Navigating Client 'Concentration Risk' in a Sale

The stakes are high as RIAs holding $2.5 trillion in assets are expected to be sold in the coming years.

By Gary Stern for RIAIntel

According to a November 2019 Cerulli Associates report, in the next five to 10 years, RIA firms with about $2.5 trillion in assets under management could be acquired.

Cerulli breaks down that number with $1.6 trillion based on retiring RIAs, $469 billion attributed to breakaway advisors, and $348 for growth-challenged firms.

This translates into a lot of deals. However, many founders and CEOs will only have only one chance in their career to sell their firm. This makes executing a deal critically important. Many can be overwhelmed with the intricacies and nuances of selling their firm, and predictably fall into certain traps, including buying firms overly reliant on a handful of clients.

Jim Dickson, CEO and founder of Sanctuary Wealth, based in Indianapolis, Ind., a hybrid RIA firm that serves about 50 partner firms overseeing a total of $9 billion, said the landscape of selling RIA firms has transformed over the last few years. Owners are increasingly selling firms gradually, over a period of years, "rather than going cold turkey and handing over the keys and retiring."

Hence, an owner might sell 20% of the firm immediately, and then another 20% over five years, which helps the transition, having the head of the firm stay in place before completing the sale outright. The best way to handle a sale is for the owner to stick around for a minimum of one to two years to help the transition, serve clients jointly, and then gradually opt out or agree on a new capacity and stay on, noted Dickson.

Nonetheless, Dickson has seen owners fall into certain pitfalls, time and time again when selling a firm.

One trap that owners fall into entails "selling to the highest bidder over choosing the right culture." Rather than determining that's there's a good fit, the owner leaps at the higher price, stays on, and then regrets it. "If you don't have a connection to the culture of the acquiring firm, your clients won't either," Dickson stated. And too many owners make the mistake of "allowing their revenue to be generated from only a top few clients."

Advisors often naturally end up with a business in which four or five clients account for 30% to 40% of the assets they manage. In turn, those clients get the most attention and advisors find that circumstance is easier and more profitable for their practices, Dickson said. But if the buyer acquires the business and one or two of these clients opt to leave, the valuation plummets or the deal could be voided.

Dickson says his firm doesn't mind owners concentrating on serving their top clients, if they delegate the bulk of their remaining clients to talented junior partners. "We'll lock in their key personnel, get to know them through our due diligence, and let them share in ownership, which encourages them to be more invested in the firm," and stay, he asserted.

He also advises owners who are selling to reach out to the younger generation of their top clients. There's going to be a massive turnover of wealth when the babyboomer generation fades away, and becoming familiar with the next generation is crucial, and doing it sooner rather than later helps retain clients.

Often when new clients of the acquired firm join Sanctuary Wealth, it offers services to the top clients that were unavailable at the smaller firm. For example, Dickson said it offers more lending services, trust services, and tax services. "We keep a lot of relationships the same, but add services and layer them on. They're getting more value," he noted.

About selling out, "The key is to have a process and stay disciplined," urged Dickson.

John Furey, founder of Advance Growth Strategies, a Phoenix-based management consulting firm for independent advisors, calls relying on too few clients "concentration risk." Buyers analyze the clients of potential sellers and a short list of clients representing a disproportionate amount of assets is a red flag, according to Furey. And that could lead to contingencies, he said.

The buyer will stipulate in the deal that the given price of the firm is dependent on most of their major clients transitioning into the new firm, or, depending on the agreement, the agreed-on price could be diminished by a certain percentage, or if most major clients don't carry over into the new firm, the deal could be nullified, Furey declared. Sometimes the deal is delayed until the new clients transition into the revised firm.

Once the acquiring firm completes its acquisition, the problem often dissipates, Furey suggested, noting that the acquiring firm is typically larger and can absorb it more easily. At times, they may have to make adjustments of how they handle certain larger clients, adding certain platforms.

Another key piece of handing over one's firm is determining the exact role the ex-owner takes in the new company. Many owners have been blindsided by being asked to sell certain products, or perform certain tasks, that they felt were beneath them. "A lot of sellers don't think through control issue enough," Furey said.

In addition, making sure that one's RIA team is firmly established and won't jump ship during a transition is another key ingredient to ensure a smooth transition during a sale.

Establishing a compensation plan to provide employees with equity in an event of the sale is another way to ensure continuity. "Given the talent shortage in the RIA industry, maintaining staff is critical," Furey asserted.

Selling one's firm is like entering a marriage, pointed out Stuart Silverman, president of Bluespring Wealth Partners, based in Austin, TX. And Silverman should know. He sold his firm Fusion Advisor Network to Kestra Financial in 2012, which owns Bluespring, and has stayed on.

"This is their baby," Silverman, based in Tarrytown, N.Y., noted. "They care about their client, their employees and their legacy."

Making sure the business models mesh and the seller can maintain his/her secret sauce and entrepreneurial outlook are also critical to ensure that there’s a cultural fit between buyer and seller.

“If the seller can’t see themselves working with these people and take that leap of faith, no matter how profitable, we advise waiting,” Silverman stated.

When Bluespring Wealth Partners looks to acquire a firm, it dissects their client base. It scrutinizes their top 20 clients to determine the value of their assets, how old they are, how long they’ve been a client, how diverse they are in terms of client base and geography. Are most clients related to one family?

And if the sellers are 70 years and older, odds are strong that many of their top clients who generate the bulk of their assets, are also of that ilk. “How long will those assets stay on the book?” Silverman wonders.

When Bluespring Wealth acquires an RIA firm, it sends a legally-required notification to its clients, highlighting the positive aspects of the deal. It emphasizes how a well-capitalized firm has now assumed ownership and underscores that a new succession plan is in place at the firm.

In person, clients are informed, in greater detail about the specific benefits that the new firm will offer, and emphasizes services they’ve come to expect will continue. Therefore clients get the message that the new ownership is “thinking about continuity long after he or she retires,” Silverman noted.

Silverman concluded that when acquiring a firm for which few clients generate the bulk of assets that “I can’t control the client, or whether he or she stays or goes.” Instead he focuses in on the future, how the firm is poised to expand in order to generate ongoing business. “We’re looking for scalability and how they can expand their footprint. Growth is key,” he said.