Forces & Factors Driving the Next Phase the Wealth Management Industry's Evolution

Presentation to

NAPFA Large Firm Forum

by

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Background

- Fiduciary Network
  - Specialty P.E. firm that invests solely in wealth managers
  - Capital used to fund acquisitions, internal succession, buying out outside shareholders
  - 23 transactions w/ 14 platform firms to date, $36B AUM in partner firms
  - W/ $315M of capital;;shown 50 to 75 opportunities in typical year
- Firm also publishes extensively on the “business” of wealth management
  - Continuation of work at Undiscovered Managers & w/ JP Morgan
  - Multiple white papers
  - Regular columnists in *Financial Advisor* and *Financial Planning*
  - All free & in public domain
  - www.fiduciarynetwork.com

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Three Topics

- Where is industry headed?
  - What is going on?
- Current valuations
  - Acquisitions, lift outs, internal sales
  - Current market & methodologies
- What does all of this mean for your firm?
  - Or “Hurley’s unsolicited advice”

Issue #1

What is going on? & Where is industry headed?

What Is Going On?

- Big have gotten bigger and more sophisticated
  - More than 600 firms > $1B of AUM;
  - Top 5% = 95% of AUM + capturing most of the industry's new clients
  - Professional management & sophisticated marketing
- 72% of industry participants are (effectively) shrinking
  - Market vs. client capital consumption dominate profitability
- Industry is getting old
  - 43% of industry over 57 [1] / 22% of industry under 40 [2] / Avg age of founder > 63 [3]
  - 1/3 of industry to retire in next decade[4] / Fidelity's "three for every eight"
  - Chronic shortage of "A" quality employees – technicians vs. successors
- Large number of *big, quality* firms incapable of internal succession
  - Owners too old vs. time required to rationally economically transition
  - Leadership vacuum – successors not up to taking over
- Capital provider landscape
  - AMG out; Focus shifting to insurance distribution model; Hightower to CIBC; United done
  - PE firm "platform" strategy w/ short tenure + sale to other PE firm

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[1]Financial Post
[2]Prince and Associates
[3]Tiburon Associates
[4]Deloitte Consulting

Where is Industry Headed?

- Battle is for people and not clients
  - PV of relationship vs acquisition cost = supply still outstrips demand
  - Obscures many structural changes already underway
  - Talent strategies even more important than marketing
- Evolution from “uber-athlete” to “hunter-skinner” model
  - Thought leader in a vertical
  - Supported by sophisticated business development people
  - Logical extension of team structure w/ increased specialization by function
- Value added up or fees down
  - “Cost of ownership” fully rationalized (ETFs + index funds)
  - Expanded core services
  - More specialized additional value added
- Technology integral to sustaining margins
  - Ability to adopt and implement key determinant of success
  - Rebuilding train as it goes 100 mph down the track

M&A Volumes Increasing But Bifurcated

- Sellers driven by owner demographics & not economics
  - Often triggered by potential shift in internal power
  - Psychology, theater & a little finance
- Firms w/ material economic value
  - Relatively small volume but much greater than only three years ago
  - Successor acquisitions or steroid shots
  - Fairly efficiently priced market
  - Non-linear function of price vs. scale/sophistication
- Frieden's "winners will be lucky"
  - Buyers everywhere vs. limited number of invitees
  - Small number of independent WM's w/ access to capital + completed deals
  - Importance of demonstrated ability
- Depleted oil wells
  - 90%+ of industry transactions
  - Old owners + old clients = little value for either buyer or seller
  - Rate of depletion vs. aggravation

Size Will Matter (Even More)

- Capacity to capture clients will eventually exceed supply
  - Client acquisition costs will dominate economics
  - Custodial referral programs provide template
  - @ 25% to 30% of revenue for client acquisition, what is your profitability?
- In the interim, competition for talent + aging client bases will drive economics
  - Larger volumes of new clients required to offset capital consumption
  - Talent shortage will persist for long time
  - Home-grown talent insufficient volume, too slow, low probability of success
  - Poaching + acquisitions
- All point to higher fixed costs
  - More sophisticated/specialized/costly management
  - Greater regulatory scrutiny = much more time and resources
  - More costly technology – firms & not custodians will pay for
- Unremarkable
  - Welcome to capitalism
  - Question is not whether but when?

Industry Structure Today vs. Future

- Only ~ 200 to 250 firms currently sustainable enterprises
  - 900 to 1000 firms with scale (>$500M) but unsustainable models
  - 18,000 barbershops
- Future structure
  - Big firms (>$75M of rev)
    - Thomasson: 5 to 10; Tibergien: 40 to 50; Hurley: 25 to 30; Nesvold: 40 to 50; Frieden 5 to 10
  - 100 to 125 specialists ($50M to $75M of annual rev)
  - Thousands of barbershops
- Winners not yet determined
  - Top of the fourth inning
- Key question: Is sufficient scale possible without acquisitions?
  - Talent as well as clients
  - FA Magazine “Mensa club” consensus: No

Issue #2

Valuations

Generic (Not Extremely Useful) Examples of Current Valuations

- Acquisitions
  - 6.5x projected “accretion” for existing business
    - 4x to 4.5x @Closing
    - 1.75x to 2.25x retention payment @ Y3 or Y4
  - Earnout of 0x to ∞ @ Y5
- Internal succession
  - W/ outside capital:
    - Early sales (effectively) 3x to 4x
    - Later sales 7x to 8x
  - W/o outside capital: 3x to 4x
- Lift outs
  - 60% to 70% of effective marginal economics
  - Combination of comp, stock, bonuses, etc.

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Wealth Management Valuation Methodologies – an Overview

- How should you value a wealth management business?
  - Due to demographics, asked with increasing frequency (and urgency)
- Methodology 1.0
  - 2x revenue, % of AUM, etc.
  - Fundamentally silly
- Methodology 2.0
  - Customary textbook/"CFA" approaches
  - Comparable companies
  - Precedent transactions
  - DCF
- A pragmatic alternative
  - Given the context, how much can the buyer pay?

Comparable Companies and Precedent Transactions

- Valuation by reference to similarly situated companies
  - Comparable companies – benchmark vs. market-based financial metrics (e.g., price-to-EBITDA)
  - Precedent transactions – benchmark vs. multiples paid in prior M&A transactions
  - Goal is to create a range of reasonable valuations
- Results of these methodologies depend on the quality of the input data
  - At this time, however, there is NO RELIABLE DATA
- "Comparable companies" used in an actual valuation
  - Boston Private Financial Holdings
  - Virtus Investment Partners
  - Washington Trust Bancorp
  - Calamos Asset Management
  - Bryn Mawr Bank
- "Precedent transactions" will depend on the investment banker's internal database
  - Deal terms are not announced publicly
  - Keep in mind – investment bankers are marketing
  - Transaction structure matters (closing payments, retention payments, earn-outs, etc.)

Discounted Cash Flow

- Seductive tool – to be used carefully
  - Present value of cash flows is "value" of the stock to *you*
- Extremely sensitive to assumptions
  - Discount rate / WACC
  - Terminal Value
- WACC
  - $WACC = \left((r_d \times (1 - t)\right) \times \frac{D}{D+E}) + (r_e \times \frac{E}{D+E})$
- Cost of Equity
  - $r_e = r_f + \beta_l \times (r_m - r_f)$
- Really?

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Scientific Determination of a Discount Rate

- Example of scientific approach to discount rate – Briaud Financial Advisors
  - *In his own negotiations, Pine found that discount rate is by far the most important input in the model. It was also the hardest to arrive at, since it doesn't come out of the books and records of the advisory firm. "That is the hardest thing you have to negotiate," says Pine. "A little tweak makes a huge difference of hundreds of thousands of dollars, so you have to find an expert who you trust who will give you a number you aren't going to argue over."*
  - *In their own case, Roger and Natalie called Mark Hurley of Fiduciary Network and Mark Tibergien of Pershing Advisor Solutions, and asked them for a fair discount rate for buying an established advisory firm. "They said 20% and 25%," says Pine, "**so we split it down the middle and used a 22.5% discount rate for the model.**"*

Being Wrong With Infinite Precision

- Strong temptation to be wrong with infinite precision
  - Methodologies proposed by “experts” are way too complex
  - Physics envy
- Factors NOT “modeled” by FN when making investments
  - Client-by-client AUM
  - Unique, client-by-client fee schedules
  - Age-based spending and savings projections
  - Life expectancy
  - Detailed line-by-line expense projections (particularly over long periods)
  - “Proprietary” formula for determining risk/discount rate

Internal Equity Sales – Overview

- Unavoidable governor on internal sales: successors don't have much money
  - Typically in 30s or 40s w/ $100k to $300k / year comp
  - Consuming comp the way young families typically do (first homes, children, college savings, etc.)
- Most successors require a loan
  - Bank loans (hard to get) or seller financing (moral hazard)
- Dominant factor in price = repayment requires after-tax dollars
  - Interest rate only marginal impact
- Four (maybe five) step process to "modeling" price
  - #1 – Agree on objective methodology for calculating annual dividends
  - #2 – Make key tax assumptions
  - #3 – Input terms of the financing
  - #4 – At various prices, run reasonable projections of the loan payoff
  - #5 (maybe) – Repeat steps #1 through #4 assuming employee invests personal cash (or comp)

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Internal Equity Sales – Modeling Price

- Step #1 – Agree on an objective methodology for determining dividends
  - Selling owners typically have voting control – could “bonus out” 100% of profitability
  - Be wary of “soft comp” – cars, travel, meals & entertainment, etc.
  - Successors need contractual protection that “profits” will actually be distributed on equity
  - No “perfect” methodology
  - Options
    - Use a % of EBOC (i.e. a % of profits before founders / selling owners are paid)
    - Implement a “comp plan” that includes objective (formula-based) limits on comp and bonuses
- Step #2 – Make key tax assumptions (in the real world, taxes matter)
  - Corporate form matters (C-corp, S-corp, LLC, partnership, etc.)
  - Combined state and federal income tax rate of the successor / buyer
  - Deductibility (or not) of interest on loan used to purchase equity
  - Deductibility (or not) of “goodwill” write-off / depreciation

Internal Equity Sales – Modeling Price

- Step #3 – Input terms of the financing
  - Term / maturity date
  - Interest only period, if any (HINT: you are going to need it)
  - Interest rate (fixed, floating, etc.)
- Step #4 – At various prices, run reasonable scenarios to determine loan payoff
  - Consider a range of prices (for simplicity, framed as a multiple of the dividend)
  - What rate of earnings growth is required to result in a payoff of the loan?

Internal Equity Sales – Modeling Cash Flows

	Closing	Year 1	Year 2	Year 3	Year 7
Revenue	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000
Expenses (Excludes Owner Compensation)	3,000,000	3,000,000	3,000,000	3,000,000	3,000,000
EBOC	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000
Dividend Pool (assumes 75% distributable)	**1,500,000**	**1,500,000**	**1,500,000**	**1,500,000**	**1,500,000**
Valuation Multiple	8				
Valuation	12,000,000				
Equity Purchased	5%				
Purchase Price	600,000				

Loan Repayment	**Closing**	**Year 1**	**Year 2**	**Year 3**	**Year 7**
Distributions		75,000	75,000	75,000	75,000
Interest (@ 5%/yr)		(30,000)	(27,878)	(25,703)	(16,459)
Pre-Tax Cash Flow		45,000	47,123	49,297	58,541
Goodwill Writeoff		(40,000)	(40,000)	(40,000)	(40,000)
Taxable Income		5,000	7,123	9,297	18,541
Tax		(2,550)	(3,632)	(4,741)	(9,456)
Amount Available for Principal Payment		42,450	43,490	44,556	49,085
Loan Outstanding	**(600,000)**	**(557,550)**	**(514,060)**	**(469,504)**	**(280,095)**

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Internal Equity Sales – Loan Payoff Tables

- At any valuation multiple, what earnings growth rate is required to payoff the loan?

Interest Rate = 5.0%

Valuation Multiple	Earnings Growth Rate 0.0%	2.5%	5.0%	7.5%	10.0%	12.5%	15.0%	17.5%	20.0%	22.5%	25.0%
3	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS
4	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS
5	FAIL	FAIL	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS
6	FAIL	FAIL	FAIL	FAIL	PASS	PASS	PASS	PASS	PASS	PASS	PASS
7	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	PASS	PASS	PASS	PASS	PASS
8	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	PASS	PASS	PASS	PASS
9	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	PASS	PASS	PASS
10	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	PASS	PASS
11	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	PASS
12	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL

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* NOTE: Assumes loan with seven year term (i.e. maturity at seventh anniversary).

Internal Equity Sales – Loan Payoff Tables

- At any valuation multiple, what earnings growth rate is required to payoff the loan?

Interest Rate = 10.0%

Valuation Multiple	Earnings Growth Rate 0.0%	2.5%	5.0%	7.5%	10.0%	12.5%	15.0%	17.5%	20.0%	22.5%	25.0%
3	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS
4	FAIL	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS
5	FAIL	FAIL	FAIL	PASS	PASS	PASS	PASS	PASS	PASS	PASS	PASS
6	FAIL	FAIL	FAIL	FAIL	FAIL	PASS	PASS	PASS	PASS	PASS	PASS
7	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	PASS	PASS	PASS	PASS
8	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	PASS	PASS	PASS
9	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	PASS
10	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL
11	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL
12	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL	FAIL

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* NOTE: Assumes loan with seven year term (i.e. maturity at seventh anniversary).

Internal Equity Sales – Discussion Points

- Is an internal equity sale a realistic succession plan?
- At current “valuation” how much of the business can you really sell?
- What is the “real world” borrowing capacity of your successors?
  - How many successors do you have?
- What is your successors’ risk appetite?
  - Will they invest any of their money?
  - Willing to sign a full recourse loan? Under what conditions?
- Will your successors commit to investing any of their compensation?
  - Can assist in bridging a “valuation gap”
  - Challenging to get successors to agree

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Issue #3

What Does All of This Mean For Your Firm?

Questions to Consider

- Where does your firm fit in the current industry landscape?
  - Scale relative to peers
  - Succession plan implementation
  - Service offering
  - Marketing capability
- What competitive advantages do you currently have?
  - Depth and strength of successor pool
  - Size
  - Unique, well branded high value expertise
  - Geographic
- What do you want to be when you grow up?
  - Large vs. specialized vs. “lifestyle” practice/barbershop
- What must you do to make that a reality?
  - Scale + service offering & expertise + talent

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Which Current Competitive Advantages Are Sustainable?

- Talent
  - Efficiency of labor markets
  - Culture necessary but insufficient
  - Thomasson's "$20M wealth creation opportunity"
- Size
  - Rapidly rising fixed costs
  - Growth required to provide sufficient wealth creation opportunity to retain talent
  - Marginal cost of recruiting future clients
- Geographic
  - Other market entrants
  - Wannabe super regionals
  - Acquire smaller competitors & ramp up marketing
- Specialization
  - Monopoly market share vs. temporary advantage

What Will Your Fixed Costs Be in the Future?

- Core service offering expands or expect lower fees
  - Unclear how but UNHW provides template
  - Examples emerging:
    - Impact investing
    - Health care cost management,
    - Info sec
    - Client privacy
- Greater numbers of (more) sophisticated management
  - COO/CCO/CISO/CMO
  - HR department?
- Marketing & technology

How Big Will Be "Big"?

- Currently
  - <$4M of revenue = barbershop
  - <$15M of revenue = Small
  - $15M to $30M = Mid-sized
  - >$30M = Large
- In seven years:
  - Big firms >$75M
  - Highly profitable specialty firms = $30M to $75M of revenue
  - Everything else = Jobs / "lifestyle practice"

How Do You Get Big?

- Organic: Possible but challenging
  - Aging client bases and capital consumption
  - Only offset by greater & greater volumes of new clients
  - At what marginal cost?
- Key obstacles
  - Volumes / time required for new clients vs. existing ones
  - Sourcing / recruiting existing talent
  - Wealth management growth conundrum
- Other alternative: Acquisitions
  - Limited opportunities in current geographic market
  - Complex, require luck and capital
- Requires planning & strategy
  - Legions of competing buyers

What Does Specialization Really Mean?

- Ability to diagnose and craft solutions to important but very complex client problems
  - Enhanced expertise in challenges faced by small subset of clients
  - Unavailable from most large competitors
  - In addition to (not in lieu of) expanded service offering
- Examples:
  - US Canada Tax Treaty opportunities
  - Wall Street Women's Forum
  - Coca Cola Executives
  - Extraordinarily (but justifiably) pissed off women
- Providers have pricing power
  - Demand for expertise create inelastic pricing
- But sustaining is constant exercise in enhancing expertise
  - Lasik vs. repairing bad Lasik

My (Unsolicited) Advice

- Figure out what you want to be when you grow up
  - No strategy = certainty of bad outcomes
  - Once a firm realizes it needs a strategy, it is too late
- If goal is continued independence, work out succession plan ASAP
  - Create opportunity for successors to build wealth
  - Fairly remunerate founders for what they have built
  - Precondition to making firm sustainable
  - *Or merge with another firm that has already done this*
- If acquisitions are part of your strategy, get it in gear
  - Many peers have sophisticated acquisition strategies & access to capital
  - Risk of not being part of the discussion
- Good luck!