

Acquisitions of Investment Management Businesses in the UK and the US

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Investment Manager Transactions in the M&A Universe

Defining characteristics

Like M&A in other highly regulated businesses, success of transaction depends on extraordinarily close coordination between corporate M&A team and regulatory/compliance teams

Special risks associated with client consent requirements

UK and US Key Business Drivers

Valuation and consideration terms

Personnel matters

Incentivisation of key individuals

Bringing on the next generation

Synergies and strategic direction

Governance and control

Exit Transaction or Combination?

Like other M&A transactions, IM M&A transactions can be loosely divided into adviser/fund combinations and exit transactions:

Combinations: Acquisitions of advisers with management team, lift-outs

Exit: Divestiture of family of funds to a larger fund sponsor, acquisition of specific accounts

Exit Transaction or Combination?

The exit transaction typically presents a different set of issues than the combination – hard bargaining on economic terms on a more zero sum basis than in the combination

Asset managers may also reorganise to position themselves to be sellers and empower next generation leadership

Asset Manager Combinations

US/UK Common Issues

Typical transaction involves sale of shares or assets of investment adviser and contractual opportunity to provide asset management services

Key issues in transaction:

- Valuation of the acquired firm and related advisory contract

- Purchase price and adjustments of cash or stock of purchaser

- Multiples of EBITDA, management fees or asset revenues

Asset Manager Combinations

US/UK Common Issues

Asset-based vs. performance revenue streams

Consider special values or negatives in acquired assets

Earn-outs, put/calls on continuing interests and profits interests balancing Buyer's need for protection of going forward expectations

Indemnification protection of value of Buyer's purchase vs. practical consequences of suing continuing management of the acquired business

Retention of key investment personnel vital in acquisition of advisory firm with management team, use of restrictive covenants

Governance desire of seller/management for autonomy vs. Buyer's desire to exploit synergies with other business units



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Asset Manager Combinations U.S. Regulatory Issues

Basic Elements of Adviser/Fund Acquisitions --

In U.S. - generally substantial consideration is paid by a successor fund investment manager to its predecessor simply for the opportunity to provide asset management services for one year (subject to renewal); few tangible assets

U.S. Investment Company Act of 1940 prohibits assignment of advisory contracts which terminate on change of control

Asset Manager Combinations - U.S.

Compliance with safe harbor provisions key post closing Fund Board independence and no unfair burden on Fund shareholders [ICA Section 15(f)]

Buyer seeks assistance from seller in obtaining requisite approvals from Fund directors and shareholders for new advisory arrangements and changes in Fund board

New directors nominated by existing directors
Supermajority of new board must be independent [75%]

Asset Manager Combinations - U.S.

Disclosure considerations SEC proxy material and registration statements used in connection with approval process; comparative fee information and historical performance metrics

State corporation law governs requisite shareholder vote to approve fund reorganisations

Asset Manager Combinations - U.K. Key Legal Issues

Key Structuring Issues

- Advantage of LLP

- Flexibility compared with Ltd but less familiarity

- Limited liability

- Tax transparency (except VAT)

- NICs for key personnel

Obtaining Client Consents

U.K. Regulatory

- Takeover Panel for U.K. plc takeovers

- Change of control

Asset Manager Combinations - U.K. Key Legal Issues

Financial assistance – section 151 Companies Act 1985 – it is not lawful for an English target (or its English subsidiary) to give financial assistance directly or indirectly for the purpose of an acquisition of shares in the English target company, unless an exception exists

Example – acquisition funding secured on target assets is prima facie not lawful

Structuring Contingent Purchase Price Earn-outs

Generally -

- Highly negotiated, fact sensitive

- Seek agreement on maximum contingent/incentive amount or pool

- Set time frame to permit maximisation of contingent purchase price

- Consider interplay with employment contracts with key employees of seller

- Valuation of the acquired firm and related advisory contract
 - Purchase price and adjustments of cash or stock of purchaser

- Multiples of EBITDA, management fees or asset revenues



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Structuring Contingent Purchase Price Earn-Outs U.K.

Use of earn-outs

Use of retentions/escrows

Use of loan notes for CGT planning

Asset Manager Contribution Special Issues

Earn-out and Contingent Pricing

Indemnification

Retention of Key Personnel

Restrictive Covenants

Governance

Earn-outs and Other Contingent Pricing: Buyer Objectives

Freedom to continue to operate and develop other business units

Maximisation of cross-selling potential, other synergies

Create the right incentives

Ability to exercise control as majority owner of acquired business

Earn-outs and Other Contingent Pricing: Buyer Objectives

Avoidance of non-contractual liabilities (*e.g.*, implied fiduciary duties)

If using LLC structure, buyer will want to form in states permitting maximum possible waiver of fiduciary duties

NOTE: In U.K., LLP structure is common

Earn-outs and Other Contingent Pricing: Seller/Management Objectives

Maximise management control over conduct of acquired business going forward

Minimise ability of buyer to make material changes in business plan without management approval

Establish triggers for accelerated and/or maximised pay-out, *e.g.*

- Material transactions or corporate restructurings

- Termination of one or more members of management without cause

Pricing/Contingent Sale Mechanisms Transaction Examples

Deal A

Closing Payment:

An amount equal to an agreed multiple of Closing Date Fund Revenues (daily average of Fund Assets) with apportionment between cash (95%) and purchaser public stock (5%)

Provisions dealing with pre- and post-closing calculation of Fund Revenues, certifications, valuation methodology

Pricing/Contingent Sale Mechanisms

Contingent Sale Consideration:

Establish time period for earn-out (say, 5 years), thresholds triggering annual payments and size of Contingent Payment Pool (total of all possible contingent payments based on changes in Fund Assets)

Provide access to work papers, schedules and other information

Establish dispute resolution procedures

Agree on effect of change of control of Buyer during Contingent Payment Period and size and calculation of contingent compensation payment (for example, amount based on cumulative annual growth rate of Fund Assets prior to change of control)

Pricing/Contingent Sale Mechanisms

Deal B

Initial Payment, subject to retention of hold back amount (re: client consents)

Client Consents Adjustment

purchase price adjustment if revenues attributable to necessary client consents does not achieve expected annualised fee revenues (say 90% or more)

Allocation of Purchase Price between cash (70%) and stock of publicly held acquirer (30%)

Post-Closing Adjustments

working capital adjustment for acquired adviser



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Pricing/Contingent Sale Mechanisms

Deal B (continued)

Contingent Purchase Payments (max approximately equal to Initial Payment)

Payable in three annual contingent payments in fixed dollar amounts

Make whole payments

Total maximum contingent payment approximates Initial Payment

Dispute resolution procedures



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Asset Manager Combinations Warranties and Disclosure

Warranties and Representations Defining the
business to be sold, scope

In U.S., indemnities are the usual measure for
recovery

Disclosures in acquisition agreements

Asset Manager Combinations

Warranties and Disclosure

Contract disclosure U.K.

As well as specific disclosures, disclosures of general public information (e.g. all information at the Register of Companies concerning the target) is common

Disclosure letter

Warranties are traditionally assessed on common law basis, although subject to seller protection

Contract disclosure U.S.

Reps and warranties, disclosure schedule

Any hot-button issues

Setting the right disclosure thresholds

Knowledge qualifiers

Indemnities are used for specific and identified problems and do not necessarily affix to all warranties.



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Indemnification -- Protecting the Buyer's Bargain

Is there a deep pocket other than continuing Indemnities management of the acquired business?

Indemnification negotiations are most difficult where:

Acquired business is management owned

Non-management equity held by financial investor

Where management has had significant autonomy in operation of business, non-management owners likely to resist all but limited indemnification

Negotiate amount for deductibles (aggregate and per item), cap on indemnification obligators as a percent of purchase price; establish survival period

Consider escrow or other security for indemnification



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Possible Indemnity Solutions U.S. Practice

Tiered layers of indemnification

All holders *pro rata* to threshold, then management

Use of retained interest, equity incentives as indemnification currency

Little satisfaction to buyer, but has at least some *in terrorem* benefits

Back-loading of purchase price (contingent payments as *de facto* escrow)

Representation and warranty insurance

Still relatively novel and untested



U.K. Retention of Key Personnel

UK employment protections: no employment at will

Statutory minimum notice period up to 12 weeks

Mandatory employment contract

Statutory minimum working hours/holiday/wage/redundancy payment

Unfair dismissal award up to £58,400

U.S. Retention of Key Personnel

Employment at will U.S. state law issue

Employment agreements

Non-compete/non-solicitation of clients and employees

Incentives (cash/equity)

Governance

Relative representation of buyer and management

Matters reserved for member votes

Voting agreements

Minority approval/veto rights

Management holding companies

How involved should buyer be in structuring,
drafting?

What rights does buyer have to approve future
changes?

Exit Transactions

Buyer/Seller Perspectives

Typical rationale for a seller of a family of funds
with or without existing adviser

- concentrate on core assets

- poor or mediocre returns

- small funds/separate accounts may not fit with
corporate strategy

Typical rationale for a purchaser of fund assets

Buyer/Seller Perspectives Exit Transactions (continued)

Grow assets under management and align
acquired assets with existing funds and
management

Diversify existing fund portfolio

Perspectives of buyer and seller may differ markedly
over structure, assets to be sold, price, due
diligence/timing, contingencies, conditions, transaction
costs and related issues

Exit Transactions

Alternative Views of Structure --

Buyer:

Acquire selected fund assets without acquiring advisory firm and related personnel

Merger/reorganisation of select funds with Buyer's funds

Seller:

Sell adviser's shares and current investment management agreement with seller and some fixed assets

Exit Transactions

Purchase Price and Adjustments Point/Counterpoint

Buyer:

Establish price of specified AUM (basis points range multiplied by closing date assets acquired)

Cherry pick assets or asset classes to be acquired (strategic, performance, alignment with Buyer funds)

Seller responsible for liquidation of funds not acquired

Exit Transactions

Purchase Price and Adjustments (continued)

Buyer Proposed Payment Terms:

- ❑ Fixed percentage (say, 50%) up front with remainder paid after closing (say, 18 months)
- ❑ If AUM is less than closing amount, payment is reduced
- ❑ If AUM is less than 50% at closing, no additional payment is due.

Seller's Counter:

- ❑ Robust views on pricing and assets acquired
- ❑ No price adjustment Buyer to retain assets

Exit Transactions

Timing and Contingencies

Buyer:

- Confidentiality and exclusivity period to conduct due diligence and refine valuation (45-60 days)
- Satisfactory completion of due diligence

Followed by:

- Completion of purchase negotiations
- Approval of senior management of Buyer or its parent organisation
- Receipt of applicable regulatory approvals
- Execution of definitive agreement
- All required Fund board and shareholder approval

Exit Transactions

Seller:

Confidentiality short exclusivity period (2-3 days) to confirm only that no material adverse facts exist

Purchase negotiations completed before due diligence begins

Buyer s approval before due diligence

Negotiations over terms of agreement before due diligence begins

NOTE: Aggressive position

Followed by:

Required fund board and shareholder approvals

Exit Transactions

Conditions --

Buyer:

Seller to use reasonable efforts to support reorganisation of funds

Facilitate transition of employees

Seller to support promotional aspects of reorganised funds for 1-2 years after closing

No material adverse change



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Exit Transactions

Conditions

Seller:

If a stock sale, maintain same job requirements and compensation levels no guarantee of commissions

Maintain seller s agreement for minimum period

Exit Transactions

Transaction Costs --

Buyer:

Set limit on transaction costs, including fund reorganisation and deal costs

Seller:

Buyer to pay all legal fees and costs

Concluding Remarks

Many similarities

Same language

Paying attention to differences is useful in the pre-legal phase for early wins

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