WRITTEN BY MICHAEL BETLEY

THE RISE OF PRIVATE EQUITY

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How has the increase in private equity investment in the trust sector in the Channel Islands and beyond impacted the industry and what will the consequences be, asks Michael Betley of Trust Corporation International.

The entrepreneurial spirit has much to do with the successful evolution of the trust sector in Guernsey which has developed beyond all recognition from its embryonic state in the late 1960s. It started with the arrival of the first of many international merchant banks on the island.

External demand created opportunities which spawned the offshore trust industry and has shaped the sector into what it has become. One of the more recent catalysts of change has been the increasing influence of private equity firms (PE) interested in the sector not for its product set but for its investable qualities. The simple operating models and stable cash flows are particularly attractive and easy for PE to exploit.

It is the more mature and scalable investment funds sector which has seen the most significant investment activity of this sort and gives an indication of how PE may end up influencing the less mature trust sector. Whether you view the private equity influences positively or negatively, you cannot ignore their presence or influence in the ongoing transformation of the industry.

The early investors in the sector were the banking institutions who were attracted by the ability to "harvest" assets and charge the same client for a range of services and financial products. This cross-selling opportunity and cross-border regulatory arbitrage meant that banks were able to move clients from one jurisdiction to another to minimise the increasing regulatory burden whilst still retaining the multiple income lines.

During the 1990s, changes to international accounting standards and practices meant that the big international accounting firms who had in-house trust companies sought to divest themselves of those businesses to enable them to continue to represent global audit and advisory clients unencumbered by potential conflicts.

The likes of Royal Bank of Canada seized on this as an opportunity to acquire professionally owned and run trust businesses starting with the acquisition from PwC of Abacus Financial Services and later Regent Trust Company from Ernst & Young. Kleinwort Benson entered the fray and acquired Orbis Management from KPMG in a competitive bidding process. It has only been since the global financial crisis starting in 2008 that private banks more clearly understood what "fiduciary risk" meant and there has been a full scale retrenchment of private banks from non-core business including divesting their trust businesses.

Guernsey is currently home to 156 regulated trust companies that are authorised to provide a range of professional services. In addition to the usual creation and management of a variety of different holding and trading vehicles, trust companies are developing more specialised investororientated services, managing family offices, creating pension products and establishing global custody and unregulated lending platforms.

The excellent service level systems which are in place have provided trust companies with new market opportunities and greater potential for growth.

Many structures have a lengthy life span which means there is considerable annuity value in the predictable income streams. Whilst not all 156 licensees will necessarily have a physical presence in Guernsey, they have the ability to undertake regulated activities from the island. Many of the licensees have acquired a fiduciary licence so that they can undertake ancillary regulated activities which may simply be a by-product of their core offering.

For example, a number of collective investment scheme administrators who are regulated under a different regime may also have a fiduciary licence to allow them to provide a fuller range of services unconstrained by the peculiarity of Guernsey's division based regulatory regime. A number of licensees may also be "managed trust companies" which are owned by non-Guernsey based practices or institutions who engage a Guernsey manager to administer their own book of business from the island.

Recent statistics show that 44 percent of trust companies are manager-owned locally. The other major ownership categories are international financial groups (27 percent) and those owned by international legal and accounting practices (15 percent).

It is interesting to note that during the initial transitionary phase following the introduction of the Fiduciary Regulations in April 2001, there were 160 trust companies with an additional 34 pending applications awaiting approval.

The transitioning of the trust sector into regulated business created immediate opportunities for consolidation and, by 2003, the number of full fiduciary licensees had reduced to 151. In over a decade, therefore, and with the current number of 156 operators within the trust company space, the sector has remained largely static. In the 10 years to 2015, reported turnover in the sector has increased by 494 percent but over the same period the number of trustee appointments within the trust sector has diminished by 29 percent. Business is clearly becoming more profitable. It is this impressive growth trajectory which is at the heart of why PE finds the trust sector so attractive.

There remain more buyers of trust businesses than active sellers, however, there continues to be M&A activity despite what the statistics might infer. Whilst the headline numbers have remained largely static over the last decade, there has been consolidation but the pace of innovation and change has attracted new entrants too.

Prior to the Fiduciary Regulations, business practices and anti-money laundering procedures were not embedded within the firms and a considerable amount of remedial work was needed to bring not just the client book up to the new regulatory standard, but the businesses themselves.

The introduction of the Fiduciary Regulations was a welcome benchmark for private equity houses as whilst client and business remediation would still take some time to work its way through the system, it offered the opportunity for external investors to have confidence in investing in a more transparent and compliant book of business.

The emergence of PE as an interested investor in this sector started to take hold soon after regulations came in. The first obvious private equity deal was the creation of Equity Trust by Candover Investments plc who saw the potential to create an international business platform by bolting together a number of separate Crown Dependency and international trust and corporate service businesses, starting with its acquisition of Insinger de Beaufort.

Candover sold Equity Trust in 2010 for an enterprise value of EUR 350 million suggesting it had achieved a 24 percent uplift in value over that period. It is not just PE seeking investment targets which is at play as businesses themselves seek financial backing to help deliver their strategic plans.

Successful businesses can outgrow their management, others can reach their growth ceiling due to capital constraints and, often, business ownership and succession drive management to seek funding options. The apparent abundant capital available to many PE houses is an attractive source of finance to help management and business owners achieve their aims and overcome growth hurdles. PE can help stimulate expansion and diversification, incentivise employees and re-invigorate stagnating businesses.

However, PE invariably comes at a cost. Ultimately this means the loss of control so that choosing the right PE firm to properly align the capital providers with the management strategy is key. Whilst PE has been the dominant player in consolidating the trust sector in Guernsey, new capital providers are emerging. Private or family investment offices are entering the market, attracted by the stable returns and easily understood businesses. Such investors are likely to be less demanding regarding management change, targeted returns and more sympathetic to management objectives.

An interesting new development adopted earlier this year by the Sanne Group, was the first independent fund and corporate service provider to list on the London Stock Exchange. Following its IPO, Sanne is currently trading at 22 times its enterprise value showing how it is possible to stimulate the capital value of businesses.

This is at a time when there has been a wholescale divesting programme by international banks of their trust companies, including the likes of Royal Bank of Canada who until this year had probably acquire d more trust business than any other. Is this likely to be cyclical? I have no doubt these financial institutions will return to the sector as senior management reappraises its risk and return objectives over the next 5 to 10 years.

As a consequence, there remain continuing opportunities for trust businesses to nurture their future either alone or as a target for savvy investors wanting to participate in stable income from growing businesses. This is a positive outlook for Guernsey and its trust sector with a significant number of quality businesses within the industry. PE has undoubtedly fine-tuned business models to make them attractive investment targets, but it is the businesses themselves who must continue to make their offering compelling by evolving and creating future demand.

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PO Box 655, St Peter Port,
Guernsey, GY1 3PN
+44 (0)1481 720071
INFO@WEAREGUERNSEY.COM

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