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Q2 2018

PitchBook

First-Time Funds

PErspectives

on U.S. Middle Market Private Equity

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Introduction

Comparing the sub-$1B & first-time U.S. PE buyout fund subsectors to the overall U.S. PE buyout middle market

The sub-$1 billion PE buyout market has seen noticeable divergence from the overall middle market within the U.S. While sub-$1 billion PE funds become more sophisticated and increasingly adopt a number of strategies and best practices from larger funds, their deals are different from those of their larger peers and require a nimble and deft touch to accommodate the distinct characteristics of their counterparties.

Differing even further are the trends among first-time PE buyout funds relative to the entire market. Within this quarterly edition of our PErspectives on the U.S. PE middle market, we showcase in a more concise, visually rich manner just how the sub-$1 billion market compares to the overall market, contrasting our specific approach against PitchBook's traditional methodologies for the overall middle market. Furthermore, we spotlight how first-time fundraising stacks up against and correlates with aggregate fundraising, with additional commentary provided by Akerman and its clients.

A few key takeaways:

- The subset of the market that Akerman analyzes, relative to its prior figures, has exhibited considerably more resilience in deal flow and exits in Q1 2018.
- However, even in its search for better-priced, smaller companies, Akerman's sample of PE buyers has still spent a hefty sum; at $14.8 billion in aggregate deal value already, the Q1 2018 total stands at a third of 2017's total.
- Q1 2018 has seen a slower start to fundraising within Akerman's sample compared to a blockbuster 2017, which is only to be expected when taking typical cycles into account.
- When it comes to first-time fundraising, investors took a breather in Q1 2018. But the prior two years experienced torrid activity, with 41 first-time funds closed on more than $13 billion, the strongest two-year tally ever. In our spotlight on page five, we delve into these figures more deeply; read on for our analysis of the drivers behind the surge.

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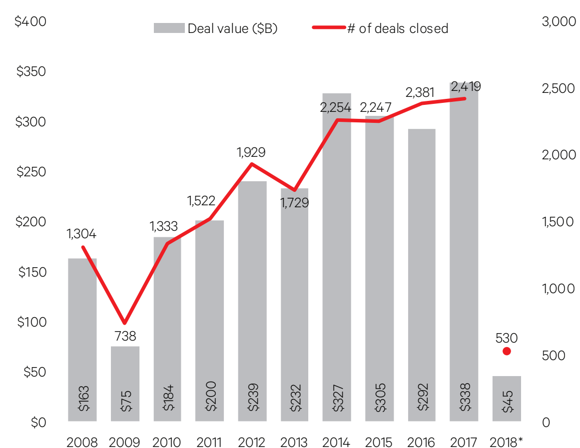
Akerman LLP is a top 100 U.S. law firm recognized by *Financial Times* as among the most forward thinking firms in the industry. Its more than 700 lawyers and business professionals collaborate with the world's most successful enterprises and entrepreneurs to navigate change, seize opportunities, and overcome barriers to innovation and growth. Akerman is known for its results in middle market M&A and complex disputes, and for helping clients achieve their most important business objectives in the financial services, real estate, and other dynamic sectors across the United States and Latin America.

The Akerman Corporate Practice Group advises public and private companies, including private equity funds, on M&A, capital markets, financings, and other transactional matters, with a strong focus on the middle market. Akerman is top-ranked nationally for mergers, acquisitions and buyouts: middle market by *The Legal 500* and is recognized as a leading U.S. law firm by *U.S. News - Best Lawyers* for corporate, M&A, private equity, securities/capital markets, securities regulation, and banking and finance law, and is listed in PitchBook league tables as among the most active law firms in the United States for M&A deals.

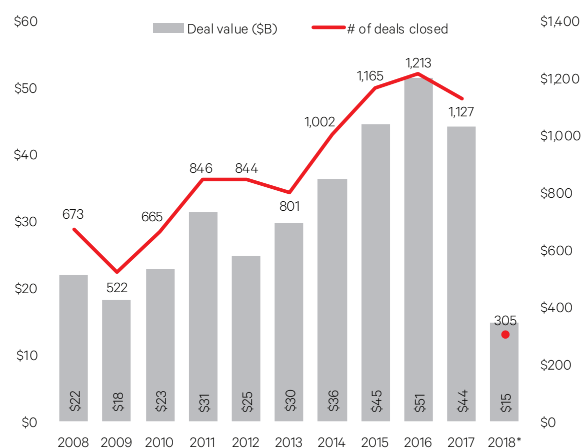
Sub-$1B market vs. the whole

PE middle market deal flow (PitchBook methodology)



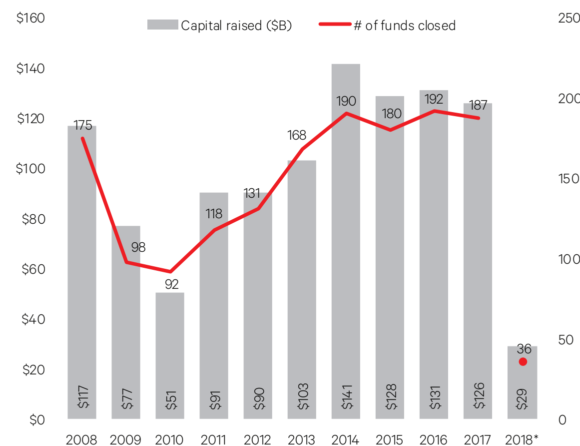
Source: PitchBook
*As of March 31, 2018

PE sub-$1B market deal flow (Akerman methodology)



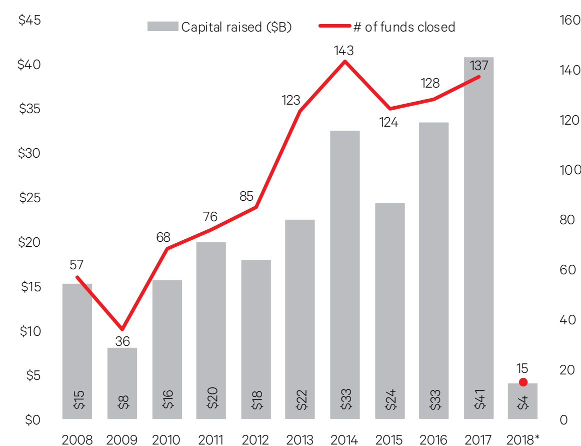
Source: PitchBook
*As of March 31, 2018

PE middle market fundraising (PitchBook methodology)



Source: PitchBook
*As of March 31, 2018

PE sub-$1B market fundraising (Akerman methodology)



Source: PitchBook
*As of March 31, 2018

Methodology

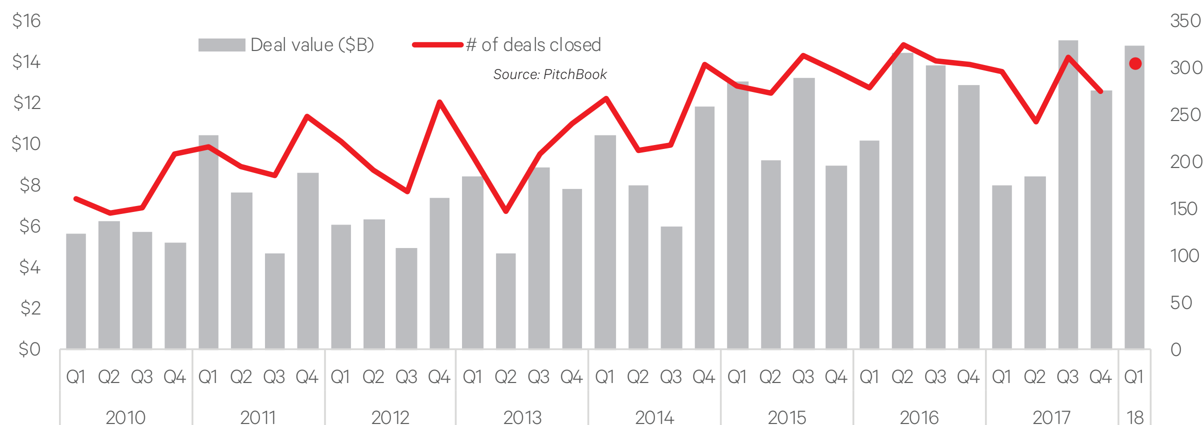
PitchBook: PitchBook defines the middle market as U.S.-based companies acquired through buyout transactions between $25 million and $1 billion. Note that minority deals are not included. This methodology covers only U.S.-based middle market companies that have undergone a buyout. PitchBook defines middle market funds as PE investment vehicles with between $100 million and $5 billion in capital commitments. The methodology includes only PE funds that have held their final close. Funds-of-funds and LP secondary funds are not included.

Akerman: Akerman's analysis of the sub-$1 billion market is performed at the investor level, defined by the investor's assets under management (AUM) and most recent fund size. All investors included in Akerman's methodology must have estimated AUM of less than $2 billion in total, with their most recent fund being less than $1 billion as well. Deals must be less than $200 million in size to be included in this methodology. Fundraising figures, however, include all funds of said investors. Exits must have said investor tagged as a seller/exiter on the given transaction. Geographic scope is also U.S.

Sub-$1B funds

Deal flow

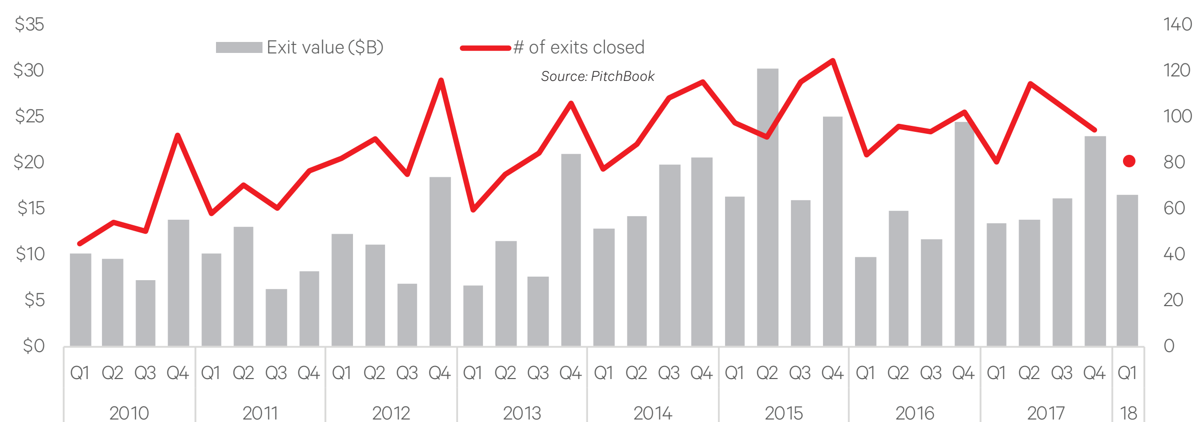
PE deal flow by quarter



PE add-ons by quarter

Exits

PE exit activity by quarter



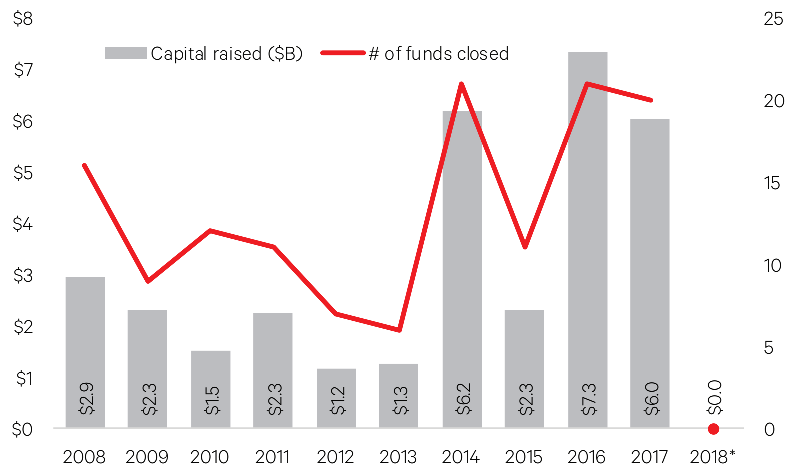
First-time funds

Buyout fundraising has been on a tear for several years now, culminating in a remarkably strong 2017. Last year saw $40.7 billion amassed in commitments across 137 vehicles, the latter tally topped by only one other year this decade. As alternative investments have grown in popularity in general, more limited partners (LPs) are looking to gain exposure to niche PE strategies. Not every LP can or wishes to allocate to mega-funds; moreover, as sub-$1 billion funds have grown in sophistication, more and more investors have begun to actively target smaller, niche strategies to diversify their own holdings. The PE fundraising market today, while strong, reflects a simple supply-and-demand issue for LPs looking to keep pace with their stated asset allocations. Accordingly, first-time general partners (GPs) continue to enter and replenish the market, breaking away from larger firms to pursue differentiated strategies based on their expertise.

First-time managers inevitably face significant challenges in the fundraising market, regardless of how well-prepared they are. Credibility takes time to earn, and subscribing to a new firm's competitive advantages requires, to some degree, a leap of faith for LPs. However, many years of first-time fund returns data suggests that first-time funds perform better as a whole than sophomore-or-later funds. A separate PitchBook analysis of global PE fund returns found that first-time funds return a median 17.1% internal rate of return (IRR) for 2012-2014 vintages, compared to a 10.8% median for follow-on funds of the same vintages. TVPI multiples also fare better. For 2009-2011 vintages, first-time funds produced a median 1.54x multiple against a 1.33x median for follow-on funds. Several other statistics show clear outperformance among more recent vintages. Why?

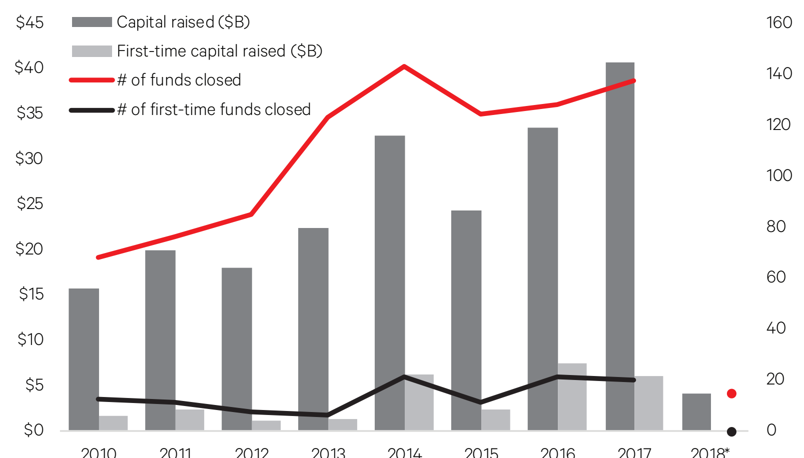
As the challenges of raising first-time funds are so significant, those successful in raising a first-time fund typically have an extraordinary history of success. And as there is virtually no room for error for a first-time fund that seeks to raise a sophomore fund, perhaps GPs are more focused, as well. Moreover, the new fund executives often make outsized contributions to first-time funds using their own money, sometimes out of necessity or as a "skin-in-the-game" signal to skeptical LPs. Perhaps most importantly, first-time funds tend to focus on niche strategies in less efficient (and often smaller sized) markets. Those markets tend to attract less generalist attention and smaller multiples, as well.

First-time fundraising



Source: PitchBook
*As of March 31, 2018

First-time fundraising vs. total sub-$1B fundraising



Source: PitchBook
*As of March 31, 2018

Spotlight on First-Time Funds

With Jed Freeland, Partner, Akerman, Brian DeFee at Capstone, Eric Deyle at Eaton, and Laurence Lederer at Branford Castle

Jed Freeland, Partner, Corporate Practice, Akerman

Jed Freeland represents buyers and sellers in M&A, leveraged buyout and recapitalization transactions with a focus on representing private equity sponsors and their portfolio companies in a wide range of industries.

Jed Freeland (Akerman): First-time fundraising has enjoyed three of its strongest years in recent memory, and more GPs are on the road to raise first-time funds than ever before. As leading placement agents, why do you believe first-time funds are succeeding today compared to 2009-2013?

Brian DeFee (Capstone): On the timing aspect, from 2009 to 2011, there weren't a lot of new private market commitments in general. At Capstone, we saw the wave of first-time funds start in the 2012-2013 time frame, and it has continued ever since. We've seen a significant rebalancing of LP portfolios, and if they invested in a firm's first fund 15 years ago, they're now backing the firm's fourth fund, which often isn't as interesting to LPs given sizable fund size increases. Part of the rebalancing has LPs coming further down market with a greater willingness to back first-time funds at the lower end. We've also seen research showing that first-time fund top-quartile performers are outperforming the more mature funds. It's a bit deceptive because the delta between the top and bottom quartiles is pretty significant, so it really comes down to picking the right first-time managers. It is also apparent to LPs that spinout teams are the next generation of leaders, because they are hungry to prove themselves, and they often bring large firm experience and an institutional mindset to the lower-middle-market, which is viewed as less competitive and less efficient. These factors are a recipe for outperformance.

Jed: What qualities and characteristics for first-time managers are increasingly critical to succeed in today's competitive market of discerning LPs?

Brian: Differentiation is critical. It can't be another me-too story. In private credit, for instance, there's so much product in the marketplace. One LP told me everything tastes like chicken—it's very difficult for them to find differentiation. The same dynamic won't work in private equity. GPs need to stand out somehow and clearly articulate the difference between themselves and competitors, but in the end it comes down to execution. Oftentimes, these first-time funds need to have a deal or two to demonstrate the strategy, as case studies bring credibility to the articulated strategy. Anchor investors and personal relationships are critical as new LPs really need to see some movement from investors who know the GP. Maybe it's knowing the team members from a prior fund or co-investing with them in the past, but LPs want to know

Brian DeFee, Managing Director, Capstone

Brian DeFee is responsible for distribution and business development in the Northeastern and Eastern United States and leads the firm's energy/real assets advisory efforts.

Laurence Lederer, Managing Director, Branford Castle Partners

Laurence Lederer is primarily involved in the sourcing, acquisition and oversight of Branford Castle Fund investments. Branford Castle primarily invests in companies with less than $100MM in sales.

Eric Deyle, Managing Director, Co-Head of Private Equity, Eaton Partners

Eric Deyle leads business development, fundraising strategy and client management for private equity mandates.

whether those prior relationships are backing the manager on their new fund.

Eric: Oftentimes, the biggest hurdle our clients face when fundraising is how to clearly articulate a compelling narrative. What is the fund's distinct, differentiated (but not too unique) investment strategy? What are the firm's competitive edge and advantage? What is the team's motivation? LPs see such a broad swath of the market that a first-time fund manager's competitive advantage is not always articulated well in an elevator pitch. Oftentimes, GPs get frustrated with their inability to communicate a differentiated strategy in a format that LPs can fully digest. Our role at Eaton Partners is to help our clients formulate a simple, concise narrative that answers the question, "How do you make an outsized return?"

Jed: What advice would you give to first-time funds on agreeing to economic concessions with LPs?

Eric: "The first dollar in is always going to be the hardest." We work closely with our clients to mine their ecosystem and existing network of relationships. Given our experience raising more than 30 first-time funds, we know it is a tall order to enter the market as a first-time manager without the support of existing relationships and third-party validation. When it comes to incentivizing early/anchor investors, we advise our clients to be commercial but not to sell the farm. There is a burden of proof on first-time fund managers when they have not proven out their investment thesis with realized investment returns. So instead of attracting anchor investors with fee concessions, first-time fund managers should capture investors' attention with actionable deals. First-time managers should not just go out and sell a deal pipeline. They must prove that they can close on it. To me, that is the single most important factor that will accelerate a first-time fund manager's time in market.

Jed: Please give us your thoughts as to the outlook for first-time funds closed in the past few years.

Brian: With historically elevated purchase price multiples, low interest rates and the inevitability of this long economic cycle turning, it's going to be challenging for all private equity funds to succeed unless they have competitive advantages in sourcing, execution and operations. Those who have these advantages and are disciplined in deploying capital will be most successful. Teams are spinning out from firms that have gone up market because the new teams want to go back to their roots. At bigger firms, they were being pushed to write $100-$200 million checks, when they'd prefer to write $20-$50 million equity checks at the smaller end of the market. It's more compelling for them personally, which has an effect on their decision to go their own way. And a positive factor for first-time funds as a class is that succession issues at legacy PE shops are driving strong teams to spin out and raise first-time funds. One would think that returns would be relatively strong for successful next-generation investors who want more responsibility and autonomy and believe that they can drive better economics for themselves by striking out on their own. These factors are leading to an increased number of talented professionals with a history of success raising first-time funds.

Jed: As a first-time fund, how did Branford Castle successfully manage simultaneously fundraising, teambuilding, sourcing and executing one-off deals, while managing existing portfolio companies?

Laurence Lederer (Branford Castle): At Branford Castle, prior to raising our first institutional fund, we had a 30-year history operating as a family office and a link to Castle Harlan, a middle-market private equity firm. With those 30 years as a family office, and with the managing partners, CFO and infrastructure already in place, we were fortunate to be more fund-ready early on. Having said that, even with our senior team being complete well before we went to market, we had to be quite driven and disciplined in balancing fundraising, sourcing and execution. Things have been very busy after raising the fund (which closed in October 2016), and we are off to a good start. We're about to close our fifth platform transaction just 20 months into the new fund, and we're buying niche market leaders with proprietary capabilities at an average EBITDA multiple of 5.7x. We've deployed over 50% of our capital in about a third of the investment period. Many existing and potential LPs appear to be excited about our pace.

Jed: How were existing relationships important to your fundraising?

Laurence: When interacting with potential LPs, you have to keep in mind that there are lots of private equity firms out there. You have to differentiate yourself and be patient in telling your story to potential investors. We were fortunate and delighted to have a successful raise for Fund I, but there were a number of potential LPs that decided not to participate in our first fund. We still have very positive conversations with them, and they keep track of our progress and are interested to hear how the firm is developing with an eye towards upcoming funds. Regarding personal relationships, you have to leverage any and all relationships that you have, whether it's on the LP side or with management teams or intermediaries and deal sourcing—relationships for all these aspects of your business are critically important. When it comes to LPs, personal relationships are a great way to get in the door, but ultimately you'll be judged on your merits and your track record.

Jed: How have you become known as a firm with whom management teams want to partner?

Laurence: One of our strengths is that we listen to management teams. We don't look to impose a solution on any given transaction. We listen first—a lot of these companies are founder-owned or multi-generational, so we need to understand what the sellers are looking for. We need to make sure it's a cultural fit and visions are aligned. One recent example is Earthlite Massage Tables, which had founding shareholders that were looking to retire and exit completely. They had hired a strong management team that was excited to partner with institutional capital and re-invest more than 50% of their transaction proceeds. It comes down to trying to find out and really listen to the needs of the sellers. In addition, we then work with management teams to bring some of the best practices we've seen from other businesses to theirs. Those can be extremely helpful in helping our portfolio companies grow their top line. Something else that is very attractive to sellers is showing them the returns that our other management teams have achieved from partnering and investing alongside Branford. We always encourage sellers and management teams to talk to our other CEOs and management team to hear what it's like to work with us and how they have done in our prior investments. That's always quite compelling for folks to hear about.

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