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Hybrid Structures

Financial Crisis to Slow Convergence of Hedge Funds and Private Equity Funds, But Not for Long

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Two of the most significant types of alternative investment funds worldwide are hedge funds and private equity funds. For years, these two alternative investment strategies have been converging. Although the financial crisis may slow this convergence, the trend will ultimately continue and strengthen – albeit with some important variations across countries.

In part because private equity funds and hedge funds both seek returns that are uncorrelated with overall markets, there is a natural synergy between the funds that has already helped fuel their convergence. Indeed, institutional investors often view their allocations to each type of fund as relatively interchangeable components of their overall allocation to alternative investments.

"Strategic" Convergence

In practice, private equity and hedge fund convergence takes place along two different and potentially overlapping dimensions. First, convergence may take place on the investment strategy or activity level (strategic convergence). Hedge funds may make long-term investments in illiquid assets that are normally the domain of private equity funds. Hedge funds may also compete with private equity funds for buyouts of large public companies or the purchase of mezzanine debt, or even by taking long-term equity stakes in companies with the goal of changing how management operates them.

Strategic convergence may take place either at the manager level, with a multi-strategy hedge fund that uses private equity strategies, or through a fund-of-funds structure. Strategic convergence more commonly consists of hedge funds utilizing private equity strategies than vice versa. This is because hedge funds are generally more flexible and opportunistic in their strategies and are therefore more likely to hire the requisite professionals where needed.

"Structural" Convergence

Private equity and hedge funds both typically operate as private limited partnerships that charge their investors a two percent management fee and a 20 percent performance fee. However, convergence can also refer to the ways in which the structures of the funds may become even

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more similar than they already are. Like private equity funds, hedge funds may use lock-up provisions that require investors to commit their capital for several years or may employ "hurdle" rates.

Hedge funds may also compensate managers on a longer-than-annual basis, not only to align manager and investor incentives on a longer-term basis than annual fees, but also so that, like private equity funds, hedge funds do not compensate managers until long-term assets are actually sold and gains are realized.

Impact of the Financial Crisis

The credit crunch, stock market crash, and ensuing international financial and economic crisis have deeply impacted both the global private equity and hedge fund industries. In 2008, the value of private equity investments decreased by two-thirds, and the funds raised nearly 75 percent less in the fourth quarter than in the fourth quarter of 2007. The result will be that private equity funds will likely consolidate, increase their mezzanine and distressed investing, decrease LBO and venture capital activities, and find new sources of capital from sovereign wealth funds. In the hedge fund sector, historic stock market losses and economic volatility in the fourth quarter of 2008 led to declining asset values, margin calls, and redemptions that resulted in the hedge fund industry losing approximately $582 billion in assets in 2008.

In general, the financial crisis is likely to temporarily stem the tide of convergence. Due to the effect of poor economic conditions facing private equity fund portfolio companies and the closures of many hedge funds, both private equity and hedge funds will likely focus on stabilizing their own funds before venturing out into new territory through convergence.

On the other hand, there are also forces that will likely drive more convergence in the longer term, even if convergence slows down until financial conditions improve:

- First, sophisticated fund investors are becoming more comfortable with hedge funds taking on private equity investment strategies.
- Second, national governments may take measures to mitigate the costs of the financial crisis by encouraging more private equity or by directly investing in private equity themselves through sovereign-wealth funds. China's government-owned Shanghai International Group, for example, has formed a joint venture with China's largest investment bank to manage a $2.9 billion private equity fund. The Chinese government is also encouraging more private equity by granting new licenses to local brokerages.
- Third, the development of secondary markets to trade illiquid mortgage-related securities may have the consequence of enabling convergence. Hedge funds could either use a secondary market to sell their mezzanine debt interests, or hedge fund investors could exit a fund simply by selling their hedge fund interests in a secondary market.

The current decrease in LBO and venture capital activity will force private equity funds to focus on those strategies that are most likely to experience convergence. Mezzanine debt, for example, is a strategy where hedge funds compete with private equity funds. In addition, activist hedge funds – the small number of hedge funds which take relatively large equity stakes in public companies and seek to influence their operations or structure – have performed relatively well in recent years. Because this is a profitable strategy, more hedge funds are likely to migrate there.

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Credit Derivatives: An Enabler of Convergence

Private equity funds may also begin managing their portfolios as if they were hedge funds. Private equity funds may utilize credit derivatives to manage the risks inherent in their equity or debt securities. Credit default swap indices could allow private equity firms to hedge the greater credit risks to which they are exposed in emerging markets. For example, buying protection through a credit default swap index referencing emerging market bonds may be a way for a US investor involved in a cross-border venture capital deal to hedge its risk (since there is a correlation between the success of an emerging market start-up and the overall health of the local economy).

Distressed Debt: Already Converging

Distressed debt investing is another potential area ripe for strategic convergence, both in the US and abroad. Hedge funds have already been increasing their investments in distressed debt securities. In 2009, a hedge fund managed by John Paulson, for example, purchased mortgage-related securities, the debt of bankrupt companies, and high yield bonds. In addition, a group of private equity and hedge funds converged by entering into an agreement to purchase the failed bank IndyMac.

These examples suggest that additional debt fund convergence is likely. Distressed debt securities are likely to be in large supply over the next few years as mortgaged-backed securities and other bonds come under continuing cash-flow pressure. Accordingly, hybrid private equity/hedge funds dedicated to distressed securities may emerge to offer investors different structures under which to invest in the securities. In addition, funds of distressed funds, which may allocate capital to private equity and hedge funds, may be a route for investors to gain a structurally diversified exposure to distressed securities.

Redemption Demand will Prevent Convergence

In 2008, investors were frustrated with hedge funds imposing gates and using other contractual provisions to prevent investors from withdrawing their capital. Accordingly, it is unlikely that hedge funds will be adopting stricter redemption constraints. Hedge funds that permit greater liquidity of their shares are likely to attract more investors than those with longer lock-ups or other redemption restricting devices. In this regard, hedge funds will likely diverge from private equity.

Convergence Around the Globe to Take on Different Forms

Convergence is generally less likely to occur outside of the most developed private equity and hedge funds jurisdictions. However, non-US jurisdictions may present significant opportunities for the convergence of distressed debt hedge funds and private equity funds as is already taking place in the US. In addition, convergence is likely to take on different forms depending on the jurisdiction.

In a 2004 MIT Sloan Working Paper, Josh Lerner and Antoinette Schoar studied private equity deal structures around the world. They found that in developing nations, more than one-half of

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the private equity deals utilize common stock and a significant portion use debt. This stood in stark contrast with the US, where convertible securities are often part of private equity deals. Lerner and Schoar also found that private equity transactions in jurisdictions with French or socialist legal origins are more likely to involve obtaining a majority stake in a portfolio company.

These findings have important implications for the shape of convergence in developing markets.

Both mezzanine private equity funds and convertible arbitrage hedge funds often utilize convertible preferred shares. Given this overlap, these types of funds will likely see greater strategic convergence in mature markets. On the other hand, because common stock is utilized by private equity firms in developing nations, opportunities for convergence between private funds and equity hedge funds may be greater in developing nations.

In an October 2008 study of how private equity funds in 39 nations made disclosures to institutional investors, Douglas Cumming and Uwe Walz examined whether differences in accounting standards explain how well private equity funds disclosed the value of their investments to their investors. The authors found that private equity funds in nations with lower-quality legal and accounting systems often overvalued their unsold assets when making disclosures to investors. This is because less stringent accounting standards give more discretion to private equity fund managers to value unsold investments. Accordingly, in nations with weak accounting standards, strategic convergence may have a unique attraction to hedge fund managers by using side pockets to invest in illiquid assets.

Crisis to Have Profound Effect on Convergence

The financial crisis's impact on the convergence of private equity and hedge funds will be profound. This impact is likely to play out differently around the world due to international differences in regulation and underlying economics.

Fundamental differences between hedge fund investment strategies, private equity, and the interests of their investors will prevent the two types of alternative investments from converging completely. But as regulatory regimes, economic conditions, and business practices become more homogenous around the world, international differences between the types of convergence will decrease. The result will be that private equity and hedge fund convergence will not only be a function of the differences between the funds, but will also reflect the differences between the jurisdictions in which the funds carry out their activities.

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