

Observations on Fund Manager M&A

January 7 2010

2010 Deal Outlook -- *Bravely Up and Over, Lads!*

In November 1917, the use of tanks in massed assault put an end to three years of Trench Warfare. After three years of war-of-attrition at strategic buyers and a financing drought for financial buyers, we see a breakout year for transactions in 2010.

For the last twenty five years, excepting the last two, it has been a seller's market. Why? Because big companies cannot innovate and talent seeks opportunity, because bringing in new talent can transform the buyer and oh yeah: because purchase accounting enables corporate buyers to bid on a 15-year view. In boardrooms it is common to commit capital based on five to seven year returns; in barrooms and bedrooms, one to three years is the far horizon.

On the other side, founders are hydra-headed: as entrepreneurs they are giddy about the value of their equity, as founders they feel immortal, and as craftsmen of portfolios or process they are hyper-aware of weakness and risks and full of dread.

This year strategic buyers will seek an integrated suite of talented teams. With calmer capital markets, the boardroom issue will be profit growth from new high-margin revenue. The build vs. buy equation favors buyers if they have the nerve to face instead of evade myriad integration issues.

Owners are waking from Jacob Marley's visit. As the new day dawns, we expect them to reconsider their capital structure and their obsession with every aspect of autonomy. Encouraged by large clients and forgiven by small ones, they will opt to sell. With less hubris, the Holy Trinity of seller concerns -- partner, participation and price -- may for a time be in the range of the reasonable.

How about the conglomerates? With few exceptions -- PIMCO, Axa Rosenberg, Pru's Jennison -- conglomerates own second tier firms. In the crisis the subs produced lower profits (or a capital call!), reputation risk and demands for compensation and autonomy. As the conglomerates rationalize their main businesses amid much tougher competition, they may decide to *sell the ingrates*.

Retail businesses sell easily, but institutional teams can muck up a deal. The CEO of a conglomerate must be mindful of precedent. No integrated conglomerate can afford to act like a holding company or be held up by its employees. The pillage of Julius Baer by a now very wealthy team is a cautionary tale!

Many private equity portfolio companies are "seasoned" -- ripe for exit. The best will IPO early in 2010, but others have a problem of interrupted growth. A 10x sale is the likely pricing but will make no heroes at Committee. Backing a firm to be a buyer as a "platform" at lower leverage means the equity holders including management must average down. Selling to a consolidator breaks trust with management (yes, the good firms really do care about this!).

As buyers, private equity will have a tough time -- true colors will be on display. Only a few deals will be available at a good value, and leverage will remain low after MDP's unforced errors at Nuveen. PE firms new to the space will angst and underbid but a few may prevail through grit and vision.

Banks, insurance and brokerage firms will not be big buyers -- they have strategic and capital issues. What they will do is spend a great deal of time in reconsideration of their product and distribution mix, and then seek

a red-haired left handed flute playing lemur. There may be a transformational divestiture or two, but more likely will be a handful of tiny purchases from the big guys. Ameriprise may be an exception, against a tide of client conflict and its challenges in conglomeration, as what passes for strategy there is a big appetite and fond memories of the 1980's.

From a dealflow standpoint, in addition to divestitures and fund consolidations we see some interesting developments:

- Multimanager Hedge product is in a big rebound (see *Observations* in Q1). FoHFs have a permanent place in the industry. Madoff and over-diversification killed off the bad actors, and multi-strat did not deliver except at a few houses. FoHF is no longer "training wheels for institutions," more like a Vespa: useful, easy to drive and for some a permanent way to go. We expect deals to rebound as distribution houses get with it.
- Despite a few pre-announcements, we do not expect hedge fund firms to recap by selling minority interests (Goldman feeding a pet Tiger cub is not a trend!). The real trend is firms either remaining a team of investors or becoming a fully functioning institutional firm. The former will do all manner of single digit deals, "in the family," priced over drinks and papered by amateurs. Institutional quality firms have a *strategy* to find the *best partner* to buy a double digit stake so the firm can tool up for the long haul.
- Larger alts firms are distressed and confused (especially real estate) but we do think a few of the universal banks (not GS or BX) may buy to increase their performance fee revenue and deepen prop trading capabilities and returns.

- There will be resurgent interest in long-only firms. The emphasis will be on firms with deep quant or deep research teams.

In terms of deal structure, we expect a high proportion of non-cash consideration to be the rule a la BLK/BGI and IVZ/Van Kampen. Reverse mergers may predominate as firms swap private interests for cash and public shares (and earn-out interests). As SPACS sink into the tar pit, the role they played will be usurped by public companies:

- PE holders will distribute positions at the deal or hold them to ripen depending on the vagaries of the GP incentives;
- Management and founders monetize value and get their estates in order.
- Strategic and tax advantages can be big, and they coexist in a reverse merger – a rare thing indeed.
- A holding company structure can create transparent value if properly structured.
- Accretion for the public shareholders is easy to deliver, and a floated company that "gets it" can do more than one deal as it expands its products and presence.

Being public sometimes seems a liability or nuisance (BX, FIG, GLG, HBRF). Certainly one lesson of 08/09 is that it can be a rough ride (AB, FII, JNS, LM, PZN). Still, we think a listing is an advantage in M&A if the share base is diverse. In 2010 several pure play public companies will come off the sidelines and close an accretive deal at size.

There is a partner for everyone at the M&A Cotillion, where the prize is glory. Watch out for your toes, though: without advice on the steps, more than just a dance can be ruined!

