

The Perpetually Independent Firm: Promoting Stability and Continuity in the Asset Management Industry

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

The value of independence has been a subject of much debate in the industry for many years. Some of the most successful firms in the industry have achieved great success while remaining independent, with ownership and the resulting incentives retained by the firm's principals. Capital Group, Wellington Management, Dodge & Cox, and Grantham, Mayo Van Otterloo (GMO) are notable examples.

Prospective clients often value such independence when searching for quality asset management services. Talented professionals are also drawn to these organizations when looking for attractive and compelling places to work, which in turn, further enhances the economic and productive values behind the brand.

But independence has its challenges as well. Perhaps most prominent among them is the inability to provide substantial liquidity to retiring principals as equity ownership passes from one generation to the next, a key issue for employee-owned firms. An internal transfer of ownership often involves individuals who lack the financial means to provide the selling principals a fair value for their received interest in the firm.

Historically, fair value has been provided primarily by the sale of part or all of the equity of an asset manager to a third party buyer. This, however, erodes or eliminates independence while failing to provide a meaningful equity interest to the next generation of principals. These transactions reduce a firm's autonomy, do not allow remaining principals to have ownership in a firm's success and often erode franchise value. The lack of equity participation for key talent contributes to employee turnover, which may negatively impact investment performance and client service, and hamper the gathering of new business mandates.

When company principals fail to meet the needs of their key employees, they are building less value for themselves. Conversely, by providing successive generations with the means to continue to build upon the value originally created by the founding principals, a company can generate better results for its clients, its employees, and ultimately its owners - systematically creating, preserving and extracting long-term value during each stage of its development.

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Traditional Capital Sources: A Misalignment of Interests

Owners of privately-held asset management firms historically have had a limited number of options available to them when attempting to capitalize the value of their businesses. In order for the owners (often the firm's managing principals) to receive value for their business, they have typically resorted to third parties to provide the capital for liquidity. If an asset management firm wanted to remain independent and sell equity to other members of the firm, the owners either took a significant discount to their value by subsidizing or self-financing the purchase, or saddled the next generation with the onerous requirements of bank debt. If this was not desired or possible, the firm would need to find a third party to purchase equity which would allow the owners to be paid a "fair value", resulting in a firm that was no longer claim to be truly independent.

Bank Debt: Independence at a Price

Most asset management firms lack the capital base and physical assets to provide the needed security for lenders to make bank debt an efficient source of capital. In contrast to other industries that frequently use leverage in the normal course of business, asset management firms often lack the appropriate banking relationships. As a result, lenders often impose onerous financial covenants on the business, including the requirement of personal recourse to the firm's principals, in order to provide credit.

To the extent that personal recourse is not an impediment to utilizing bank debt, given the risk-aversion of lenders, the firm can only monetize a limited portion of its free cash flow. In fact, most banks have not been very aggressive lenders to the asset management industry, if available at all. This limitation on capital will result in only a portion of equity being financed; or the sellers accepting a potentially deep discount for the equity being purchased or redeemed. Even in those instances when the firm is able to find a bank to assist the next generation in its purchase of equity, the debt will normally have a term that is under three years and, as a result, require some sort of liquidity event within that timeframe. This can make it extremely difficult for the potential new owners to find comfort in utilizing bank debt, given the cyclicity of the asset management business.

For these reasons, attempting to utilize bank financing is not usually a desirable option for principals seeking to develop an ownership transition plan that provides competitive value.

Private Equity: Moderate Capital with Moderate Independence

Historically, selling equity to a third party was the only real option for principals of asset management firms who wished to receive a meaningful amount of capital for their business. Those committed to retaining a sense of operational independence would seek to sell a minority stake in the business, often to a private equity firm.

Because these purchasers are not investing in an asset management firm with the expectation of realizing synergies and improved rates of return, the sellers are normally not able to maximize their value. Further, while the investors may be somewhat flexible as to the amount of equity they purchase, they will typically attempt to impose some degree of governance control over the asset manager, usually including voting rights, compensation limits and consent requirements. This is a less than ideal situation.

Beyond this archetypical desire to influence the operations of the firm, private equity investors might also seek to influence the long-term economics associated with their investment. To insure that investors realize targeted returns on their investments, private equity transactions can include the right to “put” equity back to management in the future. Given the unlikely ability of management to pay the pre-negotiated price (typically the formula is pre-negotiated with the actual amount being variable), this exit by the private equity investor can precipitate a liquidity event, which may result in the sale of the equity of the firm to another third party at a time that is not necessarily in the best interest of investors or management.

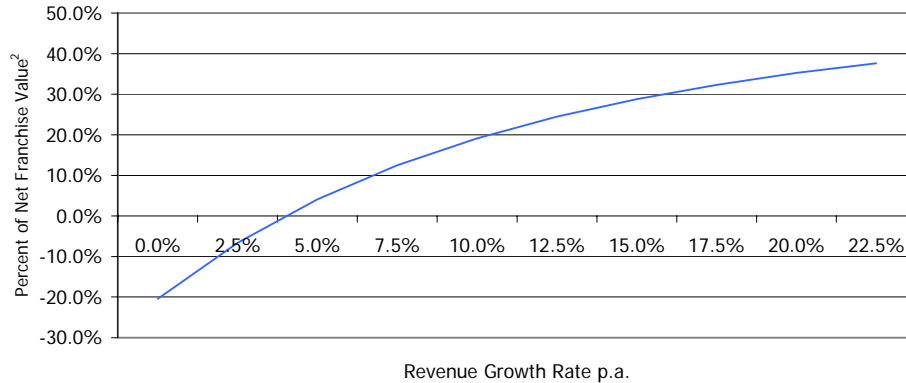
Beyond this, private equity financing does nothing on its own to transition ownership to the next generation, but rather shifts ownership out of the firm.

Strategic Acquirer: Maximum Capital with Limited Independence

If the owners of an asset management firm are intent on maximizing their current value, they will sell to a strategic partner who will pay incremental value based on its view of perceived synergies and the associated long term growth potential. Further, with a more diversified capital base, a strategic acquirer might also require lower rates of return than an investor financed entirely with equity capital, thus further enhancing valuations.

This approach provides substantial capital to the sellers, but it typically comes at a high economic cost – particularly for growing organizations. Beyond the simple cost of funds, the perpetual nature of equity capital's interest in the firm's economics contributes to variability in the effective cost of capital. The chart below demonstrates the percent of the franchise value of the business the owners give up by selling equity across different growth scenarios.

**Opportunity Cost of Equity Transaction:
50% of Firm Sold at 9.5x Cash Flow**



As a result, selling principals will seek to minimize their effective cost of funds and, therefore, will be motivated to maximize value and “sell high” – liquidating ownership positions when they believe the value of their equity is at its peak and the firm’s outlook seems to them less robust than the current environment. Accordingly, common interests give way to “competition” between buyer and seller and goals are systematically misaligned as a result.

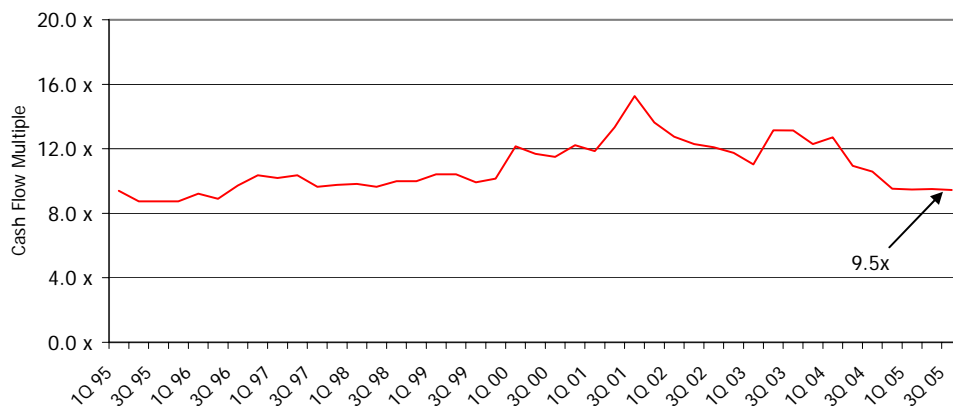
In the past, most financial institutions were interested in acquiring an asset management business in order to receive the “recurring” fee-based revenue associated with the industry. In the late 1990s, almost any asset management firm that decided to sell its equity was able to find an assortment of strategic buyers (e.g. banks, insurance companies, broker/dealers). These organizations typically had substantial distribution capabilities, and believed that by also owning the manufacturing of investment management products they could benefit further from the flow of retail assets into the markets, thereby increasing their own profitability. These perceived synergies resulted in marginal asset management firms selling for attractive multiples of cash flow (i.e. 10-12x EBITDA) while the top tier managers received meaningful premiums – sometimes selling for as much as 15x cash flow or more.

When the bull market of the 1990s came to an end, consumers of asset management services and products began to realize that the firm selling the product was not necessarily the best firm to manage that same product, particularly as real and perceived conflicts of interest came under scrutiny. As a result, distributors (many of whom had been strategic buyers of asset management firms) often reemphasized offering third party product to their clients. Realizing that the relationship was more valuable to them than the ability to manufacture the product, they have since embraced open architecture as the preferred distribution model.

² Net Franchise Value of a firm is determined as the present value of cash flows over a ten-year period, discounted at 15% rate, plus estimated terminal value equal to 9.5x EBITDA at the end of year 10. The analysis examines that portion of Franchise Value allocated to the 3rd party strategic acquirer, less the upfront proceeds of the transaction.

This movement toward open architecture has made quality independent asset management firms all the more valuable, though it has all but eliminated the notion of premium pricing for the industry as a whole. For those principals looking now to sell their equity for maximum value, the limited number of potential third party buyers has brought about the end of the “sellers market” with valuations dropping for attractive firms to 10-12x cash flow. The range for typical firms has declined to approximately 8-11x cash flow. This range is in line with historical trends³. In addition, these acquirers purchase the majority, if not all, of the asset management firm’s equity and therefore exert control over its operations, regardless of the perceived autonomy that they may claim to give principals.

Historic Acquisition Multiples of Private Asset Management Firms



Asset Management Finance: Revenue Share Interests

The historically conflicting objectives of independence for asset management firms and liquidity for their owners are mutually addressed in a novel form of financing made possible through the use of Revenue Share Interests (“RSI’s”). Developed by Asset Management Finance Corporation (“AMF”), RSI’s provide significant capital to asset management firms or their principals in exchange for a percentage of top-line revenue for a fixed period of time. Due to the passive nature of this limited-term financial instrument (term length is between 7 and 20 years), RSI’s do not result in the assumption of ownership by AMF. Moreover, the RSI structure effectively transfers significant business risk to AMF, due to the revenue sharing nature of the financing arrangement. During the investment period, AMF generally receives its share of revenues only, with no guaranteed minimum payment or recourse to firm or individual assets. However, through the use of caps and floors or other forms of “optionality”, multiples paid can be further enhanced.

³ Source: Putnam Lovell NBF Securities, as of September 30, 2005

The RSI structure accommodates 100% retention of equity by the asset management firm and is an extremely effective way to transfer ownership to individuals within the firm, allowing the organization to keep in place the powerful incentive of employee ownership. Furthermore, through a series of RSI structures, it is possible to completely turn over ownership without sacrificing autonomy or independence. The all-in valuation to selling principals can be comparable to, if not higher than the value if they were to sell to a third-party equity buyer. The primary factors that will influence the aggregate valuation will be the revenue growth and volatility of the business, the amount of revenue financed by AMF, and any expansion of the firm's margin of operating profitability.

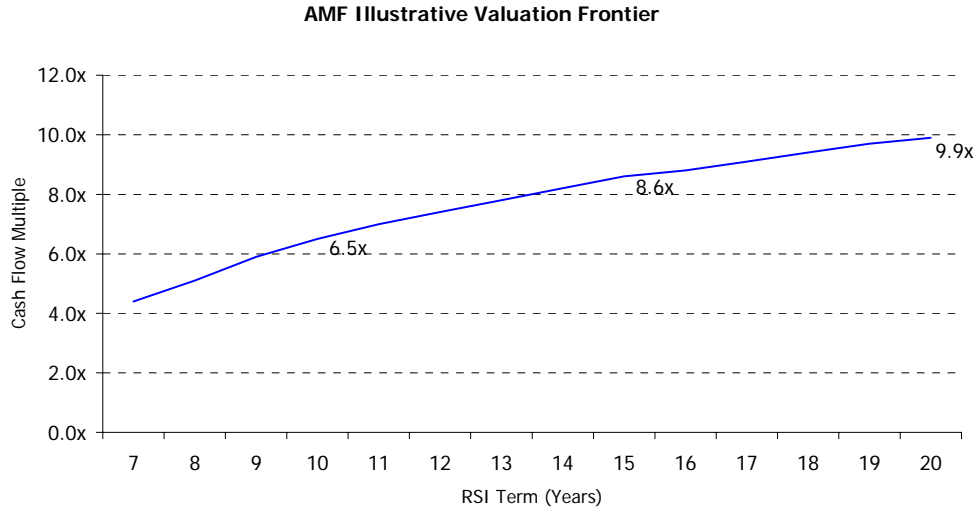
As part of its underwriting program, AMF examines the drivers of growth in assets under management ("AUM") and corresponding revenues earned by an asset management firm - specifically, the firm's track record, not only with respect to product performance but also with respect to the firm's ability to attract and retain clients.

The expected revenue growth and corresponding volatility of that growth will determine the value of AMF's investment, expressed as a multiple of the cash flow it is monetizing. As one might expect, the better the balance between risk and reward, the better the multiple for a given time-horizon

Valuations increase for longer investment periods, and the range of valuation multiples produces a frontier of investment values based on term. For example, in the hypothetical illustrative frontier⁴ below, representing 20% of the revenues for an asset manager with a \$20 million run rate, AMF might invest \$26.0 million for a ten-year investment (6.5 x \$20.0 million x 20%) and up to \$39.6 million for a twenty-year investment (9.9 x \$20.0 million x 20%). At twenty years (the nearest point to a perpetual equity-like investment), AMF's valuation of 9.9x for this hypothetical opportunity is slightly above the current average acquisition valuation of 9.5x⁵ for asset management firms.

⁴ See hypothetical asset manager description on page 7

⁵ Source: Putnam Lovell NBF Securities; September 30, 2005



AMF, as a rule, does not monetize more than one-half of the free cash flow or profits of a firm. This restriction is to assure that the owners of the asset management firm maintain sufficient “skin-in-the-game”, as well as to protect against adverse operating effects from any compression of profit margins over the life of the investment period. As a result, AMF cannot completely transfer 100% of the ownership of a firm in a single transaction.

However, through a series of two or more successive transactions, a firm can effectively transfer all of its ownership to the next generation of principals, generally providing value comparable to what could be expected from a strategic sale, without considering any positive impact enhancement associated with the proper alignment of interests or the enhanced organizational stability that comes from the firm remaining employee-owned. This can be seen in the following case study, where we have demonstrated the power of this technique using a simple hypothetical example, portions of which are referenced above.

Case Study: ABC Capital Management

Company Overview

Consider ABC Capital Management (“ABC”), a hypothetical asset manager which runs \$3.0 billion of actively managed portfolios broken down roughly into 80% Core U.S. Equity and 20% Core U.S. Bonds. ABC’s investment performance has generally been good, outperforming the benchmarks in most recent periods. ABC has demonstrated a relatively stable pattern of attracting and retaining institutional clients and the firm has experienced positive net client related flows of 3% to 5% annually, with no significant terminations relative to its asset base. Through discussions with the firm, AMF has no reason to expect this behavior to change in the foreseeable future.

ABC earns roughly 67 basis points of advisory fees per annum on assets under management, or \$20 million on current assets under management. In addition, the firm's current profit margins are 40% of revenues, or \$8 million.

ABC is 100% owned by its Founder who, as he approaches his fiftieth birthday, would like to put in place a succession plan that would equitize and incentivize several key employees he has identified as the future leaders of the company. The Founder, while desiring to preserve the autonomy and entrepreneurial environment of the firm he created, wants to receive a fair value for liquidated equity in support of a plan for a generational transfer of ownership. He is still an important contributor to the business and wishes to remain active for many years to come, as he sees significant opportunities for continued growth. As such, he would like to liquidate his interest in the firm over time, and retain some of the upside potential of the firm.

AMF Structure

Based on the attributes of ABC Capital Management, AMF has valued an expiring Revenue Share Interest in the firm, which is illustrated on page 6.

The actual dollars invested in a single transaction would be a function of investment term and the size of the partnership interest that ABC is seeking to monetize. For example, a Revenue Share Interest where AMF participates in 20% of the revenues of ABC (one-half of the free cash flow at a 40% margin) for a ten-year period would result in a \$26.0 million upfront investment.

A. Run Rate Revenue	\$20.0 million
B. Free Cash Flow Margin	40.0%
C. Free Cash Flow	\$8.0 million
D. 50% of Free Cash Flow	\$4.0 million
E. AMF Maximum RSI %	20.0%
F. Ten-Year Cash Flow Multiple	6.5x
G. AMF Initial Investment ($G=A \times E \times F$)	\$26.0 million

Since AMF limits the amount that it will finance in a single transaction to one-half of the total free cash flow or profits, AMF can structure two sequential ten-year transactions (or any other term combination) in ABC Capital Management in order to accomplish a complete generational transfer of equity.

Upon its initial investment in ABC, AMF monetizes half of the equity units of the firm from the Founder and converts its interest to a 20% participation in ABC's revenues for the next ten years. The equity rights and profits associated with these units are then free to be transferred to designated individuals, pursuant to ABC's generational transfer strategy, although the profits related to those transferred units are reduced by AMF's revenue participation during the ten-year period.

Over the ensuing ten years, the Founder continues to hold units of the firm entitling him to one-half of the profits of ABC. To capture the economic value of this profit participation, we assume that ABC's cost structure, like many asset management firms, is highly variable, with a substantial portion of its annual expenses in the form of bonuses and variable compensation. For ABC, we postulate that seventy percent of its current costs are of a variable nature, with the balance represented by fixed expenses growing at a 5% per annum rate. Therefore, as revenues increase over this ten-year period, the profit margin of the business may expand beyond its current 40% level. Under our assumptions, should revenues grow at a compound annual rate of 12.5% (a rate consistent with the identified attributes of ABC Capital Management); the margins of the firm will expand to roughly 50% by the end of year ten. Conversely, if revenues are flat over the ten-year period, the margins contract to approximately 34%, as the growth of the fixed expenses (5% p.a.) reduces the overall variability of the cost structure and therefore erodes profitability.

Despite AMF's focus on the revenues of a firm, the emphasis on ABC's profits is important in its analysis for two principal reasons: an increase in revenues between the two AMF transactions will (i) increase the efficiency of the firm and thereby the profits retained by all owners of the firm and (ii) for the second transaction, the one-half of the firm's free cash flow remaining to be monetized will represent a greater portion of revenues, and therefore greater economic value. For example, under a 12.5% annual revenue growth scenario, AMF's second investment would monetize the remaining half of the Founder's units in the partnership, which, at the end of year ten, account for 25% of the firm's revenues, compared with the 20% monetized in the first transaction.

After ten years under a 12.5% annual revenue growth rate, the economic characteristics of ABC and the details of AMF's second investment⁶ are as follows:

A. Run Rate Revenue	\$64.9 million
B. Free Cash Flow Margin	50.1%
C. Free Cash Flow	\$32.6 million
D. 50% of Free Cash Flow	\$16.3 million
E. AMF Maximum RSI %	25.1%
F. Ten-Year Cash Flow Multiple	6.5x
G. AMF Initial Investment (G = A x E x F)	\$105.9 million

As a result of revenue growth and margin expansion, AMF's second investment to monetize the Founder's remaining equity interest in ABC is worth \$105.9 million at the end of year ten.⁷ Applying a weighted average cost of capital estimate for the asset management industry of 15%, the second investment is worth \$26.2 million in present value terms to the Founder. Taken together with the initial investment of \$26.0 million, this results in a total present value consideration paid to the Founder of \$52.2 million.

It is important to note that the Founder's real economic value should include the value of interim partnership distributions through year ten, for the half of his ownership not yet equitized. Discounting the Founder's share of interim profits of ABC to present value, the all-in value to the seller becomes \$73.8 million, or 9.2x his current interest in ABC.

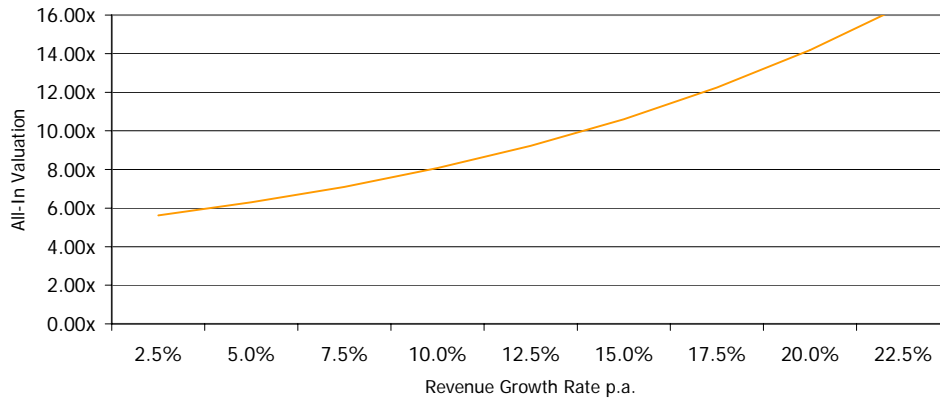
Viewing the Founder's all-in value in this way is, of course, partially dependent on the revenue growth realized until his interest is completely monetized. The graph below illustrates the all-in present value⁸ expressed as a multiple of current value of the Founder's interest in cash flows under different growth scenarios.

⁶ As a practical matter, ABC Capital Management would be completely revalued for the second transaction. For these purposes, we have assumed that the business and the corresponding cash flow multiple are both identical, except for the passage of time as it relates to the size of the business. Accordingly, the second transaction assumes stable growth in AUM, consistent with a modest long term US equity expectation and consistent client service experience.

⁷ This valuation is enhanced by 25% as a result of the margin expansion. If margins were stable at 40% despite the 12.5% p.a. revenue growth, the valuation for the 2nd ten-year term financing would be \$84.4 million.

⁸ All-in Valuation includes the present value of AMF investment proceeds (both transactions) to the Founder, as well as the Founder's profit allocation over the next ten years. 15% discount rate applied, representing an estimate for the weighted average cost of capital for the asset management industry.

**Valuation of Seller's Interest
Complete Generation Transfer**



This valuation dynamic has obvious benefits to the Founder who might wish to retain some upside from future growth of the business over the next ten years. In this regard, a two-part liquidation of the Founder's interest could have significant economic advantages over a 100% equity sale today. Relative to current sales multiples for privately held asset management firms of 9.5x⁹, AMF's financing techniques offers a competitive all-in valuation, while preserving the autonomy of the firm and offering an ownership incentive to attract and retain top talent.

Conclusion: RSIs Allow Managers to Focus on Building Their Businesses

Revenue Share Interests represent a new, efficient, sustainable capital resource for the asset management industry. Asset managers can access significant risk sharing capital without sacrificing autonomy or ownership and, as a result, are free to pursue an optimal re-alignment of the economic interests of those principals deemed to be critical to the continued success of the company. By transferring meaningful equity participation within the organization at a fair price, asset management firms can continually motivate, attract and retain top talent. As the marketplace embraces the virtues of the pure play paradigm, asset managers using RSI's can now effectively avoid many of the disruptions and pitfalls that traditionally accompany a search for liquidity, allowing them to focus on performance, brand building and creating franchise value.

⁹ Source: Putnam Lovell NBF, September 30, 2005