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PRIVATE EQUITY FIRMS SET THEIR SIGHTS ON WEALTH MANAGERS

YOU ARE THE OWNER AND FOUNDER OF SMALL WEALTH MANAGEMENT FIRM WHO IS APPROACHING RETIREMENT, YOU'RE WORRIED ABOUT THE IMPACT ON YOUR CLIENTS OF SELLING OUT TO A LARGE INSTITUTION, BUT AT THE SAME TIME DON'T HAVE JUNIOR PARTNERS WITH ENOUGH CAPITAL TO BUY A PIECE OF THE BUSINESS. What's a wealth manager to do? Thanks to recent trends in the private equity industry, prospective sellers have a new range of options to consider.

It's no secret that the private equity industry is hot. In the first nine months of the year, the industry raised $300 billion, and Private Equity Intelligence figures the total will hit $400 billion by year's end, compared with $283 billion for the record year of 2005. Multi-billion dollar deals involving private equity groups are now commonplace, with seven of the 10 largest transactions in the industry's history having taken place this year, led by the $33 billion buyout in July of U.S. hospital chain HCA.

The industry has been aided by the same factors driving the growth of other alternative investments, such as hedge funds and real estate: the generally lackluster returns offered by publicly traded stocks in recent years, as well as easy money. "I've never seen a market with this much liquidity and capital available," said **KKR** founder Henry Kravis earlier this year.

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Although the headlines naturally focus on the big deals involving major firms such as KKR and **Blackstone Group**, in reality the industry is characterized by far more modest transactions. And as private equity players broaden their investment horizons, they have become increasingly intrigued by the opportunities furnished by asset managers. This includes one of the hottest areas of asset management, wealth management.

Historically, interest among private equity firms in wealth managers, and the larger asset management industry, has been limited. This is largely a reflection of the investors' aversion to risk: to ensure they don't walk away empty-handed if an acquired company goes belly-up, private equity firms have tended to target brick-and-mortar companies with tangible assets. Wealth managers pose particular issues. For example, the fact that many such companies are dependent on a handful of employees with strong client relationships creates an area of potential risk for investors. In addition, the small size of many of the firms makes it difficult for private equity firms to employ one of their favorite tactics for revving up investments – cost reductions.

In their latest "World Wealth Report," Capgemini and Merrill Lynch note that in the 10 years between 1996 and 2005, the wealth of high-net-worth individuals worldwide (those with $1 million or more in financial assets) grew at an average annual rate of 8%, doubling during that period to $33 trillion – an astonishing three times the size of the U.S. economy.

This traditional view of wealth managers is changing, however, in tandem with the private equity industry's ever-growing pool of capital. In many respects, wealth management presents an ideal arena for private equity firms. For one thing, unlike other parts of the asset management industry that have undergone considerable consolidation, wealth management remains highly fragmented, with thousands of firms operating worldwide and new ones being minted all the time. When you add in attractive profit margins and the growth in the number of wealthy individuals, the investment case becomes all the more compelling.

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On the other side of the negotiating table, sellers have their own reasons for cutting deals. The industry's attractive profile notwithstanding, many smaller firms still lack the scale and/or expertise required for sustainable long-term growth. For aging owners, succession issues are another factor driving potential sales. Post-bubble regulatory pressures are also taking their toll, as the addition of compliance officers and related legal costs eat into profits. Another drain on profitability in the post-bubble world: the cost of superior talent, which is always in danger of being poached by larger firms.

For those firms seeking a partner, private equity buyers may provide a more appealing post-acquisition style than that offered by banks or other asset managers. Of great importance to many sellers, private equity firms tend to leave varying degrees of ownership in the hands of existing management as a performance incentive, along with operational control (provided financial targets are met, of course). At the same time, they can lend assistance with succession issues by providing the capital required for younger managers to acquire equity from the original owners.

The more sophisticated private equity players also bring scale and expertise to the table in areas such as back office assistance, which can reduce costs and free up management to focus predominantly on clients and business growth. Then there's the cultural fit: the more entrepreneurial nature of the private equity industry often meshes well with the tone of a small wealth management company. Along similar lines, private equity firms are unlikely to fiddle with a wealth manager's identity, while many banks and asset managers prefer to wrap acquired firms under their brand umbrellas.

There are several private equity companies notable for their interest in wealth managers. One of the most ambitious is Focus Financial Partners, a New York-based firm started up earlier this year by American Express alumni Rudy Adolf and backed by private equity firm Summit Partners (to the tune of $35 million, with a promise of more to come).

On the flip side, there are a couple of thorny issues that wealth managers must consider in weighing a sale. By their nature, private equity firms are not long-term investors, generally seeking to cash out their holdings within a three-to-five-year time frame by either selling to a larger corporation or taking a firm (or amalgamation of like firms) public. This creates a measure of uncertainty and potential upheaval up the road. Because private equity firms have a high threshold for return on investment, they also tend to be prudent bidders.

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Focus' strategy involves taking a 40% to 60% stake in high-growth firms that "follow a client-centric and fiduciary approach" while leaving the partner firm autonomous. For its part, Focus provides back-office services such as marketing, human resources and technology, as well as access to a broader menu of products. Payment involves a mix of cash and equity in Focus, with earn-out incentives providing an additional sweetener.

The firm's game plan involves gathering $25 billion in AUM over the next three to five years via organic growth and a flurry of 30 to 50 acquisitions of firms managing a minimum of $350 million in assets each. Focus will also consider "sub-acquisitions" of firms with less than $350 million in AUM, done through its affiliates. The ultimate goal: take the company public.

San Diego-based **HoyleCohen**, acquired in June, is typical of the companies Focus targets. Formed in 2002 through the merger of two small firms, HoyleCohen has $300 million in AUM and targets high-net-worth clients in Southern California, but it needed a partner to expand. "We joined Focus for its unique model that maximizes the benefits of autonomy while benefiting from the resources, scale and best practices of a large national firm," says founding partner Kevin Hoyle.

For Summit, founded in 1984 and based in the U.S. and the U.K., Focus represents its second wealth management-related move in as many years, coming on the heels of its 2005 $127 million investment in California's **Coast Asset Management**, an established fund of hedge funds manager that serves wealthy individuals as well as institutional investors.

Wealth Trust of Nashville, a subsidiary of brokerage firm **Morgan Keegan** (itself a part of **Regions Financial Corp.**), is a more established investor that also follows a consolidation strategy, primarily targeting companies in smaller Southeast cities with $1 billion or less in AUM. Begun in 1997 by established money manager Rusty Benton – and backed by a $25 million investment from Morgan Keegan two years later – Wealth Trust leaves a minority interest with management, while providing back office and marketing assistance. The company has made 10 acquisitions and its affiliates manage a total of $6 billion in assets. The most recent investment, in 2004, involved a minority stake in **Optimum Investment Advisors**, a Chicago-based firm with offices in Dallas and San Francisco and $1.5 billion in AUM for individuals and institutions.

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Three-year-old **Asset Management Finance** of New York takes a different approach providing capital in exchange for an expiring interest in an asset manager's future gross revenues. The deal structure, which can run from seven to 20 years and funding between $5 and $50 million, offers a company liquidity for a variety of uses (from business expansion to buying out partners), while enabling management to retain control. Founded by former United Asset Management CEO Norton Reamer, AMF has raised $250 million in backing and has aggressive plans to put the money to work, targeting firms with from $500 million to $40 billion in AUM. This year, AMF has made deals with three companies, including two with private client arms, **Newgate Capital Management** of Connecticut and **Opus Capital** of Cincinnati.

Rosemont Investment Partners is an established private equity firm focused on asset managers, with a strategy involving "meaningful minority interests" in companies "structured to create competitive compensation mechanisms that are balanced between near-term income and long-term value creation." Rosemont made an initial investment in 2002 in a New York-based start-up, **Silvercrest Asset Management Group**, which provides traditional and alternative financial products to families and individuals with investible assets of more than $25 million. *Wealth Manager* magazine ranked Silvercrest No. 9 on its most recent list of top advisory firms, with an average client relationship of more than $37 million.

Chicago-based **Convergent Capital** (AUM: $27 billion) is another established firm that over the course of 12 years has taken stakes in 10 asset managers, many of which count wealthy individuals and families as part of their overall business. This includes its first investment, made in 1995, of **AMBS Investment** of Grand Rapids, Mich. (AUM: $540 million).

For small wealth management firms in search of a solution to a range of challenges – from succession planning to expansion to back-office support – the private equity option holds a number of benefits. Of particular importance, the capital structure employed by the industry is diverse and flexible, in many cases allowing for continued control by a firm's management. For the private equity industry, wealth management offers a strong growth profile combined with an industry that remains wide open, with hundreds of potential targets. Culturally, the two industries also share many similarities, a factor that bodes well for successful transactions.❖