Start-ups and spin-outs: establishing a credible investment advisory business and maximising success

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1. Introduction

If you are ready to establish or expand your investment advisory business – congratulations! Or perhaps you have seized an opportunity to redirect your business or set up on your own. Once the thrill of the big decision wears off, you have a considerable amount of work to do. As a startup or a spinout, how will you ensure your credibility with investors considering whether to entrust you with their funds? How will you assemble and maintain a best-in-class management team to deploy those funds? How do you even go about setting up a new enterprise?

This chapter addresses some of the keys to success for investment advisory start-ups and spin-outs and examines how early foresight in the startup or spinout process can give you an advantage when your business is ready for its next stage.

In this chapter, we use 'spinout' to mean the separation of individuals or an entire business unit from an existing business to pursue their own investment advisory business or platform. This could be a private equity management team separating from an institutional sponsor that conducts a broader business in other areas, or an individual principal or small group of principals from an independent private investment firm leaving to pursue their own separate business line or start a competing business; or it could be a branded investment advisory firm separating from an anchor investor. In spinning out, you may be thinking of completely severing your ties with the existing business, or you may be looking to leverage the old relationship in your new venture.

The term 'startup' includes any new investment advisory enterprise starting up business for the first time. It could be the result of a spinout or not.

While there are important differences between start-ups and spin-outs, planning and executing either of them successfully involves many of the same considerations. Of course, each situation is unique and will present its own set of challenges, including distinct business, regulatory and tax structuring challenges.

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2. Laying the foundation

Whether you are starting up or spinning out, establishing the credibility of your new venture is critical to your success. Your credibility allows you to attract and retain the right team members, the investor base you want for your new business and the opportunities that will make your investment strategy successful. Each successful company addresses its credibility in its own way, but successful start-ups and spin-outs always have three characteristics in common:

- a compelling management team;
- a solid track record; and
- access to the necessary economic resources to get the new enterprise off the ground.

2.1 Funding your startup or spinout

In the investment advisory world, you need money to make money. Without the right economic resources, it is difficult to get your capital-intensive business up and running.

If you are bringing your own large bank account to the new business, then you have it easy. But if you have not yet achieved that level of net worth or you do not want to put it all on the line, there are other options for obtaining the resources your business will need. Whether you are starting up or spinning out, there is likely to be a period of time where you need to fund the day-to-day overhead of the investment advisory business or the costs of fundraising before the management fees are locked in. You will also need to be in a position to make a healthy sponsor commitment to the investment vehicles you advise.

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(a) Seed funding

Chances are, you may need some seed funding. At its most basic, seed funding comes in two varieties: equity and debt. But not all equity and debt are created equal.

Equity: If your seed money will be equity, make sure it comes from the right source. An equity owner in your business is a potential co-owner for life; it is critical to make sure the equity you give matches your long-term goals for the business. There is plenty of appetite in the current market among investors, and even among funds formed to make seed investments in sponsors, to find an anchor investment for your business that will provide the funding resources you need. When bringing in an anchor investor, there are many ways to divide the spoils and you will want to cut the deal that is right for you.

Gross revenue share versus full participation: When selling a gross revenue share, the anchor investor will take a top-line share of your operating profits in exchange for the anchor investment. This structure maximises your freedom to run your business but it also means the burdens of the business are entirely yours. If your anchor investor is instead fully participating in the business and receiving only a share of the residual net profits that would otherwise accrue to you, your burdens will be shared with the anchor investor but the trade-off will likely be that you provide the anchor

investor with cost controls and some level of joint decision making over the way you run your business. Your anchor investor's interests may not be aligned with your interests in running the business and your anchor investor almost certainly will not share the same expertise you bring to the business.

Single-fund investment versus multi-fund investment versus ongoing stake in your enterprise: Think carefully about what longevity you sell to your anchor investor. A single-fund investment means your anchor investor has a one-time deal that will not apply to your next generation investment vehicle or to your new product lines. Once you have successfully established your business, you can increase the price of participation the next time around or perhaps you no longer need outside equity participation at all. In a multi-fund investment, you are selling the participation rights to some of those future vehicles now and your future success may bear out that the anchor investor has paid a very low price for those rights. You might also choose to sell a perpetual participation right akin to true ownership in your enterprise, or perhaps you are selling true ownership itself. If that is the best way to finance your startup or spinout needs, be sure to think about what that permanent participation may mean for the next stage of your business as you grow and your goals change. Looking towards your eventual exit is the smartest way to go into your entry.

Debt: For some sponsors, seed funding in the form of debt will be an attractive alternative or add-on to equity investment. Debt may come from traditional lending sources such as banks, from other third parties or from the higher-net-worth members of the management team. In friendly spin-outs, debt might even come from the prior business, in cases where both parties would have something to gain.

Hybrids: Preferred equity can be an interesting alternative to seed funding from common equity or debt. Preferred equity can be structured to provide limited upside to its holder, while also minimising the downside risk to a sponsor that comes with debt. Seed capital obtained through a properly structured preferred equity instrument can be a meaningful value-add for the right startup or spinout.

Seed funding for the team: In addition to lining up the right funding for the business, sponsors should consider whether sponsor-backed lending programmes will be helpful for individual team members to meet their personal obligations to the business, whether in respect of capital commitments to investment vehicles or otherwise. These programmes may be part of a well-crafted incentive package to attract and retain top talent.

(b) Who's got talent?

A best-in-class team of investment professionals is an excellent way to show the credibility of your startup or spinout. For some spin-outs, the best-in-class team has already been built, is cohesive through the business transition, and is ready to hit the ground running. For other spin-outs and for start-ups, at least some part of the team must be built. Credibility of the team can be enhanced through the right

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relationships with industry experts who might be brought on in senior advisory, operating partner or investment committee roles to increase the talent offered by the sponsor. To build out the best-in-class team that will most effectively ensure the early success of your business, the considerations below are key.

Compensation: Compensation of the team will be at the forefront of everyone's minds, and competitive compensation packages are essential. While incentive structures need to be competitive, they must also reflect the business goals and ethos of the particular sponsor. The structure of salaries, bonuses, carry awards and other compensation will influence how the members of the team work individually and together – including whether team members are driven to focus on the success of their own work, on the success of the business as a whole or on both. In determining how best to set up compensation incentives, some sponsors weight total compensation to a non-discretionary base component, while other sponsors weight total compensation to a discretionary or non-discretionary bonus component.

Taking ownership: How you choose to compensate your team members will also affect the structure of your new business. Some will be owners of the business while others will be employees, and the business structures will need to be set up to reflect this. A well-designed startup or spinout business gives thought to future succession planning and how future opportunities for advancement and ownership will be made available to the team. Ownership of the business also means ownership of its goodwill – and how you share the goodwill becomes particularly pertinent when someone leaves the business, or when you are ready to sell a stake in the business or the entire enterprise.

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Splitting the pot: Setting up an effective methodology for allocating carried interest among the team is another critical aspect of a well-designed team incentive package. New sponsors should adopt a carried interest allocation regime that both makes the sponsor competitive and incentivises successful investing for the sponsor's investment vehicles in a manner consistent with the sponsor's fiduciary duties to those investment vehicles. It is important to develop a fair vesting schedule that reflects the value-creation lifecycle for the sponsor's investment vehicles, as a misalignment of vesting with value creation can result in early team departures and an inability to sufficiently compensate – and therefore attract – qualified replacement professionals.

Where a sponsor brings in an anchor investor, the anchor investor may receive a share of the carried interest pool as part of its consideration for the seed funding. Where carry is shared, so must the burdens of clawback obligations and clawback credit support be shared. Terms of clawbacks and credit support for anchor investors should be addressed early in the negotiation and should provide flexibility to fairly allocate any unexpected additional credit support that may later be negotiated by investors coming into the sponsor's managed investment vehicles.

(c) *Other business fundamentals*

A number of other fundamentals will be as important to the business as the economic arrangements you agree upon. These other fundamentals can profoundly affect the business and the individuals involved.

Setting up shop: When some or all of your team is ready to set up shop, you will need to find a place to put down your roots. Settling on one or more geographic locations, and then finding the right office space, will be your first step. The choice of geography may be obvious, or you may need to balance the following and other competing concerns:

- finding a location that enhances your ability to attract and retain the necessary professional talent;
- whether you can draw talented support staff to your preferred location at the right price for your operating budget;
- whether you need to be based in the natural epicentre of your investment strategy for the effective deployment of your capital or for credibility with your investors or investment counterparties; and
- operating within local laws and regulations that may impact your investment advisory business, your tax burdens and your employment relationships.

If you end up sharing office space with others outside your company, you will need to configure your physical space and your technology to protect client privacy and confidentiality. Sharing computers, printers and other office machinery may present real compliance concerns for your regulated business.

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Building your infrastructure: How will you approach the operational logistics of your business? Back office capabilities will need to be built among your team, outsourced or some of each. You will need furniture, technology, equipment, security systems, disaster recovery plans, employment policies, compliance policies, medical and dental programmes, retirement programmes and more.

Protecting your most valuable assets: Your track record and investment methods are your precious intellectual property, the crown jewels of your business. One does not leave valuable jewels sitting on a counter, free for anyone to grab. They must be protected at all times and treated with great care. Your investment advisory intellectual property is no different. As you build your team of owners and employees, you will need clear agreements among everyone as to who owns the track record and other intellectual property, who can use it, who can give it away or sell it, and who gets bought out of its ongoing value when they leave the business. You will need well-defined confidentiality obligations and limitations on disclosure, to ensure that any use of your intellectual property is solely to benefit your business.

Spin-outs may involve intensive negotiations over the portability of the track record and other intellectual property that the new business will need. You may have paid a high price for your own portability rights. If you did, you should not make the mistake of leaving future portability or ownership claims by others to chance. In determining

how best to protect intellectual property, sponsors are well-advised to consider not only the interests of the business as it exists today, but also the intended future evolution of the business and the inevitable changes in personnel that will happen along the way.

Restrictive covenants: Your critical business assets will include not only your track record and investment methods, but also your client relationships, your deal sourcing relationships and your personnel. Owners and employees who leave your business may have a lot to gain by taking your relationships with them; if you are a spinout, you may have been able to take some of these valuable relationships with you or you may have to rebuild. Non-competes, non-solicits, non-disparagements and exclusivity rights are just some of the restrictive covenants you may need among your owners and employees to ensure that your key business relationships stay with you when the inevitable personnel departures occur.

Where a business is seeded by an anchor investor, the anchor investor may require a set of covenants running in its own favour, to ensure that the value underlying its purchase does not leave the business. Covenants in favour of an anchor investor are no substitute for the sponsor having its own remedies. But with all things, the benefit to the business of highly restrictive covenants must be balanced with the creation of an incentive package that will attract and retain top talent. The stick alone is not enough; you will need the carrot too.

2.2 A little thing called tax

All best laid plans can be foiled by the wrong tax results. When setting up shop, sponsors should consult qualified tax professionals to optimise tax structuring for the new business. Tax structuring should take into consideration not only the optimal results for operating the business today, but also the optimal results for the future evolution of the business, which may include future sales of all or part of the business, future personnel departures with accompanying buyout or redemption payments, and other events. Improper or inadequate tax planning can have significant economic consequences. Smart planning now can save you from paying later.

This is an extract from the chapter 'Start-ups and spin-outs: establishing a credible investment advisory business and maximising success' by Nadia Sager, Amanda Molter and Zachary Thompson in Global Investment Funds: A Practical Guide to Structuring, Raising and Managing Funds, *published by Globe Law and Business.*

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