ADVISOR GROWTH STRATEGIES

Accelerating Business Excellence

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The RIA Deal Room

New demands and realities in M&A

2019

Executive Summary

Advisor Growth Strategies' inaugural M&A research study provides the industry with a deeper dive into the mechanics of RIA M&A transactions. Trends in M&A activity beyond the approximate number of transactions is not broadly available. AGS secured information from over 50 M&A transactions to achieve a sample large enough to examine the relationships between price and terms. The driving force behind the research was gaining a better understanding of what is driving M&A in the RIA industry. Why are specific acquirers more successful at M&A? Why are sellers saying yes? What are the differentiators in RIA M&A? AGS took a data-driven approach, complemented by industry commentary, to provide insight that ultimately helps the industry achieve greater M&A success.

The rising tide of RIA asset and revenue growth over the last several years has not impacted firms in the same way. Valuation multiples are favoring larger firms (based on asset size) disproportionately. Valuation multiples remained steady from 2015 to 2018 for 90% of the RIA market, and outsized, "headline," multiples were most likely to apply to top firms. The notion that valuations increased across all segments of the market is not true based on the research sample. Advisor Growth's results show the median adjusted EBITDA multiple for M&A transactions was 5.1x and experienced less than 10% variation in any selected year.

The current RIA M&A landscape is placing higher demands on buyers and new realities on sellers. Buyers are faced with an M&A market that requires reliable access to capital, a long-term growth story, a robust platform, and strong integration acumen. Sellers found that chasing the highest valuations may result in more structure and terms, and gravitated towards balanced transactions with buyers that help the seller easily explain how clients, team, and owners benefit from a sale.

The RIA Deal Room is an ongoing study that informs the market of RIA M&A characteristics. Please contact us to learn more about the research study and how we help RIAs evaluate M&A. We are excited to share the results of our inaugural research and are looking forward to engaging our dynamic market going forward!

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BlackRock on the Evolving RIA M&A Market

M&A within the RIA industry has been a hot topic for the last several years. The pace of acquisitions YTD has already exceeded 2018 numbers and shows no signs of slowing down. Like any other large transaction in business or real estate, there is a natural imbalance of information. Trends in deal terms, deal structure, succession plans, and valuations are all dynamically changing over time by the very participants who engage in these activities.

Advisor Growth Strategies is at the forefront of these industry trends having gathered and thoughtfully analyzed this data over several years. More important than the flashy valuations we've been hearing about on the largest deals, the why and the how is what really matters in these transactions. We believe this research will help the RIA community better understand and assess their position as a buyer or a seller, help build a succession plan or strategically grow their business.

At BlackRock we pride ourselves on the holistic support we provide our clients and believe this research is valuable for an RIA in running their business and planning for their future growth. We hope the insights from this report will help you better assess your firm's position in the industry and give you the guidance and foundation to take the next step with confidence. Advisor Growth Strategies and your BlackRock team are here to help.

– **Hollie Fagan**, Head of BlackRock's RIA business

For more information on how BlackRock can help, please reach out to your local BlackRock Partner or contact Michael Guirguis to start a conversation. He can be reached at **609.751.4915** or by email at **michael.guirguis@blackrock.com**

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Takeaways – Past Meets Present

	New Demands on Buyers	New Realities for Sellers
5.4%	RIAs are being forced to decide how they want to compete. A barbell has formed in the industry, with 5.4% of firms controlling nearly 63.2% of AUM at the end of 2017[i]. RIAs must decide if they want to compete through scale and inorganic growth or stick to a boutique approach.	Multiples did not rise for everyone. Sellers accepted structured deals to achieve the transaction's purpose. The top .5-1% of firms (by AUM) in the industry are commanding premium multiples, but their journey is not for everyone.
42%	Large acquirers set the pace, and deal sophistication increased. These Acquisition Brands completed 42% of transactions from 2016 -2018. A compelling story built on long-term outcomes is critical as access to capital is now table stakes[ii].	Acquisition Brands are communicating turnkey offerings for prospective sellers. Robust capabilities, target markets, and deal model discipline mean rational expectations on price and structure are required.
60%	Prospective buyers have higher barriers to entry than ever before. The average deal demonstrated balance and high down payments. Are potential buyers ready to deploy 60% of cash consideration at closing?	Prospective sellers are experiencing an average of 60% of cash at closing. However, focusing on liquidity impacts the overall valuation. Are sellers willing to trade cash for the highest possible valuation?
<10%	Buyers have been competing in a landscape of increasing cash flows. A balance between price and terms based on the transaction's purpose and a focus on broader transaction benefits is key to getting sellers to "yes."	The median adjusted EBITDA multiple experienced less than 10% variation from 2015 – 2018. Approaching M&A with the long-term in mind is vital unless sellers are ready to enter an auction process and prepared to accept aggressive terms and structure.
>40%	What makes your equity more valuable than the firm you're acquiring? More than 40% of the average price consisted of the prevailing firm's equity. Buyers must be prepared to illustrate a path to liquidity, a repeatable growth engine, scale, and platform, or risk being pushed out of conversations altogether.	Why are you seeking a transaction? Tradeoffs exist in every transaction structure. More significant transactions tend to favor equity, and smaller deals tend to prefer cash. Sellers should think carefully about the ideal buyer profile before entering the market as not all match the seller's goals.
>70%	The days of transactions placing all risk on the seller (e.g., all contingent, earnout, etc.) are over. Greater than 70% of transactions have a balance of cash and equity, and buyers must prepare for integration precision or risk losing to a more established acquirer.	Are sellers ready to help their prospective partners? Sellers must prepare for shared risk and force potential buyers to articulate how all parties come through a transaction. Sellers are saying yes to balanced purchases and integration acumen.

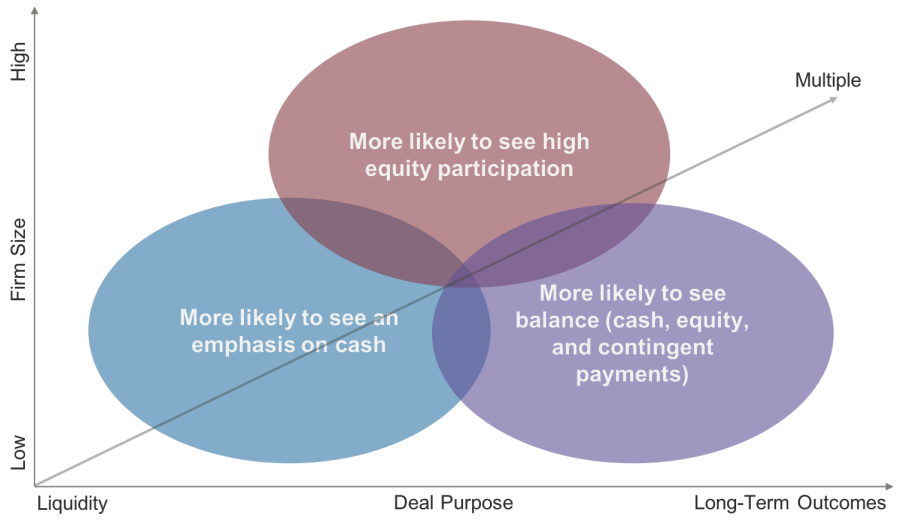
A Rising Tide Lifts All Boats?

The RIA industry is rapidly evolving as large M&A participants seek differentiation and the industry's support system increases. Growth, scale, and succession are driving many RIAs to consider a transformational transaction. AGS estimates that roughly 1.5% – 2.5% [iii]of all RIAs over $100M in AUA/AUM are entering into an external transaction each year. Increased transaction volume coincided with an aggregate decline in the total RIAs, but consistent breakaway movement and low barriers to entry make near-term consolidation unlikely.

From an AUM perspective, the RIA industry has formed a barbell. According to Cerulli & Associates, RIAs and Hybrid RIAs greater than $1B in AUM made up 5.4% of the RIA population and controlled 63.2% of total assets[iv] at the end of 2017. The industry experienced an 11.3% compound annual asset growth rate from 2010 – 2017, and the AUM compound annual growth rate was much higher for firms greater than $1B in AUM versus smaller size segments. Size and scale benefited the largest RIAs, and they are also the firms commanding the highest valuations.

Most of the market did not experience the same upward valuation pressure as larger firms. The pure economics of many RIAs have never been better than 2015 – present and steady stock market returns put many RIAs in a strong financial position. During the research analysis, it became evident that one question deserved consideration; "Are valuations rising due to better financial results, expanded multiples, or both?"

The data suggest that valuations increased for 90% of RIA firms due to sustained financial performance rather than multiple expansion. Evaluating transactions occurring from 2015 – 2018 provided an opportunity to search for outliers, and the results were telling. From 2015 – 2018, the median adjusted EBITDA multiple was 5.1, and there was less than 10% positive or negative variation in the yearly median results. While the financial results have continued to grow cash flow models, the median multiple on cash flow or EBITDA was consistent.

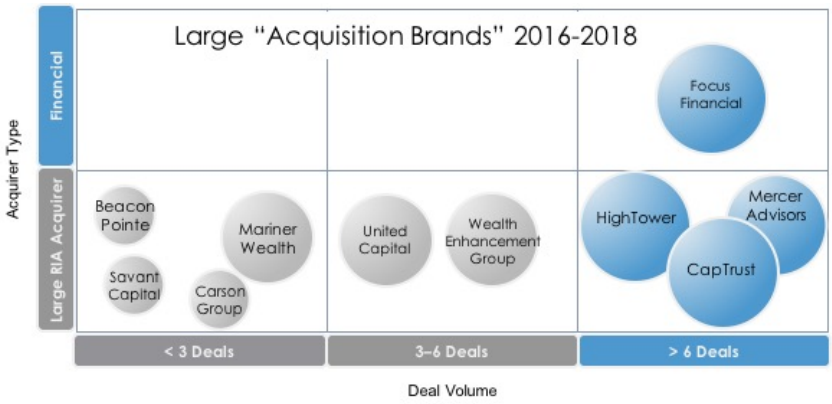


An interesting dynamic is forming in the M&A market. Multiples are not necessarily increasing for all firms, but more RIAs are saying yes to a transaction. The research results support the hypothesis that deals are won on more than the multiple or valuation alone. Instead, sellers are engaging in balanced transactions, and buyers are delivering a structure that is competitive for the firm's size and matches the transaction's purpose.

> ***"We are constantly evaluating the strategic benefits of a transaction for Emigrant and our partner firms, and understand that not all opportunities are worth pursuing. Successful buyers and sellers have to articulate goals clearly and prepare for a mutually beneficial transaction."***
>
> **– Karl Heckenberg, CEO, Emigrant Partners**

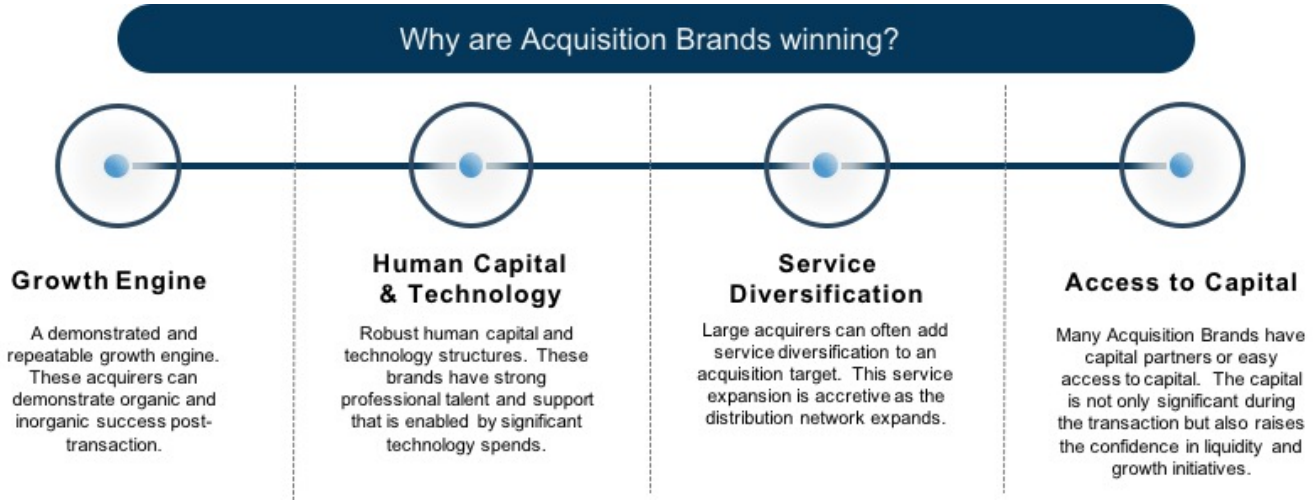
Acquisition Brands Are Setting the Pace

Advisor Growth Strategies defines Acquisition Brands as firms that have completed multiple transactions and have made M&A a known growth objective. From 2016 – 2018, AGS estimates that 10 large acquirers completed 42% of all reported transactions. These firms are actively acquiring RIAs and providing a consistent base of transaction volume.



Why are these firms successful? These Acquisition Brands have a successful deal model, capital access, a robust platform and growth engine, and integration capabilities. Acquisition Brands have solidified that access to cash is now a requirement to be relevant in an acquisition opportunity of any significant size. These large firms can point to their considerable platform investments, intentional human capital approach, and diversified services to help prospective sellers see a path to improved outcomes beyond the transaction.

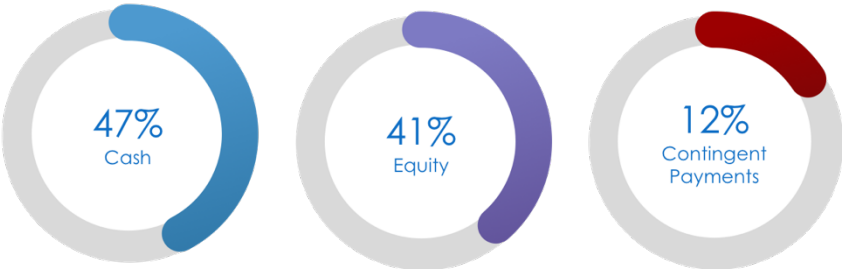
Acquisition Brands have also established an ideal M&A candidate profile, and consistently target firms meeting their criteria. Evaluating publicly available data on Acquisition Brands shows these firms have spent time and resources developing platforms designed to help advisors grow and scale their businesses. These firms have a compelling narrative that appeals to their ideal targets and easily explains post-transaction success.



> ***"Historical M&A activity proves that firms with an integrated platform and capital access are winning in the deal market. Firms that regularly acquire have professionalized their M&A approach and leverage their broad capabilities to compete."***
>
> **– Shirl Penney, President and CEO, Dynasty Financial Partners**

New Demands on Buyers

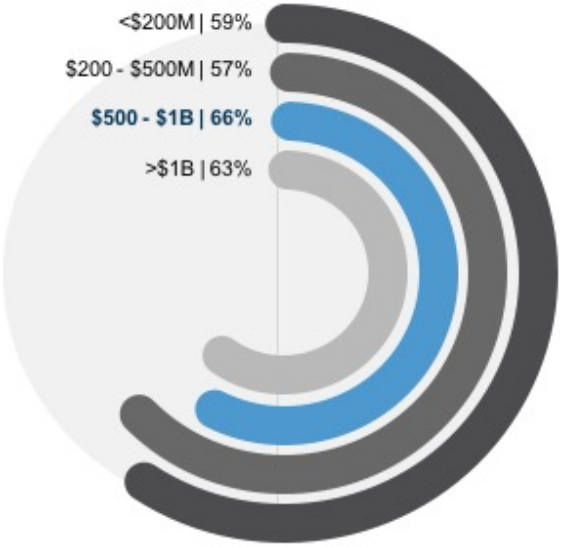
An evolving industry and increasing activity from Acquisition Brands have set a new standard in RIA M&A. The result is higher barriers to entry for prospective buyers. To establish a baseline, every RIA may become a buyer or a seller based on circumstances. This relationship is the Schrödinger's cat for independent financial advisory firms; you don't know which you are until you evaluate M&A as a strategy. The RIA Deal Room research highlights the competitive pros and cons when sitting on each side of the table.



There was a time that reliable access to capital and a modest size differential were enough to differentiate. In today's M&A market, access to capital is table stakes, and sophisticated buyers are articulating a story built on long-term success. This relationship is emphasized by the average deal structure deployed in the dataset. The average deal included 47% cash, 41% equity, and 12% contingent payments. Overall, deals were successfully completed by balancing short-term needs and long-term outcomes.

Delivering cash at closing was a consistent term from 2015 – 2018. Over 60% of the cash consideration in a transaction was paid at closing on average. Prospective buyers should be ready to put several million dollars down on a meaningful purchase, or they will not be competitive. The pressure on the cash side of the equation was consistent among the different AUM size segments evaluated. RIAs with less than $500M saw an average of 50% of deal consideration in cash. RIAs with more than $500M saw an average of 38% in cash consideration. Both groups realized significant down payments (cash at close) with averages of 58% and 62%, respectively.

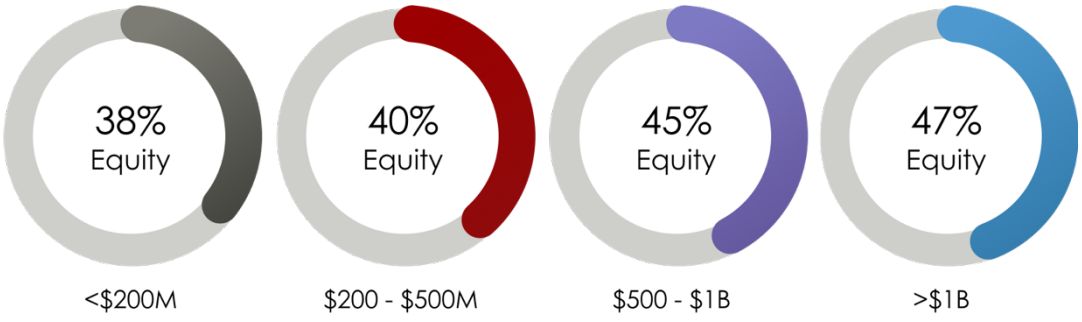
Percentage Cash at Closing by AUM Segment



Prospective buyers are also facing non-cash considerations that require careful evaluation. Introducing buyer equity in RIA M&A transactions changes the evaluation process on both sides of the deal. "What makes a buyer's equity more valuable than a seller's?" This question becomes acute as prospective buyers seek to align risk through equity and contingent payments. As deal size grows, the use of equity becomes even more common. Using equity and other long-term consideration

emphasizes risk alignment and forces buyers and sellers to discuss how to achieve maximum success after the transaction. The data shows that larger transactions favor a higher percentage of equity and underscores that competing in today's M&A market requires an intentional approach to different segments of the market.

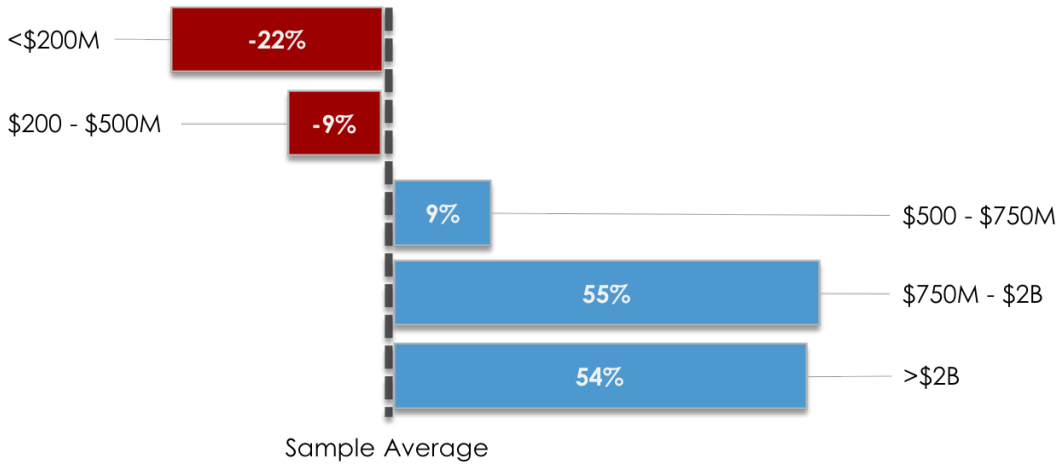
Average Equity Use by AUM Segment (2015 – 2018)



> ***"Our deal model and robust platform allow us to offer significant cash while remaining confident we don't have to compete solely on valuation multiples."***
>
> **– Marty Bicknell, CEO and President, Mariner Wealth Advisors**

You Tell Me "Why"; I'll Tell You How — New Realities for Sellers

Average Adjusted EBITDA Multiple Variance by Size Segment

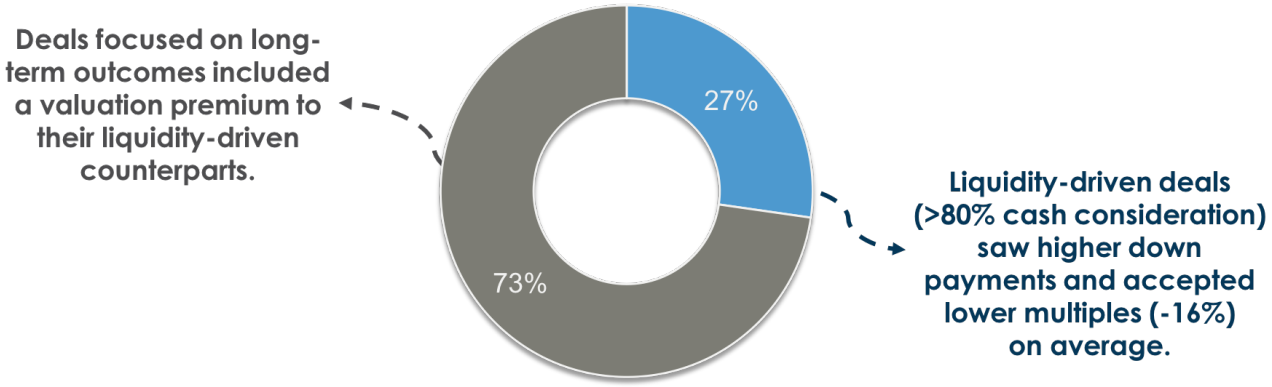


Size matters! Overall, the median adjusted EBITDA multiple had only limited variability year-by-year from 2015 – 2018. The most significant variation was observed when segmenting the selling firm by AUM and Revenue size. Firms over $750M saw average adjusted EBITDA multiples that were greater than 150% the overall sample mean, while firms less than $200M experienced average multiples about 78% of the average. This relationship demonstrates that larger firms were commanding significantly above-average multiples relative to the rest of the market.

Every deal had some structure, and the final structure appeared to be primarily driven by the deal's "why." The purpose of a transaction is highly influential in determining the final valuation, and the optimal consideration mix (cash, debt, equity). Industry heavyweights used to say; "you name the price, and I'll name the terms" when describing RIA M&A. This saying was a simple way of highlighting that almost any price can be justified with the right amount of structure. In recent years we are witnessing an evolution to; "you tell me why and I'll tell you how." Increased competition is setting a new standard in the market, and buyers are appealing to sellers for specific reasons. Sellers looking to achieve significant liquidity in a transaction experienced a lower average multiple than those with greater ties to long-term outcomes.

> ***"The best deals align capital partners, owners, employees, and clients. Placing too much emphasis on getting the highest multiple may come at the expense of overall alignment and subpar long-term results."***
>
> **– Brent Brodeski, CEO, Savant Capital Management**

Average multiples in liquidity-driven transactions (deals with more than 80% cash consideration) were 12% less than the sample's average and 16% less than deals with less than 80% cash consideration. Prospective sellers should expect a competitive valuation and terms that match their desired outcome. Sellers have rational optionality as Acquisition Brands continue to refine their target markets, and new entrants emerge that focus on specific seller characteristics. Placing too much emphasis on a deal's multiple or valuation can have adverse impacts as the tradeoffs may become severe. The data supports an argument that prospective sellers are likely to receive more structure and terms in a transaction if they enter an auction process or push for irrational valuations.

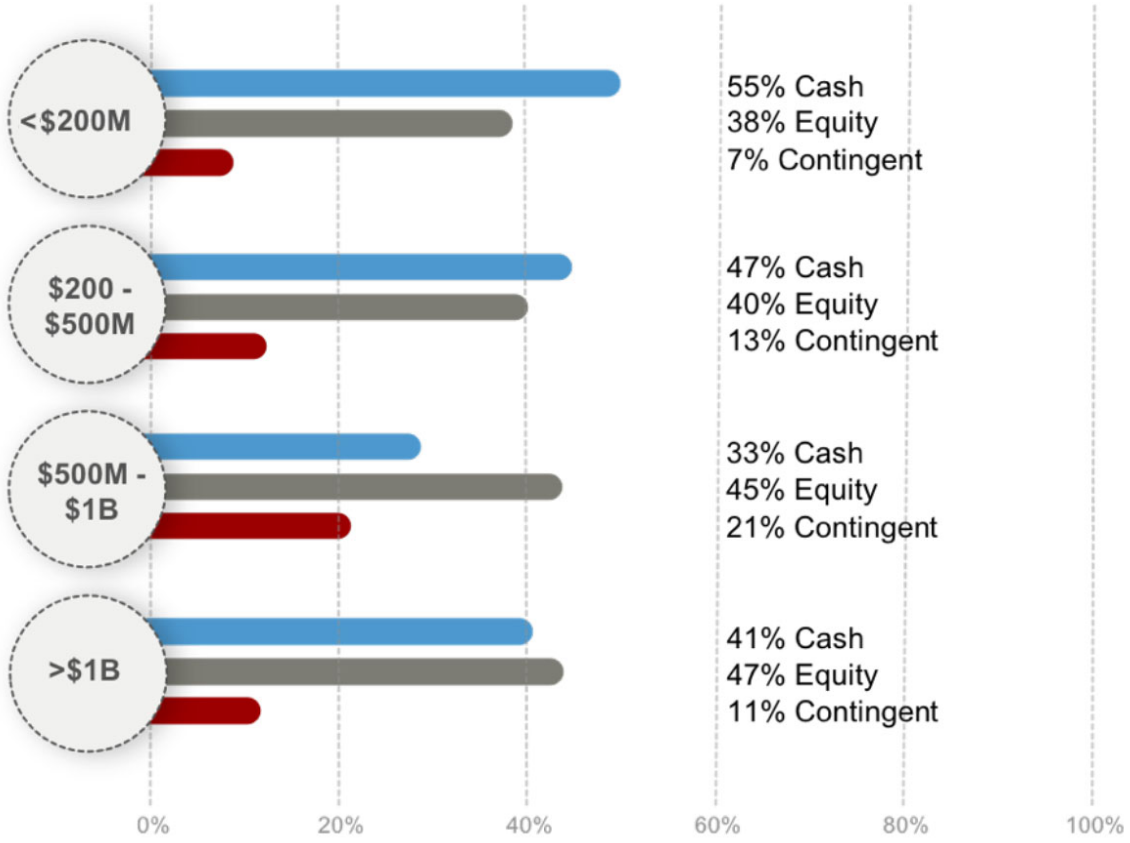


Aligning Risk is Driving Deal Terms

M&A is part art and part science. The art of any transaction is offering a fair valuation and terms that reflect the transaction's purpose. A simple way to think about this scenario is by asking, "What problem is the transaction solving?" Both buyers and sellers will have to thoughtfully consider the desired transaction outcome before entering into deal discussions because the valuation, deal structure, and the integration approach are all tied to the strategic objective.

The most common jargon used when describing deals is "the multiple." To effectively analyze the research sample, it is important to consider; "a multiple of what?" Most transactions in the RIA space are being done on adjusted or pro forma Earnings before Interest, Taxes, Depreciation, and Amortization (or "EBITDA"). EBITDA is a popular metric, and the critical terms are "adjusted" or "pro forma." This distinction is essential because the variation between operating and adjusted EBITDA can be significant depending on the transaction's purpose, buyer, and underlying firm characteristics.

For example, the average multiple of unadjusted EBITDA (or operating EBITDA) is over 30% higher than the average multiple of adjusted EBITDA. Meaning, the total valuation based on adjusted EBITDA multiples is capitalizing operating EBITDA at a much higher rate. The same relationship is real in revenue or AUM multiples as the data shows significant variation and very little correlation. Overall, the data suggests that buyers are focusing on pro forma earnings above all other metrics as correlations were observed between size, structure, and adjusted EBITDA.

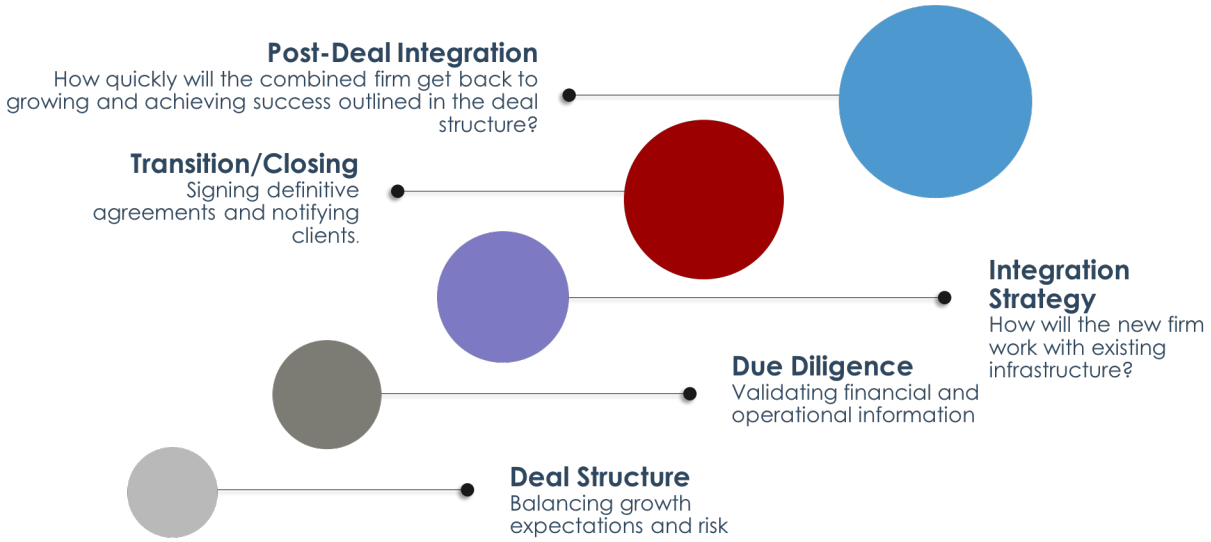


The result is the ability to customize transactions, align valuation, and create balanced terms using pro forma results. Deals in today's market are far more customized than one might expect. The dataset showed consistent patterns when it came to cash, equity, and contingent payments. For example, the data revealed a model that shifts towards more equity with larger deals and more cash with smaller transactions. Buyers were more willing to negotiate a higher price when using equity and more likely to suggest aligning long-term risks as the deal price increases. Using contingent payments such as earnouts and notes was still a strategy, but 75% of the transactions studied had less than 25% of the total consideration allocated to contingent payments. When sales did focus on contingent payments, 100% of the transactions received payments in three years or less.

The overall impact is prospective buyers must be intentional, and potential sellers must have realistic expectations. The use of cash, equity, and contingent payments will vary based on deal size and purpose. Buyers must prepare to deliver significant money at closing and align fair terms to get to a "yes." Sellers must realize that the best outcome may be tied to long-term success rather than the current valuation.

Integration Acumen is the New Competitive Differentiator

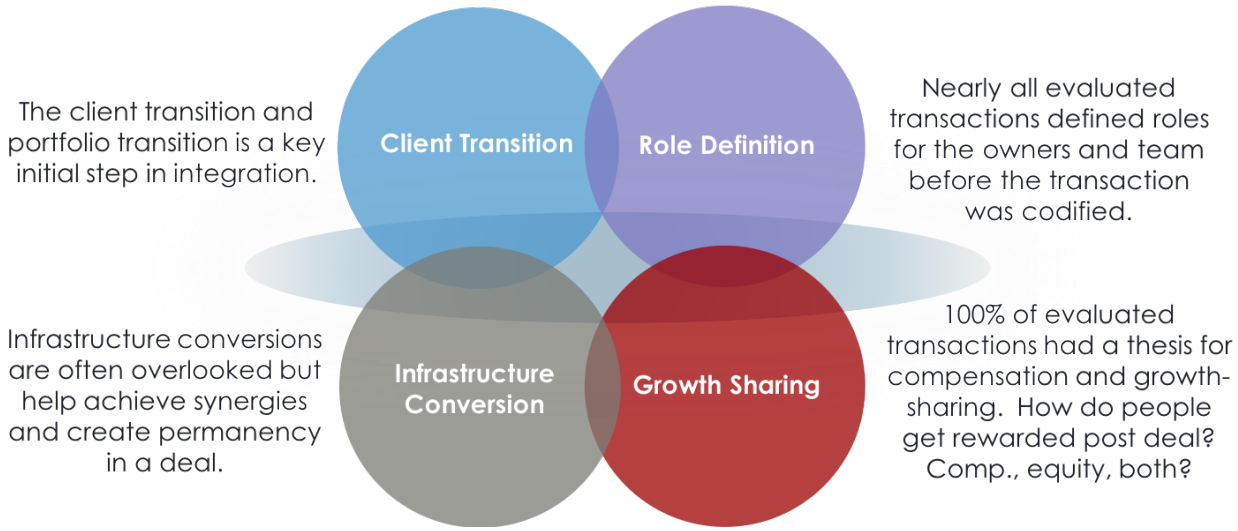
Evaluating the relationship between deal price and structure reinforces that sellers said yes to balanced transactions and buyers proving how all parties benefit over the long-term. Aligning risks and achieving balance has also increased the need for integration acumen. Integration acumen is the ability to transition clients, people, processes, and technology to the new entity quickly and efficiently. The Acquisition Brands in the RIA space have the benefit of completing multiple transactions and, in some cases, have dedicated employees that help accelerate integration. Integration capabilities must span the entire organization and must give the counterparty confidence that their clients and team will get integrated smoothly.



Integration acumen has become the new competitive frontier due to the sophistication of the deal market. Deal structures are implying short-term results through cash terms and contingent payments, and long-term effects through equity participation. Adjusting an acquisition target's cash flows explicitly demonstrates that savings are a part of the transaction and additional terms such as contingent payments demand continued performance levels *after the deal.* Successful integrations shine when there is an intentional focus on client

> ***"Winning in this market environment takes a compelling story about how clients, team members, and owners all become more successful. Our differentiator is that we are building a 100-year firm and are not building to sell, which guides our culture and how we invest in the business, think about deal structure, and evaluate the advisors and firms that we bring into our partnership."***
>
> **– Aaron Schaben, President, Carson Group**

transition, human capital, compensation, and infrastructure conversions. Prospective buyers that are winning in the market can position integration early, and often, to explain value beyond deal consideration. The integration storyline is best highlighted when acquirers come prepared with a compelling operating and human capital structure that easily applies to their counterparty. Prospective sellers benefit from equity, contingent payments and any synergy assumptions that are priced into the deal when integration is top-of-mind.



A Look Ahead – What Should the Market Expect?

Deal volume continues to increase. Transaction data suggests that sellers will continue saying yes to balanced transactions, provided the expectations are aligned. Prospective buyers must be intentional in their approach to the M&A market. AGS doesn't believe that multiples will increase substantially for 90% of the market without significant adjustments to terms and structure. The market will likely continue to move the needle on down payments, cash consideration, and a compelling growth and scale story. Historical competitive differentiators like access to capital and deal "know-how" will continue to be commonplace due to new entrants and lower cost of capital.

The top 10% of the RIA market will see continued upward valuation pressure on a multiples basis as they appeal to large, sophisticated buyers that are fiercely competing to win business. Private equity firms, advanced platforms, and flexible capital providers will put pressure on traditional acquirers as these firms have built-in growth engines and tangible ways to drive value through competitive capital sourcing, creative deal structures, and accretive exit strategies.

Overall, we're expecting 2019 to show increasing emphasis on long-term success. Acquisition Brands will continue winning in their desired segments, and the need to evaluate the ideal partner before entering the market will be essential. Prospective sellers will need to approach "the highest price" with caution as the tradeoffs may not be worth the outcome. Potential buyers will need greater precision in their deal model and approach as sophisticated buyers continue raising the bar on balancing terms, driving integration, and delivering on promises of shared success. All firms will need to be intentional in considering the buyer or seller type they are seeking to engage before going to market. The rapidly evolving RIA M&A space continues placing demands on prospective buyers, and sellers will have rational optionality if they are thoughtful in selecting the right partner and deal structure.

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About the Research

AGS collected transaction data and surveyed industry participants over six months. AGS included data on 55 change-of-control transactions that covered a broad industry demographic. Overall, the data included over $30B in sellers AUM, $550M in total valuation, and spanned over 20 unique acquiring firms. The following methodology was used to secure and evaluate the data.

- AGS contacted RIAs nationwide to ask for actual transaction data, and included existing internal data. The data collection process happened in late 2018 and early 2019.
- AGS provided context and a data collection format. AGS secured the selling firm's AUM, Revenue, EBITDA, consideration mix (cash, equity, other), post-transaction compensation, post-transaction success (qualitative), and post-transaction success (growth).
- The number of transactions by seller revenue size:
    - 16 transactions under $2M in revenue
    - 27 transactions between $2M - $5M in revenue
    - 12 transactions greater than $5M in revenue
- 23 different acquirers were represented in the dataset. Some acquirers did multiple deals. AGS validated that no deals shared the same consideration structure.
- 15 transactions were removed from the dataset to arrive at 55 transactions. The 15 removed transactions included tuck-ins and transactions with incomplete financial data.

Glossary and Definitions

- AUM/AUA – Assets under Management or Assets under Advisement. The total assets managed by an RIA on behalf of end-clients.
- RIA – Independent Registered Investment Advisor. For the purposes of this research, RIAs include fee-only and hybrid RIAs. Hybrid RIAs maintain a relationship with a broker/dealer.
- EBITDA – Earnings before Interest, Taxes, Depreciation and Amortization.
- Adjusted EBITDA – EBITDA after adjusting for one-time, non-operating, or synergies in a transaction. Adjusted EBITDA may also include known income or cost events that impact a target firm's economics.
- Integration acumen – AGS defines integration acumen as a track record of transitioning clients and employees and converting systems and processes to the prevailing firm's structure.
- Cash consideration – cash at closing (down), escrow payments, or installments.
- Equity consideration – any form of ownership used in a transaction (voting or non-voting).
- Contingent payments – ongoing revenue-sharing (earnouts), long-term notes, or any form of consideration that is dependent on the ongoing economics beyond one-year.
- Acquisition Brands – large RIA acquirers (financial or strategic) that have done multiple transactions and make M&A a known growth objective.

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[i] Source: 2018 Cerulli RIA report.
[ii] Source: Wealth Management M&A Transaction Reports 2016-2018. Fidelity Investments. 42% removes all outsourced providers and breakaway transactions.
[iii] 1.5-2.5% assumes a base of over 6,000 RIAs (Fee and Hybrid) over $100M in AUM and approximately 90-150 of those RIAs entering into a transaction per year. Data sourced from Cerulli, AGS analysis, and Fidelity M&A report.
[iv] Source: 2018 Cerulli RIA report.
[v] Source: Wealth Management M&A Transaction Reports 2016-2018. Fidelity Investments. 42% removes all outsourced providers and breakaway transactions.