RACING PARTNERSHIPS: PART II

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Racing partnerships come in all shapes and sizes and price points. Identify which kind you would like before entering one

BY LAURA A. D'ANGELO

This is the second of a two-part series on partnerships. Part I, which focused on creating and selling partnerships, appeared in the Nov. 5 issue.

IMAGINE HOW EXHILARATING IT WOULD BE to watch your racehorse cross the finish line first (or even second or third) in a Breeders' Cup race. Is that possible? Is world-class racing too lofty of a goal for a prospective new owner or one without the wherewithal to invest millions of dollars?

The reality is that the price tag of the horse is not necessarily predictive of its future success. Breeders' Cup winners, Kentucky Derby (gr. I) winners, and Horse of the Year victors come in all shapes and sizes and from all backgrounds (and price tags). Yes, there are sheikhs and princes and big commercial farms with horses in these races, but if you want to participate in racing, there is an entry point option at a reasonable price utilizing racing partnerships.

Partnerships, or syndicates, are designed to let an investor buy into a horse or a group of horses for much less than it would cost to go it alone. Partnerships are an excellent entry point for a first-time buyer, as well as great fun and entertainment for repeat buyers. It's all the fun and excitement, but with less financial commitment and therefore less risk.

What prospective investors need to know

Little Red Feather Racing, Eclipse Thoroughbred Partners, West Point Thoroughbreds, and other racing partnership groups had entries in the recent Breeders' Cup at Santa Anita. These partnerships provide an entry point for first-time and repeat investors to experience the thrill of competing at all levels of racing.

This article is written primarily for first-time racing partnership investors. What follows is a guide to some of the more common variations seen in racing partnership agreements. Some racing partnerships are entered into among friends on a handshake or loose verbal agreement. However, you may be investing with a more formally organized group and that group will likely present you with an organizational document such as an LLC operating agreement, partnership agreement, or syndicate or co-ownership agreement.

The points below are not exhaustive but are intended to be a guide to help you review the documents and ask questions about the provisions that may matter to you as a potential buyer.

Ask around about the various partner-

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ships, meet the principals, and choose a partnership with objectives that align with your own. There are almost unlimited variations in the structure, operation, and management of various racing partnerships. There isn't a model that is necessarily better than another. Rather, identify what kind of partnership you would like to be involved in based on financial model, where the horses run, what kind of horses are to be purchased, and other key factors.

Like any business venture, it is key that you do your due diligence as a purchaser.

1. Purpose of the Partnership. Is this a partnership to buy yearlings and sell at the 2-year-old sales (pinhooking)? Is it to buy 2-year-olds that are ready to race? Yearlings to develop and race? Identify the aspects of the Thoroughbred business that you want to participate in and your time line. Pinhooking can be high-risk but also presents the possibility of a quicker, high return. Buying a 2-year-old already in training should let you get to the track faster. Buying yearlings is generally less expensive, there are more choices, and your team develops these young horses as the trainers see fit, offering a bit longer time frame but often more control over the course of events.

2. Capital. A minimum and maximum amount of money to be raised is identified either in the document or in a term sheet circulated in advance of closing. If the minimum isn't raised, then the offering doesn't "close" and your deposit is returned. How much is raised between the minimum and the maximum matters if you are planning to invest a fixed amount (say, $50,000). If $100,000 is raised, you will own 50%. If $500,000 is raised, your risk is still the same ($50,000) but your interest is diluted, and your expenses may be reduced as well.

3. Horses Purchased. How many horses are expected to be purchased from funds raised? What will the quality and character of those horses be? Age, sex, upper limit in price? Some partnerships only invest in fillies so that they may ultimately be sold as broodmare prospects. With a decent pedigree, this is a relatively easy exit strategy. Buying colts generally means they have to have significant success on the track to be a stallion prospect in today's market. Some will end up gelded, meaning that at the end of their racing career, a new career will need to be identified. Do your research on the price points that typically have a positive return on investment (ROI). The Jockey Club and others keep track of purchase price versus success on the racetrack and percentage of horses that are successful on the track.

4. Racing Region and Claiming. Some partnerships focus their efforts on a particular racing region, for example: California, New York, the Midwest. Ask questions about past history and trainers used so that you can determine where the horses are likely or targeted to race. It is most fun when you are able to see your horse race in person—although in today's environment, watching online or on TV is always an option. Note if the operational document permits a horse to be entered in a claiming race. Typically this is not permitted as the claiming race value will set the value of the horse (for insurance purposes, etc.) and/or cause the horse to be "sold" if it is claimed. However, some highly effective partnerships are formed for the sole purpose of trading in and out of claiming races.

5. Insurance. Critical to the operation of the business is insurance. The operation should have a general liability policy in place as well as mortality insurance on each horse. Most partnerships cover both in the expenses so that coverage is in place and management dictates coverage amounts. Some, however, leave the mortality insurance to the individual partners. You may choose to insure or self-insure. You can insure a percentage interest in a horse, but you will need to coordinate with the manager and other partners on valuation. Competing policies with different insurance companies may create coverage issues in the event of a claim, so often the best practice is one policy administered by the manager.

6. Management. The document should set forth a "managing member/partner" or other equivalent. If the manager is an entity, find out the beneficial ownership of that entity and who really calls the shots day to day. Interview the manager. Ask questions about his/her background, education, experience, and track record with prior partnerships. Request references from past and current investors and interview the investors about their experience. The website www.ownerview.com publishes the winnings by partnership, which can be useful.

7. Management Compensation. There are numerous ways that managers may be compensated. Some charge a modest monthly management fee. Some take the bulk of their money on the front end by purchasing horses and contributing the horses to the partnership at a mark-up. If you are curious about the degree of the mark-ups, all public sale-price history is available online or through industry resources. Some managers employ more of a hedge fund formula (i.e. 10/10/10) where the manager takes a percentage of assets under management each year and sales commissions on the horses on the way in and out of the partnership in return for their efforts in identifying or selling prospects.

8. Removal or Replacement of Manager. Most agreements provide for a supermajority vote to remove a manager and some will provide for removal upon "cause," which might be for conviction of a crime or for any reason that results in the manager not being able to be licensed by a racing commission or being sanctioned or suspended by a racing commission. Provision should be made for selecting a successor manager should one be unable to continue to serve.

9. Member Voting. Do the members (non-managers) have a say in any decision-making? Most commonly, if this is a partnership that is managed by someone who does this for a living, the members do not have a vote on any day-to-day decisions and infrequently on major decisions. Some agreements provide for a supermajority vote to admit a new member, terminate the partnership, change the manager, spend above a certain amount, borrow money, and similar big-ticket items. But do not be surprised if as a minority member you do not really have a vote on

most issues. Remember, you are relying on the manager, who has experience, to make these decisions for you and to educate you along the way.

10. Ongoing Funding. Some partnerships collect enough money in the initial capital raised to fund the partnership for some period of time beyond the initial horse purchases. This time frame may be six months or a year, or through the 2-year-old sales in the event of a pinhooking partnership. Either sales or purses may continue to fund the group. Alternatively, or eventually, you may be billed monthly or quarterly for expenses. Check if expenses are passed through or marked up to the partnership. All of these arrangements exist and are acceptable—just know what the situation is and budget accordingly. More importantly, if expenses exceed ongoing earnings (and they are likely to), will the manager make a capital call? Is that capital call voluntary or mandatory? Be prepared and budget for such calls. If the calls are voluntary, the agreement should provide that if one investor makes the additional capital contribution and one does not, the non-contributing investor's interest will be ratcheted down, pro-rata. Most partnerships estimate the cost to keep a single horse in training at $50,000 per year, the bulk of which is generally the trainer's day rate that includes stabling, feed, and employees.

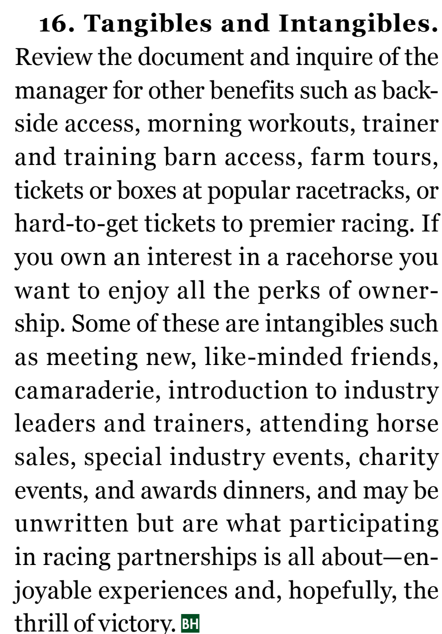
11. Re-Sale of Interests. Partnership interests are typically closely-held with significant buy-sell restrictions. Such restrictions are in place for good reason; first, so that the parties are not trading what may be characterized as a security and, second, to control who participates. Both the manager and the other members want quality partners who understand the model, how it will work, and will pay their bills. So if an interest can be transferred, it is usually subject to a right of first refusal back to the remaining members at the offered price, and for the manager and/or members to vote whether or not to permit a transfer. Death, divorce, and bankruptcy ("involuntary transfers") may be covered in the document as well.

12. Taxation. The typical racing partnership (LLC, partnership) will generate partnership returns (K-1s) and the profits and losses will flow through to the investor's personal return. Be aware that investors in racing partnerships are largely "passive" investors, meaning that an investor does not invest a material amount of time or authority in decision-making and management. Passive losses can be taken against passive income (rental income, for example) or taken at the termination of the partnership. Consult your personal tax advisor on these matters. Be sure that management files the necessary papers in the state of organization upon dissolution of the partnership to put an end date on both taxation and possible liability issues.

13. Financial Reporting. Determine how often you will receive a profit and loss statement (monthly, quarterly, annually). Inquire as to the detail on the reports and whether you can clearly identify how and where the money is spent, if it matters to you. How often are profits, if any, distributed? Some partnerships deduct profits from expenses and pay or request the difference. Some partnerships bill monthly or quarterly, but pay out your share of the purse money after every successful race, without offset of expenses other than those deducted at the track level for jockey fees, etc. This can be fun, as you are cashing checks along the way.

14. Career-Ending Decisions. What if a horse is injured and cannot subsequently race or simply isn't cutting it as a racehorse? Is there a plan for placing a horse that cannot race or isn't suitable for sale for breeding purposes (lack of pedigree, gelding, etc.) as a sport horse? To a Thoroughbred retirement/rehabilitation facility? Responsible Thoroughbred ownership is important. Inquire of the management how they handle such decisions.

15. Exit Strategy. This is by far one of the most important provisions. Inquire of the manager to determine when and how the partnership will be wound up. There are many options. Racing horses may be sold at public auction by a particular date (say in the fall of their 3- or 4-year-old year). Some may provide for conversion of the partnership to a breeding partnership or syndicate by the vote of the members. If you are buying an interest to race, are you willing to own a broodmare, which takes time to realize a return and requires the payment of long-term boarding fees, vet bills, and stud fees? What if the partnership or manager receives an enticing offer for all or part of a particular horse? Who decides if the horse should be sold? Often this is a management decision as they are generally best-suited to determine fair market value. Sometimes up-and-coming 3-year-olds that are on the Derby trail or other horses headed to the Breeders' Cup will attract attention from potential buyers (individuals or stallion farms). Some of those potential buyers want to own 100% of the horse and will not entertain having the original owners stay on as partners. Sometimes the seller of the interest can stay in for a percentage (even if a minority interest) in order to enjoy the ride to the Derby or the Breeders' Cup. These details get negotiated at the time of the offer.



16. Tangibles and Intangibles. Review the document and inquire of the manager for other benefits such as backside access, morning workouts, trainer and training barn access, farm tours, tickets or boxes at popular racetracks, or hard-to-get tickets to premier racing. If you own an interest in a racehorse you want to enjoy all the perks of ownership. Some of these are intangibles such as meeting new, like-minded friends, camaraderie, introduction to industry leaders and trainers, attending horse sales, special industry events, charity events, and awards dinners, and may be unwritten but are what participating in racing partnerships is all about—enjoyable experiences and, hopefully, the thrill of victory. BH

This article is not intended to provide legal advice and should not be relied upon as such. Please consult with your own attorney and other professional advisers as necessary.

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