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Succession

Succession Planning Series: Selling a Hedge Fund Founder's Interest to an Outside Investor (Part Two of Two)

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When a veteran hedge fund founder begins to contemplate retirement, he or she has choices to make about the nature of the firm to be left behind. In a previous installment in our two-part series on succession planning, we explored the issues surrounding one such choice: bequeathing the management firm as an independent entity to be wholly owned and led by a successor generation of firm principals. In this second installment, we address a different decision that a founder nearing retirement might make: selling the founder's stake in the firm to an outside investor. More specifically, this article touches on the following topics: reasons for selling a firm, finding a buyer, valuation issues, franchise protection (including strategies for retaining key employees), control rights (including veto rights), future rights to increase or decrease ownership (including exit opportunities for the remaining principals), fund documentation issues, other legal issues and investor relations issues.

In certain respects, these alternative choices have similar consequences and raise similar issues because each path is a way to institutionalize the manager's business in conjunction with the founder's exit. Valuation of the founder's interest, for example, will be a central concern in each scenario. Post-closing retention incentives for the manager's remaining talent is also a common theme, as are investor relations and fund documentation issues. In other respects, however, a sale transaction differs significantly from an internal succession. In the sale context, grooming and making visible a new internal leadership generation may not be as important; valuation will be negotiated with a third party and may be AUM-centric; and arrangements regarding post-closing control and ownership rights between the buyer and the remaining principals will loom large.

Why Sell?

Any number of factors could lead a hedge fund founder to sell a large interest in the manager to an outside party, but the most probable reason is financial. The main impediment to leaving the firm as an independent entity is the difficulty the firm's remaining principals might have in financing a buyout of the founder's equity interest. Especially in the case of a successful manager that has accumulated a large franchise value and that is owned primarily by the founder, the burden of purchasing the founder's stake could be crippling for the remaining principals; besides the personal financial stress on the individuals effecting a large buyout, the manager could be left without sufficient financial resources to attract and compensate the talent necessary to the firm's future viability. Such a financially stressed outcome might be avoidable if the founder is willing to retain a meaningful degree of equity or sell his or her equity incrementally to the remaining principals over time. But for a founder who wants to achieve a significant liquidity event at a stroke, selling his or her interest in the firm to a third party may be the only realistic option.

A sale need not – and for reasons discussed below, probably will not – involve the transfer of all equity in the manager. It is likely that in the context of the founder's exit, the remaining principals will retain or be granted equity in the manager, such that they are co-owners with the new third-party investor. But the third-party purchaser or acquiror likely will want majority ownership and managerial control, in each case perhaps to a very significant degree.

Finding a Buyer

Whether any particular firm is a realistic acquisition target of course depends on a host of factors. These include historical performance; the perceived dependence of the business on the founder; the founder's possible willingness to remain involved for a post-closing transition period; the strength of the management bench; the nature of the client investor base; and exogenous conditions such as general purchaser demand and access to financing. Assuming the manager is a viable sale candidate, purchaser interest might emerge from various quarters. In recent years, hedge fund M&A has been driven to a large extent by traditional financial services firms that want to begin offering a hedge fund product. In other cases, a financial services firm that already offers some hedge fund products may wish to add a focus on a particular strategy, and acquiring an existing manager with a strong record in that strategy may be an appealing bolt-on opportunity.

Besides evaluating potential buyers by the amount they are willing to pay, the founder may be concerned about the post-transaction success of the manager – whether the firm under new ownership is likely to continue producing returns for investors, grow AUM and provide good incentives for the principals and other employees who remain on board. A founder with these concerns will want to understand how the manager will fit into the acquiror's organizational and business environment. What other investment products does the acquiror offer, and will they compete with the manager for resources and clients? How will the acquiror support and incentivize the manager's remaining principals and employees? Are those individuals likely to thrive in the acquiror's operating culture?

Valuation

Assuming one or more serious potential buyers are interested in a transaction, the first question is how to value the founder's interest. The quantity and quality of the manager's AUM likely will be key elements of the valuation analysis.

Analyzing AUM

Not all AUM is created equal. Other factors held constant, the higher the management and performance fees that a portfolio earns, the more attractive it is to a potential purchaser. And qualitatively, AUM that is historically "sticky" is generally more alluring than AUM from a newer investor with no established pattern of long-term commitment to the manager. Perceived AUM value also may be affected by the illiquidity of certain types of portfolio assets and the related impact on fee generation. Other factors may 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 shrinkage in those strategies or classes.

In recognition of the different implicit values of distinct subsets of AUM, parties often adopt a relative valuation methodology. One approach is to split existing AUM into a number of "buckets," with a different valuation multiple assigned to each bucket. In this way, total AUM might be

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broken into sub-categories by reference to management fees, incentive fees, investor redemption rights and demonstrated investor loyalty. An alternative is a formula-based approach, where management fees and performance fees are weighted and valued on a proportional basis against an industry benchmark.

Allocating the Risk of Post-Closing Changes in AUM

Once an AUM valuation model has been agreed, a more specific question arises: Who bears the risk of changes in AUM after closing? Fund investors who are disturbed by the change in ownership of the manager may exercise their key-man special redemption rights or their next normally-scheduled redemption rights prior to closing. And even investors who leave assets with the manager through closing may merely be waiting until the first post-closing redemption date to reconsider their commitment.

One way to allocate the risk of post-closing AUM movement is to include a purchase price adjustment mechanism in the acquisition terms. There are a number of approaches, 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 purchaser receives a downwards price adjustment; if it has increased, an additional payment is made to the founder. The parties should agree on whether a change in AUM following closing will be deemed to include only net investment flows, or whether it also will include underlying portfolio appreciation/depreciation. The parties also might agree to limit the risk of loss/windfall through the use of collars or similar arrangements.

Franchise Protection

In our prior article discussing an internal succession process that passes an independent firm to the next generation of manager principals, we noted the importance of creating a compensation environment to motivate the principals and other key employees on an ongoing basis. The same concern arises when the founder is selling his or her stake, albeit with the purchaser's franchise-protection goals now providing a key impetus for whatever incentive and retention terms are agreed. Besides preserving franchise value, incentive and retention strategies also may be helpful in demonstrating to the manager's clients that key investment talent remains committed to the business following the founder's exit. In this connection – as in the internal succession paradigm – it will be advantageous if the founder has made a sustained effort to introduce and promote that talent to investors over time, well in advance of the exit transaction.

Incentives

The biggest and most obvious performance incentive for the remaining principals is the fact that the purchaser is not obtaining 100 percent ownership of the manager. Since the remaining principals will retain an equity interest, they should be keenly interested in promoting the firm's future success. Specific incentive tools are available to reinforce this motivation.

One useful tool is a variant of the purchase price adjustment described above. To the extent AUM reaches a designated threshold as of a certain date, the principals are rewarded with a bonus 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. The parties may determine to set aside a specified percentage of net revenue out of which to pay bonuses or other incentive compensation.

Retention

If incentive payments are a "push" that inspires continued managerial effort under the new majority ownership, it may be equally useful to build in "pulls" that discourage investment talent from jumping ship after closing. This type of franchise-protecting measure may include carry-forfeiture provisions, non-compete agreements (which normally also feature non-solicitation clauses) and/or a requirement that, for a specific period, the remaining principals must maintain a certain degree of personal investment in the general partner and/or funds advised by the manager.

Control Rights

A separate set of issues concerns the control rights that the purchaser will obtain as the manager's new majority owner. The degree of control sought is often linked to the purchaser's strategic objective. If the purchaser is itself a strongly branded fund manager that intends to rebrand the firm in its own name, it likely will approach control rights aggressively. A purchaser that is new to the space and is using the manager as the platform to begin building a hedge fund presence may agree to more limited control rights in the interest of preserving the manager's long-term franchise and the continued visible involvement of the remaining principals. Whatever the agreed post-closing control structure, a separate question is how long it will last – that is, are the purchaser's or the remaining principals' control prerogatives subject to change with the passage of time or upon the occurrence of specified events?

Control arrangements are highly 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. Control rights that do not marginalize the remaining principals therefore may be seen by investors as a sign that the purchaser is committed to the firm's historic investment philosophy and operating culture, which may in turn reduce the risk of investor flight.

Board Rights and Management Rights

A fundamental control issue is the composition of the board of managers or similar supervisory body that will have monitoring authority over the manager following closing. Typically, the purchaser of a majority ownership stake will get control of the board, with the remaining principals getting minority representation. The remaining principals typically continue on as day-to-day management and/or as majority members of a principals-controlled management committee.

Once board and management committee composition is established, it is important to delineate decision-making authority between the two bodies and to decide whether and to what extent the minority in either body has veto power. The allocation of these powers varies, 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 purchaser acquiring an increased ownership percentage, the departure of principals or the lapse of time. A frequent general theme is that control/managerial power is shared more evenly at the outset but eventually shifts to the majority owner.

Veto Rights

Veto rights benefit the remaining principals as minority owners. Veto rights most often are designed to give the remaining principals comfort that managerial actions 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 purchaser, this usually means setting out whether it has the right to buy interests held by the remaining principals at specified times or upon the occurrence of particular events. For the remaining principals, this often involves fleshing out the freedom to cease employment and/or the right to be cashed out of their post-closing equity position.

Purchaser's Ability to Add to Its Ownership Position

Call rights are one means by which the purchaser 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 purchaser to call (on a pro rata basis among the remaining principals) all or any portion of the remaining principals' equity interests at fair market value. In addition, if the manager itself has call rights with respect to the remaining principals (e.g., in the event a remaining principal ceases employment with the manager), the purchaser may have the right to exercise the call in the manager's stead if the manager declines to do so for its own account.

It is also common for the purchaser to reserve a right of first offer (ROFO) or first refusal (ROFR) in connection with any proposed disposition of equity by a remaining principal. This ROFO/ROFR right is typically negotiated in conjunction with the remaining principals' post-closing lock-up obligation described below. The purchaser generally also has the right to sell the manager and to drag the remaining principals into the sale. This right may be restricted in terms of time and/or price.

Exit Opportunities for the Remaining Principals

Given the purchaser's desire to protect the manager franchise in which it is investing, it is normal for the remaining principals to be barred from disposing of their equity interests for a specified period post-closing. Following this lock-up period, it is typical for the parties to contemplate opportunities for the remaining principals to reduce their holdings. A standard means to achieve liquidity for the remaining principals is to provide them with annual rights – beginning after expiry of the lock-up or some other agreed period – to put their equity interests to either the manager or the purchaser, 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 purchaser may bargain for the right to receive the interests that a remaining principal elects to put if the manager wishes to assign the purchase obligation to the purchaser.

Fund Documentation and Other Legal Issues

A sale of the founder's interest raises many of the same fund documentation and other legal issues discussed in our prior article on internal successions. 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 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, key-man special redemption rights triggered by the founder's departure and similar provisions.

A second set of contractual issues may arise under the Investment Advisers Act of 1940 (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 a majority interest in 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 the transaction.

Finally, as in the internal succession scenario, fund documents, marketing materials, regulatory disclosures and third-party contracts will need to be reviewed and amended as necessary to reflect a manager's new ownership structure.

Investor Relations

Valuation, incentives, control rights and careful adherence to fund documents 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 change of control can succeed without the acquiescence of some critical mass of the manager's current investors, their support for the transaction must be accurately gauged and effectively sought. Again, a founder that has prepared the ground for an eventual exit by increasing other principals' responsibility and visibility to investors will stand a better chance of success on this point than a founder whose exit seems to come out of the blue. The founder therefore is likely to engage in some sort of quiet outreach to key investors as the proposed sale of his or her interest takes shape, and may even introduce the potential buyer to key clients.

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Conclusion

A sale of the founder's interest to an outside investor is a watershed event in the life of a hedge fund management firm. Handled thoughtfully, it can produce an outcome that secures the firm's place within a new institutional structure, with ongoing opportunities for investors, manager personnel and the buyer alike.

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