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Building Blocks of a Successful PE Firm

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Building Blocks of a Successful PE Firm

Key Findings

1. **Success with private equity deals doesn't guarantee success in building a firm.**
2. **New firm managers may be surprised by unexpected tasks.**
3. **Establishing infrastructure at a firm takes time and money.**
4. **Tighter regulations may require hiring a compliance officer.**
5. **Attracting young professionals with an entrepreneurial spirit is key.**

The Panelists

Kenneth Clay
Executive Managing Director, Corinthian Capital Group

Steven Millner
Managing Principal Gen II Fund Services

Robert Nolan
Managing Partner, Halyard Capital

1. Success with private equity deals doesn't guarantee success in building a firm.

Doing private equity deals and building a private equity firm are two very different jobs that require very different skill sets. And challenges often arise when "deal guys" underestimate the work needed to get a PE firm up and running—and up to institutional standards.

"Most people who have started a firm have experience in the industry, obviously, and they mostly come from the deal side," says Kenneth Clay, who co-founded Corinthian Capital in 2005. "So you've got deal guys with track records who are intelligent, successful individuals, and they decide to strike out on their own. And what they probably underappreciate is that there is a whole infrastructure that has to be created, and you have to manage a business, which is different than being a successful investor."

As an adviser, Steven Millner of Gen II Fund Services has had a front-row seat at a lot of construction sites. He's helped launch more than 100 private equity

firms. He's observed that the founding team is usually composed of deal professionals—and the savvy ones sit down early on and decide what jobs they can and can't do.

"Among them, they figure out what they need," he says. "'Do we need a CFO? Do we need general counsel? What's the size of the firm?' And what's occurred more recently is the regulatory burden, which has added new weight to how you think about configuring your firm."

Halyard Capital was spun out of the Bank of Montreal in 2006. Managing partner Robert Nolan says this helped Halyard on the infrastructure side—the firm leaned on the bank for assistance—but that, when it came to support staff, some assembly was required. The same goes for any newly founded firm.

"It's a mixture of insourcing and outsourcing services, be they accounting, be they compliance, be they legal," he says. "I would say the skills are administrative, they're financial, they're obviously deal-doing, and lastly they're managerial. It takes a mixture of people and a mixture of skill sets, and it may well take a mixture of insourced and outsourced capabilities."

2. New firm managers may be surprised by unexpected tasks.

As Donald Rumsfeld once said, there are the known knowns, there are the known unknowns, and then there are the unknown unknowns. Founders of new firms often find themselves facing the latter. Clay recalls he was on the road when Corinthian was choosing a compliance officer and he drew the short straw—rather, someone drew it for him. He got the job.

"I hadn't counted on that," he says. "So I went through the whole process of becoming compliant with Dodd-Frank and all the things that go with it."

But rookie firm managers are getting better at handling the curveball. Often they can bring their deal-making skills to unfamiliar roles. "I was able to use deal skills in negotiating health insurance," Clay says. "As we were building out our space, there were financial assur-

Kenneth Clay, Corinthian Capital Group

Spinout Crash

Launching a spinout PE firm is harder than ever. Even GPs who enjoyed star status at their previous firms are being raked over the coals by wary LPs.

"The level of diligence at the time we raised our first fund was high, and it's only gotten higher," Clay says. "If you think about things from the investor's perspective, there is an awful lot of product out there. They have made a buy decision on your old fund, so therefore they're going to look at things with a critical eye. When you spin out on your own, that level of goodwill may or may not follow you."

In fact, it's more likely not to follow you. Why? Because investors hate uncertainty, and there's nothing more uncertain than a new fund with no history of success. "With a new firm, there are lots of moving pieces," Clay says. "I think many deal doers are probably surprised at the level of scrutiny. Not that the LPs don't wish you well, but it's just a new game."

Steven Millner, Gen II Fund Services

The Madoff Effect

Given the increased level of LP diligence, GPs who want to create spinout funds are well advised to have a bulletproof game plan before hitting the market. They simply can't rely on their previous relationships with investors, no matter how chummy they were.

"I think Madoff changed everything," Millner says. "Suddenly there was this bright line for investors who typically relied upon relationships to invest money unbridled. That's also when regulation and compliance kicked in to a higher degree."

First and foremost, Millner advises GPs to lawyer up, especially if they're departing an old firm and starting a new one. "The lawyers need to be involved in terms of what information can be shared and how track records work," he says. "We've actually had to reconstruct several track records to conform with what's currently being offered to give the investors a better sense of what the return profile would look like to them. That's an important element and consideration when a group is planning a departure."

ances we gave the landlord, and some of those fell away in negotiating for early releases of deposits and escrows and the like. There are lots of things you don't anticipate, because you can't know everything. Some of those things are new activities, others draw on deal skills."

A lot of new firms rely on consultants like Millner-to tackle tasks outside their skill set. "Now when they come and express interest and they meet with new firm managers, they have thick due diligence questionnaires," Millner notes. "We're getting more and more of these DDQs sent our way, and we can fill out the back-office, cyber security, disaster recovery and business continuity answers on behalf of our clients."

3. Establishing infrastructure at a firm takes time and money.

A partner can work at an established firm for years without appreciating all the parts and personnel that make the place function, from back-end databases to the guy who delivers the bottled water. When they launch their own firms, they quickly come to appreciate the scope of the infrastructure required.

"I needed to hire my own finance person, needed to suddenly have fund management taken care of," Nolan says. "Obviously Bank of Montreal had an in-house general counsel's office. And I had a chief administrative officer who assisted me who suddenly disappeared."

"We started from scratch," Clay recalls. "We had the core of a terrific group. But we had to find office space, we had to sign a lease, we had to do the build-out. I still remember the early days of us all huddled in one office with cheap chairs and a single phone line coming down from the ceiling. We were all huddled around one speakerphone."

Most things a GP at a big firm takes for granted were missing, he says. "We didn't have a PBX system, we didn't have central servers. We had to procure all those services—radio cars, American Express corporate accounts, all of that. It takes a lot of time and some money."

And usually more of both than anyone foresees. “It takes time to find office space,” Millner said. “It always takes longer to build it out. It always costs more money. And then you’ve got competing interests—you want to get out and start talking to potential investors—and that creates a lot of challenges within the organization. There are stress points associated with that.”

4. Tighter regulations may require hiring a compliance officer.

Private equity is now far more regulated than it used to be—and that goes for fledgling firms as well. “Little did we know we posed systemic risk to the U.S. financial system,” quips Clay. All this regulation means new firms must dedicate ample resources to compliance.

“The good news is that there are a number of firms that have been assisting hedge funds for some time and have adapted to the private equity world,” Nolan says “They helped organize us in terms of the types of materials and processes we needed to put into place. We then had to designate a chief compliance officer internally.”

Nolan took on the job when Halyard launched, not altogether happily. “It wasn’t an aspiration,” he notes. But he was in a better position to handle it than many new-firm founders.

“People with Bob’s background, who have worked at large institutional banks, they get it as it relates to regulation and compliance,” Millner says. “They’ve grown up in that environment. What’s interesting to me are the private equity firms who have been doing this for the last 20 years who need now to change the culture of the organization, change some of their priorities to adapt to this new environment. These firms face the greatest challenges today.”

Corinthian was still a young firm when the new regulations were put in place “and we went from a fairly thin employee manual to a 100-plus-page monster,” Clay says. “It seemed extraordinary, given that we are a firm of less than 20 people, to have that level of infrastructure, but it’s needed today.”

Robert Nolan, Halyard Capital

Measure of Success

One of the first qualities LPs look for in newly independent GPs is attribution: the ability to prove that they were indeed the partners who were largely responsible for the successful deals at their previous firms.

Nolan says that, without question, attribution is the most intense part of the due-diligence process for new groups. “It’s particularly important when you’re spinning out of a large institution, because the suspicion is that somehow the institution subsidized both the deal sourcing and assisted in the deal doing.”

Nolan also warned that different LPs have different ways of measuring success, which can trip up unsuspecting GPs. “Some LPs are much more quarterly focused, and as a result, IRR becomes the governing standard,” he says. “Other investors, like a family office or an endowment, may look more for a multiple of invested capital as opposed to IRR. As a fund that’s more focused on growth-oriented companies, it was a surprise to me how many people wanted quarterly deliverance of capital return and gains.”

5. Attracting young professionals with an entrepreneurial spirit is key.

The most important aspect of a new private equity firm—same as any new company—is good people. And recruiting good people to a just-launched firm is not easy, because successful and talented PE professionals have a lot of choices.

Good people can come from many places, Nolan notes. “It may come from investment banks, it may come from other private equity funds, God forbid even a law firm. But the fact of the matter is, you’re not going to compete with the largest brand names for those who desire the largest brand names. But for those who want to come and be part of an original effort and gain more traction as a meaningful member of the team than they might at a large institution, that’s what you’re selling them. You’re selling them the entrepreneurial promise.”

Clay quotes the old adage: The one position you can never be promoted to is founding partner. But that is a position new firms can offer to attract top-flight people, provided they have the right attitude.

“Deal professionals are risk-averse,” Clay says. “They weigh the prospect of going to a very large firm where they’re never going run things, in all likelihood, but where they have so much under management that they can have a very nice livelihood versus building something and being much more influential. We found that there’s a clear division between the people who want to do banking on the buy side with big firms and those who want to get involved with something entrepreneurial. And if you get the right talent in, it’s critical to building the firm.”

“If everything goes well, you invest in a bunch of loans, none of them default, and it’s fine,” he says. “But if things don’t go well—and particularly in a decelerating environment where you have increasing distress and asset values declining and things like that happening—there will be losers in that situation. ◆

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Managing Principal,
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