Brave New World of Wealth Management:

Opportunities, More Competition, Demographics and Growth Conundrums

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Introduction

This report is designed to provide owners of wealth management businesses with a “30,000 foot view” of the current state of the industry and, given the forces confronting the industry today, how we expect the structure and the economics of the business to evolve over the next decade. It is the third of three such examinations of the industry. Several of the co-authors of this white paper helped prepare the first study in 1999 while at Undiscovered Managers, LLC, and in 2005 assisted JPMorgan with an update.

The industry has undergone a fascinating metamorphosis since we completed the original study. It is no longer a cottage industry of small start-up enterprises. Today more than one hundred firms manage more than $1 billion of client assets and some manage in excess of $10 billion. The basic business model – fee-only billing coupled with completely independent and non-conflicted advice – which once was “cutting edge” within the broader market for investment advice, has now been widely adopted. In an effort to remain competitive, even traditional large competitors like broker-dealers and insurance companies have reengineered their offerings to create the appearance of providing a similar service. Furthermore, not only is the industry maturing, but so are its owners. Many of the young and energetic wealth management business founders who we first met back in the 1990s are now nearing retirement.

By way of background, our business is investing in wealth management firms. We buy non-voting, minority stakes in wealth managers so they can fund an internal transition of ownership to successor generations, acquire another firm or buy out an outside shareholder. We have made 12 such investments to date.

Drafting a study like this is an immense undertaking requiring hundreds of hours of work by many people in our firm. But it is, at most, only tangentially related to our business. Given the resources required, an obvious question is: why would we undertake such an effort, especially for the third time?

For two reasons.

First, we have been gratified to learn that our earlier reports were widely read and discussed throughout the industry. And although more than a few industry participants disagree (some even vehemently) with our conclusions, numerous owners have told us that they have found these reports to be useful tools in their business planning. Consequently, our studies have given us a way to build relationships with people at hundreds of advisory firms. Because of these relationships, if and when a firm concludes that it needs outside capital, we often are one of the providers that are considered.

Second and from a more personal level, our work on these studies has also led to many friendships with individuals throughout the industry. It is hard to describe how much fun it has been getting to personally know many of the great people who built this industry.
As with all of our earlier reports, it would not have happened without the help of many people outside of our organization. Although it is impossible to mention them all, we would be remiss if we did not acknowledge the following people for their assistance:

The leaders of each of the firms in which we have invested were very generous with their time and ideas. In particular, David Bugen and Jennifer Papadopolo of RegentAtlantic Capital; Harold Evensky, Matt McGrath and Lane Jones of Evensky & Katz; Jane Williams and Brian Dombkowski of Sand Hill Global Advisors; Chris Dardaman, Ray Padron and Dave Polstra of Brightworth; Dan Silver, Dan Wiener, Jim Lowell and Chris Keith at Adviser Investments; Roger and Brenda Gibson of Gibson Capital; Steve Janachowski and Kurt Brouwer of Brouwer & Janachowski; John Ueleke, Jim Isaacs and Duncan Miller of Legacy Wealth Management; Hal Anderson, Lon Henderson, Tyler Wilkinson and Kim Anderson of Soltis Investment Advisors; and Bob Keats and Dale Walters of Keats Connelly and Associates were all extremely helpful. They have built great firms and we feel very fortunate to be their partners.

Jeff Thomasson, founder of Oxford Financial Group, has built the most successful independent wealth management firm in the United States. He was very kind by spending a great deal of time helping us to understand in intricate detail the different steps wealth management firms can take to sustain very high rates of growth for decades.

Mark Tibergien of Pershing Advisor Solutions has long been one of the industry’s thought leaders and over the last two decades has helped hundreds of wealth managers to operate much better businesses. David Canter built the Practice and Management Consulting Group at Fidelity and works closely with numerous wealth managers on improving their firms and addressing succession issues. And to the great benefit of its advisor clients, Nick Georgis returned to Schwab a few years ago after a six year hiatus and now is in charge of its Advisor Services Practice Management and Strategic Business Development Group. All were very generous with their time, ideas and help.

Allan Starkie of Knightsbridge Advisors has built the leading executive recruitment firm for wealth management businesses. Steve Prostano is a longtime industry veteran who has managed wealth management firms for the past two decades. Each shared with us their insights into the unique challenges of recruiting and managing professional staff in this industry.

A substantial portion of this study concerns mergers and acquisitions. Steve Levitt has spent nearly two decades advising on such transactions and similar to most wealth managers is a successful entrepreneur. His firm, Park Sutton Advisors, is one of the leading investment banks for wealth managers. He was extraordinarily helpful to us in understanding the perspectives of owners and the traits of those who are most successful in selling their firms. We also received many ideas and insights from Scott Ketner of Berkshire Capital and John Temple of Cambridge International Partners. All have extensive experience advising both buyers and sellers of wealth management firms.
All of the aforementioned people contributed greatly to this study. However, any of its shortcomings are solely ours.

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Executive Summary

The vast majority of those people who were brave enough to start a wealth management business two decades ago have been incredibly successful. In the beginning, however, that success seemed far from certain. Few of the entrepreneurs who founded a firm during the 1980s or early 1990s would have imagined that they would someday manage $100 million of client assets, let alone the $1 billion or more that many firms manage today. Even fewer would have predicted that so many owners would now be multi-millionaires.

Notwithstanding their success, many owners of wealth managers are anxious about the future. Most sense that the operating environment is becoming more challenging. Every year, there are fewer and fewer prospective clients who do not already have a financial advisor. Client bases are aging, resulting in net capital consumption rather than capital accumulation. Operating costs continue to increase at a high rate and experienced and capable successor professionals are hard to find.

For the last two decades it seemed as though almost any approach to this business could succeed. However, now it is unclear whether the business strategies that carried the industry to its present prosperity are the right ones to rely on going forward.

A. Three business models have emerged within the industry

A starting point for sorting through these issues is to consider what the industry looks like today. The industry is far from homogenous and is extremely fragmented with more than 19,000 firms. However, industry participants can be largely grouped into one of three general business models:

Evolving Businesses – approximately 200 firms that have taken the messy and difficult steps necessary to evolve into businesses that both are sustainable in the long-run (i.e., after the departure of the founder(s)) and have meaningful enterprise value;

Books of Business – almost 18,000 wealth managers with relatively low annual revenue, few (if any) capable successor professionals and no obvious strategic plan, firms that in many ways are better described as “jobs” rather than “businesses”; and

Tweeners – 1,000 to 1,200 firms that have substantially greater scale and profitability than Books of Business, but, unlike Evolving Businesses, have been unable and/or unwilling to take the necessary steps to evolve beyond a founder-centric model that resembles a very large sole-proprietorship.

B. Five forces will drive the next phase of the industry’s evolution

The industry is at the front end of the next phase of its evolution. We have identified five forces that will combine to create an operating environment that is vastly more challenging and competitive than the one that firms grew accustomed to during prior decades.
To be sure, wealth management will remain a fabulous industry in which to work. The demand for independent financial advice is immense and will continue to grow over time. Few (if any) firms will go out of business.

However, we also believe that the easy money from this industry has already been made. And only those organizations that adapt their strategy and business model to the realities of the next decade will prosper. The owners of those firms that cannot adapt will have to work harder for less money, and their businesses will ultimately have little enterprise value.

1. Fewer new millionaire households with more firms competing for them

The supply of millionaire households (the core prospective clients of wealth managers) declined sharply with the 2008-2009 financial correction and, to date, has not recovered to pre-correction levels. Of course, at some point it is likely that economic growth will accelerate and more new wealth will be created. Unfortunately, even when the supply of prospects expands, firms will find heightened competition for new clients.

There are now in most geographic markets many more large firms with sophisticated marketing and business development functions than even only a decade ago. While business development efforts in the wealth management industry once could be described as a “land-grab,” today’s environment is vastly more competitive.

2. Aging client bases with higher capital consumption

The average age of clients serviced by many wealth managers is now much older than only a decade ago. Because most new clients are in their 50s or early 60s when they hire a wealth manager, those who were recruited over the last decade are likely to now be in their mid to late 60s and those from the previous decade are in their 70s.

An aging client base creates a drag on wealth manager revenues in two distinct ways. First, whether due to retirement, charitable giving or other age-related reasons, older clients often increase their gross rate of capital consumption. Second, because older clients have a reduced appetite for investment risk, a larger portion of their portfolios are allocated to lower risk assets that generate lower nominal rates of return. The combination of higher average gross capital consumption and lower investment returns results in greater net capital consumption by clients, reducing the wealth managers’ assets under management and the corresponding fees paid by the clients.

3. Potentially prolonged period of low return on lower risk assets

The Federal Reserve recently announced that it will continue quantitative easing until unemployment is below 6.5% or inflation exceeds 2.5%. Until then, the Fed intends to keep the yields on fixed income securities at or near their current record lows.

This new policy is very problematic for any business – such as most wealth managers – that receives fees based on a percentage of assets under management. Nearly all wealth management clients allocate a substantial portion of their portfolios to lower risk asset classes as part of a rational diversification strategy. Because the nominal returns generated by these types
of investments – shorter term fixed income securities, hedged investments, etc. – typically track to U.S. Treasury securities with a modest premium, wealth managers should expect returns well lower than historical averages. The impact to wealth manager revenues is direct: slower appreciation in a material segment of clients’ portfolios will result in slower revenue growth.

Not surprisingly, a prolonged period of very low nominal returns on low risk assets would compound the issues raised by aging clients (who, over time, invest larger and larger portions of their portfolios in fixed income and lower risk assets). Their net rates of capital consumption will be significantly higher, creating further pressure on wealth manager revenues.

4. Operating costs accelerating at a rate higher than inflation in general

While the three factors described above will negatively impact the rates at which wealth manager revenues grow, wealth managers also will face an expense issue over the next decade: operating costs – and compensation costs in particular – will continue to rise at a faster rate than general inflation.

Nearly every wealth manager that FN has studied is currently experiencing average annual cost inflation of at least 5% to 7%, largely driven by higher labor costs for qualified professional employees. A shortage of even semi-qualified professional staff is reflected in their salaries: typical wealth manager non-owner compensation costs are rising about 7% to 10% annually. Other costs will rise as well. An increasingly adversarial regulatory environment will raise compliance costs, newly litigious clients and former employees will result in the incurrence of legal fees well in excess of historical experience and heightened levels of competition for new clients will require increased marketing and business development budgets.

5. Aging founders

Overshadowing the four previous forces is the irreversible fact that most of the founders of wealth management firms are approaching that point in their lives when they need to consider doing their own financial planning. More than a few of these founders have built up lavish lifestyles, the maintenance of which requires significant annual expenditures. But for most, their single most valuable financial asset is the equity in their businesses. Consequently, the value they ultimately receive for that equity will be a key determinant in their ability to sustain their current lifestyle in retirement.

C. Impact of the forces on individual firms will vary based on current business model

The first four forces described above will affect the economics of every wealth manager. However, the impact on any particular firm will vary based on the organization’s current business model.

The Evolving Businesses, with younger client bases, institutionalized brands and marketing efforts, diversified ownership and mature governance structures, are in the best position to adapt to, and capitalize upon, the forces. Their primary challenge is finding a way to maintain their historically high rates of profitability growth.
To be sure, we have little doubt that most Evolving Businesses will be able to consistently grow their profits at least 5% per year into the foreseeable future. However, meeting the robust ambitions of many founders and creating attractive long-term career opportunities for talented successor professionals will require much higher rates of earnings growth. Unfortunately, growth is going to be far more challenging over the next decade than in the past.

As relatively large organizations, Evolving Businesses must add increasingly larger volumes of new clients each year in order to maintain revenue growth rates at a time when the supply of prospects has stagnated. Moreover, even if their business development efforts are successful, servicing ever larger volumes of new clients requires substantially increasing their cost structures. The resources required to onboard a new client are 15x to 20x greater than the resources required to service an established client — a feature of the wealth management model that effectively caps the number of new clients any firm can add at any one time. Thus, every large industry participant faces a “growth conundrum.”

Evolving Business firms have four strategies available to them to overcome these obstacles to increasing their profitability: (i) slow the rate of cost inflation by improving operating efficiency, a goal that requires constant review and improvement of internal processes; (ii) redesign compensation systems to increase the amount of variable and equity components and more closely tie salaries to the performance of the firm, effectively realigning risk between owners and employees; (iii) offer more specialized, higher value-added advice targeted to specific sub-segments of individuals who will pay a premium for customized services; and (iv) acquire other wealth managers.

The obvious management challenge for the owners of Evolving Business wealth managers is to determine which of these four alternatives make the most sense for their firms and the optimal time to pursue them. We expect that most will pursue a combination of all four at different points in time over the next five years. The first three offer opportunities to marginally improve profitability; the fourth, acquisitions, presents the unique opportunity to condense several years of future growth into a single transaction. However, for reasons discussed below, we expect fewer than half to successfully complete an acquisition.

In contrast, firms in the Tweener category will be the most changed by the forces confronting the industry. While the forces threaten the future operating margins of all firms, the potential strategies available to Evolving Business firms are largely impractical for most Tweener firms. The latter already operate at robust margins so they have far less room to improve their efficiency and cut costs. Their owners have kept for themselves the lion’s share of their firm’s economics for so long that shifting greater compensation risk to their employees creates a risk of fomenting a revolt. They also lack the depth and breadth of professional staff and infrastructure essential to specializing and/or integrating an acquisition.

Instead, the owners of Tweeners will find that the strategy of the past two decades of maximizing near-term profitability at the expense of reinvestment —

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1 There are a relatively small number (30 to 50) of Tweener firms which have recruited exceptional successor professionals and are beginning the process to become Evolving Businesses. If they are successful in evolving their businesses, the four strategies for Evolving Businesses described above will be available to them.
which for many of their owners has been extraordinarily successful in building personal wealth – soon will be unsustainable. Their only practical alternatives will be to: (i) take the messy and expensive steps necessary to convert into an Evolving Business; (ii) sell the firm; or (iii) slowly devolve into a Book of Business.

Unfortunately, the last group of wealth managers – the 18,000 or so Books of Business – have few options available to them. They will be largely at the mercy of the broader forces sweeping through the industry. Their owners will work much harder and get paid much less.

**D. Future shape of the industry**

Given these forces and their likely impact on the economics of individual firms, some might expect that we would forecast a wave of consolidation within the industry. However, we think that is an unlikely outcome and instead believe that the industry will become much more “concentrated” than “consolidated.”

The vast preponderance of the 18,000 participants that today fall in the Books of Business category will remain in business. However, owning a Book of Business will be far less pleasant than in prior decades. As noted earlier, owners will make less and they will receive very little consideration when they sell their firms.

At the other end of the continuum, a relatively small number of Evolving Business firms will capitalize on (as opposed to endure) the forces confronting the industry. Those that are able to successfully acquire other, material wealth managers, over the next five to ten years, will become very large enterprises.

In reality, this shift is already happening as several firms in the Evolving Business category today generate more than $50 million of annual revenue and dozens more generate in excess of $20 million. With a combination of acquisitions and organic client growth, some of these firms will wind up having as much $75 million to $150 million of annual revenue ten years from now.

Still other firms in the Evolving Business category will likewise become significantly larger enterprises with at least $20 million of annual revenue. Some may merge with other, similar firms. They will also become much more specialized businesses.

The Tweener category will largely no longer exist a decade from now. Perhaps counter-intuitively, we believe only a small percentage of these firms will be acquired. Only about 50 to 70 (out of nearly 1,000 to 1,200) Tweeners will be acquired or merged with other wealth managers, 10 to 20 will be acquired by banks\(^2\) and perhaps another 30 to 40 will be purchased by roll-ups. In other words, only about 8% to 10% of the Tweener firms in total will wind up consummating some sort of transaction.

Instead most Tweeners will slowly devolve into Books of Business. Their assets under management will shrink while their costs continue to rise. Their profitability will begin a long slow decline that, at some point in the next four to

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\(^2\) We believe that over the next decade a small number of Evolving Businesses (in particular, very large ones) may be acquired by banks in addition to 10 to 20 Tweener firms. However, because Evolving Businesses are growing, profitable businesses with broad ownership, the price that prospective bank acquirers will have to pay to persuade their owners to sell will have to be quite robust and far greater than for any Tweener firm.
seven years, will accelerate suddenly. Although they will continue in business in some form, most of the enterprise value that they might possess today will disappear.

Several factors lead us to this conclusion. First, most of the owners of Tweeners are “anchored” to the operating environment of the last twenty years. Thus, while they will be able to see that the industry is changing, it will be very hard for them to fully appreciate how much and how fast their firms’ economics will change. This lack of realism will lead many owners to have unrealistic valuation expectations. It also will cause them to wait too long to sell their firms – so long that they will no longer be attractive and/or material to potential acquirers.

Second, for one potential group of buyers – banks – most Tweener wealth managers are too small to justify the time and brain damage involved. At the same time, roll-up firms (which are far less discriminating buyers) will have very limited success in convincing potential selling owners to accept stock as consideration. Thus, they will have to fund their acquisitions mostly with cash, greatly constraining the aggregate number of deals they will be able to consummate.

Third, few owners of Tweener firms and those of Evolving Businesses (the best potential buyers) have any experience in mergers and acquisitions. And when two extremely inexperienced parties try to merge together, it is somewhat analogous to virgin porcupines trying to mate – there are more than a few obstacles and risks that could prevent a successful outcome. All acquisitions are complicated; unfortunately wealth management M&A transactions are some of the most complicated. These businesses lack any tangible assets and a transaction is largely just the sale of goodwill by an imperfect company. The lack of experience by both the selling and buying owners in such complicated transactions (transactions that invariably require a very lengthy and emotional deal process) greatly diminishes the chances of success.

Lastly, all wealth management M&A transactions are “three handed”. That is, they require striking an agreement between three parties – buyers, sellers and the sellers’ successor professionals. Each has unique (and often conflicting) interests, biases and egos, all of which create enormous obstacles to deal completion.

Notwithstanding all of these challenges, we believe that at least 100 Tweener firms will be acquired and 50 to 70 of these will be by Evolving Business wealth managers. We have identified ten traits that we believe will be common to the most successful sellers and ten others that will be shared by the most successful buyers.

**E. Traits of the most successful sellers**

1. **Decide to sell when they are still attractive and material to potential acquirers**

The economic attractiveness (generally, the quality and consistency of its cash flow and client base) of any wealth manager (but, in particular, a Tweener firm) as an acquisition candidate can diminish over time, particularly if (or when) the average age of the seller’s clients increases. Additionally, size matters. For any given seller, there is a limited universe of potentially interested buyers.
Should prospective buyers become much larger firms, wealth managers that today might be attractive acquisitions quickly become immaterial (and, thus, uninteresting) opportunities.

Consequently, smart sellers carefully analyze their firms’ future economics and client demographics as well as the landscape of potential acquirers in their geographic area, allowing them to make much more informed decisions as to whether and when to sell. And if they chose to come to market, they do so while they are still attractive and material to their universe of prospective buyers.

2. Do not go to market until they are mentally prepared to sell their businesses

At the same time, sophisticated sellers do not come to market until they are mentally prepared to actually let go of their firms. They understand that an owner must be over a sort of “mental Rubicon” or it will be emotionally impossible for them to consummate a transaction. Moreover, should they come to market but find themselves with cold feet at the last moment, they will have substantially damaged the potential value they may achieve from any future sale. Not surprisingly, buyers are unwilling to incur the significant costs (in both time and out-of-pocket expense) in a sale process with a seller who has a history of walking away just prior to closing.

3. Are realistic about the economics they will achieve if they retain their firms

The most successful sellers also have a realistic, detailed understanding of their firms’ future economics on a standalone basis. Acquirers have little difficulty determining the actual trajectory of a potential seller and will price a transaction accordingly. However, sellers who are unrealistic as to their businesses’ future profitability are at risk of having potentially delusional expectations as to price, precluding a sale from being consummated.

4. Are prepared for a difficult, very emotional and time-consuming process

All sale processes are long and emotionally draining – selling your business is hard. The owners of the most successful sellers accept that there is little they can do to change this and prepare accordingly. They discipline themselves to not overreact to the ebb and flow of the negotiation. They likewise appreciate that they might not fully understand the true intent of certain bargaining positions taken by the buyer and avoid the temptation to feel personally slighted or insulted, recognizing that no rational buyer would ever want such an outcome. Moreover, they remain focused on the big picture (namely, the aggregate outcomes from the transaction) and do not let the minutia that is endemic to any deal influence their decision making.

5. Understand the buyer’s perspective and make it easier for them to bid

Smart sellers recognize that for every seller there are likely only one or two potential economically and culturally attractive buyers (although there may be many other buyers that either are unattractive or lack the financial ability to consummate a transaction) and, thus, do not want to discourage any firm from bidding. They also are empathetic to difficult challenges facing prospective buyers, in particular those that have never previously closed an acquisition. Thus, they work closely with buyers’ management, helping those who are
advocates for a transaction to build an internal consensus to participate in the bidding process.

6. Recognize that buyers invariably underpay for rapid assumption of risk and overpay for certainty

Wealth manager acquirers almost always underpay in those transactions in which they must rapidly assume large amounts of risk and often are willing to overpay for greater certainty. The most successful sellers recognize this calculus. Thus, they work closely with the bidders to help them better measure and understand the risks of client retention and prepare integration plans to ensure a seamless post-closing transition.

7. Recognize that transparency benefits the seller and helps buyers understand the “facts”

In a similar vein, buyer uncertainty as to the quality of a firm’s client base, personnel and systems is very costly to a seller because prospective acquirers, in the absence of good information, must assume the worst and adjust their bids accordingly. Consequently, the most successful sellers are as transparent as possible, providing any and all information requested by potential bidders. They also educate potential buyers as to the true condition of the business and avoid offering unrealistic projections of its future financial performance as a standalone enterprise.

8. Recognize that pricing is based solely on contribution and not EBITDA, AUM or revenues

Smart sellers recognize that post-closing contribution to the buyer’s earnings is the only factor in the buyer’s pricing model; metrics such as the seller’s standalone EBITDA, AUM or revenue are irrelevant. Moreover, each buyer will independently prepare its own estimate of contribution, making efforts by potential sellers to influence this calculation a waste of time and potentially counterproductive. Further, sophisticated sellers avoid the temptation of using their own analysis of potential contribution as the basis for their own expectations as to what buyers will pay for their firms.

9. Accept that they are selling their firm to, and not merging with, the buyer

Buyers view acquisitions solely as economic transactions and post-closing will take the necessary steps to maximize their financial outcomes. Thus, the operations of the selling firm will be very different post-closing. So too will be the role of the seller’s previous owner(s). This aspect of acquisitions can be incredibly emotionally difficult for many selling owners. Consequently, smart sellers take steps to prepare for this inevitability prior to ever bringing their firms to market. Many even retain an executive coach or a counselor to help them plan the next phase of their lives.

10. Make wise choices in selecting and managing their transaction advisors

Smart sellers recognize that they will require a great deal of sophisticated legal advice and, in some cases, advice from an investment banker. Legal advice for wealth manager transactions is highly specialized; M&A experience in other industries, including investment management, does not translate well. Moreover, there are only a handful of attorneys who understand the
wealth management business and have completed multiple transactions. They charge a great deal for their intellectual capital and smart sellers are willing to pay for it.

Many sophisticated sellers do not need investment bankers to help them to identify potential buyers or analyze bids. Rather such services are most useful when a firm has a diverse shareholder base and thus, needs help in building an internal consensus to do a particular transaction. Additionally, in certain instances a banker can be very helpful by effectively serving as the selling owner’s “psychiatrist” during the lengthy and emotional transaction process. Regardless, no rational seller ever pays investment banking fees on consideration paid as stock until such time as the stock is liquid and free to trade.

F. Traits of the most successful acquirers

1. Understand that all commercial activity with wealth managers is predated by relationships

Wealth managers generally are reluctant to transact with any entity (money managers, custodians, etc.) with which they do not have a preexisting relationship. Given that the most significant transaction any owner will ever enter into is the sale of his or her firm, sophisticated buyers invest a large amount of time building relationships with owners and professional staff of prospective sellers in their geographic area long before these firms are ever brought to market. They make efforts to learn about, and genuinely understand, the potential seller’s values and capabilities. Doing so helps the target firm become comfortable with the buyer’s organization.

2. Understand that all potential acquisitions are very low probability events

Sophisticated acquirers also recognize that the likelihood of completing any acquisition, regardless of its size, is extremely low, as many factors (e.g., timing, pricing, personalities, etc.) must line up all at once for any deal to be consummated. Thus, they do not waste their time on acquisitions that will not immediately and materially improve their organization’s profitability. They also minimize how much time and emotional energy they invest in a prospective transaction until they are confident that it offers reasonably attractive economics and that they are dealing with a rational seller who is emotionally prepared to sell his or her business. And under no circumstances will they disrupt their own organizations until they are convinced such conditions exist.

3. Appreciate that the longer it takes to for a deal to get done, the less likely it is to close

At the same time, sophisticated acquirers understand that the longer it takes to consummate a transaction, the less likely it is to close. Time is the enemy of successful transactions: sellers may get cold feet, successor professionals may attempt to sabotage the transaction, financing may fall away and all parties suffering “deal fatigue” may begin to act irrationally. Thus, when buyers have an opportunity to make a material acquisition, they do whatever they can to sustain the momentum of the transaction even if requires working nights and weekends and effectively having a second full time job.
4. Pragmatic in evaluating potential sellers and how an acquisition will change their own organizations

Sophisticated buyers are pragmatists. They accept that every acquisition comes with its own set of idiosyncratic problems and challenges and avoid the temptation to quickly disqualify potential opportunities simply because they are less than perfect. Further, they recognize that no successful deal has ever been closed without compromises on both sides. Even the acquirer will be a different organization after closing. However, smart buyers are willing to accept all of these tradeoffs provided the benefits outweigh the associated costs and brain damage.

5. Accept that they are going to have to pay sellers a large amount of consideration, including at closing

Another shared trait of smart buyers is that they accept that they will have to make a significant cash payment (including a significant closing payment) for any material, attractive acquisition. Some buyers believe that sellers should accept a well-below-market price for the honor and privilege of joining their firms. Smarter buyers keep their focus on their own economics and not how much a seller might be paid. They also understand that risk allocation matters far more than price.

6. Recognize that their capital raising options are limited and will include unattractive aspects

A consequence of having to pay a full price for a material acquisition is that most wealth managers will have to raise permanent capital. Sophisticated buyers, recognizing that even the industry’s largest firms are at best small businesses, accept that they have limited capital raising options. All capital is expensive and comes with defined cash flow rights as well as some say in the future governance of the acquirer. Further, few (if any) providers are willing to endure the headaches of transactions involving multiple investors.

7. Recognize that success in transactions is ultimately based more on psychology than finance

Sophisticated acquirers understand that offering to pay a lot of money is only a necessary but grossly insufficient condition to completing an acquisition. During the transaction process many sellers are more emotional than a pubescent teenager, making psychology a far greater determinant of success than finance. Thus, smart buyers go out of their way to make the selling owners as comfortable with their organizations as possible and are extremely patient and careful to not say anything that can be taken out of context.

8. Understand and appreciate that the seller’s successor professionals are important and scared

As noted earlier, every wealth manager M&A transaction is effectively a “three-handed” deal because the seller’s successor professionals are essential to the ultimate success of the transaction. Consequently, sophisticated acquirers allocate a substantial portion of the transaction’s aggregate economics to the successors and, in some cases, offer them the opportunity to become shareholders of the new combined entity. Equally important, they design customized recruitment and retention packages to meet the needs of each
successor professional. They also recognize how unnerving a transaction can be to these individuals and spend a great deal of time and energy getting them comfortable with the acquirer’s organization.

9. Focused on ensuring (and communicating to the seller the importance of) a continuity of client experience

Smart acquirers recognize every selling owner has some anxiety about the potential for client loss should the acquirer make dramatic changes post-closing. They also accept that the seller’s clients are getting nothing out of the transaction. Thus, these buyers ensure that the client experience post-closing remains largely constant and any and all changes are gradually implemented. And they communicate to prospective sellers that they will follow this approach when integrating the firms.

10. Prepare detailed transition plans

Similarly, sophisticated buyers understand that successfully integrating two firms involves an extraordinary amount of highly detailed planning and preparation. To ensure a successful post-closing integration, smart buyers will enlist the seller to help them develop an individual transition plan for each client that identifies the team members from each organization who will be assigned to each of the seller’s clients, creates a schedule for beginning to include employees from the buyer in the client meetings and specifies the nature of the services and ongoing reporting that will be required.

Near term choices will determine where firms land in the Brave New World of Wealth Management

The ultimate shape of this industry a decade from now is one in which 150 or so extremely profitable, large firms will manage the vast preponderance of assets. Some firms will be quite large. Others will be larger than they are today and more specialized.

The industry’s remaining 19,000 participants will not fare so well. While they will remain in business indefinitely, they will be marginally profitable and have little enterprise value. The choices that owners make over the next couple of years will largely determine where their firms ultimately land in this Brave New World of Wealth Management.
I. The State of the Industry and the Emergence of Three Business Models

The owners of most wealth management businesses sense that the industry is at a crossroads.

On the one hand, they are savoring their great success resulting from two decades of hard work. The industry, which finds its roots in the 1980s and grew into a cottage industry by the early 1990s, is now a $5 trillion behemoth. Individual firms with aggregate client assets in excess of $1 billion are commonplace – an outcome few of the industry’s pioneers would have predicted two decades ago. Fewer still would have foreseen how profitable their firms would become. Many founders of wealth management businesses are now multi-millionaires.

On the other hand, most owners recognize that the business is becoming significantly more challenging. New clients are harder to find, operating costs – and employee compensation in particular – are increasing and regulators are becoming more hostile. Additionally, looming over all of these changes is a much greater, immutable force: old age. The founders of the industry’s participants, with an average age of 59, are reaching an age at which personal needs and objectives shift in preparation for retirement.

The purpose of this paper is to take a closer look at this crossroads and provide a forecast of its direction, economics and shape over the next decade. We believe that, for most firms, their future will be a function of the decisions that they made in the past. Consequently, before looking forward, we first will look at the current shape of the industry, the emergence of three business models within the industry and the critical factors in bringing the industry to where it is today.

A. Defining “wealth management”

The scope of this paper is limited to the wealth management industry. Yet defining “wealth management” and the organizations comprising the industry has become a challenge for three reasons.

First, the size of the industry’s participants is far from homogenous. It is populated with more than 19,000 firms that range from very small proprietorships to businesses with more than $50 million in annual revenue.

Second, as the fee-only, independent model has gained favor with potential clients, a wide variety of other types of businesses (e.g., brokerages, insurance agencies, accounting firms, etc.) jumped on the bandwagon, claiming to be, and attempting to brand themselves as, wealth managers.

Third, although nearly all practitioners within independent firms see a meaningful distinction between the services of a “wealth manager” and a “money manager” (a position with which we strongly agree), we find no consensus on how to clearly define the distinction. The confusion is understandable: both provide advice to individuals and institutions, both are fiduciaries, both (typically) have discretion over client assets and both are “registered investment advisers” under the Investment Advisers Act of 1940. Additionally, there are many “hybrid” firms – that is, organizations that both provide wealth management advice and manage money. Many of these firms had originally aspired to become large
institutional managers for pensions, foundations and endowments but found greater success managing money for the “millionaire-next-door.”

Consequently, for purposes of this paper our analysis will include only those organizations meeting each of the following two criteria:

1. The organization must be an independent RIA. Brokerages, insurance agents and other organizations with employees that sell products (as opposed to provide advice) on a commission basis are excluded. We also have disregarded organizations that offer advisory services through another organization’s RIA.

2. The organization must derive at least 50% of its revenue from providing financial advice to individuals that goes beyond traditional money management. Wealth managers, like money managers, are in the business of providing investment advice. Problem solving, however, is the core value-add of a wealth manager. Thus, they provide additional advice regarding, for example, asset allocation, financial planning and tax planning, customized to fit each client’s unique circumstances. Money managers, by comparison, are focused almost exclusively on maximizing investment returns within a particular investment strategy.

B. Dividing the industry into three business models

Within the wealth management industry (as we have defined it), three primary business models have emerged. These models are closely tied to the degree to which a firm has evolved into a sustainable business.

More importantly, precisely how the forces which will sweep through the industry over the next decade will impact an individual firm is closely tied to its business model. Thus, understanding each of these models is critical to predicting how the industry will likely change over the next decade.

They are:

1. Evolving Businesses

We define an “Evolving Business” as a firm that is taking the messy and difficult steps necessary to evolve into a business that is both sustainable in the long-run (i.e., after the departure of the founder(s) and has meaningful enterprise value.\(^1\) Evolving businesses are broadening their equity ownership beyond the original founder(s), shifting to partnership cultures in which all employees are held individually accountable for performance, developing and nurturing successors who have business development skills in addition to the ability to retain existing clients and building systematic marketing programs that involve most of the firm’s professionals.

While this group has the smallest number of firms, it includes most of the industry’s largest participants and the majority of its assets. However, the sizes of individual firms vary widely.

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\(^1\) As described in our earlier study “Creating, Measuring and Unlocking Enterprise Value in a Wealth Manager” published in June 2010, enterprise value is simply a discounted cash flow calculation of the value one achieves \textit{solely} for owning the equity of a company. It excludes any amounts paid to owners in their roles as employees of the company. Thus, firms with sustainable enterprise value are enterprises which will likely remain profitable (again, in excess of what owners are being paid to work as employees) for the indefinite future.
2. Books of Business

At the other end of the continuum are “Books of Business.” Books of Business – relative to Evolving Businesses and even many of the Tweeners described below – are tiny enterprises. Although they do a great job of advising their clients, they have low annual revenue, few (if any) capable successor professionals and no obvious strategic plan.

In reality, these firms are better described as “jobs” rather than “businesses.” A Book of Business certainly can provide its owner with a nice living so long as he or she continues to work. However, when the owner retires, the owner is likely to find that the firm has no material enterprise value and, if sold, the consideration paid will be both modest and highly contingent.

To be sure, by identifying this lack of enterprise value, we are in no way suggesting that the firms in the Books of Business category are on the verge of extinction. Rather, just as today there still are thousands of small bookkeeping firms and as many barbershops, thousands of Books of Business will continue to exist for the foreseeable future.

3. Tweeners

From a business evolution perspective, the most interesting category of wealth managers are “Tweeners” – those firms that fall between the extremes of Evolving Businesses and Books of Business. They will see the most change over the next five to ten years.

Tweeners enjoy greater scale and profitability than Books of Business, but, unlike Evolving Businesses, they have been unable and/or unwilling to date to take the necessary steps to evolve their companies. Despite their scale, most still function as glorified proprietorships that are extremely founder-centric. The founders source the predominance of the firm’s clients and, consequently, the firm’s brand remains, in essence, the brand of the individual founders themselves. In most Tweener firms, professional employees function primarily as leverage for the founders. Furthermore, their ownership is concentrated in the hands of its founders.

To be sure, there are a relatively small number of Tweener firms that are just beginning the process of becoming an Evolving Business. Unlike most of their peers, these types of Tweener firms typically have several very talented and capable successor professionals. However, these organizations have yet to begin broadening their ownership and institutionalize their marketing and branding.

It is also important to note that Tweeners can be extremely profitable – many generate greater than $5 million in annual revenue and some have gross operating margins in excess of 80%. However, unlike Evolving Businesses, Tweeners have limited long-run enterprise value precisely because the businesses, as presently configured, are unsustainable beyond the departure of the original owners.

That being said, Tweeners have potential enterprise value that can be realized in one of two ways. One alternative is for the owners to take the steps necessary to become Evolving Businesses. The other alternative is to sell the firm to either an Evolving Business wealth manager or a financial buyer such as a bank or a roll-up.
Exhibit 1.1  Wealth Management Business Models

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Evolving Businesses</th>
<th>Tweeners</th>
<th>Books of Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Firms</td>
<td>≈ 200 firms</td>
<td>1,000 – 1,200 firms</td>
<td>18,000 firms</td>
</tr>
<tr>
<td>Profitability</td>
<td>Prudent reinvestment</td>
<td>Maximized margins. Profitability going to limited group of owners</td>
<td>Inseparable from owner comp</td>
</tr>
<tr>
<td>Brand</td>
<td>Institutionalized</td>
<td>Founder-centric</td>
<td>None</td>
</tr>
<tr>
<td>Client Relationships</td>
<td>Clients of the firm</td>
<td>Clients of the founder(s), limited relationship with service personnel</td>
<td>Eat what you kill</td>
</tr>
<tr>
<td>Hiring Philosophy</td>
<td>Hire the best</td>
<td>Hire the cheapest</td>
<td>Hire the fewest</td>
</tr>
<tr>
<td>Professional Employee Roles</td>
<td>Client retention, business development, and operational strength and integrity</td>
<td>Client retention, owner part time participation</td>
<td>Leverage the founder</td>
</tr>
<tr>
<td>Compensation Plans</td>
<td>Performance-based/variable, clear criteria and goal measurement</td>
<td>Fixed salaries, arbitrary bonuses</td>
<td>Fixed salaries</td>
</tr>
<tr>
<td>Equity Ownership</td>
<td>Widely-held</td>
<td>Concentrated</td>
<td>Meaningless</td>
</tr>
<tr>
<td>Governance</td>
<td>Partnership</td>
<td>Founder-based dictatorship</td>
<td>Irrelevant (no business to govern)</td>
</tr>
<tr>
<td>Compliance</td>
<td>Attorney-driven program. Culture of compliance across management and employee base</td>
<td>Consultant-driven program. Seen as an operational issue</td>
<td>&quot;Compliance in a box&quot;, one of many founder “hats”</td>
</tr>
<tr>
<td>Enterprise Value</td>
<td>Robust &amp; sustainable in the long-run</td>
<td>Potential</td>
<td>De minimis</td>
</tr>
</tbody>
</table>
**C. How the industry got here: a brief history of the past three decades**

A precondition to understanding how an industry might evolve in the future (as well as to better understand the emergence of the three business models), requires a brief review of its history.

1. **The mid-1980s to the late 1990s: low-hanging fruit**

The independent wealth management firm as we know it today first emerged as a business model in the late 1980s and early 1990s. The founders of these firms were much more like missionaries than businesspeople. They were principally focused on providing a conflict-free, fee-only alternative to the more dominant brokerage model; actually making money was, for many, a secondary consideration.

Starting a fee-only wealth manager at this point in time was fortuitous for two reasons. First, there was little to no competition for clients. Hundreds of thousands of families were looking for holistic wealth management. Second, and more importantly, the launching of the industry coincided with the inception of one of the greatest bull markets in history. Client assets appreciated rapidly and so too did the fees paid to their wealth managers. Consequently, typical wealth manager revenues rose 13% to 14% annually before adding any additional clients.

This decade-long equity market “revenue subsidy” effectively insulated even the weakest industry participants from many of the normal market forces that shape any new business. Although costs rose, revenues almost invariably rose faster. It simply was a glorious time to be in the business.

2. **The aughts: the first sign of headwinds**

In the decade that followed the bursting of the dot-com bubble, owners of wealth management firms faced a series of new challenges.

First, advisors could no longer count on an extended bull market – with its accompanying appreciation in client portfolios and wealth management fees – to provide a consistent revenue subsidy. Consequently, growing profitability became a function of adding large volumes of new clients.

Second, and for the first time in the industry’s brief history, cost inflation – principally related to compensation costs – became an issue plaguing every wealth manager’s income statement. The explanation is simple: the demand for qualified professional employees exceeded – and continues to exceed today – the supply.

Demand for professional employees was in part a function of the evolution of the industry. As many firms grew from small start-up companies into multi-million dollar businesses their founders eventually ran out of bandwidth, creating a tension between business development and servicing existing clients (as well as the quality of the founders’ lifestyles). Leveraging the time of the founders depended upon the addition of sophisticated professional staff.
Many more professional employees also were needed because a surge in demand for fee-only wealth management services followed the collapse of the Internet bubble. Sophisticated, conflict free, holistic advice became much more compelling to many individuals who previously invested their own money or who tried to chase hot stocks on the advice of a broker. The end of the financial orgy that was the dot-com craze suddenly made asset allocation, diversification and focusing on long-term financial objectives much more compelling.

However, the skills, expertise and (most importantly) judgment essential to providing competent wealth management advice take many years to develop in any individual. Thus, unlike in other industries in which well-educated individuals with experience in other fields can be trained within a period measured in months, wealth management firm owners could not grow their own talent fast enough to satisfy their needs.

Consider for a moment what the confluence of these two factors meant: right at the point that wealth management firms needed to add professional staff, there was no natural pool of trained and experienced individuals in the industry from which to recruit. However, wealth management firms could only take advantage of their numerous new client opportunities if they increased their capacity. Consequently, the demand for – and, thus, the cost of – even semi-qualified professional staff skyrocketed, sparking significant cost inflation in wealth management businesses that continues to this day.

3. Reinvestment decisions and the current shape of the industry

Cost inflation and the end of a market-driven revenue subsidy forced the owners of the industry’s strongest firms to make a difficult choice. They could forego near-term cash flow in order to make investments in incremental staff, infrastructure and technology that were necessary for building a sustainable enterprise and continued growth. Alternatively, they could maximize near-term distributions at the expense of reinvestment.

This was not an easy decision. Many owners had developed robust lifestyles that required a great deal of ongoing cash flow to support. Additionally, reinvestment is always risky – there is no guarantee of an adequate return. Further, wealth management firm owners were (and are) extremely protective of their corporate cultures. Reinvesting and increasing the size of their firms would increase complexity, and, with greater size, their cultures would inevitably shift over time.

However, we believe that the industry’s current shape – with three dominant business models – can be directly traced to decision-making regarding reinvestment.

The owners of about 175 to 200 larger firms decided that they wanted to build standalone businesses with sustainable enterprise value. Thus, they sacrificed a great deal of near-term profitability in order to finance the evolution of their businesses: hiring talented successor professionals, broadening their ownership, creating career paths, expanding their marketing programs and building brands around the organization and not just a few key individuals.
These firms now dominate the Evolving Business category.\(^2\)

Other owners were less interested in building large valuable businesses than focusing on the quality of their lifestyles and other activities outside of their businesses. They made a nice living servicing their existing clients (and perhaps adding a handful more each year) and many spent more time at conferences and industry events than actually working in their businesses. Other owners took six, seven or even eight weeks of vacation each year – amounts unrivaled in any other industry.

These firms are now the “Books of Business”. Although many have a few employees, they are largely owner-centric proprietorships. Their owners make a nice living, but the underlying organizations have little or no enterprise value.

Finally, the owners of the last segment of the larger wealth management firms – those which today populate the “Tweener” category – chose a third path for their firms. Most of them consciously maximized short term profitability by growing with as little incremental cost as possible.

Although Tweeners added professional staff over time, they did so very gradually. They also have been able to grow, but, because they depend almost entirely on their founders to recruit new clients, the pace of their growth has lagged Evolving Businesses significantly.

More importantly, Tweeners have not yet evolved as businesses. Equity ownership, governance and decision-making authority, branding and marketing all remain founder-centric. Consequently, these firms are unsustainable over the long term as standalone businesses.

To be sure, from a personal wealth creation standpoint for many Tweener founders, this had the potential to be a brilliant strategy. After decades of taking out all of the current profitability, some Tweener owners even have built a personal net worth in excess of $25 million. They also potentially possess some enterprise value but to capture it they will have to sell the firm to an outside buyer.

\(^2\) Within the Evolving Business category there are a small group of new firms that were first launched in the early part of the 2000s or were acquired almost entirely by successor management over the last decade. Many of these firms today manage well in excess of $1 billion of assets. We like to refer to these twenty to thirty firms as the “Young Guns.” Their owners are typically in their early to mid-40s and because they launched (or acquired) their firms without the benefit of a roaring bull market (and its accompanying revenue subsidy) these owners have had to be much better businesspeople than many of those individuals who founded wealth management firms in the late 1980s or early 1990s. They clearly will be ferocious competitors in the industry in the years to come.
II. Forces That Will Reshape the Industry over the Next Decade

As noted in the previous chapter, a series of macro factors – an unprecedented bull market, a sudden spike in demand for independent financial advice, limited competition for clients, etc. – allowed even average wealth management firms to enjoy two decades of financial success. While reinvestment decisions played a critical role in the evolution of firms, even owners of Books of Business who chose not to reinvest were able to earn a nice living. However, the macro factors are about to change – in a fundamental way.

Five forces are poised to reshape the industry. The first four – fewer millionaire households, aging client bases, low investment returns on low risk assets and operating cost inflation – will create previously unseen profitability challenges for every firm. The tailwinds enjoyed during the industry’s infancy aren’t simply gone; wealth management firms are now flying into stiff headwinds. The fifth – aging founders and owners – will further contribute to the rationalization of the industry over the next decade.

A. Fewer new millionaire households with more firms competing for them

Everywhere we go, the owners of wealth managers tell us that acquiring new clients has suddenly become more challenging. The numbers bear this out: organic growth rates are uniformly declining across the industry, regardless of firm size, geography or specialty. The observation is unremarkable given the state of the broader economy (and its resulting effect on wealth creation) and the increased level of competition within the industry today (as compared to even a decade ago).

The supply of millionaire households (the core prospective clients of wealth managers) declined sharply with the 2008-2009 financial correction and, to date, has not recovered to pre-correction levels. According to Spectrum Consulting (as shown in Exhibit 2.1), the number of households with at least $1 million of investable assets declined by 600,000 between 2007 and 2011. A more recent Boston Consulting Group study indicates that the number of millionaire households declined by an additional 129,000 in 2012. Even when the economy once again begins to create new wealth, we will need an extended period of growth simply to restore the pool of potential clients to 2007 levels.

Further complicating the acquisition of new clients is the marked increase in competition. In the industry’s early years, clients without financial advisors were plentiful and there were few large advisory firms to serve them. Neither fact remains true today.

Now, the overwhelming majority of wealthy families with a desire for holistic wealth management services already have an advisor. Consequently, until the economy begins to grow again at a high rate (thus, creating many new millionaire households), acquiring clients frequently requires convincing families to switch advisors rather than simply hire an advisor in the first place.

In addition, the wealth management business is no longer a cottage industry of small businesses serving local clients. Although only a decade ago a firm with at least $300 million of assets under management was considered a
rarity, today firms with at least $1 billion are relatively commonplace. These larger firms have sophisticated marketing programs, offer the same kinds of independent fee-only advisory services that are as good as that provided by their smaller counterparts and seek large volumes of new clients in order to sustain their high rates of organic growth.

B. Client bases are gradually getting older and beginning to consume more of their capital

An equally important (albeit, subtler) force that will also reshape the industry is that the average age of clients serviced by many wealth managers is now much older than only a decade ago. Whereas ten years ago the average age of many wealth managers’ client bases was about 63 or 64, today it has shifted to 67 or 68. Such a shift in client demographics is somewhat inevitable given the length of the typical wealth manager-client relationship and the limitations that wealth managers have in servicing large numbers of new clients at once.

More specifically, the typical wealth manager-client relationship lasts 25 to 30 years (or even longer). Given that a typical new client is in his or her 50s or early 60s,1 those clients recruited over the last decade are likely today in their mid to late 60s and those from the previous decade are in or near their 70s.

As existing clients (inevitably) age over time, so too shifts the average age of the client base unless the wealth manager is able to add increasingly larger volumes of new, younger clients. For example (and as shown in Exhibit 2.2), consider a wealth manager with 300 clients, $5 million of annual revenues and an average client age of 64 years. Assume it has historically added 15 net new relatively young (between 50 and 60) clients per year. As shown in

1 The new clients of firms located near major technology centers such as Silicon Valley are typically much younger due to sudden wealth creation resulting from the IPO or sale of start-up companies.
Exhibit 2.2, even if the firm continues to add 15 net new clients per year, the average age of its clients will increase over the following decade to almost 67.

Unfortunately (for reasons we will discuss in greater detail later), large wealth managers are effectively capped in the numbers of new clients which they can service at once. Thus, even if a wealth manager was able to overcome the dual challenges of (i) fewer new clients without existing financial advisors combined with (ii) increased competition for them, it would not be able to accept a sufficient number of new clients to offset the aging of its client base.

The increase in the average age of a wealth manager’s clients is problematic for two reasons.

First, as clients get older, their gross rate of capital consumption increases. Many are retirees who no longer work and largely live off of their investments. Those who conclude that they are not likely to “outlive their money” consume even more and/or begin the process of giving more of it away. Additionally, those clients who have money in tax deferred accounts must, in order to avoid penalties, begin taking required minimum distributions during the year in which they turn age 70 1/2 and pay taxes on the amounts withdrawn.

Second, older clients, with a limited time horizon to recover from any significant market decline, (understandably) have less of an appetite for investment risk. Thus, a larger portion of their accounts are typically allocated to lower risk assets, i.e., investments that generate lower nominal rates of return.

The combination of higher average gross capital consumption and lower nominal rates of return on investments results in clients consuming much more of their capital over time on a net basis. Consequently, their assets gradually decline over time. Given that wealth management fees are typically
Exhibit 2.3 ERB Wealth Management Client Distribution in 10 Years

Assumes ERB Wealth Management brings in 15 new clients per year each paying initial fees of $15 thousand, new clients are evenly distributed between ages 50-60, and that client’s assets are liquidated at age 90.

C. Potentially prolonged period of low return on lower risk assets

The Federal Reserve recently decided to change some of its longstanding policies on how it manages interest rates. It announced that it intends to continue extensive quantitative easing until such time that unemployment is below 6.5% or inflation is more than 2.5%. And until either occurs, the Fed intends to keep the yields on fixed income securities at or near their current record lows.

This new policy is potentially very problematic in two ways for wealth management firms. First, a substantial portion of all client assets are typically invested in lower risk assets as part of any rational asset allocation and diversification strategy. The nominal returns generated by these kinds of investments (shorter term fixed income securities, hedged investments, etc.) while greater than U.S Treasury securities, typically track to these rates – i.e., the lower the nominal return generated by Treasuries, the lower the returns generated by other lower risk asset classes.

As shown in Exhibit 2.4, Treasury bills today have yields that are barely above zero and ten year Treasury bonds are yielding less than 2%. Both of these yields are at their lowest point since the inception of the wealth management industry, three decades ago.²

² Because the return on an allocation to lower risk asset classes includes both interest/distributions and capital appreciation, fixed income performance since the inception of the 2008-2009 market correction has been strong as interest rates have been driven down to record lows. However, given that most yields on Treasury securities are now near zero, there is less room for any additional appreciation.
Consider for a moment the potential impact of this change in Fed policy for wealth managers. Many firms historically have assumed in their financial planning models that the lower risk portion of their clients’ portfolios would generate returns over the long term in the 4% to 6% range. Assuming higher risk asset classes would generate an 8% to 9% average annual return, a traditional 60% high risk assets /40% lower risk assets portfolio would generate a pre-tax, pre-wealth management fee nominal return of about 6.5% to 7.5%.

However, if Treasury rates remain at current levels for an extended period of time, projected returns on low risk asset classes will be closer to 2% or 3% instead of 4% to 6%. Under these return assumptions, the projected annual nominal return from a 60%/40% portfolio would be only about 5.5% to 6.5% per year.

By itself, an extended period of low returns on fixed income would significantly slow the future rate of growth of a typical wealth manager’s revenues. Unfortunately, the impact is exacerbated by the increasing average client age. Many clients who initially were appropriately invested in a 60% high risk /40% low risk allocation will need to shift to a 40%/60% (or even 30%/70%) portfolio as they approach or enter retirement.3

Finally, it is important to keep in mind that a reduction in fees caused by reduced returns on low risk assets will not be accompanied by any reduction

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3 The authors recognize that asset allocations vary between clients based on a wide variety of factors and not just age. These examples are intended only to provide a framework to consider the effect of a prolonged period of returns on future wealth manager revenues.
in costs. Clients are not leaving or otherwise requiring fewer services; rather, they are simply paying their wealth manager less money to do the same level of work.

**D. Operating costs will continue to rise at a rate higher than inflation in general**

Colliding with the three factors described above (fewer new millionaire households and more competition for them; gradually aging client bases and resulting higher net capital consumption rates; and lower returns on lower risk asset classes), all of which will negatively impact the rates at which wealth manager revenues grow, will be rapidly increasing operating costs. Nearly every wealth manager that FN has examined is currently experiencing average annual cost inflation of at least 5% to 7%. Four factors will contribute to the continuation of this trend.

1. **Labor costs**

As discussed in Chapter I, labor costs for professional employees are the primary driver of cost inflation in the industry. The shortage of qualified candidates, which first emerged as an issue during the decade of the 2000s, continues today and is unlikely to improve at least in the near term.

By one recent estimate, only 22% of the industry’s professionals are under 40 and fewer than 5% are younger than 30. As we also noted in an earlier study published three years ago, in 2010 more than 60% of the industry’s participants were over 50. In other words, for every two and a half to three people leaving the industry in the next decade or so, there is only one replacement.

With the demand for even semi-qualified professional staff continuing to outpace the supply, typical non-owner compensation costs are rising about 7% to 10% annually. Although this may seem a bit robust at first glance, it is consistent with the thinking of many firm owners we interviewed. When asked how much a typical non-owner professional, who today makes $150,000 in total compensation (i.e., including benefits, payroll taxes, etc.), should expect to make in five years, a common response was in the range of $225,000, a figure that implies an annual growth rate of about 8.5%.

2. **Client acquisition costs**

In the industry’s early years, the typical firm’s marketing strategy could – with only modest exaggeration – be described as: “wait for the phone to ring.” Those days, however, are over.

As noted earlier, the supply of millionaire households is smaller than it was five years ago. Further, even if the economy once again begins creating new wealth, the competition for new clients is going to be much more intense than in previous decades.

Only ten years ago, being fee-only and providing sophisticated and non-conflicted advice allowed wealth management firms to differentiate themselves from their primary competitors (i.e., brokers). However, today even brokers and insurance agents describe themselves as wealth managers. They also use the term “fee-based,” a label which many prospective clients are unable to distinguish from “fee-only.”
Furthermore, the source of competition for new clients is increasingly other fee-only wealth managers offering similar services and the same quality of advice. Even referral sources are becoming more difficult to cultivate; most “influencers” (accountants, estate planning attorneys, etc.) already work with one or more independent firms.

Going forward, wealth managers that want to grow are going to have to use more of their time and resources on branding and marketing.

3. Regulatory costs

A rapidly changing and increasingly adversarial regulatory environment is likewise forcing (and will continue to force) wealth management firms to spend more of their time and resources on compliance. In the wake of the Madoff scandal, regulators in general (and the SEC staff in particular) are under great pressure and scrutiny from Congress to take a much more aggressive approach to regulating wealth managers. In no small part because two individuals who once were the so-called “leaders” of the wealth management industry have recently been sanctioned and/or indicted (Mark Spangler and James Putnam), the regulatory community in general no longer views fee-only wealth managers much differently than it does brokers.

For the industry, this will be a marked change from the relationship it held with the SEC over the last two decades. Historically, most firms have been examined only once every four or five years – some wealth managers have been examined only once a decade. Industry participants should now expect the frequency of exams to increase over the next decade. Furthermore, when exams do occur, wealth managers should expect the examiners to be more hostile.

Further complicating matters, the current regulatory framework is ill-suited to address advances in technology such as social media. Thus, at the same time that wealth managers are struggling to adapt their business models to cultural transformations in how current and prospective clients communicate and affiliate, they are going to have to do so with limited guidance from the SEC on what is appropriate and legal.

Consequently, wealth managers will have to spend substantially more money on legal advice and dedicate more management time to compliance issues. Additionally, the compliance function will have to be run by a more qualified and more highly compensated individual than in the past.
Compliance Issues Will Help to “Thin the Herd”

In the course of our research, we continue to be surprised by the cavalier attitude many advisory firm owners have toward compliance matters. They have not yet fully accepted that the regulatory environment in which they operate has fundamentally changed. Many are dismissive of the changes and assume that any heightened regulatory scrutiny is temporary or even illusory. Consequently, they haven’t made the investments necessary to upgrade their compliance programs to the levels required by today’s environment.

For example, many firms continue to rely on low-priced “compliance consultants” – i.e., relatively unsophisticated organizations largely staffed by former mid-level regulators – in lieu of more expensive legal counsel. Not only is the advice from compliance consultants frequently poor, the advice itself is not protected by legal privilege. Consequently, any report generated by consultants must be provided to the SEC during audits – effectively providing a road map for the regulators to bring an enforcement action against the wealth manager. The reluctance to pay for good legal counsel is ironic given that wealth managers have a business because their clients are willing to pay a lot of money for quality advice.

As both investors in and observers of the wealth management industry, we view the reluctance of many wealth firms to substantially upgrade their compliance programs and to seek out and pay for highly sophisticated legal advice on compliance issues as a “Darwinian” process – i.e., it is somewhat analogous to Nature’s way of thinning the herd. Those firms that do not sufficiently change and improve their compliance programs will ultimately be sanctioned with significant regulatory enforcement actions that will kill their future prospects for growth and may even put them out of business.

4. Litigation costs

Litigation has, for the first time in the industry’s history, become a material economic risk. Until recently, the industry was insulated against litigation by its own small size – because firms and their owners did not have the financial capacity to pay large sums in settlement of lawsuits, they weren’t an attractive target for clients, former employees and their contingency fee lawyers. With many firms now generating in excess of $10 million in annual revenue, the industry should prepare for a spike in litigation.

Firms will need to dedicate considerably more time and resources to managing the risks of lawsuits. To mitigate employee litigation risks, every employee’s rights and responsibilities will have to be clearly spelled out in writing – poorly drafted, ad hoc agreements with employees will need to become a thing of the past. As firms become larger and increase headcount, the risk of hiring the wrong person increases. Firms should recognize that nearly every termination of an employee creates an opportunity for the departing employee to file a lawsuit. To mitigate client litigation, firms will need to involve legal counsel more heavily than they have in the past. Client communications, disclosures and contracts will need to be regularly and closely reviewed by counsel.
Unfortunately, even if wealth managers prudently manage these risks, many will still wind up spending a great deal of money defending themselves from nuisance lawsuits filed by an industry of parasitic contingency fee attorneys.

**E. Founders of most wealth managers are getting old**

While the four forces discussed above will combine to raise material challenges to profitability over the next decade, the final force should act as a catalyst for reshaping the industry.

Most of the founders of wealth management firms are approaching that point in their lives when they need to consider doing their own financial planning. According to Tiburon Strategic Advisors, the average age of an owner of a wealth manager is somewhere between 55 and 56. However, included in that statistic are many second generation owners of wealth management firms who are much younger than the founders. Those in the latter group on average are 59.

Many founders have grown accustomed to relatively lavish lifestyles which require a great deal of ongoing cash flow to maintain. Because most of them have the preponderance of their net worth tied up in the stock of their businesses, the value they ultimately receive for that equity will determine their ability to sustain their current lifestyles in retirement.

To be sure, many founders (in particular, founders of the Evolving Businesses) have already begun to monetize portions of their ownership. Some have done so through mechanisms within their organizations designed to provide ownership opportunities to their key professional staff. Some have even implemented full-scale transition plans that contemplate a full sale by a date certain.

In contrast, the founders of most firms in the Tweener and Book of Business categories have yet to monetize the value in their ownership stakes. Their firms lack successors with either the interest in buying out the founders or the resources to do so at a price anywhere near fair value.
III. Responding to the Five Forces

The five forces described in Chapter II will fundamentally alter the economics of every wealth manager. To put it simply, maintaining historical levels of profitability and growth will be much harder. So, the critical question for every owner of a wealth management firm is: what should you do?

The alternatives that are available to owners vary depending upon a wealth manager’s business model. The more evolved the business, the greater the number of options it has.

First step for all firms: build a trajectory analysis and remove the “anchor”

Based on numerous discussions with the owners of wealth management firms, we are certain that few owners (regardless of business model) have emotionally accepted that the world is changing. Fewer still have developed strategic plans to adjust to the new environment. Even industry veterans seem unprepared.

In one sense this is not surprising. One of the more brilliant insights uncovered by a recent winner of the Nobel Prize for Economics, Daniel Kahneman, is that the mechanisms used by the human brain in processing new information make it almost impossible for any decision maker to easily adapt to changes in his or her organization’s operating environment.

More specifically, Kahneman found that the brain’s decision making processes do not rationally consider all available information (both new and old) with an equal weighting. Instead it relies on a hardwired processing mechanism that begins with a preexisting reference point tied to one’s earlier experiences – the “anchor”. All of the new information is then compared against this reference point with a strong bias against moving away from the anchor. It is extraordinarily difficult for the brain, even with the new information, to “un-anchor” itself from its reference point.

The reference point for wealth managers has been an operating environment with plentiful new clients and little to no competition; one in which most clients were relatively young, capital accumulators; and one in which lower risk asset classes appreciated on average 5% per year over time. Combined, these factors made it relatively easy to grow profits at 10% to 15% per year for the last 20 years.

Although owners recognize that their operating environment has changed, it is hard for them to accept the premise that the trajectory of their firms will be fundamentally different going forward. In fact, in conversations leading up to this paper, most wealth management firm owners we spoke with confirmed their agreement with our thesis regarding the five forces. But, when questioned about the impact of those forces on their particular firm, nearly all gave us the same answer: “Well, we’re different.”

In our experience, the only way an owner can “un-anchor” and accurately assess the impact of the forces confronting the industry on the firm is to conduct an

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¹ Though not specifically addressed in Chapter II, owners of wealth management firms might also consider the threat to profitability if inflation were to return to historical levels (or even higher) at some point in the near future. With a stagnant economy, the Federal Reserve at the moment is effectively printing money so as to avoid deflation. However, if general inflation returns to 3% to 4% per year, would wealth manager operating costs begin to rise at 7% to 11% per annum (rather than the 5% to 7% mentioned in Chapter II)?
Objective multi-factor analysis of the firm's trajectory. The goal is to quantify the firm's economics across a wide variety of scenarios.

**Comparing the current trajectory of an Evolving Business wealth manager with that of 10 years ago**

For example, consider “BJR Wealth Management.” It is an Evolving Business with $10 million of annual revenue, $5 million of gross profitability (i.e., profits before distributions to senior owners) and 500 clients. Ten years ago, consistent with the experience of other similarly sized firms, BJR had $4 million of annual revenue, $2 million of gross profitability and 200 clients. The firm’s client base at that time (as shown in Exhibit 3.1) was relatively young because it had acquired most of its clients over the previous decade.

Had the firm conducted a trajectory analysis back then, it probably would have assumed long term returns on higher risk assets of about 9% and 5% on lower risk asset classes. Since it had had very little client turnover, an assumption of about 1% per annum likely would have been considered reasonable.

To grow its profitability at 10% annually over the next decade BJR would have needed to add 20 new clients per year that pay initial average annual wealth management fees of $15,000, causing its operating costs to rise by about 7% per year. The resulting projected trajectory for the firm at that time might have looked like Exhibit 3.2.2

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2 Our trajectory analyses include nine factors: (1) average projected returns from both low risk and high risk asset classes; (2) projected annual client turnover; (3) current revenue segmented by age group; (4) average asset allocation by age group; (5) average annual gross accumulation (or consumption) of capital by client age group; (6) projected annual operating cost inflation; (7) projected additional new clients per year; and (8) average annual fees paid by new clients and (9) average annual wealth management fees. We assume that new clients acquired are evenly dispersed on average evenly across the 50-59 year age groups. We also have ignored changes in wealth management fees due to price breaks for clients both adding and consuming their capital, assuming that, on average, deposits and withdrawals largely offset each other.
For three reasons this projected trajectory would likely have been inaccurate. First, the returns on higher risk assets over the last decade were closer to 5% rather than the anticipated 9% due to the financial correction of 2008-2009. At the same time, however, prospective new clients were also a bit more plentiful than the firm may have expected. However, adding many additional new clients would also have caused the firm’s operating costs to rise at greater than the originally projected rate.
Assuming BJR instead added on average 30 new clients per year instead of 20, and its operating costs rose at 9.5% per year, its profitability would still have grown at about 10% per annum. And its trajectory (as shown in Exhibit 3.3) over the last ten years would have led it today to have $10 million of annual revenue, $5 million of ongoing profitability and 500 clients.

**Even with the same number of new clients per year, very different trajectory**

Unfortunately, for several reasons the trajectory for BJR Wealth Management, as we look into the next decade, is quite different. As shown in Exhibit 3.4, the revenue-weighted average age of the client base is now older. Those clients who were in their 50s ten years ago and had been capital accumulators are now a decade older. At the same time, many of the newer clients which the firm captured recently are still in the capital accumulation phase. Thus, a larger portion of the firm’s assets (that generate a greater portion of the wealth management fees) are owned by older clients.

Lower projected nominal returns on low risk asset classes will likely slow the associated growth in wealth management fees and, while the firm’s annual client turnover will remain very low, it should increase slightly as the market for clients becomes more competitive.3 Finally, the firm today is much bigger than it was a decade ago. Thus, it must add many more net new clients per year to sustain the same relative rate of revenue growth.

The combined effects of these (relatively small individual) changes on the trajectory of BJR are shown in Exhibit 3.5. If it continues to add 30 net new clients per year while at the same time limiting its annual cost inflation to 5%, its earnings over the next decade will on average grow less than 0.5% per year.

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3 Thus, for purposes of this example we have assumed that client assets invested in lower risk asset classes and higher risk asset classes will have 2% and 9% average annual appreciation, respectively, and the firm’s annual client turnover will increase to 2%. 

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**Exhibit 3.4  BJR Current Client Distribution**

2012 Revenue Weighted Distribution by Age

See Appendix for Asset Allocation and Consumption Function Information.
In other words, BJR is an extraordinarily successful wealth manager that has been able to grow profitability at about 10% year for a decade. However, even assuming it is able to add as many new clients each year as it has in the previous decade, its earnings will only effectively go sideways.

Such a material change in a firm’s trajectory points to why it is critical for owners to conduct such quantitative analysis if they want to have a realistic view of their firm’s future economics. Absent this information, it is extraordinarily hard for them to fully comprehend how different their going forward operating environment will be and what steps they need to take to address these changes.

**A. Strategies for Evolving Businesses:** *growing profitability and building enterprise value*

The owners of Evolving Businesses have embraced the difficult challenge of evolving their organization and business model. Their goal is to build a sustainable firm with meaningful enterprise value. Integral to achieving that goal is profitability growth.

To be sure, we believe that most (if not all) Evolving Businesses will be able to grow their profitability at least modestly (≈4% to 5% per year). However, much faster profit growth is essential for two reasons. First, it creates economic opportunities of a magnitude sufficient to attract and retain high quality successor professionals – not just care-takers but leaders, a precondition to sustaining any organization’s enterprise value. To put it simply, talented people do not join relatively stationary organizations.

Equally important, owners understandably expect to be handsomely rewarded for suffering through the headaches of building a sustainable firm. And it
is the future value of their ownership – which is directly correlated to how quickly earnings grow over time – that will determine whether their effort was worth it.

**Growth conundrum of the large wealth manager**

As noted earlier, all wealth managers will have to navigate obstacles to growing their profitability that did not exist in prior decades. Unfortunately, Evolving Businesses, as large wealth management firms, face an additional issue – a “growth conundrum” – that is a byproduct of their own success and the limitations on scalability within their economic model.

More specifically, most wealth managers spend vastly more time “setting-up” a new client than servicing an established client. During the first stage of the client relationship, the advisor is helping the client to work through a series of life-determining decisions. After this “set-up” process is complete (typically about 18 months), the amount of employee time required to service the relationship declines dramatically. Wealth managers typically meet with their clients only a few times per year and infrequently encounter the type of material “life events” that necessitate revisiting the financial planning and investment strategy established during the “set-up” process.

This resource requirement differential (about 15x to 20x greater for new clients vs. established ones) is a structural governor on business development – at any given level of cost structure, or any given number of professional employees, firms have a finite capacity for adding new clients at any one time. Growth in excess of the cap becomes a possibility only with significant investments in staff and overhead.4

Consider again the case of BJR Wealth Management. If the firm wanted to grow its earnings at about 10% per annum, it would have to add 71 net new clients per year (instead of its current 30). However, even if it was able to recruit so many more new clients in the new, more competitive environment, it is unlikely that it could limit its cost inflation to only 5% per year when it was increasing its total clients by roughly 9% each year.5

If instead BJR’s costs went up by 8% a year, then adding 71 new clients per year would no longer be sufficient to achieve its earnings growth rate. The firm now would have to recruit on average 85 net new clients per year. But adding an additional 140 net new clients over the next ten years would likely push costs up even faster. However, if annual cost inflation was instead 10%, the firm would now require 96 new clients per year, further pushing costs up, and so on and so on.

This growth vs. cost spiral is the underlying source of the growth conundrum of large wealth managers and makes it very challenging for them to grow

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4 One way to look at this anomaly in the wealth manager economic model is to consider our earlier example of a firm with $10 million of annual revenue and 500 clients. It could probably service an additional 500 established clients without having to add much more to its operating costs. At the same time, if 75 new prospects showed up at the firm in one day, it would be overwhelmed and probably unable to accept many of them as clients.

5 The authors want to emphasize that the financial models in this study do not assume a linear rate of client addition (i.e., the same number of new clients per year). Rather if a firm adds an average of 71 clients per year over ten years, in the first year it would add about 47 and even more in each subsequent year, ending in Year 10 with about 95 net new clients.
earnings every year for many years. Addressing it requires that firms consider implementing several different strategies over time.

**Four strategies for Evolving Businesses**

We propose four strategies for Evolving Businesses to maintain their growth trajectories. The strategies are listed in ascending order of potential: the first (improving operating efficiency) is the easiest to implement but is insufficient in scale, on its own, to solve the growth conundrum; the fourth (acquisitions) requires the occurrence of an extremely low probability event (the consummation of a deal) but has the greatest potential to result in transformational levels of growth.

1. *Improve operating efficiency*

As with any business, one approach to preserving profitability growth is to slow the rate of cost inflation. Several of the industry’s best firms already do this well by improving operating efficiency and finding ways to more efficiently use the time of their professional employees.

They review all of their processes at least annually with a goal of determining how they can produce the same quality of output but in a less costly manner. They also try to make their most expensive and scarcest resources (i.e., their professional staff) as productive as possible. As part of this, they carefully monitor how their professionals use their time and hold them accountable (and compensate them accordingly) for their contributions to the firm’s profitability. They also try to reduce the amount of time these individuals spend on administrative tasks freeing them to instead focus the overwhelming preponderance of their time on either recruiting new clients or working directly with established clients.6

However, solely improving operating efficiency is unlikely to solve a large wealth manager’s growth conundrum. It largely reduces, at the margin, the total number of new clients a firm must add each year. Rather, wealth managers that want to sustain a high rate of profitability growth will have to also implement other changes.

2. *Reallocate risk between employees and owners*

A second strategy for Evolving Businesses is to redesign their compensation systems so that, over time, larger and larger portions of a professional employee’s total compensation are variable and directly tied to the performance of the firm.

Compensation costs are, by a wide margin, the largest expense item in any wealth manager’s cost structure. While they almost certainly are going to rise over the next decade, firms can take steps to more closely tie them to profitability growth.

Today, too many firms rely on compensation systems that were more appropriate for the operating environment of prior decades. More specifically, in these

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6 While limiting the time spent by professional staff on administrative tasks can improve efficiency, it only makes sense if a firm’s professionals are required and able to use their freed-up capacity to recruit and service much larger volumes of new clients. Otherwise, such a strategy lowers a firm’s profitability.
Owners often bear all the risk

Organizations the preponderance of the compensation paid to employees is fixed (i.e., base salaries and benefits) and only a small portion (typically 15% to 25%) is variable (typically subjective bonuses with potential additional payments for new client recruitment). Where fixed base salaries overwhelm variable performance-based payments, owners effectively bear nearly all of the risk associated with the firm’s performance. Owners keep the upside and the downside – each of which is a problem. In those cases, the employees have no material incentives to control costs or grow profitability.

Compensation plans with large fixed components may have been rational for owners when earnings growth was relatively easy, as it has been for the past two decades. Over the next decade, however, such plans are far less logical. Further, as discussed above, growth over the next decade will depend on capturing high volumes of new clients. Professional employees capable of generating new business are rare – those who can recruit new clients will understandably expect to get paid much more than those who cannot.

Some of the best managed firms in the industry have already redesigned their compensation systems, making them more variable, tied to both hard and soft performance metrics. Compensation is increasingly tied to both individual and firm-level performance. The link assists firms with preserving profit margins both when revenue increases (by preventing compensation costs from gobbling up all the new profits) and when revenue decreases (by forcing employees to bear some of the pain).

However, simply shifting more risk to professional staff could create, from the perspective of the employee, an unfavorable risk/reward tradeoff, at a time in which there is a chronic shortage of qualified professional staff. Thus, persuading key employees to accept greater downside risk in their compensation will likely require sharing a larger participation in the firm’s success.

Consequently, the wealth managers who have had the greatest success in reengineering their compensation structures have also added an equity ownership component. Those individuals who perform at a high level are given the opportunity to buy equity that has contractually defined rights to cash flow.

3. Specialize (a premium pricing and more cost-efficient marketing strategy)

Specialization, with respect to a particular service offering, that can command a premium price from clients and attract new clients in a more cost effective manner is a third strategy for boosting profitability. The strategy is not unique to wealth management. Despite modest market share, Apple enjoys margins envied by its smartphone peers by selling its iPhone at a premium price to a segment of the market that is willing to “pay up” for features that go beyond basic phone and e-mail needs.

Similarly, there is clearly room in the market for wealth managers to position themselves as providers of specialized services. As noted earlier, the core “value-add” of wealth managers is diagnosing and solving client problems. Financial advice is simply the treatment for the problem after it has been properly diagnosed.

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7 For example, at one of the largest and fastest growing wealth managers in the country, about 90% of the aggregate compensation for the professional staff is now variable.
Thus, specialization in the wealth management industry involves helping clients to diagnose and solve problems that are extremely complicated and unique to a relatively small segment of the population. Finding a solution to these problems is often so important to these clients that they are willing to pay an above market price for these services. Additionally, potential clients with a need for specialized advice will often seek out on those organizations that possess the expertise to help them, lowering a wealth manager’s marketing costs while enhancing its ability to grow. Higher average fees and lower cost and more efficient marketing enable wealth managers to add smaller volumes of new clients while still continuing to grow their profitability at a high rate.

Examples of specialized wealth management service offerings include: financial planning strategies customized for particular industries or even particular companies; full-service coordination of advisors for clients undergoing difficult and sudden transitions (death, divorce, etc.); and expert support for families aiming to more effectively, and efficiently, use their wealth to improve the world.

Specialization, however, has a finite shelf-life. What is considered a specialty today quickly becomes a commodity over time – success will always be copied. Consequently, in order to sustain a specialization strategy, wealth managers must constantly improve and upgrade their particular expertise. More importantly, the firms must be able to effectively communicate the importance of its incremental expertise to the relatively small pool of current and prospective clients who may need their expertise.

4. Acquire other wealth managers

The final strategy for Evolving Businesses to tackle their growth conundrum – and the most challenging to implement – is acquiring other wealth managers.

The strategy is attractive for four reasons:

First and foremost, an acquisition allows a wealth manager to capitalize on the unique nature of scalability in its economic model. As noted earlier, wealth managers have great scalability – but only for established clients. An acquisition allows a wealth manager to pick up a large block of established clients while, at the same time, only marginally increasing its operating costs.

Second, acquisitions provide wealth managers with an opportunity to acquire additional qualified professional staff. As discussed earlier, there is a chronic scarcity of such individuals and recruiting them is as important to a firm’s future growth as is recruiting additional clients.

Third, acquisitions can be “life-changing” events. Consider the example shown in Exhibit 3.6. The buyer currently has $10 million of revenue and $5 million of gross profitability. The target has $5 million of revenue and $2.5 million of gross profitability. Because the target firm is located in the same geographic market, the buyer can leverage its preexisting infrastructure with respect to office space, technology, compliance and non-client-facing administrative staff. Retaining and servicing the seller’s clients will effectively require only the seller’s client-facing professional staff.

Under these assumptions, the projected accretion (i.e., the increased profitability of the acquirer) should be in the range of 72% to 77% of the
Acquisitions can accelerate more than five years of growth into a single event. In other words, although the seller on a standalone basis generates $2.5 million of profitability, the buyer’s profitability will increase by $3.75 million per year due to the elimination of overlapping costs. This increase in profitability is what makes a transaction potentially attractive to both the buyer and the seller. More specifically, it allows the buyer to pay a price that is sufficiently attractive to persuade the selling owner(s) to sell. 

Because wealth managers that acquire other wealth managers in their geographic market can strip out so much cost from the seller, they are usually (by far) the best buyer. To be sure, there have been instances of banks and the occasional rollover firm overpaying for wealth managers. However, as we described in great detail in our earlier study, such instances have been extremely rare and reports of their occurrence have been greatly exaggerated.
A successful acquisition has a fourth (albeit, less obvious) benefit for a wealth manager: the resulting increase in profitability makes it easier for owners of the buyer to increase reinvestment, a precondition to future growth. We find that once some sort of “Maslovian” threshold for owner compensation is met, most owners become far more willing to reinvest any incremental profitability above the threshold in lieu of taking additional money out of the business.

For example, assume the buyer shown in Exhibit 3.6 has ten owners who, prior to the acquisition, each take out $500 thousand in aggregate compensation per year. If, as a result of the acquisition, the firm’s operating profitability increases by $2.5 million (after financing and other acquisition costs), the firm could increase the cash paid to each of the firm’s owners by $200 thousand per year and still reinvest an additional $500 thousand. Without the acquisition, the owners would be reluctant to reinvest that level.

While the economics of acquisitions are very attractive, relying on an acquisition strategy can be a source of frustration for many wealth managers. All transactions are very low probability events. For reasons detailed in Chapter IV, only a handful of firms ultimately will be successful in completing acquisitions.

**Is True Owner Happiness Possible Without An Acquisition?**

We have recently observed an immense surge in interest in acquisitions. A week does not go by without a wealth management firm owner inquiring about acquisition candidates and the availability of transaction financing.

Nearly all of these potential acquirers are profitable and growing; albeit their owners have observed that their rates of earnings growth have slowed. These individuals are also very ambitious and have begun to worry that their firms may fall short of their expectations unless they successfully complete a material acquisition.

We believe that they are probably correct. Consider our earlier example, BJR Wealth Management. It would be a fairly typical Evolving Business firm with $1.25 billion of client assets and $10 million of annual revenue. However, even if it is able to add 40 new clients per year that on average each have $2.5 million of assets, it will still have less than $2 billion of assets under management ten years from now. Why? – Because many of its existing clients will consume a portion of their capital over time.

Building a wealth manager with almost $2 billion of client assets should be considered a great success by any measure. However, for more than a few owners with whom we have met it would be disappointing.

5. **A final thought for Evolving Businesses: strategy matters**

We believe that most Evolving Businesses will at least consider adopting each of the strategies described above. The challenge for the owners of Evolving Businesses is to determine, with respect to each strategy, both the optimal moment to pursue the strategy and the appropriate level of resources to dedicate to it.
We believe that a few firms – most likely those that consummate one or two material acquisitions – will emerge from the current pack of 200 or so Evolving Business wealth managers and become very large, profitable businesses, including some with annual revenues in excess of $75 million and enterprise value in excess of $1 billion. At the other end of the continuum, some of the current Evolving Business wealth managers will be unable to continue to grow their profitability. These organizations will have to merge with another firm or be at risk of falling into the Tweener category.

Regardless, unlike in prior decades, strategy and business planning are going to be key determinants of a wealth manager’s level of success. More specifically, for the past two decades, strategic planning had little to do with success in this industry. As noted earlier, participants were mostly very small businesses, there were more new prospective clients than anyone could potentially service and financial market appreciation effectively subsidized these organizations’ growth.

However, the conditions are quite different now. Successful firms will make strategic bets, investments without any guarantee of success, which will be funded with a material portion of their ongoing profitability.

The most forward-thinking owners recognize that while they may have some sort of “vision” for their firms, strategy will need to be continually adjusted. Compromises that might have been unthinkable only a decade ago – changing corporate culture, cutting costs, and increasing the variability in employee compensation, for example – will become commonplace.

Successful firms will make strategic bets with no guarantees of success

### B. Strategies for Tweeners: avoiding getting caught in the middle

Tweeners will find themselves in a difficult position over the next decade. Although they are larger and more evolved than Books of Business, they have yet to take the necessary steps to have sustainable enterprises capable of growth in a more challenging economic environment. From a business development perspective, Tweeners remain too founder-centric: their brands are nearly inseparable from their founders; founders recruit nearly all the new clients; and many have hired second generation professionals incapable of generating new business or assuming leadership positions. Over the next decade, as costs rise and profitability begins to depend almost exclusively upon a firm’s ability to add new clients, Tweeners are not well-positioned to respond.

So, what should Tweener firms do? Unfortunately, the strategies for addressing the forces described in Chapter II that are available to Evolving Businesses simply are not viable options for Tweeners.

Like Evolving Businesses, Tweener wealth manager costs are rising at 5% to 7% per year (notwithstanding the fact that inflation remains low). However, 

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6 Precisely how many current Evolving Business wealth managers will be able to become so-called “Dominant Competitors” is unclear. Thirteen years ago while at Undiscovered Managers, some of the authors of this report published a study that predicted (based on what had happened in other segments of the financial services industry) that ultimately there would emerge 25 to 50 such giant firms. Given the challenge that the “growth conundrum” poses to sustaining the long-term profitability growth of a wealth manager and that today there are only about 200 Evolving Business wealth managers, it strikes us that this forecast remains reasonable.
because they typically operate at relatively robust margins (55% to 70%), they have far less room than Evolving Businesses to cut costs or improve efficiency.

Further, the ownership of Tweener firms is typically concentrated in the hands of very few owners and the overwhelming preponderance of their key employees’ remuneration is fixed. As a result, increases in costs are mostly unrelated to changes in the profitability of the organization.

The two remaining options available to Evolving Businesses – specialization and acquisitions of other wealth managers – are likewise impractical for most Tweener firms. More specifically, a specialization/premium price strategy requires that a wealth manager to continually upgrade a unique expertise in solving the extremely complicated problems of a relatively small segment of clients. However, most founder-centric Tweener firms lack the depth and breadth of professional staff to successfully execute the strategy.

Similarly, successfully acquiring and integrating another wealth manager into a Tweener firm is extremely complicated. It also requires a firm with an infrastructure capable of supporting a large number of additional clients at once. However, few if any Tweener firm owners have sufficiently reinvested back into their businesses to create such an infrastructure.

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**Becoming an Investment Manager in Lieu of Fixing the Wealth Management Business**

A small group of Tweener wealth managers are trying to forestall a decline in their businesses’ profitability by developing investment management products. They have ceased to solely be a wealth manager and instead are trying to repackage and sell to other users a portion of the same intellectual capital that they already generate for their wealth management clients.

For example, several firms currently manage their own proprietary hedge fund of funds (HFOF), which originally provided an efficient method for allocating a portion of their own wealth management clients’ assets to alternative investments. Because the incremental costs of managing additional assets within pooled vehicles are limited, some wealth managers are now attempting to separately market their HFOF to non-wealth management clients.

Other Tweener firms are marketing proprietary risk management products conceived in the aftermath of the financial market correction of 2008-2009 as downside protection for their own clients. They are now trying to repackage the same strategies as separate products with the hope of selling them to single family offices, small institutional investors and other wealth managers. Some firms have even created their own mutual funds, with dedicated marketing staffs, to offer these strategies.

Firms pursuing these strategies fail to recognize the fundamental differences between wealth management and investment management.

Investment management is a mature and brutally competitive industry. Wealth managers who launch investment products often do so on the preliminary thesis that the particular strategy of the product is unique, only
to discover later literally thousands of competing products. Additionally, new products, without an auditable long-term track record, are at an enormous disadvantage. Consequently, even if the strategy is compelling, convincing decision-makers to invest is extremely challenging.

In addition, the key determinant of the profitability of any investment management business is the cost of distribution. However, almost all distribution requires material upfront investments in additional staff, legal work and marketing. Additionally, by expanding into the investment management business, these organizations also expose themselves to a broader set of regulators, increasing their firms’ compliance costs. Thus, the firm must generate a substantial amount of incremental revenue from the new product lines simply to break even, much less delay the decline in profitability in their core business.

Finally, many wealth managers have predicated their marketing strategies for these products on the assumption that they will be able to persuade other wealth managers to employ them when investing their clients’ assets. However, their peers – due to a combination of personal ego and a healthy degree of skepticism about the wisdom of introducing their own clients to another firm with its own wealth management offerings – are typically very reluctant to invest their clients’ assets into a product produced by another wealth manager.

Consequently, very few Tweener wealth managers have had any commercial success in the investment management business.

We see three practical strategies for Tweeners over the next decade.

1. Convert into an Evolving Business

As noted earlier, there are a relatively small number of Tweener firms that are just beginning the process of becoming Evolving Businesses. They are different than most of their Tweener firm counterparts in that they have very capable and talented successor professionals and have made greater reinvestment back into their businesses. If these firms are able to take the necessary steps to evolve further, the four options described earlier likewise will be available to them for addressing the coming changes to the industry.

Unfortunately for most other Tweener firms, converting into an Evolving Business, while possible, will be extraordinarily difficult. The conversion requires a commitment from their owners to take a fundamentally different approach to managing their firms.

Most of these organizations are personal cash cows for their owners – they are designed to maximize short-term profitability so as to finance their owners’ lifestyles. The failure to reinvest in the business manifests itself in a number of ways.

First, the professional staff tend to be “care takers” – capable of servicing and retaining clients but incapable of generating new business. The result should be unsurprising: talented employees, employees capable of leadership, strategic planning and business development, are unlikely to join organizations, like Tweeners, that do not offer a career path.
Second, the ownership and economics of the firm are also largely in the hands of the founders. For the owners of many such Tweeners, sharing equity ownership – a critical factor in becoming an Evolving Business – can be emotionally challenging.

Finally, many owners of these kinds of Tweeners are “retired-on-active-duty” – that is, although they personally capture the preponderance of the firm’s economics and retain control over all of its major decisions, they do not work very hard (some visit their offices only once or twice a week). Thus, the idea of shifting to an Evolving Business model – which requires an extremely high level of personal accountability for everyone including the founders, substantial ongoing reinvestment back into the business at the expense of personal lifestyle and the sharing of the firm’s economics on the basis of individual contribution – is unfathomable for these individuals.

2. Sell to realize enterprise value

Another practical strategy for the owners of Tweeners is to sell their firm. As noted earlier, while these firms have little value on a standalone basis, they may have material value to a potential acquirer.

However, as we will explore much more extensively in Chapter IV, we believe that there will be far fewer transactions between wealth managers than current conventional wisdom may suggest. In part this relative paucity of deals will be because most Tweener firm owners lack a realistic understanding of their organization’s actual trajectory. Consequently, many will be unrealistic in their expectations of value or they will wait to sell until their firms are worth very little.
Waiting Too Long to Sell

As noted earlier, it is extremely hard for the owners of any wealth manager to fully grasp how much their economics will likely change in the industry’s new operating environment. However, the economics – and potential attractiveness as an acquisition target – of Tweener firms are at the greatest risk.

For example, consider the Tweener firm shown in Exhibit 3.7, DRB Wealth Management. It has $5 million of annual revenues and 60% gross operating margins. For another wealth manager in its geographic market that has between $4 million and $8 million of annual revenue, DRB might be an attractive, material acquisition for which it would pay a large amount of consideration.

However, if DRB remains a standalone business, this will change quickly. The revenue-weighted age of the clients (as shown in Exhibit 3.7) is about 69, fairly typical of most Tweener firms. With such robust operating margins, its operating costs likely will rise at least 7% per year (or about $140,000 in total next year), even if it is adding a relatively small number of new clients. Assuming it has annual client turnover of 3% and is adding about five new clients per year who on average pay $15,000 per year in fees, DRB’s long term trajectory is relatively grim. As shown in Exhibit 3.8, in five years its profitability will be about half of what it is today. Even worse, it is no longer attractive or material to many acquirers. It has only about $4 million of annual revenue and that is declining rapidly, making it immaterial to any potential acquirer that has grown. Even worse, its client base is far less attractive to a potential acquirer. As shown in Exhibit 3.9, the average age of its clients has increased and become far more concentrated with individuals who are likely to consume much more of their capital in the future. Quite frankly, why would any acquirer pay very much for a firm with this kind of client base?
3. Drift downward into a Book of Business

The third option available to the owners of Tweener firms – do very little to respond to the forces that will change the operating environment of wealth managers – is consistent with the strategy that many such firms employed to get to where they are today.
While they are successful, their success is in no small part due to the extraordinarily favorable environment in which they operated over their first two decades of existence and had little to do with any sort of strategic planning. Those owners who elect to continue to follow such a strategy will see their businesses gradually devolve into Books of Business.

**C. Strategies for Books of Business: survival in the new environment**

As noted in Chapter II, more than 90% of all industry participants are very small firms that fall into the Books of Business category. They typically have low annual revenue (<$3 million) and, while many do a great job of advising clients, they more closely resemble jobs than sustainable businesses.

To be sure, it has been a great run for their owners. The owners of many Books of Business have earned an attractive living for several decades without working particularly long hours. And, for most, the business has been fun. Owners of Books of Business have built close relationships with each other and have shared in the excitement of building a new industry. The profession has certainly been rewarding.

However, the changes sweeping through the industry over the next five to ten years will be quite unpleasant for Books of Business. They will have to spend a great deal more time and money on regulatory matters. Capturing new clients will become much harder and existing clients will become smaller as capital consumption accelerates.

Many such Books of Business firms also are very concentrated from a revenue perspective – i.e., although they have many clients, most of their revenue is generated by fewer than ten of them. Should only a couple of these larger clients depart the firm then all of these downward trends will accelerate.

This is not to suggest that these types of organizations are going to go out of business. Rather, their owners will have to work much harder than they do today while at the same time many will see their take home pay cut in half or even more. And while they may find someone to buy their business in the future, the consideration will be relatively de minimis.

To be sure, a very small number of the firms in this category are growing rapidly and still could potentially grow into “Tweener” firms or even into the “Evolving Business” category. Many such enterprises were started less than a decade ago and are owned by people in their late thirties and early forties. Their owners work extremely long hours and their take-home compensation is less than they would likely make as employees of other firms because they are reinvesting in their businesses on an ongoing basis.
IV. Future Shape of the Industry

An economist examining the wealth management industry would likely conclude that the next decade would be marked by massive consolidation. From the perspective of an economist, an industry with a highly fragmented competitive landscape, pressure on revenue growth, escalating operating costs and a high percentage of founders and owners approaching retirement would present a textbook case for a wave of strategic mergers, allowing firms to outrun a rapidly approaching squeeze on profitability. Consolidation would be the only rational outcome.

However, a psychologist conducting the same analysis likely would arrive at a markedly different conclusion. When interviewing the owners of the industry’s businesses, the psychologist would observe that they tend to be highly confident, fiercely independent entrepreneurs. They are also anchored to the belief that the operating environment of the next decade will resemble the benign conditions of the last two decades. Thus, few firms will see any need to achieve scale through strategic transactions. In other words, consolidation may be economically rational, but the industry’s decision-makers may not agree with the conclusion.

A. FN’s forecast: more concentration than consolidation

Our view is that the truth lies somewhere between these two extremes, though perhaps a bit closer to the perspective of the psychologist. We expect the next decade to be remembered as a period of concentration, in which the largest firms, the Evolving Businesses, overcame the challenges to growth and became substantially larger businesses, rather than a period of consolidation, in which hundreds or even thousands of firms ceased to exist.
We anticipate that the vast preponderance of the 18,000 firms in the Books of Business category will remain in business indefinitely. With limited barriers to entering the business and continuing demand for holistic financial advice, we see no reason to predict the extinction of the small, local advisory firm. The problem for Books of Business, however, is that the business is going to be much more challenging – owners will be paid much less over time and probably will have to work much harder.

At the other end of the continuum, a relatively small number of Evolving Business firms will capitalize on (as opposed to endure) the forces confronting the industry. Over the next five to ten years these top performers will become much bigger enterprises, far larger than their founders might have ever imagined when they first started more than two decades ago.

In reality, this shift is already happening as several firms in the Evolving Business category today generate more than $50 million of annual revenue and dozens generate more than $20 million of annual revenue. Some of these firms (as well as others that today are much smaller) through a combination of acquisitions and organic client growth will have as much $75 million to $150 million of annual revenue ten years from now.

The remaining firms in the Evolving Business category will become much more specialized and significantly larger enterprises. Some will merge with their counterparts and ultimately there will be about 125 to 150 very profitable wealth managers which will fall in this group.

How Big Is Big?

As noted earlier, all but a few wealth managers are very small businesses when compared to other industries. However, many owners by their very nature are quite competitive and regularly like to describe their firms as being “big” relative to other industry participants. They often point to their assets under management in making this claim.

Unfortunately, only Bernie Madoff spends assets. Given that we have encountered firms with as much as $3 billion of AUM but less than $3 million of annual revenue, it is our view that annual revenue is a much better metric than AUM for comparing the relative size of firms. So, what level of revenue constitutes a “big” wealth manager today when compared with its peers?

Evolving Businesses in general are larger than most of their Tweener counterparts and all Books of Business firms. However, in determining the relative hierarchy among Evolving Businesses, our analysis suggests that today any firm with less than $6 million to $7 million of annual revenue should be considered “small.” One with $7 million to $20 million should be considered “mid-sized” and those greater than $20 million are “large.”

But these benchmarks will most likely shift over the next decade. We project that in ten years firms with less than $20 million of annual revenue will be considered small. And only firms with at least $50 million of annual revenue will be viewed as large.
We suspect the greatest number of strategic transactions will occur within the Tweener category. However, we expect far fewer deals in aggregate than some forecasters (namely, investment bankers) are currently predicting.

For reasons discussed below, we estimate that, among the 1,000 to 1,200 Tweener firms, only between 50 to 70 will be acquired by other wealth managers, 10 to 20 by banks and perhaps another 30 to 40 by roll-ups. In other words, only about 8% to 10% of the Tweener firms in total will consummate a transaction.

The remainder of the Tweener firms will follow one of two paths: (i) they will undertake the steps necessary to become Evolving Businesses or (ii) devolve into Books of Business.

While it is unclear how many will take each path, there are at least 30 to 50 Tweener firms that we are aware of (and there probably are more) that are beginning the challenging and messy process of evolving their businesses. These organizations already have many talented potential successors; however, they have not yet broadened their ownership and institutionalized their marketing and branding. As part of their evolution some may acquire other Tweener firms and/or merge with an Evolving Business. Those that successfully evolve will ultimately be part of the ranks of the 125 to 150 smaller but very profitable and more specialized Evolving Businesses.

The outlook for the remaining Tweener firms is somewhat bleak. With aging client bases in the capital consumption phase of life and slow organic growth, their assets under management will slowly shrink while their costs continue to rise. Their profitability will begin a decline that at first may be gradual or even hard to detect but will accelerate suddenly at some point over the next four to seven years.

**B. Banks: unlikely to be material participants in wealth management M&A**

We frequently hear from industry commentators that banks will be big players in wealth management M&A over the next decade – a prediction that we believe is inaccurate for two primary reasons.

First, bank acquisition strategies are almost entirely “cycle-dependent” – a bank becomes an active acquirer during periods when its management team

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1 It is important to note that while there have been many reports and surveys over the last few years suggesting a high volume of mergers and acquisition activity in the industry, the preponderance of these transactions (in terms of number of firms as opposed to assets) have involved Books of Business wealth managers. Thus, in reality, most reported transactions are little more than the sale of a client list rather than the sale of a business. The 100 to 140 transactions that we are forecasting fall into the latter category.
believes that its stock is overvalued relative to the likely future earnings of the institution. The strategy is relatively simple: acquisitions financed with an inflated currency can provide a quick boost to earnings. During such periods, wealth managers are particularly attractive targets because their earnings do not correlate with traditional banking businesses that are closely tied to changes in the credit cycle.

Unfortunately for wealth managers hoping to be acquired by a bank, the equity markets currently are not paying a robust premium for bank earnings (and, thus, few banks’ stocks are inflated). Although the market could shift, an anemic economy and its accompanying limited opportunity for making attractive loans make it unlikely in the near term.

Second, and perhaps more importantly, as a result of the 2008-2009 market correction, far fewer publicly traded small banks – the logical bank acquirers, if any, for wealth management firms – exist today than ten years ago. Hundreds of small banks failed during the correction. Others were acquired. And still others – those that prudently did not take on a lot of risky loans – have grown immensely over the last five years and no longer are small institutions.

More importantly and unlike what has occurred in the aftermath of other, earlier financial corrections, the resulting void in the number of small banks has not been filled with new start ups. According to the American Banker, no de novo banks were chartered in either 2011 or 2012.

Because most wealth managers are too small to be material (and thus attractive) acquisitions to any but the smallest of banks, the decline in the number of those small banks should limit the number of wealth management acquisitions. More specifically, buyers are only willing to suffer the brain damage involved in making and integrating an acquisition target if the transaction has the potential to materially improve earnings. Most wealth managers (and in particular, Tweener firms) are too small to justify the risk-headache/reward tradeoff of such an acquisition.

However, we do believe that a very small number of large Evolving Businesses will be acquired as part of the 10 to 20 projected bank acquisition transactions. Their size will make them more material as potential acquisitions. However, as growing profitable businesses, their owners have little urgency to sell. Thus, the price paid by prospective acquirers will have to be very robust, making such acquisitions relatively unlikely until bank stocks are again very inflated.

**C. Roll-Ups: cash availability will constrain their number of acquisitions**

The wealth management industry is full of roll-ups. As a group they have completed to date about 50 transactions. All rely on a similar strategy: buy cash flow from numerous wealth management firms at a low multiple, pool the cash flow together and, finally, re-sell the cash flow to the public markets (in an IPO) for a much higher multiple as quickly as possible.

With an investment model premised on speed, the financial sponsors financing the roll-ups have an odd set of incentives. The long term sustainability of the acquired firms isn’t an issue – they simply want the acquired pool of cash flow to hold together long enough to complete an IPO. Consequently, roll-ups
Roll-ups are not particularly picky about the degree to which a wealth manager has (or will) become an Evolving Business.

Because roll-ups pay for their acquisitions with a combination of cash and private stock and the owners of target firms benchmark a roll-up transaction against the economics of simply keeping their firms, the key question becomes: what is the value of the stock component?

In a typical transaction, the roll-up acquires the preponderance of a wealth manager’s ongoing economics, a feature of the model that largely eliminates the economic incentives for the successor professionals to grow the business. Not surprisingly, roll-up-owned firms are far more vulnerable to the forces discussed in Chapter II. Thus, roll-ups are largely collections of Tweener firms that not only have little hope of become Evolving Businesses but are likely to devolve into Books of Business over time. So, why would anyone want to own stock in such an enterprise?

We have found that the owners who sell to roll-ups recognize that the stock portion of the consideration – regardless of whatever optimistic valuation metrics the roll-up purports to use – likely will never be worth much. In particular, in the very unlikely event that the roll-up is able to successfully complete a public offering, the preponderance of its aggregate economics will be allocated to its debt and to the preferred shares held by its financial sponsors, leaving little value for the shares that owners receive as consideration. Further, subsequent to the initial public offering, the shares that they hold (unlike those of the roll-up’s financial sponsors) will be largely restricted from sale for a long period of time (typically three years), creating great uncertainty as to what they ultimately might receive for them.

Consequently, most owners have demanded that the cash portion of the total consideration be on its own more compelling than retaining the business. Typically, the selling owners then personally take most of the cash and allocate most of the stock consideration to their successors.

However, this demand by sellers for substantial amounts of cash as part of a transaction effectively limits the number of wealth manager acquisitions that roll-ups will ultimately consummate. The economics of roll-ups are highly dependent upon persuading sellers to accept as much stock consideration as possible and their ability to pay cash consideration is very constrained. But because any rational owner’s decision to sell is tied almost entirely to the amount of cash he or she receives as part of the transaction, we project that roll-ups will acquire only about 30 to 40 more (almost entirely Tweener) wealth managers over the next ten years.

**D. Wealth manager acquisitions of other wealth managers: a rational option with irrational challenges**

As noted earlier, any rational economic analysis of the wealth management industry would point to massive consolidation.

Acquisitions are essential for Evolving Business firms that hope to continue to grow their profits at a high rate over the next decade. With sustainable ownership structures, talented professional employees, ambitious management teams and the ability to quickly integrate and service large
volumes of established clients, acquisitions present the best opportunity to grow in a non-linear fashion.

At the same time, selling can be a rational strategy for the owner of a Tweener. For those Tweener firms unwilling to make the reinvestments required to become an Evolving Business, selling the firm provides an opportunity to (i) address succession planning concerns, (ii) provide a long-term home for their clients, (iii) create career paths for successor professionals and (iv) maximize enterprise value for the owners (the ability to capitalize and scale and eliminate redundant costs typically permits an Evolving Business to be the highest bidder for a Tweener firm).

Notwithstanding the fact that acquisitions in the wealth management industry can be structured in ways that make a great deal of economic sense for both buyer and seller, we believe that only 50 to 70 wealth managers will be acquired by their peers over the next decade.

One factor limiting the number of transactions is that many Tweener firms – the most obvious acquisition candidates for Evolving Businesses – have unattractive client bases due to either or both concentration risk (the revenue of many Tweeners is dominated by a handful of client relationships) or demographics (as noted earlier, many Tweener client bases tend to be quite old).

However, the real challenge in executing a transaction is overcoming the inexperience on both sides of the negotiating table – wealth management firms have no experience in M&A transactions as either buyer or seller. Consequently, owners of these firms are acutely unprepared to deal with the complexities inherent to buying and selling businesses that have no material tangible assets.

Wealth management deals are premised (and valued) on the ability to transition to the buyer the goodwill built up over many years between the seller and its clients. In other words, all of the value is contained within the very human relationship between the seller and its clients. Consequently, psychology – navigating human preferences, emotions and biases – becomes far more important than economics in successfully consummating a deal.

We see four primary non-economic hurdles to wealth managers completing acquisitions of other firms.

1. **Sellers have unrealistic expectations**

Many wealth management sellers are unrealistic about the value of their businesses and, therefore, their bargaining power in a transaction. Driving this lack of realism is an absurdly optimistic expectation of their firm’s likely future profitability as a standalone enterprise, despite all of the changes that are sweeping through the industry.

As noted in Chapter III, few firms have quantified the future trajectory of their businesses under realistic assumptions regarding, for example, new business development, investment returns, client capital consumption rates, compensation costs, etc. Instead they take the cognitive shortcut of assuming that the future will resemble the past. Most will concede that their own “worst case scenario” is a long, slow decline as they approach their own
retirement dates. But in all cases, the owners assume that they will continue to be able to take a substantial amount of money out of their businesses into the foreseeable future.

However, potential buyers have no such illusions and clearly can see how the economics of the selling wealth manager will change over time. This gap in reality can create an insurmountable gulf between what a buyer will pay and a seller will accept.

2. Buyers have unrealistic expectations

At the same time, a lack of realism is not the exclusive domain of the sellers. Many firms with a stated goal of acquiring other wealth managers are only willing to consider a seller that would be a “perfect fit” – in other words, a seller with high growth potential, a client base that resembles their own, top-tier professional employees, similar corporate culture and, of course, an identical investment philosophy. In short, typical buyers believe that they should not be troubled to change any of their own operations in connection with an acquisition.

Consider for a moment the absurdity of this perspective. A material acquisition is the economic equivalent of a wealth manager instantly increasing the size of its existing client base by 75% to 100%. Growth at that level – regardless of its cause – will irrevocably change any wealth manager. Moreover, any firm meeting the criteria for a “perfect fit” probably would not be for sale in the first place. In fact, most owners choosing to sell do so precisely because imperfections in their firms make a sale to another wealth manager the most efficient strategy for unlocking any enterprise value.

3. All material acquisitions require material amounts of capital

Any acquisition worth pursuing will require a material amount of permanent capital to finance the purchase price. Quality sellers will have multiple suitors and the competition among them drives the purchase price to rational levels. Furthermore, payments to sellers must be made out of after-tax cash flow (for example, to make a $10 million closing payment, the buyer is effectively using about $20 million of pre-tax cash flow).

However, few (if any) wealth managers – or their owners – have the means to finance an acquisition without the assistance of an outside capital provider. Unfortunately, even fewer wealth managers have any experience in raising capital. Consequently, owners of wealth managers tend to be downright delusional when it comes to raising capital to fund an acquisition.2

Some (foolishly) cling to the belief that they can fund a materially accretive transaction solely with non-recourse term debt. However, wealth management deals are a poor fit for classic debt financing for several reasons. First, lenders like collateral, hard assets that can be sold to repay the debt in a worst case

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2 In fairness, most wealth managers are simply naïve. Some have personally raised (or seen others raise) small amounts ($1 million to $3 million) from wealthy individuals (perhaps even clients) who were unsophisticated in understanding the economics and enterprise value of wealth managers and thus, made few demands in exchange for their capital. However, the market (and resulting terms) for substantially larger amounts of capital is quite different. Others rely on the advice of either a client or a friend who is an “expert” in capital raising and / or mergers and acquisitions. While these “experts” may have some experience in either or both activities, he or she typically has no experience with wealth management businesses.
scenario. The absence of hard assets severely constrains the amount of debt financing available for wealth management deals.

Even among the owners who recognize that they will require a large amount of permanent capital to make acquisitions, most are completely unfamiliar with market terms for equity financing. They refuse to accept that outside capital providers expect to receive cash flow as well as some say in how the business is managed post-transaction. Still other potential acquirers somehow believe that they can effectively “rent” equity capital – i.e., they can demand the right to buy out the capital provider in the future, regardless of whether it is in the provider’s best interest. Some even expect to raise a “blind pool” of capital (i.e., a line of committed capital which the wealth manager can use with few restrictions to acquire other firms).

In reality, even wealth managers with $1 billion to $5 billion of AUM are still very small businesses. After paying their owners a market level salary, almost all earn less than $20 million per year (in fact, most earn less than $10 million.) In other words, they are “mini-micro” cap companies. And while they could be very profitable and valuable enterprises at some point in the future, none will ever be the next Facebook or Google.

Rather, as tiny businesses with no tangible assets and far less potential upside than a technology start-up, the capital raising options for wealth managers are relatively limited. Any sane capital provider is going to demand both a contractually defined set of cash flows and a series of contractual governance rights that – at a minimum – prevents the owners of the wealth manager from unilaterally changing the economics of the capital provider’s ownership stake.

4. Buyers and Sellers underestimate the degree to which wealth management deals are “three-handed”

Both buyers and sellers typically fail to recognize the relevance of a third party to the transaction – the successor professionals of the seller, regardless of whether they are owners.

Consider for a moment what any buyer is actually acquiring in a wealth management transaction: a portfolio of relationships with the seller’s clients. The typical Tweener firm owner has a group of professional staff who service the firm’s clients on an ongoing basis and, thus, are integral to increasing the likelihood that the acquirer will retain the clients after closing. Consequently, for any (rational) acquirer, retaining and motivating the seller’s professional staff post-closing is critical to the success of the transaction.

However, in almost every transaction, the professional staff recognizes this fact and the bargaining power that it provides. And they (understandably) use this power to participate in a portion of the value created from the transaction.

At the same time, there is a finite amount of economics which the buyer is prepared to pay for an acquisition. Whatever is given to the seller’s successors comes directly out of the consideration potentially paid to the selling owners, the individuals who took the risk involved in building the firm in the first place.

The resulting clash between the interests of the selling owners and their successors typically unleashes a series of emotions that have been repressed...
over many years. Invariably, both sides at some point feel as though the other is taking advantage of them. Finding a middle ground that will allow for a transaction to be consummated is extraordinarily difficult.
### Exhibit 5.1  **10 Traits of Successful Sellers**

1. Decide to sell while they are still attractive and material to potential acquirers  
2. Do not go to market until they are mentally prepared to sell their businesses  
3. Are realistic about the economics they will achieve if they retain their firms  
4. Are prepared for a difficult, very emotional and time-consuming process  
5. Understand the buyer's perspective and make it easier for them to bid  
6. Recognize that buyers invariably underpay for rapid assumption of risk and overpay for certainty  
7. Recognize that transparency benefits the seller and helps buyers understand the "facts"  
8. Recognize that pricing is based solely on contribution and not EBITDA, AUM or revenues  
9. Accept that they are selling their firm to, and not merging with, the buyer  
10. Make wise choices in selecting and managing their transaction advisors

### Exhibit 5.2  **10 Traits of Successful Acquirers**

1. Understand that all commercial activity with wealth managers is predated by relationships  
2. Understand that all potential acquisitions are very low probability events  
3. Appreciate that the longer it takes for a deal to get done, the less likely it is to close  
4. Pragmatic in evaluating potential sellers and how an acquisition will change their own organizations  
5. Accept that they are going to have to pay sellers a large amount of consideration, including at closing  
6. Recognize that their capital raising options are limited and will include unattractive aspects  
7. Recognize that success in transactions is ultimately based more on psychology than finance  
8. Understand and appreciate that the seller's successor professionals are important and scared  
9. Focused on ensuring (and communicating to the seller the importance of) a continuity of client experience  
10. Prepare detailed transition plans
V. Traits of Successful Sellers and Acquirers

As noted earlier, notwithstanding the compelling economics of acquisitions within the wealth management industry, we are expecting to see a relatively limited number of transactions because of the inexperience of firm owners with M&A transactions. When two extremely inexperienced parties try to merge together, the process is somewhat analogous to virgin porcupines trying to mate – there are more than a few obstacles and risks in the way of a successful outcome.

In the course of our research for this study, numerous owners of both Tweener and Evolving Business firms who we interviewed expressed an interest in learning how to best position their firms as either a buyer or a seller. We also found in our discussions with them that there is an immense gulf, with respect to how M&A transactions work, between their perceptions and reality. Thus, we thought it would be useful to include in this study a chapter on the traits of the most successful sellers and acquirers.

A. Traits of the most successful sellers

1. Decide to sell when they are still attractive and material to potential acquirers

Those owners who have had the greatest success in selling their firms decided to sell when their organizations were still attractive and material to potential acquirers. More specifically, the attractiveness of any wealth manager (but, in particular, a Tweener firm) as an acquisition candidate may diminish over time for two reasons.

First (and as noted earlier), the average age of most wealth manager client bases will likely significantly increase over the next five to ten years. This demographic shift is problematic because older clients typically consume larger amounts of their capital over time and, thus, pay lower wealth management fees. Moreover, prospective acquirers recognize that older clients’ rates of capital consumption are not static. Rather, the rate of consumption accelerates as clients age.

Consequently, the revenue-weighted average age of a wealth manager’s clients is a key determinant of its attractiveness. Buyers (understandably) pay less for firms with older clients than those with younger ones. More importantly, at some point a wealth manager’s clients may become so old that the firm ceases to be a rational target for any buyer.

Second, (rational) buyers are only interested in transactions with the potential to materially improve profitability. In other words, an acquirer that currently has $10 million of revenue and $5 million of gross profitability would likely have great interest in an acquisition that would increase its profitability by another $5 million but far less interest in a deal contributing just $1 million to $1.5 million.

Size matters because all potential acquisitions have a very low probability of actually closing. And, regardless of size, all deals involve an immense amount of work and headaches. Thus, the limited rewards of an immaterial acquisition do not justify the investment of an acquirer’s time and resources.
Many wealth managers that are material potential acquisitions today are unlikely to remain so indefinitely. The 200 or so Evolving Business firms that constitute most of the prospective acquirers are growing, while most Tweener firms are stagnant or shrinking. Thus, a Tweener firm that currently has $5 million of revenues and today would be a potentially compelling acquisition for many firms in its geographic market should expect to be far less attractive in five years. And in ten years it may be unable to generate much interest from any buyer.

2. Do not go to market until they are mentally prepared to sell their businesses

At the same time, smart sellers do not begin down the path of a sale process until they are mentally prepared to actually close. The final decision to sell is extremely emotionally challenging; sellers often walk away from a deal unless they are over a sort of mental Rubicon.

We understand the surface appeal of “testing the market” and getting a sense for transaction options and valuation. Unfortunately, there are few better ways to damage the potential value of a wealth manager than to take it to market and, at the last moment, renege on a transaction.

The sellers’ successor professionals have increased bargaining power after a failed sale process. A transaction heightens awareness of their importance to the organization’s ability to monetize its enterprise value as well as the (often vast) disparity in their ongoing remuneration as compared to the economics that have been paid to the owners for many years. Consequently, in our experience the owners of the seller are nearly always forced to renegotiate the economic bargain with the successors in order to retain them.

Even worse, the bidders who participated in the sale process are (understandably) reluctant to participate in any future sale of the firm. They also are going to wonder why the transaction with the original winning bidder never closed, likely assuming something (very bad) was uncovered in due diligence. Thus, even if they can be brought back to table, their future bids will be much lower.

3. Are realistic about the economics they will achieve if they retain their firms

In evaluating offers, a rational seller considers the relative tradeoffs between retaining the business and selling it. However, doing so requires the seller to realistically assess the future trajectory of the firm’s economics on a standalone basis.

Unfortunately (and as noted in Chapter IV), most owners of Tweener firms have yet to analyze, in an objective and quantitative manner, the likely trajectory of their firms. Instead they remain blind to the inevitable changes that are occurring throughout the industry and to their individual businesses. Thus, many continue to believe that they will be able to take out large amounts of money each year for the foreseeable future as a standalone enterprise.

This Pollyannaish viewpoint is problematic because it makes many owners unrealistic as to what buyers should and will pay for their firms. Acquirers can clearly see the actual trajectory of a business and will pay accordingly (though, perhaps ironically, many acquirers struggle to be as objective and realistic
about their own businesses. And this lack of realism among many selling owners is (as noted earlier) a key reason why so few transactions ultimately will be consummated.

The most sophisticated sellers conduct (and do not shy away from) detailed analyses of their firm’s trajectory and economics as a standalone business. They know that they will have to weigh many factors in determining what to do with their firms. A realistic trajectory analysis facilitates a more informed decision.

4. Are prepared for a difficult, very emotional and time-consuming process

Any owner considering a sale should be emotionally prepared for a challenging process.

All sales processes are lengthy – at a minimum, nine to twelve months from start to finish. The workload can be overwhelming – sellers should expect late nights reading legal documents and weekend conference calls with the buyer. Further, it will be an emotional roller-coaster. For owners, the sale of their business is more than just an economic event. Rather, it also marks the end of a phase of their lives and focuses them on their own mortality.

Unfortunately, many less sophisticated sellers cannot handle the stress. Many reach a point of capitulation well short of the closing; at some point in the negotiation, suffering from “deal exhaustion,” they resolve to complete the sale quickly, regardless of their own outcomes.¹

In contrast, the most successful owners prepare in advance for the challenges of the process itself. They discipline themselves to not overreact to any new information. They likewise appreciate that they might not fully understand what the buyer is saying at different points during the process. Thus, they avoid the temptation to feel slighted or insulted, understanding that no rational buyer would ever want such an outcome. Moreover, they remain focused on the big picture (namely, the aggregate outcomes from the transaction) and do not let the minutia that is endemic to any deal to drive their decision making.

5. Understand the buyer’s perspective and make it easier for them to bid

As important as it may be for sellers to understand their own emotions, it is equally essential for sellers to recognize that the management of a potential acquirer is also going to be (understandably) nervous. Most buyers have never made a prior acquisition. And at closing they will write a multi-million dollar check to the seller without any certainty that the seller’s clients will transfer to and remain with their firm.

Additionally, simply working on (much less successfully closing) a potential acquisition is as disruptive to the buyer’s organization as it is to the seller’s. In a relatively short period of time the acquirer is going to have to analyze the seller’s economics, clients and professional staff and figure out what it is willing to pay. Additionally, simultaneously with the due diligence

¹ Many owners of wealth managers are often surprised when they learn the (unfavorable) terms which their peers agreed to when selling their firms and wonder what led these individuals to such an agreement. In our experience, unfavorable transactions often can be directly traced to deal exhaustion. Sellers are unable to control their emotions and become so tired of the transaction process that they just want it to end by agreeing to terms which no rational seller would ever accede to.
process, the acquirer will likely have to raise some outside capital to fund the acquisition.

The time involved in preparing and negotiating a bid for another firm will dominate the acquiring organization’s time, resources and emotional energy for almost six to nine months prior to closing. Post-closing integration of clients, staff, systems and procedures adds at least an additional year to the equation.

In the case of Evolving Business acquirers, typically only one or two individuals take the lead on the entire transaction process: they are responsible for leading due diligence, arranging financing and, ultimately, building a consensus within their own firms to make a final offer to the seller. These individuals face a difficult task. If they are unable to persuade both the capital provider and their fellow owners to support the transaction, their firm ultimately will not be a buyer.

There is a temptation for many potential sellers to view these issues as “buyer problems.” However, such a viewpoint can be extremely self-destructive to the seller’s own interests.

For every seller there are only a handful of wealth managers who are economically and culturally attractive as buyers. In fact, in many transactions sellers discover that there is often only one firm to which they are comfortable selling their business.

From a cultural standpoint, the selling owners and professional staff are going to have to work at the acquirer for several years after the transaction closes. The seller’s clients are going to become the clients of the buyer and the success of that transition will be a major determinant of the aggregate consideration ultimately paid to the selling owners.

Consequently, a seller’s challenge is to find a wealth manager that both offers an attractive cultural fit (for both clients and staff) and possesses the means to pay a full price. This is no small challenge; the last thing any rational seller wants to do is to discourage any firm from bidding.

Smart sellers attempt to facilitate the bidding process. They try to ameliorate buyer anxiety throughout the process. They do not use buyer-seller meetings to spend all of their time talking about themselves, their desires, demands and fears. Rather, they try to understand the internal dynamic that the representatives of different potential buyers must address. They also help these advocates to build a consensus within their organizations that an acquisition would produce a great outcome for the buyer.

6. Recognize that buyers invariably underpay for rapid assumption of risk and overpay for certainty

Risk is a critical element in pricing an acquisition. Buyers typically will “underpay” in transactions in which they must rapidly assume large amounts of risk and “overpay” for greater certainty.

Perhaps the most difficult due diligence issue is assessing the risk associated with transitioning the seller’s clients to the buyer. Without any direct access to the seller’s clients, buyers struggle to rationally determine the odds that
those clients will become “sticky” long-term clients. Consequently, there is a tendency of acquirers to overestimate the risk of client loss in a transaction (and, thus, pay less than they should).

Bizarrely, we have found that many potential sellers (and even their advisors) do not recognize that a non-linear relationship exists between potential price and degree of buyer certainty – transaction structures that make modest concessions to addressing risk will result in material improvements to valuation. For example, many sellers are reluctant to get a large percentage of their clients to affirmatively consent to the transaction.²

Consider for a moment how irrational such behavior is and why it is so contrary to the seller’s best interests: sellers are trying to persuade buyers to pay them large amounts of consideration solely tied to the assumption that the seller’s clients will become long term clients of the buyer. But, at the same time, the selling owners are effectively signaling that they have little confidence of such an outcome. Quite frankly, there is no better way to scare off potential buyers, much less encourage them to lower their bids.

For example, if a seller is unable to get its clients to affirmatively consent to a transaction, what chance does the buyer have of retaining them immediately after closing, much less over the long term? Further, if a seller is mostly focused on the consideration paid at closing, how confident can any buyer be that the seller will help ensure a smooth transition?

In contrast, sophisticated sellers go out of their way to provide buyers with as much certainty as possible. Some will often agree to get a higher percentage of their clients to sign affirmative consents than is typical or even what a buyer might ask for. And while they (understandably) expect to receive a material closing payment, they also recognize that any sane buyer will demand that a material portion of the potential consideration be tied to post-closing performance.

7. Recognize that transparency benefits the seller and helps buyers understand the “facts”

In a similar vein, buyer uncertainty as to the quality of a firm’s client base, personnel and systems is very costly to a seller. In the absence of information, prospective acquirers are only going to assume the worst and discount their bids accordingly.

To be sure, we have encountered more than a few prospective sellers who are “offended” when buyers want to conduct a robust due diligence process on their firms. Some even believe that they can shield their firm’s true condition and prospects by providing acquirers with bullish financial projections that are

² In connection with all transactions, the assignment of investment advisory contracts to the buyer requires the consent of the seller’s clients. Depending upon the state in which the seller resides, this consent process can often be completed in one of two ways. The first – affirmative consent – involves going to clients and requiring that they sign and return an agreement consenting to assignment. The second – negative consent – is a process by which clients are notified that their agreements will soon be assigned to a potential acquirer unless they object.

Clearly the former provides any buyer with much greater certainty that the seller’s clients understand that they are about to be advised by a different organization and are agreeing to this arrangement. In contrast, it is unclear to any buyer that with the latter process the seller’s clients are fully aware of what is happening. Consequently, buyers will typically require that a certain percentage of the seller’s clients (in particular, the largest ones from a revenue perspective) sign affirmative consents as a condition to closing.
divorced from reality. After little to no net new client growth for several years, sellers provide projections that assume a flood of new clients and rapidly growing profitability.

Such projections – often assembled by investment bankers attempting to put “lipstick on a pig” – are typically viewed by buyers as both humorous and somewhat insulting to their intelligence. And the only thing that such ridiculous forecasts accomplish is to lead prospective acquirers to be skeptical about everything else that a seller will say in the future.

In reality, if a seller is an attractive firm, it is in its interest to make sure that prospective buyers understand as much about it as possible. The challenge is how to best educate potential buyers.

8. Recognize that pricing is based solely on contribution and not EBITDA, AUM or revenues

Sophisticated sellers also recognize that the purchase price paid by any (rational) acquirer is going to be solely tied to its risk-adjusted forecast of how much it will make from the acquisition over time. It will try to identify its marginal cost of integrating and servicing the seller’s clients and also estimate the likely fees it will capture from them in the future.

Smart sellers also understand that any potential buyer will conduct its own analysis to determine what will be the likely marginal costs and potential contribution from an acquisition. Thus (as described above), sophisticated sellers will work with a prospective buyer so that it precisely understands the level of resources (and associated marginal costs) required to retain the seller’s clients.

Unfortunately, many sellers take a different approach. Some expect that valuation will be based on metrics such as standalone EBITDA, AUM or revenue. Sellers will find, however, that the only financial metric relevant to a buyer’s analysis is post-closing contribution to earnings – all others are irrelevant.

Other sellers believe that they are in the best position to determine the post-closing contribution to earnings. Consequently, these sellers (often with the help of their investment bankers) spend many hours preparing detailed projections that typically assume relatively modest marginal costs for the acquirer. It is not uncommon in such instances for a seller with twenty or more employees to claim that the buyer could hire as few as two or three without jeopardizing client retention.

Similar to the (absurd) standalone financial projections described earlier, preparing these types of contribution analyses are largely a waste of time for a seller. Quite frankly, acquirers will conduct their own analysis and will not be swayed by projections provided by the seller. Moreover, these kinds of contribution analyses often lead potential sellers to inflated valuation expectations.

For example, valuations based on cash flow (EBITDA) multiples that are often mentioned at industry M&A events are always calculated by reference to the seller’s cash flow on a standalone basis (i.e., before elimination of any redundant costs). If a seller were to apply those multiples to a calculation of the contribution to a buyer’s earnings (i.e., after elimination of redundant costs), the seller would arrive at a valuation no rational buyer would be willing to pay.
9. Accept that they are selling their firm to, and not merging with, the buyer

For buyers, acquisitions are economic transactions, an opportunity to capitalize on their existing platform and dramatically increase their earnings. However, striking a bargain on price that makes sense for both buyer and seller requires significant changes to the seller’s operations. Some (if not most) of the seller’s staff will be let go. Locations are consolidated. The seller’s client relationships and other systems over time are shifted to the buyer’s technology platform. And the investment strategies used by clients of the two firms are gradually merged.

This element of change can be incredibly difficult for many selling owners. They have spent a great deal of their lives building their firms. They enjoy running them and having ultimate authority over all major decisions. Sophisticated sellers, however, recognize that they are not merging their firm with the acquirer. Rather, they are selling it and that is why they are getting paid a lot of money.

Consequently, they accept that the enterprise that they built over many years will look very different in the future. Similarly, they personally will have significantly proscribed future roles in the combined enterprise. Most importantly, they no longer will be the decision makers.

Smart sellers prepare for these changes. Some spend time with an executive coach or counselor discussing the next phase of their lives prior to ever bringing their firms to market. They know that after they sell their firms they will be entering the next phase of their lives and, with some thoughtful planning, the transition will be much smoother.

In contrast, potential buyers do not want to discover during the diligence process a seller who will be unwilling to let go. From the perspective of the acquirer, the “headache” factor in the transaction quickly achieves migraine levels if the selling owners expect to have any significant say in how the combined enterprise will be run post-closing. The potential economic benefits from the transaction can be outweighed by the brain damage involved.

10. Make wise choices in selecting and managing their transaction advisors

Smart sellers recognize that they should retain a high-quality attorney to assist in navigating the sale process. Some (but definitely not all) firms may also need help from an investment banker. However, sophisticated sellers carefully select and manage their advisors and compensate them rationally.

All M&A transactions require specialized legal advice – a local tax, real estate or trusts and estates lawyer is not qualified to represent you in the sale of your business. However, general M&A experience in other industries also provides an insufficient background for transactions in the wealth management industry. In wealth manager transactions, there are no hard assets – buyers are paying for the relationships the seller has established with its clients.

Unfortunately, there are only a handful of capable attorneys who have any real understanding of the wealth management business and have completed multiple transactions. And the good ones charge a great deal for their intellectual capital. (However, so too, do wealth managers with their clients.)
Legal Experience with Investment Managers Does Not Translate to Wealth Managers

There are numerous attorneys who claim to have expertise advising wealth managers in M&A. But a closer examination of their prior transactions often shows that their experience is with investment managers and not wealth managers. While both are subject to a similar regulatory framework and share many similar terms and a lack of tangible assets, the two industries are quite different, making these attorneys’ prior experience of little use to wealth managers.

More specifically, investment management firms are analogous to financial manufacturing businesses – they manufacture products that are largely sold based on their historical performance. Thus, investment managers have immense operating leverage but their economics are mostly driven by their distribution costs, forcing them to become much larger (than wealth managers) in order to have sustainable profitability. A byproduct of this need for greater scale is that the overwhelming preponderance of investment management M&A transactions involve firms which have revenues which are an order of magnitude greater than that of most wealth managers.

In contrast, wealth managers have a fundamentally different economic model. At their core, they diagnose and solve individual client problems. They have a fraction of the operating leverage of investment managers and (most) are unable to use investment performance records in marketing their services. They also are much smaller companies.

All of these factors make the legal advice that is most useful to a wealth manager very different from that which would be for an investment manager. In particular, the market standards for the allocation of risk in purchase agreements are fundamentally different for smaller companies than for larger ones. Further, those factors and issues which will most affect both buyer and seller outcomes in wealth management transactions are also very different than those in investment management.

While sophisticated sellers accept that they are going to have to pay robust legal fees they also require that their attorneys prepare a detailed budget before beginning work. Although most attorneys hate doing so, budgets impose a level of discipline and mitigate the risk that the lawyers waste their time (and the seller’s money) on issues that do not really matter.

Further, sellers are paying their attorneys for legal and not business advice. An attorney’s job is to document the transaction and negotiate legal issues – but not to negotiate business points. And few things more inflate the costs of a transaction than when a seller’s lawyer forgets his or her role and tries to morph into an investment banker.

Similarly, attorneys are supposed to be the calmest people in the room who facilitate getting a deal done. Unfortunately, some attorneys allow their egos to take a transaction hostage, dramatically increasing legal fees and putting a closing at risk.
Thus, sophisticated sellers recognize that the attorney they need is a technician with a very specialized expertise. General corporate attorneys with whom they have worked with in the past probably should not advise them in the sale of their business. They also avoid any and all flamboyant and/or self-important attorneys as well as those who claim any expertise as “deal makers.”

Similarly, smart sellers also only select investment bankers with extensive wealth management experience. Such advisers can be particularly useful in those transactions involving very large firms with multiple owners, helping the organization to arrive at an internal agreement. They also can add a great deal of value as the selling owners’ “psychiatrist”, helping guide them through the emotionally challenging sale process.

Additionally, in almost every transaction the seller will be paid a portion of its consideration over several years. At the same time, investment bankers typically will want to receive most (if not all) of their fees at closing. However, smart sellers never pay fees on that portion of the consideration which is paid in private stock until it is public and free to trade or has been liquefied.

B. Traits of the most successful acquirers

1. Understand that all commercial activity with wealth managers is predated by relationships

All commercial activity in the wealth management industry is predated by relationships. More specifically, wealth managers are reluctant to transact with anyone (e.g., mutual fund companies, money managers, custodians, etc.) prior to investing a great deal of time getting to know the counterparty, its people, its values and its capabilities.

Sophisticated buyers recognize this trait when it comes to merger and acquisition transactions. Thus, wealth managers with plans to acquire other firms conduct detailed studies of the industry landscape in their geographic region, the demographic profiles of firm owners and how these organizations market themselves to prospective clients. And they build relationships with the owners of each firm that at some future point could become an acquisition target.

To be sure, the potential acquirers have no idea as to whether a firm will ultimately be for sale or, if so, when. However, they also know that if they have been able to build a relationship with the owners of a potential seller, their chances of success are significantly greater if it is ever brought to market.

2. Understand that all potential acquisitions are very low probability events

Sophisticated acquirers also recognize that the likelihood of completing any one particular acquisition, regardless of its size, is extremely low. So many factors (e.g., timing, pricing, personalities, etc.) must line up all at once for any deal to be consummated.

However, they also understand that the resources involved in pursuing a transaction that does not close can be immense. Thus, they carefully manage their time and energy in pursuit of new deals. More specifically, a sophisticated buyer does not waste time on acquisitions that will not materially improve the organization’s profitability. The opportunity cost involved in trying
to consummate an acquisition is so great that, if successful, the deal must provide the acquirer with an immense immediate financial benefit to make the inherent risk/reward tradeoff rational. Further, they know that larger acquisitions often have a greater success of closing because selling owners are typically much more realistic than those of smaller firms. (In fact, there tends to be an inverse relationship between the sanity of an owner and the size of his or her firm.)

Smart buyers also try to minimize how much time and emotional energy they spend on a prospective transaction until they are confident that it offers reasonably attractive economics and that they are dealing with a rational seller who is emotionally prepared to sell his or her business. As noted earlier, if a seller is either delusional about value and/or is not yet over the necessary mental Rubicon about selling the business, further pursuit of the acquisition will be only a waste of the buyer’s time.

To be sure, sophisticated acquirers also understand that selling owners are likely going to be extremely emotional throughout the transaction process. Thus, the buyers have to be patient, ignore some of the selling owners’ more outrageous outbursts and somehow try to deduce the selling owners’ true intent.

Ultimately, the most sophisticated acquirers view the early stages of a transaction solely as an opportunity to create some option value for their firms. In other words, they recognize that until they sign a purchase agreement, they can always walk away. And while the ultimate goal is to be in a position to buy the seller, a smart buyer only expends the minimum amount of time (and emotional energy) that is necessary to determine whether a transaction makes sense. And under no circumstances do they disrupt their own organizations until they are convinced such conditions exist.

3. Appreciate that the longer it takes to for a deal to get done, the less likely it is to close

Once a smart buyer has identified an opportunity to make a material acquisition, speed becomes an imperative; the longer a transaction process drags out, the less likely the deal is to close. Deals are all about momentum. Too many unpredictable variables (e.g., the seller gets deal exhaustion or second thoughts, a new buyer shows up out of nowhere and tries to preempt the process, tax laws change, etc.) can suddenly materialize, causing the opportunity to vanish. And all of the time, money and energy the acquirer has invested in trying to complete the deal have been wasted.

Consequently, smart buyers do whatever they can to sustain the momentum of a potential acquisition and close it as fast as reasonably possible. Accomplishing this requires working nights and weekends – you effectively pick up a second full time job. And although the seller may at times seem to be dithering, it is in the acquirer’s self-interest to never be the source of delay in a transaction.

4. Pragmatic in evaluating potential sellers and how an acquisition will change their own organizations

Sophisticated buyers are very pragmatic when it comes to acquisitions. They recognize and accept that every acquisition comes with its own set of
idiosyncratic problems and challenges. Moreover, if they disqualify potential opportunities simply because they are less than perfect, they have no chance of succeeding and should not waste their time considering acquisitions.

Further, they recognize that integrating an acquisition into their business will require a great deal of work and compromise. However, if the benefits from the acquisition outweigh the associated costs and the associated brain damage, smart buyers are adaptable enough to make the transaction work.

A key part of their pragmatism is also being disciplined and focused on the larger benefits from the transaction and ignoring the many nuisances that invariably accompany any deal. For example, it is not uncommon for a potential seller to try to “nickel and dime” the acquirer over every marginal cost in the transaction. Although the (understandable) tendency of most buyers is to get angry at this behavior, smart buyers largely ignore it. Provided the economics are sufficiently compelling from the transaction, they do not allow themselves to get upset when the seller begins acting selfishly.

Further, sophisticated buyers recognize that their businesses will be significantly changed by a material acquisition. And although it has been run in a certain way – i.e., focusing on only a narrow type of potential client and providing only a specific set of services – it will function differently after closing the transaction. However, smart buyers recognize that all firms will change as they grow over time – regardless of whether the growth is organic or in connection with an acquisition.

5. Accept that they are going to have pay sellers a large amount of consideration, including at closing

The market for sellers with attractive businesses is relatively efficient.

Most large wealth managers are finding that it is hard to sustain a high rate of organic growth. Consequently, there is no shortage of potential buyers for attractive, material firms. As with any other market, this level of demand has made it relatively efficient, full-priced and certain to include a significant cash closing payment.

To be sure, it can be emotionally difficult for a potential buyer to accept that the selling owners will be paid so much for their firms, in particular when the business is only owned by one or two individuals. However, sophisticated acquirers worry about their own economics and not the seller’s. Further, sophisticated buyers understand that risk allocation matters far more than price. They are delighted to make the selling owners very wealthy provided that the transaction likewise makes them a lot of money.

6. Recognize that their capital raising options are limited and will include unattractive aspects

Those wealth managers who will have the most success in acquisitions also recognize that the options available to them for raising the capital that is necessary to fund a material acquisition will be limited and that all capital options will have unattractive aspects. More specifically, it is almost mathematically impossible to fund a material acquisition solely with ongoing
Rather, the acquirer will need a large amount of permanent equity capital to just fund the closing payment, much less the subsequent, ongoing payments to the seller.

Should the acquirer’s owners personally lack the necessary permanent capital, they must raise it from outsiders. The good news is that there is no shortage of prospective capital providers to the wealth management industry. They include angel investors, private equity firms and roll-ups.

However, all outside capital is expensive. And, in exchange for their capital, outside providers will (understandably) demand a contractually defined set of cash flows including typically a minimum required annual amount. The providers will also demand (at a minimum) contractual protections that their economics may not be unilaterally altered by the wealth manager. Some will want to serve as voting board members of the firm and many (in particular, roll-ups and traditional private equity firms) will even demand voting control. More importantly, most capital providers will also demand the contractual right to force a liquidity event (i.e., sale of the firm) at a specific date of their choosing.

Further, few (if any) capital providers to the wealth management industry are interested in investing in transactions in which there are multiple outside investors. Technology companies – which have the potential for explosive growth – have the ability to raise capital in multiple rounds from multiple investors. However, wealth managers have no such operating leverage. They are – and are likely to remain for the foreseeable future – relatively small businesses. Consequently, the headache involved in dealing with even one other outside investor (that has its own set of contractual rights) in a firm far outstrips the potential benefits from investing.

Clearly, the owners of wealth managers (or for that matter, of any acquirer) wish that they could raise capital without any such conditions. But a trait of the most successful acquirers is that they are realistic and pragmatic.

Thus, while they accept that all capital is expensive, they try to find the lowest cost. While they recognize that their firms will no longer be completely autonomous, they seek capital from providers who are willing to take a minority position in their firms, have limited voting rights and little interest (or capability) of being involved in management’s day-to-day decisions. They also take capital from investors who will not require the contractual right to force the sale of the business prior to when management wants to do so (if ever).

Most importantly, sophisticated acquirers do not look at raising capital for an acquisition in a vacuum. Rather, they take a longer view and select their capital providers based on their willingness and ability to also fund their organization’s likely future capital needs (i.e., liquidity for owners, debt funding for internal sales, etc.).

7. **Recognize that success in transactions is ultimately based more on psychology than finance**

While smart buyers accept that they will have to pay a full and robust price in order to make a material acquisition, they also recognize that price is only a

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3 The authors want to reemphasize that when they speak of “material” acquisitions, they are referring to those which increase the gross profitability of the acquirer by at least 75% to 100% at closing.
necessary but insufficient condition to success. In reality, success in wealth manager transactions is based more in psychology than finance.

During the transaction process most sellers are more emotional than a pubescent teenager. As noted earlier, the sale of their business is a life changing event. Consequently, while they may be listening, they may not really hear what an acquirer is really saying. They also have a tendency to overreact to insignificant comments made during the negotiation.

Further, in nearly every transaction a significant portion of the potential consideration (in some cases, more than half) is tied to post-closing performance of the seller’s business. Consequently, the seller will have to work with the acquirer for many years. Thus, even an unemotional selling owner is going to be very concerned about the fit between his or her organization and the buyer’s. Although sellers who actually make it to closing accept that they will no longer be the decision-maker, they worry whether the buyer will value their input. They also are extremely concerned as to whether the acquirer will be able to keep the seller’s successor professionals – an integral element to keeping the seller’s clients and maximizing the post-closing consideration.

Sophisticated acquirers understand that every bidder is going to offer to pay a lot of money; successful bidders offer transactions that are attractive beyond mere economics. They are patient with the selling owners throughout the sale process. Should a selling owner say something ridiculous, they ignore it and assume that this person will be more rational after he or she calms down. Although they are not going to do a transaction unless they can conduct full scale due diligence, they ask for information in a way that is not offensive and stage their requests to avoid overwhelming the seller. Smart buyers also understand that the selling owners have valuable experience and clearly communicate that they want to design material post-closing roles for the selling owners. Finally, their deal structures are designed so that they provide the seller’s successors an incredible career opportunity provided they remain with and transition their clients to the acquirer.

8. Understand and appreciate that the seller’s successor professionals are important and scared

As noted earlier, every wealth manager M&A transaction is effectively a “three-handed” deal because the seller’s successor professionals are an essential to the ultimate success of the transaction. Because the successors typically have the greatest amount of ongoing contact with the seller’s clients, the likelihood of retaining those clients after the closing is closely tied to the buyer’s ability to retain and motivate those successors.

When a firm’s successor professionals first learn that the business is being sold, they experience a great deal of anxiety. Somewhat analogous to children learning that their father is about to get a new wife, they see their world suddenly changing and are unsure of what will happen. Invariably any information voids are filled with negative thoughts.

Additionally, many Tweener owners have been able to capture the lion’s share of their firm’s economics for many years only through a series of individual deals with different professional staff members, often having made in each of them a series of implied promises. These tenuous agreements can quickly fracture when the successors learn that the owners are selling the business.
In some instances it can even turn into an outright revolt that potentially threatens the seller’s survival. Understandably, selling owners are terrified of letting their successors know that the business is being sold and do so only after they are highly certain they have an attractive transaction in hand that is likely to close.

Sophisticated acquirers recognize this dynamic and understand the importance of getting successor professional support for completing a transaction. Thus, smart buyers allocate a substantial portion of the aggregate economics of their transactions to these individuals. In many cases, successors are often offered the opportunity to become shareholders of the new combined entity.

Equally important, smart buyers recognize how unnerving an acquisition can be to a successor professional at the selling firm and the importance of them feeling that they have complete transparency as to what is occurring. Thus, when the successor professionals are first informed about the transaction, they are also given as much information as possible as to terms and details of the opportunity that they will be provided.

Further, sophisticated acquirers do not take a “one-size-fits-all” approach to designing recruitment and retention packages for the seller’s successor professionals, instead customizing them to the needs of each individual seller successor professional. Although doing so may require, for some period of time, different compensation systems for different people within the new enterprise, the buyers are willing to compromise because the potential aggregate contribution from the transaction is so significant. They also rationally view these temporary issues as simply part of the one-time transaction costs inherent in any deal.

Most importantly, smart buyers go out of their way to make the seller’s successor professionals feel comfortable and excited about becoming part of a bigger, more profitable firm. The acquirers recognize that, although they are buying the firm, they are likewise recruiting these individuals to become their business partners. So they spend many hours getting to know them personally and giving them the opportunity to fully understand why the acquirer will be a great place to work.

9. Focused on ensuring (and communicating to the seller the importance of) a continuity of client experience

Almost every selling owner is concerned about losing clients once the deal is announced. Although most owners will claim to prospective buyers that there is little risk of client loss, deep down the selling owners are unsure. Their anxiety is due in part to having told their clients for many years that they would never sell the firm. Thus, they fear a loss of credibility and trust.

Further, the owners of wealth managers like to believe that their firms provide a unique set of services and intellectual capital that clients cannot get anywhere else. But if their firm is sold, this uniqueness may vanish and clients could conclude that they have no reason to remain with the successor organization.

In reality, the best wealth managers provide very similar intellectual capital and services. Clients also recognize that every wealth manager, at some
point, must address succession planning concerns. However, the most sophisticated acquirers are very careful to ensure as much continuity as possible with respect to the client experience. For example, investment portfolios are only gradually changed over time. The same personnel at the seller who have worked with individual clients for many years continue to be their primary contacts (albeit, augmented by additional team members from the acquirer) for the foreseeable future. Even the format of client reporting remains the same in the near future and is only gradually modified over time.

These buyers recognize that clients are getting nothing out of the transaction. Moreover, they understand that there is a risk that some clients may have been considering finding a new advisor prior to the transaction and material changes may give them the excuse and motivation to actually move.

Finally, smart buyers also communicate in no uncertain terms to sellers that they are committed to not changing how clients are serviced. These acquirers understand that any rational seller is going to be concerned about potential client losses and their resulting effect on the amount potential post-closing consideration that will be paid. Thus, they work closely with the seller to understand the personalities and peccadilloes of each individual client.

10. Prepare detailed transition plans

Integrating two firms involves countless individual details. Technology and locations have to be rationalized. Employees have to be trained on the acquirer’s compliance policies and procedures. They also must be transferred to the acquirer’s benefit plans. And client, custodial and software agreements have to be modified and standardized.

Most importantly, an acquirer and a seller must jointly develop an individual transition plan for each client. They have to identify the team members from each organization who will work with clients. They must determine how to communicate the transaction to each client. They must also decide when and how often they plan to meet with the seller’s client over the first twelve months following the transaction and who should be at each meeting. Finally, they need to determine the specific set of services and ongoing reporting that will be required for each client.

As noted earlier, these plans must be developed and executed while the clients of both firms perceive little or no change to either organization. It is analogous to trying to redesign a train while it is racing down the track at 100 mph.

Consequently, the last key trait of sophisticated acquirers is that they begin detailed transition planning prior to acquiring the seller. The resulting plan is developed with the help of the seller’s key staff and tries to address every possible detail of the transition.

Ideally every buyer would like to have a fully completed plan in place prior to signing. At the same time, however, most sellers (as well as their bankers) want to get the transaction closed as quickly as possible.

4 The most common reaction that we have found among seller clients is relief that the succession issues are being addressed through a transaction. Many selling owners have told us how surprised they were that the clients not only were supportive of the transaction, they recognized that the owners were getting old and saw the sale of the firm to another wealth manager as a way of ensuring that little would change.
To be sure, it is likewise overwhelmingly in the interest of the buyer to try to quickly consummate the deal. At the same time, however, no acquirer is going to commit to pay the selling owners millions of dollars unless it is highly confident that it will be able to successfully integrate their firm into the larger enterprise.

Smart buyers typically try to strike a balance between quickly getting to signing and being prepared to acquire the seller and its clients. These acquirers conduct as much potential transition planning as possible as part of their due diligence activities but accept that there still will be many details to be addressed between signing and closing. That much said, they will also insist that the individual transition plans for all material clients be completed prior to executing a purchase agreement.
Conclusion

The wealth management industry’s operating environment over the next ten years will not resemble its previous two decades. Heightened competition, increasing operational complexity and the inevitable retirement of many of the industry’s pioneers will reshape its structure. At one point in time the fee-only, independent, conflict-free business model by itself provided a competitive advantage. Now, strategic planning, prudent reinvestment, risk-taking and the ability to better manage a business will be the determinants of future success.

We concede that wealth management remains a “profession” – but success will be found by those firms that continue the difficult evolution from a mere collection of professionals into sustainable businesses. Still, the opportunities are extraordinary.

The ultimate shape of this industry a decade from now is one in which 150 or so extremely profitable, large firms will manage the vast preponderance of its assets. Some will be quite large. Others will be larger than they are today and more specialized.

The industry’s remaining 19,000 participants will not fare so well. While they will remain in business indefinitely they will be marginally profitable and have little enterprise value. The choices that owners make over the next couple of years will largely determine where their firms ultimately land in this Brave New World of Wealth Management.
The Following Assumptions Apply To Exhibits: 3.1 & 3.2

<table>
<thead>
<tr>
<th>Age</th>
<th>Higher Risk Asset</th>
<th>Lower Risk Asset</th>
<th>Pre-Tax Return</th>
<th>WM Fee</th>
<th>Gross Capital Consumption*</th>
<th>Net Capital Consumption</th>
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<td>50 to 55</td>
<td>65%</td>
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<td>7.60%</td>
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<tr>
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<td>7.40%</td>
<td>0.80%</td>
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<td>9.60%</td>
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<tr>
<td>61 to 70</td>
<td>45%</td>
<td>55%</td>
<td>6.80%</td>
<td>0.80%</td>
<td>5.00%</td>
<td>1.00%</td>
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<tr>
<td>71 to 80</td>
<td>30%</td>
<td>70%</td>
<td>6.20%</td>
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<tr>
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<td>0.80%</td>
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* A negative gross capital consumption denotes a capital accumulator.

The Following Assumptions Apply To Exhibit: 3.3

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<th>Age</th>
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</thead>
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* A negative gross capital consumption denotes a capital accumulator.

The Following Assumptions Apply To Exhibits: 3.4 – 3.5 & 3.7 – 3.9

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* A negative gross capital consumption denotes a capital accumulator.
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