THINK AGAIN: BUSTING THE EMERGING MANAGERS MYTHS

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Overview

Emerging managers, those who are launching their first or second funds, are often viewed sceptically by investors. They are perceived as risky due to their limited track record as a team, smaller AUM and lack of institutional backing. Instead of relying on preconceived notions, investors should assess both hard facts, such as performance data and strategy, and soft factors like team experience, agility, innovation and alignment of interests. By looking beyond the myths, a more nuanced and informed perspective can help LPs answer the billion-dollar question: "Are emerging managers worth the risk?"

While, as with any private equity investment, risks do exist, emerging managers give access to highly attractive opportunities that are often unavailable through larger, established managers. At Unigestion, we have been investing alongside emerging managers for 30 years. During these past three decades we have learned how to take most of the risk of investing in emerging managers off the table. Our recipe is not as spicy as one would think.

Myth number 1

"Investing in an emerging manager is risky"

Myth busted: not true - but investment experience matters

The term "emerging manager" in private equity is a misnomer. Rather than inexperienced newcomers, these managers are typically seasoned private equity professionals with 15-20 years of industry experience who have decided to establish their own firms. Their deep expertise and proven track records make them well-equipped to launch and manage successful investment vehicles. They often bring a distinctive approach to deal-making, and typically employ less leverage in their transactions, as Figure 1 below illustrates, favouring a more conservative capital structure that can better weather market volatility. This approach reflects both their experienced perspective on risk management and their heightened focus on preserving capital.

A key characteristic of these funds is their focus on specific sectors. The founding partners of these firms usually launch funds in industries where they have accumulated deep expertise throughout their careers. This specialised knowledge allows them to identify overlooked opportunities and create value through operational improvements rather than financial engineering alone.

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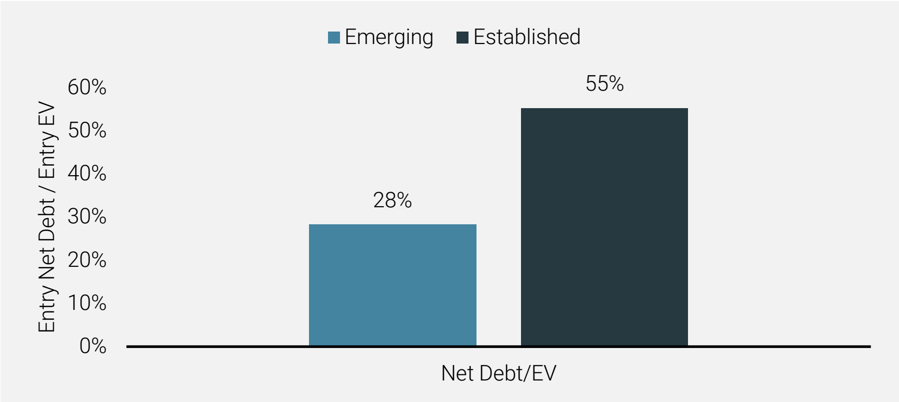
Key Points

1. Emerging managers can outperform established managers with the same level of risk
2. Emerging managers create value differently and rely less on leverage and multiple arbitrage
3. Allocating to emerging managers as a category can offer attractive risk-adjusted returns for investors

Figure 1: Leverage ratio at entry: emerging vs. established managers



Source: Unigestion. The dataset includes 2,654 realized and unrealized transactions closed between 2000 and 2024

For the founding partners, launching their own fund represents a career-defining opportunity. Unlike established firms where partners might have multiple career options, these entrepreneurs are fully committed to their fund's success. There is no Plan B. This commitment is further demonstrated through significant personal financial investment: founding partners typically commit 5% - 10% of the fund size from their own capital - and in some cases, even more. This level of personal investment means their wealth is heavily concentrated in the fund's success, creating a powerful alignment of interest with their limited partners.

Early investors in these funds often have the opportunity to negotiate preferential terms, which can include improved economics, co-investment rights, and greater transparency. This ability to secure advantageous terms can provide significant long-term benefits, especially if the manager goes on to raise larger subsequent funds.

In summary, the combination of experienced leadership, focused strategy, strong alignment of interests, and favorable economics creates a compelling opportunity for investors and can provide advantages in an increasingly competitive private equity landscape.

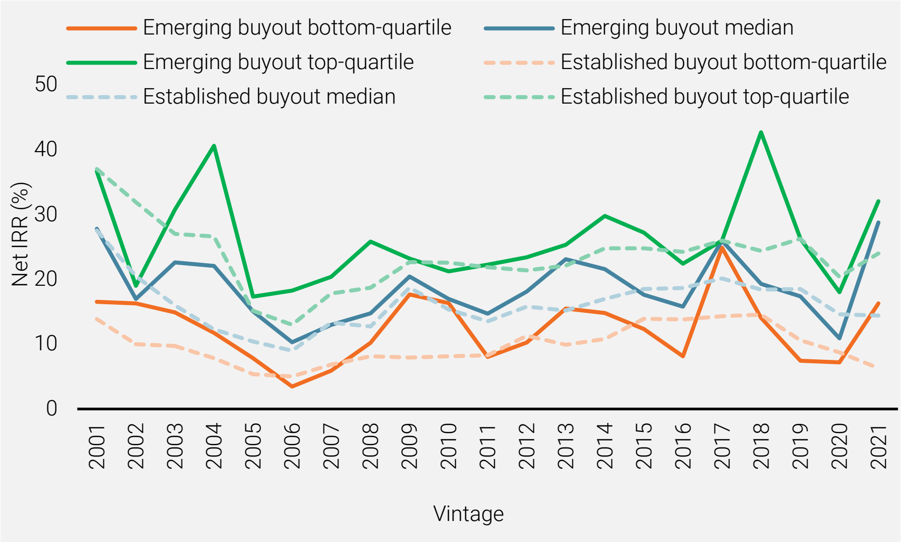
Myth number 2

“My established GPs can deliver similar outcomes with a lower dispersion of returns”

Myth busted: not true

Historical performance data reveals a compelling pattern: emerging buyout managers have consistently outperformed their established counterparts across the return spectrum according to Preqin data (Figure 2). This outperformance was evident not only in the upper quartile of returns but also notably in the lower quartile, suggesting that emerging managers as a category can offer attractive risk-adjusted returns for investors.

Figure 2: Emerging vs established buyout funds performance by vintage



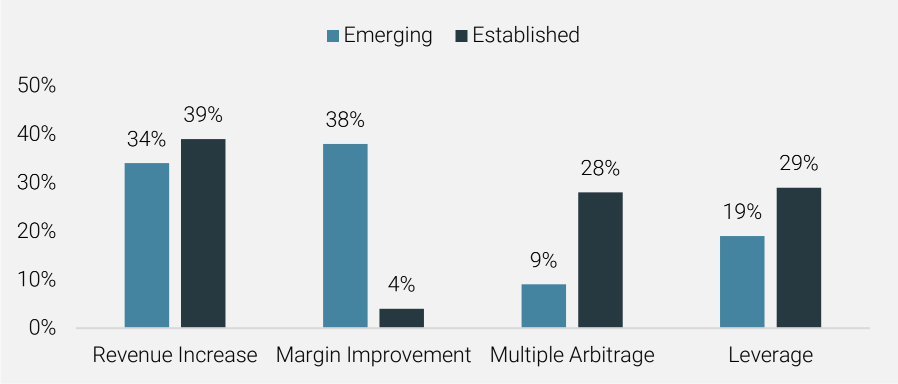
Source: Preqin as of 09.09.2024

The superior performance these funds demonstrated can be attributed to several structural advantages, with fund size being a crucial factor. Emerging managers typically raise smaller amounts of capital compared to established managers and tend to have more concentrated portfolios. With less capital to deploy and more time to create value, these managers can be highly selective in their deal choices, focusing only on the most promising opportunities that align perfectly with their investment thesis and expertise.

One of the most significant advantages emerging managers enjoy is the absence of legacy portfolio management obligations. Unlike established firms that must dedicate substantial resources to managing existing portfolio companies from prior funds, emerging managers can focus all of their attention and resources on identifying and executing new investments. This clean slate allows the investment team to be fully present in the current market. In addition, they are not constrained by historical investment strategies or outdated theses that may be less relevant in the current environment. This flexibility allows them to adapt their investment approach to present market conditions and take advantage of emerging opportunities that established managers might otherwise miss.

With a smaller number of portfolio companies, the investment team can provide more hands-on attention to each investment, potentially leading to more material operational improvements and value creation (Figure 3). The ability to dedicate significant time and resources to each portfolio company can be particularly valuable in challenging market conditions or when companies require substantial operational improvements.

Figure 3: Value creation breakdown emerging vs. established managers



Source: Unigestion. The dataset includes 2,654 realised and unrealised transactions closed between 2000 and 2024.

Myth number 3

"Lack of track record as a team is a deal killer"

Myth busted: not at all - but it is time-consuming to due diligence

While the absence of a fund-level track record is often cited as a concern when evaluating emerging managers, this factor alone should not be a show-stopper. In any case, LPs should be careful about interpreting track records. Recent research (Harris, Jenkinson, Kaplan, Stucke, 2023) [1], based on a dataset spanning over three decades and more than 2,300 funds, found that performance persistence in U.S. private equity funds has weakened over time, particularly after 2000. Allocating to emerging managers is not just a matter of diversification, it can also maximise the chance of finding a first quartile fund.

Partnership dynamics serve as a crucial foundation for fund success. This assessment begins with understanding the history of working relationships among partners, examining how their skill sets complement each other, and evaluating their defined roles within the organisation. Special attention should be paid to decision-making processes, as well as the alignment of team culture and values. Similarly, track record attribution requires a granular approach. This involves conducting detailed analyses of individual deal attribution, verifying team members' specific roles in previous transactions, and performing thorough reference checks with former colleagues and portfolio company CEOs. Understanding each partner's value-add contributions and reviewing historical investment committee materials provide crucial insights.

Team stability represents another critical dimension and requires careful examination. This includes analysing compensation structures, understanding the distribution of carried interest among team members, and assessing equity distribution within the firm. Additionally, evaluating promotion paths and talent development programs helps predict long-term team cohesion. Again, accurately assessing these factors and associated risks is critical in making informed investment decisions.

[1] Harris, R. S., Jenkinson, T., Kaplan, S. N., & Stucke, R. (2023). Has persistence persisted in private equity? Evidence from buyout and venture capital funds. *Journal of Corporate Finance*, 81, 102361. https://doi.org/10.1016/j.jcorpfin.2023.102361

For the investor, it's hard work: dozens of reference calls – most importantly the people not provided on the official reference list – are needed to get a 360-view on the founding partners and their past history. The key lies not just in the evaluation framework itself, but in the investor's ability to assess and select successful managers across these dimensions.

Myth number 4

"Emerging managers lack resource to attract top-talents and build the proper infrastructure to compete with established managers"

Myth busted: wrong!

It may be true that emerging managers typically lack the extensive resources available to established GPs, creating significant challenges across multiple operational dimensions. This resource gap may manifest in difficulties attracting and retaining top talent, building robust operational infrastructure, and achieving the level of institutionalisation investors increasingly expect.

However, several key elements mitigate these challenges. First, emerging managers should focus on attracting entrepreneurial talent deeply committed to building the organisation. These individuals should possess a founder's mentality rather than corporate thinking - professionals willing to weather uncertainty and contribute beyond their formal roles to ensure the fund's success and consequently reap the personal rewards.

Second, emerging managers can turn their smaller size into an advantage through greater agility and technological adaptability. By embracing innovative solutions that address operational requirements more efficiently and cost-effectively, emerging managers can build competitive infrastructure without massive capital investments from day one.

Finally, establishing a minimum fund size requirement serves as formal "insurance" against premature operational failure. This threshold ensures sufficient runway to develop track records and organisational capabilities before market pressures become existential threats. With adequate capitalisation, emerging managers can focus on performance rather than mere survival - ultimately creating sustainable investment platforms.

Myth number 5

"My career is at risk if an emerging manager investment ends up underperforming."

Myth busted: no – investing in emerging managers grants access to the key value drivers of the future

At first glance, investing in emerging managers might appear to present an asymmetric career risk for institutional investors. If the fund underperforms, one's judgment might be questioned more severely than when backing established managers. However, this perspective overlooks the substantial strategic advantages and future opportunities that come with being an early supporter of emerging managers.

Being an early investor in these funds provides unique insights into innovative value creation strategies. Emerging managers often bring fresh perspectives and novel approaches to deal-making and portfolio company management. This exposure keeps institutional investors at the forefront of evolving industry practices and emerging market opportunities, demonstrating strategic foresight rather than career risk.

The long-term benefits of early participation are particularly compelling when considering future access rights. Early investors typically secure priority allocation rights in subsequent funds, which can become increasingly valuable as the manager builds a successful track record and raises larger vehicles. These rights often include preferential co-investment opportunities, allowing investors to deploy additional capital alongside the manager on attractive terms.

Furthermore, early supporters have the opportunity to increase their allocation as the manager's track record develops. This scalability can be particularly valuable for institutional investors looking to build meaningful relationships with high-performing managers. The ability to grow alongside the manager from their first fund creates a strong foundation for a strategic partnership that can extend well beyond traditional limited partner relationships.

Perhaps most importantly, general partners never forget their first investors. This goodwill translates into tangible benefits throughout the relationship, from increased transparency and communication to preferential treatment in capacity-constrained situations. The loyalty factor should not be underestimated – managers often go to extraordinary lengths to ensure their early supporters are well-served, even as their platform grows and attracts larger institutional investors.

Rather than viewing first or second time funds as a career risk, supporting promising emerging managers should be seen as a demonstration of sophisticated investment judgment and long-term strategic thinking.

Key takeaways

Emerging managers, despite their label, are typically led by seasoned professionals with extensive industry experience. Their historical outperformance across return spectrums can be attributed to several advantages: smaller fund sizes enabling greater deal selectivity, absence of legacy portfolio obligations, and strong alignment of interests through significant personal investment.

The research data indicates that the potential rewards of investing with emerging managers can meaningfully outweigh the perceived risks associated with backing a new fund. While the lack of a fund-level track record may raise initial concerns, these can be effectively mitigated through a comprehensive evaluation of partnership dynamics, track record attribution, and team stability.

For institutional investors, backing these managers represents not just a compelling investment opportunity but a strategic advantage in securing valuable future rights and enduring partnerships.

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