit committee meeting.

Don't interfere in management. If you feel you have to, you may have the wrong CEO, Give advice, but let them manage. I currently sit on one board where I fear we are distracting a good CEO. Years ago, for another company, I selected return flights to Minneapolis such that the board meetings would have to end after four hours. One of the board members had a bad habit of wanting to talk about shrink rates by store.

Be available as an unpaid consultant if the CEO asks for your help. Requests include interviewing management candidates, visiting potential store sites to provide a second opinion, serving on the real estate committee and providing help in dealing with other board members. One of my favorite consulting roles was serving on the internal store design committee at PETsMART at the request of the then CEO, Sam Parker. One enduring product of that work is the curvy design of the company name. When I am involved as a consultant, I need to periodically remind myself that I am not there as a board member. I must permit and demand that the CEO and the management team make the decisions.

Venture capitalists can often be valuable when asked by a CEO to recommend outside resources. We have broad experience with executive search firms. The same is true for market research, consumer research, industrial psychologists and real estate site procurement.

Selecting the right investment banks for an IPO, a merger or a fundraising is very important. Too often CEO's are influenced by brand names rather than who will actually do the best long term job for the company. Those underwriters who specialize in growth retailers are much more valuable than the ones that focus on the Fortune 100. This reminds me of a favorite story. Office Depot was going public and they were on their roadshow. Traveling in a limo provided by the investment bank, the President commented that his \$75,000 salary was probably lower than almost all of the investment bank employees working on the financing. At that moment the driver turned around and said that even his salary was higher.

Financial modeling is an important part of both due diligence and company building. Oak's competitive modeling advantage that existed 18 years ago has mostly gone away. Everyone does modeling now. Sometimes we have found that our results are different than a company's, even using the same assumptions. Once we found a company was using more aggressive same store sales numbers than what they stated was in their assumptions. In other cases we realized that we had not understood part of their profit formulas. We do an annual model for five years. We do a quarterly model for at least two years. I must confess that we once did a weekly model. The lights in our office dimmed when we were running that one. We

do sensitivity analysis to understand both downside and upside cases. All assumptions are checked against our databases of industry information.

Field work is critical. Nothing can substitute for experiencing a store or restaurant the same way that a customer does. Make purchases. Eat the food. Visit the competitors. Go to all their main markets. Go to new stores and old stores. Go to good stores and bad stores. We bid on the Claim Jumper company earlier this year and by the time our due diligence was done, we had eaten at almost 30 of their roughly 35 units.

Figure out how big the relevant market is. This often requires real digging. Most market size estimates are overstated. A big market can suddenly look a lot smaller if the price points being sold by the company are high. Recently, someone looking at a bridal gown company quoted a huge market size. The problem was that the number he was using included the wedding receptions and the cost of the honeymoons.

It is hard to select a CEO if you have never managed anything. Theory is great and necessary, but not when you are picking people. Young people often come to me and ask for advice on becoming a consumer venture capitalist. Since there are no patents that protect you in my industries, operating execution is critical. My advice is to first get some industry experience in a line position.

It is quite possible to become a successful private equity consumer investor with a pure financial background. Financial structuring is critically important in that arena. Since private equity investments typically have positive cash flow, actions do not have to be taken as fast and there is less company building. Consumer venture capital is different and many people have failed in part because of their failure to recognize the differences.

Now on to my last section, the world. I hope everyone is still awake.

Thomas Friedman is correct, the world is flat. And that is good. In the last twenty years, hundreds of millions of people have escaped poverty. As more people are brought into the economic mainstream, our chances of destructive wars and terror are reduced. I heard Bill Gates say a few weeks ago that it would be good if the average incomes in China and India eventually match the U.S. That assumes all three grow, but at different rates. More customers, fewer potential suicide bombers.

I have suggested to our children that they forget about the traditional recommendation that a young American keep 20% of their equity holdings in international stocks. About half makes more sense to me. Over the long term, I try to invest where the growth is going to be. When I was a young analyst at DLJ in the early 1970's, there were 50 growth stocks called the "Nifty Fifty" that got bid up to very high relative P/E multiples. People viewed the prices they reached as a bubble. Their relative prices did collapse and owning them for a few years was a painful experience. Twenty-five years later, however, a study was done measuring the Nifty Fifties relative performance compared to the overall stock market from their peak. Guess what? They outperformed the market. Owning growth companies usually pays over the long term, particularly if you can figure out which companies are great. Of course, Warren Buffett has done pretty well with a value orientation.

My partners and I are particularly excited about the potential for investments in India. Next year we hope to launch a \$200 million consumer fund. Two general partners have been recruited. India's combination of a large, young, growing English speaking population with few large restaurant and retail companies is immensely attractive. As of the beginning of this month, there are non-stop flights from Chicago to India and that will make my life easier.

A keen interest in our rapidly changing world and a belief that we can influence its direction in a positive way prompted Ellen and I to establish a Foundation.

The Gallagher Foundation's vision is to promote peace and prosperity through education. Our method of doing that is to provide college scholarships to very talented young people in selected developing countries. Education is a natural cause for us to support because we believe that well-educated leaders are the key to a successful future.

In addition to academic achievement reflecting unusual intelligence and ability, we want evidence of leadership potential in the candidates. A high level of ethical values is desired, with each scholar firmly believing that progress can be achieved without violence. Race, gender and religion are not considered as factors in the scholarship selection. Academic majors can be business, education, engineering, law, medicine, science or technology. In order to have a scholarship renewed, the student must be successful academically, fluent in English and computer literate.

All of the candidates come from economically disadvantaged backgrounds. Prior to being selected, each candidate must commit to living and working in their country for the rest of his or her life.

Criteria we use in selecting countries include a democratic government, an excellent university, a developing economy that is strong enough to provide sufficient job opportunities to very talented and well educated young people, a sizable population, laws that promote religious freedom and ban discrimination (religion, race, gender), extensive use of the English language even though it does not need to be an official language, the reality or the promise of a peaceful environment and, finally, a geographic location in a region different than our existing programs.

South Africa was the first with our original group of scholars starting their freshman year in February 2002. Mexico has been successfully launched as our second country. Next is Turkey where our first students began their studies in the fall of 2005. Being a predominantly Muslim country, Turkey fits with our desire to have diversity in our program. There remains the possibility we will add additional countries, but we plan to wait until at least 2006 before we give this expansion serious consideration. If we do add a fourth, India is the leading candidate.

We also want diversity within each country. For example, we seek a good balance of males and females. In addition, students from all sections of a country are preferred along with a mixture of urban, suburban and rural backgrounds. If there is religious diversity within a country, we would like to have that within our scholar group.

Two candidates are interviewed by Foundation representatives for each available scholar position. In South Africa, an independent company presents the candidates they have screened, while in Mexico and Turkey that job is done by the universities.

Currently there are 42 Gallagher scholars and two graduates.

We take pride in the fact that all three of our children are supportive of this effort, despite the fact it will significantly reduce their inheritance.

Nothing would make me happier than if some of our scholars became successful entrepreneurs and created lots of jobs in their countries.

Two weeks ago, Ellen and I talked to our South African scholars for twenty minutes each. We feel as if they are part of our extended family.

Building things is fun. That is true for families, careers, houses, companies and countries. It is certainly hard work, but satisfying. I hope to continue this type of activity for as long as my energy and health are there. My wish for you is that you have as much fun as I am having. Perhaps as entrepreneurs and venture capitalists, we can make a difference for the world as a whole while we accomplish our own personal goals.

Thank you.