MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Buy-Sell Agreements for Wealth Management Firms

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INTRODUCTION

There are roughly 13,000 Registered Investment Advisors ("RIAs") in the U.S., and each tailors its services to a unique set of clients and maintains an individualized business model. Be that as it may, most who call us face one common issue: ownership succession.

Ownership can be the single biggest distraction for a professional services firm, and it seems like the wealth management community feels this issue more than most. In Schwab's 2019 benchmarking study, which surveyed 1,300 RIAs, a full 92% of respondents indicated that they were considering internal succession, but only 38% of firms have a documented path to partnership.

Most wealth management firms are closely held, so the value of the firm is not set by an active market. They are typically owned by unrelated parties, whereas most closely held businesses are owned by members of the same family. Compared to other industries, a greater-than-normal proportion of wealth management firms have significant value, such that there is more at stake in ownership than most closely held businesses. Consequently, when disputes arise over the value of an interest in a wealth management firm, there is usually more than enough cash flow to fund the animosity, and what might be a five-figure settlement in some industries is a seven-figure trial for these businesses.

Avoiding expensive litigation is one reason to focus on your buy-sell agreement, but for most firms, the more compelling reasons revolve around transitioning ownership to perpetuate the firm and provide liquidity for retiring partners. Clients increasingly seem to ask us about business continuity planning—and for good reason. In times of succession, tensions can run high. Having a clear and effective buy-sell agreement is truly imperative to minimizing costly and emotional drama that may ensue in times of planned or unplanned transition.

BUY-SELL AGREEMENT BASICS

Simply put, a buy-sell agreement establishes a process by which shares of a private company transact. Ideally, it defines the conditions when the buy-sell agreement is triggered, describes the mechanism by which the shares are priced, addresses the funding of the transaction, and satisfies all applicable laws and regulations.

These agreements aren't necessarily static. In wealth management firms, buy-sell agreements may evolve over time with changes in the scale of the business and breadth of ownership. When firms are new and more "practice" than "business," these agreements may serve more to decide who gets what if the partners decide to go separate ways.

As the business becomes more institutionalized, and thus, more valuable, a buy-sell agreement – properly rendered – is a key document to protect the shareholders and the business (not to mention the firm's clients) in the event of an ownership dispute or other unexpected changes in ownership. Ideally, the agreement also serves to provide for more orderly ownership succession, as well as a degree of certainty for owners that allows them to focus on serving clients and running the business instead of worrying about who gets what benefit of ownership.

The irony of buy-sell agreements is that they are usually drafted and signed when all the shareholders think similarly about their firm, the value of their interest, and how they would treat each other at the point they transact their stock. The agreement is drafted, signed, filed, and forgotten. Then an event occurs that invokes the buy-sell agreement, and the document is pulled from the drawer and read carefully. Every word is parsed, and every term scrutinized, because now they are not simply co-owners with aligned interests but rather buyers and sellers with diametrically opposed interests.

Triggering Events

Buy-sell agreements govern the process and terms of a transaction if certain defined events occur. These "triggering events" can stem from voluntary or involuntary circumstance.

Voluntary Circumstances	Involuntary Circumstances
Retirement	Death
Management Buyout	Divorce
Sale to Outside Investor	Forced Restructuring
Combination / Merger	Bankruptcy

Many buy-sell agreements call for an independent appraisal upon a triggering event to establish the price at which shares will transact. In cases where ownership is more fluid, some agreements require an annual appraisal to establish the price at which all transactions during the year will take place.

Voluntary Circumstances

At any time, one generation of business owners is preparing for retirement, having planned (or frequently not planned) for a successful ownership transition from one generation of business leaders to the next. A buy-sell agreement is one of the most important steps to ensure a successful, planned transition of ownership, and as such, it should complement your succession plan. An effective succession plan could call for the sale of the retiring partner's stake to current management or an outside investor group or may require the sale of the entire firm to strategic buyer.

If your exit strategy includes a sale to an insider, it should specify the terms and the price that shares are transacted at as an owner exits to retire. This is often a point of contention as young partners and retiring partners have inherently opposed objectives. A retiring partner will want to exit at the highest share price possible while the continuing partners are ultimately financing this repurchase.

Because many wealth management firms are highly valuable, successors are often financially stretched to take over the founder's interest in the firm. By establishing the price and terms at which the shares will be transacted, a buy-sell agreement mitigates any potential drama. As such, a buy-sell agreement is foundational for your firm's succession plan.

If your exit strategy is to sell your firm to an outside buyer, you should be aware of your opportunities and make it explicitly known to your firm that this is your intention. For example, you should know the different incentives of potential buyers and what options exist with financial or strategic buyers. A buy-sell agreement should specify the process by which a sale to an outside investor group is agreed to. We once worked with a client whose operating documents required unanimous consent to bring on a minority partner, as this required an amendment to the operating agreement, while the sale of a majority of the Company just required the consent of a super majority. You should make sure that your buy sell agreement makes sense in companion with your other operating agreements.

Knowing your exit strategy options will help clarify what is needed from your succession plan and your buy-sell agreement going forward.

Involuntary Circumstances

Buy-sell agreements guard against undesirable transitions in ownership from a potential partner to an unaffiliated party; they also define a set price per share to ensure a fair transaction. In the case of death, disability, divorce, and bankruptcy, current partners will ultimately need to redeem the shares of their colleague.

For instance, in the event of the death of a shareholder, a buy-sell agreement can protect the deceased's family, ensuring such shares are bought at a fair price and in a timely manner. It can also protect your Company from the inheritors of a deceased owner, who may want to benefit from the firm's earnings but are not able to contribute to the growth of the business. Life insurance policies for owners are advised to protect your firm in case of an untimely death or a disabling scenario. A life insurance policy will secure your firm's ability to repurchase shares in the case of the death or disability of an owner.

Additionally, if an owner files bankruptcy, the firm will need to repurchase his or her stake to avoid the shares being acquired by the owner's creditors. In the case of a divorce, an owner's shares may legally transfer to his or her spouse, in which case ownership would be ceded to the ex-spouse. A buy-sell agreement will outline the process through which a price is set and the transaction is financed.

OUR ADVICE: KEY CONSIDERATIONS FOR YOUR BUY-SELL AGREEMENT

At Mercer Capital we have read hundreds, if not thousands, of buy-sell agreements. While we are not attorneys and do not attempt to draft such agreements, our experience has led us to a few conclusions about what works well and what doesn't. By "working well" we mean an enduring agreement that efficiently manages ownership transactions and transitions in a variety of circumstances. Agreements that don't work well become the subject of major disputes – the consequence of which is a costly distraction.

The primary weaknesses we see in buy-sell agreements relate to issues of valuation: what is to be valued, how, when, and by whom. The following issues and our corresponding advice are drawn from our experience of agreements that performed well, and those that did not. While we haven't seen everything, we have been more involved than most in helping craft agreements, maintaining compliance with valuation provisions, and resolving disagreements.

1. Decide What You Mean By "Fair"

A standard refrain from clients crafting a buy-sell agreement is that they "just want to be fair" to all the parties in the agreement. That's easier said than done because fairness means different things to different people. The stakeholders in a buy-sell scenario at a wealth management firm typically include the founding partners, subsequent generations of ownership, the business itself, non-owner employees of the business, and the clients of the firm. Being "fair" to that many different parties is nearly impossible, considering their different motivations and perspectives.

Clients. As the asset management industry faces growing concerns over client retention, due primarily to the rise of passive investing and fee compression, client relationships in the wealth management industry are becoming the single most important safeguard to such trends. In a field where relationships have become the most valuable asset of the business, avoiding internal disputes is crucial. Clients pay for an enduring and trusting relationship with their investment manager. As the profession ages, we see transition planning as either a competitive advantage (if done well) or a competitive disadvantage (if disregarded).

Founding owners. Aside from wanting the highest possible price for their shares, founding partners usually want to have the flexibility to work as much or as little as they want to, for as many years as they so choose. These motivations may be in conflict with each other, as ramping down one's workload into a state of partial retirement and preserving the founding generation's imprint on the company requires a healthy business, which in turn necessarily requires consideration of the other stakeholders in the firm.

We read one buy-sell agreement where the founder had secured his economic return by requiring the company, in the event of his death, to redeem his shares at a value that did not consider the economic impact of his death (the founder was a significant rainmaker). One can only imagine, at the founder's death, how that would go when the other partners and employees of the firm "negotiated" with the estate – as if a piece of paper could checkmate everything else in a business where the assets of the firm get on the elevator and go home every night.

Subsequent generation owners. The economics of a successful wealth management firm can set up a scenario where buying into the firm can be very expensive, and new partners naturally want to buy as cheaply as possible. Eventually, however, there is symmetry of economic interests for all shareholders, and buyers will eventually become sellers. Untimely events can cause younger partners to need to sell their stock, and they don't want to be in a position of having to give it up too cheaply.

The firm itself. The company is at the hub of all the different stakeholder interests and is best served if ownership is a minimal distraction to the operation of the business. Since handwringing over ownership rarely generates revenue, having a functional shareholders' agreement that reasonably provides for the interests of all stakeholders is the best-case scenario for the firm. If firm leadership understands how ownership is going to be handled now and in the future, they can be free to do their jobs and maximize the performance of the company. At the other end of the spectrum, buy-sell disputes are very costly to the organization. These disputes can distract the senior-most staff from matters of strategy and client service for years, and they rarely end with a resolution that compensates for lost business opportunities which may never even be identified.

Non-owner employees. Not everyone in a wealth management firm qualifies for ownership or even wants it, but all RIAs are economic eco-systems in which all employees depend on the presence of stable and predictable ownership.

The point of all this is to consider whether or not you want your buy-sell agreement to create winners and losers, and if so, be deliberate about defining who wins and who loses. Ultimately, economic interests which advantage one stakeholder will disadvantage some or all of the other stakeholders.

If the pricing mechanism in the agreement favors a relatively higher valuation, then whoever sells first gets the biggest benefit of that, at the expense of the other partners and anyone buying into the firm. If pricing is too high, internal buyers may not be available and the firm may need to be sold to perfect the agreement. At relatively low valuations, internal transition is easier and business continuity is more certain, but the founding generation of ownership may be perversely encouraged to not bring in new partners, stay past their optimal retirement age, or push more cash flow into compensation instead of shareholder returns as the importance of ownership is diminished.

Recognizing and ranking the needs of the various stakeholders in a wealth management firm is always a balancing act, but one which is typically best done intentionally.

BUY-SELL AGREEMENTS AND CONTRACT THEORY

The 2016 Nobel Prize in Economics was awarded to Professors Oliver Hart (Harvard) and Bengt Holmström (MIT) for their work in developing contract theory as a foundational tool of economics. The notion of contract theory organizes participants in an economy into principals (owners) and agents (employees), although the principal/agent relationship can be applied to many economic exchanges.

Agents act on behalf of principals, but those actions are at least partially unobserved, so contracts must exist to incentivize and punish behavior, as appropriate, such that principals can be reasonably assured of getting the benefit of compensation paid to agents. The optimal contract to accomplish this weighs risks against incentives. The problem with contracts is that all of them are incomplete, in that they can't specify every eventuality. As a consequence, parties have to be designated to make decisions in certain circumstances on behalf of others.

Contract theory has application to the design of buy-sell agreements in the ordering of priority of stakeholders in the enterprise. If the designated principal of the enterprise is the founding generation, then the buy-sell agreement will be written to protect the rights of the founders and secure their ability to liquidate their interest on the best terms and pricing. Redemption from a founder's estate at a premium value would be an example of this type of contract.

If, on the other hand, the business is the designated principal of the enterprise, and all the shareholders are treated as agents, then the buy-sell agreement might create mechanisms to ensure the long-term profitability of the wealth management firm, rewarding behaviors that grow the profits of the business (with greater ownership percentages or distributions or performance bonuses) and punish agent actions that do not enhance profitability.

If the firm's clients are also the principals, then the buy-sell agreement might be fashioned to direct equity returns to agents (partners or non-owner employees) based on investment performance or client retention. An example of this would be carried interest payments in hedge funds and private equity.

2. Clearly Define the "Standard" of Value Effective for Your Buy-Sell Agreement

The value of your firm may vary depending on which party is designated a "principal" or an "agent" as well as the varying context surrounding the triggering of a buy-sell agreement. Thus, it is important to specify which "standard" of value that your buy-sell agreement will uphold.

The standard of value essentially imagines and abstracts the circumstances giving rise to a particular transaction. It is intended to control for the identity of the buyer and the seller, the motivation and reasoning of the transaction, and the manner in which the transaction is executed. Clearly defining the standard of value in your buy-sell agreements will save time and money when triggering events occur.

Portfolio managers have a particular standard of value perspective, even though they don't always think of it that way. The trading price for a given equity represents market value, and some portfolio managers would make buying or selling decisions based on the relationship between market value and intrinsic value, which is what they think the security is worth, based on their own valuation model.

Investment analysts inside a wealth management firm think of the value of their firm in terms of intrinsic value, which depending on their unique perspective could be very high or very low. CEOs, in our experience, think of the value of their wealth management firm in terms of what they could sell it for in a strategic, change of control transaction with a motivated buyer.

None of these standards of value are particularly applicable to buy-sell agreements, even though technically they could be. Instead, valuation professionals such as our group look at the value of a given company or interest in a company according to standards of value such as fair market value or fair value.

In our world, the most common standard of value is fair market value, which applies to virtually all federal and estate tax valuation matters, including charitable gifts, estate tax issues, ad valorem taxes, and other tax-related issues. It is also commonly applied in bankruptcy matters.

Fair market value has been defined in many court cases and in Internal Revenue Service Ruling 59-60. It is defined in the I*nternational Glossary of Business Valuation Terms* as: *The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.*

The benefit of a fair market value standard is familiarity in the appraisal community and the court system. It is arguably the most widely adopted standard of value, and for a myriad of buy-sell transaction scenarios, the perspective of disinterested parties engaging in an exchange of cash and securities for rational financial reasons fairly considers the interests of everyone involved.

The standard known as "fair value" can be considerably more opaque, having two different origins and potentially very different applications. In dissenting shareholder matters, fair value is a statutory standard that varies depending on legal jurisdiction. In many states, fair value protects minority shareholders from oppressive actions by providing them with the right to payment at a value equivalent to that which would be received in the sale of the company. A few states are not so generous as to provide aggrieved parties with undiscounted value for their shares, but the trend favors not disadvantaging minority owners in certain transactions just because a majority owner wants to remove them from ownership. The difficulty of statutory fair value, in our experience, is the dispute over the meaning of state statutes and the court's interpretations of state statutes. Sometimes the standard is as clearly defined as fair market value, but sometimes less so.

Making matters more complex, fair value is also a standard under Generally Accepted Accounting Principles, as defined in ASC 820. When GAAP fair value was originally established, members of the Financial Accounting Standards Board, which is responsible for issuing accounting guidance, suggested that they wanted to use a standard similar to fair market value but didn't want their standard to be governed and maintained by non-related institutions such as the U.S. Tax Court.

GAAP fair value is similar to fair market value, but not entirely the same. As GAAP fair value has evolved, it has become more of an "exit value" standard, suggesting the price that someone would pay for an asset (or accept to assume a liability) instead of a bargain reached through consideration of the interests of both buyers and sellers.

The exit value perspective is useful from an accounting perspective because it obviates financial statement preparers' tendency to avoid write-downs in distressed markets because they "wouldn't sell it for that." In a shareholder dispute, however, the transaction is going to happen, so the bid/ask spread has to be bridged by valuation regardless of the particular desires of the parties.

If a shareholders' agreement names the standard of "Fair Value," does it mean statutory fair value, GAAP fair value, or does it really mean fair market value? It pays to be clear.

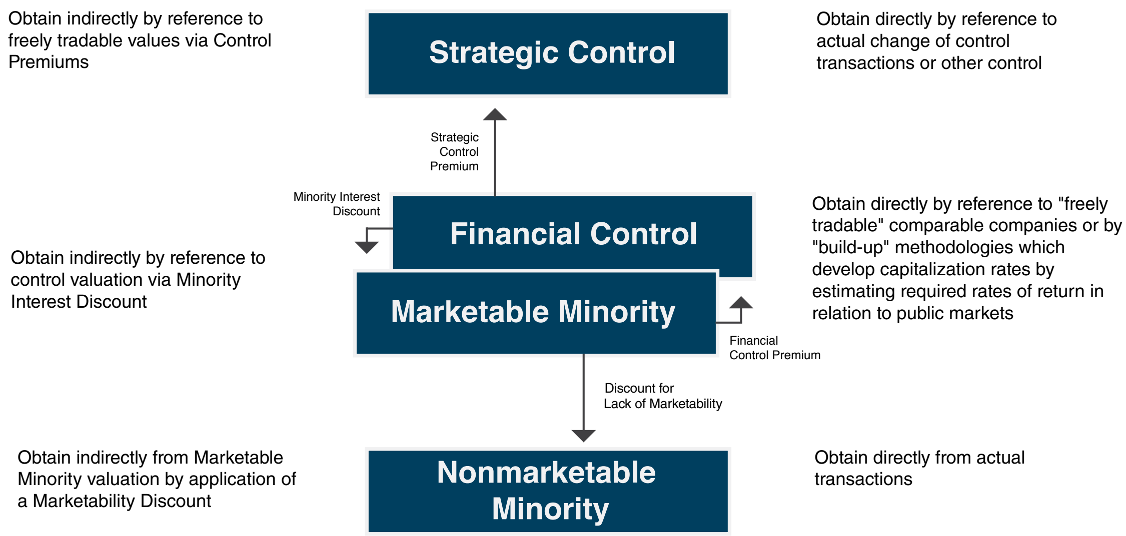
The standard of value is critical to defining the parameters of a valuation, and we would suggest buy-sell agreements should name the standard and cite specifically which definition is applicable. The downsides of not doing so can be reasonably severe. For most buy-sell agreements, we would recommend one of the more common definitions of fair market value. The advantage of naming fair market value as the standard of value is that doing so invokes a lengthy history of court interpretation and professional discussion on the implications of the standard, which makes application to a given buy-sell scenario clearer.

3. Avoid Costly Disagreement as to the "Level of Value"

Just as the interests and motivations of particular buyers and sellers can affect transaction values, the interest itself being transacted can carry more or less value, and thus the "level" of value, as it has come to be known, should be specified in a buy-sell agreement.

A minority position in a public company with active trading typically transacts as a pro rata participant in the cash flows of the enterprise because the present value of those cash flows is readily accessible via an organized exchange. Portfolio managers usually think of value in this context, until one of their positions becomes subject to acquisition in a takeover by a strategic buyer. In a change of control transaction, there is often a cash flow enhancement to the buyer and/or seller via combination, such that the buyer can offer more value to the shareholders of the target company than the market grants on a stand-alone basis. The difference between the publicly traded price of the independent company and the value achieved in a strategic acquisition is commonly referred to as a control premium.

Closely held securities, like common stock interests in wealth management firms, don't have active markets trading their stocks, so a given interest might be worth less than a pro rata portion of the overall enterprise. In the appraisal world, we would express that difference as a discount for lack of marketability.



Sellers will, of course, want to be bought out pursuant to a buy-sell agreement at their pro rata enterprise value. Buyers might want to purchase at a discount (until they consider the level of value at which they will ultimately be bought out). In any event, the buy-sell agreement should consider the economic implications to the wealth management firm and specify what level of value is appropriate for the buy-sell agreement.

Fairness is a consideration here, as is the sustainability of the firm. If a transaction occurs at a premium or a discount to pro rata enterprise value, there will be "winners" and "losers" in the transaction. This may be appropriate in some circumstances, but in most wealth management firms, the owners joined together at arms' length to create and operate the enterprise and want to be paid based on their pro rata ownership in that enterprise. That works well for the founders' generation, but often the transition to a younger and less economically secure group of employees is difficult at a full enterprise level valuation.

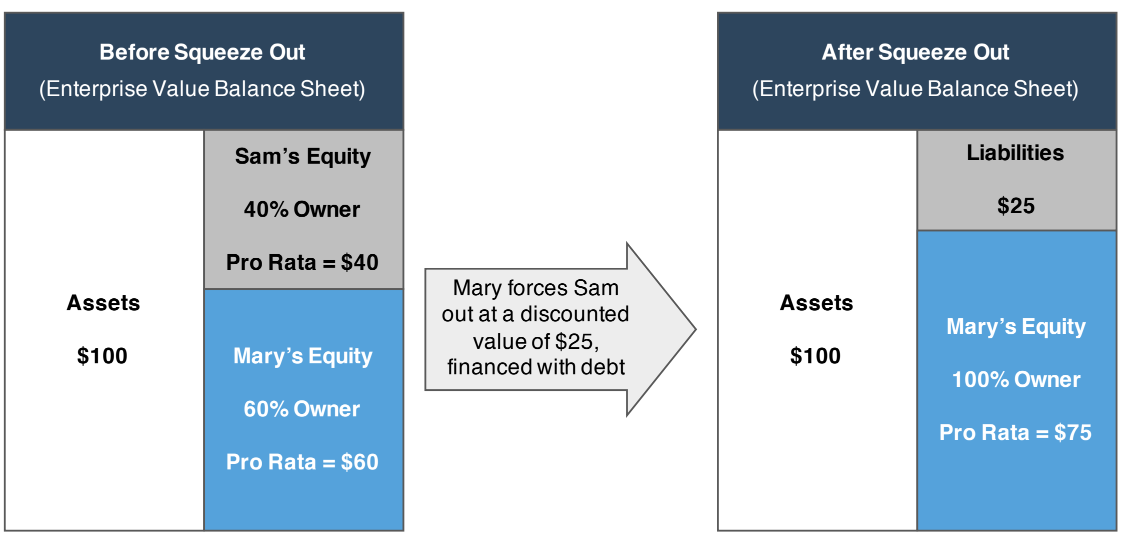
Further, younger employees may not be able to get comfortable with buying a minority interest in a closely held business at a valuation that approaches change of control pricing. Ultimately, there is often a bid/ask spread between generations of ownership that has to be bridged in the buy-sell agreement, but how best to do it is situation specific.   Whatever the case, the shareholder agreement needs to be very specific as to level of value.

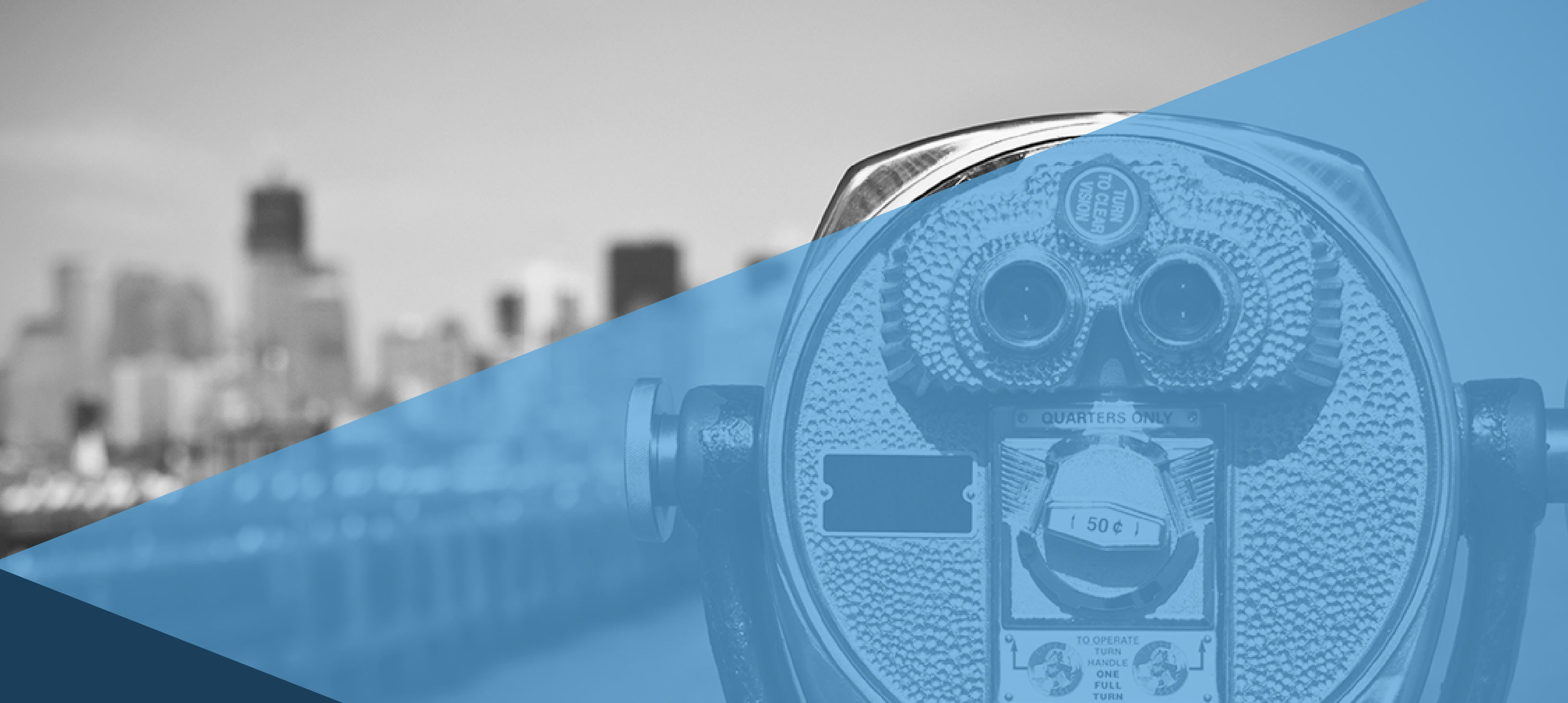
One thing to avoid in buy-sell agreements is embedded pricing mechanisms that unintentionally incentivize the behavior of some partners to try to "win" at the expense of other partners. We were involved in one matter where a disputed buy-sell agreement could be read to enable other partners to force out a minority partner and redeem their interest at a deeply discounted value.

Economically, to the extent that a minority shareholder is involuntarily redeemed at a discounted value, the amount of that discount (or decrement to pro rata enterprise value) is arithmetically redistributed among the remaining shareholders. Generally speaking, courts and applicable corporate statutes do not permit this approach in statutory fair value matters because it would provide an economic incentive for shareholder oppression.

By way of example, assume a business is worth $100, and there are two shareholders, Sam and Mary. Mary owns 60% of the business, and Sam owns 40% of the business. As such, Mary's pro rata interest is worth $60 and Sam's pro rata interest would be valued at $40. If the 60% shareholder, Mary, is able to force out Sam at a discounted value (of say, $25 – or a $15 discount to pro rata enterprise value), and finances this action with debt, what remains is an enterprise worth $75 (net of debt). Mary's 60% interest is now 100%, and her interest in the enterprise is now worth $75 ($100 total enterprise value net of debt of $25). The $15 decrement to value suffered by Sam is a benefit to Mary.

This example illustrates why fair value statutes and case law attempt to limit or prohibit shareholders and shareholder groups from enriching themselves at the expense of their fellow investors.





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Does the pricing mechanism create winners and losers? Should value be exchanged based on a control level valuation that considers buyer-seller specific synergies, or not? Should the pricing mechanism be based on a value that considers valuation discounts for lack of control or impaired marketability? Exiting shareholders want to be paid more and continuing shareholders want to pay less, obviously. What's not obvious at the time of drafting a buy-sell agreement is who will be exiting and who will be continuing.

There may be a legitimate argument to having a pricing mechanism that discounts shares redeemed from exiting shareholders, as this reduces the burden on the firm or remaining partners and thus promotes the continuity of the firm. If exit pricing is depressed to the point of being punitive, the other shareholders have a perverse incentive to artificially retain their ownership longer and force out other shareholders. As for buying out shareholders at a premium value, the only argument for "paying too much" is to provide a windfall for former shareholders, which is even more difficult to defend operationally. Still, all buyers eventually become sellers, so the pricing mechanism has to be durable for the life of the firm.

4. Formula Pricing, Rules-Of-Thumb, and Internally Generated Valuation Metrics Don't Withstand Time

Since valuation is usually the most time consuming and expensive part of administering a buy-sell agreement, there is substantial incentive to try to shortcut that part of the process. At one time, wealth manager valuations were thought to gravitate toward about 2% of AUM.

We have written extensively about the fallacy of formula pricing. No multiple of AUM or revenue or cash flow can consistently estimate the value of an interest in a wealth management firm. A multiple of AUM does not consider relative differences in stated or realized fee schedules, client demographics, trends in operating performance, current market conditions, compensation arrangements, profit margins, growth expectations, regulatory compliance issues, and a host of other issues which have helped keep our valuation practice gainfully employed for decades.

The example below demonstrates the problematic nature of this particular rule of thumb for two wealth managers of similar size, but widely divergent fee structures and profit margins.

	Firm A	Firm B
Assets Under Management	$1,000,000,000	$1,000,000,000
x Realized Average Fee	1.00%	0.40%
= Revenue	$10,000,000	$4,000,000
x EBITDA Margin	25.00%	10.00%
= EBITDA	$2,500,000	$400,000
Implied Value at 2% of AUM	$20,000,000	$20,000,000
Effective Multiple of EBITDA	**8.0x**	**50.0x**

Both Firm A and Firm B have the same AUM. However, Firm A has a higher realized fee than Firm B (100 bps vs 40 bps) and also operates more efficiently (25% EBITDA margin vs 10% EBITDA margin). The result is that Firm A generates $2.5 million in EBITDA versus Firm B's $400 thousand despite both firms having the same AUM. The "2% of AUM" rule of thumb implies an EBITDA multiple of 8.0x for Firm A—a multiple that may or may not be reasonable for Firm A given current market conditions and Firm A's risk and growth profile, but which is nevertheless within the historical range of what might be considered reasonable. The same "2% of AUM" rule of thumb applied to Firm B implies an EBITDA multiple of 50.0x—a multiple which is unlikely to be considered reasonable in any market conditions.

We've seen rules of thumb like the one above appear in buy/sell agreements and operating agreements as methods for determining the price for future transactions among shareholders or between shareholders and the company. The issue, of course, is that rules of thumb—even if they made perfect sense at the time the document was drafted—do not have a long shelf life. If value is a function of company performance and market pricing, then both of those factors have to remain static for any rule-of-thumb to remain appropriate. This circumstance, obviously, is highly unlikely.

But the real problem with short cutting the valuation process is credibility. If the parties to a shareholder's agreement think the pricing mechanism in the agreement isn't robust, then the ownership model at the firm is flawed. Flawed ownership models eventually disrupt operations, which works to the disservice of owners, employees, and clients.

5. Don't Forget to Specify the "As Of" Date for Valuation

This seems obvious, but the date appropriate for the valuation matters. If the buy-sell agreement specifies that value be established on an annual basis (something we highly recommend to manage expectations and avoid confusion), then the date might be the calendar year end. If, instead of having annual valuations performed, you opt for an event-based trigger mechanism in your buy-sell, there is a little more to think about.

Consider whether you want the event precipitating the transaction to factor into the value. If so, prescribe that the valuation date is some period of time after the event giving rise to the subject transaction. This can be helpful if a key shareholder passes away or leaves the firm and there is concern about losing clients as a result of the departure. After an adequate amount of time, the impact on firm cash flows of the triggering event becomes apparent. If, instead, there is a desire to not consider the impact of a particular event on valuation, make the as-of date the day prior to the event, as is common in statutory fair value matters.

6. Appraiser Qualifications: Who will perform the Valuation?

Once you decide to engage a professional to value your firm, you'll need reasonable criteria to decide whom to work with. Often, partners in wealth management firm feel they are equipped to value their own business as wealth management firms (unlike many other closely held businesses) have ownership groups with ample training in relevant areas of finance that enable them to understand financial statement analysis, cash flow forecasting, and market pricing data.

What insiders lack, however, is the arms' length perspective to use their technical skills to determine an unbiased result. Many business owners suffer from familiarity bias and the so-called "endowment effect" of ascribing more value to their business than what it is actually worth simply because it is well-known to them or because it is already in their possession. On the opposite end of the spectrum, some owners are prone to forecast extreme mean reversion such that they discount the outperformance of their business and anticipate only the worst.

Partners with a strong grounding in securities analysis and portfolio management have a bias to seeing their business from the perspective of intrinsic value, which can limit their acceptance of certain market realities necessary to price the business at a given time. In any event, just as physicians are cautioned not to self-medicate, and attorneys not to represent themselves, so too should professional investment advisors avoid trying to be their own appraiser.

Over time, we have reviewed a wide variety of work product from different types of service providers, but have generally observed that there are two types of experts available to the ownership of wealth management firms: Valuation Experts and Industry Experts. These two types of experts are often seen as mutually exclusive, but you're better off not hiring one to the exclusion of the other.

There are plenty of valuation experts who have the appropriate training and professional designations, understand the valuation standards and concepts, and see the market in a hypothetical buyer-seller framework. The two primary credentialing bodies for business valuation are the American Society of Appraisers (ASA) and the American Institute of Certified Public Accountants (AICPA). The former awards the Accredited Senior Appraiser designation, or ASA, and the latter the Accredited in Business Valuation, or ABV, designation. Both require extensive education and testing to become credentialed, and continuing education. Also well known in the securities industry is the Chartered Financial Analyst designation issued by the CFA Institute. While it is not directly focused on valuation, it is a rigorous program in securities analysis.

There are also a number of industry experts who are long-time observers and analysts of the industry, who understand industry trends, and who have experience providing advisory services to wealth managers.

However, business valuation practitioners are often guilty of shoehorning wealth managers into generic templates, resulting in flawed valuation conclusions that don't square with market realities. By contrast, industry experts are frequently guilty of a lack of awareness concerning the use and verification of unreported market data, the misapplication of valuation models, and not understanding the reporting requirements of valuation practice.

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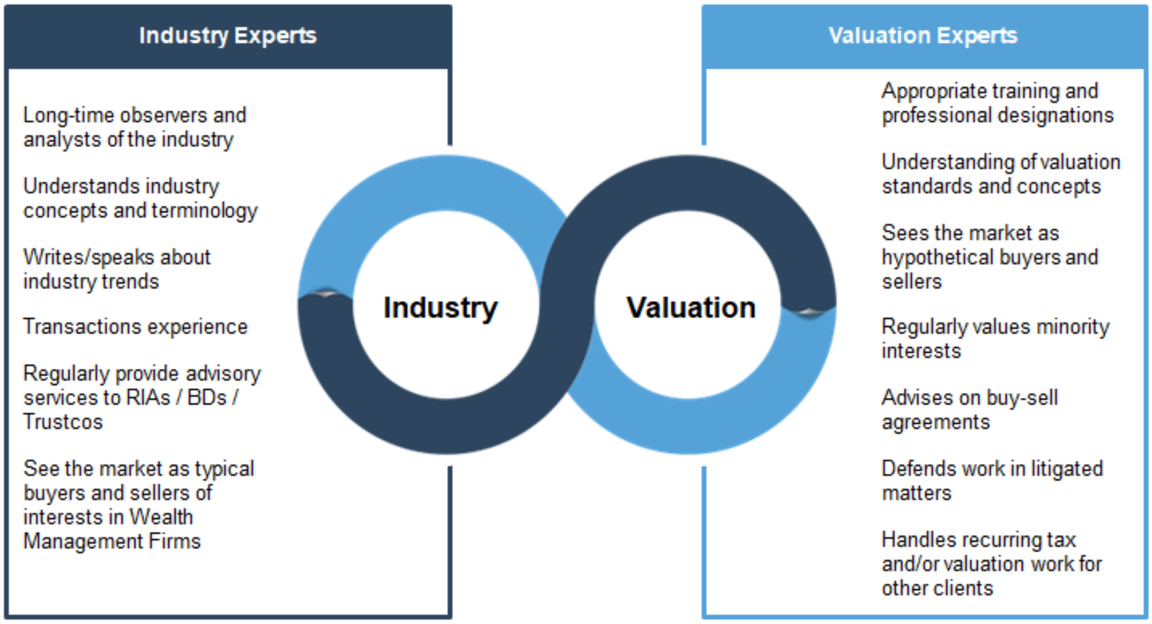

We think it is most beneficial to be both industry specialists and valuation specialists.

The valuation profession is still, for the most part, populated with generalists. But as the profession matures, an increasing number of analysts are realizing that it isn't possible to be good at everything, and that they can do better work for clients if they specialize in a type of valuation or a particular industry. Because our firm has had a specialty in valuing financial institutions since they day we opened for business in 1982, it was easy to pursue this to its logical conclusion.

Ultimately, you want an expert with both professional standards and practical experience.

7. Manage Expectations by Testing Your Agreement

No matter how well written your agreement is or how many factors you consider, no one really knows what will happen until you have your firm valued. If you are having a regular valuation prepared by a qualified expert, then you can manage everyone's expectations such that, when a transaction situation presents itself, parties to the transaction have a reasonably good idea in advance of what to expect. Managing expectations is the first step to avoiding arguments, strategic disputes, failed partnerships, and litigation.

Annual valuations do require some commitment of time and expense, of course, but these annual commitments to test the buy-sell agreement usually pale in comparison to the time and expense required to resolve one major buy-sell disagreement. If you don't plan to have annual valuations prepared, have your company valued anyway. Doing so when nothing is at stake will make a huge difference if you get to a situation where everything is at stake.

Most of the shareholder agreement disputes we are involved in start with dramatically different expectations regarding how the valuation will be handled. Going ahead and having a valuation prepared will help to center, or reconcile, those expectations and might even lead to some productive revisions to your buy-sell agreement.

PUTTING IT ALL TOGETHER

As in all industries, succession is often accompanied by some level of risk, but in the wealth management industry, such risk is often exacerbated because the adviser-client relationship is one of the main drivers of value for a firm.

There is a lot to consider when crafting a buy-sell agreement for your wealth management firm. Most wealth management firms have a shareholder agreement, but in many cases the agreements do not account for the many circumstances briefly addressed in this whitepaper.

If you already have a buy-sell agreement in place, our advice is to read it, carefully, and compare it to the commentary in this paper. If you don't understand something, talk with your partners about what their expectations are and see if they line up with the agreement. Consider having a valuation firm review the agreement to point out deficiencies, and then have your firm appraised. If there is a substantial difference of opinion in the partner base as to the value of the firm, or the function of the agreement, you know that you don't actually have an agreement.

On the positive side, a well-functioning agreement can serve the long-term continuity of ownership of your firm, which provides the best economic opportunity for you and your partners, your employees, and your clients. Strategically, it may well be the lowest hanging fruit available to enhance the value of your company, and to ensure your own career satisfaction.

About Mercer Capital

Mercer Capital provides investment managers, wealth managers, independent trust companies, and financial institutions with business valuation and financial advisory services related to corporate disputes, litigated matters, 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 investment managers from sell-side, buy-side, and mutually retained perspectives
- Providing financial statement reporting services related to purchase price allocation and goodwill impairment testing
- Providing expert witness testimony for purposes of marital dissolution and shareholder disputes
- Assisting RIAs and other asset managers with annual ESOP valuations, fairness opinions, and appraisals for gift and estate tax compliance

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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