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Are novice private equity funds risk-takers? Evidence from a comparison with established funds

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ABSTRACT

This paper explores whether private equity firms that are new to the industry take excessive risks relative to funds from established firms. We use differences between the implicit incentives of managers of experienced and of novice funds as an identification strategy. We find that novice funds invest more slowly than experienced funds, contradicting the risk-taking hypothesis. However, the size of their investments, in value and as fraction of fund size, is larger; this could be consistent with risk-shifting by novice funds but also with alternative hypotheses. We find that the size difference increases over time and is absent from buyout investments. We also find that novice funds tend to underperform most dramatically for early large investments, and that the size of their investments increases after a first successful exit. These and other findings are in conflict with the excessive risk-taking hypothesis, but largely consistent with alternative explanations that emphasize differences in expertise.

1. Introduction

Typical incentive structures in the private equity industry suggest the possibility that fund managers take excessive risks since they give fund managers a considerable share in the upside via carried interest but no corresponding responsibility in the downside risk (Metrick and Yasuda, 2010; Robinson and Sensoy, 2012). The incentive to gamble is particularly important if fund performance is low since typical fund contracts oblige fund managers to first "claw back" to a minimum required return before they are entitled to any carried interest. Also, buyout funds, unlike venture capital funds, make highly leveraged investments, which increases further their incentives to take risk. The question about excessive risk-taking is even more urgent since the financial crisis in 2007/08; in the US and elsewhere, regulators' heightened alertness to the origins and propagation of risk explicitly encompasses private equity.[2]

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[2] E.g., in the United States, the Dodd–Frank Act of 2010 obliges much of the private equity industry to register and file regular SEC reports, abolishing the "private investment adviser" exemption, and mandates the SEC to force disclosure "for purposes of assessment of potential systemic risk". In Europe, the Alternative Investment Fund Managers Directive (AIFMD) adopted in 2011 refers to risk concerns to justify limits like leverage, resale constraints, and cash fiduciaries.

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Earlier empirical tests for excessive risk-taking in private equity are scant. It is challenging to devise suitable tests. One difficulty is that standard risk measures are inadequate since regular return frequencies, such as daily or monthly returns, cannot be calculated in private equity for lack of liquidity and information.[3] In addition, contractual terms for private equity funds (incl. performance-based compensation) are private and typically not fully observable. However, the few studies that have access to contract data confirm that there is very little cross-sectional variation in contract terms (Metrick and Yasuda, 2010; Robinson and Sensoy, 2012). This suggests little variation in *explicit* incentives among fund managers.

We focus, therefore, on *implicit* incentives and their impact on the possible risk-taking behavior of novice private equity firms. In view of the many difficulties to measure risk-taking in this illiquid and opaque industry of the financial sector, our strategy is to identify differences in implicit incentives between different groups of fund managers sorted by experience, and to explore whether they allow us to detect evidence in favor of risk-taking in one of the categories, namely inexperienced managers. Managers of new firms – without extensive prior experience – have a high upside if they can establish a reputation as good managers. The reputational benefit mainly comes from the possibility to raise follow-up funds and to increase the scale of operations in these future funds. These implicit intertemporal benefits are generally large (Chung et al., 2012). For a novice firm, the downside loss in case of severely negative realization is limited, certainly when compared to the loss of an established fund. By contrast, for an experienced firm, the upside of another high performing fund is limited but the downside effect is much more dramatic since the firm's entire reputational capital is at stake. Thus, novice firms clearly face different *implicit* risk incentives relative to those of experienced firms. We use this difference as our principal identification strategy to try to detect evidence for risk-taking among novice funds.

Under the assumption of rational decision-making, excessive risk-taking can only occur because the objective function of the fund manager, a delegated portfolio manager, differs from that of the principal, the investors. If risk-taking is excessive or inefficient, then it is because rational agents' personal preferences matter for investment decisions, and differ from those of the principal.[4] The term “excessive risk” is ambiguous since it encompasses two different meanings: it can refer to risk that is undesirable for society as a whole, or to risk that is merely undesirable for investors because the risk-return trade-off is inadequate. The second interpretation is typically adopted in finance research, and in this study as in much of the ongoing debate on private equity. A considerable advantage of our research strategy is that it is also applicable when excessive risk-taking is analyzed from society's point of view.

The argument that managers of young firms are willing to take more risks is not new. The seminal contribution is the grandstanding hypothesis developed by Gompers (1996) who argues that novice firms are willing to take on greater risk at the beginning of the fund's life in order to build their reputation, and presents evidence that they favor early attention-grabbing exits. Ljungqvist et al. (2008) present evidence that inexperienced funds make larger investments, and hence are less diversified. They also show that funds of novice firms are relatively insensitive to market timing opportunities. They propose a theoretical model in which inexperienced funds want to quickly establishing a reputation as successful fund managers, and do so by concentrating investments and investing independently of market conditions. We refer to this hypothesis, pioneered by Gompers (1996), as the risk-taking hypothesis.

This paper builds on this earlier work but addresses a major difficulty in the strategy of identifying risk-taking via observed differences in investment portfolios, which is that these measures of risk-taking may pick up confounding effects stemming from *other* explanations. That is, the observed investment behavior of young and of experienced funds might differ for reasons other than risk-taking motives, such as differences in funds' opportunity set, or differences in their experience or competence. There is evidence in favor of such alternative explanations. Gompers et al. (2008) show that experienced funds are better capable of directing their investments to industries and time periods where investment conditions are favorable. They interpret these findings as supporting the view that differences in the investment behavior are driven by the greater ability of experienced funds to locate and exploit investment opportunities. This reasoning is a leading candidate for an alternative explanation. A related alternative explanation is that experienced funds have a broader set of investment opportunities, based on their better network connections or better screening capabilities. We refer to these leading alternative explanations, based on differences in know-how and/or access, jointly as the expertise hypothesis, and define it in a sufficiently broad manner in order to encompass the major alternatives to risk-taking incentives. Fortunately for us, the predictions implied by the expertise hypothesis are in stark contrast to those of the risk-taking hypothesis. If young funds are willing to take risk they should do so early, and reduce risk-taking later on. If the behavior of young funds is dominated by lack of experience, it is rational that they initially proceed cautiously, and become bolder later on. Similarly, access constraints should ease over time. Also, risk taking of young funds should be more pronounced for fund types that can easily do so; learning should induce young funds to be more cautious in industry segments with complex deal structures and less opportunities to learn from others.

Our study employs a comprehensive array of measures of the investment behavior and its dynamics that are useful for our empirical strategy. First, we investigate the sequence of investment decisions by looking at two measures, the time until the fund makes its next investment, and the size of every single investment of a fund. Second, we distinguish between the two main branches of the PE industry – venture capital and buyout – because they differ in multiple ways that may help to discern between the two leading hypotheses. We also use conditioning information that makes our main investment measures conditional on the

[3] Returns can only be calculated between the infrequent points in time when funds invest and exit.

[4] In PE funds, the General Partner, the fund manager, typically is in full control of investment decisions. Funds normally have a limited life-time, most often around 10 years but some flexibility of extension to facilitate divestments. The committed funds are almost always drawn down and invested within the first 5 years, the investment period.