

## **RPM—56 | The case for emerging managers with Ted Panarese and Aditya Fontana-Raina**

**Anna Marcus:** Hello and welcome to RPM, the Stepstone Group podcast that delivers sharp insights into the world of private markets. I'm Anna Marcus, your host for today's episode, and today I'm joined by Ted Panarese and Aditya Fontana Reina, New York based managing directors on our private equity team. In today's episode, we'll be discussing a super relevant topic, The case for Emerging Managers. So, we look at whether emerging managers truly represent a disproportionate source of risk, or if the opportunity may have been mischaracterized. This episode follows the recent release of our white paper called The Case for Emerging Managers, which was also on this topic. Ted and Aditya, welcome, thank you for being here...let's get started.

**Ted Panarese:** Thanks, Anna. It's great to great to be here.

**Aditya Fontana-Raina :** Yeah. Thanks for having us. We're excited to chat. Emerging managers.

**Anna Marcus:** Great, yeah. So I think maybe to start, our viewers and listeners would be interested in learning a little bit about your backgrounds, your journey to Stepstone. Ted, let's start with you.

**Ted Panarese:** Sure. So, Ted Panarese, a managing director here at Stepstone in the New York office. I spend much of my time in our co-investment business and then our primary funds coverage business, focusing on the lower middle market and middle market, uh, with the focus on North America. Uh, much of my time is spent looking at emerging managers prior to Stepstone actually, uh, worked at, uh, emerging manager, um, on the GP side. So I have some direct experience with this segment of the market, but it's, uh, it's a part of the market we're very active in, and one that I spent a lot of my time covering.

**Anna Marcus:** Yeah...and then Aditya.

**Aditya Fontana-Raina :** Sure. Um, so my name is Aditya Fontana Raina, also a managing director at Stepstone, based in our New York office. Um, not all that different in terms of

coverage areas from Ted where I spend most of my time on our lower middle market buyout manager coverage team. So we define that as managers in North America, with buyout funds raising target fund sizes of 2 billion and under so pretty large swath of the market. But it definitely captures the emerging manager part of the ecosystem, which is what we're talking about today. And then I also spend a lot of my time similar to Ted on our co-investment practice. And that, again, is all buyout co-investments. I've been at Stepstone for about 12 years. Prior to this, I was an investment banking really focused on small mid cap transactions. So again, I've always been focused on at the lower end of the market.

**Anna Marcus:** All right. Great. Thank you both. So now diving into the topic at hand. Let's get into it. Ted I'll start with you. So, what prompted you to write this emerging managers paper, now, why revisit the case for emerging managers...

**Ted Panarese:** Emerging managers, which we define as any GP who is raising their first, second or third fund are an incredibly important piece of our overall business. They represent 40 to 45% of our primary funds deal flow each year, and it's a segment of the market that we're very, very active in. I think we have long believed that early Roman numeral funds can have very attractive alpha generation potential to a balanced private equity portfolio, but we really wanted to put some numbers to it. Uh, at Stepstone, we fortunately sit on a vast data set that lets us measure performance across a very broad cross-section of, uh, metrics and angles. And then I think, just to take a step back, um, emerging managers, um, I think broadly, have earned a reputation for being high risk, high reward propositions. And there're, frankly, a lot of LPs who struggle to gain comfort, you know, with fund ones in particular on that basis. That was another conception that we really wanted to test using our data. Uh, and I think the results were pretty interesting.

**Anna Marcus:** Yeah. So that actually leads to our next question, which is due early funds really outperform. Aditya, what would you say the data actually says about fund performance?

**Aditya Fontana-Raina :** Yeah, it's a good question. And we spent a lot of time just letting the data speak for itself, and I think the short answer is yes, funds actually outperform. Early funds actually outperform. But I think it's important to designate a few things related to that one. Um, there is a subset of early funds that outperform. You need to make sure you have prudent and strong manager selection to make sure you are in the first or second quartile of those, uh, of that market of emerging managers that outperform. And the

second caveat to this, which I think is actually a positive thing, is that it's not just outperformance on an absolute basis, it's outperformance on a relative basis. And I think that's really important. So, when you look at fund one, buyout funds, the median net IRR that we found in our data, which is across over 500 plus, uh, fund ones, it was a net IRR of about 18% versus something like in the mid-teens for later funds, let's call it fund four and beyond. Um, so that is pretty attractive on an on an absolute basis at that 18% net IRR. But even on a relative basis, around 60% of fund ones and even fun twos outperform the median buyout fund. And that stat for fund four and beyond was more, more like 50%. So there's a real meaningful outperformance on average for for early funds relative to the more mature funds. Um, and we saw in the data that performance is actually consistently declined as fund sequences advance. Um, that has been a pattern that's shown up across cycles. Um, I think what's maybe just as interesting is the dispersion of returns. So yes, there's outperformance, but it doesn't necessarily come with what I would call the perceived downside risk. Based on the data that we saw. The downside risk of emerging managers is not meaningfully all that different from what we see in the broader small mid-cap buyout ecosystem. The return dispersion is actually more skewed to the upside for, for emerging managers. And I think that really showcases how much alpha opportunity there is in fund ones twos and threes.

**Anna Marcus:** Okay, really interesting...so then Ted, if early funds do outperform what separates the good from the bad. Is there an ideal fund one profile.

**Ted Panarese:** Yeah. So I think this is where our analysis got pretty interesting. Um, so in addition to asking the broader questions around whether or not emerging managers outperform, we wanted to see if we could identify features and traits of certain manager cohorts that correlate with outperformance and conversely, underperformance, just to help us be better at our jobs, which is identifying managers and in this case, emerging managers. So we cut our data a bunch of different ways to try and answer that question. We looked at things like founder, age, founder, experience, number of Founders Fund size. And I think the punchline is that there is not a magic formula per se, but there are some common threads that we observe across higher performing fund ones. So what are they? Uh, first, uh, fun size. So smaller fund ones simply do better to put some numbers to it. Uh, 67% of fun ones that are, uh, \$500 million or less outperform the median, which is pretty remarkable once you go above \$500 million in a fund. One, the advantages of, uh, that you typically get with fund ones really start to fall away. I don't think that this was necessarily a big surprise to us. It generally fits our institutional beliefs around the lower

middle market. When you have a smaller fund, you know you're targeting smaller companies. Valuations are typically lower. Supply demand dynamics are typically better. They're simply more companies to buy with less capital chasing them.

**Ted Panarese:** You aren't as reliant on leverage or financial engineering drive returns. It's generally easy or easier to prosecute value creation initiatives that really move the needle in a small company versus a large company, and you have a very large and fertile universe to sell those companies into once they've scaled with lots of exit optionality. So we aren't necessarily making the point that smaller funds only do better. When we're talking about emerging managers, it's probably more of a universal dynamic, uh, that we observe across lower middle market. But that was an important analysis that we ran with, I think, some compelling, um, uh, findings. Next we looked at, uh, founder experience level, and this was perhaps a little bit more surprising to us. Uh, one of the features of emerging managers that we've long found to be attractive is the overall alignment and hunger, uh, level of the founders. So we thought there was a good chance that younger, uh, fund one founders who are unlikely to have generated significant personal wealth to that point in their careers from their prior firms, would generate the best outcomes. And that actually wasn't the case. And the data actually suggested that experience really does matter. And founders with longer careers leading up to their spin outs were the most likely to outperform, uh, the median and, uh, their peers. Um, the next was founder count. This again surprised us a little bit. The data suggested that there really was no benefit to having more than one founder and a fun one. To caveat that I do think there are some qualitative advantages and real advantages to backing an early fund with two or more founders. Key person risk is at the top of that list, and then I think capacity, particularly in fund two and beyond, once these firms have built an unrealized portfolio, can firms with a larger group of founders, you know, can typically scale up a bit better.

But I think if you're looking purely at the data, we didn't see the advantages show up. Um, you know, in, uh, first time funds with 2 or 3 founders versus those with, um, a sole leader. Um, and I would just say broadly, we are continuing to cut our data and look at other metrics that we'll unpack in future iterations of this paper. Um, like the profile of the predecessor firm, any strategy drift from the predecessor firm, including, you know, how large of a move down market the founders are making and many others. So, you know, this is a living, um, Breathing white paper and effort that we continue to work on and look forward to rolling out future variations of. But I think in general punchline is that there isn't

a magic formula for emerging manager selection, and you need to evaluate every opportunity on a case basis.

**Anna Marcus:** Yeah, thanks for that, Ted. And then maybe switching gears a bit to risk. Aditya, what are some real risks with fund investing? Is dispersion an issue? Can you talk about that?

**Aditya Fontana-Raina :** Yeah. Of course. Um, and I think you'll see a theme kind of running through Ted and I's responses, where there's probably a short answer to all these questions, but I think all of them have a bit more nuance to it where there isn't, you know, a silver bullet as it relates to an archetype for a fund one manager. Similarly, the question around is dispersion the real issue? I think the short answer is yes, but I would say it's not really dispersion to the downside. Um, there is a wider dispersion in emerging managers. But what we're seeing is that while there is this larger spread between winners and losers, the downside spread looks not too dissimilar from more mature buyout funds, which I mentioned earlier. What the difference is that there's a greater opportunity to outperform, but you need to be in that first quartile. So if you look at the findings in our chart in the white paper, you'll see that that bucket of top quartile and even some of the second quartile for emerging managers are fun ones and twos and threes is actually quite a bit larger than what you see for more mature funds. So there is this meaningful upside opportunity where alpha can really be generated in emerging managers.

**Aditya Fontana-Raina :** But I think what the real risk is, is around is more related to due diligence and manager selection. It's a pretty opaque, fragmented part of the market when we're talking about the emerging manager ecosystem. So it really requires, um, a few things.

Those are probably strong sourcing and access, uh, good qualitative and quantitative due diligence and then ultimately prudent manager selection because you really need to be in that first quartile. Otherwise you're really only capturing the same risk return opportunity that you could get from the broader small mid-market buyout, uh, opportunities, which nothing to scoff at. You know, we're big proponents of that part of the market. But I think for LPs who are taking the risk, whether real or perceived, and we would argue a lot of it is perceived, um, of investing behind emerging managers. You want to be compensated for taking that risk, and that compensation is in the form of outperformance. And to get that outperformance, you really need to be in the first quartile. So I think that is the real

risk. It's how do I get to that first quartile? How do I get compensated for the risk? I'm taking backing this nascent platform.

**Anna Marcus:** Okay. And then, Ted, for those who want to get into this space, what is a disciplined, emerging manager playbook really look like?

**Ted Panarese:** Yeah, it's a good question. I think first, you really need to be in the flow. A GP raising its first fund probably isn't going to have a sophisticated investor relations apparatus, and they aren't always as easy to find as a more established name brand GP that's in market raising a fund. So, it's really important to know who the highest performing deal teams are at established GPS. And be when those teams spin out, it can help to have a presence at emerging manager events, of which there are many. And, you know, across a number of cities, you know, North America and in Europe, but it's equally important, I would say, to leverage your network and existing relationships to keep a finger on the pulse of the market and be there to meet. Meet those opportunities when they arise. And I think second, you need to have a real focus on what institutional quality looks like. It's not enough to have a website and a track record. Things like team scale, team cohesion, back-office infrastructure, financial controls, valuation policies and much more. Those things are really critical to understand, when you're assessing the back ability and viability of an upstart GP. The next thing I would say, you really need to leverage your network to validate, things like experience, track, record, reputation. These things are not going to be handed to you on a platter. In fact, it's very rare for a GP, especially those spinning out of a high quality, established firm to be given formal attribution.

So, you either need to have extensive familiarity with the predecessor firm and knowledge of who led what deal, or a network with relationships at those firms or at peer firms that work, you know, closely, you know, with the predecessor firm to really unpack attribution and stress test what you're being told by the manager and a stepstone. I think this is one of our big advantages when it comes to emerging manager diligence. There's an incredibly high probability that we will have extensive institutional familiarity with the manager's prior firm. We're able to therefore very quickly figure out what their roles, reputations and track records look like. But I think at the end of the day, it's all about pattern recognition, and being in the flow of opportunity because not all emerging manager opportunities are created equal, right?

**Anna Marcus:** Yeah. Okay. So not all emerging manager opportunities are created equal. So then Aditya, how do you think or how would you say LPs should underwrite fund one risk. Why should LPs care? What should they do?

**Aditya Fontana-Raina :** Yeah. And maybe to piggyback off of some of the things that Ted was saying, I think it's important to note that because not all emerging managers are created equally, this idea of pattern recognition is really important. I think going through different opportunities that you have access to and creating that real muscle memory around what is institutional quality, what is high quality, what does that really look like is really important. So, as I think about LPs that are starting out with an emerging manager program, I often recommend not being too quick to pull the trigger, spend some time, learn about the market, take those meetings, go to some of these events that Ted alluded to earlier, and really get a sense of what's out there and what looks good, what is institutional quality? What is high quality. So, that I think is maybe I'll start there, but as we think about underwriting, I honestly break it up into two buckets. One is underwriting at the program level and then underwriting at the portfolio level. So at the program level, I think LP should be expected to be compensated for the risk that they're taking. Again, whether real or perceived, use that emerging manager exposure to really achieve that alpha that you cannot get in other parts of the market, which we've seen through the data that we've collected, um, really higher octane, greater alpha type return profiles, if done correctly, I think we don't really recommend timing markets and generally believe in the persistence of outperformance of private equity, um, uh, especially in emerging managers.

But I think as we're seeing growing questions around, um, private equity outperformance relative to the public markets, I think this type of emerging manager exposure is a great way to make sure you are still capturing that alpha compared to your public portfolio.

**Aditya Fontana-Raina :** So I think this is even more of a timely topic as we're thinking about private equity allocations. So, that's really on the program level where you want to make sure you're getting that alpha. So, you're compensated for the risk at the portfolio level. There's probably a few different topics that I would think about as I'm underwriting an emerging manager. And I think Ted alluded to a lot of these, we talked about experience. I think there is a clear correlation between experience and return. I would go one step further and say, relevant experience is important. You need to make sure that whatever these founders or investment professionals were doing prior to founding this new firm really makes sense for the strategy going forward. Because if it's not, then it's not particularly useful or helpful and may not be all that correlated or a driver for future performance or outperformance. Um, then there's the track record. You're likely not going to have formal attribution. I think Ted mentioned that for a lot of these emerging managers. So, validating and getting to the truth in a track record for emerging managers can be a dirty job. You got to use data. You got to use references to validate that attribution, assess the relevance of that prior track record. Does what they did before again have a good correlation or a good relation to what they're doing with this new strategy? And then I think another bucket is alignment.

**Aditya Fontana-Raina :** Um, will commit capital to their funds. And with emerging managers, you want to make sure that the people you're backing, uh, are very vested in this new endeavor, both from an economic standpoint but also from a time and effort standpoint. And some of that's more qualitative than quantitative. Um, but that, again, is part of underwriting and emerging manager. And when you think about the broader team at this emerging manager, you also need to make sure that those folks are aligned and are properly incentivized to go execute on this strategy and then more broadly on, I would say the organizational structure of emerging managers. And I think this is really important. Um, and there can be a lot of lessons learned around, around this is how do I make sure this is institutional quality? Is this fund actually going to be raised? Does this GP have the back-office functions, infrastructure and really the protections related to a strong private equity firm.

And that's a whole another topic around private equity due diligence that we have separate teams that really focus on that. But that is a really important part of

understanding if this is an institutional quality emerging manager. So I would be remiss if I didn't add that to the to the list. But those are some things I think about when I'm thinking about just underwriting an emerging manager, both at a program level and then maybe more so at the manager or portfolio level.

**Anna Marcus:** All right. I think that kind of summed up the white paper. But maybe one final question for you both. Ted, I'll start with you. What is one takeaway from your findings in this paper that you'd like to share with our audience here?

**Ted Panarese:** You know, I think high level, just the, um, how important it is for us to be open minded about fun ones in particular. We talked a little bit about this, but one observation we talk about in the paper is just persistence of returns. So, emerging managers who generate great outcomes in their fund one are much more likely to generate great outcomes in fund two. So, there's a real persistence and stickiness of returns. Now, the challenge with fund ones is rarely access. It's diligence and being able to, you know, process and assess and evaluate the challenge in fund two, if that GP has been successful in fund one access. So, LPs that, you know, did not get on the bus, so to speak, in fund one. Then, you know, fund one hits it out of the park. It's going to be very, very difficult for them to get into fund two, so I think, you know, to build and maintain a vibrant, robust emerging manager program, you really need to be open not just to fund twos and threes, but fund ones if you want those long term, fruitful partnerships that will deliver, you know, above median and hopefully, you know, top quartile for, for multiple vintages over time.

**Anna Marcus:** Yeah, that's a good point. Aditya. Do you have any anything to add there?

**Aditya Fontana-Raina:** Yeah. It goes back to maybe the last question on why LP should care. Because I think that is really the takeaway. We're hoping to to drill home, uh, with this white paper and hopefully with this podcast. But I think it's probably multifold, let's call it. But some of the key takeaways that I would bring up are just with disciplined manager selection fun. One risk is manageable and the payoff can be pretty significant as you think about returns.

And then two, I think to Ted's earlier point, strong fund one performance shows meaningful persistence into subsequent funds, which is how I think some of these durable partnerships get built. But all of this and everything we're talking about in the white paper and the data, which I think is really robust and speaks for itself in a lot of ways, is only

really tangible or achievable for an LP through a strong diligence process. And we talked about a lot of those types of, um, criteria around how to assess an emerging manager. And I think that is something we're spending more and more time on at Stepstone. I think it's something we're trying to institutionalize a little bit more and give access to our LPs and clients through, I would call them training modules as part of our Stepstone Academy program, because not only do we think this is a pretty fruitful part of the market that LP should take advantage of, but we also think it's a pretty nuanced part of the market that requires a little bit more effort around the diligence process and some specialized diligence processes and criteria to look at. So we're really trying to do a lot more around this space and make it more accessible and beneficial to the LP community.

**Anna Marcus:** Awesome! Well, that's it for today's episode. Ted and Aditya, thank you very, very much.

**Aditya Fontana-Raina :** Yeah. Thank you for having us.

**Ted Panarese:** Yeah. Thanks, Anna.

**Anna Marcus:** And then thanks to our audience, as always, for listening and watching. For more information on this topic, you can check out that recent white paper we've been referring to, which is called The Case for Emerging Managers. It's on our website. And as always, you can find our RPM on YouTube, Spotify, Apple Music, wherever you get your podcasts. So thank you again.