2020 Whitepaper

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LBO Private Equity Makes Its Mark in the IBD Channel

An Analysis of Cetera and The Advisor Group IBDs Leveraged Buyout Entry Into the Independent Broker-Dealer Space and What It Means for Advisors

Before 2018, private equity (PE) involvement in the independent broker-dealer (IBD) channel was limited to growth equity. Broker dealer purchases were transacted entirely with the capital from institutional investors committed to the PE firm.

Since 2018, with Genstar's purchase of the Cetera broker dealers, leveraged buyout (LBO) private equity has made its entry.

The difference with leveraged buyout (LBO) private equity is that the purchase price is transacted through a combination of institutional capital and the sale of junk bonds. Leveraged buyouts are frequently employed when the PE firm does not have enough institutional capital to complete the transaction in its entirety due to the large scale of the purchase.

Acquisitions are typically financed with a large portion of junk bonds, which end up being owed by the acquired company. This means that the PE firm and its investors can put in a comparatively small amount of cash and magnify gains if they sell at a profit. The fees to PE firms are huge, with traditional PE structure following a "2 and 20" rule, which is a 2% annual fee, plus 20% of profits above a certain level. The "20"part, known as carried interest, is especially lucrative because it receives favorable tax treatment.

Two Recent LBO Examples

When the Cetera broker dealers were purchased by Genstar Capital in July of 2018, $1 Billion of the $1.7 Billion (59%) price tag was financed by junk bonds that were rated B3 from Moody's Investors, with a Debt to EBITDA ratio of 7.5 as reported in August of 2018 by Investment News. As a comparison, LPL's CFO reported in a July 2018 conference call that they had a net debt to EBITDA ratio of 2.3.

One year later, in August of 2019, Investment News reported that Reverence Group purchased The Advisor Group for $2.3 Billion, with $1.6 Billion (69%) of the purchase financed with junk bonds. The junk bonds were rated B+/Negative by Standard & Poor's (S&P), with debt service payments over the next year calculated to be about $150MM.

There are a number of similarities between the Cetera and The Advisor Group LBO purchases, and an accompanying number of risk factors for the advisors. For example, one credit downgrade on Cetera's junk bonds would bring them down to a Caa1 rating (poor standing and high credit risk), while The Advisor Group downgrade would be to B with both B+ and B ratings being described by S&P as "faces major future uncertainties."

While much has been written about risk to the PE institutional investors, little has been written about risk to advisors at broker dealers that are purchased through LBO PE. PE of any kind has its own risks to advisors, but LBO carries additional risks that affect the advisor experience in multiple ways.

Types of LBO PE ownership risks to advisors:

1. Declining service levels
2. Market risk
3. Reduced technology/services investment
4. Ownership risk

1. Service Risk

Both the Cetera and The AdvisorGroup broker dealers have approximately half of their cash flow dedicated to servicing their junk bonds. The remaining cash flow is primarily dedicated to aggressive recruiting packages and continued acquisition of broker dealers. The goal of the PE firm is to grow top-line revenue, while limiting corresponding expense growth, making the asset more profitable and therefore increasing valuation.

Another objective is to maintain top-line revenue but cut expenses through reduction in force, increased

efficiencies or consolidation (merging aggregated broker dealer back offices for example). The bottom-line objectives are to 'lean out' the broker dealer purchases in two ways:

1. By not growing administrative support while the additional revenue comes in and advisors are added
2. By whittling down tech expenses and not substantially investing new dollars

For both these LBO PE-owned broker dealer families, broker dealers add advisors through recruiting and acquisition. Back office expenses are cut to the bone with ever increasing advisor to staff ratios so that the service experience becomes increasingly mediocre for advisors and their staff.

2. Market Risk

"Each percentage point increase in interest rates causes the price of a high yield bond fund to fall four to five percentage points."

—*The Conservative Income Investor*

If interest rates sharply increase by three percentage points, then high-yield bonds could decline by up to 15%. In addition to interest rate risk, a protracted market correction can cut the cash flow of a broker dealer substantially. Investment News reported S&P stating, "Even assuming the firm realizes all of its expected earnings improvements, [earnings before interest, taxes, depreciation and amortization] to total debt service would be only about 2x," according to the report. We believe such low debt-service coverage, in an industry whose results are correlated with volatile market conditions, leaves the firm's debt-service capacity exposed."

An example of this would be to assume $300MM (2x debt service) of cash flow reduced to $200MM due to a major market drop, the firm would still have $150MM obligation to service junk bonds, leaving only $50MM for recruiting, acquisition, paying staff and everything else. This scenario, coupled with the potential for ratings downgrades on the bonds creates a breeding ground of uncertainty for the broker dealer and advisors.

If interest rates drop, as Moody's cautions in their rating of Cetera, the money market sweep account, which accounts for a substantial portion of profits, will diminish. The result is that LBO PE broker dealers are negatively impacted in either scenario, and thus also advisors.

3. Technology/Services Investment Risk

"Research has shown that companies acquired through leveraged buyouts (LBOs) are more likely to depress worker wages and cut investments, not to mention have a higher risk of bankruptcy. Private equity owners benefit through fees and dividends, critics say, while the company is left to grapple with often debilitating debt."

—*Bloomberg Businessweek, Everything is Private Equity Now*

Non-PE broker dealers are generally transparent if not boastful about how much they spend on technology in a given year. For example, LPL spent $150MM on technology in 2018. We've seen some PE owned firms (not LBO PE) invest as much as $20MM on technology in a given year.

LBO-PE firms are less likely to share figures on their capital outlays for technology/services improvements. There may be an occasional press release about outsourcing a newer technology or service, but these announcements are more often than not a token, "Look, we're doing something!" statement rather than a quantifiable and deep investment on technology or services improvement. Technology and services have been lagging behind competitors during this LBO-PE ownership trend, as spending on recruiting, acquisition and compliance take precedence.

Moody's reported during the Cetera purchase that their rating of B3 reflected a difficult operating and regulatory environment for independent broker-dealers, requiring them to constantly invest in systems and processes to maintain their compliance. With heavy expenses being spent on complying with RegBI, and half the cash flow going to servicing their debt, what is left for technology and services?

4. Ownership Risk

According to Bloomberg Businessweek, there are now 8,000-plus PE backed companies, almost double the number of their publicly listed counterparts. What is the end game for private equity, which is all about risk transfer, not true ownership?

One broker dealer is on their third PE owner, which makes one wonder how long this game of musical chairs with private equity firms will continue. At some point, we run out of buyers and someone is stuck holding. For the larger groupings of broker dealers,

there is the possibility that they can go public, while smaller PE owned firms must flip the firms to a new owner, typically in under five years.

At this writing, it has been announced that the Ladenburg broker dealers are being bought by The Advisor Group, with the two combined certainly giving them the scale to go public. LPL had two PE firms that owned them before they went public in November of 2010 when the market for IPOs became more favorable after brutal market conditions in 2008-2009. Part of going public required LPL to go self-clearing for profitability reasons. They recruited heavily before going public, offering unusually high retention bonuses, but kept staffing lean in spite of the growth.

This window-dressing when going public came back to bite them, with a wave of compliance issues hitting them for years afterward, primarily due to lack of supervision. Rapid advisor growth has a history of coming back to bite broker dealers because they can't keep up with compliance tracking and overall service. Since we started tracking broker dealers in the 90s, we've seen a repeating pattern where rapid growth has a compliance backlash two to three years later. This is especially true when staffing is thin relative to number of advisors.

Private Equity Myths Unraveled

Danielle DiMartino Booth, a former adviser to the president of the Dallas Fed, author of *Fed Up: An Insider's Take on why the Federal Reserve is Bad for America*, and founder of economic consulting firm Money Strong, LLC had this to say about PE regulation:

"When Dodd-Frank was implemented, what Wall Street did was say, 'Now that they are going to regulate this corner of investment banking that was the most lucrative, we'll move all our most lucrative business outside of traditional investment banks that are now overly regulated and move to the private equity world.' There are trillions and trillions of PE dollars in this country that are not regulated by any entity, which can cause problems in and of themselves. Nobody is looking over private equity, so in essence, the fox is back in charge of the hen house, which is what keeps her up at night. What Countrywide was in the 2000s, PE has taken their place as this new shadow banking system."

A common claim of Private Equity is that they offer higher returns with lower risk, guided by the wisdom of elite managers. The problem with this claim is that because of the closed, Amish-society-like nature of Private Equity, it is very difficult to prove these claims.

In his February 20, 2018 *American Affairs* article, "Private Equity: Overvalued and Overrated?" Portfolio Manager Dan Rasmussen, who worked in the key PE industry firms Bain Capital and Bridgewater Associates prior to founding of small cap mutual fund Verdad noted,

"What makes private equity dangerous is the use of debt—and the use of phony accounting to conceal the riskiness of these leveraged bets. The average PE deal is 65 percent debt financed, and whereas the valuations of public equities are determined by transparent, liquid public markets, PE firms determine the valuations of their own portfolio companies. Unsurprisingly, they report far lower volatility than public markets."

Rasmussen also observed that,

"In 2007, private equity debt levels reached 5.2x EBITDA. Today, they are at 5.8x EBITDA, and they have been above 5.2x every year since 2013. The 2007 vintage deals did not end well for investors. Today's higher-priced and more leveraged deals could end even worse.

These levels of leverage leave companies with no margin of safety. Most companies' cash flows are too volatile and unpredictable to sustain high debt levels for long. In addition, the recent tax reform caps interest deductibility at 30 percent of EBITDA, which for most firms translates to about 5x EBITDA of debt. This will be particularly problematic for highly leveraged firms, especially in any downturn when EBITDA declines."

Rasmussen found a way to answer the opaque question of, "Do PE Firms truly improve growth and competitiveness?" According to Rasmussen,

"…there is, actually, a way to answer this question. As it turns out, many PE firms issue debt to finance acquisitions and, in those cases, the firms are required to provide investors with the company's financials. These financials can be used to compare a company's pre- and post-acquisition performance to determine exactly what the PE firms achieve.

My firm, Verdad, took that information and compiled a comprehensive database of 390 deals, accounting for over $700 billion in enterprise value (EV), a substantial set of data representing the majority of the largest deals ever done. We then analyzed it to understand what has actually been going on in the PE industry:

- **in 54 percent of the transactions we examined, revenue growth slowed;**
- **in 45 percent, margins contracted; and**
- **in 55 percent, capex spending as a percentage of sales declined.**

Most private equity firms are cutting long-term investments, not increasing them, resulting in slower, not faster growth."

Again, according to Rasmussen,
"In 70% of cases, PE firms are leveraging up the businesses they buy. They typically double the amount of debt on the balance sheet, from 2.5x EBITDA to 5x EBITDA—the biggest financial change apparent from our study.

As an industry, PE firms take control of businesses to increase debt and redirect spending from capital expenditures and other forms of investment toward paying down that debt. As a result, or in tandem, the growth of the business slows. That is a simple, structural change, not a grand shift in strategy or a change that really requires any expertise in management.

Bain & Company's 2017 global private equity report came to similar conclusions. They compared deal model forecasts for revenue and EBITDA with the results for PE deals in their proprietary database. More than two-thirds of the time, PE deals underperformed the EBITDA forecasts made at the time of purchase."

Andrei Shleifer, Professor of Economics at Harvard University and a founder of behavior economics, said, "There are three ingredients to a financial panic or fire sale: consensus, leverage and illiquidity. With LBO Private Equity, you have all three."

2018 marked the entry of a new player (LBO PE) into the IBD channel, and introduced new risks. Advisors meticulously gauge risk for their client's portfolio's but often times are unaware of risks to their own broker dealer. It's time to look under the hood and reassess.

Read more about private equity:

Is Private Equity Bad for Broker-Dealers?
By Jon Henschen 10/15/2018
www.henschenassoc.com/the-dangers-of-private-equity-to-broker-dealers-and-the-financial-system/

Is Private Equity IBD's Savior or Sorcerer?
By Jon Henschen, 7/26/2016
www.henschenassoc.com/is-private-equity-ibds-savior-or-sorcerer/

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Acquisition of Cetera being financed through $1 billion junk bond sale, August 21, 2018, Investment News,
http://www.investmentnews.com/article/20180821/FREE/180829975?template=printart

Advisor Group acquisition financed by debt rated 'junk' by S&P, August 23, 2019, Investment News,
https://investmentnews.com/article/20190823/FREE/190829962?template=printart

A 5% Junk Bond Bubble: What Could Possibly Go Wrong?, July 16, 2019,The Conservative Investor,
https://theconservativeincomeinvestor.com/a-5-junk-bond-bubble-what-could-possibly-go-wrong/

Everything Is Private Equity Now, October 3, 2019, Bloomberg BusinessWeek:
https://www.bloomberg.com/news/features/2019-10-03/how-private-equity-works-and-took-over-everything

Inflation Has Run Amok—Danielle DiMartino Booth, August 29, 2018, USAWatchdog,
https://usawatchdog.com/?s=inflation+has+now+run+amok

Private Equity: Overvalued and Overrated?, Spring 2018, American Affairs,
https://americanaffairsjournal.org/2018/02/private-equity-overvalued-overrated/

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