

# Find the Right Buyer to Ensure Your Firm's Future Success

*By Sean Keenan*

Director, Head of Business Development  
Advisor Solutions  
BNY Mellon's Pershing



# Introduction

You've built a successful registered investment advisory (RIA) business. It's taken decades to do so but the firm is reputable and well-known. Along the way you've attracted strong talent, invested in technology and created a client experience that is the envy of your peers.

Perhaps most important of all is that your firm has helped countless families manage their wealth wisely and develop plans to ensure that your clients' life savings will not only take care of their next generation but also make a mark on their communities and leave a proud legacy.

So as you think about what's next for your firm, how do you build value, achieve liquidity and connect the on-going business to a buyer or investor that will serve your clients with the same sense of purpose and values that you have? It's important to take the same care to make sure you maximize value and income of your advisory firm, the fulfillment of a lifetime of hard work. That way, the succession plan that you've cultivated—serving clients and developing the next generation of talent—has the wherewithal to do so. The answer often is that most founders have been so busy with ensuring the success of their clients that they've neglected to ensure the long-term financial viability of their own firms.

## A New World

Last year, mergers & acquisitions (M&A) in the wealth management industry reached a record high for the seventh year in a row. According to the investment bank Echelon Partners, M&A deals rose 12.2 percent in 2019, posting a 15.4 percent annual growth rate over the last five years. “Larger firms benefit from cost savings, have improved resources to invest in the latest technology, and have an easier time recruiting talent,” according to Echelon’s report on the year 2019, which noted that the largest deals came from private equity firms and large financial institutions as measured by transacted assets under management (AUM).<sup>1</sup>

Then came the coronavirus. At the beginning of 2020, those record high firm valuations and year-over-year increases in M&A activity experienced a completely new challenge, COVID-19. The M&A market will face a considerable amount of headwinds, especially from a seller’s perspective, as valuations are compressed. Given the climate of uncertainty as well as capital markets volatility, the time to plan for your future (as you’ve extolled your clients for decades) is now. Indeed, the recent market decline and new firm valuations may force advisors to delay retirement as they try to rebuild the firm and account for declining assets. So use the extra time to your advantage.

Let’s start with an assumption; namely, taking a course of action that relies on an exclusively internal succession tends to offer you a lower price and less favorable terms, not to mention causing unnecessary strife among loyal colleagues. How best, then, to attract the right outside sources of capital that will result in a sufficient reward for your life’s work—all while continuing a firm that has come to be known as a star in the RIA universe?

Let’s also make a clear distinction between sale planning and succession planning. What this paper focuses on is the former; that is, providing for the transfer of ownership. Succession planning, on the other hand, provides for the development of individuals and the transfer of responsibility. One depends on the other to some extent: The optimal sale can often ensure a seamless succession.

After you’ve answered the following questions that are vital to determining how your firm continues beyond your retirement, you’ll have a clearer notion of what kind of capital (say, equity or debt in their many forms) that will be most appropriate to fuel your plan. There are plenty of capital providers and many types you can leverage to create a roadmap. Get help from an objective party and delay no longer.

<sup>1</sup> “The 2019 Echelon RIA M&A Deal Report,” Echelon Partners, Los Angeles, 2020.

Many RIA owners with more than \$500 million of assets under management (AUM) or revenue of more than \$4 million a year might consider outside capital in some format. Then again, if you've spent decades investing in talent, then the well-developed people you've hired can borrow from both the company and a bank to buy the firm. If the cash flow supports the purchase price, such a scenario should work.

Of course, there's the inability to determine just how lasting the economic effects of the coronavirus will be. In the short run, this much is clear: Deal terms will change. Buyers will be more cautious and acute to downside risk because of deteriorating markets. Valuations will be lower yet access to capital and the current rate environment will still steam activity.

Start with the checklist and then determine what's right for your firm.

## Checklist

### BEGIN BY ASKING YOURSELF:

- Do you have sufficient wealth accumulated outside of your business both to maintain your lifestyle and protect your family if your business ceased to exist?
- What is most important—current cash flow, maximizing exit value or maintaining 100 percent control?
- Do you employ family members? If so, how do you provide them an opportunity that enables them to be their best?

### NEXT, TURN TO HOW YOU WANT TO TIME THE PLAN:

- How hard do you want to work in the short term (1-5 years), intermediate term (5-10 years), and long term (beyond 10 years)?
- If you were to partner or sell, what is your ideal time period to exit completely from your business, if at all?
- If there is more than one significant owner of your firm, are your time frames for exiting the business in alignment? If not, do you have a funding mechanism to provide liquidity to the owners with a shorter time horizon?

### **NOW DETERMINE YOUR LEVEL OF NEED FOR OUTSIDE RESOURCES:**

- Would a larger scale, more structured approach to human capital and defined career tracks enhance your ability to attract and retain top talent?
- Do you need capital to fund M&A opportunities or do you want your firm to remain independent?
- Would you be able to grow faster as part of a larger organization that had more capabilities and provided you more support?

### **HOW READY ARE YOU FOR A TRANSACTION?**

- Do you have a realistic understanding of the fair market value of your practice?
- If you choose to partner or sell, is the price or the terms (how you share risk) more important?
- Are you willing to integrate your processes and methods with those of a partner firm?
- Do you have signed and defensible non-solicitation and/or non-competition agreements in place for your key team members? Are you willing to sign one?
- Are there any compliance or financial management matters that might complicate partnering with another firm?
- Are you running your business in a way where you have clearly segregated your business life and personal life?

### **NAVIGATING SOURCES OF OUTSIDE CAPITAL**

Now that you've considered these key questions, it's time to evaluate sources of outside capital. Questions of timing are not only essential to your evaluation, but, based on the source of capital you select, timing will vary widely.

Debt capital is less expensive than equity capital. But debt can subject the firm and buyers to higher levels of risk in the case of a significant market decline or poor economy. Use debt to complement more expensive equity capital as well as to fund acquisitions. From a founder/seller perspective, the following types of debt capital are most important.

# Debt

## 1. SELLER FINANCING

Seller financing is often used in internal succession transactions. Depending on how you answered the questions above, however, so-called seller debt can be a useful way for RIA owners to sell their firms to outside buyers. Seller debt can create favorable terms for buyers and tax benefits for sellers in the form of sales installments. It allows for flexible terms, limited covenants, and the interest could be tax deductible in certain cases.

On the other hand, sellers should consider the potential for default and its ramifications. It's also difficult to enforce contracts when utilizing seller debt, and sellers can often face low interest rates. Other considerations are that its structure makes it both difficult to share risk and distribute profits.

## 2. BORROWING FROM A TRADITIONAL BANK

A local bank or an industry purpose-driven bank can provide financing for the next generation. Their loans are typically subject to coverage ratios that limit the amount of debt that a buyer can take. Traditional banks might also require founders to backstop defaults and covenants could impair the business in market declines or if the transition does not go well.

What's most appealing about doing business with your local bank is that it's usually the cheapest source of capital, loans are tax deductible, and the equity isn't diluted—all characteristics that the next generation will appreciate.

Of course, with advantages come aspects on which to keep a watchful eye. Beware of onerous terms and covenants, the potential for defaults, personal guarantees, the ability to distribute profits, and the extent to which amortization consumes cash flow.

## 3. BORROWING FROM A SUBORDINATED OR NON-TRADITIONAL DEBT LENDER

Very large firms that seek short-term bridge financing to structure a buyout of founders might consider non-traditional lenders. Their loans are typically refinanced in the short- to medium-term and require recapitalization. This type of financing has limited use in the RIA universe because the capital sources are limited and the cost of capital is high.

Let's first take a look at the advantages of subordinated debt. It's typically interest-only—interest that can be tax-deductible—with limited or no amortization. A seller has the ability to use this debt to complement loans from a traditional bank. There's no dilution of equity and personal guarantees generally aren't required.

On the flip side, you should watch out for higher interest rates and significant fees from lenders. Borrowing can often involve providing warrants or other equity kickers, and amortization can consume cash flows. Also consider the potential risk of defaults.

## Equity

Be sure to consider the benefits of equity capital sources as well.

Although equity capital is more expensive than debt capital, it has the advantage of being permanent. At one extreme, you can sell your equity and ride off into the sunset. On the other hand, you could attract outside investor capital that would allow you to sell part of your holdings in order to raise capital for acquisitions or issue equity to key employees. Check out the following types of equity capital:

### 1. A STRATEGIC BUYER OR BANK

Going with this choice means selling 100 percent of your firm. Strategic buyers might combine your company with their own or acquire your firm to give themselves additional capabilities, density in a particular market, or the ability to cross-sell their products and services. Examples include banks, insurance companies, brokerage firms, or foreign companies that desire to enter the American market.

If you're looking for a source of permanent capital that offers you the highest valuation for your firm, then banks and strategic buyers are the places with which you should be engaging. The transactions might be all-cash, or partly liquid securities. As such, the structure of the deal could provide many creative opportunities to compensate the next generation.

The downside of a high valuation and permanency might have a high correlation with the loss of autonomy and independence. In fact, it's not unheard of for founders to struggle to remain at the new company. That's why such deals usually involve only multi-billion-dollar firms.



## 2. A FINANCIAL BUYER

Perhaps the opposite of a strategic buyer is a financial buyer. What's the distinction? You get to keep your name on the door for starters. That is to say, financial buyers allow for significant autonomy and offer turn-key deal structures. These structures are especially helpful if you've waited a bit too long to sell the firm.

Of course, wait too long at your own peril. A financial buyer typically doesn't purchase the entire firm (so no riding off into the sunset, at least immediately). So for you sunset folks, portions of the roll-over equity that you might be required to re-invest in the firm will be illiquid. That's because a financial buyer is likely trying to buy more than just your firm. So expect the possibility of below-market pricing, onerous consent rights and equity that may not pay dividends.

## 3. PRIVATE EQUITY FIRMS

The initial choice you must make is whether to do business with a firm that wants a majority stake in your company or just enough to be part of an advisory firm with a bright and lucrative future. A so-called "control" private equity firm can often offer a premium valuation and cash at that. Although you'll lose control of the firm that you've built from the ground up, that premium cash offer can do away with any second thought you might have before signing on the dotted line.

"Control" private equity firms tend to be filled with incredibly smart and highly skilled financiers—which means that they might not necessarily know the intricacies of running the businesses in which they invest. The private equity firm's partners could very well be indifferent to the needs of employees and clients alike, so long as the advisory is producing the kind of returns that made them step up to the plate in the first place. It should come as no surprise, then, that most private equity firms are only interested in achieving the economies of scale that come only with multi-billion-dollar RIAs. Also a part of that scenario are short time frames and high leverage.

Minority-interest private equity firms bring a different set of cards to the table. An RIA founder will maintain control and receive a decent valuation. And instead of one skillset snuffing out another, minority stakes tend to bring out the best in both businesses. For example, you as the founder as well as your senior staff have additional liquidity to embark on a carefully planned program of organic growth. At the same time, the private equity firm's partners can provide the kind of expertise you'll need if you decide to merge or acquire other firms (before that ride into the sunset).

“BNY Mellon | Pershing’s relationship team brings together the resources of technology, marketing and business consulting across the entire enterprise to help navigate the different capital options in today’s marketplace.”



**Sean Keenan**  
BNY Mellon | Pershing

Still, in the end you’re dealing with a private equity firm. Even taking a minority interest usually translates into a limited time frame (three to five years) with an option to sell its interest back to you at a higher multiple. Along the way, you’ll absorb any and all associated transaction costs with the prospect that, at the end of a five-year horizon, your firm will be flipped to another private equity firm in search of the same nice returns. And who knows? Those future private equity firms could be more interested in acquiring the entire company.

#### **4. A PRIVATE EQUITY-BACKED PLATFORM COMPANY**

Then there’s what’s known as a sub-acquisition. If you prefer dealing with a private equity-backed company that’s closer to yours in size and scope, then a platform company might be the answer to your equity needs. Platform companies are accustomed to providing turn-key deal structures and permanent capital. An issue that could result from such structures is that matters like ownership and capital needs could be less than certain. Consider the possibility that your firm could lose its brand name and future liquidity could come at a discount.

#### **5. A LARGER RIA**

You’ve heard the saying that in the world of M&A, there’s actually no such thing as a merger, right? One company always acquires another—no matter what the two companies claim. By selling to a larger RIA, you’re almost sure to lose control (and the name) of your company, but think of the capabilities the next generation will have at its disposal. You’ll be providing new career tracks for your loyal employees, as well as all the other benefits that come with scaling up.

#### **6. FAMILY OFFICES AND ULTRA HIGH-NET-WORTH INVESTORS**

Finally, the best source of equity might very well come from those whom you’ve served for decades: your clients, better known as patient outside investors. They’ve learned from you that it pays to invest in private companies over the long haul and to use as little leverage as possible. Talk about know-your-customer. Although you might not attain a sky-high valuation, these investors can’t exactly walk away from your business. True, negotiating with people who feel as though they’re members of your extended family might prove difficult, but you’ve done more than your share of due diligence with this crowd. You know the family office well, and its next generation might provide your RIA with new lines of business. So in essence, everyone wins.



## Pershing

BNY Mellon's Pershing and its affiliates provide a comprehensive network of global financial business solutions to advisors, broker-dealers, family offices, hedge fund and '40 Act fund managers, registered investment advisor firms and wealth managers. Many of the world's most sophisticated and successful financial services firms rely on Pershing for clearing and custody; investment, wealth and retirement solutions; technology and enterprise data management; trading services; prime brokerage and business consulting. Pershing helps clients improve profitability and drive growth, create capacity and efficiency, attract and retain talent, and manage risk and regulation. With a network of offices worldwide, Pershing provides business-to-business solutions to clients representing approximately 7 million investor accounts globally. Pershing LLC (member FINRA, NYSE, SIPC) is a BNY Mellon company.

---

### Important Legal Information—Please read the disclaimer before proceeding.

- Please read these terms and conditions carefully. By continuing any further, you agree to be bound by the terms and conditions described below..
- This paper has been designed for informational purposes only. The services and information referenced are for investment professional use only and not intended for personal individual use. Pershing LLC and its affiliates do not intend to provide investment advice through this paper and do not represent that the services discussed are suitable for any particular purpose. Pershing and its affiliates do not, and the information contained herein does not, intend to render tax or legal advice.

### Warranty and limitation of liability

- The accuracy, completeness and timeliness of the information contained herein cannot be guaranteed. Pershing and its affiliates do not warranty, guarantee or make any representations, or make any implied or express warranty or assume any liability with regard to the use of the information contained herein.
- Pershing and its affiliates are not liable for any harm caused by the transmission, through accessing the services or information contained herein.
- Pershing and its affiliates have no duty, responsibility or obligation to update or correct any information contained herein.

©2020 Pershing LLC. Pershing LLC, member FINRA, NYSE, SIPC, is a subsidiary of The Bank of New York Mellon Corporation (BNY Mellon). Pershing does not provide investment advice. Affiliated investment advisory services, if offered, are provided by Lockwood Advisors, Inc. (Lockwood), a Pershing affiliate and an investment adviser registered in the United States under the Investment Advisers Act of 1940. For professional use only. Not intended for use by the general public. Trademark(s) belong to their respective owners.

---

©2020 Advisor Solutions. Advisor Solutions refers to the brokerage services business of Pershing Advisor Solutions LLC and/or the bank custody solutions business of BNY Mellon, N.A.

Pershing Advisor Solutions LLC, member FINRA, SIPC, is a subsidiary of The Bank of New York Mellon Corporation (BNY Mellon). Clearing, brokerage custody or other related services may be provided by Pershing LLC, member FINRA, NYSE, SIPC. Pershing Advisor Solutions relies on its affiliate Pershing LLC to provide execution services. Bank custody and private banking solutions are provided by BNY Mellon, National Association (BNY Mellon, N.A.), member FDIC, a wholly owned subsidiary of The Bank of New York Mellon Corporation.

Pershing LLC, Pershing Advisor Solutions LLC and BNY Mellon, N.A. Bank Custody Solutions do not provide investment advice. Affiliated investment advisory services, if offered, are provided by Lockwood Advisors, Inc. (Lockwood), a Pershing affiliate and an investment adviser registered in the United States under the Investment Advisers Act of 1940.

Trademark(s) belong to their respective owners.

### **pershing.com**

One Pershing Plaza, Jersey City, NJ 07399

1175-PAS Sale Planning White Paper-06-20