REDEFINING EMERGING MANAGER PROGRAMS

AN INFORMED PERSPECTIVE FROM AN "EMERGING MANAGER"

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PURPOSE

Create new programs to evaluate, cultivate and guide emerging managers to qualify for institutional capital allocations.

BACKGROUND

Emerging managers are investment management groups that are typically "smaller" or deficient in some area that make them less than qualified for institutional capital to invest directly with them. Concerns regarding AUM, number of employees, platform size, track record and tenure of partnership, among others, are common reasons why these managers are overlooked and/or not selected as qualified managers. Traditional "Emerging Manager" programs were created to identify and provide opportunities for new operators. In cases where investors do not have staff and/or expertise to run this type of program, a Manager of Managers ("MoM") program is put in place whereby investors engage an investment manager to select emerging managers. CalPERS / Canyon Capital, New York State Common / Artemis and Texas plan sponsors (including Texas Teachers) / GCM Grosvenor are the dominant Manager of Emerging Manager programs today.

Emerging managers come in different shapes and sizes. Some examples are:

- MARKET EXPERT- Operators that identify local inefficiencies and have niche strategies
- SPIN OUT- Seasoned professionals who worked together and left a company to launch their own platform

- STEALTH - Operators who are ‘under the radar’ – direct experience in specific asset type or market/geography but have limited capital or infrastructure to qualify for institutional capital

Traditional managers typically meet prescribed requirements for the following criteria – AUM, number of employees, platform size, track record and tenure of partnership. If emerging managers do not meet these levels, an evaluator is not provided other criteria with which to assess these otherwise considered “non-traditional” managers. Unfortunately, a rigid adherence to these metrics means that some talented managers are missed because they are being evaluated with an inflexible perspective. Adjustments need to be applied in order to find overlooked talent. Think of this in baseball terms. In sports, athletes are found in many arenas - Big Leagues, AAA league, AA league, College, High School, etc. Players are drafted from either College or High School. The easiest and safest choice to make for MLB teams would be to only draft College players because they have satisfied more of the “rigid” baseball metrics MLB teams require. MLB teams have made an adjustment and have started drafting High School seniors before their College counterparts because MLB teams are now evaluating a player’s potential “ceiling” in terms of innate talent while also identifying the intangibles (off-the-field work ethic and maturity) that are strong indicators of future performance. In some instances, athletes with special abilities are tracked as early as Junior High School. There should be similar levels of evaluation and support for emerging managers to identify the intangibles that are the ultimate difference makers.

CASE STUDY

As the principal of a small boutique shop, I do not have the time to pursue current emerging manager programs. More often than not, it has been shown that allocations are awarded to groups not like me. It seems ridiculous that the definition of an “emerging manager” include groups with up to $2B AUM or that are raising up to third institutional fund. Pursuing emerging manager programs is a full-time job. It takes away from time that could be spent on doing things that yield returns such as focusing on deals.

I had a candid conversation with a former plan sponsor from the East Coast a few years ago. I asked her why investors continue to allocate money to non-female, non-minority managers. Her answer shocked me. She told me because “the other guys” get the better deals – they see better deals and get more favorable debt and equity terms. I appreciated the honesty of her feedback. I imagine her bonus was tied to performance and so she continued to invest with the other guys that she thought would get her the “better” returns. However, emerging manager programs were originally created so that capital could be allocated to minority-owned and female-owned firms – groups that traditionally did not benefit from the “right” networks that led to investments by institutional investors. Unfortunately, minority-owned and female-owned platforms are not getting these allocations. While representation is not justification for the existence of emerging managers, it should be a big factor in the evaluation process if the industry wants to give minorities/females the same opportunities. Modification in the process is important if the groups that were initially targeted by these emerging manager initiatives are at the starting line with a disadvantage.

It is understood why plan sponsors must have intermediaries, but a disconnect exists between intermediaries and the emerging managers. Because of stringent requirements put in place, it is challenging, if not outright impossible, for true emerging managers to qualify for many of the existing emerging manager programs. Many operators do not even get the opportunity to talk about their strategy because MoMs end the conversation once they have ascertained that the operator does not check off all boxes (AUM, number of employees, platform size, track record, tenure of partnership). There should be consideration for groups that check off some of the boxes AND also credit given for other value brought to the table (e.g. relationships, niche strategy, etc.).

I was lucky to find a GP partner who worked closely with their operating partners on successful ventures. In the early 2000’s I was introduced to Blue Vista Capital Partners. Blue Vista had just launched their platform and raised their first fund, which was focused on GP co-investment. They had invested in my first company’s value add office deals in Honolulu which were very successful. The portfolio was sold in August 2007. My former platform decided to sit out the rest of the cycle. When there were signs that the market was going to turn, I put a new platform together. I immediately called Blue Vista with my pipeline of value add and opportunistic deals. We partnered on deals. My team sourced and underwrote the deals, identified the LP, executed the business plan and managed the equity/debt relationships. Blue Vista provided the deposit and the GP co-investment requirement. What I appreciated most about my relationship with Blue Vista is that they understood that, as an emerging manager with a niche concept of investing/developing in the Hawaiian Islands, I would find it challenging to get institutional investors to listen and even begin to try to understand the Hawaii office and retail market. As I reached out to many potential LPs, Blue Vista helped in guiding me - here's what you need to do; here's what you need to look out for; this is how you need to structure it. Their analyst took our proforma and worked with us to be certain that it met institutional standards. They basically incubated my platform in an unofficial capacity. This type of partner is what is missing in the industry.

While it is not Blue Vista's job to grow emerging manager platforms, they see beyond the deals. Their track record speaks volumes. They evaluate good deals and can identify operators with potential to create something meaningful. The magic is their ability to see if they can intersect the two. Other MoMs have told me why I cannot qualify for programs and what I needed to do before I come back to them. Blue Vista figured out what boxes I checked off and said *let me see if I can help you get started*. They are resourceful mentors for the sponsor/operator and an even better fiduciary for the investor.

RESOLUTION

In a world where capital is flowing but deals are lacking, there must be diversity of thought – this should mean diversity across operating partners. Having such diversity should facilitate different types of investment opportunities. Current emerging manager programs should be called something different as they do not support the definition of a "true" emerging manager as I outlined earlier. In the interim, however, a new type of program should be created to incubate operators that are working their way to becoming qualified emerging managers.

An accelerator program should be created for those operators that do not qualify for typical emerging manager initiatives. The program would have an incubator fund manager oversight. The manager would be responsible for finding operators that have the potential to later qualify on their own for institutional capital (emerging manager program or direct allocation). The manager would screen operators, review business plans and deal pipeline. From this evaluation process, the manager would determine what the operator needs to get to the next level. Assistance could be in the form of rounding out the operator's team with skillsets that are missing in order to create a more robust execution capability. Capital allocated to operators could be for operating capital and/or co-investment in deals. If operators do not have suitable partners (e.g. development partner, limited partner, etc.), the manager could help identify the partner for the operator. The manager would assist in molding operators during the infancy stage. This programmatic venture would allow the operator to work with the manager on governance, management and scalability of strategy, resulting in a platform with stable foundation. The manager would identify several operators with which to create programmatic joint ventures in the incubator program.

Underwriting emerging managers takes time and resources as they present unique challenges during the vetting process. A manager of managers (or fund of funds) vehicle reduces risk and allows investors to diversify by investing across many managers and strategies. With a qualified MoM to oversee these early stage managers and mentor them, they will help prepare them to be well-rounded teams with solid platforms by capitalizing on strengths and enabling improvements in areas of deficiency during the “incubation” period.