

Fundraising Options: Seed Versus Strategic

One of the challenges facing emerging managers is how to raise capital without a track record. Many investors want to see results before they are willing to allocate to a fund. But emerging hedge-fund managers cannot produce results until they have capital to invest.

To solve this dilemma, increasingly emerging managers are looking to jump-start—and later grow—their funds by securing outsized, early stage investments. Such commitments are typically made by seed or strategic investors. Of the more than 120 investors surveyed for this report, more than 50% indicated they would consider providing seed capital or making a strategic investment.

Seed Investors

Seed investors usually make two types of investments in an emerging manager: they provide capital in exchange for an economic interest in a fund's general partnership, and they make an investment directly into the fund. Although seeders do have expectations about the performance of the fund, their main objective is to help an emerging manager grow and scale the business. Seed investors are looking toward the future when they will not only reap returns from the fund but also share in a percentage of the profits of the firm at the general partnership level. (See Figure 9.)

FIGURE 9: A Seed Investment Example

	Year 1		Year 2		Year 3	
Fund AUM	\$50M		\$100M		\$200M	
Management Fee (2%)	Firm: \$1,000,000	Seeder: \$200,000 ¹	Firm: \$2,000,000	Seeder: \$400,000	Firm: \$4,000,000	Seeder: \$800,000
Performance Fee (20%) ²	Firm: \$1,500,000	Seeder: \$300,000 ¹	Firm: \$3,000,000	Seeder: \$600,000	Firm: \$6,000,000	Seeder: \$1,200,000
General Partner's Annual Fees	\$2,500,000		\$5,000,000		\$10,000,000	
Seeder's Economic Stake	\$500,000		\$1,000,000		\$2,000,000	
¹ In exchange for seed capital, the investor acquired the right to 20% of all management and performance fees earned by the fund. ² This calculation is based on annual gross fund returns of 15%.						

Seeders are investors who like to get in on the ground floor. They play an active role in setting up funds, which puts them in a position to influence policies and procedures, such as those related to transparency and risk.

“We feel seeding funds provides us a distinct advantage. It allows us to offer significant insight and recommendations to the fund manager that we would not be able to give as a regular LP.”

—A New York seeding platform

How much do seeders invest in emerging managers? The answer is, it depends. The investors we interviewed indicated that they tailor their commitments to each firm.

“We don’t base the amount of an allocation on a fund’s track record. The size of the investment depends largely upon a manager’s capacity to grow.”

—A U.S.-family office seeding platform

For emerging managers, one of the benefits of having seeders invest is credibility; they put an institutional face on what is otherwise an unknown brand. This endorsement can be helpful especially as an emerging fund hits critical asset thresholds, such as \$20 million, \$50 million, and \$100 million. An association with a seeding institution attracts investors and provides many benefits, including:

- Credibility in the marketplace
- Helping to alleviate concerns about potential business risk

A seeding institution also provides:

- A broader investor network
- Insight into legal and compliance issues
- Already established relationships with top-tier service providers
- Mentoring and guidance from experienced partners

“In the post-2008 era, I consider seeding an institutional stamp of approval. There is a scarcity of assets and a surplus of talent, and I believe I can access better managers by identifying them early.”

—A U.S. family office

The terms of seed investments vary and are negotiated directly with each investor. Overall, however, the seed investors we interviewed stated that they view a relationship with an emerging manager as a partnership.

A seed partnership doesn't come easy as there are many hurdles for a manager to overcome. Some of the typical concerns seeders have about emerging managers are:

- They are great idea generators, but they usually have not executed on a stand-alone platform
- They may be superstar traders, but they have not previously assumed overall risk management and asset allocation responsibilities
- They lack real-world experience dealing with compliance and administrative issues, particularly those who are spinoffs of larger firms
- Some come from the long-only world, do not have short-selling experience, and have not typically used derivatives for hedging purposes
- They have not faced the challenges of running their own firm
- They have never been in a position where they are the owner and the buck stops with them

Strategic Investors

For managers reluctant to give up a stake in their firms, there are early stage strategic investors. The goal of these investors is to accelerate the growth of a fund's assets by making a large allocation directly to the fund. An infusion of capital from a strategic investor can kick-start a fund's ability to raise additional capital from other sources.

Early stage strategic investors often look more favorably upon funds that are willing to negotiate both management and performance fees. Traditionally, managers earn 2% of assets under management and 20% of a fund's profits. Emerging managers who demonstrate a willingness to negotiate their fee structures increase their marketability to prospective strategic investors.

Of the investors surveyed for this report, 58% said that over the past 12 months, emerging funds have shown increasing flexibility when discussing fees. (Different share classes of a fund can have different fee structures. It is important that emerging managers adhere to the laws and regulations governing the industry. Therefore, all transaction documents should be approved by managers' compliance and legal teams.)

A willingness to compromise on fees is not the first thing an investor looks for when researching emerging funds, however, the majority of investors indicated it was a factor that would be taken into consideration during the due diligence process. If all other factors are equal, and one manager is willing to make a concession while another is not, the first manager would be looked at in a more favorable light.