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## MONETIZING THE NEW EQUILIBRIUM

### *The Changing Supply/Demand Dynamics of Early-Stage Capital*

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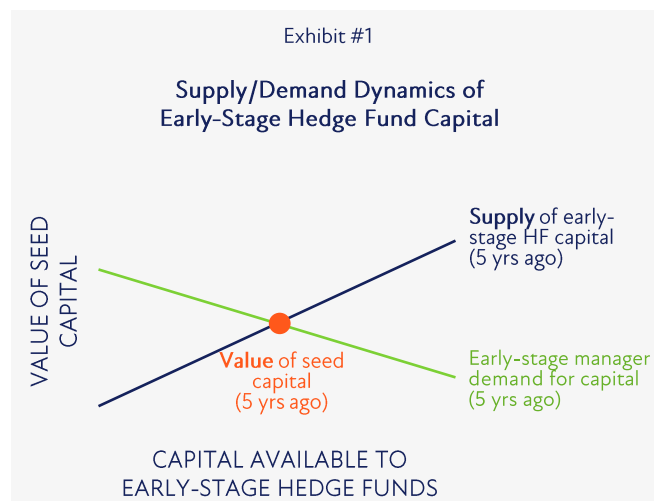
Principal, Investments

*Borealis is a seed capital provider solely focused on backing early-stage hedge fund managers*

Supply/demand dynamics have evolved in favor of investors in early-stage hedge fund managers. Due to shifting industry trends, the value of seed capital to early-stage managers has increased meaningfully, creating an attractive backdrop for investors positioned to capitalize on this opportunity. This paper focuses on the recent observable shifts in the supply of capital from allocators and demand for capital from managers.

### SUPPLY / DEMAND BEFORE

Approximately five years ago, the supply of capital available to hedge funds was abundant as pension fund investors were enthusiastic allocators to the industry, eager to initiate or expand their hedge fund allocations. Additionally, funds of funds, despite nursing wounds from the global financial crisis, were still actively allocating to early-stage managers. Concurrently, the barriers to entry for new hedge funds were low due to a relatively benign regulatory environment, allowing many managers to operate and thrive on a low level of assets (Exhibit #1). Amid abundant capital availability and relatively low demand for seed capital from newly launched managers, allocators of seed capital were more likely to be exposed to adverse selection and less advantageous terms.

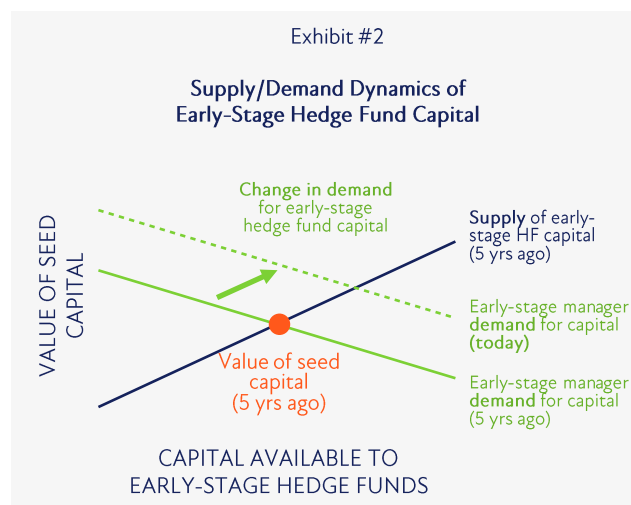


## CHANGE IN DEMAND FOR EARLY-STAGE CAPITAL

In response to the financial crisis, regulators substantially increased their oversight of most financial institutions, including hedge funds. The implementation of Dodd-Frank in 2011 required, among other things, that managers with at least \$150 million in assets under management register with the SEC. The implications of registering included the formation of a compliance program, development of firm infrastructure, and preparation of the cumbersome Form PF.

Meanwhile, investors responded to the financial crisis and the numerous frauds exposed during this time (e.g. Bernie Madoff, Marc Dreier, Thomas Petters, Allen Stanford) by increasing their emphasis on operational due diligence. Large hedge fund allocators increased staffing for back office due diligence, while dedicated operational due diligence firms were launched to service smaller allocators. To pass this level of scrutiny, managers often needed to hire qualified CFOs, COOs and/or general counsels. The cost of hiring the incremental staff varies considerably by geographic market and strategy. Assuming a cost of \$500k (salary, benefits, etc.) for some combination of CFO, COO, and general counsel, the manager needed to raise an additional \$50 million of capital at a 1% management fee to fully offset this expense. In the world of start-up managers where assets under management range from zero to \$100 million, raising an incremental \$50 million is no small feat.

In addition to sound internal controls, many investors started to require that hedge funds use top-flight, third-party service providers, particularly for audit and fund administration. Unfortunately for the start-up managers, these service providers were increasingly less likely to onboard them as clients unless they met minimum assets under management (AUM) thresholds or paid a substantially higher fee as a percentage of assets.

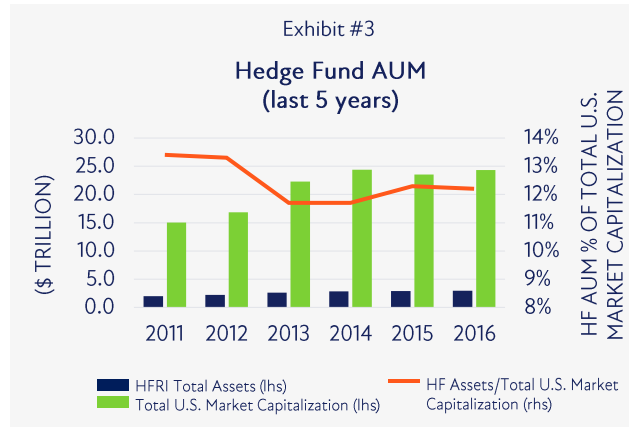


The escalation of demands from regulators and institutional investors upped the ante for launching a hedge fund business, effectively putting an end to the days of “two guys and a Bloomberg.” Within the context of the supply/demand framework, this change in environment caused a shift right in the demand curve (Exhibit #2).

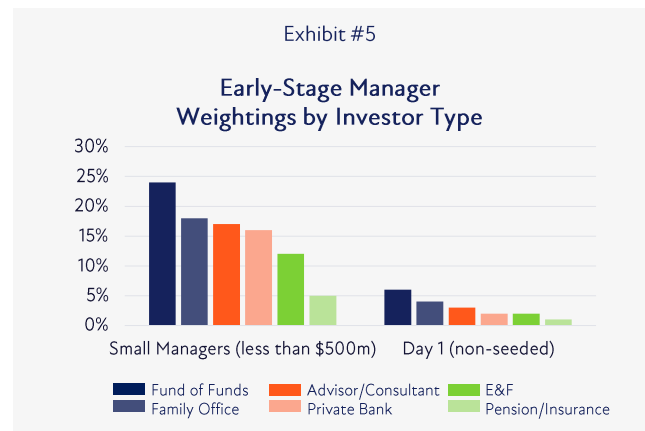
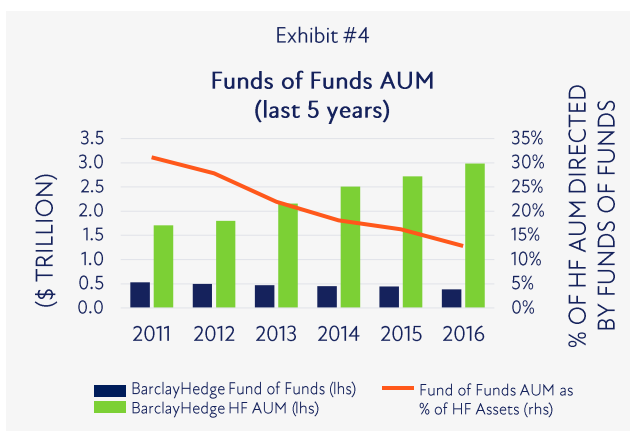
## CHANGE IN SUPPLY FOR EARLY-STAGE CAPITAL FOR MANAGERS

While early-stage managers' demand for capital has increased, the overall supply of early-stage capital has declined from previous years due to stagnant overall industry flows and a change in allocator mix.

Hedge Fund Research Inc. (HFR) reported that total hedge fund AUM reached a record level on December 31, 2016 at \$3.02 trillion<sup>1</sup>, but the capital appreciation in equity markets is masking the industry's outflows. Per HFR, Q4 2016 marked the fifth consecutive quarter of hedge fund net outflows. As a percentage of the total U.S. equity market capitalization, hedge funds now comprise just 12.2% of the market, down from 13.4% in 2011 and 15.3% in 2007 (Exhibit #3).<sup>2</sup>



In addition to overall industry outflows, the composition of the hedge fund allocator base is also changing, creating a more challenging backdrop for early-stage managers to attract assets. Incremental hedge fund capital is now more likely to come directly from a client or through a consultant, rather than through a fund of funds. Nearly one-third of the capital invested in hedge funds was directed by funds of funds in 2011, and that figure has fallen to just 13% as of September 30, 2016 (Exhibit #4).<sup>3</sup> While the shrinking AUM for funds of funds was a natural development given investors' efforts to reduce their overall fees paid, it has created a void in early-stage investing. Typically, funds of funds are more likely to invest early in a manager's life cycle, while other institutional or consultant-directed hedge fund investments are more likely to wait for a manager to meet a specific track record length and/or fund AUM (Exhibit #5).<sup>4</sup>



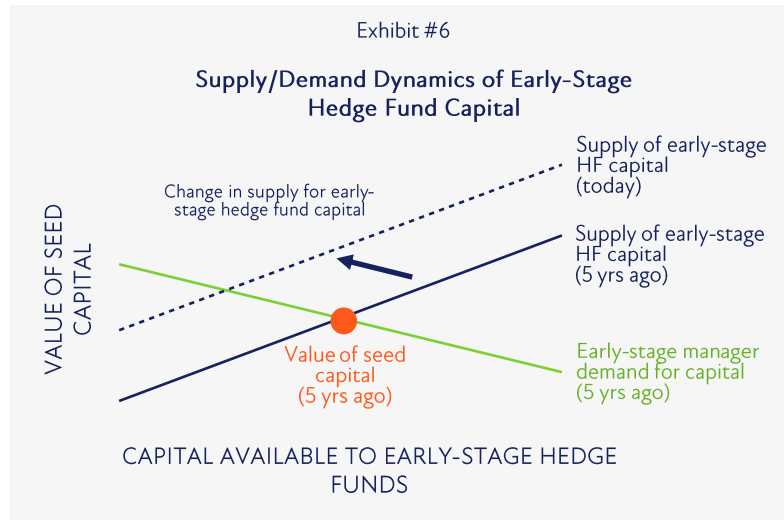
<sup>1</sup>Source: Hedge Fund Research, Inc.

<sup>2</sup>Source: Hedge Fund Research, Inc. and Bloomberg

<sup>3</sup>Source: BarclayHedge Alternative Investment Databases

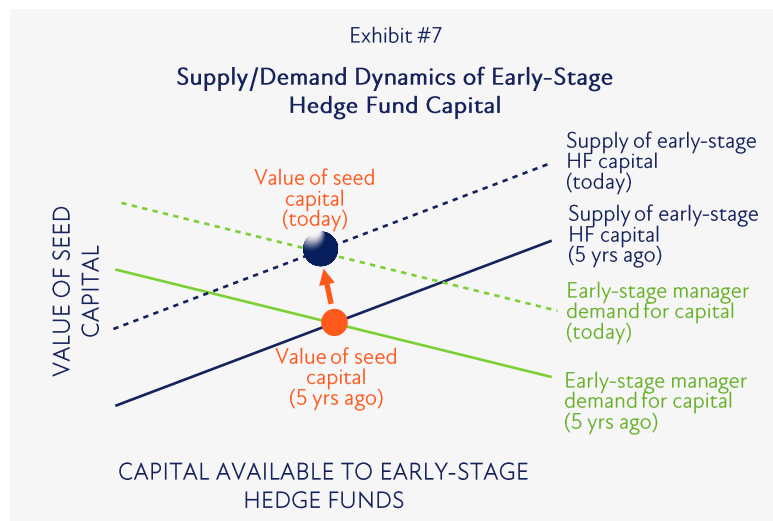
<sup>4</sup>Source: Barclays Capital Solutions Group

Fund of funds' shrinking presence and stagnating overall hedge fund industry flows have shifted the supply curve of capital available to early-stage managers (Exhibit #6).



## CHANGE IN SUPPLY FOR EARLY-STAGE CAPITAL FOR MANAGERS

When taken together, the shifts in both the demand for and supply of capital for early-stage hedge funds have created a far more favorable environment for seed capital providers today, as compared to five years ago. Now, investors with seed capital command a scarce resource with substantially increased value (Exhibit #7). With the change in value of early-stage capital, seed investors are now better positioned to structure more aligned partnerships with the next generation of top-tier investment talent.



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