What happened when Fidelity Investments called 25 deal-making protagonists to its Boston sanctum for a talk about the suboptimal RIA M&A market

by Guest Columnist David Canter

Brooke's Note: When it comes to RIAs being bought and sold like houses, cars or cattle, there are three major problems: the buyers, the sellers and the people who act as middlemen. Too many buyers think that they can apply the snap-on approach of big banks and big brokerages. Too many sellers think they can run their practices like lemonade stands and then sell them as if they are L.L. Bean. Too many "merger experts" are bringing a spreadsheet to a psychologically dysfunctional situation. How to make a silk purse out of all this? Buyers and sellers will always be afflicted with delusions of grandeur. So the RIA business should focus on what can be controlled — getting its own house in order. To the credit of David Canter and the Fidelity folks backing him, this is the seed they just tried to plant in Boston. (Coincidentally, another M&A event was hosted by Dan Seivert in Santa Monica almost simultaneously. We'll have that report, written by a top LA advisor, soon.)

This month, Fidelity Institutional Wealth Services, our Boston-based RIA custody unit, held the inaugural M&A Idea Exchange as part of our expanding mergers-and-acquisitions and consulting program for advisory firms. The sole purpose of the gathering was to discuss the state of M&A and how to better support the industry's growth through M&A.

For this event, we brought together 25 industry experts, investment bankers and active acquirers. Participants were from around the country and represented a variety of models. They were selected based on their success in sourcing, completing and integrating deals. The acquirers represented a collective $200 billion in assets under management, and each firm had completed at least one transaction in its history.

Third-party experts included Frank Kettle of Colchester Partners LLC; Bruce Cameron of Berkshire Capital Securities LLC; Steven Levitt of Park Sutton Advisors LLC; David Selig of Advice Dynamics Partners; David DeVoe of DeVoe & Co. and **John Furey**, principal and founder of Advisor Growth Strategies LLC. Also present were Marty Bicknell of Mariner Wealth AdvisorsLLC, Rush Benton of CAPTRUST Financial Advisors and Fred Schaard of Rehmann Financial Services LLC, all of whom are among the subset of RIAs that have a track record of buying other firms.

Penetrating the black-box deal

The collective buzz among these M&A leaders? We may need to take a page out of the far-more-fluid real estate market in order to see more deals happening in the RIA M&A market.

David DeVoe, founder and managing partner of DeVoe & Co., explained it well.

“There is no reason for the slowdown in deals. This is an industry of 10,000 firms. We’ve seen 50 deals this year. We should be seeing 300 deals, given the state of the industry.” See: The RIA M&A market stumbled in 2012, but giants were not deterred, Schwab end-of-year data shows.

What is pretty inarguable among RIAs and M&A practitioners alike is that not nearly enough deals are getting done, relative to the maturity of our industry. The 2013 Fidelity RIA Benchmarking study revealed once again that too few firm owners have focused on succession—only 13% of participating firms reported having a succession plan in place, ready for implementation. See: Favorite succession plan of RIAs remains the same: none at all.

Our big takeaway from the event was that more deals would happen if there was more transparency around the “guts” of the deal. As it stands, RIA mergers are pretty opaque — often a complete black box — unless they are completed by a public company that is forced to disclose details.

Frank Kettle tells crowd: No one wants to give the details if they’re not required to disclose them.

Beyond the numbers

Frank Kettle espoused the view that deals are happening but firms are reticent about letting the world in on it. “M&A activity has actually been strong this year,” said Kettle. “Deals are happening, but the deals that tend to get disclosed are from public companies. No one wants to give the details if they’re not required to disclose them.” See: Even as mired markets stalled Q2 merger deals, private-equity-fueled national acquirers revved up prices..

This is where the concept of a Zillow for M&A came up — or at least a manually created facsimile of its intellectual product. Zillow has brought great transparency to the real estate market, providing a wide range of valuation information and property details on a database of more than 110 million U.S. homes. The name Zillow actually “evolved from the desire to make zillions of data points for homes accessible to everyone,” according to the company’s website.

It was clear from the M&A Idea Exchange that there are also zillions (or at least scores) of data points that M&A experts want to know.

The participants discussed a desire for some kind of reference library or benchmarks on a number of different deal elements, and not just price, size of firm, etc., but other elements harder to compile because there are hundreds of variables to measure that go beyond the numbers. There’s a thirst for how others in the market are making these things happen.

Zillions of data points.

Breaking through

And, really, that was the point of the M&A Idea Exchange. My team and I were having a lot of individual conversations with clients and experts on all of these variables on a day-to-day basis. Ultimately, we thought, wouldn’t it be great to get these guys in a room, talking to one another.

With so many great ideas exchanged, I wanted to extend some of the key takeaways from the event to RIABiz readers. These insights may explain what’s holding some firm leaders back, and what it may take to create additional activity in the industry. I hope these insights will spur some discussion within your own firm.

5 big ideas exchanged in the 5 phases of a deal

So, what were some of the big ideas exchanged?

We discussed the critical phases of a deal: establishing your M&A objectives; identifying potential opportunities; telling your firm’s story; structuring a deal and aligning interests; valuation considerations and techniques; and integration and post-deal considerations. Here are the takeaways from each discussion:

1. Write down your what your M&A objectives are, and who does what in your firm

Most of the participants had what they deemed a “two-thirds” process for M&A, meaning, they had general guidelines but no written procedures. This is largely because no two deals look alike. Firm principals shared that they were often deeply involved in deals, which made it more difficult to run the day-to-day operation.

Considerations for acquirers: First, you need to know what is important about your firm, its culture and differentiators. Then you can layer on the long-term vision and include why you are looking, the types of firms you want to acquire and how you want the combined entity to look. One firm used an analogy that “you can’t fall in love with someone else until you know deeply who you are.” See: Two accounting firms abandon merger talks leaving giant Schwab RIA surprised and crestfallen.

David Canter with one of his brightest M&A pupils, Marty Bicknell — or is it the other way around?

Keep your strategy client-focused and ask yourself how the alliances add value to them. Also, anoint a dealmaker for your firm in order to maintain a steady focus on all aspects of targeting, evaluation and deal making.

2. Learn the thrill of the chase — and make sure spouses aren’t cut out of the deal

The “dating” process is one of the most difficult aspects of the deal. Bicknell shared that he had met with approximately 120 firms to acquire just four. It takes extreme patience and focus to find the right fit. And, like dating, you have to get to know one another before proposing a marriage. Cultural fit is key — with “culture” being defined as what you do when nobody is looking or telling you what rules to follow. See: Marty Bicknell self-declares a slowdown after bringing on $700 million more of RIA assets to punctuate an epic streak of deals.

Kettle said, “I’ve seen deals crumble at the last minute based on a cultural clash. It’s important to establish a shared philosophy upfront.” See: Why the Moss Adams-Rowling Dold merger came apart despite looking picture-perfect on paper.

“Also, don’t forget to engage the firm principal’s spouse or significant other,” said DeVoe. “He or she could become your ultimate deal-breaker or advocate.”

Considerations for acquirers: Know thyself. Many of the participants acknowledged that they needed to work on their pitch books to get their own stories down before attempting more acquisitions. Do a thorough risk assessment. Run, don’t walk, to the nearest exit if compensation and deal structure comes up immediately — it’s probably not the right fit.

Acknowledge the seller's fear of "re-captivity": They're in the independent channel for a reason and are likely seeking to retain a high degree of autonomy. At the same time, a successful acquirer is realistic and appreciates that few targets represent a 100% "perfect" match.

3. Yes, include lawyers in the process sooner rather than later

The big takeaway from this discussion was to keep it simple. But that's easier said than done. Participants advocated for bringing lawyers for both the buyer and the seller early into the process in order to establish a framework for a more seamless transition. A few emphasized the importance of engaging attorneys who are familiar with transactions in the wealth management/asset management area. The complexion of advisory businesses, including the regulatory considerations, were highlighted as particular reasons to seek out this expertise. See: RIAs reveal their M&A war stories with 200 Schwab IMPACT attendees.

Considerations for acquirers: An operating agreement is critical. While not all of the experts agreed, several suggested considering a "pre-nup" — that way, there's an easier way "out" for both parties in a relationship.

In addition, it is important to protect against attrition through the appropriate clauses in employment agreements. The group discussed the notion of "non-acceptance" provisions to supplement "non-compete" and "non-solicit" provisions. Kettle explained the nuances as follows: a "non-compete" would mean an advisor can't work in the wealth business at all for a certain time frame, a "non-accept" would prohibit an advisor from accepting any clients of his/her former firm for a certain time frame and a "non-solicit" would mean that once an advisor leaves he or she can't solicit clients of the former firm to follow him or her. Experts noted that these provisions are perhaps more critical in the world of social media, where anyone is easy to "find."

Tax considerations are also critical. Engage a solid tax expert.

4. There's no Zillow for advisory firms, so bring in an expert to help set valuations

From the session on valuation, we learned that it's more complex than most are willing to admit. Using earnings before interest, taxes, depreciation and amortization or earnings before owner's compensation, and employing a discounted cash flow methodology, or a multiple of cash flow or revenue, are all options. See: Rush 'Rusty' Benton is back in the deal game — wielding the checkbook and credibility of $85-billion CAPTRUST.

Kettle explained that smaller deals tend to get done on revenue — not multiple of EBITDA. He continued that deals may be based on a multiple of earnings where the operating margin gets into the 25% and above range.

The experts agreed that an internal sale to the younger generation is never going to produce the kind of liquidity as would an external deal — but for many firm principals, the continuity it provides for the firm and its clients is well worth taking a haircut of anywhere from 20% to 40%, which is commonly associated with the internal transfer of equity.

Considerations for acquirers: The key takeaway was: Don't do this alone. Bring in an expert to feel out your options. In messaging to a potential acquisition, value should be conveyed in terms of the firm that you're joining — focus on that as the core benefit. See: Bob Veres adds his bottom line to valuation debate started by Mark Hurley.

5. Build in two years after the honeymoon for the glue to set

It's hard to add value after the deal, so the true success in this phase is determined by whether the deal was built well in steps 1 through 4. Assuming that went well, the experts agree that, in a successful merger where one firm principal is transitioning out of the business, it takes at least two years of continued commitment to the new entity in order to ensure a smooth merger.

After several hours, the art of the RIA deal began to take colorful shape on Fidelity's whiteboard wall.

In addition, it is helpful to create work streams, with clear project management owners around key post-deal implementation areas, including: staff responsibilities, technology reconciliation (e.g., if different systems are employed), onboarding, client reporting, billing and other significant issues. Don't underestimate the details associated with bringing together two firms with potential distinct technology systems, policies and procedures, and general business practices. See: How Julian Koski's maverick stock picking method led to a merger with Guggenheim.

Considerations for acquirers: Think about obtaining insurance on the firm principal(s) or key talent in the target firm: "key person insurance." And, use the tools you built in step 3 (the operating agreement and the "pre-nup") to your advantage.

Having shared the complexity of the acquisition process, firms might think carefully about the side of the equation they'd like to be on. Determining one's core objectives may lead an advisor to consider joining with or merging into another firm. We've seen this many times before — buyers can quickly become sellers, and vice versa, in order to satisfy their growth goals.

John Furey summed it up well, “Ten billion in assets under management is the next billion. It’s the advent of real business managers in the space, where firms are converting from running practices to owning businesses. It’s all about the next generation — and stepping up to create the first real phase of succession in our industry.”

David Canter is executive vice president of practice management and consulting at Fidelity Institutional Wealth Services. The M&A Idea Exchange is an extension of Fidelity’s M&A program, which centers on education and insight, succession plan considerations, access to financing, and connections to firms looking to buy, sell or merge.

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