The Five Tools of Private Equity – Part Five: Fundraising & Series Wrap-Up

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Can't spend it if you don't have it.

This scene has played out an uncountable number of times in small conference rooms across the world: a team of a few, haggard from late nights of analysis, poring over projections and legal documents, arrives at a conclusion. They have before them an outstanding investment opportunity, in an industry they know cold. Bulletproof thesis. Clean transaction structure. Willing seller. But—it's a big check.

They eye each other nervously. One of them speaks:

"Can we raise the money?"

We've saved the best for last in our Five Tools of Private Equity series: **fundraising**, a catch-all for how an investor comes up with the equity under the "sources" side of the "sources and uses" table in a transaction. (We will set aside an investor's relationship with debt for another article or two.) In our opening scenario, if our plucky fictional team has in fact developed a fantastic investment opportunity, the good news is that they'll find the capital to complete the deal. But what they give up—in time, frustration, and economics—can vary widely depending on their approach.

In this article, we'll take a quick look at some of the ways this capital might come together, with an eye toward understanding their benefits and downsides, as well as ways investors can leverage third-party expertise in the process. And as all good things must come to an end, we'll contextualize fundraising among the other four "tools" and give a final look back at what we've learned over the series. But first: how can our fictional investor group raise the capital it needs?

Fundraising: Building a Healthy Capital Base

By the time our tired investors have reached this point in their process, they've already implicitly decided to raise capital for the deal, instead of first raising a committed fund. It used to be that almost by default, raising a fund was the clear first choice for investors, with raising funds deal-by-deal a distant second preference. Today, the choice is far less clear.

Committed Capital

We won't spend much time here on the structure of committed funds, as that's a topic covered ad nauseum elsewhere on the internet. What we should highlight, however, is that weighing the costs and benefits of raising a committed fund is more complex than it appears on the surface. At first glance, the benefits of having committed capital are obvious: it provides the ability to move quickly in a time-constrained process; the investment approval process is defined and straightforward; a fund provides a management fee base that can be used to pay operating and transaction fees; and the economic relationship between capital and investor is set and doesn't need to be renegotiated in the midst of a transaction. But what sets in later are some of the downsides:

Fundraising is a long, time-consuming process. If it were easy to raise a fund (especially a first fund), more people would. It is not uncommon for a first-time raise of a middle-market fund to stretch 18-24 months, and those months are filled with travel and rejection. It's a grind.

Regulatory requirements are a pain. The SEC does not take managing others' money lightly, so fund managers have to be prepared to consistently provide documentation (and documentation of the documentation processes—yes, really) on the fund, investors, employees, and investments.

Investor relations doesn't go away after the fund has been raised. Investors of varying sophistication will have different needs for their own reporting and documentation processes, sometimes monthly. Some investors skirt the line between curious and nosy, and can quickly tie up resources.

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Lack of investing flexibility. Most institutional investors require a fund to have a pretty narrow investment scope, since they're trying to balance their private equity diversification across multiple fund commitments and don't want the goalposts moving. For the fund manager, it means that there's limited flexibility to adjust as markets adjust. If you raised a fund to invest in transportation and logistics in 2020, too bad. This lack of flexibility also extends to timing, as a closed-end fund has a clock that starts as soon as capital is committed.

Because of the inherent difficulty of matching capital to investors, the placement agent industry has developed as a way to support the private equity fundraising process. Similar to a sell-side investment banker, a placement agent helps the fund manager to communicate and market its investing prowess, and helps solicit investment from institutional investors that might be a fit, ultimately earning ~1.5-2.5% of the committed capital. Given the cost of the service compared to the value of raising the capital (and shortening the fundraising timeline), it would appear on its surface that the benefit of a placement agent is well worth the price. Lived experience is a little less clear, as not all placement agents are created equal, and service levels differ. But at their core, even the best placement agents are communicators and connectors, not magicians, and a fund manager unprepared for the challenges of working with institutional investors is not going to be successful in raising committed capital.

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Deal-by-Deal Fundraising

The alternative to a committed fund is to raise money every time it's needed, in the context of an actionable deal. It is very much the converse of a committed fund, in that the main benefits are the flexibility provided in investment scope and capital base, so that an investor is free to pursue good investments (wherever or whenever those may develop), and can recruit capital that aligns with that particular deal.

However, there's a reason this approach is less popular than a committed fund, as it is not without its own challenges:

Fundraising is a long, time-consuming process. Look familiar? Except this time, the investor gets to do it on every deal. It's still a complicated process, it still takes time, it's still a grind. Add in that limited partners can have very different expectations on involvement in the investment process, with portfolio company boards, and with investment economics, and the challenge compounds.

Timing and participation. There was a time where operating without a fund automatically disqualified an investor from participating in auction processes, since the fundraising process in parallel with the other transaction workstreams adds uncertainty and pulls attention away from the deal. That's not the case anymore, as a track record of completed, timely investments can lessen that concern on the seller's side, but it still is a hurdle to clear.

Investor relations can spiral out of control. Don't check my math here, but every time the number of investors in a deal doubles, the administrative burden of managing the investor base quadruples. When there starts to be multiple deals with different investor bases (and different economics, and different governance schemes), it can be suffocating. I knew an investor once with 92 limited partners in a deal. Never saw him again.

Historically, there was not a placement-agent-equivalent for deal-by-deal fundraises, as it was much more of an informal, word-of-mouth, private networking process. Many quiet wealthy investors wish to remain both quiet and wealthy, so they guard their privacy, which limits access to anyone that isn't already in the know. However, as the independent sponsor model has grown, so have service providers looking to help link investors with deals. This function is nascent, so there's more variability in the service offered and the fees paid, but the end result (and the potential drawbacks) align with what it's like to work with more traditional placement agents.

The truth is, as you have gathered by now, that there's no easy path to investing other people's money. Unfortunately for most of us, if we only invested our own personal funds, there wouldn't be much room to make investments of any consequence. There are some experienced investors that have the best of both worlds, developed over a career of delivering results: they raise funds deal-by-deal, but with deep-pocketed investors who are reliable capital sources that can participate quickly and definitively on reliable terms. If this is you, please call me, as I would like to be your friend.

Fundraising in Relation to Other Tools

There's a reason that at the beginning of the article, we referred to fundraising as the lifeblood of investing: it is the single most critical element to investing. In the very first article in this series, we said that sourcing was one of the two non-negotiable abilities in the investor's toolkit.

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The other is fundraising, because in the absence of funds, the entire rest of the investment process is an academic exercise. Additionally, the type of relationship a fund manager has with a capital base can have a meaningful effect on the outcome for the manager; negotiating a 20% carry instead of 15% won't change the investments themselves, but it will certainly change the manager's earnings.

This is not to say that the other tools are not important. In fact, the presence of demonstrated expertise in the other domains is the greatest predictor of success in the committed fund fundraising process. But at the end of the day, an investor with a great idea and no money sits on the sidelines. An investor with no idea what he's doing but capital at his disposal can at least close a deal and take a shot.

Looking Back at the Five Tools Series

At the outset of this series, we said we would investigate the five unique domains of a private equity investor: sourcing, evaluation, transaction execution, portfolio management, and fundraising. For the sports fans in the audience, it seems only fitting to both rank them and pair them with their baseball equivalent.

1a. Fundraising – Hit for Average

1b. Sourcing – Hit for Power

We can get into a chicken-and-egg debate about these tools, as good deals attract capital, and capital enables the development of good deals. Suffice to say that they are the two non-negotiable elements of making investments. In baseball, the path to success for position players goes through the batter's box. A good hitter will find success regardless of how he rates across the other tools; an investor with good deal flow and available capital will make investments, although with other tools, they're more likely to be good investments.

3. Portfolio Management – Defense

A competent portfolio manager will help avoid catastrophes, but won't in and of himself be a great driver of returns—unless, in some specific industry scenarios, a fantastic portfolio management capability can be the cornerstone on which the entire investment thesis can be built. Defense is the same way; most defenders are competent enough to not give runs away with errors, but are just good enough so that their bats can be included in the lineup. At the same time, a superlative defender at a handful of positions—center field, shortstop, catcher—can be so valuable that he changes the construction of a team and earns a starting spot regardless of his offensive output. It's difficult to argue that portfolio management is more important than fundraising or sourcing, but it is the tool with the next greatest ability to affect outcomes.

4. Evaluation – Speed

Speed is useful on the baseball field, but as an augmentation of other abilities, not as a stand-alone capability. It'll make a good defender great, and it'll help raise a hitter's average, or even result in an extra base or two. But if you put a track star on the field, they're not going to be successful. Evaluation works the same way for an investor. Paired with investible funds and solid deal flow, a well-developed evaluation machine can help focus on ultimately successful investments (or avoid potential traps), but without real opportunities to evaluate, the tool is academic.

5. Execution – Arm Strength

There is not a single position player in the Hall of Fame who got there on the basis of his arm strength alone. That said, all else equal, a player with a strong throwing arm is always more desirable than one without, and since throwing is such a fundamental element of the game, there is a point where a player's throwing strength becomes so poor that he can't play the game. Transaction execution can be thought of similarly. Investments need a basic level of transaction competence to be successful, and ultimately it is strength in the other domains that will result in the investment's overall success. At the same time, all else equal, a strong transaction execution tool is always preferable, as it reduces the risk in the deal process and with it the likelihood that the other tools are wasted. Like a weak arm, an execution tool can be weak enough to put the entire process at risk, an avoidable outcome given the options investors have to augment their execution strength with a third party.

We hope this series has been useful, and at the very least, not boring. At Zachary Scott, we pride ourselves on our knowledge of each of these Five Tools of Private Equity and would welcome an opportunity to talk with you or your organization to help you develop strength across them all—and become your own version of a "five-tool player."

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