Bloomberg
https://www.bloomberg.com/news/articles/2022-06-08/hedge-fund-d1-could-face-losses-as-private-companies-values-plunge

Hedge Fund D1 Borrowed Billions for a Hot Bet That Now Faces Reckoning

The firm borrowed money to buy stakes in private companies and posted massive gains. But as valuations fade, such bullishness is veering into losses across the industry.

By Hema Parmar and Miles Weiss
June 8, 2022, 12:01 AM EDT *Updated onJune 8, 2022, 11:30 AM EDT*

Hedge funds were tallying gains on their hottest bet in years when Dan Sundheim reached an unusual deal with JPMorgan Chase & Co. to go even further.

With the bank's help in August 2020, Sundheim's D1 Capital Partners used its stakes in private companies as collateral for borrowing $2 billion that the firm could put toward yet more of those stakes, among other things. Last year that focus on private companies looked brilliant, as D1 updated its valuations and posted a whopping 70% gain in that part of its portfolio.

Now, the industry is bracing for a reckoning.

Across Wall Street, billionaire investors and their advisers are urgently trying to figure out how much exposure they have to plunging values in Silicon Valley unicorns and other private ventures. They're reviewing disclosures by some of the most active buyers of those assets, including D1, Tiger Global

Management, Coatue Management, Lone Pine Capital and Viking Global Investors.

Clients had been giving their money managers more leeway to buy assets that can be hard to value and slow to sell. Some firms used leverage to boost returns.

Yet valuations of many closely held companies are tumbling even harder than the technology stocks that slumped on public markets this year. That has left hedge fund investors trying to figure out whether their money managers might suspend withdrawals, face demands from lenders to post more collateral, or -- in a worst-case scenario -- have to start selling investments quickly enough to drive down asset prices in a chain reaction.

“Years of cheap and easy money have driven up valuations,” said Taylor Rosanova, head of the fair value group at Marcum, which helps investors mark privates. “This year company multiples will fall, investor marks will fall, values in totality will fall.”

There’s a reason hedge funds haven’t traditionally loaded up on stakes in private companies. Such assets are usually the domain of venture capital and private equity firms that retain investor funds for anywhere from three to seven years, giving managers ample time to find an opportune moment to sell. Hedge fund clients, in contrast, generally expect access to their money in windows every month or quarter.

Valuation declines are starting to come into focus. Venture capital firms have watched their holdings slump enough to push the Refinitiv Venture Capital Index down 47% this year -- more than double the 22% slide in the Nasdaq Composite Index of publicly traded stocks.

Drops in the value of specific companies are emerging in a variety of places. Pandemic darling Instacart Inc. slashed its estimated valuation by almost 40% to $24 billion in March after struggling with decelerating growth. In April, mutual fund giant Fidelity Investments marked down a stake in social media platform Reddit by more than a third. Other once-high-flying private companies including Epic Games, Chime and Klarna are trading at discounts ranging from 20% to 60% in secondary markets, data from Next Round Capital show.

The impacts are starting to take hold at notable funds. Tiger's hedge fund lost 52% this year through May. It blamed several stocks and substantial markdowns on private assets. Even before Instacart lowered its valuation, Tiger slashed its own estimate, pegging the company at $14 billion, according to people familiar with the matter.

Meanwhile, D1 has told investors who selected a 50-50 mix of public and private assets that the strategy lost 23% through May. The firm attributed most of the damage to public investments, which fell 44%. It marked down private assets only 8% -- including 0.05% last month. There's a reason it wasn't more dramatic: D1 assesses the value of its private stakes quarterly, with only some exceptions in the interim. The next round is due at the end of this month.

While D1 will likely mark down some of the companies in its portfolio, its biggest investment, SpaceX, is expected to be marked up by about 25% after a recent funding round, according to a person with knowledge of the firm's thinking.

When valuations turn sharply downward, private markets can take six to nine months to settle on new prices, said Ken Smythe, founder of Next Round Capital, which helps institutional investors trade such assets. One reason is that sales tend to stall after a plunge, with investors reluctant to lock in losses.

"The secondary market is in a quandary because people can't figure out what stuff is worth right now," Smythe said. "Buyers are demanding lower prices, making liquidity difficult for many of these names." Sellers, meanwhile, "don't want to accept the reality of how much less they're worth now."

In the starkest sign yet of the strain on hedge funds, Tiger said last week that it couldn't continue to fill redemptions the normal way because so much of its portfolio was invested in hard-to-sell stakes in private companies. As the firm saw losses and some redemptions in the first quarter, it exited 83 stocks. Now if investors want to pull money from Tiger's hedge and long-

only funds, a portion of the liquid assets will be sold, but private investments will be placed in a separate account to be cashed out later.
Read more: Tiger Global's 52% plunge prompts fee cut, redemption plan

Coatue Management also began "side-pocketing" venture capital stakes this year for investors who withdraw from its flagship fund. Like a number of other hedge fund managers, it also runs more-traditional venture capital funds with lockup periods.

Once among Wall Street's most celebrated risk-takers, hedge fund managers have been humbled over the past decade by lackluster returns that trailed most private equity and venture capital funds. One exception was Tiger, which specializes in venture capital investments, and found success by weaving those private stakes into its hedge fund portfolio.

Tiger eventually inspired a generation of hedge fund managers to pursue similar strategies. Sundheim, the former chief investment officer at Viking Global, set up D1 in 2018, joining the fray with a novel system.

From the start, D1 let clients select how much of their money would be shunted into a portfolio of private assets, initially allowing them as much as 35% exposure. Clients can redeem the liquid portion of their investment relatively quickly but have to wait until the private portion is sold to access that cash. Sundheim later offered even more exposure to private assets, letting clients allocate as much as 99% of their money to that strategy.

The majority of investors when they came into D1, elected up to 50% of their capital in privates, according to people with knowledge of the matter. Since then, that proportion has changed as equities fell and its private bets appreciated in value. D1 currently has about $17 billion of privates — $2 billion of which were funded by the JPMorgan loan — and another $7 billion in equities. The firm sold out of 21 stocks during the first quarter, including Carvana and JD.com Inc., according to regulatory filings.

D1 doesn't collect fees on the performance of its illiquid wagers until it exits the positions. About 19% of the firm's private investments are in software companies, 44% in consumer companies and 25% in real estate and industrial companies, one of the people said.

While it's normal for hedge funds to lever up bets, the structure of D1's financing deal with JPMorgan resembles the so-called NAV loans more commonly used by private equity funds. People with knowledge of D1's facility described its size, $2 billion, and said it hasn't faced collateral calls. They noted that the assets used to obtain the financing were worth multiples more than the amount of money borrowed -- providing a cushion in the event of markdowns.

Read more: As Tiger's VC arm borrows billions, JPMorgan calls in more banks

To secure the loan, D1 placed private investments into holding companies that it put up as collateral, according to a financing statement reviewed by Bloomberg. The document also notes that D1 made a "commitment to provide credit support," backed by a portfolio of public securities.

Less than half a year after D1 set up that loan, it reached an additional deal with a US unit of Barclays Plc that included an "arranged lending and custody account agreement" with an affiliate of the bank in London, according to another financing statement. The terms of that pact aren't spelled out in the document.

Spokespeople for D1, Tiger, JPMorgan and Barclays declined to comment.

Six Lenders

The document describing the loan arranged by JPMorgan doesn't specify which assets were used to provide collateral or how the financing was ultimately used.

The loan has become a particular point of fascination among hedge fund investors trying to learn more about what sorts of conditions could trigger a demand for more collateral, according to people with knowledge of their concerns.

Even billionaires who don't have money with Sundheim have been trying to figure out what kinds of holdings he might be pressured to sell if losses mount. That's because of the herd behavior of many hedge funds, which often favor the same stocks and private assets. Hasty disposals by one investor could drive down prices and trigger losses for others.

D1 has not tried to sell any of its privates stakes outright or in the secondary market and has no immediate plans to do so, one of the people said.

In any case, JPMorgan's exposure is likely limited. The financial statement describes the bank as the collateral agent, and the financing was ultimately provided by a half-dozen lenders, according to a person with knowledge of the structure. Banks offering NAV loans typically extend only 10% to 20% of the value of the underlying collateral. Even with that buffer, they charge interest rates around 3 to 6 percentage points higher than comparable government bonds.

Diverging Valuations

It can take hedge funds months to adjust valuations on illiquid assets. During a downturn, startups may be less likely to raise money for fear of a lower valuation. And no news on that front can be a relief for fund managers, letting them leave numbers where they were.

Many funds base estimates on a mix of factors that, in addition to fundraisings, can include a private company's latest financial reports, or comparisons to a basket of similar publicly traded companies. While managers also get valuation assistance from third parties like SS&C Technologies Holdings or Houlihan Lokey Inc., a fund generally has wide latitude in setting policies, as long as it doesn't mislead investors.

"Could you look across various funds' portfolios and see each marking the same asset differently? That's a real possibility," said Kristen VanGelder, deputy chief investment officer at Evanston Capital. More conservative methods would adjust for this year's stock slide, she said. "Just because there hasn't been a recent financing round there may still be reason to mark down a private holding based on what we've seen happen in public markets."

Some hedge funds are looking to a practice that gained attention during the 2008 financial crisis: the use of side pockets.

Parking certain holdings in special entities that can be wound down later -- once prices stabilize -- helps to avoid fire sales. The practice came into vogue during the credit crunch when jittery investors sought to redeem hundreds of billions of dollars only to watch money mangers lower the gates on withdrawals.

That step may ultimately protect a hedge fund's backers from steeper losses -- but it has a tendency to raise alarms among other investors and ratchet up pressure on rival money managers to explain their valuations.

“The days of funds being able to claim ‘our private book is fine’ are over,” said Smythe at Next Round.

— With assistance by Sridhar Natarajan, and Katherine Burton