

Alternative Asset Manager Acquisitions

Addressing the human paradigm in the integration process

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In our recent article titled “New Paradigm in Asset Manager M&A,” published in *The Hedge Fund Journal* last November, we discussed several of the business and legal issues faced by parties engaged in forming hedge fund and financial institution alliances. In this article, we address several challenges to achieving success in these transactions relating to the human component of these joint venture relationships, including control of the business, dealings with investors/clients and employees and integrating the cultures of entrepreneurial alternative asset managers with the more bureaucratic and formal institutional acquirer counterparts.

The context for transactions

Asset manager acquisitions frequently include a unique combination of deal elements that both facilitate and hinder integration. As opposed to other majority investments where the Buyer assumes control, or at least the right to control, all matters, in alternative asset management transactions the Sellers invariably maintain control over investment decisions, employee matters and other day-to-day aspects of the target business while the Buyer’s control is deferred for long periods.

The Sellers’ demand to retain control is driven by a deal structure common to alternative asset manager deals: the earnout. A significant portion of the deal price (frequently ranging from 25%-75%) is contingent — the amount earned is based on financial performance of the business over periods ranging generally from three to five years after closing. Therefore, substantial sums are dependent on the Sellers’ ability to achieve or exceed target performance goals. In addition, the Buyer often requires the Sellers to reinvest a meaningful portion of the purchase price into the funds of the target business. Since the Sellers have substantial financial rewards riding on the success of their business, they insist on control, to the exclusion of the Buyer, over key aspects of the operations that could impact that success.

Investor retention

The initial step in assuring the future success of the asset manager is to retain the clients

and investors of the manager and reinforce its ability to attract new investors based on historical performance. Investors become concerned that the manager’s performance will trail off as a consequence of the “sell out” by the owners or the expansion of the amount of funds that the manager oversees, and they will be concerned that the structural and managerial changes imposed by the Buyer could be disruptive and negatively impact performance. To placate investors, the parties must convince them that there are no meaningful adverse elements to the transaction. Most importantly, the individuals perceived to be responsible for the manager’s prior success must be seen as being in charge post-closing without impediments. Since the earn-out and purchase price reinvestment features of alternative asset management create strong Seller incentives to balance growth of assets under management with continued successful performance, those incentives are emphasized in marketing the deal to investors, although the exact metrics are rarely revealed.

Employees

Advance preparation of an employee integration strategy is critical; employee matters need to be initiated as soon as the transaction is announced, and continuously and meticulously managed after that. Even where the parties have the best intentions with respect to their employees, uncertainty surrounding the transaction creates a perception of risk from the perspective of the employees. Uncertainty drives employees to consider other options and put plans in their lives on hold until the situation is resolved. This anxiety reflects negatively on and is a cost to the organisation. In turn, doubt and negativity among some employees can quickly spread into a loss of employee morale among other employees.

As with investors and clients, the parties must convince employees that the transaction will not be disruptive, either to their working lives or livelihoods. If the compensation system is left unchanged, the task is simpler. However,

the parties must nevertheless be sensitive to a basic reality: when the key employees learn that the Sellers will receive substantial sums at the closing, they may resent their non-ownership position. To address this and assure employee loyalty, the parties frequently introduce special bonus/retention programs, sometimes supported by the Sellers. Where the employees of the asset manager will be integrated into the Buyer’s human resource division, the task becomes more difficult as substantive changes cannot be prevented, making it all the more important to reassure employees as to their futures.

Culture, administration and compliance

There can be a substantial difference between integration for efficiency and integration for the sake of uniformity. The distinction is particularly significant where a larger, more formal institution acquires an equity interest in a hedge fund manager. The impact is felt throughout, from the Sellers — who will take on the role of employees of the Buyer with specific reporting and functional duties that they have not had for years, if ever — to the rank and file employees who have enjoyed the informality and variable perquisites that their employers have afforded them.

Combining back-office and IT functions is the most nettlesome element of the integration process. If the Buyer is a larger organisation than the target asset management business, it will typically have a more developed back office and IT structure. The Buyer may have extensive policies and procedures on a wider array of matters, including more formalised training structures. In many cases, it will make sense for the target asset management business to take advantage of the more rigorous compliance and administrative structures of the Buyer. It may be economically efficient in terms of reducing duplicative costs to develop and maintain policies and procedures. However, the Buyer’s systems were not designed for the target, and despite the efficiency created by coordinating the systems, the Buyer’s procedures may not be superior on the whole.

The wholesale application of the Buyer's "culture," as expressed through a series of minor and major policies and practices can give the target employees the feeling of being "run over" by the Buyer, as if they are employees of a second class. If the Buyer does not immediately adapt its practices to the needs of the target business, a number of morale difficulties can arise. On the other hand, if the Buyer allows the target business to maintain its own culture and policies, the differences in approach across the Buyer's organisation can create internal employee morale issues for the Buyer. For instance, the asset manager's employees may have a private gym on site, receive catered free lunches, and not be subject to the same business dress code as the Buyer's employees. These perquisites may in fact be suitable to hedge funds where traders and their support staffing are expected to

remain at their desks from the early morning, but their continuation post-closing may be difficult where uniformity of treatment is considered essential. Employee acceptance of the transaction is driven not only by core decisions like compensation levels and benefits, but also by small differences in perception and by comparison to others within the new, larger organisation.

Closing thoughts

Asset manager acquisitions are frequently the result of protracted negotiations, during which the Buyer and Sellers learn the sensitivities of the other, and learn to get along with each other. The parties are motivated to focus on constructive solutions when they recognise that the longevity of the relationship is as critical as the terms that are actually written into the agreements.

We have learned that there is no single blueprint for integration — instead, mutual respect and understanding of the other party's needs, whether or not there is a contractual requirement to do so, are the most important components to a successful integration process. **THFJ**

The authors have led Schulte Roth & Zabel LLP teams on hallmark alternative asset manager transactions. Among the transactions are the JPMorgan/Highbridge and Blackstone/GSO 100% acquisitions, as well as the acquisition of a non-controlling minority stake by Credit Suisse in York Capital Management.

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