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Private Equity Startup Guide

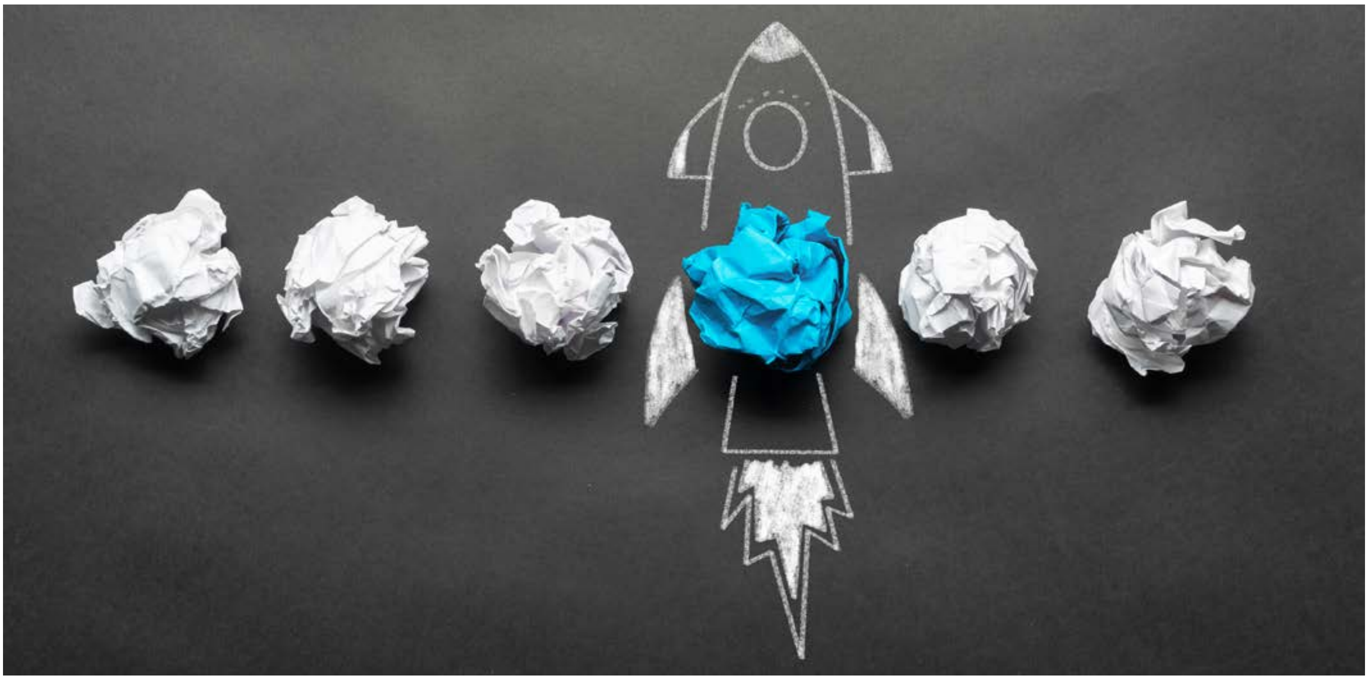
IN FOCUS 2021

MARKET COMPLEXITY
More complex deals as manager fight for capital

RISING COMPETITION
Startups contend with challenging environment

REGULATORY SCRUTINY
Regulation barrier of entry gets higher

Featuring Anchin



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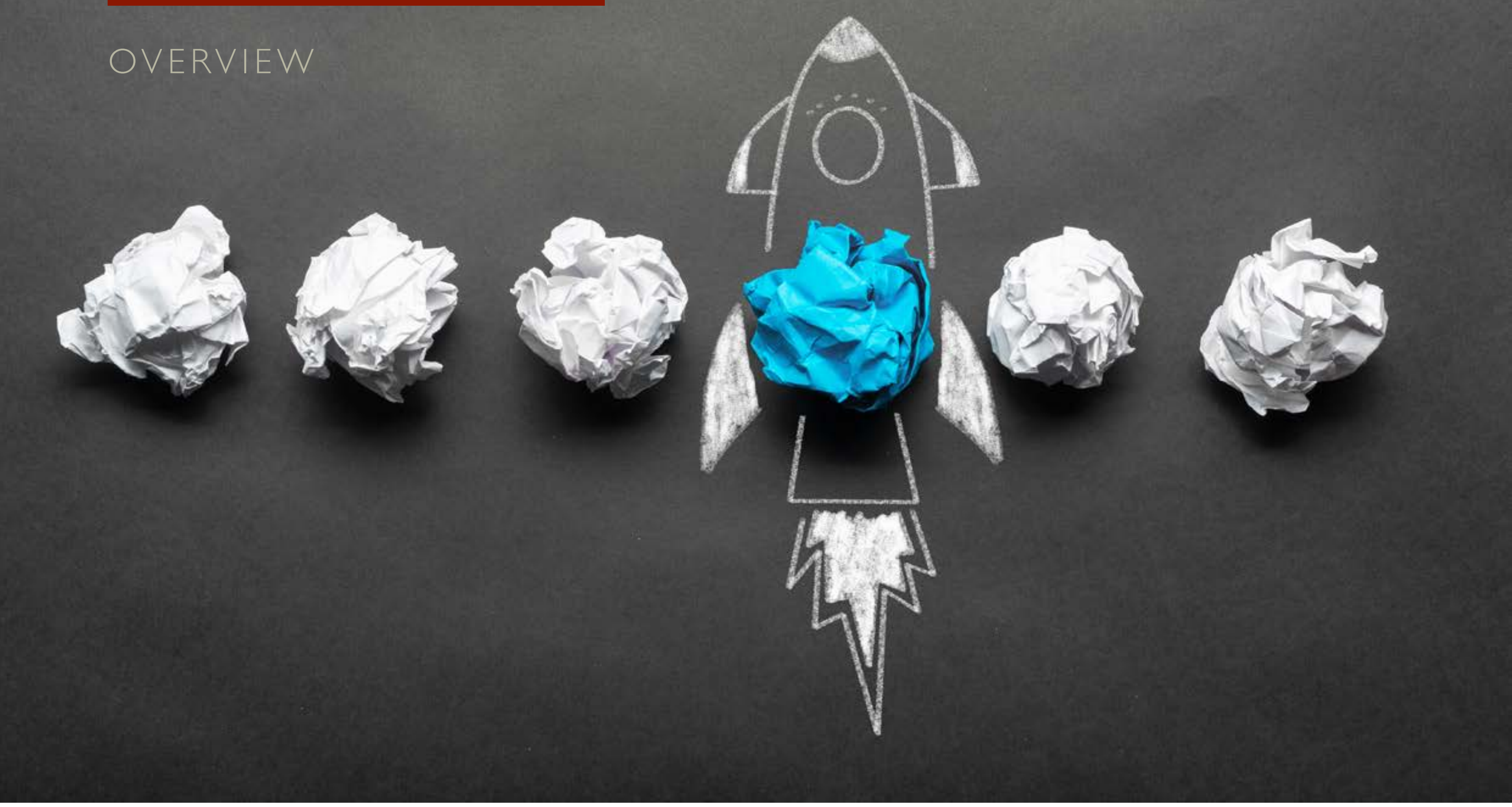

Higher barriers to entry with rising competition and regulation

By A. Paris

Despite any headwinds caused by the pandemic, the private equity industry has remained strong, with investor demand and planned allocations continuing to grow. However, with high levels of dry powder and increasing regulator scrutiny, startup private equity funds have much to contend with.

"There is currently more money available in private equity. The among of dry powder has exploded and is the highest it's been in 10 years," remarks Alain Kinsch, co-chairman of the Association of the Luxembourg Fund Industry (ALFI) Private Equity Committee and Vice-President of the Luxembourg Private Equity and Venture Capital Association.

According to Hugh MacArthur, Partner, Bain & Co: "Total investment value last year was supported by ever-larger deals, not more deals. This fact is important because it means many GPs did not get the deals done that they had intended to in 2020.

"With soaring levels of dry powder, robust credit markets and recovering economies, 2021 deal markets promise to be incredibly busy."

Reportedly, 80 percent of LPs are confident private equity will continue to perform in 2021. Around 40 percent say they are underallocated to the asset class, with the vast majority planning to either increase or maintain their commitments in 2021. Within this context, managers planning to launch new PE funds have a few key considerations to make.

Regardless of the economic background, experts note that the fundamentals of investing in venture capital or launching a new fund in the private equity space remain the same. Mainly it's about spending time to find a good time with the right commitment, in the right sector within a certain market niche worthy of developing.

What does make a difference in the current environment however is that there are more hunters than there is prey: "There are more and more players coming into the market because the stock markets are not delivering the expected

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>
> Alain Kinsch, ALFI

results. In addition, governments are now allowing pension funds to invest higher percentages into private, non-liquid assets which means demand from these entities has also increased," Kinsch says.

Clarity and differentiation

Therefore, emerging and startup managers need to be clear about their strategy. "You need to create your strategy and differentiate your financial plan from those offered by competitors. This requires significant, in-depth research into a defined market or individual sector," writes consultancy Intertrust Group in a piece providing advice to new launches. "You need to find the 'secret sauce'. Learn everything there is to know in your chosen area so that you're familiar with the history but can also predict future outcomes. In this way, you can position yourself to investors as a source of real expertise and thought leadership."

Kyle Dunn, business development at MJ Hudson advises managers to align their marketing strategy with their investment strategy. He writes in an article: "The strategies they [PE investors] deploy are sophisticated, deeply thought-out, technical, and innovative. Although the manner in which they present themselves is often elementary, unrefined, uninteresting, and antiquated."

Dunn says managers can't profess to be modern and relevant if they don't look modern and relevant: "For example, does your website portray you as dynamic and progressive, or does it look like it was built in 2002. In my experience, as it pertains to this industry, the latter is more common."

Having a marketing stance which is out of synch with the investment proposition can discourage limited partners (LPs) looking to invest.

Once they make the decision to allocate, LPs want managers to follow through with strong performance. In order to provide this, PwC believes private equity funds need to reconfigure their value creation playbook to outperform in the current environment. "You'll need a strategy that focuses more closely on strategic positioning, operational excellence and capital efficiency in your business and the portfolios you manage," write Will Jackson-Moore and Mike Greenstein in a report entitled Prime Time for Private Markets 2021.

"Private equity is the 'asset class of the moment,' as opportunities for acquisition and corporate turnaround increase. Strong fundraising has heightened pressure to put dry powder to work and has therefore inflated valuations. The challenges will have managers looking for new ways to create value," the report outlines.

In Kinsch's view, one of the key ways managers can differentiate themselves is through specialisation: "The managers who specialise in certain industries and really understand those sectors have the potential to identify better performing target companies. This will help distinguish them from the pack which is investing more broadly. Another way for startup or emerging managers to stand out is by having a deep technological understanding."

The *2021 Preqin Global Private Equity and Venture Capital Report* highlights: "Disruptive technologies such as artificial intelligence are helping fund managers to improve operational efficiencies and identify new opportunities. The rich pipeline of companies that are successfully innovating with these technologies will also attract investors' attention."

Eye on regulation

As the scope of the PE market continues to grow, smaller investors are now allocating to the asset class, with structures like Special Purpose Acquisition Companies (SPACs) even being offered to retail investors. This is leading to increased scrutiny by regulators, an element which startup and emerging managers need to be aware of.

"Private equity is becoming less 'private' and more regulated, like other investment classes. This increased regulation is becoming a bigger hurdle or barrier of entry. Managers cannot launch a fund with minimal resources. They need to be registered and have a set up to handle any potential complaints," Kinsch warns.

The way the market is structured at the moment means funds need to carry out a lot more reporting which has an impact in terms of time and money spent on compliance. However, according to Kinsch, this is a positive development as it deters any potential 'cowboys' from entering the market.

Regulatory concerns are of particular relevance in the context of the growing focus on environmental, social and governance (ESG) factors. This dimension is now one almost all startup and emerging managers need to take into consideration.

The *McKinsey Global Private Markets Review 2021* identifies that global ESG regulations and laws have grown by 90 percent since 2016, with 2020 seeing efforts to standardise existing frameworks and taxonomies. "With EU regulation already pushing companies in this direction and comparable legislation widely expected in the United States, it is broadly acknowledged that the regulatory environment is shifting, and PE firms and investors are working quickly to adapt," the report concludes. ■

Rise in complexity for deal-hungry managers

Interview with George Teixeira

The growing appetite for private capital on behalf of investors has led to an increasingly competitive environment. Therefore, managers, especially startups, need to be at the top of their game to fight for those deals.

"Every manager I speak to is both excited and anxious at the same time. There are many good deals available but there are also many other managers going after those same deals," explains George Teixeira, partner and leader of Anchin's Private Equity Group.

He notes a rise in competitive spirit is also causing a growing complexity in the deals themselves. Given managers are intent on winning and making deals, they are having to be more flexible on their fee terms and the way they structure said deals. "They should set parameters for how far they are willing to compromise and adhere to those limits," Teixeira advises.

The fees that managers command is one of the factors they need to consider when setting those parameters. Having a flexible or innovative approach to the way fees are structured can give an emerging manager a competitive edge. Teixeira points out: "If a fund manager tells me they're going to offer a 2 and 20 fee structure, I would suggest they consider other structures given the number of investors and the level of capital available."

Different fee options are now becoming more commonplace in the PE industry with firms offering different fees to investors providing anchor capital (investors who commit early on in the fund's life) as well as investors committing capital for a longer period of time.

Clear path ahead

Fundraising is critical to general partners (GPs) and will remain a priority – after all a fund cannot be launched without the requisite number of investors and their capital commitment. However, Teixeira cautions, startup and emerging managers should also focus on formulating a clear business plan.

Most funds don't launch with USD10 billion in assets and therefore will not have a fully staffed support team at their disposal to help with all the heavy lifting and the manoeuvring. As a result, initially, having the right service providers will help startups get going. Those relationships will grow alongside the fund and help the manager along the way. "When you first launch, these service providers are going to be your partner; they will be part of your team," Teixeira highlights. "Startup managers need support on the practical side, for things like reviewing documents before they're released to potential investors.

"For example, a PE fund's limited partnership agreement defines what the manager plans to do. Investors want to read that and understand it. They want this information to provide the comfort that the manager is not going to change what they do dramatically."

Choosing the right partners can set managers up for success and Teixeira stresses that although cost efficiency is key, the decision should be more focused on service and value rather than the lowest cost denominator.

However, he acknowledges the sensitivity emerging and startup managers have around fees: "At launch, managers often don't have the capacity to pay high legal or administration fees. Also, they are focused on delivering performance so don't want that to be absorbed by exorbitant fees at the outset. Most firms and service providers understand this and will work with those managers.

"We have an emerging manager platform and offer these managers lower fees for the duration of their first private equity fund. We know that the goal with private equity is to launch additional future funds, at which point our fees will become a secondary concern. So we partner with them to help them grow to that point, while charging fees along the way that are commensurate with the stage in their business cycle."

Tax and cyber concerns

In terms of practical support, Anchin provides advice around tax

structure, which Teixeira explains is a crucial consideration managers must undertake when first starting out: "They need to know where they plan on investing and what types of investors they will be attracting. These decisions will influence the way their fund should be structured from a tax perspective."

For example, they need to consider whether they will have an onshore or offshore structure or whether they plan to cater to foreign investors. From the GP vehicle perspective, managers also need to consider what type of entity (or entities) they will need. The most efficient structure will largely depend on types of fees they will charge investors as well as what state(s) they will have nexus in.

Another key concern startup managers need to consider is cybersecurity. This may be an aspect which may be under-serviced. Most managers understand the necessity of investors and accountants but might not fully acknowledge the importance of protecting the data they hold within their firm.

"Managers who don't have a robust approach to cybersecurity will have a hard time growing or even staying in the industry," Teixeira highlights. "Even we, as accountants need to be mindful of this. We are privy to so much sensitive information from our clients that if we're not at the top of our game when it comes to protecting that data, then we wouldn't be in business for very long."

From its perspective, Anchin is more than a service provider. Teixeira comments: "We're a good sounding board for our clients. We want to be part of the managers' team and help them navigate different aspects of their business operations. Fostering that relationship is very important to our business and we want managers to have faith in us and our advice." ■

George Teixeira
Tax Leader, Financial Services Practice, Anchin

George Teixeira, CPA, is a tax partner at Anchin. He is the Tax Leader of the Firm's Financial Services Practice and Leader of the Firm's Private Equity Group, as well as a member of Anchin Private Client and the Emerging Manager Platform Team. He is experienced in servicing the alternative investment, private equity and financial services industries. His expertise includes tax planning for high net worth individuals, broker-dealers, venture capital companies, hedge funds (and their investors), investment partnership management companies and general partner entities.