Many public and private pension funds have begun including emerging private equity managers in their alternative asset allocations—and with good reason.

Along with mainstream private equity firms, emerging managers may offer investors some advantages over publicly-traded securities. These include historically higher returns, diversification and a strong alignment of interest. Additionally, many plan sponsors consider investing in under-represented and emerging talent to be an essential element of their mandate. This paper defines the emerging manager sector, discusses the potential advantages of allocating to the sector and explores the critical factors to consider when investing.

Defining emerging managers

Though the definition of emerging managers varies, we define an emerging manager as a firm with one or both of the following characteristics:

- Diversity manager: a firm with significant women or minority representation; or a firm with an investment strategy targeting underserved communities or emerging U.S. geographic areas
- Newer manager of institutional capital (i.e., has not managed more than two funds in which the LPs consisted primarily of institutional investors)
Emerging manager opportunity

The emerging manager segment within the private equity industry is both dynamic and maturing, growing steadily for the better part of 20 years. There is increasing diversity representation at firms, and as more women and minorities enter the industry they can develop into the leaders of these firms.

The difficult fundraising environment since the financial crisis has adversely impacted many firms, with emerging managers particularly hard hit. Yet there continues to be a strong influx of emerging managers with excellent investment experience and high quality teams that have had oversubscribed fundraises due to strong performance.

Of the roughly 3,300 U.S. private equity firms representing $3 trillion in assets, we estimate approximately 5%-10% of the firms have significant women or minority participation. This is consistent with the approximately 220 annual offerings from emerging manager firms received by the J.P. Morgan Private Equity Group over the last seven years. In terms of market capitalization, we estimate that $20-$30 billion has been committed to diversity managers. Many emerging managers target niche strategies or specific geographies that leverage their expertise. This allows for differentiation in a very competitive and difficult fundraising environment. And more established emerging managers have taken advantage of the improved economic environment to exit their earlier investments and are proving out their investment strategies and track records with solid returns.

Many institutional investors recognize this positive activity and are moving into the emerging manager segment to gain:

- Potential for significant risk-adjusted returns
- Broader company access and differentiated deal flow
- Early connections to the industry’s potential new stars

Emerging managers have generated strong, competitive returns

As active members of the National Association of Investment Companies (NAIC), the J.P. Morgan Private Equity Group was part of the working team that generated the Recognizing the Results performance survey in 2012 and noted first-hand the strong performance generated from several diversity firms. Nearly 75% of the vintage years represented between 1998 and 2011 performed in the top quartile (Exhibit 1).

In the NAIC performance study, minorities owned 79% of the NAIC member firms and 69% had women or minorities in at least half of all investment roles.

The J.P. Morgan Private Equity Group believes that the risk/reward outlook for diversity managers is strong, as our own emerging manager performance attests. We thoroughly understand the market because we are active participants with leadership roles in a variety of industry trade groups, annual conferences, and organizations that specifically target diversity managers. We have a long track record of investing with both first-time funds and diversity managers, and their results have been additive to the group’s overall performance.

<table>
<thead>
<tr>
<th>Metric</th>
<th>NAIC</th>
<th>All U.S. PE</th>
<th>U.S. buyout</th>
<th>All U.S. PE</th>
<th>U.S. buyout</th>
</tr>
</thead>
<tbody>
<tr>
<td>Median net IRR (%)</td>
<td>13.2</td>
<td>3.6</td>
<td>7.1</td>
<td>9.6</td>
<td>6.1</td>
</tr>
<tr>
<td>Median net MOC</td>
<td>1.45x</td>
<td>1.10x</td>
<td>1.32x</td>
<td>0.35x</td>
<td>0.14x</td>
</tr>
<tr>
<td>Upper quartile net IRR (%)</td>
<td>22.7</td>
<td>11.5</td>
<td>14.6</td>
<td>11.2</td>
<td>8.2</td>
</tr>
<tr>
<td>Upper quartile net MOC</td>
<td>1.76x</td>
<td>1.42x</td>
<td>1.59x</td>
<td>0.35x</td>
<td>0.18x</td>
</tr>
<tr>
<td>Capital-weighted net IRR (%)</td>
<td>26.1</td>
<td>6.3</td>
<td>8.1</td>
<td>19.8</td>
<td>18.1</td>
</tr>
<tr>
<td>Capital-weighted net MOC</td>
<td>1.77x</td>
<td>1.25x</td>
<td>1.34x</td>
<td>0.52x</td>
<td>0.43x</td>
</tr>
</tbody>
</table>

| NAIC > top quartile net IRR | 73% of vintage years |
| NAIC > top quartile net MOC | 73% of vintage years |

Source: National Association of Investment Companies (NAIC)
Successful investing in the emerging manager sector

Whether relying on internal or external investment resources to establish and manage an emerging manager allocation, investors should carefully consider what it takes to be successful in this space. In our view, the factors for success are very much the same as for investing in any segment of the private equity market: experience, a solid investment track record, an established network of relationships and sourcing opportunities, as well as a rigorous process for initial due diligence and continual monitoring. Given that emerging managers typically have a shorter track record and face the challenges common to any business in its formative years, these factors for success are particularly important in identifying and developing the next top-tier private equity firms.

The J.P. Morgan Private Equity Group effectively identifies these critical success factors before investing in emerging managers. The institutional knowledge of private equity that we have acquired through managing over 350 private equity sponsors deeply informs our evaluation of today’s emerging managers. For example, when an emerging small buyout manager was considering investing in a retailer focused on urban markets, we were able to provide a valuable historical perspective. We recounted the course of a similar deal from the mid-1990s—profitable for some investors, unprofitable for others—highlighting the potential advantages and pitfalls of this type of investment. In another example of valuable personal connections, we were able to sponsor the spinout of a diverse, lower middle market manager from a mid-market private equity firm due to the fact that we had a decade-long relationship with the senior partner who launched the spinout.

Our strategy for emerging managers includes investing with professionals with whom we have long-standing business relationships and the selective identification of new emerging groups with unique skill sets or a differentiated strategy. We seek to invest with partnership sponsors whom we expect will develop strong franchises and quality deal flow, and produce attractive net returns.

We spend a great deal of time understanding the investment backgrounds of the principals. Gathering the pertinent data to become comfortable with an emerging manager and develop a comprehensive profile of the firm can require more utilization of our own resources. We want to understand the team dynamic of newly formed partnerships, including decision-making, economics and operating infrastructure. Key strengths of the J.P. Morgan Private Equity Group are the depth of resources and the experience of our team to conduct the extensive manager assessment required for our process. The additional time we employ is often a benefit to the emerging managers as our scrutiny and constructive feedback leads them to reflect on their own business plan and where they are in their life-cycle.

All members of the J.P. Morgan Private Equity Group participate in the investment decisions related to emerging manager portfolios, not just a small subset of the team. A representative emerging manager client portfolio of 12 investments demonstrates the critical strength of our team:

- Number of portfolio managers involved in manager due diligence: 16
- Average number of portfolio managers per investment: 5
- Average years of related experience per deal team: 19 years
- Average years with Private Equity Group: 14

Sourcing opportunities

Searching the landscape to find top managers is a critical task. To identify high quality emerging manager investments, we draw on a range of sources, including: existing emerging managers, investment professionals “spinning out” of existing sponsors, and experienced professionals at non-partnership entities. We see more than 500 investment opportunities each year, with over 200 of them qualifying as emerging managers. Seeing this broad number of opportunities enables us to select the best managers through our rigorous selection process.

We actively engage in the emerging manager community through sponsoring and participating in alternative investment events and conferences. For example, we have served as a sponsor of The Consortium, formerly known as The Plan Sponsor and Minority Manager Consortium, a well-attended gathering for institutional investors focused on emerging managers, for every year since it began in 2004. In addition, we have sponsored emerging manager-specific conferences with the NAIC, the Association of Asian American Investment Managers (AAAIM) and the National Association of Securities
Professionals (NASP), among other organizations. Several members of the J.P. Morgan Private Equity Group have served on the boards of the NAIC and AAAIM.

Furthermore, we continually look to broaden our emerging manager network through organizations such as the Robert A. Toigo Foundation (Toigo). This organization aims to increase diversity in the finance industry by offering the only MBA fellowship program dedicated to developing minority professionals ready to lead in the finance industry. Our connections to Toigo are long-standing. One of J.P. Morgan Private Equity Group’s members has served in leadership positions on Toigo committees and we currently have two Toigo fellows in our group. Through their relationships with the Toigo alumni network, we have been able to source new emerging managers.

We also have a long-standing relationship with the Small Business Administration (SBA), including communication with senior SBA staff on a regular basis. We maintain regular interaction with other investors, general partners and intermediaries throughout the investment community to maximize our network. Additionally, through the monitoring of existing investments, we are able to identify co-investors and regularly cross reference general partners’ opinions on investments.

These activities and relationships enable us to be proactive as we continually look to discover promising new investment opportunities.

Helping hand: Mentoring our managers

Given our group’s 33 year history of investing in private equity, and emerging managers specifically, we have the experience necessary to assist and help structure new firms. This mentoring activity is an important component of our emerging manager program. We serve as a resource to emerging managers by providing such sponsors with advice, guidance and feedback on their investment strategies, offering documents and fundraising. This includes coaching and constructive feedback on the content and delivery of presentation materials. Given our relationships, these general partners seek us our early to have a sounding board on fund formation ideas. The feedback and suggestions provided to emerging managers are a natural extension of the process that we believe provides significant value regardless of our ultimate investment decision.

Once a firm is in operation, we can share best practice ideas for reporting, annual meetings and capital call notices, and provide other ways to help managers operate efficiently. We also introduce firms to each other to help them create their own networks, particularly for the “back office” functions. These services provide firms with additional value as they build up their teams and market their strategies, while developing a relationship with us that could evolve into an investment commitment. Importantly, we believe such mentoring and value-added activity is an important contributor to the sourcing and identification of promising opportunities.

In mentoring emerging managers, we take a targeted approach to the individual needs of the specific manager. Here are a few examples of how we add value through mentoring:

- When a diverse manager was raising a second fund with a slightly different strategy, we helped them enhance their sales presentation to include a matrix of portfolio companies and their strategies (stages, size, industries, etc.), in order to highlight the differences between the first and second funds
- We identified and introduced a new CFO to an emerging manager
- We host “New CFO” days, where we invite first-time CFOs to our office to network with each other, meet and learn from experienced CFOs and hear members of our accounting team share best practices
- We introduced several partner candidates to emerging firms as well as interviewed potential new hires

Robust due diligence process and ongoing investment monitoring

Our investment process is defined by rigorous due diligence and a belief that investments made with top managers can yield significant rewards over the long-term. We use the same due diligence process for emerging managers that we employ for more established funds. Nevertheless, investments with such sponsors may involve other risks than are generally associated with investments with more established sponsors. Less established sponsors tend to have fewer resources (including capital and employees) and, therefore, are more vulnerable to financial failure. Such sponsors may also experience more acute start-up or growth-related difficulties.
The list of attributes considered in determining the potential of investment talent is quite extensive. Throughout the due diligence process, we focus on evaluation areas that include, but are not limited to:

- Demonstrated high levels of integrity and fiduciary responsibility
- Overall investment management experience
- Attributable investment management track record consistent with the strategy
- Complementary experiences among the professionals in the general partner team
- Significant industry contacts or thought leadership
- Long-term compensation opportunity broadly available across the investment and support team
- Breadth and depth of relationships with deal source communities
- Facility with financing structures and relationships with financing sources
- Quality of interaction among investment team members

Evaluation of an organization’s financial stability and infrastructure is also an important component of the due diligence process. This includes a thorough review of budgets and financial statements. Such an evaluation also extends to the quality of administrative personnel and outside service providers. We expect to closely review the background of controllers and other financial officers and give serious consideration to their independence and integrity.

At J.P. Morgan’s Private Equity Group, portfolio monitoring and performance reporting are core competencies integral to providing excellent client customer service. We monitor investments by acting as a lead investor, serving on advisory boards, and maintaining a dialogue with managers regarding their strategies and investment decisions. We seek advisory board seats on every investment and currently sit on the advisory boards for more than 200 partnership investments.

Resource breadth and depth

Our clients join a powerful alliance, drawing on the unique benefits of working with a leading global investment firm. The J.P. Morgan Private Equity Group leverages the resources of J.P. Morgan Asset Management’s back office, risk management, legal and compliance, reporting, human resources, operations, technology, and client servicing divisions. Additionally, we utilize the expertise of the buy-side analysts, capital markets professionals and economists at the firm. At the same time our group maintains the ability to independently make business-related decisions including, but not limited to, products, portfolio management, investments and personnel.

Conclusion: Identifying and developing tomorrow’s top-tier managers

The J.P. Morgan Private Equity Group considers it a priority to deepen our identification, mentorship and investment in emerging managers. We believe that maintaining a long-term perspective on this sector is of paramount importance because investment firms operate in natural life cycles based on the interests of the general partner leadership, the development of their professional ranks and the durability of their internal cultures. Because excellent new managers continue to emerge out of this community, the growth of the emerging manager effort represents a significant long-term business opportunity.

Concurrently, many investors are looking for new sources of risk-adjusted return. Top-tier emerging private equity managers provide investors with the potential for significant returns as well as early access to the industry’s potential new stars. But finding those prospects is not easy. Investing in emerging managers demands a very particular skill set—deep institutional knowledge, strong relationships, extensive due diligence capabilities—which few investment firms can provide.

J.P. Morgan’s Private Equity Group seeks to deliver the experience, global investment expertise, stability and resources to meet each client’s objectives for successfully investing in emerging manager private equity.
THE J.P. MORGAN PRIVATE EQUITY GROUP: INVESTING WITH EXPERIENCE

Our emerging manager program draws on the substantial and unique resources of J.P. Morgan Asset Management’s Private Equity Group:

• One of the largest and most successful private equity firms in the industry, managing about $24.6 billion on behalf of more than 125 institutional investors

• The group began investing with emerging managers in 1980, as part of the AT&T pension fund’s private equity team. In 1997 substantially all of the members of the team joined J.P. Morgan Asset Management and established J.P. Morgan’s Private Equity Group

• We are today a seasoned, cohesive unit of dedicated investment professionals with exceptional continuity; its founding members have an average tenure of 23 years

• We began managing our first emerging manager separate account in 2005 and currently manage $1.1 billion on behalf of institutional clients in separate accounts
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