MANAGEMENT CONSULTANTS

THE GROWTH PARADOX

ACHIEVING ORGANIC GROWTH IN WEALTH MANAGEMENT

AT A GLANCE

- Strong financial performance in the UK wealth management industry has spurred significant M&A in recent years.
- CIL has conducted proprietary research and analysis to model ‘baseline’ growth, which shows that overall organic growth has been 7-8% CAGR, 2016-19. This reflects mainly passive, market-wide growth elements.
- Firms growing at or below this 'passive' growth rate are in most cases doing so without material levels of new client wins.
- We conclude that growth through new client acquisition is in fact a rarity. It is therefore a powerful form of differentiation that should be pursued in order to protect and enhance both future profits and valuations.

THE BULL RUN IS OVER

For the best part of a decade, the UK wealth management industry has remained a growing and profitable market, offering high levels of recurring revenue. However, with large-scale macroeconomic disruption expected in the wake of the COVID-19 pandemic, investors and management teams must ensure that these businesses are positioned to remain competitive and valuable.

The attractive financial performance of the wealth management (WM) industry, combined with high fragmentation of targets, has led to significant private equity interest and M&A activity over the past decade. The inorganic, buy and build growth strategy has proved popular, supported by relatively cheap debt and a broad consensus that a larger, professionalised platform is worth more than the sum of its acquired parts.

With this strategy proving viable, the sector has attracted an increased level of investment. Yet, with more interested parties pursuing high-quality targets, inevitably there is upward pressure on valuations, which in turn presents some threat to the amount of multiple arbitrage available. The COVID-19 pandemic is also expected to have an effect on the availability of debt and the flow of targets willing to sell.

Additionally, the aforementioned macroeconomic disruption will be a substantial setback to growth for the industry, with fees largely linked to global equities and other asset prices that in most years offer single digit percentage contributions to top-line growth.

Furthermore, the recent flurry of defined benefit (DB) pension transfer activity, which has flattered the growth of assets under management (AUM) amongst some firms, is likely to continue to slow given increased regulatory attention.

THE LOST ART OF ORGANIC GROWTH

How can investors and management teams protect growth and enhance valuation at exit? The answer is simple: **win new customers.**

At least part of the answer lies in an often-overlooked element of WM businesses – **organic growth**, particularly new client wins.

However, not all organic growth is equal. Some, such as increasing average fees from a static client book, are less sustainable than an ability to consistently identify, convert and retain high-quality new clients. Furthermore, in a mature WM market like the UK, genuinely new customers are either rare or inherently lower value because they are earlier in the accumulation phase of their lives. Consequently, individual advisor incentives are rarely aligned with finding and converting new customers and the seeds of future growth are not being sown.

Creating a strong organic growth engine offers several compelling advantages:

- Raising the potential growth rate ceiling
- Mitigating rising valuations for typical acquisition targets
- A proven long-term ability to refresh and grow the client book commands higher valuation at exit.

With so much acquisitive activity in the sector, it can be difficult to understand and compare underlying organic growth. Here, CIL analyses what typical, market-level growth looks like in the industry – this is the level at which all firms are carried forward passively by underlying market dynamics – and identifies the drivers of potential organic growth beyond this baseline.

REVENUE GROWTH FUNDAMENTALS

Generally, revenue models for UK private wealth financial advisory (FA)[1] firms are driven by AUM and the average fee generated by those assets. There are exceptions: introductory fees; time and materials charges for complex actions; commission-based services such as mortgage broking. But, overall, 'AUM x fee' covers the majority of revenue. Movement in these two variables will likely be behind any substantial change in overall revenue for a given firm.

What drives AUM growth?

The level of AUM within a client book is a product of a range of inflows (new clients contributing new money, existing clients 'topping up' portfolios) and outflows (lost clients, decumulating clients drawing down their assets and fees) in combination with fluctuations in asset prices.

The dynamics of this are shown on the following page.

What drives fee levels?

A client investing via a professional adviser will typically pay total annual fees of ~2% of the value of the portfolio. The fee structure shown in *exhibit 1* is common. Whether or not a specific FA firm captures all of this value or not depends on their proposition and level of vertical integration. The overall proposition and the mix of clients within the different layers of charging determine the average percentage fee charged by a firm across their client base.

There are three main levers for increasing the fees charged:

1. Firms can increase their level of fee capture through adding a discretionary fund management (DFM) proposition. This is typically a client-by-client decision, as the in-house DFM may not be appropriate for all clients.

2. Firms can increase their overall fee level by creating their own bespoke and exclusive range of funds, outsourcing underlying asset management through specialist institutional mandates and marking up an institutional rate to their retail clients.

3. Finally, firms can simply charge more for their services. That said, few firms appear to have increased like-for-like fee rates in recent years, even though wealth management clients rarely compare prices and are often slow to switch.

A notably successful buy and build strategy is to acquire non-vertically integrated FA firms and aim to place the acquired client book into the DFM of the acquirer, where appropriate. Not only does this provide multiple arbitrage by virtue of being part of a larger, professionalised platform, but it also allows an immediate increase on earnings for a given client book.

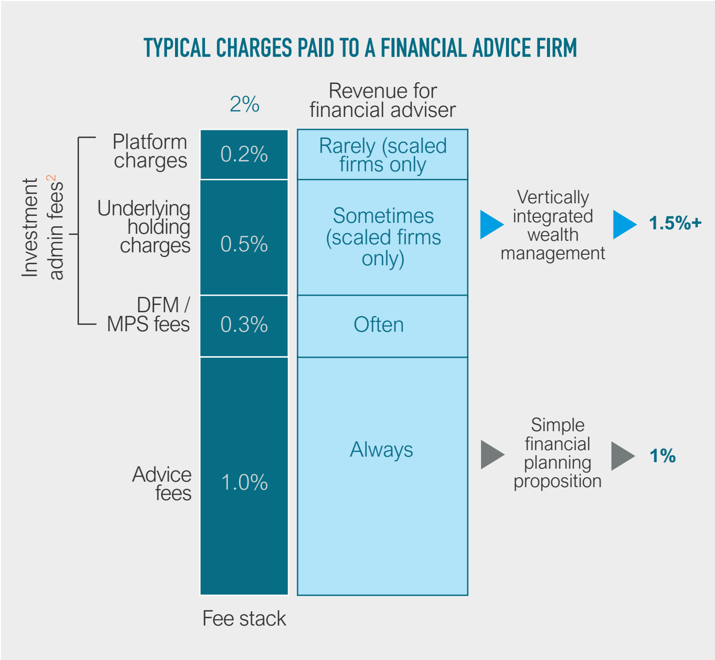


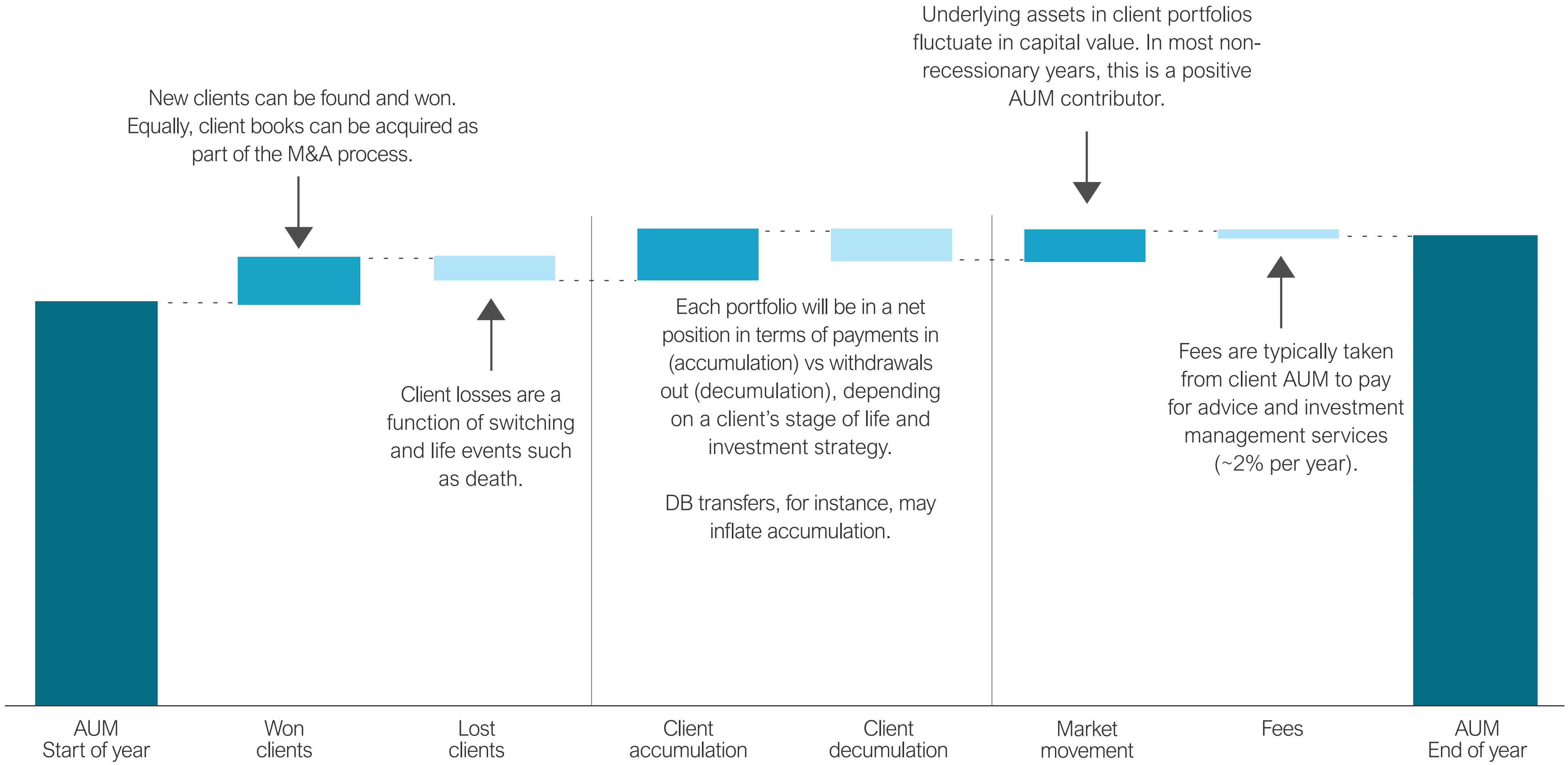
Exhibit 1.

1 For the purposes of this article this will consist of at least a financial planning proposition but may also be vertically integrated into asset management.

2 Investment admin fees can be much higher or lower depending on portfolio complexity and active vs passive strategies. Not all clients will use a DFM or managed portfolio service (MPS) service, but will typically be subject to higher underlying fund fees if not held via a DFM or MPS service, which access volume discounts.

MEASURING AUM GROWTH

AUM growth has many moving parts. In order to understand how much organic growth a wealth management business is really achieving, we need to disaggregate them.



ESTIMATING BASELINE 'PASSIVE' GROWTH

It is imperative to disaggregate **passive** growth factors (which benefit all wealth managers in the market to some extent), from **active** growth factors which are the result of a differentiated strategy or proposition.

For example, whilst a few outliers achieve abnormally high or low investment returns, most firms have a similar mix of portfolios delivering relatively similar risk exposures and returns.

Furthermore, most WM firms have a similar mix of accumulating and decumulating clients. As such, inflow / outflow rates from each group do not drive material performance differentials.

However, organic growth across the industry has lately been accelerated by DB pension transfers. Different firms will have had different exposure to this based on risk appetite and client types.

In addition, fee awareness and transparency has increased in recent years and percentage fee uplifts are largely generated through mix and vertical integration, rather than many firms being able to substantially increase like-for-like fees without altering service level.

Therefore, there are three main strategies that we expect to drive organic revenue outperformance beyond baseline 'passive' revenue growth:

1. **Most sustainable:** Organic client acquisition
2. **Less sustainable:** Recent vertical integration
3. **Least sustainable:** Substantial exposure to DB pension transfer assets

Based on proprietary analysis, published research, and company reports, CIL has researched and analysed each revenue lever and modelled ‘baseline’ growth for the 2016-2019 period.

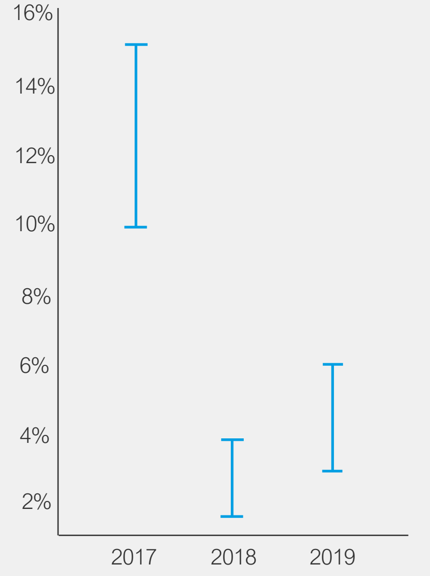
CIL’s model predicts a baseline growth of 7-8% CAGR for wealth managers between 2016-2019. Our methodolgy is shown on the following page.

BUILDING THE MODEL

We have built a model which captures all of the assumptions below to predict a baseline growth rate for the industry from 2016-2019.

Revenue levers	Baseline or differentiator	Research and analysis	Assumption
Fee stack (like-for-like pricing growth)	Baseline growth	CIL database Proprietary research	The fee stack has been relatively stable for the past few years at ~2% of AUM. Few firms have achieved material growth through like-for-like price uplifts, but some may have captured share of the stack (see below).
Share of fee stack	Growth differentiator	N/a	No assumption modelled. Organic growth above baseline is an indicator for this being a growth driver for a given firm.
AUM – net new clients	Growth differentiator	N/a	Implicit assumption of organic client acquisition sufficient to maintain consistent ratio of accumulation and decumulation. Organic growth above baseline is an indicator for this being a strength for a given firm.
AUM – existing clients	Baseline growth	CIL database Investor relations reports Proprietary research	Calculations regarding the share of a client book that is accumulating and decumulating, combined with average rates of accumulation and decumulation, indicate growth contribution to AUM appear to be 3-4% CAGR. This figure is partly flattered by unsustainable levels of DB transfers.
Market movement	Baseline growth	CIL database Investor relations reports Proprietary research	Portfolio returns a weighted average annual return on investments of 7% CAGR 2016-19 (with the majority of growth coming in 2017, where many saw double digit returns).
Fees taken from AUM	Baseline growth	CIL database Proprietary research	Annual fees taken from clients' AUM (standard practice) at an average of 2%

Typical private wealth management investment portfolio annual returns for UK investors



BASELINE GROWTH OF 7-8% CAGR FOR WEALTH MANAGERS 2016-19

OUTPERFORMING THE BASELINE

To test how our model compares to real-world performance, we have analysed the financials of a sample of WM firms from the *Financial Times* Top 100 Advice Firms 2019 for which sufficient data was available. We have stripped out acquisitions to measure just organic effects.

Analysis of this peer group is consistent with our modelled baseline[3] but importantly identifies several outliers.

The analysis presents some immediate conclusions:

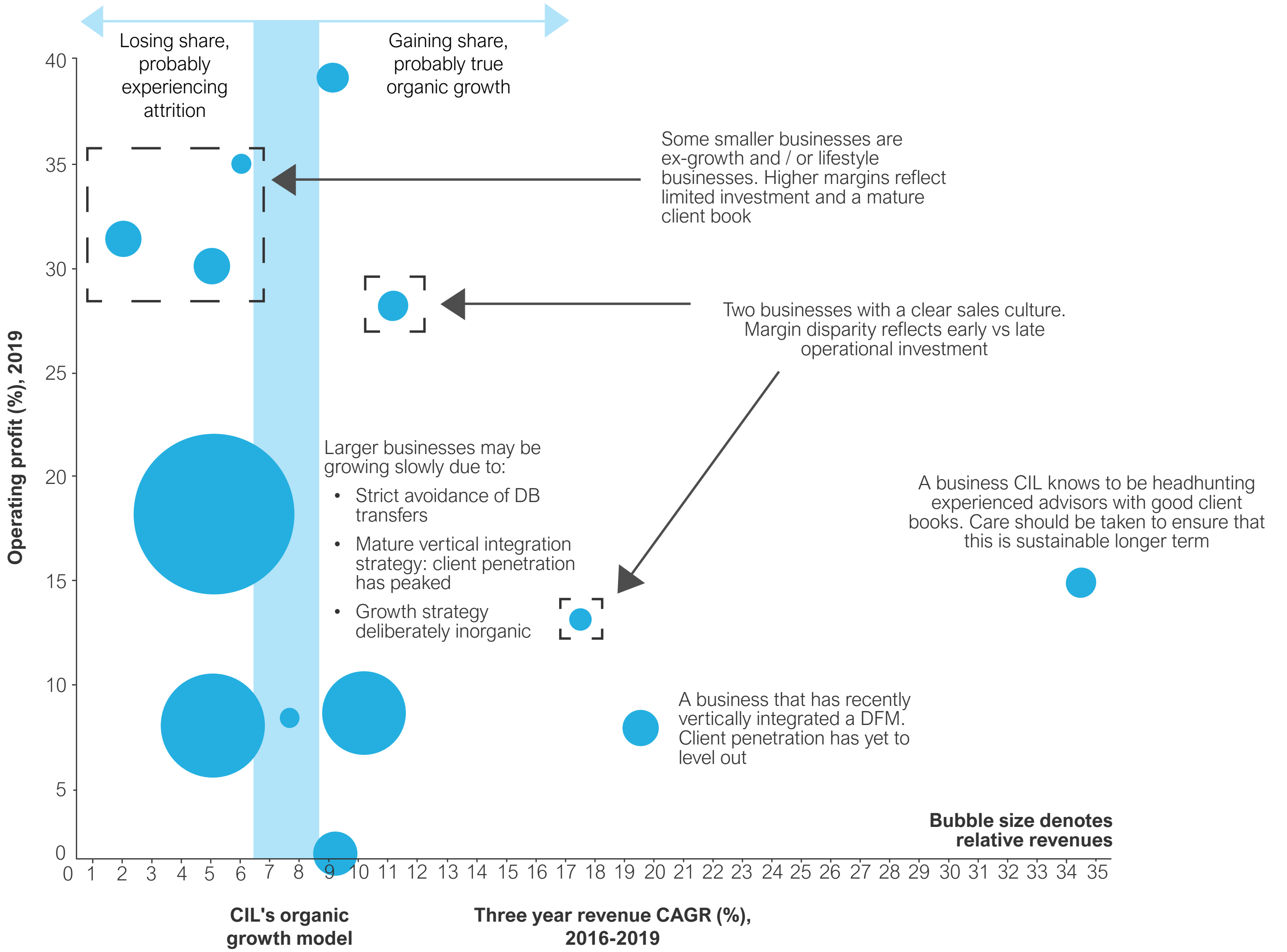
1. All firms which outperform the baseline growth rate are SMEs in which we have been able to identify either an entrepreneurial approach to client acquisition or a vertically integrated approach to grow share of the fee stack.

2. Whilst profitability is not a focus for this analysis, it does indicate that investment in supporting infrastructure or adviser remuneration is required in order to unlock high organic growth.

We have also compared the performance of listed firms with the performance of CIL clients (not shown); their results further support our conclusions.

Selected[4] wealth management firms' 2019 operating profitability (%) vs revenue CAGR (%), 2016-19

Plotted against CIL's organic growth model



3 The sample presented on this graph shows marginally lower weighted average baseline growth than our predictive model as a result of the sluggish performance of some larger groups.

4 Data driven by analysis of public information on a cleaned sample from FT Top 100 Advice Firms 2019. All firms have been anonymised. We have drawn our conclusions based on market commentary, published opinion / explanation and analysis of available data. These conclusions may not align with the views of the companies themselves.

A SUSTAINABLE WAY TO GROW

Many wealth management businesses have been flattered by a passive growth rate of 7-8% in recent years. However, the disruption brought about by COVID-19 threatens to kick away this crutch, which will compress values.

The problem

Many WM businesses have been able to maintain this 7-8% baseline growth level without specific growth initiatives or strategies – **this will become harder**, particularly in the aftermath of the COVID-19 pandemic.

Furthermore, while risk-averse clients tend to remain loyal during a downturn, **economic recovery can prompt switching**, creating opportunity for those firms with a strong sales strategy.

Vertical integration stimulates short-term revenue growth as in-house DFM penetration increases, capturing greater share of the fee stack *(see exhibit 1, pg. 5)* However, after an initial step change in growth rate, this approach tends to plateau in the medium-term; small, in-house DFMs tend not to attract substantial sums of money from other advisers.

As more and more firms pursue both vertical integration and client book acquisition strategies, **entry multiples will rise**. Can firms without an organic growth story justify a commensurate rise in exit multiple?

The solution

Investing in a first-class sales capability within a WM business is challenging as these are people businesses that should have strong and distinctive cultures.

Key pillars of effective organic growth include:

1. An ability to recruit, train and retain adviser talent
2. A consistent and scalable approach to sales and advice
3. Incentivisation which encourages the right behaviours
4. A well invested operations function creating freedom for advisers to sell while maintaining risk controls
5. An ability to identify and sell to new customers earlier in the accumulation cycle.

This last point presents **the true growth paradox**. Clients that are advised well early on in their life are loyal, but initially deliver the wrong KPIs (portfolio size, cost to serve, customer acquisition cost). Firms that can incentivise advisers appropriately to find and convert such clients are sowing the seeds of long-term organic growth.

GET IN TOUCH

CIL has extensive experience advising both management teams and investors in fast growing financial services businesses at both SME and multinational scale.

To discuss how CIL can help your business grow its organic sales function, please get in touch.

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