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NEWS & ANALYSIS

Churchill AM: Alpha starts with doing what you said you would

Churchill Asset Management tests managers for a clear edge and the discipline to stick to it by using co-investments, advisory board seats and annual re-underwriting, managing director Anne Philpott tells PEI Private Equity.

When it comes to figuring out which new manager is best positioned to beat public markets, Anne Philpott starts by learning what makes each GP special.

"When selecting managers, we lead with asking, 'What is your unique angle?'" says Philpott, a managing director leading private equity fund investments at Churchill Asset Management.

That angle can be a sector specialty, such as a healthcare manager who knows the legislation and technology inside out. It can also be sourcing: "A lot of times, the GPs in our portfolio are not the highest bidder in an auction, but they're able to connect with the management team."

The value-add could also be operations: the resources, network or experience to know which step to take first in building out a plant or managing labour shortages.

Having an angle is only the start. Managers have to show they've "done it before and… have a vision to do it again", she says.

Philpott works on Churchill's junior capital and private equity solutions team, leading the primary private equity fund investment strategy while sitting on the firm's investment council and PEJC investment committee. As of October, the fund programme had $14 billion of commitments and was deploying more than $1 billion a year on average.

Stated strategy vs reality

Philpott's main test is whether a manager does what it says it will do. She gives the example of a spin-out with a strong team, clear attribution and a good track record: it told Churchill it targets mid-market companies with about $30 million of EBITDA. The first co-investment it showed targeted a company with $200 million of EBITDA. "Great company, great outcome, but not for us," she says.

The deal turned out well for the manager, but for an LP trying to build conviction in a new firm, "the mismatch in what they stated and what actually happened is sometimes just too high of a hurdle".

That test matters more with emerging managers. Historically, they have outperformed established managers, she says, "but there's a lot more volatility in that part of the market, and so it's very important to have the manager selection process refined".

Churchill found in a recently published analysis that emerging managers generated a median net IRR of 18.9 percent, compared with 15.8 percent for established managers with less than $1 billion in AUM and 15.1 percent for established managers above $1 billion.

Churchill also asks to see a new manager's pipeline. "You can have all these ideas and you can have a thesis, but have you started the work of reaching out to bankers and talking to management teams?"

Philpott wants to know how a manager has thought through portfolio construction, including how many platforms, how concentrated the fund will be and how much leverage the manager will use. The managers that stand out might not have all the answers, "but they've thought about it and they can articulate it".

Personal relationships

Churchill sits on the advisory board of more than 80 percent of the funds it backs. It also runs a direct business across senior lending, junior lending, equity co-investment and secondaries. That means it has often worked with a spin-out team's dealmakers long before they raise a first or second fund. "They might be new to the market, but they're not new to us," she says.

That history helps with the perennial problem of investing in emerging managers: how to figure out track record attribution.

Churchill can see who "was on the board call three months ago, or who sourced the transaction". It can then ask, "This is what you've done historically… Does that match with what your plan is going forward?"

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She called co-investing "one of the best ways to diligence a manager, emerging or established". Churchill builds its own model and reviews the sponsor's base, upside and downside cases, which shows how a team communicates and processes information. It doesn't always have to close the deal: "[Just] being offered an opportunity and working through that process is a really, really great way to diligence an emerging manager," she says.

For managers already in the portfolio, Churchill asks sponsors to re-underwrite their assets. "You bought the asset in 2022. How did you expect it to be performing [and] what's changed since you underwrote the investment?" she says. "You can't control external factors, but the best performers will always have a view on, or be prepared for, events in the market that are outside your control."

Reference calls with portfolio company CEOs round out the picture; the strongest signal comes when those CEOs invest in the manager's next fund. Philpott calls that "the biggest vote of confidence". With spin-outs, partners at the team's old firm sometimes commit, too.

Consistency over home runs

When Churchill does measure performance, it benchmarks against top-quartile returns. Philpott says more than 70 percent of its funds are currently top-quartile performers. However, what she prizes most is consistency.

"We'd much rather have a fund that is generating 2x, 2.5x, 3x consistently versus a fund with each platform varying widely with a zero and a 5x and a 1x," she says. Wide swings usually come from a manager that leaned into a deal outside its wheelhouse, overlevered a business or paid too high a multiple. "At that point, you're subjecting yourself to the market correcting itself, and you need to rely on external factors to generate a return."

Churchill – which is owned by Nuveen, the investment arm of insurer TIAA – makes commitments in the range of $30 million to $60 million, according to its website.

"We don't want to get into a situation where we commit $10 million to one fund and $200 million to another fund," Philpott says. "Then you're relying on a few managers to drive return."

Churchill has backed emerging managers every year since 2011 without a set allocation target, and its median fund size has always been just under $1 billion.

For managers heading out to raise, Philpott says past returns won't carry them on their own. A quarter of funds are top quartile by definition. "So, how do you narrow that down, that funnel, and stand out?

"It's not enough to come to market and say, 'Our last three funds were a 2.2 net,'" she adds. "You really need a go-forward strategy and a clear picture of the value add."

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