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Mergers & Acquisitions

Buying a Majority Interest in a Hedge Fund Manager: An Acquirer's Primer on Key Structuring and Negotiating Issues

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The hedge fund space has seen significant recent M&A activity. Deals in late 2010 included Man Group's purchase of GLG Partners; RBS Wealth Management's acquisition of BlueBay Asset Management; the acquisition by Japanese financial services group ORIX of a majority stake in U.S. hedge fund platform Mariner; and Carlyle Group's purchase of a controlling interest in Claren Road Asset Management. Early indications suggest that 2011 will also be a robust year for hedge fund transactions.

On the surface, hedge fund M&A may be seen simply as bringing the maturing alternative investment industry into line with the broader financial services market, where consolidation has been a fact of life for years. Deeper reflection, however, suggests that deal activity is being driven by the unique features of the hedge fund sector itself. Some traditional financial services firms perceive a need to begin offering hedge fund investments to their clients, and buying a fund is a way to plug that product gap. Or, a financial services firm that already offers some hedge fund products may wish to add a focus on a particular sector, and acquiring an existing fund that fits the bill may be preferable to starting a new fund from scratch. Acquirers may also consider hedge fund acquisition opportunities particularly appealing in light of recent performance issues and their (perhaps temporary) depressing impact on firm value.

Industry dynamics may be especially compelling to sellers as well. From the hedge fund manager's perspective, selling an interest in the firm may spell relief from the volatility and financial stress of recent years. A transaction also may give principals a welcome chance to diversify personal assets by monetizing a significant stake in their business; this motivation is perhaps coming increasingly to the fore as a generation of hedge fund founders begins to consider retirement. Finally, a hedge fund manager may be attracted by the prospect of business support from the acquirer, which may take the form of enhanced marketing resources, introductions to prospective investors, assistance with the development of new products, capital for strategic expansion, bolstered compliance and legal functions, or opportunities for cost savings and synergies.

This article examines key transaction structuring points in the acquisition of a majority interest in a hedge fund manager (the "Manager"). We assume a cash deal in which the acquirer (the "Acquirer") purchases from certain principals of the Manager (the "Selling Principals") a majority equity interest in the Manager, with the Selling Principals retaining a minority stake. As discussed below, there are at least six major themes at work in such a transaction: regulatory diligence; valuation; incentives and franchise protection; control rights; the parties' ability to increase or reduce their holdings post-closing; and investor relations. These themes are inter-related and a successful transaction must find common ground between the Acquirer and the Selling Principals on each one.

Stepping Back for a Moment

Before proceeding, it is worth recalling the deeply personal nature of the hedge fund enterprise. Appreciating it is central to negotiating the purchase of a majority interest in a Manager and realizing the Acquirer's hoped-for value after closing.

In our experience, successful hedge fund founders and their key personnel are keenly entrepreneurial, intellectually nimble and tenacious. A flourishing hedge fund will reflect these personal traits – it will be a dynamic, high-conviction, regulatory-minded organization. The people who run a healthy hedge fund will be tough, robust and adaptable, and their business will be too.

At the same time, the very features that contribute to a fund's prosperity – precisely because they reside within the individuals who have founded and manage the business – make the fund a potentially impermanent venture. A Manager is little more than a group of people and the assets they invest. In many other types of business, management generally functions as stewards, with a view to building and carrying forward the business franchise and handing it off to the next generation of managers. For hedge funds, by contrast, the existence of the franchise is often inextricably linked to the founders and other key personnel. In their absence or without their enthusiasm, successful continuation of the business is not a given.

For an Acquirer, these realities mean that the goal in purchasing a majority stake in a Manager must be more than a mere closed transaction. For long-term value to be achieved, the objective must be arranging what amounts to a happy marriage, in which the Manager is integrated into the Acquirer's organizational and business environment in a way that respects the historical motivations and, at least to some degree, the ongoing independence of the Selling Principals. Such a union requires a show of flexibility by both sides, and advance planning to create a post-transaction structure in which the parties can thrive.

Recognition of this objective will affect numerous practical transaction-related decisions, including the appropriate level of regulatory-focused diligence; how to value the Manager's AUM; methods of motivating and retaining the Selling Principals and other investment professionals; and the structure of post-closing control rights. In short, the highly personal nature of the hedge fund enterprise makes hedge fund M&A unique. A prospective Acquirer – and, critically, its counsel – must have a strong sense of what makes hedge funds tick.

Regulatory-Focused Diligence

How an Acquirer intends to "fit" the Manager into its existing business and compliance framework is a significant question in terms of both pre-acquisition diligence and post-acquisition integration. Indeed, regardless whether the Acquirer's diligence process uncovers compliance weaknesses or issues at the Manager, the compliance cultures and structures of the parties may need to adapt to accommodate one another. The pre-transaction diligence process thus can have a dual purpose: assessing potential enterprise risk and confirming that the Acquirer's integration objectives can be met with a minimum of disruption.

Enterprise risk assessment should be undertaken before any serious negotiation of terms commences. With the passage of the Dodd-Frank Act, hedge funds have been made subject to enhanced regulation and scrutiny. The SEC and criminal prosecutors have been training their attention on hedge fund activities and are not letting up. These factors make a thorough due diligence investigation even more critical than in a standard M&A deal.

Working within the compressed time frame typically available to the Acquirer, and with the short leash typically given by the Manager for diligence inquiries, the Acquirer must seek to uncover any issues – either regulatory or cultural – that could negatively impact integration and/or continuation of the ongoing business. Among the questions to be pursued are: Is the Manager the subject of recent or pending litigation or complaints from fund investors and, if so, what is their nature? What is the Manager's reputation and standing with its regulators? Is the Manager in receipt of regulatory or prosecutorial inquiries, information requests or subpoenas? Is the Manager engaged in activities that have attracted regulatory or law enforcement scrutiny more generally and, if so, how does the Manager's approach to those activities compare to industry practice? What is the tone at the top of the firm? Are the Manager's compliance culture, policies and procedures appropriately robust for the scale of the enterprise? At the extremes, the answers to these and other questions may call into question the wisdom of the acquisition itself, or confirm for the Acquirer the solidity of the Manager and the attractiveness of the proposed acquisition. More typically, the answers will leave the Acquirer with one or more issues with which to grapple during negotiations.

Beyond the matter of reviewing for nascent regulatory problems, the due diligence process also can provide valuable insights into whether the Manager's compliance infrastructure is sufficiently scalable to support any growth or expansion of the business the Acquirer may contemplate. If the conclusion is that infrastructure enhancements will be required, their estimated cost can be considered in negotiating the acquisition.

Valuation

Arriving at an agreed purchase price hinges on appropriate valuation of the Manager. Valuation is generally based largely on the quantity of assets under management (AUM). The parties' views on appropriate valuation of that AUM will be shaped by a number of factors, which boil down to questions about the amount of fees the AUM generates and the possibility of growth or shrinkage of the AUM post-closing.

Analyzing AUM

From a valuation perspective, not all AUM is created equal. All other factors held constant, the higher the management and performance fees that a portfolio earns, the more attractive it is to a potential Acquirer. Similarly, apart from a portfolio's fee-generating characteristics, AUM that is historically "sticky" is generally more alluring than assets from newer investors with no established pattern of long-term commitment to the Manager.

In recognition of the different implicit values of distinct subsets of AUM, parties often approach valuation by agreeing on a methodology of relative valuation. One approach is to split existing AUM into a number of "buckets," with a different valuation multiple or "credit" being assigned to each bucket. In this way, for instance, total AUM might be broken into sub-categories by reference to management fees, incentive fees, investor redemption rights and historical investor loyalty. Alternatively, some deals use a formula-based approach, where

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management fees and performance fees are weighted and valued on a proportional basis to benchmark fees (such as 2 and 20).

Discussions of AUM value also should consider the illiquidity of certain types of assets and the related impact on fee generation. Other factors that may lend themselves to the relative valuation analysis include the length and volatility of the Manager's track record in identified strategies or asset classes and the Manager's experience of AUM growth or declines in those strategies or classes. Moreover, to the extent that red flags emerge in connection with regulatory due diligence (but do not call into question the wisdom of the acquisition itself), it may be appropriate to apply a global discount to AUM.

Allocating the Risk of Post-Closing Changes in AUM

Once an AUM multiple has been agreed, a more specific question arises: Who bears the risk of changes in AUM after closing? Investors who are unhappy with the Manager's change in ownership may exercise their next-occurring redemption rights. And even investors who consent to the transaction may merely be waiting until the next redemption date to reevaluate their investment – an investor's decision to leave its assets with the Manager through the closing date may be of limited predictive value regarding the investor's ultimate intentions.

One way to allocate the risk of post-closing AUM movement is to build a purchase price adjustment mechanism into the acquisition agreement. There are a number of approaches here, but the basic idea is to revalue the AUM as of an agreed post-closing date (after one or more redemption dates have passed), using the same metrics that were employed to arrive at the initial AUM valuation. To the extent AUM value has declined since closing, the Acquirer receives a downwards price adjustment; to the extent it has increased, an additional payment is made to the Selling Principals. The parties should agree on whether a change in AUM since closing will be deemed to include only net investment flows, or whether it will also include underlying portfolio appreciation/depreciation. The parties may also agree to limit the risk of loss/windfall through the use of collars or similar arrangements.

Incentives and Franchise Protection

A central issue in any hedge fund acquisition is planning to retain and properly incentivize the Manager's investment talent, including the Selling Principals who continue to be involved in the business. Incentives and retention are, of course, two sides of the same coin and are equally important to preserving the franchise value of the acquired business.

Incentives

The biggest and most obvious performance incentive for the Selling Principals is the fact that the Acquirer is not, at least initially, obtaining 100% ownership of the Manager. Since the Selling Principals will retain a significant equity interest in the Manager, they should, notwithstanding the partial liquidity event the Acquirer has just afforded them, remain keenly interested in promoting the Manager's future success. Additional specific incentive tools are designed to reinforce this motivation.

A particularly useful incentive is the purchase price adjustment mechanic described above. To the extent AUM reaches a designated threshold as of a certain date, the Selling

Principals are rewarded with an additional payment. This type of incentive payment may be a one-time opportunity after closing, or there may be multiple hurdle-based payment opportunities structured to occur over a number of years. A sub-question concerning incentive compensation is the extent to which valued Manager employees who are not Selling Principals should be able to share in the rewards for future AUM growth. The parties may determine to set aside a specified percentage of net revenue out of which to pay bonuses or other incentive compensation to these individuals.

Retention

If the incentive payment structure mentioned above is a "push" that inspires continued managerial effort under the new ownership regime, it may be equally useful to build in "pulls" that discourage investment talent from jumping ship in the aftermath of closing. This type of franchise-protecting measure may include non-compete agreements (which normally also feature non-solicitation clauses) and/or a requirement that, for a specific period, the Selling Principals must reinvest a certain percentage of their transaction proceeds in funds advised by the Manager.

These incentives and retention strategies also have an ancillary benefit – they may be especially helpful in demonstrating to the Manager's clients that the investment talent that drew them to the Manager remains committed to the business.

Control Rights

A separate set of issues concerns the control rights that the Acquirer will obtain as the Manager's new majority owner. Control terms are often the most sensitive topic of negotiation. Discussions can quickly become counterproductively "personal" and it is important that the Acquirer, in particular, proceed thoughtfully.

The degree of control acquired is often linked to the strategic objectives of the parties. A strongly branded Acquirer that already offers similar products, is buying the Manager primarily to acquire additional AUM or add a new product to its suite, and intends to rebrand the acquired fund in its own name will likely approach control rights aggressively. At the other end of the spectrum, an Acquirer that is new to the hedge fund space and is using the Manager as the platform to build a hedge fund presence will likely be more keen to preserve the Manager's long-term franchise and the continued visible involvement of the Selling Principals, and thus will generally seek fewer control rights than its raw percentage ownership might seem to warrant. Whatever the agreed post-closing control structure, a separate question is how long it will last. That is, are the Acquirer's or the Selling Principals' control prerogatives subject to enhancement or diminution with the passage of time or upon the occurrence of specified events?

Control arrangements are almost infinitely variable. The broad point to keep in mind is that these arrangements send strong signals about the parties' views of each other and will indelibly color the parties' future relationship. It is therefore imperative – before negotiations move too far along – that the parties have a clear idea of their respective strategic objectives and what they are willing to accept.

Board Rights and Management Rights

A fundamental control issue is the composition of the Board of Managers or similar supervisory body that will have overall monitoring authority for the Manager as a business. Typically, an Acquirer of a majority ownership stake will get control of the Board, with the Selling Principals getting minority representation. Conversely, Selling Principals typically continue on as day-to-day management and/or as members of a Selling Principals-controlled management committee.

Once Board and management composition is established, it is important to delineate which decisions can be made by the Acquirer-controlled Board and which can be made by the Selling Principals-controlled management committee, and whether and to what extent the minority has veto power. The allocation of these powers will vary from one transaction to another, but it is not uncommon for all portfolio investment decisions and day-to-day business decisions (e.g., personnel decisions, marketing activities, broker relationships, etc.) to be left to the management committee. The Board may exercise approval or direct authority over strategic and big-picture matters (e.g., approving annual budgets, major capital expenditures, allocation of resources to new products, expanding product offerings, the wind-up of large funds, incurrence of significant leverage, acquisitions, senior management appointments, etc.).

Board and management committee composition may be designed to change over time. Events triggering a change in relative control and managerial power might include the Acquirer acquiring an increased ownership stake, the departure of Selling Principals, or simply the passage of time. The possible permutations are endless, but a frequent unifying theme is the idea that control/managerial power is shared more evenly at the outset but eventually shifts to the Acquirer.

Veto Rights

Veto rights inure to the benefit of the Selling Principals as minority owners. Veto rights most often are designed to give the Selling Principals comfort that, in the near term, changes that could adversely affect their ability to earn their incentives do not occur without their consent. Thus, veto rights might cover topics like changes in investment focus or products, changes to key personnel, significant changes to total overhead, large capital expenditures, issuance of additional equity, equity redemptions, etc. Veto rights may be structured to dissipate as incentives are earned or as the majority ownership position increases.

Future Rights to Increase or Decrease Ownership

Closely linked to the subject of control rights is the parties' future ability to change their ownership position in the Manager. For the Acquirer, this usually means setting out whether it has the right to buy interests held by the Selling Principals at particular times or upon the occurrence of particular events. For the Selling Principals, this topic often involves fleshing out the freedom to cease employment and/or the right to be cashed out of their post-closing stake.

Acquirer's Ability to Add to its Ownership Position

Call rights are one means by which the Acquirer may create future opportunities to boost its ownership position. An example might be an annual right, beginning a specified number of years post-closing, for the Acquirer to call all or any portion (on a pro rata basis among the Selling Principals) of the Selling Principals' equity interests in the Manager, at fair market value. In addition, if the Manager itself has call rights with respect to the Selling Principals (e.g., in the event a Selling Principal ceases employment with the Manager), the Acquirer may have the right to exercise the call in the Manager's stead if the Manager declines to do so for its own account.

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It is also common for the Acquirer to reserve a right of first offer or first refusal in connection with any proposed disposition of equity by a Selling Principal. This ROFO or ROFR is typically negotiated in conjunction with the Selling Principals' post-closing lock-up obligation described below. Acquirers generally also have the right to sell the Manager and to drag the Selling Principals into the sale. This right may be restricted in terms of time and/or price.

Exit Opportunities for the Selling Principals

Given the Acquirer's desire to protect the franchise it is purchasing, it is normal for the Selling Principals to be barred for a specified period post-closing from disposing of their retained equity interests in the Manager. Following this lock-up period, however, it is typical for the parties to contemplate opportunities for the Selling Principals to reduce their holdings. A standard means to achieve liquidity for the Selling Principals is to provide them with annual rights – beginning after expiry of the lock-up or some other agreed period – to put their Manager interests to either the Manager or the Acquirer, for fair market value. Often this annual put right is limited to a certain percentage of the seller's holdings. As in the case of Manager call rights noted above, the Acquirer may bargain for the right to receive the interests that a Selling Principal elects to put if the Manager wishes to assign the purchase obligation to the Acquirer.

Investor Relations

Of course, careful valuation, thoughtful incentive planning and well-designed control rights mean nothing if the Manager's AUM does not make it to closing or disappears shortly afterward. The existing investors in the Manager's funds are therefore a vitally important "audience" for the parties' proposed deal. Because no hedge fund acquisition can succeed without the acquiescence – expressed or tacit – of some critical mass of the Manager's current clients, their support for the transaction must be accurately gauged and effectively sought. There are both contractual and "soft" aspects to this process.

From a contractual perspective, it will be necessary to review the limited partnership agreement or similar governing document (e.g., articles of association for a Cayman or BVI entity) of each underlying fund with which the Manager has an investment advisory agreement. These agreements may or may not contain consent provisions concerning changes of control of the Manager.

A second contractual issue arises under the Investment Advisers Act of 1940 (the "Advisers Act"), which generally will require the Manager's investment advisory agreement with each fund to provide for the fund's consent in the event the advisory agreement is "assigned" by the Manager to another party. It is sometimes the case that a sale of a majority stake in the Manager to a third party is an "assignment" that requires fund consent for purposes of the Advisers Act. A detailed examination of the Advisers Act is beyond the scope of this article, but the need to determine whether an acquisition of the Manager is an assignment of the fund advisory agreements – and, if so, the process for soliciting and obtaining fund consents – should be built into the timeline of any proposed acquisition.

Separate from the possible legal need to solicit investor consent to the transaction, the Manager and the Acquirer will be concerned about ensuring that the transaction does not prompt key investors to withdraw their AUM before or soon after closing. The Manager therefore is likely to engage in some sort of quiet outreach to key investors as the proposed acquisition takes shape. At a minimum, the goal is to convince investors that they have nothing to fear from the Acquirer's arrival on the scene – that the Selling Principals' cession of percentage control is not going to change the investment approach or personnel lineup that attracted the investors originally. Ideally, the Manager will also have another message, to the effect that affiliating with the Acquirer will affirmatively strengthen the Manager through, for example, additional capital resources, product development support, enhanced compliance infrastructure or some similarly positive contribution. The degree of handholding and/or selling required among the investor base will vary by circumstance, but the process must at some point take center stage.

Other Issues

A myriad of other issues will need to be addressed following the acquisition of a hedge fund manager. As with the topics discussed above, the greater the clarity of the parties' intentions from the outset, the more smoothly these issues can be tackled.

One major set of post-closing issues may be grouped under the heading "integration challenges." The issues here are multiple, but may involve, for example, the need to mesh compliance regimes (e.g., if the Acquirer's investment program entails the receipt exclusively of public information and the Manager receives "syndicate" or other non-public information about the same issuers). The post-closing compliance regime also may need to become newly sensitive to avoiding principal trades and cross trades under the Advisers Act, particularly if the Acquirer and the Manager have funds or accounts that trade in similar types of securities. The need to revise and coordinate disclosure to investors on Form ADV is also a typical focus of post-acquisition compliance efforts.

Particular integration issues may arise when the Acquirer is a public company. In this case, for example, the parties may need to work on ensuring that the Manager's financial statements feed properly into the Acquirer's financial reporting process.

Conclusion

Successfully structuring the majority acquisition of a hedge fund manager requires careful attention to a range of interwoven issues. These include regulatory diligence, valuation, incentives and franchise protection, control rights, provisions for post-closing percentage ownership changes, and investor relations. Coloring the parties' approach to all of these issues is the essential "personal" nature of the hedge fund enterprise and the related need to identify and cooperatively resolve issues concerning the Selling Principals' reduced but ongoing role in the business. The process of careful analysis and trust-building negotiation is inherently challenging. In our experience, though, a thoughtful Acquirer – with its eye on the long term and assisted by counsel that understands what makes a hedge fund go – can achieve significant value over time.

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