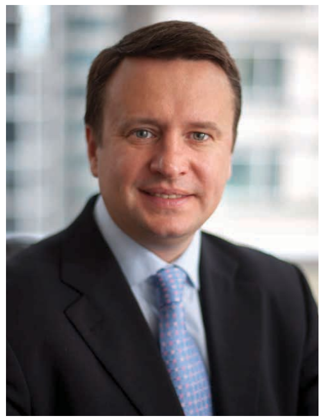
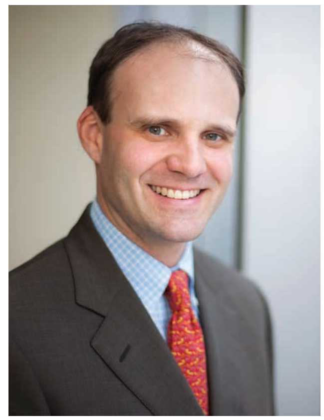
KEYNOTE INTERVIEW

From upstarts to titans

Emerging managers can provide an edge in pursuing niche, overlooked or special strategies, say Adams Street's Sunil Mishra, Sergey Sheshuryak and James Korczak

Q What criteria do you use to define an emerging partner?

Sunil Mishra: It's by no means a totally industry standard term, as each private equity manager and investor defines what qualifies as an emerging manager based on their own financial and operational parameters.

From an Adams Street perspective for this discussion, an emerging manager is a private equity or venture capital fund manager raising their initial three funds at $1 billion or less. Others may use different metrics – perhaps based on assets under management (AUM), or whether they have a diverse GP construct, for example. It is a bit subjective.

Q Why is it important to follow emerging managers?

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SM: In addition to working with established GPs who have a demonstrable record, it's also worthwhile taking a calculated risk on relative newcomers who are pursuing niche, overlooked or specialized strategies, and who look for opportunity in less efficient pockets of the market.

Adams Street is in its 51st year of operation, but we were once the scrappy upstart, too.

We couldn't have laid the foundations of a global private markets investment business with more than $54 billion in AUM without the backing of others in our early days. And we continued that tradition by being early supporters of several franchises that today could be considered establishment private equity players in the US, Europe and Asia.

So we empathize with those who aspire to be part of the next generation of leading private markets investment managers. In our experience, collaborating with emerging managers with differentiated views on the future of private markets investment is an important building block for long-term success.

Adams Street seeks to invest in exceptional companies in technology, healthcare, advanced manufacturing and changing consumer preferences sectors. These are businesses that we believe stand to benefit from long-term secular change, dislocation and growth – for example, from the digitization of the global economy. Our manager selection tends to follow this bias and often emerging managers are more focused on these disruptions. They are very likely tomorrow's titans. Over the past five years alone, we have backed almost 150 emerging manager funds globally, and are monitoring a further 300 or so.

Q What are some of the key metrics or characteristics that you look for when assessing newcomers?

Sergey Sheshuryak: Backing emerging managers implies higher risk. To reduce the risk, we prefer to work with a group of fund managers with a shared history. We often invest with managers that have spun out of a franchise that we have an existing relationship with, or a fund manager that we have tracked closely, giving us firsthand insight into the caliber and potential of the new endeavor.

While most emerging managers that we back fit that criterion, it doesn't make a spinout of a team from another private equity firm a guaranteed success. While their prior track record from an established franchise may be excellent, it may take some time for them to establish a new brand in the market as well as settle in working together as a coherent team in a new setup.

That's why it's important to understand the team's structure and motivation for setting out on their own. Other key considerations include understanding how their investment process will work, who would be key decision makers and whether they have a good balance with the team.

Q We've seen significant valuation resets recently amid concern that inflation and higher interest rates will weigh on growth. Does that push you more toward well-established GPs?

SS: We do not have a top-down allocation to emerging managers, rather we are driven by the attractiveness of specific investment opportunities. We are in a fortunate position to have availability of capital during such downturns, allowing us to continue making commitments to well-established GPs as well as to continue to add selective emerging opportunities to our portfolio.

Having said that, the market uncertainty has made investors more cautious, for sure. The focus has shifted from "growth at all costs" to profitable growth, which shows that investors generally show less appetite for risk in the current environment.

Adams Street's third annual global

Q What red flags might make you hesitate about working with a new entity?

James Korczak: One potential concern would be if the 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, roles, and the working relationship, in addition to investment style and risk appetites, are essential precursors to any fund investment.

A first-time manager with no attributable history can only be considered on a truly exceptional basis. That could be the case if 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.

"We were once the scrappy upstart, too"

SUNIL MISHRA

investor survey, published in late February, found that investors are increasingly prioritizing private markets investment managers with a strong record – 32 percent of respondents cited it as important, up 6 percentage points from 2022. And a recent report by PitchBook found that the top 35 funds took in 75 percent of limited partner capital raised by US private equity funds in 2022.

Some institutional investors are also currently overallocated to private equity, ironically because the industry outperformed other asset classes in their portfolios. We already see a tighter fund-raising market, with many institutions focusing exclusively on re-ups with existing managers and even reducing the number of GP relationships in their portfolio, let alone adding new ones.

So, it's a dynamic that clearly favors established GPs with deep sectoral experience, strong relationships, brand recognition and a good reputation. A lack of these characteristics can make it harder for emerging managers to attract capital in the current market. However, these times of dislocation also create opportunities, and some of today's established PE firms started out in slow fund-raising markets.

Q How do you go about finding emerging talent? Do you wait for new managers to reach out or do you have a more proactive approach?

JK: 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 emerging managers by their very nature come with inherently different risk-return profiles.

"These times of dislocation also create opportunities"

SERGEY SHESHURYAK

Q If you opt not to invest in a debut raise, is that the end of it, or do you keep the new entity on a watch list?

SM: When we decide not to invest in an initial offering, it can still be worthwhile to keep an eye on an emerging manager with a view to supporting subsequent vintages. It can be satisfying to see initial concerns alleviated as a team demonstrates its strategy and capabilities. Some signals to watch out for include step-up in fund size, scaling at the GP level, team expansion and a portfolio that closely aligns with the original investment thesis.

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. So, when we choose to invest in successor funds we typically do so in situations where we believe the risks we identified – such as around depth and maturity of the opportunity set, history, governance constructs, and portfolio construction – have declined to an acceptable degree.

And sometimes it's just a question of time. We keep a watchful eye on a number of managers who had strong records in their established prior firms but have 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.

Q What are some of the key lessons you've learned by working with emerging managers, both for you and for them?

SS: First and foremost, there is no substitute for the personal knowledge of founders and their prior record. Also, while many teams look good on paper, working together in a high-stress, conviction-led business is easier said than done.

New entrants who are seeking to build their brand and reputation should never underestimate fundraising risk or firm management aspects, and lastly, having skin in the game and alignment of incentives is important, but there is also a balance to strike. ■

Sunil Mishra, Sergey Sheshuryak and James Korczak are partners on Adams Street's primary investments team, in Singapore, London and Chicago, respectively