TOP TALENT FINDING SUCCESS ON THEIR OWN

By Alan Hughes of the National Association of Investment Companies

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Diverse managers who have succeeded at world-renowned firms have done so by consistently delivering superior returns over many years in both good and bad economic environments. After building reputations as skillful investors, a growing number of these professionals are using their stellar performance records and gold-plated resumes to establish or join boutique shops, and are outperforming the competition along the way.

Frank Baker is one such manager. Baker, who got his start in the Mergers and Acquisitions group of Goldman Sachs, was handling investments at the $5 billion Ripplewood Holdings when he got a little taste of independence and found it to his liking. After years of building a reputation for delivering exceptional returns, Baker was confident he could continue to do so under his own banner. “I lived in Tokyo for four years. I liked the freedom and the responsibility that came with it,” he recalls. “I thirsted to be on my own.”

In 2011, that independence took the form of Siris Capital, which is focused on making control-oriented investments in data, tele-communications, technology, and technology-enabled business service companies in North America. Baker, who holds an M.B.A. from Harvard Business School and has excelled at every stage of his decades-long career, admits there were early concerns about building his own team. “We were on our own. It was long and painful and stressful with uncertainty,” he says. “Getting money from folks is a long process, and it takes one of them really getting to know you and understand you as a person. That just takes time.”

It wasn’t smooth sailing in those early days. “I always say we had 500 LP meetings. It felt like we did, at least. The first 150 people said ‘hell no’. The next hundred just said ‘no’,” he recalls. “You get a lot of ‘no’s before anybody gives you the time of day. It’s a long and painful ride.” It wasn’t until after closing the firm’s first deal that Baker felt fully confident in the venture. “That deal performed well and that’s when I felt like we actually had something that we could get to a sustainable final close.” That fund’s performance paved the way for the firm to raise its second fund, which came in at $1.8 billion.

A GROWING TREND

Baker is just one of the many diverse investment professionals who have come to the realization that they could continue to meet and exceed the expectations of capital allocators outside the confines of a large institution. Packing up their high-performance track records, ivy league educations and business insights, they continue to leave some of the most widely known private equity shops in the world to prove that they, like the titans of the industry, can succeed with their own shops.

According to the National Association of Investment Companies (NAIC), roughly 80 percent of its member firms’ executives honed their craft at one of the bulge brackets. At these large firms, investment teams were able to build a track record of performance that they could reference when raising capital for their own funds.

There are numerous reasons for this trend toward independence. Craig Fowler, Managing Director of HarbourVest and an NAIC board member, says he believes that programs focused on diverse managers, such as those managed by HarbourVest Horizon, may provide additional incentive for managers to start their own firms. He adds that some managers choose to leave large firms and open their own as a result of limited promotion opportunities and minimal availability of shares in firm economics, while others have always been entrepreneurial and leave a firm after gaining the skills necessary to start one of their own.

Establishing a new firm is extremely risky; remaining at a large firm is certainly safer. Professionals must be prepared to trade in multimillion dollar salaries and bonuses for millions of dollars in expenditures with no guarantee of success. They must also exchange relative stability for the emotional and financial volatility that come with creating a new enterprise. In addition to the financial impact, these entrepreneurial ventures may also pose a risk to professional reputation. Should the venture underperform or fail, the executive’s name suffers, making it more difficult to return to the same large firm where he or she built his or her reputation to begin with.

INVESTING IN THEMSELVES

Ray Whiteman is a storied investor whose stellar record propelled him to the upper echelons of the renowned Carlyle Group. As the highest-ranking African American at the prestigious firm, his was, by all measurements, a true success story. But he was unsatisfied. “I had been managing that fund for three vintages–close to ten years. We were coming up on another close to having to launch again, and it just dawned on me that this was kind of going to be the extent of my life,” he recalls. “There was this real desire to be your own boss, to call your own shots, especially given the type of investing we focused on–distressed and special situations.”

Now as Managing Partner of Stellex Capital Management, which invests in and manages US and European corporate assets, Whiteman admits it wasn’t an easy decision to leave the prestige and security of an established firm. “First you have to really think about the economic consideration and what am I leaving on the table,” he says. “I think even earlier than raising capital is just looking at some of the golden handcuffs that firms such as Carlyle have on partners.”

Daphne J. Dufresne, Managing Director of RLJ Equity Partners, is a professional who joined the firm at its inception. Formerly a Venture Partner for Parish Capital Advisors and Principal at the $3.4 billion firm Weston Presidio Capital, Dufresne liked the idea of getting in at the ground floor. “Really the allure was the start-up,” she says. “The opportunity to create something from scratch, work with a successful entrepreneur like Bob Johnson, and build a team of minority professionals.”

Dufresne developed a carve-out program for direct investment and co-investment in individual companies at Parish, and led full due diligence, monitored investments and exited investments at Weston Presidio. She attributes the growing number of money managers turning entrepreneur to several factors. “People enjoy betting on themselves and not getting bogged down by some of the bureaucracy or politics that can sometimes play in a person’s career at a larger firm,” she says. “I think you’re seeing that migration to smaller firms so that they can do the deals they want to do, generate the higher returns.”

At the smaller firm, Dufresne says she does a little of everything. “You’re involved from fund-raising and helping to bring in capital, going out and sourcing deals, involved in taking those deals that are sourced from bringing them in the shop to closing them and driving the investment decision to a ‘yes’ so they become a portfolio company.” And the work doesn’t stop there. “Once they’re a portfolio company, you’re working with that company and its management team to help drive the growth initiatives that we’ve laid out so we can generate significant returns for our limited partners.”

OBSTACLES TO SUCCESS

As with all entrepreneurs, diverse managers must overcome challenges when establishing their firms. It often requires a skillset that differs from sourcing deals or structuring a transaction. Without targeted programs from institutional investors these investment executives may find raising capital difficult. Additionally, in many cases these individuals formerly operated on the transaction side of the house and, as a result, may lack strong investor relationships and fundraising experience.

Dufresne also cited raising capital as a major obstacle. She says that capital allocators necessarily must be judicious with their investments, so they tend to be very skeptical towards first-time funds. “That’s what we were when we raised our first fund. It was lots and lots of meetings, lots and lots of smiles but ultimately ‘no’s. We managed to do it.” According to Dufresne, RLJ Equity Partners’ first fund is fully deployed at $230 million and the firm is in the process of raising for its second, which is expected to total $300–$350 million.

In nearly all cases, these professionals have deployed capital and delivered returns with larger institutions, but when they moved to a newer firm, many capital allocators become reluctant to partner with them. “There’s still a mindset of ‘well, it was under the guise of a place like Carlyle,’ as though I was kind of smart while I was at Carlyle but now that I’ve left I’m not as smart as I was anymore,” Whiteman says. “That’s just the nature of the beast. That being said, it goes back to is this an individual that can execute transactions, that can source transactions, that can create value. That skillset is there.”

For Whiteman, a dealmaker extraordinaire with an M.B.A. from New York University’s Stern School of Business, startup costs were also a big issue, particularly when factoring in costs for offices in both New York and London. At the same time, he was dealing with porting his cherry-picked team over from Carlyle. All of his expenses were out-of-pocket. “Someone asked me, ‘What sort of liquidity do you need to get it off the ground?’” Whiteman recalls. “At least $3 million. To do it perfectly, in such a way that no one will call question to anything, probably closer to $4-5 million.”

Another issue is being able to deliver consistent performance. Baker likens it to being a rookie quarterback who takes the field for the first time during the third or fourth game of the season and plays a stellar game. “After five or six games, defensive coordinators get enough film and make a plan for playing him. We had a great first fund. Now that the world is looking at us, can we continue to perform? That is the pressure that we have in our real big boy fund.”

Despite these challenges, many elite diverse investment managers continue to depart large institutions and form new ventures, often outperforming the behemoths along the way. “To run your own private equity fund, you need to be a pretty talented guy. You need to be smart. You need to be charismatic,” says Baker. “Those are the types of guys that have gone to the best colleges. Those are the types of guys who are getting the best jobs out of college. Those are the kinds of guys that get the best jobs in private equity. It makes sense that they’re the type to start their own firm.”

This movement is likely to continue as high-performing managers seeking new challenges and independence leverage decades of experience at team-building, sourcing, structuring and executing transactions to create smaller firms which have the distinct advantages of flexibility and innovative approaches. Similarly, these firms are expected to sustain equal–if not superior returns as the bulge brackets in which they honed their skills.

At the smaller firm, Dufresne says she does a little of everything. “You’re involved from fund-raising and helping to bring in capital, going out and sourcing deals, involved in taking those deals that are sourced from bringing them in the shop to closing them and driving the investment decision to a ‘yes’ so they become a portfolio company.” And the work doesn’t stop there. “Once they’re a portfolio company, you’re working with that company and its management team to help drive the growth initiatives that we’ve laid out so we can generate significant returns for our limited partners.”