Suitcases of cash for RIA M&A deals are one COVID-19 victim, as RIA buyers leverage economic uncertainty to force more risk on sellers

Sellers are still getting paid at familiar sales prices, but some of the bad old days of 'earn-outs' are back, which delays the time when they can stop worrying about firm cash flow

By Charles Paikert for RIABiz

The COVID-19 fallout is infecting the RIA M&A market -- like it's 2015 all over again-- with whittled cash and more IOUs at closing.

Buyer's are less indulgent because of the freshened fear of pandemic uncertainty. Only a year ago, they flashed cash in a way that let seller's -- more than ever before -- take the money and run, according to John Furey, managing partner of Advisor Growth Strategies.

Numerous other sources contacted for this article were quick to agree with his take based on a study. The new normal for terms is like a reversion to five years ago, Furey adds.

The average RIA M&A deal in 2019 had buyers paying 70% of the purchase price in upfront cash, according to the recently released study by Advisor Growth Strategies.

Contingent payments accounted for only 8% of average deals, while equity consideration totaled 22%, Advisor Growth found.

This year, however, Furey estimates that contingent payments in deals will more than double to around 20%, with a corresponding decrease in upfront cash.

Buyers have been able to leverage deals with earn-outs and other longer-term payouts instead of cash, but they still don't have the upper hand in deals.

"It's still a seller's market," says Scott Wetzel, CEO of Skyview Partners. "We're seeing valuations hanging right in there."

It's an "extremely busy" RIA M&A market, and don't blame the buyers for substituting paper promises for cash at closing, says David Selig, principal of Advice Dynamics Partners in Mill Valley, Calif.

"It's personal risk, and lenders are unwilling to have buyers put down as much," he says.

New norm

It's neither a buyer's nor a seller's market; it's a gorilla market, Furey contends.

"It's a scale buyer's market. The larger you are, the more your risk profile goes down," because a serial buyer can survive buying a bad apple in the bunch.

Stricter performance metrics, lengthier payout periods and less cash flash is the norm now, says John Burns, CEO of Exencial, the $3 billion Oklahoma City RIA that bought Willingdon Wealth Management, an $800 million firm in suburban Charlotte, N.C. at the end of April.

“Clearly the pandemic has impacted everybody, buyers and sellers,” he says .

“Risk is everywhere and is front and center now. It was part of all our conversations, and it impacted what we did with our transaction.”

Indeed, risk aversion is the name of the game.

“The buyer is taking a substantial risk [in this environment] and should be allowed to protect themselves if revenue thresholds are not met,” says Frontier Wealth Management CEO Nick Blasi.

Frontier, in Kansas City, acquired Highwater Wealth in Colorado and Karstens Investment Counsel in Omaha, Neb. in 2020.

Contingent payments are being extended from two- to three-years out to three- to four-years, Blasi says. And if revenue targets aren’t met, “the total agreed upon purchase price needs to be adjusted."

Shifting metrics

Even the industry’s biggest deals are now playing by new rules. For one major transaction, a buyer insisted on changing contingency payments after the pandemic's onset.

While the purchase price remained the same, the buyer set new earn-out incentive metrics for the seller. “We took money out of their front pocket and put it in their back pocket,” says an executive with knowledge of the transaction..

Wetzel says he still sees plenty of cash at closing and credits how well RIA revenues are holding up in a downturn.

Some of the banks he uses specialize in small businesses and always favored presumed cash cows like dentists and funeral homes -- which have had a rough go of it in the shutdown.

"RIAs have had no delinquencies or defaults," he says.

A vivid example of such an adjustment was revealed in April when Blucora amended its purchase price of HK Financial Services to $100 million from $160 million. See: Dissecting Blucora's giant act of financial engineering -- adding a broker-dealer to a software roll-up

Citing “current economic conditions” in its Securities and Exchange Commission (SEC) Form 8-K filing, Blucora not only decreased the upfront cash payment but added two “potential post-closing earn-out payments."

They will be determined by HK's AUM and "the achievement of certain performance goals" one and two years after the deal closes.

Those goals, Blucora told the SEC, include "substantial growth" in HK's AUM "through strong operational performance and market improvement." If the AUM falls short of the agreed-upon metrics for that period, Blucora "would not be required to make any earn-out payment to the Sellers."

Healthy skepticism

Negotiations between buyers and sellers always produce conflict, of course, but the new emphasis on risk-sharing is bound to "heighten" the inevitable tension, Burns says.

"The buyer wants to be sure what they're paying for is actually delivered, while the seller is looking for more certainty when they sell," he points out.

Wetzel says he is seeing a newly appreciated deal mechanism in the market.

Between 20% and 50% of the deal consideration gets put in escrow for two- to three-years. Not only does it protect the buyer, but it also protects the seller because the final price can get adjusted on the upside, too.

Both parties always try to "hedge out risk," notes Tim Bello, managing partner at Merchant Investment Capital, which just acquired a minority stake in Octavia Wealth Advisors in Cincinnati.

What's changed in the COVID-19 era, Bello says, is that buyers are increasingly risk conscious, and they are thinking more about what a deal can do to them, rather than what a deal can do for them.

"What you're seeing now," he says, "is a lot of healthy skepticism."

Getting Out

M&A attorney Corey Kupfer cited a recent deal he worked on where the RIA seller wanted the downside risk to be adjusted so that the potential decrease in any adjusted price would be capped at 10%.

That might have flown last year, but not today, Kupfer says.

"The buyer was not willing to take that risk," he says. "They insisted on a dollar for dollar adjustment [for metric-based contingent payments].

"Last year many sellers had a cushion if they didn't meet their targets and would still get 100% of the sale price. Now there's no downward adjustment. Sellers are not in the driver's seat as much."

Selig says he's seen anecdotal evidence that seller anxiety about getting out is much more apparent in 2020.

Historically, most inbound calls at his firm are from new buyers expressing interest. That script flipped entirely this year, he adds, with most calls from sellers wanting to get acquainted.

Dakota Wealth Management buys free cash flow, says M&A veteran Peter Raimondi, the firm’s CEO.

Terms of the deal depend on maintaining the level of cash flow at the time of the sale, he explains. “There’s a potential claw-back if EBITDA falls below that number."

Conversely, if the seller exceeds projections, Dakota “may pay an extra bonus.”

Commanding a premium

The coronavirus pandemic has impacted the run-rate projections used to determine targets for payments, according to Raimondi.

Buyer and seller now try to take into consideration black swan factors,such as lockdowns, that could impact an advisory firms’ business.

“We’re a little bit more cautious on the overall multiple of what we’re willing to pay for your forecasted EBITDA,” he says.

The median adjusted EBITDA multiple for an advisory firm increased to 6.6-times in 2019, a nearly 30% jump from the prior three years, according to Advisor Growth Strategies “RIA Deal Room.”

Blucora reports that it valued HK Financial Services at approximately 6.32-times 2020 EBITDA.

Firms with more than $2 billion in assets, however, commanded a substantial premium last year, reaching a multiple of at least 10-times cash flow, according to the Advisor Growth study. And the very best firms can sell for multiples in the mid-teens.

For the most part, those RIA valuation multiples are holding steady, according to Furey.

“There’s still great demand for quality firms,” he says. “Long-term deal drivers such as recurring revenues, organic growth, geographic position and the need for both top talent and succession planning haven’t gone away.”

Fierce competition

M&A slowed in May; only ten deals were completed, according to Fidelity's monthly report. The result was a 45% drop in total deal assets year-to-date. Even so, market participants insist deal-making negotiations remain quite active, albeit slower to finalize.

What's more, demand to buy RIAs continues to outstrip the supply of firms for sale, says investment banker Steve Levitt, managing partner at Park Sutton Advisors. "We're seeing ten buyers for every seller," Levitt says.

Buyers dispute that ratio, but no one denies that M&A competition for RIAs remains fierce.

In fact, pressure to complete a deal for fear of losing out to a rival can mean that buyers sometimes have to continue to give sellers high levels of cash upfront, despite increased risk concerns, says Scott Dell'Orfano, chief strategic officer for Boston-based Congress Wealth Management.

"It's still a very competitive environment, and if you want to get the deal done, you need to be flexible," says Dell'Orfano, whose firm bought California-based Domus Capital Group earlier this year. See: How Scott Dell'Orfano is helping to double the size of Banyan Partners just six months after leaving Fidelity

"If there are minority shareholders, you want to make sure there's enough monetization for them, which means being able to have enough cash to make sure people are happy."

Turning tables

CI Financial, as it turns out, was also in the unusual position of also being a seller this year, completing a deal last month for a minority stake in Canadian asset and wealth manager Congress.

Being on the other side of the table, Congress actually welcomed larger contingent payments, Dell'Orfano says.

"The management team wanted more weight on the back-end," he explains. "We were willing to share the risk so we could participate in the company's future growth."

Advisory firms with younger executives may indeed be more than happy to take increased contingent payments, while those with older, exiting partners and founders are more likely to negotiate for larger upfront cash payments.

Either way, the pandemic has changed the rules of the game, Furey says.

"Most sellers who don't want to share risk based on shared outcome are going to get less cash," he says. "As long as there's so much unknown in the market, that's going to continue."