Client: Nazo Moosa
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As Megafunds Dominate, New Entrants Tout Virtues of Being Nimble

Several new firms are seeking deals too small for ever-expanding buyout funds, writes *Ed Ballard*

At a time when the largest private-equity funds are taking an ever-rising share of investor capital, some in the industry are taking the view that small is beautiful.

Capital flowing into private equity in recent years has overwhelmingly found its way into funds raised by established firms. While more money was raised by private-equity firms in 2017 than ever before, first-time managers raised less than they did a year earlier. They raised a total of $26 billion across 226 funds, down from $36 billion across 283 funds, data provider Preqin Ltd. said in a report last month.

Because of the limited amount of capital heading their way, first-time funds still tend to be small. While funds raised by established managers have more than trebled in size since 2010, the average size of a first-time fund climbed by just 36% over the same period to $131 million in 2017, according to Preqin.

But for some private-equity investors, a smaller fund size is a reason to back emerging managers. Philippe Poggioli, managing partner at Paris-based fund-of-funds firm Access Capital Partners, said Access Capital backs emerging managers because they can pick up assets more cheaply.

Backing a midmarket manager typically means investing in companies acquired at around nine-and-a-half times their earnings before interest, tax, depreciation and amortisation, he said. "If the midmarket was giving me seven times Ebitda with reasonable levels of leverage, I would be happy to do midmarket," he added.

Mr. Poggioli said the concentration of capital in ever-larger funds will eventually drag down private-equity returns. Access Capital sometimes stops investing with good-performing managers that move on to raising larger funds, he added. It is "absolutely inevitable" that deal sizes will creep up when funds get larger, he said.

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"If anything, in the last five years we have reduced the average size of the funds to which we are committing," he said.

Access Capital recently backed the €83 million third fund of Jolt Capital, a Paris-based growth investor founded in 2011, Jolt said in a statement in November.

Smaller deals

For several new firms that have launched in Europe recently, a key part of the pitch to investors is that they will target deals that are too small for the dominant players.

London-based hedge fund manager Toscafund Asset Management launched a new financial services-focused buyout strategy last year, seeking deals that are smaller than those pursued by established firms whose funds have got larger over the years.

Fabrizio Cesario, a partner at Toscafund who is jointly leading the strategy, said Toscafund wants to write equity cheques of between €25 million and €100 million—a size bracket he said falls below the typical scope of established financial services specialists.

"At our previous shop we had access to a number of opportunities where the strategy was geared to larger tickets," Mr. Cesario said.

Mr. Cesario and his co-founder, George Koulouris, joined Toscafund from London-based financial services investor AnaCap Financial Partners last year.

Another new entrant seeking deals too small for its established peers is VT Partners, a technology-focused investment firm based in London. It was founded last year by Nazo Moosa and Natalie Tydeman, formerly of C5 Capital and GMT Communications Partners respectively, to back technology companies that are too large for venture-capital players but not large enough for most established growth investing firms.

"Natalie and I worked for larger funds and we found ourselves frustrated by the inability to invest in good underlying businesses that did not fit the standard criteria," Ms. Moosa said. She said the tier of the market VT is targeting—the firm is seeking majority or minority investments of between €5 million and €25 million—is underserved because most technology-focused growth investors need to strike larger deals to deploy their capital, Ms. Moosa said, citing what she called a "ballooning" of growth funds.

Other new entrants are applying the same reasoning elsewhere. Last year, executives from midmarket firm Bowmark Capital left to set up a new firm, Apiary Capital. The firm is targeting deals that might once have appealed to midmarket firms such as Bowmark, but are now too small because those firms are writing larger cheques to deploy their larger fund sizes, Private Equity News reported last year.

On the debt side, special situations investor Signal Capital Partners is aiming at transactions too small for the likes of large established players in the market such as Oaktree Capital Management, Chief Investment Officer Elad Shraga told Private Equity News last year after Signal closed its first fund.

But whatever the merits of their strategy, emerging managers are swimming against the tide. Last year's decline in first-time fundraising reflects the difficulty of standing out in today's fundraising environment, according to Preqin.

Ever-larger funds are an inevitable consequence of investors' efforts to increase their private-equity allocation by writing big cheques, said Mr. Poggioli.

Ms. Moosa added that investors who are keen to take a punt on an untested proposition remain the exception, rather than the norm. Compared with the U.S., Europe has a dearth of so-called emerging manager programmes set up by big investors to foster new players in private equity, she said.

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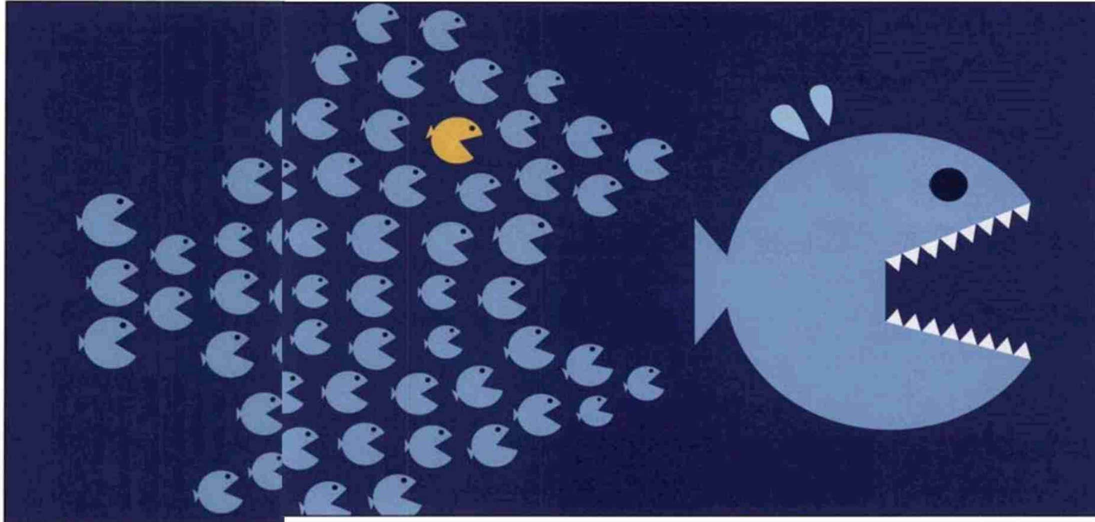

'Natalie [Tydeman] and I worked for larger funds and we found ourselves frustrated by the inability to invest in good underlying businesses that did not fit the standard criteria'
Nazo Moosa, VT Partners

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For investors willing to back emerging managers, picking the winners presents a challenge. Many investors want to see a proven track record of deals before committing money to managers.

First-time funds tend to be small, and the variance of small funds—the spread between best and worst—tends to be twice as great as that of megafunds, according to a recent McKinsey & Co. analysis of private-equity returns data from investment firm Cambridge Associates. That variance, rather than their average performance, is the advantage of smaller funds. They have more scope for outperformance but also more potential for disaster.

Devil in the detail

Neil Harper, chief investment officer of the private markets team at Morgan Stanley's Alternative Investment Partners, said "the devil is in the detail" when considering whether to back a manager who is promising outsized returns from small investments. Investors need to check that the team in question has experience of sourcing deals of that size, he said. Commenting on the host of established firms that have launched dedicated small-cap strategies, he said investors need to ask whether the strategy is "just an asset-gathering game to grow the franchise".

For some investors, the increasing pressure to write big cheques to gain access to brand-name funds is a reason to invest with promising emerging managers. First-time funds can be a good option for smaller investors to gain exposure to the asset class, said Sweta Chattopadhyay, a senior investment manager at U.K. pension fund RPMI Railpen.

"At £28 billion [of] assets under management, we're not the same size as a sovereign wealth fund, so we can't write £100 million cheques," Ms. Chattopadhyay said.

She joined Railpen in 2016 from Adveq, a fund-of-funds known for backing emerging managers that was acquired by asset management giant Schroders PLC last year, marking a shift in Railpen's private-markets strategy towards emerging managers, direct investment and coinvestment.

Last month the firm formed a tie-up with Alaska Permanent Fund Corp. and The Public Institution for Social Security of Kuwait to invest a combined $700 million in emerging managers.

Backing first-time managers can offer investors potentially lucrative co-investment opportunities. Railpen was an early backer of the first fund raised by Limerston Capital, which closed at £200 million last year, and also co-invested in the firm's first deal, an investment in energy supplier Spark Energy.

It matched its fund investment with a £20 million co-investment in the deal, Ms. Chattopadhyay said.

"We're not going to get that type of arrangement with more established funds," she added.

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