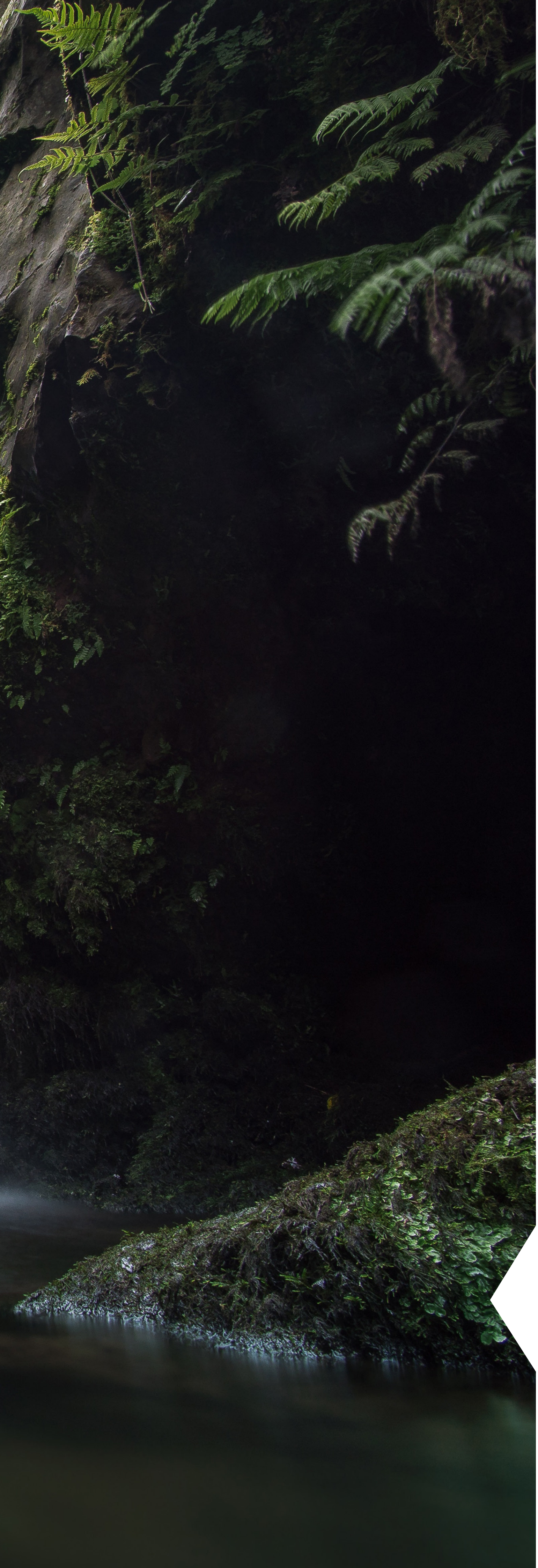
DISCUSSION PAPER

The flow of capital in the UK financial advice market

VERTUS CAPITAL

A pure source of independent capital

Put clients first. Grow your business. Exit with integrity.



The adviser firm market is changing and succession is clearly one of the big challenges.

A lack of practical succession options available to financial advisers has resulted in this aspect of the market being sub-optimal. This paper considers how this situation has arisen, a major factor being the absence of independent capital.

As a provider of independent capital, and with a clear view on how adviser succession planning should work, Vertus is well positioned to help business owners grow and exit their businesses with integrity.

By Matthew Marais of Vertus Capital

Where are we now?

How do owners of financial advice firms fund their businesses? It seems like an odd question and there's good reason. With no need for a widget machine, or a factory to house it in, there is little need for working capital in advice firms. The modern advice firm's business model results in high levels of recurring income. Surplus cash balances only build when the owner takes less money out of the business. As a result, advice firms tend not to save enough cash to self-fund acquisition opportunities.

The market

With the exception of a very small number of firms, the UK independent financial adviser market is made up of owner-operator businesses. Small in terms of any official description of a business, they are almost exclusively funded by the founders.

History

Many of the advice firms of today were started in the 80s and 90s. The barriers to starting an advice firm were low and capital requirements minimal. Often described as 'a people business', the primary assets were the professionals that advise clients.

In recent years the proposition has moved towards a long-term relationship-focussed approach, based around financial planning. Accumulating client assets on a platform and receiving a recurring annual fee, which creates a solid business with little need for capital injections.

This lack of demand for funding and the scant structure of adviser firms' balance sheets has certainly resulted in a lack of supply. The traditional banks have shown little appetite for the adviser space and challenger banks don't appear to be any different from their traditional counterparts. But if there's no demand and no supply, why does it matter? Well, with shifting demographics and market dynamics, opportunities now abound for firms with access to capital. As a result, the demand for capital is starting to increase.

Changes

Firm size is still modest with 90% of financial advice firms having five or fewer advisers in 2020 (FCA FAMR baseline report 2020). So, the market remains dominated by small, professional businesses with little capital investment and a focus on free cash flow generation.

One of the key change drivers is the ageing demographic of advice firm owners. Anecdotally, we know most advisers deal with clients whose age is plus or minus five years of their own and Baby Boomers are now at retirement, with their advisers looking to head there too.

Where has the capital been going?

Consolidators

The demand for exit options, the change in business model (towards centralised investment propositions with platforms as facilitators) and the opportunity to increase client fees (up to 1% per annum), all contributed to the existence of consolidators. This and a lack of like-minded succession alternatives. Private equity funded, staffed with professional managers and keen to leverage a vertically integrated business model, these firms have made an impact. Their business model of choice delivers shareholder value, is scalable and helps manage risk. But is it good for the end client?

Indeed, the regulator expressed concerns in their February 2017 supervision review report, where they stated that they 'were disappointed overall that none of the firms assessed were able to consistently show that clients' needs were suitably considered.' They only reviewed 6 firms (out of 9 they identified) and there were positives, but overall their view was that commercial benefit for the acquiring firm, trumped the impact on individual client needs.

Creating alternatives

Is it right to significantly change the client proposition to justify value for a seller? Does a conflict need to exist between the interests of firm owners and their clients when managing succession deals? Perhaps there is an alternative succession model which could align the interests of clients, shareholders and employees. If client interests are put first and the focus of succession becomes continuity of service and value, then clients will remain loyal. This loyalty should make the business worth more. Given the obvious benefits of this alternative, why has it not been the go-to option for advice firms? In short, because it requires a third-party capital provider who is willing to fund the business. This requires independent capital that not only enables, but encourages, the continuity of advice to clients.

Beyond organic growth

Traditional advice firms are focussed on organic growth by referrals and growth in funds under advice. Anecdotally, organic growth is very hard to predict, coming as it frequently does from referrals and being managed at the adviser level (ie. business development rather than firm-wide marketing).

While organic growth satisfies the needs of many, an increasing number of ambitious financial planning business owners are working to create scalable businesses, through a combination of organic and inorganic growth strategies. These firms need a capital partner to help their plans become reality.

> Is it right to significantly change the proposition for clients to justify value for a seller?

The challenge of growth

The growth opportunity

As baby boomer clients transition into retirement, those advising them are looking to do the same. The column inches dedicated to M&A in the financial planning space are now significant. The number of firms funded by private equity exceeds thirty at the time of writing and many business owners will be facing the turbulent transition from founder to employee, seeing out their final few years working hard as an adviser inside the large corporate organisation they sell out to. This presents a huge opportunity for a like-minded firm, interested in making acquisitions.

Back to the adviser firm business model

If a firm is planning to supplement growth through acquisition, they will need to develop a business model for consistent, predictable growth. This will enable the firm to scale profitably. Ignore this essential strategic preparation and owners struggle to effectively scale the advice proposition, which can negatively affect clients and firm value.

So, what is this platform for growth? It incorporates every aspect of the business. Typical projects include people development, brand creation, marketing strategies, operations improvements, technological enablers, compliance oversight, and effective risk management. This enables the business to service more clients with a high-touch level of advice in a cost-effective manner, thereby generating a good long-term return on investment.

Vision

Strategic growth through acquisition requires the firm owners to be aligned in their vision, timeline and strategy. Many forward-thinking advice firms are hiring and developing professional management resources to focus on implementing the growth strategy. Key to their objectives here is to move the goodwill of clients from the individual advisers within a firm to the firm itself.

Creating a culture where advisers actively embed the goodwill of their client relationships into the firm will result in a stronger, more valuable firm. When you couple this with a scalable operational platform for growth, the opportunity to execute acquisitions as part of the growth strategy becomes compelling.

Funding growth

When it comes to raising capital for acquisitive growth, there are two primary sources available to any growing business; equity and debt. Let's have a look at equity investment first.

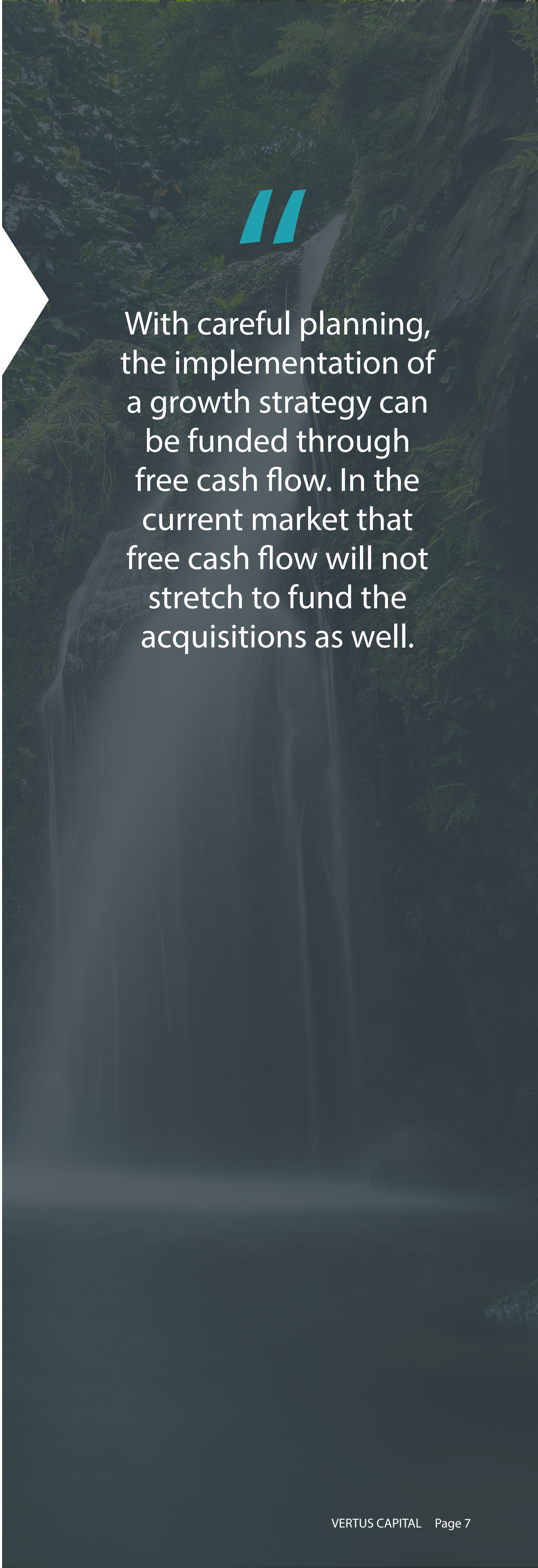
Equity investment

The vast majority of professional investors are investing indirectly through private equity firms and their funds. These funds are closed-end, typically with a 10-year duration. Within this timeframe, private equity fund managers must find and invest in target firms, facilitate whatever activity is needed to create the desired return and then divest.

The time factor creates significant pressure, which often results in compromise where performance has not been as expected. Squeezing every last penny from an investment, shifting focus from the original business plan, making sub-optimal acquisitions, cutting costs, all are typical, as are a loss of equity investment for 'under-performing' managers, causing a divergence of incentives and likely further damage.

Debt providers

The alternative to an equity investor, is a debt provider. However, the typical security profile for a business loan is sub-optimal. Financial advice businesses do not have tangible assets, with most of their value being the ongoing cashflow from clients. These loans are too small and bespoke to be interesting to banks and other lending institutions. Ultimately, these loans end up being personally underwritten by the shareholders.



> "With careful planning, the implementation of a growth strategy can be funded through free cash flow. In the current market that free cash flow will not stretch to fund the acquisitions as well.

> "Every financial advice firm owner looking to exit, must balance two primary considerations: the ongoing welfare of their clients and the on-going welfare of their own families. There is often great tension between these two goals, but it doesn't have to be this way.

Meeting the challenge

A new option

Vertus Capital believes that advice firms deliver a unique and valued proposition to clients. This has led to steady growth and profitability through various market cycles and regulatory changes. These firms need solutions that enable them to sell their businesses in such a way that the client proposition remains protected. Loyal clients mean that these deals will provide stable cashflows to justify the underlying loan.

Underpinning these deals is the experience, professionalism, and credibility of the advice firms themselves, and their track record in looking after their clients. Vertus Capital's focus is to enable continuity for like-minded firms in the UK by providing debt to conclude succession deals. Borrowers are assessed based on their track record of client retention and growth.

No two deals in this sector are the same, and the terms are customised to each deal. Suffice to say that deals which focus on continuity of the advice proposition to client are good deals. Vertus Capital's role is to enable these deals to happen in a manner which provides fair value to both parties and enables advisers to manage succession planning with integrity.

The ‘house view’

Parties to transactions must have taken external advice and our view is that some common themes ensure all parties are protected in a transaction:

- Part of the payment to the seller is deferred (20%-40%) to ensure smooth handover of client relationships.
- The seller receives a meaningful tranche upfront. The transaction should be a capital event for the seller to encourage a constructive handover.
- The buyer is able to adequately service the clients to a similar standard and cost as the seller. Clients should not experience significant upheaval as a result of the deal.
- Independent third-party capital to support deals brings security to all parties that the funds are available when required.

Sample transaction structures and ways for buyers to differentiate themselves from other M&A offerings in the market are contained in the Guide For Buyers. This content can be found on the Vertus website here www.vertuscapital.co.uk under resources.

Process of fund raising

While it seems straightforward to apply for a loan, there is a logical sequence that will make the process less painful, particularly where acquisitions are concerned.

Firstly, it is better to start with your own business planning (vision, current situation, strategy for growth, financial projections and action plan).
This content can be found on the Vertus website here www.vertuscapital.co.uk under resources. It is highly recommended that you take advice at this stage. We can put you in touch with professionals who can advise you.

Secondly, early engagement with Vertus is key. As tempting as it may be to start meeting potential vendors and discussing an acquisition, this can create some difficult situations further down the road. One of the first questions vendors typically ask is whether the buyer has the requisite capital to fund the purchase. Be prepared for this question and avoid getting off on the wrong foot. A high-level term sheet or letter of comfort should be enough to satisfy a curious vendor and give you comfort to negotiate with confidence.

Once you’ve agreed outline terms with a potential vendor, you can then go through the formal application and credit approval processes, which usually runs parallel to your deal process.

Conclusion

Powerful demographic, economic, technological and regulatory factors are driving a significant increase in the number of financial advisers planning to exit their businesses.

Sellers have two primary considerations in succession planning. The welfare of their clients and their own welfare. These two considerations create great tension when it comes to planning
an exit.

While private equity funded consolidators provide one solution, we believe they do not help bring about the optimum balance between the interests of clients and their selling adviser. Independent debt finance is cleaner and while the flow of traditional debt capital to small firms remains constrained, there is one source of independent capital supporting independently owned financial planning firms in the UK. This is Vertus Capital.

To find out more go to www.vertuscapital.co.uk

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CONTACT

0203 239 0499
info@vertuscapital.co.uk