Sub-optimal risk-return profiles in private equity: The case of minority business enterprises investing

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Private equity and socially responsible investments: converging trend lines

The main intersection is: minority business enterprises investments

- Scientific basis
  - Socially responsible investing (SRI) has a limited influence on listed stocks [Amenc & Le Sourd, 2008]
    - Best-in-class approach (stock filtering)
    - Limited shareholder involvement > no improvement according to SRI criteria
  - Private equity has superior corporate governance [BVCA, 2008; Gottschalg, Talmor & Vasvari, 2010]
    - Demonstrated higher shareholder involvement compared to other forms of ownership [Acharya, Hahn & Kehoe, 2010; Meerkatt, Rose, Brigl, & alii, 2008; Quiry & Le Fur, 2010]
    - Strong alignment of interest between investors and company managers [Chemmanur, Krishnan & Nandy, 2008; Katz, 2008]

- Difficulties
  - Applying SRI criteria through PE corporate governance has proven to be difficult
    - Passive investing (best-in-class investment approach) is only relevant for stock picking in listed markets
    - Active investing (implementing SRI criteria) is too burdensome (bureaucracy/additional costs) for SMBs post-investment

- Applied solution
  - SRI criteria („environmental, social and governance") are filters pre-investment
  - Intersection:
    - venture philanthropy: use VC methods to finance emerging business to generate **in priority social returns** [EVPA] (niche)
    - social private equity: creating value for society by addressing public sector & market failures through application of market based solutions in innovative ways [Maretich & Bolton, 2010] (niche)
    - **minority-related investments**: adds due diligence criteria pre-investment, **targeting financial returns and to correct certain social imbalances** [Rubin, 2003]

... But minority-related investing is still not part of mainstream private equity. WHY?

Minority-related private equity remains an investment niche
The reason lies in the fact that it presents a sub-optimal risk-return profile

- What is „minority-related investing“ (or „minority backed enterprises)?
  - Difficult to define: „*ethnically diverse businesses*“, „emerging domestic markets“, „underserved markets“ (NAIC); „inner cities investing“ [Porter, 1995] > **what is the „right background“? „Ownership cut“?**
  - Target is to generate returns: „member companies invest in privately held businesses that have a high probability of growth and the ability to *generate significant returns* for investors and shareholders“ [NAIC]

- Minority-related investing is not part of mainstream private equity
  - NAIC declares that its members manage USD10 billion (vs 1‘500 billion worldwide for private equity [Preqin])
  - Not known enough by potential limited partners [Alphonse, Hellmann & Wie, 1999] > **It is a US phenomenon**

- Conflicting interests of PE & MBE: is it the reason of this niche role?
  - Ownership rule > not explicit. However:
    - Minority PE exists (VC, Growth, minority LBO) > not really a problem for a majority of the segment
    - Majority PE is not excluded from MBE (actually possible, see IVC & Bates, 2010] > leadership of company might be enough (but a moving target...) – if this is a mandatory criteria, could be troublesome
    - PE is supposedly adding superior corporate governance > can go around the „simple majority ownership“ criteria

  > Cannot be ruled out, but difficult to explain why it would prevent MBE to be a major PE investment segment.

If not related to the ownership/corporate governance rule, then it is related to the risk/return profile of MBE investing.

Return puzzle
MBE private equity does not work – not surprisingly

- MBE: why is this a topic?
  - Less accessible to capital than similar white-owned firms [Bates & Bradford, 2008]
    - This market inefficiency leads to potential higher returns [Bates & Bradford] > **but why?**
  - The hypothesis of higher return potentials
    - These businesses better adress local needs (share „same specific character") and are trend setters [Porter]
    - They can serve local and adjacent markets, as well as „similar communities" (national & international) [Porter]
  - The hypothesis of lower costs
    - Moderate costs [Porter]
    - Community knowledge / special human resources [Porter]

- Does it work? No
  - Private equity funds have cash, try to find new strategies and still do not invest in MBE
    - Where there is a long-standing return potential to address in private equity, the market addresses it: emerging markets (China, Vietnam, India, Africa), new strategies
    - Uninvested private equity amounts estimated between USD400 (Preqin, 2010) and 500 (Pitchbook, 2009) billion

  > Why would the market ignore **local opportunities** (risk reduction) based on gender/social/ethnic background?

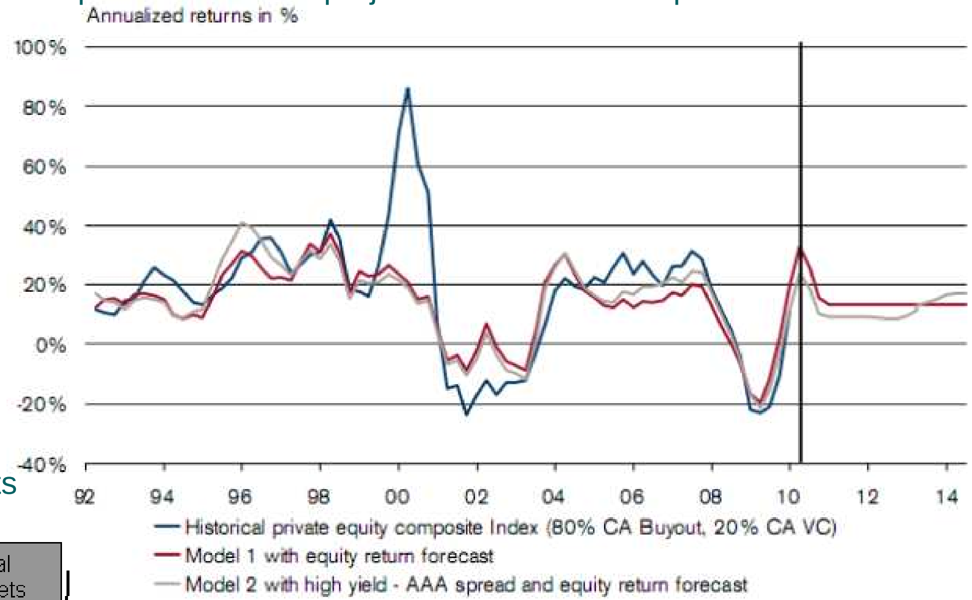
- Is it surprising? No
  - In 1995, Porter made the implicit assumption that either risk, or returns (or both) would disappoint
    - Give incentives to equity providers through specific tax breaks > **contradicts the assumption of Bates & Bradford**
    - Possible reason 1: lower returns for a certain level of local risk > **why?**
    - Possible reason 2: real or perceived risk not compensated by additional returns > **much be significantly higher (what would it be)?**

MBE investing has been ignored for 40 years

Because its risk-return profile is not in line with expectations of PE fund managers

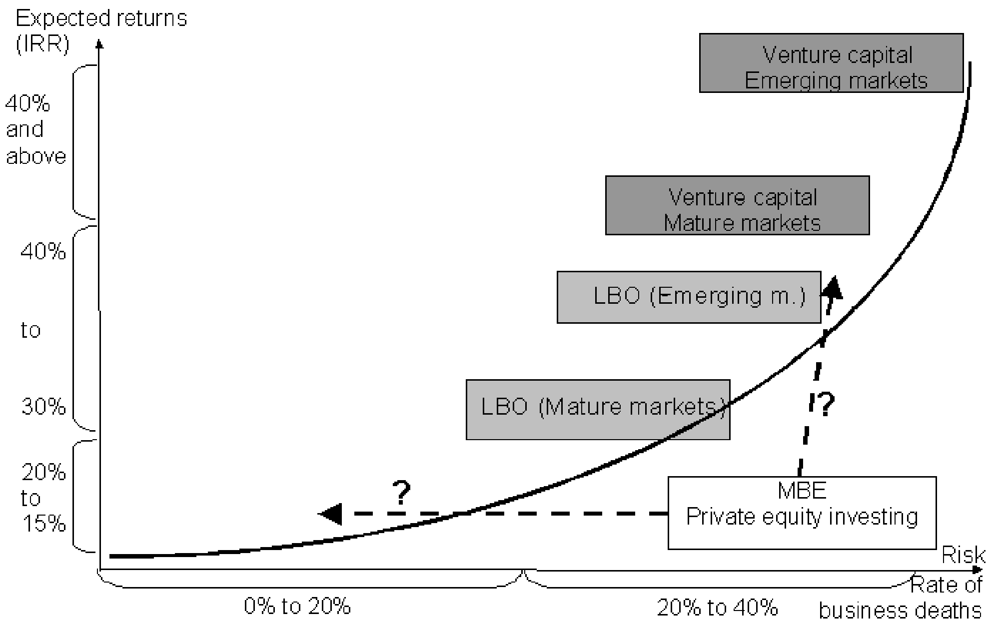
- MBE investing should at least match a mature market average net return of **12.2%** [JP Morgan 2007; Crédit Suisse, 2010]...

Compared actual and projected PE annual net performance



Source: Crédit Suisse

Stylised curve of risks-returns profiles of operations and markets



- ... Or an emerging market risk-return approach with a substantially higher return for a given level or risk

Positioning MBE investing

A relatively high risk, lower return investing activity (1/2)

- If MBE was providing convincing investing opportunities, it would have attracted capital
  - Persistence of private equity returns [Kaplan & Schoar, 2008] is driving this trend on the mid to long term

> This is not happening (USD 10 billion, while the NAIC was created in 1971)

- By suggesting tax breaks, Porter assumes that the **return level** of MBE investing is close to usual returns associated to PE investing
  - This remains to be proven...
  - Bates & Bradford provide an estimated 17.7% „net“ return for NAIC members PE investments short of the 20 years average in the US private equity
  - ICV generated a gross 20% return [Bates, 2010], mainly from non-MBE investments and opted out of MBE investing

Average risk and net returns for US LBO, venture capital and private equity sectors (1980-2000)

	Average net IRR (in %) Return	Standard deviation (in %) Risk
Venture Capital	23.17	19.66
LBO	18.21	12.78
Private Equity	**19.87**	10.63

Source: Thomson Venture Economics, Ibbotson & Associates.

Positioning MBE investing

A relatively high risk, lower return investing activity (2/2)

- Risks in private equity and MBE investing are diverging
  - Rough assessment of the risk of MBE investing from Bates & Bradford [2008].

Average risk and net returns for US LBO, venture capital and private equity sectors (1980-2000), and MBE-related private equity (1989-2003)

	Average net IRR (in %) Return	Standard deviation (in %) Risk
Venture Capital	23.2	19.7
LBO	18.2	12.8
Private Equity	**19.9**	**10.6**
MBE-related private equity	**17.7***	**21.1****

Source: Thomson Venture Economics, Ibbotson & Associates, Bates & Bradford, Author.
** The result is declared as "net" by Bates & Bradford but this statement can be discussed.*
*** This is a rough estimate based on data from Bates & Bradford, 2009.*

Consequences

The source of the extra risk has to be addressed

- The source of the extra-risk associated with MBE private equity investing
  - Probable: extra criteria applied without direct extra return
    - Reduction of the investment universe (risk increase)
    - Same or below-par return potential
  - How to reduce this risk?
    - By redefining the selection criteria, notably to avoid anti-selection
    - Thanks to the competence of the MBE-focused PE investor

- Redefining selection criteria
  - **Investing in equity and quasi-equity in non listed companies**
    - Beyond VC, the full PE value chain
    - Addresses the debt glut for MBEs (signal)
  - **Managed significantly or in majority by underprivileged populations** > focus on **stigmas**
    - Bars ethnicity, gender or social status > white,male & underprivileged also (EU compatible too)
    - Discrimination is not only geographical (inner cities), or based on nationality (immigrants)
    - Refers to education, social and cultural capital, as well as abilities (physical or mental)
    - Underprivileged refers to a relative scale
  - **In order to generate positive risk-adjusted financial returns**

- Fostering the competence of UP-focused PE investors
  - Change the way UP-focused PE investors work
    - Specialisation in economic sectors [Acharya, Hahn & Kehoe; Meerkatt, Rose & alii] - not the case [Bates & Bradford]
    - Focus and rigour in process > at the moment, they make investments „well above the sector‘s average“ [Bates & Bradford]
    - Develop an edge to detect attractive opportunities, negotiate them rapidly and at favourable terms
  - Change the perception of the „signal“ factor send by „MBE-focused PE investors“ (current: stigma)
    - Prevent anti-selection and exclusion from deal syndicates
    - Hands on approach (operational improvements) with specific competences (adapted)

Being a UP-focused PE investor
Some specific dimensions have to be implemented

- Be a local investor
  - No stigma if
    - Professionalism
    - Active branding and communication
  - Virtuous circle potential
    - Expertise recognized locally, which strenghten the attractivity of the investor
    - Alleviates the asymmetries of information [Gompers & Xuan, 2008]
    - Expertise compensated by valuation discounts (VC: 30% [Hsu, 2004])
    - Creates a connection with potential co-investors (cluster membership)
    - Better monitoring and soft information gathering [Chen, Gompers, Kovner, Lerner, 2009]

- Develop a specific know-how
  - **Underserved communities are not interchangeable as they differ in important ways [Rubin, 2010]**
    - Cultural, linguistic and social expertise
    - Specific networks (education, social needs, etc.)
  - **MBE-focused PE investors will have to merge and pool higher amounts of capital**
    - Economies of scale
    - Reduce the overall fixed charges [Bates, 2008: MBE-focused PE funds have on average a size of USD 30 million]
    - Refers to education, social and cultural capital, as well as abilities (physical or mental)
    - Underprivileged refers to a relative scale
  - **Develop a role of bridge between typical PE and MBE worlds**
    - Focus on intensive executive and management trainings
    - Develop specific hiring networks and advisory techniques
    - Analyse specific outsourcing patterns and industrial and commercial partnerships

Maybe enhance temporarily the returns of the UP-focused funds by a social impact bond?

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Q&A

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