**WHEN SHOULD AN RIA TRANSACT (OR NOT)?**

## Market Backdrop

While the severe economic and market downturn of 2008-2009 affected a wide array of sectors, the asset and wealth management industry may have been one of the most directly hit. This industry particularly suffered, as revenues and profits are linked to assets under management (AUM). The magnifying effect of a drop in AUM on firms' profitability has left deep discomfort across the industry. As a result, this financially and emotionally challenging period for asset and wealth managers has caused Registered Investment Advisors (RIAs) to be more cognizant than ever before that their asset growth over the past eight to ten years in many cases was boosted by investment performance more than by distribution strength. Recent surveys by TD Ameritrade[1] of RIAs confirm the qualitative observation of Park Sutton Advisors that a near- and medium-term priority of firms is to grow AUM.

## Why Transact?

Historically, a primary driver of RIA transactions has been the desire of firms to **grow assets**, and, as a result, revenues and profitability. Many firms reach a point at which they have tapped out their circles of influence and are challenged to grow assets further. From this perspective, sellers are typically motivated to seek a strong partner with proven **marketing and distribution capabilities** that can help them take the business to next level.

An additional challenge for some RIAs is that of serving **aging clients with income requirements** that contribute to eroding AUM. For instance, one RIA client of Park Sutton Advisors with a large book of retired clients needs to grow its assets by 8% annually merely to stay even, placing additional pressure on asset growth for this firm. RIAs who are less successful at youthening client bases over time are likely to risk erosion in value of their businesses.

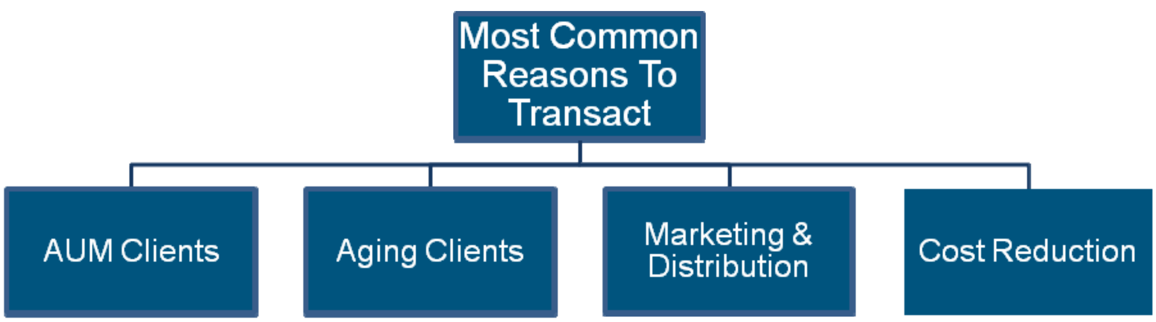
Many small RIAs themselves desire to execute acquisitions of other small advisory firms as a mean to grow assets. First, these deals can be challenging to identify, as there is typically an oversupply of buyers versus sellers. These deals are often not easy to close for a myriad of reasons including disparate valuation expectations, cultural barriers, or

[1] "Preparing for Growth in the New Era of Delivering Financial Advice" – TD Ameritrade Survey, Winter 2010

merely the fact that sellers are often approached by multiple suitors. When RIAs themselves contemplate a sale or merger, a primary objective is their own desire to tap into a partner's marketing and distribution. An individual or partner who can accelerate an acquired firm's asset growth is attractive.

Margin expansion can be achieved through asset and revenue growth but it can also be accomplished through a strategic combination that facilitates **cost reduction**, which is another significant reason to transact. For instance, a combined firm does not need to employ two CFOs or two General Counsels. A combined firm can leverage resources, skills, or infrastructure, and it can potentially enable a sub-scale firm to become more profitable.

Exhibit #1: Most Common Reasons To Transact: Summary




**Other Drivers of Transactions**

Transactions often involve a need to **address succession planning and liquidity needs**. Some small firms may lack internal successors, which requires bringing in an outside individual(s) to whom to transition clients or assets over time. It may be the case that firms have internal successors, but the owner(s) are not prepared to (mostly) "seller finance" a deal or transact at a multiple which is often at 50% discount to market. Liquidity may require bringing in an outside party, which also could potentially facilitate the transfer of some equity to the next generation. A recent Jefferies study[2] concurs that a

[2] "Turning Tides – First Half 2010 M&A Activity in the Asset Management Industry" – Jefferies & Company, Inc, August 2010

growing backlog of aging owners needs to address retirement and estate-planning issues, which should accelerate the need to transact.

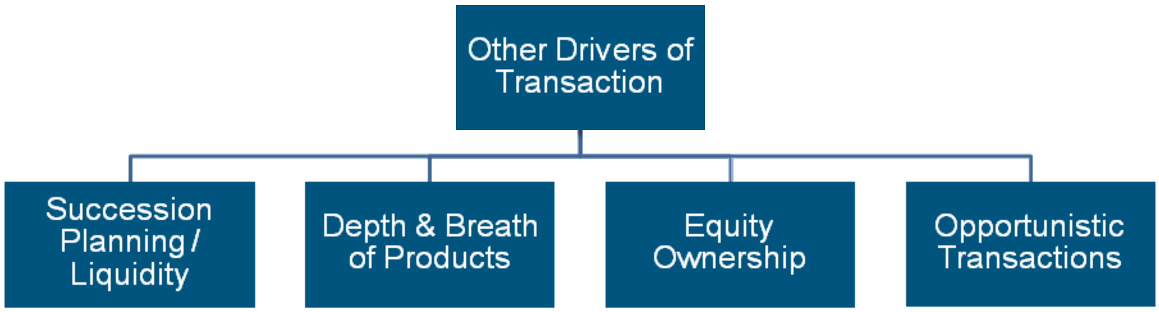
Additionally, some RIA deals occur because the relationship managers desire a transaction with a partner who can provide **depth and breadth of products**, *i.e.*, access to a wider array of products and services, including those on the alternatives side. As the marketplace has moved in the direction of open architecture, some firms recognize that, as wealth managers, their competitive differentiation is in client service and relationship management. Their expertise is in assisting clients on a wide range of financial needs rather than in focusing narrowly on investment product manufacturing.

Many investment or wealth management professionals at independent RIAs are entrepreneurial-minded. **Equity ownership** can be a key motivator to transact. Equity or equity-like incentives are important motivators that can aid an RIA in its ability to be a competitive employer and recruit and retain top talent. Equity ownership and transfer can be a key element in driving value creation.

Park Sutton Advisors has witnessed some deals occur because the founders are not prepared to make the **capital investments necessary to take the business to the next level**. Compliance costs continue to rise as do technology requirements. Many wealth management professionals prefer to focus their scarce time on clients rather than on infrastructure and other back-office distractions.

Finally, some deals occur when **a target is opportunistically approached** even when the owners are not proactively pursuing a transaction. Perhaps the sellers transact because they receive an offer they cannot refuse or appreciate the various synergies offered by a specific strategic buyer. If a seller thinks a transaction could make sense for any of the aforementioned reasons, it is not unwise to listen to what a suitor has to say. Park Sutton Advisors estimates that perhaps as many as 50% of the deals that occurred were not deliberately sought. Jefferies agrees that, as the market continues to recover, more and more buyers will come out of the woodwork, which could prompt interesting opportunities for sellers.

Exhibit #2: Other Drivers of Transactions: Summary




**How Important Is the Timing of a Deal?**

An asset or wealth management firm is not a business with a sizable balance sheet or hard assets. They say in the business that the "assets go up and down the elevator every day." Thus, the value of an asset or wealth manager vacillates yet is linked to the firm's track record, ability to retain clients and professional talent, and ability to grow the business. Too many sellers do not appreciate the fact that, while a potential buyer is assessing a target's historical performance, which is important and does influence the buyer's interest level and valuation of the target, the buyer is investing based upon the firm's potential and future business prospects. As such, a target generally has a higher perceived value and more attractive strategic opportunities when the business is growing, profitable, and generally performing well. This is an important factor to consider with regard to the timing of a deal. For all sorts of reasons, sellers get values in their heads that sometimes defy rational estimates of their true worth. Many think that they would like to sell when they can attain a certain value for the business. In other words, many think that they can "market-time" a deal, which is difficult to accomplish in practice. Just as assets move around, so do valuations and market appetite. For instance, many buyers were interested in buying hedge fund of funds in 2002. This was a less so the case in 2007. In 2010, appetite for alternative investment managers is increasing once again.

If a firm, for any of the reasons discussed in the first section of this paper, believes that a transaction makes sense in the near- to medium-term, it is often advantageous to **transact**

**when the business “has the wind at its back.”** There are, however, reasons to wait it out.

**Reasons to Delay a Transaction**

Park Sutton Advisors has identified internal and external reasons to delay a transaction and effect it a later stage, once the appropriate conditions are in place.

<u>Internal Reasons</u>

**Depressed profitability** can be a motivation to wait to transact. For a myriad of reasons, a firm’s profitability may be experiencing an unusual period of low margins. Whether expansion plans (*e.g.*, taking on additional space), staffing decisions (*e.g.*, hiring of additional personnel in anticipation of expected growth), or other reasons are responsible for lower margins, these all can, and ideally should be, corrected prior to a transaction. In fact, it is Park Sutton Advisors’ experience that buyers generally prefer that sellers themselves take corrective actions–and monitor progress–prior to a transaction. Nobody knows a firm better than its owners. It is better to face corrective actions and make a firm as attractive as possible prior to commencing transaction discussions.

Additionally, if the profitability of an RIA is temporarily depressed due to **recent, non-recurring capital investments** in the business that owners are fairly certain will pay off in the medium term (*i.e.*, over 3 years), then it might make sense to wait to transact. Unfortunately, many buyers do not consider these capital investments in their valuation assessments of a firm if the result is reduced profits. An exception might be the case of a buyer who is desirous of a developed platform or infrastructure. This type of buyer might be weighing the cost of buying versus that of building. In such an instance, a low profit margin for a non-recurring capital investment might not be much of an obstacle to obtaining an attractive valuation. It is important to note that a low profit margin, in and of itself, is not a reason to wait if the RIA at hand is a consolidation candidate, and cost reductions are likely to be achieved through a combination.

Another reason to wait to transact is to address **existing partnership dissent issues**. A sale process is not the time to publicly air dirty laundry. Sometimes partnerships have internal issues to address and erroneously think that a transaction can help smooth over their unresolved internal problems. Despite attempts to mask the warts, most sophisticated buyers see through the smoke screens and are hesitant to transact with a firm facing internal challenges. Some sit back and wait for the pieces to fracture and see if they can pick them up cheaply or for free. If a business does have a lot of warts and is being dressed up for sale, Park Sutton Advisors’ advice to the seller is to get the deal done as fast as possible, before the buyer perceives the negatives as outweighing the positives.

While some buyers do not necessarily require top decile or quartile investment performance, the latter is a factor that could influence the timing of a transaction. Under certain circumstances, asset management firms may have made investment decisions that caused **performance to lag peers, or underperform a specific benchmark**. While this is not necessarily a deal-killer, it may be wise to focus on fixing short-term performance issues and getting results back on track prior to considering a transaction. In some other instances, a departing portfolio manager or team could sidetrack the prospects of a transaction. Park Sutton Advisors has experienced situations where the investment professionals had to be replaced prior to the firm's being placed for sale.

Sometimes, it may pay for an RIA to take specific short-term actions to prepare the business for a sale over a six- to twelve-month time frame.

External Reasons

An important reason to wait to transact typically falls beyond the control of sellers. **Extraneous market conditions** and where we are in the **economic cycle** can pose a threat to a successful transaction. The market environment that started in late 2008 created a significant challenge for transactions, particularly for firms that were not compelled to transact for reasons discussed earlier. Panic, wide bid/ask spreads, and a widespread belief that sellers were, for the most part, in a position of weakness created an environment in which deals had to be postponed or completely discarded. In addition, lower multiples paid for businesses also discouraged many parties that did not have to sell in order to wait for a rebound in interest and equitable pricing. Even in this challenging environment, however, and for the right reasons, a transaction could be executed for a fair or even rich price. Park Sutton Advisors has worked with firms during these challenging markets on deals with strong multiples being offered. The reason for such strong pricing was that all the elements for partnership were there, and no reasons existed to wait to effect transactions. This may not, however, be the case for some other firms, and prudence dictates that waiting for better times could be the right choice for them.

Exhibit #3: Reasons to Delay A Transaction: Summary