FINANCING OPTIONS AVAILABLE TO ASSET AND WEALTH MANAGERS IN THE CONTEXT OF M&A AND SUCCESSION PLANNING

Overview

Prior to the "Great Recession" of 2008-2009, and for the past few years, M&A transactions were supported by robust equity and credit markets. While credit options to assist small- and middle- market M&A transactions (typically defined as transactions with deal sizes between $5 million and $200 million) and succession planning in the asset & wealth management industry have always been limited, since the fourth quarter of 2008 access to financing has been more challenging than ever. Potential borrowers should be aware of their various alternatives and proactive in order to ascertain their best option(s). This paper addresses the range of financing alternatives available.

1) Seller Financing

In today's middle-market M&A environment, buyers are unable to leverage deals as aggressively as they could in prior periods. This has created a gap between the cash required by the seller and the amount of equity and leverage some buyers are able to assemble in order to complete a transaction. As a result, in many M&A transactions, sellers are being asked to provide more financing than in the past, especially in smaller transactions where the target is privately-owned and the buyer has limited cash resources.

In seller financing, as part of the deal to sell a business, the seller agrees to finance a portion of the sale price over a specified term at a specified interest rate. The buyer offers a promissory note payable over a period of time, typically three to five years, although the period may be as long as seven to ten years. Once a down payment is made at closing, the buyer will continue to make payments according to the agreement with the seller. Payment terms vary significantly, and may be monthly, quarterly, semi-annually, or annually. In addition, some notes are structured as interest-only for the first year post-closing, and thereafter principal commences. Other notes may involve balloon payments. Interest rates are often similar to those charged by senior lenders; however, note repayment is typically subordinate to senior and junior lenders. As a result, the final structure of a note will be subject to the approval of any senior and junior lenders.

In addition, a seller note is often an unsecured obligation of the buyer and subordinated to other indebtedness of the buyer. Typically, senior and junior lenders will have priority liens on the assets and stock of the company ahead of the note. Sellers should try to obtain a corporate guarantee from the strategic buyer, or a personal guarantee from the principals of the buyer, if appropriate and possible. Financial buyers such as private equity firms typically will not guarantee their notes. Seller financing should be distinguished from an earn-out (discussed later) whereby future payments are contingent upon future revenue and/or cash flow. That being said, notes are less risky than earn-outs. Should a downturn occur and cash flow materially decrease, sellers will be in a position to receive payments on a note ahead of earn-out payments.

Seller financing involves both pro's and con's to both buyer and seller. First, this financing option provides a buyer who might not meet the stringent requirements of a commercial lender, particularly in the current credit environment, the ability to finance a purchase. In addition, it offers the buyer the option to deploy a lower amount of equity at closing, and provides the buyer with available recourse for indemnification if the seller breaches the acquisition agreement. From the seller's perspective, the seller can continue to profit from the sale through interest income. Seller financing may also provide tax advantages to the seller if the financing qualifies for installment sale treatment (i.e. the seller may recognize a gain from the sale over several years as it receives payments on the debt).

At the same time, this type of financing effectively increases the seller's vested interest in the company post-acquisition because the buyer's ability to service interest and make principal payments will depend, at least in part, on the success of the business post-closing. The buyer's ability to pay down its obligations may be materially affected by mismanagement of the company and further deterioration of economic conditions and, as a result, the creditworthiness of the buyer and the terms of the note should be assessed prior to reaching final terms.

In the asset and wealth management industry specifically, transitions of practices to the next generation often involve seller financing whereas as little as 20-25% of the enterprise value is paid to the seller initially. However, not all sellers are willing to sell to a party requiring seller financing over many years; understandably, some would prefer to sell to a third party offering the highest price and percentage of enterprise value paid at closing.

2) Earn-Out

The earn-out is a contingent consideration payable to the seller on the basis of the target's post-closing performance. In other words, a portion of the purchase price is paid after closing if the acquired company meets certain pre-agreed performance targets.

As a result of the Great Recession, buyers noticeably lowered the percentage paid at closing. Pre-crisis, an asset or wealth management firm would typically receive a closing payment representing 40-50% or more of the enterprise value of the firm. In some cases this amount can now often be as low as 25%, shifting more of the economics to the earn-out component of the deal. This involves part of the purchase price being variable and dependent upon how the target performs over an agreed period.

Common types of earn-out based performance targets are revenue, assets under management, and EBITDA. Earn-out periods typically range from three to five years although Park Sutton Advisors has witnessed some as long as seven years and some as short as one year. Structuring an earn-out that is acceptable to both parties requires skillful negotiation: sellers typically prefer earn-outs linked to top-line revenue since it is the acquirer who manages the expense base post- transaction. It is not uncommon for some earn-outs to have a "minimum earn-out" (i.e. floor) to protect the seller, and a "maximum earn-out" (i.e. cap) to protect the buyer. Following the transaction, payment of earn-outs achieved could be in cash, notes, or stock, as negotiated in the definitive documentation.

3) Bank Financing

Commercial banks represent a natural source of capital, particularly since RIAs typically have pre-existing custody or brokerage relationships in place. Often the principals of the firm may also have a personal/private banking relationship with one side of the institution.

The challenge faced by most asset and wealth management firms is the unwillingness of many banks to provide capital to firms that in essence have strong human capital (i.e. talented money managers or advisers) but minimal hard assets to secure a loan. Pure cash flow underwriting without hard assets as collateral tends to make most lenders uncomfortable. To circumvent this shortfall, most lenders will typically require personal guarantees from the RIA's partners to secure a loan. In practice, however, most partners feel that they have enough capital at risk in their businesses already and are reluctant to pledge personal assets in addition. Park Sutton Advisors is aware of a wealth management firm in Texas that has just engineered the buyout of retiring partners with financing from its custodial firm. Personal guarantees were required.

Some of the banks who have lent to asset and wealth managers for M&A and succession planning in the past are ING, Bank of America, City National, PNC Bank, and US Bancorp. RIAs seeking bank financing options should proactively approach local banks in their community. Park Sutton Advisors receives frequent inquiries as to lenders facilitating financing without the pledge of personal assets as part of the underwriting process. In our opinion, a terrific opportunity exists for lenders to carve out a profitable niche lending to firms in this industry. We believe that this could not only represent a profitable lending practice for a bank's commercial division but also create significant opportunities to cross-sell other products and services to an RIA and its principals (e.g. custody and brokerage services, personal loans, mortgages, and even become the "go-to" lender for the RIA's own clients).

4) Private Equity

Private Equity ("PE") is another source of succession planning and acquisition financing. Numerous groups specialize in the asset and wealth management industry, and all have different investment criteria including minimum deal size, use of proceeds, minority/majority control, and the PE's specific level of involvement. All of these factors should be considered when exploring this option. Some of the leading private equity groups in this industry are Rosemont Investment Partners, Northern Lights Ventures, Lovell Minnick Partners, Lincoln Peak Capital Management, Century Capital Management, and TA Associates. One big obstacle that many asset and wealth management firms face upon approaching PE is that the desired investment amounts are often below the minimums of these PE firms, except in the context of bolt-on opportunities (i.e. consolidating a target into an existing portfolio company of a PE firm). PE firms investing in asset and wealth management are generally seeking to place $25-50 million or more to work although in some cases they will go as low as $3-5 million. Finally, PE capital is expensive with groups often seeking to achieve 25-30+% IRRs.

While harder to identify, it may make sense for small RIAs that fall below certain thresholds to consider other options, such as local PE firms. Often the latter seek regional investment opportunities and will make small equity investments.

5) Multi-Family Offices ("MFOs"), Family Offices ("FOs"), High Net Worth ("HNW") Individuals, and Angel Investors

When PE capital is not available, or the deal size falls below certain investment levels, asset and wealth managers might also consider approaching MFOs, FOs, HNW individuals, and possibly Angel Investors.

Wealthy investors often are existing clients of an RIA. As individuals with wealth who believe in the principals of an RIA, they may be willing to make a small equity investment. Capital may be used for succession planning, growth initiatives (e.g. acquisitions), or working capital. A small start-up firm raising capital from one of these groups or individuals might try to retain a call option to repurchase the shareholder's equity in the future. As the business grows, it may have access to additional financing sources that enable it to buy out early investors.

In particular, the sale of a stake by an asset manager to an MFO or a FO may have an added benefit as the transaction may involve additional assets for the asset manager to manage. Some MFOs and FOs are interested in strategic relationships with asset managers particularly within their specific region.

However, there are drawbacks to this source of capital. The most significant one is that, for good or bad, not all RIAs are interested to share confidential information (including financials and client pricing) with an individual who may be a client. In addition, Park Sutton Advisors has faced situations where an RIA is increasingly frustrated over time as cash flow grows yet is diverted (as distributions) to initial investors who are not actively contributing to a firm's on-going growth. Relationships can grow contentious in such instances.

6) Other Capital Providers

There are two other capital providers offering financing solutions worth mentioning. One is Asset Management Finance ("AMF"), a subsidiary of Swiss bank Credit Suisse. Their investment structure is based upon Revenue Share Interests ("RSIs") that provide upfront capital to asset or wealth management firms or their principals in exchange for a fixed percentage of top-line revenue for a finite period of time. The term of the RSI is flexible and can be as short as 7 years or as long as 20 years. Unlike traditional banks, AMF does not typically require personal guarantees. However, the expected rate of return will be higher than that sought by a bank (but lower than that sought by PE). One challenge with AMF is that it is usually seeking to place a minimum of $10 million in equity capital to work in a single investment unless the target represents a bolt-on opportunity.

Finally, Fiduciary Network ("FN") is a long-term financial investor that provides fee-only wealth management firms with capital to transition equity internally, allowing them to remain independent and under the control of current and future management. FN's capital is provided by the Milstein family, owners of New York Private Bank & Trust Corporation, the holding Company for NY-based Emigrant Savings Bank in NY. In essence, FN lends money to a company's non-owner professionals so that they can gradually, over several years, purchase as much equity as possible from the firm's current owners. At the same time, FN gradually purchases the company's remaining cash flow from the owners with an instrument that converts into non-voting stock of the company. All owners are paid in cash (not stock) for each sale of their equity or cash flow to either their successor management, or to FN. The FN option can be attractive to certain suitable firms. FN is most interested in growing wealth managers with strong margins, and they are typically seeking a strong next generation. FN is interested in bolt-on opportunities as well.

Table No. 1: Summary

Summary	
Seller Financing	• Seller agrees to finance a portion of the sale price over a specified term at a specified interest rate. The buyer offers a promissory note payable over a period of time. • Repayment of promissory note is usually subordinate to junior and senior lenders. • Gives buyers increased ability to finance purchases over commercial lenders. • Less risky than earn-outs.
Earn-Outs	• Consideration paid to seller that is contingent upon the target's post-acquisition performance. • Earn-out performance targets are typically linked to revenue, AUM, or EBITDA. • Earn-out periods generally range from three to five years. • Can be structured to have minimums and maximum earn-outs, and be paid out in cash, note or stock.
Bank Financing	• Often seen as a natural source of capital due to pre-existing relationships between RIAs and commercial banks. • Can be challenging to attain for firms with substantial human capital but few hard assets; lenders typically require personal guarantees from RIAs' partners. • Banks who have historically lent to asset and wealth managers: ING, Bank of America, City National, PNC Bank, US Bancorp.
Private Equity	• Investment factors include: minimum deal size, use of proceeds, minority/majority control, and level of PE firm's involvement. • Desired investment amounts can often be below PE firms' minimums (typically $25-50 million). • PE capital can be expensive as PE groups seek to achieve high IRRs. • Leading PE groups for asset and wealth managers: Rosemont Investment Partners, Northern Lights Ventures, Lovell Minnick Partners, Lincoln Peak Capital Management, Century Capital Management, TA Associates.
MFOs, FOs, High-Net-Worth Individuals, and Angel Investors	• A viable option when PE capital is unavailable or deal size is below minimum investment levels. • Wealthy investors who are existing clients of an RIA can be a source of capital; firms can retain a call option to repurchase equity. • The sale of a stake to an MFO or FO may involve the introduction of further assets to manage. • May require RIA to share confidential information with existing clients which can make the firm uncomfortable.
Other Capital Providers	• Asset Management Finance: uses Revenue Share Interests that provides capital in exchange for a percentage of top-line revenue. Expected IRR is higher than for banks but lower than for PE firms. • Fiduciary Network: provides fee-only wealth management firms with capital to transition equity internally; non-owner professionals receive capital to gradually purchase equity; FN purchases alongside professionals.