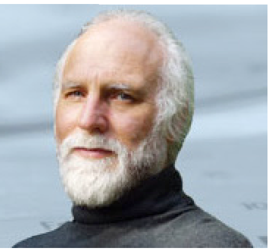
VOLUME 33, NUMBER 8 AUGUST 2023



Edited/Published for leading financial professionals - www.bobveres.com

Special to this issue:

Valuations in a Down Market

Synopsis: ***How does a bear market impact the value of RIA firms in the M&A market? It depends on who you ask.***

Takeaways: ***The most likely adjustment is not valuation, but deal terms, shifting more of the price to an earnout arrangement. If the deal involves stock in the acquirer, pay attention to how that is valued. And recognize that acquirers who have done many of these deals will have much more sophistication than the sellers they're negotiating with.***

It's a hypothetical that we all know could become a reality: if there as a 15% downturn in the marketplace, how would that affect the value of an advisory firm? Any advisor with an equity stake in their firm (founders, G2 and G3) has an interest in the answer, and one might argue that staff could be impacted as well. The valuation affects internal sales metrics, sales of clients, sales of operating businesses, and generally what advisors can expect to receive for the businesses they've built.

At the NAPFA Large Firm conference, Dan Sievert of Echelon Partners (*https://www.echelon-partners.com/*) was asked that exact question, after he had shown the audience a very complicated valuation model (graded metrics included historic and projected growth, profitability, various client characteristics including age, wealth and whether one large client made

EARLY WARNING

Are large 401(k) providers trying to keep financial planners from managing their clients' qualified plans? The state of Washington has ruled that using Pontera—which allows advisors to manage client plans without having access to passwords—is an 'unethical business practice.' The SEC has taken the opposite position. Fidelity, Merrill and others want to be the exclusive option for managing those assets, so this could become a nationwide lobbying battle.

Meanwhile, look at the first-ever SER Conference for Latino financial advisors in Phoenix, AZ Sept. 26. Register: *https://www.sersummits.com/*.

The Insider's Forum conference (October 4-6, San Antonio, TX) sessions are up on the conference website. Topics include the new realities of talent acquisition, how to to create a hyper-personalized client experience without spending additional time and effort, a new concept for tracking and improving your client services, and a 'futuristic thinking' keynote by Angie Herberse. Plus the Herbers preconference that will help midsized advisory firms take full advantage of their advantages in the marketplace. Register using discount code 23INSIDER (*http://www.insidersforum.com*).

up a big percentage of the AUM, the quality and historical stability of the firm's human capital, the quality of management and relationship with the vendors, the business model (aka pure asset management vs. financial planning vs. life planning), whether there's a continuity plan in place and the quality and success of the firm's marketing efforts that he uses in his M&A work) and his response was interesting in a potentially shocking way.

Shocking? Threading that 15% downturn through the model, Seivert told the audience that it would probably result in a 10% decline, on average, in overall client assets, which would result in 10% lower AUM revenues for a company with a 30% profit margin. That would lower the EBITDA by about 40%, and, well, his bottom line was a 47% decrease what his formula says the company would be worth.

Yes, there are a lot of assumed numbers in there, and that doesn't include the drop in multiple of EBITDA that Seivert assumed that savvy buyers (many of them PE-backed) would demand (from 10 times to 9 times). But I think it's fair to say from the audible gasps coming from the audience that my use of the word 'shocking' is justified.

And then the session ended. I think the profession deserves a longer, more nuanced answer to this not-totally-hypothetical question. So I reached out to Seivert for clarification, and received an email in return. I also reached out to Seivert's primary (albeit somewhat larger) competitor in the large firm M&A market, David DeVoe of DeVoe & Company (*https://www.devoeandcompany.com/*), and was granted a short interview. Finally, I was able to schedule longer interviews with two experts who were more generous with their time and insights: David Grau, Jr., founder and CEO of Succession Resource Group (*https://www.successionresource.com/*) in Lake Oswego, OR, and Aaron Wells, Director of Valuations at FP Transitions (*https://www.fptransitions.com/*), also in Lake Oswego.

> ***The acquisition market today is too competitive for buyers to hold back or underprice their offers during a market downturn.***

What did they say? Let's find out.

Adjusting terms vs. valuations

Seivert's email response to my invitation to clarify added some nuance. He said that the valuation decline only applies if the firm doesn't take corrective action (not specified but could include layoffs) on the expense side. I wondered if the seller could simply wait for the market to recover in order to get that higher valuation back, but Seivert said that might be a long wait. But he also noted that the sale process typically takes 9 to 15 months, and each month (or really, each day) the seller could decide that the lower valuation offer is not acceptable. "Sellers are just going down a route of creating an option for themselves," Seivert wrote. "They can always not exercise the option… If markets or other circumstances reduce their deal proceeds during the process, then they will likely not exercise the option."

Most notably, Seivert did not back away from the dramatically reduced value based on his metrics. If relatively benign (and temporary) market movements did indeed have a significant downward impact on advisory firm valuations, one might expect that a lot of firms that are negotiating a sale will back off and total sales would dip.

DeVoe offered a different perspective. In his view, dropping a firm's valuation during a market setback is (his words) old school thinking. "That is the way the market behaved back in 2008," he says. "Back then, the market declined, acquirers blindly used a multiple of cash flow, and the rationale was, *hey, your cash flow is down and consequently your firm is worth less than it was before*."

DeVoe points to two differences in today's M&A market. The first is that things are much more competitive today than they was in the past; that is, there are more buyers competing with each other than ever before. "In today's environment, buyers don't want to miss out on acquiring a potential seller, because they know a competitor will come in with an offer," he says. "Their competitors know that the spring is going to uncoil eventually, that it's just a matter of time before the equities markets some back. So they figure out how they can structure a deal where they protect themselves and the seller can benefit when the markets recover."

In other words, there would more likely be an adjustment in deal terms rather than valuation—which is the second difference between today and 2008 in the acquisition space. "Today's M&A marketplace is much more sophisticated in terms of understanding the industry," DeVoe says. "Instead of compressing the multiple, the acquirers will extend the earnout portion of the payment for a longer time. In another environment, sellers would not be excited about that," he adds, "but the rational is that we all participate when the spring uncoils. We are going to give you more time so that if the markets take a while to come back, you won't be inappropriately punished."

As the interview ended, DeVoe offered an insight that I think most sellers might miss: that the most sophisticated PE buyers are looking underneath all the fancy valuation metrics and focusing primarily on an advisory firm's cash flow. "Any cash flow compression, especially one time, is going to manifest itself in the offers," he says. "If the market dropped tomorrow morning, depending on whether we were representing the seller or the buyer, we would be making assumptions about how that would affect the revenue and cash flow, over what period. Everyone has a different crystal ball," DeVoe adds. "But I think it would be an inappropriate assumption to assume that the market correction would be sustained indefinitely."

Before DeVoe had to leave for another conversation, I asked if these principles applied across the board, or if they were different for larger firms than smaller ones. The short answer was yes, they can be different.

"Larger firms offer value in the enterprise," says DeVoe. "There is a premium paid for these larger firms because there are more firms that are interested in acquiring them, and you are buying processes, and talent, in addition to revenues." Purchasing a smaller firm means buying cash flow. So the complicated valuation metrics—formulas like Seivert's—are more applicable to enterprises than practices.

The valuation process is more complicated with larger firms than smaller ones, where an enterprise is for sale rather than a client base.

Size matters

When asked about the valuation metrics in a market downturn, David Grau, Jr. immediately asked me about the size of the hypothetical firm. Where Echelon and DeVoe tend to provide investment banking and valuation advice to firms with \$5-\$10 million in revenues, Succession Resource works with a broader spectrum of RIAs, ranging from that upper level down to lifestyle practices, providing valuations for internal succession, for bank-financed (as opposed to PE-financed) acquisitions and successions, and generally M&A work across the spectrum. Grau estimates that Succession Resource will provide 300+ valuations in a given year.

Like DeVoe, Grau says that the valuation process will be increasingly complicated as you move toward enterprise status. "If somebody is selling a \$500K RIA," says Grau, "then no one cares about your profitability. They are going to look at the demographics of your

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book of business—the average account size, average fee, number of households and the age of the clients. But if one is selling a $10M business," he adds, "then profits and sustainable growth rise to the top of the list."

Grau also says that my question contains an implicit assumption that the firm that is being valued hasn't experienced any growth in clients or assets during that aforementioned bear market—which he thinks is kind of unusual in the real world. "Last year, Nasdaq was down 33%, Russell 2000 was down 21.6%, the S&P was down 19%," he says. "But the average advisor grew assets by 4%. In many cases, profit margins and revenues will be holding steady in a downturn, and advisor valuations won't be greatly impacted."

In the price negotiations, pay attention to how the acquiring firm is valuating the stock that is included in the purchase price.

Grau agrees with DeVoe that a temporary market downturn is often washed out in a longer-term appraisal of the seller's firm.

"In reality, when you go through the valuation process, regardless of who does it, you will be taking into account what happened in the last quarter," he says; "but you are also looking at the last 12 months and the last five years. There might be a bit more weight on the last 12 or 24 months," he adds. "But where most valuators are going to apply the most heavy weighing is their prediction of the future. At least half, if not two-thirds, is tied in some way to expectations of future performance. Big swings in the market," he adds, "short-term, for good or bad, just don't move the needle very much." That, of course, answers the inverse of my question: advisors shouldn't expect a bump in the value of their firms if the markets hit a home run?

Terms and covenants

What about those deal terms? Grau says that different kinds of transactions will include different terms. The most straightforward are the ones where the acquisition is financed by a bank or other lender and the seller receives cash. "Banks today can finance up to $50-$60 million transactions," he says, "while five years ago there was a $5-$10 million cap."

Grau says, with some understatement, that, despite their evolving comfort level with RIAs and their ability to generate cash flow, no bank wants to call in the loan, repossess a planning firm and start serving its client base. So these uncollateralized loans will come with loan covenants that many advisors may not be familiar with. Grau lists loan-to-value ratio covenants, where, if the appraised value of the firm drops below a certain ratio, the loan becomes callable. Another covenant requires the firm's AUM to stay above a certain amount; that, too, can lead a loan to be callable. "Similar to that, most of these banks now have a debt coverage ratio built into the loan," Grau adds: basically keeping revenues above a percentage of the debt or payments.

When an offer is coming from a PE-backed firm or serial acquirer, only about a third of the purchase price will be paid in cash up front. The remainder will be a third in stock from the acquiring company, and a third in an earnout over some period of time. If something happens in the market (a downturn, say), then Grau, like DeVoe, expects to see the offer's percentages adjusted to put more weight on a somewhat more extended earnout.

This will typically be structured with earnout hurdles, where the selling advisor(s) will have to meet certain goals in order to earn specified amounts from the sale. Advisors, as noted earlier, might benefit from this different weighting; if those goals are exceeded due to a bounce-back in the markets, then the valuation and therefore the last tranche of the purchase price will bump up. Performance-based provisions are also, of course, included when the buyer wants to keep the owner involved with the firm.

Grau warns that the hurdles may not always work to the seller's advantage. "To your original question, the problem is not the valuation you get pre-sale during a market correction," he says; "but if the market correction happens after the purchase, then hitting those growth hurdles becomes increasingly difficult—especially if there is a five- or six-year earnout. If market conditions adjust downward in year two, it can throw you off so that you would never hit the hurdles for years three, four or five."

Meanwhile, don't take your eye off of that middle third of the compensation, the acquiring company's stock. "The larger, more experienced buyers have learned to use their equity in the transaction very deftly," says Grau.

Meaning? "They might value your firm at 14 to 15 times earnings, which sounds like a fantastic deal until you notice that they are valuing their own stock at 29 times earnings," says Grau. "What you are getting back, I don't want to say it is overvalued, but it might be generously valued."

Risk characteristics

Aaron Wells of FP Transitions agrees that the PE-backed buyers tend to focus on future cash flow first when evaluating a purchase, which means that a short-term market downturn won't affect their valuation metrics in the same way that Seivert was describing to his audience. "Earnings, for better or worse, can be manipulated pretty strongly," he says. "What I assume for expenses and compensation can impact EBITDA. But once we get below EBITDA into operating cash flow," he adds, "the numbers are a lot harder to fudge, because you have to take into account not only what I need to run the operations of the business, but how much cash I need to reinvest. All of these things come into a discounted cash flow analysis, where we discount back to present value using a bespoke discount rate that is calculated based on the risk characteristics of the business and other market opportunities."

But Wells says that the actual offer may be higher or lower than the widely published metrics, depending on what the purchasers are looking for. "Buyers are paying a premium for institutionalized processes, or a history of organic growth," he says. "Is the firm located in a market where they really want to have an office? What are the staff members like? The competition for talent is really huge in this current marketplace."

Beyond the valuation metrics, a buyer might pay a premium if the firm's office is in a location it wants to have a presence in.

And of course there will be an evaluation of the client base. If the buyer is simply buying the clients, then most of the assessment will be the age of the clients, the concentration of wealth in the client base (if you were to lose one client, would that dramatically change the revenue metrics?), along with whether the purchase includes an attractive staff member or two and (again) whether the office is in a location that the acquiring firm wants a presence in.

Getting back to that 15% market downturn, Wells says that, in his experience, the longer-term metrics are more important than what might have happened in the last quarter or two. But those metrics will be more impacted when the acquired firm is a lifestyle practice vs. a more established entity.

"If I am simply buying top-line revenue, then I'm potentially more exposed to what happens in the market," he says. "The benefit stream that I'm going to use to pay off this note just decreased substantially, and it is now on me as the buyer to get that revenue back up. But when you're buying an established business, you're buying a cash flow generating machine, and you look at the track record of generating these cash flows. If it is a mature business, it will have weathered a market downturn or two in the past."

The difference can show up in the deal terms being offered. "If you're selling a book of business," says Wells, "then you might see some sort of performance clause that says that if 90% of the revenue transfers over within the first 12-18 months post-closing, then the seller will receive X. If it doesn't, then there will be an adjustment to the purchase price depending on what doesn't come over. The idea is that you want to make sure there is some incentive for the seller to transfer those relationships to the buyer."

Lately, based on some push-back from sellers who want to be insulated from market shifts that are outside of their control, Wells has seen these hurdles measured in client relationships rather than revenues.

> ***PE-backed acquirers are now turning their attention to smaller RIAs, due to overcrowding in the market for large ones.***

Consulting better valuations

Both FP Transitions and Succession Resource Group offer consulting to would-be sellers, helping them make their firms potentially more valuable to an outside acquirer. Wells says that advisory firms can get a valuation based on their current operational status and whatever the market might be doing, and then address whatever objections the marketplace of buyers might pose.

The time frame for this 'dressing up' process can be daunting. "Ideally, we try to work with businesses anywhere from 18 to 24 months before they are actually ready to sell," says Wells. "We'll look the business over and say, *your client metrics and your growth rate is great, but you might need to look at client segmentation and narrow in on client quality, focusing on clients who best fit your business model now, vs. where you were five or ten years ago*. We do a deep dive into their numbers," he says, "and identify those KPIs that will drive a measurable improvement in the business metrics and, ultimately, the valuation."

And then, if the market goes down, would-be buyers might see an opportunity to make a fair value offer in order to get a bit ahead of the crowd. "The buyer to seller ratio is at an all-time high right now," says Wells. "In a bear market, you don't need to sell at a discount just to get the deal done. If you understand your KPIs, you know what your growth engine is and you have set up appropriate risk mitigation measures, then you are probably going to be just fine in the sales process regardless of what's happening in the markets. But," he adds, "if you waited to start addressing your operations and business planning until the markets start to slide, then you waited too long."

Asymmetry of knowledge

In the presentation that kicked off this article, Seivert predicted that, despite everything you read in the press, the valuations of advisory firms purchased in the PE-backed market are going to go up in the future, not down. Grau agrees. He says that the experience of PE investors in the advisor market has been better than their investments elsewhere. "When you look at the actual free cash flow they're getting from these deals, it looks fantastic," he says. "Even after debt service and expenses related to the acquisition, they are almost all cash-flow-positive in year one. There are not a lot of industries right now where that is the case."

Wells has noticed that the PE-backed firms have begun looking at smaller firm acquisitions due to the crowding of buyers for $5 million (revenues) RIAs. "There has been an assumption that smaller firms in the sub-$500 million (AUM) space don't have a systematized business or talented staff," he says. "In my work with business owners, I'm finding that there are plenty of firms, even in the $250 million and below space, that have processes and a trained workforce in place."

In that smaller firm market, the buyers are somewhat more selective, which is why preplanning can be important. "If I am an RIA who has been riding the market wave, and I have an owner who has been working maybe 25-30 hours a week, without a multi-generational ownership structure or talent that is really attractive, maybe I get passed over by the bigger buyers, because they might have an alternative firm that they can buy that DOES have those things," he says. And they'll be more willing to work on the price and terms.

But Wells says that even the larger acquisition targets can be at a significant disadvantage when they negotiate prices and terms. "When most advisors engage in this conversation, I think they have the unspoken expectation that the pricing multiples that are quoted in

What About Internal Successions?

Alert readers will have noticed, in this article, that private equity firms are experiencing high returns on their RIA purchase. Does that mean that G2 and G3 participants in an internal sale are getting extraordinary bargains when they purchase equity at a discount?

The short answer is yes, but with a caveat.

"I have this conversation with advisors all the time," says Wells. "We'll give them a valuation for an internal succession, and six months later they'll come back, throw the valuation on my desk, and say, *well, you told me I was worth this, and these two buyers came and offered me 30-40 percent more, so you were wrong*."

The difference, he says, is that the PE-backed buyer will add an additional layer of value, either because of the strategic value of having a new office in an attractive location, or creating synergies by consolidating back offices, or (perhaps more problematically) instituting cost controls that raise the profitability of the office.

"The point is that a buyer can often add an additional layer of value on top of what the seller has created," Wells adds. "Internally, the firm's value might be, say, 8X, but if there's a buyer who can add an additional layer of value, for them it might be 10X or 12X."

The tradeoffs are significant, however: loss of control and (due to potential cost cutting) diminished client service—and those have great, if intangible, value to a founder who is contemplating the decision to sell internally (for less) or externally (for more).

Grau notes that internal transfers are much easier to manage today than they were some years ago. "For the first ten years that I was doing this, there was no capital available, and it was a pretty tough argument to create a workable equity transfer," he says. "The offer was: *I'll sell my practice a piece at a time to you, the G2 successor, and give you some of my profits, you pay the taxes, and then you'll give those profits back to me to pay the loan off, I'll pay taxes—and I get my money back, just less of it*. But today," Grau adds, "there are probably a half-dozen committed industry lenders in this space. The successor buyers can borrow the money and get ten years to pay it back, while the seller gets cash up-front."

Some of the most creative succession structures are coming from BD firms. "The broker-dealers, like LPL, are now taking equity stakes in their RIAs," says Grau. "Dynasty announced that they're doing buy-ins with their folks. Raymond James and Cetera are offering these kinds of programs for their biggest firms," he continues, "to let the founders take some chips off the table. LPL recently announced that they were taking a 20% stake in the Independent Advisor Alliance, one of their biggest OSJs."

Wells says that he's seeing more creativity in the internal transfers, including hybrid arrangements where the seller participates in the financing along with the bank note.

"In many cases that we're seeing, the internal formula is not *sell and get out*," he says. "The successors want that founder in the chair running the business, and the founders want to exit slowly over the next five, ten or 15 years."

In these arrangements, the advisor might make up for the difference in purchase price by continuing to own part of a faster-growing, potentially more profitable RIA. "This is also how some firms have responded to the talent shortage in this industry," says Wells. "If my firm has two or three advisors who are really performing well, and I can get them some sort of equity compensation, they stay with the firm for the long haul—and instead of wondering what their quarterly distributions are going to be, they're focused on increasing top-line growth and the value of their equity."

the industry are somehow fixed," he says; *"If I have this much AUM, I am going to sell for 10-15 times EBITDA*. The reality" adds Wells, "is that there is an asymmetry of knowledge and experience between serial acquirers and one-time sellers. The seller will be doing that transaction just once in their lifetime. The buyers are familiar with all the levers and deal structures. They may be offering a fat 15-20 times multiple, but all of that is contingent on the seller taking a lot of risk. My best advice," he adds, is: "don't try to do this alone. You want an expert at your side when you're working out the details. Get someone who has worked with a bunch of buyers in this industry, so they can inform you: *hey, I know the market just dipped 15%, but because you're located in downtown Miami Beach, and this buyer really wants an office in Miami Beach, they're willing to pay a premium*."

Grau expects to see a lot more M&A activity in the future; he thinks that the consolidation is actually in its beginning phase. "There are a lot of advisors who are retired in place in this marketplace," he says. "They've built a great business, they have team members, and they started by taking Fridays off, and then Mondays, and then they realize that if they take Monday off, it just turns Tuesdays into a Monday, so they are taking half days off on Tuesday."

The evidence of this comes when Grau tries to contact these owners to gauge their interest in listing their firms.

"If we send out a thousand emails, no matter what day of the week it is, at least one-third of them are going to get an out-of-office reply," he says. "There is a lot more bank financing and private equity in our space now than we had five and ten years ago, but still not nearly enough of it for the amount of advisory firms that are starting to age out," he adds. "I expect to see a lot of healthy consolidation in the next 5-10 years."■

The Big One

Synopsis: ***Major financial services firms that serve the planning community have been victimized in an epidemic of data hacks.***

Takeaways: ***Find out how dependent your venders are using the MOVEit transfer software, and be prepared for the possibility of difficult conversations with clients.***

If you've been following cybersecurity news and anxiously waiting for The Big One, well, we're not sure what could be bigger than this. As first reported on the T3 website (*https://t3technologyhub.com/important-lessons-from-the-moveit-hack/*), the Russian hacking community has found us. Two major financial services firms, Genworth and Jackson National, suffered data breaches due to a hack of the MOVEit software that is commonly used to transfer large data files. The breach--as they all seem to do--led to the exposure of confidential data—most likely involving the clients of financial planning firms that are served by the two organizations, most likely whatever is needed for a successful identity theft operation.

> ***Planning professionals might have to have difficult conversations with clients whose data has been hacked.***

The two firms mentioned above join a list of victims impacted by MOVEit vulnerabilities. Recently, hackers breached Schwab's newly-acquired TD Ameritrade subsidiary's MOVEit file transfer software. Other MOVEit-related hacks struck CALPERS, 1st Source Bank, First Merchants Bank, Deutsche Bank, ING, Commerzbank, Shell PLC, British Airways and the Radisson Hotel chain.

In an attempt to assess the impact of this epidemic of successful hacks aimed at the financial planning profession, T3's Joel Bruckenstein reached out to Brian Edelman, the CEO of FCI Cyber (*https://fcicyber.com/*), a nationally recognized expert specializing in cybersecurity protection and compliance (and one of the most visible speakers at last year's T3 conference). Edelman found it to be somewhat reassuring that Genworth and Jackson National responded quickly and appropriately to the breach.

But he also warned that a significant number of financial services firms still have exposure to MOVEit.

"I would suggest that every advisory firm have their designated security officer reach out to their vendors to inquire whether or not they have been impacted by the MOVEit vulnerability," he said. Firms that do not have a robust mass vulnerability response plan will need to improve their readiness, because other vulnerabilities are likely to occur as the Russian hackers move down their list. Financial services professionals—for better or worse—need to be ready to make a difficult call to clients.

Schwab has announced that it plans to notify affected customers, but will it also notify the advisors who are servicing those clients? And how would those clients react, if they were to hear that their data was compromised from their custodian but not from their advisor?

Meanwhile, Russian-based group Cl0p, which claimed responsibility for some of the attacks, has published Shell's data to the dark web after the company failed to pay a ransom.

Bruckenstein's take is that this could be the wake-up call for advisory firms and planners who have not hired an independent cybersecurity firm to protect client data, and who may not have been diligent about monitoring their vendor protocols. If the Big One doesn't motivate advisors to take cyber seriously, and protect their clients from increasingly sophisticated Russian hackers, then what will? ■

The Next Agenda

Synopsis: ***Meet NAPFA's new CEO, who is charged with implementing an aggressive new course for the organization.***

Takeaways: ***NAPFA will become more aggressive in its outreach and messaging (shades of its early years) and is creating more focused conference presentations and outsource leadership training. The membership is as engaged as ever.***

As the National Association of Personal Financial Advisors (NAPFA) celebrates its 40th anniversary this year, it faces an uncommon number of potentially transformative issues. Last year, NAPFA's Board hammered out a new strategic framework for the next three years, which represents a focal shift in a number of areas. The Board also announced a controversial adjustment to the membership criteria which would permit would-be members to continue accepting up to $2,500 in annual trail commissions, provided that they do not generate any future commissions (trail or otherwise), that they donate any trail revenues they receive to charity, and that they attest that these standards are being met.

NAPFA's strategic initiative represents a new course for the 40-year-old organization.

Finally, NAPFA has hired a new CEO, Kathryn Dattomo, to implement the new framework and lead the organization into the next chapter of its history. By way of perspective, Geoffrey Brown, who preceded Dattomo, could be credited with professionalizing NAPFA's staff management and internal processes, and he guided the organization toward normalizing its public messaging with the other members of the Financial Planning Coalition (the Financial Planning Association and the CFP Board).

But one suspects that the new strategic initiative might have been a bit more aggressive than Brown's (conservative) comfort zone would have allowed. Among other things, it calls for greater advocacy—which means more aggressive PR and visibility for fee-only planning, and more resources devoted to creating educational programs and training for NAPFA firms and their professional staff. (Brown, who was diverse in a number of ways, would have welcomed the third strategic driver: more focus on diversity, equity and inclusion.)

Dattomo, in contrast, seems

energized by the prospect of leading a more aggressive NAPFA. "One of the things that I thought was interesting when I was interviewing for this position," she says, "is that the 40th anniversary is a milestone, and this is an organization that is poised for an evolution, ready for its next phase. NAPFA has this rich and robust history, and has grown a lot," she adds. "My role here now is to help NAPFA navigate how it is going to evolve."

Dattomo's background is interesting in the context of the financial planning profession. For the past 20 years, she has served as the chief development officer at the American Association of Neurological Surgeons (AANS), and in various capacities, including executive director, of the American Society of Gastrointestinal Endoscopy (ASGE). That means she has association executive experience (she also holds the Certified Association Executive credential and is licensed with CFRE International), and understands the financial and business management of a nonprofit in a professional space. But perhaps more importantly for NAPFA, she is familiar with the client-first concept of fee-only planning, having worked with physicians who take for granted the idea that benefiting the patient is the first and only priority.

In fact, Dattomo actually seemed a bit confused at first when I brought up the idea that NAPFA members were unusually idealistic in their conception of their professional role; after all, she spent two decades working exclusively with professionals who had the same basic orientation. "In healthcare, there is a similar consumer-focused mindset," she says. "So that's something that I'm very used to in my professional background. But," she adds, "I have to say that I was attracted to the client focus of the NAPFA membership, and the idea that they have a higher calling to serve their clients."

***Kathryn Dattomo:** Leading a more aggressive NAPFA.*

Her work in the medical field also prepared her to recognize how there can be different specialized corners of a larger ecosystem—true of medicine, and also true of the financial planning world.

First impressions

So what was Dattomo's first impression about NAPFA and the financial services industry in general? "The very first thing I noticed was how enthusiastic people are about being members of NAPFA," she says. "That was very motivating in a lot of ways, to come into this new role and from the start have people be very welcoming and really enthusiastic." Working with such an engaged community has its ups and downs, as will be discussed shortly, but it does mean there is no shortage of prospective volunteers for all the work that an association has to accomplish.

"I also think that the organization is in a really positive space," Dattomo continues. "There has been a lot of membership growth, we are in a good place financially, NAPFA has put on successful events and the board has been making investments in technology and a new learning management system, which I think will benefit members."

She is not, in other words, inheriting a fixer-upper. "This is not a situation where you are walking into something where you have to do a lot of repair work," Dattomo explains. "We do have to get through a transition period, but this is a stable organization that has a lot of opportunity for the future."

Perhaps the biggest opportunity lies in the fact that the future of the profession is fees for service—fee-only, in the NAPFA parlance—which suggests that the organization stands squarely in the path of the profession's evolution. One might imagine a future where every advisor has given up commissions and those who have the CFP credential suddenly become a prospective NAPFA member. But that potential future—exponential growth in membership, much greater influence on the profession's advocacy and standards-setting—feels threatening to a percentage of the (mostly older) members, who can be heard to complain that they no longer feel the intimacy of the organization's past, that they don't recognize most of the attendees of this or that conference.

Dattomo says she hasn't yet heard the 'small vs. large NAPFA' debate personally, but she recognizes it as something every professional organization has to navigate. "That is the challenge and the opportunity of growth, that as you grow, you still want everybody to feel like it is their organization," she says. "When people talk about NAPFA, what they talk about most is the community, and you always want to have a membership that is engaged and excited to be part of its community. It's harder, the bigger you get," she acknowledges, "but the initiatives in our strategic framework are focused on building community resources that will grow and expand as we do."

NAPFA is not in a situation where the new CEO has to come in and do a lot of repair work.

Such as? Dattomo points to the 'professional excellence' strategic driver in the strategic framework, which reads, specifically: 'Expand the breadth of NAPFA resources dedicated to enhancing business, behavioral and cultural competencies.' She is currently working with board and committee members to completely review the quality and relevance of the sessions at NAPFA's Spring and Fall conferences.

"The goal is to ensure that the topics are relevant," she says, adding that this means more focused content on particular micro-audiences within the NAPFA community. Instead of choosing among a lot of general programming, future conference attendees will be able to attend sessions that have been curated for their particular specialty or business model—and have input into how that content is created and presented.

An early focus of attention is on the different educational needs of advisors at larger vs. smaller firms. "They have very different needs in their day-to-day business lives, and in many cases they practice very differently,' says Dattomo. "Both are tremendously important audiences, and we want to make sure we are not painting with too broad a brush with our sessions. I think we can serve both of those communities of members at a deeper level going forward."

But conferences are only one vector that Dattomo and the educational volunteers are looking at. The obvious addition is webinars and blog content, but—initially, at least—Dattomo seems to be more focused on creating outsourced training opportunities that members can access through NAPFA. "Firms are starting to provide more internal professional development and leadership training," she says. "I think there is an opportunity for NAPFA to partner with different firms, and take content that we've curated and help advisory firms in their training efforts."

The initial focus will be on leadership training—and (that word again) focused networking. "The long-term benefit of belonging to an organization like NAPFA," says Dattomo, "is the ability to make connections with colleagues who are doing something already that you're planning to implement, where you don't have to reinvent the wheel. We have members who have implemented educational and leadership training programs at their firms, and have developed toolkits that others can use. Our goal is to say: *here is a program that we can help you implement*."

Leadership is one thing; what about outsource marketing training, or client communication training? "We know that the softer skills are the hardest to train and evaluate and learn," says Dattomo. "In the past, we have relied on learning those things by experience. We're in the process of doing a gap analysis, on where there are training needs that are not being filled," she adds.

Aggressive promotion

The other debate within NAPFA has been how to—or whether to—aggressively promote fee-only advice and tell the consuming public that fee-only advisors are the best (or, maybe, safest) option. Before NAPFA joined the Coalition, it had great success communicating this message with financial journalists, but that voice was muted and merged with the messages of the Coalition partners, whose communities include dually-registered and wirehouse-affiliated advisors.

Why is this controversial? There are multiple dimensions to choosing an advisor; NAPFA, like the Financial Planning Association, is CFP-centric, but can NAPFA members claim superiority over, say, AICPA PFP Section members or those with the PFS credential? The successful PR efforts of the past focused on fee-only vs. commission compensation. But if that argument is made too stridently, as it may have been in the early days of NAPFA (rough paraphrase: *all commission-compensated planners are thieving dirtbags*), then the blowback is that the rest of the planning community thinks that NAPFA advisors believe they are 'holier than thou,' leading to a lot of pointless inter-professional squabbling. Prior staff leadership seemed to find it too challenging to walk the fine line of promoting fee-only without being offensive about it, but Dattomo seems to relish the challenge of dancing along this linguistic tightrope.

NAPFA's PR challenge is how to promote fee-only without being unduly offensive. Dattomo has experienced the same challenge in the healthcare industry.

"Consumer awareness is one of the pillars of our strategic framework," she says. "It is something that our board wants us to be focused on. I fully understand the delicate balance," Dattomo adds. "I'm familiar with it from healthcare. There are many medical organizations that put out consumer information that tells the public to seek out a professional who is board-certified in the specialty in your area of need, or a physician who has specialized training. They do not say that every other medical professional is unqualified or should be shunned or avoided," she continues. "We want to be able to say: *your financial picture is an important aspect of your life, and you are making important decisions, and there are a lot of choices out there to get advice. we think that the gold standard is to seek out a fee-only advisor.* I think there are ways to message that in a way that does not admonish the rest of the industry for what they do."

Controversy

Many readers might have expected this article to lead with a fuller discussion of the recent contretemps about the new wrinkle in membership standards—and, indeed, most of the rest of the trade press seems to think that is the entire story to be told about NAPFA these days. Dattomo admits, perhaps with considerable understatement, that she has heard from NAPFA members about the change. "I have been fully experiencing the passion of the NAPFA membership these past couple of weeks," she says.

The change reignites the debate between small vs. large NAPFA, and it revived speculation that somehow the staff is compensated based on membership growth—and therefore has a conflict of interest in relaxing standards. (*"You know how much we NAPFA members hate conflicts…"*) But Dattomo says that there is no such provision in her compensation structure; she doesn't get a bonus or a higher salary if NAPFA gains more members or, for that matter, if it were to lose membership. "My compensation is not directly tied to membership growth," she says. "I serve under the general direction of the board, and the board will review my job performance annually."

Nor does she offer an opinion on the Board's action, which was taken at the recommendation of the NAPFA Compensation Committee. Her job is to implement the Board's decisions, not second-guess them. But she notes that the Board has been monitoring member feedback, and particularly the recommendations of potential adjustments and improvements, and is certainly self-reflecting on how to more proactively communicate with members about initiatives that are under consideration. All of this is in their wheelhouse, not hers.

Instead, she is rolling up her sleeves and diving into the multitudinous implications and initiatives that are embodied in the new Strategic Framework—and along the way learning more about NAPFA and about the profession that surrounds it. "Remember, I'm still in my first 100 days," she says. "I've gotten a warm welcome into a strong organization that is poised for growth, not just in membership, but in service. We just had our summer leadership meeting, and we're prepared for the kickoff for our new year in September." ■

Annuity Solution

Synopsis: ***A new program allows advisors who are transitioning to fee-only to continue to monitor and manage clients' annuity assets.***

Takeaways: ***The program automatically seeks out 1035 exchange options, and allows annuity assets to be integrated into portfolio reporting systems.***

NAPFA's amendments to its membership criteria put a spotlight on one of the more obscure issues that advisors face as they transition from one business model to another. The issue is more than just association membership; if an advisory firm wants to leave its broker-dealer and drop the licenses, it has to figure out a way to continue monitoring the variable annuity contracts that were sold in the past, that clients still own as part of their overall investment picture. How would a responsible fiduciary continue to manage and monitor client VA assets as a fee-only advisory firm?

> ***The early solutions on annuities for advisors who wanted to go fee-only were clunky and expensive.***

Furthermore, suppose that an existing fee-only firm is recruiting a would-be fee-only advisor or team from a local BD affiliation. The advisor/team hasn't sold anything in at least half a decade, so the mindset is compatible. The negotiations are going along smoothly, until you reach the point where nobody can figure out how to handle the annuity contracts that might have been sold five years ago and are still on the books.

Where there are challenges, the marketplace will find solutions, but the solutions that emerged in the past were clunky, expensive or intolerable. The intolerable solution was to leave the annuities behind, allowing them to fall into the 'house account' category. The BD would then assign the advisor of record role to a different rep, who would immediately have a business relationship with the clients that the advisor wants to move over to a fee-only platform.

Expensive? An RIA could file to create its own introducing broker-dealer, which could serve as the agent as record for the annuities and as a conduit for any trail commissions. Clunky? Expensive? The firm could park the advisor licenses at one of the niche broker-dealers that will collect a hefty percentage of the trails.

Better still, the new fee-only advisor could execute 1035 exchanges from whatever was sold to fee-only (commissionless) products, putting her clients into less expensive annuities (benefiting them) and solving the licensing issue once and for all (benefiting the advisor). In the past, this required a lot of paperwork, but then along came DPL Financial Partners (*https://www.dplfp.com/*), which offered to handle the legwork and also made it relatively easy to do an online database search for annuities whose feature set matched what the client already owns, and identify the thriftiest option from a growing number of carriers.

"For the advisors we were working with, that was what we called a 70 percent solution," says David Lau, DPL's founder and CEO. "The 1035 exchange probably made sense for roughly 70% of your block of business."

The other 30% of advisor-sold annuities fit into a variety of categories; the most common was surrender changes that had not yet run out. Others were contracts owned by clients who were resistant to the paperwork required to do the exchange, or who might no longer be active clients at all. Still others might have a high benefit base or high water mark for the guaranteed minimum withdrawal benefit (GMWB) rider, which would be lost if there was an exchange to a new contract.

So how do you go from a 70% solution to a process that would apply to the entire range of annuity contracts? Recently, DPL introduced something called the Breakaway Accelerator Program, which addresses a variety of challenges with one solution.

Advisors move the annuities to DPL's BD and DPL hires them to manage the assets. The annuity assets are also integrated into client performance statements.

Annuity management

The simplest way to think about the Accelerator Program is to envision DPL as a souped-up equivalent of that broker-dealer that would allow advisors to park their licenses and collect trails. "The basic idea is that we take those annuities and move them from your broker-dealer to ours," Lau explains. "We become the agent of record, and you're free to drop your licenses."

The 'souped-up' part comes in a greatly expanded set of conveniences for the advisor. "The advisory firm can continue to manage those annuity assets through our program," says Lau. "The way it works is that we hire you back in a similar way that you would hire a TAMP to manage assets. We are the agent of record, we control the annuity, but we are hiring you to manage the accounts. You become the advisor of record to manage the policy."

Advisors can set their own fees, but not the full 1% that they might be charging on their custodial accounts. "You wouldn't charge 1% to manage a commissioned product," says Lau. "You would normally charge something like what a TAMP charges for managing assets, in the neighborhood of 20-30 basis points." Any trails are collected and kept by DPL, which offsets some of the cost of hiring the advisory firm.

Since DPL has integrations with the various portfolio management software programs, those annuity assets can now, often for the first time, be included in client performance statements. And DPL will also monitor the marketplace, so that when an annuity comes out of the surrender window, advisors can see possible 1035 opportunities—and after the exchange, those assets will still be included in the performance statement integrations.

Changing the math

Lau says that there have been, so far, two primary use cases for the Accelerator Program. The first and most obvious is advisory firms that want to drop their licenses and leave the FINRA/BD world behind. The second is firms that are interested in recruiting those firms as tuck-ins. In the current talent shortage environment, a growing number of fee-only firms have been (cautiously) looking at bringing in BD-affiliated advisors who aspire to become fee-only, but dread the idea of starting their own firm. The most aggressive of these are the large aggregators (Dynasty, Hightower, Beacon Pointe, etc.) who needed a way to get past the complexities of annuity assets held by the teams they were recruiting.

"Accelerator has become a way to unlock some people who might have been too complicated to bring on," says Lau. Interestingly, it has also changed the math on some of the acquisitions. "An aggregator is looking at a firm with $1 billion in client assets," Lau explains. "Maybe $800 million is billable AUM, and the other $200 million are in annuities. The aggregator is going to completely discount those annuity assets if they're left behind, when making the purchase offer." But if those assets suddenly become billable at 25 basis points, the value of the acquisition, and the purchase metrics, go up accordingly.

Lau offers an example of the 70% solution vs. Accelerator. "A firm that has been a DPL member for a number of years had a $300 million block of annuities, and they were transferring out of their broker-dealer,' he says. "They liked the idea of 1035 exchanging. And so over the years, they were having each of their advisors go out, client by client, and move their annuities individually. Over the years, we'd moved about $40 million of that block."

Then DPL went back to the firm with Accelerator, and moved everything else in real time. "When you give them the complete solution," says Lau, "it removes a lot of time and effort."

Although DPL's platform includes commission-free long-term care, variable and VUL life insurance contracts and other non-annuity insurance products, the Accelerator program is currently limited to annuities. Lau says that, right now, that seems to be the profession's biggest pain point.

What does DPL charge for the Accelerator service? The easy answer is 'nothing,' but that's not totally accurate. If there are still trail commissions involved, then DPL will collect those. And, as an explanatory one-pager explains the process, *'as their legacy annuities mature, your clients can access modern, low-cost solutions that deliver greater value and performance potential.'* Upfront and ongoing, DPL is evaluating the existing annuities, looking for 1035 opportunities. In those conversions, DPL earns its compensation from the insurance company.

"We really don't want to be in the business of simply unloading assets from broker-dealers onto our broker-dealer; that is not why we exist,' says Lau. "We exist to create better outcomes for clients through better products."

The Inside Information audience is virtually all fiduciary, and most members are either fee-only or 90+ percent compensated by fees. For the latter cohort, DPL offers an easier path to qualify for

The most aggressive early adopters of the Annuity Accelerator Program are the large aggregators, who want to get past the complexities of annuity assets held by the teams they're recruiting.

NAPFA membership, and it is certainly a way to get past the sticking point of, if they are negotiating a tuck-in or merger arrangement, what to do with any existing annuity contracts.

Accelerator also makes it easier for independent fee-only RIAs to dip their toes into recruiting tuck-ins from the BD world. In this tight labor market, with a shortage of experienced advisors, the fiduciary, near-fee-only advisor down the street could be an attractive merger target. But anecdotally, I've heard objections from advisors that negotiations broke down over how to value annuity holdings and how to fit them into a fee-only construct.

Finally, I would imagine that some of those near-fee-only advisors with legacy annuity assets would like to have a way to incorporate them, via portfolio reporting integrations, into their client account statements. Bottom line: the movement to fee-only, and the movement away from the most widely-recommended commission products, has just been accelerated. ■

Parting Thoughts

Deja Vu

Oscar Wilde once remarked that "A fool is someone who knows the price of everything and the value of nothing." I think that lesson is being played out before our eyes in the financial planning profession, only instead of 'fool' in that quote, you can substitute 'private equity firm,' or 'bean counter.'

Ever since I wrote the article telling stories about firms that were acquired, and the issues that the acquired advisors faced in their new workplaces, I've been looking a bit harder at the current consolidation, driven by an ever-growing flow of private equity money.

The more stories I hear, the more I see, the more it reminds me of the leveraged buyout frenzy of the mid-1980s in Corporate America.

If you're too young to remember that era, it was a time when any fool could float junk bonds and buy viable corporations using the soon-to-be acquired assets of those viable corporations as collateral. Then a bunch of bean counters would rush into the management ranks and cut everything in sight. 'Chainsaw' Al Dunlap was a poster boy for this sort of thing, and his evisceration of the Sunbeam company, through a variety of acquisitions and cost cutting that slashed through fat, meat, bone and vital organs, ended in a huge mass of accounting fraud.

Not all of the outcomes were exactly like this, but what they had in common was new management that turned its attention to the numbers rather than to the products, the customers or the talent on staff. Seldom did this end well, but of course the acquirers walked away from the messes they created with pots of money. The postmortems often used the word 'looting' to describe the outcomes.

In the financial services world, I'm hearing stories that sound eerily similar. The advisory firm is acquired, and the new owners turn their immediate and focused attention on the numbers. *What can we cut to generate more profits? Why can't advisors work with 200 clients instead of 75?* Of course, the people asking these questions have never actually worked with a client, and they don't really understand the ripple effects of their budget cuts. Their speciality is engineering profits.

At what cost? The story begins when there are proposed cuts, many of which will impact (that is, diminish) the quality of client service. *But* (the bean counters will argue) *our retention rate is 95%. Can't we afford a little less of this expensive client service thing?*

The first to object are the advisors who are closest to the clients, who see themselves as advocates for clients and client service. If these client advocates persist in objecting as more budget cuts are enacted (and they usually will), then they will be encouraged to leave because they are 'not team players.' Of course, these are the most valuable members of the acquired firm, the people who have the best relationships with clients, and incidentally, the kind of people who can quickly find a new job anywhere else in the profession.

Now that the bean counters have gotten rid of the squeaky wheels, they can really go to work. Profits soar. But then they notice that client retention is not what it should be, and fewer clients from the newly-acquired firms are being retained. Those lazy (remaining) advisors are the cause! We should be paying them less or withholding their bonuses because they aren't delivering as our forecasts projected.

I think you can see where this spiral is going, and I think we are in the very early stages of it. I saw the same phenomenon back at the old IAFP during the mid-1980s, when the limited partnership collapse caused many of the companies (that were supporting the organization with unlimited funds) to go under. The members who sold those partnerships were in distress, awash in lawsuits, unsure what to recommend to clients, dealing with the dual shock of a severe market downturn and a new tax act that eliminated the value of their tax planning services.

So what did the IAFP do in response? Step up with additional guidance and service to its members, supporting new tools and finding sponsorship from companies that would be more appropriate recommendations? Au contraire! The executive director was compensated based on the profitability of the organization (you can snicker a bit at the fact that the IAFP was ostensibly non-profit), and his solution was to cut, cut, cut, every department, every service, anything he could get away with, which was a lot.

Of course, I was a squeaky wheel during this process, and I actually drew an analogy for the management team and selected board members. The story goes something like this:

The Campbell soup company is experiencing a period of reduced profitability. What to do? The company accountants, who will henceforth be referred to as the bean counters, came up with a brilliant suggestion. *Why don't we cut out some of the chicken in the chicken noodle soup? That way, we can save money and profits will go back up*.

Sure enough, the strategy worked. For a while.

But then the company noticed that its sales of chicken noodle soup were declining for some unexplained reason. What to do?

The bean counters were ready with a suggestion. *Cut more of the chicken!*

The strategy restored profitability. For a while. But then sales declined further.

I could go on with the story, but really what you need to know is that at the end, the company has cut out the chicken and the noodles, to the point where it is selling canned water, pretending it is soup, and sales are down around zero. The bean counter solution provided short-term profit boosts, and eventually destroyed the profits altogether.

I noted as I told the story that membership in the IAFP was already plummeting, because we basically weren't offering anything more valuable than canned water. After I left, the plummet continued, not to my surprise. I warned them.

And now I'm warning the profession.

Here's a test. When the new managers come in to reform the balance sheet, ask them what new services they think the advisory firm should be offering. I guarantee that you will get a blank look. *What do you mean, services? NEW services?*

That, at least, will get the business engineering team to look up from the numbers and see you for the first time. It might even motivate them to look past you at the clients, but I wouldn't bet on that.

My best guess, as an amateur futurist, is that some of these aggressive acquirers are going to go through some unpleasant times, some will go under, and the profession as a whole is going to learn a very hard lesson: that the most valuable items on an advisory firm's balance sheet are the staff talent, the client relationships and the service model. Anything done to tinker with those things, and with their budget, should be done with care, and an awareness that they are the drivers of the retention rates that are too often taken for granted.

I will also venture to guess that the PE firms will depart with bags of money, leaving behind what business management professors, using technical language, would call a 'mess.'

But while that lesson is learned, another dynamic will play out. Those smaller advisory firms that are wondering how they can ever compete with the emerging consolidated giants now have a strategy. Just keep offering great advice and great service, keep your eye on client relationships and be welcoming and understanding when refugee clients knock on your door and tell you how the service level deteriorated at that office of a giant firm down the street, and how the advisor they had such a great relationship with over there (the squeaky wheel) is no longer there to hold their hands. That advisor actually might now be working for you.

Offer those underserved refugees your best service, and I guarantee, while the private equity firms figure out this easy to understand, hard to learn lesson, you will do just fine. ■