Asset Management M&A In The COVID-19 Era: Part 1

By Joe Castelluccio and Reb Wheeler (June 9, 2020)

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In the early stages of the COVID-19 crisis, the ripple effects of the pandemic and the ensuing economic turmoil have combined to chill the M&A market across most industries. The asset management sector has been no different.

The reasons for this are no mystery — business models and valuations in this sector are closely tied to the performance of the capital markets and the value of assets under management. It is easy to see how plummeting markets and increases in volatility would make asset management deals more difficult.

At the same time, some of the prepandemic dynamics in this sector suggest that we may see asset manager deal activity recover sooner than M&A in other industries. In this environment, it will be important for parties and their financing sources and advisors to approach deals with a well-developed toolkit for addressing the challenges that will inevitably arise.

In a three-part article, we will consider what may lie ahead for asset management M&A and discuss key considerations for deals in this sector.

In this first installment, we will look at some factors that may drive deal activity in this sector despite the pandemic, and discuss the impact of market conditions on deal structures and valuation.

The following two parts will focus on regulatory issues, retention of key personnel and considerations for getting to closing, all in the context of M&A in the sector in light of COVID-19.

Prepandemic Dynamics May Drive Continued Deal Activity in the Asset Management Sector

While COVID-19 has created a new normal in many aspects of business, certain trends and dynamics in the asset management industry that were driving strong deal activity before the pandemic have not changed. As a result, these factors could drive a speedy recovery in deal flow after an initial phase of relative inactivity.

These potential drivers include the following:

Declines in Valuations Could Lead to Opportunities

Precrisis, the years-long bull market and the swift pace of asset manager M&A had led to an upward trend in the multiples buyers were willing to pay asset management businesses.

Asset managers with fundamentally sound businesses and investment strategies are still inherently valuable, but market turmoil and uncertainty about when AUM and revenues will recover may lead to a downward adjustment of valuation multiples for these businesses. That, in turn, could generate renewed momentum in deal activity in the sector.

Generational Transition

Since the 2007-2009 financial crisis, generational turnover and manager/founder retirement has been a significant driver of deals in the asset management industry. Managers who are currently near retirement may not have the career runway to postpone an exit transaction until business conditions recover. This may compel owners to continue to seek exits notwithstanding potentially lower valuations.

Digitization of Financial Services

While most institutional and high-net-worth asset management businesses continue to be people-centric and relationship-driven, technology has and will continue to disrupt and transform the industry. Firms that are behind in addressing this in their businesses may come to market as sellers —to those better utilizing technology — or as buyers — to catch up to the competition.

Asset Aggregation Is Still a Thing

Prior to the COVID-19 pandemic, asset management businesses were attracting significant levels of private equity investment. Private equity sponsors continue to have capital to put to work and a mandate to do so.

Reports from early 2020 indicated that private equity funds were holding approximately $1.5 trillion in dry powder. It seems likely that a portion of that capital will continue to be directed toward acquisitions of asset managers.

It is also worth noting that, while the effects of the current pandemic are similar in some ways to what we saw in the 2007-2009 financial crisis, no two crises are the same. Some distinctions can be drawn between what's happening today and the situation in 2007-2009.

In particular, while declining equity markets and increased volatility certainly played a role in the M&A market slowdown in the asset management sector during 2007-2009, there were other factors at play that are thus far not at play in the current crisis, including a near-total lack of debt financing for deals, due to frozen credit markets, and a crisis of confidence in buyers' ability to diligence advisers, resulting from the discovery of Bernie Madoff's Ponzi scheme.

Without those added complications, asset management M&A activity may recover more quickly than expected. That said, the deals that get done first in this environment will have to be able to solve for two factors that existed in both the last crisis and the current one — volatility and challenges in coming to terms on valuation of assets and businesses.

Impact of Volatility and Valuation Challenges on Deal Structure and Terms

Issues relating to asset valuation and uncertainty as to investor behavior are likely to pose challenges to pricing and structuring acquisitions involving asset management businesses until the economic turmoil being wrought by the effects of COVID-19 subsides.

In the near term, parties pursuing transactions in the industry are likely to focus in particular on how these issues affect earn-outs and other deferred-consideration structures, purchase-price adjustments, and closing conditions based on financial metrics.

Complicating factors facing parties pursuing M&A transactions involving asset management businesses in the wake of the pandemic include:

Volatile Asset Values

The fallout from COVID-19 and related governmental restrictions has led to steep drops in the prices of broad swaths of publicly traded securities.

At the same time, the fluid nature of the pandemic and the world's response has resulted in extreme volatility in the capital markets, such that predicting with any degree of confidence where prices may be headed over any given time frame is nearly impossible.

Valuation of Illiquid Assets

Aside from the volatility in the public capital markets, asset managers investing in illiquid markets — such as private equity, real estate, venture capital, private credit, funds-of-private-funds and the like — have had their own issues determining proper asset valuations.

The problems posed by uncertain valuations can cause more headaches for some managers than others. In particular, managers that charge fees based on AUM may face difficulties valuing assets for purposes of calculating their fees, and managers of open-end private funds may also face challenges in striking a net asset value for the fund for purposes of calculating both redemptions and new subscriptions.

Client Withdrawals and Redemptions

Many firms managing portfolios of liquid securities have faced, or may face, higher-than-usual rates of withdrawals, as some investors become spooked by global events and others require funds to meet expenses.

Also, some asset managers of open-end private funds dealing with the challenges of valuing illiquid assets in the current environment have resorted to imposing redemption gates or suspensions. In those cases, there may be large redemption queues accumulating during a period where redemptions are limited or suspended, which could lead to eventual asset outflows that may also damage long-term relationships with investors.

These issues are likely to ripple through structures and deal terms for asset manager acquisitions in the near term. Areas of particular focus are likely to include:

Earn-Outs

Deferring some portion of the deal consideration through an earn-out tied to certain performance metrics for the target business is very common in asset manager acquisitions.

Depending on the nature of the target business and the type of assets its clients or funds are invested in, earn-outs tend to be tied to changes over some time period after closing in metrics such as AUM, run-rate revenues, profitability, or a combination of the foregoing.

These metrics, in turn, are often based on complex calculations that may or may not take into account factors such as client inflows and outflows, market movements or other changes in underlying asset values or that may contemplate thresholds above or below which certain changes will not be taken into account. Considerations for earn-outs in asset management deals in the current environment include:

- It seems likely, given the uncertainties discussed above, that deals that get done in the near term will allocate more deal consideration to the earn-out than to an upfront payment. In addition, given the lack of visibility into how long it may take for businesses to stabilize, parties may be inclined to stretch earn-outs over a longer period of time.
- Parties should be careful about the extent to which earn-out payments are tied to changes in asset values. Given the volatility in liquid asset prices and the potential uncertainty in the values of illiquid assets, metrics tied to client retention or flows or run-rate revenues metrics that disregard changes in AUM based on market movements may be preferable.
- Parties should be cautious in using metrics that take into account client outflows if a manager has imposed limitations on withdrawals or redemptions. In those situations, any historical withdrawal/redemption rate may not be indicative of what may come when restrictions are lifted.
- There will likely be an even greater focus on post-closing buyer covenants intended to support achievement of the earn-out metrics. Sellers will likely push for more control over decisions as to matters such as rate changes or personnel moves that could affect the business given their increased skin in the game. At the same time, uncertainty about what the future may bring will likely compel buyers to insist on flexibility to manage the business as they deem appropriate as circumstances change.

Purchase-Price Adjustments

Many of the issues that are likely to bear on earn-out structuring may also come into play in negotiating purchase-price adjustments. Purchase-price adjustments in asset management transactions are often tied to, among other things, changes in the same kinds of metrics that are used to calculate earn-outs.

Parties should be cautious about tying adjustments to calculations that will be overly influenced by changes in asset values. Changes in AUM based on the significant volatility of liquid assets in the current environment could give rise to surprises.

In the case of businesses managing client accounts or assets invested in illiquid assets, the parties should be as prescriptive as possible about how those assets will be valued for purposes of the purchase-price calculation, to the extent variations will be taken into account. Detailed methodologies and agreed-upon illustrative examples of their application will help avoid disputes.

Value-Based Closing Conditions

The challenges relating to asset valuation and volatility and unpredictable client behavior in the current environment are likely to also lead parties to focus on closing conditions tied to financial metrics and client retention.

These kinds of closing conditions often interrelate with purchase-price adjustments. For example, a purchase-price adjustment may have a limit or a collar, but the buyer may be able to invoke a closing condition that's tied to a deterioration not captured by the purchase-price adjustment in order to walk away from the deal.

As with the considerations for earn-outs and purchase-price adjustments, in the near term, parties may favor closing conditions tied to client retention and inflows or outflows or to run-rate revenues or AUM metrics that disregard changes based on market movements or underlying asset values.

In the next installment of this three-part article, we will describe some heightened regulatory considerations and key personnel considerations in this environment.

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