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Hedge Fund IPOs Are Not for Everyone

By Emma Trincal, Senior Financial Correspondent
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NEW YORK (HedgeWorld.com)—Which will be the next hedge fund to go public, and is everyone in the alternative investment world equally positioned to conduct a successful initial public offering?

The market is buzzing with rumors of hedge fund or private equity firms that are thinking about going public after the well-publicized IPO of Fortress Investment Group LLC in February, the first of its kind in the United States. Rumor became reality when another giant firm, The Blackstone Group LP, followed suit a month later by filing an IPO registration. And yet, who will be big enough and diversified enough to succeed?

"Clearly, IPOs are not for everyone," said Steven Nadel, partner in the investment management group at New York law firm Seward & Kissel LLP. "It's only going to work for certain managers that are going to whet the appetite of the marketplace."

In the meantime, not a day goes by without some new rumor about the next public listing. Carlyle Group, Kolberg Kravis Roberts & Co., Apollo Management LP and AQR Capital Management LLC all have all been recently reported to be potential followers of Fortress and Blackstone. And why not? With bulge-bracket firms such as Fortress and Blackstone going the IPO route, it's no surprise that other hedge fund managers are now considering IPOs for themselves. By raising a hefty $634 million in the stock market, Fortress created an attractive money-making model. Yet there is a gap between contemplating a public listing and being able, or even willing, to do it.

There are many benefits to conducting an IPO, and bringing riches to those at the top is certainly one of them. The stock market is in rally mode, which is one of the drivers for this trend. In addition, an IPO can help a fund manager raise a substantial amount of money without depending on prime brokerage financing. It also gives firms a tool to finance acquisitions and to retain talent, two factors that can lead to more growth. But how many hedge funds will actually be successful in conducting an IPO? That is the question asked by Seward & Kissel in a recent client memo titled "IPO Transactions for Private Fund Managers," authored by several lawyers including Mr. Nadel.

"My guess is that we'll see a dozen IPOs by the end of the year. But once we pass the top 12 or 20, then your IPO candidates no longer belong to the first quality tier," Mr. Nadel said in an interview.

Mr. Nadel said that one of the biggest issues to address when doing a hedge fund or private equity IPO is complying with the Sarbanes-Oxley Act, which requires independent directors on the board. "Some managers may not want to go that route even though there is a lot of money to be made," Mr. Nadel said.

Additionally, going public means a lot of work on several fronts, including accounting, tax, investment management and disclosure, as well as regulatory and capital markets-related issues, the authors wrote in the memo.

Valuation, for instance, can be especially challenging as it relies on the track record of a firm's portfolio managers as represented by the historical returns of the firm. Investors take a risk when the success of their investment depends on the quality of a limited number of portfolio managers, which is why larger firms with a solid infrastructure and a well-diversified platform of products are more likely to succeed.

Another problem is the requirement to file a prospectus with the registration statement, and balance sheet data for the past five years. In this regard, Blackstone's 220-page S-1 filing was an example of broad disclosure. Analysts agreed that a lot was contained in this document, except for the information relating to partners' compensation, which was a particular source of disappointment for the press.

Another concern for managers is the fear of losing their independence with the introduction of a board composed of independent directors. Blackstone found a way around that, which was to offer investors common units in a limited partnership rather than shares in a corporation. The difference matters. By issuing units instead of shares, Blackstone no longer has to have a majority of independent directors on its board, and in fact, unit holders won't even be allowed to vote to elect directors.

Basically, the Blackstone way "allows the hedge fund to retain its independence," said Mr. Nadel. "A lot of other options can be explored. And we've worked on that with clients," he said. But while the independence issue may be solved, "You still have to report and you still have to comply with Sarbanes-Oxley."

IPO candidates should not underestimate the cost of a public listing. The Seward & Kissel memo made it clear that management has to take into account the underwriters' fee, which is typically in the range of 6% to 7% of the gross offering proceeds. In addition, a prospective public hedge fund will have to pay substantial legal and accounting fees, SEC and stock exchange listing fees, certain underwriters' regulatory fees, as well as printing costs and road show expenses.

The entire process is also time-consuming. For instance, the actual offering typically takes place four to five months after the initial filing. Finally, managers need to free up a substantial amount of their time to dedicate themselves to the process, the authors of the memo wrote.

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