

THE HEDGE FUNDS' HEDGE

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Having expanded and multiplied and thus grown into a more and more dominant equity market presence, hedge funds have recently begun to make their way with equal assertiveness in the field of credit capital. As a result, and just as hedge fund liquidity has done much to support equity valuations, senior debt terms are making their way to historically unprecedented standards. Pushed in that direction largely if not entirely by hedge funds invading the traditional domain of banks and finance companies, aggressively structured and priced credit capital is becoming difficult to refuse by some issuers.

Leverage multiples in the high single-digits (based on EBITDA), bullet or other heavily back-ended maturities, and thinning spreads over LIBOR, are discussed with growing frequency. Syndicated debt oversubscribed by multiples, is becoming a working assumption. Increasingly one hears about traditionally active banks refusing to compete in this environment, and the names of hedge funds, in this context, always seem to surface.

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In a way, the pattern stands to reason. In addition to the substantial hedge fund liquidity that needs to be put to work, in addition to the diminishing number of profit opportunities in equity markets, there may be a still more important rationale for the entry of hedge funds into this new realm of fixed-income and limited-upside senior credit: It is a way for hedge funds to do what the blueprint calls for – to hedge.

...akin to going long the enterprise value at a discount...

In an environment in which public valuations may seem inflated as a result of excess liquidity (i.e., as opposed to fundamental business conditions), shorting the market can be an unduly risky proposition as long as this liquidity remains high. Alternatively, there is the equity hedge inherent in going long a more senior tier of the balance sheet. If structured at a reasonable discount to enterprise value, in order to create a cushion against equity devaluation, this mechanism does not result in loss of capital under favorable circumstances (as a short position would), and does not necessitate long exposure to high-priced equity. Instead, senior credit is akin to going long the enterprise value at a significant discount. Pricing the typical credit transaction off floating LIBOR is added protection against a rise in interest rates – a circumstance that would otherwise trigger a fixed-income (and equity) devaluation.

There is, as well, another angle to the capital flows described, another advantage to the lender which may this time also resonate with issuers. Unlike traditional credit sources such as banks, hedge funds are unregulated vehicles that are not unaccustomed to owning equity. Should high financial leverage lead to an eventual restructuring, hedge funds may not show the hesitation that many banks have shown in the past, to assuming a major equity position. And they will have done so for the mere cost basis of current-pay senior debt, offered to a profitable company.

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