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The importance of size in private equity: Evidence from a survey of limited partners☆

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ABSTRACT

Using a comprehensive survey, we show that investors with a larger capital allocation to private equity are more specialized – measured by the degree to which the investor focuses on private equity rather than other classes of investments – and have a wider scope of due diligence and investment activities. Other investor characteristics (experience, type, location, compensation structure, number of funds under management) play no role. In particular, endowments are not special according to the survey measures. These results are consistent with the changing LP–GP relationship in private equity as capital is increasingly concentrated in the hands of large investors.

1. Introduction

This paper conducts a worldwide survey of Limited Partners (LPs) — the name given to institutional investors which allocate money to Private Equity funds. The goal is to investigate the dimensions along which LPs differ in (i) their due diligence practices regarding their potential investments in private equity funds, and (ii) the extent to which the investment professionals in charge of the private equity portfolio are specialized to that task.

Previous work has pointed toward endowment investors as especially successful, sophisticated and diligent private equity investors. For example, Lerner et al. (2007) argue that certain types of investors are better able to process information about opaque asset classes such as private equity. They find evidence that endowments outperform other type of investors on their private equity investment decisions. They further connect this finding to a broader literature, arguing that differences in performance may be caused by differing levels of sophistication in selecting investments, and by 'cultural' differences such as the use of performance-based compensation or high staff turnover rates. On the other hand, Sensoy et al. (2014) find that the outperformance of endowments no longer holds in the most recent decade of data. This raises the question of whether endowments really are different from other types of investors and whether, as Sensoy et al. (2014) argue, endowments were just lucky in the early part of the sample period because they had access to top venture capital funds at that time. Our paper is uniquely positioned to answer the question of whether endowments are special amongst LPs, because it has direct evidence on what LPs actually do when it comes to selecting and monitoring GPs.

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We contacted the (nearly) 2000 LPs that are listed in the Limited Partners Directory published by Private Equity International, a consultancy firm. We invited these LPs to answer detailed questions about their due diligence process and offered to give them the aggregate results once our survey was finished. This gave these LPs the opportunity to benchmark their due diligence, free-of-charge and anonymously. We obtained 249 sufficiently complete responses spanning 30 countries. Respondents range from pension funds and endowments, to family offices. To our knowledge, this is the largest survey of private equity investors to-date in terms of the number of respondents, geographical coverage, and scope.

The main results are easy to summarize: the only consistently significant dimension along which LPs differ in their practices is the size of the private equity portfolio (in absolute value). The institutions with large allocations to private equity are those spending most time on due diligence for each fund and those undertaking the most initiatives in the due diligence process. There are a number of other LP characteristics that are not related to the intensity of due diligence. Perhaps the most notable of these, given prior literature, is whether the LP is an endowment. More broadly, this paper sheds new light on the way in which investors seek to address information asymmetries when they invest in opaque asset classes such as private equity.

Firstly, we measure the specialization of investment teams. We ask whether the professionals in charge of private equity investing are also responsible for investing in real estate (a related asset class) or in hedge funds (an unrelated asset class, but one that often goes under the same umbrella of 'alternative investments'), and the fraction of investments that are made via fund-of-funds. We find that LP size is significantly related to each measure of team specialization. Private equity teams at larger LPs are more likely to supervise only private equity funds and invest less via funds-of-funds. Smaller LPs are less specialized, but they outsource their due diligence to a similar extent as larger LPs. Hence those smaller LPs that manage private equity alongside hedge funds and real estate are not just outsourcing due diligence activities. They undertake less due diligence, whether in-house or outsourced.

We then ask investors about due diligence and monitoring activities. We find that investors' scope of activities, including those outsourced, is strongly related to their size. Larger LPs engage in a wider range of due diligence activities, including legal activities (e.g., benchmark and negotiate contracts), accounting activities (e.g., develop their own models to evaluate funds' reported Net Asset Values), co-investing in deals alongside the private equity funds to which they have committed capital, visiting and interviewing portfolio company executives, and sitting on private equity funds' advisory boards. This result holds when controlling for the fraction invested via fund-of-funds to account for the possibility that smaller LPs may outsource indirectly by investing more in fund-of-funds. Consistently, we also find that large LPs spend more than twice as much time evaluating a given investment proposal than small LPs.

Our results are robust to the inclusion of control variables that account for alternative explanations. In particular, we control for the fraction of the LP parent's portfolio allocated to private equity and for the existence of performance-based salary. Hence, our results are not driven by organizations exerting higher effort when private equity is a more important part of their portfolio or when employees are better incentivized. Furthermore, we find that larger LPs have more investment professionals but that their number is not strongly related to the scope of activities.

The conditional correlations we document are interesting *per se* and show a robust pattern in the data. Interpreting these results as causal, however, is challenging. In particular, reverse causality is plausible: some investors start operating in a more thorough way than others and are therefore more successful. Because they are more successful, they end up with more money to manage. Hence it is the wider scope of activities that implies larger LP size and not vice versa. To assess this perspective, we conduct three tests. First, we show that LP size remains strongly correlated to the scope of investor activities for LPs whose allocation depends less on past performance (which we ask directly in our survey). Second, we show that the same holds for LPs who have less than 10 years of track record. This is particularly salient, as size depends much less on past performance for these LPs. Third, our results hold when we control for the share allocated to private equity by the LP's parent, which under the reverse causality hypothesis, should be the one driving force behind investors' scope of activity. Although we cannot rule out reverse causality, none of these tests support this view.

The rest of the paper is organized as follows: Section 2 describes the data. Section 3 provides empirical evidence on investors' organizational structure; Section 4 provides evidence on investors' scope of due diligence and monitoring activities. Section 5 focuses on the relation between team size and LP size. Section 6 examines investor investment criteria. Section 7 concludes by discussing the implications of our results.

2. Data and investor characteristics

2.1. Survey design

The survey was designed with the help of a senior LP executive and was presented to investors as a unique opportunity to (anonymously) benchmark their due diligence practices against those of a large set of other investors for free. Respondents do not therefore have clear incentives to misrepresent any information.

To construct our sample of respondents, we used the 2008 Directory of Limited Partners published by Private Equity International (PEI). During the year 2009, we emailed all of the 1,723 LPs listed in the directory to introduce the survey and to provide the website address for responding.[1] Respondents to the survey could leave their contact details; two thirds did so. When investors left their contact details but did not answer some of the questions, we followed up by phone.

We have received 249 responses from LPs in 30 countries, giving a response rate of 14.4%. This compares well to other academic large-scale surveys. For example, the CFO survey of Graham and Harvey (2001) had a response rate of 8.9%. We believe that this relatively high response rate reflects a significant interest in the investor community about how others perform due diligence.[2]

2.2. Main investor characteristics and sample representativeness

From the survey, we obtain LP characteristics that could explain heterogeneity in due diligence practices. Four of these characteristics are also available in the PEI Directory and can help us gauge the representativeness of our sample. In this sub-section, we describe these four investor characteristics.

2.2.1. LP type

The first characteristic we collect is 'LP type', i.e., the nature of the parent organization. This is motivated by the study of Lerner et al. (2007), who point out that an important source of heterogeneity across institutional investors is their organizational type. They find that endowments outperform other types, and infer a number of advantages that endowments have over other investor types when

[1] The Directory contains several organizations that are GPs, or that no longer invest in private equity. It also contains fund-of-funds, which we exclude.

[2] Groh and Liechtenstein (2011) conduct a similar survey on how investors select venture capital funds.