The Berkshire Capital Newsletter

2005 3rd Quarter | New York | Denver | London | www.berkcap.com

Berkshire Capital Securities LLC is a privately-owned investment bank that provides merger, acquisition, valuation and strategic advisory services to clients focused in the investment management and securities industries. Since 1983, Berkshire Capital has completed almost 200 transactions (with AUM transfer of over $340 billion and an aggregate value of over $8.7 billion) and over 150 valuations, strategic reviews and fairness opinions.

Headquartered in New York City, the firm has offices in London and Denver. The Berkshire Capital team consists of about 40 professionals and support staff dedicated to our mandate with more than 20 years experience focused in the investment management and securities industries.

535 Madison Ave., 19th Floor
New York, NY 10022
212.207.1000 (phone)
212.207.1019 (fax)

The Berkshire Capital Newsletter is distributed electronically.

To subscribe or unsubscribe, contact:
bcs.feedback@berkcap.com

© 2005 Berkshire Capital Securities LLC. All rights reserved.

Some information presented in this publication may be obtained from third-party sources considered to be reliable. Sources are not required to make representations as to the accuracy of the information, however, and consequently, Berkshire Capital Securities LLC cannot guarantee its accuracy.

AS THE HEDGE FUND INDUSTRY ENTERS THE NEXT PHASE OF ITS LIFE CYCLE, OWNERS FACE A RANGE OF QUESTIONS REGARDING THEIR STRATEGIC OPTIONS

The hedge fund industry has been enjoying an extraordinary run over the last 10 years. The number of funds, which has more than tripled during that time to reach 8,000, continues to increase. Indeed, there are now roughly as many hedge funds as there are U.S. mutual funds and the hedge fund universe is now larger than the one housing publicly traded stocks. New funds continue to launch and fail on a daily basis.

> **But as the industry enters the next phase in its life cycle, what will happen to the firms that are run by the most creative and entrepreneurial among those managers?**

Assets under management (AUM) have grown around 10 times during that period and have doubled in the last four years to reach $1 trillion. **Hedge Fund Research, Inc.** figures net inflows exceeded $38 billion in the first half of 2005.

Hedge fund managers themselves have become the superstars of the asset management industry, their reputations enhanced by the shroud of mystery that envelops their activities. But as the industry enters the next phase in its life cycle, what will happen to the firms that are run by the most creative and entrepreneurial among those managers? There are a number of indications that the hedge fund industry's hyper growth years may begin to yield to a gradual period of maturation:

- Although institutions will increase their investment in hedge funds, **The Tower Group** has forecast that the annual growth rate for hedge fund assets will moderate in the years ahead to about 15% over the next 3 years.

- The performance of the industry as a whole has turned uneven. While hedge funds generated superior returns during the three-year bear market through 2002, performance lagged the S&P 500 index in 2003 and again in 2004. This year overall investment performance has remained somewhat uneven with significant variability between top quartile players and those in the lower half.

- A recent survey by **Citigroup Private Bank** and **McKinsey & Co.** of ultra-high-net-worth individuals found that while they remained committed to investing in hedge funds, a majority expressed concern about the sustainability of returns going forward.

• The Securities and Exchange Commission has taken tentative steps toward oversight following a lengthy study period last year, and the European Commission is planning a review of the industry. Investors have joined regulators in calling for greater transparency.

• While the industry has come a long way from the Long Term Capital Management debacle, the risks facing investors were underlined recently by the fraudulent activities at **Bayou Group** as well as several other financially troubled hedge funds.

• The media have begun to follow the industry more closely, and the coverage has become more skeptical. In its May 30, 2005 issue, a front-page headline about hedge funds in Barron's asked, "Is the Party Over?"

Although observers may differ regarding the extent of the changes facing hedge funds, there is a broad consensus that the industry is entering a new phase in its life cycle. And, with more than 8,000 funds in operation, the industry could be facing a shakeout. This situation will lead increasing numbers of firms that wish to grow and create capitalized value to consider their options,which may include any of the following: go it alone, partial capitalization, strategic business expansion, IPO, merger or some combination of the above.

A substantial shift in the thinking of some founders is causing them to consider the partnering approach, which can take three forms: merging with a complementary firm; selling into a strategic partnership; or taking stakes in other hedge fund firms.

The easier decision for firms that plan to go it alone involves tactical moves such as expanding or rationalizing a product line or investing in internal or third party marketing. Due to the large wave of assets flowing into the top end of the sector, selected aggressive hedge funds are leading the convergence into a private equity/merchant banking model. These funds are taking controlling interests in whole companies and major stakes in exotic or esoteric assets such as ships or fine art. Other leading and mid-sized firms are contemplating joint ventures or other strategic alliances with private equity firms that already have this capability.

For some owners who will have made their fortunes and wish to reward the people who helped build their businesses, an internal option for capitalizing value involves selling the firm to employees. In these transactions, owners typically offer a discounted price and a deal structure that involves a payoff over time. The marketplace is seeing more boutiques and large institutions offering to facilitate the financing for this type of transaction.

A few firms with the size and track record to attract investors–and the willingness to contend with public scrutiny–may opt for initial public offerings. Last year, **RAB Capital** (AUM: $1.8 billion) began trading on the London exchange, where it joined hedge fund giant **Man Group**, although these remain the only two publicly-traded hedge fund groups. The depth of interest among investors in this market remains unclear. In any event, we believe this route is limited to the larger hedge fund managers and may only appeal to a select set of those that have the option.

A substantial shift in the thinking of some founders is causing them to consider the partnering approach, which can take three forms: merging with a complementary firm; selling into a strategic partnership; or taking stakes in other hedge fund firms. New York's **Asset Alliance** showed last year that it is moving past the challenges it faced with one of its acquisitions–troubled **Beacon Hill Asset Management**–as it took a stake in hedge fund advisor **Spencer Capital Management**, a deep-value investor. Meanwhile, **Ospraie Management** sold a minority stake to **Lehman Brothers** in a deal that provides the highly regarded 5-year-old firm with cost synergies through the offering of Lehman's prime brokerage services.

When **Highbridge Capital Management** (AUM: $7 billion) sold a majority share to **JPMorgan Chase** for as much as $1.4 billion, it was the first $1 billion-plus deal involving a hedge fund manager. Highbridge co-founder Glenn Dubin described the deal as "perhaps the vanguard of the institutionalization of the hedge fund industry" and cited JP Morgan Chase's ability to "strengthen our portfolio financing operations and access to intellectual capital across product and business lines." The fund of hedge funds sector also has a large-scale transaction in process as **Permal Asset Management** (AUM: + $20 billion) has agreed to be acquired by **Legg Mason**. Subsequent to the announcement of these landmark transactions, the number of M&A related private discussions in these sectors have increased considerably.

For the entrepreneurial and independently-minded managers who start up hedge funds, selling a majority share raises a fundamental question: How do you want to live the day after the deal? Selling to a larger firm can bring generous upfront financial rewards, along with operational synergies and a potentially more stable investment capital base. But it also means giving up autonomy and to some extent becoming an employee once again.

As sellers weigh their options, another major obstacle to cutting deals results from the outsized nature of the industry itself: owner expectations regarding pricing can be excessive, though the past year has seen a closing of the bid/ask spread between buyers and sellers. Both sides are continuing to work their way through the valuation and deal structuring paradigm.

Traditional asset managers weighing acquisitions or strategic investments are intrigued by the growth, fee levels and profitability of hedge funds. As a result, there is an increasing acceptance of the benefits of an in-house hedge fund or fund of funds business. For buyers, "key man" risk tops the list of concerns. The potential volatility of performance is another challenge. Also, structuring deals for buyers necessitates both protecting against poor future performance while providing generous incentives for continuing superior returns. The marketplace is becoming more comfortable with this balancing act, partly through the avenues of staged transactions and longer-term earnouts.

> **For the generally entrepreneurial and independent-minded managers who start up hedge funds, selling a majority share raises a fundamental question: How do you want to live the day after the deal?**

So, where does the hedge fund market go from here? For many hedge fund owners, the strategy is to institutionalize their businesses by developing a broader platform. Multi-strategy organizations appear to be a logical way to diversify and stabilize the income stream, while reducing the dependence on a single manager, channel, investment idea or market segment. Moreover, these organizations may become formidable challengers to funds of funds, which are characterized by the additional layer of fees and lack of direct investment expertise. An alternative strategy to build a multi-product platform may be the merging of single strategy hedge fund groups.

High net worth clients are asking for alternative products, and institutions are also increasingly attracted to this sector as they see the Harvard and Yale endowments outperform the long-only market, on the strength of carefully selected investments with premier hedge fund managers. The key for larger investors is to assure that they are able to capture some of the limited capacity of the premier firms and that they achieve diversification so that they, like the managers themselves, are not overly dependent on a single strategy or individual.

As more hedge fund firms trade or go public, the range of experience will make management more comfortable with not only the reasonableness of the valuation range, but also the expected amount of leverage that can be realized from distribution and captive market share.All this will take time, just as the development of the market for traditional managers took many years to mature. In the meantime, hedge fund managers will continue to build for the future and the industry sophisticates will tap into the lucrative income stream that the industry affords. ❖