Trends in Fundraising

The Private Equity Lifecycle - Part 1

White Paper

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Introduction

The new Private Equity Lifecycle series from Merrill DataSite is designed to keep you informed on trends and help you gain competitive advantage through each transactional stage. This first chapter focuses on the key elements to consider in developing your fundraising plans, as well as how factors, such as the global recession and regulatory changes in the EU and the U.S. are altering the way investment firms market their funds and solicit investors.

Key Elements to a Successful Fundraising Plan

At its core, an effective fundraising plan looks somewhat like a standard business plan – it will require a well thought-out strategy, a clear assessment of the competitive landscape, a concise definition of your fund and how it is differentiated from others, plus a well-executed communication plan to reach potential investors. On top of that, fund managers need to consider industry-specific and regulatory requirements.

We consulted Kelly DePonte, partner at global advisory firm Probitas, for practical advice in establishing an effective plan. Following is a shortlist of best practices to consider:

1. **Establish the team.** A first time fund needs to establish a key core team that is openly committed to the fund before it launches. All of those team members must be disclosed when the fund launches with no key member being held back in their commitment until the fund has a first close. For an established fund, all key members of the team must be committed to the management team at least over the proposed investment period of the fund – which means the economic splits and the specific roles must be agreed too. Having a key staff member depart in the midst of fundraising, because these issues were not settled in advance, can kill the process.
2. **Review your strategy.** This point can often be overlooked because it can be easy to assume the fund team members intuitively understand it. The strategy should be a living document that is periodically discussed and modified as market conditions and business needs change. The entire team must speak with one voice while fundraising.
3. **Seek fund formation legal advice.** If this is your first fund or if your firm has not been in fundraising mode for the past five years or so, seek the advice of a fund formation attorney (FFA) to ensure compliance with current formation requirements. Also, it's best to interview not one, but several FFAs before choosing an attorney.
4. **Consider the advice of placement agents.** These professionals have their finger on the pulse of the market and are invaluable in learning about the competitive landscape, investor preferences and other keys to successful fundraising. DePonte recommends talking to several placement agents, even if your firm decides not to go on to use an agent and instead raises the fund on its own. "These conversations will give you a good feel for the marketplace and help you identify issues you may face in your specific area," he said.

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5. **Seek early, informal feedback from your largest LPs.** According to DePonte, this is a critical step in refining your strategy and also in preventing surprises. "It's wise to test the waters through informal conversations with the largest LPs on your advisory committee," he said. "They tend to be more sophisticated investors with in-depth knowledge related to industry, geography, timing, size, etc." Going to market without doing this can be very damaging. "The fallout can be huge," said DePonte. "For example, a key investor may decide they are not going to reinvest in the new fund, resulting in a large liquidity issue. This is a risk you want to know about and address well beforehand."
6. **Revisit your pitch.** If this is your first fund, take time to craft your pitch to truly address your investors' needs and questions. Or, if it's been five years since your firm last raised a fund, you may find that a standard pitch from five years ago is no longer appropriate. Make sure your messaging clearly and concisely differentiates your fund from all the others. Solicit objective feedback and refine accordingly. "Many fund managers think they're doing this, but they're not," said DePonte. "Unfortunately, too many end up sounding exactly alike."

The Keys to Effective Marketing – Plan for Change

Today's fund managers also face an environment where marketing strategies are evolving. The days of "traditional" marketing for investment funds are long gone as fund managers face increasing competition from new funds entering the marketplace. Attracting the right kind of investors is now a long-term rather than short-term practice. "Pre-marketing is no longer something you focus on getting done in the three months before launching your fund," noted Toby Mitchenall, director of BackBay Communications. Mitchenall, who advises private equity firms on branding, marketing and public relations, sees a general trend where pre-marketing activities have blended with investor relations and have become a constant relationship-building exercise with new and existing investors.

"Those funds that successfully raised capital in the wake of the financial crisis did so by maintaining a healthy dialogue with limited partners and being very consultative about their upcoming marketing effort," said Mitchenall. "There is also an increasing recognition among the best private equity firms that their communications programme should go beyond their investors to the market as a whole; if the market never hears from you, and the media never writes about you, then people will start to think you are inactive… that you are lagging behind the competition."

At the same time, investment funds are dealing with new regulatory changes in the way they market their funds. In the European Union (EU), investment funds must be prepared to adapt to more stringent regulations introduced by the Alternative Investment Fund Managers Directive (AIFMD), while in the U.S., private equity firms are seeing new marketing opportunities as bans on general solicitation are being lifted.

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The AIFMD Looms Near – What's Your Approach?

Alternative investment funds (AIFs) targeting European investors are facing significant change very soon, when the AIFMD takes effect in July 2014. This directive, which became law in July 2013 with a one-year transition period[1], represents the first pan-European regulation of alternative investment fund managers (AIFM) and, in many European countries, the first time fund managers have had to adhere to any regulation whatsoever. The AIFMD impacts AIFMs based in Europe, as well as any AIFM that markets its funds to EU investors. Different rules apply depending on whether the AIFM has its registered office in the EU and whether the AIF is an EU AIF.[2]

In effect, the AIFMD will require AIFMs to become authorised in order to market funds in the EU and adhere to a new regime for doing business. This will include increased capital requirements, a higher level of reporting and disclosure, possible changes to a firm's legal and organisational structure, and changes to risk management policies. When an AIFM becomes authorised, it will be granted a pan-EU marketing pass that will allow it to market to professional investors across the EU.[3]

While there are some clauses that exempt certain funds from having to obtain this passport, any AIF seeking to market to EU investors will need to be AIFMD-compliant. As Private Equity International (PEI) noted in a recent white paper, "It may be hard to market a fund at all without an AIFMD passport and therefore there may be an advantage to getting authorised before July 2014 if an AIFM wishes to market a fund during that year to professional investors in the EU."

According to Heather Stone, partner at Edwards Wildman and chair of the firm's Fund Formation practice, firms are falling into two general groups regarding their strategy to address the new marketing environment: those who are resigned to compliance and those who are looking for an exemption from it.

Many non-European funds are taking a step back on marketing in the EU while the AIFMD continues to take shape. "Private equity firms that have a European office may have little choice but to determine what is required for compliance," she said, "But many PE firms who've been marketing in Europe but do not have an office there, have simply chosen to discontinue their marketing efforts for now and rely on limited partners coming to them."

1. The one-year transition period applies to EU-based AIFMs. There are different, state-by-state transition rules for non-EU AIFMs. **2.** Simon Witney, King & Wood Mallesons SJ Berwin, "The Alternative Investment Fund Managers Directive: Main provisions and implications for private funds," Private Equity International, The Private Fund Compliance Forum 2014. **3.** Simon Witney.

One of the challenges with interpreting the impact of the AIFMD, according to Stone, is that the directive is not being implemented in a standard way across all EU countries. Therefore, PE firms must weigh their risks and opportunities on a country-by-country basis. Based on her firm's extensive research, she sees EU countries falling into three general categories:

Firms that move ahead on marketing trips without researching the AIFMD and seeking counsel may find themselves accidentally subject to compliance.

1) Countries, such as the U.K. and Germany, that have begun implementing the AIFMD in their home country and have clear transition rules (particularly for non-EU based AIFMs) in place
2) Countries, such as Denmark or Sweden, that are in the early stages of considering the AIFMD, but lack clear transition rules
3) Countries, such as Austria, France or Ireland, that have yet to begin to address the impact of the AIFMD in any substantial manner

Stone strongly recommends that any firm whose strategy includes marketing to EU investors seek legal advice before making any moves. "If you are likely to be captured by the AIFMD because of an EU office or an EU AIF, consult with a qualified attorney to understand what will be required on a state-by-state basis," she said, "Non-EU AIFMs seeking to avoid unintentionally becoming subject to AIFMD, at least at this early juncture, would be well advised to consult with an experienced U.S. attorney to learn how they can manage their activities appropriately going forward."

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Impact of the JOBS ACT on Marketing Funds – Who Are the Early Adopters?

With the passing of the Jumpstart Our Business Startups (JOBS) Act in 2012, both U.S. and international firms have now gained the means to publicly market their funds to U.S. investors. Prior to the JOBS Act, investment funds traditionally worked in a very quiet manner to attract investors to securities offerings conducted under Rule 506. This approach offered one significant positive in that firms were able to sell securities with no dollar limitations to up to 100 accredited investors, or even more "super accredited" or "qualified purchaser" investors.

However, the quiet approach also meant very limited marketing. General solicitation through television, radio, print or Internet advertising was not allowed, so firms had very few ways to gain introductions to wholly new investors. This challenge led many private funds to retain placement agents because the SEC allowed an issuer to market to a placement agent's pre-existing substantive relationships, even if the issuer had no such direct relationship.[4]

The gateway to broader marketing practices opened up when the JOBS Act repealed the ban on general solicitation and advertising for securities offerings conducted in compliance with new Rule 506(c). Now, firms can engage in general solicitation, provided they adhere to certain guidelines. A firm:

1) Must file its Form D with regulators 15 days in advance of the general solicitation
2) May engage in general solicitation, but can only sell to accredited investors
3) Must take steps to validate that potential investors fall into the accredited investor category
4) Must also take steps to identify all persons covered by "bad boy" disqualification rules[5]

Compliance with the new guidelines is critical. Firms that are found to be out of compliance run the risk of being banned by the SEC from raising a fund for a period of one year.

Some firms may believe it is safer to stick with the old rules, but this is not necessarily so, warns Stone. "The SEC has also pointed out that the old rules were in place for decades and over time people have gotten a little more loose with what they did. So there is a new focus

4. Kirkland and Ellis, "SEC Adopts JOBS Act Rules Allowing Public Marketing of Private Fund Securities," The Kirkland Pen, July 17, 2013. **5.** This requirement now applies to all Reg D offerings, even those under the "old" rules.

on people's current and historical practices as part of implementing these general solicitation rules," she said. "So they're saying in effect, 'We're not at all saying that what you did before (just because you did it before) was in compliance. You may think you're not generally soliciting, but we think you are.'"

Slow Adoption by Alternative Investment Funds

What is interesting is that, despite the opportunity, the new rules on general solicitation representing investment funds have been rather slow in taking advantage of them. In Stone's opinion, this is more due to a perception of reputation than any other reason.

"So much of the private equity industry is about a firm's perceived reputation in the marketplace," she said, "I think many firms believe that if they pursue general solicitation, they'll be perceived as being a more available commodity, or a 'weaker' group. It's a mindset of, 'you shouldn't need to generally solicit – you should be oversubscribed with investors beating down your door.'" Also, large institutional investors don't choose funds to invest in based on general solicitations. Almost by definition, general solicitation is more targeted at individual investors.

Where Stone does see PE firms getting exposure to the general solicitation practice is through capital raising efforts by their portfolio companies, so they are very informed of the risks by virtue of managing ten or 15 of their companies through the process. Other PE advisors have noted that this is a typical trend. They expect to see smaller funds taking advantage of the new rules first, with mid-sized and large funds coming aboard when the practice is more accepted.

Bottom Line: Revisit Your Fundraising Marketing Practices – Old and New

Whether your firm is still practicing fundraising and marketing under the "old rules" or plans to begin to take advantage of the new general solicitation rules, consult with an attorney to put the right processes in place. It also pays to be prepared for change. Getting a grasp on the new general solicitation rules can give your firm a competitive advantage in getting in front of new investors where others may lose out.

Technology That Can Enhance Fund Marketing

Fund managers continue to invest in technology to sharpen their fundraising acumen. Tools, such as data analytics, which are increasingly being adopted by PE firms and corporates to identify targets, can also be useful in refining the search for investors.

Virtual data room (VDR) technology has also taken on an increasingly important role in helping M&A professionals navigate in dynamic global markets. A top-quality VDR platform can be a command centre to support every stage of the PE life-cycle from fund raising to IPO, M&A or divestiture. Perhaps most importantly, today's Internet-based VDRs have given investment funds a secure platform to market from and exchange intelligence all over the world.

Merrill DataSite would like to thank all those who contributed to this paper, with special thanks to BackBay Communications.

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