Exchanges at Goldman Sachs

Why Hedge Funds Are Turning to the Private Markets

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Allison Nathan: This is Exchanges at Goldman Sachs and I'm Allison Nathan, a Senior Strategist in Goldman Sachs Research. Today we're going to talk about the growing role that hedge funds are playing in the private markets, what that means for investors, and how that's affecting the interplay between the public and private markets. To do that, we're joined by Kristin Kramer and Freddie Parker from our Global Markets Division. Kristin, Freddie, welcome to the program.

Kristin Kramer: Thanks so much for having us.

Freddie Parker: Thank you.

Allison Nathan: Your team recently published a report that looks at the nature of hedge funds' participation in the private markets, particularly in private equity and venture capital. Put this into context for us. And talk about how and why you decided to focus on this topic.

Kristin Kramer: Absolutely. We've observed an acceleration of activity in private markets among our hedge fund clients. So, we wanted to understand the key drivers and the implications on our industry. We believe there is a confluence of factors at play here. And the first is that there's been a pretty significant shift in the capital formation process for companies.

You'll often hear this conventional wisdom that companies are staying private for longer. And that may be the case over a multi-decade period. But our research actually suggests that the time to IPO has been largely stable for the past 15 years or so. And that's about nine to ten years on average.

What has changed is the enormous amount of value creation during the private phase of a company's life. The median company today now goes through an average of three equity funding rounds prior to going public. That was just one back in 2011. And on average, companies are raising almost twice as much capital pre-IPO as they did a decade ago.

So, as I'm sure you can imagine, the impact on these valuations has been dramatic. And one of the best ways to exemplify this is by looking at the number of unicorns or private companies that are valued at over a billion dollars. There's almost 400 of these companies today versus just nine a decade ago. And it's pretty stunning that 155 of these attained that status just in the first half of this year alone.

Allison Nathan: So, why are we seeing this shift in activity and behaviors?

Kristin Kramer: As you may expect given this expanding opportunity set, we've also seen private equity and venture capital performance outpace that of other asset classes. And the five-year growth rate for private equity and venture capital as an asset class has doubled that of hedge funds. So, all of these factors combined, certainly, have led a lot of our hedge fund clients to spending a bit more time looking at privates.

Allison Nathan: Right. So, you've got a strong opportunity set. You've got strong returns. That's a great recipe. But are there other dimensions that are adding to this? Freddie, maybe you have--?

Freddie Parker: Yeah, absolutely. So, there are a few different dimensions to this. I think one of them has a lot to do with the capital markets. And we've seen in the last couple of years a real acceleration in the amount of activity in the capital markets, particularly in equity capital markets. 2020 was a record year for the amount of equity issuance, you know, US equity and equity-linked issuance was coming up on $500 billion dollars last year. It looks poised to surpass that this year. On top of which, you know, I think there's been the strong IPO pop phenomenon, by which we mean the tendency of IPOs to outperform in the days or weeks after IPO. Which means it's become increasingly competitive to get access to these deal allocations.

So, what's this to do with the private markets phenomenon? The first is that there is a liquidity pull effect. So, if you're investing in late-stage private companies, they're able to go public more quickly than they might ordinarily have been able to do. And the second is, with the IPO pop, there's a lot of incentive to get an allocation to an IPO, which is a competitive process. So, investing before that point definitely gets you in a better position to secure an allocation to the IPO.

There are a few other dimensions to this, I think, that hedge funds are taking into account, one of which is information synergies. So, if you look at the public companies and private companies, you can use the insights derived from one to inform the other. And particularly thinking about private companies, generally the level of disclosure that you'd expect as an investor is much higher than you'd get in the public markets. So, it enables you to have this much more holistic view of what's going on across the public/private divide, but also, hopefully, investing in privates informs your opinion on your public market investments.

And then lastly, we talked about performance dimension. One other dimension to the performance question is around volatility. So, if you're a hedge fund and you have privates inside your hedge fund vehicle, you actually get the volatility dampening effect or the sort of smoothing effect of not marking to market your private portfolio on the same rate as you do your public portfolio, which obviously gets marked on a day-to-day basis as the markets go up and down. So, there's a sort of natural smoothing effect, which I think allocators appreciate. And I think all of those are certainly additional factors in drawing hedge funds into the private markets.

Allison Nathan: I want to follow up on that, a couple of follow up questions, but before I do that can we just take a step back? How big is the footprint if you can size the volume of the participation of hedge funds in the private markets today?

Kristin Kramer: To give a little bit of historical context on that question, this is not hedge fund's first rodeo as it pertains to investing in privates. In the decade prior to this great financial crisis, hedge funds participated in an average of about 50 private deals per year. And that rose to about 200 private deals per year between 2010 and 2015. And we've just seen acceleration from there.

This year is on pace to be the biggest year by volume in history. And to put a number around that, hedge funds have invested in 770 private deals this year, well outpacing last year, which had been the prior year on record.

However, while this is a really big uptick for the industry, hedge funds' overall share of private deal activity versus all of the other private markets practitioners is still pretty modest. We think it's about 4 percent of the total volume of private deals that have been done.

Where you really see the bigger impact of hedge funds investing in privates is in terms of dollars deployed. So, in aggregate, hedge funds have put about $153 billion dollars to work in private deals this year, which is about 27 percent of the total capital deployed into private deals.

Allison Nathan: Okay, so they're about a quarter of--.

Kristin Kramer: The overall activity. Exactly.

Allison Nathan: Okay. Interesting. And so, Freddie, talk to us a little bit about their investing strategies. Where are they investing? How are they investing?

Freddie Parker: So, predominantly from a strategy point of view, these are equity long-short managers who are doing this. Over the universe of managers that we see active in privates, about 85 percent give or take are long-short equity funds. Within that, I would say there is a pretty profound skew towards sector specialists. So, a lot of the managers that are doing this are healthcare or TMT oriented managers. Many of them are larger. So, the majority of this universe are managers that have upwards of a billion dollars of assets under management.

But also, despite the sort of size bias towards larger managers, there is definitely a healthy representation of younger managers. So, we've seen a tendency within managers who launched in the last five years to be investing in privates. And actually, if we look at the new launches we worked with in the last year, about a quarter of the long-short funds that we worked with globally had some privates dimension to their strategy. So, there's definitely an uptick amongst the younger cohorts of managers.

And then, in terms of where they're active, I think a lot of this sort of mirrors the types of managers that they are. So, a lot of these deals are within the realm of the TMT/healthcare sectors. About 70 percent of all the deals hedge funds have done historically have been in those two sectors. For comparative purposes, those sectors account for about half of the cap weight of the S&P 500. So, certainly a skew towards TMT and healthcare.

And then geographically as well, there's definitely a skew towards the U.S. historically, which has always been the case. But actually, we've seen a growing participation in deals and companies based in Asia, and specifically China.

Allison Nathan: And you mentioned before that one of the key motivations is this information advantage, you know? Getting more information about private companies by investing in them before they go public. So, ultimately at what stage then are they choosing to invest in these private companies?

Freddie Parker: So, these are deals that are being done within the realm of what we'd traditionally considered the venture capital or growth equity space. Within that though, I would say there is a definite skew towards the later stages and later funding rounds. So, where we see hedge funds active is most often in the series C and later rounds, which accounts for about 50 percent of the deal activity done by hedge funds.

And if you look at it on a dollar basis, it's even more profound. So, about 80 percent of all the dollars that have been put to work for hedge funds are in those sort of series C, series D, and even later rounds.

Allison Nathan: So, obviously, hedge funds are not the only type of investors that are active in this space. We have private equity venture capitalists who have had long expertise in investing in this space. So, what differentiates the hedge fund investor from the PEs and the VCs in this space?

Kristin Kramer: One of the key defining features that we hear managers tout is just a unique set of relationships. So, your traditional private equity or venture capital firms have their own set of relationships, their own network that they're utilizing for deal sourcing. And given that hedge funds play in a different sandbox, they're potentially leveraging other connections that will lead to a unique set of companies that they'll invest in.

We also hear a lot of hedge funds talk about their hands-off approach. So, as Freddie mentioned, since a lot of these hedge funds are investing in later stage deals, they're really letting these companies' management teams run their businesses as they see fit. And they're not requiring a board seat, for example, in exchange for their capital. At the same time, hedge funds aren't afraid to bring their public markets insights to the table to help these companies, particularly to help coach them and help them navigate the process of going public and everything that comes with being a public company.

Not only are a lot of these insights really valuable, but hedge funds may also have a competitive advantage when it comes to their own capital duration. They can be a true lifecycle investor with a company. They can participate in crossover rounds prior to the company going public. They can even cornerstone that IPO and then be a multiyear holder of the company's public stock. This is a really different pitch than what you might hear from a number of the incumbent players in the venture capital space given they're typically running limited life funds that at a certain point they'll have to return that capital back to their investors given their mandate.

Allison Nathan: So, we've talked a lot about the hedge funds moving into private markets. But have you seen signs of private market investors, you know, PE and venture capitals investing in hedge funds to compete?

Freddie Parker: So, we've started to see, I think, more of that development. And I think particularly in light of many of these sorts of competitive advantages that hedge funds have when they're playing in the private markets, I think we see private equity and VC funds wanting to move in the other direction to maybe try and sort of retake some of that competitive advantage. But it's relatively nascent. And I don't think there's a very large number of firms that you can point to who have successfully built out large hedge fund franchises thus far.

So, we think there’s 20 or so PE or VC firms that have hedge fund businesses, of which many are actually equity long-short businesses. So, theoretically comparable businesses to many of these hedge funds that are moving in the other direction. But thus far at least, many of those businesses still remain relatively small, both on an absolute basis. So, a lot of them are in the sub $500 million bracket. And relative to the overall assets of those firms. So, a lot of them have less than 5 percent of the assets that these firms are running. So, still, quite nascent businesses within the context of the overall size of their assets.

With that said, I think anecdotally we're starting to observe more private equity and VC firms come to the table and try and understand what the opportunity set might be on the public markets and explore whether it might be appropriate for them to launch a hedge fund business or another type of public markets business to be able to compete in the world where the lines between public and private are ever increasingly blurred.

Allison Nathan: So, if we think broadly about the hedge fund space versus the private markets, hedge funds are typically thought of as a very liquid asset, whereas private markets are thought of as less liquid. So, how are hedge fund investors thinking about this allocation to our private markets? Are they comfortable with it?

Freddie Parker: So, I think there are a few schools of thought there. The first thing I would say is there's definitely variation amongst types of allocators. There are some types of allocators who are very happy to underwrite this activity, or comparatively happy to underwrite this type of activity. I would put at that end of the spectrum endowments and foundations, sovereign wealth funds, family offices. What these investors have in common, in many cases, is they have very long duration capital. So, the liquidity/illiquidity comparison, I think, is maybe less relevant to them. And they can think about the opportunity set more holistically and they're not so constrained.

Similarly, if you look at it geographically, U.S. investors and Asia-based investors tell us that they're relatively happier to underwrite hedge fund activities on the private side versus European investors who tend to be more liquidity sensitive as a whole. With that said, I would group investors into two camps. I would say there are those who are very enthusiastic proponents of this. They believe in all the advantages that hedge funds potentially can have in the space. And I think in many cases they view it as potentially a differentiated set of opportunities than they're getting from their traditional VC/PE portfolio.

And then on the other side of the table, I think you have some investors who I would characterize as maybe more reluctant acceptors. So, these are groups that have, I would say, the ability to and on occasion will underwrite hedge fund's involvement in private markets. But they'll do so maybe more because they're particularly compelled by a single manager and their abilities and their differentiators.

And the pushbacks that we hear from those investors tend to fall into a few different buckets. One is to do with that liquidity point and the fact that they have, I would say, silos in their portfolios. And this sort of crossing over and blurring of the lines makes it difficult for them to position these investments in their portfolios. In many cases, they have different teams within the same organization who have to underwrite public market investments versus private market investments. So, you have to find a way to marry the work of those teams to be able to underwrite these positions.

And then there are the considerations, I think, around risks involved in this. So, the implications it has for the total liquidity of your portfolio, especially when, as you say, hedge funds are typically characterized historically as liquid investments. And then perhaps memories of some prior crises where you've seen illiquidity in portfolios become problematic. And I think some investors, therefore, are a little bit reticent. And I think especially when you consider the amount of money that's flowed into the private markets, not just from hedge funds but from other investors as well, may be a little bit more reticent to underwrite those sorts of forays into privates on the part of hedge funds at this point as a result.

Allison Nathan: So, do you think there is actually reason to be worried about this trend and this illiquidity? And again, thinking about past crises and this hasn't always gone well.

Kristin Kramer: Right. So, on the one hand, while we have those memories in the not too distant past, we do think that hedge funds are trying to be very thoughtful this time around about how to better align their terms so that they can support their private investing efforts, but also better solve for asset liability matching. And we tend today to see hedge funds structuring their private investments in two key ways.

So, the first is actually having privates in traditional hedge fund vehicles themselves. And most often this is done via a side pocket, which allows hedge funds to segregate privates from public assets. And in certain cases, enables the underlying investors to choose whether they want to have exposure to privates and how much. This has become a much more commonplace way to have hedge funds actually structure privates within their own vehicles. And was much less the case during the 2008 crisis.

We've also seen a meaningful number of hybrid funds launched, which we define as hedge funds that can invest 20 percent or more of their assets in privates.

The second way that hedge funds are offering privates to investors is through separate and dedicated vehicles. This could be through a standalone, drawdown private equity fund or through a co-investment, which an investor can select to participate in to get exposure to a single deal.

So, overall, I think the bottom line is that there's a much more intentional approach on the part of many hedge fund managers to get the right separation of public and private and the right aligned terms for those vehicles. And we'd also emphasize that there's no one size fits all approach. So, a number of our hedge fund clients are offering multiple structures given investors have different needs. And at the end of the day, these allocators really need to take a hard look at what the hedge funds' private investing strategy is, the way they've decided to structure it, and then determine how that fits into their own portfolios.

Allison Nathan: Understood. So, the implementation is just a lot different it sounds like this time around.

Kristin Kramer: Absolutely. That's what we've observed.

Allison Nathan: So, we think about the future, do we think this is a trend that's going to persist? Or is it more cyclical in nature, something that, you know, may be here today, gone tomorrow?

Freddie Parker: So, when we interviewed hedge fund managers on this topic, we asked them "How do you see this developing in the future for your business?" And all of them said, "We see this as a structural phenomenon in our business. We don't see this as being something cyclical. Our overall allocation to privates may vary. It may go up. It may go down as the opportunity set shifts through time. But we see privates as being something that are going to be here to stay as something in our toolkit that we will use going forward."

Allison Nathan: Kristin, Freddie, thanks so much for sharing your insights on this really interesting trend.

Freddie Parker: Thank you very much.

Kristin Kramer: Thanks so much.

Allison Nathan: That concludes this episode of Exchanges at Goldman Sachs. Thanks for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating and comment.

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