



Hedge Funds Sell Out

By Gerelyn Terzo

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BNP Paribas' prime brokerage business recently transferred a number of its smallest hedge fund accounts to middle-market investment bank Jefferies as part of an effort to focus resources on larger clients. BNP also found homes for much of the talent that serviced these accounts, and the employees similarly migrated to Jefferies.

Separately, hedge fund manager Stark Investments recently acquired the assets of rival hedge fund Deephaven Capital Management, including the firm's largest multi-strategy hedge fund plus four others, with a combined \$1.2 billion in assets under management at a depressed price. In this situation, personnel was not part of the deal, although Stark is considering "certain additions," according to a company spokeswoman.

Although the transactions differ, the deals are indicative of a trend unfolding in the hedge fund industry: consolidation.

Hedge funds are fighting for their survival in creative ways in response to changes in the financial markets and asset allocations by investors. The good news for many funds is that there are signs institutional investors are once again discussing earmarking capital for hedge funds. But recent events that have unfolded - not the least of which include fraud and dismal performance - have tightened the reigns on investment criteria to favor large institutional firms with high transparency and layers of risk management teams.

"Hedge funds with less than \$1 billion in assets under management will be competing more fiercely for a shrinking pool of investor dollars, which is largely being directed towards the bigger firms," says Robert Olman, founder of Alpha Search Advisory Partners. This is in part fueling the acquisitions of single-strategy hedge funds.

The typical hedge fund seller manages between \$200 and \$400 million in assets. By selling their fund, a hedge fund manager agrees to fold that strategy, portfolio securities, capital and talent into a larger firm. One of the appeals of selling is gaining access to the marketing prowess of an institutional hedge fund.

"They may be rolling their strategy into a large multibillion-dollar, multi-strategy fund with a large marketing staff that has deep institutional relationships," Olman says.

Hedge fund buyers, in turn, gain access to a proven hedge fund strategy without the expense and time involved in launching a new fund. Changes in the financial markets have hammered certain hedge fund strategies, such as short-biased funds, and created opportunities elsewhere, such as in distressed debt investing.

For example, the manager of an equity-based hedge fund might want to gain exposure in debt, in which it has no investment profile. One option is to build this strategy from scratch by hiring a team, building out the platform for debt

investing and allocating capital for trading and compensation. Or, this manager can locate a team that has the expertise to invest in debt with assets under management that pay fees, salaries and overhead.

Often times, these transactions are cashless or near cashless. Instead, the exchange is about the integration of a team of investment professionals.

"When you want to add a new investment strategy, the question has always been to build or buy. That question has been answered with hedge funds opting to buy," says Anne Gregg, who was recently tapped by Alpha Search to spearhead its new Hedge Fund Consolidation practice, a business that advises hedge funds through the acquisition process. Previously, Gregg specialized in M&A transactions at Bank of America, although she is quick to point out what's happening in the hedge fund market is different.

"We don't run auctions and we don't shop our clients indiscriminately. We rely on our relationships with hedge fund principals and founders," she says. "We have developed a targeted list of partners and approach them discreetly on behalf of our clients."

So discreetly, in fact, that the early stages of the acquisition process are completely anonymous. Alpha Search reaches out to a potential partner - either a buyer or a seller - outlining characteristics of another firm, all the while keeping the description of a hedge fund manager's background generic until a firm expresses explicit interest in the strategy.

Alpha Search is currently advising one asset manager in New Jersey that wants to acquire a hedge fund strategy from a financial institution that is divesting a non-core business.

"In this instance, I expect there will be some cash consideration with the bulk of it to be paid on earnouts contingent upon performance and assets under management retention," Olman says.

Hedge fund managers, however, are inherently entrepreneurial and accustomed to complete autonomy, and many of them left once-comfortable jobs at large institutional banks to be their own boss.

For these reasons, some fund managers might opt to close their doors before selling out. "These guys are all emperors who are trying to build their own businesses. I see people hanging on as long as they can pay rent," says Rob Davis, head of hedge fund service sales at Concept Capital. And even if consolidation does prove more prevalent, not every firm that wants to sell its strategy is an ideal candidate.

"The fact is that not all firms are going to survive. Last year alone 15% of hedge funds were liquidated ,"
Gregg says.

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