FIRST-TIME FUND MANAGERS

*Here, we provide an overview of first-time private equity fund managers, including fundraising, performance and investor interest, using data from **Private Equity Online**.*

The private equity industry continues to grow as new entrants emerge and market their funds to investors. Strong investor appetite for the asset class as well as recent high distributions have encouraged LPs to invest large sums of capital back into the industry in order to meet their target allocations. Despite this demand, there are signs that the market is bifurcating, making it more difficult for emerging managers launching their first fund as many investors seek out established managers with a proven track record. Only 195 first-time funds closed in 2016, the lowest number of emerging funds closed since 2010, raising $25bn in aggregate capital (Fig. 1).

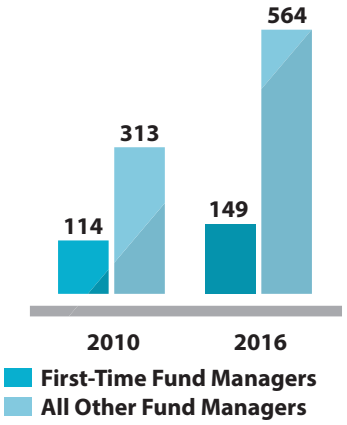
FUNDRAISING

The recent lower levels of first-time funds reaching a final close reflect a broader trend in which fundraising by emerging managers as a proportion of the total private equity industry has decreased. Where first-time funds made up 27% of funds closed in 2009, they represented 23% in 2016 (Fig. 2). Although the proportion of capital raised by emerging managers has varied, it has generally followed the same trend, with the 2016 proportion (7%) lower than that of 2009 (12%) and significantly below the recent peak of 20% in 2011.

Furthermore, there is a widening division between the average size of funds raised by first-time and established fund managers. Although historically experienced fund managers have on average been able to raise greater sums of capital than first-time managers, the difference has increased in recent years. The average size of a first-time fund closed in 2010 was $114mn, compared with $313mn for non-first-time funds; for funds closed in 2016 the first-time average has increased to $149mn, whereas the average size for established managers has jumped to $564mn.

There are other advantages to coming to market from an experienced position, as can be seen in the proportion of funds exceeding their target size. In 2016, 54% of closed non-first-time funds exceeded their target size, with 23% coming in under target; by comparison, only 35% of first-time funds exceeded their target size and 30% fell short. Additionally, the need to persuade investors of the benefits of a first-time fund and conduct the necessary due diligence means that first-time funds typically spend longer in market before reaching a final close: first-time funds closed in 2016 had spent an average of 15 months raising capital, compared to 14 months for their established peers.

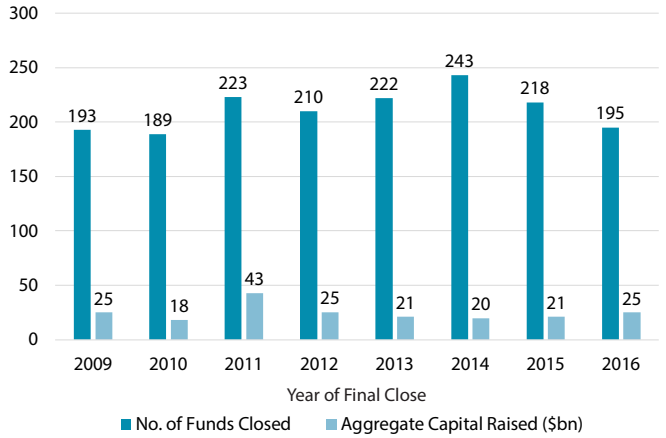
AVERAGE FUND SIZE ($mn): 2010 vs. 2016



PERFORMANCE

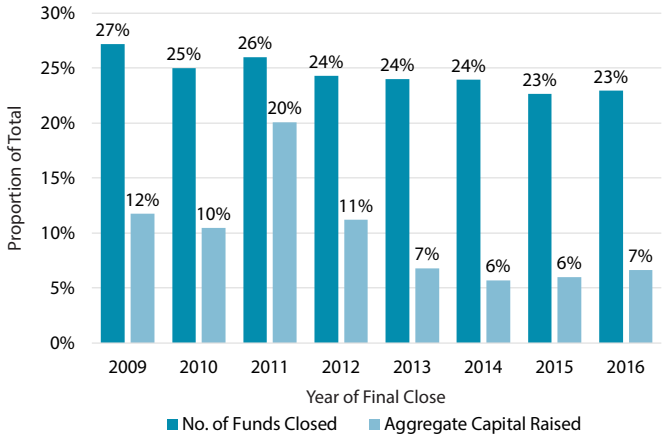
Although emerging manager funds have generally found it more difficult to attract investor capital, they have tended to deliver better returns to investors. Fig. 3 shows that first-time funds have higher median net IRRs across most vintages since 2000, with a significant difference (of at least three percentage points) for 2000-2003 vintage and 2010-2012 vintage funds. The outperformance can be seen particularly in terms of quartile rankings: when compared to similar funds, 31% of first-time funds fall in the top quartile, with a further 23% in the second.

Fig. 1: Annual First-Time Private Equity Fundraising, 2009 - 2016



Source: Preqin Private Equity Online

Fig. 2: First-Time Fundraising as a Proportion of All Private Equity Fundraising, 2009 - 2016



Source: Preqin Private Equity Online

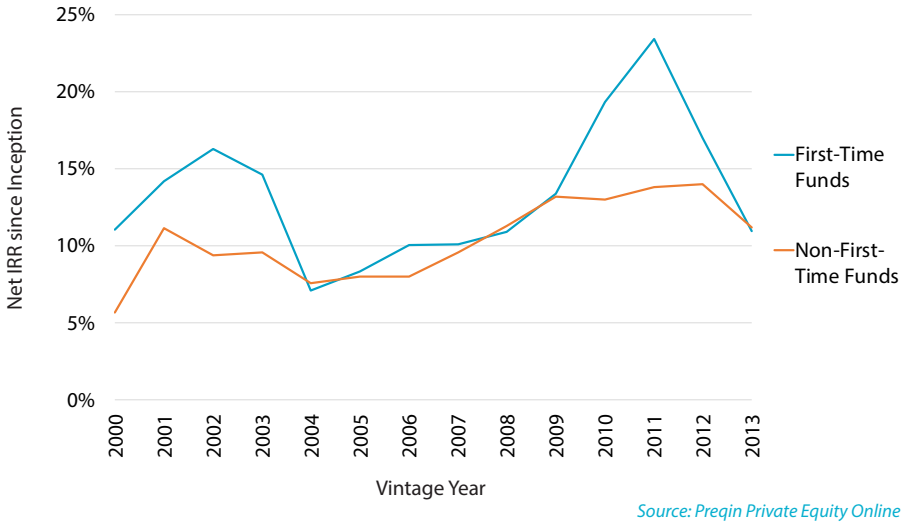
Fund selection remains important, however, as there are considerable differences between the performance of first-time funds in the top and bottom quartiles, with at least a 10 percentage point difference in median net IRRs for all vintages except 2007 (Fig. 4).

INVESTOR INTEREST

Despite some investors' reservations about first-time funds, there remains a sizeable group of institutions interested in investing with emerging managers: 30% of investors tracked by Preqin's **Private Equity Online** have expressed a preference for investing in first-time funds, with a further 10% that will only invest in spin-offs. An additional 17% will consider investing in first-time funds. However, in line with LPs' recent views on the importance of track records when sourcing funds, the proportion of investors that will invest in first-time funds has decreased slightly from five years ago (Fig. 5).

Larger institutions are more likely to be open to investing with first-time fund managers than smaller LPs; while many LPs recognize the potential for portfolio diversification and higher returns in some first-time funds, larger LPs are more likely to have the internal resources necessary to carry out the additional due diligence and also a private equity portfolio large enough to include exposure to first-time fund managers alongside established firms. Sixty-five percent of investors with over $10bn in AUM either currently invest or would consider investing with emerging managers; the figure drops to 50% for investors with less than $1bn.

Fig. 3: Median Net IRRs by Vintage Year: First-Time vs. Non-First-Time Private Equity Funds



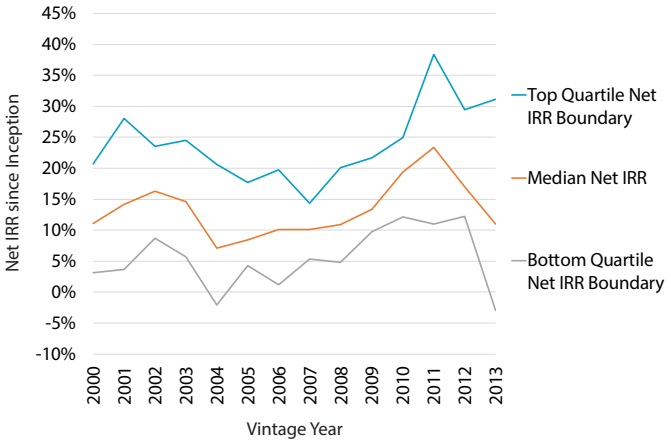
Source: Preqin Private Equity Online

Some larger investors, recognizing the potential benefits of exposure to new managers, go further in their backing of new talent in the industry. California Public Employees' Retirement System (CalPERS), for example, has developed an Emerging Manager Program which supports early stage managers raising their first or second fund with allocations of between $8mn and $20mn. The pension fund announced in June 2016 that it plans to invest an additional $4bn via the program by 2020 across all asset classes including private equity, global equity and real estate, in addition to its $7bn investment in its new Transition Manager Program.

OUTLOOK

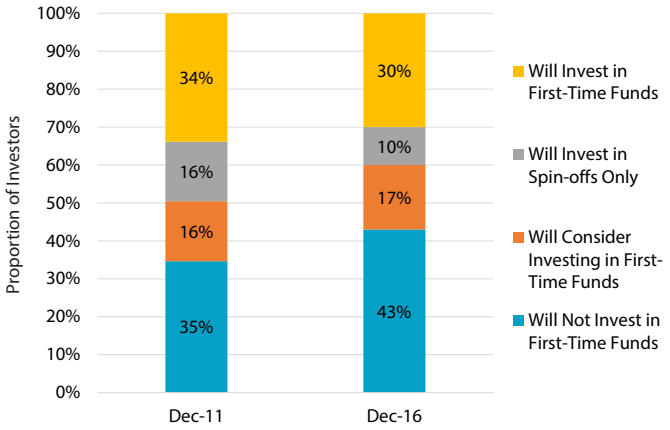
Notwithstanding the challenges, new fund managers continue to bring vehicles to the market: at the start of 2017, there are 654 first-time private equity funds on the road, seeking an aggregate $197bn in capital commitments from investors. Although some investors have become more cautious about allocating to new managers, the potential benefits of doing so – diversification and higher returns through identifying talented managers early, the opportunity to build a relationship that may help in gaining access to successor funds and the favourable terms that some managers offer to early supporters of their firm – mean that other investors will continue to be open to first-time funds and that there will remain opportunities for these fund managers to attract capital in the year ahead.

Fig. 4: First-Time Private Equity Funds: Median Net IRRs and Quartile Boundaries by Vintage Year



Source: Preqin Private Equity Online

Fig. 5: Investor Appetite for First-Time Private Equity Funds, 2011 vs. 2016



Source: Preqin Private Equity Online