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The Role of Earn-outs in Asset Management M&A

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Earn-outs are as common to investment management firm transactions as they are misunderstood.

Despite the relatively high level of financial sophistication among RIA buyers and sellers, and broad knowledge that substantial portions of value transacted depends on rewarding post-closing performance, contingent consideration remains a mystery to many industry M&A participants. Yet understanding earn-outs and the role they play in RIA deals is fundamental to understanding the value of these businesses, as well as how to represent oneself as a buyer or seller in a transaction.

This whitepaper is not offered as transaction advice or a legal primer on contingent consideration. The former is unique to individual needs in particular transactions, and the latter is beyond our expertise as financial advisors to the investment management industry. Instead, we offer this to explore the basic economics of contingent consideration and the role it plays in negotiating RIA transactions.

Earn-outs are Fundamental to RIA Transactions

As the saying goes (which has been attributed to at least a dozen famous figures), it's difficult to make predictions, especially about the future. This reality is the single most difficult part of negotiating a transaction in the investment management industry. The value of an RIA acquisition target is subject not only to a large number of variables but also a wide range of possible outcomes:

1. Performance of financial markets (standard deviation varies)
2. Skill of the investment management staff (difficult to measure)
3. Sustainability of the acquired firm's fee schedule (not as much a given as in the past)
4. Retention of key staff at the acquired firm (absolutely necessary)
5. Retention of key staff at the acquiring firm (absolutely necessary)
6. Motivation of key staff (absolutely necessary)
7. Retention of client assets (depends on third-party behavior)
8. Marketing strength of the merged enterprise (tough to predict)

Without faith in the upward drift of financial markets, favorable margins in investment management, and the attractiveness of the recurring revenue model, no one would ascribe material value to an RIA. But actually buying an asset manager is making a bet on all of the above, and most people don't have the stomach.

Readers of this whitepaper understand that only by way of an earn-out can most investment management firm transactions overcome so much uncertainty. Nevertheless, in our experience, few industry executives have more than an elementary grasp of the role contingent consideration plays in an RIA transaction, the design of an earn-out agreement, and ultimately the impact that these pay-for-performance structures have on valuation.

If nothing else, earn-outs make for great stories. Some of them go well, and others go like this:

From Earn-out to Burn-out
ACME Private Buys Fictional Financial

On January 1, 20xx, ACME Private Capital announces it has agreed to purchase Fictional Financial, a wealth management firm with 50 advisors and $4.0 billion in AUM. Word gets out that ACME paid over $100 million for Fictional, including contingent consideration. The RIA community dives into the deal, figures Fictional earns a 25% to 30% margin on a fee schedule that is close to but not quite 100 basis points of AUM, and declares that ACME paid at least 10x EBITDA. A double-digit multiple brings other potential deals to ACME and crowns the sellers at Fictional as "shrewd." Headlines are divided as to whether Fictional was "well sold" or that ACME was showing "real commitment" to the

wealth management space, but either way the deal is lauded. The rest of the investment management world assume their firm is at least as good as Fictional, so they're probably worth 12x EBITDA. To the outside world, everybody associated with the deal is happy.

The reality is not quite so sanguine. ACME structures the deal to pay half of the transaction value up front with the rest to be paid based on profit growth at Fictional Financial in a three year earn-out. Disagreements after the deal closes cause a group of advisors to leave Fictional, and a market downturn further cuts into AUM. The inherent operating leverage of investment management causes profits to sink faster than revenue, and only one third of the earn-out is ultimately paid. In the end, Fictional Financial sold for about 6.5x EBITDA, much less than what the selling partners wanted for the business. Other potential acquisition targets are disappointed when ACME, stung with disappointment from the Fictional transaction, is not willing to offer them a double-digit multiple. ACME thought they had a platform opportunity in Fictional, but it turns out to be more of an investment cul-de-sac.

The market doesn't realize what went wrong, and ACME doesn't publish Fictional's financial performance. Ironically, the deal announcement sets the precedent for interpretation of the transaction, and industry observers and valuation analysts build an expectation that wealth management practices are worth about 10x EBITDA, because that's what they believe ACME paid for Fictional Financial.

Earn-outs and Transaction Strategy

We offer this transaction example to shed light on several issues presented by the use of earn-outs in RIA transactions.

Most post-deal performance doesn't get reported, other than AUM disclosures in public filings. If the acquired entity is folded into another RIA, you can't even judge a deal by that. Thus, we don't have comprehensive data on ultimate deal value in many investment management firm transactions. One example **we have reported previously on our blog, *RIA Valuation Insights***, was the disastrous post-transaction performance of Killen Group after it was acquired by Tri-State Capital. Killen missed by so much that it cut the total consideration paid by almost half and reduced the effective EBITDA multiple paid from nearly 11x to around 6x. Which multiple represents the real value of Killen? No doubt the buyer in this case, as in most others, would rather see the kind of performance that would justify paying the full earn-out, and the seller would obviously prefer that as well.

Sometimes bad deals can be saved by good markets, but that's not much of an acquisition strategy. As a consequence, earn-outs are the norm in RIA transactions, and anyone expecting to be on the buy-side or sell-side of a deal needs to have a better-than-working knowledge of them.

As noted above, RIA transactions usually feature earn-out payments as a substantial portion of total consideration because so much of the seller's value is bound up in post-closing performance. Just as the financial press never writes about periods of "heightened certainty," so too are buyers of RIAs justifiably concerned about the ongoing performance of their acquisition target after the ink dries on the purchase agreement.

Earn-outs (i.e. contingent consideration) perform the function of incentives for the seller and insurance for the buyer, preserving upside for the former and protecting against potential losses for the latter. In

investment manager transactions, they are both compensation, focusing on the performance of key individuals, and deal consideration, being allocated to the selling shareholders pro rata. Even though earn-out payments are triggered based on meeting performance metrics which are ultimately under the control of staff, they become part of overall deal consideration and frame the transaction value of the enterprise.

For all of these reasons, we view contingent consideration as a hybrid instrument, combining elements of equity consideration and compensation, and binding the future expectations of buyer and seller in a contractual understanding.

Earn-out Parameters

Contingent consideration makes deals possible that otherwise would not be. When a seller wants twice what a buyer is willing to pay, one way to mediate the different expectations is to pay part of the price up front (usually equal to the amount a buyer believes can safely be paid) and the remainder based on the post-closing performance of the business. In theory, earn-outs can simultaneously offer a buyer some downside protection in the event that the acquired business doesn't perform as advertised, and the seller can get paid for some of the upside he or she is foregoing by giving up ownership. While there is no one set of rules for structuring an earn-out, there are a few conceptual issues that can help anchor the negotiation.

1. Define the continuing business acquired that will be the subject of the earn-out.

Deciding what business's performance is to be measured after the closing is easy enough if an RIA is being acquired by, say, a bank that doesn't currently offer investment management services. In that case, the acquired company will likely operate as a stand-alone enterprise with division level financial statements that make measuring performance fairly easy.

If an RIA is being rolled into an existing (and similar) investment management platform, then keeping stand-alone records after the transaction closes may be difficult. Overhead allocations, staff additions and subtractions, expansion opportunities, and cross selling will all have some impact on the value of the acquired business to the acquirer. Often these issues are not foreseen or even considered until after the transaction closes. It then comes down to the personalities involved to "work it out" or be "fair." As a friend's father used to say: "fair is just another four letter word."

2. Determine the appropriate period for the earn-out.

We have seen earn-out periods (the term over which performance is measured and over which contingent consideration is paid) as short as one year and as long as five years. There is no magic period that fits all situations, but a term based on specific strategic considerations like proving out a business model, defining investment performance objectives, or the decision cycle of key clients are all reasons to develop an earn-out time frame.

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

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The buyer wants the term to be long enough to find out what the true transferred value of the business is, and the seller (who otherwise wants to be paid as quickly as possible) may want the earn-out term to be long enough to generate the performance that will achieve the maximum payment. Generally speaking, buyer-seller relations can get very strained during an earn-out measurement period, and after they're done, no one wishes the term had been any longer.

We tend to discourage terms for contingent consideration lasting longer than three years. In most cases, three years is plenty to "discover" the value of the acquired firm, organize a merged enterprise, and generate a reliable stream of returns for the buyer. If the measurement period is longer than three years, the "earn-out" starts to look more like bonus compensation, or some other kind of performance incentive to generate run-rate performance at the business. Earn-outs can be interactive with compensation plans for managers at an acquired enterprise, and buyers and sellers are well advised to consider the entirety of the financial relationship between the parties after the transaction, not just equity payments on a stand-alone basis.

3. Determine to what extent the buyer will assist or impede the seller's performance during the earn-out.

Did the buyer lure the seller in with promises of technology, products, back-office support, and marketing? Did the buyer promise the seller that they would be able to operate their business unit independently and without being micromanaged after the transaction? These are all great reasons for an investment management firm to agree to be absorbed by a larger platform, and they may also help determine whether or not the acquired firm meets performance objectives to get contingent consideration.

While bad deals can be saved by good markets, counting on false confirmation is not a sound deal strategy. Instead, buyers and sellers should think through their post-close working relationships well in advance of signing a deal, deciding who works for whom, under what circumstances, and what the particulars of their mutual obligations to shared success look like. If things don't go well after the transaction – and about half the time they don't – the first person who says "I thought you were going to…" didn't get the appropriate commitments from his or her counterparty on the front end.

4. Define what performance measurements will control the earn-out payments.

It is obvious that you will have to do this, but in our experience buyers and sellers don't always think through the optimal strategy for measuring post-closing performance.

Buyers, ultimately, want to see profit contributions from the seller, so some measure of cash flow is a natural way to pay for the kind of desired performance from an acquired investment management operation. There are at least two problems with this, however, which suggest maybe another performance metric would be more effective for the buyer (and the seller).

First, profitability is at the bottom of the P&L, and is therefore (potentially) subject to manipulation. To generate a dollar of profit at an RIA, you need some measure of client AUM, market performance, a fee schedule, investment management staff, office space, marketing expense, technology and compliance,

capital structure considerations, parent overhead allocations, and any number of other items, some of which may be outside of the sellers' control. Will the sellers accuse the buyer of impeding their success? Can the factors influencing that success all be sufficiently isolated and defined in an earn-out agreement? Arguments can start over the color of the logo. It's more difficult than it looks.

Second, much of the post-transaction profitability of the acquired business will depend on the returns of the financial markets, over which nobody has control. If a rising tide indeed lifts all boats, should the buyer be required to compensate the seller for beneficial markets? By the same token, if a deal is struck on the eve of another financial crisis, does the seller want to be held accountable for huge market dislocations? In our experience, returns from markets don't determine success, over time, nearly as much as returns from marketing. Consider structuring an earn-out based on net client AUM (assets added net of assets withdrawn), given a certain aggregate fee schedule (so nobody's giving the business away just to pad AUM).

5. Name specific considerations that determine payment terms.

Is the earn-out capped at a given level of performance or does it have unlimited upside? Can it be earned cumulatively or must each measurement period stand alone? Will there be a clawback if later years underperform an initial year? Will there simply be one bullet payment if a given level of performance is reached? To what extent should the earn-out be based on "best efforts" and "good faith"?

Because these specific considerations are usually unique to a given transaction between a given buyer and a given seller, there are too many to list here. Nevertheless, a couple of points of experience on this topic: 1) transaction values implied by earn-out structures are often hard to extrapolate to other parties to other transactions. 2) The earn-out can address many of the concerns and hopes of the parties to a transaction about the future – but it cannot create the future. Earn-outs manage uncertainty; they don't create certainty.

Above all, we emphasize that a plan for contingent consideration be based on the particular needs of buyers and sellers as they pertain to the specific investment management business being transacted. There is no one-size-fits-all earn-out in any industry, much less the RIA community. If an earn-out is truly going to bridge the difference between buyer and seller expectations, then it must be designed based on buyer and seller considerations. A bridge that doesn't successfully link two points is not a bridge, it's a pier. A pier will eventually leave either buyer or seller in deep water.

RIA Transaction Example

Consider the example of a depository institution, Hypothetical Savings Bank, or HSB. HSB has a substantial lending platform, but it also has a trust department that operates as something of an afterthought. HSB's senior executives consider options for closing or somehow spinning off the trust

operation, but because of customer overlap, lengthy trust officer tenure with the bank, and concerns by major shareholders who need fiduciary services, HSB instead hopes to bolster the profitability of trust operations by acquiring an RIA.

Following a search, HSB settles on Typical Wealth Management, or TWM. TWM has 35 advisors and combined discretionary assets under management of $2.6 billion (an average of $75 million per advisor). TWM has a fifteen year track record of consistent growth, but with the founding generation nearing retirement age, the firm needs a new home for its clients and advisors.

The Seller's Perspective

TWM's founders are motivated, but not compelled, to sell the firm. TWM generates 90 basis points of realized fees per dollar of AUM, and a 30% EBITDA margin. Even after paying executives and advisors, TWM makes $7MM of EBITDA per year, and the founders know that profitability has significant financial value to HSB, in addition to providing strategic cover to shore up the trust department.

Further, Typical Wealth Management has experienced considerable growth in recent years, and believes it can credibly extend that growth into the future, adding advisors, clients, and taking advantage of the upward drift in financial markets to improve revenue and enhance margins.

Seller Projections ($000,000)				
	Current	Year 1	Year 2	Year 3
Advisors	35	35	37	39
AUM/Advisor	$75.00	$85.00	$95.00	$105.00
Realized Fee	0.90%	0.90%	0.90%	0.90%
Revenue	$24.00	$27.00	$32.00	$37.00
EBITDA Margin	30%	30%	32%	34%
EBITDA	**$7.00**	**$8.00**	**$10.00**	**$13.00**

Given what it represents to be very conservative projections, and which don't take into account any cross selling from the bank or potential fee enhancements (TWM believes it charges below-market fees to some clients), the seller wants 12x run rate EBITDA, or about $85 million, noting that this is only about 10x forward EBITDA, and less than 7x EBITDA three years hence.

The Buyer's Perspective

The commercial bankers at HSB don't really understand wealth management, but they know banks rarely double profitability in three years and suspect they'll have a tough time convincing their board to pay top dollar for something without tangible book value.

Bank culture and investment management frequently do not mix well, and they worry whether or not TWM's clients will stay on if the senior staff starts to retire. Further, they wonder if TWM's fee schedule is sustainable in an era of ETFs and robo-advisors. They create a much less sanguine projection to model their possible downside.

Buyer Projections ($000,000)				
	Current	Year 1	Year 2	Year 3
Advisors	35	34	32	31
AUM/Advisor	$75.00	$80.00	$80.00	$80.00
Realized Fee	0.90%	0.90%	0.88%	0.86%
Revenue	$24.00	$24.00	$23.00	$21.00
EBITDA Margin	30%	30%	29%	28%
EBITDA	**$7.00**	**$7.00**	**$7.00**	**$6.00**

Based on this, HSB management want to offer about $40 million for Typical, which is about six times run rate EBITDA. This pricing gives the seller some credit for the recurring nature of the revenue stream, but doesn't pay for growth that may or may not happen following a change of control transaction.

The Compromise

With a bid/ask spread of $45 million, the advisors for both buyer and seller know that a deal isn't possible unless one or both parties is willing to move off of their expectations significantly (unlikely) or a mechanism is devised to reward the seller in the event of excellent performance and protect the buyer if performance is lackluster. Even though the buyer is cautious about overpaying, they eventually agree to a stronger multiple on current performance and offer $50 million up front for TWM. The rest of the payment, if any, will come from an earn-out. Contingent consideration of as much as $30 million is negotiated with the following features:

1. TWM will rebrand as Hypothetical Wealth Management, but the enterprise will run as a separate division of the bank during the term of the earn-out. This division will not pay any overhead charge to the bank, except as specifically designated for marketing projects through the bank that are managed by the senior principals of the wealth management division. As a consequence, the sellers will be able to maintain control over their performance and their overhead structure during the term of the earn-out.

2. The earn-out period is negotiated to last three years. Both buyer and seller agree that, in a three year period, the value delivered to the seller will become evident.

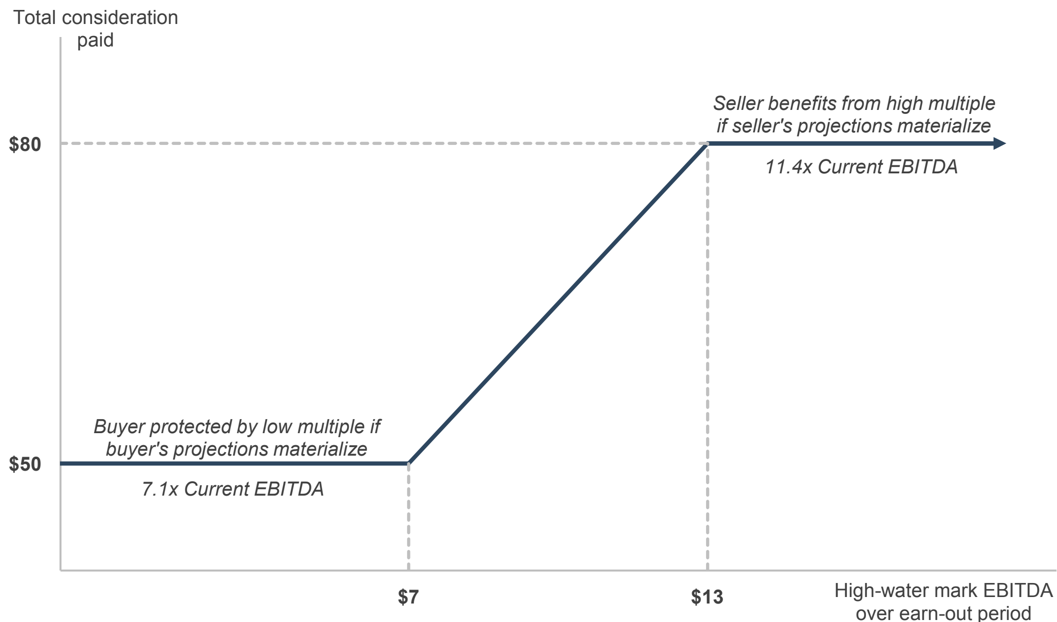
3. Buyer and seller agree to modest credits if, for example, the RIA recommends a client develop a fiduciary relationship with the bank's trust department, or if the bank's trust department refers a wealth management prospect to the RIA. Nevertheless, in order to keep matters simple during the term of the earn-out, both parties agree to manage their operations separately while the bank determines whether or not the wealth management division can continue to market and grow as an extension of the bank's brand.

4. To keep performance tracking straightforward, HSB negotiates to pay five times the high-water mark for any annual EBITDA generated by TWM during a three year earn-out period in excess of the $7 million run-rate established during the negotiation. It is an unusual earn-out arrangement, but the seller is compensated if by steady marketing appeal or strong market returns, AUM is significantly enhanced after the transaction. The buyer is protected, at least somewhat, from the potentially temporary nature of any upswing in profitability by paying a lower multiple for the increase than might normally be paid for an RIA. As long as management of Typical can produce at least $6 million more in EBITDA in any one of the three years following the transaction date, the buyer will pay the full earn-out. Any lesser increase in EBITDA is to be pro-rated and paid based on the same 5x multiple.

5. The earn-out agreement is executed in conjunction with a purchase agreement, operating agreement, and non-competition / non-solicitation agreements which specify compensation practices, reporting structures, and other elements to govern post-transaction behavior between the bank and the wealth manager. These various agreements are done to minimize misunderstandings and ensure that both buyer and seller are enthusiastic participants in the joint success of the enterprise.

As the earn-out is negotiated, buyer and seller run scenarios of likely performance paths for Typical after the transaction to see what the payout structure will look like per the agreement. This enables both parties to value the deal based on a variety of outcomes and decide whether pricing and terms are truly satisfactory.

Typical Wealth Management's Illustrative Earn-out



Conclusion

Earn-outs are Interactive with the Value of RIAs

Risk is enigmatic to investing. While we might all desire clairvoyance, it would only work if we were the sole investors who could see the future perfectly. If everyone's forecasts were proven accurate, assets would all be priced at something akin to the risk free rate, with no premium return attached. Uncertainty creates opportunity for investors, because opportunity is always a two way street.

Pricing uncertainty is another matter altogether. Not everyone "believes" in CAPM, or at least maybe not the concept of beta, but most agree that the equity risk premium exists to reconcile the degree of un-likelihood for the performance of a given asset with the value of that security. In an ideal world, a reasonable cash flow projection and a reasonable cost of capital will yield a reasonable indication of value.

In the vacuum sealed world of fair market value, we can reconcile discordant outlooks with different cash flow projections. The differing projections can then be yoked together into one conclusion of value by weighing them relative to probability. The discount rate used in the different projection models captures some of the risk inherent in the cash flow, and the probability weights capture the remainder of the uncertainty. In a real world transaction, however, buyers want to be paid based on their expectations if proven right, and sellers also want to be paid if outcomes comport with their projections. With no clear way to consider the relative likelihood of each party's expectations, no one transaction price will facilitate a transaction. Risk and opportunity can often be reconciled by contract, however, by way of contingent consideration.

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- Negotiating transactions involving asset managers from sell-side, buy-side, and mutually retained perspectives
- Providing financial statement reporting services related to purchase price allocation and goodwill impairment testing
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Mercer Capital's Asset Management industry group publishes research on the industry via its quarterly newsletter, *Value Focus: The Asset Management Industry*. The Group also writes about issues important to the industry on the *RIA Valuation Insights* blog.

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