ADVESTRA INSIGHTS

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M&A activity in the Swiss wealth management industry – does FinIA herald a new era?

After decades of self-regulation, Swiss wealth managers[1] face new rules under the Swiss Financial Institutions Act. They need to apply for a license and comply with certain capital and organizational requirements once the phase-in period lapses by the end of 2022. These requirements will trigger more M&A activity in the sector as smaller wealth managers may decide to merge with larger players or join forces with similarly sized wealth manager(s). This edition of Advestra Insights focuses on typical challenges experienced in M&A activities in the wealth management industry and some lessons learnt from recent transactions.

1 INTRODUCTION

So far, there has been only little mergers and acquisitions (*M&A*) activity in the Swiss wealth management sector. Although until now, there has been limited impact, Switzerland's new Federal Act on Financial Institutions of 15 June 2018 ("FinIA") which entered into force in 2020, ending decades of industry self-regulation, is likely to bring more consolidation in the industry which counts roughly 2,500 external asset managers ("EAMs"). This new trend is expected to be further accelerated by the fact that wealth managers face the challenges of an aging client base and the digitalization of what has to date been a very personalized service.

Typical Swiss wealth managers are smaller firms that value their independence and take pride in what they have achieved over the last decades. Selling a business or merging with a competitor is, therefore, not only a challenging commercial decision but often also a highly personal one, which might be one reason why there have been so few transactions to date.

[1] For the purpose of this Insights, the term wealth manager refers to portfolio managers in the meaning of art. 17 para. 1 FinIA (*Vermögensverwalter*) and does not include banks, securities firms, fund managers or collective asset managers. Furthermore, the terms wealth manager and external asset manager ("EAM") are used congruently.

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However, many players will face the challenge of adjusting to the new regulatory landscape, in which they have largely been unregulated except for anti-money laundering regulation, and even then, the supervision and enforcement was largely left to self-regulatory organizations ("SROs"). Under the new FinIA rules, Swiss wealth managers need to apply for a license by the Swiss Financial Market Supervisory Authority FINMA ("FINMA") as portfolio manager (art. 17 (1) FinIA; *Vermögensverwalter*) or, if they manage assets of occupational pension schemes, as managers of collective assets (art. 24 FinIA; *Verwalter von Kollektivvermögen*), subjecting them to the same regime as asset managers managing assets of collective investment schemes. To be authorized, wealth managers must, among other things, maintain a good reputation and provide for verification of proper business conduct by the responsible directors and officers. They will also need to give adequate financial guarantees and have an appropriate organization, including an adequate internal control system, risk management and compliance functions as well as appropriate segregation of these functions. While FINMA is responsible for licensing wealth managers, supervisory organizations (*Aufsichtsorganisationen;* "SOs") are responsible for the ongoing supervision.

In 2020, 2,521 wealth managers and trustees reported to FINMA that they intended to submit a license application to FINMA by 31 December 2022. However, as of 25 April 2022, only 409 of these institutions had submitted a complete application. Of those, FINMA has licensed 242 institutions: 235 portfolio managers and 7 trustees.[2] Accordingly, it seems that many firms have been postponing the implementation of measures to comply with the new rules. This decision is presumably largely driven by the substantial increase in costs involved in running a regulated business, which include, in addition to the costs and expenses to obtain the license, the costs of compliance staff and the additional burden of complying with the new regulatory framework and responding to requests of the supervisory authority and possibly FINMA.

Existing EAMs have until the end of 2022 to make the necessary changes and submit their license application to FINMA (which also includes a confirmation of affiliation by an SOs and therefore requires submission of the license application to such SO well in advance of year-end 2022). In many cases, an M&A scenario looks like the obvious route to take, especially as complying with the new regulatory regime oftentimes requires greater scale due to increased costs and governance requirements. Many larger companies will see this as an opportunity to buy out struggling independent rivals while smaller companies may decide to join forces with similarly sized EAMs. Overall, the new regulations under FinIA are expected to accelerate consolidation within the Swiss wealth management industry.

2 DEAL STRUCTURE AND CHANGE-OF-CONTROL REQUIREMENTS

2.1 Considerations with regard to deal structure

Feasible acquisition structures include (i) a mere share deal (followed by a statutory, then intra-group, merger), (ii) direct merger between the target and the acquirer or one of its subsidiaries, (iii) bulk transfers (*Vermögensübertragung*) in which the respective agreements (and other assets and/or employees) transfer *uno actu* from the transferring entity to the receiving entity by operation of law upon the entry of the bulk transfer in the commercial register or (iv) referrals where clients terminate the contract with their existing EAM and sign a new contract with the new, licensed EAM.

Buyers in the financial services industry typically prefer asset deals to limit the assumption of potential legacy risks and to achieve a step-up in book value. Sellers on the

[2] See FINMA Guidance 01/2022, p. 4.

other hand often prefer share deals, generally allowing them to generate capital gains subject to no or privileged taxation. Given the time pressure and general market environment, we anticipate that referrals and potentially also bulk transfers are more likely to prevail. For either scenario, buyers should, however, keep in mind that onboarding with new custodian banks typically requires some time in case the new clients have custodian banks with whom the EAM does not yet have existing relationships.

Wealth managers must notify their SO of any changes in the facts on which the original licensing was based (art. 22 (1) Financial Institutions Ordinance ("FINIO") in conjunction with art. 8 (1) FinIA). If the changes are material, the wealth manager must obtain prior approval from FINMA as well (art. 8 (2) FinIA). Irrespective of the transaction structure, a prior approval by FINMA must likely be sought (in case of an already licensed wealth manager) before closing the contemplated transaction.

2.2 Change of control

With respect to share deals and other transaction structures that result in a change of control, the following should be considered: Under FinIA, not only the wealth manager and its management must provide for a guarantee of irreproachable business conduct (*fit and proper test*) and maintain a good reputation. These requirements also apply to any qualified participant of the wealth manager, *i.e.* any person holding directly or indirectly 10% or more of the wealth manager or having other significant influence (art. 11 (3) FinIA).

In principle, FINMA-licensed wealth managers and their qualified participants are exempted from notifying FINMA in case of a change of control (art. 11 (5) and (6) FinIA in conjunction with art. 11 (7) FinIA). However, such wealth managers must obtain prior approval from FINMA, in addition to notifying their SO, of any changes in material facts on which the original licensing was based. The relevant ordinance considers facts to be material if, amongst others, (i) they are likely to call into question the guarantee of irreproachable business conduct on the part of the qualified participants or (ii) they call into question prudent and sound business activity on the part of the wealth manager as a result of the influence of its qualified participants (art. 10 lit. d and e FinIO). Therefore, a change of control involving a FINMA-licensed wealth manager will typically trigger a prior approval requirement by FINMA.

3 THOUGHTS ON PRIVATE EQUITY AND TECH OWNERSHIP

Typically, private equity investments in Switzerland across industries have been made to acquire control of the target. However, private equity investments to acquire control in Swiss financial institutions have remained rare. The consolidation wave, however, might offer them the chance to build up their portfolios of wealth management businesses with steady cash flows. Looking at other jurisdictions, PE investors have been drawn to EAMs' recurring fee revenues, high levels of client retention and the opportunity to act as an aggregator allowing them to conduct roll-up transactions for value creation. Inspired by these opportunities, acquirers backed by PE firms accounted for almost 55% of global wealth management acquisitions in the first quarter of 2022.[3] Furthermore, many bigger Swiss wealth managers are well capitalized leaving more room for profit transfers to its owners without extensive scrutiny from FINMA. This may also increase the attractiveness of the Swiss wealth management industry for PE investors.

Separately, the wave of digitalization in the wealth management industry could potentially attract new players to the sector, such as tech companies. However, the FinIA's

[3] Based on recent PitchBook data published on 6 July 2022.

new licensing requirements mean that wealth managers will need to be run by financial professionals with experience of working in the wealth management industry, which may deter entrepreneurs with different industry background from entering the fray.

4 OUTSOURCING & SECONDMENT – OPPORTUNITIES AND LIMITS

Particularly in cases where smaller companies decide to consolidate their activities to form a larger player in the market, delegating certain activities and functions to third parties by way of an outsourcing setup might be one way of complying with the applicable licensing requirements without incurring extensive costs.

In principle – and subject to a few specific exceptions – all significant functions may be outsourced. However, wealth managers may outsource tasks to external third parties only if the third parties possess the necessary skills, knowledge, experience and authorizations to perform such tasks. In addition, portfolio managers may only delegate tasks (i) that are not within the decision-making remit of its corporate bodies and (ii) which do not relate to governance, supervision, and control. The delegation must also not impair the appropriateness of the financial institution's operational organization. The operational organization is no longer deemed appropriate if the financial institution does not have the necessary personnel and specialist knowledge to select, instruct and monitor the third party and manage the associated risks, or does not have the necessary rights to issue instructions to or control the third party.

If a financial institution outsources significant functions, the outsourcing service provider will be subject to information and reporting duties to FINMA and possible FINMA audits. Wealth managers must set out the significant functions delegated as well as details of a potential sub-delegation in a written agreement with the outsourcing provider and in their organizational regulations. The delegation must be set up in such a manner as to allow the wealth manager, its internal auditors, the audit firm, the supervisory organization and FINMA to inspect and review the delegated tasks.

The outsourcing of the investment decision to a person located in a foreign jurisdiction may be conditioned by FINMA on the existence of an agreement on cooperation and exchange of information between FINMA and the regulator of the relevant jurisdiction.

As an alternative to outsourcing a function, wealth managers may also consider a secondment setup to procure requisite skills. In an outsourcing framework, the service provider performs the outsourced services in its own responsibility as service provider. In contrast, under a secondment arrangement, certain employees employed by a third party are leased to the wealth manager and work under the direct instruction and control of the wealth manager. Typically, such secondment setups are subject to less stringent requirements, provided they do not concern members of the board of directors or executive management, who must be formally employed by the regulated institutions. However, secondment setups may be subject to the Federal Act on Employment Exchange and Personnel Leasing and require an operating permit.

5 VALUATION CONSIDERATIONS

Applied valuation multiples in the wealth management industry include 'Enterprise Value to EBIT' multiples and 'Enterprise Value to AuM' multiples. As a rule of thumb and in our experience, valuations between 1% to 2.5% of the 'Enterprise Value to AUM' are usually observed for wealth management companies in the Swiss market. Under these methods, value derives from the profit that is generated on the revenues. Wealth management companies with low profitability typically have an AuM multiple on the lower end of the range while companies with sustainably higher margins typically end up with higher 'Enterprise Value to AuM' multiples.

More recently, given the potential synergies involving M&A transactions in the wealth management industry, we have seen a shift towards alternative valuation methods, including the discounted cash flow (*DCF*) method or comparable dividend discount models. This approach involves forecasting the anticipated cash flow stream for a certain period and then discounting it back to a present value at an appropriate discount rate.

6 EARN-OUT STRUCTURES TO ACCOUNT FOR THE PERSONAL NATURE OF THE BUSINESS

Strategic buyers face two major challenges when acquiring a target in the financial industry: the first one is the risk of client attrition. The second is the risk of the buyer seeing itself forced to exit certain relationships if they do not meet its standards. Both risks, if they materialize, may lead to less AuM and hence decrease the value of the deal. Indeed, clients of EAMs are generally loyal to their client advisors, as a personalized service is usually one of the selling points of an EAM and a competitive advantage over larger financial institutions, including private banks, who may often offer a comprehensive service offering.

Furthermore, sellers are often reluctant to allow a buyer to engage on extensive due diligence exercises to protect client confidentiality and their client base from future attempts to induce clients to move business to the buyer. These factors may lead to a valuation gap between buyers and sellers.

The parties can bridge the gap by deferring a part of the consideration and using an earn-out over a period of typically six months to two years. This gives the parties an opportunity to true-up and validate the initial purchase price at a later point in time. While the buyer's risk of overpaying based on growth assumptions that do not transpire is reduced, the seller can still benefit from a strong post-transaction performance. Furthermore, particularly where the seller is key to the current success of a business (which is often the case for EAMs, *e.g.* due to client relationships), the buyer will often want to keep the seller on board with a financial interest in the company's success for a certain period of time post-transaction.

However, as a flip side, earn-out clauses are often the subject of disputes and, hence, should be carefully negotiated and drafted. Typical earn-out metrics in the wealth management industry can be based on assets under management, top-line revenue, operating income or gross profit.

7 CONCLUSION AND OUTLOOK

Switzerland's new FinIA regulation in combination with market trends and developments in the Swiss wealth management industry may well turn out to be a game changer for M&A activity in the industry, as more and more wealth managers consider strategic transactions as a way forward. This particularly holds true as more and more wealth managers face a hard deadline by the end of 2022 at which point they will either need to have filed the license application with FINMA (including the required confirmation of affiliation issued by an SO) or found an alternative route of operations such as an M&A transaction. Otherwise, such companies run the risk of intentionally operating without a license after the deadline resulting in supervisory and criminal law consequences. Alternatively, and given that suitable partners are rare to find for market players looking for M&A opportunities, interested actors may also consider "hybrid" forms of transactions such as revenue sharing agreements. In any case and despite the approaching deadline, regulatory and financial implications should be carefully assessed to make sure both the interests of sellers and buyers are accommodated.

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