Buy-out provisions in seed transactions

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Although the typical hedge fund seed investment provides for perpetual seed economics (rather than phasing out or terminating after a certain period of time), seed transactions often provide the manager with a buy-out right to allow the repurchase of full ownership and control of the business. Key considerations related to these buy-out provisions include timing, scope, and, of course, pricing and payment details.

Timing is a key consideration with any buy-out right, as a seeder will want to ensure the business has had sufficient time to scale and become highly valuable before it is required to sell its stake. Accordingly, from the seeder's perspective, it is important to ensure that a buy-out right is exercisable only after the business has had a chance to mature; otherwise, the buy-out price may not adequately capture the potential of the business.

Another important aspect of timing is the period during which the manager may exercise any buy-out right.
The manager will prefer maximum optionality in its ability to exercise a buy-out right (for example, an evergreen annual – or more frequent – exercise right), whereas the seeder generally prefers that any buy-out right be exercisable once, and then only for a limited period. Sometimes the parties strike a balance on this point and provide for a series of buy-out rights based on various time periods or escalating AuM thresholds.

Of course, even if no longer exercisable, the parties can always agree to a transaction outside of a contractual buy-out.

One of the primary benefits of a buy-out is reclaiming full ownership and control of the business, and so a partial purchase may not achieve the desired results. A seeder is likely most covetous of retaining its economics in a scenario where the manager, which should understand the prospects of its business better than anyone, is willing to concentrate its exposure to the business.

The vast majority of buy-out rights use a formulaic approach for valuation, although it is possible to base pricing on an appraisal by a neutral valuation expert (but this entails extra costs and may be viewed by some as more subjective than a formulaic test).

The most common formula is a multiple (typically 4x or 5x) of average annual payments made to the seeder in the trailing 12/24/36 months. This pricing methodology serves to smooth out chunkiness and volatility in fund performance (and the related irregularity of incentive compensation).

However, from the seeder's perspective, if the business is improving and there are near-term catalysts for additional profitability, this hindsight-biased method may produce a lower buy-out price versus a multiple based on run-rate revenue.

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Another option to price a buy-out is based on a percentage of AuM. This option can take the place of the multiple-based approach, or it can serve as an additional test (such that the seeder would receive the greater of the buy-out price calculated under either method).

This method is particularly protective of seeders when a buy-out right is exercised at a time in which there has recently been weak performance but a bullish outlook for the fund's investors, and further carries an implicit run-rate benefit.

In addition, tax considerations will play an important role in determining the form of any buy-out payment. Because a simple buy-out would require the use of the manager's post-tax dollars, alternative buy-out structures are sometimes considered, although such structures raise the possibility of distortive tax or economic effects.

There may also be accrued but unearned incentive compensation at the time of the buy-out, in which case the seeder will often receive its economics at the end of the relevant performance period based on the lesser of, first, the amount of accrued incentive compensation at the time of the buy-out, and second, the incentive compensation actually earned at the end of the performance period in which the buy-out occurred.

While parties to a potential seed transaction are focused on a long-term business relationship, it often makes sense to consider when and how to potentially part ways in the future through a manager buy-out right.

When doing so, care should be given to the timing, scope and pricing details of any such right in advance.

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