SEWARD & KISSEL'S SEED TRANSACTION DEAL POINTS

Hedge Funds, Private Equity and Private Credit

11th Annual Study

SEWARD & KISSEL LLP

Introduction

Our 2024 observation period revealed an extension of a number of trends in investment fund seeding transactions that we have been tracking for more than a decade. First, institutional seeders continued to represent an outsized share of observed seed transactions – importantly, acting as the driving force behind a significant increase in the observed median check size, as well as continuing to focus on ensuring a high degree of alignment between the manager/GP, the seeder, and third-party investors. Second, seed investments were nearly as likely to be made in private equity/private credit and other illiquid or less-liquid strategies, as opposed to the historical significant overweighting of seed investments in hedge funds and similar highly liquid products. Overall, observed activity was steady year over year, with institutional seeders again being the most active participants.

While no longer representing a majority of observed seeding activity, investments in traditional long/short equity strategies (especially those with a defined industry or thematic focus) remained a significant portion of our dataset, particularly in terms of their share of the aggregate seed investment dollars. Multi-strategy managers remained a popular candidate for seeders looking to access in liquid strategies. Illiquid or "closed end" fund structures – such as those focused on private credit or traditional private equity – continued to be very popular; these transactions have driven an evolution in many of the core terms of a seed investment, taking into account the differences in the capital formation strategies and rate of AUM scalability of private market focused funds vs. conventional hedge funds. Based upon observed trends, it would not be surprising if private equity/private credit seeding ultimately equaled – or even exceeded – the hedge fund seeding category.

As in prior years, strategies that are more resistant to fee compression were in high demand, as were, in the case of liquid products, strategies that were able to provide enhanced liquidity to their investors. Consistent with the last several years in our dataset, we observed a modest increase in investor level gates in seeded liquid strategies (with seed investment liquidity oriented accordingly). Illiquid strategies continued to show a high degree of variance in the structure and quantum of economic terms, reflecting some apparent immaturity in this segment of seeding; we expect more time and more transactions will be needed for equilibriums to emerge for these strategies/structures. Other terms largely tracked prior years.

Managers and GPs who were able to obtain a seed investment generally enjoyed a considerable head start for their businesses, with the seed investment serving as a springboard to attract additional investors or, with respect to closed-end funds, a catalyst for a first closing. The persistence of 2-to-3-year (and longer) lock-ups as the market standard for liquid products incentivized seeded managers to invest greater resources in their businesses and orient their decisions – both investment and operational – with an eye towards the long-term. Similarly, private equity and private credit seed deals included various "carrots" and "sticks" to orient a seeder towards long durational support of the business across multiple vintages.

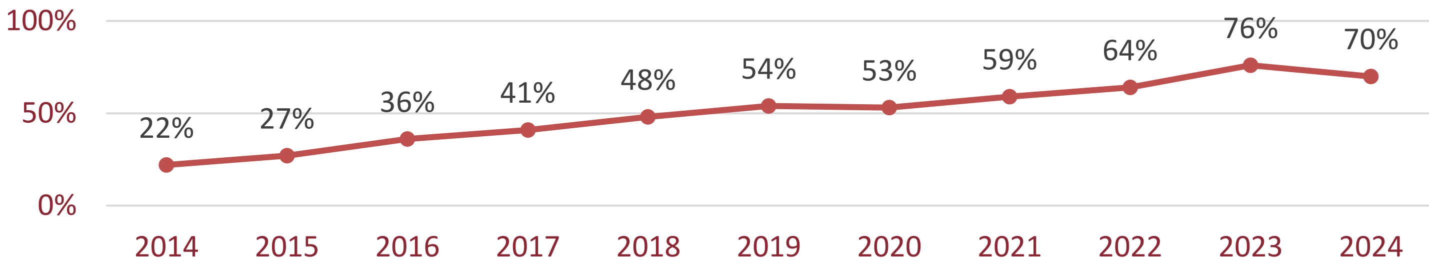
Our 2024 data suggests that the core economic terms of seed deals continue to trend toward more "manager/GP-friendly" and "third-party investor friendly" structures; two key continuing trends are seeders' willingness to (i) align themselves with managers/GPs by agreeing to bear a portion of the start-up costs of the new business, and (ii) align themselves with third-party investors by being subject to a liquidity profile (following the termination of any lock-up) that is similar to other investors in liquid funds. Seed investors in liquid strategies have continued to push hard to include additional protections to manage the risk of unknown market conditions and against the re-emergence of significant volatility – these protections were often expressed in narrower performance-related early lock-up release triggers.

As noted above, our 2024 dataset is somewhat overweight in a concentrated subset of institutional seed investors whose activity represents a majority of our observations. As a result, our 2024 study continues to skew somewhat towards terms appropriate for seeders of this type. Nonetheless, most of the leadership and innovation in the last decade of seeding terms has been driven by institutional seeders, and therefore we believe our 2024 dataset remains representative of the state of the marketplace for seed investment transactions (hedge fund, private equity/credit and otherwise) in 2024.

For more information about the Current State of Seeding, or Seed Transactions generally – or to receive a copy of our recent HFMWeek article "Recent Developments in Hedge Fund Seeding" – contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com.

Working Capital Support

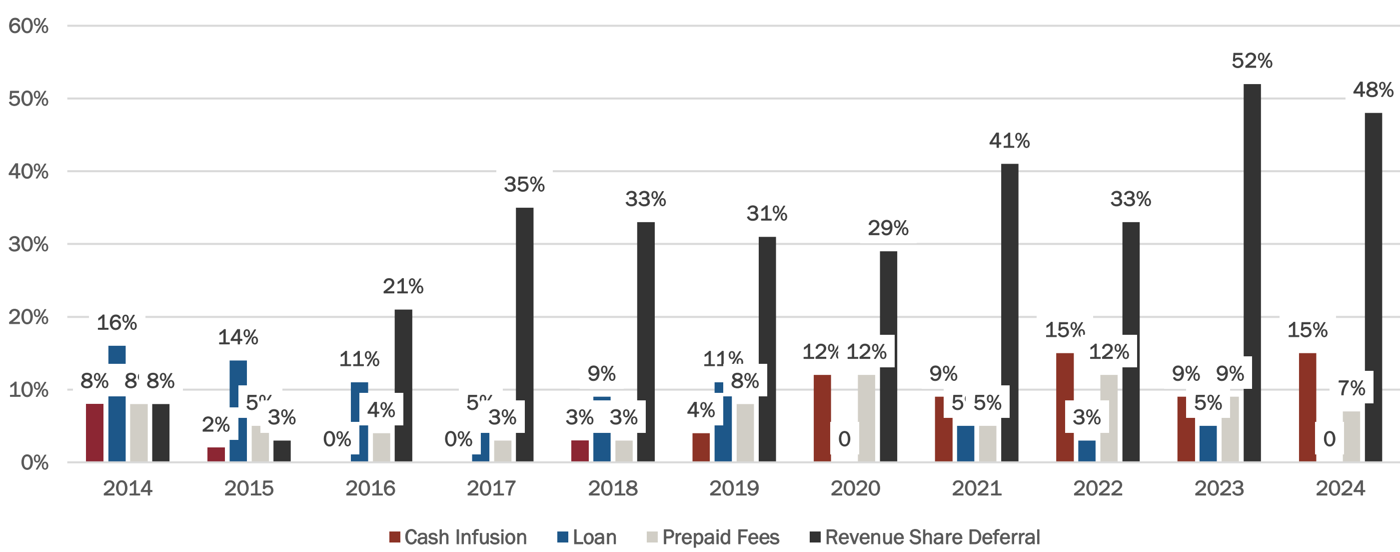
Percentage of Deals with Working Capital Support



Forming a new asset management business with sufficient operational depth and capacity to manage often +$100 million of day-one assets requires a significant amount of working capital, particularly in today's environment where major allocators require institutional level capabilities and infrastructure as a prerequisite to seriously consider an investment. GPs of private equity funds further need to assemble the capital necessary to fund their GP commitments (typically 2% of the total commitments). While historically founders have relied upon their own assets to finance the various working capital requirements, asset managers are increasingly looking to seeders to provide capital assistance to fund the anticipated expenses of the business until the management fee-based revenue is sufficient to cover the core operating expenses. This assistance can take multiple forms, including direct capital investments, lending facilities, prepaid management fees, or, most commonly, a deferral of the seeder's revenue share. Certain structures also exist that allow a portion of the seed investment to be positioned as part of the GP commitment. Each of these approaches must be carefully structured to avoid distorting the underlying business deal and/or tax posture of both the seeder and the manager. Of the deals where some type of working capital support is provided – which is now a substantial majority of seed deals – a clear preference has emerged for the deferral-based approach as a way of increasing the amount of capital available to fund the manager's operations.

For more information on Working Capital Support, contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy of our HFM Global article "Working Capital in Hedge Fund Seeding".

Structure of Working Capital Support



Structuring a Seed Deal

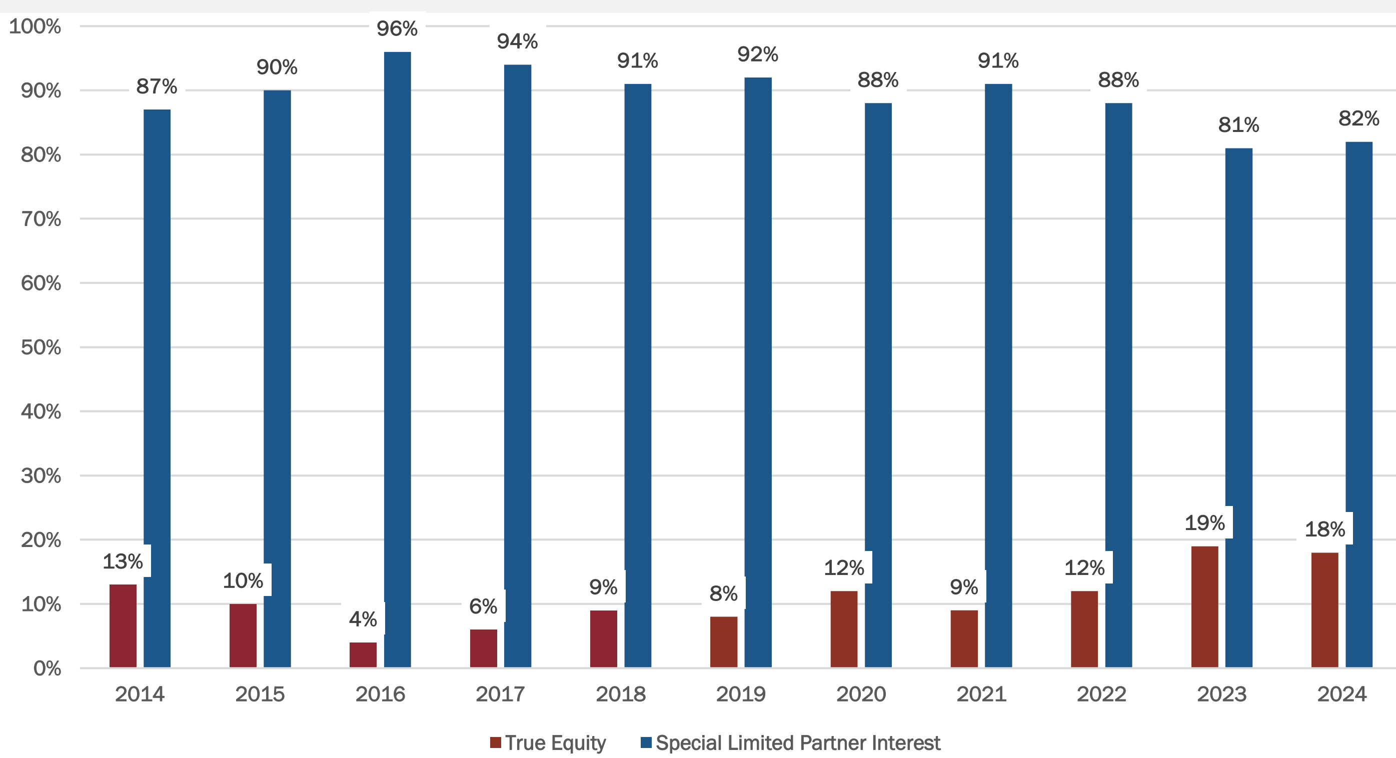
A threshold question in any seed deal is whether to structure the seeder's interest as a top-line revenue share (which occasionally nets out certain third-party expenses, such as placement agent fees, but is still fundamentally calculated by reference to revenue), or a bottom-line equity interest (which almost always excludes the above-the-line impact of key person compensation in excess of a modest base salary). While a true revenue share remains the overwhelmingly preferred means of structuring seed economics, a select few seeders require that their interest in the manager take the form of a direct equity ownership stake. The advantages of the latter structure include greater governance/control and greater transparency. However, some have worried that there is a theoretical risk that even a passive equity ownership increases the seeder's liability exposure to investors in the fund or other third parties (regardless of long-settled legal principles that limit equityholder liability). Moreover, the ownership of a direct equity interest in the manger may require that the seeder be subject to the manager's compliance manual and/or Code of Ethics, and further a seeder equityholder may be required to be listed as an owner in the manager's Form ADV.

Because the general benefits of equity ownership can almost always be achieved through careful structuring (most commonly by making the seeder a special limited partner or a holder of allocation class shares in the funds) without negatively impacting the seeder's liability and disclosure profiles, an economic interest structured as a special limited partnership interest in the fund remains the dominant method of establishing a seeder's stake in the manager's business.

As in all prior years during our study's observation period, seed deals structured as true equity remained relatively rare in 2024, reflecting the continued preference of seeders for the contractual approach. That being said, the growth of the private equity/credit sector for seeding has resulted in more observations of these deals using an true equity structure, often due to the bottom-line economic characteristics of the seeder's interest in private equity firms (which are in turn owing to the much thinner margins that are typical in a pre-scaled private equity/credit business).

For more information on Structuring Seed Deals, see our HFM InvestHedge article "State of the Art", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy.

Structure of Seed Deals



Lock-Ups

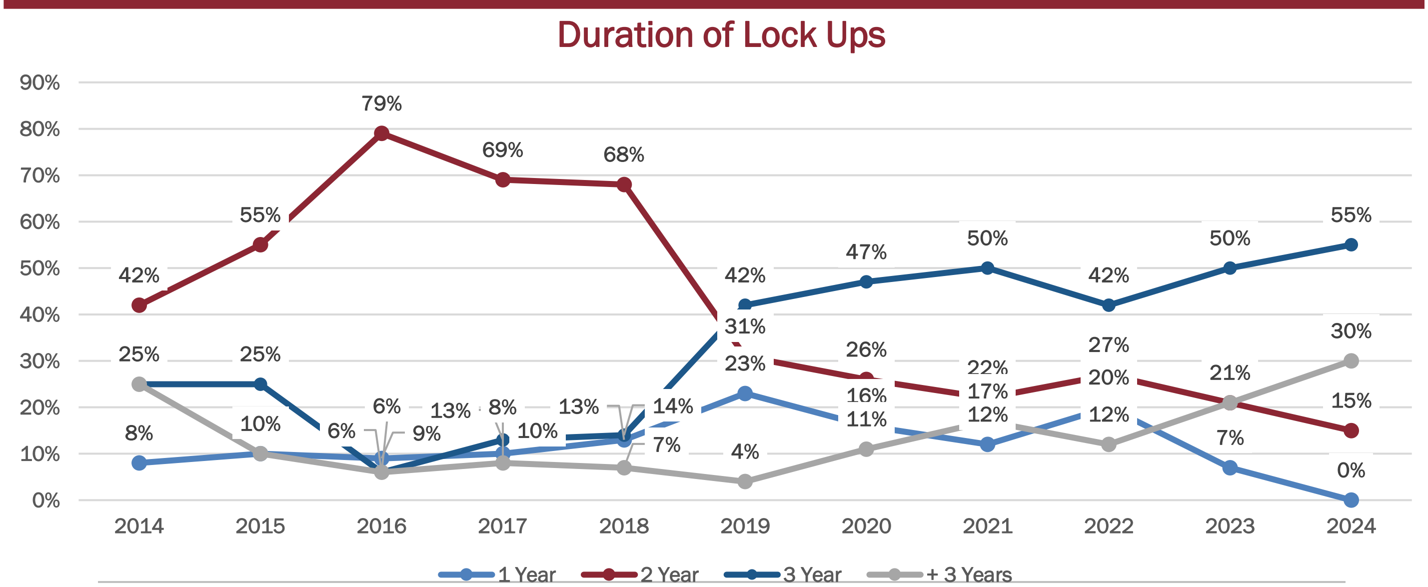
The primary currency of any seed deal – i.e., the reason a manager will grant a seeder a significant economic interest in their business – is the seeder's provision of significant and durable capital, providing scale and, for liquid products, a type of "ballast" for the initial fund. For funds providing regular liquidity to their investors, to ensure this capital is "sticky", managers require the seed investment to be "locked-up" for some duration, most often for 1-3 years. For these liquid products, having a critical mass of capital that may not be redeemed helps "collateralize" the redemption rights of third-party investors because the quantum of potential redemptions as a percentage of overall AUM will be smaller than funds that do not have significant locked up capital; this benefit to third-party investors positions the seeded fund as comparing favorably to other investment funds during fundraising.

The nature of the lock-up varies between seed deals, with many managers preferring a "hard" lock-up, where the seed investment may not be redeemed for the entire duration of the lock-up period (subject to certain special redemption rights in the event of material adverse events, as discussed on the following page), and others willing to agree to a "soft" lock-up for some portion (or sometimes the entirety) of the lock-up period. "Soft" lock-ups traditionally take the form of early redemption charges and/or the loss or reduction of the revenue sharing rights of the seeder in connection with any redemptions.

Following the expiration of the lock-up, the seed investment most commonly rolls into the liquidity of the class into which it was invested (often the founders' class or a special seed class whose terms otherwise mirror the founders' class). To the extent that such class is subject to separate lock-ups or investor/fund level gates, the seed investment often negotiates "credit for time served", such that the full amount of the seed investment would be eligible for redemption at the end of the lock-up period (assuming the lock-up period exceeds the aggregate gate). In such events, to balance the underlying portfolio liquidity concerns that inform the need for general lock-ups and/or gates, the seeder will be required to provide irrevocable notice of its election to redeem the seed investment well in advance of the expiration of the lock-up period (with effectiveness as of the expiration of the lock-up period) so as to give the manager sufficient notice to create the requisite portfolio liquidity. For example, a seed investor might be required to give such notice a year before the expiration of the lock-up if the underlying share class has quarterly liquidity subject to a 25% investor level gate.

While the early years of our dataset showed a wide variety of lock-up period durations, a clear trend has emerged in recent years for 2-3 year lock-up periods. Most typically, these are "hard" lock-ups for the entire period – though a combination of a 1 or 2-year "hard" lock-up coupled with an additional 1-year "soft" lock-up is not uncommon. Importantly, our dataset for lock-ups and related terms is focused solely on liquid funds, as the concept is not relevant to illiquid investment vehicles.

For more information on Lock-Up Terms, see our HFM Global article "Aligning Seed Investor Liquidity Rights", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy.



Early Termination of the Lock-Up / Commitment Period

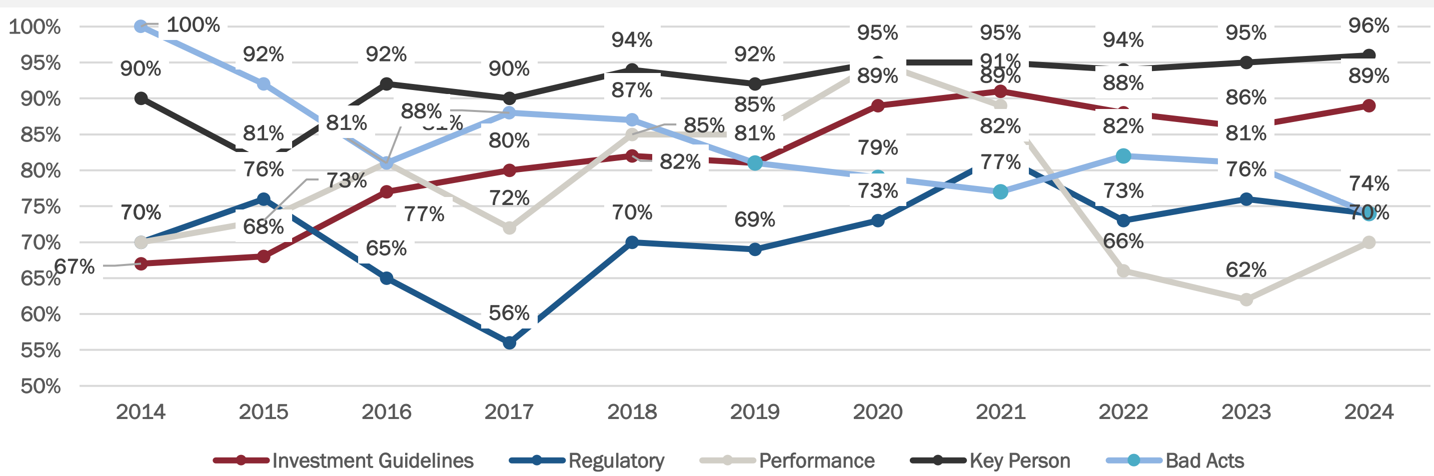
Notwithstanding the general illiquidity of a seed investment during the lock-up period, seeders in liquid strategies customarily require the ability to redeem their capital in the event that the fund or the manager experiences any one of a variety of harmful events – whether these events represent damage to the seed investment itself or compromise the manager's ability to successfully manage assets in the future (thus eroding or eliminating the expected value of the revenue share). These events include certain levels of losses (which are typically carefully calibrated to protect only against volatility in excess of that which is implicit in the applicable investment strategy) or if the manager and/or its key personnel engage in behavior that may be subject to legal or regulatory censure. Our observations in 2024 indicate a continuation of the increased focus by both seeders and managers on the performance triggers for the lock-up release because of the volatility experienced in the early days of the COVID-19 pandemic as well as more recent concerns about a market correction, interest rate changes and/or inflation dynamics, with seeders seeking narrower triggers and managers asking for greater tolerance for volatility.

If any such events occur, the lock-up terminates and the seed investment becomes redeemable, often on an accelerated basis; however, in response to historical investor concerns over seeders having accelerated liquidity (particularly given they often represent a significant share of the overall assets of the fund during the lock-up period), it is increasingly common for a release trigger to be treated as an early termination of the lock-up period (such that the seeder rolls into ordinary liquidity) as opposed to triggering a preferential immediate redemption right.

As noted, the most common of these liquidity rights are keyed to the protection of the asset value of the seed investment (e.g., breaches of, or changes to, the investment guidelines or negative performance) and events adversely affecting the manager's future as a business (key person, bad acts, regulatory matters, etc.). Key person events remain the most common of these liquidity rights, arising in almost all seed transactions over the observation period; special liquidity for investment guidelines breaches/changes has become almost as universal as more seeders have focused on protecting the seed investment. Performance and adverse legal events remain extremely common liquidity rights as well; these have become nearly ubiquitous in our 2024 observation period for liquid funds – however, because they are generally inapt for private equity funds (which form a meaningful portion of our dataset), our data showed a phantom decrease in the usage of these terms.

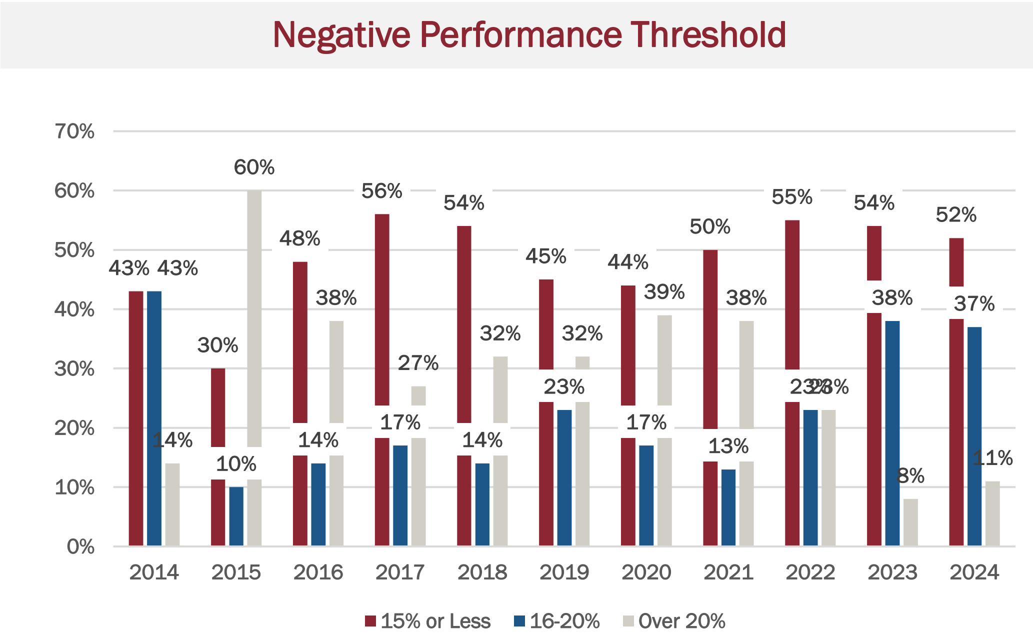
With respect to illiquid vehicles – particularly classic private equity/credit funds – while lock-up releases are not relevant, seeders nonetheless have a strong interest in protecting their seed investment against fallout from the occurrence of a key person event. As such, seed deals for these vehicles often have provisions giving the seeder (whether in its capacity as a member of the LPAC, or as a separate and unilateral right) the ability to force an early termination of the fund's investment period upon the occurrence of a key person event (or certain other events).

Top 5 Special Liquidity Rights

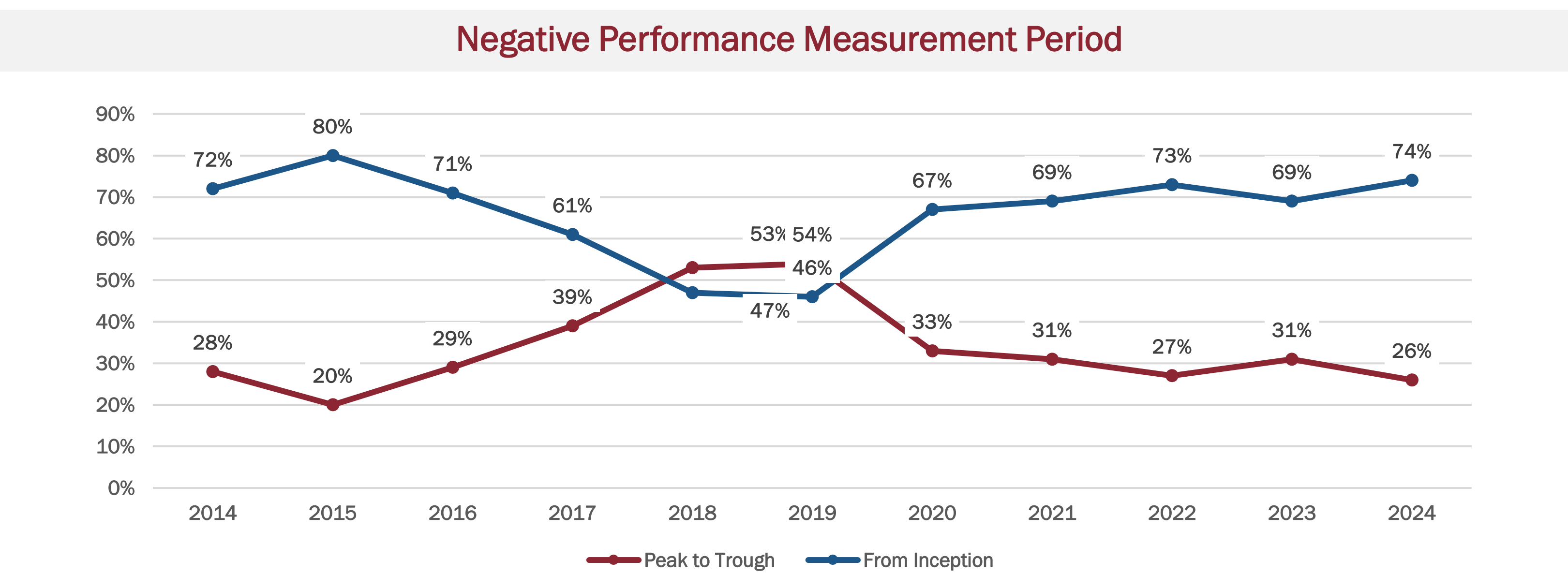


Lock-Up Releases

As a primary goal of almost any investment (seed or otherwise) is preservation of capital, and because the strongest indicator of the success of an asset management business remains its ability to generate positive returns, seeders of liquid products typically negotiate performance tests allowing a seeder to "cut its losses" if the seed investment significantly underperforms. These tests are typically structured either as absolute declines or declines relative to a benchmark. Over our 2014 - 2024 observation period, negative performance thresholds tended to be 15% or less (approximately) half of the observed transactions), which in part reflects the relatively low volatility expected in the investment strategies that attract seed capital. However, as previously noted, the extreme volatility in Q1/Q2 of 2020 relating to the COVID pandemic put renewed focus on this core protection.



The effect of the applicable trigger percentage will be impacted by changes to the basis of calculating the measurement period (e.g., a peak-to-trough test may result in triggering a lock-up release for a very successful fund which gives back a portion of its overperformance, despite overall returns remaining highly positive). Despite an observed convergence trend between the two approaches over 2018-2019 observation period, our datasets beginning in 2020 showed increased favor for the "from inception" approach, which, as a "manager friendly" term, likely has its derivation as a compromise where the seeder otherwise insisted upon a lower percentage threshold trigger.



Preserving Goodwill / Business Integrity

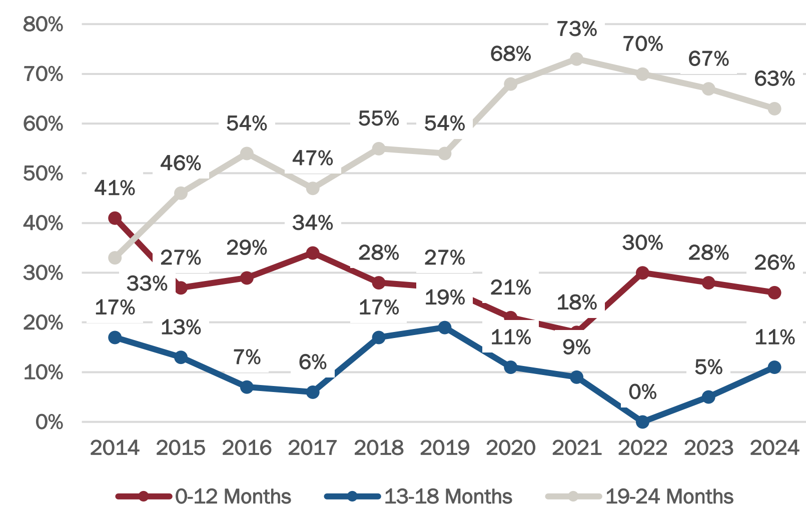
Owning an interest in an asset management business carries unique franchise risks due to the inextricable relationship between the value of the business and the human beings who generate its track record and maintain and grow relationships with investors. In a very real sense, the goodwill of an asset manager “walks out the door” each evening, and this requires special provisions for the benefit of a seeder to ensure that this goodwill (and therefore the seeders portion of the economics) remains intact, and that the key persons cannot functionally deprive the seeder of the revenue share by abandoning the seeded manager and launching a separate asset management business.

Seeders likewise want to protect an investment management business that has been institutionalized and can survive the departure of a key person – for these firms it is important to prevent a departed key person from pursuing former investors or engaging in trading strategies that can reduce the investment capacity in the fund’s strategy or otherwise harmfully impact the fund’s investments or ability to attract additional capital. Therefore, key persons are typically restricted from engaging in certain competitive activities for 12-24 months following their disassociation and/or withdrawal from the manager; over the observation period, the duration of this period has trended somewhat upwards with 24 months becoming the most frequent.

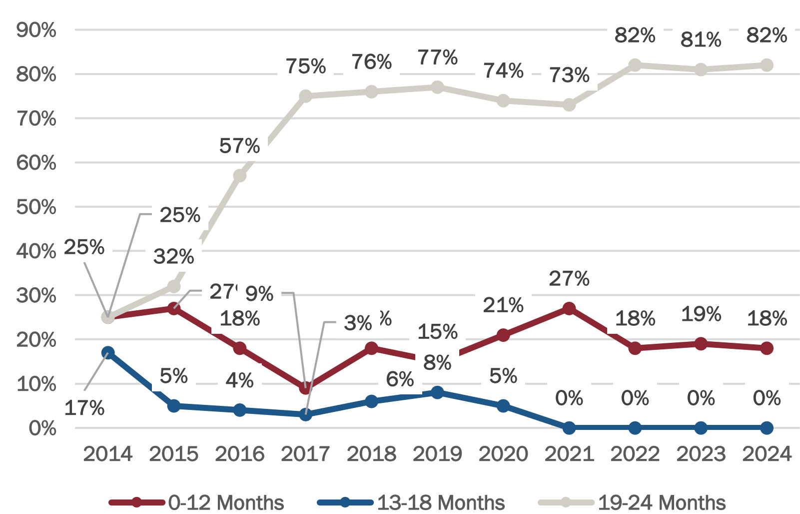
Key persons are also restricted from soliciting the legacy clients/investors and employees for a period of time, often at least as long as the non-compete period. In recent years, non-solicit periods are even beginning to outrun non-compete periods (e.g., a one year non-compete and a two year non-solicit), possibly owing to proposed changes to state and federal employment laws surrounding the enforceability of non-competes (despite seed investment terms not necessarily establishing an employment relationship). However, managers typically seek to have the non-compete covenants mitigated in certain ways, such as retaining the ability to work at a non-portfolio manager level for non-fund trading platforms (i.e., at a family office or endowment) or reducing the non-compete period in the case of failure by the manager/fund to build a business capable of supporting itself after the lock-up period.

For more information about Protecting the Seeders’ Economic Share, see our HFM Week article “Restrictive Covenants and Tail Right Provisions in Seed Transactions: Balancing Seeder Protection and Key Person Autonomy”, or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy.

Non-Compete



Non-Solicit



Preserving Goodwill / Business Integrity

While non-competition and non-solicitation provisions are, at their core, designed to ensure that a key person's post-withdrawal activities would not permit trading against the fund's positions or poaching talent and/or investors (e.g., in circumstances where the business remains viable following the key person's departure), seeders also commonly require "tail rights" which allow them to receive their seed economics in any businesses started or managed by the applicable key person(s) within a defined period following such key person's withdrawal from the business (subject to certain limitations).

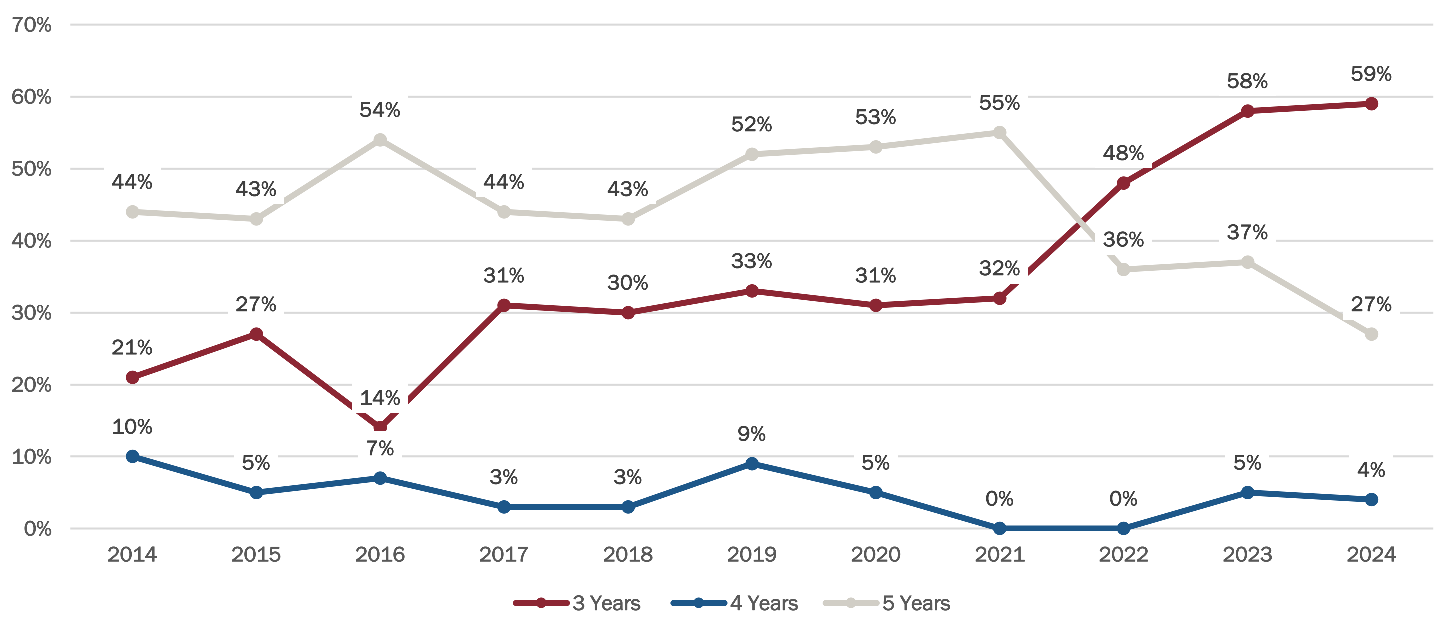
The rationale for these rights is that the goodwill that is created in the business is a proximate result of the original seed investment, and therefore a portion of this goodwill can be rightly considered to be owned by seeder. As the goodwill in an asset management business is closely linked to the key person's reputation (based in large part upon the track record of the fund), this goodwill is generally thought to have a potency that lasts beyond a relatively short non-compete period; therefore the seeder should retain some rights to any new business where any remaining goodwill is utilized.

Accordingly, the scope of the tail right is carefully limited to distinguish between acting as an ordinary employee of another asset management business (where the tail right would not apply) and involving the key person's reputation with another asset management business (where the tail generally would apply). Where tails apply, they are almost always perpetual, as they are designed to replicate the interest that the seeder would have had were the key person to have remained with the firm.

These tail periods historically were clustered in the five-year range; however, over the last several observation periods, 3-year tail periods have become increasingly common – and in 2024, a majority of our observations.

For more information about *Protecting the Seeders' Economic Share*, see our HFM Week article "Restrictive Covenants and Tail Right Provisions in Seed Transactions: Balancing Seeder Protection and Key Person Autonomy", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy.

Tail Rights



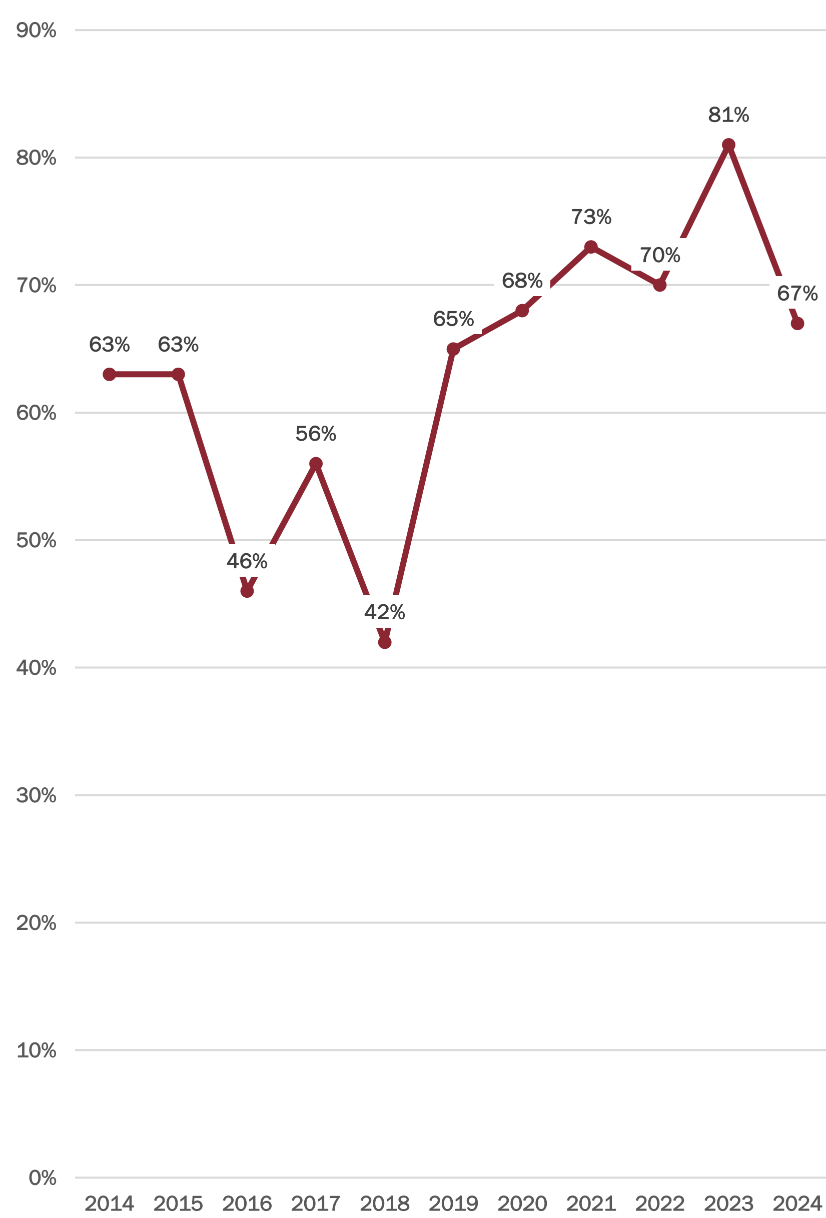
Buyouts

Managers often seek a buyout right so that they may eventually reclaim full ownership and control of the seeded business. Buyout rights typically become exercisable after a fixed number of years following the investment (so as to ensure the business has time to mature), and managers prefer buyout rights to be "evergreen" (i.e., exercisable at least annually), while seeders prefer a "bullet" where a manager only has the right to exercise the buyout once, such that if the manager declines to exercise within the applicable period, the buyout right will be lost. Of course, even if no buyout is prescribed in the seed agreement, the parties can always agree to a buyout or similar transaction outside of the contract; this approach allows for then-current market and other factors to be incorporated into the transaction pricing and structure, while the pre-negotiated buyout terms may be less reflective of the then-current economic and valuation realities. Private market focused firms - that often have significant unrealized gains in their portfolio which are monetized irregularly and, if there remains a substantial exit horizon, still subject to significant changes in value – are poor candidates for formulaic valuation techniques, as even a relatively complex formula would likely apply assumptions that may be inapt at the time of the actual buyout or not properly value unrealized gains in an illiquid portfolio. Buyouts, while in decline for several years, have once again appeared in roughly 2/3rds of observed transactions.

In structuring buyouts, much attention should be paid to the timing of payments: e.g., paying the entire buyout price upfront vs. paying in tranches over a period of time, in which event each tranche may or may not be repriced based upon the then-applicable performance of the business. Also, careful consideration must be paid to the tax effect of the buyout, as a simple buyout requires use of post-tax dollars (i.e., the buyout price paid is not a deductible expense). The parties may consider certain structures which allow for pre-tax dollars to be used — though generally speaking, unless carefully structured, use of these approaches can have distortive tax and/or economic effects for the seeder.

For more information on Buyouts, see our HFM Week article "Buy-out Provisions in Seed Transactions", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy.

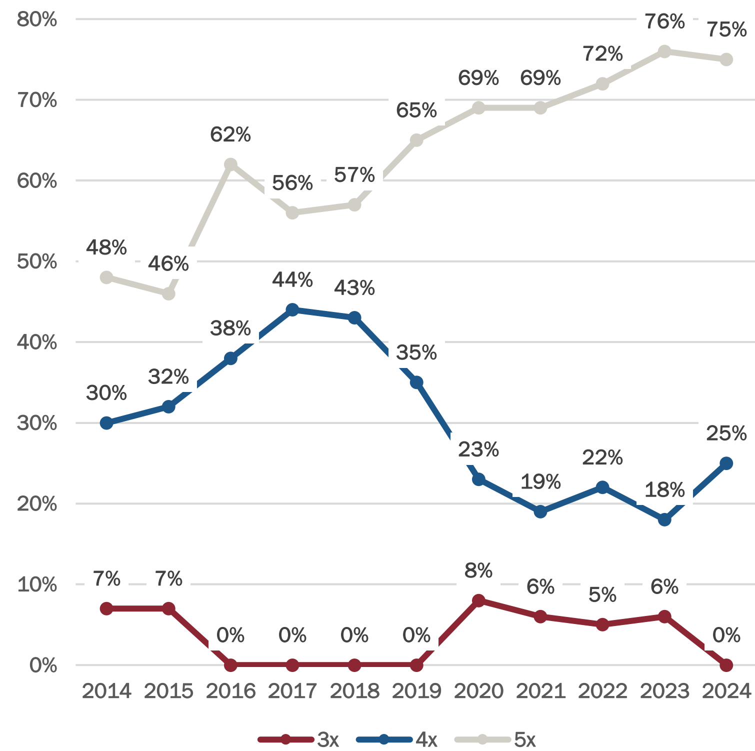
Percentage of Seed Deals with Buyouts



Pricing a Buyout — Revenue Multiple

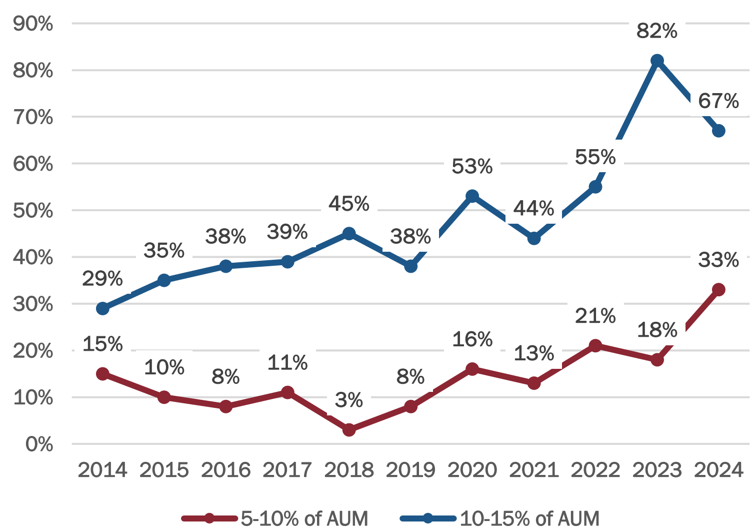
Many seed deals that include a buyout feature use a formulaic buyout price. Other approaches include having a valuation expert make the determination of the buyout price at the time of the buyout (assuming the parties are unable to agree on a number), but this is generally only used where either the seeder's economics are subject to a number of adjustments based upon unknowable events that render a formulaic buyout methodology inapt, or the seeded business is deploying a private equity or venture capital strategy, where irregular harvesting of carried interest revenue and large unrealized gains make a formulaic approach crafted years earlier a poor means of determining fair value.

The most common formulaic buyout price – used in nearly every buyout formula – is based upon a fixed multiple of the average payments made to the seeder in the trailing 12/24/36 months. The backward-looking duration of the reference period is designed to smooth out volatility in fund performance (particularly incentive fees), though this approach can also yield a relatively lower buyout price vs. a run rate revenue-based multiple if the business is on an upswing. A multiple of 5x has remained the most common over the observation period, followed by a 4x multiple, with very few observations of greater or lesser multiples in the past several years – so few for 6x in recent years that we no longer present it in our data.



The increase in frequency of FMV based buyouts has skewed our dataset a degree, and may be an early signal of a developing trend.

Pricing a Buyout – AUM Percentage

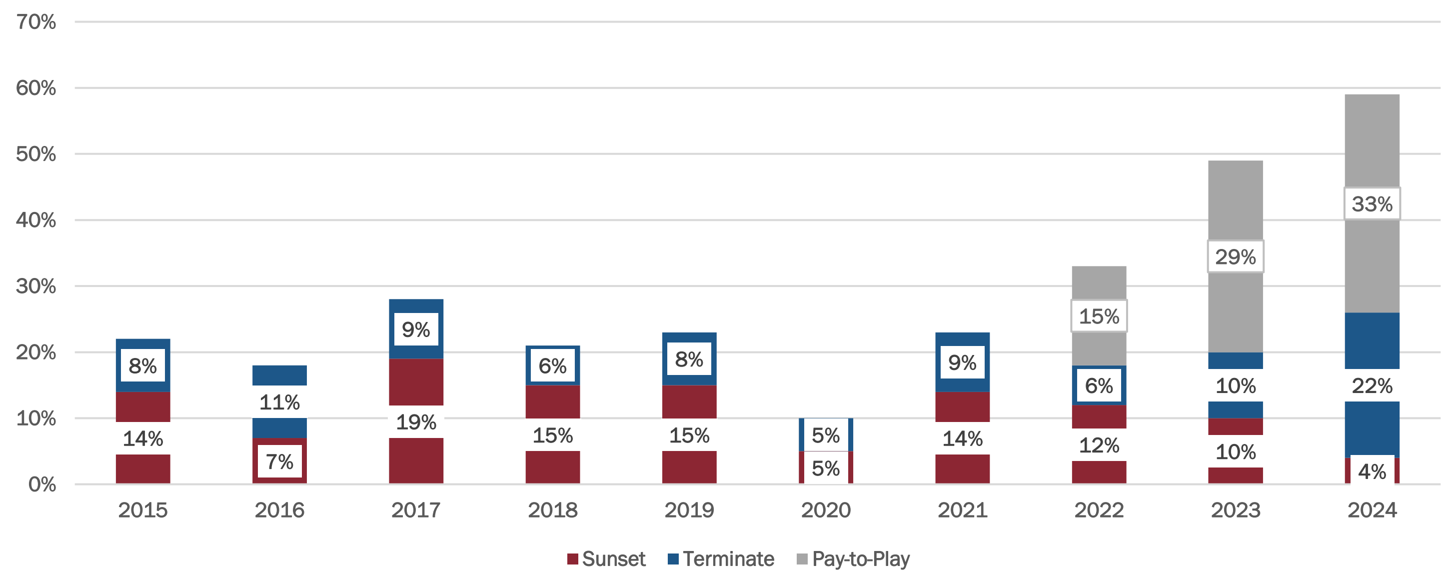


In recent years seeders sought to also include in the calculation of the buyout price an additional test based upon AUM (so as to ensure that any buyout price will not be disproportionately skewed by recent poor performance) – in which event the seeder would receive the "greater of" the price implied by the two methodologies.

Where AUM tests are used (which was somewhat rare in our FY2024 dataset), a manager should ensure that the AUM is weighted for the fees actually paid (as due to special fee terms, some AUM generates greater fee income and therefore is more lucrative than reduced fee AUM). These tests are common and were used in approximately half of the buyout provisions in our dataset; where they are used, an AUM percentage of 10-15% is by far the most common approach.

Scope and Duration of Revenue Share

Terminating Economics



While somewhat uncommon (particularly in our recent datasets, which have been overweight institutional seeder observations versus prior years), a number of seed deals include some form of a step-down, a sunset or an outright termination of the seeder's economics. Sometimes the decrease occurs on a fixed schedule or at a fixed time, regardless of other factors, and other approaches require the seeder to continue to invest in the funds – whether beyond the lock-up period for liquid products, or an obligation to seed multiple vintages in the case of private equity/credit products – for the seeder's economics to continue. Predictably, these types of arrangements rarely have buy-out clauses (as paying a high multiple when the seeder's economics are impermanent has little justification or appeal) and are mostly accepted only by seeders whose seeding motivations extend beyond pure revenue sharing economics. For example, a seeder whose core business is a fund-of-funds strategy and who has extended its manager selection expertise to seed investments may ultimately be more focused on receiving significant capacity rights at reduced fees and therefore be willing to forego some amount of seed economics to be able to place a larger chunk of capital (at favorable rates) with highly sought-after managers. While this approach may seem less appealing than retaining a "free" revenue share, enhanced capacity rights that result in a seeder being able to place an additional $100mm in a strategy that generates +20% annual returns will almost always (at least in early years before major AUM and corresponding revenue share growth) be more profitable in absolute (i.e., non-risk adjusted) dollars than a typical seeder revenue share.

Additionally, given the relatively little present value associated with cash flows that will be realized perhaps +10 years out under a conventional discounted cashflow analysis, it is not necessarily economically irrational for a seeder to forego these distant and highly uncertain future payments (though the same argument would suggest that the underlying manager shouldn't over-weight these cashflows in the negotiation either). Because terminating seeder economics is generally seen as being very favorable to managers, a seeder whose motivations are more closely linked with capacity rights has a real opportunity to distinguish their offering by using a step down or termination of the seed economics to source and close a deal with a best-in-class new manager who may otherwise either pursue a larger seed deal or forego a seed deal altogether. Our FY2024 study included data from seeders that historically had not been included in our dataset and who favor terminating economics; accordingly, while these inform our dataset, they do not necessarily indicate a new trend.

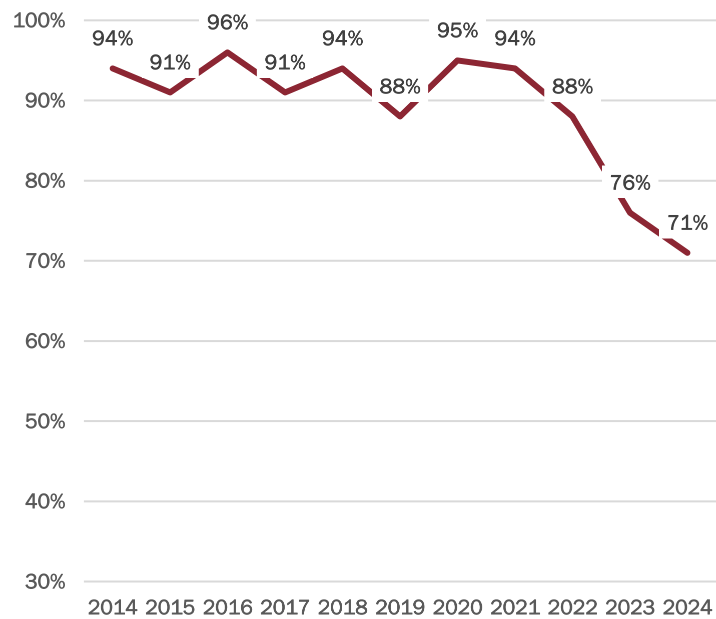
We have also included in our 2024 data "pay-to-play" requirements. It is not uncommon to see a seeder's revenue share in private equity/credit and venture capital businesses limited to one or two vintages of the applicable fund, or sometimes being subject to a "pay to play" requirement where the seeder is required to make similar seed investments in each subsequent vintage to retain its economics in those new vintages.

Participation in Evolutions

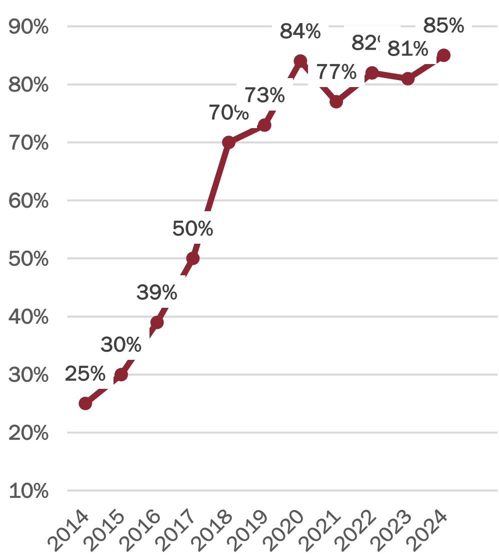
Participation in New Funds/Products

Regardless of the duration of the revenue share, a seeder of a liquid fund will almost always require that its economic interest extends to any additional products or vehicles managed by the manager. The rationale is that because the seed investment forms the initial asset base of the manager's business which creates the goodwill that allows for the successful marketing and launch of subsequent products, the seeder should have full participation in all economic streams arising from the entire business. Moreover, this protects a seeder against a manager essentially stripping value away from the revenue share (and therefore converting economic value to the manager) by creating and favoring new products whose strategy/fee terms/liquidity profile/etc., are more attractive than the fund which is subject to the revenue share.

As a result of these considerations, almost all seed deals over our observation period have included participation rights for the seeder in all new products of the manager. Our read of the slippage in our 2022-24 data suggests that the observed drop in participation rights is closely related to the growth of pay-to-play requirements in private equity/credit funds in our dataset.



Participation in Sales (Tag-Along)

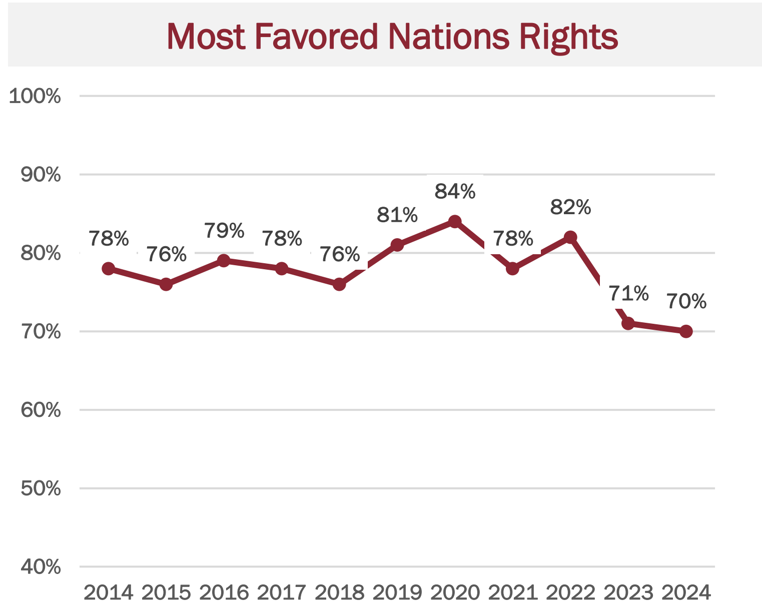


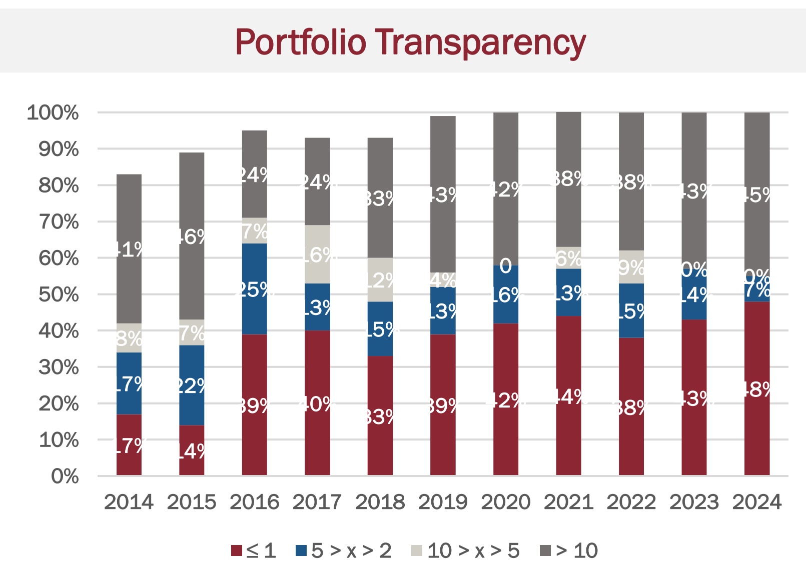
As a partner in the manager's business (regardless of whether the economics are structured as true equity or as a special limited partnership interest in the fund), seeders expect that they will be permitted to participate in sales and other liquidity events of the manager. While in many instances a seeder simply requires an outright consent right over any sale or issuance of equity (and presumes that it will condition its consent on being permitted to participate in the transaction), it is also common for a seeder to pre-negotiate a "tag-along" right to participate in any sales. In the case of seed transactions where the seeder's economics are calculated by reference to revenue (the overwhelming majority of seed transactions), the tag-along right often will also include a conversion mechanic to account for the fact that the seeder's top-line interest in the business is considerably more valuable than a traditional bottom-line equity interest (which also means that the manager generates extra value for itself when expanding its margins, as the seeder will then receive a smaller conversion percentage). As the number of buyers for stakes in asset managers has increased over the last several years – thus making an exit or partial exit through a sale more likely – seeders have been increasingly likely to require this right, with the frequency of this feature more than tripling over the entire observation period.

Traditional Side Letter Terms

Seed transactions typically provide seeders with some degree of information rights beyond what they are eligible to receive as ordinary investors under the fund's governing documents. These information rights often provide the seeder with a level of transparency that allows them to validate compliance by the manager with the fund's investment guidelines and also ensure that the seeder receives its full entitlement under its economic sharing rights. Managers typically seek to limit these rights to ensure that the seeder cannot use this information in any manner negative to the fund (such as trading ahead of a public market focused fund) or to replicate fund positions without paying the related management/incentive fees – with seeders usually quite willing to accommodate.

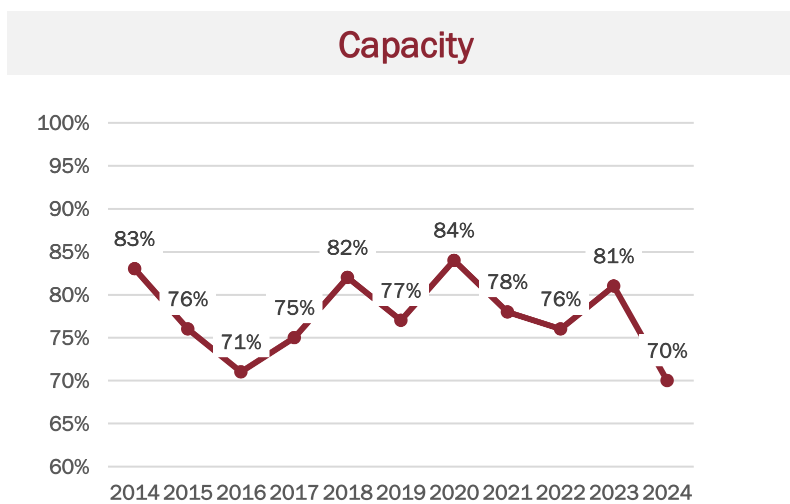
While T+1 or even more immediate transparency remains fairly common, our data suggests that seeders, as a whole, are becoming more comfortable with a longer lag on transparency – frequently asking for trade and position reports at the end of each month or beyond, rather than at the end of each trading day.





In addition to the seed capital, seeders typically require that a manager reserve investment capacity in their fund and other products to ensure that the seeder can invest additional amounts with the manager. Typically, these amounts are structured as either a fixed amount or a percentage of an investment vehicle's AUM. Seeders typically seek to ensure that dollars invested pursuant to their capacity rights will be made on the same preferential terms as the seed investment (e.g., reduced fees), and further will be subject to a "most favored nations" provision, to the extent applicable.

To ensure that a seeder's deal terms are at least as favorable as other investors in a fund, seeders will typically seek a standard "most favored nations" provision that allows seeders to elect to receive the benefit of any more favorable terms granted to other investors. Managers often seek to carefully define a seeder's right to receive these terms through restrictions on "cherry picking" (i.e., taking more favorable terms but not agreeing to be subject to any corresponding obligations which are more onerous) or by requiring the seeder's investment to equal or exceed the investment size of any investor to whom more favorable terms are offered.



Indemnification and Exculpation

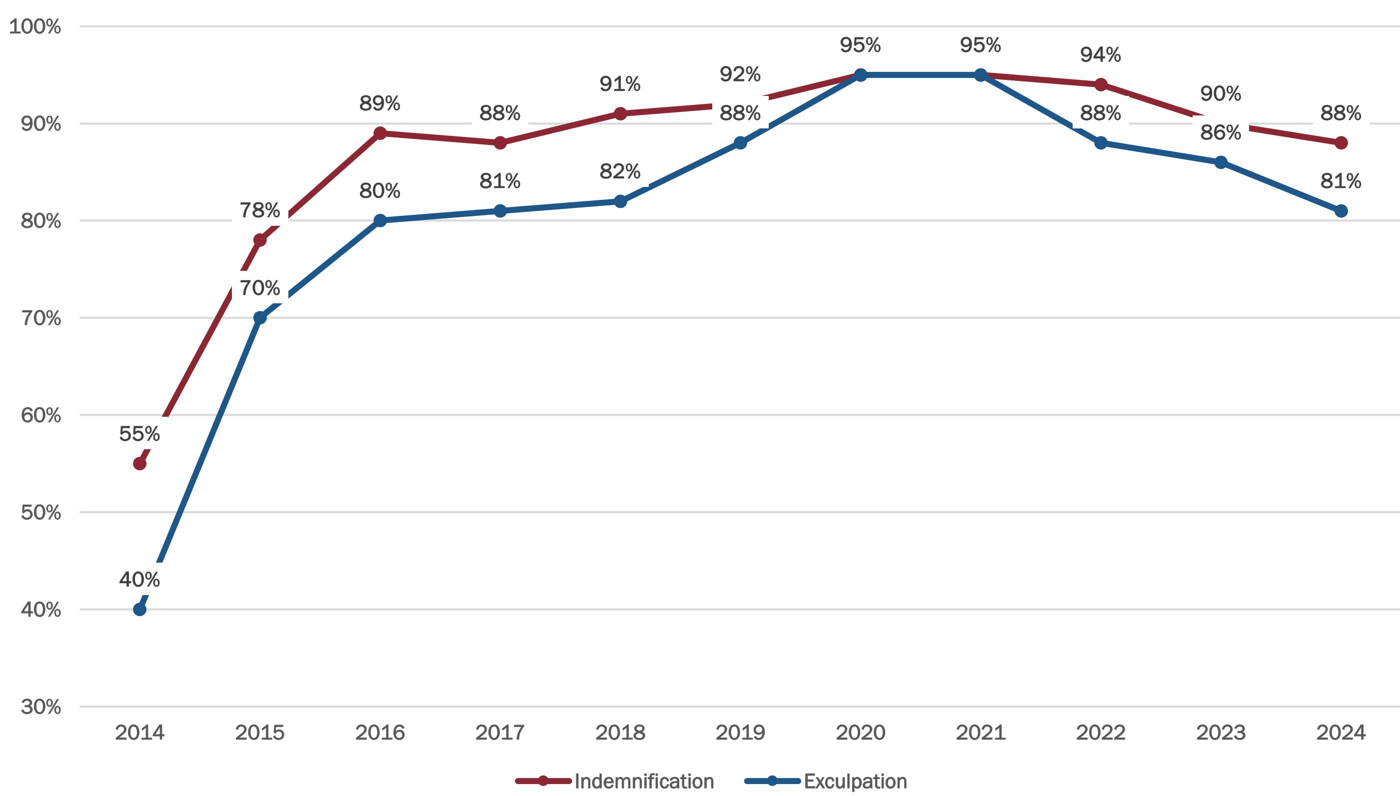
While a seed deal requires a willingness to expose a seeder's assets to the risks inherent in the underlying strategy, seeders traditionally are also very concerned about non-investment risks such as being named in lawsuits from investors in a fund that they have seeded – particularly given that seeders tend to be viewed as "deep pockets" by litigious parties.

Accordingly, seeders typically require that they are explicitly exculpated (removed from liability) and indemnified (made whole for any damage sustained) by the ***fund*** to the same extent that the fund indemnifies the manager (e.g., including the seeder as an "indemnified party" under the fund documents). Further, seeders customarily are separately indemnified by the ***manager/GP*** if the seeder is damaged in connection with the seed investment (other than for ordinary investment losses), such as a situation where the fund level exculpation/indemnification are inadequate to fully insulate the seeder from any damages. Managers often also indemnify the seeder for breaches of the seed agreement or the manager's fraud, willful misconduct or gross negligence. Some seeders further require the ***key person(s)*** to indemnify seeder for such key persons' own bad acts – in these instances, an overall cap on the key person's liability may be included in the indemnity package.

Some seeders request that, in addition to being exculpated and indemnified by the fund to the same extent applicable to the manager, the ***fund*** additionally commit to indemnify the seeder for the manager's or the key person's bad actions (e.g., breaches of the seed agreement); however, such indemnification may create serious conflict of interest and fiduciary duty issues for the manager, and therefore such indemnification arrangements should be avoided at all costs.

Specific exculpation and/or indemnification terms were always relatively common, even in the beginning of our observation period; over the past several years these terms have become standard in nearly all seed transactions.

Indemnification & Exculpation

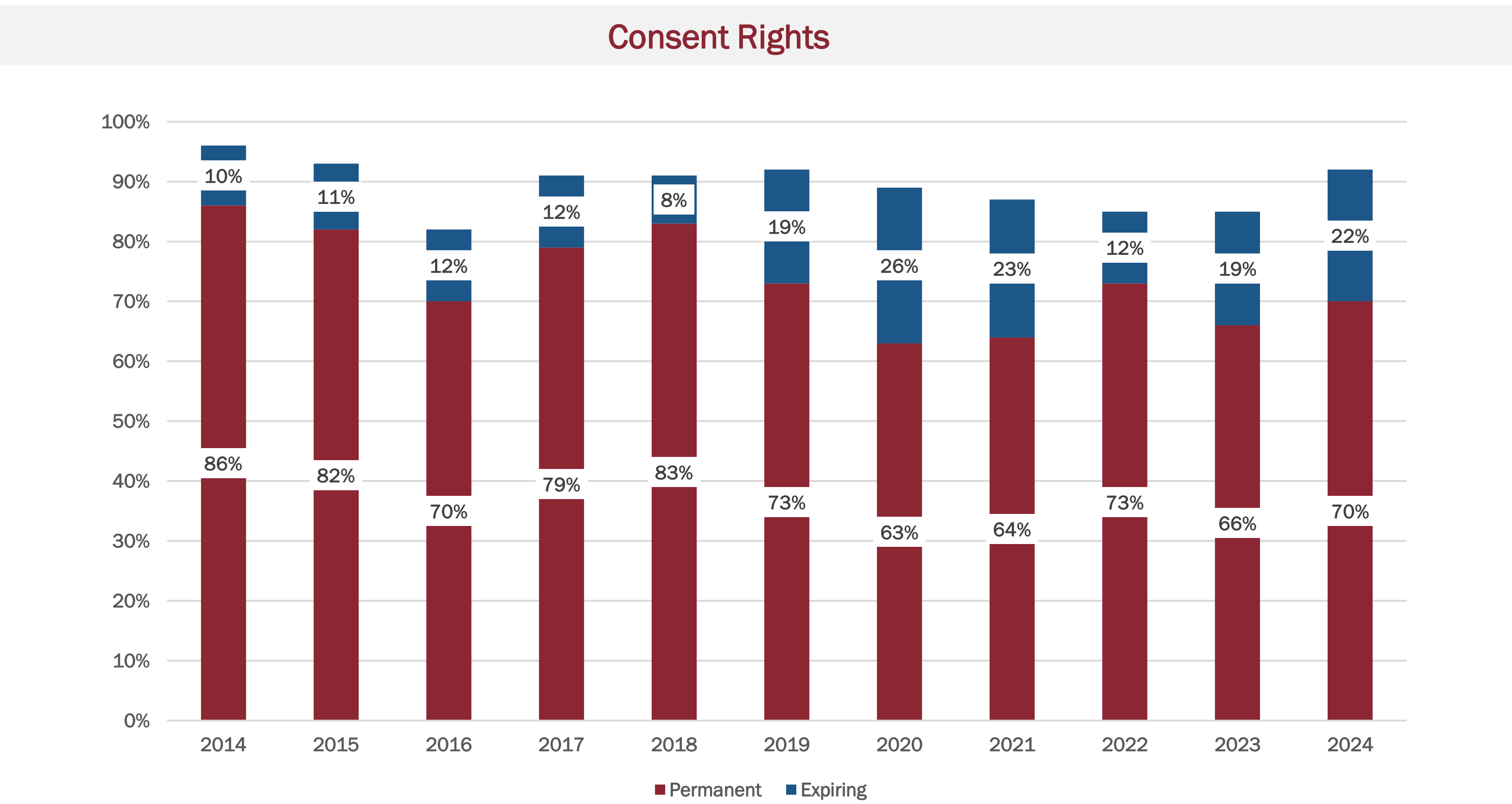


Consent Rights

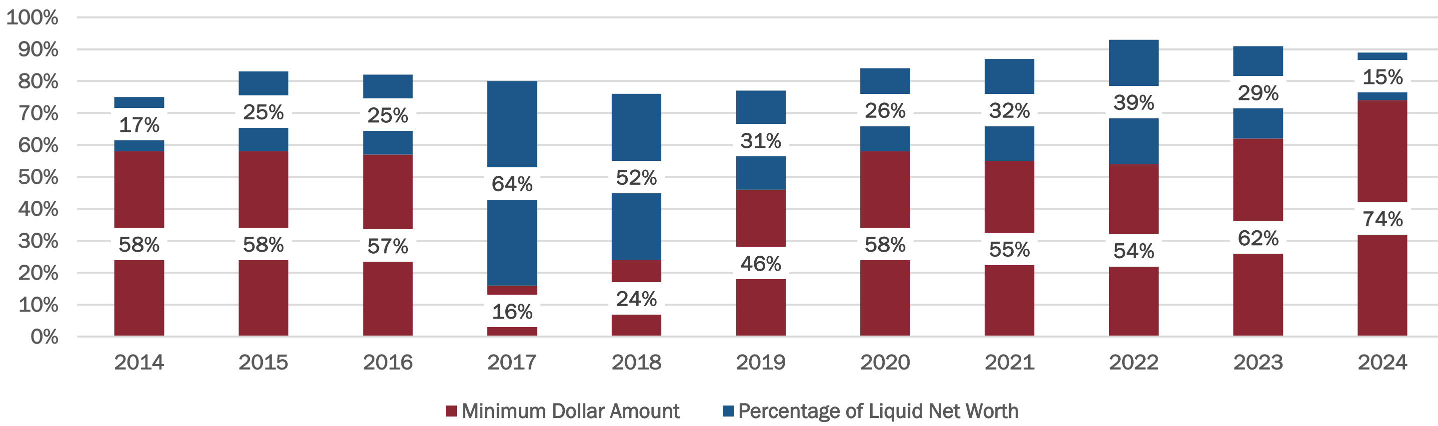
Seeders typically require a variety of consent rights in connection with making a seed investment. At their core, these rights should ensure both that the seeder's economic interest cannot be adversely impacted by unilateral action of the manager and that the manager cannot change the fundamental terms of the fund in a manner adverse to the seeder (particularly where the seeder is unable to "vote with its feet" on any changes by redeeming its investment). Many seeders - particularly institutional seeders - also ask for additional consent rights that relate to the operations of the manager's business (e.g., incurring indebtedness or launching new products). Seeders also typically request veto rights on certain issuances/sales of equity, both to ensure that the manager retains a minimum ownership of the business ("skin in the game") and also to prevent the manager from selling a piece of itself to a strategic or financial buyer without the seeder having an opportunity to consent to (and participate in) the transaction. Our review of data through our observation period suggests that consent rights, as a general category, remain a foundational part of any seed deal (appearing to some degree in virtually all transactions reviewed), and further that the scope of these consent rights remained relatively broad. The more popular of these consent rights include amendments of fund documents, liquidating or selling the business, issuing equity in the manager or changing the investment guidelines of the seeded fund.

While consent rights are commonly perpetual throughout the seed relationship, these rights sometimes expire after a certain period of time or upon the occurrence of certain events (e.g., following the first or second vintage, the end of the lock-up period or at the time the seeder's investment falls below a defined threshold amount). During our 11-year observation period, approximately 10%-25% of seed deals with consent features had many of these consent rights subject to expiration. Where these rights did expire, it was increasingly common for this to be keyed to the expiration of the lock-up or the investment period.

For more information on Consent Rights, see our HFM Week article "Consent Rights in Seed Investment Transactions", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy.



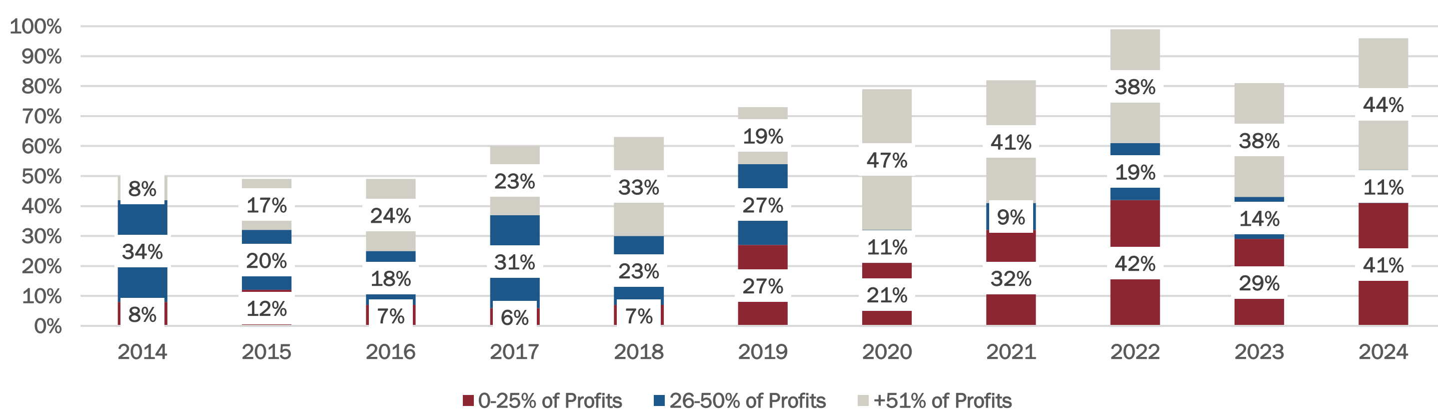
Key Person Investment Obligation



In addition to requiring that a key person retains a minimum amount of ownership and control of the business, seeders also require that the key person make and maintain significant investments in the fund, typically representing a significant portion of the key person's liquid net worth. As indicated above, this obligation may take the form of a specific dollar amount or a percentage of liquid net worth. Early in our observation period most seed deals involving hedge funds required the manager to invest a set dollar amount – an approach that had faded in recent years in favor of a percentage of net worth, but that has reasserted itself as the preferred approach in our 2019-2024 datasets (in part due to the certainty provided to seeders and managers alike). For private equity and venture capital seed investments, this concept is manifest in the minimum GP commitment to the fund, with seeders often seeking a GP commitment that is greater than the traditional 2% GP commitment.

Further, hedge fund seeders often require that the key persons reinvest a percentage of their after-tax profits to ensure that, as the key person's net worth increases due to the success of the business, the key person's economic exposure to the fund remains a significant portion of their liquid net worth. These requirements often build in some tolerances to accommodate the expense burden of the manager's business and therefore are often calculated net of ordinary business expenses (other than key person compensation). Minimum investment obligations remained a common part of seed agreements throughout the observation period; where featured, the most typical percentage was 51% or more of net profits, though as noted above this number generally takes into account certain expenses such that the effective percentage is often considerably lower.

Reinvestment Obligation



A New Role for Seed Investors: Enhancing Evergreen Fund Liquidity Via a Committed Equity Backstop Facility

Evergreen funds present a key solution to balance the benefits of access to illiquid investments while attempting to meet the liquidity preferences of investors. However, this balance becomes precarious during periods of net redemptions (i.e., when new redemptions exceed new subscriptions), which often force redeeming investors into liquidating accounts, frustrating the practical liquidity that these vehicles offer. A potential solution may exist by creating a structure that incentivizes strategic capital with a long-term mandate to backstop net redemptions with an equity subscription facility, offering substantial benefits for (i) strategic investors willing to assume this role, (ii) the third-party investors whose liquidity is enhanced, and (iii) evergreen fund GPs that will gain an advantage when marketing a more "truly liquid" product.

The proposed structure involves backstopping redemptions through an equity facility that is committed to fund new subscriptions to offset any periodic net redemptions. This mechanism not only enhances actual liquidity but also instills confidence among investors about their ability to redeem investments when needed, and therefore likely would constitute a significant advantage in the fund's capital raising efforts.

In return for providing a committed equity backstop facility, strategic investors would be expected to negotiate various economic benefits, such as revenue/profit sharing, highly reduced fees on facility capital that is funded, and/or requiring an economic haircut from investors who are receiving liquidity as a result of the backstop.

Critically, this approach requires regular guidance on the fair value of the fund's portfolio to ensure that all parties are treated fairly. However, these marks are already a feature of many evergreen structures and are likely going to be more accessible – faster and at cheaper rates – as valuation products become more accessible and artificial intelligence is broadly assimilated into valuation engines.

The proposed structure presents a real solution to the liquidity challenges faced during net redemptions. By leveraging long-term capital from strategic investors, funds can ensure liquidity, attract larger allocations and foster a more stable investment environment. The economic benefits and protections offered to these strategic investors further incentivizes their participation, making this a mutually advantageous arrangement. As the private fund landscape evolves, these structures could redefine how funds manage liquidity and growth, ultimately benefiting all stakeholders.

For more information about Seed Investments as a Backstop Facility, see our Private Equity Law Report article "A New Role for Seed Investors: Enhancing Evergreen Fund Liquidity via a Strategic Partner Backstop", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy.

Using Seed Investments to Stabilize a Portfolio

While the traditional role of seed investments has been as a capital formation tool for launching new investment vehicles, or, in certain situations, helping more mature funds "accelerate" their fundraising using a seed investment as a catalyst to attract a fresh look from large allocators, the recent market events surrounding the response to COVID-19 and other dislocations (both macro and secular) have suggested other roles that seed-type investments can play in the life cycle of a fund. For example, in periods of significant market volatility it is not unusual for smaller – but successful and established – managers to experience significant redemption requests as investors repurpose capital from their relatively liquid investments to support weaker areas in their portfolios and/or build a deeper cash cushion. This pattern has been observed over the years in sharp corrections and/or significant adverse macroeconomic events, and was widely reported to have played a role in the rescue of certain investment funds that had heavy exposure to the GameStop short-squeeze in early 2021.

In such circumstances, seeders are well positioned to make a "stabilizing" investment in the fund, such that the seed investment provides fresh and durational capital to (partially or fully) replace the assets being redeemed and/or restore to health the fund's leverage ratios. If timed correctly, the influx of capital could avoid – or at least mitigate – any need by the fund to (i) quickly liquidate investments (often at artificially low prices) to raise cash and rebalance its portfolio in anticipation of funding redemptions, or otherwise (ii) gate – or even suspend – redemptions altogether.

Because seeders are uniquely positioned to provide this sort of funding, it is expected that these investments would be structured similarly to conventional seed investments and on traditional seeding terms. From the seeder's perspective, such an investment has very compelling attributes, as the stabilization investment would be in support of an established business that already has an infrastructure and strong track record (all the more so if it held up well during the market upheaval), and presumably a proven history of successful fundraising. These factors would imply for the seeder a considerable de-risking of the classic seed investment thesis where so much is unknown and unproven, in addition to the seeder having a "free look" at the portfolio of the fund before actually investing, thus allowing the seeder to further manage its exposure.

Accordingly, these investments represent a very compelling opportunity for seeders and managers alike across the entire investment cycle of the markets and the life of the funds.

For more information about Stabilizing Investments, see our HFM Week article "Using Seed Investments to Stabilize Mature Funds in Liquidity Crunches", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy.

Seed Investments in Private Equity / Private Credit Firms

While most seed investments involve managers focused on liquid strategies (e.g., hedge funds and liquid credit-focused products), each year we also see numerous seed investments in private equity or private credit funds, a category of seeding that has been growing tremendously in recent years.

GPs of these investment vehicles are interested in obtaining a seed deal for largely the same reasons as hedge fund managers: a critical mass of AUM at the initial closing and the endorsement by a large allocator of the GP's strategy, track record, and team. However, because one of the core value propositions of a hedge fund seed deal – the lock-up – is implicit in any closed end fund structure given the long-term, illiquid nature of these vehicles, many GPs will resist conventional seed deal terms. In addition, from a seeder's perspective, private equity and illiquid credit vehicles have more complex economics (management fee stepdowns after the investment period, an often 5-10 year lag before the harvesting of carried interest, and the potential for clawbacks) and are not immediately scalable (these vehicles typically stop accepting subscriptions/commitments after 12 months or so and new vehicles with similar strategies often cannot be launched until a significant majority of the prior vehicle's assets have been deployed). Private equity GPs also often have leaner profit margins (at least until carried interest is generated), and therefore the seeder's economic rights are often weighted more heavily to long-term performance/carried interest amounts.

However, a seed investment remains an attractive tool as a catalyst for the initial closing of the fund, particularly given many large allocators have a preference to only invest with new GPs after a successful initial closing. Some structures can create near-term benefits for seeders and GPs alike, such as a seeder providing the capital for what will be a pre-launch warehoused investment that would ultimately be contributed to the fund as part of the seed investment – this approach provides a good opportunity for a seeder to get to know the GP as they work together to close the investment in the target, the seeder getting a "free look" at an investment that will be part of the portfolio, and the warehoused investment being a nice story around which the GP can orient its fundraising. Seed investments can also be used to finance part of the GP commitment to a new fund, particularly where the seeder is able to be included as part of the GP group; this has been observed as a trend in both seed investments and minority stake deals.

As noted above, seeding activity for private equity and private credit firms has been on an uptick for the past several years, both in respect of new seeders and private equity GPs considering seed investments, and we expect activity in this area to grow in the foreseeable future.

For more information about Seeding Private Equity and Private Credit Funds, see our Private Equity Law Report article "The New Trend in PE Fund Seed Investments, Unique Deal Features and Several Options for Seed Sources", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy.

If you have additional input that you would like to share with us, or have any questions, please contact your primary attorney in Seward & Kissel's Business Transactions Group.

The Business Transactions Group and partners have been widely recognized for our expertise in the industry by a number of organizations including but not limited to the following:

Recognitions:

Attorney Advertising. Prior results do not guarantee a similar outcome.

SEWARD & KISSEL'S SEED TRANSACTION DEAL POINTS

Hedge Funds, Private Equity and Private Credit

11th Annual Study

SEWARD & KISSEL LLP

New York
One Battery Park Plaza
New York, NY 10004
+1-212-574-1200

Washington, D.C.
901 K Street, NW
Washington, D.C. 20001
+1-202-737-8833

www.sewkis.com

The information contained in this newsletter is for informational purposes only and is not intended and should not be considered to be legal advice on any subject matter. As such, recipients of this newsletter, whether clients or otherwise, should not act or refrain from acting on the basis of any information included in this newsletter without seeking appropriate legal or other professional advice. This information is presented without any warranty or representation as to its accuracy or completeness, or whether it reflects the most current legal developments. This report may contain attorney advertising. Prior results do not guarantee a similar outcome.