How Important is the First Close?

With attracting investor capital remaning a challenge, Louise Weller analyzes the importance of the first close in the fundraising process. We take a look at whether fund managers are now taking longer to reach a first close and if less capital is being secured, and how this can impact future fundraising success.

The first close is often viewed as a significant milestone in the private equity fundraising process. Firstly, it demonstrates a fund manager has attracted sufficient capital for investment from investors and secondly, the fund is able to put the investor capital it has secured to work and can begin making investments in suitable opportunities. It is therefore interesting to look at the role of the first close in the fundraising process, and whether this is of increasing importance in today's challenging economic climate.

Time Taken to Reach a First Close

Seventy-one percent of private equity funds that held a final close in 2007 held a first close within six months of the start of their fundraising process, as Fig. 1 displays; however, this figure dropped to 61% for funds closed in 2012.

On average, funds that held a final close in 2007 took five months to reach a first close, whereas this increased to eight months for funds that held a final close in 2012, demonstrating fund managers are finding it increasingly difficult to attract investor capital and are having to spend longer in market before reaching a first close.

Proportion of Target Raised by First Close

On average, private equity funds are taking longer to reach a first close, but the proportion of capital secured by the first close has not increased to compensate for this. As can be seen from Fig. 2, a fifth of funds that held a final close in 2006 secured between 76% and 100% of their target size by the first close, while a further 11% exceeded their target. However, fewer funds have achieved this feat since, with just 12% of funds that held a final close in 2012 securing more than three-quarters of their target by the first close. This figure dropped to just 6% for funds closed so far in 2013.

Furthermore, the proportion of funds securing a quarter or less of their target capital by the time they held a first close has increased each year, from 11% of funds closed in 2009, to almost a quarter (23%) of funds closed in 2012. This demonstrates that many fund managers are finding it increasingly difficult to attract LP capital before an initial close.

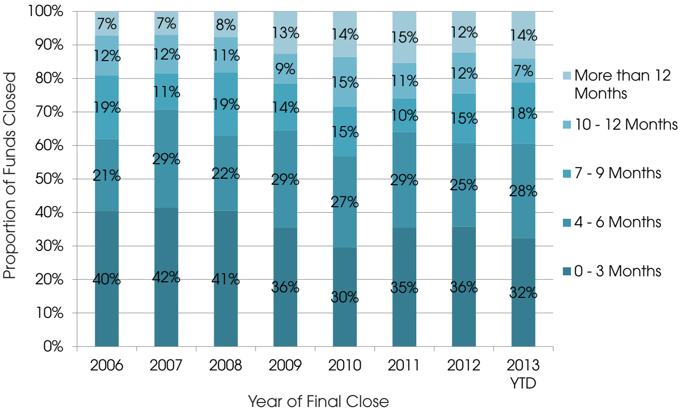
Benefits of Investing Before a First Close

Investing in a fund before it has held a first close and made any investments can be advantageous to investors for a number of reasons. As Fig. 3 shows, 41% of LPs we spoke to in December 2012 for Preqin's Investor Outlook: Private Equity, H1 2013 actively invest in funds before a first close has been held.

Many investors told us the main reason they look to invest in a fund before a first close is because fund managers will often offer more favourable fund terms and conditions, such as a reduction in management fees or co-investment rights in order to gain investor support early on. Furthermore, one Malaysian government agency told us: "It is beneficial to be a cornerstone investor and commit capital before the first close, as you can often negotiate board representation."

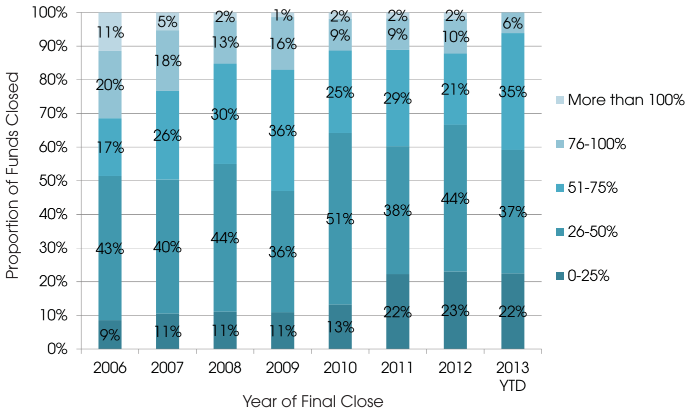
Funds offering incentives to investors that commit capital before the first close is now increasingly common. Permira V, for example, offered a 5% reduction on its annual management fee for first-close investors, while CVC European Equity Partners VI offers no fees on 5% of fund commitments to LPs that commit before the first close. Furthermore, Tasman Capital Partners allows first-close investors a pro-rata 40% share of carry, a discount of 50 basis points on the management fee and preferential co-investment rights.

Fig. 1: Time Taken to Reach a First Close by Year of Final Close, 2006 - 2013 YTD (As at 9 May 2013)



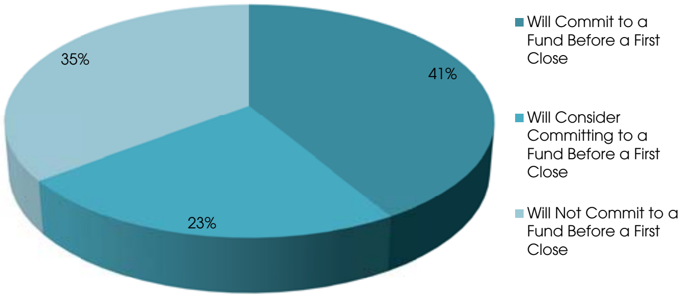
Source: Preqin Funds in Market

Fig. 2: Proportion of Target Raised by First Close by Year of Final Close, 2006 - 2013 YTD (As at 9 May 2013)



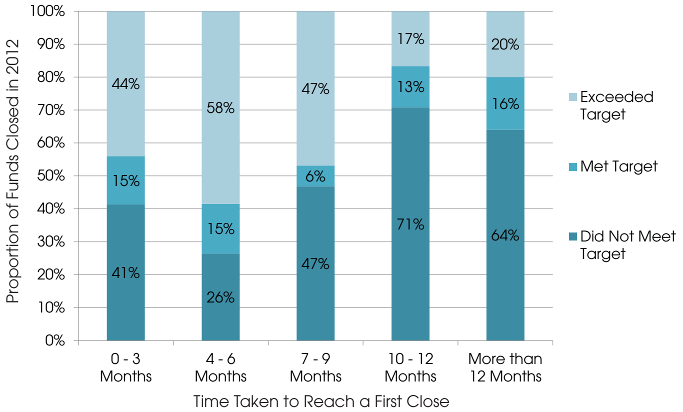
Source: Preqin Funds in Market

Fig. 3: Proportion of Investors that Will Commit to a Fund Before a First Close



Source: Preqin Investor Outlook: Private Equity, H1 2013

Fig. 4: Proportion of Private Equity Funds Closed in 2012 that Did Not Meet, Met or Exceeded Target Size by Time Taken to Reach a First Close



Source: Preqin Funds in Market

Investing before a first close can also help to build trust between GPs and LPs, enabling closer relationships to be formed over a period of time. In addition, certain LPs also view investing before the first close as beneficial, as it can generate further interest in the fund if investors see that notable LPs have already made a commitment. This in turn helps the fund to grow and move closer towards its target.

Investors that Consider Investing Before a First Close

Almost a quarter (23%) of investors we spoke to told us they consider investing in funds before a first close has been held, but often there are restraints that affect their willingness or ability to do so.

A number of investors told us they will only consider investing in a fund before the first close if they have a prior relationship with the GP or if they are a top-tier manager with a proven track record. Although in general LPs are becoming more selective with which fund managers they choose to re-up with, many feel more confident investing in a fund before a first close with existing managers in their portfolio, as they are more familiar with their investment strategy and ability to reach a final close.

Some LPs cited timing as a hindrance to investing in a fund before an initial close, particularly with extensive due diligence processes that require board approval. One US-based public pension fund told us: “We will consider but rarely ever make a first close due to the various parts involved in our due diligence process.”

To overcome this problem, some LPs have reviewed their investment policy in an effort to be able to commit to funds before a first close in order to take advantage of the associated benefits. Nebraska Investment Council, for example, approved a policy in Q3 2012 which allows investment staff to re-up with specific fund managers without having to obtain board approval, enabling the public pension fund to commit to certain funds before a first close if favourable terms and conditions can be secured.

Investors that Will Not Invest Before a First Close

It is important to recognize, however, that over a third (36%) of LPs do not consider investing before a first close, as a UK-based public pension fund told us: "We don't see the need for taking the risk; if you come in later you can see more."

Firstly, investors prefer to wait until after the first close to view which investors have already committed to the fund, as one Denmark-based foundation told us: "If we like the look of the other investors in the fund then we are more likely to make a commitment." Secondly, waiting until after the first close allows LPs to view which investments the fund has already made, and can then decide whether the fund's investment strategy is a match with theirs.

Furthermore, investors want reassurance that a GP will go on to meet their fundraising goals and be able to hold a final close; a first close goes some way towards this and shows that a fund manager has attracted a certain degree of investor interest. One US-based investor stated that: "We have done this with the last two commitments and one failed in its fundraising efforts; therefore we are unlikely to invest before a first close again."

Fundraising in 2012: Impact of First Close on Final Close Size

Fifty-eight percent of funds that held a final close in 2012 met or exceeded their target, while 42% fell short. Interestingly, of the funds that held a final close in 2012 and that reached a first close within three months of launching, 59% then went on to meet or exceed their target size, as shown in Fig. 4. Furthermore, for funds that held a first close within four to six months, 58% went on to exceed their initial target size, while an additional 15% met their target. Advent International, for example, launched its latest fund, Advent Global Private Equity VII, in March 2012 and held a first close in July 2012 after securing €5.8bn towards its €7bn target. The fund then went on to exceed its target and held a final close in November 2012 on €8.5bn after less than a year in market; it is one of the largest private equity funds closed in recent years.

However, Fig. 4 demonstrates that not reaching a first close relatively quickly can impact future fundraising success. If a first close has not been reached within six months, funds are more likely to fall short of their final target. Almost half (47%) of funds that reached a first close within seven to nine months did not reach their target, while 71% of funds that took between 10 and 12 months, and 64% of funds that look longer than a year to reach a first close did not meet their final target size.

Importance of First Close by Fund Type

The time taken to reach a first close varies significantly by fund type. As shown in Fig. 5, all secondaries funds closed in 2012 held a first close within three months, while a significant 79% of natural resources funds that held a final close in 2012, reached a first close within six months.

The majority (64%) of buyout funds and distressed private equity funds (60%) that closed in 2012 held a first close within six months of the start of fundraising. Just 33% of mezzanine funds that closed in 2012 held a first close within six months, while 44% spent over a year in market before reaching an initial close.

In terms of capital raised, half of natural resources funds that closed in 2012 secured 50% or more of their target by the time a first close was held, as Fig. 6 displays.

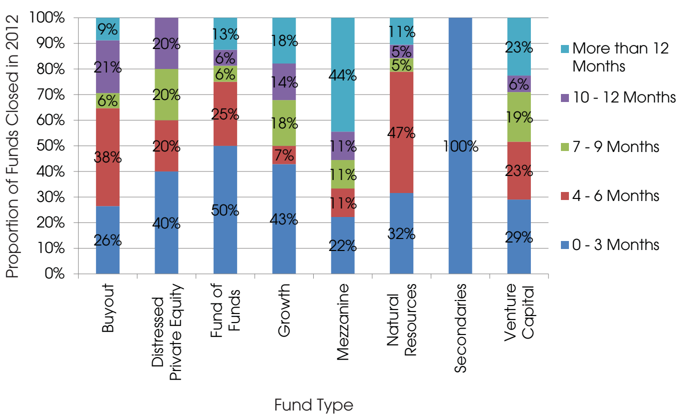
Almost a fifth (19%) of buyout funds that closed in 2012 secured more than three-quarters of their target capital by the time of reaching a first close. Ares Corporate Opportunities Fund IV, for example, secured $3.2bn towards its $4bn target by the time it held a first close in May 2012 and went on to exceed its target and close on its hard-cap of $4.7bn in August 2012.

Funds Currently in Market

As of the beginning of Q2 2013, there are 1,922 private equity funds currently in market seeking to raise an aggregate $793bn. Forty-six percent of funds currently on the road have so far spent 13-24 months in market, while a further 28% have spent more than two years seeking investor capital.

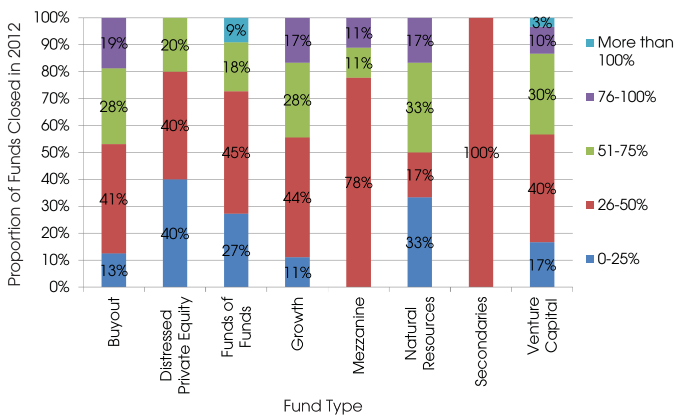
Almost half (46%) of funds currently in market have held a first close, 28% of which attracted LP capital quickly and held a first close within three months of beginning fundraising, while a further 20% reached a first close within four to six months. However, it is important to recognize that a notable 20% of funds currently in

Fig. 5: Time Taken to Reach a First Close by Private Equity Funds Closed in 2012 by Fund Type



Source: Preqin Funds in Market

Fig. 6: Proportion of Target Raised by First Close by Private Equity Funds Closed in 2012 by Fund Type



Source: Preqin Funds in Market

market that have reached a first close have taken longer than a year to do so.

Outlook

In the present economic climate, private equity fund managers are finding it increasingly difficult to attract LP capital. This is shown in the fact that private equity funds are now on average taking longer to reach a first close, and are also securing a much smaller proportion of their target capital than prior to 2008. Looking at funds closed in 2012, it is evident that the time it takes for a fund to reach a first close can influence whether a fund goes on to reach or exceed its final target or not. Reaching a first close quickly indicates LP demand, and therefore the fund is more likely to meet or exceed its final target, as opposed to funds that take a long time to reach a first close.

Sixty-four percent of investors will consider investing in a fund before a first close, many of which will do so to take advantage of favourable terms and conditions that may be offered. However, it is important to recognize that certain investors are cautious about investing before a first close and want to see evidence that a fund will go on to reach a final close before they make a commitment.

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The data used in this article has been sourced from the new **Fundraising Momentum** feature on Preqin's **Funds in Market**, which analyzes fundraising progress for funds currently in market, including time taken to reach a first close and proportion of capital secured.

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