Merger & Acquisition Game Changer

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As financial and strategic acquirers scale back, the RIA consolidation game is morphing into more of an intra-industry affair. Firms increasingly are looking among themselves to merge or acquire and grow their businesses to create both scale that could enhance value and the internal dynamics necessary for succession.

Still, the vast majority of advisory firms lack a sufficient amount of the single most important ingredient to initiate sizable acquisitions—capital. As private firms structured as S corporations or LLCs, RIAs see the bulk of their profits passed through to principals, who are then required to pay taxes, often at the top marginal tax rates.

Data from Schwab Advisor Services reveals the extent to which RIA firms, not consolidators or other acquirers, are now dominating the M&A space. In the first three quarters of 2011, individual RIA firms accounted for 45% of all transactions, up from the 30% to 33% range in 2007 and 2008. Between 2010 and the first three quarters of 2011, consolidators' share of total deals fell from 42% to 30%. While recovering regional banks staged a modest comeback from about 2% to 14% of all deals during the period, they are a much less salient factor than they were in the middle of the last decade.

In terms of total volume, it would appear that merger activity is stalling somewhat. In 2010, Schwab's database tracked 70 transactions valued collectively at $62.7 billion in assets under management. For the first three quarters of 2011, it counted 44 deals representing $37.7 billion worth of assets.

This scarcity of external capital creates a problem if an advisory business hopes to cash out part of its position in the new business. Instead, the advisor may have to simply swap equity. As with most small businesses in the current lending environment, financing sources may or may not be available. And even when they are, the cost of borrowing is frequently unattractive.

But there are many types of transactions. When Kochis Fitz and First Quintile got together in 2008 to form Aspiriant, it was "a true merger," says CEO Rob Francais. With the goal of creating a coast-to-coast advisory firm, Aspiriant executives went to work establishing the organization they wanted to leverage, creating the client service offerings, compensation structures and governance model that could take the new entity to the next level.

Two years later, Aspiriant bought Deloitte Investment Advisors from Deloitte Tax in July 2010. Deloitte was forced to sell its advisory arm largely for regulatory reasons. Though Francais refuses to disclose the terms of the transaction, reports are that Deloitte originally asked for $25 million to $30 million, but that Aspiriant emerged as the winning bidder for $7 million.

For a firm looking for a national footprint, the deal made strategic sense. Some top principals at Aspiriant were Deloitte alumni—Francais himself had been a tax partner at the Big Four firm—so there was a cultural fit. Moreover, the Deloitte deal brought in about 40 new people, more than 30 of whom were client-facing. Deloitte had offices in six different Midwestern and Northeastern cities and Aspiriant had clients in 42 states, so the transaction made it easier to serve clients far away from the firm's San Francisco and Los Angeles offices.

The Deloitte deal was held out as an acquisition, but Francais says that in the way it was structured Aspiriant carved out about half the deal as a management buyout, permitting 12 former Deloitte advisors to become Aspiriant principals.

"We don't really believe in acquisitions," Francais says, adding that most future transactions are likely to be "fold-ins." He expects to do another transaction "when we feel we are one firm again." Although Francais says they are 75% to 80% of the way there, the "last 20% takes the longest" because of the education process.

Currently, Aspiriant has 120 employees, including 42 partners. As Francais sees it, there are two primary goals behind its desire to grow the business. The first is to create an environment where the client experience endures long after the founders have retired. The second goal is to generate the scale so that retiring partners can sell out at a higher multiple.

Whatever the actual price was, the Aspiriant-Deloitte transaction was the kind of major deal that required external capital. Aspiriant made sure to mention that Schwab Advisor Services was one of the lenders in its ADV. Some, though not all, the terms of the loans were spelled out. For instance, the ADV mentions that Aspiriant agreed to retain Schwab as its custodian for at least $3.75 billion of its $7 billion or so in assets under management.

Going forward, Francais acknowledges that Aspiriant may seek capital from a variety of sources for future acquisitions. "I expect to because there are firms out there that are good firms that don't do succession planning," he says. "That should be expected with thousands of RIAs out there."

Obtaining financing from a vendor could prove to be the best, most cost-effective avenue for an RIA, but advisors also need to avoid potential conflicts of interest. Many custodians have long-established relationships with advisory firms and it clearly is in the custodians' own interest to help these firms grow. Furthermore, as the average age of advisors keeps rising, custodians don't want to lose assets, so they have additional incentives to facilitate deals among their clientele. Advisors also have to be careful not to cross ethical lines. "We would not provide financing to an RIA if that was the only reason they selected Pershing as a custodian," says Pershing Advisor Solutions CEO Mark Tibergien. "The reason is because that would be 'tying,' which is a violation of banking rules. It also skates the edge of the fiduciary standard, since the purpose of the financing would not be to the benefit of the client."

That said, Pershing would consider financing an RIA transaction if the advisory business selected Pershing as a custodian because the advisor favored Pershing's value proposition "vis-a-vis our competitors," Tibergien adds. Needless to say, Pershing would also have to properly vet the transaction like any other loan and closely analyze the risk parameters and viability of the deal.

"Advisors seeking money for acquisitions need to be careful that their lender doesn't have more invested in the enterprise than they do, and that they have sufficient collateral to repay the loan if things go sour, and that the deal makes cash flow sense. Unfortunately, many who seek outside capital and request funding do so because none of the conditions exist," Tibergien warns.

Officials at Schwab won't talk about specific transactions, but they acknowledge they are interested in facilitating transactions. "Capital can be a challenge," says David DeVoe, managing director and head of M&A services at Schwab. "Schwab and others are looking to connect advisors with a variety of options."

Like Tibergien and DeVoe, Fidelity Investments' CEO of custodial services, Mike Durbin, acknowledged that Fidelity will finance certain transactions. Currently, TD Ameritrade Institutional refers advisors to **ECHELON Partners**, an investment bank, but CEO Tom Bradley says the custodian will unveil its own acquisition finance program in the next few months. Since the firm is 45%-owned by Toronto-based TD Bank, it could be the best-positioned custodian to finance RIA transactions.

But experts in the M&A space say that financing is rarely a major deal-breaker.

According to DeVoe, firm culture and the lack of a fit typically torpedo most courtships when advisors start heading to the altar. All too often, this happens way too late in the game.

DeVoe thinks advisors could save themselves a lot of time and emotional capital by addressing the deal-killers at the outset. He estimates that only one out of five or six courtships get consummated.

"What do they have to have? Is it a certain valuation or that several employees have to keep their jobs for several years?" DeVoe asks. Ask questions about how each firm works with clients during a market downturn or how it deals with an employee who isn't performing, he adds.

In the end, it's about more than money.

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