M&A is Booming in the RIA Channel. Where Do Earnouts Fit In?

By Charles Paikert for Barron's

Earnouts are the unwelcome guests at the otherwise raucous RIA mergers and acquisitions party, where new records for deal activity keep getting shattered. Buyers typically insist that earnouts, or performance-linked payments, be part of an M&A purchase agreement, while financial advisor sellers usually wish they would just go away.

"Some sellers worry about how the earnout measurement process will be managed and discount the likelihood that they will actually achieve the full amount," says M&A veteran Peter Nesvold, who heads the merchant bank Nesvold Capital Partners.

"Earnouts may be unloved, but they are a very effective way to bridge the gap between a seller's pie-in-the sky expectations and a buyer's risk going forward after the sale," Nesvold says. "Ultimately, most buyers are more than happy to pay if growth projections are met."

The specifics of the earnout are, of course, negotiable—the percentage of the total purchase price, the time period when the money will be paid out, and the metrics used to measure the earnout targets.

"Earnouts perform the function of incentives for the seller and insurance for the buyer," says Matt Crow, president of Memphis, Tenn.-based M&A valuation firm Mercer Capital. "Contingent payments preserve upside for the seller and protects the buyer against potential losses."

Last year's onset of the Covid pandemic had a major impact on earnouts in RIA transactions. Buyers asserted that the steep decline in the markets last year and the deeply uncertain state of the economy increased the risk they were taking when purchasing an advisory firm. As a result, contingency payments as a percentage of deals more than doubled to around 20% or more, according to the industry consulting firm Advisor Growth Strategies. Payout periods also increased to between three and sometimes five years for many deals, according to industry executives.

"The buyer is taking a substantial risk in this environment and should be allowed to protect themselves if revenue thresholds are not met," Frontier Wealth Management CEO Nick Blasi said at the time.

But as the year went on and the markets recovered, the economy stabilized and the advisory business (and sales of advisory firms) boomed, sellers regained leverage and the role of earnouts in M&A deal structure began to decline.

Advisor Growth Strategies and M&A executives estimate earnouts will make up around to 10% to 15% of total consideration this year, with the rest divided between cash upfront and equity allocations.

In fact, one of the industry's most active buyers, Mercer Advisors (which has no affiliation with Mercer Capital), has cut its earnout period down to one to two years from three or more.

"We're doing shorter earnouts because sellers want it," said Vice Chairman Dave Barton, who heads M&A for Denver-based Mercer Advisors, which bought 13 firms last year with total assets over $6 billion. "We want to remain competitive and our deal structure is very favorable to sellers compared with other buyers."

Mercer Advisors' competitors are also cutting back on earnout requirements.

"Risk has shifted to the buyer," says Matt Cooper, president of Beacon Pointe Advisors, based in Newport Beach, Calif. "There's less consideration placed in earnouts now and the time period is shorter. We're seeing around 90% of consideration paid up front and the remaining 10% payable in one to two years, where it used to be 70% upfront and the rest over three years or more."

The role of earnouts in a deal is a direct function of whether the M&A market is a buyer's or seller's market, according to Nesvold. RIA sellers most assuredly have the upper hand in the market for advisory firms. Transactions set a record high in 2020, with M&A strategy and consulting firm reporting 159 deals, a 20% increase from 2019. Nor has the torrid pace slowed down this year, according to DeVoe, a leading consulting firm for RIAs.

"This unprecedented volume is being driven by Covid's wakeup call for succession planning, high valuations and seller's interest in gaining the power of scale," says firm CEO David DeVoe.

Indeed, aggressive buyers such as Toronto-based CI Financial, which has acquired at least 15 RIAs in the past year with total assets nearing $60 billion, are pushing valuations up by paying premium prices, especially for firms with close to or over $1 billion in AUM.

Advisor Growth Strategies estimates that the median adjusted multiple for an RIA now exceeds eight times EBITDA, a 25% jump from two years ago. And market participants report that cash flow multiples for large RIAs with billions in AUM can range from the low to high teens. As Mercer Advisor's Barton put it: "If I'm a seller, I don't know why I'm waiting."

Nonetheless, despite the increased leverage of sellers, many buyers still need reassurance that their investment will yield returns in the future, meaning earnouts remain fundamental to M&A deals.

What's more, advisory firm sellers who simply crave cash should be forewarned, says Mercer Capital's Crow: "More cash means more risk for the buyer and a lower price for the seller."

What are the key performance metrics buyers emphasize?

Business growth as measured by revenue and free cash flow is critical for Mercer Advisors, Barton says. Also key: data on clients. Are clients accumulating or decumulating assets? What is the median age of clients? Is a firm adding new clients? Retaining existing ones? How many services are clients offered?

“The biggest problem we see is that many firms that are up for sale don’t know their own numbers,” Barton says. “Sellers also tend to want 100% cash. That may be possible, but they have to realize it’s a short-term solution because the value of the firm will go down.”

Client retention and compound annual growth rates are also key earnout metrics for Beacon Pointe, Cooper says. RIAs selling to Beacon Pointe usually need to keep between 85% to 95% of their clients after an agreed-upon number of years, he explains. Every one percentage point drop below the upper end of the range represents a 10% deduction in earnout payments.

Both buyers and sellers of advisory firms need to keep in mind that the value of an RIA transaction is subject to “a large number of variables and wide range of possible outcomes,” says Brooks Hamner, a vice president of Mercer Capital. In addition to measuring assets, revenue, and client retention, other performance metrics may include sustainability of the acquired firm’s fee schedule and retention of key staff.

But there is no one-size-fits-all earnout template, Crow says. “An earnout can ease the concerns and fulfill the hopes of both parties about the future,” he adds. “But an earnout cannot guarantee the future.”