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Hedge Funds Continue to Encroach on Mezz Territory

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A record amount of capital chasing similar investment strategies. A stock market stuck in neutral that's making outsized returns harder to come by. A seemingly endless stream of new entrants crowding the industry. What's a poor hedge fund to do? The answer: broaden its horizons beyond the public markets and start placing bets in private equity, of course.

Increasingly, the private equity investment of choice for hedge funds is mezzanine debt financing. In particular, funds like Silver Point Capital, Citadel Investment Group, Cerberus Capital Partners, Golden Tree Asset Management, and Fortress Investment Group are focusing on the second lien market, a junior capital solution that competes with mezzanine.

In 2001, there was only about $500 million in the second lien market. Last year, however, more than $12 billion in second lien loans were made, according to Standard and Poor's Commentary and Data. The market is expected to reach $20 billion this year.

Many of these hedge funds are building dedicated lending practices and poaching talent from investment banks and private equity firms to round out their lending expertise. For instance, sources say Silver Point nabbed key talent from Goldman Sachs, while Eton Park Capital Management recently hired Oliver Goldstein away for Warburg Pincus to head up the fund's private market investments.

For buyout shops, the appearance of a hedge fund in the secondary financing market can be a mixed blessing, say industry watchers. On the one hand, there are more options to choose from. Hedge funds can often move much more quickly than traditional lenders like banks. "Whereas a hedge fund can step in and get the deal done over the weekend, a bank can take weeks and weeks going through credit committees before it finally accepts or rejects a deal," says Brad Johnson, a vice president at Tremont Capital, an industry research firm and fund of hedge funds that manages about $10 billion in capital.

Hedge funds can also compete very aggressively in terms of price and leverage, especially compared to a more typical mezzanine provider. But critics say these funds can be reckless players that may look good in the short term but can be deadly in the long run.

"I think some of these guys are amateurs that can mess up the market and introduce a deterioration in credit quality," says Lawrence Golub, founder of Golub Capital, which manages an $800 million mezzanine fund. "They're out there making loans we wouldn't touch because the capital structures are way too aggressive. We plan to make a lot of money buying those loans at a discount when these guys are forced to sell."

Hedge fund activity in the mezzanine space shouldn't come as a big surprise. "As these funds grow in size, they are looking for multiple strategies that can earn acceptable returns," says Paul Isaac, chief investment officer of hedge-fund-of-funds firm Cadogan Management LLC in New York. "There are a number of funds with analogous experience where they can extend that into different forms of high yield paper."

It also helps that these pieces of paper can generate returns in the high teens. That's looking awfully good to hedge funds that are struggling to generate the kinds of returns their investors demand. Areas where hedge funds have typically experienced healthy returns have suddenly turned anemic.

Take convertible arbitrage. From 1995 to 2003, this was an investment strategy that had annualized returns of 15%. But over the past 21 months, convertible arbitrage had a negative return of -1.5%, according to research firm and fund of hedge funds Greenwich-Van. "This is a traditional hedge fund strategy that is no longer working because there is too much money chasing the same returns," says Kevin Campbell, a vice president at Greenwich-Van. "This compression across the industry is forcing hedge fund managers to branch out in new directions."

R. Adam Smith, managing director at buyout firm Circle Peak Capital, says hedge fund have brought greater flexibility and responsiveness to the junior capital market. "The process is healthier because you can better evaluate where the demand is," he says.

Circle Peak is currently working with a hedge fund on a deal that has not yet closed. Smith concedes that not all hedge funds are created equally and that it is important to select a group with some experience in the industry. But he says he has noticed a growing sophistication on the part of hedge funds as they build up their lending practices and continue to get their feet wet in private equity deals.

A scant 18 months ago, for instance, most of these deals were one-off opportunistic investments in distressed financing. But today, say observers, there is a more structured, institutionalized approach to the asset class, especially as the larger funds like Silver Point and Citadel begin to nurture dedicated lending teams. "We are seeing hedge funds move from more passive participants to more active participants," says Smith. "Eventually, they will become viable anchor tenets in a security. Their ability to lead is a reflection of their rising credibility and savvy in the market."

Speaking off the record, however, one buyout manager said he doesn't believe the sophistication of hedge funds is quite at a level where he feels totally comfortable doing business with them. "Greater options don't mean better terms, it just means you have to be more careful how you spend your time," he says. "The best partner is not always the one with the cheapest price. You really have to consider your relationship with the debt provider. The investment philosophy and guiding principles of the investment should bear heavily on any decisions."

Golub says a strong partnership between a sponsor and a lender is critical, especially if the deal hits a bump in the road. He argues that sponsors are not going to create successful deals by shaving a few basis points off the transaction, but that they can jeopardize a deal by selecting lenders that aren't prepared to handle unexpected business needs after the close. After all, the last thing sponsor wants is a lending partner that will bust covenants and bail out at the first sign of trouble without trying to fix the deal.

Traditional mezzanine lenders like Golub admit they are losing deals to hedge fund upstarts. But Golub says hedge funds are also doing plenty of deals that more prudent lenders wouldn't go near. His firm recently turned down a second lien on the recap of a middle market consumer products company. "The sponsor was taking out a huge multiple, the leverage was ridiculously high, a majority of the company's revenue came from a single customer, and the due diligence was two and half years old," says Golub. "This was an easy pass for us, yet some hedge fund that I never heard of ended up making the loan."

Another mezzanine fund manager who asked not to be identified agreed that hedge funds are attacking the market. But he said sponsors for the most part are sticking to tried and true lending firms. "There is a view in the market by sponsors that hedge funds are unknown quantities and that if it ever came to crunch time they could threaten to let a portfolio company blow up."

Ed Bagdasarian, managing director at investment banking firm Barrington Associates, questions this kind of incendiary assessment. He says hedge funds bring plenty of positives to the market. Because they are risk takers, they are not afraid to back high-growth companies with short-term, two- to three-year debt financing, and in some cases even participate in the equity side.

"Sponsors are finding more options available to them," says Bagdasarian. "If sponsors want to finance a high-growth company without a long operating experience, they are more likely to find a hedge fund that will advance capital on a shorter term basis to get the deal done." These are deals

that are much harder to accomplish with traditional mezzanine sources that are more conservative and prefer longer time lines.

Still, even those who advocate hedge funds say it is often a case of buyer beware because some of these players are relative newcomers to mid-market buyout financing and don't know at all the ins and outs of this market. "I've seen some hedge funds get real excited and quickly commit do doing a deal on a certain timeline, but after they do more diligence they start changing the terms or pulling back," says Bagdasarian. "This is a fairly new asset class for them and so these guys area still learning how to price the asset and structure the deals."

As an investor in hedge funds, Isaac of Cadogan says he is happy to see them enter the mezzanine market as long as they have the capabilities, contacts, and background to make it work-and as long as the fund does not have a disproportionate amount of its capital in illiquid investments. This is a key concern, because unlike with private equity funds, investors in hedge funds can redeem their assets at almost any time.

"If you have a fund that specializes in equity short selling and suddenly it starts making large loans on a private equity basis, you would naturally have some questions about that and you probably would be inclined to pull your money out," says Isaac.

It's still too early to judge how well hedge funds have performed in the mezzanine market. But it seems increasingly likely they are more than just opportunistic investors, and are actually here to stay. "I would absolutely do more deals with hedge funds," says Smith of Circle Peak. "They are smart, sophisticated, aggressive partners that have been supportive of our deals." That may not be music to the ears of most mezzanine funds, but it's a tune they'll be hearing a lot more.