Bloomberg.com

Hedge-Fund Firms Pressed to Consolidate After Losses Erode Fees

Email | Print | A A A

By Saijel Kishan and Jonathan Keehner

Feb. 18 (Bloomberg) -- **Mohammed Syed** has spent the past seven years scouting out the best hedge-fund investments for clients of his Axiom Fund Manager Ltd. Now, he's seeking to expand the $100 million he oversees by acquiring rivals.

"I am looking for two or even three firms that can complement my business," said Syed, 45, who founded London-based Axiom in 2002. "A year ago most people wanted huge premiums for their businesses, but now it's a different story."

Hedge funds are consolidating after record investment losses and customer withdrawals cut assets by 37 percent in the second half of 2008, squeezing their main source of fees. As many as 40 percent of the 9,000 hedge funds and funds of funds may disappear in the next two years, according to Karamvir Gosal, a New York- based investment banker at **Jefferies Putnam Lovell**. While some will return money to investors and shut their doors, mergers and acquisitions will be more prevalent than in the past.

"The conditions at the moment lend themselves to a surge in M&A activity in the hedge-fund world," said Udi Grofman, a partner at Schulte Roth & Zabel LLP, a New York-based law firm that advises hedge funds. "We've already seen some players looking to take advantage of the low valuations and get their foot in the door, particularly when it comes to managers specialized in areas that are likely to be active in the near future, like mortgages and distressed debt."

Deephaven Capital Management LLC, the hedge-fund unit of Knight Capital Group Inc., agreed last month to sell most of its investment assets to Stark & Roth Inc. The deal was struck three months after Minnetonka, Minnesota-based Deephaven stopped clients from withdrawing their money from its multistrategy fund, which lost 15 percent in the first nine months of 2008.

Under Pressure

GLG Partners Inc., the London-based firm run by **Noam Gottesman** and **Pierre Lagrange**, said on Jan. 20 that it hired the founders of Pendragon Capital LLP. Pendragon had lost 40 percent last year, a person familiar with the situation said at the time. GLG in December bought Societe Generale SA's U.K. fund-management unit that oversees $8.2 billion.

"The entire industry is under tremendous pressure to improve performance, reduce costs and manage the downturn," Axiom's Syed said. "The main problem is finding quality fund managers who have a demonstrable edge."

Hedge funds managed $1.2 trillion at the end of last year, down from a June peak of $1.9 trillion, according to Morgan Stanley analyst **Huw van Steenis** in London. The industry may shed as much as $450 billion in assets, or 38 percent, through market losses and client withdrawals this year, he said.

2007 Record

Mergers and acquisitions among hedge funds and fund of funds peaked in 2007 with 51 transactions valued at $8.5 billion, compared with seven deals in 2004 worth $1.1 billion, according to Silver Lane Advisors LLC, a New York-based investment bank that focuses on the asset-management industry.

There were 43 M&A deals done last year valued at $3.8 billion, according to Silver Lane, compared with $2.48 trillion of transactions in all industries last year, according to data compiled by Bloomberg.

Hedge funds are private, largely unregulated pools of capital whose managers can buy or sell any assets, bet on falling as well as rising asset prices, and participate substantially in profits from money invested. Managers typically charge fees equal to 2 percent of client assets and 20 percent of investment profits.

Hedge funds haven't traditionally been involved in M&A because many managers enjoyed the independence of running their own businesses as fees rose along with client assets, according to Seward's Abbott.

Blackstone, Citigroup

"Many had made the decision to leave bigger organizations to run smaller businesses in the first place," he said. "The attraction to merge with others just wasn't there as many funds were doing so well or at least generating a mediocre performance."

Over the past five years, dealmaking was dominated by banks and other asset managers buying stakes in hedge funds to boost fees, as well as to sell their services to fund clients.

Blackstone Group LP, the New York-based buyout firm, last year bought GSO Capital Partners LP for as much as $930 million. Citigroup Inc. in 2007 paid $800 million for Old Lane LP, which was run by Vikram Pandit, who later became Citigroup's chief executive officer. The New York-based bank shuttered the fund in June.

'Need for Survival'

Morgan Stanley, based in New York, has owned stakes in hedge funds including Avenue Capital Group, Lansdowne Partners LP and FrontPoint Partners LLC. Lehman Brothers Holdings Inc., the New York-based firm that filed for bankruptcy in September, has had holdings in D.E. Shaw & Co. and Ospraie Management LLC. Ospraie told clients in September that it was closing its flagship fund following losses in commodities.

"The nature of the transactions is going to change this year," said **Elizabeth Nesvold**, managing partner at Silver Lane. "Many combinations will be based on the need for survival. There's a complete reversal in attitude. Some managers who had no interest whatsoever in having conversations with anyone else a year ago have been so humbled by this market environment that they're willing to consider talking now."

Smaller funds, with $1 billion or less in assets, are in trouble, said Jefferies' Gosal. "They need to ask if the business model is sustainable without performance fees. Many will find it challenging to operate profitably."

The need to pair complementary strategies, asset classes and geographic focus in a challenging environment will also drive consolidation for funds, according to Nicholas Sheumack, managing director at New York-based Keefe, Bruyette & Woods.

"Diversification will be a critical theme coming out of the financial crisis," said Sheumack.

To contact the reporters on this story: **Saijel Kishan** in New York at **skishan@bloomberg.net**; **Jonathan Keehner** in New York at **jkeehner@bloomberg.net**

Last Updated: February 17, 2009 19:01 EST