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### By the numbers
Distributions rise – but not by enough; PE performance and company improvement; fundraising sentiment improves; PE more attractive post-crisis; lowest exit multiples since 2004; LatAm and India lose appeal.

### Nurturing innovation
How do you nurture and commercialise innovation? What are the pros and cons of venture capital and corporate venture capital programmes? We speak to Josh Lerner, who explores these issues in his latest book, *The Architecture of Innovation*.

### Because they’re worth it?
Do higher fees dent performance? And does higher GP investment in a fund lead to better results for LPs? New research lifts the lid on the issue of GP incentive structures, with some surprising results.

### Bitter experience
LPs increasingly seek co-investment opportunities, but how well do these investments really perform? We discuss the findings of new academic research with its authors and some highly experienced LPs.

### Steady through boom and bust
With a strong track record behind it, a Coller Institute case study reviews a fund of funds pioneer. This case study examines the firm’s fund selection processes and some of the factors in its success.

### Special purpose, special incentives
Special purpose acquisition companies, or cash shells, may help PE raise capital for single deals or provide an alternative exit route. But new research suggests these structures may be fundamentally flawed. We debate with three academics, plus two practitioners.

### Are VCs avoiding risk?
How do future fundraising prospects affect investment decisions in venture capital? The Coller PhD Prize runner-up paper takes a look at this issue.

### Coller Institute of Private Equity news
We report from the Private Equity Findings Symposium, where delegates debated the role of innovation, examined LP-GP dynamics and perused the latest research from across the globe.
We strongly feel that with the Coller Institute of Private Equity at London Business School we are establishing something unusual and significant. This global research centre opens up new possibilities for rigorous academic research, for academic exchange, for teaching future industry leaders and for encouraging outstanding young researchers to work on PE and VC subject matters. While seeking open exchange and debate with the international PE and VC industry, the Coller Institute strives to make academic research findings more accessible for practitioners by hosting a number of topical events in London and around the world every year and by publishing our unique Private Equity Findings journal.

The articles in this edition once again showcase new PE and VC related research from leading international academic thinkers, discussed and challenged by senior academics and practitioners. Explore new thinking about optimising business and how funding models nurture innovation. Josh Lerner shares the insights and key hypothesis of his recent book, *The Architecture of Innovation*, comparing the benefits and shortfalls of corporate R&D with VC models while testing a new solution. Also enjoy a debate between academics and industry experts about whether bargain hunting for lower manager fees yields the best outcome for LPs.

While special purpose acquisition companies, or SPACs, seem to be enjoying growing investor attention, the structures are also subject to strong criticism. Our roundtable article, a traditional feature of our journal, invited a panel of academics and practitioners to exchange their views and academic findings regarding SPACs.

One young American academic in the PE/VC field caught our attention and became the 2012 runner-up of our coveted PhD Coller Prize. We are delighted to share with you his hypothesis regarding the risk appetite of VC fund managers – or the lack of it – and we hope to hear your thoughts on his findings and the subject in general.

The discussion of a new academic paper, which challenges the merits of co-investments, should not be missed. We would be delighted to hear your opinions regarding our articles. Input and debate encourage new research, often trigger further investigations for current research or simply highlight that one can disagree with academic findings. The Coller Institute also invites its community to articulate research topics of interest.

Please note that our academic work requires sustainable funding. If you share our passion and want to support our work, comprising rigorous academic research of the highest quality and the nurturing of outstanding young academics in the PE and VC field, please talk to us. There are several ways of getting involved. Or visit our 7th Symposium (2-3 June 2014 in London) to meet our management and faculty for a conversation. Please feel free to send your comments and suggestions to Nicole Hergarten-Tucker, the Institute’s executive director, at nhergarten@london.edu. If you want to obtain a copy of our latest research report, *The Extent and Evolution of Pension Funds’ Private Equity Allocations*, or to find out more about our events and activities, please visit our website at www.collerinstitute.com.

Professor Francesca Cornelli
Director, Coller Institute
**By the Numbers**

**Distributions Rise – But Not by Enough**

- Global PE and VC distributions to LPs reached $125bn in 2012 – 97% of the peak 2007 year by dollar amount. But LPs remain concerned about liquidity.
- This chart from Capital Dynamics demonstrates why. While distributions as a percentage of previous years’ NAVs have increased from the recession average of 11% to 16% in 2012 and an estimated 14% in 2013, they are still well below the 23-year average of 20% – and significantly below the peak year average of 30%.
- The unrealised value of US and European portfolios was at its highest level ever in June 2013, at $738bn. As much as 70% of this is tied up in funds dating from 2007 or before, and half of the NAV in PE funds is concentrated in the 2005-2007 vintages.

**PE More Attractive Post-Crisis**

- As economic volatility has become the new normal since the crisis began, LPs are seeking more stable investment options. Nearly half of LPs surveyed for the Winter 2013 issue of Coller Capital’s Barometer said that PE had become a more attractive asset class as a result. Just 12% said it had become less attractive. The rest had not changed their views.

**Latin America, Brazil and India Lose LP Appeal**

- As many emerging market economies look set for a period of slower growth, LPs are shifting their appetites towards newer and potentially more promising markets. A recent survey of LPs by the Emerging Markets Private Equity Association found that Sub-Saharan Africa is now ranked by LPs as the most attractive among the emerging markets. India’s popularity among PE investors has declined rapidly over the past four years (MENA – not shown – ranked lowest overall).
- Also becoming less attractive are Brazil, China and Latin America, while South-East Asia and Central and Eastern Europe are seeing a rebound in popularity among LPs.

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Source: EMPEA.
The largest component of PE’s gross returns is derived from strategic and operational improvement in the companies it backs, according to EY research into European exits between 2005 and 2012.

Stock-market returns (a proxy for multiple arbitrage) accounted for 30% of the outperformance, leverage (over and above the public company average) for under 35% and improvements to portfolio companies for over 35%, despite the difficult market conditions since the crisis.

The study, based on 527 exits of PE-backed companies with an entry enterprise value of €150m+, found that PE-owned companies outperformed comparable public companies by a factor of 3.6x during 2005-2012.
Driving innovation is seen as fundamental to economic development. So how important is the growth of the start-up world’s share of R&D nowadays?

Josh Lerner: “You are seeing two patterns. First, if you look at companies with under 500 employees, their share of R&D business expenditures is growing quite considerably. Second, the productivity of that money is higher. Our research, and that of several others, suggests the productivity of venture innovation is considerably higher than for corporate R&D. So not only is more money being spent on it, but venture innovation has a bigger impact in terms of the amount of innovation it spurs.”

Yet fostering innovation and bringing new ideas to market are far from straightforward, as you outline in your book. Can you explain what the key issues are here, in your opinion?
If we’re talking about corporate venturing, not all programmes have been that successful, have they?

JL: “It is probably fair to say, because of some well-publicised failures in the past and the flakiness of some of the companies involved, that there has been a tendency to be dismissive about corporate venturing as an area of activity. But when you look at the empirical record in terms of exactly how these programmes have worked, they seem to have got a bad rap.”

We’re now seeing more organisations look to corporate venturing. Why do you think this is?

JL: “I think a lot of it has to do with the difficulties of the traditional corporate R&D laboratory. In many cases, companies, often after World War II, set up very elaborate central research laboratories that were supposed to do basic science and be ‘ivory towers’. Over the course of the 1980s and 1990s, disillusionment with central labs set in. Instead, there was a move towards setting up divisional facilities, which would in theory be much closer to the customer and do research that was more commercially relevant. But in many cases, those have not worked that well either.

“As a result, there is now a lot of interest in ‘open innovation’ of various kinds.

Companies are figuring out ways of reaching outside the organisation for ideas. Corporate venturing is just one arrow in the quiver of new approaches. Organisations are looking to do things differently, and corporate venturing represents an important and potentially promising way to do so.”

In your research, you tracked why corporate venturing groups have gone wrong in the past. One example was Xerox, where the programme got shut down for being almost too successful. What do you think companies have learned from this type of experience?

JL: “One of the big tensions in corporate venturing has to do with compensation. In many different forms of human endeavour, when you ask a group of people to behave like other people but do not pay them like those other people, you have a recipe for problems. In many instances, corporations created corporate venture groups, asked them to invest like venture capitalists, to sit on boards like venture capitalists, and build a visibility in the industry like venture capitalists, but did not pay them like venture capitalists. In many cases, this led to defections from corporate venturing programmes.

“In a few cases, like Xerox, where the firm promised to pay its team like venture capitalists, which Lerner illustrates by describing the envy of corporate investors parking their Fiestas next to their VC peers’ Ferraris.

He singles out SR One, which is the longstanding corporate-venturing unit of GlaxoSmithKline, for praise for the way it handled this thorny issue.

The SR One unit was headed by Peter Sears from 1985 to 1999. In his book, Lerner praises the unit not only for its “stable management” but also for investing in biotech firms such as Amgen, Cephalon and Sepracor, and co-investing with “major venture firms” such as Kleiner Perkins and New Enterprise Associates.

Lerner argues that SR One’s compensation scheme “had a large role in the success”. The unit received a bonus of 15% of profits generated and a further 5% bonus based on less-tangible benefits to the corporation.

This helped the venture unit’s investors remain focused on both financial and strategic gains, according to Lerner.
“THERE IS NOW A LOT OF INTEREST IN ‘OPEN INNOVATION’. COMPANIES ARE FIGURING OUT WAYS OF REACHING OUTSIDE THE ORGANISATION FOR IDEAS”

capitalists, they find themselves unable to honour their promises. As you can imagine, such events created an enormous amount of scepticism in the venture community about how serious corporations are in regard to venturing programmes. “But in a number of other instances, such as the restructuring of Lilly Ventures, which now has more of a market-based compensation scheme, there has been a willingness among corporations to step outside the box, and say, ‘even though this does not fit well with our incentive schemes, we are going to find a way to make this work’.”

If you have corporates paying like venture capitalists, they would say that corporate-venturing programmes have the edge over VC funds in terms of getting the right talent on board? JL: “Clearly, in a market like today’s, raising a venture fund is an enormously difficult task in itself. If you think about the team that is running a corporate-venturing group, they are essentially getting the funds handed to them. Yet a corporate-venturing group has a bigger challenge than independent funds. It has to wear two hats: one of the audiences it must work with is its external constituency – entrepreneurs and others – and then there are relationships to be managed within the corporation as well.

“It is not a trivial or easy job running a corporate-venturing programme. On the one hand you can say they have it easier, but also there are some unique challenges associated with running these programmes.”

What other measures would you recommend corporate-venturing programmes take to maximise their chances of success? JL: “One of the things that has bedevilled these programmes has been the lack of staying power of the corporations. Companies will get into this and then walk away, having been disillusioned. A new CFO, CEO or even a new chief counsel will often decide to kill the pet projects of his or her predecessor. Often, corporate venturing is one of the things that gets put on the chopping block.

“If you have a situation where everyone is sceptical about your staying power, this is going to translate into entrepreneurs being less willing to take money from you, high-quality people being less willing to join your corporate venturing group, and so forth.

“As a result, corporations should do more to formalise the process: making a legal agreement; putting the funds for the corporate-venturing unit in escrow; bringing in third parties; incorporating the entities getting the funding. All these things can help ‘tie the hands’ of the corporation, and make it that much harder for a corporation to kill it off prematurely.

“Another area to highlight is internal transformation or internal absorption. Too often, corporations have a corporate-venturing unit that invests in a number of ideas that are very relevant to the firm, but somehow the ideas never get internalised or translated back into the organisation. Figuring out a way to absorb the knowledge the corporate-venturing unit is picking up is important.”

What might a VC fund learn from a corporate programme? JL: “One of the big areas one would begin with is thinking about the way funds are structured. From the very early days of VC partnerships, these funds were set up with a lifespan of between eight and 12 years. There was pretty much a one-size-fits-all model in terms of the length of the funds.

“It is puzzling how that came about. It is not immediately obvious how investing in social media, where you can put a site out and get feedback about popularity in a few hours, has much to do with the innovation process of clean-tech or biotech, where it can take decades between coming up with the initial idea and the product reaching the market. Why are we seeing this one-size-fits-all model in VC instead of seeing it customised to the particular challenges it is facing? VC has been about funding innovation, but in some ways it has not been very innovative itself.”

How do you see corporate venturing affecting wider innovation across the globe, assuming it becomes entrenched? JL: “In the developed economies, there is a desperate need to stimulate growth. This has translated into a desire to encourage innovation. In emerging economies, which have traditionally grown more quickly, there are now concerns about employment generation and these have created a lot of interest in innovation as well.

“Corporate venturing or other hybrids are not a magic bullet. But to the extent that they can contribute to the innovative process, these initiatives could have big returns – not just for individual firms but for society generally.”

Toby Lewis is editor of Global Corporate Venturing (www.globalcorporateventuring.com)
Please note that the online ticket sales for our 7th Coller Institute of Private Equity Findings Symposium, held on 2nd and 3rd of June 2014 at the Royal College of Physicians in London, has started.

Spaces are limited so register now to secure your seat.

To RSVP, please follow the following link to our website where you can register your place at the event: http://www.collerinstitute.com/Events/Show/102
Private equity is often hailed as a model for alignment of interests between investors and fund managers. However, the industry has come under attack from a number of quarters over recent years for managers who get so rich from fees that they are no longer incentivised by performance rewards. Sceptics point to an industry that has evolved beyond the terms that originally dictated LP agreements, which have gone largely unchanged for 20 years. Their claims often centre on ‘excessive’ fees and insufficient ‘skin in the game’ by way of GP investment into the fund.

However, new research suggests that these criticisms may be overblown: it finds that net performance is not negatively correlated with fund manager compensation. The upshot is that expensive funds effectively achieve gross returns sufficient to offset their higher fees.

While this may shock some LPs, the authors of Do Private Equity Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance were unsurprised. In essence, their findings are a story of market equilibrium. “LPs are sophisticated and able to look after themselves when dealing with GPs,” points out Berk Sensoy, associate professor of finance at Ohio State University’s Fisher College of Business and co-author of the study with David Robinson of Duke University.

“We expected this to be the case – if they feel a management fee is excessive, they have the option to go elsewhere. This implies that if they back a manager with higher fees (or other terms that are less favourable to LPs), it is because they remain convinced that the net performance is still preferable to the alternatives.”

The study finds evidence of terms swinging in favour of GPs in boom times, reflecting increased demand for their product. “Fund managers have more bargaining power if there is more demand for their product. But investors allow them to push on terms because they believe they will not do worse with them than with their competitors even when the fees are considered,” explains Sensoy.

A surprising finding was that, within the buyout sphere, GPs with low levels of skin in the game tended to outperform those where GPs contributed more to their funds. “This surprised us since it effectively means that LPs are getting better performance in return for lower alignment of interest with their fund managers,” Sensoy says.

Perhaps the onus of having to raise future funds is sufficient to drive the fund managers to perform. It is also possible that GPs, loath to put too much of their capital into the fund, negotiate with investors in other areas; for example, they may lower their fees to offset the low-level contribution.”

So if fund managers within PE are indeed earning their hefty fees, what can LPs learn from Sensoy and Robinson’s research? “LPs on average are doing just fine – they are not allowing GPs to get away with charging too much or putting too little skin in the game,” says Sensoy.

“Those that eat more fees tend to outperform, so you’re not worse off by paying for them. This is consistent with the world view that the more expensive products are usually worth it. That said, you always want to try to drive a hard bargain – do not grow complacent as a result of these findings, but keep doing a good job of negotiating.”
he best performers are much in demand, especially when the asset class is performing well and expectations are high,” says Margot Wirth, director of CalSTRS’ $21.7bn PE portfolio. “So some managers get paid like sports stars. When you invest you don’t know what the performance will ultimately be, but you know what the fixed compensation will be. In some cases, an oversized fee becomes like a signing bonus, in that a manager is practically guaranteed a large income, regardless of how the fund subsequently performs.”

The CalSTRS view is that fund size is often more important than the fee loads, and Wirth feels that much of the misalignment that came about in the aftermath of the last boom period was the result of inflated fund sizes.

“When funds perform well, two things tend to happen,” she says. “First, the fees tend to go up. But they do so in small increments – say 25 basis points, and we are not typically going to disqualify a fund based solely on that. But the other thing that can happen is that fund sizes go up, and that is often a more important variable. This is where the excess demand manifested itself in the last cycle.

“Some managers are within their capacity in managing a multi-billion dollar fund successfully; others are less capable. It is about ensuring that your managers are raising the right amount for the expected market conditions, as well as for their investing capacity and ability.”

Another finding of David Robinson and Berk Sensoy’s study was that skin in the game does not necessarily lead to better performance – low management ownership in the buyout space actually outperformed in the sample. While this surprised the authors, Wirth offers a possible explanation: “If you have nothing to lose and everything to gain, you may be willing to take more risk,” she explains.

“On the other hand, if what they’re putting in is a substantial proportion of their net worth, they might tend towards a conservative investment strategy, which may lead to lower performance in a strong market.” Additionally, funds in which a GP has more at risk might tend to be safer and perform better in troubled markets.

Of course, this does not mean that CalSTRS is not demanding when it comes to alignment. “We continue to stress the need to put skin in the game, but we have found that it is certainly no guarantee that a fund will perform well,” says Wirth. Ultimately, LPs are concerned about cash in and cash out. “It’s a marketplace: the market sets the fees. If the asset class isn’t performing, then we don’t care what the fee is – it could be zero and that is still too high if we are not earning a decent return for the risk involved,” says Wirth. “It’s about the net results – if they’re too low, we’re leaving.”

Wirth also believes that fees may come down, driven by an over-abundant supply of talent within top PE firms. “The industry has attracted a record number of very, very intelligent people. But there are now so many of them that a rationalisation is taking place, and we will see this reflected in lower transaction fees and management-fee offsets. It is market economics at work.”

The research

In Do Private Equity Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance, authors David T Robinson (Duke University) and Berk Sensoy (Ohio State University) study whether PE managers who demand lower compensation earn lower gross returns (gross of fees). The study is based on a novel dataset of 837 buyout and VC funds between 1984 and 2010, 80% of which were based in the US. Robinson and Sensoy discover that PE funds that charge higher fees achieve higher gross returns (gross of fees). On the other hand, the study reveals that, due to taking away higher fees, the respective net-of-fee returns are very similar to the ones discharged by low-fee funds. The authors also find some evidence that buyout funds with high carried interests outperform (the statistical significance of this result is limited by the fact that there is not much variation in the carried interests charged by funds).

Perhaps surprisingly, the data revealed that, contrary to popular belief, buyout funds with relatively low levels of GP contribution tend to outperform those with higher levels of GP commitment – possibly suggesting that top-tier GPs tend to diversify their personal investments.
More and more limited partners are now seeking co-investment opportunities to boost returns and lower fees. But new research suggests that they may not achieve the returns they expect.

By Vicky Meek.

For LPs looking to reduce fees, increase returns and fine-tune their PE exposure, co-investments appear to be something of a panacea. There is certainly plenty of anecdotal evidence to suggest that LPs are increasingly asking for co-investment rights when committing to a fund. And the anecdotes are backed up by hard numbers. Over half of LPs have co-invested with their GPs in the last two years, according to the Winter 2013 issue of Coller Capital’s Barometer. In addition, two-thirds of North American LPs and half of European LPs say they would like to be offered more co-investments.

While the potential advantages of co-investing may be clear, what is less apparent is how well this type of investment performs. This is the subject of new research conducted by Josh Lerner and Victoria Ivashina of Harvard University and Lily Fang of INSEAD. “LPs are showing increased interest in co-investments,” says Fang. “It’s a new trend in PE investing, as LPs have become increasingly motivated by the idea of reducing fees. We wanted to explore the trade-off between using intermediaries for PE and LPs making investments themselves.”

In The Disintermediation of Financial Markets: Direct Investing in Private Equity, the academics sought to understand how direct (or solo) investments and co-investments by LPs performed relative to each other and to fund investments. Using a dataset of nearly 400 investments, comprising direct and co-investments drawn from seven large institutional LPs, they found that solo investments outperformed both co-investments and fund investments, and that co-investments not only underperformed solo investments but also fund investments.

“Our paper shows that in co-investments, the LPs are not doing so well,” says Ivashina. “The same investors that can generate good returns in solo investments don’t perform as well when they make co-investments. In addition, the co-investments in our sample underperform the funds from the same GP.”

Possible explanations
So why should this be? “There are two possible explanations for the underperformance in co-investments,” says Ivashina. “One is that the LPs lack investment skill, but our findings on the
Yet we advise them to think through the risks, says Billy Charlton, partner at Altius Associates. "A lot of clients are interested in co-investments," intensified by the issue of concentration risk. "If a GP, you are unlikely to be approached first and allocate more co-investments to larger LPs in the deal being offered by a GP. "GPs tend to commit more co-investments when they need extra capital – typically at times of heated markets. As the research shows (see chart on p14), the largest amounts of capital were directed towards co-investments in the sample during the boom period of 2006 and 2007."

“The research reflects our own experience of co-investments to a point,” says Charles van Horne, managing director at Abbott Capital Management. “We did an analysis of the space in the mid-2000s and became more concerned about the relative sizes of the co-investments being offered by GPs, especially where they were stretching. So, while our performance at that point was pretty good, we decided to let the co-investment programme go into run-off as we felt the risks were very different from those our investors were seeking.”

Ralph Aerni, chief investment officer at SCM, picks up this point. The firm has never done any co-investments, but it has looked closely at whether it should, given the demand among LPs for this type of investment. “When we did our own research, we found that co-investments underperformed the funds from which they were sourced,” he says. “It wasn’t entirely clear why, but it seemed that GPs were syndicating deals that were riskier than the deals they would normally do and so co-investments tended to have a bias towards riskier deals.”

Aerni adds that the size of the LP’s commitment may also affect the risk profile of the deal being offered by a GP. “GPs tend to allocate more co-investments to larger LPs in their funds,” he explains. “If you are a smaller LP, you are unlikely to be approached first and so you may get offered even riskier deals.”

If LPs are being offered the opportunity to invest in deals that are riskier in any case, this is intensified by the issue of concentration risk. “A lot of clients are interested in co-investments,” says Billy Charlton, partner at Altius Associates. “Yet we advise them to think through the risks involved. Our research has shown us that you have a fairly high chance of losing money because of the dispersion of returns in PE. LPs’ co-investment portfolios tend to be small and so if you have investments in, say, 10 companies, if one or two go wrong, that can affect the performance of the whole portfolio. Of course, the reverse is true and you could get stellar performance, but if you then layer on the possibility of adverse selection, whereby you are missing out on the top 10% of deals, it seems unlikely.” In addition, the LPs that make co-investments are likely already to be exposed to the deals via their fund investments, which further concentrates their exposure risk.

Fang agrees. “LPs see the potential benefits in co-investing – and these could be large,” she says. “Yet our research shows that they appear to have little control over the situation. "The same sentiment runs counter to one of the findings in the research paper, namely that solo investments outperformed co-investments – suggesting that investment skill is not the main cause of co-investment underperformance (though the authors do not entirely rule this out). Many LPs, such as some of the Canadian pension plans and Middle Eastern investors, have built up their direct and co-investment teams with staff who have direct experience.

Yet there are nuances to the solo outperformance result. The research found that LPs were better able to time the market with solo investments than with co-investments (as the chart on p14 demonstrates). But it also found that solo investments’ outperformance was limited to situations where the LP was closer to the investee company, was better able to understand it (ie where R&D was not
Some good returns

Indeed, even co-investment detractors suggest that, in the right hands, co-investment programmes can produce good returns. “There is a difference between investor type,” says Dréan. “Many institutional investors are not ready to take the direct deal-doers and you’d be unlikely to pay them market rates in any case. Funds of funds, for example, and some of the large endowments will have the right people in place and should be able to generate higher returns from co-investments.”

Overall, the results should be viewed “as a cautionary tale around co-investments”, says Fang. If LPs are pushing for co-investments on the grounds that they can access the PE market more cheaply and they do not manage the inherent risks adequately, they may co-invest at the cost of performance.

“Co-investments should be viewed as a tactical decision,” adds van Horne. “Given the potential for problems to arise, you need to have your best resources dedicated to them – people who can tap into contacts and networks and conduct independent due diligence.”

Ivashina concludes: “LPs need to understand how a drive towards co-investment may affect their performance. The research helps to shed light on the potential for adverse selection. And if the LPs in our sample, which managed to execute successful solo deals, didn’t get around the problem of adverse selection, other LPs should be asking themselves if they can avoid the lemons.”

The research

In The Disintermediation of Financial Markets: Direct Investing in Private Equity, Lily Fang of INSEAD and Victoria Ivashina and Josh Lerner of Harvard University set out to understand how LPs’ direct PE investments performed, given the trend towards institutional investors increasingly eschewing intermediaries (PE funds). The academics compiled a proprietary dataset of 392 investments comprising direct and co-investments from seven institutional investors. Of these, 288 were co-investments and the rest direct (solo) investments made by the LPs.

The research found that co-investments underperformed solo investments, which themselves outperformed all benchmarks, even when the cost of running internal programmes had been factored in. While solo investments generated a weighted average portfolio IRR of 14.58%, the figure for co-investments was 9.68%. Co-investments underperformed the fund investments made by the same GP by an average of 8% IRR.

The research suggests that, given the outperformance of solo deals by the same investor, the explanation for the underperformance of co-investment does not lie with a lack of LP investment skill. Instead, the authors find that adverse selection (or the “lemons problem”) may be a cause. Institutional investors can only co-invest in deals that are offered to them – and these tend to be much larger than the sponsor’s average deals and more likely to be offered at a time of market peaks. The research finds that co-investment deals are nearly five times larger than an average sponsor’s deal and the underlying company’s enterprise value is three times larger than other deals done at the same time by the GP.
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London experience. World impact.
Funds of funds face a challenging future as many investors seek more innovative – and cheaper – ways of accessing the PE market. So what does it take to remain relevant in today’s environment? A recent Coller Institute of Private Equity case study takes a look.

By Vicky Meek.

In the run-up to the crisis, funds of funds had become a standard way for many LPs to access the PE market. They promised access to top-performing managers, outsourced PE fund selection capabilities and a means of achieving vintage year, geographic and strategy diversification. However, more recent times have seen many investors focus on value for money (and they are less and less likely to want to pay the ‘fees on fees’ that many LPs complain about), as well as increased granularity and control in devising investment strategies. LPs have also built up PE fund investing expertise over the years, so have less need to invest via traditional funds of funds, opting for more bespoke arrangements such as segregated accounts and co-investments.

Figures from Preqin point to the trend away from fund-of-fund investing. In its Private Equity Fund of Funds Review 2013, it finds that, while funds of funds accounted for 11% of aggregate PE capital raised in 2009, for the year to November 2012 this share had shrunk to just 5%.

In a recent survey of institutional investors by Towers Watson, the consultancy reported that, “Funds of funds continue to grapple with the evolving landscape in which the appetite for traditional commingled fund of funds solutions is diminishing further… Only a few fund-of-funds organisations with significant scale have the ability to adapt to the evolving business model, so we continue to see consolidation in the industry.”

Despite these trends, it seems unlikely that the fund-of-funds model will disappear – many investors still do not have the requisite experience to invest themselves, while others may seek funds of funds that can offer them specific strategies. So what does it take to remain relevant in the market today?

A recent academic case study by Florin Vasvari, associate professor of accounting at London Business School and fellow of the Coller Institute of Private Equity, together with Rogelio Prieto and Adam Dawson, explores how one fund of funds, established in 1979, has modified its investment processes and strategies in response to changes in the market, while continuously growing its business. It has more than 575 primary fund investments, 250 GP relationships, 265 direct investments and 130 secondary investments, as well as holding more than 120 advisory board seats worldwide. The firm’s AUM stand at around $23bn, drawn from around 270 investors.

The study, Adams Street Partners: A pioneer investor’s approach to constructing private equity portfolios, examines how the firm puts together its fund-investment programmes and how it selects the managers it backs. “We chose Adams Street because it has been in this market for a long period and could therefore be expected to reflect industry best practices,” explains Vasvari. “It gives students an opportunity to learn how a large PE investor thinks about the investment process and selects appropriate PE funds.”
The approach
As the case study points out, Adams Street is slightly unusual in that it raises its funds through an annual subscription plan, with the capital invested over the following three years or so, rather than the traditional three- or four-year fundraising process common to many funds of funds. It is a structure that the fund of funds has been operating under since 1996. The firm claims that it provides flexibility to investors to maintain or increase exposure to PE, particularly if they are mature enough to be in receipt of high volumes of distributions. The firm also says that its approach provides a constant source of capital — fundraising risk can be offputting to GPs themselves seeking capital from funds of funds. Finally, the firm claims that its approach allows it to monitor the market and source and invest constantly, rather than pausing for fundraising efforts.

In order to determine the correct amount of capital to raise, the firm has devised what it calls a ‘hierarchy-of-size model’, which, according to the case study, “illustrates the relationship between the size of Adams Street’s capital deployment to PE and portfolio-construction considerations”. It takes into consideration four critical decisions that the firm needs to take: What is the optimal size of the PE allocation? What should the weightings be between different PE strategies and geographies? Which managers should be selected? How much should be allocated to each manager? As a key part of this process, Adams Street relies on a bottom-up approach to fund investment. Through a process of constant review, the firm is able to forecast which GPs will be out in the fundraising market, and when. While the macro picture to portfolio construction — the top-down element — is important for identifying whether a particular region or sector will be attractive, mapping out the managers the firm would like to work with in advance is a fundamental part of constructing its portfolio.

“For us, the quality of execution and skillset of a particular manager are the most important factors in targeting fund investments, rather than trying to find a GP that fits a particular strategy,” explains Arnaud de Cremiers, partner at Adams Street. “Macro bets are problematic in PE because of the length of a fund’s life — by the time a good opportunity becomes apparent, it will be time for a GP to be harvesting investments rather than making them.”

In addition, the firm makes similar-sized investments in each of the funds it backs. “By maintaining a steady investment pace and investing in equal bitesizes, we hope to neutralise the peaks and troughs of returns,” says John Kremer, partner and head of business development at Adams Street. “That means we don’t become outsized when the market grows exponentially in boom periods and we don’t become overweight in large funds.”

One of the claimed advantages of the bottom-up approach, together with a network developed over several decades, is an ability to spot emerging managers at an early stage in their development. While this is not a large part of the overall portfolio, the firm believes it is important in the overall portfolio construction process. “Adding new managers balances out the portfolio,” says de Cremiers. “One of the things we have to keep a watch on is the maturity profile of the portfolio — by having new, emerging managers in there, you mitigate the risk of having succession issues in several GPs at one time.”

AnaCap commitment
The case study highlights one of the firm’s emerging manager investments — its commitment to the first fund raised by financial services specialist AnaCap Financial Partners. The fund’s strategy was to acquire or build rapidly growing consumer and asset-based financial services companies and help them institute complex financial and risk-management techniques to complement established operational processes.

“Adding new managers balances out the portfolio,” says de Cremiers. “And if we can’t do that, then we’ll follow them during fund I so that we’re in a good position for fund II.”

“[THE CASE STUDY] GIVES STUDENTS AN OPPORTUNITY TO LEARN HOW A LARGE PE INVESTOR THINKS ABOUT THE INVESTMENT PROCESS AND SELECTS APPROPRIATE PE FUNDS”
Florin Vasvari, London Business School

The emerging managers that Adams Street tends to back fall into one of two categories, de Cremiers says. One is first-time funds raised by managers that are well known to the firm through previous investments — ie spinouts. "We know the individuals, their track records and how they have been rated internally, so we can be comfortable about backing them in a new setting,” he says. The second is more unusual — a GP raising international capital for the first time. “Often, we don’t know of the GP previously, but through our network we can usually get a good view of the people involved," says de Cremiers. “And if we can’t do that, then we’ll follow them during fund I so that we’re in a good position for fund II.”
As SPACs have become an increasingly common means of raising capital for private companies over the past decade, many PE houses have been eyeing these structures as a possible exit route or a means of raising capital for single deals. But how have these vehicles performed? Some recent research takes a look at this, together with the incentive structures of SPACs.

Although they have been around for many years, the period in the run-up to the financial crisis saw an explosion of special purpose acquisition companies (SPACs or ‘blank-cheque companies’). Of the 280 US IPOs in 2007, 66 were SPACs, and from 2003 to 2008 SPAC IPOs constituted one-third of the entire US IPO market. While the market has slowed since then, SPACs remain part of the market. PE firms, among others, have taken advantage of investor appetite for this kind of vehicle as an exit route or as a means of raising capital for single deals. But how do these vehicles perform for their investors? Do their structures create conflicts of interest for SPAC sponsors and provide them with perverse incentives? Or are they more likely to make better acquisitions than their listed corporate cousins? Three recent academic studies have explored some of these issues.
To provide context, how has the SPAC market developed over recent years?

Dimitrova: “While blank-cheque companies have been around since the 1990s, they mainly did small deals. During good market conditions in the 1990s, it was easy for smaller companies to raise money in traditional IPOs. However, in the past decade, the IPO market has tightened significantly and that’s when SPAC activity began to pick up. They offer companies a cheaper and faster way to go public. In addition, SPACs have grown significantly in size in recent years, and are now chasing bigger and bigger targets.”

Tran: “Yet the crisis did cool the market in the US [the market studied by all three papers]: in 2009, there was only one SPAC, which raised $36m. SPACs do seem to have revived in 2011, when 16 SPACs went public. However, these raised less than a third of the proceeds that 17 SPACs raised in 2008. There were nine SPACs in 2012 and four so far in 2013. Overall, although we seem to observe renewed SPAC activity, the offering size hasn’t returned to the level we saw in 2007. Interestingly, the slight increase in SPAC IPO proceeds we have seen in 2013 is mostly due to PE using SPACs to raise capital because of limited funding from institutional investors.”

Rubinstein: “If we look at why SPACs became popular in the first place, some of the early ones found good targets and completed their transactions, their sponsors and investors did well, and people started to take notice. As Lora notes, at that time SPACs were on the smaller side, and the underwriters tended to be smaller, focusing on small-cap and micro-cap companies.

“In the ensuing years, as deals saw more investor interest and more sponsor interest, people piled in. You started to see some of the larger underwriters get involved. Citi underwrote a SPAC called Boulder Specialty Brands, which was very successful. Then all the other bulge bracket investors got involved, such as Deutsche Bank and Bank of America. The market snowballed and you saw larger and larger SPACs. Even Goldman Sachs tried to get involved in underwriting a SPAC, although by the time that got moving, the downturn happened and its SPAC did not get done.”

Lora, there are certain characteristics of SPACs that your research suggests create perverse incentives. Can you explain?

Dimitrova: “The whole purpose of the SPAC is to raise money in the IPO market and then use the cash to acquire a target within – this is the important part – a predetermined time period, usually two years. If the SPAC cannot complete the deal within this period, the fund is liquidated and the money returned to investors on a pro-rata basis. However, SPAC founders do not receive cash compensation for the shares they acquired.

“In addition, the founders are typically awarded a 20% interest in the SPAC after the successful completion of a deal. Our research shows that this gives SPAC founders very strong allowances for bank and broker fees. The securities placed during IPO normally comprise one share of common stock plus one or two warrants. The warrant can be converted when a business merger has taken place. Once the qualified merger has taken place, the shares will continue trading as a regular listing on a stock exchange. Founders are expected to buy (for a nominal amount) between 10% and 20% of the aggregate equity interest immediately after IPO and to hold those until completion of a qualifying acquisition.”

What are SPACs?

A special purpose acquisition company (SPAC) is formed for the purpose of acquiring a business through merger. The target company is not named at the time of the IPO. The SPAC raises funds through an IPO. SPACs are listed as non-operating cash entities and after the merger transformed into a regular listing. Most of the IPO proceeds are placed into a trust account, to be used to identify and acquire an operating company to acquire within, in most cases, between 24 and 36 months of listing. If no merger is executed, the money is returned to the investors with allowances for bank and broker fees.

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incentives to make a bad acquisition, rather than to pass on it. They may either buy the target too soon, right after the SPAC IPO (without doing proper due diligence), or make last-minute, opportunistic deals just prior to the SPAC’s expiry date.

“The SPAC founders also have to spend at least 80% of the SPAC’s net assets on the target business combination in order to avoid liquidation. This requirement may give SPAC sponsors the wrong incentives to overpay for the target. In other words, the sponsors may use this 80% as an anchor in their decision when they evaluate potential targets, and may find it more convenient to overpay for a smaller target, rather than consider what is best for the interests of minority shareholders.

“The SPAC underwriters also have hidden incentives. At the time of the IPO in many cases, part of their underwriting fees are being deferred and paid conditional on a successful merger.”

Anh Tran, your research comes to different conclusions, does it?

Tran: “We find that, overall, SPACs make better private company acquisitions than others. Sponsors expend a lot of effort in getting the right deals. They typically seek advice from investment bankers, PE professionals, business brokers, business owners and lawyers on targets and they generally consider a large number of potential target candidates. To narrow the field, SPACs solicit confidential information from the most promising target firms. Once the final target is chosen and the merger is executed, the deal has to be approved by the majority of the SPAC’s shareholders. This high threshold of 60-80% approval creates a higher-than-usual rate of deals that are not completed.

“However, it is certainly true that the fact that SPAC managers are not officially compensated during the two-year period, and that they receive an ownership stake in the combined firm only if the acquisition is completed, can create some conflicts towards the end of the period: it might pressure the managers to execute an unsuitable acquisition, I find that potential acquisitions announced towards this deadline earn lower returns, but that they are also frequently filtered out as they are more likely to be rejected by shareholders.”

What do the others think?

Rubinstein: “I agree with Anh. I don’t think there is a conflict of interest per se between the interests of the sponsor and the interests of investors. For one thing, sponsors have to put up a lot of their own risk capital, and the value of that is tied up in the SPAC’s securities. They want to make sure they find a deal that the market is going to accept. The SPACs that I have been involved with have worked very hard to find high-quality deals. Public investors aren’t going to stay in a deal if it’s not good, because investors have the option to get their money back. That’s why SPACs work – everyone has the ability to get their money back. And if investors don’t stay in, then the deal won’t get done.

“Also, before investors decide whether or not to stay in the deal, they get a proxy statement, and all the disclosure you would typically have in an S-1 registration statement for an IPO. They get a complete look at the company. Sure, there’s a financial incentive for the sponsor for a deal to get done, but it’s not as though they can hide the ball. It doesn’t mean there haven’t been situations where there is a Hail Mary at the last minute. But in a lot of those cases, investors were not fooled, and the deal was voted down.”

Jenkinson: “I would say that, in general, SPACs are well set up to avoid conflicts of interest in that they allow investors to reject or accept a given deal. That’s different from a regular PE fund, where you give the GPs your money for 10 years and they invest in what they want. SPACs are more like single PE deals.

“Instead, I think the problem comes when shareholders are not necessarily paying attention, and don’t notice that the people doing the deal can alter whether the deal goes through. The ability for related parties to buy shares is not usually limited in these structures. You can end up with the company sponsor buying shares and voting for the sale itself. SPACs create the highest power incentives that you see in the capital system. The typical SPAC structure allows the sponsors to get 20% of the capital structure, not 20% of the profits. Wealth-reducing deals can still mean a big payday for the sponsors. Investors know that the sponsors have that conflict of interest, so they have to play an active role in the votes. They shouldn’t just leave it to other people.”

Statter: “For me, the experience of being involved with a SPAC was eye-opening in that, in the right circumstances, using these vehicles can be a great strategy. We used a SPAC to create a mortgage real estate investment trust (MREIT), Two Harbors Investment Corp. The SPAC enabled us to do this in a much more capital-efficient way. And as a result, it was one of the most successful SPACs of its time. Yet this strategy only really works when you are bringing a target that has enough scale and has strong enough management to be a respectable public company in its own right.

“I agree that there are enormous time pressures involved in SPACs – we completed our deal just within the two-year timeframe. But I would argue that sponsors have their own capital at risk and so they have a serious incentive to do a good deal. In our case, after reviewing around 200 targets, we had three investment prospects under consideration. We had a choice. The board followed strong and sound corporate governance practice in ensuring the best outcomes for investors – the board spent a lot of time looking at risk, for example.

“In addition, I think the governance provided by the ability of shareholders to vote in favour of or against a particular deal provides a good incentive for sponsors to get it right. That also provides a level of discretion to investors that you don’t get in, for example traditional PE funds. If investors don’t want to be involved in a deal, they can get their money back.”
What does your research say about how SPACs perform?

Dimitrova: “Over the long run (ie one year after the deal has closed), SPAC acquirers significantly underperform the market. However, there is a large variation in the returns and these returns are related to specific characteristics of the deal, as well as some governance characteristics in place at the time of the acquisition.

“In particular, as we’ve explored, the deadline to purchase a target within two years of the SPAC IPO puts SPAC sponsors under enormous time pressure. This appears to affect performance as I find that there is a significant inverted U-shaped relationship between the time it takes for a SPAC acquirer to find a potential target and its short-term performance. My results suggest that there is an optimal time for the acquirer to announce an acquisition. In other words, the longer it takes for the SPAC to announce an acquisition, the higher the stock returns, as the sponsors are potentially putting in more time to conduct thorough due diligence and purchase the most suitable target. However, acquisitions that are announced too quickly or too late are perceived by the market as less valuable.”

Jenkinson: “The interesting point about SPACs, as opposed to more traditional PE deals, is that you have an observable share price. When a deal is announced, the share price is highly informative about whether it’s value-reducing or not and that’s where we focus our research. If you see the share price jump, that’s indicative: the market is showing a value-creating deal. If the share price stays at the value of its underlying cash, then that says something else. This is a perfectly feasible simple rule that investors could follow, and if they follow that rule, our research shows they will seldom lose money on SPACs – at least in the short term.

“However, our results also show that more than half of approved deals immediately destroy value. One of our basic research questions was: why do those deals get approved? After all, the share price should be informative about what the deal actually is. Our analysis was that sometimes there can be some jiggery-pokery going on in the share registers as sponsors or their affiliates buy up shares to get the deal through, although we didn’t find evidence of buying votes in all the SPACs. In some cases, it just looks as though investors missed it – they were asleep at the wheel and just waved it through. Maybe there were charismatic sponsors involved.”

Rubinstein: “As with PE, average SPAC performance is probably not great. And also as with PE, the performance is dependent on the SPAC team, their ability to locate and consummate a good deal, what they were looking at, what sector they’re doing a deal in. It’s certainly true that SPACs have a limited time to consummate their deals, but I don’t really think the timing of when a SPAC does its deal within its lifespan is that important.

“For example, we worked on a deal for JWC Acquisition Corp where we completed it with a week left before it would have been required to liquidate. Even though the deal was announced late in the lifecycle, it was one of the most successful SPAC deals: its stock price almost tripled within a year after the deal. So I think it’s hard to generalise.

“If you look more closely at individual cases, in the past you had a lot of people piling into SPACs who didn’t really have great operating experience, or otherwise, and shouldn’t have been the right team. There was a lot of money in the market – that is a dynamic that nearly always results in poor performance.”

Statter: “I agree that the success really depends on the SPAC team’s ability to source the right deal. As I said, the target really needs to be a company that would make a good public company in any case.

“The other point to bear in mind about SPACs is the shareholder base and how that can skew vote outcomes. Many of the SPAC investors in the run-up to the 2008 crisis were hedge funds that found they could use them as an arbitrage opportunity because they had been able to sell off the warrants attached to the common stock and have a basis lower than the cash in the trust account. And when the crisis hit, many investors of all kinds were simply voting no to deals because they needed the liquidity – a no vote enabled them to get their cash back. In our deal, which closed in autumn 2009, we still had to give back close to half of the money raised by the SPAC because many investors at that time did not want to stay in the market.”

Has the market changed since the financial crisis, when many of the deals analysed for the research took place?

Jenkinson: “When the market was very hot, the sponsors could extract very good deals for themselves. Just like PE funds extracted good deals, with transaction fees and monitoring fees, which have disappeared in the post-crisis period. It’s entirely predictable that investors now want to make sure alignment of interest is there, and that the deal isn’t too sweet for the sponsors. It’s a balance of supply and demand.”

Rubinstein: “Many of the terms have changed over the last few years. When SPACs came back in the early 2000s, sponsors didn’t put 100% of the money into the trust account. As sponsors piled in, investors were demanding more money in the trust account, and it reached where it is now, with 100%. This has raised the bar in terms of the risk capital that sponsors need to put in. In many cases, the sponsor now overfunds the trust account to more than 104%. The money is invested in treasuries, so investors are earning interest that they are not going to earn anywhere else with that level of safety.

“In addition, in order to incentivise the sponsor to find a deal that will perform well after the business combination, a lot of SPACs now are structured so that a percentage of the promoted shares, often 25% of them, will be forfeited if the stock doesn’t reach a specified threshold after the acquisition.”

What is the future of the SPAC market?

Jenkinson: “SPACs overcome one of the
problems we have with the PE structure, and that is that exits can be problematic.

“Well-designed SPACs have good protections for investors, and I think they can enable firms to transition between the private and public with a new ownership structure. That’s why they were very popular in the pre-financial crisis time period. We also think that many companies held by conventional PE funds could use SPACs as a potential exit route in the future. However, the current economics of SPACs in which large equity stakes accrue to the sponsors will not necessarily persist.”

Statter: “We are now in a period of an active IPO market. There is more liquidity and less aversion to risk. My view is that investors will fund SPACs with the right sponsors and in the right circumstances. SPACs will continue to be a niche product that will follow the broader market cycles.”

Rubinstein: “The market is much reduced, and we are seeing a lot of investor demand for the right team. We are also seeing that the bar has been raised. The sponsor team has to be of a higher calibre. They have to have public company and operating experience. Many of the sponsors now have prior SPAC experience.

“Also, if you look at the universe of underwriters, it’s much reduced. You have a few bulge bracket and a few smaller underwriters doing it. These days, at least 100% of the money is going into the trust account. That means the sponsors have to put in whatever the difference is to cover underwriting commissions and other fees and expenses. That’s not something that everyone can come up with. I also believe the Securities and Exchange Commission has become much more comfortable with SPACs over the years, making the offering and business combination process generally more predictable.

“Overall, I still see a strong pipeline. I think you’re going to continue to see IPOs getting done, as well as these back-end deals, but I don’t foresee the type of explosive growth you saw before. I think you’ll see a steady output of SPACs with higher-quality sponsor groups and offering sizes typically ranging between $50m and $150m.”

The research

In Why SPAC Investors Should Listen to the Market, Tim Jenkinson and Miguel Sousa, of Said Business School at the University of Oxford, devise a single rule of thumb to evaluate SPACs. If the share price of a company rises upon announcement of a SPAC acquisition, the deal will likely be favourable for investors. If the share price falls below the trust value of the shares when the deal is announced, investors will likely lose value. The authors observe the post-acquisition share price performance of 43 SPACs that approved and consummated an acquisition, studying trading price data up to the end of December 2008. Jenkinson and Sousa then characterise SPACs in their sample as either ‘good’ or ‘bad’ on the basis of share price movement. Twenty of the sample were good and 23 bad. They find that investors who went against this market signal lost around 39% of their investments within six months, and more than 79% after a year. It suggests that sponsors may be wrongly incentivised to acquire large stakes in SPACs to achieve a vote in favour of the acquisition — they receive a 20% payment on the capital value of the acquisition made, while they lose the value of their shares in the SPAC if it makes no acquisition and is liquidated.

However, the research does not suggest that the SPAC structure is flawed — indeed, the authors conclude that SPAC investors’ ability to observe market prices on the announcement of acquisition as well as vote on proposed acquisitions gives them more control than in conventional private equity. Those that voted in favour of an acquisition when the SPAC share price rose “reaped handsome, low-risk profits”, the research says.

The Perverse Incentives of SPACs by Lora Dimitrova, lecturer in finance at the Xfi Centre for Finance & Investment at the University of Exeter, focuses on how the SPAC structure affects incentives for sponsors and underwriters. Dimitrova collects a dataset of 73 SPAC acquirers from 2004 to 2010 and suggests that some of the incentives in the SPAC contract may lead to value-destroying outcomes. For instance, she finds that the short-term performance of SPAC acquirers is worse for acquisitions that are announced closer to the two-year deadline for making acquisitions. In addition, the research finds that the long-term performance is negatively related to high levels of sponsor stock ownership, consistent with the Jenkinson and Sousa research. However, where a SPAC founder is CEO or chairman of the target, there is an average 71 percentage point increase in the one-year post-acquisition return of the vehicle.

Blank Check Acquisitions by Anh Tran, professor at Cass Business School at City University London, finds that SPACs typically make better acquisitions than other public acquirers. Tran analyses a sample of 3,130 US acquisitions from January 2004 to May 2009, of which 108 are SPACs. He finds that SPAC sponsors negotiate an additional 7.6% discount compared with other public acquirers that bid for private targets. Tran suggests that specialisation, ownership structure and independent long-term institutional blockholders’ monitoring are important corporate governance mechanisms in SPACs and that this accounts for the ability of SPACs to achieve the additional discount. Unlike the two other studies, Tran finds little evidence of perverse incentives among sponsors to make unsuitable acquisitions, suggesting that these are mitigated by the presence of long-term institutional shareholders.
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In his paper *Career Concerns and Venture Capital*, which was the runner-up for the Coller PhD Prize 2012, Crain’s main finding was that managers who perform well in their initial investments, and thus face less concern about their ability to raise a new fund, take more risk with their remaining capital. Poorer-performing peers, by contrast, remain risk-averse. What interested Crain was that very little is known about what informs the investment decisions of VC managers. “Despite the notion that VC is both scarce and connected to important economic outcomes, we know very little about what determines the portfolio composition of VC funds,” he says.

Crain adds that he found the findings from his study somewhat surprising. “My initial intuition was that we would see a pattern of investment decisions that was more in line with what we see from mutual-fund managers and hedge-fund managers. There is academic literature that suggests that, in both those settings, the incentives to attract new fund flows tend to encourage excessive risk taking. I find that the opposite holds for VC funds.”

Do VCs steadily become more risk averse, and how does this influence their investment decisions? The Coller PhD Prize runner-up paper takes a look at this issue.

By Nicholas Neveling.
“INVESTORS ARE MORE CONSERVATIVE AND ARE HAPPY TO TRADE OFF HIGHER RETURNS FOR LESS RISK. FOR A MANAGER, THAT IS DIFFICULT TO IGNORE”

Bob Ackerman, Allegis Capital

Maintain focus

Bob Ackerman, managing director of Allegis Capital, a San Francisco-based firm that provides seed capital and backs early-stage start-ups, says that Crain’s findings tally with his experiences in industry, where he has observed a noticeable shift by VC firms and institutional investors towards safer, less risky deals. “At the moment, we are not in a normal fundraising environment. Many investors are cautious and have a bias towards deals that can deliver immediate returns, even if these returns may not be as large,” he says. “Investors are more conservative and are happy to trade off higher returns for less risk. For a manager, that is difficult to ignore. Managers are mindful that they need to demonstrate success. You have VCs out there now who are investing in companies just six months before an IPO.”

However, Richard Henderson, managing partner at MTI Ventures, a VC firm with offices in the UK and the US, says that in his experience GPs who sell a fund to investors based on a particular strategy tend to stick to the risk profile their investors have backed. “When a fund is sold to investors, the investor is buying a product as presented,” he says. “It makes no sense for a firm to sell a strategy to investors and then execute on a different risk profile.”

The MTI managing partner says that, if anything, firms are likely to take less rather than more risk if a fund has performed well in its early stages. “If a firm is targeting a certain return, and returns are poor early on in a fund, then I can understand why a manager would invest more aggressively later to improve that return,” he says.

Counter claims

Another academic, Jean-Noël Barrot, the winner of the 2012 Coller PhD prize, looked at the question of how investment decisions are influenced by where a fund is in its lifecycle. Barrot’s findings, however, suggested the reverse relationship between the stage in the lifecycle and the level of risk taken; ie that less successful funds tend to add risk in the later stage of the fund’s life and those that performed well in their early stages had less incentive to add risky targets to their portfolio (see Private Equity Findings, issue 8, pp24-25).

Crain says that his paper looked into different questions from Barrot’s, although there was overlap between the two pieces of research and some conflicting findings. “I liked his paper, and there are some interesting differences that need to be discussed further and resolved,” he says.

Different datasets may be one of the main reasons for the divergence in findings. Barrot used a sample of PE investments made between 1980 and 2010, involving more than 1,500 PE funds. The data was provided by commercial providers. Crain, by contrast, worked with data of a much smaller sample – just 181 VC funds – but his dataset included the quarterly cash flows and valuations for every portfolio company, which is a level of detail unavailable from commercial providers. The fact that one looked at buyout funds while the other examined VC funds may offer another explanation.

For Crain, this demonstrates the challenges that academics still face when it comes to obtaining credible and consistent data for research. “The commercially available data sources have limited information at the portfolio company level that would allow researchers to look at the range of different investments,” he says.

Crain’s findings provide important material for GPs and LPs to ponder. In difficult economic times, it is tempting for LPs to play it safe and limit capital allocations to firms that are experienced and have a track record. The long-term consequence, however, is that firms may be taking fewer risks in order to deliver what investors want. This could mean that fewer managers – and less capital – are targeting start-ups and disruptive technologies, which are riskier bets but offer bigger upside potential and greater innovation.

For Ackerman, that is a concern: “It is essential that there are firms out there willing to invest in and support early-stage companies,” he says. “These companies are the seed corn of the future.”

The research

In his paper Career Concerns and Venture Capital, Nicholas Crain, formerly of the University of Texas at Austin, examines how ‘career concerns’ (concerns about the ability to raise a new fund) influence the risk level of investments selected by VC managers. Crain, now at Vanderbilt University, finds that VC fund managers strategically adjust the level of risk in their portfolios to give themselves the best chance of raising a follow-on fund. To achieve this, managers can become more risk averse. Managers with funds that perform strongly in the early stages, however, are more willing to take risks later on in the life of a fund. Crain demonstrates this by using a maximum likelihood methodology to show that VC fund managers select more risky portfolio companies following good performance, and they tend to be less diversified.

Crain’s analysis of this data shows that for a GP operating a first fund, three years into the fund’s life, an increase of 10% in the reported IRR of the fund corresponds with a 17% higher variance of future portfolio company investments (ie each subsequent investment is prone to more extreme gains or losses). The same increase in performance corresponds to a 7% increase in the initial size of portfolio company investments, resulting in less diversification.

Crain’s findings also confirm the 2005 research by Steven Kaplan and Antoinette Schoar that firms managing successful funds raise larger follow-on vehicles at a faster pace. For his study, Crain obtained a unique set of proprietary data from a large alternative asset manager that operates a number of PE funds of funds. The dataset covers the investments of 181 VC investments but, unlike commercial data, the dataset obtained by Crain includes the quarterly cash flows and valuations for every portfolio company investment from a large pool of VC funds.

In his paper, Crain says that to his knowledge this is the first dataset used for VC research to include detailed cash-flow information at the portfolio company level.
At this year’s Private Equity Findings Symposium, delegates heard academic thought leaders and influential practitioners present their research findings and views on the industry’s latest concerns. Here, we highlight the main issues discussed and offer a rundown of the featured papers.

PE and innovation
With general agreement that growth largely depends on innovation, speakers looked at the current agents of innovation – corporate R&D or VC – and the innovative imperative of PE, especially in the post-crisis economic environment. Some argued that the winners of the future will be innovative PE firms that are committed to achieving positive risk-adjusted returns, best use their talent, fulfil a client need, solve a problem and exploit the universe of lenses when looking for investment opportunities or, in other words, see through the obvious. Speakers hypothesised that the future lies in innovation of business models and investment schemes.

An alternative control model
Speakers and panellists further touched upon the question of whether the reign of the ‘ownerless’ public company governance model is coming to an end and whether family ownership, block ownership, shareholder activism or PE offer better performing alternatives.

There was a lively debate about investor choice and value, with some arguing that the premium returns of PE over public markets more than compensated for the intrinsic illiquidity of the former. It was also said that PE outperformance was based on taking a more strategic view or longer-term view on how markets develop, exploiting sectorial growth opportunities or significant discontinuities for longer-term value creation by providing ‘patient capital’. The fact that PE funds regularly face

### Featured academic papers

**The Alpha and Beta of Private Equity**, by Morten Sorensen, Ulf Axelson and Howard Kung, determines the alpha and beta of PE investments such as buyout transactions, based on deal-level data instead of the fund-level data used in previous academic work on this subject.

**The Operational Consequences of Private Equity Buyouts: Evidence from the Restaurant Industry**, by Albert Sheen and Shai Bernstein, measures operational improvements achieved by PE firms. Observing improvement of sanitation and food safety at restaurant franchises in the US, the paper also finds that PE affects staff-level optimisation.

**The Disintermediation of Financial Markets: Direct Investing in Private Equity**, by Victoria Ivashina, Lily Fang and Josh Lerner, investigates the performance of traditional PE investments, PE co-investments and direct corporate investments (see p12).

**Michael Weisbach, Berk Sensoy and Yingdi Wang’s paper, Limited Partner Performance and the Maturing of the Private Equity Industry**, takes a closer look at questions such as: What actually triggers PE performance? Do endowment funds outperform other types of large institutional funds? How has the growth of the PE sector changed the fundamental economics of the industry?

In their paper – **Is the Rise of Secondary Buyouts Good News for Investors?** – Ludovic Phalippou, Francois Degeorge and Jens Martin compare the returns of secondary buyouts (SBOs) with those of the other buyout investments made by PE funds, such as primary buyouts (PBOs). The paper analyses three potential explanations for SBO underperformance (not mutually exclusive): value gains being too limited for the buyer of an SBO; agency problems between PE funds’ managers and investors, generating an incentive to overpay for SBOs; and SBOs being less risky.

**Fund Managers Under Pressure: Rationale and Determinants of Secondary Buyouts**, by Zsuzsanna Fluck, Sridhar Arcot, José-Miguel Gaspar and Ulrich Hege, investigates the drivers for SBOs, the balance of power and the implications of pressure on the buy-side and sell-side in SBO transactions.

**A Theory of LBO Activity Based on Repeated Debt-Equity Conflicts**, by Andrey Malenko and Nadya Malenko, explores how LBO activity is related to aggregate economic conditions, how buyout leverage is driven by economy-wide factors and the identity of the financial sponsor. It investigates ex post conflict between debt holders and equity holders of portfolio companies, competition among PE firms for targets and repeated interactions of PE firms with the debt market and how aggregate economic conditions and sponsor characteristics impact the equilibrium LBO activity and deal characteristics.
RECENT EVENTS

ABU DHABI LP CONFERENCE – PE INSIGHTS INTO THE MIDDLE EAST AND AFRICA – 9-10 OCTOBER 2013
This year’s conference offered views on the MEA investment environment. Presentations looked at how GP turnover affects performance and shared PE-specific research findings (Francesca Cornelli).

PE AND THE GLOBAL HEALTHCARE SECTOR: IMPACTS AND OPPORTUNITIES – 29 OCTOBER 2013, LONDON
This discussion revealed the limitations and opportunities in healthcare.

GREEN AND CLEANTECH: OPPORTUNITIES AND CHALLENGES FOR PE, VC AND PROJECT FINANCE – 14 NOVEMBER 2013
This event, hosted with the ICAEW Corporate Finance Faculty, investigated the value-add and limitations of PE and VC investing in this sector.

ANNUAL MVISION ROUNDTABLE: QUANTITATIVE EASING REDUCTION AND REGULATORY PRESSURES – OUTLOOK FOR PE IN DEVELOPED MARKETS – 26 NOVEMBER 2013
The annual MVision Roundtable discussed the consequences of the end of quantitative easing and regulatory changes for future PE investing.

THE EXTENT AND EVOLUTION OF PENSION FUNDS’ PRIVATE EQUITY ALLOCATIONS – 14 JANUARY 2014, LONDON
Adveq and the Coller Institute welcomed over 100 delegates to a discussion of the Institute’s first report under the new Adveq Applied Research Series.

UPCOMING EVENTS

MARCH 2014, HONG KONG
The Institute will host an academic event for PE and VC practitioners in Asia.

7TH PE FINDINGS SYMPOSIUM: BATTLE OF THE ASSET CLASSES – 2-3 JUNE 2014, LONDON
Ticket sales have started and discounted tickets are currently available.

EVENTS CALENDAR

2013 COLLER PRIZE IN PRIVATE EQUITY WINNERS

This year’s PhD prize-winning thesis, by Juanita Gonzalez Uribe from Columbia Business School, was on ‘Venture capital and the diffusion of knowledge’. The runner-up, Lora Dimitrova from London Business School, wrote on ‘Strategic acquisitions by corporate venture capital investors’. Coller Case Study prizes were awarded to the following London Business School teams: Steven Stolk and Luiz Henrique Spinardi de Campos for their case study on a buyout of a financial services company by Advent International, and Nick Ibery, Kunal Sinha and Rishabh Mehreia for theirs on a two-tiered buyout of a pharmaceutical company by Nordic Capital.

See www.collerinstitute.com for further relevant research papers.

Is the LP-GP dynamic changing?

One of the panels addressed LP-GP dynamics, including the question of co-investments and whether a trend is emerging of large PE investors seeking to become co-investors or even turning into GPs. Participants agreed that only the largest investors wanted to afford the costs of expert hires and international offices required for successfully sourcing, researching and actively managing global corporate direct investments. With many arguing that the current environment will lead to a consolidation of the PE industry, there was no consensus about the extent to which GPs will go out of business in the coming months.

Fundraising shows a significant split, with some funds exceeding their fundraising targets and others facing a disappointing outcome. Some pointed out that the current environment has led to more buying power, with LPs negotiating more favourable terms, while others found that it hugely depended on the track record of the relevant GP. One panellist agreed with earlier speakers, saying that innovative investment products are one way of addressing changing investor requirements. Regarding the future of funds of funds, one hypothesis was that the future landscape will favour either very large funds of funds or specialised niche players, catering for specific investor appetites.

Listed versus non-listed PE

Comparing listed and non-listed PE models, the final panel asked: “What is the right vehicle to provide the PE facility or service to the end investor?” The panellists discussed the models of listing the GP, listing the PE fund and classic PE investing. They also debated potential conflicts of interest caused by listing the GP or PE vehicle and how portfolio companies would react to such listings. The discussion further explored the impacts of market discipline and the consequences of answering to a wide range of stakeholders. Speakers highlighted the need to protect listed PE firms from being taken over in order to offer portfolio companies continuity.
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