

# **Buy-Sell Agreements for Investment Management Firms**

An Ounce of Prevention Is Worth a Pound of Cure

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# Why This Matters to You

Your buy-sell is essential to managing the ownership of your business


**Every closely held  
business with multiple  
owners needs a functional  
buy-sell agreement**



To define the conditions which  
activate the agreement



To describe the valuation  
process or procedure to be used



To address the funding of the  
transaction

# Why This Matters to You

Shareholder agreements are particularly important to RIAs

## **RIAs Are Often Very Valuable**

Worth so much no one can afford to buy them

## **RIAs Are Typically Owned by Unrelated Parties**

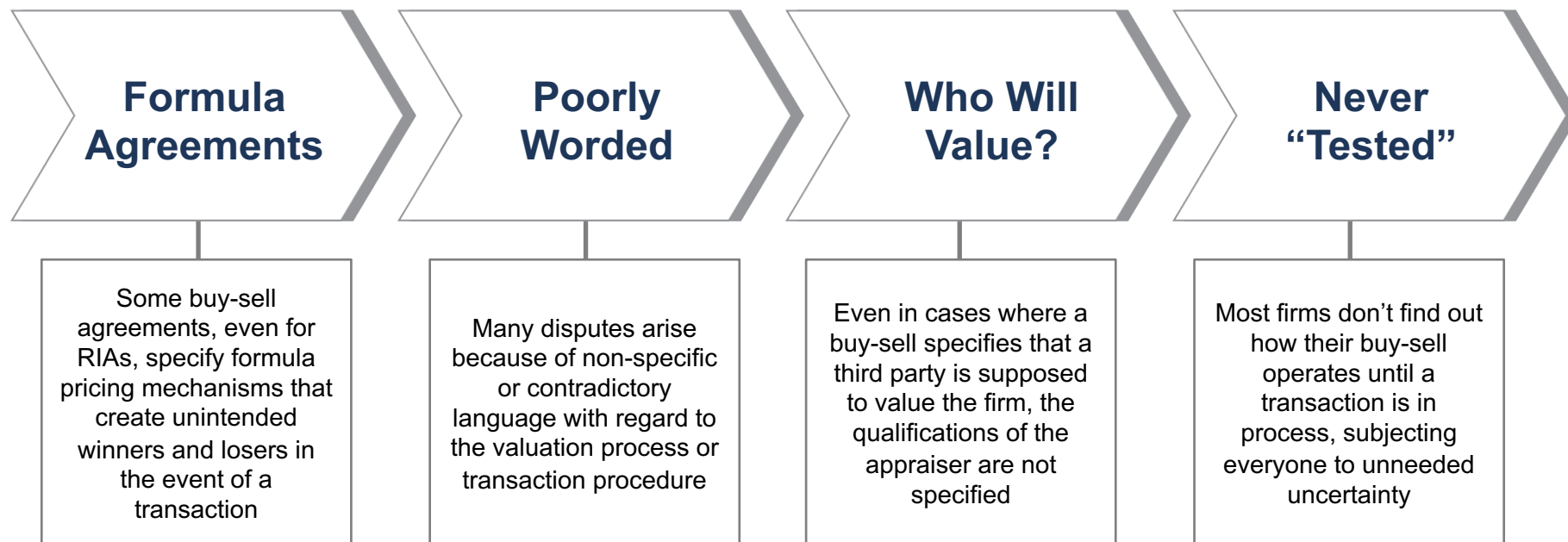
Most private companies are family businesses

## **RIAs Typically Tie Equity Participation to Employment**

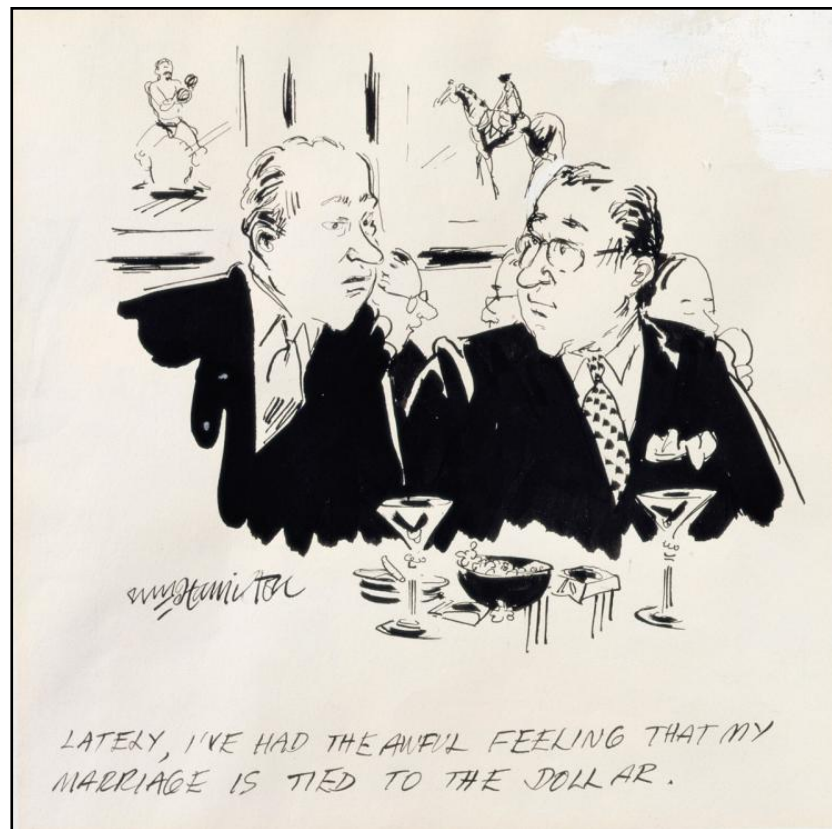
Passive ownership is difficult unless the scale is very large

# Why This Matters to You

Most RIA buy-sells are either out of date or otherwise inadequate



# Formula Agreements



# Why Not Use a Formula Agreement?

Don't RIAs "typically" sell for 2% of AUM?

	Firm A	Firm B
Assets Under Management	\$1,000,000,000	\$1,000,000,000
<b>x Realized Fees</b>	<b>0.65%</b>	<b>0.30%</b>
=Revenue / Management Fees	6,500,000	3,000,000
<b>x EBITDA Margin</b>	<b>40%</b>	<b>15%</b>
= EBITDA	2,600,000	450,000
Implied Value at 2% of AUM	\$20,000,000	\$20,000,000
<b>Effective Multiple of EBITDA</b>	<b>7.7x</b>	<b>44.4x</b>

# Formula Agreement Case Study

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Death of a founder

**Firm:** Mature \$2B RIA, mix of institutional and HNW clients

**Situation:** Founder dies unexpectedly holding 30% of common stock

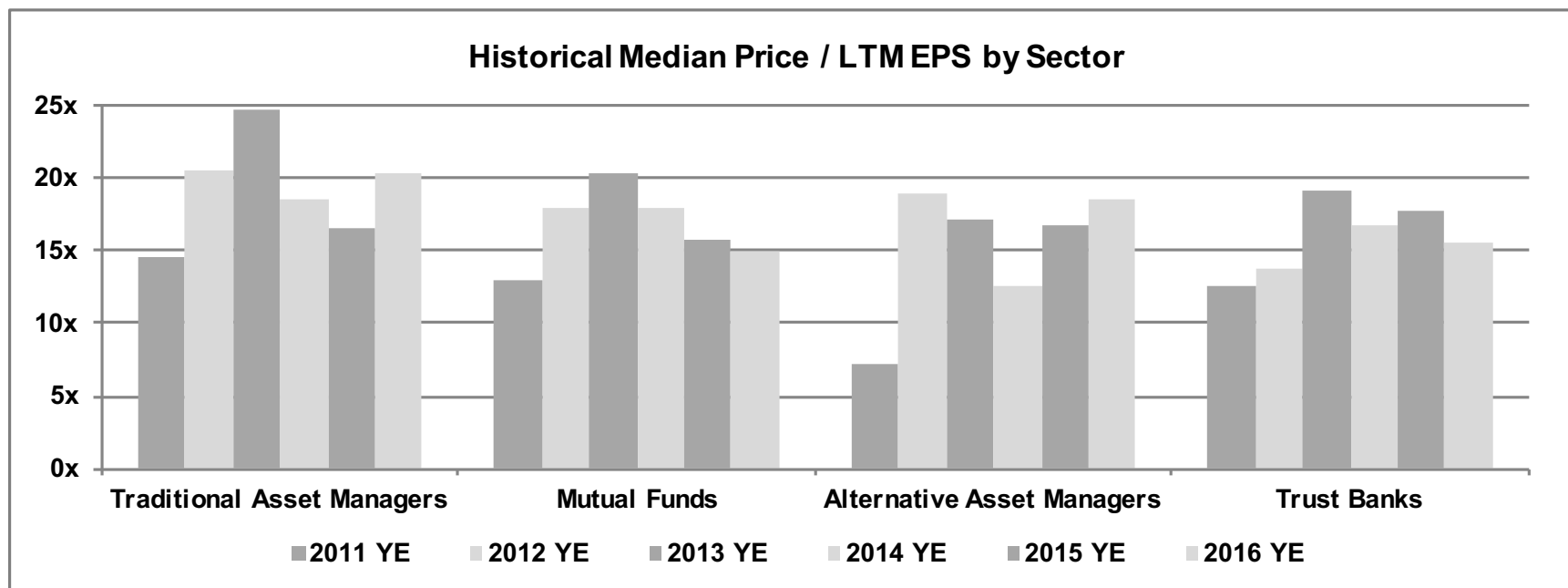
**Buy-Sell:** Specifies that estate shares be redeemed at pro rata value, prepared by formula and approved annually by the board

**Our Involvement:** Hired by the *estate* to ensure it was receiving adequate consideration pursuant to the buy-sell agreement

**Outcome:** Formula significantly overvalued founder shares, resulting in firm being obligated to pay about 50% of firm value for a 30% block. Fair to the estate, yes. But to the firm?

# Formulas Have Many Limitations

Advice: Specify a third party, independent valuation



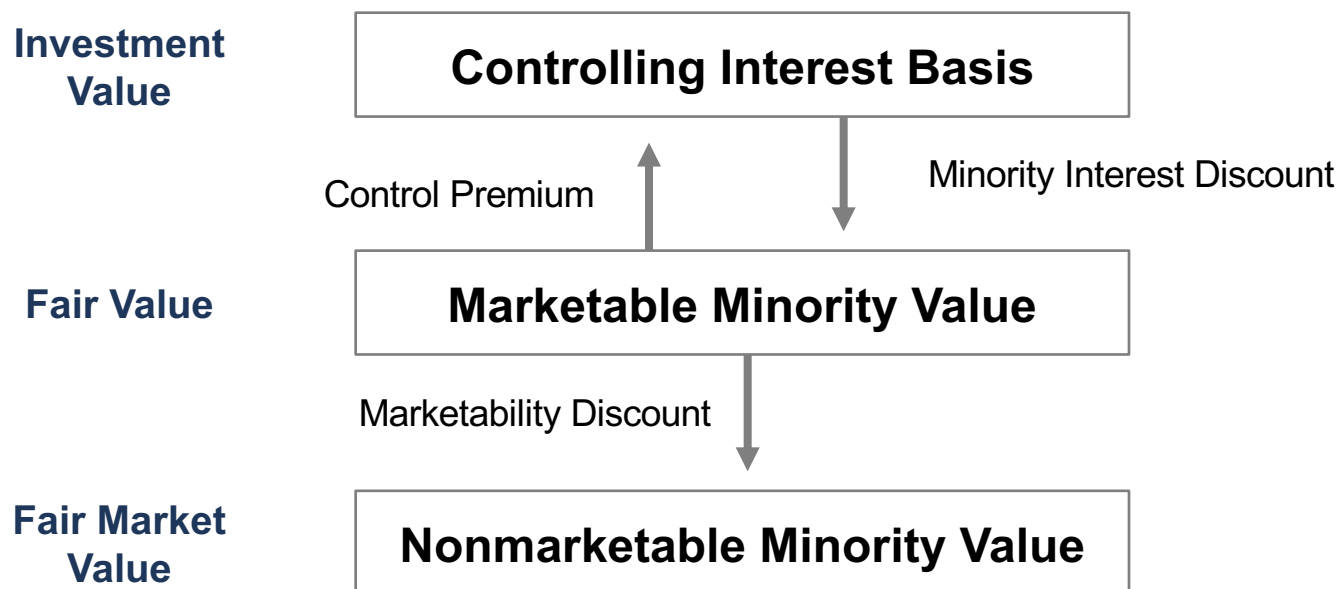


# Watch Your Language



# Why Language Matters

Standard of value often implies a certain “level” of value



# Watch Your Language Case Study

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Ambiguous terminology leads to costly arbitration

**Firm:** \$500 Million TrustCo, mostly HNW clients

**Situation:** ~40% shareholder acquires bank, triggering a forced sale of its interest in TrustCo. Debate over whether or not this invokes dissenter's rights

**Buy-Sell:** Such a “transfer by operation of the law” requires TrustCo to buy out shareholder at “fair market price” (undefined)

**Our Involvement:** Hired by shareholder to establish “fair market price” of subject interest in TrustCo

**Outcome:** Arbitration panel decides “fair market price” was the average of our valuation and the TrustCo's (expert) valuation

# Buy-Sell Agreement Specifics

<b>Business Name</b>	Usually obvious but needs to be defined for complex businesses with common ownership
<b>Business Interest Under Consideration</b>	Usually dictates level of value (50% or more is typically control while less than 50% is often nonmarketable minority)
<b>Standard of Value</b>	Needs to be specified (fair value, fair market value, etc.) and defined in the agreement
<b>Level of Value</b>	Agreement needs to be clear on whether or not discounts for lack of control and/or marketability are applicable to the subject interest
<b>Effective Date</b>	Especially important during volatile market conditions – often the day of or month/week preceding trigger event, but maybe later or as of some reporting period
<b>Type of Engagement</b>	Dictates the scope of work (calculations, limited appraisal, appraisal)

# Appraiser Qualifications



# Traditionally, There Are Two Kinds of Experts

## Industry Expert

- Regularly follows the industry
- Understands industry concepts and terminology
- Writes/speaks about industry trends
- Transactions experience
- Regularly provide advisory services to RIAs
- See the market as typical buyers and sellers of interests in RIAs

## Valuation Expert

- Appropriate training and professional designations
- Understanding of valuation standards and concepts
- Sees the market as hypothetical buyers and sellers
- Regularly values minority interests
- Advises on buy-sell agreements
- Defends work in litigated matters
- Handles recurring valuation work for other clients

# Qualifications Case Study

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Two bad valuations don't average to make a good one

**Firm:** Established \$1B wealth manager

**Situation:** Disabled partner forced out by others

**Buy-Sell:** Specifies that each party is to hire an appraiser and if the values were more than 10% apart, a third appraiser was to be hired to develop a binding conclusion of value

**Our Involvement:** Hired to be the third appraiser

**Outcome:** Exiting partner hired boutique I-banker who doesn't do appraisals. Firm hired CPA appraiser with no industry experience. Conclusions differed by a factor of eight. Our conclusion was somewhere in the middle, which didn't stop *six years of litigation over the issue*

# Qualifications Matter

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Specify a credentialed appraiser with adequate industry experience

## Professional Requirements

**CFA** credential from CFA Institute. Not an appraisal credential, per se, but at least indicates an appraiser has completed rigorous training in securities analysis relevant to the investment management industry. No continuing education required

**ASA** credential from American Society of Appraisers. 5 years experience, skills training and testing, ethics and valuation standards training. Requires continuing education

**ABV** credential from AICPA. Extensive training and education in valuation. No term of experience required. CPA pre-requisite. Requires continuing education

## Practical Requirements

The 20,000 or so RIAs, independent trust companies, unregistered investment companies, and consultants all have unique business models, but an industry specialist should have enough experience to understand the particular economics of a mutual fund sponsor as opposed to, say, a venture capital manager



# Qualifications Matter

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How to specify the choice of appraiser in your buy-sell

## Helpful

“An independent appraiser who is credentialed by a known professional business appraisal organization and who has experience in the valuation of investment management firms”

## Not Helpful

“Arthur Andersen”

# Checking on Your Buy-Sell for Value



# Checking on Your Buy-Sell for Value

Considerations in determining the cycle for updates

**So, How  
Frequently  
Should You Have  
Your Firm  
Valued?**

**Well...**

**How big is your RIA?**

**How many owners do you have?**

**Is your ownership held in a qualified plan?**

**Any outside (non-employee) shareholders?**

**How volatile is your AUM in aggregate?**

**How concentrated is your ownership?**

**How often do your shares transact?**

**Are you transitioning ownership?**

**How controversial is your value?**

# Case Study on the Wisdom of Testing a Buy-Sell

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With no appraisal history, value expectations can vary wildly

**Firm:** Platform sponsor with several startup RIAs, less than \$500MM aggregate AUM. Startup mode but with blue-chip founders who had previous success with a similar model

**Situation:** Buyout of former minority partner with >10% stake. Huge disparity in perspective over success and prospects for the business, importance of previous capital raises to value

**Buy-Sell:** Confusing as to valuation process in the event the parties couldn't agree on a value. Court ordered jointly retained appraisal process to resolve valuation issue

**Our Involvement:** Mutually retained appraiser pursuant to court order

**Outcome:** Lengthy and expensive appraisal process involving both parties and their attorneys, in which both sides had numerous opportunities to offer their perspective. Seven figure litigation over a six figure subject interest

# Testing Your Buy-Sell Agreement

...even if no one is buying or selling

## **The Appraisal Process is Valuable even if No Transaction is Pending**

The valuation “checks” the buy-sell for any irregularities or inconsistencies in the agreement

The valuation helps identify who would do the work in the event of a transaction

The valuation manages the expectations of the parties to the buy-sell as to the process and the outcome

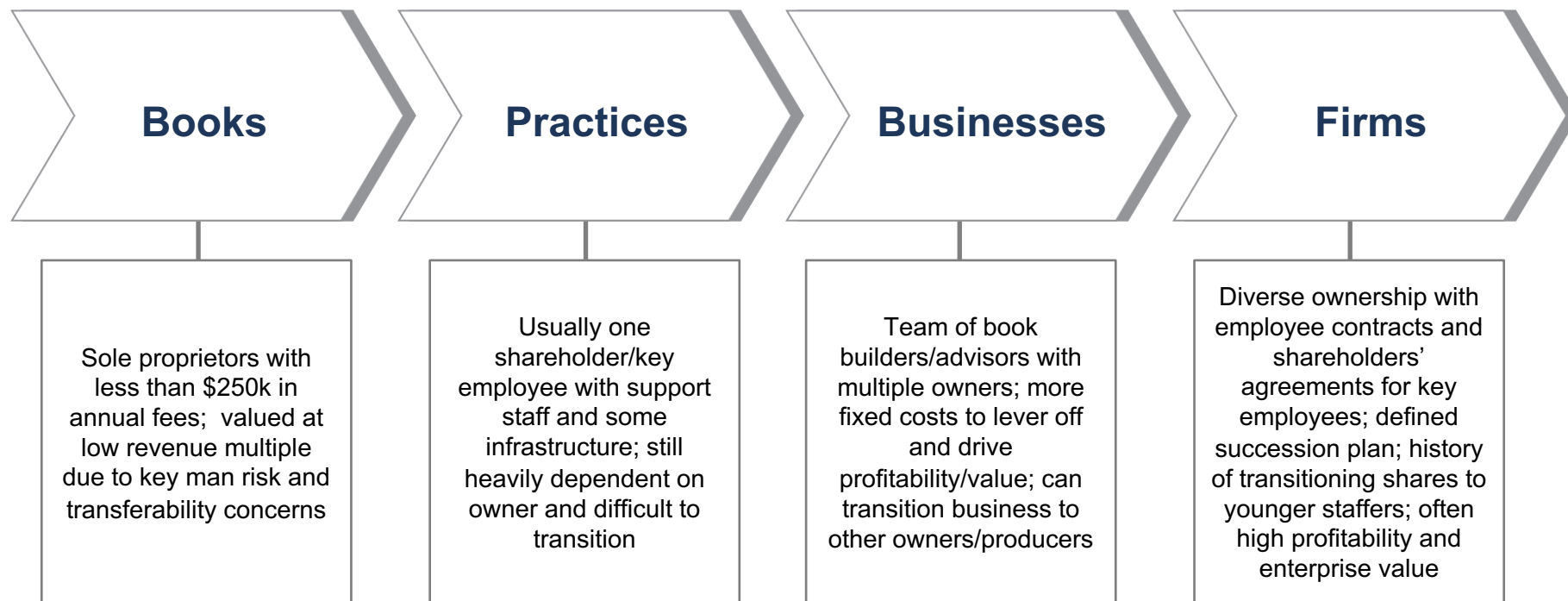
The valuation offers the opportunity to clear up language in the agreement or expectations in the minds of the parties when nothing is at stake

The appraisal can be a five-figure dress rehearsal to avoid a seven-figure argument in what might be the most momentous corporate issue your firm will ever face

# Ownership Transition & Sustainability



# Sustainability Drives Value



# Ownership Transition Case Study

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Information about value makes transition more smooth

**Firm:** \$2.5 billion RIA founded in late 1960s

**Situation:** Majority owned by outside shareholders and founders with no involvement in this business

**Buy-Sell:** Specifies that existing employees can buy in at value determined by an independent appraiser on an annual basis

**Our Involvement:** Hired to be annual appraiser

**Outcome:** Business transitioned from 70% owned by founders/outsider parties to 70% employee ownership in just a few years through steady stream of transactions between the ownership groups



# Questions?



# About the Speakers



**Matthew R. Crow, CFA, ASA**  
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**Matt Crow** is active in valuations related to asset management firms and also has broad industry experience in insurance, real estate investment ventures, and technology companies accumulated by working with hundreds of client companies during his tenure at Mercer Capital. Along with Brooks Hamner, Matt publishes research related to the asset management industry and is a regular contributor to Mercer Capital's blog, *RIA Valuation Insights*.

Matt provides corporate valuation services related to corporate planning and reorganization, transactions, employee stock ownership plans, and tax issues. He is also experienced in the valuation of intangible assets, options, and assets subject to specific contractual restrictions.



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**Brooks Hamner** is active in valuation work for asset management firms and has broad industry experience gained during his tenure with Mercer Capital. Along with Matt Crow, Brooks publishes research related to the asset management industry and is a regular contributor to Mercer Capital's blog regarding the asset management community, *RIA Valuation Insights*.

Circumstances giving rise to the engagements, Brooks is involved with include corporate planning, employee stock ownership plans, and estate and gift tax planning and compliance matters. In addition, he actively participates in projects in a litigated context.

# About Mercer Capital

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Mercer Capital provides asset managers, trust companies, and investment consultants across the nation with corporate valuation, financial reporting valuation, transaction advisory, portfolio valuation, and related services.

Mercer Capital is a full-service business valuation and financial advisory firm. We offer a broad range of services, including corporate valuation, financial institution valuation, financial reporting valuation, gift and estate tax valuation, M&A advisory, fairness opinions, ESOP and ERISA valuation services, and litigation and expert testimony consulting. We have provided thousands of valuation opinions for corporations of all sizes in a wide variety of industries.

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