PitchBook

Beyond Fund I

Performance and fundraising progression of US PE emerging managers

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Contents

Note: Data presented in this note includes US PE buyout funds. Fund I, II, etc. refer to a firm's first, second, etc. institutional funds overall (not in a given strategy or fund family). We define "emerging manager" as those raising or having most recently raised Fund I, II, or III.

Key takeaways

- Contrary to conventional wisdom, there is little differentiation in step-ups between larger emerging manager funds ($500 million+) and smaller funds.
- Also contrary to conventional wisdom, emerging managers do not consistently outperform established managers, although there are some nuances. First funds exhibit the most performance variation, while second funds underperform and third funds slightly outperform. However, these trends vary significantly by vintage. Very large emerging manager funds ($1 billion+) perform in a tighter band, with less outperformance. Additionally, first-time funds return capital more quickly than second and third funds.
- Since the global financial crisis (GFC), specialist emerging managers have outperformed generalists.
- At each stage of progressing from Fund I to II, III, and IV, about one-third of managers fail to raise the subsequent fund. The success rate for subsequent fundraises increases modestly as fund number increases.
- Because managers often begin fundraising well before they have realizations from their previous fund, LPs primarily look for persistent strategy execution when deciding whether to reup with an emerging manager. Failure to raise a subsequent fund can often be traced to early portfolio losses or key personnel turnover.

Introduction

Some LPs look favorably on first-time funds as a way to achieve outperformance from a hungry, new manager that needs to perform well to remain competitive in raising their subsequent funds. Additionally, investing in first-time funds has been a tactic for some LPs to build relationships early with GPs that could later raise much larger and more sought-after funds, to obtain favorable fee terms, or to diversify into small-cap or specialist investment strategies.

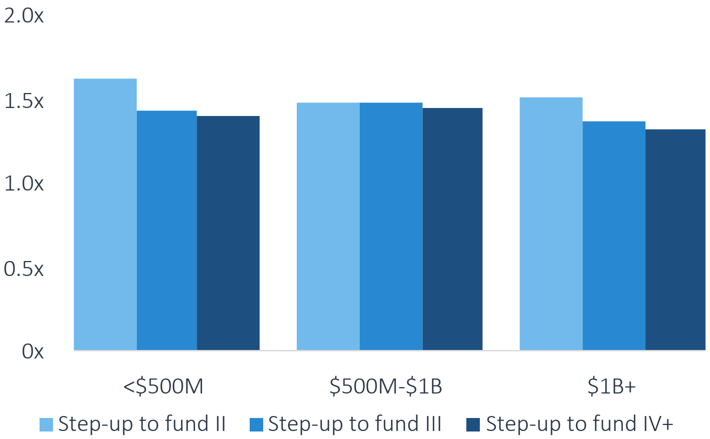
In a previous analyst note, we found that despite the narrative around first-time funds outperforming their more established peers, the outperformance levels are minimal in aggregate and sporadic in timing. However, first-time funds do deliver outsized returns (more than 25% IRR) more frequently, deliver poor returns (less than 5% IRR) less frequently, and tend to return capital more quickly. LPs may wonder how long this advantage lasts in the firm's progression from Fund I to Funds II, III, and beyond. Some may also wonder if GPs that have raised based on their potential to deliver alpha against established managers will eventually see their performance drop as they raise subsequent funds and lose that initial hunger and size advantage. In addition, LPs may be concerned about style drift and loss of focus in what used to be exciting niche funds as managers turn to asset gathering and try to manage a bigger portfolio of investments and funds and become less specialized.

Fund step ups and style drift

While conventional wisdom dictates that larger funds tend to seek smaller step-ups and smaller funds tend to scale more quickly, our data illustrates that the effect is mild for emerging managers. In theory, it should be much easier to double a $100 million fund than a $1 billion fund. However, emerging managers that have the ambition (and fundraising ability) to become the next mega-fund GP tend to target their first funds for over about $500 million, although we have seen numerous $1 billion+ first funds in recent years. They tend to be high-profile spinouts whose founders may have relationships with large LPs that can (and often prefer to) write bigger checks, driving rapid AUM growth. These managers may also feel more comfortable writing larger checks which require larger funds. By contrast, emerging managers that raise smaller funds are often pursuing a focused lower-middle-market or small-cap strategy and tend to attract LPs looking for exposure to that market segment. As a result, they scale up more slowly than might otherwise be expected. For example, Wavecrest Growth Partners, a B2B tech growth equity firm focused on $5 million to $20 million revenue companies, prioritized discipline in raising $290 million for its Fund II (a roughly 50% step-up, or 25% counting Fund I co-invests), despite LP demand exceeding the initial hard cap. Co-founder and managing partner Deepak Sindwani said his desire to grow incrementally stemmed from the conviction that the firm can achieve superior returns at smaller fund sizes, in part through leveraging its specialized operating platform.[1] Across the board, the step-up between Fund I and Fund II is greatest. This may be due to the ability to bring in larger institutional LPs for Fund II that are less likely to commit to first-time funds and to the small size of many first funds.

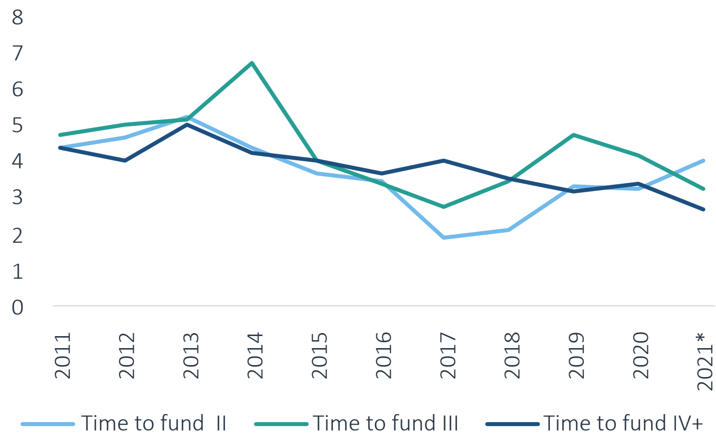
1: Deepak Sindwani, phone interview with Jinny Choi and Rebecca Springer, July 29 2021

Median fund step ups by fund size and number (2014-2021*)



Source: PitchBook | Geography: US
*As of July 27, 2021

Median time (years) between funds by fund number

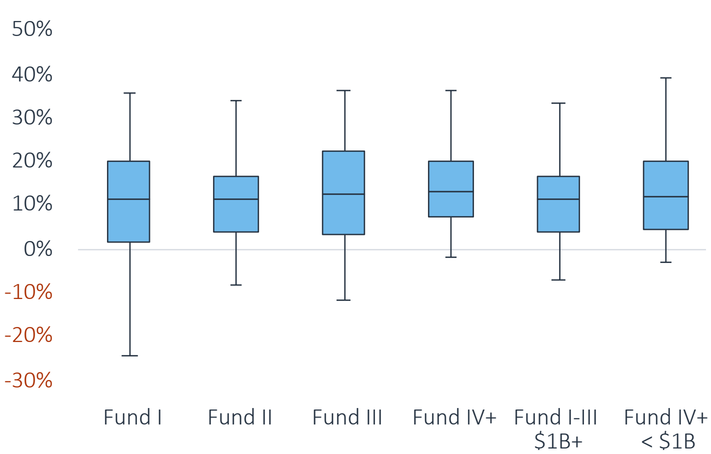


Source: PitchBook | Geography: US
*As of July 27, 2021

In terms of timing successor funds, emerging managers broadly come back to market in two to five years, mirroring mature firm fundraising cycles. Median time between funds for funds II and III has been falling along with broader PE trends. This increases LPs' need to rely on what they can observe about a firm's early strategy execution in committing to subsequent funds, since previous funds are unlikely to have a significant proportion of the portfolio realized at the time of the fundraise. For example, MiddleGround Capital, an automotive- and industrials-focused lower-middle-market firm, closed $1.05 billion across its second flagship, a separate coinvestment vehicle, and a targeted mobility fund less than two years after closing Fund I. MiddleGround executed this fundraise in four months based on its executed capital deployment and operational improvements, its demonstrated commitment to ESG principles, and the provision of attractive coinvestment opportunities for LPs.[2]

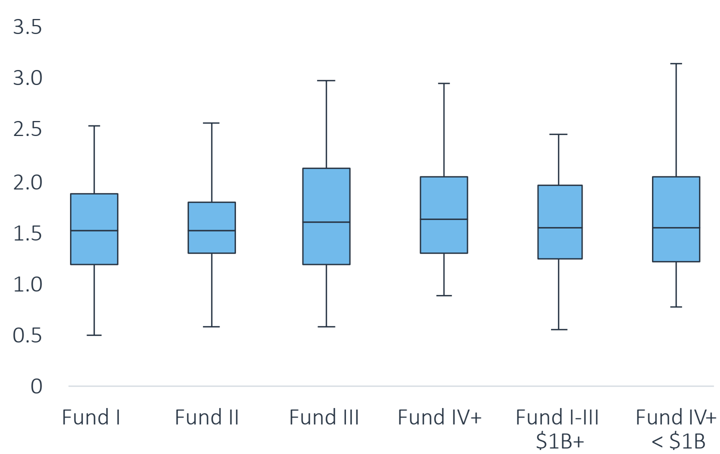
Performance

IRR distribution by fund number and size



Source: PitchBook | Geography: US
*As of December 31, 2020

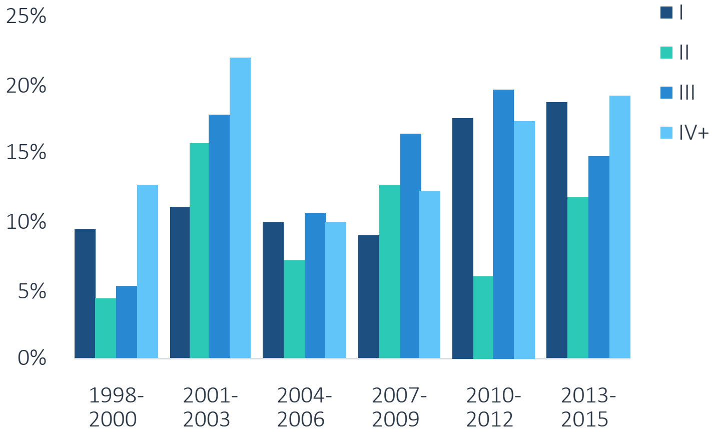
TVPI distribution by fund number and size



Source: PitchBook | Geography: US
*As of December 31, 2020

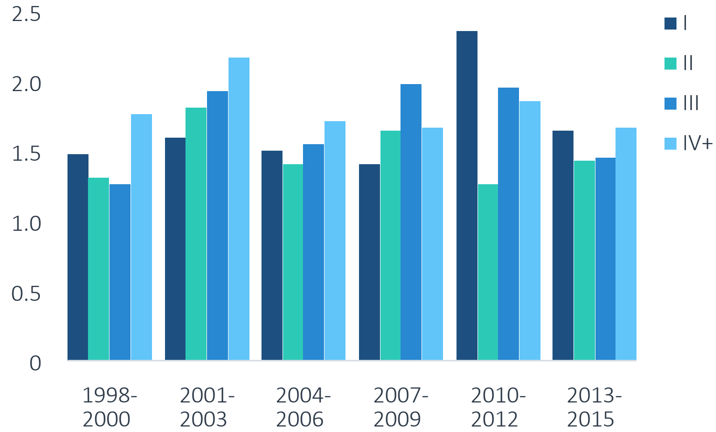
2: John Stewart, phone interview with Jinny Choi and Rebecca Springer, August 30, 2021.

Pooled IRR by vintage cohort and fund number



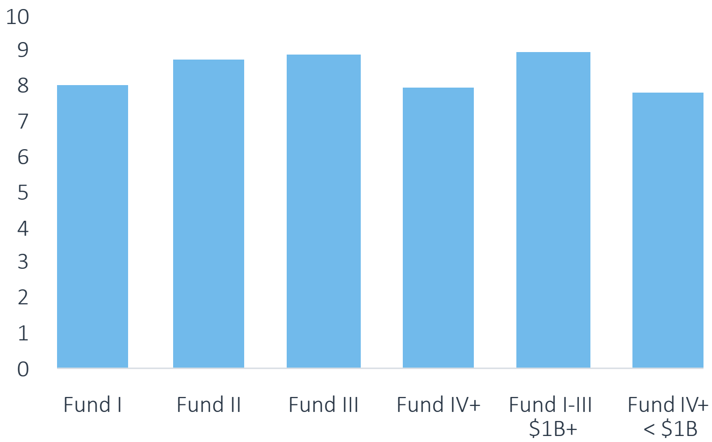
Source: PitchBook | **Geography:** US
*As of December 31, 2020

Pooled TVPI by vintage cohort and fund number



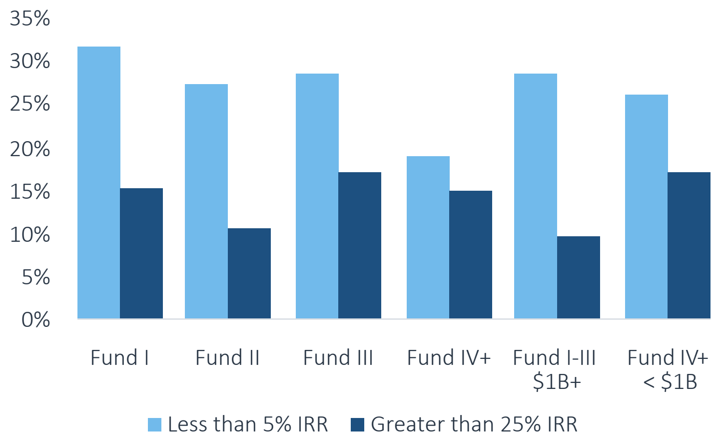
Source: PitchBook | **Geography:** US
*As of December 31, 2020

Years until distributions exceed paid-in capital



Source: PitchBook | **Geography:** US
*As of December 31, 2020

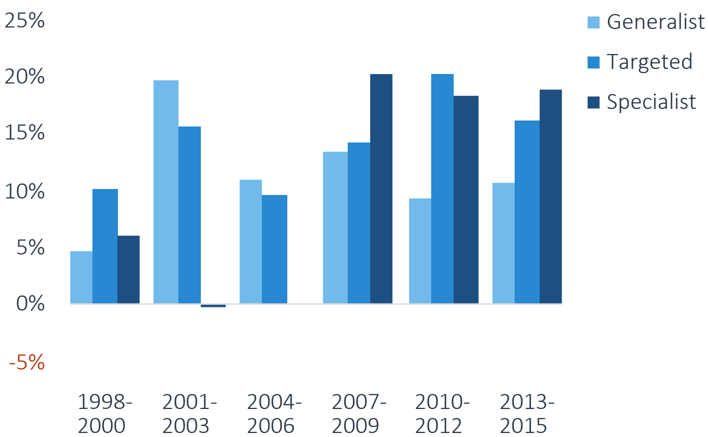
Performance outcome by fund number



Source: PitchBook | **Geography:** US
*As of December 31, 2020

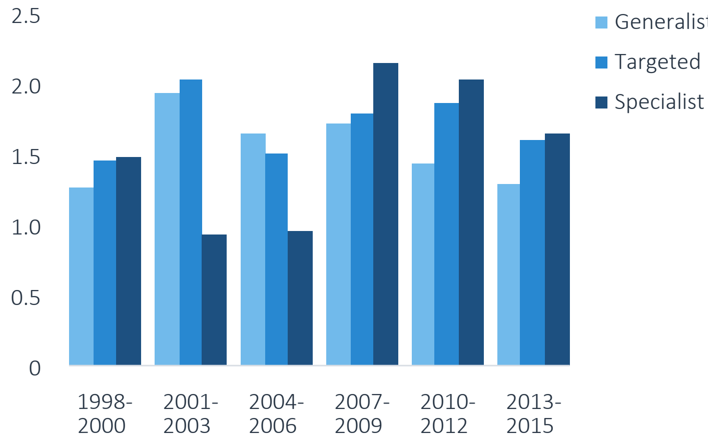
Despite many LPs' belief that emerging managers tend to outperform, our data indicates inconsistent performance differences between emerging manager and established manager funds. (This concurs with our previous findings on first-time fund performance.) First-time funds show greater variation in performance compared to subsequent funds, with pooled IRRs comparable to or slightly lagging established manager funds in most vintages. First-time funds perform better when measured by TVPI, which suggests that some of the IRR underperformance may be attributed to an underutilization of capital call facilities and dividend recaps by first-time fund managers. First-time funds also return capital to LPs rapidly, in part because managers raising their first fund must have a strong deal pipeline in place, and in part because smaller fund sizes mean there is less capital to deploy. In second funds, performance variance reduces, and overall performance tends to lag slightly. Some second funds may suffer because firms return to market so quickly after the first fundraise, more than doubling their workload while growing the team and organizational resources incrementally. They are also likely to have put their best deal opportunities in the first fund and may not have had sufficient time to build back up a robust deal pipeline. Third funds, by contrast, show improved median IRR and TVPI and periodically outperform first and second funds, especially when measured using IRR. This suggests that emerging managers may have greater financing sophistication by the time they reach their third fund. Selection bias also plays a role in these modest performance variations as the weakest firms are weeded out by LPs between funds I and II and between funds II and III. Overall, the differences between first, second, third, and established funds are modest and sporadic between vintages.

Pooled IRR by vintage cohort and style (funds I-III)



Source: PitchBook | **Geography:** US
*As of December 31, 2020
Note: Data counts are low for specialist funds.

Pooled TVPI by vintage cohort and style (funds I-III)

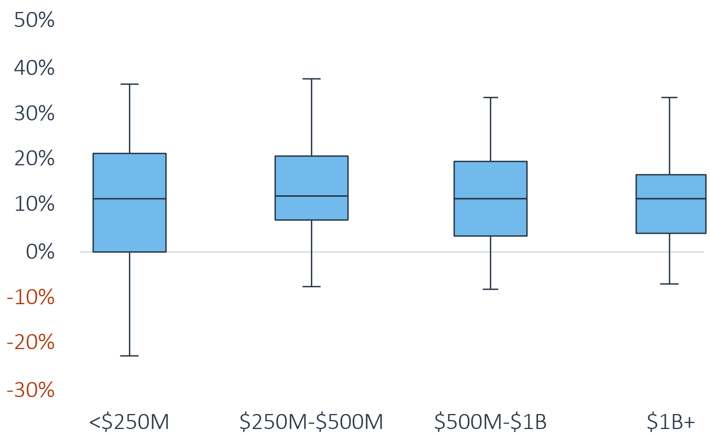


Source: PitchBook | **Geography:** US
*As of December 31, 2020
Note: Data counts are low for specialist funds.

Assuming current trends hold, LPs can gain a clearer performance advantage by investing with emerging managers who are sector specialists.[3] Although specialist emerging managers underperformed before the GFC, they have consistently outperformed other emerging managers in recent years. Unlike large, established GPs, emerging generalists may not yet have been able to build multiple sector-specific teams that can mimic the expertise and industry connections of a specialist firm. Our data shows that emerging managers are driving the overall specialization trend within PE, as many new managers leave larger generalist firms in part to pursue a more focused strategy. LPs also may prefer to invest with specialists to facilitate portfolio diversification.

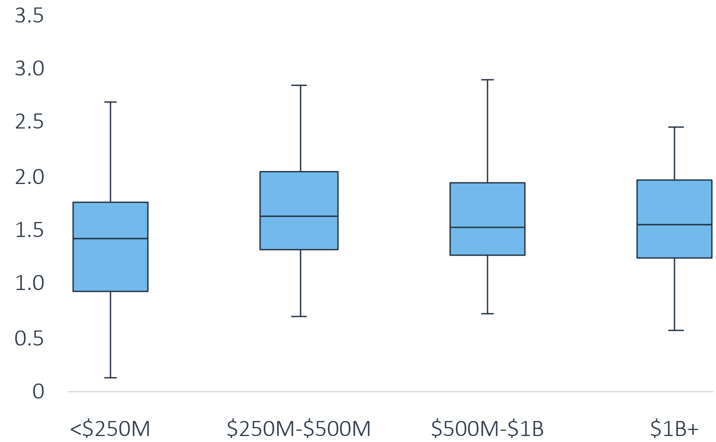
3: For our manager style classification methodology, see this analyst note.

IRR distribution for funds I-III by size



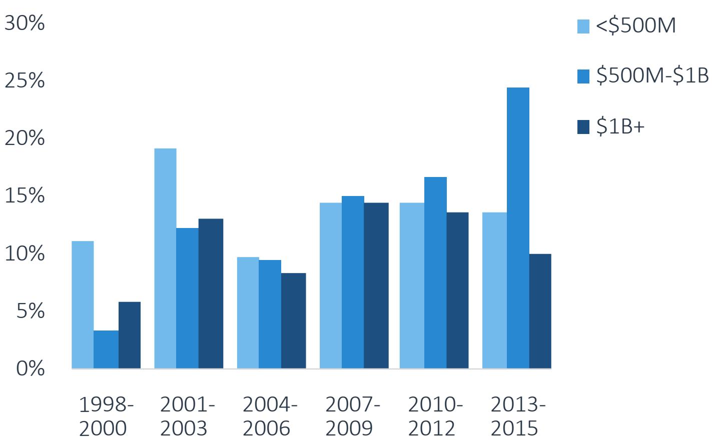
Source: PitchBook | **Geography:** US
*As of December 31, 2020

TVPI distribution for funds I-III by size



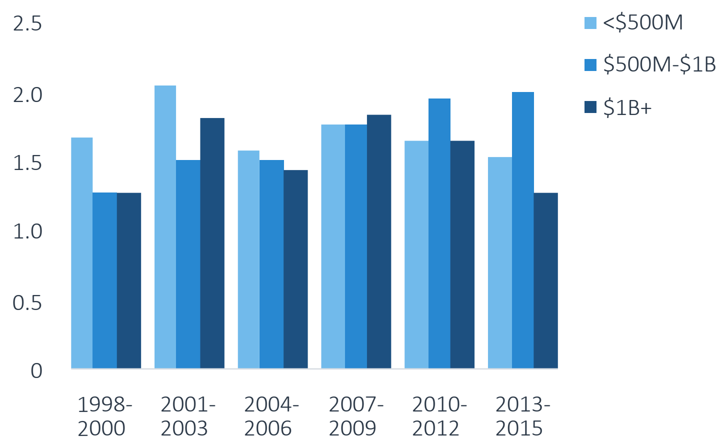
Source: PitchBook | **Geography:** US
*As of December 31, 2020

Pooled IRR by vintage cohort and fund size (funds I-III)



Source: PitchBook | **Geography:** US
*As of December 31, 2020

Pooled TVPI by vintage cohort and fund size (funds I-III)

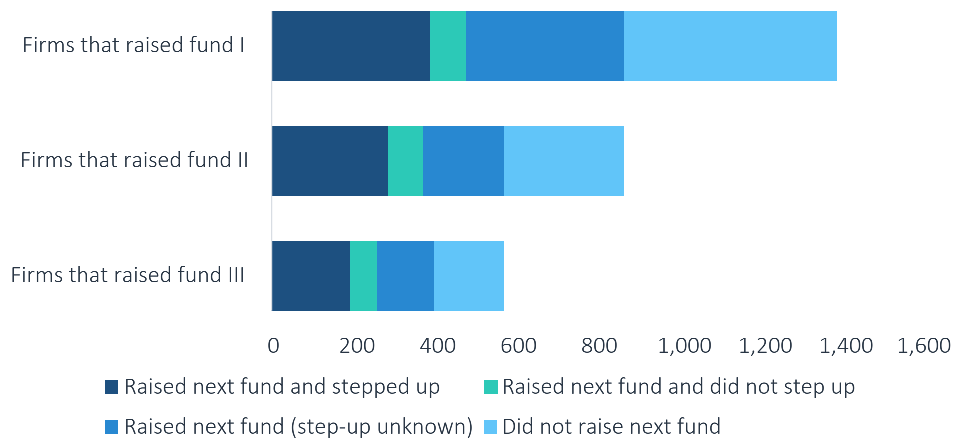


Source: PitchBook | **Geography:** US
*As of December 31, 2020

Finally, some LPs believe that the outperformance of emerging managers is partly due to the fact that these managers tend to raise smaller funds and invest in smaller companies relative to established managers, thereby eschewing the fierce competition and elevated acquisition multiples for companies above around $500 million EV. However, when we compared the performance of funds I through III in different size buckets, we found only modest performance variation. Emerging manager funds between $500 million and $1 billion have outperformed in recent vintages. Small funds I through III (less than $250 million) exhibit more downside potential, while very large funds I through III ($1 billion+) are less likely to outperform relative to other emerging funds. This resonates with our previous analysis, which found that larger funds tend to have a tighter performance band.

Raising Funds II and III

Number of funds closed by fundraising outcome



Source: PitchBook | **Geography:** US
*As of July 27, 2021
Note: "Did not raise next fund" refers to firms that did not raise a subsequent fund within any timeframe. However, firms that raised a Fund I, II, or III within the past 5 years and have not raised a subsequent fund have been excluded.

At each stage of progressing from Fund I to II to III to IV, about one-third of emerging managers are unsuccessful in raising the next fund. With each next fund raised, the success rate of raising another fund increases by a couple hundred basis points.

In our conversations with various LPs, all expressed that their most important criterion for reupping with an emerging manager is persistent strategy execution. LPs have limited information from which to evaluate reup decisions for emerging managers because the fundraising process for Funds II usually starts two years after the first fund's close. At this stage, Fund I IRRs are not yet meaningful and may even be negative. Therefore, a manager's ability to not only execute on a proposed deal pipeline, but to accurately underwrite deals and implement early operational value-adds, bodes well for future performance. If a manager completed deals as a fundless sponsor or used a warehousing structure prior to raising their first fund, these more mature deals will be heavily scrutinized during diligence. For Fund III reup decisions, LPs will begin to analyze performance metrics for Fund I in addition to examining the early execution of Fund II.

By contrast, firms that fail to progress have likely experienced early portfolio company mortality or key personnel turnover, which LPs view as key reasons for relationship terminations in emerging managers. Early losses in the portfolio can be fatal for emerging managers, as LPs find it hard to look past misses on strategy even if they don't expect to see realizations early in the fund. Team risk is another important consideration for LPs in committing to emerging managers because of the heavy reliance on a small number of deal professionals early on and the economic constraints of a young firm. Since LPs are putting confidence behind the founding partners of first-time funds, any key personnel turnover can be detrimental and result in elongated investment timelines, which prolongs the duration of the J-curve for LPs.

Emerging managers must also consider thoughtful team buildout. Once the initial fund is raised and begins deploying capital effectively, LPs look out for measured growth in the deal team, operations, and back-office personnel. Deal team growth should be pursued with careful thought to future AUM targets, since junior team members ultimately look to rise through the ranks and share in the firm's economics. Some LPs may prefer to see firms add more back-office support, such as a chief compliance officer or increased capacity for environmental, social, and governance (ESG) reporting. Some may also prefer to see managers begin to bring outsourced back-office functions in-house over time. However, LPs also understand that this type of development may happen slowly, especially for firms managing smaller funds. Overall, team buildout needs to be methodical, ensuring that it is a manageable pace and size to effectively implement fund strategy and operations.

Additionally, there are several factors to consider for the LP mix as funds progress. For both GPs and LPs, a bigger and more diverse LP base is important to manage risk for the fund. GPs need to consider the type of investors for their differing liquidity and allocation needs, and those that would make good thought partners. LPs often emphasize alignment with both fund managers and fellow LPs in the firm's vision, capital flow, and exit strategies when deciding to commit to a fund. Family offices and funds of funds are usually open to backing early funds to gain extra alpha, while GPs may look to bring in more long-term capital such as pensions, insurers, endowments and foundations, or consultants/funds of funds that can provide access to other large LPs in funds II and beyond. GPs must also be conscious of the check sizes that different LPs will want to grow to, as a misalignment of expectations can lead to friction in determining subsequent step-ups.

Lastly, decisions made to help accelerate fundraising for Fund I may affect the fundraising process in Fund II. For instance, some new LPs may balk at the presence of a seed deal (which typically lasts through Fund III), because they fear that the seeding LP will have disproportionate influence or that the firm may struggle to attract and retain talent while still sharing economics with the seeder. Emerging managers must structure their organizations and funds with a long-term view to continue to attract investors at each fundraise.