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Firms' Independence Key to Entrepreneurial Spirit

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As the asset management industry undergoes a period of restructuring and realignment, independence is emerging as an important strategic asset when it comes to gathering assets, building a brand and attracting and retaining employees.

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Independence is not without its challenges, however. In particular, tension often exists between the members of the founding generation, who understandably want to realize fair market value for the firm as they head towards retirement, and the desire to maintain the firm's legacy and independence.

The asset management industry is viewed, correctly, as a business with excellent return on capital for those who are successful. However, asset management is also a highly personal business. Firms often depend on a small number of highly motivated and talented individuals for their success. This can create challenges from an owner's point of view and has led to what can be characterized as an historic misalignment of interests between sources of capital and the asset management firms seeking this capital to manage growth, evolution and generational transition issues.

The principals of an asset management firm seeking capital have historically had four options: banks, private equity, strategic investors and self-financings. Each can have significant shortcomings from management's point of view. Banks are generally reluctant to lend to an enterprise with little in the way of tangible assets. When available, bank debt tends to be restrictive and of a shorter-term nature.

The cost of private equity capital is likely to be extremely high, and accessing that financing will almost certainly require firm principals to cede some measure of control. What's more, the presence of a private equity firm may trigger a liquidity event of a different kind down the road should these opportunistic investors seek to "put" equity back to management or sell it elsewhere in the future.

The third option is the sale of part or all of the equity to a strategic buyer, but that means the loss of a significant measure of independence and difficulty in providing a meaningful equity stake to the next generation of principals.

Finally, self-financing—effectively subsidizing the sale of equity to other members of the firm—also has significant limitations. It often requires the owner or owners to accept a substantial discount to the firm's true value to make the transaction affordable to the more junior, less well-compensated members of the team, or to saddle the next generation with onerous debt.

The notion of independence tends to cycle in and out of favor in the asset management industry. This is reflected in the ebb and flow of acquisitions and divestitures over the years, and in the valuations accorded to the firms involved. Not too long ago, distribution was held to trump manufacturing as the most effective tool for accumulating new assets. That led to a round of consolidation.

The flaws in this strategy quickly became apparent, in particular the potential for generating conflicts of interest between investors and firms emphasizing distribution of proprietary products. Less obvious and harder to quantify—but in my view no less significant—was the frequent adverse impact on firm management and culture that resulted from consolidating formerly independent asset managers into larger organizations.

The chemistry that allows an entrepreneurial-minded independent firm to succeed is easily disturbed and difficult to repair. The end result is often not only the loss of key personnel but also the degradation of performance.

Independence is a competitive advantage. Independent managers are better positioned to avoid pressure from outside owners or strategic partners that may compromise an investment process or encourage style drift. Independence becomes an asset to be nurtured and preserved.

At least some of the industry's larger players have arrived at this conclusion as well, as evidenced by the recent **Merrill Lynch-BlackRock** deal, which created a $1 trillion independent asset management firm.

For many independent managers, there will inevitably come a time when money is needed to provide liquidity to retiring principals, to fund growth or to distribute equity more broadly across the organization. Until recently, available sources of capital all required managers to cede some measure of independence or management control.

Fortunately, new sources of funding are starting to enter the market, drawing upon sophisticated financial modeling techniques and analysis of the asset management business to make capital available based on past and projected cash flows.

As the asset management industry continues to seek the proper balance between creating and managing investment products and delivering those products to the marketplace, it needs new, non-traditional sources of capital.

Financial structures that foster long-term independence with minimal disruption should be at the top of every privately held money manager's list of strategic financing options. MME

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