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Feels like the first time

Analysis of first-time PE funds

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Key takeaways

- First-time PE funds have made a resurgence in recent years, driven by the broader exuberance in private market fundraising. In 2016, first-time managers raised $14.05 billion across 36 first-time vehicles, accounting for 8.3% of fundraising volume that year.

- Contrasting the underperformance of 2003-2005 vintages, first-time PE funds have outperformed follow-on funds in more recent vintages. For 2012-2014 vintages, first-time PE funds have produced a median IRR of 17.1%, compared to 10.8% for follow-on funds.

- Against a backdrop of intense limited partner interest for private market exposure, we expect first-time fundraising to continue growing in the near term. There are currently 26 first-time PE funds in the market that have held at least one preliminary close.

Why contribute to a first-time fund?

Every successful GP was unproven at some point, but each one had LPs take a chance by investing in their first fund. These new managers typically have not launched a fund on their own and lack the extensive infrastructure and resources of developed firms. Furthermore, they face an uphill battle of building a pipeline of potential deal opportunities and attracting other LPs to the fund. Why would an LP take the risk of committing to one of these first-time funds?

The possibility of building a mutually beneficial relationship with an emerging manager cannot be overlooked. Those who commit large funds early in a fundraise (often called "anchor investors") may be in a better position to negotiate preferential terms such as co-investment rights, management fee breaks or reduced carry. In the case of first-time funds, if the manager is successful, anchor investors may also be more likely—and sometimes have a contractual right—to get their preferred allocation in the second fund.

"The possibility of building a mutually beneficial relationship with an emerging manager cannot be overlooked."

While first-time managers may seem risky, they frequently outperform incumbents (whose past performance does not guarantee future results). First-time fund managers often focus on a particular strategy or sector, which can be a competitive advantage. Furthermore, first-time funds tend to be small relative to the broader market, meaning the target companies also tend to be on the smaller end of the spectrum; as we've shown in previous research, smaller deals tend to have lower purchase-price multiples. New managers may also be more motivated than established GPs, for not only do they have to build a track record to prove their merit to the market, but first-time managers often put a significant portion of their net worth into their first fund while the GP commitment from more established managers is likely to be less material.

Naturally, there are additional risks to consider with first-time fund managers since they are inherently unproven. Even if the investment professionals at a first-time fund have established a strong track record elsewhere, they may not have collaborated on the same team, or lack firsthand experience overseeing the compliance, reporting and the back-office operations necessary to manage a fund. In addition, the diligence required to properly vet first-time fund managers may be more intensive and costly, particularly relative to a re-up with an existing manager,

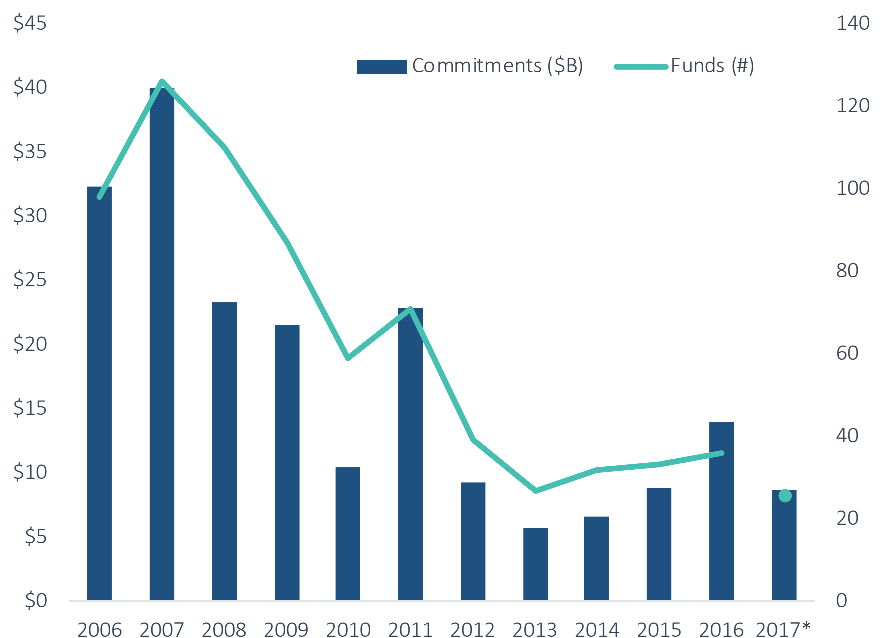
increasing the resources required to pursue such commitments. Given the resource requirement, larger LPs who need to make larger commitments to efficiently meet their target allocation to alternatives may find it even less appealing given that first-time funds tend to be (but aren't always) smaller.

"First-time funds accounted for 9.8% of all fundraising volume thus far in 2017."

Fundraising

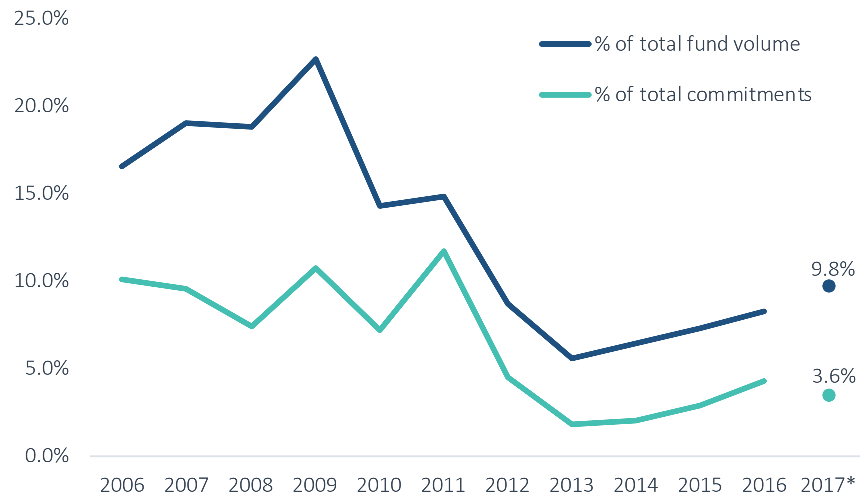
First-time funds have accounted for 9.8% of all fundraises thus far in 2017. That's nearly double the 5.6% we saw in 2013, but not even half of the 22.8% recorded in 2009. The proportion of first-time fundraises was elevated significantly the year after the crash because these emerging managers would have decided to launch a new fund in 2006 or 2007, when the broader fundraising market was setting new records. However, in the shakeout following the financial crisis, industry-wide fundraising subsided and would-be first-time managers became less likely to strike out on their own, resulting in just 27 first-time fundraises totaling $5.7 billion in 2013, a decade low.

First-time PE fundraising



Source: PitchBook. Data scope: global
*As of 8/22/2017

First-time PE fundraising as proportion of total



Source: PitchBook. Data scope: global
*As of 8/22/2017

"The extended bull market in fundraising since the crash has likely lent confidence to those considering opening their own shop."

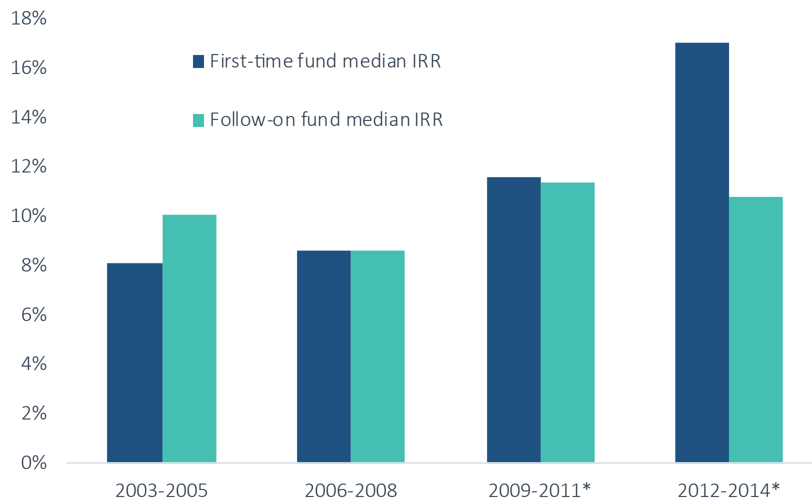
First-time fund managers have seen growth every year since 2013, both in terms of the number of funds and the percentage of overall fundraises they account for, likely due to improving market sentiment and the outperformance of first-time funds in recent vintages. Like the boom years in 2006 and 2007, the extended bull market in fundraising since the crash has likely lent confidence to those considering opening their own shop. Distributions to LPs of PE funds grew every year from 2009 to 2014, enabling LPs to recycle more capital back into new funds. In addition, the reverse denominator effect created by rising public equity valuations has forced LPs to increase their contributions to PE in order to maintain target allocations. Because of heightened fundraising, industry AUM has grown substantially over that period, and experienced investment professionals see an opportunity to participate in that upside.

Returns

The performance of first-time PE funds compared to that of follow-on funds has improved for more recent vintages. For vintages from 2003 to 2005, the median IRR of first-time PE funds is 8.2%, underperforming follow-on funds by nearly 200 basis points. By contrast, first-time funds from 2012 to 2014 vintages have produced a median IRR of 17.1%, well above the 10.8% produced by follow-on funds.

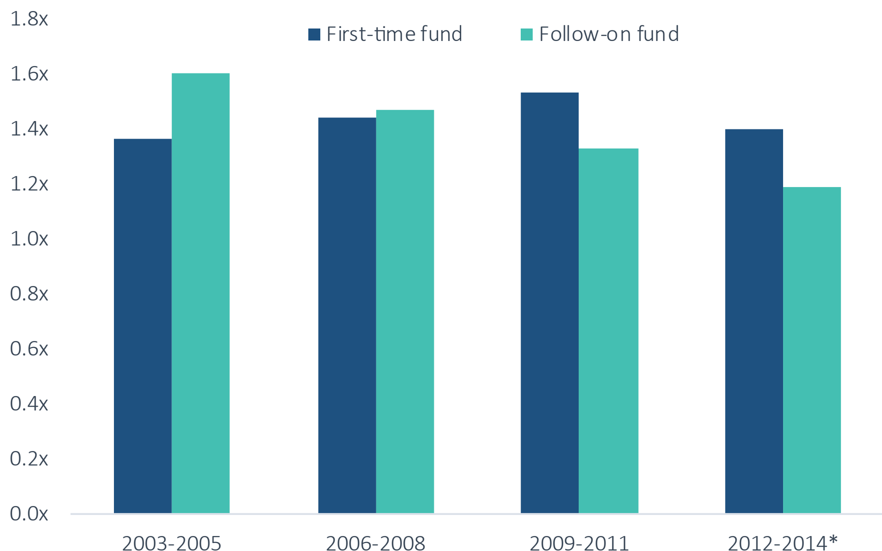
"The performance of first-time PE funds compared to that of follow-on funds has improved for more recent vintages."

First-time PE fund median IRR by vintage



Source: PitchBook. Data scope: global, using returns data through 3/31/2017
*2009-2011 first-time funds n=27, *2012-2014 first-time funds n=18

First-time PE fund median TVPI by vintage



Source: PitchBook. Data scope: global, using returns data through 3/31/2017
*2012-2014 first-time funds n=21

First-time PE fund median multiples

METRIC	2003-2005	2006-2008	2009-2011	2012-2014*
TVPI	1.36x	1.44x	1.54x	1.40x
RVPI	0.11x	0.41x	0.76x	1.07x
DPI	1.14x	0.92x	0.78x	0.24x

Source: PitchBook. Data scope: global, using returns data through 3/31/2017
*2012-2014 first-time funds n=21

Follow-on PE fund median multiples

METRIC	2003-2005	2006-2008	2009-2011	2012-2014*
TVPI	1.60x	1.47x	1.33x	1.19x
RVPI	0.10x	0.37x	0.80x	0.99x
DPI	1.42x	1.04x	0.54x	0.12x

Source: PitchBook. Data scope: global, using returns data through 3/31/2017
*2012-2014 first-time funds n=21

"The most likely explanation for the improving performance of first-time funds relative to their more established competitors is that first-time funds are more likely to pursue niche strategies, whereas incumbent firms are raising increasingly large pools for generalist strategies."

Similarly, cash-on-cash multiples for first-time funds of recent vintages have improved relative those of their peers. The median first-time-fund total value to paid-in multiple (TVPI) for 2012 to 2014 vintages is 1.40x, compared to 1.19x for follow-on funds. It should be noted that much of these first-time funds returns data for the 2012-2014 vintages (both IRRs and cash-on-cash multiples) include paper gains that are not yet realized; however, the same is true of follow-on funds within those vintages, so it remains likely that first-time funds from more recent vintages will continue to outperform once these funds are fully liquidated.

Taking out any effect from unrealized paper gains, first-time funds in more recent vintages have also returned more cash to investors. The median distributions to paid-in multiple (DPI) for first-time funds from 2012-2014 vintages sits at 0.24x, double the 0.12x returned by follow-on funds from the same period.

The most likely explanation for the improving performance of first-time funds relative to their more established competitors is that first-time funds are more likely to pursue niche strategies, whereas incumbent firms are raising increasingly large pools for generalist strategies. Other big firms are branching into new territory as they try to capitalize on their brand name; PE firms that used to focus on buyout deals now offer strategies targeting growth

equity, credit, and real estate. For example, Advent International and Thoma Bravo, two firms that historically focused on buyout strategies, recently announced plans for dedicated debt and credit funds. As firms raise larger funds and expand ancillary strategy offerings, investment professionals may find it more difficult to focus on their area of expertise, particularly if it's on the smaller end of the market. On the other hand, first-time funds managers may have a more targeted, and thus profitable, approach.

"Aided by the success of general private-market fundraising, and the outperformance of first-time PE funds in recent vintages specifically, first-time PE fundraising is poised to continue growing in the near term."

A second potential explanation for first-time funds' outperformance in more recent vintages is that, in general, today's first-time managers are more experienced than they used to be. Many of the investment professionals that strike out on their own now have plenty of experience at top-tier firms but also benefit from the greater motivation and focus resulting from having more skin in the game. For example, first-time managers of recent vintages include individuals with experience at firms such as Carlyle, H.I.G., and Apax.

A third, albeit more difficult to track, potential explanation is that well-established GPs haven't adequately prepared for the next generation of leaders to take over the firm. A lack of succession planning, and resulting lack of clarity surrounding career prospects, could incent the most capable rank-and-file employees to strike out on their own.

Conclusion

Aided by the success of general private market fundraising, and the outperformance of first-time PE funds in recent vintages specifically, first-time PE fundraising is poised to continue growing in the near term. Currently, there are 26 first-time PE funds in the market that have held preliminary closes on a combined total of $3.66 billion. Additionally, there are 86 first-time PE funds in the market that have not yet held a preliminary close.

In addition to the proliferation of fundraising, we expect first-time PE funds to continue their outperformance of follow-on competitors, due mainly to their likelihood of employing more niche strategies.

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