

Buyouts

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LPs

GEM's Caroline Dallas: 'Exciting time to back emerging managers'

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Caroline Dallas, director in the investment research group at GEM Investments, spends her time sourcing opportunities in the emerging manager space, including building relationships with fundless sponsors. In the tough fundraising environment of the past few years, Dallas sees new firm formation proceeding at a strong pace, providing a wealth of opportunities for investors who back this part of the market.

Buyouts recently chatted with Dallas, who is set to be a featured speaker at PEI Group's NEXUS 2025 conference in March.

What is your view on new firm formation in the tough fundraising environment?

I think it's a really exciting time to back emerging managers. Something we've observed that's come out of these market shifts — namely, the growth in the number of emerging managers — is that sponsors are getting more comfortable with using alternative structures to get going. It's not, "I immediately have to go and raise a fund or I've failed." People are willing to engage in deal-by-deal relationships or more programmatic relationships with LPs, and I think some of the most talented investors in the market today are starting in those types of structures, which is encouraging. I think it's because there are institutions like GEM, who are willing to partner



Caroline Dallas, GEM

with these investors like an institutional LP, instead of as a co-GP, so that's been exciting to see, too.

We don't have to convince people to do pre-fund deals like we might have had to a few years ago. I think investors are recognizing that it is actually a nice way to get going, especially if they have one partner who they can really trust and rely on to provide the equity for their deals. That's actually a great relationship to have as they build their team and their business and get some initial deals done versus having to pour their heart and soul into fundraising, meeting hundreds of LPs, and then hoping some of them come into a blind pool fund.

Seems counterintuitive - an exciting time to form a new firm at a time of tough fundraising. How does that work?

Many of the LPs that we know are looking for ways to create more alpha in their private portfolios after a prolonged period of insane valuations, valuations that did not make sense relative to public comps, and easy debt. Now all those things have just suddenly gone away, and LPs are sort of upside down in their private portfolios. LPs are looking at themselves and saying, "Where can I really find alpha opportunities in private markets?" Often, it is with these emerging managers, where the LPs are super aligned with the manager, the fund size makes sense relative to the deals that the manager is doing, and there aren't distractions from other products that the manager is offering. We think other LPs are seeing that as well.

If anything, there are a lot more people who are trying to tap emerging managers now, whether that be Funds I, II, III, or even pre-fund. As a word of caution: I don't think pre-fund dealmaking is for the faint of heart; we've observed a lot of people who we don't believe are qualified to raise a blind pool of capital that tend to aggregate in that market.

The talent creating new firms is coming out of larger shops. What is driving that movement?

The biggest thing that we noticed from

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2016 to 2019 was that debt was free, so that meant that deals were really easy to get done, that everything was up and to the right, and that fundraising was sort of a no-brainer. There was a lot of capital flowing, and if you were a talented, mid-level to junior partner-level person, you were probably kept very happy at your mid-market or large-cap PE fund; there wasn't a ton to worry about from a comp perspective. Companies were exiting, the deal flow cycle was quick, and carried interest was flowing.

When that all came to a halt about two or two and a half years ago, people picked their heads up for the first time after being buried in deal activity for a number of years and thought, "What do I want to do with my life?"

Some people had the chance to take a breather and say, "There's no deal activity getting done, and it's really because my firm has raised way too much money, we're not doing the interesting deals we used to do, we have to rely on financial engineering — essentially leveraging these businesses to get our returns — and this isn't what we were doing when I started here. We aren't working as closely with companies, we aren't as operationally focused. I miss that part of being a private equity investor, and I think I'm going to leave to do my own thing. And, by the way, my carry is going to be tied up for a long time or might not even be

worth what I thought it was a couple years ago, so that doesn't help motivate me either."

We're looking for the managers who have had that conversation with themselves before it becomes obvious that the firm is not going to fundraise. You get the sense of who has that entrepreneurial bug early in the cycle of a private equity firm's turning from an easy fundraising environment to a not-so-easy one.

We've observed more turnover in these mid-market and large cap firms, and for us, it's about sorting through the suddenly very full pipeline that we have and trying to understand who really wants to do this for the long term. Who really has the entrepreneurial spirit, wants to build their own franchise, wants to build a team, and wants to be that next great generational investor? That's actually the more complicated part for us right now.

How important is it for a new manager who is raising a fund to follow a 'seasoned primary' strategy?

It's great to go out and build a big team and fund that personally, and that does show a certain level of commitment to building one's own organization. But nothing is going to get LPs in the door like having deals that we can underwrite alongside the manager and being able to see how they work. Can these new

managers do what they claim they can do outside of the bigger firm?

In our experience, the first or second deal for the new manager is really going to make or break his or her career. If the first deal or so that the manager brings to the broader LP audience is sort of a middling outcome, it might not create the momentum they would like to see in a fundraise. The opposite can be true if they have a really compelling deal in hand that's going to get LPs excited to actually underwrite the sponsor. It also serves as a proof point that LPs can highlight when taking these managers to investment committee; it says, "Look, this person is executing at such a high level. They're doing this really interesting strategy in the lower middle market, we think the returns are going to be excellent, and they have great training from a larger firm that gets us comfortable with downside risk as well."

So yes, I think it's absolutely critical that managers stay active in the market and keep investing as they're fundraising, because fundraising can take two years, and that's a long time to be out of the market.

Dallas will be a featured speaker at PEI's NEXUS 2025 conference. Interested in emerging managers? PEI's NEXUS 2025 private equity conference in March will feature an extensive lineup of emerging manager GPs, LPs and content. Check it out here for more information.