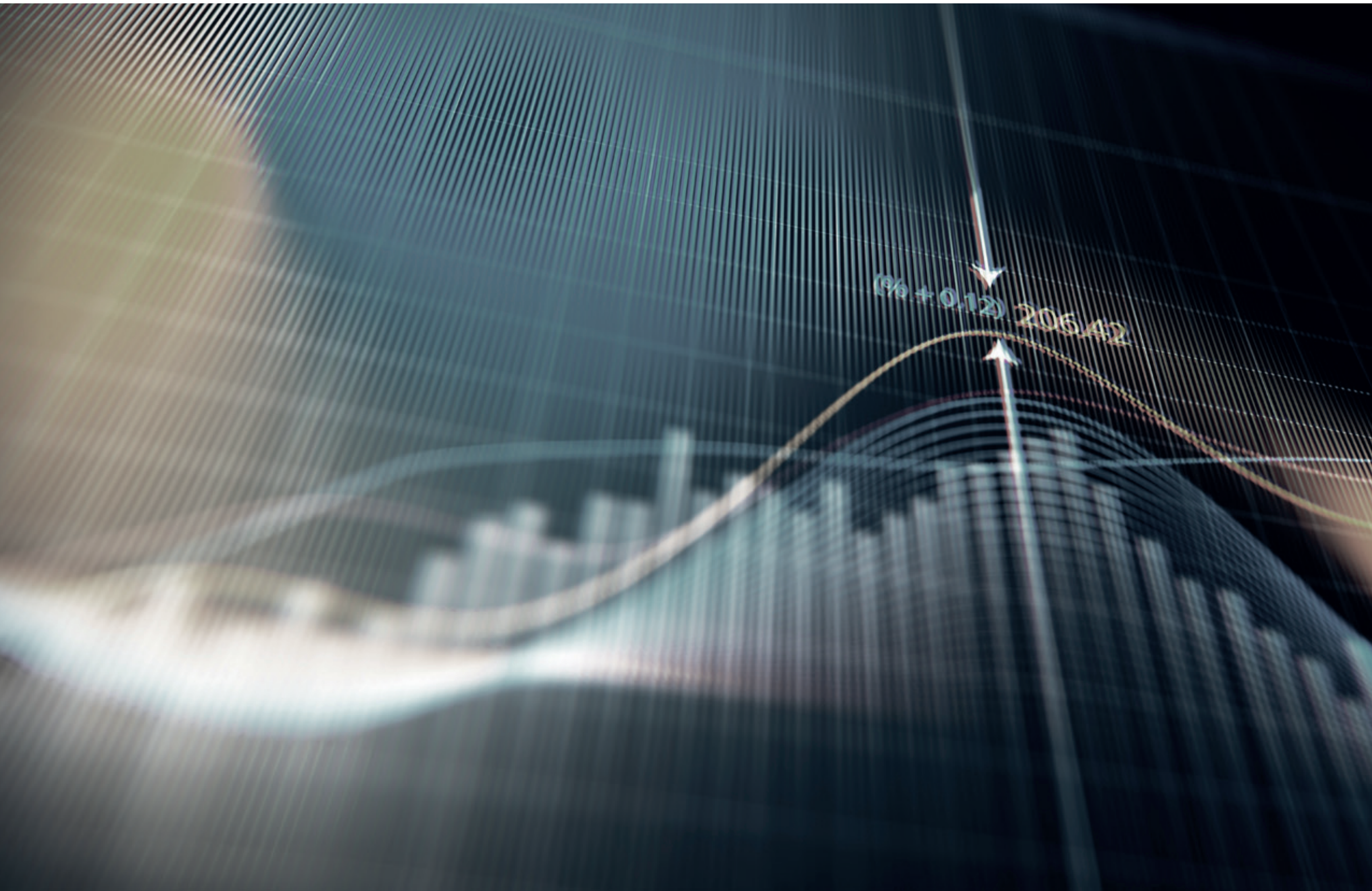
M&A GROWTH IN THE RIA CHANNEL



INTRODUCTION

The wealth management industry continues to evolve in lockstep with new client expectations and demands. One such demand is the removal of any conflict of interest a wealth manager may have when servicing a client relationship. As such, many retail clients are deciding to do business with Registered Investment Advisors (RIA), a specific type of wealth management firm held to the highest fiduciary standards within the industry.

Increased client demand for independent investment advice has led to a proliferation of RIAs across the US. The RIA channel continues to grow faster than any other wealth management segment, as firms of all sizes saw strong organic growth over than last five years. In addition to gathering new clients, and increasing wallet-share of existing clients, many firms are pursuing inorganic strategies to augment growth.[1]

The last two years have seen unprecedented levels of M&A activity in the RIA space. In 2019, 127 deals were closed worth $151.3 billion in client Assets Under Management (AUM). These totals represent an increase of 44 percent in deals and 38 percent in AUM over 2018 totals, which itself was a record year.[2]

Strong deal flow continued into the beginning of 2020. Through the first three months of the year, 23 deals were closed, representing just under $30 billion in client assets, a 35 percent increase over 2019 Q1 AUM totals. The majority of these deals, however, were completed in January and February, with only three closing in March due to the COVID-19 pandemic.[3]

This article will highlight the critical forces driving M&A activity, key players in the space, and the potential ramifications of COVID-19 moving forward.

WHAT FORCES ARE DRIVING M&A ACTIVITY?

Although the outbreak of COVID-19 slowed deal-making in recent months, fundamentals remain supportive of an active market coming out of the crisis. Four key trends help explain the increase in M&A activity over the last few years and will continue to propel deal-making moving forward.

1. An Influx of External Capital

Today, few RIAs execute growth strategies by relying solely on existing cash flow. Instead, firms are drawing on available capital from three main sources: lenders, passive investors, and private equity firms. Each source of capital provides unique trade-offs around autonomy, business support, and growth rate.

On one end of the spectrum, debt financing allows firms to retain their autonomy and expand their businesses, as creditors generally do not take any active ownership in the company. Debt terms are often accommodative to a firm's liquidity needs and time horizons. Firms tapping debt markets usually are smaller (< $1 billion) with less ambitious growth targets. These firms primarily use financing to support working capital needs and small-scale acquisitions such as partner-buyouts and tuck-ins. Creditors in the space consist of the Small Business Administration (SBA), traditional banks, and firms providing more creative debt financing.[4]

Passive investors fall in the middle of the autonomy spectrum, with different types skewing towards being less active and more active in the underlying business. Investors primarily interested in a reliable stream of periodic cash flows are not overly concerned with aggressively growing the business. As such, these investors take a hands-off approach, leaving key decisions surrounding growth trajectory to the firm's leadership team. More involved investors, usually those with previous experience in wealth management, are interested in financing more deliberate growth, thus increasing the value of their equity investments. These investors, however, largely take an advisory approach, refraining from involvement in an RIA's day-to-day operations. Types of passive investors include insurance companies, family offices, pension funds, and retired wealth management executives.[5]

On the active end of the spectrum, private equity firms participate in large-scale deals with aggressive growth targets. Private equity firms will usually take seats on portfolio companies' boards to effectively steer decision making. These professionals work directly with RIA business owners to implement strategies conducive to quickly scaling their businesses. These strategies involve leveraging both organic growth, by optimizing the firm's business model, and inorganic growth through M&A. The time horizon for these deals is typically in the three to five year range.

Many options exist for RIAs looking for capital partners to help grow their businesses. An RIA's size, desire for autonomy, and strategic growth goals will help determine the right partner and subsequent deal terms.

2. Increased Operating Costs

The RIA channel is the fastest-growing segment of the wealth management industry, with roughly 1,500 firms entering the space yearly. The industry currently comprises over 14,000 firms managing nearly $5 trillion in client assets. RIAs account for 25 percent of wealth management AUM, a number expected to grow to 30 percent by 2023.[6]

As the RIA space grows, so does the level of competition across firms. Increased competition is puting additional pressure on advisors to provide clients with more robust service offerings for the same or lower fees. As a result, smaller firms are struggling, as many cannot afford table stakes technology, top-end advisor talent, innovative marketing campaigns, growing compliance overhead, and increasing staff headcount. Moreover, many advisors prefer to spend their time servicing clients, rather than dealing with the operational complexities of running a business.

As a result, smaller firms are folding into larger firms, which can handle the industry's growing technological, operational, and regulatory requirements. The increased scale large firms obtain through the acquisition of smaller RIAs helps to offset rising overhead and increase firm-wide productivity.

3. Succession Challenges

Roughly 44 percent of financial advisors in the US are over the age of 55. As many advisors draw closer to retirement, they must figure out viable exit strategies for their businesses.[7]

Succession planning is a unique value-add that buyers can offer sellers looking to wind down their careers. According to a recent Fidelity survey, 43 percent of sellers identified a lack of a viable succession plan as a key driver for seeking out M&A.[8]

Both buyers and sellers have a strong incentive to ensure a smooth and seamless transition of the business. Client retention is of utmost importance to buyers, while knowing their clients are in good hands is critical to sellers. The design and execution of a well-thought-out succession plan are paramount to achieving these goals.

4. Highly Fragmented Market with Top Heavy Segment

While the RIA channel has experienced high levels of M&A over the last few years, the industry remains highly fragmented, with a few large firms controlling the lion's share of industry assets. Many large firms will look to to sustain high growth rates by continuing to acquire smaller firms in need of a strategic partner.

The overwhelming majority of firms in the RIA space are small-scale businesses with local client bases. According to a recent report from Cerulli, 87 percent of RIAs manage less than $250 million in client assets, accounting for only 14.4 percent of total AUM market share.[9]

While smaller shops account for the majority of firms operating in the RIA space, a limited contingent of firms manages the majority of industry AUM. Firms managing above $1 billion in client assets represent 3.6 percent of the RIA segment, but account for 64.4 percent of AUM market share. Moreover, 63 firms, representing 0.5 percent of the total market, manage 34 percent of all industry assets.[10]

The unique distribution of firms within the RIA segment makes the channel conducive to high levels of M&A activity moving forward. Larger, growth-oriented firms will look to build scale through the acquisition of smaller firms executing succession plans, experiencing growth challenges, needing stronger technology, and those looking to offload the operational burden of running a stand-alone firm.

PLAYERS AND TYPES OF DEALS

While deals in the RIA space come in all shapes and sizes, transactions broadly fit into three categories. The below section will profile three of the most common types of deals.

1) RIA Acquiring RIA

Overview:
Large, standalone RIAs ($1 billion <) acquiring smaller shops is becoming increasingly common in the acquisition market. An RIA-to-RIA deal is usually highly strategic, as the two firms must possess unique value propositions that complement each other. These synergies include culture fit, shared vision and values, service model alignment, and growth goals. Due to the unique requirements necessary to transact a successful deal, buyers are highly selective and, as a result, less active from a volume perspective. Many plan to complete between two-five deals over their lifecycle.

Buyer Motives:
In an increasingly crowded market, large RIAs are looking for new ways to grow and remain competitive. In addition to heightened competition, overhead costs continue to rise, pressuring many RIAs to increase scale. M&A provides a way for larger firms to scale quickly, which helps to drive operational efficiency and improve advisor productivity. Additionally, the acquisition of smaller firms can provide larger firms with efficient access to a new geography or client segment.

Seller Motives:
Like their larger counterparts, small RIAs are under increasing competitive and financial pressures. Teaming up with a larger firm allows smaller shops to mitigate these challenges, as larger firms offer better resources and provide support across a variety of key areas, including business development, compliance, technology, and investment strategies. Additionally, leadership within smaller firms can continue to contribute to the direction and business strategy of the new joint entity.

Deal Highlight:
Last year, The Mather Group (TMG), a fast-growing RIA with over $7 billion in AUM, acquired Astraeus Advisers, a multi-family office managing over $1 billion of discretionary assets. The Mather Group used the acquisition of Astraeus Advisers as the building block for a new segment of its business, The Mather Group Family Office. Before closing the deal, the two firms identified shared values, such as continuing to remain fee-only and independent from private-equity or Wall Street partnerships. Astraeus' leadership was also attracted to The Mather Group's next-gen advisor talent, which it viewed as an important asset to facilitate future growth.[11]

2. RIA Aggregator Acquiring RIA

Overview:
As the name suggests, RIA aggregators' business models are acquisitive by nature. Aggregators are large, resource-rich firms providing acquired RIAs with access to an end-to-end operating platform and specialized business advisory services. With sizable investments made to provide advisors with top-end support, aggregators must acquire firms at a rapid rate to increase operating margin.

In 2019, ten aggregators closed 68 deals, accounting for 54 percent of all activity. Eight of these firms closed more than five deals in the year. In addition to deal volume, aggregators are closing many of the industry's largest deals. Last year, five aggregators accounted for 17 out of the 30 largest deals.[12]

Aside from having business models designed to diligently and efficiently source and close deals, many of the top aggregators have the backing of large private equity firms. With the ability to leverage their professional expertise and plentiful access to capital, aggregators are likely to remain on the frontlines of the acquisition market for years to come.

Buyer Motives:

Aggregators' primary motive is to increase growth by acquiring top-level advisor talent. These firms are also looking to expand into new geographies to create stronger national brands, while continually growing their advisory asset base.

Seller Motives:

Sellers who partner with aggregators do so for reasons differing from firms partnering with large, standalone RIAs. Aggregators provide a flexible, one-stop-shop servicing all advisor needs. In exchange for equity or subscription payments, sellers receive industry-leading technology, client servicing platforms, compliance oversight, marketing expertise, investment services, and succession planning support. Aggregators also offer a-la-carte servicing to firms with specific needs.

Deal Highlight:

Last February, Hightower Financial Partners, a private equity backed aggregator based in Chicago, purchased a stake in Green Square Wealth Management, a Memphis based RIA managing roughly $2.6 billion across 120 families and institutional clients. At the time of the deal, Green Square's assets pushed Hightower's total client assets to just under $70 billion spread across 94 advisory firms. More importantly, Hightower added a high quality, growth oriented firm with a diversified business model and next-gen advisor talent. The partnership will allow Green Square to focus exclusively on servicing existing clients and generating new business, as it will outsource its middle and back-office functions to High Tower.[13]

3. Complementary Business Acquiring RIA

Overview:

As the RIA model continues to grow in popularity, firms looking to enter the wealth management arena, or expand an existing footprint, may do so by acquiring an RIA. The diversity of the space allows potential buyers the flexibility to partner with RIAs that are complementary to their existing business models.

Buyer Motives:

Non-RIA buyers could be one of many types of businesses, such as retail banks, investment banks, independent broker-dealers, wirehouses, or asset managers. While the buyer's motive will undoubtedly depend on the nature of its business, a few motives are likely to be drivers across all business segments. Adding an advisory business will help firms diversify their business models, which will help to smooth revenue volatility in the core businesses. Moreover, an RIA will provide financial firms with cross-selling opportunities, widening a firm's potential client base and further ingraining existing customers into the firm's eco-system.

Over the last few years, we have seen a number of firms expand their businesses through the acquisition of an RIA. Perhaps the most notable transaction was Goldman Sachs' acquistion of RIA aggregator United Capital, which provided the investment bank with exposure to the mass affluent wealth market. We have also seen more tactical moves, such as AmeriLife, an insurance distributor with 75 partnerships, acquire a large RIA to increase distribution of its services through the RIA channel.[14]

Seller Motives:

Similar to buyers, a seller's motive will largely depend on the type of business it will be partnering with. Aside from specific synergies between the two businesses, most sellers will likely be enticed by the opportunity to increase scale, access to top-end technology, receive internal referral sources, and leverage complementary business capabilities such as specialized investment products or banking resources. RIAs partnering with businesses outside the wealth domain might be able to maintain autonomy over their practices and help steer the decision making of a larger organization. For an acquiring firm already operating in the wealth space, sellers may be attracted to the idea of joining a larger organization with a diverse range of wealth professionals.

Deal Highlight:

Earlier this year, Fiduciary Trust Company International, a wealth management firm, agreed to terms with Athena Capital Advisors, a $5.8 billion RIA focused exclusively on impact investing for the ultra-high net worth investor segment. Athena's unique focus on impact investing, and its additional offering of outsourced CIO services, made it a strong fit for Fiduciary Trust, which lacked a presence in the impact investing space. For Athena, the RIA receives access to Fiduciary's banking and trust capabilities, as well as its digital client tools and operational efficiencies.[15]

WHAT TO EXPECT MOVING FORWARD

Both 2018 and 2019 were record-setting years for activity in the RIA M&A space. 2020 may well have been another banner year had it not been for the COVID-19 pandemic. After a hot start to the year, with 20 deals closing in the first two months, only three deals closed in the final month of the quarter. Deal flow will likely remain slow over the next few months as firms turn their attention inward to focus on servicing clients and managing overhead.

While 2020 may not be a record-breaking year, the M&A market should remain active. The effect of COVID-19 on the market will differ deal by deal, with notable variables being the source of acquisition capital, balance sheet strength, and deal structuring.

Firms with equity capital at their disposal are in a position to be active buyers in the market. On the other hand, firms relying on debt to finance deals will likely have more trouble deal-making, as creditors, such as banks, have less of an appetite to finance speculative deals in the current environment.

Most firms, especially those with revenues tied to the market, will experience margin compression, as revenues fall while client servicing volume increases. As a result, firms, especially those with weak balance sheets, may be more inclined to sell, as the current environment could prove too difficult to navigate alone.

Lastly, expect to see changes in the structuring of deals. In an effort to de-risk acquisitions, buyers are likely to insist that up-front cash payout percentages decrease, with more of the payouts being allocated along a performance-based runway. Not only will this structure protect the buyer from another market downturn, but it will benefit the seller, as he or she will be able to participate in the market recovery, which will likely translate to a higher valuation.

Even with the headwinds of the current environment, we expect industry fundamentals to remain supportive of strong M&A activity moving forward. Specifically, advisor revelations triggered by the crisis may increase the number of sellers in the market, once valuations recover. Thousands of advisors starting firms during the recent bull market will likely reassess the trade-offs of running a stand-alone business, as many have now dealt with their first recession as a business owner. The increase in client servicing demands, coupled with the technical and operational burdens of running a firm remotely, will likely bring more advisors to the M&A market. These sellers will be met with open arms by aggregators and other large firms looking to jump-start growth out of the recession.

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