

Hedge Funds Fill the Void With a Flexible, Non-Traditional Approach

While hedge funds certainly are not new in the U.S., a recent surge in hedge fund lending has created a relatively new dynamic in the financing arena — one where hedge funds are playing roles traditionally filled by asset-based lenders. However, recent deals such as the \$225 million financing to Krispy Kreme obtained through CSFB and Silver Point Finance illustrate traditional lenders and hedge funds can share a seat at the same table.

By Warren H. Feder

When Carl Marks Advisory Group set out to secure cash financing for Salus Surgical Group to fund a major expansion by the developer of premium physician-owned outpatient surgery facilities and hospitals, the first funding offers came from what just five years ago would have been an unexpected source: hedge funds.

While hedge funds certainly are not new in the United States, a recent surge in hedge fund lending has created a relatively new dynamic in the financing arena, one where hedge funds are playing roles traditionally filled by asset-based lenders.

Much has been written in the business and financial press about this new dynamic, including the impact their aggressive lending strategies are having on traditional asset-based lenders. Many have questioned whether certain hedge funds are courting disaster with overly aggressive lending.

While viewpoints may vary, one thing is clear: It certainly appears that there is plenty of room for both players.

Take Krispy Kreme, for example. Earlier this year, the troubled doughnut company avoided a trip to bankruptcy court by obtaining \$225 million in loans from a group led by Credit Suisse First Boston and hedge fund Silver Point Capital.

The loans came at a hefty price by way of high interest rates and illustrated how more traditional lenders and hedge funds are sharing a seat at the table. Hedge funds are particularly active when it comes to dealing in second lien loans, which comprised much of Krispy Kreme's loan structure. In the event of a bankruptcy, second lien loans take a back seat to first lien lenders, who are first in line to get paid.

The willingness of hedge funds to shoulder the risk has created more flexibility and options for companies in need of non-traditional financing. "Direct lending by hedge funds is increasing quite rapidly," says Paul Solomon, a former investment banker who now serves as chief financial officer of Salus Surgical. "Their success is due in large part to their flat management structures and entrepreneurial style, which provides them the ability to act quickly and creatively."

And many companies, including Salus Surgical, are finding that the trend is working in their favor. After considering several offers from different hedge funds, Salus Surgical secured a \$22 million senior secured term

facility, far exceeding the company's \$15 million target. The new credit facility, arranged by Carl Marks Advisory Group, replaced a \$12 million senior secured credit facility, with proceeds earmarked for repayment of outstanding senior indebtedness and for general corporate purposes, including supporting Salus Surgical's ongoing expansion initiative.

Headquartered in Beverly Hills, Salus Surgical develops premium physician-owned outpatient surgery facilities and hospitals in partnership with leading physicians. The company has facilities and hospitals in California, New Jersey and Ohio.

"This was a significant transaction for Salus and for Carl Marks Advisory Group. We succeeded in meeting our client's two main objectives:

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speed of execution and maximization of proceeds," says Mark Cluster, a partner of Carl Marks Advisory Group. "Not only was the deal significantly upsized, but it also closed in just about ten weeks' time."

Cluster said his firm was able to help Salus Surgical secure its new financing based on collateral that the company's existing lender wouldn't accept: California workers compensation receivables. Outside the constraints of traditional asset-based lending restrictions, Fortress Investment Group LLC was able to accept as collateral Salus Surgical's ability to collect on millions of dollars in workers' compensation claims, which will be paid over a number of years. As a result, the company secured its desired financing in an expeditious closing, positioning Salus Surgical to continue realizing its expansion goals.

"We were extremely impressed with the way that Fortress took a non-traditional, yet very thorough, approach to analyzing this atypical asset class," said Solomon. "Most asset-based lenders have eligibility criteria stretching out to 120 or 150 days, which clearly is not relevant to our workers comp portfolio, which has a very consistent record of paying out over two to three years."

The Salus Surgical transaction helps illustrate the ability of hedge funds to move more quickly than traditional asset-based lenders to meet an organization's financing needs in non-traditional situations. As a result, such companies are finding more flexibility and options in securing the financing they need to achieve their business objectives.

And while Salus arguably was far from a risky deal, the proliferation of hedge fund lending as it relates to high-risk transactions has some raising concerns regarding the long-term effects.

In his June 6 remarks to the International Monetary Conference in Beijing, Federal Reserve Chairman Alan Greenspan said that most of the "low-hanging fruit of readily available profits has already been picked" by hedge funds, which are now actively engaged in securing other opportunities in a quest for high returns.

"But continuing efforts to seek above-average returns could create risks for which compensation is inadequate," said Greenspan in written remarks. "Consequently, after its recent very rapid advance, the hedge fund industry could temporarily shrink, and many wealthy fund managers and investors could become less wealthy. But so long as banks and other lenders to these ventures are managing their credit risks effectively, this necessary adjustment should not pose a threat to financial stability."

In his remarks, Greenspan tied the big risks hedge funds have taken on with the unusually low long-term interest rates prevailing around the globe. "One prominent hypothesis is that the markets are signaling economic weakness," he said. "This is certainly a credible notion. But periodic signs of buoyancy in some areas of the global economy have not arrested the fall in rates."

Greenspan also said the abnormal behavior of interest rates had encouraged greater risk-taking. "Whatever the underlying causes, low risk-free, long-term rates worldwide seem to be one factor driving investors to reach for higher returns, thereby lowering the compensation for bearing credit risk and many other financial risks over recent years," he said. "And for high-flying hedge funds, the increased appetite for risk seemed likely to lead to losses."

Although warning of hedge fund troubles ahead, Greenspan reiterated his view that the industry had helped increase the economy's resilience, including through their increasingly active role in the estimated \$200 billion-per-year business of lending money to mid-size companies.

The funds have moved in on market shares of leading asset-based lenders and non-bank specialty lenders by lending directly to businesses, and as a result are forcing some players to drive down loan prices and ease up, to the extent possible, on credit standards.

And while the competition can at times be fierce, through it all, constructive working partnerships are emerging as asset-based lenders find that hedge fund lenders can shoulder some of the risk that simply don't fit the credit profiles.

Today, it is not unusual to find hedge funds getting in at all levels of lending, perhaps carving out an A piece to an asset-based lender, quoting a lower rate than what is proposed for a B piece. As a result, some hedge funds have emerged as one-stop shops, originating loans and dictating terms of portions out to other lenders.

"We have even seen situations in which asset-based lenders have refinanced hedge funds out of a credit," says Claster. "While in some instances, this might reflect the improved credit quality of the borrower. In other cases, however, it illustrates an increased tolerance for risk among some more traditional asset-based lenders."

It is unclear how hedge funds will fare in the next round of restructuring. However, with a growing number of hedge fund rosters that now include highly respected leaders from the ranks of traditional asset-based lenders, many funds are adding the kind of premier credit quality talent and expertise that should prove valuable.

Examples include Stuart A. Armstrong, who was recently named president and chief executive officer of Black Diamond Commercial Finance, LLC., after 13 years with GE Commercial Finance, and Carl Toriello, who was appointed in 2004 as senior managing director and head loan officer of Jefferies Babson Finance after more than 30 years of credit and lending experience, most recently serving as senior vice president and New York group leader of GE Commercial Finance.

That kind of crossover, coupled with emerging working relationships between hedge funds and asset-based lenders, should help enhance the credibility of hedge funds, which for some companies are providing a lifeline that might otherwise not be available.

"With a more flexible, non-traditional approach, hedge funds are filling a void that others simply cannot cover," Claster says. [abfj](#)

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