

# FINANCIAL PLANNING | DAILY

## To Market, to Market

*Mergers and acquisitions have finally started to pick up. But you may be surprised by the prices that good practices are not getting.* By Elizabeth Wine

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Observers and participants say the M&A market is just starting to recover from the economic disaster of the last two years. When assets dropped, firms' revenues dropped, buyers got scared and deals dried up.

In 2008, the typical firm lost 19% in assets under management. By 2009, that had translated into an average loss of about 10% of revenues, according to Dan Inveen at FA Insight in Tacoma, Wash., the consulting firm that prepared the Real Deals report on M&A for Pershing Advisor Solutions. "That affected the value firms could command," he says.

Now the recovery is starting to add assets back to clients' statements and revenues to advisors' balance sheets. And there is pent-up demand for deals.

Even so, prospective buyers remain wary. Looking ahead, they see growth rates lower than they were in the boom years. That caution means negotiations are taking a long time.

"There's a big price disconnect," says Liz Nesvold, investment banker at Silver Lane Advisors in New York, a boutique M&A investment bank specializing in asset and wealth management companies. "Out of this market, everybody's talking, but there's not a lot of doing."

### BUYERS VS. SELLERS

That gulf between buyers and sellers can be traced back to the ultra-frothy market that peaked in 2007, Nesvold says. Starting around 2000, wealth managers were in high demand from a variety of buyers, ranging from banks and wirehouses to other RIAs, later in the cycle. With so much competition, pricing was bid up.

At the height of the frenzy, buyers made little distinction between truly outstanding businesses and practices that were little more than a hefty client list. Everything got snapped up based on a multiple of revenues, regardless of the quality of those revenues. Advisors who had built high-quality, profitable businesses commanded relatively small premiums over businesses with lots of cash flowing in, but far fewer profits.

And now advisors think their businesses should still be worth those inflated prices. Many are not. "For thinly profitable businesses, it's hard to tell people your business isn't worth what you want, but it's even harder to tell them you were never worth what you thought you were worth in 2007," Nesvold says.

Making matters worse, Nesvold says, the pendulum has swung too far again, and overly cautious buyers are making the same mistake in reverse. Now buyers are discounting profitable firms. "Everyone was treated equally from a revenue perspective in 2007, now they're all being penalized equally," Nesvold says.

Nervous buyers want more guarantees and warranties about the businesses they're buying. Those demands are making sellers nervous too. "Buyers are further scrutinizing every possible aspect of your business, from client relationships at every point since inception to the market now and in the future," she says.

## **BACK IN THE GAME**

Still, Nesvold and other market watchers agree things are looking up. She believes the market will pick up again in earnest in 2011 and 2012. Meanwhile, more optimistic souls say the good times have already started. Schwab Advisor Services in San Francisco, which tracks small advisory firms, including some with less than \$100 million in assets under management, reported 53 deals this year, to mid-August. That's on pace to pass the 71 deals they tracked in 2009.

By comparison, Nesvold, who starts counting at \$200 million in assets, records 23 deals year-to-date. David DeVoe, Schwab Advisor Service's director of strategic development, predicts a rising pace of deal growth over the next five to seven years, citing demographics. Advisory principals are nearing retirement; the average age is 55, with up to 30% over age 60.

DeVoe also notes growing demand from several sides, including other RIA firms, and the increasing ranks of consolidators, or holding companies such as HighTower Advisors and Focus Financial Partners. There is even growing interest from private equity investors.

## **RULE-OF-THUMB PROBLEM**

Nesvold recalls that when she started in the business 20 years ago, a financial advisor lift-out commanded one times trailing revenue. At the peak, the top tick for wirehouses hit a multiple of 23/4. Another yardstick used-revenue multiples-were anywhere from 1.5 times to four to five times at the peak.

Observers say there are two problems with those rules of thumb. First, everyone applies the top multiple to their own businesses, giving themselves an inflated sense of worth. Mark Tibergien, CEO of Pershing Advisor Solutions in Jersey City, N.J., calls it the "Lake Wobegon Effect" after the popular radio show by humorist Garrison Keillor. In Lake Wobegon, "all the women are strong, all the men are good-looking and all the children are above average." At meetings of advisors, Tibergien asks the group how many of them think they're above average. Everyone raises a hand.

The second, bigger problem is that experts say the rules don't work with wealth management businesses. That's because each business is unique and should be valued using a variety of measurements. Inveen says if you must use some sort of yardstick, start with price to profits or price to cash flow, rather than revenues. Either would be a better measure of a firm's value, because the profitability of a firm can vary, and that is not captured in a revenue multiple.

Nesvold says some firms with hefty revenues are not that profitable because they have been overspending to service clients. That problem was highlighted in the aftermath of the market crash. She suggests buyers focus on the deliverable earnings, not revenues.

But all the experts warn against using any yardstick exclusively. "It's dangerous to compare deals on any kind of multiple," Inveen says. They agree a holistic view is necessary when sizing up deals.

## **KNOW WHAT MAKES VALUE**

Firms with different sizes and service models will obviously command different prices. But Inveen notes that even similar firms may have a different value.

Firms that have institutionalized their processes will always be worth more. A firm that has created transparent and repeatable processes for running its business is more valuable than a firm where all the knowledge resides with the owner. Tibergien puts it succinctly: "That's a practice, not a business." Businesses that share knowledge and that boast a deep management bench will be far more attractive to a buyer.

Another difference in firms is the type of client. An older client base made up largely of clients in retirement will always be worth less than a younger client base. But it does not stop there; even if a firm has demographics on its side, it must be more active in replenishing clients and have the marketing capability to bring in new clients.

Then there is the issue of transition. How long do you plan to stay with the firm to make sure the changeover goes smoothly? Buyers don't want to see an owner hit the retirement road as soon as the ink is dry on the contracts. Clients want the reassurance of knowing there is continuity.

At the same time, experts warn that too long a transition can be negative for all concerned. "Sellers are like fish and relatives," Tibergien says. "You want to get them out of there." Because relationships can often sour, he recommends that the buyer spell out expectations in the contract, including how long the seller will stay with the firm, how many new clients are expected to come into the firm and so on.

Dean Harman, owner of Harman Wealth Management, a wealth management and planning firm with \$100 million in assets in Woodlands, Texas, has already bought one firm and is in the process of buying another. The 41-year-old advisor let it be known in his area he was looking to grow via acquisition. "We have excess capacity within our staff, so if we can bring in \$20 million in one acquisition versus going out and finding new clients, it makes a lot of sense," he says, adding that although a successful transition takes several years, "I'm planning on being in the business for 20 or 25 years."

Nonetheless, he was very cautious about his deal. As the experts advise, he looked carefully at the structure of the target firm's revenues-commission-based business dependent on new sales or bringing in new assets was worth less to him than assets based on recurring revenue, such as managed accounts. He checked to make sure the client base was not too old, taking a lot of IRA distributions that would drain assets.

Harman was pleased with his first deal in 2006. He and his partner were a good match. They agreed that Harman would keep the seller on a contractual basis and to review the contract each year. For four years Harman extended his seller's contract. The seller would be there still, were it not for the fact that he died after a motorcycle accident at 71. "The clients had four years of transition, so it was not a strain," Harman says. "But had he not sold his practice, it would have been a disaster for his wife."

Harman believes advisors should have a plan in place at least three years before they want to stop coming to the office. He is amazed at how many advisors nearing retirement age are dreaming of simply finding a buyer and retiring in about six months. Most experts say at least three years is necessary to identify a good buyer fit, negotiate the sale and see it through the transition.

## **NOT ABOUT THE MONEY**

It's ironic that advisors safeguard other people's finances for a living, but often do not take sufficient care of their own when selling their businesses. Even so, money is not everything in a sale.

Inveen says that many advisors fall into the trap of "fixating on the right price" for their firm. Even though the bottom line is important, it's not the first thing to look at.

"First, do some hard thinking about why you need to do a deal, whether you're a buyer or a seller," Inveen says.

"What are you trying to achieve? What is your business strategy? What are your personal ambitions? Then make a determination on whether a deal fits."

He advises prospective sellers to keep coming back to personal and business goals, making sure their interests, personal ambitions and business strategies are aligned with their prospective buyers. Personal chemistry is nice too.

"We always like to jump right into prices and term structure and that stuff," he says.

Tibergien agrees. "It's premature to discuss numbers before the rest of the story unfolds." When buyers flatly assign a value to the business a seller has spent 30 years growing, the seller's feelings are often hurt. "You're dealing with financial people—they're naturally inclined to talk about what they know."

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