INVESTCORP-TAGES

Enhancing Returns:
The Case for Hedge Fund Seeding

White Paper

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Enhancing Returns: The Case for Hedge Fund Seeding

AN OVERVIEW OF HEDGE FUND SEEDING

Seeding or acceleration capital investments can help investors with patient capital to decrease hedge fund investment costs and to increase hedge fund returns. In exchange for making a day one investment ("seed capital") or early-stage investment ("acceleration capital") into the manager's hedge fund, investors can directly participate in the management and performance fee revenues of a hedge fund manager's firm.

This economic interest is typically structured as a gross revenue share participation which allows the investor to receive a percentage of the management and performance fees earned by the manager without bearing exposure to the costs of running an asset management firm. This economic interest is received at no additional cost to making the initial investment in the manager's fund.

Invested capital is typically subject to a commitment period of two to three years, during which the investor may not redeem, unless certain pre-negotiated negative events have occurred; for example, a predefined loss of capital. Following the expiry of the commitment period or one of these "redemption trigger events", the investment can be redeemed on standard redemption terms.

Following expiration of the commitment period, the revenue share interest continues for the life of the transaction (typically for a minimum of 10 years but in many cases, this can be perpetual[1]). This is irrespective of whether the capital remains invested or not. We estimate that the revenue share participation can contribute, on average, over five times the profits that would be received on a hedge fund portfolio, in the absence of the revenue share participation.

In this paper, we illustrate this enhancement to hedge fund returns under different return and asset raising assumptions. We do this by simulating different return outcomes drawn from a random sampling of hedge fund strategy index returns, and mapping these against an asset raising grid which we constructed based on assumptions made between early-stage fund performance and asset raising over the life of each transaction. The objective of the exercise is to demonstrate the consistent enhancement to returns which is available from seeding, as well as the positive skew to the distribution of returns.

We also discuss the challenges of comparing returns from seeding to other asset classes which also derive their returns from the economics of asset management firms. For example, private equity funds investing in minority equity interests in the management companies or general partnerships of alternative asset managers (commonly referred to as "GP stakes investing"). This is due to the mismatch between the term over which the seed capital is at risk (the fund investment period, typically 2-3 years) and the term over which the gross revenue share is potentially earned (the transaction period, typically 10+ years). This can make direct comparison of traditional metrics potentially misleading and we illustrate this by modelling a seed portfolio where recycling of capital continues over a similar measurement period to a typical private equity fund.

This characteristic of seeding may also be interesting for investors subject to regulatory capital charges against their hedge fund portfolios.

THE EVOLUTION OF HEDGE FUND SEEDING

Prior to 2000, hedge funds were typically incubated within banks or seeded by wealthy individuals. Some successful managers seeded their protégé's launches, a practice which remains a common source of seed capital. In the early 2000's, some alternative investments firms, typically those affiliated with an existing fund of hedge fund business, began to seed new managers under more structured seeding programs. Investcorp was at the forefront of this development, launching its seeding program in 2004. However, several seed investors struggled during the Global Financial Crisis (GFC) and only a few of the original players remain in the business of seeding today.

The industry investor base has changed materially since the GFC, 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 consolidation within the fund-of-hedge funds universe resulted in an overall decline in seed capital available to new launches.

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 463 firms managing over $1bn (the so called "billion-dollar club") accounted for $2.7trn or 90% of Assets Under Management (AUM) at the end of 2019 as compared to 79%

[1] Seward & Kissel 2020 Seed Transaction Deal Points: 80% of transactions were perpetual over the 2015-2020 review period

of AUM in 2009 (although this did fall in 2020 to approximately 87%[2]). Institutional allocators often require a minimum fund AUM to limit concentration and business risk. It is estimated that approximately 30% of investors allocate to emerging managers (defined as launched within the past 2 years[3]), but many prospective allocators have maximum holding ratios, minimum track record requirements, or minimum AUM requirements before they will consider investing in a fund.

This provides an attractive opportunity for seed investors to support a manager in the early years and to scale their AUM. New entrants to seeding who were attracted to this profile of returns or as a way to decrease costs post the GFC, included some of the larger pension funds, in particular in North America, as well as some of the large multi-strategy firms who began providing seed capital to in-house managers wanting to spin out and launch their own firms. However, there remains a scarcity of dedicated seed capital providers, particularly in mid-size transactions, defined as those in the $50m-$100m range.

THE DEMAND FOR HEDGE FUND SEEDING

There continues to be a strong pipeline of high-quality, talented managers with hedge fund experience, attracted to the high margins available in the industry (40%+ margins are common[4]). 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. One option to overcoming these difficulties is for managers to partner with a strategic investor who can provide patient seed or acceleration capital. 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.

Prior to the GFC, some institutional allocators and hedge fund managers viewed the decision to take seed capital, in exchange for giving up economics, as a negative signal that the manager was not in sufficient demand to launch on their own. As the industry has matured and some high-profile institutional investors have directly or indirectly entered the seeding space, this perception has reversed.

The demand for emerging managers has been increasing over the past five years. By way of example, managers with under $500m in AUM have received net inflows of $53bn since the GFC, while mid-sized managers ($1-5bn in AUM) received net outflows of $102bn over the same period. Larger managers ($5bn+ in AUM) increased AUM significantly until 2015, but have received net outflows over the past 5 years[5].

However, many investors still have minimum AUM requirements, maximum holding ratios and/or require evidence of business stability prior to investing. A seed investors' contribution to this stability, via committed AUM, due diligence on the business, and direct or indirect working capital (via fees), can help an emerging manager to get early-stage investors comfortable with making an allocation. This contribution to stability is now highly valued by allocators who were previously sceptical on seeding, as well as by many of the bank capital introduction teams.

Although there is a wide range of emerging manager cost structures, 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 considering seed economics and/or some level of fee discounting to attract early-stage capital, we estimate that this equates to an AUM break-even range of $100m-150m, prior to performance fees.

In addition, many institutional investors expect to see a material level of "skin in the game" from the principals. This could run into multiple single to low double-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(s) in their former roles.

These barriers to entry present an acute challenge to early-stage managers, which can make seed and acceleration capital 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 important.

[2] HFM Billion Dollar Club

[3] Morgan Stanley Quarterly Vantage Points Feb 2021

[4] Barclays Under the Hood – HF Financials November 2020

[5] HFR Global Hedge Fund Industry Report 2020

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HEDGE FUND SEEDING ECONOMICS

Returns of a seed investment are derived from 1) the performance generated on the underlying fund investment while invested in the fund and 2) participation in the revenues generated by the hedge fund manager, including those derived from management and performance fees earned by the manager. These fees often extend across any funds managed by the manager over the term of the transaction. These revenues are dependent on asset growth, fees charged and performance of the underlying funds.

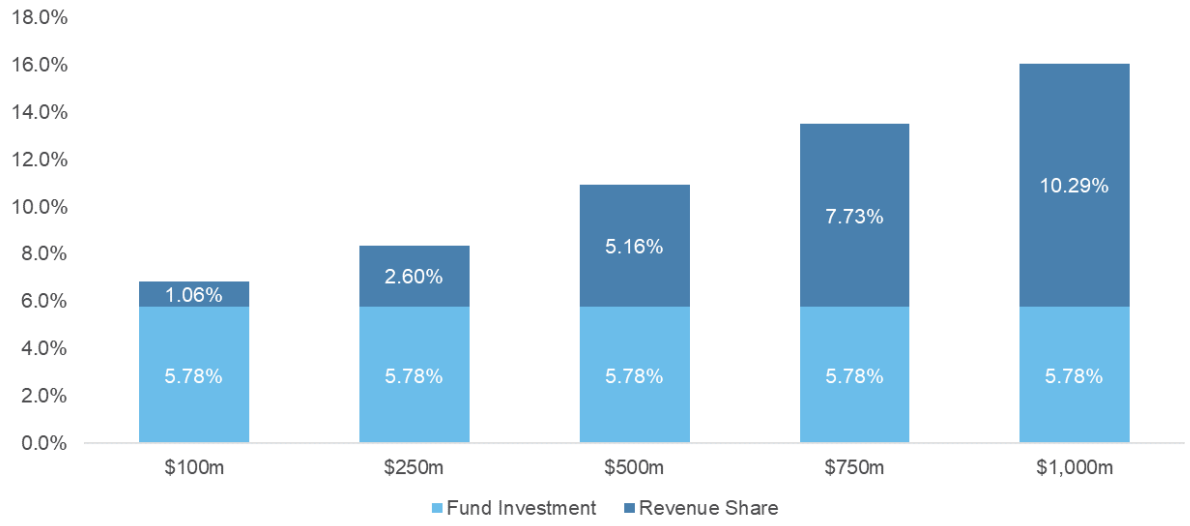
For the purposes of illustration in this paper, we will make some simplifying assumptions, but it is worth noting that most seed transactions are highly negotiated with bespoke terms for each transaction. Given the strategic nature of the relationship, this also provides the opportunity to negotiate other benefits such as preferential fees, capacity rights and co-investment opportunities. A typical seed transaction will also include various risk mitigation / protective clauses, but within this section we will focus on the main drivers of potential returns to the seed investor.

As shown in Chart 1, we provide an illustration of the potential enhancement to returns that a seed investor could achieve in any one year over and above a standard hedge fund investment.

In this illustrative example, we assume a $50m seed capital investment on 1.50% management fees and 17.5% performance fees, a gross fund performance of 9%, additional fund expenses of 0.50%, a gross revenue share participation of 20%, and average fees charged by the manager on third party capital of 1.35% management fees and 17% performance fees.

The chart illustrates the enhancement to returns which can be achieved in any one year, depending on different levels of AUM.

Chart 1: Enhancement to returns from revenue share participation in any single year of investment



In Chart 2, we provide an illustration of the fee savings on the seed capital invested given the revenue share earned in each year while the seed capital is invested. At approximately $260m, the seed investor participates to 100% of the gross profits earned on the seed capital with the revenue share participation offsetting management and performance fees.

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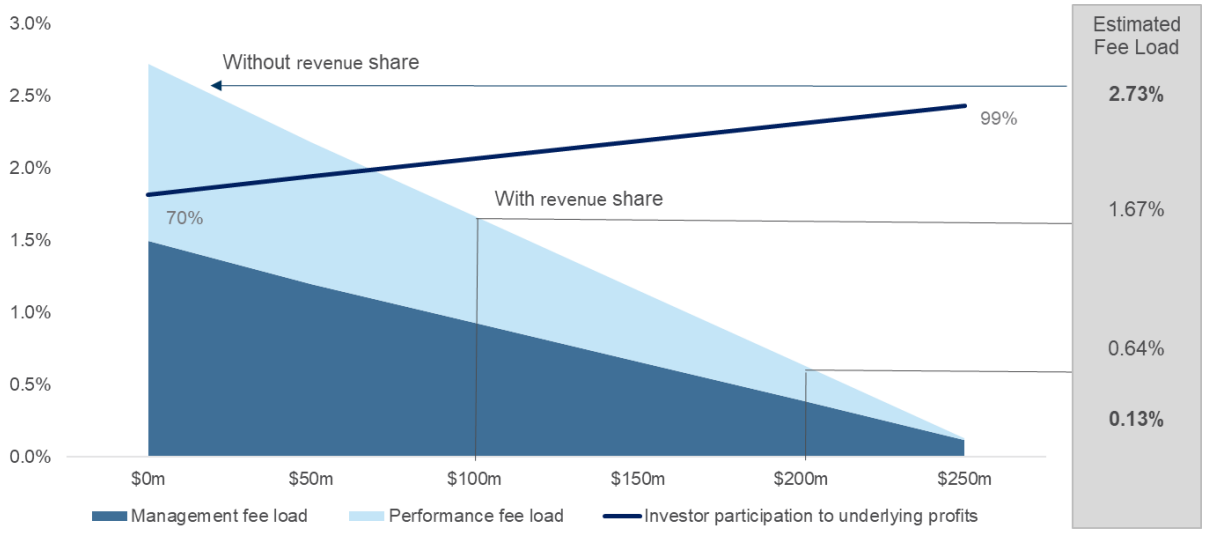
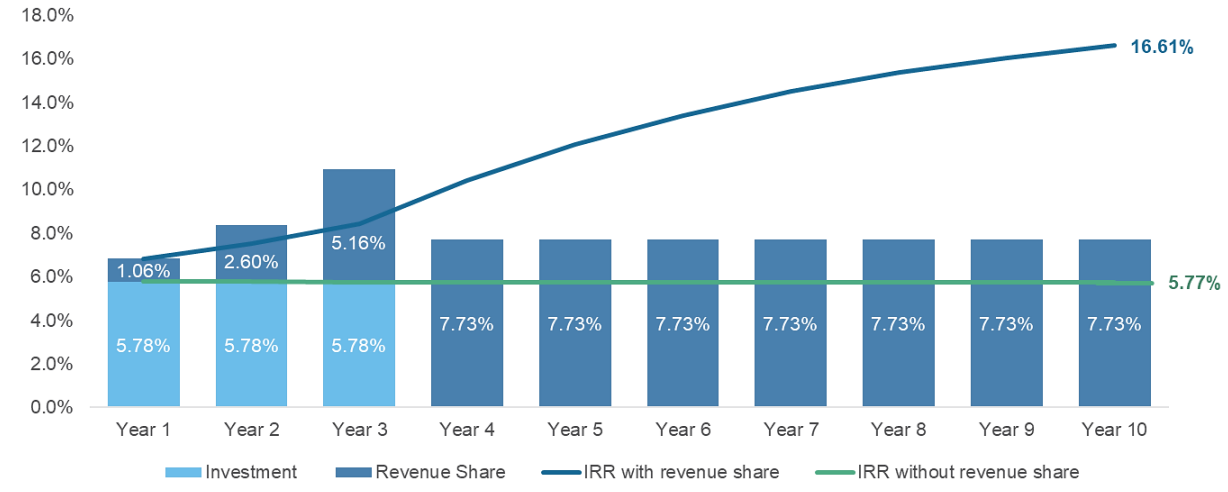
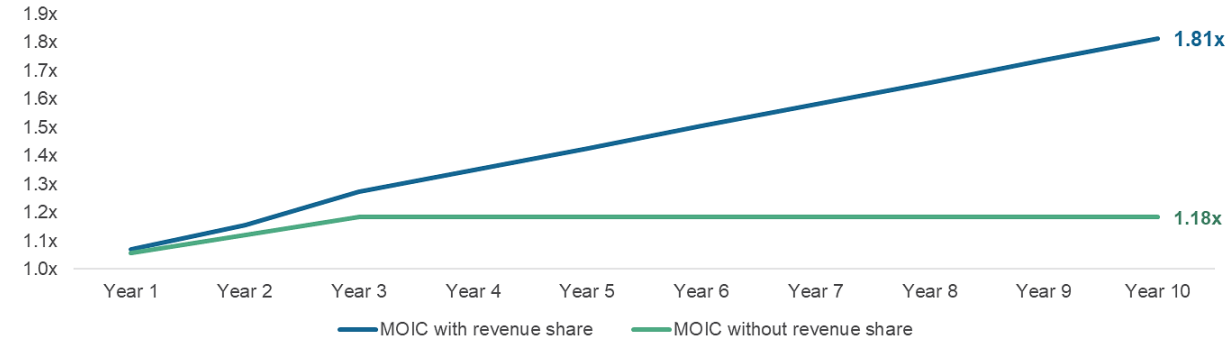
Chart 2: Fee offset at different levels of fund AUM, due to revenue sharing



In Chart 3, under the same set of assumptions, we provide an illustration of the cash flows, assuming that the revenue share interests are earned for 10 years and peak assets of 15 times the invested capital are achieved by year 4. This conservative assumption is meant to illustrate the revenue share enhancement to the Internal Rate of Return (IRR) and the Multiple on Invested Capital (MOIC) from hedge fund seeding, even at lower levels of AUM multiples for a single transaction, although most seed investors would be targeting a higher multiple than this.

Chart 3: Single transaction returns with and without revenue share participation





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SEEDING RETURNS AT A PORTFOLIO LEVEL

To demonstrate how seeding can significantly enhance risk-adjusted returns to investors at a portfolio level, we used a Monte Carlo process to simulate the potential return distribution of hedge fund portfolios, with and without a revenue share participation. We assumed each portfolio to be composed of six individual funds, whose strategy was assigned independently and probabilistically using the strategy's relative AUM weight in the HFRI indices (i.e., the greater the AUM, the greater the likelihood of a strategy being assigned). For the sake of simplicity in this example, each fund received a similar capital allocation. For each portfolio, we created a return stream for each underlying fund by randomly selecting a month of returns, applied consistently across strategies, and allowing for resampling of each month. By bootstrapping these observations, we created 10 years of fund return data for each simulated portfolio. We also assumed that a loss of greater than 15% from starting capital triggered a redemption after the typical three-month redemption notice, and therefore resulted in the fund's exit from the portfolio and a cessation of the revenue share participation. The AUM path of each fund in the portfolio was derived from the asset grid detailed in the Appendix. We assumed that capital, even if available, was not recycled during the investment period[6].

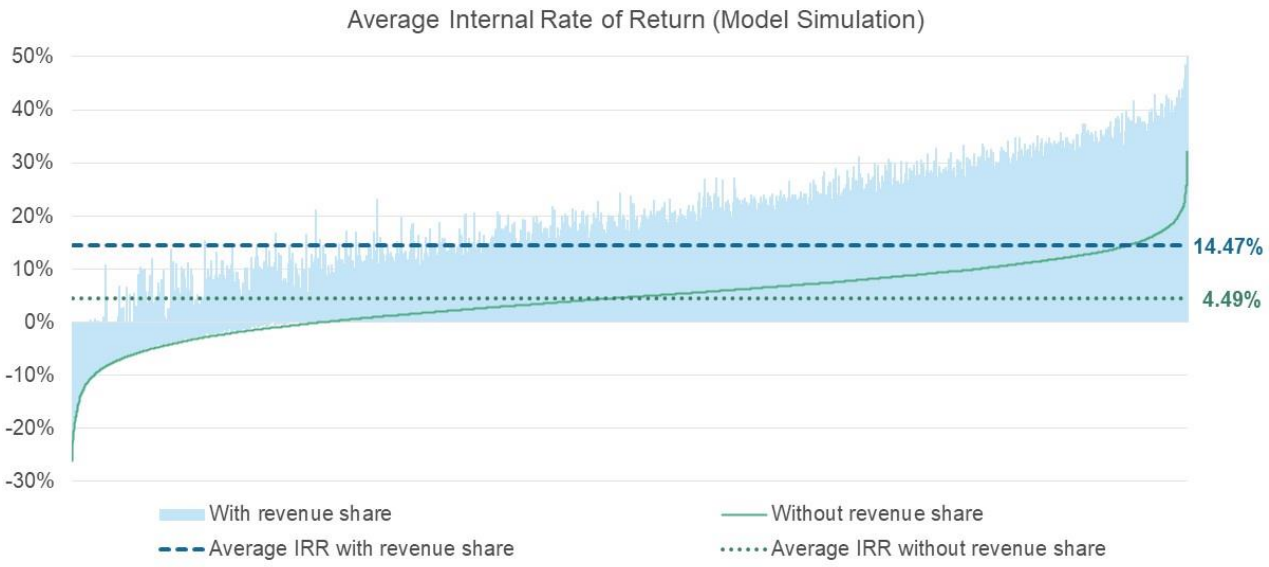
Over a sample of 10,000 iterations, the average portfolio without revenue share participation resulted in a MOIC of 1.14x with an IRR of 4.49%, very similar to the median portfolio observation. With revenue share participation, the average MOIC was 1.71x, which represents 5 times the average profits earned without revenue share participation. Table 1 displays the range of modelled returns.

Table 1: Seeding model simulation – distribution of returns (with no recycling of capital)

	No Revenue Share		With Revenue Share	
Sample	MOIC	IRR	MOIC	IRR
Max	2.15x	32.22%	4.82x	50.01%
Mean	**1.14x**	**4.49%**	**1.71x**	**14.47%**
Median	1.13x	4.71%	1.55x	14.56%
Min	0.87x	-7.56%	0.90x	-5.74%

Chart 4 shows the IRR distribution of the 10,000 portfolio simulations, with revenue share and without revenue share participation, and from lowest to highest. Revenue share participation increases the average IRR from 4.49% to 14.47%.

Chart 4: Seeding model simulation – distribution of IRR observations (with no recycling of capital)



[6] All returns are shown net of manager fees, but do not include any costs or fees associated with managing the seeding portfolio. Further details on the assumptions and calculation methodology behind the model are included in the Appendix.

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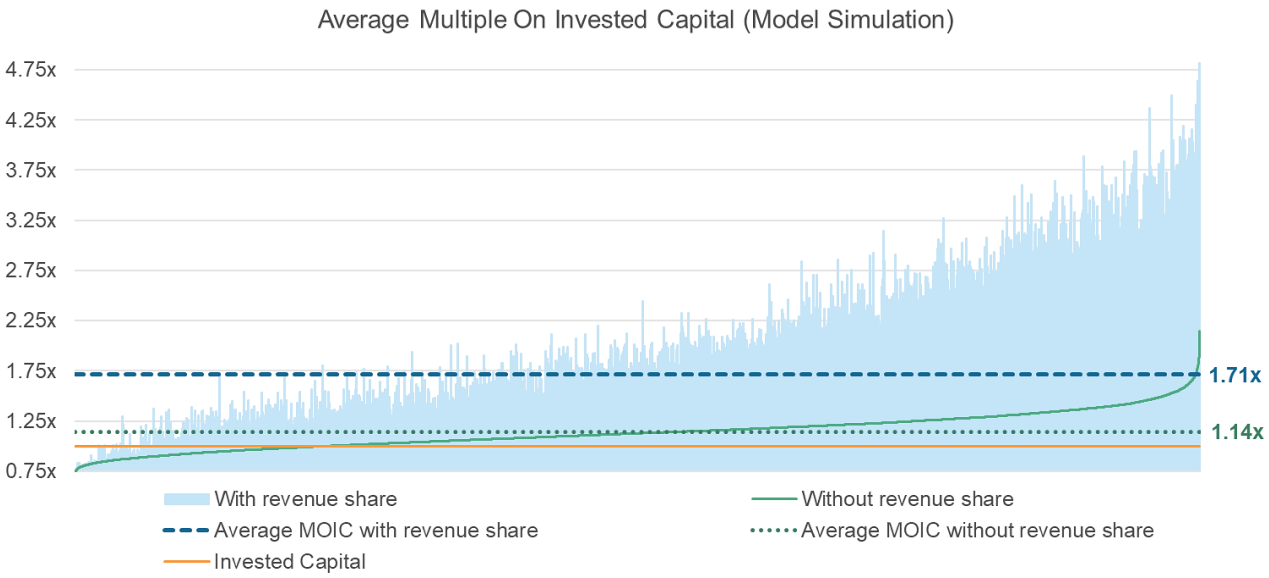
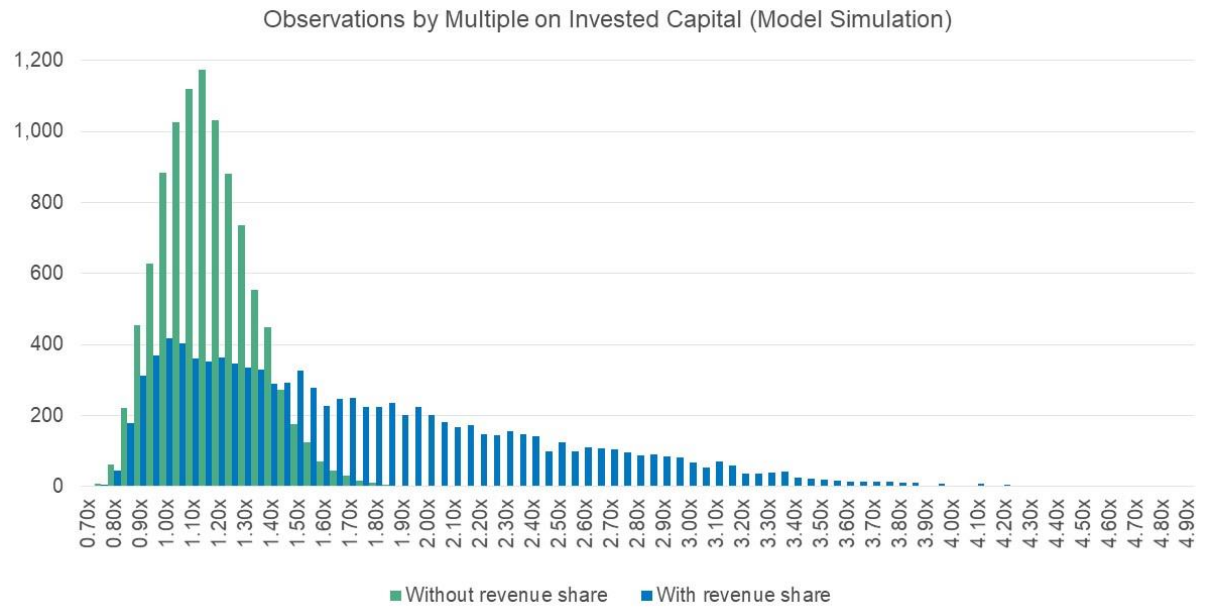
Chart 5 shows the MOIC distribution of the 10,000 portfolio simulations, with revenue share and without revenue share participation, and from lowest to highest. Revenue share participation increases the average MOIC from 1.14x to 1.71x.

Chart 5: Seeding model simulation – distribution of MOIC observations (with no recycling of capital)



It is notable that, with revenue share participation, the mean MOIC is greater than the median MOIC, illustrating the positive skew in returns from seeding. This is intuitive as the seed investor is not exposed to the costs of underlying managers and therefore the revenue share can only be a positive contribution to returns. Where a fund underperforms, there is no additional loss to that incurred in the portfolio without revenue share participation (to the contrary, there can still be a contribution from revenue share participation). However, the funds that outperform tend to raise assets and consequently contribute to the revenue share, and therefore to a higher average multiple for portfolios in the higher deciles of modelled returns. This right tail skew to returns from seeding can be seen in Chart 6 below.

Chart 6: Seeding model simulation – histogram of MOIC observations (with no recycling of capital)



WHY DIVERSIFICATION OF SEED TRANSACTIONS MATTERS

Dispersion between single transactions can be high. Using the same methodology above, we selected only the first transaction in any portfolio (i.e., 10,000 iterations). Keeping in mind that this model simulation includes a 15% drawdown trigger, with 3 months to exit the position, the range of outcomes for a single transaction without revenue share participation is large, namely the worst transaction observation had a drawdown of 44% (or MOIC of 0.56x) and the best transaction observation had a MOIC of 2.50x. A seeding portfolio of 6 transactions, without revenue share participation, exhibited a much tighter range of outcomes with a worst portfolio observation of a 29% drawdown (or 0.71x MOIC) and a best portfolio observation with a MOIC of 2.15x. The median and mean outcomes were very similar.

When adding in the revenue share participation, the benefits of diversification are even more pronounced. The worst observations have a similar profile to the differences exhibited with no revenue share (given that the worst observation comprises a series of poor transactions outcomes, each of which are individually unlikely to raise assets). Unsurprisingly, the correlation between weak performance and poor asset raising is high. However, the median observation is a MOIC of 1.23x across the single transaction population set, as compared to a MOIC of 1.55x across the portfolio population set. The best outcome in the single transaction population set was a MOIC of 5.74x, as compared to a MOIC of 4.82x across the portfolio population set.

Intuitively this makes sense, as a revenue share participation can be thought of as a fund investment plus a long call option on the economic success of the manager. A portfolio of transactions can be thought of in terms of a diversified portfolio of fund investments, with a lower expected worst case loss scenario than any one single transaction, plus a portfolio of call options which are floored at zero value. By diversifying the number of seed transactions that an investor makes, the investor increases the probability that one or more of these options will pay off and increase overall returns. As shown in Table 2, this profile provides for a positively convex return distribution.

Table 2: Seeding model simulation – distribution of returns (with no recycling of capital)

	Single Transaction		Portfolio - without recycling	
MOIC	Without revenue share	With revenue share	Without revenue share	With revenue share
Max	2.50x	5.74x	2.15x	4.82x
Mean	1.14x	1.70x	1.14x	1.71x
Median	**1.13x**	**1.23x**	**1.13x**	**1.55x**
Min	0.56x	0.56x	0.71x	0.72x

COMPARISON TO PRIVATE EQUITY STAKES IN ASSET MANAGERS

Some investors compare seeding to private equity investments which purchase a minority stake in alternatives asset managers. Although both strategies are exposed to the asset raising and performance success of the underlying asset manager, the strategies are quite different and are exposed to different risks and rewards.

Private equity funds investing in minority equity interests of alternative asset managers (commonly referred to as “GP stakes investing”) pay for a minority equity stake, typically between 15% and 25%, in the management company or general partner of an established manager. This equity is exposed to the revenues and costs of the manager, as opposed to a seeding or acceleration transaction, where the investor typically receives 20% – 25% of the gross revenues of an emerging manager but does not pay for this. For a manager with 40% – 60% gross margins, a 20% revenue share participation, if perpetual, is the equivalent of a 33% – 50% equity stake.

In the case of the GP stake, the investor is typically able to make an attractive yield from day one, by investing in an illiquid equity stake in the already established manager. This equity can increase in value if asset growth and performance is strong. However, this can also decrease in value if assets decline or performance is poor, to nil value in the extreme scenario of a manager going into liquidation.

The seed investor on the other hand is invested for a limited time in the manager’s underlying fund (typically 2 – 3 years), which is often comprised of liquid securities which can be redeemed at the end of the commitment period. The fund can also be redeemed in the event of a defined loss (e.g., a 15% drawdown) or a breach of covenants such as investment guidelines.

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Both transactions typically have similar types of protections negotiated to protect the economic interest in the manager, such as consent and information rights. In the case of the GP stakes investor, the remedy to a breach of one of these rights could be a contractual claim against the manager. In the case of the seed investor, the remedy could be a contractual claim, but more importantly this typically results in a redemption trigger event and the right to redeem the seed capital on standard redemption terms.

Both investment strategies have attractive characteristics which can meet the different needs of investors. However, it can be challenging to make a like-for-like comparison between the two strategies when using traditional metrics. This is due to the mismatch between the term over which the seed capital is at risk (the fund investment period is typically 2-3 years) and the term over which the gross revenue share is potentially earned (the transaction period is typically 10+ years). This can make direct comparison of traditional metrics potentially misleading and we illustrate this by modelling a seed portfolio where recycling of capital continues over a similar measurement period to a typical private equity fund.

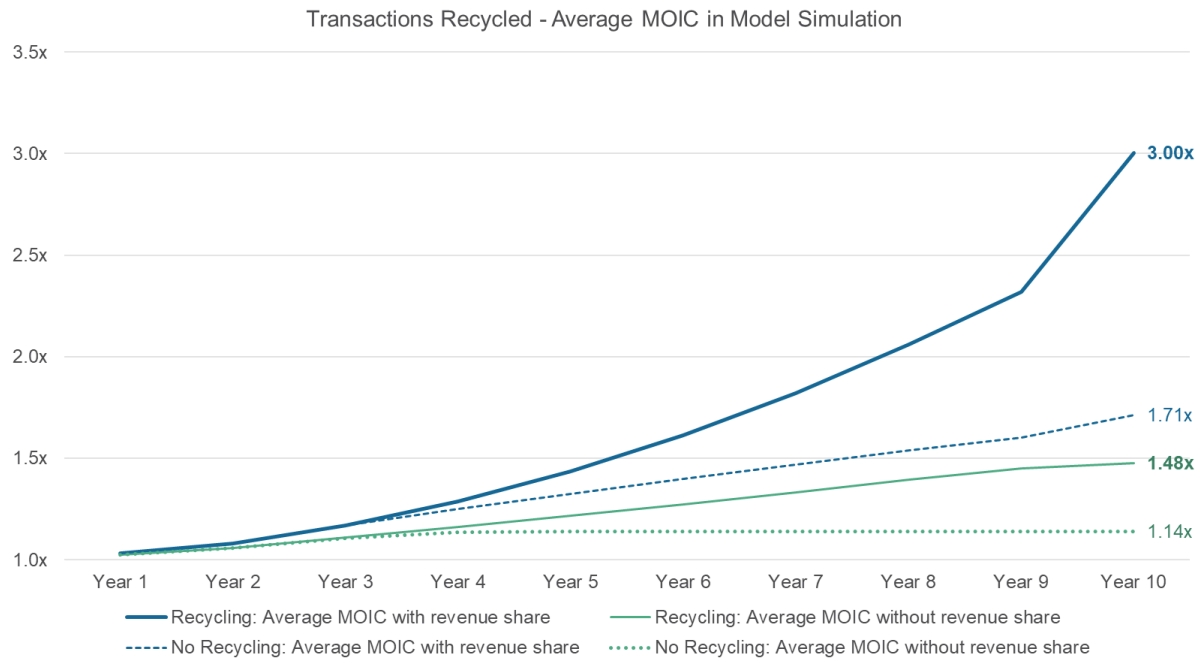
Using the same underlying assumptions, we rerun the model simulation but, in this case, we assume that capital is recycled continuously within a 10-year period to approximate the experience of a private equity investor. In this case we assume 18 transactions are executed over a 7-year period, with full return of the fund investments after 10 years (which can be achieved by standard fund redemptions rather than the secondary market sale required by a GP stakes business). We calculate an embedded value for the revenue share stakes after 10 years, by discounting forecast cashflows at a 30% discount rate to simulate a sale of the underlying revenue share stakes, similar to the experience of a private equity investor at the end of the life of a closed ended vehicle.

Table 3 illustrates the multiple expansion by deploying capital over a 10-year period. The average MOIC with revenue share participation was 3.0x across 10,000 simulations. Of this, 85% is comprised of realised profits (i.e., a distribution to paid in capital (DPI) of 2.56x, prior to the sale of any residual revenue share interests). Chart 7 displays the profile of the MOIC with and without recycling of capital. We believe that this multiple would be the appropriate metric to use when comparing these two different strategies.

Table 3: Seeding model simulation – mean / median returns (with recycling of capital)

	Portfolio - without recycling				Portfolio - with recycling			
	Without revenue share		With revenue share		Without revenue share		With revenue share	
Sample	IRR	MOIC	IRR	MOIC	IRR	MOIC	IRR	MOIC
Mean	4.49%	1.14x	**14.47%**	**1.71x**	4.61%	1.48x	**15.02%**	**3.00x**
Median	4.71%	1.13x	**14.56%**	**1.55x**	4.73%	1.42x	**14.97%**	**2.70x**

Chart 7: Seeding model simulation – average MOIC per year



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WHY MID-MARKET SEEDING REPRESENTS GOOD VALUE

If the objective for an investor is to maximise the IRR and MOIC on their seed capital, then we believe the ideal seed or acceleration ticket size is in the $50m-$100m range. This, together with the principal's capital and day-one investors paying discounted fees, can often result in a launch size of $100m or higher.

A seed investor may target a minimum revenue share asset base multiple of 20 times the seed investment to target the average IRR and MOIC multiples discussed in this paper thus far. However, although that may be the target minimum asset base multiple for a single transaction, the average target asset base multiple across a portfolio will likely be lower as there will be some managers in the portfolio who do not achieve that type of asset growth. We would hope that more successful managers would raise a significantly higher multiple than this to partially offset those managers that do not. Referring to the Appendix, Chart 10 shows the average portfolio asset base multiple, which was generated in the model simulation without recycling, which peaked at an average of 13.21x.

In practice there are several strategies which are capacity constrained and so will be limited as to what the top end of that multiple can be. Whenever a strategy is capacity constrained, this creates an upper boundary on asset raising contribution to those successful managers that will contribute to the investors' returns. Put another way, a seed investment of $200m needs to achieve a peak asset base of $4bn in AUM to achieve the same returns as a seed investment of $50m with a peak asset base of $1bn in AUM, all else being equal.

There is a limited universe of managers that can manage $4bn in AUM without materially degrading performance, so the larger seed ticket has a lower number of managers and strategies available to choose from. Alternatively, if capacity is not a key consideration, there is nothing preventing a successful manager from achieving the higher asset base multiple by starting out with the lower seed capital investment.

The counterpoint to this is that a larger seed ticket may help a manager scale quicker in the earlier years, may provide additional credibility to day one investors, and may be important in securing trading counterparty support in certain strategies (e.g., balance sheet intensive strategies such as fixed income arbitrage).

It is also worth noting that larger seed tickets do not typically receive a higher revenue share participation, and certainly not a pro-rata uplift, although this would be transaction specific.

Alternatively, if the ticket size is too small, a manager may find it challenging to scale to the important $100m threshold and fees may cover too low a percentage of working capital. For this reason, we think the "sweet spot" for seeding or acceleration is in this "mid-market" space, with the optimal ticket size being approximately $75m.

OTHER BENEFITS TO BEING AN EARLY-STAGE INVESTOR

Managers have been deploying creative solutions to incentivise investors to make an early-stage investment for some time. These include offering founder and early bird share classes, with discounted fee structures to invest on day one, within a fixed time or before achieving a certain capital raise objective. In addition, some managers offer 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.

These hybrid approaches can be viewed as a revenue sharing of sorts, with a cap on the amount of revenue that the manager forgoes and only payable for the 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.

Typically, the seed investor will still negotiate capacity rights and low fees for any additional capital that is invested on a non-locked basis. This can be particularly helpful to a manager when the seed investor is part of a broader allocator business, where clients are looking for emerging manager exposure for low fees. Most seed investors will also look to negotiate Most Favoured Nations (MFN) rights, whereby no other investors can receive more favourable terms than the seed investor (although this would not be expected to apply to fees on the seed capital during the seed capital commitment period).

Some seed investors also look to obtain exclusive access to the manager's skills for a set period of time before they are allowed to take on other investors. However, 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 (e.g., discounted fees, additional capacity rights, most favoured nation rights, information transparency and a cap on fund expenses).

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.

FAVOURABLE REGULATORY CAPITAL CONSIDERATIONS

In addition to enhancing returns, seeding can present a regulatory capital cost effective way of investing in hedge funds. This is due to the duration mismatch between the time the seed capital is invested in an underlying liquid hedge fund and the period over which the insurance company or bank is receiving revenue share distributions.

For example, while the seed capital is invested, let us assume that for the hedge fund strategy that is seeded by an insurance company attracts a Solvency II base capital charge of approximately 49% under the standard model. Due to the strategic position that a seed investor is in, they are likely to be able to obtain full position level transparency and so may be able to decrease this if an internal model is being used.

However, even if we assume that this is not the case, there can still be a material benefit in treatment because while the seed investment is only invested for two to three years, the revenue share participation is received for a much longer period so the charge is lower as a percentage of the overall returns than investing without a revenue share participation.

VALUE CREATION OPPORTUNITIES

A seed investor is incentivised to maximise both performance on their seed capital while invested and to maximise the revenue share participation via both asset raising and performance over the life of a transaction. The seed investor is strongly aligned with the manager to maximise revenues and therefore the investor (or their appointed asset manager) is incentivised to 1) help to raise capital, 2) help on business strategy and product development and 3) advise on implementing the right operational infrastructure in order to scale and create a sustainable business.

Professional seed investors will be resourced with experienced professionals who are able to help managers in each of these areas. It can be extremely helpful to the manager if the seed investor has a distribution capability, a strong network of early-stage investors, and the experience of raising capital for managers.

As the seed investor will often be the first institutional investor to perform due diligence on a manager, feedback and impartial advice on fund structures, fund terms, best practice in operations, and fund governance can be invaluable to helping a manager prepare for early-stage investors and can act as a "stamp of approval" from a reputable seed investor. This can be both a competitive edge to securing the highest quality managers and an advantage to raising the locked-up capital required to secure these transactions for clients.

Although the majority of revenue share participation is expected to derive from quarterly revenue share distributions, transactions will typically include 1) provisions for consent and tag along rights in the event of the sale of the business, 2) a mechanism or terms under which a manager can buy back the revenue share interest and 3) rights to sell this economic interest to a secondary market buyer. With the increase in private equity funds seeding GP stakes, we expect that opportunities will arise to sell gross revenue share stakes in successful managers, especially where multiple product lines have been developed by the manager across more than one team.

Enhancing Returns: The Case for Hedge Fund Seeding

CONCLUSION

Both increased barriers to entry and high industry margins available to emerging managers that can obtain scale, offer an opportunity for seed investors to extract a significant liquidity premium for locking up capital and supporting a hedge fund manager at an early stage in their life cycle. Seed investors can benefit from multiple streams of cash flow including management fees, performance fees and carried interest earned on existing and future products that a seeded manager may launch. This economic interest can be obtained at no additional cost to making an early-stage investment in the manager's fund, with multiple contractual risk mitigants which are heavily negotiated prior to executing a transaction.

In return for making a seed or acceleration capital commitment, we believe that investors can achieve an average of five times or greater the return on the same hedge fund investment without a revenue share participation. However, seed transactions can be complex to negotiate and require an experienced team to source, due diligence, structure and negotiate. This paper demonstrates the benefits of seeding via a portfolio approach to diversify downside risk, and to benefit from the positive return convexity that a seeding portfolio can provide. Revenue share participation continues after redemption of the seed capital which is typically invested in liquid underlying securities. This presents a duration mismatch which can enhance risk-adjusted returns and provide a favourable regulatory capital treatment as compared to investing directly in hedge funds without a revenue share participation.

When considering the return potential from seeding, one should look at the return profile of seeding in a systematic way via a portfolio approach. By recycling capital over a term like that of a typical private equity fund, we believe it is possible to achieve highly competitive returns on capital, while investing in a significantly more liquid underlying asset class. The supply and demand dynamics in the hedge fund industry are currently favourable to seeding and those capital providers who can commit capital at an early stage of the hedge fund life cycle. However, we believe the key drivers to success is through correct partner selection, management of downside risk, and the availability of resources to help managers build a sustainable business.

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APPENDIX: MODEL ASSUMPTIONS AND CALCULATION METHODOLOGY

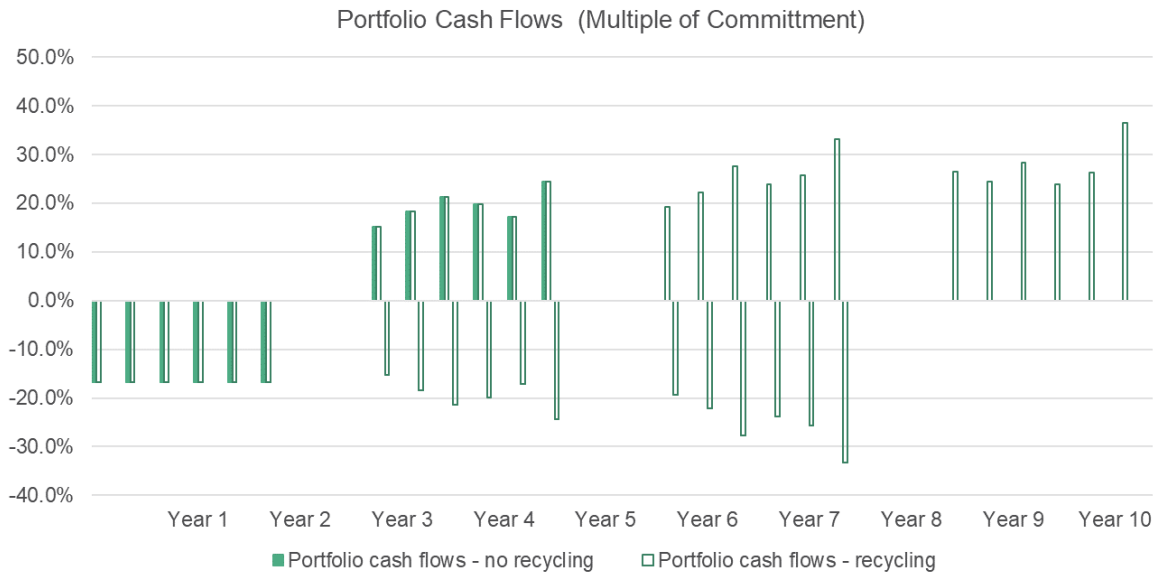
Model assumptions are shown in Table 4 below. For simplicity, we assumed a portfolio of 6 transactions of $50m seed capital, each is deployed based on a transaction every 4 months (or 3 transactions a year). This is what is referred to as the non-recycled portfolio, with the assumptions highlighted in green. For the recycled portfolio, we assumed that each transaction that is redeemed is deployed the following month into another seeding transaction, with a total of 18 transactions over 7.33 years, which are redeemed fully within 10 years. For simplicity and to be prudent, we kept these investments cycles standard even though some of the transactions may have been available for earlier recycling depending on performance.

Table 4: Seeding model simulation assumptions

Transaction	Transaction Lag (Months)	Execution (Month)	Capital Commitment (Months)	Redemption Lag (Months)	Redemption (Month)	Strategy	Transaction Commitment	Revenue Share Term (Years)	Revenue Share Termination (Month)	Revenue Share Participation	Seed Management Fees	Seed Performance Fees	Average Management Fees	Average Performance Fees	Seed Performance	Expense Cap
1		0	30	3	33	Sampled	$50,000,000	10	120	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
2	4	4	30	3	37	Sampled	$50,000,000	10	124	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
3	4	8	30	3	41	Sampled	$50,000,000	10	128	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
4	4	12	30	3	45	Sampled	$50,000,000	10	132	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
5	4	16	30	3	49	Sampled	$50,000,000	10	136	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
6	4	20	30	3	53	Sampled	$50,000,000	10	140	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
7	14	34	30	3	67	Sampled	Recycled	10	154	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
8	4	38	30	3	71	Sampled	Recycled	10	158	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
9	4	42	30	3	75	Sampled	Recycled	10	162	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
10	4	46	30	3	79	Sampled	Recycled	10	166	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
11	4	50	30	3	83	Sampled	Recycled	10	170	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
12	4	54	30	3	87	Sampled	Recycled	10	174	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
13	14	68	30	3	101	Sampled	Recycled	10	188	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
14	4	72	30	3	105	Sampled	Recycled	10	192	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
15	4	76	30	3	109	Sampled	Recycled	10	196	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
16	4	80	30	3	113	Sampled	Recycled	10	200	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
17	4	84	30	3	117	Sampled	Recycled	10	204	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%
18	4	88	30	3	121	Sampled	Recycled	10	208	20.00%	1.50%	17.50%	1.35%	17.00%	Sampled	0.50%

We assumed an average commitment period of 2.5 years, with a 3-month lag between expiry and redemption. This is consistent with the industry averages, for example a recent survey showed an average of 45% of seed transactions were locked for 3 years and an average of 48% were locked for 2 years or less over 2019 / 2020[7]. Chart 8 shows the portfolio cash flows for a non-recycled portfolio and a recycled portfolio if the gross performance was assumed to be 9% across all transactions.

Chart 8: Cash flow example



We assumed a standard revenue share profile of a fixed 10-year participation at 20% of gross revenues. While many transactions are perpetual in nature and we believe that a seed investor can obtain a higher participation than 20%, we made this simplifying assumption for the purposes of uniformity.

We assumed that the seed investor pays “headline fees” on the seed investment, prior to any revenue share participation which would indirectly decrease these fees. We assumed that the remaining capital raised pays an

[7] Seward & Kissel 2020 Seed Transaction Deal Points

average of 1.35% management fees and 17.00% performance fees with no hurdle. This is in line with various industry surveys, from HFR which recently reported an average of 1.36% / 17.97% across newly launched funds to Preqin which recently reported average fees of 1.47% / 18.18% for emerging managers (less than $500m)[8].

We compiled strategy buckets, referencing the AUM of the main strategies and sub-strategies in the hedge fund industry and those that a seed investor would be likely to focus on (which we defined as having over $70bn in AUM[9]). As shown in Table 5, these strategies account for 88.7% of the hedge fund industry AUM.

Table 5: Strategy AUM split

Strategy	Strategy Bucket	2019 AUM > $70bn	Strategy Totals	Strategy %
HFRI Macro: Discretionary Thematic Index	Macro	$125,561		
HFRI Macro: Multi-Strategy Index	Macro	$101,494		
HFRI Macro: Systematic Diversified Index	Macro	$313,744	**$540,799**	**18.4%**
HFRI ED: Activist Index	Event Driven	$133,124		
HFRI ED: Distressed/Restructuring Index	Event Driven	$204,682		
HFRI ED: Multi-Strategy Index	Event Driven	$86,277		
HFRI ED: Special Situations Index	Event Driven	$398,564	**$822,647**	**27.9%**
HFRI EH: Equity Market Neutral Index	Equity Hedge	$71,146		
HFRI EH: Fundamental Growth Index	Equity Hedge	$127,774		
HFRI EH: Fundamental Value Index	Equity Hedge	$520,827		
HFRI EH: Sector - Technology/Healthcare (Total) Index	Equity Hedge	$99,829	**$819,576**	**27.8%**
HFRI RV: Fixed Income-Asset Backed Index	Relative Value	$99,201		
HFRI RV: Fixed Income-Corporate Index	Relative Value	$156,100		
HFRI RV: Multi-Strategy Index	Relative Value	$508,587	**$763,888**	**25.9%**
		$2,946,910		

For each transaction, we sampled this strategy universe, based on a random selection out of the percentile of AUM that the random seed mapped to. This aimed to achieve an AUM split across the simulated population of transactions and portfolios that we constructed, that reflects the AUM split across the main hedge fund strategies in the industry.

In order to simulate transaction and portfolio returns, we used index returns from the 14 HFRI sub-strategy indices over the period of 31 January 2008 to 30 April 2021 (160 observation points, thereby ensuring our sample period would include crisis periods such as the GFC in 2008-2009, the European Crisis in 2011 and the Pandemic Crisis in 2020). Recognising that indices tend to exhibit a lower volatility than the underlying fund components, we volatility adjusted the sub-strategy index returns, while controlling for the same mean return. We did this by adjusting each observation by a "loading factor" which was calculated as a ratio of the volatility of the current sub-strategy index fund components (over a 24-month lookback period from April 2021), over the relevant sub-strategy index volatility over the same time period. The "loading factors" are shown in Table 6 below.

Table 6: Index returns: "loading factor" calculation using a 24-month lookback period

Sub-Strategy	Index Volatility	Average Volatility Underlying Managers	Loading Factor
HFRI Macro: Discretionary Thematic Index	7.56%	16.49%	2.2x
HFRI Macro: Multi-Strategy Index	7.16%	15.90%	2.2x
HFRI Macro: Systematic Diversified Index	5.65%	13.21%	2.3x
HFRI ED: Activist Index	21.40%	23.10%	1.1x
HFRI ED: Distressed/Restructuring Index	11.18%	16.75%	1.5x
HFRI ED: Multi-Strategy Index	9.81%	17.02%	1.7x
HFRI ED: Special Situations Index	14.71%	18.23%	1.2x
HFRI EH: Equity Market Neutral Index	3.49%	10.19%	2.9x
HFRI EH: Fundamental Growth Index	14.35%	19.95%	1.4x
HFRI EH: Fundamental Value Index	16.59%	23.11%	1.4x
HFRI EH: Sector - Technology/Healthcare (Total) Index	11.16%	17.63%	1.6x
HFRI RV: Fixed Income-Asset Backed Index	10.38%	10.78%	1.0x
HFRI RV: Fixed Income-Corporate Index	9.68%	11.77%	1.2x
HFRI RV: Multi-Strategy Index	5.98%	10.54%	1.8x

We then simulated a return stream over 240 months, by mapping each monthly observation (i.e., month 1, 2, 3, … 240) to a random month selected from an observation period of 31 January 2008 to 30 April 2021 (160 observation

[8] Preqin Global Hedge Fund Report 2021
[9] HFR Global HF Industry Report 2019

points, e.g., month 1 = 30 April 2016, month 2 = 31 August 2014, month 3 = 31 October 2016, …. Month 240 = 28 February 2019).

For each monthly observation we mapped the month to the adjusted sub-strategy index return for that month across all the strategies, as defined in Table 5. For each transaction, based on the random strategy sampled, we bootstrapped a return stream for that transaction, starting from the subscription date to the end of the revenue share period. So, for each transaction in a single iteration of a portfolio, each monthly return in the portfolio return matrix came from the same random monthly sub-strategy index return that had been mapped to the relevant monthly observation point. However, no serial correlation was assumed between months as these had been randomly selected, as described previously.

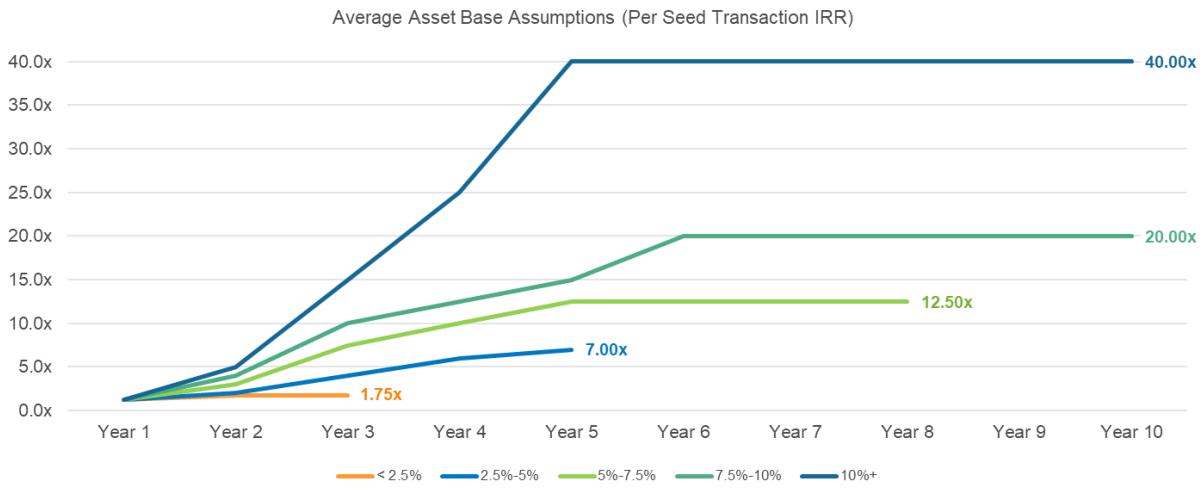
For each simulated transaction, an assumption was made that if there was a cumulative drawdown of 15% or more, from par, at any point in the return stream, the fund would be redeemed with a 3-month lag (i.e., allowing for potential further losses or recovery, as is the case in the real world).

Eighteen transaction return streams were calculated per simulation and two portfolios were constructed, a "portfolio without recycling" which was comprised of the first 6 transactions and a "portfolio with recycling" which was comprised of 18 transactions.

These cash flows were then used to calculate a simulated return stream across 10,000 iterations, to calculate a distribution of IRRs and MOICs for a single transaction, a portfolio with recycling of capital and a portfolio without recycling of capital. The resulting mean IRR of approximately 4.5% appears reasonable as compared to the HFRI Fund Weighted Composite Index 10-year annualised return of 4.7%, 5-year annualised return of 7.8% and 3-year annualised return of 8.32%[10].

Once we had a simulated IRR for each transaction over the seed investment period, we created an asset base grid to map the average asset base available to earn a revenue share on, in each year for that transaction. Chart 9 displays the asset base grid and is derived from what we believe the average manager can achieve, given this performance. Note that the range of potential outcomes within this group is wide in practice, but for the purposes of illustrating the enhancement available to seed investors, in particular at a portfolio level, we believe this simplification provides a good "rule of thumb" from which to begin. It is also consistent with what we believe is the target minimum peak asset raise of a typical institutional seed investor when entering into a transaction, i.e., a minimum peak asset target of 20 times the seed capital invested (e.g.., $1bn in AUM for a $50m seed investment or $1.5bn in AUM for a $75m seed investment).

Chart 9: Asset Base Grid



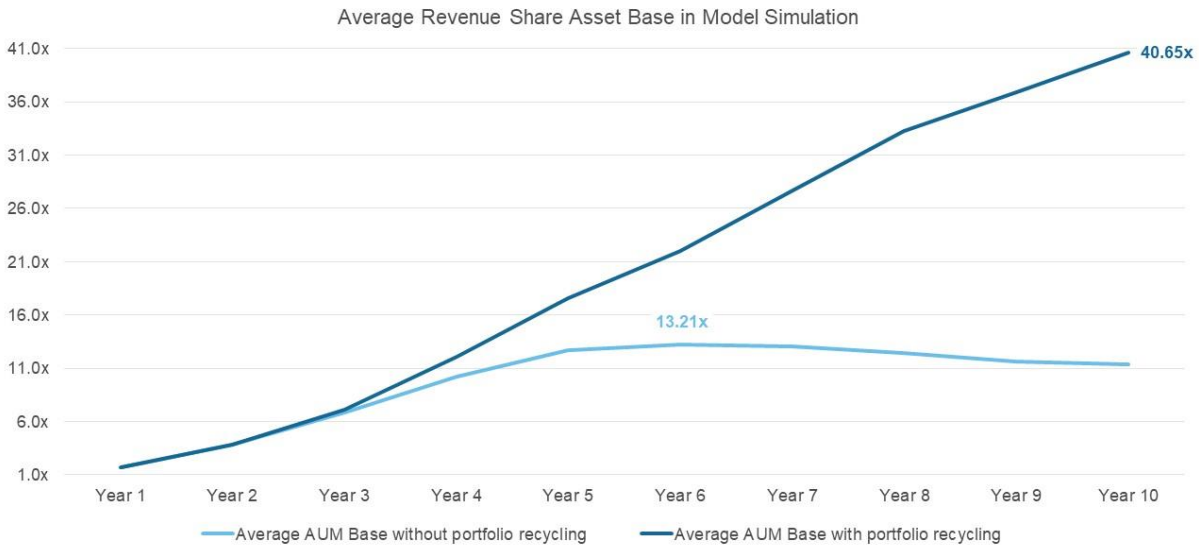
Next, we mapped the simulated return stream per transaction against the asset grid to calculate a simulated asset raise and AUM profile for each fund. We calculated the management and performance fees and allocated these cash flows across each portfolio to calculate a gross revenue share per year, which was then allocated on a cash flow basis (assuming management fees are paid quarterly, and performance fees are paid annually, each with a

[10] HFR as of April 2021

one-month lag). This enabled us to then calculate the IRR and MOIC per portfolio, “with no recycling” and “with recycling” of capital, and subsequently run 10,000 iterations of these portfolios to draw conclusions on the distribution of outcomes.

Chart 10 shows the average asset base profile at a portfolio level, with and without recycling of capital, across the 10,000 simulations.

Chart 10: Average Portfolio Revenue Share Asset Base per year



Note that these assumptions resulted in an average transaction life of 5.9 years across the simulation. This is consistent with the “real world” in that there is a high attrition rate in hedge funds which is highly correlated to performance. Per one study on survivorship, only 76% of managers survive past 3 years, 62% past 5 years and the “breakeven point” at which 50% of managers remain up and running is somewhere between 6 and 7 years[11].

[11] Goldman Sachs Hedge Fund Survivorship Study 2020

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