Capital Fundraising for Alternative Investment Funds

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Capital fundraising is one of the most important and challenging tasks faced by alternative investment fund managers today. For many managers, it is the hardest part of their job. Current economic conditions and the vast array of investment products competing for investor attention have made the process of attracting new capital into private funds increasingly difficult.

EisnerAmper LLP recently held an event at the Mandarin Oriental, San Francisco on the subject of "Capital Fundraising for Alternative Investment Funds." The following highlights the key discussion points made by the panel during the event.

Having a Marketing Strategy Is Critical

Too many emerging managers make the mistake of adopting a "spray and pray" technique to fundraising. This is the exact opposite of a real marketing strategy because no actual plan exists. Under a spray and pray approach, the manager spends a lot of time and energy attempting to meet a large volume of prospects, which is physically and emotionally draining due to the effort and time required and the high level of uncertainty in results. The spray and pray manager is hoping for success without having first researched whether his plan provides any reasonable basis for believing that what he is doing will achieve positive results.

A more sophisticated approach involves a manager profiling the specific clients or client groups he wants to target to make capital contributions into the fund. This is applicable whether a manager is targeting institutional, high net worth or any other type of investors. By profiling targeted investors or groups, the manager will ensure that he understands, among other things, their background(s) and general philosophy, investing goals, time frame and turn-ons/turn-offs, risk/return tolerance and the amount of deployable assets. This allows the manager to learn how and why targeted investors or groups may or may not be interested in his fund. The manager can use this to identify relevant industry stories he can share with a prospect that demonstrate his philosophy, investment ideas or previous accomplishments to get their attention. Using the information learned through profiling, the manager can ensure he articulates his stories in the most effective way that check all of the boxes a prospect needs to check before he will subscribe capital.

Recent studies show that there are at least 8,500 U.S.-based hedge fund managers and 3,000 U.S.-based private equity fund managers operating today. However, if as thought, only one in three managers actually report results to databases, this could mean that there are closer to three times this number of hedge funds and private equity funds actually on the market. This emphatically demonstrates that the private fund domain is an extreme buyers' market and that the power resides with investors. A manager must carefully create his marketing strategy to be able to cut through all of the "noise."

All new funds undergo a pre-marketing period and a marketing period. The pre-marketing period must be used effectively to profile targeted investors and identify the service providers with whom the manager is going to partner. The choice of service providers needs to complement the fund, the manager and the types of investor groups the fund wants to attract (which must also be aligned with the amount of dollars the manager thinks he can raise and the fund's budget for service provider costs). The manager will also work with a fund formation attorney to create the most appropriate fund entity structure and offering documents for his strategy and targeted investor groups.

An emerging manager will also need to consider which parts and how much of his overall infrastructure he wants to outsource. The private fund industry is increasingly seeing more outsourcing, including the Chief Financial Officer and even the Chief Investment Officer functions. Generally, outsourcing can be a cost-efficient way to handle infrastructure and is not viewed as a negative by investors because it is perceived to increase transparency and provide an extra layer of objectivity about a fund's systems and reporting. This is especially true with respect to outsourcing fund accounting to an independent third-party fund administration firm. In the post-Madoff world, most investors insist on a manager outsourcing this process; recent survey results show more than 80% of alternative investment funds already outsource their fund administration function.

Emerging managers need to take the pre-marketing period seriously. Failing to properly complete this step can harm a manager's business and be counter-productive in the long run. It leaves the manager in danger of spending much of his time unproductively and risks burning multiple bridges within his network when the marketing period for his fund finally begins.

The Best Time to Raise Money Is Often When You're Not Raising Money

Even when he is not raising capital, it is still worthwhile for a manager to meet with prospective investors. Many investors are pleasantly surprised that a manager would even meet with them if he isn't specifically raising money for a fund. The meeting may just involve the manager wanting to share ideas; or explaining how he currently thinks about an asset class or, say, private equity generally; or discussing other asset management shops his firm competes with in that geographic region that he thinks of highly. This presents the manager as being willing to see beyond himself and talk about others he sees that are savvy in the industry. This educational process helps investors and allocators look and become smarter, and is appreciated.

A manager might say to an investor, "Here is my two-to-three-year plan for the fund. By all means, you can come in now, but just as importantly I also want to tell you my story as well as understand what you're looking for, because maybe we're not a perfect fit for each other right now but we might be in a year or two." The message of selling by not selling can be a powerful one.

By sharing with potential investors what the fund plans to do down the road, the manager can ask if he can revisit them again in a few months. The follow-up meetings can be used both to update prospects on the fund's significant achievements and to demonstrate that the fund accomplished all of the goals set by the manager during the previous meetings. The manager should seriously consider not taking the fund's PPM or subscription document to an initial meeting. This creates another valid reason to arrange a follow-up meeting with the investor where these documents could then be discussed.

Make a Strong Presentation to a Prospective Investor

A manager's marketing strategy is also his relationship strategy. Trust is often much more important to an investor than fund performance. People want to buy from people they like and trust. Experience shows that it is important for a manager to lead an initial meeting with a prospect by building the relationship between them and gaining the investor's trust rather than asking for money.

Talking to prospective investors can be condensed down into four areas: people, strategy, process and performance. A manager's pitch needs to address all of these. A strong presentation contains a succinct, simple, well-articulated story; it should not be long-winded or complex. A manager should never open a first meeting by offering a fee break. This can send a bad signal to an investor and make them wonder why the manager didn't want to first talk about his people, strategy, process and performance. The presentation must convey the message that the manager is excited about his own strategy and process. A manager is also strongly recommended to have some of his own money invested in the fund. Investors insist on a fund's manager having "skin in the game." This is a truth serum for investors.

Managers looking to raise approximately $1 million each from potential prospects are usually targeting the high net worth individual investor group. Many high net worth investors are "do-it-yourselfers" from an investing perspective. They also like to directly participate in the markets and make their own stock picks, alongside deploying capital with professional asset managers. Leading a pitch to such a prospect with ideas rather than fund terms is a way for a manager to put his best foot forward. By making people money, even if by just giving them good ideas, a manager will endear himself. Terms are often viewed by potential investors as a red flag and convey a much less positive experience than learning what is going on inside the manager's head.

The networks of high net worth individual prospects are immensely important. Historically it has not been uncommon to see pods of related investors in a single successful fund, and to be able to trace large chunks of capital subscriptions in the fund back to just one or two initial relationships. Capital fundraising in high net worth individual networks is largely about investor confidence and getting people to entrust a manager with a lot of money.

As well as getting to know potential investors, it is just as important to also meet with the advisor network an investor surrounds himself with, including his CPA, attorney and wealth manager. An investor will normally seek the counsel of his advisor network before making a major investment decision. Before the manager makes his presentation to a prospect, he should consider pitching the fund, its strategy and approach to the prospect's advisors and getting their seal of approval or "check mark." This can significantly expedite the prospect's own due diligence process because the investor's advisor network will already be familiar with the manager and comfortable with him cutting a check to the fund.

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A manager's chances of success with a prospect are always greatly increased if he can get someone to advocate for him who is also a trusted advisor to the investor. It is critical for a manager to learn the existence of and create mutual connections between himself and a prospect, including the investor's entire advisor network. Often this will provide the best validation of the manager's credentials.

It is very important for a manager to remember the dynamics of the fund product he is offering. If the fund charges a typical hedge fund fee structure of 2/20 but has a long-only portfolio, an investor will normally judge that fund manager's story and performance against other long-only managers rather than judging him against hedge funds in general just because of the fund's fee structure. It is important for a manager to not try to convince a fiduciary that his strategy is different from what his performance or fee structure suggests it is. This again speaks to the high importance placed by investors on being truthful and trustworthy.

Finally, when an investor is ready to commit capital, the manager needs to have an effective closing process. It is important to clearly communicate a close date, whether this is to enter a closed-end private equity fund or to join the next subscription round in a hedge fund. Psychologically, the close date leads to an "action plan" and advances the subscription in the investor's mind beyond just being a good idea. Managers are advised to state the fund's minimum investment amount during the meeting. Managers need to think through carefully what this minimum amount is (which will also be stated in the fund's offering documents), since invariably this is the amount the investor will subscribe rather than an additional amount. Finally, when an investor is mentally committed to the fund, the manager can often close the deal by asking, "Can I soft circle you for $XX on the next subscription date?"

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Get Out of Sales Mode

When initially approaching each potential investor, a manager needs to get out of sales mode and first find out what the prospect actually needs. Only then can he align the client's needs with how he can help. A manager who doesn't obey this rule will only be selling his fund to himself during a pitch meeting. A common mistake made by many new managers is to go after anybody with money as a target for the fund without knowing or finding out what exactly that investor is looking for in his portfolio or from his advisor.

The more a manager can get a prospect talking about his or her own business or personal situation, what they're looking for and the problems they are facing in their job or with their portfolio, the greater the connection that is established between them. Rather than just talking, the manager must be listening and understanding the problems the prospect is facing in his own portfolio that the manager can solve, either now or in the future. For example, the prospect may need to add something liquid or long or in a particular sector or asset class.

A manager has no control over when an investor will subscribe to his fund because it's not his checkbook to control. Oftentimes, a prospect just doesn't have the capital to deploy. If the manager walks out of the meeting having demonstrated how he can solve the particular problem the prospect is facing, he will have achieved the greatest likelihood of success he can reasonably expect from that meeting. He will remain in the prospect's mind when the money ultimately becomes available for investment at a later date. Based on the outcome of a meeting, prospects can be labeled A, B or C. This helps the manager prioritize who to follow up with later and how soon after the initial meeting.

Educational marketing can be an effective tool. Investors love to hear case studies and to be educated. A manager who is able to share with a prospect a well-structured real-life case study, describing how he identified an investment, how he sized it up and how he determined when to sell, can deliver a strong message. This is a great way for an emerging manager to distinguish himself from the pack. The manager is saying, "I'm not just going to show you my monthly performance; I'm also going to share with you a case study involving my fund and educate you with a pertinent story about an exit our fund just had."

Presenting a Track Record

In making an effective presentation to a prospect, a manager should look beyond just focusing on impressive returns and present as many meaningful metrics as possible. He should talk about the revenue growth of his portfolio companies, disassemble the sources of his returns and help the investor understand the sustainability and consistency of his returns. He should also consider discussing his (or the fund's) "batting average" and the size of his bets. A manager who can demonstrate his non-correlation to the market if it rolls over and his ability to preserve capital, get through a market downturn and identify value when it shows up will attract an investor's attention.

While doing all of this, it is vital to avoid trying to change history, for example by changing data to exclude certain events in order to present a track record in the best possible light. A manager needs to make sure his track record shows all "black eyes" suffered and all bad years.

There is an assumption among many investors that if a manager is not saying anything about certain facets of his fund then the reason must not be good. For example, if the manager only discusses gross returns in his presentation, a prospect may assume that net returns are unimpressive or disappointing. The solution here is to present both gross and net returns. Likewise, if the track record is only showing five years of data because the firm didn't exist prior to that, the manager should make sure this fact is clearly stated in his presentation. This avoids a prospect assuming the firm's track record was poor six or more years ago. A prospect is always expecting a manager to put his best foot forward in the clearest, most transparent way. Some managers neglect the really good and interesting parts of their story because they're not aggressive enough about "polishing the apples" they do have.

Should an Emerging Manager Make a Deal with Seed Capital Investors for a Piece of the General Partner Entity?

Giving away a piece of the general partner entity to a seed investor should only be used as a closing tactic during negotiations and never as an opening tactic. Emerging managers need to remember that in the long term, they will make their real money in this entity rather than in the fund. For this reason, an emerging manager must treat his general partner entity preciously and communicate to others that it is precious. Leading a proposal with an offer to give up a piece of the general partner entity gives the impression that the manager doesn't value his own crown jewels, since he is willing to give them away so readily.

A better approach for a manager is to wait until an investor is mentally committed to the fund and has begun negotiating terms and conditions. If the prospect wavers at this point, the manager can always ask if there is something in particular that would compel him to subscribe. The answer to this question could be anything, and likely will be much less expensive than a piece of the general partner entity. It may be that merely a fee break would get the prospect over the line.

A manager who elects to offer a piece of his general partner entity to a seeder should consider negotiating a sunset clause as part of the seed capital agreement. The seed agreement could be structured such that the seeder's ownership percentage of the general partner reduces to zero over time. The agreement could also contain terms to renegotiate the seed deal toward the end of an initial three-to-five-year period. This allows the manager to retain the power to take back full ownership of his investment advisory business in the future along with all of the income it generates. The ability to return the seeder's initial capital and no longer share a cut of the general partner's income is especially lucrative if the manager is successful! When negotiating a sunset clause with a seeder there is a trade-off between how much capital the seeder is willing to commit now and how much they'll potentially have to give up later. An emerging manager should keep the idea of a sunset clause handy for the back end of negotiations when a decision has to be made on the terms of the seeding deal.

It is very important for an emerging manager to keep in mind that the existence of a seed investor in a fund can affect the buy (or not) decision made by subsequent investors. The magnitude of this effect depends on who the seed investor is. If the seeder is well known or is someone the prospect has an existing relationship with and trusts, this likely enhances the probability of the prospect also wanting to have a relationship with the manager and his fund. If the seed investor is a sponsor that the prospect doesn't know or doesn't have a long-standing relationship with, this could be a business risk. Some allocators and investors don't want to subscribe to funds that have a sponsor or that are part of a bigger corporate platform. In these circumstances, the prospect is concerned that the manager isn't thinking exclusively about his fund's portfolio because he is also mindful of having to keep a major stakeholder happy.

Founders'-Fee Deals

It is important to distinguish between seed deals and founders'-fee deals. Under a seed capital deal, a manager elects to give up part of his general partner entity in order to secure a capital subscription to his fund. Under a founders'-fee deal, the manager is only giving investors who are in the first or early rounds of capital subscriptions a reduction on the fund's standard fee terms. However, if a manager gives a preferential fee deal to, say, the first $75 million subscribed to his fund, and then another potential investor comes along three years later, will the new investor also expect to receive the founders'-fee rate?

A number of funds have been observed in recent years offering distinct fee breaks below the industry norm, such as a 10% carried-interest or charging no asset-based (management) fee. The marketing team to one such fund admitted that they found it harder to sell this fund to prospects than a fund containing a standard industry fee structure because the fee break was perceived by investors to mean the manager or his fund must be damaged. No good deed goes unpunished…

Whatever fee structure an emerging manager chooses as part of his business model, it is vital that the management fee is sufficient for him to be able to live off of and also cover his operating overhead. In a year in which fund performance is down, the fund will likely only generate a management fee since it will have to exceed its high-water mark again before it can receive any of the more lucrative performance-based compensation (or carry). Negative fund performance exerts significant downward pressure on assets under management (AUM), through both P&L losses and investor redemptions. A reduced AUM will compound a manager's cash flow concerns by decreasing his next asset-based fee to be received from the fund. For this reason, an emerging manager needs to be careful when deciding how low to originally set his asset-based fee and founders'-fee rates to ensure these aren't discounted so low that he cannot continue to cover his business overhead.

Further, an emerging manager needs to consider what constitutes his "fee floor." This minimum fee level will generally rise over time as overhead increases due to extra regulatory costs and the expense of maintaining infrastructure sufficient to satisfy investors. In this respect, investors are almost at war with themselves because generally they don't want to pay a manager enough fees to cover his operating expenses, but at the same time, through their due diligence, they admit to placing a very high emphasis on his infrastructure. This issue again requires an emerging manager to be mindful of the critical AUM he needs and the advisory fees he must charge during the start-up phase in order to stay in business.