The Forces Boosting RIA Valuations and Driving a Dramatic Shift in Deal Structure

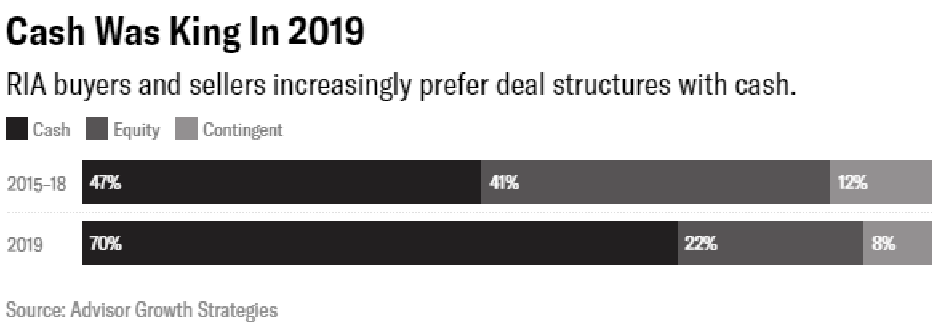
To both buyers and sellers, cash is taking precedence in deal structure, according to a new report.

by Michael Thrasher for RIAIntel

Buyers and sellers of RIAs have begun heavily favoring cash to fund deals. But valuations have increased despite the immediate payouts to sellers, a sign of the growing prevalence and clout of large RIAs in the country.

In 2019, the average acquisition of one RIA by another was funded by 70% cash, 22% equity and 8% contingency (meaning a future payout would be determined by conditions agreed upon by the buyer and seller). That preference for cash represented a "large shift in deal structure," according to a new report by Advisor Growth Strategies, a consulting firm to wealth managers.

From 2015 to 2018, the average acquisition was funded by 47% cash, 41% equity, and 12% contingency, according to the report, which closely examined 31 transactions last year between RIAs managing anywhere between $100 million and billions of dollars.



There were a record 203 deals involving all types of wealth managers in 2019, and the first quarter of 2020 was one of the most active in history, with 46 transactions, according to Echelon Partners, an investment bank and consulting firm focused on wealth and investment managers.

"We're calling it a flight to certainty," Brandon Kawal, a principal at Advisor Growth Strategies, told *RIA Intel*.

Buyers suddenly preferred cash to at least partly guarantee what they would be paying for an RIA. Especially for buyers that are intent on growing and or improving their profitability in the future, their shares could be worth much more down the road. If a seller's business disproportionately contributes to that growth, using equity capital to purchase it could be expensive in hindsight.

RIAs that can shop with cash will use it, since the cost of that capital hovers around 4% and 5%, compared to 15% to 20% annualized, or more, for equity, according to Peter Nesvold, an adjunct professor at Fordham University who teaches courses on mergers, acquisitions, and leveraged buyouts. Nesvold was previously a managing director and chief operating officer of Silver Lane Advisors, a division of Raymond James Investment Banking focused on financial services firms.

It's harder for sellers to get some ownership of any buyer, but it is especially difficult to pry it away from private equity-backed RIAs, which prize the shares of their fast-growing investments, according to Nesvold and the AGS report. Sellers who can get some, stand to gain a lot. RIAs who haven't, or refused to sell in exchange for equity, have missed out on millions before.

Some RIAs have grown large enough to fund transactions with their own cash. For others, the cost of debt capital was cheap in 2019 — interest rates for traditional loans were low and the most prolific RIA buyers have private equity sponsors providing that funding.

Private equity-backed buyers accounted for 61% of deals between RIAs in 2019, up from only 37% in 2016, according to the AGS report.

That's partly why valuations counterintuitively rose from a median adjusted EBITDA multiple of 5.1-times from 2015 to 2018, to 6.6-times in 2019, according to Kawal. In previous years, a seller's valuation in a cash transaction would typically fall an average of 18%, he said.

Like buyers, RIA sellers also like the certainty of a cash windfall. Most independent RIAs have only one or just a few owners, whose wealth is tied up in the business. As they begin phasing out or leaving the industry entirely, a liquidity event is attractive to them.

More advisors are approaching that decision, too. In the next decade, more than 111,500 financial advisors — representing one-third of the workforce and assets under management — are expected to retire (and not enough people want to fill their shoes). Over that same period, RIA firms with about $2.5 trillion in assets under management could be acquired, according to a Cerulli Associates.

But even though the group of prolific RIAs buyers flush with cash has grown, there still aren't enough of them to take advantage of the entire wave of deal volume approaching. The recent AGS report found that only 16 RIA buyers accounted for 66% of all RIA transactions in 2019.

If more RIA buyers don't enter the market, there could be a shift in supply and demand, Kawal said.

"It doesn't mean you won't get a fair deal," Kawal said about sellers. But convincing a buyer to pay a multiple beyond the average will be more difficult.