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The disintermediation of financial markets: Direct investing in private equity☆

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ABSTRACT

We examine 20 years of direct private equity investments by seven large institutions. These direct investments perform better than public market indices, especially buyout investments and those made in the 1990s. Outperformance by the direct investments, however, relative to the corresponding private equity fund benchmarks is limited and concentrated among buyout transactions. Co-investments underperform the corresponding funds with which they co-invest, due to an apparent adverse selection of transactions available to these investors, while solo transactions outperform fund benchmarks. Investors' ability to resolve information problems appears to be an important driver of solo deal outcomes.

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1. Introduction

In recent years, institutional investors have increasingly invested directly in private equity, bypassing the traditional intermediated fund structure. These direct investments include transactions in which an institutional investor co-invests in a deal that is originated by a private equity fund manager (which we term co-investments) and ones in which the institutional investor originates and invests in the transaction alone (solo investments). According to Preqin survey data, in 2014, 52% of investors in private equity funds intended to increase their direct investment activity, and a further 36% planned to maintain their current level.[1]

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[1] Preqin, "The state of co-investments," https://www.preqin.com/docs/newsletters/pe/Preqin_PESL_Mar_14_Co_Investments.pdf, 2014. Also see "South Carolina to start an investment firm for its private equity bets," http://www.nytimes.com/2010/09/28/business/28carolina.html, September 27, 2010; "Abu Dhabi Sovereign Wealth Fund eyes direct investment in Indian real estate," http://www.altassets.net/private-equity-news/by-news-type/firm-news/abu-dhabi-sovereign-wealth-fund-eyes-direct-investment-in-indian-real-estate.html, March 9, 2012; and "NY State: interested in more direct private-equity investments," http://online.wsj.com/article/BT-CO-20120518-713093.html, May 18, 2012.

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The growing appetite for direct investments is spread across all types of institutional investors, often at the expense of allocations toward traditional private equity investing. Lower fees—and, consequently, the promise of higher net returns—appear to be the primary reason behind this trend. Yet, as we will show, running a successful direct investing program can be challenging.

Our main contribution is a pioneering empirical assessment of the relative performance of direct and intermediated investing in private equity for a large sample of investments over two decades. In broader terms, this study relates to one of the enduring questions in the corporate finance literature: why intermediaries are ubiquitous in financial markets. The widely offered explanations are two-fold.[2] The first involves transaction costs. By pooling capital across multiple individuals and institutions, the costs associated with assessing and undertaking investments can be shared, thereby enhancing investors' returns. The second explanation highlights the information advantages of financial intermediaries. Notably, Leland and Pyle (1977) argue that intermediaries invest in assets where they have special knowledge, while Diamond (1984) suggests that these financial actors serve as "delegated monitors". Chan (1983) and Admati and Pfleiderer (1994) highlight how informational advantages may motivate investors to deploy equity capital through private equity funds.

Against this theoretical backdrop, private equity might appear to be a textbook case where the benefits from financial intermediation would be substantial. The transaction costs associated with structuring these investments are large [for example, see Kaplan and Strömberg (2003) and (2004)], and substantial information asymmetries surround the monitoring and nurturing of the investments, giving rise to potential information advantages for specialized investors. However, intermediaries are far from a panacea. A key concern is the classic principal-agent problem: the intermediary may behave in its own interest, rather than that of the investor.[3] In the private equity setting, funds may grow fees at the expense of returns (Kaplan and Schoar, 2005; Lopez-de-Silanes, Phalippou, and Gottschalg, 2013), invest aggressively at market peaks when expected returns are modest (Axelson, Jenkinson, Strömberg, and Weisbach, 2013), and exit transactions prematurely to facilitate fundraising (Gompers, 1996). Moreover, the consequences of these behaviors on the part of the managers (agents), which are attributable to agency problems, are compounded by the evidence that many classes of institutional investors (principals) appear to suboptimally choose which private equity groups to invest with (Lerner, Schoar, and Wongsunwai, 2007; Hochberg and Rauh, 2013).

In this context, the interest on the part of institutional investors in undertaking direct investments—and thus bypassing intermediaries—calls for a detailed evaluation. Towards this end, we compile a proprietary data set of direct investments from seven large institutional investors. For these investors, we have *complete* coverage of their direct investment programs, including solo investments (those deals originated and completed by the limited partners (LPs) on their own) and co-investments (deals where LPs invest alongside general partners (GPs)). Our data set consists of complete and detailed cash flows for 390 direct investments made by these institutions between 1991 and 2011. We examine the investing patterns, as well as the performance of these direct investments. We compare the performance of these direct investments against that of public market indexes and private equity funds, thus directly assessing whether the trend towards "going direct" is economically justified. We use a number of different benchmarks from various data sources and performance metrics, with a particular emphasis on market-adjusted performance (PME, or public market equivalent).

Our analysis suggests several conclusions:

- The direct investments perform better than tailored public market indices. The best performance is concentrated in the buyout fund investments and those made in the 1990s.
- There is limited evidence of outperformance of the direct investments relative to the corresponding private equity fund benchmarks. For venture capital (VC) deals, we find that direct investments underperform the fund benchmark, especially in the 1990s. This is consistent with the evidence on unique skills of VC funds—as reflected in the persistence of their returns (e.g., Kaplan and Schoar, 2005; Harris, Jenkinson, Kaplan, and Stucke, 2013; Korteweg and Sorensen, 2014).
- Co-investments underperform the investments of the corresponding funds with which they co-invest, with the performance gap widening in the latter half of our sample. This underperformance of co-investments, which are executed alongside private equity groups (often the same ones where the institutions have fund investments) and are the cornerstone of most institutions' direct investment programs, is surprising.[4] We provide evidence that this underperformance appears to be driven by selection (a "lemons problem"): institutional investors can only co-invest in deals that are available to them. In particular, these transactions are substantially larger than an average sponsor's deal and appear to be concentrated at times when ex post performance is relatively poor. At the same time, it is important to acknowledge that these direct investments allow firms to put substantially more funds to work.

[2] For a more detailed discussion of the role of financial intermediaries, see Allen (2001), Allen and Santomero (1998), and Gorton and Winton (2003).

[3] A voluminous literature on the behavior of banks during the run-up to the financial crisis has highlighted how agency problems led them to neglect the interests of their capital providers. Mutual funds and insurance companies have also been shown to engage in behaviors that benefit portfolio managers at the expense of their investors (e.g., Chevalier and Ellison, 1997; Becker and Ivashina, 2013).

[4] It is common for selected co-investments to be offered as a "sweetener" for the large LPs participating in the traditional fund.

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