First Closes

For emerging and established managers alike a “first close” comes with a profusion of sentiments. A first close is a multiheaded chameleon that harbors many characteristics and uses – it can be an existential marker, a customary show of fundraising progression, a necessary action to allow for deal execution, a timekeeper and barometer of the level of fundraising success so far, etc. Most veteran GPs tend to talk about their first closes with cautious certainty while emerging managers rarely speak of their first closes without expressing apparent anguish. Certainty around first closes is a harsh differentiator that gets even more exacerbated during unforgiving fundraising environments (such as the current one). At its core, the first close is a signal. This signal generally tells the world that as a GP, you have convinced a decent amount (typically denoted by 20% to 50% of target commitments) of investors to ride along with your strategy. Of course, there are some elite (based on a proven history or market hype) GPs whose first closes are also their final closes. However, for the broad GP population (emerging managers in particular), the first close and its accompanying dynamics need judicious forethought around signaling, creative enticements, and the deliberate weighing of ultimate fund/organizational goals.

As an allocator, I empathize with managers who have cleared rigorous due diligence bars but still struggle to attain critical mass for a first close. The equation these GPs are solving for is reminiscent of the chicken/egg metaphor where cause and effect playfully torment your existence. Prospective investors want assurance of a certain threshold of first closers to ensure their dollars will not stand alone. Yet, these same investors’ dollars are critical in attracting others into the fund. Regardless of conviction in a fund, the risks of carrying part of the manager's existential load, the administrative time and effort expended to fill out sub-docs amidst legitimate uncertainty regarding an eventual final close, and the financial burden of bearing the initial capital calls, may be too great for many LPs to handle. What is the best way for GPs and prospective LPs to navigate this dilemma? What should be assessed before wading into these uncertain waters? What balance must be struck between the viability of a strategy and living to fight another day? Where is the best source of piloting advice for first closes? These questions (and countless others) plague many with poltergeist-like incessance. Below, I list factors that GPs and LPs should pay attention to when presented with “first close” conundrums.

- **Size Considerations**: As a GP prepares to broadcast its strategy intentions to investors, its target fund size is one of the most critical decisions it must make. The fund's target size comes under even greater scrutiny after the first close because the clock officially starts ticking. There must be broad and deep thought put into the minimum viable fund size needed to execute the strategy – the number of portfolio holdings, deal/portfolio risk, portfolio company ownership percentages, returns variations, etc. need to be assessed in conjunction with different fund size scenarios. For instance, if you raise 30% of the target fund size in your first close, how does that increase (or diminish) the potential of reaching the ultimate target? Through rigorous modeling, a robust scenario analysis should be readily available to show contingency plans. Prospective LPs gain confidence from knowing a GP has taken the time to think through how the sanctity of its strategy could/would remain intact at different (usually less than target) fund sizes. Despite the harsh realities of modern-day fundraising, investors have the fiduciary and prudent responsibility to ensure that capital is not frivolously committed. It is incumbent on GPs to convincingly display the sturdiness or adaptability of their strategies at various fund sizes. My argument is not about voodoo math, but rather discipline, transparency, and honesty regarding a threshold below which the strategy is no longer viable as a fund.

- **Incentives:** In the private assets industry, incentives to attract early adopters have long been a hot topic. Many funds start with non-negotiable fund terms and a steadfast fund size target, but as fundraising reality hits, resolve slowly erodes to an open-minded state where firstborns and left arms are now on the table. First close enticements have included management fee discounts, reductions in carried interest, increases in preferred return hurdles, co-investment rights (including first refusal and allocation seniority), rights to status quo commitment sizes together with allocation increases in subsequent funds, etc. These days, creativity around incentives is only constrained by the imagination. A first close is a prize worth fighting for but not at all costs. I have encountered too many GPs so blinded by reaching the first close goalpost or avoiding looking like a failure that they lose a part of their essence.

- **General Caution**: Related to the above point, GPs must be cautious to avoid being swayed by fear and vanity into a short-term first close goal that will handicap them for the long term. GPs should ensure that all incentive-granting decisions are made with long-term economic survival, strategy sanctity, autonomy preservation, and risk appropriateness in mind. Overly high fee discounts and carried interest reductions can financially encumber funds from hiring key personnel and hinder the effective execution of deal due diligence. Also, high preferred return hurdles and off-market lower carried interest can subliminally signal to LPs that there is little conviction in attaining target returns and that these hurdles/targets are just ceremonial. With incentives designed to spur a first close, there is a tricky balance to be struck that requires the flexibility of a deal maker but the fiscal responsibility of a business owner.

- **Be Wary of Predatory Behavior**: Other than death and taxes, another inalienable truth you can set your clocks to is the fact that the most vulnerable in society will always be exploited. I have witnessed calculating prospective LPs steamroll GPs who are dangling on the existential cliff edge of a first close. Although I understand that most LPs have stakeholders to whom they owe fiduciary obligations, it concerns me when proposed terms by some prospective LPs could negatively impact a GP's ability to autonomously execute its strategy/business. GPs in precarious situations find it difficult to resist the promise of a relatively large (anchor) commitment as well as the opportunity to utilize that investor's name (especially if it is recognizable) to attract more capital. My top pick for areas where GPs are susceptible to the most abuse is the practice where some prospective anchor investors require a stake in the management company, thus enabling them to partake in the GP’s excess management fees (profits) and carry. Ownership stakes in the management companies of sponsors tend to have no sunset provisions (they are infinite in nature) unless otherwise negotiated. Additionally, discounted fees/carry in the present and subsequent funds, deal opt-out provisions, right of first refusal for co-investments in the present and future funds, co-investment allocation agreements in the present and future funds, veto rights, fund size restrictions, etc., are areas I have seen vulnerable GPs get excessively taken advantage of. GPs must maintain honest and realistic standards regarding their fund management autonomy as well as their present and future economic needs. Over-incentivizing one set of investors can lead to a detrimental lopsided investor composition that puts overall alignment and future survival into question.

- **Composition**: In addition to the amount of capital raised for the first close, GPs should recognize that the source/composition of that capital is almost equally as important. The first close typically sets the tone for subsequent closes. The constituents of the first close will invariably act as catalysts and springboards for subsequent closes. Funds with institutional investors as their first closers are more likely to attract high-quality follow-on investors than those with friends, family, and local high-net-worth individuals as their first closers. At a time (during the first close battle) when every cent committed is deeply cherished by managers, the uncomfortable truth of investor quality may seem unfair, but it is also a poignant reminder that when the journey eventually ends, those who stood with you in the early days can indisputably be considered your tribe.

- **Dry and Wet**: The degree of telegraphed dampness of a first close comes with a variety of repercussions. An indicated "dry close" assures investors that after the close, no capital will be called, nor management fees charged on committed capital. On the other hand, a "wet close" designation prewarns investors that management fees on committed capital will likely be charged and investment capital will likely be called. Different investors react differently to the prospect of a wet or dry close. The onus of determining the most advantageous "moisture" level for a first close lies with the fundraising GP.

- **Final close**: While the clock officially starts ticking at the inauguration of the first close, the ultimate goal for any fundraising manager is to reach the "final close" with committed capital that is as close to the target as possible. The space (usually 12 or 18 months) between the first and final closes should be chosen with humility and reverence for the unforeseen. Arrogance, or an inferiority complex, are two ends of the human personality spectrum that must be avoided on the road to a final close. Achievement of a "first close" should be seen as an indication that you are doing something right, subsequent closes are further indications that momentum is building behind something real, and the "final close" is a time for gratitude and a moment to take full inventory of the degrees of loyalty of your newly formed tribe.

Getting to a first close is a milestone worthy of dogged pursuit but GPs should not lose their essence in the process. I wholeheartedly believe that the concept of "first closes" should be viewed as an important fundraising stepping stone and confirmation of the viability of a fund's investment strategy, but not a time for groveling and soul-selling. Everything worth pursuing takes time, perseverance, and self-belief.

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June 16th, 2024.