

Private equity goes upstream with asset manager investments

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By Thomas Mason

In a private equity market flush with investor dollars, firms could increasingly be setting their sights on the asset management industry, a space offering such enticements as a legion of high-net-worth individuals and a near guarantee of organic growth. And while there are some potential trouble spots, such as the ability of entrepreneurial money managers to jump ship, industry observers say it is easy to avoid these pitfalls if one has the right expertise.

There is little question that private equity investors have deep pockets these days, as evidenced by blockbuster deals like Blackstone Group LP's agreement last month to acquire Equity Office Properties Trust for \$36 billion. Furthermore, a group of roughly a dozen industry heavyweights, including Blackstone, Apollo Management LP, Carlyle Group LTD and Kohlberg Kravis Roberts & Co., calculated that private equity managers raised more than \$300 billion in 2006 and that capital available to the industry stands in excess of \$700 billion.

Some private equity forays into the asset manager space have also managed to grab headlines, like Hellman & Friedman LLC's announcement in May that it would acquire Gartmore Investment Management Plc from Nationwide Mutual Insurance Co. At the time, the deal represented the single largest management-led buyout in the investment management industry by AUM, according to Putnam Lovell NBF Securities.

More recently, Comerica Inc. made a splash in July with word that it would be selling off the majority of its asset manager arm Munder Capital Management, which sparked a bidding war among private equity firms. While Crestview Partners and Grail Partners LLC ultimately emerged victorious, TA Advisers, Summit Partners LP, Apax Partners and Lovell Minnick were

all reportedly hungry for the Birmingham, Mich.-based asset manager.

But while several of the aforementioned firms best exemplify the larger players in the game, with many investing in a wide variety of sectors, there are also a number of private equity funds that are dedicated entirely to the asset management industry, as well as those willing to take more modest stakes.

Rosemont Investment Partners LLC, for example, typically invests between \$3 million and \$20 million in asset management companies that will give the West Conshohocken, Penn.-based firm a stake of between 15% to 50%. Over the past six years, it has completed such transactions as taking a minority stake in Allegiance Capital LLC, a "core" fixed-income manager based in Huntington Beach, Calif., with over \$4.8 billion in AUM as of June 30, and providing equity for Cadence Capital Management to acquire a majority stake from Allianz Global Investors AG.

New York-based Circle Peak Capital LLC also has a particular focus on the asset management industry, typically seeking to work with management in its deals. For example, in November the firm joined Falcon Investment Advisors LLC in the sale and recap of WealthTrust Inc., formerly a unit of Regions Financial Corp., backing WealthTrust founder and CEO M. Rush "Rusty" Benton and the rest of the management team.

Another firm worth mentioning, Convergent Capital Management LLC, which is a subsidiary of City National Corp., also focuses on asset managers; the organization currently consists of 10 affiliates with more than \$9 billion in AUM and administration. Its roster includes such names as Grand Rapids, Mich.-based AMBS Investment Counsel LLC, which provides both corporate and public retirement plans management as well as individual advisory to wealthy clients, and Honolulu, Hawaii-based Cadinha & Company LLC, a nationally recognized investment counsel-

ing firm which also has a branch office in Nashville.

And while not strictly a private equity firm per se, Asset Management Finance, a company started by former Putnam Investments CEO Norton Reamer, employs a completely passive model. In transactions with money managers like Newgate Capital Management LLC, AMF enters into a "revenue share interest" agreement, which provides financing in exchange for a portion of Newgate's revenues over a period of time and can be structured for anywhere from seven to 20 years.

Berkshire Capital Securities LLP noted this increased interest in asset managers in its latest quarterly newsletter, also profiling the activities of Rosemont and AMF, and arguing that the traditional aversion to investing in the space has begun to dissipate. While PE firms might have once viewed asset managers as too risky, given the lack of brick-and-mortar operations and the limited ability to employ cost reductions in the typically small asset-management firms, according to Berkshire, industry trends like growth in high-net-worth individuals have helped to add some luster to the space.

"With respect to the organic opportunities in the wealth management space, given the baby boomer dynamic, there is a lot of pent-up need for those types of services. So it's a pretty good bet to be in the wealth-management space in particular," Elizabeth Nesvold, a managing director and principal for Cambridge International Partners, told SNL Financial. As a former partner with Berkshire Capital, during which time she co-founded the first wealth management M&A advisory practice in the investment-banking industry, Nesvold says she has seen activity "evolve nicely" over time and suspects that opportunities for dispositions have also fueled interest in the space.

"Private equity firms tend to like to back management in the recap of a business. Management-led buyouts are suggestive

of a more dynamic business growth trajectory with the prospect of premium pricing on the ultimate exit, whether through a sale to a strategic partner or through an IPO."

The industry also remains relatively fragmented, another possible lure for PE investors, with SNL data showing that out of roughly 8,700 registered investment advisers with positive discretionary AUM figures, over 7,000 have less than \$1 billion in discretionary AUM. Furthermore, only 18.8% of all discretionary AUM is managed by the top 10 firms. By contrast, figures for the banking industry indicate that 42.7% of all retail deposits are held by the top 10 firms, a percentage which has steadily climbed within the past few years.

As Lovell Minnick Partners LLC Principal Robert Belke also points out, asset management is a relatively high-margin business that tends to throw off a lot of cash, and its heavy reliance upon equity market performance almost guarantees organic growth over an extended time frame. "Long-term, generally the market is going to go up, which means long-term, the assets under management will go up even if nothing else happens," he told SNL. "That's one element of the space that I think a lot of people overlook."

Belke also said that in an industry with such an intense focus on people, where the retention of money managers can be critical, one has to understand the ins and outs of compensation and bonus plans. "If you're good at aligning the interests of people through equity incentives and compensation, you can be very successful as a private equity firm." While Lovell Min-

nick can be considered an active investor, often taking large positions and seeking at least one board seat to have a hand in certain strategic decisions, Belke said Lovell Minnick leaves the day-to-day asset management operations with the company. "We're not going to tell them how to manage money. We will assist them in how to manage their business. We'll help them do acquisitions or lift-outs, or we'll help them bring in teams of people that we might know about."

For Capital Advisory Group Inc. founder and CEO W. Richard Smith, retaining autonomy over his Richmond, Va.-based wealth advisory firm was a foremost concern in his decision to partner up with Focus Financial Partners LLC, a company that has formed a consortium of investment advisers across the country with a \$35 million initial investment from Summit Partners.

"The Focus model allows you to maintain your sovereignty as an independent firm while having the benefits of being part of a bigger, national company," he told SNL.

In a structure similar to National Financial Partners Corp., Summit and Focus have sought to create a roll-up of relatively large independent firms, generally with a minimum of \$350 million in AUM, with Focus typically taking a 40% to 60% stake in each firm's ongoing economic interest and putting some financial controls in place to ensure the firms aren't "walking out the back door with the money," as Kevin Hoyle, a founder of another Focus partner firm, HoyleCohen, told SNL.

In return, Focus provides such benefits as incentive pools for employees and assistance in succession plans, which can

be nonexistent for some wealth advisers, according to Smith. Focus also provides capital for the firms to acquire other shops, which Smith said is becoming increasingly important in light of Wachovia Corp.'s move to allow its brokers to create more entrepreneurial practices. "As that becomes more the norm in the wirehouse industry and the brokerage industry, you're going to find that the independent advisers don't have the distinct objectivity advantage, and they'll have the disadvantage of not having all the capital that the large brokers do," he said.

The asset manager business model also bears some similarity to that of private equity firms — albeit with some important differences — in that it involves the managing of investor money with an eye to maximizing returns.

But it is this sort of overlap that does not square with the thinking of Paul Schaye, a managing director for investment advisory firm Chestnut Hill Partners. "To pass that money back upstream just doesn't make sense to me," he told SNL. Since a portfolio manager is supposed to diversify his or her portfolio allocations, the act of putting money back into the hands of asset managers, who will perform a similar task, seems somewhat counterintuitive.

Still, investors are not likely to complain if a private equity firm can generate high enough returns, irrespective of industry, and Nesvold believes the asset management space offers that opportunity. "If you think about TA Associates Inc., [which] is one of the notable, early-on private equity investors in the space, having backed [Affiliated Managers Group Inc.], there is clearly an opportunity for 10-bagger returns that private equity firms dream of."