Crossing the line: The growing convergence of private equity and hedge funds

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About the author

Harris Smith, Grant Thornton West region managing partner.[1]

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I. Executive summary

This white paper explores a trend that has received an increasing amount of press coverage — the phenomenon of convergence of private equity firms and hedge funds. As this trend has gained visibility, affected investment communities seek a broader perspective on how it developed, who is driving it, how widespread it has become, how it impacts market participants, what challenges it creates for large and middle-market firms, and how this trend may evolve.

To explore these questions, Grant Thornton undertook a survey through the auspices of the Association for Corporate Growth (ACG) and MARHedge, a leading news service that serves the hedge fund industry (the ACG/Grant Thornton Survey). For the survey, ACG polled its member private equity firms and MARHedge polled hedge funds that subscribe to its news services. Survey questions probed a number of areas related to the convergence of hedge funds and private equity groups. We supplemented this survey with background research and interviews with several hedge fund and private equity senior executives and a number of other individuals involved in these areas.

The survey reveals that companies seeking funding will likely benefit from the vast amounts of capital available from an increasingly wide range of sources. At the same time, a number of significant challenges may stifle convergence beyond the very largest hedge funds and private equity funds and potentially limit this phenomenon from moving to the middle market in a significant way. As with any investment, the future growth will ultimately depend on investor appetite for these offerings and the market conditions in effect.

Note: Convergence occurs when hedge funds and private equity firms go beyond their traditional domains to offer both types of investment funds. Readers may find it useful to refer to the Appendix, which provides definitions of a number of other terms used in this paper.

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II. Introduction

As the public equity markets struggle through another lackluster year, record numbers of institutional investors are seeking the higher yields private equity funds and hedge funds can generate. According to *Buyouts* magazine, there were 267 buyout and mezzanine funds being raised in the first half of the year, which together amassed $82.8 billion in new commitments. Last year, U.S. buyout funds raised a record-breaking $173.5 billion, according to *Buyouts* magazine data. This brings the total U.S. private equity capital under management by 1,546 U.S. private equity firms to $811.2 billion as of June 30, 2006, according to Thomson Financial. Worldwide, there are approximately 3,000 private equity funds managing $1.5 trillion, according to Freeman & Co. At the same time, MARHedge reports that 8,800 hedge funds are now managing some $1.2 trillion in assets worldwide, with approximately 60 percent in the United States.

This influx of capital — and the challenges of deploying it — are leading many of the largest private equity and hedge funds to expand their traditional horizons and offer both hedge and private equity funds under one roof. For example, traditional private equity firms Auda Advisors, Bain Capital, Blackstone Group, Carlyle Group, Kohlberg Kravis Roberts & Co., Mesirow Financial and Texas Pacific Group all offer investors both private equity and hedge fund alternatives. Hedge funds such as Cerberus Capital Management and D.E. Shaw are becoming more involved in private equity-type investments. The acquisition of Kmart by hedge fund ESL Investments and the subsequent merger with Sears is a hedge fund transaction that looked very much like a private equity buyout.

Convergence of private equity and hedge funds is also producing some unusual hybrid structures that blur the lines between these vehicles. With increased frequency, hedge funds that historically have offered relatively easy access to liquidity are now structured to require up to three years for an investor to receive a full redemption. Together, these activities signal an evolution that raises a number of complex philosophical, operational and accounting questions.

The combination of convergence and the large capital flows mentioned above has clearly been a boon for companies trying to raise capital, since they now have greater choice and flexibility when bringing new debt and equity capital to their balance sheets. It may prove equally advantageous for private equity and hedge funds, which have capital to deploy, infrastructures to support, risks to manage and investors to reward. However, this phenomenon is not without its challenges and prices. The landscape for reasonably priced investments has become far more competitive, with more sources of money pursuing the same target companies. Convergence has also introduced a number of challenges relating to fund formation, ongoing management and value realization. Future convergence will depend on how effectively funds address these challenges, as well as continued demand from the investment communities.

For now, it appears the trend will continue with the larger fund operators. At the same time, the future is less clear for middle-market funds, where a number of obstacles are keeping most from crossing the line.

Future convergence will depend on how effectively funds address these challenges, as well as continued demand from the investment communities.

III. Market overview: Defining the universe

In a piece published in late 2004,[2] Freeman & Co.[3] presented a thoughtful perspective about how perceptions of asset classes have changed since the 1950s, and how this evolution has impacted asset allocation. From the 1950s through the 1980s, asset classes such as equities, real estate, international, emerging markets and mutual funds evolved from alternative assets to broadly accepted and widely employed parts of asset allocation models. In the 1990s, private equity and hedge funds entered the picture, and the current decade has yielded broad acceptance of these investment classes among institutional investors.

Today, substantial capital is flowing into these newer asset classes as institutional investors increase their portfolio allocations. What's more, there is every indication that these flows will continue for some time to come. The Freeman white paper projects that by 2010, U.S. assets invested in hedge funds will grow to $1.08 trillion (a 9.1 percent annual growth rate), while private equity investment will reach $1.61 trillion (a 10.7 percent annual growth rate).

As these allocations increase, private equity firms and hedge funds are employing increasingly creative and complex strategies to differentiate their funds in a highly competitive market. Table 1 broadly outlines the predominant fund strategies managers are using today — and how they align in the competitive landscape. Fund types listed next to each other can and do compete for investments in their respective spaces.

TABLE 1: Fund strategies

Private equity funds	Hedge funds
Global Buyout	Global Macro
Middle Market Buyout	—
Country Focused	Emerging Market
Mezzanine	Fixed Income
Distressed Debt Trading	Distressed Securities/Event Driven
Distressed Debt Control and Restructuring	Distressed Securities/Event Driven
Secondaries	—
Industry Sector	—
Venture Capital — Technology, Life Science,[4] Other	Equity Hedge Long/Short
Fund of Funds	Fund of Funds
—	Market Neutral
—	Market Timing
—	Futures
—	Convertible Arbitrage

Although the table illustrates some of the variety of investment vehicles that operate in these spaces, in some respects, it provides little sense of the complexity of the current environment — especially as large hedge funds launch separate private equity funds, create hybrid funds and invest in companies in ways that look like private equity transactions. For example, hedge funds are now regularly buying debt issued by portfolio companies of private equity groups. The line blurs even further with complex vehicles like equity hedge long/short funds. In some circumstances, they provide capital that enables venture-backed companies to either replace other funding sources that are no longer available or achieve financial leverage that is not otherwise available. Our interviews with fund managers and bankers revealed that these activities by hedge fund operators are creating intense competitive and pricing pressures for larger, sponsor-focused mezzanine funds.

The ACG/Grant Thornton Survey[5] confirms that convergence has become the new status quo. In fact, only six percent of private equity respondents and four percent of hedge fund respondents said "there is no significant overlap."

[2] *Convergence in Alternatives*, Nov. 29, 2004.

[3] A boutique M&A advisory and strategic management consulting firm focused exclusively on the financial services industry.

[4] It is not unusual for venture funds to fund both life science and technology investments.

[5] The ACG/Grant Thornton Survey, conducted in June 2006, was completed by 123 ACG private equity members and MARHedge hedge fund subscribers.

IV. Survey results

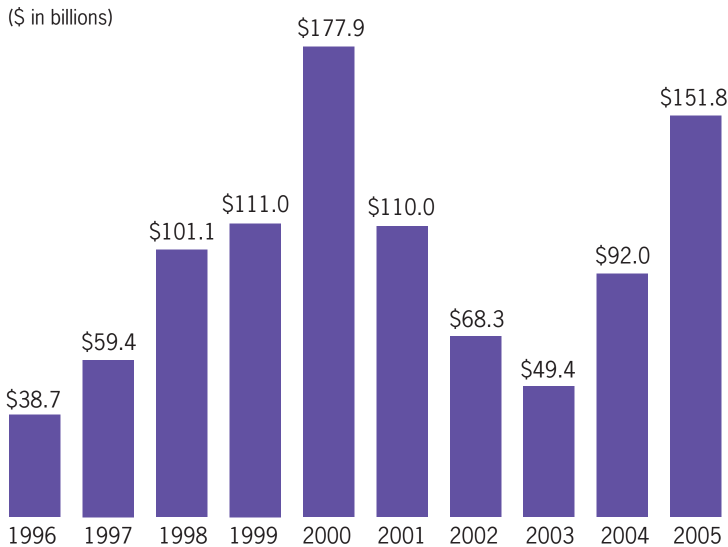
Growth of convergence

Any analysis of the convergence of private equity and hedge funds must begin with the broader trends of dramatically increased fund sizes and the steady influx of new funds. By way of example, in 2005 a private equity fund raised more than $10 billion for the first time — a threshold that is now crossed regularly. Table 2 lists representative fund sponsors who have raised some of the larger funds.

TABLE 2: 2005 Private equity fundraising

The amount of private equity investment capital raised increased greatly in 2004/2005 after three years of rapid decline

Private equity funds raised



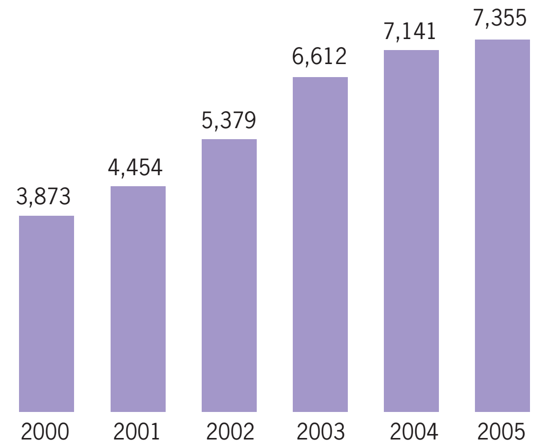
Source: *Private Equity Analyst*

Selected recently reported fund raises

Sponsor	Fund	Amount
Recently closed		
Carlyle (+Europe)	Fourth	$10.10
Goldman Sachs	Fifth	8.50
Warburg Pincus	Ninth	8.00
CVC Europe	Fourth	7.30
BC Partners	Eighth	7.30
Apax Partners Worldwide	Sixth	5.20
PAI Partners	Fourth	3.50
Advent International	Fifth	3.30
CVC Capital Partners Ltd. (Asia Pacific)	Second	2.00
Credit Suisse	Third	2.40
Sun Capital Partners Inc.	Fourth	1.50
Currently being raised		
Blackstone Group	Fifth	$12.00
Apollo Advisors	Sixth	10.20
Warburg Pincus LLC	Fifth	8.00
Thomas H. Lee Partners LP	Sixth	7.50

Hedge funds have received a significant amount of new investment. Table 3 shows the amounts invested in hedge funds.

TABLE 3: Hedge fund industry assets and number of funds

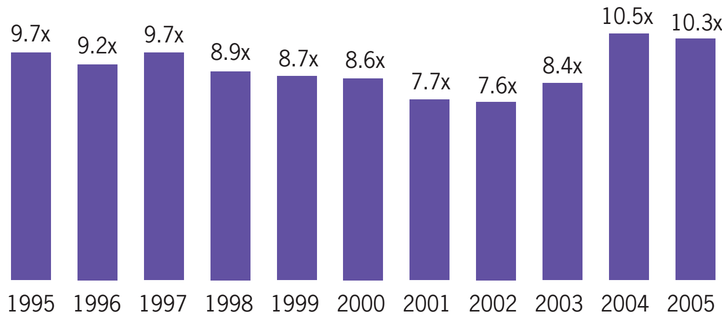


Source: Freeman & Co.

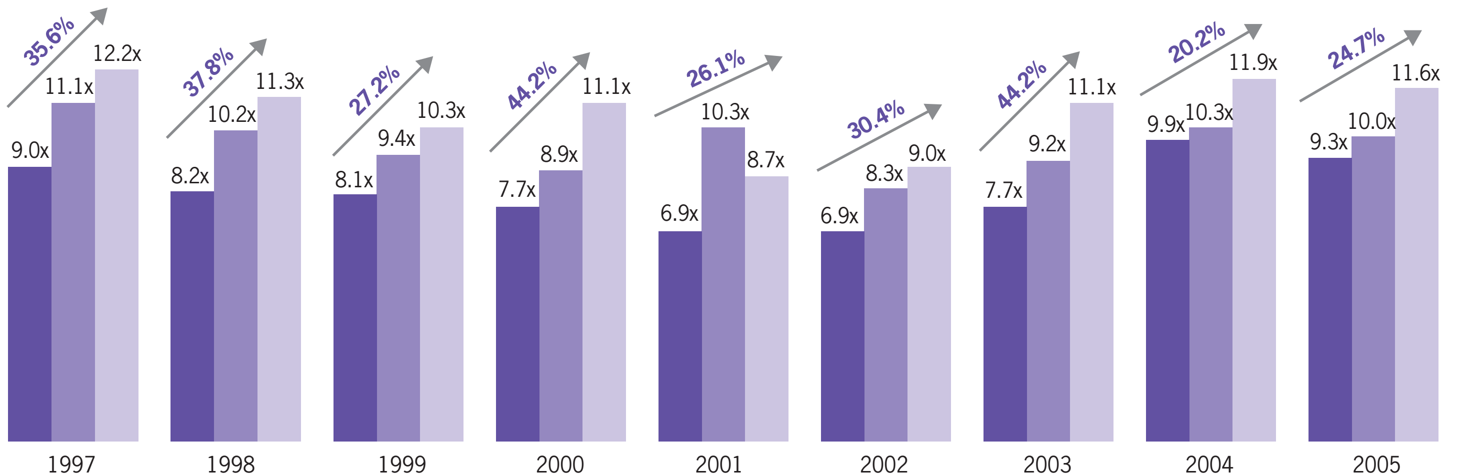
Private equity funds are facing increased competition, and valuations and EBITDA multiples have increased significantly after dipping in 2001 and 2002. Table 4 shows the average multiples for private equity-backed transactions from 1995 to 2005, and the relationship between these multiples and deal size.

TABLE 4: Private equity fund multiples

Median enterprise value to EBITDA transaction multiples



Median enterprise value to EBITDA transaction multiples (based on deal size)

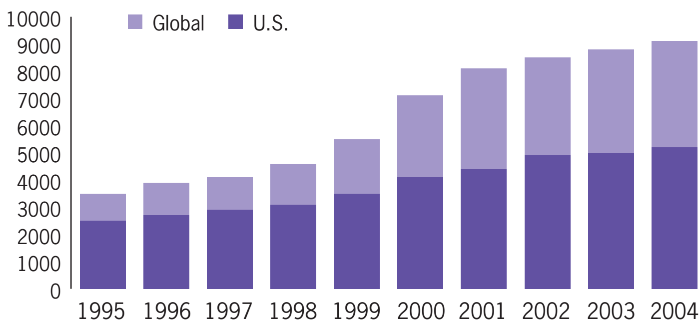


Although larger companies continue to be valued at a significant premium compared to middle-market companies, the spread has narrowed recently to its lowest level in several years.

Source: The Blackstone Group, Credit Suisse, Houlihan Lokey Howard & Zukin

Perhaps most revealing, the number of private equity and hedge funds continues to increase dramatically. Table 5 shows the growth of private equity funds since 1995.

TABLE 5: Growth of private equity funds



Source: Thomson Financial

This dramatic increase in both investment capital and competition has placed intense pressure on private equity and hedge funds to deploy capital wisely. In this environment, convergence represents a natural evolution.

Table 6 lists some recent offerings of funds by organizations that cross the line from private equity to hedge funds or vice versa.

Faced with more competitors and strong demand for underperforming public companies, hedge funds are pursuing convergence because they must deploy their growing fund assets across a broader spectrum of financial opportunities. In doing so, they hope to leverage their true market advantage — the value of their human capital and knowledge — in these new areas.

Private equity firms are seeking ways to realize gains on a more current basis, rather than waiting for portfolios to mature.[6] Some firms are catering to limited partners who seek greater portfolio diversification. This "all things to all people" approach takes private equity funds from the world of private transactions with limited public disclosure to the more transparent environment of Regulation FD.

TABLE 6: Examples of recent convergence

Private equity firms that have started hedge funds

- Bain Capital
- The Blackstone Group
- Carylye Group
- Quadrangle Group
- Texas Pacific Group

Hedge funds with private equity

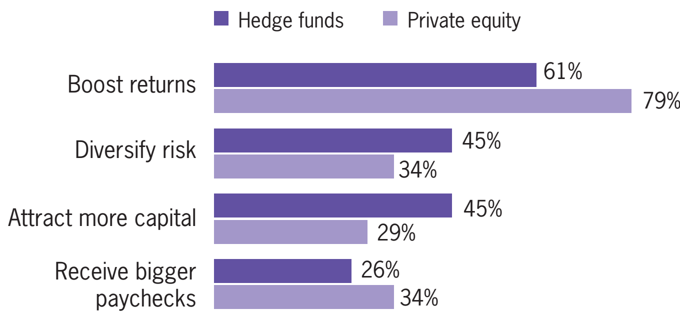
- Carlson Capital
- Cerberus Capital Management
- D.E. Shaw
- Eton Park Capital Management
- HBK
- Och-Ziff Capital Management
- Odyssey Partners
- Reservoir Capital

[6] Examples of this include Silver Lake's Seagate going private and subsequently going public play, and the Merrill, Carlyle Group and Clayton, Dubilier & Rice acquisition, re-cap and filing for an IPO for Hertz, as well as Ripplewood Holdings taking their portfolio of Japanese companies public on the Benelux exchange.

The ACG/Grant Thornton Survey supports and extends this analysis as demonstrated in Table 7. Hedge funds responded that they are targeting the private equity space to boost returns (61 percent), attract more capital (45 percent), diversify risk (45 percent) and receive bigger paychecks (26 percent).

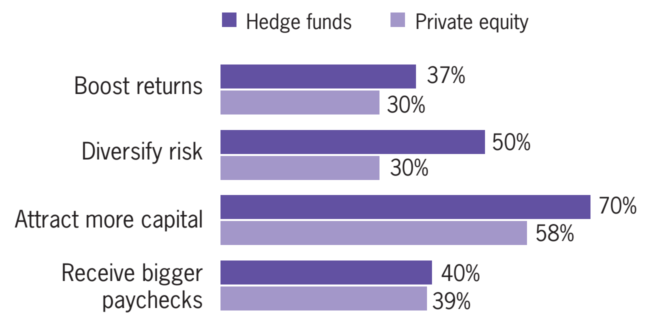
Private equity firms reported that entering the hedge fund space will help them attract more capital (58 percent), receive bigger paychecks (39 percent), boost returns (30 percent) and diversify risk (30 percent) as demonstrated in Table 8.

TABLE 7: Reasons for hedge fund involvement in private equity



Source: ACG/Grant Thornton Survey

TABLE 8: Reasons for private equity involvement in hedge funds



Source: ACG/Grant Thornton Survey

The ACG/Grant Thornton Survey also provides insights into the spread of convergence. Respondents agree that it has become a widespread trend with the very large buyout funds, with 41 percent of private equity managers and 52 percent of hedge fund managers responding that the trend is confined to the largest funds. In addition, 46 percent of private equity managers and 52 percent of hedge fund respondents believe that convergence will continue to grow within the large fund sector.

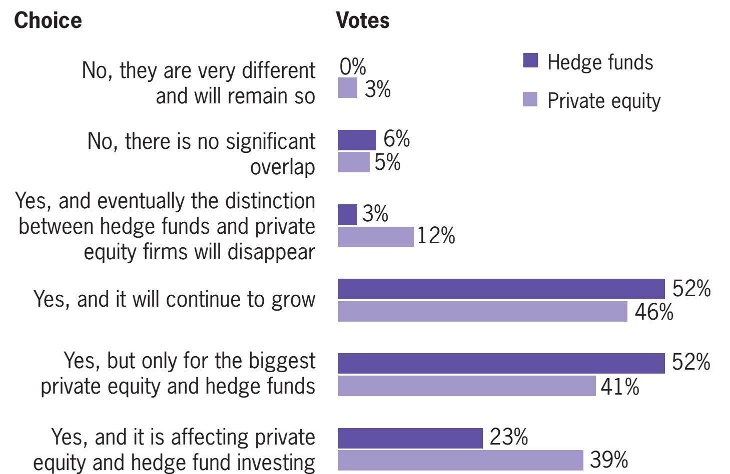
This response may reflect the strong belief by managers of both private equity and hedge funds that, except for the largest firms, their peers should resist crossing the line. Fifty-five percent of private equity firm fund managers hold this opinion, with 30 percent responding that convergence only makes sense for the largest buyout firms. Hedge fund managers are equally skeptical that private equity firms have the knowledge and resources to succeed in the hedge fund arena. Forty percent responded that it doesn't make sense for private equity firms to cross over, and 40 percent responded that it only makes sense for the largest buyout firms.

The extent to which convergence has penetrated the middle market (defined for this paper as funds managing up to $1 billion in assets) is less clear. Carl Icahn's Quadrangle Group moved in this direction by launching a hedge fund. H.I.G. Capital recently announced its decision to raise a $500 million hedge fund.

Respondents to the ACG/Grant Thornton Survey generally believe that convergence in this sector is less prevalent. Table 9 shows that while most respondents in both asset classes believe that the lines between private equity and hedge funds are blurring, there is substantial evidence that this phenomenon is limited to only the biggest ($5 billion plus) of funds.

TABLE 9: Blurring the lines between private equity and hedge funds

Are the lines between private equity firms and hedge funds blurring?



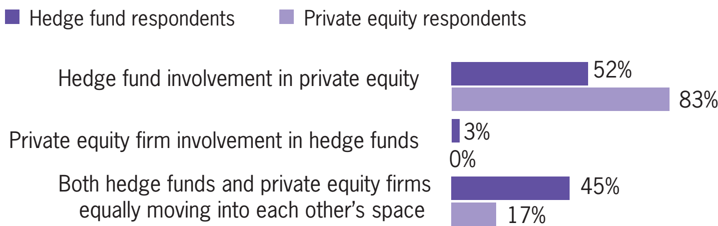
Source: ACG/Grant Thornton Survey

Leaders of convergence

The ACG/Grant Thornton Survey also revealed some significant divergence in thinking about which fund category is driving this convergence as demonstrated in Table 10. Eighty-three percent of private equity fund respondents believe that hedge funds are more likely to become involved in private equity, while only 52 percent of hedge fund respondents share this opinion. In addition, only 17 percent of private equity respondents believe that both hedge funds and private equity funds are moving equally into each other's space, while 45 percent of hedge fund respondents believe this to be the case. This finding suggests that hedge funds are far more willing and likely to expand their horizons than are private equity funds. Many private equity firms and hedge funds also revealed that despite the convergence trend, they prefer to stay within their traditional investment comfort zones.

TABLE 10: Hedge funds leading convergence

Blurring of the boundaries between hedge funds and private equity is being driven primarily by:



Source: ACG/Grant Thornton Survey

Reasons for convergence

Today's competitive investment environment clearly has private equity firms and hedge funds looking further afield to invest. The ACG/Grant Thornton Survey suggests that convergence is ultimately about following the money. Fully 79 percent of private equity respondents believe that the potential for higher returns is driving hedge funds to invest in private equity, and 61 percent of hedge fund respondents concur.

As the survey suggests, other forces are at work as well. These include:

Deal sizes. As noted above, both private equity and hedge funds today have increasingly large asset pools to invest, and they face tremendous pressure to find strategically focused investments that can meet target return thresholds. In addition, the dramatic increase in allocations to hedge funds has created especially tough challenges within their traditional domain.[7] These factors, coupled with the sharply higher EBITDA multiples being paid in private equity deals over the last several years, have substantially increased the size of many transactions. This has naturally brought more public companies into play, further enhancing the likelihood that private equity and hedge funds will cross the line into the other's territory.

[7] As one interviewee put it, the easy money in arbitrage has gone by the boards, suggesting that the competitive landscape has become much more challenging for hedge funds operating in this segment.

According to Dealogic, nine out of the 10 largest private equity transactions ever were announced in 2005. As the scale of transactions has increased, private equity firms are now competing with hedge funds for smaller public companies. Historically, these companies have been too large for most private equity firms, but with increased fund sizes and the recent phenomenon for large private equity firms to team up in "club deals," they are now susceptible to buyout arrangements.[8]

PIPEs have emerged as the most common financing technique private equity firms use to invest in public companies. This structure first took hold in the late 1990s, when the public markets were generally closed to companies that went public prematurely and needed expansion capital. Now, this technique is quite common. According to the *Los Angeles Business Journal*,[9] in the first quarter of 2005, almost 400 PIPEs were closed. Over half were with companies whose market capitalization was under $50 million, and 75 percent were with companies whose market capitalization was under $100 million. These deals typically include terms and conditions such as preferred stock, warrants or convertible stock-designed in many cases to produce gains resulting from the deal structure as opposed to any operationally driven increase in the value of the issuer of the PIPE. The natural outgrowth of this has been more investment in public companies by both private equity firms and hedge funds, creating an appearance of convergence.

Use of brand. Groups such as Carlyle, KKR and Blackstone have achieved significant visibility and brand recognition with both the general public and potential investors. They are leveraging their brands to sell new types of financial products, especially to their existing investors. As a result, these big-name players have attracted a large share of capital, giving the appearance of convergence, if not consolidation.

One-stop approach. This concept has two dimensions — one internal to the private equity firm or hedge fund and one resident with investors. Firms that can offer a breadth of products may also be able to elevate their status from product purveyors to comprehensive solution providers who are more deeply embedded with their clients. In other words, by offering both private equity and hedge funds, these firms can provide comprehensive asset management and placement services to institutional investors who have been increasing allocations to alternative investments. In turn, these investors can rely heavily on these private equity and hedge funds to produce returns that meet the investors' needs.[10] Having fewer managers for this asset class makes it easier for institutional investors to manage their growing portfolios. As noted below, increasing numbers of larger funds and investors are using both funds of funds and separate accounts.

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[8] Although we have not seen a great deal of evidence to support this, we would have thought that Sarbanes-Oxley would have also driven many smaller public companies to go private, because of the cost of compliance with SOX, and its effect on earnings and, at least theoretically, valuation.

[9] *Los Angeles Business Journal*, June 20, 2005

[10] We would note that particularly with larger fund managers and larger institutional investors, there is a significant increase in the number of fund of fund offerings being utilized and in the allocations being made to those offerings. It appears that the driver for this is principally risk mitigation; the thinking is that more diversified portfolio of managers provides less risk of significant, fund-specific loss.

Leverage of knowledge bases and human capital. Typically, private equity investment professionals develop expertise in specific industry segments and financial engineering, while their counterparts with hedge funds rely more on technical analysis (e.g., pricing inefficiencies, arbitrage, etc.) to drive their investment decisions. This industry knowledge applies equally well to both the private and public markets and works to the advantage of private equity funds as they cross over. When hedge funds target private companies, the financial information they typically rely on is not nearly as easy to obtain as comparable information from public companies, often making it difficult and more time consuming to gather .[11] With the increasing scale of hedge funds, fund managers need to deploy their human resources efficiently to maximize the value of their existing human capital and knowledge bases. Their success will have a significant impact on investment performance.

Results. Though it's too early to tell whether convergence will produce the returns private equity firms, hedge funds and investors hope for, respondents to the ACG/Grant Thornton Survey are clearly skeptical. Nine percent of hedge fund respondents indicated that hedge fund investment in private equity type deals would outperform private equity fund performance, while 43 percent think their returns would be worse than private equity funds. Similarly, five percent of private equity respondents believe that hedge funds will outperform private equity funds in their private equity investments, and 68 percent think hedge funds will underperform private equity funds.

When considering private equity firms investing in hedge fund-type investments, 10 percent of both private equity and hedge fund sponsors believe that private equity firms' returns will outperform, while 44 percent of hedge fund sponsors and 57 percent of private equity fund sponsors believe that private equity firms' investments in what are typically shorter-term or public company hedge fund investments will underperform.

These responses indicate that many private equity firms and hedge funds are unwilling to stray too far from their known areas of expertise.

With the increasing scale of hedge funds, fund managers need to deploy their human resources efficiently to maximize the value of their existing human capital and knowledge bases.

[11] Significant advances have been made with respect to the quantity and quality of private company information available through subscription-based services such as CapitalIQ, Thompson Financial and others.

V. Implications for market participants

As more capital has become available from a wider range of sources, market participants are evaluating their opportunities and challenges carefully and are shaping their strategies accordingly.

Target companies. Companies looking to raise capital may have the most to gain from convergence. Adding new investors to the roster of available capital sources will mean more choices as providers of capital. Although this competition may or may not result in stronger pricing, it will almost certainly provide additional choice and flexibility when companies want to bring new capital to their business.

For example, companies seeking late-stage venture capital are now tapping the deep pockets of hedge funds, according to Jeff Heely, senior managing director at Advanced Equities, Inc., an investment bank focused (among other things) on serving venture capital firms. He noted that hedge funds usually forego board representation, opting instead for observation rights. He also commented that hedge fund investors are far more concerned about buying at the right price than their venture counterparts. This dynamic may make negotiations for late-stage investments quite interesting and offer companies some real advantages in deciding where to go for funding. All of this said, this type of investment activity certainly benefits companies looking to raise capital from what had previously been unlikely sources.

Fund operators. Convergence has a significant impact on private equity firms and hedge funds. The repercussions are myriad and vary widely depending upon where in the market these funds are positioned.

For the largest fund operators, convergence presents an opportunity to shift their focus from fund management to asset management. Although this may make it easier to attract talent, there is some concern that this shift may cause misalignment with investor interests. For smaller fund operators, including some that many would not consider small in any sense of the word, convergence will ripple through their businesses and impact even most basic matters. On one hand, it will raise fundamental questions about what private equity and hedge funds do, how they do it and how they position themselves in the market. It will also influence more operational and seemingly mundane matters such as compensation, employee retention, fund design and capital raising. Although the specific effects of these issues will vary, convergence will clearly complicate the operational requirements of all but the largest fund managers.

Investors. The investor community (or more accurately, communities) will ultimately decide the direction and extent of convergence. If forces like one-stop shopping and ease of relationship management weigh more heavily, convergence will mostly likely continue to take hold and become even more prevalent throughout the various strata in the alternative asset space. Conversely, if administrative complexity, potential conflicts of interest and muddied investment platforms move to the fore, then only the larger asset managers will continue to offer both types of investments, and convergence will not move down market.

A recent study of institutional investors by Probitas Partners[12] sheds some light on institutional investors' views regarding the market conditions that seem to be fostering convergence. When asked to identify their biggest concerns in the near term, respondents indicated over-leverage (especially in the large buyout market), excessive fees and too much capital in the space as their biggest concerns. They expressed additional concerns about a divergence of alignment between private equity firms and hedge funds and their investors, and the pressures of placing large amounts of money rationally.

In addition, the Probitas survey revealed some resistance to hedge fund investments. About half of the investors surveyed indicated that they either have or are planning to invest in hedge funds (51 percent), five percent are considering such an investment, and about 40 percent have no inclination to invest in hedge funds. Our interviews confirmed these concerns. One fund of funds manager we interviewed expressed significant concerns about the shifts being seen in hurdle rates[13] and other structural terms and conditions in hybrid funds.

[12] Probitas Partners 2006 Private Equity Investor Survey.

[13] The rate of return at which returns shift more favorably toward the fund managers.

VI. Challenges

No discussion of convergence would be complete without some analysis of the challenges, issues and potential pitfalls private equity firms and hedge funds face when considering a dual-offering strategy. Although private equity and hedge funds share a number of similarities, several structural differences and operational considerations relating to fund formation, fund management and value realization make convergence quite complex — especially when it takes the form of hybrid structures.

Fund formation

Private equity firms and hedge funds have some notable and often conflicting demands on their structures that make convergence into a single vehicle problematic from a valuation, compensation and marketing perspective.

Combined funds present significant challenges when it comes to valuation, performance reporting and compensation. For example, hedge funds that contain illiquid assets must decide how to account for these assets. Because of their need to allow for redemptions, they provide frequent valuations of their portfolios so that investors can know what their interest in the hedge fund is worth. This is straightforward when their portfolio consists solely of publicly traded assets that can be marked to market easily, but for obvious reasons it becomes far more complex when the portfolio has assets that are not easily valued. This affects not only valuation for redemption (and purchase) purposes, but also fund manager compensation, because hedge funds typically tie compensation to quarterly performance.

Frequent periodic evaluations of illiquid assets lead to significantly higher administrative costs, since these valuations require independent professional analysis and validation. (Allowing a general partner to value illiquid assets leaves open the possibility for abuse.[14]) Bifurcating the compensation structure to address different asset types contained in the same fund presents its own issues. At minimum, it adds a layer of complexity that may drive investors away. This strategy may also make compensation arrangements more complex, thereby making it more difficult to draw talent to the fund.

Private equity-type vehicles such as BDCs have had to deal with the valuation issue for the past several years, and, in fact, several of the larger PE funds have recently initiated processes for independent valuations of their portfolio companies on an annual or semiannual basis. A call for more transparency within private equity funds has fueled some of these changes. Another possible reason is the potential desire for private equity funds to provide more liquidity to investors. Thus, the initial steps have already been taken to bridge this particular challenge.

Although private equity and hedge funds share a number of similarities, several structural differences and operational considerations relating to fund formation, fund management and value realization make convergence quite complex — especially when it takes the form of hybrid structures.

[14] In addition, obtaining an opinion of an illiquid asset's fair value does not easily translate into what that asset would be worth if it were sold.

Combined funds also create challenges in presenting to investors the fund's financial condition and performance. Funds need a clear way to present financial information when a portion of the portfolio has values that are readily ascertainable and can be marked to market easily, and the remainder consists of investments that have no ready market and are typically carried at the lesser of cost or fair value.

Dual or hybrid fund structures present even more significant challenges when it comes to compensating fund managers and investment professionals. Hedge funds award compensation based on short-term changes in fund value. Private equity firms necessarily model their compensation to align with the longer-term horizons associated with their investments, resulting in an emphasis on the carried interest of the fund. Beyond the valuation issues discussed above, combined funds must address this compensation issue in a way that private equity and hedge funds find acceptable. Although some funds create compensation arrangements that take into account the activities of multiple funds, accomplishing this within a single fund seems extraordinarily complex. A number of respected private equity professionals have been recruited by hedge funds offering substantial compensation packages.[15]

Convergence also complicates the way private equity firms and hedge funds market and present themselves (and their fund offerings) to institutional investors. As discussed earlier, it is allowing large fund operators to position themselves with investors as one-stop solution sellers. However, asset allocation models may stand in the way of this marketing strategy. Most institutional investors allocate monies to private equity shops as part of a pool of money oriented to the longer term, while allocations to hedge funds are typically made from different investment pools — and typically by different institutional decision makers. This disconnect between concentrated product offerings and hybrid structures and the typical institutional investment decision-making process may undermine this asset management marketing and branding approach.

Fund management

Funds that combine liquid and illiquid assets also present practical challenges for managers of private equity firms and hedge funds, since they must determine how much liquidity is available to investors. Typically, hedge funds provide for periodic (i.e., quarterly) redemption rights, something that is relatively straightforward given the liquid nature of their investments.[16] Those hedge funds that invest in more illiquid assets, such as non-public debt, generally have instituted processes for periodic independent valuations or reviews of the general partner's valuation processes for these assets. Of course, these are generally newer funds that experienced this administrative burden during their formation. Thus, they were able to build these costs into their fees or anticipated overhead.

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[15] We also note that, particularly with larger private equity funds, the reply to this has been a dramatic increase in current compensation levels, which can be afforded as a result of the increased fees generated by the larger funds.

[16] This assumes, as discussed in Section VIII of this paper, that hedge funds invest only in liquid assets. While the author recognizes that this is not always the case, it is generally true with "typical" hedge funds.

Private equity funds cannot offer this option because their investments are generally highly illiquid, and often are held for significantly longer periods before value can be achieved. These investments typically extend from at least several years to seven to 10 years or more.

Generally, attempts by general partners to institute independent valuation processes, especially on pre-existing funds, would result in additional administrative costs that have to be borne by the general partner, since amending the partnership terms is not easy.

Some fund managers have departed from the traditional hedge or private equity funds models by adjusting lock-up periods and using so-called side pockets. These hybrid funds are being offered by both pure hedge fund operators (e.g., Eton Park Capital, Odyssey Partners and Reservoir Capital) and private equity players (e.g., Texas Pacific Group's TPG-Axon fund). These funds typically allow investors to redeem assets in liquid parts of the fund, but not in the illiquid parts .[17] Although this structure may address the immediate liquidity needs of investors, it may also result in imbalance should a fund's performance in the public markets drive a large segment of investors to request redemptions.

Our discussions with several of the larger hedge funds revealed that fund management structures are in a state of evolution and flux. Some fund managers are modifying fund structures to create longer lead times for investors to redeem their interests. Others are setting up teams to attack market segments that have been the purview of private equity and altering their strategies to be able to pursue opportunities outside the traditional realm of hedge funds. We also found at least anecdotal evidence that managers of smaller hedge funds may be using side pockets with greater frequency, though some believe investors resist this structure in smaller funds. This blending of strategy within a fund is clearly a move to both garner more capital and achieve a broader base for returns. The success of this strategy will depend on whether the fund sponsor has the skills and managerial breadth to adopt a longer-term strategy for some portion of its investment portfolio.

Another dimension to the liquidity question is the fund's ability to reinvest proceeds from the sale of its investments. Hedge funds uniformly have the right (and indeed, are expected) to reinvest monies resulting from the sale of their portfolio holdings. Private equity firms typically are structured to distribute the proceeds from the sale of an investment, or the stock issued by the portfolio company in the event of an IPO. Although this may be addressed by segregating investments in a hybrid fund, this segregation and the added complexity it requires may diminish some of the allure of a single fund pursuing investment strategies that traverse this investment universe .[18]

Our discussions with several of the larger hedge funds revealed that fund management structures are in a state of evolution and flux.

[17] See, for example, interview of Jeffrey E. Tabak, partner at Weil, Gotshal & Manges, in *The Metropolitan Counsel*, February 2006.

[18] It is this kind of consideration that may encourage fund managers to offer both types of funds separately under the same organizational umbrella rather than try to house both types of investments in the same fund.

Convergence also places the responsibility on fund managers to carefully control access to information, since allegations of insider trading can be devastating both financially and to a firm's reputation. Investment houses have lived with and addressed this issue by limiting the access investment professionals have to non-public information. The challenge becomes more complex as more investment professionals become involved in both hedge fund and private equity investment decisions.

Maintaining walls between different teams of hedge and equity investment professionals is especially complex and risky in an environment where cross-compensation agreements tie various segment managers' compensation together. Compensation structures are typically aligned with the type and timing of the returns these funds anticipate generating. As a result, hedge funds tend to use current results as the primary mode of compensation, while private equity shops have (necessarily) emphasized carried interests resulting from the sale of their portfolio companies some years after the fund's initial investment.

When a team works on both hedge and private equity investments, this difference in orientation creates a potential conflict of interest that could lead fund managers and investment professionals to focus on the short-term (liquid) assets at the expense of the long-term (equity portfolio) assets, or weight the funds more toward liquid assets in order to receive a more immediate return. As a result, fund managers face the daunting task of aligning the investment team's compensation program with a combined fund's desired results. Kelly K. Deponte, a partner at Probitas Partners,[19] noted, "Though the level of carried interest received by both hedge funds and private equity funds is similar (with the standard being roughly 20% of gains) the carry on hedge funds is usually paid on an annual basis based upon portfolio market value, while the carry on private equity funds is calculated on the basis of realized gains on positions that are exited."

The larger asset management firms seem to be enhancing cooperative alignment by having discreet teams that cross-share portions of their carried interest[20] in their various funds. This structure seems like a workable solution when the fund manager has sufficient resources to do this, but it seems less likely to succeed in asset management firms whose teams are smaller, or in protracted up or down markets where differences can become quite pronounced.[21]

Maintaining walls between different teams of hedge and equity investment professionals is especially complex and risky in an environment where cross-compensation agreements tie various segment managers' compensation together.

[19] Probitas is a boutique investment bank that raises money for private equity firms and offers secondary marketing services for institutional investors.

[20] Another way that these larger funds address this conflict is to have both funds invest simultaneously, if they are going to do so, and to document their plans and intent, so as to mitigate the risks to the managers. While this seems workable, it not only adds a layer of administrative burden and complexity, but also may have risks as unanticipated events occur after an investment that undermine or alter the thinking relating to an investment, potentially putting pressures into play that might not otherwise be present.

[21] An example of this is when the dot-com bubble imploded, and the carries at many venture capital firms lost their value.

Fund exits

Mixed funds raise complex questions about whether, how and to what extent monies realized on investments can be reinvested or distributed to investors. In establishing investment timelines, private equity firms and hedge funds must reconcile the fundamental difference between the short-term horizons of hedge fund investors and the long-term strategies of private equity investors.

Although this issue may be addressed in part by lock-ups, or by parsing the fund into two buckets and establishing different terms and conditions for each one, this latter approach limits the value of having one fund make both hedge fund and private equity-type investments.

Hedge funds appear to be addressing this issue through extended (three or more years) lock-ups for investors that move into more illiquid investments, and traunched or tiered lock-up arrangements. Although this approach may mitigate many of the lock-up issues, it does not mitigate the risk of heavy redemption demand creating an unbalanced portfolio. It may also result in cultural, compensatory and asset allocation challenges. For example, imagine the potential for investor dissatisfaction if substantial redemptions after poor absolute performance in the public markets leave a hedge fund substantially overweighted in illiquid investments.

In establishing investment timelines, private equity firms and hedge funds must reconcile the fundamental difference between the short-term horizons of hedge fund investors and the long-term strategies of private equity investors.

VII. The future

It is clear that many of the largest private equity and hedge funds are now offering institutional investors both private equity and hedge funds, and that a number of hedge funds are trying to structure their offerings to create single funds that encompass both hedge and private equity-type investments. Both kinds of convergence present significant operational and organizational challenges. At the same time, companies seeking funding — particularly those that several years ago may have been IPO candidates — are benefiting from a broader range of capital sources.

For the moment, substantial funds are being invested in these alternative assets, and hedge funds in particular have experienced rapid growth. Nevertheless, there seems to be some significant institutional investor resistance to the convergence trend, which could mitigate future capital flows into these funds. In addition, the operational challenges facing smaller fund operators to make converged funds work may also prevent this trend from moving down market.

Two forces could provide significant impetus for further convergence. First, industry knowledge can be used across public and private markets without regard to the type of fund using that knowledge. This seems to be a compelling force that would encourage joint or shared resources across fund platform type. Second, there is a great deal of financial sophistication in this arena. As public and private markets have gotten more efficient, it seems logical that traversing from public to private investments makes sense for both private equity firms and hedge funds and their investors. This is especially true for hedge funds given the very rapid growth of money flowing into them.

The ACG/Grant Thornton Survey was revealing in this regard. Not surprisingly, the survey found more interest and discussion by hedge funds of moving into the realm of private equity. Six percent of hedge fund respondents indicated that they either plan to start a private equity fund or co-invest in private equity, and 40 percent of the hedge fund respondents indicated they have had discussions about moving into private equity, but have no current plans to do so. With private equity respondents, only four percent of respondents indicated that they have plans to either invest in or start a hedge fund, and 26 percent indicated that they have had discussions, but no current plans to do so. Finally, 33 percent of hedge fund respondents indicated that they would never get involved in private equity investments, and 58 percent of private equity respondents indicated they would never get involved in hedge fund investments.

The survey seems to suggest that private equity firms and hedge funds, at least for the moment, are sticking to what they know how to do. At the same time, hedge funds in particular are actively exploring ways to broaden the areas in which they can place and make money. This intellectual unrest, coupled with the financial stakes of successfully deploying their growing assets, suggests that the ending of this story is still being written.

As public and private markets have gotten more efficient, it seems logical that traversing from public to private investments makes sense for both private equity firms and hedge funds and their investors.

VIII. Appendix

The following definitions will help readers understand this new terrain — and clarify some key terms used in this white paper. Convergence has created some confusion in existing terminology and has led to new terms that require definition.

Convergence - *The American Heritage® Dictionary of the English Language, Fourth Edition*, defines convergence as "the occurrence of two or more things coming together, and a representation of common ground between theories or phenonmenon." For the purposes of this white paper, we focus on two aspects of this "coming together" between hedge funds and private equity—the offering of these asset classes by the same organizations, and the pursuit of investments that historically have been in the domain of one type of entity by a fund operating as the other type of entity.[22]

Hedge fund - A hedge fund is a fund, usually an investment vehicle for wealthy individuals and institutional investors, that is designed and intended to use a wide variety of strategies, including selling short, leverage, program trading, swaps, arbitrage and derivatives. Hedge funds are exempt from many of the rules and regulations governing other mutual funds. This allows them to execute more aggressive investing goals. Hedge funds typically invest exclusively in publicly traded securities. As with traditional mutual funds, investors in hedge funds pay a management fee; however, hedge funds also pay a percentage of the profits (usually 20 percent) to their managers.

Hybrid fund - A hybrid fund is a fund that is authorized to invest in both private and public (or other relatively liquid) investments. Typically, these funds have provisions that straddle what have been the lines that separate private equity from hedge fund investments.[23] It appears that there are more hedge funds that have become hybrids than private equity funds.

Private equity fund - With the proliferation of private equity funds in recent years, the breadth of fund strategies has expanded as well. There are private equity funds that invest in subordinated or mezzanine debt, focus on leveraged (LBO) or management-led (MBO) buyouts, funds that look to assist business owners to address generational transition issues through recapitalizations, and funds that do not require majority control. Given this breadth of strategies, we will define a private equity fund for the purposes of this paper as a professionally managed fund that provides capital either through the acquisition of a stake in private companies and/or entire business units to restructure their capital, management and organization. Target companies are typically privately held, or delisted, held private and restructured over a period of three to seven years, and then either sold to another financial or a strategic buyer or, less frequently, listed through an IPO.

PIPE (Private investment in public equity) - A PIPE is a transaction in which accredited investors are allowed to purchase stock in a public company, usually below the listed market price. The stock is registered with the SEC so that it may later be resold to the public. This type of investment has allure for both hedge funds (because they have at least the potential for liquidity and ease of valuation of assets) and private equity funds (frequently used with smaller public companies of the type often appealing to private equity funds, ability to invest in illiquid and potentially undervalued companies).

Side pockets - Side pockets are separate accounts used by hedge funds to hold illiquid, difficult-to-value and typically longer-term private equity investments. These have particular importance because of the way that hedge fund manager compensation is determined.

[22] These two types of convergence are, in the author's opinion, key to understanding the current activities. As will be discussed, it is this author's belief that convergence is happening for the larger fund providers in the forms of different types of investments they offer, but that convergence in the underlying structure of funds (that is, combining hedge and private equity funds in a single vehicle) is a relatively isolated occurrence.

[23] E.g., a hedge fund requiring lock-ups for some portion of the investment.

Offices of Grant Thornton

National Office
175 West Jackson Boulevard
Chicago, IL 60604
312.856.0200

International
175 West Jackson Boulevard
Chicago, IL 60604
312.856.0200

National Tax Office
Suite 300
1900 M Street, NW
Washington, DC 20036
202.296.7800

Office of Financial Services
Suite 300
1900 M Street, NW
Washington, DC 20036
877.835.1723

Arizona
Phoenix 602.474.3400

California
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Missouri
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Nevada
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New Jersey
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Albuquerque 505.855.7900

New York
Long Island 631.249.6001
New York - Downtown 212.422.1000
New York - Midtown 212.599.0100

North Carolina
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Greensboro 336.271.3900
Raleigh 919.881.2700

Ohio
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Cleveland 216.771.1400

Oklahoma
Oklahoma City 405.218.2800
Tulsa 918.877.0800

Oregon
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Pennsylvania
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South Carolina
Columbia 803.231.3100

Texas
Dallas 214.561.2300
Houston 832.476.3600

Utah
Salt Lake City 801.415.1000

Washington
Seattle 206.623.1121

Washington, DC
Alexandria, VA 703.837.4400
McLean, VA 703.847.7500
Washington, DC 202.296.7800

Wisconsin
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