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Hedge secondaries market loses its edge of distress

David Walker , Investment Europe

The private market for trading hedge fund shares might not have returned to a pre-crisis state, with transactions often occurring above NAV. But nor is it any more "distressed sellers selling distressed assets in distressed funds", which prevailed immediately post-crisis, say intermediaries and advisors Gamma Finance LLP.

The London-based illiquid assets specialist, which provides solutions and advisory services to buyers, sellers and asset managers, says the reasons for selling illiquid shares have widened out, changing the landscape dramatically since Florian de Sigy founded the firm in 2009.

"Back then it was distressed sellers looking for cash, to cover private equity calls or real estate credit, with sellers driven by urgent demands for liquidity," he says.

"We are no longer talking to distressed sellers selling distressed assets because they think they are poor quality assets. Instead, the majority of sellers are simply calculating the benefits of remaining in a fund versus the opportunity of exiting privately in the secondary market."

For example there may be a bank that has identified the balance sheet cost of holding illiquid assets will rise under Basel III regulations.

Benjamin Keefe, director of Gamma Finance's new advisory business, adds: "Even if an investor still has conviction in the manager, developments in the underlying portfolio may diverge from their original investment objective, causing the investor to explore an exit solution.

"Our advisory business performs detailed, independent analyses of illiquid hedge fund portfolios. This enables us to inform and increase appetite from our buy-side clients, which in turn assists those wishing to sell."

For example, assets in a trade finance or ABL fund could have changed markedly if the refinancing of a loan made to a company - which was expected to furnish an exit for portfolio investors - fell through, or if the manager has subsequently had to take control over the company's hard assets.

Where this happens the fund might have transformed from an interest-bearing structure to a hard assets portfolio, changing its balance sheet dramatically. And while fixed income investors may then want to leave, hard-asset investors might spy a chance to enter, and at attractive levels.

Gamma Finance also helps hedge fund managers sell illiquid asset lines in their fund where potential buyers have appetite only for portions of the portfolio, for example private equity buyers seeking ownership of companies in specific sectors, or real estate funds with appetite for particular regions.

Sellers may also be unwilling to spend disproportionate time analysing relatively small illiquid portions of their total portfolio. "Buyers might have the opposite approach, having identified illiquid hedge funds as an asset class with yields far in excess of current interest rates" de Sigy says.

He notes some investors dedicated to buying private stakes have spent between $250m and $1bn of ‘first round money' in acquisitions, and are now returning with just as much fresh capital to buy more.

"Some have invested over $500m already, and are willing to commit further assets of up to $1bn," de Sigy says.

Family offices and funds of funds have been involved, but with such large asset sizes involved, the ultimate backers of some dedicated secondaries investors could well be institutional.

However, the sizes of stakes Gamma Finance has helped trade vary immensely, down to $1m and up to $500m. It quotes on between 150 and 200 funds for which it already identified supply or demand, as well as specific assets with fund portfolios.

As the crisis climate abates, so too might some asset managers' hesitancy to allow secondary trading of their funds, for fear a trading price - usually discounted from NAV - might be thus attached to their portfolio.

The number of managers vetoing transfers is now "extremely limited", says Keefe.

Indeed, managers may welcome direct transfers because managers then need not sell assets to honour redemptions, and might be able to replace an investor who wants to exit with a new one aware from the outset of the situation.

"Rather than thinking they are locked in an illiquid asset, the new investor is happy to take a longer term view and focus on value maximisation rather than short term liquidity," says de Sigy.