In Theory versus In Practice

When people go through the process of selling their practice, they often find that the “conventional wisdom” they believed to be true doesn’t match reality. To try and help you look beyond the “theory” of deals and understand what transactions look like in practice, we’ve put together this guide to help you navigate through this complex process. We hope it will arm you with perspectives key to achieving any good deal.

Profit & Loss Statements

Topic	In Theory	In Practice
Owner Compensation	***“If the seller chooses to continue to work, they will be continued to be compensated at their market rate.”***	Buyers and sellers must come to an agreement on what the market value of their services is considering the seller’s role may be changing. Additionally, buyers and sellers should consider holistic cash flow to the seller from both compensation and deal payments. Valuation is directly affected by the seller’s compensation post transaction because it affects profitability. Negotiate compensation at the same time as valuation to provide the full picture of cash flow to the seller.
Synergies	***“Mergers always provide significant synergistic value by consolidating redundant systems.”*** For example, instead of two technology systems there would be savings by leveraging just one system. However, it is not always as simple as eliminating redundancy due to complexities of the industry.	The total synergy value varies by deal. The similarities and size of the two transacting firms influence the synergistic value. For example, the buyer may have pricing power, due to their larger size, on a trading/reporting platform. This would reduce the operating costs to run the selling assets than on a standalone basis. On the other hand, the seller may use software required to service their clients that the buyer doesn’t utilize. This may cause a reduction in value if the buyer must take on this additional cost post-transaction.
Proforma def. “Adjusted financials that include projections and presumptions”	***“The seller’s Profit and Loss Statement will inform the buyer’s valuation.”***	The buyer and seller should prepare a thorough, thoughtful proforma, that is built using the seller’s standalone P&L, to adjust and reflect the expenses and revenues of the combined company. The proforma may look similar or different to the standalone P&L based on possible synergies and other expense or revenue changes. The result will be a reengineered P&L that the buyer will use to create a fair market valuation.
Owner Expenses	***“Expenses such as country club memberships and car allowances that contribute to the seller’s growth strategy are business expenses.”***	The acquirer may have different policies or different tax restrictions that would impact the continuation of these expenses. The buyer and seller should work together to determine what are appropriate business costs versus what expenses will be the seller’s responsibilities on a go forward basis. A conversation should be had to provide full context around such expenses and often a mutually satisfactory solution can be reached.
Revenue	***“Every revenue dollar is valued equally by the buyer.”*** RIA’s can have several different sources of revenue including investment fees, planning fees, tax service fees, commission and several more.	into two buckets, recurring or nonrecurring. Revenue that is recurring (i.e. investment fees, some planning fees) in nature is valued at a premium over unpredictable, nonrecurring revenue (i.e. insurance policies, many commission products).

Valuation and Deal Structure

Topic	In Theory	In Practice
Price (firm valuation)	***"This is the "sticker" price that the buyer and seller have agreed to as a result of negotiations."***	Price can be dynamic depending on the structure of the deal. A typical deal structure includes adjustments upward and downward in accordance with the terms set in the transaction agreement at some future date(s). Deal structures include a trailing twelve months (TTM) revenue adjustment, growth or profit related performance kickers, earnouts and other contingency mechanisms and comparative metrics to "true-up" firm value after the client transition. Buyers and sellers should analyze the benefits and risks of each deal structure respective to their own personal goals and risk tolerance. Additional factors that affect price are length of payment schedule, interest rates, financial stability of buyer, amongst others.
Terms	***"The terms of a transaction are relatively standardized and there is little flexibility."***	Before an offer is presented to the seller, there should be multiple discussions between buyer and seller about their respective goals. The offer of terms doesn't have to be unilateral if the communication channels are open from the beginning of the process. Buyers often need time and information to fully understand the seller and their firm to arrive at price and terms that both parties will find agreeable.
EBITDA	***"The EBITDA used for valuation is calculated based on the seller's standalone Profit and Loss Statement."***	The buyer will calculate an adjusted EBITDA from their proforma after considering synergies and other adjustments from merging. The seller must be reasonable about maximizing their firm's valuation while still leaving value on the table for the buyer.
Multiples	***"Top and bottom line multiple benchmarks that are published in articles are consistent across firms."***	Every firm is unique and "published" multiples many not be relevant or accurate in every case. For example, source of revenue, staff experience, client demographics and location (market demographics) influence the value of a firm and therefore the multiple paid. While benchmarks are useful metrics, they cannot be perceived as law. Additionally, buyers and sellers should focus on cultural and operational alignment which have big impacts on transitions and in turn post deal success. The highest multiple is not always the best deal.
Acquisition	***"The buyer purchases and controls the seller's firm post-sale in a full acquisition."***	Acquisitions can look very similar to mergers in some cases. Some firms push their model upon the seller while other firms allow for more autonomy and collaboration. Understanding the buyer's strategy using their past acquisitions as data can help the seller understand how things will look post-sale.

Partnership Structures

Topic	In Theory	In Practice
Shares(equity in firm)	***"All equity of an RIA behaves the same."*** "Partner A's 5% equity is the same as Partner B's 5% equity" is not always a correct characterization.	Equity can be issued in many ways and with many different benefits. Share classes defined in the operating agreement outline the costs and benefits of the varying shares. Smaller firms may not have multiple share classes, while larger firms likely will. It is important for the seller to understand the class of share they are receiving and what rights/responsibilities those shares offer. Shares vary in voting rights, distribution rights, cost to buy in, capital call requirements among others.
Vesting Period def. "The period of time to earn or realize a present or future payment (i.e. bonus, equity, etc.)"	***"The seller will not be able to sell their shares for a period of time."*** Most firms issue shares that are subject to a defined vesting period or "Lock-Up" period where shareholders "own" shares, but are unable to sell them. The vesting schedule can include a gradual vesting of a percent of shares at different time horizons (i.e. 25% vested in two years, 100% vested in two more years).	While it is very common for buyers to utilize a vesting schedule when issuing equity, buyers may have flexibility to suit the seller's preferences. For example, a seller desires equity and to retire in three years, but the buyer traditionally imposes a five-year vesting period. The buyer may be willing to compromise with the seller and reduce the vesting period to less than five years. Again, early and frequent conversation regarding respective goals is critical. As a final point, the seller should consider if equity is the right form of payment to fully realize the value of their firm due to the longer-term nature of equity's growth, generally.
Profit Interest def. "Right to share in distributions or profits on a pro rata basis"	***"A profit interest is less valuable than pure equity."***	Depending on the seller's risk tolerance, financial situation and time horizon, a profit interest can be a more appropriate way to participate in a firm's success.
Control	***"Minority shareholders have less "say" in a firm's strategy than majority shareholders."***	Shareholders may own different percentages of the firm, but the power of equity is not always equal. Having less percentage but with more voting authority may give a minority shareholder more control. Also, a shareholder that is also an executive may have the ability to exert more influence of the firm's success than a larger shareholder that isn't a managing partner. Regardless of the size of firm, traditional organization structures define and delegate management oversight. It's not uncommon for certain shareholders to manage certain aspects of the firm which allows for a sort of "checks and balances" approach to the overall strategy of the firm.
Liquidity	***"An equity investment in an RIA is more illiquid than other more traditional investments."***	It is fair to say that an ETF or mutual fund most likely has greater liquidity than a stake in a privately-owned RIA. However, depending on the operating agreement language, cash flow/reserves, some firms may be able to offer attractive liquidity options for shareholders. This mechanism allows shareholders to have flexibility should life or professional circumstances change dramatically.