

# Berkshire Capital | NEWSLETTER |

3rd-Quarter 2009

NEW YORK | DENVER | LONDON

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## A Clearing Ahead?

Could the fog that has enveloped and stymied dealmakers in the asset management industry finally be lifting? A succession of high-profile transactions in the second and third quarters, combined with an apparent stabilization of financial markets and the global economy, may provide the clarity and confidence asset managers need to conclude a larger number and broader array of deals.

There's little argument among observers about the backlog of demand on both sides of the negotiating table. But there's particular pressure on the sell side, as small to mid-size asset managers, as well as banks and insurers, adjust to a precarious post-crisis environment. Just a month before his company's mega-deal for **Barclays Global Investors**, **BlackRock** vice chairman Bob Doll opined that when the financial crisis ends, "There will be a number of large, broad-based successful global firms and a huge number of niche firms that are good in one or two things. The fund managers that are in the middle, which are trying to be all things to all people, they won't be able to get through."

As the companies "in the middle" consider their futures, one of the key ongoing challenges they faced — scale — has been joined by an equally compelling one: declining profitability. A Boston Consulting Group survey of asset managers worldwide revealed that between the investor flight to safety and the loss of assets, the average operating margin dropped four points between 2007 and 2008 to 34%, the lowest level in five years. While that decline may appear modest given the turmoil in the industry last year, "the differences among asset managers were substantial," BCG points out, with 30% reporting a drop in profits of 30% or more. Another survey by Danish researcher SimCorp StrategyLab paints a bleaker picture, maintaining that 41% of asset managers are either treading water or in the red, when lost reserves and capital costs are factored into the equation.

In another global survey of asset managers conducted by KPMG during the first quarter, nearly three-quarters said they expect new regulations to "seriously increase costs" while 63% indicated they did not expect to be able to pass on those costs to clients. In its report, SimCorp holds that the "new business environment in the investment management industry is dictated by increased competition, tightened regulatory requirements and a sustained pressure on margins, which suggests that a short-term approach to cost management will no longer suffice." In the foreseeable future, many analysts and asset managers also expect passively managed products such as index funds to benefit at the expense of actively managed products, placing additional pressure on the bottom line. Not surprisingly, over the past year publicly traded asset managers have ratcheted down five-year estimates for annual growth in earnings per share by three points at the low and high ends, to between 9% and 12%.

Although earnings estimates have dimmed, the low valuations many buyers were assigning targets during the height of the crisis — one of the major stumbling blocks for potential sellers over the past year — may be easing, in sync with developments in the public markets. In the year-to-date through October 2, asset managers in the Dow Jones U.S. Total Market Industry Groups saw their stocks rise a collective 24.2%, compared with 11.5% for the larger financial industry and 13.5% for the S&P 500. Multiples for asset managers, which had ranged as low as four to eight times trailing earnings in November 2008, had rebounded to 12 to 17 times by June of this year.

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For the moment, a number of bigger players are taking the lead in defining the marketplace, often capitalizing on the dislocation to expand regionally or internationally. This includes the marquee deal — BlackRock's transformational \$13.5 billion acquisition of Barclays Global Investors, announced in June. The transaction also fits a recent pattern of opportunistic purchases at the expense of banks and insurers eager to reorganize businesses and raise capital. In BGI, BlackRock, saw a once-in-a-lifetime opportunity to become the world's dominant asset manager and snare a leading position in the growing exchange traded fund (ETF) industry, through BGI's iShares business.

**Barclays**, intent on avoiding the clutches of a government bailout, received a quick infusion of cash that allowed it to strengthen its balance sheet. The deal, which valued BGI at 8 times trailing EBITDA and around 0.9% of AUM, was split about evenly between cash (\$6.6 billion) and a 19.9% shareholding for Barclays in the new firm, **BlackRock Global Investors**. In concluding the transaction, BlackRock also trumped an earlier bid for the iShares business by private equity firm **CVC Capital Partners**. With its massive size (\$2.7 trillion in AUM), BlackRock is reportedly at work developing a no-fee internal trading platform for clients designed to bypass existing exchanges.

In July, institutional manager **Guggenheim Partners** also gained entry to both the ETF and retails markets through its acquisition of **Claymore Group**, which has \$13 billion in assets under management or supervision, including around \$2 billion in ETFs. Founded in 2001, Claymore has earned a reputation for offering innovative ETF products covering such industries as solar power and global airlines as well as the BRIC markets (Brazil, Russia, India and China). Claymore said the deal provides it with the opportunity to capitalize on its new parent's resources and global reach.

One of the poster children for the financial crisis, **AIG**, finally divested its asset management business in September — a long-awaited deal involving an unexpected suitor, Hong Kong-based **Pacific Century Group**. A privately held investment company controlled by Richard Li, the son of legendary Hong Kong billionaire Li Ka-shing, Pacific Century paid \$500 million for AIG's \$89 billion in AUM. As is the case with a number of transactions in the crisis-tinged environment, a part of the announced value is tied to future performance. Li indicated he will build off Pacific's base in Asia to expand the AIG business regionally. AIG's asset management business has operations in 32 countries. Although the transaction represents a leap into the asset management business for Pacific Century, Li had previously owned an insurance venture that he sold to **Fortis** two years ago. The deal also provides the tantalizing prospect for sellers that deep-pocketed and increasingly confident Asian investors may emerge to purchase strategic shareholdings or make outright acquisitions.

In another cross border deal involving an Asia-Pacific buyer, Australia's **Macquarie Group** paid \$428 million for **Delaware**

**Management**, owned by Philadelphia-based insurer **Lincoln Financial Group**, another much-anticipated divestiture. Macquarie said the acquisition is "consistent with [its] strategy to develop a global asset management capability" and allows it to gain "broader access to the world's largest capital market." Delaware provides a significant boost to Macquarie's asset management business, adding \$125 billion in institutional and retail AUM to the \$175 billion Macquarie already manages. Australia's banks, with limited exposure to subprime instruments, have emerged from the financial crisis in a relatively strong position. Lincoln Financial said the divestiture of the 80-year-old firm allows it to focus on its core insurance business. The company, which is on the hook for \$950 million in funds from the Troubled Asset Relief Program (TARP), had been shopping Delaware for months.

**Bank of New York Mellon**, which in June told Bloomberg it was on the lookout for acquisitions, cut a deal two months later with yet another troubled financial firm, **Lloyds Banking Group**, to acquire **Insight Investment Management** (AUM: \$130 billion). For BNY, the \$375 million transatlantic deal adds a specialist in liability-driven investment solutions for pension funds. BNY Mellon said the deal "deepens our global capabilities and is consistent with our ongoing strategy to create broad-based solutions for our clients and address key issues facing the investment industry."

Although the private equity industry has taken its share of lumps during the crisis, it retains significant firepower and continues to show interest in the asset management industry. Luxembourg-based CVC Capital Partners started up an opportunistic financial institutions group in September 2008 and then made its \$4.4 billion bid (10.1 times 2008 EBITDA) for Barclays' iShares business before being trumped by BlackRock. (CVC is due to receive a \$175 million break-up fee for its troubles.) **Hellman & Friedman** was involved in the auction for Insight Investment Management. While those two bids failed, in June, New York private equity firm **Aquiline Capital Partners** was successful in acquiring Hartford-based Conning & Co. (AUM: \$70 billion) from parent **Swiss Reinsurance Co.** Conning is an institutional firm with a specialty in fixed income products geared toward the insurance industry. Swiss Re, which reported a second-quarter loss following investment writedowns, said the sale is "in line with [its] strategy to focus on out core business" while noting that it would "maintain a strong relationship" with Conning. Aquiline is run by Jeff Greenberg, the son of former AIG chief executive "Hank" Greenberg.

Two high-profile firms that pursue an affiliate structure have stepped into market, in another sign of a potential thaw. In June, **City National Corp.** acquired Boston-based institutional and wealth manager **Lee Munder Capital Group** (AUM: \$3 billion), a deal that allowed CNC to add scale in that important market, where it already owned institutional manager **Independence Investments** (AUM: \$1 billion). The two companies were

merged and now operate under the Lee Munder name as an affiliate of CNC's Chicago-based asset management holding firm, **Convergent Capital Management**, whose seven affiliates have \$19 billion in AUM. Lee Munder, the founder of the 9-year-old company that bears his name, said the deal positions his firm "for its next stage of growth" by providing access to expanded distribution and "additional growth capital."

**Affiliated Managers Group**, one of the industry's most prominent acquirers, has been keeping its powder dry during the financial crisis, but in July finally moved to complete a deal for **Harding Loevner** (AUM: \$5 billion) first announced a year earlier and then postponed and restructured in January of this year "in light of market conditions." AMG took a 60% stake in the New Jersey-based firm, a global equity manager founded 20 years ago. AMG noted that it was "very impressed" with the performance of Harding Loevner "during the extreme market volatility." Based in suburban Boston, AMG has indicated throughout the financial crisis that it anticipated attractive long-

term opportunities emerging from the ashes while emphasizing the capital at its disposal for such transactions.

Other high-profile buyers and potential buyers indicating their intentions include **Ameriprise Financial**, which on September 30 announced the latest megadeal, for **Bank of America's Columbia Management** equity and fixed income fund business. The billion-dollar transaction nearly doubles the size of the Ameriprise's business, to \$400 billion in AUM. BlackRock or **Federated Investors** are believed to be targeting Columbia's money market business. **Invesco** is reportedly prepared to buy the **Van Kampen** mutual fund operation owned by **Morgan Stanley**. Van Kampen, which has been on the sale block since the summer, has around \$86 billion in AUM. **Credit Suisse Private Banking** chief executive Walter Berchtold told investors his firm was "clearly ready" to make acquisitions, while **Julius Baer Group**, the Swiss private bank that was just spun off from its parent, said it would also be seeking expansion via acquisitions.

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