Buyouts

Emerging Manager Report

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Buyouts

Emerging Manager Report

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Insight

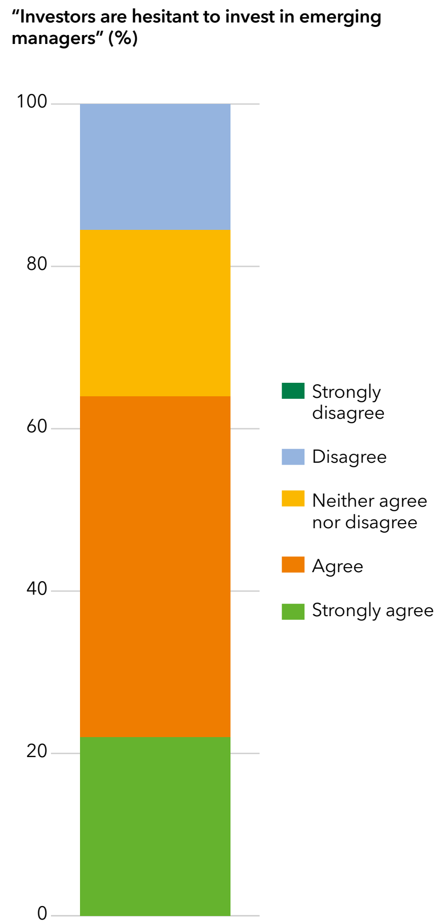
Buyouts Emerging Manager Survey 2022 **In a fundraising environment that is tougher than ever, here are the key findings that every emerging manager should know**

A volatile macroeconomic and geopolitical environment means many investors are pulling back on risk. Meanwhile, the denominator effect is creating capital constraints, and an unrelenting wave of re-ups means LPs are being pushed to their limits. All of which is resulting in a flight to the familiar and a punishingly tough fundraising environment for emerging managers, according to the sixth annual *Buyouts Emerging Manager Survey*, conducted in partnership with Gen II Fund Services LLC, ***writes Amy Carroll***.

However, those young firms that display the essential ingredients of track record, team composition and a differentiated strategy will continue to attract attention, because savvy investors recognize that turbulent markets drive emerging manager outperformance. Unencumbered by legacy portfolios and hungry for success, this could be the time for emerging managers to shine. ■

Risk-off

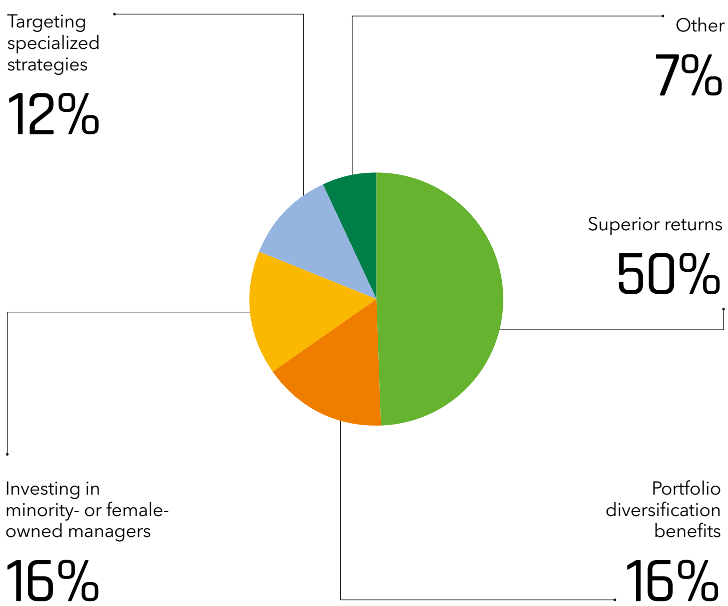
Nearly two-thirds of survey respondents either agree or strongly agree that investors are hesitant about backing emerging managers; only 15 percent disagree. A degree of risk aversion is understandable, given the macroeconomic and geopolitical challenges that are facing the industry. However, organizations with a dedicated focus on emerging managers believe that a cyclical approach to emerging manager investing is counterproductive. "The irony is that data shows emerging managers outperform during the most challenging periods," says Paul Newsome, private equity partner and head of portfolio management at Unigestion.



Access all areas

Half of LP respondents say the primary purpose of their emerging manager program is the ability to generate superior returns. Other objectives include portfolio diversification and exposure to specialist strategies, as well as the ability to handpick managers owned by minorities or women. Also key is the ability to secure access to a firm that may limit commitments from new investors when it gains in popularity. "LPs want to discover the next successful franchise," says HarbourVest managing director Carolina Espinal. "Because, by the time a GP raises its third or fourth generation, it can often be that either access becomes constrained or performance tails off."

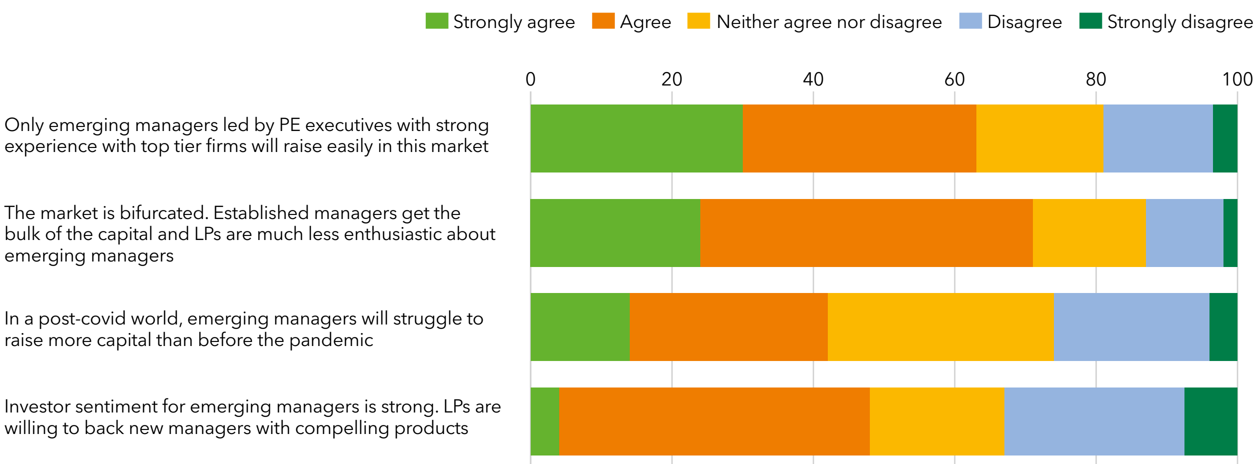
What is the primary purpose of your emerging managers program?



Remote chances

Almost half of GPs believe that investors are willing to back emerging managers with compelling products. However, 72 percent say the market has become bifurcated, with established firms attracting the bulk of LP interest. Meanwhile, 47 percent say the market is more challenging now than it was before the pandemic. Indeed, emerging managers are struggling with the persistence of remote fundraising, even as travel restrictions have eased. "Everyone is getting more comfortable with Zoom, but it mutes that sense of connectivity," says John McCormick, partner at Monument Group.

How do you perceive market sentiment around emerging managers right now? (%)



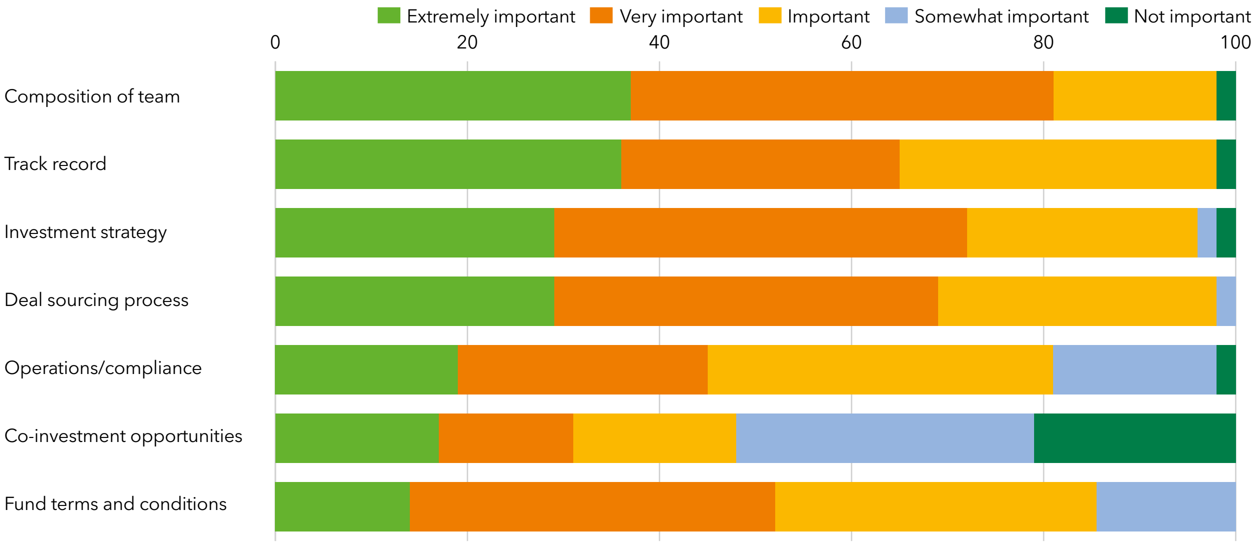
Source: Buyouts Emerging Manager Survey 2022

Figures have been rounded

People, performance and process

Team composition was deemed the most important factor for investors reviewing emerging manager opportunities again this year, followed by investment strategy. Other key considerations include deal sourcing, operations and compliance strength and, of course, track record. "When it comes to due diligence, it is all about the three Ps: people, performance and process," says HarbourVest's Carolina Espinal. Access to co-investment is a significant issue for a third of all LPs, while terms and conditions are deemed important by more than half.

How important are the following factors when evaluating an emerging manager fund? (%)

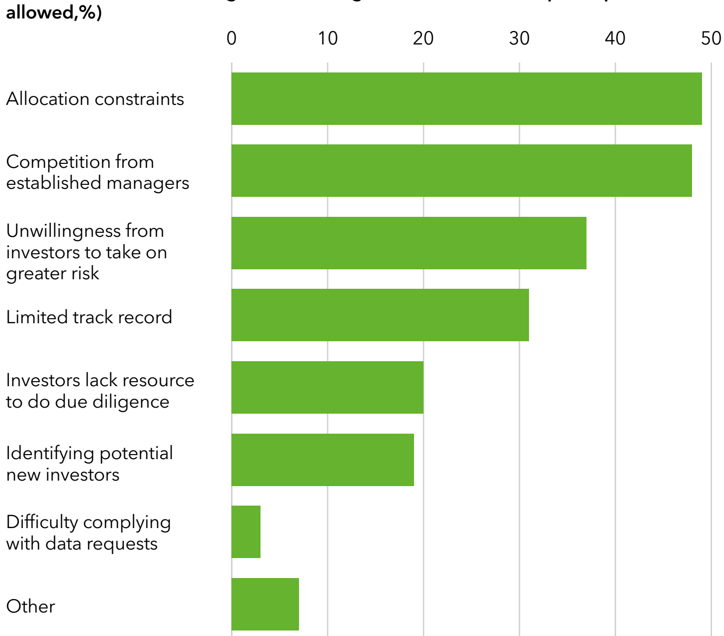


Figures have been rounded

Trying to make yourself heard

The most significant challenges that GPs say they face on the fundraising trail are allocation constraints and competition from established managers. Public market performance means the denominator effect has taken hold. Some investors are also looking to boost returns by reallocating fund capital to co-investment. Meanwhile, a deluge of re-up requests means it is hard for emerging managers to command attention. "It was a lack of bandwidth, rather than a lack of interest, that we were fighting against," says Gil Klemann, managing partner at GHK Capital Partners, which closed its debut fund this year.

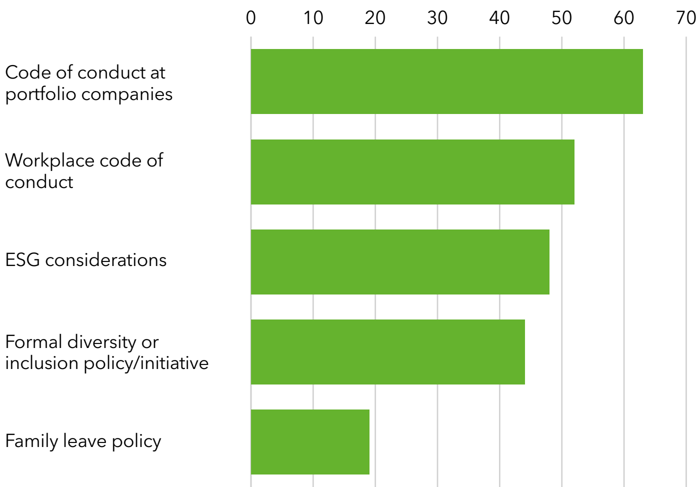
What are the main challenges to attracting new investors? (Multiple responses allowed,%)



Evolving ESG

It is perhaps surprising that less than half of LPs said they take ESG considerations into account when reviewing an emerging manager. This could reflect a recognition that emerging manager infrastructure is typically immature. "ESG is an important area, but it is difficult for emerging managers to have a strong program out of the gate," says Christine Winslow, managing director at Grafine Partners. "It is nonetheless important for emerging managers to incorporate ESG into their strategy and lay out a plan for where they want to go." Interestingly, only a little over half of LPs said they believe ESG correlates positively with performance.

Do you look for any of the following in an emerging manager? (Multiple responses allowed, %)

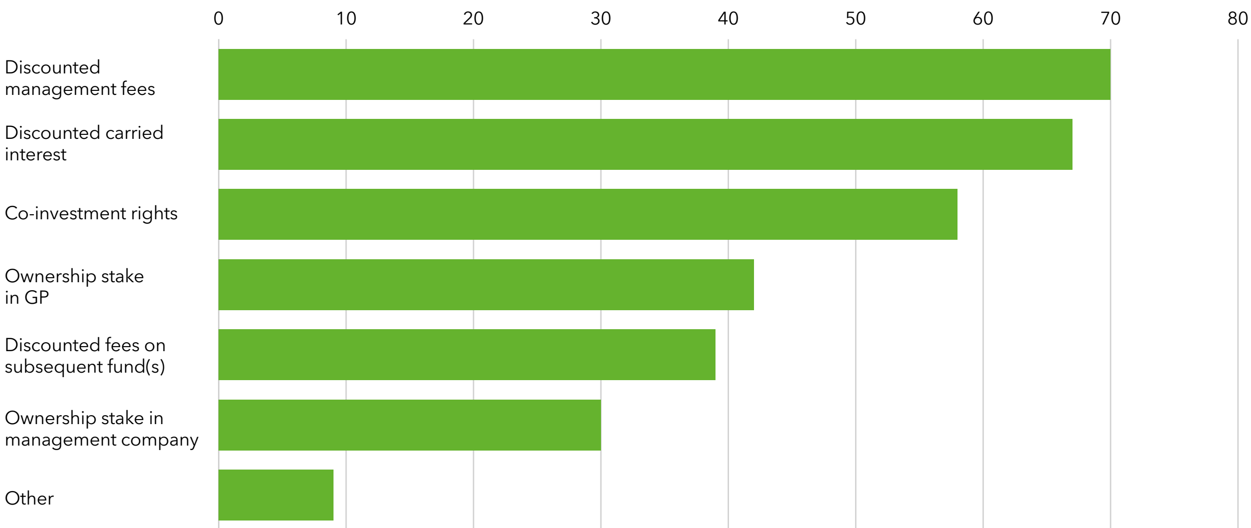


Anchors away

Getting a strong first close can be critical for a first-time fundraising. But securing an anchor investment can be costly. More than two-thirds of investors open to making an anchor commitment said they would seek a discounted management fee in return. Meanwhile, 67 percent would look for discounted carry and 58 percent for co-investment rights. Importantly, more than one-third would try to secure preferential terms for subsequent funds, while 42 percent would seek a stake in the general partnership itself.

"It is important to limit what you give away as an emerging manager," says Monument's John McCormick. "It is also important to make sure whatever is given away is ringfenced."

If you were to make an anchor commitment, what special terms would you seek? (Multiple responses allowed, %)



Source: Buyouts Emerging Manager Survey 2022

The Gen II View **Shifting dynamics impact fundraising**

Expert analysis by **Jeff Gendel**, principal, Gen II Fund Services

At this time last year, emerging managers seemed to have survived the challenges brought on by the pandemic and were finally poised to pick up where they left off before it began. LPs were eager to make commitments to new managers, and the fundraising market was robust. 2022 has brought shifting dynamics for emerging managers in this tentative economic environment, and responses to the *2022 Buyouts Emerging Manager Survey* from both LPs and GPs indicate that the landscape for private capital fundraising has clearly changed.

Driven by the declining performance of public equities – triggering the dreaded denominator effect – investors are rejiggering their private capital portfolios and initiating a more conservative approach to capital allocations. With established firms coming back to the well sooner than ever before and raising increasingly larger funds, re-ups are absorbing much of the bandwidth of investors.

This is making it difficult for emerging managers not only to get a slice of the pie, but even getting in front of investors can prove challenging. Investor allocations for 2022 are already stretched thin. LPs report that the percentage of their private equity/venture capital portfolio allocated to emerging managers has been cut by nearly a third in 2022. It has become a buyer's market, with more managers, both emerging and established, chasing less capital.

Fundraising across the board is becoming more challenging, but this is especially true for emerging managers. While LPs are still deploying capital, fundraising timelines are longer, requiring many more meetings and, ultimately, more time to get to the finish line. In 2021, 31 percent of managers said to get from first introduction to signed commitment typically took one to four months; in 2022, fewer than one in 10 were able to secure commitments within such an abbreviated timeline. Far more common, more than half said it typically takes five to nine months.

> "Fundraising across the board is becoming more challenging, but this is especially true for emerging managers"

The good news is that the majority of investors are confident their allocations for new commitments to emerging managers will increase in the next three years. Indeed, the demand is still there. However, in a crowded market with an uncertain economic backdrop, emerging managers face even more scrutiny from potential investors, and a longer timeline for an expected closing of their first fund.

The bar is set high

LPs are always looking to add new managers and want to invest with newly formed firms with genuine differentiation. Anecdotally, many believe GPs are "hungriest" to perform for funds with Roman numerals one through three. At the same time, they recognize the challenges emerging managers face, to not only source investments and create value but to set up a back and middle office to meet their LPs' rigorous reporting and compliance demands. So, while there is still space for new players seeking capital, the bar is set high.

Two-thirds of the LPs cited superior returns and portfolio diversification as the primary reasons for their emerging manager programs, and almost 79 percent of LPs indicated they are most likely to invest in an emerging manager formed by a team spun out from a larger firm. At the same time, LPs are putting increased pressure on emerging managers when negotiating terms, including discounted management fees, co-investments, and the ability to opt out of certain investments, a provision that doubled from 15 percent in 2021 to 30 percent in 2022.

Whether this is the right approach to position fledgling fund managers to thrive – because they're certainly not reducing their reporting demands – it underscores the pressures facing new managers. In this more risk-averse environment, it is even more important that emerging managers partner with the right service providers so they can focus on the mission-critical tasks of raising, investing, and growing capital without taking on the back- and middle-office responsibilities that might otherwise create a distraction.

Increased demand for real-time access to accurate, timely information

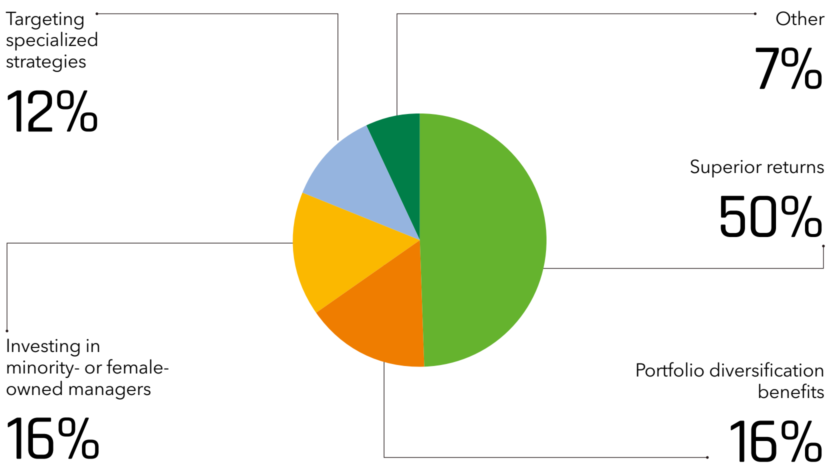
Given the significant levels of capital invested in the alternative investment space and a larger addressable market of investors, automation, accuracy and transparency have never been more critical.

In the private markets, implementing technology is a requirement to handle not only the increasing volume of investors but the growing complexity of the fund structures. Increased competition is driving next-generation technology to fill a critical role in the fund administration process for emerging managers.

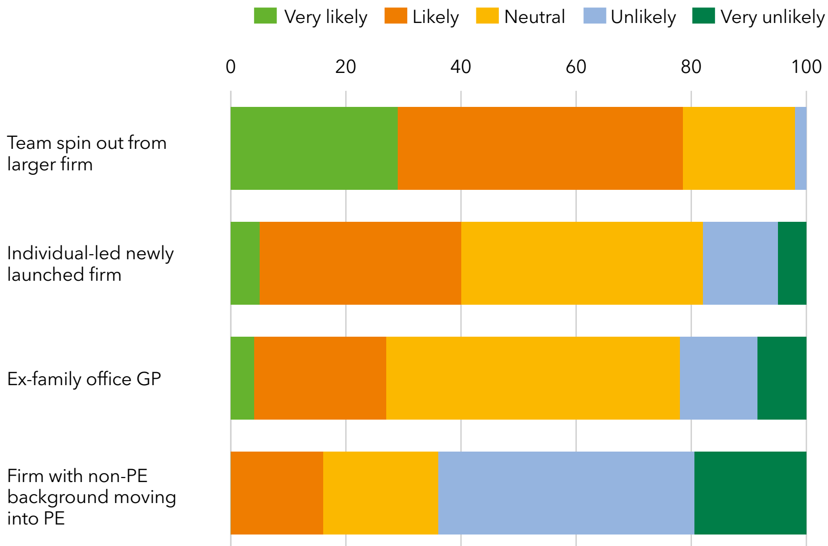
Not only are LPs in the driver's seat when it comes to capital raising and negotiating terms, but they are also driving trends in fund operations. This is especially true around new technology, which is fast becoming table stakes to facilitate improved onboarding through electronic subscription documents, bespoke and more frequent reporting, and more depth and transparency around performance and attribution reporting as well as portfolio monitoring.

Technology is changing how GPs onboard investors by digitizing the

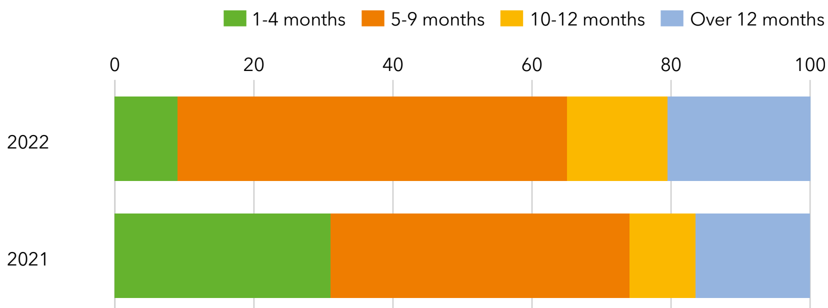
What is the primary purpose of your emerging managers program?



How likely are you to invest in the following types of emerging managers? (%)



How long does it typically take from first introduction to a signed commitment? (%)



Source: Buyouts Emerging Manager Survey 2022

fund subscription process from a labor-intensive, error-prone paper process to an automated, digitized subscription process that is more accurate, reliable and customizable. Utilizing electronic subscription documents not only improves the LP experience, but it also gives fund managers immediate visibility into investor activity and fundraising analytics. This visibility is critical in an environment where the competition for capital is heightened.

As the asset class matures, there will be a sea change in reporting frequency, particularly to the extent managers welcome high-net-worth and accredited retail investors. Historically, reporting is done on a quarterly basis. However, some LPs are starting to ask for more frequent reporting, seeking the same access to information that they have for their public market investments. The adoption of technology will likely be required to accommodate the acceleration in the timeliness and accuracy of information LPs are requesting.

Private equity sponsors are also embracing technology around portfolio monitoring. They're leveraging data and analytics for real-time insight into how they're generating returns and using these capabilities to optimize decision-making. With the growth in private equity as an asset class, we are seeing much more demand for data and precision in analytics as sponsors realize that their data is a potential source of differentiation.

> “In this more risk-averse environment, it is even more important that emerging managers partner with the right service providers”

Working with specialist fund administrators like Gen II levels the playing field for emerging managers by enabling them to gather and analyze data faster and make it more consumable. Gen II has the tools that give sponsors "corner office" analytics and insight into their portfolios, and a performance analytics platform that offers both a 30,000-foot view of their enterprise or fund as well as granular details at the investment level. These capabilities through Gen II allow emerging managers to offer best-in-class bespoke reporting for LPs that are increasingly demanding transparency, custom reporting requirements, and real-time access to details of their investments, performance attribution, management/performance fees paid, etc.

At Gen II, we believe that investing in technology and investing in people go hand in hand. We look for a balance and try to invest in technology in areas where we can scale, reduce cycle times and improve quality, but also maintain capabilities to ensure that we can administer and manage these complex structures or even enhance the "operational" alpha embedded within them.

Scalability, performance and experience truly matter

The majority of emerging managers start their life with an administrator relationship. Given the increased complexity of fund structures, escalating stakeholder expectations, and complex regulatory requirements, it is vital that emerging managers team up with a provider that can demonstrate relevant and specialized experience. Equally

> “With the growth in private equity as an asset class, we are seeing much more demand for data and precision in analytics”

important considering the long-term nature of these relationships, is a commitment to technology investment, team continuity, and the ability to scale with clients.

Gen II has helped launch more than 100 emerging managers. We have partnered with them to build a strong foundation for success, and help them scale as they add new funds, LP types, geographies, and even alternative strategies – from every flavor of PE to private debt and real assets. The private equity entrepreneurs we work with value the confidence our experience imparts, and they can trust their funds will be well-run.

For the remainder of 2022 and beyond, the survey reflects that while capital raising for emerging managers is temporarily decelerating, it appears poised for continued growth over the long term.

However, lower capital allocations, economic uncertainty and hesitation to take on greater risk are causing LPs to be more selective and take longer to evaluate emerging managers. A highly qualified set of professional service firms – fund administrators, auditors, placement agents, compliance consultants and attorneys – with deep experience supporting first-time funds will continue to be vital to the emerging manager's success. ■

Editor's letter

Savvy investors keen to find new talent

Graeme Kerr
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Now in its sixth year, the annual *Buyouts Emerging Manager Survey*, conducted in partnership with Gen II Fund Services LLC, is one of the most eagerly awaited editorial events in the *Buyouts* calendar. That's especially true this year, as capital constraints make the fundraising environment tougher than ever. A flight to the familiar could be expected, and an uphill battle for emerging managers.

Thankfully, for first-time funds, it's not quite that simple, the survey suggests. As Jeff Gendel, principal of Gen II Fund Services, describes in his expert analysis on p. 6, there are plenty of grounds for optimism among young firms: "The demand is still there," says Gendel. "The majority of investors are confident their allocations for new commitments to emerging managers will increase in the next three years."

"Savvy investors view emerging managers as a route to superior returns"

But in a crowded market with an uncertain economic backdrop, there is even more scrutiny from potential investors, and emerging managers face a longer timeline for an expected closing of their first fund. The other bit of cheer for the new kids on the block is that savvy investors view emerging managers as a route to superior returns, with over half of respondents agreeing that the risk/return profile for emerging managers versus established managers is attractive.

It's clear that pedigree counts, however. Almost 80 percent of LP respondents said they were likely or very likely to back a team that had emerged from a larger sponsor, making spin-outs the most popular type of emerging manager. This comes across in our interview with emerging managers. For OceanSound, which closed the largest Latino-led first-time fund ever, the respected backgrounds of the team led to some anchor capital commitments, pre-covid, which allowed them to begin making investments during 2020. "Those investments were critical proof points of what we stood for as a firm," co-founder Joe Benavides recalls on p. 24.

It's a fascinating survey – and we're grateful, as ever, to Gen II for partnering with us in this thought-provoking poll.

Graeme Kerr

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A counter-cyclical approach

Macroeconomic uncertainty means many investors are flocking to the familiar, but savvy LPs recognize that emerging managers outperform in a downturn

Emerging manager fundraising is tough at the best of times. Add in the legacy of a global pandemic, coupled with pervasive economic and geopolitical uncertainty, and the prospect of launching a new firm becomes more daunting than ever.

Indeed, two-thirds of emerging manager respondents to the sixth annual *Buyouts Emerging Manager Survey*, conducted in partnership with Gen II Fund Services LLC, either agree or strongly agree that investors are hesitant to place bets on young entities.

Meanwhile, more than 40 percent say fundraising has become markedly more challenging since covid struck. Investors appear to have embraced the efficiencies of remote interaction that were forced on them during rolling lockdowns and, despite the removal of travel restrictions, getting in-person meetings remains tough.

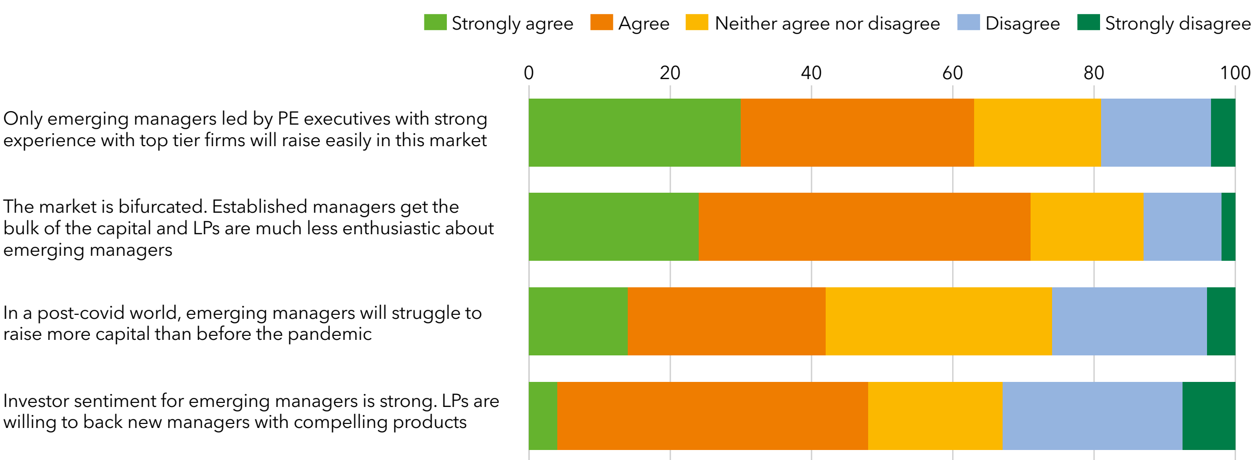
"Fundraising dynamics have changed," says John McCormick, partner at Monument Group. "So much is now done virtually, which makes it that much harder for an emerging manager to forge a connection with an LP. Private equity is a people business. You want to be able to look an investor in the eye and compel them with your capabilities. Everyone is getting more comfortable with Zoom, but it limits the ability to truly connect."

McCormick adds that the enhanced efficiencies of remote fundraising also means investors have more time for window shopping. "It is more challenging to gauge who has genuine interest and capacity for emerging managers because almost everyone is willing to take the meetings for fear of missing out," he says. The situation has been exacerbated by a deluge of established managers returning to the market with new funds, making it hard for emerging managers to command attention.

"This has been an extremely busy year for established managers coming back to market," says Carolina Espinal, managing director at HarbourVest, "and some of those offerings are being prolonged into 2023, given the macroeconomic backdrop. That can make it very difficult for emerging managers to get mindshare."

And it is not only time that is in short supply; it is capital, too. "There is a shortage of human resource," says McCormick. "Investors can only review so many managers at one time. But allocations are also coming under pressure due to the denominator

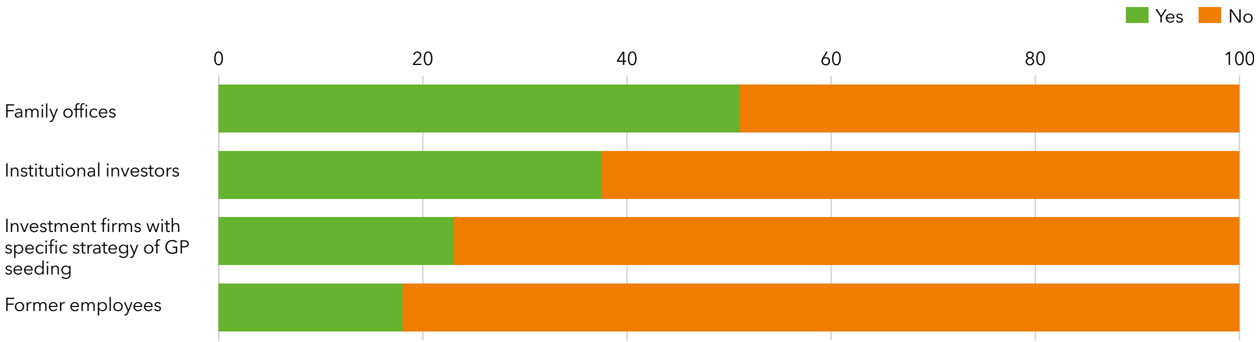
How do you perceive market sentiment around emerging managers right now? (%)



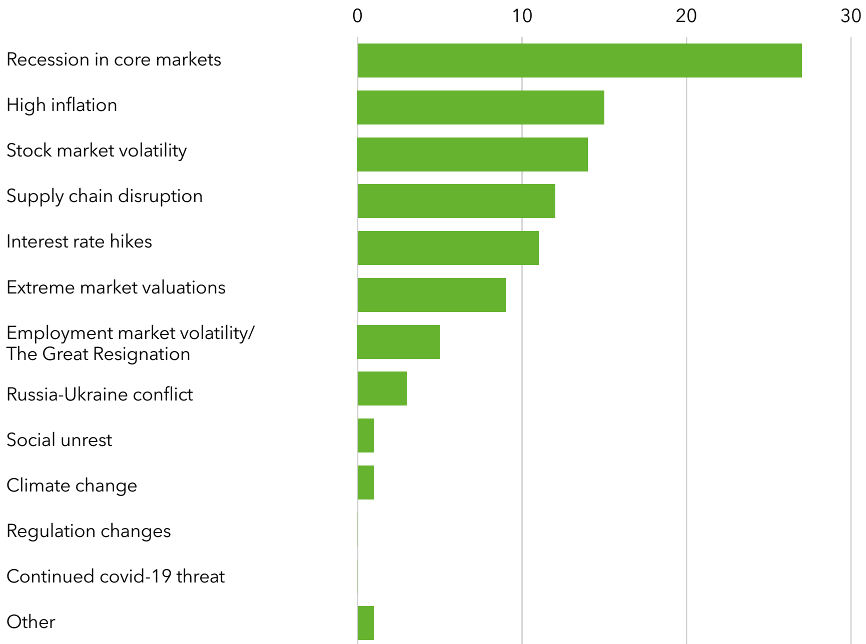
Source: Buyouts Emerging Manager Survey 2022

Figures have been rounded

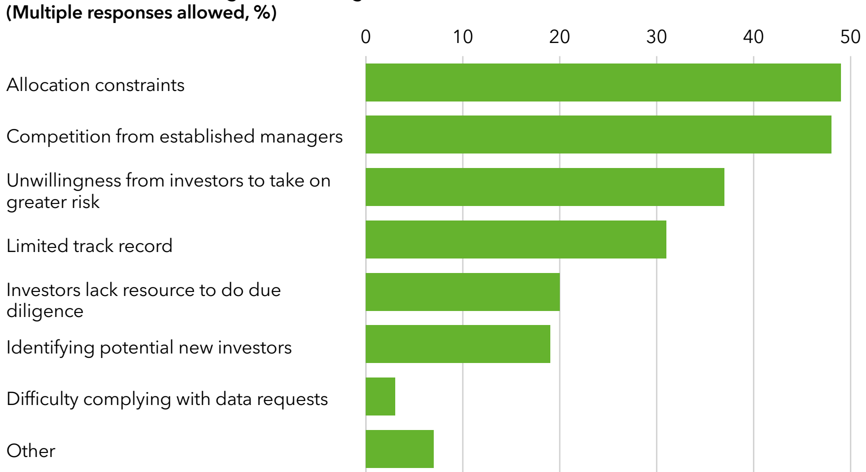
Has your firm utilized seed funding from the following sources? (%)



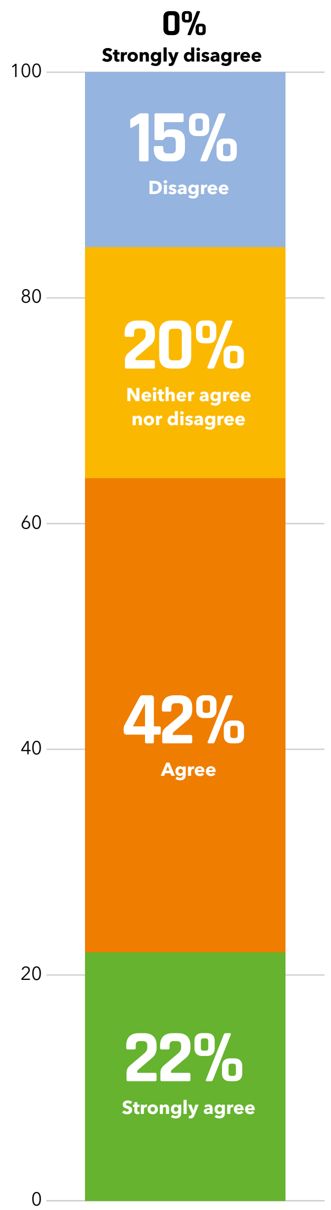
Which of the following factors do you think will have the greatest impact on private markets investment performance in the next 12 months? (%)



What are the main challenges to attracting new investors? (Multiple responses allowed, %)



"Investors are hesitant to invest in emerging managers"



effect and, in some cases, reallocation to co-investment."

Risk aversion

An element of risk aversion is also creeping in for some investors. "Appetite for emerging managers is often procyclical," says Scott Reed, co-head of US private equity at abrdn. "When the economy is stable and distributions are strong, LPs are more willing to step out on the risk spectrum and commit capital to newer firms. But history shows us that when markets become more volatile and distributions dry up, a lot of LPs focus their capital on tried and true managers, and appetite for emerging managers wanes. That is what we are seeing today."

Indeed, 71 percent of GP respondents claim that the market is bifurcated, with established managers receiving the bulk of investor interest. Emerging managers also cite allocation constraints and competition from established firms as the biggest challenges they face in the fundraising market.

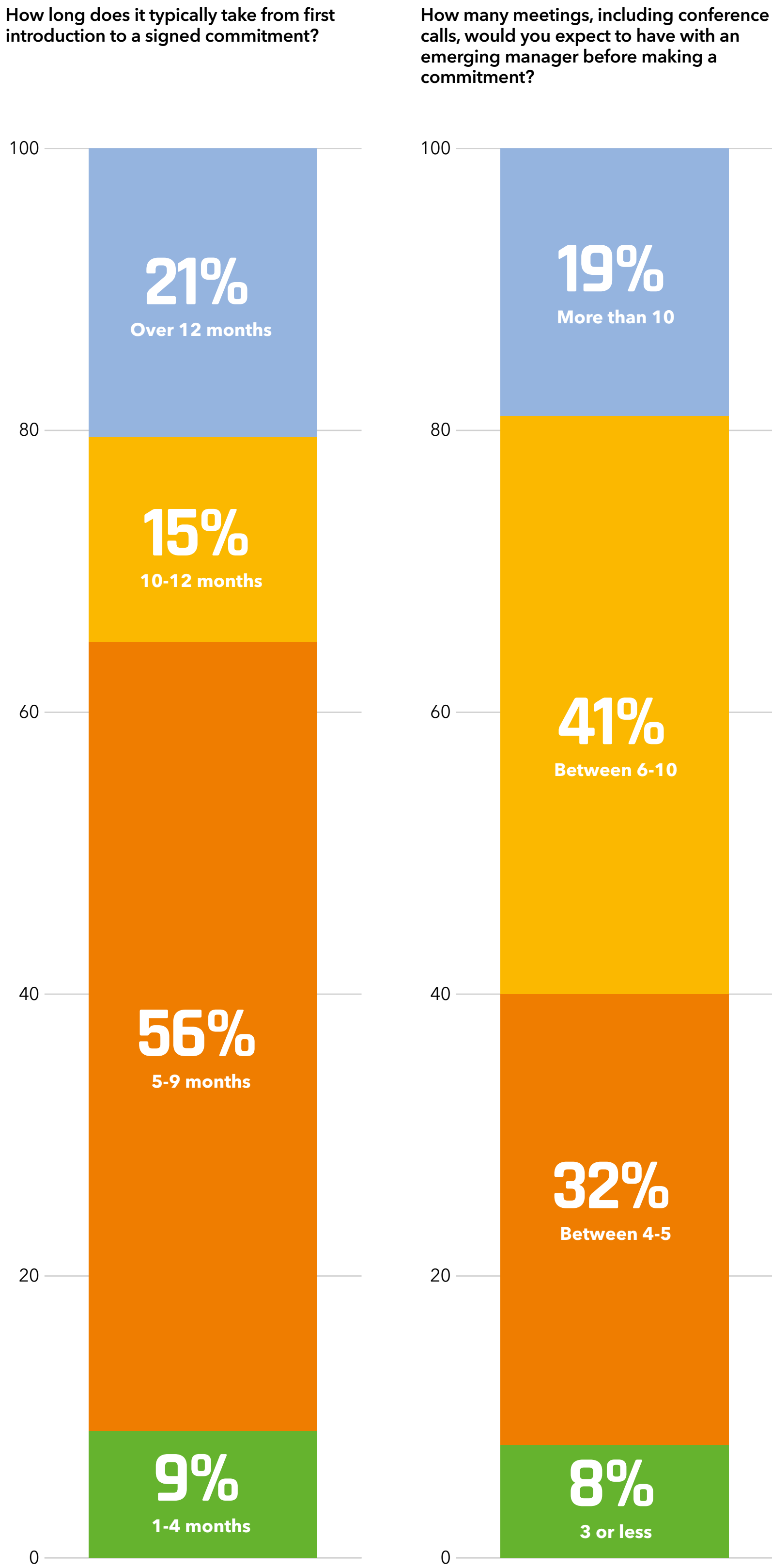
Established managers are taking advantage of this flight to the familiar by launching new strategies, which many investors include in their definitions of emerging managers, detracting attention from independent start-ups. "Unfortunately," says Christine Winslow, managing director at Grafine Partners, "a proliferation of strategy extensions at mega-firms is detracting from appetite for other emerging managers."

Outperformance

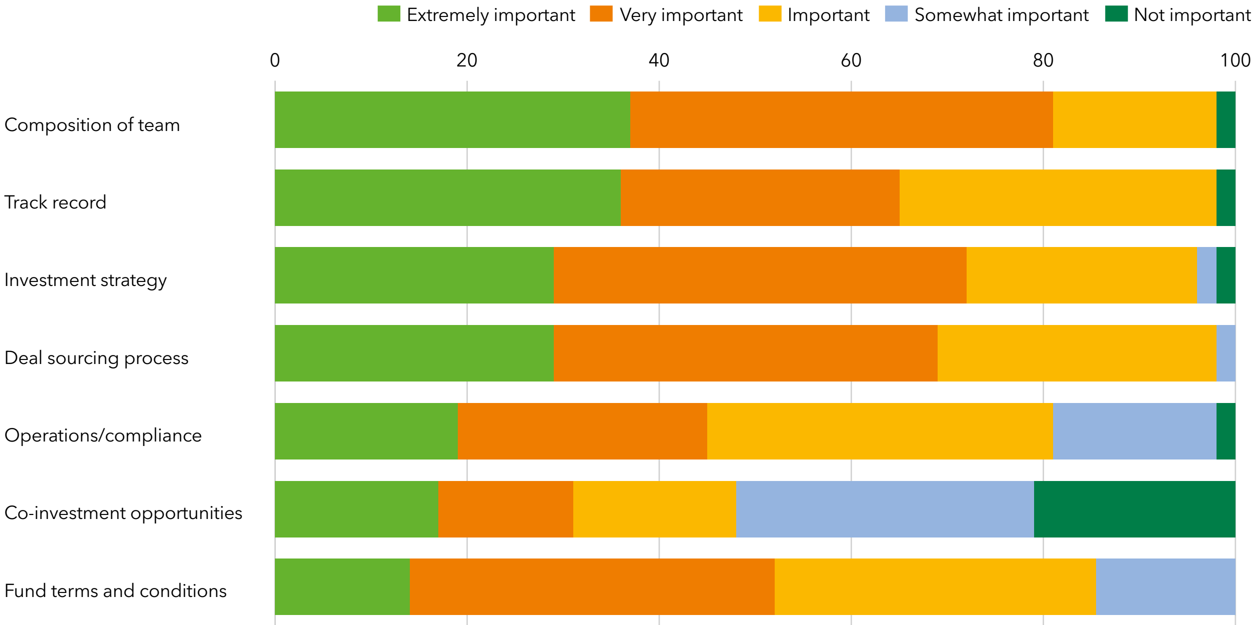
This may not be the wisest course of action, however. "Mega-firms are generally more focused on asset gathering, while returns have become a secondary objective," Winslow says. "Emerging managers, on the other hand, are laser-focused on generating high returns on their deals in order to build their track records and firms. They have much more of a vested interest so the alignment with LPs is much stronger."

Paul Newsome, private equity partner and head of portfolio management

LPs



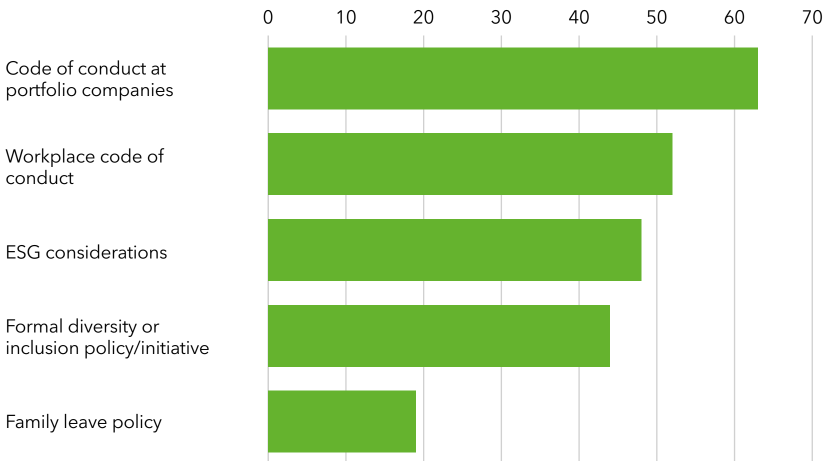
How important are the following factors when evaluating an emerging manager fund? (%)



Source: Buyouts Emerging Manager Survey 2022

Figures have been rounded

Do you look for any of the following in an emerging manager? (Multiple responses allowed, %)



at Unigestion, agrees that, perhaps counterintuitively, a downturn is not the time to pull back on emerging manager risk. "In difficult conditions, many LPs seek comfort with brand names," he says. "But the irony is that data shows emerging managers outperform during the most challenging periods, for example in the years following the GFC."

Indeed, savvy investors with a longstanding commitment to emerging managers, are "keeping their foot on the gas," says Reed. And, despite challenges, almost half of emerging manager respondents agree or strongly agree that investors are willing to back teams with compelling products.

The road will be long and arduous, certainly. Most investors take between five and nine months to sign a commitment after an introduction, and for 21 percent of respondents, the time taken exceeds 12 months. Meanwhile, 60 percent of investors take upwards of six meetings with an emerging manager before making their final decision – 20 percent take more than 10.

But the best emerging managers will continue to successfully raise funds. "There are headwinds, certainly, but there are tailwinds as well," says Sarah Sandstrom, partner at Campbell Lutyens. "There are many programs focused specifically on identifying the next best great thing. The private equity industry is also in an interesting phase, with many firms dealing with generational succession, which is creating spin-out opportunities and, definitionally, firms are graduating from emerging manager programs, creating space for new names."

"Emerging managers remain a compelling part of the market at all points in the cycle," adds Winslow, "perhaps even more so in the current macroeconomic environment. Emerging managers will have no distressed assets in their portfolio distracting them from taking advantage of attractive valuations."

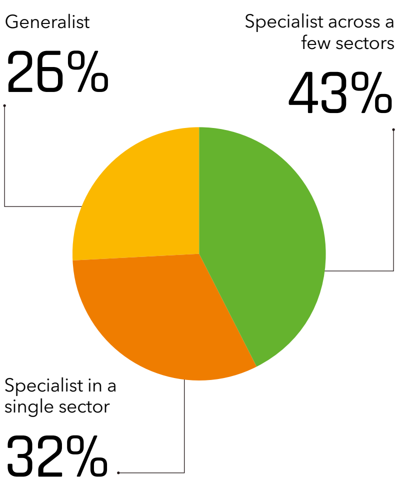
Methodology

More than 120 fund managers and 50 institutional investors contributed to the 2022 Buyouts Emerging Manager Report, produced in partnership with Gen II Fund Services LLC

Field work for the sixth annual *Buyouts Emerging Manager Survey*, conducted in partnership with Gen II Fund Services LLC, was carried out between June 30 and August 15, 2022. A total of 127 managers self-selected as "emerging managers" were surveyed.

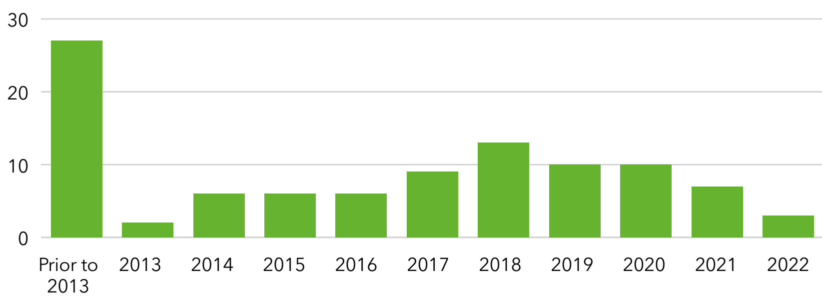
The initial list was narrowed down to managers that have fundraised or are in the process of fundraising their third fund or fewer. A total of 58 institutional investors with a self-identified appetite for emerging managers were surveyed. Incomplete fund manager and investor surveys were reviewed for inclusion in the sample on a respondent-by-respondent basis. ■

Would you consider your firm to be a...

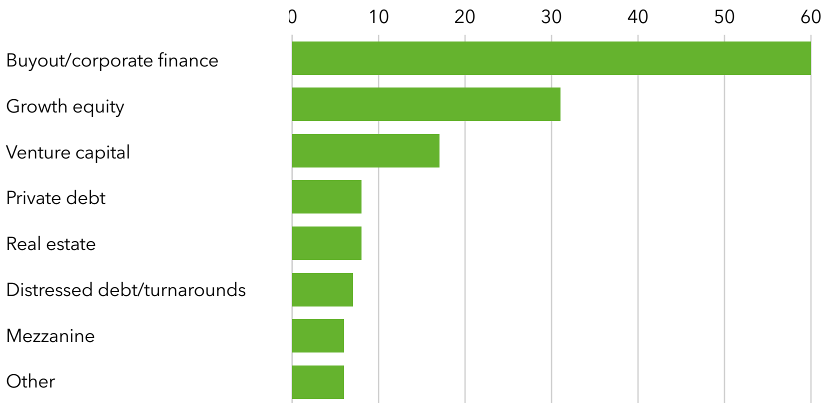


Source: Buyouts Emerging Manager Survey 2022

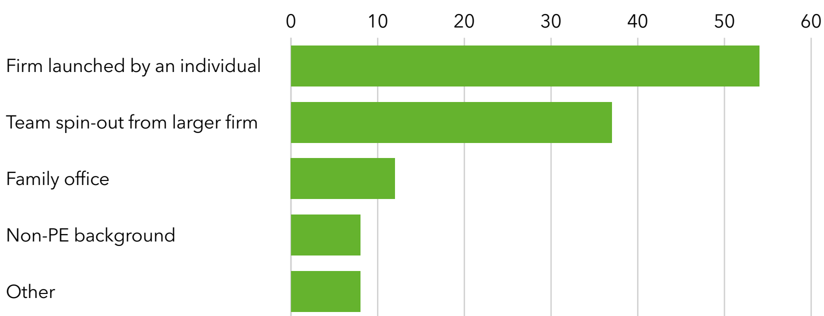
What year was your firm founded? (%)



What kind of investment strategy does your firm pursue? (Multiple responses allowed, %)

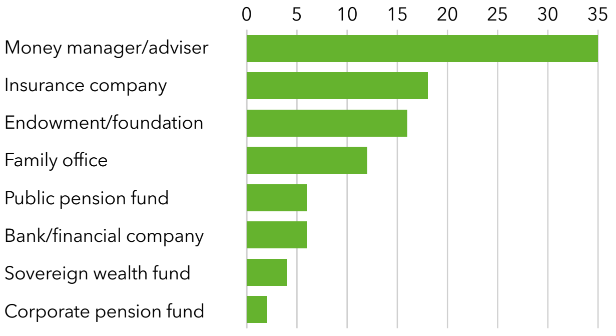


What is your firm's heritage? (Multiple responses allowed, %)

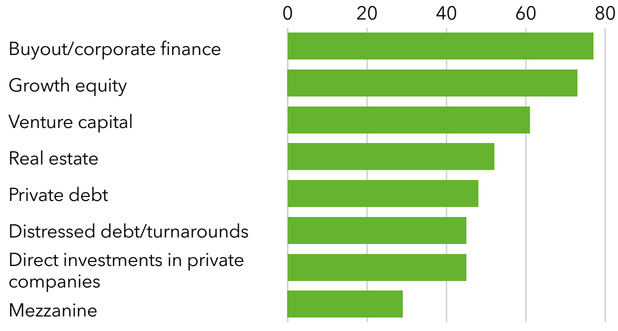


LPs

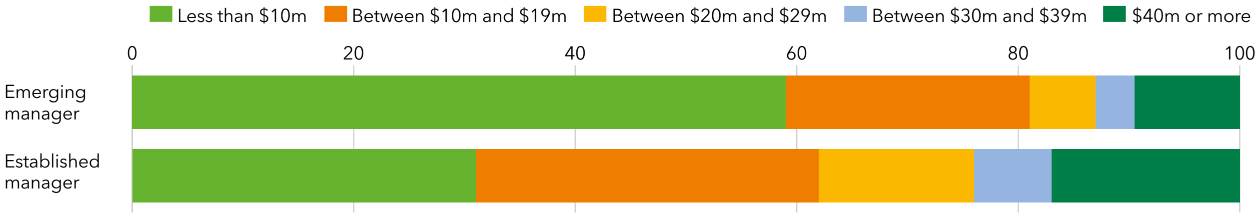
What kind of institution do you work for? (%)



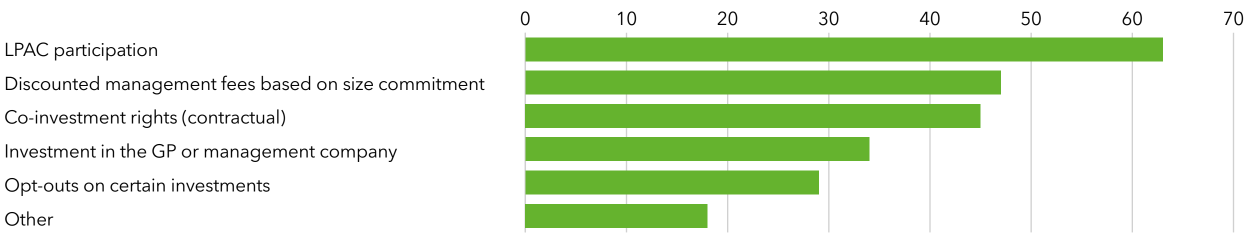
What kind of alternative investment strategies do you invest in? (Multiple responses allowed, %)



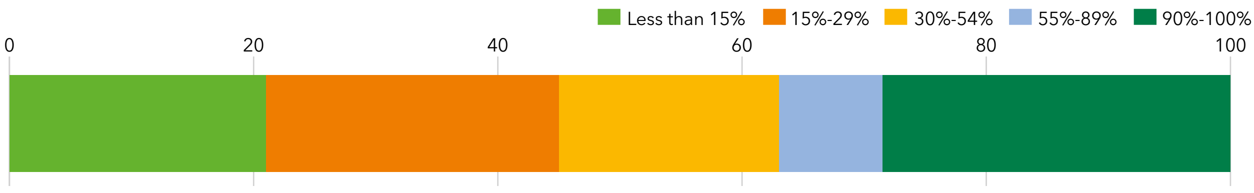
What is a typical commitment size you will make to an emerging manager or an established manager? (%)



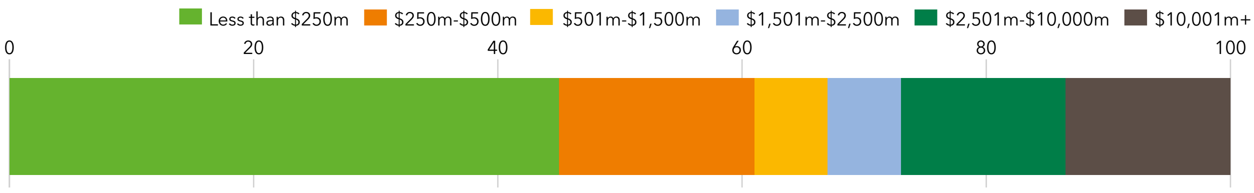
What kind of terms do you try to negotiate with emerging managers? (Multiple responses allowed, %)



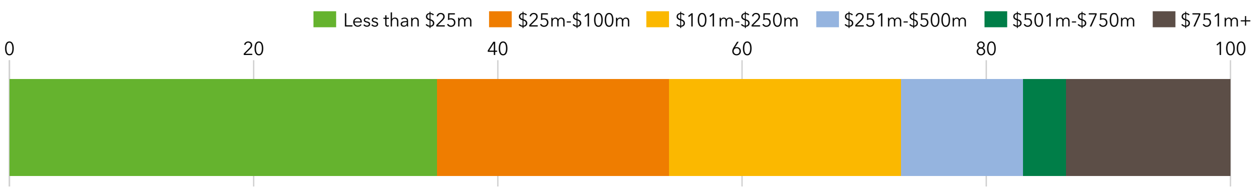
What is your target allocation to PE/VC, as a percentage of your overall portfolio? (%)



What is the value of your overall PE/VC portfolio? (%)



How much capital do you commit to PE/VC funds of all types per year on average? (%)



Defying the downturn

Raising a debut fund is tougher than ever, but market dislocation could cause more managers to set up on their own

The pandemic was brutal for emerging manager fundraising, but there are indications that the pressure is easing – at least temporarily. The average time taken to raise an emerging manager fund stands at 11 months, according to the sixth annual *Buyouts Emerging Manager Survey*, conducted in partnership with Gen II Fund Services LLC. This is compared with 19 months a year earlier.

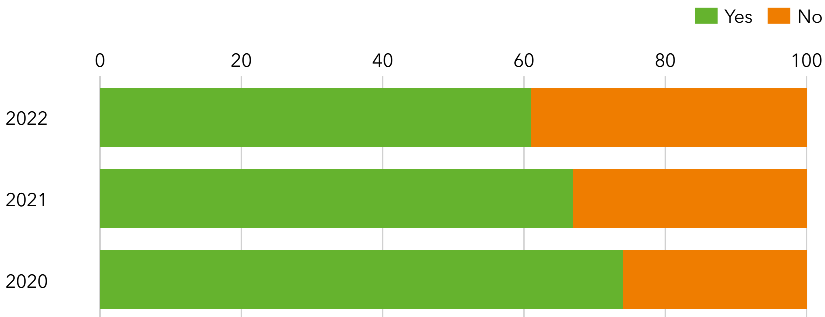
A spate of US debutantes appears to have taken advantage of this window of opportunity. Former TPG Growth duo John Bailey and Shamik Patel's new outfit Knox Lane, for example, closed its inaugural buyout offering on $610 million in March 2022. The mid-market consumer and services fund closed above its initial target of $500 million and hard-cap of $600 million, despite having launched the offering in March 2020, which Bailey describes as being "right in the teeth of the pandemic."

"In a business that is all about relationships and long-dated capital, it is hard not to be able to shake hands," Bailey says. "But we had high conviction in the team we had assembled."

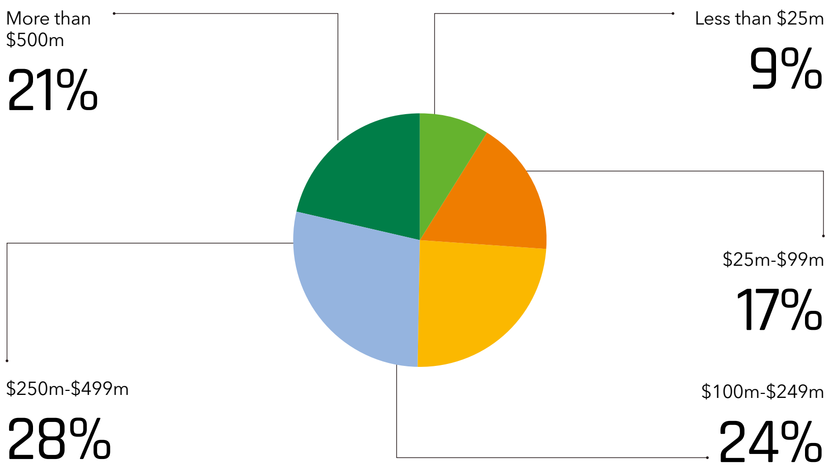
According to GP respondents to the survey, family offices and wealthy individuals are the most prolific investors in emerging manager funds, with institutional capital proving harder to attract. Knox Lane, however, was able to secure commitments from pensions, insurers, foundations and funds of funds, once the fundraising market reopened during 2021, having spent much of 2020 working on its deal pipeline.

"That helped us put points on board and shine a light on the firm's strategy," Bailey says. Mid-market industrials investor GHK, meanwhile, went one step further, completing two investments on a deal-by-deal basis, in order to build a track record independent of founder Gil Klemann's former shop, Goldman Sachs.

Are you currently fundraising? (%)

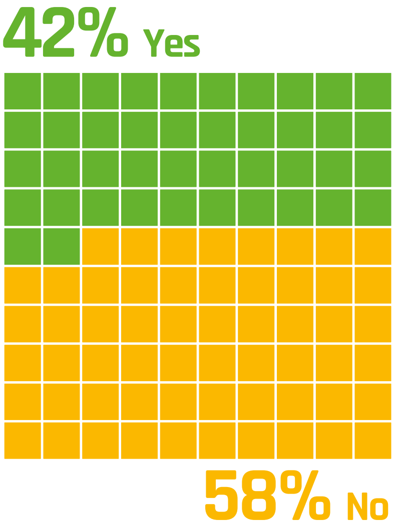


What is the target of the fund you're currently raising?

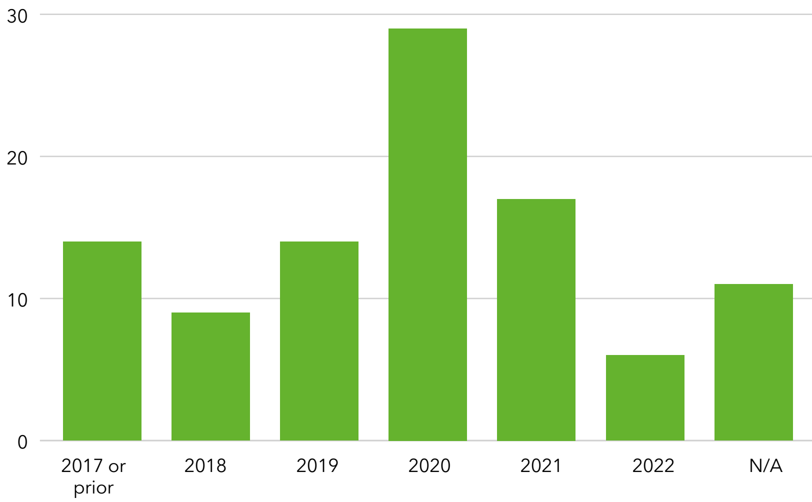


Source: Buyouts Emerging Manager Survey 2022

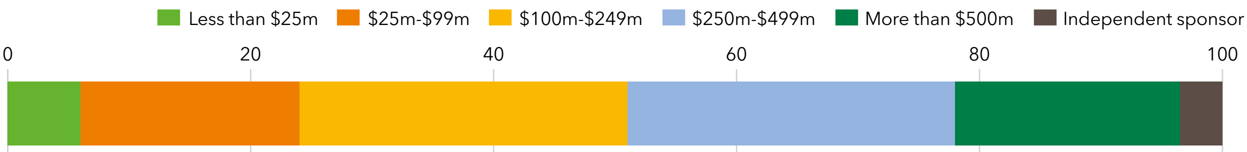
Are you using a placement agent in the fund you are currently raising?



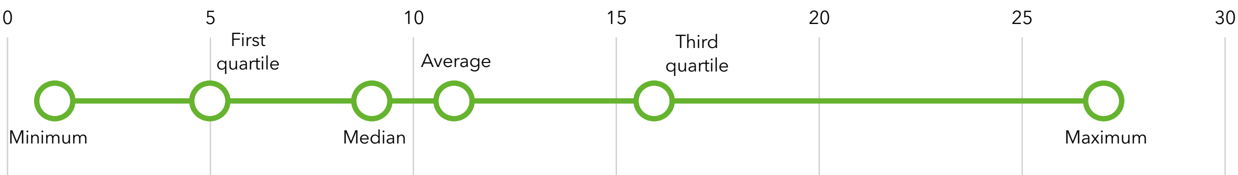
When did you launch marketing for the fund? (%)



What is the size of your most recently closed fund? (%)



Time taken to raise the most recent fund (months)



Those deals included an investment in Hasa, a company that produces chemicals to treat pools, in 2020, and ITS Logistics in 2021. GHK then used its third deal, Auveco, a distributor of fasteners to the automotive body hardware aftermarket, to seed its maiden fund.

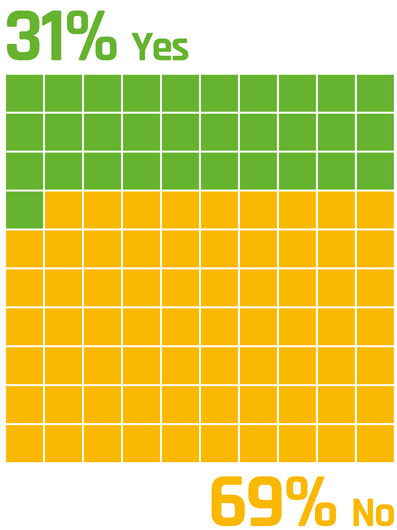
Other 2022 emerging manager fundraising success stories include HighPost Capital, founded by consumer veteran David Moross and Mark Bezos, which sealed $535 million for consumer-focused investing, despite spiraling inflation and intense pressure on consumer spending.

HighPost was able to secure capital from institutions and endowments, but, as with so many emerging managers, family offices and high-net-worth investors were key. Indeed, the firm boasts Amazon founder Jeff Bezos – HighPost's founder's brother – among its LPs.

Meanwhile, Patient Square Capital – a firm led by former KKR healthcare specialist Jim Momtazee – is purported to be on track to raise the largest first-time fund in history, with a $4 billion target. That is not to say that emerging manager fundraising is easy, however. GP respondents to the survey report a wide range of challenges, including the persistence of remote fundraising and the difficulty in staying on investors' radars in a market dominated by re-ups.

"Emerging managers have always faced the challenge of differentiating

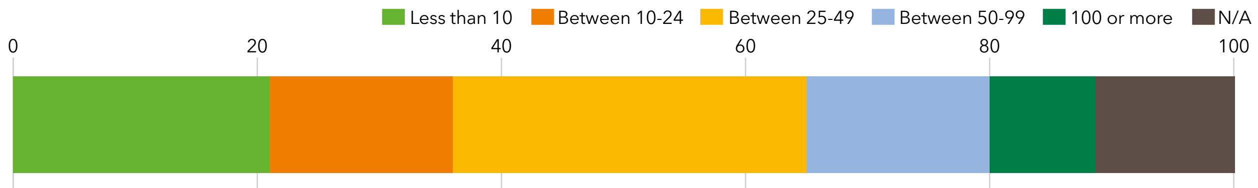
Did you use a placement agent in your last fund?



How many prospective investors did you meet with? (%)

For investors who ultimately committed, how many meetings (including conference calls) did you have with them on average? (%)

How many limited partners do you have in your most recent fund? (%)

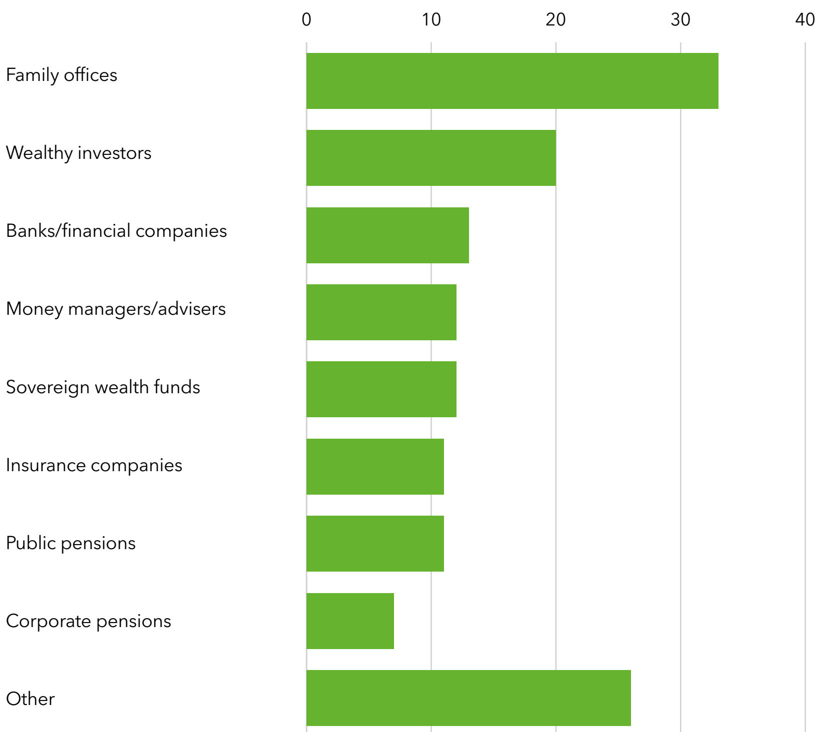


themselves," says Joe Benavides, managing partner and co-founder of OceanSound Partners, which closed its debut this year. "But with the pandemic, you then had the additional challenge of established managers coming back looking for big capital increases with their follow-on funds. It has not been unusual to see firms looking for double what they had raised before. The differentiation you need as an emerging manager is therefore greater than ever."

"LPs are often so tied up with re-ups that they don't have the bandwidth

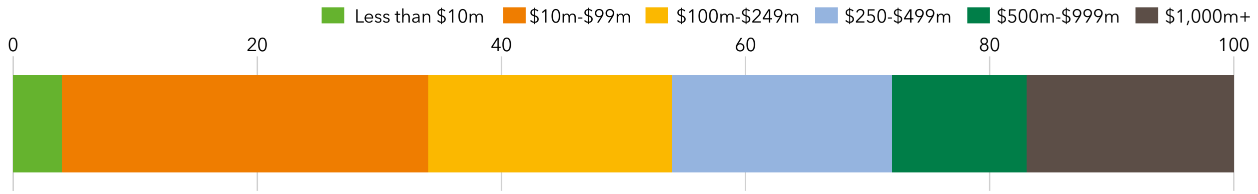
> *"We anticipate seeing an increase in emerging managers in the coming years"*
>
> **CAROLINA ESPINAL**
> **HarbourVest**

What percentage of capital came from the following sources? (%)

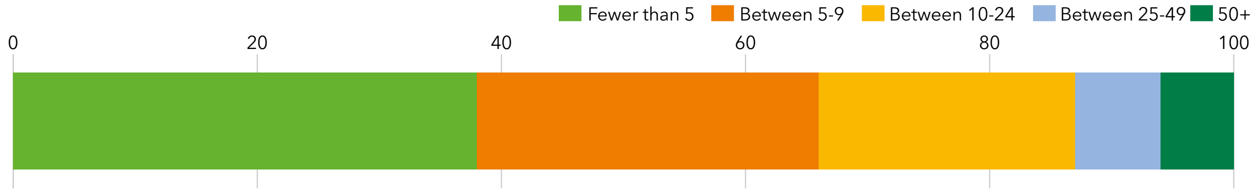


Source: Buyouts Emerging Manager Survey 2022

What is the total committed capital to all your active funds? (%)

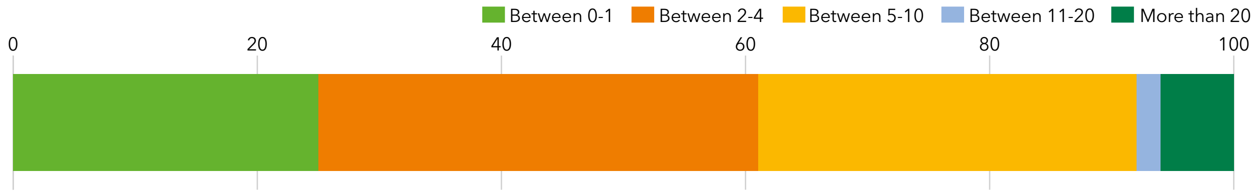


How many active portfolio companies do you have? (%)



How many new platform investments do you anticipate making over the next year? (%)

How many new add-on investments do you anticipate making over the next year? (%)



to review new relationships," admits Paul Newsome, private equity partner and head of portfolio management at Unigestion. "The biggest challenge that emerging managers face is cutting through that noise to get in front of potential investors."

One way to ensure a firm's profile is raised in such a congested market is to hire a respected placement agent. Indeed, Benavides says he cannot imagine having embarked on the emerging manager journey without a placement agent in tow.

"Having a placement agent was monstrously helpful for us," he explains. "There are so many plates spinning for a first-time manager. You are hiring people; setting up the back office; working on sourcing and execution. You need that added support reaching out to new LP relationships."

Perhaps surprisingly, then, less than half of emerging manager respondents to the survey – 42 percent – utilized a placement agent's services.

Getting more complicated

In addition to the challenges associated with attracting attention in a market dominated by established firms, Benavides says it is simply more complicated – and expensive – to launch a manager today than it would have been in the past.

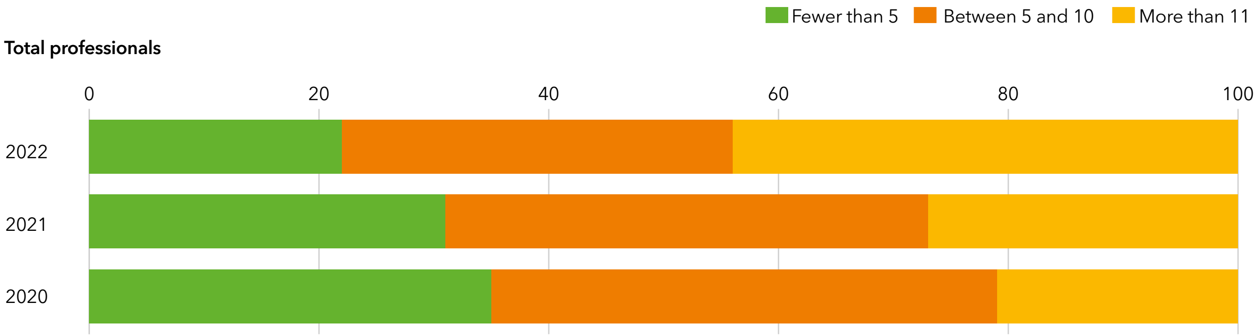
"Diligence requirements have increased materially, including ESG and DE&I issues, and it is harder for young firms to have all the infrastructure and systems they need in place," he explains. "You typically have to have more people on board from the start."

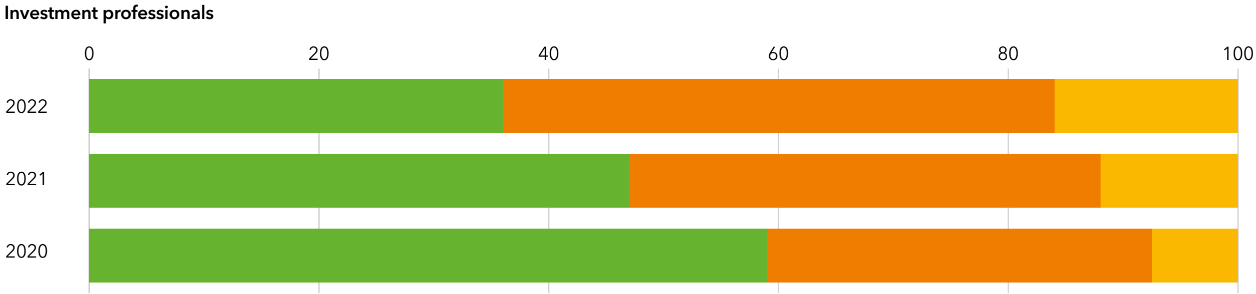
The survey found that 44 percent of emerging managers have more than 11 people working for the firm, more than double the 21 percent with the same level of employees two years ago.

Neither bureaucracy and expense, nor macroeconomic turmoil and fundraising headwinds, are likely to deter other private equity professionals from setting their sights on going it alone, however. Indeed, there is an argument that periods of dislocation lead to a spate of new entrants.

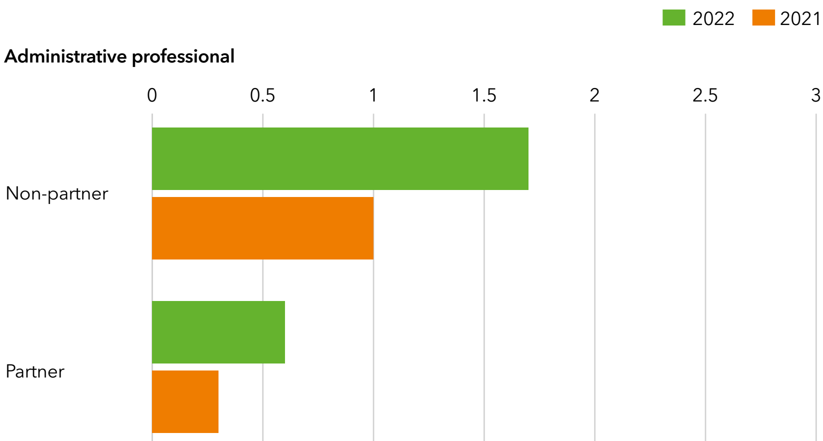
"In more difficult times, such as after the global financial crisis or the

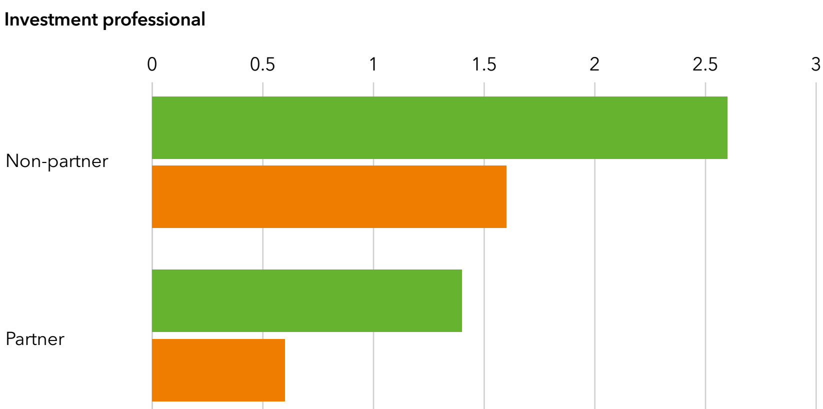
How many people work for your firm? (%)





On average, how many staff do you plan to add at the following levels and roles?





Source: Buyouts Emerging Manager Survey 2022

dotcom bust, private equity professionals tend to reflect on what the carry payouts from their existing programs are likely to be, and, if they have entrepreneurial ambitions, they may decide it makes sense to set up on their own," says Carolina Espinal, managing director at HabourVest. "We anticipate seeing an increase in emerging managers in the coming years."

Scott Reed, co-head of US private equity at abrdn, says: "Logic suggests that a positive economic environment would be a good time for GPs to hang out their own shingle and start something new.

"But we also see new fund formation during periods of market dislocation when some GPs may feel their existing portfolio is challenged and there are better opportunities to be found starting afresh."

"At the same time, one of the major attractions of backing younger firms is performance potential. And in periods where returns across the asset class are coming under pressure, investors may be willing to step out on the risk spectrum to get those returns from emerging managers."

Service selection

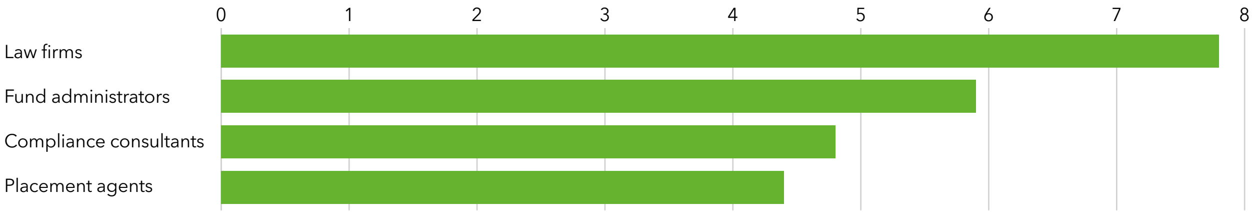
Emerging managers prioritize proven experience in their selection of service providers

In addition to assembling their front- and back-office teams, emerging managers must also engage the necessary service providers ahead of a fund close. And it is law firms that are typically the first to be brought on board. On average, emerging managers participating in the sixth annual *Buyouts Emerging Manager Survey*, conducted in partnership with Gen II Fund Services LLC, secured lawyers 7.8 months prior to holding a first close.

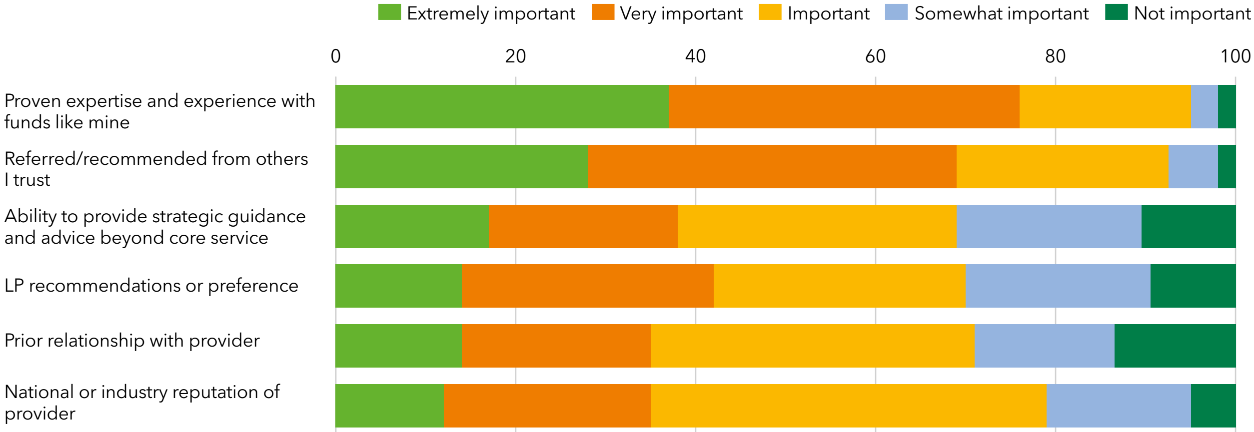
Fund administrators are the next to come on board, followed by compliance consultants, and last – but certainly not least – by placement agents. Indeed, Joe Benavides, managing partner and co-founder of emerging manager OceanSound, says he could not have contemplated embarking on the mission to raise a first-time fund without the support of a placement agent partner.

Meanwhile, proven expertise with similar firms is what emerging managers deem most important when selecting a service provider. Other criteria that are taken into account include the provision of strategic advice beyond the core offering, the endorsement of a national or industry group, LP preferences and a prior relationship.

How many months in advance of the first closing did you engage with (or do you anticipate engaging with) the following professional services firms?



How important are the following factors in choosing service providers? (%)



Source: Buyouts Emerging Manager Survey 2022

ESG and emerging managers

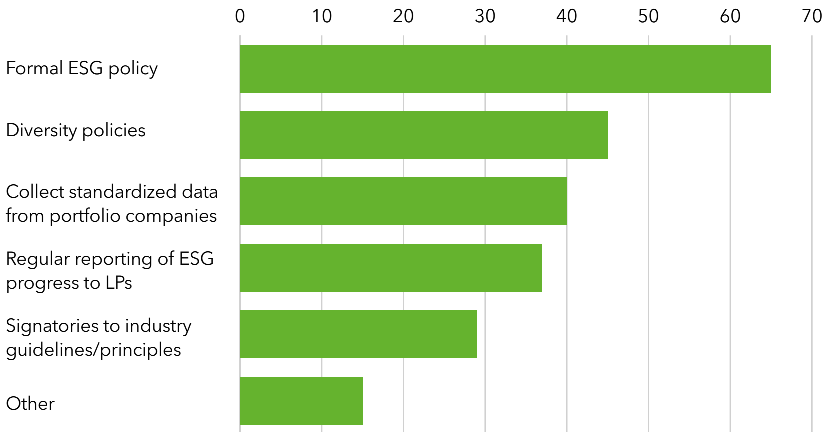
Despite a lack of infrastructure, emerging managers are stepping up on ESG and diversity

Two-thirds of emerging managers have a formal ESG policy in place, according to the sixth annual *Buyouts Emerging Manager Survey*, conducted in partnership with Gen II Fund Services LLC. Furthermore, more than half of GPs and LPs believe ESG positively correlates with performance.

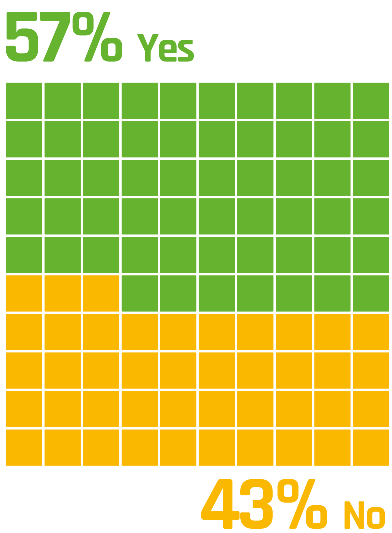
Meanwhile, the majority of investors believe that, despite their relative youth, emerging managers compare favorably with their more established peers when it comes to ESG reporting. Indeed, Paul Newsome, private equity partner and head of portfolio management at Unigestion, says he increasingly finds emerging managers to be superior in their approach to ESG, because they understand from the outset that it is a key component of value creation as well as a requirement for LPs. "Emerging managers can also sometimes be nimbler in implementing the right processes when compared to more established players," he adds.

Carolina Espinal, managing director at HarbourVest, agrees: "We have been pleased to see that a number of emerging managers are coming to market fully prepared when it comes to ESG and [diversity, equity and inclusion]. They are doing so because they know it is an increasingly important consideration for investors."

How do you demonstrate a commitment to sustainability and DE&I initiatives? (Multiple responses allowed, %)



Do you believe a commitment to ESG principles positively impacts performance?

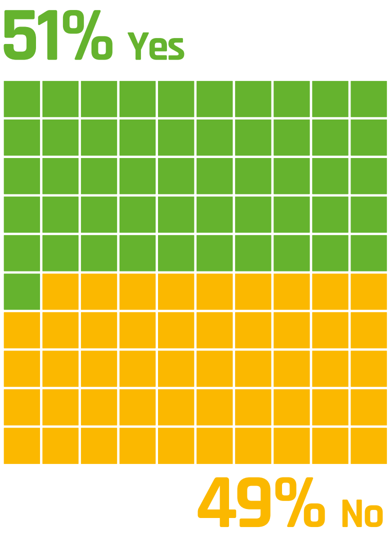


A lack of resources can prove an obstacle, however. "ESG and DE&I requirements are all adding to the cost of starting a new firm today," says Joe Benavides, managing partner and co-founder of emerging manager OceanSound Partners.

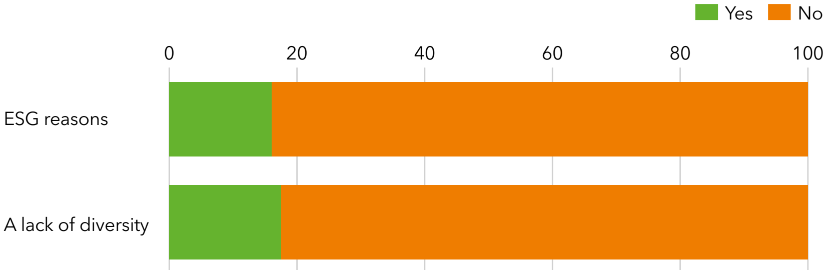
But this is something that investors are realistic about, says Christine Winslow, managing director at Grafine Partners. "ESG is an important area generally, but it is difficult for emerging managers to have as strong a program out of the gate as an established manager who has been able to invest in people and process over an extended period of time. It is nonetheless important for emerging managers to incorporate ESG into their strategy and lay

LPs

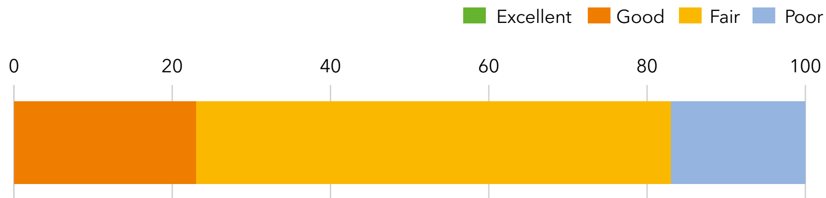
Do you believe there is a positive impact between ESG and investment performance in emerging managers?



Has your institution ever refused an investment opportunity from an emerging manager based on ESG reasons or a lack of diversity? (%)



How good is the quality of ESG documentation received from emerging managers, versus a more seasoned firm? (%)



Source: Buyouts Emerging Manager Survey 2022

out a plan for where they want to go with it."

"We are cognisant of where a manager is on their journey and the scale of their fundraising," Espinal adds. "They may not have all the infrastructure and systems in place to track and report on ESG from day one. But we are looking for the same focus and attention on these themes in an emerging manager as we are with an incumbent relationship."

Newsome, meanwhile, sees an immature ESG program as an area where Unigestion can add value. "Even if emerging managers are not all that advanced, they tend to be willing to learn and take on board best practices, which is something we like a lot."

Diversity progress

Just under half of emerging managers surveyed have formal policies in place around diversity and inclusion. But this is clearly an area that is growing in emphasis. "Unsurprisingly, since the pandemic and events surrounding George Floyd, DE&I has become a more tangible issue," says Benavides.

> *"Since the pandemic and events surrounding George Floyd, DE&I has become a more tangible issue"*
>
> **JOE BENAVIDES**
> **OceanSound Partners**

In particular, Benavides says, this has led to an increase in opportunities for emerging managers from disadvantaged backgrounds. "Capital is being specifically allocated to this theme, which is a new phenomenon. Ultimately, of course, investors are looking for returns, and there is plenty of data to suggest that emerging managers from non-traditional backgrounds outperform. There is a compelling argument to suggest that this isn't just the right thing for investors to do, socially, it is also a means of generating great performance."

However, despite a demonstrable focus on ESG and DE&I issues, it is still relatively rare for investors to decline an opportunity based on failings in either of these areas. The survey found that just 16 percent of LPs have rejected an investment for ESG reasons, while 18 percent have done so based on a perceived lack of diversity. ■

Q&A

OceanSound closed its first fund on $780m, the largest Latino-led first-time fund ever raised. Buyouts spoke to Joe Benavides, the firm's managing partner and co-founder, about its debut

Q What is the story behind your debut fund?

A The US economy is undergoing a massive transformation where the pace of technology adoption to drive productivity improvements is accelerating at an increasing rate. This dynamic is highly relevant to the government and regulated end markets that we know well. Our firm invests in mid-market tech and tech-enabled companies serving government and highly regulated markets, where our substantial expertise allows us to help build better, faster-growing businesses. We started the firm because we felt our team's focus and thesis was slightly different than where we were previously.

Q What was fundraising like during that period?

A When we launched our process during the summer of 2019, we had expected some turbulence. The public equity markets and private equity fundraising markets had experienced strong growth since the global financial crisis and it was highly probable that the bull cycle was approaching a turning point. But we certainly had not expected a pandemic, which created conditions that were more challenging for first-time funds than anything that had been experienced previously in PE.

We have seen different types of recessions. We have seen unprecedented dislocation like we experienced post-9/11. But what we had not seen was a situation where organizations of all kinds, certainly private equity investors, did not participate in face-to-face meetings for a period that lasted many months. How can you enter into what had historically been a high-touch, high-trust relationship with LPs when you can't even get in front of them?

Fortunately, my team and I all came from respected backgrounds at firms such Veritas Capital and Blackstone. Those experiences led to some anchor capital commitments, pre-covid, that allowed us to begin making investments during 2020. Those investments were critical proof points of what we stood for as a firm.

Q What were the biggest challenges in getting your first fund over the line?

A We are very proud of the team we have built. We have many years of experience working together. However, there are a lot of balls in the air for any emerging manager. You not only have to build the firm and ensure that you have all of the processes in place, but you also have to raise a fund and execute new investments. Established fund managers have the firm building and process piece in a far more settled place than an emerging manager. Underneath all the major objectives for an emerging manager, there were many workstreams that were challenging as a first-time fund. Among them was coordinating the bespoke and intensive first-time fund diligence processes of various LPs towards a set timeline – it is a challenging exercise in parallel processing for reasons that are natural.

Q How open are investors to emerging managers?

A Investors are very open to emerging managers. However, it is a difficult process for them. The purpose of an institutional investor is to preserve capital and generate strong returns while being as operationally efficient as possible to invest and deploy capital. Emerging managers, as a general matter, have a variety of start-up and blind pool risks. Therefore, first-time fund commitments are the hardest "yes" decisions that an institutional investor needs to make. That said, there is ample analysis and evidence that a well-crafted portfolio of emerging managers outperforms a portfolio of larger, well-established private equity funds, so there's a strong economic rationale for increasing exposure to emerging managers. ■

LP priorities

Team composition, differentiated strategy and deal-sourcing prowess top investors' emerging manager wish-list

Just 21 percent of LP respondents to this year's *Buyouts Emerging Manager Survey*, conducted in partnership with Gen II Fund Services LLC, have a formal allocation to emerging managers. But those that do tend to invest prolifically.

Emerging managers account for almost 50 percent of the total portfolio for these organisations and three-quarters of respondents typically invest in more than 10 emerging managers a year.

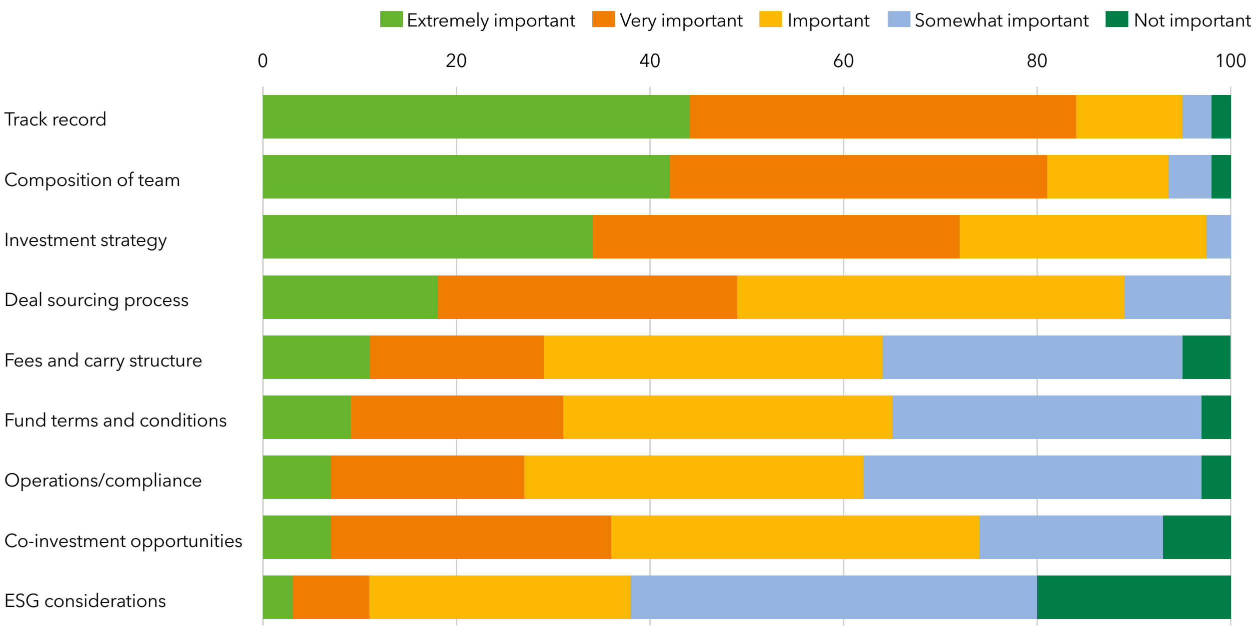
The macro environment is not expected to have any meaningful impact on this activity, meanwhile, with three-quarters of respondents claiming there has been no change in their allocation to date. Furthermore, 20 percent of respondents actually intend to increase their exposure over the next year, rising to 33 percent over a three-year period.

Superior returns represent the primary objective of an emerging manager investment program, cited by half of all LP respondents. Indeed, over 50 percent of LPs either agree or strongly agree that the risk/return profile for emerging managers is currently attractive when compared with their more established counterparts.

"Funds one and two tend to generate exceptional returns," says Sarah Sandstrom, partner at Campbell Lutyens. "Having the opportunity to take a seat at the table early also means investors will be able to maximize their allocation in subsequent funds as the manager continues to perform."

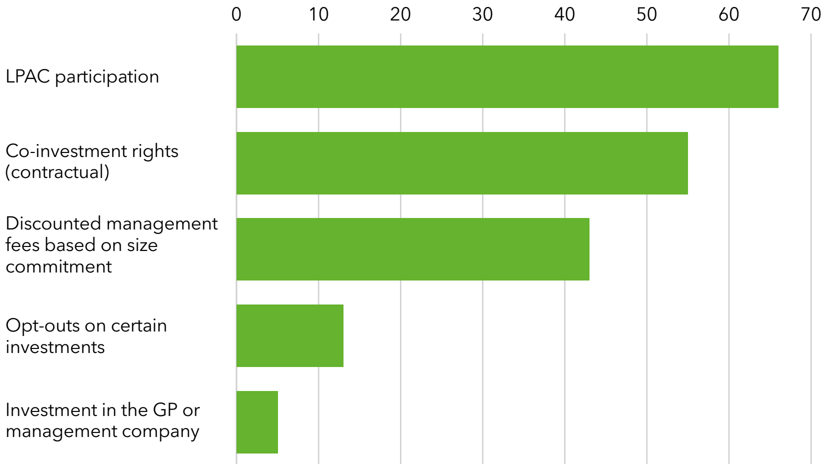
"We have invested in emerging managers for over 20 years," adds Paul Newsome, private equity partner and head of portfolio management at Unigestion, "and emerging managers have

How important do you believe the following factors are for LPs evaluating your fund (%):

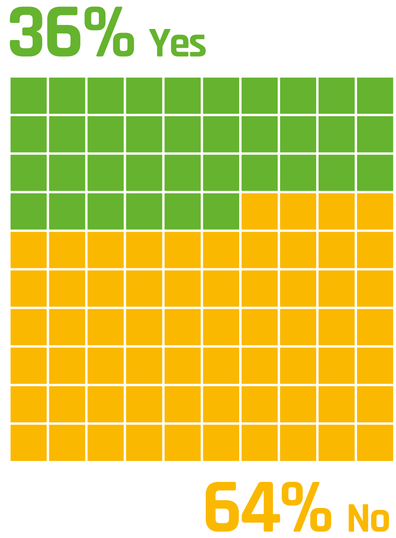


Source: Buyouts Emerging Manager Survey 2022

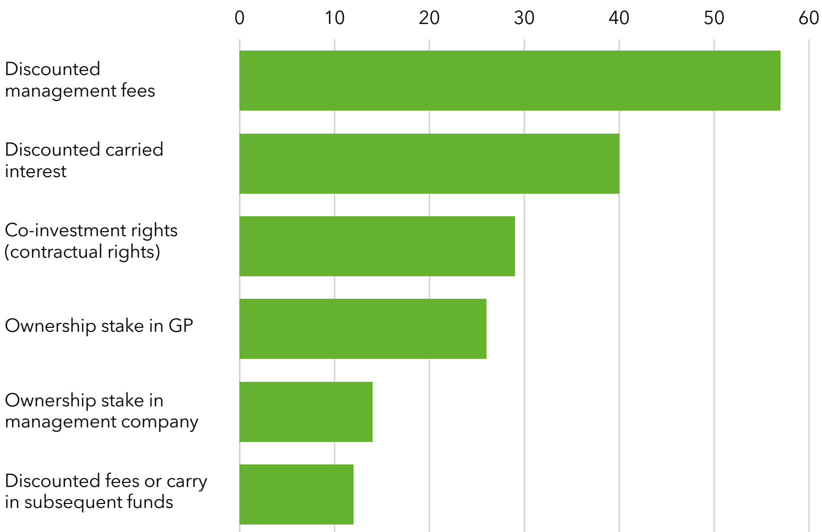
Which of the following terms did you offer/provide to investors? (Multiple responses allowed, %)



Did you have an anchor investor with more favorable economic terms?



If so, what terms did the anchor investor receive? (Multiple responses allowed, %)



Source: Buyouts Emerging Manager Survey 2022

historically made up around 50 percent of our overall deployment to funds. Indeed, emerging managers represent the best performing part of our portfolio."

Other advantages afforded by emerging managers include portfolio diversification, access to specialist strategies and access to managers that are owned by minorities or women.

"Emerging managers lend a different spice to an institution's portfolio," says Newsome. "They can also give you access to sectors and deals that you might not otherwise get access to through established firms."

Not all emerging managers will be successful, however. The bar is high. GPs believe that a track record is the most significant component of an early fundraising, cited by 84 percent of emerging manager respondents as either extremely or very important.

Investors have a slightly different perspective, meanwhile, with team composition deemed the number one priority, followed by investment

"Being able to articulate what you might be doing differently or what you may have learnt from investments you made in the past is very important"

SARAH SANDSTROM
Campbell Lutyens

strategy and deal sourcing processes, with track record coming in at number four.

Spin-outs

The combination of coherent track record and cohesive team that is afforded by a whole team spin-out from an established firm makes this one of the easiest forms of emerging manager for investors to get their heads around.

Almost 80 percent of LP respondents said they were very likely or likely to back a team that had emerged from a larger sponsor, making spin-outs the most popular type of emerging manager. Investors are markedly more cautious, however, when it comes to individual-led franchises, ex-family offices and teams without a private equity background.

"When it comes to de-risking an emerging manager proposition," says Carolina Espinal, managing director at HarbourVest, "there are clear benefits to backing individuals who have previously worked together and that have a strategy in line with their prior activities."

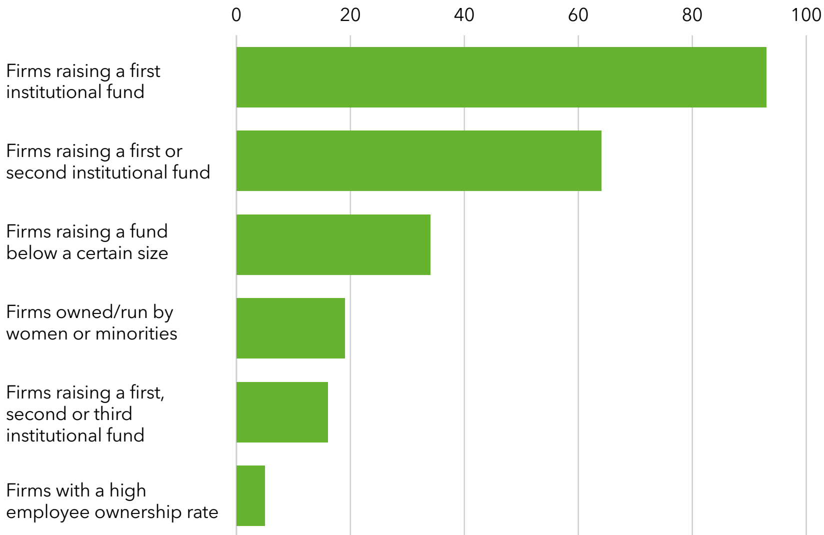
Scott Reed, co-head of US private equity at abrdn, agrees: "Successful emerging managers tend to have the cleanest stories. They are often teams that have spun out from credible and well-known firms, with a demonstrable history of working together. When people come together from different houses, it is harder to determine whether they will work together well. Those fundraisings are more likely to struggle."

LPs also want to understand whether a new firm can manage a fund, as well as investing capital, says Newsome. "Will they build a diversified portfolio? Will they reserve the right amount of capital for add-ons?"

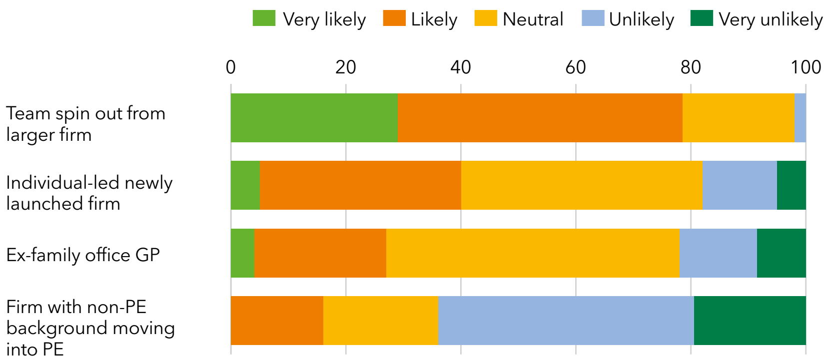
Reed agrees. "They might be great as individuals, but how well do they work together? Do they have the experience to build an actual firm? Do they have expertise, not only in making good investments, but in everything

LPs

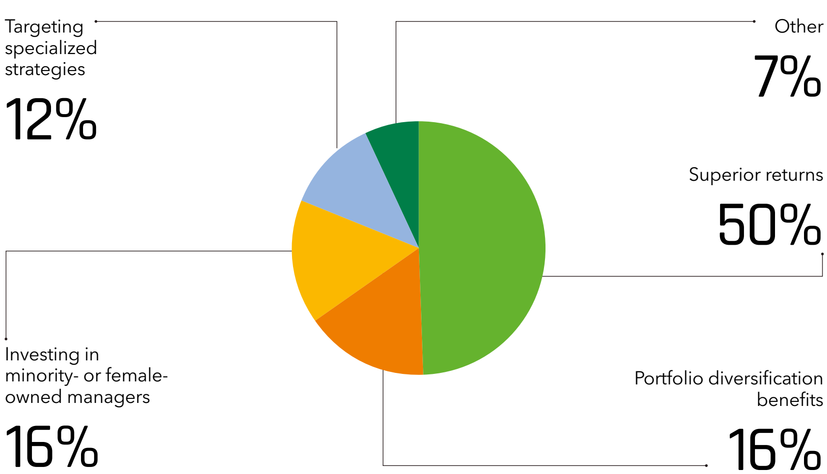
How do you define the term 'emerging manager' when it comes to PE/VC? (Multiple responses allowed, %)



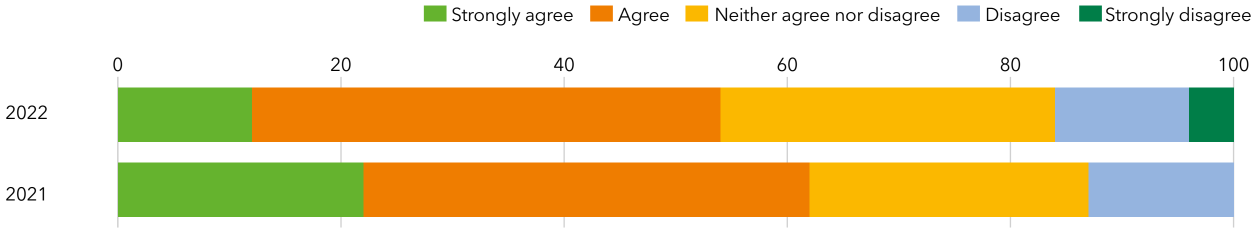
How likely are you to invest in the following types of emerging managers? (%)



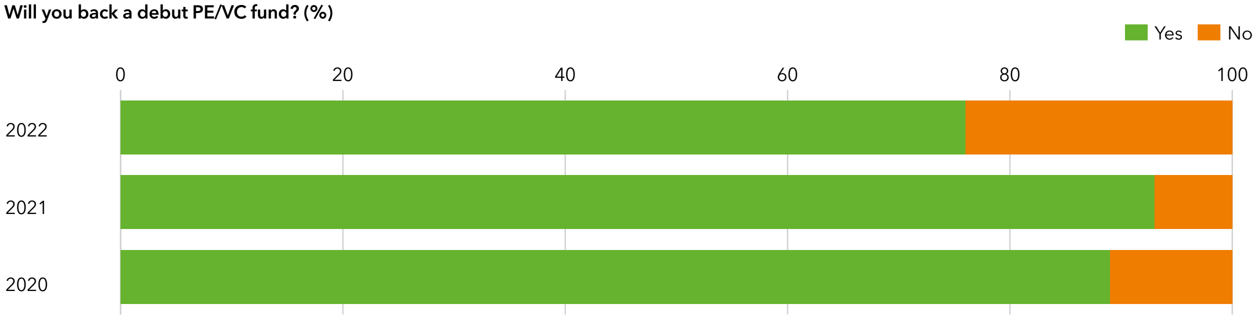
What is the primary purpose of your emerging managers program?



"The risk/return profile for emerging managers is attractive at the moment versus established managers" (%)



Will you back a debut PE/VC fund? (%)



that goes into portfolio management? Is there a commitment to building out the layers of the organization beneath them? There's a lot to unpack with emerging managers," he says.

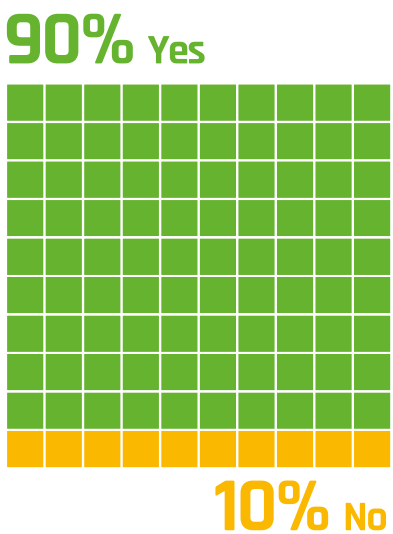
A differentiated strategy is another top priority. "We want to see a clear competitive edge," says Newsome. "Why are we putting money with this emerging manager and not with an established player in the same sector? Asking that question really focuses your thinking on why this team is the best in a particular niche."

Espinal says HarbourVest has particularly noticed a rise in the number of emerging managers focusing on ESG and impact themes, for example.

Newsome, meanwhile, cites an emerging manager that Unigestion has recently backed that focuses on mid-market enterprise software companies in German-speaking Europe. "The team includes individuals with operational backgrounds and entrepreneurs. It was very clear that these guys were the best in the space."

But differentiation can also be based on execution capabilities, Newsome adds. "Another example in our portfolio involves more of a generalist – a

Will you back a manager raising its second fund?



Source: Buyouts Emerging Manager Survey 2022

firm that focuses on three different sectors. Their unique skill set is buy-and-build at a micro level. That requires expertise in finding platform companies, identifying add-on targets and then integrating those businesses. It is a very compelling story."

Reed agrees: "The world doesn't need another mid-market buyout fund. Any manager that is going to be successful raising capital for the first time is going to have a point of differentiation – a reason to exist. Sometimes that will involve a sector or industry focus. Or it could be a distinct investment style, such as expertise in buy-and-build or debt-for-control. It could even be a regional orientation within the US – a group with a deep and differentiated network in a certain provincial part of the states that affords them unique access to dealflow."

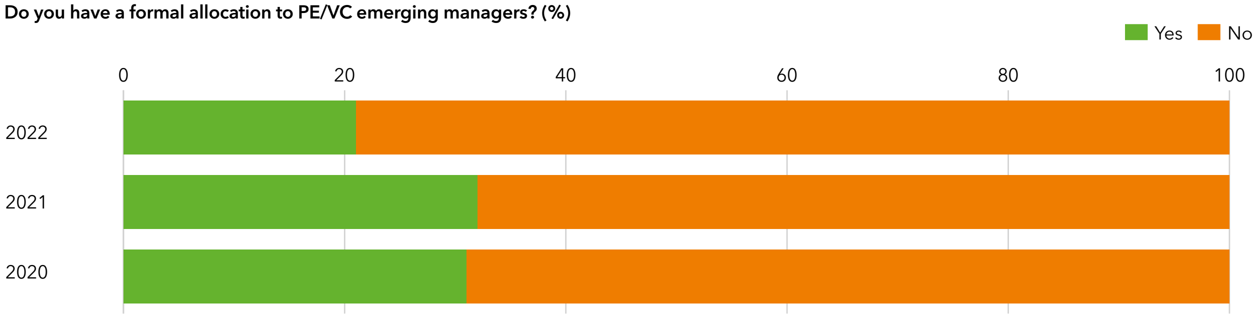
Sarah Sandstrom, partner at Campbell Lutyens, adds: "Being able to articulate what you might be doing differently or what you may have learnt from investments you made in the past is very important. That edge and that sense of learning resonates well."

On whose terms?

Meanwhile, just over 30 percent of emerging managers believe that terms and conditions were an important or very important aspect of their fundraising for LPs, compared to 52 percent of LPs themselves. And there is a wide breadth of points of negotiation.

Two-thirds of emerging managers

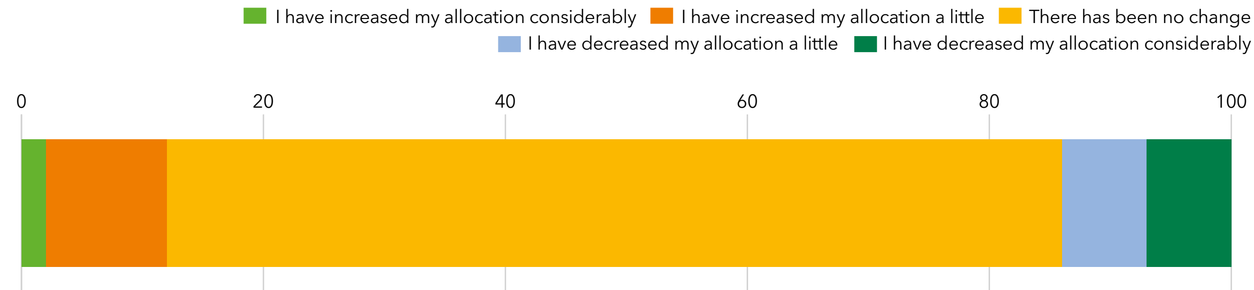
Do you have a formal allocation to PE/VC emerging managers? (%)



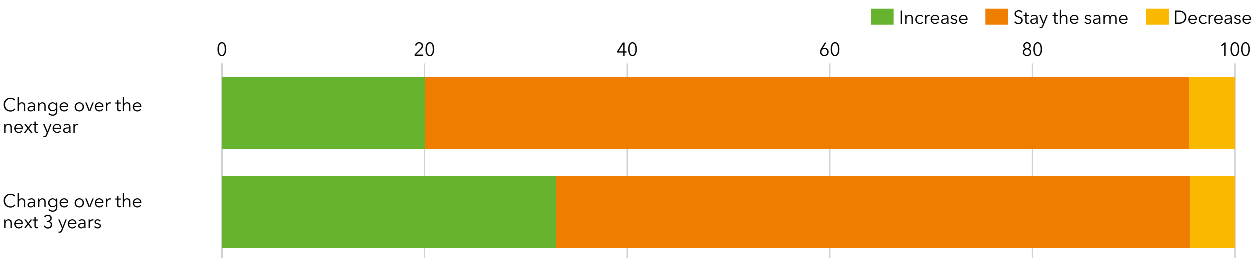
If yes, what is the allocation target as a percentage of your total PE/VC portfolio?

53%	67%	47%
2020	2021	2022

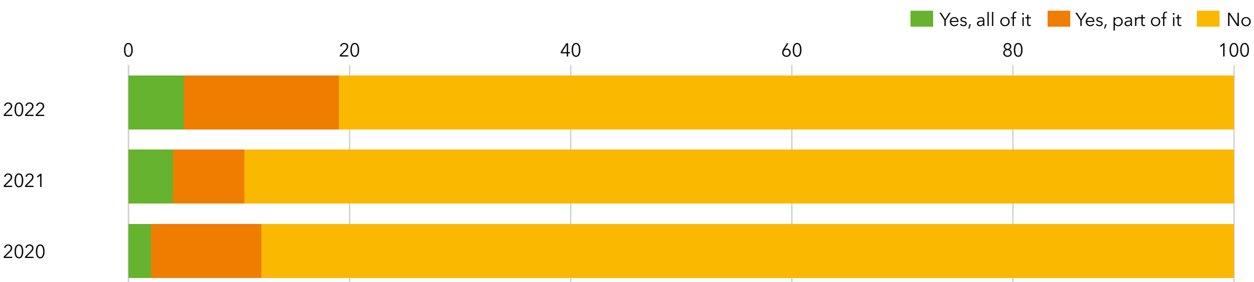
How have recent market gyrations (to multiples, valuations) caused a change in your allocation to emerging managers? (%)



How do you anticipate your allocation to emerging managers changing over the next year? Three years? (%)

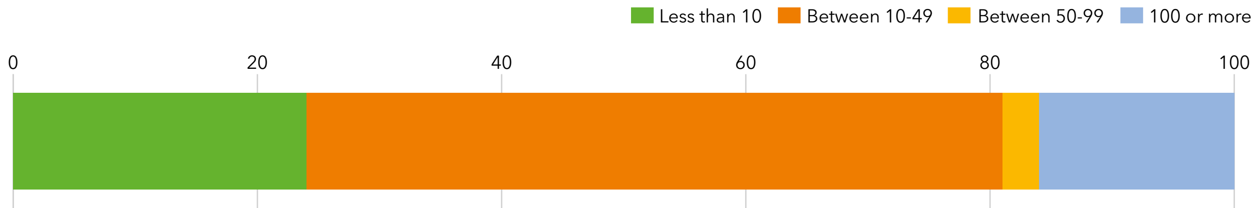


Do you outsource at least a portion of your emerging manager program to a third-party adviser? (%)



Analysis

How many emerging managers do you meet with per year? (%)



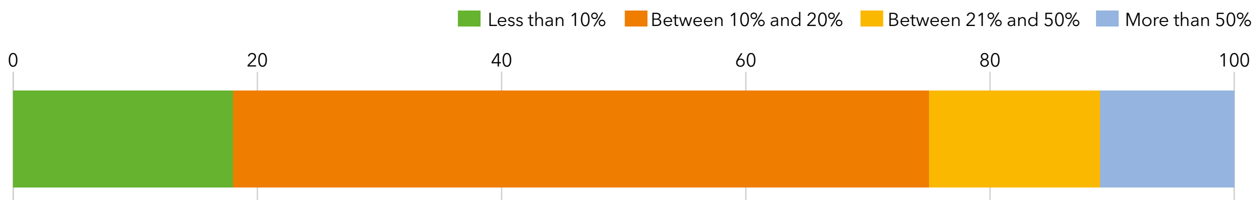
How many emerging manager funds...

Do you currently back? (%)

Do you anticipate backing over the next year? (%)

If you make co-investments with emerging managers, how many do you anticipate making over the next year? (%)

What is your target allocation as a percentage of your total PE/VC portfolio regarding co-investment opportunities? (%)



What is a typical commitment size you will make to an emerging manager fund? (%)

Source: Buyouts Emerging Manager Survey 2022

offered investors LPAC participation, while over half offered co-investment rights. A sizeable 43 percent, meanwhile, were prepared to offer a discounted management fee, based on the size of the commitment.

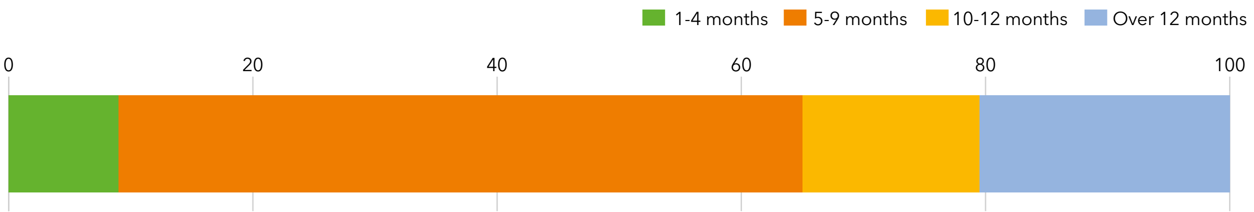
Less popular concessions included opt outs on certain investments, while selling a share of the GP or management company was deemed the least attractive of all. Just 5 percent of respondents sold a stake as part of the fundraising process, compared with 18 percent a year earlier and 24 percent in 2020.

> *"Successful emerging managers tend to have the cleanest stories"*
>
> **SCOTT REED**
> **abrdn**

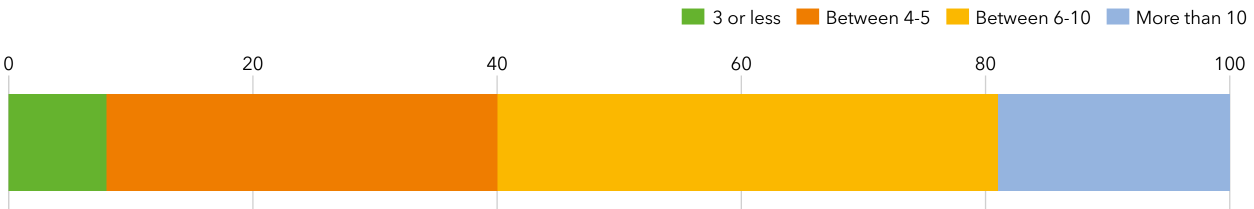
However, it is clear that the ground ceded is significantly higher when an anchor commitment is involved. Just over a third of managers with an anchor offered those investors preferential terms. The most common concession granted was a discounted management fee, followed by co-investment. A little over 10 percent extended these terms into subsequent funds.

Investors prepared to give a new manager the vital capital to kickstart

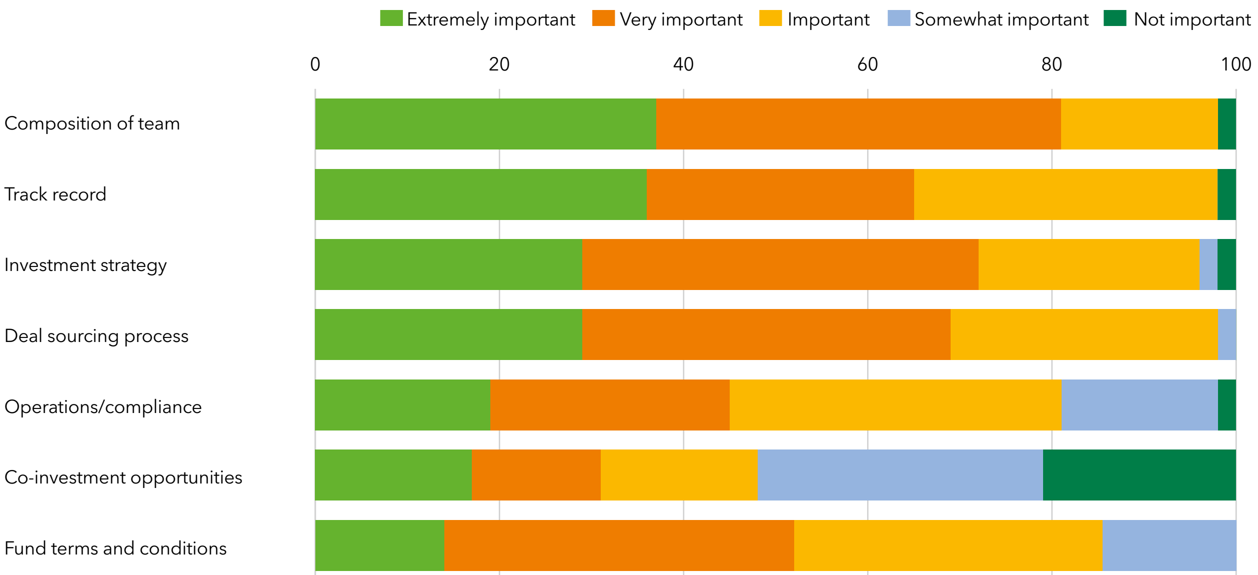
How long does it typically take from first introduction to a signed commitment? (%)



How many meetings, including conference calls, would you expect to have with an emerging manager before making a commitment? (%)

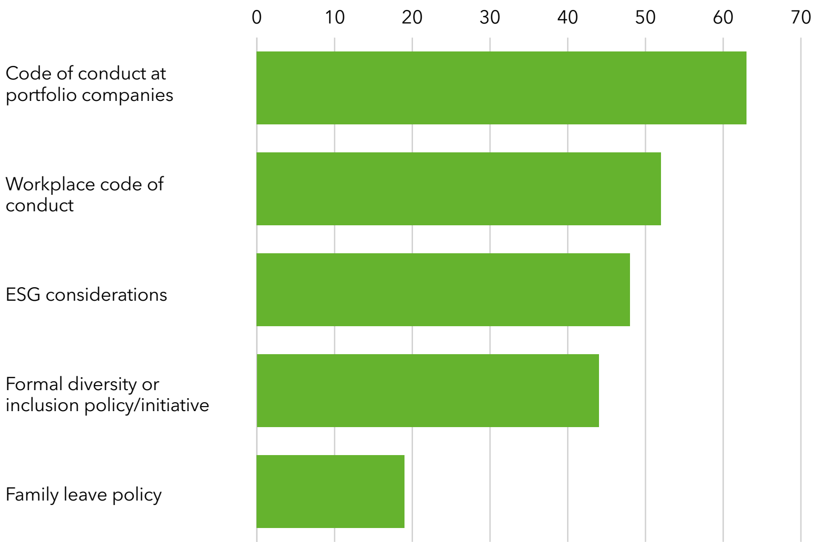


How important are the following factors when evaluating an emerging manager fund? (%):

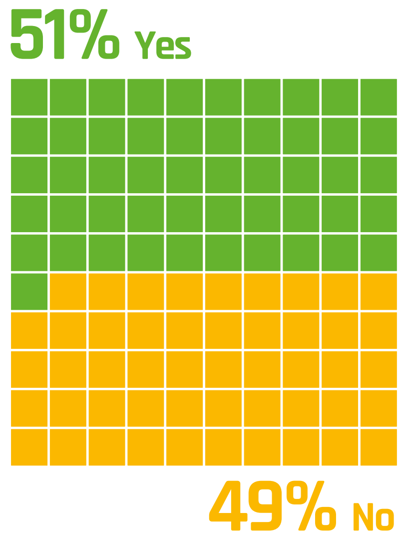


Analysis

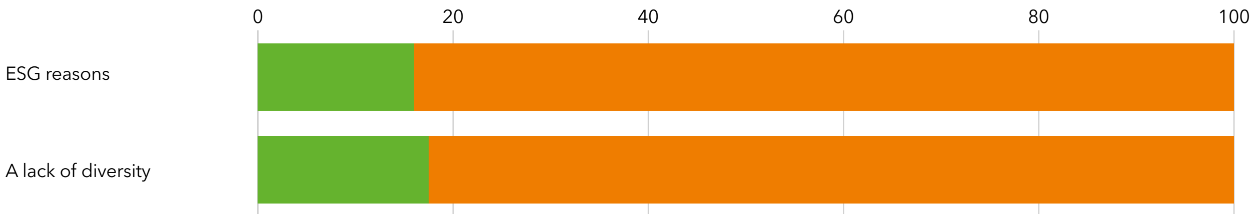
Do you look for any of the following in an emerging manager? (Multiple responses allowed, %)



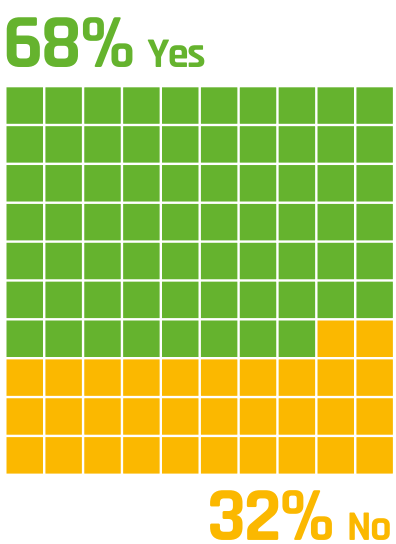
Do you believe there is a positive impact between ESG and investment performance in emerging managers?



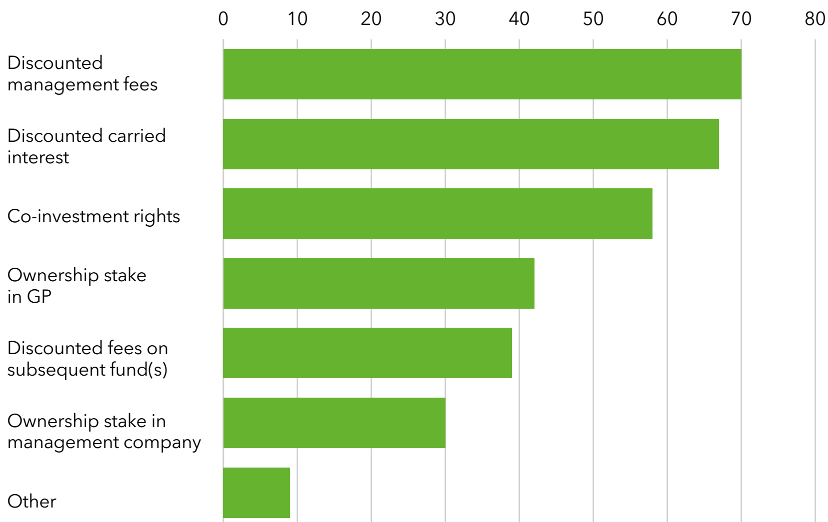
Has your institution ever refused an investment opportunity from an emerging manager based on ESG reasons or a lack of diversity? (%)



Would you make an anchor commitment to an emerging manager?



If you were to make an anchor commitment, what special terms would you seek? (Multiple responses allowed, %)



Source: Buyouts Emerging Manager Survey 2022

Due diligence

Investor due diligence of emerging managers tends to be more time consuming and complex than for a more established firm.

"There is a lot more leg work to be done when compared to a manager on fund five or fund six, with a wealth of evidence they can point to, to show you they perform well in good times and in bad," says abrdn's Scott Reed. "With emerging managers, you have to synthetically create that body of work and then form an assessment as to how sustainable the approach is going to be."

LP due diligence of emerging managers also tends to focus heavily on referencing, says Carolina Espinal of HarbourVest. "We spend a substantial amount of time in emerging manager due diligence, pursuing on-list and off-list references. We try to build a complete view of what it is like to work with these individuals, particularly if they are coming from different firms."

Joe Benavides, managing partner and co-founder of emerging manager OceanSound Partners, adds: "Investors are looking at historical experience. Where has the firm come from? What deals have the investors touched? There are a lot of reference calls and massive in-depth interviews. Then there is the operational due diligence. What is the capability of your back office? What are your policies and procedures? There is in-depth due diligence of IT, accounting and tax planning. Investors are weighing up whether you are a team that can make a few investments or if you can really build a business."

"[Emerging managers] can also give you access to sectors and deals that you might not otherwise get access to through established firms"

PAUL NEWSOME
Unigestion

their firm also expect plenty in return. Over two-thirds of investors would provide an anchor commitment to an emerging manager, with the majority, 70 percent, expecting discounted fees. Over two-thirds would look for discounted carry and 58 percent would seek co-investment rights. A significant 42 percent would also look to secure a GP stake.

"There are certainly LPs that want to take a small stake in the GP," says John McCormick, partner at Monument Partners. "These LPs rarely seek governance rights. They are not looking for a seat on the board or to influence investment strategy. It is more about having a stake in the growth of the firm from an economic standpoint."

He adds that there are pros and cons to giving into the demands of anchor investors. "If that capital helps the manager get into business; if it enables them to get to that first close and start doing deals, then it may well be worth it. But managers need to go into these negotiations with their eyes wide open. In particular, they need to be mindful of questions from other LPs about the relationship and the rationale behind it." ■

Under pressure

Emerging managers may be prepared to cede some ground on terms to get their first fund away, but regaining control can be challenging

Investors will often look to secure attractive terms when committing to a first- or second-time fund, particularly if coming in at a first close. Indeed, 61 percent of LP respondents to the sixth annual *Buyouts Emerging Manager Survey*, conducted in partnership with Gen II Fund Services LLC, concede they negotiate harder on terms with emerging managers, although interestingly the emerging managers themselves appear broadly unconcerned. Two-thirds of GP respondents described receiving little or no pressure on fees.

The standard 2 percent management fee remains the accepted norm, adopted by 79 percent of emerging managers. Investors recognize the importance of the management fee for funding the roll-out of the firm. "We look to influence terms and conditions, but we don't try to nickel and dime managers, because fees are obviously important to their development," says Paul Newsome, private equity partner and head of portfolio management at Unigestion. "We don't try and get discounts for the sake of it."

HarbourVest is another investor that believes heavy negotiation can be detrimental, according to managing director Carolina Espinal. "I know there are LPs that try to de-risk their investment by getting preferential economics, but we prefer market standard terms and equal alignment across all LPs."

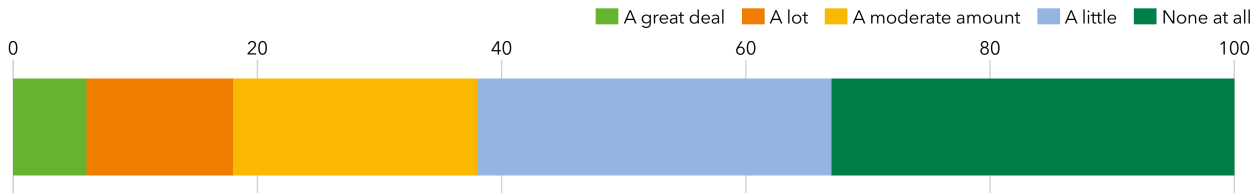
Enhancing alignment

Rather than squeezing young firms on management fees, investors are more likely to seek to enhance alignment by requiring substantial GP commitments and encouraging tweaks to the carry structure. Unigestion, for example, likes to implement a tiered carry system. "We also like shorter duration funds – two years plus five – which improves the cashflow profile of the fund, while reducing our downside risk," says Newsome.

However, Scott Reed, co-head of US private equity at abrdn, believes it is reasonable to seek preferential economics, particularly if an LP is willing to provide a cornerstone or anchor commitment. "We will often use that as leverage to command a better terms package," he says. "That could involve anything from fee breaks to changes to the carry waterfall, or preferential co-investment

What management fee as a percentage have you asked for in your fund? (%)

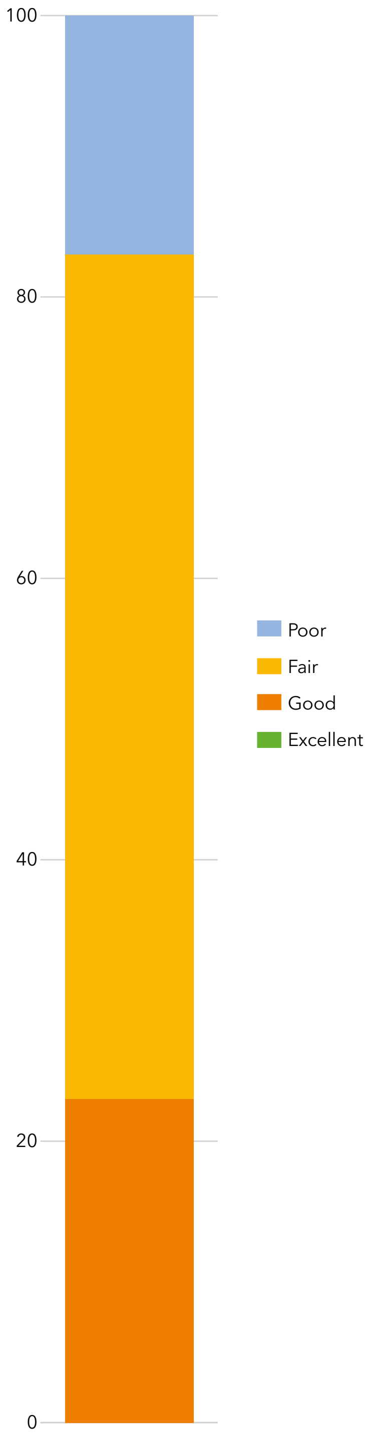
Do you receive pressure from investors regarding fees? (%)



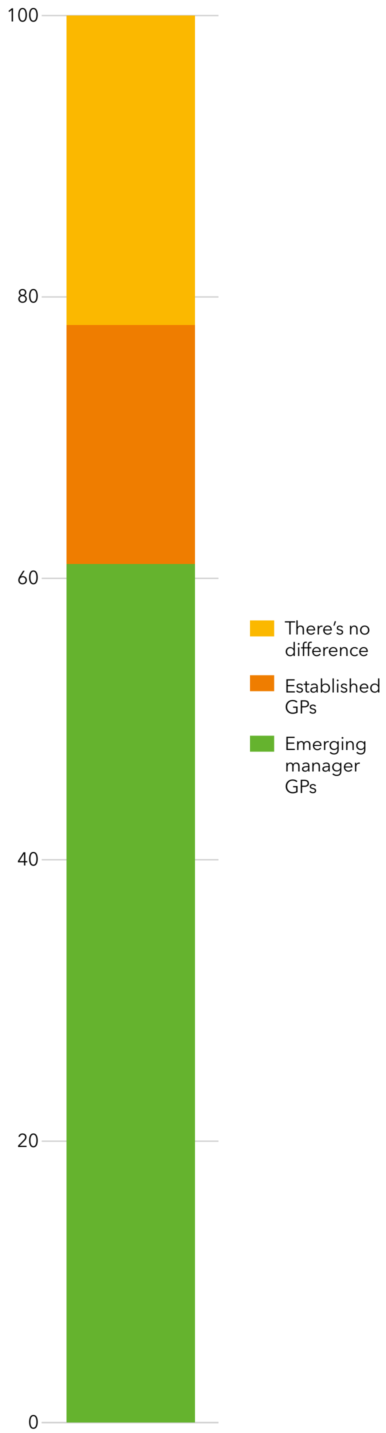
Source: Buyouts Emerging Manager Survey 2022

LPs

How good is the quality of ESG documentation received from emerging managers, versus a more seasoned firm? (%)



When negotiating fees, do you believe LPs generally negotiate harder with... (%)



"It is important to limit what you give away on firm economics as an emerging manager"

JOHN MCCORMICK
Monument Group

terms. It may even involve a small stake in the GP itself."

The GP must weigh up the benefit of that cornerstone commitment against the concessions that need to be made, says Sarah Sandstrom, partner at Campbell Lutyens. "Ensuring a strong first close is highly beneficial for emerging managers, particularly when it comes to attracting other LPs at subsequent closes.

"That cornerstone commitment is also what enables the firm to hire more investment professionals and start doing deals, so if the manager needs to give a little around certain terms to nail that strong first close, that can sometimes make a lot of sense."

Where a GP does give way on terms, however, it can be challenging to return to market norms in subsequent funds. "It is important to limit what you give away on firm economics as an emerging manager," says John McCormick, partner at Monument Group. "It is also important to make sure whatever is given away is ring-fenced. We always try to limit the tail on any concessions and to ensure it is a one-time only event."

The co-investing conundrum

Offering co-invest can be a powerful way of enticing investors into a fund, but this must be balanced against the reduced economics

Over half of the investors canvassed in the sixth annual *Buyouts Emerging Manager Survey*, conducted in partnership with Gen II Fund Services LLC, are looking to co-invest alongside the emerging managers they back. Indeed, 87 percent expect to complete at least one co-investment alongside a young firm next year and 40 percent plan to execute on upwards of three co-investment transactions.

"Access to co-investment can be one of the rationales for backing emerging managers," says Sarah Sandstrom, partner at Campbell Lutyens. "Those LPs that come in at a first close, in particular, will be considered for preferred co-investment rights, potentially at a ratio of one-to-one of co-investment to committed dollars."

Paul Newsome, private equity partner and head of portfolio management at Unigestion, says his firm gets a lot of co-investment dealflow from emerging managers because of the strong relationship established early on, and often because the emerging manager requires a partner with whom they can co-underwrite deals.

GHK Capital, for example, which closed its maiden fund on $410 million this year, actually plans to deploy around double that figure, writing equity checks of up to $250 million in any one deal. "Our fund is functionally undersized," says managing partner Gil Klemann, "which means co-investment is a very important part of our story. Co-investment can be a useful driver of a first-time fundraising."

> *"Co-investment can be a useful driver of a first-time fundraising"*
>
> **GIL KLEMANN**
> **GHK Capital**

John McCormick, partner at Monument Group, agrees: "As LPs have become more active on co-investing across the board, it has become part of the conversation from the outset. Co-investment has become a way of engaging with new investors. It also allows investors to dig into the way a manager invests and operates."

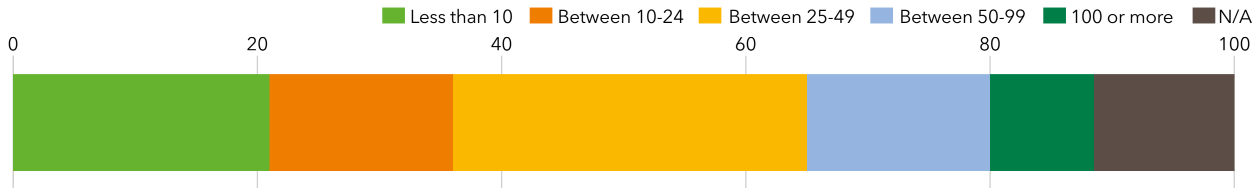
McCormick issues a word of caution, however, pointing out that emerging managers must weigh the benefits of using co-invest to help close a fund and get a firm up and running with the economic consequences of offering co-investment on a no-management-fee, no-carry basis. "Co-investment can be a great way to engage, but a balance must be carefully struck."

Meanwhile, appetite for emerging manager co-investment mirrors demand in the wider portfolio, with 82 percent of LP respondents citing a target co-investment allocation of at least 10 percent. A quarter of all respondents have an allocation target of upwards of 20 percent and for 11 percent the target is 50 percent plus. ■

How many prospective investors did you meet with? (%)

For investors who ultimately committed, how many meetings (including conference calls) did you have with them on average? (%)

How many limited partners do you have in your most recent fund? (%)

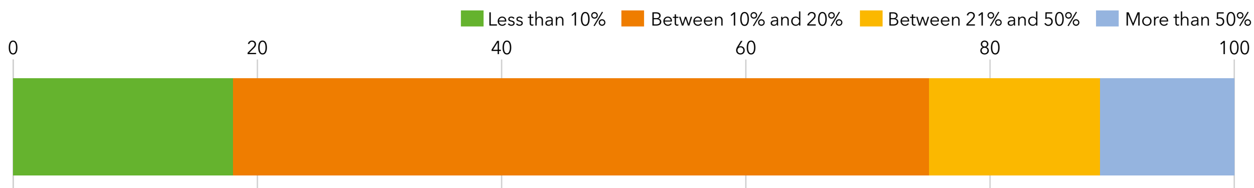


LPs

Do you make co-investments with emerging managers? (%)

If yes, how many co-investments do you anticipate making alongside emerging manager funds over the next year? (%)

What is your target allocation as a percentage of your total PE/VC portfolio regarding co-investment opportunities? (%)



Source: Buyouts Emerging Manager Survey 2022

Company Overview

Gen II Fund Services, LLC is the largest independent, U.S. based, private equity fund administrator, administering over $900B+ of private capital. The Gen II team is the longest-tenured, most experienced team in the fund administration industry. Our senior management team has more than 25 years of experience and are recognized as leaders in private equity fund administration. Our dedicated client service teams, led by a Principal with an average of 15 years of fund administration experience, provide our clients with world class service and expert guidance.

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Founded 2009

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source: Convergence

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Private Fund Capital

Client Retention
99%

25+YRS
Fund Administration Experience

Helped Launch
100+
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50,000+
Investors for Our Clients

Servicing
6,500+
Fund Entities

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Q&A

GHK took a deal-by-deal approach to prove its thesis to investors before raising its first fund, says Gil Klemann, the firm's managing partner

Q What is your background, and what led you to launching your own firm?

A I spent my career at Goldman Sachs before deciding to launch GHK. I wanted to move into the mid-market, where I saw more opportunity for value creation relative to the large deals we focused on at Goldman.

Q You initially operated on a deal-by-deal basis. Why did that make sense?

A We completed two deals on a deal-by-deal basis prior to launching the fund. The primary reason was to establish a track record as our own firm, away from Goldman, and to prove out our thesis in and around the mid-market industrial space. It was always our intention to raise a fund, and those first two deals were helpful for demonstrating our capabilities and for establishing relationships with LPs. We then lined up our third deal to be the first deal of the fund. In other words, we used it as a mechanism to drive the first close.

Q Why do you think you were successful in a market that is so challenging for first-time funds?

A I think investors liked the focus of our strategy. They also liked the fact that a number of our team had worked together at Goldman prior to launching the fund. I started GHK on my own, but with the intention of bringing people over, over the course of a couple

of years, which I did. That meant there was some continuity among the investment team, and this was valued by LPs. The success of our pre-fund deals was also crucial for demonstrating our differentiated approach.

Q What areas of due diligence did investors spend most time on?

A Investors went into depth across the board, but particularly around our sourcing engine, and our differentiation in terms of how we drive value creation across the portfolio. They looked at the depth and substance of our executive network, our pipeline of deals and our relationships with intermediaries. But the real challenge for emerging managers over the last couple of years has been getting mindshare from LPs, who have been unbelievably busy. It was oftentimes a lack of bandwidth, rather than a lack of interest, that we were fighting against.

Q Did you receive much pushback on terms?

A The short answer is no. Our fees are market standard. The desire for co-investment is very high among investors, however, given the economics relative to fund commitments. And at $410 million, our fund is functionally undersized, which means co-investment is a very important part of our story.

We haven't guaranteed co-invest to anyone in any of our deals, but, practically speaking, we are putting $100 million to $250 million of equity to work in any given transaction. A substantial portion of that equity will come from co-investment, which means our fund will function more like an $800 million or $900 million fund. Co-investment can be an important driver of a first-time fundraising. It also allows investors to observe the way you operate up close.

Q What advice would you give other emerging managers raising their first fund?

A It is, objectively, a very challenging undertaking, and there will be bumps along the way. Perseverance is critical. You need to be able to accept the inevitable rejection and maintain conviction in your thesis. Mentally and emotionally, it is tough, and we consider ourselves very lucky to have gotten in and out of the market, particularly in the midst of a pandemic. ■


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