

An LP's Perspective ~ The Small and Emerging Manager Opportunity

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Fundraising across the private equity asset class has been especially robust in the last few years, leading to a supply and demand dynamic heavily in favor of GPs. Given the increased LP appetite for private equity (and thus the amount of capital targeting the space), blue chip private equity firms can be very selective with respect to whom they bring on as investors. The excess capital being turned away, either for capacity reasons or FOIA issues, has trickled down to the small and emerging manager ("SEM") market, which has recently experienced significant investor demand.

Drivers of the Opportunity

Driving the focus on this market segment is an increasingly competitive environment among larger, more established funds. As the market for larger managers and transactions becomes increasingly efficient, the return profile becomes potentially less attractive. For instance, smaller capitalized funds have outperformed larger funds over the past 10, 15 and 20-year time horizons. Such performance is likely to continue due to attractive market fundamentals at the smaller end of the private equity market, which is more fragmented, offering favorable entry multiples, greater opportunity for multiple expansion and consolidation as well as more exit opportunities.

For example, buyout purchase price multiples have increased as a whole over the last five years, but have remained relatively constant at the lower end of the middle market. Entry multiples for companies \$250 million or less have moved from 5.8x to 6.6x during the 2001-2004 time frame. Corresponding entry multiples for companies \$500 million or greater range from 6.3x to 7.4x. In addition, annual M&A exit volume has been consistently robust at the lower end of the middle market, outpacing the average volume of larger targets by over \$30 million from 2001-2004.

This combination of factors has led many seasoned investment professionals to refocus on their original successes, venturing out on their own or in smaller groups to raise smaller funds.

Investment Thesis

From an LP perspective, the SEM market will remain a compelling investment opportunity for a number of reasons. With respect to diversification, emerging funds give investors an ability to more clearly target a given sector, strategy or geography. For instance, SEM funds increasingly focus on emerging geographies (e.g., the Southwest, Pacific Northwest) and sectors (e.g., energy, nanotechnology) virtually ignored by more established funds.

Investing in SEMs also provides an opportunity to develop a relationship with a manager early, which helps to gain a meaningful allocation to the current and possible future funds. This has become an increasingly important issue, particularly in the venture capital space, as LPs seek larger bite sizes in an effort to put more capital to work.

In addition, SEMs often have a better alignment of interests with LPs given that they have more to gain from the success of their initial funds. For example, management fees typically cover expenses, as opposed to being utilized as a profit center. SEMs are also more willing to accommodate financial and structuring arrangements than their more established brethren.

Evaluation of a SEM

Due diligence on a SEM often requires a savvier LP perspective to evaluate issues more commonly associated with emerging groups than with more established managers. Some topics for consideration include the following:

- ▶ *Limited track record* – SEMs may have limited private equity investment experience in terms of capital invested, capital realized and maturity of portfolio companies. An institutional investor needs the resources and capabilities to independently analyze an SEM's prior performance including the professionals' operating experience, value generation through board participation and roles in deal sourcing, execution and exit.
- ▶ *Deal attribution* – An SEMs actual contribution to various investment activities may often be difficult to determine. An institutional investor should conduct an extensive independent reference calling effort to confirm the manager's involvement in investment activities and validate each professional's ability to operate outside of an established private equity franchise.
- ▶ *Lack of institutional investment experience* – While SEMs are generally well-versed with the scientific, technological and operational aspects of companies, they may not have experience managing third party institutional capital. Consequently, they may have a limited understanding of the LP community, as well as legal terms and conditions. An institutional investor should utilize its expertise to ensure that the partnership is managed to institutional quality standards.
- ▶ *Limited experience working as a team* – The investment professionals of SEMs may not have had substantial experience making investments as a collective group. An institutional investor must analyze the level of collaboration, common prior experience (e.g., co-investments, industry/educational organizations) and commitment of the principals.

Despite the demand for SEM funds, the fundraising hurdle for new firms continues to be high as institutional LPs require that emerging managers come with a pedigree and a historical track record of success within their stated strategy. Expect the SEM space to continue to be a compelling investment option for LPs going forward.

Sources:

National Venture Capital Association
Standard & Poor's M&A Statistics
SDC Platinum, a Thomson Financial company
Thomson Venture Economics, a Thomson Financial company