Emerging managers mix methods to secure capital in challenging fundraising environment

Fundraising as an emerging manager right now is a slog. Although the deep fundraising freeze which set in last year (with European VC fund count dropping to its lowest annual total in a decade[1]), appears to be beginning to thaw[2], securing fresh commitments as an early-stage manager remains fraught with challenges.

Competition for allocation is fierce, with an ever-increasing number of early-stage funds in the market and a liquidity-constrained pool of LPs due to the mismatch between the fundraising demands of new funds and the recent low levels of distributed to paid-in capital of many existing funds[3] (leaving LPs less inclined to re-up with VCs that haven't returned much cash).

First-time managers in particular are more reliant than ever on securing reliable anchor investor support to help them navigate the high hurdle of a first closing within a reasonable timeframe. Second and third fund managers are similarly reliant on the 'stickiness' of their existing LP base for re-investment in the new fund as the institutional funding options narrow, hopeful that they've demonstrated in their previous funds a compelling access to deal flow, sensible valuation entry-points, and strong reporting standards - all in the likely absence of distributions to paid-in capital ("DPI").

As managers seek to minimise any deviations from what they perceive as market-standard terms and also cast the net wider to more LPs to achieve a given closing target, various levers and strategies are being adopted to try and maximise chances of securing fresh capital.

Longer fundraising periods

The first tool in the toolkit is an obvious one to lean on. Standard fundraising (or "commitment") periods last for 12 months from a first closing date, allowing GPs to hold further closes during such period until the doors are closed to new applications. We're currently seeing the six-month extension

option being exercised by managers already in their initial commitment period (such extension often (but not always) subject to LP consent). Where the manager is yet to hold its first closing, the initial period can alternatively be set upfront at 18 months (with a six-month extension option on-top taking the full period to as long as 24 months). Hitting a target first closing date is notoriously difficult, and so by extending the period in which to close additional capital beyond a full calendar year permits the manager more breathing space in which to promote the new fund.

Worth noting however that in addition to the equalisation process which takes place when subsequent LPs join a fund (paying in an amount to ensure that ownership of the fund's assets are properly reallocated between the enlarged group of investors) first closing LPs will also typically expect to benefit from a late entry rate payable by subsequent closing LPs to the first closing LPs to compensate them for taking the initial risk on the manager. The longer a commitment period is extended by the manager, the more likely first closing LPs will want to ensure that late entry rate has been pegged at a level which justified their participation from day one (rather than waiting for 18 months to elapse before investing).

Co-investment opportunities

The ability to offer attractive co-investment opportunities to LPs (either on a deal-by-deal basis or via a dedicated sidecar vehicle) is a persuasive card for a manager to play due to the typically lower fees attached to the co-investment arrangements. For first closing investors and/or large strategic investors, the manager can also consider waiving fees (and additional carry) entirely in respect of such opportunities.

Often co-investment opportunities are at the discretion of the manager in terms of allocation to LPs, but, in addition to offering low or no fees to certain LPs, a manager can agree (either by side letter or in the main LPA terms) to automatically offer all co-investment opportunities above a certain monetary threshold to first closing and/or large strategic investors (on a pro rata basis).

Such opportunities may not always be possible (particularly since the manager is obliged on a good faith basis to prioritise the main fund), but sometimes a manager will either be able to obtain an allocation in a new round which is surplus to the main fund's allocation, or the main fund is entitled to pre-emption rights as an existing investor in a later-stage portfolio company which it can't take up fully, and so those rights can be offered to certain LPs to take up directly (as 'affiliates' of the fund).

Promoting strong co-investment capacity and priority co-investment terms to prospective LPs is a great differentiator, particularly if main fund terms are being kept as vanilla as possible.

Economic concessions

If an anchor investor is backstopping a first closing with a substantial commitment, then an economic concession via discounted management fees for such investor can be a fair trade-off. Caution is advised in offering generous and/or too many concessions in respect of fees however, particularly for first-time fund managers, as fee income in the formative years of a fund launch when AUM is at its lowest can already be lean – particularly so if working with an umbrella fund manager whose own fees are typically settled from the general partner's fee charged to the fund (i.e. out of the standard 2% fee as a general partner cost, and not in addition to the 2% fee as a fund cost).

Offering a lower carried interest charge to certain LPs than the headline rate (e.g. a 90/10 split of profits in favour of the LPs rather than an 80/20 split) should only really be considered in exceptional circumstances. The vast majority of VC funds operate on a whole-fund basis in respect of carry

entitlement (rather than on a deal-by-deal basis) and if a manager has succeeded in delivering fund returns which has taken the fund "into carry" then the market standard 80/20 split is just reward for performance, and so any upfront forfeiture of entitlement is arguably a disincentivising move which is harmful to both manager and investor in the long-run.

If admitting any US investors to the fund, then be mindful that incoming US SEC rules on the mandatory disclosure of preferential treatment will apply such that the manager will need to disclose to all LPs (irrespective of commitment) any economic concessions given to certain LPs, not just LPs investing the same or a greater amount as those with the preferential terms (as has long been the market convention).

Seed investment transfers

For first-time fund managers (particularly super angels or converting family offices) it's often the case that there is an existing portfolio of investments which can be promoted to prospective LPs as evidence of the manager's early track record/deal flow access.

In the absence of a major anchor investor, another way to "backstop" the fund is to commit to transferring such investments to the fund at first closing at cost for the benefit of the fund's investors. In doing so the manager de-risks the proposition for first closing investors in that they can invest knowing that they'll immediately acquire a share in those companies. For the manager, it's a value sacrifice on those investments (assuming they have risen in value since the original investment) which can be swallowed in exchange for securing the new LPs vote of confidence, and perhaps also allowing for a smaller GP cash commitment to prove 'skin in the game'.

Access and feeder structures

Managers seeking out high-net worth individuals and quasi-retail investors as a capital source have become increasingly prevalent in the last few years, thanks in no small part to the advent of intermediary platforms facilitating such access with significantly less friction than before.

Feeder structures can optimise the administration of taking on smaller cheques (including taking all of the feeder investors' capital upfront rather than via separate drawdowns) but are not a panacea for avoiding the regulatory burden which comes with descending the mass affluent spectrum.

VC funds are 'non-mass market investments' for UK promotional purposes, and so with an increasingly watchful eye from the UK regulator on what it perceives as "*informal governance processes*"[(4)] used by some when it comes to onboarding smaller ticket investors, care should be taken in ensuring a fully compliant approach is followed.

Concluding thought

In a competitive environment where there is often little to differentiate between new fund propositions given the standardisation of key fund terms and overlapping investment theses, creative levers and strategies such as those summarised above can often prove the difference between securing the capital required to hit minimum closing targets and coming up short.

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4 March 2024

References

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(2) "VC distributions sink to 14-year low" by Marina Temkin, Pitchbook, 9 February 2024. Link here.
(3) UK Financial Conduct Authority: Dear CEO Letter August 2022 (Our Alternatives Supervisory Strategy). Link here.