Trends in Hedge Fund M&A and Valuation: 2000-2012[1]

March, 2013

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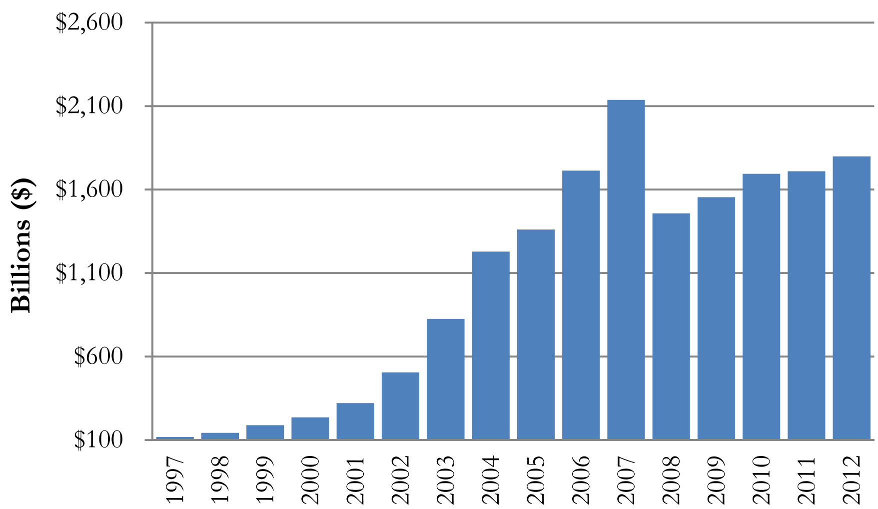
The Market Environment

The amount of money managed by hedge funds has seen a steady increase from the drawdown experienced in the aftermath of the collapses of Lehman Brothers and Bear Stearns. At the end of 2012, excluding fund of funds assets, the industry had nearly $1.8 trillion in assets under management (AUM).[2]

Exhibit 1: Hedge Fund Industry AUM



Source: BarclayHedge

One of the notable trends in the hedge fund industry is the increased concentration. As of 2011, the

[1] This article updates a previous article, "Hedge Fund Valuation," by Ezra Zask (Journal of Alternative Investments, Winter 2000)

[2] Hedge Fund Industry – Assets Under Management, Barclay Hedge, http://www.barclayhedge.com/research/indices/ghs/mum/HF_Money_Under_Management.html

322 hedge funds managing over one billion dollars accounted for over 50% of the industry's total assets. [3]

The increased concentration and institutionalization of the hedge fund industry has led to an increased interest in mergers and acquisitions for both hedge funds and fund of funds. There are several drivers that point to an increase future M&A activity in the hedge fund space:

- Institutionalization of Alternative Investments: Institutions (pension funds, sovereign wealth funds, endowments) now constitute the majority of assets managed by hedge funds, surpassing high net worth individuals.[4] As a general rule, these institutions favor larger hedge funds with well-developed infrastructure. This self-reinforcing driver will continue to favor larger funds raising the barrier to entry in the future and causing further consolidation.
- Regulatory environment: The SEC requirement that hedge funds register has increased the cost of compliance and les to higher infrastructure costs beyond what some smaller firms can afford, forcing them to sell to larger firms. Similarly, the Volker rule, which restricts hedge fund ownership by depository banks, has also forced many large banking institutions to divest themselves of their internal funds. This was illustrated by the announcement in December 2012 that Citigroup would spin off its hedge fund unit as it prepares to comply with the rule which takes effect in 2014.
- Competitive Pressure: Hedge funds are facing increased competition from both mutual fund, who are increasingly launching "hedge fund light" products and private equity firms who have launched fund of hedge fund platforms. These firms are massive in comparison

[3] Ezra Zask, All About Hedge Funds, Second Edition, McGraw Hill, 2013, p. 87.
[4] *Ibid,* p. 86

to hedge funds with global reach and access to institutional investors, placing pressure on hedge funds to grow in order to compete.[5]

- Maturity of Hedge Fund Managers: Many "first generation" hedge fund managers are looking to monetize their hedge fund ownership either by passing the firm to partners[6] or selling all or part of the firm. For example, the Texas Teacher Retirement System recently increased its stake in Bridgewater Associates to 20%, diluting the stake of Bridgewater's founder, Ray Dalio.[7]
- The tax climate: Proposed changes in the carried interest tax and the enterprise value tax will lead owners to consider selling and taking advantage of the current more favorable capital gains rates.[8]

Hedge Fund Company Valuation

One of the obstacles to hedge fund M&A is the difficulty in valuing hedge funds and fund of funds. There are three methodologies that are commonly used in valuing companies: comparable transactions; comparable companies; and discounted cash flow (DTC). All three methods face difficulties from the fact that few hedge funds are publicly traded and that there are relatively few

[5] As of this writing, BlackRock, a private equity firm which has rebranded itself as an alternative investment firm, manages nearly four trillion dollars in assets. As a point of comparison, the largest hedge fund, Bridgewater, manages $100 billion.

[6] In a recent article, Dr. Donald May detailed the considerations that partners in a hedge fund need to take into account in the valuation of their fund. Dr. May pointed out that the nature of hedge funds makes valuation of partner shares complex and ambiguous, leading to potentially high costs upon the departure of one or more partners. According to Dr. May, to reduce ambiguity and future break-up costs, guidelines for the valuation of investments should be linked to the assets that the fund invests in, and the fund's overall investment strategy. The optimal way to take all the complexities of the situation into account is to craft a partnership agreement that specifies how valuations and payouts will be determined, ideally leading to a single valuation or range of valuations that reflect the expectations of the fund partners. It is important to foresee these ambiguities in crafting a partnership breakup agreement that will lead to an orderly departure of partners, as opposed to a drawn-out litigation that could be very expensive and potentially destroy the fund itself.

[7] "Bridgewater Sells Stakes to Institutional Investors" FINalternatives, Feb. 21, 2012

[8] In the case of the carried interest tax, the proposals currently before Congress would treat carried interest as ordinary income, taxed at 35%-39.6% instead of the lower capital gains tax of 15%-20%. The treatment of profits from the sale of investment management partnerships, such as private equity firms and hedge funds, would also face an increased tax rate if the current proposals pass.

M&A transactions in the hedge fund industry, and the details of those deals are often hidden. Perhaps most importantly, the task is complicated by the fact that hedge fund revenues are more volatile than most firms. Unlike the steady revenue streams in the traditional money management business and the publicly traded private equity firms, the lion's share of a hedge fund's value is derived from the option-like potential of performance fees.

In practice, all three valuation methodologies are used in valuing hedge funds. The relative weight assigned to each depends on the particular circumstance. However, given the paucity of publicly traded hedge funds and transparent transactions, the discounted cash flow method is most widely used and assigned the greatest weight. The sections that follow present some of the research and analysis conducted by SFC on the relevance of each method when valuing hedge funds.

Comparable Company Method

Finding comparable companies for hedge funds and other alternative investment managers means finding publicly listed firms. Although in the past few years more alternative asset managers have become publicly traded, a vast majority remain private. Exhibit 2 and 3 show key valuation statistics for publicly traded traditional and alternative asset managers.

Exhibit 2: Valuation of Publicly Traded Traditional Asset Managers

Traditional Asset Manager	Ticker	Market Capitalization ($ bil)	AUM ($ bil.)	AUM Multiple	Price	P/E Ratio
Franklin Resources Inc.	BEN	31.62	814	3.89%	147.76	16.22
T Rowe Price Group, Inc.	TROW	19.11	577	3.31%	74.11	22.05
Northern Trust Corp.	NTRS	12.86	759	1.69%	53.74	19.12
Affiliated Managers Group, Inc.	AMG	7.96	432	1.84%	151.49	46.17
SEI Investments Company	SEIC	4.94	458	1.08%	28.63	24.27
Eaton Vance Corp	EV	4.66	238	1.95%	39.92	23.57
Legg Mason, Inc.	LM	4.05	661	0.61%	31.38	14.68
Waddell & Reed Financial, Inc.	WDR	3.63	96	3.77%	42.36	24.07
Federated Investors Inc.	FII	2.45	380	0.65%	24.39	13.53

Janus Capital Group Inc.	JNS	1.73	157	1.10%	9.39	17.18
			Median	**1.77%**		**20.59**

Source: Bloomberg, Company Press releases
Note: Data as of 3/18/2013

Exhibit 3: Valuation of Publicly Traded Alternative Asset Managers

Alternative Asset Manager	Ticker	Market Capitalization ($ bil)	AUM ($ bil.)	AUM Multiple	Price	P/E Ratio
BlackRock, Inc.	BLK	44.9	3,670.0	1.22%	255.56	15.10
The Blackstone Group LP	BX	23.5	205.0	11.46%	20.54	11.90
Invesco Ltd.	IVZ	12.7	667.4	1.90%	28.85	18.10
KKR & Co. L.P.	KKR	14.0	66.3	21.06%	19.72	8.90
Oaktree Capital Group LLC	OAK	7.8	81.0	9.65%	51.99	13.70
Apollo Global Management LLC	APO	8.7	110.0	7.91%	23.53	2.93
Och-Ziff Capital Management Group LLC	OZM	4.0	32.0	12.50%	9.69	2.32
Man Group PLC	MNGPY	2.8	60.0	4.67%	1.52	-
Cohen & Steers Inc.	CNS	1.5	44.9	3.34%	34.94	23.50
			Median	**7.91%**		**12.8**

Source: Bloomberg, Company Press releases
Note: Data as of 3/14/2013

The AUM multiple, calculated by dividing a firm's market capitalization by its assets under management, is one of the key metrics that has historically been used in the valuation of investment managers. Comparing the valuation of traditional and alternative managers along this criteria shows that the median AUM multiple for alternative managers (7.91%) greatly exceeds that of traditional managers (1.77%). This difference is due to ones, and we notice that the median for alternative managers, 7.91% is higher than that of traditional managers with a median of 1.77%. A number of reasons account for this difference. First, alternative investment firms have the potential of realzing outsized profits as a result of their incentive compensation while traditional firms, by contrast, are prohibited from earning incentive compensation and must rely entirely on management fees for their revenue. In addition, alternative investment firms have been growing at a much faster rate than traditional firms for a number of years, and most projections expect this trend to continue. Finally, the assets of alternative management firms are considered "sticky" compared to open-end mutual funds. In the latter, investors can redeem their shares at the end of day each day based on the fund's NAV calculation.[9] Private equity firms and hedge funds have longer capital lock-up periods and more restrictions on redemptions. For hedge funds, these can range from several months to several years. [10] These restrictions keeps hedge funds' assets under management relatively stable, bringing in revenue through management fees even in years of underperformance.

It should be noted that only Och-Ziff Capital Management Group LLC and Man Group Plc. are entirely hedge fund firms. The rest of the alternative managers are private equity firms that may also have hedge fund units. As a result, the comparable company method, while it may serve to provide some market information, is not given undue weight in valuing a hedge fund.

Comparable Transactions Method

Another valuation method involves the use of comparable M&A transactions to the one being considered. Over the last ten years there have been a number of transactions in the hedge fund industry. While most of time deals terms are not publicly disclosed, there are still enough publicly disclosed deals to validate the use of this method. SFC has identified 88 hedge fund deals between 2002 and 2012, excluding fund of funds manager transactions. Exhibit 4 shows the deals with terms that were publicly disclosed over the ten year period.

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[9] NAV stands for Net Asset Value and it is the total dollar value of the assets in a portfolio minus liabilities. In a mutual fund context, the NAV per share is calculated by summing up the end of day market values of each security in the portfolio, subtracting the fund's liabilities and dividing by the number of shares outstanding.
[10] "Average maximum hedge fund lockup remains relatively stable from 2011", *Pensions & Investments,* March 27, 2913

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Exhibit 4: List of Hedge Fund Transactions 2006 - 2012

Target	Strategy	Acquirer	Transaction Date	% Acquired	Deal Value ($ mil)	Target AUM ($ bil)	AUM Multiple
Bridgewater Associates LP	Multi Strategy	Teacher Retirement System of Texas	Mar-2012	20	250.0	120.0	1.04%
Apidos Capital Management LLC	Credit	CVC Capital Partners	Jan-2012	67	25.0	5.6	0.67%
Vermillion Asset Management	Commodities	Carlyle Group	Oct-2011	55	37.0	2.2	3.06%
Emerging Sovereign Group	Emerging Markets	Carlyle Group	Jun-2011	55	155.5	1.6	17.67%
Ore Hill Partners	Credit	Man Group PLC	Mar-2011	50	18.0	1.9	1.89%
Bluecrest Capital Management Services Ltd	Multi Strategy	Bluecrest Capital (Managemet Team)	Mar-2011	25	633.0	25.0	10.13%
Emerging Markets Management LLC	Emerging Markets	Ashmore Group PLC	Feb-2011	62.9	246.0	10.0	3.91%
BlueBay Asset Management	Credit/EM	Royal Bank of Canada	Oct-2010	100	1,500.0	40.0	3.75%
Gavea Investimentos	Multi Strategy	JPM (Highbridge)	Oct-2010	55	270.0	6.0	8.18%
York Capital Management	Multi Strategy	Credit Suisse	Sep-2010	33	425.0	15.0	8.59%
GLG Partners	Multi Strategy	Man Group PLC	May-2010	100	1,600.0	40.0	4.00%
Deephaven Capital Management	Multi Strategy	Stark Investments	Jan-2009	100	7.3	2.0	0.37%
Heritage Fund Management	Asia Long/Short	Bank of China	Jul-2008	30	8.7	0.4	7.25%
Nephila Capital	Reinsurance	Man Group	Jun-2008	25	50.0	2.5	8.00%
Aladdin Capital Holdings	Fixed Income/Credit	Mitsubishi Corp	May-2008	20	39.0	18.0	1.08%
Trafalgar Asset Managers[1]	Multi Strategy	GS Petershill	Apr-2008	20	75.0	2.8	13.39%
Ore Hill Partners	Credit	Man Group PLC	Mar-2008	50	235.0	3.0	15.67%
GSO Capital Partners[2]	Credit	Blackstone Group	Jan-2008	100	930.0	10.0	9.30%
RAB Capital	Asia Long/Short	Pi Investment Management	Oct-2007	100	26.0	0.2	11.82%
Och-Ziff Capital Management	Multi Strategy	Dubai International Corp.	Oct-2007	10	1,200.0	30.0	40.00%
Old Lane Partners	Multi Strategy	Citigroup	Apr-2007	100	800.0	4.5	17.78%
Lansdowne Partners	Multi Strategy	Morgan Stanley	Nov-2006	19	300.0	12.5	12.63%
FrontPoint Partners	Multi Strategy	Morgan Stanley	Oct-2006	100	400.0	5.5	7.27%
Avenue Capital Group	Distressed Credit	Morgan Stanley	Oct-2006	20	300.0	12.0	12.50%
Northwest Investment Management[3]	Multi Strategy	RAB Capital	Sep-2006	100	40.0	0.5	8.00%
Cross Asset Management	Event Driven	RAB Capital	Jun-2005	100	16.0	0.2	8.00%
Highbridge Capital Management	Multi Strategy	JPMorgan Chase & Co.	Dec-2004	55	1.4	7.0	0.04%
Iridian Asset Management	Equities	Bank of Ireland	May-2002	61	171.0	11.0	2.55%
					Median	**5.8**	**8.00%**

Notes:

[1] The final price was between $50 - $100 million, we took the average in order to calculate AUM multiple

[2] $620 million is initial payment, with $310 million payable under certain conditions over next 5 years

[3] $40 million was the maximum consideration for the acquisition. The upfront cash payment was $10 million.

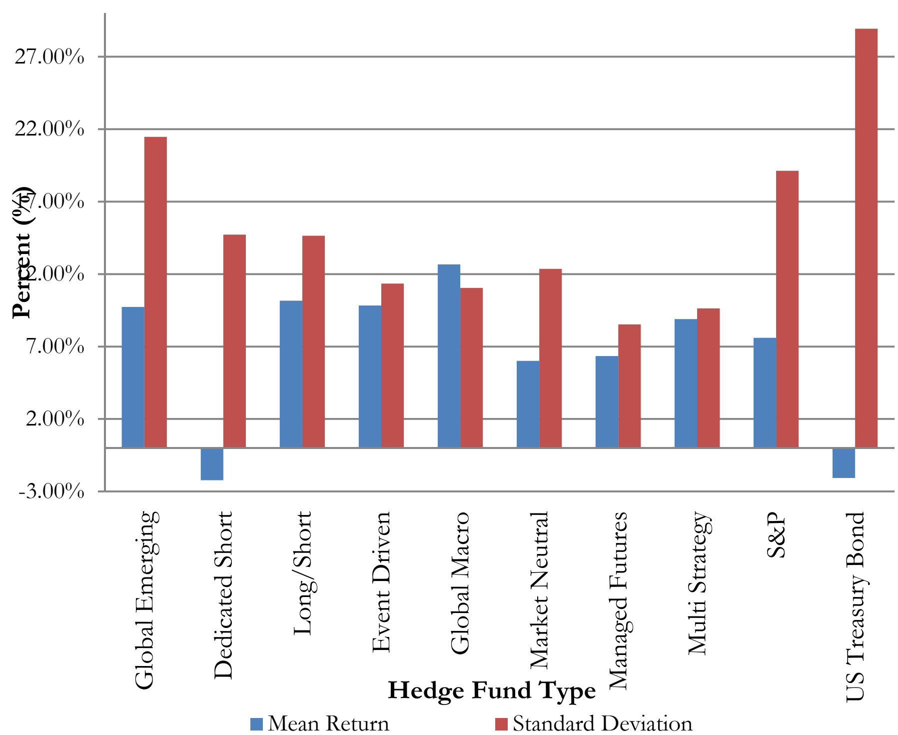
Sources:

Bloomberg, Reuters, MarketWatch, FINalternatives, Berkshire Capital, Madison Capital, New York Times

One thing that is evident from Exhibit 4 is that the AUM multiple varies greatly, ranging from as little as 0.04% to 40%, with a median of 5.8%. There are several possible factors that could have contributed to this wide range of AUM multiples including the size of the firm, the strategy employed by the fund, its historical performance, inception date, AUM growth, the manager's experience and reputation and the previous or future affiliation of the hedge fund.

The importance of the strategy pursued by a hedge fund for its revenue, and hence its valuation, can be seen by the relative mean returns and standard deviations (volatility) of the different hedge fund strategies, can be gleaned from Exhibit 5, which also compares these metrics to the S&P and Treasury bonds.

Exhibit 5: Mean Return & Standard Deviation of Hedge Fund Returns (1994- 2011)



Data Source: Bloomberg

Partly as a result of these factors, the median AUM multiple for multi-strategy and emerging market focused fund transactions were 8.18% and 3.91% respectively, while credit focused funds had a median multiple of 3.75%.

Characteristics of the buyer are also important when using the comparable transaction method. For example Carlyle Group, a private equity firm, paid $156 million for a 55 percent stake in Emerging Sovereign Group, a deal with a 17.67% AUM multiple. The premium was at least partly because Carlyle wanted to expand its product mix before going public as a way of attracting investors. In April 2007 Citigroup paid an AUM multiple of the 17.78% for Old Lane Partners, the highest in our database, reportedly in order to enlist the services of Vikram Pandit, one of the founders of Old Lane, who went on to become the CEO of Citigroup.

In summary, the use of comparable transactions is useful for hedge fund valuation. However, allowance must be made for the various factors noted above which can either increase or decrease these multiples.

Discounted Cash Flow (DCF) Method

The DCF is the foremost used method when valuing hedge funds and most companies. This method discounts a company's future cash flows using a discount rate to derive the company's present value. This method is also known as a two stage model. The first stage involves making income and expense projections three to five years out and calculating the terminal value" at that point. In the second stage, the projected cash flows and terminal value are discounted by the relevant rate to arrive at a present valuation for the firm. Traditionally one would use the weighted average cost of capital (WACC) or the required rate of return in order to discount future cash flows to present. The choice of discount rates is extremely important in the final valuation of the entity and typically incorporates such factors as future risk and uncertainty as well as liquidity and size considerations. For example, private deals involving a small firm would demand a higher discount rate (i.e., would result in a lower present value).

While most hedge funds don't publicly disclose their financials, because the revenue and expense structure is similar for most funds it is possible to make some assumptions about cash flows. Revenue for hedge funds is a function of the fund's assets under management as well as its performance. Revenues are comprised of a management fee, typically ranging from 1% to 2% of assets under management, and a 20% or higher in incentive/performance fees for most managers. Both of these are discussed next.

Management Fees

Multiplying the assets under management of fund by 1% approximates the firm's revenue from management fees. Clearly, the higher the firms AUM the greater the management fee. Similarly, the less susceptible the AUM is to sudden withdrawals the more stable the management fee. This provides a clear motivation for hedge fund managers to increase the size of their assets as well as to take steps to mitigate the outflow of funds, especially during rough markets. One way of achieving this goal is with more stringent withdrawal terms or longer capital lockup periods. Another is to avoid any sharp performance drawdowns that may drive away investors. Some large hedge funds have drawn criticism that they have become overly conservative as the importance of management fee increases.

Compensation, which comes from management fees, represents the most significant cost for most asset managers and it is the same for hedge funds. Somewhere around one to two-thirds of the management fee revenue is typically considered to cover compensation and other operating expenses. In recent years, deferred compensation has added some complication to this calculation since the timing of the outlays becomes more uncertain.

Performance Fees

Most hedge funds take annual performance or incentive fees, typically around 20% of the return on investment for the years if the fund has exceeded its highwater mark. Incorporating performance fees into the valuation of hedge fund presents some major problems especially because it is often a major (if not the major) component of the final valuation. This revenue stream is dependent on a number of factors including the market environment, the hedge funds' strategy, and the assets under management (which are also effected by the hedge fund industry's growth; note the fluctuations in assets in Exhibit 1, especially around the credit crisis of 2007-8). Also critically important but difficult to measure is the managers' skill and risk management abilities. While historical numbers offer some guidance (as we show in Exhibit 4), there is clearly a good deal of uncertainty surrounding the future value of this important component of valuation.

Once cash flow projections have been made three to five years out, we have to calculate the terminal value, which is the component of the firm's valuation that is the result of the cash flows it generates as it continues operations in perpetuity. This is a difficult calculation as it requires the analyst to come up with a constant growth rate for cash flows, which are in turn a function of the firm's strategy, abilities and the industry's growth.

In practice, the DCF methods also incorporates methodologies to compensate for the uncertainty surrounding the projection of profits into the distant future. The most commonly used strategies are scenario analysis (which subjects the cash flows to various market conditions) and Monte Carlo simulations, which projects multiple scenarios (sometimes in the thousands) to derive a distribution of possible future cash flows.

Summary

Valuing a hedge fund is a complex and difficult exercise. While there has been a growth in publicly listed alternative asset managers, as well as more M&A activity in the hedge fund space to provide more reference points for the comparable company or the comparable transaction methods, the DCF method is still the preferred approach. However, DCF analysis can be very complex due to the complicated and unique structure of hedge funds. With all methods, proper considerations must be made regarding the structure, strategy and size of the fund in addition to the general market conditions to properly value a hedge fund.