KINGFISHER CAPITAL

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THE ACQUIRED ADVISOR'S LONG, HOT SUMMER

Tensions between advisors and consolidators are producing on-the-job retirements at some firms.

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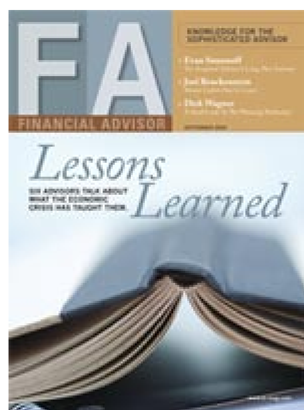

Warren Buffett likes to say that in every deal there's a sucker, and if you can't figure out who the sucker is, there's a very good chance it's you. Over the last few years, a growing cadre of successful independent RIAs have sold equity stakes in their businesses to private equity firms with an eye toward succession planning and a potentially lucrative payday should the roll-up entity achieve critical mass and go public.

But some unfortunate things are happening to a number of advisory firms on the road to their big paydays. Most of these firms rely on assets-under-management (AUM) revenue models. After the dramatic declines in their AUM last year, they experienced commensurate declines in revenues and operating income.

Unfortunately, many private equity firms structure deals in ways that protect themselves in the event of a major revenue downturn and leave the advisors holding the bag. Take capital preference shares. Not all private equity firms use them, but a number of the bigger players in the business do.

The Art Of A Deal

Here's how some typical deals might work. Firm A is worth $10 million and its owners sell 60% to roll-up Firm B for $6 million. Firm A owners get $2.5 million in cash and $3.5 million in Firm B's stock.

In exchange, roll-up Firm B gets 60% of Firm A's operating cash flow or gets an amount equal to 60% of Firm A's operating cash flow the year when the deal was closed—whichever is greater. And that's the kicker: Even if operating cash flow declines in subsequent years, roll-up Firm B must be paid a much larger amount of money—equal to 60% of cash flow at the time of the deal. So if advisory Firm A had cash flow of $2 million in year one when contracts were signed, but this year earns only $1 million, it still owes Firm B $1.2 million.

Moreover, a private equity firm typically funds a roll-up and its shares outrank others. So to continue our example, Firm A's shares in Firm B are subordinate to the shares of private equity Firm C, which invested $30 million in Firm B and its management. Firm C is entitled to 100% of Firm B's capital plus 12.5% on its $30 million investment. Since $6 million was invested in Firm A, it gets a 12.5% return on that amount that Firm A must pay. That amounts to another $720,000 that Firm A owes, bringing the grand total to almost $1.3 million that it now owes roll-up firm B and private equity firm C.

This game of three-card monte gets even worse. After the 12.5% is paid to the private equity Firm C, its managers could be entitled to a return on their personal shares that end up being extracted from Firm A before the advisor sees a dime of the money his firm is earning. These compounding preferences are problematic, especially if roll-up Firm B takes longer than originally anticipated to get to a payday, such as by going public.

The financial advisors who agreed to give up control of their firms are supposed to be intelligent business owners with far more financial sophistication than business owners in other industries witnessing major consolidation, like car dealerships and trash collection operations. But the sad truth is that, when compared to Wall Street lawyers, most advisors might as well be bumpkins who fell off their turnip trucks.

The upshot is that the one-sided legal terms of certain contracts are triggering a series of sagebrush rebellions—or on-the-job retirements—at some advisory firms. Since the private equity roll-up firms rely heavily on debt, the financial crisis of the past year has put them on the hot seat with lenders. As they bump up against debt covenants or violate them on occasion, executives at the holding companies are exerting much greater control over advisors' business operations.

This confluence of events is spawning unconfirmed reports of advisors skipping their long, hot summers in the office and instead going on tours of Europe and extended golf or fishing vacations. It's hard, though, to get people to talk about it openly. A number of officials at private-equity consolidators were unavailable for comment for this article, while several advisors who have entered transactions with roll-up firms would not speak about it, at least not on the record.

Yet some firms have managed to extricate themselves from parent companies without huge legal battles or any real animosity. Earlier this year, Palo Alto, Calif.-based Sand Hill Advisors, which manages about $800 million, bought out its former parent, publicly held Boston Private Holdings Corp., with financing from the Fiduciary Network of Dallas.

In Charlotte, N.C., Kingfisher Capital recently bought itself back from WealthTrust, a consolidator in Nashville, Tenn. **Alex Miles, chief investment officer of Kingfisher**, says his firm was able to negotiate a price that was fair, but no steal. “We never felt like we were buying the firm,” says Miles, adding that he considers himself a value investor. “We felt like we were buying our way back to independence.”

Miles has only positive things to say about WealthTrust—and he was not a victim of capital preference shares. But he has spoken with several advisors who have done deals with other consolidators and he has some serious words of advice for colleagues contemplating these transactions.

Fixated On Wrong Numbers
Both private-equity investors and advisors in these deals may be obsessed with the wrong numbers. The buyers at roll-up firms are investors who are overly concerned with monetizing their investments as quickly as possible, Miles explains. Many advisors, on the other hand, often are fixated on an up-front payout number and don’t clearly understand the contract’s terms and legal requirements.

Frequently, the private equity folks view an IPO as their primary exit strategy, but today those exit doors are boarded up. Several consolidators reportedly are running low on capital, and the buyout firms, faced with increasingly dissatisfied institutional investors behind them, aren’t willing to invest more capital because it would vastly reduce their internal rate of return (IRR), according to several sources in the private equity world. Once they’ve sold a controlling interest in their firm, advisors often find their ability to generate a satisfactory IRR is far more important to their new owners than the health of their business or their clients.

When they enter contracts with roll-up firms, some advisors fail to do their homework on exactly what they are signing. The astonishing decline in equity prices wasn’t on many people’s radar screen. But advisors are negotiating with sharp corporate lawyers steeped in deal-making who are paid handsome fees to protect private equity clients against a smorgasbord of unlikely events and outcomes.

In a few cases, advisors have received phantom equity that doesn’t necessarily convert into the same holding company shares that the consolidators own. Consequently, they could find themselves getting bupkus in the now-improbable event that their parent goes public. “A lot of these folks don’t realize how penal these structures are,” one source says.

In contrast, private equity players are intimately familiar with legal agreements. Contract language possesses a life of its own and can linger on even after extraordinarily broad noncompete agreements expire. Fortunately for some advisors, noncompete terms may be so broad they won’t hold up in court. For example, a national noncompete agreement is likely to be invalidated when it prohibits someone’s right to earn a living in his profession anywhere in the nation because such a provision is not constitutional.

Knowing this, the shrewder private equity concerns use state laws whenever possible to restrict advisors from taking existing clients with them should they decide to bolt from the corral.

Fundamentally Flawed?
Even in good times, more folks are reaching the conclusion that the roll-up model is fundamentally flawed. Consolidators are paying healthy up-front prices for past performance, but investing little in the business to stimulate future performance thereafter.

“How much value is really there in 20 to 30 disparate independent businesses that have different individualistic ways of working with clients?” one advisor asks. The roll-up firms talk about building out platforms to help the firms in their network, but many firms are relatively mature businesses and the senior people end up feeling they have no incentive to work harder to grow their firms.

In fact, after the consolidator makes its first big investment, the advisory firm is rarely structured to succeed as a going concern and often offers few incentives to the younger, junior partners who could be instrumental in growing the business. “Over time, it can erode the quality at a firm,” an advisor says. “When junior management isn’t incentivized, and senior partners are largely cashed out, and cash flow is being upstreamed to the parent to do more acquisitions, the firm just wallows.”

For his part, Miles of Kingfisher believes it is possible, though difficult, for private equity operators to structure deals that produce win-win outcomes for everyone. “These strategies really have to be tweaked carefully [so the firms] can be successful as going concerns,” he explains.

In the end, Miles and his partners were forced to ask themselves whether they wanted to be part of a larger company that conceivably could be worth a lot of money later or wanted to control their own business and destiny. They chose the latter.

Some Success Stories
It should be noted that not everyone who has entered a transaction with a private equity firm is miserable these days. Mike Kabarec of Kabarec Financial Services in Palatine, Ill., reports that the deal he entered into last October 1 with Mesa Holdings is going well.

Mesa, which attempts to create synergies by providing its acquired firms with back-office services, could have cut its price when it closed

the deal in the middle of the financial crisis, but it didn’t. As a result of the generous pre-financial-crisis price Mesa paid, Kabarec has a “little catching up” to do to hit his bonus targets, but no complaints.

He reports a few normal “glitches” while converting to Mesa’s back-office systems, but things are running well now. Mesa has done six transactions so far, and Kabarec says there are several others in the pipeline.