HEDGE FUND SEEDING

Enhancing Returns in a Low Yield Environment

JUNE 2016

About Tages Capital

Tages Capital is a European seed investor active across both developed and emerging/frontier markets and has invested approximately $600m across 12 funds over the past 3 years, including via a dedicated private equity-like vehicle which invests on a multi-year commitment basis and a vehicle dedicated to seeding UCITS funds. Tages Group oversees $7.7bn of assets. Tages Capital LLP is an asset manager regulated by the FCA with offices in London and Milan, with approximately $2.3bn of assets under management as of 31 March 2016. Tages Capital was recently judged “2015 Best Seeder” in the Hedge Funds Review, 14th Annual European Fund of Hedge Funds Awards.

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Executive Summary

The environment for hedge fund seeding and acceleration looks increasingly attractive relative to the low yields available from traditional investments. For those with a multi-year investment horizon, seeding or acceleration capital investments can help investors to decrease hedge fund investment costs and enhance returns by directly participating in a greater proportion of the industry economics.

The industry investor base has changed materially since the global financial crisis, with a significant increase in institutional investors and consultants focused on larger funds. The introduction of regulatory restrictions on global banks investing in hedge funds and a decline in the number of fund of hedge funds has resulted in a scarcity of dedicated seed capital providers, particularly in mid-size transactions.

There continues to be a strong pipeline of high quality talent, often second generation managers with hedge fund experience attracted to the still high margins available in the industry. At the same time, increasing institutional minimum asset size requirements and escalating regulatory, compliance and operating costs have increased the barriers to entry and therefore increased the attractiveness and value of seed capital.

There is significant academic evidence to suggest that on average emerging managers outperform. Investors have found recent returns from larger established managers to be disappointing. At the same time, some larger managers are closed or have returned capital to investors recently, including a number of high profile family office conversions. Increasingly institutional allocators are looking at emerging managers, but these funds require a minimum asset base to be investable. As a result, there are a number of potentially lower risk acceleration capital opportunities with pedigree managers who are managing funds already.

The strong growth in alternative UCITS products in Europe is also expanding the opportunity set, for those seed investors who have experience in liquid alternatives, to partner with established managers to launch new funds.

Hedge fund seeding can provide annuity excess returns over and above investing directly into hedge funds or via a fund of funds portfolio, due to direct participation in the gross management and performance fee revenues received by the underlying managers. Additional benefits such as fee discounts, capacity and co-investment rights are also typically negotiated.

Revenue share interests provide positive convexity to a portfolio, and benefit from netting, unlike fund of fund portfolios, in that revenue streams are received independent of other portfolio funds' performance.

In a low yield environment, the revenue share participation could make up almost half of the return over the life of a seed investment, if the right managers and strategies are selected. In a portfolio with a target IRR of 12%-15%, we estimate that this could equate to a 5-7% contribution, assuming a 7.5-10X average AUM base relative to the initial investment made.

In this paper we explore some of the industry trends relevant to seeding, illustrate the potential economics available to seed investors and provide some background on the Tages approach to structuring a seed transaction.

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Section 1 - An Introduction to Seeding / Acceleration

BACKGROUND

Increased regulation, rising operating costs, a shift to a more conservative industry investor base and a decline in the number of traditional seed investors has made it increasingly difficult for early stage managers to attract sufficient capital to build a long term viable business. One option to overcoming these difficulties is for managers to partner with a strategic investor who can provide patient seed or acceleration capital, often contractually locked for a minimum period of time, in exchange for economics in the manager which typically continues after the capital has been redeemed. In many cases, the seed investor will also work with the manager to develop the business infrastructure and distribution capabilities given the alignment of interest on both performance and asset-raising.

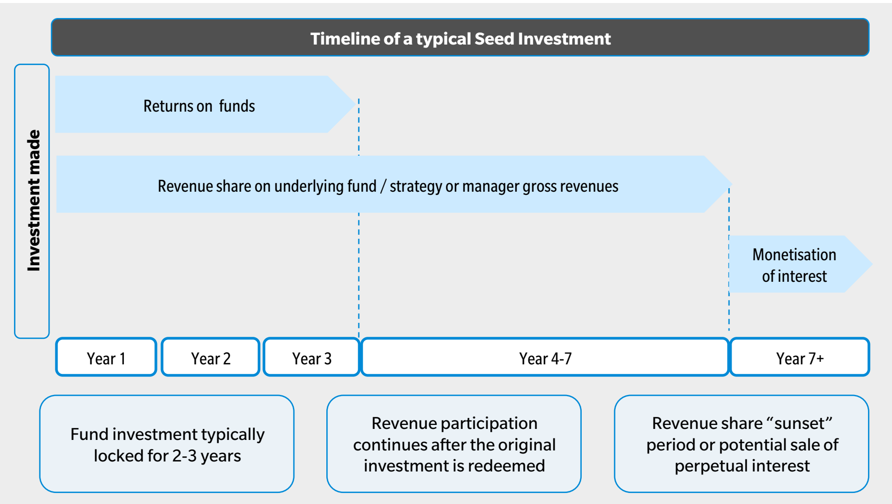
For the seed investor that is able to harvest this liquidity premium by locking up capital for a 2-3 year time period, this can be an attractive opportunity to add a complementary asymmetric return stream to a hedge fund portfolio, while dampening volatility and benefiting from access to some of the potentially high margins earned in the industry. Given the strategic nature of the relationship, this also provides the opportunity to negotiate a number of other benefits such as preferential fees, capacity rights, co-investment opportunities, as well as a number of risk mitigating protections.

SEEDING / ACCELERATION TRANSACTION

In exchange for making an early stage investment, a seed or acceleration capital investor receives an economic interest in the underlying alternative investment manager. This can be structured as an equity or gross revenue share participation. Revenue share participation is more common today as these agreements are often simpler and quicker to negotiate, come with less potential liability and taxation risks, require less involvement in the manager’s business decisions and are simpler to administer. However, agreements are still typically structured to provide some equity-like protections and sale participation rights to the seed investor.

Invested capital is typically “locked” (i.e. cannot be redeemed) for 2-3 years, following which the investment can, but does not have to be redeemed and may be available for further re-investment. The revenue share interest continues for the life of the transaction (typically 7-10 years, but can be perpetual). This remains the case even though the invested capital may be redeemed after the commitment period or in the event of a redemption trigger being exercised.

Chart 1. An example of a seed investment revenue timeline



Source: Tages Capital

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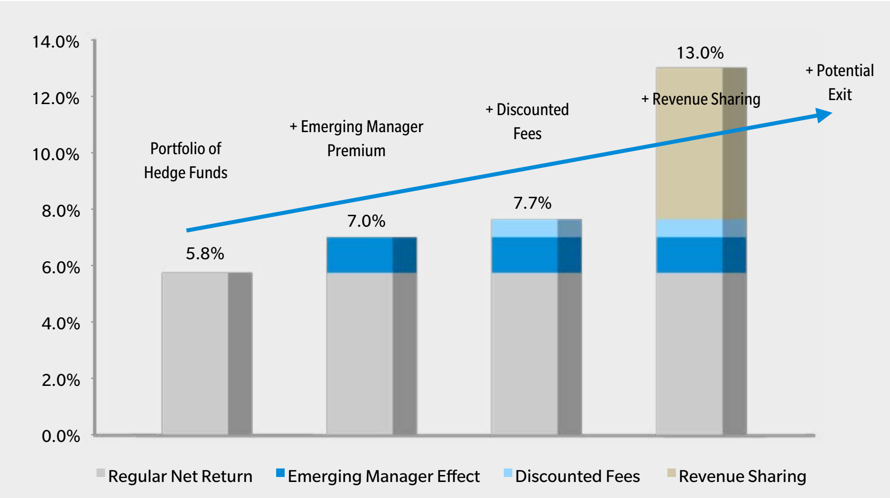
A seeding transaction can take anywhere from 3 months to a year from the point of first contact to final execution, with significant resources required to source the best possible managers, due diligence the manager, consult on best practice and negotiate and execute the final agreements.

SOURCE OF RETURNS

Returns from a seeding arrangement can derive from multiple potential sources:

- Returns of a concentrated portfolio of hedge funds
  - \+ A potential "early stage" premium of investing in emerging managers
  - \+ The ability to negotiate significantly better terms (capacity and fees)
  - \+ Participation to the asset growth of the managers (revenue sharing)
  - \+ A potential monetisation event in the management company/strategy

Chart 2. An illustration of potential return contribution from a seed investment



Source: Tages Capital (detailed calculations are shown in Appendix A)

For the purposes of illustration in this paper, we will make some simplifying assumptions, but it is worth noting that most seed transactions are highly negotiated with bespoke terms for each transaction. As well as the "economics", a typical seed transaction will include various risk mitigation / protective clauses, but within this section we will focus on the main drivers of potential returns to the seed investor.

In Chart 2, we provide an illustration of the potential returns that a seed investor could achieve over and above a standard hedge fund investment in an established manager. We break down the returns into:

1. A regular return from established managers assuming a gross return of 8.50% and average fees of 1.50%/17.5%, in line with average annualised HFRI net returns (refer Appendix B) and estimated average current industry fees;
2. An "Emerging Manager Premium" of 1.5% - an estimated gross outperformance attributable to emerging managers, based on academic research (discussed later in this paper);
3. Discounted fees, typically available to early stage investors – seed investors participate in this either directly or indirectly via a revenue share on the seed investors' investment (depending on how the transaction is structured); and
4. A revenue share, assumed to be a straight 20% of management fees and performance fees received by the manager, on the assumption that the manager raises a total of 10X the original seed investment in AUM.

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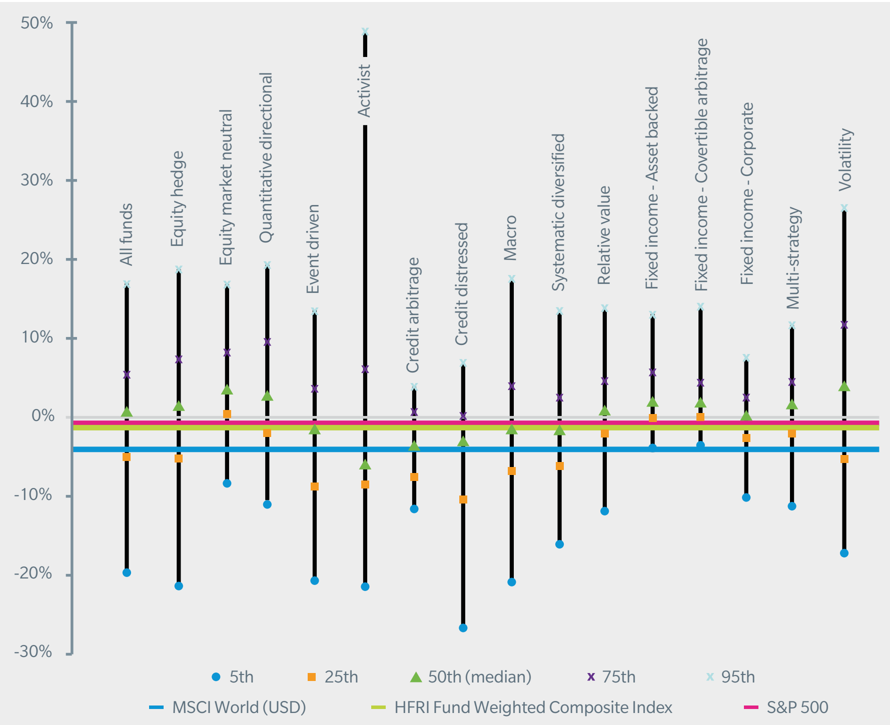
Returns of a concentrated portfolio of hedge funds

During the investment period, the main driver of returns will be the returns from the underlying fund investment itself. When combined with other seed investments, this equates to a concentrated portfolio of hedge funds. In addition to portfolio construction and strategy selection, the level of concentration and ability to diversify this risk will be driven by the time it takes to source new investments, negotiate and structure each transaction and then call capital to make the investment.

The importance of selecting the right strategies and the right managers at the right time is highlighted in Chart 3, showing the level of dispersion between and within different hedge fund strategies in 2015.

Chart 3. 2015 cumulative hedge fund performance dispersion by strategy



Source: Deutsche Bank Alternative Investment Survey, 2016; HFR

"Early stage" emerging manager premium

There is a significant body of academic work (refer Appendix C) which suggests that smaller and emerging managers tend to outperform larger and more established managers on average. The theory is that emerging and smaller managers have stronger incentive effects, can be more nimble in their trade implementation, are able to exploit more niche opportunities due to their size and tend to offer greater fee discounts which support a higher net return to the investor.

Outperformance of emerging managers could be explained by a higher tolerance for risk taking than established managers who are motivated more by the stability of their management fee revenues and have a higher proportion of large institutional investors who have a lower expected return requirement. For this reason it is important to include risk guidelines in a seed agreement and concentrate on risk adjusted returns at the portfolio level.

While investors are reminded that past performance is no guarantee of future results, based on the research done in this field it does appear reasonable to conclude that there is a potential "emerging manager premium" to be earned from investing early stage with managers, which we estimate in this paper to be approximately 1.5% of additional performance, for illustration purposes.

Better terms

Early stage investors typically receive a fee discount for investing on day one or within the earlier of a certain timeframe from launch or reaching a pre-defined AUM level, often referred to as "founder or early bird share classes".

Seed investors are in a good position to negotiate fee discounts as well as expense caps as part of the wider transaction negotiation. However, this has to be balanced against the requirement for the manager to earn sufficient working capital in order to be financially viable while growing the business.

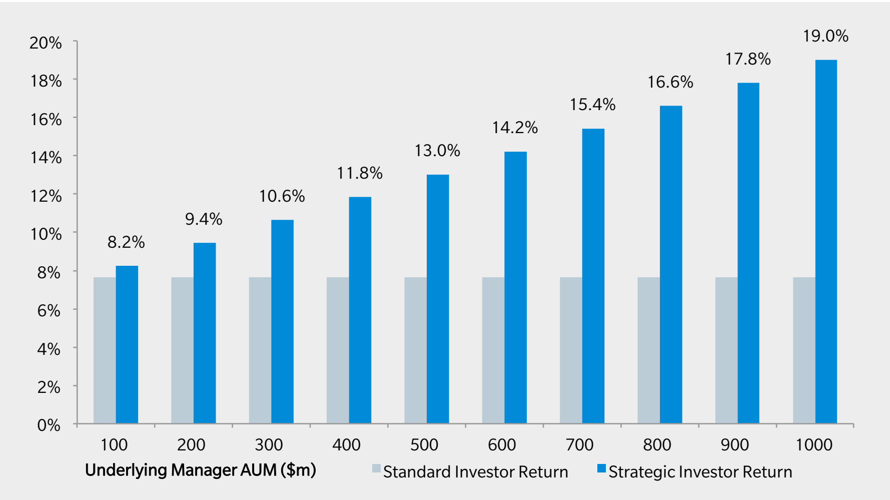
Typically a seed agreement will also include most favoured nation (MFN) rights, additional capacity rights and co-investment rights. However, we believe it is important not to seek preferential liquidity rights which could give cause for concern to other investors. By this we mean that if a redemption trigger event occurs, and the seed investor exercises discretion to redeem before the end of the commitment period, this should be on the same terms as any other investor.

Revenue sharing

Every revenue share agreement is bespoke to the particular transaction and is highly negotiated. For the purposes of this illustration, we will assume a straight forward economic arrangement of 20% revenue sharing for 7 years based on a $50m investment for 3 years locked capital, with a discount on assumed standard fees of 1.5% and 17.5%, equivalent to the revenue share participation.

Chart 4 provides an illustration of the potential impact of the revenue share on a seed investors' return profile for different levels of AUM, as compared to returns of a standard early stage investor at discounted fees.

Chart 4. Potential revenue share contribution at differing levels of AUM



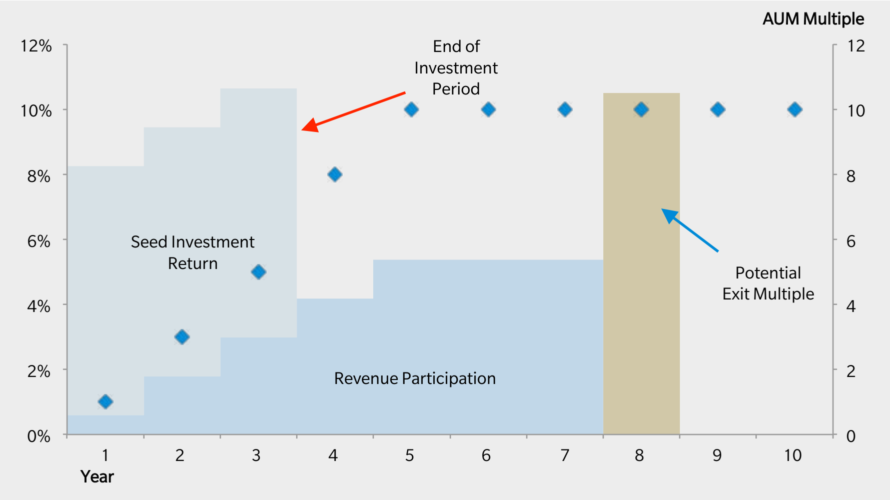
Source: Tages Capital (detailed calculations are shown in Appendix A)

In our experience, seed investors can obtain more favourable terms in the current market, but we will use the above inputs in the illustration provided in Section 3, for the benefit of simplification.

Seed Investment Cash Flow Profile over Time

Chart 5 illustrates the expected cash flow profile of a typical seeding transaction over time - using the same return assumptions used in Chart 2, and an asset raising profile reflected by the AUM multiple in the chart i.e. achieving a 10x asset raise multiple within 5 years (the equivalent of a $50m seeded fund growing to $500m in AUM over 5 years) and remaining at this level for the remainder of the revenue share period.

Chart 5. Potential revenue share contribution at differing levels of AUM



Source: Tages Capital

Potential monetisation

In a typical revenue share agreement, the seed investor has contractual rights to participate in any sale of the business, usually pro rata to the implied equity interest derived from the revenue share percentage, grossed up to take into account an assumed or historical net operating margin.

In some cases the manager holds a call option enabling them to buy out the seed investor at a pre-defined valuation (often a pre-agreed multiple applied to normalised revenue share participation, taking into account the remaining life of the transaction). In some cases the seed investor will also hold a put option enabling them to sell the revenue share interest back to the manager at predefined points in the transaction term. In practise though, this can put a significant financial burden on the manager who may not be in a position to finance the transaction, even though payments are usually made out of retained earnings over a multi-year period.

An alternative approach is to structure a transaction with a sunset clause in the remaining years of the transaction or to agree an early exit right for the manager after a certain period of revenue share participation. In the latter case, the valuation may be agreed at the time of this right being exercised, on the basis of currently available information and with a pre-defined mechanism to obtain an independent valuation and ultimately binding arbitration if a valuation cannot be mutually agreed.

In practice, given the small number of transactions which are ultimately monetised and the level of uncertainty in determining a forward looking valuation, for the purposes of the illustration in Section 3, we will ignore any potential monetisation event.

Risk Mitigation

In order to mitigate some of the early stage investing risk, each seed transaction includes a number of contractual rights which are negotiated as an additional layer of protection available to the seed investor. Some examples are shown in Table 1.

Table 1. Contractual risk mitigants

Redemption Triggers	Key Person Event
	Maximum Drawdown Event
	Minimum Principal Investments
	Strategy Changes
	Investment Guideline Breaches
	Minimum Staffing Requirements
	Potential Asset Raising Targets
	Regulatory Infringements
	Adverse Tax Events
	Material Reputational Risk
Consent Rights	Changes to Fund Terms
	Changes to Service Providers
	Changes to Governance Structure
	Other actions that could affect the revenue share
Additional Protections	MFN rights
	Fee discounts / Expense Caps
	Non-Compete / Non-Solicit
	Minimum Principal Equity Interests
	Drag Along / Tag Along Rights (Equity Sale)
	Information rights
	Indemnification provisions
	Potential to insure revenue share interests

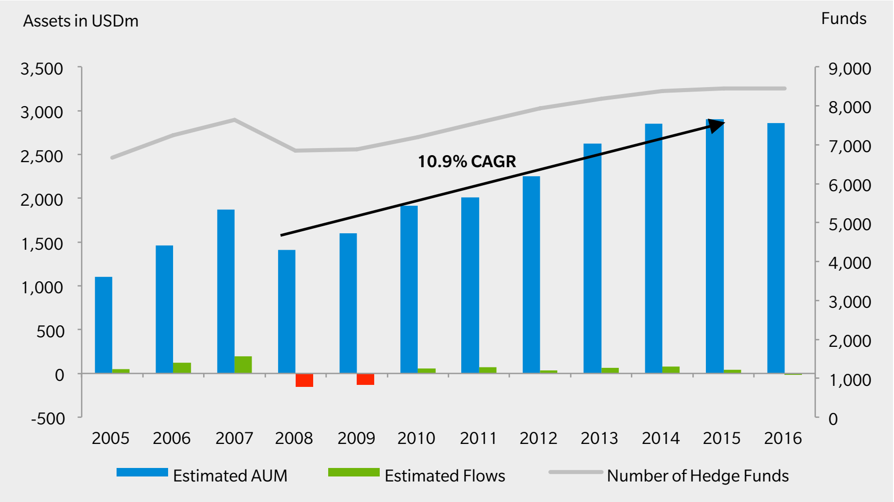
Source: Tages Capital

Section 2 - Industry Trends

INDUSTRY GROWTH PROSPECTS

Despite regular media commentary about investor appetite waning, the hedge fund industry has grown at a compounded annual growth rate of 11% since 2008. This growth has slowed over the past two quarters, with the industry experiencing a challenging start to 2016, receiving net redemptions of $15bn, which are the largest net quarterly outflows since 2009. To put this into context, this represents 0.50% of industry assets. Although the pace of net flows would appear to be slowing, many institutional investors continue to look to alternatives for consistent, risk-adjusted returns that are uncorrelated to the broader market, in particular when faced with historically low expected returns from their equity and fixed income allocations and challenges addressing funding gaps in a low rate environment.

Chart 6. Estimated Growth of Hedge Fund Industry Assets and Net Flows



Source: HFR

Capital outflows in the first quarter of 2016 were concentrated in the industry's largest firms in the face of disappointing returns and a number of high profile manager returns of capital or family office conversions. Firms managing less than $250m actually recorded net inflows of $730m[1], providing some support for the trend we have seen of allocators paying more attention to emerging managers as some of the larger firms have provided disappointing results.

This growth in the hedge fund industry has been consistent with the trends seen in the broader sector, where alternatives have been growing at a compounded annual growth rate of 10.7%, as compared to the traditional investment sector which has been growing at 5.4% since 2005[2]. In their 2014 report, McKinsey forecast that "for asset managers, the continued rise of alternatives represents one of the largest growth opportunities of the next five years". While this enthusiasm may need to be tempered in light of recent performance, this could be a positive development for emerging managers, where increasing interest from institutional investors and a recycling of capital away from larger underperforming managers may represent an opportunity if these managers can get to scale quickly.

Albeit off of a much lower base, hedge fund strategies offered through traditional regulated fund wrappers have been growing at an even faster rate. It is estimated that the Alternatives UCITS segment grew at a compound annual growth rate of 27%, between 2008 and 2015[3], with the

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[1] HFR 1Q16 Global Hedge Fund Industry Report, 2016
[2] McKinsey & Company: The Trillion-Dollar Convergence: Capturing the Next Wave of Growth in Alternative Investments, 2014
[3] LuxHedge Alternative UCITS Overview, Feb 2016

amount of capital estimated at being raised into UCITS funds now exceeding the capital being raised into offshore funds in Europe. In Europe in particular, this provides an advantage to seed investors who are experienced and able to seed UCITS funds.

A growing number of allocators are also engaging with hedge fund managers to run their long only portfolios. There is an opportunity for hedge fund managers to apply their perceived superior expertise and skill to managing traditional assets and for seed investors who negotiate firm wide economics to benefit from this trend in the long run.

INCREASING BARRIERS TO ENTRY

Despite overall industry growth, it is becoming increasingly more difficult and costlier to launch a hedge fund business. Increased institutional due diligence demands, costs of regulation and compliance, as well as higher investor minimum AUM requirements continue to increase the barriers to entry into the industry.

The post 2008 regulatory framework on financial institutions has resulted in a number of headwinds to successfully launching a stand-alone hedge fund business. Compliance and regulatory costs are estimated to have an outsized impact on emerging managers, with 35% of hedge funds with less than $250m in AUM estimated to be spending more than 10% of their total operating costs on regulatory compliance[4].

Solvency II requirements, along with the implementation of AIFMD, has driven a demand from institutional investors for onshore regulated products in Europe as well as for (often bespoke) segregated mandates providing full transparency. At the same time, there has been continued pressure on fees, especially from large institutional allocators. Managing these relationships has become costlier as a result.

Basel III represents a significant structural challenge to the prime brokerage model and therefore to the traditional hedge fund financing model, meaning that financing costs have increased, as have the minimum size and profitability required by a hedge fund to engage a top tier prime broker in the first place. In particular, it is getting more difficult and more expensive to launch strategies which are balance sheet capital intensive for the prime brokers, for example some distressed, fixed income or structured credit strategies.

The same "Catch-22" situation applies to other top tier service providers who now focus their resources on established, proven managers, or only on top tier entrants, given the higher working capital requirements and therefore higher probability of failure when launching a new fund today. However, without appointing top tier service providers, the probability of attracting sufficient assets to become viable decreases exponentially.

The analysis of hedge fund margins in Chart 7 clearly illustrates the challenge faced by emerging managers in the face of fee pressures and escalating costs.

[4] KPMG/AIMA/MFA Cost of Compliance, 2013

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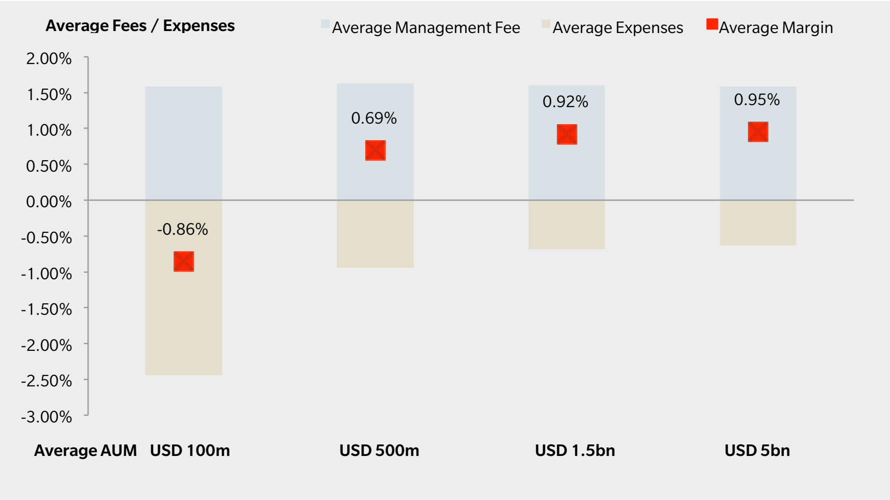
Chart 7. Average Estimated Hedge Fund Margins, before Performance Fees



Source: Citi 2014-15 Annual Hedge Fund Operating Metrics Survey

Although there is a wide range of emerging manager cost structures, based on an analysis of our existing portfolios, we estimate that the working capital requirement for a new launch today is between $1-2m per annum, depending on the strategy and location. When taking into account seed economics and/or some level of fee discounting in order to attract early stage capital, we estimate that this equates to an AUM break-even range of $100m-150m, prior to performance fees and with limited principal drawings.

In addition, many institutional investors expect to see a material level of "skin in the game" from the principals. This could run into the multiple single digit millions of dollars. Although all circumstances are different, early stage investors are likely to focus on this aspect of due diligence if the level of this co-investment is inconsistent with the perceived pedigree and expected earnings of the principal in their former roles.

These barriers to entry present a serious challenge to early stage managers, which can make seed and acceleration capital all the more valuable, both from a working capital perspective and as a signalling mechanism to service providers and prospective investors. However, it also makes the size of the seed capital and the momentum of asset raise within the first three years all the more important.

NUMBER AND QUALITY OF FUND LAUNCHES

Although the overall number of hedge fund launches is decreasing, our experience suggests that the number of managers with relevant buy-side experience and an often demonstrable track record is increasing.

Traditionally, and in particularly more recently in response to the Volcker rule, the main source of talent for new hedge fund launches came from the proprietary trading desks of the large banks. This has largely changed.

With the banks downsizing, and much of the trading talent having already departed, many of the new fund launches are originating from the buy side, with second or third generation managers who feel they have outgrown their current firms and/or want to put their own name above the door. Many larger hedge funds have also reached capacity, closed their doors to new investments, or in some cases are returning capital and converting to family offices. This has provided an opportunity for good next generation portfolio managers to set up their own businesses.

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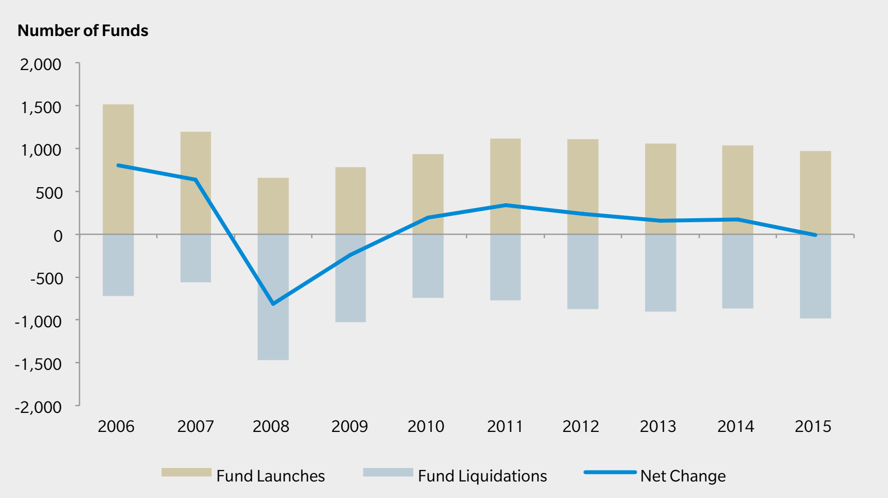
Perhaps indicative of the increasing barriers to entry to the industry, 2015 saw the fourth straight year of a decline in new entrants, with a 7% decrease in the number of hedge fund launches to 968 and a slight net decrease in the overall number of hedge funds, for the first time since 2009.

Chart 8. Number of Hedge Fund Launches and Liquidations



Source: HFR

This actually under reports the number of potential seed investments, as it only represents those managers that got to the point of launching a fund. In reality though, only a fraction of those funds would be interesting to a seed investor. By way of illustration, when looking at fund launches over $50m in 2015, there were 184 new launches globally, down from 237 in 2014[5].

Now that the supply of new talent originates predominantly from within larger existing asset management businesses, these hedge fund managers typically have a greater awareness of the requirements and challenges of setting up a new business. While many of the prop desk spin-outs of earlier years have been successful, a number of the more recent high profile launches have subsequently shut down due to underperformance or a lack of asset-raising. The lesson seems to be that running a hedge fund business can require a different skillset than trading within a bank.

SCARCITY OF EARLY STAGE CAPITAL

Since 2008, there has been a noticeable bifurcation in the industry, with the lion's share of the asset growth going to the largest managers. As an illustration of this, the top 428 firms managing over $1bn (the so called "billion dollar club") accounted for $2.48bn or 89% of AUM at the end of 2015[6] as compared 79% of AUM in 2009.

Institutional allocators often require a minimum fund AUM in an attempt to limit concentration and business risk. Based on industry surveys, it is estimated that nearly half of prospective allocators require a minimum AUM of $100m before they will consider investing in a fund.

[5] Hedge Fund Intelligence Global Review, Spring 2016
[6] Hedge Fund Intelligence Global Review, Spring 2016

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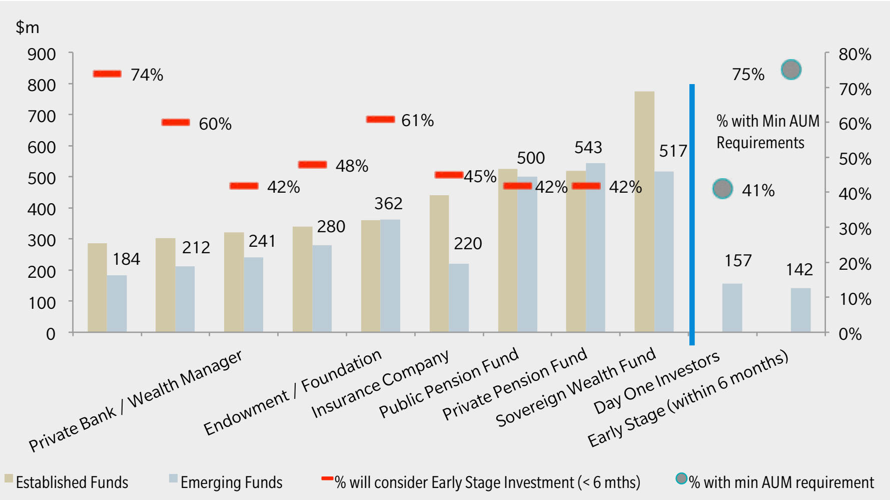
Chart 9. Average minimum fund AUM required for investment by investor type



Source: Deutsche Bank Alternative Investment Survey, 2016

60% of allocators say they can allocate within 6 months of launch, but of those investors, 75% have a minimum AUM requirement, which averages $142m, as shown in Chart 9.

The growth in the consultant industry, often in direct competition with fund of funds, has had two main side effects with respect to seeding. The increased competition and margin compression has decreased the number of fund of funds in the industry either through consolidation or closure. As fund of funds traditionally had the expertise and resources to support a seeding program they made up a significant source of early stage capital for start-up managers. Secondly, consultants historically have not managed discretionary assets (although this is changing) and their business model is more averse to advising clients to taking the perceived risk of investing in early stage managers. Therefore the institutional trend towards direct allocation, supported by advisory relationships has decreased the number of traditional seed investors in the market.

BENEFITS TO BEING AN EARLY STAGE INVESTOR

Managers have been deploying creative solutions to incentivise investors to make an early stage investment, often offering founder and early bird share classes, with discounted fee structures to invest on day one, within a fixed time period or before achieving a certain capital raise objective. Some managers have additionally provided for further discounts on fees for the early stage investor once they achieve a certain AUM level, effectively a proxy for achieving a certain level of working capital into the business from the existing investor base.

Some seed investors look to obtain exclusive access to the managers' skills for a set period of time before they are allowed to take on other investors, but most seed investors are happy to enhance their potential returns by participating in the growth of the business, preferring to leverage their strategic investor status in order to obtain additional benefits such as discounted fees, additional capacity rights, most favoured nation rights, information transparency and a cap on fund expenses, by way of example.

These hybrid approaches can be seen as a revenue sharing of sorts, with a cap on the amount of revenue that the manager forgoes and only payable for the time period that the investor stays invested. They are typically much cheaper structures to implement, often being able to be implemented via a side agreement rather than a lengthy and complex revenue share negotiation, but with significantly less participation to the upside if the manager is successful.

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CO-INVESTMENT

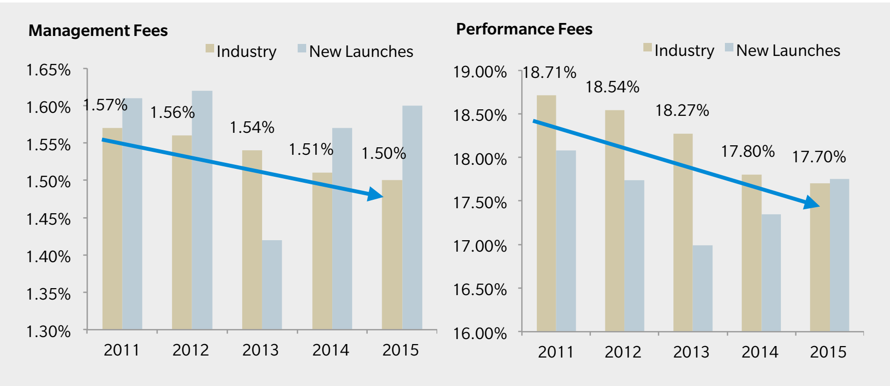
Over the past few years there has also been a significant increase in co-investing opportunities provided by managers. Early stage investors develop the relationships with managers which may provide access to participation in these co-investment opportunities. This approach can provide access to a manager's best ideas as well as taking a more concentrated position in these ideas than a manager may be willing or able to take in the comingled fund. It is also used by some investors as a means of decreasing the overall cost ratio of investing with a manager, as management fees (and possibly performance fees) associated with co-investments are often much lower than the comingled fund. In the case of a seed investor this is typically a contractual right built into the seeding agreement.

HEDGE FUND REVENUES

The alternatives industry accounts for over 30% of industry revenues despite comprising only 12% of the asset management industry assets[7]. It would be reasonable to expect that the higher margins available would attract competition with a resulting margin compression.

There has been much written about the compression of fees in hedge funds and the institutionalisation of the industry has certainly resulted in a lowering of fees since 2008. However, perhaps surprisingly given the level of media attention in this area, our experience, supported by a number of industry surveys, suggests that fees have settled in a range of 1.50%-1.55% for management fees and 17.5%-18% for performance fees, which represents only a 5% decrease in levels over the past 5 years.

Chart 10. Average Hedge Fund Fees (2010-2015)



Source: HFR

One might expect there to be greater fee pressure on emerging managers, with most managers offering founder class and early bird discounts for early stage investments. However, according to Hedge Fund Research, "for the vintage of funds launched in 2015, the average management fee was 1.6 percent, an increase of 3 bps over the vintage of 2014 launches, while the average incentive fee for 2015 launches increased to 17.75 percent, an increase of 40 bps over funds launched in 2014"[8].

However, as more institutional investors focus on emerging managers we believe that there will be continued pressure to discount fees more aggressively in start-up phase, making these managers more reliant on performance fees in order to be profitable while they are small.

[7] McKinsey & Company: The Trillion-Dollar Convergence: Capturing the Next Wave of Growth in Alternative Investments, 2014
[8] HFR Hedge Fund Market Microstructure Report for Fourth Quarter 2015

GROWTH IN ACCELERATION OPPORTUNITIES

Given the scarcity of capital available to many emerging managers and the importance of getting to a scale at which a manager is both profitable and at which institutional investors will consider investing, there is an increasing opportunity for seed investors to provide "acceleration capital" to a manager who already has the infrastructure and a track record in place but cannot raise sufficient capital alone to get to the required critical mass.

This can propel the emerging manager into the next stage of its asset-raising life cycle, while avoiding the additional time and potential risk involved in entering into an agreement with a manager without a live portfolio and prior to a business and fund structure being set up.

There is typically a window of opportunity for managers to benefit from this approach. While having a multiple year track record is a distinct advantage, there is also an important momentum effect to asset-raising which can be lost if a manager waits too long.

Some seed investors are also taking advantage of the move to liquid alternatives. In our experience and supported by industry surveys, investors are prepared to invest in smaller funds in UCITS format, perhaps taking some comfort from the liquidity profile and regulated nature of these products. This has provided an opportunity for seed investors who are experienced in this space and are able to provide both capital and advice to managers who are looking to launch these funds. This also provides the opportunity to enter into seed type arrangements with established managers, which should mitigate some of the start-up risk, but can be less lucrative as participation is typically at the fund level only.

IMPROVING EXIT OPPORTUNITIES

There has been a more recent trend for some of the larger traditional seed investors, joined by new entrants from the private equity space, to focus on acquiring minority equity stakes in established large managers. This can be perceived to be a lower risk strategy which provides yield from day one. However, this model is quite distinct from the traditional seeding model in that the investors put their entire capital at risk to the management company closing down, typically with no clear exit strategy, rather than making an investment in the underlying fund with drawdown protections and a clear return of capital timeline.

In the case of listed groups such as Man Group or AMG, making acquisitions are often driven by a need for continued growth and buying managers at unlisted valuations which are accretive to their earnings multiples. There have also been a number of special purpose vehicles raised to take equity stakes in mature hedge fund organisations. Examples include the $1bn Petershill Fund raised in 2007 by Goldman Sachs, the $3bn+ raised across two vintages by Dyal Capital which was created by Neuberger Berman in 2012 to invest in minority equity stakes and the $1.4bn raised by Blackstone in 2014 with a stated goal to raise this to $3bn. Carlyle, TPG, KKR and a number of smaller players have all pursued variations of a similar strategy.

Although this model is typically premised on buying stakes in mature managers with a $2bn-$5bn+ asset base, a diversified client base and multi-PM/product structures, there is significant competition and a limited supply of these types of managers. Time will tell which model provides for better risk adjusted returns, but we do expect that this will result in capital seeking transactions of a smaller size which will have a trickle-down effect to smaller managers and present potential exit opportunities for traditional seed investors in the long term.

With the high growth rates in the industry, higher industry cost burdens, clear economies of scale and the current fragmented nature of the hedge fund industry, some participants are also forecasting a consolidation in the industry similar to that which took place in the traditional investment industry[9].

Over the next 5 years this may provide for increased monetisation opportunities, although this is likely to require smaller managers to broaden their product range, diversify their talent pool, mitigate key man risk and achieve sufficient scale and institutionalisation to be attractive to these players. For seed investors, this will prove to be the exception to the rule, but agreements are still typically structured to benefit directly from this possibility.

[9] McKinsey & Company: The Trillion-Dollar Convergence: Capturing the Next Wave of Growth in Alternative Investments, 2014

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Section 3 - The Seeding / Acceleration Capital Model

There is no publicly available return database for seeding transactions. Given the small number of dedicated seeding vehicles in the market, the different structures utilised, the bespoke nature of most seeding transactions, the unique timing of capital calls / investment periods and the different objectives of seed investors, it would be very difficult to construct an index of seeding transactions in order to accurately assess the historical returns achieved by seed investors.

For the purposes of this paper we have set out to provide an illustration of how seeding economics work and what the return profile of a hedge fund seeding portfolio may look like under different scenarios on a forward looking basis.

Firstly we run historical simulations using the HFRI index returns from January 2000 to December 2015. Although this doesn't adequately adjust for our estimated "Emerging Manager Premium", we believe it is a better starting point for the analysis than using other asset weighted indices available. Refer to Appendix B for further comment and source data.

In practise there are a multitude of variables that feed into the gross performance of a seeding portfolio. We make a number of simplifying assumptions in order to illustrate the principles:

Table 2. Seeding Illustration – Investment Assumptions

Seed Investments	Average Investment of $50m per seed transaction
	Portfolio of 8 seed investments
	Investments are made on day one (in practice capital would be called over time)
	Invested capital is locked for 3 years (in practice this could be longer or shorter)
	Investment is redeemed after 3 year lock
Fee Terms	Management Fee of 1.5% (consistent with current industry average)
	Performance Fee of 17.5% (consistent with current industry average)
Revenue Share	20% for 7 years (in practice this is likely to be longer)
	No monetisation event during the life of the transaction
	No reinvestment of proceeds

Source: Tages Capital

In order to illustrate the additional potential returns from seeding, we show the Internal Rate of Return (IRR) attributable to each portfolio under 3 different average asset raising assumptions:

Table 3. Seeding Illustration - Asset Raise Assumptions

$m	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Investment	50	50	50				
Low	50	100	100	100	100	100	100
Medium	50	150	375	375	375	375	375
High	50	200	500	1,000	1,000	1,000	1,000
AUM Multiple	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**
Low	1	2	2	2	2	2	2
Medium	1	3	7.5	7.5	7.5	7.5	7.5
High	1	4	10	20	20	20	20
RSA Base	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**
Low	400	800	800	800	800	800	800
Medium	400	1,200	3,000	3,000	3,000	3,000	3,000
High	400	1,600	4,000	8,000	8,000	8,000	8,000

Source: Tages Capital

In reality, in any seeding portfolio there will be a mixture of outcomes in respect of performance and in asset-raising. The assumption underlying this illustration is that the diversified portfolio of seed investments results in a compounded annualised growth rate (CAGR) equal to each 3 year rolling CAGR of the HFRI index (which is published net of fees) in the 3 years that we assume the portfolio to be invested. Under this scenario, the CAGR will equal the IRR of the portfolio if cash flows from the revenue share are not taken into account.

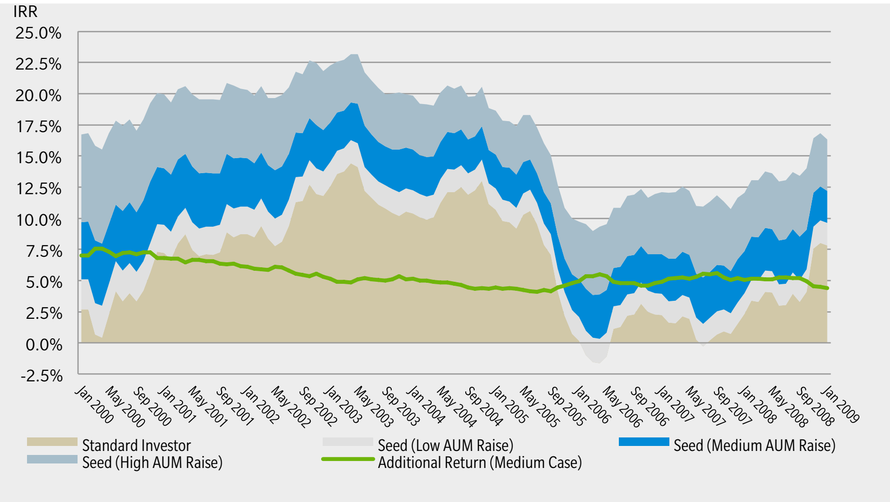
However, in order to assess the overall gross return to the seed investor, we must calculate the IRR over the full 7 year assumed revenue share period, as the seed investor will continue to receive cash flows for a further 4 years after redemption of the seed capital.

The above asset raising scenarios assume a "J-curve" to asset-raising with lower AUM in the first 3 years, then escalating in years 3 and 4 of the transaction. In reality, the overall IRR of a seeding portfolio is likely to be driven by one or two of the top performing funds in the portfolio, while at the same time trying to avoid any material drawdowns in any single fund (partially mitigated by the various guidelines and drawdown triggers negotiated as part of any transaction).

By way of example, in the "Medium Case" scenario above, the RSA Base (AUM on which revenues are earned) in a portfolio of 8 funds, could reach $3bn (or a 7.5X multiple of invested capital) within 3 years of investment by 2 funds reaching $750m in AUM, 2 funds reaching $500m in AUM and 2 funds reaching $250m in AUM, with no further asset raising necessary from the other 2 funds. This could also be achieved by 1 fund reaching $3bn in AUM and no other funds raising any capital.

Chart 11 shows the simulated IRR which would have been achieved in each month of launch from January 2000 to December 2008, for each asset raising scenario assumed above.

Chart 11. Seeding Simulation - IRR over each 7 year period from date shown



Source: Tages Capital

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Table 4 breaks down the same scenarios per 7 year period after the calendar year of inception of the portfolios:

Table 4. Seeding Simulation - IRR over each 7 year period from date shown

	Standard	Seed Investor Return			Seed Investor Excess		
Launch Date	**IRR**	**Low**	**Medium**	**High**	**Low**	**Medium**	**High**
Jan 2000	2.7%	5.1%	9.7%	16.7%	2.4%	7.0%	14.0%
Jan 2001	7.2%	9.5%	14.0%	19.9%	2.2%	6.8%	12.7%
Jan 2002	8.7%	10.9%	14.8%	20.3%	2.2%	6.1%	11.6%
Jan 2003	12.5%	14.5%	17.7%	22.3%	2.0%	5.2%	9.7%
Jan 2004	10.4%	12.3%	15.5%	19.8%	1.9%	5.1%	9.4%
Jan 2005	10.7%	12.4%	15.1%	18.7%	1.7%	4.4%	7.9%
Jan 2006	0.2%	2.1%	5.1%	9.7%	1.9%	4.9%	9.5%
Jan 2007	2.2%	3.9%	7.1%	12.1%	1.7%	4.9%	9.8%
Jan 2008	2.3%	4.0%	7.4%	12.0%	1.7%	5.0%	9.7%
Jan 2009	7.8%	9.6%	12.2%	16.3%	1.8%	4.4%	8.5%
Average	**6.3%**	**8.3%**	**11.8%**	**16.8%**	**2.0%**	**5.5%**	**10.5%**

What is interesting to note is that although the range of total portfolio returns is quite wide, being driven by the investment returns in the first 3 years, the excess return for the seed investor as a result of the revenue sharing is much more consistent. This is to be expected given that the seed investor benefits from participation in the more stable management fee income (with no exposure to costs).

Unlike a typical fund of fund investor, the seed investor also benefits from the lack of performance fee netting across the portfolio of seeded funds. In a typical fund of fund portfolio, the investor takes on the netting risk (i.e. some managers are paid a performance fee for positive performance, even though the net return of the portfolio may be negative). In the case of a seeding portfolio, the seed investor is still subject to this risk over the investment period, but also directly benefits from this characteristic through the longer time period of the transaction via the participation in each manager's performance fee income, which is not subject to the performance of the other managers in the portfolio.

We estimate that the additional gross return available from seeding, not taking into account a potential "emerging manager premium", should be 5-7% in additional IRR relative to making a standard investment in a portfolio of established managers. In a low yield environment, this could account for more than half of the total return.

Conclusion

The environment for hedge fund seeding and acceleration looks increasingly attractive due to:

Heightened Demand

- Low yields from traditional investments are driving sophisticated investors with longer investment horizons to take advantage of seeding premiums
- Disappointing high profile manager returns has increased allocator focus on emerging managers, who require a minimum asset base to be investable
- Investors are seeking low correlated, lower cost alternatives, capable of generating double-digit returns

High Quality Supply

- Strong pipeline of high quality talent, often with buy-side experience continues to be attracted by high industry margins
- Scarcity of seed capital available, especially in mid-size transactions
- Increasing barriers to entry due to higher institutional demands, minimum asset requirements and escalating regulatory and operating costs
- Increasing number of lower risk acceleration capital opportunities
- Increasing number of opportunities to seed UCITS with established managers

Enhanced Economics

- The hedge fund industry continues to deliver high margins
- Seed/Acceleration investments enable investors to decrease costs and participate in a greater proportion of the industry economics
- Returns are generated from a combination of Portfolio of Hedge Funds (initial period only, with a potential emerging manager premium) + Discounted Fees + a share in Manager Revenues + a potential Exit Monetisation
- Seed investors can also negotiate additional rights such as low fee capacity or co-investment rights given their strategic position

We estimate that the additional gross return available from seeding, not taking into account a potential “emerging manager premium”, could contribute half of a target IRR of 12%-15% for a seeding portfolio.

Managing a seeding program is resource intensive and requires sufficient scale and experience to execute successfully. Each seed is a bespoke, highly negotiated transaction. Success is dependent on many factors, including strong manager selection ability, deep due diligence capabilities, negotiation, structuring and transaction execution skills, as well as extensive transaction management during the life of a seed investment.

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Appendix A

Table 5. Potential return contribution from a seed investment

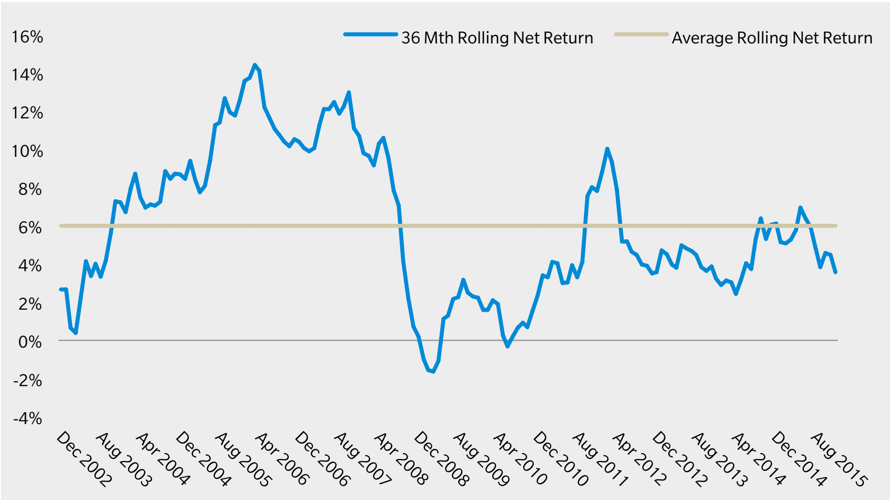
	Standard Investor			Strategic Investor (Seed Economics)			
	Established Manager	Emerging Manager	Early Bird Fees	Various AUM Scenarios			
Fund Investment	50,000,000	50,000,000	50,000,000	50,000,000	50,000,000	50,000,000	50,000,000
Assets Raised		50,000,000	50,000,000	50,000,000	200,000,000	450,000,000	950,000,000
Fund AUM	1,000,000,000	100,000,000	100,000,000	100,000,000	250,000,000	500,000,000	1,000,000,000
Management Fees	1.50%	1.50%	1.00%	1.50%	1.50%	1.50%	1.50%
Performance Fees	17.50%	17.50%	15.00%	17.50%	17.50%	17.50%	17.50%
Revenue Share Participation				20.00%	20.00%	20.00%	20.00%
Gross Fund Return	8.50%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
Less Management Fee	7.00%	8.50%	9.00%	8.50%	8.50%	8.50%	8.50%
Less Performance Fee	5.78%	7.01%	7.65%	7.65%	7.65%	7.65%	7.65%
Return on Investment	2,887,500	3,506,250	3,825,000	3,825,000	3,825,000	3,825,000	3,825,000
Revenue Share - Management Fee				150,000	600,000	1,350,000	2,850,000
Revenue Share - Performance Fee				148,750	595,000	1,338,750	2,826,250
Total Return on Investment	2,887,500	3,506,250	3,825,000	4,123,750	5,020,000	6,513,750	9,501,250
Return on Investment	**5.8%**	**7.0%**	**7.7%**	**8.2%**	**10.0%**	**13.0%**	**19.0%**

Source: Tages Capital

Appendix B

We use the HFRI index as a starting point for the illustration, as this is an equally-weighted index, covering the broader hedge fund performance universe, calculated net of fees and with an inclusion criteria of $50m minimum AUM or > 12 month track record, whereas the HFRX Global Hedge Fund index is asset weighted with a minimum $50m and 2 year track record and the components are therefore skewed towards larger managers. Although this doesn't adequately adjust for our estimated "Emerging Manager Premium", we believe it is a better starting point for the analysis than using other asset weighted indices available.

Chart 11. 36 Month Rolling HFRI Net Return



Source: Tages Capital, HFR

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Appendix C

There have been a number of studies performed which support the thesis that smaller and emerging managers tend to outperform larger and more established managers on average. The theory is that emerging and smaller managers have stronger incentive effects, can be more nimble in their trade implementation than larger managers, are able to exploit more niche opportunities due to their size and tend to offer greater fee discounts which support a higher net return to the investor.

In their 2009 paper, Aggarwal and Jorion conclude that "emerging funds and managers, narrowly defined as the first two years of a hedge fund's life, generate an abnormal performance of 2.3% relative to the later years. This difference is statistically and economically significant. A simple linear regression of abnormal returns on time reveals that each additional year of age decreases performance by 42 basis points, on average". They go on to make 2 other important findings, namely that "this effect does not seem to have a simple relationship with size" and that "there is strong evidence that, for individual funds, early performance is quite persistent ... for up to five years for emerging funds"[10].

A study done by Singapore Management University in 2009 using data on hedge fund performance from 1994 to 2008 shows strong evidence of an inverse relationship between hedge fund performance and size. Teo finds that "small hedge funds outperform large hedge funds by 2.75 percent per year after adjusting for risk", where "small" was defined as below median AUM[11].

In a 2012 a Pertrac study, concluded that young funds (< 2 years) presented the best Sharpe ratio (1.46) compared to Mid-Age funds (2-4 years) (0.86) and Tenured funds (4 years+) (0.70) funds. The average "young" fund had outperformed its peers in 14 of the last 16 years[12].

In terms of emerging manager performance, an analysis from Preqin found that most strategies have exhibited an "emerging manager" outperformance over the period reviewed, starting in 2007. The analysis done by Preqin compared the average of the first three years returns of funds launched between 2007 and 2010, as compared to the equivalent average three year returns across established managers over the same time period[13]. On average over the time period analysed, emerging managers exhibited an approximate 2% outperformance. The analysis also showed a wider dispersion of returns for emerging and small managers as compared to large ones.

In 2012, Petrac found that small funds (<$100m) presented the best Sharpe ratio (1.04), followed by mid-size funds ($100m-$500m) (0.81) and large funds ($500m+) (0.69) funds[14].

A more recent study by Clare, Nitzsche and Motson of Cass Business School, came to a similar conclusion after analysing data from 1994 to 2014, with their finding of "a strong, negative relationship between hedge fund performance and size ... but that rather than dissipating during the two periods of financial crisis, other things equal, investors would have been better off with a small hedge fund rather than a large one during these periods"[15]. The research showed that on average a hedge fund with $200m of assets could be expected to outperform a $5bn hedge fund by approximately 120 basis points a year.

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[10] The performance of Emerging Funds and Managers, Aggarwal and Jorion, August 2009
[11] Does Size Matter in the Hedge Fund Industry? Teo, Singapore Management University, 2009
[12] Petrac – Impact of Size and Age on Hedge Fund Performance, 2012
[13] Preqin – The Performance of Emerging Manager Funds, November 2013
[14] Petrac – Impact of Size and Age on Hedge Fund Performance, 2012
[15] Are investors better off with small hedge funds in times of crisis? Clare, Nitzsche and Motson, Sir John Cass Business School, July 2015

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