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TRENDS IN Wealth Management Acquisitions

THE CURRENT LANDSCAPE

This review provides our insight into the current transaction trends in acquisitions of wealth management entities.

Fact vs. Fiction

- Transaction and trend information is abundant but real facts are sparse. Many deal terms have never been disclosed. Buyers are protective of their offer models. Sellers are protective of information on remuneration they have received. When disclosed, we strongly believe that buyers and sellers inflate or deflate actual numbers depending on their short-term strategic objectives inclusive of building interest in their firm for the next potential deal.
- Rumors about the "best deal out there" drive this industry. Sellers speak endlessly about the deal they almost had without disclosing the real reasons deals fell apart. Buyers, especially financial only buyers over strategic buyers, often discuss success factors of their financial models that have never materialized.
- However, size is important in the industry. Studies by McKinsey and others have shown that the cost per assets ratio drops substantially for asset management firms as the firms reach scale, particularly as they reach above the $25 billion level.

Who Believes in Metrics?

- The gap between today's buyers who finally need to confront financial reality and amplify ROI and current sellers who cling to unrealistically high expectations of price is very large.
- Many sellers have limited understanding of simple M&A metrics, and negotiations can fall apart quickly as sellers want to be paid for EBOC (Earnings Before Owners Compensation) or revenue instead of EBITDA while still maintaining owners' compensation at current levels.
- Pre-crash multiples were very high and assumed EBITDA growth levels that would have to be well above 20% CAGR inclusive of market appreciation to produce any reasonable payback period.
- Post-crash multiples are more reasonable but the number of deals has dropped off for a range of reasons including a wait and see attitude on the part of sellers.

Beware the Growth of the Target

- Many selling firms do not have a true growth story or strategy and, even if currently successful, may have outgrown the internal organic opportunity that allowed them to achieve their initial success.

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- Pricing is very dependent on the size of the target with much higher multiples paid for firms with AUM above $1B, though many of these larger firms are no longer growing quickly or truly investing in their own growth.

What We Believe

Opportunities for acquisitions that generate acceptable returns exist but only if the buyer pursues firms (RIA, BD or bank based) that:

- Are actually growing with an integrated and successful sales and marketing strategy
- Have a natural market that has significant headroom in which to grow
- Either have already put together a business structure that allows them to be integrated into a larger entity or have created client relationship structures that will withstand the change
- Will be willing to abandon current practices and adopt the back office, marketing and investment platform of the buyer – we believe strongly in the buyer's way or the highway
- Will do a deal where the total growth factor for success of the deal is calculated between 7.5% and 10% annually for the base case inclusive of market appreciation and all other growth past the base case is paid for on an earn-out model
- Have AUM above $500MM so that they can quickly become a meaningful contributor to the buyer's earnings
- Can prove that they are set up for succession planning
- Have zero level of compliance problems and have adopted today's most stringent compliance standards
- Have adopted or will be willing to risk clients to adopt a low dispersion model of asset management across client accounts
- Will migrate to the buyer's brand within a reasonable period of time

General Trends

Deal shifts from 2007 to today:

Types of Buyers and Deal Terms

During the peak of the market, banks, asset management consolidators and other large wealth management entities dominated the buying scene. Capital was abundant, deals were priced assuming continued and rapid growth, and venture capital and private equity drove the engines of the consolidation firms. Being opportunistic often outweighed strategic. Getting good pricing was less important to buyers than getting additional scale and beating out their competitors for deals. Post deal, minimal if any attention was paid to merging brands, infrastructure, investment products, marketing and sales forces. These deals were all about growth at any cost. Synergy, if any, was just supposed to "happen."

In this era, innovative financial structures were being used to buy target firms at high prices. Up-front and aggressive earn-out payments were paid in a combination of cash and either real stock of a public firm or options/warrants/phantom shares of a consolidator that professed that it would go public in the future if it had not already completed its IPO. Some serial acquirers began to buy firms under the "Newco" model where the cash flow stream of an existing firm would be split into two

	2007	2008/2009	Today
Types of Deals	Institutional buyers	RIA/RIA mergers	Combination of both
Deal Drivers	Valuation and profit	Desperation	Strategy
Currency	Stock and cash	Cash only	Cash and stock from stable firms

tranches. The acquired tranche of revenue would accrue only to the buyer and would have minimal expenses. The Newco tranche would stay with the seller who would continue to pay all expenses of the acquired firm.

Post crash, the buying population changed dramatically. With rare exception capital dried up. Newco tranches could no longer meet their cost obligations. Some serial buyers had also bought mortgage banks which threatened the entire entity and devalued the stock that had been used to purchase HNW firms. Many purchased firms looked for exit strategies from their buyers, but few solutions were found.

RIA/RIA deals began to dominate over transactions where corporate entities were buying up smaller organizations. While some experts attributed this evolution to a change in strategy, we tied these new trends directly to capital availability and a change in seller behavior.

Sellers, post crash, were no longer willing to accept unhedged stock as a major part of their payments for either up-front or earn-out compensation.

Today, we see a re-entry of institutional buyers into the market with a strong preference for cross-border as well as domestic transactions. Cash is still king. Quality sellers are only accepting stock-based deals from the most stable and prestigious institutions.

Pricing

2004 to 2007

For RIA-based deals, BDs essentially operating as RIAs, and bank-based wealth management practice lift outs, we found that prices accelerated rapidly in the 2004 to 2007 era. Industry sources give a very wide range of multiples of EBITDA, EBOC and free cash flow.

For smaller firms, those with AUM under $1B, the ranges quoted are 6X to 11X EBOC. For larger firms over $1B AUM, the range quoted is from 6X to 17X EBOC. In most cases, EBOC is the most useful number used in determining how firms established these multiples unless they are already corporate owned entities.

At Optima Group, we find these ranges suspect. Our deal experience and our involvement in firms sold during this era indicate that 11X EBOC was an extremely high multiple at the time. We only saw higher multiples for this era assigned to firms with a strong reputation for institutional asset management as well as wealth management and only if that institutional product was in a unique asset class with a GIPS compliant record that was important to the buyer. The 11X EBOC multiple deals only "paid off" when the acquired firm grew very rapidly as in the case of a well-known firm that combines HNW and mass affluent strategies with a direct marketing new business development structure.

In general, we found that well-run, high-quality RIA-based firms (AUM over $500MM and in some cases over $1B) that would meet our criteria in the 2004 to 2007 period commanded EBOC multiples of 7X to 8.5X with a few firms commanding 9X if they brought ancillary services into the seller that were key for strategic reasons. Smaller firms were selling for 6X to 8X EBOC during the same period of time.

2008 and 2009

Prices during the crash contracted quickly. Buyers saw new offers drop off by an average of 20% from 2007 pricing in 2008 and by an additional 10% in 2009. Deal volume contracted and a significant number of deals that made it to at least the level of an exclusive letter of intent did not close as capital became unavailable at the last minute.

Cash-focused sellers were unwilling to part with quality firms during this period of time. Some of the serial acquirers and consolidation firms did make headway during these two years, but deal terms indicate that other factors such as a seller needing to raise cash, lower expenses, or to sell their business because of an aging management team dominated these transactions over pure strategic criteria.

2010 and 2011

Pricing rationality and strategic purchases have re-entered the marketplace. Sellers are more accepting of the "real value" of their firms as long as the currency used for purchase is stable. Good buyers are being more strategic in both their choice of acquisition targets and their deal terms.

In general, we now find that well-run, high-quality RIA-based firms (AUM over $500MM and in some cases over $1B) that would meet our criteria command EBOC multiples of 6X to 7.25X with a few firms commanding 7.5X if they bring products such as structured investments or other alternative proprietary opportunities to the seller. Smaller firms are now selling for 4.75X to 6X.

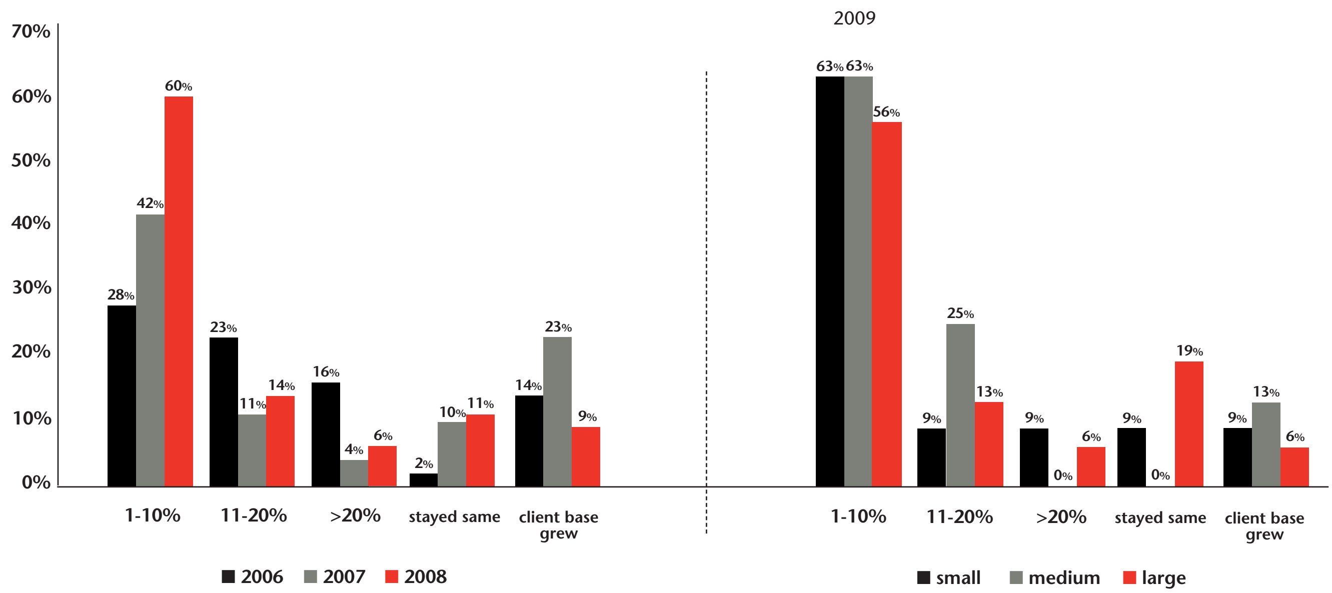
An EBOC/EBITDA Caveat

While pricing has rationalized, buyers must still be very careful when analyzing the earnings of targets. A trend that started in 2004 still continues with sellers highly discounting expenses that they label as one-time events. Many of the expenses these sellers indicate are single events would actually recur (especially in sales and marketing) in any real world continuation of these sellers' business models.

Risk of Losing Clients

One final factor in analyzing organic growth versus acquisitions is to estimate the loss of clients post deal. Estimates of this loss rate have been recently studied by PWC and are presented in the charts below.

Proportion of client base of acquired entity lost within 12 months.



Source: PWC; GfK NOP