PitchBook

First-Time PE Funds Overview

Examining performance and fundraising trends

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Contents

Key takeaways	1
Introduction	2
Fund performance	2-4
Fundraising trends	4-5
Raising a first-time fund	6-7
Looking ahead	8

Key takeaways

- Our research finds that first-time funds do not deliver statistically significant outperformance using cash multiples compared to non-first-time funds, even when compensating for size differences. Comparing IRRs presents a more complex picture in which first-time fund mediums sometimes underperform. However, the data also shows that first-time funds deliver outsized returns (more than 25% IRR) more frequently, deliver poor returns (less than 5% IRR) less frequently, and return capital more quickly.

- In recent years, first-time fundraising has held steady as a proportion of PE fundraising overall, including in 2020. Tailwinds in booming sectors such as technology and healthcare may have partially offset the pandemic headwinds.

- Although raising a first-time fund is a difficult and labor-intensive process for both LPs and GPs, the playbook for first-time fund managers has expanded. Options for new GPs now include developing a track record as an independent sponsor before raising an institutional fund, seeking backing from a seeding platform, and securing an anchor commitment. Common investors in first-time funds include family offices, large institutions with emerging manager programs, and funds of funds.

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Defining first-time funds

While "first-time fund" may seem like a straightforward description at first glance, opinions differ on whether a fund can be considered a GP's first if, for example, the partner(s) previously operated as independent sponsors or managed a very small friends-and-family fund or SBIC (Small Business Investment Company).

In this and subsequent PE emerging manager research, we define a "first-time fund" as any first institutional fund raised by a GP, and "first-time fund manager" as a GP who is raising or has raised only one institutional fund. We define "emerging manager" using the same criteria but encompassing the first through third funds. In both definitions we exclude joint ventures and special purpose vehicles (SPVs) created by established GPs or LPs to explore new investment strategies.

Introduction

There are several competing narratives around investing in first-time managers. For LPs looking for a performance edge, the concept of the "hungry" emerging manager—whose existence as a GP depends on the first fund's performance—represents a compelling investment thesis. While several studies have suggested that first-time funds outperform comparable more-established funds, there is some confusion as to how much of this outperformance results from a first-time fund's smaller size, since smaller funds also tend to outperform. In fact, many LPs commit to first-time funds precisely because they are "pure strategy" plays, with managers who left large generalists to focus on a specific niche of expertise.

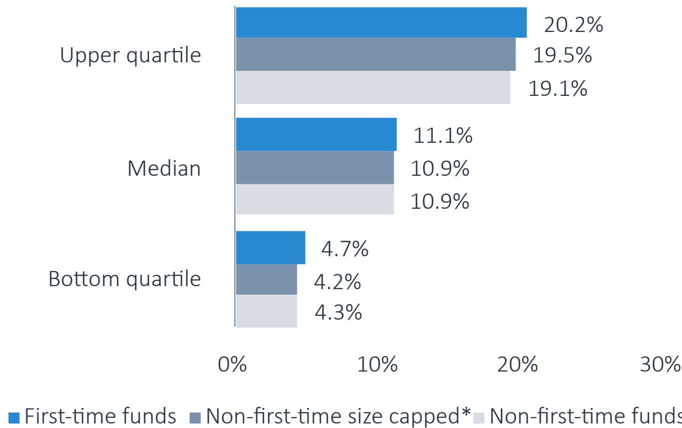
For other LPs considering first-time funds, the small size of investments will hardly budge the needle, even if an outsized return is achieved; instead, these LPs are focused on building relationships with the next generation of great managers, which allows the LPs to have preferential access to their larger funds as the firm matures. Another class of LPs, including several of the largest pension funds, operates emerging manager platforms that often explicitly aim to invest with diverse managers (either women and/or minority owned). However, the demographic profile of first-time fund managers still mirrors that of PE funds overall—about seven in 100 managing directors are female for both first-time funds and all PE funds.

Fund performance

Despite the narrative around first-time funds outperforming their more-established peers, our data suggests outperformance levels are minimal in aggregate and sporadic in timing.

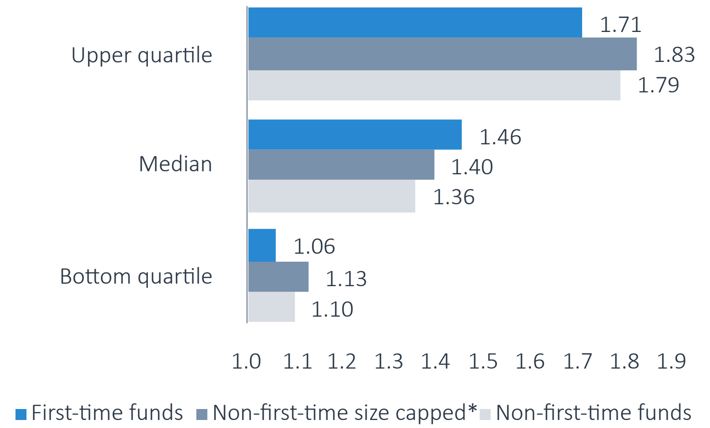
Comparing first-time funds to more established funds shows first-time funds outperform by approximately one percentage point or less for IRRs across the bottom quartile, median, and top quartiles. It should be noted that first-time funds do hold the performance edge in each IRR quartile, even compared with other funds under $1 billion. Looking at cash multiple returns, the results are clearer. But again, the difference between first-time funds, non-first-time funds, and sub $1 billion non-first-time funds is negligible across the bottom quartile, median, and top quartile. This nuances the notion of significant first-time fund outperformance and indicates that it is more important to pick top quartile managers, regardless of the number of the fund from which the manager is investing.

IRR quartiles by fund type



Source: PitchBook | **Geography:** US
*Fund size capped at the size of the largest first-time fund in each group.

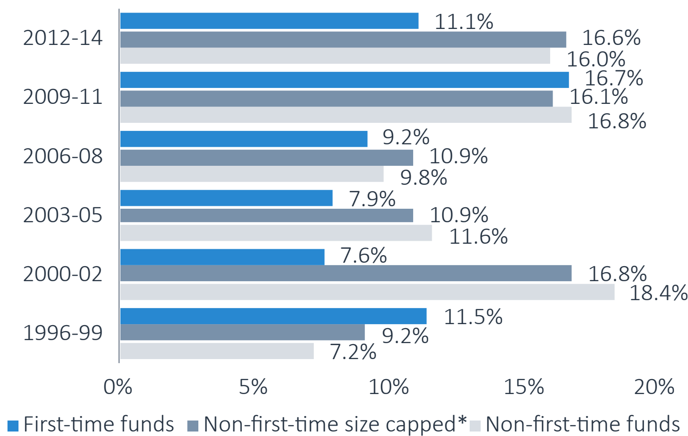
TVPI quartiles by fund type



Source: PitchBook | **Geography:** US
*Fund size capped at the size of the largest first-time fund in each group.

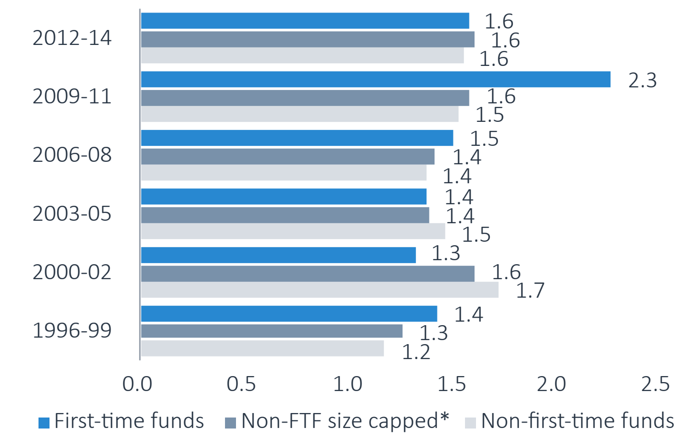
Comparing IRRs and cash multiples by vintage cohorts allows us another option for slicing the returns data. While the results appear inconclusive, with first-time funds outperforming in some instances and non-first-time funds outperforming at other times, one aspect does stand out. In recent years, first-time funds have delivered healthy cash multiples but have come up short compared to non-first-time funds using IRR. This may be for multiple reasons, including that first-time funds may take longer to exit portfolio companies, which would drag down the IRR. Non-first-time funds may also be able to secure dividend recaps more easily than their first-time peers and may be better versed in using capital call facilities, which would boost a fund's IRR while having little effect on the cash multiple. This highlights the importance of including cash multiples when comparing performance across fund types and vintages.

Pooled IRR by vintage cohort



Source: PitchBook | **Geography:** US
*Fund size capped at the size of the largest first-time fund in each group.

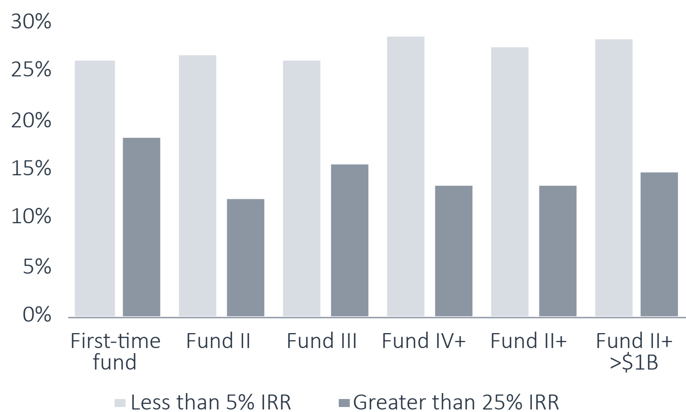
Pooled TVPI by vintage cohort



Source: PitchBook | **Geography:** US
*Fund size capped at the size of the largest first-time fund in each group.

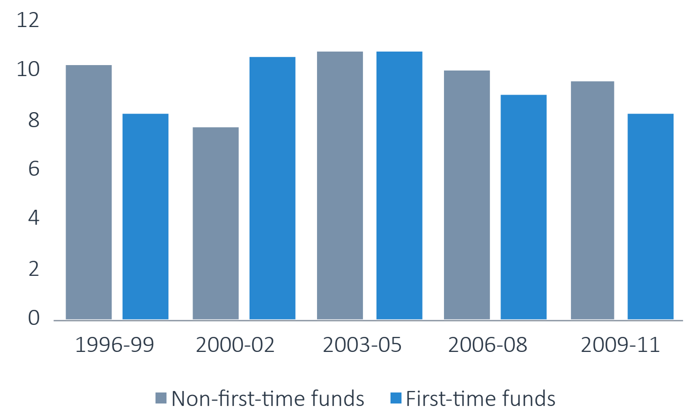
The data reveals that first-time funds have a level of downside risk that is similar to more established vehicles. First-time funds have just over a 25% chance of achieving an IRR of less than 5%, marginally lower than second, third, and other funds. The bull case, however, does appear more promising, with first time funds delivering IRRs of more than 25% most frequently—at 18.3% of the time. Similarly, although first-time funds often post lower IRRs than more established funds despite equal cash multiples, first-time funds have a quicker payback period.

Performance outcome by fund number



Source: PitchBook | **Geography:** US

Years until DPI ≥ 1.0



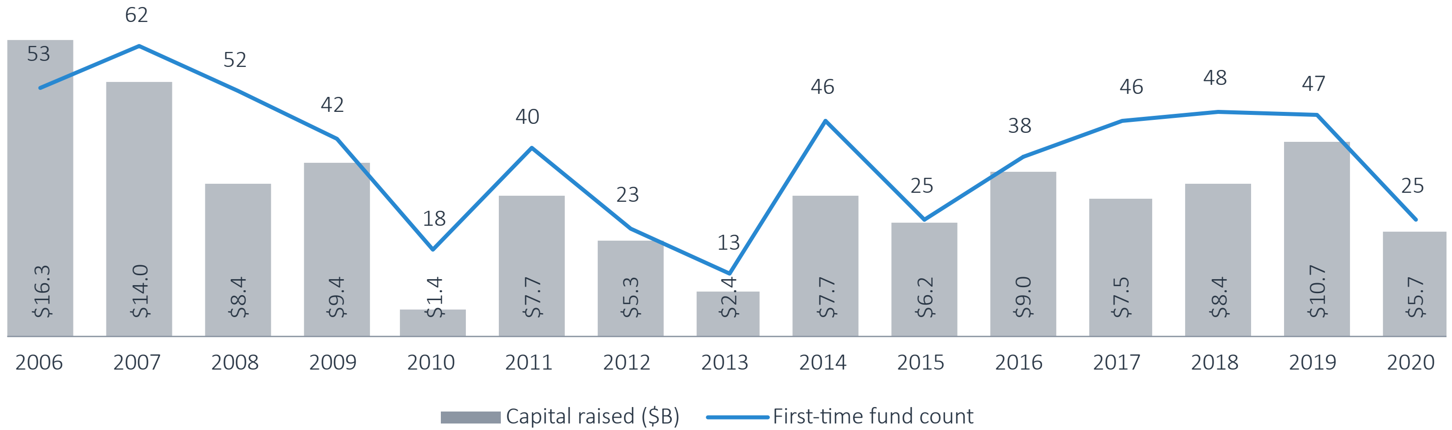
Source: PitchBook | **Geography:** US

Fundraising trends

The run up to the global financial crisis (GFC) was the heyday of first-time fundraising. During this period, the private equity industry was less developed, resulting in more opportunities for new managers to prove themselves. First-time funds accounted for around a quarter of all PE funds raised from 2006 through 2009 before plummeting in 2010. (The effects of economic downturns lag in fundraising numbers due to the roughly 1- to 2-year fundraising period.)

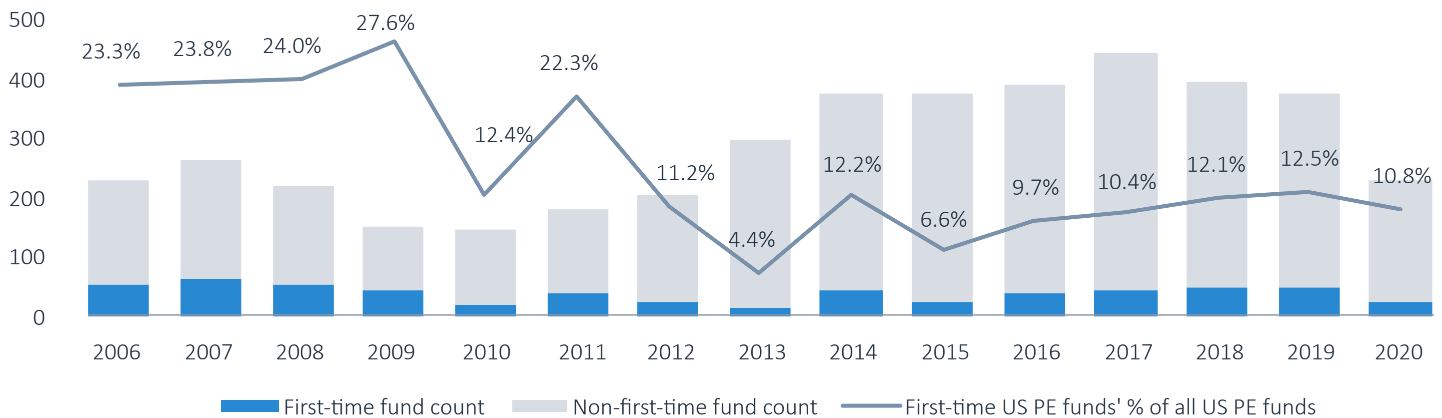
Since the GFC, LPs have been more conservative in their allocations to first-time funds. The unprecedented buildup of dry powder in recent years has been driven not by new entrants to the PE manager landscape, but by investors' appetite for mega-funds as well as established managers launching new strategies and entering new geographies. Meanwhile, first-time fundraising as a percentage of funds raised overall has held relatively steady since the mid-2010s. This includes 2020, a year that many observed anecdotally to have been particularly challenging for first-time fundraisers because of the problems posed by conducting due diligence without in-person meetings. Although the number of first-time funds raised nearly halved from 2019 to 2020, the drop-off was commensurate with overall declines in PE fundraising. This may be because funds that closed in the earlier part of the year had already completed most of their fundraising before the COVID-19 pandemic hit. The pandemic may have even provided a tailwind for firms that specialize in resilient, fast-growing sectors such as technology and biotechnology. It remains to be seen whether there will be a lagged decline in the proportion of first-time funds raised in 2021, but our PE outlooks are predicting the best numbers in more than a decade.

First-time fundraising activity



Source: PitchBook | **Geography:** US

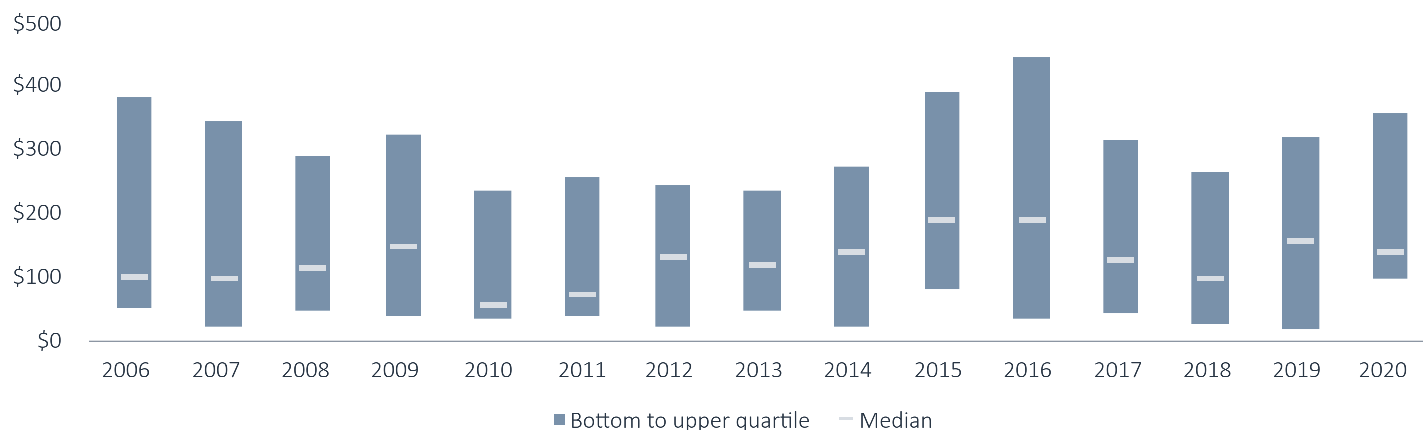
First-time fund count (#) as a proportion of PE funds



Source: PitchBook | **Geography:** US

First-time fund size has held relatively steady over the past decade, with the median first-time fund hovering roughly between $100 million and $200 million. Notably, in down periods for first-time fundraising—such as 2010, 2013, and 2020—the spread between top- and bottom-quartile fund size tends to compress. This may be because GPs raising larger first-time funds rein in their aggressive targets while LPs allocate less capital to fewer first-time vehicles in times of relative pessimism.

First-time fund size quartiles



Source: PitchBook | **Geography:** North America

Raising a first-time fund

Raising a first-time fund is difficult and labor intensive for LPs and the GP. The due diligence process is notoriously arduous, and first-time managers may have to fund company expenses out of their own pockets for years. Since first-time fund managers often lack fully attributable track records, prospective LPs lean heavily on references to determine what role the manager has played in dealmaking—from sourcing through execution—and portfolio company management at their prior firm. However, the playbook for raising a first-time fund has more options now than before the GFC, providing first-time managers more routes to raising a fund than ever.

One path to raising a first-time fund is to build a track record as an independent sponsor. This route is more frequent for teams that have not worked together before, are leaving less well-known firms, or do not have a background in the PE industry. These are individuals or small teams who make investments on a deal-by-deal basis, securing funding from select LPs only after an attractive deal has been identified. While some independent sponsors choose to work outside of the closed-end fund structure because they are seeking flexibility late in their careers, others are working to build a track record of fully attributable investments that will allow them to successfully raise an institutional fund in the future.

However, the preferred route for most managers is to immediately attract LP capital in a commingled fund. While there is no "typical" first-time fund LP, family offices are often seen as more likely to invest in first-time funds. This is because they are more incentivized to seek outperformance than large institutional investors, whose managers are more likely to prioritize mitigating downside risk and must work within stricter legal and compliance bounds. The smaller fund size, aligned interests, and entrepreneurial spirit of first-time managers also appeal to family offices. First-time fund GPs can also benefit from participation in the emerging manager programs offered by many larger institutional investors, such as Invesco and CalSTRS. These programs invest in early institutional funds and often aim to back firms with female and/or minority partners. Finally, funds of funds—especially those that target investors

operating in the lower middle market—are also a common port of call for first-time fund managers. For example, 45 of the 103 funds invested in by Siguler Guff's small buyouts program are the GP's first institutional fund.[1]

Arrangements that facilitate the launch of first-time funds while providing LPs and GPs the opportunity to benefit from preferred terms have proliferated in recent years. Several firms are now in the business of "seeding" first-time funds. Although the terms of these investments are highly bespoke, they typically involve the seeder making a significant commitment to the first fund accompanied by an agreement to share in revenue or management fees and carry, which usually tails off in subsequent funds. First-time funds may also benefit from the use of placement agents or from relationships with banks and consultants, who can make introductions to potential LPs and lend brand-name credibility. Many first-time managers may seek an "anchor" commitment—a relatively large commitment that often comes in before the first close from an LP or a fund of funds—that in theory helps to encourage other LPs to come on board. LPs and fund of funds GPs who make anchor commitments are often able to negotiate favorable fees and terms. How much of a discount the anchor provider secures depends on the size of their commitment and how early in the fundraise it is, as well as the new manager's other fundraising prospects. In some cases, though, confident first-time funds forego any anchor commitments because they are unwilling to give the economic advantage to an outside party. In researching this analysis, our analysts held discussions with a couple of managers who raised their first funds sans anchors.

Looking ahead

In future research on the space, we will dive deeper into the emerging manager space, including the rate at which first-time funds raise subsequent funds. Many LPs worry about the attrition rate for first-time managers and prefer to build relationships that last decades. We will also explore the issue of style drift and fund step-up size. While some LPs back emerging managers with the aim of building relationships with tomorrow's mega funds, others are seeking exposure to niche, smaller-cap strategies, which may lead them to part ways with emerging managers as they raise larger funds. Finally, we will also evaluate whether sophomore funds, third funds, or later funds deliver the outperformance LPs are seeking.

1: Kevin Kester, Telephone Interview, Jan. 28, 2021.