PHOTOGRAPH BY RODNEY SMITH

BETTER THAN ONE

BY KEN MASSON

Done with care, merging with a bank can bring an adviser a good price, more business, and better services for clients

JOHN RAFAL'S CHILDREN HAD MADE IT CLEAR that they had no intention of becoming financial advisers when they grew up. So when Rafal sat down to consider his succession plan five years ago, it had a pretty big hole he'd have to fill. Selling out to a competitor or an employee was out of the question: a competitor might not share his approach to client service, and an employee might not be able to pay full value for a firm he'd spent 20 years building. Besides, Rafal, president of John W. Rafal & Associates in Essex, Conn., was only 48 at the time and wanted to continue working—and any competitor or employee he sold to would most likely expect him to make a quick exit. Finding the right dance partner wasn't going to be easy.

Large strategic buyers, like certified public accounting firms and banks, could pay him full value and most likely would want him to stick around. But he'd been running his own show for two decades and had little interest in surrendering control. He also feared that if his practice was merged into a large institution, the interests of the acquiring company might prevail over those of his clients. Then Rafal got a call from Rowland Ballek, chairman of Essex Savings Bank, in Essex, Conn., who was interested in generating fee-based income for his 152-year-old mutual savings bank to try to ensure its survival. The two men had been friends for some time and were in step when it came to issues like client service. When the bank made an offer to purchase a 60 percent stake in Rafal's firm, he accepted the deal.

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The experience so far has been a good one. In the five years since the deal was made, says Rafal, "we've doubled the size of the advisory practice." The firm now manages some $1.1 billion in client assets. "We've also given the bank a 20 percent annual cash return on its investment over the past five years." What's more: "They have not tried to get involved in our business," says Rafal. "They've simply referred clients to us and helped us in areas where they could—for instance, we bought health insurance together."

Many owners of financial-advisory firms facing similar succession-planning issues or looking for a faster way to grow their business are also considering selling out to the right buyer. According to an annual study released earlier this year by FP Transitions, a Portland, Ore., firm that connects buyers and sellers of planning practices, the number of advisers placing their businesses on the market increased 17.3 percent from 2001 to 2002. "Certainly, the number of announced sellers out there is going up," says Chip Roame, managing principal of Tiburon Strategic Advisors, a consulting firm in Tiburon, Calif., which reports that 457 financial advisers sold their firms between January 1, 2001, and May 15, 2003. "A lot of this is driven by the demographics of the advisory business. Advisers are aging, and some of them want out. Complicating the situation is the threat of increased competition—more people are getting into the business of financial planning."

Kimberly Kitts, president of Marquis Consulting in Orleans, Mass., says she frequently takes calls from advisers wondering how much their practice is worth. "I tell advisers it depends on what they're trying to accomplish," she says, "and who the potential buyer is." Kitts says she also hears routinely from banks and other firms looking to acquire advisory practices.

Indeed, the number of buyers interested in advisory practices increased 44 percent from 2001 to 2002, according to the FP Transitions 2003 practice transitions report. "Various types of banks, but community banks in particular, are looking to become true financial-services centers," says Mark Tibergien, a partner with Moss Adams, an accounting and consulting firm in Seattle. Buying advisory firms, Tibergien adds, enables banks to generate fee income to complement their more traditional interest income and to "build a higher fence around clients" by providing more services.

Apart from small community banks like Essex Savings, a number of regional and national banks have also been making deals. In April, for example, Northern Trust Corp. completed its acquisition of Legacy South, an Atlanta firm with $300 million in assets under management serving high-net-worth clients and private foundations. In October 2002, Wells Fargo & Co. bought Nelson Capital Management, a Palo Alto, Calif., advisory firm with $600 million in client assets.

The type of planning firm a particular bank is looking to buy depends in large part on the size and makeup of the bank. The Wells Fargos, Northern Trusts, and other larger banks have primarily been acquiring fee-only advisory firms that manage multiple hundreds of millions of dollars in assets, often for top-tier wealthy clients. "Size isn't our primary consideration," says David Lamere, president of the private wealth-management group at Mellon Financial Corp. "But for something very small—say $100 million or

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so—[the deal] doesn't make a lot of sense for either party because the acquisition mechanics take over." In the last three years, Mellon Financial has acquired three fee-only firms serving primarily wealthy clients: the Trust Company of Washington in Seattle; Van Deventer & Hoch in Glendale, Calif.; and Weber Fulton & Felman in Cleveland. And earlier this year, the bank agreed to acquire the Arden Group in Atlanta. At the time the deals were signed, those firms had assets under management of $500 million, $1 billion, $800 million, and $750 million, respectively.

Like many other large banks, Mellon's chief interest in acquiring the firms was to establish a presence in new geographic markets. "We look for firms that have a set of community contacts and relationships that would take [us] years—in some cases generations—to build," says Lamere.

Community banks and the smaller regionals are generally more flexible about the size of the advisory practice they'll consider purchasing. Often they're not as interested in a fee-only practice as they are in one that does a mixture of fee and commission business. "That's because they have walk-in traffic," says Roame. "And they don't want to tell the guy with $3,000 who comes in to open an IRA, 'Sorry, we do only fee business.' "

Regardless of their size, banks nearly always prefer acquiring firms whose principals plan to work for the bank. In other words, banks don't want to get involved with the 65-year-old adviser who's built a lucrative practice and is ready to retire; they're looking for the 40-year-old who wants to continue growing his business. "I haven't seen any deals where an adviser sells his book of business to a bank and walks away," says Len Reinhart, president of separate-account services for Bank of New York. In October 2002, Reinhart sold his own firm—Lockwood Financial in Malvern, Pa., which provides managed accounts—to the Bank of New York. "If the adviser left," says Reinhart, "the business probably would disappear. He may eventually leave, but the bank will want some sort of transition over two or three years."

Such continuity is key, but it isn't the only reason banks want principals to stay in the game. Banks often acquire financial-advisory firms not just to add clients but also to inject an entrepreneurial spirit into their organization. "Where banks struggle when entering the financial-services business is in the execution," says Tibergien. "Just because you deal with numbers, doesn't mean you're equipped to render advice to clients. There's a level of education and credentials required of financial advisers that bankers don't have." Tibergien recalls that five years ago a bank teller suggested that his father-in-law, who was very conservative, roll his money out of certificates of deposit into zero-coupon bonds. "That's the kind of thing you worry about in an environment where people don't understand the context for the recommendations they're making," he says. "Traditionally, banks have more of a product orientation, whereas advisers have more of a client orientation."

Banks assign a high value to such planning expertise—and are willing to pay for it. According to Roame, fee-only firms sold in 2003 have commanded 2.1 times revenue; fee-based firms (firms compensated with a mixture of fees and commissions) have gone for 1.8 times revenue. The fee-only firms command a premium because it's assumed they have a more solid relationship with their clients.

Interestingly, banks tend to pay more than other buyers. "Banks are notorious for paying very well, at least for their first acquisition," says Roame. It's worth it to them "because the purchase can create some real synergies." In other words, says Roame, banks not only can capture the fee income generated by referring clients to the newly acquired adviser but they're also likely to gain new bank business from the adviser's affluent clients. Still, "if you want the premium price for your firm," says Roame, "make sure you talk to the bank before anyone else does." Once a bank has paid top dollar for an advisory firm, he says, it might not feel the need to be so generous the second time around.

Sometimes banks can get cold feet. For example, EverTrust Bank, a regional bank with several branches, including ones in Everett, Wash., and Seattle, had been shopping around for advisory practices but has now put that plan on hold and instead hired four portfolio managers, two relationship managers, and some back-office support to build its private-client group internally. "We want to be comfortable that advisers aren't overpricing their businesses," says Mike Deller, president of the bank. Still, price wasn't the primary reason the bank stopped looking. "We want to see how much demand there is for financial planning in our area," says Deller. If demand is high, EverTrust may decide to negotiate to buy a planning practice.

Rafal believes he negotiated a very fair deal with Essex Savings. To come up with a valuation for his practice, the parties took an average of three valuation benchmarks: 1 percent of assets under management, seven times net revenue, and three times gross revenue. The bank took a 60 percent stake in Rafal's firm and retains the right to buy the balance of the business after five years, but no later than 10 years, from the date of the sale. "This provision gave me an incentive to stay and work hard, because I have a second bite at the apple," says Rafal. In fact, because of the substantial growth his business has experienced in the last five years, his 40 percent share is now worth more than the bank's 60 percent share was at the time of the deal.

From an adviser's point of view, the terms of the transaction should be just as important as the price, says Tibergien. For starters, advisers should, as best they can, negotiate an employment contract with the bank, separate from the price and terms for the business. Of course, "if yours is a really dinky firm, the bank will insist that it's one and the same, because the firm has no value without you," he adds.

Because the bank wants you to keep your head in the game after the sale is completed, expect to be paid a portion of the negotiated price up front and the remainder, over a period of three to five years, as an earn-out (future payments made by the buyer of a business to the seller if the business's profits exceed a specified limit). Bob Kleiber, chief executive officer of New Century Asset Management in Wayne, N.J., wound up with such a deal when his practice was acquired as a wholly owned subsidiary nearly four years ago by Valley National Bank, a regional bank with

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Photograph by Rodney Smith

128 branches in New York and New Jersey and about $8 billion in assets. "We received money up front, an earn-out over several years," says Kleiber, "and we participate in the growth of the assets of the corporation."

Banks will often pay partly in cash and partly in stock. So make sure you carefully evaluate the type of compensation you're receiving, says Tibergien. For example, many community banks will issue restricted stock, which, because of its illiquidity, must be heavily discounted. If you're paid in cash, on the other hand, that generates immediate tax consequences.

Because Essex Savings is a mutual savings bank, it has no stock, so Rafal was paid entirely in cash. "It was a capital-gain transaction," Rafal says, "but I'm very pleased with my arrangement. At first I thought not having stock would be a negative, but now I see it as a plus. If somebody bought this bank out, who knows where I would be? Who knows where my clients would be?"

The biggest advantage of selling to a bank is the opportunity for growth. Before selling his practice to Valley National Bank, Kleiber had been building his practice organically. To accelerate its expansion, in 1997, he began to shop for advisory practices he could acquire himself. "But we decided a better way to [expand] was to first become affiliated with a bank. A bank has the financial resources to make strategic acquisitions, whereas we have the expertise to evaluate which firms are best to acquire." Since allying with Valley National, Kleiber has advised the bank on the purchase of Hallmark Capital Management in Wayne, N.J., and Glenn Rausch Securities in New York. Kleiber and the other two firms, in turn, rely on the bank for client referrals. "There's nothing like leads coming from a bank," says Kleiber. "When you've educated people at a bank on what you offer and they like what you do, they want to get their clients in front of you because they're trying to solidify their relationship with bank customers."

Even under the best of circumstances, however, the transition may not be entirely smooth. The bank's trust department, for example, may take some careful handling. The cautious adviser will make certain before selling or merging with a bank that steps are in place to avoid any conflict. You could end up with two factions working at cross-purposes, says Reinhart. "If you're an adviser moving into a bank, you want to make sure there is a strategic plan to ensure that the trust department and your practice will work together"—and not wind up competing for clients.

Efforts at coordination, though, can get carried away. For many advisers, maintaining some form of independence within the bank is key. "So make sure this is what you want to do," says Kleiber. "Because when you sell your business to someone, you give up your freedom. Are you willing to do that?" Valley National promised Kleiber that he and his staff could continue to run the firm as they saw fit, because they had the expertise. "And over the last four years, they have in fact allowed us to run this business." In short, Kleiber says, his arrangement with Valley National gives him the best of both worlds: he runs his practice as he chooses, but the bank handles many administrative headaches for him. "It does our accounting; it does our payroll, insurance, and benefits. It provides a lot of services for us, which helps us concentrate on running the business."

These perks are often overlooked by independent advisers. They may see only the downside and not the advantages of a corporate culture, Tibergien says. "People call it bureaucracy; I call it structure." Small advisory firms often struggle, he says, because the businesses are not well organized or disciplined.

But whatever their organizational problems may be, a more formal structure is hardly the feature that prompts most advisers to sell their practices. "I don't know that it's an advantage," says Dana Halberg, a principal with the Arden Group, which has agreed to be acquired by Mellon Financial. "But it's not so big a problem that we can't work around it."

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The time to assess the differences—bureaucratic or otherwise—is before the merger. Advisers, bank officers, and consultants agree: the most important issue to consider—beyond price, terms, or compensation—is whether the culture at the bank is compatible with your firm's. Before they agreed to be acquired by Mellon, the principals at the Arden Group had received offers from four other financial-services firms. "We couldn't see a fit with any of them, so instead we decided to explore getting trust powers on our own," says Halberg. Once they agreed to talk to Mellon, they recognized what Halberg calls a "supreme cultural fit." She adds, "I love the people I work with, but my relationship has always been with my clients. That's why we exist. And Mellon wants us to continue to have that same relationship."

But a comfortable fit with a bank can be difficult for some advisers to achieve. Randall Richard, CEO of Allegiance Financial Group and AFX Global Advisors, two independent advisory firms in Portland, Maine, has worked a lot with banks. He's done consulting, shared referrals, and has even been approached by some regional banks interested in acquiring his firms. Some wanted to merge his practices into their trust department. But Richard turned them down. "If we found a partner that said, 'Yes, we want to own you, but we'll allow you to be separate and distinct,' that would be different," he says. Not only was Richard concerned that he would not be able to maintain his business plan but he also believed the firm's association with a bank would scare away wealthy clients. "There needs to be a Chinese wall, because clients don't want their banks to know everything about them. They don't want someone who's deciding if they're going to get a business loan to find out, for example, that they're having problems with their personal cash flow."

Nevertheless, Richard can see how a merger with the right bank could be advantageous to advisers. But the key is to find an organization that's willing to let the adviser maintain a level of independence—and understands the adviser's needs. Of course, he concedes, that's a two-way street. "The quickest way to blow a relationship would be to come in and focus only on your own needs and not have any understanding of the bank's."

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