Will This Overlooked Segment Drive M&A Among RIA Firms?

By Brandon Kawal for Barron’s

M&A activity is picking up again for RIA firms and there’s a lot of anticipation about what the industry can expect for the rest of the year and in 2021. Many are focused on $1 billion-plus AUM firms that have consistently commanded strong valuations. These large firms — highly sought-after acquisition targets — made up less than 6% of all RIAs at the end of 2018, according to research firm Cerulli Associates.

In research this year by my company, Advisor Growth Strategies, 68% of RIA firms had less than $1 billion in AUM; we found the average increase in EBITDA multiples was similar to that of larger counterparts. Higher valuations were met with greater certainty as deals averaged 70% cash and less than 10% in contingent payments. In recent months we have seen a shift away from certainty and a greater focus on risk-sharing.

While it may seem that smaller practices are overlooked, firms with less than $1 billion in AUM represent a massive addressable market and have sufficient opportunity to impact the buy-and-sell-side of the M&A market. The future of RIA M&A will depend on choices this segment makes, and whether firms address key structural themes to maximize future options. (See RIA Mergers and Acquisitions Just Set a Quarterly Record.)

Most owners and operators of RIAs are proud of the experience they offer clients. As firms grow, that experience becomes more difficult to scale and client experience may suffer. RIAs also consistently need to find ways to scale their value proposition (often through enhanced services) to fend off potential fee compressions. In our latest RIA survey, 28% of respondents listed scale as a reason to consider selling their firm.

In the same survey we found that managing technology (31%) and building operational processes (28%) were challenges for RIAs. The pandemic has revealed gaps in technology, roles, responsibilities and processes. Sub-$1 billion RIAs will need to determine how much time and effort is required to drive scale in their advisory platforms to maximize the chances of keeping their firms independent.

Many founders are strong at growth execution — until they run out of bandwidth. RIAs have shown signs of growth throughout the pandemic, but a long-term sustainable growth engine is a more difficult proposition. Organic growth may come from a niche an RIA cultivates, or from multiple growth channels. About one-third (32%) of our survey respondents said organic growth was a top challenge, and 22% said growth would motivate them to search for a potential M&A partner. One thing is certain: Long-term sustainability is dependent on the growth engine. Those that have it will gain better market position.

Without developing a repeatable growth engine, RIAs may have to partner with a firm that has access to credible growth channels that can help free time for professionals at the selling firm to focus on execution. The most successful firms in the RIA vertical are growing rapidly by cultivating growth channels, and making the process internally and externally transferrable. RIAs that focus relentlessly on consistent growth will maximize their future options.

Sourcing and retaining talent are some of the biggest challenges RIAs face. Owners said finding talent (56%) and managing people (27%) were top challenges for their firms. Overcoming this challenge is critical to long-term success and is also a strong driver on the buy-side of RIA M&A. Nearly one-quarter (22%) of respondents in our new RIA survey said human capital was a primary reason to pursue a deal. Firms that can attract and retain talent by providing a defined career path, professional development and financial upside will stand out compared with peers. This may involve creating a true path to ownership that diversifies a firm's near- and long-term ownership. If successful, an RIA will create more strategic flexibility, increase the probability of internal succession — addressing one of the industry's biggest problems — and strengthen their external valuation.

Investing in growth and sustainability is easy on paper. Some owners will conclude that they are not interested in decreasing cash flow materially to invest in growth, talent and the advisory platform. Similarly, many owners will find that their team does not have the capabilities or desire to become the future operators of the business. While liquidity and access to capital are table stakes in the M&A environment, nearly 50% of our survey respondents said succession and liquidity were the primary reasons to consider a transaction. RIAs less than $1 billion will need to determine if consistent financial discipline and investment in the business is palatable to facilitate sustainability. If not, a partner with greater financial resources and succession options might become the best alternative.

The world of RIA M&A is more diverse than outsized multiples and favorable terms, and there are opportunities for sub-$1 billion firms to address critical structural items before M&A becomes the only option. As M&A becomes more dynamic, RIAs should consider the strategic implications of building, outsourcing or partnering to achieve their goals. At a minimum, the education obtained during the process will help owner-operators in the most addressable market segment make better decisions that align the business long term.

Brandon Kawal is a principal of Advisor Growth Strategies, a consulting firm serving the wealth management industry.