TRIAGO

M&A AT THE GATE: 30 YEARS AFTER THE BARBARIANS

MAY 2018

MERGERS AND ACQUISITIONS BETWEEN PRIVATE EQUITY INVESTMENT MANAGERS

In Private Equity, people are predisposed to think of M&A at the level of portfolio companies rather than between investment managers. And while changes in shareholding structure are typically thought of as driven by major firm-specific events, for example generational transition, today's strong wave of M&A is equally driven by a realistic assessment of a fast maturing marketplace.

By Triago's reckoning, more than 150 M&A transactions involving Private Equity management companies have taken place since 2005, including 65% over the past 5 years. That represents an average of 10 deals per year and some 15 deals annually since 2010. The more than 25 deals recorded in 2017 mark an all-time high.

The maturity of the Private Equity market, combined with the diversity of LP profiles and investment appetites, is the catalyst of consolidation. Consolidation yields everything from large, fully independent teams to captive teams; as well as a variety of different capital structures. Independence is no longer the Holy Grail for an investment manager when it comes to doing deals at the investment company level, provided that governance and alignment of interest are well-defined and advantageous for all parties.

The consolidation trend is also being fueled by a side effect of the market's maturity: succession issues. The increasing age of founding partners has created a need for liquidity that cannot always be fulfilled within the existing team. In many cases, the Global Financial Crisis (GFC) may have delayed carry distribution, resulting in a mismatch between the younger partners and founders' wealth and opening consideration to external solutions.

KEY FIGURES

+150 M&A transactions involving Private Equity management companies since 2005

65% of those M&A transactions closed over the past 5 years

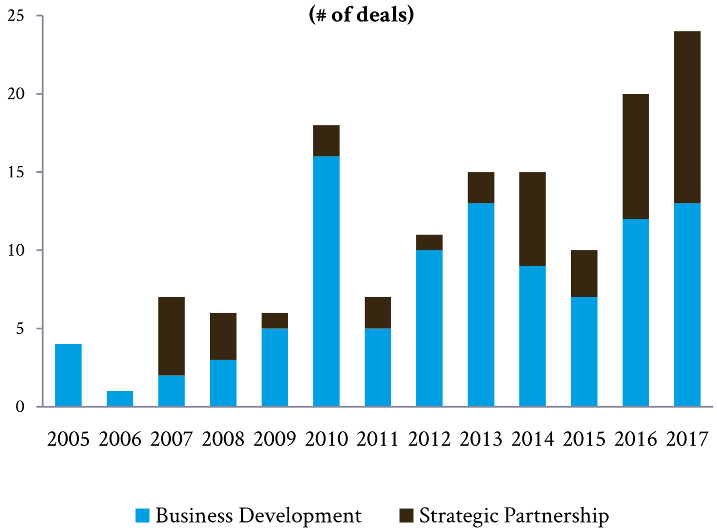
15 deals on average per year since 2010

2/3 of M&A involves acquiring a majority stake in Management Companies

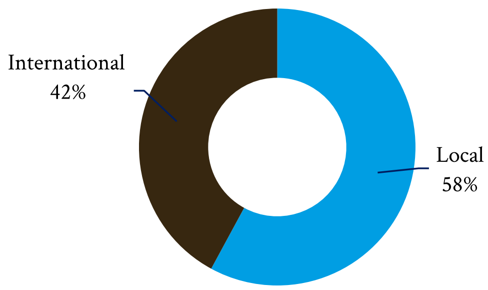
1/3 of M&A transactions are linked to investments in the GP's fund(s)

FROM LOCAL MARKET CONSOLIDATION TO AN INTERNATIONAL TREND

PE Investment Manager M&A activity since 2005 (# of deals)



Split between local and international M&A deals (# of deals)



MAJORITY STAKES FULFILL GP BUSINESS DEVELOPMENT NEEDS

In two thirds of cases since 2005, acquirers have purchased a majority stake in the targeted firm. These business development plays are occurring as large institutional investors aim to build out their Private Equity strategies.

As mentioned in a previous Triago white paper, “Funds of Funds: Demise or Renaissance?”, the Private Equity consolidation trend began with Fund of Funds transactions, which represent around 30% of M&A deals since 2005. Funds of Funds transactions right after the Global Financial Crisis were local in scope and designed to keep firms afloat – this was the case in the UK, Germany and France. Yet more recent operations have been geared towards asset and geographic diversification.

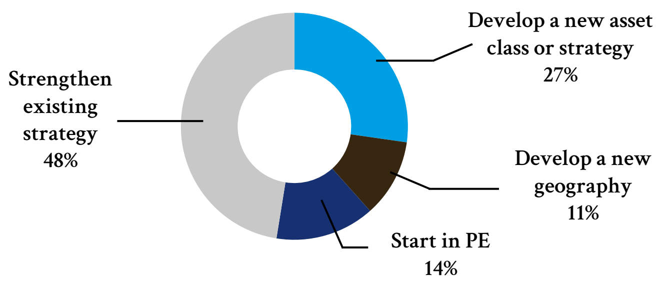
Consolidation as a tool for business development got its start with acquisitions of Private Equity firms by large investment institutions seeking to build a Private Equity practice and enlarge their expertise. Examples are AMG acquiring Pantheon in 2010 and Carlyle acquiring Alpinvest in 2011. Quickly thereafter, seasoned Private Equity players, including venture and buyout fund managers who had successfully survived the dot com bubble and the GFC, emerged as very active buyers. Some 50 percent of acquisitions to date have focused on enhancing existing strategies. Yet recent transactions are more focused on developing products in new asset classes (the lion’s share in Private Debt and Real Assets, as evinced by Stepstone’s extensive acquisitions), or geographies (Catterton/LCapital, Ardian/Seven Miles).

The business development needs of General Partners are focused on two main objectives:

- Increase Assets Under Management to keep growing the firm, retain talent, and mitigate revenue cyclicality, often by adding a new strategy, asset class or geography,
- Leveraging brand power to capture growing average ticket sizes among investors, who allocate greater commitments to fewer managers.

The push for diversification is particularly apparent among the 40 largest General Partners globally. More than two-thirds of them have built multi-product platforms with, on average, three different product lines under the same brand. Only a handful resorted to M&A, choosing instead to meet their specific needs by building teams from scratch.

Split of M&A Business Development deals per underlying rationales



Acquiring a manager with an existing team and track record is usually beneficial to the buyer in terms of implementation and fundraising timing. However, most of the mega-GPs have preferred to take on first-time team risk rather than the integration risk of an external entity (and the potential mismatch with their own DNA). Choosing in-house development is also linked to the challenge of defining the right pricing for a Management Company, an issue addressed below.

DIFFERENT WAVES OF MINORITY STAKE TRANSACTIONS

One third of Management Company M&A deals since 2005 are minority transactions, with over 90% of them motivated by strategic and business development goals.

The first major wave of minority stake transactions took place in 2007-2008 and was spearheaded by Asian and Middle Eastern Sovereign Wealth Funds (e.g. CIC, ADIA), which acquired strategic minority interests in flagship managers such as Apollo, Blackstone and Carlyle. Buyers benefitted from seasoned GPs’ experience in Private Equity at a time when they were new to the asset class and less sophisticated than they are today. Moreover, following the GFC, investors benefited from relatively cheap entry prices, making minority M&A transactions even more attractive. Since then, a handful of Sovereign Wealth Funds, as well as Family Offices and large Institutional Investors have opportunistically continued acquiring strategic minority interests in investment managers.

Recently, the minority stake has become the investment *du jour* for a growing class of specialized “GP stake funds” launched by major players – Goldman Sachs, Blackstone, Neuberger Berman, Alpinvest and the like. Such groups pounced on what was an untapped market of founding partners open to third-party shareholders, but reluctant to divest control of their firms. This practice was initiated in the Hedge Fund world before moving into Private Equity. GP stake funds account for no less than 70% of all minority transactions over the past 3 years.

SNAPSHOT OF GP MINORITY STAKE FUNDS

Dozens of players investing in minority stakes have emerged in the Private Equity market. Their investment approach tends to align with GP needs and objectives regarding third party capital.

GP stake funds have access to Management Company dividends and potential revenue upside from carried interest and further AUM growth. GP stake funds typically assume a passive role through non-voting rights, preserving the independence of the management team and its investment process. Yet at the same time they offer a wide range of potentially valuable support services to managers. Most notably, GP stake funds help their managers fundraise by offering access to their own LP base. This advantage is particularly crucial for emerging managers and first-time strategies. GP stake funds can also offer assistance with product development and planning (e.g. diagnostic, operational support), talent management and training, or even sharing support functions (e.g. risk, compliance, accounting), although the reality and effectiveness of some of these services has yet to be proven.

Perhaps in a testament to the intrinsic value perceived in such services, fundraising for GP stake funds has been very successful recently. Dyal Capital Partners III closed at $5.3 billion in February 2017, almost tripling the size of its sophomore fund. Given their increasingly large size, investment from GP stake funds will mostly go to medium to large cap managers able to accommodate sizeable tickets of between $100 and $600 million.

Many of these players have adopted structures similar to traditional Private Equity funds (i.e. 4-5 year investment period, closed-end funds). However, it remains to be seen whether such structures will prove suitable for the long-term and illiquid Private Equity asset class. While secondary or public market sales may gradually crystalize, exit scenarios for GP stakes remain a question mark at this stage.

MANAGEMENT COMPANY FINANCING

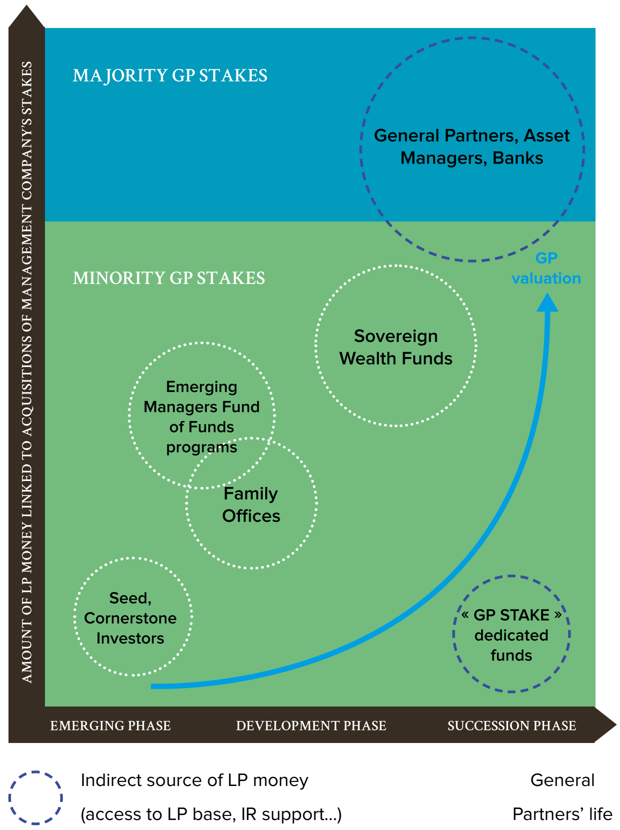
Money out:

- Financing of a succession plan for the next generation by enabling partners to monetize their stakes

Money in:

- Business diversification in new product lines, through both internal growth (hiring and infrastructure investments) and external growth (acquisitions)

WHAT ABOUT LP COMMITMENTS LINKED TO TRANSACTIONS? LPs CAN PLAY THIS GAME TOO



To mitigate first-time fund risk, seed investors commonly negotiate preferred terms, which can include buying in to the GP shareholding structure. But such terms are rarely a mandatory prerequisite for investment. In the 1990's, Capital Z (backed by Zurich insurance) pioneered the practice of seeding emerging managers. Since then, dedicated initiatives to back the management companies of emerging managers have been a natural diversification and value play for a range of Fund of Funds managers. They leverage off of deep, longstanding relationships with GPs to source spin-offs or new team situations where cornerstone capital is essential to put fund managers in business.

As mentioned above, Sovereign wealth funds and family offices have also been known to buy minority stakes in GPs. Both have primarily geared their commitments towards well-established managers. Sovereigns in particular gravitate towards GPs with a demonstrated ability to deploy large amounts of capital in line with their sizeable LP commitments. Yet sovereigns have become less active, as they increasingly set-up their own direct investment practices.

Minority investment contrasts with the practices of groups that buy majority control in GPs. Majority stake holders don't always invest directly in GPs' underlying funds but leverage their own client base or internal capital raising functions for fundraising.

VALUATION, VALUATION, VALUATION...

Theoretically, the valuation of a Private Equity GP can be based on recurring cash flows, just as with any other long-term contract business. However, setting a price that matches both buyers and sellers' expectations is complex and elusive. Indeed, inability to find common ground is the main reason why deals fail.

Why is finding mutually acceptable pricing difficult? First of all, the valuation exercise requires analyzing a host of non-standardized terms. The rise of tailor-made separate account mandates has made this only more complicated. Additionally, Private Equity is still an opaque market, particularly when it comes to jealously-guarded disclosures of financial performance and past shareholder transactions. Moreover, valuation statistics for the asset management market offer little help since Private Equity-related transactions represent less than 5% of overall transaction activity from both a value and volume perspective. Lastly, the volatility of public markets and their knock on effect on private equity firm valuations, has the potential to upset even the best laid plans at the last minute.

To try to sort through the complexity, a wide range of pricing benchmarks are applied to a host of indicators, including assets under management, EBITDA, net earnings and Discounted Cash Flow (DCF) models. Most of the time, final pricing results from a blend of several methodologies. Based on public stocks and private comparables, the valuation spectrum has proven to be very broad, with estimated enterprise values ranging from 5 to 18 times EBITDA, 4% to 20% of assets under management, and 9 to 26 times net earnings. Comparatively, the median acquisition multiple for 2017 in the traditional asset management sector was 14.2x run-rate EBITDA, and the forward P/E of US asset and wealth management deals was 13.2x by year-end 2017.

Beyond the transaction dynamics, acquiring a minority or a majority stake in a Private Equity company is a long-term investment where buying at the right price is only one of many critical success factors. Future fundraising and business development capabilities have to be assessed with the utmost care and are linked to the quality of management. That is why lock-up periods for the founders (in the case of a majority sale), as well as earn-out payments dependent on future financial results have facilitated an increasing number of acquisition processes.

CONCLUSION

Some 30 years after the book Barbarians at the Gate created a stereotyped image of the private equity industry, the marketplace has undeniably matured. Today our industry faces the same challenges as any other business. Similarly to their portfolio companies, Private Equity firms will have to find ways to achieve long-term sustainable growth, retain and attract the best talent and successfully manage succession issues. M&A is a useful and increasing accepted tool for achieving these ends.

Track records are relatively easy to assess and benchmark, but valuing a management company is a much more nuanced affair. In addition to running a DCF model and finding market comparables, to properly value a management company, a wide range of other topics must be evaluated. These include current and future fundraising capabilities linked to Key Differentiating Factors and private equity-specific components like carried interest, GP commitment, key-man and change-of-control clauses. Specialist Advisors with deep industry expertise and understanding of LP investment decision drivers are ideally suited to this work.

With over 40 M&A transactions in the last two years involving Private Equity management companies, we believe that we are just at the beginning of the consolidation process in our industry. To successfully help the management teams they partner with - and ultimately make private equity stronger and more prosperous - acquirers will have to up their game in an increasingly competitive marketplace.

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TRIAGO - CREATIVE THINKER, INDEPENDENT AND DISCREET

Triago was founded in 1992 by Antoine Dréan to assist general partners in raising capital from investors in the United States at a time when there were very few limited partners in Europe and when most private equity groups were captive to larger organizations. Independent, pragmatic and success driven, Triago today is a dedicated private equity fund advisor operating on a global basis.

Triago's three complementary activities (fundraising services, secondary transfers and strategic advisory) allow its experienced team of professionals to fully address the needs of both limited and general partners in fundraising, portfolio management and strategic development. Triago's unique positioning in the market generates creative and effective responses for clients, adding value across all cycles.

ENVIRONMENT

Change in regulations and practices
Pressure on investment returns
Need for differentiation
Fluctuation in brand value
Consolidations among GPs and LPs

CHALLENGES

Keep a leadership position
Build best-in class processes
Attract top-quality LPs
Answer to clients' needs
Retain and motivate team

DEEP-ROOTED PLAYER

Daily interactions with PE players (GPs, LPs)
Global PE coverage
Broad experience of fundraising
Strong knowledge of the market

PRIVATE EQUITY SPECIALIST

For private equity managers
For institutions
For corporates
For banks, for funds

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