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Understanding the Value of Your Practice

Practice valuation is the starting point for owners who want to effectively manage their equity and build a business of enduring and transferable value. Owners, and prospective owners, need to accurately determine the value of a financial services practice, understand what drives that value, and learn how it can be increased and improved.

Over the past few years, practice value and valuation have been part of a rapidly changing landscape as the financial services industry has shifted from theory to practice. The independent side of the industry has witnessed an evolution in valuation approaches, moving away from simple gross revenue multiples towards a more comprehensive approach that takes into account many of the complexities in valuing a privately held, independent, financial services practice.

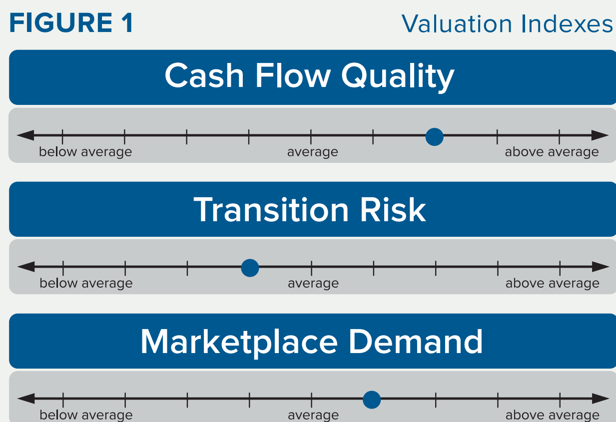
To address the need for a more thorough and affordable approach to valuation, FP Transitions developed its Comprehensive Valuation System, which analyzes a broad range of parameters over three major indexes to produce a 70-page report that not only gives a clear picture of the value of a financial services practice, but also provides a complete understanding of how that value is derived, by looking at the key factors underlying the strengths and weaknesses of any given practice.

Methodology

The FP Transitions Comprehensive Valuation System, at its simplest level, uses the GDC (Gross Dealer Concession, or, for an RIA practice, Gross Revenues) of a subject practice, followed by a series of adjustments based on the Transition Risk, Cash Flow Quality, and Marketplace Demand of the practice (Fig. 1). In addition, deal terms and length of financing are taken into consideration to produce a final, realistic, market-generated value.

Gross revenues provide a clear, straightforward method of comparing one practice to another, and hence are the foundation of this market-based valuation system. The complexity of this approach lies in how those revenues and the clients that generate them are treated. The FP Transitions approach is unique in terms of taking into account critical factors in assessing the strength and durability of the revenue. The first step is to assess the Transition Risk for the subject practice.

Transition Risk refers to the likelihood that the clients of the practice will transfer to the buyer or successor of the practice, and be retained in the years immediately following the sale. Said another way, the GDC of a practice is only as good as what can be transferred, and retained. If the client base is not strongly attached to the practice and the selling practitioner, then the buyer may or may not receive the full revenue base being bargained for. By looking at key factors affecting the Transition Risk of a given practice and selling situation, the FP Transitions valuation system adjusts the GDC for this risk.



The sample sliders above show how the indexes effect each practice's value.

The next step is assessing the strength of the revenues of the practice – referred to as Cash Flow Quality. Cash Flow Quality focuses on the revenue stream to be acquired, and takes into account the demographic qualities, concentrations, and wealth index of the client base, as well as the expenses associated with servicing the client base. The Cash Flow Quality index also looks at the critical growth components of a particular practice. By taking all of these factors into account, an overall Cash Flow Quality

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index can be assigned to the subject company's revenue. An added benefit here is that the Cash Flow Quality index is benchmarked against an average, giving the advisor a yardstick with which to compare their practice against other successful practices.

FIGURE 2 Factors of Practice Value

The last step in determining the value of the practice is to apply a market-driven capitalization rate to the adjusted GDC, determined by what is referred to as Marketplace Demand. This is the process that firmly links the valuation to the market for such practices, by applying capitalization rates that are keyed to the type, size, and geographic location of the practice, among other things. It should be noted that, as with the adjustments to Transition Risk and Cash Flow Quality, none of the individual assessment factors for Marketplace Demand have a large impact on value themselves, but rather collectively make incremental adjustments to value and, in sum, produce results which closely mirror the reality of the marketplace.

The Impact of Deal Terms

The presentation of value included in the Comprehensive Valuation Report is not a traditional appraisal number, because there is no static value for most privately owned, independent financial service businesses – values are subject to the deal structure, and, without presenting "the number" in that context, value is not relevant in an open-market situation. The FP Transitions Comprehensive Valuation System, therefore, presents market value in line with the most commonly employed supporting deal structure (as an industry average) – approximately one-third in a cash down payment; one-third of the purchase price paid in the form of an adjustable promissory note; and one-third of the purchase price paid in the form of an earn-out arrangement.

The Comprehensive Valuation Report provides additional details on other commonly used deal structures or payment terms. The pricing matrix illustrated in Fig. 3, taken from the pages of a sample Comprehensive Valuation Report, simulates the range of values you could expect to receive based on a variety of deal terms. The average value, or what would usually be referenced as the "value" of the practice, is the number supported by the most commonly used deal structure.

Since value is inextricably tied to these deal structures, it is important to understand the supporting transaction structure in order to fully appreciate the values being presented.

FIGURE 3 Impact of Deal Terms on Practice Value

	Valuation Matrix		
Deal Structure	Years: 1	Years: 4-6	Years: 7-9
All Cash	$877,000		
Average Structure		$958,000	$1,042,000
All Contingent		$1,015,000	$1,121,000

Depending on the structure of the deal there will be greater risk to one party or another; this risk factor impacts the value of the practice. An average structure over two years has a more balanced risk factor between buyer and seller, creating a shared-risk, shared-reward relationship.

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Tax Implications

There are different tax implications for both the buyer and the seller in a financial services practice sale or acquisition, depending on the structure of the transaction and the tax allocation of the purchase price. Most buyers and sellers structure their transactions around the sale of assets, when a 100 percent interest is being bought/sold, a factor considered in the Comprehensive Valuation Report.

The tax consequences to the seller of an asset sale depend upon the tax classification and treatment of the individual assets that comprise the business, and the arms-length agreement of the parties to the transaction. Typically, the assets to be sold include:

- Seller's goodwill
- Client files and associated revenues
- A personal agreement not to compete or solicit
- Furniture, fixtures, and equipment
- Marketing system
- A personal services contract obligating the seller to assist post-closing

The amounts paid for each of these assets varies. In the typical transaction, the majority of the purchase price is paid to the seller at the capital gains tax rate, and the remainder of the purchase price is allocated across the remaining assets. The actual numbers will vary depending on the Transition Risk and Cash Flow Quality. The tax treatment also may vary between practices due to the circumstances surrounding the transaction.

Building a Business of Enduring Value

Traditionally the solo model has dominated the independent advisory market, with one advisor providing most of the services to his or her clients and serving as the primary talent behind the business. This "virtuoso" model reflects favorably on the individual talents of the service provider who provides all of the artistry and skill needed to satisfy a small group of clients, but unfortunately, the talents and services developed by the virtuoso do not survive the provider.

By combining several virtuosos in one office, a slightly different model emerges, something closer to that of a "string quartet," each of whom, while working together, continue to offer their services as individual talents but appear as a larger group to the public. Recently, however, another model has been emerging within the independent financial services market. This new model is best described as an "orchestra," where the artistry and talent is derived not from a single individual, but rather from the skills of a team working together to provide the marketing, administration, compliance, investment services, and client management that makes up the business.

The orchestra model puts a different focus on the role of the owner, shifting to that of the "conductor," whose job it is to get the numerous and various talents in the orchestra to play together as one unit, while providing the inspiration, content, and direction for the artistry which is being performed and delivered.

All of these models work. Each can provide professional financial services competently and successfully to their clients. And all three models have value in the marketplace. But what is becoming clear is that, in the longer term, they will be valued, managed, owned, and transferred quite differently. Treating these models as though they were of one mind fails to recognize the different sets of challenges that each faces in terms of continuity planning, succession planning, and value of what they are building.

What is different between these models is where the value lies. In the case of the virtuoso or even the string quartet, the value of the financial services practice is almost exclusively vested in the clients they have accumulated – their book of business. Whereas within the orchestra model, the clients are still the primary component of value, but the organization that is being built – its systems, operations, and most importantly its key individuals – significantly contributes to the value of the business. This style of business has surpassed the value of just developing an attractive client base; they are now being sought, and paid for, as businesses that are robust, dynamic, and most importantly, can grow into the future and outlive their founders.

Emphasizing the business value component of a financial services practice brings into sharper focus where long-term value is being built or could potentially be built in the practice. For owners, it is important that their choice of model and approach is by design and not default.

Many owners feel that they simply do not have the necessary people or other resources needed to build their practice into a business. Others simply are not comfortable with the idea of being anything other than the single owner and leader, and would feel uneasy sharing those roles. Others fail to understand the value and differences of these unique models. Understanding the different models is not about promoting one over the other. The goal, through careful analysis, is to determine where a practice owner is today, and where they ultimately want to be at some point in the future. All models have pros and cons associated with them, and as such, selecting the appropriate model should be an active choice.

Conclusion

In creating the FP Transitions' Comprehensive Valuation System, the goal was to provide independent financial service practice owners with an affordable tool not only to assist them in making business decisions, but also to guide them throughout their careers in establishing and monitoring the considerable equity value in such a practice. By understanding what drives value, owners will gain insight into how to manage it for the future.

FP Transitions is the nation's leading provider of equity management, valuation, and succession planning services for the financial services industry. Based in Portland, Oregon, FP Transitions operates the largest open market for buying and selling financial service practices in the U.S.

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