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Asset Managers Go Slow on Deals

The slowdown in asset management M&A activity that began in the second half of 2008 continued into the first quarter of the year, even as punishing business conditions and the resulting pressure on revenues and profitability argued in favor of consolidation. Indeed, the current ebb underlines the potential for a surge in deals once a measure of stability returns to the marketplace.

During his first quarter earnings conference call in April, **BlackRock** chairman and CEO Laurence Fink again weighed in favor of that view, saying the industry is headed for a period of "dramatic consolidation." Fink cited the general business climate, including related challenges like risk management and increasing regulation. He also noted that his firm "is overwhelmed with the amount of institutions that are approaching us in terms of opportunities and in terms of acquisitions for BlackRock or some form of mergers." Nevertheless, Fink indicated a cautious approach on deals, although BlackRock did reach agreement in April to acquire **R3 Capital Management**, a credit-focused hedge fund started up last year with a $1 billion investment from **Lehman Brothers**.

The downturn in the number of asset management deals mirrors larger trends, as the value and number of deals in all industries worldwide dropped 29% (to $473 billion) and 19% (to 8,062), respectively, in the first quarter of 2009, according to Thomson Reuters. But even those numbers aren't entirely representative of how quiet the market has become, since governments accounted for a towering 31% of value, driven by investments in the banking industry. Private equity firms ponied up a paltry $16 billion for acquisitions worldwide, the lowest quarterly total since 2001, while leveraged buy-outs accounted for just $1.4 billion in deals in the Americas, the lowest amount in seven years.

In the asset management industry, the primary factors constraining deals are uncertainty about the direction of financial markets and the economy combined with a gulf that has emerged between buyers and sellers on valuations. That chasm is not surprising, given the merciless decline in equity markets, particularly between October 2008 and early March of this year, and the devastating effect on fee-generating assets. But in assessing price, buyers must also grapple with the impact of the financial meltdown on a democratic and robust investment culture that the industry took for granted in divining future performance.

According to Federal Reserve data, for example, Americans parked more new money in savings accounts in the first quarter of 2009 than they did in all of 2008. Money market fund assets also continued to grow despite the well-publicized problems of reserve and other funds, reaching $3.8 trillion in March 2009, significantly above the $3.3 trillion in equity funds (which suffered combined net outflows of $52 billion in February and March after a positive January). A *Financial Times* headline in March 2009 asked if Americans are retreating "back to the Fifties," in a reference to the subdued investment culture prevailing during that decade. "You lost an entire generation of investors after 1929 who just didn't invest," economic historian and investment advisor William Bernstein told *Investment News* in April. "It could happen again."

The result: a stalemate in which many buyers are recalibrating valuations downward while sellers hang tough awaiting an improvement in the external environment. **Affiliated Managers Group**, whose business is built on a steady diet of acquisitions, is indicative of the go-slow approach: it announced two acquisitions in the first half of 2008 but none since. Nevertheless, in the company's fourth quarter conference call on January 28, AMG president and CEO Sean Healey called the deal environment "increasingly favorable for us, as we see far fewer competitors and lower valuation levels." He added: "There continues to be a large number of very attractive boutique firms facing demographically driven succession issues, and the range of transaction alternatives for these firms has diminished substantially. We

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also believe there will be an increasing number of transaction opportunities involving corporate sellers of asset management firms."

The near-term challenges notwithstanding, deals continue to be completed, with several potential trends emerging. First, parties are increasingly likely to address uncertainty by linking the ultimate transaction value to future performance. This approach allows buyers to hedge against over-paying and sellers the opportunity to realize value in better times. **Stark Investments** took this tack in January when it acquired most of the assets of **Deephaven Capital Management**, the hedge fund unit of **Knight Capital Group**. Stark, a Wisconsin hedge fund with $10 billion in AUM, paid only $7.3 million for approximately $2 billion in AUM, but the agreement calls for additional payments of up to $37 million by 2011, based on performance and the number of Deephaven clients who remain with Stark (which will wrap Deephaven's assets into existing Stark funds). As was the case with many hedge funds last year, Deephaven's flagship Global Multi-Strategy Fund suffered significant losses and redemptions, with AUM falling by more than half from $3 billion.

In the latter part of 2008, **Federated Investors**, a perennial buyer of smaller asset managers, cut two deals employing earn-out payments exceeding upfront payments. These included the $36 million upfront payment for **Clover Capital Management**'s $2.8 billion in AUM, with five year contingent payments that could add another $57 million to the price; and the $43 million paid for two funds from **David W. Tice & Associates** (the **Prudent Bear Fund** and the **Prudent Global Income Fund**) with a total of $1.7 billion in AUM, with four year contingent payments of up to $99.5 million. In its March acquisition of up to 55 offices from **UBS Wealth Management Americas** (AUM: $15 billion), **Stifel, Nicolaus & Co.** also incorporated a two year performance-based earn-out provision.

A second possible trend, unrelated to pricing, involves tie ups between smaller firms committed to retaining their "boutique" cultures but seeking greater scale to survive the downturn. **Forward Management** of San Francisco, which last year more than doubled its AUM to $5 billion through the acquisition of Seattle's **Accessor Capital Management** and California's **Berkeley Capital**, this year added $1.4 billion through the purchase of another small West Coast firm, real estate fund manager **Kensington Investment Group**. In a letter to its clients, Kensington cited the stronger marketing, distribution and sales support Forward would provide, but also referenced their "privately held, entrepreneurial" and "tight-knit company cultures." Forward, started up in 1998 by oil heir Gordon Getty, touted the opportunity to expand its portfolio of products.

The third and most pronounced trend that will send companies to the deal table involves banks and insurers divesting their asset management arms in whole or part as they seek to raise capital and rationalize businesses. In the biggest deal of the year, **Barclays** reached agreement to sell its **iShares** exchange-traded funds business to private equity firm **CVC Capital Partners** for $4.4 billion, or 10.1 times 2008 EBITDA. For Barclays, the deal means parting with an attractive and leading business but provides much needed capital to bolster its balance sheet and avoid a bailout from the government.

As part of the deal, Barclays will provide $3.1 billion in financing but also retains a "participation interest" through which it stands to gain 20% of the future value of the iShares business, payable in cash, if CVC enjoys certain returns on its investment. (According to the agreement, Barclays has until June 18 to solicit additional offers for iShares, but would need to pay $175 million to CVC if it receives a "superior" offer not matched by CVC.) Based in Luxembourg, CVC is one of largest private equity firms in the world, with a portfolio of 52 companies. CVC, which says it typically holds companies for five years or more, created a financial institutions group in September 2008 to capitalize on opportunities in the sector. Other private equity firms that were reportedly circling the iShares business included **Apax Partners, Bain Capital and Hellman & Friedman**.

Bank of America, grappling with its own challenges, is reportedly shopping around **First Republic** private bank, which it inherited with the acquisition of **Merrill Lynch**, and the **Columbia Management** fund group (gained through the acquisition of FleetBoston in 2003). **AIG** is in the process of auctioning off its asset management business, with more than $100 billion in AUM (the largest portion of which is fixed income investments). Several prominent private equity firms have been named among potential buyers for that business. In late 2008, AIG sold its Swiss private bank for $250 million to an Abu Dhabi investment group, **Aabar Investments**. UBS is reportedly mulling the sale of its large hedge fund business to management, as part of the reorganization of the overall company.

Among pure asset managers, the most notable distress sale this year took place in the U.K. and involved **Henderson Group**'s purchase of onetime high-flyer **New Star Asset Management**. Founded in 2000 by noted money manager John Duffield (who started **Jupiter Asset Management**), New Star enjoyed a fourfold increase in AUM in the four years through 2007, to $35 billion. But the collapse in equity markets and redemptions combined with a heavy debt load created a liquidity crisis for the company, which was effectively taken over late last year by its creditors. In April, London-based Henderson paid $160 million in cash and shares for New Star, which by then had around $15 billion in AUM. For Henderson, the addition of New Star provides greater scale in the U.K. retail market, where it will become the No. 5 player. Henderson had $75 billion in AUM prior to the acquisition.

For his part, the 70 year old Duffield appears undeterred by the demise of New Star. In April, Duffield launched a new asset management firm in London, initially tasked with handling his own fortune estimated at some $450 million, much of that derived from his sale of Jupiter to **Commerzbank** in 1995. ▲