

**PART III – A Checklist for
Emerging Fund Managers:**

Navigating Economic Uncertainty



This is the third article in our **Emerging Fund Managers** series, where we explore strategies and best practices that serve as a bedrock for fund managers operating in a shifting macroeconomic environment. To read more about considerations for initial fund formation and capital raising, see [Part I](#). For more about managing growth and operational issues, see [Part II](#).

Ongoing volatility in recent years has left many emerging fund managers grappling with uncertainty about what comes next for the market environment. While fund managers can't control the markets, they can pursue several time-tested strategies that help build resilience. These strategies take a proactive approach to help emerging managers prepare for a range of market conditions, and they are organized into three key principles for supporting operational success:



Cost discipline

Fund managers should continuously assess the fund budget for potential cost efficiencies.



Infallible fund management strategy

Managers need a consistent approach to portfolio management built upon a clear valuation strategy and strong auditor relationship.



Proactive risk mitigation and compliance

Planning for and mitigating risk requires comprehensive processes and controls, as well as a consistent approach for meeting evolving regulatory guidance and compliance requirements.

Adopting a Cost Discipline Mindset



The most successful fund managers apply scrutiny to their budgets to ensure cost discipline and look for new opportunities for cost reduction. To do so, emerging managers should begin with a review of the management company forecast to identify and consider discretionary spending items to trim.

Cost discipline isn't just about controlling discretionary expenses. To assess budget efficiency, fund managers should also take a critical look at their fixed costs, starting with their service providers.

✓ Fixed Cost Assessment

Fund managers should consistently be benchmarking third-party vendor fees and capabilities with the marketplace to ensure they are in line with what others are charging and that they are receiving the maximum value. Benchmarking can be accomplished by comparing fees billed to the actual hours a service provider is spending on the emerging manager's account. If there is doubt surrounding the existing fee structure, emerging managers may wish to review any departures in budgeted hours with their service providers or perhaps even go out to bid with alternative vendors to at least ensure the work scope is in step with the fee structure.

The emerging manager may also wish to perform a structural analysis of fund costs and determine areas where services can be significantly reduced or eliminated altogether. For example, a fund-by-fund cost analysis can identify legacy funds which are no longer in investment mode or even winding down. Some cost savings to consider include:

- ▶ Are there special purpose vehicles (SPVs) whose limited partners may either not require an audit or may be serviced by an unnecessarily large brand name for the audit?
- ▶ In the case of fund administration, can the emerging manager save costs by self-administering these investment vehicles, particularly if they hold only one or a small handful of investments?

Sequential fee increases over just a few years by service providers can often cause professional fees to grow to a point where they are misaligned with the actual work scope, particularly as portfolio companies exit or are in wind down mode. Also noteworthy are situations whereby the fund structure only holds one or two portfolio investments or even contingent rights. In such circumstances, a full fund audit may be unnecessary, and it is worthwhile for the emerging manager to explore with their fund attorney for a possible waiver by limited partners.

✓ The Importance of Liquidity

From a fund and portfolio company perspective, it is critical to always ensure there is some liquidity available, especially during periods of financial uncertainty. Fund managers should revisit individual portfolio company budgets and forecasts to identify discretionary costs that can be either reduced or cut to free up liquidity. It is also possible to achieve important synergies or service arrangements with key service providers (e.g., insurance, payroll services, outsourced IT) across multiple portfolio companies to create economies of scale to gain favorable terms, particularly pricing. Emerging managers should also be aware of and identify patterns of cost reductions across multiple portfolio companies to create a standardized approach to measuring cost reduction and comparing cash outflows across companies they are invested in. In doing so, fund managers can ensure consistent cost discipline across their investments and set in place processes for capital preservation in any market environment.

Managing Portfolio Investment Valuation



Emerging managers must ensure the appropriate valuation protocols are in place to mark private company investments to fair value in a consistent and fair manner. At no time is this more important than during times of market volatility, when public company multiples or discount rates can fluctuate dramatically, causing large swings in portfolio company valuations. In cases where private portfolio investments comprise a majority of a fund's net asset value, the implications of significant fluctuations in fair value will have a meaningful (and material) impact when performing the year-end audit.

✓ Developing a Nimble Valuation Strategy

Proactively planning and mapping out a clear strategy for handling portfolio valuations at the onset can help emerging managers navigate the waters when periods of volatility do occur. A recommended best practice for the emerging manager is to regularly revisit and update their valuation models and approach to ensure the most relevant comparable companies and applicable discount rates are being employed. Likewise, an emerging manager should avoid last-minute changes to their valuation approach, like updating calibrated inputs, to arrive at their portfolio company's fair value. Emerging managers should conduct scenario planning to test their valuation approach, including modeling scenarios for volatility, to ensure their methodology and models are robust enough to produce a reasonable, meaningful, and consistent output, even in adverse circumstances.

✓ Auditor Relationship Management

Emerging managers should be directly involved in discussions with auditors regarding portfolio company valuations. As the drivers of the portfolio investments, they have unique insight into the investment thesis. By developing relationships with auditors, emerging managers can often streamline valuation discussions by providing real anecdotal performance data or key information on important milestones to auditors when public markets exhibit significant movements. This is especially important when working on valuations for early-stage companies.

✓ Valuation Policy

A robust valuation policy can help to outline specific contingencies and procedures to [navigate through periods of market volatility](#). This is important in order to avoid subjective calls on portfolio company valuations, which can lead to lengthy discussions with auditors. While hiring an outside third-party valuation specialist can resolve a perception of independence, these valuation specialists oftentimes use similar or the same valuation inputs as the emerging manager to maintain consistency of investment thesis. Contingency planning in one's valuation policy for such volatility events and closely collaborating with an emerging manager's accountants can help to avoid uncertainty with portfolio company valuation.

✓ Aligning with Standard Industry Practices

Often, in periods of volatility, it is easy for emerging managers to fall into a trap of subjectively modifying valuation models to a point where they have little meaning. Consideration should be given to keeping the valuation approach in line with generally accepted industry practices and valuation approaches.

It is important that emerging managers keep pace with evolving industry standards, specifically the FASB's ASC 820 Fair Value Measurement. While the AICPA provides regular and important industry guidance on widely accepted valuation approaches, as previously noted, market volatility and uncertainty can be extremely challenging when approaching private portfolio company valuations. It may be worthwhile for the emerging manager to periodically perform a review on both valuation models and approach on a company-by-company basis to ensure they are aligned with industry valuation practices and approach.

Navigating Risk Management and Regulatory Concerns



✓ Counterparty Risk

To reduce risk, emerging fund managers should diversify their ecosystem of different counterparties rather than working with just a small handful of partners. For routine business continuity, an emerging manager's fund accountants, attorneys, and administrators should satisfy internal growth requirements and outside limited partner expectations per the limited partnership agreement. However, spreading risk amongst different service providers can help to mitigate counterparty risk and provide a higher degree of cost transparency and accountability at the same time. Financial institutions are among the counterparties that emerging managers should consider. Emerging managers should ensure their bank is capable of sustaining lines of credit at reasonable rates during periods of volatility and uncertainty.

✓ Preparing for Financial Risk

Beyond bank financing, there is a real cost to funding portfolio companies, particularly during an economic downturn when perceived risk is increased and causes lending standards to tighten and interest rates to rise.

When the appetite for follow-on financing or incremental outside investment sours, emerging managers must walk a tightrope between allocating fund capital to sustain real portfolio company growth and simply keeping a faltering portfolio company in business. It is important for fund managers to take preemptive action in anticipation of a slowdown to help mitigate the cost of financing and sustaining portfolio companies. In a similar vein, emerging managers should have ample liquidity on hand to finance worthy portfolio investments and avoid being backed into a corner with respect to disadvantageous investment terms from a new financing round with outside investors, which can significantly dilute their existing investment stake.

Tapping existing fund resources to sustain portfolio investments can lead to a rationing of resources, thereby forcing the emerging manager to allocate capital selectively to only

those portfolio company investments that are deemed to have the best chance of success. While raising a new fund can help to alleviate financing concerns during an economic downturn, less favorable investment terms may be required by limited partners. Thinking through and establishing a redundant financing contingency and protocol around portfolio company investment ahead of time, either through internal or external means, can go a long way towards safeguarding against unforeseen events. Emerging managers might be better equipped to estimate financing costs and capital availability during uncertain periods.

✓ Anticipating Compliance Requirements

Regulatory compliance is an essential part of a fund manager's responsibilities, but it's particularly important during periods of uncertainty. From a regulatory perspective, prolonged volatility that has a meaningful impact on an emerging manager's fund returns should be very closely monitored, updated, and documented. In the event the emerging manager wishes to launch a subsequent fund and plans on using existing fund performance for advertising purposes to solicit investors, particular attention should be paid to portraying a consistent and "fair and balanced" representation of the fund's return to avoid any subjective calls on a period of performance.

This is critical for compliance with the [SEC's Marketing Rule](#). Fund managers should be sure to avoid subjectivity and selectivity in representing a particular (and potentially more favorable) past performance period when marketing a new fund. By carefully documenting and monitoring an existing fund's performance in accordance with the SEC Marketing Rule, an emerging manager can avoid the appearance of misrepresenting return performance. It is recommended that before embarking on a new fund raise, the emerging managers carefully consult with their fund attorneys to consider specific past performance returns and how they can frame past performance so that it aligns with the SEC Marketing Rule.

Looking Forward

The most successful fund managers take advantage of stable market conditions to plan and set in place processes to guide fund operations so they are well positioned to weather any economic conditions. By spending time up front building resilience and preparing for market fluctuations, emerging managers can save valuable time and resources by positioning themselves and their portfolios for success.

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