Interview with Clay Deniger

Capstone Partners

What is your current perspective on the fundraising environment?

The fundraising market remains difficult, and I think for the near term it will continue to present challenges. There was a tremendous bottleneck of 2005, 2006 and 2007 vintage funds that otherwise would have been back in the market, but took longer to right their portfolios coming out of the financial crisis. So 2012 was a particularly heavy re-up year, which has lightened in 2013. We would expect 2014 to be similar in terms of normalized re-up levels, which is obviously good news for GPs who should find themselves in a less crowded market relative to 2012. That said, it remains tough and today we consistently see binary outcomes in the fundraising world. It is a tale of two timelines. Those GPs who are highly sought after, who have a compelling story, and who can generate momentum in their fundraising early, tend to be in market for three to six months. Those GPs who have to fight harder and scratch and claw to generate momentum find themselves in market for 12-18 months or longer. This clearly puts focus and importance on coming to market at the right time with a clear strategy and portfolios in the best shape possible for generating fundraising momentum.

The first half of 2013 has produced good fundraising numbers. Do you expect that to continue throughout the rest of the year?

We expect 2013 to be a strong year and even to carry over into 2014, which is positive news for those managers currently fundraising. While we expect the flow of dollars and commitments to be strong through the end of the year, many of those Q3/Q4 commitments are already spoken for today in re-ups or soft circles. A GP needs to keep that in mind when thinking about chasing commitments in the second half of this year or any calendar year.

What strategies are LPs viewing most favourably at present?

In general, LP portfolios in the US and Europe are mature and stable and not many LPs are looking to dramatically change how their portfolios are constructed, so it is much more about fine-tuning around the edges. Within the category of fine-tuning, we are seeing a few things. While large cap buyouts will always be a critical part of any portfolio, there is a general move of some dollars (or Euros) out of large cap and mega buyouts and into the middle market based on the belief that more inefficiencies exist at the smaller end of the buyout world. Geographically, for North American investors, we are seeing an opportunistic move into Europe, both through equity and credit strategies. In recent years, North American LPs have been largely on the sidelines in relation to Europe, waiting for things to settle a bit and to develop their own strategies around playing the macro challenges in Europe. We are seeing the interest in European funds materialize into commitments this year and expect that trend to continue.

How do LPs view the asset class compared to prior years?

LPs' macro view of the asset class largely comes from the success of the underlying portfolios and sponsors that they manage. The fact that GPs are returning capital means we are seeing more investments go cash-to-cash and LP commitments are being returned. LPs are enjoying gains on those commitments, which then primes the pump for them to make new commitments this year and in coming years. The liquidity that exists, particularly from North American managers, is helping to support continued enthusiasm for the asset class.

Competition for LP commitments is still tough. What is critical for a GP to do to be successful?

The prerequisites for successful fundraising remain the same: strong and experienced teams; a repeatable, sustainable strategy; and a well-articulated, underlying track record that demonstrates successful execution of that strategy – in this respect, fundraising is no different than in prior years. We advise clients that the most important thing in driving a successful fundraise outside of these prerequisites is giving LPs a reason to act. Their allocations are so tight and their calendars so full that unless they have a reason to focus on the underwriting of your fund, as a GP, you just won't be able to grab the mindshare that is required to obtain commitments. For the most successful GPs, that call to action comes from scarcity value and momentum during a fundraise. This is certainly the best case for a GP - having an LP focus on your fund because they run the risk of missing it. For many other managers that have some of the prerequisites but perhaps not the necessary momentum, we increasingly see the need to offer LPs a special reason to act. Whether that is preferred economics for committing early in a fundraise or access to co-investments on a reduced or no fee basis, offering motivation beyond the typical fundraising tools is an important part of what a GP needs to do to generate momentum that is essential to drive successful closes.

What do first-time managers without a track record need to do to be successful in fundraising?

Without a track record, we advise GPs to find some other connection point with an LP that makes them comfortable that a strategy will be successful. That connection usually comes from the manager's existing relationships, whatever those may be - whether they are friends and family or investors that backed them at a previous firm. Both cold starts and developing new relationships without a track record are extremely difficult to accomplish. Getting the backing of previous investors and close relationships or investing in deals with other managers to build out a track record is critical, so that when you do come to market you have a track record that offers some level of proof of concept for the stated strategy.

What benefit have you seen in GPs informally talking to LPs between fundraises?

We regularly advocate to GPs that marketing between funds is no longer an option; it really is a prerequisite. Back to the crowded nature of an LP's portfolio and the pressure on re-ups, if the only time you are having discussions with LPs is when you are asking for new commitments or attending an AGM, you have missed the opportunity to deepen the relationship and increase the likelihood of a re-up or new commitment. Re-ups are not automatic as they once were, so taking the time to both nurture existing LP relationships and advance discussions with targeted new LPs between fundraises is a critical function. This is true not just for large firms with IR departments but also for mid-market firms and for smaller funds as well. For some smaller funds it can be even more important, as they may have a less prominent position in the investor's portfolio, so deepening existing LP relationships is particularly crucial. We also encourage GPs to see priority prospective investors several times a year to ensure they are on forward investment calendars so that the LP is tracking the sponsor as much as the sponsor is tracking the LP.

Has the way GPs communicate with LPs changed overall recently?

Yes, I think GPs are getting the message. They recognize that they need to nurture their investor base and give them the same focus and commitment as they do to deal sourcing. Both sides of the business are critical for their ongoing success. You cannot just focus on systematically making investments; you also need to be systematic about ensuring sources of capital are available for the long term, which means treating LPs like partners and communicating regularly.

Do you see any change in terms and conditions?

I wouldn't say we have seen bright lines or binary changes in terms and conditions. Generally, we have seen downward pressure on fees particularly in the larger cap funds, which is translated as direct pressure on management fees. In smaller funds, fee pressure may be reflected in LPs looking for alternative ways to deploy lower cost capital, as in reduced or no fee co-investments. Regarding specific terms, there remains pressure on deal-by-deal carry and transaction fees in particular, but I would characterize it as pressure, as opposed to "we will or will not support this type of fee structure." Investors recognize that, even in this market, top GPs are rewarded with premium terms and those that drive scarcity value in a fundraising process continue to command premium fees. Those GPs who must fight harder to generate momentum find themselves in a weaker negotiating position and can end up with terms that are less aggressive, particularly in those two areas - the sharing of transaction fees and deal-by-deal carry.

What impact are you seeing on the implementation of the AIFMD?

The main theme today on AIFMD is uncertainty. As the July 22nd deadline approaches, it is still unclear how offshore funds will be able to market to the bulk of European LPs. The cleanest answer is to work hard to close prospective European investors prior to July 22nd, but that advice only applies to cases where an investor is already in advanced diligence. For the broader universe post July 22nd, we advise GPs to be extremely careful and to work closely with counsel, based on the belief that the additional clarification and regulatory infrastructure will start to unfold in the coming months.

Thank you for your time.

Clay Deniger is responsible for North American Operations including project management, transaction structuring, and firm operations.

Prior to Capstone, Clay was founder and CEO of Substrate Technologies, Inc. (STI), a venture-backed semiconductor component supplier. At STI, Clay raised capital from strategic and institutional investors on three continents, and ultimately deployed the proceeds for construction of a dedicated manufacturing facility in Shenzhen, China. In 2003, Clay negotiated the sale of STI to a group of China-based investors.

Prior to STI, Clay was founder and CEO of Customer Survey Technologies (CST) a boutique technology research firm operating in North America and Europe. Clay raised CST's critical capital through strategic investors and foreign government backed financings in the US and Europe. In 1998, he sold CST to a domestic competitor.

Clay has written extensively on the subject of technology and tech industry investment. He is a Magna Cum Laude graduate of Hamilton College.

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