FINANCIAL NEWS

Thursday, 28 June 2012

Banks evaluate their stakes in funds

Harriet Agnew

27 May 2011

Nearly five years ago, Morgan Stanley went on a hedge fund buying spree, snapping up stakes in three hedge fund firms in as many days. A global financial crisis later and opinion remains divided as to whether buying all or part of a hedge fund manager is a good idea.

Not for sale

The Volcker Rule, which has effectively banned investment banks from using their own money to speculate in the markets, has raised the question of whether banks that bought stakes in hedge funds are going to have to sell them.

Morgan Stanley's sale of a majority stake in FrontPoint Partners to its management and Man Group's sale of its 25.5% stake in BlueCrest Capital Management back to BlueCrest demonstrate that the issue is not one-size-fits-all. Decisions will be made on the merits of each case.

There is a wide variation in the performance of firms where stakes have been taken: some have proved lucrative, others have been sent reeling by internal or external pressures.

Bankers say alternatives transactions – which represent a growing percentage of asset management deals – will remain attractive as potential buyers look to tap into the renewed surge in hedge fund growth. The decision will be on what kind of investment banks require: economic or strategic.

The Volcker Rule

The Volcker Rule has helped shape thinking. There has been uncertainty as to the precise application and time frame of the rule and how it will affect banks that own hedge funds. A closer look at the legislation suggests, in most cases, banks will be able to keep these existing hedge fund stakes. Robert Lustrin, a partner at law firm Seward & Kissel in New York, said: "To the extent that owning a hedge fund firm doesn't require the bank to make investment in its funds, they aren't barred from ownership."

The Volcker Rule is concerned with what banks do with proprietary capital, rather than those firms that manage money on behalf of a third party, such as hedge fund managers.

Goldman Sachs declined to comment on its Petershill fund, which sits within its asset management division and has several minority stakes in hedge funds.

A spokesman for Morgan Stanley said it was in the process of evaluating its hedge fund stakes.

Credit Suisse, which bought a 30% stake in York Capital Management, declined to comment. JP Morgan, which owns 100% of Highbridge Capital Management and has a majority interest in Brazilian alternatives manager Gávea Investimentos, was unavailable for comment.

Mixed experiences

So far, the experience of banks buying stakes in hedge funds has been mixed.

Aaron Dorr, head of asset management investment banking at Sandler O'Neill, said: "The current value of stakes in hedge funds must be looked at on a case-by-case basis. However, those that were bought in 2006-2007 are either worth significantly more or significantly less than they were, depending on how individual managers performed during the crisis."

In some instances, the fates of these stakes highlight the fragile nature of hedge fund companies, and potential pitfalls for investors.

Ben Phillips, partner at management consultancy Casey Quirk, said: "It's human capital. It's highly mobile."

Assets are also very mobile. Early last year, the Petershill fund bought a stake in Shumway Capital Management, an $8bn hedge fund firm run by "Tiger Cub" Chris Shumway. In February, Shumway announced he was shutting down the firm after management changes unsettled investors, who opted to pull $3bn and were expected to redeem more. Shumway and Petershill declined to comment.

Firms are also vulnerable to external circumstances. Level Global Investors, a $4bn firm in which Petershill also owns a stake, said in February it was closing the firm and returning cash to clients, after a November raid by the Federal Bureau of Investigation as part of a federal insider-trading probe. Level Global did not respond to a call and an email seeking comment, and Petershill declined to comment.

Other stakes have been highly successful. Kevin Pakenham, co-founder of advisory firm Pakenham Partners, said: "I think generally these stakes have been perfectly profitable. However, I'm not sure that they've brought a great deal of synergies."

Winton Capital Management, in which Petershill bought a 10% stake in 2007, made net profits of £206m in 2008 and £45m in 2009, and has seen assets more than double from just under $11bn to $22bn over the course of Petershill's investment.

Capula Investment Management, in which Petershill bought a stake in February 2008, made profits of £92.2m in the 12 months to September 2009 and profits of £57.5m in the six-month period ending March 31, 2010.

Since JP Morgan began its relationship with Highbridge in December 2004, initially acquiring a majority interest, but taking full ownership in July 2009, Highbridge's assets under management have grown from $7bn to more than $27bn.

Tapping into growth

The market for alternative investment grew last year. As a percentage of total asset management deal activity, it grew from 26% in 2009 to 44% in 2010, according to Sandler O'Neill. There were 38 total transactions in 2009 and 57 the following year.

Dorr said: “At base level, it’s driven by the existing and expected growth in the hedge fund industry. Given the opportunity, many firms look to acquire exposure to this rather than build it themselves.”

Others have opted for a stake that gives them a strategic advantage, but no say in running the fund.

Phillips said strategic stakes could help with generational change, distribution and managing the business. In April, when Swiss private bank Reyl & Cie bought a 50% stake in emerging markets specialist Samena Capital’s hedge fund seeding business, V-Nee Yeh, the chairman of Samena said the deal would help Reyl further its ambitions in the region, while Samena would benefit from the Swiss firm’s “extensive knowledge in mutual fund management and European distribution”.

Dorr said: “Financial deals typically involve a passive investment, whereas strategic deals involve groups who have an ability to influence the future of the business through distribution or other synergies. Amongst strategic buyers we’ll start to see more of the majority transactions; where motivations remain financial we’ll see more in the minority category.”

Phillips said: “You’re less likely to find financial buyers right now; they’re going to be strategic.” Pakenham said that the big distinction for the buyer was whether they have control or not. He said: “I think that the model of full integrated ownership is the way that people will want to go.”

Man Group took this route earlier this year when it sold back its 25.5% stake in BlueCrest and, shortly afterwards, took full ownership of hedge fund boutique Ore Hill Partners.
How do you own a hedge fund management firm? Very carefully.

The Dresdner Kleinwort 104: Where are they now?

European investment banks 'still overstaffed'

Barclays and Libor: a transgression too far

Ten questions to be answered on ‘Liborgate’