

The background of the slide is a dark blue gradient with a series of bright, multi-colored streaks (red, orange, yellow, and blue) that sweep across the frame from the top right towards the bottom left, creating a sense of motion and energy.

**Morgan Lewis**

# **M&A ACADEMY**

**Key Considerations in Investment  
Management M&A Transactions**

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April 7, 2020

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# I. Background

## Sellers and Buyers

- Sellers
  - Institutional advisers
  - Mutual fund advisers
  - Wealth management firms
  - Alternative liquid (e.g., hedge fund) managers
  - Alternative illiquid (e.g., private equity, real estate, or specialty credit) managers
- Buyers
  - Institutional advisers
  - Mutual fund advisers
  - Wealth management firms
  - Alternative liquid (e.g., hedge fund) managers
  - Alternative illiquid (e.g., real estate or specialty credit) managers
  - Financial institutions: banks, insurance companies, securities firms, trust companies, and other financial services companies

# I. Background (cont'd)

- Management
- Private equity firms
- Reasons sellers sell
  - Monetization
  - Diversification of net worth
  - Change in strategic direction
  - Succession planning
  - Opportunity for better distribution
  - Lack of scale/margin pressures
  - Life event (retirement, death or disability, divorce, etc.)
  - Increase product offering to clients
  - Possible changes in tax law (e.g., potential increase in capital gains tax rates)

# I. Background (cont'd)

- Reasons buyers buy
  - Fill gaps in product offering
  - Fill geographic gaps
  - Improve manufacturing capabilities/acquire talent
  - Change in strategic direction
  - Economies of scale
  - Financial buyer
- Reasons to sell control vs. minority interest
  - May be more potential buyers for a change of control transaction
  - Balance taking chips off the table vs. reduced share in upside of the firm
  - Tolerance for loss of autonomy
  - Regulatory considerations
  - Investor considerations
  - Employee considerations
  - Majority sellers need to focus on liquidity with respect to minority stake

## II. Forms of Transactions

- Third-party purchase of all or substantially all of the adviser's stock or assets (and, in the case of alternative advisers, the general partner or other direct or indirect equity interests in the fund)
- Third-party purchase of a minority voting and equity interest in the investment adviser (and, in the case of alternative advisers, the general partner or other direct or indirect equity interests in the fund)
- Third-party purchase of a controlling voting interest in the investment adviser (and, in the case of alternative advisers, the general partner or other direct or indirect equity interests in the fund), but a minority economic interest
- Third-party purchase of a line of business of an investment adviser
- Externalization of proprietary trading desks

## II. Forms of Transactions (cont'd)

- Seeding a fund and investment in a new manager
- Management buyout of adviser
- Lift out/de novo firms (focus on access to track record/track record data)
- Joint ventures
- Acquisition of revenue share/partnership with managers
- Fund adoptions/reorganizations (mutual funds, ETFs)

## III. Valuation

- Variables in determining the multiple used in valuing a target
  - Category of target (mutual fund, hedge fund, high net worth, institutional, etc.)
  - If there are performance fees, how are these weighted compared to advisory fees?
  - Historic growth rate
  - AUM
  - Geography
  - Investment style (fixed income vs. equity; small vs. large caps; etc.)

## III. Valuation (cont'd)

- Valuation methodologies used to value targets
  - Discounted cash flow
  - Comparable public company
  - Comparable acquisitions
  - Other
  - Firms typically trade at a multiple of cash flow. In current market, the multiples are generally in the range of:
    - 6–8X pre-tax cash flow for alternative managers
    - 7.5 – 10X pre-tax cash flow for most traditional managers
    - 11 – 12X for highly sought-after traditional managers



## IV. Key Agreements

- Purchase Agreement
- Guaranty Agreement (if purchaser is not independently creditworthy)
- Employment Agreements
- Operating Agreements (Limited Liability Company/Limited Partnership) for adviser and general partner (majority or minority stake deal)
- Distribution Agreements (if strategic purchaser is acquiring a non-controlling interest)
- Services Agreement (transition or otherwise). If services provided by prior owner (e.g., a bank), these services must be continued or replaced

## V. Purchase Agreement

- Parties
- Assets or equity sold
- Purchase price
  - Closing payment
    - Fixed amount (what if AUM changes between signing and closing?)
    - Fixed amount adjusted for client consents, market movement between base date and closing, additions and withdrawals (or redemptions from funds) between base date and closing, and working capital changes between base date and closing
    - Various mechanisms for adjusting for these factors
  - Role of escrows
    - Indemnification
    - Specified items (e.g., post-closing purchase price adjustment for client loss)

# V. Purchase Price Adjustment Mechanism

## Acquisition of Rich Folks Management

A Client Name	B AUM as of 3/31/19 (in millions)	C Fee Rate as of 3/31/19	D Revenue Run Rate as of 3/31/19 (in millions)	E Net Deposits/Withdrawals Since 3/31/19 (in millions)	F Adjusted AUM as of Closing Date (in millions) (B – E) <sup>2</sup>	G Fee Rate as of Closing Date	H Revenue Run Rate as of Closing Date (in millions)	I Consent	J Consenting Revenues (in millions)
Chu	\$100	.75%	\$.75	0	\$100	.75%	\$.75	Y	\$.75
Johnson	\$200	.75%	\$1.50	0	\$200	.75%	\$1.50	Y	\$1.5
Jones	\$300	.65%	\$1.95	0	\$300	.75%	\$2.25	Y	\$2.25
Kim	\$400	.65%	\$2.6	\$50	\$450	.65%	\$2.925	Y	\$2.925
Smith	\$400	.65%	\$2.6	[\$25]	\$375	.65%	\$2.4375	N	\$0
Thompson <sup>4</sup>	0	-	-	\$75	\$75	.75%	\$.5625	Y	\$.5625
Williams	\$500	.65%	\$3.25	0	\$500	.65%	\$3.25	Y	\$3.25
Total	\$1,900		\$12.65	\$100	\$2,000		\$13.675		\$11.2375

- 1) Purchase agreement signed 4/4/19 for \$75 million, based on \$6.5 million EBITDA and 12 x multiple.
- 2) Does not reflect any change resulting from market movement.
- 3) Break point on fees increased to \$500 million of AUM.
- 4) Account funded on April 15.
- 5) When added to 5% cushion equals 93.83% of contract purchase price. (On contract purchase price of \$75 million, the adjusted price is \$70.375 million, assuming a dollar-for-dollar reduction in price due to decline in revenues below the 5% cushion.

Consenting Revenue Percentage (\$11.2375 / \$12.65) is 88.83%<sup>5</sup>

## V. Purchase Agreement (cont'd)

- Contingent Payment
  - As a percentage of total value may be larger in alternative firms than in traditional investment manager transactions (smooth out volatility of performance fees)
  - Criteria for satisfying contingency; typically fee revenue, EBITDA, cash flow, or combination; possible separate contingencies for management fees and performance fees in alternative firms
  - Length of earn-out period. Three to seven years is customary range
  - Cliff payment vs. multiple payments over a period, with or without catch-up
  - If payment is conditioned on continued employment, the contingent payment may lose capital gains character
  - If buyer is strategic, sellers will benefit from buyer's distribution capabilities in achieving earn out
  - Governance during earn out period is often a subject of negotiation

## V. Purchase Agreement (cont'd)

- Stay bonuses; not purchase price but may be required for non-owner employees
- Continuing profit participation; not purchase price but may be required where (i) there is a disparity between equity ownership and actual importance to business; or (ii) not all sellers remain with the business after closing.
- Representation and warranties of parties
  - Purpose of reps and warranties:
    - Confirm due diligence
    - Accuracy is a closing condition
    - Breach gives rise to termination right and indemnification
  - Key Reps: client AUM and fee rates; legal compliance and regulatory
  - Scope of reps re: funds highly negotiated topic
- Pre-closing covenants of parties
  - Business operated in ordinary course
  - Access to information
  - Maintenance or termination of employee benefit plans
  - Distribution of cash in excess of working capital requirement

## V. Purchase Agreement (cont'd)

- Post-closing covenants
  - Restrictive covenants
    - Reasons for Restricting Sellers
      - Assets (i.e., portfolio management skills and client relationships) go up and down the elevator every day
      - “Egg on your face” if a buyer pays a hefty price only to see the sellers setting up shop across the street and soliciting the “acquired” clients
      - Together with service commitments, contingent purchase price payments or grants of equity to key personnel, rounds out the “carrot and stick” approach

## V. Purchase Agreement (cont'd)

- Types of Restrictive Covenants
  - Confidential information (may include track record, strategies, client/investor information)
  - Intellectual property (may include software)
  - Non-compete
    - Scope (business sold vs. all investment management)
    - Duration (3-7 years typically for sellers)
  - Non-solicitation or non-interference
    - Clients/investors (should include no-accept)
    - Vendors/service providers
    - Employees (should include no-hire)
    - Scope/duration
- Enforceability of Restrictive Covenants in Sale of Business
  - More liberal evaluation of restrictive covenants in sale of business context than in employment context because:
    - More equal bargaining power of parties
    - Sale proceeds provide means of support
    - Premium paid by purchaser for restrictive covenant
    - Restrictive covenants necessary to protect purchased goodwill
    - CA does not enforce restrictive covenants except re: trade secrets or sale of business

## V. Purchase Agreement (cont'd)

- Conditions to closing
  - No MAE (focus on definition, including carve-out for changes in markets)
  - Accuracy of representations and warranties
  - Performance of covenants
  - Expiration of HSR waiting period
  - Minimum AUM/consenting client revenue run rate/cap on redemptions
  - Key employees continue to be employed and have signed employment agreements
  - Third-party consents
  - For mutual funds, board and shareholder approval of new mutual fund contract and, if applicable, fund reorganization
- Indemnification
  - Survival of representations and warranties (fundamental reps vs. general business reps)
  - General vs. specific indemnification
  - Deductible/basket
  - Caps
  - De minimis claims
  - Consequential damages
  - Mitigation obligation
  - Reduction for insurance/tax benefits
  - Procedures for defending third-party claims
  - Set-off (e.g., buyer contingent payment obligation offset against seller indemnification obligation)



## VI. Client Consents

- Investment Advisers Act
  - Under Section 205(a) of the Investment Advisers Act, every investment advisory contract must “provide, in substance, that no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract.”
  - Under Section 202(a)(1) of the Investment Advisers Act, an “assignment” includes any direct or indirect transfer of an investment advisory contract “or of a controlling block of the assignor’s outstanding voting securities by a security holder of the assignor.”
  - A “controlling block” of voting securities is not defined in the Investment Advisers Act, but in the Instructions to Form ADV a person is presumed to control (i) a corporation if it has the right to vote or sell 25% or more of a class of the corporation’s voting securities; (ii) a partnership if it has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the partnership; or (iii) a limited liability company if it has the right to vote 25% or more of a class of the interests of the limited liability company, has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the limited liability company, or it is a manager of the limited liability company.

## VI. Client Consents (cont'd)

- Under Section 2(a)(9) of the Investment Company Act, any person who owns beneficially more than 25% of the voting securities of a company shall be presumed to control such company. Under Section 2(a)(42) of the Investment Company Act, a “voting security” means any security presently entitling the holder to vote for the election of directors of a company.
- Under the Investment Company Act, a deemed assignment of an advisory agreement results in its automatic termination.
- Rule 202(a)(1)-1 under the Investment Advisers Act and Rule 2a-6 under the Investment Company Act provide that a transaction that does not result in a change of actual control or management of an investment adviser is not an assignment.
  - Factual analysis
  - SEC no action guidance finding no change of control (merger of 2 widely held public companies with no resulting controlling interest, 45% economic stake and 11% voting stake)
  - SEC no longer gives guidance
- Client Consent Mechanics
  - Direct Accounts
    - Affirmative vs. negative consents
  - SMA/Wrap Accounts
    - Wrap sponsor
    - Underlying client
  - Collective Trusts
    - Trustee
    - Other participants

## VI. Client Consents (cont'd)

- Private Funds
  - General partner or manager (typically affiliated with investment adviser)
  - Investors (negative consent, investor vote, special redemption right)
  - Implication of Rule 206(4)-8 under the Investment Advisers Act (Pooled Investment Vehicles); it is a violation of the Act for an adviser to a pooled investment vehicle to “otherwise engage in any act... that is fraudulent, deceptive or manipulative with respect to any investor...in a pooled investment vehicle”
  - If a transaction requires changes to a fund’s limited partnership agreement, may need to amend ppm and obtain consent of investors
- Registered Funds
  - Board approval
  - Shareholder approval
  - Exemptive orders regarding subadvisers
  - Applicability of Rule 15a-4 under the Investment Company Act (permitting interim advisory/subadvisory contracts)
    - Duration of no greater than 150 days
    - Terminable upon 10 days’ written notice
    - Same material terms as previous contract
    - Escrow of fees

## VI. Client Consents (cont'd)

- Section 15(f) of the Investment Company Act
  - Rosenfeld v. Black (445 F. 2d 1337)
    - 1971 case in which Second Circuit held that investment adviser to mutual fund, which realized profit in connection with appointment of new adviser upon its recommendation, violated its fiduciary duty.
  - Section 15(f) enacted in response to Rosenfeld v. Black
    - Under section 15(f), an investment adviser of a registered investment company may receive an amount or benefit in connection with the sale of securities of, or sale of any other interest in, the investment adviser that results in the assignment of an investment advisory contract if the following two conditions are met:
      - For three years after the assignment, at least 75% of the board of the investment company are not interested persons of the investment adviser or its predecessor; and
      - There is not imposed an “unfair burden” on the investment company as a result of the transaction.

## VI. Client Consents (cont'd)

- An “unfair burden” includes any arrangement, during the two-year period after the transaction, whereby the investment adviser or its predecessor or successor receives any compensation (i) in connection with the purchase or sale of securities or other property to or from the investment company (other than bona fide, ordinary underwriter compensation) or (ii) from the investment company for other than bona fide investment advisory or other services.

## VII. Employment Agreement

- Term
- Duties
- Compensation
  - Salary
  - Bonus
  - Possible profit participation
- Severance; definition of “cause”
- Non-compete/Non-solicit
- Reinvestment commitment into fund; amount; duration of commitment; optional reinvestments
- Liquidated damages as a means of addressing tax issue on earn out

## VIII. Operating Agreements (LLCA or LPA)-Majority Sale Transactions

- Many sophisticated buyers & sellers prefer majority sale deals rather than 100% acquisitions
  - Retained equity keeps management (both founders and “next generation”) motivated and permits sellers to enjoy strategic benefits of transaction (e.g., buyer’s distribution capabilities)
- Franchise value enhancing features of majority sale transaction
  - Management participation in operating distributions & sale transactions
  - Management participation in governance
  - Spreading equity ownership to “next generation”
  - Restrictive covenants and service commitments made in exchange for equity
  - Time based liquidity for management retained equity through put and call rights at fixed multiples
  - Departure based liquidity
    - Call rights vs. sunset tail participation
    - Different pricing for Good Leavers (Fired w/o Cause, Good Reason or Retirement) vs. Bad Leavers (for Cause termination, quitting without Good Reason), payment with note vs. cash or upfront vs. installments, forfeiture
  - Vesting of new equity issuances
- Classes of equity; can separate voting rights from economic interest & tailor economic interests

## VIII. Operating Agreements-Majority Sale Transactions

- Restrictions on transfer
  - Permitted transfers (affiliates for institutions, estate planning for individuals)
  - Drag-along/tag-along
- Offset rights (indemnification, breach of restrictive covenants or other commitments)
- Governance
  - Autonomy vs. non-autonomy transaction
  - Investors may favor retained autonomy of sellers, in particular in investment functions
  - Contractual autonomy
  - Loss of autonomy may trigger ability to put retained equity, shorten non-compete duration, etc.



## VIII. Operating Agreements- Issues in autonomy transactions

- Guardrails in autonomy transactions
  - Non-ordinary course decisions
  - Hiring/firing key employees
  - Budget and expense approval
  - Legal, compliance, HR and accounting policies
- Buyer's goals
  - At the end of the initial employment term, business should not be dependent on sellers unless they have significant retained equity. Sellers can make buyer pay for the business a second time.
  - Be able to make changes if there is underperformance or regulatory or other material issues.

## VIII. Operating Agreements- Minority Stake Transactions

- Minority stake transaction with path to majority
  - If initial transaction is a sale of a minority interest with the goal of a COC, the buyer will want minority protections until control changes at which point sellers will want minority protections
- Economic interest: top-line (revenue share) vs. bottom line (profit participation)
  - Governance and budget approval rights
  - Treatment in sale transaction
  - Alignment between majority and minority vs. free rider problem
- Transfer Restrictions
  - Minimum hold period
  - Drags/tags
    - Capture above market comp and other payments in aggregate transaction proceeds
    - Right to receive cash or liquid securities
    - Permitted Majority Sale & Permitted Minority Sale
  - ROFO vs. ROFR

# VIII. Operating Agreements- Minority Stake Transactions

- Minority Consent Rights
  - Typical rights
    - Admitting/removing members/issuance of additional equity
      - Carveouts for issuances to employees, subject to minimum holding %s for key management owners and appropriate restrictive covenants for new management owners
    - Hiring/firing key employees
    - Changes to investment strategy
    - incurring indebtedness/pledging assets
    - Entering new business lines or creating new funds/products
    - Purchasing another business
    - Sale transactions
      - Permitted Majority Sales & Permitted Minority Sales
    - Annual budget/Incurring expenses over a threshold (bottom line transaction)
    - Changing key service providers (especially auditors)
    - Commencing/settling litigation or administrative proceeding
    - Affiliate transactions
    - Compensation/bonus pool
    - Opening new offices
    - Formation of subsidiaries or joint ventures
- May impact Investment Advisers Act's "assignment" analysis and "control" analysis for bank regulatory purposes.

## **IX. Transaction Timeline: A year or more to complete transaction is not that unusual, so be patient**

- Engage investment banker (even if you are approached by buyer you like)
- Consult with banker on process for identifying buyer
  - Confidential discussions with a single buyer
  - Approach multiple candidates
    - Possible preparation of confidential memorandum
    - Identify buyer candidates to be invited for due diligence based on preliminary indications of interest
- Execute NDA (if not already done)
- Select counsel (if not already done)
- Organize due diligence (e.g., establish electronic data room)
  - Business

## IX. Transaction Timeline

- Legal/compliance
- Financial
- Narrow group of bidders or select winning bidder
- Execute term sheet/letter of intent (typically with exclusivity agreement)
- Prepare definitive agreements while more extensive diligence continues (e.g., disclosure of investors)
- Approach selected clients prior to signing
- Execute definitive agreement
- Post-signing, pre-closing
  - Solicit client consents, including solicitation of mutual fund shareholders
  - Seek regulatory consents (including HSR if required)
  - Buyer obtains financing, if required

## IX. Transaction Timeline (cont'd)

- No SEC approval required
- If buyer is a banking entity, regulatory approval of bank regulators may be required
- After HSR waiting period is terminated, focus on business integration
- Closing

## X. Key Takeaways

- Investment management M&A transactions are all about talent management and negotiating appropriate “carrots and sticks” to incentivize the team and maximize franchise value.
- Client consents are generally necessary in these transactions. It is important to understand the types of consent needed as well as how to allocate risk around the necessary consents in terms of adjustments to the purchase price and satisfaction of closing conditions.
- In light of unprecedented volatility in today’s market, think creatively about market risk. Profitability is directly tied to AUM, which is subject to market movement.

**QUESTIONS?**





## Biography



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Nathan R. Pusey advises public and private clients, primarily in the financial services industry, in mergers and acquisitions, joint ventures, and restructuring transactions. He regularly represents a variety of industry leaders in transactions involving traditional and alternative asset management firms, including acquisitions and sales of majority and minority investments, spin-outs, joint ventures, seed investments, and strategic relationships.

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Gitte J. Blanchet has 20 years of experience advising on corporate, mergers and acquisitions (M&A), and securities transactions. She focuses her practice on M&A for companies from emerging businesses to large public corporations including carveouts, divestitures, and asset acquisitions. As the deputy leader of the firm's Boston corporate practice, Gitte's active corporate practice represents public and private corporations, investment management firms, and private equity and venture capital firms.

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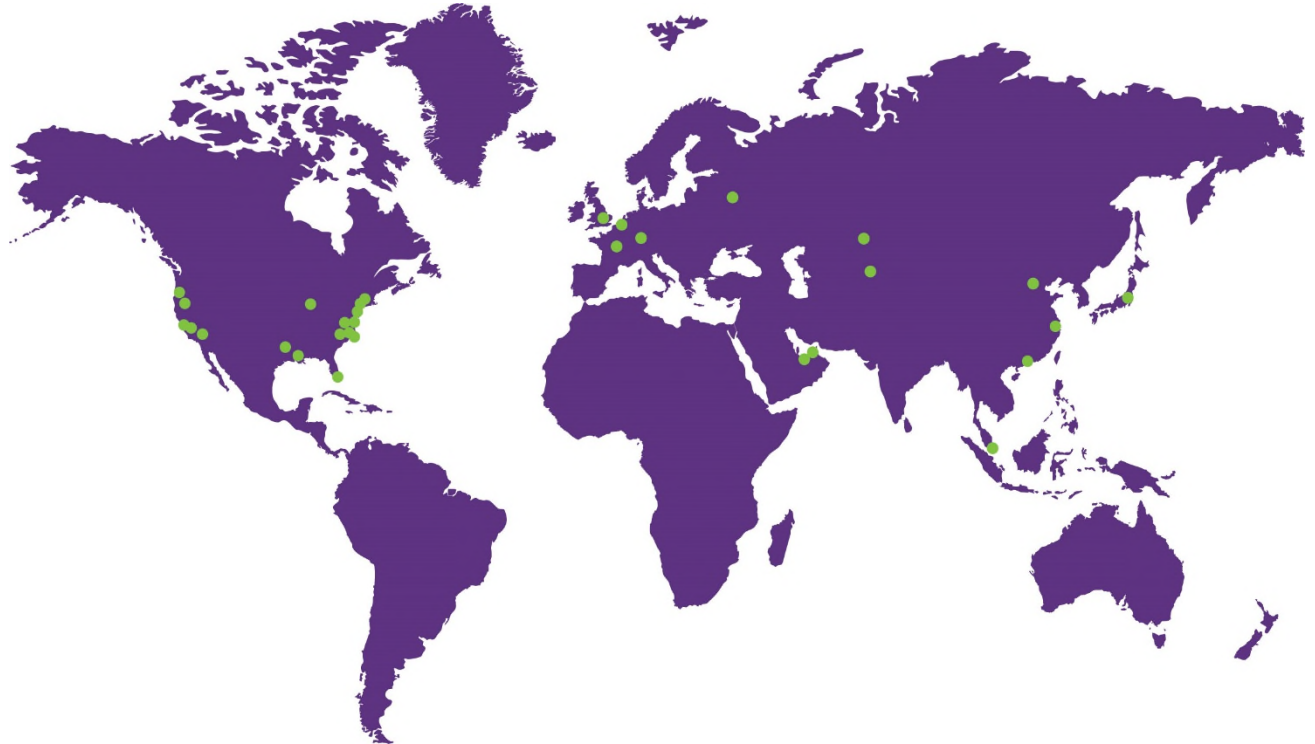
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