MERCER CAPITAL

BUSINESS VALUATION &
FINANCIAL ADVISORY SERVICES

Succession Planning for Investment Management Firms

Financing Your Ownership Transition

Mercer Capital

www.mercercapital.com

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About Mercer Capital

Mercer Capital provides RIAs, independent trust companies, and alternative asset managers with business valuation and financial advisory services related to ownership transition, corporate transactions, dispute resolution, tax compliance, and financial reporting requirements. Mercer Capital also provides transaction advisory and consulting-related services.

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

- 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 financial statement reporting services related to purchase price allocation and goodwill impairment testing
- Assisting RIAs and other asset managers with annual ESOP valuations, fairness opinions, and appraisals for gift and estate tax compliance
- Providing expert witness testimony for purposes of marital dissolution and shareholder disputes

Mercer Capital's Investment Management industry team 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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Introduction

Succession planning has been an area of increasing focus in the RIA industry, particularly given what many are calling a looming succession crisis. The demographics suggest that increased attention to succession planning is well warranted: a majority of RIAs are still led by their founders, and only about a quarter of them have non-founding shareholders. Yet when RIA principals were asked to rank their firm's top strategic initiatives, succession planning lagged far behind strategic initiatives with more immediate benefits like new client and staff growth. Fortunately, there are many viable options for RIA principals looking to exit the business.

- **Internal transition to the next generation of firm leadership.** One way to maintain independence is by transitioning ownership internally to key staff members. This process often takes a substantial amount of time and financing as it's unlikely that the next generation is able or willing to assume 100% ownership in a matter of months without external financing.
- **Debt financing**. One way to finance the buyout of retiring shareholders is through debt financing. There is a growing number of specialty lenders who are accustomed to working with RIAs.
- **Sale to a consolidator or roll-up firm.** Consolidators and roll-up firms provide capital to fund ownership transitions, back office support, and differing levels of autonomy for remaining principals. While there is a relatively small number of consolidators, their share of sector dealmaking has increased dramatically in recent years.
- **Sale to a private equity firm.** Private equity can be used to buy out a retiring partner, but it is not typically a permanent solution. While PE firms provide upfront cash, remaining principals must sacrifice most of their control and potentially some of their ownership at closing.
- **Minority financial investment.** Minority financial investments can provide existing ownership with liquidity while allowing remaining shareholders to maintain control and an ongoing interest in the firm's economics. Minority investors typically do not intrude on the firm's operations as much as other options but will seek deal terms that adequately protect their interest in future cash flows.
- **Sale to a strategic buyer.** A strategic buyer is likely another RIA, but it could be any other financial institution hoping to realize certain efficiencies after the deal. This scenario often makes the most economic sense, but it does not afford the selling principals much control over what happens to their employees, clients, or the company's identity.

In this white paper, we expand upon the options outlined above.

Internal Transitions

Internal transitions of ownership are the most common type of transaction for investment management firms, and for good reason. Many RIA owners prefer working for themselves, and their clients prefer working with an independent advisor. Internal transitions allow RIAs to maintain independence over the long-term and provide clients with a sense of continuity and comfort that their advisor's interests are economically aligned. A gradual transition of responsibilities and ownership to the next generation is usually one of the best ways to align your employees' interests and grow the firm to everyone's benefit. While this option typically requires the most preparation and patience, it allows the founding shareholders to handpick their successors and future leadership.

A common roadblock when planning for internal succession is pricing. We generally recommend that firms have a buy-sell agreement that specifies the terms and the price at which shares are transacted as an owner exits and/or retires. By establishing the price and terms at which the shares will be transacted, a buy-sell agreement mitigates any potential drama.

However, after the price has been set, the next question is how will the next generation pay? Many wealth management firms have significant value, and successors are often financially stretched to take over a founder's interest in the firm. The deal can be seller financed, but that requires the retiring shareholder to maintain significant business risk at the same time they give up control over the business. External debt or equity financing are options that can mitigate some of the drawbacks to seller financing.

Debt Financing

Debt financing has become a readily available option for RIA principals working on succession planning as more specialty lenders have entered the market. Some of the benefits of debt financing are outlined below.

Despite these benefits, debt financing does increase the remaining shareholders' personal risk since it is an obligation to repay borrowed funds, unlike equity financing which typically does not require repayment. Debt financing for RIAs also typically includes a personal guarantee, which many borrowers are opposed to. Borrowers are also more exposed to their own business by using leverage to purchase an equity stake.

Increasing Number of Specialty Lenders for RIAs

Lending options for RIAs have increased dramatically in recent years. While traditional lenders look for tangible assets to use as collateral, RIA lenders focus on cash flow. Prior to the proliferation of cash-flow based lenders, most RIAs had to turn to local banks, who generally aren't comfortable with the asset-light balance sheets and fee-based structure of RIA firms. Some of the firms offering debt financing specifically for RIAs include **Live Oak Bank, Oak Street Funding**, **Merchant Credit Partners**, **PPC Loan**, and **SkyView Partners.**

In their book *Success and Succession*, Eric Hehman, Jay Hummel, and Tim Kochis examine the complexities of the leadership transition process and summarize their findings from their own experience.

- Both the founder and the successor need to be aware that firm-wide growth often declines in the first year following the change in management, as the founder-centric firm shifts its brand image and the successor takes on responsibility for creating new business. If a successor is unaware of this trend, he or she could feel additional stress regarding the financial burden he undertook when buying out the former owner. The founder could feel the need to resume full-time involvement in operations, fearing for his ongoing financial benefits from the firm. The authors advise both founders and successors to take a long-term view and not focus on this short-term pullback.

- Regardless of the firm's performance in the first few years following succession, both the founder and the successor need to set definite (as in finite) expectations regarding the founder's continued involvement or lack thereof. The founder may need to remain accessible, as his or her guidance is crucial when the successor faces major issues early on. But it should also be clear to everyone that the successor is now the one charged with minding the store.

- Though some things do need to change following a succession of management, the successor should avoid creating new positions to retain people who no longer fit into the firm's long-term goals. One benefit of succession is that the new manager may have a fresh perspective on areas of the firm in which cost cutting measures or other efficiencies are possible. Although it may be difficult to assess which employees should remain after the transition, allowing those who are poor fits to remain with the firm does significant damage to the firm's culture and does not set the proper tone for post-transition success.

- It is crucial to separate compensation for labor from profit share rewards as the exiting owner becomes less involved in day to day management of the firm. This issue can be resolved through the establishment of a strict reinvestment versus distribution policy going forward. The authors even suggest that the founder employ an independent financial advisor in order to objectively estimate a fair amount of compensation following the sale.

- Though it is clear that the founder took on a significant amount of financial risk in the creation of the firm, it must be noted that the successor is also taking on risk in the amount of debt he or she must incur to buy out the owner. Both parties have a lot to gain and a lot to lose in the process of succession, and both bear a significant emotional burden. The founder may perceive the transition as a loss of a personal identity that is tied to the firm, and the successor must now bear the responsibility of the ongoing success of the business.

- Controversy over what is fair or what is "enough" in terms of a sale price can be resolved through an independent valuation. While it might seem easier to rely on rules-of-thumb metrics or transaction examples, these tactics are purely short term solutions and can result in overly optimistic estimates. The financial terms of the valuation are already emotionally charged. A third party valuation can provide a much needed "reality check."

Typical Terms for RIAs

The terms for loans made to RIAs vary significantly depending on the risk profile of the firm. Additionally, the terms interact with each other and are difficult to discuss in isolation. For example, a higher origination fee could reduce the need for a pre-payment penalty. At the risk of over-generalizing, we have outlined terms RIA principals can expect when seeking debt financing in the table below.

Typical Loan Terms for RIAs	
Time to Close	Between 1 - 3 months
Term	5 to 10 year amortization
Interest Rate	Can be fixed or floating; Spreads will vary significantly based on credit profile or borrower
Payment Option	Monthly or quarterly payments of interest and principal
Origination Fee	Generally 50 bps to 200 bps depending on the size of loan
Priority	Often require senior position
Prepayment	Typically includes a lock up or prepayment penalty of 1% to 5% if pre-paid prior to 3 year anniversary
Covenants	Typically include debt service coverage ratio between 1.3x and 2.5x and/or AUM threshold dependent on your current AUM
Deal Expenses	Typically less than $50,000
Other	Likely includes some form of personal guarantees and life insurance

One term of particular interest is the personal guarantee. Most lenders require a personal guarantee, which is a legal promise by the partners to repay the loan made to their business in the event the business defaults. While it is typical that lenders to small businesses require this additional layer of protection, it is important to understand how a personal guarantee works and what it could mean for your personal finances.

A personal guarantee gives your lender the right to pursue your personal assets if your business defaults on the loan. While you can ask your lender to replace your personal guarantee with a personal guarantee from a new owner, the lender is typically not required to do so. Given the lack of fixed assets at most RIAs, it is clear why this is important to lenders.

Similar to evaluating mortgage options, it is important to talk to multiple lenders to guarantee the most favorable terms for your business transition. Having a knowledgeable advisor to manage this process allows continuing ownership to remain focused on running the business while ensuring consideration of all appropriate options.

RIA Consolidators

RIA consolidators have emerged promising a means for ownership transition, back-office efficiencies, and best practices coaching. The consolidator model has been gaining traction in the industry in recent years. 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 overall deal volume in the sector.

For RIA principals who are looking for an exit plan, 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 the next generation of 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 about 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 Wealth Enhancement 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.

Consolidator 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.

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

RIA Valuation Insights Blog

Mercer Capital's blog, *RIA Valuation Insights*, presents weekly updates on issues important to the investment management industry. To visit the blog or to subscribe, visit **mer.cr/RIAInsights**.

Value Focus: Investment Management Newsletter

Mercer Capital's Investment Management team also produces a complimentary quarterly newsletter which contains an industry market overview, a review of recent transactions, and tracks multiples by industry sector. To view the current issue and the archives or to subscribe, visit **mer.cr/RIA-nl**.

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 may 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.

Consolidator Deal Structure

Consolidators often 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 continuing management team 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. If that sounds a little like selling a job, it is, and we are hesitant to endorse the viability of such an expectation.

Further, consolidators often use their own stock as part of the total consideration. For publicly traded companies, it's clear exactly how much that's worth. For closely held aggregators like **Hightower** and **Captrust**, their stock price is not so readily apparent. Even if the consolidator is publicly traded, sellers should be wary of any lock-up provisions since stock prices for these companies can be volatile.

Private Equity

Private equity is sometimes used to cash out a former partner. Drawn to the industry's typically high margins, low capital expenditure needs, and recurring revenue model, private equity managers have sharpened their focus on investment management firms in recent years.

Private equity can provide a relatively straightforward path to diversification for existing RIA principals. In many cases, a significant portion of an RIA principal's net worth is tied up in his or her business with no immediate access to liquidity. PE firms allow these owners to take some cash off the table and reduce their dependency on the business. RIA principals will have to weigh the benefits of diversification and instant liquidity with the costs of losing control to outside ownership.

.Private Equity Model

Private equity funds are investment vehicles run by professional asset managers that often focus on acquiring majority control of privately-owned middle and lower-middle market companies. The ultimate goal for the PE firm is to realize a one-time increase in company value from a future sale to another PE firm or strategic buyer, or to potentially lead the company through an IPO.

Private equity funds often have a relatively short investment horizon, typically three to seven years. In order to achieve their investment objectives, private equity firms may put pressure on RIAs to take on more clients, reduce costs, or pursue add on acquisitions to maximize proceeds in a future exit. Additionally, the buy and flip model of PE firms means a new owner with new demands will take over in the not-so-distant future.

Private Equity Deal Structure & Pricing

To align the incentives of the PE firm and the seller going forward, it is common to see some equity retained by the seller. Earnouts based on specific financial metrics or milestones can also serve this purpose. PE firms frequently purchase a majority interest to assume control over future operations. Such a sale creates a larger liquidity event for the sellers, but at the cost of relinquishing control. Many RIA owners aren't comfortable with the latter, so these discussions sometimes don't get past the initial call.

Selling (outside) partners usually favor this type of investment because PE firms can pay more up front. Principals remaining in the business usually don't want any ownership lingering in the hands of former employees, but in this scenario they've effectively swapped one outside investor for another. There's no guarantee that the second one will be any better.

> Even if the price is right, a private equity investment may not be a good fit for you and your team. Your due diligence on the prospective buyer is just as important as their due diligence on you.

Minority Financial Investor

Minority financial investments can allow exiting ownership to realize liquidity while allowing remaining owners to maintain control and an ongoing interest in the firm's economics. While the lack of interference in day to day operations is an attractive feature for remaining owners, a minority financial investor is not the solution for management teams hoping to achieve a clean break.

Minority Financial Investor Model

A minority financial investor is typically interested in acquiring less than 25% of your business to participate in the distribution of cash flow or upside from selling your company in a few years to another investor or strategic acquirer. Often, a change of control is thought to occur when greater than 50% of the equity changes hands. However, the notion of control can be more complicated with RIAs as an “assignment” of client contracts necessitates client consent. When a “controlling block” of voting shares changes hands, the SEC considers there to have been an assignment of client contracts. While the SEC does not define a “controlling block”, it is typically thought to be the holder of 25% of voting shares or a partner who has the right to receive 25% of the capital upon dissolution.

Minority Financial Investment Deal Structure

In general, a minority financial investment can be structured as a term investment or a permanent investment. PE firms typically invest for a three to seven year term with the goal of improving the company’s financial profile in order to sell it at a higher multiple, while permanent capital investors (often single family offices) are more interested in the business’s long-term cash flow potential.

While every agreement with a minority financial investor will have differences in the details, there are two commonly-used ways to structure these deals.

1. Revenue Share
2. Preferred Equity

Revenue Share

A revenue share is a right to a percentage of revenue instead of a right to distributable cash flow. This structure works exceptionally well for passive minority investments because the minority investor’s distribution is not affected by the operational decisions of management, such as the size of the bonus pool, because their distribution is determined before consideration of expenses. Given this structure, a revenue share arrangement generally does not include board representation for the minority investor.

There are benefits to a revenue share for businesses that have stable or expanding margins. As shown in the example below, as margins expand and more flows through to the bottom line, the revenue share as a percentage of EBITDA (as a proxy for free cash flow) decreases, and the common equity holders split a larger share of the distributable cash flow. On the flip side, if margins contract, the size of the revenue share as a percentage of EBITDA will increase and the revenue share owner will gain a larger share of distributable cash flow.

Margins Expand	Revenue Share: Expanding Margins						
			Year 1	Year 2	Year 3	Year 4	Year 5
	Revenue		$1,000,000	$1,150,000	$1,350,000	$1,600,000	$1,850,000
	- Operating Expenses		(750,000)	(800,000)	(850,000)	(900,000)	(1,000,000)
	- Revenue Share	10%	(100,000)	(115,000)	(135,000)	(160,000)	(185,000)
	Cash Flow to Common Equity Holders		$150,000	$235,000	$365,000	$540,000	$665,000
	EBITDA Margin		25.00%	30.43%	37.04%	43.75%	45.95%
	Revenue Share as % of EBITDA		40.00%	32.86%	27.00%	22.86%	21.76%

Margins Contract	Revenue Share: Compressing Margins						
			Year 1	Year 2	Year 3	Year 4	Year 5
	Revenue		$1,000,000	$1,150,000	$1,350,000	$1,600,000	$1,850,000
	- Operating Expenses		(750,000)	(900,000)	(1,080,000)	(1,300,000)	(1,550,000)
	- Revenue Share	10%	(100,000)	(115,000)	(135,000)	(160,000)	(185,000)
	Cash Flow to Common Equity Holders		$150,000	$135,000	$135,000	$140,000	$115,000
	EBITDA Margin		25.00%	21.74%	20.00%	18.75%	16.22%
	Revenue Share as % of EBITDA		40.00%	46.00%	50.00%	53.33%	61.67%

A revenue share usually includes customary minority protections. For example, consent is typically required for certain matters such as:

- Bringing on excess debt or changing the company's capital structure in a way that would adversely affect the revenue share owner
- Entering into a JV, related party transactions, or new lines of business
- Changing accounting / billing practices or tax election in a way that would adversely affect the revenue share owner

Preferred Equity

Like a revenue share, preferred equity holders participate in the distribution of cash flow before common equity holders; however, distributions to preferred equity holders are determined by the bottom line, not the top. Because of this, preferred equity holders are more interested in operational decisions such as executive compensation and budgeting because their distribution could be reduced with additional expenses. Preferred equity holders typically ask for board representation and veto rights on certain key items. Such protective rights include required distributions of excess cash flow, budget approval, approval of executive compensation, tag along rights, and preemptive rights to protect preferred equity holders from dilution.

Although preferred equity holders rank higher than common equity holders, a preferred equity holder faces more risk than a revenue share holder. In the example of margin compression explored above, the preferred equity holder would likely face a similar decline in distributions as the common equity holder.

Minority Financial Investment Deal Pricing

The goal when structuring minority interest deals is often to balance the competing concerns of management and the minority investor by providing adequate protections to the minority party with minimal intrusion on business operations. Based on the risk profile of the investment, the pricing will change. For example, a revenue shareholder may be able to offer more in terms of pricing than a preferred equity investor, because a revenue shareholder typically has more downside protection.

Strategic Acquirer

Strategic buyers in the RIA space take many forms, including PE-backed acquirers, large RIA acquirers, branded acquirers, and strategic aggregators. The unifying theme among these acquirors is that they are interested in how a target company fits into their own long-term business plans.

Consolidation in the RIA industry is often driven by a desire to increase operating leverage. One way to address the rising costs of compliance and technology is through synergies to preserve profitability. Additionally, strategic acquirers may be interested in acquiring an RIA to expand distribution platforms or move into new markets.

Compared to financial buyers, strategic acquirers generally make significantly more changes to the status quo. For sellers, it is important to analyze how the business will change post-transaction, particularly since the deal terms will likely be structured in such a way as to keep the seller around for several years at least after the transaction. A strategic acquirer may continue to operate the target RIA under its existing branding, or they may rebrand and fully integrate into their own business.

Strategic Acquirer Deal Pricing

Because of the possible synergies a strategic acquirer can realize, they can (in theory) rationalize paying a higher price for a controlling interest position than purely financial acquirors. However, whether or not a strategic buyer is the right exit strategy is situation specific. For sellers that don't mind giving up significant control of their business, a strategic acquirer may be a good fit. For sellers that want to maintain control, a financial buyer or internal transition may make more sense.

As with other deal types, acquisitions by strategic acquirors will typically include employment agreements and some form of earn-out designed to incentivize the selling owners to transition the business smoothly after closing.

Conclusion

There's much to consider when planning for succession, and this is certainly not an exhaustive discussion. Many sellers choose a combination of these options to achieve their desired level of liquidity and control. Founding shareholders have different needs and capabilities at different stages of their career, so a permanent capital infusion, for instance, may make more sense before ultimately selling to a strategic or financial buyer.

If you're a founding partner or selling principal, you have a lot of exit options, and it's never too soon to start thinking about succession planning. Proper succession planning needs to be tailored to the circumstances, and a variety of options should be considered. The longer you wait, the more limited your options will be in the future.

FREQUENTLY ASKED QUESTION

"What sectors of the industry do you serve and what services do you provide?"

Sectors Served

- Wealth Management Firms
- Registered Investment Advisors
- Money Managers
- Mutual Fund Companies
- Independent Trust Companies
- Investment Consultants
- Hedge Fund Managers
- Real Estate Investment Companies & REITs
- Private Equity & Venture Capital Firms
- Bank Trust Departments
- Broker/Dealers

Services Provided

- Corporate Valuation
- Fairness Opinions
- M&A Representation & Consulting
- Buy-Sell Agreement Valuation & Consulting
- Financial Reporting Valuation
- Tax Compliance Valuation
- Litigation & Dispute Resolution Consulting/ Testimony
- ERISA Valuation

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