

MACFARLANES

Private Capital Solutions

Acquisition of investment management businesses

From exiting founders, ongoing management and
purchaser perspectives

Introduction

This note sets out an overview of the key considerations on the sale of investment management businesses, being:

- the initial stake sale;
- the subsequent liquidity arrangements in respect of the retained stake; and
- the new incentive arrangements and management incentive plan (MIP) for management.

We are focused here on transactions involving the upfront sale of at least a 50% stake in the investment management business, with a future liquidity mechanism to acquire the retained stake. This is in contrast to so-called stake sales, which are also seen regularly in the market but tend to be structured as a direct investment from a new investor into the business for a minority equity or revenue share.

Acquisition of initial stake

Structure of consideration

The consideration for the acquisition of the initial stake is typically split between an upfront payment and subsequent earnout amount. The upfront payment is usually subject to adjustment based on the target group's regulatory capital position, with further adjustments to reflect the group's financial position at the point of closing also being common (e.g. updated management fee revenue and/or assets under management). The complexity of these adjustments makes it difficult to deal with them on a pre-agreed basis using a locked box mechanism. As a result, a completion accounts price adjustment mechanism (or hybrid completion accounts/locked box structure) is typically included in the acquisition documentation.

Treatment of carried interest

Carried interest in the target's existing funds is not typically transferred as part of the acquisition. In our experience, this is often as a result of the difficulties in agreeing what value should be attributed to the carried interest and also the desire to show existing LPs that carry remains in the hands of the management team and so will continue to be a key incentivisation tool for them. Despite this general position, the purchaser can still expect to obtain some indirect exposure to a "house share" of carried interest for future funds by virtue of its shareholding in the group holding company. The market position now is that the house will receive a c.25% share of the future fund carried interest.

Balance of upfront payment and earnout

When negotiating the consideration for the initial stake, the exiting founders will need to balance the certainty provided by the upfront payment, with the potentially higher overall amount available through an earnout mechanism. If significant value is expected to be delivered through the earnout, then the exiting founders will be very focused on ensuring that they have sufficient control rights in respect of any matters that might impact the metrics to which the earnout relates. This same dynamic applies to the sale of the retained stake.

Future liquidity for retained stake

Structure of liquidity arrangements

To provide certainty about the purchaser's path to 100% ownership of the target group, the parties will typically pre-agree a liquidity mechanism for the retained stake. This is normally achieved via put and call option arrangements, which are typically exercisable within three to five years after closing of the initial acquisition. The options are sometimes exercisable on more than one occasion to allow the retained stake to be sold down on a staggered basis or to be exercised in one bullet after, say, five years.

Purchaser objectives

The purchaser will have a number of different objectives to balance when considering the structure of the future liquidity arrangements. On one hand, it will want to keep the founders engaged in the business for as long as it thinks they are needed to protect the value in the business. However, the purchaser will also want to be able to see a path through to removing the founders from the capital structure at the appropriate point in time. Alongside this, the purchaser will be keen to ensure that management who have a part of the retained stake continues to hold a meaningful investment in the business (separately to the MIP) and potentially for a longer timeframe than the exiting founders.

With this in mind, a key consideration for the purchaser will be the leaver provisions that attach to the retained stake. In particular, the purchaser will want to avoid the founders being over rewarded if they decide to leave the business early. This can be an emotive issue in discussions with founders, who will see their stake as effectively being fully vested at the time of the initial acquisition and so will be resistant to any suggestion that this should ever be subject to a forcible transfer at anything less than market value.

New governance arrangements and MIP

Management objectives

The autonomy and incentives for management to run the business and grow its value under the new ownership structure will depend largely on the new MIP and governance arrangements that are implemented upon closing of the initial acquisition.

The management team will want to ensure that the new MIP is attractive and aligned with the performance and potential of the business, and that it does not dilute or conflict with their existing or future equity interests. Management will also want to ensure that the new governance arrangements provide them with day-to-day control and decision-making authority over the business, and that they are not subject to excessive or unreasonable interference or oversight from the purchaser or exiting founders. In addition, management will be keen to ensure that the purchaser delivers on any promises it has made about its future support for the growth and development of the business, such as providing distribution and marketing support or funding new strategies or GP commitments.

Key tax concerns

From a tax perspective, there are couple of key points to focus on in relation to the governance arrangements.

- First, the impact of the proposed board composition on the tax residency of the group's holding company needs to be considered. In particular, the parties will need to assess whether the proposed directors are resident in the relevant jurisdiction and, if not, whether they are willing to travel.
- Secondly, the parties will need to agree the level of control that the purchaser should have over the target group's tax affairs in the interim period between the initial acquisition and the purchaser reaching 100% ownership. The purchaser will naturally expect to have some input into the group's tax affairs, but the exiting founders and management will want to ensure that the purchaser cannot unilaterally change the tax practice and structure of the group.

Conclusion

Acquisitions of investment management businesses are complex and nuanced transactions. Each of the parties involved will have different objectives and perspectives. However, the exiting founders, ongoing management and purchaser are all ultimately aligned in their desire to drive continued growth in the target group so that they all can share in the value this creates.

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