Hedge fund and hedge fund group IPOs – The way forward

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Opalesque' special report on hedge fund IPOS, published in the Connecticut Hedge Fund Association and the University of Connecticut School of Business report ("The Current State of the Connecticut Hedge Fund Industry") which was presented at the October 11th CTHFA event: "Hedge Fund IPOs - the 4th Wave" (http://www.cthedge.org/events.html).

There are signs that hedge funds are shedding the characteristics and principles they are best know for, namely privacy, secrecy and exclusivity, to probe the public markets in order to attract permanent capital, public kudos, top talent and favourable exits. The phenomenon is rather new – it started with Man Group in 1994 and last year in the U.S. Some believe it is a sign of things to come, that hedge funds are adapting and evolving. Some believe it is just a market top.

I will start with a short history of the hedge fund IPO's – as it has indeed a short history - then relay the regulators and expert's views and finally detail the pros and cons of taking such a step.

The many Wall Street firms (Goldman Sachs, Morgan Stanley, Bear Stearns..) that are public and have large alternative investment divisions shall not be mentioned, nor shall hedge fund companies that have sold stakes or who have been acquired by such large groups. I shall however include firms who are not just in the hedge fund business but also in the private equity business.

A short history of hedge fund IPOs

1. European roots

The United Kingdom is ahead of the United States in the IPO game; it indeed started back in the 1990s. London's Alternative Investment Market (AIM), for example, has easier requirements, is friendlier to small size companies, and allows managers to open their doors to foreign investors.

1994: London-based **Man Group** was the first hedge fund group to have

listed in London The initial share price was £5.25; the shares then rose up to around £30 and then were split 6 for 1. The shares trade at around £4.79 today (x6). Man was also the first ever hedge fund company to list its products on the Channel Islands (which do not have the same restrictions as the U.K.); *Man Alternative Investments Ltd* (2001) and the *Close Man Hedge Fund* (2005).

“Man has experienced the listing as a good thing and it has ensured that Man has maintained high levels of disclosure and financial discipline,” Charlotte van den Berg of Man Investments told Opalesque. “This is something that also our clients appreciate.”

In August 2007, **Man Group** delayed indefinitely the planned IPO of one of its smaller fund, the *Man Dual Absolute Return Fund*, on the NYSE due to market conditions.

1999: **Liontrust Asset Management** listed on the LSE.

May 2005: **RAB Capital PLC** announced that the RAB Special Situations Company Limited had raised £40 million before costs via a placing of units of shares and warrants at 100p per share. RAB SSC is an investment company offering exposure to the RAB Special Situations strategy.

At that time, the media argued that even though such investments were good ways to boost income, they were not generating great returns for the managers. As the two quoted hedge funds (Man and RAB) were denied market endorsement, it was believed that no hedge fund company would follow suit, as the market may not put a fair price on them.

March 2006: **Dexion’s Alpha Strategies Ltd** (manager) raised $130 mil, one of the largest initial capital raisings to date in the London-listed funds of hedge funds sector. The FoF is advised by RMF, a core investment manager of Man Investments. In the same period, **Partners Group,** the Swiss based global alternative asset manager, launched its initial public offering on the SWX Swiss Exchange. The company said that the IPO served the purpose of strengthening the firm’s foundation for long-term independence and continuity. And **Absolute Capital Management** listed on AIM.

April 2006: shares in **Charlemagne Capital Limited** were admitted to trading on AIM within London Stock Exchange.

October 2006: ordinary shares of **Ashmore Group PLC** were listed on the London Stock Exchange.

November 2006: **BlueBay Group** got listed on London’s main market. In the same period, London-based **Marshall Wace** sold share of its hedge und, *MW Tops,* a closed-end investment company investing in two

Marshall Wace funds. This highlighted one of the reasons to list a hedge fund which was to reach less affluent investors. Indeed, few of the investors who bought the shares were already clients of MW.

January 2007: following regulatory changes by the FSA allowing single strategy hedge funds to list, **Brevan Howard** announced it would be the first to float a single strategy hedge fund on the London stock Exchange (*BH Macro*).

March 2007: **Braveheart Inv. Group** got listed on London Stock Exchange's Alternative Investment Market.

2. The U.S. saga

In the U.S., Fortress, GLG, Third Point (and PE group Blackstone) went public amid a burst of enthusiasm and predictions of more to come. Och-Ziff is still working on it and Citadel might just do so. The private placement route, also called the 144A market, was hailed as an alternative to raise capital as a number of other hedge funds postponed their listing during the subprime fall-out. At that time, there also were hopes that share prices would pick up when banks would be allowed to issue recommendations.

September 2006: **Fortress** was the first U.S. hedge fund group to go public, opening the way to other U.S.hedge funds. Fortress announced it was considering an IPO that could value the company from $5 to $7 billion. The Fortress Investment Group LLC IPO was filed in November and shares started being traded in February 2007, with great success (68% rise on the first day of trading). Fortress raised nearly $635 mil for an 8.5% stake. It was the group that was listed, not its hedge or PE funds (75% of Fortress' business is classified as equity).

The media reflected that the IPO would allow investors to profit from its investment advisory fees and incentive compensation rather than its funds. It was considered a "move to further break down the walls of secrecy that surround the industry". Insiders expected dozens of high quality hedge funds to get listed within the next few years and other hedge funds watched closely. Hedge fund groups who diversify in private equity and real estate such as Avenue Capital, Perry capital, Citadel Investment Group were thought to be the most likely to go public next. It was also argued that a hedge fund IPO would mean the 20% incentive fee usually charged by hedge funds would be transferred to shareholders, thus taking away the incentive from the managers who would be likely to perform less effectively – and thus drive down profits for all. This problem would however not apply to Fortress as its managers retained a large stake in the firm.

March 2007: New-York-based private equity group **Blackstone Group Lp** filed with the SEC to raise up to $4 bil for an IPO on the NYSE. <p>
June 2007: public shares in Fortress were down 28%. It was said that news that the U.S. Congress might tax financial-services partnerships as corporations, from the current 15% to up to 35% had had a negative impact on Fortress' shares.

July 2007: New-York based **Och-Ziff Capital Management Group** announced it was planning an IPO on NYSE that could raise around $2 billion, saying it planned to use the IPO proceeds to expand abroad in search of new strategies and investors. As the group planned to sell shares to the public as a partnership, it would not be subject to federal income tax, and also will not have to provide the same level of disclosure as most other publicly traded companies.

In the same period, London-based **GLG Partners** went public in the U.S. by selling itself in a reverse takeover deal. And New York-based hedge fund **Third Point LLC** unveiled plans for an IPO on the London Stock Exchange. Third Point ended up raising 24% below it target.

As the market for IPOs was cooling and share prices for Blackstone, Fortress, Man Group's MF Global were declining, it was suggested that listed hedge fund company share prices might pick up again as soon as the bank analysts who underwrote the offerings and who were temporarily barred from issuing stock recommendations and distributing research on the stocks, would be able to do so.

According to HedgeWorld, firms "could instead access institutional capital through the private market, conducting an initial equity offering via a private placement, also called the 144A market, which issues unregistered securities to a small circle of elite investors." In August 2007, Apollo Management LP began trading shares of itself in the 144A market, following the lead of Oaktree Capital Management, which did this in May 2007.

Connecticut-based hedge fund **AQR** Capital Management announced its plan to file for an IPO to raise $500 mil. But in the midst of the subprime debacle, AQR later postponed the plan. Rumours that private equity group **KKR** might be pulling out of its IPO due to the market turmoil were published.

Summer 2007 was not the best time to go public. The collapse of the Bear Stearns hedge funds and worries about higher taxes depressed valuations in the alternative investment sector. Raising money became much more difficult, given the subprime mortgage fallout and pressure on banks left holding the bag on bad loans.

In August 2007, the IPO market remained somewhat robust anyway, although hedge funds which rely on credit became less attractive to investors due to the credit freeze. So hedge funds had the choice of either cope with lower offering prices or wait until the market steadies again. And if the market~~s~~ continued to be difficult, hedge funds could always pull out and find alternate ways to raise capital.

September 2007: It was suggested that Citadel might be considering an IPO. In December 2006, Chicago-based **Citadel Investment Group** had sold $500 million of 5-year notes in the first-ever sale of bonds by a hedge

fund, highlighting another way to raise capital.

3. Signs of burgeoning in LatAm and Asia
July 2007: There were rumors that **Gavea Investimentos**, a Rio de Janeiro-based hedge fund, would attempt an IPO.

August 2007: Hong Kong-based **Value Partners** announced plans to become the first firm to launch an IPO on the Hong Kong stock exchange later this year. Chinese companies have raised $17.6 billion in Hong Kong IPOs this year, according to data compiled by Bloomberg, as investors bet on increasing demand in the world's fastest-growing major economy.

The regulators' point of view: generally positive

In March 2007, the SEC Commissioner Roel c. Campos shared his enthusiasm before a round-table: "…I would not be surprised if 2007 witnessed the advent of several other hedge fund managers entering our public markets, and I would welcome such a development. If hedge fund managers are willing to provide the transparency required of all public companies to its investors, I have no objections to them tapping the deepest and most liquid capital markets in the world. Moreover, these public offerings can also benefit investors by offering them yet a different way of getting a piece of the "hedge fund action." Investors who wish to share in some of the gains (as well as losses) of publicly offered hedge fund managers would be able to do so without the high minimums, fees, and long lock-up periods that would typically be required to invest in the manager's hedge funds."

In July 07, Mr. P. Borg, director, Alabama Securities Commission and president of NASAA, put forward before a U.S. House of Representatives committee an argument titled "After Blackstone: Should Small Investors be Exposed to Risks of Hedge Funds?" He stated that the Investment Company Act of 1940 ("the ICA") would offer vital protections against the risks inherent in the IPO of alternative investments.

In September 2007, Mr. Théodore, deputy CE of NYSE Euronext, said that public listings for funds could ease insecurity, as funds would provide more transparency.

The expert's view: the way to go

"Over the last 6 months we have continued to see more public transactions and… I anticipate it to continue going forward," Brian Sniger, senior vice president of the **Hennessee Group** said to Opalesque. "The big issue is about what fund managers believe they can get in the public markets; if the valuations are not what they hoped to realise then they won't go public. As a benchmark a lot of them are being valued at 30% of AUM. How profitable these organisations are will ultimately determinate their valuation. In terms of the credit crunch, some hedge

funds have exposure to credit but there are a lot of hedge funds that are doing very well in this environment as well…. Hedge funds are very different from private equities in that there are a lot of different ways of managing a hedge fund. I suspect hedge fund IPOs will continue as long as valuations are strong. There is a strong desire amongst hedge funds to acquire permanent capital and by going public. The larger groups are the more likely ones."

"(With regards to the transparency issue), there already are requirements in the U.S.; for instance a hedge fund has to file reports with the SEC for every equity investment that they have made in the U.S. I don't see the different requirements when going public really exceeding the existing ones a whole lot."

"A lot of hedge funds are trying to diversify their business, like Citadel, which is more than a hedge fund manager now, and I think that it is going to continue.

Charles Gradante, co-founder of the same group, had made similar predictions in Februray 07: "Large hedge funds are evolving into small investment banks and ultimately I see them doing an IPO to monetize equity interest" and thereby accelerate the already existent competition with larger investment houses. (Forbes).

Deterrent factors

Transparency

To go public, a U.S. firm has to file 10Qs and 10Ks with the Securities and Exchange Commission. The fact that managers are subject to strict disclosure and transparency requirements and the partners must disclose their compensation may not seem attractive to secretive hedge fund groups. They may instead float a small stakes and thereby disclose only parts of their trading instead. One of the edges that hedge funds have, is investment secrecy - one's strategy cannot be imitated by competition, and a good inefficiency opportunity does not become less profitable by the sheer number of participants. So the transparency that is required in public markets might put off some hedge funds and affect the returns of those who have taken the IPO step.

Fees

As mentioned above, there is the possibility that a hedge fund IPO mean the 20% incentive fee usually charged by hedge funds to investors would be transferred to shareholders, thus taking away the incentive from the hedge fund managers who would be less likely to perform as effectively – and drive down profits for all. Also, management fees (normally around 2% p.a. in private hedge funds) are awarded a higher multiple of earnings than incentive fees. So the best way to raise those fees is to manage more money – which could hinder the returns if the fund has too much capital.

Capital pressure

The problem with permanent capital is that there is pressure to put it to work, whether opportunities are there or not. Public hedge funds cannot, like private hedge funds, return surpluses to investors when the targeted markets are dormant. Public companies must answer to shareholders regularly and therefore managers, if under pressure from shareholders, may not be able to pursue long-term strategies. However, hedge fund firms (such as Och-Ziff) may wind up taking steps to try to reduce shareholders' power.

An advisor painted a pessimist picture however to the WSJ: "The burst of IPOs from huge hedge funds may be a market top. These people are enjoying significant cash flows that are unsustainable and they know that," says Michael Napoli, who runs Absolute Return Group, a Los Angeles-based hedge-fund advisory firm. "Why not realize some value when the flows from investors continue."

The allure of going public

No redemptions

On the other hand, permanent capital does have its charm. Whereas redeeming investors might be problematic for a private hedge fund, shareholders selling their shares would not affect a public hedge fund unless earnings underperform – which would affect the fund's brand and its ability to raise money. Once the shares are sold, they're in the investorshareholders' camp and the money raised does not have to be returned. And the manager gone public no longer has to constantly market his fund.

More AUM can be better

There is also the view that being large with more AUM may be a good growth factor; lower trading fees and financing costs, better risk management, greater variety of strategies. Larger hedge funds do better than small ones in a lot of the cases. Also, a public hedge fund, being in the public eye, may attract top talent – an undeniable benefit.

Exit doorway

The other appeal that may help some managers decide to go down the IPO route is that it is a good exit strategy for them, should they wish to cash out. Smaller hedge funds may take a different route to achieve the same results, such as M&A.

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If is possible that true alpha deliverers will be, in the end, few and far between and hedge funds will be under pressure to lower their fees - with the emergence of hedge fund replicates, say. Speakers at a recent Reuters Forum said that the hedge fund and private equity industries may have reached a near-term peak in their cycles after years of rampant growth. These rumors of impending pressure might be a sign of more IPOs to come. Boutiques may become rarer and large, public, diversified groups may become more prevalent.