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# Mergers & Acquisitions in the TPA Channel: The Quest for Success

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*The purpose of this article is to help TPAs successfully transition their businesses by using a thorough preparation process and by understanding buyer types and motivation.*

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Consolidation in the third-party administrator (TPA) channel has gradually increased over the past eight to ten years and sped up even further over the last three to five years. Contributing factors to this trend include: aging of the business owners, regulatory challenges (notably the SECURE 2.0 Act), threats of commoditization by the bundled providers, and the need for capital investment to keep up with the technology necessary for growth and scaling of the business.

Concurrently, the demands of buy side acquirers are changing and becoming more discriminating, particularly around positive profit margin and operational expectations. Changing interest rates also have been having an impact on buyers using financing to fund the purchase.

The supply and demand dynamic of TPA firms has become another significant influence in the M&A environment, as the supply of TPA firms has been gradually diminishing. TPA numbers within the Mega

(>$15 million in top-line revenue), Large ($8-$15 million), and Medium ($3-$8 million) segments have been in decline over the past four to five years, due to consolidation at an accelerated rate. At the same time, firms in the Small ($2-$5 million) and Micro (<$2 million) sectors still exist in significant numbers due to lower buyer demand. Interest in the larger sectors remains high as supply dwindles.

The purpose of this article is to help TPA firms make themselves more attractive to buyers and better prepared to meet their demands. Better preparation paves the way to smooth transition, enabling sellers to work more successfully with buyers' due diligence requests and, in turn, attract a more aggressive offer. The article will cover the three phases of preparation, buyer types, and drivers of interest.

## Preparation

The single most important element of a TPA business owner's quest to "transition" their business is preparation.

For many years, TPA business owners have been talking about "succession planning" at conferences, TPA workshops, and regional meetings with their peers; however, they do nothing. What they should be doing is preparing their firms to make themselves more marketable.

There are three phases of preparation, all of great importance, including psychological, operational, and financial.

### Psychological Preparation Phase

Psychological preparation is often dismissed, but it is important as both an offensive and a defensive strategy. A good first step is to objectively evaluate your business and determine if your TPA firm is a "practice" or a "business."

A practice refers to providing expertise to a client for a fee, in a consulting capacity. In contrast, a business is a formal entity, centered on providing a service or a product, with an established value, strategic business plans, and employees.

It's crucial to understand that the buyer is looking at the target as a business. As noted in a Forbes article, a business "has a management structure because it is aimed more at sales than billable hours." [*https://www.forbes.com/sites/steveparrish/2014/04/14/practice-or-business-which-one-is-a-better-fit-for-you/?sh=593a93f07a52*]

One of the key elements of a business is that the owner is only one aspect of what makes the company profitable. It's the product that drives the business income, rather than solely the consulting relationship. This means that the role of the owner after the sale will likely be different from before.

You must develop your own picture of what a successful outcome would be for you, both financially and emotionally. Prepare yourself mentally to remain engaged if the buyer requires you to be around for 12 to 18 months through transition. If you remain longer than that, you should be prepared that this generally will be in a lesser or different role. In addition, you should think about what role you will play in the post-transition process to make the sale successful (thereby reducing the risk of post-transaction problems that could create indemnification claims or a reduction of after-transaction buy-out payments).

**Checklist for Psychological Preparation**

1. Set personal goals (financial target, future roles, timelines, for example, how long to stay).
2. What do you want your days to look like after closing? Consider whether you want to continue working, and if so, in what type of role?
3. Understand that you should plan to stay on for a year or two to ensure or enhance a smooth transition, all with the intent of mitigating transition risk. This risk is a key concern for a buyer and could negatively impact a buyer's offer.
4. Be aware that post-closing, while your opinion and input may be valued, your "vote" may not.
5. Develop a clear and concise answer to these questions that a buyer will ask you: What do you hope to be doing post-closing?, and What is your exit timeline?

As difficult as it may be for both the seller and the employees, it is important to *let go*. Post-closing, step back. While change management is an adjustment for all, if the new leadership isn't given the space to establish itself within the new culture, the sense of teamwork will be that much more difficult to establish and retain.

### Operational Preparation Phase

This phase typically focuses on systems, processes, and procedures and will take time—up to two years—to ramp up efficiency through upgraded systems. This is where you make sure that your company is ready for sale, sort of like painting and changing the carpets in your house before it goes on the market. In fact, smart business owners do this long before getting

Exhibit 1

| | | | *Guaranteed EBITDA Multiples* | |
|---|---|---|---|---|
| | | **Revenue** | **Less Revenue \| Lower Growth** | **More Revenue \| Higher Growth** |
| **Revenue Based** | Scaled TPA (Positive Profit Margin, Platform Potential) | $5m + | 1.75x | 3.00x |
| | Mid-Sized TPA (Positive Profit Margin) | $2m - $5m | 1.50x | 1.75x |
| | Small TPA | $0 - $2m | 1.25x | 1.50x |
| **EBITDA Based** | Scaled TPA | $5m + | 8.50x | 9.00x |
| | Mid-Sized TPA (Positive Profit Margin) | $2m - $5m | 6.00x | 8.50x |
| | Small TPA | $0 - $2m | 4.00x | 6.00x |

ready to sell, as part of improving their operations and profitability.

**Checklist for Operation Preparation**

1. Scale your business to increase revenue at a faster rate than costs. Businesses achieve this in a number of ways, from adopting new technologies, to finding "gaps" in their operations that can be streamlined. Utilize a Cost Benefit Analysis (CBA) on both capital expenditures and staffing expenditures. If you don't know what metrics can be reviewed to understand whether your business is solid or weak, talk to your accountant or a business advisor. It's critical that you know at all times whether you are objectively successful.
2. Make yourself unimportant to the day-to-day operations. Do not make your presence or success of operation contingent upon your involvement. Make sure operations can function without you.
3. Develop "bench strength" or Gen 2 leadership.
4. Ensure the new leadership becomes very familiar and eventually trusted by your centers of influence (advisors, RIAs, CPAs). Begin having your sales consultants and customer-facing staff who work with your advisors and COIs become highly visible, well-known, and eventually trusted.
5. Take great care on a monthly or quarterly basis to improve your margins. You need to focus on these continually.
6. Develop your own internal data tracking capabilities.
7. Develop or fine-tune a documented workflow model and processes and procedures.
8. Document your cybersecurity program.

### Financial Preparation Phase

This phase focuses on optimizing your accounting systems (such as the billings system), including such functions as cleaning up debt, ensuring that accounts receivable are up-to-date, and on a normalized fee schedule.

**Checklist for Financial Preparation**

1. Develop your financial data tracking capabilities for each type of revenue stream, including: recurring fee revenue, transaction fees (for example, loans and distributions), documents, consulting fees, plan terminations, recordkeeper revenue-sharing by each provider, etc.
2. Track revenue from each client type and amount. Strive to have a clear fee schedule and stick to it. Limit special deals and discounts to a case specific basis, as consistency in billing is key. Try to avoid special deals because it can be very problematic in due diligence for buyers when there is no consistency in fees.
3. Regarding employee compensation, your census data should clearly track and identify salary and hourly rates and bonus data for each individual.
4. When possible, favor discretionary bonuses over salary increases. Because bonuses are non-recurring

one-time expenses, they do not increase a step-up in recurring expenses. Buyers tend to prefer non-recurring expenses.

5. Make every effort to eliminate or reduce business debt as much as feasible.
6. To lower rent expense, especially if you have multiple locations and/or remote employees, consider consolidating offices and/or locations.
7. Consider incorporating an annual document maintenance fee into your standard fee schedule. This tactic shifts both restatement and other document fees into your recurring revenue "column." (Understand, however, that this means that the huge spikes in income you may have historically experienced during any prior six-year restatement cycle will be leveled out.)

## Buyer Types

Market demand for TPA firms is still high, as measured by deal flow volume and multiples. The demand for firms with scale, Generation 2 leadership, established production, distribution models, and platform components have attracted the highest multiples over the past five years despite economic indicators, such as volatile markets, social unrest, and a global health crisis,

The current market forces have impacted the frequency of M&A transactions, causing buyers to become more selective with their purchases. However, buyers still have the private equity-backed fire-power to acquire and scale. Generally, there are two types of buyers: internal and external.

### Internal Buyers

This group is comprised of employees or family. While such a transaction would be by far the quickest and easiest to execute, it generally yields the least financial gain while producing the greatest risk to the seller. This risk is that the most common structure of these "internal" sales is a cash payment at closing, followed by an "earnout" over a specified number of months or years, payable from future business earnings. In this scenario, the seller is completely at the mercy of the buyers to successfully sustain adequate cash flow to support the ongoing payment stream.

On the other hand, internal buyers know the business and know the people, and you will have (hopefully) groomed them to take over the business. If this statement is incorrect, start immediately to make that happen. Even if your people don't buy the business, the education you give them will help them be in good stead with the buyers or wherever they end up after the business sale.

### External Buyers

External buyers fall into two types: (1) revenue-based or (2) *earnings before interest, taxes, depreciation, and amortization (*EBITDA)-based. For example, a revenue-based buyer will make an offer and buy at a multiple of top-line revenue. This type of acquisition tends to be more common in smaller transactions. In contrast, the EBITDA-based buyer will determine their offer and purchase price based on a multiple of EBITDA.

External buyers may come from the following groups: other TPA firms; TPA aggregator firms, such as TRA, Definiti, Strongpoint, and Prime; financial services firms interested in vertical integration (for example, an insurance agency adding an internal TPA); and private equity (becoming more prevalent in larger deals).

Exhibit 1 shows both top-line revenue and EBITDA multiple deal ranges as of Q2 2023. Multiples have continued to rise for third-party administration firms, as many buyers remain in the early-to-mid stages of building out their scalable operating platforms.

## Drivers of Buyer Interest

Across all segments and buyer types, the top eight items of buyer interest over the past few years are:

1. Recurring revenue
2. Top line revenue
3. Compound Annual Growth Rate (CAGR)
4. Stable, tenured staff
5. Diversified book of business that includes defined benefit plans and all defined contribution plans
6. Diversified revenue models
7. Future growth prospects
8. Strong and stable margins

It's important to understand that recurring revenue carries a higher weighting in determining your Enterprise Value (EV), which for some buyers is the multiple applied in producing the purchase price. Note that a good number of buyers give either a partial or no weighting for Cycle 3 restatements for P & L trailing years.

## Conclusion

Selling your business is a daunting and complex endeavor and you have one chance to do it right. Prepare and do your homework to be confident you're getting the best deal available. Furthermore, aim to give yourself more than one option.

What is the best deal? It's the right fit. Know that, while financial considerations are important, the majority of successful deals are based upon shared values, culture, and the continuity of the business' value proposition.

Selling your business should never be rushed; do not underestimate how intense the due diligence process can and will be. Just as every TPA has their own unique and differing characteristics, so does every merger and acquisition. Granular data across both financial and operational phases are extremely important as you can't manage what you can't measure.

Last but not the least—post-closing—step away from the business. Lingering on is counterproductive, as it can cause prior employee allegiances to impede the culture of the company to grow and adapt for the future. I will add from personal experience that this is very difficult, but critical for future success. ■

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