What's the Real Deal With M&As?

A new report examines drivers and successful models in advisor deal making.

by Mark Tibergien for ThinkAdvisor

A new report produced by **Advisor Growth Strategies** and sponsored by **BlackRock** examines the driving forces of price and terms in advisory firm mergers and acquisitions. The core of the analysis provides a window into successful deals, including which buyers are prevailing and which sellers are optimizing transactions.

Entitled "**The RIA Deal Room: New demands and realities in M&A**," the study busts some common myths that circulate in our industry. For example, the so-called multiple is not the same regardless of firm size and client characteristics. Nor are all deals cash deals.

Industry professionals with experience in transactions know that economics do contribute to the price. Terms are defined by other factors as well, however, such as who is assuming the risk, the proclivity of clients to move to the new firm, the organic growth potential of the business and the demonstrated history of solid financial performance.

Much to the dismay of many prospective sellers, 30 years of advisory experience alone will not command a premium price. They also must have an enduring business, depth in their team, a process for generating new business and a balance of older and younger clients who are accumulating wealth.

Furthermore, cash is not always king. Transactions driven by the liquidity needs of a seller tend to result in a lower total payment.

An analysis of the data showed that the median multiple for practice sales in the 2015-2018 period was 5.1 times EBITA. The same methodology applied to free cash flow found it to be roughly the same — without meaningful balance sheets, there isn't much of a difference.

So, what does change the overall multiple? Brandon Kawal of Advisor Growth says, "It's likely to be a flip in the supply-demand equation. More sellers = picky buyers = lower multiples." He added, "When Cerulli estimated there are $2.4 trillion of assets in motion in the next decade, it will become a demand-supply equation instead."

The researchers did find a material change in deal terms over the past few years, with structure often being defined by the size of the firm being acquired.

As an example, the typical financial terms involving RIAs with under $200 million of assets under management were 55% cash, 38% equity and 7% contingent on certain performance elements. On the opposite end of the spectrum, RIAs with between $500 million and $1 billion of AUM were paid 33% in cash, 45% in equity and 21% contingent.

What Does It Mean?

While the authors did not explore the reasons for this swing, several key ideas emerged from their study.

First, in smaller firms, the owner likely will ride off into the sunset; the transaction is more like a purchase of his assets than an acquisition of his business. However, the equity in the combined enterprise helps to ensure that the seller remains interested in the company for a period after the deal is done to ensure continuity.

In the case of the bigger firms, buyers are acquiring a growth business and the larger equity component effectively transforms the sellers of the old firm into partners in the new firm. The contingent component mitigates risk and ensures that their new "partners" stay focused on driving client retention and growth. The larger risk in the big firms also means that shifting more of the terms to the sellers makes sense.

Advisor Growth observed that large acquisition brands have been setting the pace in recent times. Firms such as **CAPTRUST** Financial Advisors, **Mercer Advisors** and **HighTower** have a great history with mergers and acquisitions as well as integrating firms into their own brands.

Many of these players are on the road to creating nationally-branded wealth management firms under an RIA charter much as Schwab, TD Ameritrade and E-Trade have done as brokerage firms. This sets up an interesting battle for clients at all wealth levels in the coming years.

Prospective sellers must understand each buyer's history, experience and process for integrating new acquisitions. It can take from one to three years to achieve a comfortable synergy between the buyer and seller. Most sellers only make one deal in their life, while the brand firms have a history of transactions.

This not only gives them an edge in negotiation, but also gives the seller comfort in how the deal will evolve post transaction.

Post-transaction success is defined by the buyer's ability to integrate the business, accelerate growth and leverage management and staff to drive an even better outcome.

This raises another concern for prospective sellers. A large portion of the transaction (at all size levels) occurs in equity of the acquiring company.

Advisors are both seller and buyer. First, they must find a suitable mate and negotiate a compelling price and attractive terms. Then, they must evaluate the company stock that they will be receiving in exchange for their own equity.

While it's been a long time since many advisors have managed individual securities, the process of evaluating how the acquiring firm makes money, how it manages risk and how it drives growth is key. So, too, is understanding their methodology for assigning a value to their stock — especially because only a couple of larger acquirers have a public float, albeit thinly traded.

New Directions?

The report by Advisor Growth Strategies does not delve into the implications for the industry beyond trends that should inform both buyers' and sellers' future M&A decisions, but the research suggests many possible challenges and directions.

As an example, with so many state-registered RIAs finding it difficult to locate new custody relationships, will they need to be part of a study group, or seek an affiliation that gives them negotiating leverage? Or will they need to become part of a larger firm, so that they can focus on their profession and not on running a business?

With a very small percentage of firms managing over $1 billion of assets, will the next phase focus on the midsize firms to keep up the momentum for serial acquirers with private equity backers?

How will the eventual exit of private equity investors from these firms impact the direction, the access to capital and even the independence of these firms? The capital has been a huge benefit but the great unknown is "what's next" and what plans these firms have for that exit.

Will individuals who contributed to the growth of the selling firms feel disenfranchised or taken advantage of because of the big check their bosses get? Will they enjoy being part of a large firm where they have little or no ownership or leadership responsibility? Will they seek to start their own RIA or join another smaller firm where they can adapt to the culture?

Clearly, the business of financial advice is going through a profound transformation. The rate of M&A is a natural stage in the evolution of any industry as pioneers phase out and new capital finds opportunities for great returns. This change is not negative in itself, but the uninformed run the risk of being on the wrong end of a deal.

Stay on top of the changes afoot. Reading this report (available through **advisorgrowthllc.com**), is a good start.