Why I Sold - Part 3
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This article is the third installment in a multi-part series exploring the issues Jim Whiddon faced as he decided to sell his practice. To see the other articles in this series, click on “more by the same author” in the left margin.

When I decided to sell my small wealth-advisory practice, my due diligence focused on the internal threats and weaknesses I faced. But I took an equally hard look at external threats – industry-wide issues that all firms, regardless of size or stature, will face in the coming years. I quickly realized those overarching issues were beyond my control and more difficult to overcome.

The global financial crisis, take 2

The global financial crisis of 2008-09 could have ended my firm. If I had not been in a strong financial position personally at the time – which gave me the needed resources to support my company – it would have been catastrophic. But it was painful to dip into my personal savings to keep my most valuable asset viable. And while none of us want to ever experience 2008 and its aftermath again, we all understand that an occasional market retraction is inevitable to have the creative destruction we need for bull-market runs.

Nevertheless, pullbacks can devastate smaller firms. After revisiting the personal price I paid financially and emotionally, I considered whether I had the stomach to weather another major market storm as the sole owner of my firm.

It took about four years after the crisis for the value of my firm to return to a level where it made sense to consider a transaction. In 2012, with the markets still hovering around all-time highs, I felt there was a window of opportunity that could close at any time. If you are in your 60s now and a significant market correction occurs, you could be in your 70s before a market rebound returns your firm to its former valuation.

A merger would give my clients, my staff and my family the financial stability we needed to withstand the next market retraction — and the one after that.

Regulatory oversight

By the end of 2013, fewer than half of the 398 new regulations authorized by the Dodd-Frank legislation had been finalized. The task of understanding and complying with regulations – even before Dodd-Frank – was a real chore for our small firm. The additional advent of the Consumer Financial Protection Bureau was just being unwrapped.

There was also a question as to which agency would govern independent registered investment advisors (RIAs) in the future. A study by a Boston Consulting Group showed that, annually, a user-fee program (through the Securities and Exchange Commission) would cost between $100 million and $270 million, Financial Industry Regulatory Authority oversight would cost between $550 million and $610 million and a new self-regulatory organization would cost between $610 million and $670 million. In a regulatory environment in which scores of news rules are on the horizon, it would be difficult for a small firm to keep up with proper procedures and rising implementation costs.

The online advice threat

I remember reading an article in the mid-1990s that portrayed the end of an entire profession – travel agencies. Why? Suddenly and dramatically, travel vendors (airlines, hotels, etc.) chose to stop paying commissions. The arrival of computer systems had made the services of travel agencies obsolete.

Similarly, there is a burgeoning trend of online financial advice. More than 130 online advisory startups are
trying to win middle-class clients who resist paying high fees to conventional financial advisers. Companies including Wealthfront Inc., Personal Capital Corp. and FutureAdvisor (along with more than 125 startups) now offer services that use computer algorithms designed to replace human investment advisors. In addition, they have some pretty good humans helping them out – folks like Burton Malkiel and Charles Ellis. More than $200 million of venture capital was provided to these businesses in 2013, indicating a validation of the model.

Some advisors may believe that these companies will not fundamentally change our profession. It may be true that the current generation of clients will stick with us based on the desire to have face-to-face interaction. But the next generation and certainly the one after that will be less dependent on personal relationships.

For any small independent RIA to remain sustainable in the long-term, older clients will need to be replaced. One of the big considerations in the not-too-distant future for financial services firms will be how and how much to invest in an online service offering for the technology generation. A larger partner firm would provide my firm with the human and financial resources to address this challenging issue.

The baby boom tsunami

A tsunami is gathering that will hit successful yet unsuspecting business owners in the U.S.

In the decades following World War II, government regulation was light and entrepreneurs thrived. It is estimated that around 12 million businesses are still owned and operated by baby boomers or senior citizens. In the financial-services industry, as in many other businesses, the average age of RIA principals is in the early- to mid-60s. For those owners, their firms are their primary asset for retirement. What does this mean? Over the next 15 years, 8 million to 9 million sustainable businesses will go on the market. More than 500,000 transactions will occur each year in a more highly regulated environment in which money may continue to be tight. In comparison, the highest number of announced business transactions ever reported in the U.S. was approximately 11,000 in 2006.

The next 15 years will see the largest generational transfer of wealth in the history of humankind, estimated at over $10 trillion. Supply and demand will drive prices down. As we say in Texas, "Get out while the gettin' is good."

But to that end, where could I turn to find a buyer? Internally, there wasn’t an employee that could purchase my company. And even if there were someone interested in buying me out, any kind of large down payment or lump sum is unlikely in today’s tight credit markets. Typically, a seven- to 10-year promissory note is needed. Buyers don’t want a long-term commitment that shifts all the risks to them. And if a payout is based on cash flow earned, I reasoned that I might as well maintain my ownership – even if doing so meant the threats already mentioned come back into play.

Some advisors may have a son or daughter working in their firm that could purchase the stock. Negotiating a price within the complex dynamics of a family can make negotiations even tougher. Proceed with extreme caution if that is a possibility in your situation.

The musical chairs problem

I dreaded one situation above all else: My biggest local competitor could make a deal with a dominant independent player before we did.

If this situation were to play out, my firm would incur great marketing costs. My current clients likely considered my closest competitor before they chose us. If the competition merged with a larger company, the news of the transaction could cause our clients to consider our rival again – requiring us to win their confidence a second time. But this time around, our clients would no longer be deciding between two similar firms, and our rival would have the upper hand in framing the new contest. Any new prospective clients would also compare our firm to our new, bigger competitor.

The threat was not only that we could lose current clients and future prospects, but also that our valued employees would be tempted to leave. If they chose to work with our new, larger competitor, we could lose current clients in an employee transition.

Selling first would eliminate this threat.

Conclusion

In conclusion, when assessing the industry and economy on a macro level, I came to believe that my
smaller RIA would face greater and more robust competition that would ultimately drive fees lower, make it more difficult to compete for talent and reduce our enterprise value. These obstacles threatened to undo what I’d worked so hard to achieve.

Next time, I will review which considerations I took most seriously when choosing to merge with a larger partner.

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