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Strategies to become a successful emerging fund manager

By Sara L. Terheggen

First-time funds have been growing at a healthy pace year over year with continued upward growth since 2013. While bulge bracket private equity shops continue to close multi-billion dollar funds, investors are looking for broader diversification in their portfolios and to establish early relationships with promising fund managers. This is particularly beneficial for investors since well-established GPs have not adequately focused on succession planning and follow-on funds tend to be underperforming as a result. Further, talented fund managers with an entrepreneurial spirit may not be willing to wait to rise the ranks of a traditional private equity shop and choose instead to launch out on their own despite the challenges of raising a first-time fund.

The prospect of being an emerging fund manager is a challenging pursuit. Raising capital for a fund is difficult for even the most established of players, often taking the entire 12 months of a typical fundraising cycle to hit their target. First time funds can expect to be in the market even longer, often for 18 months or even two years to raise what is quite often a much smaller amount of capital. Despite the obstacles, there are some strategies that an emerging fund manager can use to overcome certain challenges. This includes (i) understanding why investors choose first-time funds so an emerging manager can focus and align their efforts accordingly and (ii) identifying structural and operational aspects to facilitate success.

An Investor's Perspective for Choosing a First-Time Fund

For an investor, committing to a first-time fund can be a risky undertaking. Some limited partners, especially institutional investors, will not even entertain the thought while others have specifically established emerging manager programs in order to provide a pool of capital that is specific to first-time funds, often with a focus on increasing the amount of dollars going to women or minority-owned funds. The disadvantages most noted include lack of investment track record and lack of infrastructure and resources of

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developed firms. Another disadvantage is the length of time spent fundraising which can detract from time spent sourcing deals and making investments, or less time spent focusing on portfolio company investments already made. That said, all investments, even in a bulge bracket private equity fund comes with risk and first-time funds do have some unique advantages when compared to their larger peers. These include:

- *Investment Strategy:* Emerging managers will often have a highly differentiated investment strategy or a targeted sector that provides opportunities for diversification.
- *Transaction Size:* Emerging managers are more likely to have exposure to smaller deals with lower purchase-price multiples and potential for larger upside.
- *Performance:* Research by Preqin and others has shown trends that first-time fund managers frequently outperform follow-on funds despite having shallower track records.
- *Economics:* Anchor investors in first-time funds can often negotiate reduced management fees and carry.
- *Rights:* Committing to a first-time fund lends itself to opportunities to negotiate additional rights and controls around governance, co-investment rights and preferred allocations in subsequent funds.
- *R&D:* Opportunity to establish a relationship early with a promising fund manager can serve a type of R&D function for investors by cultivating trends in the next generation of investing expertise.
- *Alignment:* Finally, because general partners of first-time funds tend to put more of their own personal capital at risk, there is often much stronger alignment of interests.

Emerging Manager Strategies to Align with Investor Needs

To better ensure that an emerging manager can succeed in raising their first fund, the advantages and disadvantages discussed as to why investors choose or choose not to take a risk on first-time fund managers highlights a suite of strategies that emerging managers can deploy to increase their chances of being funded. These strategies can be grouped into three categories: (i) Investments, (ii) Operations and (iii) Flexibility.

Investments. Minimal or lack of track record would arguably be the biggest disadvantage noted by investors for why they do not invest in a first time fund. While it can be difficult to overcome, a few strategies that can provide an opportunity to build track record and/or build and expand investor relationships include angel investing, special purpose vehicles and specially managed accounts.

- *Angel Investing:* For aspiring venture capital fund managers, angel investing is a good way to establish track record and build relationships in the venture capital community which is critical for getting future access to deal flow.
- *Special Purpose Vehicles:* Special purpose vehicles offer the opportunity to raise capital for a specific investment which provides an opportunity to build investor relationships while generating track record. Investors in special purpose vehicles can also be a good source of capital when a manager begins fundraising for their first blind pool fund.
- *SMAs:* SMAs, or specially managed accounts, offer another great opportunity to build track record. In an SMA, you typically have one limited partner who provides the capital and you as the fund manager are tasked with identifying good investments and putting that capital to work.

Operations. Lack of infrastructure is another cited reason why an investor would choose to invest their capital in a bigger, more established fund. If you do not have sufficient personal capital to both fund investments and build out your team, one option is to identify a co-founder or more than one co-founder to help fund investments and infrastructure. Another strategy is to identify a network of providers (tax, accounting, legal) who you can outsource to assist. This allows you a lower-cost alternative to hiring someone. Finally, while not common, some emerging managers are raising seed capital for their management company.

Flexibility. This strategy really boils down to being willing to make adjustments for interested investors and entice them to invest in your fund. This may mean reducing your management fee, giving up some of your carry or offering a limited partner better governance or other rights, such as direct co-investment opportunities. Some argue that providing these types of economic incentives or rights results in locking yourself into terms forever. While that can be true, the alternative is losing potential investor capital. It is important for an emerging manager to decide which terms are really important at the outset. This will allow one to stand strong on those few terms while maintaining flexibility on the rest. This is also where a strong fund attorney can assist with developing creative provisions that may provide some flexibility at the beginning without locking such terms into the fund indefinitely.

Getting to a Fund

It is no surprise that raising a fund is an extremely difficult process. In addition to needing a solid track record and a well-established infrastructure, you also need an extremely robust network of investors who are willing to take a chance on a first-time fund. Utilizing the strategies discussed herein will not guarantee the outcome of a fundraise but offer concrete, practical suggestions for increasing the likelihood of success.

Sara L. Terheggen, Ph.D., J.D. ("Dr. T") *is the founder and managing director of The NBD Group, Inc., a leading legal and business solutions firm. Dr. T has advised on transactions with an aggregate value of more than $100 billion and she has been recognized more than 30 times for her professional expertise and leadership.*

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