Fundraising: An Insider's View

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Interview Conducted by Tim Friedman, Preqin

TF: How do you go about making sure that the funds you work on are well prepared in the current environment?

TB: The headline issues are setting GP expectations according to market conditions and thorough preparation – it's critical we get these right from the starting point. LPs are generally faced with significant re-ups in 2011 which will take priority and impede consideration of new fund relationships. It's very important to construct a campaign that is built on careful preparation, processing and thoughtful phasing – target the right LPs in the beginning and more will follow as you work into a raise, building momentum and creating scarcity value. The best agents are constantly interacting with a broad base of LPs across a range of mandate types and market conditions, and therefore have a wealth of knowledge that ultimately directly benefits GPs. Combining this knowledge in close working partnership with GPs and careful fundraising execution will produce the best results in a market that is hugely over-supplied with funds and will continue to move slowly over the next 12-24 months.

We know that there are lots of funds out there struggling to find support, but we have also seen some funds executing quick fundraises and above target too. How willing are LPs to commit in the current climate?

Fast raises are the exception in a market where the average raise takes approximately 18 months. LPs are certainly healthier and more open to investing compared to 2009/2010. The public markets have recovered some of the lost ground. Investment professionals and their investment committees are far enough away from the real low point of the industry and depth of their portfolio valuations and are in the position now where they can look up with a clear view and be willing to take on new relationships. That said, bringing a new LP relationship on board requires a long list of qualities, time and perseverance – the new GP is often replacing a legacy GP relationship. Capital has a way of migrating to the best opportunities, but we remain convinced fundraising timeframes for most of the GP community will remain extended this year.

How important are the relationships that placement agents bring?

LP relationships are our primary currency. Coaching, positioning, writing the materials and guiding a process are all important, but our LP relationships and reach are critical. You're only as good as the quality of the offerings you bring to the LPs time and time again; the way they're presented, written up, all the diligence – it's all got to stack up or you risk diminishing the access to that relationship.

I'm still surprised at the number of GPs that will look across the table at the end of a meeting and say, "That's great, I enjoyed learning about your capabilities and mandates, now tell me who your 20-25 house accounts are that have invested in every fund that Capstone raised?" The answer is honestly zero. These are sophisticated investors who do their own work, make their own decisions and they're buying the GP not the agent. The agent's job is absolutely to be a credible advocate for that GP, to know them inside out and be able to effectively achieve some kind of prioritization for that GP. If we could look inside the office of any active LP around the world, what you would see is a fire hazard of PPMs, way too many for any typically small team of LPs to process. Part of the value proposition of any professional agent is to bring additional credibility to a particular offering and to help an LP understand why they should: a) prioritize consideration; b) commit to meeting the principals; and c) ultimately invest in it.

Presumably you have to be very selective in terms of the GPs you represent, otherwise it will ruin your reputation with LPs?

We've taken a very disciplined, "less is more" approach in the last three years, carrying a somewhat lighter mandate load than in prior years. Good selection is critical to our success and continuing strong LP relationships. Our GP and fund evaluation is 90% the same as that which the LP does; the same boxes, set of reference calls, diligence analysis, and review of prior track records. The 10% delta relates to commercial considerations, i.e. universe of targeted LPs, our confidence in reaching target, timeframe for the raise, and chemistry with the fund management team to name a few. As a pure play placement firm that takes on 8-10 mandates a year, we've got to be very careful in evaluating the 500-600 funds we consider annually to select the eight we engage.

With so many funds out there, how important is past performance as a differentiating factor for potential LPs? How can first-time funds tackle this issue?

Prior track record is very important; the more cash to cash the better, the more compelling the IRRs/multiples the better. That said, we're in a market where, despite a good dose of realizations and distributions over the past year, the average LP looking at the funds coming across in 2011 will have to do a fair amount of deep diligence on a large, unrealized portfolio in most any vintage 2005-2008 funds returning to market. The LP has to analyze the unrealized companies in a GP's portfolio and make judgments about how they're marked, what's the trajectory, and do they have a few realizations coming over reasonable time frames? That workload fuels the time drag that will feed into what can be construed as a very slow fundraising market in spite of some funds getting raised reasonably quickly.

First-time funds can get raised; there are good examples and they happen every year. The requirement is that it's not a first-time principle investing team. The GP must be a high-quality team with a successful track record investing in a compelling investment strategy. We regularly raise first-time funds that possess these qualities.

What are LPs looking for? Are there any trends, specific types, sizes, geographies, etc?

The smaller fund theme is still the headline. Different investors will define them in a variety of ways – sub $2bn or $500mn and below. Let's just say that a small fund pursuing less efficient markets is one that has a better chance of producing outsized returns.

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There is continued interest in the small buyout arena and the distressed space, more so on the controlled distressed/turnaround side of the fence than the distressed debt side. Industry-specific funds in a handful of areas remain topical, particularly with very seasoned investors that have a lot of their core positions already established. Typically, they will include specific geographic or industry concentrations they want a specialist to give them exposure to, for example energy, infrastructure, consumer goods and financial services.

Geographically, there are a couple of emerging markets that are of clear interest, like Brazil. With any emerging market, a big portion of the LP interest is exploratory, and a part is real and will migrate into that region. The question becomes do you invest in Brazil-only funds or do you invest in pan-South America funds, or employ both tactics? Different LPs will opt for different ways of getting exposure. China is still in the spotlight, but it is becoming increasingly difficult to differentiate between the plethora of China-focused funds that have been cropping up. China is a very different market, and depending on what statistics you believe, there are upwards of 500 private equity funds that are China-centric. You have to figure out which, other than the obvious brand names, are the groups to back. It's an area that will continue to attract capital, and it's increasingly hard for LPs from other parts of the world to try to figure out who the winners are.

Do you think we'll continue to see a move away from big funds? Or will they always be ok raising the $10bn-plus funds?

The well-established brands will continue to raise their money. It's ironic because the surveys show that very few LPs have interest in mega funds, but the Blackstones of the world continue to show an ability, if they stay in market long enough, to raise capital. The other big brands will have to cast their nets farther geographically and down market into different channels of investors in order to do it, but they will get their funds raised.

In summary, although capital allocated to the PE asset class will likely increase in 2011, there will continue to be a high standard for past fund performance. The bar is high, and LPs will have many viable fund choices across sectors, strategies and cap sizes. Fundraising for most of the GP community will take longer than in prior vintages, and leak into 2012 in many cases. That said, most in the PE community will "take" 2011 over 2009 and 2010 any day.

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