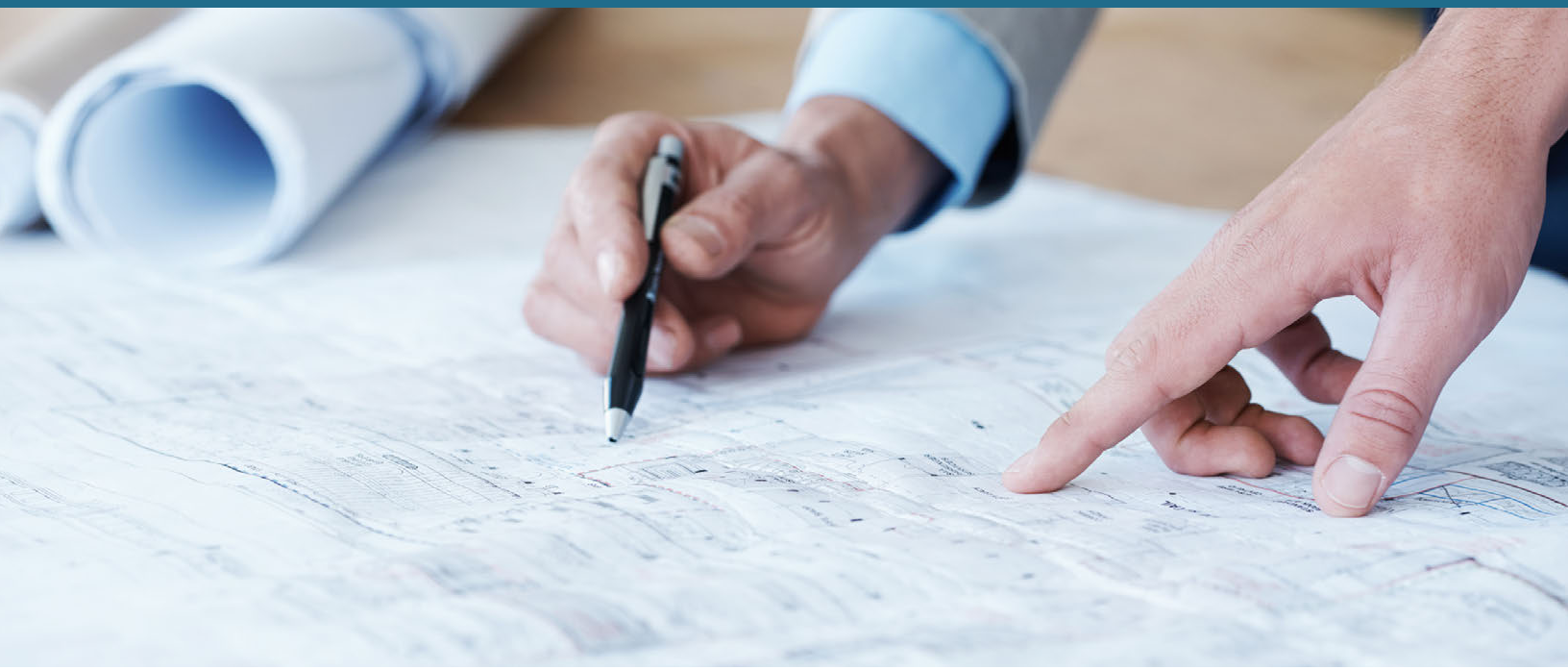
HOULIHAN LOKEY

EN PRIMEUR: A Guide to First-Time Fundraising



Private market first-time funds have significantly increased in prominence in the past decade. In 2017, $26 billion of capital was raised for 226 first-time funds globally, representing 25% of the total number of funds raised that year.[1] The reason for this rise in prominence is twofold. First, more investment professionals are willing to leave established companies to form new firms, and second, more limited partners are eager to support new platforms.

These market dynamics have not always been the case. As recently as 2009-2010, many emerging managers struggled to raise capital. LPs' views on such firms were that they were risky, and did not offer the potential to deliver outsized investment returns compared to established managers. Perceptions of both of these factors have changed over time.

[1] Preqin data

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With regard to risk, while market risk is present for all private managers, execution risk can be limited. As such, firms which are perceived as spin-outs of established teams from mature organizations tend not to be perceived as holding the same risk as first-time teams. Similarly, the ability of individuals to leave organizations with track records attributable to them is one way to convey successful prior investment experience to limited partners considering the new fund. Lastly, limited partners who are willing to be early supporters of the firm and who, through that support, allow the manager to reach a first closing will help reduce fundraising risk.

As it relates to the return potential of emerging managers, a study of 13,523 portfolio companies found that performance persistence has declined as the private equity industry has matured and become more competitive.[2] This means that the value to limited partners of supporting a manager across multiple funds, despite waning performance, is falling. Many LPs will now replace existing managers with new firms, along with data supporting the switch: in the 15 vintage years between 2000 and 2014, first-time funds have outperformed established peers on 13 occasions.

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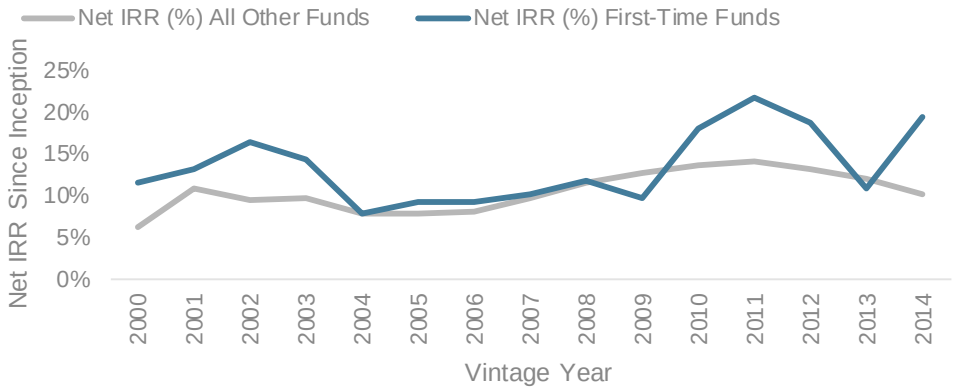
Private Equity Median Net IRRs by Vintage Year: First-Time vs. All Other Funds



The supply of new firms for LPs to invest in has also increased. Many investment (and operating) professionals, particularly those at the principal and junior partner level, are now able to take advantage of strong personal track records at larger organizations and avoid the slide away from investing towards broader corporate asset management that is prevalent at larger firms. This entrepreneurial drive, previously very challenging to capitalize on, is now increasingly supported by limited partners, who seek to back the teams within larger firms who have delivered the most value for the organization, regardless of the firm they work for in the future.

[2] R. Braun, T. Jenkinson, I. Stoff, How Persistent is Private Equity Performance? Evidence from Deal-level Data, (Journal of Financial Economics)

No. 1 Global Private Equity M&A Advisor

Source: Pitchbook.com 2017 ranking

No. 1 Global M&A Fairness Opinion Advisor Over the Past 20 Years

Top 10 Most Active Global M&A Advisor

No. 5 M&A Advisor for Global Transactions under $1 billion

Source: Thomson Reuters 2018 ranking

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Houlihan Lokey holds an indirect minority stake in Leonardo & Co. S.p.A., an investment bank with an office in Milan.

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As perceptions of the relative risk and return of new and established managers have changed, and barriers to entry have decreased, LPs have increasingly backed emerging firms. Preqin survey data highlights 59% of limited partners now invest or consider investing in first-time funds and spin-offs. As is often the case, however, first-time funds are not created equally, and many new firms do not successfully convince limited partners to support their funds.

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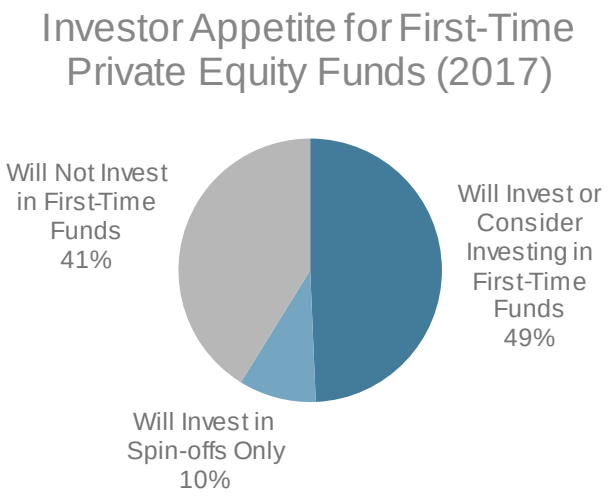


What does it take to succeed as an emerging manager?

While there is no definitive list of factors that can predict the success of a new firm, the following elements have all contributed to successful first-time fundraises in the past:

- Teams with experience in working together with main senior hires in place (more than just the founders)
- Attributable prior track record, or single deals post-departure to prove the concept
- A clearly defined, credible strategy that keeps the story simple
- Evidence of the team's ability to exit investments (i.e., fully execute strategy)
- Fund size is appropriate for the strategy, and supported by prior deal pace and future deal flow
- Attractive pipeline of investments
- Term sheet is in line with market expectations for the proposed strategy and team size
- Support from "early adopter" investors
- Demonstrated ability to offer co-investment
- Patience—most fundraises take more than 12 months and most capital is raised in the last six months of the fundraise versus the first six months

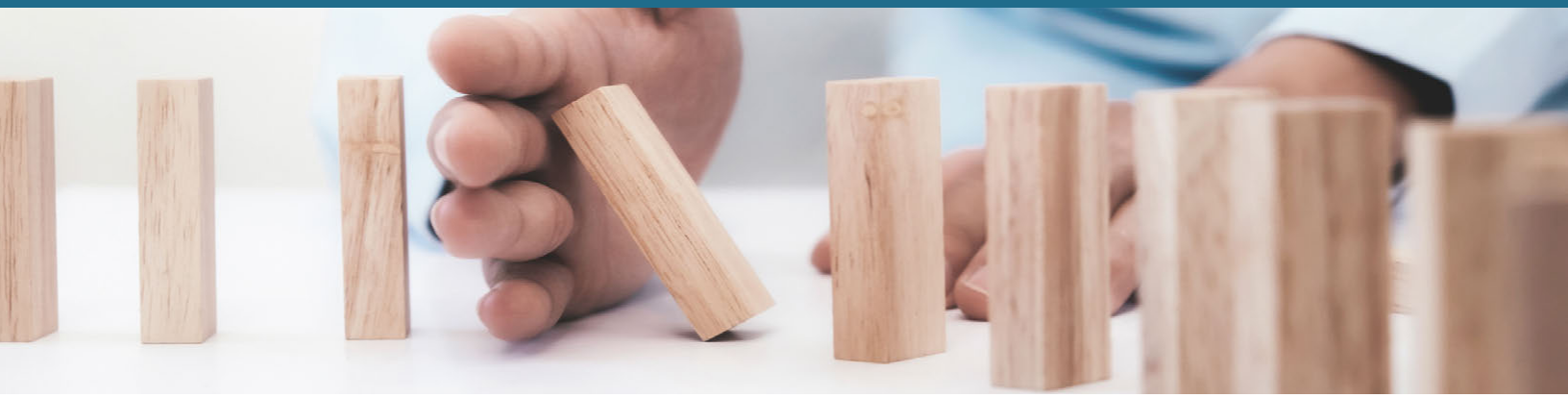
Even if a firm has many of these elements, fundraising remains a challenging and fundamentally inefficient process. The greatest challenge in converting an LP's interest into a commitment is no longer the lack of capital, but the lack of time to evaluate each opportunity. The ability to articulate a GP's story clearly, and in a way which differentiates the firm to others in the market, takes practice and patience—the hardest part of the process is reaching a first close. Once a first close has taken place, LPs who have chosen to "wait and see" how the story develops may reevaluate the fund.

If you're thinking of making the leap, what are the first steps?

> Sixty-four percent of GPs surveyed by the BVCA[3] recommended using a placement agent for a first-time fund, and for good reason: Preqin data shows that 43% of first-time managers using a placement agent exceeded their fundraising targets, compared to 23% of first-time managers who did not.[4] Furthermore, placement agents can give confidential early guidance on the optimal fundraising approach for the specific circumstances.

In addition, and ideally in conjunction with a credible fund formation counsel, take time to structure exit agreements to limit the prohibitions on solicitation of employees, solicitation of investors of the firm, and competition.

[3] BVCA, First-Time Fundraising Barometer, 2018
[4] Preqin data



What are the typical pitfalls, and how should you avoid them?

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Exclusive Placement Agent*

Many of the problems that present themselves in first-time fundraises are self-inflicted and avoidable. The following pitfalls represent the most common mistakes that new firms make:

- **Launching too soon to too many LPs**
  You only get one chance to make a first impression. Some managers approach a large number of LPs before the fundraising story is at its best. Once an LP declines a fund or loses focus, it's hard to revive interest.

- **Overcomplicating the story, or coming to market as a tweener**
  Many new managers either seek to do too much under one investment strategy, or create a strategy so unique that it doesn't fit within LPs' mandates. An agent will help you refine your messaging; the rule of thumb is to make your story unique, but still conforming.

- **Going alone**
  LPs will want to see a core investment team in place who have worked together previously, before backing a new manager; in addition, having only one partner or senior professional raises key man risk concerns.

- **Changing the strategy or fund size during the fundraise**
  One potential result of approaching LPs too early without the right fact pattern is that managers will then seek to make changes to chase LPs' strategies. The damage, often, has already been done.

- **The first deal isn't what LPs would expect**
  Make sure your first investment is entirely "on strategy." The first deal will define how LPs perceive your fund.

- **Not hiring an agent…**
  And then hiring an agent. Placement agents will add the greatest value when helping develop your firm's messaging, and positioning your story with LPs. While agents can still change the trajectory of a fundraise, the biggest impact can be made prior to and immediately following launch.

* Selected transactions were executed by Houlihan Lokey professionals while at other firms acquired by Houlihan Lokey, or by professionals from a Houlihan Lokey joint venture company.

Houlihan Lokey's Private Funds Group brings together extensive fundraising and in-house operating experience. Through this unique combination, we seek to maximize the efficiency and effectiveness of the fundraising process for general partners and provide tailored advice on the development and implementation of strategic initiatives designed to improve market positioning, investor relationships, and fundraising effectiveness over the long term. This is a unique alternative to legacy placement agency options.

Since 2015, members of the Private Funds Group have raised capital for eighteen first-time funds or emerging managers seeking first-time institutional capital, with total capital raised by those funds exceeding $3.9 billion.

Houlihan Lokey is a global investment bank with expertise in mergers and acquisitions, capital markets, financial restructuring, valuation, and strategic consulting.

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ABOUT HOULIHAN LOKEY

Houlihan Lokey (NYSE:HLI) is a global investment bank with expertise in mergers and acquisitions, capital markets, financial restructuring, valuation, and strategic consulting. The firm serves corporations, institutions, and governments worldwide with offices in the United States, Europe, the Middle East, and the Asia-Pacific region. Independent advice and intellectual rigor are hallmarks of the firm's commitment to client success across its advisory services. Houlihan Lokey is ranked as the No. 1 M&A advisor for all U.S. transactions, the No. 1 global restructuring advisor, and the No. 1 global M&A fairness opinion advisor over the past 20 years, according to Thomson Reuters. For more information, please visit www.HL.com.