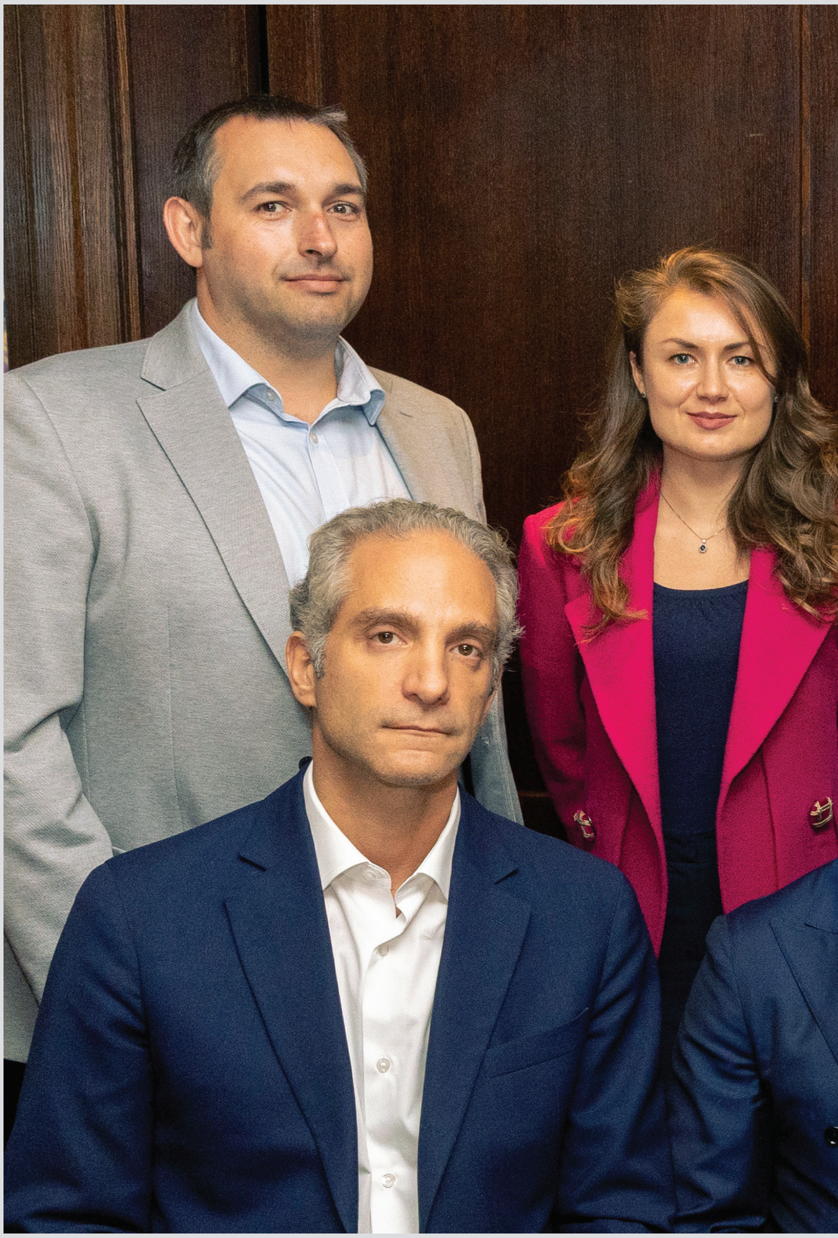
STANDING TALL

Industry experts gathered to discuss how emerging managers can succeed despite a difficult fundraising environment



From left: Ryan Taylor, Jean-Marc Jabre, Eleanor Blagbrough, Nicolo Miscioscia,

AT THE TABLE

Roxana Mirica
Apax

Paul Newsome
Unigestion

Joanna Ernst
Frog Capital

Eleanor Blagbrough
Blume Equity

Nicolo Miscioscia
Decalia

Jean-Marc Jabre
Capital D

Mark Vidamour
Suntera

Ryan Taylor
Suntera

Moderated by
Taku Dzimwasha
Editor, Real Deals

Launching a new fund during the current challenging fundraising environment might seem like an impossible task. However, some managers are bucking the trend with a variety of unconventional strategies and innovative approaches. In this exclusive roundtable, industry experts come together to delve into the strategies that prove effective and those that fall short.

What are the current challenges and headwinds you're seeing that are affecting emerging fund managers in this tough environment?
Eleanor Blagbrough: Fundraising is tough right now, especially for first-time funds. Differentiating your strategy is crucial. At Blume, we're focused on climatetech. Some institutional investors in Europe are reallocating toward climate, which helps funds focus on that theme.

Joanna Ernst: I agree. It's challenging enough to raise a fund and convince LPs to take a chance on you in any market environment, but to convince LPs to take a chance in the current environment requires some clear differentiation. In the decade leading up to 2022, a record amount was raised in private markets, but we've seen that pace of growth slow considerably, leaving us in the most competitive market for new capital I have seen since the global financial crisis (GFC).

It's also a crowded market – many established funds are raising and many funds are staying open for longer, all making it more challenging for funds to differentiate themselves and attract investors. This is also harder in the current market when LPs haven't been getting any distributions, and as we have seen in the cases of some investors, the denominator effect has led to reduced allocations.

So, given the bigger picture, we've seen LPs want to derisk; they want to see sustained outperformance, which is harder of course for an emerging manager to demonstrate.

Jean-Marc Jabre: You need to have a clear and compelling reason to exist. With thousands of private equity firms in the market, LPs have a vast array of options to choose from, especially considering the numerous re-ups they need to manage. To stand out and gain LPs' attention, you must be relevant.

One way to be relevant is by aligning with current market trends. For instance, the field of climatetech is currently topical. Similarly, our focus is disruptive companies, which makes Capital D of interest to investors. Investors are eager to gain exposure to climate-related investments, making it a prime opportunity for an emerging manager.

Having some form of incentive based on warehouse facility transactions can make committing to a dry pool more appealing. It's more challenging to commit upfront when there isn't an existing seed asset that people can get involved with from the start.

Nicolo Miscioscia: We view managers primarily as entrepreneurs. These managers must identify the right talent, secure working capital, address data and warehousing challenges, formulate a strategic approach, handle branding concerns, and more – responsibilities akin to those of any entrepreneur. The managers we support have not only proven that their competence sets them apart but also that they possess the capability to establish a sustainable company.

One of the most significant risks is whether the manager and his or her team will endure for a decade as a firm. This requires having the right capital, the right incentive schemes, being able to retain their people, and so forth. These elements are of paramount importance for any emerging fund manager, beyond any short-term cycle considerations.

Mark Vidamour: Just to follow on from the point about emerging managers essentially being entrepreneurs. What we've observed, especially in emerging managers, is that individuals transitioning from larger management organisations often face challenges in setting up the necessary infrastructure for their own firms. This can divert their attention from their core strengths, which are in investing and successfully securing deals. We've supported a few emerging managers, with advice in respect of what their back-office functions need to be achieving, to assist them with their establishment. This allows them to focus on what they do well – investing.

As a service provider, are you noticing any particular trends that emerging managers are

Photography by **Rolfe Markham**

Mark Vidamour, Ian Horsewell, Paul Newsome, Joanna Ernst, Roxana Mirica, Taku Dzimwasha (Real Deals)

adopting to establish themselves?
Ryan Taylor: What's particularly interesting, and aligns with our observations of the managers we've been collaborating with during the past 18 months, is their response to rising interest rates. In light of these changes, there's a growing desire in the market to exercise more control and transparency. Many managers have shifted from the blind pool model to a deal-by-deal transactional approach. They are now favouring capital raises over debt raises, which do not appear as attractive given the double-digit interest rates some are encountering, especially in the context of private credit.

Consequently, managers are exploring alternative fundraising methods. This includes considering online platforms, not only for secondary trading but also for transferring interests. Some partners may want to exit their positions earlier than usual. Additionally, they are exploring digital placement agency platforms. We've noticed the emergence of fintech firms offering solutions to assist managers and LPs in utilising these platforms, which is especially beneficial for emerging managers dealing with smaller ticket sizes.

Roxana Mirica: I'd like to pick up on the point on private credit. With the rise in interest rates, we have noticed a clear shift among the largest asset managers that are deploying capital into private credit. However, it's important to note that the private credit market is still in its early stages of development. What we often see is that large asset managers have limited pools of capital to allocate. As a result, they may opt for well-established firms, believing it's a safer choice, despite earlier vintages yielding decent but not exceptional returns.

This situation resembles the journey private equity went through years ago. The challenge is to not become just another player in what's currently a relatively crowded market. Instead, emerging managers need to define their USP.

Investors question why they should invest in an emerging manager rather than an established firm. Thus, ongoing education is essential. It may take a few years for large asset managers to fully comprehend the nuances of this market and appreciate the value of a diversified landscape, rather than concentrating their investments on a handful of major managers.

It's obviously a tough fundraising environment for various reasons. What is your assessment of the landscape for emerging managers?
Paul Newsome: I believe we should consider the current environment from a 'glass half full' perspective. The present situation can be seen as positive in several ways. Firstly, the lack of fundraising has been depleting the excess dry powder that existed three years ago across all market levels, including the smaller end. Now, those who secure capital in the midmarket and lower midmarket segments, particularly emerging managers, have a distinct advantage and can make excellent investments at attractive valuations. So, even if managers aiming for $200m only raise $100m, it's still a success. Those unable to close a fund can proceed deal by deal, which is also a viable approach. In this environment, there are ample opportunities for those who have capital.

Additionally, from our standpoint, this environment benefits us, as it allows us to negotiate better terms and there are more opportunities for us to co-invest in attractive deals. From the perspective of emerging managers, it's a healthy situation, marked by a natural selection process where only those managers with a clear and compelling value proposition can raise capital.

What strategies can emerging managers use to successfully raise capital for their first-time private equity funds? Any unconventional strategies in fund structuring, fee arrangements, or investment approaches that have been successful in capturing investor interest?

Jabre: Whether you're an emerging manager or managing a fund in its seventh iteration, investors always appreciate more favourable economics. For example, offering an early-bird discount on fees and providing priority access to co-investment opportunities are common practices. Some funds also address working capital and bootstrap issues by securing a significant commitment from an anchor investor in exchange for a stake in the GP. This is particularly common, with buyout clauses in place to regain full independence down the road. Additionally, you can contribute seed assets through either a warehouse facility or by structuring individual deals, making it possible to incorporate some of these assets into the fund at the time of closing.

Miscioscia: Offering investors to participate in deal-by-deal arrangements can be highly advantageous for several reasons. One compelling factor is the opportunity it provides to investors for thorough due diligence, ensuring transparency and trust throughout the process. Moreover, there are multiple elements to consider in this approach. Firstly, it enables investors to underwrite each deal individually, mitigating blind pool risks and tailoring their investment strategy. It also showcases the ability of the manager to assemble and lead an investment syndicate, proving execution capabilities.

This, in turn, ticks essential boxes for investors, demonstrating a capacity to deliver results. Furthermore, structuring favourable fund fee arrangements and offering co-investment rights alongside a fund investment with preferential terms at the outset are typically compelling incentives. Moreover, it's worth noting that organisations like the European Investment Fund and development finance institutions can be valuable partners for first-time fundraisers, providing essential support and resources in building trust and credibility. At Decalia, we specialise in partnering with emerging managers with capital and operational support, exactly to help overcome these initial challenges and provide guidance on the best solutions.

Newsome: We also consider a few other aspects that we may negotiate. For instance, we are big fans of short-duration funds, which have a two-year investment period. These funds are positioned somewhere between a deal-by-deal approach and a full fund. This approach provides us with improved visibility regarding portfolio creation, shortens the J-curve, and enhances the overall total expense ratio (TER). Another feature we like is tiered carry. For example, the initial carry could be 10% over an 8% hurdle rate, and then it could increase to 15% over a 15% hurdle rate, and finally 20% over say a 25% hurdle rate. This structure promotes outperformance and further reduces the TER for investors. In addition to co-investment agreements, we sometimes negotiate an overflow pool that runs in parallel to the fund, on a no-fee, no-carry basis. Such a setup would allow more discretion and certainty for the manager than straight co-investments.

Miscioscia: When it comes to discounts and GP-stake sales, it's a somewhat delicate matter. On one hand, as an emerging manager, there's a strong incentive to pursue these options. However, there's also a significant risk that the team may not survive. If you remove economic incentives, people can't sustain themselves. On the other hand, as a backer of an emerging manager, you naturally desire special terms, given your unique position. So, investors bear the responsibility to find and propose the right balance.

Mirica: Speaking about fee structures, there was a notable example of an established credit manager launching their first fund in a new market with a zero management fee structure. This move demonstrated the challenge of competing in a saturated market. However, the question at hand is whether it's possible to initiate a first-time fund with reduced fees and then later transition to a more standard market rate. How will investors react to such a move?

Taylor: Over the years, we've observed that emerging managers are often willing to accept a 1% management fee for their first $50m, as opposed to the standard 2%. However, as they raise additional capital, say another $30m, they face challenges in generating sufficient income. This can lead them to consider selling stakes in the GP to secure additional operating cash.

In my opinion, it's crucial for your GP fee to be aligned with your capital raise and costs. This fee serves to cover operational expenses and maintain the day-to-day operations. Your source of profit as a GP should come from the carried interest, while the GP fee covers ongoing expenditure. Striking the right balance can be tricky for emerging managers, particularly when they are in

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