Using Seed Investments to Stabilise Mature Funds in Liquidity Crunches

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Traditionally, the role of a seed investor is to provide day-one capital to promising new managers who appear poised to quickly assemble and deploy significant amounts of assets in favourable market environments.

Conversely, during times of major market dislocation, seeders tend to preserve dry powder, waiting for market conditions to settle before making new seed investments.

However, this approach may overlook the considerable opportunity to deploy capital into mature but distressed funds in seed investment-like transactions during chaotic market conditions (such as the current Covid crisis) – an opportunity that can well-reward seed investors who are able to move quickly and dynamically when others are unable – or too timid – to act.

With market tumult reaching extremes in mid-March 2020, many LPs have found themselves facing significant financial pressure as they search for cash to plug holes in their portfolios.

This stress is even greater for those LPs facing margin calls, breaching financial covenants, or struggling to maintain solvency.

Drawing upon the investment management industry's experience in 2008-9, these pressures can result in investment funds that are relatively liquid being used as "piggy-banks" for LPs that need cash to reallocate to the distressed portions of their portfolios.

Perversely, the effect of this behaviour can be most acute for funds that have performed relatively well versus their peers, but whose inherent liquidity makes it a capital source of first resort.

For example, in the 2008-9 cycle, there were many funds that strongly outperformed the market – often being down only low-single digits or even flat – but still experienced levels of redemptions that effectively sounded their death knell (as redemptions forced these funds to liquidate positions to finance these redemptions, resulting in a vicious cycle of more liquidations in an attempt to avoid concentrating illiquid and less-liquid positions).

For funds that find themselves in this unfortunate situation, procuring an injection of fresh capital to stabilise their capital base and allowing them to maintain a balanced portfolio becomes a primary goal.

Seed investors – whose business already entails allocating $50m, $100m, or even greater amounts as LP capital – are uniquely positioned to fill this need for funds that are otherwise at risk of imploding through no fault of their own.

Stabilisation investments are a new tool to provide an essential lifeline for investment funds in distress

While an investment to stabilise a fund could be considered an evolution from a classic seed investment (although, such a transaction would share many qualities with an "acceleration" investment, which is essentially a seed investment for a post-launch fund that is made as a catalyst for fund-raising growth), there are many attributes that would make such an investment compelling and well within a traditional seeder's mandate.

Structurally, a stabilisation investment would likely be a large LP investment enhanced by seed-type economics, and therefore would mirror the core attributes of a seed deal (other than the point in the fund's life cycle that the investment is made).

However, because the investment would be in a fund managed by a manager that already has a proven track-record, the seed investor can better evaluate its potential returns.

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Moreover, these investments would be in funds whose manager has already built an infrastructure and demonstrated an ability to raise capital and run a business – critical considerations when evaluating a candidate for a seed investment.

These factors are widely considered the core of an optimal seeding opportunity, and in a stabilisation investment, the seeder would have the opportunity to get a "free look" at each factor, implying a substantive de-risking of the investment.

That the seed investor would be able to analyse a fully constructed portfolio as part of its investment diligence (which portfolio may well be valued at a discount based upon the market conditions that created the opportunity) – as opposed to investing in a blind-pool – simply adds to the risk mitigation. And, given the current difficulties in conducting traditional on-site due diligence, investing with a better-known and more mature manager becomes even more important.

Managers can expect that a stabilisation investment would be conditioned on the seeder being granted economics in the manager's business, similar to conventional seed deals.

While any variance from traditional seed economics (ie, a roughly 20% top line revenue share) will be based upon the risk/return profile and relative leverage points of the transaction, the structure itself of a passive, special limited partnership interest in the fund(s) through which the seeder receives its entitlements should remain the paradigm (which will require modest amendments to the existing governing documents of the fund).

As timeliness will be essential to achieve the rationale for these transactions, it should be expected that seeders will seek to make these investments on terms consistent with (and likely in many cases mirroring) the terms used in traditional seed investments.

Stabilisation investments are a new tool to provide an essential lifeline for investment funds in distress and, for seeders, expand their traditional opportunity set across the entire market cycle.

While seed investments have shown themselves over the last several decades to provide a compelling balance of managed risk on the fund investment and a venture capital return profile on the seed economics, a stabilisation investment can harness this as well with the corresponding de-risking that comes from investing in a known quantity

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