

When AI Meets PE (101)

A Webinar Sponsored by
Private Capital Project at Harvard Business School
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Summary

The rise of artificial intelligence (AI) is changing the landscape of private equity. As we see a boom in both the power and accessibility of these tools, AI has the potential to assist both private equity investors and portfolio firms. However, bringing AI into the PE industry comes with its own set of challenges, from ensuring the quality of the output to ensuring compliance with legal requirements. This webinar explored the different ways that AI is impacting PE, shedding light on the exciting possibilities and the hurdles along the way:

- AI's growing influence in identifying investment opportunities and streamlining the investment process.

- Challenges in integrating AI with PE practices, such as ensuring data quality and balancing automation with human insight.
- Specific risks AI poses to sectors like healthcare, necessitating strategic risk management.
- The importance of data privacy and the implementation of secure, closed systems to maintain data confidentiality.
- The advantage of AI-first firms in innovating processes, with larger firms facing innovation limitations due to established systems.

AI's Impact on PE

When AI Meets PE (101), a roundtable held on December 5, 2023, provided various perspectives on the current and future relationship between artificial intelligence and the private equity sector. The event brought together industry experts and academics to discuss the impact of AI on private equity, delving into both its transformative potential and the challenges ahead.

In short, AI's contribution to streamlining due diligence and data valuation is poised to redefine investment strategies, bringing an era of stronger data-driven decision-making. Despite this promise, the path to AI integration in PE is fraught with concerns about data integrity, the complexity of meshing AI with established systems, and the delicate balance between human expertise and automation.

One of the central topics of the webinar was AI's significant influence on deal sourcing in private equity, and investment decisions. The panelists discussed AI's ability to enhance identifying often overlooked investment opportunities due to automated models potentially being more objective. However, reliance on historical data (the key input to these models) may also lead to the neglect of future opportunities: for instance, it is natural to fear that these models will deemphasize truly radical disruptions or businesses founded by minorities historically underrepresented in private capital portfolios.

The panelists also viewed AI as a key driver in making due diligence more efficient, enhancing the value derived from data, and potentially redefining traditional investment strategies. This aspect of AI's application promises to deeply alter investment methods, introducing a new era of data-driven decision making. One illustration related to a potential portfolio company active in global markets. The technology was used to analyze data in different languages, which drastically cut down the time needed to go through large datasets. This technique also eliminated the need for translating large amounts of materials.

The discussion also ventured into how AI could alter the mixture of private equity investments themselves. For instance, an investment group may be inclined to offer a higher price for a company based on the perceived potential benefits they could obtain from integrating AI technology into their operations.

Meanwhile, some sectors, notably healthcare and consumer services, are at a heightened risk of AI-induced disruption, prompting PE groups to devise strategies that include mandatory AI disruption-risk evaluations prior to investment commitments. For instance, companies offering services like radiology reading or translation were traditionally highly regarded for their stable cash flows and attractive margins. However, these companies are seen today as highly vulnerable to the disruption caused by AI and are thus avoided. As one of the panelists framed the issue, PE groups must now be proactive in working on the “defensive” for their current portfolio. On the other hand, companies can take a proactive “offensive” approach by anticipating how AI trends will affect an industry. As a result, AI considerations are already shaping private capital portfolios, even among non-technology investors.

Challenges to Incorporating AI in PE

The adoption of AI in private equity is not without its challenges. Concerns were raised about data quality, the complexities of integrating AI with existing processes, and finding the right balance between human expertise and automated solutions.

While agreeing that AI's role in enhancing operational efficiency and aiding in product development could enhance the value of portfolio companies, there was debate about how profound an impact it would have on the investment process. Some panelists advanced the notion that private capital is a “people first” business, while others were more optimistic about the ability of data-driven approaches to shape investment and value-creation decisions in the industry.

Data privacy and security also emerged as crucial concerns, particularly regarding the use of external AI tools. The panel underscored the need for stringent security measures to ensure the confidentiality of proprietary data. One of the practical challenges highlighted was the issue of data confidentiality when utilizing new technological tools. The concern arises from the fact that some large language models (LLMs), when fed with data, may inadvertently share this sensitive information with others as it becomes part of the tool's learning model. To mitigate this risk, many firms have made the strategic decision to employ closed systems, ensuring that any data input remains within the confines of the organization, thereby preventing any unauthorized dissemination of sensitive information.

During the panel discussion, some speakers expressed concerns about the potential consequences of using more complex models. They were worried that as a model becomes increasingly complex, it may become more difficult to understand the reasoning behind its results. This could lead to confusion and uncertainty about the accuracy and reliability of the model. Similar issues could arise with a model being overfitted – where it simply gives a historical account of what occurred.

Advantages to Smaller and Larger Firms

One focus of the discussion was whether the shift to AI in private capital would benefit disproportionately larger or small investment groups.

It was suggested that younger private capital groups may possess a competitive advantage over larger, established ones, due to their agility and lack of entrenched processes. The past decades have demonstrated that startups have the unique ability to innovate by redesigning how tasks are accomplished, unencumbered by vested interests or previous investments in traditional methods of operation. This agility has led to their ability to transform many industries.

Larger private capital groups often face limitations imposed by existing procedures and sunk costs, which can inhibit innovation. The emergence of open source AI programs like LLaMA may accelerate these trends. The consensus was that firms with an "AI-first" mindset could reimagine entire processes and thus hold a strategic advantage.

The greatest challenges, the panelists conjectured, will be faced by smaller firms with traditional approaches. Large firms can leverage their scale and in-house expertise: many groups have already built up substantial data science teams. While the adjustment process to a world where AI is central to decision-making may be challenging, it is likely that they will successfully make the transition.

Other firms—particularly those without founders conversant with these new technologies—are likely to rely on external vendors and partners. These can be costly and successful integration with the group can prove to be time-consuming. Firms without the resources of the largest firms and whose leaders do not have deep familiarity with these technologies may find the evolving technological landscape to be particularly challenging and expensive to navigate.

In Sum

The discussion provided a nuanced exploration of artificial intelligence's role in private equity, highlighting its potential to enhance deal sourcing and due diligence, while also acknowledging the challenges of data privacy, integration complexities, and the need for a balance between human expertise and automation. The discussion reflected on AI's transformative capabilities against the backdrop of risks such as biases in models and the imperative of stringent security measures to protect sensitive data. Looking ahead, the panelists anticipated AI's continued impact, mindful of the ethical and regulatory considerations that accompany technological advancement.