INVESTMENT EUROPE
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Gamma Finance's Florian de Sigy on private equity's hunt for hedge fund stakes
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Although fundraising has slowed a little in the last quarter, levels of capital raised by private equity investors in 2011 have been a significant improvement on the prior two years.

According to Preqin, over 60% of institutional investors are planning to increase their private equity commitments by mid-2012, and less than 10% are planning to reduce funding. In the private equity real estate market, the figures are even more bullish: over 70% of investors plan to increase their commitment to such projects.

The issue now for many managers of private equity funds is how best to put this capital to work.

Whilst there are many businesses out there seeking investment and funding, this does not mean that there is a limitless supply of quality, accessible investments.

Indeed, reports are that originating new transactions is increasingly challenging.

With usual lines of supply approaching exhaustion, where should private equity fund managers start looking?

The answer may be surprising to many, but at Gamma Finance we see many such opportunities on a regular basis: within the portfolios of illiquid hedge funds.
Prior to the post-Lehman financial crisis, the hedge fund sector experienced a significant growth, with funds seeking alpha through the increasing use of leverage, and the utilisation of increasingly long-dated investments.

Asset-backed loans and credit instruments with a six to 18-month exit point became popular, whilst other funds started to encroach on those areas more traditionally associated with private equity.

Wind forward four or five years, and the situation has changed significantly. There currently remains around $70bn of illiquid hedge funds that had to introduce gates and suspend redemptions as their underlying assets became too illiquid to meet investor redemption requests.
This action was taken to avoid a firesale of assets and a severe erosion of investors' capital.

Many commentators estimate that around 50% of asset-backed loan hedge funds in existence at the end of 2008 were winding down or reorganising into new funds by the end of 2009. Through its wide network, Gamma Finance's view is that the percentage is far higher.

In many of these cases, the funds originally holding collateralised debt issued by private companies have seen their portfolios evolve dramatically. Instead of a portfolio of loans, many hedge funds now find themselves holding the assets that the loans were secured against, often physical real assets, or have had their debt substituted by the equity in the borrowing company.

In both cases, exit horizons were considerably extended when compared to the original investment.

These hedge fund managers are faced by two issues: first, the liquidity question of how to release capital to return to investors; and second, the portfolios now hold positions that may be beyond their core expertise.

It is difficult to put a precise value on the levels of such assets but estimates would suggest several billions of US dollars.

These assets, with three to five year investment horizons, are problematic for hedge fund structures - whilst being ideal for private equity buyers. Because private equity buyers are specifically looking for assets with this liquidity profile, they can be less punitive in terms of the illiquidity discount - making them ideal purchasers of such assets. This was a primary catalyst in the development of Gamma's corporate finance business.

To identify these undiscovered opportunities, private equity investors need to both know where to look, and how to get access to this discrete marketplace that has historically been quite separate to the private equity space.

It is an opaque market, rife with inefficiencies, and at we help such parties navigate and source opportunities.

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.

The bridge between the hedge fund supply and private equity demand is developing rapidly.