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The Art of the Spinout

What fund managers should know before going out on their own

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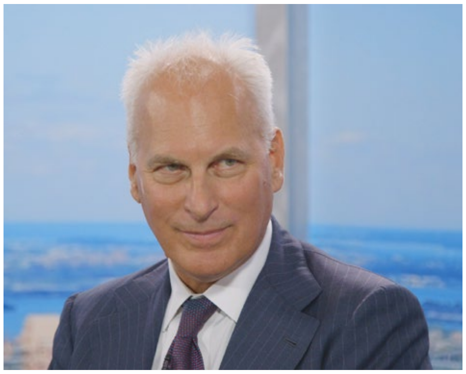
The Art of the Spinout

Key Takeaways

1. Spinouts are much easier said than done
2. Team and theme are essential elements for spinouts
3. GPs who spin out new firms often underestimate the commitment
4. New firms must go the extra mile to impress investors
5. Investors know the warning signs—you should, too

The Experts



David Conrod
Chief Executive,
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Kathryn Stokel
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Michael Elio
Partner,
StepStone

1. Spinouts are much easier said than done

So many partners today want to spin out their own firms, but few appreciate the steep incline. Being a virtuoso investor is only a small part of the race.

“Especially at this time in the market, it’s a very common desire to spin out and be your own lead GP,” said Michael Elio of StepStone. “But these guys need to realize that there’s a lot more to it than just being a good investor. There’s a huge infrastructure required just to run a firm and a laundry list of other items that they should consider before they make the leap.”

“When you’re spinning out, you’re asking LPs to invest in a blind pool of partners that hasn’t even been formed yet,” said Kathryn Stokel of Abbott Capital. “That’s a double whammy. So you really need to think through what you’re offering, what your value proposition is to potential investors, and how you can minimize the risk you’re asking them to take on.”

Smart GPs proactively reassure investors. One strategy is to demonstrate proof of concept with a solid success. “What accelerates fundraising for a new fund is to have a deal, something you’ve closed on,” said David Conrod of FocusPoint Private Capital Group. “Either you’ve bootstrapped it or you’ve rounded up some money to get the deal completed. This may save you six months of fundraising because experienced investors will say, ‘Sounds great, why don’t you come back and see me when you’ve completed a deal?’”

Conrod mentioned a GP he knows, who spun out from a well-respected firm and spent three to four years bootstrapping eight deals on his own and generating high financial returns. Two very large endowments signed on, based on that success.

Make LPs Feel Special
Michael Elio
StepStone

One way for emerging managers to attract LPs is to make them feel like privileged partners in the fund. And a good way to do that is by offering co-investment rights. This allows the LP to make direct investments in portfolio companies alongside the GP. A number of investors also like to use the co-investment process to perform due diligence on a fund because these transactions can clearly reveal the GP’s dealmaking ability.

“In a world of growing fund sizes, LPs are looking to be more important in their remaining relationships,” Elio said. “If you can rise to that level, those LPs will embrace you and follow, because they may be looking for co-investment opportunities or some other preferential treatment.”

Another way for GPs to make investors feel special is to give them a higher percentage of the overall fund. “If an LP has $100 million in a billion-dollar fund, they’re more important than if they have $100 million in a $23 billion fund,” Elio said.

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2. Team and theme are essential elements for spinouts

New firms need to spend quality time on two assets critical to attracting investors: team and theme.

Specifically, LPs are searching for PE firms with a clearly differentiated strategy. They want to invest in partners who are intimately familiar with a particular industry, can uncover superior opportunities, and can generate proprietary deal flow. "LPs such as endowments and family offices have a large portfolio and they're always thinking; What's additive to my portfolio?" said Conrod. "They want a strategy that's very focused, as well as a team that's been in that space for a long time and has a superior track record of delivering high financial returns in that sector."

It can't be overemphasized—a team must have direct experience in the targeted sector. The last things LPs want is a new fund in which the partners are doing something they've never done before.

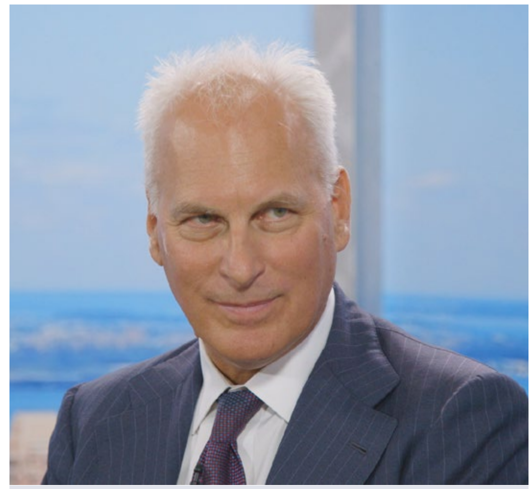
3. GPs who spin out new firms often underestimate the commitment

Partners who have spent years in a large firm often don't appreciate the expense required to keep the firm running smoothly day-to-day. "And not just the expense but also, the time," Stokel said. "The time and commitment it takes to hire someone, the time and commitment it takes to think through your marketing materials or your sourcing platform can be very significant."

Top-gun GPs don't have to bother with tasks like these at an established firm, so if they go their own way they must be sure they're up to the task or hire someone who is. "The administrative piece of running a firm is something that two smart guys from Goldman, who spin out to start their own firm, will underestimate," Elio said. "But if they surround themselves with the right people, they can bring on the marketing, the compliance, the administrative, and the CFO to make it work."

There is also the sheer patience and perseverance of raising a fund. The work is more involved than it was prior to the financial crisis. "The number of meetings required to get funded is probably twice what it was," Conrod said. "Yes, things are more efficient with these online data rooms. It's easier to monitor who's doing the work and when but despite that, the competitive intensity is greater than it's ever been."

"In the old days, people just wanted an investment schedule," Stokel added. "Now they want to know operating projections for each of your underlying portfolio companies."



Distinguish Yourself with Deal Sourcing
David Conrod
FocusPoint Private Capital Group

How can first-time fund managers rise above established competitors in the market? One way is to uncover superior opportunities in a specific sector and effectively build relationships in that market.

"If you have deep knowledge and you understand a sector, then you can quickly figure out who are the top 10 companies that you want to get to know," Conrod said. "Then you can really be much more focused about establishing relationships with those targets and hopefully even buy one."

The good news is that emerging managers don't need an army of associates to help source deals today. "There's a lot less cold-calling involved when you're going in and sourcing deals," said Conrod. "Sourcing now can be much more targeted by using technology. Any company that's worth investing in is on the web. You can find a lot of information about that company."

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4. New firms must go the extra mile to impress investors

Getting in the door is the first step. Once in, a GP with a spinout firm must keep in mind that the investor already has well-established relationships. So the newly independent fund manager must not only look attractive, he must look better than the guy that the investor is already with.

"You've gotta kick someone out of their seat, which is much harder," Stokel said. "Investors don't want to have 100 managers anymore, they want to have 20 or 30. And if they already have 20 or 30, then they're still in that dilemma of 'Geez, do I want to start a new relationship, add to the number, or kick someone out to keep my number the same?'"

5. Investors know the warning signs—you should, too

Most LPs have been around the block. They recognize the signs when a team is working well together. "You'll see a consistent track record through up and down markets that's defendable, and you'll see that the partners who are responsible for that track record are still at the firm," Conrod said. "Those are obvious signs that jump out."

Then there are those signs that say stop. "When people come into our office and there's one person who just dominates the conversation, who does 90 percent of the talking, that's a classic sign that something is not working," Stokel said.

GPs should keep in mind that when an investor sits down across the table and asks questions, she already knows the answers because they're in that 300-page due diligence questionnaire, or they should be. It's how the answers are delivered that counts.

"That's incredibly revealing," Elio said. "I remember one due diligence on-site last year. There was one dominant person in the room and there was an obviously midlevel person who had his one slide to present, and I'll tell you, he was sweating bullets. He got to his slide and the dominant person looked at him like, 'If you mess this up, you are dead to me.' Quite frankly, that says a lot about team dynamic." ■

Know Your Limits
Kathryn Stokel
Abbott Capital

Some emerging managers have a tendency to get greedy. They come out guns ablaze and try to raise massive new funds.

"I've seen groups that come out and they want to raise 2.5 billion dollars on the first shot because that's what they feel they need to execute their strategy," Stokel said. "But if they had come out with maybe $500 million or $750 million and then two years later came back for more, I think they would've had an easier shot at it."

Another mistake emerging managers make is boasting about proprietary deal flow—when they don't have it. "We'll ask the CEO, 'Who else looked at the deal?'" she said. "You'd be surprised how many times I was told by GPs that it's proprietary, and then the CEO says, 'Oh, we talked to these five PE firms.' It will get checked, so make sure you're not stretching the truth."

About **FocusPoint**

Chief Executive David Conrod explains

We raise capital for small and mid-cap funds. The strategies range from early stage and growth, to buyout. Lately, we've had success with a variety of credit strategies ranging from film/TV royalties, real estate, lease backs, and asset-backed lending.

Our team has been working together for almost 20 years. We've been very successful raising everything from first-time funds to funds V and VI. We know our markets. Increasingly, investors are looking for highly specialized and focused strategies. We have a good understanding of the market and the investors looking to allocate capital to those strategies at any given time. ■

David Conrod
Chief Executive,
FocusPoint Private Capital Group

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The Art of the Spinout

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