Privcap/ Briefing
Context for Private Capital Investment

Q4 2014

Five Reasons Why You Won't Raise Your Next Fund

Three experts discuss the turn-offs that may cause them to pass on a GP's fundraising

Five Reasons Why You Won't Raise Your Next Fund

Five Reasons

1. **You Stray from a Strategy Without Explanation:**
   You have made your intentions for a fund clear, but you haven't stuck to them.

2. **You've Been a Poor Communicator:**
   Think a couple of phone calls a year to investors is enough? Think again.

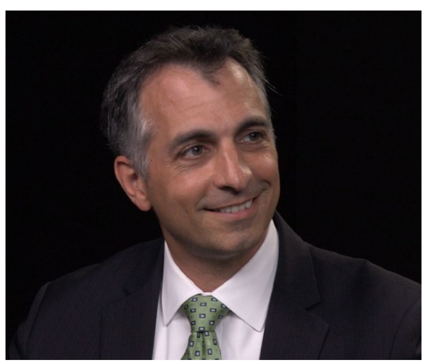
3. **It's Not You, It's Them:**
   Despite how much you dazzle an LP, it may pass on your fund.

4. **Your Deal Sourcing Isn't Unique:**
   A GP needs to prove it's different (and successful) in the way it sources and lands deals.

5. **Your Bench Is Weak:**
   It may have a great team, but will a GP be able to retain everyone in the long term?

The Panelists

Mounir Guen,
CEO
MVision Private Equity Advisers



Michael Elio,
Partner
StepStone

William Chu,
Executive Director
Zurich Alternative Asset Management

"It gets very dangerous when a GP deviates from an area where the investor is comfortable. If they're a buyout investor all of a sudden doing credit, it's not the space that the investor gave that GP the money to invest in."

–Michael Elio, StepStone

1. You Stray from a Strategy Without Explanation

It's survival of the fittest in the private equity fundraising market. If a GP doesn't explain why it deviated from a stated strategy used in raising its last fund, an LP may pass and look for a better option.

"Deviation without explanation is one of the more frustrating points that all LPs face," says William Chu, executive director at Zurich Alternative Asset Management.

Chu adds that, ultimately, investors are spending time, energy, and effort to underwrite what a GP is trying to articulate as a thesis, and "the last thing we want to do is get negatively surprised, where they completely do a 180 in terms of that strategy."

When looking at opportunities that present themselves, one thing that should be looked at is how much of an equity stake a GP is taking, says Mounir Guen, CEO of MVision Private Equity Advisers. A lot of the deviation is done over simple parameters, such as the size of ticket per investment, he says. There's also a fixation on loss ratios, and investors don't want to see volatility within the portfolio.

"They want consistency of execution as opposed to taking significant bets," Guen says.

Many GPs are not clear when it comes to fund strategy, says Michael Elio, a partner at StepStone. LPs and investors really like a good story, but it needs to be a complete story ending with good performance, he says. And GPs need to state their strategy, what differentiates them, and how that impacts performance.

"It gets very dangerous when a GP deviates from an area where the investor is comfortable," says Elio. If they have a history of deviating to some extent, that's fine, he adds, but "if they're a buyout investor all of a sudden doing credit, it's not the space that the investor gave that GP the money to invest in."

Being proactive about communication with LPs is "absolutely critical," says Chu. Investors are rational and flexible, to some degree, but the LP or consultant has spent the time to underwrite particular managers and strategies.

2. You've Been a Poor Communicator

Lack of communication or transparency can be a hindrance when investors aren't getting all the information they need.

GPs often underestimate the amount of interaction they should have with investors, contacting them only a couple of times and not really communicating the risks of the investment, Guen says.

"The key message here to general partners is, ensure you have a dialogue with your investors," he says. "Double-check that the investors actually understand what you're doing with the portfolio companies."

Elio says that poor communication falls into two camps: failing to make sure current investors are up to speed on what's happening with the fund and its performance, and a lack of communication with new investors that the GP is going after during a fundraise.

"If you communicate with your investors just once, that one communication is what the LP bases their entire perception of you on," he says. "If you communicate with them 10 times, they can see a trend and get comfortable."

It's important for the LP to take the initiative to understand the portfolio the GP has built for you, Chu says. The LPs should be proactive about understanding the risks they're taking and that

"The key message here to general partners is, ensure you have a dialogue with your investors. Double-check that the investors actually understand what you're doing with the portfolio companies."

—Mounir Guen, MVision Private Equity Advisers

communication is happening.

"There's a lot to be made about the annual meeting, but it's also important to recognize those intermittent touch points," Chu says. Those GPs that aren't communicating very frequently should be aware that their competition probably is, and when fundraising time comes, the investor is likely to go with managers they've been in closer contact with.

3. It's Not You, It's Them

Just as in dating, sometimes despite a GP's impressive portfolio track record, an LP may have to pass on a fund for reasons that may have nothing to do with their potential partner.

Different LPs have different mandates and different places where they want to invest their money, says Elio, and a lot of GPs come through their door. "If an LP is not looking for that type of investment, it's just not a fit."

Even if a reputable GP presents an incredible opportunity, an LP may still reject it if they are already over-allocated to that investment type or are prioritizing another area.

Relationships with GPs have become more concentrated in recent years, which means the shots they have with GPs are limited, Guen says. And if an LP is full-up on a certain kind of investment, even if you are a GP with an excellent track record, you are going to get a pass, he adds.

Chu notes that in Canada and more recently in the U.S., an LP will be using part of the "total pie called private equity" for co-investments and secondaries. "So don't be surprised that limited partners will have to pass on some of their managers," he says. LPs also have to keep a cap on the number of relationships they have happening.

"One thing that GPs probably need to understand is allocations are changing, and the days of LPs being a primary commitment lot are gone," Elio says. "They're committing to co-investments, secondaries. They're not bucket fillers anymore."

4. Your Deal Sourcing Isn't Unique

In a competitive deal market, GPs need to up their game and show how they are able to win transactions and to prove they have a solid track record.

There is less proprietary deal flow, Chu says, "and so it gets more and more focused on how you go about winning, and then it goes to the caliber of the team that you have that was engaged in the process."

A team has to be able to "make a compelling case to show that you have historically, and continue to, generate or originate deal flow in a way that few others can," he adds.

GPs should realize that they may be focused on differentiating themselves from the pack, but LPs may not see their story as unique, says Elio. "Now you have to really get into the meat of what is the value-add that you plan to add, and how did this attract that particular management team, executive team, or owner of a small company to pick you over someone else, even though your bid may have been less?"

What is absolutely essential, in the eyes of Guen, is a GP being able to talk through their deals and be able to take apart and explain their strategy.

When it comes to a GP winning a deal, it could be because they've paid the highest price at auction and not because the LP fell in love with their operating partners. But the situation may not be that simple.

"What you buy [a company] at isn't the end of the story," Elio says. "What you do with it afterwards, and did you get out of it at a good price as well—that

> **"I would seriously encourage GPs to have all of their facts and information and be transparent. If you want to ensure that your investor is going to be a happy investor, the last thing you want to do is give them negative surprises or lead them down the wrong path when they can do their homework."**
>
> —William Chu, Zurich Alternative Asset Management

all comes in."

Price is one facet of an LP's review of a GP's history, Chu says, but understanding the mosaic of deals they've sourced is also important. "The industry has become more competitive, institutionalized, and that's a natural effect. The price does bump up over time, but is it where we stop the diligence? Absolutely not."

One key differentiator is how a GP runs itself as a business and that they're doing it well, with the right people and infrastructure, Guen says.

LPs realize they're investing in a fund and not a "great deal guy," Elio says, so that's the thing they're interested in. "They're investing in Fund 6, so they need to know that a GP can generate good returns for that fund."

5. Your Bench Is Weak

Investing in a private equity fund is a long-term commitment, and LPs need to be sure that a GP has a competent team to manage their capital through the next 10 to 15 years. In other words, they need to not have a "weak bench."

There are several inadequacies that can be found in a team, Elio says. "The team has to have the right age and depth to handle this money over a very long period of time."

The economic incentives need to filter through the organization to motivate staff and instill confidence that the team will remain in one piece, he says. Otherwise, talent may be tempted to spin out and seek greener pastures.

The days of legendary founders starting PE firms and inspiring people to give them huge amounts of capital are largely over, Guen says, replaced by institutions that are more like leveraged asset managers.

"As the funds get larger and they have larger budgets, all of a sudden they have very impressive benches," he says, "and the skill sets are all there, and they're structured. The question is, will they stay like that, or can they evolve? If they evolve, they have to institutionalize."

Chu says it's important to understand the roles and responsibilities of people who worked on a deal. "I would seriously encourage GPs to have all of their facts and information and be transparent," he says. "If you want to ensure that your investor is going to be a happy investor, the last thing you want to do is give them negative surprises or lead them down the wrong path when they can do their homework."

Sometimes a midlevel GP may sense weakness or an inequality in the partnership economics of their firm and be tempted to leave. Guen says that the "the whole point is the motivation of the compensation, because historically in the U.S., it's deal-by-deal carry."

Deal professionals like pursuing transactions, says Chu, and sometimes when a firm grows from a small buyout fund to a huge one, that thrill of the hunt is lost, and they wish to leave and start their own smaller firm.

But sometimes a partner may simply need a change despite an out-of-the park return and decide to go off and form their own firm, Guen adds.

"At the end of the day, change is good, and to let two of us go off and form our [own] firm, it doesn't mean we're not friends anymore," he says, "but it means that we want to go do something different." ◆

Privcap/ Thought Leadership for the Private Capital Markets

Series / Five Reasons Why You Won't Raise Your Next Fund

Watch the series in its entirety at Privcap.com

- Strategy Deviation Without Explanation
- Repercussions of Poor Communication
- It's Not You, It's Them
- Undifferentiated Deal Flow
- Cursed With a Weak Bench

This thought-leadership series is sponsored by MVision Private Equity Advisers.

About Privcap

Privcap Media produces and distributes high-quality digital content for participants in the global private capital and private real estate markets. Our members gain access to our firstperson thought-leadership videos, transcripts, podcasts, articles, and supporting material without the expense and hassle of traveling to industry conferences. The valuable context we provide allows investors to make better decisions and achieve greater success across private capital access classes.

To join, visit Privcap.com or PrivcapRE.com.

Contacts

Editorial
David Snow / dsnow@privcap.com
Ainslie Chandler / achandler@privcap.com
Andrea Heisinger / aheisinger@privcap.com

Sponsorships and Sales
Gill Torren / gtorren@privcap.com
Matthew Malone / mmalone@privcap.com

Privcap.com