OPALESQUE

newmanagers

Opalesque's Emerging Manager Monitor

ISSUE 06 • June 2012

How do seed deals impact on fund raising for new hedge fund managers?

The Fundana series discusses investments in Emerging Managers, derived from the real world experience of the Fundana team. Fundana is the investment advisor to several Funds of Hedge Funds and directs around half of its new investments to Emerging Managers. The investment process typically involves allocating a small amount Day 1 or Early Stage (within the first year after the fund's launch) to new managers who have strong pedigrees.
The objective of this series of articles is to share thoughts around our key observations. It does not aim to be "statistically significant" but to create a dialogue around those observations.

This article *from Nick Morrell* looks at one of the key non-investment decisions that a new manager faces prior to launch:

"Should I look for a seed deal?"

The seed deal landscape has changed significantly over the last decade. In the years leading up to the financial crisis the seeding business was relatively idiosyncratic, with money coming from within the industry as well as a small number of institutional seeders. Players in the space included Reservoir Capital and Protégé Partners, as well as Julian Robertson with his "Tiger Cubs". A number of other hedge fund legends also seeded spin-outs or other new launches such as Chris Shumway (Shumway Capital), David Einhorn (Greenlight Capital) and Jim Simons (Renaissance Technologies).

Since 2008 there has been an institutionalization of the seeding business, with a stronger focus on the large private equity-style funds which have been set up to seed new hedge fund managers. The quantity of capital available has meant that these businesses are often fighting to seed the best managers. The big players in this space include Blackstone, Goldman Sachs, Reservoir and Protégé.

What's the (big) deal?

Every new manager looking at accepting a seed deal will be playing off two factors: how big is the seed deal investment in the fund; and how much of the profits they will have to give up to the seed investor. Typical seed investments range from $20-200m (the average is $87m for those managers in our database) and involve giving up 20-50% of the economics of the business, with the more favourable deals going to those managers with the strongest pedigrees.

Whilst a seed deal clearly helps managers to set off on the right foot, this article looks at how seed deals are perceived by other investors – in other words, does a seed deal help or hinder a new manager to raise external AUM.

In a later article in this series we will develop this theme further, looking at the impact of seed deals on the mindset of the managers to pose the question: "Does accepting a seed deal impact on performance?"

As usual, we will focus on small and mid-sized launches (typical Day 1 assets under management ("AUM") of between $20m and $500m). The dataset has been compiled from all the new investments made in our Funds of Hedge Funds since January 2006, encompassing 69 Day 1 / Early Stage investments in the Long/Short Equity, Global Macro and Event Driven strategies, of which 57 have been operating for more than one year as of the end of April 2012.

Q1. How does a seed deal affect the ability to attract external AUM at launch?

Here we will analyze all funds in our database to determine whether managers who use seed deals find that this is useful for attracting further assets at launch. For this we will look at external AUM raised at launch which is total AUM less seed deal and the manager's personal investment. Looking across all time periods, Table 1 suggests that those funds which have a seed deal (37 funds in our database) in place are twice as likely to launch with less than $25m from other investors than those with no seed deal (32 funds).

External AUM raised Day 1	With seed deal	No seed deal
<25M$	62%	31%
25-50M$	8%	28%
50-100M$	16%	13%
>100M$	14%	28%

Table 1: External AUM raised at launch

As in previous articles, we will also analyse the same data split between two time periods: the first period runs from January 2006 to July 2008, hence before the industry crisis; and the second period runs from August 2008 to date. Table 2, below, compares the same data as for Table 1, but split across the two time periods.

External AUM raised Day 1	With seed deal		No seed deal	
	Pre-crisis	Post-crisis	Pre-crisis	Post-crisis
<25M$	33%	81%	0%	46%
25-50M$	13%	5%	50%	18%
50-100M$	27%	9%	0%	18%
>100M$	27%	5%	50%	18%

Table 2: External AUM raised at launch split between pre-and post-crisis time periods

This temporal split highlights two key trends:

- First, prior to the crisis, a seed investor had more than 50% chance of being accompanied by significant (>$50m) Day 1 external capital (54% vs. 46%). Since the crisis, almost all managers taking seed deals are launching with no other significant external capital (86% vs. 14%).

- Second, for those managers without a seed deal, prior to the crisis all managers launched with at least $25m, with half of these raising more than $100m. In contrast, since the crisis almost half of the managers launched with less than $25m of external capital and just 18% had more than $100m.

Q2. How does a seed deal affect the ability to attract additional assets during the first year?

Whilst Day 1 assets are clearly important, the long-term viability of a hedge fund can be better assessed by looking at asset growth over time. This second analysis looks at the same group of hedge funds (excluding those which have not yet reached their first anniversary) and reviews how AUM has changed.

Tables 3 shows the AUM growth of all funds over the first year of operations (adjusted to exclude performance gains), split between those funds with (27 funds) and without (28 funds) a seed deal. This suggests that there is no significant difference in ability to raise additional assets in the first year.

Increase in AUM in Y1	With seed deal	No seed deal
<0%	**11%**	**7%**
0-100%	44%	32%
100-200%	22%	25%
200-400%	15%	25%
>400%	7%	11%

Table 3: Increase in AUM in first year

Table 4 again shows the same data, but split between pre- and post-crisis time periods.

Increase in AUM in Y1	Pre-crisis		Post-crisis	
	With seed deal	No seed deal	With seed deal	No seed deal
<0%	15%	10%	7%	6%
0-100%	23%	10%	64%	44%
100-200%	23%	30%	21%	22%
200-400%	31%	40%	0%	17%
>400%	8%	10%	7%	11%

Table 4: Increase in AUM in first year split between pre-and post-crisis time periods

The key observation here is that post-crisis a lot fewer funds significantly increase their AUM during the first year. As highlighted in Table 3, whether the manager has taken a seed deal or not does not seem to have a major impact on ability to increase assets during the first year, across both time periods.

What conclusions can we draw from these results?

The first conclusion is perhaps the most obvious – since the 2008 crisis fundraising has become significantly more difficult.

Anecdotal evidence suggests that securing a seed deal can be extremely time-consuming for a new hedge fund manager. Particularly in the post-crisis environment, it is perhaps unsurprising that new launches with a seed deal often have little other capital at launch, as the manager either does not have the time or the contacts to fund raise effectively from seed investors and other potential external investors at the same time.

But our analysis does highlight that there are managers who are still able to raise significant assets at launch without a seed deal. Our experience suggests that these managers typically have one of two things to help them: either they have an extremely strong hedge fund pedigree (such as Joshua Berkowitz of Woodbine Capital who had previously worked for Soros and SAC); or they have the backing of one of the large investment banks (such as Pierre-Henri Flamand of Edoma Capital who had previously been running the prop desk at Goldman Sachs Principal Strategies).

Outside of these successful launches, it is also clear that post-crisis many new managers are facing a stark choice: they can either accept a seed deal and give away a significant percentage of their business; or they can launch small and try to build a track record and attract investors in that way.

Nick Morrell
Head of Operational Due Diligence and Chief Risk Officer
Fundana SA
www.fundana.ch