



FORTE
ASSET SOLUTIONS

MARKET COMMENTARY 2020



https://freeaussiestock.com/free/Australiana/slides/bush_fire_rewgrowth.htm

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2020 a year that will forever be in the global collective consciousness for the social, health and political crises experienced.

Australia entered the New Year with a fire season that started in 4th qtr of 2019 which had devastating consequences in early 2020. It was a physical dramatisation of what financial services has gone through in 2018 and 2019. Though it seems the landscape has been forever changed, there are scars but we are seeing regeneration emerging on the horizon.

2019 was our industry's annus horribilis (see 2019 commentary) and 2020 was actually a year of affirmation and demonstration of resilience. As a community, financial services participants can consider ourselves as survivors and much like the economy, we have experienced a very significant bounce back with better businesses and greater public trust. We stood at the front-line re-information dissemination in a time of great need and client value was never more evident.

The leading headlines for 2020

- IOOF acquired the MLC Wealth business for \$1.44 B at 7.4x UNPAT
- AMP Limited was the subject of an adviser class action, the controversial exit of its wealth chief executive, Alex Wade, the consequent exit of its chair, David Murray, a sexual harassment scandal around its chosen chief executive for AMP Capital, Boe Pahari and then a takeover bid
- Iress acquired OneVue
- More than \$35 billion was withdrawn from superannuation under early release arrangements
- The chair of the Australian Securities and Investments Commission (ASIC), James Shipton, stood aside amid an expenses scandal. His deputy, Daniel Crennan, first stood aside and then announced his resignation
- The Financial Adviser Standards and Ethics Authority (FASEA) financial planning exam continued to generate 79% to 88% pass rates but dissent continued around its code of ethics
- The Australian Securities and Investments Commission (ASIC) started its review of the Life Insurance Framework

Resource: Money Management

However, behind the main headlines there was other activity that also needed noting, as the themes they reflect will not only be seen through 2021 but beyond. The below activity is not purporting to cover all transactions.

Dealer Groups

- Madison sale to Clime Asset management for \$4.4m. Madison had 100 advisers \$3.8b FUM and gross revenue of \$34m. The sale was borne out of the collapse of Trustee Partners
- Hub 24 sold Paragem to Easton Group for \$4m shares in Easton Group or 40% shareholding
- Picture Wealth buys Licensee Neo Financial with 94 advisers and \$2b FUA
- Ares take-over of AMP for \$6B withdrawn in Feb 2021
- Ord Minnett's management buy-out circa \$115m from 70 % IOOF and 30% JP Morgan. Ord Minnett had 264 advisers, \$10.1B FUA and net profit circa \$11m
- Subsequently Ord Minnett acquired EL&C Bailieu

Funds Management

- Perpetual buys 2 American wealth groups Barrow Hanley Mewhinney and Strauss and had earlier acquired Trillium.
- ETF growth 2020 rose from \$62B to over \$100B due to cost as low as .07 for Aust Equities and .03 for international. Growth is not just due to low cost but also performance relativity to active managers - 92% of global indexes outperformed international equity managers over the last 10 yrs. 82% of time Australian Indexes outperformed equity funds over the same 10-year period

Industry Funds Consolidation

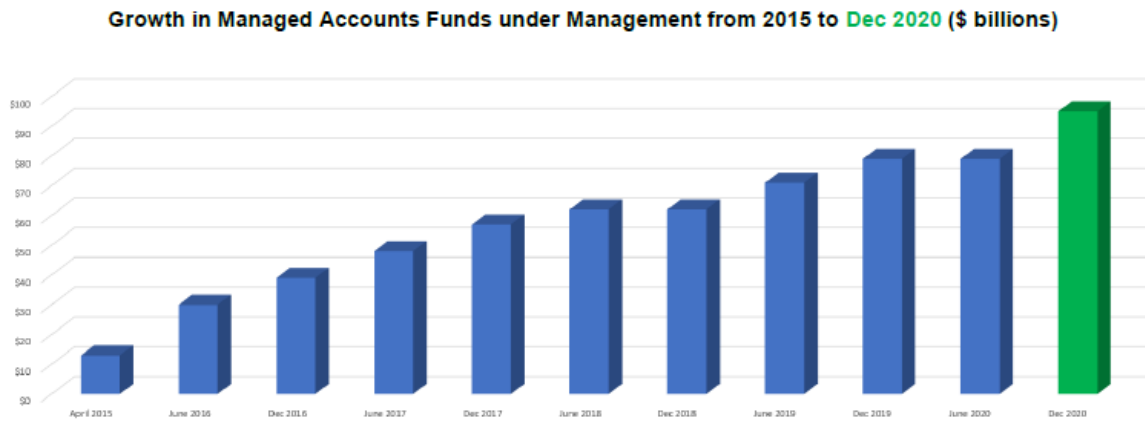
- Stateplus merge with Vic Super to become Aware Super
- Sunsuper and Qsuper in discussions
- We will see further consolidation in this space as size and scale is required as well as the government focus on portfolio performance

Platforms/ Technology

- Iress buys Onevue Holdings for \$107m
- Premium buys Powerwrap for \$56m with combined assets of \$27B
- HUB24 acquires Xplore for \$60m
- HUB24 acquires Ord Minnett non custody Portfolio and Reporting Service for \$10.5m
- IOOF acquires Wealth Central for \$30m
- BT Panorama potentially for sale
- AMP North platform potentially for sale

Forte expects more consolidation in the platform space where there has been winners and losers from the price war which has seen average administration fees fall 30 to 50% over the last four years. Administration fees will potentially continue to fall and there will be a focus on cash rates as we continue to see FUM flow to new generation platforms from legacy platforms.

Managed Account Industry growth is directly correlated with adviser migration and asset appreciation.



Source: Milliman - IMAP

Fintech

- NAB buys Neobank 86 400's for \$220m and is to be merged with Nab's UBank
- Fintech take up is likely to be accelerated with the retraction of the banks who required large balance sheets and service infrastructure from any supplier. Bank management was often scared of making a mistake which stifled innovation. The process of approval, beta testing, warranties meant a very slow overall market adoption.

Covid-19 accelerated technology adoption and the uptake of Fintech and Regtech will increase substantially in the future as late adopters who reluctantly moved get greater comfort as to the ease of transition especially around client communication.

Mortgage industry consolidation

We have witnessed the largest consolidation of aggregators ever seen.

- AFG and Connective \$120 million merger.
- NAB announced in November to sell 100% of PLAN Australia, Choice, Fast to the family-owned Loan Market Group. Each aggregator to be run separately HUB24 acquires Xplore for \$60m.
- Aussie Home loans merge with Lendi. Commbank retaining 45% in merged group.
- Westpac's simplification strategy with RAMS Home Loans is to their products and not alternative broking services. This strategy will be questioned by franchise owners as well as how Best Interest Duties (BID) introduced in January 2021 are managed.
- Strong macro themes including the booming housing market and business re-financing has seen the mortgage industry perform strongly in 2020.

The banks strategy of simplification has been an exercise in de-risking, increasing liquidity, capital and operational capacity.

It has been the greatest landscape change that the mortgage industry has ever seen and reflects the changes we have experienced in wealth as banks divested.

The broker market represented 60% of market share in 2020 and set to grow further in 2021 and beyond. Forte believes this aligns with advice growth into the future with legislative certainty and the return of trust, confidence and better client outcomes.

Financial Planning

Challenges

ASIC LIF Review

The Wealth industry and the financial planning profession has a good lesson to learn from the mortgage industry. They came together to fight against the Hayne recommendations of upfront client paid fees and the cessation of upfront brokerage and recurring revenue. The risk industry has the same fight; the consumer does not want to pay fees that are commensurate with the work done and would rather amortise the cost within the loan or within the policy.

I agree in client's best interest as the mortgage industry must now illustrate as this effectively combats conflicts of interest. Let the client choose the methodology of how they want to pay but let commission be one of those ways. Yes, a product is paying the adviser, but it is with the direct consent of the client whose commissions are stated upfront and ongoing. Service must be delivered for the fee and there should never be a fee if there is no service.

The other fight is the same educational requirements for Financial Advisers being placed on risk specialists. Australia has chronic under-insurance.

An excellent article sponsored by Zurich should be seen by all interested

<https://www.adviservice.com.au/2020/03/cpd-risky-business-australias-underinsurance-problem/>.

Also, for interested readers Rice Warner report <https://www.ricewarner.com/new-research-shows-a-larger-underinsurance-gap/>

KPMG direct extracts on recent findings... Bushfires, storms, floods and a global pandemic have combined to give Australia's insurance sector one of its worst years on record.

KPMG measured the performance for 12-months ending June 2020, and the numbers are dire across key metrics. The loss ratio jumped beyond 70% – a near 3% increase from last year. Factors at play here include a boom in claims around natural catastrophes and hazards, mostly relating to bushfires, hailstorms and flooding.

Then there is Covid-19. For insurance companies, the pandemic brought a host of new technological, regulatory and compliance costs on the back end, bumping the expense ratio up by more than 1%. At the front end, earnings have been taking a hit from all directions, with profits dropping by nearly 50% to reach \$2.3 billion – compared to more than \$4 billion last year.



Source: KPMG Australia

Risk product net profit after tax for the life insurance industry over the year to 31 March 2020

Risk product	Year to March 2019 (\$m)	Year to March 2020 (\$m)	March 2020 quarter only (\$m)
Individual lump sum	653.3	360.4	39.7
Individual disability income insurance	-782.0	-1,395.1	-141.4
Group lump sum	100.0	-369.8	-69.7
Group disability income insurance	-66.2	-240.4	-19.9
Total	-94.9	-1,644.9	-191.3

Source: APRA

Disability Insurance faces significant challenges especially with the claim increases due Mental Health during and post pandemic.

Over recent years we have seen significant divestment of Australian Insurance Underwriters to Internationals and now Australia is facing a crisis in this sector due to climate change, longer life expectancy and economic hardship.

To add to these challenges, we await the ASIC LIF review or more specifically the potential recommendations pertaining to remuneration models.

All associations, underwriters, advisers need to come together and be a united voice as we need a healthy insurance industry to protect Australians.

The mortgage industry has also shown us that when a sector comes together it can achieve reasonable outcomes and then thrives. M&A activity returns with confidence once there is a known legislative environment.

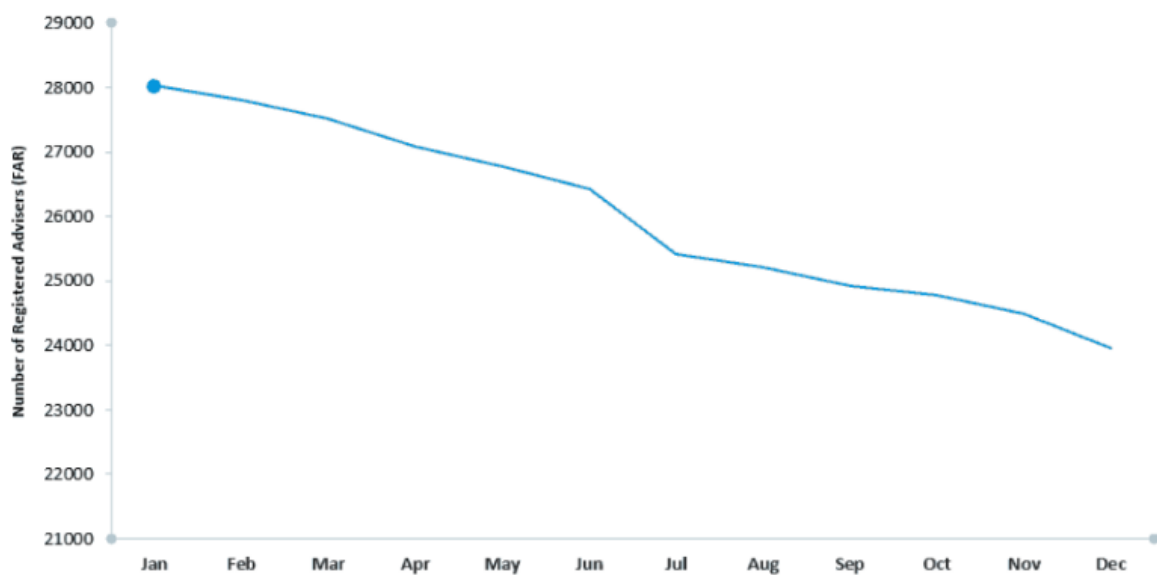
This confidence is starting to be seen in Financial Planning in the last quarter of 2020 and continuing to date at an accelerated rate. However, we still face several significant challenges.

Challenges 2020 and beyond

Adviser migration/Education

The year started with 23,686 advisers and ended with 20,715 and 7,738 have left the industry in the last two years (Adviser Ratings).

Adviser migration 2,772 moved licences in 2020 down from 3,332 in 2019. In the last two years 6,104 advisers have moved licences the greatest movement ever seen. (Adviser Ratings).



Source: Professional Planners

Forte specialist business unit Forte Licensing Solutions assists financial planning businesses transition to the most appropriate dealer for their business needs, has seen significant numbers of those advisers that remain have either changed, or are considering changing their licensing arrangements. Whether that be a change in Dealer Group or the creation of their own AFSL. Mid-tier licensees (from a head count perspective) have continued to be the benefactor of this adviser migration. Although, the mid-size dealer groups own success arguably has pushed them towards a size that advisers are typically sceptical of receiving consistent service delivery.

The recent focus on advisers and the services they provide to their clients has increased adviser's consideration and awareness of what a licensee provides to assist them. Not simply cost analysis, but deeper into such things such as business development, brand reputation and significantly compliance practices of the AFSL. Self-licensing has now become a realistic consideration with some Dealer groups actively positioning themselves to assist with the transition and thereafter providing their services as an ongoing outsourced solution.

Recently, there is evidence that Dealer Groups are now becoming more focused and selective of those advisers and their respective businesses they onboard. Whilst Dealer Groups in the main, have a common core suite of services that differ little from one to the other, how-ever this stronger selective focus is providing for a real differentiation in the market and that is culture, average size and client segmentation.

Covid extensions on FASEA for Code of Ethics exam from January 1st, 2020 to January 1st 2021 and degree qualification extended from 2024 to 2026 reduced significant stress and extended exit dates for many.

The last three months of 2020 saw a slow-down of exits of any previous quarter in the last two years. Given we still have the FASEA Code of Conduct exam termination date of 1.01.22 we may still see an increase of exits as only 52 % or 11,241 have passed 48% still need to complete by the end of 2021. Those that have delayed need to enrol immediately as failure rates are increasing with less enthusiastic forced participants, and if you have not enrolled already your chances of a re-sit are ever diminishing. It is extremely unlikely there will be a further extension and if the plan is to sell you need to sell now as it is taking six to nine months to go to market and receive first payment (explanation further on).

It is estimated the industry will be left with a core 15 to 16,000 dedicated professionals at the end of 2021. Whilst Forte is not as pessimistic, the outcome depends on the LIF review as we can expect further losses of experienced specialist risk writers.

With a diminishing talent pool and organic growth, we can expect increasing adviser salaries in the immediate future.

Data Security

ASIC is suing ANZ Wealth Management former owner of RI Advice (current owner IOOF) potentially for \$12m for failing to ensure financial advisers under its control provided protection of sensitive data from a "brute force" cyber- attack. ASIC alleges RI Advice failed to have adequate cybersecurity systems in place thereby breaching Corporation Act. (Aleks Vickovich AFR Aug 2020). The attacks were not isolated to a single adviser or office. It started by ransomware where access was gained and then information was encrypted and made inaccessible. I would suggest that RI Advice had better protection and protocols under ANZ in place than most practices in this country. The number of cases we are hearing is growing and the risk to clients, business reputations and punitive damages is very real. The RI Advice experience should be a warning to all Dealers and Advisers.

Business Health estimate that 60% practices in Australia have experienced a cyber incident. Cyber Insurance is adding to the cost of production but is a must.

Compliance

Wind Up of FASEA and new disciplinary body to take over from FASEA. The new body will be overseen by ASIC. Treasury will have responsibility for policy i.e education and this has

been welcomed given Treasury's history of seeking industry consultation before legislative change.

Valuations

Supply:

The market has faced an artificial suppression of supply. For the last three years the elements of fear, legislative uncertainty, educational requirements, business re-engineering and client service has dominated business owners' thoughts and any planned exits have been deferred.

We have seen the greatest level of disruption in the history of our industry ever, evidenced by mass migration and forced or voluntary exits. The migration was due to the exiting of the banks and the movement to mid and small licensee. The change management required of moving licensee should not be undervalued – this comes from Dealer selection, due diligence by Dealer, data migration, (especially the institutional use of Coin to smaller licensees preference for Xplan or alternatives) staff and client communication and FUM platform migration. In our experience at Forte Licensing Solutions, the average timeframe from start to finish (i.e. from conception to everything in place and operational under the new license) is approximately nine months, whether that be transitioning to an alternate Dealer Group or obtaining your own AFSL. Whilst it is possible to reduce this timeframe significantly, and in some cases is urgently required, changing your licensing solution should be considered as a key foundation of your business planning and future success, getting it wrong can be very costly.

Whilst all this change is happening, other changes are often embraced simultaneously not only by those moving- house but also the wider marketplace. Most businesses in the last three years have reviewed their value propositions, systems and processes. Client servicing software, pricing especially in preparation of annual fee engagement requiring moving from % based to fixed or hybrid, asset management philosophy and outsourcing of Intellectual property (evidenced by the growth of Managed Accounts see above) have been the focus of industry management changes.

The mass exits have counter intuitively not led to an increase in supply. Those that have left have primarily been salaried advisers and accountants who could not operate without exemptions. Small books of business that were significantly impacted by the removal of grand-fathered revenue or deemed uncommercial and potential compliance risks by Dealer Groups (< \$400K Revenue) were the majority of businesses who have exited. Many of these businesses were sold, transferred internally or simply walked away from.

There may-be further forced exits due to FASEA Code of Conduct but to date we have seen no distressed sales.

The last three years has been the lowest level of supply Forte has ever seen in our 18 years of experience and at the same time we have seen substantially increased demand.

Demand:

The growth in demand is directly correlated to increased costs and flat lining or diminishing profit. In a recent Business Health survey, they found the average profit of practice sub \$500k revenue was 10.1% and over \$500k revenue average profit 28.2%. This was assuming a salary for the principal adviser of only \$100k. Forte assumes a salary of \$150k for metropolitan practices and \$120k for regional so from our perspective profit levels are even lower than nominated.

To maintain value to historical recurring revenue multiples of three times a business needs to operate at greater than 35% to 40% of EBIT to gross revenue. Therefore, many practices have experienced price devaluation especially as the use of EBIT valuation methodology increases in application.

Profit diminution is due to several reasons; the loss of grand-fathered revenue, the cutting of client numbers to improve efficiency and compliance whilst costs have increased for PI (anecdotally 30%), Dealer fees (average 25% and still to increase), ASIC levies, increased tech stake, cyber security insurance and for the first time for many years labour costs are increasing as the talent pool reduces.

Productivity losses have also been experienced with re-engineering exercises. We are seeing organic growth post pandemic lockdown, but for many this growth is insufficient to compensate the rise in costs.

In the absence of meaningful organic growth, the only option to achieve size and scale is inorganic strategies, especially in a period of lowest interest rates ever and an abundance of capital partners for large firms.

The increased demand has seen on average 30 to 50 interested parties for every Metro business listed. The historical average is 15 to 20. Given this higher level of interest transaction timelines have increased from 6 months to 9 months as every potential buyer needs to be assessed on whether they are the best adviser for the clients being sold.

Current market

We started to see the more supply in the last quarter of 2020 which has continued into 2021. The businesses that are in or are coming to market are better businesses in most cases as they have re-engineered and have engaged clients with demonstrable value propositions.

Like post FOFA and now post Hayne and Pandemic, we are seeing better businesses that are being rewarded with price appreciation. There is also a slight scarcity premium or demand inflation being seen but rising prices is more reflective of better practice profitability. Price improvement is only a recent experience which we can expect to see further evidence of into 2021 and the chart below is a summary of 2020 only.

The chart below illustrates no change in the last 24 months. However, we saw a wide price range spread, so we have taken out some extra-ordinary performances that would have inflated the average market view.

Revenue Type	Recurring Revenue
Financial Planning General	2 – 2.8 x (Large gap reflects the demand for quality)
Grandfathered Revenue	0 x
Financial Planning HNW	2.5 – 2.8 x
Financial Planning 35%+ of clients 70+	2-2.5 x
Large Financial Planning	5 – 6.5 x EBIT
Risk	2-2.5x (Less demand/ less supply)
C & D clients	2 x (less demand/ less supply)
Corp Super not default funds	2 x (no demand or supply)
Corp Super default, member pay	1 – 2 x (no demand or supply)
Accounting with FP	1 x (Maintainable Earnings), SMSF Admin 1 X or 4 x EBIT
Mortgage	TBA (historically 2 – 2.5 x)

The Future

The genie is out of the bottle and we will continue to see the uptake of technology solutions. The unicorn for our industry is the development of a system that is efficient from the front to back-office solutions with an automated CRM. There is rising confidence this can happen and whilst this could be a single provider, it is very likely that there will be more open architecture to allow multiple providers sharing the same data. With integrated front and back office, we will see productivity and profitability improvement and corresponding valuations will reflect this.

We will see more M&A activity across all sectors including technology providers, platforms, Industry Superfunds and wealth as confidence and growth returns.

The advice profession will rise much like the mortgage industry has and we will see the creation of super boutiques filling the vacuum left by the banks and further consolidation as small-businesses merge to create medium-sized or large businesses.

The creation of super boutiques (\$1 billion plus FUM) is being stimulated by ready access to capital, debt and private balance sheet equity. Behind the scenes, the wholesale market (family offices/ ultra HNW) is coming down the value chain into the retail HNW market in preparation to future legislative change to the definition and service (SOA's) delivery to "sophisticated investors". The intellectual property (IP) from the wholesale market specifically in asset management is cascading down and the compliance, systems and processes IP from the HNW retail market is cascading up. It is not just the IP and client outcomes that is attracting both parties coming together, but also the Return on Investment that can be achieved by scale synergies.

The rise of "independence" means the end of mass-produced homogenous advice with more individually tailored solutions provided. The quality of output will be improved but unfortunately the costs must also reflect the higher costs of production. There is no subsidisation for advice distribution from asset management. Advice costs are increasing but platform and asset management costs are decreasing so in many cases the cost to the consumer is similar to the past, but the experience is significantly greater.

With the departure of the banks, greater education requirements, increased compliance, and governance we have taken a big step from being an industry to a profession and importantly bridging the trust deficit created by previous structural impediments. This is being reflected by organic growth and greater consumer confidence.

M&A activity is returning with confidence in legislative certainty, revenue stability and growth, rising consumer need for advice and corresponding growth. I believe, or hope, we will see the same level of confidence in regard to sensible LIF review outcomes. Financial services is seen as a recession proof sector, given the greater need for advice and the unlocking and migration of super which is attractive to private capital.

M&A activity will also increase due to fundamental economics. Most of the marketplace is brandless, under-capitalised and exposed to key person risk whilst there is also the absence of scalable systems, processes, and a repeatable client experience. Many have reached full utilisation and lack the required infrastructure to onboard new clients to any meaningful

quantum. Few have excess capacity and in coming years there will be a shortage of talent and labour costs which reflect this. In an environment of substantially increasing cost of production, we will see substantially more mergers as like-minded practices come together to achieve economies of scale. Funds Under Management (FUM) is scalable, advice is not given the required client to adviser ratio needed to provide high quality compliant service delivery. The solution is capital and technology; how-ever capital is attracted to the top end of the market with Returns on Investment greater than 15%. For small to medium-sized businesses the solution is in many cases singularly technology.

Emerging from the period of disruption with more legislative confidence (exception LIF review), there has been the greatest adoption of technology ever seen, especially around client interfacing, mass communication and enhanced client relationships correlating to valuations increasing.

We need to dust ourselves off from the debris of the Royal Commission, Hayne Recommendation, the global pandemic, mandatory education standards, rising advisory production costs and look to a future with less participants, profit per client service offers, restoration of trust, organic growth, and affirmation as a profession - and not just as an industry.

Conclusion

The future holds great promise. We can look forward to:

- The rise of “independent” advisers post the retraction of the oligopolies.
- Higher household savings.
- Higher barriers to entry.
- Less competition.
- Restoration of trust.
- Better articulation of value.
- Growing market with 4 out of 100 Australians currently to seek advice.
- Legislative Superannuation growth.
- Baby Boomer sale of businesses and retirement.
- The largest intergenerational wealth transfer in history is rapidly approaching. An estimated \$3.5 trillion of wealth to be transferred in Australia over the next 20 years.
- Technology innovation.

Our market is in a stronger position than any-time before with better businesses driving better client outcomes. Yes, we still have hurdles in front of us and the cost has been significant to many, but we have built resilience after fighting the greatest challenges ever seen in the shortest period of time. We have adopted new technology and our fear of technology change has diminished.

Australia needs a strong advisory and insurance offering. We have breached the trust deficit with pro-active information flow and our clients, future clients and even government has seen our value as we stood tall in 2020 to assist Australians in difficult times.

We are evolving from an industry to a profession which is never easy and has brought seismic changes. Now, we are primarily free of mass-produced homogenous distribution being the largest and most visible section of the industry. Current and future optics will be professionals who have invested in themselves and their businesses. We will see more innovation as we strive to ensure that Australians will have their best interests met and value will be self-evident.

We have a lot to be proud of and to look forward to.