Hedge fund restructuring – navigating treacherous waters

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When restructuring, hedge funds need a detailed and realistic plan that addresses the needs of both creditors and investors.

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Pre-crunch, as investors became comfortable with the concept of absolute returns and increased their exposure to hedge funds, the pressures for transparency, liquidity and lower costs were growing. The credit crunch has accelerated this but it has also brought some big new challenges of its own.

The downward spiral of liquidity needs, forced selling, negative returns and heightened risk has caused managers, investors and counterparties alike to question who they trust. They are revisiting the fine print of the complex agreements which govern their relationships.

Today, even some of the most successful hedge fund managers are faced with a set of challenges they have not experienced before, with few advisors to which to turn.

New challenges

Four of these challenges appear to drive hedge funds' response to the credit crunch: the extent of liquidity mismatches (and investor reaction); insolvency and liability risks; the need to treat parties equitably; and, the need to live within reduced incomes.

In most cases, hedge fund managers are still run by their founders. Talented money-makers, they are typically not experienced in crisis management. With the help of competent COOs and good legal advice, some have come up with feasible restructuring plans. Yet for others 'denial' seems to be the order of the day and many are failing to seek the commercial advice and support needed to navigate the challenges – strange for a sector which focuses on its strengths (i.e. investing) and outsources much of the rest.

Understanding investors' needs

For those that need to restructure, the first step is to design a plan that works for individual investors. Historically, the relationship that hedge funds had with investors was somewhat one-sided with investors generally accepting 'standard' terms unsuited to a worst case scenario. Now, with hedge funds weaker, investors with money not only have the power to negotiate better deals but also need to be convinced of the merits of restructuring plans. Investors who don't (or can't) support a restructuring need another solution, such as the opportunity to partially redeem their interests in a fund. Either way, knowing the investors' approach is vital.

A restructuring plan should encompass detailed cash flow modelling, consider all the options (including good fund/bad fund splits), contingency planning, liability management and investor communication.

Funds' managers and directors have to become involved in a way that they have never had to before, acknowledging their duties to both creditors and investors. But while good legal advice is essential, many lack the commercial expertise to navigate the challenges of liquidity, solvency and liability whilst also doing their day jobs.

Realistically, many hedge fund managers, directors, investors and counterparties will need early advice and support to achieve an ordered restructuring. Leaving it late may mean the only realistic option is insolvency.

Investment Management and Real Estate contacts

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