Andreas Krause

Chapter 17.1

Viability of partnerships

Outline

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Characteristics of partnerships

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Characteristics of partnerships

- Investment banks were traditionally organised as partnerships

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- The owners are actively engaged in the business

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- Investment banks were traditionally organised as partnerships
- The owners are actively engaged in the business, they are called partners

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- New partners are appointed from existing employees

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- New partners are appointed from existing employees, called associates
- New partner buy a stake in the company

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- New partner buy a stake in the company and if they leave, sell it to a newly appointed partner

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Mentoring associates

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- Partners can be either highly-skilled, generating surplus V_H

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- Partners can be either highly-skilled, generating surplus V_H, or low-skilled, generating surplus V_L

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- Partners can be either highly-skilled, generating surplus V_H, or low-skilled, generating surplus V_L
- A partnership has M partners

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- Each partner mentors N associates, who might become partners

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- Profits to a partner consists of his own surplus V_H

- $\Pi_P = V_H$

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- Mentoring costs C and partners do not know the type of partner an associate will be without mentoring
- Profits to a partner consists of his own surplus V_H and the surplus V_L of all associates he mentors, less the wages they are paid
- $\Pi_P = V_H + N\left(V_L - w_A\right)$

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Profits of joining a partnership

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Profits of joining a partnership

- Associates do not know if they are highly skilled and chosen as partners, they assign probability $\frac{1}{N}$ to this
- If appointed as partner, they obtain their initial wage

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Profits of joining a partnership

- Associates do not know if they are highly skilled and chosen as partners, they assign probability $\frac{1}{N}$ to this
- If appointed as partner, they obtain their initial wage and in the next time period the profits of being a partner

- $\frac{1}{N}\left(w_A + \frac{\Pi_P}{\rho}\right)$

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Profits of joining a partnership

- Associates do not know if they are highly skilled and chosen as partners, they assign probability $\frac{1}{N}$ to this
- If appointed as partner, they obtain their initial wage and in the next time period the profits of being a partner, less the mentoring costs

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- $\frac{1}{N}\left(w_A + \frac{\Pi_P - C}{\rho}\right) + \left(1 - \frac{1}{N}\right)$

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- If appointed as partner, they obtain their initial wage and in the next time period the profits of being a partner, less the mentoring costs
- If not appointed as partner, they obtain their initial wage and in the next time period gets paid his contribution
- $\frac{1}{N}\left(w_A + \frac{\Pi_P - C}{\rho}\right) + \left(1 - \frac{1}{N}\right)\left(w_A + \frac{V_L}{\rho}\right)$

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- $$V_L + \frac{V_L}{\rho}$$
- If not joining the partnership, they obtain their contribution in the current and next time period

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- If not appointed as partner, they obtain their initial wage and in the next time period gets paid his contribution
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- They join the partnership if this is more profitable

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- Associates join the partnership if $w_A \geq V_L - \frac{(V_H - V_L) - C}{N(\rho - 1)}$

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- If $C \leq C^* = V_H - V_L\left(1 + (\rho - 1)\, N\right)$, we can set $w_A = 0$

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- Problem and model assumptions
- Associates joining the partnership
- Taking up partnership offers
- Not appointing unskilled partners
- Mentoring of associates
- Summary

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Value of partnership

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Value of partnership

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Payment if partnership is refused

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Payment if partnership is refused

- Associates not appointed partners join the job market

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Payment if partnership is refused

- Associates not appointed partners join the job market, there will be $M\,(N-1)$ unskilled associates generating V_L each

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- Average surplus is then $\frac{M(N-1)V_L+V_H}{M(N-1)+1}$

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Condition to accept a partnership

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- If joining the partnership they get $\Pi_P - C$

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Unskilled associate accepting the partnership

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Unskilled associate accepting the partnership

- If an unskilled partner is appointed the investment bank loses reputation

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Unskilled associate accepting the partnership

- If an unskilled partner is appointed the investment bank loses reputation and it cannot be sold

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Unskilled associate accepting the partnership

- If an unskilled partner is appointed the investment bank loses reputation and it cannot be sold
- Unskilled partners will generate surplus V_L

$$V_L$$

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Unskilled associate accepting the partnership

- If an unskilled partner is appointed the investment bank loses reputation and it cannot be sold
- Unskilled partners will generate surplus V_L and obtain surplus V_L from each associate

$$V_L + NV_L$$

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Unskilled associate accepting the partnership

- If an unskilled partner is appointed the investment bank loses reputation and it cannot be sold
- Unskilled partners will generate surplus V_L and obtain surplus V_L from each associate and they have previously spent P to purchase the partnership

$$V_L + NV_L - \rho P$$

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Unskilled associate accepting the partnership

- If an unskilled partner is appointed the investment bank loses reputation and it cannot be sold
- Unskilled partners will generate surplus V_L and obtain surplus V_L from each associate and they have previously spent P to purchase the partnership, which cannot be recovered

$$V_L + NV_L - \rho P$$

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- If an unskilled partner is appointed the investment bank loses reputation and it cannot be sold
- Unskilled partners will generate surplus V_L and obtain surplus V_L from each associate and they have previously spent P to purchase the partnership, which cannot be recovered
- If not a partner, the unskilled associate would obtain V_L

$$V_L$$

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- Unskilled partners will generate surplus V_L and obtain surplus V_L from each associate and they have previously spent P to purchase the partnership, which cannot be recovered
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- Accept the partnership if $V_L + NV_L - \rho P \geq V_L$

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Avoiding appointing unskilled partners

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- If no highly skilled associate is available, $M - 1$ partners remain

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Avoiding appointing unskilled partners

- If no highly skilled associate is available, $M-1$ partners remain, the total value of the partnership is then $(M-1)\,P^*$

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Avoiding appointing unskilled partners

- If no highly skilled associate is available, $M-1$ partners remain, the total value of the partnership is then $(M-1)\,P^*$
- If an unskilled associate is available, we retain M partners

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Avoiding appointing unskilled partners

- If no highly skilled associate is available, $M-1$ partners remain, the total value of the partnership is then $(M-1)\,P^{*}$
- If an unskilled associate is available, we retain M partners, the total value if the partnership is MP^{**}

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Avoiding appointing unskilled partners

- If no highly skilled associate is available, $M-1$ partners remain, the total value of the partnership is then $(M-1)\,P^{*}$
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- This requires $w_P \leq w_P^{*} = V_H + \left(1 - \frac{\rho-1}{\rho}\frac{M}{M-1}\right) NV_L$

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Not appointing new partners

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- If mentoring associates, the value of the partnership is P^*

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Not appointing new partners

- Partners must have incentives to mentor associates
- If a partner does not mentor and does not appoint an unskilled associate, there are only $M-1$ partners left
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- Problem and model assumptions
- Associates joining the partnership
- Taking up partnership offers
- Not appointing unskilled partners
- Mentoring of associates
- Summary

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Remuneration differentials with partnerships

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Andreas Krause: Theoretical Foundations of Investment Banking, Springer Verlag 2024
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