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Structuring for Success

An Evaluation of Hedge Fund Seeding Frameworks

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Borealis Strategic Capital Partners provides seed capital to top-tier, early-stage investment talent in return for direct economic participation in their growth and success.

Hedge fund seeding has historically yielded a wide array of deal structures, each employing attributes intended to optimize economic upside and mitigate business risk. Despite best intentions, deal terms often create unintended consequences that may adversely impact the implementation and long-term success of a seed relationship.

This white paper examines the benefits, drawbacks, and interplay of the principal components of seeding deals. **We address how these factors impact the alignment among the manager, seeder, and constituent LPs – and why it is critical to evaluate seed deal frameworks holistically.**

A Brief History of Hedge Fund Seeding

Going back to the hedge fund industry's early days, large and informed capital providers have often played an essential role in staking tomorrow's elite investors. Whether it was Frank Meyer's backing of Ken Griffin and Citadel, the Ziff family partnering with Dan Och, or Julian Robertson funding a slew of Tiger seeds, the success of many of today's largest hedge funds often traces to a single backer willing to underwrite and catalyze those businesses by being that first dollar in the door.

As the industry evolved, becoming more commercial and institutional, so too did hedge fund seeding. Select investment firms launched seeding vehicles as a means for external investors to access the opportunity. The successes and failures from early seed deals informed and spawned the latest generation of hedge fund seeding models – which now employ a variety of diverse underlying ingredients.

Form Follows Function: Structure Informs Outcomes

Many hedge fund allocators find seeding to be an attractive means of deploying capital. Their objectives, however, can vary widely and are manifested in the key deal terms. Some view seeding through a private equity lens that is transactional in nature and focuses on achieving an IRR target, while others consider seeding an effective means to building a hedge fund portfolio by cultivating long-term, aligned partnerships with investment managers.

In addition to their own preferences and objectives, seeders must also consider what structure works best for the underlying manager. By focusing on alignment, the seeder maximizes the value of its capital by incorporating bespoke features specific to underlying managers' needs.

Underlying managers must contemplate the short, intermediate, and long-term needs of their businesses when partnering with a seed capital provider. These considerations are idiosyncratic to each manager and are impacted by trading strategy, capacity, budget, and fees, among other factors. Some proposed structures might appear to be an attractive solution to launching, but ultimately inhibit the manager's ability to attract additional outside capital.

The following eight critical components serve as the primary levers in striking the right balance to achieve a mutually beneficial outcome, rewarding both the seeder and the manager, while building a solid foundation for an early-stage investment firm to achieve its long-term goals.

Principal Components of a Hedge Fund Seed Deal

Comparing and Contrasting Seeding Terms

LP Investment Size

While the size of the seed investment appears to be the most straightforward deal term, defining the ideal size for both seeder and manager is complex and situation-dependent. From the manager's perspective, a larger check is generally preferable (capacity constraints notwithstanding). Not only does a larger seed investment provide the manager with greater revenues, it is also likely to enhance awareness and credibility at launch. Furthermore, a larger seed check is more likely to provide validation to the scalability of a manager's early performance – for example, if a manager can generate high-quality returns on $100m+, allocators will be more confident in the manager's ability to do so at $1b+. Altogether, a larger seed check is likely to improve the manager's business sustainability.

Managers must be wary of any seed deal that does not get them to critical mass, as too small of a seed check is more likely to impair their early-stage business than it is to catalyze it. If the management fees derived from a seed investment do not sufficiently support the manager's working capital needs and help them achieve "exit velocity," a seed deal may prove overwhelmingly burdensome. This conclusion is corroborated by a Morgan Stanley Prime Brokerage report from November 2017, which showed that small/mid-sized launches (day-one capital <$100m) from 2012 to 2016 were more than twice as likely (39% vs. 15%) to be out of business (OOB) than mid/large-sized managers (day-one capital >$100m).

SMALL/MID-SIZED-LAUNCHES (DAY 1 CAPITAL <$100M)				
	<$25m	$25-50m	$50-100m	**Total <$100m**
#OOB	29	13	12	54
# STILL OPEN	35	23	25	83
% OF TOTAL OOB	45%	37%	33%	39%

MID/LARGE-SIZED-LAUNCHES (DAY 1 CAPITAL >$100M)				
	$100-200m	$200-500m	$500m+	**Total >$100m**
#OOB	7	4	2	13
# STILL OPEN	27	30	15	72
% OF TOTAL OOB	21%	12%	12%	15%

Source: Morgan Stanley

From the seeder's perspective, determining the optimal size of a seed deal requires nuanced thinking. The process of projecting *pro forma* returns (i.e., the "seed math") would conclude that small seed checks are preferable to large. However, that interpretation fails to consider that larger seed deals improve the probability of long-term business success of the manager, thus improving the realized seed economics.

Ultimately, the ideal seed check provides business stability for the manager, makes the manager investable to external LPs, and optimizes the upside potential for the seed investor.

Investment Duration

Another critical term to consider is the duration of the seed capital lock-up. This ultimately establishes how long of a runway a manager has to establish success and build a business. With increased business visibility, a manager is empowered to recruit a higher caliber team and build for the medium- to long-term. Furthermore, a stable capital base affords the manager the ability to invest without the immediate pressure of being "under the gun" and potentially causing a manager to take undue investment risk.

The seeder must consider the opportunity cost associated with the duration of the lock-up. In that framework, a shorter lock-up is almost always preferable when considered in a vacuum. However, a lock-up that potential LPs deem "too short of a runway" has the potential to erode the catalytic value of a seed investment.

Calculating the "Seed Math"

Understanding the upside of seed economics

Illustrative Formula

$$\text{Return on Economic Participation} = \frac{\text{Economic Participation (driven by participation \%, manager AUM, and investment performance)}}{\text{Seed Capital Invested}}$$

Form of Economic Participation

Many classic hedge fund seeding structures feature a formal equity stake in a manager's GP. Due to the seeder's cut of the "bottom line," seeder and manager theoretically have an alignment of interests. However, the seeder must then also occupy an important seat at the table when considering decisions that impact the firm's cost structure. This relationship can often lead to an adversarial dialogue and caustic meddling by the seeder that might be at odds with the interests of the manager and its fund investors.

A solution born out of this inherent conflict is the revenue-sharing model, akin to a royalty stream, which leaves the hedge fund's ownership structure and decision-making authority intact. Because the seeder's cut of firm economics is on the "top line," this model is more hands-off in its approach, as the seeder is less likely to influence personnel decisions or other business considerations that impact profitability.

Perhaps the most important consequence of a revenue-share relationship is that it provides one less element of complexity for external LPs to underwrite – one formal equity owner, rather than two.

One of the perceived drawbacks of revenue sharing is that if the seeded manager's cost of doing business increases, causing a decline in profitability, the seeder's economics would be unaffected. However, because early-stage managers' businesses tend to be much simpler with mostly upside operational leverage, this is a more relevant concern for mature hedge funds with larger institutional infrastructures.

Economic Participation Exit

The buyout provision, in which the manager has a pre-determined option for buying back the seeder's perpetual interest, has been a standard facet of hedge fund seeding arrangements for decades. Seeders who utilize this exit provision likely view seeding as shorter-term (generally within 3-5 years) and transactional in nature. Exit terms often include a buyout multiple, based on factors such as the manager's prior-years' profitability and current AUM.

While the buyout provides an attractive lump sum for the seeder at the end of the relationship, managers may find it to be financially burdensome. Furthermore, the negotiation and potential financing of the exit can be an ongoing distraction from managing the investment portfolio.

To address the adverse ramifications of the buyout, the sunset exit provision is a relatively recent development in hedge fund seeding. The sunset defines the finite duration of the economic sharing agreement in which the seeder's interest declines to zero over a multi-year period. Due to the certainty and visibility of the exit, a sunset is often considered cleaner for the manager and more aligned with constituent LPs.

Because sunset provisions are financially advantageous for the manager, relative to perpetual interests, seeders are in a position to achieve more attractive terms (such as lower fees and/or a higher participation percentage) in return.

Investment Vehicle

Seeders have diverging preferences for investing into a manager's commingled fund versus a separately managed account (SMA). Some seeders require that their assets are invested via an SMA, driven by investment and operational objectives, including transparency, custody, and capital efficiency.

Conversely, by investing the seed capital into a commingled fund structure, the manager is likely better positioned to raise additional capital, substantially enhancing the value of the economic participation. For less liquid strategies, an SMA can deter external investors from investing in a manager's commingled fund, as fund investors are wary of their "second-class citizenship" relative to an SMA's advantaged liquidity and transparency. Furthermore, SMAs may add operational complexity as a result of managing several vehicles, proving burdensome for a young investment firm. Lastly, commingled fund structures promote alignment as the seeder and constituent LP capital is invested alongside the manager's personal capital.

Fees

An important distinction between seeders is whether they pay full or discounted fees on their underlying seed investment. Because negotiated fee levels represent only part of the manager's revenue equation, seed check size being the other primary factor, discussing fees in isolation is incomplete.

Nevertheless, this variance in approach traces back to whether a seeder seeks a long-term investment relationship or a shorter-term, private equity-like transaction. In the case of the former, the seeder is more likely to insist on discounted fees in perpetuity (and perhaps capacity rights at those discounted fees). For seeders with a shorter-term orientation, they are less likely to value fee breaks to the same degree.

One important, but potentially opaque, element worth highlighting is whether a seeder's capital is subject to its own economic participation. Some seeders, while representing that they pay full fees on their seed capital, may also take a revenue/profit share on that capital, thus creating an effective fee discount on a net basis. Furthermore, if a seeder charges its investors a carry on the economic participation in underlying managers, this method can subtly increase the effective fee paid by the seeder's investors to the seeder.

Seed Capital Composition

The underlying composition of capital varies across seeders, ranging from single investors to multi-party buying cooperatives.

From a manager's point of view, a single investor often appears to be the optimal source of seed capital, due to the simplicity of dealing with a single counterparty. However, the concentration of capital being tied to a single party leads to a binary, high variance (all-in/all-out) redemption outcome at the end of the lock-up that the manager may underappreciate.

In contrast, structuring a multi-party seed agreement has its own drawbacks, including the coordination risk associated with multiple parties attempting to achieve their own desired outcomes without a single decision-maker leading the process.

A third route is a structure that serves as a hybrid of these two options, in which a multi-party buying cooperative is represented by a single party. This approach offers the simplicity of a single decision-maker on the way in – sourcing, vetting, and structuring – and the benefit of diversified decision making on the way out. With this structure, each underlying investor retains their own redemption discretion and underlying managers benefit from the diffused investor concentration risk.

Operational Support

Seeders may offer a range of services and operational support, from arms-length consultation to "plug-and-play" platform access (including trading and execution, risk reporting, HR, IT, accounting, compliance, investor relations, and marketing services).

Managers who value the "plug-and-play" solution do so because the shared platform services offer institutional-grade operational support, while also minimizing the time, effort, and financial outlay required to build the capabilities internally.

While the business case for shared services across a platform might intuitively make sense, the idiosyncrasies of each manager and strategy make it challenging for a centralized platform to sufficiently address each manager's needs; the platform's decisions are made for the benefit of the whole, rather than each manager specifically (for example, choice of counterparties and service providers). This lack of a stand-alone back office may restrict trading activity and impair fundraising efforts, as prospective LPs are likely to question the manager's autonomy and control. Allocators generally prefer managers who run independent, self-sufficient business enterprises in which there are no additional interdependencies with the seeder to underwrite.

Concluding Thoughts

As presented above, seed deal frameworks are complex, necessarily bespoke, and best evaluated holistically. When structuring any seed agreement, it is essential to address the following:

- What structure provides the ***manager*** with the most stable foundation on which to build a business for the long term?
- What structure best rewards the ***seeder*** for its early commitment to and ongoing support of the manager?
- What structure makes for the most aligned and welcoming partnership for ***subsequent investors***?

While the stakeholders involved in a seed agreement may have differing objectives, maximizing alignment among all parties is critical. The optimal deal structure will incorporate the motivations of manager, seeder, and constituent LPs in order to create the most sustainable long-term value for all parties involved.