

RIA BUYERS AND SELLERS ARE GROWING WISER

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Experienced players at the Deals and Deal Makers Summit 2015 reveal the art of the transaction

Do you wish to strike a deal for your firm? What sort of deal is best for you? Do you know your firm's value? Some people still believe that firm valuation centers on gross revenues. I recently participated in the **annual Deals and Deal Makers Summit, hosted by Echelon Partners**, where I learned that such a simplistic formula ignores market and economic reality. Advisory firms today have access to multiple ways of achieving liquidity, buying a stake in the business and obtaining financing for growth.

This year's event yielded four big conclusions among many very good ideas:

1. Size matters when it comes to pricing a deal.
2. Sharing the economics between buyer and seller ensures a better deal for both.
3. Business model impacts value.
4. Consider the pros and cons of going public.

SIZE MATTERS

Conference host Dan Seivert, founder of Echelon Partners, shared the components that determine an advisory firm's value: free cash flow, risk and growth.

Firms often use Earnings Before Interest, Tax, Depreciation and Amortization (EBITDA) instead of free cash flow, which has a more specific definition, but the key measurement must reveal the bottom line after revenue is generated and expenses are paid, including fair compensation to the owners.

Size matters. Large firms have the ability to spin out more cash flow than smaller firms for several reasons: Often they have pricing power; they attract larger, more profitable clients; they have a more leveraged and productive business structure; and they have the capacity to take in more clients. Further, the operating expenses of larger firms drop precipitously. On the small end of the scale, a typical advisor could spend as much as 45 cents of every dollar on overhead like rent, utilities, administrative staff, marketing and compliance. The best performing large firms with over \$1 billion of AUM often get their expense ratio down to 30% of revenue. These advantages positively impact the bottom line, both in absolute terms and as a percentage of revenue. Having a larger number to which one can apply an appropriate capitalization rate results in higher value.

In addition to free cash flow, metrics around risk and growth contribute to firm valuation. Firm size impacts these two key elements as well.

Thinking of risk in terms of what could imperil an advisory firm's ability to function or grow, large firms are able to withstand the loss of a major client or a key employee better than a small firm. Further, large firms tend to be professionally managed and are more likely to have a command and control structure that provides a degree of oversight to individual activity.

On the growth side, large firms tend to grow faster than smaller firms. They have a greater market presence, an enhanced marketing budget, more points of contact, a managed discipline around business development and service, and a greater capacity to take on more complex clients.

All other things being equal, these three elements — cash flow, risk and growth — tend to favor large firms over small. Is your firm where you want and need it to be in order to take the next step?

SHARING ECONOMICS

Both parties in a deal should contribute something of value to the other. Buyer and seller must decide whether the combination of the two businesses will result in better economics and a higher combined worth. If the answer is yes, and both parties are contributing something of value, then why shouldn't both benefit? Deals are becoming more complex and nuanced in structure.

Well-managed mergers typically help both parties reduce expenses by eliminating redundancies. They also create marketing synergies, with all advisors benefitting from multiple points of contact. Ideally, the combined firms also experience productivity gains unachievable as smaller entities. These combined factors result in higher positive cash flow.

In today's deal making environment, more money is pursuing sellers than ever before, giving practice owners leverage to negotiate. Very few deals are paid as cash and many include performance clauses that result in more money paid out to the seller. While no absolute formula dictates how much of the economics a buyer should share with the seller, the advantage almost always goes to the selling firm; it would be near impossible for a buyer not to share some of those gains with the owners of the other firm.

BUSINESS MODEL IMPACT

The business model also impacts firm valuation. Advisory businesses are more valuable than transactional businesses because they have a more consistent, predictable income stream. Wealth management firms tend to be more valuable than investment management firms because they have deeper client relationships that aren't dependent on investment performance.

The most compelling component of the business model is firm structure. In traditional advisory firms, as in the brokerage model, each individual has his or her own book of business, support staff and way of doing things. Advisors leverage some central resources like administration, research and sometimes even investment management, but still operate as silos. From a merger and acquisition standpoint, this model falls short; for all intents and purposes, the firm includes multiple lines of business with separate subcultures.

The most valuable models are ensembles, and are organized around a common vision, a consistent process and a commitment to the same outcome. Ensembles tend to be much more efficient and effective in running the business and serving their clients.

IS PUBLIC OWNERSHIP PRACTICAL?

Businesses go public for two primary reasons: to raise capital or to provide liquidity to the majority shareholders.

Advisory firms rarely need this type of capital unless they plan to acquire other firms or expand geographically. Most firms use bank debt to access cash, a far less expensive solution than giving up ownership and less burdensome than operating as a publicly held entity.

Liquidity is a legitimate consideration for many. Bear in mind, however, that in order to be compelling as a publicly traded company, the market wants to see a minimum of \$500 million in market capitalization and preferably closer to \$1 billion. Assuming a multiple of 10 on an advisory firm that generates a net profit of 25%, this requires a revenue base of \$400 million in order to get to the high end of the IPO range. While that may be possible one day, the more likely candidates for such a scenario would be large consolidators such as Focus Financial or active recruiters such as HighTower.

Yes, a firm could go public at a lower market capitalization — but would it be worth the hassle of complying with the rules of being public, including quarterly statements and regular disclosures, plus the effort it would require to remain interesting to investors? Advisory firms don't lend themselves well to passive shareholders. Much would have to be given to investors and profits likely would not be distributed to key people as they are today.

As the business of financial advice becomes more complicated, and the opportunities for growth through mergers and acquisitions become more real, we expect to see greater sophistication in deal structures. This presents an interesting parallel to the advisory business. When individual financial lives become more complex and daunting, investors seek out professional advice. At this point, however, most advisors rely on lawyers and attorneys to test and document their plans. The need for professional help portends a whole new segment of growth for the industry — investment bankers who focus on helping advisory firms manage through their evolution and ultimately to the transition of ownership.

Just as you advise your clients, plan ahead! If you are contemplating the end, don't start planning when you only have a year to go.
