EDHEC Alternative Investment Days 2007

Bringing Academic Insights to Alternative Investment

14:30-16:00
Stream 1B:
Hedge Funds and Private Equity

Chairman:
Frédéric Ducoulombier, Associate Professor of Finance and Director, EDHEC Asset Management Education

Speaker:
François Serge Lhabitant, Associate Professor of Finance, EDHEC Business School and CIO, Kedge Capital

Panellists:
Vincent Beaujeu-Dumontel, Sales Manager, CACEIS Investor Services
Patrick Fenal, CEO, Unigestion and Advisory Board Member, EDHEC Risk and Asset Management Research Centre
Cecilia McAnuty, Managing Director, Centaurus Capital

EDHEC-RISK
Asset Management Research

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EDHEC-RISK

Asset Management Research

Old Quotes …

Although they look so current!

– *"It was so much easier to go to the public markets. It was cheaper, and there were very few covenants…It was fantasy….Smart money was able to raise dumb money from passive investors—money that would accept high risks for skimpy rewards".*

Forbes, October 1,1990

– *"Since we have the opportunity to invest in private equity on private equity terms, why would we want to invest on worse terms."*

A well known pension fund manager

How can you make money in financial markets?

- **Beta** - Take on a systematic risk for which the market compensates you by a risk premium.
  - Betas are easy to capture
  - We should not pay much for them.
- **Alpha** – Take money away from other participants
  - Alpha is zero-sum before fees.
  - Only investors who are smarter than the market will be able to reliably provide alpha.
- What do we want to pay for?

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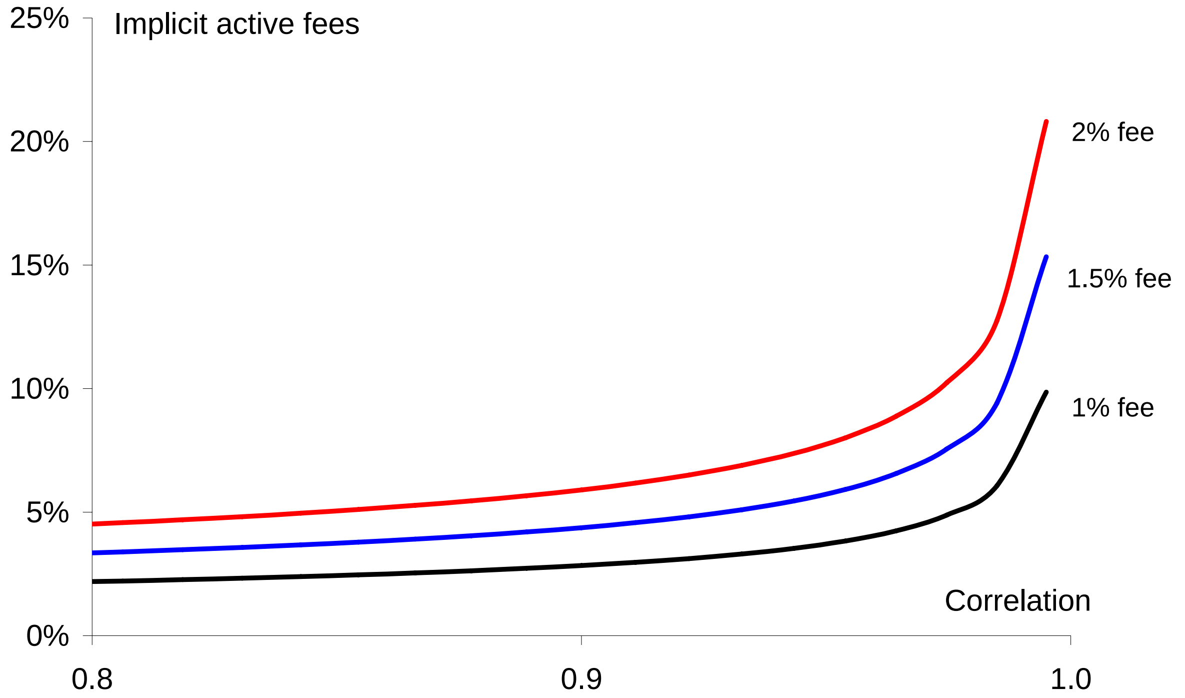
How much do you pay for alpha?



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Structural Differences

Hedge Funds

- 12,000 funds
- $1.5 trillion
- Indefinite life
- Ongoing fund raising
- Full investment
- 7% to 15% return
- Annual incentive fees
- No hurdle

- Flexible, opportunistic
- Portfolio skills
- Marked to market
- Active Risk Management

- “Fast food”

Private Equity Firms

- 3,000 funds
- $500+ bio deployed
- Fixed term (“vintage”)
- Closed after ramp-up period
- Drawdown (future liability)
- 15% to 20% return
- Fee on realised profits
- Hurdle rate (8%)

- Static
- Operating skills
- Marked to “model”
- Passive diversification

- “Long slow dinner”

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Why?

- Hedge funds
  - Pressing investment mandates.
  - Lofty performance objectives.
  - Enormous capital reserves and need to deploy capital.
  - Increased competition.

- PE firms
  - Diversification of revenue sources.
  - Natural extension of business model.
  - Smoother cash flows for the managers.
  - Poor average returns.

- HF and PE firms can compete in three key areas:

- **Institutional gatekeepers level:**
  - Leverage relationships and trust by offering services in another asset class
- **Product level:**
  - Combine private equity fund of fund capabilities with fund of hedge funds.
- **Strategy level:**
  - Distressed lending, mezzanine finance, activism, and in some of the larger buy-out transactions.

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Where is the overlap?

Appropriate Structuring is Required for PE Investments

– Hedge funds structures are inappropriate for PE.

– Hedge fund fees are inappropriate for PE.

– Origination, operating and corporate finance skills must be acquired.

Possible solutions

- Facilitate illiquid investments
  - Side pockets
  - Gates
  - Lockup
  - Drawdown and special situation funds

- **Beware of regulatory arbitrage!!**

Examples (1)

- **Combination to create a new firm**
  - Jeff Aronson, Angelo Gordon, Distressed Debt with Mark Gallogly, Blackstone Private Equity
- **Private Equity Adding Hedge Funds**
  - Blackstone Group, Bain Capital, Texas Pacific Group, Carlyle Group (fund of hedge funds; later equity l/s), D. E. Shaw & Co.
- **Hedge Funds Adding Private Equity**
  - Eton Park (hired Oliver Goldstein, Warburg Pincus), Och-Ziff (hired David Stonehill, Blackstone & Anthony Fobel, CVC Capital, HBK (structured-finance credit fund)

Examples (2)

- Sun Capital Securities
  - $300 mm first tranche (2004), Minority equity or debt investments and purchases in middle market companies
  - $3 - $50 mm; 1-3 year profile, 3-Year lockup; annual liquidity; perpetual fund; once invested, add next tranche; co-investing is allowed.

- SPAC: “special purpose acquisition company”
  - Blind pool raised through IPO
  - ~85%-90% held in escrow; 10%-15% for costs
  - ~18 months to buy a company
  - More than a dozen SPACs in past two years

Examples (3)

- Collaboration
  - Recognize strengths and complements
  - Recognize circumstances that are best for each profile of investment
- Ways To Work Together
  - Deal sourcing and origination
  - Financing
  - Exit strategy
  - Creative solutions

Conclusions

- PE and HFs have a lot in common, but also have major differences
  - HFs have a more attractive business model that enables them to buy high calibre expertise if required.
  - PE firms require long-term horizons and the skills to add value, areas few hedge funds are equipped to compete in.
- Investment mission and liquidity profile drive most differences
- Firms Are Adapting
- Convergence is currently occurring primarily among larger firms
- Collaborate rather than compete

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