First Time Funds

The Fundraising Environment is Strong; The Fundraising Process is Hard

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Raising capital for a first time private equity fund is difficult. First time fund managers often are surprised by how long it takes to secure enough capital commitments to hold a fund's initial closing, particularly when seeking commitments from institutional investors.

The good news is that first time funds have recently been in favor with investors. First time fund managers have seen growth every year since 2013, both in terms of the number of funds raised and in the percentage of the industry's overall fund raises, according to Pitchbook.

Investors are attracted to the strong performance of first time funds

Strong performance is one reason why investors seek out first time funds. First time funds outperformed follow-on funds by a significant degree in recent years. Pitchbook reports that for 2012-2014 vintages, first time private equity funds produced a median internal rate of return of 17.1%, compared to 10.8% for follow-on funds.

Three factors help to drive the strong performance of first time funds: their smaller size, the managers' incentives, and the absence of distractions from legacy portfolio investments.

First time funds tend to be relatively small compared with funds raised by established managers. Smaller funds can focus on smaller, less-efficient segments of the market where the lack of competition offers potentially higher returns. They can pursue narrowly-focused strategies where the manager has a competitive advantage in industry, geography, or asset class. A smaller fund size also forces the manager to ration the fund's capital, which creates an incentive for the manager to be more disciplined when executing the fund's strategy.

First time fund managers have many incentives to produce strong returns for their limited partners, while limiting the risk of losses. If a manager's first fund is successful, the manager can look forward to receiving generous payments of carried interest, raising a larger follow-on fund that will provide a second management fee stream for the firm, and potentially achieving financial and professional independence. If the manager's first fund suffers losses, however, the manager's professional reputation may be harmed, the manager may suffer significant financial losses, and the manager will have disappointed the fund's limited partners, many of whom may be family, friends, or business colleagues. With so much at stake, the pressure to succeed can create a sense of urgency that keeps the management team focused, diligent, and prudent when executing the fund's strategy.

A first time fund manager, by definition, only manages a single investment fund. The manager therefore can devote all of his or her time and attention to that fund, without being distracted by the need to manage legacy investments made by his or her prior funds.

Institutional investors perform extensive due diligence on new managers

When evaluating first time fund managers, institutional investors tend to focus on the firm's strategy, deal sourcing capabilities, track record, team continuity, and back office operations. Managers seeking capital from institutional investors should be prepared to go through an

extensive due diligence process that covers each of these topics, among others.

Strategy. The fund must have a compelling strategy, and the manager must be able to clearly articulate that strategy to prospective investors in the fund's offering documents. The fund's strategy ideally will be in an area where the manager has a competitive advantage, whether through his or her expertise, network, or otherwise. The strategy should be tailored to the manager's strengths. A manager that has a strong track record investing in early-stage cloud application companies based on the West Coast of the United States will likely have more success raising capital for a fund that focuses on that narrow strategy and geography, rather than for a fund that has a more generic focus of investing in early-stage technology companies based anywhere in the world.

Sourcing. The manager must be able to demonstrate that it will be able to find enough suitable investment opportunities for the fund to invest all of its capital. If the manager has difficulty finding suitable investment opportunities, he or she might seek to invest the fund's capital in less suitable opportunities (i.e., those that are riskier or offer less potential upside) or decide to invest less than all of the fund's committed capital, which results in a higher expense-to-investment ratio for investors. Diligent investors will test a manger's sourcing claims by, for example, evaluating whether the manager's historical access to investment opportunities was based on the manager's own personal relationships or on a non-portable source, such as a former employer.

Track record. Institutional investors want to see a track record, which clearly presents a challenge for new managers. Institutional investors often say that they will invest with first time managers, but never with first time investors. Presenting a track record is easier when a new manager has a history of making investments at a prior firm. It is more difficult when the manager is someone whose attractiveness to potential investors is based more on the manager's industry knowledge and connections than on investment experience, such as a former chief executive officer.

Managers who do not have established investment track records may have difficulty attracting capital from institutional investors. These types of managers sometimes pursue a strategy of being a "fundless" sponsor – someone who offers investment opportunities to prospective investors on a deal-by-deal basis. This strategy helps the manager develop a track record over time while also building relationships with a core group of investors who may become anchor investors when the manager raises a traditional multi-investment private equity fund in the future.

Team continuity. One risk of investing with a new manager is that the management team might not get along with each other. This risk is mitigated when the management team has successfully worked together for a number of years at a prior firm, but is heightened when the management team is comprised of people without substantial prior relationships. Regardless of the level of continuity among a manager's team, the manager should be prepared to explain to prospective investors why they should not worry about the team's cohesiveness.

Fund operations/back office. Institutional investors will evaluate a new manager's infrastructure to determine whether the manager will be able to handle the basic operational requirements of a private equity firm. These requirements range from managing the fund's cash flows to navigating an increasingly complicated regulatory environment.

An investor evaluating a firm's operations might ask questions such as the following:

- Is the firm's accounting being handled in-house by someone new to the private equity industry, or by an experienced private equity fund administrator through an outsourcing arrangement?
- Is the firm using a private equity transactional lawyer, or someone who is experienced with private equity fund formations and operations?

- Does the firm have policies and procedures in place to manage potential conflicts of interest between the manager and the fund?
- Does the firm have policies and procedures in place to ensure that expenses are appropriately allocated between the fund and the manager?

The back office due diligence process is intended to ensure that investors' money will be used for its intended purposes (and will not be stolen in a Ponzi-scheme), that investors will only pay for the items for which they are responsible (and not for the manager's personal expenses), and that investors will receive accurate information about the status of their investments over time.

Managers that are prepared for the diligence process have a fundraising advantage

The fundraising environment is strong, but the fundraising process is hard. New managers can give themselves an advantage in the fundraising process by anticipating the questions that investors will ask, and by preparing thoughtful answers to those questions. Some of the important topics that investors will examine are identified above. More are available in standard industry due diligence questionnaires.[1] All of these questions, regardless of their specificity, fall within two broad categories — What is the upside potential? What is the downside risk? Focusing on the first category might attract the attention of investors, but ignoring the second category might allow them to slip away.

For more information, please contact a member of our Private Investment Funds and Advisers Practice.

Footnotes.

1. The Institutional Limited Partners Association publishes a standard due diligence questionnaire that was designed to ease the administrative burden placed on private equity limited partners and general partners by standardizing the most frequent diligence questions posed by investors. ILPA's questionnaire is more appropriate for established managers with significant track records than for first time fund managers. The questionnaire, however, provides valuable insight into the types of questions that institutional investors will ask. A copy of ILPA's questionnaire is available on the ILPA website or by clicking here.