# Keys to Successful Succession Planning for RIAs

## Insights on optimizing negotiating power for firms in transition

II Thought Leadership Studio

FRANKLIN TEMPLETON INVESTMENTS

# Sponsor's Perspective
## Succession planning is a critical component of success

Registered investment advisors (RIAs) share one essential characteristic — they put their clients' interests above all other concerns. In today's challenging environment, this can be an all-consuming endeavor. While a client-centric approach is the hallmark of RIAs, it's important that firms and advisors plan for their own futures as well. Developing a succession plan is one of the most important activities RIAs can undertake.

As part of our mission to help advisors succeed, we took a deep dive into the topic of succession planning to identify the issues that are most relevant to RIAs. The research findings highlighted the significant role that succession planning plays in protecting client interests as well as the interests of firm owners and employees.

A significant number of RIA firms are contemplating a change in ownership over the next five years, with most anticipating an eventual acquisition, merger, or buyout. It's never been more of a seller's market, with informed estimates putting the ratio of buyers to sellers at around 50 to 1. Nonetheless, buyers will play a dominant role in transactions when sellers come to the table unprepared. Sellers who haven't emphasized succession planning may be challenged when it comes to receiving the full valuation on an otherwise attractive firm.

While the seller's market is likely to continue for some time, potential buyers are seeking value for their money. They emphasize total AUM, revenue, and profitability, as well as compatibility in firm cultures. In fact, organizational culture is a primary decision criterion when transactions are under consideration. Finding a disconnect at the 11th hour has proved a deal breaker in more than one major transaction.

M&A activity in the industry is likely to increase dramatically over the next 5–7 years. For RIAs who want to take advantage of this trend, succession planning will play an important role in securing the best terms in any transaction. Developing a succession plan is a time-consuming and ongoing process. RIAs who want to guarantee the future of their firms, the best interests of their clients, and the well-being of their employees should make succession planning a priority.

At Franklin Templeton, we are deeply committed to supporting the independent investment advisors with whom we partner. One obvious

way we do this is by providing the comprehensive array of investment strategies and vehicles RIAs need to help clients achieve their goals. But our support extends far beyond the obvious. An institutional level of investment research, dedicated asset class specialists, portfolio consulting, and research on topics of special interest are just some of the resources we offer to help RIAs meet their clients' needs. We're committed to providing exceptional service to each and every one of the independent investment advisors we serve.

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# Executive Summary

The RIA industry looks to be at a major inflection point. A detailed survey of 162 RIA leaders at small, medium, and large US firms indicates that many of them are looking to transition into retirement, as two-thirds of prospective sellers anticipate a transaction within five years. That finding is not unexpected given the industry's aging demographics, however the survey reveals some surprising related trends.

## Key Findings

**Little more than a third** of RIA leaders surveyed have begun in earnest the process to ensure they will smoothly execute their transition to retirement. By underestimating the amount of time and the expertise required to prepare for a transition, whether internal or external, many RIA leaders are at risk of suboptimal outcomes for their firm as well as for the future of their clients and employees. It's revealing that nearly half of respondents feel this lack of preparedness will not diminish the pool of potential buyers or merger partners for their firm.

**Potential buyers** are looking to capitalize on sellers' "need for speed" brought on by poor planning, or are willing to wait for valuations to decline, perhaps driven by a downturn in the markets' fortunes. RIAs looking to grow via acquisition or merger recognize that the numbers say it's a seller's market, with would-be buyers far outstripping would-be sellers. However, given lofty current valuations and increased competition from other corners of the market, they are opportunistic rather than serial acquirers, by a 4-to-1 margin. While recognizing the value of growth, they generally aren't willing to leave their financial comfort zones to make deals.

**RIAs on both sides of the buy/sell equation agree** that organizational culture can make or break a deal. Nearly three-quarters of potential sellers and more than 85 percent of potential buyers feel cultural fit is a primary criterion in potential mergers or acquisitions. How "culture" is defined is less clear and quite subjective, but it is clearly a major component in good, bad, and failed matches.

To a surprising extent, leaders of RIA firms seem underprepared to transfer stewardship of their firms, placing clients and employees at risk.

## Eyeing transition without a plan

“Physician, heal thyself.” It’s an old proverb that feels especially relevant to the state of play in succession planning for registered investment advisors (RIAs). Wealth managers should by virtue of their work understand better than most the importance of thoughtful planning to financial health. Yet to a surprising extent, these leaders — often the very people who have helped shepherd the RIA community through a remarkable period of growth — seem underprepared to transfer stewardship of their firms, according to a joint *Institutional Investor*/Franklin Templeton survey of 162 RIA leaders at US firms ranging from approximately $100 million in AUM to upwards of $5 billion. The result is that the people they identify as being dearest to their firms — clients and employees — are at risk. These risks exist because many RIA firm leaders are too busy tending to more immediate demands on their time, a fact that seems laudable on the surface but does little to mask the widespread lack of succession planning.

In a related finding (figure 2), 41% of those surveyed identified themselves as prospective acquisition, merger, or buy-out candidates “who will eventually leave the investment advisory business.” Clearly, not all who see themselves exiting the business have a thorough plan for actually doing so.

The split between those who view themselves as buyers and those who identify as sellers does not mirror the broader RIA M&A market, as many informed estimates place the current ratio of would-be buyers (including private equity, wirehouses, pension funds, etc.) to sellers in the neighborhood of 50:1. While those numbers suggest a continued seller’s market, an unready seller can hardly expect any favors from the other side of the negotiating table: To cite another old proverb, business is business.

**EXPERT INSIGHT:**
**Buyers are better prepared**

“It’s been a seller’s market for 20 years,” says David Grau, Sr., JD, President and Founder, FP Transitions, and one of several valuation consultants interviewed for this report. “Sadly, buyers still dominate it, though, because they come to the table more prepared.”

**Figure 1. Succession plans among prospective sellers**

*Which of the following best describes your current succession plan?*

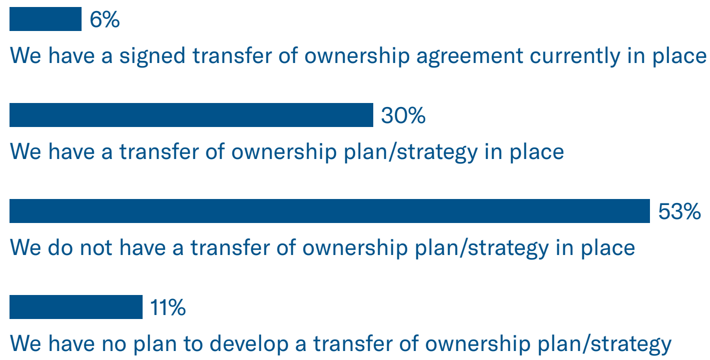
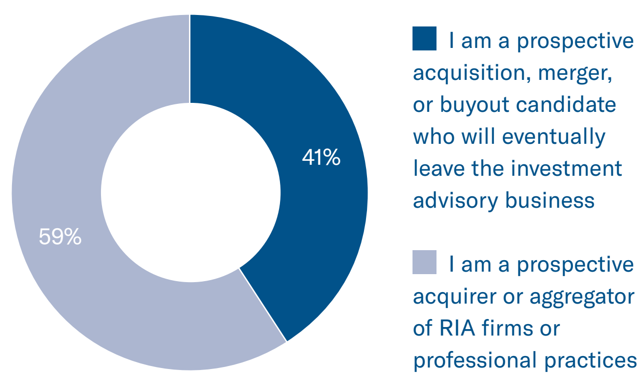



**Figure 2: It’s a Seller’s Market**

*Which of the following best describes your current position?*



## Sellers are in a hurry, but underestimate the time it takes to properly plan succession

RIA leaders looking to sell, merge, or otherwise depart the business are looking to do so in rather rapid fashion, with 50% anticipating such an occurrence within the next three years (see figure 3).

This finding underlines the outsized role that aging baby boomers play in the field. Two-thirds of the would-be sellers noted that preparing a succession plan and exit strategy was among their three highest professional priorities during this three-year period, followed by at least one related issue — expanding the client base and AUM, and preparing the firm's staff for an ownership change, as shown in figure 4.

The emphasis on preparing a succession plan reinforces the finding noted earlier — many firms currently don't have a succession plan in place.

One such example of the unprepped: The managing partner of a boutique firm with $100 million-$250 million in AUM, who says that she receives three to four calls a month from advisory firms, potential acquirers, and companies that would take over back-office functions. Her preference is to remain a stand-alone company. "We're a firm that wants to grow organically, and would rather be succeeded by someone that we groom," she says, while acknowledging she has yet to begin a succession plan. "That was the goal for this past year, and it's something we need to do," she says. "We just haven't had the time or the bandwidth."

This managing partner, a Gen Xer, isn't expecting to sell for at least a decade, making the back-burnering of succession planning more understandable — but no more advisable. Veteran consultants believe that succession planning should at least begin at the founding of a firm, can take 3-5 years to solidify, and should be updated continually. A lack of readiness undermines a would-be seller in numerous ways.

**EXPERT INSIGHT:**
**Waiting too long hurts valuation**

"Sellers typically wait too long to do succession planning, and if you do it is difficult to get a full valuation for an otherwise attractive firm that you've built," says Aaron Dorr, Principal of the Investment Banking Group at Sandler O'Neill + Partners. "Buyers want to come in with the confidence that they are not solving your problems."

**Figure 3: Two-thirds of prospective sellers anticipate a change of ownership within five years**

*When do you anticipate you will sell, merge, or conduct a transaction through which you will leave the investment advisory business?*

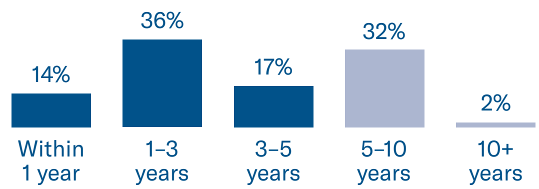
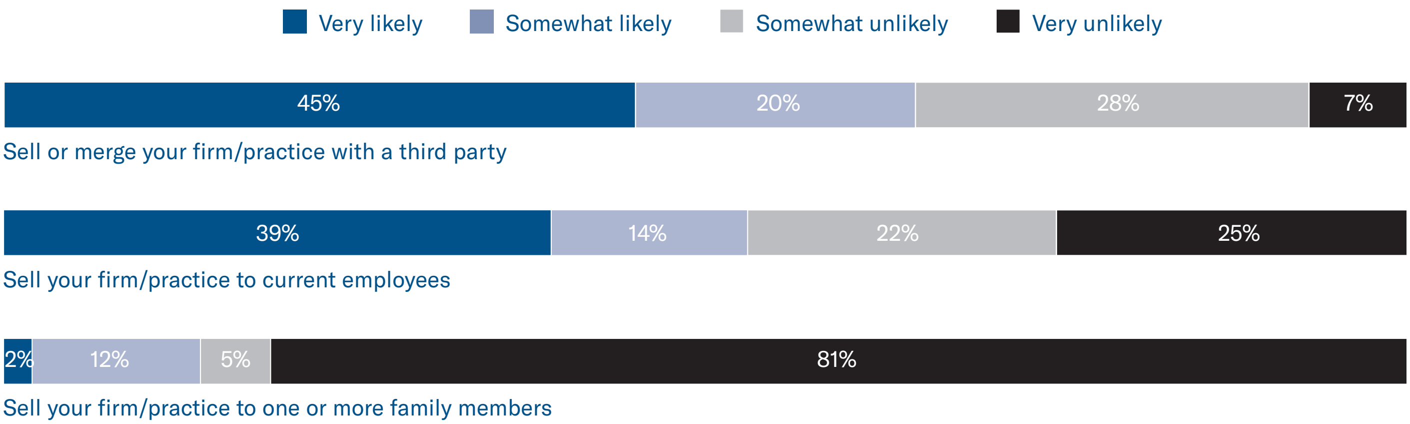



**Figure 4. Sellers focused on exit strategies and related issues**

*Which of the following are your highest professional priorities over the next three years?*

**Figure 5. RIA firms are most likely to sell to third parties**

*How likely are you to use the following transaction structures in your succession plan?*




## Looking for the next generation

Many buyers want to know that would-be sellers have a next generation in place, which places emphasis on the need for RIAs to institutionalize their firms — but only 11% of RIA sellers say that institutionalizing their investment process and building in-house investment management capabilities are among their three highest priorities over the next three years. Potential sellers seem to believe that their succession planning, or lack thereof, will have little impact on the potential pool of transaction partners. A little less than half feel it is very likely that they will sell or merge their firm with a third party, only slightly more than the 39% who believe it's likely that they will sell to current employees (see figure 5). It's possible, however, that some respondents don't grasp the nuance or the heavy lifting involved in some of these transactions.

**EXPERT INSIGHT:**
**An army of one undermines value**

Aaron Dorr, Principal of the Investment Banking Group at Sandler O'Neill + Partners, believes smaller RIA shops struggle with the challenge of institutionalization. "Asset management is a very people-centric business, and if 'people' means one person it's hard to get full value," he says.

One portfolio manager/research analyst who is a partner in a boutique firm with more than $1 billion in AUM says that he and his partners do grasp the complexity of succession planning, and they are putting in the work. "We've been doing a fair amount of planning, in particular around making sure we have evaluation formulas in place, and then exploring a transition, or structures of transition, for both internal and external sale," he says. "We feel like we have a very strong, next-gen team internally, which we've built specifically over the last five years both to match our growth and to be building a strong bench. They create that option for internal succession."

While matching up the next-gen's resources with the firm valuation for an internal sale could take considerable time and might eventually entail a combination of owner-financing and leverage, this potential route appeals to many in management at this particular firm.

"That would open the door a bit more to myself and my partners to have flexibility in easing out of the business, and not be quite as subject to the stringent structure that an outside firm may want in place," he says.

Still, he notes that while his firm has thought about engaging an outside consultant "so we have two sets of perspectives," it has not yet done so.

"The industry is woefully underprepared. Ego is one of the biggest things that gets in the way of people being able to transition their business to somebody else to own it, run it, and continue to take care of their clients."

**EXPERT INSIGHT:**
**There's a difference between internal succession and external sales**

- *Most RIAs prefer internal succession*
- *About a third plan properly and succeed on their own terms*
- *For the rest, the execution of a transition is often poor*

"Relatively few independent advisors really understand the difference between creating an internal succession plan and an external sale of the business," says David Grau, Sr., JD, President and Founder, FP Transitions. "A full succession plan is sophisticated; there are a lot of intricacies involved. It takes a diversified team to look at the problems and solve them from a variety of angles. A sale, that's different. That's simpler. That's business-broker stuff."

In Grau's experience, almost every RIA's preference would be to go the internal succession route. The appeal: ongoing cash flow, the satisfaction of continued work if they so choose, and seeing what they built live on in something like its current form.

According to Grau, about a third of those who desire internal succession plan effectively and succeed on their own terms. Another third begin to run out of runway and have to accelerate their plans and their own departure, with internal successors. The final third must sell to a third party or merge in order to see anything come of the business they worked so hard to build.

"Sometimes, they just don't have the time, enough talent, enough business acumen, growth rates, cash flow, and so on," he says.

Such delays look to be the norm. Louis Diamond, Executive Vice President and Senior Consultant, Diamond Consultants, says his experience also has shown that RIA sellers underestimate the groundwork involved in succession planning.

"Often the plan is just, 'There's a guy I'm friendly with down the street, and we play golf together and he seems like a good person,'" says Diamond. "Advisors often just don't take the proper amount of time to think through the plan; instead, they just kind of tick the box on succession planning. If it's not properly planned out, the execution is often poor."

## A tendency to overvalue

Consultants note that psychology plays a role in transitions, too. RIA leaders, they say, tend to overestimate the strength of their relationship with their clients, one factor in their strong tendency to overvalue their firm and underprepare for their eventual exit from the stage. One self-identified potential buyer of RIAs, the president of a boutique firm, put it in no uncertain terms.

"I think the industry is woefully unprepared, and ego is one of the biggest things that gets in the way of people being able to transition their business to somebody else to own it, and run it, and continue to take care of their clients beyond their career," he says.

Some RIAs, however, are not only looking toward the horizon but busily preparing for the sunset. The principal of a sole proprietorship with $500 million in AUM has firmly committed to transferring the business to current employees, preferably in the next three years, via a combination of an outside loan and owner financing, and recently hired an external consultant to help regiment the process.

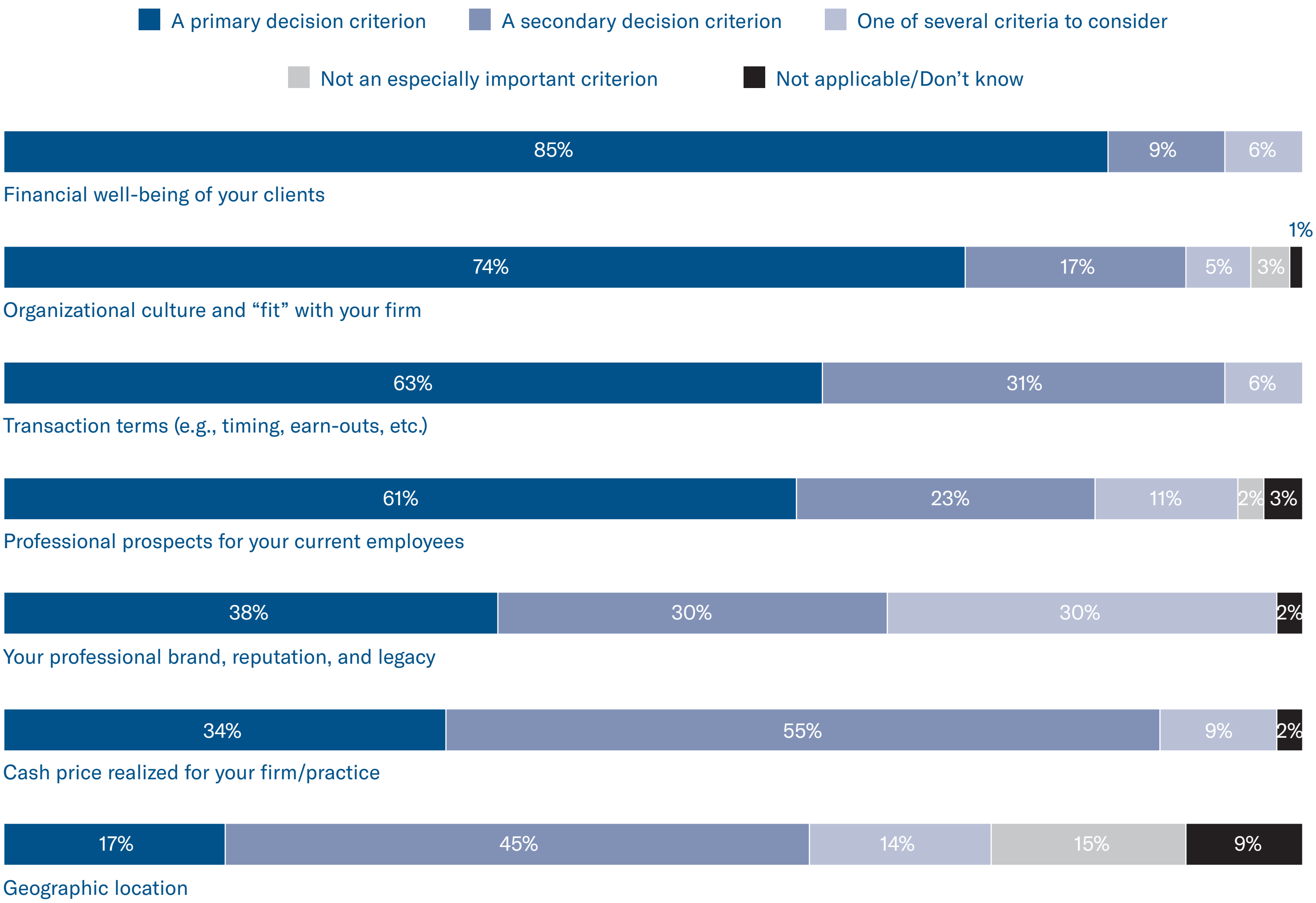
"We're looking at potential structures and approximate sale price and timing," the principal says. "We've been meeting with the new ownership group on a regular basis to train them. Every other session, we talk about the transaction, and prepping for that, and other sessions are more technical training."

This principal doesn't plan to retire completely but rather function more as an employee, focusing on client work instead of administration and management. Beyond cherry-picking the desired function and workload, the succession route also appealed to this principal's principles.

"I've built this whole practice on the team approach," she says. "With [an internal succession plan], I can ensure that my clients are still going to be well taken care of and that my employees will continue to have the nice situation that they have now."

**Figure 6. Client concerns and cultural fit outweigh geography, brand, and even price**

*To what extent will the following factors contribute to your decision to select an acquirer, merger partner, or other transaction arrangement?*




## Culture matters – but what exactly is it?

The centrality of culture in finding the right fit between would-be buyers and sellers — and the complexity of defining and determining "culture" itself — is another key takeaway from the survey. Sellers placed the financial well-being of their clients at the top of the list of decision criteria for assessing a buyer or merger partner, followed by organizational culture at 74% (see figure 6). Potential buyers, meanwhile, seem somewhat less focused on new employees absorbed in a deal: a little less than half say they "usually" include employment commitments to an acquired company's professional staff.

The data above may seem to indicate a lack of emphasis on "Show me the money" from the sellers' perspective, but it is worth noting that, when asked what sort of advice and support they might be looking for from any external consultants in advance of a would-be sale or merger, more than three-quarters of potential RIA sellers cited the valuation of their firm, widely outpacing the notion of developing a formal succession strategy and plan, as shown in figure 7.

**Figure 7. Prospective sellers will call on experts for valuation advice**

*As you prepare for a sale or merger, do you anticipate drawing on external advisors (consultants, asset managers, lawyers, accountants, etc.) for advice and support in the following activities?*


> "Managing directors may be happy with their lives and their compensation, but we have younger employees, too, and if we plateau, they'll leave us, and then we're in big trouble."

**EXPERT INSIGHT:**
**Don't lead with the pricing conversation**

"RIAs [considering a sale] will often lead with the pricing conversation, when that's probably five or six steps down the line," says Louis Diamond, Executive Vice President and Senior Consultant, Diamond Consultants. "If the proper fit is identified, then price and terms fall into place. If you find the right fit, there's pretty much a market rate for the business."

## DEAL-BREAKER / Separation Anxiety

David DeVoe has been involved in countless RIA deals over the years as the managing director and founder of DeVoe & Co. Among deals gone wrong, an early blowup has remained continually instructive. The two sides of the transaction had gone through virtually the entire acquisition process, with the soon-to-be coworkers even looking at new office space together. And then….

"Two weeks before the expected signing, with tens of thousands of dollars in bills paid, the seller walked away out of the blue," DeVoe recalled. "He gave some throwaway reason that obviously wasn't true. The reality was that the seller had not gone on the psychological journey that he needed to go on to be able to sell his firm."

Like many would-be sellers, this one had gotten caught up in the shiny object that is valuation, and all the many great things, financial and professional, that can happen for the principal and his employees. Only when he caught his breath did he become aware that he wasn't ready for retirement – or change, period. Entrepreneurs tend to be by their nature controlling, and succession means ceding control; after decades of being known as a wealth manager CEO, their very identity is called into question, too.

"We sometimes refer to ourselves as therapists with spreadsheets," says DeVoe. "After that experience, we learned that we need to reach across the table and work intimately with the seller, even though they're not paying our fees. The psychological journey is profound, and we need to help them go on that journey."

The president of a large Midwest RIA who identifies as a buyer noted that two of its last five deals have been plagued by precisely these issues.

"One of the challenges is to be able to emotionally prepare an exiting advisor," he says. "It's a little like how until you've had kids you never realized how much you could love being a parent. We might be able to negotiate how that transaction works at the very end a little better – not to sugarcoat things, but maybe have that more pre-negotiated." ●

## What's whetting buyers' appetites?

Would-be RIA sellers will find no shortage of interested buyers, but most of those looking for an acquisition are not serial acquirers seeking to bump up AUM, revenue, and profits. Rather, nearly 80% of buyers describe themselves as opportunists.

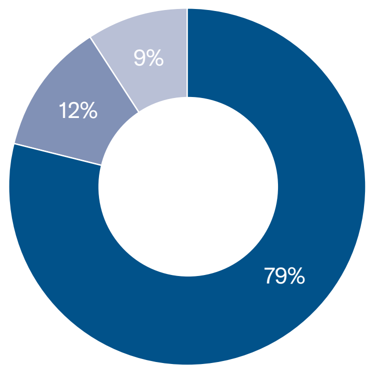
Would-be acquirers are looking to grow for a myriad of reasons: (1) The difficulty of creating significant organic growth is one driver. "We have the infrastructure to handle a lot more volume, so if we can acquire and plug these people, clients, assets, and talent into our infrastructure, it's a win-win," says the president and COO of one boutique firm. (2) Short-term sustainability is another. "A little larger organization is a bit more sustainable to market during a big downturn," says the managing director of a boutique Midwest RIA with $500 million–$1 billion in AUM. (3) Long-term sustainability is yet another. "While the managing directors may be happy with their lives and their compensation, we have younger employees, too, and if we plateau, they'll leave us, and then we're in big trouble," says the same Managing Director. "So, we want to create exciting career opportunities for them, and that's where growth is absolutely critical." (4) And some are kicking the tires for scale. "In a maturing industry, the only way to keep up and offer more at a lower cost is through scale," says the president of financial services for a Midwest firm. "Fintech is disruptive, and a by-product of that will be [a need for] scale, because if you have that you can offer more things at a lower cost."

The same executive, who also notes the arbitrage opportunity that comes with increasing size — "We'll buy a $1 million shop at 5-6 times earnings. A $50 million shop all of a sudden is probably going to be worth 10 times earnings. And if you go publicly traded, now you're at 16 times earnings" — isn't alone among would-be buyers in seeing growth as an existential issue. An SVP/buyer at one boutique RIA says that the firm is "out of the game right now due to excessive valuations. We're using our own money, so not overpaying for anything," but he believes a downturn in the market will be a catalyst for a firm such as his that is ready to grow once valuations decline to the point where they are again attractive.

**Figure 8. Buyers are most likely to approach acquisitions opportunistically**

*Which of the following best describes the role of RIA-firm acquisitions at your company?*

- Opportunistic acquirer: we are likely to acquire or merge with an advisory firm only when presented with a very good opportunity
- Serial acquirer: we use multiple acquisitions/mergers as a source of growth in AUM, revenue, and profits
- Aggregator: acquisitions and mergers are a cornerstone of our business strategy




"We don't think the middle-market guys will survive," he says. "To be a player, you have to have some scale. You have to have the people, the money to pay the people, the access to investment differentiators, and top-notch advisory work — everything from financial planning to estate planning to tax planning to insurance planning. Of course, we could be completely wrong, but that's what we believe."

## DEAL-BREAKER / "(Not) Sharing the wealth"

The president of one RIA firm has done five transactions in the past 15 years, which have added around $200 million to its AUM. But most memorable to him is one that fell through despite the proprietor's strong interest in selling.

"We were very close to an acquisition, but the founding partner owned all the equity," he says. "He had two key employees who managed maybe 70% of the client relationships, but he had given them no equity."

The risk was clear: Those employees had no skin in the game and could, and probably would, hit the road in the case of a sale, taking as many clients as possible with them.

"They're thinking, 'We've got the client relationships, we can just take them and go across the street,' says the RIA president. "So, we required that those two employees have equity before we came in, or receive equity in the transaction from the seller, not from us.

"He pushed back on that a bit, so we just walked away."

**Figure 9. Sellers are likely to have an upper hand**

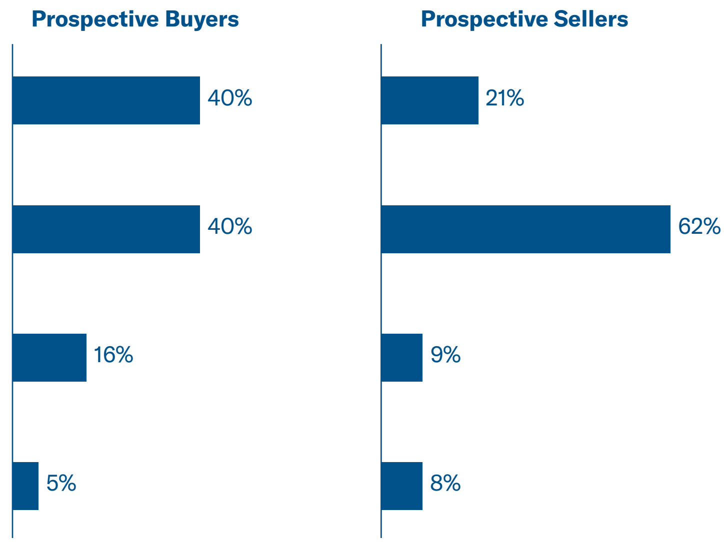
*Which of the following best describes your expectations for the market for acquiring advisory firms/practices in your market segments five years from now?*

**Seller's market:** I anticipate qualified acquirers or merger partners will have to compete aggressively for high-quality acquisition candidates five years from now.

**Niche market:** I anticipate acquirers or merger partners will have to spend substantial effort to find the right acquisition candidates five years from now.

**Buyer's market:** I expect attractive acquisition/merger candidates will be abundant five years from now.

**Another type of market**




## Concern over valuations

Implicit in the notion of being "opportunistic," and explicit in their words, is that would-be RIA buyers aren't looking to pay above the odds. Some say that has been, and remains, a difficult task, especially as private equity, pension funds, and the like elbow their way to the table. The pool of buyers has only broadened as the industry has proved itself out.

"We thought valuations in the space overall were pretty rich three years ago, and they're richer now," says a portfolio manager at a boutique RIA.

"The multiples that a lot of firms are able to garner now just throws our math off. That's particularly true as you get into the larger transactions, the $300 million-$500 million or larger firms. A lot of those groups have investment bankers that can go out and get non-strategic buyers."

The president of financial services for a large RIA adds that "it's a seller's market, primarily because you've got silly money on the sidelines, like private equity firms, that are willing to throw huge multiples at the sellers."

## Buyers will have to compete hard

Potential RIA sellers and buyers share a similar view of what the marketplace will look like in five years — a little more than 80% of sellers say they expect a seller-centric market (with those viewing it as a warm "niche market" outpacing a hot "seller's market" by about 3-1), a view mirrored by buyers (although with an even split between "niche market" and "seller's market" views).

## What do buyers' value? Value

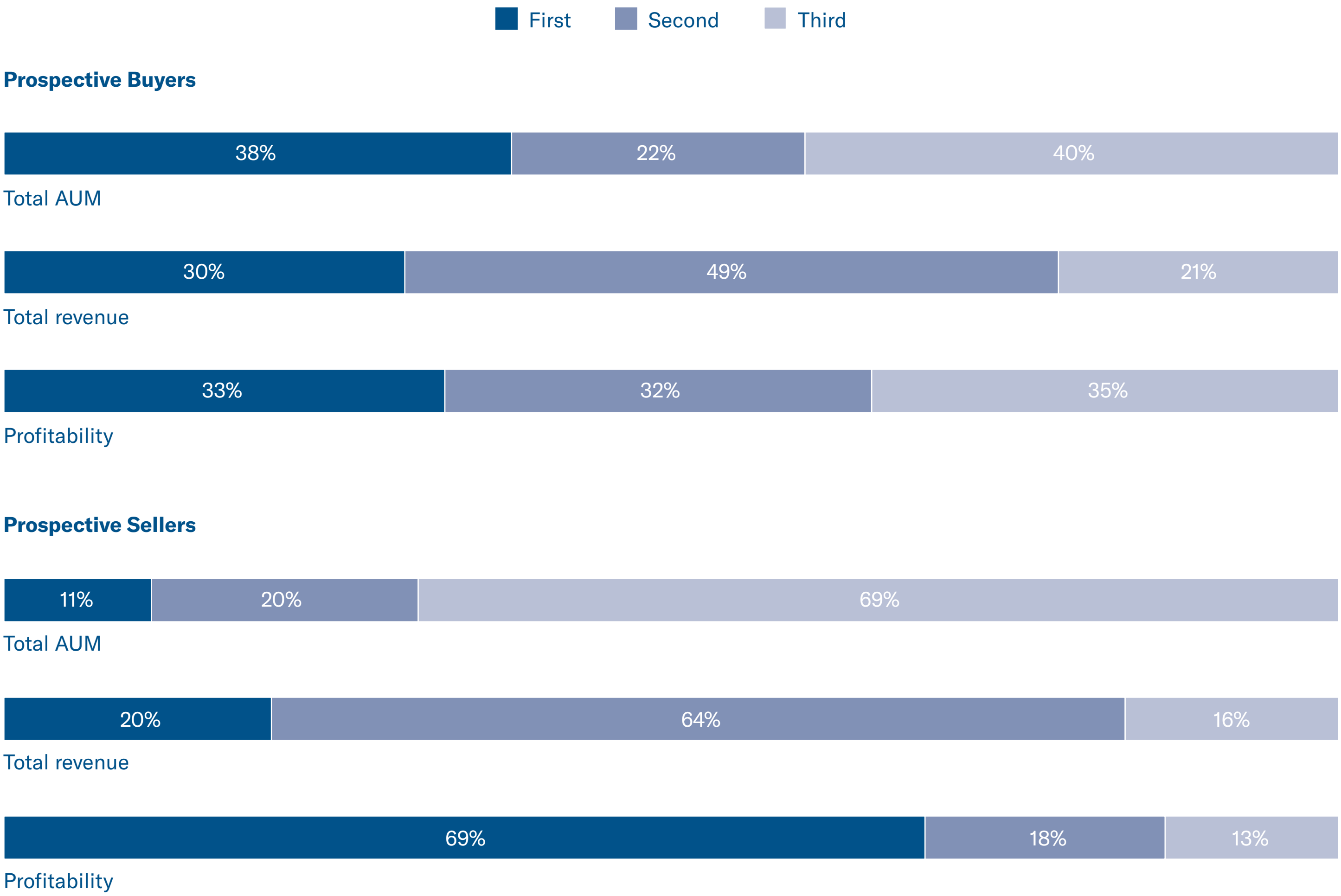
Potential buyers clearly want value for their money, a sometimes vexing expectation in the current deal climate. In addition, they want to avoid obvious red flags (disciplinary or regulatory issues), and they want similar or complementary business models, value propositions, and client bases. By and large, they also want the seller to stay around long enough to help transition over those clients.

"It would be rare where we would be interested in acquiring a firm where it was a 'Sell and I'm leaving the business' situation,'" says the president of a boutique RIA firm. "It's very difficult to retain client assets over a three-year or better time horizon in that scenario. Once their advisor leaves, you're basically having to resell them on your firm. It becomes more and more risky."

From a financial perspective, what do would-be buyers place the highest value on — profitability, revenue, or AUM? Unlike sellers, who

**Figure 10. Buyers seek assets to manage, while sellers expect profits to make their firms attractive**

*Please rank the importance of the following financial metrics in maximizing the attractiveness of your practice/firm as an acquisition or merger candidate.*




clearly rated maximizing profitability first, revenue second, and AUM third, buyers proved almost evenly split between these three drivers. It is a split that suggests buyers are especially circumspect in their evaluation of prospective acquisitions.

"It's profitability for us," says a senior research consultant at a large RIA firm. "We don't want to just grow for growth's sake."

Some argue that AUM is "almost an irrelevant feature," in the words of a would-be RIA acquirer also in the profitability-first camp.

"It could be that somebody has built a business up and priced their services way below where they ought to be," says the president of one firm. "It's going to be a really steep and difficult mountain to climb to get the revenue on that AUM to where it ought to be, and if you can't get that, you're never going to get to profitability. And it becomes risky if you think you're going to buy the revenue and find a way to squeeze operating expenses out and generate more margin on it. What ends up happening is that the experience the client had with their advisor or firm becomes watered down. Ultimately, you can have shrinking revenues and shrinking AUM."

Nonetheless, AUM is king to many buyers. "We think we can do a better job on the operations and increase profitability, and given the association with a group like ours, we think the revenues can grow," says an SVP at one firm. "So, to us, AUM is a better demonstrator of success before we get involved with growing their practice. We would expect a high profitability ratio — if they're terrible at their business, that would be a big negative — but part of what we bring to the table is business operations that help leverage what they are good at, and grow and be more profitable."

Those who feel strongly that they can take out a lot of non-personnel overhead costs in an acquisition have an eye for revenue. "Revenue is important to us given how integrated our platform is now from a technology standpoint," says the portfolio manager of one firm. "We think it's really scalable from a front office, middle office, and back office point of view."

## DEAL-BREAKER / Too slow to go

Deals that look good on paper often go wrong due to personality conflicts and other culture-based factors. But sometimes only in the run-up to the conclusion of the transaction does it become apparent that a seemingly good fit isn't. It is a lesson that Louis Diamond of Diamond Consultants learned in trying to broker an acquisition between a Midwest RIA and an East Coast RIA.

"One of the firms had an investment approach that was very appealing to the other firm because they were outsourcing more of the investment management. And both firms had clients in each other's markets even if they didn't have a physical presence," Diamond recalls. "Their philosophies were aligned, and they became great friends."

Beyond this hand-in-glove fit, everything looked good on paper, too, with the general deal terms sketched out to everyone's satisfaction. And then...

"It just fell apart because the momentum was lost," says Diamond. "The acquirer took forever to figure out the equity structure in the deal, and ultimately the smaller firm that was looking to sell realized that if they joined this firm, everything would be like banging their head against the wall.

"The deal became a lens into what it would be like to work at the firm, and they pulled the plug." ●

### EXPERT INSIGHT: What determines valuation?

- *Profitability, growth trajectory, and minimal organizational risk are three major criteria*
- *Discounted cash flow is complicated, but other methods of calculating valuation are risky*
- *Valuation varies depending on internal succession or external sale*

According to valuation consultant David DeVoe, while there are countless factors that determine valuations, they all fall under the categories of profitability, growth, and risk.

"It's the ability for the firm to optimize — not necessarily maximize — profitability, have a solid growth trajectory and growth plan ahead of them, and have a less risky organization," DeVoe says. "A firm that has optimized the first two and mitigated as much risk as they can is going to be more attractive and valuable."

As to how to calculate valuation, DeVoe is unambiguous.

"There's one right way to do it, and that's discounted cash flow. Any other way is either risky, inadequate, or dangerous," he says. "Multiples of cash flow or revenue are particularly concerning. These are very blunt instruments. You're using math that a 12-year-old could do in their head to value a firm worth millions of dollars. It's your life's work, and you're doing it on the back of a napkin?

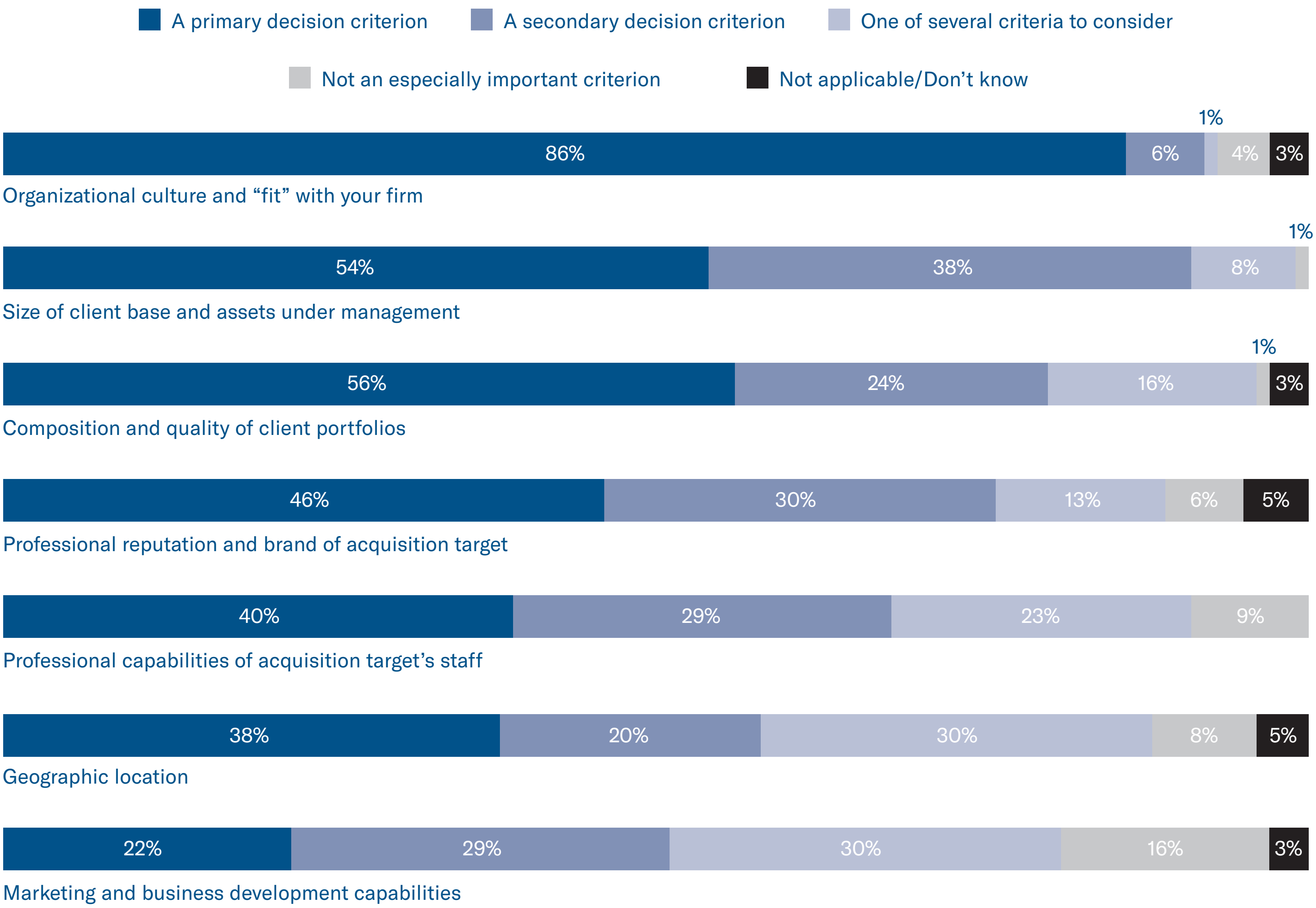
"Discounted cash flow is complicated," DeVoe says. "But it will create an accurate valuation that is appropriate for people risking large sums of money, and it also creates a mini-business plan for the organization."

Aaron Dorr, Principal of the Investment Banking Group at Sandler O'Neill + Partners, says RIA buyers are just like those in any other industry — they care about the profits they are buying. "The RIA space is really focused on earnings, EBITDA, cash flow," he says. "Valuation is based largely on the profitability of the company today, and an expected trajectory of those earnings over the next few years."

The question of how to value an RIA is inextricably linked to whether it's an internal or external transition, according to David Grau, Sr., JD, President and Founder, FP Transitions. "Doing a bottom line — even a discounted cash-flow, bottom line looking up — makes total sense in an internal transition," Grau says. "In an external transition, buyers aren't buying the bottom line. They're buying the seller's goodwill, client relationships, AUM, and cash flow. That's it. That's the entire list."

**Figure 11. Organizational fit prevails as a primary decision criterion**

*In your experience, how important are the following when evaluating prospective acquisition candidates?*




## The importance, and meaning, of culture

If potential buyers of RIA firms are split as to the most relevant financial metrics, they speak largely with one voice when it comes to the significance of organizational culture. Questioned about the importance of various criteria when evaluating a prospective acquisition candidate, fully 86% of would-be buyers deemed organizational culture and “fit” a “primary decision criterion,” far outpacing any other consideration.

If cultural alignment breeds contentment, misalignment can breed contempt.

“There are a lot of advisors that have a really good work-life balance,” says the president of a large RIA firm. “They play golf three or four times a week, have a bunch of clients who are friends at the country club, church, whatever. They work 20, 30, 40 hours a week at the most. That typically would not be a good fit for us. If I’ve got someone working 50 hours a week to support the growth of the business and making less than an advisor who strolls in at 9:00 and leaves at 2:00? That’s not going to breed the culture we want.”

For the president of another firm, learning about a potential acquisition target is inevitably, and by design, a drawn-out affair involving formal meetings, phone conversations, lunch, cocktails.

"I don't think being fast in getting a transaction done is appropriate in a personal services business," he says. "I find if you ask in the first conversation why they are interested in a merger, they're not always 100% honest. They get maybe 10% more honest in the second conversation, and you keep probing, but gently. It's almost a slow erosion before you finally get down to what's really making them tick in terms of wanting to do a transaction."

The president of one firm perhaps sums up culture best: "Yes, culture is squishy, but you want to have some kind of personal connection — you have to live with these people. At the highest level, it's people that you respect, and that have the same ethical outlook that you have."

## The future of RIA M&A

According to DeVoe & Company's *RIA Deal Book*, the first quarter of 2018 saw 47 transactions, a record number, and a 42% rise over the prior quarter. Valuation consultant David DeVoe is among the many who see continued strong M&A activity.

"M&A is likely to increase and possibly even accelerate dramatically over the next 5–7 years," says DeVoe. "There are a number of structural drivers that will put pressure on mergers and acquisitions. It's the demographics, it's the lack of succession planning in place, it's the power of scale."

With continued low barriers to entry in such an attractive field, DeVoe doesn't see overall firm numbers shrinking significantly, but he does see consolidation at the top, with 20-30 megafirms growing faster than the rest of the market.

Louis Diamond, Executive Vice President and Senior Consultant, Diamond Consultants, expects the same. "If I had a crystal ball, I'd say there are going to be a lot fewer RIAs, much like the number of accounting firms, and the larger, scaled players are going to be the ultimate winners," he says.

It's not all about the big getting bigger, and the middle getting squeezed. David Grau, Sr., JD, President and Founder, FP Transitions, points to the rise of bank financing as a game-changer. "SBA loans, conventional financing – they change the internal deals and the external deals," he says. "We have a level playing field for the first time. The sellers don't have to take all, or sometimes any, of the risk. We let banks do what banks do well — lend money and patiently wait to get paid with interest. If you had 50-to-1 interested buyers to sellers, but most of the buyers are bigger and stronger, what happens when the smaller folks can play, too? You might actually see a higher buyer-to-seller ratio in the future." ●

**EXPERT INSIGHT:**
**How do you assess cultural fit?**

- *People matter = culture matters*
- *Identify a firm's overall personality, e.g. growth culture or performance culture*
- *Take note of how a firm services its clients and deals with difficult ones*
- *Attire can be a good cultural tell*
- *The goal isn't perfect cultural overlap*

"Culture matters because this is a people business," says Aaron Dorr, Principal of the Investment Banking Group at Sandler O'Neill + Partners. "If the employees aren't happy, then the clients aren't happy, and the employees leave and the clients leave. Because people matter, cultures matter."

Which begs the question: What, exactly, does "culture" mean in the context of buying and selling RIA firms?

One element of culture is a firm's overall personality. Client service is another aspect of culture that is fairly easy to spot. "Some firms insist on having the person who generates the client also manage the client," notes Dorr. "Larger firms tend to compartmentalize those functions. If a business is, 'I do everything,' is that culture? Either way, it informs culture and makes it harder to pull the business together."

To get to the heart of the matter, valuation consultant David DeVoe advises his clients to ask some fraught questions. One example: "How do you handle a client that's abusive to your staff?"

"That's a cultural thing," DeVoe says. "Some will say, 'The client gets two strikes and they're out – they don't even get three.' Others will hem and haw, and say, 'We do our best to work around clients like that – we act as a team to try to mitigate that.' Those are two different cultural elements."

Louis Diamond, Executive Vice President and Senior Consultant, Diamond Consultants, points to the corporate uniform as another signifier, as well as demographics. "Attire is a pretty good tell of culture, how loose or laid back it is versus one that's more buttoned up and corporate," says Diamond. "And a firm of baby boomers is likely going to have a very different culture versus a firm with a lot of millennials."

No matter the precise definition, advisors stress the importance of having antennae up for cultural cues while emphasizing that cultures don't have to be identical.

"You're not looking for perfect cultural overlap, if that even exists," DeVoe says. "You're looking for cultures that are generally aligned with certain principles, values, and cultural elements."

## Conclusion

As buyers and sellers of RIA firms navigate M&A deals, they'll work out transaction terms by considering factors such as the size and quality of client accounts, assets under management, and post-transaction stewardship of client and employee relationships. Buyers and sellers may well disagree on the valuation of RIA firms. And while it may appear that sellers have a distinct advantage, buyers are reluctant to overpay for firms in pursuit of growth at any cost.

Both sides of M&A transactions concur, however, on the importance of cultural alignment between acquirers and their targets. Buyers, sellers, and their advisors agree that a firm's personality — its values and treatment of people — reveals especially useful indicators of cultural fit. Accordingly, they advise their peers to pay special attention to factors such as work ethic, client service, generalist professionals versus specialists, and a firm's growth outlook in their assessment of M&A partners. ●

## About This Research

In the autumn of 2018, Institutional Investor's Custom Research Lab, in collaboration with Franklin Templeton Investments, launched a research study composed of a survey and interview program among RIAs in North America. To explore RIAs' succession planning practices and concerns, we surveyed 162 RIAs and conducted a series of interviews with RIAs and valuation consultants to gather additional insight into the survey findings. The demographic highlights of the study are below.

**What are your firm/practice's total AUM?**

| | |
|---|---|
| $25 billion or more | 2% |
| $5 billion to $25 billion | 9% |
| $1 billion to $5 billion | 41% |
| $500 million to $1 billion | 7% |
| $250 million to $500 million | 21% |
| $100 million to $250 million | 14% |
| Less than $100 million | 6% |

**Which of the following best describes your firm?**

| | |
|---|---|
| Sole proprietorship | 7% |
| Boutique firm with several equity holders | 72% |
| Large, well-established firm owned by a corporate parent, private equity, or public market | 10% |
| Other | 11% |

**Where is your position located?**

| | |
|---|---|
| Northeast | 16% |
| Midwest | 33% |
| South | 11% |
| West | 40% |

**What is your title?**

| | |
|---|---|
| Chief executive officer or equivalent | 45% |
| Principal, partner, or equivalent | 22% |
| Chief investment officer or equivalent | 12% |
| Managing director or equivalent | 8% |
| Financial advisor, portfolio manager, or other title | 7% |
| Business development, M&A, or equivalent executive | 6% |

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