

DISCUSSION OF:

“Investing Outside the Box: Evidence from  
Alternative Vehicles in Private Capital”

by Josh Lerner, Antoinette Schoar, Jason Mao, Nan Zhang

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Discussion by:

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# Lerner, Schoar, Mao, Zhang

Motivation 1: Reconciliation of:

- a) PE Puzzle that some LPs have persistent returns with
- b) Berk/Green that GPs with skill should have larger funds (decreasing returns to scale)

Via: Pastor, Stambaugh, Taylor (also Gerakos, Linnainmaa, Morse):

- Monopsony bargaining power of large investors versus GP power via Berk/Green

Motivation 2 (related, but not explicitly in the paper): Conflicting prior literature about whether GP-directed co-investment takes advantage of LPs

# Prior Papers

The authors were quick to dismiss the two prior papers on this topic:

*“The only exception are studies which focus on **select samples of direct investments by limited partners**: Fang, Ivashina, and Lerner (2015) analyzed co-investments and solo investments using information from only seven large (and undoubtedly non-representative) limited partners, while Braun, Jenkinson, and Schemmerl (2017) looked at co-investments recorded in the CapitalIQ database, which only captures a (potentially non-random) selection of transactions.”*

Samples: Counts of Investments		
	Co-investment	LP Direct Investment
Fang-Ivashina-Lerner	286	104
Braun-Jenkinson-Schemmerl	1016	
Lerner-Schoar-Mao-Zhang	819	883

# Prior Papers

- I read these other papers. Both were serious contributions.
- Fang-Ivashina-Lerner:
  - Punchline of adverse selection.
  - Co-investment opportunities offered to LPs are lemons, taking advantage of large pools of capital needing to be put to work
- Braun-Jenkinson-Schemmerl:
  - GPs offer large deals to investor, not lemon deals.
  - Pension funds outperform in buyout market, supporting ideas of long-term relationships for big pools of capital getting preference.

# Lerner, Schoar, Mao, Zhang

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Analysis focus: Characterize GP-LP matches and test which features matter in returns. Conclude with how evidence supports bargaining story.

Concern: Lot of dimensions of plausible causal stories.

# My Suggestions

- Re-cast a bit more toward:

Motivation 2 (reworded): Conflicting prior literature does not disentangle all the agency relationships in financial intermediation

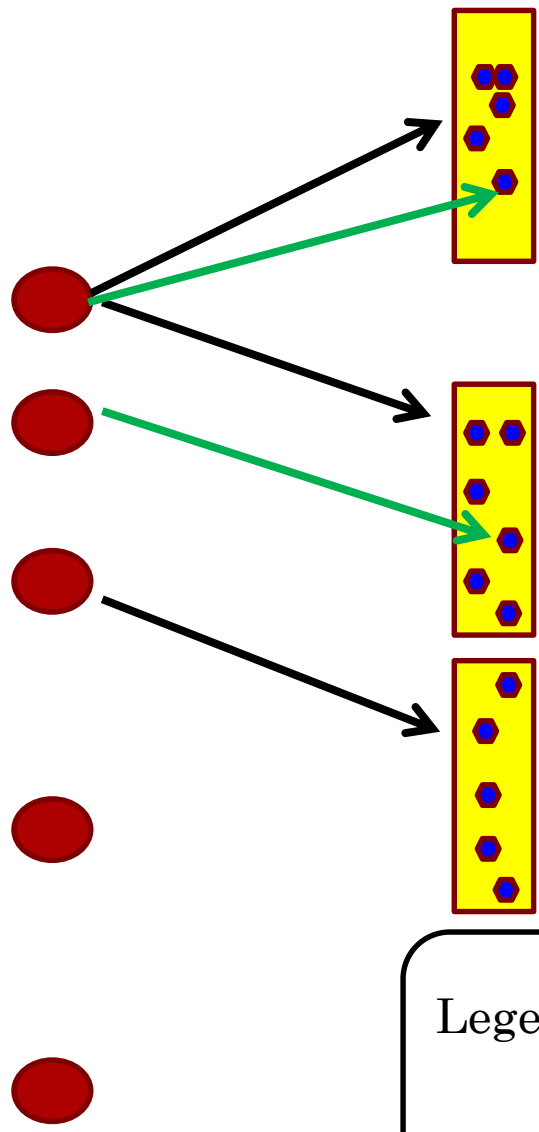
- Set up analysis with an agenda following a matrix of predictions about returns and matches to test different stories

My opinion:

- More convincing on identification if in a matrix of competing stories,
  - Does not ignore literature,
  - Easier to read,
- ... compared to starting with a bargaining story in intermediation

# Matrix of stories

- Adverse selection (lemons)
- Pricing power to GP a la Berk-Green (better skill)
- Pricing power to GP correlated with portfolio company needing value-add
- Pricing power to LP via monopsony power
- Pricing power to LP via relationship favoritism
- LP expected return is declining in placement of large pool of capital (flip side of Berk - Green)



Graphics:

Consider an GP-directed Co-Investment versus a Fund Investment

– (Ignoring Discretionary but could do same exercise)

Problem in testing theories of intermediation:

– Confounding stories of supply side, demand side, and matching

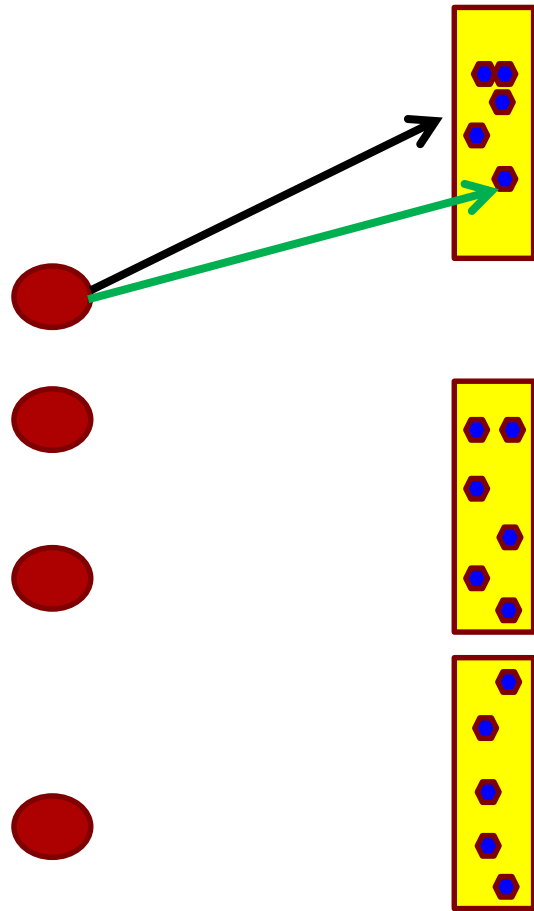
Suggestion: Use Isolation of comparisons to untangle



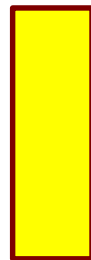


## Adverse Selection

Estimate within Fund performance of Co-investments versus Fund investments



Legend:



PE Fund



Portfolio Company



Fund Investment



LP Investor



Co-Investment

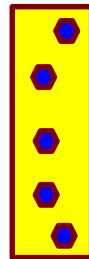
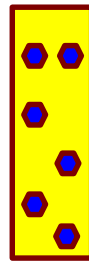
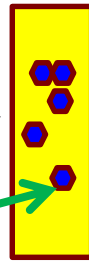
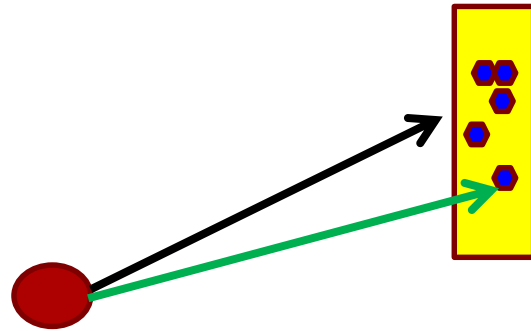
## Fang, Ivashina, Lerner

### Main result

Co-investments underperform overall same-fund return

- Explanation: selection/**lemons** problem
  - GP picks which portfolio companies to offer for co-investment
- Alternative consistent explanation: **Access**
  - Underperformance is especially true in large portfolio companies (large funds).
  - Result could reflect scarcity in opportunity in asset class.

Same Fund Returns – Testing Selection & Access



Legend:



PE Fund



Portfolio Company



Fund Investment



LP Investor



Co-Investment



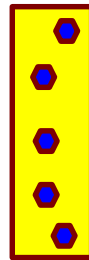
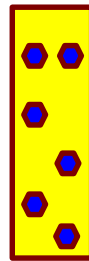
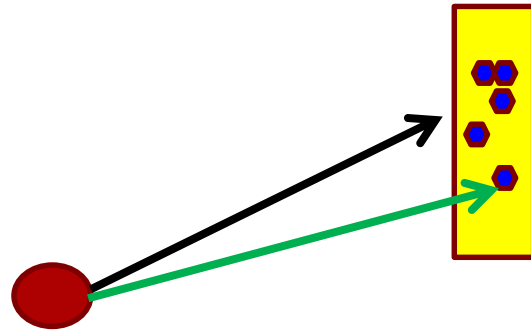
## Braun, Jenkinson, Schemmerl

### Result 1

No difference in performance between portfolio companies offering co-investment and portfolio companies in same fund not offering co-investment

- Interpretation No Adverse Selection

Same Fund Returns –  
Testing  
Selection &  
Access



Legend:



PE Fund



Portfolio Company



Fund Investment

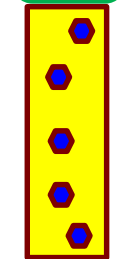
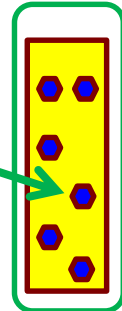
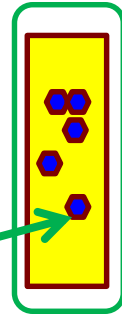


LP Investor



Co-Investment

Which Funds  
/Portfolio  
Companies offer  
Co-Investment  
Opportunities?



Legend:



PE Fund



Portfolio Company



Fund Investment



LP Investor



Co-Investment

Braun, Jenkinson, Schemmerl

Result 2

It is the large portfolio company deals that offer co-investment opportunities

- Interpretation: GPs limit exposure to any one portfolio company and thus use large LPs to gain access to big deals
- Alternative interpretation: Effective way for GPs to offer more supply to preferred large investors

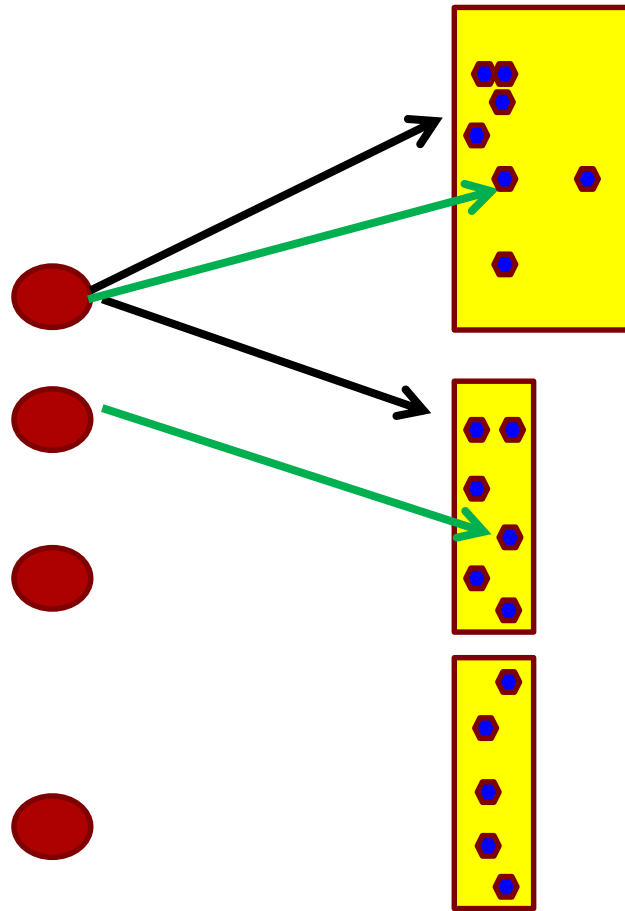
# Matrix stories

- Adverse selection (lemons)
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- Pricing power to GP correlated with portfolio company needing value-add
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## Pricing Power – 1

### Berk/Green Returns to Skill :

- Coinvestment returns should be neutral
- But dynamics of past GP fund performance and growth in the size of total fund size + coinvestments offered should reflect decreasing returns to scale and intermediation dollar profits



Legend:



PE Fund



Portfolio Company



Fund Investment



LP Investor

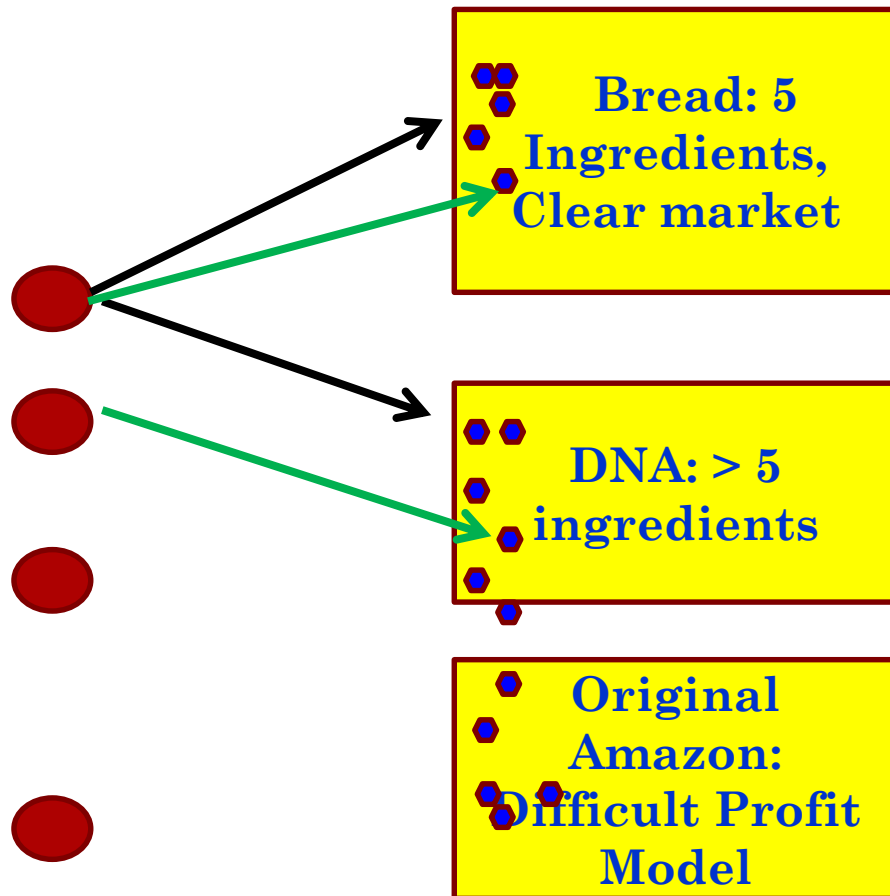


Co-Investment

## Pricing Power – 2

### Value-Add Scale Effects in Intermediation:

- Coinvestment returns should be decreasing in industries, locations, stage, etc, with greater need for value-add
  - LPs are not offering value-add.



Legend:



PE Fund



Portfolio Company



Fund Investment



LP Investor

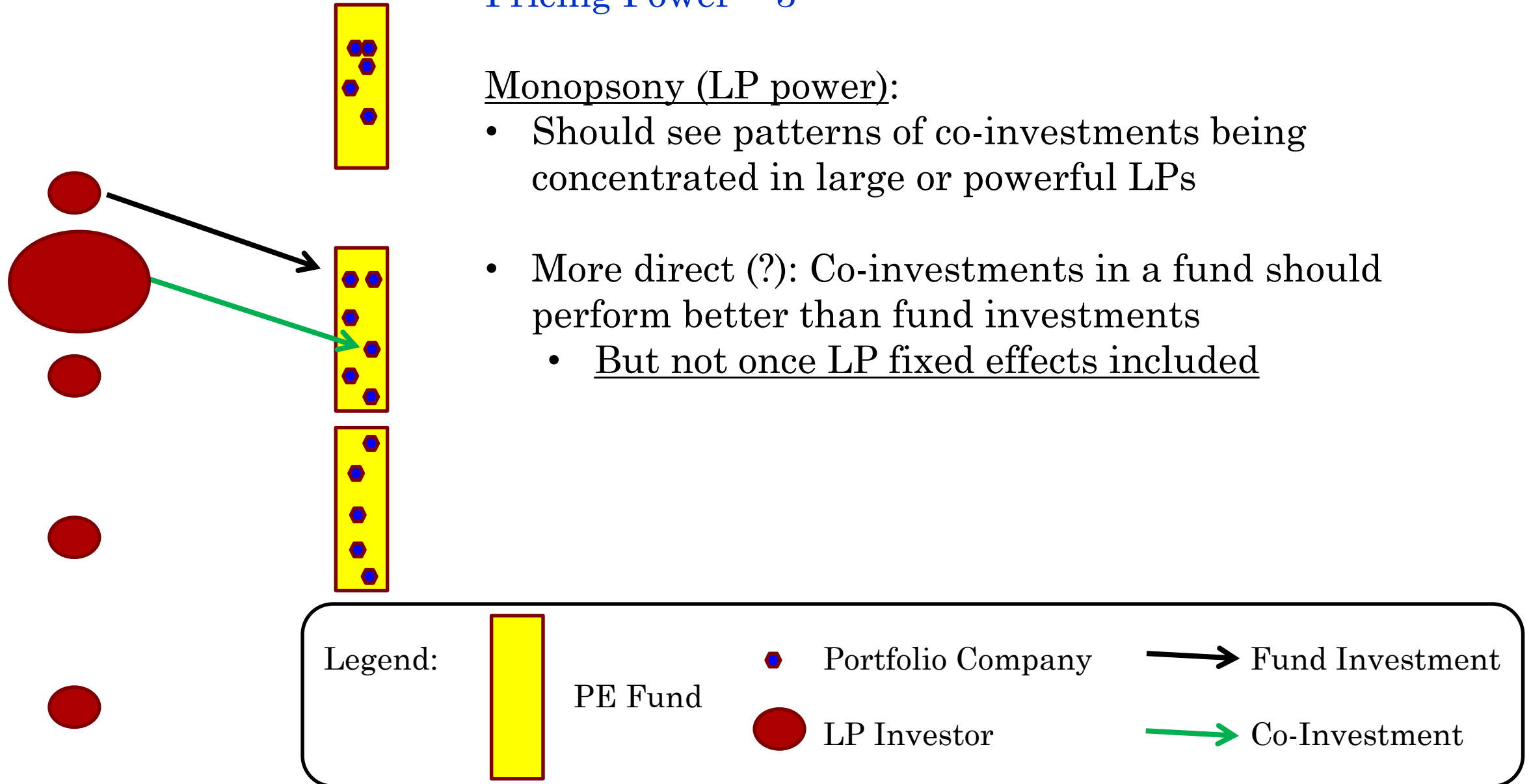


Co-Investment

## Pricing Power – 3

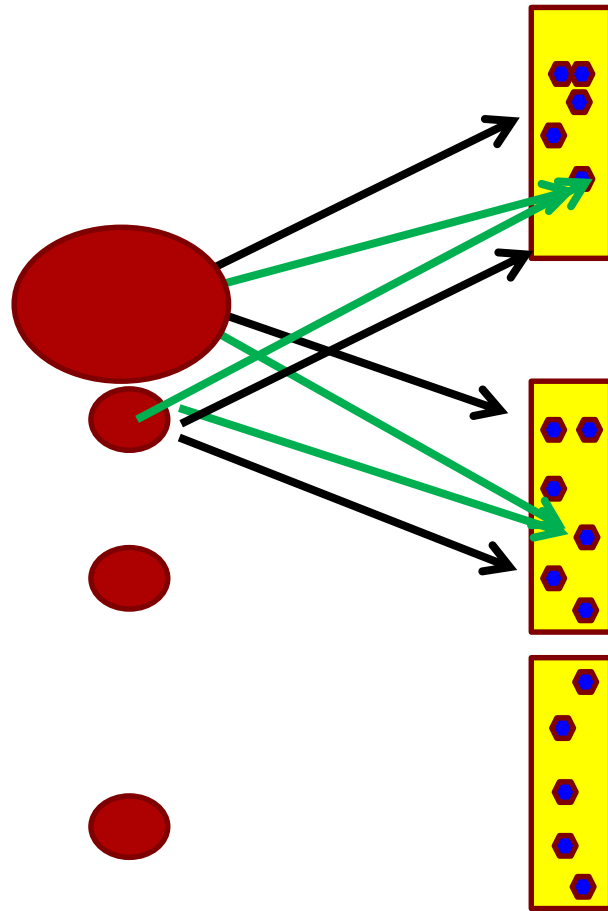
### Monopsony (LP power):

- Should see patterns of co-investments being concentrated in large or powerful LPs
- More direct (?): Co-investments in a fund should perform better than fund investments
  - But not once LP fixed effects included





## Access to Placing Capital / Relationship Access



Returns of Co-investment minus Fund investment should be decreasing in LP size within same-fund investments

Returns of Co-investment minus fund investment should be increasing in relationship

Legend:



PE Fund



Portfolio Company



Fund Investment



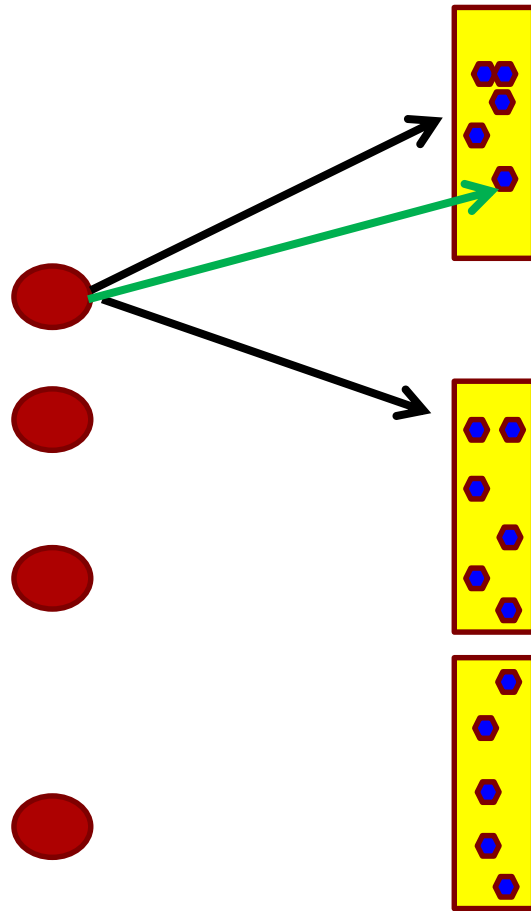
LP Investor



Co-Investment

## Favoritism in Granting Access to Placing Capital

Returns of LP's all capital in funds with coinvestment  
>  
Returns of LP's all capital in funds without  
coinvestment



Legend:



PE Fund



Portfolio Company



Fund Investment



LP Investor



Co-Investment

# Summary

- The evidence in this paper is surely convincing on bargaining
  - But it does not rule out two or three other stories with confounding effects getting the same result
  - Perhaps the frame I've suggested will help make the truth “shine” through all the details

## Really great data work and topic

- We need to know these answers – so much capital and so many people's welfare is riding on intermediation