Re-ups – Do you still love me?

The ultimate goal for most private equity investors is for their private holdings to eventually become self-sustaining. This means that private investors ultimately want distributions from prior investments to one day cover or surpass ongoing capital calls. When this happens, investors no longer have to fund capital calls from other parts of their portfolio such as liquid holdings or cash equivalents. However, this steady state takes time - conservative estimates provide about eight to ten years as guidance (if a consistent allocation is maintained throughout those years). The problem is that real life does not care about estimates; real life is all about throwing wrenches into the mix and watching how you choose to deal with the unforeseen to survive. Occurrences like recessions, manager blow-ups, denominator effects, interest rate fluctuations, etc. affect distributions, and consequently, also affect ongoing commitments.

When you commit to invest in a manager's fund, there is an implicit agreement to support the manager in subsequent funds. This implied agreement is intrinsically tied to the manager doing what it said it would do, and the investor rewarding this adherence to past promises with follow-on capital. But I have come to realize that the implied promise of future capital is assumed more firmly by the GP than the LP - this is because LPs deal with more variables in this area than GPs. GPs need more capital to invest in new deals and to cover the ongoing capital needs of the business they have built. On the other hand, LPs are assessing new options for capital deployment, juggling changing selectivity metrics, calculating cost of capital and degrees of reward, balancing stakeholder expectations, navigating fundraising (in the case of funds-of-funds), etc. It is not that simple for an LP to just create a timeline of upcoming re-ups and let it ride - the capital is real, the opportunity costs are real, and the internal questions that need to be answered are real. I hear a lot of LPs say that before they invest in a subsequent fund, they perform the same level of due diligence as they did for the previous one. This sounds good as a tactic to underscore a strong process or imply thoroughness. However, I strongly doubt this statement in practice because dynamics certainly change when you have already been in a relationship with a GP. I am not saying subsequent due diligence cannot be as strong as before, but I am trying to make the point that questions and the degree to which answers are believed change the longer you have been dealing with a GP on a first-hand basis.

I have never been eager to have re-up conversations. They almost always felt premature, and there never seemed to be enough information to facilitate a straightforward decision. The relatively easier re-up decisions were usually because of common sense things that no one could refute. But for the most part, re-up conversations are always tinged with awkwardness, subtle or blatant flexing depending on where the power lies (with the GP or LP), promissory/IOU games, electronic hide-and-seek, and bureaucracy. Understandably, the LP re-up percentage is an important statistic when a GP is fundraising, that is why LPs ask about this as part of their due diligence, and why GPs with high recurring LPs visibly flaunt it (in dollar and actual LP terms). Below, I talk about a few things that facilitate or hinder the smooth execution of re-ups.

- **Feeling like educational capital**: LPs don't want to feel like guinea pigs. We don't like feeling like the capital given for the previous fund was for educational purposes and with the training that we inadvertently financed, the GP is now well-practiced and ready to execute at a high level on the next fund. This is a real pet peeve for me – I recall so many annual meetings where past funds (with still active deals) are just sped through to make ample time for the newer and more exciting deals as though the old dollars somehow have less value, or the GP is now such a completely different entity that harping on past deals is a waste of everyone's time. But I digress. Generally, re-up conversations tend to be heavily weighted toward the ongoing investment/market opportunities or some fantastic deal that the GP has under LOI, has warehoused, or just needs capital to consummate. These on-the-verge-of-closing deals always sound better than deals already in the LPs' portfolio. This feeling that the best is yet to come is extremely frustrating. It also plants a seed in the minds of LPs that with every subsequent fundraising, legacy investments will get relegated to a place of less importance. Of course, with time, GPs evolve, and skillsets get polished, but sending subconscious signals about how much more improved you have become and making those that provided the sandpaper for you newly attained polish is quite upsetting. I believe the best re-up conversations occur when LPs get the sense that past deals are just as good as prospective/upcoming investments - it is a hard balance to strike, but GPs who can convincingly and genuinely show this will likely have more constructive re-up conversations and higher re-up closing rates.

- **Goodwill erosion**: There are internal battles that occur within organizations that the underwriter of the investment has to face – these tend to be more grueling if the fund is relatively new (emerging managers) or has some "hair" that needs deeper explanations for comfort to be attained. Details of these bureaucratic and/or intellectual skirmishes are usually not explicitly shared with the manager, although hints are sporadically dropped. However, it is not difficult for a GP to imagine the reputational currency a supporter had to expend within his/her organization to get the fund across the commitment line. There is a certain amount of goodwill expected for being an internal champion of a fund that is still in the process of crystalizing its place in the investment ecosystem. In my experience with some GPs, success quickly turns into ego, and ego becomes a tool that shortens memories and renders goodwill archaic. Success from some strong exits or the market recognizing the unique prowess of a GP in a market segment tends to attract new LPs. These LPs come in different shades - some are more prestigious, some have lower costs of capital, and others have less strenuous due diligence processes. Some GPs quickly lose sight of the folks who were there in the beginning at took the biggest risks. After all, private investing is a business, so LPs try not to take this personally. But cynically, LPs know that the great equalizer, "market cycles", will eventually administer karmic payback. My advice to GPs is not to forget the human element of the business and to have empathy for what your allies had to endure to attain a commitment for your fund.

- **Feeling rushed**: There seems to be some sort of scorecard among GPs related to how quickly a fund hit its target amount. In my view, LPs do not place a lot of emphasis on this. Of course, if the fund was fundraising for an exceptionally long time or if the fund target seems out of reach, LPs will investigate, but generally, the nitty-gritty details of the speediness of fundraising tend to matter more to GPs and their peers. This secret society scorekeeping ritual is probably the reason why so many GPs try to rush LPs during the re-up process – haha. In all seriousness, there are likely more practical reasons for the sense of urgency, but GPs don't realize that creating a hurried state can nudge an LP to become increasingly more selective by adding "annoyance" to its selection criteria and passing on the fund. There are incentives such as fee breaks that can naturally entice LPs to move quickly, but rushing folks awakens instinctive suspicions (sometimes unfounded ones) with adverse effects on the GP.

- **Strategy shifts**: Other than inexplicable team turnover and outrageous fund size increases, the quickest way to reduce re-ups is to put forward an ongoing investment strategy that looks tangibly different from the previous fund. On the periphery, adjacent (to the original) sectors can be added with little fanfare, and strategy refinements are openly welcomed, but altering a core focus or overly diluting/switching the manager's pre-described essence is a flashing red flag to LPs. Sometimes it is a less hazardous orange flag because the manager offers the option for LPs (returning and new) to select from a strategy menu. This means an LP could choose to participate in the overall fund (with additions and all) or just the parts that align with their view of the manager's strengths. Managers tend to get strangely creative during re-up time – this period brings all types of announcements including the formation of new business lines (new strategies), personnel changes, geographical expansion, etc. LPs can feel overly bombarded with all the new things to assess when considering a follow-on investment. I believe the simpler and less altered the invitation, the higher the likelihood of attendance.

- **Reserves and whatchamacallits**: Funds usually come back to market after 75% of their previous fund has been put to work. This 75% threshold tends to be subject to numerous forms of interpretation, in fact, the math always seems to work in favor of raising a new fund. Reserves and a myriad of other line items are routinely thrown into the "capital put to work" equation to justify the right time to raise a new fund – the answer is almost always "today". It is rare to come across a fund using this technique that has failed to make the case to be back in the market. Some strong LPs with real sway can sometimes flex their muscles and hold funds to task around this matter but for the most part, LPs find themselves at the mercy of the GP (particularly managers with tangible ongoing demand). I would like to see more transparent depictions of capital at work and less wishy-washy inclusions to get to the threshold. I acknowledge that this is probably a pipedream.

- **Pre-recordings in lieu and diligence days**: The 'LP due diligence' and 'GP fundraising' processes are time-consuming and tedious. Many aspects of these can seem inefficient. Industrious GPs (particularly the more seasoned ones) have developed ways to attempt to make processes more efficient. Pre-recordings by various relevant parties (portfolio company personnel, fund advisors, operating partners, etc.) and due diligence days (set days for LPs to hear presentations from relevant parties) are becoming a thing. Due diligence is turning into a kind of assembly plant or food service line where you stop by (or click on) a section to find what you want. Only certain GPs can pull this off with a straight face – these GPs are the ones who are viewed (rightly or wrongly) as so elite that commitment dollars are just a commodity (highly interchangeable). My beef here is that you are only hearing what they want you to hear, and the subliminal message is "You should be okay with that". Any work done on such GPs is not real due diligence in my opinion, it is merely a checking-of-the-box exercise. Many LPs know this and still choose to go by reputation, past returns (sometimes way in the past), and echo chamber adherence. LPs should never believe that being able to ask your own questions so you can interpret the answers in your own way is some sort of privilege - this is a right, especially if you are a true fiduciary. The adage that says "Go where you are celebrated/appreciated and not merely tolerated" should very much also apply to investing.

The slowdown in private assets commitments overlaid with the ongoing upsurge of investment options accentuates the importance of cherishing re-up dollars. In theory, re-ups should be a straightforward win for GPs - these folks you are courting have scrutinized you in the past, liked you, and invested with you. But many GPs keep discovering new ways to fumble the bag/ball with practices that give returning investors pause. Some severe things will cause any LP (no matter how benevolent) hesitation to reinvest, but the goal should be to avoid the avoidable actions that restrict re-ups.

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