

You won control. Now what do you do?

Art vs. Science – How to bring private equity focus and expertise to hedge funds

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Convergence

With the increasing levels of growth, consolidation and convergence in the alternative investment industry, hedge funds must continue to find new ways to manage a menagerie of investment strategies....and that means accessing and recruiting different types of talent to help them be successful. Alpha, after all, is created by people.

In this article, we will explore one of the most critical aspects of convergence – how to staff for it. In particular, we will focus on the multitude of hedge funds, in particular distressed debt and activist equity funds, who find themselves – either accidentally or on purpose – with control positions in companies. How can hedge funds access new talent with different skills than they currently have in-house?

The dog that caught the car it's been chasing

Hedge funds invest an enormous amount of time and effort in identifying unique targets to pursue, chasing them down, striking the right price, and fighting for control. Once they sink their teeth in and win, they now control an entire company. Their role as investor suddenly changes – they do not merely own a bunch of stocks or bonds, the hedge fund now has a company to run and must figure out how to create value by managing that investment to successful exit. The game has changed....and it looks and feels a lot like private equity.

Art vs. Science

At their core, hedge funds employ science in investing – their strength is **measuring** value and risk. The rigor and discipline of trading involves high IQ, or strong quantitative, analytical and technical skills (reinforced by the number of PhDs that some hedge funds employ). Like scientists with beakers and test tubes, hedge fund managers are fixated on “measurement” – they are beholden to the precision of pricing, trading, and risk management....and getting the mix and timing right so that the trade won't blow up in their faces. This deep-rooted psychology is further ingrained by the constant measurement of their performance by investors as well as how they get paid.

Private equity, on the other hand, is more of an art – it involves **creating** value over time by working with management to design and implement new corporate strategies. The human

element of interacting directly with portfolio investments involves EQ or “emotional intelligence”, the soft skills of people management such as personal competence and social competence. (In his 1998 book *Working with Emotional Intelligence*, Daniel Goleman defines EQ as "self-awareness, self-confidence, and self-control; commitment and integrity; the ability to communicate and influence, to initiate and accept change.")

Using art as a metaphor, private equity is like an Impressionist painting – success is in the bold brush strokes and color, management’s vision for building the business. By design, this vision can be blurry – often new revenue streams and cost cuts come from different avenues than management envisions at the outset. The critical element is management’s creativity and agility to change course to weather a storm or exploit new opportunities.

By nature hedge funds can be cold and exacting – if an investment isn’t performing, they can dump it and cut their losses. Hedge fund managers become insiders of control investments, however, and they can’t just sell these illiquid investments. Control investments, therefore, become “personified”. Hedge funds have to live with the company, management team and board of directors. Rather than just watch positions on a screen, they now must employ a proactive approach and human touch to get to know (and often kick out) management and board members, and find replacements they can trust.

Certain structural differences also can impact how each of these investors behaves. With portfolios being constantly marked to market and investors who can redeem on a short-term basis, hedge funds arguably have a greater sense of urgency to create value. With long-term lock-ups on their funds, private equity firms enjoy the luxury of time to create value without the constant scrutiny of public markets.

Talent Overlap

The success of both hedge fund and private equity investors lies in their ability to find interesting companies to buy, measure value and risk, execute transactions, and then exit those investments at substantial gains. Both must be talented at all activities throughout the investment cycle – origination, execution, portfolio management, and exit. When and how they extract value can differ – and this difference is most accentuated during the portfolio management phase.

Origination – Both hedge funds and private equity firms must excel at idea generation, research, due diligence, and quantitative and qualitative analysis. Both firms rely on in-house and third-party providers for research and market insights. Identifying unique, proprietary investment ideas is central to their success, even though their techniques may be different.

Execution – Hedge funds create significant value in their trading activities, and private equity firms create value through complex capital structuring and financial engineering. While a poorly-structured or over-levered deal could send a private equity investment into bankruptcy (with many distressed debt investors waiting in the woods, licking their chops), a cheap acquisition price does not ensure an attractive total return. Winning over management as a “value-added” investor is often more important than price in closing a private equity deal, since more of the value is extracted post-investment, e.g. by growing revenues and cash flow.

Portfolio management – For hedge funds, this involves monitoring positions, managing risk, and trading in and out of positions....all at arms’ length. In contrast, the requirements for managing control positions (whether public or private) range well beyond investing into

corporate governance, strategy, and operations...and the value creation cycle may take multiple years to implement. The fund must motivate management to execute a new strategy, and decide whether a stick or a carrot will work best. Outside the typical scope of trading, hedge funds with control positions now find themselves responsible for a whole new set of activities:

- Designing new corporate strategies (e.g. driving revenue growth, cost cuts, turnarounds, add-on acquisitions, etc.)
- Evaluating and recruiting management teams
- Establishing compensation programs to attract, motivate and retain key executives
- Advising on corporate governance
- Sitting on boards
- Recruiting outside board members

Exiting – Arguably one of the most difficult aspects of investing is the discipline, strategy and timing regarding selling positions or exiting investments – equally challenging whether the investment is public or private, long only or long/short. Like hedge funds, private equity funds can be beholden to capital markets to extract value, especially in timing IPOs or strategic sales.

Paradigms for Accessing Operating Talent

Private equity investors, who exist on a daily diet of control investments, stay up at night struggling with these same issues – how to identify and leverage operating expertise to create value in their portfolio. Typically investment bankers by background, very few have operating experience themselves. As a result, private equity investors have spent decades exploring different methodologies to optimize the depth of their skills by accessing operating expertise or developing it in-house...and hedge funds could benefit from this experience.

The idea is to allow hedge fund managers to leverage their time and skills so that they can focus on what they are good at – identifying and executing new, unique investments...not necessarily running companies. While hedge fund managers can contribute significantly to boards, their “highest and best use” may not be spending 6 hours per board meeting on a handful of boards. (As a rule of thumb, private equity investors begin maxing out on their contribution if they sit on more than 5-10 boards at a time.)

Outlined below are four paradigms that private equity firms use to access operating expertise. These techniques are not mutually exclusive and can be used by hedge funds on a deal-by-deal basis or with different investment strategies as they evolve:

1. Outsource Everything

Hedge funds often outsource aspects of managing their own firm (e.g. operations, technology, legal, compliance, accounting, and even research), but private equity firms are much more familiar with outsourcing expertise to manage their portfolio companies. Consulting firms can be hired on a retainer or project basis to help with the wide range of issues associated with managing control investments:

- Corporate strategy
- Turn-around management

- Interim management
- Recruiting executives and board members
- HR / benefits
- Compensation consulting
- PR / corporate communications

As with most outsourcing arrangements, this strategy can be cost effective to a point. Once a hedge fund reaches critical mass, they must decide whether to implement other strategies below instead.

2. Structure Joint Ventures

Private equity firms have been co-investing for years and now are forming consortiums to jointly invest in mega-buyouts. Some hedge funds have begun to create affiliations with firms with complementary skills or industry knowledge to invest together on a single deal or targeted investment strategy, e.g. the steel industry or underperforming companies in Japan. These partnerships can range from simple co-investment arrangements to jointly-managed funds with shared resources and insights.

When a distressed debt manager in the U.S. determines that the next wave of investment opportunities will be in Europe and Asia, how do they get access to the best ideas? And how do they effectively manage a portfolio of these investments? Rather than recruiting a team of local investment professionals – which can be time consuming, costly or imprudent – hedge funds can consider creating a joint venture with a private equity or hedge fund with a long-standing local presence, contacts and experience in the region.

Joint ventures may ultimately lead to team lift-outs, spinouts,, or acquisitions, depending upon each side's ultimate goals and contributions. These partnerships work best when each side brings something other than money to the table, e.g. ideas, industry expertise, and market knowledge.

3. Bring Talent In-house

To manage control investments, hedge funds do not necessarily have to do what hedge fund giants like Cerberus and D.E. Shaw have done – hire entire investment teams to make private equity investments. If only post-acquisition operating skills are required (not origination and execution), hedge funds could consider hiring full-time operating partners, ideally executives who have extensive experience in a wide variety of industries, strategies, and highly-leveraged situations.

Some private equity firms have successfully hired operating partners, typically former corporate executives with global industry experience and a wide range of relevant skills. Private equity firms, however, have found it difficult to integrate operating partners into the investment process and make sure that their skills are leveraged and their time fully utilized. Also, it can be difficult for former CEOs who have enjoyed the “celebrity” of running a business and managing thousands of people to take on a much less glamorous role and contribute behind the scenes to a portfolio of companies.

4. Create Advisory Boards

Perhaps the best overall solution, and most cost effective, is to create an advisory board or stable of operating executives with significant executive management and board level experience. Ideally these senior advisors are not just “big names” but have successfully managed through difficult or adverse situations involving limited resources, high leverage, turnarounds, bankruptcies, rapid growth, etc. Cerberus, for example, has a stable of 100+ operating executives, many quasi-retired, on hand to assist with due diligence, company and industry analysis, sit on boards, and take interim or full-time management positions.

Many private equity firms have Advisory Boards and “Special Venture Partners”, with bios prominently displayed on their websites. In addition to using advisors to provide strategic and operating advice, private equity firms also use them to help with marketing, fundraising, investor relations, winning over management teams, and general franchise building (e.g. Jack Welch is “Special Partner” of Clayton, Dubilier & Rice, Lou Gerstner is Chairman of the Carlyle Group, and Bono is Managing Director and Co-Founder of Elevation Partners). As hedge funds grow and diversify, some of these side benefits could become equally valuable to their increasingly visible and institutionalized organizations.

Peas in a Pod

Many private equity investors find it difficult to admit that there might be some things that they're not good at, e.g. managing portfolio companies. Although their DNA make-up is different, hedge fund managers are likely to have this same personality trait.

With increasing overlap in investment strategies, hedge fund and private equity investors could learn from each other, including the nuance of the art vs. science and EQ vs. IQ of their respective businesses. With their new-found control investments, hedge funds could borrow some tried-and-true techniques from private equity firms.

A good start would be knowing when to ask for help and establishing a structured network to access talent when they need it, whether in-house, affiliated, or outsourced. By demonstrating a formal process for handling the post-acquisition side of control investing, hedge funds also can differentiate themselves in the market and in the eyes of their investors.

Private equity firms have spent decades learning to appreciate the art of control investing the hard way. Hedge funds don't have to become Impressionist painters overnight...perhaps they just need to find the right artists to commission to help them create works of significant value.

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