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# Wealth Management M&A Activity Is Starting to Heat Up But Caution Rules

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Deal activity is once again looking up in the wealth management industry.

During the financial crisis, assets dropped, firms' revenues fell, buyers got scared and deals dried up.

In 2008, the typical firm lost 19% of assets under management. By 2009, that had translated into an average loss of about 10% of revenue, according to Dan Inveen at FA Insight in Tacoma, Wash. "That affected the value firms could command," he said.

Now the recovery is adding assets back to clients' statements and revenues to advisers' 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," said Liz Nesvold, an investment banker at Silver Lane Advisers in New York, a boutique mergers and acquisition firm specializing in asset and wealth management companies. "Out of this market, everybody's talking but there's not a lot of doing."

That gulf between buyers and sellers can be traced back to the ultrafrothy market that peaked in 2007, Nesvold said. Starting around 2000, wealth managers were in high demand from a variety of buyers, ranging from banks and wire houses to other registered investment advisers 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. Advisers 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 advisers 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 said.

Making matters worse, she said, 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 said.

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 said.

Still, Nesvold and other market watchers agree things are looking up. She said 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 Adviser Services in San Francisco, which tracks small advisory firms, including some with less than $100 million of 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 of assets, records 23 deals year-to-date. David DeVoe, Schwab Adviser 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 Advisers and Focus Financial Partners. There is even growing interest from private-equity investors.

Nesvold recalls that when she started in the business 20 years ago, a financial adviser lift-out commanded one times trailing revenue. At the peak, the top tick for wire houses hit a multiple of 23/4. Another yardstick — revenue multiples — was 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, the CEO of Pershing Adviser Solutions in Jersey City, N.J., calls it the "Lake Wobegon Effect" after the popular radio show by the 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 advisers, 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 said 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 said 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 suggested 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 said. They agree a holistic view is necessary when sizing up deals.

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

Outfits 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 one 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 customers 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 said. "You want to get them out of there." Because relationships can often sour, he recommended 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, the owner of Harman Wealth Management, a firm with $100 million of assets in Woodlands, Texas, has already bought one firm and is in the process of buying another. The adviser let it be known in his area that he was looking to grow via acquisitions. "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," Harman said, adding that although a successful transition takes several years, "I'm planning on being in the business for 20 or 25 years."

Nonetheless, Harman was very cautious about the acquisition. As the experts advise, he looked carefully at the structure of the target firm's commission-based business dependent on new sales. He checked to make sure the client base was not too old, taking a lot of individual retirement account distributions that would drain assets.

Harman was pleased with his first acquisition 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 said. "But had he not sold his practice, it would have been a disaster for his wife."

Harman said he believes advisers 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 advisers 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.

It's ironic that advisers 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 said that many advisers 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 said.

"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."