Bienz, C., Thorburn, K. S. and U. Walz (2017). *Skin in the game, wealth and risk-taking: Evidence from private equity funds*

Discussion by **Marie Lambert**, Associate Professor, HEC Liège (Liège Université)

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The paper in a nutshell

- **Research question**: Impact of the co-investment of GPs on their risk taking investment behavior
    - <u>Definition of risk-taking investment behavior</u>: business/industry risk (asset/unlevered beta) of the target companies as well as the diversification of the portfolio of companies
    - The authors also examine the impact on the risk-adjusted return of the deals

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The paper in a nutshell

- **Research question**: Impact of the co-investment of GPs on their risk taking investment behavior

  - Economically important topic: Co-investment is required (among other rules on compensation scheme) to align GP with LP interests

    It is therefore important to

    - Control for the efficiency of the rule
    - Control for extreme risk taking behaviors

Comment #1 – Identification issues

Is beta the right measure of risk?

- Buyout deals are looking for alpha by bearing specific risk
  - Risk-taking should be measured with regard to specific risk rather than systematic risk
  - Systematic risk is mostly driven by the strategy announced by the fund
  - Tables 5-… show that firm-specific variables - you control for - do not affect beta (profitability/activity ratios, size)

Comment #1 – Identification issues (*continued*)

Do low business betas' firms produce stable cash flows?

- Assumption made by the authors
- Betas only capture the market determinants of the cash flows, not the specific risk of the companies in portfolios which could also affect stability of CF generation

Comment #2 – Theoretical modeling

The paper starts with a theoretical model showing the impact of co-investment on risk-taking behaviors

- The theoretical modeling assumes that the value of the deals are not affected by debt. Is it realistic for buyout deals?

- ”To make debt financing attractive, we assume that the sum of CF upside and downside should be superior than the hurdle rate reduction due to debt financing?” Oops… I do not understand…

$$\Delta + \rho - R > D(1 + e)$$

Comment #3 – Data

Family funds: 11 Nordic private equity firms, 20 buyout funds, 62 companies

- Are the data representative? The investment behavior of the 11 private equity firms might be similar within the different portfolio companies
- Assumption of no endogeneity issue for risk-taking as the contracts are settled before the investment decisions. Is this assumption valid for follow-up funds?

Comment #3 – Data (*continued*)

Family funds: 11 Nordic private equity firms, 20 buyout funds, 62 companies

- Is the risk-aversion of the managers decreasing – and therefore the level of risk taking increasing – with the fund sequence (as their personal wealth increases)
  - Fund sequence is used as a control
  - Can it interact the relationship between risk and co-investment (adding an interaction variable?)

Comment #4 – Empirical analysis

- Impact of the co-investment of partners and professionals: Could you be more precise? What should we expect: to be different or not?

- Compensation scheme (management fees and carried interests) should be considered together with co-investments and used as controls. Clawbacks could also play a role

Comment #5 – Results

Higher co-investment leads to lower risk-taking behavior

Somehow misleading as it induces more financial risk – leverage – (even though the total beta is also reduced)

Back to the question on risk definition…

Comment #5 – Results (*continued*)

Page 2 : "While a large co-investment mitigates incentives for excessive risk taking, it may also make a risk-averse manager too conservative, foregoing valuable investment opportunities with high risk"

Page 22: "We believe we should not expect to find a relationship between GP's co-investment level and the NPV of the investment"

- Look inconsistent
- Besides, you compute the NPV using a constant discount rate (constant leverage), is this realistic for buyout?
- Results on 26 firms, is this a representative sample?
- Not rejecting the null hypothesis does not mean there is no relationship… be careful in your interpretations…

Minor comments

- You should avoid using the notation “beta” when referring to the co-investment measure as it is confusing with the risk measure

- Make sure to translate every variable in english

Good luck with your paper!