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The Expansion Of Hedge And Private Equity Funds

Law360, New York (May 11, 2010) -- As the competition for stable investor capital grows fiercer, asset managers who operate only hedge funds or private equity funds have become increasingly interested in offering an "a la carte" array of investment alternatives for their clients. These alternatives may include the following strategies: absolute return, private equity, venture capital, mezzanine, hedged, real estate, long only, separate accounts, fund of funds and even investment banking.

By offering a wide array of investment options, these managers seek to: (1) provide investment choices suitable for all investment climates, (2) broaden their target investor audience, (3) diversify their revenue streams, (4) compete better with large financial institutions, and (5) generate greater amounts of investment intelligence internally.

While there are clear advantages to the expansion approach, there are a number of concerns that such managers must consider:

1) Distraction From the Main or Flagship Business Line

Of paramount importance, managers must be cognizant of what has brought them to their current level of success. Resting on one's laurels and passing off too much responsibility on the flagship product in order to focus on the new venture can result not only in diminished returns in the main fund but, if not properly messaged, can also cause investor level panic akin to a key man event taking place.

Moreover, by going into different business areas, managers need to be wary of whether their message or brand is somehow being diluted, and whether it confuses the investor marketplace as to those investment buckets in which they should be viewed as being true players.

Finally, the manager needs to be fully committed to the new business line; if not, employees likewise will not be committed long-term and will use the opportunity as merely a resume-building launching pad.

2) The Tainting of the Entire Organization by One Business Line

Generally speaking, when a manager expands into a new business line, the new line will take on the established brand name of the entire organization. While there may be clear advantages to doing so from a marketing standpoint, there are also some important disadvantages that should be weighed.

First, if the manager opts to use the same management vehicles for the new line as are being used for the existing line, a lawsuit or claim made with respect to the new product and its management could end up crippling the entire management of the overall organization.

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Second, even if new management vehicles are established, a failure of the new line will nonetheless result in some potentially serious reputational harm across the entire platform.

3) An Increase in the Size and Complexity of the Overall Organizational Infrastructure

As the number and variety of products offered grows, so too does the pressure on internal firm infrastructure. With new business lines in place, additional personnel will need to be hired, additional offices may need to be opened, new management and execution policies will need to be developed and implemented, and, most importantly, all of this will have to be organized into one fully integrated, efficiently operating business.

4) An Increase in Tax and Regulatory Issues

Beyond the operational burdens discussed above, managers entering into new business lines will also have to contend with increased tax and regulatory issues.

From a tax perspective, some of the more typical issues include the exposure of the manager to different tax regimes through the opening of other offices, the changes in tax rates depending on the strategy being offered, and the inability of some investors to participate in certain products due to adverse tax consequences.

From a regulatory angle, common concerns include the adoption of proper valuation policies, the allocation of trades across the firm's different products, the taking of differing investment positions across the firm, and the creation of effective information barriers within the firm to prevent insider trading and other regulatory abuses.

5) A Change in Firm Culture

As the business grows, more staff and offices are added, and more policies and procedures are implemented, oftentimes it becomes a challenge to maintain the same corporate culture that existed prior to the expansion.

Not taking steps to maintain the corporate climate, however, can lead to disastrous consequences, including especially the turnover of key personnel. In fact, this is such a major issue, that many times special consultants are brought in to counsel management on how to proceed.

Conclusion

While there are clear benefits associated with expanding into other business lines, hedge fund managers and private equity fund managers must remain aware of the issues that expansion can pose and map out a carefully thought-out plan that best addresses them.

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