**Blog Post on Vanacker, Forbes, Knockaert and Manigart AMJ Paper**

Breaking into any well-established field is tough. Credentials will only get you so far – what employers and investors alike value is experience and a proven track record. What’s a newcomer with lots of potential but not much in the way of proven outcomes to do?

Recent research by Professors Tom Vanacker, Daniel Forbes, Mirjam Knockaert and Sophie Manigart[[1]](#footnote-1) points to a simple but surprising solution: boost the signal you *are* sending.

**Background**

Fundraising is a challenge for everyone in Private Equity (PE), but especially so for relative newcomers. Without a past track record to hold up as an indicator of potential future outcomes, Limited Partners (LPs) are understandably wary of investing in such firms.

One deeper explanation for why stems from signaling theory, which posits that established PE firms convey critical information to investors in ways that are difficult for smaller newcomers to copy. While past returns weigh heavily in investment decisions, board composition, team characteristics, and endorsement relationships also send strong signals to LPs to “green light” investment decisions.

Until now there’s been little research on what investors do when new PE firms send different quality signals about their realized versus potential performance outcomes. The question is not just a theoretical one. In the real world, investors are bombarded with information and rarely reach a decision based on one clear signal. When combined with the time and cost of evaluating investment alternatives and the fact that there are many more early than late-stage PE firms in which to invest, you can understand why LPs report being faced with information overload.

As a result, investors rely on heuristics and simplifications to help them cope with the uncertainty and cognitive overload they experience. Intuitively, it makes sense that the strongest signal will grab the attention of LPs: investors aren’t going to cross the road given a “walk” signal if they also see a large flashing stop sign. The question for new PE firms is if there’s anything they can do to attract the interest of investors to their “yellow” traffic signal when more established firms have the blinking green light of an established track record.

**The Context**

To find out Vanacker et al. looked at the scenario where new PE firms, having managed a first-time fund, need to raise a follow-on fund *before* having demonstrated significant realized performance at the end of the investment period. This is a critical point in the life of many new PE firms, as investors are more likely to seek more objective performance measures in deciding to reinvest than they initially did when the new firm’s social ties or human capital signals had to suffice. Lacking a track record of strong realized performance and able only to rely on relatively weaker unrealized performance signals, a large percentage of PE firms fail to raise a second fund; indeed, of the 205 firms studied in this experiment, less than half (46%) were successful.

Realized performance has repeatedly been shown to predict a firm’s ability to attract investors—the kind of strong signal that LPs look for in making investment decisions. The high mortality rate of PE firms between the first and second funding rounds also shows that unrealized performance is not a strong enough signal to entice investors. Although certified by external auditors, the valuation of unrealized performance ultimately rests in the hands of the PE firm and relies heavily on estimates and forecasts. It’s clear that many investors simply won’t proceed “blindfolded” through an intersection on the word of a firm’s general partners that the coast is clear and opposing traffic has been stopped. Is there anything else new PE firms can do to boost the signal strength of their unrealized performance in such a way that investors will “greenlight” their follow-on funds?

**The Experiment**

The answer is yes, and involves using “information intermediaries” to augment the weak signals new PE firms send as a result of lacking a past track record. One route new PE firms can take to increase the signal strength of their unrealized performance is through attracting media attention.

Media attention operates in several ways to increase the chances that a new PE firm will attract second-round investors. To start, boosting the signal sent to investors causes the fund to be more likely moved into what researchers call the “consideration set”—the funds from which the investor will ultimately choose from to invest in. But the assessment of unrealized performance also operates as a “starting point” for valuing the investment opportunities of the follow-on fund. Firms whose unrealized performance is more highly valued also experience a greater likelihood of LP investment in their funds, helping turn what was a maybe into a yes.

Evaluating unrealized performance is a complex process, and even the best due diligence by investors cannot accurately measure unrealized performance. Vanacker et al.’s research shows that media attention positively affects the assessment of unrealized performance by LPs—in fact, it further legitimates and “anchors” the positive valuation in the minds of investors. In short, media attention both elevates the visibility and attractiveness of funds, having a significant effect on their viability.

**The Outcome**

The mean realized performance of first-time PE funds at the end of their economic lifetime in Vanacker et al.’s study was 132%, with the number being significantly higher for those first-time PE firms that were able to raise a follow-on fund (151%) compared to those that did not (110%). Using a variety of different models that incorporate eventual realized performance, their analyses confirmed that to investors unrealized performance is a weaker signal than realized performance, but also that first-time PE funds with higher unrealized performance were more likely to raise a follow-on fund.

Vanacker et al.’s results show that fundraising outcomes for new PE firms changes when media attention boosts the signal strength of their unrealized performance. General improvement to unrealized performance can increase the likelihood of raising a second fund from 2.1% to 5.1%; but for PE firms with high media attention the shift in probability increases from 5.4% to 16.2%. At the same time, the data reveal that realized performance speaks for itself, and media attention has relatively little effect on improving its signaling effect with regard to fundraising for PE firms.

These outcomes have significant and far reaching implications for new PE firms. For example, they are often advised to convey strong signals to LPs by recruiting prominent affiliates. However, this generates a chicken-and-egg conundrum, as affiliates also rely on strong signals when choosing who to affiliate with. The findings of Vanacker et al. suggest that firms may be able to overcome that deficit and draw the attention of affiliates by boosting their weak signal strength through media attention.

Doing so might also in the end lead to better returns, as new PE firms with significant unrealized potential might be tempted to show realized performance early on and leave money on the table. Vanacker et al.’s results suggest that they ought to consider the relative costs of boosting the weaker unrealized performance signal instead and let interested investors bear the cost of the due diligence needed to assess its credibility.

While it might be argued that media attention is to some degree out of a firm’s control, new PE firms can still work to attract it through secondary marketing efforts like speaking at industry events or engaging in customer education efforts.

These findings have implications for savvy investors as well. They should know that the media attention a PE firm receives affects the perceived attractiveness and valuation of their unrealized performance. Instead of getting swept up in the hype, sage investors would be advised to “yellow light” such opportunities and proceed with caution, as the media attention doesn’t alter the fundamentals of whether or not the fund is worth investing in.

1. “Signal Strength, Media Attention, and Resource Mobilization: Evidence from New Private Equity Firms,” forthcoming in *Academy of Management Journal*, https://doi.org/10.5465/amj.2018.0356. [↑](#footnote-ref-1)