Privcap/ Report

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Countdown to Your Next Fundraise

An executive summary of the Privcap thought-leadership series on private capital formation

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Countdown to Your Next Fundraise

Key Takeaways

1. Always be fundraising
2. Differentiate or fail
3. Star GPs may fade in the future
4. First-time funds present challenges for GPs
5. First-time funds present opportunity for LPs

The Experts

Terrence Mullen
Co-Managing Partner
& Co-Chief Investment Officer,
Arsenal Capital Partners

Rudy Scarpa
Partner,
Pantheon

David Conrod
CEO,
FocusPoint Private Capital Group

1. Always be fundraising

Fundraising has no off-season. Rudy Scarpa, a partner at Pantheon Ventures, advises GPs to spend quality time with investors—even when they're not fundraising. "It's actually better to visit with a limited partner when your hand is not out asking for capital," he says. "Give them an update on what's going on in the fund. That goes a long way to building the relationship and laying the groundwork."

Establishing and maintaining these touchpoints makes all the difference for a GP. "Be continuously in the market, build relationships, build partnerships," advises Terrence Mullen, co-managing partner at Arsenal Capital Partners. So go on the road and meet investors, even if you're not officially raising a fund at the moment.

David Conrod, CEO of FocusPoint, believes that taking a proactive approach to fundraising is especially important for groups entering the market for the first time with new or differentiated strategies. "There is a period of education that you have to go through," he says. "You have to be thoughtful in how you deliver it to the right candidate, and it's going to take a longer period of time, so it does make a lot of sense to get out early and develop relationships and start the dialogue sooner rather than later."

2. Differentiate or fail

The market grows more crowded by the year, which means that, when fundraising, it's more important than ever for GPs to stand out. They must craft a truly differentiated story, bolstered by a long list of references—because prospective LPs will want to speak with everyone on that list.

This level of detail is critical to demonstrating a differentiated strategy. "When we raised our last fund, most of the investors with whom we were speaking had known us a long time," Mullen says. "But the level of diligence and thoroughness they asked was higher than ever. They wanted to see the model, the team, the depth of the organization, the specific industry strategy we were pursuing, the portfolio companies, and the value-add—and how all of those would string together in a system."

A lot of institutional investors these days are rationalizing their private equity relationships. Large pension plans are culling relationships and investing with fewer groups. The result is what Scarpa calls "a bifurcated private equity fundraising market, where you have the Apollos of the world raising huge amounts in a very short period of time and then other groups that are struggling to get attention from those investors who are reducing their relationships to a more concentrated core."

LPs Go Rogue
Rudy Scarpa
Pantheon

A feature of any due diligence effort is the tried-and-true reference call. GPs typically provide a long list of people who will sing their praises. Good LPs will dutifully call each and every one on the list before making an investment. Great LPs will go rogue and also call people who aren't on the list.

Scarpa said his firm does plenty of reference calls when it's looking at a new general partner. And it doesn't limit calls to folks on the reference list, for good reason. "It shouldn't be shocking, but oftentimes only good references are on the list. It's the off-list reference calls that are really the important ones. Those are the ones where you'll talk to a CEO or a former partner at the private equity firm and you'll learn a lot more. And sometimes they won't comment on an issue or just refuse to even have a conversation with you. That's a huge red flag, and that's where I think you pick up a lot about a GP."

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To get attention, a GP must be additive, not duplicative. This means deep sector expertise and the documentation to prove it. "We do a lot of reference calls—in some cases we'll make a minimum of 40 reference calls on a prospective management team, speaking to as many CEOs as we can or intermediaries," Conrod says. "That's where you pick up a lot of information about the value-add, the specialization, the knowledge, and the deep sector expertise of these management teams. We learn a lot through those calls that we can weave into the story. That's been successful for us."

3. Star GPs may fade in the future

It's a universal truth: Times change, and we must change with them. And yet it eludes many GPs, even those at the top. "Firms that have been in the market a long time—fund three, four, five, six, some of them 10—not all of them appreciate that what got them here ain't going to get them there, meaning their points of differentiation, their true value-add in a very crowded market," Mullen says.

Investors don't so much want to know what you did yesterday as what you can do tomorrow, particularly when the forecast is for heavy weather. "There's definitely going to be some down cycle in the next five years," Mullen adds. "So it's a question of who can actually succeed in tougher markets. It's not always the firms that are 20 or 30 years old."

Firms that don't evolve will go the way of the dinosaur—and some of these will be household names. "We really have three categories: rising stars, established stars, and fading stars," Conrod says. "The markets move quickly and will take out some well-known brand names that may not have stayed as focused as they should have."

A firm must examine itself every year and ask what it can do better. How does it ensure that its strategy offers an advantage in a crowded field? How can it improve its team and execution to continually raise the bar? "We've done that every year for 18 years," Mullen says. "It's a two-month process for us, both at the firm level and in each of our industrial and healthcare strategies."

4. First-time funds present challenges for GPs

A GP raising a first-time fund must be aware of the commitment required—all the challenges, from the concrete to the creative. They have to hire staff, find office space, set up an IT system. And they have to establish core values, develop a consistent culture, and put together a management team.

Hone Your Message
Terrence Mullen
Arsenal Capital Partners

One of the biggest shifts in private equity over the past several years is rising expectations among LPs. "The bigger organizations in private equity have continued to raise the bar on institutional standards, and LPs have become accustomed to that," said Mullen. "So now they actually expect it from midsize and smaller managers too."

He said the onus is now on these smaller players to be as savvy and sophisticated as their larger counterparts—and to prove it. "You have to get your house in order and distill all your information down to a crisp message, which is the hard part. How did you grow organically? What were the multiples? How did you improve margins? Why did you make the moves you did? You have to get all those things organized before you even begin your marketing."

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"I get a lot of calls from people looking to start first-time funds, and my response is, think hard about this, because it's going to take you twice as long and cost you twice as much as you think," Mullen says. "But also remember that there are over 5,000 private asset firms in the world today, and they all came from somewhere, so many, many people have gone through this process."

Of course, it's more difficult now than it used to be. "It's such a crowded market that you have to have some differentiated strategy just to cut through all the noise," Scarpa says. "You may have to get creative for a short period of time. If you can't get LPs to commit to a blind-pool fund, there's nothing wrong with, for example, doing a pledge fund, a deal-by-deal. That's a great way to start generating relationships with LPs, then prove the concept, prove you can execute on a strategy that's differentiated."

5. First-time funds present opportunity for LPs

A lot of LPs tell new firms, "We won't invest in funds one through three, but if you do well, we'll come back and invest in fund four." There is an effective response to such an approach, Mullen points out. "Yeah, but there may not be capacity available, and you may be missing out on some very high financial returns over a long period of time."

LPs that support a GP in a first-time fund will likely be invited to future funds if the GP does well. "We're grateful to the people who put us in business, who co-invested with us, and we sincerely appreciate those relationships," Conrod says. "They backed us early on, and so they were able to scale with us as we've grown."

By fund three or four, it could be too late to join the party. Successful GPs often don't have the capacity to add new investors. There are existing investors who want to increase their allocation, and GPs tend to be loyal to them because they stepped up when they were most needed.

"For LPs out there that are interested in a particular manager, they might have to be a little bit less comfortable and invest in a fund earlier than they normally would to get that slot," Scarpa says, "because they're not going to be able to scale up with that GP over time if they don't get in early." ■

Patience Is Rewarded
David Conrod
FocusPoint Private Capital Group

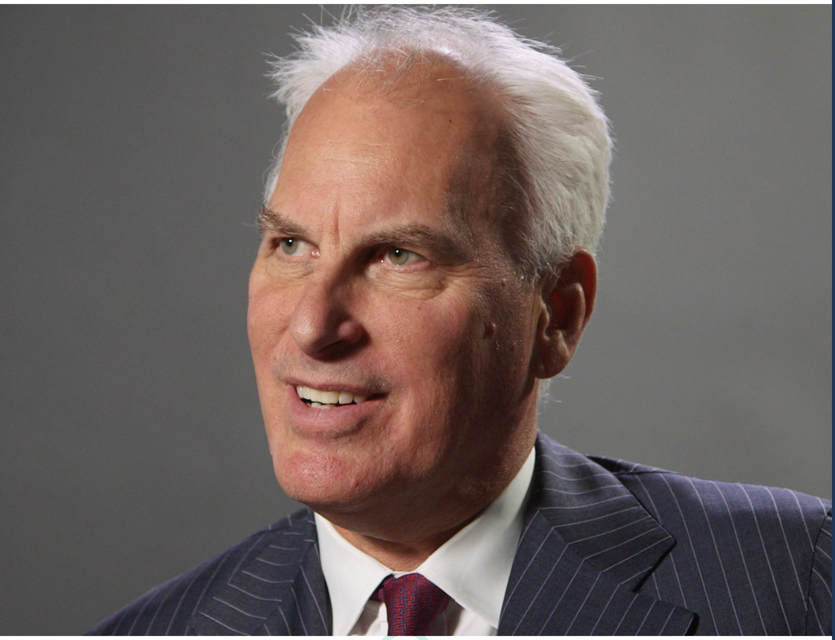
GPs who think they can snap their fingers and quickly raise their next fund are usually disappointed. Raising a fund in less than a year? "That's ambitious," said Conrod. "You'll be humbled very quickly."

He uses two words to describe the fundraising process these days: patience and perseverance. And that applies to even seasoned GPs who are on fund four or five. "It's never easy," he said. "You have to be methodical and thoughtful and never quit."

He added that LPs increasingly want to spend time meeting and vetting your deal team. "They'll want to know if these are the right people, who can attract management and entrepreneurial talent. If LPs are going to commit capital for a long period of time, they want to make sure that the team is going to be with them. That's what they're sizing up."

Expert Q&A: David Conrod

FocusPoint Private Capital Group



David Conrod
CEO,
FocusPoint Private Capital Group

Privcap: What do managers about to embark on a fundraise with FocusPoint need to understand?

David Conrod, FocusPoint Private Capital Group: We're hired by a general partner that has one objective: to get funded. And to get funded as soon as they possibly can with the highest-quality investors that there are. That's what we have to be thinking about all the time. For different types of strategies, there are different types of investors. And that may have something to do with the size of the fund, the strategy of the fund, or the roman numeral on the fund.

What are the strengths of the FocusPoint team?

Conrod: What separates us from other providers is the fact that a lot of us have been doing this for a long period of time. The core team has been working together since the early 2000s. The core of our team worked together at an investment firm that was a startup that grew to over $250 billion in assets. We were the distribution team at that firm prior to becoming FocusPoint. We understand our markets and have come into contact with many different investment strategies that certainly benefit us now as we assess a new management team. We also have tremendous pattern recognition, because we've seen thousands and thousands of managers. As a result, we have a pulse on all the differentiated strategies in the marketplace.

How can your team help a GP target the right LPs?

Conrod: We have a distribution team that covers the entire LP landscape, from the large sovereign wealth funds down to a newly formed family office. We have a very experienced team that knows the markets and knows the investors. And we're constantly meeting with new investors and taking their temperature on what types of strategies they're looking for. Our goal is always the same: to match the right LPs with the right GPs, and to shorten the time frame from the initial closing to final close.

What advice would you give a GP about to hit the fundraising trail?

Conrod: The manager has to want to win and to be successful. That has to be their highest priority, period. They have to understand that they're in it for the long term and that it's going to take patience and perseverance. They're building long-term relationships, so they cannot be flippant in how they interact with prospective investors—whether they're high-quality names that you read about or new names that may not be terribly obvious from day one. ■

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