The Berkshire Capital Newsletter

Mid-Year Investment Management & Securities Industry Review

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M&A ACTIVITY REMAINS ROBUST

Merger and acquisition activity, which jumped 41% worldwide last year by value (to $1.95 trillion), remained red-hot in the first half of 2005, rising 43% to $1.26 trillion–the best showing since the second half of 2000, according to Thomson Financial. The financial sector accounted for the largest share of value ($238 billion), while cross border deals made up one-third of the total.

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In the U.S., deal value rose 40% to $592 billion; in Europe, value was up 54% to $403 billion. It's worth noting that in Japan, the value of deals more than doubled in the first half, to $109 billion, though the strength of the economy remains uncertain.

In the asset management business, there were two significant developments that may portend a larger move among diversified financial companies away from money management. In February, **American Express** announced it will spin off its Financial Advisors (AEFA) unit. The tax-free transaction means the newly independent company cannot undergo a change of control for at least one year. Although Amex acquired the well-regarded **Threadneedle Asset Management** fund business in the U.K. in 2003, its large U.S. fund business has been more of a struggle. AEFA has $410 billion in AUM and had 2004 revenues of around $7 billion and net income of $700 million.

Citigroup also opted to reduce its involvement in money management and focus on the distribution side of the business instead, in June swapping its funds and other investment products with **Legg Mason** for the Baltimore firm's brokerage operations and $1.5 billion in stock. The $3.7 billion deal provides Citigroup with a strategic investment in a major asset manager while removing the conflict of interest issues that can draw the interest of prosecutors, regulators and the media-and ultimately impact corporate reputations and share prices. **Merrill Lynch** was also reportedly in talks with Legg Mason on a deal that would have provided a greater level of independence for its fund operations.

Other deals and discussions in the mutual fund industry in the first half underline the impact that new regulations are having on money managers, as smaller and mid-size firms-already grappling with financial issues related to scale-increasingly cite the burden of compliance costs in explaining their decisions to sell. In a recent interview with the *Financial Times*, Legg Mason President and CEO Raymond "Chip" Mason opined that a fund company needed a minimum of $50 billion in AUM to remain competitive.

Amid the strong pickup in M&A activity, in the first half of the year-and for the fifth year in the last six-the U.S. stock market continued to disappoint. Ongoing skittishness about the U.S. economy teamed up with $60-per-barrel oil, talk of a housing bubble and Federal Reserve intentions on interest rates to depress investors. In the first six months of 2005, the Dow Jones Industrial Average dropped 4.7%, while the S&P 500 was off 1.7%, and both indices remained well below the highs achieved in the first quarter of 2000.

General Motors, which has served as a window into the drift of the American economy since the heady 1920s, in the first half embodied some of the biggest long-term fears dogging the U.S. economy, with its descent into junk-bond status, announcement of 25,000 job cuts, and warnings regarding the need to trim its hefty obligations. In a preview of the sort of predicament many observers fear Washington will face in the decades ahead, GM's health care benefit costs alone are projected to be nearly three times operating cash flow this year.

CROSSING BORDERS IN EUROPE

Europeans, accustomed to far more government largesse than Americans, made their feelings about free markets and globalization apparent enough in the second quarter, as the French and Dutch both rejected the proposed European Union constitution. In Germany, Chancellor Gerhard Schroder's tentative effort to reform that nation's perennially sluggish economy by tackling entitlements and courting business hasn't gone over too well with the public either, accounting in part for the black eye his Social Democrats suffered in May in the country's largest state, North Rhine-Westphalia. Meanwhile, the EU continues to limp along for yet another year, with economic growth projected at only slightly more than 1%.

While much of the citizenry has been rejecting free markets and reform, the European banking community has picked up the cross border torch lit by Spain's **Santander Central Hispano** last year when it acquired **Abbey National** of the U.K. for $15 billion. In June, Italian giant **UniCredito** topped SCH's record cross border deal when it reached agreement to acquire Germany's No. 2 bank, **HVB**, for $19 billion, with shares serving as the currency.

In May, the European parliament approved a new law designed to cut some of the legal tangles preventing cross border mergers among companies in the EU.

In Italy, with its notoriously fragmented and protected banking sector, Spain's **Banco Bilbao Vizcaya Argentaria** made a $7.8 billion bid for **Banca Nazionale del Lavoro**, a mid-sized bank in which it already holds a minority stake. **ABN Amro** of the Netherlands battled a local suitor to acquire the smaller **Banco Antonveneta**, an effort that ultimately became embroiled in controversy when documents were leaked indicating that Bank of Italy Governor Antonio Fazio displayed a bias in favor of an all-Italian deal. Separately, in May, the European parliament approved a new law designed to cut some of the legal tangles preventing cross border mergers among companies in the EU.

In the U.S., the consolidation trend continued apace, with **Bank of America** accounting for the largest deal worldwide, with its $35 billion stock-and-cash offer for **MBNA**. **Washington Mutual** cut a $6.5 billion deal for another credit card issuer, **Providian Financial**. On the other side, major credit card issuer **Capital One Financial** expanded into the retail banking arena, with its acquisition of **Hibernia Bank** of Louisiana for $5.4 billion. French bank **BNP Paribas** strengthened its U.S. presence by acquiring **Commercial Federal** of Nebraska for $1.4 billion.

MONEY FLOWS

China National Offshore Oil Corp.'s $18.5 billion unsuccessful cash bid for Unocal of California highlights that nation's growing global economic clout and sophistication, the same factors that are drawing asset managers to China in increasing numbers. **Deutsche Bank** in March entered a joint venture with **Harvest Fund Management**, China's fifth-largest mutual fund company, with assets of $2.2 billion. UBS has formed a JV fund company with **China Dragon Fund Management** (AUM: $390 million), owned by the **State Development Investment Corp.**, while **Credit Suisse First Boston** reached agreement with **Industrial and Commercial Bank of China** and **China Ocean Shipping Group Co.** to create an asset management JV. CBC is China's largest commercial bank and has 100 million customers. **Merrill Lynch** has signed a memorandum of understanding with **Huaan Securities** to form a joint securities firm.

Meanwhile, Bank of America will pay $3 billion for a 9% stake in **China Construction Bank** (CCB), the second-largest commercial bank in the country, while **Royal Bank of Scotland** headed up a group of firms that paid $3.1 billion for a 10% holding in **Bank of China**. BoC is planning an IPO in Hong Kong in the first half of 2006. **Principal Financial Group**, which last year expanded its presence in Hong Kong's money management business through an acquisition of Dao Heng Fund Management, is also in talks with CCB regarding the formation of a fund management JV. The yin-yang of doing business in the Middle Kingdom was underlined by the news in March that the chairman of the CCB was the focus of a corruption probe. CCB was also planning an IPO on Hong Kong's stock exchange.

A review of some of the asset management deals that took place between January and June of 2005 follows, by sector.

WEALTH MANAGEMENT

Assets managed by private banks jumped 13% last year, to around $6 trillion, while the industry's pre-tax profits rose 24%, according to consulting firm Scorpio Partnership-a set of numbers that underlines the powerful attraction of this business. Accordingly, the wealth management industry, which accounted for nearly half of asset management transactions in 2004, remained active for deal-makers in the first half of 2005.

UBS, which made six acquisitions in 2004, was back in the market soon after the new year, enhancing its Italian business with the purchase of a small Milan-based institutional and wealth management firm, **Etra SIM** (AUM: $600 million). While the company took an acquisition breather afterwards, its wealth management business has remained red-hot, attracting a record $16.4 billion in net inflows in the first quarter.

Europe also hosted the sector's largest transaction in the first half, involving **Rensburg PLC**'s $330 million acquisition of **Carr Sheppards Crosthwaite**. Described by Rensburg management as a "transformational" deal, the combination of the two firms created the seventh-largest private client fund manager in the U.K., with $18 billion in AUM. Carr Sheppards had been owned by **Investec**, a South African and British banking firm. (*See "Europe" section for a discussion of additional wealth deals.*)

In the U.S., major financial firms such as Boston Private Financial Holdings and Lehman Brothers were in the market as buyers.

In the U.S., major financial firms such as **Boston Private Financial Holdings** and **Lehman Brothers** were in the market as buyers. Boston Private's $245 million acquisition of **Gibraltar Financial Corp.** was the largest deal, providing the firm with entry to the attractive Florida market through a company whose AUM has tripled over the past five years. Boston Private Chairman and CEO Timothy Vail called Coral Gables-based Gibraltar "one of the premier private banks in America with a very strong foothold in one of the nation's fastest-growing regions." Lehman Brothers made a tack-on acquisition of large- and mid-cap value investor **Sloate, Weisman, Murray & Co.**, which manages $300 million for wealthy individuals and institutions.

Rhode Island-based **Washington Trust Bancorp.** acquired **Weston Financial Group** (AUM: $1.2 billion) of Massachusetts for $20 million, with a three-year earn-out that will boost the price by a minimum of $6 million. Washington Trust Chairman and CEO John Warren called the acquisition "major for us," saying, "It significantly increases the size and capabilities of our wealth management group, and expands our presence in the New England marketplace." Two Connecticut-based firms joined hands, as **NewAlliance Bancshares** acquired **Trust Company of Connecticut** (AUM: $700 million) for $19.3 million, in a deal that extends NewAlliance's presence in the central part of the state.

Silvercrest Asset Management (AUM: $6 billion), a fast-growing three-year-old New York firm, made two acquisitions of multi-family offices: **The LongChamp Group** of New York and **Heritage Financial Management** of Virginia. *Bloomberg Wealth Manager* ranked SilverCrest No. 9 in the U.S. among private banks, as measured by average size of client relationship ($29 million).

MUTUAL FUNDS

While equity markets wobbled along in the first half, equity fund flows in the U.S. remained positive and a number of notable transactions were completed. In a continuation of the small, strategic deals seen in recent years, **Hennessy Advisors** picked up the **Henlopen Fund**, a 13-year-old small-cap growth fund with $340 million in AUM. In explaining the rationale behind the sale, fund manager Michael Hershey pointed to the pressures created by the "current regulatory environment" that have made it "increasingly difficult to cost-effectively manage a stand-alone mutual fund."

In Canada, where the mutual fund industry has been in a consolidating mode for several years, AGF Management acquired ING Investment Management's 14 mutual funds (AUM: $240 million).

AmSouth Bancorporation cited similar issues for the sale to **Pioneer Investment Management** of its mutual fund business, comprising 23 funds and $5.5 billion in AUM. Pioneer, which paid $65 million for the funds, plans to reorganize them into its brand family. Pioneer, owned by **Unicredito Italiano**, also picked up the well-regarded **Cullen Value Fund** (AUM: $42 million) while leaving **Cullen Capital Management** in place as the subadvisor.

In Canada, where the mutual fund industry has been in a consolidating mode for several years, **AGF Management** acquired **ING Investment Management**'s 14 mutual funds (AUM: $240 million), while **CI Financial** made an unsolicited bid for **AIM Trimark**. The latter offer, rejected by parent company **Amvescap**, would have created Canada's largest fund company, with $75 billion in AUM. Undaunted, CI proceeded to bid for the parent, only to be rejected again. In 2000, CI lost the takeover battle for Investors Group, another leading Canadian mutual fund giant, and two years later teamed with **Sun Life Financial Services** of Canada, which took a one-third stake in CI. While CI weighs its options on Amvescap, observers are keeping watch to see if other suitors emerge with their own offers.

One proposed sale that didn't occur involved **Nuveen Investments**, which majority owner **St. Paul Travelers Cos.** had been shopping around. When a buyer failed to emerge for publicly traded Nuveen, St. Paul instead sold its stake in a secondary offering. One obstacle to the sale was price: Nuveen, which has $115 billion in AUM and is the largest U.S. manager of closed-end funds, has a market capitalization approaching $4 billion.

INSTITUTIONAL

The institutional sector, which enjoyed a big bounce in activity last year, when the value of such deals more than tripled, remained busy in the first six months of 2005. Aegon, **Deutsche Bank**, **HSBC**, **JP Morgan Chase**, **Lazard Freres & Co.** and **Merrill Lynch** were among the high-profile buyers.

Merrill Lynch made one of the larger and more significant acquisitions, purchasing the in-house asset management group of Dutch electronics firm Philips, **Philips Pensions Competence Center BV**, and securing a 7-year contract to manage the company's $16 billion pension fund. Observers believe the deal could presage similar corporate divestitures, a possibility Merrill Lynch Investment Managers President and Chief Investment Officer Robert Doll alluded to in saying the transaction provides the company with a "leadership position to conduct similar deals across Europe, and enhanced credibility in the growing area of liability-driven investing."

Separately, Merrill purchased the U.S. defined-contribution record-keeping business of Amvescap.

The asset management arm of **Lazard Freres & Co.** acquired Minneapolis-based **Knelman Asset Management Group**, a growth manager with $250 million in AUM that complements Lazard's "traditional relative-value approach," as the company put it. Lazard completed an IPO in May of this year. HSBC enhanced its fixed-income capabilities by acquiring **Atlantic Advisors LLC** (AUM: $700 million), a privately held manager specializing in emerging markets. HSBC plans to integrate Atlantic into its newly formed HSBC Halbis Partners, an investment manager specializing in fixed income products, emerging markets, European markets and alternative strategies.

BB&T Corp. added considerable scale to its growing asset management business by taking a stake in another North Carolina-based firm, privately held **Sterling Capital Management LLC**. Sterling serves more than 110 institutional and 100 high net worth clients and has $8 billion in AUM, primarily in fixed-income instruments. BB&T, which acquired wealth manager **de Garmo & Kelleher** last year, had $16 billion in AUM prior to the deal.

In the U.K., **Britannic Group** acquired **Century Group Ltd.** for $76 million, in another move designed to meet its goal of being a "major owner and administrator" of "closed-life" funds. The deal adds $3 billion in AUM to Britannic's existing $25 billion in assets. Last year, Britannic entered the closed-life fund market via the purchase of **Allianz's Cornhill Insurance** unit and made clear its intention to continue expanding that business through acqusitions.

ALTERNATIVE

In the real estate management sector, Municipal Mortgage & Equity made its second acquisition in three years, acquiring MONY Realty Capital, a transaction that provides MuniMae with an additional $2 billion in AUM and extends the company's product line beyond multi-family housing. MuniMae CEO and President Michael Falcone also noted that the deal "allows us to provide existing products to new customers and new products to existing customers." For MRC parent **AXA Financial**, the deal provides an exit from a non-core business. Two years ago, MuniMae significantly expanded its business by acquiring the Housing and Community Investing business of Lend Lease Corp., which was then in the process of unwinding its U.S. operations.

The most notable deal in the first half involved Legg Mason's $800 million acquisition of Permal Group, the fifth-largest fund-of-funds manager in the world, with $20 billion in AUM.

In an institutional deal with a real estate component, **Brascan Corp.** acquired **Hyperion Capital Management**, a New York company with $13 billion in AUM. Hyperion's portfolio of mortgage-backed securities complements Brascan's real estate investment management business, consisting of premier office properties.

In a real estate-related transaction in the continuing care retirement community sector, publicly traded **Sunrise Senior Living Inc.** acquired **Greystone Communities Inc.** for $45 million plus additional performance-based payments. The acquisition expands Sunrise's participation in the critical non-profit sector, providing it with management of 14 continuing care retirement communities and 17 communities that Greystone has under development for clients.

Although performance in the hedge fund arena has cooled off, fund flows have remained positive this year following a record 2004, and interest in these investment vehicles as both investments and acquisition targets remains strong. The most notable deal in the first half involved **Legg Mason**'s $800 million acquisition of **Permal Group**, the fifth-largest fund-of-funds manager in the world, with $20 billion in AUM, primarily for high-net-worth individuals outside the U.S. Legg Mason acquired 80% of the firm and can purchase the remaining equity over the next four years. In explaining the deal, Legg Mason President and CEO Raymond "Chip" Mason cited Permal's "consistent" long-term performance record, which has "enabled it to build broad and deep distribution relationships with world-class, geographically diverse partners."

Another major player, Lehman Brothers, took a 20% stake in **Ospraie Management** (AUM: $2 billion), run by an alumni of Julian Robertson's Tiger Management, Dwight Anderson. For New York-based Ospraie, which invests in basic industries and commodities, the Lehman connection will provide the resources necessary for the introduction of additional funds, including Lehman's prime brokerage business and a client base. Earlier in the year, Lehman was reportedly in talks to acquire **GLG Partners**, one of the world's largest hedge funds. Lehman holds a minority stake in that London-based firm.

EUROPE

A number of interesting asset management deals joined the higher-profile banking deals that dominated the headlines on the Continent. Belgian-Dutch financial firm **Fortis** acquired **Dryden Wealth Management** (AUM: $11 billion) from parent **Prudential Financial**, a $104 million deal that provides Fortis with a private banking presence in a number of European and Asian financial centers, in line with its ambitions in that sector.

Barclays Bank strengthened its existing high net worth business in France by acquiring ING's wealth business in that country. The transaction gives the British bank a French high net worth operation with more than $12 billion in AUM. David Roberts, chief executive of Barclays International Retail and Commercial banking, said the deal furthers Barclays' "stated aim to grow the proportion of our income from outside the UK" while enhancing its business in "one of the most attractive wealth markets" in Europe.

In another cross border deal involving a British buyer, **HBOS** acquired the life assurance and pension product business of Germany's **MLP AG** for $335 million plus additional performance-based payments. British private equity asset manager **Capital Dynamics** acquired Swiss- and U.S.-based **Westport Private Equity Ltd.** from hedge fund manager **Man Group plc**. The deal more than doubles Capital Dynamics' AUM, to $5.3 billion, making it one of the world's largest independent private equity asset managers. Thomas Kubr, chief executive of Capital Dynamics, said the combination will provide his firm with the scale and sophistication required to serve the sector's growing institutional client base.

SECURITIES FIRMS

The brokerage industry had a very active first half, led by a major deal in the discount arena, as Ameritrade acquired the U.S. operations of TD Waterhouse. In completing the $3 billion deal, Ameritrade beat back a higher bid from **E*Trade Financial Corp.** Under the terms of the complex transaction, Waterhouse parent **Toronto-Dominion Bank** is selling TD Waterhouse in exchange for a 32% share in Ameritrade, among other considerations.

In a statement, Ameritrade said the transaction "combines highly complementary franchises … with the scale, breadth and financial strength to be a leading player in the increasingly competitive and consolidating investor services industry." The combined company will operate under the TD Ameritrade name. Volume and margins for discount and online brokerages have been under considerable pressure since the collapse of the bull market, and analysts have been expecting some of the larger players to ultimately join hands.

As noted at the outset, **Citigroup** swapped its fund operations for **Legg Mason**'s brokerage arm and $1.5 billion in stock. For Citigroup, the addition of more than 1,300 Legg Mason brokers to its own force brings that operation near parity with industry leader Merrill Lynch, which has some 14,000 brokers. Significantly, the divestiture by Citigroup of its asset management business removes the regulatory conflicts that can arise from having that same staff selling in-house funds. For Legg Mason, the swap provides even greater scale for its highly regarded fund business while removing a brokerage business that had become far less significant as a profit center.

In a notable transaction involving two venerable regional brokerage firms, **Janney Montgomery Scott LLC** of Philadelphia acquired Pittsburgh-based **Parker/Hunter Inc.**, one of the largest remaining independent brokerage firms in the Mid-Atlantic region. The acquisition gives Janney greater scale while offering clients of both firms a more robust product line.

Two other deals of note involved **REFCO Group**'s acquisition of the global brokerage operations of **Cargill Investor Services** for $208 million, with future performance-based payments of between $67 million and $192 million, and **Bank of New York**'s $159 million acquisition of **Instinet Group**'s **Lynch, Jones & Ryan** unit, which provides trading services to institutions.