Private Wealth Focus
A FOCUS POINT PRESS PUBLICATION

Guest Column: Current Trends Relating to Accelerated Acquisition of Assets through both Organic and Non-Organic Means

Posted by Marianne Nardone on 3/06/12 • Categorized as Research / White Papers

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1. Background

Since the crash of 2008 and the market's somewhat tentative return to health, the Wealth Management industry has been obsessed with recruiting client-facing professionals with portable assets, and sales professionals with proven track-records of consistently high production numbers. This should come as no surprise. In a fee-based model any major contraction of AUM leads to a direct reduction of top line revenues. Cost cutting, which has been a prevalent trend, primarily by reducing middle management and sales management, can only do so much to ameliorate a crushing blow to the top line. This is particularly true in our world of open architecture in which such a large portion of fees are used to remunerate outside managers. And so the illusive panacea that we are often tasked to find is a quick transfusion of assets, to stabilize our asset-anemic clients.

2. Current Trends

a. Individual Producers

Over the last four years 64% of our searches have targeted two types of revenue generating professionals: the rarest of creatures, the million dollar revenue producers who remain the unicorns of wealth management, and relationship managers with a strong sales component to their responsibilities. Perhaps one of the repercussions of our present SMA world is that fewer institutions are utilizing a pure hunter sales force. This is quite understandable. In the ancient world of a decade ago, a sales professional could focus on selling the purported superior performance of his firms' proprietary products. Now as sales professionals "sit on the same side of the table as their clients," as the current euphemism extols, the sale is considerably more subtle. It generally is a sale of superior service, a more holistic approach, and a bond of trust in the culture and values of the institution. Snake oil is clearly not on the menu, and many institutions are scornful of traditional hunter approaches and scoff at the use of such pedestrian words as "sales" and "production". And so the unicorn is slowly becoming extinct.

Twelve years ago five percent of the national sales force managed to produce one million in new annual asset management revenues. Today the number is under one percent, based on a survey we conducted last quarter. There are only a handful of firms that even employ a pure sales force that hands-off the relationship upon closing. Although there still is great value in utilizing hunters, even within a primarily private banking model in which a relationship manager will become the client service professional after closing, we find a number of regional banks eliminating their external sales forces entirely. Pure hunters are found primarily among the trust companies and asset management companies, but almost never among international money centers, wirehouses, or most RIA's. So the unicorn is no longer regarded uniformly as the asset generating solution of choice that the industry is longing to acquire. Several firms use a hunter model very effectively and I do not wish to imply that it is obsolete or ineffectual, simply that the number of top producers has dwindled, the patience of the industry to allow an adequate ramp-up time for production has dissipated, and there are essentially almost no viable training programs which are needed to develop a future generation of top producers.

So in a world in which so few hunters provide exemplary production; particularly in their first two years with a new firm, there has been a growing trend to recruit relationship managers with sound production records and the hope of some degree of portability. This can be very dangerous for two reasons. The first reason is that many relationship managers with impressive production numbers rely extensively on intra-bank referrals from other lines of business, the most obvious being commercial lending. One can dissect their production numbers and try to isolate what has been hunted externally, but it is a difficult thing to validate, and even externally sourced business is often a result of a strong bond between the referring center of influence and the wealth management firm itself. The second danger involves moving relationship managers from a banking environment to one in which credit is not a major component of the firms offering (particularly balance sheet lending). Even if one isolates the asset management portion of the book from the credit and deposit business, and then tries to make a calculation on the asset portability, the analysis will probably be faulty. Clients are still very hesitant to move assets from a bank with which they have an existing credit relationship, even if the assets are not securing a line of credit. One needs to identify clients in the book of business that essentially have a pure asset management relationship with the relationship manager and are not tied to the bank by other products. Once this small group has been identified a reasonable portability expectation would be no more than 20% in the first year. Even wirehouses have experienced enormous drops in portability (some estimates place the figure at 55% down from 85% in 2007).

b. Team Lift-Outs

The next turn the industry has taken, a bit like a mouse running frantically through a maze and turning at each blank wall, has been an increased move toward team lift-outs. This can be a viable option if caution is exercised, because the term "Team Lift-Out" is rather vague, and can mean anything from a newly hired producer bringing a sales assistant, to lifting-out the entire team of specialists that surrounds a group of clients. Although one occasionally encounters teams that are actively seeking to move together, more often a team lift-out needs to be created, almost in the manner of recruiting an intelligence operative within a foreign government entity. In the cases in which an intact team is marketing itself one can assume that the hiring firm will be actively competing with a number of other institutions that the team has approached. As a result the cost will typically be considerably higher than constructing a team lift-out in a clandestine manner. The other advantage in the clandestine approach is it generally allows the acquiring firm the element of surprise which always increases portability, as opposed to the team that is selling itself; for regardless of the precautions they may undertake to insure secrecy, it is virtually impossible for their employer not to get suspicious and begin developing a contingency plan to retain their clients.

The first step in executing the clandestine approach is to identify institutions in which a "hard-wired" client team is the prevalent model. That is to say that a relationship manager has an actual team (typically in the hub and spoke configuration), in which the same specialists surround each client relationship. The key players need to be the portfolio manager, trust administrator, and lead relationship manager. We always encourage the hiring institution to also bring any support personnel that actually engage in frequent interaction with the client. Typically the best way to construct a lift-out is to approach one of the senior members of the team as if you were recruiting him individually, and the hiring institution should sincerely be willing to hire this professional even without his team following immediately. During the initial interview process, after a sense of trust has been established, the question of a team lift-out should be broached. It is essential that the recruiting firm examine any non-solicitation agreements undertaken by the employee you wish to use as the clandestine operative. If he is prohibited from soliciting employees, it is then essential that the recruiting firm contact each team member individually and create the lift-out in a manner in which the members are not perceived as soliciting each other. If no non-solicitation agreement exists it naturally is an easier process, in which the lead employee can act as the negotiator and spokesperson for the team.

The other ingredient in a successful lift-out is orchestrating the method and timing of the mass resignations, and having complete clarity on any restrictions regarding soliciting clients. Since restrictions usually apply (outside of firms that have joined the Protocol) it is important that bonuses used to enrich the team for portable assets be created on a success basis, and never as upfront sign-on bonuses.

c. Acquisitions of RIA's

The more surprising trend that we are currently experiencing is not only a heightened interest in team lift-outs, but a virtual stampede to acquire RIA's in an effort to immediately increase assets. Within the last twelve months we have experienced slightly more requests on the M&A side than on the lift-out front, from a host of firms from regional banks, to other RIA's. It is an interesting phenomenon when you consider that a recent report from Schwab Advisory Services chronicled that in 2011 only 57 RIA's were sold in the entire country, representing a sale of only $44 billion in AUM (yielding an average deal size of only $798 million). Of those only 10% were purchased by regional banks, while 44% were purchased by other RIA's.

There are a number of reasons why the demand far outstretches the supply. The first reason is that RIA owners often have unrealistic expectations of the value of their company. In my local veterinary office there is a print of a cat looking in a mirror and the face of a lion is reflected back. Unfortunately, many RIA owners have a magnified sense of their own uniqueness and value that makes agreeing on a normal valuation difficult, and sometimes contentious in an overly personal way. In addition to this, since the RIA segment has also suffered from top line and bottom line compression, the basis for any valuation will almost always be lower than it was prior to 2008. One RIA owner whom we were trying to sell to a private equity firm last year reluctantly agreed to an 8 times EBITDA valuation- but insisted that the 2007 EBITDA be used against this multiple. The perplexed private equity principal responded that it would be quite similar to posting a photo of himself on Match.com from twenty years ago. But these anecdotes illustrate the simple fact that despite a huge demand for RIA's, the valuation discussions will negate many potential deals.

Another problem, is although RIA's are typically hungry for cash to either fund growth or provide some liquidity for the owners, and succession issues, they often are not willing to rejoin the same corporate banking environment against which they rebelled in the first place, and ultimately escaped to form a more nimble and versatile culture, albeit often in their own image.

So the question arises, is RIA acquisition a viable solution to quick asset growth? I think under the right conditions the answer can be yes. Let me define what I believe to be some of the right conditions as well as some common pitfalls.

Before I provide specific guidelines I would like to make the blanket warning to avoid trying to roll-up a series of disparate RIA's under the illusion that through economy of scale one will cut overhead costs drastically and create a more efficient organization. As Tolstoy said "Happy families are all alike; every unhappy family is unhappy in its own way." One should then focus on acquiring only those firms that will fit well within the culture of your family, and do so in a manner that will benefit the key staff of the acquired RIA as well as your firm's strategic goals. Here are some guidelines:

- A wanton roll-up strategy with a poorly defined, pathetically hopeful IPO exit strategy for the most part is doomed. One unhappy family is unfortunate; a harem of unhappy families is a tragedy. As for economy of scale, I have seen very little cost savings devolve from roll-up strategies, with the exception of the new Dodd-Frank compliance costs that might severely affect smaller RIA's bottom lines. Therefore, a strategic, well thought-out set of reasons should be clearly defined, in which collating assets, and consolidating overhead costs are not the primary goals, but the favorable outcome of a comprehensive set of selection criteria.
- Never pay the entire purchase price at closing. Tie the principals into a minimum of a three-year earn-out with very specific parameters around asset growth, retention, and earnings.
- Sign strict, long-term management contracts with the key staff to ensure that an exodus of talent and then clients does not follow after the last earn-out check clears.

- Develop a structure in which the acquiring company can act as a long-term financing vehicle to provide current owners with liquidity and future partners with cash to buy equity and a means of borrowing against the equity if needed.
- Provide a clearly defined succession plan.
- Offer minimal integration of operations with the exception of: finance/accounting; human resources/payroll; and compliance.
- Depending on the sophistication of the RIA’s back office as it relates to manager selection and consolidated reporting, these functions might also be centralized by the acquiring firm, but that decision needs to clearly be integrated into the strategic plan prior to closing.
- Freeze earn-out metrics at closing.

3. Conclusions:

We believe that in this environment all three solutions referenced above should be investigated in parallel. Individual hires with real production records, and client-facing professionals with verifiable portability should be sought, as well as back-end structured team lift-outs, and strategic acquisitions.

In the current environment we project that 2012 will reflect higher deal flow of RIA acquisitions by other RIA’s; particularly with MFO’s as the acquirer. We would expect that the large appetite for team lift-outs will continue with an increase in wirehouse to wirehouse movement, as the retention bonuses used during the meltdown of 2008 begin to amortize. Finally, we project an increase in portability of assets as the credit environment becomes slightly less conservative.