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Citigroup Said to Give CCA Managers 75% Fund Stake for Free

By Donal Griffin - Dec 21, 2012

Among Vikram Pandit's last jobs as Citigroup Inc. (C)'s chief executive officer was to decide the fate of the bank's hedge-fund unit, which employs some of his oldest colleagues. He agreed to give them most of it for free.

While Citigroup is keeping a 25 percent stake, managers at the Citi Capital Advisors unit will pay nothing for the remaining 75 percent of that business as it becomes a new firm managing as much as $2.5 billion of the bank's money, according to people with knowledge of the plan. The lender will pay the executives fees while gradually pulling out assets to comply with impending U.S. rules, said the people, who requested anonymity because the terms aren't public.

The deal was Citigroup's response to the Volcker rule, which seeks to protect the financial system by restricting banks' hedge-fund investments and proprietary trading. Instead of selling the funds or winding them down, the New York-based bank will give managers time to attract money from other investors while also granting them control of the business. CCA executives, who make bets on assets ranging from risky European loans to complex credit instruments, can wager with the lender's money until it's withdrawn.

"They're getting a couple of years to diversify the client base away from Citi and to build a stand-alone firm," said Craig Cognetti, a partner with Grail Partners LLC in New York. "If these efforts are successful, this could be very lucrative for the owners of the business."

'Extremely Generous'

Jonathan Dorfman, 50, and James O'Brien, 52, who once worked with Pandit at Morgan Stanley (MS) and are currently co-heads of CCA, will run the new entity, the people said. They will own about 25 percent of the firm. CCA portfolio managers and employees will share a 50 percent stake, the people said.

If the deal proceeds, Dorfman and O'Brien could end up in charge of a firm valued at more than $100 million, according to Cognetti and Ezra Zask, the head of New York-based SFC Associates, which consults on hedge funds. They based their estimates in part on internal CCA performance data in a report obtained by Bloomberg News.

“The details of this spin-out seem to me to be extremely generous to current employees,” said Gerald Hanweck, a former Federal Reserve economist who’s now a finance professor at George Mason University in Fairfax, Virginia. “It seems like an awfully good deal. The alternative is for Citi to sell it off. What’s stopping them from doing that?”

‘Stable Transition’

The new firm, which has yet to be named, may include about 10 funds overseeing roughly $3.4 billion that use shareholders’ cash for bets on everything from mortgage-backed securities to the debts of struggling companies, according to the CCA data, which, according to the internal report, is unaudited. Citigroup has as much as $2.5 billion invested in CCA hedge funds, one of the people said.

Citigroup explored other options in a “thorough process” for complying with the new regulation before deciding on the current plan, said Danielle Romero-Apsilos, a spokeswoman for the bank, who declined to comment on the deal’s terms.

“The board and management both concluded that this transaction allows us to accomplish our objectives and balance the interests of the affected stakeholders,” she said in an e- mailed statement. “It allows us to withdraw our proprietary capital in an orderly manner, mitigates risk for shareholders and provides a stable transition for investors.”

Careers Entwined

James von Moltke, a senior Citigroup investment banker, helped design the deal, the people said. Pandit hired von Moltke from Morgan Stanley in 2009 to help him dispose of unwanted assets after the lender almost collapsed and took a $45 billion bailout from U.S. taxpayers. Von Moltke declined to comment.

The Citigroup board ousted Pandit on Oct. 16 and replaced him with Michael Corbat, 52. Directors awarded Pandit $6.7 million in 2012 compensation and barred him from working for CCA and a group of competing banks for a year. The board inserted the CCA restriction into his pay package to avoid any suggestion of a conflict of interest, according to a person with knowledge of the directors’ intentions.

The careers of many of the Wall Street veterans who run CCA have long been tied to Pandit’s. Citigroup bought Pandit’s Old Lane Partners LP hedge fund for $800 million in 2007 in a deal that brought him to the lender. CCA executives Mukesh Patel, Rajeev Narang, Derrick Queen, Manu Rana and Kevin Bespolka also joined from Old Lane, which the bank closed the next year.

Volcker Rule

Pandit’s first job at Citigroup was to lead the fund unit, which managed about $11 billion of the bank’s money in private equity, venture capital and hedge funds. Within months of his arrival, Citigroup purchased Carlton Hill Global Capital LLC, a hedge fund that O'Brien and Dorfman founded after they left Morgan Stanley. They later rose to become co-heads of the unit while Pandit became CEO.

Before his ouster, Pandit was among Wall Street CEOs grappling with the approaching Volcker rule. The proposed regulation, named after former Fed Chairman Paul Volcker, bans deposit-taking banks from owning more than 3 percent of a hedge fund's assets or investing more than 3 percent of Tier 1 capital in the funds.

While the rule doesn't go into effect until 2014, Wall Street firms have begun to comply. Goldman Sachs Group Inc. (GS), the fifth-biggest U.S. bank, pulled about $800 million from hedge funds this year through September, reducing the fair value of its total investments to $2.45 billion, according to regulatory filings. Morgan Stanley's investments in hedge funds have dropped 61 percent since the end of 2009 to $939 million, filings show.

Few Choices

Bank of America Corp., the second-biggest U.S. bank, doesn't operate in-house hedge funds, according to Jackie Fine, a spokeswoman for the Charlotte, North Carolina-based lender. Investments with outside managers are a "small portion" of the bank's $1.45 billion "strategic capital portfolio," Fine said in a phone interview.

Pandit may have had few choices as he considered CCA's future, according to Charles Whitehead, a law professor at Cornell University who's written about the Volcker rule. Shutting the funds and quickly withdrawing Citigroup's cash could result in losses because the money may be tied up in complicated bets, while granting managers a stake in the new firm could provide incentive to improve returns and maximize the bank's stake, he said in a phone interview.

"Giving them 75 percent to divide up among themselves -- that's a pretty strong incentive," said Whitehead, a former Citigroup executive who has no knowledge of the bank's hedge- fund strategy.

Management Fees

The new firm's structure was based in part on Overland Advisors LLC, a hedge fund that traces its roots to Wells Fargo & Co. (WFC), according to a person with knowledge of the matter. The San Francisco-based bank spun off the fund in 2010 before selling a majority stake to a company controlled by managers in February. The lender didn't disclose how much the managers paid for Overland.

Citigroup hasn't disclosed how much it intends to pay the CCA executives in fees for managing its assets. That makes it difficult to accurately value the firm, said Elizabeth Nesvold, managing partner with Silver Lane Advisors LLC, an investment bank that specializes in mergers and acquisitions of asset- management companies.

Hedge-fund managers typically earn 2 percent of assets they oversee and 20 percent of the profits. Citigroup may have secured a "sweetheart" deal on management fees because it was the early-stage investor in many CCA funds, which could reduce the new firm's initial value, Nesvold said.

'Highly Lucrative'

"The spinoff can still be highly lucrative for the managers and Citigroup, if fund performance is compelling," Nesvold said.

That prospect wasn't enough for Rajesh Kumar, head of the unit's mortgage hedge fund, who's leaving in a dispute over the new firm's pay structure, the people said. Rather than receive regular management fees, portfolio managers will instead get a bigger slice of their funds' profit, the people said. Kumar thought this policy was unsustainable and would encourage managers to take too many risks, one of the people said.

Kumar declined to comment on his plans when reached by telephone. Romero-Apsilos also declined to comment.

Kumar was one of CCA's best performers after he set up the Mortgage/Credit Opportunity Fund in May 2008 with $200 million of the bank's money. His team returned 17 percent for the rest of that year, as delinquent mortgages soared in the U.S. and lenders including Citigroup teetered on collapse.

Outside Money

The fund invests in securities tied to mortgages, including bonds backed by risky home loans and shares in real estate investment trusts, or REITs. Kumar's team gained 24 percent this year through Nov. 8, the third-best performance among CCA strategies, internal data show. The fund, which has about $460 million, most of which belongs to Citigroup, will still be part of the new firm, the people said.

Kumar's departure could harm the new entity's efforts to attract money from outside clients, said Don Steinbrugge, managing partner of Agecroft Partners LLC, a Richmond, Virginia- based advisory firm. Investors tend to associate a fund's historical performance with its managers and that credibility can suffer if the person leaves, he said.

CCA manager Mark Franklin also won't be part of the new entity and neither will his $1 billion Emerging Markets Special Opportunities fund, or EMSO, the people said. The fund, CCA's biggest, will be part of a separate firm that he'll run, according to the people. Romero-Apsilos declined to comment on who'll own the business.

Other Funds

EMSO was one of CCA's steadiest funds, internal data show. It bets on developing-market debt and has returned an average 10 percent annually since it opened in May 2000. The fund gained 6.8 percent this year through Nov. 8, the data show.

Franklin has also had success raising money from new investors. The New Mexico Educational Retirement Board, which manages almost $10 billion, invested $75 million this year in EMSO because it was “head and shoulders above the rest,” according to minutes of a July 2011 meeting posted on the Albuquerque, New Mexico-based pension fund’s website.

While Citigroup’s investment in CCA represents a fraction of the bank’s $1.9 trillion in assets, the unit’s strategies show the risks that U.S. lenders are still able to take while regulators prepare to enforce the Volcker rule. For Citigroup in 2012, many of those risks were rewarded.

Synthetic Portfolios

CCA’s London-based European Credit Opportunities Fund soared 41 percent this year through Nov. 8, returning a profit to the bank, which owns most of its $232 million in assets, one of the people said. CCA executive Michael Micko invests in leveraged loans and riskier debts of European companies, according to the bank’s website.

Fred Hoffman oversees about $418 million in two CCA funds that invest mostly Citigroup’s money in complicated credit instruments, the people said. The Strategic Credit fund gained 14 percent through Nov. 8, reversing a loss of a similar size last year, the data show.

Former Old Lane and Citigroup proprietary trader Ramakrishna Putcha joined the Strategic Credit fund this year to help it profit from riskier bonds and collateralized loan obligations, or CLOs. These are holdings that bundle high-yield loans and slice them into securities of varying risk and return.

Hoffman’s Synthetic Portfolio Equity fund, which invests the bank’s money in complex credit derivative products, jumped 30 percent this year. Credit funds on average gained 10 percent in 2012 through October, according to a Bloomberg index.

Not ‘Efficient’

Others CCA funds haven’t performed as well. Bespolka’s $239 million Global Macro Fund, which wagers on interest rates and currencies, is down about 6 percent this year, the documents show. The fund has gained less than 1 percent since its November 2008 inception, compared with the 9 percent increase in a Bloomberg index of macro funds.

CCA managers also run a $322 million fund called D-Star, which invests money for Singapore’s sovereign-wealth fund and is up about 21 percent this year. A $517 million fund called C-Star invests Citigroup’s money in other CCA funds, the people said. The fund has gained 13 percent this year, the data show.

As regulators push banks to invest in safer assets to prevent another financial crisis, keeping Citigroup money in hedge funds is “not an efficient way” to use the bank’s capital, said Mark Williams, a lecturer at Boston University and former Fed examiner.

‘Lion’s Share’

“Citi shareholders are paying a cost right now for a decision made a decade earlier to venture into risky hedge funds,” Williams said. “They’ve got billions of dollars of shareholder capital, which is really held hostage in this hedge- fund segment.”

Pandit had to do something to respond to the Volcker rule and withdrawing too quickly from CCA funds could destroy an “immense amount” of shareholders’ money, Williams said. Still, if the new firm is a success, the deal should ensure that shareholders benefit as much as the CCA managers, he said.

“There’s got to be upside given back to the shareholders who took the risk,” Williams said. “The Old Laners should not be the ones that gain the lion’s share of the profit.”

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