

Private Markets Insight

The art of partnership:

Providing next-generation GPs
with a platform to thrive

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**Federated
Hermes** 

Private Markets

www.hermes-investment.com
For professional investors only

Introduction

Private equity has long been seen as the asset class of innovation, providing visionary investors with the time, space, and capital to realise their potential. In recent years, however, on account of their success, many private equity firms have themselves become mainstream, multi-product asset managers raising large pools of capital and running funds of a size that necessitate a more standardised approach. With less room for innovation within larger funds, the most-visionary investors are carving out new pathways to pursue opportunities that inspire them, free of institutional constraints.

This breed of highly experienced, entrepreneurial private equity experts is breaking away from the established managers and launching spin-off enterprises. They are smaller, nimbler and more able to deliver on the promise of superior risk-adjusted returns.

These so-called ‘next-generation managers’ are re-energising the private equity industry from the point of view of both approach and performance. They are generally hands-on, growth-oriented investors with an entrepreneurial drive and a desire to replicate and, ultimately, outperform the success they achieved within established firms.

Key advantages of ‘next gen’ managers

-  **Entrepreneurial**
 - Spin-out teams from well-established players - eager, nimble and innovative
 - Drive and desire for greater control of the investment strategy
-  **Specialised**
 - Target themes or focused strategies – eg B2B value chain technology, health tech
-  **Driven**
 - Must outperform to survive
 - Investing significant personal wealth
 - Smaller funds - driven by carry, not management fees
-  **Focused**
 - Free from large legacy portfolios – can devote full time and energy
 - ‘Hands on’ - especially relevant during times of market turmoil
-  **Partners**
 - Early commitments - the best way to ensure future co-investments with ‘rising star’ GPs

A long history of backing rising stars

Our Private Equity team, Federated Hermes GPE, are experts in identifying successful managers. Having backed new private equity ventures since the 1990s, our perspective is both global and long term. For example, we backed Bridgepoint Capital I in 1996 and Bridgepoint Europe I in 1998.

Our next-generation strategy allows us to tap into the significant alpha opportunity in the less-known, less-covered, and less-price-efficient lower mid-market.

Since 2010, we have developed a leading global platform that supports and partners with the highest-potential managers in this space. **With approximately 70 deals completed with almost 50 next-generation managers, we consider ourselves among the pioneers in the field of systematically introducing these dynamic managers to a growing base of limited partners (LPs) who are looking to diversify their private equity exposure.**

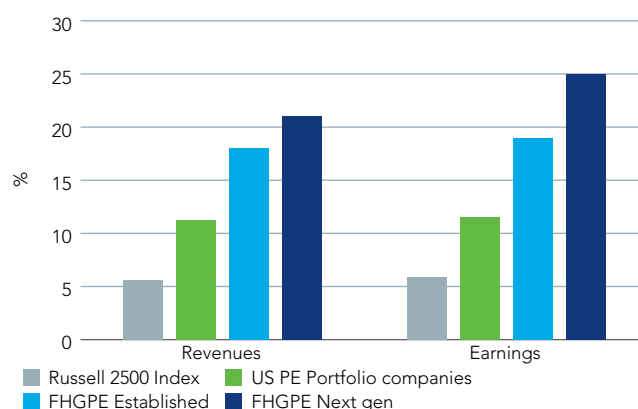
We are particularly proud of the relationships we have established with this innovative pool of GPs and the performance we have delivered over the period. This success is attributable to several factors, including our team’s skill and global perspective, along with our experience in sourcing, partnering and supporting next-generation managers.

The drivers of outperformance

Our longevity and experience have allowed us to understand the success factors that have driven next-generation managers to forge ahead of the industry from a relative performance point of view.

First, when talent makes the decision to break away from a larger manager, they do so in the knowledge that they are leaving behind what is often an impressive track record. Therefore, without past performance data to rest on, these managers are highly motivated to rebuild their track record in the awareness that they must match or outperform the market in order to survive.

Revenue and earnings CAGR, equally weighted



Source: Federated Hermes GPE and Cambridge Associates – [Ten Years of CA Operating Metrics, November 2022](#).

Analysis looks at FHGPE co-investment portfolio revenue and earnings actual results where available between FYE 2015 and FYE 2021. Unique companies CAGR values are equally weighted. One company excluded for one year due to unique circumstances (outlier). Public operating metrics based on the Russell 2500 index as per Cambridge Associates. US PE market operating metrics sourced by Cambridge Associates based on 10 years of data up to FYE 2020.



The second success factor that makes this cohort of managers stand out is their passion and desire to be close to the source of performance. This often leads them to take a hands-on approach to managing portfolio companies. In our experience, managers who show such level of commitment and deep sector expertise are less likely to take undue investment risk. This is particularly true for next-generation managers, many of whom commit multi-million dollars of personal wealth as part of a small group of individuals into single deals. They are, therefore, highly motivated to see the fund succeed.

Finally, due to the smaller fund sizes (in our experience next-generation funds are, on average, one-third the size of established GPs in the same strategy), they will often only realise profits from the carry, as opposed to the management fees. Similarly, the size of the venture means that the managers have fewer portfolio distractions and fewer decision-making layers, allowing them to stay highly engaged with their investment teams.

On account of these characteristics, next-generation managers are an exciting, high-potential area of the market.

Our industry-leading edge

Broad private equity offering

Our next generation platform is the cornerstone of Federated Hermes GPE's broad private equity offering which has a 31 year track record in fund investments and 22 years' experience in co-investments. We have invested alongside more than 130 GPs and committed \$7.7bn to 314 funds and \$4.5bn to 275 co-investments. (As of 31 March 2023). With offices in London, Singapore, and New York, our truly global strategy offers investors a broad range of private equity investment solutions, including investment funds, hybrid primary and bespoke solutions through segregated accounts.

Next-generation managers have been a core part of our investment strategy for over a decade.

As the specialist partner, the manager carries out the stock picking and the portfolio management to deliver the exposure while we provide guidance and an additional risk overlay.

Our successful franchise is built on the principles of partnership investment; an approach that allows us to take a catalytic role in funds, without seeking to run ahead of the managers we partner with.

We ski alongside them. We do not ride the slopes on their behalf. Our role is to help them navigate the landscape by drawing on the depth and diversity of our own expertise. As the specialist partner, the manager carries out the stock picking and the portfolio management to deliver the exposure while we provide guidance and an additional risk overlay.



This approach is different from the traditional direct investment strategy in which GPs buy into companies on their own and run all aspects of the investment. Instead, our next-generation programme acts as an investment engine, sourcing a wide variety of deals, and benefiting from a relationship in which managers see us as partners, not competitors. Via this platform, we provide a through-road for LPs to access some of the highest-potential opportunities in the asset class, globally, with Federated Hermes providing the established brand overlay, additional risk controls and the scope to diversify.

Understanding the nuances of this misunderstood aspect of next generation risk is key to successfully investing in this segment.

Balancing opportunity and risk

Next generation managers are likely to be passionate, successful, highly experienced investors, but in the absence of a track record for their new venture, the market often places them further along the risk spectrum than is warranted. Understanding the nuances of this misunderstood aspect of next generation risk is key to successfully investing in this segment.

Despite being early stage firms, unknown to the broader market, next generation managers comprise some of the most forward thinking investors in private equity, having had storied careers in many of the industry's most established firms. Over many years they will have often built relationships across their specialist sectors along with a deep knowledge of the landscapes across which they seek to invest. These managers are also differentiated by the characteristics that drive them, namely their passion as investors, their highly specialised approach and their drive to outperform. This sets them apart from many of their larger, more established peers. For this reason, many of the best aligned and best risk adjusted deals that we currently see are emerging from the next generation space.

However, investing in this sub-sector requires more than the standard risk management approach. At Federated Hermes GPE, we subject each manager to robust ongoing risk assessments and controls that provide an additional layer of assurance to LPs. Having committed to more than 300 funds over the course of 30+ years (as at May 2023), we have built a robust and repeatable fund selection process that combines rigorous quantitative, operational, and qualitative assessments, and is supplemented by extensive referencing through our industry network.

Our highly involved process requires us to spend substantial time with managers to track their work closely over extended periods, and to conduct professional operational due diligence before committing to a new fund. Our experience also allows us to provide day-to-day guidance to managers on issues ranging from deal structuring, investment process, ESG and risk management.

By virtue of the diversity of the managers we partner with, our programme carries a lower risk profile than the typical private equity exposure. Our latest vintage hybrid fund had exposure to almost 50 GPs across 33 funds and 44 co-investments. In addition to the number of holdings, our approach of investing alongside different managers with different strengths, weaknesses, strategies, and styles, provides additional factor diversification.

We also place a high value on quality. To deliver this, a precise and future-focused manager selection process must be employed. We draw on our own experience, honed over many years in this asset class, to achieve this. It requires a bespoke sourcing methodology, a broad network of industry relationships, and an in-depth review process that is often based on limited public information. Our most valuable insights are gained while reviewing actionable investment opportunities alongside next-generation managers. We are reviewing more than 600 deals per year, with overall selectivity below 3% and selectivity on next-generation GP deals even lower. This creates a high hurdle for those next-generation GP-sponsored deals and funds that make it into the portfolio. Our strategy also takes account of qualitative factors such as team dynamic, and the managers' expertise and passion for the sector into which they invest.

Against this backdrop, investing in next-generation managers necessitates a specialist strategy, process and risk management approach that unlocks the vast opportunities of this dynamic and fast-moving sub-sector.

Delivering alpha through access

We believe the most compelling opportunities lie within founder owned businesses.

Gaining access to top line growth and long term profitability exhibited by these businesses can be challenging for many of our competitors whose larger fund sizes dictate the volume of capital they are committed to deploy, representing a barrier to entry into this next generation segment.

Our ability to access founder owned businesses' alpha performance advantage stems from our flexibility and an authentic alignment of interests between our clients, partners and the GPs with whom we co invest. Motivated by alpha, rather than management fees or AUM, our disciplined constraint of fund capacity, our industry positioning and extensive network enables us not only to gain access to the next generation space, but to specialise and diversify within it while maintaining a focus on investment return.

Our portfolio naturally tilts towards fast evolving sectors such as healthcare and technology and alongside thematic considerations, ESG analysis is integrated into our investment process. We are instrumental in helping next generation GPs navigate the ESG landscape to futureproof their funds and meet the evolving expectations of investors, regulators and society at large. The managers benefit from our support in exploring and taking advantage of the ever growing opportunities presented by the global shift towards a more sustainable economic growth model.

Long-standing relationships with the leaders of tomorrow

The GPs we work with appreciate that we do not seek to 'ski ahead or behind them'. We offer unique support by being by their side, providing stability during the exciting early stages of their journey. This relationship is key to the success of our strategy. We see the number of successful and ongoing relationships we have built with next generation managers over the last decade as evidence of the strength of our investment-led partnership approach.

Partnering with next-generation GPs in our unique way creates a foundation for strong long-term relationships. By being an effective early partner, helping GPs to launch and grow their franchise, we create 'relationship equity' that endures over the long term and can provide mutual benefit as these funds grow and become the global industry leaders of tomorrow.

An exposure to this strategy can represent a strong alpha complement to an LP's existing portfolio of traditional PE managers.



Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns and, where possible, to contribute to positive outcomes that benefit the wider world.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** private equity, infrastructure, real estate, private credit, natural capital
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

For more information, visit www.hermes-investment.com or connect with us on social media:



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