The Unbearable Lightness of Being a Fund 1/Emerging Manager (Part 3)

The ongoing vicious cycle of reduced M&A and IPO exit activity, which leads to limited distributions to LPs and subsequently causes a decrease in new investment activity due to a decline in investable capital, appears to be the primary topic of discussion among everyone in the private assets ecosystem these days. Throw into the mix the current economic uncertainty, and you now have a cyclone of paralyzing factors that affect all GPs but disproportionately impact new and emerging managers more adversely. In times of scarcity and doubt, most LPs retreat with their limited resources to areas of safety, which usually means sticking to the familiar and being more selective with investment choices. New and emerging managers are confronted with uphill battles in all economic climates; however, the current one is a perfect storm of adversities, with each day flinging a new Molotov cocktail of investor sentiment to navigate.

I believe the current heightened state of new and emerging manager angst has been a catalyst for increased requests for me to continue my “Fund 1” series of guidance to new managers. The first and second compositions were primarily aimed at GPs embarking on their maiden journeys. In this third installment of the series, I am broadening the scope to discuss scenarios that emerging managers are increasingly encountering in the current environment. Below are the headline points that were expounded upon in the previous writings.

- Your network is your saving grace.
- Avoid too many chefs in the kitchen.
- Beware of knights in shining armor.
- Capital is king, but information and connections also have value.
- Be creative.
- Avoid defensiveness.
- Learn the competitive landscape of your space.
- Build a catalog of frequently asked questions.
- Aspire to be institutional (even in the smallest ways).
- Why should we take a chance on you?

In this iteration, I want to highlight four specific situations that emerging managers have encountered and from which they have sought my thoughts and advice from an allocator’s perspective.

- **Investing while fundraising**: It is common for managers to start putting money to work from a fund they are still fundraising for. For new and emerging managers, investing while fundraising can be a high-risk endeavor because the pace of fundraising momentum and the eventual fund size are significantly less certain than for established managers. Like established managers, emerging managers recognize the importance of remaining relevant in a market that is continuously reading signals to evaluate the viability of potential counterparties. Long periods of inactivity can be detrimental to reputations and to attracting high-quality deals in the future. My advice here is for GPs to ensure that their first close (usually the green light that allows for investment initiation from the fund) is set at a dollar target that can (in the worst case scenario) be a standalone fund (albeit either with a smaller number of deals or the same number of target deals but with smaller bite sizes). A first close size discipline can also be critical in adhering to LP concentration considerations, as most LPs do not want to be a majority of any committed capital base.

Additionally, seeking alternative sources of capital to help keep a GP in the market is another worthy endeavor. Warehouse facilities and co-investment capital from early fund adopters and allies can be crucial for GPs to sustain a market presence without compromising on the preferred number of deals and/or ownership amounts per deal.

- **Lack of subsequent investor traction following a first close:** What happens when an emerging manager begins raising its second fund, completes a first close with re-ups from its most loyal Fund 1 investors, but then encounters a significant slowing of fundraising momentum? What does this manager do if the first close occurred over a year ago, and pushback from subsequent prospective LPs revolves around a lack of Fund 1 exits that can be used as proof of concepts, a systemic lack of liquidity in their portfolios, and general economic uncertainty? In this case, the manager has decided to halt all fundraising activities and is seeking advice on how to communicate this to closed LPs. This is undoubtedly an unenviable situation, but one that GPs face more frequently in the current environment. My feedback was to lean on honesty – this golden rule hardly ever fails in all GP/LP dealings. LPs are active participants in the investment space, so details about fundraising difficulty are not a foreign concept to them. A GP should lay out their plan to halt fundraising, provide clear reasons for this decision, state that they will be focusing on getting Fund 1 investments to exit, share insights about how the organization will (if true) be able to economically survive in the short term, and propose courses of action for capital that has been closed on. For the capital that has been closed on, a GP can provide options to LPs that should include a full release of committed capital obligations, an option to invest on a deal-by-deal (with LP discretion, and modified management fees) basis, and permission to go forward in a fund structure with a smaller capital base (while also seeking co-investment capital on a case-by-case basis). LPs prioritize transparency above all else, so a clear description of the situation along with options that don't make them feel steamrolled will typically elicit a positive response and preserve built goodwill.

- **How does one rebut the familiarity argument?**: I am guilty of this turning-of-the-table line of questioning, where LPs ask the GP why they should invest in a new manager in the current environment, where it would clearly be prudent to just stick with the familiar. This question is both fair and unfair. It is fair because it gives the GP a chance to make a case for its strategy among the many other options. However, it is unfair because the answer should be known based on its investment criteria. The answers to this question that resonate with me the most are when GPs emphasize and illustrate their immense hunger for success, demonstrate a higher degree of alignment with LPs compared to other managers, and argue for the desirable and nuanced sector exposure gained from being in their funds.

- **The uncomfortable situation of defending the whole asset class**: Many new and emerging GPs tell me that, aside from having to defend their own strategy, many LPs are increasingly asking them to justify investing in the entire private assets class at this point in time. To this very big ask, my advice is to fall back on the foundational elements of private investing, which include the rewards of portfolio diversification, the positive attributes of hands-on value creation, the advantages of reduced volatility from some shielding from public market fluctuations, and the ability to choose private strategies that agree with preferred and desired structural and sector exposure. From this base of understanding, a GP can then make an even more nuanced case for why its strategy is well-suited and why its approach to investing in the current environment provides added benefits. Statements like "If the current state of the market disillusions you, wouldn't you want your long-term capital to be in ……………………….?" typically work quite well when the narrative is clearly articulated.

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