

Recent Trends for Seed Investments in Private Equity Funds

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Over the last two decades “seed investment” transactions have arisen as an important capital formation strategy for alternative asset managers raising day-one capital. These transactions are essentially a “teaming up” of the asset manager and a large investor – often an institutional investor or one or more family offices – where the investor provides the initial capital base needed to anchor the asset manager’s first fund in exchange for economics in the asset manager’s business. While these transactions have historically been most prevalent in the hedge fund industry, over the last five or so years there has been considerable growth in the number of closed-end funds and private equity GPs that have been “seeded”, with industry feedback suggesting that this category of investment fund seeding is well positioned for significant growth in the short to medium term – and beyond.

In its most basic form, a seed deal is a large investment in the first fund of a newly established asset management business, where in exchange for the investment the seed investor receives not only the typical LP exposure to the fund’s investments, but further receives an economic stake in the fund’s GP. This GP stake is essentially granted to the seed investor for no additional consideration other than a willingness to be the GP’s anchor and first-close investor (and in certain circumstances providing other enhancements to the GP’s business and/or the fund’s offering).

The GP stake may be limited to economics in the fund that is being seeded, or it may be a more durable stake in the GP’s business going forward. Often the seeder is required to make follow-on investments in subsequent vintages to retain its full economic interest, and in some cases the seed investment is paired with working capital in the form of prepaid management fees, a loan or a direct balance sheet investment (this working capital, particularly where funded prior to the first close, provides the GP with essential capital to attract and retain high-caliber talent, facilitating an institutional quality offering for the GP’s target investors). Other value provided by the seeder may include deal sourcing, diligence and execution assistance, as well as enhancing the GP’s credibility among potential portfolio investment targets with whom the GP may be negotiating a potential acquisition or other investment.

While seeders of liquid products like hedge funds have generally received top-line economics in the form of a gross revenue share, seed investments in private equity funds most typically involve the GP stake bearing a portion of the operating expense burden of the GP, particularly where the margins of a new GP are expected to be quite thin. There are a number of ways seeders can bear their share of these costs, whether through a bottom-line interest, limited participation in management fees (in favor of full economics in the carry), and/or a mix of deferrals and hurdles applied to the headline seeder economics.

The rationale for structuring a deal as a seed investment versus a traditional anchor investment (which would not include a GP stake) often has much to do with the relative leverage points between the new GP and its day one capital sources. Simply, a large investor may be more willing to invest capital with an unproven GP if they are receiving a “sweetener” to do so, and a GP who might otherwise struggle to raise capital may find the economic tradeoff of a seed investment compelling if it otherwise would likely be unable to successfully launch its own firm – the classic view that “it is better to have a share of something than all of nothing”.

Other GP benefits from a seed investment can include using a portion of the seed investment to warehouse an initial portfolio investment for the new fund, thus seasoning (to a degree) the new GP’s offering and further providing a successful “test-case” transaction to market to other investors. Having the backing of a prominent institutional investor and one or more warehoused portfolio acquisitions can help push reluctant investors to move forward – thus providing significant support to the capital raising efforts of the GP.

GPs who successfully source seed capital receive the benefit of a significant day one investor (providing a capital base for the fund and an inherent “good housekeeping seal of approval” from a prominent name) and greater certainty that its first vintage will successfully launch.

Rather than taking an ownership stake directly in the GP, a typical seed investment is structured as a special interest in the fund itself (in addition to the seeder’s LP interest). This structure creates positive tax attributes for both the GP and the seeder, while providing a degree of risk mitigation for the seed investor (as the seed investor is able to avoid being a partner in the GP). This approach also provides for greater operational autonomy for the GP, ensuring that, while the seeder has robust protections for its investment (both in the fund and in the overall economics of the GP), the seeder’s relationship is fundamentally a passive one. Nonetheless, the seeder would generally be subject to carried interest clawbacks and similar terms to the same extent as the GP.

A typical private equity seed deal incorporates a dozen and a half or so categories of terms which exist to protect and align the parties. These categories include:

- terms related to the GP’s capital commitment to the fund (including any alterations to standard fee terms or adjustments to the calculation of carried interest),
- the terms of the fund itself, certain rights in connection with key man events (such as an automatic termination of the investment period in certain highly adverse circumstances),
- the seeder’s core economic benefits,
- capacity rights (in respect of successor funds),
- most favored nations rights,
- consent rights,
- LPAC rights,
- information rights,
- transfer rights (both in respect of the seeder’s interests as an investor and its economic interest in the GP),
- co-investment rights (often including over-allotment rights), and

- restrictive covenants and tail economics (which restrict a GP's ability to deprive the seeder of its economic rights through legal/structural machinations).

While the scope of these terms is subject to significant variability based upon the needs of the applicable GP and seeder and their relative leverage, at this point – borrowing from the very mature hedge fund seeding arena – the range of reasonable outcomes has generally been identified by the market and equilibriums have been established.

It is reasonable to expect that the continued growth of private equity seeding transactions will have very positive effects on the industry as a whole, as well as considerably strengthening the offerings of new GPs that attract one of these investors.

If you have any questions regarding the foregoing, please contact your primary attorney at Seward & Kissel LLP.