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The Market Shifts for Buyers and Sellers

Although the financial crisis has pounded the financial services industry with increasing ferocity since the summer of 2007, buyers and sellers in the asset management industry have continued to cut deals at a pace approaching last year's record-setting level. In recent months, however, the marketplace has been changing with events. The major investment banks that were regular buyers of assets managers, particularly hedge funds, are bankrupt (**Lehman Brothers**) or engaged with their transformation into commercial banks (**Goldman Sachs** and **Morgan Stanley**). Commercial banks with existing asset management operations are generally focused on strengthening their balance sheets as opposed to making targeted asset management acquisitions.

Meanwhile, two major banks that have emerged from the crisis as apparent winners — **Bank of America** and **Wells Fargo** — are busy merging the operations of **Merrill Lynch** and **Wachovia**, respectively, both of which have large asset distribution and/or management businesses. In Europe, diversified financial firms with asset management operations such as **ING, Royal Bank of Scotland** and **UBS** have all seen their fortunes decline precipitously with the credit crisis, with many forced to secure government funding. The ability of many of these companies to focus on acquisitions is questionable. **Santander**, which has survived the credit crisis better than most, had been seeking to divest its large asset manager for months until it finally shelved that plan in late October due to "market conditions."

At the moment, "market conditions" generally refer to one of two factors. First, potential buyers are having more difficulty raising capital. Second, and more importantly, the turbulence in financial markets is playing havoc with valuations. According to the Investment Company Institute, assets in U.S. stock funds totaled $4.96 trillion in September 2008, down from $5.85 trillion in June and $6.94 trillion in October 2007. The sharp decline in fee-based assets, and its impact on the bottom line, is apparent in the quarterly results of publicly traded asset managers of all sizes, including those with previously turbo-charged performances.

Although the prevailing environment is forcing dealmakers to place transactions on hold in the short term, there is a flipside: independent asset managers of all stripes are under the most intense financial pressure they have faced in recent memory, and many need to find a partner to survive. Additionally, several mid-size banks with asset management units, such as **Fifth Third Bancorp**, are reportedly reviewing divestitures as a means of raising capital — and in some cases to exit a business that in the best of times can be difficult for banks to master. Debates over valuations notwithstanding, these possible distress sales bode well for flexibility at the bargaining table. As **Northern Trust Global Investments** president Stephen Potter recently told *Investment News* in discussing potential acquisitions: "We believe it will only increasingly be a buyers' market."

BlackRock chairman and CEO Laurence Fink reinforced that view during the company's third-quarter conference call. Fink said he expects "huge opportunities in the investment management business for consolidation," citing the impact on companies of diminished asset bases combined with the increased costs of research and risk management, as well as the additional regulation that he believes is likely next year. BlackRock has "had more inquiries recently about merger opportunities than we've ever had," Fink said, but noted that the company had not "begun any of the conversations" given the state of financial markets.

BlackRock, with its scale and financial strength — it still posted net income of $218 million during a disappointing third quarter — should be in an enviable position to enhance its business through selective acquisitions. But private equity players are also expected to assume an important role in the reshaping of the industry. Although the financial crisis has impacted the industry's fund-raising prowess and its ability to employ leverage, private equity firms worldwide still hold an estimated $450 billion in cash. (In the third quarter of 2008, the industry raised $88 billion, the lowest quarterly total since 2005, according to Preqin.) Over the last few years, the industry has shown an increasing interest in asset managers, and

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in 2007 a private equity firm accounted for the largest asset management deal (**Madison Dearborn Partners**' $5.8 billion acquisition of **Nuveen Investments**).

That trend has continued into 2008, with the largest asset management transaction so far this year, the joint $2.2 billion bid by **Bain Capital** and **Hellman & Friedman** for Lehman Brother's **Neuberger Berman** asset management business (AUM: $230 billion). That deal, announced in September, was quickly challenged in bankruptcy court by another private equity giant, **Carlyle Group**, joined by former Neuberger CEO Jeffrey Lane. In seeking to make a counter-offer, they raised objections to the knockdown price, which was about one-third the valuation placed on the Neuberger business prior to Lehman's collapse. Several other private equity firms are also reportedly sniffing around the business. (Bain and H&F have negotiated a breakup fee of more than $52 million should the deal collapse.) A U.S. bankruptcy court judge approved a new auction process ending December 1.

In the first half of the year, there were two other private equity deals of note. **TA Associates** of Boston invested in an estimated $500 million in **Keeley Asset Management**, a 26-year-old Chicago firm with $10 billion in AUM and one celebrated mutual fund, the **Keeley Small Cap Value Fund**. In explaining the investment, TA managing director Roger Kafker said, "Keeley typifies the attractiveness of the asset management business, with recurring revenues, high margins and a non-capital intensive business model."

The second deal involved a a joint effort, with **Pharos Capital Group** and **TPG Capital** teaming up for the $480 million purchase of **American Beacon Advisors** (AUM: $65 billion), the asset management arm of American Airlines' parent AMR Corp. The transaction was done via a new joint company, **Lighthouse Holdings**. In addition to challenging the Neuberger bid, Carlyle made a $75 million investment (25% of equity) in **Boston Private Financial**, part of an effort by the publicly traded wealth manager to strengthen its balance sheet. Small private equity firms are also cutting deals, with **Sienna Group** entering the industry via a $40 million investment in wealth manager **Freestone Capital Management** (AUM: $2 billion). Sienna was started up by Scott Svenson, who founded and then sold to Starbucks the U.K.-based Seattle Coffee Company chain.

A unique firm that falls just outside the private equity parameters, **Asset Management Finance**, should also be a factor in the marketplace. Since its founding in 2003 by former United Asset Management chief Norton Reamer, AMF has completed 12 transactions, including three this year, and the company has set an aggressive annual goal of six to eight transactions. AMF operates by providing capital to targets to finance acquisitions in return for a passive, limited-term interest in future revenues. In August, **Credit Suisse Group** acquired AMF from **National Bank Financial of Canada** for $384 million, a deal that Reamer said "will bring global resources and scale to AMF and its partner firms." Subsequently, Reamer told FINalternatives that AMF is seeking to diversify into hedge funds and with Credit Suisse's backing will look at deals involving $100 million and more in financing, nearly twice its previous funding cap.

Asset managers that pursue an affiliate model have joined the private equity firms in maintaining a robust posture. This year, **Affiliated Managers Group** announced a couple of acquisitions of U.S. institutional managers with a total of $13 billion in assets (**Gannett Welsh & Kotler** and **Harding Loevner**) while aggressive privately held wealth manager **Focus Financial Partners** has purchased **Greystone Financial Services** of the U.K. and **Wespac** of the U.S., bringing to 16 the number of affiliates in its portfolio. Focus is itself backed by private equity firm **Summit Partners**. AMG did acknowledge during a third-quarter conference call that it had put potential investments on hold "until markets stabilize." At the same time, president and CEO Sean Healey argued that the "competitive dynamics in the merger market have tilted very much in the favor of buyers."

Asset managers and financial firms that have survived the financial crisis in reasonable health are also likely buyers, including mutual life insurance companies. In the first quarter, **Massachusetts Mutual Life Insurance** acquired **First Mercantile Trust Co.** of Tennessee, an institutional firm with $5 billion in AUM. MassMutual manages $500 billion in AUM and incorporates subsidiaries such as **Babson Capital**, **Baring Asset Management** and **OppenheimerFunds**. **New York Life**, with some $250 billion in AUM, could be another opportunistic buyer.

Federated Investors, whose business is dominated by money market products, saw AUM grow 25% between the third quarters of 2007 and 2008, to $344 billion, while income was essentially flat. As a result, the Pittsburgh-based company has been able to make four diverse acquisitions this year that enhanced its money market and equity fund operations. Some smaller, publicly traded banks that appear to have weathered the credit crisis have been buyers of small wealth managers this year, including two from Pennsylvania, **Susquehanna Bancshares** and **Bryn Mawr Bank Corp**.

HighView Investment Group is a high-profile firm that cropped up since the summer to capitalize on opportunities in the beleaguered hedge fund industry. In the U.S., **Evercore Partners**, **Stone Point Capital** and the co-founder and former president of BlackRock, Ralph Schlosstein, teamed up to launch the firm, which plans to make minority investments in a range of hedge funds managing more than $2 billion in assets. The company has initial capital commitments of $600 million.

Although news from Japan's big banks has been negative of late, they have re-emerged in recent years with cash to spend and have been using that bounty to assume minority shares in their troubled counterparts in the U.S. and Europe. Additionally, the banks have been making strategic investments in asset managers. **Mitsubishi UFJ** acquired nearly 10% of **Aberdeen Asset Management** (AUM: $200 billion) in October, a deal designed to help both firms win institutional business in Japan. In August, **Mizuho Corporate Bank** invested $120 million in Evercore Partners in part to help the U.S. company expand its asset management business. In the second quarter, **Mitsubishi Corp**. paid $40 million for a 20% stake in Connecticut hedge fund manager **Aladdin Capital Holdings** (AUM: $18 billion) and agreed to make an additional $300 million investment in a joint fund with Aladdin. ▲