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# Why Transact in this Market Environment?

by

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January 9, 2009





## Market Overview

2008 will be a year to remember. The M&A world has changed dramatically, particularly since October 2008. Global merger volume dropped by almost a third, ending five years of deal growth, as a result of limited access to credit, plunging stock markets, and a worldwide financial crisis that has undermined the ability of many companies to make acquisitions. According to Thomson Reuters, global merger volumes for all of 2008 totaled \$2.89 trillion, marking the lowest annual volume since 2005. A record of 1,309 deals valued at \$911 billion previously agreed was abandoned, according to Dealogic. In the fourth quarter of 2008 alone, merger volume plunged 44%, making it the lowest quarterly volume since the third quarter of 2004.

Until the collapse of Lehman Brothers in September, bankers believed that companies with strong balance sheets would exploit falls in rivals' share prices to snap up bargains. But when the Lehman bankruptcy occurred, the mood among many chief executives quickly changed and conservation of cash took priority over acquisitions. This dramatic dislocation we are experiencing and the scarcity of credit is defining the winners and the losers in various sectors, and consolidation will likely accelerate during 2009.

Park Sutton Advisors believes that the drive toward consolidation within certain industries, attractive valuations, and the need for capital by many organizations will spur a series of deals, echoing the experience of previous crises of the 1930s, 1970s, and late 1980s. History is on the side of companies that buy at the bottom, and as a result, we expect some opportunistic deals to occur during 2009.

## Asset and Wealth Management Industry

In the asset and wealth management industry specifically some of the most pressing challenges currently faced are:

- **Accelerated Market Declines**

We have just closed the year that appears to be the worst for US equity market performance since the Great Depression. While asset managers do have recent experience with an equity market decline in excess of 40% (which is around what most equity markets have dropped for 2008), this decline occurred over a multi-year period between 2000 and 2002 upon the burst of the Internet bubble. At that time, the dividend-adjusted S&P 500 index declined about 9%, 12%, and 22% for those three calendar years, respectively. This time around, however, the speed of the plunge has been sudden and shocking, and will make it difficult for some managers to right-size their businesses and restore profitability quickly enough. In addition, today's markets are atypically experiencing declines across virtually all asset classes, as seen in the public debt and



bank loan markets, where securities currently trade well below par, even for many investment grade companies. Finally, the market has divergent points of view as to when the market will finally “reach bottom” and recover thereafter. Some predict that the market will turn around by the third quarter of 2009, while others believe that a reversal will not occur until 2010. While the Fed and most Central Banks are fighting the world crisis in unison, investor sentiment remains shaky and there is no real clarity at the moment regarding the timing of a turnaround.

- **Market Effects on AUM**

Market performance and net asset flows are the two primary drivers of asset and wealth manager AUM. The effects of the market during 2008 on managers’ assets were drastic. Data provided by Moody’s indicates that the AUM levels for 11 publicly-traded asset managers between September 2007 and September 2008, a period when the S&P 500 declined 26%, dropped over this period by 15% for 7 of the 11 firms studied (AllianceBernstein, BlackRock, Legg Mason, Invesco, Franklin, GAMCO, Waddell & Reed, Nuveen, Janus, Eaton Vance and Fidelity). Even those with a relatively high percentage of fixed income AUM suffered casualties.

To add to the severity of this situation, by the end of December 2008 some firms, mostly equity-focused, experienced AUM declines in the 40% - 50% range. Even firms with a sizable fixed income presence in some cases experienced AUM declines of between 20%-30% for the 2008 calendar year.

- **Flow Effects on AUM**

Data from The Investment Company Institute and Lipper indicate that the impact of market weakness on long-term fund flows is dramatically worse today than that experienced from 2000-2002. According to one source, investors withdrew \$320 billion from mutual funds during 2008. Much of the cash withdrawn was allocated to money market funds which saw inflows of over \$420 billion during the year.

Since revenues and EBIDTA margins in the asset and wealth management industry are directly tied to AUM, it is clear that the above effects have placed significant pressure on the profitability of many industry participants. Such firms generally benefit from operating leverage during up-markets. In turn, the impact is magnified during down-markets as the decline in revenues is not matched by an equivalent decline in fixed expenses. Quickly implementing expense cuts -- including reductions in headcount, performance-based compensation, and general and administrative costs – can be challenging, particularly when groups need to ensure retention of their best and brightest more than ever.



- **Valuation Adjustments and Other Challenges**

Pressure on AUM has ultimately placed pressure on firms' valuations: when AUM drops, profitability drops thereby translating to a decline in a firm's value. Firms are affected irrespective of their strong or weak (relative) investment performance. The number of firms at risk of failing has clearly increased, and some bottom-fishers, including numerous private equity groups, are on the prowl for bargain basement prices. At the same time, many successful firms that otherwise might have entertained transaction discussions for a host of reasons are electing to hold off for fear of selling at the bottom of the market.

Valuation discussions are particularly difficult in the context of firms who are in the late stages of transaction discussions. Several months ago they likely had pricing and deal structures wrapped up, or so they thought. To the extent a deal price was fixed, in many cases the buyer no longer wishes to honor this price. To the extent a multiple was agreed, with AUM down 20-40%, firms' valuations are drastically lower since September 2008 thereby deterring some sellers from completing transactions. One buyer of wealth management firms, who consummated four transactions during the first three quarters of 2008, reports a decision to hold off on deal-making for the foreseeable future given their expectation of a challenging 2009.

## **Why Transact in this Market Environment?**

Does this mean that deal-making in the asset and wealth management industry is dead or should be dead? In many cases a strong rationale to transact will continue to exist:

1. Many firms face succession planning issues that need to be addressed and which are independent from short-term market moves;
2. A major reason firms transact is to achieve access to marketing and distribution. Deals can provide firms with access to new markets that would be otherwise too costly or too difficult for them to tap independently;
3. In the case of investment managers who manage money internally for private clients, the shift of marketplace demand toward open architecture will continue to challenge them. It will be as important as ever for investment counseling firms to be reflecting on the competitive landscape and how they will be able to successfully compete against larger wealth managers offering a broader array of products and services;
4. A desire for liquidity, which means taking some money -- and risk -- off the table;
5. The need and desire to gain access to centralized administrative and operational services -- thereby allowing professionals to focus on wealth management, investment management, and research;



6. Finally, a transaction may position two entities to better “weather the storm” of 2009 and achieve a more promising combined future.

## **Other Asset and Wealth Management Deal Considerations**

Asset and wealth management firms are “people” businesses, and interpersonal chemistry – people “fit” – is the key ingredient to a successful partnership. It is as important as ever that deal participants remember at every moment of a discussion the strategic rationale that brought them together in the first place. However, they should expect negotiations to take longer than usual and should also be committed to negotiating together in good faith. In the current market, closing deals requires even more creativity, willingness to compromise, and perseverance than usual. Each side needs to reflect hard on their deal must-haves and non-starters, and should not be frustrated should pricing and deal structure require extended negotiation or re-negotiation.

Firms’ advisors, on the other hand, must be prepared to offer extra handholding and patience. Given the current environment, a skillful advisor who can effectively build trust and flexibility between the parties will have a more fundamental role in the negotiation process. An important aspect of flexibility involves both sides being open to considering price adjustment mechanisms. For instance, buyers may wish to consider agreeing to a fixed price so that sellers need not deal with the anxiety of witnessing their firms’ values’ move substantially daily prior to signing. Additionally, sellers may need to be open to price adjustment mechanisms that involve reduced amounts paid at closing with greater amounts earned at later points should the market recover to certain levels.

One example of a deal undeterred by a challenging market environment is the soon-to-be-announced sale of a wealth manager in the Central US, a Park Sutton Advisors’ client, to a larger wealth management organization. To keep the deal alive, terms were re-negotiated. The new terms included a reduced valuation at closing, and thus a lower closing payment. After jointly exploring with the buyer multiple options, the seller agreed to a revised deal structure that included easier earn-out tests that could potentially allow for larger future contingent payments. Such a structure was intended to potentially allow the seller to recover a meaningful portion of the value lost at closing. For this negotiation to be successful, the seller had to recognize the world had changed since October and be willing to agree to a lower closing valuation. He still wanted to do the deal as it was a strategic opportunity for him for two main reasons: this deal facilitated a much-needed succession plan for his firm; and it also provided the firm with a wider array of wealth management capabilities thereby enabling his relationship managers to better serve their private clients. This is one example of many deals likely to occur during 2009 for highly-strategic reasons.



Park Sutton Advisors is a leading authority on the financial services industry, and specializes in providing high-touch, confidential advisory services on small- and middle-market transactions. These include mergers and acquisitions, valuations, divestitures, strategic alliances, joint ventures, fairness opinions, and planning for equity transitions and successions.

For Latin American families, Park Sutton Advisors offers exceptional wealth management services. Operating under the key principles of objectivity and transparency, Park Sutton Advisors is instrumental in helping families achieve harmony and success in asset growth and transfer across multiple generations.

## About the Authors



### **Steven M. Levitt**

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Steven leads and co-founded Park Sutton Advisors. He has focused on middle-market M&A and strategic advisory work in the financial services sector for the past 12 years working with asset and wealth managers, broker-dealers, and fund administrators globally.

Prior to co-founding Park Sutton, Steven worked with three investment banking boutiques where he focused on strategic and transactional work in the securities and investment advisory industry. He was a partner with Cambridge International Partners, which he joined from Millenium Associates where he led that firm's North American practice. Earlier, Steven worked at Putnam Lovell.

Steven holds a BA degree in Economics from Stanford University and an MBA in Finance from The Wharton School of the University of Pennsylvania. He is an alumnus of Stuyvesant High School. He is also a General Securities Principal.

Steven is a frequent speaker at industry conferences and seminars, and has been particularly active in the Speaker Retainer Program of the CFA Institute speaking on the topic of valuation of asset and wealth managers. He has served as an investment banking course instructor for Baruch College of the City University of New York. He is fluent in Spanish and prior to Wharton spent several years living in Mexico City.



### **Jaime Carvallo**

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Jaime co-founded Park Sutton Advisors. Prior to Park Sutton, Jaime spent 8 years advising Latin American high-net-worth individuals representing over \$500 million in assets. Most recently, he was a Private Banker with Deutsche Bank, actively involved in developing the Andean Region client base for the bank's New York office.

Prior to Deutsche, Jaime spent over three years with HSBC Private Bank, also focused on developing the Andean Region market and advising clients on their wealth management needs. At HSBC, with the bank's CEO for Latin America, Jaime co-managed the largest offshore relationship managed from New York. He was also awarded membership into the high-profile Group Private Bank's High Potential Development Programme ("HPDP"), a 3-year program accepting only 50 new members globally each year. Prior to HSBC, Jaime spent over four years with The Citigroup Private Bank also actively advising wealthy Latin American clients. From 1995 through 1999, Jaime was a corporate banker with Banco de Credito del Peru, the country's largest commercial bank, managing a significant portfolio of loans and performing credit analyses for some of Peru's largest private corporations.

Jaime is a dual Peruvian – Italian citizen and holds a BA in Business Administration from the University of Lima, Peru. He also holds an MBA in Finance, Marketing, and Strategic Management from The Wharton School of the University of Pennsylvania. He is Series 7, 63 and 66 certified. Jaime is passionate about 20<sup>th</sup> Century French decorative arts.