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Published on September 19, 2023

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An LP's Guide to Manager Selection

Thoughts from a former LP on what to examine beyond IRR

PitchBook is a Morningstar company providing the most comprehensive, most accurate, and hard-to-find data for professionals doing business in the private markets.

Introduction

In [Allocator Solutions: Evaluating Persistence in Fund Performance](#), we concluded that while some pockets of the private markets provide weak support for performance persistence, there is still a wide dispersion of outcomes within each strategy. In addition, our work shows that even if there is persistence, it is based on the IRR when the fund has liquidated its holdings. At the time a fund is in the market hoping to attract LPs, the prior fund has not typically been fully realized and returns are based largely on valuation estimates. In fact, we see significant movement between the IRR of a fund in the three-to-four-year time frame and its final IRR. We have also examined if the second and third funds prior to the current fund in market are predictive, and the relationship is even weaker than when we looked at the immediate predecessor. Because of these difficulties, looking to factors beyond performance is advisable when seeking fund managers with whom to partner.

By definition, private markets are opaque. No investment option's outcome is known in advance, but given that many private market funds are blind pools—LPs commit before the underlying investments are identified—allocators have even less to go on than they do with, say, a mutual fund, where they can see companies and sector weights around the time they allocate to the fund. In addition, in contrast with public market funds, you cannot get out immediately if you lose confidence in the fund manager or strategy exposure. When diligencing a private market fund, the job of the allocator is to gain trust in the ability of the fund manager to provide the returns contemplated over a 10-year life or longer.

When a GP comes to market, the previous fund in the strategy is often performing well.¹ The running joke among allocators is that all managers pitching a fund somehow seem to be in the top quartile. Our work shows that the performance of a fund that is only 3 to 5 years old (the typical age of a predecessor fund at the time of the next fundraise) is not predictive of where that fund will eventually fall among its peers, so recent performance is something that should be given a light weight in the evaluation of a new fund.

1: "Private Equity Fund Valuation Management During Fundraising," Harvard Business School, Brian K. Baik, August 2022.

For those managers with no track record at all, evaluating past performance is an even more problematic exercise. While these managers do have more difficulty fundraising, typically between 50% and 60% of the funds raised in a given year come from emerging managers—those raising their first, second, or third fund.² Granted, emerging managers raise a significantly smaller portion of capital—in recent years it has been around 20%—but many hundreds do reach a successful close every year. While many LPs may believe that first-time or emerging fund managers are hungrier and more likely to provide outsized returns,³ not all will, and because diligence seems much harder without a track record, institutional investors often stay away, not wanting to take a chance on something new.

If past performance is not available and recent fund performance is not a great indicator of eventual top managers, what can an allocator do?

The Spinal Tap of due diligence

It may seem trite, but there is a long history of business advice being framed with five Ps. A quick internet search reveals five Ps of marketing, five Ps of success, five Ps of strategy, five Ps of leadership, five Ps of equity investing, and so on. Like the fictional heavy metal band Spinal Tap, whose loud performances gave birth to the phrase “Turn it up to 11,” I have taken the Ps up one more notch—to six—and even offer a bonus P. This framework highlights the areas that LPs should evaluate when faced with a potential fund investment. It must be noted at the start that there is no single correct response to any of these areas of inquiry, but the answer must make sense in the context of what the GP is offering, and all the responses must form a holistically coherent picture.

For that latter point, I will provide a few examples. It is not wrong for a GP to say that it incentivizes its people on the deals they work on (an “eat what you kill” model), but if the manager also says it has a team-based culture where everyone’s complementary skills make the fund a better whole (also a perfectly fine answer on its own), then the individualized incentive structure may not be in alignment with the intended team culture. For another example, if a GP claims that environmental, social & governance (ESG) principles are important, but the team slide in the GP’s presentation indicates a lack of diversity, the addressable market slide shows oil drilling and tree cutting in sensitive ecosystems, and the GP has been in the news due to labor litigation at portfolio companies, an LP may accuse the GP of greenwashing, or professing ESG principles without credible supporting behaviors. For a third example, when a fund manager seeking to raise a \$50 million fund says its portfolio will include 15 to 20 companies with enterprise values of \$1 billion or more, and that it plans to take controlling positions, perhaps the GP has not done the math on how these components will fit together.

²: For more on fundraising trends for emerging and first-time managers, please refer to the [Q2 2023 PitchBook Analyst Note: How Tough Is the Fundraising Environment Actually?](#)

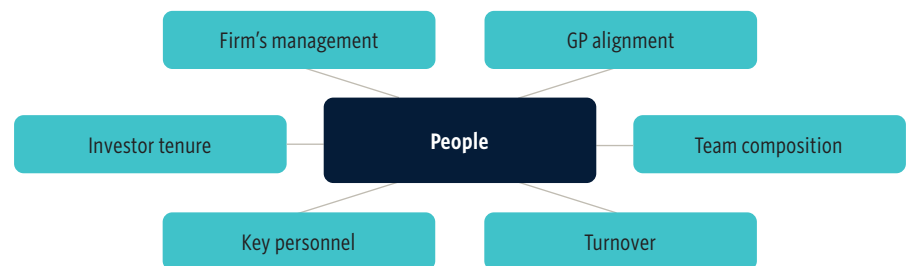
³: “From Upstart to Titan: Why Emerging Managers Can Provide an Edge,” Adams Street, James Korczak, et al., January 11, 2023.

The primary job of the allocator to private funds is to identify if the right mix of factors are present to provide a desirable risk/return profile suitable for its objectives. By using a fundamental approach to fund manager evaluation, the presence of a prior IRR becomes much less important if one becomes accustomed to evaluating the people, philosophy, process, and more of any fund under review.

With the help of the six Ps, thinking carefully about the whole picture can ensure that an LP has gone beyond simple performance ranking and has a better view of the GP's overall capabilities. This is not, of course, an exhaustive list, and there are other frameworks that LPs may follow in performing their due diligence, but the guidance should be useful for teasing out potential red flags or diamonds in the rough.

The six Ps

People



The first P, people, includes everything about a firm's management: how and why it came to be, who works for the firm and who runs it, who owns it, how firm-level decisions are made, and so on. Also falling under the "people" umbrella is the investment team responsible for the fund under consideration. At a small firm, there will likely be a large overlap between the investment and management teams, but for firms with multiple strategies on offer, investment and management teams typically have few members in common. Each of the areas outlined below are important because of the long-term nature of these investments and the trust you must have in the organization and its people. To provide more perspective, here are some questions LPs should consider asking:

- Why was the firm created?** Answers to this question may range from spiteful reactions to prior situations to a clear entrepreneurial vision of a workplace that consciously operates differently from the firms in which the founders learned their craft. If a GP has purposely abandoned an approach from a prior firm, it must be very specific about what skills the individuals are contributing that are relevant to the current firm as well as the things they are hoping to jettison—and why the new firm will be the better for it. In determining if the story is reasonable, LPs should ask if the new GPs have the same support structure, the same freedom from business management responsibilities, and the same access to talent and deals. The answer is probably not, making any track record problematic as a predictive tool.

- **How is the firm managed?** Who has a say? Who has ownership? How will ownership be allocated over time? Is there [outside ownership](#), and if so, what is the nature of the deal? A lot of GPs put very little in their pitches about firm management, but these questions speak to the viability of the asset manager, how thoroughly it has thought about how decisions surrounding the firm will be made, and whether it understands that running an asset management firm is more than just doing deals. If the same people are handling the investing, managing, and fundraising as well as performing investor relations functions, it may feel like nothing is getting anyone's full attention, and investment performance could suffer. In sum, this set of questions is about how the business of the GP will be run. Some of the more differentiated GP responses to these questions tie lessons the GPs learned from managing deals and operating companies to how they plan to run their own partnership.
- **How is the GP aligned?** How well are the individuals managing the fund aligned with the performance experience of the LPs? To paraphrase a previous manager of mine, if the LPs are suffering in a fund, the GPs should be suffering as well. With the amount that some larger asset managers are taking in from fees, it is hard to imagine that anyone is suffering, but smaller funds may truly be keeping the lights on with the management fee and may be, through the carried interest incentive, very well aligned with maximizing investment performance for both LPs and themselves. When it comes to newer fund managers, if the team does not have the financial resources to collectively commit 2% of the fund size, they should be open about that and be willing to prove that what is being committed is a significant personal stake.⁴ While these questions may be culturally delicate to ask, GPs should be prepared to answer how they are aligned with their partners.
- **How is the team composed?** Why is each person important to the team? How are the team members complementary? If team members are carbon copies of each other, with the same investment banking background and the same prior employer, they may seem interchangeable—which could be good if someone leaves—but they may also lack fresh perspectives and be prone to groupthink. Having team members with different areas of specialized knowledge could ensure that the GP has the collective capabilities to maximize the value of an investment through the structuring of a deal, the operation of a company, and the exiting of an investment.
- **Who are the Key People and why?**⁵ GPs are proposing to form a long-term relationship with LPs. In addition, LPs are being asked to commit to a blind pool, so the main comfort they have is that the people they put their trust in will be there throughout the life of the fund. GPs should do some soul-searching about how many departures they could absorb and by which team members before the strategy would no longer be viable. Of course, the GP's perspective will be more forgiving than that of the prospective investors. GPs may have a difficult

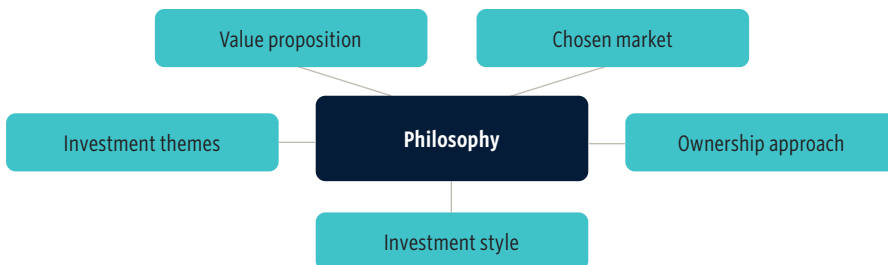
4: For more on the alignment of interests between LPs and GPs, [read ILPA's principles](#) that it feels ought to be industry-standard approaches to this topic.

5: A "Key Person" generally has specialized knowledge, skills, and/or leadership qualities that are vital to a fund's success. An event (such as a death, retirement, termination, or long-term illness) that materially affects a Key Person's ability to contribute to a fund's success will typically trigger the Key Person Clause in a limited partnership agreement (LPA), which would prohibit the GP from making new investments.

sell if they try to convince LPs that every member of the team is important when, in reality, half of the team would need to leave before a Key Person Clause is triggered.

- **Background checks:** LPs should be prepared to do reference checks and/or background checks to ensure that the GPs are who they say they are and that the experiences of previous LPs match up with what the GPs say they will do. If LPs work with an investment consulting firm, hopefully it is the consultant's standard practice to run a background check on the GP's Key People as part of its own due diligence.
- **Are there longevity issues?** Some new GPs launch themselves based on the hallowed experience of someone with a very long tenure in private market investing—so long that some might question whether the end of that person's career will predate the end of the fund. While many investment professionals portray the idea of working until they die in their office chair as virtuous, LPs are right to question what the GP's plans are should this person leave the firm before the fund ends. End-of-career considerations aside, succession plans for any eventuality should be in place regardless.
- **Who has left the team?** What roles is the GP still hoping to fill? It is possible that past fund performance may be irrelevant if key personnel from the prior funds are no longer with the new fund in question. On the other hand, many emerging managers plan to do some hiring after they begin to collect management fees, so a conversation around these potential hires is needed. People are such an important element to the running of a fund, and if the fund under review will not have the same people who build a record or who will be managing the next fund, then it becomes difficult to know what to expect.
- **What functions does the GP outsource?** Some managers utilize external research to inform their views, to tap for portfolio company board seats, or to fulfill other roles an LP might normally expect to be housed within the asset manager. LPs should be sure to ask about any functions performed beyond the team, why the GP has chosen that course, and if it has any plans to alter that approach.
- **Finally, a pet peeve of mine: Does the fund manager quote a cumulative years of experience number?** I usually call them out on it. First off, a 50-year figure could hide the fact that one person has 41 years of experience and the other nine on the team have one year each. In addition, the main reason that time is an important indicator is that investors learn by going through different cycles, so if 10 people have been investing together for 10 years for a cumulative 100 years of experience, they have faced the same crises and bubbles in the same 10-year horizon. The experience is not additive. I always find this "statistic" to be cringeworthy when included in a pitch.

Philosophy



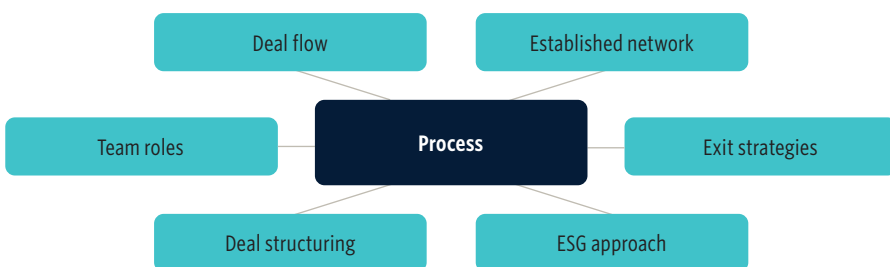
Philosophy is sometimes difficult to articulate, but it aims to understand the market opportunity the GP is hoping to address and how it plans to exploit it. This seems straightforward, but in a world where LPAs are typically written to provide the fewest constraints on the GP, it may be helpful for LPs to press newer managers to clearly articulate a tight philosophy to give a better idea of their intentions. Being able to articulate the themes and sectors to be targeted, the diversification elements to be employed, the value to be added to portfolio companies, and the pitch to convince portfolio company owners to allow the GP to purchase or sell a stake will go a long way toward making LPs comfortable with the vision. While GPs may be tempted to leave all avenues open because the future is murky, those managers without a track record would be well served by a clearly articulated approach that allows LPs to form expectations. A bonus is that having a clear philosophy will help the GP focus on its key strengths and provide a rationale for avoiding out-of-scope investments, even if they do seem like the opportunity of the century.

Here are some potential philosophy questions and thoughts about each:

- **What is the GP's value-add?** The answer to this question needs to go in two directions. First, it should address how the team is best positioned to buy, manage, and sell assets for a positive fund outcome. Second, it should state what the team can bring to potential portfolio companies to convince them that the fund manager will provide a better result than other sources of capital. If cash is all that a GP can bring to a deal, it might not be able to gain access to the savviest entrepreneurs, which should be concerning to prospective LPs.
- **Why is this the GP's chosen market?** While an investment team's experience in a sector will often be a big reason, the team should also discuss why small deals/midsized deals/megadeals are right for them, why geography A/B/C is their target, and whether they have enough credibility in these markets to attract the attention of entrepreneurs and business owners seeking capital. In addition, not every area is ripe for outsized investment returns at all times, so GPs should have knowledge of their spaces and their current prospects.

- **What common themes tie targeted investments together?** Will the GP seek orphaned assets, companies ready for the next phase of growth, products seeking international distribution, or something else? Connecting the expertise of the team to these themes will help bring credibility to the articulated philosophy.
- **Does the GP feel strongly that it must control or lead deals to be effective?** Does it believe it must be on the board? If it does not intend to lead deals, then what is its experience working with other GPs to effect positive change at a company, and what is its experience in influencing an investment from a minority position? Again, the GP must be ready to explain how the team's experience is well suited to the styles of management that the fund plans to implement.
- **Does the GP see itself as an operator, a financial engineer utilizing company-level and/or fund-level leverage, a roll-up strategist, a mentor, or some combination of these?** The response should be placed in the context of the market opportunity. Particularly in times when multiple expansion is a questionable source of upside, it is incumbent on the GP to have a plan for value creation independent of a generally rising tide.

Process



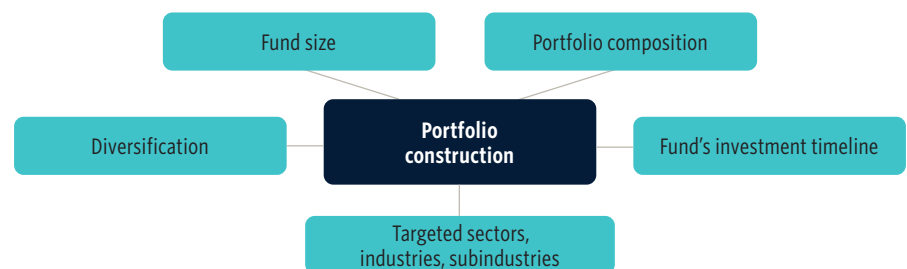
Process is the end-to-end description of how a GP will source and close deals, manage portfolio companies, work with co-investors, and profitably exit investments. Many GPs spend a large portion of an LP pitch talking about the deal sourcing funnel and, hopefully, some time on how they will manage the companies to a profitable exit, but the discussion about exits is often incredibly basic. While investors would all like to think they can create such a desirable asset that buyers will flock to them with very little effort, that seems rather optimistic; a GP should be able to demonstrate that it has experience running multiple types of exits and not just answer with a vague “Hopefully the IPO window will be wide open when we are ready to sell.”

Here are some potential process questions and thoughts about responses:

- **How is the team structured in relation to the process?** If decisions are made by committee, how are votes decided? Are the Key People named in the LPA involved with every decision, and if not, should others be named as Key People in addition or instead? Also important is determining if those who make the deals are the ones who will be managing the deals or staging deal exits. Some firms have specialists for each stage of the investment, while others feel it is important to have continuity, with the deal team staying with an investment from start to finish. There are no right or wrong answers to these questions, but GPs should be able to describe their thinking and experience here in great detail.
- **If a GP says it has proprietary deal flow, as most do, can it back up this statement?** How is the GP sourcing deal ideas in a way that others are not or cannot? Especially in PE, so much is done by auction that it is rare to find anyone with valid sources that will lead to a noncompetitive process. Some GPs do, however, have a hookup that seems legitimate. One example could be a VC fund of funds (FoF) that provides banking services to VC companies, partners, and entrepreneurs. At times when the best VC funds are difficult to access, that banking relationship may help the FoF gain an allocation that others are unable to get.
- **Does the GP have an established network for sourcing deals?** What about for supporting portfolio companies? A GP must be able to describe its network and how deep it is to prove that it will come up with a sufficient number of quality deals to fill and support a fund. Many first-time fund managers come to market with a sweetheart deal or two lined up to impress potential investors, but they must be able to speak to the ways they will be able to uncover more.
- **What experience does the team have in structuring deals?** Does the GP have specialists for this step, or are people at the firm working on all the steps in the process? Getting a company to take your money can be easy, but getting the best companies to accept your capital at a fair price because the GP is bringing more than just capital to the table is a more difficult skill to hone.
- **What does the GP do when leading an investment?** If it says it is very actively involved with both the companies and the boards, what specifically are its typical activities, and why is it in the best position to be performing them? Is there a formula for what the GP intends to do for a company, or has it demonstrated flexibility in its approach by tailoring its actions to a company's unique situation? Some GPs swear that their operational prowess is the key to their ability to provide outsized returns, but then they go on to split deals with other PE firms, sharing the burden of management and potentially diluting their impact if there are conflicts about how best to extract value from an investment. This is yet another reason to have a clear philosophy and process, as it should keep the GP from straying from its demonstrated strengths.

- How has the GP maximized profits on exits?** Does it have experience with multiple types of exits and the ramifications of each? IPOs are very appealing in their public nature, but not only are they relatively rare,⁶ but they also introduce risk if shareholders are not able to sell their stakes right away due to lockup restrictions.
- Is the team staffed to support the level of involvement they plan to have?** How many boards can one person sit on and still bring enough time and attention to each company? GPs typically have their annual meetings in the spring or fall, and LPs often find themselves having to decide which to attend due to conflicting dates and locations. GPs face the same problem with portfolio companies. If one person is on too many boards and has to miss meetings or spend too much time turning around one or more investments, then their best efforts are not being applied evenly across the portfolio.
- How does the GP plan to handle currency issues?** While not every GP will be crossing international borders in their acquisitions, some do it enough that they may consider hedging strategies.
- What is the GP doing with respect to ESG?** As laid out in our analyst note [ESG and the Private Markets](#), ESG is not a strategy on its own but can be another component of the traditional investment process. Material nonfinancial risks such as ESG should be understood and mitigated as much as possible to limit foreseeable negative events and create a more sustainable long-term business model. According to our [2023 Sustainable Investment Survey](#), 76% of VCs and 69% of non-VC GPs have declined to make or recommend an investment due to ESG concerns, so hopefully this majority of managers can articulate the value they find in utilizing an ESG risk framework in their investment process. If nothing else, a thorough response backed by demonstrable activities can be a positive differentiator for those LPs that have a focus on ESG.

Portfolio construction



This P is largely about how the GP plans to diversify its fund across several dimensions, although it starts with how big the fund will be. A surprising number of managers do not know much about the offerings of their competitors, so they are unaware of how they are positioned among other funds in the market. For each of these questions, GPs should not only have an answer but also a reason

⁶: Exit counts by type can be found in the [US PE Breakdown](#) and [PitchBook-NVCA Venture Monitor](#) reports.

for why they have made that decision. There is no single right answer; we have shown that [executing a strategy](#) as either a generalist or a specialist can provide outsized returns.

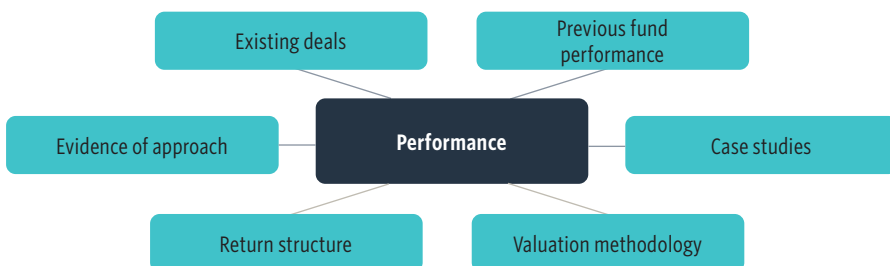
Here are some potential portfolio-construction questions and thoughts about responses:

- **What is the fund size?** Some GPs struggle with choosing their targeted fund size. If this is a first-time fund, the size can largely be mathematically determined by the investment amounts required and the number of companies in the portfolio. Any fund manager should be able to demonstrate what it costs to get a deal done in their chosen area. If it is a follow-on fund and the GP is planning to increase the size from the predecessor fund, the GP should be able to explain why the fund needs to be larger. Was the original fund unable to carry out the strategy as outlined because it underestimated how much it would cost to acquire targeted companies? Did the GP discover that the original strategy was more effective with the larger companies it purchased? Did the GP expand its investment team to provide more bandwidth for more deals? As an LP, it can be unsatisfying to hear that a GP is raising its fund size because everyone else is doing it. Often, getting larger means greater competition for deals as you enter the realm of funds with much deeper pockets. GPs should have a very good reason for stating that bigger will be better for them.
- **How many companies will the portfolio ultimately comprise?** This should logically connect to the size of the investment team and how many deals one person can not only work on but also manage through to an exit. The answer to this question should also have some relation to calculations the GP has made regarding how it plans to make money. Does it plan to operate under the VC Power Law,⁷ where a small number of deals drive most of the returns, or does it seek to have every investment pull its own weight in contributing to positive fund returns? The former may require a larger portfolio of companies to ensure that no one failure sinks the entire fund, while the latter, more common in PE, may allow a GP to focus on a handful of investments with less expectation of either a massive win or a catastrophic loss.
- **What is the largest proportion of the fund's capital that one deal may receive?** This may need to be worded carefully in the LPA, as an early deal may be a very large portion of first-close commitments, but it may be a more reasonable share of the fund's ultimate target size. Even so, one bad deal can be extremely detrimental to a fund's total performance, so a limit on how much capital may go into any single investment is a rule many see as prudent. This can also limit the temptation to throw good money after bad should the investment team overestimate the prospects of a company already in the portfolio. Some claim that knowing when to abandon a company is just as important as identifying a good investment in the first place; having an upper limit on the capital any one investment may receive provides some discipline around that idea.

⁷: "The Power Law in VC," VC Lab, August 9, 2023.

- **What sectors, industries, and subindustries will be targeted, and in what proportions?** While some GPs choose to focus a fund on a highly specialized sector, should that sector be hit with exogenous factors such as supply chain disruptions, adverse regulatory or judicial decisions, or a massive firm utilizing tremendous resources to block potential disrupters, an entire portfolio could be negatively impacted. For that reason, even in a specialist fund, assembling a portfolio with companies serving different client types, producing parts for different end products, or exporting to different geographies can provide some protection should there be a systemic failure in one particular area.
- **How quickly will the fund's capital be invested?** How will the GP pace the acquisition of portfolio companies? While the investment period stated in the LPA may be something around five years, is there a minimum number of calendar years across which the GP intends to invest the fund? Some GPs have been known to come back to market with a successor fund very quickly, suggesting a lack of selectivity when closing on deals or a drift in style if the individual deals are absorbing more capital than intended. This can put stress on an LP if it had different expectations of when it might need to supply capital to the fund. By putting some guardrails around the time to invest, these outcomes are more likely to be avoided.

Performance



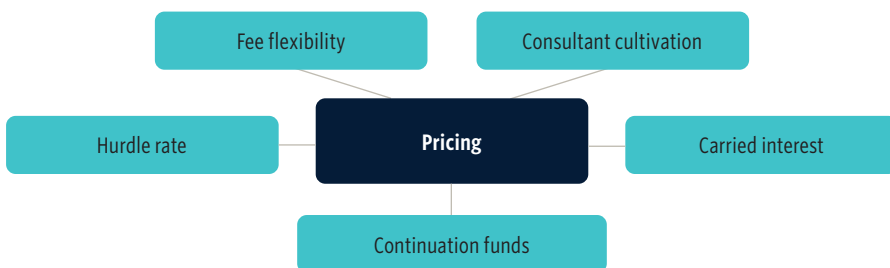
As mentioned in the introduction, performance is problematic as a predictor of future fund success, but it should still be examined. This is most difficult when evaluating emerging managers, as they cannot point to a fully realized portfolio that reflects the team, philosophy, and process of the fund currently being contemplated. It is tempting for a new GP to draw a direct link between itself and the performance of funds or deals upon which the members of the current GP team may have had only a glancing impact. Taking credit for a deal that occurred within a completely different infrastructure (such as a larger firm, a fund with a different strategy, or an investment team with very little overlap to the current team) should be met with skepticism.

So, how can an LP approach this portion of the diligence conversations?

- **Ask about any existing deals completed by the current team at the current firm.** Many emerging managers will go to market with a deal or two initially funded by short-term loans or seed investors to show proof of concept. The GP can talk about how the team sourced these deals, what the plans are for them, how the investment is progressing, and how its actions have impacted this progression. While exits from these deals may be some years off, prospective GPs should discuss likely prospects for these companies and how the team has the expertise and network to positively influence the results. Above all else, they should tie the existing holdings to the philosophy and process outlined earlier in the conversation. GPs must show that they are following through on what they promised and that the pool is not as blind as it seems because there is evidence of the strategy in action.
- **If the team did a full lift-out from a prior GP, it might be possible to discuss fund-level performance, but even here, the track record will not be an exact proxy.** Presumably the current team is not with the prior firm for a reason, and that reason could have a significant influence on how the new fund will be managed. GPs must talk openly about the similarities between prior funds and the new one and be frank about what has changed—key among them the fact that the prior GP may have been larger, had more institutional back-office capabilities, and provided synergies across multiple strategies that the new firm cannot access. It is to be hoped that most of the changes will benefit investors, but the GP should be able to articulate how the resources of the prior firm will be replaced, how the old ways may have constrained fund performance, and how the new firm will have a better chance at success.
- **If an emerging manager does not have any deals yet and the team did not work together at a prior firm, the offering will be even more difficult to evaluate.** But it may be possible to identify proof of the strategy in action through case studies. The GP should be able to name deals that this team or individuals of this team worked on that relate specific past investment activities to the philosophy and process of what is being proposed. It should be open about what the current team members did and did not do to provide the successful outcome being highlighted. As mentioned earlier, work done at a prior firm will almost always have been in a different environment with different infrastructure surrounding the team and deal, so LPs should be on guard against overstating the contribution any one person made to the success of a prior investment.
- **Valuation methodology should be an explicit conversation, especially in relation to the prior portfolios being held up as evidence of skill.** LPs should look at the prior funds still in operation and separate out the performance of realized and unrealized assets, as the latter will be influenced by how the GP has chosen to value them.

- **GPs should have put some thought into how they expect to earn their returns—not just the nuts and bolts of purchase price, company improvement, and sales price, but also the composition of returns.** Does the GP believe it will make most of its return on a couple of massive wins, or does it expect to avoid losses but also produce no stratospheric gains on any one holding? Either way, can the GP tie its return strategy to previous experiences—either positive or negative? Maybe a lesson was learned that led to the current approach, or perhaps a prior model feels particularly natural to the team, and they plan to bring it to the current fund.

Pricing



Fund fees and terms could be the negotiable part of the discussion—if the GP is willing. In 2020, [we published a note](#) detailing how fees and terms are not as straightforward as they seem and mentioned that emerging managers might try to appear more LP friendly to distinguish themselves from the pack. In addition, in 2021 [we published another note](#) discussing how emerging managers may consider accepting seed or anchor investments to get their firm off the ground and attract other investors.

Emerging managers, just like any fledgling business, need to be cautious about how they fund themselves. LPs should understand this and caution GPs not to give too much away in a panic to land investors. If the GP decides to take on an anchor investor in exchange for a reduced management fee, it must be sure the deal is not so advantageous to the outside investor that the GP cannot run its business appropriately. The GP should have a business plan that accounts for the money required to properly diligence investments, pay top talent, and retain appropriate support services such as IT, auditing, and legal, and set fees accordingly.⁸

8: The Securities and Exchange Commission’s rules for private fund advisors that were released in August 2023, but will not be in effect for up to 18 months, will impact side deals that GPs make with LPs going forward, though the final rules (already subject to legal challenges) seemed to walk back originally proposed prohibitions as long as any deals are disclosed to all LPs.

Here are some additional thoughts related to fees and terms:

- **Some LPs may feel that higher fees are acceptable if the expected returns are better than cheaper options.** Others figure a bird in the hand—or a lower fee for the life of a fund—is better than two in the bush—or potential gains from this long-term investment. Investment managers still well below their fund size target may be willing to make a deal. This may happen in a side letter so that the GP does not have to live with an LPA that codifies lower fees when it is redlined to the next fund, but deals do appear to be common. Our data shows that more than half of private market funds charge less than 2% for their management fees. Given that above a certain fund size, some fund managers are giving away their management fee income to outside investors, there should be some negotiating power for LPs without the concern of constraining a GP in the operation of its business.
- **While it is true that large LPs often have the power to negotiate better fees, other LPs may have an opportunity to improve their deal.** Some LP consultants will pool investors, and if they reach certain commitment hurdles, the fund managers will offer discounted fees. Emerging managers may be less likely to catch the eye of an investment consultant, but some consultants may be influenced by ideas coming from their LPs.
- **There was talk of GPs trying to lower or cut the 8% hurdle rate when interest rates were at record lows, but now that rates have risen, LPs should no longer have to accept that GP-friendly adjustment.** Because this fund term does not come into effect until the GP exits the fund's investments, LPs may be in a position to swing the pendulum to a higher hurdle without damaging the GP's ability to run its business.
- **In a hopefully bygone era, GPs used to distribute shares from IPOs rather than cash, but they would calculate carried interest based on the price on the day of distribution even though the shares were still in lockup, and LPs might have received a lower cash return when they were able to sell.** The modern take on this end-of-investment conflict is the GP-led secondary. Prospective LPs should consult the new ILPA piece on these deals to ensure that the LPA's language is as LP friendly as possible for this practice.⁹ The new SEC rules also addressed this practice, mandating that GPs obtain and distribute an independent fairness opinion or valuation opinion in connection with an "advisor-led secondary transaction."¹⁰
- **There is no way to address every fund term and how LPs might think about them, but ILPA has produced incredible work on a variety of fund terms to help the industry in its thinking about a plethora of issues.** I encourage LPs to become familiar with these and other ILPA guidelines and best practices:
 - [ILPA Principles](#), which touch on GP and fund economics, fund term and structure, Key Person, and more terms
 - [Continuation funds](#)
 - [Subscription lines of credit](#)

9: "GP-Led Secondary Fund Restructurings," ILPA, April 2019.

10: "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews," Federal Register, September 14, 2023.

Potpourri

The promise was for only six Ps, but some additional thoughts that are potentially useful to LPs as they attempt to identify new fund investments do not fit neatly into the above framework, necessitating a bonus seventh P:

- **Placement agents:** They call, wanting to know your priorities, and then they call again with an idea that seems to have no relation to your stated priorities.¹¹ That said, placement agents get by on their reputation. They do their own diligence on funds before agreeing to represent one, so there is some comfort in that added layer of scrutiny. Keep in mind, however, placement agents sell themselves to GPs based on their ability to raise a fund, not on that fund's eventual performance outcome.
- **Carefully consider your access point.**¹² An allocator's staffing and governance may have some impact on how it will access the private markets. For example, if the investment committee is made up of people who are not professional investment practitioners and it meets only twice a year, then maybe an annual commitment to a fund of funds may make sense to not overstress the committee with decisions that require a lot of education. On the other hand, if an allocator has staff with deep expertise in dealmaking and private market commitments, then a more direct approach may be merited—making both commitments directly to private market funds and potentially having an active co-investment program.
- **Be findable.** If an LP has a very specific mandate, such as identifying emerging managers or a specific area of Impact investing, finding such managers may be difficult. The press tends to highlight the largest managers, while hundreds of GPs raising funds at any given moment cannot attract this sort of attention. It may admittedly bring unwanted marketers to the door, but LPs can update databases with their current specific mandate information to hopefully attract the right fund opportunities.¹³ There are many GPs who are desperately trying to find LPs who are looking for exactly what they are selling, so an LP can help that discovery process by keeping its database information current.
- **Do your own due diligence.** While a list of other allocators may give some reassurance that a fund manager is reputable, I would caution any LP from relying too heavily on this. Bernie Madoff and FTX successfully raised capital from investors because of such a halo effect. It is the allocator's fiduciary duty to perform its own due diligence, even if it seems like smarter investors have already done so.

11: [Our primer on placement agents](#), while written with a GP audience in mind, may be of use to LPs wanting to understand what function these intermediaries serve.

12: For more on how LPs access private markets, please read our [Primer on Private Market Access Points](#).

13: To update your profile on PitchBook, send an email to survey@pitchbook.com.

- **Investment consultants—upsides and downsides:** I have been both a client of and a manager researcher at an LP consulting firm. They can be a great sounding board, as they are able to meet more managers than the typical LP and thus provide a deeper sense of the private funds marketplace. That said, I have seen firsthand when LP consultants provided a positive opinion of a fund they felt was not top-notch in order to maintain a relationship. The better course would have been to express concerns and not provide the secondary positive opinion that the investment committee wanted to hear. If a fund does not feel right based on your own diligence or the consultant seems to be lukewarm or is enumerating a lot of concerns, there are plenty more options out there. LPs must have conviction in every commitment they make and not put the consultant in the position of having to obfuscate their actual views.
- **Accessing advisory boards/committees:** Many LPs feel that the most prudent way to monitor and assess their private fund investments—and consequently better diligence the next offering in a fund family—is to serve on the advisory committees of the funds to which they have committed. While sometimes an exception is made for a particular type of LP (such as a pension, foundation, or fund of funds), generally speaking, those asked to serve on the advisory committee for a fund are those who made the largest commitments to the fund. Since many LPs have a rule that precludes them from representing more than 20% of a fund's size, you will generally be invited to the committee if you are that large. For megafunds, however, often no investor represents that large of a proportion. If you are interested in being added to the committee, ask the GP when negotiating the LPA if you might be considered. An LP should not, of course, commit more than intended just to get on the committee, but if it cannot be large enough for a particular fund and being on a committee is important, then it may make sense to look for smaller funds where there is a greater likelihood of being invited to be part of the conversation.

Summary

The six Ps provide a framework to help organize areas of due diligence that an LP should consider. This framework is not prescriptive, however. Some managers may require a deeper level of questioning around one of the Ps given the responses they provide to the initial questions. I have generally found that there is no one right answer to any of the areas of due diligence, but it is a good sign to have a consistent story across the areas, and one that rings true to the allocator asking the questions without raising any red flags. If there was only one way to run a fund, then the investment industry would be very boring, and there would be little scope for diversifying a portfolio. Be open to different approaches, but be sure to stress-test any assertions that do not feel right.

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