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- Data from Preqin
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First-Time Funds

Veteran LPs discuss their appetites for emerging private equity fund managers

With Expert Insights from:

Allianz Capital Partners
Abbott Capital
Caspian Private Equity
Cliffwater LLC

Beginner's Skill

Many first-time funds of today will be the megafunds of tomorrow. That being said, in most cases it would be better to be in a future titan's first-time fund than in Fund VII, statistically speaking.

According to Preqin data (p.5), first-time funds have tended to outperform non-first-time funds in almost every vintage year, on average. There could be many reasons for this. First-time funds tend to have a lower target size than follow-on funds and benefit from the inefficiencies that characterize a smaller market. They tend to be managed by hungry, highly motivated GP teams. And once a successful team moves to a larger fund, it must typically do deals in a more efficient, larger market.

However, it is very difficult to identify a first-time group that is going to succeed. Forget about turning in a good fund performance—it's hard to tell who is even going to make it to a first close, as capital available for so-called emerging managers is limited.

This report is intended to offer a collection of views and information on the subject of first-time fund; since the future of this asset class so clearly will be determined by the emerging managers of today; since so many talented investors dream of leaving an established firm and hanging their own shingle; and since so many LPs want to back the right emerging managers but recognize the difficulty they face in due diligence.

Enjoy the report,

David Snow
CEO & Co-founder,
Privcap
@SnowsNotes

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Happy Together

Allianz Capital's managing director and head of U.S. fund investment, Susanne Forsingdal, explains why first-time managers who have worked together are easier to back

Susanne Forsingdal
Allianz Capital Partners

Allianz Capital Partners
HQ: Munich, Germany
Founded: 1998
Private equity AUM: $14B

"You have to be part of the network and all the receptions where there is gossip about managers."

– Susanne Forsingdal, Allianz Capital Partners

"**The basics of working** with a first-time manager are the same as when we look at managers that have been in place for a while. It really comes down to the trust and the faith in the comfort that this manager will be able to build a strong program.

The reason why you would back a spin-out manager is because typically they would have some track record from the past. What we prefer is the managers are members of a team that has worked together in the past. That makes it easier. It's definitely more difficult if people are coming from all kinds of different experiences or backgrounds.

What has worked for Allianz [in identifying such managers] is to have an office on the ground—that is very important. You have to be there, not on a visit once or twice a year. You have to be part of the network and all the receptions where there is gossip about managers, and you get all the kinds of information that you don't get in a very polished presentation, in a presentation that lasts for an hour and you only get the highlights." ■

This article is excerpted from a broader interview with Forsingdal that appears on Privcap.com.

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The Wide Range of Emerging Managers

Abbott Capital president Jonathan Roth is open to backing emerging managers, and to cutting off established managers who disappoint

Jonathan Roth
Abbott Capital

Abbott Capital
HQ: New York
Founded: 1986
Private equity AUM: $7B

"**There's a wide, wide range** when you speak about emerging managers. We can look at a lot of emerging managers who never had the benefit of managing institutional capital, but had the benefit of a balance sheet from an insurance company or from a bank. They were able to create a track record of making principal investments as a group, and executing a strategy that they want to replicate going forward.

There are a lot of great stories of teams leaving that balance sheet, or source of capital, and spinning out: Welsh Carson spinning out of Citibank; Madison Dearborn spinning out of First Chicago; Golder Thoma spinning out of First Chicago. So a lot of banks have been ... have been sources for this trend, as have insurance companies.

We had the fortune of identifying [middle-market private equity firm] The Jordan Company. [Founder] Jay Jordan had been around forever, but never really raised an institutional fund. In 2002, he raised his first institutional fund, and we invested in it. You might say that's not really an emerging manager, but quite frankly today they're on their third fund. They've raised $3.5B, and they're a serious player managing institutional capital. There are all shapes and sizes of emerging managers, and we consider all of them.

There's been an amazing development of information and data collection. Getting information about people, organizations, investments strategies, is a lot easier today than it was in the 1980s. We consider all managers of tenure, and when you're looking at experienced managers, what you should see from a cycle-tested managers is discipline. In the wake of the Great Recession, we didn't see that discipline necessarily applied by the best and experienced managers, and that's where we would begin to make changes in our manager base going forward. We felt that we had expected better discipline, and it wasn't applied.

> **"We're all about finding the next manager, while also supporting the ones who are worthy and established."**
>
> –Jonathan Roth, Abbott Capital

We're all about finding the next manager, while also supporting the ones who are worthy and established, but carefully pulling back from the ones who we don't see having that productive future going forward." ■

This excerpt is from a broader interview with Roth. Click here to view on Privcap.com.

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By the Numbers

First-time fund statistics, according to Preqin

Bursting Out of the Gate

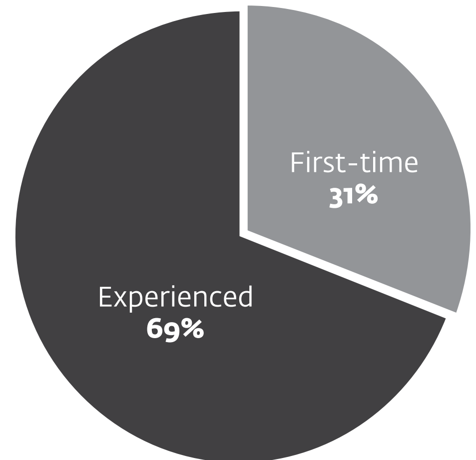
First-time funds tend to perform well—when they actually get raised

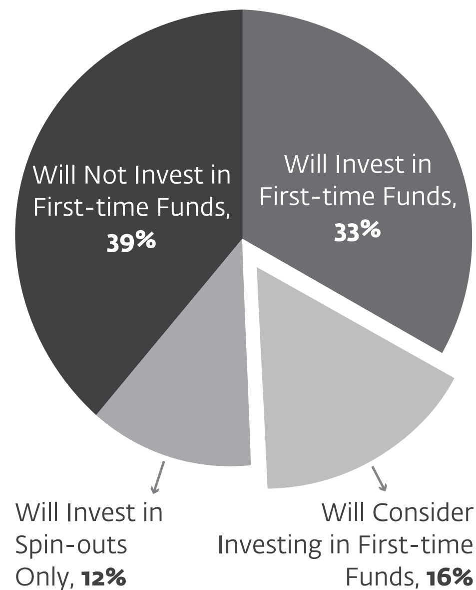
Vintage Year	Median Net IRR: First-time Funds	Median Net IRR: Non-first-time Funds
2000	11.0	8.1
2001	14.2	10.8
2002	16.9	10.8
2003	14.3	9.1
2004	6.9	8.1
2005	8.2	7.6
2006	8.0	7.9
2007	10.0	9.5
2008	11.8	11.1
2009	21.9	13.3
2010	17.7	13.3
2011	19.3	11.9
2012	23.8	11.8

Preqin is the leading source of information for the private equity industry. Over the past 12 years we have helped thousands of clients raise billions of dollars, providing actionable and intelligent data on over 6,000 investors in private equity, including 2,400 that consider investing in first-time funds. To find out how Preqin can help you, please visit www.preqin.com.

First-time Funds Flood the Market

There are more than 1,700 private equity funds currently being raised, and 31 percent of them are classified as first-time funds





LPs are Open to First-timers

When Preqin asked 2,598 LPs their attitudes and policies about first-time funds, the results showed an investor population open to emerging managers

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Track Records Matter

Sheryl Schwartz, managing director, investments, at Caspian Private Equity explains why the firm recently backed a first-time fund with managers who had a track record in the healthcare sector

Sheryl Schwartz
Caspian Private Equity

Caspian Private Equity
HQ: New York
Founded: 2008
Private equity AUM: $2.3B

"Just because you're newly formed doesn't mean you haven't been cycle-tested.

In fact, a lot of the newly formed funds are [from] people who are spinning out of other groups. They have worked together before, and they were sector-focused, so they definitely have a track record in that sector.

"A lot of the newly formed funds are [from] people who are spinning out of other groups. They had worked together before, and they were sector-focused, so they definitely have a track record in that sector."

–Sheryl Schwartz,
Caspian Private Equity

We ask these managers: What did they do in the last down cycle? How much leverage are they putting on the companies? Are they structuring the companies to be able to withstand an increase in interest rates and a down economy at the same time, which will probably happen over the next five years? How much are they paying for companies? What kind of exit multiples are they assuming based on what they're paying? What's the strategy?

We recently made a commitment to a first-time fund that was a spinout from a larger firm. It was a healthcare fund and one of [the managers] was was a doctor so they definitely had experience in the medical field. But it took us much, much longer to do due diligence because they were new, but I wouldn't say that they didn't have experience in a prior cycle or that they didn't have experience in different economic environments. They had everything that I look for in a manager, but just proving it took a lot longer. It just means you have to really verify their track record and spend significantly more time in underwriting. But we do a lot of younger, emerging managers, that's not unusual for us." ■

This excerpt is from a broader interview with Schwartz. Click here to view on Privcap.com.

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Sometimes Smaller Is Better

Many LPs would rather swim in a smaller pool with first-time managers, says Cliffwater LLC senior managing director Peter Keliuotis

"There's a lot of attention on trying to identify firms that are going to have an initial growth trajectory and success."

–Peter Keliuotis, Cliffwater

Peter Keliuotis
Cliffwater

Cliffwater LLC
HQ: Marina Del Ray, CA
Founded: 2004

"There's room for us to be interested in a first-time fund manager, as long as they've brought with them to the new firm the pedigree and the successful track record that they've been able to demonstrate at prior firms.

We've seen a few relatively new firms that have really grown rapidly in the past few years.

Especially among the endowment foundation community, we see a lot of attention to first-time funds because they're typically trying to focus on smaller GPs. There's a lot of attention on trying to identify firms that are going to have an initial growth trajectory and success.

There are some investors out there who say that once the manager gets to a certain level of assets—maybe it's $1B, whatever the number might be—we're no longer typically interested in investing. They really try to focus on the smaller market or smaller firm side of private equity. So there's definitely room for newer GPs and for first- time funds, as long as we are comfortable that the experience and the success that they've had in the past is something that they can bring to the new organization." ■

This excerpt is from a broader interview with Keliuotis. Click here to view on Privcap.com.

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Marketing a First-time Fund

Emerging managers face high hurdles in branding, securing an anchor investor, and establishing a robust back office, say three fund-formation experts

Charles Eaton
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).

David Tegeler
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.

Steven Millner
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. Previously he served as managing director and co-president of BISYS Private Equity Fund Services, Inc.

➜ CONTINUES ON NEXT PAGE

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Gen II's Millner, Eaton Partners' Eaton; Proskauer's Tegeler, Privcap's Snow

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?"

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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.

"In a nutshell, the LPs are saying to managers of first-time funds that they need to have the same stuff 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, 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."

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 estimates that on top of fund formation expenses, which can run between $5M and $10M, emerging managers need to have 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.
"It used to be 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, or business continuity on 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 than an inflow of money during this period."

There is also a 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 they've shown that they can work together. People have a track record they can look at."

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 polices, 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

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terms of their comfort with the investment."

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

Emerging managers should 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, but anchor investors can weigh heavily on the economic side of the fund. 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 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 and should make sure that the calculation of returns and the accurate flow of capital to the proper entities are in place. "Everybody cares about getting the right share of a return," Millner says. "The challenge oftentimes can be at the GP level, where allocation was negotiated in the first place. No two GPs are the same. The complications really come at the split between GP and LP. The market standard is 20 percent carry, but then where do those carry points go?" ■

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