

FIRST
TIME'S
a charm



WAFRA

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EXECUTIVE ADVISORY AND RESEARCH DEPARTMENT
WAFRA INVESTMENT ADVISORY GROUP, INC.



FIRST TIME'S *a charm*

> **Historically, first-time private equity* (“PE”) funds** have been perceived as being high-risk investments. This outdated—and we believe inaccurate—idea of first time PE funds has affected the behavior of institutional investors, 60% of which do not invest in first-time PE funds as a policy.¹ First-time PE funds, however, have seen a recent rise in popularity as the current low-return world is forcing investors to reassess their risk/reward assessments across asset classes and strategies within those asset classes. From 2013 to 2016, the percentage of investors who said that they explicitly would invest in first-time PE funds nearly doubled, increasing from 19% to 34%. In 2016 alone, investments in first-time funds increased by 19% to \$25 billion, whereas overall PE fundraising only saw a 5% growth.²

*Note: This report uses the term “private equity” to cover Preqin’s definition of closed-end private capital, which encompasses private equity, private debt, real estate, infrastructure and natural resources.

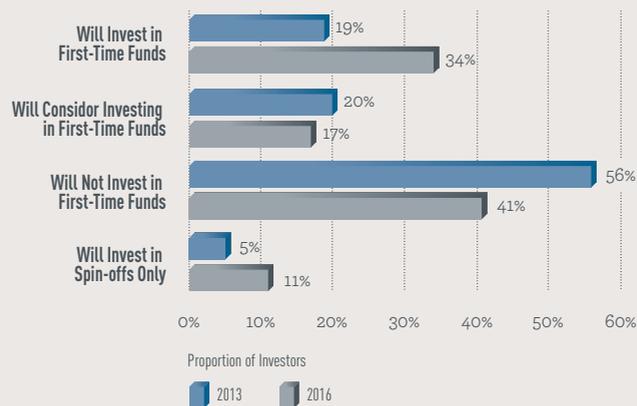
¹ Preqin, “Preqin Special Report: Making the Case for First-Time Funds,” November, 2016.

² id.; Preqin, “2017 Preqin Global Private Equity & Venture Capital Report – Sample Pages.”

First Time's a Charm

- > **As the advantages of first-time funds** become more recognized, sovereign and pension investors (“SWFs”) should consider including them as an integral component of their asset allocations.

Fig. 1: Investor Attitude towards First-Time Private Capital Funds, 2013 vs. 2016





IN THE BEGINNING, THERE WAS EXPERIENCE

- > **From 2007 to 2016**, the number of first-time funds being raised grew to over 1,200—more than the number of raises for subsequent funds.³ Though the story of every fund is distinctive, there are three main archetypes into which first-time funds often fit:

³ Preqin; Aberdeen Asset Management, “Private equity: an ever-renewing landscape.”

In the Beginning, There Was Experience

SPIN-OUTS

- > Teams inside established PE firms that wish to raise their own fund
- > Can be caused by the established firm seeking to deploy increasingly large amounts of capital in successive funds or by varying opinions regarding investment strategy or compensation

GRADUATING FUND-LESS SPONSORS

- > Teams that begin investing on an deal-by-deal basis with commitments from investors who are less risk-averse
- > This allows teams to coalesce and get a track record to raise a fund
- > The fund raise allows these teams more stability and alleviate the team from having to raise capital separately for each deal

LOOSELY- AFFILIATED VETERANS

- > Partnership of two senior investors who have worked together at times, but not as part of the same deal team
- > They are generally very well connected and have strong capital formation, as well as high personal stakes in the fund
- > Team has a strong investment pipeline

Source: Aberdeen Asset Management

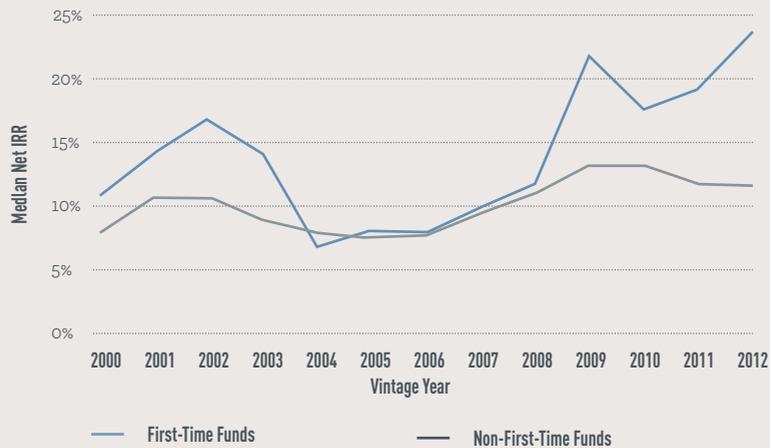
> **Given the common types of first-time funds above,** the trope of the typical risky and inexperienced first-time GPs begins to look questionable. First-time PE fund managers often come from well-established institutions where they have gained years of substantive investment experience, and their investment strategies often mirror—or are an extension of—strategies they have pursued at a name-brand firm.



FUNDS WITH BENEFITS

Outperformance of First-time Funds: Is it Real?

Fig. 2: Private Capital – Median Net IRRs by Vintage Year: First-Time Funds vs. Non-First Time Funds



Source: Pegin Private Equity Online

⁴ see Note 1.

Funds with Benefits

- > **Though we believe there are a number of benefits to investing in first-time PE funds**, perhaps the most attractive aspect may be their general outperformance relative to subsequent PE funds. In a 2016 report about first-time funds, Preqin noted that from 2000-2012, first-time PE funds outperformed subsequent PE funds, with an average net IRR of almost 300 basis points greater.⁴ For the 13 vintage years from 2000-2012, first-time PE funds outperformed subsequent PE funds every year, except 2004.⁵

- > **Preqin's findings have elicited a multitude of questions regarding its methodology**, and two potential issues with Preqin's study are that its researchers accounted for neither:
 - > fund size; nor
 - > survivorship bias.

- > **Regarding fund size**, it is possible that the outperformance of first-time PE funds is due, in part or in whole, to the higher volatility of smaller, more concentrated funds in an environment that has generally experienced growth. This would result in a situation in which the assumed concentration of first-time PE funds simply provides extra energy to fuel their performance in positive economic cycles.

- > **However, if concentration boosts performance in positive years** (and the years covered in the study were mostly positive), one would also expect concentration to impact performance negatively in down cycles. In fact, Preqin data show the persistence of first-time-fund outperformance even in down cycles like 2007-2008, which suggests the effect of fund size and assumed concentration may not be the controlling factor in first-time-fund outperformance.

⁵ *id.*

Funds with Benefits



- > **Further, an eVestment study of the hedge fund universe separated the performance of small hedge funds from the performance of young hedge funds (<2 years),** finding that “age appears to play a greater factor in relative performance than size.”⁶ The study specified that young hedge funds—which can be similar to first-time PE funds—had higher average annual returns than mid- and large-sized funds from 2003-2014, also posting higher risk-adjusted returns in 10 out of 11 years.⁷ Interestingly, young hedge funds also generally outperformed small hedge funds (<\$200m)—both in average annual and risk-adjusted returns—from 2003-2014, suggesting that youth may be more closely correlated with outperformance than size.⁸
- > **Compared to young hedge funds,** where risk-adjusted returns were often greater than more established peers, small hedge funds tended to be more volatile and showed inconsistent risk-adjusted performance vis-à-vis mid-size and large funds. Therefore, not only did young hedge funds generally outperform, they may have done so while taking less risk than hedge funds that were simply small. To the extent that it is possible to extrapolate from the hedge funds covered in the eVestment study to PE funds, it appears that young or first-time funds may not benefit from the same advantages as small, concentrated funds.

⁶ “Impact of Size and Age on Hedge Fund Performance.” eVestment Alternatives Research, July 2015.

⁷ *id.*

⁸ *id.*

Annual Returns for Hedge Funds

Figure 3: Average and median annulized returns by size for funds with >10 months of performance in respective year

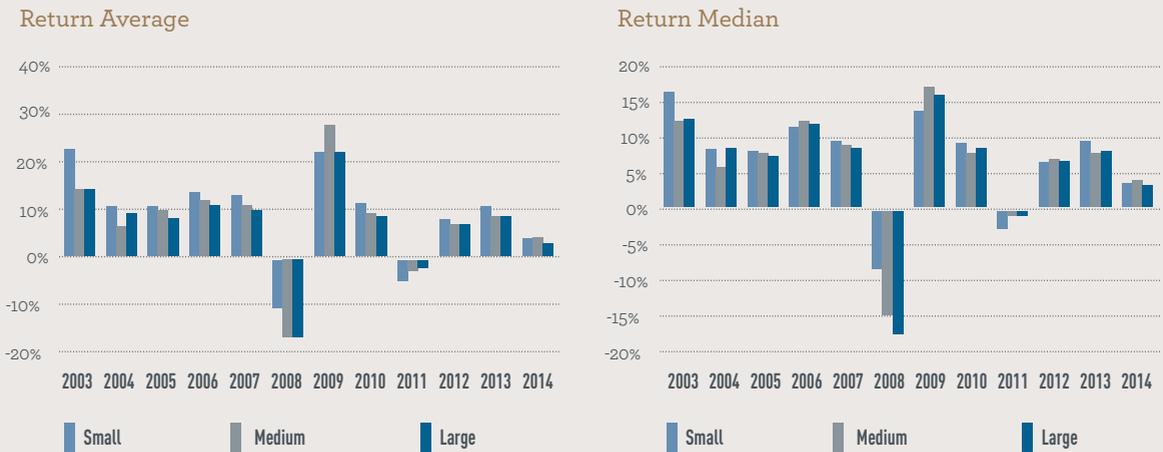
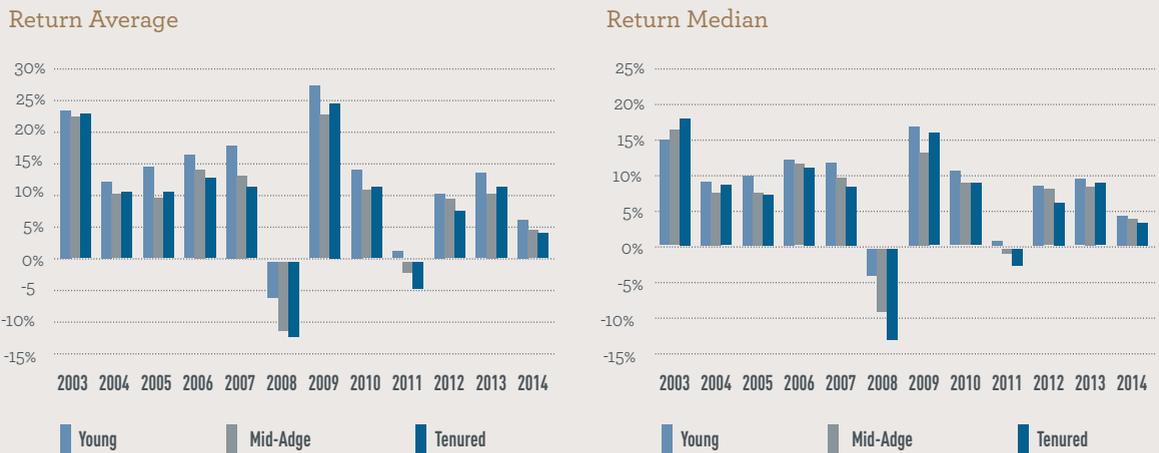


Figure 4: Average and median returns by age for funds with >10 month of performance in respective year



Source: eVestment

Annual Risk-Adjusted Returns for Hedge Funds

Figure 5: Avg. and median annualized Sharpe ratios by size for funds >10 month of performance in respective year

Sharpe Average



Sharpe Median

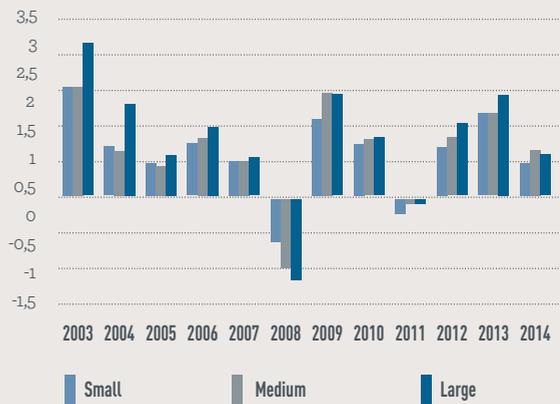
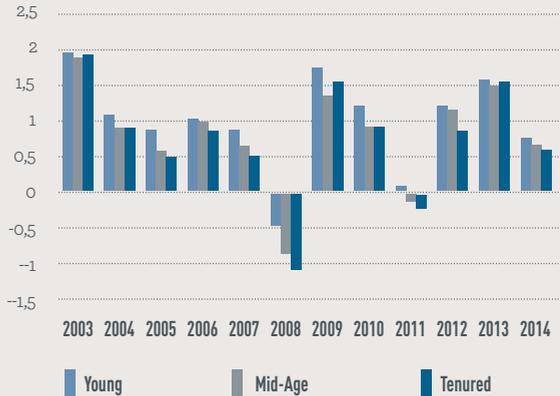


Figure 6: Average and median annualized Sharpe ratios by age for funds >10 month of performance in respective year

Sharpe Average



Sharpe Median



Funds with Benefits

- > **Regarding survivorship bias**, Preqin considered whether reported first-time PE fund outperformance might be overstated because abandoned funds might withhold performance data. Using both LP and GP performance reports, they found that there was no clear evidence of survivorship bias and, furthermore, were able to demonstrate that at least 200 bps of annualized first-time PE fund outperformance are attributable to other factors such as those described here.⁹
- > **Preqin researchers only included information from first-time PE funds that reported performance**, which could allow unsuccessful first-time PE funds to be omitted from the data pool. This may artificially boost the performance of first-time PE funds in Preqin's report, and given that first-time PE funds accounted for 57% of all abandoned funds in 2013, the potential effect of on first-time PE fund outperformance could be significant. In a report provided by Preqin, researchers sought to measure the survivorship bias in first-time fund reporting from 2000-2012. Assuming that unsuccessful first-time GPs would forego reporting at a higher rate, researchers measured the performances reported by LPs alone against the performances reported by both LPs and GPs. Thus, if there were bias in GP reporting, combined GP-LP reporting would consistently exceed LP-only reporting. The report found evidence of survivorship bias, with 60% of surveyed vintage years showing combined LP and GP-reported performance exceeding LP-only reported performance. On average, combined GP-LP results exceeded LP-only results by 215 bps.
- > **However, the data provided may not be representative**, as this report suffered from low incidence of results from LP-only reporting. LPs that report performance to Preqin are generally institutional investors that prefer large ticket sizes, and therefore very few of these LPs invest in first-time funds and were able to report on performance. Specifically, "the average vintage sample size of LP-only data was 13 funds, with the lowest sample size for a vintage year being just one result." This flaw in reporting metrics limits the reliability of the LP-only data and of the report's overall indication of survivorship bias.
- > **We believe that survivorship bias in first-time fund outperformance remains possible**, and is, arguably, one of the strongest explanations for first-time fund outperformance.

⁹ Preqin, "The Troubles with First-Time Funds," April, 2014.



Why the Outperformance?

- > **To the extent that first-time PE funds outperform—especially given the possible survivorship bias in Preqin’s report—the possible reasons for this outperformance are not surprising.** In addition to generally being managed by seasoned investment professionals, the investment strategies executed by first-time PE funds often use excess deal flow from successful upmarket funds that lack capacity, or simply represent an opportunity that a GP may have noticed but did not have the mandate to pursue.¹⁰ Other first-time PE strategies may have been tested and proven in multiple deals on a fund-less sponsor basis.
- > **In other words, first-time GPs have had ample time to hone investment theses and diligence certain investments, and the first-time PE fund may allow them to act on their most promising ideas.** In addition, first-time GPs are generally highly aligned—personally—with the success of their fund, and may have greater incentive to perform. In undertaking the challenge of building their own business—with their financial and professional well-being at stake—first-time fund managers may be more engaged and even “hungrier” than managers working on successor funds or who are less personally invested in their PE firm.

¹⁰ see Note 3.



Additional Benefits

- > **Because of their general difficulty raising capital**, first-time funds are often more flexible regarding the rights of LPs. This flexibility can help LPs in a number of ways, which may include:
 - > lower fees;
 - > greater openness for LPs to co-invest alongside the GP;
 - > greater transparency on the part of the GP regarding investment process; and
 - > potential capacity rights for future funds
- > **Forming deep relationships with first-time GPs** and gaining capacity rights can be especially valuable to institutional LPs. As more and more capital flows into private markets, having access to quality PE managers, as the result of an early fund investment, may represent an important factor for institutional investors looking to reach or maintain certain target PE allocations.
- > **According to a study of over 5,000 members of the digital investment platform, Palico**, 89% of PE professionals from around the world “believe increasing specialization is the future of PE.”¹¹ First-time funds often represent new, innovative strategies executed by teams that have established their investing credentials at more traditional, generalist firms. Allocating to first-time PE funds may therefore be a way to diversify a PE portfolio with varying niche strategies, while also potentially benefiting from the increased alpha of specialization in strategies with less competition.

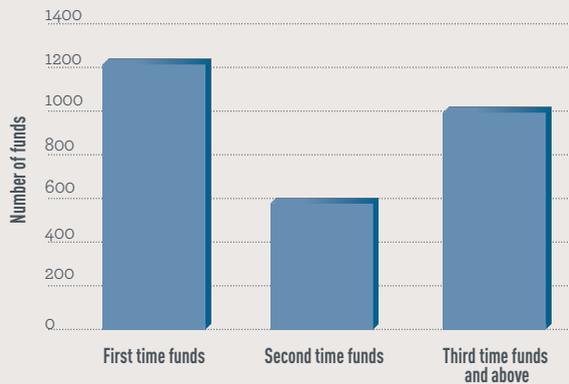
¹¹ “The Down of a New Golden Age for First-Time Private Equity Funds.” Antoine Drean, *Forbes*, 8 September 2014.



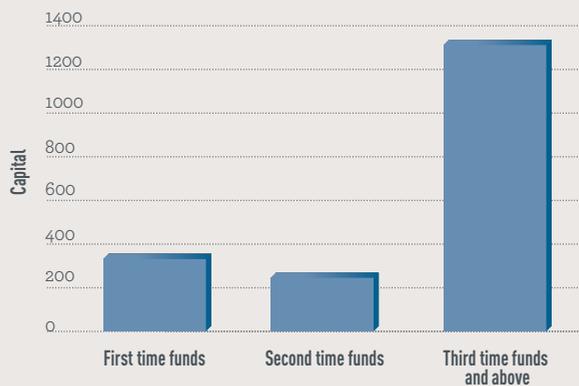
POTENTIAL RISKS OF FIRST-TIME FUNDS

Capital Risk

Number of funds raised over the last ten years



Capital raised over the last ten years



Potential Risks of First-time Funds

- > **First-time PE funds can be more susceptible to a number of risks that are generally less prevalent for more established funds.** The first, and potentially serious risk for first-time PE funds is capital risk; it is generally more difficult for first-time PE funds to raise capital. From 2007-2016, despite constituting over 40% of all PE funds raised, first-time PE funds accounted for less than 20% of the capital raised, and though investors seem to be increasingly open to first-time PE funds, only about half of investors will even consider investing in them.¹² The inability of first-time PE funds to raise capital can lead to a chain reaction of consequences, including:
 - > inability to procure the quantum of capital necessary to pursue the envisioned investment strategy;
 - > over-concentration of investments; and
 - > difficulty retaining talent, as low salaries and high instability may lead to an exodus of top performers.
- > First-time GPs may simply abandon their funds if they cannot raise enough capital, which may explain why first-time funds represent 57% of all abandoned funds.¹³
- > **To overcome potential capital risk, SWFs may consider providing a large share of the initial capital that stabilizes the fund, which can allow the GP to appropriately execute its strategy, retain talent and develop the operational capabilities of the fund.**

¹² see Note 1,

¹³ see Note 9.



Business Risk

- > **Another potentially serious risk is operational;** though first-time GPs tend to be experienced with investing, they are not experienced with leading an organization and developing a middle- and back-office effort to support the front office. Even when first-time PE funds establish a proper operational infrastructure, it may take time to implement accounting, risk and compliance processes that support the investment process. As reporting is a major component of both interaction with investors and fulfilling certain regulatory requirements, first-time PE funds may risk the health of their investor relationships and regulatory good-standing by falling behind in their middle- and back-office management.
- > **Understanding the operational challenges and providing adequate business services support to the fund may help avoid operational errors.**



Break-up Risk

- > **Many first-time fund teams have not invested together formally**, and their chemistry working together is untested. Though first-time GPs may have investment experience, the intense process of building a business while managing investments may present challenges for the fund. Important front-office talent may leave the fund for a myriad of reasons, including discontent with a new role, inadequate compensation, or fatigue associated with starting a first-time fund. The loss of talent can wound a young fund, which may be unable to replace lost talent or capital.
- > **Performing thorough due diligence on the fund team, both individually and as a group, is often necessary to gauge the team's dynamics and potential pressure points.** Further extensive reference checks for each of the key team members may also provide an insight into how the person in question works within a team and to what extent their style enhances or detracts from the fund's prospects. Alternatively, SWFs can simply choose to focus on first-time PE funds whose teams already have demonstrated experience working together.



Attribution Risk

- > **Attribution risk represents the uncertainty of a first-time GP's investment capability as an independent operator.** A portfolio manager may have demonstrated experience at a major PE firm; however, investors will likely not know exactly how that portfolio manager will perform on his own without the institutional backing he previously utilized. It is possible that the portfolio manager's prior performance has been helped by previous firm's reputation, or by an unsung colleague who provided key insights that led to favorable, or prevented certain unfavorable investments. The respect of certain firms' investment decisions may therefore create a self-fulfilling prophecy regarding the success of that firm's investments.
- > **Attribution of the first-time GP's prior success is often difficult to assess** and can lead to uncertainty about a first-time GP's ability to continue producing independently.
- > **In order to ascertain how a first-time GP will likely perform, SWFs may need to conduct extensive reference checks—both on named references and unnamed—to seek details about the GP's exact role in the GP's past successes and whether those successes can be repeated now that the GP no longer has the same support.**



SHOULD FIRST-TIME PE FUNDS PLAY A ROLE IN INSTITUTIONAL INVESTORS' PORTFOLIOS?

- > **We believe that the benefits of investing in first-time PE funds represent a compelling argument for why institutional investors should consider making space for first-time PE funds in their portfolios.** Aside from potential outperformance, the broader benefits of first-time PE funds seem to match the needs of SWFs who are increasingly seeking to assert greater control over their asset allocations, reign in fees, and potentially create long-term returns on their capital.

Should First-time PE Funds Play a Role in Institutional Investors' Portfolios?

MAINTAIN TARGET YIELD

- > In a low-yield environment, the potential outperformance of first-time PE funds can help SWFs reach their mandated target performance, which may be high, given the low-yields of current financial markets

REIGN IN FEES

- > difficulty raising capital can make first-time funds more flexible with regards to fee arrangements, leading to greater savings for SWFs
- > This flexibility can also lead to increased opportunities for co-investments, with little or no fees

GREATER CONTROL OVER INVESTMENTS

- > As first-time GPs may be more open to co-investments alongside LPs, SWFs may be able to exert greater control over which investments they make
- > Co-investing alongside a more willing first-time GP will provide SWFs the opportunity to develop and foster in-house investment capabilities that can lead to greater control over a portfolio

FOCUS ON LONG-TERM INVESTING

- > While PE is already a relatively illiquid asset class, creating strong relationships with quality first-time GPs can lead to future capacity or co-investment rights
- > Future capacity/co-investment rights may be particularly valuable, due to potential scarcity caused by the growing popularity of private markets among institutional investors



THE SEEDING OPPORTUNITY FOR SWFS

- > **Seeding first-time PE funds presents an opportunity for SWFs.** The current supply-demand imbalance regarding the fundraising abilities of first-time PE funds can create a situation of distressed talent, in which even some of the best first-time GPs are open to seeding transactions. Seeding could provide a strong capital base, potentially allowing the fund to gain stability and build a track record.
- > **Notably, SWFs could be strategic investors in these seeding transactions, potentially enhancing the fund's status and the likelihood of follow-on LP investments, both by the SWF and/or by other major institutional investors.** Specifically, the SWF may benefit from both LP and GP stakes from seeding the fund, providing the SWF incentive to support the first-time GP's deal-sourcing, fundraising and operational efforts. The SWF's vertical integration into the PE business could provide long-term returns and cash flow, which correspond to SWFs' desire for long-duration investments.
- > **Seeding first-time PE funds is attractive to GPs and could represent multifold benefits to SWFs.**



LOOKING FORWARD

- **As SWFs continue to search for higher yield in the current low-return environment, first-time PE funds can offer certain benefits, which may include potential outperformance, lower fees, greater transparency and future capacity rights.** In addition, the potential for seeding first-time PE funds presents an option for deploying long-term capital and establishing deep relationships with quality fund managers, who are eager to access the stability of long-term institutional capital. Overcoming the challenges associated with investing in first-time PE funds can require intensive amounts of capital and diligence, which certain SWFs may be well-placed to provide.
- **First-time PE funds represent a unique investment opportunity that could play an important role in a SWF's broader asset allocation.**



EXECUTIVE ADVISORY AND RESEARCH AT WAFRA



The Executive Advisory and Research Division at Wafra develops financial and strategic solutions for non-U.S. pension funds, sovereign wealth funds and other sophisticated institutional investors. We provide informed guidance on strategic asset allocation, risk management, organizational structure, and other complex challenges. Our clients look to us to enhance the performance of existing investments and to design and implement customized products, drawing on expertise from across Wafra. Within Wafra, we support new product initiatives, drive business development efforts, manage specialized investment vehicles, and provide our investment teams with insights on trends in global industries and financial markets.



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