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Niche RIA Taps Financing to Buy Rival

by Tom Stabile

Two competing Dallas-based wealth managers have joined forces in one of the few acquisitions of independent registered investment advisors (RIAs) so far in 2008, after a banner year for deals in 2007. The deal entailed one of the firms trading a share of its future revenues for the financing that let it acquire its rival.

In the deal, Asset Management Finance of New York is getting a piece of future revenues of PHH Investments after supplying the upfront capital that allowed the RIA to purchase the other Dallas firm, RAA Wealth Management. PHH bought its rival from New York-based E*Trade Financial, which announced the sale in February.

The acquisition closed last Friday, and the combined PHH firm now has \$2 billion in client assets. Both RIAs have had a client base of retired airline industry crew members. None of the parties would disclose the terms of the deal.

The revenue-tapping arrangement is Asset Management Finance's second in the wealth manager arena and 10th overall. While other sources of capital for acquisitions have dried up, the firm has a pipeline for more deals, says Rob Jakacki, managing director.

"Leveraged private equity investment seems to be on the sideline, and the bank market seems to be a little bit slower, but we are very active," he adds. "We don't have any wealth management deals at the point of an announcement but we're looking at a few opportunities."

The stumbling financial markets have had little impact on Asset Management Finance's business model, says Barry Klayman, also a managing director at the firm. "We are very bullish on the asset management sector," he says.

The deal is notable for taking place during a relatively quiet market for capital-raising RIAs, says Philip Palaveev, senior manager at Moss Adams, a Seattle-based consultancy. RIAs generally seek capital from outside investors to execute succession plans, acquisitions, product roll-outs, or other growth moves.

"So far this year, this is the fourth transaction announced of a substantial size, which is significantly behind 2007," Palaveev says.

Palaveev says the fundamentals of the RIA deals market have not changed. Instead, he says independent advisors are probably deferring moves until later in the year, waiting for the return of more financing options and for better revenues, which would augment valuations of their firms.

A February tally by Schwab Institutional, which tracks RIA deals, also saw the market slowing this year with only seven transactions involving a combined \$9 billion, off the pace of the 80 deals at firms with \$101 billion in assets last year.

Palaveev says the deal is also notable because it involves one RIA buying another. In recent years, the more common buyers were banks, trust companies, or “roll-up” holding companies that buy up equity stakes in multiple RIAs.

“It’s easier for one independent to absorb another than for a bank to do it, because they are culturally more compatible and have a similar approach to clients,” Palaveev says. “It’s also significant because the mere combination of two independent firms in one market can dramatically change the local competitive landscape.”

The PHH deal entails the firm getting capital for its acquisition while agreeing to provide a share of revenues to Asset Management Finance for a fixed time period that the firms would not disclose. The financier would not gain an ownership stake in the RIA, but instead taps a fixed percentage of the revenue, with the amount rising and falling based on the wealth firm’s performance. The RIA always keeps a majority of the revenues, and once the deal’s time frame ends, the RIA owes nothing further. The revenue-tapping periods run seven to 20 years.

The deal is Asset Management Finance’s first to provide capital for an acquisition. Its prior wealth management deal was last November, when it financed Chicago-based Gresham Partners to help younger partners buy out its founder.

Keeping control of PHH was tantamount, says Ronald Simmons, the CEO. He says even a bank loan would have resulted in unattractive governance changes.

“When independence becomes your criteria, your options get smaller and smaller,” he says. “Lots of private equity firms were interested in us. But once you’ve been independent, it’s hard to fold yourself under a larger umbrella, even if they say they don’t exercise control.”

The good news for RIAs seeking capital is that there are now several mature options for the market, Palaveev says. “Two years ago, there were fewer and they were newer,” he adds. “Today, you find a lot of options and a lot of nuance.”

He adds that RIAs today are able to call around to the pioneers of these deals for feedback. “It’s the same way penguins test the water for sharks,” he says. “They push one in the water and see what happens.”

PHH’s acquisition was an attractive deal to finance because it takes two dominant firms that both ran about \$1 billion in a niche market and created a stronger player, Klayman says. “They have very strong growth prospects, and combined they have no major competitors,” he adds.

PHH was founded in 1980, and RAA in 1991. Simmons actually had co-founded RAA, sold his interest about 10 years ago, and was invited to join PHH’s board in 2001. He eventually rose to the CEO slot, and says he was naturally interested when E*Trade called last fall offering RAA.

E*Trade had initiated a “turnaround plan” last year to improve its capital standing, and was selling non-core assets, including RAA, which it had only acquired in 2006. E*Trade did not respond to a request for comment, and it is unclear whether it plans to keep other wealth management shops in its business, such as Howard Capital Management in Los Angeles and New York.

The combined RIA firm now has 2,000 clients across 45 states who average \$1 million in assets. PHH also has a Palm Desert, Calif., office. The firm now will probably crack the top five in terms of assets in the Dallas-Fort Worth market, Simmons says. "That will automatically give us opportunities in the high-net-worth area," he says. "We think the Metroplex is underserved."

PHH primarily uses no-load mutual funds but also has some separately managed accounts, such as products from Westwood Holdings Group, a manager based in Dallas.

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