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BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Purchase Price Allocations for RIAs

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PURCHASE PRICE ALLOCATIONS

There's been a great deal of interest in RIA acquisitions in recent years from a diverse group of buyers ranging from consolidators, other RIAs, banks, diversified financial services companies, and private equity. These acquirers have been drawn to RIA acquisitions due to the high margins, recurring revenue, low capital needs, and sticky client bases that RIAs often offer. Following these transactions, acquirers are generally required under accounting standards to perform what is known as a purchase price allocation, or PPA. In this whitepaper, we describe the PPA process, including attributes unique to the investment management industry.

INTRODUCTION

Purchase price allocation is a critical step in the transaction reporting process under ASC 805. Future amortization expense, changes in the fair value of earnout liabilities, and even goodwill impairment testing all depend on the outcome of the initial allocation. A purchase price allocation is, as the name suggests, an allocation of the purchase price paid for an acquired business among the acquired tangible and separately-identifiable intangible assets. The excess of the purchase price over these assets is residual goodwill. The following figure notes that the acquired assets are measured at fair value.

	Value of Total Assets *(Implied by the transaction)*
-	Fair Value of Tangible Assets *(Measured at the transaction date)*
-	Fair Value of Intangible Assets *(Measured at the transaction date)*
=	**Residual Goodwill**

The initial allocation of transaction consideration among the various assets is important because certain assets are depreciated, others amortized, and other items (like contingent consideration) are remeasured at fair value in subsequent periods.

Deal Structure and Consideration for Asset and Wealth Manager Transactions

Transaction structures involving RIAs can vary from relatively straightforward asset purchases to more complex stock acquisitions. While the transaction structure itself would not dictate which intangible assets should be recognized, the structure of a deal (e.g., taxable vs. non-taxable) could influence the fair values of the assets acquired. Purchase agreements may include balance sheet adjustments, client consent thresholds, complex earnout provisions, and specific requirements that interact with other documents like buy-sell agreements. Asset and wealth management firms are unique entities with value attributed to several metrics (assets under management, management fee revenue, realized fees, profit margins, etc.). Understanding how the general industry characteristics and those attributable to a specific firm influence the values of acquired assets in these transactions is important.

Deal consideration might include cash, notes, equity (rollover or otherwise), options, warrants, contingent consideration (or earnouts), and deferred consideration. Most of these forms of payment are self-explanatory, but we find that rollover equity and earnout consideration can be particularly nuanced, so we provide an overview below.

Equity Consideration

In the context of a business combination, equity consideration typically refers to rollover equity, which is equity in the newly combined business. In the RIA industry, rollover equity has become **more popular** as a component of deal consideration. The benefits of rollover equity, from the acquirer's perspective, are twofold: 1) rollover equity helps align the interests of the acquired employees with the acquirer's business, and 2) rollover equity, like contingent consideration, offers downside protection compared to

cash consideration. Advantages of rollover equity from the acquiree's perspective include the satisfaction of continued ownership in the operations they manage and the opportunity to increase the value of their stock holdings alongside the acquirer. After all, investment management is an **owner-operated** business, and converting from "owner" to "employee" may feel like a demotion to some, even when accompanied by a multi-million-dollar payout.

Equity consideration may also include replacement of the acquiree's share-based payment awards with those of the acquirer. Depending on the exact nature of each party's share award contracts, this item may impact the value of the consideration.

Contingent Consideration & Earnouts

Earnouts are a **key provision** in most RIA transactions. We often see earnouts structured into a deal as a mechanism for bridging the gap between the price the acquirer wants to pay and the price the seller wants to receive. Earnout payments can be based on any metric agreed upon by the parties, such as asset retention, fee revenue growth, or new revenue generation from additional clients, assets, and product offerings. Structuring a portion of the total purchase consideration as an earnout provides some downside protection for the acquirer while rewarding the seller for meeting or exceeding growth expectations.

Earnout arrangements represent a contingent liability for the acquirer that must be recorded at fair value on the acquisition date. Depending on the term of the earnout and the reporting requirements of the acquirer, the earnout liability may need to be remeasured quarterly or annually, with changes in the liability flowing through the income statement. When these liability changes are significant, they can introduce added volatility to an acquirer's earnings.

Common Intangible Assets

Because most investment managers are not asset-intensive, most value is typically allocated to intangible assets. Common intangible assets acquired in purchasing private asset and wealth management firms include the existing customer relationships, tradenames, non-competition agreements with executives, and the assembled workforce.

The AICPA's recently issued draft *Accounting and Valuation Guide on Business Combinations* **provides** guidance on the valuation of intangible assets. An overview of some of the more common intangible assets is provided below.

Customer-Related Intangible Assets

Customer-related intangible assets ("CRIAs") may include, for example, customer lists, order or production backlog, customer contracts and related customer relationships, noncontractual customer relationships, and customer loyalty programs.

In our experience, the most common CRIA is customer relationships, whether contractual or noncontractual. Generally, the value of existing customer relationships is based on the revenue and profitability expected to be generated by existing accounts, factoring in an expectation of annual account attrition. Attrition is often estimated using historical client data, prospective characteristics, or industry churn/attrition rates.

Due to their long-term nature, relatively low attrition rates, and importance as a driver of revenue in the asset and wealth management industries, customer relationships often command a relatively high portion of the allocated value. We can see this in the public filings of RIA aggregator Focus Financial (which was taken private in 2023). Between 2018 and 2022, Focus completed 125 acquisitions of RIAs. Of the aggregate allocated consideration for these transactions, about 51% was allocated to customer relationships. Most of the remainder (about 48%) was allocated to goodwill.

	Focus Financial Allocations					
	2018	2019	2020	2021	2022	Aggregate 2018-22
Goodwill	$347,496	$229,799	$160,341	$677,195	$249,677	$1,664,508
Customer Relationships	294,785	349,447	215,686	616,283	287,172	1,763,373
Other	11,334	15,374	(1,561)	14,670	10,428	50,245
Total Allocated Consideration	$653,615	$594,620	$374,466	$1,308,148	$547,277	$3,478,126
Goodwill	53%	39%	43%	52%	46%	48%
Customer Relationships	45%	59%	58%	47%	52%	51%
Other	2%	3%	0%	1%	2%	1%
Total Allocated Consideration	100%	100%	100%	100%	100%	100%
Number of Acquisitions	19	31	21	36	18	125

Source: Form 10-K SEC Filings

Tradename

Tradenames (or trademarks) are words, names, symbols, or other devices used in trade to indicate the source of a product and to distinguish it from the products of others. The fair value of a tradename in a business combination should reflect the perspective and expected use of the name by a market participant, not necessarily the subject acquirer. Some acquirers might expect to use the acquired firm's name into perpetuity or only use it during a transition period, as the acquired firm's services are brought under the acquirer's name. This decision can depend on many factors, including the acquired firm's reputation within a specific market, the acquirer's desire to bring its services under a single name, and the ease of transitioning the asset/wealth manager's existing client base. In any event, for most relatively successful small-to-medium-sized RIAs, the tradename has some positive recognition among the customer base and in the local market. Still, it typically lacks the "brand name" recognition that would give rise to significant tradename value.

Generally, tradename value can be derived with reference to the hypothetical royalty costs avoided through ownership of the name. A royalty rate is often estimated through analysis of comparable transactions and an analysis of the characteristics of the individual firm's name. The present value of cost savings achieved by owning rather than licensing the name over the future use period provides a measure of the tradename value.

Noncompetition agreements

In many asset and wealth management firms, a few top executives or managers may account for a large portion of new client generation. Deals involving such firms will typically include non-competition and non-solicitation agreements that limit the potential damage to the company's client and employee bases if such individuals were to leave.

These agreements often prohibit the covered individuals from soliciting business from existing clients or recruiting current company employees. In the agreements we've observed, a restricted period of two to five years is common. In certain situations, the agreement may also restrict the individuals from starting or working for a competing firm within the same market. The value attributable to a non-competition agreement is derived from the expected impact of competition from the covered individuals on the firm's cash flow and the likelihood of those individuals competing in the absence of an agreement. Factors driving the likelihood of competition include the age of the covered individual and whether or not the covered individual has other incentives not to compete aside from the legal agreement. For example, if the individual is a beneficiary of an earnout agreement or received equity in the acquirer as part of the deal, the probability of competition may be significantly lessened.

Recently, the FTC has moved to place **restrictions** on non-competition agreements and, in most cases, disallow them. However, non-competition agreements arising in connection with a transaction would most likely still be enforceable and, thus, hold value.

Technology (Patented and Unpatented)

Technology-based intangible assets may include software, databases, license agreements, patents, know-how, or trade secrets. To be allocated value, technology assets must generally be separable, documentable, transferable, or otherwise distinguishable from other acquired assets.

Technology assets are typically allocated value based on the cash flow or revenue stream the asset is expected to generate over its useful life. The fair value of a technology-based asset would consider the existing functionality of the technology, anticipated market demand, and functional/economic obsolescence of the existing technology.

In-Process Research and Development Assets (IPR&D)

Intangible assets used in research and development activities acquired in a business combination are initially recognized at fair value and classified as indefinite-lived assets until completion or abandonment. IPR&D is typically valued using the income approach. In certain circumstances, the cost approach may be applied instead, depending on the stage of development. In subsequent periods, an IPR&D asset would be subject to periodic impairment testing. Upon completion or abandonment of the R&D efforts, the acquirer would reassess the useful life of the indefinite-lived intangible asset.

In our experience, asset and wealth management firms do not typically invest in research and development, so IPR&D assets may not be applicable.

Operating Rights

Operating rights are legal rights necessary to operate a business. Key characteristics of operating rights include regulations governing access, use, and transfer of the asset, as well as scarcity of the asset. Operating rights include commercial franchise agreements, government-granted broadcast licenses or taxi medallions, and government-granted monopoly rights. Operating rights are typically valued using the income approach. In certain industries, operating rights may comprise a significant portion of the fair value in a purchase price allocation because of the legal necessity to possess such rights in order to operate the subject business, as well as their scarcity. In the case of RIAs, SEC approval to offer certain financial products may constitute an operating rights asset.

Assembled Workforce

In general, the value of the assembled workforce is a function of the avoided hiring and assembly costs associated with finding and training new talent. However, in relationship-based industries like asset and wealth management, getting a new portfolio manager or advisor up to speed can include months of networking, building a client base, and learning the firm's operations. The ability of employees to establish and maintain these client networks can be a key factor in a firm's ability to find, retain, and grow its business. An existing employee base with market knowledge, strong client relationships, and an existing network may suggest a higher value allocation to the assembled workforce. Unlike the other intangible assets previously discussed, the assembled workforce value is not recognized or reported separately but instead is included as an element of goodwill under GAAP. The value of an assembled workforce is commonly recognized as a supporting (or contributory) asset to other, more pivotal intangible assets in a transaction (such as customer relationships or technology).

Goodwill

Goodwill arises in a transaction as the difference between the price paid for a company and the value of its identifiable assets (tangible and intangible). Expectations of synergies, strategic market location, and access to a particular industry niche are common examples of the factors that contribute to residual goodwill value. Generally speaking, the higher the price paid in a transaction (relative to other bidders or the prevailing "market" price in the industry), the more goodwill will be recorded.

Allocation to goodwill is ultimately calculated based on the unique factors pertaining to each transaction. Goodwill allocation trends may vary both between and within industries. For example, Mercer Capital's Energy Team's **2024 Energy PPA Study** found that the percentage of consideration allocated to goodwill varied between oilfield services companies and midstream companies. In the RIA industry, based on internal data, we have historically seen goodwill encompass roughly half of deal consideration on average, although allocations can vary significantly based on specific facts and circumstances.

Goodwill must be tested for impairment under **certain circumstances**, such as changes in the macroeconomic environment or in firm-specific metrics. The accounting guidance in ASC 350 prescribes that interim goodwill impairment tests may be necessary in the case of certain "triggering" events.

For public companies, perhaps the most easily observable triggering event is a decline in stock price, but other factors may constitute a triggering event. Further, these factors apply to both public and private companies, even those private companies that have previously elected to amortize goodwill under ASU 2017-04.

The PPA Process

General Guidance

While every acquisition will present different circumstances that will impact the purchase price allocation process, there are a few general rules common to all properly prepared reports. From a qualitative standpoint, a purchase price allocation report should satisfy three conditions:

1. The report should be well-documented. As a general rule, the reviewer of the purchase price allocation should be able to follow the allocation process step-by-step. Supporting documentation used by the valuation specialist in the determination of value should be clearly listed and the report narrative should be sufficiently detailed so that the methods used in the allocation can be understood.

2. The report should demonstrate that the valuation specialist is knowledgeable of all relevant facts and circumstances pertaining to the acquisition. If a valuation specialist is not aware of pertinent facts related to the company or transaction, he or she will be unable to provide a reasonable purchase price allocation. If the report does not demonstrate this knowledge, the reviewer of the report will be unable to rely on the allocation.

3. The report should make sense. A purchase price allocation report will not make sense if it describes an unsound valuation process or if it describes a reasonable valuation process in an abbreviated, ambiguous, or dense manner. Rather, the report should be written in clear language and reflect the economic reality of the acquisition (within the bounds of fair value accounting rules).

This can be particularly daunting if the reviewer of the purchase price allocation report does not have significant experience working with RIAs. Unique factors surrounding the RIA industry can lead to a lack of understanding among purchase price allocation report reviewers that lack a deep industry background.

Definition of Assignment

A purchase price allocation report should include a clear definition of the valuation assignment. For a purchase price allocation, the assignment definition should include:

- Objective. The definition of the valuation objective should specify the client, the acquired business, and the intangible assets to be valued.

- Purpose. The purpose explains why the valuation specialist was retained. Typically, a purchase price allocation is completed to comply with GAAP financial reporting rules.

- Effective Date. The effective date of the purchase price allocation is typically the closing date of the acquisition.
- Standard of Value. The standard of value specifies the definition of value used in the purchase price allocation. If the valuation is being conducted for financial reporting purposes, the standard of value will generally be fair value as defined in ASC 820.
- Statement of Scope and Limitations. Most valuation standards of practice require such statements that clearly delineate the information relied upon and specify what the valuation does and does not purport to do.

Background Information

The purchase price allocation report should demonstrate that the valuation specialist has a thorough understanding of the acquired business, the intangible assets to be valued, the company's historical financial performance, and the transaction giving rise to the purchase price allocation.

Understanding of the Business

The purchase price allocation report should include a discussion related to the acquired company which demonstrates that the valuation specialist is knowledgeable of the company and has conducted due diligence for the valuation. The overview should also discuss any characteristics of the company that play a material role in the valuation process. The description should include discussion related to the history and structure of the company, the competitive environment, and key operational considerations.

In the case of acquisitions within the RIA industry, the pertinent facts include a thorough understanding as to the demand for the subject company's services within the target market. Unlike many other industries, RIAs may provide services which, at first glance, are very similar to services offered by competitors, but the specific fund strategies offered, investment team experience, and distribution strategy have a material impact on the way the RIA operates. Therefore, expectations regarding the specific fund strategies may be of much greater importance than expectations for the overall RIA industry. For example, although trust companies, financial planners, and venture capital managers may all fall under the umbrella of the "investment management industry," the services offered by these companies are entirely different.

Potential Pitfalls and Best Practices for PPAs

What are some of the pitfalls in purchase price allocations?

Sometimes differences arise between expectations or estimates prior to the transaction and fair value measurements performed after the transaction. An example is **contingent consideration** arrangements. Estimates from the deal team's calculations could vary from the fair value of the corresponding liability measured and reported for GAAP purposes. This could create misunderstandings at the management or board level about the anticipated payments or the magnitude of future payment exposure.

Similarly, to the extent that amortization estimates are prepared prior to the transaction, any variance in the allocation of total transaction value to amortizable intangible assets and non-amortized, indefinite lived assets – be they identifiable intangible assets or goodwill – could also lead to different future EPS estimates for the acquirer.

How can I learn what intangible assets are commonly recognized in the RIA industry?

At Mercer Capital, we have prepared hundreds of purchase price allocations across numerous industries. We discuss these types of questions frequently with prospective and current RIA clients. One common method of answering this question is to review public filings of companies in the asset and wealth management industry to review their purchase price disclosures, as we did with Focus above. Many companies will disclose the types of intangible assets acquired, their relative values, and useful life estimates for various assets. These types of disclosures can be very helpful when planning for a purchase price allocation.

What are the benefits of looking at the allocation process early?

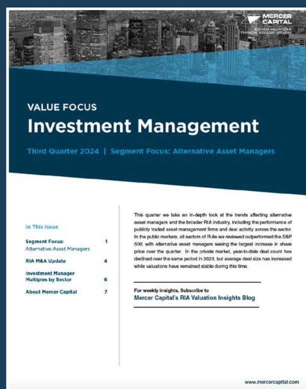
The opportunity to think through and talk about some of the unusual elements of the more involved transactions can be enormously helpful. We view the dialogue we have with clients when we prepare a preliminary PPA estimate prior to closing as a particularly important part of the project. It can also be helpful to hold a preliminary call with the valuation team and the external auditor to discuss the potential intangible assets in the deal, the anticipated valuation methods/approaches, and any unique circumstances. This deliberative process results in a more robust analysis that is easier for the external auditors to review, and thus better stands the test of time, requiring fewer true-ups or other adjustments in the future.

While ASC 805 permits companies up to one year to finalize and true-up the allocation, the time to begin estimating the accounting and financial impact from the intangible asset allocation is before a deal closes, not the week before the audit or quarterly filing is due.

CONCLUSION

The proper identification and allocation of value to intangible assets and the calculation of those asset fair values require both valuation expertise and knowledge of the subject industry. Mercer Capital's investment management valuation team brings these together with decades of experience serving the needs of RIAs. If your RIA has recently completed a transaction or is contemplating its next acquisition, call one of our professionals to discuss your valuation needs in confidence.

Stay Updated on How Current Events Are Affecting the Value of Your Firm



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VALUE FOCUS

Investment Management

Third Quarter 2024 | Segment Focus: Alternative Asset Managers

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This quarter we take an in-depth look at the trends affecting alternative asset managers and the broader RIA industry, including the performance of publicly traded asset management firms and deal activity across the sector. In the public markets, all sectors of RIAs we reviewed outperformed the *S&P 500*, with alternative asset managers seeing the largest increase in share price over the quarter. In the private market, year-to-date deal count has declined over the same period in 2023, but average deal size has increased while valuations have remained stable during this time.

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Value Focus: Investment Management Newsletter

The team produces a complimentary quarterly newsletter which contains an industry market overview, a review of recent transactions, and tracks multiples by industry sector.

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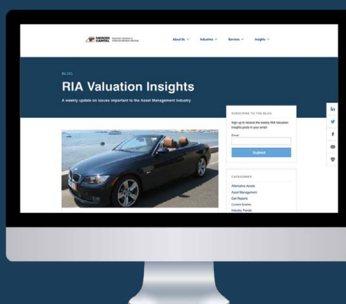

RIA Valuation Insights Blog

Mercer Capital's blog, *RIA Valuation Insights*, presents weekly updates on issues important to the investment management industry.

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ABOUT MERCER CAPITAL

Mercer Capital's investment management group provides valuation, transaction, litigation, and related services to a client base consisting of asset managers, wealth managers, independent trust companies, broker-dealers, PE firms and alternative managers, and related investment consultancies.

Mercer Capital provides a comprehensive suite of valuation and financial advisory services to meet your needs. Experience includes:

- Assisting RIAs and other asset managers with annual valuations, fairness opinions, and appraisals for gift and estate tax compliance
- Valuing start up managers with as little as $50 million in assets under management to established industry leaders managing over $400 billion
- Negotiating transactions involving asset managers from sell-side, buy-side, and mutually retained perspectives
- Providing expert witness testimony for purposes of shareholder disputes, commercial litigation, and marital dissolution
- Providing financial statement reporting services related to purchase price allocation and goodwill impairment testing

Mercer Capital's Investment Management industry group publishes research on the industry via its quarterly newsletter, ***Value Focus: The Investment Management Industry.*** The Group also writes about issues important to the industry on the ***RIA Valuation Insights*** blog.

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