Inside the World of Crazy M&A Valuations

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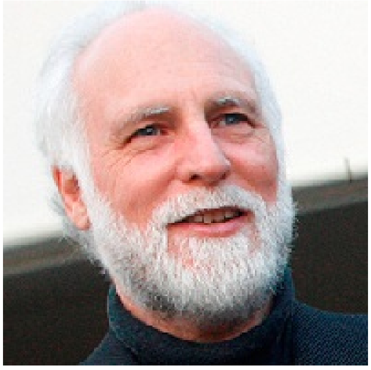

Ultra-low interest rates and a flood of private equity dollars seeking a decent return have driven the valuations paid in the M&A market to crazy levels, according to two of the most prominent acquirers.

Before we dig into those numbers, let's consider how far we've come these last 20 years of advisory firm mergers and acquisitions. Back then, advisory firm owners were just beginning to discover that they were adding enterprise value to their practices, which might (who knows?) someday be monetized. Today, the trade press is filled with talk about "inorganic growth" – buying or merging with other advisory firms to achieve scale, efficiency and remote office locations.

For the most active acquirers, the goal is to secure themselves at the top of the food chain. As Peter Mallouk of Creative Planning put it in a recent Insider's Forum webinar presentation, "We're going to see a few enterprises emerge out of the profession." Currently, he said, the top 25 wealth management firms control a significant percentage of total assets and clients, and the larger firms seem to be capable of attracting organic growth at a faster pace than their smaller peers. "Ultimately," Mallouk added, "I think there will be five firms that have a disproportionate share of the marketplace; they will be truly national RIAs. And I think that 20-30 other large firms are going to control a lot of the rest of the assets. In all, I think 75% of all clients will be working with those firms."

In addition to Mallouk , the webinar featured Tom Orecchio of Modera Wealth Management, and the presentation was moderated by renown business consultant Angie Herbers of Herbers & Company. (I was a quiet co-moderator.) Mallouk's Creative Planning firm sits squarely near the top of that food chain, with 750 employees in 30 offices, having purchased a remarkable 14 RIAs in the past 15 months. Modera has 17 partners, six locations and $3 billion under management, and the firm has done eight deals since its inception. The two serial acquirers were there to discuss the sometimes-hidden details of M&A activity.

Modera and Creative Planning do acquisitions very differently from each other, and this illustrates the spectrum of opportunities that sellers have in what both presenters clearly consider to be a seller's marketplace. Mallouk said that all of his transactions have been for cash – some up-front, the rest as part of an earn-out arrangement based on client retention. Modera, in contrast, is open to including cash in its deals, but offers mostly equity in the firm, and Orecchio views his arrangements more as mergers than acquisitions. Many of Modera's partners came onboard through these merger arrangements; their partnership share was straightforwardly calculated as their firm's proportion to Modera's valuation at the time of the transaction.

But the firms were similar in other ways: They require the other firm to merge itself wholly into their corporate structure, adopting their branding and their way of doing business.

This led Mallouk to offer some advice to potential sellers. "You have to decide what you want in the transaction," he said. "If you say, *I want to leave my name brand on the door, I want to keep using my CRM, I want to keep doing my own investment philosophy using my systems*, there are really excellent options, but Creative Planning is not one of them." He would point an advisor who wants that arrangement toward Focus Financial and Buckingham Asset Management, while advisors who simply want someone to take over their expensive back office services would be directed toward Mariner and Dynasty. "So you start by saying, what do I want?" Mallouk concluded. "You first want to know, *what am I trying to accomplish*?"

This, of course, is different from what you read in the trade press, where the emphasis is on deal structure. Orecchio said that he doesn't look at the valuation or potential revenue gains in the early meetings; whenever he sits down with a potential merger partner, his first goal is to put himself in the other principal's shoes. "I want them to think about what it would be like to suddenly have your name come off the door as owner of their firm," he said, "and the next day they're part of Modera. Is that an issue? Do they want equity? Do they want to be a partner making decisions, or is their goal to get rid of the headaches and work with clients as an advisor? Once we understand those things," he concluded, "then we can structure the transaction so that it fits them better."

Both Mallouk and Orecchio see many potential transactions (Mallouk said he currently has more than a hundred in his pipeline), but they also said that they can quickly weed out opportunities that aren't going to work. Interestingly, the factors that lead them to decline an acquisition all involve a compatibility (or lack thereof) of culture.

"In looking at a firm, we will only consider a situation where the cultures fit," said Orecchio. "Do they have a similar investment philosophy, financial planning philosophy, do they treat their employees and clients the way we do? If they do, then we think we might have a fit," he added. "If they don't, if they are short-sighted rather than taking the long view, or if they're more about investments and less about planning, then maybe we're not a good fit."

Mallouk said that he has never engaged in M&A talks with a breakaway broker. "It is not a cultural fit for us," he said. "They're used to a different environment. They might be great advisors, but the risk is too high." Other firms that have significant commission revenue are also weeded out in the initial conversation. "If that has been a substantial part of their business, I'm not interested," said Mallouk. "They say they're willing to dissolve that part of their business, and they may be totally sincere," he added. "But why spend the time and effort trying to make that work? It is not part of our culture."

So what *does* he look for? "I want to see a lot of alignment before we're even starting," Mallouk said. "Planning-led, similar investment philosophy, a consultative and educational approach with clients, a model where you're paid fees for investments and planning work – and if you hold yourself to those criteria," he added, "you're going to wind up with people who are probably thinking like you already. No one wins if you try to make something work if those aren't in alignment. And we tell the firms we're not interested in: There are places that will serve them much better than we would."

Later, Mallouk said that he is most interested in firms where the owner doesn't lead with the financials. "The most attractive options always want to get to know me first," he said. "They want to meet some people at Creative, and they are focused, first, on culture the same way we are. They want to know, *what would my life be like if I went there? What will be the clients' experience if I go there?* And they tend to lead with that."

I asked about the metrics that Mallouk and Orecchio look for once they've determined that there's a cultural fit. But the most interesting thing to come out of the question is that the metrics determine the price, not whether they're interested in doing a deal in the first place. "If the other firm's average client is 77 years old and withdrawing money every year, that's a much less attractive practice than if the average client is 44 and *adding* money every year," said Mallouk. "If the owner and the key people are only going to work one more year, you have to ask yourself, *what am I buying?* The client base and where the advisor is in his or her career are factors that make the numbers come alive."

"The reason we didn't want to lead with those quantitative issues," Orecchio chimed in, "is because in many cases you can make the numbers work. But you can't make it work if the culture doesn't fit. If you don't have the cultural aspects in place up-front, the numbers don't matter."

How does the initial negotiation work? Orecchio said that his firm has a rule: Put all the elephants on the table, up-front. "We want to know all the possible deal-breakers right out of the gate," he said, "because I don't want to waste their time, and I don't want to waste my partners' time. If we can get past those potential deal-breakers, then maybe we have the makings of a good transaction."

What do those look like? Orecchio said that sometimes the investment philosophies may be intractably different. Another, he said, is the way that financial planning is delivered (modular or all at once, consultatively or autocratically), and whether the other side really does want to keep their name on the door or otherwise operate independently of the Modera way. "We like to say that we are one Modera," said Orecchio. "Everybody is rowing in the same direction. If you can't buy into that 'one Modera' theme, then it's not going to work for us."

Mallouk said that there are at least 100 deal killers for his firm. Does the other firm have a very different way of paying the staff? Is there unexplained staff or client attrition? "If somebody tells me, *we are going to use our own trading software*," he said, "*or the CRM we're used to*, that is a deal killer."

But he also said that the ball is primarily in the seller's court, and his firm may have deal killers that make the seller turn away to a better option. "Most sellers will eliminate a lot of the buyers," he said, "because they aren't that interested in a firm that doesn't have the things they want in place, or they're not doing business the way they're used to doing business. If the seller gets down to two good options, and they are pretty similar," Mallouk added, "then they're going to go with the one where they have the least disruption with their staff and clients. It's not like there are 100 big buyers. There is a very small group of buyers, and they're pretty different. So the sellers usually find out who they like and move on with them."

How long do these negotiations take? “If we’re moving at lightning speed,” said Mallouk, “then it will still take several months. You have the financial due diligence, you have to review all the contracts and leases, you have to meet the leadership and they have to visit you, and before all that you have a couple of calls.”

Neither panelist offered a firm valuation on what a business is worth, nothing that every advisory firm is different and there are a lot of moving parts. But Mallouk said that he is paying more today than perhaps people would have paid three or five years ago. “The valuations in this environment are just crazy,” he said, adding that private equity bidders and ultra-low interest rates have driven up what advisors can get for their firms.

“Part of the reason you’re seeing all these mergers and acquisitions today,” Mallouk added, “is that a lot of people know that when someone called them randomly three years ago, versus today, the numbers are dramatically different. That is why you’re seeing so many transactions happening in this space.”

Orecchio agreed that valuations are higher than they have ever been. But he thinks they could go higher still. “As you create larger national firms,” he said, “they will trade a lot like public equity does, at higher multiples than what we’re seeing today for your average RIA firm.”

Whenever a firm is acquired or there is a merger, there will inevitably be redundant staff – that is, people who perform many of the same functions at each firm. During the ‘get to know you’ phase of the merger/acquisition, the staff members will become aware of this, and it is human nature that they’ll get nervous about their job safety. What do the panelists do about that?

“When we do mergers, we have a rule that we won’t make any staff changes in the first year,” said Orecchio, “because there is typically enough change going on at the clients’ end, and the last thing we want to do is disrupt that relationship even further.” After that, he said, he has found that the best and most flexible staff people can be repurposed. Others will be less enthusiastic than the owner about working in the new environment, and wonder: *Do I have a home here? Do I like this new environment?* And they may decide to move on.

Mallouk takes a different approach. “Before we do a transaction,” he said, “we actually go through every single employee, and we talk about what they’re doing at their current firm, and what it would look like at Creative Planning. Can we pay for a designation for them to do something that fits our model? Or will they move to our headquarters, where we can find a position for them?” Redundant staff issues are sorted out in advance, and Mallouk indicated that if there is an intractable overlap, the tie goes to the current Creative Planning staffer. “Once you are on the team, you are on the team,” he said.

Of course, this also allows the principals at the other firm to re-evaluate, should the plan call for some of their staff members to be let go. “Sometimes they’ll tell us, *our team is not going to like this, and we’re not going to do the deal*,” said Mallouk. “And that’s fine, and good to know up-front. At the end of the day,” he added, “our goal is to have a bunch of happy people who have done transactions with us, because we know that the next people we meet are going to call them. I want the former people to be able to have an honest and transparent conversation and say, *everything that Peter said was going to happen is what happened*.”

The conversation turned to some of the intangibles in an M&A arrangement, and it quickly became apparent that there are some pretty significant benefits to an acquisition that aren’t reflected in the numbers.

“The acquisition is not just about buying clients and revenues,” said Orecchio, even though those are the things that his firm is actually paying for. “It’s also about talent joining our firm. If we have good people coming onboard, and they want to be partners, and they fit the bill, we view that as an extra benefit to the acquisition.”

Mallouk noted that buying clients and acquiring advisors (and offices) accelerates growth in two dimensions: adding revenues and increasing staff leverage.

The talent component, Orecchio said later, is underpriced; it’s almost a throw-in on a transaction that focuses on buying the EBITDA at a fair price. Both firms said that they’re comfortable bringing on advisors who only want to stick around for another three to five years before retirement, because that provides a long runway to allow clients to become accustomed to the new firm. Both firms focus on retaining the people that the advisor has trained and developed. In fact, both Creative Planning and Modera have dedicated staff members whose job is to train the employees of the acquired/merged-in firms into the systems and procedures of their new home.

The conversation uncovered another valuable throw-in to these deals: better ways of doing business. Orecchio said that his firm will do an evaluation of the firm it’s merging with, and look for best of breed ways of doing business that can improve Modera’s service model or operational efficiency. He compared the firm to a race of creatures called the ‘borg’ in the Star Trek series, who assimilate other cultures and add their technology – to terrifying effect.

The effect at Modera is a bit less terrifying, however. Orecchio cited the example of a merged-in firm whose principal was doing a great job of marketing herself through a regular podcast. “We’re now in the process of growing a part of our firm to do that,” he said, “and she’s going to be a big part of it.”

Mallouk’s firm also has ‘borg-like’ tendencies. “Every firm we buy has ideas that we incorporate,” he said. “We recently bought a small firm that had created a library of recommendations to consider for very specific niche professions. We incorporated that in the same week. Any time you bring in talent and experience,” he added, “you’re evolving.”

The point bears repeating: When a larger advisory firm makes an acquisition, it will be paying for the future revenue or profit stream, and get, almost as a throw-in, new talent and staff leverage, plus the best operational and marketing ideas of the acquired firm. That makes the M&A activity more valuable than it would appear on the surface.

At the end, Orecchio warned that any buyer thinking of entering the M&A space should recognize that the first acquisition, and every subsequent one, is going to change the nature of your firm and what you do on a daily basis. “I spend a fair amount of my time having conversations about mergers and acquisitions with other firms,” he said, “and if we were not in this space, I wouldn’t be spending the majority of my time doing this. I would probably be spending the majority of my time serving clients. It takes you 20-30 years to build your culture,” he added. “It takes just one bad M&A move to wreck it.”

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