ABBOTT CAPITAL

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 FOR 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. Part I of this series focused on some of the potential benefits and challenges of investing in emerging managers from our perspective as an LP. This installment provides our guidance for GPs on some of the important aspects of firm-building, including:

- Fundraising considerations for emerging managers
- LP/GP relationship-building considerations

Fundraising considerations for emerging managers

As discussed in Part I, building a private equity firm from scratch can be a grueling task. Even the most talented investor may find themselves challenged by the responsibilities of setting up shop, including talent acquisition, implementing operational and compliance management, and raising capital. In terms of fundraising, we value managers who have taken a strategic approach to their fund's target size and limited partner universe, believing it will be additive to the fund's (and firm's) overall success.

Target fund size:

Before the fundraising process even begins, a GP should have a clear understanding of how much capital they will be comfortable investing, irrespective of how much LP demand the manager might have. Setting the right target fund size with respect to the investment strategy, based on the perceived depth of the GP's deal pipeline and the execution fire power of the team, can be crucial to the future success of an emerging GP. A fund sized too small may result in a lack of diversification and increased risk of underperformance, making each individual deal even more critical in a context where every investment counts. Conversely, a fund that is too large might face challenges in deploying capital. Even with a more measured fund size, by being mindful of recycling opportunities

and carefully managing the fund's reserves, a GP may be able to put a greater percentage of investor capital to work in deals, which ideally will have a positive effect on ultimate performance.

LP base:

Seeking experienced and cycle-tested limited partners can offer many advantages, including a potentially higher retention rate for future fundraises. In addition, from a strategic standpoint, securing a few strong and respected LP names can go a long way toward brand-building as these investors may have the ability to draw on their long tenure in private equity to provide valuable strategic feedback and advice. An investor base comprised of a diversified mix of seasoned, sophisticated investors will ideally be available to offer support and guidance throughout a GP's lifecycle, as well as introductions to fellow LPs in search of emerging manager exposure.

The "institutional mindset" that we discussed in Part I is not only a critical due diligence consideration for LPs, but also an argument for a GP to thoughtfully consider when LPs ask for highly preferential terms or large GP stakes. While certain LPs may offer a valuable strategic relationship in return, granting excessive economic concessions may hinder a GP's ability to allocate the necessary resources for sustainable growth and attract more opportunistic investors that may not be long-term oriented.

LP/GP relationship-building considerations

From first contact with a potential LP and throughout the life of a fund, there are several actions an emerging GP can take to help foster the relationship. Periodic updates are generally welcomed by prospective and existing LPs alike, as maintaining a dialogue in between fundraises allows investors to track and benchmark developments, thus putting the emerging GP in a stronger position when they commence raising of their next fund. In our experience, a long-term partnership often begins and is strengthened off-cycle when LPs have the ability to see how the organization and performance are developing, particularly when compared to the GP's initial projections or targets.

Embrace transparency:

During due diligence - Transparency is crucial to building a relationship based on trust and partnership. This first starts in diligence and the evaluation of GP's prior track record. In general, when a GP is in control and/or authorized to market their track records from their prior organizations, it is critical to disclose all of the attributable transactions. This includes accurately portraying a GP's role in value creation in an older investment, be it as a deal lead, board member, or general deal team member. LPs may conduct references throughout their own networks and trust and transparency concerns can increase significantly if an LP learns of any discrepancies.

Moreover, in select instances where a segment of the prior track record is not relevant to the go-forward strategy, including an explanation discussing the rationale for the exclusion can be valuable for those conducting diligence. Ideally, the criteria for excluding these deals would be fact-based, such as deal size, discontinued sector, etc. Including the performance of the excluded investments, even if separate, will then allow prospective LPs to evaluate an investor's complete historical track record.

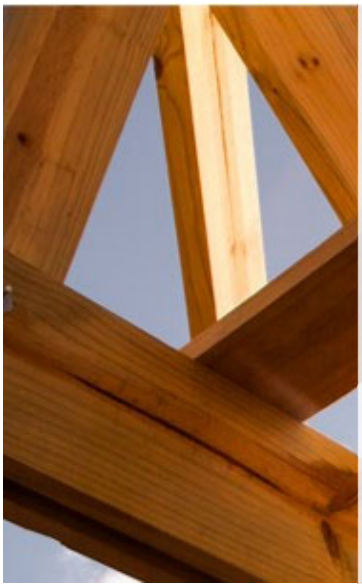
After the fundraising process - While it may be more difficult and uncomfortable to communicate negative news such as a team departure or portfolio underperformance, these situations and how a GP reacts to them can be critical inflection points in defining and cementing the LP/GP relationship. For example, downplaying or not addressing the departure of a colleague previously showcased as an important part of the story is likely to raise alarm bells for LPs, especially for an emerging manager who has less of a history of working together as a cohesive team. Proactively addressing any concerns can enable a GP to take control of the narrative and reassure potentially concerned LPs.

Engage in consistent communication:

It's important for a GP to determine, and adhere to, a cadence of communication beyond standard performance reporting. Supplementary communications include some combination of annual meetings, portfolio commentary and firm updates. A GP should not only be consistent with the amount of touch points, but the engagement style as well. Understanding LPs' communication needs and preference can add a more custom, personal touch to the relationship and help strengthen the LP relationship from the outset. An emerging manager firm, or any firm for that matter, can benefit from getting into the habit of maintaining an annual general meeting (AGM) and limited partner advisory committee (LPAC) meeting cadence early on, even if there's not much to discuss.

Conclusion

A successful partnership should be a two-way road, so finding the right fit between LP and the emerging GP is key to fostering mutual growth and success. Establishing a thoughtfully determined target fund and well-curated LP base, comprising experienced and respected investors, can not only provide capital but potentially invaluable strategic guidance. By engaging in consistent communication, embracing transparency, and establishing a partnership-oriented approach, GPs can build long-lasting relationships with their LPs that become the cornerstone of the firm's long-term success. Ultimately, the road to becoming a successful GP can be paved with challenges, but with the right mindset and strategies, an emerging manager can achieve their goal of build a resilient and thriving private equity firm.



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