FIDELITY INSTITUTIONAL INSIGHTS

M&A Valuation and Deal Structure—Insights from Leading Serial Acquirers

Exploring M&A deal multiples based on insights from serial acquirers.

In the last six months of 2020, 28 $1.0B+ firms sold, evidence of accelerating consolidation in the fragmented RIA channel.

Introduction

M&A activity in wealth management continues to accelerate as motivated private equity capital moves into the space and firms themselves wrestle with operating scale, competitive service models, and leadership succession challenges. Across the industry, the fragmented RIA channel receives the most media attention around M&A due to the high number of transactions and the continued emergence of new acquirer models. M&A has accelerated at a rapid pace since June 2020, which marked the beginning of a rebound from a three-month slowdown driven by the onset of the coronavirus pandemic. Full of record highs and lows, 2020 culminated in 130 RIA deals representing $182.8B, which is up 4% and 22%, respectively, from the records set in 2019. Larger deals dominated, with 13 $1.0B+ deals representing 79% ($61.5B) of the quarter's AUM. The median deal size in 2020 increased 33% since 2019 to $585M.[1]

After two years of transformative transactions in the IBD space, 2020 has had fewer transactions as firms focus on integrating acquisitions. It is worth noting that, during 2019, 15% of existing IBDs were recapitalized or acquired. Therefore, it is not surprising that activity in 2020 decreased in this space.[2]

Among the questions that advisors and firms continually ask is: What do today's valuation multiples look like and how are they trending? The B-D market, with more public firms and transactions that are publicly disclosed, is relatively transparent regarding multiples. By contrast, it is challenging to obtain accurate, quantifiable valuation data for independent wealth management channels.

With that as the backdrop, the research in this report is focused on RIAs, in part to provide insight and transparency into deal details that would otherwise remain private.

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23
RIA firms featured in the *2019 M&A Deal Valuation and Structure Study* that accounted for nearly 50% of RIA M&A activity from 2017 through June 2019

The *2019 M&A Deal Valuation and Structure Study,*[3] fielded by Fidelity in 2019, is informed by leading strategic acquirers in the RIA channel. Most of the firms are members of Fidelity's M&A Leaders Forum. Formed in 2015, this group is composed of senior-level executives of strategic acquirers and several industry-focused investment banks. Over the last several years, the 23 serial acquirers in our study have been prolific in M&A. They have executed multiple transactions and driven nearly half of the M&A activity in the RIA space from 2017 through mid-2019, as recorded in the *Fidelity Monthly Wealth Management M&A Transaction Report*.

This report examines how these strategic acquirers approach and execute M&A today and provides new insight into the primary deal motivations of buyers as well as sellers. As part of that, we explore expectations around valuation multiples and deal structure, and consider what the industry can expect to see in the way of M&A activity in the future. This research will help firms of all sizes and stages understand why deals get done, when and why they fall through, and where firms on both sides of the transaction need to focus in order to achieve their firm's objectives.

Our paper looks at the state of play in M&A in wealth management by exploring four interrelated elements:

1. **The Serial Acquirer:** What has been the experience of the serial strategic acquirer in completing deals regarding valuation and deal structure, and what characteristics do they find attractive in target firms?
2. **The Seller:** Why are sellers coming to the table today and what are their objectives?
3. **Expectation Gaps Between Buyer and Seller:** What are the key disconnects in what buyers and sellers expect from deals?
4. **The Deal:** How has deal structure changed, and how is that impacting transactions on the buy- and sell-side?

In each of these elements, we found that an explicit alignment of interests between buyer and seller is key to successful deal execution.

The Serial Acquirer

Between 2017 and 2019, serial acquirers featured in the study collectively completed 146 deals[4] (Exhibit 1), with a median deal size of $250M. From 2014 to 2019, these same firms completed 227 deals altogether (Exhibit 2). From 2014 to 2019, 9 of our 23 firms each completed 10 or more deals, with total deals by the 9 firms representing 73% of all the deals in our study. Between 2017 and 2019, 6 of the 23 firms completed 10 or more deals, representing 61% of all the deals in our study for that period.

These aggressively acquisitive firms are fully prepared with the necessary resources, including due diligence and negotiation teams and capital at the ready to do deals, and they have a clear M&A strategy. Perhaps even more telling, these firms have looked at nearly 1,200 deals between 2017 and 2019, which further indicates how deeply engaged they are in the process and how competitive the wealth management M&A marketplace really is.

EXHIBIT 1: Tracked M&A deals by strategic serial acquirers between 2017 and 2019.

Q—How many M&A transactions have you completed since January 1, 2017 (i.e., two-plus years ago)? Please give your best estimate.

EXHIBIT 2: Tracked M&A deals by strategic serial acquirers from 2014 to 2019.

Q—How many M&A transactions have you completed in the last five years? Please give your best estimate.

The *Fidelity M&A Wealth Management Transaction Report* reveals that RIAs completing multiple transactions (three or more deals) accounted for nearly two-thirds of the total M&A transactions and half of AUM in 2020, pointing to the growing concentration of AUM among the largest firms. (Please note that some of these firms were included in our study, but not all.)

In today's competitive market, these buyers focus on communicating a compelling and differentiated value proposition to target firms. As part of that, they can help sellers address increasing business operating challenges through superior technology, operating models, and service platforms. They are also able to help sellers resolve the lack of viable succession plans in most firms, and re-channel their energies on market- and client-facing activities. Conveying this vision successfully to firms that are hesitant to relinquish their independence often leads to multiple meetings over several months before deals move forward. Hence, successful serial M&A requires top leaders from both sides to dedicate a high level of attention to the deal.

15 RIAs completed multiple deals in 2020, accounting for 80 deals and **62%** of the activity.

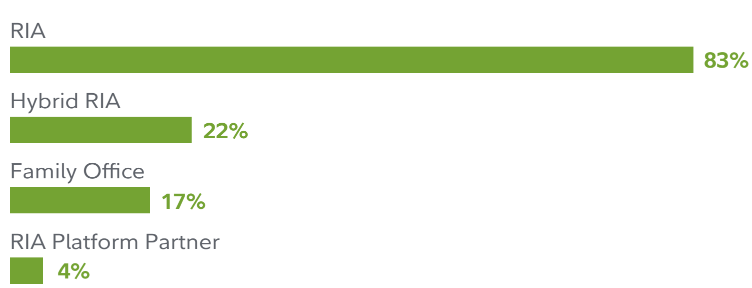
Gaps Between Buyers and Sellers

Regardless of any short-term market or economic fluctuations, there is every indication that the pace of M&A activity will continue as the trends mentioned proceed to drive deals and reshape the industry. In support of that theme, three-quarters of firms participating in the survey report that they expect to do more deals in the future, and more than 80% of participants indicated that they are focused on the RIA channel (Exhibit 3).

As dealmaking proceeds in what is arguably a seller's market, our research uncovered a few key misalignments in what buyers and sellers in wealth management are looking for from each other and why. More specifically:

1. EBITDA (earnings before interest, tax, depreciation and amortization) expectations may be misaligned
2. Buyers and sellers approach the deal with different objectives

EXHIBIT 3: Focus segments for M&A.



Q—Which wealth management segment(s) are you focused on for mergers and acquisitions? Select all that apply.

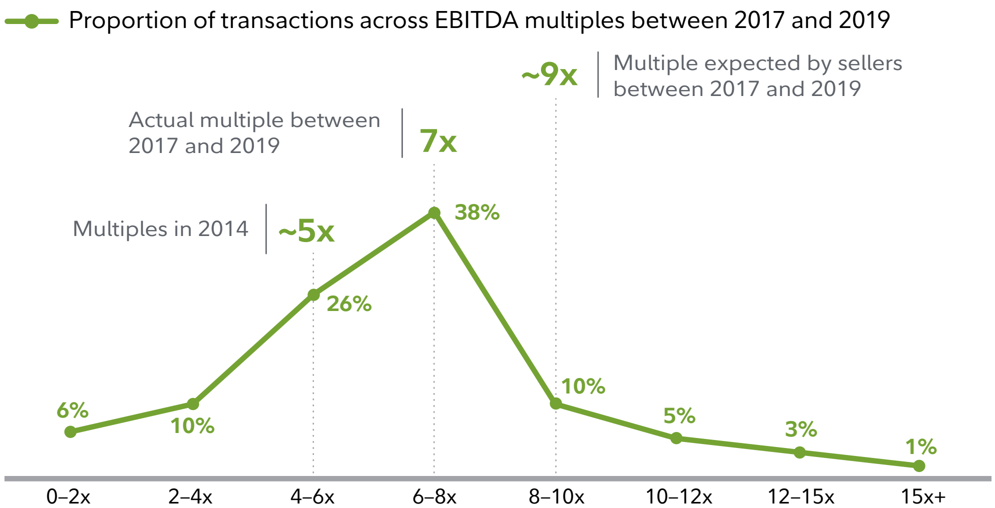
Understanding these different motivations can help sellers increase their appeal, and possibly their multiples, and allow buyers to get more of what they need to close deals.

EBITDA—Expectations Versus Reality

Our research shows that the median EBITDA multiples for deals between 2017 and 2019 has risen to 7 times (Exhibit 4), up from about 5 times in 2014.

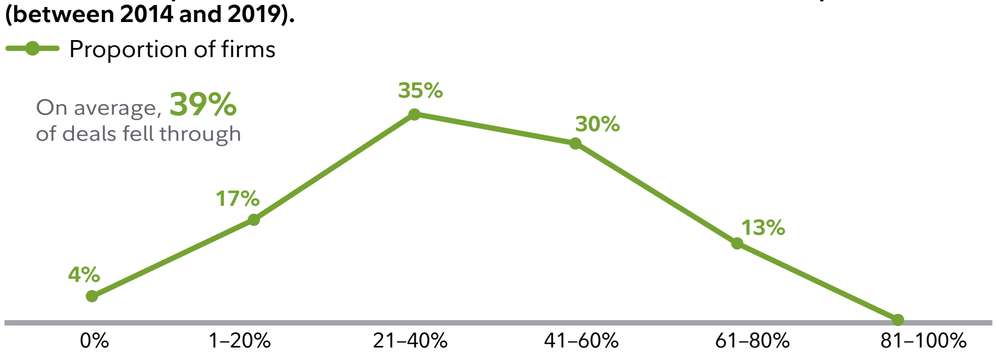
While that's good news for RIA firms that are deal-ready, our research also found that sellers may have inflated expectations of the multiples they can realistically receive. In fact, we found that sellers expect EBITDA multiples of around 8–10 times. Perhaps as a result, survey respondents report that two in five deals between 2014 and 2019 have fallen through due to unrealistic valuation expectations (Exhibit 5).

EXHIBIT 4: EBITDA multiples for M&A transactions.



Q—Since January 1, 2017, please list the number of those transactions that fall into each EBITDA multiple range [listed at the bottom of the Exhibit 4]. Q—What would you say was the median EBITDA multiple for transactions five years ago? Q—Of the firms that have approached you to sell their business, what is the median EBITDA multiple they were expecting?

EXHIBIT 5: Proportion of deals that failed due to unrealistic valuation expectations (between 2014 and 2019).



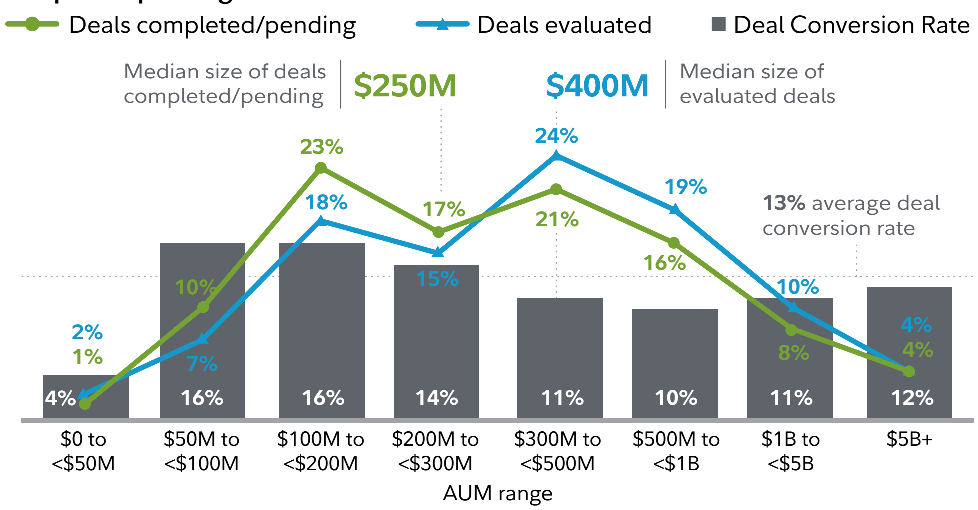
Q—Over the last five years, what percentage of deals failed to be completed due to unrealistic valuation expectations? (Include pending deals.)

Even beyond buyer expectation, there is a relatively low conversion rate across firms of all sizes. Despite the increased M&A activity, sellers' emphasis on high multiples often appears to slow and even derail many transactions.

While we continue to see valuations increasing, it's not necessarily for the reasons many sellers expect. It's possible that some sellers are too easily influenced by anecdotal media reports on uniquely high valuation, and don't entirely understand what drives valuation. For instance, of the 146 deals completed in the two-year period between 2017 and 2019, nearly two-thirds were valued between 4 and 8x EBITDA, with an overall median of 7x. Only 10% of transactions were above a 10x multiple and 5% above 12x. Contrast that with sellers' expectations (in the 9x range) and we see that seller expectations for valuations are far above what disciplined buyers are willing to pay.

The bottom line is that while aggressive acquirers appear to be paying up in some cases, and that is making the acquisition game more competitive, multiples overall are still reasonably close to where they were in 2014—and below what some sellers expect.

EXHIBIT 6: Proportion of deals by AUM range (between 2017 and 2019): completed/pending vs. evaluated.

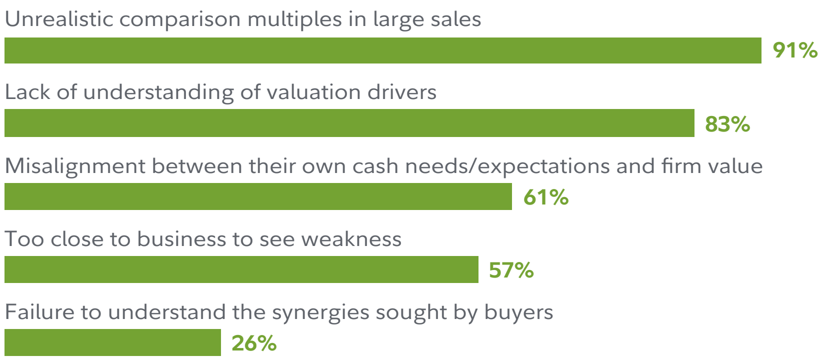


Q—Of the deals completed or pending since January 1, 2017, please indicate the number of completed or pending transactions within each of the AUM ranges [listed at the bottom of the Exhibit 6]. Q—Now please think about all the transactions you have evaluated (deals completed, competed for, passed on, etc.). Please indicate the number of evaluated transactions within each of the broader ranges [listed at the bottom of the Exhibit 6].

What's causing the discrepancy?

Ninety-one percent of firms told us that unrealistic comparison multiples caused sellers to have inflated expectations (Exhibit 7). For most firms considering a sale, it is the first time they have engaged in the process, and buyers report that sellers initially overvalue their businesses (as small business owners often do in most industries) and focus on exceptional, highly publicized transaction multiples, as well as on their own personal need to ensure a continuation of their current cash flow.

EXHIBIT 7: Factors driving sellers to overvalue their business.



Q—What factors, if any, drive sellers to overvalue their business? Please check all that apply.

Eighty-three percent of firms in the survey attributed a lower percentage of deals completed to a lack of understanding of valuation (Exhibit 7). For example, many sellers concentrate on a revenue multiple, but few transactions today are actually executed based on that metric. Instead, buyers are interested in profitability, not simply top-line revenue, and emphasize organic growth, client demographics, leadership talent, and the age of the advisor and client base in their valuations. In addition, 61% said the misalignment between the sellers' cash needs/expectations and actual firm value are causing sellers to overvalue their businesses (Exhibit 7).

All these reasons point to a possible shortfall in strategic perspective on the part of opportunistic sellers. As founders look for liquidity and succession opportunities, they also need to gain a clear understanding of what buyers find most attractive in firms they attempt to acquire.

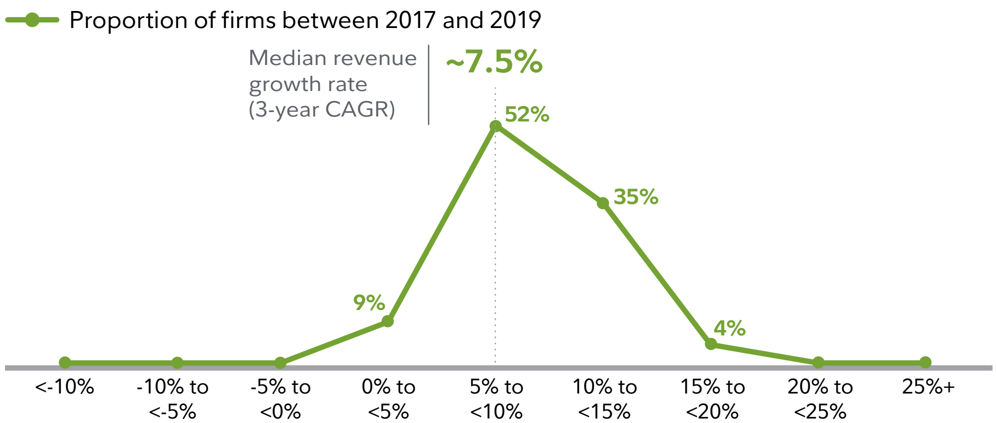
What Drives Multiples

A competitive marketplace and private equity funding are two major factors that were identified as drivers of high EBITDA multiples in recent years—but that's just the beginning.

Another leading factor is healthy growth. Interestingly, the median revenue growth rate for firms that were acquired between 2017 and 2019 is positive. Ninety-one percent of sellers experienced a median revenue growth rate of 5% or more in the 3-year period prior to the transaction. And according to comments from our serial acquirers, organic growth is an especially important piece of the acquisition puzzle. A significant number of survey respondents remarked that if a seller isn't growing organically, they're a less attractive target for M&A and the deal will result in a lower EBITDA multiple.

In addition, between 2017 and 2019, the median client asset growth rate was 8%, with deals ranging typically between 0 and <5% at the lower end, and between 10% and <15% at the upper end. The median revenue growth rate for deals between 2017 and 2019 was around 7.5% (Exhibit 8). Scale also plays a part in increased multiples, including repeatable/scalable client experience and more productive middle/back office operations. These are some of the elements that help sellers achieve premium multiples, in part because they reduce the risks for buyers.

EXHIBIT 8: Median revenue growth rate (three-year compounded) for transactions between 2017 and 2019.



Q—What was the median revenue growth rate (3-year CAGR) of deals completed since 2017?

According to our research, the median operating margin of firms/deals between 2017 and 2019 was 28%, with respondents saying the ranges for operating margins typically fell between 20 and <30% on the lower end, and between 30 and <40% in the upper end. Median operating margin is between 30 and <40% for firms doing more than the average number of deals in the same time period. So, firms that have done more deals seem to acquire firms with a higher median operating margin on average (although both types of firms' acquisition targets have experienced similar growth rates in terms of revenue and client assets). What does this mean? Experience matters. In addition, high operating margins drive value, contribute to higher EBITDA multiples, and make for an attractive target for buyers. Plus, larger firms can both spread operating costs around and add specialized functions necessary to improve performance, and that is a driver of buyer motivation as well.

The need for next-generation talent also drives higher multiples, according to serial acquirers in our study. Faced with an aging advisor population, acquirers may be willing to pay more for firms that have the talent and skills to carry them into the future. Many leading acquirers openly state that talent acquisition is at the center of their M&A strategy.

All of this suggests that firms that aren't necessarily preparing to sell today are well advised to take actions to improve operating performance, scale, and productivity as well as organic growth. They also need to be attentive to gaps in skills and talent within their firm. Being proactive may well position the firm to achieve a more attractive multiple when the time comes to sell. In short, sellers should look beyond their own wish list for the deal to factor buyer criteria into their firm planning and succession.

94%
Average client asset retention rates after M&A activity.

Motivations—Buyers Versus Sellers

The *2020 Fidelity RIA Benchmarking Study*[5] notes that 29% of RIA firms (who may or not have been a part of an M&A transaction in the past) stated that pursuing an M&A strategy was in their top five strategic initiatives for 2020. And, with an average post-deal client asset retention rate as high as 94%, why wouldn't firms want to engage in M&A activity? That said, our research found that often buyers and sellers are consummating deals for different reasons. While that alone may be self-evident, we would argue that conversion rates have a better chance of rising when buyers and sellers are aligned around the deal's objectives. In addition, sellers may be in a better position to improve their valuation when they understand what buyers really want and factor that into their succession planning.

What is each deal party really interested in?

Sellers: According to the serial acquirers in our study, sellers may be looking to either exit the business or reduce their involvement in day-to-day business operations in order to return to their roots: providing holistic financial planning and investment advice to clients. Interestingly, while firms doing a higher-than-average number of deals believe that the top driver for sellers is full/partial liquidity for owners, those acquirers doing a lower-than-average number of deals indicate that the lack of a feasible succession plan is the main driver for sellers.

And, when it comes to buyers, they are looking for something different altogether.

Buyers: Serial acquirers are coming to the table strategically. They are highly motivated to acquire top advisors and leadership talent in a competitive talent

EXHIBIT 9: Top 3 drivers of seller interest in M&A.

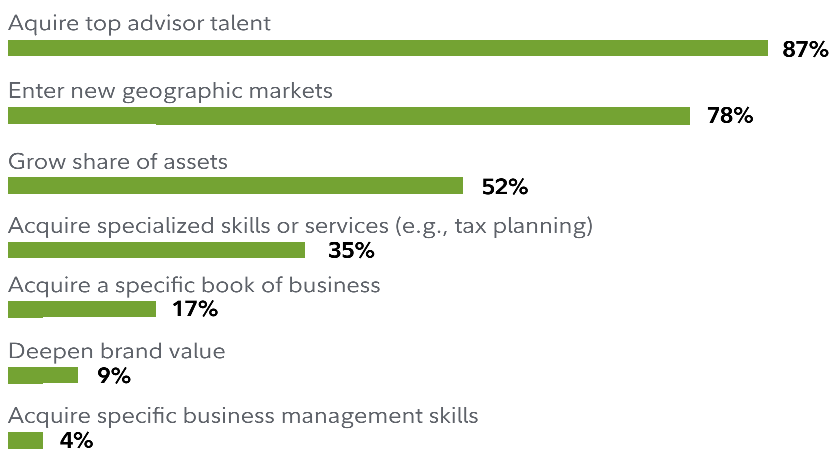
Q—Please rank up to top 3 most important drivers for seller interest in M&A.

environment. They are also seeking to expand their geographic footprint to establish a regional or national branded presence and grow their share of assets managed.

For half the participating firms, growing their share of assets is one of the top drivers for engaging in M&A. However, strategic buyers are not interested in a potential acquisition simply for its large book of business; additional factors must be accounted for to help make the transaction a success.

For both buyers and sellers, it's important to note not only their own motivations for pursuing a deal but also those of the other party. Sellers, for example, may be interested in liquidity and off-loading operating activity, but they need to demonstrate how they will help the acquiring firm to grow and improve client service. Often a third party, such as a banker or transition consultant, can help a firm articulate its value to a buyer more objectively and effectively than the firm can on its own. Likewise, buyers need to communicate how their organization will address the gaps that a seller, who is in the driver's seat in many cases, wants to close. How will they help firms improve operating scale, implement competitive service models, and address leadership succession challenges?

EXHIBIT 10: Top 3 drivers of buyer interest in M&A.

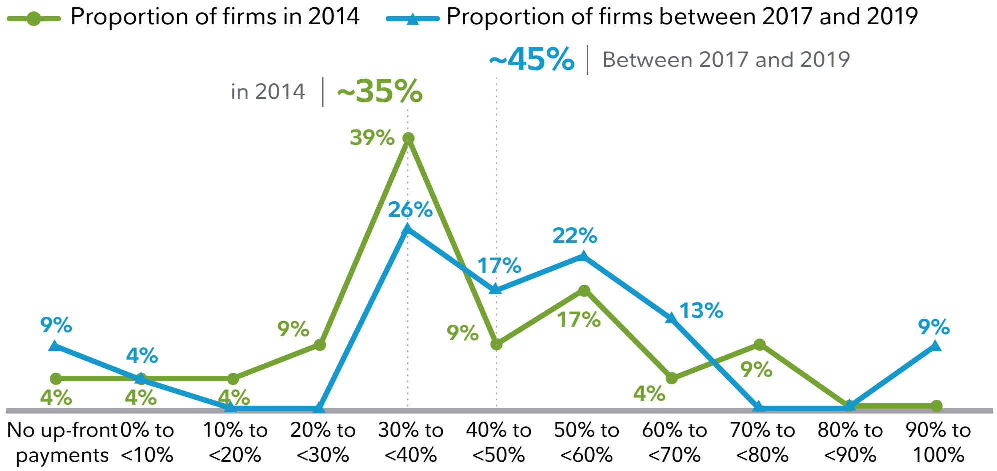


Q—Now please rank up to top 3 most important drivers for buyer interest in M&A.

What's the Deal with Deal Structure?

Deal structure remained relatively consistent between 2014 and 2019, with some notable change to levels of up-front cash and the length of earn-out periods. While average deferred payout has remained steady at ~3 years, and cash to equity ratio has remained more or less constant at about 3X, the median up-front payment between 2017 and 2019 was about 45%, up from around 35% in 2014. That's a consequential increase. And, looking deeper, 43% of firms mention that for the majority of the deals conducted between 2017 and 2019, up-front payment (cash and/or equity) was over 50%, (by comparison, in 2014, just 30% of firms reported deals with up-front payments over 50%), with 9% of firms paying over 90% percent up front (cash or equity) for the majority of their deals at close compared to 0 in 2014 (Exhibit 11). So what is causing the increase in up-front payments?

EXHIBIT 11: Median up-front payment.



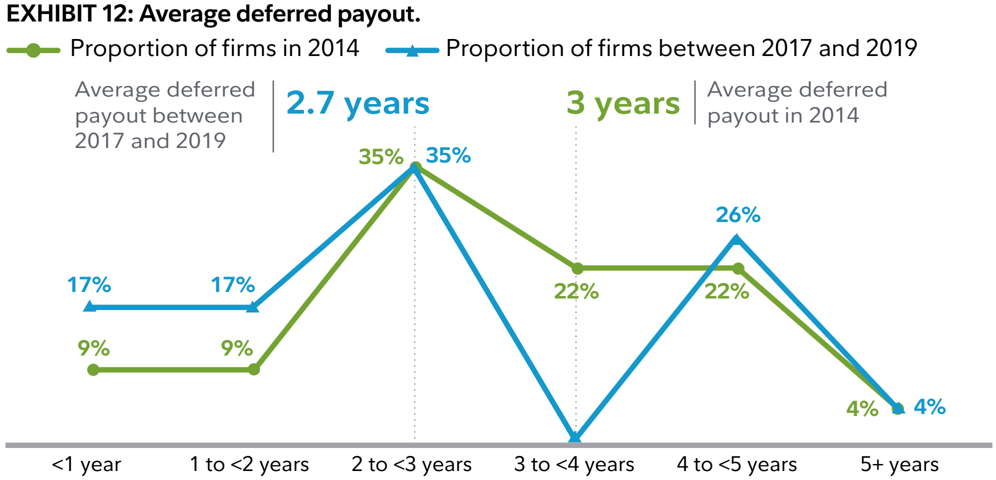
Q—What is the median percentage of the purchase price given as an up-front payment to the owner (cash and/or equity)? (Regarding deals completed between 1/1/17 and the present). Q—For deals completed five years ago, what was the median percentage of the purchase price given as an up-front payment to the owner (cash and/or equity)?

Many buyers indicate a desire to maintain valuation discipline and a preference to place more risk in the deal structure (percentage paid at close and length of earnout) as opposed to multiples.

Conversely, respondents also report that equity continues to become a more attractive currency for younger advisors who want to be part of something bigger than themselves. Part of that, of course, is their recognition that over time equity can exceed a taxable cash payment.

With the movement toward a higher proportion of cash up front, there's also a trend toward shorter earnouts, although the average for deferred payouts doesn't show much movement (Exhibit 12).

EXHIBIT 12: Average deferred payout.



Q—As part of a deal structure, how long is the average deferred payout (in years, and regarding deals completed between 1/1/17 and the present)? Q—As part of deal structures five years ago, how long was the average deferred payout?

When we focus on the trajectory of deferred payouts, however, we see the percentage of firms with average payouts of three years or longer has dropped from 48% in 2014 to 30% between 2017 and 2019. For firms considering a sale today, that means they can reduce their risk and achieve liquidity far more quickly than just a few years ago.

Finally, much has been made of the aging of RIA owners and the lack of succession planning—and this research underscores the importance of that trend. According to 48% of the participating firms, the average age of sellers was between 60 and 69, with 39% of firms reporting it was between 50 and 59 years. Importantly, buyers motivated by a search for leadership and advisor talent would prefer to purchase firms with leadership that intends to continue with the acquirer rather than transition out after a short period. Given that a typical deal in our study takes an average of nine months to complete, and the range is between 3 and 18 months, sellers should consider their timing and desired future role as they develop their transition and eventual exit strategy.

Conclusion

Several forces are impelling an accelerated pace of M&A in the independent wealth management space: the drive for scale to improve operating productivity, leverage operating and technology platforms, and enhance functional client service capabilities; the aging of advisor founders and the lack of succession plans; and the significant amount of capital in a low interest rate environment, enabling emerging serial acquisition models to execute transactions. Our research with active, repeat acquirers reveals that valuations are increasing, and deal structure is evolving in terms of up-front cash payout and shorter earnout periods, reflecting an attractive market for potential sellers.

There are clear lessons from these experienced buyers: they are well prepared with teams, capital, and clear acquisition strategies, and they know what they want. The range of valuations also suggest that buyers are becoming more selective in the firms they target and what they are willing to pay.

For firms evaluating a sale, it is important for them to identify their strategic value to potential buyers and explore a range of options before entering into a transaction. They need to define what they most want in a buyer and determine what their role as a firm, and as firm leaders, will be in a post-sale environment. Some additional considerations for firms to help them navigate the M&A process:

- Educate yourself on the options and on what drives valuation and deal structure terms. For many firms, getting a valuation prior to pursuing a sale may be a worthwhile consideration, and identify opportunities to improve value to a potential buyer.
- Engage with outside M&A advisors. They can help firms avoid typical pitfalls in negotiating transactions, accelerate the process, and save time. They also may enhance potential valuations by increasing seller visibility, improving a firm's story, and targeting the most appropriate buyers for a firm.
- Determine what you seek in a buyer and why you are selling, beyond liquidity. What role would you like to play post-deal? What about your key employees and advisors? Are you trying to close specific gaps in your service or operating capabilities, and what are they?

M&A continues to reshape wealth management as firms strive to stand out in their ability to provide clients with the advice and services they need. A wide range of attractive options exists to enable independent firms to chart their future as they consider selling and joining organizations that can help them improve service and execution for their clients, employees, and partners.

Endnotes

[1] Fidelity Quarterly M&A Review–Fourth Quarter 2020. Fidelity compiled the data for this report from public information. Data for this report covers the period from January 2016 to December 2020.

[2] U.S. Broker Dealer Marketplace Report—Cerulli Report 2020

[3] The *2019 M&A Deal Valuation and Structure Study* is based on data from firms consisting of M&A Leadership Forum members and other clients identified as doing M&A who participated in an online survey constructed by Fidelity Investments. The study was fielded from May 29 through August 6, 2019. Twenty-three clients completed the survey. No weighting has been applied to the results of the study. Hence, all base sizes and proportions are unweighted. Due to the low bases, comparisons among subgroups are NOT tested for statistical significance.

[4] For the purposes of the 2019 M&A Deal Valuation and Structure Study, completed deals also include deals that have been announced and are yet to be completed.

[5] The *2020 Fidelity RIA Benchmarking Study* was conducted between March 10 and May 20, 2020; 188 firms participated. This information is derived from information provided by study participants. Accordingly, Fidelity cannot guarantee that such information is accurate, complete, or timely. Fidelity RIA benchmarking studies are conducted in collaboration with independent third-party research firms unaffiliated with Fidelity Investments. The experiences of the RIAs who participated in the studies may not be representative of the experiences of other RIAs and are not an indication of future success.

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