

Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS DESKBOOK SERIES

Fund Size: Targets, Caps, Minimums, and Reductions

"Fund size" is a significant and material term. Whether it is determining the maximum amount of capital that you can prudently manage or the minimum amount that will constitute a viable operation, the answer depends on a variety of factors, including the fund's investment focus, the anticipated size of deals, and the number of investment professionals. Fund size is also important because it impacts management fees, the timing of follow-on funds, and the attractiveness of the fund to portfolio companies as an investor.

Setting a Target

"What amount do we put on the cover?" This is a frequent question that bedevils new fund managers anxious to convey a substantial fund size for offering purposes without setting a target that is too high to achieve and that would be perceived as a failure if not reached or exceeded. One solution is to simply not put anything on the cover, but that, of course, simply defers the question to the term sheet or elsewhere. You still have to determine what size fund you want and if you can effectively manage it. At a basic level the answer can be reduced to the following algebraic formula:

$$\frac{A \times B \times C \times D}{1 - (E \times F)}$$

Where:

A = Number of senior investment professionals

B = Average number of new deals anticipated per year

C = Average anticipated deal size (including reserves for follow-ons)

D = Expected investment period in years

E = Annual management fee rate

F = Term of the fund in years

For example, for a firm of three principals doing three deals per year of \$5 million each over three years and a management fee of 2.5% for 10 years, the formula yields a fund target of roughly \$180 million. This calculation provides a rough estimate, but it gives a useful framework in which to consider the question rationally and to be able to defend it to limited partners.

Fund Cap

Buried in the term sheet and the fund's partnership agreement will be a fund cap, the absolute maximum amount of commitments that the fund may accept. Sometimes this is the same as the target, but more frequently it is a number that is generally about 10% above the target. It is much like the "green shoe" available to the underwriters in an oversubscribed public offering that allows for additional sales to interested subscribers. Typically, a cap cannot be exceeded except by amendment of a partnership agreement. Limited partners generally disfavor increasing caps without an operational justification for

doing so (e.g., if the fund wanted to add a principal), otherwise the investors fear that managers are simply taking advantage of the interest in the fund to enrich themselves on management fees from a larger fund and that they will be pressured into making larger and overpriced investments in order to put all the additional capital to work. Also, when establishing a cap, give careful consideration to what is actually included. Does the cap cover the general partner's commitment? Does it include any parallel funds?

Minimum for the First Closing

No one wants to be the only one at a party, and investors are the same way. Even if a minimum fund size is not specified in the documents as a condition to holding the first closing (and they often aren't), limited partners may impose one in practice by withholding their commitment until you have reached a minimum they are comfortable with. Similarly, some limited partners have investment policies that limit their commitment so that it cannot exceed a certain percentage of the fund's commitments, generally 10%-20%, thereby ensuring among other things that they are not the only ones investing. Likewise, fund managers don't want to host a party without enough guests to make it worthwhile, so they should carefully consider what the minimum fund size will be, assuming no other commitments are made, that would constitute a viable fund consistent with the business plan. This is especially important for first-time fund managers where the fund will be the sole source of management fees on which to run the operations of their new business.

Reductions in Fund Size

Occasionally, during periods of economic downturn a fund manager will announce a reduction in fund size. During such downturns the original assumptions that went into the algebraic formula discussed above to determine a fund size dramatically change. Presumably, investment pace will slow significantly and deal sizes may drop. Personnel may leave. In such situations investors will be concerned that fund managers will continue to collect fees despite the significant reduction in the investment pace. As an accommodation, a fund manager may elect or be pressured to reduce its management fees. A fund manager may elect to waive a certain amount of fees. However, the more common approach is to agree with the limited partners to reduce their fund commitments as a way of reducing management fees, which are based on such commitments, because this also has some beneficial effects for the fund manager. By reducing the fund size, the fund manager is also readjusting the thresholds set for when it can raise a new fund, which is typically set as a percentage of the overall commitments having been invested or reserved for investment. If the pace has slowed significantly, it will take additional years before a fund manager may raise a new fund. The advantage of a new fund is that it isolates losses in the old fund and restarts carry calculations on the new fund. Subject to negotiation may be whether such management fees should be reduced only prospectively or if the reduction is also retroactive, and whether the commitments are waived entirely or can be called later if necessary.

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For more information on the issues discussed here, please contact your Morgan Lewis [Private Investment Funds Practice](#) attorney.

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Morgan Lewis has one of the nation's largest private investment fund practices and is consistently ranked as the "#1 Most Active Law Firm" globally based on the number of funds worked on for limited partners by *Dow Jones Private Equity Analyst*.

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