December 30, 2010

Expanding Through Acquistion

Small RIA firms are a slowly dying breed, like one-of-a-kind restaurants, independent cleaners and independent auto repair shops. In this world, the options are to sell or grow.

By Chester C. Wright

Today only 15% of RIA firms control some 85% of assets under management and they are expanding through all means including aggressive acquisition. They have large advertising budgets and are reaching out aggressively to both new investors and current clients of small firms.
Small firms simply cannot afford to purchase the sort of recognition that will allow them to thrive. Even though there are a huge number of firms with less than $25 million under management, many of us believe that they are a slowly dying breed, like one-of-a-kind restaurants, independent cleaners and independent auto repair shops.

Most owners of small firms take home what may well be a "decent" salary. And until their clients age and die may live comfortably until they retire.

For those who do not find this prospect inviting there are two options: sell or grow.

If you chose not to sell, the most feasible growth option is acquisition. If you have decided to become a bigger firm through acquisition, here are some of the issues that you will face.

While acquiring other small RIAs or CFP firms is certainly the easier of the various expansion options, it is not as straight forward as it might seem. There are over 40,000 RIA firms in the United States.

Because of nomenclature problems, it is impossible to know the number of CFA firms and of course registered investment advisors (RIAs) and certified financial planners (CFPs), which frequently set up shop together. How many of them are actively or potentially for sale is an absolute unknown. Your search becomes more realistic with the assistance of an aggressive, nationwide business broker.

Buying a financial firm is a little more complicated that buying a candy store, so your broker is going to need some help. Even remotely potential acquisitions must know that you are in the market. The firm you are seeking is not distressed, so they may not know that they are for sale. You should be prepared to convince them that they are. Here are some tips to help find the most appropriate targets. The three most important things are:

A. Is this really a successful business? The easiest way to dispose of the walking dead is to sell it to some sucker who doesn't do his homework. Absorbing a new entity is hard enough if it is successful. Trying to rehabilitate a floundering enterprise is a no win. If they are not prepared to at least provide verifiable cost and income data, they are not an acceptable bet.

B. What evidence makes you think existing clients will stay after you have acquired the firm? Are clients personally attached to the current owner and will they have no particular reason other than inertia to stay on? The only way to be reasonably sure is to ask, not the firm, the clients. You shouldn't ask directly; they will tell you what they think you want to hear just to get you to go away. The local university probably has a survey service equipped to measure client attitudes. People are generally a lot more straight forward with third parties. Hire the professionals.

C. Is there a strong account management team with established client relationships that you can confidently expect to stay with the firm? Otherwise you are buying an empty shell. Once again, the only way to be reasonably sure is to ask. Do this yourself. One at a time. Privately. In their space if it is private, and take your time. This is, "getting acquainted," not interrogating a prisoner of war. Find out what they will need to make them stay and work to retain their clients. Then decide if that is acceptable.

The ideal target is a firm with an aging owner who has a strong, younger, second in command. You are not buying work to do yourself; you are buying accounts and, hopefully, someone to manage those assets.

You will have to be flexible; the owners may want cash but be reluctant to give up work completely or see the firm that consumed their life disappear. You can, for example, negotiate an extended exit plan. The firm retains its name while the owner can work part time concentrating on transferring management and retaining or even expanding the number of clients. This will also give you time to gently make clients aware that you are in the picture and that nothing that is important to them is going to change.

Don't overestimate your own skills when you enter serious negotiations. You will need a forensic accountant to tell you the actual financial condition of the target firm and if the asking price is in the ball park. Use a legal firm that specializes in acquisitions to help negotiate the final agreement and prepare all legal documents. It is hard to believe the traps that a flawed or incomplete contract can present.

With a carefully selected target and your acquisition team in place you are ready to proceed.

The biggest surprise for many who find themselves the owner of a larger firm is the change in the nature of their job. There is an enormous difference between what is required for the management of a five-employee firm and an organization of 100, or even 500, employees.

If you enjoy investing and expect to continue, forget it. Real management is a full-time job. It requires a whole set of skills that are not learned being a good money manager. Large organizations routinely provide specialized training to new managers. You will be on your own.

Let's look at three of the biggest changes you will face moving from running a small firm to managing a more substantial enterprise. They are compartmentalization, delegation, and, for want of a better word, investigation.

First of all, while you may be responsible for everything, you cannot do everything. You will have to define the major components of your business and select a manager for each.

There are a number of ways to compartmentalize an organization. For an RIA, a functional breakout is probably the best choice. That will leave you with at least three major divisions or more, depending on the size of the business. The three minimum are: ADMINISTRATION, which includes record keeping and marketing; INVESTING, which includes both sales and ongoing client relationships; and COMPLIANCE.

As you grow, administration may also grow to include information management, accounting and human resources. The same expansion will happen with each activity. Each will have a manager and each will have its problems and daily decisions that must be made.

Each job must be described in writing and the limits of authority spelled out.

If you find that a person you have selected can't do their job, then it cannot be corrected through your micro management. You should not have to do a job you are paying someone else to do. You have selected the wrong person.

Once you have selected managers for each business division, you will have to let them do their jobs. This means that they will frequently be making decisions without consulting you. The decisions made will seldom be exactly the same as you would have made. If you can't live with that then you can't run a bigger business. You must keep your second guessing to yourself. Nitpicking is not compatible with good management. If you insist on personal involvement in every decision ahead of time the result will be indecisiveness and delay. If on the other hand, you second guess your managers and change their decisions after the fact no one will trust their decisions as final and all the best managers will spend their full time looking for a better job.

The third element involved in growing into management of a larger business is what I have called "investigation." This is what must be done when a subordinate has made a truly bad decision. Your objective is to assure that this decision or one like it is not repeated. To do this, you must find out why the mistake was made in the first place.

You would be amazed at how infrequently the most direct approach to this problem is overlooked. If you want to know why something happened ask, "Why?" Not, "Why the hell did you do that!" But what both you and the erring manager understand as really--why? Did they not have information they needed? Was policy ambiguous? Why? You both want to know, not to assign blame, but to try to assure that corrective measures are taken and that the possibility that the same mistake will recur is reduced. The bonus from this approach is that you still have a subordinate with intact self respect and the confidence to continue as an effective manager.

The fact that you are a good investment manager will still be important because you will be nurturing investment managers. It just will be one of a multitude of tasks.

As soon as your new firm is on a sound sustainable footing, you are ready for the next step, another tempting target to acquire.

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