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Banks dealing with the alternatives?

By [Mindi Westhoff](#)

As banks face the threat of having to sell off their alternative asset management businesses under the "Volcker rule," analysts see the potential for more deals in the space, with pure-plays like [Legg Mason Inc.](#) or other large financials eager to take advantage of the divestitures.

The so-called Volcker rule's [ban on proprietary trading](#) at bank holding companies had been debated extensively in the first half of 2010, with analysts speculating on [whether or not](#) the rule would actually go into effect. But as more bankers pushed for the elimination of [Section 716](#) — which asked banks to move their swap desks, making them a separately capitalized unit — industry observers [believed](#) that the implementation of those guidelines could be sped up.

Under the bill as recently passed, banks could have up to seven years worth of implementation and appeals before they have to fully come into compliance, according to Concept Capital analyst Jaret Seiberg.

Fortunately, said Convergent Capital Management President and CEO Rick Adler, the ability to diversify product lines via an acquisition of an alt asset management unit is a huge draw for many companies, given their often attractive returns, and could lead to deals depending upon the speed with which companies come into compliance.

However, as pointed out by Rosemont Investment Partners managing director David Silvera, buyers looking to add or consolidate alternative investment units tend to come up against valuation issues surrounding performance fees, among other things. Adler also pointed out that banks in particular have historically been successful at housing such units, as they can afford to properly compensate the people managing the firms, and it could be difficult for a small company to provide similar incentives for these shops.

"I think any larger financial institution is used to having to come up with creative solutions to compensation," Adler told SNL Financial, adding that, while certainly interested in buying the units, some smaller companies would have to find ways to properly match the compensation large banks are able to provide.

Pure-play asset manager Legg Mason could be that large financial institution, according to Gabelli & Co. analyst Macrae Sykes. The company has [openly expressed](#) its appetite for bolt-on acquisitions or lift-outs of management teams, and given the current equity, fixed-income, cash and alternatives units it already has in place, Sykes said he expects the company [would be open](#) to "a best of breed" business, or one with superior performance if it becomes available in the near term.

"Their balance sheet has been improving, so their ability to do acquisitions has improved," Sykes told SNL Financial.

While an alternate option would be to spin off the units as standalone companies rather than sell to a large asset manager like Legg Mason, Adler said some private equity units could lose out on the capital infusions they currently receive from banks in that scenario, so being acquired by a large nonbank might be a better option.

"Not having to do fundraising right now, that's a major plus," Adler said. "So when someone makes a decision to go to the outside world, one of the issues is what is their ability to go out and raise capital?"

And at companies like [Goldman Sachs Group Inc.](#), where commitments to alt investment units well exceed the 3% cap of Tier 1 capital allowed to be put into them, such units could face major disruption as their parents attempt to come under the regulatory requirements, Lovell Minnick Partners CEO Jeffrey Lovell pointed out.

Another stumbling block in trying to operate independently, Lovell said, is that some of these units do not have substantial third-party assets and are looking after only the parent's investments. Becoming a standalone company could prove too challenging, he said, without third-party assets, a solid investment track record and continuity in the management and investment teams.

One option — and the most likely going forward — Lovell said, would be to model the divestitures after [Citigroup Inc.](#)'s recent sale of its private equity investment management assets, wherein the bank transferred the management of the unit's activity to [StepStone Group LLC](#) and then sold the interest in the funds to [Lexington Partners Inc.](#)

Regardless of the length of time allowed to implement the changes, banks will have to sell off units at some point. And in the end, Circle Peak Capital President and CEO R. Adam Smith said the market has already seen evidence that even the threat of regulation inspires companies to begin making changes in their lines of business.

While Citigroup did not cite the regulation specifically, and there could have been a variety of motivations for the divestiture, its recent sale came amid growing speculation over the Volcker rule, and Smith said others in the market are already making decisions in anticipation of its impact.