What the Cetera takeover means and why the non-RIA product-through-the-pipe direction in the hands of a hard hitter is an eyebrow raiser

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Brooke's Note: If consumers' retirements weren't hanging on these events, I'd almost say that the old-time Wall Street swagger here is refreshing. But this appears to be a real RIA back eddy, a reverse flow on a trend that seems consumer friendly. Imagine Nabisco buying Whole Foods to sell more Oreos. Many consumers, even the Whole Foods types, want more Oreos — at a better price. But it may not be favorable for consumers' long-term health or an evolving supermarket business. We don't want to pre-judge but we do want to look at the bigger picture here.

With a few strokes of a pen, Nicholas S. Schorsch may have changed the trajectory of the RIA business with his purchase of independent broker-dealers First Allied Holdings Inc. in June then Cetera Financial Group and J.P. Turner & Co. this week. See: Why exactly Lovell Minnick sold First Allied about five years ahead of plan.

The chairman of New York-based RCS Capital Corp. — directly or indirectly from the winnings of his money-minting REIT — has installed himself as a force for the future by taking the financial advisory business back to where it came from — into the land of cheap distribution for expensive financial products.

Too good to pass up

The move comes at a time when big names in the business like LPL Financial and Raymond James are rushing in the opposite direction — throwing balloon stents into the previously plaque-ridden arteries of open architecture.

Schorsch did not respond to requests for comment for this article or the previous one we wrote involving First Allied in June..

But to his credit, the real estate investment trusts magnate doesn't seem to be making any bones about his designs: each deal has been a too-good-to-pass-up offer to the IBD owner.

Schorsch is looking to make money the old-fashioned way — by selling more proprietary products and reaping the fat margins.

Juicy margins

The purchase of El Segundo, Calif.-based Cetera "represents for us a truly transformative event," he says in a prepared remark. "We intend for RCAP to be the most important full-service financial services and securities distribution company in the industry by joining our financial advice practice, wholesale distribution and capital markets expertise, and continuously executing on these strategies through our transaction management group."

Note that in a single sentence of intent, Schorsch uses the words "full-service," "securities distribution," "wholesale distribution," "capital markets" and "transactions management." The distribution and transactional mindset exhibited by these remarks is shocking to hear after several years of a chastened financial advisory where the advisor is in the driver's seat and the product manufacturer meets its demands.

This back-to-the-future event may be connected to the rising euphoria engendered by the financial markets, according to Welsh. "It's almost about the irrational exuberance of the product guys. Schorsch knows the juicy 9% margins he was paying on non-traded REITs to third-party distributors."

Welsh explains that RCS' core non-traded REIT products tend to run into trouble because they are non-traded, hence illiquid — a big problem for investors when markets turn south and they want to cash out. Welsh that Cetera, comprised of all former insurance IBDs, may be perfect for RCS. ING and Genworth agents are accustomed to working in that sales culture and selling products.

Big eyes

Such exuberance seemed to be on display in a remark made by Schorsch, and paraphrased by Bruce Kelly in InvestmentNews, that he saw his company as the next Merrill Lynch or Raymond James.

Those companies both have vertical monopolies of sorts but are vastly different in their operations — other than having big brands a little-known party crasher would be excited to be compared to.

Schorsh backed up that Merrill-Raymond James comment in the IN article with thoughts about how his broadening scale could produce a better clearing deal — something that could legitimately be in the interests of consumers and advisors.

But while the budding Schorsch IBD empire, stoked by a product angle, holds promise for prospering in this bull market, it could also set the stage for a comeuppance both for itself and the industry, Welsh adds.

"It flies in the face of what every successful wealth management model does in moving its business toward a fee-based management. There'll eventually be client complaints and regulators will come in, look at the suitability of these products. It'll be a stain on the industry if this doesn't work."

Welsh, who was at the Laserfiche conference when contacted for this interview, says that IBD execs there were "shaking their heads" because they believe this deal could portend a wave of consolidation that would take the IBD business in a very corporate direction.

Shared vision

Chief executive of Cetera Financial Group, Valerie Brown, has taken these IBDs in a wealth-management-first direction since aggregating the old broker-dealers of ING and Genworth Financial Wealth Management that were pushing their own insurance products — and reaping the big margins. Brown, for instance, made a variety of hires from the RIA business — most notably Barnaby Grist.

She, too, is now touting scale and products first in her statement to the media:

"By joining the RCS Capital family of companies, we become the cornerstone of the second-largest independent financial advisor network in America and are positioned for even greater success in the future. Our shared vision for building a better industry through a combination of products, services and advice that begins and ends with the investor is what made the decision to merge an easy one."

Brown and her management team will continue to operate Cetera's respective brands as part of the RCAP family of companies.

Public-firm discount

She is among the executives and investors who appear to be on the verge of making a killing by selling Cetera to Schorsch.

At the top of the list of deal beneficiaries is private-equity firm Lightyear Capital LLC-founder and former Paine Webber chief executive Donald Marron, 79, defying skeptics who wondered about his age and how sage it was to roll-up, but not integrate, a bunch of cast-off independent broker-dealers. Marron offered an interview through his PR agency yesterday then withdrew the offer.

Marron achieved about a 40% internal rate of return on investment for the four years he had investor cash in Cetera. His Lightyear fund invested about $120 million initially in the venture and follow-on purchases and capital infusions may have brought the net investment near to $400 million, insiders says.

The sale for $1.15 billion of the Cetera to Schorsch's RCS Capital is in keeping with the discount of public firms associated with this kind of transaction, according to **Daniel Seivert, chief executive of ECHELON Partners of Manhattan Beach, Calif.**

"I'd call it a fair valuation," he says. "[Schorsch] bought this at 105% of revenue — a 33% discount to what the revenues would sell for were it a public company."

Letting it ride

But the hundreds of thousands of investors handled by the advisors in the Cetera network will have to see about the fiduciary direction in which their advisors go as an unabashed product manufacturer leans on them to sell their products.

Lightyear was wise to take the offer, according to **Seivert**. It had accomplished two sterling acts of dealmaking and there was little reason why it should push its luck on the third.

"I would give them a lot of credit for playing the market cycle," he says. "They also get good credit for buying it at an attractive price and average credit for what they did with it once they got it."

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