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PERSPECTIVE

DR. T ON SECURITIES

Emerging managers in venture capital

By Sara L. Terheggen

The COVID-19 pandemic impacted just about every industry and that impact initially resulted in an environment where risk assessment became the center of attention. This was particularly pronounced in the world of investment funds, especially in the world of venture capital funds. Emerging managers were disproportionately impacted in the early days due to the complete halt of in-person activities which significantly hampered diligence efforts. For example, investors often require in-person meetings to gain approval from their investment committees to place capital with emerging managers. Further, in a time of extreme risk aversion, investors were much more comfortable placing capital with funds that had track records. With more capital being allocated to larger, more well-established venture capital funds, the number of first-time funds fell significantly in 2020 with only 87 funds launched compared to 145 in 2019. This inadvertently translated to less women and minorities and diversity, equity and inclusion in venture capital took another hit.

As the world has started to enter post-pandemic normality, emerging managers may have an opportunity resulting from a confluence of events. These include investors becoming more comfortable with virtual fundraising and even adapting their own diligence and approval processes to conform; a desire for even more expansive portfolio diversification; access to unique deal flow and an increasing emphasis on diversity, equity and inclusion. Emerging managers, especially women and minorities, can gain an edge by focusing on preparation, unique deal flow and alignment of interests and incentives.

Preparation

As investors become increasingly comfortable with a virtual fundraising environment, emerging managers can take advantage of this flexibility and demonstrating preparation and persistence will be key. Prior to fundraising, emerging managers should set up digital data rooms and populate the data room with information regarding the fund, pitch materials and any performance information that will be pertinent to any investor's diligence process. Emerging managers should expect to work much harder than their more well-established peers when it comes to diligence. This is particularly true given emerging managers are less likely to have the people, processes, structures and systems in place that large investors have come to expect. To overcome lack of track record, emerging managers must be prepared to show flawless operational capabilities and strong execution capabilities. The more rigorous and thorough the diligence package and the more documented a firm's policies and procedures, the more likely an investor will be comfortable taking a chance on a fund with no or minimal track record.

Unique Deal Flow

Because of their smaller size and often because the funds are started by women or minorities, or focused on unique geographic locations, emerging manager funds can provide a level of diversification in deal flow that larger funds are not capable of accessing. Highly differentiated investment strategies and/or targeted sectors also provide opportunities for diversification in deal flow. Further, emerging managers are more likely to have exposure to smaller deals with lower purchase-price multiples and potential for larger upside.

Research by Preqin and others has shown trends that first-time fund managers frequently outperform follow-on funds despite having shallower track records. A large factor contributing to this outperformance is unique deal flow. Emerging managers should be prepared to spend time on cultivating an investment strategy and deal flow that is unique to their own capabilities, thereby providing investors a level of diversification they cannot achieve elsewhere. They must then harness those unique characteristics into a compelling story that will justify strong investor returns.

The importance of unique deal flow is not lost on larger, more established venture capital funds. There is increasing examples of such larger funds attempting to acquire these smaller funds or attempting to convince one or more of the general partners of these smaller funds to join the larger funds as a means to gain access to these lucrative deal pipelines.

Alignment of Interests and Incentives

One thing emerging managers can offer to investors which is much more difficult for larger, well established funds is flexibility when it comes to incentives. This can mean a number of different things. This can be as simple as reduced management fees and carry. Incentives can also include controls around governance, priority co-investment rights and preferred allocations in subsequent funds.

Co-investment rights allow investors to invest in companies directly alongside general partners. This allows investors to allocate more capital into deals of interest without incurring additional fees. Larger, more established funds tend to reserve such co-investment rights for very large investors or even refuse to grant co-investment rights at all. This gives emerging managers an opportunity to gain an edge.

Further, given the expanding emphasis on diversity, equity and inclusion initiatives, women and minority-owned funds are well positioned to align their funds with investor purpose and mission. Increasingly, investors are focused on identifying fund managers who are aligned with their goals and many investors have expressed publicly their desire to promote fund manager diversity and are taking this factor into account when making their investment allocations.

An Opportunity for Emerging Managers

Raising a fund is difficult for anyone but this is particularly true for emerging managers. In addition to often struggling against the additional barriers imposed on women and minorities, these funds must differentiate themselves. Emphasizing preparation, highlighting unique investment strategy and deal flow and aligning incentives and interests offers emerging managers concrete, practical suggestions for increasing the likeli hood of success in their fundraising. ■

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