Schulte Roth Partners Discuss Hedge Fund Seeding

No fixed template for a complex relationship

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As a leading law firm serving the alternative asset management industry, Schulte Roth & Zabel has a vista of early stage deal flow globally and is well-positioned to comment on trends in deal structuring. Here, we focus on hedge fund seeding, but the wide breadth of Schulte's practice means that the firm also gets involved in advising on seeding of long-only, private equity, venture capital, real estate, and alternative lending funds, among others.

Schulte advises both seed investors and asset managers on the full spectrum of deal types, ranging from in-house seeding of new funds, spinoffs of management teams or subsidiaries, to seeding 'platforms' and 'one-off' seed deals. These can involve an infinite variety of deal structures and terms.

"Clients often ask: what is typical for seeding? There is no typical deal or arrangement. Deals are all over the place. This has much to do with what the seeder brings to the table in infrastructure, administrative help, assistance with distribution and capital raising, investment capital, working capital, and with how desperate is the manager. All of that affects the economics and terms, and there is no-one-size-fits-all," says Schulte Roth & Zabel Investment Management Partner David J. Efron.

"We see a wide mix of structures, terms and economics," Efron goes on. Schulte sees some deals structured with an interest in the general partner and sometimes also the management company, others with an interest in the fund's economics, and some involving a combination. Efron offers some high-level hints on which approaches are the most popular. Some structures make it simpler to work out how to slice up the pie and avoid complications in terms of governance: "Gross Revenue Shares (GRS) make the deal as straightforward as possible going forward. A GRS is easier as it is a percentage of the top line. The seeder does need to worry about monitoring and measuring expenses for their share. The manager can maintain independence and has the flexibility to avoid having to answer to entities with interest in the bottom line."

In contrast, deals based on modified net income, net profits and/or equity of the manager, will entail more complication.

The duration of any interests is another negotiated matter. "Sometimes the economics are perpetual and sometimes there is a sunset. The sunset can scale down over a period. And we have seen both, with part of the deal a scale down and some piece of it perpetual," points out David Nissenbaum, Schulte Roth & Zabel Investment Management Partner and a member of the firm's Executive Committee.

Focusing his practice on corporate, securities and bank regulatory matters, Nissenbaum states that time horizons also vary with the type of seeder. "Firms that are in the serial seeding business tend to favour perpetual deals. If seeding is instead more opportunistic, perhaps involving a family office or other entity with a prior relationship to the manager, there may be more variety over the terms," he said.

Vehicles and lock ups

As part of Efron's practice, he represents hedge fund managers in connection with SEC regulatory issues and compliance-related matters. He finds "from a regulatory angle, it is cleaner for seed capital to come into a comingled fund, but it can come in through a managed account. In either case, any preferential terms must be disclosed to investors."

This brings us to the question of whether firms might prefer to avoid registration, which is in some jurisdictions associated with running a fund. We do know of a number of 'mini-primes' (miniature prime brokers) working with very small funds of one (perhaps running single digit numbers of millions), managers and individuals, none of which are registered. However, Efron takes the view "there is little wiggle room to avoid registration. Funds below $150 million of net assets may avoid full registration but seeders usually want growth, while institutional seeders will also want regulation for compliance and oversight."

Fund structures are nearly always open-ended, but seed investors invariably have a lock-up of 18 months to three years. Exceptions are structured as exit clauses that can include adverse performance loss triggers, problems with the management company, key person clauses, and for cause events such as 'bad actor' clauses. A put option might allow the seeder to put the stake back to the management company. Binding commitment can apply on both sides: managers may be subject to restrictive covenants, such as non-competes or non-solicits, preventing them from walking away.

Some seed deals may contain provisions for the manager to buy the seeder out of the deal. Efron rarely sees managers exercising the buyout option as they cannot predict revenues with enough confidence to justify the typical cost of a buyout. Efron does see strategic investors coming in and buying seed stakes, however. Thus, there is a secondary market in trading these interests.

A handful of seeding platforms do house funds in their own offices, though this need not imply an intrusive level of monitoring or control. One of the few generalisations Efron can make is that in hedge funds "most deals are passive stakes and do not have day-to-day involvement in the management of companies. It is rarely desired, or works well, to have a role like a private equity portfolio fund manager in running a business."

But seeders may typically have consent rights over extraordinary transactions or events involving the fund or management company. These could include new strategies, debt exceeding certain thresholds, or consenting to a sale of the business at any time or during the first five years.

Fees and terms

The seeders' percentage of economics and fee levels are among the most negotiated items.

Some seeders do seek fee breaks, in addition to taking a share of fund or management company economics. Nissenbaum views this as "two bites of the apple. If the seeder wants to share in the profitability of the business, it may be asking too much to get a fee break."

In particular, if a strategy is capacity constrained, and the seeder gets capacity rights on top of lower fees, as well as a share of the economics, it may be hard to profitably grow the business. Still, as in all negotiations there are trade-offs. Nissenbaum often sees "seeders paying full freight with 20% of the economics, or taking a smaller share with lower fees."

In addition to preferential fees, seeders may request and secure superior transparency. The obverse of this is that other investors need appropriate protections, which may also be minority investor protections, at least initially.

Non-US investors

The origin of seed capital can be an overriding consideration in some cases and require special structuring. "If capital comes from outside the US, and owns part of a US business (e.g., a US management company), then the non-US seeder could incur federal taxes of up to 54.5% and be required to file a US federal tax return (with US state taxes and tax filings on top)," Efron warns. "US net income taxes apply to business income but generally not to trading income," he adds.

Therefore, many non-US investment funds benefit from an exemption so the appropriate structure may, in broad brush terms, be to give the non-US seeder an over-allocation from the fund. However, Efron cautions that "structuring is not that simple. You need to do a few twists and turns in order to take the economics out of the fund. It is kind of 'apples and oranges' to get to a good place tax-wise." The structuring seems simpler for shorter term, hands-off trading strategies than it is for lending or bankruptcy workouts, where the fund is more likely to be deemed to be carrying on a taxable US business when it has a management team based in the United States.

Types of seeders

The spectrum of seed investors Schulte interacts with include venture capital-style seed/incubation firms; hedge funds, private equity funds and funds of funds; family offices and endowments; and commercial and investment banks. Some insurance companies can also be active. The names of many leading seeders are disclosed in press releases, not least since some of them are public companies. But the number of dedicated, professional institutional seeders is probably declining. Nissenbaum thinks it could be down from 25 a few years ago, to five or 10 today. Still, there are other providers who will sometimes prefer to maintain a lower profile. "In the last two years we have seen more family offices come into the space," notes Nissenbaum.

"Each type of seed investor approaches a deal differently," he adds. Efron sees some institutional platforms that set-up with the intention of helping funds to spin-out, rather than to own perpetual participations. "Some funds join a hub and spoke platform that provides everything and then spin-out alone, potentially with some ongoing revenue share, but not necessarily still in the same office," Efron observes. He thinks that Sovereign Wealth Funds (SWFs) actually do rather less seeding than might be inferred from the media attention that some of them get. "SWFs are so big that most seed deals would not move the needle for their returns," he explains.

Post-Volcker Rule, US banks (and their branches and affiliates) can own stakes in management companies, but cannot put investment capital into funds, beyond seeding their own funds for short periods of time subject to certain criteria. European banks, in theory, may enjoy more freedom, but are grappling with far greater challenges, including non-performing loans and regulatory capital requirements, which are continuing to force most of them to deleverage.

In summary Nissenbaum says "seeding is not as critical to launching as it was a few years ago, but it remains a very active part of the start-up market and an important aspect of the business." **THFJ**