The Case for Emerging Fund Managers: Private Equity

TIFF Private Equity Team
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Within TIFF's private equity (PE) program, we constantly strive to assemble a roster of best-in-class managers combined with attractive co-investments and secondaries that, together, we believe have the potential to meet our long-term goal of generating at least 500 basis points of outperformance vs. public equities across market cycles. We have historically surpassed this goal, thanks in large part to our ongoing ability to identify, and willingness to place capital with, relatively new managers that we believe have the potential to become top-tier groups—firms we label "emerging fund managers." Private equity firms have a definable life cycle. In our view, smart portfolio construction therefore includes taking the pulse of, and when appropriate, investing in high-potential, emerging fund managers in order to continually refresh our manager roster and make sure every dollar we invest has the potential to grow several times over. Of course, TIFF pursues emerging managers focusing on marketable equities as well, and you can read more about that effort in a companion article. In private equity, the long-term nature of the strategy means the benefits of finding a strong emerging manager can deliver rewards for a decade or more. A mistake will be with you for that long, as well.

Access, Visibility, Alignment, Terms

TIFF has dedicated its time and resources over the years to engaging with emerging fund managers for several reasons. First, we believe investing with these managers is the best way to access the markets where we see the highest return potential –early-stage venture capital and lower middle-market private equity. Managers in these segments tend to face less competition and have a greater ability to add value through operational improvements and company-building measures.

Second, by getting a foot in the door with an emerging fund manager, we get a seat at the table before many of these groups, primarily those that prove to be successful, close to new investors. Over the years, we have backed emerging managers whose strategies ranged from US and non-US buyout to venture and real assets, each commitment coming early in the life cycle before the manager was "proven." Over time, many earned a reputation for maintaining high-quality partnerships and organizational continuity as well as strong performance. They are now well-established, high-demand PE brands with limited access for new investors.

Third, emerging fund managers tend to have strong alignment of interests with their investors as well as an inherent motivation to be transparent partners and exceptional investors. The investment industry is littered with smart, hard-working, creative individuals; many of these people are driven by the desire to accumulate wealth. Unfortunately, they sometimes conclude that the most effective way to do this is to

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grow assets under management and add products (to further grow AUM and diversify their revenue streams) in order to maximize profits from management fees and generate larger carry dollars, even with mediocre performance. Emerging fund managers are taking significant career risk, typically leaving highly compensated jobs at other investment firms to start a new firm with no committed capital (and therefore no management fees). They are betting on themselves and their ability to make great investments; the only way they accumulate wealth and stay in business is to earn the trust of outside investors, generate strong returns, avoid big losses, and, over time, earn carried interest *if* they generate significant profit for limited partners (LPs).

Fourth, it is hugely advantageous for us to negotiate preferred terms with more flexible groups that are just starting out, securing lower fees and carried interest as well as co-investment rights, and helping to shape the direction of the firm as a trusted advisor and advisory board member. Lower fees and carry can significantly improve net returns to our members, while preferred access to co-investments gives us an opportunity, should we choose to invest, to generate attractive risk-adjusted returns and to get to know the general partner (GP) in even greater depth. This happens as we evaluate their investment theses and risk-assessment skills while working side by side.

TIFF's Advantage

Our edge in identifying emerging fund managers derives from several sources, including TIFF's longtime commitment to and reputation for backing new groups, our sourcing capabilities, our investment process, and our focus on smaller groups—those having the highest return potential. From the launch of TIFF's private investments (PI) program in 1997, we have successfully identified myriad emerging fund managers that have gone on to prove their worth as consistently strong performers. Peer institutions, established funds that we backed when they were emerging brands, and placement agents are all aware of our willingness to evaluate new managers, and they regularly refer emerging groups to us. Our board is another valuable source of referrals.

Our investment due diligence process for emerging fund managers is just as rigorous as the process we employ for established managers. It includes multiple in-person interactions over several months or even years, extensive on- and off-list reference calls, deal-by-deal underwriting, and extensive reviews of a manager's operations and compliance processes by TIFF's in-house teams. In addition, we sometimes invest alongside a pre-fund sponsor on a co-investment basis prior to making a full fund investment; this was the case with Monogram Capital Partners, described later in this paper. Understanding exactly with whom we are partnering and having the time to go through our vetting process is critical. Founders of a new firm are limited in number as compared to larger, established partnerships whose organizations have been built up over years or decades. With a lean founding team, we enjoy a clear line of sight to the people driving value creation in a fund's returns. This results in increased transparency and accountability. To gain access to a large, successful franchise after it is firmly established, LPs often must move quickly with their work and potentially compromise their due diligence standards in exchange for "trusting the brand." In the case of emerging fund managers, there

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is no mystery about who is responsible for successes and for failures. And these smaller, newer managers are typically motivated to help with our due diligence process, not to try to contain or minimize it.

It is important to note that backing emerging fund managers is not a distinct strategy allocation that we feel we must fill. These managers compete for our capital like all others, and we size all commitments so that they have the potential to move the needle at an individual fund level. Put simply, we seek to identify and fund best-in-class emerging fund managers with the aim of forming a relationship with the next generation of elite funds before they become high-demand offerings.

What the Data Says

According to research published in 2015 by Cambridge Associates, new and emerging firms (defined as funds I-IV) consistently accounted for 40%–70% of the value creation[1] in the top-100 venture capital deals each year for the 10-year period ending December 31, 2014. In a follow-up study published in 2016, Cambridge Associates looked at the top-ten US venture capital funds within the top quartile in each vintage year from 2004 to 2012 as of September 30, 2015, and determined that, on average, new funds (I and II) and developing funds (III and IV) represented 70% of the universe and established funds (fund V+) 30%. For US private equity funds, the split was even more pronounced at 75%/25%. This strongly suggests that trying to discover potentially top-tier managers early in their formation is time well spent.

We have also examined our performance experience with emerging fund managers since the inception of TIFF's PI program in 1997 through June 30, 2020, compared with that of established managers. We found that funds I-IV have outperformed funds V and later, on average, by 370 basis points (bps) annually.

	# of Funds	Gross DPI	Gross TVPI	Gross IRR
Emerging Managers (Funds I-IV)	165	1.7x	2.0x	16.9%
Established Managers (Funds V+)	128	1.2x	1.7x	13.2%
Total	**293**	**1.5x**	**1.9x**	**15.5%**

When we limit the data set to venture capital funds, the return differential is even more pronounced at 950 bps.

[1] Value creation is represented by total gains, defined as the total value (realized or unrealized) of a given investment less that investment's total cost. The analysis then focused on the top 100 investments per initial investment year, as ranked by total gains. The data set included 1,800 investments, representing 1,211 companies, made by 682 funds, representing 265 global venture capital managers.

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Fund Number	# of Funds	Gross DPI	Gross TVPI	Gross IRR (USD)
Emerging Managers (Funds I-IV)	46	2.3x	3.0x	24.1%
Established Managers (Funds V+)	38	1.0x	1.7x	14.6%
Total	**84**	**1.7x**	**2.4x**	**21.1%**

Our analysis also found an inverse correlation between fund size and returns, which echoes broader market data.

Fund Size	# of Funds	Gross DPI	Gross TVPI	Gross IRR (USD)
Up to $150M	59	2.1x	2.7x	28.6%
$150M-$450M	112	1.4x	1.8x	12.5%
$450M-$1B	74	1.3x	1.6x	11.1%
>$1B	48	1.3x	1.6x	10.3%
Total	**293**	**1.5x**	**1.9x**	**15.5%**

Source: TIFF Investment Management.

Performance data represent past performance and does not guarantee future results. There can be no assurance that TIFF funds will achieve their objectives or avoid substantial losses.

Gross IRRs include both realized and unrealized investments. Unrealized investments are valued by underlying funds in accordance with the valuation principles contained in the documents governing such fund. Ultimate realized returns on unrealized investments will depend upon, among other factors, future operating results, the value of the assets and market conditions at the time of disposition, any related transaction costs, and the timing and manner of sale, all of which may differ from the assumptions on which the valuations used in performance data set forth herein are based. Accordingly, the ultimate returns on these unrealized investments may differ from the returns indicated herein. **Gross IRRs do not reflect fees and expenses incurred at the TIFF fund level (including TIFF management fees and carried interest)**. **Note that TIFF fund-level fees and expenses will reduce investment returns.** As an example of the impact of fees on an investment, assume a fund management fee of 0.75% of an investor's commitment annually for years 1-7, 0.35% of the commitment annually for years 8-12 and 0.15% of the commitment annually thereafter, and administration, audit, tax, legal, and insurance expenses of $100,000 to the fund annually. Also assume a fund size of $100,000,000 and a fund life of 15 years. For purposes of this example, the fund does not charge any incentive fees. If an investor commits $1,000,000 to the fund, $89,500 of that commitment will be attributed to fees and expenses over the life of the fund. More information on the fees and expenses of the TIFF PE funds can be found in TIFF Advisory Services, Inc.'s Form ADV Part 2A and the offering materials of the individual TIFF PE funds.

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While industry-wide data show that there is greater volatility in outcomes for emerging fund managers relative to established managers (which our data corroborates), we believe our process enables us to reduce downside volatility while maintaining upside potential. Over our history, a good number of emerging fund managers have been led by partners who spun out of top-tier PE firms in which TIFF was an investor. As a result, we had years to get to know the founder, saw the deals he had led at his prior firm from start to finish, and, therefore, were able to reduce the risk of backing the new firm. Pearl Energy, described later in this paper, is one example. In a similar manner, with pre-fund managers, TIFF is able to underwrite a new firm, evaluate potential investments deal by deal, and thus get to know the GP extremely well—both the good and the bad. This allows us to use our deep knowledge of the GP, a perspective most other LPs lack, to better decide whether to anchor their fund I. Our in-depth, bottom-up, time-intensive due diligence process allows us to pluck the highest-potential emerging fund managers from the sea of new entrants. The result has been a loss rate for emerging investments—a ratio of investment dollars lost across all emerging funds to the total committed [2] —of less than 5%, which is consistent with our overall loss rate across all private investments. TIFF has had great success with emerging fund managers over the last two decades, but we've also made mistakes. We've limited these errors, however, by carrying in our manager-selection toolbox an institutional knowledge of "red flags"—teams that have never done an investment together prior to raising a fund, an aggressive target fund size, and the sale of GP ownership stakes to outside groups, to name just a few.

Case Studies

Since 2011, TIFF has generally hired two to five new private equity managers per year; a majority would be classified as emerging fund managers. Among our recent experiences are three North American lower middle-market managers, each of which shows a slightly different twist on the emerging manager process and profile: Pearl Energy, an upstream oil & gas manager; New State Capital Partners, a buyout manager; and Monogram Capital Partners, a growth equity manager focused on emerging consumer and retail companies.

Pearl is led by Billy Quinn, who spent 20 years at Natural Gas Partners (NGP), a well-known and experienced oil & gas-focused private equity manager that TIFF worked with for many years. So, when Quinn started Pearl, TIFF was one of his early calls. Quinn's co-founder, Chris Aulds, spent several years as an operator, founder, and CEO in the energy industry and thus brought a significant Rolodex and valuable hands-on operating experience to Pearl. The experience level of this duo in their target market, combined with their track record and credibility, were all convincing factors in our decision to invest. Furthermore, TIFF had a head start on due diligence, given our lengthy history with Quinn's predecessor firm. To add alignment to the first Pearl offering, they granted founding LPs several

[2] Loss rate is calculated by dividing the total amount of capital lost in those funds where total value to paid-in (TVPI) is less than 1.0x by the total commitments to an equal-weighted portfolio of all funds. For example, given five $10 million funds, if one fund's TVPI is 0.8x because it lost $2 million, the loss rate would be $2 million/$50 million, or 4%.

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attractive terms, including a below-market management fee, guaranteed minimum investment rights in the successor fund, and caps on the fund size for this and the successor fund. The unusual combination of deep experience, strong track record, and extraordinary alignment with LPs was core to our thesis with this new partnership. TIFF closed its first commitment to Pearl in 2015, with a second commitment to Pearl's Fund II in 2017.

New State was formed in 2015 by David Blechman, a private equity veteran with experience at HIG, Tower Three, and Sun Capital. Blechman had assembled a small but diverse team with a broad array of investment, financial, turnaround, and operating experience, making the group well-equipped to pursue a strategy of acquiring fundamentally sound companies with operational, financial, or structural complexities at deep-value prices. From our initial interaction with him, Blechman struck us as a strong leader whose combination of deal expertise, operational wherewithal, and high integrity created a solid foundation for the partnership. This impression was continually reinforced in conversations with references. TIFF closed its first commitment to New State in 2015 and we made a second commitment in 2018. In addition to our fund commitments, we have co-invested in six companies alongside New State through a mix of pre-negotiated, fee-lowering commitments and targeted commitments, and we purchased an off-market secondary in New State's Funds I and II where we had special insight into the portfolio due to our relationship with the firm. As an early backer of New State, TIFF is represented on the firm's LP advisory committee.

Monogram is a prime example of another important component of our emerging fund manager sourcing strategy: pre-fund sponsors. For TIFF, investing on a deal-by-deal basis with high-potential, aspiring private equity managers eliminates the blind-pool risk of committing capital to a first-time fund. It is also an opportunity for us to gain first-hand knowledge of the manager's investment process while providing us with an opportunity to make attractive returns on co-investments and positioning us as a trusted partner and future anchor investor down the line. If we do not gain conviction that the pre-fund sponsor will be a best-in-class manager, we cease looking at deals with them. In 2015, we backed Monogram, which was founded in 2014 by Jared Stein and Oliver Nordlinger after each left vice president roles at two of the most highly respected private equity firms in the world. Stein was with Golden Gate Capital, a buyout manager for TIFF since the late 1990s (an emerging fund manager when we backed them in their first fund), and Nordlinger was with Leonard Green & Partners. In Monogram, we saw a young team with outstanding potential to apply strong investment acumen and private equity skills acquired at best-in-class firms. TIFF undertook full investment, operations, and compliance due diligence on Monogram and approved it as a pre-fund sponsor with the goal of getting to know the firm by investing small amounts of capital in attractive direct deals and potentially becoming an anchor investor in a first fund.

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Collaborating with Monogram in this way afforded us a unique vantage point from which to observe how they built the firm and sourced and worked with their companies. It also positioned us as a trusted advisor tapped to weigh in on best practices around fund operations, compliance, and the structuring of their first fund. Over the following two years, we co-invested in five deals alongside Monogram, including Chewy, an online retailer of pet products that was acquired by PetSmart in April 2017 for $3.4 billion in what was then the largest-ever e-commerce acquisition. Our remaining Monogram co-investments are unrealized. In 2017, having gained substantial conviction in Monogram's ability to source, structure, and exit interesting consumer investments, we became a lead investor in the team's first institutional fund. Based on Monogram's continued strong performance and our conviction in the team, we committed to the firm's Fund II in April 2020.

Pearl, New State, and Monogram exemplify the high bar we set for emerging fund managers and pre-fund commitments, which comprise a relatively small but important component of our overall private equity strategy. We have funded well under 5% of the emerging fund managers that we have evaluated and expect to maintain the same level of discipline going forward as we aim to identify the next generation of leaders in private equity. The optionality afforded by a commitment to a compelling emerging fund manager, combined with the opportunity to have a meaningful voice in the manager's development, is a winning combination, in our view, as we strive to meet our steadfast goal of delivering superior private equity investment returns to our members.

Summary

Identifying and funding high-potential emerging fund managers across our programs has long been a hallmark of TIFF's investment approach. It has been an integral component of our private investment approach since we initiated TIFF's private investments program in 1997. Engaging with emerging PE fund managers affords us a unique vantage point from which to observe and collaborate with groups that are starting out while providing us the optionality to continue supporting them down the road when access is likely to be limited. The effort requires dedication, patience, and an allocation of resources that not all institutional investors can support. Fortunately, TIFF can. TIFF's performance experience with emerging PE fund managers shows the success of this work to date and why we expect emerging fund manager commitments to continue to be an important piece of private investments portfolio construction that will help us achieve our long-term return goal of public equities plus 500 basis points.

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Glossary
Distributed to Paid-In (DPI) Ratio of total distributions to cumulative capital called.
Total Value to Paid-In Multiple (TVPI) The ratio of an investment’s current fair market value plus any previously distributed capital to its cost at the time of acquisition. This is a simple but meaningful measurement of how many times an invested dollar has been multiplied by a given investment. A 2x TVPI indicates that an investor has received $2 of realized and/or unrealized value for each $1 of invested cost. The term “cumulative value multiple,” which is less widely used than TVPI, is calculated in the same manner.

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