Are wide-eyed RIAs pricing themselves out of the market?

By Charles Paikert

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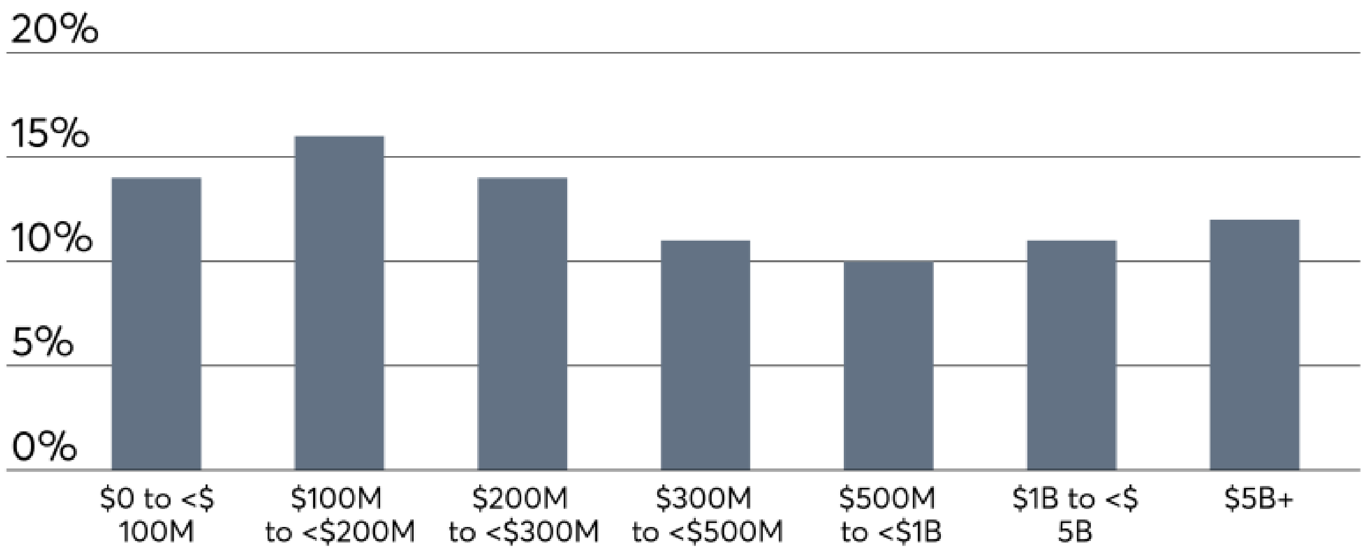
Sky-high buyer demand stoked by headline-grabbing EBITDA multiples in the high teens are leading advisory firm owners to overestimate their worth, according to a new study by Fidelity Clearing & Custody Solutions.

"Sellers appear to have inflated expectations of their firms' values compared to the reality of the market," according to the Fidelity report, which surveyed serial acquirers.

Those expectations have some basis in fact: the median EBITDA multiple for all RIA deals in aggregate since 2017 is approximately 7X, up from around 5X five years ago, according to Fidelity's M&A Valuation and Structure study.

Deal conversion rate; RIA M&A deals since 1/1/17



Source: Fidelity 2019 M&A Deal Valuation and Structure Study

Sellers, however, expect an EBITDA multiples ranging from 8X to 10X, buyers reported — a disconnect leading to nearly 40% of M&A talks falling through.

According to buyers, sellers are paying too much attention to the higher multiples being paid for larger firms and don't understand what actually drives valuations.

"There's a misalignment in motivation," says Scott Slater, vice president of practice management & consulting for Fidelity. "Sellers are looking for liquidity, want to reduce their operating duties and often don't have a succession plan."

"Valuations are often outdated, inflated or use outdated metrics."

Michael Ruane, director of corporate development for Savant Capital Management

It's a tension also highlighted in DeVoe & Company's most recent RIA Deal Book, which notes that well capitalized buyers with sophisticated models designed to increase margins and growth rates are often willing to "pay at the extreme end of valuations," according to founder David DeVoe.

But not all buyers have those capabilities and such deals are not the norm, the report states. Sellers, therefore, "should not assume that buyers are paying record valuations across the board," he says.

While tensions between buyers and sellers are predictable, the Fidelity report does reflect a marketplace reality, say M&A dealmakers.

"We've had five examples [of RIA sellers having unrealistic valuation expectations] in the last three months," says Michael Ruane, director of corporate development for Savant Capital Management. "Firms with less than $300 million get valuations for different reasons. It can be for insurance purposes, for a buy-sell agreement and sometimes for divorce settlements."

The problem, Ruane says, is that the valuations are often outdated, inflated or use outdated metrics, most often multiples of revenue.

"Deals for larger firms are much less likely to collapse."

Steve Levitt, managing partner for Park Sutton Advisors

"For the seller, this is usually their first go-round in M&A and they say 'That's my purchase price,' as if it's not just a starting point," Ruane says.

Lack of expert representation is often the biggest stumbling block for seeing deals through to the finish line getting deals done, says Hoyt Stastney, general counsel and head of M&A for Wealthspire.

"The best indicator of getting a deal done is whether you're well represented by an industry expert," Stastney says. "Otherwise sellers are prone to overestimate the value of their firms."

"Look, to a degree sellers are always unrealistic," Levitt says. "Look at the New York real estate market right now. But the kind of firms who work with us and other investment banking firms are usually willing to listen."

As a result — and thanks to buyers far outnumbering sellers — deals at the higher end of the RIA market tend to get done, he says, despite the occasional difficulty of agreeing on a valuation in an "opaque" market.

Levitt professes himself skeptical about the study's finding that four-out-of-10 of deals tank in the current market due to big-eyed sellers.

"I don't believe that 40% of deals don't get done," he says. "There are a lot of tire-kickers, but large, well-run firms that are serious and well represented are seeing prices bid up and getting better terms. It's a very active market right now."

The Fidelity report also notes that deal structures have improved for sellers. Buyers responding to the survey said they're paying more upfront money to sellers now than five years ago and shortening the average length of payouts to acquired firms.

In the coming year, the report foresees "an attractive market for potential sellers," with valuations continuing to increase and improved deal terms.

But it also cautions that buyers "are becoming more selective in the firms they target and what they are willing to pay."

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