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Capital concerns lay seeds for incubators

But there's more of them, so terms are getting better

writes Barry Cohen

The flow of assets into new hedge funds is on the increase, and more and more innovative – and even esoteric – strategies are popping up all over the industry. But emerging managers are paradoxically finding it harder than ever to raise money. If you don't have the pedigree and track record of a William von Mueffling or an Eric Mindich, it's a struggle. "This is the most difficult environment for raising capital that I have ever seen," says Bob Leonard, head of global capital introductions at Credit Suisse First Boston.

As a result, many new funds are looking at incubators for seed capital – despite past complaints regarding the tough terms they demand. Regulatory changes and disillusionment with prime brokers' capital introduction services are also sending fledgling managers into the arms of incubators. On the flip side, there's a proliferation of incubator firms, making it possible for new managers to negotiate better terms than a few years ago.

"We have more opportunities today than we have ever had, because there are more managers looking for money than ever before," says Mazen Jabban, the chief executive of Focus Investments, a New York-based incubator. "As the number of new, but unknown, managers grows, it's harder for them to gain attention. And, in the first two years, the manager is going to be under the radar screen for institutional investors."

All too frequently, start-up managers are driven by the media hype that the hedge fund industry is an unstoppable juggernaut that devours an enormous stream of investor capital. The truth is that while there's more money for new funds, overall investment flows into hedge funds have slowed, which has turned the landscape for raising assets into a highly bifurcated one. A handful of star managers, with blue-chip reputations and exemplary track records, can raise billions of dollars relatively quickly and enjoy the luxury of closing their new funds practically on day one. But others are having more difficulty.

"Many good managers looking for seeding today could have probably raised money on their own just two years ago," says Mark Jurish, chief executive of the incubator firm, Larch Lane Advisors.

And some hedge fund managers who initially avoided going the incubator route now see its virtues. One who started off with only $1 million of her own money in the late 1990s, now thinks she should have turned to an incubator at the outset. After spending a great deal of her capital, she still had only managed to raise $5 million. At that point, she turned to a well-known incubator who provided two tranches of $20 million each in return for a 49% stake in the firm over a three-year period. This volume of capital, combined with good performance, enabled her to grow the fund to $300 million in assets.

"The great danger lies in making deals with incubators just to get going," she says. "But hedge funds should be funded for a minimum of two to three years worth of working capital so that they don't have to worry about trading into the budget."

Because so many start-up managers want to build an institutional quality business to attract the big pension funds and funds of funds, they need sufficient capital to create an adequate infrastructure as well as critical mass. Whereas the recent mantra that $100 million in assets was the necessary minimum to appeal to institutional investors, many consultants insist that the threshold is shooting up to $200 million.

The changing regulatory environment is partly responsible for the increased demand for incubator backing. Because the Securities and Exchange Commission requires a higher degree of capital and infrastructure to enable a fund to register, "You need to have enough assets under management right out of the gate to be able to employ staff and consultants that you would traditionally hire at a later stage of development," remarks Jane Halsey of the independent cap intro event firm Roundtable Forum. Indeed, many incubators will provide the systems necessary to comply with the SEC rules. "If you talk to a manager who started 10 years ago, I guarantee it would be a totally different start-up picture," says Halsey.

As recently as five years ago, incubators resembled more of a cottage industry where only a handful could boast of a high-quality service and reputation. Dozens of firms are now starting from scratch, while other brand-name, highly capitalized hedge fund firms, such as Perry Capital or Highbridge Capital Management, are seeding new funds. Others, such as Pequot Capital Management, have created in-house incubator platforms.

To a large extent, the proliferation of incubator firms is in part a by-product of the failure of prime brokers to effectively help the lesser-known managers raise initial capital, according to many industry insiders. Certainly, many emerging managers frequently express dissatisfaction with their cap intro service.

"The prime broker capital introduction model is slowly falling apart and investors are losing interest," say Jane Halsey. "The only guys who are getting attention are those who are coming out of established shops and most likely to succeed and, therefore, able to generate more fees on the prime broker side in the future. Consequently, lots of interesting opportunities fall through the cracks."

Although some managers have experienced frustration with the inadequacies of the cap intro approach, they may not always be eager to rush into the arms of an incubator. Having made the risky decision to strike out their own, they refuse to surrender their coveted independence and control over their new businesses. (See "The Downside of Incubators", p. 32.)

While incubator firms say they are receiving a growing number of enquiries from start-up managers, there are still many reasons managers shy away from using them. Some managers fear they may be giving away too much of the economics of their businesses, and that they will be perceived by investors as lacking the pedigree and clout to raise money without – at the very least – seed capital. "Almost every time incubation comes up in our discussions with start-up managers, their first reaction is to reject that option," says Alan Pace, global head of business advisory at Lehman Brothers.

Some managers worry that capacity rights demanded by incubators, which can be as high as 30%, can be a Catch-22. Chris McGuire, a partner at Phalanx Capital, launched the Phalanx Japan Australasia Multi-Strategy Fund in April 2005. Having built up an infrastructure that would allow the fund to manage as much as $700 million, he is now looking for seed capital. But he warns: "An incubator might flood you with capital, but if the markets change, they may pull a lot of money away. So I have to ask how much risk am I prepared to take?"

Investors, too, may look askance at managers seeded by incubators. For one thing, they worry that they may be disadvantaged because the incubator may have side letter arrangements offering it much more preferable terms on their investment. As the CEO of a New York incubator firm explains, "A CIO of an endowment fund may feel he wants every dollar of his investment to go to the people who are putting the money to work every day and not to a strategic partner who is not a day-to-day person."

Beyond the new economic imperatives, there are other attractive reasons for going down the incubator route. If the manager is backed by a brand-name incubator, for instance, investors will be reassured that the firm will have already undergone a high degree of due diligence and may be starting off on a more stable footing. Moreover, a substantial commitment of seed capital can also be regarded as a "Good Housekeeping" stamp of approval. It's also worth recalling that some of the biggest brand names in the hedge fund industry, such as Och-Ziff Capital Management, HBK Investments and York Capital, were all seeded in their early stages, albeit not necessarily by conventional incubators. Besides, many well-informed investors are generally highly aware of the difficulties that start-up managers face and understand the necessity to go for seeding.

Moreover, increased competition has also improved the terms of business start-up managers can often negotiate with incubators, who are increasingly aware that managers especially want to see a reasonable exit strategy. "Every platform has a different formula," says Chris Kelley, chief executive of Weston Capital Management, a major incubator based in Westport, Conn.

In the past, incubators often used a benchmark which gave them a 1% equity stake in a new fund for every $1 million worth of seed capital. Today, they might provide $50 million, but only demand a 25% stake. In reality, the permutations are endless.

"Essentially, we would determine the value of our holding as a multiple of the firm's cash flow," says Kelley. "But as we regard it as a revenue-share warrant deal, rather than an equity stake, we would probably sell our ownership to a global third-party player rather than have the underlying firm buy it back."

There is no simple formula for the typical incubator or seeding deal. "You can send five different start-up managers to the same incubator and, depending on the strategy, size, prospects for success, and the incubator's view of the manager, you will probably see all five walking away with different offers," says Bob Leonard, head of global capital introductions at CFSB. "A lot comes down to what the market will bear."

At one end of the spectrum is FrontPoint Partners in Greenwich, Conn., which provides a platform for early stage, seasoned professionals. Managers receive between $50 million to $150 million of seed capital, a robust, centralized infrastructure covering all aspects of the operations and a high-quality institutional investor base. According to Mike Kelly, a partner at FrontPoint, who prefers to describe the firm as "a fully integrated asset management operation," rather than an incubator, the 11 fund managers receive FrontPoint equity, autonomy over their funds, and the firm's brand name. FrontPoint takes 50% of the revenue and the other 50% goes into the FrontPoint pool of capital from which managers will ultimately benefit as equity participants.

BRI Partners of Chicago, which has a joint venture with Mesirow Advanced Strategies Funds of Funds, provides various kinds of support to the managers it incubates, such as introducing them to potential investors. BRI has seeded 10 funds after having gone though the process of reviewing more than 1,300 funds since its launch in 2001. "We don't take equity stakes," says Adam Brass, the firm's CEO. "We prefer a fee sharing agreement, which also means it's very clean and a far more manageable relationship."

> "Asset Alliance provided us with $5 million of seed capital, offices, marketing and paid the bills until we broke even. The idea was to set us up as if we already had a $100 million operation"

But there are still many incubators that do take an equity stake. Founded in 1998, Capital Z Management says that half of the $2.3 billion it manages is allocated to long-term investments in experienced managers, who are in the process of launching or taking their firm to the next level. In what it calls a private equity approach, Cap Z takes an equity stake of between 20% to 50% in the management company, acts as general partner and structures the board of directors of the companies in its portfolio, which currently total nine. In return, it gets full transparency of the investment process as well as capacity rights. As Elizabeth Flisser, the partner responsible for monitoring its seeded funds, explains: "Typically, we sign lockups in excess of what general partners are usually asking because we want the managers to feel they are managing a long-term portfolio. But we regard ourselves as a net income equity participant as opposed to a revenue participant."

Another veteran incubator, Asset Alliance, provides seed capital and helps the manager to raise additional capital while providing some infrastructure and business advice. "Although there are some good managers out there, very few are great managers," says Bruce Lipnick, president of Asset Alliance. "The key is to find enough good managers and couple of great ones to build a great business."

London-based Wessex Asset Management, which launched in December 2000, was the first non-U.S. manager to receive backing from Asset Alliance. "We were fully aware that hedge funds usually fail, like other small businesses, because they are undercapitalized and the managers don't have enough time to focus on their competencies. So we realized that we needed to outsource the financial risk and non-core skills," says Tim Weir, CEO of Wessex, which now runs $400 million in assets.

"Asset Alliance provided us with $5 million of seed capital, offices, marketing and paid the bills until we broke even. The idea was to set us up as if we already had a $100 million operation so that when investors came to see us, they would find a proper professional operation."

At the other end of the spectrum lies the more hands-off business model which firms like Focus Investment offer. Focus concentrates on providing seed capital and some degree of business, portfolio and risk management advice. Apis Capital decided to go this route with Focus. The long/short equity fund, based in Old Greenwich, Conn., was launched in April 2004 with a modest amount of "friends and family" money. But, needing additional capital, the partners chose to go through the beauty contest of meeting with 10 incubators. If the first meeting clicked, a further series of meetings were arranged with different layers of management, followed by an exhaustive due diligence process.

"We naively started off not really understanding the types of deals and structures that people would suggest in the end," says Dan Barker, managing partner and co-founder of the $50 million fund. "To us, it seemed like they wanted your first-born child and expected to stick with you for 10 years. We thought we would rather eat dog food."

After short-listing three firms, the partners decided to strike a deal with Focus Investment. "It came down to our comfort level from a personality standpoint, and the fact that the economics were less intrusive," says Barker. In the relatively straightforward agreement with Focus, Apis basically received an infusion of capital and backup advice. In return, Focus obtained a share of the revenue, monthly transparency reports and rights to future capacity. A sign that the relationship worked out well is that Focus has subsequently allocated more capital than it originally committed.

Although the partners have still not drawn a pay check, seeding capital did enable them to concentrate on building the business and generate good returns. "The two main reasons why even talented managers fail is because they don't understand there is a business to run, and they are compelled to spend a lot of time marketing," says Barker. "In the first nine months, we didn't do any marketing because if you have good performance, investors will find you."

THE DOWNSIDE TO INCUBATORS

Rich Sansaricq has never been a fan of incubators, and his recent experience only reinforced that view.

On July 1, 2004, Sansaricq and his partner, Doug Millett, launched their long/short equity fund based in White Plains, N.Y. Sansaricq had previously been the U.S. prime brokerage sales chief at Credit Suisse First Boston, while Millett had been a principal at Kynikos Associates. With their pedigrees, a personal investment from Jim Chanos of Kynikos, and early indications from investors that the partners could start with at least $300 million, they set out to build an institutional quality firm with the necessary sophisticated infrastructure and an 11-strong staff.

"We thought we would be a semi-megalaunch, but we launched in a perfect storm," recalls Sansaricq. "Other sizeable mega-launches were taking place, which sapped quite a bit of capital out of the industry, while major hedge funds that had been closed decided to reopen. At the same time, a lot of funds of funds were scaling back and didn't want to take risks with start-ups. So many initial promises of substantial allocations of capital just failed to materialize. If we had launched a year before, we would have had a better to chance to succeed."

After six months of trading and $50 million of assets, the partners realized that they could not continue to pay their staff, largely out of their pockets, and they still remained far away from their breakeven point of $125 million. In an attempt to avoid shutting down the firm, in January 2005, they began negotiations over a period of three months with various incubators.

"We met with up to 15 incubators who were ready to cut deals," says Sansaricq. "Some were more flexible than others, but they weren't ready to put up the amount we needed. Others were prepared to commit anywhere from $50 million upwards, but only on egregious terms. We were looking for a three- to five-year buyout, and these guys wanted to be in for the life of your business, which we weren't prepared to do. They would typically want a 70% stake for the first three years which would decrease to zero over the next four or five years. On those terms, you're really working for someone else."

By the end of the negotiating process, the partners made the painful decision to close down the fund. In hindsight, Sansaricq believes it was a "great experience and I would do it again if I had to." Although he says that he would never contemplate going back to an incubator, he might consider a traditional seed investor that would typically be looking for a revenue-sharing agreement over a three-year period.