FINANCIAL NEWS

Issue 180
April 30, 2007
ISSN 1741-9085

PRIVATE EQUITY NEWS

www.efinancialnews.com/pen

Hedge funds outpace buyout firms in fundraising stakes

Despite being overshadowed, the fees mean there are few complaints from the industry, writes Claire Smith

The private equity industry may have attracted record levels of investment from institutional investors in the past few years, but the growth of assets under the management of hedge funds has far outstripped its expansion.

JP Morgan estimates the value of assets invested in alternative investments globally stood at $3 trillion (€2.2 trillion) last September. This included hedge funds, private equity firms, real estate and commodity funds.

The researchers found that 40% of that money, or $1.2 trillion, went to hedge funds, 30% to private equity, 27% to commercial real-estate investments and the remaining 3% to commodity funds.

According to hedge fund adviser Hennessee Group, the number of hedge funds globally has increased from fewer than 1,000 in 1992 to more than 10,000. Over the same period, the industry's assets under management have grown from around $100bn to $1.2 trillion.

By contrast, private equity assets under management in Europe and the US have grown from $50bn to more than $350bn during the same period, according to Hennessee.

One placement agent explained the difference by pointing out that private equity funds often generate higher multiples than hedge funds but are less accessible to institutional investors. He said: "Hedge funds are liquid on the whole, and private equity funds are not. When you look at the return profile of the hedge fund, it will generate a 1.3-times multiple, but 20% to 30% internal rate of return, actual cash on cash. By contrast, the top quartile of private equity funds, on a net basis, is looking at 2.5 times."

Mounir Guen, chief executive of private equity placement adviser MVision, said: "Private equity can only consume so much money and that's why the megafunds and the listed vehicles are becoming so interesting. The beauty of the megafunds is the ability to absorb large amounts of capital."

Last year was a record one in terms of private equity fundraising, with figures from data provider Private Equity Intelligence showing 684 funds raised $432bn, 38% higher than in 2005. The 10 largest funds raised $101bn between them, or 23% of the global total, with record distributions fuelling the appetite of investors (limited partners).

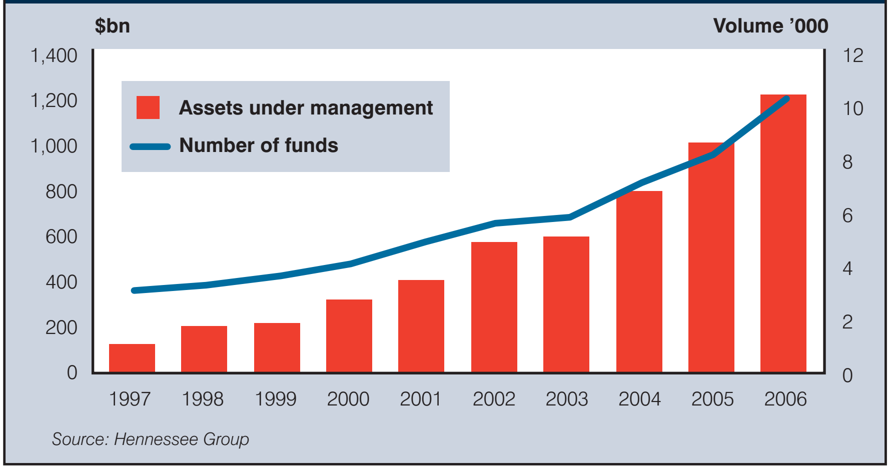
Most investors want to increase their allocations to the asset class, such that PEI predicts another record this year, with 900 new funds on the road. Those currently marketing are seeking $390bn, leading the analysts to conclude that a $500bn total for the year is not unreasonable.

However, Guen said: "Whatever happens, there's a cap, and with hedge funds there is no cap. The hedge funds are basically replacing the available debt and equity asset allocations. They are not replacing private equity."

The largest institutional investors have significantly increased their commitments to alternative vehicles over the past few years, with an estimated 50% to 60% of hedge fund assets now institutional, according to a study by Credit Suisse and Tremont, a fund of hedge funds.

Stuart McLaren, investment management

Growth of hedge fund industry



Source: Hennessee Group

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director at accounting firm Deloitte, said: "Typically, institutional investors have been in private equity for some time now, but a couple of years ago many wouldn't have had any money in hedge funds at all. Now, the flexibility that hedge funds can offer, because of their variety of strategies, means there is more money going in.

"There's still a way to go in all these categories, but I would say hedge funds have the greatest ability to increase the amount of assets allocated to them, because the variety of strategies means an investor could easily have 100% hedge fund investment without having any crossover in strategies."

A study by Deloitte suggests that even more pension fund assets could flow into US-domiciled hedge funds as a result of the 2006 US Pension Protection Act, which will ease their disclosure and reporting requirements.

The largest investors continue to increase their already large allocations to private equity. The top backer of the industry is the California Public Employees' Retirement System, according to Dow Jones data, which last year allocated $12.4bn to private equity, equivalent to 6% of its assets, up from 5% the previous year.

The New York State Common Retirement Fund, in second place, allocated more than $11.5bn to private equity in 2006, or 9% of its total assets.

The growth of the private equity industry has resulted in a huge increase in management fees globally, with aggregate management fees for funds in their investment periods now around $12.4bn, according to PEI, compared with $5.5bn in 2000.

The total carry earned by the industry globally between late 2005 and late last year was around $24bn, meaning it is still the biggest element for most general partners, giving private equity its interest-aligning quality.

At the start of this year, more than 20 funds globally were earning in excess of $100m a year in management fees – only one reached that figure in 2000. But Calum Thomson, head of investment management at Deloitte, said: "Institutions will always balance the fee structure and against the returns they are likely to get.

They will be prepared to pay higher fees if they are going to get higher returns, or less risk, or whatever it is that they are looking to achieve."

For now, the fundraising efforts of the alternative investment managers are being positively received and, while the hedge funds may be stealing a march, there are few complaints from the buyout shops.