

KEYNOTE INTERVIEW

Understanding the seeding opportunity for spin-outs



*While spin-out sourcing and diligence can be challenging, there is significant upside when you back the right managers early in their firm-building journey, says Taproot Capital's co-founder and CEO, **Eric Zoller***

Q Can you explain the difference between seeding and anchoring when it comes to partnering with early-stage PE firms?

Anchor capital is provided by an investor as part of a fund's first close to support an established manager. This initial commitment serves as a catalyst for the broader fundraising process by providing early momentum and signaling investor confidence. In return for providing this capital, the anchor investor typically receives certain preferential rights, which may include fee breaks across one or two funds, but is always finite.

Seeding focuses on backing managers at an earlier stage of firm development

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and acting as a long-term partner rather than solely a capital provider. These managers have different needs as they build out the infrastructure and institutional foundation of their firms. They often seek capital to support a diverse set of needs, including first-close capital, working capital or co-investment capital.

Seed capital is not just capital in exchange for economics but capital and services in exchange for economics. The set of services provided will vary, but the economics typically involve a long-term revenue sharing arrangement and

a permanent GP stake. It is more expensive capital for the GP but comes with more in return.

Q How would you differentiate the opportunity set when looking at spin-outs versus emerging managers?

The emerging manager space has a much broader definition than spin-outs as it typically covers managers raising funds I to III and raising anything sub-\$1 billion. The challenge is that an emerging manager on fund III raising \$900 million may in aggregate have a lot more scale, with potentially \$2 billion-plus of assets under management and maybe a decade

of track record. That sort of deal does not capture the same upside as seeding a spin-out manager.

It is a lot harder to identify and source spin-out manager opportunities, so that is one reason many seeders tend to broaden the definition. For Taproot, seeding is about first-time spin-out funds only. There is a lot of empirical data to suggest that first-time funds have outperformed their peers and that returns tend to compress as subsequent funds are raised – one reason for that is greater alignment between the LP and GP at the earlier stages of a GP's lifecycle.

Returns always matter but doubly so for a first-time spin-out fund because they have a more limited body of work to point to when raising fund II. That means everything must go right in fund I, which is not the same with a fund IV or fund V.

When you're launching a fund I, you also have an opportunity to build the firm from the ground up. Fund I managers are often less constrained by an existing portfolio and various board commitments competing for their time. Spin-outs can also borrow best practices from their prior firms and apply them to how they want to invest and operate going forward. That flexibility can be harder to achieve at a more mature firm with embedded systems and processes already in place.

Q What do spin-out managers need when starting out?

A spin-out manager needs guidance before they leave their existing firm, starting with how to navigate their departure. From there, an experienced adviser can help them work through how to launch their firm, including building the front, middle and back office — from organizational design and fund sizing to budgeting, hiring and infrastructure.

Once they leave their prior firm, the focus needs to be on three things: building the team, pursuing investments and raising the fund. Having the right infrastructure and advisers in place allows them to focus on those priorities.

They also need capital – a meaningful cornerstone commitment, working capital to build the business and fund the GP commitment, and access to co-investment capital to execute transactions.

These managers need support in fundraising, as well, both for the initial

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fund and as the firm grows. Most seeders are allocators at their core and do not have advisory or fund placement backgrounds to deliver that additional fundraising expertise. We think it is important to be able to offer a fundraising solution at scale for the GPs we seed because having that capability in place can provide greater certainty for the GP and help de-risk the fundraising process, which is equally important to LPs investing in seeding.

Post-close, GP needs expand to include investor relations and broader advisory support around how to build and scale the business. Many seeders can provide pieces of the pie, but few can support the full range of needs that come with building and scaling a firm. This is where we believe firms such as Taproot can shine.

Q Where might a seeding allocation sit within an LP portfolio?

There are two types of LPs looking at seeding. The first are those already actively allocating to emerging managers. The second are LPs with smaller teams or those who don't want to source and underwrite these opportunities directly and thus avoid investing in the strategy altogether. LPs can turn to seeding, therefore, to create a de novo and diversified pool of emerging managers or for the opportunity to generate incremental alpha within their existing emerging manager book.

Q How do you due diligence a new spin-out manager compared to a more established fund sponsor?

Most established sponsors do not talk about attribution during due diligence

and instead take the position that the firm and the brand drive returns. In other words, you are buying the embedded “system”.

With a first-time fund, individual attribution becomes much more important. LPs need to understand whether a new team can replicate its prior success independent of the platform where that track record was built, by looking at the specific role the team played at the deal level as well as the role they played at the prior firm as a whole. Who originated the opportunity? Who drove the investment thesis? Who led the relationship with management? Who stepped in when a portfolio company faced challenges? Who ran the board meetings? And who ultimately drove the exit?

Often, a spin-out manager cannot present a formally attributable track record, so references become a critical part of the diligence process. We look at the available data and signals and speak with people across the individual's prior investments to build a holistic view.

Q How do you measure the scale of the current seeding opportunity and how do you see that developing going forward?

There is a strong growth trajectory for emerging managers, and they are increasingly becoming an area where LPs want exposure. As the market professionalizes, LPs also have more ways to access it. At the same time, constrained DPI and delayed carry can create greater motivation for investment professionals to spin out, while seeders are making that decision easier by providing capital and helping de-risk the firm-building process.

We think more LPs will come into the space over time and with that potentially more seeders. Ultimately, GPs will shape the market, and they will gravitate toward seeders who can act as true partners not only at their launch, but also as the firm grows and scales. At Taproot we intend to remain focused on managers earlier in their firm-building journey, where GPs are looking for more than capital – they want a partner that can provide meaningful support over the long term and that's how we have organized our firm. ■