Do you invest in first time funds?

Lisa Bushrod reports

The problem with first time funds as far as institutional investors are concerned is that they are inherently more risky than a proven formula. But the first time funds of today could be the stars of tomorrow, as every institutional investor is too well aware.

Of course when you start to research the area it becomes clear that those say they will invest in first time funds are actually talking in highly qualified terms.

"First time funds can be very complicated in today's environment. You need to show consistency in returns from an experienced team with a good story or be a spin-off team that has a track record in a popular market. Otherwise it's very hard and even more difficult in the venture area," says Mounir Guen, CEO of placement advisory firm MVision.

One of the easiest and often quickest way to get a first time fund off the ground is to get a cornerstone investor on board. This is exactly what Barlage, Knoth & Cie, a first time German fund focusing on production companies in the areas of mechanical and electrical engineering and selective parts of the automotive supply industry in the German-speaking countries, has found.

One of the co-founders, Rainer Knoth, was a member of the board of HypoVereinsbank between 1995 and 2000. It is HypoVereinsbank that has committed to the firm's first fund raising, which has 70 per cent of its €75 million target committed by investors and is scheduled to close at year-end.

Frank Hock at Barlage, Knoth & Cie says that of the institutional investors the firm approached this year during the course of its fund raising about 20 per cent said they would not invest in first time funds. And the rest said they do in principle invest in first time funds, but selectively.

The firm in turn was selective about which institutions it approached. They fell into three categories: German institutional investors, fund-of-funds managers in Switzerland, France and the UK and family offices in the German speaking countries. Interestingly two fund-of-funds approached did not say that they wouldn't invest in first time funds specifically but that they wouldn't invest in a fund that they had not had a relationship with for at least three years. That more often than not however amounts to the same thing. That said Barlage, Knoth & Cie was asked to keep in touch.

Some of those institutional investors that started to do due diligence with the firm but ultimately pulled out did so on the basis that creating shareholder value and floating a company were not the same as exiting a private equity investment. The team at Barlage, Knoth & Cie has not worked formally together in the past, only on a deal-by-deal basis. A hard proposition for today's tough fund raising market but the team's collective past experience and contacts looks set to get it off the ground.

Rod Schwartz at Catalyst Fund Management & Research was a private equity and venture capital investing novice when he set up his firm in 1997. But again as an ex-banking analyst of the highest calibre and for a short while an ex-investment banker he was extremely well-connected and benefited from a frothy fund raising market in 1999. About to embark on fund raising for the firm's second fund investing in financial services-related businesses, the firm now has a track record and a portfolio to display to institutional investors. Schwartz says raising the first fund was easier than he expected. It was no doubt helped by his contacts given the number of financial institutions that came on board with a strategic, as well as return, interest.

Of course in an overheated market enthusiasm is likely to triumph over experience - see table below for details of first time European funds raised 1999 to 2001. If 2001 looks like a depressingly sharp drop, 2002 figures are likely to be worse if the European Venture Capital & Private Equity Association figures for Q2 2002 fund raising are anything to go by - €1.6 billion raised compared to €5.3 billion in Q1 this year.

"First time funds can be very complicated in today's environment"

An interesting by-product of the technology bubble of the late 1990s was that first time funds, usually staff by individuals without so much as a whiff of prior venture capital investing, rode off the back of the excitement in the stock markets created by the venture industry returns. They literally by-passed the whole tedium of the fund raising cycle and went straight to the public markets armed with an investment proposition, a few contacts and raised money for investment.

Mostly they were termed incubators or accelerators, catalysts and variations on the theme. The London Stock Exchange's Alternative Investment Market was guilty of spawning several such companies, many of which have since imploded, merged or been reversed into due to their cash piles. The cash piles were in many cases money from the original placing that was never spent and ludicrously, post crash in 2000, some of these former stock market darlings were sitting on cash of say £20 million and being valued at just £15 million. This absolutely reflected investors' confidence in what these groups would end up investing.

Returning to the selectivity of institutional investors that Hock refers to. This amounts to sub-dividing first time funds into distinct categories. Firstly there are first time funds with no track record (Barlage, Knoth & Cie). Secondly, there are spin-offs from existing teams and so they come with a track record. Finally there are teams with a new strategy or who are adding a new component such as deal size, geography, or sector to an investing formula they have proven already.

The prospects for getting the first type off the ground in the current market are not fantastic. The second has spawned such teams as Penta Capital (ex Royal Bank Development Capital) and Alchemy Partners (John Moulton is both ex-Apax Partners and ex-Schroder Ventures.) The Penta team left Royal Bank Development Capital on the strength of Bank of Scotland's willingness to cornerstone their new venture. John Moulton, having already built a considerable reputation for himself, so the stories go, had institutions banging on his door armed with commitments in the order of £600 million just on the basis of the announcement that he was going it alone.

That said the mix must be right. The four ex-Royal Bank Development Capital guys who finally got Penta off the ground were a well-rounded and complementary team. And Moulton, despite his industry figure status, was also supported by a strong enough team for investors not to worry about what would happen to their money if he suddenly disappeared from the equation.

First time funds will continue to get a slice of the institutional investment pie, even if things are tough going for the next couple of years in terms of fund raising, particularly in the venture area. The fact is that one of the many things institutional investors have learned during the latest cycle is that there is not always a very good correlation between brand name and performance. Consequently helping get first time funds off the ground is always going to hold its attractions and given the financial commitment required during the fund raising process (one first time fund estimated the costs ran up by a four man team during the fund raising process got close to £2 million in total) only the serious need apply.

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First time European funds

Year	Total number	Total $m	Focus
1990	18	787.2	10 buyout 2 development 2 generalist 2 early 1 later 1 balanced
1991	9	461.5	3 buyout 3 development 1 balanced 1 generalist 1 turnaround
1992	4	196.3	2 buyout 1 later 1 development
1993	13	918.7	3 buyout 4 balanced 2 fund-of-funds 2 development 1 early 1 generalist
1994	14	397.0	4 buyout 1 generalist 2 early 1 fund-of-funds 4 development 2 balanced
1995	10	843.1	3 buyout 4 development 2 early 1 balanced
1996	11	2,411.5	2 balanced 5 early 2 buyout 1 development
1997	29	4,974.9	11 early 8 buyout 4 fund-of-funds 2 balanced 2 development 1 generalist 1 seed
1998	42	2,474.7	6 fund-of-funds 16 early 6 buyout 5 balanced 8 development 1 generalist
1999	47	4,338.2	17 early 2 later 3 buyout 10 balanced 10 development 2 generalist 1 expansion 1 fund-of-funds 1 real estate
2000	43	4,411.9	21 early 5 buyout 1 later 6 development 6 balanced 2 fund-of-funds 2 expansion
2001	13	1,118.4	5 early 2 development 1 later 2 seed 1 balanced, 1 fund-of-funds 1 turnaround

From 1993 fund vintage determined by year of first investment, no matter how small
Source: Venture Economics