



Fundraising tales

Five private equity experts gather to discuss the private fundraising market, how it has evolved in the past 10 years, the increasing role of the CFO and the consequences of the abundance of money for the industry

By DOMINIC DIONGSON and MARINE COLE

photography by DOUGLAS HOLT



From left: Aaron Witte, Scott Norby, Blinn Cirella, Fred Steinberg, Jeffrey Hahn

The fundraising environment has changed dramatically over the last decade. Fund sizes have increased sharply, investors have placed more stress on due diligence and CFOs have seen a marked rise in their responsibilities.

To discuss this changing market, *pfm* gathered five private equity experts in late September near the Rockefeller Center in New York. They were Blinn Cirella, CFO at Saw Mill Capital; Jeffrey Hahn, managing director, Americas, at SANNE; Scott Norby, executive director, private credit and equity, at Morgan Stanley; Fred Steinberg, managing director, New York, at SANNE; and Aaron Witte, senior investment director at SwanCap Partners.

At the time of the roundtable, confidence in US markets was still strong and pro-business policies from the Trump administration, including tax reform, was boosting the economy. Add to that low yields in most asset classes, it's no wonder that the private equity market has attracted so much capital.

"There are a lot of funds in the market," says SwanCap's Witte. "There's a lot of fundraising going on."

Private equity funds globally held final closes on \$259 billion in the first three quarters of 2018, following a record \$455.4 billion raised the previous year and \$385.2 billion in 2016, according to PEI data. These figures are up sharply from 2010 when funds closed on about \$150 billion.

Uneasiness

Witte says in the current fundraising environment, many first-time funds have been able to raise money. "There are a lot of emerging managers from larger groups with internal track records where they've had successes," he says. "They are able to

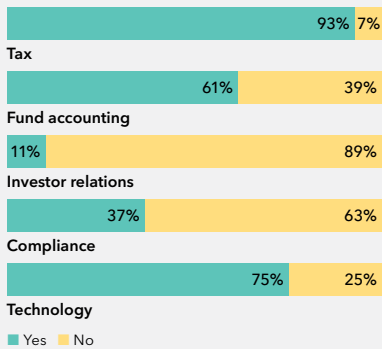
“With the increased sophistication of investors, we’ve seen the CFO take on a larger role. The CFO is the one who takes the calls”

Fred Steinberg



Going external

Are you currently outsourcing any part of these functions?



Source: *pfm/SANNE CFO Survey 2018*

start their own firms. There are many of those these days.” And funds are getting bigger across the board. According to the *pfm/SANNE CFO Survey 2018*, 63 percent of CFOs expect their next fund will be larger, while only 7 percent said it will be smaller.

But with sky-high valuations and a fear of overpaying in what increasingly looks like the top of the economic cycle, a sense of uneasiness is growing in the private equity industry.

“We don’t go into a meeting with an investor without discussing the overhang of capital that sits in all the funds and what’s going to be the impact of that,” says Morgan Stanley’s Norby. “Strong GPs have raised a series of funds quickly. I suspect it’s going to be harder to do that in the

future apart from one or two GPs with strong brands. I think you’re going to have to prove yourself more adept at growing your business both operationally and strategically and prove it out over time in order to convince investors you’re going to find a way to survive and generate alpha in this pricing environment.”

Cirella says too much money in private equity can lead to dire outcomes.

“It can slow down your investment pace because you’re nervous and you’re not going to put in a lot of money,” she says. “You’re not going to pay 11x for something you’re not comfortable with. It can also elongate your investment cycle so you may have to go back and extend your investment period.”

She adds that firms also run the risk of poor performance because they overpaid. “You don’t know how long a cycle is going to last, so you’re buying in an up market and you could be forced to sell in a down market,” she says.

More demands

Despite what may seem like an easy fundraising environment, the actual process of launching a new vehicle all the way to holding a final close has turned more cumbersome for PE firms.

This is due in part to limited partners who have become more knowledgeable about private equity and who are placing a greater importance on the due diligence process during fundraising.

According to the *pfm/SANNE CFO*

Survey 2018, nearly 60 percent of CFOs say that greater due diligence by investors has been generalized as opposed to targeted to a specific area.

“We’ve definitely seen more time spent on due diligence by prospective investors,” says Steinberg.

“As a result, I know that our teams have spent much more time helping clients prepare for their next fundraise and deal with investors’ requests. There’s a lot more investing by pension plans, institutions and sovereign wealth funds, and these are the investors asking the most questions given the size of their commitments. Also the people who invest in or from non-US jurisdictions want to ensure their capital is deployed in the most tax optimal way possible, which has led to an increased focus on structuring.”

Prospective investors need to address such concerns during the due diligence process as it is their opportunity to ensure that the right legal entity structures are in place.

Long gone are the days when LPs asked solely about fund returns. They now want to know how a firm’s back office may be organized, what it focuses on, what accounting system it is using and whether they can rely on a CFO to understand all tax and compliance issues among many issues.

These questions are often part of the due diligence questionnaires, which, as a result, have become much longer.

“The DDQs used to be a couple of pages, now they are 20, 30 or 40 pages,” says Norby. “Then the spreadsheets that you’re being asked to fill out, which often are a significant burden on the internal teams and the external teams, are incredible. It is a lot more work and it’s adding a significant level of expense from true dollars and a time perspective.”

As an LP, Witte agrees that investors

AROUND THE TABLE



Blinn Cirella is CFO at Saw Mill Capital, which invests in lower mid-market companies. She manages its financial administration and its back office, including LP reporting, accounting, and audit and tax preparation. She previously served as director at Bisys Private Equity Services.



Jeffrey Hahn is managing director, Americas at SANNE. He joined SANNE in 2016 following the acquisition of FLSV Fund Administration Services, where he was partner and CEO.



Scott Norby is executive director, private credit and equity at Morgan Stanley. Norby focuses on investor relations and product development for Morgan Stanley’s private equity and private debt funds.



Fred Steinberg is managing director, New York at SANNE. Steinberg is responsible for the day-to-day operations of its New York and Belgrade offices. He joined in 2017 from Morgan Stanley where he oversaw closed-ended alternative asset funds.



Aaron Witte is senior investment director at SwanCap Partners, an independent investment manager. Witte leads the firm’s North American investment activities, where he focuses on equity co-investments, secondaries fund investments and primary fund investments.

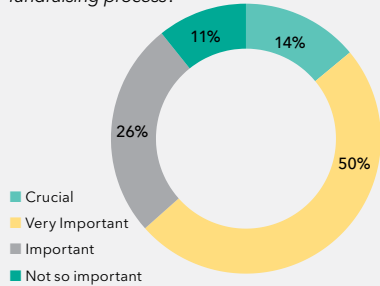
“We spend a lot of time on the data, on the analytics. We want to understand deal attribution”

Aaron Witte



Vital role

How important do you think the CFO is to the fundraising process?



Source: pfm/SANNE CFO Survey 2018

are partly responsible for that dynamic. “We’re pretty tough and thorough during due diligence, both on the legal side and the analytical side, and the side letter requests,” he says. “We spend a lot of time on the data, on the analytics. We want to understand deal attribution.”

In turn, it has increased the role of CFOs and their back office.

“With the increased sophistication of investors, we’ve seen the CFO take on a larger role,” Steinberg says. “The CFO is the one who takes the calls.”

LPs have been paying much closer attention to the way private equity firms function and, in particular, to the fundraising process. That has led the CFO role to gain in importance.

“To me this goes back to 2012 when we all had to register with the [Securities and Exchange Commission] and there was so much bad press for a series of years about bad actors doing

things they should never have done,” says Cirella.

“I think that got everybody a little bit excited and focused.”

Hahn thinks the Bernie Madoff scandal also created an inflection point for the fund administration business as investors realized the importance of internal controls and segregation of duties. “That woke people up to pay attention to the back office with an immediate impact on the CFO’s landscape,” he says.

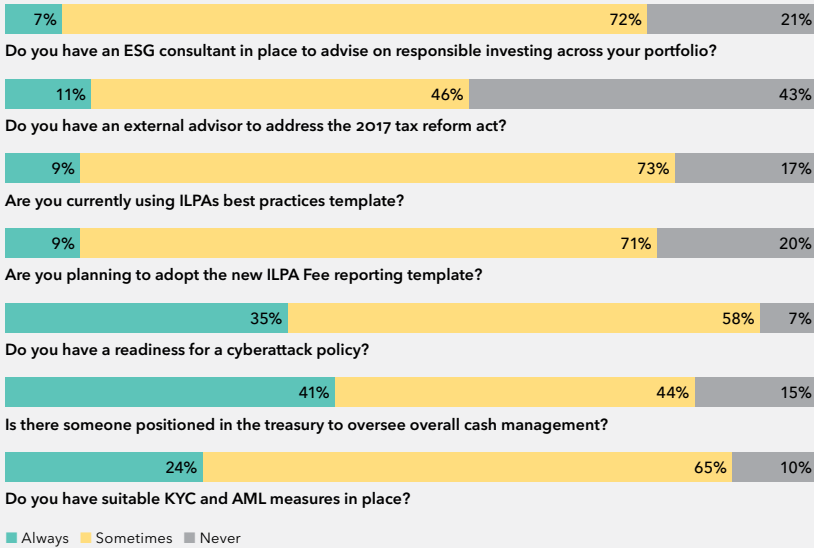
Meanwhile, “the move toward greater transparency, I think, was partly led by lawmakers and partly by [the California Public Employees’ Retirement System], who began publishing fund performance data,” he adds.

“That raised public awareness of how private equity works, what management fees are, and what carried interest is. This has brought a lot of attention to the financial aspects of the PE

The figures may not add up to 100% due to rounding

Investor concerns

To what extent do LPs ask the following questions during due diligence?



Source: pfm/SANNE CFO Survey 2018

business and put the PE CFO in the spotlight.”

Although the CFO is not likely to be a constant presence with investors during fundraising, he or she typically is the point person for all questions related to the back office and more generally data and analytics.

Asked to what extent LPs demand to see CFOs personally during the due diligence process, 83 percent said they sometimes do, while 13 percent said they always do, according to our CFO survey.

“Fundraising, in my view is mostly about the investment team and its track record,” says Hahn.

“After that, I believe institutional investors want assurances that the technology, process and control environments are sound. The CFO often is asked to provide color regarding

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Scott Norby



performance data, and certainly about the workings of the back office.”

“Our CFO is sort of in the background but he has to ensure the data is there,” says Witte. “He’s not on the frontlines of the fundraising process.” From an LP perspective, he says that SwanCap wants to make sure it knows the CFO of a GP it plans to invest with.

Greater costs

The greater oversight and transparency has made this a more complex world for CFOs to navigate. Costs are on the rise, with the back office staff count increasing as responsibilities grow. With consultants and service providers often paid for by the fund, it can make more sense to outsource some of the most complex and technical responsibilities.

A vast majority of respondents to the survey, 93 percent, said that they are

currently outsourcing parts of their tax functions, while 75 percent said they outsource technology and 61 percent outsource some fund accounting functions.

“We didn’t necessarily support all of our clients since their first fund because they started with a smaller fund that they handled in-house,” explains Steinberg.

“When the next fund doubles in the size, that’s when they realize they need help. We have many clients where we came in at Fund II. Now they are on Fund IV, and their back office has remained relatively consistent in size over the years while our back office support has grown commensurately with their number of funds. This way they really are outsourcing to access our platform and our expertise.”

“I think a lot of the need and trend towards outsourcing has to do with the

increasing complexity and increasing amount of responsibilities CFOs now face,” says Cirella. “I think that in 10 years, the private equity CFO is going to be more like a project manager.”

CFOs will eventually have several consultants or service providers to help them manage everything from LP reporting to compliance. CFOs will have to manage an HR consultant, IT consultant, valuation consultant, tax advisor, audit firm, compliance consultant, fund administrator, a fund attorney, tax attorney, management company attorney, and the list goes on. As the roundtable participants all agreed: CFOs can’t possibly go deep enough and be an expert at all these things.

This is especially true when a firm ventures into new strategies. “We constantly evaluate new strategies,” says Norby. “Not just in private equity, also in real

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assets, and long-only funds. We raised a brand new opportunistic capital fund, that is focused on both credit and equity opportunities that flow from the investment bank. We also launched a senior loan fund. Both of those brought a whole new set of issues for our CFO function at Morgan Stanley. We constantly hire experts around the world that help us decide how to do execute.”

“I think investors are looking for specialized investment models,” says Hahn. “Rather than investing in a traditional global PE fund, I believe investors prefer building their portfolios with country specific and product specific fund mandates. It is therefore on the fund managers to differentiate themselves and show expertise in a particular niche.”

Outsourcing also has a cost, and GPs need to determine what model is the most cost efficient, while also taking into account the level of expertise they will gain through outsourcing as opposed to

doing it in-house. One area where firms have found invaluable outsourced expertise is with placement agents. The roundtable participants agree that placement agencies bring real added value to the fundraising process thanks to their relationships, the introductions they can make and the doors they can open to new markets.

But are they always worth the price tag? “We did at one point discuss engaging a top off agent if we couldn’t reach our target fund size, but it is just so costly,” Cirella says. “At a time when you’re being pressed to bring down your management fees and increase your offset fees, it can be difficult to manage. Placement fees reduce your management fees and if you’re a first-time fund this is a big hit to your cashflow.”

Fees in general, and particularly management fee and fee offsets, have become a big topic of discussion as GPs try to remain competitive. This is especially true

for funds of funds. “We try to justify a fee that allows us to stay competitive in the market,” Witte says of the management fee. “We’re fee on top of fees. We have a layer of fees we have to contend with. We have to justify why it makes sense. It does make sense because we are providing access to an alternative asset class and to fund managers that they otherwise wouldn’t have access to and try to go above and beyond with high-touch service offerings.”

A turn in the economic cycle may release some pressure in the private equity market related to too much capital flowing and valuations skyrocketing. But one thing is sure: a downturn will not change the fact that private equity has become a more transparent asset class where LPs are in constant need of explanations and justifications for their investments with particular GPs.

The private equity CFO’s new world order is here to stay. ■