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Is Private Equity IBDs' Savior or Sorcerer?

Private equity firms have increased purchasing activity of BDs, but it's a mixed bag for the firms being bought

Several years ago, I attended a third-party recruiter gathering hosted by an insurance-owned broker-dealer that was working to attract advisors. During the day-long meetings, the president of this broker-dealer brought up private equity (PE) with a grimace on his face and proceeded to talk about it in terms of deep disdain. His narrative was that as recruiters, we should avoid PE-owned broker-dealers and instead funnel our candidates to the safety and stability of an insurance-owned broker-dealer. In a twist of fate, a PE firm now owns this broker-dealer. I have to assume that this BD president has done a 180-degree turn on his position and now embraces private equity ownership as something wonderful.

For my part, I've been largely neutral toward private equity involvement in the independent channel, viewing it as simply a means of access to capital. However, with the increased PE purchasing activity we are currently experiencing, it merits a closer look.

There are three forms of private equity:

- **Venture Capital**. Venture capital often funds startups with the eventual goal of going public. Silicon Valley would not exist without venture capital.
- **Growth Capital**. Growth capital supplies capital for existing larger firms to grow and sell or go public later, typically a longer-term prospect of up to eight years. We typically see this segment involved in the IBD channel.
- **Leveraged Buyout (LBO)**. An LBO takes a firm from publicly traded to privately owned with the intention of making improvements and going public down the road. LBOs claim to bring in better management, make operational improvements and make the necessary changes that these large, stodgy companies have refused to make. The perceived dark side of these changes is slashing costs by firing staff, downsizing and selling off assets, as well as funding what they bought with cheap debt and then selling the company during boom years.

What's In It for the PE Firms?

PE firms invest other people's money with institutional investors including pension funds, insurance companies, college endowments and large charities. These firms typically have a similar deal structure to hedge funds managers with a 2-and-20 arrangement: They earn a 2% fee for managing the funds plus 20% of the profits generated upon sale. They only get the 2% fee when they put the money to work, and in fact, they only get the money when they find a deal to put the money into; otherwise the money stays in the investor's bank account.

Here's an example. A PE firm promises to put all the money to work by year five and it's now year four and they've only invested $500,000 of the $1 billion fund. The PE firm now has only one year to invest the remainder of the billion dollar fund, or the investors have the right to keep their money.

Often times, the PE firm will be pressured to do any deal that comes along in order to collect the 2% of fees that they are entitled to keep. Institutional investors most commonly have a 10-year clause to get out of deals, so PE firms will try to get a sale before the 10-year period so they can show some profit. No economic value is created in companies that are handed from one PE firm to the next. However, you do create economic value to the PE firms that are handing the companies off from one to another because they are paid to do deals.

On Wall Street, you are paid to do deals, not necessarily create value in the companies bought and sold. A prime example of a company going from one PE firm to the next is Simmons Mattress Company, which was bought and sold by five different PE firms, each looking to make a profit. Each time Simmons was bought, the amount of debt doubled. Each PE firm made huge profits on its initial investment, but that profit translated into debt for the company over and over and over again. In 2008, the fifth owner of Simmons, Thomas H. Lee Partners, took out debt not just to invest in Simmons, but also to pay itself a dividend. This left the company with $1.3 billion of debt, which exposed the employees to more risk and resulted in eventual bankruptcy protection.

Is Private Equity A Distortion of Capitalism?

In a panel discussion on private equity, Eric Bolling, a panelist on Fox News' "The Five," made the argument that with capitalism, risk is retained and invested by principled individuals, whereas private equity is extractionism. Private equity uses other peoples' money under the language and auspices of capitalism but for very different purposes. Private equity borrows other people's money, creating a distortion from an opportunity-seeking culture that creates and invests things for society to a risk-transfer culture whose only incentive is to manufacture and transfer risk to somebody other than themselves. Private equity represents a loss of retained risk versus traditional capitalism.

What About Private Equity in the IBD Channel?

Here are a few examples of private equity deals that have been made to-date and the time frames of the transactions:

- **LPL** (Five years)—Bought by Hellman & Friedman LLC and Texas Pacific Group on Oct. 28, 2005, and went public Nov. 18, 2010.
- **First Allied** (Two years, 10 months)—Bought by Lovell Minnick in August 2011 and sold June 2013 to RCAP (purchases and sales close two to three months after announcements).
- **HD Vest** (Four years)—Bought by Partheon Capital Partners, Lovell Minnick & Fisher Lynch in October 2011 and sold October 2015 to accounting internet company Blucora.
- **NFP Advisor Services** (Three years)—Bought by Madison Dearborn in April 2013 and sold April 2016 to Stone Point Capital with change in branding to Kestra Financial.

With the short holding periods we see in the IBD channel, and the ample profits PE firms are able to collect—nearly 200% trailing revenue for HD Vest's sale to Blucora being the best example of upside potential—PE involvement is certain to continue. If you talk to management at broker-dealers looking for capital, the big attraction to partnering with PE firms is that they are largely hands off, supplying capital to make technology and service improvements, as well as capital to grow the firm through aggressive recruiting packages. For those broker-dealers that have been under the micromanaging thumb of insurance-owned BDs, for example, private equity can be a welcome alternative.

However, the question of whether they sell or go public and what actions they implement to improve profitability prior to the sale or going public, which typically equates to cost cutting via rounds of layoffs, remains unknown. One broker-dealer experienced three rounds of layoffs during its first year of ownership under a PE firm with complaints from the advisors that numerous key staff and management that they relied on were now gone.

Will Broker-Dealers Be Flipped from PE Firm to PE Firm?

In a May 8 *Wall Street Journal* article, "A Multiplan Bonanza for Private Equity," author Liz Hoffman brought up the issue of multiple ownerships by PE firms. She wrote, "Having one or two ownerships should work as they fix inefficiencies, cut costs and steer companies into new areas of growth. What about four times? To critics, these 'pass the baby' deals are unimaginative and overly reliant on financial engineering rather than operational improvements. Investors gripe that they end up owning the same company by virtue of having stakes in the funds on both sides, while coughing up big transaction fees. More broadly, these deals raise the question: Why would one private-equity firm sell if there were real gains left to be reaped?"

PE firm involvement is a recent phenomenon in the IBD channel. The only multi-PE to PE firm flipping we've seen is with NFP Advisor Services (rebranded to Kestra Financial) going from ownership with Madison Dearborn Partners to Stone Point Capital. With capital sources such as insurance companies bowing out due to their struggles with the Department of Labor's fiduciary standards that restrict product sales and a low interest rate environment, will PE firms be the only game in town for potential buyers? Like Simmons Mattress Co., do broker-dealers have numerous PE ownerships in their future?

We've Seen the Light and It's Private Equity

All is not dire with the private equity movement. Yaron Brook of the Ayn Rand Institute believes that private equity is an incredibly productive and a virtuous activity. As he points out, we would have no Silicon Valley without venture capital. Brook elaborates that PE firms that take over companies that are underperforming or losing money are frequently broken down, have assets sold or are closed down altogether. In taking these actions, they make a return on these activities. This is the form of PE most often criticized.

What is frequently not clarified is that these were companies locked into union contracts that made them inefficient and priced them out of the market, or they were involved in market segments that had become obsolete (zombie companies). These were businesses where there was no way of turning them around. The capital from these sales can be used elsewhere in more productive ways. Inefficient companies need to die rather than being a dead company on life support. Like it or not, profit motives bring efficiencies to the market and PE firms have been an outstanding filter for the economy in bringing efficiencies to capital use. Without profit motives, we would still have buggy whip factories.

For independent broker-dealers seeking capital support for a more attractive broker-dealer, private equity is one of the few refuges left. Capital seekers have found their savior in private equity. However, after the sale, potential financial engineering for generating profitability, with the eventual goal of a sale or going public, is where the sorcery can come to the surface.

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