DISCUSSION

WILL RISING RATES & VOLATILITY DERAIL THE ADVISOR M&A BOOM?

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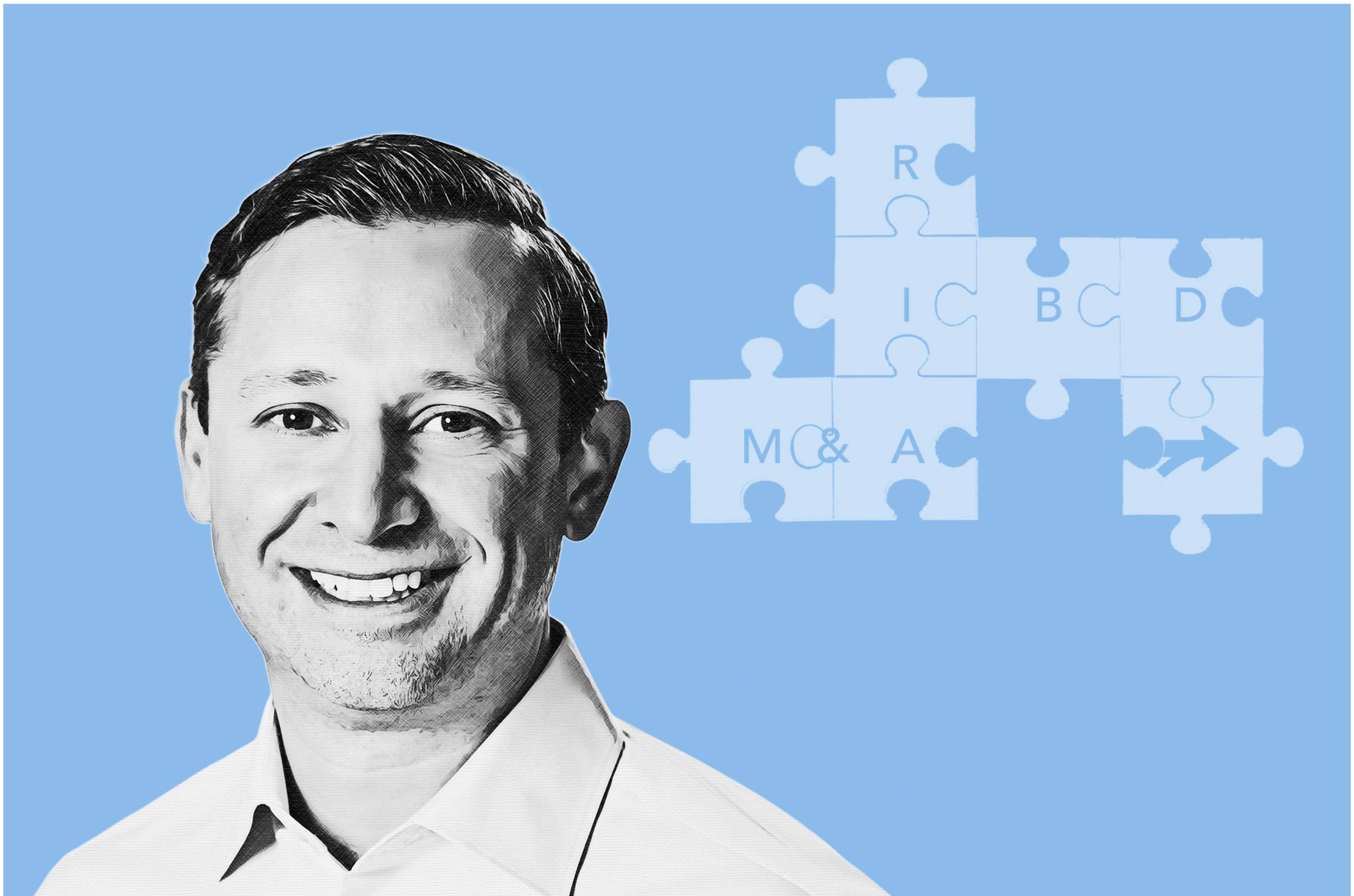

Putting The Pieces Together — *Despite macro headwinds, Lightyear Capital Managing Director Max Rakhlin explains why he believes consolidation in the wealth management industry is still just getting started.*

Consolidation in the US independent wealth management space has recently moved at a breakneck pace, with more than 300 deals announced in 2021 alone. Private equity firms have been the primary source of capital backing these acquisitions.

Lightyear Capital is one of the firms at the forefront of this trend, having made six investments in the wealth management space with two independent broker/dealers, three RIA models, and a UK-based advisor. Across those six portfolio companies, the firm completed almost 40 sub-acquisitions, with 15 of those occurring just last year.

Gravity Exists spoke with Lightyear's Max Rakhlin to discuss his views on how the macro environment and demographic trends will impact the US financial advisory industry in the coming years. Rakhlin is a Managing Director and a member of his firm's Investment Committee.

Given the volatile macroeconomic and financial environment we are experiencing today, do you anticipate that the pace of deals in the RIA space will moderate in the foreseeable future? Are there segments, geographies, or business models within the space that will feel a slowdown more than others?

" Our view is that M&A in the RIA sector is still in the early innings, and there is much more to come. Major secular forces driving consolidation in the long-term are independent of rising interest rates and financial market volatility. In fact, we've seen M&A accelerate during market dislocations.

There are three main elements to this.

First, it's a massive market, with an estimated $70 trillion in household investable net worth. It's not just a big market, though. It's also massively fragmented. Approximately 17,000 firms have less than $5 billion of assets under management in the independent RIA space. Over 10,000 firms have less than $100 million of assets under management.

Second, many of these firms are owned and managed by individuals nearing retirement. Forty-plus percent of advisors in the US are now over 55 years old. These advisors control nearly half the assets in the industry, and very few of them have a viable succession plan. For many advisors at small firms, the only way to monetize their life's work and find a good home for their clients and employees is through a sale.

The third and final piece of the puzzle is these small firms typically do not have the resources to compete with larger integrated platforms. They lack the resources to invest in the client-facing technology that clients expect. They can't invest in the necessary compliance infrastructure to keep up with regulatory demands. They struggle to attract and retain young talent. During periods of financial market volatility, small firms become even more vulnerable. And at that point — and we may be there now — they quickly realize the attraction of becoming part of a larger, more stable, and growing institution.

Put these elements together, and it's easy to see why the acquisition trend would continue to accelerate.

How do you select an acquisition model to invest in such a large and fragmented market?

" It's important to consider the world from the point of view of an owner of a small independent firm looking to find the right partner. These advisors will self-select toward the model that is right for them. They will ask themselves, 'What will make the most sense for our culture and clients?'

When we consider platforms to invest in, M&A is a secondary consideration. While economies of scale are important, they are not the ultimate driver of enterprise value. Our focus is to understand the organic growth levers a platform can pull to support its existing business and accelerate the growth of its acquired practices. While the growth levers are often unique to each platform, the most successful platform can show measurable, repeatable, and scalable organic growth.

Once you onboard a portfolio company, how do you interact with them?

" Our engagement with the management teams of firms we invest in is at the strategic Board level. We take the time beforehand to get to know the team and understand their priorities. We often discuss lessons we learned from prior investments and how they apply to a particular situation. We also provide access to our broader advisor and industry network.

Before we invest, we ensure we have an alignment of strategy, investment priorities, incentives, and an effective communication process. Having that strong partnership is critical. Management teams will make countless decisions each day that impact the business, so being confident all the stakeholders are aligned and comfortable with open, candid communication is key to our process.

Based on current macro headwinds and longer-term generational shifts, what models do you see best positioned for the coming years?

" The kind of scenario we're in now really highlights the appeal of a personalized, holistic planning model.

Individuals face increasingly complex financial responsibilities. During periods of market volatility, such as the inflationary environment and geopolitical turbulence we live in today, many people realize they could benefit from expert advice. They seek advice to help them navigate current market dislocations and guidance to achieve long-term life goals like retirement, sending their kids to college, and maintaining a certain lifestyle.

So, the models likely to be best positioned are those focused on providing broad-based financial planning while including investment advisory, cash flow forecasting, insurance planning, tax services, and more. The models offering full personalization are less commoditized and difficult to substitute.

The pandemic was a game changer, and several surveys found that many people took it as a wake-up call to seek out advice and build a financial plan.

Your firm has actively invested in the fintech space. What technology trends do you think will have the most significant impact on the wealth management industry in the coming years?
I think financial services in general, and probably wealth management in particular, have been laggards in technology adoption.

" Prior to the pandemic, there was a significant focus on upgrading infrastructure and back-office technology. For instance, a key priority was making the client onboarding processes painless and paperless.

The pandemic, however, shifted focus to client-facing technology. There was a new imperative to service a client in a virtual setting as well as provide real-time access to their data. This virtual engagement isn't just about handling current clients, though. It's about interacting with their children as a massive transfer of generational wealth approaches. Investing in client-facing technology that provides the digital user experience the future generation expects will allow advisors to build better relationships.

Do you think purely fee-based advisory services will remain competitive from a growth standpoint as overlapping demographic and macroeconomic factors change the landscape? Or do you anticipate that models embracing transactional revenues within their mix will become more attractive?

" The traditional service models were transaction-oriented. The market evolved in response to regulatory pressures and clients' desires for a fiduciary delivering unconflicted advice for a fee. I believe that evolution will continue. Clients have a wide variety of needs, and this country is diverse, so there is an opportunity for different models to coexist.

Today, we see the independent RIA model maturing. As these firms embrace a more holistic approach to service their clients' needs, they discover that some types of services are difficult to offer on a non-commission basis. That would include insurance, securities lending, and mortgage needs. So, if your firm focuses on holistic planning, you need to find a conflict-free way to provide these services.

It's a process of continuous evolution. When we first began to invest in independent broker-dealers (IBD), the overwhelming majority of their revenue was commission-based. Today, most IBDs are probably generating a third of revenues from fee-based advisory services. Meanwhile, some purely fee-based advisors have added commission products into their service mix. There appears to be a convergence between the two models as they adjust to client demands.