Lead Left Interview – Josh Lerner

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This week we chat with Josh Lerner, the Chair of the Entrepreneurship Unit and the Jacob H. Schiff Professor at Harvard Business School. He has recently been named one of the 100 most influential people in private equity over the past decade by *Private Equity International* magazine. He currently serves as Vice Chair of the World Economic Forum's Global Agenda Council on the Future of Investing.

The Lead Left: Professor Lerner, you have a unique perspective on the private equity industry. What issues are front and center for you today?

Josh Lerner: There are several issues floating around that are of intense interest to private equity. There's particular anxiety around fund structures. The general theme is LPs exploring alternatives to the traditional structures. The first option is going it alone with direct investments or co-investments. Another option is to create separate accounts with more favorable economics. Finally, there's the intent, not always successful, of large institutional investors working together, thereby bypassing the fund structure altogether.

This is really all about experimenting with a fund model that has been traditionally resistant to change.

TLL: What's been the reaction from the GPs?

JL: It's been two-fold. First, there's an accommodation to large investors when necessary. For example, the creation of separate accounts, which provides flexibility and better economics for larger clients. Another creative response has been the creation of funds lasting longer than ten years, which some LPs desire. Then there's been the turn to raising funds from outside the network of traditional institutional investors, such as high-net worth investors.

TLL: What's driving the movement to LP empowerment? Is the trend of LP empowerment irreversible?

JL: There's always a pendulum swing to these things, an ebb and flow of term changes. It's a process; part of the whole private equity cycle. But to a large extent, the current wave of LP activism has been fueled by regulatory pressures, particularly the increased transparency of fees that GPs have been forced to provide. The dollars in terms of fines for the GP community for the improper disclosure of fees to LPs have not been substantial, but the resulting LP unhappiness has been.

TLL: What other areas are you're studying?

JL: Victoria Ivashina and I will be coming out with a paper early next year on the dynamics within partnerships themselves. Private equity firms are brilliant when it comes to investing, but not as great at managing their own businesses. Of course, a lot of it comes down to the sharing of economics and carry. A frequent stress point in partnerships is who gets more of the carry split and ownership.

TLL: What does your study focus on?

JL: We look at nearly one thousand funds raised over the last fifteen years and at the alignment of interests within these funds. How was the carry split? Which partners stuck around, which ones left? Were the partners who left the underperformers or the overperformers? How did the economics of the fund influence these decisions?

TLL: Josh, what do you make of the investing environment for PE today?

JL: On the one hand it's a great market to sell, and that's making LPs and GPs happy. Certainly there have been many corporate buyers and (at least until recently) the public markets have been accommodating. LPs are getting cash back, which they want to reinvest. This creates more investable dollars, but it's been challenging to redeploy that money.

TLL: The M&A market seems to still be in pretty strong shape.

JL: Large companies are struggling in this environment to find ways to grow. Corporations are thus eager to undertake acquisitions, often being willing to pay high prices. This make it hard for PE funds to find good deals.

Another example of these pressures for growth is corporate "venturing." In many industries, including autos and consumer products, corporates are investing in start-ups. This ultimately leads to acquisitions, but again to higher valuations.

TLL: Do you think the PE model of achieving returns through financial engineering is outdated?

JL: The typical PE group will say we're all about adding value, and not about financial engineering. But when you get into the numbers, it's a mixed bag. Most groups attribute 90% or more of the value they create to operating improvements, but the relevant academic studies show a much more modest 20 or 30% is due to operational improvements (as opposed to market timing or leverage). Moreover, the pace of value creation is uneven over time: it is during the periods when spreads widen out, such as 2009-10, when managers really have to roll up their sleeves and focus on improving operations.

To be continued the week of Dec 7

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