Is a Real Deal Inevitable?

By Philip Palaveev

In each of the previous two years, the advisory industry saw record numbers of mergers and acquisitions (see figure 1). In 2007, 58 transactions occurred with firms having more than $100 million in assets under management (AUM), representing a 21-percent increase over 2005, which was the previous record-holding year. Even more important is that some of the industry’s best known and most successful independent registered investment advisory (RIA) firms are selling to acquirers, consolidators, or financing third parties. Most advisors say they wish to stay independent and transition ownership internally—yet many successful firms sell. Why?

Firms industry-wide face the problem illustrated in the following scenario: A firm has $5 million in revenue and more than $1.25 million in earnings before taxes. The 55-year-old founder holds 80 percent of the stock; three minority owners share the rest. It is not our intention to speculate on the value of the firm, but most would agree that it is worth $6 million to $10 million. While the majority owner enjoys significant success, income, and equity value, he or she also faces a challenging exit. To transition ownership within the firm, the successors would have to write checks for anywhere between $4.8 million and $8 million.

Unfortunately, the three potential successors still are paying for their 20 percent of ownership and do not have liquidity to make the purchase. In addition, the firm is growing assets by 20 percent annually. Who will buy out the founder? A deal with a strategic or financing buyer seems inevitable.

Our research found three factors that make external capitalization unavoidable for some firms:

1. The firm generates between $1 million and $2 million in revenue per partner. At this level of productivity, the firm has enough leverage to be transferable but still offers attractive economics for external acquirers.
2. The firm principal is stepping down and there is no clear succession plan in place. The clock is ticking, making external acquirers the only option.
3. The firm’s growth goals are not supported by cash flow and require additional capital. The desire to grow exceeds the capital provided by ongoing operations and the firm needs to raise additional capital to acquire other firms or enter new markets.

The second and third factors are intuitive, so we will explore the first factor: the effect of average partner (or owner) “productivity” (revenue) on the probability that the firm will be sold.

Revenue per partner helps predict whether a firm is likely to go through an external financing transaction because it represents the economics of the firm—in particular, the ability to create leverage. Consider the following questions:

- What is the real cash flow from the business, after compensation for labor? That free cash forms the basis for the transferable value of the firm—the stream of future cash that an acquirer wants.
- What are the economics of the firm? How many people (including partners) are needed to sustain this level of revenue, and what is their associated compensation?

A partner’s income consists of compensation for his labor and return on investment. Compensation for labor cannot be “sold” because the acquirers also will incur labor costs. For example, a single owner of a $1-million practice who generates about $500,000 in personal pretax income annually really has “job-related compensation” of $250,000 to $300,000 and “real profit” of $200,000 to $250,000 related to ownership.

Only the real profit may be capitalized and sold. An acquirer who pays $2 million for this firm is only buying the $200,000 to $250,000 in profit. If the original partner leaves, the acquirer must find an advisor capable of performing the same responsibilities of the departing partner—typically compensating the replacement in the same range of $250,000 to $300,000.
What happens to firms with less than $1 million in revenue per owner? As a rule of thumb, the personal income per owner ranges from 50 percent to 60 percent of the first $1 million in revenue. This first $1 million in revenue tends to be generated by the advisor, so a large portion may be attributable to compensation. Thus a $600,000 practice can be managed by one advisor who, with two assistants, services clients and generates $300,000 to $360,000 in income. The real profit is $0 to $110,000, depending on how much of it goes to compensation. The value of this firm is at best $800,000 (eight times earnings tends to be at the high range for small practices)—a disappointing amount for the advisor. Chances of a deal are slim. When revenue per owner is less than $1 million, there is too little transferable cash flow to interest institutional acquirers.

At this level of productivity we see deals between advisors that have little or no up-front cash and present high risk to the seller. In our research we define a successful deal as a well-structured transaction with significant capitalization and liquidity for the seller. Internal deals and deals between advisors are very common in this market, and institutional acquirers are rare.

Most deals occur between $1 million and $2 million in revenue per owner. Leverage occurs when the principal advisor maximizes capacity to service clients. At that point, the advisor needs to involve other specialists, or juniors, to increase productivity. For most advisors this happens somewhere around 80 to 100 clients, depending on revenue per client. With revenue per client of $6,000 (the industry average), an advisor will max out personal capacity at $480,000 to $600,000. Beyond this, leverage creates economic power. We draw a line at $1 million—roughly 100 clients, with $10,000 in revenue per client—as the point where leverage must happen.

The second million in revenue contains the leverage for a transaction. The normal profit from this revenue equals 25 percent or more of the second million, with non-owner compensation costs averaging around $200,000, including taxes and benefits. A practice with $1.5 million in revenue will average $700,000 in pretax income to the owner (with assumed overhead of 40 percent of revenue). The real profit in this practice is $400,000 to $450,000. A valuation of $3 million would not be excessive, representing less than seven times earnings.

The deal hinges on the leverage created by a non-owner advisor who generates high revenue—and sufficient earnings for an acquirer. An advisor who has excess capacity still may be willing to pay for the full $700,000 in earnings and, in a sense, overpay for the practice.

Notice that internal succession becomes problematic. If the non-owner advisor does not have liquidity for a down payment of $3 million or more, a financing party must help or a strategic acquirer may buy the entire firm.

More than $2 million in revenue per owner—is it too much? Occasionally practices go beyond $2 million in income per owner. When that happens, the advisor may be taking $1.2 million to $1.5 million or more in pretax income. A cash stream can support very hefty valuation levels, but the problem is transferability. If one advisor is single-handedly generating such revenue, it is a sign of extraordinary productivity (can someone else replicate it?), intellectual capital (can it be transferred?), pricing abnormality (clients eventually will balk), or an extraordinary client base (the best case).

What does this mean for you? This article talks about a “practice,” but we started our analysis with a large “firm” that had four owners. In reality, the number of owners tends to be a good indicator of the firm’s economics and the revenue level a senior advisor can sustain. Short-term, some factors can skew the number higher or lower—new partner introductions, delayed partner promotions, recent retirement buyouts. Over time, however, the numbers tend to converge.

The simple guideline of revenue per partner can help you consider these questions as you plan your exit:

1. Are you falling behind in creating potential successors? Revenue per owner above $2 million may signal delayed partner introductions and raise concerns about transferability of your equity value.

2. Does your firm have less than $1 million in revenue per owner? If so, focus on creating leverage—with it, transferable earnings may be insufficient to attract an acquirer, ultimately limiting your exit options.

As the industry grows and matures, advisory firms need to manage their equity just as they manage their income. The equity of the firm is its most precious recruiting and retention resource, and it should be carefully and judiciously used. Creating options and having access to potential transactions gives advisors a chance to plan their exits and maximize the values of their firms.

This article draws on the findings of the independent study, “Real Deals 2008: Definitive Information on Mergers and Acquisitions for Advisors,” published by Pershing Advisor Solutions. Request a copy of the report from pasinformation@pershing.com.

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Endnote

1 At the time this article was written, the value of the 33 companies reported by Zacks Investment Research in its investment management category ranged from six times to 16 times their post-tax earnings. As a rough approximation, corporate taxes are 35 percent of earnings, implying pretax multiples of four to 10 for large, publicly traded companies.