Acquisitions of Investment Management Businesses in the UK and the US

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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.
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
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
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
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
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
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.
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
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 terroram* 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
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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