



Building successful, sustainable organizations with revenue share interests

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Asset Management Finance

As the hedge fund industry continues to grow and evolve, organizational stability and management continuity will become increasingly important considerations for investors and their advisors. Those firms that move first to address these issues will have a competitive advantage. Revenue Share Interests (RSIs) give managers the ability to create sustainable organizations without surrendering economic value, independence or autonomy.

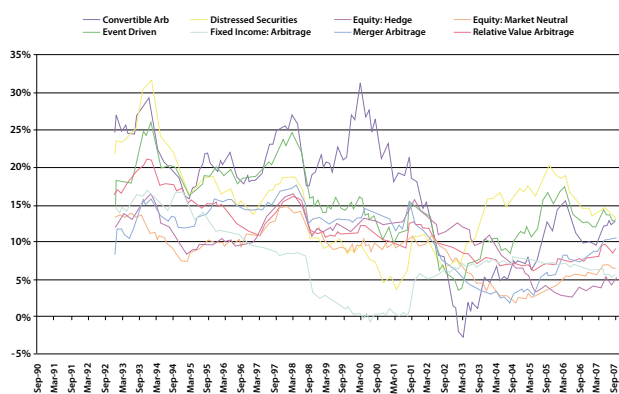
Most successful hedge funds are built on a culture of entrepreneurship and innovation. Often, they rely on a single individual or a fairly small team of portfolio managers to generate investment results. This has made it a relatively straightforward proposition for those with the contacts and requisite skill to start a hedge fund. In 2006 alone, 1,518 new funds were launched, according to data from Hedge Fund Research (HFR). Starting and sustaining are two different matters, however. Many hedge fund managers have found it difficult to maintain their competitive advantage and, by extension, their assets under management over time. That, too, is reflected in the HFR data. Approximately 717 hedge funds closed their doors in 2006, reflecting an attrition rate of over 8%.

Though it is nearly a USD2 trillion AUM industry, hedge funds continue to wrestle with a number of important organizational challenges that have the potential to impact both investment returns and long-term organizational stability. While the HFR data is mostly silent on the reasons for the fund closings, there are a number of probable causes. These include the failure to achieve a critical mass of assets under management, poor performance, acquisition by larger players, and the loss of key personnel. For hedge fund managers, losing key individuals is often a precursor to organizational instability. This, in turn, can lead to a loss of confidence among investors and their advisors, and eventually a decline in assets.

A new kind of competitive advantage for hedge funds

Though investment performance has been the sine qua non for many hedge fund managers, it is clearly getting harder to achieve in many strategies, as the chart below illustrates. This data suggests that managers will need to look at new ways to distinguish their firms in the marketplace.

Figure 1 | Selected HFRI Indices: Rolling 3-Year Return



Source: HFR

As we have seen with traditional asset managers, the ability to create an enduring organization is a critical factor that separates the firms that succeed over time from those that do not. In many respects, this challenge boils down to a matter of achieving critical mass. HFR data seems to bear this out.¹ Size clearly matters, but once a fund manager achieves critical mass, continuity becomes the priority: continuity of relationships, investment processes, and management teams, as well as the results that they generate.

Organizational continuity is difficult to establish without first solidifying the management team. A key ingredient to establishing and maintaining a management team is equity ownership.

To date, however, many hedge funds have not distributed ownership interests broadly to key professionals, relying instead on incentive fees as the primary means of compensating key employees. This, in turn, creates a narrow focus - investment performance to the exclusion of most everything else - that can lead to the eventual destabilization of the organization. The problem may be exacerbated if fund structures incorporate high water marks that must be met before incentive fees can be earned, making a fund vulnerable to losing key talent, in addition to clients, following periods of underperformance.

Providing equity to key employees is neither cost nor trouble free, however. The transfer of ownership interests from the hedge fund founder(s) to critical employees needs to be accompanied by the delivery of fair consideration for the value received. Often, employee buyers do not have the personal resources to acquire equity without help from outside capital providers. Historically, the range of capital solutions available for hedge fund managers to facilitate internal equity transfers has been limited. Traditional sources of capital have generally been limited with respect to meeting the specialized financial needs of the asset management industry, in general, and the hedge fund industry in particular.

Bank debt, when available, usually entails a fixed obligation over a short duration and is frequently subject to onerous terms and personal guarantees. Equity solutions, in one form or another, are often of limited utility when used to facilitate the transfer of ownership among key principals. While typically offering more compelling economics to founders than bank debt, equity capital solutions fall short on preserving the independence and autonomy of the hedge fund manager.

Strategic acquirers generally offer the best option for maximizing current value for the present owners, but there are challenges here as well. For the fund manager, the attraction lies in the opportunity to receive incrementally higher value based on perceived synergies,

¹ A comparison of Live Fund and Dead Fund data, provided by HFR as of May 15, 2007, suggests that, at the median, firms that fell out of the database were both smaller and younger than firms with active products listed in the HFR database. According to analysis performed by Asset Management Finance, these «failed» firms were approximately half the size at the median - AUM of USD90m for «failed» firms versus USD177m for active firms - and approximately half the age at the median - 3.0 years for «failed» firms versus 5.7 years for active firms.

access to a broader distribution platform and to so-called «permanent capital». While the economics may make sense for the founding generation, a sale to a strategic buyer frequently puts an end to many of the entrepreneurial dynamics that led to a fund manager's success in the first place.

The public equity markets have provided an exit strategy for a few select hedge fund managers. But, for most, the disclosure and regulatory issues that accompany listing on an exchange outweigh its benefits. Further, the IPO route is available only to a relatively small number of the estimated 10,000 hedge funds and funds of funds worldwide.

Revenue Share Interests

Fortunately, an alternative approach using revenue sharing techniques, originally developed and applied to the long-only asset management world, is now making its way to hedge funds. Known as Revenue Share Interests (RSIs), these vehicles were developed, in part, to address the historical tension created by the asset manager's simultaneous desire to maintain independence while accessing new forms of capital.

RSIs allow a financial investor to essentially buy a percentage of the hedge fund manager's anticipated future top-line revenues for a finite period of time, generally seven to twelve years. The expiring investment is entirely passive, does not require the hedge fund manager to give up any equity or governance control, and does not involve a fixed obligation or minimum payment to the financing party. By retaining control of 100% of the equity, the hedge fund manager can, in fact, participate in a second or a series of transactions with the financing party. Further, because the investment is passive and made for a predetermined period of time, it generally does not require client consent. RSIs provide capital that can be used for a variety of purposes including equity transfers, partner buyouts, and business development.

The challenge posed by incentive fees

The valuation of a hedge fund manager, as with that of a traditional long-only manager, is necessarily a function of the expected fees derived from investment management contracts. Of course there are differences between long-only and hedge fund managers as well as substantial variability among the strategies and business models of

hedge fund managers themselves. The two most obvious are the «two and twenty» fee structure and the presence of high water marks in many hedge fund manager agreements. But the techniques developed for long-only managers are clearly robust enough to apply to hedge funds as well.

While the fee structure is important, there are many other factors that go into determining a multiple to be paid for participation in a hedge fund manager's cash flow. For example, a manager's ability to attract and retain clients should be given significant weight, as well as the volatility of the portfolio and the predictability of returns. Performance fee issues, including hurdles and terms of fee collection, also factor into the equation. The ability of the manager to decompose and explain performance is valuable as it goes to the question of sustainability.

The age of the fund is yet another factor that may be taken into account. A mature hedge fund business will be perceived as a going concern, and be more valuable as a result. A firm lacking resources or a robust track-record will be challenged as it seeks to demonstrate its sustainability.²

To date, many of the valuation techniques used in estimating future cash flows from either debt or equity capital providers have relied on arbitrary methods for forecasting and discounting incentive fees. Scenario analysis techniques are typically employed without proper probability weighting to project these fees. Other capital providers simply value performance fees as a percentage of the per-unit value of a fund's management fees in an attempt to address the differences in fee characteristics through arbitrary discounting.

Continued evolution in the areas of information-technology and quantitative analysis afford financial investors an opportunity to embrace techniques that were once reserved for the venerable «black box.» Through the application of simulation techniques designed to illustrate the behavior of stochastic processes, financiers are now capable of accurately characterizing risk and assigning value in an appropriate fashion. As a result, they are also equipped to appropriately assess the specific nature of the option-like characteristics underlying incentive fee behavior. Risk-awareness is becoming an explicit consideration in the valuation of fund managers.

² As noted, the hedge industry overall is relatively young. According to HFR, just 24% of all funds are seven years old or older, while 40% have been around from three to seven years. About 28% are two to five years old. Start-ups – those less than one year old – make up 8% of the industry. The demographic makeup of the industry is likely to change over time, however, as more firms discover the secret to longevity.

As markets mature, this will lead to more efficient pricing, with those organizations that have taken the time to properly align key employee interests with strategic objectives in a position to benefit the most.

Conclusion

According to a study conducted by the Bank of New York and the consulting firm Casey, Quirk & Associates, institutional investor capital in hedge funds is expected to increase from USD360b from year-end 2005 to about USD1 trillion by 2010, with «institutional quality» hedge funds dominating the landscape. This is an asset pool few hedge fund managers can afford to ignore.

In the past, creating a sustainable organization may not have been at the top of the typical hedge fund manager's initial «to do» list. Attracting assets, building a team, and returning value to investors has been and will probably always be the first order of business. As the hedge fund industry continues to grow and mature, greater value will be placed on a fund's ability to create a sustainable business model for the long term.

RSIs enable hedge fund managers to facilitate the growth and maturation of their businesses by providing ownership to key professionals without sacrificing the value created by the founders. The approach has grown increasingly popular as word about its benefits has spread. To date, our firm has provided financing for nine asset management firms that collectively manage over USD40b in assets.

By using an RSI to transfer meaningful equity participation within the organization at a fair price, hedge funds and funds of funds can continually attract, motivate, and retain top talent across the organization.

Using revenue sharing to leverage future cash flow allows hedge funds to effectively avoid many of the disruptions and pitfalls that accompany most traditional sources of liquidity, freeing management to focus on more productive and satisfying professional pursuits.

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