

Could more prime brokers wave goodbye to cap intro?

BY EILIDH WAGSTAFF

HFMWeek explores the pressures being applied on bank business models and asks whether others will follow BNP Paribas' move to outsource cap intro

At the start of 2018, BNP Paribas cut its entire cap intro team. The French bank now outsources the service to Layton Road Group, which is led by former BNP executive Tom Mahala. The development has left hedge fund managers wondering whether other prime brokers are likely to follow suit and what impact that might have on the way they raise capital.

Cutting costs

Many investment banks have trimmed down their prime brokerage divisions generally in recent years, and their cap intro teams specifically. "Cap intro executives don't have revenue next to their names, so when banks need to remove heads they will often look at this area," says Sean Capstick, head of prime brokerage at GPP.

Some industry commentators suggest that PBs are juniorising as well as downsizing their capital introduction departments. A number of the industry's most experienced executives are stepping away from the sector this year. Robert Leonard, global head of capital services at Credit Suisse; Martin Visairas, ex-global head of capital introductions at Citi; and Alessandra Tocco, global head of capital advisory at JP Morgan, are among the seasoned heads to depart.

But it seems it's the mid-tier PBs that are making the most concerted effort to reduce cap intro costs. "There's a clear barbell effect," says the Emea head of cap intro at a top-tier prime broker. "The larger banks can afford to maintain all of their customer services. Then, at the

other end, you have small boutiques that are popping up. It's the middle that's being squeezed."

The rise of split prime brokerage mandates is one of the major headwinds facing mid-tier cap intro teams. The majority of hedge funds use at least one top-tier PB, so allocators receive fairly comprehensive coverage of the hedge fund landscape from the leading teams. As a result, institutional investors don't always see the need to develop relationships with the smaller players in the field.

While prime brokers across the board have been reigning in spending on capital introduction, there are firms bucking the trend. For example, Cantor Fitzgerald recently hired its first global head of capital introduction as part of a broader build-out its PB capabilities. Added to this, top-tier teams continue to spend heavily on events. Morgan Stanley is a case in point, as it reportedly pulled out all the stops for the 20th instalment of its Breakers Conference in Palm Beach, Florida, while Goldman Sachs' Rome conference has attained legendary status and is one of the most talked about events of the year.

Reaching maturity

The continuing flow of institutional money into the hedge fund industry is another factor propelling prime brokerages to change the way they deliver cap intro. One industry veteran recalls that, when the service was in its infancy, business was conducted on golf courses, in opera houses or over lavish meals. The landscape has changed radically since then. Managers now have a fiduciary duty

to select a prime broker on sound financial grounds – the personal charm of a cap intro team should no longer be a dealmaker.

As the hedge fund industry has matured, prime brokers have also become more discerning when it comes to the funds they work with. "Even five years ago cap intro was primarily focused on new launches and smaller managers," says Thomas Krauss, Americas head of capital introductions at Citi. "But the hedge fund landscape has changed since then, with the bigger funds getting even bigger and more institutional. So cap intro has evolved to be more consultative and more focused on the larger, established managers than before."

The increasing concentration of hedge fund assets in the hands of a smaller number of large names is prompting some prime brokerages to reorient their businesses to cater exclusively to these well-established mega-funds. In this new paradigm, competitive advantage stems from hard metrics, relating to balance sheet and execution, rather than from intangibles such as cap intro and consulting.

The evolving hedge fund landscape has also pushed a number of prime brokers to rebrand capital introduction. JP Morgan now refers to it as capital advisory, while Credit Suisse labels it capital services. Under these new guises, cap intro aims to engage with managers at all stages of the life cycle rather than simply matching early-stage funds with investors.

Cap intro teams are also redefining their offerings in recognition of the fact that funds are bringing

ever more asset-raising expertise in-house. Many are leveraging their unique position in the marketplace to add value. In practice, this means they act as information pipelines, relaying insights between allocators and managers. It's for this reason that a number of cap intro teams have transformed themselves into content creators, regularly publishing reports and white papers on industry trends.

Aligning incentives

Some commentators argue misaligned incentives undermine the traditional cap intro model. It's often the case that prime brokerage franchises sit within investment banks' equities divisions. Therefore, cap intro teams are often accused of being biased towards managers that do high volumes of stock trading.

"Funds that bring in the most money to prime brokers receive the most attention from cap intro teams. However, institutional investors don't care about which funds are the most profitable for PBs," says Layton Road Group founder Tom Mahala.

The structural issues don't end there. It's challenging for prime brokers to assess the effectiveness of their cap intro staff as legal constraints prevent them from directly brokering deals between hedge funds and allocators.

Mahala says the new "hybrid" form of cap intro he's pioneering at Layton Road Group aims to eradicate some of these shortcomings. Unlike a third-party marketer, Layton Road has a dual revenue stream: it's paid by prime brokerages and by managers that independently sign up for its services. This new business model is designed to be more robust and versatile than its predecessors.

Layton Road is still in its infancy so its approach remains relatively untested. However, its clients have welcomed its efforts to shake up the existing model. "When there's a new player in town, it's good for everyone. It adds new thoughts, ideas and creativity," says Howard Fischer, the CEO of \$500m Stanford, Connecticut-based multi-strategy firm Basso Capital Management.

Mahala is just one of a number of entrepreneurs working to

2018 Cap Intro Personnel Moves



Alessandra Tocco, global head of capital advisory at JP Morgan, is stepping down from her role after 10 years with the firm



Martin Visairas, Citi's former global head of capital introductions, has departed from the investment bank after eight years



Robert Leonard, global head of capital introduction at Credit Suisse, is set to retire later this year following a 15-year tenure



Emma Sugarman has joined Cantor Fitzgerald from Hudson Capital to serve as its global head of capital introduction.

overcome the perceived limitations of traditional cap intro. Funda Ayhan founded her consultancy firm, Cap Connect, to cater specifically to family offices, which she believes have been underserved in the past.

"Historically, investment banks have used their brand names and their balance sheets to access big institutions. However, family offices don't need outside capital, and brand name isn't as relevant for them. What they do need is somebody who's discrete, objective and understands who they are," she says.

Trialling technology

In recent years, predictions have abounded that a fully digital marketplace for hedge funds would emerge, eradicating the need for cap intro teams altogether. However, these forecasts are yet to bear out.

A number of firms that aimed to create digital hedge fund marketplaces, such as AltX, have been acquired after failing to gain significant traction. Edgfolio, another digital marketplace pioneer, has recently pivoted to licensing its technology to prime brokerages.

Rather than going head-to-head, technology providers and cap intro teams are increasingly working together. A number of top cap intro providers now have digital portals that allow allocators to monitor, compare and connect with managers online. But the success of such portals still depends on the information being fed into them by cap intro execs.

"In the short-term, technology is not going to replace cap intro. What it's going to do is get rid of a lot of

the boring admin work and the compliance headaches that cap intro faces. Once this is done you can unlock all the behavioural data people really want," says Rowen Pillay, the co-founder and CEO at Edgfolio.

Marlin Naidoo, global head of capital introduction and consulting at Deutsche Bank, also thinks technology will make cap intro personnel more productive without superseding their expertise. "You can't automate the entire process of cap intro – it's still a people business," he says.

Thinking ahead

Regulatory uncertainty is another dark cloud on the horizon for cap intro teams. Mifid II, which came into force in Europe earlier this year, doesn't specify whether or not capital introduction should be classified as a 'minor non-monetary benefit'. Consequently, a handful of funds are choosing to pay for the service while the vast majority are not. The ambiguity in the legislation is a cause for concern as it leaves the door open for regulators to tighten up the rules further down the line.

There are clearly an array of headwinds facing cap intro teams and it's entirely possible that other prime brokers will outsource the function, following BNP Paribas' lead. However, managers consistently say that cap intro is a service they do value. Consequently, cap intro teams are likely to continue to play a vital role in the asset-raising process as long as they're able to adapt to the changing environment by becoming ever more efficient and sophisticated. **HEM**