Cash Out? That's So 2005

by Steve Garmhausen for Barron's

In the early days of independent advisor M&A, 15 or 20 years ago, deals were often pretty simple: The seller got a chunk of the purchase price, and then the balance of the cash as he or she phased into retirement over a few years.

But a recent study from consulting firm Advisor Growth Strategies, "RIA Deal Room," finds that acquisition agreements increasingly feature terms that focus on shared risk and long-term success. We asked Brandon Kawal, the AGS principal who led the research, to walk us through it. (For more articles about independent advisor topics, sign up for The Independent, our monthly newsletter for indies.)

Q: Your study suggests it's getting more rare for sellers to essentially get their cash and walk away. What's going on?

A: I think more sellers realize that "sell and go away" is difficult without accepting significant risk. The mentality should be "sell/stay/contribute/exit" – ideally this is three to five years. The big shift we're witnessing is a focus on the win/win – let's do the deal, push for shared success, and we all win. Deals that put risk exclusively on one side of the table are a thing of the past.

Q: How does a straight cash deal create risk for the seller?

A: It can be one of two scenarios: The seller accepts less to leave the business quickly, or they accept downside risk if they don't remain an influence the outcome. My sense is that buyers will either ratchet up the risk -- thus lowering the price -- or force the seller to accept shared risk -- more contingencies -- if "sell and go away" is the strategy.

Q: Your study found that the median adjusted EBITDA multiple for M&A transactions stayed at around 5.1x from 2015 to 2018. But you did find that deals are getting more structured. What does the evidence look like?

A: For example, 18% of our sample was 100% cash deals. That's evidence point number one – most deals have some structure in today's market. Second, the M&A norm is to require a selling owner stay with the firm for a while. We see three to five years as the most common timeframe. The narrative has changed to "if you want to go fast – go alone, if you want to go far – go together."

Q: You found that buyers and sellers must both have skin in the game. What's an example of what that might look like for each?

A: Buyers are being forced to shift risks (e.g., revenue and cash flow performance) from sellers in a defined period, usually three years or less. The buyers are also guaranteeing more cash in the deal – [on] average 60% of cash at closing. Once a buyer has inspected the house and moved in, they can't expect sellers to pay for maintenance forever.

In return, sellers are putting skin in the game with client transitions -- usually a minimum transition rate -- and accepting rational valuations to decrease their risk. Sellers deliver the asset in good condition and provide a short-term warranty, as we experience in much of our lives. Separately, sellers are accepting equity in deals, and that puts skin in the game as future outcomes are aligned. Sellers are hitching their wagon to the buyers through equity, and comfortable that they can get off at their desired exit.

Q: What do you think is driving this change in deal structure?

A: I think deal purpose and competition among the acquisition brands [the large acquirers who accounted for the lion's share of transactions from 2016 through 2018 -Ed.] are driving the change. Acquisition brands are differentiating in deal structure to beat their competition, and have the experience to shift risk quickly as they have done dozens of deals.

Sellers are also seeking deals for diverse reasons – succession, scale, capabilities, or a combination. It's the same relationship as selling your home to Zillow versus an individual buyer – sellers have to be clear about their "why."

Q: 100% of deals in the study had a dedicated compensation plan for all generations of partners and employees. How is this different from what used to be?

A: Overall, buyers are seeing a benefit to activating all generations -- founders and nextgen -- in a deal. What's different in today's market is acquisition brands are linking the target's team to [the buyer's] compensation plan and organizational structure. In my opinion, past transactions placed a lot of focus on client goodwill -- clients, revenue, etc. Today, buyers are focusing on an asset that includes the clients, team, geography, and capabilities.

Q: Those deals also had a defined growth sharing approach for post-transaction success. Can you define that a bit?

A: Today's deals are offering participation in post-deal success. This is generally direct incentives for increasing revenue and cash flow. This is different because buyers aren't just acquiring the teams and clients, they are rewarding superstar performance through shared success. You're not just buying the horse, you're getting the bloodline too.

Q: Finally, you mentioned that a thoughtful integration plan is now essential. Again, how's that different from how things were done in the earlier days of M&A?

In the earlier days of M&A I think there was a "figure it out as we go" mentality to integration. This isn't unique to our industry, Deloitte's 2019 M&A survey shows integration as the top factor in deal success.

The key question for us that's different than the past [is], "Without full integration, is a deal really permanent?" Without integration, I think deals run the risk of being temporary. Weddings are always fun, marriages take shared commitment, and integration is key.

Q: Thanks, Brandon.