M&A trends for Canadian asset managers: BLG's observations and insights looking ahead to 2024

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Canadian asset management deal trends

The Canadian wealth and asset management industry continues to be attractive for M&A transactions with significant premiums paid for asset managers. During 2023, there was more interest in quality wealth and asset managers than there were asset managers available to acquire. We believe that M&A deals will continue to be especially competitive in the coming year as strategic acquirers look to build and expand in scale and scope. Institutions from across the financial services landscape and strategic private equity investors are looking to add scale to their existing platforms and/or to differentiate by entering new markets in the sector. If valuations continue to rise and, as M&A deals become an even more attractive option in the asset management sector, it also will become more strategically important.

In this Insight, we draw on BLG's deep expertise in this area to focus on the important aspects of M&A transactions for both potential purchasers and sellers. Asset management deals raise unique considerations, including risks, structuring and regulatory considerations. Additionally, the latest guidance from the securities administrators regarding conflicts of interest may inform how you plan and structure your M&A transaction.

We see a number of forces driving this demand for asset manager M&A transactions, including:

1. Fee pressure

This has been a recurring feature of the post-financial crisis period that continues to intensify and is driven by customers seeking better value for money and heightened transparency. Canadian asset managers have responded to this pressure by seeking increased scale in an effort to address the "race to the bottom" concerning fees.

2. Macroeconomic trends

High savings rates, market volatility, increasing interest rates and high inflation have all continued to impact asset flows for the asset management industry.

3. Stable businesses

Despite ongoing fee pressure, asset managers remain valuable due to their nature as stable fee-generating businesses.

4. Regulation

The industry faces increasing accounting, tech, margin, litigation, and regulatory pressures. Spurred by recent regulatory pushes to increase capital requirements for most core banking activities, banks in particular have been attracted to the asset management industry because of its relatively capital-light infrastructure and high returns on equity.

5. Technology

The industry remains inefficient and relatively antiquated from a technology standpoint, so there is significant scope to streamline further. Technology costs have risen to achieve solutions for both regulatory needs (compliance and reporting, investor transparency, anti-money laundering and anti-terrorist financing (AML) risks) and cyber-attack sophistication.

6. The drive for new capabilities

With respect to operations, investors expect modern and personalized digital wealth management services. On the investment side, asset managers are seeking capabilities in areas with higher potential returns, such as alternatives and environmental, social and governance (ESG) offerings.

7. Available capital

Asset management participants continue to have significant capital available to deploy without dependency on external leverage.

8. Purpose led growth

Canadian asset managers are embracing purpose led growth alongside efforts to improve diversity, equity, and inclusion across the industry.

We see these factors combining to create an environment that will continue to foster strong M&A deal volume in 2024 and beyond for Canadian asset managers.

Considerations unique to M&A transactions for Canadian asset managers

Anybody considering an M&A transaction with an asset manager should have a clear understanding of the unique challenges that deals in this industry present, including the highly regulated environment, reputational considerations and the risk of asset flight as a result of the transaction.

Addressing the risks of the asset management industry

Of significant importance for any asset manager is regulatory and reputational risk. The potential for substantial liability, regulatory or otherwise, is ever-present. In addition, in an industry built on reputation and client trust, the risks associated with non-compliance with applicable laws and regulations is clear. As a result, when assessing an M&A transaction, there are a number of considerations for potential purchasers. Engaging experienced counsel to advise on the risks and opportunities early in the process can help create clarity and reduce transaction risks

Due diligence: Prior to entering into a transaction, potential purchasers should ensure that they have undertaken comprehensive due diligence of the target. In addition to typical due diligence conducted in an M&A transaction, purchasers will want to engage experienced asset management counsel to review the target's compliance with applicable laws and regulations and ask the appropriate questions, particularly if the transaction is structured as a share deal. This is important since remediating regulatory issues after the transaction has closed can be time consuming, costly and lead to reputational issues with both clients and regulators. The fact that regulatory non-compliance occurred prior to the closing of a transaction is not a shield; Canadian securities regulators have brought enforcement actions against the purchaser of a non-compliant business following the completion of a transaction. Where the target's offerings include ESG related investment products, purchasers should examine the disclosure for such products to ensure that it is in compliance with Canadian Securities Administrators (CSA) rules, guidance and rapidly evolving industry practice to protect itself against greenwashing claims, potential enforcement action and/or litigation risk.

Regulatory notices and approvals: Early in the process, both parties should work with their asset management legal counsel to identify the regulatory notices and approvals that are required in connection with the transaction and to understand the expected timeframe for regulatory approval. To avoid the risk of a long interim period between signing and closing, we recommend starting this process prior to entering into a transaction.

Representations and warranties: Asset management legal counsel are essential to protecting purchasers by obtaining representations and warranties from the target that are tailored to the regulatory environment in which the target operates. Target companies will often be reluctant to provide broad and unqualified representations as to their compliance with all applicable laws, and specialized asset management lawyers can assist in drafting a representation and warranty package that addresses key risks.

Indemnification: In part because of the heavily regulated nature of the industry, there is a trend in asset management M&A transactions for purchasers to obtain more robust indemnities in connection with regulatory breaches than for other "non-fundamental" representations and warranties. This includes increased indemnity caps, longer survival periods for regulatory representations, and stand-alone indemnities focused on

particular regulatory issues that have been surfaced as part of the due diligence process.

Closing conditions: Client relationships are essential to the success of any investment management business, nowhere more so than with small and mid-sized firms. An actual or perceived change in management can lead to clients withdrawing their funds between the time the transaction is announced and its closing. To address this risk, purchasers will often require as a condition of closing that the business maintain a certain amount of assets under management (AUM) or obtain the express consent of key clients. If certain advisory or sub-advisory relationships are important, purchasers may also require their approval of the transaction and an undertaking to continue to provide advisory or sub-advisory services following closing.

R&W insurance: The use of representation and warranty insurance in Canada has grown significantly in the past decade, in particular with small and mid-cap companies. However, while representation and warranty insurers are becoming increasingly sophisticated, there remains a hesitancy in Canada when it comes to underwriting policies in an industry as heavily regulated as investment management. Furthermore, representation and warranty insurance is an insufficient substitute for a comprehensive diligence process. This protective strategy is generally used in conjunction with other strategies.

Structuring the transaction

In any M&A transaction, sellers will often prefer to structure the deal as an equity transaction, as this allows the seller to shield itself from liability relating to the business following closing. Purchasers will prefer an asset transaction as it correspondingly involves less liability risk by allowing the purchaser to identify the particular assets and liabilities it wishes to acquire and assume as part of the transaction. In investment management, there is a greater trend toward asset deals, given the desire of the purchaser not to inherit any regulatory and reputational risks. Paradoxically, if the purchaser does not have the regulatory approvals required to operate the particular investment management business being acquired, a share deal may be more attractive as it will (subject to regulatory approval) allow the purchaser to also acquire whatever registrations or licenses are required to operate the business.

Earn outs

Earn outs are a form of contingent consideration whereby a portion of the purchase price is calculated with reference to the future performance of the business being acquired. They have become a hallmark in asset management M&A transactions. Purchasers of an investment management business see earn outs as essential to preserving the value of the business they are acquiring. Furthermore, earn outs are often used to incentivize the target's management to remain committed to the business post closing, and to encourage clients to remain with the acquired entity post closing. Given the uncertainties of today's domestic and global markets, we anticipate that earn outs will be even more prevalent over the coming years.

Some of the important considerations for earn-out structuring include:

How will the performance of the business be ascertained? The parties may wish to look at the profitability of the business, changes in AUM, its revenue or EBITA. Due to the volatility of contemporary markets, sellers may wish to avoid metrics tied to changes in asset values, including AUM, and instead focus on other metrics, such as client retention.

How will the earn out be structured?

The parties will also need to consider how the earn out is structured: How much of the purchase price should be subject to an earn out? Should the metric be calculated over standalone periods or cumulative and payable when the business achieves certain milestones? Should purchasers be entitled to claw back a portion of the earn out payment if targets are not met in subsequent periods? How long should the earn out be? Sellers will understandably push for a shorter period, whereas purchasers will argue that a longer period is needed to truly determine the value of the business. The parties will also want to explore how to structure the earn out in a tax efficient way for the sellers to avoid the characterization of earn out payments as ordinary income (compared with the lower capital gains rate).

Reliance on the purchaser for performance

Where a portion of the purchase price is subject to an earn out that is contingent on the performance of the business, sellers will often want to have a role in managing the business following the closing. Sellers will negotiate certain governance or veto rights in respect of various business-related decisions to ensure that the business is not managed in a manner that erodes their entitlement to an earn out. Sellers may also ask for post closing covenants from purchasers relating to the management of the business. For example, in the case of a fund manager where the earn out is based on AUM, the seller may require that the fund manager continue to offer the funds to certain retailers, market the funds in a manner consistent with past-practice, or include requirements that the purchaser not launch funds which might be seen as competitive with or cannibalize the AUM of the business's funds during the post closing period. On their part, purchasers should consider whether any of the restrictions could place them in a potential conflict of interest with their statutory and contractual duties to their clients. The CSA have focused their regulatory attention squarely on conflicts of interest and will be alive to any conflict or potential conflict of interest that has not been identified, disclosed and managed in the best interests of clients.

Difficulties in record keeping

The parties should have a clear understanding of how the earn out will be calculated during the post closing period. For example, if the earn out is calculated with a view to the EBITDA of the business, how will the purchaser allocate costs, such as marketing or shared services, across all of its businesses?

Regulatory considerations associated with M&A transactions

Regulatory considerations are a key driver to deal structure and timing. To avoid closing delays, it is highly advisable to engage counsel that is experienced in making the regulatory filings required by securities laws in connection with M&A transactions early in the process, as it is often possible to make the required regulatory submissions as

soon as the parties have signed a letter of intent. Strategically managing the timing of filings is of particular importance, as we continue to observe slower-than-usual turnaround times on approvals, etc., from most of the regulators.

Notice and approval in connection with acquisitions of registered firms

National Instrument 31-103 - *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) requires a registered firm that is acquiring another registrant or a registered firm whose securities are being acquired to provide notice to the applicable provincial securities regulator at least 30 days prior to the closing of the proposed acquisition or sale, respectively.

This notice requirement is triggered by: (i) the acquisition by a registrant of 10 per cent or more of the voting securities (or securities convertible into voting securities) of a firm registered in Canada or another jurisdiction or the parent company of such firm; (ii) the acquisition by a registered firm of all or substantially all of the assets of such a firm; or (iii) the acquisition by a non-registrant of 10 per cent or more of the voting securities (or securities convertible into voting securities) of a firm registered in Canada or the parent company of such firm.

The notice must include material facts regarding the transaction to support submissions relating to conflicts of interest, compliance with securities legislation, investor protection and that the transaction would not be prejudicial to the public interest.

It is common for the CSA to issue a technical objection to the proposed transaction if the comments raised by them have not been addressed to their satisfaction during the 30-day notice window.

Additional Canadian Investment Regulatory Organization requirements

In addition, if the firm is a member of Canadian Investment Regulatory Organization (CIRO) then it must receive the approval of CIRO in connection with: (i) the acquisition of a “significant equity interest” (10 per cent of the equity securities) of the registered firm; and (ii) the acquisition of all or a substantial part of the assets of a registered firm. A “substantial part of the assets” includes the registered firm’s book of business or a division of the firm. The timeframe for notice and approval by CIRO is similar to the approval required by the CSA and is commonly handled by way of a joint submission. Similar to the provincial regulators, CIRO will assess the transaction as it relates to conflicts of interest, compliance with securities legislation and investor protection as well as a more specific focus on financial impacts, including risk adjusted capital of the firm.

Focus on conflicts of interest in regulatory review process for M&A transactions

The CSA and CIRO have implemented a more enhanced conflict of interest screening process when assessing and approving asset management M&A transactions. NI 31-103 clearly sets out the basic principle that a registered firm must take reasonable steps to identify existing or reasonably foreseeable material conflicts of interest. A registered firm must address all material conflicts of interest between a client and itself, including each individual acting on its behalf, in the best interest of the client.

As part of the regulatory approval process for asset management M&A transactions, parties must carefully consider whether certain commercial terms or business strategies create a conflict of interest and how such conflicts are to be managed. For example, firms should consider some of the following issues:

- Does the proposed purchase price structure – flat amount, a percentage of the earn-out target, a multiple of the amount exceeding the performance target, or any other pre-defined formula – create a conflict of interest?
- What other incentives – financial or otherwise – may create a conflict of interest and how will both parties manage and/or mitigate such conflict?
- What due diligence has the seller completed to confirm that its choice of purchaser is suitable and in the best interests of the firm's clients?
- Will there be changes in fees payable by the seller's clients pre and post acquisition? How do such fees compare to the fee schedules for the purchaser's existing client base (both in quantum and methodology)?
- Will there be a change in products and/or services available to the seller's clients which would impact the seller's recommendation to move client accounts to a successor firm?

The regulatory review process may require the production of client notices and communications, data points on actual fee changes and copies of the disclosure to be provided to clients identifying and addressing the conflicts of interest.

Securityholder approval for a change of manager

In addition to the requirements of NI 31-103, where the acquisition involves a change of the manager of an investment fund, securityholder approval is required. This approval necessitates the drafting and dissemination of an information circular that discloses all material information regarding the business, management and operations of the new manager and a description of all material effects the change will have on the investment fund's securityholders.

Conclusion

Due to the number of factors driving demand, we expect the pace of M&A in the asset management industry to persist, with consolidation and disruptive technology continuing as key factors. It is vital that Canadian asset managers continue to pay attention to the unique considerations associated with transactions in this sector, which includes the evolving regulatory focus on this industry.

Your ambition. Our advice.

While the current M&A market presents its fair share of complexities, there is an undeniably optimistic undercurrent as companies remain focused in their pursuit of advancing their strategic goals and realizing their corporate ambitions. BLG is dedicated to being your strategic partner in achieving your business and growth objectives.

Rather than just bridging legal gaps, our multidisciplinary team has and continues to forge enduring relationships with both buyers and sellers, working alongside them in the long term to uncover opportunities and proactively manage potential risks. With our

finger firmly on the pulse of ever-evolving market trends, we stand ready to provide you with the guidance necessary to unlock opportunities and position your enterprise for a future of success, today.

By

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