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Hedge funds pursue alternative lending

By Miles Johnson, Hedge Fund Correspondent

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Hedge funds have begun lending to businesses such as fish and chip shops. Sharp-suited hedge fund managers used to look down with disdain at the humdrum world of commercial banking. Now, this low-octane finance is being viewed by some as the biggest opportunity in a generation.

Traders that previously concerned themselves with credit derivatives and complex arbitrage have suddenly begun to evangelise about lending to fish and chip shops and managing the invoices of fabric importers.

In the past year some of the largest hedge funds in the UK have started investing their own money in platforms that bring together small savers and borrowers, as well as providing financing to small local businesses.

Others have begun to invest in so-called factoring companies, which allow businesses to manage their working capital by selling unpaid invoices to the platform at a discount to their face value.

Tungsten, a UK-listed electronic invoicing company, has attracted investment from some of London's most established hedge funds, including Odey Asset Management. Edmund Truell, who founded Tungsten, says hedge funds have become increasingly aware of the potential returns to be made from betting on disruptive finance in its early stages.

If you look at the impact of Amazon on its market, that is what we are trying to do in our area. We all know we need to do this now, because if we don't someone else certainly will

- **Edmund Truell, Tungsten**

While peer-to-peer lending and electronic invoicing may not match making bets on hostile takeovers for glamour, the hedge funds that have invested in these platforms argue there is now a compelling logic for their newfound fondness.

Old-style lenders have been forced by post-crisis regulation to shrink their balance sheets and reduce personal and commercial lending at the same time as new technology has allowed online peer-to-peer lending platforms to reach consumers without the need for a costly branch network.

Hedge funds can now step in, either by using existing lending platforms to provide their own capital to lend out, or by taking stakes in the platforms themselves to profit from their growth as banks flounder.

"I describe this as last mover advantage," says Steve Clark, co-founder of the London hedge fund Omni Partners that has launched a secured property lending fund. "Unlike banks we don't have an enormous branch network, lawsuits from legacy issue, or computer systems that won't talk to each other. What we do have is smart capital, the ability to distribute."

Earlier this year Marshall Wace, one of London's oldest hedge funds managing $18bn of assets, launched a £200m closed ended fund that invests in loans sourced by various peer-to-peer platforms. Marshall Wace had already taken a controlling stake in one of these platforms – Eaglewood – in April.

Other recent investments by UK hedge funds in what could be deemed as "alternative finance" include Arrowgrass, which manages $5bn, taking a stake in Zopa, the UK's second largest peer to peer platform, as well as Toscafund making a £30m investment in Hoist, a Swedish company that recovers distressed consumer loans.

"New names like us are moving into disruptive lending for a simple reason; the big guys have left a big hole," says Simon Champ, chief executive of Eaglewood Europe. "The four UK banks collectively have reduced their balance sheets in a huge way, and this means there is a large amount of lending that was done before that is being done now. I see this as having the potential to have the impact that Ryanair had on British Airways."

Traditional banks, meanwhile, have shown signs of trying to counteract this threat by teaming up with hedge funds. BlueBay, the London-based credit hedge fund, earlier this year struck a deal with Barclays to invest in the bank's riskier loans – the first instance of a bricks and mortar bank choosing to embrace alternative lenders in Europe.

But for hedge funds that are well accustomed to investing billions of dollars the numbers involved in such lending are still small. While few hedge funds doubt the sector's potential, they also recognise that capacity – creating enough demand for loans to allow large amounts to be invested through the platforms – will constrain the returns they can generate.

Those that have already invested believe that such are the potential of challengers to traditional finance that a small amount today would be worth many hundreds more in several years.

It is this raw potential that is drawing hedge fund investors into sectors they might never have dreamt of considering several years ago. Arrowgrass recently teamed up with Basware, a Finnish software company specialising in payment and transaction technology, to develop a so-called electronic invoicing factoring business.

"There is optionality now for investors in these platforms," says Geoff Miller, chief executive of GLI Finance, a London-listed company that makes investments in several peer-to-peer lending platforms. "If you don't put the money in now you may lose the chance to do so as they can grow quickly to lend billions of dollars a year. If you don't make that investment now you might never get the chance to again."

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