PitchBook

PitchBook Data, Inc.

John Gabbert Founder, CEO

Nizar Tarhuni Vice President, Institutional Research and Editorial

Daniel Cook, CFA Head of Quantitative Research

Institutional Research Group

Analysis

Zane Carmean, CFA, CAIA
Lead Analyst, Quantitative and Funds Research
zane.carmean@pitchbook.com

Susan Hu
Associate Quantitative Research Analyst
susan.hu@pitchbook.com

Kaidi Gao
Analyst, Venture Capital
kaidi.gao@pitchbook.com

Van Le
Senior Data Analysis Manager
van.le@pitchbook.com

pbinstitutionalresearch@pitchbook.com

Publishing

Designed by **Megan Woodard**

Published on April 29, 2024

Contents

Key takeaways 1

Overview 2

Age is not just a number 3

Buyout 6

Venture capital 9

Real estate 13

Private debt 16

Concluding remarks 19

Establishing a Case for Emerging Managers

Exploring the effect of manager experience on private fund returns

PitchBook is a Morningstar company providing the most comprehensive, most accurate, and hard-to-find data for professionals doing business in the private markets.

Key takeaways

- Established managers have the advantage of accrued experience managing capital across market cycles, which they leverage to demonstrate a track record of success to potential LPs. Emerging managers, lacking such a track record, must rely more heavily on forward-looking narratives. Our funds returns data provides the historical record on the debate regarding emerging versus established managers while offering insights into "ancillary" emerging fund offerings of established GPs as an alternative comparison.

- Established buyout managers have historically shown more consistent performance, but emerging managers have recently afforded higher upside, as most established peers have grown into megafunds. Through fund selection simulations that aggregate performance of hypothetical portfolios over the past decade, we find that emerging buyout managers have delivered higher upside and better downside for LPs since the GFC.

- VC funds offer significant upside potential, with emerging managers having consistently outperformed since the late 1990s. However, returns from emerging VC managers are more volatile than their established peers.

- Emerging real estate managers, focusing on niche areas, show potential for alpha generation, especially after the GFC. However, ancillary real estate families of established firms have achieved attractive upside with more muted downside compared with pure emerging managers in the space.

- Emerging private debt managers exhibit a higher upside potential alongside greater downside risk, with bottom-decile performers showing a nearly 6% difference in excess IRRs compared with the 2% difference among the top-decile performers. Fund selection simulations indicate a favorable trend for emerging debt funds, especially in a higher-interest-rate environment.

Overview

In many aspects of our lives, we are inundated with choices. Take, for example, the dozens of streaming platforms, each offering hundreds of unique shows and movies. In his book "The Paradox of Choice," Barry Schwartz remarks, "Learning to choose is hard. Learning to choose well is harder. And learning to choose well in a world of unlimited possibilities is harder still, perhaps too hard."[1] On a Friday evening, sometimes it is just easier to pick an old classic. For institutional investors evaluating private fund managers, that feeling likely resonates.

The building blocks of capital allocators' private market portfolios are the external managers investing on their behalf. Establishing a robust, alpha-generating portfolio requires careful diligence and underwriting of the GPs implementing their strategies. However, the growth of private markets over the past few decades has led to an enormous number of GPs from which to choose. More than 25,000 GPs have successfully raised at least one private fund since 1990. We are currently tracking well over 10,000 open funds seeking LP commitments.

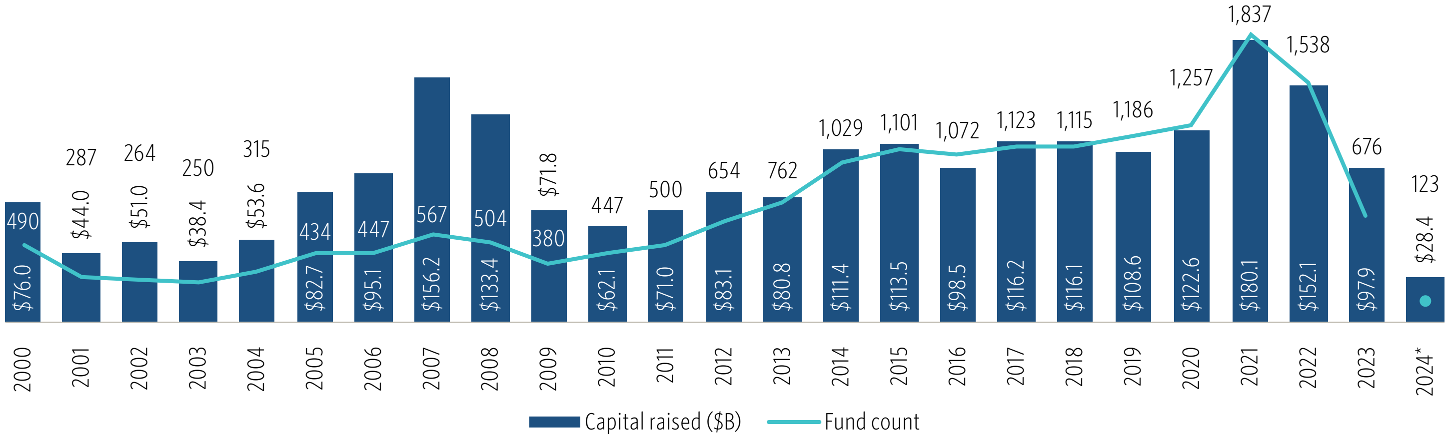
For those LPs, the myriad choices, coupled with smaller private market budgets stemming from slower distributions, has led to a retrenchment of new fund commitments. Invariably, that has meant shrinking capital available to new and emerging fund managers hoping to become the next KKR or Sequoia. The share of US fund closings by "emerging" managers—defined as GPs with three or fewer successful fund launches—has shrunk to 44.7% of total fund count and 15.7% of total capital raised, down from 55.0% and 23.4%, respectively, for the 10 years ending in 2019. As private markets have matured, that share has been shrinking naturally, but we have seen an acceleration of the trend in the past couple of years. Similar to selecting a classic movie, LPs are increasingly going with "established" managers—defined as GPs with four or more funds—to build out their private fund portfolios.

But are allocators sacrificing performance by shunning the new upstarts? After all, the name brands of today began as emerging managers. Interest alignment with external managers is a powerful tool, and, theoretically, alignment exists most naturally with new firms that need to prove their value to their LPs. Emerging managers tend to be smaller, which can increase the potential upside that a GP can achieve due to the diminishing returns of larger-scale firms. Smaller size also means lower management fees in nominal terms, making performance incentives a bigger driver of smaller GPs' economics, amplifying interest alignment with LPs. For these reasons and more, many allocators try to mitigate the paradox of choice by carving out dedicated programs for emerging managers. Some examples include LACERS,[2] CalPERS,[3] and the New York State Common Retirement Fund.[4]

1: "The Paradox of Choice," Barry Schwartz, Harper Perennial, 2004.
2: "Private Equity Specialized Manager Program," LAFPP, n.d., accessed April 22, 2024.
3: "Emerging & Diverse Manager Program," CalPERS, July 6, 2023.
4: "Emerging Manager Program," Office of the New York State Comptroller, n.d., accessed April 22, 2024.

In this note, we compare the historical record of established managers with that of emerging managers while providing additional nuance on the impact that fund size has historically had on performance. Much of the conversation in the industry on the merits of emerging managers has focused on VC and PE funds, but LP dollars have grown substantially across real assets and credit. Because of this, our analysis also includes historical returns on real estate and private debt. We also analyze newly launched fund families at established firms and how those ancillary strategies compare with emerging GPs and flagship vehicles of established brands. Of course, much of the analysis is backward-looking, but we hope the results will spark new thoughts and questions for allocators trying to decide which among the sea of GPs to entrust with capital.

Fundraising activity by emerging managers



Source: PitchBook • Geography: US • *As of March 17, 2024

Age is not just a number

The differences between emerging and established managers come down to more than whether an LP recognizes the firm's logo. Material deviations exist when it comes to investment strategy, sourcing opportunities, and check size, which can translate to a risk/return trade-off that looks quite different, despite funds being of the same "asset class."

Managers become established by accruing experience in managing capital through varying market environments and building a durable franchise through strong performance. Plenty of GP marketing materials to potential LPs highlight their investment teams' cumulative experience, signaling they can manage a portfolio through good and bad times. Going through the lifecycle of a portfolio helps managers build muscles in different market environments.

That experience provides established firms with an edge over their emerging counterparts on multiple fronts. First, with more history on their performance, established GPs can lean on past returns to convince prospective LPs that their strategy works. Even though recent analysis shows track record is a poor predictor of future performance, seeing points on the board is no doubt comforting. Emerging managers, by definition, do not have nearly the history to showcase when pitching to LPs, as the first fund or two are generally not fully baked yet. Therefore, they must rely on a more forward-looking story.

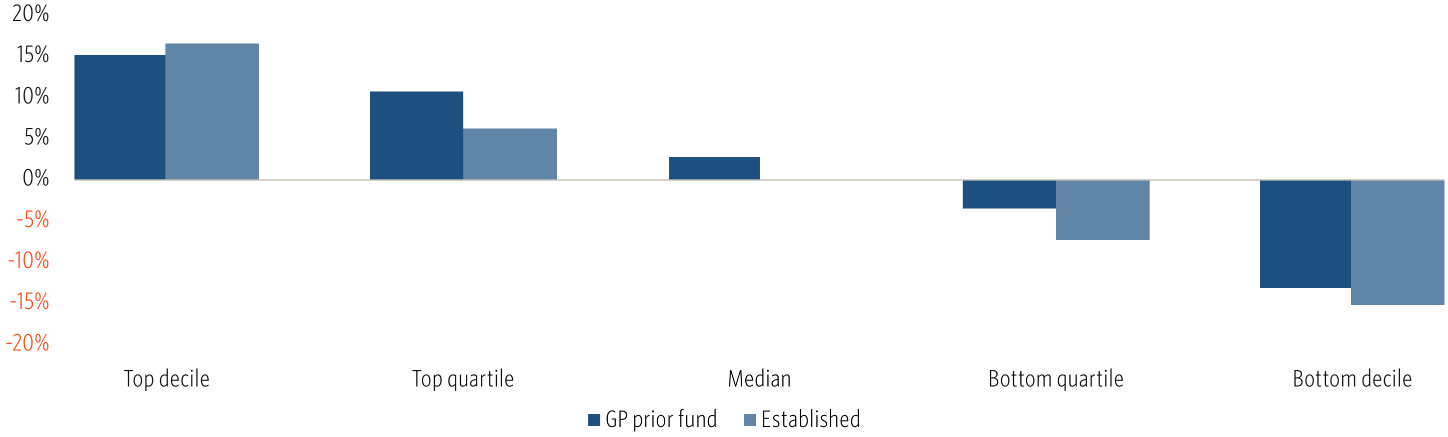
Having a track record also helps managers remain competitive from a dealmaking and management perspective. The best GPs see and win the best deals, add value during the holding period, and understand how to exit well. Long-standing GPs have a higher chance of winning competitive deals and tapping into exit channels, as they often have deeper networks and institutionalized portfolio management processes.

On the other hand, every established manager we see today once belonged to the emerging cohort, and there are advantages to accessing the name brands of the future early in their lives via attractive fee arrangements and stronger incentive alignment. Some emerging managers are also able to differentiate themselves from the crowd by bringing a unique investment thesis, sometimes aided by having an in-depth understanding of an emergent technology or a specialized sector. An emerging manager should have a good answer to the question, "Why does your firm need to exist?"

Additionally, operator- or angel-turned-manager GPs may hold proprietary access to a particular network, having worked at large firms or having been involved in underwriting a large volume of investments. Across private markets, there are examples of GPs starting firms after leaving the name brands where they cut their teeth. In venture, there are famous cases of GPs who have found success as "spinouts" from pedigreed funds, such as Sunil Nagaraj, who founded Ubiquity Ventures after departing from Bessemer Venture Partners, and Tomasz Tunguz, a Redpoint Ventures veteran who now runs Theory Ventures. For an LP evaluating the opportunities at upstart firms, looking at the track record of funds the GPs had previously been at can provide helpful context on past performance.

As a sample, we identified 21 investors that launched funds and that also have available returns data at their prior firms. When juxtaposing this venture fund data with that of departing spinout managers, we find that spinout managers that successfully raise their own funds tend to come from firms that historically have outperformed.

VC spinout manager excess IRRs at prior firms*



Source: PitchBook • Geography: US • *As of September 30, 2023

Of course, the fact that there are pros and cons to established and emerging GPs alike means that LPs must ingest a lot of information to get an idea of how to best build a lineup of external managers across asset classes. To analyze the historical performance of emerging versus established managers, we present findings across several different perspectives for buyout, VC, real estate, and private debt strategies.

Economic periods

Due to the drawdown structure of closed-end private funds within a finite investment period, the economic climate in which a GP invests has a meaningful impact on the eventual returns that an LP receives. A cohort of funds launched at the beginning of a long business cycle upswing will have more tailwinds than those that were unlucky to have put capital to work just before a recession. It is reasonable to think that established firms with greater experience than their emerging peers will be able to weather poor investing climates better. On the other hand, emerging managers often have a wider risk/return profile, one that benefits from the lifting tides of stable economic periods. Where data is available, we will group fund returns of various vintage cohorts to examine the effects that different environments have had on emerging and established manager performance:

- 1991-1996, 2010-2014: Early cycle to midcycle
- 1997-1999, 2003-2006, 2015-2018, 2019-2021:[5] Late cycle
- 2000-2002, 2007-2009: Recession and new cycle

We will also leverage our Manager Scoring framework to consolidate performance by computing an excess net IRR figure, providing a vintage-agnostic return comparison.

Portfolio simulations

Relatedly, LPs do not generally pick a single fund to make up their entire allocation. Each portfolio comprises a collection of funds across vintage years to achieve diversification in managers, portfolio companies, and economic environments. The industry averages can also be misleading due to the wide dispersion of returns experienced by LPs, depending on the funds in which they were invested. To simulate this experience, we leverage a simple random fund selector to create hypothetical LP portfolios. We segment portfolios into those choosing emerging managers versus those choosing established managers. We assume an equal commitment amount to one fund per year and track the performance of each portfolio over three 10-year periods, running 1,000 iterations to provide a dispersion of hypothetical returns. The three 10-year time horizons are 2006-2015 (capturing a ramp-up during the global financial crisis), 2010-2019 (reflecting a relatively more stable, low interest economic period), and 2014-2023 (incorporating the COVID-19 pandemic and recent higher-rate environment). We pool aggregate cash flows and ending net asset values (NAVs) to compare portfolios on a total-value-to-paid-in (TVPI) capital basis.

5: 2019-2021 vintages are still early in their lives, so performance data should be considered with caution.

Ancillary strategies

The debate regarding emerging versus established managers often lacks the nuance of offshoot strategies launched at established firms. For example, Blackstone initially launched with its flagship buyout strategy but quickly built a successful real estate franchise early on in its history. Because LPs must evaluate a fund offering within a family, the track record and experience level of other strategies that a GP manages may be less than helpful. A new strategy might not have the same quality as the flagship offering on which the GP built its reputation—despite marketing the same logo. As such, there is the potential that a new offering with a different investment team could resemble the risk/return profile of an emerging manager. Alternatively, synergies could exist between strategies, such as a newly launched credit fund providing debt capital to portfolio holdings of the flagship buyout fund. We break out established GP funds into the "primary strategy" and emerging "ancillary strategies" to provide allocators more insight into evaluating how multistrategy firms with new ancillary programs might fit within a portfolio.

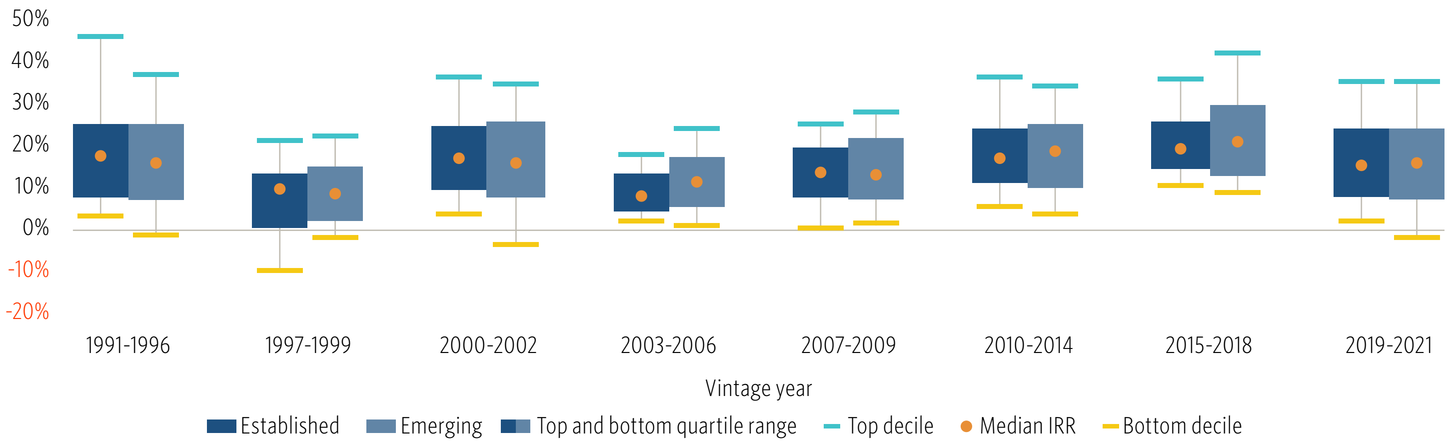
Buyout

PE buyout funds are a staple for alternatives allocations in institutional investor portfolios. The global total AUM managed by PE funds is nearing $6 trillion, making it the largest GP-managed strategy across private markets. That also makes it one of the most mature segments of the alternative landscape, with more and more capital being taken up by established firms with long track records. In our historical performance data, we find evidence that LPs are justified in focusing on commitments to experienced firms, although the bag is mixed, and recent performance trends suggest emerging managers have made up ground.

Historically, emerging managers have shown a wider dispersion of returns compared with their established counterparts. However, unlike in VC, which we will dive into in the next section, the higher dispersion does not always correlate with the same level of higher top-end returns. In the industry's nascency, established managers with deeper institutional knowledge, extensive networks, and proven strategies tended to display more consistent performance and higher upside. Median returns and top-decile performance of funds across our cyclical vintage cohorts, pre-2003, were greater for established managers than emerging.

As the industry has matured, the network of service providers and market participants dedicated to private capital has expanded. The barriers to launching a successful emerging strategy have in many ways been reduced—not to mention, many new firms have smaller fund sizes with a more targeted strategy or niche where there may still be some additional alpha available. The confluence of these factors has caused the script to flip in favor of emerging manager performance—at least when looking at the best 50% of funds in our cohorts. Top-quartile performance of emerging managers has eclipsed the equivalent percentile of established managers throughout our more recent vintage year buckets, while top-decile and median performance were better in all but one grouping. While more recent vintages have yet to fully realize their returns, the results suggest that emerging managers by-and-large have represented higher upside potential in the past 10 years or so.

Buyout fund net IRR dispersion by vintage cohorts and manager experience*

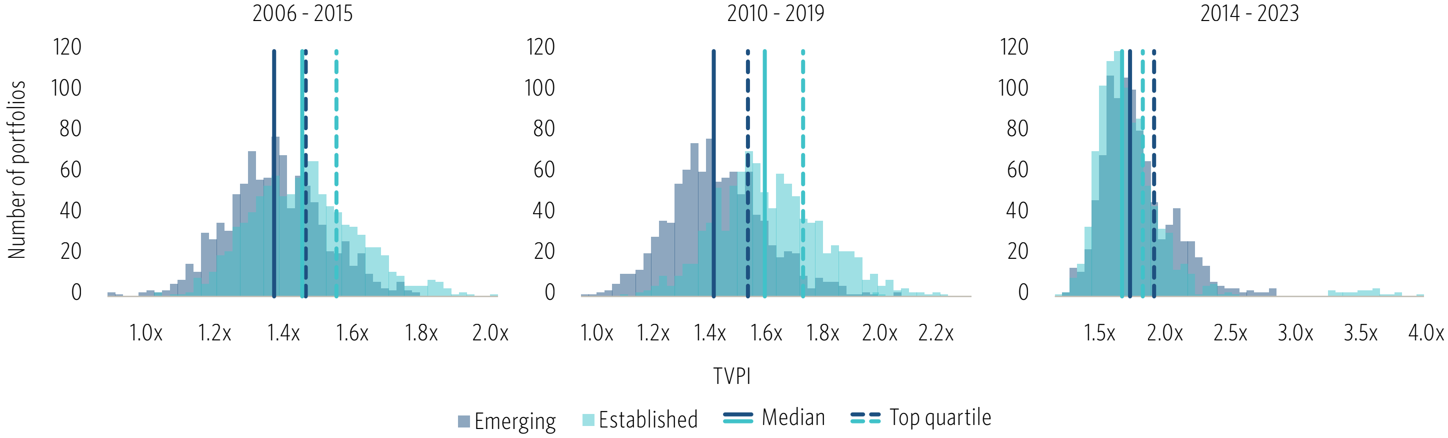


Source: PitchBook • Geography: US • *As of September 30, 2023

To test that theory in a portfolio-construction context, we ran our simulation results across established and emerging manager buckets with starting points in 2006, 2010, and 2014. The two earlier starting points resulted in lower TVPIs for emerging manager programs across the best- and worst-performing simulated portfolios. The top decile of simulations with established managers beginning in 2010 had a TVPI of 1.88x after 10 years, compared with only 1.65x for the top decile of emerging manager portfolio simulations. The bottom-decile gap was not much better at 1.38x and 1.22x, respectively. Similar results held with simulations running for the 10 years starting in 2006, with the worst-performing portfolios made up of emerging GPs.

However, when we ran the simulations through the 10 years beginning in 2014, the emerging manager portfolios flipped to outperforming the established manager portfolios. Top-decile simulations resulted in TVPIs of 2.16x and 2.02x in the emerging and established manager portfolios, respectively, with the former eking out a better bottom-decile simulation of 1.49x and the latter 1.47x.

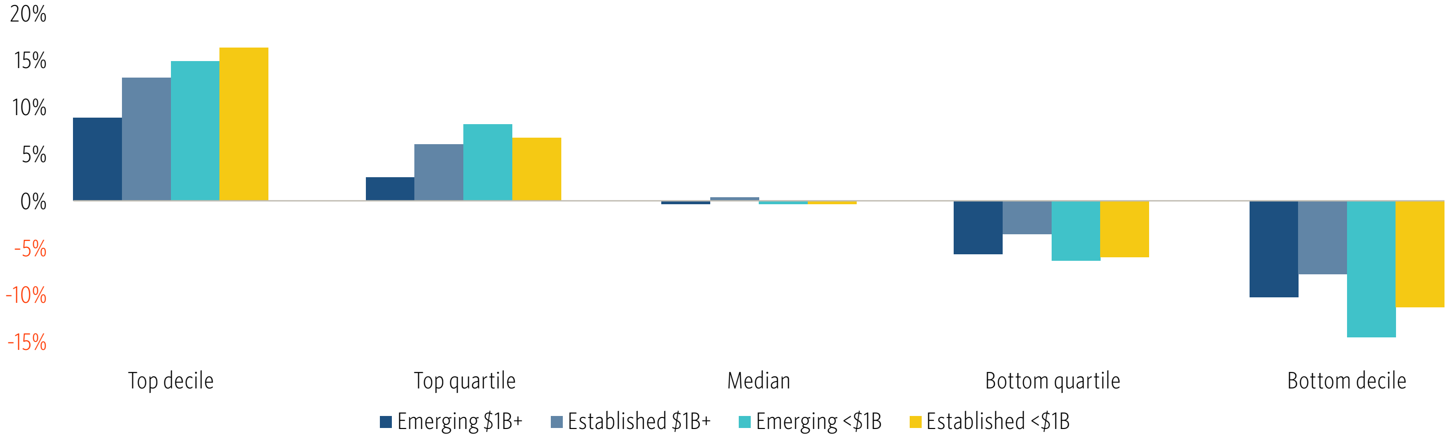
Buyout fund pooled TVPI simulation results by time frame and manager experience*



Source: PitchBook • Geography: US • *As of September 30, 2023

As established brands have ballooned in size, their performance has become more beta-like, offering steadier IRRs but sacrificing the upside potential that emerging firms have taken advantage of with their size. Since 2000, top-decile and top-quartile emerging manager funds below $1 billion have generated 200 basis points in additional excess IRR than the best-performing $1 billion+ buyout funds of established managers. That said, long-standing franchises that have kept fund sizes under $1 billion screen even better than emerging managers across the top-performing funds, while emerging managers with large funds out of the gate have struggled to generate the upside of their smaller peers. Similar results hold when looking at just vintages after the global financial crisis (GFC).

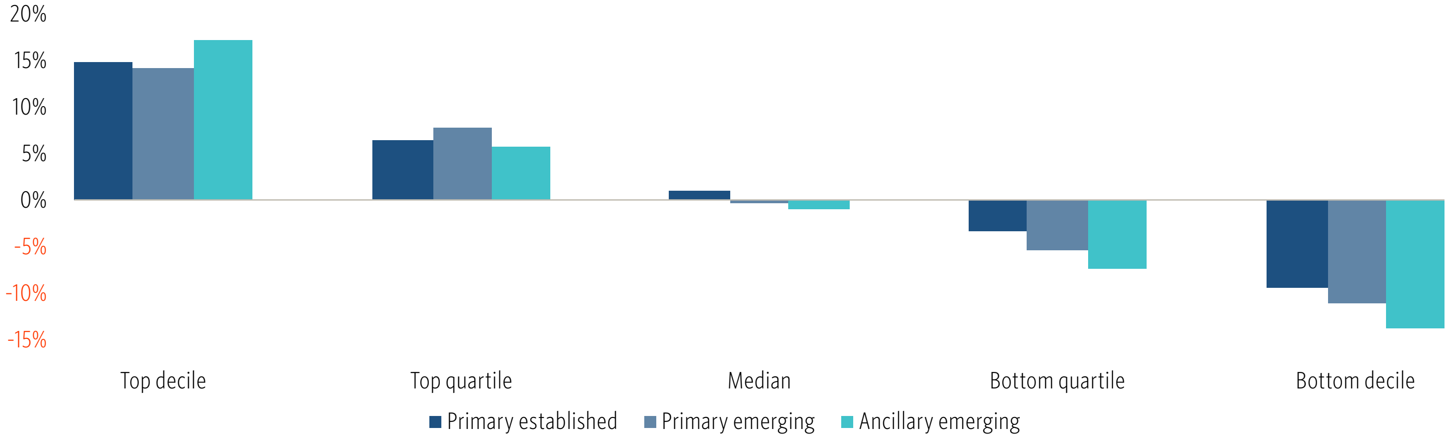
Buyout fund excess IRRs by size and manager experience*



Source: PitchBook • Geography: US • *As of September 30, 2023
Note: This data includes 2000 to 2018 vintages.

Additionally, newly launched ancillary strategies at established firms can provide LPs with the upside characteristics of the best-performing emerging managers but with lower risk on the downside. Leveraging an established brand with successful investment teams from other parts of the firm can help new buyout fund families post strong results. When looking at funds launched over our 2000-2018 time frame, the best ancillary buyout strategies at established firms have generated excess IRRs relative to their vintage-level peers of nearly 17.2%, handily outpacing the top decile of emerging GPs, which have generated 14.2% in excess IRRs historically. However, we find that the poorest-performing ancillary strategies have had even lower relative returns than emerging managers and established GP funds. As such, when evaluating a new offshoot buyout strategy, LPs should be thinking of the risk/return trade-offs differently than when diligencing a flagship offering.

Buyout fund excess IRRs by fund family experience*



Source: PitchBook • Geography: US • *As of September 30, 2023
Note: This data includes 2000 to 2018 vintages.

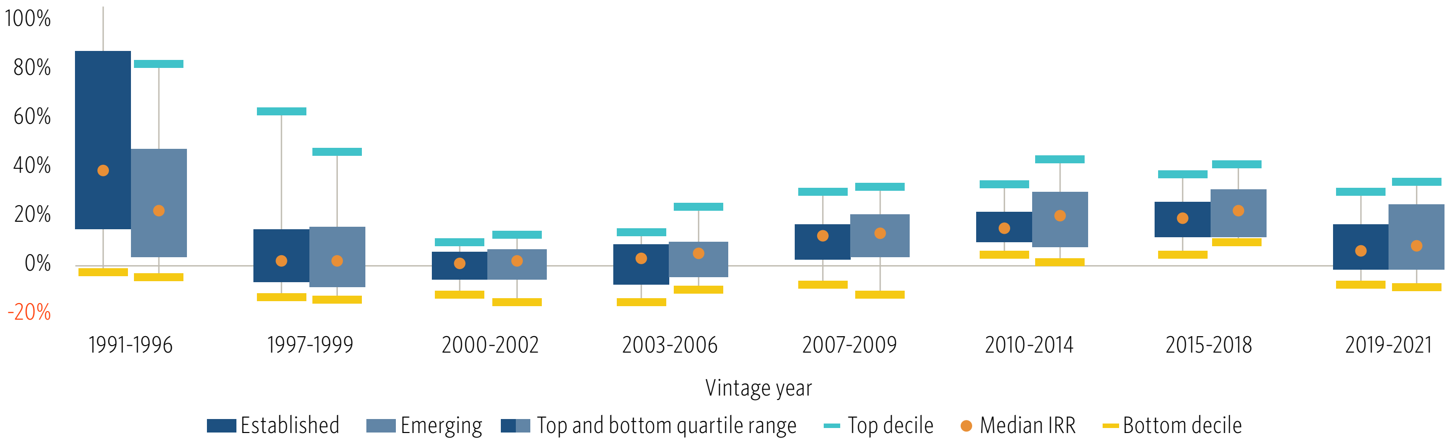
Venture capital

VC typically makes up a small portion of an institutional investor's total asset allocation. That said, a modest amount of exposure to the venture asset class—in an ideal state of execution—could drive significant upside in overall returns.

Two characteristics that set VC apart from the rest of mainstream private market strategies are its high cyclicality and power law nature. Each year, a handful of venture-backed startups make up the lion's share of total exit value generated by the asset class. Drawing a parallel between startups and VCs, a small number of funds drive the bulk of returns from all venture firms. This pattern speaks to the need for LPs to focus on managers that can consistently outperform.

It is reasonable to expect a higher proportion of the top-performing funds to come from the emerging manager cohort, primarily due to their smaller fund size and earlier-stage focus. At the same time, LPs face a twofold challenge when allocating to emerging managers: getting needle-moving exposure and finding predictability. Hypothetically speaking, while generating a 5.0x return from a $30.0 million seed fund is exceptional, DPI from that fund is unlikely to make a meaningful impact on a large institutional investor's AUM. In addition, assembling a roster of managers that can consistently produce top-quartile returns is a challenging task. While the best-performing funds often come from emerging managers, there tends to be a wider range of outcomes with lower persistency within this cohort.

VC fund net IRR dispersion by vintage cohorts and manager experience*



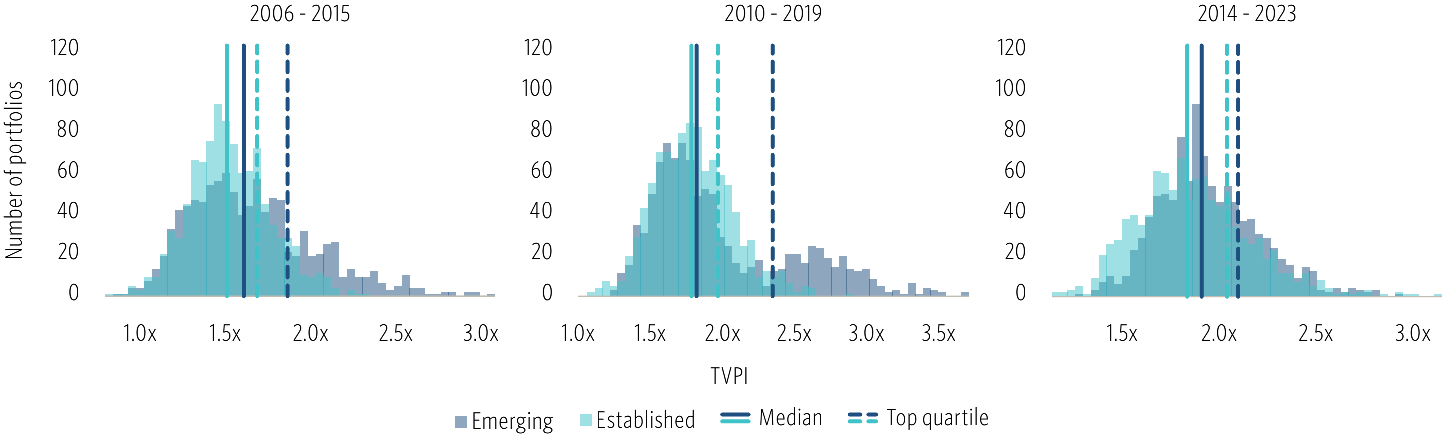
Source: PitchBook • Geography: US • *As of September 30, 2023

Note: The top decile for established managers in the 1991-1996 vintage cohort is 129.0%.

Segmenting vintage years into groups, we find that since the few years leading up to the burst of the dot-com bubble, emerging managers have consistently outperformed their established peers. In each vintage year bucket from 1997 onward, emerging managers have delivered a higher median IRR than established managers. We observed the widest gap between median IRRs in the 2010-2014 group (4.5%). During this period, the private market gradually emerged and recovered from a financial meltdown. During and shortly after the GFC, there was a pullback in LP commitments to venture. A research report published by the Kauffman Foundation in 2012 stating that institutional investors were "shortchanged by their investments in venture capital funds" was particularly illustrative of heightened allocator cautiousness around venture.[6] Our simulation results suggest that emerging managers that secured LP commitments during this harsh fundraising climate outperformed by investing in nascent, high-quality startups with fund structures that ensured the winners had a disproportionate amount of impact on the overall fund return. The valuation environment during this period also likely served as a tailwind for financial returns over a long horizon, when most of the ensuing decade after the GFC featured a bull market.

6: "We Have Met the Enemy and He Is Us: Lessons From Twenty Years of the Kauffman Foundation's Investments in Venture Capital Funds and the Triumph of Hope Over Experience," Kauffman Foundation, William Weeks IV and Diane Mulcahy, May 7, 2022.

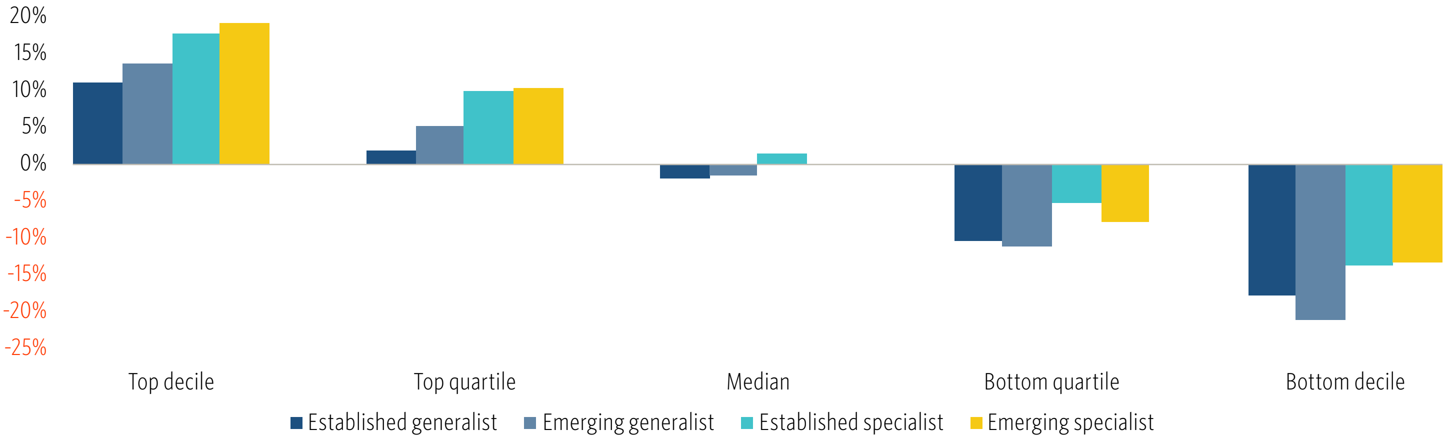
VC fund pooled TVPI simulation results by time frame and manager experience*



Source: PitchBook • Geography: US • *As of September 30, 2023

While the largest outperformance tends to come from emerging managers, returns from this cohort are more volatile. In our simulation, between 2010 and 2019, if a dollar was contributed to only funds run by an emerging manager, LPs had a better chance of getting a higher return. The median return of emerging fund portfolios narrowly exceeded that of their established counterparts, while the top-quartile figure delivered by emerging managers significantly outperformed. The pattern speaks to the ability of emerging managers to generate outsized returns while there is a wider spectrum of returns, which speaks to less predictable performance.

VC fund excess IRRs by investor style and manager experience*



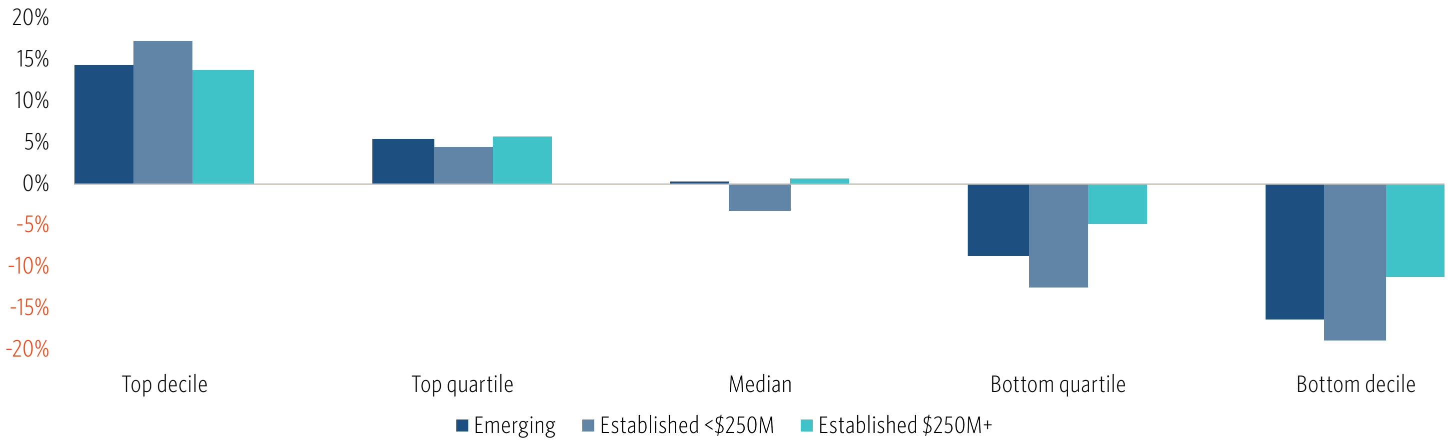
Source: PitchBook • Geography: US • *As of September 30, 2023
Note: This data includes 2000 to 2018 vintages.

We next break down VC managers by experience and then compare performance across investor styles. The proportion of deals concentrated in one sector is used to categorize managers as generalists or specialists.[7] Within both the established and emerging manager groups, specialists outperform their generalist peers. While some generalist funds have investors dedicated to a specific sector, specialists often

7: We rebucketed the target investor designations into specialists.

have an advantage from a sourcing perspective, as founders operating in a highly specialized space likely prefer working with a sector-dedicated fund. Established and emerging specialists are overall more likely to generate higher returns, a trend corroborated by the top- and bottom-quartile excess IRRs of specialists exceeding those of their generalist counterparts regardless of experience.

VC fund excess IRRs by size and manager experience*

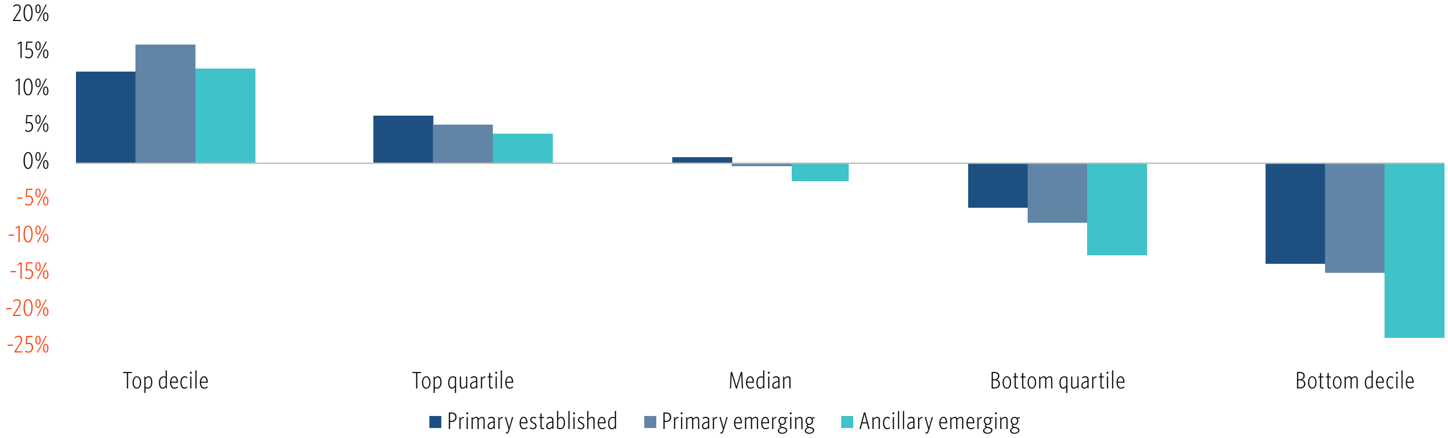


Source: PitchBook • Geography: US • *As of September 30, 2023
Note: This data includes 2000 to 2018 vintages.

For an established manager to outperform consistently, beyond formulating and executing a thoughtful succession plan, it is also important for the manager to periodically review their size and strategy to determine in which market segment they are most likely to continue generating alpha. Established managers choose to stay close to a market segment they are most comfortable with by keeping their fund size modest despite prior success.

Established managers with fund sizes north of $250 million tend to generate the most stable returns, although the largest return potential is capped. Historically, the excess IRR dispersion of the smaller-scale, established manager cohort (under $250 million) is the widest among the three buckets (larger-scale established managers, smaller-scale established managers, and emerging managers). The broad range of performance suggests that selected established managers that intentionally kept a modest fund size generated exceptional returns, although a caveat is the relatively low fund counts in our dataset. With a healthy dose of luck, LPs that committed to those successful funds run by established managers that did not grow their fund size significantly were able to capture lucrative gains from the small number of managers with three to four times the TVPI. The Union Square Ventures 2012 Fund with investments in Coinbase, MongoDB, and Duolingo serves as an outstanding success story. LPs that miss the relatively low proportion of funds that capture multiple fund returners risk ending up with established managers that underperform their larger-scale peers.

VC fund excess IRRs by fund family experience*



Source: PitchBook • Geography: US • *As of September 30, 2023
Note: This data includes 2000 to 2018 vintages.

Over the past decade or so, we have seen some established managers start to branch out, growing their core fund size while introducing new strategies. Take Andreessen Horowitz as an example. The firm started in 2009 with two GPs and a $300.0 million, early-stage-focused fund.[8] Over time, Andreessen Horowitz launched multiple strategies that are sector-specific or target later stages of the venture lifecycle. Offering multiple strategies allows the firm to accommodate evolving market needs and capture alpha with complementary approaches. To analyze the effect of those offshoot strategies, we break down performance by established managers and emerging managers, as well as established firms with ancillary funds.

Fund performance data collected for VC managers across the 2000-2018 vintage years shows that the highest return tends to come from emerging managers, although the performance of this group is also more volatile. For VC managers that deliver top-decile returns, the best-performing emerging managers have generated 15.9% in excess IRR, 3.6% and 3.0% higher than their established and ancillary emerging counterparts, respectively. On an aggregate basis, the primary strategy of established VCs is the safer bet for LPs in terms of demonstrating outperformance. Across top- and bottom-quartile and median metrics, established funds outperform their peers. The trend is particularly pronounced for the bottom-quartile and bottom-decile figures, where established managers are much more likely to help LPs minimize downside potential, whereas underperforming ancillary strategies pose the risk of dragging down a name-brand firm's historic performance.

Real estate

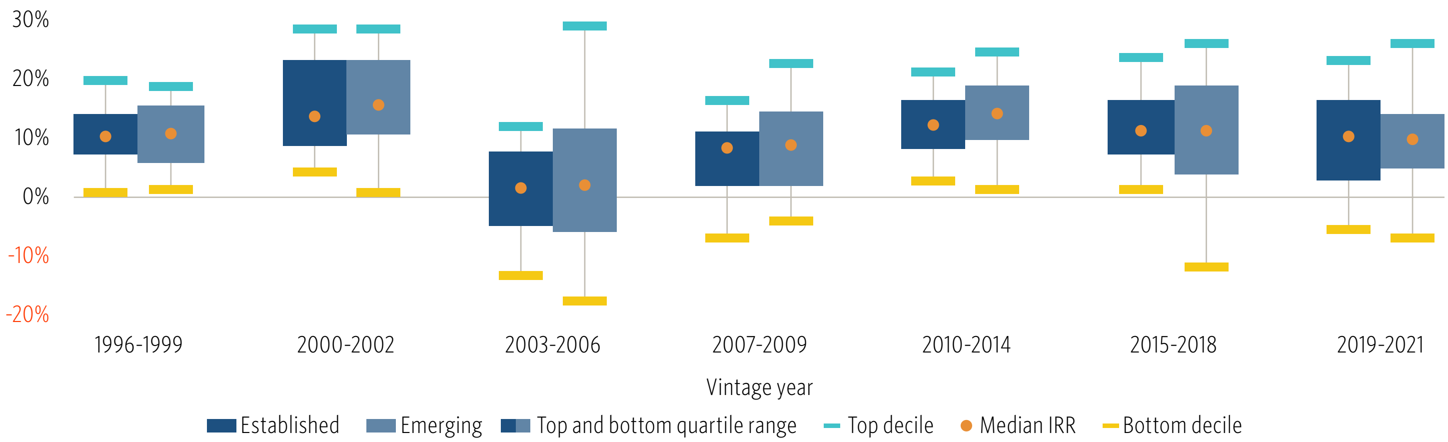
Real estate is generally considered to be a stable strategy with attractive downside and inflation-hedging characteristics. Evergreen and open-ended core funds make up sizable portions of institutionally invested capital in private real estate markets, not to mention many properties are held directly by institutional investors. That said, the closed-end fund universe, predominantly made up of opportunistic and

8: "New Funds, New Era," Andreessen Horowitz, Ben Horowitz, April 16, 2024.

value-add strategies, has risk/return characteristics closer in nature to PE, which results in a great deal of return dispersion and cyclicality for both established and emerging managers. Often, bottom-decile funds in either cohort generate substantially negative IRRs, even when looking at relatively stable periods such as funds launched in the 2010s.

Part of the advantage for emerging GPs in the real estate sector is that many specialize in niche property types or secondary/tertiary geographies. With more on-the-ground knowledge of their focus area, the potential to find alpha is theoretically greater than a large, diversified fund could provide. For example, relatively new upstart Longpoint Realty Partners has successfully focused on industrial properties, a category that has benefited immensely from the growth of e-commerce. They closed a $225.0 million specialty fund last year to target grocery-anchored shopping centers in specific markets, a strategy with notable tailwinds.[9] Endeavor Opportunity Partners III,[10] the largest emerging-manager fund closed last year, raised more than $600 million in capital that is focused on five key markets: Austin, Texas; Dallas, Texas; Charlotte, North Carolina; Nashville, Tennessee; and Salt Lake City, Utah.

Real estate fund net IRR dispersion by vintage cohorts and manager experience*

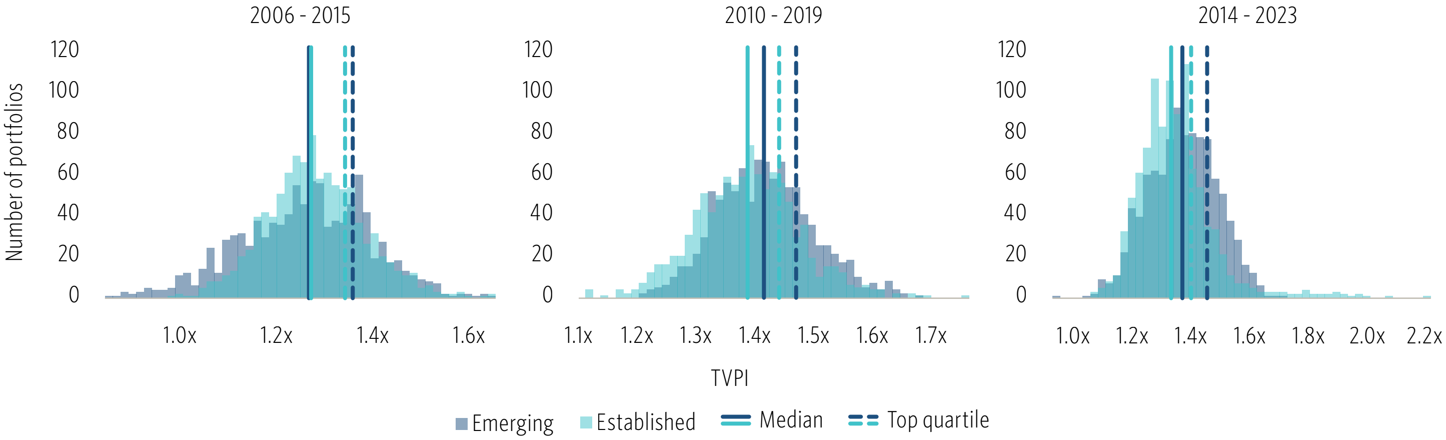


Source: PitchBook • Geography: US • *As of September 30, 2023

From a portfolio construction standpoint, we can see the impact of the upside/downside characteristics as these real estate GP cohorts play out. Investing capital into emerging strategies before the GFC would have left an allocator with significant underperformance based on our left tail of portfolio simulation outcomes. The collapse in the real estate market during that time significantly crimped fund returns in absolute and relative terms for the bottom-performing emerging funds. That translated to -6.4% and -4.1% less pooled TVPI in bottom-decile and bottom-quartile emerging GP portfolios than established ones during the 10-year investment horizon starting in 2006. Following the GFC, the performance trends flipped in favor of emerging managers across all quartiles of our portfolio simulations. However, the outperformance is marginal given the lower absolute cash-on-cash returns that real estate funds typically achieve compared with buyout or VC funds.

9: "Strip Malls Are the New King of Retail Real Estate," The Wall Street Journal, Kate King, October 30, 2023.
10: Although the firm was founded in 1999, it has raised only three standalone LP funds to date.

Real estate fund pooled TVPI simulation results by time frame and manager experience*



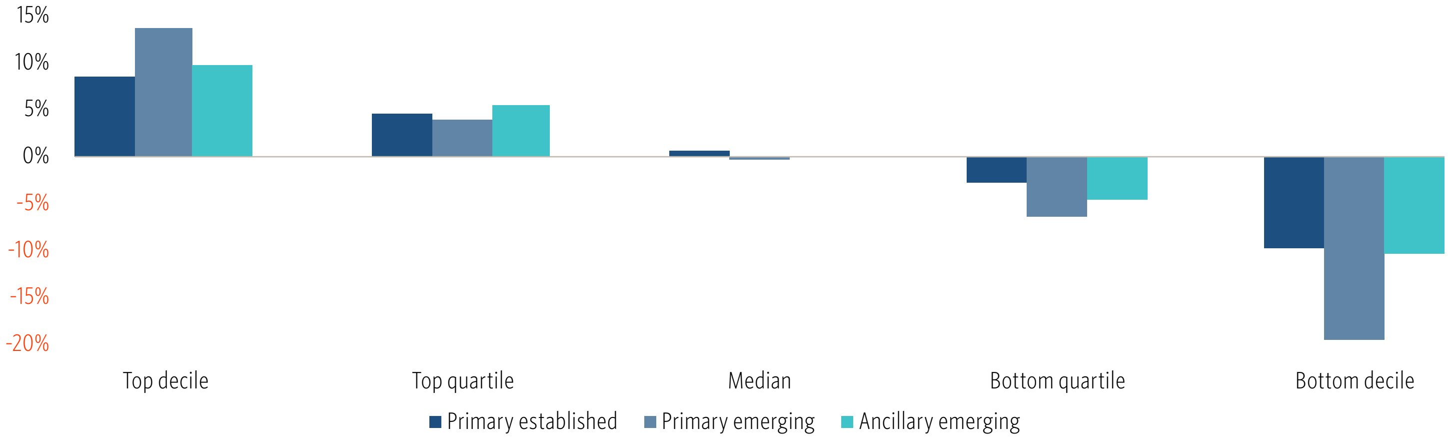
Source: PitchBook • Geography: US • *As of September 30, 2023

All the major original buyout firms have dedicated real estate offerings and have found success leveraging expertise from across the firm. An example is KKR, which started in 1976 and led the early buyout boom. It has since expanded into other strategies, including real estate in 2011. Its multi-billion-dollar Americas real estate family has so far generated double-digit IRRs for its LPs, and the firm touts its global network of investment teams, portfolio companies, and macroeconomic experts as the sources of its performance.[11]

Beyond just anecdotes, these types of ancillary offerings can be a source for upside based on our data of new real estate family launches since 2000, with top-quartile funds delivering excess IRRs of 5.6% versus peer benchmarks. That compares favorably with emerging manager real estate offerings and the more established strategies of dedicated real estate GPs. Although the top decile suggests the upside still lies with pure emerging managers, putting capital to work in the wrong newcomers can result in more significant underperformance. Bottom-decile performance of emerging GPs has historically been venture-like: -19.4% relative to benchmark median IRRs.

11: "We Are Thematic Investors Who Pursue Opportunities Across the Real Estate Capital Structure," KKR, n.d., accessed April 22, 2024.

Real estate fund excess IRRs by fund family experience*



Source: PitchBook • Geography: US • *As of September 30, 2023
Note: This data includes 2000 to 2018 vintages.

Private debt

Private debt is a unique asset class among the plethora of choices that investors face in the private markets.[12] Distinguished from allocators in other asset classes, allocators in private debt funds often enjoy a more regular income stream from interest payments on their portfolio holdings, making them a theoretically lower-risk alternative.

Since the GFC, private debt has become even more mainstream due to the pullback from banks, its heavily regulated counterparts, resulting in its global AUM growing 5x to $1.6 trillion in 2023. Direct lending has come to be increasingly preferred over bank syndicated loans in the past couple years. The LBO boom during the COVID-19 pandemic, paired with rate hikes after the pandemic resulting in more hung deals; banks' concerns over increased capital requirements because of the Basel III endgame;[13] and decreasing risk appetite from investors to other, riskier asset classes such as venture capital all serve as catalysts for private debt's growth.

Since the asset class has become more attractive, there is a growing concern that newcomers are entering the playing field without much expertise. However, our research shows that although emerging managers increased their share of total fundraising to 10.1% in 2023 from 7.6% in 2022, it is still far below the 14-year average of 21%. At the same time, LPs are becoming increasingly cautious with their allocations. A survey conducted by Private Debt Investor pointed out that only 45% of LPs are looking to increase their GP roster, the lowest number since 2020.[14]

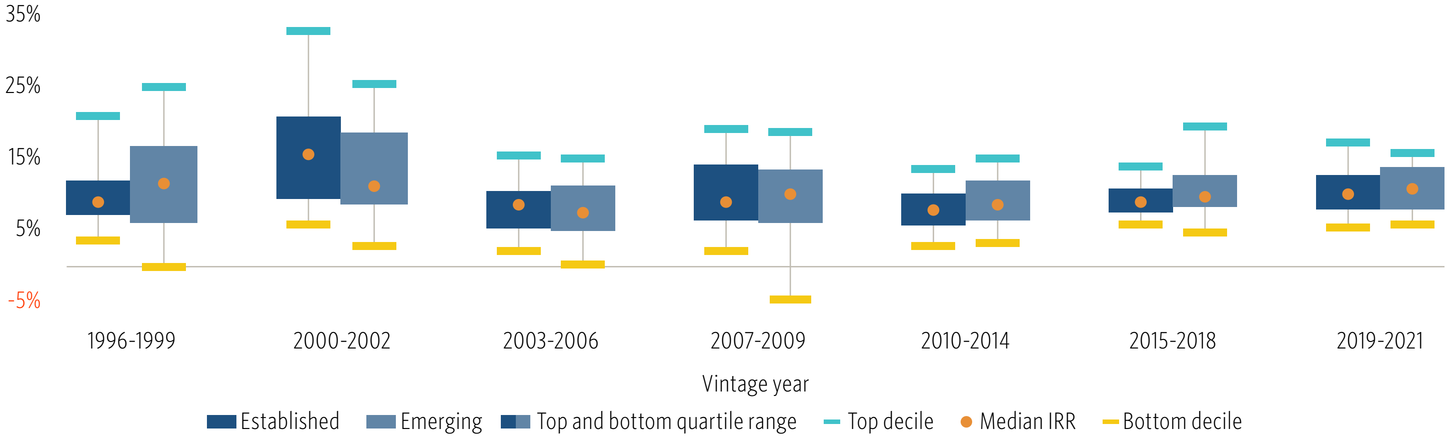
The main concern, however, resides in whether emerging managers truly underperform. Our analysis of private debt funds from the 2000-2018 vintage reveals a mixed history. While it is clear that established managers of 2000-2006

12: Our definition of private debt funds with performance data for this research includes mainly direct lending, distressed and credit special situations, mezzanine, and real estate debt.
13: "Explainer: What Is the 'Basel III Endgame' and Why Are US Banks Worked Up About It?" Reuters, Pete Schroeder, April 4, 2024.
14: "LPs Cautious About First-Time Funds," Private Debt Investor, Claire Coe Smith, February 1, 2024.

funds outperformed their emerging counterparts, GPs who emerged during the GFC and later have caught up with their established peers. Although we see a wider dispersion with an almost perfectly consistent lower bottom decile across vintages, median IRRs and top performers of the 2007-2018 emerging cohort surpass those of the established cohort. Most notably, the best emerging managers of the 2015-2018 vintage cohort have generated better IRRs than their established GP peers.

However, one noteworthy distinction for debt funds compared with other asset classes, especially for more risk-averse allocators, is that the upside potential of emerging GPs does not necessarily make up for the downside risk. Our analysis of the 2000-2018 vintages shows that the negative excess IRR for the bottom-decile performers is almost a 6% difference, compared with only a 2% difference achieved by the top-decile performers.

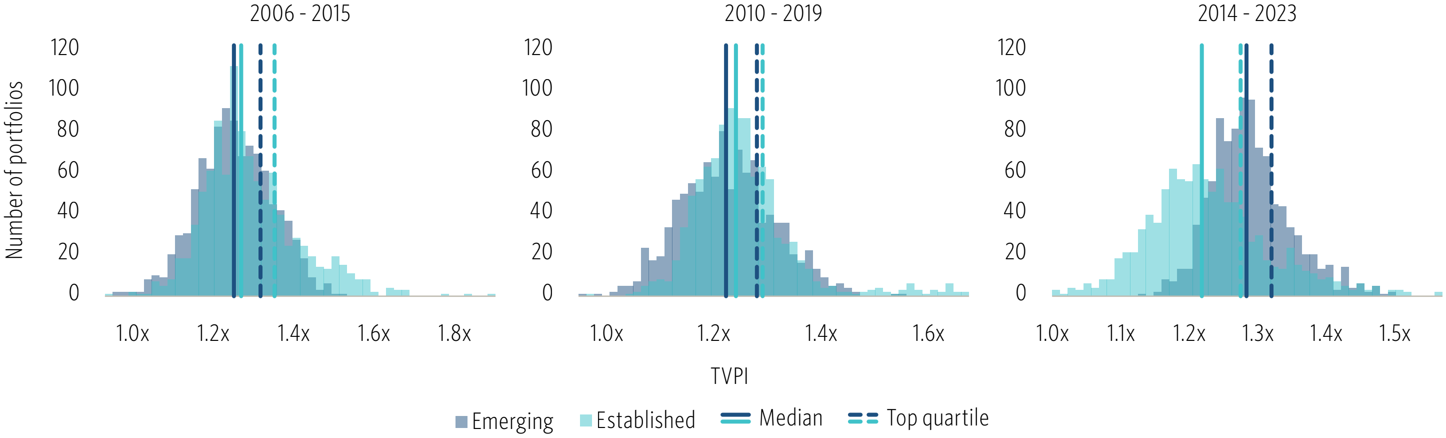
Private debt fund net IRR dispersion by vintage cohorts and manager experience*



Source: PitchBook • Geography: US • *As of September 30, 2023

Our portfolio simulation offers a different angle when contrasting the two cohorts in different economic conditions. Similar to buyout funds, while our portfolio simulations show a worse trend for newcomers both in the 2005-2014 and 2010-2019 periods, it results in a favorable trend for emerging debt funds in the most recent period (2014-2023) for many of the same reasons outlined under buyout funds. In addition, the higher-interest-rate environment impacting the whole market unsurprisingly also favors emerging debt funds, especially the bottom-half performers. Specifically, while the established cohort has a top decile of 1.36x TVPI, compared with 1.37x from their emerging counterpart, there is a wider gap in performance for the median (1.23x versus 1.30x) and the bottom decile (1.15x versus 1.24x).

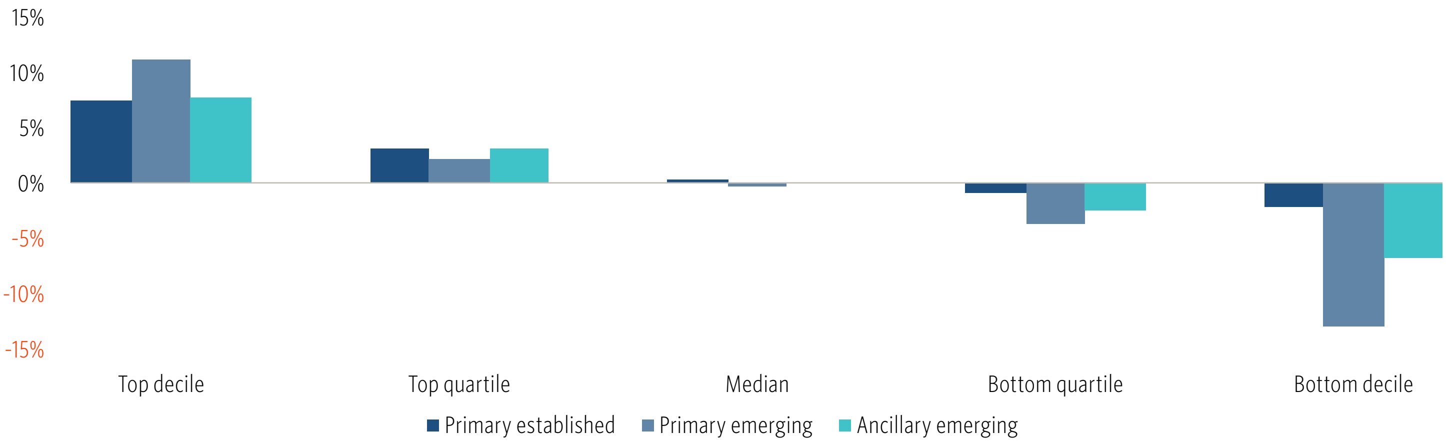
Private debt fund pooled TVPI simulation results by time frame and manager experience*



Source: PitchBook • Geography: US • *As of September 30, 2023

Lastly, when examining debt funds by family experience level, while established fund families are LPs' safest bet with the lowest dispersion, we observe the least favorable trend for ancillary emerging strategies with higher downside for the bottom performers compared with primary established funds, and lower upside for the top performers compared with primary emerging funds. Many of these ancillary emerging fund families are debt programs established by big buyout firms such as Blackstone, Carlyle, and KKR, as well as additional distressed and special situations debt strategies established by credit firms such as Oaktree and Ares. This suggests that although established managers have more expertise as a whole, they are not always the best at capturing alpha when it comes to setting up additional products. Moreover, when looking at these funds at the fund-family level as opposed to looking at firm experience, the upside potential that primary emerging managers bring is worth considering for LPs when deciding whether to expand their existing relationship with established managers into a product or take a risk with new managers.

Private debt fund excess IRRs by fund family experience*



Source: PitchBook • Geography: US • *As of September 30, 2023
Note: This data includes 2000 to 2018 vintages.

Concluding remarks

The manager selection process is fraught with risk challenges. Entrusting a manager with capital is a long-term commitment, and getting the choice wrong is costly. Emerging managers can provide attractive upside or exposure to niche strategies that are tough to replicate in other parts of the portfolio, but choosing from the multitude of options is difficult on its own. On top of that, selecting a new manager often requires the initial choice to not re-up with an established GP that has an established relationship with the investment team. Without an abundance of capital to put to work in private markets in this higher-rate environment, it is no wonder many emerging managers have struggled to raise capital. While emerging managers may present higher risks, they can also offer unique opportunities and diversification benefits that established managers might not provide.

LPs should weigh these factors carefully, perhaps considering a hybrid investment approach that incorporates both established and emerging managers while considering ancillary strategies that have a clear source of alpha. Such a strategy could harness the potential upside from top-performing emerging managers while still capturing the stability and lower downside risk associated with established funds. This approach would enable LPs to balance the desire for high risk-adjusted returns with the necessity of managing investment risks effectively.