THE HEDGE FUND JOURNAL
[JUNE 01 2012]

Corporate finance and hedge funds: how to add value to illiquid assets

Ben Keefe, Director and Head of Advisory, Gamma Finance LLP

The secondary market for buying and selling illiquid investments continues to undergo rapid change. Many stigmas about the sector have faded with the realisation that, post-crisis, most institutional investors and alternative fund managers hold some investments they can now describe as illiquid on their books. Whereas once this market was typified by distressed sellers, it is now the domain of competing, sophisticated buyers. However, unlocking value is more than just a matter of finding a buyer; it is also about being able to understand the fundamental value of the opportunity, and the best way that the value can be realised.

As a leading provider of corporate finance services to the alternatives sector, Gamma Finance has become well placed to support such transactions. Since its formation in 2009, Gamma Finance, through its global network of hedge fund, private equity and real estate investors and managers, has helped facilitate a range of client specific solutions involving transactions in illiquid investments from $1 million to over $200 million in value.

Evolution of the illiquid hedge fund market

The volume of illiquid hedge funds – i.e. those no longer providing their investors with the redemption rights stated in their prospectus due to gates, suspensions and restructurings - grew exponentially across the latter half of 2008. From a negligible pre-crisis base, volumes rose to approximately 14% of all hedge fund assets by the first quarter of 2009 ($200 billion out of a total $1.4 trillion). This increase, whilst severe, is understandable: in the search for returns during the pre-crisis bull market, hedge funds increased their leverage levels and increased their exposure to less liquid investments. This latter strategy was conceptually sensible: empirical evidence demonstrates that, on average, the greater timeframe a fund manager has to 'work' an investment, the higher the alpha generation.

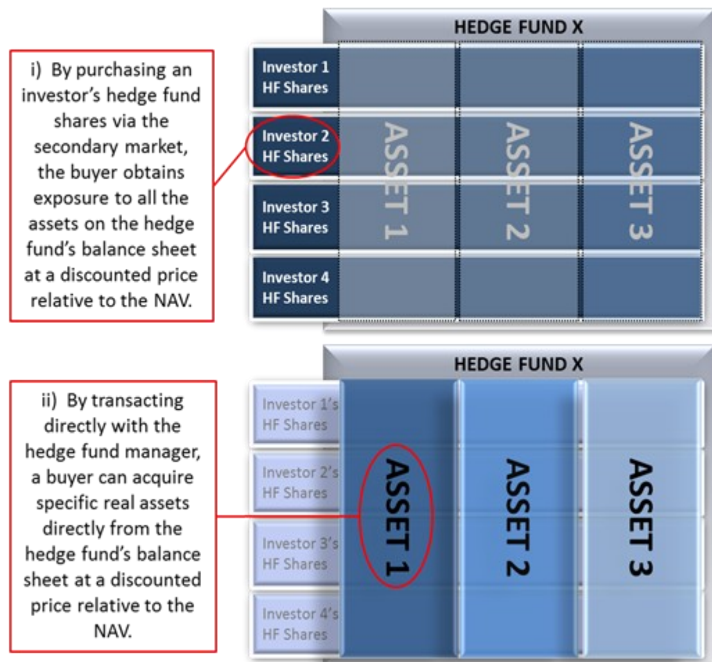
Indeed, hundreds of funds were launched across 2005-2007 which explicitly sought to exploit the alpha available through longer dated investments, for example privately originating non-tradable loans with maturities of 6 to 18 months. The redemptions terms offered to investors reflected the reduction in underlying liquidity – instead of a typical equity long/short fund offering monthly liquidity, such funds may offer six monthly exits, or notice periods of up to a

year. Such terms enabled funds to deal with 'normal' redemption levels of, say, 20% per redemption date. However the speed, scale and indiscriminate nature of the crisis was not anticipated, and many hedge funds found that liquidity in their underlying assets deteriorated just as redemption levels increased beyond levels previously thought likely – resulting in a severe structural liquidity mismatch.

In such cases, many fund managers opted to preserve capital by avoiding a fire-sale of assets in depressed markets: some exercised their gate; others side-pocketed the illiquid assets and issued shares in the side-pocket; some funds suspended redemptions entirely; others restructured into a 'continuing' and 'redeeming' share-class; and those funds that received a critical level of redemptions commenced an orderly wind-down of the investment vehicle. Mostly these actions were taken with investors' best interests, and the preservation of value, in mind. However the necessary trade-off was a deterioration in the liquidity provided to investors.

Current opportunities

As we move into 2012, the volume of assets on the balance sheets of illiquid hedge funds has fallen to approximately \$50-\$70 billion. This reduction is due to both distributions to investors, and the downward revision of asset valuations to reflect current market conditions. This impacts the wide spectrum of investors who allocated to such funds including asset managers, investment banks, leverage providers, fund of funds, family offices and private banks. Whilst this pool of 'locked up' investment vehicles can be problematic for investors seeking to exit, opportunities exist at two levels for investors searching for yield in a market currently characterised by low returns (see diagram 1).



First, investors that have been left holding illiquid hedge fund shares, and who have become frustrated waiting for cash distributions from the underlying hedge fund, have sought to sell their shares on the secondary market. The secondary market has only seen notable transaction volumes since the crisis, and whilst transparency continues to increase, it remains relatively inefficient - bids are often focussed on a few single hedge funds and, even with these sought-after names, there is ready

supply. Demand for other hedge funds is muted and inconsistent - bids may reflect the dynamics of buyers' individual situations, rather than reflecting an informed, objective assessment of the value of the underlying assets. Even those buyers that have access to capital and have an appetite for illiquids typically have small teams and a lack of up-to-date knowledge regarding many of the names that appear on "supply lists". This lack of knowledge, in conjunction with the comparatively few numbers of large buyers, mean that bids are often punitively low, especially for those names outside of the "sought-after" bracket.

Regulatory changes are further increasing supply. Basel III requirements are causing the regulatory capital cost associated with holding illiquid assets to rise, and banks have been considering whether their balance sheets may be more efficient if illiquids were sold. Solvency II is having a similar effect on insurance companies. The net effect of the regulatory drive to increase the resilience of the balance sheets of financial institutions is to also increase the supply of illiquids.

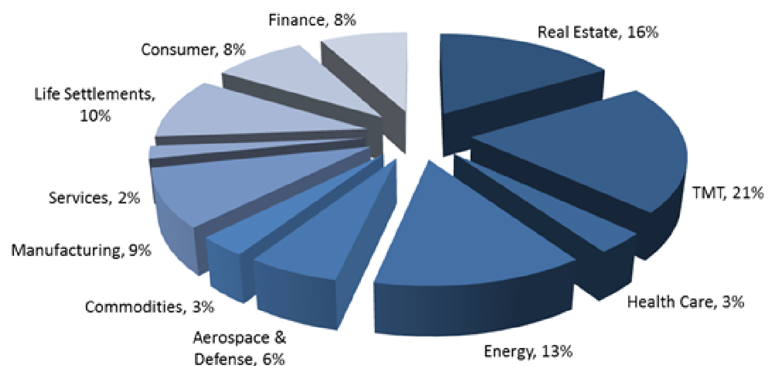
The above factors lead to the fact that the $50-$70 billion in illiquid hedge fund assets that remains today significantly outweighs the demand for $3-5 billion. This is a buyer's market.

Second, a market is developing in the acquisition of assets held on the balance sheets of illiquid hedge funds. In many cases, funds that today remain illiquid have seen their portfolios evolve dramatically. For example consider the case of privately originated debt or asset based lending: instead of a portfolio of loans, many such hedge funds now hold the assets that the loans were secured against (for example real estate, shares or machinery), or have had their debt substituted by the equity in the borrowing company. In both cases, exit horizons can be considerably extended when compared to the original investment.

This presents hedge fund managers with two issues: first, how to release capital to return to investors; and second, managing positions that may be beyond their core expertise as credit managers. Estimates would suggest several billions of US dollars of assets within this category. These assets, with three to five year investment horizons, are problematic for hedge fund structures and too illiquid for most investors' hedge fund allocations. However, this profile is ideal for those less constrained by liquidity, such as private equity buyers, sovereign funds, and family offices. At Gamma Finance we have noted that because private equity buyers are specifically looking for assets with this liquidity profile, they can be less punitive in terms of bids – making them ideal counterparties. A holder of an illiquid hedge fund share can recover notably more cash if the hedge fund manager sells the fund's assets to such buyers, when compared to the cash that investor could recover through a simple sale of their hedge fund shares in the secondary market.

To identify these opportunities, private equity investors need to both know where to look, and how to access this discrete marketplace that has historically been quite separate to the private equity space. It is an opaque market, and at Gamma we help such parties navigate and

source opportunities. Diagram 2 provides an illustration of the diversity of the assets available from a sample of underlying funds totalling $2.5 billion. Managers of illiquid hedge funds have long since overcome the initial taboo associated with holding illiquid assets, and often look for assistance in divesting themselves of specific illiquid stocks to free up capital either to return to investors or breathe life into the portfolio. Private equity buyers are turning to specialists to help access this supply of assets: as a result a bridge between the hedge fund supply and private equity demand is developing.



Valuation considerations and the merits of illiquids

The illiquids market reflects various valuation methodologies, both relating to the fund's net asset value (NAV), and the discount to the NAV required by the buyer. Hedge funds have, generally, marked down their net asset value over the past three years, in some cases quite ruthlessly, to reflect the impact of current markets on their assets. Any acquisition will require consideration of both the valuation methodology that is reflected in the NAV (and the extent to which it reflects 'fair' value), and the discount to the NAV required by the buy-side. For example, a buyer may look to acquire an asset for 50 cents per dollar (i.e. a 50% discount versus the NAV), with an expectation the fund will distribute over a three year period whilst depreciating by 20%. The buyer may expect to recover 80 c/$, allowing for 30 c/$ (or 60%) profit, translating into approximately a 20% annual rate of return.

Given the low yields available in the fixed income markets, low interest rates, and fear prevalent in the equity markets, such returns are increasingly being sought by sophisticated investors. However, does an asset that is available for purchase at steep discount to NAV always translate into a good buying opportunity?

In some cases funds trade at significant discounts because buyers, who are far fewer than the sellers, are unfamiliar with the fund's underlying assets. Lack of knowledge, rather than a considered assessment of the underlying risks, results in the punitive bid. Bids are frequently based upon partial or incomplete information, and sellers often recover less than they may otherwise expect. Such situations are common, but can be mitigated by using specialists: when working with institutions on sell-side mandates, it is possible to identify suitable buyers including family offices, private equity and dedicated buyers of secondary interests (existing buy-side clients have appetite of over $2 billion), and work to redress the informational imbalance to increase cash recovery.

In other cases, the discount may be appropriate given the risks within the underlying portfolio. For example, hedge funds holding assets that require on-going cash injections to maintain their value are particularly sensitive to depreciations. Consider a fund that holds a portfolio of life settlement policies. The fund is often the beneficiary of the policy pay-out, which can be substantial, even allowing for the payment of insurance premiums. Industry standard valuations use discounted cashflow models to derive the present value of the cash required to pay the premia, netted with the eventual receipt of the insurance policy pay-out. However, such models do not reflect the potential risk that the policies will lapse worthless if the hedge fund is unable to source the cash required to pay the insurance premia. In cases where there is legitimate concern that the hedge fund may be forced to let the policies lapse, thereby destroying the value of the asset, such funds are likely to trade at a sizeable discount. Conversely, other funds operating this strategy that may have limited cash flow concerns may be caught in the contagion and also trade at aggressive discounts – if they can be identified, they may represent an attractive buying opportunity.

Next steps in the evolution

There are several trends which we believe will characterise the illiquid hedge fund market over the next 12 to 24 months.

Sellers will continue to explore innovative ways to raise liquidity from their illiquid hedge fund shares. Where secondary market cash bids are too low, sellers will take advantage of solutions which raise immediate liquidity whilst preserving their balance sheet. We expect this to be welcomed by the dedicated buyers, who will have access to a pool of quality illiquids which has thus far been unavailable.

The current macro climate of low levels of lending and funding feeding into the real economy - resulting from the banks' efforts to recapitalise - will generate an increase in the supply of illiquid assets. Legacy illiquids will have their exits extended as re-financings fail, and new illiquids will be created as companies default and enter bankruptcy, unable to meet their liabilities to creditors.

This increase in supply will, in part, be absorbed by an increase in demand as this assets class receives further scrutiny and capital allocations from sophisticated buyers. Dedicated funds have already been created, backed by sovereign funds, pension funds and family offices. Many of these funds have been highly successful, and their backers are making further allocations.

We are expecting an increase in acquisitions of the assets directly from the illiquid hedge fund's balance sheets. We are already seeing strong appetite from private equity funds, who are keen to tap into this supply (see diagram 2). In many cases it is also administratively simpler to transact with the fund, rather than with multiple individual fund shareholders. Furthermore, supply can be directed towards buyers with specific appetite, increasing the probability of a successful bid. There will be an increase in the acquisitions of entire hedge fund

portfolios. Sometimes the incumbent managers will be recruited to manage the new vehicles.

We expect that the final few hedge fund managers who prevent investors transferring their shares to new investors will relax their view, as has been demonstrated by the majority of managers. These managers will see the benefit that can be achieved by replacing unhappy investors who want to leave, with new investors who have specific appetite for the liquidity of the underlying assets to which they have taken exposure.

At Gamma we have positioned ourselves to support clients through the evolution of this marketplace, which continues to be characterised by low levels of transparency, meaningful discounts, high yields, sophisticated buyers and appetite from investor groups not usually associated with the hedge fund space.