Advisor M&A Post-Covid: Winners and Losers

by Steve Garmhausen for Barron's

CONSOLIDATION IN THE RIA SPACE has accelerated steadily for the past decade, in part because aging firm principals have sought to cash out and retire. But a good number of owners, enjoying steadily rising assets and revenue courtesy of the long bull market, procrastinated.

Those folks "are likely having a lot of regret now," says David DeVoe, head of the M&A consultancy DeVoe & Co. In short, March's market plunge was a blunt reminder that firm values can fall as well as rise.

As buyers and sellers look ahead in the Covid-19 era, they see a changing M&A landscape. Buyers are likely to sharpen their focus on firms that have demonstrated the ability to attract clients even in bad markets. Sellers outside the top tier could see far lower bids. And with advisors' cash flows less certain, buyers will expect sellers to keep more skin in the game.

"Prices just got cheaper and business just got harder," says Ray Sclafani, CEO of consultancy ClientWise.

DEAL SLOWDOWN

Industry participants expect a temporary slowdown of deals as a result of the pandemic's blow to the market. Until now, a combination of low interest rates, profit margins north of 20%, and motivated sellers had served as a brisk tailwind. Firm principals were aging and regulatory and technology costs were rising. Years of rising deal volume culminated in 2019's full-year record of 132 transactions, and this year was off to an even stronger start, with 34 firms changing hands in the first quarter.

Now, deals already in the pipeline in 2020 are moving ahead, but new ones are tapering off. Dave Welling, CEO of $15.8 billion-asset Mercer Advisors, in Denver, Colo., says he's seeing 20% fewer sellers compared with January and February.

"This is like a dark cloud on the horizon," says Welling, whose business snapped up 21 advisory firms between 2016 and 2020.

One practical challenge right now is how to value firms. Prices are typically expressed as a multiple of future expected earnings, and the uncertain capital market outlook makes that tricky. "It's really the million-dollar question," says Bob Oros, CEO of Chicago-based Hightower Advisors, which has $57 billion in assets under management and acquired 31 firms in the four years through 2019.

DeVoe says that most of the deals already in progress will move forward, followed by a step back toward the middle of this year, then a spike in volume. He points to 2010, when deals jumped by 54%, and says that the older ages of firm principals could amplify this effect. That's not to mention the fact that there are now more well-capitalized buyers in the market, with more experience structuring transactions. Finally, deal volume will return to normal, though it's difficult to say when, DeVoe says.

CONTRACTING MULTIPLES

With the S&P 500 still well off its February highs, firms whose growth depended on market appreciation are now being exposed, while those that continue to attract new clients and assets are shining, industry participants say. The latter are likely to continue fetching high prices – at least six times future earnings using what's known as the discounted cash flow model. Others could see their multiples fall as far as four times future earnings, says Matt Cooper, president of $9.9 billion Beacon Pointe Advisors, in Newport Beach, Calif.

"Most firms under $5 billion were not really growing by adding new clients," says Cooper, whose firm made five acquisitions from 2016 through 2019. "If they were growing organically before all this, that gives you more confidence that they can continue to add clients and grow — so I expect a sharper focus on quality sellers."

To land high-performing firms, buyers will have to not only pay up but also show concrete ways they can help accelerate the acquirees' growth, says Brandon Kawal, a principal at the consultancy Advisor Growth Strategies. This can take the form of coaching, for example, or even supplying a pipeline of new-client leads. "If you can tell a seller that story, that's going to be highly attractive," Kawal says.

Lower-quality sellers, meanwhile, may be in for a rude awakening. Some may pull out of the market when they find out they're worth less than they were last year, while others may even fail to attract bids, observers say.

Regardless of selling firms' quality level, expect deals to include more risk sharing, says Kawal. With future earnings less certain, buyers are likely to offer less guaranteed cash; payments will hinge to a greater degree on performance over time. "We're likely to see opportunities to get a fair price, but that risk is going to have to be shared," Kawal says.

SELLER URGENCY

Many of the would-be sellers who procrastinated prior to the pandemic will likely go to market as soon as they can, observers say. Even those who believed they could go it alone as an independent may reconsider, says Richard Bennett, founding partner of $1.2 billion Durbin Bennett Private Wealth Management, in Austin, Texas. Durbin Bennett has spent years building a self-sufficient firm and planning an internal succession, but firms without that running start may now find that process too daunting, says Bennett.

"This is going to take the wind out of a lot of people's sails," Bennett says. "It may be more than they bargained for, and they will probably merge or sell out, even though valuations are down."

A flood of new supply, especially among less-than-stellar firms, could help drive down multiples for that group.

Not all deals will be done by big, so-called acquisition brands. Firms with $1 billion or $2 billion of assets under management increasingly see acquiring succession-challenged practices as a quick way to boost growth, says Sclafani. "Every top team is looking for a way to acquire something," he says.

Nor will all the deals take the form of outright acquisitions. Many smaller players will turn to platforms, the biggest of which is Dynasty Financial Partners, that provide a range of turnkey. “For firms that are not having fun anymore operating the business, partnership could be the way to go rather than cashing out,” says John Furey, managing partner with Advisor Growth Strategies.

To a large degree, the future of advisor M&A is in the hands of private equity firms, who in the past decade have bought numerous wealth management firms and funded their acquisitions, earning high, frictionless returns.

Private equity-backed firms, including Hightower, Mercer, Wealth Enhancement Group, and Beacon Pointe, say the market slump hasn’t affected their plans and that they’ll continue buying as the opportunities arise.

“We could do three or four [additional acquisitions this year], or we could do 20,” says Mercer’s Welling.

DeVoe & Company isn’t concerned either; the firm recently wrote that acquirers’ management teams and private equity backers likely anticipated a market decline at some point and worked it into their plans.

But Peter Mallouk, the head of of Creative Planning, in Overland Park, Kansas, argues that private equity firms could pull back from new commitments, despite cheap credit, if markets remain tumultuous longer than everyone seems to expect. “If this resolves this quarter, in a V-shaped recovery, I think everyone can survive,” he says. “Three quarters? A complete and total game changer that would decimate the buying class.”

Simply put, private equity buyers, who borrow heavily to buy firms, will shy away from adding more leverage as it becomes harder to service existing debt, Mallouk argues.

HIATUS HOMEWORK

Would-be sellers who believe that M&A is heading into a hiatus should be thinking about how use that time to strengthen their firms. The first order of business should be solidifying client relationships, says Jeff Dekko, CEO of $11.8 billion Wealth Enhancement Advisory Services, in Plymouth, Minn., which made 12 deals between 2016 and the end of 2019. In structured deals, payouts depend on the percentage of clients who stay on with the new firm.

Sellers should assess their business through a buyer’s eyes. Cooper says. “Invest where buyers will find value,” he explains. “Most won’t find value in a great investment research process, but rather in great talent – financial planners, client service specialists and business development people.”

Oros, meanwhile, says wealth managers should use what they’ve learned during work from home to rationalize their cost structures. The pandemic is teaching them that they might not need so much office space or travel. “A new engagement model has emerged through this crisis, and it’s actually pretty good,” says Oros. “It doesn’t replace the old one, but it’s absolutely a new and important part of the playbook for more scale and efficiency.”

DeVoe, for his part, urges firms to position for an eventual economic and market rebound. His advice: Continue to invest in client service, marketing and business development so that you can ultimately hit the market as a strong grower.

“We might see some firms that separate themselves from the pack by making good decisions through this Covid crisis. “But firms that fall behind on growing their companies might be the ones that don’t find buyers or find their valuations compressed.”