Burgeoning - Getting Bigger and Bigger

"What is your target fund size?" – this is one of the first questions asked by LPs (Limited Partners) to GPs (General Partners) when contact is initiated. This question is foremost in the minds of LPs because the answer houses a bounty of information. The amount sought by a fund to make its investment strategy viable reveals how thoughtful the GP is regarding diversification (and hence, risk), how the GP thinks about workload/deal capacity, how the GP could potentially grow (in staff and/or asset size) from that point, what fees (total charge per year) the GP believes makes its investment undertaking worthwhile, the amount the GP has to return to LPs before it takes its incentive fees (carried interest/carry), the types/quality (e.g. value or growth) of assets it will acquire, the amount of planned contingency/reserve/follow-on capital, etc.

For the most part, the size of a GP's first fund tends to be shrouded in modesty and goodwill - the message and reasoning around the target fund size seem clear, and the GP's response to any prospective LP pushback is infused with open-mindedness and appreciation. This is a honeymoon period of sorts because at that stage the GP is at its most vulnerable. However, as we all know, dynamics in relationships can abruptly shift depending on who the perceived power resides with at a particular point in time. The ideal scenario for most LPs is to find an extraordinary fund, still early in its existence, gain an ideal allocation, and maintain that relationship for the long term. Yet, what is preferred by one party is not necessarily ideal for the other. Research analysts realize quite early in their careers that funds are a business, and no matter how much you like the people running these funds, most of them are motivated by a myriad of things that are not all necessarily aligned with yours or easily understandable.

Things can change very quickly - the Fund II (GP's second fund) conversation becomes very different if the first fund experiences early outsized traction in terms of impressive markups or outright strong exits. Regardless of how evolved LPs claim to be, private assets research and due diligence remain an extremely backward-looking exercise with past achievements unabashedly harnessed to indicate the high likelihood of future success. If you are not one of those renowned LPs with a respected legacy of making sizeable commitments early in a GP's existence, I am sorry to convey the solemn message that you are powerless when it comes to influencing ongoing fund sizes. Since many of the prominent pioneering LPs buy into the concept that smaller fund sizes tend to correlate with stronger performance, they use their influence to contractually lock in future fund sizes – this benefits all LPs. However, this sway is finite and loses potency as the GP experiences more success and raises higher Roman numeral funds.

Fund size growth is typically justified by a select few repeat culprits – some of which are quite understandable and others which are less amicable.

1. **Portfolio construction tweaks**: There are circumstances when a fund manager realizes that contrary to what it had initially theorized and modeled out, the size of its previous fund was not optimal for the targeted strategy. Reasons for the lack of optimality run the gamut from inadequate diversification, lack of sufficient reserves, lack of favorable asset dynamics that could be related to maturity/size/sector of holdings, etc. In such cases, if the reasoning behind the size growth is thoughtful and coherent, LPs try to be amenable to the changes. However, when fund size increases are primarily instigated by reasons related to pursuing different (maturity/size/sector/etc.) asset characteristics from the previous fund, thorough LPs will engage in some degree of probing around whether that fund manager has the

prerequisite skills and experience to be successful in that relatively new direction. Regardless of what prompted the portfolio-construction-tweak-related fund size increase, any unexpected large jumps in this category will draw scrutiny and debate.

2. **Economy-, sector-, and/or industry-specific factors**: GPs sometimes use market dynamics as the provocation for a bigger fund. Inflation, scarcity, and increased competition are all factors that can cause targeted assets to become more expensive. If these factors can be coherently proved, it makes perfect sense for the subsequent fund size to increase even if the GP is pursuing a status quo portfolio construction approach. However, the potential for erosion of future returns and the likely diminishment of differentiation are consequences that thorough LPs will closely examine before signing on.

3. **The clever co-investment justification**: This one spurs a variation of diplomatic smirks, polite okays, and reluctant acceptance by prospective LPs. When a fund manager says, "We had to give up portions of our past deals to LPs and other parties (non-LPs) on a no-fee and no-carry basis because we did not have enough capital to do the deals ourselves", the pain seems very real. This serves as a logical premise to increase the size of the next fund because a solid case about the suboptimality of the previous fund has been made. When this excuse started popping up, LPs were understandably sympathetic. However, with time, LPs have realized that the newer bigger funds still had a good portion of deals going to co-investors, further establishing a foundation for an even bigger next fund. So when does this end? Are the GPs continuously going for bigger deals or are they just endlessly caught off guard by market dynamics beyond their control (which always seems to point up)? In any case, how much confidence should LPs have in presented portfolio construction models that are easily and eventually ignored by GPs?

4. **Team changes and/or bandwidth capacity**: As an investment team grows and/or becomes more experienced/seasoned due to tenure and increased savviness from lessons learned, a convincing case can be made for a bigger fund because logically, more tasks can be handled by personnel. Additionally, with time, older deal workloads lessen due to exits, stabilization, and/or write-offs, so bandwidth per team member increases. LPs will still place a keen eye on the quality of team members and whether team growth occurred mostly as a means to get bigger or vice versa.

5. **Broader LP base (i.e. LP diversification):** As GPs mature, they start paying more attention to the composition of their LP base. In the very beginning of a GP's life, when beggars can't be choosers, most LPs willing to do the work and invest, are welcomed in. As time goes on, and as tangible success can be shown, the GPs gain increasing power to choose who they want to partner with. A decent amount of allegiance remains to folks who took the early risk in the manager, so to allow new choice LPs (adding diversification in investors and investor categories) into future vehicles, the fund size gets bigger. Sometimes, adding new LP categories like pensions and sovereign wealth funds, which tend to need larger allocation sizes and/or have lower costs of capital, can change the essence of a fund - discerning potential investors usually are (or should be) cognizant of this possibility.

6. **Natural progression**: Living in a world that mostly leans capitalist, the quote "If you are not growing, you're dying" serves as a latent soundtrack for almost every human endeavor. Historical success is sometimes the only justification needed for fund size growth. Of course, increased efficiency and economies of scale can be used as catalysts for these types of fund increases, but the truth usually lies

in the thought process of "Why not raise a little more capital because it shows that things are progressing well?" This approach is typically in clear view when hard-caps (the maximum stated amount of capital that a fund will/can raise) are left open-ended or are a lot larger than the stated fund size target.

7. **Increasing reserves**: Related to the "portfolio construction" point (#1) mentioned above, making sure a fund has adequate reserves for its deals can be an acute cause for the increase in fund size. This is particularly noticeable with venture funds where not having enough capital for follow-on rounds in portfolio companies can lead to suboptimal ownership as additional dilutive equity is raised. LPs tend to closely assess what protocol is used to determine which companies get the reserves – is it "first come first served" or some determination of which companies are superior based on quantitative and qualitative signals?

8. **Because why not (blatant greed)?**: Last but not least you have good old "greed". Bigger funds equal more management fees - simple and plain - no other explanation is needed. The sharp, well-trained research analyst in their most offense-neutral voice will ask the fundraising GP the astute 'Research 101' question "How do we know whether you are raising this fund for management fees of carry"? In retrospect, this question is a little laughable, because: DO THE MATH. At a certain fund size, and in many cases, the amount of fees being churned out on an annual basis makes carried interest a "nice to have" – there is no other way to state this. Many GPs will self-righteously argue that one cannot base their legacy on just management fees (and ignore carry), but the length of time it takes for funds to be exposed as mediocre, the millions of dollars generated in annual management fees, and the lavish lifestyles afforded in the interim, all beg to differ. To be fair, greed is sometimes a driving force that pushes people to overachieve. However, as analysts, it is imperative to make sure that signs of extreme/unadulterated greed are not rewarded with more capital.

Although limited in frequency, there remain a few managers who raise capital directly commensurate with a well-laid-out opportunity set. Some of these almost-extinct funds have kept their fund sizes stable over many fundraising cycles. Some have even given capital back (released commitments) when they could not find investments that matched pursued strategies. Even more unbelievable, some GPs have raised smaller funds (not because there was no LP demand, and not because they could not find any ol' deal) because they believed a particular disciplined fund size would be the most effective for a particular market segment. Insightful LPs view high-performing managers with this level of integrity as the holy grail for portfolio building. A fund size increase does not always signal the presence of something sinister, but it subtly or glaringly invites deeper investigation.

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January 14th, 2024.