MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

A VALUATION MAGAZINE FEATURING MERCER CAPITAL'S LATEST THINKING

VALUE ADDED™ 2019

Selling Your RIA to a Consolidator

Zachary W. Milam, CFA

As we explained in a recent post, there are many viable exit options for RIA principals when it comes to succession planning. In this post, we will review some of the considerations when partnering with an RIA consolidator.

The opportunity for consolidating wealth management firms is well publicized: an industry composed of many small, fragmented firms with aging ownership bases and no clear succession plans is supposedly poised for consolidation. RIA consolidators have emerged to capitalize on this landscape, promising a means for ownership transition, back-office efficiencies, and best practices coaching.

Consolidators have been gaining traction in the industry. Most well-known RIA consolidators have grown their AUM at double-digit growth rates over the last five years, and acquisitions by consolidators represent an increasing portion of deal volume in the sector.

For RIA principals that are looking for an exit plan, selling to a consolidator is one option to consider. A sale to a consolidator typically provides the selling partners with substantial liquidity at close, an ongoing interest in the economics of the firm, and a mechanism to transfer the sellers' continued interest to next generation management.

There are several considerations when considering a sale to an RIA consolidator. Price, of course, is the big one. But after the deal closes, the selling shareholders will typically have to stick around for several years at least (the deal terms will make sure of that). Thus, another important feature to consider is what life will look like after the deal closes. RIA owners who are considering selling to a consolidator should think carefully about which aspects of their business they feel strongly and how those aspects of the business will change after the deal closes.

Consolidator Models

There are several different consolidator models, and they can vary significantly in terms of the effect they have on the day-to-day operations of the acquired RIA. This is largely a function of the amount of integration that consolidators do for their partner firms.

At one extreme, there are consolidators such as Focus Financial that standardize only the minimum level of business processes across their acquired firms, which typically include back-office tasks such as compliance and accounting. This "stay as you are" model has minimal impact on how the firm is run and theoretically maintains the selling partners' sense of entrepreneurship. Acquired firms can retain their own branding and client-facing processes after the deal closes, and there is usually little or no impact from the perspective of the firm's clients. This model also mitigates the risk of culture clash since acquired firms aren't forced into a one-size-fits-all mold.

At the other extreme, there are consolidators like United Capital (now part of Goldman Sachs) or Mercer Advisors, which unify the branding of acquired firms and present a homogenous wealth management platform to clients. Under this model, most functions of the acquired RIA—things like marketing, HR, and technology—are moved under the corporate umbrella. Sellers have much less control after the deal closes under this model. Some sellers may see this as gaining freedom from the day-to-day management of their firms, but others may be reluctant to relinquish that much control.

Deal Pricing

The multiples paid by consolidators will vary depending on the current market environment, but they are generally competitive with other exit strategies. Different consolidator models can have characteristics that more closely resemble either a financial buyer or strategic buyer, and this classification can impact the multiple that the consolidator is able to pay.

Consolidators like Focus Financial, which make minimal changes to the acquired business, are best classified as financial buyers. Financial buyers purchase the business "as is", with few plans to make changes to the way the business operates beyond moving selected business functions to the corporate office. There may be some plans for expense reductions or revenue enhancement, but financial consolidators are unlikely to pay the buyer for those potential benefits.

Other consolidators can be considered strategic buyers. Companies like Mercer Advisors fall into this category. By making major changes to the way the acquired RIA operates, strategic consolidators have more opportunity to realize synergies and initiate growth-oriented strategic objectives. In theory, this gives strategic consolidators the ability to pay a higher multiple, but at a cost to the selling shareholders of giving up more control in how the business is run after the deal closes.

Deal Structure

Consolidators typically purchase 100% of RIAs, but that doesn't mean that they purchase 100% of the acquired firm's economics. RIAs are for the most part owner-operated businesses, so some portion of the acquired firm's earnings before owner compensation (EBOC) needs to be diverted to the selling shareholders in order to keep them around and align incentives after the close. For RIAs, it can be difficult to disentangle EBOC into returns to equity versus returns to labor. As a practical matter, the normalized or post-closing compensation for selling shareholders is a negotiating point when striking a deal with a consolidator.

The selling shareholders are likely to maintain an ongoing interest in the economics through earnouts, employment agreements, or other deal features. For example, Focus Financial structures its deals so that a portion of the acquired EBOC is directed to a newly established management company owned by the selling shareholders. Initially, this structure provides the selling shareholders with compensation that varies with the profitability of the firm. In the longer term, the management company equity can, in theory, be sold to the next generation of management when the selling shareholders retire.

Cash vs Stock Consideration

It's also worth noting that consolidators often use their own stock as part of the total consideration. For publicly traded companies like Focus Financial, it's clear exactly how much that's worth at any given time. For closely-held aggregators like Hightower and Captrust, their stock price is not readily apparent.

Even if the consolidator is publicly traded, you should be wary of any lock-up provisions since stock prices for these companies can be volatile.

Facilitating M&A

Another purported benefit of selling to a consolidator is that the acquired firm gains access to the consolidator's balance sheet to pursue its own acquisitions. The low cost of capital for consolidators can allow the acquired firms to complete their own acquisitions in a way that is still accretive to the selling shareholders.

Many partner firms of Focus Financial, for example, have completed their own acquisitions, and presumably, these deals make financial sense for the partner firm's principals. For firms that are considering inorganic growth, this aspect of a sale to a consolidator may be a key consideration.

Other Options

Selling to a consolidator is just one exit strategy among many, and RIA owners should carefully weigh the pros and cons selling to a consolidator relative to those of other exit strategies. In subsequent posts, we will discuss other viable exit options for RIA principals.