The Troubles of First-Time Funds

Although private equity fundraising has improved in recent years, many first-time fund managers have struggled to attract capital. Jessica Duong looks at historical fundraising statistics and LP appetite for emerging managers.

Bifurcation was the main theme of 2013's private equity fundraising landscape, with a clear dominance of established firms over first-time fund managers. LP sentiment seems to have waned significantly for maiden vehicles and the statistics from Preqin's Funds in Market online service indeed demonstrate a decline in the proportion of investor capital allocated to first-time fund managers. Fig. 1 shows the split between first-time firms and all other managers and the proportion each group have contributed to annual aggregate capital raised over the years.

Despite signs of recovering confidence in the markets in recent years, reflected in the increasing amounts of total capital garnered by all private equity funds from 2010 onwards, the amounts raised and proportion represented by first-time fund managers increased from $40bn (14%) in 2010 to $56bn (17%) in 2011, then declined year on year since (Fig. 1).

First-time funds have always faced challenges securing third-party capital due to the nature of the private equity industry, which places great emphasis and value on GP track record, history and the team having worked together for a long time. Reluctance from LPs stems from the risks associated with placing their money with a firm that does not have any track record of success in private equity fund management.

However, that is not to say that first-time funds cannot thrive in the fundraising marketplace. In the peak year of 2007, first-time private equity fund managers raised an aggregate $96bn for investment. While the annual figure has since decreased due to the prevailing economic conditions, billions of dollars are still successfully raised every year by first-time fund managers. In addition to the $5bn raised by first-time funds that have reached a final close in 2014 so far, 39% of the 641 first-time private equity funds currently in market seeking capital have reached at least one interim close already, garnering $25bn. With three-quarters of the year still to go, 2014 already seems to be painting a promising picture for first-time fundraising, with much potential for last year's figure of $35bn to be surpassed.

Some first-time funds have raised significant amounts of capital. An example from 2014 YTD is SwanCap Investment Management's final close on $1.2bn for its debut vehicle, SwanCap Opportunities Fund. The direct secondaries fund, however, initially was targeting a slightly higher amount of $1.5bn, but the firm held a final close after less than 12 months on the road. Fig. 2 illustrates the proportion of first-time funds that have closed over time that have met, failed to meet, or exceeded their fundraising targets. These statistics are compared to the more experienced managers' vehicles.

Fig. 3 lists the top five first-time funds ever raised, with all top spots taken by vehicles raised before the 2008 global financial crisis, all with final close sizes over $5bn.

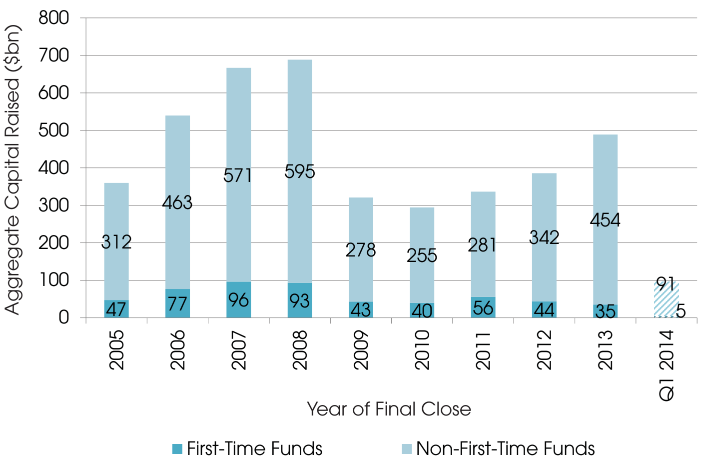
Abandoned Funds

Failing to meet the initial fund target size is not the only issue that can hit first-time fund managers on the fundraising trail. During 2013, a total of 64 funds are known to have been abandoned; these funds were seeking a combined $34bn. Further analysis reveals that a majority of fund managers that abandoned a fund in 2013 were first-time managers (57%), an increase on the proportion of first-time firms that abandoned funds in 2012 (48%). It is worth noting the data for abandoned funds is limited as it is based on only those fund managers willing to provide the date they terminated their fundraising effort.

LP Sentiment

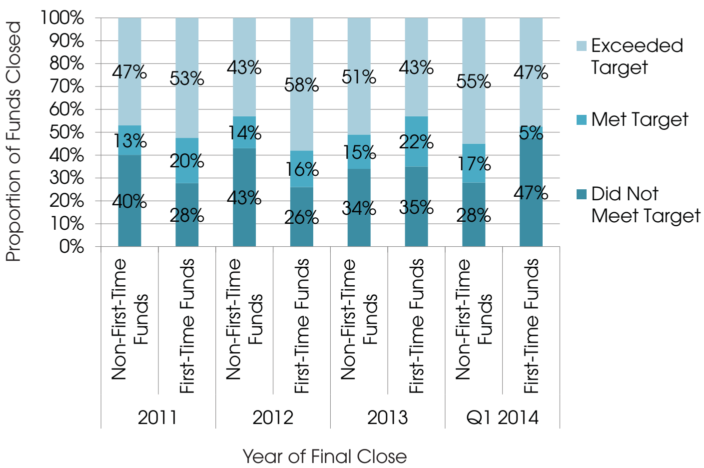
Investor appetite, which is crucial for any fund manager seeking to raise a private equity vehicle, is comparatively lower for first-time funds and this trend has persisted over the years. Fig. 4 depicts the proportion of investors that will consider committing to first-

Fig. 1: Annual Aggregate Capital Raised by Private Equity Funds: First-Time Funds vs. All Other Funds, 2005 - Q1 2014



Source: Preqin Funds in Market

Fig. 2: Fundraising Success of Private Equity Funds: First-Time Funds vs. Non-First-Time Funds, 2011 - Q1 2014



Source: Preqin Funds in Market

Fig. 3: Top Five Funds Raised by First-Time Private Equity Fund Managers, All Time (As at 24 March 2014)

Fund	Firm	Vintage Year	Fund Type	Final Close Size (bn)
Terra Firma Capital Partners I	Terra Firma Capital Partners	1994	Buyout	6.0 EUR
GS Infrastructure Partners I	GS Infrastructure Investment Group	2007	Infrastructure	6.5 USD
CVI Global Value Fund I	CarVal Investors	2007	Distressed Debt	5.8 USD
Global Infrastructure Partners	Global Infrastructure Partners	2008	Infrastructure	5.6 USD
BMB Capital Sharia Fund of Funds	BMB Capital	2006	Hybrid Fund Of Funds	5.0 USD

Source: Preqin Funds in Market

time funds, using the results of Preqin's biannual survey of over 100 LPs based across the globe. As of H1 2014, less than a fifth (19%) of investors surveyed confirmed that they would invest in first-time vehicles, which is a 10 percentage point decrease from the proportion of investors that stated the same last year. 2013 was a record year for fundraising, with the standout fund Apollo Investment VIII securing the largest final close ($18.4bn) since the onset of the financial crisis, but, as mentioned previously, was overwhelmingly dominated by established fund managers. There is evident investor appetite for established GPs, as reflected in the success of their fundraises, and investors are drawn to the prospects a firm with a proven track record can give them.

However, reluctance to invest in first-time funds will not apply to all LPs, and in fact, Preqin has noted a number of institutional investors are looking to expand and develop emerging manager programs as a part of their wider investment strategies in the year ahead. Some examples include:

- In March 2014, the California Public Employees' Retirement System (CalPERS) announced that it will allocate an additional $200mn to its emerging manager program in the private equity asset class. CalPERS will utilize a new fund of funds vehicle to deploy the capital, focusing on high-potential emerging manager funds. The pension fund's goal is to generate appropriate, risk-adjusted investment returns by identifying early stage funds with strong potential for success.

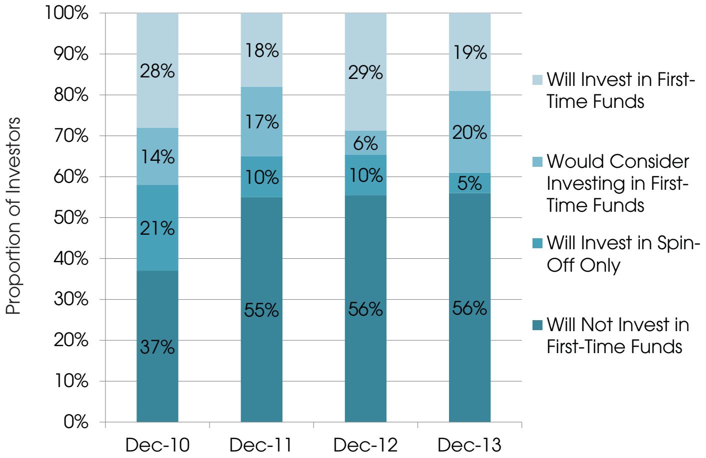
- Dallas Police & Fire Pension System has begun discussions on the potential creation of a dedicated emerging manager program. The $3.5bn public pension fund has a current allocation to private equity of 21.9% of total assets and has a preference for funds focusing on investment opportunities in the US.

- Four of New York City's pension funds (Teachers' Retirement System of the City of New York, New York City Police Pension Fund, New York City Employees' Retirement System and New York City Fire Department Pension Fund) have an in-house emerging manager program, set up in an effort to reduce the costs it would have incurred if the program was managed by an external GP. The program is headed by Alex Done, who was placed in the role in March 2012. In December 2012, the four New York City pension funds committed a combined total of $400mn to funds raised by minority- and women-owned firms, and such investments whereby new GP relationships are formed are confirmed to be a continued part of the pension funds' investment plans in 2014.

Spin-Outs

Fig. 4 also indicates that the appetite for spin-out funds has undergone a steady decline over the years, from 21% of LPs that

Fig. 4: Proportion of Investors that Will Consider Investing in First-Time Funds, December 2010 - December 2013



Source: Preqin Investor Interviews, 2010 - 2013

participated in Preqin's investor survey indicating that they would invest in spin-off funds only when asked if they would be willing to commit to first-time vehicles. This proportion halved to 10% in 2012, remained low in 2013, and halved again in Preqin's latest survey in 2014. This trend is somewhat surprising as spin-off funds are largely perceived to be lower risk than a regular first-time fund.

Spin-out funds have some advantages over other first-time funds, in that they often attract commitments from investors that invested with the previous firm, or are familiar with the management team. A successful legacy portfolio or an experienced investment team will also attract other investors to commit to funds managed by spin-off teams, especially in contrast to a newly established firm launching its first private equity fund without any track record or notable experience. However, it must be considered that the team spinning out to form a new firm is not necessarily made up of the same individuals responsible for generating the quality deal flow that was seen in the parent company. Furthermore, in some instances, the historical deal flow may not have even been driven by the private equity team, but by the relationships of the sponsor involved.

Wariness surrounding spin-outs from institutional parents could also involve questions regarding the extent of the new firm's independence. If an offering is coming from an environment where the team was previously part of a bigger financial institution, investors will be cautious in ensuring the spin-out is true, particularly if the larger organization is retaining a minority interest, or maintaining influence on investment decisions. Issues surrounding incentives can also arise if the former parent has a significant share of the profits and carried interest.

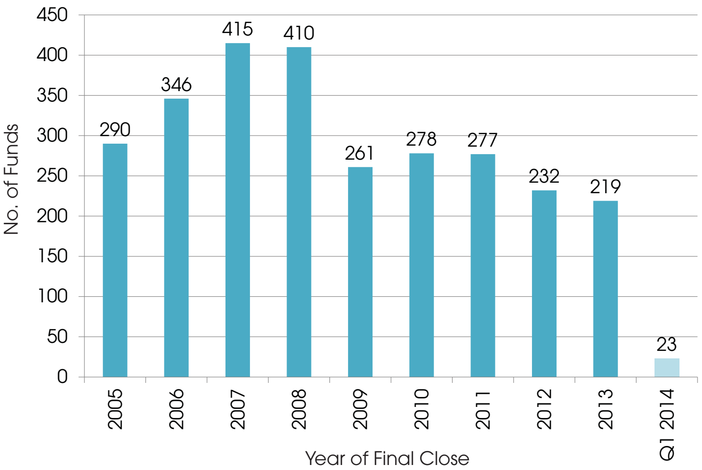
Outlook

As Fig. 5 shows, the annual number of first-time funds reaching a final close has been on the decline since the financial crisis, but while there is a lack of appetite for first-time funds among LPs at large, it is also possible to attribute the decrease to the natural maturation of the private equity industry. The first-time fund managers of yesteryear are going to be the more experienced fund managers of today. In order for the industry to grow, a continued supply of first-time fund managers is needed, offering investors alternatives to the hard-to-access big brand names in the market that may be better suited to their investment capabilities and strategies and offer diversified strategies.

In spite of the challenging path that lies before private equity firms launching debut vehicles, there is an abundance of first-time funds hitting the fundraising trail. As of April 2014, there were 641 such funds in market seeking an aggregate $141bn. This includes over 20 funds that are targeting $1bn or more, with Georgian Co-Investment Fund ranking as the largest as it is aiming to secure $6bn in total commitments. As discussed in Preqin's previous issue of Private Equity Spotlight, co-investment opportunities have gained real pace in recent times as LPs' appetite for direct investments have grown and GPs have made moves to meet this demand.

Statistics from Preqin's Funds in Market online service reveals that over $25bn has already been raised by these 641 funds via interim closes – a strong testament to the fact that there are indeed still substantial levels of investor appetite for first-time funds. Should the investment strategy of the fund offering be compelling enough, fund managers have a good chance of overseeing a successful fundraise, regardless of the number the fund falls in the series. Competition from their more experienced counterparts will have less bearing should the first-time fund manager have a clear strategy that is consistent throughout the process, and attractive prospects of niche investment opportunities suited to the LP that cannot be offered by more mature private equity funds. Despite the apparent deterrent of an unproven track record of a first-time fund manager, with no history of stability and outperformance from an existing platform, investors will overall still be drawn to strong macro-opportunities and the prospect of fruitful returns from a GP at any stage.

Fig. 5: Number of First-Time Funds that Reached a Final Close, 2005 - Q1 2014



Source: Preqin Funds in Market

Data Source:

Subscribers to Preqin's **Investor Intelligence** can click **here** to view detailed profiles for 2,089 LPs that consider investing in first-time funds, including spin-off teams. Detailed profiles include:

- Current and target allocations to private equity.
- Fund type and geographic preferences.
- Future investment plans.
- Previous fund investments and much more.

For more information, or to arrange a demonstration, please visit:

www.preqin.com/ii

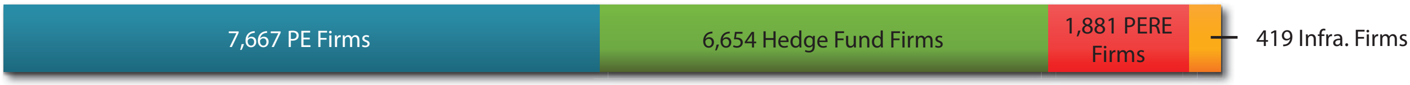
preqin
alternative assets. intelligent data.

Preqin Global Data Coverage

As of 1 April 2014

Fund Coverage: 35,828 Funds

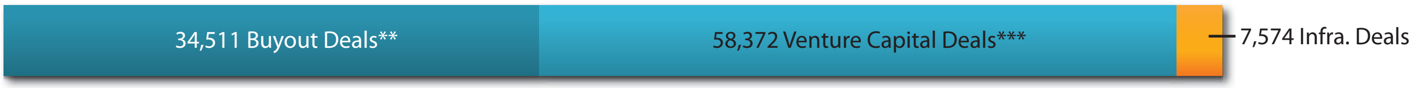
Firm Coverage: 16,621 Firms



Performance Coverage: 15,673 Funds (IRR Data for 5,368 Funds and Cash Flow Data for 2,489 Funds)

Fundraising Coverage: 14,869 Funds Open for Investment/Launching Soon Including 2,141 Closed-Ended Funds in Market and 360 Announced or Expected Funds

Deals Coverage: 100,457 Deals Covered; All New Deals Tracked



Investor Coverage: 11,740 Institutional Investors Monitored, Including 8,287 Verified Active**** in Alternatives and 88,160 LP Commitments to Partnerships

Alternatives Investment Consultant Coverage: 470 Consultants Tracked

Fund Terms Coverage: Analysis Based on Data for Around 8,800 Funds

Best Contacts: Carefully Selected from Our Database of over 274,627 Active Contacts

Plus

Comprehensive coverage of:

- Placement Agents
- Fund Administrators
- Law Firms
- Debt Providers
- Dry Powder
- Compensation
- Plus much more...

The Preqin Difference

- Over 150 research, support and development staff
- Global presence - New York, London, Singapore and San Francisco
- Depth and quality of data from direct contact methods
- Unlimited data downloads
- The most trusted name in alternative assets

New York: +1 212 350 0100 - London: +44 (0)20 7645 8888 - Singapore: +65 6305 2200 - San Francisco +1 415 635 3580

www.preqin.com

*Private Equity includes buyout, venture capital, distressed, growth, natural resources and mezzanine funds.
**Buyout deals: Preqin tracks private equity-backed buyout deals globally, including LBOs, growth capital, public-to-private deals, and recapitalizations. Our coverage does not include private debt and mezzanine deals.
***Venture capital deals: Preqin tracks cash-for-equity investments by professional venture capital firms in companies globally across all venture capital stages, from seed to expansion phase. The deals figures provided by Preqin are based on announced venture capital rounds when the capital is committed to a company.
****Preqin contacts investors directly to ensure their alternatives programs are active. We emphasize active investors, but clients can also view profiles for investors no longer investing or with programs on hold.