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Back to the Future:

The Continuing Evolution of the Financial Advisory Business

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Contents

Executive Summary		**v**
Introduction:	The Evolution Has Begun	**1**
Chapter 1:	Current Competitive Landscape of the Advisory Business	**5**
Chapter 2:	Forces That Will Shape the Industry by 2012	**27**
Chapter 3:	How the Industry Will Likely Evolve	**45**
Chapter 4:	Options (and their Merits and Drawbacks) Available to Advisory Business Owners	**61**
Chapter 5:	Conclusion	**99**

Exhibit Index

Executive Summary:			
	1.0	Current Industry Structure	**vi**
Chapter 1:	1.1	Current Industry Structure	**6**
	1.2	Segmentation of Large Participants	**7**
	1.3	The FPA Survey Divided the Industry Into Four Groups	**9**
	1.4	Many Advisory Firms are Operating Near Capacity	**11**
	1.5	Larger Clients are More Profitable	**12**
	1.6	Competitive Landscape of the Financial Advisory Business	**14**
	1.7	Try and Tell the Difference	**15**
	1.8	Merrill Lynch Spent More Than Twice as Much on Advertising as Apple in 2004	**16**
	1.9	Many New Advisors' Clients Were at Brokerage Firms	**17**
	1.10	Average Advisory Fees Have Remained Stable	**20**
	1.11	Average Equity Returns Have Fallen Significantly Since 2000	**21**
	1.12	Small Advisory Services — 1999 Income Statement	**22**
	1.13	Small Advisory Services — 2002 Income Statement	**23**
	1.14	Returns on a 70% Equity / 30% Fixed Income Portfolio Have Fallen Over the Last Five Years	**24**
	1.15	Small Advisory Services — 2004 Income Statement	**24**

Chapter 2	2.1	Operating Costs Rose Substantially Between 1999 & 2003	**28**
	2.2	More Advisory Firms are Sharing Equity Ownership	**30**
	2.3	Financial Planner Compensation has Increased 32% in Two Years	**31**
	2.4	Although Revenue has Risen, Margins Have Fallen	**32**
	2.5	Advisory Firms Spend Very Little on Marketing	**33**
	2.6	Impaler Advisory Services — 2004 Income Statement	**36**
	2.7	Impaler Advisory Services — 2007 Income Statement	**37**
	2.8	Examples of Technology-Based Outsourcing Platforms	**38**
	2.9	Functions Advisory Firms Will Eventually Outsource	**38**
	2.10	Impaler Advisory Services — 2010 Income Statement	**40**
	2.11	The Volume of Computers Sold Between 1988 and 2004 Rose 16-Fold	**42**
	2.12	Personal Computer Market Share 1988	**42**
	2.13	There are Only Ten Major Personal Computer Manufacturers Today	**42**
	2.14	Most Advisors are Over 50	**43**
Chapter 3	3.1	Future Structure of the Industry	**46**
	3.2	Cycle of Maturity of an Advisory Business	**49**
	3.3	Non-Revenue Functions that are Specialized at Professional Enterprise	**56**
	3.4	Large Firms Rely on Many More Policies and Procedures	**58**
	3.5	Current stage of Maturity for Haves	**60**
Chapter 4	4.1A	Few Small Practices Have Been Acquired and Only at Low Prices	**62**
	4.1B	Very Little Has Been Paid Upfront for Small Advisory Businesses	**63**
	4.2	Large Recurring Fee Businesses Trade at Very High Multiples	**68**
	4.3	Legacy, What Legacy?	**73**
	4.4	Cash Flows to the Owners of Dave's Advisory Services	**81**
	4.5	Internal Rate of Return on Cash Flow Sold by Dave's Advisory Services	**82**
	4.6	BRU's Internal Rate of Return on Cash Flow Bought	**82**
	4.7	Cash Flows to the Owners of Dave's Advisory Services — Down Scenario	**83**
	4.8	BRU's Internal Rate of Return on Cash Flow Bought — Down Scenario	**83**
	4.9	Cash Flows to the Owners of Dave's Advisory Services — Stock Only Transaction	**84**
	4.10	BRU's Internal Rate of Return on Cash Flow Bought — Stock Only Transaction	**84**
	4.11	Examples of Advisory Firms Bought by Strategic Acquirers Since 2000	**88**
	4.12	Future Structure of the Industry	**94**
	4.13	Overview of Large Firm Strategic Alternatives	**98**

Executive Summary

From 1980 until the late 1990s the independent financial advisory industry flourished, largely unnoticed by everyone but its clients and a handful of vendors. Barriers to entry were low, markets were robust, and clients were plentiful. Literally thousands of firms were profitable and rapidly growing; advisory firm overall assets under management approached $1 trillion. Life was good.

In 1999, an Undiscovered Managers paper predicted vast changes

In 1999, a somewhat unwelcome research paper published by Undiscovered Managers predicted that the industry's benign existence was about to change. The study asserted that the current business environment was due primarily to an excess supply of clients relative to industry participants' ability to capture and service them. And a combination of factors including new competitors, greater capacity of existing participants and the expanded use of technology would correct this imbalance and force the industry to rationalize over the next decade.

The structure of the industry would likewise change and from a highly fragmented industry made up of competitors of all sizes would emerge a small group (40 to 50 organizations) of dominant competitors: highly profitable, large firms that would "look like multi-user family offices for the semi-affluent." These firms would have at least $15 billion — $20 billion in assets under management and some would be much larger.

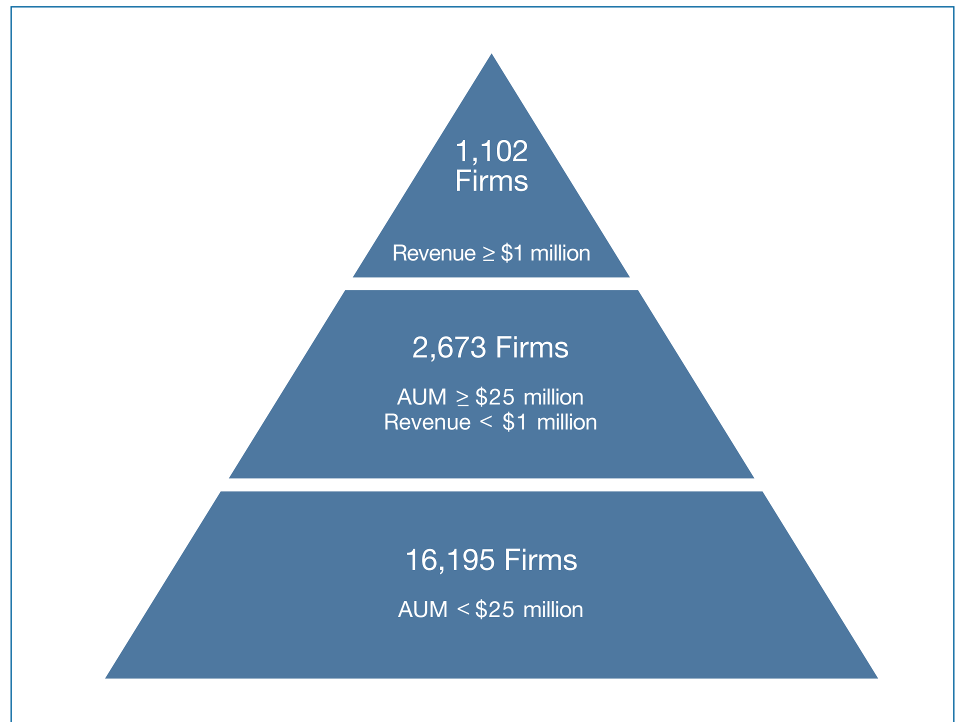
While there would still be numerous smaller firms, only one type — mid-sized niche competitors — would flourish. These high-profit specialist firms would provide sophisticated services that solve complex problems for select groups of individuals. Thousands of other small firms would continue to exist, but their owners would find that they had to work much harder, would earn far less than they did in 1999 and their businesses would possess little enterprise value.

Given that it is now just after the midpoint of the advisory business' predicted decade-long evolution, we decided to revisit the issue of the industry's future. A joint JPMorgan/Undiscovered Managers team of researchers spent twelve months studying its current state and those forces that now confront it.

Industry's current competitive landscape

Our research found that the industry experienced a mini-rationalization since 1999 that is part of a longer term evolution. This mini-rationalization reshaped the industry into a structure that is consistent with the earlier paper's predictions and that is similar to a pyramid (as shown in Exhibit 1.0). Most of the industry is made up of small, marginal businesses. Approximately 16,195 or 81% of all advisory firms have less than $25 million of assets under management and form the base of the pyramid.

Exhibit 1.0 Current Industry Structure



Source: 2004 Form ADV filings with the Securities and Exchange Commission, Cerulli 2005

Above this group in the pyramid are about 2,673 mid-sized firms (about 13% of industry participants) that have more than $25 million in assets but generate less than $1 million in revenues annually. The economics of these firms vary widely.

At the top of the pyramid are 1,102 firms (about 6% of industry participants) that each generate more than $1 million of revenues annually. About 69% of the firms in this group are mid-sized businesses that generate less than $3 million in revenues annually. Above them are 220 large, profitable firms that have annual revenues of $3 million to $8 million.

At the very top of this part of the pyramid are the 124 largest organizations. While this group does not include giant financial services companies, such as wirehouses, regional broker-dealers, insurance companies and banks, it does include several advisory affiliates of money managers, as well as some advisory firms that are part of independent broker-dealers.

Industry can also be divided into Haves and Have Nots

A more detailed analysis of recent advisory business financial data collected by Moss Adams LLP for the Financial Planning Association suggests, however, that the industry can be further divided into two broader groups — “Haves” and “Have Nots”. The former are those firms that are both profitable and have the potential to grow and evolve as businesses. They have strong long-term prospects and potentially great value as enterprises. Their ranks make up about 6% of the industry’s participants and include all of those organizations that currently have more than $3 million in annual revenue.

About 94% of industry participants fall into the “Have Not” category

The Haves group also includes most mid-sized firms with annual revenues of $1 million to $3 million and a small percentage of organizations that have less than $1 million of annual revenue but have more than $25 million of assets under management. Although not yet large companies, these mid-sized firms have robust client bases, are profitable and have the resources to grow their organizations over time.

Firms in the Have Not category, by contrast, are unprofitable businesses after paying their owners a market-level salary and have few, if any, resources to fund their growth and evolution. They are marginal businesses with bleak prospects for the future. Their owners will have to work harder and will still earn less as the industry shifts into the next phase of its evolution. These businesses will also have little or no enterprise value. This group includes about 94% of all industry participants and all of those firms that currently have less than $25 million of assets under management.

A majority of the industry’s mid-sized participants also fall into the Have Not category because they too are unprofitable as businesses despite operating at or near capacity. And companies in any industry that are unable to make money despite operating at or near capacity are by definition marginal businesses.

Within this group are those firms that generate between $1 million and $3 million in annual revenues but have unattractive client bases and/or are inefficient. Most mid-sized firms that have less than $1 million of annual revenues, but have more than $25 million of assets under management likewise, are in the Have Not category.

What caused the mini-rationalization?

Four forces have helped shape the industry over the past five years: new entrants to the industry, the repackaging of traditional competitors, technology, and markets.

1. New entrants

Scores of new competitors have entered the financial advisory business. Banks of all sizes now offer wealth management services and distribute securities. Major insurance companies are trying to convert their captive agent networks into wealth management firms. Even organizations whose primary focus is unrelated to financial planning and advice, such as E*Trade, H&R Block and numerous law firms, have entered the industry.

2. Repackaging of traditional competitors

Four forces have changed the economics of the advisory business since 1999

At the same time, the traditional competitors of financial advisory businesses — wirehouses and regional broker-dealers — have re-engineered their service offerings to at least appear to be very similar to that of independent financial advisory firms. While what these organizations now provide to their clients may in many cases differ from that of independent advisory firms, it is hard for the uninformed client to differentiate the offerings. This factor combined with massive marketing and advertising budgets has made wirehouses and regional broker-dealers more effective competitors in certain markets.

The entrance of a flood of new competitors and the reinvention of traditional competitors, however, has varied in its effect on different sized advisory firms. Larger industry participants have been only marginally impacted. These organizations now possess the scale and presence in their local markets that has allowed them to continue to attract numerous new clients, many of whom have changed advisors because of the various scandals that occurred at several financial firms over the last five years.

In contrast, smaller advisory firms have had a much more difficult time growing their businesses. They lack the presence and resources to create large numbers of new client opportunities and now find that increasing their revenues has become much harder.

3. Technology

The third force — technology — has played an important role in helping to increase the efficiency of larger advisory firms. Automated trading, client relationship management software and web-based data warehouses are just a few examples of time saving technological improvements. The aggregate impact of these improvements has been to create additional capacity for advisory firms that can be used on revenue-generating activities.

The end of the bull market of the 1990s annihilated the margins of most industry participants

4. End of a hidden subsidy

These three forces, however, have primarily affected only the long-term prospects for growth of smaller industry participants and not their current economics. Instead, a fourth and significantly more important driver of the industry's mini-rationalization was the result of two distinct trends — a sudden, irreplaceable drop in revenues and a rising cost structure. They have combined to annihilate the operating margins of many participants, in particular smaller businesses.

The market correction of 2000 through 2002 and the subsequently less robust equity market returns essentially stripped many firms of a hidden subsidy. Because of the symmetrical relationship between fees and assets under management, the returns from the roaring bull market of the 1990s substantially increased industry participants' revenues every year for a decade. This appreciation helped to mask the fact that at the same time, costs continued to rise.

Suddenly advisory firms could no longer count on 12% to 14% annual increases in revenue from the market appreciation of client assets. Unfortunately, many smaller advisory firm owners were caught unprepared. Their firms' economics were irreparably damaged and, as a result, what were once profitable and growing businesses could no longer afford to pay their owners market-level salaries, much less reinvest for the future. These companies are caught in limbo, large enough to survive but unable to replace their lost revenues (and owner compensation) through growth, at a time that a series of changes are about to sweep through the industry.

The future

Five additional forces will further alter the economics and structure of the advisory business over the next five to seven years. The first of these forces is the rapidly rising expectations of key employees at larger advisory businesses. Many non-owner professionals correctly believe that they played an essential role in building their firms and are thus entitled to a greater participation in their employer's success. Consequently, advisory firms are confronting demands from these valued employees for equity participation, leaving owners with the difficult choice of retaining a smaller personal stake in their business or losing their best staff.

Demand for professional employees will cause salary costs to skyrocket

The second force is a growing demand for professionals that will significantly increase salaries over the next five to seven years. Competition for these individuals is coming not only from other advisory firms, but also from large financial services organizations that are able to offer very generous compensation packages for experienced professionals. As more organizations enter and/or expand their presence in the wealth management business, the competition for professional employees will likewise increase, leading to skyrocketing labor costs and continued pressure on profitability margins for advisory firms.

The third major force that will shape the advisory business over the next five to ten years is higher general operating costs. On average advisory business operating costs have risen cumulatively more than 60% over the last four years. Normal inflationary pressures, higher salaries for non-professional staff and greater regulatory and compliance requirements will continue this trend.

An industry-wide addiction to growth will emerge as owners try to maintain their personal economics

Investment management skills now matter

Additionally, the lower absolute returns (as compared to the 1990s) of the financial markets have made investment management capabilities of greater importance to advisory firms. For a long time such capabilities were a useful but unessential skill because extended bull markets made it hard for firms to differentiate themselves in this area.

The current capital markets environment has changed all of this. Advisory fees are now a substantial percentage of clients' absolute returns and they will understandably demand that their advisors add significant value in this function. But to build and broaden such skills will require that firms spend much more of their time and resources on the investment function than they did in the past.

These three forces — demands by key employees for equity ownership, skyrocketing salaries for professional staff, and higher other operating costs — will pose real challenges to the economics of operating advisory businesses and, in particular, the personal economics of their owners. The combined effect of these three factors will create a fourth factor that will shape the advisory business over the next five to seven years: an industry-wide addiction to growth.

Many advisors will seek to grow their way out of this dilemma. They will try to increase revenues to compensate for their smaller equity stakes in and the higher costs of their businesses. Ironically, this strategy will only accelerate competition for both clients and for key employees, and thus exacerbate the same problems that owners already face.

At some point the combination of new entrants, reinvented traditional competitors and existing industry participants all trying to grow will overwhelm the supply of potential clients. To be sure, the demand for advice will continue to rise. But the demand for clients will grow even faster and once the demand for them exceeds the supply, the industry will undergo an even more vigorous rationalization.

A combination of factors has led the industry to a tipping point

Overlaying these industry dynamics is an immutable fact: many of the owners of large advisory firms are in their mid to late fifties, and are beginning to think about the retirement options of not only their clients, but also themselves. While most of the owners of larger advisory businesses have accumulated sufficient wealth to retire, their largest asset is their ownership stake in their firms. And the price they get for it will be a major determinant of the quality of their lifestyle during retirement.

In addition, any transaction that would involve significant consideration would also likely require that the owner remain fully involved in the business for an additional four to seven years. Delaying a transaction would thus delay many owners' opportunity to get on with the next phase of their lives until their mid to late sixties.

We believe that this combination of increased business challenges, a graying owner population, the importance of this asset to funding these individuals' retirements and the long time period inherent in any transition has placed the industry at a tipping point. Over the next few years, many advisory firm owners will likely sell their firms. It will also lead to significant consolidation at the top of the industry.

Owners of "Have Not" firms will work harder and earn less

Strategic options for owners of advisory firms

For owners of firms in the Have Not category, there are few attractive strategic options. Their companies lack the resources to fund growth and development at a time that the industry is becoming more competitive and operating margins are shrinking. They have little economic value as ongoing enterprises because after paying their owners a market salary, they are unprofitable. Additionally, their small average client size makes them unappealing acquisition targets for larger firms.

As a result, owners of these firms will have to work harder and take home a still smaller salary than they do now. Their ultimate transition plan will be to persuade the firm's employees to purchase the entity for de minimis consideration or to try to capture some value by selling their book of business to another organization.

The owners of larger advisory businesses, by contrast, will have many — albeit complicated — alternatives available to them. They can continue to operate their businesses to maximize long-term growth or near-term profitability. Or they can sell their firms to three potential buyers: their employees, a financial buyer, or, in some instances, a strategic acquirer.

Regardless of which option is chosen, the next five to seven years will be challenging. Although their companies are profitable, the combination of higher operating and professional employee costs and the need to more widely share equity in their firms will make maintaining the owner's personal economics much more difficult.

Reinvest to grow and evolve

The first alternative available to owners of larger advisory firms is to significantly reinvest in the business so that its operating structure can evolve and thus be able to support substantial growth of clients and revenue. This strategy offers the greatest potential economic payout. Firms that successfully execute a high growth strategy will build significant enterprise value and will increase the likelihood that a potential strategic acquirer will offer a substantial price when their owners decide to sell.

Most advisory firms lack the business maturity to support large scale growth

This approach, however, is problematic for most large advisory firms because they have not evolved their businesses to a sufficient level of maturity to support such a strategy. Most large industry participants are too owner-centric and lack the professional business management essential to facilitating large scale growth. They also have cultures that would abhor the inherent bureaucratic nature this type of business evolution would require.

Thus, to successfully execute a high growth strategy, organizations will have to make significant investments in personnel and infrastructure that will reduce near-term profitability and owner take-home pay. And there is no certainty that such a strategy would succeed.

Cash cow strategies mortgage the firm's long-term future for near-term profitability

Cash cow strategy

A second strategic alternative available to owners of large advisory businesses is to focus on maximizing near-term profitability. This is currently the most popular default option in the industry since it involves the least amount of change. Essentially the firm continues to rely on its existing operating and governance structure and limits the growth in new clients to what it can support. The approach does not require significant reinvestment in the enterprise and thus, its increased near-term profitability translates into much higher take-home pay for the owner.

The drawback to this "cash-cow" option is that it effectively caps the organization's potential size and renders it more vulnerable over time to the broader forces (competition for clients and employees, higher operating costs) that are sweeping the industry. After a few years of harvesting profits, these firms will find that they are less effective competitors in a more difficult business environment and will have lower enterprise value. The strategy, in effect, mortgages the long-term future of the business for near-term profits.

Sell the business

The third strategic alternative available is to sell the company. For many owners this is (or will become) a compelling option because it would allow them to better fund their retirement and get on with the next phase of their lives. It also shifts many of the more difficult strategic decisions on to their successors.

The sale option is currently problematic, however, because there is a substantial gap between what owners believe their businesses are worth and what buyers are willing to pay for them. In other words, the market is not clearing.

Buyers are typically willing to pay five to six times Saleable Cash Flow, that is, a company's prior twelve month earnings before taxes and interest *after* paying the owners a market-level salary. An analysis of the prices of companies in comparable industries suggests that once the market for advisory firms becomes more competitive (in particular after the entry of more strategic buyers) many firms will likely trade at multiples of at least nine to eleven times.

There is a substantial gap between what buyers are paying and the implied intrinsic value of advisory businesses

Another drawback to this option is that regardless of the multiple paid for a firm's cash flow, it is a multiple of a seller's *current* Saleable Cash Flow. Given that most large advisory firms have significant operating leverage and their profitability will likely grow over the next few years, many owners may decide to wait to sell in order to boost the absolute levels of consideration a buyer might be willing to pay.

The decision to sell an advisory firm is never easy. It can be an emotionally wrenching decision because so much of an owner's energy has gone into building a firm and his or her self-image is often closely tied to the enterprise. Further, the process of selling a firm is typically very lengthy (six months to two years) and has the potential to alter the selling organization irrevocably regardless of whether a sale is ultimately consummated. Thus, properly managing the sales process, including potential buyers and the information provided to employees and clients, is critical in protecting a firm's enterprise value.

Three types of potential acquirers

Potential buyers of advisory firms can be broken down into three groups: legacy, financial and strategic acquirers. Transactions with these types of buyers differ significantly because they each have different perspectives and goals in acquiring advisory businesses.

1. Legacy buyers

A legacy transaction occurs when the owner sells the business to its employees. For most firms, large and small, a legacy transition will be the only option available to the owners to monetize their stake in the company. Its advantage is that it is the least disruptive to the firm, its culture and its clients.

Legacy transactions do not create a “legacy” for sellers

There are three major disadvantages, however, to these kinds of transitions. First, typically it results in the lowest risk-adjusted price because employees have substantial bargaining power over owners. These buyers have the best information about a firm’s strengths and weaknesses, as well as the owner’s motivation to sell. They also recognize that this transaction is often the owner’s only means for capturing some value for his or her ownership stakes and that failing to reach an agreement will likely lead to the employees’ departure from the company, a disastrous outcome for the enterprise.

Second, legacy transitions do not add value to an advisory business and instead only redistribute its current economics. As a result, the company will not be any better prepared for the many changes that will sweep through the industry in the coming years.

Third, the term “legacy” is often misleading because there is no certainty that an owner’s successors will be as willing to forgo consideration in the future so as to continue the firm in its current state. The financial services landscape is littered with organizations that transitioned ownership to a second or third generation only to see the new owners sell the firm to the highest outside bidder.

2. Financial buyers

Financial buyers capture most of the economics, while sellers bear most of the risk

Financial buyer transactions will likely be the second most common way that advisory firm owners transition their businesses. They involve the sale of all of a company’s equity and only a portion of its cash flow to an outside entity that specializes in providing liquidity to advisory firm owners.

Three aspects of these types of transactions are potentially attractive to advisory firm owners. First, they typically offer a higher absolute amount of consideration for a firm than that is paid in legacy transitions. Second, the day to day operations of the seller are largely left unchanged after a transaction. Third, many advisory firms do not have a successor generation in place and lack the scale to be an attractive acquisition for a strategic acquirer. Thus, a financial buyer transaction may be the only means for their owners to monetize the value of their ownership stakes.

There are also many drawbacks to these kinds of sales. Sellers are exposed to a wide variety of risks including: the quality (or lack thereof) of the other firms purchased by the buyer; any adverse changes to the financial markets or the condition of the seller's business; and the buyer's ability to continually do more acquisitions. Additionally, at current pricing and under almost all scenarios, nearly two thirds of the economic value captured from these kinds of transactions inures to the benefit of the buyer, often generating internal rates of return in excess of 100% on its capital.

Financial buyers add no value to their acquisitions

Further, financial buyer transactions add no value to the purchased entities. Similar to legacy transitions, the enterprise's competitiveness is not improved at a time that the industry's economics are going to change significantly. More problematically, unless the firm experiences significant growth, this transaction also substantially diminishes the incentives for the seller's next generation of owners, creating a significant peril to its long term viability.

3. Strategic buyers

A small percentage of the industry's largest participants will have the option of selling to a strategic acquirer. Potential strategic acquirers include banks, insurance companies and custodians.

A particularly attractive aspect of these types of transactions is that they almost always result in the highest risk-adjusted amount of consideration. Strategic acquirers can and do pay more because they are able to add value to the entities that they acquire — through proprietary new client referral networks, infrastructure and a broader brand — helping spur their growth and ensure their long-term viability. Their goal is that the resulting enterprise will have significantly higher value, a portion of which may be paid to the seller's owners.

Strategic acquirers also have substantially different objectives than those of either legacy or financial buyers. The latter two types of transactions involve dividing a firm's existing value between its current and future owners. And the outcome of this negotiation has a direct impact on the remuneration of the individuals involved.

Strategic acquirers pay more for acquisitions as they have the ability to help them grow

In contrast, the management of a strategic acquirer purchases advisory firms as part of a broader corporate strategy to succeed in the wealth management business. It expects that it will greatly facilitate the growth and value of any entity that it buys and, while it will only pay what it believes is a fair price, these individuals are not in effect negotiating its own compensation when doing deals.

Not all strategic acquisitions, however, succeed and sellers often find that the management with whom they negotiated a transaction has changed and they are now working with different individuals within a few years after a sale. Further, a key ingredient to the success of any strategic transaction — and the potential consideration paid — is the quality of the relationship between the seller and the buyer, and this relationship must evolve and adapt as circumstances change.

Strategic buyers only want to acquire firms with certain attributes

Advisory firms hoping to be acquired by a strategic acquirer will soon find that these types of buyers are only interested in companies with certain attributes. They typically seek only the largest firms in those geographic markets in which they operate other lines of business. They also closely scrutinize the quality of a potential seller's client base, its owner's motivations to sell and the maturity of its business. Strategic acquirers are looking to build much bigger resulting enterprises and thus, are only interested in buying strong operating businesses with enthusiastic management.

It is important that advisory firms also recognize that there are many buyers claiming to be strategic acquirers that are, in reality, financial buyers. While these organizations are able to add value to their acquisitions, they are reluctant to substantially share the incremental value created with sellers. These faux strategic acquirers also structure their acquisitions so that they are highly accretive to their shareholders under almost all circumstances. This is particularly unfavorable to advisory firm sellers because the stock prices of these types of buyers are closely tied to their other lines of business (such as banking or insurance) that typically trade at lower multiples than received by recurring revenue businesses such as advisory firms.

Market for advisory firms should improve

Prices for larger firms will improve to nine to eleven times cash flow

Finally, the current paucity of strategic buyers will not continue indefinitely. Many potential buyers have as key corporate objectives the building of large wealth management units and are attracted to the high quality businesses that many advisory owners have built. Their entry at some point will rationalize the market for advisory firms and help end this current deadlock between buyers and sellers.

Regardless of which sales option an advisory firm elects to pursue, its owners should recognize that a competitive process is an essential ingredient for success. No buyer wants to pay more than they have to acquire a firm and only the threat of losing an acquisition to a competitor will force it to pay full and fair value.

Conclusion

While the owners of larger advisory businesses will have many options — many more than their smaller counterparts — there is no one correct choice. Each alternative has some attractive features. Each alternative is, however, also fraught with risk.

At the same time, the industry and its economics are not going to remain static. The forces shaping the industry are being driven by extrinsic factors and by the market forces that ultimately govern every industry. The challenge for owners of advisory firms is to determine the alternative that is most appropriate to their organization while best meeting their personal goals.

Introduction: The Evolution Has Begun

Financial advisors awoke five and a half years ago to a research paper that predicted dramatic changes to their industry. The 1999 Undiscovered Managers study, *The Future of the Financial Advisory Business and the Delivery of Advice to the Semi-Affluent Investor*, took a hard look at the structure of the advisory business, the forces confronting it and made a series of prognostications as to how the industry would change over the next decade.

The principal thesis of the paper was that, due to an excess supply of clients (relative to the capacity of industry participants to service them) the independent financial advisory business had not yet experienced the same market forces that rationalize all other industries. A combination of factors including new competitors, greater capacity of existing participants and the expanded use of technology would change all of this. No longer would the advisory business remain a genteel industry whose participants cooperated instead of competed with one another. It would instead become a brutish battle for clients and personnel.

A study predicted the industry would evolve into a brutish battle for clients and personnel

To be sure, the paper argued that demand for advice would continue to grow at a very high rate. The demand by advisory firms for clients, however, would grow at an even faster rate. Eventually a crossover point would be reached at which the demand for clients would outstrip their supply. The industry would then undergo a vigorous rationalization and its structure would change significantly.

From a highly fragmented industry made up of competitors of all sizes would emerge a small group (40 to 50 organizations) of dominant competitors: highly profitable, large firms that would "look like multi-user family offices for the semi-affluent." These firms would have at least $15 billion to $20 billion in assets under management and some would be much larger.

The 1999 study was published at a time when success in the advisory business was easy

While there would still be numerous smaller firms, only one type — mid-sized niche competitors with a minimum of $550 million to $600 million of assets under management — would flourish. These high-profit specialist firms would provide sophisticated services that solve the most complex problems of select groups of individuals. Thousands of other small firms would continue to exist, but their owners would work much harder, earn far less than they did in 1999 and their businesses would possess little enterprise value.

Predictions From the Original UM Research Paper (1999)

1. Increased competition for clients and staff would rationalize industry
2. New industry structure would emerge
   a. Handful of large, highly-profitable dominant competitors
   b. Many mid-sized profitable niche competitors
   c. Thousands of small unprofitable firms

A storm of controversy ensued

The paper's conclusions were, understandably, not widely embraced. Business was booming. New clients were plentiful. Even advisors who spent the bulk of their time attending conferences, publishing books and participating in professional associations were prospering. How could such draconian changes occur in only ten years?

Some experts and industry participants argued that since advisors were "professionals" and not in the "business of making money", the normal market forces that shaped all other industries would benignly pass theirs by. Still others felt that viewing the advisory business solely from an economic perspective misunderstood the fundamental relationship between advisor and client, one that was largely immune to the forces discussed in the paper.

Time to take another look

The advisory business has changed dramatically since 1999

Now that it is just past the midpoint of the predicted evolution, we decided to revisit the question of the future of the advisory business. Much has changed in the past five years. The equity markets underwent their largest correction since the Crash of 1929, eviscerating many investor portfolios. Scandals emerged at financial services firms of all sizes, giving individual investors reason to doubt the quality of financial advice they received. The tax code was made much more favorable to long-term investors as capital gains rates — and the application of the alternative minimum tax to those gains — were significantly lowered. And interest rates fell to record lows, while oil prices hit all time highs.

The advisory business has likewise undergone many changes since 1999. Five years ago, building and running a successful advisory business was not very difficult. New firms started every day. The compensation of almost every owner of an advisory business rose each year. Success was so easy that in some parts of the industry, participants spent more time focused on minimizing their work load and maximizing their lifestyle than at looking at ways to build better businesses.

Today, there are far fewer de novo organizations and most new competitors are formed by individuals who have brought large numbers of existing clients from their previous employer. Although a small percentage of the owners of advisory businesses now have seven figure incomes, a much higher percentage of firm owners make less than $100,000 per year. Industry participants also now spend more time discussing how to capture and retain clients than how to avoid taking new ones.

Twelve month undertaking

This paper is the result of more than a year of work involving a joint JPMorgan/ Undiscovered Managers team. As part of our research, the team reviewed both public and private financial data. We also benefited from the help of more than 100 advisory firms, numerous consultants and many other service providers.

We had three goals when we embarked on researching and writing this document. First, we wanted to provide advisors with a better understanding of how the financial advisory industry has evolved since 1999 and what caused these changes. Second, we wanted to present firm owners with a roadmap as to how their industry will likely change over the next five to seven years. And finally, we wanted to create a tool that advisory business owners can use when thinking about their companies' (and their own) future.

Five part paper

To meet these objectives we have divided the paper into five sections. The first chapter analyzes the current state of the industry and provides a comprehensive picture of the industry's competitive landscape. It also reviews the forces that have changed and shaped the industry since 1999.

Chapter 2 examines those forces that will — by 2012 — change the economics of owning and operating an advisory business. It also analyzes the non-economic factors that will help shape the industry.

The third chapter forecasts how the industry will likely evolve. Included in these forecasts is an analysis of the likely potential outcomes for different groups of industry participants based on their current economics.

Chapter 4 looks at the options available to advisory firms and their owners. This discussion includes a detailed examination of the merits and drawbacks of each alternative.

Finally, the paper's conclusion reviews the predictions made in the original research paper and compares them with what has happened in the industry over the last five years. This section analyzes whether the industry's evolution to date is consistent with earlier predictions, whether the changes were as a result of the forces outlined or other, unforeseen factors and what this all might mean for the prognostications made today about the next five to seven years.

Chapter 1: Current Competitive Landscape of the Advisory Business

As a starting point for this study, we examined the current structure and economics of the advisory industry. As part of our analysis, we reviewed every Form ADV filed with the SEC in 2004.

There are more than 19,000[1] registered investment advisors in the United States, of which almost 9,000 are large enough to require registration with the SEC.[2] Included in these organizations, however, are also traditional money managers — firms that manufacture products and do not compete to provide financial advice to individuals. Our challenge was to identify the actual competitive universe of the financial advisory business by separating out the pure money managers from wealth managers.[3]

To meet this goal, a team of researchers waded through all of these filings. They also visited thousands of individual firm websites and reviewed other publicly available data so that they could provide an accurate picture of the industry's current structure. Their findings are shown in Exhibit 1.1.

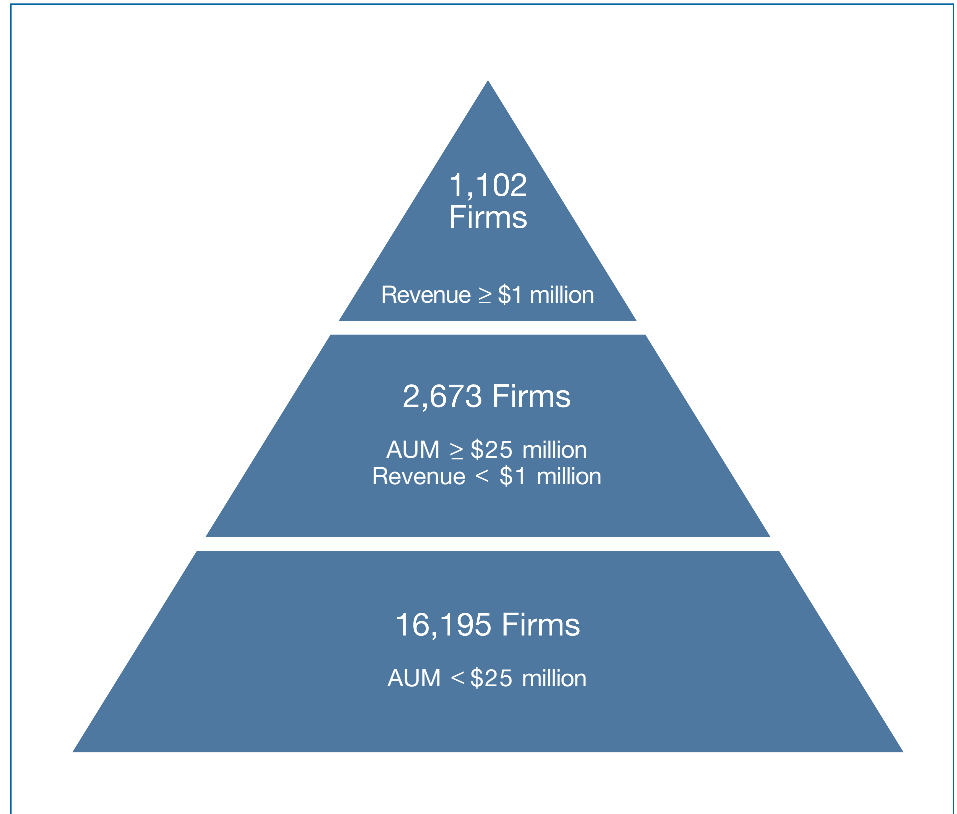
[1] Cerulli Associates 2005

[2] Advisors that manage more than $25 million generally are required to register with the Securities and Exchange Commission and file a Form ADV.

[3] The basis for much of the information contained in this paper regarding the current structure of the advisory industry is our review of the Forms ADV filed with the SEC in 2004. Our goal was to determine the universe of independent financial advisory firms that provided financial advice to individuals — both high net worth and otherwise. In order to do this, we eliminated firms that provided solely investment management services to institutions and/or mutual funds. We also eliminated the very large financial services firms (such as wirehouses, regional and independent broker-dealers, insurance companies, banks and trust companies) that provide both asset management services as well as personal financial advisory services. There are approximately 130 firms that fall into this "mega-firm" category.

We examined the data to cull firms that explicitly provided financial planning and/or provided services to high net worth and other individuals. We included, however, some money management firms that have a separate advisory practices (as well as, in some cases, a separate broker-dealer); we also included firms that provide asset allocation services for individuals but primarily manage money (as opposed to financial planning). In cases where the Form ADV did not affirmatively suggest that financial planning was offered, but the firm seemed to be providing advice to high net worth individuals, we did additional research, including reviewing websites and making informational calls.

Exhibit 1.1 Current Industry Structure



Source: 2004 Form ADV filings with the Securities and Exchange Commission, Cerulli 2005

Most advisory firms — over 80% of industry participants — are very small businesses

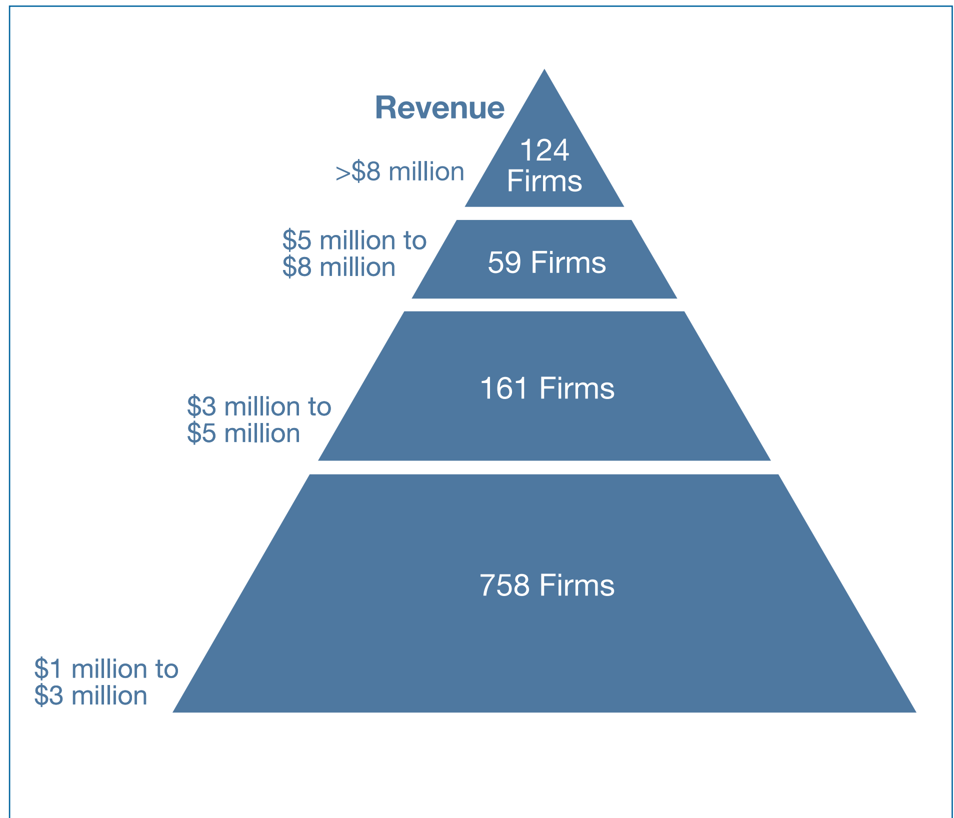
Most industry participants are small

As shown above, the industry can be segmented by the size of a firm. At the bottom of the pyramid are those organizations with less than $25 million of assets under management. Most advisory firms (more than 80% of industry participants) are very small businesses and fall into this category.

The second level of advisory businesses — firms with more than $25 million in assets under management, but estimated to generate less than $1 million of revenue — includes approximately 2,600 businesses or about 13% of the industry's participants. These organizations, while they generate much more revenue than those companies at the bottom of the pyramid, are still relatively small businesses.

Only a small fraction (about 6%) of the industry generates more than $1 million in annual revenues and is shown at the top of the pyramid. This group of larger firms, however, is far from homogeneous. As shown in Exhibit 1.2 below, they can be segmented into their own pyramid.

Exhibit 1.2 Segmentation of Large Participants



Source: 2004 Form ADV filings with the Securities and Exchange Commission

Fewer than half of the largest firms are independent registered investment advisors

At the very top of the large advisory firm pyramid above are the largest 124 firms in the industry: each generates in excess of $8 million in revenue annually. Fewer than half of these organizations are independent registered investment advisors. Instead, they are money management organizations that also provide financial advice to individuals. This group does not, however, include multi-line financial services companies, such as wirehouses, regional broker-dealers, banks and insurance companies.

The middle segments of the larger firm pyramid are made up mostly of independent advisory firms that currently generate either $3 million to $5 million (about 161 firms) or $5 million to $8 million (59 firms) of revenue annually.

The bottom of the pyramid consists of 758 mid-sized businesses with annual revenues of less than $3 million but at least $1 million. They typically have 10 or fewer employees and many of them are just beginning to generate material profits.

Two conclusions leap from the data: the industry consists of mostly small businesses with limited prospects and a handful of firms are building big companies

The current state of the industry

Two conclusions about the current state of the advisory industry leap from this data. First, a small percentage of industry participants are far along in building large, highly profitable advisory businesses. These high revenue firms have the resources to reinvest and grow and will likely prosper for the foreseeable future.

Second and at the other end of the continuum, the vast majority of the industry's participants are very small businesses with little revenue or profits. And, as we will discuss later, their small size greatly limits their long-term prospects.

Determining the current state and future prospects of the mid-sized firms — the 2,673 organizations that have at least $25 million of assets under management but less than $1 million of revenue and the 810 firms that have more than $1 million of revenue but less than $3 million — however, is a much more complicated problem. Size of assets and revenues are only two of many factors that determine the quality and profitability of a business. In addition, since these companies are privately owned entities, there is no easy way to precisely quantify their economics.

To better understand these organizations, we interviewed numerous owners of advisory businesses throughout the country. Our team also conducted a detailed analysis of advisory firm profitability data collected by The Financial Planning Association (FPA) and Moss Adams LLP in 2004, as well as data gathered by companies such as Cerulli Associates.

Mid-sized firms can be broken into two groups

Mid-sized firms can be broken into two groups

We found that mid-sized firms can be divided into two sub-groups. Most are economically unsound businesses largely because of the low quality of their client bases and (due to the forces we discuss later) their long-term prospects are relatively bleak.

This segment of the industry, however, also includes a small number of high profit mid-sized firms. They have strong businesses with attractive client bases. Their profitability provides them with the resources to invest in their businesses and their client bases make them potentially appealing acquisitions for other firms.

2004 FPA study highlighted disparity between firms

The disparity between the current economics and future prospects of firms in the middle segment of the industry is most apparent in the results of the *2004 FPA Financial Performance Study of Financial Advisory Practices*. The study grouped participants into High Profit Ensembles, High Profit Solos, Other Ensembles and

The compensation of "High Profit Ensembles" owners dwarfs those of the other groups

Other Solos, as shown in Exhibit 1.3. High Profit Ensembles are the top performing 25% of advisory firms with more than one professional. Their compensation per owner (over $360,000 per year) dwarfs the average earnings per owner of every other category of advisory business.

Exhibit 1.3 The FPA Survey Divided the Industry Into Four Groups

High Profit Ensembles	
AUM	$ 174M
Median revenue	$ 1.3M
Pre-tax income/owner	**$ 367K**
Operating margin	19.1%
Median client size	**$ 919K**
Op. profit/client	**$ 1,573**

Other Ensembles	
AUM	$ 72M
Median revenue	$ 557K
Pre-tax income/owner	**$ 104K**
Operating margin	5.3%
Median client size	**$ 527K**
Op. profit/client	**$ 293**

High Profit Solos	
AUM	$ 50M
Median revenue	$ 376K
Pre-tax income/owner	**$ 218K**
Operating margin	20%
Median client size	**$ 373K**
Op. profit/client	**$ 649**

Other Solos	
AUM	$ 20M
Median revenue	$ 175K
Pre-tax income/owner	**$ 70K**
Operating margin	4.9%
Median client size	**$ 263K**
Op. profit/client	**$ 157**

Source: FPA/2004. Data shown are median reported information.

High Profit Solos are the top performing 25% of advisory firms that have only one owner/operator, in some instances assisted by a junior technical person. These firms manage about $50 million of assets, generate median annual revenue of more than $375,000 and provide about $200,000 of annual income to their owners.

Other Ensembles, while larger than their High Profit Solo counterparts with median annual revenue of $557,000 are mostly unprofitable firms — that is, they would lose money if they paid their owners a market level salary. Instead, their owners earn about $100,000 per year or less than they would likely make as employees of a larger organization.

The Other Solo category consists mostly of small firms that do not manage much money and on average have relatively small clients who pay small fees. They are unprofitable as businesses and pay their owners only about $70,000 per year.

Most mid-sized firms are likely in the Other Ensemble category

Most mid-sized firms fall into the "Other Ensemble" category

These four groupings were based on a firm's profitability and not the size of its assets under management or revenue. If you consider these two attributes, however, it appears that most mid-sized firms fall into the Other Ensemble category. In this category (as also shown in Exhibit 1.3), advisory businesses average $72 million of assets under management and have median annual revenues of $557,000 — in both cases, slightly larger amounts than the average of those 2,673 mid-sized firms that have less than $1 million of annual revenue but more than $25 million of assets under management.

At the same time, the assets under management ($174 million) and the annual revenues ($1.3 million) of the High Profit Ensembles make it likely that a majority of the 758 mid-sized firms with $1 million to $3 million of annual revenue fall into that category. Those that do probably are high-profit mid-sized firms.

The assets under management and the annual revenue of the High Profit Solos and Other Solos make it unlikely that many mid-sized firms fall into either of these categories. In both cases, these averages are significantly lower than those of mid-sized firms. Thus, while the High Profit Solo group might include a small number of high profit mid-sized firms, they are probably some of the largest firms in this category.

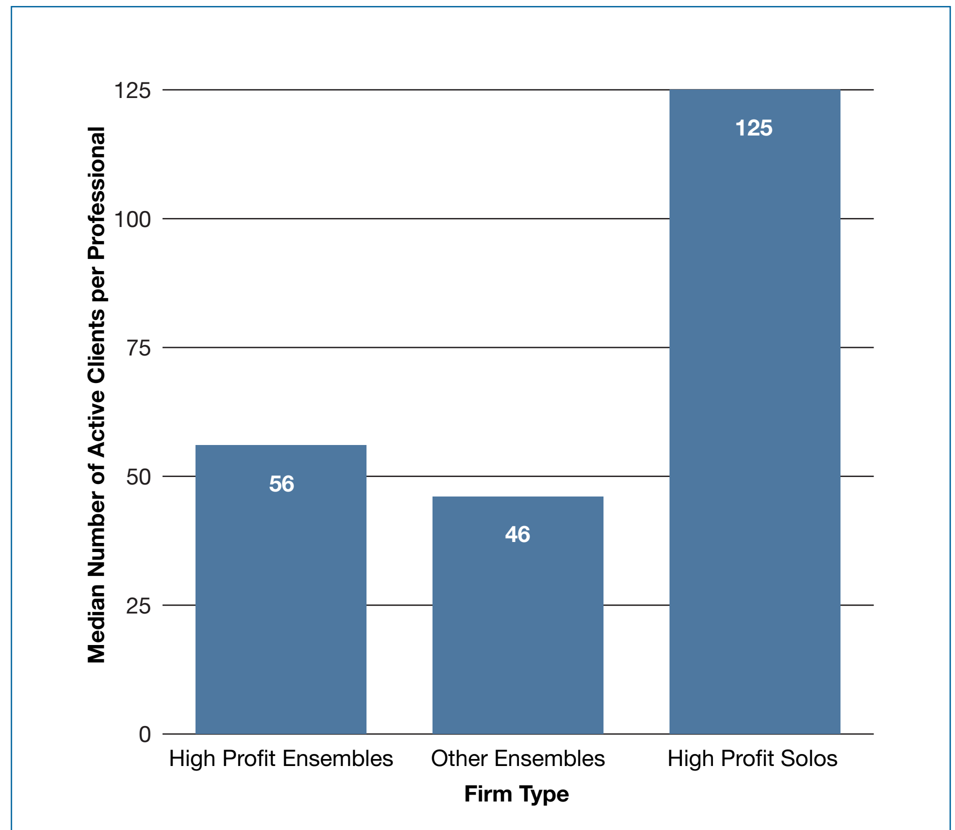
Quality of clients is a key source of differential in profitability

Quality of client base is an indicator of long-term profitability and prospects

Trying to determine into which FPA category a mid-sized firm falls is useful when predicting its long-term prospects because the quality of the clients serviced by each group varies widely. For example, High Profit Ensemble clients each generate about $1,573 of annual profit. In contrast, the median annual profitability per client of Other Ensemble and High Profit Solo category firms are only $293 and $649, respectively.

This wide variance in profitability per client is particularly important given the large volume of clients that firms in each group currently service. As shown in Exhibit 1.4, High Profit Ensembles have a median of 56 clients per professional, while Other Ensembles have 46 and High Profit Solos 125 clients per professional.

Exhibit 1.4 Many Advisory Firms are Operating Near Capacity



Source: FPA/2004

Businesses that operate at or near capacity and do not make money are marginal businesses

For the firms in the Other Ensemble group, this is problematic for two reasons. First, it suggests that they are operating at or near capacity. While there is great debate within the industry over the appropriate professional/client ratio, our research found that most profitable firms try to maintain a ratio of no more than 50 to 60 clients per professional and many prefer an even lower number. Assuming such ratios are reasonable, these organizations do not have much (if any) additional remaining capacity.

Second, despite operating at or near capacity, they still do not make any money as businesses. And companies that are operating at or near capacity but are still unprofitable are, by definition, marginal businesses.

Combination of revenue and quality of client base determine quality of business

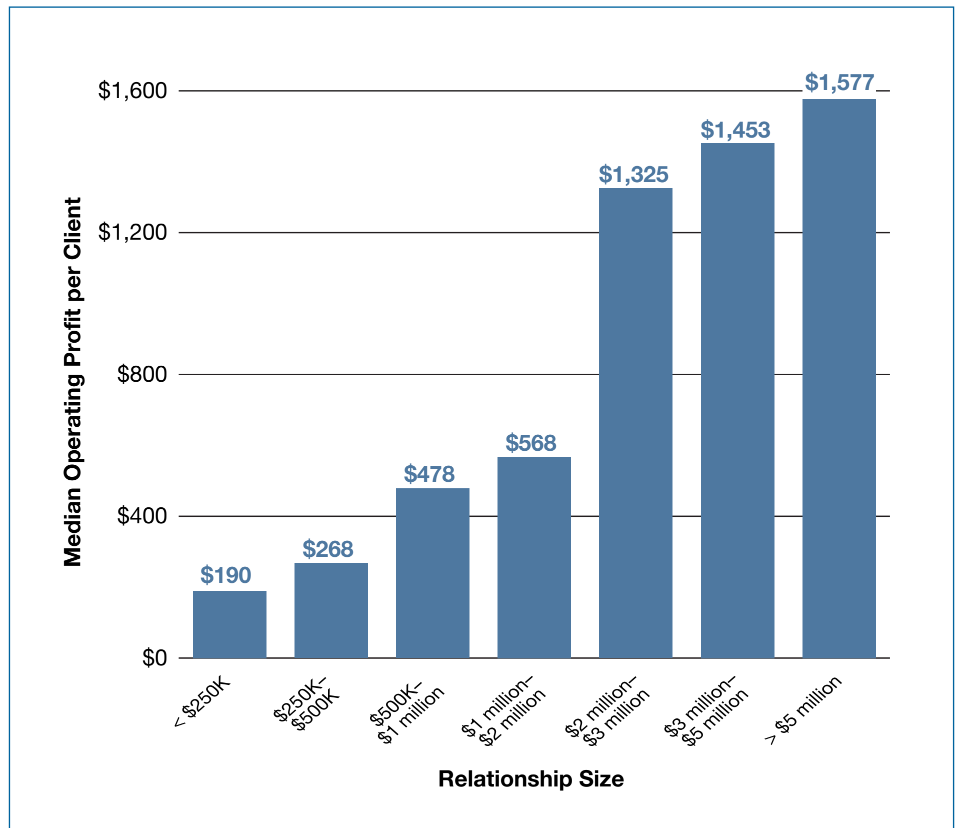
It takes both revenue and a high quality client base to build enterprise value

It is important to emphasize, however, we do not believe that a firm's current level of revenue alone is the best determinant of whether it is profitable and has strong long-term prospects. Rather, it is a firm's current level of revenue *combined with* the quality of its client base that best determine an organization's potential to build enterprise value. These two factors determine its level of profitability which in turn provides the resources it needs to finance its growth.

For example, there are currently several high profit mid-sized firms that have less than $1 million of annual revenue but that have been extremely disciplined in the selection of clients. Unlike most other mid-sized firms, they have refused to take (or have shed) low profit clients. By focusing on the quality of their client base instead of chasing every opportunity, they generate more revenue per client and per dollar of operating cost, making very profitable companies.

At the same time, there are several firms with $1 million to $3 million of annual revenue that have far too many poor quality clients. Despite their large size, these organizations are only marginally profitable. Unless they can upgrade either their efficiency or the quality of their client base, their long-term prospects will be fairly limited.

Exhibit 1.5 Larger Clients are More Profitable



Source: FPA/2004

The industry is divided into "Haves" and "Have Nots"

Haves and Have Nots

Combined, all of the data that we have reviewed — the Form ADVs, the FPA survey, our interviews with numerous firm owners and data from other third party firms — suggests that it is also possible to divide the industry into two broad groups made up of Haves and Have Nots. The term "Haves" refers to those organizations that are very profitable entities and thus have the financial resources to fund growth. The term "Have Nots" refers to those companies that are only marginally profitable or are unable to pay their owners a market-level salary and thus do not have the funds necessary to reinvest in the business.

Haves include the industry's largest participants as well as high profit mid-sized firms. While it is impossible to precisely determine how many firms fall into this category, our best estimate is that combined, these organizations total about 1,100 firms or 6% of the industry's participants.

In contrast, most advisory firms fall into the Have Not category. Because they make little or no money as businesses, are unable to invest and improve their firms and largely have clients that profitable firms do not want, they are particularly vulnerable to the changes that will likely sweep through the industry over the next five to seven years.

About 94% of industry participants are "Have Nots"

What has caused this industry structure to emerge?

What has caused the industry to divide into a collection of Haves and Have Nots? Four forces have driven this mini-rationalization of the advisory business, but they have not affected all individual participants in a uniform manner. Many firms have seen their economics irreparably damaged. At the same time, others have been only marginally impacted by these changes. And how advisory firms have been able to respond to these changes has been a key determinant in whether they are Haves or Have Nots.

Forces that Divided the Industry into Haves and Have Nots

1. Many new entrants
2. Repackaging of traditional competitors
3. Expanded capacity from technology
4. End of hidden subsidy

1. New entrants to the industry

The first force has been the entry of a flood of new competitors for clients. As shown in Exhibit 1.6, all types of financial services companies now compete for advisory firm clients. Accounting firms have both created advisory units and acquired existing businesses. Insurance companies throughout the country are trying to convert their agent networks into wealth managers. And banks have expanded beyond traditional trust services and now market advisory services to their wealthier customers.

Exhibit 1.6 **Competitive Landscape of the Financial Advisory Business**
Examples of new entrants and re-engineered traditional competitors

Re-engineered Traditional Competitors

Morgan Stanley Private Wealth Management
Prudential Investment Management Services
Merrill Lynch Global Private Client
Smith Barney Wealth Management
UBS Wealth Management USA
American Express Financial Advisors Inc.

Banks

Wachovia Wealth Management
Compass Brokerage Inc.
Commerce Wealth Advisors
Banc of America Investment Services Inc
Mellon Private Wealth Management
Wells Fargo Investments LLC
Citigroup Global Wealth Management
SunTrust Asset Management
JPMorgan Asset & Wealth Management
PNC Advisors
LaSalle Bank Wealth Management Group
Wilmington Trust Wealth Advisory Services

Insurance Companies

Northwestern Mutual Life Financial Advisory Network
NY Life Investment Management LLC
AXA Financial Inc.
Allstate Financial Services
Mutual of Omaha Insurance Company
Nationwide Investment Services Corporation
The Hartford Investment Management
John Hancock Financial Network

Accounting Firms

Financial Securities Group (Moss Adams)
Plante & Moran Financial Advisors
PriceWaterhouseCoopers Advisory Services
Financial Advisory Service LLP (Deloitte)
Mordfin Financial & Business Advisors LLC
BKD WealthPlan LLP
Honkamp Krueger & Co. Financial Planning Services

Custodians

Fidelity Portfolio Advisory Services
TD Waterhouse Investor Services
Bank of New York Financial Services
State Street Global Advisors
Charles Schwab Private Client

Law Firms

Burns and Levinson Asset Management LLC / Burns and Levinson LLP
Legacy Analytics, LLC / Cohen & Burnett, P.C.
B & D Advisors / Bowditch & Dewey, LLP

New Entrants

H & R Block Financial Advisors
E*Trade
Vanguard Asset Management

Many traditional competitors have re-engineered their offerings to resemble services of independent financial advisors

2. Repackaging of traditional competitors

A second and more ominous (from a long-term perspective) force in shaping the advisory business over the past five years has been the efforts by many of the largest traditional competitors to repackage themselves so that their service offering appears to be the same as that of independent financial advisors. As shown in Exhibit 1.7, many large brokerage organizations and banks now use many of the same terms and expressions as independent advisory firms to describe their offerings.

Exhibit 1.7 Try and Tell the Difference

A

"When one of our Financial Advisors helps you formulate your financial plan, no products or services are mentioned. You get just personalized guidance and valuable financial information."

B

"We understand your expectations: to partner with a trusted advisor who understands your goals and objectives who provides unbiased strategies that you are confident in implementing, and who is committed to developing a long-term relationship with you."

C

"Your team of advisors deliver expert, objective guidance and solutions that work for your individual situation. Set your goals. We'll help you reach for them. See how our customized solutions can work for you."

D

"Our fee-based approach means that what you pay will match the scope of the financial needs and goals that are addressed in your initial personalized plan. You pay only for what you need at that time. Once you move to the monitoring phase, the fee structure will change to meet your needs, as well."

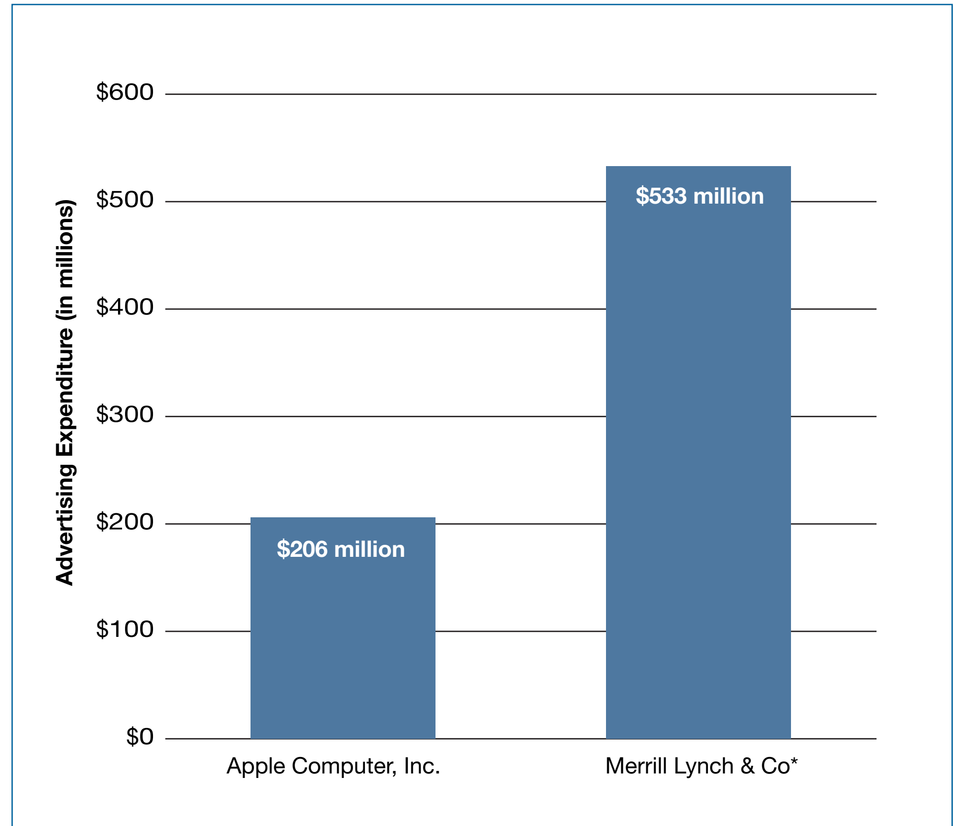
Answers

A. National Broker/Dealer
B. Financial Advisor Affiliate of an Accounting Firm
C. Bank
D. Insurance Company

As of March 2005

While the actual services provided may not be directly comparable to that of the best advisory firms, large organizations can use their immense marketing resources to position their capabilities to uninformed potential clients. Since these firms spend millions of dollars of advertising each year (one example is shown in Exhibit 1.8), it can be difficult for the average consumer to differentiate between what they would get as opposed to what the provider offers.

Exhibit 1.8 Merrill Lynch Spent More Than Twice as Much on Advertising as Apple in 2004



* $533mm represents advertising and market development.
Source: Apple 2004 Annual Report; Merrill Lynch 2004 Annual Report

Competition has affected smaller firms more adversely than larger ones

New competitive environment for clients for some firms

Combined, the various new competitors and the repackaging efforts of the larger brokerages have in general intensified the competitive environment for new clients. Their effect on individual advisory businesses, however, has varied greatly depending upon the size of the firm.

On the one hand, the Haves generally have experienced little competition for clients. Conversely, a key reason why many firms are now Have Nots is that the new entrants and repackaged traditional competitors have made it much harder for smaller firms to compete for attractive clients and grow their businesses profitably.

This disparity is even greater when you consider that most of the Haves that we interviewed are more concerned about capacity than their ability to capture new clients. Because of the high demand for their services, the Haves have been able to significantly upgrade the quality of their client bases. Many have raised their minimum fees, terminated many low profit clients and have become more selective in the kinds of individuals they are willing to advise.

For smaller firms, however, new participants to the industry have made growth a much more difficult challenge. Unlike five years ago, these smaller advisory firms now often find that they are only one of many choices that a typical potential client is considering for advice, including brokers, insurance agents who have reinvented themselves as financial advisors and other, larger independent advisory firms.

Larger firms have strong brands and referral networks

Two reasons why competition has hurt smaller firms more than larger ones

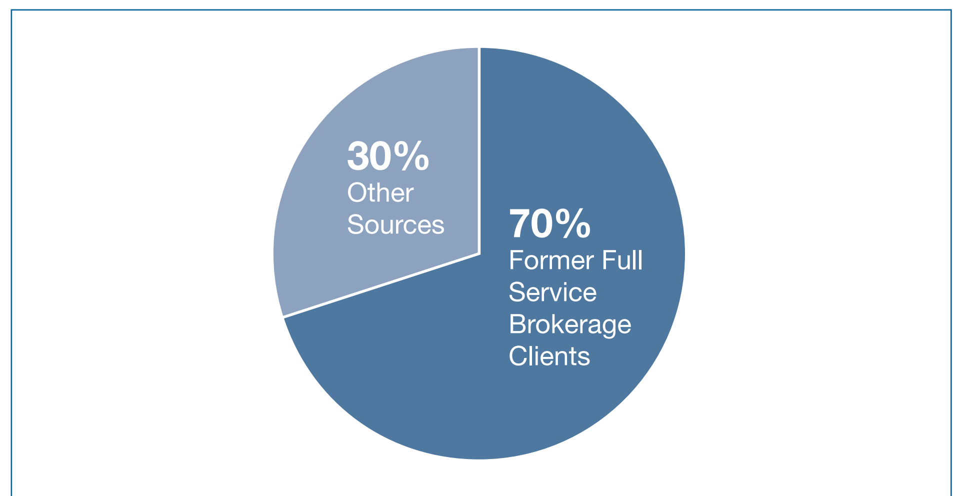
Two factors have created a disparity in the ability of advisory firms to capture new clients. First, most potential clients rely on the recommendations of friends (who are often clients of a firm) and their other service providers (such as accountants and lawyers) when selecting a financial advisor. And because many of the larger advisory firms already service high volumes of attractive clients and have built broad networks with those types of professional organizations that typically refer clients to an advisory firm, the larger firms have many more chances to capture additional attractive clients.

Smaller industry participants, on the other hand, start with two disadvantages. Their weak client bases generate fewer internal referrals of attractive potential new clients. These organizations also lack the resources to widely network with other service providers. Thus, the smaller firms receive fewer opportunities and are rarely considered for the role of financial advisor for large potential clients.

A second factor is brand. There have been opportunities for advisory firms to acquire new clients as a direct result of the problems that many financial services firms have had over the past three to five years. These organizations have lost the trust and respect of some clients, which in turn has caused them to seek the type of independent advice that fee-only advisors provide.

This migration is shown in recent data on the sources of potential clients. As shown in Exhibit 1.9, one custodian estimated earlier this year that over 70% of the net new assets of its advisory clients have been moved from full-service brokerage firms.

Exhibit 1.9 Many New Advisors' Clients Were at Brokerage Firms
Source of New Advisor Assets at One Custodian



Source: TD Waterhouse Presentation/2005

Only larger firms were able to capitalize on the problems of brokerages

While many of the refugees from brokerages were (and are) compelling potential clients for advisory firms, only the larger partcipants were generally able to capitalize on this opportunity for growth. Since many of these individuals had lost large sums of money with their previous intermediary and were understandably risk averse when evaluating a potential replacement, reputation and local brand were important criteria used in searching for new advisors. Consequently, they typically sought out the largest advisory firms in their communities — organizations that had a strong local brand or that were recommended by their accountants, lawyers, and/or friends.

The small size of other advisory firms, however, often excluded them from consideration by the most attractive potential clients fleeing wirehouses and regional dealers. The smaller firms simply lacked the brand and presence in their local markets that was necessary to be viewed by these individuals as a low-risk alternative.

3. Technology

The third force that has helped shape the advisory business over the past five years has been technology. Its impact on the economics of individual advisory firms, however, has varied greatly amongst different sized industry participants.

In general, technology has increased the efficiency — and thus the capacity — of advisory businesses. Automated trading, the ability to fill out client forms online (and not have to mail them to custodians), online research and client relationship management software that enables advisory businesses to more easily store data and communicate with clients are just a few of the beneficial effects of technology over the last five years. One mid-sized firm that we interviewed estimates that technological improvements over the past few years has saved them the equivalent of a full-time employee.

Technology has primarily benefited larger firms

The use of technology has not been uniform across the industry, however, for a couple of reasons. First, it is expensive and many smaller firms lack the financial resources necessary to pay for it. Second, technology's greatest benefit is providing greater operating leverage to large organizations. It allows businesses to more efficiently complete thousands of mundane tasks for large numbers of clients. Smaller firms simply lack the scale necessary to fully benefit from an expanded use of technology.

Thus, while technology has been a positive force in the industry over the last five years, its primary role has been to improve the efficiency of the industry's largest participants.

Example of New Advisory Firm Technology

Rebalancing portfolios is an essential part of managing a client's assets. Asset allocations within a portfolio regularly shift with the ebb and flow of the markets and clients also often need to either withdraw or invest cash. Recent research has shown that rebalancing more frequently and within optimized windows can add as much as 0.10% to 0.30% in return to client portfolios.

The rebalancing function is often problematic for advisory firms, however, because it can be complicated — all of a relationship's accounts must be evaluated as well as their tax situation. It is also very time-consuming. Performing this function manually typically takes 15 to 20 minutes *per relationship*. For a firm with 100 relationships, a highly trained individual must typically spend more than 30 hours every time it rebalances client accounts.

iRebal (www.iRebal.com) is a good example of a new technology company with a product that significantly improves the efficiency of larger industry participants. Founded by three top advisory firms in early 2004, the company's software platform adds value in two ways. First, it dramatically reduces the amount of time advisory firm staff must spend each time they rebalance their clients' accounts. Second, it includes a series of algorithms that allow an advisor to significantly improve client returns through a more tax-efficient rebalancing process.

Although it takes a fairly long time to install (typically three to four months), iRebal's system can rebalance the accounts of 100 relationships in less than ten minutes. Because it is so efficient, advisory firms with the system can more frequently perform this function and improve their clients' returns.

More importantly, the platform also allows advisors to use rebalancing as a tool for improving the after-tax returns of investors. Recent research has shown that advisors can add as much as 0.20% to their clients' after-tax returns by using tax-deferred accounts for certain asset classes and taxable accounts for others. This platform includes a layer of programming that conducts this analysis, rebalances by lot (which can potentially increase after-tax returns by an additional 0.05% to 0.15% annually) and also evaluates whether the tax consequences from the sale of an asset outweigh the benefits of rebalancing.[4]

[4] "Asset Location: A Generic Framework for Maximizing After-Tax Wealth", Gobind Daryanani and Chris Cordaro, Journal of Financial Planning, January 2005 Issue

The end of a hidden subsidy was the biggest reason for the industry to divide into "Haves" and "Have Nots"

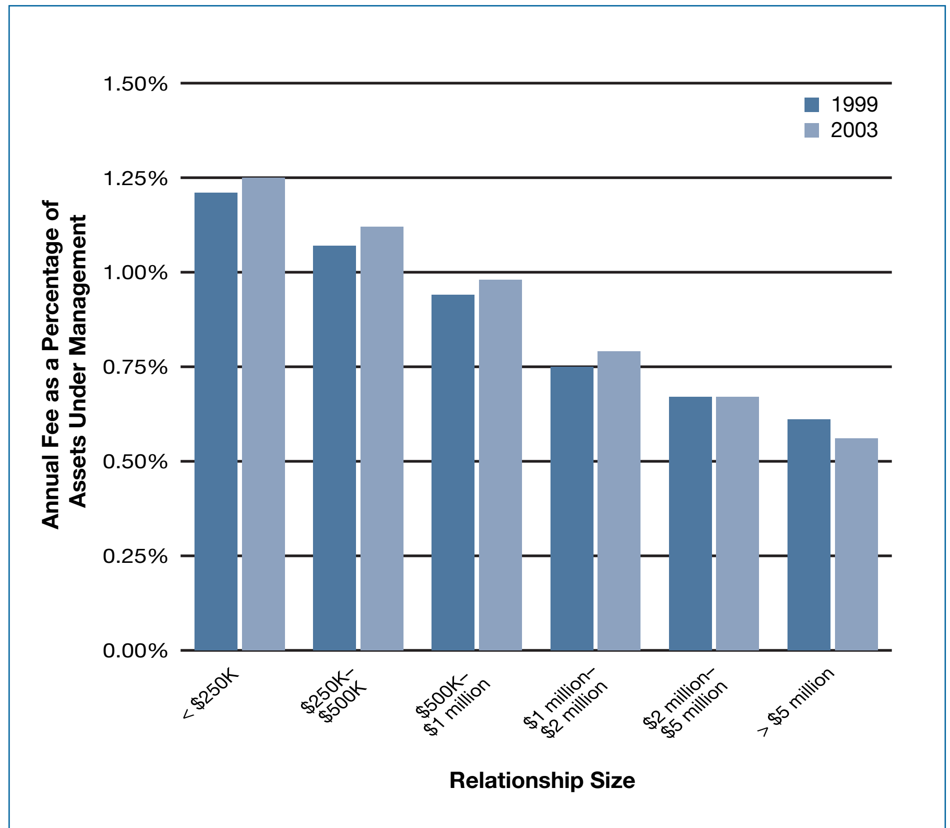
4. End of a hidden subsidy

These three forces — numerous new entrants to the industry, the repackaging of existing competitors and the expanded use of technology — have not, however, changed the current economics of most small advisory businesses. Our research found that small firms have largely been able to retain most of their clients and (as shown in Exhibit 1.10) the fees they pay have remained stable.

Rather, the combined effect of these changes to the industry has been to limit the future growth prospects of its small participants.

Instead, the segmentation within the industry over the last five years into Haves and Have Nots also exists because of a fourth force — a sudden irreplaceable drop in revenues caused by changes in the equity markets.

Exhibit 1.10 Average Advisory Fees Have Remained Stable

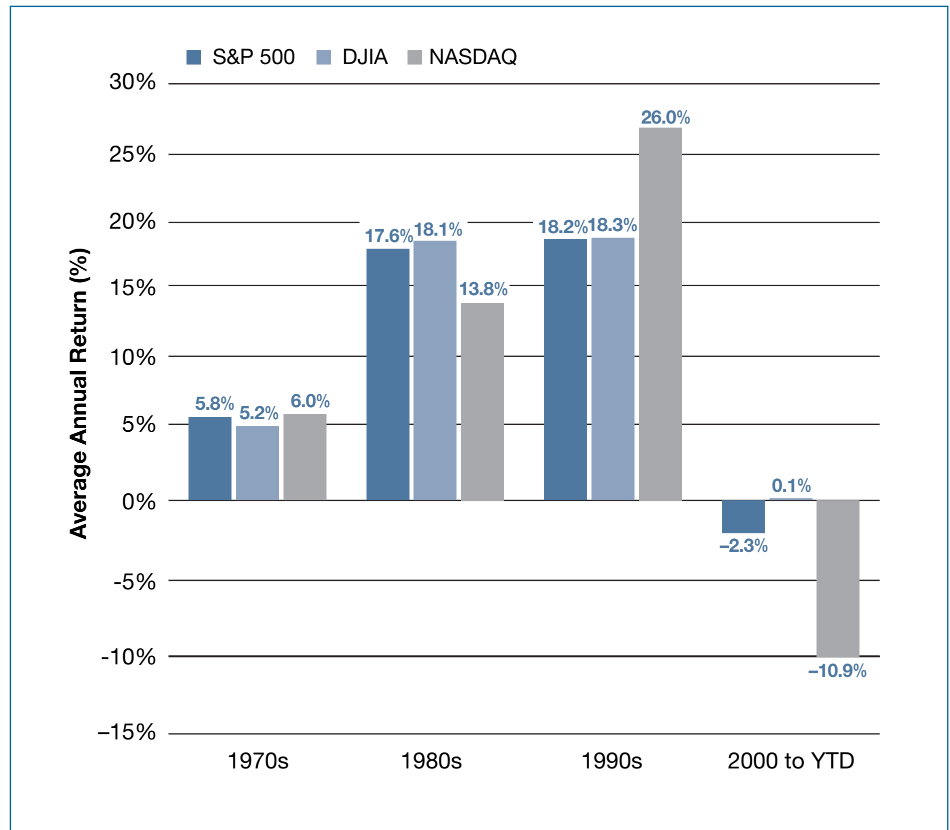


Source: Moss Adams, FPA, JPMorgan/2004

The collapse of the equity markets unmasked how addicted many firms were to a bull market

The collapse of the NASDAQ beginning in mid 2000 through 2002 unmasked just how addicted many advisory firms had become to the intoxicating equity returns of the 1990s and their accompanying annual increase in advisory fees. These organizations came to expect that their revenues would jump by as much as 10% to 12% annually from market appreciation of client assets and often neglected making many of the harder decisions required in controlling the growth of their operating expenses. As an owner of one of the industry's largest firms noted, "the market had become our largest client."

Exhibit 1.11 Average Equity Returns Have Fallen Significantly Since 2000



Source: S&P, DJIA, NASDAQ (Since 1972), JPMorgan. Data as of 05/31/05

The market correction earlier this decade obliterated the profitability of smaller advisory businesses. As the value of their clients' assets fell, so too did the advisory firms' revenues. And because most of the costs in an advisory business are fixed, nearly the entire drop in revenue resulted in an equivalent decline in profitability. Many smaller firms that previously were profitable after paying their owners a market level salary now generated so little revenue that their owners' take home pay was lower than that of some of their organizations' employees.

Lower portfolio returns and higher operating costs have further crushed operating margins

Operating margins continue to decline

More problematic to the long-term prospects of these smaller firms is that, since the end of the NASDAQ meltdown, the returns from the financial markets have not returned to the frothy levels of the 1980s and 1990s. At the same time, however, these enterprises' operating costs have continued to rise at a high rate.

Lower client portfolio returns — which translate into a slower rate of increase in advisory firm fees — and higher operating costs have further crushed the operating margins of many smaller industry participants and have made replacing profitability lost during the market correction of 2000 through 2002 impossible. Smaller firms now find that at a time of increased competition, they are unable to reinvest in their businesses, an essential precondition to growth.

The decline in profitability after the roaring bull market was not, however, the result of how these advisory firms operated or the quality of their advice. Rather, the market declines revealed that most small advisory firms lacked sound economic business models and could function profitably only if subsidized by consistent large increases in fees resulting from appreciation of client assets. And many firms that only five years ago appeared to be strong and growing are today marginal enterprises at the mercy of the inevitable next set of changes to the industry.

Example of how small advisory firm economics have changed

To get a full measure of how the economics of many advisory businesses could have been permanently altered when the hidden subsidy of a roaring bull market was removed, consider the following hypothetical example. Small Advisory Services (SAS) is an advisory firm with one professional employee and two administrative staff in addition to the firm's owner and founder. As shown in Exhibit 1.12 in 1999, SAS was a flourishing business. It had $50 million of client assets under management (with fees that averaged 0.70%), and 125 clients. Its owner earned more than $130,000 and the long-term prospects for growing the business looked bright.

Exhibit 1.12 Small Advisory Services

1999 Income Statement	
Assets Under Management	**$ 50,000,000**
Revenues	**$ 350,000**
Expenses	
Salaries—Professional Non-Owner	$ 55,000
Overhead & Other	$ 158,000
Total Operating Expenses	**$ 213,000**
Owner Compensation	**$ 137,000**

The market correction of 2000 through 2002 dramatically changed SAS' economics. Unlike the previous decade which saw the company's revenues rise on average about 12% per year simply from market appreciation, during this three year period SAS' assets and revenues fell 10%.

At the same time, however, SAS' operating costs continued to climb. Costs for professional salaries rose at about ten percent per year and its other operating costs climbed at about six percent annually.

This owner's compensation fell 61% from three years earlier

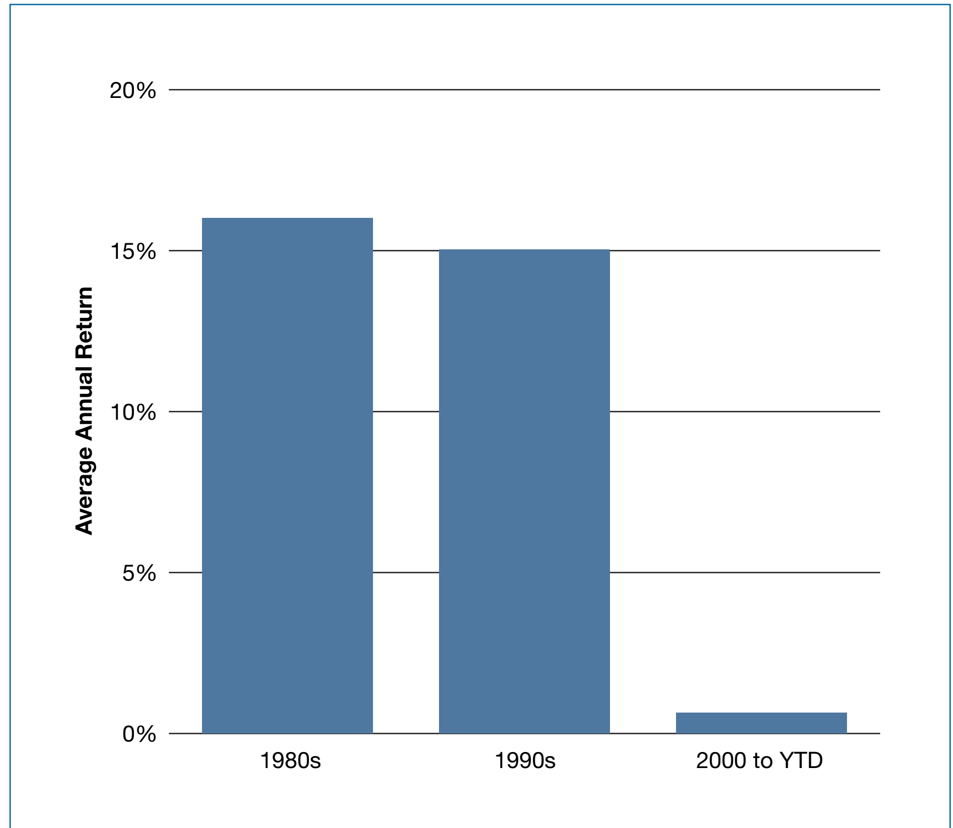
As shown in Exhibit 1.13, the combined effect of shrinking revenues and rising costs adversely changed SAS' economics. In 2002, its owner took home slightly more than $50,000 — less than she would have made as a professional employee of a larger organization and a drop of 61% from three years earlier.

Exhibit 1.13 Small Advisory Services

2002 Income Statement	
Assets Under Management	**$ 45,000,000**
Revenues	**$ 315,000**
Expenses	
Salaries — Professional Non-Owner	$ 73,205
Overhead & Other	$ 188,181
Total Operating Expenses	**$ 261,386**
Owner Compensation	**$ 53,614**

And although the market correction ended in 2003, the incredibly robust equity market returns of the 1990s did not reappear. Instead as shown in Exhibit 1.14, client portfolio returns (with a 70% equity/30% fixed income mix) have averaged only about 0.63% annually over the past few years.

Exhibit 1.14 Returns on a 70% Equity / 30% Fixed Income Portfolio Have Fallen Over the Last Five Years



Source: Lehman US Aggregate Bond Index, S&P 500, JPMorgan. Data as of 05/31/05

In Exhibit 1.15, we have assumed that through a combination of market returns and some new clients, SAS grew its asset and revenue base by about 10% per year in 2003 and 2004 and now has higher revenues and assets than it did in 1999. However, its operating costs have continued to steadily climb, and, as a result, the firm's owner is earning less than she did in 1999, and even less than the firm's professional employee.

Exhibit 1.15 Small Advisory Services

2004 Income Statement	
Assets Under Management	**$ 54,450,000**
Revenues	**$ 381,150**
Expenses	
Salaries—Professional Non-Owner	$ 88,578
Overhead & Other	$ 211,440
Total Operating Expenses	**$ 300,018**
Owner Compensation	**$ 81,132**

The firm is in a precarious situation: it is operating at or near capacity, is unprofitable and is unable to reinvest in the business

The firm now finds itself in a precarious situation. Typical of most small and mid-sized firms, it is operating at or near capacity. At the same time, the business does not generate sufficient revenue so that its owner can reinvest in order to grow the business. Additionally, its costs are going to continue to rise at a rate that might accelerate as the industry evolves over the next five to seven years.

SAS' owner is also trapped in a personal economic limbo. While the firm generates a salary that is sufficient to pay her bills, the business has no enterprise value and absent another roaring bull market, it will require a great deal of effort to maintain even a semblance of the firm's current economics over time.

A majority of industry participants now find themselves in a similar predicament. They own marginalized businesses whose economics will likely only worsen over time. And unlike their larger competitors that are growing and simultaneously upgrading the quality of their client bases, they can only brace themselves for the next stage of the industry's evolution.

Chapter 2: Forces That Will Shape the Industry by 2012

As we described in Chapter 1, the advisory business underwent a mini-rationalization over the last five years that has divided it into two distinctly different segments. At the top of the industry are about 1,100 large firms that are prospering and growing rapidly. The remainder of the industry's participants is made up of marginal businesses with limited prospects for the future.

The collapse of the equity markets exposed many advisory firms as economically unsound businesses

There were several forces that drove this partial rationalization of the advisory business. First and foremost, the severe correction to the equity markets from 2000 through 2002 along with less robust markets since then changed the economics of industry participants. Advisory business revenues had benefited throughout the 1990s from a roaring bull market that increased their clients' assets and thus, the fees paid to their advisors. Many firms had become both accustomed to and dependent upon these regular large annual increases in revenue.

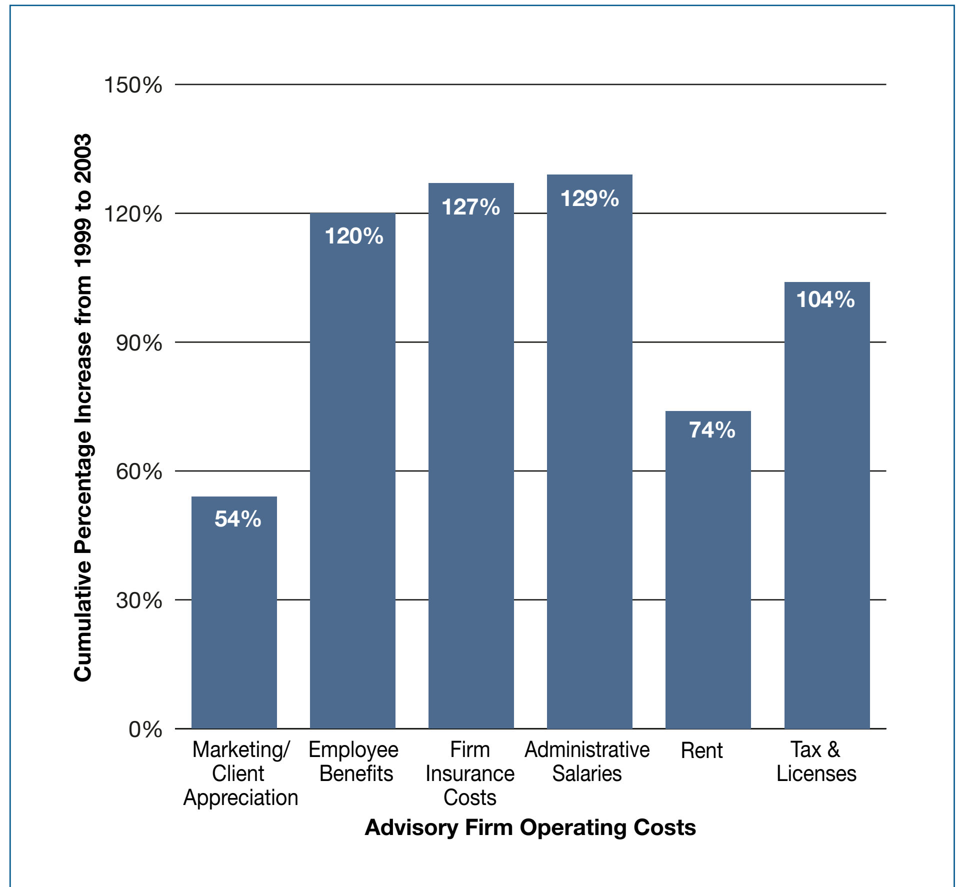
The less robust markets over the last five years exposed these organizations as economically unsound entities. Without a market-driven revenue subsidy, thousands of smaller advisory businesses now exist as low-profit enterprises whose owners' total compensation is often less than what they might make as employees elsewhere.

At the same time that advisory business economics had to adjust to more historically-normal market returns, the industry began to feel the first effects of three other factors that will further shape it over the longer term. The first of these factors — competition for clients and employees — is beginning to appear in some markets.

The second factor — higher costs — has begun to have a significant impact on operating margins.

As shown in Exhibit 2.1, from 1999 to 2003 salaries, employee benefits and company insurance costs all increased by an average of 101%. This rise in operating costs outpaced the growth of revenues (37% during the same four years), squeezing margins.[5]

Exhibit 2.1 Operating Costs Rose Substantially Between 1999 & 2003



Source: Moss Adams LLP, FPA, JPMorgan/2004

Third, the role of technology (and the resulting increase in efficiency and capacity that it provides) also grew in importance for many advisory businesses. Several of the more mundane functions of advisory businesses (such as preparing client statements and mailings) have become automated, freeing up advisory personnel for revenue generating functions.

[5] 2000, 2004 FPA Financial Performance Study of Financial Advisory Practices

What's next?

While the last five years have been challenging for all advisory firms and have irrevocably altered the economics of those in the Have Not category, the industry has undergone only the first stage of a much broader long-term evolution. During the next five to seven years, five additional forces will further shape the economics and structure of the advisory business.

Five Forces Will Reshape Advisory Industry

1. Rising expectations of employees
2. Shortage of professional employees
3. Higher operating costs
4. Industry-wide addiction to growth
5. Demographics of advisory business owners

1. Rising expectations of professional employees

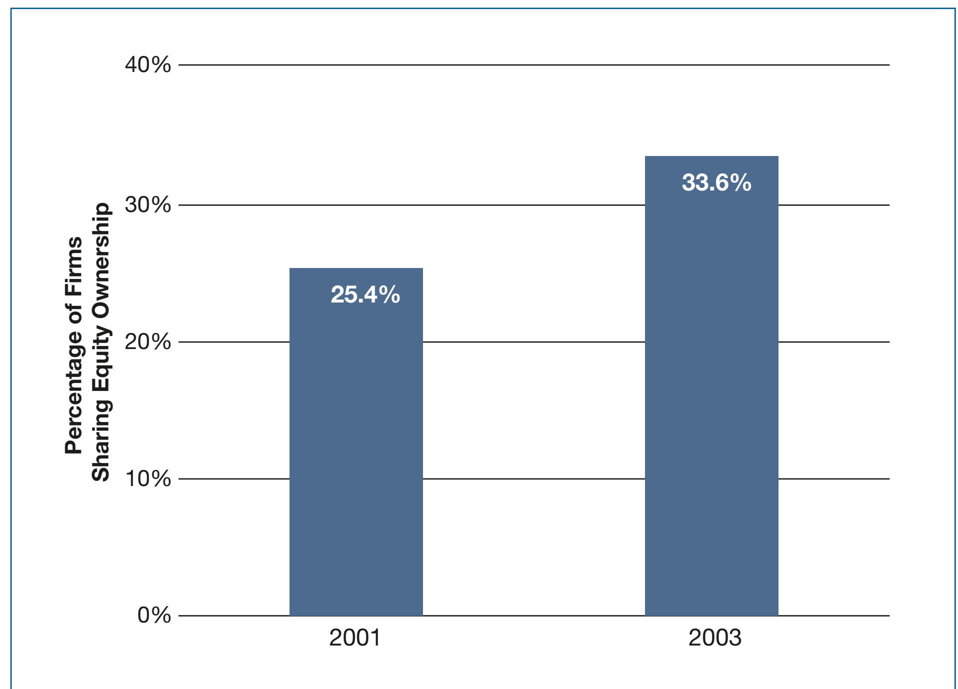
The first force is the rapidly rising expectations of key employees at larger advisory businesses. Most industry participants began as sole proprietorships or small partnerships and the only key employees were the founders. All other personnel served in an administrative or support capacity and were replaceable.

Non-owner professionals helped build their advisory firm and understandably feel entitled to an ownership stake

As advisory firms have grown into substantial businesses, they have had to expand their professional staff. Often recruiting talented young individuals directly from college, organizations have used non-owner professionals to fill key roles such as researching investments, helping to manage client relationships and marketing. When they joined their firms, these individuals were often content and excited to be merely employees, but their expectations have changed since then.

These non-owner professional employees believe that since they played a key role in building their firms from "candy shop"-sized companies into major businesses, they are entitled to a greater participation in their employer's success. More importantly, they recognize that their continued involvement is essential to the long-term prosperity of their organizations. Although they are ultimately replaceable, their departure would cause significant disruption to their company, thus providing them material leverage over their employer.

Exhibit 2.2 More Advisory Firms are Sharing Equity Ownership



Source: FPA/2001 and 2003

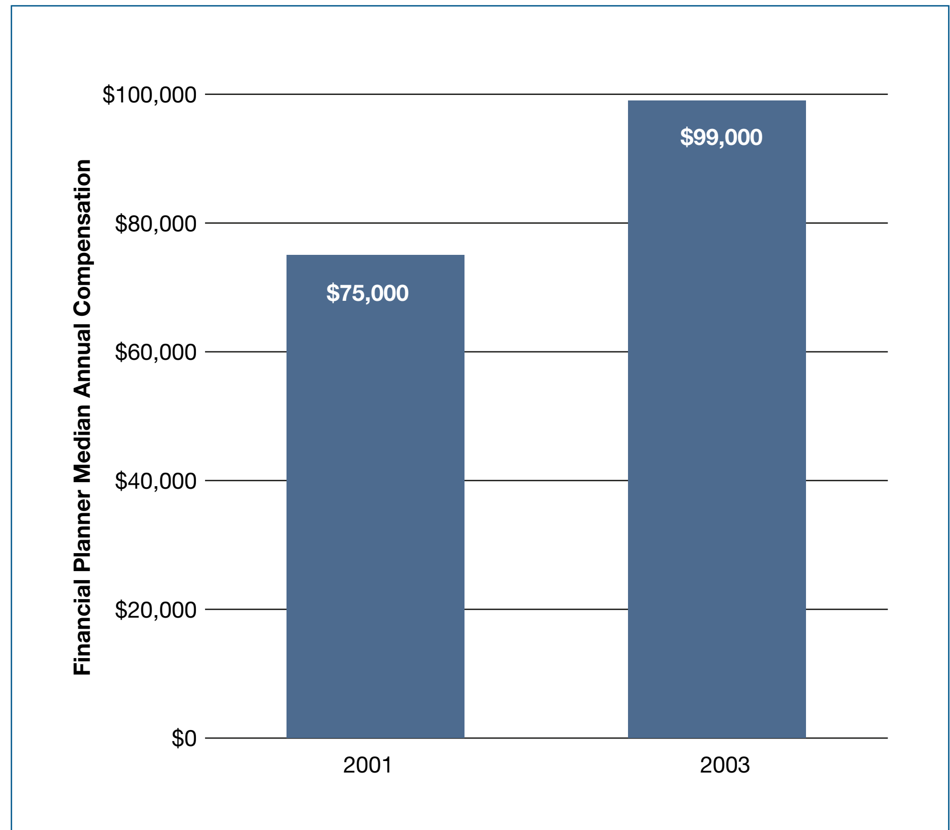
Owners will have to decide between sharing equity or losing their best employees

Consequently, advisory firm owners are confronting (and will increasingly confront in the future) demands from their non-owner professional employees for equity participation in their enterprises. And owners will be faced with the difficult choice of retaining a smaller personal stake in the businesses they helped to create or run the risk of losing their best staff.

2. Insatiable demand for professional advisory employees

This choice is particularly difficult because of the second force confronting the advisory business: a growing and insatiable demand for professional advisory employees from both advisory firms and their competitors (such as banks, trust companies and other new entrants in this industry) that will significantly increase compensation over the next five to seven years. Numerous large financial services companies are trying to build advisory units and need people to staff them. Likewise, many larger industry participants lack the capacity to capitalize on all of the business opportunities available to them and need additional professional staff.

Exhibit 2.3 Financial Planner Compensation has Increased 32% in Two Years



Source: FPA/2001 and 2003

There is no quick way to train or develop qualified professional employees

Demands for personnel, however, are particularly problematic because there is no way to quickly develop or train qualified professional employees. The expertise and judgment that distinguish financial advisors from other financial intermediaries are as much the result of years of experience as they are of education. Thus, unlike other businesses where employers can retrain different personnel to fill particular needs, there is no rapid means to fill the surging demand for professional employees in this industry.

The only alternative available to organizations needing additional trained and experienced professional staff is to poach them from other firms. To entice individuals to leave the organizations in which they have spent a large part of their professional careers, competing advisory firms will often offer extremely generous compensation packages.

What today are mere skirmishes for professional staff, will turn into an all-out war in the future

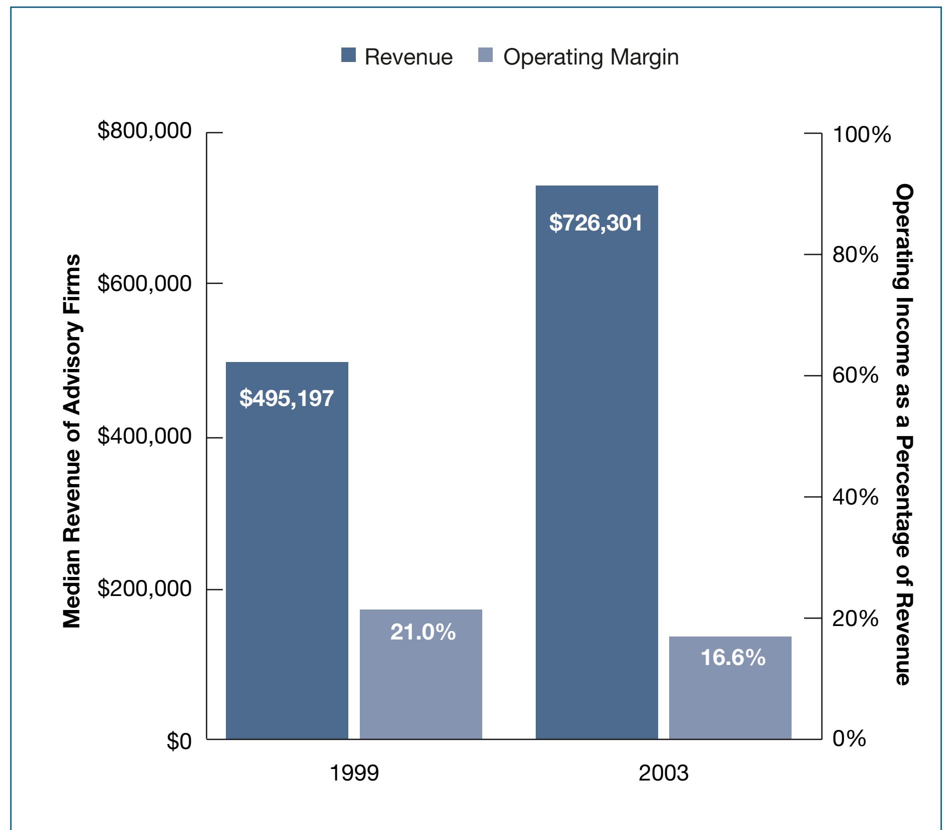
For example, at one firm we spoke to, virtually every experienced employee (including the owner) has been solicited to join a regional bank seeking to build a wealth management practice. The bank offered a 60% increase in annual salary, as well as a performance bonus.

For reasons we will outline below, what today are merely skirmishes for professional staff will turn into an all out war that will cause labor costs to skyrocket. And because these increases in compensation are not accompanied by any corresponding increase in productivity, the profit margins of advisory businesses will compress.

3. Other operating costs will surge

Although the revenues of larger industry participants have grown significantly over the last five years, as shown in Exhibit 2.4, profit margins have not likewise expanded.

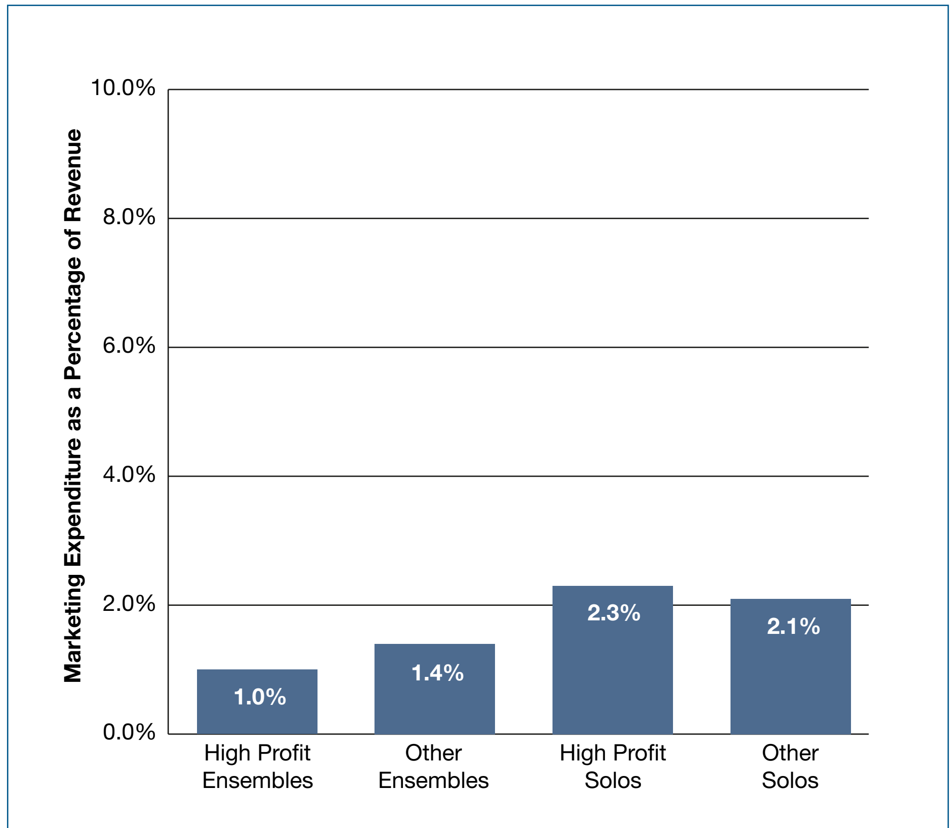
Exhibit 2.4 Although Revenue has Risen, Margins have Fallen



Source: Moss Adams LLP, FPA, JPMorgan/2004

Over the next five to seven years, significant increases in operating costs — in addition to professional salaries — will further reduce advisory business profitability. For example, marketing costs historically have been a trivial expense in operating an advisory business. As shown in Exhibit 2.5, advisory firms on average spend only between 1% and 2.3% of their revenues on marketing.

Exhibit 2.5 Advisory Firms Spend Very Little on Marketing



Source: FPA/2004

Marketing costs will rise

Advisory firms may find that their marketing expenditures rise ten-fold by 2012

For reasons we discuss further below, growth will soon become a major imperative of many advisory businesses. And in order to fuel and sustain this growth, firms will have to significantly increase what they spend for marketing staff and initiatives. In other industries, companies routinely spend a much higher percentage of their revenues on marketing and advertising and it would not be surprising if advisory firms find that their expenditures rise ten-fold over the next five to seven years.

It took 11 years for Congress to pass broad, sweeping reforms after the scandals of 1929

Regulatory burden and costs

Advisory firms will likewise find that they will have to spend a great deal more on regulatory and compliance activities over the next five to seven years. The numerous scandals that have rocked several financial services sectors have also served as a wake-up call to both regulators and legislators. A series of regulatory mandates concerning reporting and record keeping requirements have already helped drive up compliance costs. According to Rydex AdvisorBenchmarking Inc., advisory firm compliance costs rose by more than 150% in 2003 compared with 2002. [6]

Increased Regulatory Burden on Investment Advisors

1. Chief Compliance Officer
2. Written and published compliance procedures and manual
3. Code of ethics and anti-money laundering policies / procedures
4. Business continuity or disaster recovery plan

More ominously, there has yet to be a major legislative response to the flurry of recent investigations and lawsuits. Given that the principal laws that oversee the advisory business (the Investment Company Act and the Investment Advisers Act of 1940) were passed eleven years after the scandals that inspired them, it is not out of the question that Congress may yet decide to enact broad, sweeping reforms of the financial services industry. History would argue that it is also reasonable to assume that additional legislation would impose greater (and more costly) regulatory burdens on advisory businesses.

Investment management capabilities now matter

The end of the roaring bull market and the likelihood of significantly smaller absolute rates of return also will impact the economics of operating an advisory business. Surprising as it may seem, an advisor's skill at selecting investments was largely irrelevant during most of the 1990s. For most of that decade there was a roaring bull market that masked the sins and incompetence of many advisory firms and brokers. Because equity markets climbed an average of 18% per year and most client financial plans assumed a return of less than 10%, it was almost impossible to construct a portfolio of investments that would not meet a client's objectives.

Skill at investing was a useful but unessential advisory capability during the 1990s

Additionally, the atypically high returns of the 1990s also made the size of advisory fees (or in the case of brokers, commissions) largely irrelevant. The markets were so robust that even high costs were still only a fraction of an investor's returns.

Consequently, most advisory firms had little incentive to invest in developing and expanding their investment capabilities. They simply indexed a large percentage of a client's assets and tried to diversify the portfolio across asset classes.

6 Rydex AdvisorBenchmarking Study, November 2004

Some advisory organizations elected to outsource their investment function to a third party. Such vendors typically relied on a handful of standardized templates for constructing client portfolios that were not necessarily customized to a client's particular needs or circumstance. They also invested clients' assets in multi-manager funds that charged active management fees but (because the funds have so many holdings) provided index-like returns.

Advisory firms will spend more on investment management capabilities

Simply indexing will no longer generate returns sufficient to meet clients' goals

The equity market correction and a more recent environment of lower absolute rates of return from traditional asset classes will force great changes in how advisors manage money. Simply indexing in traditional asset classes will not generate returns sufficient to meet their clients' goals. Additionally, advisory fees will now constitute a substantial portion of clients' absolute level of return. Consequently, clients will soon demand that their advisors provide quantifiable added value through the investment function.

This demand will force advisors to develop a much broader and skilled investment expertise. They will need to become more knowledgeable about non-traditional asset classes — such as hedge funds, private equity, real estate, derivatives and commodities — while improving their risk management capabilities. Clients will also demand that industry participants provide extremely customized investment solutions and advisors will not be able to rely on rudimentary templates when constructing client portfolios.

Two choices for improving investment expertise

Only a handful of advisory firms can currently provide this kind of investment expertise to their clients. Other industry participants will find that they will have to choose between two options for building this capability in their companies.

One choice will be to buy this expertise by recruiting one or two professionals whose full-time job will be to oversee the organization's investment function. These individuals will often have previous experience working at a pension fund, endowment or foundation and accordingly will understand global capital markets, as well as hedging and risk management strategies.

Key professionals at smaller firms will have to spend more of their time improving investment capabilities and less on revenue generating activities

The alternative to buying expertise, however, will not be a relevant option for most advisory firms because they cannot afford to add these kinds of professionals to their staff. Such skilled individuals can currently demand high compensation, pricing them out of the reach of most small advisory firms. Smaller firms will find that they will have to, instead, organically build this expertise.

Doing so will be challenging because inherent in many non-traditional asset classes is the potential for clients to suffer significant losses in their portfolios, creating great financial and regulatory liability for advisory firms. Thus, current owners, as well as non-owner professionals, trying to build a broader investment capability in their organizations will have to spend an immense amount of their time researching and analyzing investments.

Such use of time by these individuals will be costly since it significantly reduces the firm's ability to generate revenue. Every minute spent on researching markets and investments is time that could have been used to recruit and retain clients.

Advisory business owner economics are in peril

Advisory firm owners will own smaller pieces of less profitable firms

The combined effect of demands by key employees for equity ownership, skyrocketing salaries, and higher other operating costs will pose significant challenges to the economics of operating an advisory business and, in particular, the personal economics of their owners. Without significant changes, these organizations will earn less and their current owners will be entitled to a smaller percentage of this reduced profitability.

To get a sense of how these forces might impact an individual advisory business, consider the following hypothetical scenario. Impaler Advisory Services (IAS) is a financial advisory business with $250 million of assets under management and because it has mostly larger clients, its average fee is 0.635% of assets. It is owned by two brothers, Vlad and Rod, and has a staff that includes two non-owner professionals, Judy and Bob. As shown in Exhibit 2.6 below, IAS is a very profitable business and each of the owners has a take-home pay of almost $375,000 per year.

Exhibit 2.6 Impaler Advisory Services

2004 Income Statement	
Assets Under Management	**$ 250,000,000**
Revenues	**$ 1,575,000**
Expenses	
Marketing	$ 100,000
Salaries — Professional Non-Owner	$ 180,000
Administrative Salaries	$ 210,000
Payroll Expenses	$ 37,635
Other expenses	$ 300,000
Total Operating Expenses	**$ 827,635**
Operating Income	**$ 747,365**
Initial Owners' Compensation (each)	**$ 373,683**

Judy and Bob have been with IAS for seven years, handle many client relationships and if they were to depart, the firm's economics would be severely impaired. Assume that since the labor markets for non-owner professional staff has become very competitive (as is the case in certain regions), a competitor offers Judy and Bob a very generous guaranteed salary and bonus package. In order to retain them, Vlad and Rod decide to increase their annual salaries to $150,000 and give each a 15% ownership stake in the firm.

These increased labor costs, however, materially change Vlad's and Rod's personal economics. To offset the effects of the higher costs and the reduction in their ownership of the firm and maintain their current incomes, the business will need to grow significantly. They decide to invest more in marketing activities, spending an additional 20% per year, with the goal of restoring their personal compensation levels within three years. At the same time, the firm's administrative salary costs rise about 3% per year and its other expenses rise at a rate of 5%.

IAS has to grow 11.25% per year for its owners' economics to remain constant

As shown in Exhibit 2.7, IAS would need to grow its revenue about 11.25% per year for the next three years to meet this objective. While overall profitability would simultaneously increase by 12.62% annually, because the owners now only have a 70% ownership stake in IAS, they would earn the same amount in 2007 as they did in 2004. In other words, IAS would have to grow revenue more than 37% over the next three years for the current owners just to maintain their current economics.

Exhibit 2.7 Impaler Advisory Services

2007 Income Statement	
Assets Under Management	**$ 344,177,777**
Revenues	**$ 2,168,320**
Expenses	
Marketing	$ 172,800
Salaries - Junior Partners	$ 300,000
Administrative Salaries	$ 229,473
Payroll Expenses	$ 51,094
Other expenses	$ 347,288
Total Operating Expenses	**$ 1,100,655**
Operating Income	**$ 1,067,665**
Initial Owners' Compensation (each)	**$ 373,683**

Outsourcing will become a standard procedure

Advisory firms will retain high value functions and outsource as many non-revenue generating activities as possible

As the above example demonstrates, advisory firm owners will have to rethink how they operate their businesses because of these forces. We believe that they will likely respond in two ways. First, they will change the manner in which they operate on a day-to-day basis. Just as technology companies have had to narrowly limit the functions they perform to solely those activities which they can add the greatest value, advisory businesses will similarly segment their current activities into two different types of functions: high value and non-revenue generating.

Advisory firms will continue to own those activities that add substantial value to their clients. In contrast, non-revenue or low value-added activities such as report preparation, compliance, technology support, etc. will be viewed as extraneous to the business and as many as possible will be outsourced.

Most technology-based platforms allow outsourcing of both high and low value functions

Future economics of outsourcing unclear

It is difficult, however, to precisely predict the future economics of outsourcing because most of the companies entering into these activities are either still in their nascent stages or are part of larger, bundled platforms of services. The bundled platforms are typically designed so that the advisor can outsource both low and high value functions and the platform is compensated by the advisor, its clients and their money managers.

As shown in Exhibit 2.8, several such technology-based service providers now compete in this field. Many of these platforms are opaque, allowing the platform owners to charge substantial fees that are passed through to the advisory firm clients. The benefit they provide is to allow less sophisticated advisors to focus most of their time on asset gathering.

Exhibit 2.8 Examples of Technology-based Outsourcing Platforms

Envestnet Asset Management	Assetmark Investment Services
ADVISORport	FOLIOfn
Placemark Investments	NetAssetManagement
Lockwood Advisors	FundQuest Inc.
Brinker Capital	U.S. Fiduciary Services
Open Finance Network	

Source: JPMorgan/2005

Future outsourcing will focus solely on low value, non-revenue generating functions

By contrast, future outsourcing firms will support the most sophisticated advisory firms and will focus solely on low value-added and non-revenue generating functions. Scale will enable these providers to perform and charge for these functions at a very low cost, much lower than it would cost an advisory firm that elected to retain them. The actual cost and breadth of these services, however, will depend upon how many firms decide to compete in this area.

Exhibit 2.9 Functions Advisory Firms Will Eventually Outsource

Report preparation	Compliance
Maintenance of data	Benefit plans
Process of account opening/transferring	Human resource functions
Data aggregation	Purchasing
Technology support	

Source: JPMorgan/2005

Are Outsourcing Services the Future of the Custodial Business?

One of the more surprising findings from our research was that many industry observers including some custodians forecast significant changes to the custodial business. Most of these organizations historically built their service offerings around technology platforms that allow advisors to more easily open and trade client accounts and download information to prepare client reports. Advisors would encourage their clients to custody their assets at a particular custodian in order to use these technology platforms as part of their business.

The advisor pays little or nothing for access to the technology platform. Instead, the custodian is paid by advisory clients and investment managers. There are many ways that the custodian collects fees from advisor clients, including:

- Transaction fees on mutual fund purchases
- 12b-1 fees generated from no transaction fee mutual funds
- Fees from money market funds and sweep accounts
- Referral fees
- Commissions on share purchases
- Bid/ask spreads on individual securities

Additionally, the custodian collects fees in a variety of ways from the investment manager, including revenue sharing agreements and other operational fees. Investment managers also pay substantial fees to partner with custodians in marketing alliances and client events.

New technology platforms are changing the relationship between advisors and custodians. Industry participants can now easily use more than one custodian for their clients' assets. Our research suggests that this is just one step that is part of a longer-term trend. Advisors in the future will become less dependent for much of the technology that they need for their businesses, and will effectively disintermediate their custodians.

To be sure, advisory firms in the future will still require custodial services. Their relationships with these organizations, however, will be much more like those between plan sponsors and their custodians. Typically, a pension plan's custodian will hold their clients' assets for a very low fee. It is also unable to influence or limit in any way any of the investment choices available to the plan and does not capture any revenue from other plan service providers.

Assuming these changes occur and sweep through the advisory business, how will the business of the industry's current custodians change? Although there is still vigorous debate in the custodial community over how fast (if at all) these changes will occur, the opportunity to provide outsourcing services is a potentially large business opportunity. At least one of the custodians we interviewed posited that over time, outsourcing services will become its core business and that traditional custodial services to advisory businesses will become at best a marginally profitable activity.

Outsourcing alone will not offset the effects of rising costs

Shared ownership + skyrocketing salaries + higher operating costs = need for growth

While improved operating efficiency from outsourcing will at least partially (and temporarily) reduce the effects of higher operating and labor costs, cost reductions alone will not fully ameliorate them. For example, consider our earlier hypothetical example of Impaler Advisory Services. As shown above, even if IAS could cut all of their non-professional employee salary and marketing costs by as much as a third by outsourcing them, its owners would still make less money than they do currently. Rather, advisory businesses will also have to grow their revenues at a high rate to maintain their profitability and their current owners' economics.

This need for growth becomes more apparent if you look at our earlier example and extend it beyond the next three years. As you can see in Exhibit 2.10, we have assumed that IAS' administrative salary costs and other expenses rise by only 3% per year and its annual marketing expense caps out at $250,000. We also have assumed that to handle the firm's higher volume of clients, it has added two non-owner professionals who are each paid $175,000 per year. Given these assumptions, even if IAS is able to reduce its non-professional employee and non-marketing costs by 25% through outsourcing, it will still need to grow by more than 9% per year for the next five years for the owners' annual compensation to remain constant.

Exhibit 2.10 Impaler Advisory Services

2010 Income Statement	
Assets Under Management	$ 390,104,375
Revenues	$ 2,457,658
Expenses	
Marketing	$ 250,000
Salaries — Junior Partners	$ 300,000
Salaries — Professional Non-Owner	$ 350,000
Administrative Salaries	$ 182,586
Payroll Expenses	$ 46,570
Other Expenses	$ 260,837
Total Operating Expenses	$ 1,389,992
Operating Income	$ 1,067,666
Initial Owners' Compensation (each)	$ 373,683

Why? A chief constraint to the growth of any advisory business is that each professional can only manage a finite number of client relationships. As a firm such as IAS grows from $250 million of client assets to almost $400 million it will most certainly have to add additional professional employees. And the cost of qualified professional employees is only going to increase over the next five to seven years as more firms find they need to grow.

Few advisory firm owners will be content to make less money while managing larger, more complex firms

There are two implications of this example that are particularly problematic. First, while advisory firm owner compensation remains constant on an absolute basis, it is actually declining on a real basis. Additionally, few advisory business owners that we interviewed indicated that they would be content with only earning their current compensation, especially if they were required to endure the stress of managing a much larger and complex business in order to do so.

Second, as IAS adds additional professional employees, it restarts the cycle of problems that necessitated its original need to grow. The professional staff that it recruits will be in great demand and these individuals (similar to those non-owners that helped build the firm and now are junior shareholders) will soon likewise demand greater current compensation as well as equity participation, once again fracturing the current owners' compensation, and forcing the organization to grow even faster.

4. Industry-wide addiction to growth

This example is a good illustration of the dilemma facing the owners of advisory firms. Their businesses will be less profitable because of higher personnel and operating costs and they will own a smaller part of this lessened profitability. It also shows why a fourth factor will shape the advisory business over the next five to seven years: an industry-wide addiction to growth.

As more and more firms adopt a high growth strategy, the industry will find itself caught in a vicious, accelerating cycle

Ironically, as more and more firms adopt a high growth strategy, the underlying problems that forced advisory businesses to undertake this approach will only worsen. As more firms try to grow at high rates, the demand for qualified personnel will only increase, further driving up labor pricing and the ability of these individuals to demand even greater equity ownership. At the same time, advisory firms will have to spend even more money on marketing, further raising operating costs and forcing them to grow still faster to maintain their profitability and owners' compensation.

Many industry participants will be caught up in a vicious, accelerating cycle. And their need for growth combined with the many new entrants to the industry will at some point create far greater demand for clients than the supply of them. Once the industry reaches this crossover point, it will undergo an even more vigorous rationalization, forcing firms to spend even greater amounts of money on marketing and personnel.

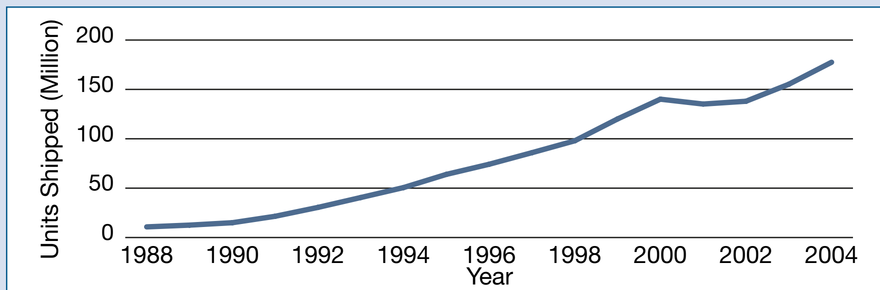
Demand for advice will continue to grow, but demand for clients will grow faster

As was emphasized in Chapter 1, however, we are not suggesting that the demand for advice will decline. Rather, the demand for advice will continue to grow at a robust rate. But the demand for clients seeking advice will grow at an even faster rate. And at some point the demand for potential clients will significantly exceed the supply.

High growth does not prevent change

To better understand how an industry can grow at a rapid rate and still experience consolidation, consider the personal computer business. In 1988, there were over thirty companies in this industry. Since then (and as shown in Exhibit 2.11), the demand for personal computers has risen from about 11 million units per year to more than 177 million per year.

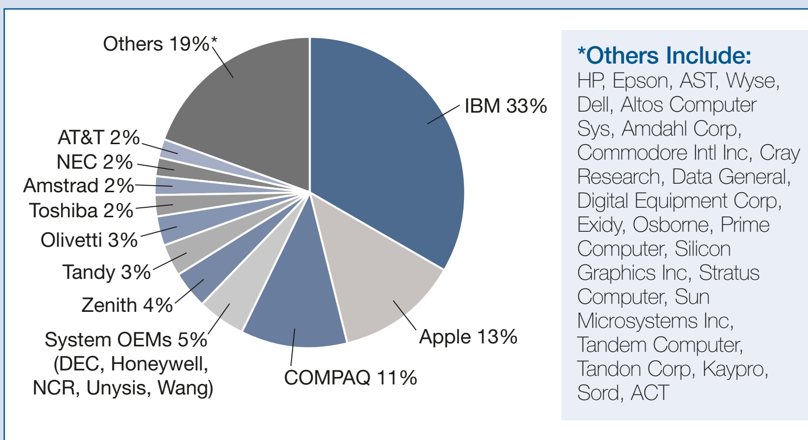
Exhibit 2.11 The Volume of Computers Sold Between 1988 and 2004 Rose 16-Fold



Sources: IDC, Company Reports, Fulcrum Global Partners LLC, Prudential-Bache Securities, JPMorgan estimates 1990–1993.

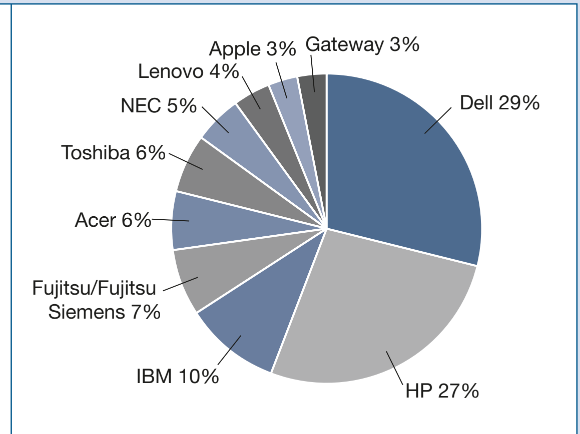
Despite this incredible surge in demand for their product (and as shown in Exhibits 2.12 and 2.13), two-thirds of the industry's competitors exited the business. Why? The capacity of the existing competitors grew at an even faster rate forcing a rationalization of that industry.

Exhibit 2.12
Personal Computer Market Share 1988



Source: Prudential Bache Securities PC Industry Report 1988, Old-computers.com

Exhibit 2.13 There are Only Ten Major Personal Computer Manufacturers Today



Source: IDC Note: Does not include companies that ship under 3000 units annually.

It is also important to emphasize that the current shortage of qualified professional employees will likely postpone for at least a few years the point at which the demand for advisory firm clients exceeds the supply. As we discussed earlier, the long lead time involved in developing this kind of staff will create a disruption in this labor market and will be the greatest obstacle to the growth of many industry participants.

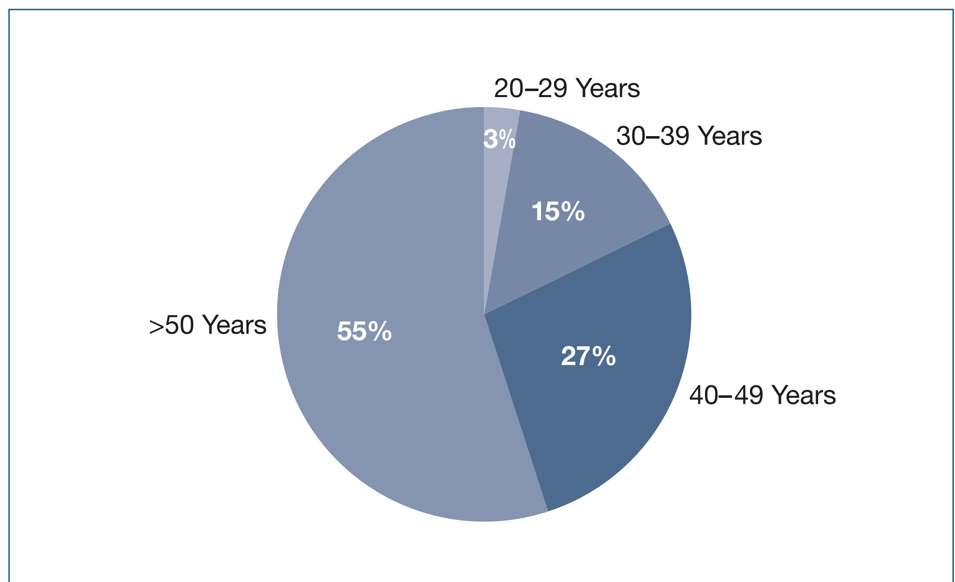
A shortage of advisory firm professionals will be corrected over time and after salaries skyrocket

Like similar shortages in all other labor markets, however, this one too will eventually be corrected once the salaries for professional employees skyrocket. Senior lawyers and accountants (as well as less conventional candidates who have the requisite business judgment and presence, if not the technical skills) will eventually flock to advisory businesses helping to fill this void. Additionally, some owners of small unprofitable advisory firms will conclude that the compensation paid by large advisory firms to their professional employees will be more compelling than running a small company and will likewise join their larger counterparts.

5. Age of advisory business owners looms over the industry

At the same time that advisory businesses and their owners are grappling with their changing economics, a fifth and final factor — demographics — looms large over this industry and will play a major role in reshaping the industry's structure. As shown in Exhibit 2.14, the average age of a financial advisor is now 52, and is increasing by half a year every year.[7] Further, owners of large advisory firms tend to be in their mid to late 50s.

Exhibit 2.14 Most Advisors are Over 50



Source: FPA membership as of December 31, 2004

[7] Investment News, April 4, 2005.

Advisory owner demographics, along with the long lead time inherent in a transition, will trigger many transactions

As we will discuss in greater detail in Chapter 4, the confluence of an aging population of advisory business owners and the long lead time inherent in almost any transition of ownership will trigger the sale of many firms over the next five to seven years. It will also accelerate the consolidation of the top end of the industry.

Even the owners of the largest advisory businesses will face many challenges

The combination of the five forces confronting advisory businesses — rising employee expectations for equity ownership, larger professional salaries, increased operating costs, a resulting industry addiction to growth and a graying of the ownership of many of the industry's larger participants — means that even those organizations that successfully weathered the mini-rationalization of the last five years and are currently prospering will face many challenges in the next five to seven years.

These changes will occur gradually and no single factor will force this evolution. The cumulative effect will be subtle, and build over time. Their owners' personal economics will change and may even worsen. Many will find that they must operate much larger and more complex businesses than in the past. And several will face the inevitable decision of how many more years they want — or can — remain in the business.

Chapter 3: How the Industry will Likely Evolve

As described in Chapter 2, advisory businesses will be buffeted by a series of forces over the next five to seven years. Demand for professional employees will fuel significantly higher salary costs and force owners to more widely share ownership in their firms. At the same time, non-employee operating costs will also rise.

The ownership of many large firms will change hands

These factors will create an industry-wide addiction to growth. Only through much higher revenues will owners be able to offset the effects of higher costs and smaller personal stakes in their own firms and keep their personal economics compelling.

This industry-wide addiction to growth, however, will only exacerbate the problems that created the need for growth in the first place. As firms try to grow, the demand for professional employees and the need to increase marketing expenditures will become chronic and many industry participants will find that they are caught up in a seemingly unending cycle.

At the same time, the ownership of many larger firms will change hands. A combination of demographics, the long lead time required to complete a transition and a desire by many owners to move on to new challenges will fuel transitions throughout the industry.

The advisory industry will ultimately divide into three groups:

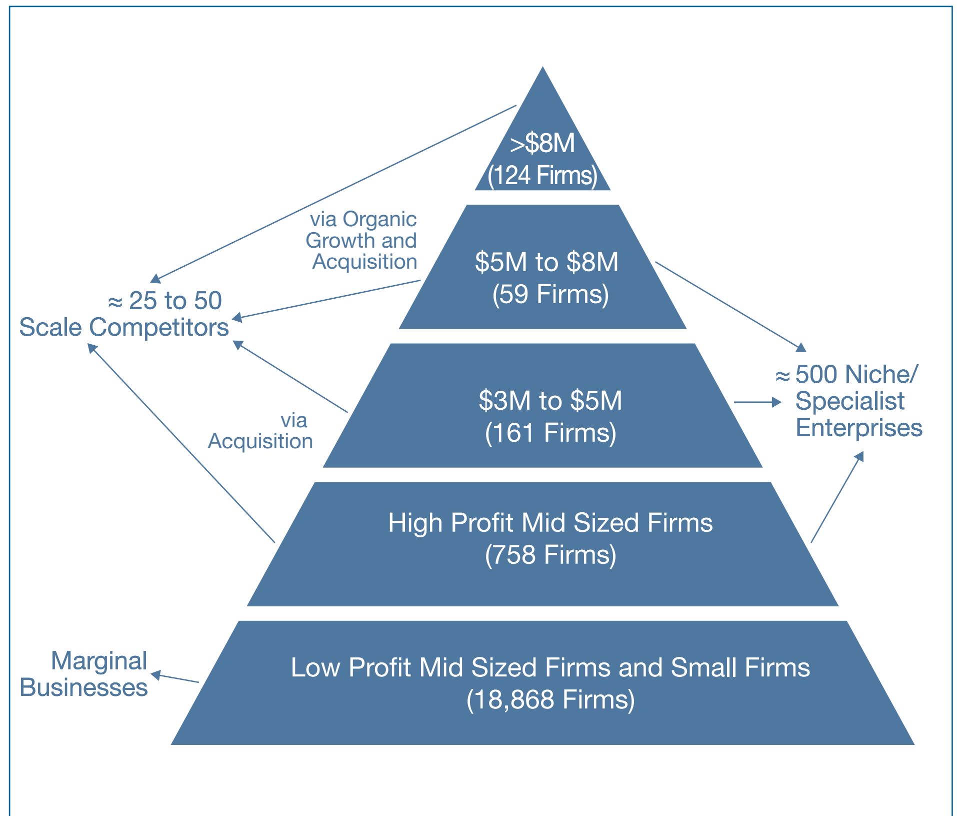
- Scale competitors
- Niche/Specialist enterprises
- Marginal businesses

New structure of the financial advisory business

So how will these forces reshape the industry? Our research suggests that the changes that have occurred to the industry's structure over the last five years — from a highly fragmented industry to a collection of Haves and Have Nots — are only the first stage of a broader evolution, one that will ultimately divide the industry into three groups.

As shown in Exhibit 3.1, by 2012 about 25 to 50 very large firms with assets in excess of $15 billion and revenues greater than $50 million will emerge. Some of these organizations will be current industry participants that expand through organic growth. Others will result from multiple acquisitions by large public companies seeking to establish a presence in the wealth management business. Still others will evolve from a combination of both growth and acquisitions.

Exhibit 3.1 Future Structure of the Industry



Source: JPMorgan/2005

Approximately 50% to 60% of larger advisory businesses will be acquired

These large advisory firms will be extremely profitable and have great economic value. And the owners of the handful of organizations that are able to achieve this dominant size mostly through organic growth will become very wealthy.

These large companies will have hundreds of employees and will likely operate in many locations, although in some regions, a firm could operate in a single market and still achieve the size necessary to be a dominant competitor. They also will make substantial investments in technology and marketing.

Their challenge will be to take advantage of their great scale to deliver low-cost, high-quality advice while still retaining high-touch personal service that is essential to a great client experience. Their success will be dependent upon a continued ability to recruit and retain exceptional professional staff.

Of the 1,100 or so larger advisory businesses that currently are prospering, we believe that approximately 50% to 60% will become part of this pool of 25 to 50 scale competitors. The remaining 500 to 600 firms will continue to operate as mid-sized businesses that over time will specialize in niche clients. While they will be larger companies than they are today (at least $550 million to $600 million in assets), their competitive advantage will be their great expertise in solving the unique problems of their target clients and their ability to add significant value to their clients' lives.

The specialty firms will also be profitable businesses that in most cases will endure in some form for many years after the departure of their current owners. As we will discuss in greater detail in Chapter 4, however, the relatively small size of these firms will likely mean that many of their owners will ultimately receive only modest amounts of consideration for their ownership stakes.

Life will become harder for smaller firms

The remaining advisory businesses that have already been largely marginalized over the last five years will find that life will become even more challenging. Their owners will have to work harder and will earn less, often far less than they would if they were an employee of a larger organization. These organizations lack the resources to invest in marketing at a time that competition for clients will increase. Thus, capturing new desirable clients will be increasingly difficult. In many cases they will be relegated to competing for those individuals that the larger or specialty organizations do not want as clients, such as people with small amounts of investable assets or those who are not worth the aggravation regardless of the fees they might pay.

It is unlikely that many small advisory firms will go out of business any time in the near future

It is important to emphasize, however, that it is unlikely that many of these smaller firms will go out of business any time in the near future. Just as corner convenience stores coexist alongside giants such as Wal-Mart Stores and specialty retailers such as Whole Foods Market Inc., thousands of marginal, small advisory businesses will continue to operate for many years.

At the same time, the combination of their owners receiving less compensation than they would earn working for another company and an unattractive (to a potential acquirer) base of clients will mean that these enterprises will have little economic value as businesses. The greatest threat to their continuing existence, therefore, will be the current owner's decision to retire and the inability to find a buyer or even recruit a successor who is willing to work for below market wages.

Maturity of the enterprise will be an important determining factor of outcomes

While the future is brighter for the industry's larger firms than for its smaller participants, not all of the large organizations are well-positioned to execute the high growth strategy necessary to sustain their current owner's personal economics. For example, many firms are already working at full capacity and do not have the personnel or infrastructure in place that will allow them to expand and take advantage of the many opportunities that they are currently offered.

Most large advisory firms are culturally unsuited to rapid expansion and lack the necessary business maturity

Several large advisory firms are also culturally unsuited to rapid expansion, fearing that they will lose the personal touch and family-like feel of their business as they grow. Further, in some advisory businesses the founder continues to operate like a proprietor, often reluctant to delegate responsibility (or more importantly, authority) to others in the organization, something essential to being able to grow at a high rate for a long period of time.

Thus, while most of the firms in the Have category possess the financial resources to grow, own strong local brand names and are flooded with opportunities for new clients, not all will be able to execute this high growth strategy. Instead, an equally important factor in determining how well they will do is the maturity of their businesses.

Cycle of maturity of an advisory business

What exactly do we mean by "the maturity of a business?" Just like entire industries, individual firms evolve over time. The ability to make the necessary changes to evolve as a business is often as important a precondition to long-term success as is offering a good product or service. Businesses mature by evolving their operating structure and management so that they can expand their client bases and still function efficiently.

Exhibit 3.2 shows the continuum of maturity in an advisory business. At the far left of this continuum is where most advisory businesses started. Nearly all of them began as either proprietorships or small partnerships. They had only a small amount of revenue so clients of all sizes and types were accepted. Their client bases often consisted either largely of friends and friends of friends, or were made up of a portion of the advisors' books of business that they had while working for a previous employer. Many firms also relied on one or two clients who generated a disproportionate amount of the enterprise's revenues.

Exhibit 3.2 Cycle of Maturity of an Advisory Business

	Startup / Proprietorship	Adolescence	Early Adulthood	Maturity	Professional Enterprise
	Least Mature				Most Mature
Minimum Revenues	Very Small	Small	$350K	>$1mm	>$5mm
Business Decisions	Owner	Owner	Owner	Owner w/ Input	**Professional Mgmt**
High Value Functions	Owner	Owner	**Owner w/ professional staff**	**Specialists**	Specialists
Administrative Functions	Owner	**Admin staff**	Admin staff	Admin staff	Specialists
Revenue Structure	Commission w/ Some Fees	**Fee-based**	Mostly fee	Fee-only	Fee-only
Client Size	Any with Many Small	Some Larger	**All New Are Larger**	**All New Are High Revenue**	High Revenue
Client Relationships	Owner	Owner	Owner	**Institutionalized**	Institutionalized
Ownership	Owner	Owner	Owner	**Somewhat Shared**	**Widely Shared**

Source: JPMorgan/2005

Advisory businesses at this first stage of their evolution were largely commission-based. Only with significant transaction-based revenues could the firm generate enough revenue to operate. From an operational standpoint, the owners fulfilled almost all of the functions of the enterprise. They could not afford to hire staff or assistants. Instead, more of the owners' time was spent on non-revenue generating tasks than on recruiting and servicing clients.

During the startup/proprietorship phase, the sole goal is survival

During the start-up/proprietor-phase of their evolution, the sole goal was survival. The owner earned far less than he or she might as employee of a larger organization in the hope that the enterprise would be valuable someday. And each of the steps necessary to expand the business — such as acquiring bigger office space, adding an administrative assistant, expanding marketing materials and corporate brochures — involved great financial risk given the limited resources of the enterprise.

Adolescence

Demand for advice exploded in the late 1980s and early 1990s. Many advisory businesses were able to capitalize on this demand and grew their revenues significantly. With higher revenues, they were able to evolve into adolescent businesses.

Adolescent businesses are different from startup/proprietorships in several ways. They can afford the cost of the nucleus of an administrative staff, allowing their owners to spend more of their time on revenue generating functions. Owners still have to make all of the business decisions and personally supervise all activities of the firm. Instead of preparing every client report and communication, inputting every expense and revenue line item in the company's books and filling out each new client's account forms, however, full- or part-time administrative staff handle these and other functions.

Ways Adolescent Businesses Differ From Startups / Proprietorships

1. Administrative staff
2. Owners draw salary
3. Client referral network
4. Shift to fee-based

Adolescent businesses also have a high enough level of revenue to allow their owners to draw a salary. The owners typically still make less than they would as employees of larger enterprises, but they can afford to continue to operate independent enterprises indefinitely.

Adolescent advisory businesses have broader client bases than startups/ proprietorships

Another difference between adolescent businesses and proprietorship/start-up companies is tied to the types of new and prospective clients that they attract. As these businesses mature into adolescent enterprises, their owners develop networks and relationships (such as with accountants, lawyers and insurance agents) that refer them individuals outside of their initial circles. Over time, the client base of the advisory business evolves from a collection of friends, acquaintances and former clients into the firm's own set of clients.

Finally, as many advisory businesses move into adolescence they try to shift a greater percentage of their business to a fee-only structure. They gradually change from a compensation structure essential for near-term survival to one that will over the longer term build sustainable economic value in their businesses. With a larger revenue base than what they had as start-up companies, they are now able to include in their client mix individuals who generate only annual fees instead of high commissions.

Early adulthood

The next stage of evolution — maturing into early adulthood — has been much harder for many advisory firms to achieve for a couple of reasons. First, businesses in early adulthood have sufficient revenues so that they can afford to hire professional employees in addition to an administrative staff. These professional employees are able to deliver the firm's added value to individual clients, as well as perform many of the analyses that underpin these services.

Ways Early Adulthood Businesses Differ From Adolescent Businesses

1. Professional employees
2. Revenue is mostly from fees
3. Larger new clients

Professional employees are the key to becoming profitable

Professional employees are the key to an advisory firm's ability to become a profitable entity — that is, a company that still makes money after paying its owner what that individual would make as an employee of a larger organization. They allow an advisory business to service a much greater volume of clients and generate more revenue per dollar of fixed operating costs. In high-value, knowledge businesses such as providing comprehensive financial advice, achieving such scale is vital to achieving profitability.

The second obstacle to advisory businesses reaching the early adulthood phase of their evolution is tied to the structure of their client bases. Early adulthood businesses generate most of their revenues from fees paid by clients and transaction-based compensation becomes only a marginal contributor to the firm's profitability. Instead of effectively functioning as a broker who sells products (and is compensated for doing so), advisory businesses in the early adulthood phase of their evolution are primarily paid for providing advice that has no structural conflict with the client's interests.

To be sure, however, many advisory businesses in the early adulthood stage of their evolution are fee-based and not fee-only. But unlike their adolescent counterparts, these organizations have made the decision to focus their marketing efforts on capturing larger clients who want and can afford to pay for fee-only advice. And the organizations' transaction-based revenue is mostly generated from those clients that were recruited in early years and are of a size (of investable assets) that the company no longer accepts.

Most advisory businesses are still in the adolescence phase

A large percentage of the participants in the advisory business have never moved out of the adolescence phase into early adulthood businesses. Why? Professional employees are difficult to recruit, can be very expensive and take a long time to train and develop internally. And owners of adolescent advisory businesses often face a difficult choice. They must either forgo much of their near-term remuneration to finance the cost of adding professional employees or accept that the potential revenue of the enterprise is effectively capped.

Additionally, it is far easier to suggest that an organization foreswear capturing smaller clients that might generate large commissions so that the firm can build long-term enterprise value than it is to make this shift. In changing to a fee structure (even with larger clients) instead of capturing commissions, the owners of adolescent advisory businesses typically experience a significant near-term drop in take-home pay. For the owner who has probably earned less for the last several years than he or she might have as an employee of another company, such a choice can be difficult.

Hidden subsidy was the key to many firms making the jump to early adulthood

Most large advisory firms were able to evolve only because of the bull market of the 1990s

Many of today's larger advisory businesses were only able to make this jump from adolescence to early stage adulthood because of the hidden subsidy from the bull markets of the 1990s. The regular significant annual increases in revenue resulting from market appreciation of client assets made the decision to invest in professional staff a less risky decision. These organizations realized that they could count on this incremental revenue to offset the costs of expansion as well as the effect of inflation on operating costs.

The market correction of 2000–2002 and the less robust equity markets thereafter eliminated this subsidy and made the decision to evolve an advisory business to the next level more complex. Consequently, thousands of small advisory businesses are stuck in the adolescence phase of their evolution. While their owners are able to receive a salary and thus are able to pay their bills and stay in business, these firms are not profitable and lack the capital to reinvest in growth or expansion.

Early adulthood businesses are still very immature

Most businesses that are able to make the jump to the early adulthood stage of their evolution are, however, still fairly immature entities as so much of the business remains completely dependent upon their owners. They still make virtually every decision (both day-to-day and long-term) for the enterprise. While others may execute the decisions of the owners, nothing happens until they choose a course of action.

The owners also make the final decisions on all of the company's value-added services and functions. Although a professional staff member may perform some investment research functions, the owners still ultimately select each of the money managers and investment choices. While a professional staff member may prepare the tax and financial planning analyses for a client, the owners still review and decide what recommendations should be given to each client. The owners (albeit, sometimes with the assistance of staff members) also present all of the firm's recommendations to clients. Professional staff members largely serve as means of leveraging the owners' time and thus increase their capacity to service clients.

Adolescent advisory firms are books of business and not real businesses

More importantly, because of this operating structure, adolescent company client relationships are not with the organization but with the owners themselves. Thus, should the owners suddenly leave or die, it is unlikely the enterprise would continue on. Mark Tibergien of Moss Adams LLP best summed up these types of client relationships as "books of business," as opposed to being "real businesses."

Mature businesses

Maturity is the next phase of a business' evolution after early adulthood. Organizations that evolve into mature businesses are different from their early adulthood counterparts in many ways. First, they typically have begun to specialize by function those activities that the company does to add value to their clients. The term "specialization by function" refers to having specialists within an organization spending most of their time on a single function and being responsible for the preparation and delivery of one aspect of the organization's value-added services.

Ways Mature Businesses Differ From Early Adulthood Businesses

1. Specialists for high-value functions
2. Institutionalized relationships
3. Accepts only high revenue clients
4. Fee-only
5. Some sharing of ownership

The first step for most advisory firms as part of their evolution into mature businesses is the "professionalization" of the investment function. Firms at the early adulthood phase of their evolution typically view the evaluation and selection of managers and design of client portfolios as a part-time job handled by the same individuals (the firm's owners) who are responsible for recruiting and servicing clients. Mature firms instead have one or two individuals (often who have earned a C.F.A. designation and have several years of investment experience) who are responsible for the investment management function for the enterprise.

Investment and marketing specialists do not operate independently of the other professionals in their firms

To be sure, the investment staff is not given carte blanche in the investment area. They are often part of and report to a committee which oversees these decisions. Their organizations, however, rely heavily on the investment professionals' expertise and more often than not follow their recommendations.

Marketing is another function that is often specialized as an advisory business evolves into a mature firm. With early adulthood enterprises, the owners typically handle all of the organization's marketing and client recruitment. Mature businesses instead rely on professional marketing staff whose sole job is to help their organizations grow. To meet this goal, they design and produce marketing materials, develop and initiate company branding efforts within their communities and identify potential clients and help recruit them to the firm. They also help the firm to maintain and broaden their relationships with potential referral sources such as accounting and law firms, and the local offices of custodial organizations.

Just as with the investment staff, however, the professional marketing staff does not operate independently of the other professionals in their advisory businesses. Rather, as part of the broader marketing process, an advisory firm's marketing professionals must marshal their organization's resources so that the remainder of the firm's professional staff are fully involved in the client recruitment effort.

Mature firms have institutionalized relationships

The second major difference between early adulthood and mature advisory businesses is the nature of the company's relationships with clients. As discussed earlier, client relationships in businesses in the early adulthood phase of evolution are not with the business but with the owners themselves. In contrast, a key factor in an advisory business reaching the mature stage of its evolution is its ability to institutionalize its client relationships (that is, the client has a relationship with the firm as a whole as opposed to with one or two individuals in the organization).

Mature firm clients' relationships are with the organization and not just with one or two individuals

With institutionalized relationships, the client feels that he or she is receiving a level of added value from the entire company that overwhelmingly exceeds that provided by any one individual at that organization and outweighs the personal relationship that the client may have with that individual. Thus, the departure of the individual from the organization would not result in the loss of the client.

While many people have spoken about the importance of institutionalizing relationships, it is a difficult thing to accomplish in advisory businesses. Clients are provided advice of a very personal nature. As a result they develop extremely high levels of trust with the individuals with whom they work with at these organizations and often confide in them in ways they are reluctant to with many of their own family members. Converting this very personal relationship between an individual advisor and a client into one owned and controlled by the company often requires that the organization provide multiple sources of value-added services (investment management, tax planning, financial planning, etc.) delivered by several individuals in the organization.

Widespread ownership of the firm is essential to institutionalizing client relationships

Many mature advisory businesses rely on a combination of specialization by function and a team approach to ensure that the client's relationship is with the organization and not with a single individual. The client is initially recruited to the firm by a professional marketer. A group of individuals (often including the marketer) is responsible for managing the day-to-day relationship with the client. Investment advice is provided by a separate group of investment specialists that works closely with the relationship management team. Still others will work with the client on problems requiring special expertise, such as taxes or estate planning issues.

Regardless of their approach, an essential element in achieving the goal of institutionalizing relationships is widespread ownership of the organization, shared throughout the professional staff. Rather than serve just as employees, each team member has a stake in the success of the firm that will only have value if the organization has economic value.

Scale is essential to becoming a mature business

The obvious challenge to an advisory business trying to evolve into a mature organization is that only fairly large organizations have the resources to allow the necessary specialization by function that is integral to institutionalizing relationships. If a firm is going to have one or two individuals spend all of their time evaluating investments and designing portfolios, it will need to be able to spread the cost of this expertise across a large base of clients.

Similarly, full-time marketing staff are also expensive and often require a long period of employment before their efforts bear fruit. Consequently, the advisory business must effectively subsidize them out of the owners' current take home pay.

Mature businesses are typically fee-only

Mature firms constantly upgrade their client bases through high minimum fee requirements

Client base structure is another distinguishing trait of mature advisory businesses. They are typically entirely fee-only, having shed the vestiges of their early days as a quasi-brokerage. Fee-only clients provide recurring fee streams that are the source of enterprise value. Capturing such clients is the sole objective of mature businesses' marketing efforts.

These organizations also are increasingly focused on upgrading the quality of their client base. They shape and implement their marketing strategies so as to target individuals with larger amounts of investable assets who, in turn, will pay higher advisory fees. Their goal is to generate the highest amount of revenue possible from the firm's capacity available to service clients.

A common strategy for achieving this goal is to establish fairly high minimum fees, regardless of client size. Rather than worry about how much money a client might have, mature businesses evaluate a potential relationship (from an economic perspective) in terms of the fees that it will generate. The use of minimum fees puts a floor on the level of revenue from each relationship and ensures that the organization is upgrading the quality of its client base every time that it adds a new client.

Professional enterprises are run by professional business managers

Professional enterprises

The ultimate stage of evolution of an advisory business is into a professional enterprise. The term "professional enterprise" refers to those entities that have specialists in all of the organization's high value and business functions. In place of a structure that relies on an office manager to keep its books and manage the administrative staff, and an owner who still makes most of the organization's business decisions, professional enterprises have chief executive officers who are professional business managers. Professional enterprises also utilize specialists for each of the key administrative functions of the organization (e.g. chief financial officer, director of human resources, and compliance officer). These individuals have expertise in their areas of responsibility and had previously filled a similar function in another organization.

Exhibit 3.3 Non-Revenue Functions that are Specialized at Professional Enterprise

Marketing and Communications	Human Resources
Public Relations	Technology
Operations	Finance
General Auditing	Risk Management
Research	Development and Training
Legal and Compliance	

Additionally, these companies have boards of directors or management committees to which the company's management reports. While the owners of the company serve as board or committee members, they no longer make the day-to-day decisions in running the firm. It is the professional business managers that have this responsibility and authority.

Authority in professional enterprises is tied to position and job performance, and not longevity or relationship with the company's founder

Ways Professional Enterprises Differ From Mature Businesses

1. Professional business management
2. Specialists in administrative functions
3. Board of Directors / Management Committees
4. Dependence on policies and procedures
5. Widely shared ownership

Advisory firms at this level of maturity also rely on operating policies and carefully crafted compensation programs for each position in the company. Every employee has specific duties and responsibilities. And although many individuals have been with the company for many years, their authority is tied to their position and job performance and not to their longevity or relationship with the company's founder.

Professional enterprises rely on impersonal, objective rules and standards, unlike the family-like atmosphere in most advisory firms

Evolving into a professional enterprise

There are three major obstacles that a mature business must overcome to become a professional enterprise: scale, culture and the firm's owners. Scale is a precondition to reaching this stage of business maturity because professional business management is very costly and does not directly increase the revenues of the firm. Only fairly large organizations have the scale across which to spread the high fixed costs of such individuals.

Culture in many ways can often be a more difficult obstacle for an advisory business to overcome when trying to evolve into a professional enterprise. Many current owners and employees of advisory businesses enjoy a close-knit, family-like atmosphere. Decisions are often made in a somewhat arbitrary fashion in an attempt to create the highest comfort level for different employees and are often based on verbal and personal commitments made by the owners over time.

A professional enterprise, in contrast, relies upon much more impersonal and objective rules and standards to operate. The company is first and foremost a business. Its managers have a fiduciary obligation to the shareholders to manage it well. And policies that make the most sense for the entire organization are often viewed as bureaucratic by some employees of the firm.

Consequently, shifting an advisory business to a professional enterprise model can result in the departure of several of the firm's employees, often many of those with the longest tenure.

As firms mature into professional enterprises, their owners must change from enlightened despots to constitutional monarchs

The greatest obstacle to evolution is a firm's owners

The greatest obstacle to an advisory firm evolving into a professional enterprise, however, is its owners. An integral part of the changes the organization must implement are the owners' roles within the company and their personal ownership stakes. No longer can they simply serve as enlightened despots. Now they must function instead much more like constitutional monarchs.

Further, the ownership of professional enterprises is far less concentrated than their less mature counterparts. While the original owners took great risks and sacrificed much to build the company, an equity stake is an essential component of compensation for all key employees.

Now consider the difficult decision that the owners of mature advisory businesses face. Making the shift to a professional enterprise is complex and expensive. But if successful, a professional enterprise is a larger, more economically valuable entity. It is also far more likely to survive the owner's ultimate departure.

At the same time, the owners of mature advisory businesses have much broader authority and far greater latitude as to how to run their companies. They are not encumbered with bureaucracy that is inherent in a professional enterprise. And from many such owners' perspective, it may only be Lichtenstein, but it is still good to be king.

Exhibit 3.4 Large Firms Rely on Many More Policies and Procedures

Policies and Procedures at a Typical Large Mature Financial Advisory Business		
Advertising	Complaints	Investment Processes
Advisory Agreement	Corporate Records	Personal Securities Transaction & Records
Agency Cross Transactions	Custody	Principal Trading
Anti-Money laundering	Direct Brokerage	Privacy
Best Execution	Disaster Recovery	Proxy Voting
Books and Records	Disclosure Document	Registration
ERISA	E-Mail and other Electronic Communications	Regulatory Reporting
Insider Trading	Supervision/Internal Control/Annual Reviews	Solicitor Arrangements
Trading	Wrap Fee Programs	Valuation of Securities

Source: JPMorgan

List of Typical Policies and Procedures at a Large Financial Institution/Professional Enterprise		
Safety and Security	Accounts Payable & Accrued Expenses	Allowance for Credit Losses
Client Reference Data	Mortgage Errors & Omissions	Fair Lending Statement
Hedge Funds	Stamp Bond	Know Your Customer Policy
Interest Income	Umbrella/Excess Liability	Management Consulting Policy
Investment Securities	Worldwide Property	Responsibilities of Former Employees
Loan Fees	ACL Charge-Off and Recovery	Strategic Sourcing Procedures and Guidelines
Variable Interest Entities	Intercompany Accounts	Corporate Laptop
Underwriting	Legal Entities	Personal Printer
Trading Securities	Remittance Policy	E-Mail Distribution of Offering Documents
Structured Liabilities	Retention of Earnings	IT Risk Management Policy
Severance and Restructuring	Celebrations–Employee Celebrations, Gifts, Parties and Tributes	Inappropriate Use of Information Resources
Reimbursement of Expenditures	Corporate Card–Application	Record Retention Policy
Securities Acquired	Dining–Off-Premise Meals with Business Guests	Technology Usage Policy
Bankers Professional Liability	Memberships–Corporate	Telephone Tape Recording Policy
Comprehensive Transfer Agents Bond	Publications–General Interest	Conflicts
Computer Crime	Publications–Professional Journal	Anti-Money Laundering Compliance Program
Contingent & Excess Auto (Leased) Liability	Sourcing guidelines	Antitrust Prohibitions
Corporate Insurance Services Manual	Time Management Tool Restrictions	Avoiding Market Manipulation
Mail & Transit	Anti-Money Laundering Compliance Program–Global	Compliance Offshoring Guidelines
Foreign Corrupt Practices Act Policy	Appropriateness Policy	Credit Research Independence Policy
Advertising policy	Code of Conduct	Distribution Policy
Brand guidelines	Archive policy	Fair Lending Statement
Copyright standards	Press relations policy	HR Policies
Design standards	Charitable Contributions, Fundraising Dinners and Journal Ads	Global Personal Trading Policy and Procedure
Editorial style standards	Sponsorships brand standards	Compliance Training and Monitoring
Vendor use of our brand policy	Hiring Former Independent Auditor	Risk Policy
Occupancy Cost Allocation	Account Review	Global Market Risk Capital Policy
Supplier Diversity Policy	Asset Valuation	Error Escalation
Corporate Global Travel Policy	Non-IT consulting services engagement process	New Risk Approval Policy

Source: JPMorgan

Remaining at a mature or early adulthood stage of evolution is not an option if a firm hopes to implement a high growth strategy

Growth requires evolution

Advisory firm owners, however, will soon find that remaining at a mature or early adulthood stage of evolution is not a realistic option if they hope to successfully implement the kind of high-growth strategy necessary to sustaining their personal economics. Why? Growth in numbers of clients and revenues require greater numbers of professional and administrative staff. And the larger that an organization becomes, the more difficult it is to competently manage.

Further, the company's activities and decisions cannot remain centered around one or two owners if it hopes to be able to function in any rational fashion. A high-growth strategy dictates that both responsibility and authority be decentralized so that the organization can remain nimble enough to compete as a business.

Similarly, good firms cannot attract and retain good people unless they are willing to provide them a stake in the success of the enterprise. Organizations that are reluctant to share their ownership widely will quickly be unable to compete for the types of quality employees essential to the growth of an advisory business.

Thus, a first step for many owners of advisory businesses in determining the strategy for their company is to understand its current level of maturity. To be sure, these categories are very broad and many organizations may currently be in the process of leaping from one stage to the next.

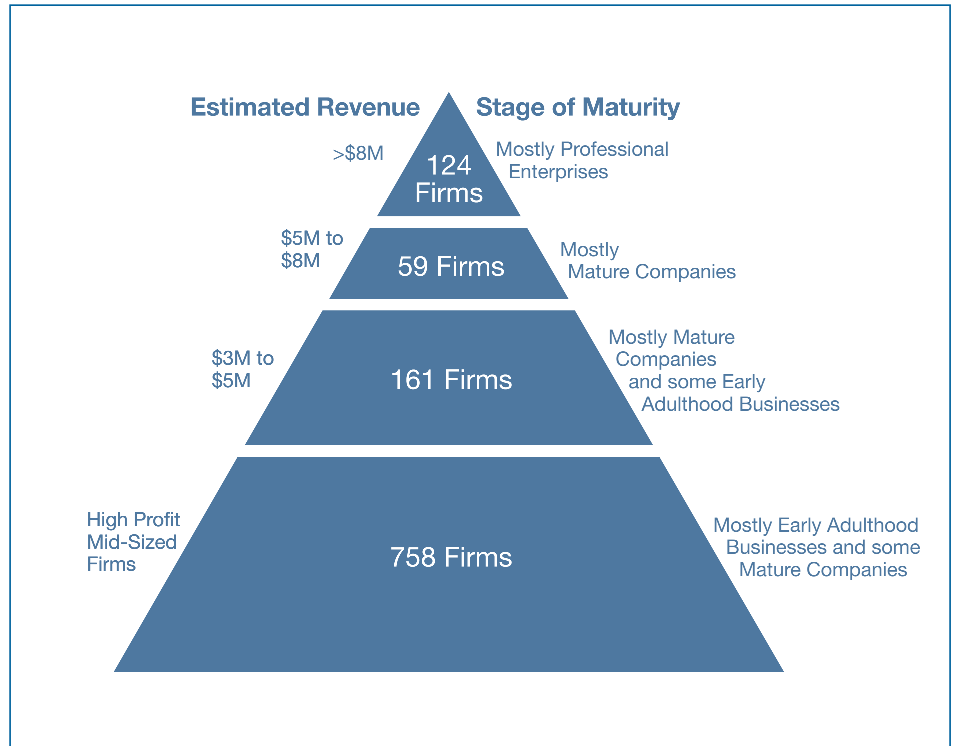
At what stage of maturity are most advisory businesses?

In reviewing the industry's current participants, it is difficult to accurately determine how many organizations currently fall into each category. Our best estimate, however, is that most of the advisory businesses that are in the Have Not category have yet to reach the mature business stage. Many lack the revenue to finance the evolution out of the adolescence stage and into early adulthood.

As the costs of operating an advisory business have risen there are fewer truly de novo startup advisory businesses. Instead most of the firms that now fall in the startup/proprietorship category are launched by top producers from traditional brokerages that decide to strike out on their own and transfer over large existing books of business.

Exhibit 3.5 provides a diagram of our best estimate of the current state of maturity of those firms that fall into the Haves category. As shown below, the preponderance of industry participants is either in the early adulthood stage or has just entered into the mature business phase of their evolution.

Exhibit 3.5 Current Stage of Maturity for Haves



Source: 2004 Form ADV filings with the Securities and Exchange Commission

While these organizations are profitable entities, their owners are facing some difficult strategic choices over the next five to seven years. As we will discuss in Chapter 4, they must select from one of three options. The first alternative is to significantly reinvest in the company so that it can evolve into the next stage of its maturity. The second is to focus on maximizing near-term profitability and forgo the investments necessary to support long-term growth. The final option is to sell the enterprise and shift strategic decisions to their successors.

Only a fraction of advisory businesses have reached the professional enterprise stage. They are some of the industry's largest and fastest growing competitors. These organizations are likely to emerge from the next phase of the industry's evolution as dominant competitors — very large, highly profitable enterprises that have great economic value.

Chapter 4: Options (and their Merits and Drawbacks) Available to Advisory Business Owners

As discussed earlier, advisory businesses of all sizes will face many challenges over the next five to seven years. Operating costs are going to rise significantly. Professional employees will be able to demand both higher salaries and equity ownership stakes in their employers. And many owners will find that they must grow their businesses at a rapid rate or their compensation and the value of their ownership stakes will decline.

Owners of smaller advisory businesses will have few options

Small advisory firms have little or no value as businesses

These changes will be particularly daunting for most of the industry's smaller participants and will leave their owners with few attractive options. Their companies are trapped in the adolescent or early adulthood stage of evolution but lack the resources required to fund growth and development. Unlike their larger counterparts, the owners of such firms will not be able to sell their companies as businesses. These entities have little economic value as ongoing enterprises because after paying the owners a below-market salary, they remain unprofitable. Additionally (and as we discussed in greater detail in Chapter 1), their firms' small average client size make them unappealing acquisition targets for larger firms.

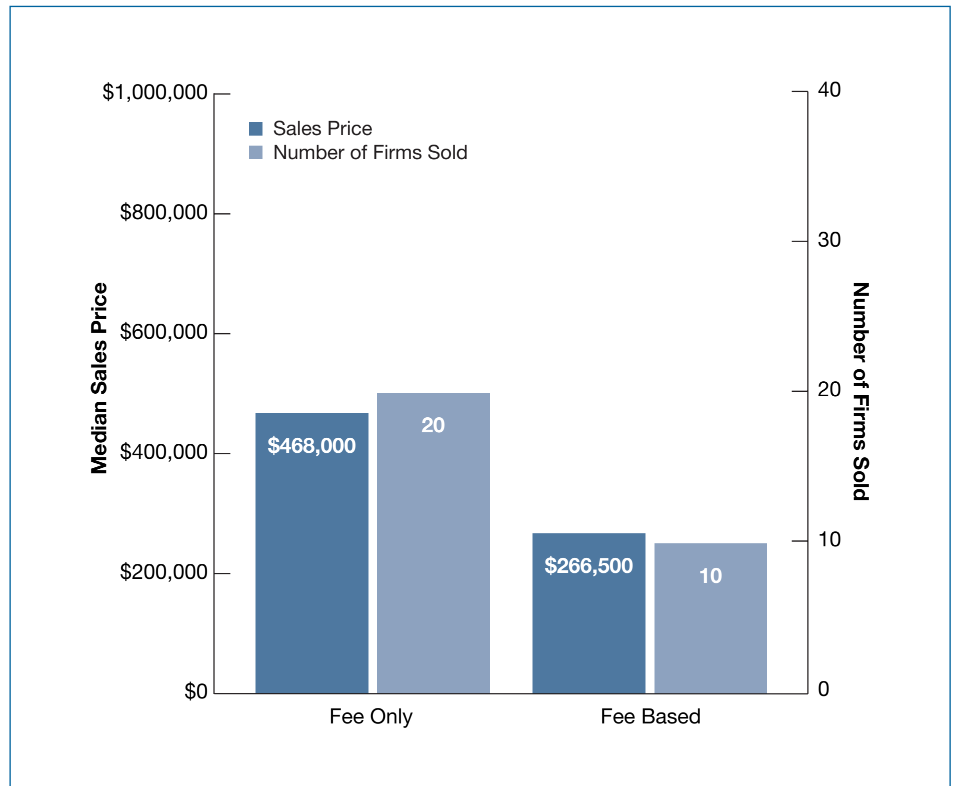
One opportunity that some of these firm owners might have to receive consideration for their businesses would be selling their firms to their employees. But because the current owners work for less pay than they might receive as employees of larger organizations, persuading their successors to simply take over the business from them — much less pay them anything for it — may be difficult.

Small firm transactions have been rare and only for low prices

There is, of course, a market for "books of business"; that is, the sale of a client list rather than the sale of a business. The only tangible assets purchased are the names, books and records of clients with the hope that they will transfer their accounts to, and remain with, the buying advisor. The acquiring advisor typically cherry-picks the best clients and terminates the remainder; the selling advisor receives a small amount of contingent consideration based on the number of clients the acquirer wants and is able to keep over time. Due to the limited scope of the transaction, the consideration paid is relatively trivial compared to that from the sale of a business.

According to Business Transitions[8] and as shown in Exhibits 4.1A and 4.1B, there have been only 30 recent small firm transactions and the average total consideration paid was small. Additionally, very little was paid up front. A majority of the risk of the transaction was instead shifted to the seller because most of the consideration was paid as part of an earn-out.

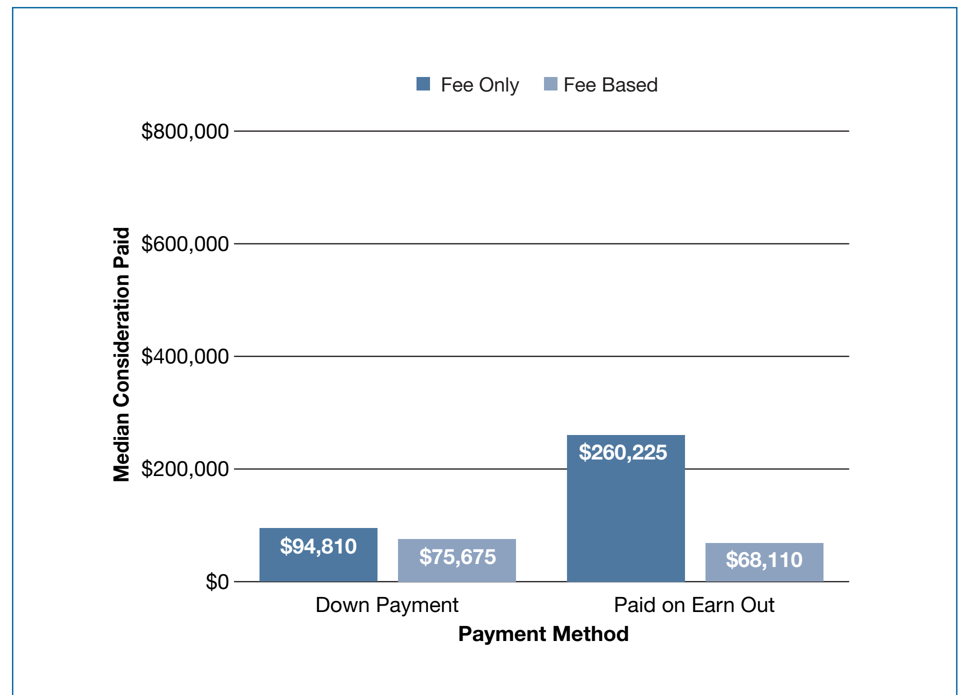
Exhibit 4.1A Few Small Practices Have Been Acquired and Only at Low Prices



Source: Business Transitions/2004

[8] Business Transitions: The Definitive Valuation Guide 2004

Exhibit 4.1B Very Little Has Been Paid Upfront for Small Advisory Businesses



Source: Business Transitions/2004

Owners of larger advisory businesses will have many (albeit difficult) choices

The owners of larger advisory businesses, by contrast, will have many alternatives available to them. They can continue to operate their companies to maximize long-term growth or near-term profitability. Or they can sell their firms to their employees, a financial buyer or (in some instances) a strategic acquirer.

Strategic Options Available to Have Firms

1. Reinvest to grow
2. Cash cow
3. Legacy transition
4. Financial buyer sale
5. Sale to a strategic acquirer

Reinvest to grow strategies have the potential to create the greatest shareholder value

But owners of larger advisory businesses will also find the coming years to be challenging. Although their companies are profitable, the combination of higher operating and professional employee costs and the need to more widely share equity in their firms will make maintaining their personal economics much more difficult.

Large firm owner option # 1: Reinvest to grow

The first alternative available to owners of larger advisory firms is to significantly reinvest in the business so that its operating structure can evolve and thus be able to support substantial growth of clients and revenue. As part of such a strategy, some larger advisory businesses might also grow through buying smaller firms that have attractive client bases. The objective of this "reinvest to grow" strategy is to boost the company's profitability (and thus, enterprise value) and in turn, improve the owner's overall economics despite a wider sharing of equity within the firm.

High Growth Strategy

Merits

1. Creates greatest potential enterprise value
2. Increases possibility of strategic sale

Drawbacks

1. Complex / difficult to execute
2. Lower near-term owner compensation
3. Requires evolution of enterprise
4. Changing culture and owner role

This strategy can be a compelling option for many owners of advisory businesses because it offers the greatest potential economics. Firms that can successfully execute a high-growth strategy will build immense enterprise value and will increase the likelihood that a potential strategic acquirer will offer a very high price for them when their owners decide to sell.

Drawbacks to high growth strategy

There is no certainty that a high growth strategy will succeed

The "reinvest" alternative, however, is not an obvious choice for several reasons. First, it will greatly limit the near-term profitability (and thus, the take-home pay of the owners) of the enterprise. Instead of their paychecks continuing to rise, they may decline as the owners find that they must make larger and larger investments in personnel, technology, marketing activities and infrastructure.

Second, while if this strategy is properly executed it will create great long-term enterprise value, there is no certainty that advisory businesses will succeed in re-engineering their firms' operating structure or in capturing a volume of clients sufficient to justify the cost of doing so.

Cash cow strategies are focused on boosting near-term profitability

Third and most importantly, this approach requires significant cultural changes to the advisory business and a lesser role for its owner. And many advisory business owners do not want to change the culture of their firms nor their own roles within them. These individuals are fundamentally entrepreneurs and have little interest in working in the inherently more bureaucratic structure of a professional enterprise.

Large firm owner option # 2: Cash cow strategy

A second strategic alternative available to owners of large advisory businesses is to focus on maximizing near-term profitability; an option that appears to be the most popular choice in the industry. It relies on using the company's current operating and governance structure and limiting the firm's growth in new clients to what it can support.

Cash Cow Strategy

Merits

1. Higher near-term pay for owners
2. Little change to organization

Drawbacks

1. Caps organization size
2. Leaves firms more vulnerable to industry changes

This "cash cow" approach is compelling to the owners of many larger industry participants because it involves little change. Their businesses can increase their capacity with the addition of only one or two more employees, significantly boosting their near-term profitability. In addition, because this strategy does not require significant reinvestment in the enterprise, this increased near-term profitability translates into much higher take-home pay for the owner.

Drawbacks to the cash cow strategy

Cash cow strategies leave firms more vulnerable to the coming changes in the industry

There are, however, significant limitations to the cash cow strategy. First, it effectively caps an organization's potential size. A firm's current ad hoc operating and governance structures will at some point become dysfunctional and inhibit the company's ability to grow and operate effectively.

Second, and more importantly, adopting this approach will render organizations more vulnerable to the broader forces (competition for employees, higher operating costs, and competition for clients) that will sweep through the industry over the next five to seven years. Their evolution as businesses will remain stagnant and, over time, they will be far less effective competitors in a more difficult business environment and at a disadvantage to other firms in their ability to keep their best people. Thus, the "cash cow" strategy effectively mortgages the organization's long term growth and sustainability as an enterprise in exchange for higher near-term profitability.

Large firm owner option # 3: Sell the company

The third option available to owners of advisory businesses is to sell the enterprise. Several reasons may make this choice an attractive option for many owners of advisory businesses. First, as we discussed earlier in Chapter 2, their personal demographics are forcing them to consider a transition. Owners of many firms are currently in their mid to late 50's. Since a precondition of nearly every transaction is that the owner continues to work in the enterprise for a certain period of time (usually four to seven years) after the point of sale, deferring a transaction requires that owners defer getting on to the next phase of their lives. And for some of these individuals, this may mean that they will be in their mid- to late-60's when they are finished with their businesses.

Selling Advisory Businesses

Merits

1. Owners can commence next phase of life
2. Takes money off table
3. Shifts decisions to successors

Drawbacks

1. Market currently not clearing
2. Low prices paid
3. Postponing may increase profitability and potential consideration

Most advisory business owners' stake in their firms is their largest personal asset

Second, the owners' stakes in their companies is often their largest personal asset. While they may have adequate savings so that they can retire regardless of what they receive for their companies, the consideration paid for their firms will have a major impact on the quality of their retirement lifestyle. A sale of the business allows them to "take money off the table" and ensure a much higher standard of living in retirement.

Third, the owners of many advisory businesses dislike the increasing complexity of managing a larger business. For them, working with clients (and not managing employees) is why they started an advisory firm. Since the changing economics of the industry are forcing many firms to grow rapidly as businesses, these owners are not enjoying their companies as much as they did in the past and have concluded that they should sell it to new owners and move on to new challenges.

Many owners will decide to sell their companies and shift the strategic decisions to their successors

Drawbacks to selling an advisory business

Actually selling a business, however, could be problematic. There currently are few strategic acquirers of advisory businesses. This scarcity has, in turn, caused the market for advisory firms to "not clear". In other words, while there are many buyers of firms and numerous potential sellers, there is a great gap between the bid and the asking price and only a small number of transactions have been consummated.

The source of this disparity is that owners of large advisory businesses (understandably) believe that their enterprises have much greater intrinsic value than current buyers are willing to pay. Our research suggests that many of these owners are correct.

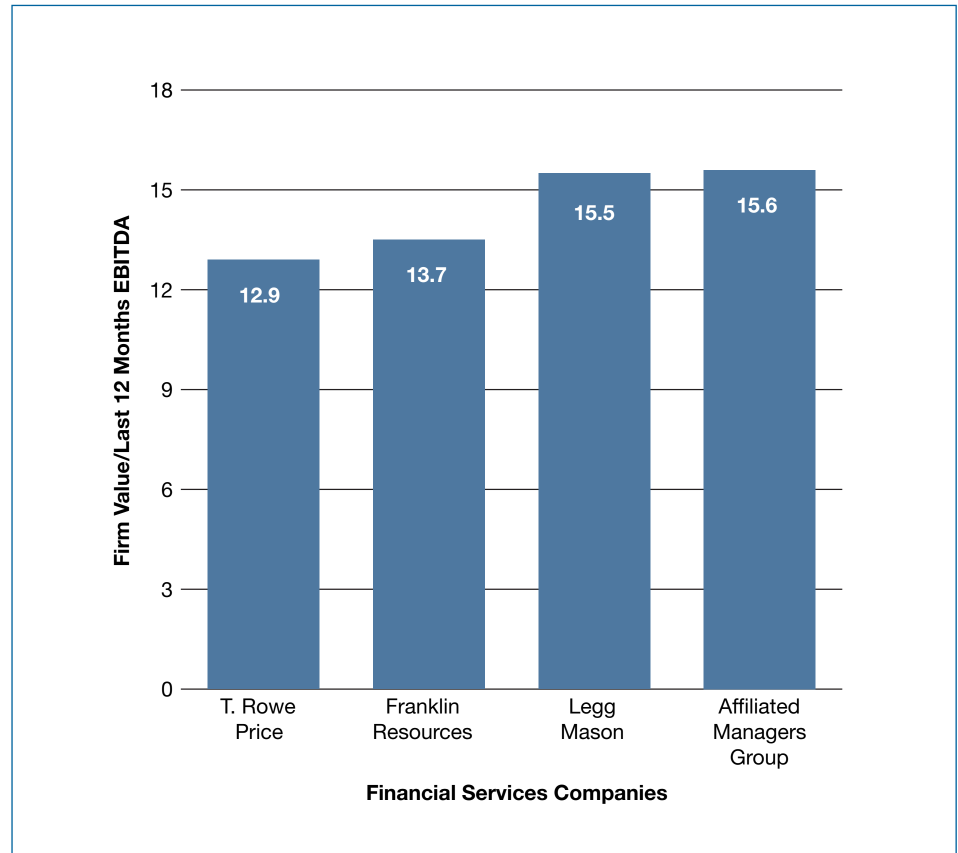
Of course, no one can calculate the "true" intrinsic value of any enterprise with absolute certainty. A variety of factors unique to each company must be included in this calculus and value is only what someone is willing to pay for something. There have also only been a small number of transactions in the industry to date and these have not involved the sale of highly profitable, fast growing firms.

It is realistic, however, to compare the advisory business with other, similar industries. For example, money management firms have similar economic structures to those of financial advisors. Both are recurring revenue businesses; that is, their compensation structure creates annual, recurring fee streams that allow them to have very predictable revenues and earnings. Participants in both industries also are able to grow these predictable earnings at rates of 15% to 20% per year with regularity. And the equity markets typically reward such kinds of businesses by paying very high multiples of cash flow for their stock.

Advisory firms are recurring revenue businesses that the equity markets typically reward with high multiples

Exhibit 4.2 provides some examples of the multiples paid for a select group of firms that meet this profile. As you can see, these multiples of EBIT (Earnings Before Interest and Taxes) currently range from 12 to 16. To be sure, we are not suggesting that small private advisory firms should trade at such lofty levels. All of the organizations in the exhibit are multi-billion dollar companies and markets certainly will pay higher multiples for large, professional enterprises than small, less-mature advisory firms. Additionally, investment managers have far better operating leverage than financial advisory firms, allowing them at different points in time to grow their earnings more rapidly.

Exhibit 4.2 Large Recurring Fee Businesses Trade at Very High Multiples



Source: Public Filings, Bloomberg; JPMorgan. Data as of June 24, 2005

Advisory businesses, however, are in many ways more stable businesses and produce more predictable cash flows than money managers because they have only minimal turnover of clients. The advisory industry participants we interviewed averaged less than 2% turnover in clients per year over the past five years, far less than the 19.7% to 27.9% redemption rate that mutual fund companies have averaged over the same period.[9]

[9] 2005 Investment Company Fact Book, Investment Company Institute.

Over time large advisory firms will likely trade as high as nine to eleven times Saleable Cash Flow

Thus, given these multiples and the differences in the two industries, our best guess is that once there is an active market for advisory businesses, many large participants (in particular, those purchased by strategic acquirers) could trade at multiples as high as nine to eleven times Saleable Cash Flow — that is its last twelve month's earnings before interest and taxes *after* paying the owners a market-level salary. And some firms may trade at even higher prices in transactions in which the seller bears most of the risk. A majority of the outside buyers currently trying to do acquisitions are offering only five to six times Saleable Cash Flow.

Most firms do not generate much Saleable Cash Flow

The second reason why the sale option may be problematic is that regardless of the multiple an acquirer will pay for a business, it is a multiple of the business' *current* Saleable Cash Flow. And most large advisory firms will be significantly more profitable in the future than they are today.

These organizations, however, have significant operating leverage and are growing rapidly. Assuming they can successfully manage and capture that growth using their current infrastructure, their Saleable Cash Flow could potentially double or even triple over the next five to seven years. Entering into a transaction based on current economics might thus generate significantly lower total consideration than if the business was sold at a later date.

At the same time, potential sellers should also understand that the multiples of Saleable Cash Flow that any buyer will pay for a particular firm will not remain static. They instead are based on the buyer's view of the rate at which it believes a potential acquisition's earnings will grow in the future. This rate at which an acquisition's future earnings grow is what determines a buyer's rate of return on the companies that it acquires.

This issue should be an important consideration for firms that are considering delaying a sale because the larger it becomes, the harder it is to maintain a high rate of growth.

For example, an advisory firm that currently has $1 million of Saleable Cash Flow will need to grow its annual profitability to about $2.5 million over five years in order to achieve a 20% compounded annual growth in earnings. If it, however, waits until it has $3 million of Saleable Cash Flow to sell, its profitability will have to grow to almost $7.5 million in five years to achieve the same rate of growth in earnings.

Given the absolute amount of growth required in each case, a rational buyer would understandably assume that a seller with $1 million of Saleable of Cash Flow would be more likely to grow its future earnings at a higher rate than one with $3 million. And the buyer would thus pay a higher multiple of Saleable Cash Flow for the former than for the latter.

Once an owner decides to sell a business, he or she crosses a mental Rubicon from which it is hard to return

Psychology of selling a business

In addition to the more obvious benefits and drawbacks of selling an advisory business, it is essential that firm owners considering this option understand just how complicated and emotional such a decision can be. A sale is typically a milestone in owners' lives, ending a major stage of their professional career. Once owners begin to contemplate selling their businesses, it becomes more apparent to them just how large an intellectual and psychological investment that they have made in their companies. The challenge of running one's own business — typically one that the owner has built from scratch — can be all-consuming and a significant portion of an owner's self-image is often tied to the enterprise.

Consequently, most owners arrive at a decision to sell their businesses only with great difficulty and over a long period of time. However, once they do, these individuals typically cross a mental Rubicon from which it is hard to return.

Trying to sell an advisory business permanently changes it

Once an owner elects to sell a business, the process of finding and negotiating with buyers triggers a series of emotional and psychological changes within an organization that affects every one of its members. Owners with minority interests must determine whether the transaction will generate a sufficient level of consideration to compel them to agree to the transaction. Non-owner professionals must reevaluate whether remaining with the company will continue to offer an excellent opportunity to develop, advance and build personal wealth. Administrative personnel will have to reconcile themselves to a changed operating environment, one that might include potential job reductions as the buyer rationalizes an acquisition.

An advisory business that is for sale, but does not complete the transaction, is irrevocably changed

Selling a business typically takes six months to two years to complete. In the interim, the owner will ride a roller coaster of emotions and the firm's employees will have more than ample time to rethink their careers and lives.

Sophisticated potential buyers of an advisory business understand all of these things and will try to capitalize on them when negotiating an acquisition. They know just how difficult it has been for the owner to reach the decision to sell and, after all of the inherent agonizing involved in reaching this point, how psychologically traumatic it would be should a transaction not be consummated. Buyers also recognize that the culture and internal dynamics of any advisory business that gets fairly far down the path of selling itself, but does not complete a transaction, are changed irrevocably and often for the worse. Some buyers will even deliberately slow the transaction process hoping that the longer it takes to negotiate a deal, the more compelled the seller will be to accept it.

Advisors must manage the sales process so as to minimize any damage should a transaction not be completed

Selling an advisory business is a complicated process

Successfully selling an advisory business is, thus, a much more complicated process than it might first appear. Potential sellers must carefully manage the sale process so as to minimize the damage to their organizations should a transaction not be completed. Buyers must be carefully screened and evaluated. They must also be forced to submit comprehensive proposals early in the sale process and prior to informing most members of the selling organization of a potential transaction. The owners must also carefully build a consensus within their firms to go forward with a sale. Confidentiality throughout the process is paramount. And owners must somehow force themselves to come back across the mental Rubicon and reject a transaction unless the buyer is willing to pay fair value for the enterprise.

Finally, it is essential that a seller understand the perspective and psychology of a potential buyer. Just as there are costs to sellers should they fail to reach an agreement, walking away from a transaction is likewise problematic to a potential buyer. The buyer often will have invested immense time and resources in evaluating an acquisition, all of which is lost should it fail to complete a purchase. Additionally, many buyers are intensely political organizations and the individuals involved in a potential acquisition can suffer significant damage to their careers should they fail to consummate an acquisition. Only by understanding and being able to take advantage of a buyer's internal dynamics (and thus, weaknesses) can a seller capture the fullest and fairest value for an enterprise.

Three classes of potential buyers of advisory firms

So what are the options that large advisory firm owners have when selling their businesses? Potential buyers can be divided into three general groups: legacy buyers, financial buyers, and strategic acquirers. Transactions with each of these types of buyers differ significantly because they have different perspectives and goals in acquiring advisory businesses.

There are three types of buyers: legacy, financial and strategic acquirers

Legacy buyers

A legacy transition occurs when the owner sells the business to its employees. For most large industry participants, a legacy transition will be the only option available to the owners to monetize their stakes in the companies.

Legacy Transition

Merits

1. Least disruptive transition
2. No change to culture of firms

Drawbacks

1. No value added to enterprise
2. Lowest risk-adjusted consideration
3. Unlikely to create a legacy

An attractive aspect of legacy transitions is that they are typically the least disruptive type of transaction. An owner gradually shifts his or her client responsibilities to the firm's employees over a three-to four-year period. As the owner phases out, the buyers assume responsibility for managing the business and servicing its clients.

Most consideration in legacy transactions is paid as an earn-out

A majority of the consideration paid for the business is structured as a multi-year earn-out. Instead of receiving a large payment at closing, the owner continues to receive a lion's share of the firm's profits for a period of time, despite having diminished responsibilities. From an economic standpoint, the structure is more analogous to a simple redistribution of equity within the firm than the traditional sale of an asset.

Legacy transitions have two distinct advantages over other types of transactions. First, they are almost unnoticeable to clients, since other than the owner being less visible and playing a smaller role in preparing and presenting reports to clients, the firm continues to operate as it has in the past. Second, the culture of the firm changes very little; it still remains a fairly cozy business.

Drawbacks to a legacy transition

There are two major disadvantages, however, to legacy transitions. First, they do not provide added value to the enterprise. The entity's economics are largely unchanged. Thus, the firm does not improve its ability to capture clients or operate more efficiently at a time that major changes are about to sweep through the industry. Second, legacy buyers typically pay the lowest risk-adjusted amounts for an advisory business. Why? Consider the perspective of legacy buyers.

These individuals have typically been employees of the organization for many years. They believe that they are (or at least should be) de facto equity holders in the company and they recognize that their continued involvement in the company is essential if the owner hopes to receive any consideration for the enterprise. Additionally, legacy buyers have a tremendous informational advantage over other acquirers of advisory businesses. They have a realistic view of the organization's strengths and weaknesses.

Legacy buyers have incredible bargaining power over sellers

They also understand the owner's personal inflection points — that is, the number of years the owner really wants to continue to work in the business and the level of motivation (or even desperation) the owner feels to consummate a transaction. Further, they hold the ultimate trump card in any negotiation with a seller: if they resign from the firm, the owner loses the opportunity to get paid any consideration for the business.

Combined, these factors provide the legacy buyer with incredible bargaining power. They best understand the asset and the seller, and recognize that they are the owner's best (and often only) hope for getting paid something for the business. Consequently, they typically pay a very low price for the businesses that they acquire. And as part of the transaction, they often pay little money upfront, leaving the seller to bear much of the business and operating risk of the enterprise through the earn-out period.

Although each legacy transaction is unique, a commonly-used structure has the owner receiving three to four times Saleable Cash Flow, paid out over a four to six year period. For the largest firms, the employees might be able to secure a loan to finance some sort of upfront payment, but rarely is it much greater than two times Saleable Cash Flow.

Legacy transitions do not create a legacy

A final point to emphasize about legacy transactions is that their title can be misleading. Several owners of very profitable advisory businesses are seriously considering entering into legacy transitions and are not exploring other potential sale options because they believe such a transaction will help them create a personal legacy. Rather than have the firm that they built over many years simply become a part of some larger, more impersonal organization, selling the business to its employees will ensure that the entity will continue in its current form indefinitely.

As noble as that view may be, however, it ignores two salient realities. First, the business is not operating independent of the forces shaping the industry as a whole. Consequently, the business will have to evolve and grow if it is to continue to prosper.

It is naïve for legacy sellers to assume that their successors will be as committed to building a legacy

Second, while the current owners of these entities may be committed to creating a legacy for themselves and be willing to sacrifice their own economics to facilitate this outcome, their successors may take a more economically rational view of this issue. Multiple examples abound in the financial services industry of organizations (as shown in Exhibit 4.3) that had been sold to a succeeding generation and were later sold by their new owners for the highest possible price to the best bidder. One can only imagine the angst suffered by early generations of owners upon learning that their successors had profited (often immensely) from their nobility.

Exhibit 4.3 Legacy, What Legacy?

Institution	Founded	IPO/Sale
The Bear, Stearns Cos.	1923	1985
Goldman Sachs Group, Inc.	1869	1999
J. Aron & Co.	1892	1981
Lazard Fréres & Co.	1848	2005
Lehman Brothers Inc.	1850	1994
Merrill Lynch & Co.	1914	1971
Morgan Stanley	1935	1986
Neuberger Berman, LLC	1939	2003
Robert Fleming Asset Management Limited	1873	2000
Salomon Inc.	1910	1981
Scudder Stevens & Clark	1919	2002
Smith Barney Inc.	1873	1987

Source: JPMorgan/2005

Legacy transactions are misnomers because it is naïve to assume that future owners of any business will be willing to forgo substantial consideration so that their predecessors' legacy may endure. In fact, an important part of the calculus of buyers in legacy transitions is the expected value that they might achieve when they sell the business at a later date.

Financial buyers

The second type of transition — a financial buyer transaction — involves the sale of all of a company's equity and only a portion of its cash flow to an outside entity that specializes in providing liquidity to advisory firm owners. Sales to financial buyers will likely be the second most common way that large advisory firm owners transition their businesses.

Financial Buyers Transaction

Merits

1. Higher absolute consideration than legacy transition
2. Minimal change to selling organization
3. Only option to generate material consideration for many firms

Drawbacks

1. Most of economics go to buyer
2. No added value to selling enterprise
3. Seller retains most of the risk

Financial buyer transactions typically pay more than legacy transitions

There are three attractive aspects to financial buyer transactions. First, sellers will typically be paid more consideration than they might receive should they sell their enterprises to their employees. Second, this kind of sale does not significantly change the day-to-day operations of an advisory business. It is a financial transaction and the seller is largely left alone to operate his or her business as they have in the past.

Third and most importantly, a financial buyer transaction may be the only viable option for many owners of advisory businesses trying to monetize at least a portion of the value of their enterprises. These organizations are too small to attract any interest from potential strategic acquirers and many do not have in place a successor generation of owners, making a legacy transition impossible.

Industry participants are currently deluged with proposals from financial buyers. To date we have encountered six different organizations trying to become financial buyers of advisory businesses and we expect that there will be many more entrants into this category.

Two reasons why financial buyers are flocking to the advisory business

Advisory firms are ideal targets for financial buyers

Two factors are enticing financial buyers to this industry. First and foremost, there is currently an enormous gulf between the price financial buyers hope to pay for Saleable Cash Flow versus what larger organizations in this industry receive for it in the public markets. While prices vary between transactions and acquirers, financial buyers are typically offering to buy a percentage of an advisory firm's Saleable Cash Flow for a price equal to five to six times of the amount sold. The public markets currently allow these financial buyers (once they have achieved enough scale to access them) to monetize this Saleable Cash Flow at a multiple of 13 to 15.

Second, the advisory business is attractive to potential financial buyers because it is an industry dominated by entrepreneurs who abhor working in a potentially bureaucratic environment and would not consider a transaction with many types of companies regardless of price. Their reluctance to work as part of a larger organization offers financial buyers an opportunity to buy at a relatively low price even those firms that might be attractive to strategic acquirers.

Combined, they make the advisory business an ideal target for financial buyers. They are able to purchase cash flow from advisors at one price and resell it to the public markets at a much higher one. And the owners of advisory firms are willing to enter into this bargain because the transaction will pay them a higher absolute price than they could generate from a legacy transaction and with potentially less aggravation than if they sold to a strategic acquirer.

Life cycle of financial buyer enterprises

An essential part of understanding financial buyer transactions is to recognize that these entities have a lifecycle made up of three phases:

1. Pre-critical mass

Financial buyers achieve critical mass at the point that they own enough cash flow to allow an initial public offering

The financial buyer uses private capital to buy stakes in numerous industry participants. Its goal is to complete a sufficient number of transactions so that it can achieve critical mass — the point at which it owns enough Saleable Cash Flow to allow it to make an initial public equity offering.

2. Print currency

After a financial buyer achieves critical mass, it enters the "Print Currency" phase. As a public entity, it now possesses a stock that can be used as a currency to acquire more Saleable Cash Flow from businesses. Ideally this currency will trade at a high multiple (higher than what they will have to pay sellers for their Saleable Cash Flow) creating an arbitrage. The financial buyer will then try to complete as many transactions (or "print its currency") as fast as possible, growing the earnings per share of the entity and creating incremental value for its shareholders.

3. Unwind

Financial buyers that are unable to grow their earnings may become unglued

The challenge financial buyers face in any professional services business is that at some point the supply of willing sellers will be exhausted. The buyers will no longer be able to increase their earnings by issuing stock and may then enter into the "Unwind" stage. The Unwind stage is so named because the inability to grow earnings through acquisitions is problematic for financial buyers and could potentially cause these organizations to become unglued. To understand why, it is important to consider the incentives of the successor generation of management of those firms that have sold cash flow to the financial buyer.

When an advisory firm is sold, the buyers are not really purchasing tangible assets such as equipment, inventory or infrastructure. Instead they are acquiring the services of the organization's key employees, without whom the firm will have neither clients nor revenue. Financial buyers recognize this reality and protect the cash flow that they purchase by requiring that the sellers remain at their firms for a minimum of three to five years in order to receive all of their consideration.

At the end of this time period, however, the entity that sold the cash flow and the buyer of it face a problem. The owners of the selling entity have typically cashed out and have little incentive to remain at the organization. At the same time, the structure of the transaction has significantly reduced the size of the future economics available to the initial owners' successors. These individuals recognize that the financial buyer will continue to receive cash flow from the company only if they elect to continue to work at their firm — an unattractive option at many advisory firms given the changed economics of the enterprise.

Financial buyers face two choices at the end of the term of a transaction

Financial buyer transactions change the incentives in the companies that they acquire

Consequently, financial buyers then must choose between one of two alternatives. First, they can try to recruit new management to the firm who will work for less potential remuneration than the original owners' successors would be willing to accept. Financial buyers try to facilitate this option by limiting the amount of cash flow they purchase from an entity to only one-half to two-thirds of its Saleable Cash Flow. Their hope is that the remaining cash flow creates a sufficient economic opportunity so that qualified professionals will continue their career at the selling enterprise.

Despite this safeguard, however, recruiting top quality management to organizations that have sold cash flow is challenging because the remaining economic pie is so much smaller. This is particularly true with advisory businesses because most industry participants simply do not generate a large absolute amount of Saleable Cash Flow.

Should a financial buyer renegotiate a single transaction, it may be forced to renegotiate all of its other transactions

For example, if a firm was generating ten or twenty million dollars of cash flow each year and sold half of that to an acquirer, the remaining cash flow in the company might be sufficient to induce many key employees to remain at their firms or to attract qualified replacements. In contrast, most advisory businesses earn less than one million dollars of Saleable Cash Flow. Stripping half of that value from the enterprise would not leave a sufficient economic opportunity to attract the type of personnel necessary to successfully operate a large advisory business and retain its clients.

The second choice that financial buyers have is to renegotiate the economics of the entity with the successor management of these companies. This choice is exceptionally unattractive to financial buyers for three reasons. First, the negotiations are almost certain to result in a significant reduction in the earnings per share that the financial buyer generates from their ownership stake in this advisory firm.

Second, financial buyers have ownership stakes in multiple entities. Once they have renegotiated the economics with one entity, successor generations at other firms in which they have purchased cash flow will likely demand similar concessions. The resulting stampede to renegotiate would be catastrophic to the earnings of the financial buyer.

Third, if it becomes more apparent that the financial buyer's economics are changing adversely, its stock price would crater. This could prove to be the undoing of the financial buyer because its core business is arbitraging the differential between public and private market multiples. Should its stock price collapse, the arbitrage would no longer exist.

Financial buyers must continually do more and more deals

Financial buyers try to mitigate their exposure to the risk of renegotiation with the successor management of entities from which they have purchased cash flow by continually completing new deals. As more and more firms are acquired, each firm itself becomes less material to the overall enterprise.

At some point financial buyers will run out of potential sellers

With this new found scale, the financial buyer has the option of simply letting an entity collapse. While this would not be an ideal outcome for a financial buyer, its ability to weather the loss of cash flow in such an event places the successor management of the entity at a distinct disadvantage.

At the point that the financial buyer has exhausted all potential sellers, however, the financial buyer no longer has the ability to replace lost cash flow through further transactions. And without this option, the financial buyer is at the mercy of the successor management of the organizations from which it has purchased cash flow. In the direst instances, it has no ability to replace its lost earnings and largely owns a diminishing asset.

Financial buyers face the same problem as sharks: they cannot sit still

In one sense, financial buyers face the same problem as sharks. Sharks lack arms or wings to force water over their gills necessary for them to breathe and thus must instead continually keep moving or they will asphyxiate. Similarly, financial buyers can never sit still. They must continually complete new transactions, purchasing cash flow from additional entities so that their earnings will grow and their stock price will remain robust.

Hence, once the supply of potential sellers has been exhausted, a financial buyer typically unwinds, selling off at a discount its few remaining assets that have any value; most of the underlying entities that sold cash flow to the financial buyer no longer exist.

Sellers must understand a buyer's evolution

It is essential that an advisory firm considering a financial buyer transaction understand the point at which the buyer is in its evolution because a large portion of the consideration is often paid in the buyer's stock in these types of transactions. The seller is effectively investing in the financial buyer and the performance of the buyer's stock will be a key determinant of what value the seller ultimately receives for its cash flow.

Financial buyers capture most of the economics of transactions

In addition to understanding at what phase the financial buyer is at in its lifecycle, there are several factors that potential sellers should consider when evaluating this type of transaction.

First, financial buyers capture a disproportionate amount of the economics from these deals. The buyer creates the economic equivalent of a cooperative made up of advisory firms and then sells stock in the resulting entity to the public. In exchange for helping to form the cooperative, the financial buyer (and its backers) at current pricing receives 55% to 70% of the enterprise's economics.

Financial buyers currently receive 55% to 70% of the economics

Second, financial buyers add no value to the enterprises that they acquire. They simply provide owners with a measure of liquidity. The selling entity does not increase its ability to capture new clients or operate more efficiently. In fact, a main selling point of the financial buyer is that it does not change the purchased entity at all.

This lack of added value by financial buyers to the enterprises that they acquire is particularly problematic given that the economics of operating an advisory business will not likely remain static over the coming years. At the point that an advisory business will need to reinvest significantly to evolve its operating structure and fuel its growth (in an environment of much higher operating costs), it will not have the resources to do so. Instead, the owners will have sold off 50% to 60% of the organization's Saleable Cash Flow to an acquirer and the entity over time will be less able to compete in a more challenging operating environment.

Financial buyers can only achieve critical mass if they complete 75 to 100 transactions

Sellers bear most of the risk

The third and most important aspect of financial buyer transactions is that they require that the seller retain almost all of the many risks involved. Financial buyers are able to shift the risk to sellers through the structure of the transaction and the use of the buyer's currency to pay for cash flow.

1. Completion risk

For example, financial buyers which are in the Pre-Critical Mass stage of their development often require that advisory businesses accept stock in the buyer's entity for a significant portion of the consideration for the seller's cash flow. This use of stock places on the seller the risk that the buyer never achieves critical mass, leaving the sellers with a private equity holding of indeterminate value and even less certain liquidity.

This risk of never reaching critical mass becomes more apparent when you consider the volume of transactions a financial buyer would have to consummate in order to achieve critical mass. Although this level will vary over time and with markets, our research suggests that it would likely need, at a minimum, $25 million to $30 million of cash flow to be able to complete a successful public offering. Given that most large advisory businesses currently have much less than $1 million of Saleable Cash Flow and financial buyers will want to purchase at most one half to two thirds of it, *a financial buyer would need to complete between 75 and 100 transactions before it would achieve critical mass!*

2. Market and business risk

Another less obvious but key facet of most financial buyer transactions is that they are structured so that the business and market risk of the seller's enterprise are largely borne by the seller. Financial buyers ensure this outcome by demanding that whatever cash flow they purchase from sellers be given a senior position in the enterprise's overall cash flow.

Financial buyer transactions require that sellers bear most of the market and business risk

In other words, if a financial buyer acquires $500,000 of cash flow from an entity than has $1 million of Saleable Cash Flow, the buyer will be entitled to the first $500,000 of Saleable Cash Flow generated by the firm every year going forward. Should the financial markets decline significantly and lower the seller's revenues so that its Saleable Cash Flow declines to only $600,000, the financial buyer would still receive $500,000 and the seller would be left with the remaining $100,000.

The only point at which the financial buyer does not receive at least $500,000 of cash flow each year is when the seller receives no cash flow. Some transaction structures even have a cumulative provision meaning that, should the business' condition and earnings improve, the financial buyer will first be made whole for any previous years' shortfall before the seller receives any of the firm's future profitability.

On the other hand, financial buyer transactions are also typically structured so that should the enterprise become much more profitable, the financial buyer's ownership of cash flow as a percentage of total Saleable Cash Flow remains constant. Thus, if the seller's Saleable Cash Flow jumps to $2 million the buyer would still be entitled to half of that amount or $1 million.

Over time, financial buyers have an incentive to be less discriminating in their acquisitions

This negatively convexed (for the seller) type of structure means that should the business run into any difficulties or the markets take a nosedive, it will come at the seller's expense. In fact, the buyer will feel no effects of these changes until the seller's portion of the company's Saleable Cash Flow is zero.

3. Reputational risk

Sellers in financial buyer transactions also bear a reputational risk as it pertains to every firm that a financial buyer has already purchased or will purchase over the next few years. The source of this risk is that sellers are paid at least a portion of their consideration in the stock of the financial buyer's company. Until the seller is able to unload these shares, it is effectively an owner of part of every entity in the enterprise.

In a highly regulated business such as the advisory industry, a handful of rogue entities could irreparably harm the reputation and economics of a financial buyer. Such a negative exposure was demonstrated recently when it was disclosed that a regulator had inquired about the compensation structure used for insurance products sold by an entity that had sold cash flow to a financial buyer. This caused an immediate 15% to 20% temporary drop in the buyer's stock price.

Further, a seller's risk from owning equity in a financial buyer that has purchased cash flow from less than ideal underlying entities only increases over time. As we discussed earlier, financial buyers have an overwhelming interest in continually doing more transactions with more entities. During the latter parts of the Print Currency stage of their evolution, many financial buyers may be tempted to become less discriminating in their purchases, leaving sellers with stock in a financial buyer that is deteriorating in quality.

Factors combine to lower risk-adjusted value

Combined, these techniques for shifting risk to the seller mean that while a financial buyer may offer a potentially higher absolute amount of money for an advisory firm than a legacy buyer, it is unclear whether such transactions are more attractive on a risk-adjusted basis. What is clear, however, is that at current pricing levels, financial buyers generate spectacular returns for their backers. Exhibits 4.4 to 4.10 are hypothetical examples of a financial buyer transaction that demonstrates just how exceptional these returns often are.

In this example, a financial buyer — Bob's Roll-Up (BRU) — is purchasing cash flow from Dave's Advisory Services (DAS). DAS currently generates $1 million of Saleable Cash Flow per year and its earnings are growing by about 10% per year. As part of the transaction with BRU, DAS sells 60% of its Saleable Cash Flow for $900,000 in cash and $2.1 million of stock.

BRU has not yet, however, completed a public offering, so DAS is given stock in a private company. As is common in financial buyer transactions, the stock is subject to several restrictions even after the financial buyer has completed its public offering. These restrictions include a complete prohibition on any sales for a minimum of three years after the completion of the transaction, a minimum lock-up of 18 months after completion of the IPO and a requirement that any sales be made as part of company-wide secondary offerings for an additional twelve months. Consequently, the seller will not achieve liquidity on the shares it receives from the financial buyer for a minimum period of three years and potentially up to five and a half years.

The buyer can pay with stock worth eight times cash flow because it is able to resell it to the market at a multiple of 14

The good news is that because it accepted stock for a portion of the consideration before BRU went public, DAS has the potential to benefit from the appreciation that often accompanies an IPO. In this example, we have assumed that had DAS been paid entirely with stock, and was able to sell it five years after the transaction was consummated, it would have a value equal to eight times the amount of cash flow sold. Since DAS is selling $600,000 of cash flow, this means that the stock it received would be worth $4.8 million. But because DAS is receiving both cash and stock and only 70% of the consideration is in stock, the shares paid to DAS would be worth 5.6 times the amount of cash flow sold to the financial buyer.

This example also assumes that BRU is able to pay DAS with stock that is effectively worth eight times cash flow because it is able to monetize the cash flow it owns in the public markets at a multiple of 14. And the difference between what BRU pays DAS and what it receives from the markets is a large source of the value that it creates for its shareholders.

As shown below, over the next five years DAS' owners will receive about $6.9 million in payments. This number includes the cash paid at closing, the value of the stock when sold and $2.7 million of retained Saleable Cash Flow.

Exhibit 4.4 Cash Flows to the Owners of Dave's Advisory Services*

	@ Closing	Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Retained EBIT	—	$ 440,000	$ 484,000	$ 532,400	$ 585,640	$ 644,204	
Cash Consideration	$ 900,000	—	—	—	—	—	
Stock	—	—	—	—	—	$ 3,360,000	
Total Payments	$ 900,000	$ 440,000	$ 484,000	$ 532,400	$ 585,640	$ 4,004,204	$ 6,946,244

*Exhibits 4.4 to 4.10 are hypothetical examples and are shown for illustrative purposes only.

Let's look at your IRR (and not mine)

A common negotiating tactic used by financial buyers to make their transactions appear to be more compelling to sellers is to calculate the seller's effective internal rate of return (IRR) on the cash flow sold to the buyer. And as shown below in Exhibit 4.5, the internal rate of return in this transaction is an impressive 42.9% and in one sense appears to offer a great return for "investing" one's cash flow.

Exhibit 4.5 Internal Rate of Return on Cash Flow Sold by Dave's Advisory Services*

	@ Closing	Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Cash Consideration	$ 900,000	—	—	—	—	—	
Cash Flow Sold	—	$ 660,000	$ 726,000	$ 798,600	$ 878,460	$ 966,306	
Stock Value	—	—	—	—	—	$ 3,360,000	
Total Economics	$ 900,000	$ (660,000)	$ (726,000)	$ (798,600)	$ (878,460)	$ 2,393,694	$ 230,634

IRR	42.9%

The problem with this type of analysis is that it ignores a few important factors. First, it ignores the high return that the financial buyer is receiving on its capital. As shown below in Exhibit 4.6, BRU receives an *internal rate of return of almost 109% per year*!

Exhibit 4.6 BRU's Internal Rate of Return on Cash Flow Bought*

	@ Closing	Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Cashflow Purchased	—	$ 660,000	$ 726,000	$ 798,600	$ 878,460	$ 966,306	
Consideration Paid	$ 900,000	—	—	—	—	$ 3,360,000	
Terminal Value of Cash Flow Purchased @ 14X	—	—	—	—	—	$ 13,528,284	
Net Value to Buyer	$ (900,000)	$ 660,000	$ 726,000	$ 798,600	$ 878,460	$ 11,134,590	$ 13,297,650

IRR	109%

Second, nearly two-thirds of the absolute dollars involved in the transaction inure to the benefit of the buyer. As shown in Exhibits 4.4 and 4.6, the two parties combined receive $20.25 million from the transaction. The seller will receive just under $7 million. The buyer, in contrast, captures almost $13.3 million or more than 65% of the total absolute value.

Third and as shown in Exhibit 4.5, after netting out the cash flow paid to the buyer, the seller receives only $230,634 more on an absolute basis than if it simply kept all of its cash flow and had not entered into the transaction.

*Exhibits 4.4 to 4.10 are hypothetical examples and are shown for illustrative purposes only.

The buyer's senior position in cash flow provides a structural cushion should an acquisition perform poorly

Buyers get most of the economics and almost none of the risk

As unattractive as the division of this transaction's economics might first appear, it should be even less compelling to a potential seller after factoring in the risk it must bear. Exhibit 4.7 shows how this type of transaction structure shifts most of the transaction's risk to the seller. In this example, we have now assumed that DAS' profitability drops precipitously over the next five years, falling ten percent per year. And by the end of the transaction, DAS is generating less than 60% as much Saleable Cash Flow as it was at the time of the transaction. And the payments to DAS total only $4.9 million.

Exhibit 4.7 Cash Flows to the Owners of Dave's Advisory Services — Down Scenario*

	@ Closing	Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Retained EBIT	—	$ 300,000	$ 210,000	$ 129,000	$ 56,000	—	
Cash Consideration	$ 900,000	—	—	—	—	—	
Stock	—	—	—	—	—	$ 3,360,000	
Total Payments	$ 900,000	$ 300,000	$ 210,000	$ 129,000	$ 56,000	$ 3,360,000	$ 4,955,000

The buyer's outcomes are likewise less favorable. But since it owns a senior position in the Saleable Cash Flow of DAS, it continues to receive a full $600,000 per year in every year but the last one. Additionally, because 70% of the purchase price was paid in stock using a multiple of cash flow that is significantly lower than what BRU achieves in the public markets, it has a structural cushion in the event that one of its acquisitions performs poorly.

Exhibit 4.8 BRU's Internal Rate of Return on Cash Flow Bought — Down Scenario*

	@ Closing	Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Cashflow Purchased	—	$ 600,000	$ 600,000	$ 600,000	$ 600,000	$ 590,490	
Consideration Paid	$ 900,000	—	—	—	—	$ 3,360,000	
Terminal Value of Cash Flow Purchased @ 14X	—	—	—	—	—	$ 8,266,860	
Net Value to Buyer	$ (900,000)	$ 600,000	$ 600,000	$ 600,000	$ 600,000	$ 5,497,350	$ 6,997,350

IRR	85%

As a result, BRU still achieves an astronomical internal rate of return of 85%. From an absolute dollars perspective, it captures almost $7 million or about 59% of the $11.95 million generated by the transaction.

*Exhibits 4.4 to 4.10 are hypothetical examples and are shown for illustrative purposes only.

To get another measure of how little risk the financial buyer takes in these transactions, consider our early example of BRU purchasing 60% of DAS' Saleable Cash Flow. Instead this time we will assume that the entire transaction will be done in stock. Additionally, DAS suffers a 50% drop in profitability in its first year and it declines an additional 10% per year. As shown in Exhibit 4.9, DAS receives $4.8 million in stock from the transaction. Because of its reduced profitability and BRU's senior claim on its Saleable Cash Flow, the stock it is paid is the only consideration that it receives from the transaction.

Exhibit 4.9 Cash Flows to the Owners of Dave's Advisory Services — Stock Only Transaction*

	@ Closing	Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Retained EBIT	—	—	—	—	—	—	
Cash Consideration	—	—	—	—	—	—	
Stock	—	—	—	—	—	$ 4,800,000	
Total Payments	—	—	—	—	—	$ 4,800,000	$ 4,800,000

Clearly a financial buyer would hope to avoid such an outcome from any transaction. However, as shown in Exhibit 4.10, BRU still generates an infinite return from the transaction. Why? BRU did not risk any capital to buy the cash flow. So long as the net inflows from the transaction exceed the stock given to DAS, the buyer receives an infinite return on its capital.

Exhibit 4.10 BRU's Internal Rate of Return on Cash Flow Bought — Stock Only Transaction*

	@ Closing	Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Cashflow Purchased	—	$ 500,000	$ 450,000	$ 405,000	$ 364,500	$ 328,050	
Consideration Paid	—	—	—	—	—	—	
Terminal Value of Cash Flow Purchased @ 14X	—	—	—	—	—	$ 4,592,700	
Net Value to Buyer	—	$ 500,000	$ 450,000	$ 405,000	$ 364,500	$ 4,920,750	$ 6,640,250

IRR	= ∞

Financial buyers keep most of the absolute dollars, take little risk and generate high returns on capital

With outcomes like these, it is no wonder why so many organizations currently want to be financial buyers of advisory firms. They are able to keep most of the absolute dollars generated from the transactions, take almost no risk and thus, generate extremely high returns on their capital.

*Exhibits 4.4 to 4.10 are hypothetical examples and are shown for illustrative purposes only.

Financial buyers understand the advisory business owner's predicament

Financial buyers view the culture of advisory firms as an opportunity from which they can profit

Financial buyers are optimistic that they can complete many such transactions because they understand the predicament that many financial advisory business owners now face. They recognize that there are few (if any) other acquirers for many advisory firms and that a legacy transaction would not generate a great deal of consideration for the seller. Financial buyers also understand the pressure that demographics create for the owners of advisory firms who are considering a transition.

The buyers also view the culture of industry participants and their commitment to their clients above all else as an anomaly from which they can benefit. Business owners who are not focused solely on making money for themselves are compelling counterparts for any savvy negotiator.

Finally, financial buyers have observed the almost fanatical abhorrence to working for a bureaucratic organization that many advisory business owners share and hope to profit from their aversion. The buyers know that a transaction that includes a promise to leave the seller's business alone can be a very seductive proposition to these owners.

Negotiating tactics reflect an understanding of advisory firm owners

Financial buyers try to anchor sellers on absolute level of consideration to distract them from the true economics of the transaction

The depth of many financial buyers' understanding of the perspective and predicament faced by advisory firm owners is reflected in their negotiating tactics. They typically try to focus most of their discussions with advisory firms on non-economic issues, emphasizing their understanding of an advisor's duties to its clients and their respect for the firm's culture.

Once the discussions inevitably shift to the economics of a potential transaction, financial buyers will often rely on three negotiating tactics. First, they will try to get potential sellers to focus solely on the absolute level of consideration that they might receive should a transaction go well. The buyer's goal is to anchor the seller's expectation on a high enough price so that even if the transaction fails to meet all of its goals, the seller still believes that it would receive adequate compensation for its cash flow. As part of this tactic, newer financial buyers will often emphasize the robust stock price of the handful of some publicly traded roll-up entities and the potentially high return available to the seller from accepting stock for Saleable Cash Flow.

Financial buyer transactions do not add value to the selling entity

A second negotiating tactic is to appeal to the advisor's self image by emphasizing a truism — that the sellers did not get into the financial advisory business in order to get rich but instead to help people. And that the type of transaction that the buyer is offering, while providing "fair" consideration, would not be appropriate for an individual whose "sole obsession in life" is getting rich.

Competition has forced financial buyers in the money management business to pay much higher prices

Finally, another negotiating tactic employed by financial buyers is to argue that the importance of "providing clarity to the market," combined with their personal commitment to "treating everyone the same in order to be fair," would make it unreasonable for the buyer to ask for a non-standard transaction with potentially higher consideration. Buyers use these tactics to avoid having to make concessions to one seller that might have to be replicated in the future to other organizations, regardless of the unique attributes or economics of the seller.

Each dollar for you is one less for me

The overall objective of these negotiating tactics is to avoid discussing the fundamental reality of all financial buyer transactions: every dollar paid to a seller in these transactions is one less dollar for the buyer. Since the buyer adds no value, the potential economics are limited to the seller's future profitability and the price at which the buyer can monetize its cash flow in the public markets — a finite pool of money to be divided between the buyer and seller.

All of this said, selling to a financial buyer will often be the best option for the owners of many advisory businesses. Their organizations, while profitable, are still relatively small and do not generate a high enough level of Saleable Cash Flow to attract a strategic acquirer.

It is also important to emphasize that the examples of financial buyer transactions provided earlier are based solely on current pricing levels. As the market for advisory firms evolves and becomes more competitive, these prices will become much more favorable to sellers.

For example, in the money management industry such competition for firms emerged at one point, leading to transactions where financial buyers were willing to pay amounts equal to ten times the Saleable Cash Flow purchased from industry participants. And the entire consideration was paid up front and in cash.

Contrary to their claims, financial buyers can and will negotiate

Financial buyers can pay much more for cash flow and still generate exceptional returns

Sellers should also recognize that even today financial buyers can and will negotiate. Their primary business is arbitraging the difference between private and public market multiples for cash flow — something they can only do if they consummate transactions. Given the current starting point for negotiating these kinds of transactions, financial buyers can pay much more for cash flow and still generate exceptional returns for their investors.

Finally and as we outlined earlier, financial buyers need to continually complete more transactions. This addiction provides potential sellers with great bargaining power — provided that they are patient and are not seduced by the buyer's rhetoric. As more financial buyer entities continue to emerge, the resulting feeding frenzy will only increase the price that potential sellers will receive for their firms.

Strategic acquirers

Strategic acquirers almost always pay the highest consideration

Some of the industry's largest participants, however, will have a third option — a sale to a strategic acquirer. Potential strategic acquirers include banks, insurance companies and custodians.

There are many reasons why selling to a strategic acquirer could be compelling. These types of transactions almost always pay the highest risk-adjusted amount of consideration.

Strategic acquirers are able to pay higher prices because they add value in two ways to the enterprises that they purchase. One way is by developing internal client referral networks that refer potential clients to their advisory firm acquisitions and, in turn, help them grow faster. These buyers typically have several other businesses that involve relationships with individuals who would be ideal prospective clients for an advisory firm.

Strategic Acquisition

Merits

1. Highest risk-adjusted consideration
2. Added value to selling enterprise
3. Improved long-term viability of seller

Drawbacks

1. Management of buyer may change
2. Integration between buyer and seller is complex
3. Flexibility is essential for success

Strategic acquirers also add value by providing the infrastructure necessary to allow an advisory firm to be capable of sustaining a high growth strategy. These types of buyers have the scale that allows them to use specialists for every administrative and support function. An advisory firm that sells to a strategic acquirer would be able to shift much of their non-revenue generating functions (such as compliance, HR, accounting) to its purchaser, focus all of its energies on growing the business and effectively evolve the firm into a professional enterprise.

Success in a strategic acquisition is tied to the relationship between the seller and the acquirer's management

By adding value to the advisory firms that they purchase, strategic acquirers also help ensure the long-term viability of the acquired organization. While the firm may have a different name on the door, it will more likely survive the coming changes to the economics of the industry and retain its clients and employees.

Drawbacks to strategic transactions

There are, however, several drawbacks to strategic transactions. The management of a strategic buyer will most likely change over time, potentially leading the organization to de-emphasize the importance of the wealth management business. And the relationship between the seller and the new management of the acquirer might not mesh as well as with their predecessors.

The potential drawback is that not all strategic transactions acquirers are successful at adding value to the firms that they buy. Many purchasers do not understand either the culture or the many nuances of the business of giving non-conflicted advice.

Strategic acquirer transactions must be flexible and carefully crafted

Third, the relationship between an acquirer and the management of an entity that it purchased — like any other relationship — will not remain static over time. Unless both parties are committed to building a successful business, this relationship could quickly sour. And because (as we will outline further below) a significant portion of the consideration paid as part of a strategic transaction is often tied to the long-term success of the sold entity, any breakdown in the relationship between a seller and a strategic acquirer could have adverse consequences for the owners.

Thus, success in a strategic transaction requires a carefully crafted structure that both protects the seller (through a combination of operating and employment agreements) but is also flexible enough to adapt as conditions change over time. Ideally, both the seller's and buyer's interests are in alignment and both parties share significantly in any future success.

Strategic transactions are rare and complicated

Sales to a strategic buyer, however, are both rare and complicated. To date, very few have been completed and many potential acquirers have yet to enter the market.

Exhibit 4.11 Examples of Advisory Firms Bought by Strategic Acquirers Since 2000

Company	Parent Company	AUM at Acquisition ($M)	Acquisition Date
Hallmark Capital Management, Inc	Valley National Bank	$ 195	2000
Creative Financial Group Ltd.	Synovus Financial	$ 940	2001
Haberer Registered Investment Advisor	Huntington Bancshares Inc	$ 500	2002
Sullivan, Bruyette, Speros & Blayney, Inc	BMO Financial Group	$ 800	2003
Tanager Financial Services, Inc	Wachovia Corporation	$ 2000	2004
Miller/Russell & Associates, Inc	Alliance Bank of Arizona	$ 700	2004
Stavis Margolis Advisory Services, Inc	Compass Bancshares	$ 500	2005

Source: Bloomberg; Public Filings; JPMorgan

Strategic acquirers view buying an advisory business differently than legacy or financial buyers

Far more strategic transactions are also attempted than are completed because a strategic acquirer takes a very different view to buying an advisory business than does a legacy or financial buyer. For example, management's perspectives are only marginally based on their personal economics. As we discussed earlier, every dollar that either a financial or legacy buyer pays a seller is one less dollar that they personally get to keep. The management of strategic acquirers, in contrast, is spending their shareholders' money.

Of course, management will closely evaluate any transaction, comparing it to other similar ones as well as the organization's expected return on its capital. But unlike financial and legacy buyers, the management team of the strategic acquirer is not effectively negotiating its own compensation when buying an advisory business.

Further, strategic acquirers by definition add significant value to their acquisitions. Thus, the overall potential economics from a transaction are much greater than with financial or legacy buyers. And the resulting larger economic pie allows the buyers to pay much more and still generate very attractive returns for their shareholders.

Finally, another key part of the perspective of strategic acquirers is that the potential dollars involved in purchasing advisory firms are relatively small when compared to the market capitalization of the acquirers. Consequently, while they want to pay a fair price for any acquisition, it is for them a far less traumatic outcome than for legacy or financial buyers if they subsequently discover that the seller would have been willing to take a lower price.

Policy issues and not economics often kill potential strategic transactions

Management of strategic acquirers must operate within the confines of their culture and policies

A second difference between the perspectives of strategic buyers and those of financial and legacy buyers is that while the strategic buyer will often have greater latitude in what it may pay for an advisory business, the management team of the acquirer must operate within the confines of its own existing culture and policies. Large companies operate through broad policies and procedures and are reluctant to disrupt them (especially for an immaterial acquisition). Thus, many potential strategic transactions fail to reach completion because the buyer and seller are unable to reach agreement on non-economic issues.

One such example that nearly killed a recent transaction in another industry was that the owner of the selling enterprise was unwilling to limit himself to the acquirers' corporate per diem rate whenever he traveled on business. Although the transaction involved many millions of dollars, the owner believed, on principle, that it was ridiculous that he be subjected to the same expense limitations as the junior employees of the acquirer. The owner's reluctance to agree to this term almost blocked the transaction because the acquirer's management was reluctant to endure the lengthy and arduous process that their organization required for exceptions to any operating policy.

Sellers must understand which issues acquirers have the flexibility to alter, and which they do not

Other strategic transactions (also in other industries) have also almost failed because of the reluctance of the seller to add the acquirer's name to their business. Such a disagreement is often extremely problematic for the acquirer because many organizations' boards have set blanket policies that its name becomes part of any acquisition. Unless a potential acquisition is so important to the acquirer that the board would be willing to waive this requirement, a transaction could not occur.

And these are just a couple of the numerous non-economic obstacles that arise as part of almost every strategic transaction. The failure of the seller to understand which issues the acquirer's management has the flexibility to alter and those that could potentially block a transaction, is a key reason why strategic acquisitions are rarely consummated.

Strategic acquirers have different goals when acquiring advisory businesses

A third difference in a strategic acquisition is motivation. Unlike their financial or legacy counterparts whose primary goal is to buy firms at as low a price as possible, the key catalyst for strategic acquirers is meeting a strategic goal set by their boards. The leadership of their organizations decided that it is essential to their long-term success that they have large, highly profitable wealth management businesses. The management then typically tried to build its own advisory unit and failed. The only remaining option for the company is to buy its way into the business.

The biggest challenge strategic acquirers face when embarking on an acquisition strategy in the financial advisory business is that there are few firms that are material to the buyers. The term "material" refers to the ability of a potential acquisition to significantly impact the acquirer's profitability. Since even most of the largest financial advisory firms generate less than $3 million of Saleable Cash Flow per year and typical strategic acquirers currently earn $100 million or more, no single advisory business is viewed as material.

This lack of materiality is a major problem for strategic acquirers for a couple of reasons. First, the disruption to the organization from a small transaction is almost as great as that from a large one. All acquisitions, regardless of size, deflect the acquirer's attention from other activities and require a great deal of time of its key employees.

Few, if any, advisory businesses are material to a strategic acquirer

Second, few individuals at strategic acquirers are willing to advocate a transaction if the target is not material in size. From their perspective, they incur as much risk to their careers from small transactions as they do from large ones because they must risk their reputations with the same key decision makers (i.e., senior management and board members) in order to consummate them. At the same time, the potential benefits to companies (and resulting credit for their advocates) from non-material acquisitions are much smaller than those with larger acquisitions. Thus, the decision to acquire a non-material company such as a small advisory business has an unattractive personal risk-return profile.

Management of potential strategic acquirers do not have the luxury of not doing deals

The management teams at potential strategic acquirers, however, do not have the luxury of not doing acquisitions if they cannot find any material targets. Because the organization's leadership has decided that success in the wealth management business is a critical corporate objective and has charged management with achieving it, these individuals risk being viewed as failures if they decide not to consummate any acquisitions. Thus, while there are only a handful of advisory businesses that a strategic buyer might view as material, it is likely that several of the largest firms will have an opportunity to participate in such a transaction.

Types of firms that strategic acquirers will want to buy

In addition to overall size and profitability there are five factors that will likely be key determinants as to which advisory businesses will be the most attractive to acquirers:

1. Location

First and foremost of these factors is location. Since high quality financial advice is of a very personal nature and typically best delivered by organizations proximate to the client, strategic acquirers will look for acquisitions that are located where they already operate businesses. Acquiring advisory firms in these locations will facilitate both the larger organization's ability to refer new clients and its ability to unburden its acquisition of many of its non-revenue generating functions.

2. Relative size within a market

Since most advisory firms are not large enough to be material to a strategic acquirer — that is, no firms generate sufficient Saleable Free Cash Flow to materially impact the acquirer's income statement — it typically will seek to purchase one of the two largest firms within a target market. By doing so it hopes to benefit from the organization's brand and existing referral networks in addition to any additional clients that it might be able to generate from its other businesses.

However, even being the largest firm within a particular market may be insufficient to draw interest from a potential acquirer. Size within a market for many acquirers is effectively used as a proxy for having a strong operating business. Should a firm be completely dependent upon on its owner or if it generates only a de minimus amount (less than $500,000) of Saleable Free Cash Flow, many potential strategic acquirers will be reluctant to acquire it.

3. Quality of client base

Strategic acquirers want to buy only firms with certain attributes

Strategic buyers look for advisory businesses that generate high profitability per client and that are able to capture clients of the type that it believes it will be able to refer to the organization.

They likewise will scrutinize how dependent a firm's revenues are on a small percentage of its clients. Like any other investor, strategic acquirers seek diversified portfolios and they thus, want the seller to have a diversified portfolio of client relationships. Many advisory businesses generate significant revenue, but the loss of only five or six percent of their clients would reduce it by as much as forty percent. Such organizations are viewed as too risky for most strategic acquirers because of their reliance on such a small number of relationships.

Above all else, strategic acquirers want to buy strong operating businesses

4. Owners' motivations to sell

Strategic buyers recognize the important roles owners play in advisory businesses. They are only interested in buying firms whose owners are truly motivated to build a much larger and prosperous enterprise. And they look for sellers who have the energy and drive necessary to help the resulting enterprise reach its full potential.

Consequently, many strategic acquirers will be reluctant to acquire firms with owners who are already in their 60s. The advanced age of the seller can sometimes create a perceived risk that he or she may be more motivated to do a transaction to simply cash out rather than build a much bigger enterprise.

5. Business maturity

While strategic buyers are not necessarily seeking organizations that have reached the professional enterprise phase, they are reluctant to purchase businesses that are too owner-centric. Instead strategic buyers seek firms that have multiple professional employees and, at least to some degree, have institutionalized their client relationships.

Consequently, strategic buyers will also insist that owners share a significant portion of the consideration paid for a firm with the company's key employees over a long period of time. The buyers are understandably concerned that the owner will cash out and the remainder of the employees will have little interest in building and running the business. By broadening the participation in the success of the resulting enterprise, a strategic acquirer can better align all parties' interests and increase the likelihood of long-term success.

Strategic acquirers want to buy strong operating businesses

Strategic acquirers will insist that a significant portion of the consideration be shared with key employees

These last two factors are particularly important because, above all else, the management of strategic acquirers is looking to buy strong operating businesses when considering acquisition targets. Consider the predicament these individuals find themselves in. They have been forced into taking personal reputational risk by having to advocate an acquisition that is not material to their organization. They also know that the success or failure of the acquisition will create varying, non-linear outcomes for their careers.

Management of strategic acquirers effectively bet their careers with each acquisition

Should the acquisition be a great success, the team involved will receive some credit. However, it will take a fairly long while before the organization can be assured that an acquisition was successful. At the same time, should an acquisition be a disaster (particularly within a year or two of consummation of a transaction) they know that its failure could end their careers at the organization. Consequently, strategic acquirers (and the individuals at those organizations responsible for completing acquisitions) are obsessed with the viability of a potential acquisition. More than anything else, the management team does not want to be embarrassed.

This focus on buying only strong operating businesses and the current landscape of the advisory business in many geographic regions are also key reasons why strategic acquirers will likely be interested in acquiring only one of the two largest firms in a particular market. The advisory business is very fragmented in general and even among the large industry participants there are usually only one or two firms within a local market that are relatively profitable and mature enterprises. The remaining competitors are typically much less (and many cases only marginally) profitable companies and far more dependent upon one or two individuals for their continued existence. Thus, while a strategic acquirer is often willing to consider buying an advisory firm that would not be material to its profitability, there are often only a couple of firms in each local market that are sound enough entities for which the acquirer's management would be willing to risk their careers.

Myth that strategic acquirers want to run their acquisitions' businesses

The overwhelming desire of strategic acquirers to only buy strong operating businesses also means that these buyers have little interest in running them. Instead of trying to interfere with the day to day operations of their acquisitions, smart strategic acquirers carefully craft their transaction structures so as to align their interests with the current management of the advisory firm.

Strategic acquirers do not want to run the day to day operations of their acquisitions

Additionally, most strategic acquirers have already tried to build their own wealth management units and failed. And they recognize that without the enthusiastic involvement of an acquisition's management they will fail again. Ironically, this dependence by strategic acquirers on the management of the companies that they purchase means that the seller's power in the relationship actually *increases* in many ways after a transaction.

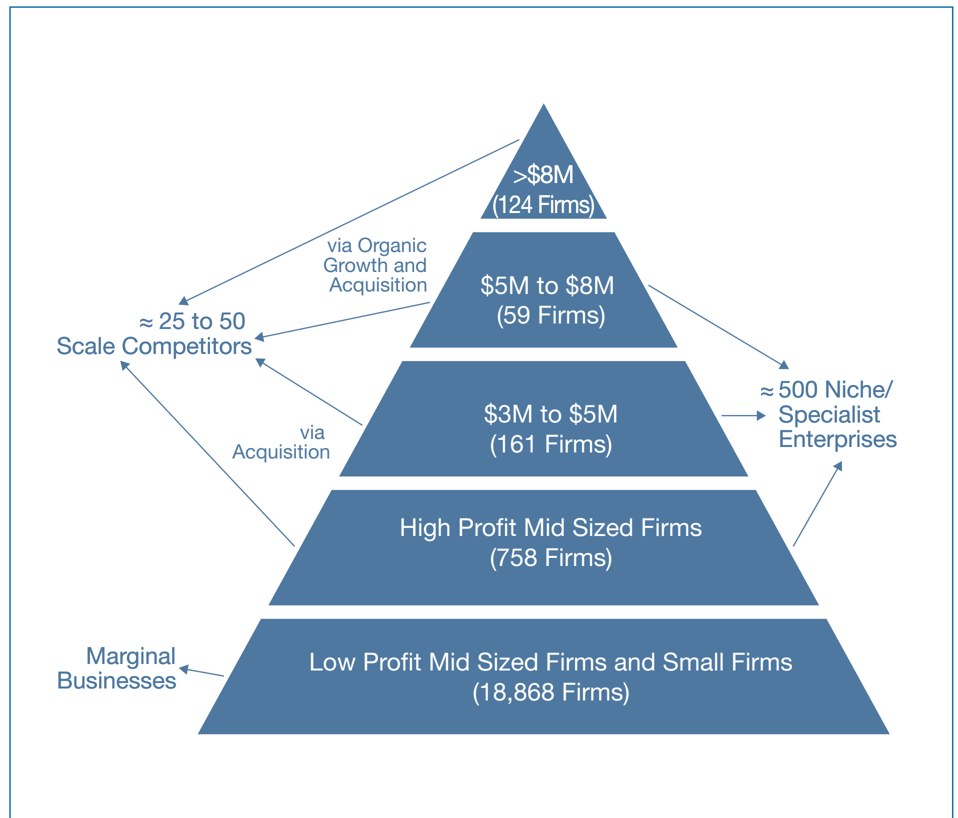
Most strategic acquirers will only become involved in the day-to-day operations of an acquisition if things are going very badly. From the perspective of the acquirer it is a disaster and they are at this point simply trying to salvage some of their investment.

Potentially 150 to 200 strategic acquisition targets nationally

Strategic acquirers want to buy the largest firms

Applying these factors (in particular geographic ones) when surveying the current competitive landscape of the advisory industry as part of our research, it suggests that there may be as many as many as 150 to 200 advisory firms (of the 1,100 or so large and high profit mid-sized advisory businesses) that could consummate a transaction with a strategic acquirer over the next five to seven years. While most of these organizations would likely come from the ranks of those firms currently at the top of the pyramid in Exhibit 4.12, geographic factors will also lead to several strategic acquisitions of organizations that currently have less than $3 million in revenues.

Exhibit 4.12 Future Structure of the Industry



Source: JPMorgan/2005 based on information from 2004 Form ADV filings with the Securities and Exchange Commission, Cerulli 2005

There is no standard strategic acquisition transaction structure

Assumptions used by strategic acquirers gives them great leeway in the prices they pay

Unlike financial buyers that hope to use a simple transaction template for all of their acquisitions, every strategic transaction has its own unique terms and structure. And the strategic acquirer's internal policies and politics are as important factors as the seller's economics in determining how the deal is crafted.

Of course, strategic acquirers will look closely at the financial condition and profitability of every advisory firm that they buy. However (as we discussed earlier), since the strategic acquirer expects to add significant value and expand the economics of the acquired entity, it has a wide degree of latitude in pricing a transaction depending upon the assumptions it uses.

For example, one way of determining an appropriate price is to calculate the discounted cash flow value of an acquisition. The industry standard method for doing so is shown in the formula below:

Year 1 Saleable Cash Flow / (Discount Rate – Perpetual Growth Rate) = Discounted Cash Flow

Under this approach, an acquirer will estimate the Saleable Cash Flow that an acquisition will generate over the first 12 months after consummation of a transaction. It will then divide that amount by a discount rate (typically 14% to 15%), less the perpetual growth rate of the acquisition's cash flow, to calculate the present value price that it should pay for the seller's business.

As is obvious, this formula provides the buyer with enormous leeway in a couple of ways when determining an appropriate price for an acquisition. First, the buyer has to estimate how profitable an acquisition will be during the first year after it is bought, and only a small change in this estimate can have a significant impact on the price paid.

More importantly, the strategic acquirer has to estimate a perpetual growth rate of the acquisition's profitability. And given that most advisory businesses currently generate less than $3 million of Saleable Cash Flow, an acquirer can use a fairly aggressive assumption and still be within the realm of reality.

$1 million Saleable Cash Flow / (15% discount rate – 10.5% perpetual growth rate) = 22.22

For example, an acquirer of an advisory firm with $1 million of Saleable Cash Flow could assume that its profitability would grow by 10.5% per year for the next thirty years and the company would still earn less than $20 million per year. If it took that assumption and used a discount rate of 15%, however, the buyer would pay a present value price equal to more than 22 *times* the Saleable Cash Flow of the seller. While it is remotely likely that any acquirer would pay such a price, it is easy to see why the pricing of strategic acquisitions can often vary widely.

Pricing of strategic acquisitions is often driven by non-economic considerations

Strategic acquirers will also typically adjust what they would be willing to pay for a potential acquisition by reviewing comparable transactions in the same industry. While it is often difficult to compare one strategic acquisition with another given their varying terms and structure, the use of comparables is designed to provide the management of the strategic acquirer with a degree of political cover. In other words, "if one of our competitors is willing to pay x to acquire companies in this industry, we will have to pay something close to x if we hope to succeed." Strategic acquirers also rely on comparables to help justify to the media the prices they might pay for acquisitions. Since most strategic acquirers are public entities, an important consideration is how the investor community will view a transaction.

Along those lines, another key issue that affects the pricing and structure of acquisitions by strategic acquirers are the expanded disclosure requirements mandated by the Sarbanes-Oxley Act of 2002. Under this legislation, acquirers must make greater disclosure of potential liabilities. With acquisitions that have most of the consideration paid tied to an earn-out such as the purchase of an advisory business, the need to be able to accurately estimate the potential liability tail to the acquirer is acute. Consequently, many strategic acquirers will be willing to pay a little more upfront to buy an advisory business, in exchange for the ability to cap the amount the buyer would have to potentially pay the seller.

Four additional points

Strategic acquirers typically want to buy only one firm in each market

There are four additional points about strategic acquirers that are important for advisory firms to understand. First, while there will likely be numerous strategic acquisitions of advisory firms, it is unlikely that the same organization will want to consummate a strategic acquisition with more than one firm within the same market. Strategic acquirers are typically seeking to buy advisory businesses that they hope to build into large organizations through organic growth. While they may elect to acquire subsequent organizations within a single market, they will likely view such transactions as financial acquisitions (on terms similar to that of those offered by financial buyers) that they can fold into their existing strategic acquisition.

Beware of faux strategic acquirers

Second, virtually all buyers like to refer to themselves as strategic acquirers albeit many are, in reality, financial buyers. Even many organizations such as banks and insurance companies that could add significant value to their acquisitions are effectively functioning as financial buyers because of the transaction structures they are proposing to potential sellers.

Faux strategic acquirers want the economic benefits of owning advisory firms but are unwilling to pay for them

There are two key differences between a strategic acquirer and a faux strategic acquirer — a strategic acquirer that is in effect acting as a financial buyer. The first difference is that, in addition to adding value to an acquisition, the strategic buyer will allow the seller to significantly participate in the wealth that is created from the combination of the seller's organization and the buyer's added value. Strategic acquisition pricing is thus heavily weighted on the future economics of the seller and not its current level of Saleable Cash Flow.

The second and more important difference is that financial buyers masquerading as strategic acquirers will only complete transactions that are significantly accretive to their organizations. They structure their deals so that regardless of outcomes, their earnings per share will increase.

More problematically, the stock prices of these faux strategic acquirers are tied to their other businesses, often banking or insurance, that trade at much lower multiples than recurring fee businesses. Ironically, a key reason why this kind of buyer is trying to acquire advisory firms is to improve its stock price. So while it wants the benefit of a recurring fee business stock multiple, it is unwilling to pay for it.

The market for advisory firms will improve over time

Third, the current scarcity of true strategic buyers of advisory businesses will not endure indefinitely. There are numerous advisory firms that have extremely attractive businesses. There also are many large organizations that want to be in the wealth management business, are trying to build their own advisory units and are having little success. At some point, these factors will entice strategic buyers to enter the market.

Competition over time will improve prices for advisory firms – patience should be part of every seller's strategy

Further, the returns on capital that financial buyers currently get from transactions are not sustainable. The opportunity to generate such high levels of return will eventually lure numerous other financial buyers into the market for advisory firms, triggering competition that will raise prices significantly. Thus, patience should be an integral part of every potential seller's strategy.

Fourth, while at some point over the next few years sellers of the largest advisory firms will have multiple suitors including strategic acquirers and financial buyers, even strategic buyers will only pay as little as they believe they have to in order to consummate a transaction. These types of buyers are not trying to pay the "fairest" price but rather one that meets their needs and constraints and still completes the acquisition. Only once these potential buyers recognize that the seller has (and is seriously) considering other alternatives will they pay a full price for an advisory firm.

Final thought

While the owners of larger advisory businesses will have many options ranging from growing their companies, harvesting profits or selling their enterprises, there is no one correct choice. Each alternative has some attractive features. Every alternative is also fraught with risk.

At the same time, however, the industry and its economics are not going to remain static. The forces shaping the industry are going to occur whether individual industry participants develop a conscious strategy for their company or simply manage by inertia.

Exhibit 4.13 Overview of Large Firm Strategic Alternatives

Strategy	Merits	Drawbacks
High Growth	• Potential highest shareholder value • Improves long-term viability of company • Makes entity attractive to strategic acquirer	• Complex/difficult to execute • Reduces owner near-term remuneration • Changes culture and owner roles
Cash Cow	• Increases near-term owner compensation • Involves little change to organization	• Unsustainable • Leaves firm vulnerable to changes
Legacy Transition	• Minimal disruption • Involves little change to organization • Often only sale option available	• Lowest price • No value-added • Precarious negotiations • Does not create a legacy
Financial Buyer	• Higher consideration than legacy transition • Minimal change in day to day operations • Often only sale option available	• Most of economics to buyer • Seller retains almost all of risk • No value-added • Enterprise less viable long-term
Strategic Sale	• Most consideration paid • Potential for high value-added • Improves long-term viability of company	• Rare and complicated • Small number of potential candidates • Does not always succeed

Chapter 5: Conclusion

The independent advisory industry has quietly grown into a financial powerhouse over the last 25 years. Driven by an exploding demand for non-conflicted, competent financial advice and further fueled in its earlier years by a roaring bull market, independent advisors today control over $1 trillion of assets.

In 1999, we argued that despite all the obvious signs of success, the advisory business was on the precipice of a major evolution. Over the next decade, a combination of competition for clients and employees and an expanded use of technology would combine to rationalize the industry, resulting in a structure that would eventually be similar to that of any other, more mature business.

New industry structure is consistent with earlier predictions

The industry structure that is starting to emerge is consistent with the one predicted in earlier research papers

Although the industry is only five years into its predicted decade-long evolution, the first signs of a structure similar to the one predicted are starting to emerge. We had anticipated that within a decade several very large firms would emerge and that most of the rest of the industry would be made up of either mid-size niche competitors or small, marginal participants. Today, from the ranks of the industry's largest firms, some very large organizations are beginning to appear. At the other end of the continuum, more than half of the industry's participants are small businesses with less than $25 million under management.

Additionally, while there are several thousand mid-sized firms, a closer examination of their current economics suggests that only a small percentage of them will either evolve into mid-sized niche competitors or be acquired by larger industry participants. The rest are businesses that have already been marginalized and have fairly bleak long-term prospects.

Much of the industry will soon be trapped in a vicious cycle of addiction to growth

This division of the advisory industry into a collection of Haves and Have Nots is the result of four forces — new entrants to the industry, the repackaging of existing competitors, technology and the end of a hidden subsidy provided by a decade-long period of abnormally high returns from the equity markets. While each of these factors has affected industry participants in varying degrees, it is the last one that has most obliterated the current and future economics of about 94% of advisory firms and has consigned their owners to a grim future of having to work harder for less money, while owning enterprises that have little or no economic value.

More changes are ahead

But the last five years have seen only the first stage in the industry's evolution; a series of new forces will further shape and rationalize it. Participants will soon have to reckon with expectations from key employees for both increased compensation and equity ownership stakes, as well as significantly higher other operating costs.

Many owners of advisory firms will find that the only means of offsetting the impact of these three forces is to rapidly grow their revenues by recruiting large numbers of new clients. The widespread adoption of such a strategy by industry participants, however, will only further exacerbate the issues that drove these individuals to accelerate the growth of their businesses in the first place. Much of the industry will find itself trapped in a vicious cycle, addicted to growth and constantly needing to attract more and more clients so that they can retain a level of profitability that allows their owners' personal economics to remain compelling.

The demand for financial advice is increasing and will increase for the foreseeable future. However, the insatiable desire for new clients by many industry participants combined with the thousands of new or re-engineered competitors that are now pursuing the same individuals will cause the demand for potential clients to greatly exceed their supply. Reaching this cross-over point will force a much harsher and vigorous rationalization of the industry and make growth of even greater importance.

Owners of "Have" advisory businesses have many, albeit difficult, choices

At the same time, a larger and more insidious force looms over the industry — old age. Most owners of larger advisory businesses are in their mid to late 50s and any potential sale of their firms, involving significant amounts of consideration would likely have as a requirement that the current ownership remain with the business for five to seven years. Thus, the industry is at a tipping point as many firm owners must decide how much longer they want to continue to run their businesses and whether now is the time to sell.

Only difficult choices for the owners of all advisory firms

The choices available to advisory business owners vary widely. The owners of advisory businesses in the Have Not category have few if any attractive options. Their businesses lack the resources to fund their growth and development, and their operating margins will be slowly strangled as the economics of the industry change.

Owners of these businesses will find that they are making far less than they could as employees of larger firms and that their firms have little or no economic value as businesses. Instead, they own books of business for which potential buyers will be unwilling to pay a material price.

The owners of advisory businesses in the Have category, by contrast, are able to select from several (albeit difficult) choices. Many will decide to continue to own and operate their firms as part of a strategy, with the goal of building a large and prosperous enterprise. Others will simply trying to maximize their near-term profitability.

Many owners who opt for the former strategy, however, own enterprises that lack the sufficient business maturity essential to supporting long-term, high-growth. They will soon find that they must forego a very large part of their near-term profitability to finance the evolution of their businesses into professional enterprises in order to make such a strategy work. On the other hand, owners of advisory firms that elect to pursue the latter strategy will likely have very high remuneration for the next few years, but they will have effectively mortgaged their firms' long-term prospects and enterprise value.

Many owners of Haves advisory firms will sell

Current pricing levels for advisory businesses are below their intrinsic value

Another group of owners of advisory businesses in the Have category will choose to sell their companies — in most cases to their employees. Although such transactions are minimally disruptive to the enterprise, they typically result in comparatively low risk-adjusted amounts of consideration for the owners and do not necessarily enhance the company's competitiveness.

A large number of advisory businesses will also be sold to financial buyers. Although under current pricing levels the consideration paid is less than the intrinsic value of their firms, competition over time will make these transactions far more favorable to sellers.

Regardless of pricing, however, these types of transactions will irrevocably alter the financial incentives in the selling organizations and will leave the selling entities vulnerable to the changes that will sweep through the industry in the coming years.

A small number of industry participants will have the opportunity to sell to a strategic acquirer. Such transactions appear to be compelling because they offer both the opportunity to improve the long-term competitiveness (and thus, viability) of the selling entity and the potentially greatest risk-adjusted price. But strategic acquisitions are both rare and complicated and often fail to meet the parties' expectations due to cultural and other issues.

New industry structure will emerge

The confluence of the forces confronting the industry and the decisions made by owners of advisory firms will reshape the top of the industry's structure over the next five to seven years. 25 to 50 very large dominant competitors will emerge. Their ranks will include advisory firms that have successfully executed a long-term, high-growth strategy as well as strategic acquirers of advisory firms. These organizations will have assets in excess of $15 billion and will be very profitable enterprises.

Our current estimate is that 50% to 60% of advisory firm owners will elect to sell their companies to either strategic acquirers or financial buyers. The 500 or so remaining firms currently in the Have category will evolve into mid-sized specialty firms. While they will be much larger than they are today, their primary competitive advantage will be a specialized expertise in solving the most complicated problems of select groups of clients.

Final observations

Changes predicted in this study occur in every industry in a capitalist system

Finally, these types of structural changes occur in every industry in a capitalist system. Competitive pressures force participants to constantly improve their products and services and deliver them at lower costs. Scale and/or specialization are key competitive advantages that participants strive for; those who fail to develop these attributes are quickly marginalized.

For two decades the advisory business was largely insulated from traditional market forces by a surging demand for advice and the hidden subsidy of a bull market. The market correction at the beginning of this decade, along with a flood of new entrants, has stripped this immunity from the industry. As a result, the advisory business has embarked on an evolution that will change the economics of all participants. The forces that have swept through the industry over the last five years and marginalized most participants will continue and only increase in their power.

Owners of large, profitable advisory businesses have many options to address these coming changes. However, there is no single right answer. They must determine a strategy that makes the most sense for their firms and try to successfully execute it. Failing to do so could prove to be disastrous because the industry and its economics are not going to remain static. And inertia in a time of great change rarely produces a good outcome.

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