Why Luminous Deal Will Be Tough to Repeat

Originally Published By Nick Rice

Even after two weeks, First Republic's announcement that it is buying Calif.-based RIA Luminous little more than four years after ex-Merrill Lynch advisors launched it is still setting advisors' minds alight across the U.S.

Although a number of industry specialists are hailing it as a sign of things to come for wirehouse stars hungry to set up their own shop, the deal – not least the $125 million that First Republic paid for Luminous – may be tough for breakaways to emulate. Here's why:

1) Size. Luminous launched in June 2008 with $1.7 billion under management and grew that in four years to $5.5 billion when the deal was announced.

That's a chunky sum to match, according to **Daniel Seivert**, CEO and managing partner at **Echelon Partners**, a Los Angeles, Calif.-based investment bank and consultancy for the wealth and investment management industries: "There are fewer than 300 RIAs with more than $5 billion in AUM [assets under management] and there are more than 13,000 RIAs with less."

2) Access. From birth, Luminous had excellent access to high-net-worth clients. Its two best known founding members, David Hou and Mark Sear, oversaw $7.4 billion in assets at Merrill Lynch, largely from unusually wealthy individuals. In Barron's April 2008 ranking of the U.S.'s top 100 financial advisors, Hou and Sear ranked 41st and 43rd, respectively, with "typical" accounts of $25 million per client.

This type of client roster will have given the team a leg up drawing assets to the new boutique, according to Alois Pirker, research director at Boston, Mass.-based financial services advisory firm Aite Group. "If your DNA is mass affluent it's hard to polish your sneaker. It's hard to grow scale for a small firm without high-net-worth or ultra-high-net-worth."

3) Location. Luminous is a stone's throw from the affluence of Los Angeles and has a foothold in the booming tech world of northern California, at Menlo Park near San Francisco. As one observer says "being in Silicon Valley, focusing on younger clients whose prime money-making years are ahead of them" can prove unusually lucrative.

But competition is tough. "These are areas that are catered to by the whole market," says Pirker. "Everyone has multiple offices there."

4) Sophistication. Luminous offered high-end investments, with highly tactical trading and alternative asset classes alongside a smattering of traditional stock market and fixed income fare. For this more nimble type of investment, Luminous would also have been able to charge more.

5) Operations. Managing such a large pool of assets in such a sophisticated way requires operations, technology and compliance more highly developed than at most RIA firms, notes Pirker.

“The majority of RIAs would have to change dramatically to get there,” he says. “RIAs are putting together platforms that start to stutter when they reach $100m. When you have more than $1 billion you have to get compliance and technology. You’re facing similar challenges to a big brokerage firm. Many RIAs are ill-equipped to do this.”

6) Growth. With a state-of-the-art set-up, Luminous grew its assets at a remarkably fast rate. Hou and Sear alone managed $7.4 billion at Merrill, but $1.7 billion when they started at Luminous, giving them ample room to bring across more money from their previous firm.

The timing of Luminous’ launch – just nine months before the U.S. equity market bottomed in 2009 – may also have played a role. Market rises will have provided a tailwind to the value of clients’ assets and hence to Luminous’ assets under management overall – with the caveat that the mix of assets that Luminous appears to pick for its clients typically has a lower correlation to the equity market than average.

Leaving aside the reasons for this rapid growth in AUM, however, it would hard to replicate—even for Luminous itself. “It is difficult for all firms to grow at rates in excess of 50%-plus,” **Seivert** says. ”As one gets larger it becomes more difficult to achieve the higher growth rates and assimilate the change that comes with it. Recognizing this may be part of the reason why they did the deal now.”

7) Speed. While it is possible to start a business and sell it in four years, the overall pace of such a turnaround is still fast.

Both Pirker and Seivert say it is possible to set up a business and iron out any kinks within two years, and then achieve a satisfactory sale within another two. Also, if an RIA is growing quickly, there may be an incentive to sell while the growth is hot.

However, as one expert observes, simply running an RIA requires an entrepreneurial streak that does not come naturally to all breakaway advisors. The ability to flip a business in four years makes even greater demands – especially to advisors used to operating within a larger business.

8) Buyers. A buyer will need substantial financial clout to pay $125 million in cash for an RIA. For the price tag to be worth it, the RIA will also need to represent a good fit for the larger acquirer. "When the fit with the buyer is high, often times valuable revenue and cost synergies open up," **Seivert** says. "In this case, First Republic will likely enjoy some opportunities to provide Luminous customers with additional services not currently available to them."

9) Valuation. Although it is clear what First Republic paid for Luminous is a fraction of its assets, industry participants tend to favor other multiples. In more everyday deals, Pirker says, acquirers pay out twice the RIA’s revenue.

Both agree, however, that the larger the firm, the higher the multiple that is typically paid for it. And Luminous was an unusually large firm.

10) The all-cash nature of the deal. It is more typical for buyers to pay for RIAs using a mixture of cash and their own stock. “It’s rare to see all cash deals and especially all cash deals of this size,”

So while Luminous may represent an attractive model, replicating it may prove difficult. However, as one expert observes, top wirehouse producers will still be tempted: “I’d be shocked if the larger teams didn’t do some soul-searching on this.”

About ECHELON Partners

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