As featured in the December 4, 2015 issue of ThinkAdvisor **ThinkAdvisor** By Jon Henschen

4 Factors That May Cause a Flood of Broker-Dealer Sales

With 9,500 Cetera Financial Group reps, 470 NEXT Financial Group reps and 4,925 AIG Advisor Group reps looking to "get bought," we may be headed for a floodtide of broker-dealer sales as prospects for their future profitability fade.

The current motives to sell are unique to these particular firms, with Cetera needing to either partially or fully sell its broker-dealers to generate revenue to cover its debt load, activist investor Carl Icahn wanting AIG to split up into three entities and focus on core business while NEXT Financial, a rep-owned broker-dealer, is looking for a liquidity event.

When firms look out over the next five years, many may determine that the risk-reward model has the risks pulling ahead, with the question becoming not whether they can maintain current profits levels but rather how much will their profits decrease.

Trends we are witnessing today will only be exacerbated by the Department of Labor's fiduciary rule over the next five years. Marketplace dynamics such as insurance company trends, the strong dollar and the inherent profit potential of the independent channel will all have influences on whether owning independent broker-dealers makes sense.

Factor 1: A Profits Hit From DOL Rule Implementation

You can easily argue that BD profit levels are as good as they will get and it will be a struggle to maintain current profit levels for the following reasons:

- The DOL's new fiduciary standard negatively impacts an advisor's ability to prospect for new clients
- Restrictions on non-liquid products in retirement accounts (large portions of broker-dealer profits have been via REITs/BDCs and alternative investments since 2008 along with the revenue-sharing arrangements with these vendors, so this will be a substantial profit hit for many firms)
- New labor-intensive requirements for what must be disclosed on websites regarding who and what gets paid through commission product sales
- Restrictive product choices, such as: presenting a client with "A" share mutual funds with breakpoints versus a variable annuity with a 5% commission; the client may not have a variable annuity as an option under the DOL's Best Interest Contract Exemption (BICE) or will only be available under strict restrictive criteria.

Couple these factors with more advisors practicing the advisory model in an already crowded space and low-cost robo advisors and you get price compression that requires more AUM to make the same amount.

Additional FINRA tracking and documenting has been an ever-increasing burden as segments of Dodd Frank have been piecemealed out, which has already been a tipping point for many broker-dealers. Now, with new fiduciary rules getting rolled out over time, what was a tipping point for firms under $10 million of revenue could reach to firms under $25 million or higher. As a recruiting firm we've already been focusing largely on firms with $75+ million of revenue as a safe haven of scale and profitability.

Factor 2: Small Firms Drowning in FINRA Rules

An advisor recently shared with me his personal dilemma with our industry, which mirrors on many levels what is happening to small broker-dealers. "The ground we are standing on is constantly shifting and breaking apart," he said. "We have to be in a full sprint to stay ahead of the collapsing ground. It would be great if government and FINRA helped to foster stability to give us some certainty in our business but instead, we're trying to advise clients while we are wondering if our broker-dealer will make it. Some of us are wondering if we can grow fast enough to get the size and scale needed to keep up with the expensive regulation that never slows down."

As an example, he pointed out the time and effort it now takes to schedule an appointment, prepare for it, generate the paperwork to open an account, "explain what we are doing to the client, get the client the proper disclosures, document the meeting, and follow up with any mistakes with the paperwork is extraordinary. My assistant and I work together on the paperwork, yet many times we spend the next couple of weeks redoing things that were not perfect." This individual said "If I weren't successful at other things in my life and in my practice, I would begin to think that I am stupid. It makes me wonder why I can't get it right more than I do. My OSJ said that what they are looking for is 'precision,' but 'precision' is killing me. I'm drowning in things that must be done to make my clients successful."

The "precision" required at the rep level is even more stringent on the broker-dealer level because a lack of precision on tracking and reporting results in steep FINRA fines. The irony with this advisor is that he is with a large broker-dealer that has good technology, practice management and marketing tools. Imagine advisors with smaller broker-dealers that have few to none of these tools to help run their businesses more efficiently or grow!

LPL has been through the ringer with FINRA over the last few years and has warned our industry that what they've been through will trickle down. Tracking and reporting are areas that many firms fall short on during audits; small firms being the least able to survive the FINRA fines that are imposed.

Since 2010 we've seen many small broker-dealers merge into larger ones and become super OSJs that hand off the duties they hate (compliance and business processing) to a larger entity. Going forward, it is very likely that we'll see an increase of firms with under $25 million of revenue go the route of Super OSJ or merge with other smaller broker-dealers.

Factor 3: The Strong Dollar Makes Sales of Foreign-Owned BDs More Attractive

With the euro-to-dollar ratio at $1.06 to $1.00, European firms have a window to sell their broker-dealers in the U.S. and benefit from the unusually strong dollar. AXA Advisors (French owned), Jackson National BDs (British owned) and Allianz (German owned) are all potential sales, especially as these naturally risk-adverse join the bandwagon of insurance companies shedding themselves of broker-dealers and focusing on core businesses (after all, broker dealers owned by insurance companies are not something actuaries can measure for risk).

With likely prospects of a weaker dollar next year, and the realization that the U.S. will never be able to pay back the near $20 trillion we owe, these European companies will have a window to get out while the currencies are in their favor. Recently we heard rumors that AXA advisors was looking for a buyer (which I stress is a rumor only), but would make sense in light of U.S. regulation's eroding effect on earnings potential going forward.

Factor 4: Shedding Independent Arms In Favor of Proprietary Products

We've seen numerous insurance-owned broker-dealers sell off their least proprietary-minded independent arms in favor of their channels that sell large amounts of proprietary products. ING, MetLife, Nationwide and most recently Transamerica have all shed their independent arms that do less proprietary products in favor of channels that are more proprietary-product focused.

Some of the retail regional/wirehouse channels also have independent arms that could be vulnerable to sale. During the third-quarter earnings call for Stifel Nicholas, Ron Kruszewski explained that Stifel's earnings disappointment in the wealth management sector was due to the recent purchase of independent broker-dealer WRP, with their independent arm not delivering the profits they had anticipated.

Wirehouses shoot for 15%+ returns on their broker-dealers. However, for independent BDs to reach such numbers requires scale, self clearing, lots of profit centers via proprietary advisory platforms and numerous markups and revenue-sharing arrangements. For independent firms that are publicly traded, hitting the 15%+ range is a must, while most privately owned broker-dealers are content with just being profitable—and if they hit 10% profitability, it's gravy.

When Stifel bought WRP what it bought was a firm that had a rather low average production per rep, with reps doing largely package products held direct and unusually high payouts so that even reps with under $100K GDC were still able to get a 90% payout—not a very profitable model even by independent standards.

If Stifel tries to raise profitability on its independent channel via lower payouts and higher costs, Stifel will experience a flight of advisors to greener pastures, making it more likely that it would sell its independent arm and focus on the more profitable retail arm.

Insurance companies will favor either more captive broker-dealer models or no broker-dealer at all, while wirehouses who have dipped their toes into the independent broker-dealer space are finding the waters largely too chilly for comfort. The exceptions are Wells Fargo FiNET and Raymond James, though the lion's share of Raymond James' recruiting growth has been in its retail channel.

Then Who Will Be the Buyers?

The only names you hear about as potential buyers for the larger groupings of broker-dealers are various private equity firms. For midsized broker-dealers, Ladenburg Thalmann is still in growth mode and a spattering of firms are looking to merge with other firms or become super OSJs under a larger firm. Small and midsized firms are merging with each other to build scale or selling to larger firms while everyone is trying to grow through recruiting.

Advisors are shopping broker-dealers, and more frequently insisting on forgivable note money, which smaller firms lack the ability to offer, hobbling their ability to recruit. If we experience a substantial uptick in sellers, we will see the prices being paid for broker-dealers go back down to earth.

The recent sale of HD Vest at near 200% of trailing revenue is a crazy highpoint I can't see being repeated. In the 2000s a sale price of 30% to 40% of trailing revenue was the norm. It's likely that we will see those down-to-earth sale prices back in vogue with the potential floodtide of broker-dealers for sale.

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