Tibergien on M&A: Who Will Be the Last Firm Standing?

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With each passing quarter, mergers and acquisitions specialists report more transactions involving advisory firms. In some cases, firms merge with strategic consolidators. Sometimes they are targets of financial buyers. Other deals come about when the selling practitioner hopes another advisor will take care of his or her clients when they no longer can.

This activity may have created the perception of a roll-up boom, yet as **Dan Seivert** of **ECHELON Partners** points out, not every buyer is a true roll-up. Dan says that true "roll-ups" rely heavily on private equity firms who usually seek a liquidity event in order to realize their return on investment. Further, he says, they often want additional capital to continue their aggressive acquisition strategy. He identifies classic roll-up firms such as United Capital, Focus Financial, HighTower and AMG.

Dan also describes a new breed of roll-up he calls "strategic consolidators." While they wish to buy up as many firms as they can as quickly as they can, they may be less motivated by a liquidity event and more focused on building a large enduring business with scale. Firms in this category include Mercer Advisors, Wealth Enhancement Group and Bronfman L. Rothschild.

Certain industries may be ripe for consolidation — those that are highly fragmented, subscale or going through deregulation. Nevertheless, most successful consolidations occur with companies that are more process- or brand-dependent as opposed to people-dependent. Funeral homes, medical practices and real estate agencies saw this sort of rapid consolidation.

Small businesses built on the individual reputations of the founders are harder to transform into scalable enterprises. Firms that have removed the identity of the owner by emphasizing a process or brand have greater success in a consolidation movement.

Winners, Losers

When I participated in my annual debate with Dan at ECHELON's annual "**Deals & Deal Makers Summit**" this fall, I remembered how fragile the financial advisory business model is in regard to transferability. Not every consolidation effort will emerge victorious. Growth-oriented firms must achieve faster growth, greater efficiency and clearer brands while at the same time becoming recognized as employers of choice in an industry suffering from an acute talent shortage.

So, which firms will get a seat when the music stops? Firms with the best chance have a strong understanding of the phases of consolidation and the will to act quickly.

In preparation for my debate with Dan, I reached into my archives for a Harvard Business Review piece written in 2002 by Graeme K. Dean, Fritz Kroeger and Stefan Zeisel. While this article focused on large, global, capital-intensive companies, many of their observations apply to the financial advice business as it experiences its own transformation today.

Stages & Phases

In "The Consolidation Curve," Dean, Kroeger and Zeisel say that it takes 25 years to progress through all four stages of the consolidation process. While the independent retail advice model has been around for more than 25 years, the consolidation wave only began about a decade ago.

For years, lifestyle practitioners dominated financial advice. These advisors rarely viewed their business as anything more than an extension of their personality and not something that would outlive them. They typically did not seek to become the dominant provider in their markets, or to create something of lasting value.

The introduction of professional management changed this dynamic in many independent RIAs, making "The Consolidation Curve" a relevant and instructive article today.

The authors refer to Stage 1 as the Opening Phase, in which new companies emerge from a newly deregulated or privatized industry. This phase began when certain retail RIA practices did not want to set up shop as registered reps under broker-dealer supervision once the deregulation of commissions came into play.

Up until then, most RIAs were asset managers who had soft-dollar arrangements with brokerage firms. The ability to use discount brokers liberated advisors from the old model and allowed them to transform into practices operating under a fiduciary standard, as professional "buyers" instead of professional "sellers."

For years, very few RIAs dreamed of building a bigger business. Eventually, as firms grew, they saw that a larger, professionally-managed enterprise might be necessary to serve more clients and attract better employees. Executive discipline becomes a huge advantage when a company is attempting to grow profitably.

Consolidators must define what type of firm fits their model, which markets they wish to dominate and how they will add value to the advisors they bring into their fold. Lack of clarity on these points makes achieving scale very difficult. Advisors contemplating a sale to a consolidator also should take note; if part of their deal is equity in the new firm rather than an outright buy-out, they are making two decisions — selling their company and investing in another one.

In Stage 2, the Consolidation Phase, major companies begin to emerge, buying up competitors and forming empires. Dean, Kroeger and Zeisel state that the top three firms in Stage 2 will own 15%–45% of their market. The markets could be local, regional or national, or they could be defined by type of client, such as 401(k) plan administrators, business owners or socially-responsible investors. The skill set for these firms shifts to merger integration tactics, including how to protect their culture and retain their best employees.

Consolidator Considerations

Particularly in the advisory business, consolidators must focus on capturing the major competitors in their most important markets. At a minimum, successful firms must attract enough of this segment to create a clearly market-dominant firm. Those who wish to succeed must move to defend themselves by building scale and establishing barriers to entry.

I worry about consolidators who lack an acquisition strategy and fail to consider how they will build critical mass. The ability to ramp up quickly and demonstrate momentum is important to building brand presence and appeal for their offer.

The authors refer to Stage 3 as the Focus Phase. This stage follows an intense period of acquisition. Now the company must focus on expanding their core business and trying to outgrow the competition. The top three firms in this phase will control 35-70% of their defined market. It helps if the number of markets is limited.

This phase includes mega deals and larger scale consolidation. We have seen this occur in the asset management and broker-dealer businesses. Leaders of companies in this phase must emphasize core capabilities and focus on profitability. They must shore up their lagging businesses and divest of weak partners.

The authors of "The Consolidation Curve" point out the threat of start-ups who seek to disrupt the dominant firm's business. As an example, firms like Schwab and Vanguard saw a threat and an opportunity in the "robo" space and invested heavily in these distribution models for their ETFs and mutual funds. The authors recommend quick action: When a dominant business model is threatened by upstarts, the company should either buy them, crush them or emulate them.

Final Period

Stage 4 is referred to as Balance and Alliance. The titans reign. We've seen this in industries such as tobacco, soft drinks and defense. One could argue that the brokerage industry arrived at this phase with firms like Goldman Sachs, Merrill Lynch, JPMorgan and Morgan Stanley; they survived the consolidation wars to become the dominant financial distribution firms.

Growth becomes more difficult when one already controls a large portion of the market, however. During the Balance and Alliance Phase, firms form alliances with peers. The authors say this stage includes the need to shore up and defend the company's current position, as dominance also tends to attract the attention of regulators and legislators.

It is difficult to predict which consolidators in the financial advice business will prevail. Long-term success depends on how quickly they progress through each stage and how well they define their markets and business models. Slower firms will become acquisition targets. Faster firms risk cultural infections and reputational damage if they do not maintain an effective structure of command and control.

Challenges abound in the consolidation process. It's fun to speculate but hard to predict who will be the last firms standing.