

The Case for Investing with New and Emerging Private Equity Fund Managers

**Grove Street Advisors, LLC
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I. Introduction

Superior financial returns in private equity can only be generated consistently over the long term if an investor has the ability to carve out major allocations with the very best performing private equity fund managers. For the largest institutions, which must put substantial amounts of capital to work in the asset class, it is particularly important to be able to identify these teams as early as possible in their development and build the close relationships necessary to position themselves for large allocations when a team has clearly moved into the top tier. In this context, GSA has prepared this white paper which describes the overall logic for the establishment of an investment program targeting high quality new and emerging private equity fund managers and then presents the general requirements and recommendations for such program.

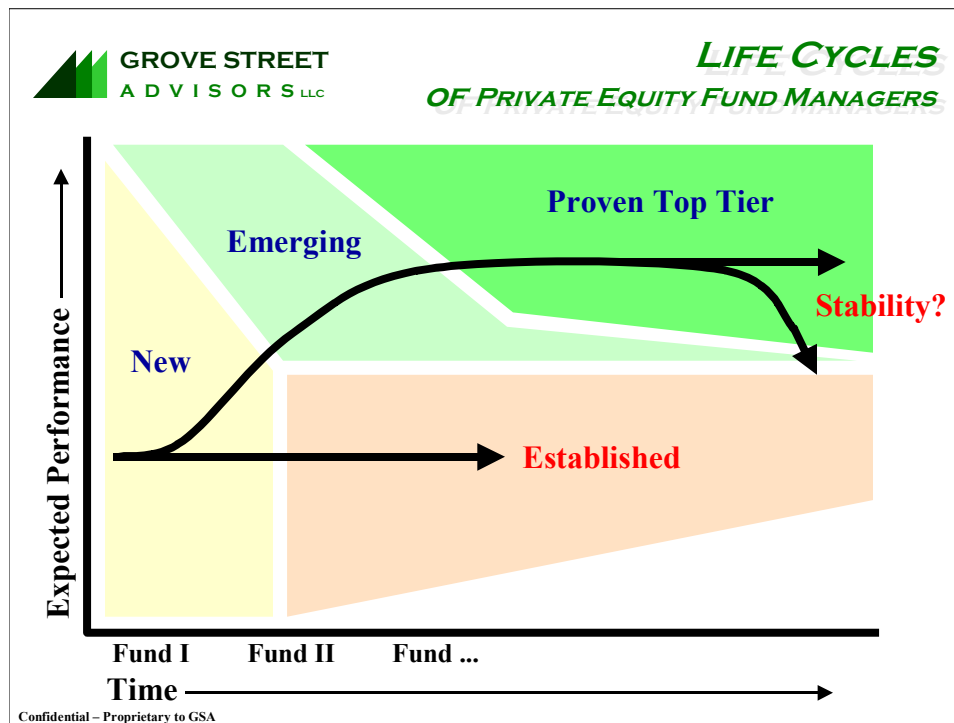
II. The case for new and emerging fund managers in a private equity portfolio

An examination of the investment strategies of many of the best performing long-term institutional investors in private equity quickly demonstrates the importance of investing with newly formed private equity fund managers. Historically, the major endowments (Harvard, Yale, MIT, etc.) have been among the largest and most successful investors in venture capital funds and smaller non-venture private equity funds. Their success can be traced back to a number of factors, including:

1. Their ability to build a high quality dedicated team of investment professionals and retain that team over long periods of time. For example, the key people making up Yale's private equity team have been together since the mid 1980's.
2. Their ability to become a reliable source of capital, with the expertise and long-term perspective to play through the inevitable peaks and valleys of the industry.
3. The expertise to identify the most promising new teams and the willingness to invest with those teams early in their development, in part managing their portfolios by capitalizing on the "life cycle" of private equity fund managers.

It is clear to any experienced investor that fund manager selection is the most important part of a private equity investment program. Statistically, there is a very broad range of performance between an average manager and a top quartile performer, typically a 15 to 30% difference in net IRR to the investor, which is compounded over the 4 to 6 years that the capital is locked into a partnership. There is also a high correlation (probably 50 to 75%) between past "top quartile" performance of a team and their future performance for a set of reasons that can be clearly defined. As a result, past performance relative to the industry benchmarks is probably a better indicator of future relative performance in private equity than in any other major asset class. Because these two points are well understood by the LP community, those fund managers that have proven that they truly can deliver superior performance are able to raise far more capital than they require from their existing investors, even in difficult fundraising environments. As a result, fund managers whose top tier performance is becoming clearly evident would have to be willing to cut back their allocations to those investors that have been loyal to them since inception to make room for a new investor, which is generally very unlikely. To gain meaningful

allocations in these exclusive funds after they are proven, a new investor needs to bring more to the table than just capital (e.g., the ability to add value to the fund's portfolio companies, strong personal relationships with the fund manager's professionals, a blue chip reputation as an investor, diversification in the type of investor, etc.). The only consistent major exceptions to this pattern are the large buyout funds, where the drive to multi-billion dollar funds meant that the managers were constantly seeking new, large investors to augment their base of existing LPs.

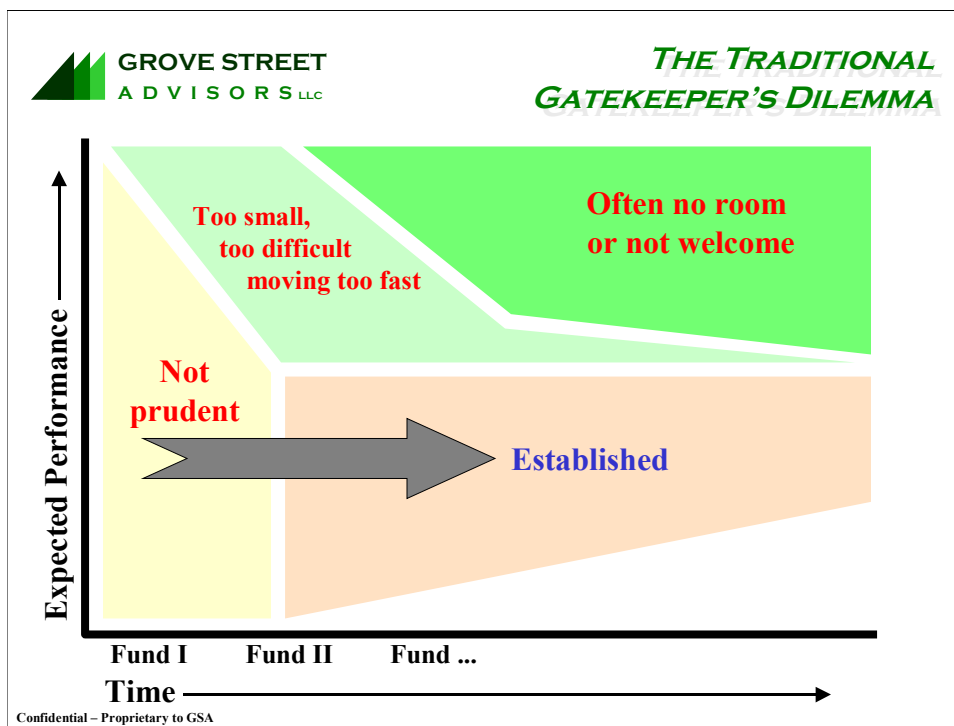


The major endowments have been able to place a larger share of their capital with the truly top performers in the industry (e.g., Kleiner Perkins, Greylock, etc.) compared with any other type of investor. When one looks into the history of those relationships, it becomes clear that most started well before these top performing firms were in fact “proven”. The endowments, in essence, earned their allocations with these firms by backing the teams early in their life cycle and becoming reliable, value-added sources of capital through the peaks and valleys of their development. These endowments typically backed a select number of new and emerging teams every year, initially with relatively small amounts of capital. Even these small amounts were extremely valuable to these teams because of the reputation that the endowments brought as knowledgeable investors. Over time, if the team performed well, the endowments increased their commitments to the point where they often became the largest investors with these top tier teams.

The traditional gatekeeper’s approach

While the major endowments have been working with new and emerging funds for more than 20 years, the traditional investment advisory firms (“gatekeepers”) serving the public pension funds have been following the opposite approach. Gatekeepers generally view first time funds as too risky and therefore imprudent investments. Teams raising their second or third fund, where their track records are still largely unproven, are too difficult to evaluate and the amounts to be invested are too small to justify the effort of most gatekeepers. As a consequence, once the teams have joined the ranks of the proven top tier fund managers, there either is very limited

room for new investors or these fund managers are simply unwilling to work with the traditional gatekeepers because of their inflexible, seemingly bureaucratic investment processes and their image as unsophisticated investors compared with the major endowments. The gatekeepers and their large public pension fund clients also typically find it difficult to make small investments from an internal efficiency perspective. It takes much more effort and manpower on a per dollar basis to evaluate a large number of emerging teams, negotiate ten \$10 million commitments and monitor those relationships than it does to put \$100 million into a single large, established fund. Moreover, gatekeepers typically have little or no incentive to invest additional effort in evaluating such teams as their traditional compensation arrangements do not provide any financial upside for a good decision while they risk significant reputational downside for a “nontraditional” investment decision that results in poor performance. As a result, the truly top tier private equity funds, as well as small funds in general, are not represented or are significantly underweighted in the portfolios of most of the major state pension funds. As shown in the figure below, these factors combine to push traditional gatekeepers (and their clients) into the “established” lower right quadrant of the lifecycle matrix.



Grove Street believes that an investor that wishes to put substantial amounts of capital to work in private equity needs to build into its overall approach the ability to identify and participate with new top performing teams early in their development. To do so, institutional investors need a strategy or vehicle that can effectively identify, evaluate and invest in a portfolio of very high quality new and emerging fund managers and over time transfer the relationships with those teams that perform well into the core portfolios of their programs.

What are the risks associated with investing in new and emerging fund managers?

There are two basic sets of concerns associated with new and emerging teams:

1. Does the team have the right mix of skills, experience and resources to perform well?
2. Will the members of the GP function well together as a team over the life of the partnership (the “team risk”)?

In terms of skills and experience, Grove Street recommends investing only with teams that have a critical mass of proven “deal skills” with a clear and relevant upper quartile track record among its partners in their careers prior to forming the fund. Other differentiating criteria (such as industry expertise, operating experience, corporate relationships, investment banking or public market experience, consulting and so on) are all valuable parts of the equation, but can not make up for a lack of prior experience in making and successfully exiting private equity transactions.

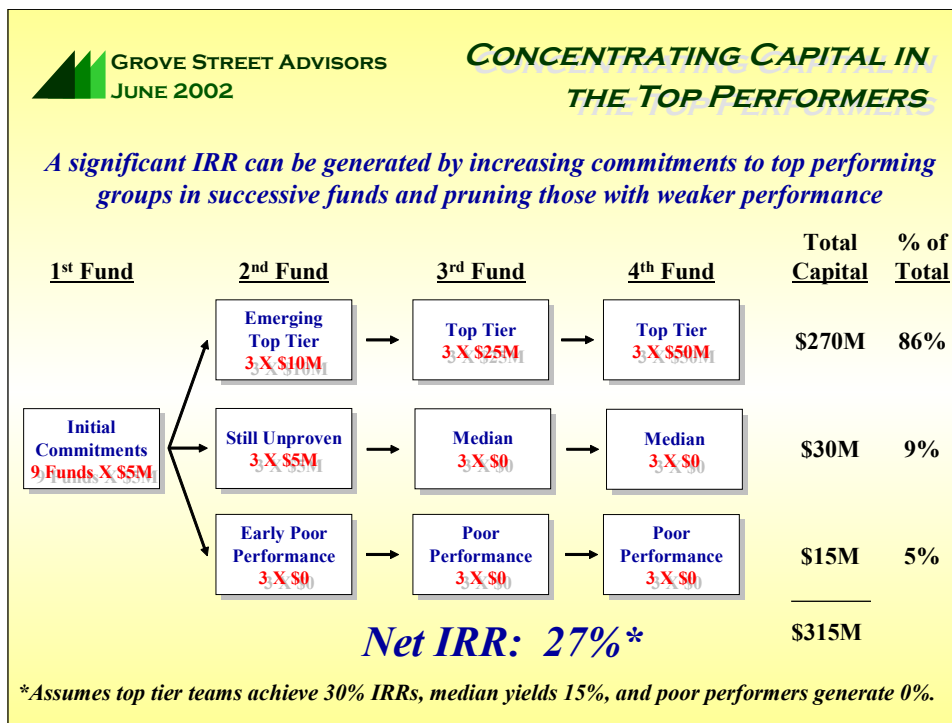
If the individuals who make up the team have proven upper quartile track records in private equity, Grove Street believes that the financial performance for a portfolio of high quality new and emerging funds should match or exceed that of a private equity portfolio of established funds for a number of reasons:

1. The actual “team risk” associated with working with newly formed private equity management teams is much less of a risk than generally believed. These teams are generally formed by individuals who have prior working experience with each other, often within the same private equity organization. Recent examples include Audax and Golden Gate, both formed by sets of individuals who spun out of Bain Capital. In addition, new teams have typically invested substantial time and personal expense to design and launch their new firm and are thus very highly motivated to work together and succeed as a firm. Especially in the current environment, GSA believes that the team risk is much higher for many of the proven blue chip firms where substantial wealth has been generated and the motivation to work effectively together may have declined.
2. The team members are not bogged down by an existing portfolio and, as a result, are able to put 100% of their efforts into maximizing the performance of their first several funds, again very relevant in the current environment.
3. The rules for success have clearly changed in both the buyout and venture capital industry. Financial engineering, transaction skills and momentum investing have given way to the need for GPs to play a hands-on role in actually increasing the value of the companies in which they invest (e.g., operating skills) and many of the established teams are finding it harder to adapt than the new teams coming into the market.
4. The capitalizations of these new and emerging funds are typically small, which means both that there is typically more manpower relative to the capital and that the ability to generate a substantial multiple on investment is probably higher than the much larger funds raised by the teams once they are proven.

- The skills and experience of key players in new teams can be on a par with those at top firms. It is possible to develop a strong attribution analysis for an individual departing another private equity organization given the right resources and skills to conduct such an analysis. The art lies in distinguishing “B” or “C” quality players leaving “A” organizations from the “A” players leaving “A” or “B” organizations.

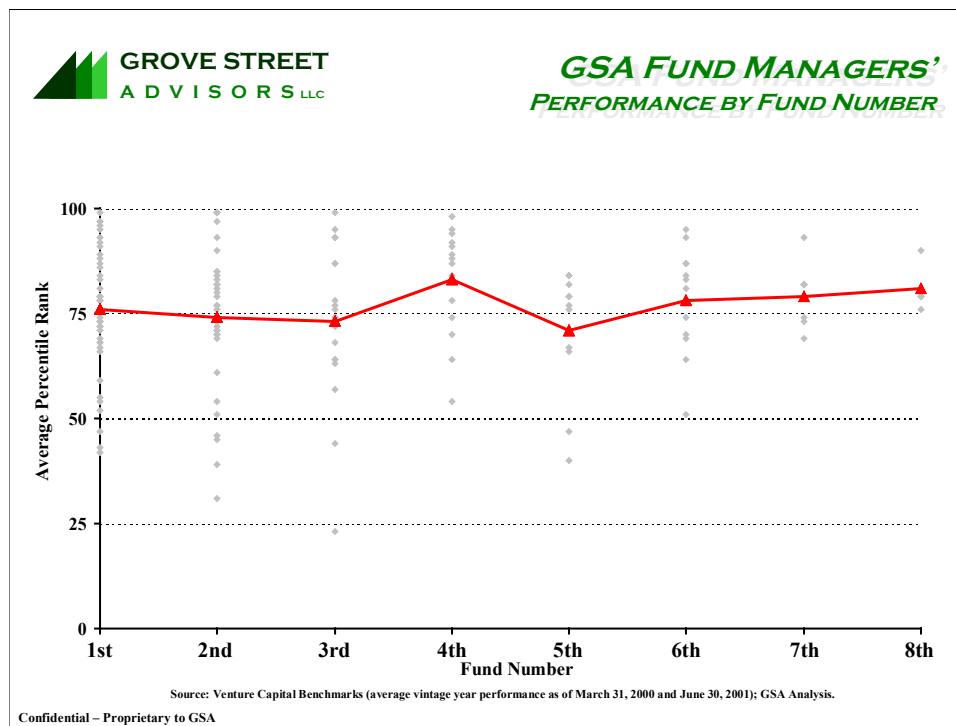
GSA does believe that the performance of these younger teams will vary more from one team to the next than established funds. Thus, a second key component of the emerging manager program, which is probably at least as important as the initial fund manager selection, is the ongoing monitoring and reinvestment decision. It is important to devote time and work closely with these teams to identify the under-performers early and either take corrective action or drop the managers from the ongoing program. The combination of a small initial investment and hands-on assistance to the team (recruiting, deal flow, access to additional resources, etc.) as they build their firm will allow the LP to put very little capital at risk with those teams that do emerge as under-performers, while forging a close value-added relationship with the highly successful groups.

This concept is illustrated in the exhibit below. The chart depicts a hypothetical portfolio of nine first-time funds where three teams turn out to be top performers, three turn out to be median performers, and three turn out to be poor performers. The process employed is to successively increase the allocation to teams that are performing well and prune teams that are exhibiting median or poor performance. In illustrating this approach we have used a set of conservative return assumptions where top tier firms achieve a 30% IRR, the industry median is a 15% IRR, and the poor performers return 0%—which is highly unlikely for a team of experienced private equity professionals with top-tier individual track records. In this example, after four full fund cycles, over 85% of the capital is invested with the top performing teams and the aggregate IRR averages approximately 27%.



Several points should be noted. First, this chart is a simplified model to illustrate the point that by backing the strong performers and pruning the weak, the bulk of the dollars are invested with the top tier groups and large allocations are obtained over time. In a real case one would expect a larger percentage of the first time funds selected to emerge as top performers, presuming strong due diligence and fund manager evaluation capabilities. In addition, it would not be unusual for one of the teams to do spectacularly well, with an IRR significantly above the 30% assumed in the model. Second, the decision to invest in second time funds is based on limited concrete performance information. Thus, the ability to invest effectively at this stage is enhanced by “seeding” relationships at the first fund stage, working very intimately with these teams, and then making a well informed decision to re-invest based in large part on subjective information and experience with the team during the first fund cycle. For example, at the time of the third fund some of the unproven teams might graduate to top tier performers while others may remain median or fall into the poor performance category. For conservatism the example provided assumes that the unproven funds become median performers and are pruned before the 3rd fund cycle of investing.

In terms of analytic support for this conceptual model, there is no publicly available data that tracks the performance of first time funds. Even if that data existed, the range in quality of the teams would be so broad as to render the averages relatively meaningless. What is clear is that in GSA’s large database of the funds managed by proven teams there is strong evidence that performance of a team generally starts strong and stays stable over relatively long periods of time. The chart below summarizes this analysis for each fund managed by a team with which GSA has invested. The chart measures how each fund performed relative to the industry benchmark for that type of fund and the vintage year. The key point is that teams that ultimately perform exceptionally well generally start off well and maintain their performance. In short, the relative performance of their first funds was essentially equal to that of their later funds.



In summary, Grove Street's believes that an investor that wishes to put substantial amounts of capital to work in private equity needs, as part of its overall approach, the ability to identify and participate with new top performing teams early in their development. GSA believes the financial performance of the emerging portion of the program should compare favorably to the overall private equity portfolio. The key challenge is that the manpower per dollar of capital employed required to build and monitor the portfolio is substantially higher than for the relatively large investments that can be made with established teams. The justification for that inefficiency is the ability to cost effectively invest large amounts of capital with the best performing of these new teams in the future. GSA offers the large public pension funds both the skill sets and a cost effective approach to identify, evaluate and invest in a portfolio of very high quality new and emerging fund managers and, over time, transfer the relationships with those teams that perform well into the core portfolios of their programs.

Does the program make sense in the current market environment?

A steady, base flow of new and emerging teams consistently enters the private equity market for a variety of reasons, including generational pressures within organizations, the reluctance of established top tier firms to pursue new market opportunities that younger team members may recognize, and a wide variety of other organizational pressures. It is critical to dispel the notion that new funds are typically just "four guys and an idea" – each year there are a number of new teams composed of proven investors, high quality operating executives and deep technical experts, typically with long-standing interrelationships, who come together to form very strong, unencumbered and highly motivated firms.

GSA believes that the current environment is a particularly good time to be investing with new and emerging funds, and that the ability to do so effectively depends upon the ability to apply operational expertise in private equity to the fund selection process. In this regard, it appears likely that there will be some dramatic shifts in leadership, both in terms of who will be the top tier teams post 2001 as well as who will be managing the top tier teams. Historically, many of the industry's most successful new teams have been launched during times of difficulty in the market. For example, in Boston just after the first real "bubble" in venture capital in the early 1980s, Bain Capital, Boston Ventures, Summit, and Advent International were all formed. Such new firms are launched, primarily because of the instability that develops inside many of the established partnerships as financial returns drop back to more sustainable levels. They succeed, at least in part, because in a difficult fundraising environment, only the most qualified teams are able to successfully launch their new business.

It is clear that we are currently in such a period. While great wealth was created for the senior partners in many of the established firms during the late 1990's, returns from recent vintage funds have collapsed. The business is much more difficult today than over the last three to five years and the rules for success appear to have fundamentally changed. As a result, many of even the most successful firms are redesigning and resizing their internal organizations or going through difficult leadership transitions. In many cases, the senior partners who control their firms are already independently wealthy and not fully committed to the much more challenging road ahead. At the same time, many of the most promising individuals of the next generation of great investors have discovered that their first meaningful allocations of carry do not appear to have any value going forward, significantly decreasing motivation and stability at this critical level in these firms.

Because of these trends, the number of high quality new and emerging teams raising capital has not slowed. GSA's deal flow is very strong and the teams that are able to raise sufficient

capital will probably do very well in this environment. It is, however, critically important to evaluate the more recent, still largely unrealized, performance of a team and identify those existing teams that appear to be likely to lose their younger star performers. Evaluating both of these issues requires operational understanding of the deal business and the proprietary contacts to know the firms where key partners are evaluating other opportunities.

III. Recommended Approach

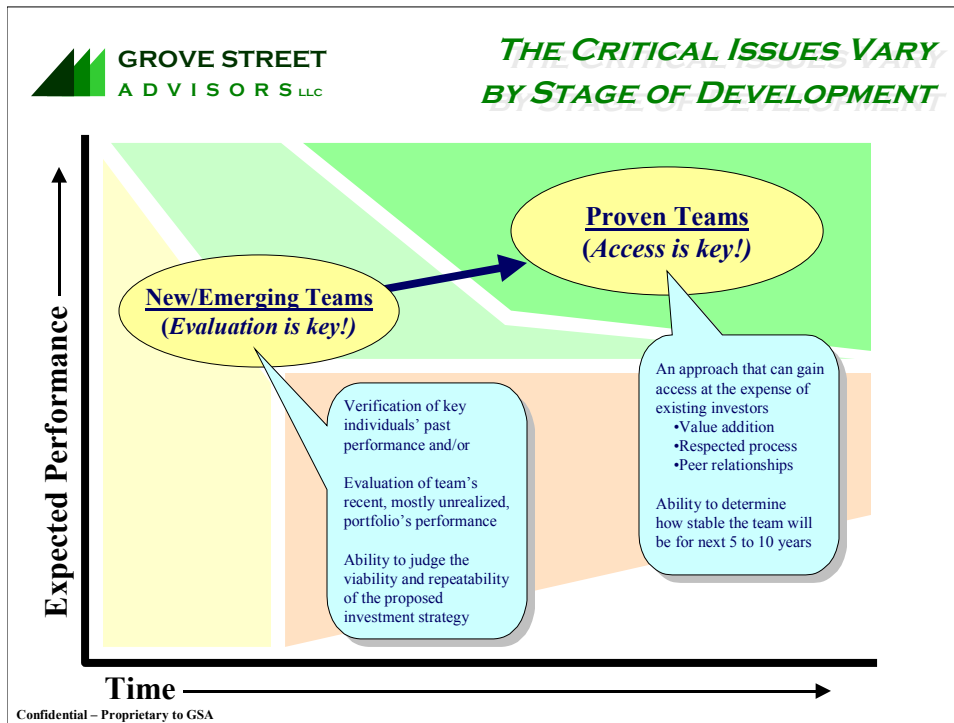
As described above, a new and emerging fund investment strategy should be an integral component of a long-term investment strategy for an institution that wishes to maintain a significant allocation to the top performing teams in private equity. GSA generic recommendation for the structure of a new and emerging fund program for a large institutional investor would consist of a dedicated fund-of-funds with an initial commitment of between \$150 and \$300 million. The fund-of-funds would be managed by an appropriately qualified manager who, within the limitations of the program's investment charter, would have full discretion for making fund investments and monitoring those relationships. The program would be tasked to build a diversified portfolio of funds managed by new and emerging private equity managers. GSA believes that the primary objective of the program should be to achieve superior financial returns relative to the private equity asset class. However, the program should also be managed to meet two additional operational objectives.

- 1) Establishing the institutional client as a valued investor with a number of the most promising new and emerging fund managers, thus providing the client the opportunity over time to become a major investor with those teams that continue to perform well.
- 2) Support the client's other private equity investment activities by providing full access to the manager's industry intelligence and insight.

The dedicated account structure is recommended because it allows the client the flexibility to customize the investment program to fit specifically within the client's overall portfolio. It also allows the investment program to target those types of funds, which, if successful, can be added to the client's core portfolio in the future. Lastly, it provides the client's staff a far superior platform than the more typical pooled fund-of-funds to build direct relationships with the fund managers in the program as well as to adjust the program over time.

GSA recommends that the capital of the program be committed to funds over one "fund raising cycle" (a 3 to 4 year time period in the current environment) and provide the client access to between 20 to 30 teams. The initial program should generally not invest in multiple funds by the same manager, but it is important that the program's second phase be put in place when appropriate to continue those relationships which are performing well. The average initial commitment to a team would be in the range of \$5 to \$10 million. This would provide an appropriate degree of diversification for the program. More important, it would also provide more than sufficient capital to attract the attention of premier newer private equity fund managers and allow the client the ability to play an active leadership role with these team. Additional flexibility could be provided to increase a commitment to particularly promising teams, at the client's discretion and on more favorable terms for the client than the core program.

What are the skill sets required to identify, evaluate and monitor investments with new and emerging fund managers?



In the current market environment, GSA believes that many of the most important skills required to invest successfully in private equity are quite different than those found in many of the traditional gatekeepers' organizations, regardless of whether the investments are with new or well established teams. These include:

- 1) **Extensive operating experience in private equity:** GSA believes superior investment decisions in an industry require real operating experience in the industry. The same way a blue chip private equity firm's operating experience in the industries in which it invests (e.g. telecommunications) helps it to identify and support high quality portfolio companies in that industry, operating experience in private equity (designing and building investment teams as well as making successful direct private equity investments in all types of industry conditions) helps a manager identify, evaluate, gain access to and support top quality funds. This is particularly essential when evaluating the quality and value of a largely unrealized track record, as is required for evaluation of emerging teams.
- 2) **Proprietary industry relationships:** A firm needs to be able to rely on extensive proprietary networks of relationships to independently evaluate the performance of a team, both the more recent unrealized portfolio performance and the prior track records of the individual partners, and to differentiate the track record of an individual from that of their overall organization. The information gained from those individuals whose names are provided as references by the team members is rarely useful in identifying the major hidden weaknesses of a team or individual. The ability to contact 10 to 15 individuals who have worked closely with a team or individual in question, but who know that their perspective will remain totally confidential becomes a very important element of due

diligence. Search industry contacts can be an import part of these relationships, particularly in evaluating the stability of the younger members of a team.

- 3) **The ability to be a value-added investor to the fund managers:** The firm must be able to play a real value-added role with the teams once the investment is made, both to support the performance of the team as it manages the capital already committed and to make the prudent investment decision regarding the team's next fund. If the manager is able to develop credibility (essentially a peer to peer relationship) with its fund managers then the manager will receive that "first phone call" when a problem does come up and will be the first contacted when a new promising team seeks to enter the marketplace.

IV Summary

In closing, there are two key points that GSA believes summarize the case for new and emerging funds:

- 1) A well designed portfolio of investments in high quality new and emerging fund managers should deliver a financial rate of return for the client that is equal to or superior to a portfolio of investments in larger, "established" teams.
- 2) If appropriately managed, that portfolio of relationships will position the client to be able to place substantial amounts of capital (a substantial multiple of the capital committed to the initial program) with the best performing of these teams for decades into the future.

The skill sets to manage such a program are clearly not those found within the universe of traditional investment advisory firms serving the major state public pension funds, but they do exist within a small number of advisory firms that are specifically structured to capture this market opportunity as part of a broader strategy to position their clients as attractive, sophisticated investors with the best performing private equity firms over time.