Perspectives in Partnership is Abbott's series that provides our audience insights into the information and knowledge we have accumulated during our nearly four decades of investing in the private equity and venture capital markets and our unique position as both a general partner (GP) and limited partner (LP).

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KEY CONSIDERATIONS WHEN INVESTING IN EMERGING MANAGERS

In this multi-part installment, we look at a segment of private equity that has garnered a lot of attention and interest in recent years: emerging managers. We will explore fundamental questions and considerations from the perspective of prospective LPs, and for emerging managers themselves. This article focuses on emerging managers from our perspective as an LP, including potential benefits and challenges, as well as some key points we consider when conducting due diligence.

What are emerging managers?

Emerging managers are nothing new in private equity as, by most definitions, even today's brand name firms were once considered emerging. Contrary to what the name suggests, emerging manager firms are not necessarily those with inexperienced teams. Rather, they are often newer firms with teams comprised of skilled professionals with relevant experience who may have a deep history of working together (e.g., spinouts, restarts, fundless sponsors). For purposes of this discussion, we are defining emerging managers as those private equity firms raising a first, second, or third institutional fund.

Why might LPs consider allocating capital to emerging managers?

As the private equity asset class has grown and matured over the past few decades, so too have the programs of many institutional limited partners. Investors with well-developed programs often have a roster of established managers they have continued to support. However, some investors have also looked to smaller emerging managers as additional sources of returns and to gain access to tomorrow's

stars. We believe LPs willing to invest with a manager in its infancy may benefit from early exposure in a variety of ways, including early access to the next generation of brand names and the potential for differentiated returns from firms that often offer strong alignment and enhanced economics.

Early access to future stars

In general, accessing historically successful GPs can be a complex, often frustrating endeavor for LPs for a number of reasons. With existing investors given priority at the beginning of each fundraise, these hard-to-access GPs often make room for only a handful of new investors from one fund to the next. This dynamic can lead LPs to seek emerging manager exposure. If picked judiciously, a portion of these groups may ultimately become market leaders in their space, enabling early investors to claim the coveted status of "existing LPs" and steadily grow their participation with these successful groups.

Potential for differentiated returns

For mature vintages since 2000, emerging manager buyout and venture capital funds have shown higher top quartile net IRR returns when compared to established funds over the same time periods (we note, however, that the data exhibits inherent survivorship bias as the funds reporting are likely those that successfully raised and performed well over time)[1]. Over the long term, a small emerging manager allocation can move the performance needle of a large PE program if a meaningful portion of the emerging managers grow into the "core" allocation and LPs can deploy an increasingly larger amount of capital into successful platforms.

Strong alignment between LPs and GPs

When it comes to performance, the stakes may be significantly higher for emerging managers in the early years. Unlike large, established firms that can absorb the impact of a mediocre fund or portfolio company, smaller firms must deliver strong, consistent returns to establish their credibility and foster trust with investors. Every investment counts as early mistakes are much more visible.

Potential for enhanced economics

In a platform's early years, there may be a discrepancy between high-quality deal flow and slow fundraising momentum. GPs may look to early anchor LPs for additional capital, such as warehousing facilities or large co-investment allocations, leading to enhanced economically efficient exposure to interesting deals. Additionally, LPs who are willing to "speak early" may also benefit from discounted carry and fees as an incentive to lead the way for others.

What are some of the challenges when evaluating emerging managers?

Any investment presents a unique set of challenges and risk factors to consider, and emerging managers are no exception. Historically, while emerging manager funds may have had higher top quartile returns relative to established funds, as mentioned above, they have also had a wider dispersion of net IRR returns[1]. This wide dispersion of returns highlights the importance of manager selection. However, selecting the right emerging managers can be a very resource intensive process.

[1] Mature vintages reflect 2000-2018. Source: Q2 2024 Pitchbook Analyst Note: Establishing a Case for Emerging Managers

While due diligence is critical to any investment decision, outlined below are a few key diligence considerations we believe are particularly relevant for emerging managers.

Performance and attribution

It is unlikely that an emerging manager will spin out of an established platform with fully vetted performance attribution credentials. Similarly, a fundless sponsor track record is unlikely to be a perfect indication of what a GP may have done in a closed-end structure (since the money was raised on the merit of each deal, essentially giving capital providers an effective veto right). Emerging GPs may not have been investment committee members or the most senior-level decision makers at the firms from which they are spinning out, or they may have been helped by strong in-house operating teams. Therefore, deconstructing the prior track record of an emerging manager is generally a work-intensive process. As we diligence an emerging manager's track record, we may also seek to leverage our network of private equity investment professionals and attempt to verify and paint a balanced picture of the role the partners played in generating their prior performance.

Personalities and chemistry between partners

Starting a new organization, be it a private equity firm or any business, can be a stressful, risky and highly work-intensive endeavor. It requires resilience, humility and a high degree of compatibility between the senior members. The personal circumstances relative to each partner, their personal risk appetite and stamina can also significantly impact the firm's early years. To get comfortable with this aspect of a firm, we typically seek to confirm the senior members have worked together successfully in the past, often through significant discussions with the partners. We recognize that this may eventually remain a "known unknown", as even the GPs themselves might not have a perfect grasp of their own ability to sustain a higher level of long-term pressure in what may be their first entrepreneurial endeavor.

Institutional mindset

Emerging managers spinning out of established organizations likely benefitted from a deep infrastructure funded and managed by their prior employer. Upon starting their own firm, they now need to build the infrastructure from scratch while also considering proper resource allocation to implement their strategy. This can quickly become an entire job on top of their investment role, and one which they are unlikely to have experienced in the past. Managers that have built a layered investment and operational function early on, despite a somewhat scarce income stream, are presumably primed to efficiently grow and scale over time. When conducting diligence, we often compare an emerging manager's organizational framework and resource allocation to that of a successful, established firm with a similar portfolio focus to ascertain the long-term viability of the emerging manager's organization.

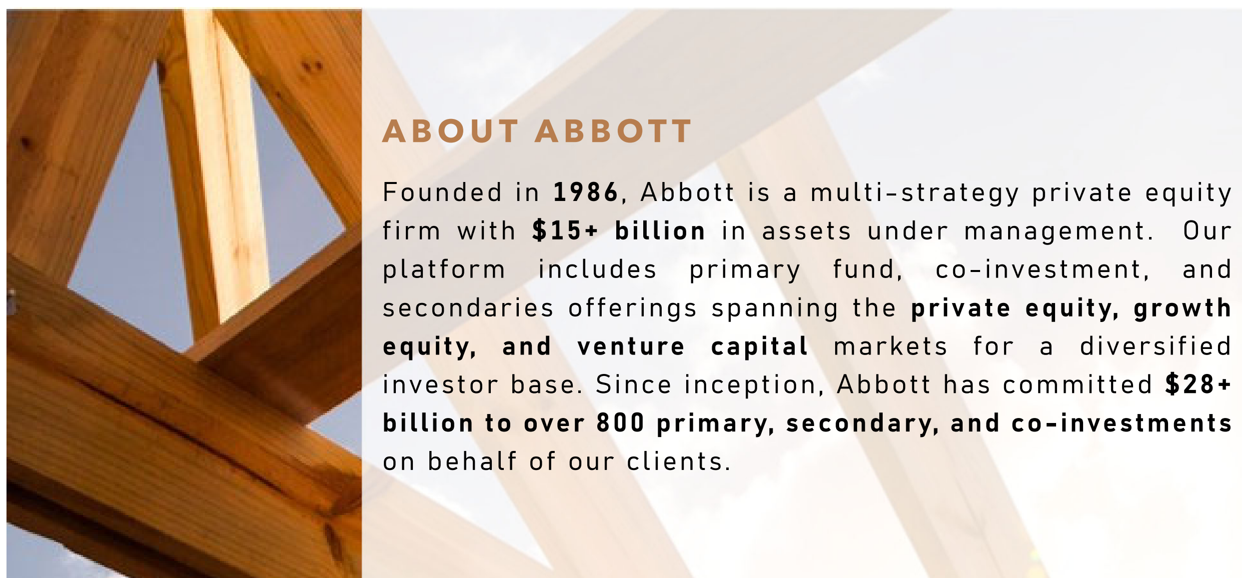
Deal sourcing and capital deployment

While some emerging managers may have a strong body of prior investment work, they are unlikely to have been the principal managers of a closed-end private equity vehicle, a critical skill for optimal fund deployment. An important part of this skill is the ability to source a steady stream of attractive deals. For managers previously part of a larger platform, they likely no longer have the resources or brand names to lean on. Therefore, circumstances

could be markedly different once they begin seeking deals under a new (and likely unknown) name, and a significant amount of work needs to be done to build the sourcing muscle and infrastructure from scratch. On the contrary, managers that were previously fundless sponsors will likely be accustomed to sourcing and winning their own deals from day one without the benefit of infrastructure or brand name. However, these individuals are not accustomed to deployment pressure associated with a closed-end fund or finite investment period. We typically examine how thoughtfully emerging GPs have considered their target fund size relative to their deployment capacity and pipeline of opportunities, and also compare the emerging manager to similar, established GPs, to gain insight if the emerging GP will likely be able to execute on the proposed strategy.

Conclusion

Emerging managers are a captivating and dynamic component of the private equity market. While they come with unique challenges - such as resource-intensive diligence and the inherent risks of newer platforms - they can also offer compelling opportunities for LPs. By investing in emerging managers, LPs can gain early access to future top-tier firms, benefit from potentially differentiated returns, and capitalize on strong alignment and enhanced economics. However, careful evaluation is essential, particularly in assessing performance attribution, team dynamics, institutional readiness, and fund management capabilities. When approached strategically, allocating to emerging managers can be a valuable component of a diversified private equity program, offering both risk and reward for those willing to invest in the potential next generation of market leaders.



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