Berkshire Capital

NEWSLETTER | 3rd-Quarter 2014

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Consolidation trend continues to define the securities industry

Since the financial crisis of 2008, deal-makers have been actively pursuing transactions in the three core sectors of the securities industry: full-service retail brokerage; independent broker-dealers; and investment banking, including mergers and acquisitions advisory and capital markets. Within the two retail brokerage sectors in particular, regulatory compliance cost pressures combined with the ongoing quest for scale among both buyers and sellers have been key drivers. Generational issues are also at play, as owners/founders look to monetize their investments and prepare for a changing of the guard. Significantly, the increased level of M&A activity points to an environment where buyers and sellers are finding more common ground on valuations through the use of earn-out structures and other risk-sharing mechanisms.

For acquirers, the buy vs. build comparison is straightforward. First, although the cost of an acquisition is meaningfully higher at the outset, the execution risk tends to be lower when compared with hiring individual advisors or investment bankers over time. The acquirer is buying an existing team with a replicable revenue stream and an in-place profit margin, as opposed to incurring operating losses over a potentially extended period of time while orchestrating a series of new hires that fit into the firm's culture as the newly formed team rebuilds its revenue base and reaches break-even profitability.

For brokers seeking to expand into new geography, the purchase of a recognizable local brand also provides an immediate footprint. Additionally, as the cost and complexity of regulation and technology grows, a buyer can typically eliminate significant redundancies within a target's back-office function, improving operating efficiencies by supporting a larger revenue base with its existing operations infrastructure. Similarly, a seller can often improve the client service model by gaining access to the often superior technology and compliance operation and broader product suite of a larger and deep-pocketed parent.

On the traditional full-service retail end of the industry, consolidation has been ongoing since the 1990s, leaving a diminished number of independent firms that offer enough size (50 to several hundred financial advisors) to be attractive targets. On the independent broker-dealer side, a recent flurry of deals has led to a similar run of consolidation, where increased compliance and technology costs have squeezed already-tight profit margins, forcing smaller independent firms to re-evaluate prospects for shareholder value as independent firms.

In addition to managing costs and gaining scale, brokerage firms of all sizes face the hurdle of recruitment in an industry beset by significant demographic challenges. The average age of a financial advisor is 51, according to researcher Cerulli Associates, with nearly one-third between 55 and 64 and only one in 10 below the age of 35. Observers warn of a growing gap in the number of advisors required that could reach 200,000 in another eight years. To an extent, acquisitions can help resolve that challenge by injecting new blood into a larger buyer.

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An emerging if still ill-defined longer-term threat to the traditional advisory model has appeared in the form of algorithm-driven online “robo advisors.” These firms have a particular eye on the Millennial generation of investors already comfortable with managing large parts of their lives online — and with minimal direct human contact. Client assets in this sector were approaching $16 billion by the second quarter of the year, according to Corporate Insight, a gain of 37% over the first quarter. **Wealthfront** is one of the higher-profile examples of this advisory model. Launched in December 2011 and based in Silicon Valley, Wealthfront has already accumulated $1 billion in client assets, on which it charges a flat advisory fee of 25 basis points. Clients also have access to tax-loss harvesting services with accounts as small as $100,000. The firm, which has financial backing from several Silicon Valley venture capitalists, counts “A Random Walk Down Wall Street” author and Princeton University economics Prof. Burton Malkiel as its chief investment officer.

Perhaps more ominously for the traditional wealth management model, **Vanguard**, with $3 trillion in AUM, has entered the race with a Personal Advisor Services business that employs the robo model while allowing for limited human interaction. With an annual fee of 30 basis points and a huge client base, assets have more than quadrupled in the last year to $3.6 billion. Punctuating this paradigm shift, **Charles Schwab** President and CEO Walter Bettinger announced at an analysts meeting this past summer that his company is “fast at work” on what he called a “groundbreaking and market-impacting introduction of an online advisory solution,” opening up a second potential competitive threat to the traditional industry.

Earlier this year, when the founders of **Manzanita Capital** considered the future direction of their firm and its wholly owned subsidiary, **McAdams Wright Ragen**, their evaluation centered on management succession, capital turnover and management distraction triggered by an escalating compliance burden, as opposed to concerns about emerging competitive threats or declining margins. The group opted to proactively seek the right partner from a position of strength, with a keen eye on cultural compatibility — a big factor in successful deals.

The challenge for buyers in deals that do not deliver expected outcomes is generally centered around advisor retention. Immediately upon announcement of a retail brokerage transaction, competitors can move aggressively to poach a buyer’s newly acquired advisors, offering front money of up to 300% of trailing 12 months’ production. This highlights the critical importance of transition management and the design of appropriate financial advisor retention programs that are rolled out when a deal is signed. Buyers that do not adequately evaluate service offering model compatibility between buyer and seller often suffer the consequences. Banks that have acquired retail brokers have had notably poor track records at retention, often the result of imposing a one-size-fits-all model on their new colleagues.

Last April, **Robert W. Baird** of Milwaukee concluded a deal for one of the Pacific Northwest’s best-known brokerage brands in McAdams Wright Ragen. While Baird was already large and growing in its own right — with 725 advisors, $117 billion in client assets, and $1 billion in revenue — MWR is a meaningful addition, with 85 financial advisors and $10 billion in client assets. Just as importantly, MWR extends Baird’s presence in a coveted part of the country.

In commenting on the deal, the two firms emphasized their cultural compatibility, noting their mutual status as employee-owned firms. Scott McAdams, president and CEO of MWR, touted his new parent’s “commitment to being a great place to work and putting clients’ needs above all else, [making] our decision to join forces the best next step for our business and our clients.” Michael Schroeder, president of **Baird Private Wealth Management**, praised the “loyalty and trust” MWR has earned from clients and said the addition allows Baird to “continue our strategic expansion in the Pacific Northwest, a region that represents tremendous additional potential for our combined firms.”

While Baird’s deal was notable in the full-service retail brokerage sector, two firms are having considerable impact in the independent broker-dealer area, led by publicly traded **RCS Capital** of New York. Started up by Nicholas Schorsch, CEO of publicly traded REIT **American Realty Capital Properties**, RCAP has made seven acquisitions of independent brokers in the last two years. In the process, it has become the second-largest independent financial advisory firm in the U.S. (behind **LPL Financial**), with more than 9,000 brokers.

With its aggressive posture and willingness to outbid competitors on deals, RCAP has also quickly positioned itself as a preferred buyer. The company cut two deals in the first half of this year, including its largest to date: the $1.2 billion acquisition of privately held **Cetera Financial Group**. In that transaction, RCAP paid about 1.00X broker-dealer revenue, significantly above the median of 0.50X on all independent broker transactions.

Based in California, Cetera provides back-office support to 6,600 independent financial advisors and 600 financial institutions, expanding RCAP’s network by two-thirds. Cetera is itself a new creation: private equity financial services specialist **Lightyear Capital** began building the firm in 2010 after purchasing three **ING Groep** broker-dealers. Last year, Cetera added two broker-dealers from **MetLife**. RCAP said it expects to generate as much as $65 million in annual synergy-related cost savings, while projecting that synergies alone should enhance margins by about 300 basis points.

The second player of note is another public company, **Ladenburg Thalmann Financial Services**, a full-service financial company based in Miami that has made numerous acquisitions of independent broker-dealers, including the transformative $150 million purchase of **Securities America** from **Ameriprise Financial** in 2011. In its latest annual report, the firm says the acquisitions have helped give it the “size and industry leading technology, back office services, marketing and practice management programs that allow us to compete successfully with any [independent broker-dealer] firms in the marketplace."

In August, Ladenburg gained "a significantly expanded presence in the Pacific Northwest" via a $24 million deal for **KMS Financial Services** of Seattle, an established firm with 325 financial advisors and $14 billion in assets. In September, in a $45 million transaction, Ladenburg announced the signing of an agreement to acquire **Securities Service Network**, a Knoxville, TN-based independent firm with approximately 450 financial advisors, $115 million in revenues and $13 billion in assets. Meanwhile, Securities America has been rolling up its own deals, including in July, when it acquired certain assets of broker-dealer **Sunset Financial Services**, part of **Kansas City Life Insurance**. Sunset had 268 registered representatives and $2.4 billion in client assets.

With the addition of the KMS, Ladenburg has 4,000 advisors and $125 billion in client assets; more than 90% of revenue is generated by its independent brokerage and advisory services unit, compared with 78% in 2010 (asset and wealth management and trust services account for the rest of income). In the second quarter, Ladenburg's revenues rose 14% from the year-earlier period to a record $221 million. Ladenburg's emergence as an independent broker-dealer marks a sea change from its roots in investment banking and a turnaround from its years in the red in the early 2000s. Much of the transformation is credited to pharmaceutical billionaire Phillip Frost, who invested in the firm and became chairman in 2006.

Stifel Financial Corp. has been another acquirer of note. The St. Louis firm has completed more than a dozen acquisitions of securities firms and asset managers since 2005, including two notable securities firms this year. On the institutional side, the company acquired **De La Rosa & Co.**, the leading independent California public finance investment bank, marking the second deal Stifel has cut for a California firm since 2011, when it bought San Francisco-based municipal bond underwriter **Stone & Youngberg**. On a combined basis in 2013, the acquisition elevated Stifel to the No. 1 ranking among underwriters of municipal bonds in California by number of issues, and No. 5 nationally. A key consideration in the deal was Stifel's opportunity to broaden its leadership within California municipal finance, with De La Rosa on its own ranking as a leader in areas such as K-12, certificates of participation and lease revenue bonds, tax increment and economic development.

In explaining the sale, Ed De La Rosa, president of the firm, told Bond Buyer that while the management of compliance costs was a factor, scale was key, noting that his competitors are either global or publicly traded. "We felt that if we were going to continue to grow in this market, and to gain more market share against these competitors, we needed to get our hands around more resources and more capital to offer to our clients," he said. De La Rosa also emphasized that the decision was "a proactive one that reflected an optimism and belief in the strength of the California market."

In a second deal this year, Stifel bought **Oriel Securities**, a London stockbroker and investment bank. The acquisition is designed to create a sizable middle market investment banking group in London. This year's transactions come on top of Stifel's $575 million purchase in 2013 of investment bank **KBW**, a specialist in bank mergers and acquisitions and financing.

On the corporate finance side, **KeyCorp**'s acquisition in July of **Pacific Crest Securities** is notable given the latter's niche in the technology arena. The Cleveland bank said the deal "underscores Key's commitment to creating the leading corporate and investment bank serving middle market companies." In the second quarter of this year, **Key Corporate Bank** accounted for about 40% of total bank revenue and half of net income.

Based in Portland, Oregon, and founded in 1990, Pacific Crest refers to itself as "the premier investment bank for technology, operating at the leading edge, where global connectivity is fueling an unprecedented expansion cycle." The company, with $86 million in revenue in the year through March 2014, works with firms in such fast-growing sectors as global internet, mobility, cloud and big data, and next generation infrastructure. Pacific Crest engages in financing, mergers and acquisitions, and equity research.

In deals involving investment banks such as Pacific Crest, buyers have become particularly attuned to distinguishing between firms that are essentially a loose confederation of talented bankers — and therefore pose "key man" risk — and those that offer a lasting platform with a deep bench, a track record for promotion, and revenue that is generated by a swatch of bankers as opposed to a handful. But in responding to a related query about employee retention from an analyst during KeyCorp's second-quarter earnings conference call, Chris Gorman, president of Key Corporate Bank, acknowledged the bank had "a very specific list of people" who it felt were "imperative" to the success of the deal. "In fact, each and every one of those folks have executed, as a condition of us entering into this agreement, a retention agreement, so that's a good start," he said. ▲