Why Private Equity Wants a Piece of the RIA Market

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The secret is out: The independent financial advisory space is the hottest growth-investment strategy for deep-pocketed private investors.

"We've seen private equity money ebb and flow over the years, but over the last few years we've seen a surge and a change in the way PE firms are investing in the RIA space," said Scott Slater, vice president of practice management and consulting at Fidelity Clearing & Custody Solutions.

In the latest testament to the success of the wealth management model, private equity firms have been pouring billions into the space to take advantage of a consolidation wave those same investors are helping to fuel.

For owners of financial advisory firms, this means an even steadier barrage of inquiries from PE firms looking to buy a stake in their businesses.

Phil Shaffer, an adviser who left Morgan Stanley earlier this year to launch Halite Partners, said he was getting solicitations from private equity investors even before he had any money under management.

"We are at an inflection point with private equity looking at the RIA space," he said.

Why now?

The stars seem to be aligning on several fronts, including more adviser movement toward the independent space, consolidation of firms within that market and private equity sitting on a mountain of cash.

"The RIA space is very fragmented, with about three-quarters of firms managing less than $100 million, but at the same time it is growing at about two and a half times the pace of the wirehouses," said Alois Pirker, research director at Aite Group.

The trend lines from Cerulli Associates bear this out. The research firm reports that wirehouse and independent broker-dealer reps made up 53.7% of the industry in 2011, while registered independent advisers and hybrid RIAs made up 19.5%. In 2016, wirehouses and IBDs made up 49.7%, while RIAs made up 22.7%.

"I definitely think private equity is adding fuel to the fire of the independent channel," said Marty Bicknell, chief executive of Mariner Wealth Advisors, whose parent company, Mariner Holdings, has $47 billion in assets. "And the momentum is absolutely on that side."

PE firms now are investing about $3.3 billion a year into the financial advisory space, with the goal of capturing double-digit returns for relatively short-term commitments, said **Daniel Seivert**, chief executive of investment bank **ECHELON Partners**. The amount invested in 2016 was $3.1 billion, up from $2 billion five years ago.

Advisory firms of all shapes and sizes should not be surprised by a stepped-up effort from PE firms to secure a piece of the action.

Consolidation capital

"Private equity firms are looking to take advantage of the kind of consolidation trend that has been present in other industries at different times," said Rush Benton, senior director of strategic wealth at CapTrust. "Consolidation requires capital, and PE firms see that opportunity, which is why the trend is here to stay."

While there are multiple ways a buyer or investor can gauge the value of an advisory firm, Mr. Shaffer said it is about increasing the value through scale.

PE firms' investments in advisory firms

"Most of the buyers are looking at firms with $3 billion to $5 billion under management and up," he said. "But we're also seeing private equity money looking at an operator that can put together $300 million. Or they might invest in five or six smaller RIAs and hire a guy to oversee them."

In essence, the private equity influence is less about playing an active role in the wealth management business than it is about leveraging the trend toward scale across the industry.

For example, if an RIA with $300 million under management is valued at a five-times-earnings multiple, an RIA with $3 billion under management will be valued at twice the multiple.

"The real driver here is what is happening to the equity value at the firms," Mr. Shaffer said. "The private equity guys get that. They can come in and buy lower-multiple firms, and build them up to create higher multiples.

"You will not be able to buy a quality RIA with $300 million in assets for a five-times multiple five years from now," he said. "People want to buy them because they are growth engines, and buyers will be competing for all the really good firms."

Another factor spurring the PE buying binge, according to Preqin, a research firm focused on alternative investment assets, is the growing pile of money in private equity funds.

Swollen coffers

Of the more than $2.7 trillion in total private equity assets, nearly $1 trillion is uninvested "dry powder" still seeking investment opportunities.

By comparison, in 2012, total PE assets were less than $2 trillion, and the dry powder was around $560 billion.

Private equity firms rarely buy entire RIA firms, but the deals almost always fuel merger and acquisition activity, which continues to pick up in the RIA space.

"Some investors are looking to get as much as they can, by taking 70% or 80% stakes," Mr. Seivert said. "That kind of deal will feel more like an acquisition."

Other deals will push the limits of ownership up to just under 50%, he said, and a third type will look more like a capital infusion, with the PE investors taking a 25% or 30% ownership position.

Limited terms

In almost every case, the PE ownership is limited to a term of about a half-dozen years before the private equity fund needs to provide its investors with liquidity. RIAs can find themselves linked to new ownership partners as part of a cycle that can last a long time.

Mr. Bicknell described the perpetual status of PE ownership as a "carousel," and said RIAs should understand this on the way in. He has not yet sold any piece of his large firm to a private equity investor, but sees the trend as a positive thing.

"Private equity is going to lead to more consolidation, which I think is the best thing for this industry, and it's also in the best interest of the clients," he said. "As we professionalize this industry, the client wins because succession issues will no longer exist, and as more capital comes into the space, I believe it will attract more next-generation talent."

Ron Carson, founder and chief executive of Carson Group, said the decision to sell a stake in his nearly $9 billion advisory firm for $30 million last year was all about growth.

"The private equity space is looking at a fragmented profession that is going to consolidate — because the larger the firm, the more valuable it is — and bigger firms are harder to mess up," he said. "Unless firms get bigger, it will be more difficult to compete, and a lot of smaller firms that want to remain independent are going to lose their clients to larger firms."

Mr. Carson does not buy into the notion of a rotating relationship with outside investors, like the recent $100 million deal between HighTower Advisors and Thomas H. Lee Partners. In HighTower's case, the PE relationship provided liquidity to other institutional investors.

"I needed private equity for very specific things, and we have first right to buy our ownership back," Mr. Carson said. "Based on where we are today, my guess is we will probably own 100% of our firm when they want to exit in four to six years. And as the deal is structured, I have complete control of the company; the only thing I can't do is ruin it."

But as Mr. Slater of Fidelity pointed out, there are multiple layers of pros and cons to consider when partnering with a private equity investor.

"There is a time line for classic private equity that raises the bar for performance for the firms they own," he said. "What you may like is having very smart people coming alongside you and putting money into your business. But what you may not like is somebody pushing you to grow your business faster.

"You need to understand that you need an alignment of interests." he said. "You can't just take the money."