MARKETING YOUR FUND II

- Clay Deniger, **Capstone Partners**

A recent Preqin special report documented the outperformance of first-time funds in a study that spanned 13 vintage years (2000-2012). The study compared median net IRRs of first-time funds against those of established fund managers and found that 2004 is the only vintage year in which non-first-time funds outperformed first-time funds.

Enticed by this outperformance and by the opportunity to forge new partnerships with the next generation of successful sponsors, LPs in recent years have continued to support first time funds. Many of those initial funds are nearing full deployment and their managers will soon be facing the prospect of raising second funds with only partial proof of concept. There is an adage in private equity fundraising (somewhat exaggerated) that says Fund I is the hardest to raise, Fund III the second hardest, with Fund II often receiving a free pass in some critical diligence areas.

For LPs, Fund II offerings pose unique underwriting challenges. Assuming the steady deployment of a fund over a 3-5 year period, the average age of a Fund I portfolio at the start of Fund II fundraising may be less than three years. This typically means few, if any, monetizations have occurred and immature holdings may still be in the early stages of transformative improvements. As a result, we recommend GPs resist the urge to attempt full proof of concept, but instead position Fund II to LPs as an opportunity to re-evaluate Fund I with significant incremental underwriting material.

Below are several key areas that deserve special attention from GPs preparing for Fund II fundraising efforts:

Avoid coming back too early, but do not wait for perfection:
There are no black and white lines around what metrics must be achieved prior to coming to market for a second fund. Historically, we would have guided a sponsor to achieve one or two realizations before launching Fund II. However, today's market is rewarding new managers that have effectively and aggressively deployed capital in quality deals with incremental capital for second funds, even in cases where the overall portfolio remains young and largely unproven. What remains important for GPs is to make a compelling, stage-appropriate argument that the strategy is where it should be, given the length of time since the Fund I close.

While a hot fundraising environment should never be the sole determinant for urgency in returning to market, we do expect that the current level of investor demand will take a step back at some point. An imperfect story in today's market may prove more successful than a more perfected story in a tightening environment.

Know the priorities and gating requirements of your audience:
While measures of distributed capital to paid-in capital (DPI) are an important quantitative underwriting tool for all LPs, emphasis on realizations can be more critical to existing LPs than to new investors. An investor that was close to committing to Fund I but eventually passed may have sufficient incremental evidence to commit to Fund II by validating sourcing concerns or team dynamics; however, an existing Fund I LP with money in the ground may hedge on a Fund II commitment until they receive a portion of their bait back. Understanding any hard and fast gating requirements from existing LPs will help managers better evaluate re-up rates and can influence the return to market timing. Having the support of existing investors is vital and will often shape the strategy used to approach the broader market.

Articulate elimination of partnership risk:
Case studies of portfolio companies, which are the heart of the incremental Fund I story, should emphasize team members' cohesive and effective execution and be attributable across the investment team. A major underwriting hurdle faced by first-time funds is partnership risk, and if the perceived impact of team members is uneven, LPs may see red flags even if the quality of the portfolio remains strong. In cases where investment professionals have worked together in the past, it is important to stress continuity with previous investment practices. Where team members have come together for the first time, demonstrating shared successes is critical.

Proof of sourcing capabilities:
A new team forging a new platform does not necessarily manufacture deal flow in the same manner as a fund sponsor with strong name recognition from decades of market exposure. LPs evaluating first-time funds must project sourcing effectiveness based on approach, deal pipelines and early transactions. The Fund II story must establish sourcing as a core competency of the firm, and sponsors should expect greater scrutiny on the forward deal pipeline. Sourcing case studies should demonstrate a proprietary insight or perspective, even if sourcing comes mainly through competitive processes. A Fund I portfolio built primarily through competitive auctions and full-price deals will obviously give LPs reason to pause when underwriting Fund II.

Demonstrate positive portfolio company trajectories:
Every investment will have its own critical success factors, and early in a fund's life not every company will be on plan. LPs will typically allow for a margin of error if Fund I execution is delayed. However, GPs with material setbacks early in Fund I should enter fundraising with the

knowledge that a compromised asset will attract disproportional attention, as LPs have no other choice than to make judgements as to the overall portfolio's trajectory based upon the clear direction (up or down) of those companies with material developments. Be prepared to discuss the details of your expectations for these companies and utilize references to support the anticipated growth of the company.

Your CEOs are your best advocates for upside:
In the absence of data-driven success indicators, many LPs will look to company management to provide on-the-ground insight into the medium- and long-term prospects for your portfolio companies. Given this scrutiny through portfolio company referencing, it is important that company management participate in the planning process which will enable them to articulate the expected trajectory of the company in a manner which is consistent with the way that trajectory is shared with LPs during fund marketing. In scoring the promise of a young portfolio, LPs will press your CEOs to communicate risks and obstacles, challenges and opportunities. The consolidated impression gained from all of these conversations must show investors a path to the targeted returns.

Plan ahead for changes in terms:
Many times a successful Fund I effort requires concessions on terms that a GP must accept in order to get in business. Successful investment activity in a Fund I can help substantiate a change in some types of terms (e.g. elimination of a key-man clause after showing the demonstrable impact of a broad investment team), while winding back other terms requires early discussions and careful consultation with first-close investors that may be less sensitive to maintaining a Fund I term sheet. A GP with clear priorities on securing modifications to terms should plan ahead with counsel, placement agent and existing LPs so steering to the desired outcome becomes a part of the early fundraising strategy.

Carefully consider step ups in fund size:
An open dialogue with existing LPs is a critical first step in setting a target size for Fund II. Given their recent experience with dramatic jumps in successor funds, LPs are likely to scrutinize your increased fund target. They will evaluate whether or not the fund size allows for a consistent application of the strategy that your current investors backed in the first fund. Some LPs have a rigid size limit on their own investment mandates that does not allow them to support substantially larger funds. If co-investment has been a benefit to LPs in their Fund I experience, or if they have indicated a priority for co-investment in Fund II, they will have heightened sensitivity to growth in fund size as every incremental dollar raised could potentially offset a dollar of co-investment.

Over-prepare before formally coming to market:
As in any ramp up for fundraising, it is critical that a Fund II sponsor over-prepare before formally coming to market. In addition to the guidelines above, that means speaking individually with each material LP, drafting key marketing documents, assembling a full data room and setting a target fund size that is supported with solid rationale and communicated with conviction. Such preparation is the first step in building momentum and communicating to the market that LPs should move to deep dive underwriting at the outset of the fundraise. Focus and attention from the LP community typically comes only when urgency and action is justified and required.

CAPSTONE PARTNERS
Founded in 2001, Capstone Partners is a leading independent placement agent focused on raising capital for private equity, credit, real assets and infrastructure firms from around the world.

CLAY DENIGER
Clay Deniger is a Managing Partner at Capstone Partners leading global management and client strategy for the firm.

www.csplp.com