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Momentum as a Key to Raising Institutional Capital

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The ability to raise capital looms as the first major hurdle for a new manager. While some new managers reach or even exceed fund raising targets, the vast majority fall short. One key to success – and an often overlooked factor – is the importance of momentum. Momentum can be thought of as the creation of interest or excitement in the industry about a new launch. While a number of factors in the process remain outside the control of a new manager (such as market conditions and investment strategy appeal), a new manager can take certain steps to create and build momentum. This article describes some of those key steps.

As a starting point, most new managers are relatively unknown to the hedge fund investor community. Moreover, investors often commit to the manager as much as the strategy, asking themselves not only whether the strategy can be successful, but also whether the manager can execute the strategy while also placing the interests of investors first. Everything a new manager does and says will help shape impressions and expectations.

Have a Plan. A new manager should develop a capital raising plan or strategy. This effort should be in addition to or as part of a broader business plan, and based on early discussions with industry experts. The plan should set a realistic launch date, and include an approach to identifying potential investors or sources of referrals, developing an appealing message about the new fund and the manager, and determining the appropriate written materials. The development of the plan will necessarily be iterative and subject to change during the process. A well-considered plan, however, will help control the process as well as expectations.

Prepare the Narrative. Potential investors will want to know why they should take a chance with a new manager. Accordingly, a new manager should think through and consider how best to answer this fundamental question. The process of developing a narrative can prove invaluable in creating a pitchbook and other written materials and also in preparing for in-person meetings.

Broadly speaking, the narrative should cover three areas. First, the narrative should provide background information about the manager. This information includes the manager's education and professional experience, as well as why the manager believes that he or she has the ability to run a fund and why this is the right time to do so. Second, the narrative should explain the manager's investment philosophy, including why the manager's proposed strategy will be successful and how it is different than other options in the marketplace. Finally, the narrative should set out the manager's vision for building out a productive firm. Topics in this area

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should include how the manager intends to assemble the team, both on the investment and non-investment side of the business, how the manager views firm culture and how to create it, and what measures the manager intends to take to align the firm's interests with those of its investors.

<u>Pay Attention to Details</u>. Investors and others in the industry who can influence the capital raising process will look for clues in everything a manager does and says, including oral and written presentations. New managers should carefully hone their presentation skills, anticipate obvious questions with prepared answers, craft their documents (with the assistance of outside counsel) and eliminate simple mistakes such as potential misstatements and typos in documents. To that end, a new manager might benefit by engaging a professional to assist in this preparation and particularly to help craft the pitchbook.

<u>Choose Personnel and Partners Wisely</u>. Potential investors will look carefully at who the new manager brings on to the team, both in terms of personnel and service providers. The hiring of a respected Chief Operating Officer ("COO"), for example, can help persuade potential investors that (1) the manager has convinced a desirable candidate to join the team and bought into the manager's vision and likelihood of success, (2) the COO has conducted his or her own due diligence and gotten comfortable with the manager, and (3) the firm will be well run with someone who can also provide a check on the manager, if necessary. Potential investors will also look to see that the COO has the necessary skill set and that those skills are appropriate for the anticipated size and complexity of the firm. Finally, a skilled COO can help in the fund raising process.

Similarly, a new manager will need to choose a number of service providers to help establish and run the firm. These service providers include prime brokers, fund administrators, law firms and accounting firms, and often outsourced trading and compliance support, among others. A new manager might also consider creating a board with independent members to provide third-party oversight and sound advice. While a new manager should select service providers that will best fit the firm's long-term needs and goals, managers need to consider when to choose service providers viewed as top tier and when and why it may be acceptable to choose service provider not perceived as falling in that category. The choice of an ill-fitting service provider is one of the easiest mistakes to avoid, and can pose significant challenges for the growth of a new firm.

<u>Capacity Limits and the Founder's Class</u>. A new manager may seek to set limits on the amount of initial capital he or she proposes to raise. A manager may do so for a variety of reasons, including to ensure that the manager can adequately deploy capital within the investment strategy, to help set a time limit on initial capital raising activities, or to help convince investors to make an early commitment.

While these situations may not arise as often as in previous times, investors still don't want to miss out on a promising new manager. To encourage early commitments and reach the capital raising target, managers may offer more favorable terms (such as reduced fees) to initial investors through a founder's class. In order to be successful with this approach, a manager needs to carefully consider a realistic amount of capital that could be raised and not overestimate its proposed limit. Capital limits can always be raised depending on investor interest, but overplaying the hand initially can lead to a disappointing capital raise.

Prepare for Operational Due Diligence. An investor's operational due diligence efforts serve as an important step in the process of making a commitment. Most ODD reviews follow a fairly standard set of questions, and a manager can obtain those questions in advance. A new manager (and the team) should avoid getting tripped up on obvious questions by preparing and organizing ahead of time. Similarly, new managers should expect potential investors to contact prior employers and references. On a related note, potential investors prefer to see a track record, though new managers often cannot reasonably claim to have one. In those circumstances, the recommendation from a prior firm or former colleagues regarding the new manager's prior contribution can be particularly significant.

Consider Multiple Sources of Capital. The best source for potential investors may be a new manager's own personal network. But there are many sources for potential investors, including capital introduction services, firms that seed new managers, and brokers who specialize in raising capital. While every situation is different, new managers should balance any conditions placed on a potential capital commitment with the ability to raise capital from other sources and the long-term growth of the firm. As noted above, new managers may make certain concessions to obtain early commitments such as offering a founder's class with lower fees. New managers that offer other concessions such as preferential liquidity or transparency may run into difficulty obtaining capital from other sources both in the initial and future capital-raising phases.

Create Good Will. At a time when a new manager is looking to raise capital and establish a reputation, a manager should look to create good will whenever possible. While the following suggestions may seem obvious, here are few to keep in mind. Treat everyone with courtesy up and down the business spectrum, from the person who writes the $100 million check to the receptionist. It can be hard to know who has influence and in what circumstances. Respect other people's time by being prompt and expressing gratitude. Follow up on suggestions and referrals by circling back and letting people know how the suggestion or contact worked out. Otherwise, people may be reluctant to provide helpful suggestions or referrals in the future. Finally, deal with rejection (and success) gracefully. A potential investor may not make a commitment today, but could be in a position to do so at a later date. And since the allocator community tends to run in similar circles, a potential investor who says no could also make a referral to someone who says yes.

Maintain Integrity. The fund raising process can be a nerve racking experience and the potential to fall short of expectations can create pressures to take short cuts. A new manager may be tempted to overstate experience, claim too much credit for success at a prior firm, or overstep the legal limits on making a private offering. Most sophisticated investors, however, will know and question claims that cannot be supported or other efforts that fall outside the norm. New managers should stick with the facts and seek wise counsel. In the long run, integrity is one of the new manager's most important assets.

About the Authors

Terrance J. O'Malley is a veteran of the alternative investment fund industry, focusing on senior executive functions, organizational structure, law and compliance. Over a 25-year career, he has held several leadership positions assisting employers and clients resolve complex middle- and back-office issues. He has also served on several industry working groups and committees, including on the steering committee of the MFA's Chief Operating Officer Forum. As a leading practitioner, Terrance is a frequent speaker at industry conferences and a contributor to top publications on industry trends and best practices. He also co-authored two influential books, The Insider's Guide to Hedge Funds: Successfully Managing the Middle and Back Office (Wolters Kluwer, 2018) and the Investment Adviser's Legal and Compliance Guide (Wolters Kluwer, 2004 – 2019).

Scott Froehlich is a Managing Director and Head of Hedge Fund Origination at Eaton Partners. Eaton Partners, a Stifel Company, is one of the world's largest capital placement agents and fund advisory firms, having raised more than $100 billion across more than 125 highly differentiated alternative investment funds and offerings. Founded in 1983, Eaton advises and raises institutional capital for investment managers across alternative strategies – private equity, private credit, real assets, real estate, and hedge funds/public market – in both the primary and secondary markets. Eaton Partners maintains offices and operates throughout North America, Europe and Asia.