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SEEDING

The New Trend in PE Fund Seed Investments, Unique Deal Features and Several Options for Seed Sources

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For the past 10-15 years, alternative asset managers have raised day-one capital by pairing with large investors – often an institutional investor, or one or more family offices – in "seed investment" transactions for the initial capital needed to stake their new funds. Those transactions have historically been quite popular but have been most prevalent in the hedge fund industry.

In recent months, however, an increasing number of institutional investors have been exploring broadening their seeding mandates to include closed-end funds and GPs of PE funds. Large financial institutions have also signaled that they will pursue seeding PE as a new business line. Further, industry data suggest many of those new entrants are primarily considering structuring their investments as true seed deals, as opposed to more traditional anchor investments.

This article explores the difference between seeding and anchoring investments, while identifying key terms and structuring considerations for seed deals. The article goes on to identify several sources of seeding opportunities, as well as the attendant benefits and issues associated with each.

See our two-part series on a Seward & Kissel study examining key terms in seed deals: "Structuring the Seeder's Interest, Key Person Covenants and Lock-Ups" (Oct. 12, 2017); "Consent Rights, Indemnification and Manager Buyout Rights" (Oct. 19, 2017).

Seed Capital Versus Anchor Capital

In its most basic form, a seed deal is a large investment in a newly launched fund that, in most cases, is managed by a new GP. Seed investors are similar to anchor investors in that both receive typical LP exposure to a fund's investments and additional fund-level rights for their investments (*e.g.*, capacity rights in future products, most favored nation (MFN) provisions, etc.). The primary difference from anchor investing, however, is that a seed investor also receives an economic interest in the GP's business.

For more on MFN provisions, see "Seward & Kissel Study Finds Reduced Fees and MFN Clauses Remain Most Prevalent Side Letter Terms" (Oct. 15, 2017); and "How Fund Managers Can Accommodate Heightened Investor Demands for Bespoke Negative Consent, Liquidity, MFN and Other Provisions in Side Letters" (Oct. 13, 2016).

The GP stake is generally granted for no additional consideration other than a willingness to be the GP's initial strategic backer (and, in certain circumstances, to provide other enhancements to the GP's business or the PE fund's offering). Further, while the economic right in the GP may be limited to the fund being seeded, it can also be structured as a more durable stake in the GP's business with an accompanying requirement to support the GP's future products.

The rationale for structuring a deal as a seed investment versus a traditional anchor investment is rooted in the relative leverage points between the new GP and its day-one capital sources. Simply, a GP that might otherwise struggle to raise capital may find the economic tradeoff of a seed investment compelling if it otherwise would be unable to launch its own firm – the classic view that "it is better to have a share of something than all of nothing".

In addition to providing greater certainty to the GP that its new vehicle will successfully launch, seeders often provide other enhancements that a typical anchor investor would not, including:

- working capital, which can be structured in various economically advantageous ways for the seeder;
- deal sourcing;
- diligence assistance; and
- execution assistance.

GPs can also benefit from using a portion of a seed investment to warehouse an initial portfolio acquisition for the new fund, thus seasoning (to a degree) the new GP's offering and providing a successful "test-case" transaction to market to other investors. When coupled with the inherent "Good Housekeeping seal of approval" from a prominent institutional investor, this can help push reluctant investors to move forward and significantly support a GP's capital-raising efforts.

For more on GP staking for mature PE sponsors, see "Legal Issues With Minority Stake Transactions: Negotiation Points for Both Parties and Key Conflicts of Interest to Avoid (Part One of Two)" (Jul. 23, 2019); and "Selling Minority Stakes in PE Firms: Recent Trends and Structural Considerations (Part One of Two)" (Apr. 2, 2019).

Structure and Key Terms of Seed Deals

Rather than taking an ownership stake directly in the GP, a typical seed investment is structured as a special interest in the underlying PE fund itself – in addition to the seeder's LP interest. That structure creates positive tax attributes for both the GP and the seeder, and it also provides a degree of "headline" risk mitigation for the seed investor by avoiding being a partner in the GP.

The approach also provides greater operational autonomy for the GP, thus ensuring the seeder's relationship is fundamentally a passive one, despite it receiving robust protections for its economic stake in the GP. Nonetheless, the seeder would generally be subject to carried interest clawbacks and similar terms to the same extent as the GP.

See "How Carried Interest Clawbacks Preserve Investor Returns and Affect Taxation (Part Two of Two)" (Jun. 11, 2019).

As with any investment, a seed deal contains standard economic terms and general terms for the underlying fund term (*e.g.*, key person provisions). Typical seed deals, however, incorporate many other categories of terms to protect and align the parties, including:

- the GP's capital commitment to the fund, including any alterations to standard fee terms or carried interest calculations;
- capacity rights for successor funds;
- MFN rights;
- consent rights;
- LP advisory committee rights;
- information rights;
- transfer rights for both the seeder's interests in the fund and the GP;
- co-investment rights;
- restrictive covenants and "tail" economics to prevent a GP from depriving the seeder of its economic rights through legal or structural machinations; and
- exculpation/indemnification provisions.

The scope of those terms is subject to significant variability based upon the needs of the applicable GP and seeder and their relative leverage. At this point, however, the range of reasonable outcomes has generally been identified by the market and equilibriums have been established based on precedents from the very mature hedge fund seeding arena.

See "LPAC by Design: Six Recommendations for GPs to Define LPAC Features During Fund Formation" (Feb. 25, 2020); and "Affiliate Versus Third Party Debate and Other Topics in Transfer Right Provision Negotiations" (Jul. 16, 2019).

Seeder Economics: Top Versus Bottom Line

While seeders have historically insisted on top-line economics in the form of gross revenue shares, in recent years they have shown willingness to bear a portion of the operating expense burden of the business to better align their interests with those of the GPs they seed. That is particularly the case in PE seeding, where a new GP's margins of are typically quite thin – particularly where a management fee step-down occurs before a GP can raise its next fund.

See "Investors Demand Variations to PE Management Fees and Distribution Waterfalls (Part One of Two)" (Apr. 16, 2019).

There are a number of ways seeders can bear their share of those operating costs, but most often, that is achieved through deferrals of, or hurdles to, the seeder's economic participation. Alternatively, some seeders are willing to agree to a bottom-line economic participation, with certain protections against a GP reducing its profitability by artificially overpaying GP owners. In addition, some seeders will consider limiting their participation to only a share of the carry.

Other seeders address the lean, early years by offering the GP working capital support. This support can be structured in a number of ways, such as:

- an outright capital infusion;
- prepayment, or overpayment, of management fees; or

- provision of a working capital loan, which is often repaid out of the revenue share in a manner economically similar to a direct equity investment in the GP.

While the amount of capital support varies from deal to deal, it is not uncommon for it to represent a significant amount of the GP's initial operating budget. That allows the GP to build a more stable and institutional quality business from inception.

See "Emerging Managers Need Appropriate Infrastructure – Not Only Solid Performance – To Attract Investors" (Feb. 25, 2020).

Traditional Sources of Seed Capital

Unsurprisingly, seed investments are often highly coveted by emerging GPs. Given the extraordinary tailwinds that can follow from a GP being recognized by a highly sophisticated and significant investor as a likely new PE star, GPs are keenly interested in identifying the traditional ways to procure seed investments.

See "How Emerging Managers Can Raise Capital in a Challenging Market Without Overstepping Legal Bounds" (Aug. 4, 2016).

Former Employers

Perhaps the most obvious way to source a seed investment is looking to the new GP's historical employer. This model was perfected in the hedge fund industry by Julian Robertson's Tiger Management, resulting in a large stable of seeded managers known colloquially as "Tiger Cubs."

The same path may be available in PE as a significant percentage of founders of new GPs in any given year are former investment team members of prominent PE firms who have decided to launch their own firms. Where the principals of the employer are willing to put real support behind that move, structuring the ongoing relationship as a seed investment in the new fund can provide a tremendous benefit to the new GP and the former firm alike.

Aside from the investment itself, there are several other unique benefits that GPs can realize from having former employers as their sources of seeding:

- the implication that those persons who best understand the new GP's investment capabilities are willing to continue to bet their money, with less oversight, on the GP;
- permission to use the new GP's historical track record, which can help optimize outreach to new investors;
- waiver of non-compete, non-solicit and similar restrictive covenants on the new GP; and
- direct or indirect support for the new GP's outreach to historical investors in the employer's fund.

See "How NY-Based Investment Managers Can Craft Enforceable Non-Competes That Do Not Provide for Post-Employment Compensation" (Nov. 19, 2019); and "Portability and Protection of Private Fund Investment Track Records" (Nov. 10, 2011).

Also, the seeding arrangement can be structured to highlight the continuity of the former employer and the new PE fund to reassure prospective investors. For example, a fund may reach the end of its term with a portfolio investment ill-suited for a liquidity event. An investment team member interested in continuing to shepherd the portfolio company could use it as a warehoused deal for a new PE fund, thereby allowing the old fund to be wound up. That would, of course, require the blessing of the former employer and the existing fund's LPs, while potentially cashing out certain of the LPs that are interested only in a return of their remaining capital.

The above approach can be especially compelling for a former employer that has reduced its focus on launching new funds by allowing it to retain access to the investment prowess of its former investment team. That enables the former employer to maintain exposure to the asset class and industry that was historically very lucrative, as well as further monetize the goodwill developed while it operated its business. Specifically, by presenting the new GP as a partial continuation of the former business, the former employers can convert goodwill into tangible value that would otherwise disappear upon closing the firm.

Institutional Seed Investors

Another primary source of seed capital is institutional investors with launched pools of capital – often themselves structured as PE funds – to pursue seeding opportunities.

Despite historically pursuing more liquid products (in particular, hedge funds), in recent years institutional seeders have seeded less-liquid products. Aside from traditional PE funds, they have also seeded open-end funds with significant liquidity restrictions (*e.g.*, lock-ups and gates that replicate PE-liquidity structures) and credit-focused funds (including collateralized loan obligation managers) that often are illiquid for five years or more.

See "What Must a PE Sponsor Consider Before Launching a Private Credit Strategy? (Part One of Two)" (Feb. 4, 2020).

Moreover, several prominent institutional seeders – including bank and non-bank financial institutions – have recently indicated that they plan to either broaden their mandates to seed GPs' new PE funds or to launch standalone businesses to pursue those transactions. In fact, some have done so already.

Spin-Outs

Another area ripe for seed investment transactions involves former executives or business development professionals at operating companies seeking to orchestrate spin-out transactions of businesses or divisions of their employers as part of their strategy to launch a PE business. With those transactions, the existing employer would typically retain an interest in the business being spun out to preserve upside exposure, while also de-risking its exposure to the business by partially cashing out its stake.

While such a transaction is certainly not an unusual way to begin a new GP, providing the operating company with a residual share of the GP's economics can be a compelling way to secure its support while also mitigating the risk of potential "seller's regret." Needless to say, those transactions present a number of conflicts of interest, although the issue is well known and can be comfortably addressed through a combination of disclosure, third-party valuations and other techniques.
See "ACA 2017 Fund Manager Compliance

Survey Addresses Investment Allocations, Conflicts of Interest and Valuation (Part Two of Two)" (Feb. 1, 2018).

Family Offices and Other Opportunistic Seeders

Other sources of seed capital are more opportunistic in nature. For example, family offices have seeded new GPs with which they have worked on other transactions – including a number of GPs who were formerly investment team members of firms to which the family offices had historically allocated capital.

Likewise, other seeding opportunities arise from syndicates of investors who collectively provide seed capital, as well as other opportunistic investing groups that seek to enhance their overall investment return through an economic interest in a GP.

Conclusion

As firms that receive seed capital often outlast and outperform their non-seeded peer set, it is reasonable to expect that an influx of PE seeding transactions will have very positive effects on the industry as a whole and will particularly strengthen the offerings of new GPs.

See "Panel Details Benefits, Tax Considerations, Common Structures and Terms of Seed Deals" (Jan. 26, 2017); and "Trends in Private Fund Seed Deals, Governance, Succession, Estate Planning and Tax Structuring (Part Two of Two)" (Oct. 2, 2014).

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