Going Public in the U.S.: One Is Not a Trend

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Part two in a two-part series

NEW YORK (HedgeWorld.com)—Now that the United States has seen its first hedge fund initial public offering, the question that's on everybody's lips is: Who's next? Or will anyone be next? While the United Kingdom is ahead of the United States in this game—Man Group has been a publicly listed company there since 1994, and RAB Capital since 2004—it remains unclear whether U.S. funds will fill the gap anytime soon.

"I would be surprised if there wasn't at least one more IPO this year," said David Heaton, co-head of asset management investment banking at Merrill Lynch. "Alternative investment managers represent less than 4% of the assets under management worldwide, but 34% of the revenues. That's why everyone wants to be in this business."

However, if many are considering the listing option, only a handful may actually test the IPO waters.

"We've got a lot of interest from various hedge funds and a lot of them have been looking at the Fortress IPO closely. But I don't see a lot of hedge funds getting listed in the next couple of months," said Art Tully, co-head of the global hedge fund practice at Ernst & Young.

To get a sense of whether hedge-funds-gone-public will soon become the rage in the United States, it is helpful to look at the perceived benefits of an IPO. One is the simple fact that an IPO can generate a lot of easy cash, as Fortress demonstrated But the overnight appreciation of an IPO stock may be short-lived and the big gains may live only on paper. As a result, not every manager is going to opt for the painstakingly regulated process of an IPO just to make a quick buck, although some do not rule out that possibility. So what else?

"Hedge funds would consider an IPO for the liquidity for the most part," said Ben Phillips, managing director at Putnam Lovell, an investment bank specializing in the financial services industry. "They also receive a stable source of capital, and perhaps most importantly they create a currency to acquire other talent and product sets for expansion. As hedge funds realize they need to continually innovate to survive, they'll need to buy new things."

The market saw a series of hedge fund acquisitions by investment banks, but looking forward, "you are going to see transactions involving hedge funds acquiring other hedge funds and you're going to see more of that," said Jim Abbott, a New York-based hedge fund lawyer who heads up Seward & Kissel's Business Transactions Group. An IPO may give a manager the opportunity to finance the right type of expansion or acquisition by raising a large pool of money fast.

"Going public is really about getting permanent capital as opposed to constantly marketing your fund," said Albert Hallac, chairman of Westport, Conn.-based Weston Capital. And there are many ways to put permanent capital to use. "You can create solid hedge fund platforms with robust infrastructure, you can seed and incubate new hedge fund managers, develop new ventures to distribute products, hire

and retain employees," said Patrick Blake, managing director at $12 billion hedge fund management firm Fairfield Greenwich Group in New York.

Finally, an IPO provides an exit strategy for the founding members of a hedge fund, enabling them to liquefy their investments.

Does it mean more IPOs are coming up? "My own personal view? There is not going to be a flood of copycats," said Mr. Abbott. "I don't think a bunch of hedge funds are going to rush off to do it. You'd have to see a second [IPO], then a third before you start wondering. I wouldn't bet on it."

Going public can be a burden for several reasons. To do so, a firm has to file 10Qs and 10Ks with the Securities and Exchange Commission. The managers are subject to strict disclosure and transparency requirements. And the partners are forced to disclose their compensation, a prospect that in and of itself may act as a strong deterrent.

Even if hedge funds may be able to shield their trade secrets by floating only minority stakes or disclosing only parts of their trading methods, the pressure of pleasing shareholders on a quarterly basis may make it difficult for the manager to pursue long-term strategies and as a result, many may be discouraged to pursue the IPO route. "They may shy away from it for reasons similar to those discouraging traditional asset managers from listing," said Mr. Phillips.

There are 14 public asset management companies worldwide, and thousands that remain private, pointed out Kevin Dunleavy, global head of hedge fund strategy and client relations at Merrill Lynch. "You'll see the same thing in the hedge fund industry. They may not want to be public because they don't want to deal with Sarbanes-Oxley, or they don't want to deal with transparency or regulatory issues," he said.

Besides, do hedge funds really need this type of capital, when they can easily raise money directly from institutional investors avid for alpha? "A management firm does not need a lot of dollars, so the ability to raise money is not such an issue here. They have little overhead. Most get 1% to 2% of the assets in management fees. That's plenty of money for management," said Mr. Abbott.

Finally, the market may just be at the early stage of the trend. "An asset management merger and acquisition deal can take anywhere from a couple of months to a couple of years, from scratch to finish," said Mr. Heaton. "You're dealing with human talent."

Meanwhile, some large alternative investment managers have already showed their cards: They won't play the IPO game. Blackstone chief Stephen Schwarzman said recently that the public markets were overrated, and the private equity firm Carlyle Group said that it was not considering a public listing, according to two recent Reuters reports. Renaissance Technologies told HedgeWorld that it would not consider going public Previous HedgeWorld Story.

"Most hedge fund managers won't consider an IPO because they aren't big enough, their track record is not visible enough, they aren't branded enough," said **Francis Gaskins, an IPO analyst at IPODesktop.com**.

"Fortress has inflated the IPO balloon greed opportunity for all other alternative investment managers to see. So if one, two, or three don't IPO by this summer, then it will appear that Fortress was a singular event, not the start of a trend," he said.

There is finally another barrier of entry, and that is the United

States itself.

London is more amenable in a number of ways to IPOs than New York. First, the requirements to be listed on the Alternative Investment Market (AIM) are more relaxed there than they are in the United States, said Mr. Tully. Managers also have a greater incentive to be listed in Europe than here, he added, simply because in Europe, many foreign investors can only invest in a company that has a listing, while there is no such U.S. requirement. In addition, the AIM is friendlier to small-size firms.

"The AIM is essentially a cross between late-stage private funding and Pink Sheets companies in the U.S. The average IPO size is around $25 million and the average market cap is around $80 million. In the U.S. the average IPO size is around $200 million," **said Mr. Gaskins**.

For hedge fund IPOs to become a big trend in the United States, the offering makers will have to fit a very specific profile. "You'll look at well-diversified firms with a strong history of adaptive product development—and that means a variety of alternative vehicles such as hedge funds, private equity, CDOs and other non-correlated investment vehicles," said Mr. Phillips. "Four guys with a computer in Greenwich running a hedge fund simply will not [have this]."

Only the largest hedge funds with a global mandate will be valid candidates, added Mr. Tully. "And when you think global, you only have about 100 managers, and that's it."

Part one of this series Previous HedgeWorld Story examined the valuation of Fortress Investment, the first hedge fund to be listed in the United States.