Working Capital in Hedge Fund Seeding

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Launching and running an alternative asset management business is becoming increasingly difficult without scale and dependable cash flow. Fledgling managers are under great demands because of heightened regulatory obligations, a competitive capital-raising environment and the need for institutional-grade infrastructure. They often seek seed investments to establish their businesses and provide tail-winds for long-term success.

Today's seed deals increasingly contain working capital support (in addition to large fund allocations) to allow the manager to build a competitive business. Great care is required in structuring any working capital component to ensure optimal tax and economic outcomes.

There are two main approaches used to provide working capital: (i) a direct infusion, or (ii) a suspension of the seeder's revenue share. Seeders can provide a direct infusion of capital by making a direct equity investment in the manager, prepaying management fees, or providing a loan facility.

Historically, direct equity investments were the primary means of providing working capital support.

However, this arrangement has fallen out of favour for a number of reasons, including the perception of increased regulatory scrutiny, enhanced reputational harm if the manager engages in bad acts, a loss of anonymity for the seeder and a loss of autonomy for the manager.

Other approaches, such as prepaying management fees, are more viable. As seed investments are almost universally subject to a multi-year lock-up, pulling forward all (or some portion) of the future management fees gives the manager much-needed working capital while not requiring seeders to deploy additional funds.

However, when using this structure, care should be employed to match the timing of prepaid fees with expenses, as any prepaid fees not offset by deductible expenses will generally be taxable.

Another capital infusion technique that has become popular is a loan facility that can be drawn down as needed. While these can be structured as "true" loans (the repayment of the loan is additive to the seeder's revenue share), a more popular approach is for an amount of the manager's revenue that would otherwise be subject to the seeder's revenue share to instead be characterised as a loan repayment until all principal and interest is repaid.

Loans are repaid with after-tax dollars (the repayment is not deductible), although the manager can often mitigate (or neutralise altogether) the tax impact by using the expenses/losses it incurred when spending the loan proceeds in the first instance.

From a tax perspective, these arrangements can be very desirable for seeders because the amounts received as loan repayments are generally tax free, while revenue share payments are fully taxable. Further, unlike prepaying management fees, this approach does not require the manager to sacrifice predictable management fee income generated during the lock-up period.

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While capital infusions provide the manager with an immediate "war chest", another way seeders provide working capital support (especially for managers with less capital-intensive business models) is a revenue share offset. Under this paradigm there is no infusion; the revenue share economics are adjusted for a finite period such that no revenue share is due until the manager has achieved an agreed-upon level of revenue (typically determined based upon the manager's pro forma operating budget).

Seeders favour this model because it eliminates the need to provide up-front working capital that is subject to risk not directly correlated with the fund's investments.

The main structuring consideration for revenue share offsets is whether to include a "catch-up" provision, whereby once the target revenues are achieved, the seeder's revenue share percentage would be increased until the seeder earns back the revenue share amounts it would have otherwise received.

For managers who do not necessarily need upfront capital, but would benefit from a longer runway post-launch, this model eliminates the tax and budgeting risks associated with other arrangements, while still aligning incentives and allowing them to focus on business growth.

For seeders, a revenue share offset feature can be used to negotiate lower fees, enhancing the overall return profiler. Due to the current realities of the alternative asset management business, the majority of recent seed deals contain some form of working capital support. And this option is expected to grow in popularity.

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