

MAKE IT OR BREAK IT: HOW GAME 4 AND FUND 3 SHARE SIMILAR QUALITIES

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The National Hockey League, the National Basketball Association, and Major League Baseball all use a best of seven game format in their championship series. Presumably this is to make it more likely that the truly superior team will prevail as the championship team has to win four games which reduces the role of lucky events determining the ultimate result. Of course, the increased revenue generation from a minimum of four games versus a single game was probably not an inconsequential consideration to the leagues as well.

The live or die position of the trailing team often leads it to adopt more risky strategies in game four which can make for either an exciting game or a blow out by the leading team.

In a best of seven game format, game four is often a pivotal game. Going into that game, there are only two possible game tallies: three to zero or two to one (for one team or the other). In the three to zero game scenario, if the leading team wins game four, the series is over, the confetti is dropped, and the championship trophy is awarded. If, on the other hand, the trailing team wins they have earned the chance to play another game (although the trailing team rarely wins the series with a recent exception being when the Los Angeles Kings came back to beat the San Jose Sharks in the 2014 Stanley Cup). The live or die position of the trailing team often leads it to adopt more risky strategies in game four which can make for either an exciting game or a blow out by the leading team.

In the two to one game scenario, the winning of game four by the leading team can give it a dominant position. However, if the trailing team wins, the series is tied up

which guarantees at least two more games; potentially leading to the pinnacle of excitement -- a championship game seven. Thus, in either the three to zero or two to one game scenarios, game four can be critical to the eventual winner of the championship.

Just as game four can be deterministic, raising and running a private equity fund three can be pivotal for fund managers.

Just as game four can be deterministic, raising and running a private equity fund three can be pivotal for fund managers. In raising fund one, investors are often buying into the “story” that fund managers are pitching. Even if the managers have attributable track records from prior funds or investment programs, there is still significant risks such as whether the team can work together and whether they can effectively manage a private equity fund. When the fund managers raise fund two, they have shown they can manage and invest a fund but they often have limited realizations in their portfolio. As a result, potential fund two investors are still making their decision at least partially on the story. However, by the time fund three is raised the fund one investments are mature and a number of realizations usually have been made. Potential fund three investors also have the advantage of observing the investment program as well as the team dynamics across two funds. For these reasons, many institutional investors wait until a manager raises fund three to consider them for inclusion in their portfolios.

The criticality of fund three does not end for fund managers once it is raised. Whereas some institutional investors might be tolerant of minor deviances from expectations in funds one and two, by the time fund three is up and running (which can be eight to 10 years),

the expectation threshold is higher. This is especially true if unanticipated issues develop in either the fund one or two investment portfolios subsequent to the raising of fund three. An important benefit for fund managers is that a successful fund three is often the transition to an enduring franchise which can, in turn, lead to significant personal wealth generation. Thus, raising and running fund three is similar in its criticality to a game four in a best of seven series. However, there is at least one major difference between a game four and a private equity fund three: a game four is certain to occur whereas a fund three is not.

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