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FINANCIAL

Cash-rich hedge funds roil middle-market lending

New players make quick deals where banks fear to tread; perils of ignorance

BY TOM FREDRICKSON

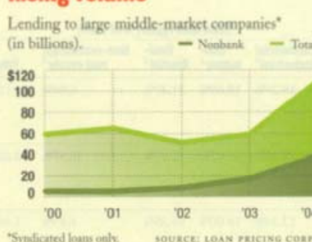
Back in February, Salus Surgical Group got a big surprise when it went looking for a loan. The California-based manager and developer of surgical centers wanted to use the cash for a major expansion.

It ended up with two funding offers, neither of which came from a bank and one of which was for a whopping $22 million—nearly three times as much as Salus' previous lender had offered.

Two for the money

"We had (offers) from two different hedge funds within 24 hours," says Mark Claster, a managing director with Carl Marks Capital Advisors, the investment bank that lined up the loan from Manhattan-based Fortress Investment Group. "There has been an influx of hedge funds into our world."

Hedge funds, unregulated investment pools created for wealthy individuals and institutions, are swarming into the $200 billion-a-year business of lending money to midsize companies. The funds are stealing market share from banks like J.P. Morgan Chase & Co. and nonbank specialty lenders such as CIT Group Inc. by lending directly to businesses. They're also forcing down loan prices and credit standards by charging into the market with open checkbooks.



"We are in a frothy market now," says David Deutsch, president of investment bank David N. Deutsch & Co. "Some deals are being done at too low a price, and certain creditors are making bigger loans than they should."

Dogged determination

Manhattan-based Cerberus Capital Management got the ball rolling. In 1998, it launched Ableco, the first major middle-market lending arm set up by a hedge fund. Fortress and Greenwich, Conn.-based Silver Point Capital followed Cerberus' lead within the past couple of years. In the last 12 months, dozens of the estimated 1,000 hedge funds with New York City-based managements have plowed into the middle market.

"Direct lending by hedge funds is proliferating quite rapidly," says Paul Solomon, a former investment banker who recently became chief financial officer of Salus.

The hedge funds are winning business because they move far more quickly than banks and their loan committees could ever dream of doing. The funds often commit tens of millions of dollars in as little as 24 hours. In addition, they have more relaxed lending standards, and they're even willing to lend larger amounts than banks.

Fortress, for example, lent money to Salus based on collateral that the California company's existing lender wouldn't accept. Fortress

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JENNIFER CHU

VESTED INTEREST: As hedge funds surge into middle-market lending, some deals are being done at overly low prices, says investment banker David Deutsch.

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based its faith in Salus on the company's ability to collect on millions of dollars in workers' compensation claims that were more than a year old.

"Hedge funds think they can be smarter lenders than the banks, and they can certainly move faster than most," says John Simons, managing partner with Corporate Fuel Partners. The investment bank is trying to interest hedge funds in lending to some of its middle-market clients.

Aggressiveness breeds agita

The funds' hyperaggressive style is making life difficult for seasoned lenders such as J.P. Morgan and Bank of America and newer ones like Merrill Lynch. But the competition is hitting giant CIT, a specialty lender, even harder.

That's because CIT and the hedge funds all focus on a particular type of middle-market lending. They primarily make asset-based loans, based not on a company's cash flow but on its assets, which can be seized in the event of default.

This riskier kind of lending carries higher interest rates. CIT has about $53 billion in asset-based loans, backed by everything from machinery to corporate aircraft. Last year, in a conference call with analysts, CIT executives specifically cited the threat posed by hedge funds as a negative for the company.

Of course, the higher potential profit in this kind of lending is precisely what draws so many hedge funds. With an estimated $1 trillion in their collective kitty, the funds have to look ever further for investment opportunities that can make money for their owners.

Their foray into lending to midsize companies began in earnest even before their entrée into direct lending. Initially, hedge funds partnered with banks and other traditional lenders.

They waded into the market by taking pieces—typically the riskier, higher-yielding ones—of larger loans originally put together by big banks through what are known as lending syndicates. Large syndicated loans to midsize companies by institutions more than doubled last year, to $38 billion, or about half as much as the banks themselves lent.

The hand that feeds them

But as time has gone on and the flow of money has become more of a flood, the hedge funds have begun to challenge their former partners, the banks, and to erode their own profit margins in their lending operations.

Eager hedge funds and pension funds have helped drive down the rates for lower-grade debt. Loans that used to yield 4 percentage points over the cost of funds are now fetching as little as 2 points above funding costs, says Bradley Hardy, senior vice president of U.S. corporate banking at Wells Fargo in Manhattan. That means less profit for all lenders.

These days, hedge funds are so eager to put their money to work that they are increasingly making loans themselves and cutting out the middlemen bankers. Many in the industry worry that hedge fund managers—which have no experience in the game, only cash—could be courting disaster. ■