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VIDEO SERIES

Briefing

Finding Success as an Emerging PE Manager

An executive summary of the Privcap video series "First-time Fund Formation"

David Tegeler
Proskauer

Charles Eaton
Eaton Partners

Steven Millner
Gen II Fund Services

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First-time Fund Formation

Key Findings

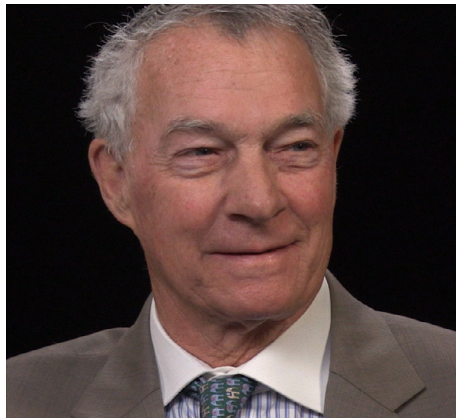
1. A crowded market requires meticulous planning and documentation
2. Don't underestimate the required investment in firm infrastructure
3. Your data room will have more data than ever
4. Having an anchor investor is recommended, but beware sticking points
5. Terms among fund founders can lead to problems down the road

The Panelists

David Tegeler
Partner, Global Co-head,
Private Investment Funds Group
Proskauer

Bio

Tegeler is a partner in the corporate department and global co-head of Proskauer's private investment funds group. He is also co-chair of the firm's business development committee and concentrates on representing private investment funds in a broad range of matters, including fund formations, buy- and sell-side secondary transactions, direct secondary transactions, restructurings, and governance issues.



Charles Eaton
Founder, Partner
Eaton Partners

Bio

Eaton founded Eaton Partners in 1983 and was a pioneer of the "placement agent" concept. Previously he was in research and institutional sales at Mitchell Hutchins, Morgan Stanley, and H.C. Wainwright & Company. He began his career as an investment research officer at Morgan Guaranty Trust Company (the predecessor to J. P. Morgan Investment Management).

Steven Millner
Managing Principal
Gen II Fund Services

Bio

Millner is a founding member of Gen II. He has more than 20 years of experience in the private equity administration business, advising private equity firms in the formation of their firms and operations. Previously he served as managing director and co-president of BISYS Private Equity Fund Services, Inc., and co-founded DML Fund Services.

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1 A CROWDED MARKET REQUIRES METICULOUS PLANNING AND DOCUMENTATION

There are hundreds of first-time private equity funds making the rounds at any given time, trying to raise money to realize an investment thesis. The success or failure of these funds wholly depends on how well the managers prepare. That includes having a well-thought-out investment strategy that clearly differentiates the fund from the myriad of others competing for the same capital.

"Have everything set up ahead of time," says Charles Eaton, a founding partner at fund placement firm Eaton Partners. "In order to be attractive, you have to have the back office, administration, legal—not your deal lawyer, a fund-formation lawyer—and a good PPM all set up. You have to understand that it's an incredibly crowded market out there, even for established funds, so a first-time fund has a real uphill battle."

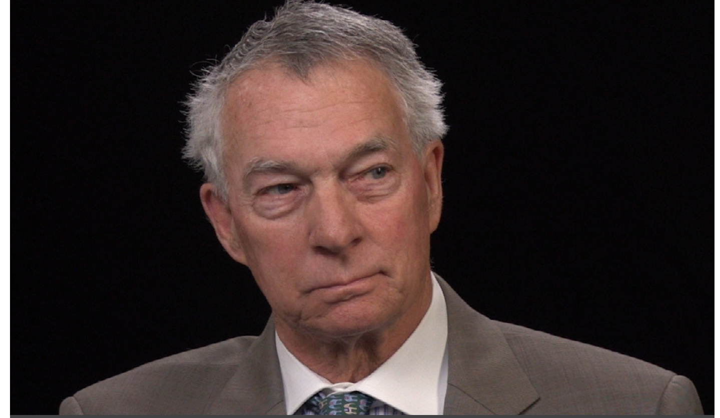
Aside from the competition, there are now several other factors that private equity firms must take into consideration when establishing a fund. David Tegeler, partner and global co-head of the private investment funds group at Proskauer, says that increased regulation over the past few years has added extra stress to an already stressful process.

"Just to establish a firm, you need to worry about compliance under Dodd-Frank," Tegeler says, referring to the Wall Street Reform and Consumer Protection Act that was signed into law in 2010. "Make sure you have your disclosure and compliance in line. Are you a registered investment advisor or an exempt reporting advisor?"

Even getting a meeting with a limited partner poses difficult challenges, with most managers needing a referral to get a foot in the door.

Gen II Fund Services Managing Principal Steven Millner says his firm has helped about 20 first-time managers raise capital in the past two years, and what he's seeing in the marketplace is an increased demand for perfection, even among newly formed firms.

"LPs are saying to managers of first-time funds that they need to have the same institutional-grade operational infrastructure in place—regulatory, personnel, systems, and reporting capabilities—as more mature funds," Millner says. "You're not getting any break at all. In fact, you're probably a little bit behind an established firm, because you also have to demonstrate that you have a cohesive team and that you're going to stick with it and go the distance.";



The "Three to Five" Rule

Charles Eaton
Eaton Partners

The most important thing emerging managers can do is to demonstrate they can work together, says Eaton Partners' Charles Eaton, and that they're in it for the long haul.

"I call it my 'three to five' rule," he says. Eaton wants to see a group of between three and five investment professionals who have worked together for approximately three to five years and who have handled $300M to $500M in assets before going out to raise their first fund. "Otherwise, institutional LPs won't put money with you, either because you're too small or you're unproven. I also want you to have 3 to 5 percent of your own capital in the deal, and would like to see three to five previous investors follow you into your new vehicle."

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The First-time Spinout

Steven Millner
Gen II Fund Services

The Volcker Rule in the Dodd-Frank Act prohibits banks from doing any kind of speculative investing that doesn't benefit their customers, and as a result, many have spun out their private equity divisions.

Gen II's Steven Millner says these types of emerging managers are unique. "They are very interesting, because they come from a big name with a substantial amount of capital behind them, and now they're entrepreneurs," he says. "Running your own business presents entirely new challenges. The emerging manager comes from an environment where they've had an internal operational support team, and now they are seeking a credible partner for that work. We've been quite helpful to these groups, enabling them to launch a business."

2 DON'T UNDERESTIMATE THE REQUIRED INVESTMENT IN FIRM INFRASTRUCTURE

Many emerging fund managers have great track records, or they likely wouldn't be venturing out on their own. However, the willingness to invest his or her own money into the fund's infrastructure could make or break the fund before raising the first dollar.

"They're going to have to put in their own money," says Tegeler. "They have to demonstrate that they understand infrastructure is as important as their investment thesis." Eaton weighs in on how much money an emerging manager should have in the bank as it sets out to raise its first fund: "I'd say $5M to $10M, but I'm not sure if that does it," he says, adding that there should be at least two years' worth of capital on hand to run the firm. "It's a tough business," says Eaton. "I tell GPs, 'This is the toughest thing you'll ever do. You've got to be prepared for the long haul. The due-diligence process gets worse and worse every year with all of the boxes you have to check.'"

Gen II's Millner says that his firm is now called in to work with funds much earlier in the process than in years past, signaling that many emerging managers are realizing that they have to invest in infrastructure in order to succeed. "In prior cycles we would get hired at the end of the process, but now we are there up front," he says, "because we can check the box on cybersecurity, document retention, ILPA requirements, business continuity and reporting." Millner says a recent Gen II survey found that where, historically, a fundraising period would last 12 to 18 months, more clients are asking for a 24-month period. "There is more of an outflow from the GP than an inflow of money into the fund during this period. GPs need to think through how they will manage this situation prior to a first close."

There is also the growing trend of fundless sponsors, where emerging managers will work together for anywhere from several months to a couple of years in order to prove their thesis and prove that they can cooperate with each other. "Then they go out, after they've done that for a few months or years, and try to raise their first-time fund," Millner adds. "And that product has an advantage in the market, because the GP has shown that they can work together. Investors have a track record they can look at. We've worked with many of these types of entrepreneurs."

3 YOUR DATA ROOM WILL HAVE MORE DATA THAN EVER

Information is power, and emerging managers should arm themselves with as much ammunition as they can carry, says Proskauer's Tegeler. "The limited partners are very sophisticated with respect to their due diligence, and they're going to expect to have a data room set up where there is specific information about deals that are mentioned in the track record, and also background information on each of the principals."

Background checks are standard operating procedure for LPs, so managers have to be prepared to answer a lot of questions about compliance, cybersecurity, insider-trading

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policies, and even personal questions about their own finances. Another thing for new firms to be aware of is that if they are coming out of other institutions, there is some limitation on what they can disclose in their PPM, and there are also SEC restrictions on what can be disclosed about a person's track record.

On the legal side, Tegeler says that sophisticated LPs will want to interview the back-office service provider that the firm has chosen. If the LP doesn't think the service provider meets their standards, they may suggest other groups they'd like to introduce to this particular GP group. "It never used to be like that," he says. "But they're depending on a strong back office, strong reporting, and strong evaluation policies. Those are all crucial in terms of their comfort with the investment."

4 HAVING AN ANCHOR INVESTOR IS RECOMMENDED, BUT BEWARE STICKING POINTS

Many emerging managers try to secure an anchor investor who will commit a significant amount of capital to a first-time fund. An anchor investor can be a public pension fund, endowment, sovereign wealth fund, or any institutional investor that, in addition to capital, has enough clout in the space to attract other investors.

"The addition of a strategic or an anchor investor provides a catalyst for the sponsor to go out and be more successful in the market," says Gen II's Millner. "But it also comes with additional responsibilities."

Those responsibilities are broad and can include the reporting and governance of the fund, plus anchor investors can weigh heavily on the fund's and firm's economics. For instance, how deep a discount on the management fee are the fund managers willing to give the anchor investor, or how much of a break on the carry are they willing to give? And then there is the issue of "follow-on" rights. "How many funds are they willing to give to this particular anchor investor?" asks Tegeler. "Most managers have a pretty good handle on this, but what is challenging is that there are upper-tier entities, like the general partner or the management company." Tegeler says part of the bargain is that the anchor investor may want to get a seat at the table in the GP entity, or a seat at the table in the management company. "Maybe they want to get equity in the management company. Maybe they want to get a seat on the

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Anchors Away

David Tegeler
Proskauer

While anchor investors are key for first-time funds to succeed, sometimes their existence can repel LPs, depending on how much power that investor was given by the general partners.

"Control by the fund managers is paramount," says Tegeler. "Often when anchor investors come into an upper-tier entity—be it the management company or the GP, in connection with their bargain for being an anchor investor—they would like to have a seat in the investment committee, a voice in management, or some sort of a vote in the future of the firm." Giving that kind of power to an anchor investor may make other potential investors wonder who is calling the shots for the fund.

investment committee as well as the advisory committee for the fund."

First-time fund managers have to be careful not to give away too much to the anchor investor, says Eaton Partners' Charles Eaton. "I've seen situations where the anchor investor has as much as 50 percent of the economics of the fund—and that's probably a tough one to overcome." Eaton says as much as 80 percent should be available for the investment team. And if too much is given away, then it becomes an issue with some LPs.

5 TERMS AMONG FUND FOUNDERS CAN LEAD TO PROBLEMS DOWN THE ROAD

A typical fund structure involves a pool of capital with no direct operations. Proskauer's Tegeler explains that investors essentially buy interests in the fund, and the fund makes investments on behalf of LPs. However, before focusing solely on raising money, managers must first create the structure for the GP and the management company. A GP has the legal power to act on behalf of the investment fund, and the management company is appointed to provide investment advice to the fund.

"We call it a hub-and-spokes model," says Tegeler, "because over time the hub, which is the management company, always stays the same. It is a limited liability entity that existed from the beginning. And the spokes are the fund and the GP entity for each of the funds that are formed over time."

Tegeler says the GP and the management company are crucial to the personality of the organization, because those are the entities that decide how the carry is split up among the principals, how investment decisions are made, and how key decisions regarding the organization are made. There are several ways to structure this. One person might make all the decisions unilaterally, three equal partners might make decisions together, or a corporate structure might call for decisions to be made by a board of directors.

Tegeler's key piece of advice to first-time fund managers is to form the management company before doing anything else. "You need a limited liability entity to sign contracts and to start operations," he says. "If you're doing it as an individual, it's very dangerous from a legal standpoint."

Gen II's Millner says LPs will want to understand exactly how the upper-tier entities are structured. GPs need to make sure that the process to calculate returns and the accurate flow of capital to the proper entities is in place. "Everybody cares about getting the right share of a return and LPs are digging in much deeper to understand the process," Millner says. "The challenge often times can be at the GP level, where allocation was negotiated in the first place. No two funds are exactly the same. Having transparency on the fund's cash flow, expenses, and calculations is front of mind with LPs today. They want to ensure it's being done with 100 percent accuracy. At Gen II we have an important role providing that clarity. It's vital for any fund seeking to raise capital today." ■

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Expert Q&A

With Steven Millner,
Managing Principal
Gen II Fund Services

How does Gen II support an emerging manager?

Millner: Emerging managers, or first-time funds, are a unique opportunity set for us—frankly, one that we really enjoy. Typically, first-time funds for us are three or four deal professionals who've come together who want to become entrepreneurs. And that's exciting, because we are entrepreneurs ourselves, and we can lend our experience to the team. We help our clients think through the ramifications of what it is going to take to launch the fund successfully. We have a boot camp for first-time funds where we usually allocate an hour to go through terms and how the fund's going to be managed.

Importantly, we are able to provide a first-time fund with the ability to check the box as it relates to operating due diligence. LPs are looking at a first-time fund no differently than they look at an established fund. And they expect to see certain institutional processes.

What do emerging managers learn from this boot camp format?

Millner: The boot camp evolved serendipitously, and we learned that it had success. What we find is that the principals of the firm know how to generate deal flow and invest capital, but they really haven't been involved in how to run the business of the business. For example, there are certain investors that are very sensitive to maximizing the IRR, and there are techniques used—legitimate techniques—to help GPs enhance the IRR for LPs. And we have a conversation about what that means and how to implement a program.

How do you help first-time managers think about running their business?

Millner: What we've learned is, while the managers are oftentimes focused on the returns that they'll generate for their LPs, they also need to be thinking about the business of their business.

And that can go from how the carry gets split, how management fees are structured, tax planning, personal planning, the whole gamut. And they need to also think about future-proofing their business, because these funds have a 10-to-15-year life. Things change, and the GP should be thinking about a dynamic to effect change. Often we find that new sponsors really haven't thought about that aspect of the business. And so by dialogue and by engaging, we bring our experience of 25 years to the table to ask provocative questions. ■

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