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The Right Time to Move Cash

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The right time to move cash

George J Mazin of Dechert navigates the paths that should be negotiated when selling to a strategic buyer

In recent weeks the press has reported Ken Griffin, founder of Citadel Group, is considering plans to take it public. A public offering would presumably make it possible to value the enterprise on the basis of public company multiples and provide a mechanism for the founder to obtain liquidity for his interest in the business. Importantly it delinks to a large extent the decision to exit the business from the decision to cash out. He can sell his equity and maintain his role at the company, or retire but maintain his investment.

For many hedge fund managers, going public is not a viable option. These managers must obtain liquidity the old-fashioned way, by selling their interest in the business. Likely buyers may include employees, existing partners, a strategic buyer, or even a competitor.

A sale to employees is best accomplished through a long-term succession-planning programme. A business can be institutionalised and an exit mechanism created through the transfer over time of the founder's equity to key employees. Where the business is formed by several partners, a buy/sell arrangement may facilitate the ability of a partner who desires to withdraw from the business to sell their interest to the continuing partners. The buy/sell agreement may specify the purchase price, may establish a formula for doing so or may rely upon a third-party valuation.

This article will consider some of the major issues that must be negotiated when selling to a strategic buyer or competitor.

The hedge fund industry remains a service business. Frequently, the buyer may

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be unwilling to purchase the entire interest of the seller in the investment management firm being sold. In order to provide an incentive to the seller to stick with the business and preserve relationships with investors, the buyer may seek to acquire control but leave the seller with a significant stake in the business, creating both downside risk and upside potential.

The agreement may include an option for the buyer to purchase the remainder of the business at some point in the future, generally based upon the value at such later date. In some cases the seller may have a put, affording them the ability to exit the business once a prescribed time period has lapsed. In other cases the buyer may purchase 100% of the business, but build in significant incentives (retention bonuses, earn outs or contingent purchase price) to induce the seller to remain involved in the business, or impose penalties (covenant against competition, clawback) if the seller fails to remain involved.

Purchase price

The purchase price will invariably be established on the basis of a multiple of earnings. Depending upon the nature of both the buyer and the investment strategy employed, greater weight (or a higher multiple) may be ascribed to management fees than incentive fees. Since incentive fee revenues tend to be more volatile, buyers may not be willing to pay as much for an unpredictable revenue stream which varies greatly from year to year.

Sellers often believe they are selling their business too early in its life cycle. As a result the seller may believe the multiple does not fairly reflect the future growth the buyers will enjoy as a result of purchasing the business. Conversely, the buyers may fear they have purchased too late. They may be concerned the business has plateaued and future revenue growth will be flat, in which case they will be unwilling to employ a high multiple to value the business.

To provide an incentive to sell, the purchase price may include a contingent element. Additional purchase price will be paid if certain targets are reached, such as growth in assets under management.

This component of the purchase price serves two purposes. First, it provides an incentive for the seller to continue to grow the business despite the sale. Second, it protects the seller against selling at a price which is unreasonably low. If the business continues to grow, the seller benefits from a higher purchase price. If the anticipated growth does not occur, the buyer will not feel they have overpaid for the business.

Contingent payments serve one further purpose. A principal of the firm being sold is likely to be an entrepreneur, accustomed to making all the decisions associated with running the business without being second guessed. After the sale, the former entrepreneur will end up working for someone else. To prevent the seller from walking out the door as soon as the new owners refuse to pursue a desired initiative, a contingent payment puts the seller at risk of foregoing a significant amount of money if they leave prematurely.

In some cases, the buyer may negotiate a clawback. This protects the buyer against a contraction in the business. If investors withdraw as a result of the change in control, or if there is a sustained period of poor performance, the sellers may be required to return a portion of the purchase price.

Covenants against competition

As a condition to paying the seller a significant sum of money, the buyer will require the seller to commit to refraining from competing against the buyer and to agree not to solicit the company's employees or investors. These covenants will continue for so long as the seller remains employed and will typically extend for a period of time (generally as short as a year and as long as three years or more) after the employment relationship terminates.

Subject to these broad parameters, there are a multitude of issues to be negotiated in structuring these covenants. For example, will the seller be released from the covenant if they are fired or forced to resign? Will a competing business be defined broadly so it encompasses the entire investment management industry, or will it be limited by geography or a particular segment of the business, for example long/short hedge funds.

Also up for discussion is whether the seller will be restricted from accepting an investment from an investor or prospective investor, or merely restricted from actively soliciting or encouraging the investor to withdraw capital from the fund advised by the company that was sold. The seller will strongly prefer the latter approach, arguing that a larger institutional investor should be able to invest with them if they are leaving to launch their own fund, so long as the investor does not reduce its investment in the first fund. Restrictions will also be imposed prohibiting the solicitation, or in some cases, hiring (whether or not solicited) of employees of the prior firm.

SEC consent

The seller may either be registered, or in the not-too-distant future, will be required to be registered, as an investment adviser with the Securities and Exchange

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Commission (SEC). Consent from the regulator to a sale or change of control of a registered investment adviser is not required under the Investment Advisers Act. However, an amendment to the adviser's Form ADV will be required to reflect the change in ownership. Once filed, this information will be publicly available. In addition, regulators in other jurisdictions outside the US in which the firm does business may have the right to pass on the transaction.

More significantly, a change in control of an investment adviser is treated as an assignment of an investment advisory agreement under the provisions of the Investment Advisers Act. The Act further provides that the advisory agreement may not be assigned without the consent of the client. While the SEC generally treats a fund (and not the investors in the fund) as the 'client' for these purposes, it will not treat the consent of the general partner of the fund to be an effective consent due to the inherent conflict.

Absent a controlling provision in the partnership agreement which spells out the mechanics for obtaining consent, consent can be obtained through the approval of the change by an independent representative acting on behalf of the limited partners, or by a majority in interest of the partners. While not clearly required, affording a right to redeem to those investors who are unhappy about the change may be prudent.

Finally, consideration must be given to whether affirmative written consent should be required, or whether acquiescence through silence and a failure to object (negative consent) would be sufficient. While affirmative consent is the preferred approach, negative consent can be effective where there is proof of delivery of the notice, coupled with the passage of a sufficient period of time and the absence of an objection or request to redeem.

Integration issues

Where the buyer is a competitor of the seller or otherwise engaged in the investment management industry, buyer and seller will face a host of integration issues following the acquisition – from personnel issues to technology to overlapping products. However, one critical integration issue is compliance. The two companies will have to designate a chief compliance officer on a going-forward basis, who will be faced with the task of integrating two sets of compliance policies. Often, when the two policies are

lined up against one another, there will be a variety of inconsistencies or conflicts between the two. The failure to reconcile the two promptly following the closing of the transaction puts the company at considerable risk. It will, at a minimum, create confusion among employees as to the applicable rules and at worst, subject the company to the potential of an enforcement action.

Representations

In structuring a transaction, the seller wants to be sure it will be able to retain all or as much as possible of the consideration it has received. The buyer is looking for the ability to recoup a portion of the purchase price if it does not get what it bargained for. The mechanism for resolving these conflicting objectives is the representations and warranties and indemnification provisions in the purchase documents. The buyer may seek to exact broad and extensive representations from the seller concerning the business being sold.

These representations may cover the financial condition of the business, past performance, accuracy of disclosure documents, absence of litigation or claims, including investor complaints or regulatory proceedings, the disclosure of material contracts and commitments, transactions with affiliates and compliance with laws. The seller will seek to narrow the representations and ask the buyer to rely upon its own investigation of the business.

If any of the representations turn out to be untrue, the buyer's remedy is to assert a claim for indemnification. Effectively, the buyer is seeking a purchase price adjustment. The indemnification provisions may be subject to considerable negotiation, including the minimum claim eligible for indemnification, the time period for asserting a claim and the ability to set off the claim through a set-off against future amounts owing to the seller.

When to sell is a personal decision that is made based upon a variety of factors, including a desire to create liquidity for an investment that may represent a significant portion of the seller's net worth, a determination that the value of the business has plateaued, a desire to make a lifestyle change or a determination there is strong demand in the market for the asset being sold.

Whatever the reason for selling, structuring a sale transaction is complex and requires great care in order to maximise the selling price, while imposing the fewest restrictions on the seller and resisting efforts to shift the risks of the transaction to the seller.

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