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Competing in the M&A Race:

How First-Time Acquirers Can Gain an Edge

In collaboration with

DEVOE & COMPANY

What's Motivating RIAs to Pursue M&A?

If you ask a room full of 100 RIA owners if they plan to buy another firm in the next couple of years, about 80 people are likely to raise their hands. Such enthusiasm to venture into M&A and grow through acquisition isn't surprising. M&A momentum in the RIA industry is at an all-time high, as firms of all sizes seek scale and greater leverage to serve their clients.

In reality, though, perhaps only a quarter of those would-be buyers are genuinely qualified and prepared. The distinction lies in how carefully they've considered and prepared for the crucial legwork involved in pulling off a successful acquisition.

Is there room for first-time RIA acquirers in the fast-growing M&A space? Absolutely. However, be prepared to put in the time, thought and hard work to differentiate your firm against seasoned M&A veterans and large, deep-pocketed consolidators. Acquiring RIAs can be transformational for your firm, but will require a clear strategic vision, a disciplined plan and an understanding of the transformational phases of a transaction.

This paper lays out a suggested path that RIA firms can follow to compete and succeed in making their first acquisition—as well as their fifth.

We will break down the foundational elements for crafting and implementing key phases of the M&A transaction lifecycle:

- Strategy and Planning
- Candidate Outreach
- Valuation, Deal Structure and Negotiation

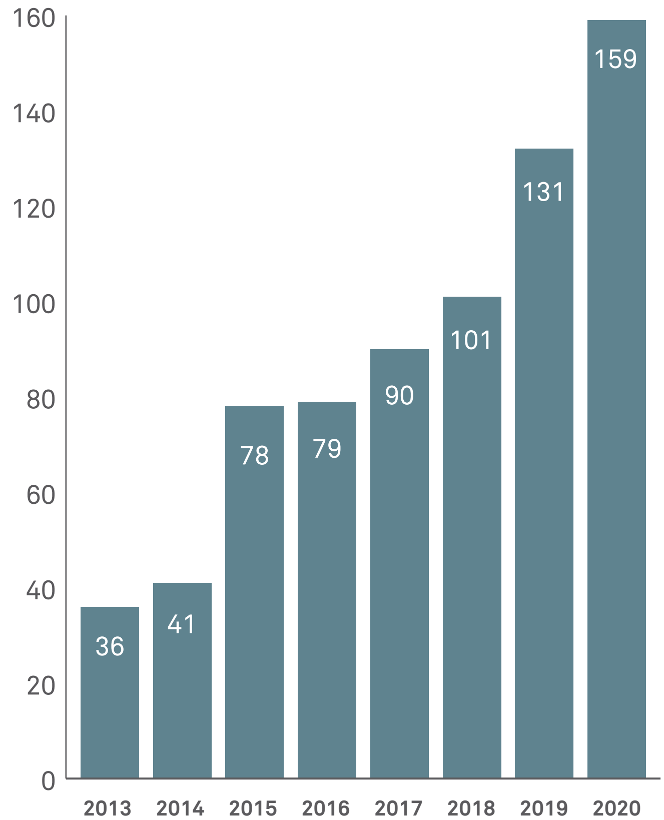
But first, let's look more closely at some of the reasons why M&A activity is on the rise.

FAST TRACK TO SUCCESSION AND SCALE

RIA M&A activity in 2020 was up 20%, with 159 transactions overall and a record 48 deals in the fourth quarter alone. This was the seventh straight record year of activity—and underpinnings within the industry signal continued M&A growth for the foreseeable future.

M&A Activity Sets Record for 7th Year in Row

Annual M&A Activity



Scale and succession are two of the biggest strategic drivers behind the recent M&A surge. Sellers want to join forces with firms that can provide a wider set of capabilities, more sophisticated technology, a broader team, and greater operational efficiency. Savvy owners recognize that joining forces with a partner will create a deeper bench of talent and offer access to services or capabilities they don't already have. M&A can put their firm on a faster track to attracting new clients.

The demographics of the industry are also driving M&A. As founders and owners steadily march toward retirement, succession activity is shifting from planning to execution. And if firms don't have next generation leaders within the firm who can afford to buy out exiting owners, selling externally can become and intentional or de facto path.

In 2020, the pandemic intensified both of these M&A drivers. In some cases, RIA owners reflected on their own mortality against the backdrop of the health crisis and finally took charge of planning for succession. In other cases, the demands of increased client service and operating in a remote environment have spurred growth-minded RIAs to seek a larger partner. Many also see the value in joining forces with a similar-sized firm where their pooled capabilities add up to 1+1=3.

M&A SUCCESS TAKES CLARITY AND COMMITMENT

While the allure of M&A can be strong—and the rewards exceptional—this quest is not for the faint-hearted. Shepherding an M&A transaction from the initial plan through final signatures and full integration demands a lot of work.

Before plowing valuable time and resources into becoming an acquirer, you will want to methodically assess whether this path makes sense for your firm. In other words: Get crystal-clear about what you seek to achieve from a deal.

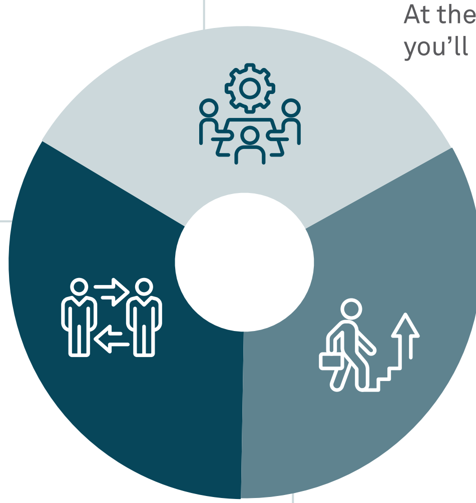
The Lifecycle of an M&A Transaction

Now that you've clearly mapped out your rationale for pursuing an acquisition—which will provide an important source of motivation and direction as you move forward—you're ready to tackle the actual work involved.

The following sections hone in on three critical phases of an M&A transaction:

Phase 1: Strategy and Planning

At the end of this stage, you'll have a detailed plan.



Phase 2: Candidate Profile and Outreach.

The goal of this phase is to find the right match.

Phase 3: Valuation, Deal Structure and Negotiation.

Here, you'll craft a transaction that benefits all parties: you as the buyer, them as the seller, your newly combined employees and—most importantly—the clients you serve.

As we'll explore in more detail, each successive phase builds upon your previous efforts and may require you to adjust course based on new information or insights. Also, the amount of time and investment involved in each phase will likely vary depending on your specific goals, resources and other variables.

Phase One: *Strategy and Planning*

An acquisition is typically the largest strategic move that a firm will ever make. It's a move not to be taken lightly or without proper planning.

Especially for first-time acquirers, this initial phase involves the most time and steps. It's where you establish a clear understanding of your firm's objectives and create the roadmap that will lead you to ultimate success. This is also where you put all your logistical ducks in a row—from assembling your M&A support team and defining your value proposition to understanding how acquisitions are structured and financed.

DEFINING YOUR M&A GOALS AND OBJECTIVES

A clear strategic vision—spanning your business priorities, professional objectives and personal aspirations—is essential to exploring the possibility of a first-time RIA acquisition. Ask yourself: Why do you seek to acquire another RIA?

Achieving growth through acquisition is certainly a good outcome, but it's usually an incomplete target on its own. If your firm is already good at organic growth, an acquisition might not be the most effective use of your time or energy. A genuinely great M&A scenario not only grows your firm's assets, but also solves one or more key strategic challenges.

Consider the types of strategic opportunities that an acquisition might support for your firm, such as:

- **Add talent-** What strengths, skill sets and expertise would complement your firm's existing team? What gap(s) might you need to fill?
- **Expand services-** An acquisition is a great way to extend your service model deeper into wealth management capabilities. Would your clients benefit from estate, tax or other specialized services?
- **Extend geography-** Consider the pros and cons of expanding your team in the same market or extending into other markets. There are important considerations for either choice.
- **Build scale-** With greater assets under management, your combined firm can afford to invest in more resources—such as technology, marketing and professional development—for sustaining long-term growth. Joining a larger RIA can also bring greater negotiating power with service providers.
- **Plan for succession-** You may seek to acquire a firm where you become the successor or where the seller has next-generation talent to fulfill your succession plan. Either can be an elegant solution to this industry exposure point.

There are many strong reasons to make an acquisition. Once you settle on yours, the next step is to engage in the planning.

SET YOUR EXPECTATIONS FOR TIMING

Nine to 12 months is about average for first-time acquirers working on their own. With the help of an investment banker, firms can often shorten their M&A lifecycle to six months. (***See Better Outcome with an Investment Banker on page 5.***)

While we're talking about time and resources, this is a good place in the planning process to consider and secure the broader team and resources you will need throughout the process.

PUT THE RIGHT TEAM IN PLACE

Your strategy and planning framework for making an acquisition should include an overview of the resources that you will need to tap quickly when you're ready to start a transaction. Think up front about who should be on the team that ultimately negotiates and closes your M&A deal.

For example, you'll need to:

- Identify an attorney
- Line up a consultant or an investment banker
- Involve your CPA or tax professional
- Network with custodians, mutual fund companies and other contacts

Another basic rule of thumb is that for every full-time employee dedicated to your M&A strategy, you can expect to complete one deal per year. More realistically: If you're the principal owner and can spend 50% of your time on a transaction, the process could take two years from initial planning to closure.

Better Outcome With an Investment Banker

Buying, selling or merging your business is one of the most important decisions of your career. Given the magnitude of what is at stake, it is often one of your most important personal decisions, too.

To be successful in such a critical transaction, you need an experienced partner who can deliver strategic thinking and technical knowledge. Just as importantly, that partner needs to understand the cultural and emotional aspects of an M&A transaction.

When you work with an investment banker, such as DeVoe & Company, you'll save time—about six months on average—and emerge with a better outcome from your deal structure. With each transaction that it supports, your investment banker builds invaluable experience and insight that benefits your firm. First-time acquirers in particular can rely on a knowledgeable investment banking partner in a variety of areas including: understanding valuation, determining the economic deal structure, assessing 'real growth,' evaluating their client base, mitigating potential risks, navigating the complex legal documents, and ensuring a smooth timeline.

You also need to make sure your internal operations and resources are up to the challenge. Ask yourself: Why do you seek to acquire another RIA?

- ☐ Can our **operational infrastructure** support an acquisition—specifically, the additional personnel, clients, accounts and assets that come with it?
- ☐ How will we adapt our **reporting structure** to integrate individuals and teams from the acquired RIA?
- ☐ Have we assigned enough **people and bandwidth** to handle this lengthy, complex process? Do you have specialized support, such as an attorney and tax advisor lined up?
- ☐ Do we have access to enough **financial capital** for the size of transaction that is in our sights?

If you can confidently answer "yes" to these questions, then you are ready to tackle the next step: how to make your firm attractive to potential M&A candidates.

CRAFT YOUR STORY

You know the objectives you're looking to achieve for your firm through a merger or acquisition. But what can you offer a prospective RIA seller in return that will make its owner(s) eager to pick you from a crowded field of suitors?

The following topics and considerations are foundational to crafting your story:

- How will you offer clear strategic value to a seller?
- Does your value proposition resonate with this target? In what key ways?
- What differentiates you from other RIA firms? For example: which of your service offerings, areas of expertise, cultural traits and approaches to client care are best-in-class?
- Can you substantiate your firm's overarching strategy with specific business, professional and economic goals?
- Are you ready to present these facets of your story in the most compelling way possible?

This story becomes your go-to-market positioning as you start to approach other RIAs. The most successful acquirers typically use a pitch book or a Confidential Information Memorandum (CIM) to package and present their story. Many of the details that you crystallized during Phase One will also be reflected in the core marketing materials you create.

Sections to include in your pitch book include:

- **Cover Letter**- This is where you frame the big picture of why your firm is interested in theirs and how you envision a potential acquisition or merger generating value for both sides. The cover letter is your first chance to make a positive impression and start differentiating yourself.
- **Company Overview**- Along with conveying basic facts—origins, founder(s), location(s), employee base, clients served and the like—this section is where you make the energy and personality of your firm come alive.
- **Key Differentiators**- Don't be shy about highlighting the key traits that enable you to excel, from your subject-matter expertise to the ways that your advisors and support staff build great relationships with clients. Remember that you're likely to be competing with multiple acquirers to grab and hold the limited attention of a busy CEO or M&A evaluation team.
- **Benefits to Prospect**- Wrap up your presentation by reminding the leaders of this firm of all the ways that a M&A union with you will fulfill their goals—spanning financial payout, succession strategy, cultural compatibility, client service, employee well-being and more.

Before reaching out to any acquisition candidates, your next step is to get familiar with how to value a firm and structure a transaction.

UNDERSTAND THE BASICS OF VALUATION

Valuing an RIA is complex. It involves assessing many dimensions, including tangible and intangible variables. Although most firms enlist a consultant with deep expertise to lead the actual valuation process, you should develop at least a basic grasp of what's involved. Otherwise, you might be struggling to learn on the fly—and find yourself at a disadvantage—when it's time to sit down at the negotiating table.

Ultimately, the value drivers for an RIA relate to three key areas: growth, profitability and risk. Essentially, a firm's ability to increase growth, profitability and mitigate any key risks will directly increase the value in a transaction.

GROWTH | **PROFITABILITY** | **RISK**

In the context of the RIA industry, discounted cash flow is the most accurate criterion for determining a firm's value and structuring the transaction. Book value, another common valuation method, doesn't apply to this industry because it represents the hard assets of a company (physical inventory), a small fraction of the business value for RIAs.

VALUATION TECHNIQUES

BOOK VALUE
WRONG

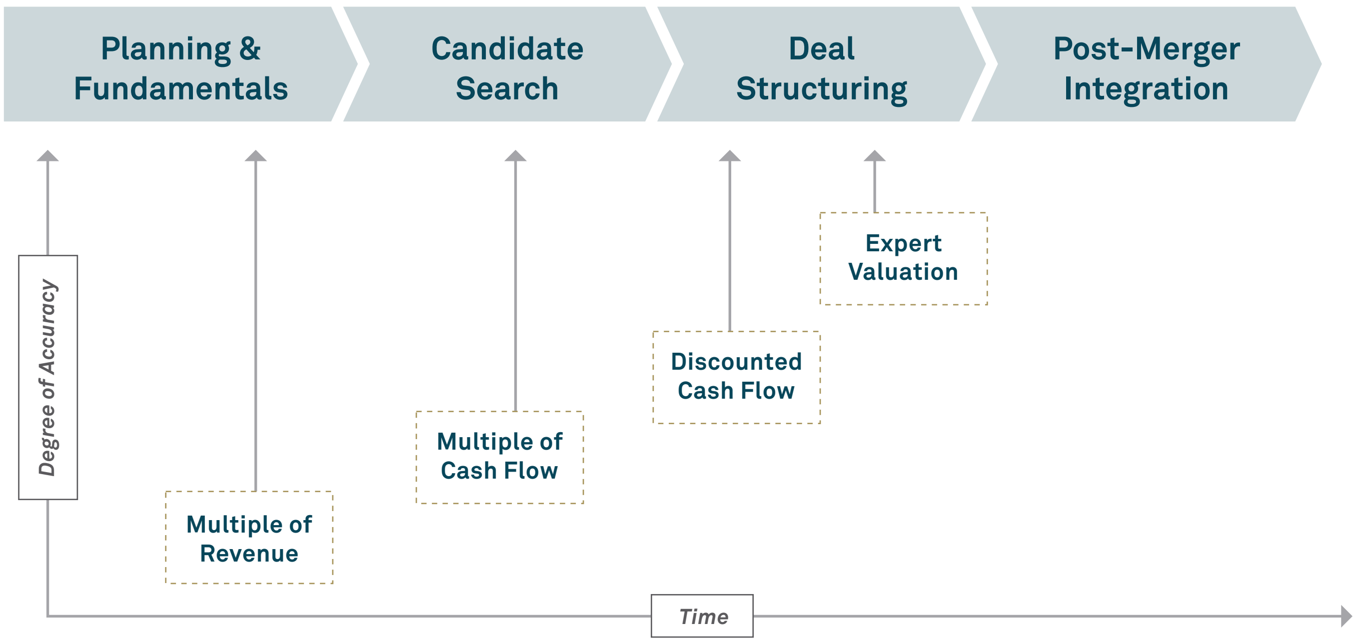
COMPARABLES
POTENTIALLY DANGEROUS

DISCOUNTED CASH FLOW
MOST ACCURATE FOR RIAs

Cash flow or profit is what pays back the investor in an acquisition. The discounted cash flow technique calculates a company's valuation by projecting the cash flows into the future and then discounting these cash flows back to the present day. DeVoe & Company uses its proprietary, 30,000-cell model, built and enhanced over the past nine years, to calculate valuation across more than 40 dynamic variables involved in growth, profitability and risk of a firm.

Other valuation methods can also serve a purpose at different stages in the transaction lifecycle. For example, comparables or other multiples of revenue may be useful in early conversations to help you get a broad sense of a company's value compared with industry norms.

Valuation Techniques During the Lifecycle of a Transaction



This section only scratches the surface of valuation. Consider working with an expert to ensure you don't pay more than is justified and that both parties feel the deal is fair. Just as you would use a realtor with deep knowledge of a neighborhood, the comparables, the market and more, you would be wise to consult an expert to determine your bid strategy for an RIA.

Once you have a handle on valuation, it's time to think about what your specific deal structure will look like.

CRAFT YOUR DEAL STRUCTURE

This step helps ensure you'll be ready to move quickly when the right acquisition target emerges. Key components of a deal structure include:

- The total consideration paid for the firm
- The amount of the down payment
- Earn-out, retention or performance provisions
- Financing requirements and sources
- Key employee compensation
- Minimum operating capital to be retained by the buyer

These are just a few of the items to think through before you finalize the economics of a transaction.

There is an old investment banker joke that one is 'willing to pay any valuation, as long as they get to choose the deal structure.' And vice versa. Despite valuation getting all the attention in the media and being top of mind for most sellers (and acquirers!) the deal structure is equally important.

With these components in place, you can start to line up sources of funding for the deal. You might think about this like getting pre-approved for a mortgage before you start touring homes.

FINANCE THE TRANSACTION

Although your financial outlay for an acquisition actually happens near the end of the process, you'll want to set these details in place well before you write the check. Fortunately, RIAs now have more sources of capital from a broader range of providers than at any other time in the last 20 years. Available options include seller financing, bank loans, SBA loans, private equity and revenue-sharing agreements. Part of the financing equation relates to whether you are purchasing 100% of the business or only a share.

FORMALIZE YOUR M&A PLAN

By this point, you have filled a blank sheet of paper (or hopefully more than one) with important pieces of the plan—including your strategy, ideal target candidate and the components of a deal structure. Before you embark on the next phase, round out your M&A plan with milestone dates for each key activity and phase. Doing so will put action behind your intentions and help you move efficiently through each step.

M&A FIRST STEPS

Create a comprehensive plan with specific dates for key milestones:

- ☐ Craft your story
- ☐ Identify the characteristics of the ideal target
- ☐ Create the outreach plan
- ☐ Identify your ‘team’ of attorneys, CPAs and investment bankers
- ☐ Carve out time to speak with tens of candidates
- ☐ Target six meetings or more before you get to LOI stage
- ☐ Understand and plan the due diligence process
- ☐ Frame out the communication plan

Allocating the appropriate time to execute your plan will be a critical factor in your success.

Phase Two: *Candidate Profile and Outreach*

As part of your strategy and planning work, you pictured an ideal RIA firm to acquire and started thinking about your own firm's value proposition. In the next phase, those two threads start to intertwine.

You've identified your strengths and weaknesses. You've articulated your value proposition and how you could be a good fit for someone. Now you want to get clear on the traits you're looking for in an RIA that you might acquire.

IDENTIFY YOUR IDEAL CANDIDATE

The clearer you can be about what makes another RIA firm a desirable match, the less time you're likely to spend in dead-end conversations. Nailing down every specific detail isn't important just yet. But you should have enough criteria in mind to form a quick first impression of potential candidates.

Here are some important traits to consider:

- **Business Model-** Is there a strategic reason why you might seek a money manager vs. a wealth manager? Are you looking only at the pool of independent RIAs? What about hybrids?

- **Size-** How large or small of a firm are you most interested in acquiring? What size can you afford? Also, decide which measurement of a firm's size is most important to you: usually, it's either AUM or the number of employees.

- **Culture-** Although this trait is difficult to gauge without meeting in person, cultural compatibility with an acquired RIA is vital for a successful integration. Do your respective values and priorities align in areas such as diversity and inclusion, professional development and work-life balance? Executives at leading acquirers say culture should be explored early in any M&A discussion.

- **Client Profile and Service Model-** Are you looking to add a firm with the same focus or an opportunity to expand the types of clients you serve? Think about how you might need to retool your brand and capabilities to fit the contours of an evolving client profile. For instance, mass affluent clients require a far different service model than those served by a family office.

- **Investment Strategy-** This is an important litmus test of a target RIA firm's compatibility with your organization. If you provide passive management through ETFs and asset allocation, for example, another firm that is actively trading individual equities to exceed a benchmark likely won't be a good fit.

- **Geographic Focus-** Are you seeking to grow within your current service area(s) or expand your footprint? Pay attention to each prospective RIA's location and your long-range strategic interest in those markets.

- **Capabilities-** Weigh the value of adding another RIA's specialties, domain expertise and reputation to your current model. An acquisition can offer a pathway to new services that current and prospective clients may want from your advisors.

- **People-** Last but not least, you might use an acquisition to deepen your bench. Are there particular talent gaps you are looking to fill? Do you need more advisors to help with strained bandwidth—or do you need more clients to fill advisor capacity? Are you seeking a strong next-generation leadership team as part of your succession plan? Or are you seeking to be someone's successor?

Once you've mapped your criteria, you can use industry-specific tools like the Discovery Database or RIA Database to start compiling a preliminary list of targets. In today's environment, you should expect to contact about 200 firms and move them through the funnel to ultimately get one transaction executed. Below is an example of how you might compare candidates.

TARGET PROSPECTIVE SELLERS

The compelling pitchbook and associated marketing materials that you assembled in Phase One will help you spread the word about your firm's interest in making an acquisition. Acquiring firms typically use a mix of direct and indirect channels to contact prospects while maintaining confidentiality.

Examples of indirect sources:

- Networking events—ranging from National Association of Professional Advisors conferences and webinars to M&A-focused industry gatherings, such as the DeVoe M&A+ Succession Summit
- Online RIA and M&A communities
- Social media platforms such as LinkedIn
- Contacts at Pershing

Examples of direct sources:

- RIA M&A listing services
- Online database of SEC-registered advisors
- Investment bankers on retainer

As mentioned earlier, staying disciplined and focused with your outreach will pay dividends in the long run. Carefully plan and manage your approach—as well as the time spent in each channel—to yield the results you are after.

Whichever sources you enlist, remember: You can make your own luck when you follow a specific and disciplined outreach plan.

For example, you might commit to check the matching services every week. You might network with various contacts at least monthly. You might aim to attend two industry events each quarter. The key is to put a structure in place and set tangible benchmarks for your progress.

From there, introductory meetings with qualified candidates will help you assess the strategic fit. That initial conversation should also help you gauge the potential to create a union in which 1+1=3, based on your M&A rationale and client profile.

Once you've found your ideal match, the actual M&A transaction moves to front and center.

Phase Three: *Valuation, Deal Structure and Negotiation*

This is where you put all your strategizing and planning into action. Despite your excitement to close a transaction and start reaping the benefits, this is actually a crucial time to slow down.

Start this phase by mobilizing the people and information you identified in Phase One. With a potential deal in sight, you're ready to enlist your attorney to draft the specific terms into a final agreement and your CPA to optimize the tax implications. In both cases, make sure you hire someone with proven M&A experience and, ideally, specific RIA industry knowledge.

If you haven't already sought help from an investment banker, think about adding that expertise as you prepare to sit down at the negotiating table. The leading RIA-focused investment banking consultants bring decades of insights gleaned from hundreds or thousands of M&A deals into your corner. (***See Better Outcome with an Investment Banker on page 5 for more details.***)

PREPARE YOUR KEY LEGAL DOCUMENTS AND PERFORM DUE DILIGENCE

The paperwork associated with a M&A transaction is complex. You should become familiar with several key documents and practices that are part of every transaction.

These include:

- **Non-Disclosure Agreement (NDA)-** Having both sides involved in the transaction sign a non-disclosure agreement after the first meeting or two helps protect your firm and theirs if the deal were to fall through.

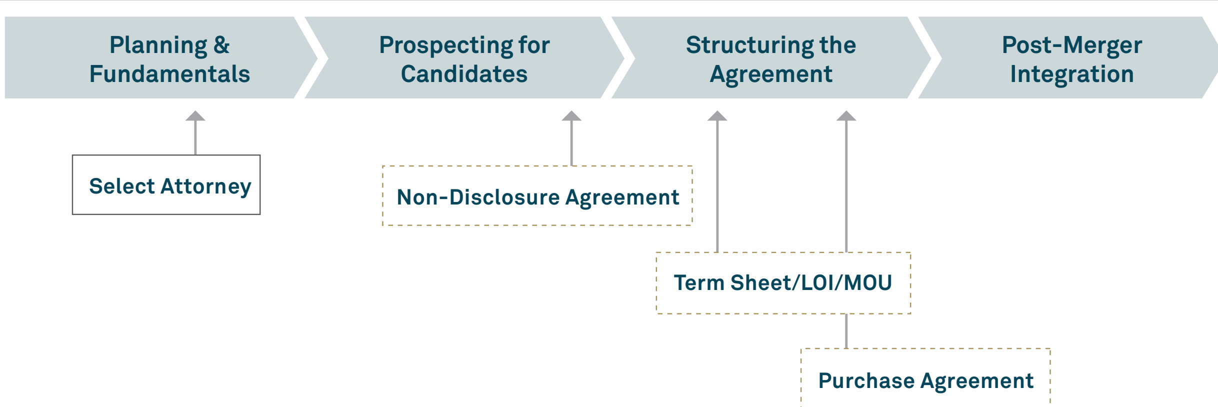
- **Letter of Intent (LOI)-** Another core document that you will need to prepare at this stage is the term sheet—also known as a letter of intent and sometimes called a memorandum of understanding (MOU). This document memorializes the major components of the transaction. Although the terms in an LOI are non-binding, treat the development of this document with care. It should clearly state the critical components of the transaction—and should be used as a tool to ensure that the parties have thought through and are aligned on the transaction.

- **Final Agreement-** Once both parties sign off on the LOI, the next major document is your formal purchase agreement. This highly detailed legal document is binding for the signatories and executes the official transaction. Depending on the size and scope of your acquisition, there will likely also be sub-agreements that pertain to financial compensation, employment terms, non-competes/non-solicits, confidentiality, intellectual property and other specific areas.

- **Due Diligence-** This is not a specific document but rather an important process related to drafting the final agreement. Due diligence includes confirming everything you have learned about the organization and ensuring that there are no risks. You may want to hire experts to help assess these various areas, which include:
  - Client composition and pricing schedules
  - Investment selection, model portfolios and performance
  - Company financials for three to five years
  - Personnel information, employee agreements, and organization chart
  - Real estate leasing agreements
  - Technology and key external vendors
  - Legal entity information

- **Client Agreements-** In particular, you should review language in the seller's client agreements that specifies whether negative or positive consent can be used when obtaining clients' consent to transfer the agreement to the buyer firm. The use of negative or positive consent will drive different communication and closing plans—and sometimes client agreements include both types of scenarios. Plan for 30-60 days after signing the purchase agreement to obtain the required client consents and close the transaction.

Major Legal Steps in the Transaction



EXPECT SOME EMOTIONS

While this phase is focused intensely on final negotiation and legal documents, be prepared for emotions to emerge as people get close to actually signing on the dotted line. For both the seller and your firm as the acquirer, significant life decisions are involved.

Remember that your counterparts across that table are handing ownership of a firm that they may have nurtured for the last 35 years or more. Above all, be supportive with their personal journey while reminding them of the end goal.

As the paperwork comes to fruition and you await closing, you will want to map out the steps involved in communicating the new partnership and getting started on the first details of your new life together. Some of the most immediate considerations include:

- Preparing the announcement—both internally and externally
- Informing clients directly
- Adjusting office space
- Managing client accounts and integration
- Crafting a comprehensive integration plan

After the Deal: *Blending Your Two Firms*

Once the final agreements are signed, most buyers and sellers raise a toast to celebrate that the transaction is complete. But also, take a deep breath—because the real work is just getting started.

Now that you've joined forces on paper, next come the practical tasks: integrating various systems, personnel, responsibilities, reporting structures, office space and other aspects of your combined RIA firm.

Over the course of weeks or months, you'll be implementing the comprehensive plan that you recently crafted to shape how the two organizations will fit together and expand each other's value. Often, firms appoint an integration leader within their organization to oversee the intricate facets of merging their operations.

You should first focus on ensuring a smooth transition for clients. Integrating staff typically comes next. For some employees, the transition may create opportunities for a better career path. The lengthiest stages of the process usually involve operational and IT systems-related integration. This work can be complex and may last for months or even years. But the good news is that your integration process will lead to improvements across the combined organization.

The single most important step that leaders of a newly merged RIA firm can take is to encourage transparent communication throughout the integration phase. Second, allow ample time to complete this process. The care that you devote up-front will pay off for years to come.

Run the M&A Race with Eyes Wide Open

Many RIAs aspire to purchase another firm in their lifetime. When a transaction is accomplished with intention, the end result can be rewarding for all parties. Of course, the number of RIAs that want to acquire another firm is higher than those that actually follow through on their ambition.

When you decide to pursue another firm, you will be embarking on a strategic initiative that requires significant time and attention.

Start with a clear and pragmatic vision of how an acquisition will not only make your unified firm bigger, but also better—across its operations, services and client relationships. With that perspective as your foundation, you can further improve your odds of success by moving carefully and thoughtfully through each successive phase of the M&A lifecycle.

The potential power of M&A is profound. There are few other strategies that can unlock benefits so quickly for the parties involved. When you are ready to begin the process, consult this framework and consider which experts and partners to bring in for help.

To learn more about creating an M&A strategy that is right for your business, please reach out to your Relationship Manager.

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