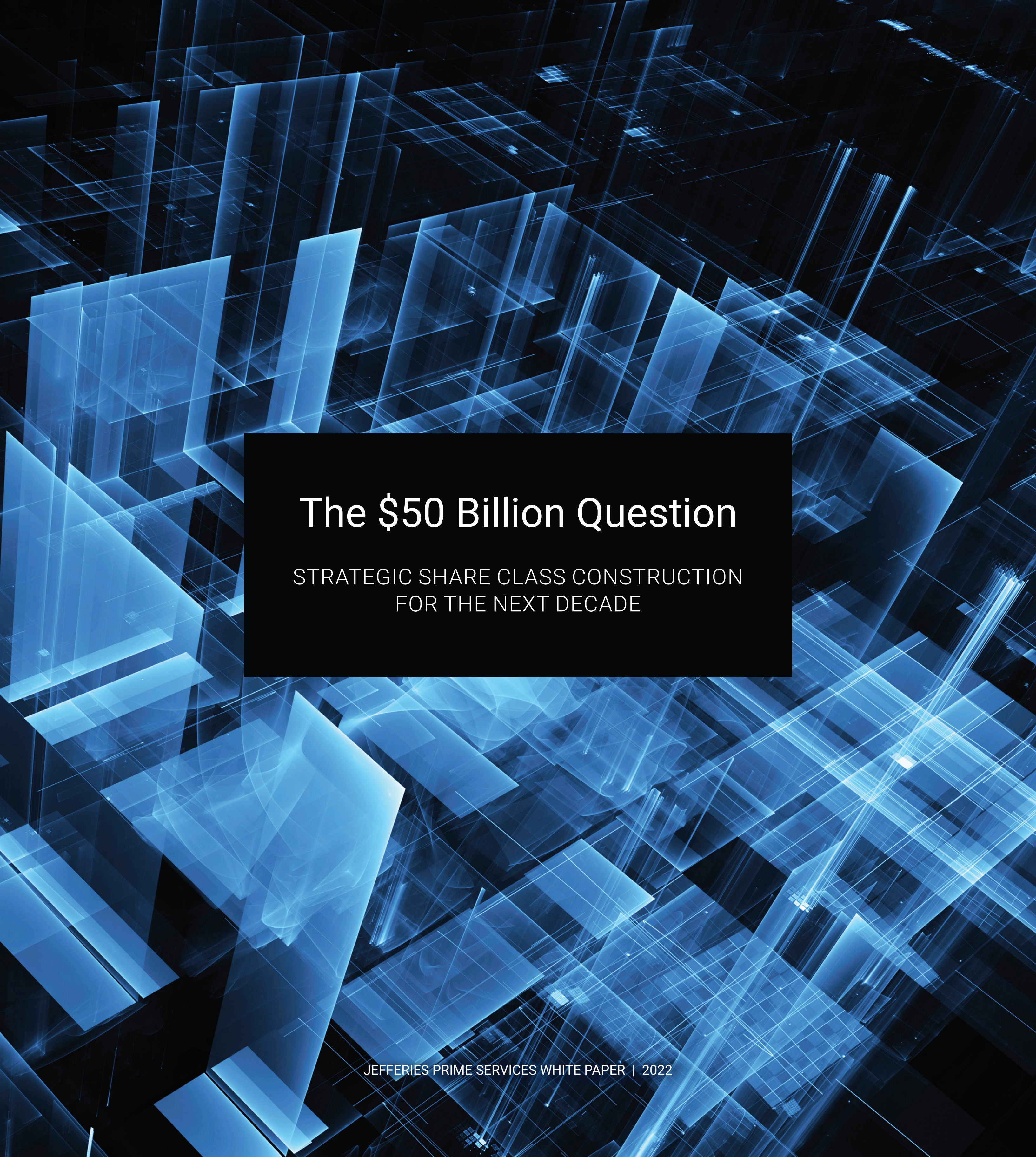

# The $50 Billion Question

## STRATEGIC SHARE CLASS CONSTRUCTION FOR THE NEXT DECADE

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Jefferies

# It’s Not Zero Sum:
# Strategic Share Class Construction for the Next Decade

With assets hovering around $4 trillion, the hedge fund industry conservatively will welcome ~$50 billion in management fees this year – before capturing a basis point of performance.* This is a fraction of the trillions in performance driven growth in recent years, and these revenues are critically important to build firms that live up to their value propositions for their LPs.

While headlines have claimed asymmetric risk/reward for managers and LPs, the reality is, strategic share class construction can create shared prosperity and win/win outcomes for both stakeholders. Especially given their shared objectives.

What do investors want? Stable businesses, solid returns and their fair share of the upside.

What do managers want? They also want to manage stable businesses, deliver solid returns and be fairly compensated for their performance.

What “strategic” means is different for different managers, depending on a variety of factors: the firm’s strategies, the maturity of the fund, their operating footprint and the shape of their LP base. But the principles are the same: alignment of interest, with a focus on enduring capital that facilitates reinvestment and business growth to help deliver robust performance over cycles.

Strategic share class construction and building a more enduring capital base allows managers to:

- Weather periods of stress in the market and minimize forced selling
- Better align interests between managers and LPs
- Take advantage in periods of market dislocation to potentially enhance returns
- Incubate new strategies and further organizational innovation
- Solidify resources to minimize employee turnover
- Enhance valuation

There are benefits to both managers and LPs in building more stable capital bases. The $50 Billion Question explores various dimensions of this process, the challenges and opportunities, and the tradeoffs to ensure managers are realizing an “efficient frontier” balancing both their needs with their LPs’.

After years of myths that term and fee structures were a “zero sum game” with winners and losers, a growing number of firms see share class structuring as a way to strengthen individual organizations – and by, proxy, the broader industry – while ensuring LPs are delivered a fair and solid value proposition.

We hope this piece helps understand shifts in share class structuring, and helps arm all industry participants with the right questions to determine the appropriate options for their firms.

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** This assumes a simplified and flat 1.5% management fee across $4 trillion of assets. Management fees have a wide range, but Jefferies Capital Intelligence has seen 1.5% as a common average in recent years.*

# Durability: Why Care About Share Class Construction

### Benefits of a more durable capital base are shared across managers and allocators

| | Managers | Allocators |
|---|---|---|
| | Grows stability of firm's operating footprint | Lowers business/operational risk |
| | Helps support the incubation of new strategies and firm innovation | Supports firm's ability to stay current with best practices |
| | Works to lower concentrated redemption risk and potential forced selling | Can lower LPs vulnerability to others' redemptions and potential forced selling |
| | Can enhance valuation due to recurring revenues | Helps retain top talent in an increasingly competitive environment |
| | Provides critical support across market cycles to reinvest in the business | |

Performance is a critical component of hedge fund success and lifecycle. But while headlines paint a simplistic picture of comparing funds to broad based indices like the S&P 500 in an up tape, the function and value of hedge funds varies to asset owners – *especially in down markets*. In 2008, for example, broader equity markets had a drawdown of nearly one-third, while funds saw a down year of ~19%.[1] Market conditions are never perfect, and over cycles, management fees are an important part of ensuring funds can not only protect themselves, but also have assets on hand that may take advantage of dislocations. This is an intuitive, but critical point for strategic planning: understanding the trade offs between performance revenues and management fee revenues across time and over cycles. After witnessing more than $280 billion in assets get redeemed in 2008 and 2009, managers have increasingly focused on building durable asset bases.

## 2008 – 2009: Redemptions Across the Board

$285 BN

Amount of assets redeemed

Percent of industry assets redeemed

18%

1 HFR, Bloomberg

# Diversification & Evolving Types of Share Classes

As noted earlier, what constitutes 'strategic' share class construction varies by manager, but the underlying principles are the same. One of the biggest time drags for managers – especially emerging managers who more frequently play a material role in marketing – is spending too much time with investors who are the wrong fit.

By strategically structuring share classes, managers are more likely to create an environment where the 'right' LPs are opting in. Share class construction sends signals to the market as to what 'kind' of fund the manager is, and by selecting the right structure, managers put into practice many of their firm's values. For example, a concentrated long-biased fund may want to send different signals to the market than a market neutral sector fund that reflect the realities of their portfolio construction and risk processes.

Managers are increasingly diversifying the options they offer LPs – both *within* funds, and across the industry. Below are some models of share class offerings.

**Selected Approaches to Share Class Construction**

| TRADITIONAL APPROACH | LONG LOCK/ STREAMLINED APPROACH | LEVER APPROACH | MATRIX APPROACH | ONE & DONE APPROACH |
|---|---|---|---|---|
| Two share classes, typically founders/builders share class and a standard share class | Typically aggregates capital under one share class that is longer locked (3+ years) in duration | Implements various levers including: longevity or loyalty discounts, hurdles, step downs, or other dimensions to enhance alignment of interests with LPs | Leverages a smaller number of parent share classes, but with fee or liquidity options that result in more permutations of terms, fees and liquidity | One share class for all LPs with consistent terms, fees and liquidity for all |

# Potential Considerations for Share Class Diversification

## Avoiding Unnecessary Complexity

Managers should take care not to create unnecessary complexity in their share class offering. As many have pointed out – the "paradox of choice" can lead to paralysis and frustration, and by offering *too many* share classes, managers may find potential LPs actually have a harder time selecting the appropriate avenue for investment.[2]

So it's important to balance diversification and *over* diversification. Share class diversification can also create different incentives or rewards for long term partners like step-downs or longevity "discounts." Of course, some managers choose a simplified approach, but there are different tradeoffs given what share class model is adopted.

**Benefits of Diversification**

- Offers LPs and potential LPs term and liquidity optionality
- May create a "ladder" of staggered assets/share classes that lower concentration risk around redemptions
- Allows managers to offer incentives for early investment or longevity/loyalty

**Questions & Considerations**

- What is the proper number of share classes that results in optionality for LPs, but does not create too much complexity for operations personnel?
- Would new share classes introduce inefficiencies or unnecessary complexity to pre-existing investment or risk processes?
- Do new share classes create an incentive for strategy creep?
- Can we balance incubating new strategies with maintaining a focus on core competencies?
- Do new share classes create "*too much choice*" for LPs?

2 *"Why People Want Less Choice,"* Andrew McAfee. Harvard Business Review. November 11, 2010

# Revenue Parity of Management & Incentive Fees

In planning across cycles, managers will think about target returns needed to deliver returns that meet or exceed those earned from management fees. Below we model a simplified 1.5% and 1.75% management fee fund (ignoring, for the moment, high water mark considerations), and the ballpark returns needed to deliver the same revenues as the management fees would.

Thinking about revenue streams across cycles | Estimates of management and incentive revenues in four models

| Model | Management Fee | Incentive Fee | Required Return to Hit Fee Parity |
|---|---|---|---|
| **1** | 1.50% | 17.5% | ~8.6% |
| **2** | 1.50% | 20.0% | ~7.50% |
| **3** | 1.75% | 17.5% | ~10.0% |
| **4** | 1.75% | 20.0% | ~8.75% |

A simple example follows (in which we are not including fund charges, solely performance and management fees over time). A $1 billion fund with a 1.5% management fee earns $15,000,000 annually. To match that $15,000,000 through incentive fees, at the fund would need to return at least ~8.6% with a performance fee of 17.5%.[3]

Because LPs keep more of the upside with lower incentive fees, some firms are increasingly looking at structures that offer more of those options – especially for longer locked capital. Many of the headlines seeing terms and fees as a zero sum game have focused on management fees.

But share class construction is inherently a risk management exercise as well. While two share classes on the surface deliver the same total revenues in a given year, digging a little deeper reveals revenue mixes change depending on performance and exogenous forces. In some cases, it makes sense for managers to explore what the suitable level of management fees is across market cycles, while potentially offering a larger percentage of incentive fees to LPs.

In many years, managers will strongly outperform what they earn from a management fee perspective. But this relationship matters overall because not every year is a positive performance year – or even a year in which managers will make as much in incentive fees as they do in management fees. Firms need stability of capital in order to protect themselves in drawdown environments *and* to invest in an ongoing basis to help achieve stand out years.

It is critically important for management fees to sustain businesses across cycles to:

- ✓ Smooth volatility of returns, allowing managers more opportunities for strongly positive years
- ✓ Protect talent and operating footprint in down years – after the hedge fund industry was outperformed the S&P 500, with the industry down ~19% in 2008, it then bounced back to *return* +19% in 2009[4]
- ✓ Managers often use revenues earned during outperforming years to help innovate, strengthen the organization or incubate new strategies. In years where this is not the case, management fees help pursue these opportunities
- ✓ And of course, fees inform valuation and estimated future cash flows

3 Jefferies
4 HFR

# Valuation: How Share Class Construction Can Impact Enterprise Value

### IRS Ruling 59-60

The IRS Ruling 59-60 is generally recognized as a source of guidance for valuation of closely held businesses. As more and more alternatives firms sell themselves, or parts of themselves, to other firms, these drivers of valuation come into focus.

Among others, IRS ruling 59-60 lists these value drivers:

- The nature of the business and history since inception
- The economic outlook in general and the condition and outlook of the specific industry in particular
- The book value or net assets and the firms financial condition
- **The earnings capacity of the firm (management/perf fees)**
- Any dividend paying capacity
- If there is goodwill/intangible value
- Historic sales of other interests in the fund
- Any market price of companies engaged in similar lines of business

*Source: Internal Revenue Service*

### Earnings Capacity, Revenues & Valuation

Over time, management fees are valued at a premium to incentive fees, given the volatility of the latter. As such, the earnings capacity of the firm, viewed through its management and incentive fees, are a critical driver of enterprise value.

The value of management and performance fees and ultimately, a firm's profitability, is driven by:

- Total AuM
- Amount of investor AuM at or above the high water mark
- The returns across funds

There are many factors that can impact a firm's valuation – including estimated returns over time, AuM growth or decline, redemptions and subscriptions, and liquidity/structuring of share classes. Below we model three years of a manager who has achieved scale of $1 billion, with middle single digit returns, before having a down year.

That down year *could* reflect considerable outperformance of broader benchmarks or indices – we do not indicate whether the down year reflects outperformance or underperformance. What is important is to understand the cycles and duration of revenues across a potential three year span.

### Potential Three Year Span of $1 Billion Manager & Revenue Split by Percentage

| Year | Fund AuM | Est. Return | Management Fee | Performance Fee | % of Total Revenues From Management Fees | % of Total Revenues from Incentive Fees |
|---|---|---|---|---|---|---|
| 1 | $1 bn | 7.50% | 1.50% | 20% | ~50% | ~50% |
| 2 | ~$1.075 bn | 7.50% | 1.50% | 20% | ~50% | ~50% |
| 3 | ~$1.15 bn | -2.00% | 1.50% | 20% | 100% | 0% |

*Source: Jefferies. All numbers are estimates and may not be wholly inclusive of other fees OR be reflective if managers are compensated for outperforming benchmarks in a down year, as could happen in year 3*

# Looking Ahead & How Jefferies Can Help

## Looking Ahead

A growing number of managers are looking at share class construction as a fundamental building block of their institutions. As we also increasingly see headlines that reflect mature, institutional funds selling stakes in themselves, the underlying drivers of enterprise value come back into frequent conversation. In the coming years, we expect managers to be keeping an eye on:

- The balance between diversified share classes and *overly* diversified share classes that could lead to strategy drift or operating inefficiencies
- Risk management and the tradeoffs between delivering consistent high single or low single digit returns with higher volatility returns over time
- The interplay between asset growth, loyalty discounts, builders' share classes, step downs, and other potential levers of engagement between managers and LPs
- How to offer value to a new generation of hedge fund investors, understanding new value propositions in a rising rate environment, and how to articulate this succinctly and effectively

## How Jefferies Can Help

The Jefferies Capital Intelligence team provides strategic advisory services on share class structuring, strategic capital raising and return on invested time in the capital raising and management process. Especially as firms look to launch, scale and institutionalize, it may make sense to roll out additional share classes or optimize assets under management by rolling assets into a longer locked share class (if possible). Navigating and understanding the shifting allocator landscape is critical for managers as we head to the middle of the decade. LPs' priorities are changing, and building enduring partnerships requires managers *and* LPs to understand the mutual benefits of an enduring and stable asset base. We look forward to collaborating with clients to push the share class and asset base discussion forward in the years to come.

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