Has Persistence Persisted in Today's Private Equity?

A Roundtable Sponsored by the Notre Dame Institute for Global Investing and the Private Capital Research Institute

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On June 13, 2017, a group of limited partners, academics and general partners met to share their thoughts on performance and persistence in private equity investments. Overall, the evidence suggests that the conclusion was that the once robust persistence of performance across buyout funds has weakened, along with the historical outperformance of private equity relative to the private markets. The discussion among the practitioners focused on the various approaches employed in selecting fund managers, factors influencing performance in the current environment, industry trends and performance benchmarks, comparisons between venture and buyout investing, alignment issues, and the importance of culture. These views were balanced by the empirical research findings presented by academics.

Limited Partnership Perspective

Michael Donovan from the University of Notre Dame led a panel discussion on performance and persistence with a group of limited partners. Discussants included Dan Feder from Washington University, Patrick Lynch from Caisse de Dépôt et Placement du Québec, and Paula Volent from Bowdoin College.

Donovan began the discussion by asking the panelists to define what they thought were the hallmarks of a consistently successful private equity firm. The panelists generally agreed that persistence is harder to find than ever. Therefore, going back to the usual suspects like the large VC firms on Sand Hill Road may no longer be the best play. One panelist observed that it is important to see which partners had the successful deals and to see whether they are still active at the firm. He added that success often results from advantaged sourcing or was the product of a special, proprietary skill. According to this discussant, product proliferation can sometimes be the enemy of performance.

Another panelist felt that the best firms have a clear understanding of what attributes have made them successful and are proactive in adapting to changing market conditions. Yet, some firms, primarily venture firms with strong records, can coast for decades with strong demand for their funds regardless of recent performance. Lastly, the discussants added that they preferred long-term partnerships and were unlikely to make one-fund commitments based on performance.

Next, the issue of how to best measure persistence was addressed. There seemed to be broad agreement that money in and money out is more reliable than internal rate of return (IRR), which can be manipulated by recaps and credit facilities. Nevertheless, there was also a prevailing sense that more effective benchmarks for measuring performance need to be developed. In addition, there was no clear consensus around when one can conclude that a manager has settled into a persistent quartile. One panelist pointed out that, statistically, firms move around a lot in terms of quartiles, with some firms residing in all four quartiles at some stage in their history. Others felt that quartile performance is misleading because it lumps everything together and does not take into account factors such as risk and variations for sector specialization. It was noted that firms that encounter difficulties and drop in quartile ranking can be among the most interesting prospects because they can often successfully engineer a turnaround and re-energize themselves.

This led to the question of how to protect against success begetting mediocrity. One discussant added that a "same team, same strategy, and same fund size" strategy used to be the accepted wisdom when evaluating new funds. Today, given the dramatic changes in the market, that anchoring assumption may not be as valid as it once was. Opinions were split on whether investors managing large pools of capital, such as sovereign wealth funds (SWFs), looked at GPs differently than other investors, such as small endowments, and whether larger funds might have outsized influence. Also, for smaller LPs, this disparity raises concerns about the possibility that larger funds might have outsized influence on the LPAC and preferential treatment in co-investment opportunities.

The panelists went on to discuss the issue of GP-ownership stake sales and the push-back that such sales have provoked. The consensus view was that a public GP necessarily has another constituency to please: public shareholders. This means that the priority shifts to raising more assets and charging more fees, thus decreasing alpha. These ownership stakes can become especially problematic when the investment environment is difficult, because the GP could get distracted addressing public shareholder concerns. Another area for discussion was generalist versus specialist funds. Most agreed on a "core generalist and satellite specialist" strategy. In other words, most LPs prefer to invest with a generalist with demonstrated capabilities to transact in a distressed situation rather than with a narrowly focused distressed manager.

Academic Panel Perspective

Josh Lerner from Harvard Business School led a panel discussion on performance and persistence with a group of academics. Discussants included Rüdiger Stucke from Warburg Pincus, Michael Ewens from California Institute of Technology, and Lin William Cong from University of Chicago.

Stucke began by presenting his co-authored research[1] that studied the persistence in performance of US private equity (buyout and venture capital) funds using Burgiss data. The dataset was sourced from over 200 institutional investors representing over $1 trillion in committed capital and included their transactional and valuation history. Using detailed cash-flow data for the funds, Stucke evaluated the performance persistence of the same general partners across different funds. He found a strong persistence for buyout funds, particularly, for venture funds during the pre-2000 period. This trend generally held across multiple performance measures, including PME, IRR and MOIC.

Post-2000, however, he found little evidence of persistence for buyout funds, except at the lower end of the performance distribution. When the funds were segmented into quartiles based on the performance of previous funds, the performance of subsequent funds after 2000 were statistically indistinguishable. For venture capital, performance in post-2000 funds remained as persistent as pre-2000.

Stucke argued that given the lack of persistence for buyout funds, it makes sense for the LPs to focus more on the performance of the most recent funds, even though the investments maybe unrealized, rather than fully-realized fund record. Rigorous and fair valuation of recent funds is a better approach to make investment decisions.

Next, Ewens presented his research,[2] along with Rhodes-Kropf, on whether individual venture capital firm partners have repeatable investment skill, as well as the relative importance of the partner and the firm in explaining investment performance. Analyzing close to 1,600 VC firms and 5,000 VC partners, Ewens and Rhodes-Kropf find that there is a strong partner-level performance persistence, i.e., a partner's past investment success does predict future success. In addition, using a database with over 20,000 investments that track VC partners who switch VC firms, they find that a partner's human capital is two to five times more important than the VC firm's organizational capital in explaining the performance. Further, the partner's performance is persistent over time, even after controlling for a large set of individual and VC firm characteristics. This suggests that the partners have some time-invariant skill that is transferable when the partner moves to a new VC firm. This finding also supports the evidence of skill and exit style differences even among general partners investing at the same VC firm at the same time.

One question from the audience was why we do not see all the best VC partners coming together to create a super VC firm. The impediment of creating such a VC firm comes down to division of economics. In a firm of all partners, each partner would demand an equal slice of the pie. In a firm with one or a few star partners, there is more of an opportunity for the few star partners to take a disproportionate share of the economics.

Lastly, Cong's presentation focused on how luck induces fund heterogeneity that in turn leads to differential investment performance. Using a theoretical model, Cong demonstrates how luck induces and amplifies fund heterogeneity that in turn leads to differential investment opportunities and, thus, performance for the VC partner. If a manager is lucky in her current fund, she may find it easier to raise the next fund on more favorable terms. Also, the good performance may in turn allow investors to be more tolerant towards failures and experimentation, attracting better deals that perpetuate her good performance. Therefore, an initial temporary and random shock (luck) could have a persistent impact in VC. This positive reinforcement can lead to persistence in differential performance across managers even when they do not differ in skills. Cong's conclusions are broadly consistent with empirical findings, such as persistently outperforming venture funds encouraging greater innovation and attracting better entrepreneurial projects even with less favorable terms. This also suggest "incumbent bias" in manager hiring, compensation improvement for recently successful managers, and performance persistence in other investments.

Questions were raised regarding whether it matters for an LP if the success of a manager is due to luck rather than ability. Cong's response was it matters if persistence takes into account the performance level net of fees, because it gives the LPs a better bargaining power for splitting the rents. Recognition that the success of a particular GP stems from some endogenous heterogeneity allows LP to secure a better deal since the manager is replaceable.

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1) Harris, Robert, Tim Jenkinson, Steven Kaplan, and Rüdiger Stucke, "Has Persistence Persisted in Private Equity? Evidence From Buyout and Venture CapitalFunds" Working Paper, April 2014
2) Ewens, Michael, and Matthew Rhodes-Kropf, "Is a VC partnership greater than the sum of its Partner?," *Journal of Finance*, June 2015

GP Panel Perspective

Anne Martin, Chief Investment Officer at Wesleyan University Investments, led a panel discussion on performance with a group of leading GPs. Discussants included Philip Berney, Co-Chief Executive Officer at Kelso Private Equity; Joseph Linnen, Senior Partner at The Jordan Company; Terry Mullen, Partner at Arsenal Capital Partners, and Dave Thomas, Partner at Court Square.

The panelists offered their perspectives on factors that they believe contribute to sustain performance and long-term success in private equity investments. They acknowledged that sometimes luck and getting in early are important factors for success. However, they all agreed that taking the time to get out there and do the upfront work to decide what to buy was extremely critical. They also stated that maintaining the cultural and social factors of their firms were important for success. They felt that all their successful senior managers had to "sit in the broom closet" early in their career to really learn the culture of the firm. The panelists also agreed that sharing the wealth is a key component to keeping strong talent in-house. Furthermore, the discussants noted the importance of hiring good managers, but recognized that while a variety of tools are used to assess talent, predicting individual success is still extremely difficult. Lastly, other factors for success that were mentioned were embracing innovation, offering strategic differentiation and sector expertise, adapting to the market environment, and having a lot of passion.

Next, Martin led the panel in a discussion of whether private equity is becoming a commodity product. In an increasingly competitive world, the panelists felt that innovation is an ever more important value creator. In addition, they felt that there is a need to re-think the operating-partner role, which historically was viewed more as a second-tier role. Now, the role has evolved to be more important early in the investment evaluation process as the need for strategic and technical skills has grown. Next, in order for GPs to successfully differentiate themselves, the panelists pointed out that firms need to prove brand positioning, expertise, and good judgment in the marketplace.

The panelists went on to discuss their thoughts about fund size. One panelist cautioned that growing too fast without a good strategy to source good deals could lead to poor performance. Furthermore, another panelist pointed out that another key factor to successfully grow is that firms need to be able to get the right expertise when expanding into new sectors. Thus, maintaining a smaller fund size with specialization in potentially high growth sectors may be a better strategy than expanding. Lastly, it was noted that having a competitive of strategy and being aware of what your competition is doing are very important in the current environment.

Lastly, the panelists acknowledged that technological innovation has brought great challenges as well as opportunities. More investment and capital now flow to small, high-growth, technology firms focusing on deep learning and artificial intelligence. In addition, all types of businesses are constantly being challenged to innovate or face disruption. This has brought fresh blood to private equity investments, but it has also emphasized the importance to recruit talent with this kind of specialization.