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Private equity fundraising and firm specialization

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ABSTRACT

Using a firm-level perspective, this study examines the effect of specialization on the fundraising activities of private equity (PE) firms. We consider three dimensions of specialization: stage, industry and geographic location. Using a large sample of U.S. PE firms, we find that specialized firms raise new funds more quickly than generalists only if the type of the new fund coincides with the current area of the firm's expertise, suggesting that expertise cannot be easily extended to other areas. We further explore what explains the observed link and provide evidence supporting the idea that specialization accelerates future fundraising through increased value-adding to the current portfolio of PE firms. We also show that, specialization benefits increase as the PE firm becomes more experienced.

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1. Introduction

Fundraising is an essential activity of any independent private equity (PE) firm (Cumming, Fleming, & Suchard, 2005; Gompers & Lerner, 1998). PE management firms set clear investment objectives for each of their funds that, in turn, are in line with the expertise of fund management and that are communicated to potential investors (so-called limited partners) through private placement memoranda. These fund characteristics are important for limited partners to decide whether to commit capital, in line with their own investment objectives.

While some PE funds are highly specialized, others are generalist funds. Beyond specialization at the fund level, specialization also takes place at the PE firm level, such that they systematically raise funds for the same asset class (e.g., venture capital [VC] only or a narrow set of industries). To the best of our knowledge, only three studies have taken a firm-level perspective of specialization in private equity (Cressy, Munari, & Malipiero, 2007; Gompers, Kovner, Lerner, & Scharfstein, 2009; Knill, 2009). However, these three studies do not allow us to draw conclusions on the link between firm specialization and fundraising activities of PE firms. This is critical because PE firms not only seek good performance from their investments in portfolio companies but also, due to the closed-end structure of most funds (Kaplan & Strömberg, 2009), need to secure new fundraising to stay in the market.

To better understand the costs and benefits of firm-level specialization, its consequences on the fundraising activity of PE firms must also be analyzed. This is particularly important because future compensation of PE managers is significantly affected by follow-up fundraising capacity, which leads to generating more management fees in absolute terms in the future. Most prominently, Chung, Sensoy, Stern, and Weisbach (2012) document that fees have a substantial incentive effect on PE managers in the form of implicit incentives; managers may expect to raise larger funds in the future if they perform well today. This, in turn, will boost the level of fees (in absolute amounts) they can charge in the future in follow-up funds.

The purpose of this article is to help explain the link between firm-level specialization and fundraising. However, rather than simply investigating the impact of specialization on fundraising likelihood, we focus on explaining the link between specialization and fundraising time because the time of launching a subsequent fund can provide important information about the PE

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firm's fundraising capacity. Because PE managers need to allocate their managerial time between governing current investments and attracting new capital commitments, a firm that has recently raised a fund will wait longer to raise a subsequent fund than a firm that has not done so for several years. Given that the supply of skilled fund managers is fixed in the short run, a PE firm will be able to raise a subsequent fund as soon as its managers free up the time from current investments and become available for setting up a new portfolio of companies and governing their investment process. Thus, fundraising speed depends on how quickly a PE firm selects portfolio companies, adds value, and exits them. In turn, these activities will largely be affected by the degree of specialization of the firm, which is associated with important costs and benefits in the PE firm's investment activity. As previous research (Knill, 2009) indicates, benefits of specialization include the increased pool of skills and knowledge that positively affects quality and the speed of value-adding. However, specialization may also induce costs because it acts as a constraint for a PE firm looking for promising investment opportunities in the market, which can delay the investment selection process. Indeed, selecting a promising portfolio company in a very specific industry or stage of development may take more time than making the selection without such industry or stage constraints. Thus, specialization can either delay or enhance the PE firm's investment activity as a result of two opposite effects: the increased speed of value-adding and the reduced speed of investment selection. The final impact on fundraising time will be determined by which effect dominates, an issue we address empirically in this study.

We consider specialization across three dimensions: stage of development, industry and geographic locations. We measure firm-level specialization using standardized Herfindahl-Hirschman Index (HHI). It allows us both: measuring concentration of investments across different dimensions and comparing corresponding benefits in fundraising. Using a large sample of U.S. PE firms, we show that more specialized firms raise follow-up funds more quickly than generalists. This finding holds for all three dimensions of specialization, however especially for industry and geographic dimensions. We also show that specialization benefits increase as the PE firm becomes more experienced, which is in line with our hypothesis that accumulation of expertise through specialization helps PE firms to exit faster from their investments and become available for setting up and managing a new fund. Moreover, our study documents that fundraising is accelerated when the PE firm has many ongoing investments, consistent with the idea that they may soon exit them and being able to reallocate time to new investments. Fundraising is also accelerated when the PE firm has made an IPO recently, consistent with the grandstanding hypothesis (Gompers, 1996) that PE firms time fundraising with recent success stories. In contrast, fundraising is delayed when the last fund being raised is large (controlling for fund type). One possible explanation is that fundraising is less needed, since more capital is available to the PE firm.

Studies on fund management further indicate that managers might try to extend their expertise in other areas, a phenomenon called "style drift" (see Cumming, Fleming, & Schwienbacher, 2009, for style drift in venture capital). To investigate this phenomenon in the context of PE fundraising, we link the expertise area of a PE firm to the type of the newly launched fund. Across stage dimension, we consider two main types of private equity funds: buyout (BO) and VC funds. Across industry dimension, we compare dynamics of fundraising with investment focus on high-tech versus non-high-tech industries. Our results based on the competing risks model indicate that fundraising is accelerated for follow-up funds within their current area of expertise but delayed for funds outside their area. This suggests that expertise cannot be easily extended to other areas and that any style drifts come at some costs.

To shed some light on what explains the documented relationship between firm-level specialization and fundraising, we next examine the impact of specialization on portfolio selection and divestment. We find that specialized PE firms are slower at building the portfolio of companies for new funds. However, analyzing the time between investment and exit from a company shows that specialized PE firms have shorter investment durations, consistent with findings of Cumming and MacIntosh (2001). These results imply that benefits of increased speed of value-adding may dominate the costs of reduced speed of investment selection and, thus, translate into quicker follow-up fundraising.

We make the following contributions to the literature on the topic. First, although previous research highlights the importance of specialization on PE investment activities (Gompers et al., 2009; Knill, 2009), its impact on PE fundraising activities has not yet been investigated. Our particular angle is to investigate determinants of the duration between two subsequent funds, rather than simply the size of the next fund. Therefore, our study complements exiting studies by providing additional evidence on the costs and benefits of firm-level specialization. Our study shows that the impact of specialization is even more important on fundraising than documented in previous studies, since specialization does not only lead to larger funds (due to higher performance, as documented in the literature) but also to shorter intervals between fundraising campaigns. Our analysis further suggests that the positive link between specialization and time to fundraising may be explained by shorter investment durations. Second, we provide evidence on the PE firm-level determinants of quick fundraising, such as recent performance, experience, fund size and number of active investments (ongoing investment portfolio under management). And third, we contribute to a better understanding the importance of PE firm-level specialization, a type of specialization that has attracted much less attention than fund-level specialization. Firm-level specialization captures overall specialization, which differs from fund-level specialization if funds of a same PE firm are specialized but investing in different areas or asset classes. Thus, it relates to the global strategy and expertise availability of a PE firm. We document that firm-level specialization helps explain the dynamics of fundraising activities of PE firms.

The remainder of this article proceeds as follows: Section 2 describes previous literature on fundraising determinants and specialization that offer possible implications for the link between specialization and fundraising time. Section 3 presents the data employed for this study, key variables, and summary statistics. Section 4 describes our empirical analysis and the results obtained. Section 5 concludes.

2. Fundraising determinants and specialization

The literature on PE fundraising identifies several market- and firm-specific factors that determine fundraising. For example, Poterba (1989) shows that many of the changes in fundraising at the market level arise from changes in either the supply of or the demand for VC. Cumming and Zambelli (2013) further study the impact of extreme market regulation on the supply of PE capital, providing evidence on the negative link between the two variables. Huson, Malatesta, and Parrino (2009) investigate how general market conditions influence the level of PE activity. They argue that public market conditions influence the choice between public and private sources of capital and the bargaining power of investee firms. They find that private funding is more likely to occur following periods of relatively high stock market returns.

Regarding firm characteristics, Cumming et al. (2005) find that reputation and experience positively affect the ability to raise new funds. Moreover, PE firms that achieve higher returns are more

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