In an Uncertain Market, Opportunities (and Risks) Abound

▸ Adam Hilkemann, partner with Akin Gump, discusses trends in investment management – including hedge funds, hybrid and customized funds, and real estate – and how investors and fund managers are dealing with the ongoing pandemic.

CCBJ: Tell us about your background and how your practice has developed.

Adam Hilkemann: I'm a lifetime Akin Gumper. I summered at Akin Gump, and I've been here my entire career. I recently made partner in our investment management practice in Dallas. Our office has a long history in hedge funds, particularly in Texas, but also in private equity and all things funds-related. Myself in particular, I've spent a lot of time working on real estate and real estate–related funds, including real estate co-investments and programmatic real estate joint ventures for fund sponsors. Primarily, I've worked on the sponsor side, but sometimes on the limited partner side as well. I've also worked frequently with hedge fund and hybrid-style clients, again, particularly on the sponsor side. Many times it's been for clients with more of a niche or specialized investment strategy – things like litigation finance, technology, multi-manager, cryptocurrency, digital asset funds, but also plain vanilla hedge funds and associated compliance work. I've also been spending more and more of my time doing investor-side representation for large institutional clients that are investing in other funds, which I think has probably been a trend across many firms.

What investment and asset management trends have you been seeing over the course of the pandemic, and how are investors and fund managers pivoting and prioritizing?

The simplest way to address that question is to split the answer into whether or not we're talking about liquid products, like hedge funds, or more illiquid investments and products. On the liquid side, certainly the first quarter and early second quarter of 2020 saw a significant performance downturn. Maybe not the biggest in the industry's history, but overall, for hedge fund managers as a whole, for months like March, it was probably worse than the global financial crisis, and it really erased all of the gains that had been made in 2019, when people were starting to talk about a hedge fund resurgence. A lot of that was wiped out. That being said, hedge funds did mostly outperform market as a whole, which was down maybe twice as much as a lot of these hedge funds – even if the hedge funds themselves had double-digit losses.

Right after that, in the second quarter, along with a lot of the rest of the market, there was a pretty historic upswing for hedge funds, which essentially erased a lot of the first-quarter downswing. And again, hedge funds generally outperformed the market, which is obviously what they are supposed to do. Now we are seeing new funds being launched, especially by the more established managers. There is a trend in the industry toward more established so-called "mega managers." As far as liquidity and inflows and outflows, the outflows in the first quarter were pretty significant, and there was certainly a lot of ink spilled about how this could turn into another 2008 liquidity crunch – that we were going to hit a liquidity wall again, like we did in the global financial crisis. But we never saw it.

I think a variety of things account for that. Managers are more sophisticated now; terms are more sophisticated. Maybe investors are a bit more patient and sophisticated too, and you're starting to see investors and managers working together, trying to come up with compromise terms, getting less liquidity, perhaps in exchange for fee breaks, or even renegotiating existing deals, negotiating withdrawals or cancelations of withdrawals. It's hard to say if it's an overall trend, but I think it does point at an acceleration toward more customized hedge fund products and terms that really match investor needs with what managers would like to see,

in particular as investors continue to seek out alternative investments in a low-interest-rate environment.

Since we're still in the middle of the pandemic, it's difficult to say where this is all going to lead. As managers continue to negotiate various alternative liquidity structures, there's also a trend toward potential conflicts and operational difficulty as those play out over time, especially if there is another crunch or large market downturn. It's going to be important to have increased compliance awareness as we move forward.

On the illiquid side, you've got historic amounts of dry powder, as is being reported semi-constantly in industry and industry-adjacent publications. Even from investors with a lot of dry powder, funds of funds, institutions, you saw some tentativeness in the first quarter, since people weren't sure what was going to happen. When they saw that the markets did not break, and in fact the stock market picked back up and a liquidity crunch did not occur, fundraising and deployment picked back up. And on the fundraising side, definitely in terms of the large and very large mega managers, you're still seeing institutional investors oversubscribing big closings – as well as co-investments and other sorts of specialized funds that play to the manager's strengths and crown jewel–type assets.

That being said, you're still seeing some hesitancy from sponsors to really push investors for more manager-friendly terms, despite being oversubscribed. As with the liquid market, you're seeing increasing sponsor focus on specialized funds. Maybe even half of the sponsors are considering or have implemented customized funds or funds of funds. In other words, a different or narrower strategy than their main fund. Maybe a different investment timeline, harvest horizon, maybe more information or veto rights. A lot of times those investments will be more or less in parallel with their other products, though they are not true "parallel" funds that are investing in everything that the main fund is doing. And we have seen a heightened focus on potential conflicts relating to that. A lot of focus on allocation policies. There's an Office of Compliance Inspections and

Examinations (OCIE) alert that went out recently that's certainly getting attention. And on the expense side, we're starting to see more focus on allocations as we start to see more industry adoption of the pass-through of internal expenses, like internal legal and accounting expenses. The Institutional Limited Partners Association (ILPA) has seemingly adopted an approach that permits that sort of pass-through. Although the current trend is to see broad carve-outs for the general partner to allocate investments and expenses flexibly, as long as it's fair and equitable.

You have a considerable representation within the real estate community. And many organizations are reconsidering real estate investments, leases and more. How are your real estate investment clients reacting to these events?

Certainly there's some concern in this space generally – especially real estate related to hospitality, shopping malls, downtown offices, other similar kinds of commercial uses. And there's still a big question mark out there, since this pandemic still hasn't played out fully yet, right? We had the COVID-relief stimulus bill. We've had some tenant relief at different levels of government. But we're not seeing a lot of flexibility from the special servicers in the agency and bond markets that are essentially responsible for this debt. We did see some extensions early on, limited extensions for people back in March, April, May and maybe June, when people were hoping for an early end to the pandemic and were giving borrowers some relief.

But now we're seeing a lot of those forbearance periods expiring, and I think we'll start to see more foreclosures and more collateral renegotiation with borrowers. Once again, it's difficult to say how it will play out, how much cash borrowers are going to be willing or able to put up. Estimates about foreclosures are all over the place. There haven't been too many yet, but certainly some estimates are that this could be even worse than 2008.

Acceleration and customization are the main themes.

That's the bad news. The good news is that there are a lot of sectors that are still active. Medical properties, infrastructure, food, energy, communications, data centers and related investments. So even if there's been some discomfort in existing investments in sectors that have been hit hard, sponsors may have the ability to ride it out. And if they've got a lot of cash, they may be able to make opportunistic investments in other sectors that are down or slightly down – like multi/single family residential or education – which has generated a bit of a boom in opportunistic real estate credit and net lease–type strategies.

I think there will be continued pressure for managers to support valuations where they're holding investments at cost, both from an investor and regulatory perspective, particularly if those valuations impact their fees or performance. If they have net asset value-based fees or performance affected by write-downs and write-offs, we'll probably start to see more conflict renegotiation here as investments that involve more than one fund start to go bust.

What role are hybrid funds and other customized vehicles playing in risk-management strategies?

As we discussed earlier, you're starting to see increasing customization of products, particularly in the credit space – credit funds of all types, from the traditional to the more unconventional. These are for funds that are not illiquid per se but are not as liquid as a conventional hedge fund either. There's been some investor concern about what's the right liquidity framework for these vehicles – but they're not quite ready to do a traditional private equity model either. So there are some trade-offs. Sometimes people aren't paying fees on commitments, so they're not paying on unde-

ployed capital, which is good for investors, but now maybe they're paying fees based on that asset's value or even net asset value with leverage. So they may end up paying more fees overall. Maybe people have to do an early exit, or slow pay liabilities in exchange for a manager getting a longer overall turn or ability to raise series after series of capital.

We're seeing that lead to the return of "evergreen permanent capital structures" of various types. You raise pocket after pocket of capital and then deploy constantly. These types of structures can give managers a more predictable source of capital, although they need to be careful about actually being able to call or utilize that capital for follow-on investments or delayed draw credit agreements. These evergreen funds also have to be cautious about the potential for style "drift." Sometimes they're also limited by what the administrators can accomplish, and the complexity can be a burden as well. And, with the more specialized hybrid funds, things like trigger funds, where investors want to take advantage of specific market triggers or events, investors may not quite be ready to have their capital tied up. So once again, you're seeing customization and hybridization that attempts to meet investor and manager goals.

How are you advising fund managers about their near and long-term risk management and compliance strategies in the current environment?

I'll break this answer down into liquid and illiquid as well. On the liquid side, in the short term, there's reviewing your fund terms, checking your gates, checking your ability to create side pockets, reviewing side letters for restrictions, and then also getting in front of investors and addressing potential issues in advance – before quarterly or semiannual withdrawal deadlines, or as requests start to stack up. A lot of that's already been done through renegotiations, maybe in-kind redemptions, liquidating vehicles, or sometimes by investors that were a little nervous canceling those requests and staying in the fund.

Investors are increasingly sophisticated and willing to participate in more specialized structures or terms.

Long-term, you're starting to see managers think about new and creative share classes, and they're trading off less liquidity for less or more creative fees. You're also starting to see, especially on the liquid side, the hedge fund side, people revisiting their expense allocation policies – people that maybe were used to having just one fund or maybe a couple of funds with different strategies. Now they've got this proliferation of vehicles – funds of funds, managed accounts, sidecars, and so on – and the hedge fund expense allocation policies are now in Private Placement Memorandum (PPM) disclosures that are starting to look a lot more like private equity. It's also important to encourage hedge fund managers to review their conflict disclosures related to offering investors different liquidity or offering them side letters, getting them to think about their compliance manual and the recent OCIE alert I mentioned earlier. For some of our really large or international managers, we're also making sure that they're looking at the United Kingdom and the rest of Europe in terms of what they're going to do there, because there's a higher concern over there about whether there's a liquidity mismatch between funds, investments and their investment terms.

On the illiquid side, short term, some of the same things. Looking at event investment and expense allocation policies, looking at side letters, revisiting their strategy and make sure there's not style drift just because of the current market conditions making certain sectors more attractive. Revisiting their valuations and their reporting methodology, and to the extent they can, running issues by their limited partner advisory committees and taking their temperature, particularly on the private equity side.

Long-term, we want people to think about new fund terms, broadening investment strategies, or creating buckets for things that are going to be outside of their main strategy as private investors start to look for more nontraditional private equity–type investments. Also, especially in the credit space, think about potential shadow banking "regulation," as this may be a sector that is ripe for more regulation, similar to the existing banking regulation structure. Other things we're doing include encouraging people to review their private placement memorandum, conflict and risk disclosures, and on the investor side, utilizing co-investments and other types of similar structures to draw in investors who might be on the fence with lower average fees, without reducing the headline fees they're offering.

What opportunities should investors and asset managers be considering during all this?

Acceleration and customization are still the main themes. On the investor side, beyond just the traditional total relationship fee breaks, where you get a fee break from the manager based on your overall commitments to all of the manager's funds, it's smart to approach advisors like partners, in areas that play to the manager's strength, as part of putting together a complete investment strategy. Maybe even on a mix-and-match basis rather than a take-it-or-leave-it basis – which we see managers increasingly willing to do for large investors. Also, for investors, caution them to continue monitoring disclosure and conflict issues. The private placement memorandums are no longer simply boilerplate – to the extent that they ever were – and there's more and more that's being disclosed to investors. Investors should be aware of what's in there.

On the manager side, there are a lot of opportunities to deploy capital opportunistically in a wild market, especially in specialized sectors, or with specialized strategies. And also, on the manager side, partner with investors to drive assets under management and overall performance, focusing on investor reporting and education. We're starting to see more and more managers adopt the ILPA reporting. It's a greater reporting burden for them, but the flip side is that internal expenses that weren't traditionally passed through, like accounting and legal, including costs associated with that reporting, have now seemingly been blessed by ILPA.

I think investors are increasingly sophisticated and willing to participate in more specialized structures or on specialized terms. They're familiar with hybrid structures, they're familiar with impact funds and other customized funds and the related issues. And, advisors may soon have the ability to start marketing under the new advertising rules that would give them more flexibility, especially with institutional investors.

Lastly, there's also a greater potential for tax optimization in the current work-from-home environment. It's not a large trend yet, but we've started to see a number of firms considering either changing their tax domicile or at least the domicile of the principals, although that could be very complicated. It's definitely something to pay attention to though. ■

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