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GUEST ARTICLE

Small Talk From A Big Advisor To LPs

By Frank Angella, Grove Street Advisors LLC

I've been hearing a lot of small talk lately. I don't mean hopes for warm weather in Boston or the juicy story about the general partner who... I'm referring to the small buyout fund kind of talk. It is true that the rise in value of public equities and faster-than-expected reopening of the debt markets has taken some of the pressure off many high-priced, high-leverage mega-deals inked during the buyout boom. Nonetheless, that roller coaster ride caused many institutional LPs to realize that a portfolio heavily weighted towards the large brand name funds is actually pretty correlated to public markets (and the funds are also correlated to each other). Furthermore, a large-only portfolio ignores a significant and attractive segment of the economy. People have been talking about investing in smaller funds.

The challenge for institutions both large and small is how to execute. Many factors—including smaller allocations, performance dispersion, deal flow, bandwidth to take meetings and perform due diligence—can make it difficult to tackle the segment. Grove Street has been systematically investing in smaller buyout funds for a decade: In fact our role for our clients is to provide an efficient way to participate in smaller funds. It is hard work, but well worth the effort. Doing it well requires a number of interconnected processes and philosophies. But before we get into that perhaps we should define the attributes of smaller funds and look at their performance.

Punching Above Their Weight

We think of "smaller" as including buyout funds up to $2 billion. This is still a fairly high upper limit, but leaves room to stick with one's successful smaller funds that grow over time but are still worth backing (more on that later). The real sweet spot is probably funds of between $150 and $750 million, and they come in all sorts of flavors—turnaround, growth, regional, niche sector, etc. What they tend to have in common

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are some pretty important attributes: less use of leverage, more proprietary sourcing, lower entry prices, operational focus and a high alignment with their limited partners. Smaller funds also have a natural advantage; not only is it usually easier to improve the earnings of a smaller company but a well-managed sale of an improved company will typically result in some degree of multiple expansion.

As shown in the chart on p. 2, according to benchmark data from The State Street Private Equity Index, smaller funds have performed as well or better than larger funds over a range of time horizons.

While smaller funds, as a group, appear to do as well or better than larger funds, this is not the whole story. If you look at performance versus size for most periods in the history of private equity you find that the further down the size scale you go the higher the dispersion in performance from fund to fund. That is to say, while some small funds will underperform the average (a thorough diligence process should screen these out), the better ones will dramatically outperform the industry. This opportunity to catch some 4x and 5x funds means that a 10-30 percent allocation to a well-selected slate of smaller funds should, as a portfolio, enhance performance for a program of mainly larger funds. Sorting through many managers and picking the right ones is the key factor for successful smaller fund investing.

Take The Meeting

Far be it from me to imply fund managers are frogs and we are seeking a prince, but you might connect the analogy. As stated, small funds have a greater dispersion in performance, so to build a successful program you have to pick the upper fraction. Picking the best starts with seeing the universe—and there are a lot of them. An LP has to cultivate a reputation for being interested in small funds and has to be willing to take a lot of meetings.

Some of the best smaller teams are spin-outs from existing groups. Private equity funds are legendary for mismanaging succession and for founders resting on their laurels. In other cases, scale brings bureaucracy. When this happens the real money makers often leave. (If you are one of them feel free to call me). The entrepreneurial drive to build a great firm that is your own has always been, and will always be, part of the private equity lifecycle. An important aspect of our deal flow is referrals from GPs when a close friend at another firm is thinking of launching out on their own. At any given point in time we are talking to one or more individuals who are thinking about it and want a confidential sounding board to dry run what track record, strategy and organization it would take to spin out successfully.

Lastly, history shows that most strongly

GUEST ARTICLE

performing smaller funds will become big funds quickly. However, there are those rare few that do well but stay rather small. These are the 'no road show" funds. You have to proactively look for these and when you hear of one you have to travel to them and fight your way in.

Picking Winners

This gets into the secret sauce—and the secret is there is no consistent recipe. One of the common attributes of successful small funds is that they succeed in many different ways. For teams like **American Industrial Partners** and **Wynnchurch** it is about the hands on operational skills to improve complex industrial companies. In the case of **Gencap** and **Sorenson**, success comes from proactive sourcing of small companies in the underserved regional markets like the Southeast or Mountain West. Internationally, teams like **IVF** in India, **Innova** in Poland or **SAIF** in China bring a world class approach to high growth emerging markets.

In almost all cases the fundamental challenge for LPs is that smaller teams often have less history. This doesn't mean the individuals are inexperienced (to the contrary, we will not back teams unless the people are experienced investors); but it may mean the team's track record is only partly mature. As such, the core skill for evaluating them properly is to be able to really dig into their unrealized portfolio companies to validate the investment thesis, value added by the general partner, operating trajectory and range of outcomes. We also try to dissect the source of return such as leverage, multiple expansion and earnings growth. For spin-out teams the art for the LP is often getting to the truth in deal attribution. In this regard, partnering with a small fund specialist can make sense even for investors who are accustomed to making their own decisions in the rest of their portfolio.

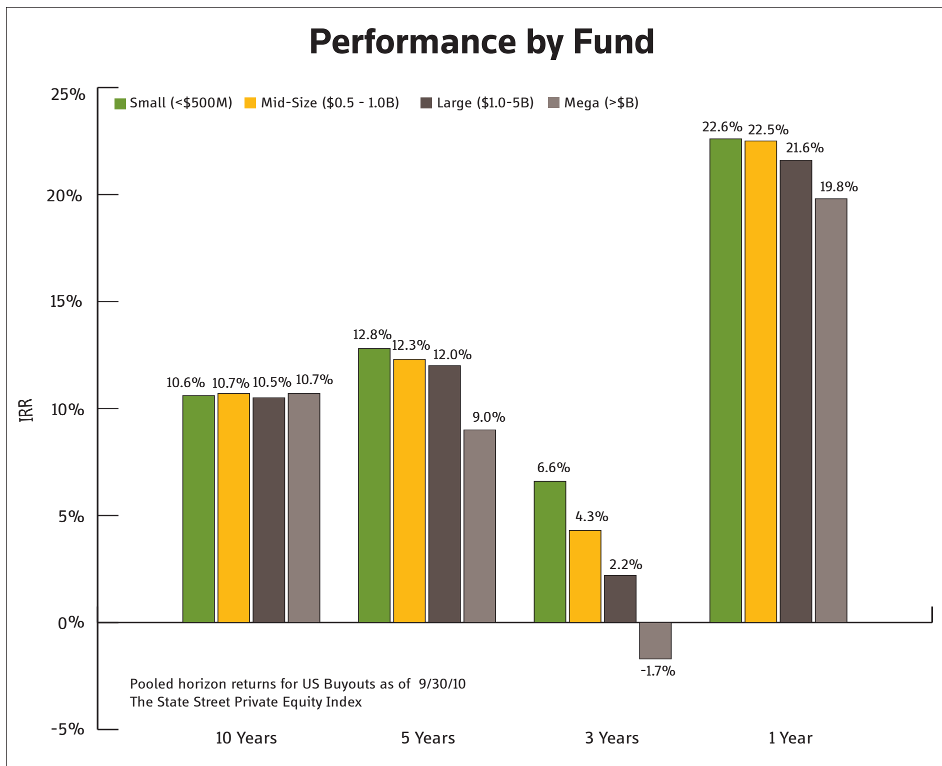
If we had to sum up our criteria in a few sentences, we look for operationally-oriented GPs who really know the sector they are targeting. The best evidence of this is a track record of creating value by actually doing something to improve the company during the ownership period. Combine that with low leverage and a discipline on entry prices and you have a fairly durable way to make money in and out of cycles.

Know When To Hold Them

We sometimes say we like to start small, double down and then either hand off or back off. In practice that means when we start a relationship with a smaller fund we do it at sufficient scale to impact our portfolio but at small enough scale that we have room for several. Some of these new relationships do just OK, but some do very, very well. We then use our inside knowledge and seat at the table to double down on the really strong performers.

There is no fixed rule, but we generally expect a good smaller fund will be a productive Grove Street investment for 2 - 4 fund cycles. After that they will tend to fall into one of two camps. The first are the fast growers where we fear reversion to the mean. (Look for some data coming soon from our advisor, **Josh Lerner** of Harvard Business School, on this topic. The short preview: While there is a correlation between larger funds and lower performance, the impact is even greater for funds that grow significantly from one fund to the next). It is not that these groups won't do fine as larger funds, we just think we can do better by reallocating our capital back to teams in the highest-performing part of their lifecycle.

The second group includes those teams that may have grown fund size but we believe are well managed and have a unique positioning based on sector or other expertise. Great examples here include **ABRY** in the media sector and **KPS** in special situations. We keep investing in these and, depending on the situation, we also facilitate them graduating to relationships our clients invest in directly at the $50-100 million per fund scale that makes sense for the client's core portfolio. Through this "farm team" approach we have transferred several billion in allocations with top teams on to our clients. Not only does this transfer process lower our client's cost and renew our mission, the fund GPs are delighted to have won a large, long-term investor.



Role Of Small Funds

Based on their size and the math of meeting their allocation targets, larger institutions will always need to invest most of their portfolio in larger funds. However, creating an efficient structure and approach to participate in smaller funds can provide both diversification as well as enhanced absolute returns.

Smaller institutions face a different set of choices. Because of their more modest scale they can meet their allocation objectives with a portfolio primarily made up of smaller funds. While a few well-selected larger funds in the mix can be sensible, smaller institutions have an opportunity to outperform the industry by capturing the alpha achievable in the less competitive niches in private equity.

Every large proven brand-name buyout fund by definition started as a smaller fund and many generated their best performance at this phase of their development. A systematic program to invest in these funds not only allows the LP to capture the returns from a team's strong early funds but also creates the seat at the table to be one of the team's largest investors as they grow their franchise. Tomorrow's brand name funds are today's top performers. ❖

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