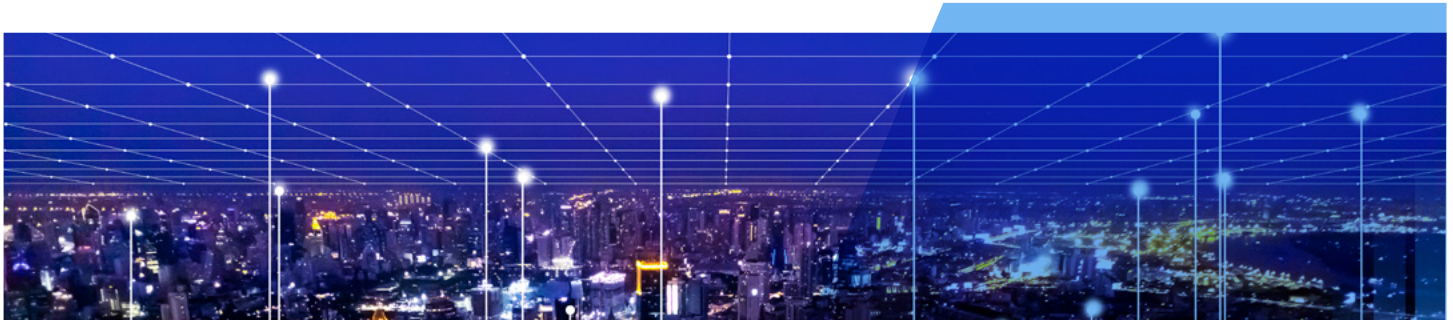


From Upstart to Titan: Why Emerging Managers Can Provide an Edge

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KEY TAKEAWAYS

- Teams spun out from established private market investment companies have the potential to identify opportunities in inefficient niches that might be overlooked by more established players
- Tracking emerging managers requires the same rigor and discipline as monitoring investment opportunities – an ad hoc approach isn't sufficient
- When it isn't feasible to invest in a manager's initial fund, it can still be worthwhile to follow an emerging manager with a view to supporting subsequent funds once they have demonstrated their strategy and capabilities

With a brace of Best Actor Oscars and about \$10 billion in global box office receipts, Tom Hanks is what Hollywood studio executives would call a bankable asset, someone who can be relied upon to create a return for the projects he works on.

Timothée Chalamet, on the other hand, while less accomplished, is a rising star with the potential to generate a bigger ROI from a blockbuster hit.

That's the calculus facing movie producers – dependable veteran or riskier shiny new thing.

It's also a question we get asked: do we stick with established General Partners (GP) with a solid, demonstrable, record, or do we also take a calculated risk on relative newcomers, emerging managers that are pursuing niche, overlooked, or specialized strategies, who look for opportunity in less efficient pockets of the market?

Early Support

While Adams Street turned 50 in 2022, we were once the scrappy upstart. And we laid the foundations of a global private markets investment business with more than \$50 billion in assets under management thanks in no small part to those who were willing to support us in those early days. By turn, we were also early supporters of several franchises that today could be considered establishment private equity players in the US, Europe, and Asia.

Investing in emerging managers is unlikely to work if it's treated as an ad hoc, sporadic endeavor. The information asymmetry around deal sourcing, investment alignment, and management style requires rigorous assessment. Gaining the necessary insights requires proactive monitoring and a disciplined approach to selection, since – by their very nature – emerging managers come with inherently different risk-return profiles.

Less experienced GPs often require more handholding as they develop the knowledge and skills needed to grow effectively. The greener the manager, the more likely that is to hold true.

Safest Option

A group of portfolio managers with a shared history may be the least risky route to take. We believe the best bets for first-time fund managers are often those that are created by a spinout of a team from another private equity firm.

An appraisal should try to get a handle on the team's motivation for setting out on their own. It should also consider the structure of the team, how it chooses and analyzes investments, conducts due diligence, and the backup systems and reporting capabilities in place. And while there should obviously be alignment on prior deals the team has completed, it can often be just as useful to know why they ultimately walked away from other opportunities.



Understanding team dynamics, key roles, and the working relationship, in addition to investment style and risk appetites, are essential precursors to any investment.

One risk, among others, is if the key principals only previously worked together in a looser, co-investment capacity while at different firms, or were colleagues in non-investment roles. Understanding team dynamics, key roles, and the working relationship, in addition to investment style and risk appetites, are essential precursors to any investment.

Most emerging managers that we work with have spun out from a franchise that we have an existing relationship with, or a portfolio manager that we track closely, giving us firsthand insight into the caliber and potential of the new entity.

But that doesn't make a new manager a shoe-in. While the record of a team of next-gen managers spun out from an established franchise may be excellent, in their new roles it may take some time for them to settle into a different pace of portfolio construction and fund management discipline.

Historical Interest

While a first-time fund from a high-caliber team spun out of a private equity company with a strong heritage can be worth exploring, a first-time manager with no attributable history can only be considered on a truly exceptional basis. One such exception might be where a team lacks an investment record but understands a sector intimately, has unique directional insights, strong business building experience, and the commercial acumen to pursue exits.

But we have found such situations to be quite rare.

When we have determined that we prefer not to invest in a manager's initial offering, it can still be worthwhile to keep a watch on those emerging managers with a view to supporting subsequent vintages. It can be exhilarating to see initial concerns alleviated over time as an emerging team demonstrates its strategy and capabilities. Some positive signals to watch for include a step up in fund size, scaling at the GP level, team expansion, and a strongly performing and diversified portfolio that closely aligns with the original investment thesis.

When we have chosen to invest instead in successor products we have typically done so in situations where we believe the risks we had previously identified – such as around depth and maturity of the opportunity set, history, governance protocols, and portfolio construction – have been mitigated to a degree we believe is acceptable.



Over the past five years alone, Adams Street has backed almost 150 emerging manager funds globally, which we would define as private equity or venture capital fund managers raising their initial three funds of \$1 billion or less.

Sometimes the decision for us to invest is just a question of time. Adams Street has kept a watchful eye on a number of managers who had strong records in their established prior firms but struggled to generate the same quality of deal flow in the early years of their new-found independence purely because of a lack of brand recognition in the marketplace. Missing out on some of those deal opportunities can obviously hinder the growth of a new enterprise.

Emerging funds take time to build and nurture, so that being accessible for multiple conversations and having a reputation for being a leader who can move quickly goes a long way. First-hand interactions via informal catch-ups and onsite meetings, along with an on-the-ground presence to build rapport with key professionals, also carry advantages.

Building Trust

Having experienced significant growth as a firm itself, Adams Street empathizes with those who aspire to be part of the next generation of leading private markets investment managers. Over the past five years alone, Adams Street has backed almost 150 emerging manager funds globally, which we would define as private equity or venture capital fund managers raising their initial three funds of \$1 billion or less. We are monitoring a further 300 or so, and some lessons we've learned along the way include:

- There is no substitute for the personal knowledge of founders and their prior record.
- While many teams look good on paper, working together in a high-stress, conviction-led business is easier said than done.
- While focus and experience are critical to successful outcomes for all investment managers, emerging managers must be able to demonstrate it yet again.
- Do not underestimate the fundraising risk or firm management aspects.
- Skin in the game and alignment of incentives is important but there is a balance to strike.



The focus at Adams Street is on finding exceptional companies operating in technology, health care, engineering and manufacturing, and changing consumer preferences sectors that we believe are positioned to benefit from change, dislocation, and growth.

As such, in our experience, an important building block for long-term success is working with emerging managers with differentiated views on the future of private markets investment. After all, at its core, the goal of private market investments is to discover tomorrow's titans – there's no reason that shouldn't include investment talent as well as innovative, disruptive companies. ■

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