Emerging managers: how to analyse a first time fund

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Chart One: US venture capital fundraising, new vs. follow-on funds, 2001-2004

Year	No. of New Funds	No. of Follow-on Funds	Total
2001	106	199	305
2002	57	107	164
2003	44	90	134
2004 YTD	33	92	125

Source: Thomson Venture Economics & National Venture Capital Association

Over the last several years, institutional investors have grown more interested in investing in private equity funds run by emerging managers. As evidence, a number of large institutions, such as CalPERS, CalSTRS and the Texas Teachers Retirement System, have all developed specific programmes targeted at the sector. Furthermore, a number of fund of funds managers, such as Parish Capital Advisors, have developed vehicles concentrated on such investments. The rationale for this interest varies from seeking access to early stage venture opportunities by targeting new managers who have room to accept allocations, or identifying attractive small middle-market firms active in fragmented markets, to literally 'finding the next Kleiner Perkins or Blackstone'.

The maturing of the private equity market has led to this phenomenon in two very different ways. First, a number of established private equity fund managers seeking to maintain a fund size consistent with their investment strategy – especially in the venture capital space – currently fundraise 'by appointment only'. They simply return to their established base of investors to determine appetite, and then go through an allocation process to choose those investors from whom they will accept commitments. The dynamic among buyout funds is somewhat different. As the general mergers and acquisition market has grown apace, the trend among successful buyout managers has been to grow their commitments steadily fund by fund. Most of them start as managers focused on buying middle -market companies and over a cycle of three to five funds become large buyout managers, operating in a very different environment. For investors seeking exposure to the middle-market – one that is more fragmented and more susceptible to tactics that can increase earnings at the company level – maintaining a significant allocation requires an almost constant review of newer and emerging managers to replace those who have outgrown the sector.

The maturing of the market has also led to emerging managers becoming a distinctive niche in an odd way: 25 years ago, all private equity managers were 'emerging' simply because there were no established managers. The Darwinian process of natural selection hadn't determined yet which fund manager groups would be successful, and for most fund managers an 'historical track record' did not exist. It is only with the maturity of the market that the concept of an 'Emerging Manager' finally makes sense.

And though emerging managers are a niche area of private equity investment, it is not a small area in terms of numbers of opportunities coming to market each year. As noted in Chart One, approximately 30% of the US venture capital funds that have come to market in each of the last four years have been first time funds – though it should be observed that their fundraising success has been chequered and quality has varied widely.

Key points in the analysis of emerging managers

The techniques of fund manager due diligence are similar across the various sectors or geographies of private equity. What can vary is the emphasis that needs to be placed on various factors in the investment analysis, and to a degree the skill set required of the investor reviewing fund managers.

The first criteria: the team

As with all areas of private equity, the fund management team is the most important factor in selecting an emerging manager. Most institutional investors are only interested in backing managers who have a demonstrated history of success as private equity investors. For fund managers, having individuals with significant attributable private equity track records as part of the team is crucial. Of course, a group that has a combination of private equity, operational, technical and investment banking skills is attractive, but the lack of a successful private equity track record – including realisations – makes an emerging manager much less credible.

Even with some sort of track record in place, the most difficult issue to diligence is the team dynamic and its impact on stability. For true first-time funds – where the team is coming together for the first time – this is especially key. Any fund of institutional size – roughly larger than $100 million or €100 million – is difficult to manage with a single person. A team of three or more senior investors is usually preferred. If the team does not work well together – if it in fact is not a cohesive team – it can fracture and put the fund and investors at risk.

Evaluating the team dynamic and potential team stability is an art rather than a science. It requires the experience of having performed due diligence on a large number of managers in the past. Key process items and areas of focus include:

- *Group and individual interviews*
  There is no substitute for meeting with the team extensively in order to develop a feeling for how well they will work together. How they interact with each other while being questioned on their investment strategy, their investment process and their personal relationships is a key check on how well they have considered these issues internally before starting the fund marketing process. Importantly, time needs to be spent both in group meetings and on a one-on-one basis with senior team members. Group sessions are important not only for what is said but also for body language – how they react to what the other is saying. This is important to help determine whether they agree on important issues, respect one another, and like one another – all important factors in weathering difficult times. One-on-one sessions are also key in determining whether they still espouse the basic tenets of the team when they are not presenting as part of the group and that the corporate culture of the team is truly engrained in its senior members.

- *Previous working relationships within the team*
  Besides interviews, of course, a review of previous working relationships amongst the team members is important. If the team is assembling for the first time, it is important to determine if they've worked together before – either on individual transactions while at other firms or even in other businesses before becoming involved in private equity. Personal social ties can also be important, though it must be noted that the tenor of those relationships is likely to be different from that in a high-pressure working environment. Last, it needs to be noted that even for team spinouts, drilling down in this area is important, especially if only a part of a group of investment professionals has left another organisation to form an emerging manager. Teams are not just collections of individuals, but rather a social grouping whose members play various roles dynamically interacting with other members of the group. When a subset of a group breaks off, the team dynamic can change dramatically – sometimes for better, sometimes for worse.

- *Internal firm economics*
  The internal division of carried interest and ownership shares of the fund management company are always important in determining team stability, whether with an established or an emerging manager. A large disparity in the distribution of carry amongst senior investment professionals often leads to dissension and turnover – and the structure of most private equity funds is not usually geared toward a single individual dominating the investment and company oversight process in a diverse portfolio of investments. Ownership positions in the management company not only drive certain economics, but also affect the ability of individuals to share in the direction of the firm, helping to build commitment to the team.

Emerging managers: a definition

There is no one definition of an emerging manager. Different investors apply different criteria. However, the four classifications below broadly cover the sector:

- **First time fund, first time investors**
  In this case, a group of professionals looks to form an investment vehicle with a senior team that does not include a single individual with significant private equity experience. Fundraising for these groups is often very difficult; and often these groups actually fail to raise a fund.

- **First time fund, experienced investor team**
  In this case, a group of professionals who individually have extensive private equity experience, but have limited experience working together, form a fund. Groups like this would include the first funds of Fox Paine and Shasta Ventures.

- **Team spinouts**
  In this instance, a team of professionals who have worked together within a fund manager decide to spin out and form a separate firm. Examples include: Triton Partners spinning out from Doughty Hanson; Alta Partners, Alta Communications and Polaris all spinning out of Burr, Egan, Deleage; the recent creation of Diamond Castle by senior professionals from DLJ Merchant Banking; and the founding of Exponent by senior team members from 3i.

- **First institutional fund**
  Since the process of raising a first time fund is very difficult, many fund managers start the process differently – by raising money on a deal-by-deal basis or creating a fund with significant support from government programs (such as the SBIC program in the US) or financial institution sponsors. These groups then approach the broader institutional market with a follow-on fund, but have at that point had a chance to prove their investment ability, their access to quality deal flow, and their strength as a cohesive team. Fund managers who started in this manner include Littlejohn & Company, W Capital and KRG.

Track record and attribution

Even with emerging mangers, few investors are willing to back groups unless they have an attributable track record of successful private equity investing. However, the process of vetting such a track record for an emerging manager can be much more difficult. Gaining access to information and being able to verify it is a greater challenge, and often requires review of such issues as the following:

- *Attribution letters*
  Emerging managers with a track record have usually gained that experience while working for a more established firm. Since private equity investing is a collaborative effort, it is often difficult to sort out responsibility for individual transactions and the issue can be very contentious. It is becoming more common for private equity professionals to negotiate an 'attribution letter' when leaving a firm that details the roles they played on various investments, as well as the carrying value on those investments at the time of their departure.

  Attribution letters are most often very detailed, highlighting the specific roles that a professional played in sourcing an investment, undertaking due diligence, negotiating purchase price, overseeing the investment and serving on the company's Board of Directors, or directing the exit of an investment. It may also identify other individuals also active in those roles.

  An attribution letter is a helpful tool in analysing an individual's track record and can also be helpful to the firm offering the letter, as it usually eliminates a future fund raise problem: that of having a competing vehicle in the market claiming full attribution for investments that are part of its track record as well. In the absence of such a letter or a formal agreement between the parties, the normal process of reference checking can become contentious and mutually harmful.

- *'Cherry picking,' or what is left out*
  One aspect of attribution letters that is most beneficial to an investor doing due diligence is that it tends to eliminate 'cherry picking'; that is, having a fund manager construct a track record just from his successful transactions while failing to mention investments that faltered. In negotiating an attribution letter, a fund manager's former firm has no reason to hide transactions that haven't gone well, and in fact would be better off if it can clearly identify transactions that underperformed that were the responsibility of someone who is no longer with the firm.

  Ironically, it is often more difficult to identify poorly performing investments that a fund manager leaves off his record than it is to verify successful deals that are included. An attribution letter often levels that playing field.

- *Company executive reference checks*
  Reference checks are always an important part of any due diligence. For emerging managers, references are critical. Most investors are looking to back fund managers who bring more than money to the table and can add value by providing advice and guidance to company management. The individuals who are in the best position to give crucial feedback in this area are company Chief Executive Officers and Chief Financial Officers. Dialog with such referees is especially important when competing individuals claim key roles in driving the investment performance of the companies that they ran.

- *Imputed fund structures*
  A key part of the due diligence process for many investors is benchmarking track record performance. The most common method of doing this is Vintage Year Comparison – comparing the performance of a fund manager to other funds with similar strategies investing over a similar time frame in a similar market environment. For many first time managers, this sort of analysis requires combining investment track records from a number of different individuals in order to create synthetic imputed fund structures.

While this is a useful piece of analysis, investors have to be careful when using the data. The selection of which transactions go into which imputed fund can dramatically affect the vintage year comparisons. The inclusion of deals in the track record that are not on strategy for the new fund effort (for example, including venture capital transactions in track record for a new fund focused on buyouts, or vice versa) can also distort the results and dilute the effectiveness of the tool.

Deal flow

One of the reasons that fund vehicles were created in the first place was to help professional investors generate and maintain deal flow. Company executives looking to start or sell their company want to know that, once they decide whom they want to work with, that team has cash immediately available to execute a transaction. First time funds or spinouts are in the awkward position of trying to generate deal flow so that they can begin investing as soon as possible, while simultaneously dealing with the fact that, if things move too quickly, they won't have the cash available to make the investment.

In addition, it is often difficult to determine whether the individuals or the team spinning out to form an emerging manager were truly responsible for generating deal flow, or whether others in their previous organisations were responsible. Attribution letters and company executive references are helpful in this process, but other areas also need to be reviewed:

- *Deal pipeline*
  The primary focus of a first time fund manager is fundraising to obtain commitments from investors. Otherwise the fund won't exist. Close behind that priority, however, is striking the delicate balance of generating deal flow for the fund, as investors will want to see money invested soon after the fund closes. Fund managers typically maintain a preliminary deal pipeline report covering opportunities that they are tracking, even in the early steps of fundraising.

- *Deal-by-deal funding*
  In certain instances, fund managers make arrangements with other financial institutions to fund transactions that must be completed before they have a fund closing. This can involve either a long period of deal-by-deal activity to prove the ability of a team to work well together – sometimes a GP can operate on such a basis for years. In other instances, this can involve a more interim arrangement that takes place during the fundraising process, sometimes with the investments being targeted for transfer into the fund when a closing occurs. In any case, these transactions go far to prove the deal flow credentials of the fund manager.

Critical mass

For emerging managers, launching a first time fund involves a major commitment of time, effort, and cash. Without an existing fund in place to cover expenses and salaries, fund managers must be prepared to finance the expenses of running a new business from their personal resources. In order to limit up-front cash requirements, most funds are launched with a core team of senior investment professionals, but very often without junior investment staff, administrative staff, and back office personnel. In reviewing such an opportunity, what constitutes critical mass?

- *Senior investment professional commitment*
  Before a fund can be launched, a senior team of typically three to five professionals needs to be fully committed to the fund and not working with another party. (The exact number is dependent upon the both the total amount of money targeted to be raised and the fund strategy). This team will be the core group devoted to investing the fund and whose track records will be the drivers of the imputed track record of the fund. A team of this size provides the minimal levels of cross coverage, support, and investment acumen required to oversee an institutional quality private equity fund. In addition, the senior team (unlike more junior staff) should have more financial resources in place to take the entrepreneurial risk of living without a salary.

Sponsored funds: a special case

Creating a first-time private equity fund is a difficult process as noted elsewhere in this chapter. Some of the risks that the fund manager runs can be mitigated by finding a sponsor that can provide both working capital and a significant commitment to the fund. The arrangement is usually meant to allow the fund manager to staff up more quickly, to provide an initial pool of cash that can be used to prove deal flow by executing transactions while fundraising, and to provide momentum to the fundraising process itself through an early close. When the sponsor is a financial institution, it is often argued that the sponsor may bring other assets to the arrangement, such as access to deal flow or due diligence insight.

Sponsorship, however, is usually a mixed blessing, both for the fund manager and other potential investors, for several reasons:

- **Sharing of carry**
  Most sponsor relationships, especially in situations where operating capital is provided, require that the fund manager share a portion of the carried interest generated by the fund. Shared carried interest payments often range between 25% and 50% of the total carry available. The basic problem with this is that the higher the amount paid away, the lower the amount available for incentive payments to professional staff at the fund manager responsible for generating returns. Without proper incentives, of course, team stability is an issue, especially for investors who are looking for a strong team that they can back across several potential future funds.

  In addition, in certain instances portions of the management fee are paid over to the sponsor or, in extreme cases, the entire management fee is paid to the sponsor, who in turn pays fund management personnel a salary.

- **Control of the fund management company**
  The last example of management fee splits noted above usually occurs when the sponsor has a controlling position in the management company of the fund – which exists as a separate legal entity from the fund itself, but oversees management of the fund. There are various issues raised by control of the management company, but the largest is the

potential ability of the sponsor to fire members of the fund manager. This can be especially troubling when the interests of other investors and the sponsor diverge.

- **Investment Committee participation**
  In certain instances, sponsors require formal participation in the fund's Investment Committee. Though rarely making up a majority of the Committee, the participation both raises the spectre of potential conflicts of interest between the sponsor and other investors, and requires additional due diligence by investors on the sponsor's role in the decision making process.

- **Investment size, influence, and potential conflicts of interest**
  Even in situations where the sponsor does not have an economic stake in the fund or the management company, and does not have an active stated role in managing the fund, other investors may perceive the potential for conflicts of interest if the commitment amount of the sponsor is very large. On a de facto basis, a commitment equal to 25% or more of the fund often begins to raise questions in investor's minds.

As the result of all these factors, most sponsorship arrangements raise as many issues as they are meant to address. An investor performing due diligence on a sponsored fund needs to pay particular attention to the agreement between the fund manager and the sponsor and the economic and governance issues that can arise from such an arrangement.

From time to time, one or two individuals will try to raise a fund on the basis of promising that they will add unspecified senior individuals to the team once they have had a first close. Most institutional investors decline these opportunities saying 'If these individuals haven't committed to the fund, why should I?'

- *Action plan after a first close*
  Though a complete organisation does not need to be in place when a fund is launched, the team needs to have a well-thought plan of action for the hiring steps they will take once they have a first close. They should have identified the type and number of people they will need to add over their first year of operations and should have a number of specific candidates identified for these positions.

  For first time funds and spinouts, there may be legal agreements in place that limit the hiring of junior staff from a previous employer or employers. This may limit their ability to build out an organisation totally with staff that they have worked with most recently. Investors should also review their past ability to build out an organisation from scratch.

- *Back office staffing and reporting*
  Back office staffing and reporting are worth special mention. Investors today are finding prompt, accurate reporting of substantial information more and more important. For most emerging managers launching a fund, this is the area of least concern as the fund first has to be raised and then the first investments have to be made before reporting to investors takes place. However, setting up the process correctly at the start and installing a culture focused on 'investor friendly' reporting is a differentiating factor in due diligence and offers investors confidence that reporting won't be an issue in the future.

  The most significant event in this area is the fund's selection of the Chief Financial Officer. An individual with previous experience working for a reputable private equity fund is the most sought after choice here. Adding such an individual either as part of the core group or as one of the first hires after the fund's first close demonstrates the importance placed on the area.

Summary

Performing due diligence on an emerging manager requires analysis similar to any other private equity due diligence. What is different, however, are several key qualitative factors that are more difficult to judge. Analysing the team dynamic of a group that has not worked together before, for example, requires significant experience in private equity due diligence that is not easy to teach. Pattern recognition is required; an art that is developed in an apprentice-like fashion by participating in many due diligences and seeing how the story presented during the fundraising process plays out in reality, generally over many years.

While the task is difficult, it can also be rewarding. Those emerging managers with the combination of the correct skill set, the correct focus, and the correct team dynamic can emerge into sustainable top quartile managers, and their early funds – where they are hungriest to demonstrate their abilities – are often superior performers.

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