UNDERSTANDING THE VALUE OF YOUR BUSINESS

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TABLE OF CONTENTS

UNDERSTANDING THE VALUE OF YOUR BUSINESS

Business valuation is the starting point for owners who want to effectively manage their equity and build a business of enduring and transferable value. Sellers, and prospective buyers, need to accurately assess the value of a financial services practice, understand what drives that value, and learn how it can be increased and improved–all in an unbiased manner.

Obtaining a professional valuation of your business can feel like a monumental task, but it does not need to be. A professional and thorough assessment of value should be supported by a comprehensive analysis designed to provide you data driven insights that are tailored to your specific purpose. The first step is to establish a clear understanding of the valuation purpose and the intended use. This will inform many of the steps that follow. Secondly, the level of value needs to be established. This, along with the purpose will establish if the market value of the client relationships (e.g., the "book of business"), cash flows/rights to cash flows, or a combination of the two need to be considered.

From there, the appraiser can accurately determine which valuation approaches to use and the content that must be included in the report. Regardless of the approach selected, the business is analyzed on a broad range of key performance indicators, that we separate into three indices: Market Demand, Transition Risk, Cash Flow Quality. These key indicators are used to determine a value based on the unique risks and opportunities present in the subject practice.

PURPOSE

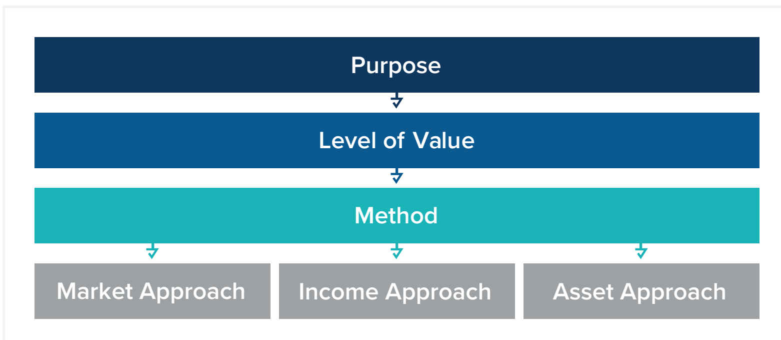
The need for a professional third-party's opinion of the value can be driven by various factors. The most common motivations are:

1. **General Knowledge.** For strategic planning, performance monitoring, and continuity planning.
2. **Reasonability Assessments.** To determine whether an ask or offer price is reasonable.
3. **Bank Loans.** To assess the value of the collateral in order to securing a loan.
4. **Tax Related Matters.** For estate planning and charitable contributions.
5. **Disputed Matters.** For divorce, breach of contract, or partnership dissolutions.

While the list above is not exhaustive, it covers the most common reasons an advisor seeks a business valuation. It's important to understand is each purpose listed above has unique factors that need to be considered to estimate value for that specific circumstance. In other words, there is not a single value solution that can be uniformly applied to all purposes.

Once the purpose has been identified, the type of sale needs to be determined. The type of sale can be broken into two categories: asset sales or equity sales.

FIGURE 1.



Asset sales are the most common type of transaction that occurs in our industry when 100 percent of the business is sold. These transactions usually occur on a debt-free basis. Asset values for financial service businesses don't always include the value of tangible assets as they are often minimal or not transferred. Instead, most of the asset value in a financial services business resides in intangible assets, namely personal and professional goodwill. Our transaction data tells us that asset sales rarely happen as "cash transactions." In other words, the consideration exchanged between buyer and seller involves elements other than cash, such as a promissory note or stock in the acquiring entity. This is important, because the value of the business will be dependent upon the assumed deal terms of the contemplated transaction, which should be clearly stated in the valuation analysis.

Equity sales differ from asset sales in that these transactions are usually on partial interest in the business and must account for the totality of a business' invested capital. This invested capital includes both equity investments and debt incurred to support the growth and operations of the business. An owner of fractional interest is buying rights to future cash flows and capital appreciation, which are both impacted by debt. While not all equity sales are "cash transactions," our data tells us that equity is more likely to be transacted on a cash basis and it is typical for equity values to be quoted on a cash or cash equivalent basis.

LEVEL OF VALUE

After determining the type of sale, the next step is to determine the level of value–strategic, controlling, or a minority interest.

A strategic value, sometimes called "Investment Value" is used for most scenarios where a controlling interest is expected to be transferred to buyer that is in the same line of business as the seller. There is usually a premium implied in a strategic value, which is the result of a strategic buyer realizing synergies with the seller's business, such as revenue enhancements, cost reductions, process improvements, and risk reduction. Common realizations of these synergies in the purchase of a financial services practice are: (1) a buyer absorbing the seller's households into their expense and capital structure and servicing the households at a scale the seller cannot, (2) the seller's location opens up a new market for the buyer to sell into, (3) the seller brings a new service line and set of capabilities to the buyer's practice (such as a wealth management practice purchasing a financial planning practice) and/or; (4) the buyer uses pricing arbitrage to receive an increased payout from their broker-dealer on the acquired book of business (if applicable).

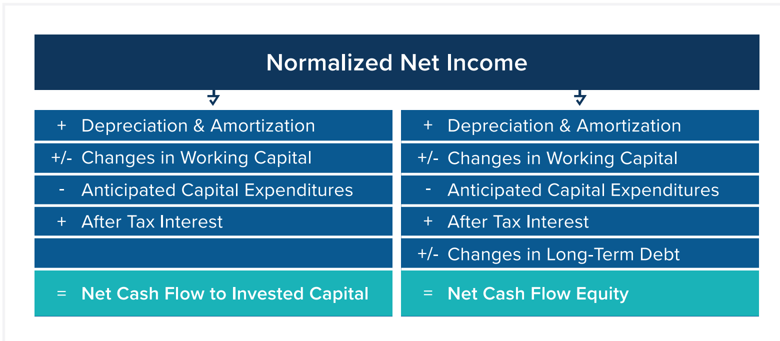
A control value represents the sale of a practice to a buyer in am arm's-length transaction that will have the ability to market and sell the practice at any time and will be afforded the prerogatives of control. When the sale of a controlling interest is made to a buyer that does not have their own separate distinct practice/business, the buyer is considered a financial buyer, who is essentially an investor in the business that can't experience the synergies that a strategic buyer could. In this case, the expression of value is usually Fair Market Value (as opposed to Investment/Strategic Value).

When assessing equity value, the level of value can be variable depending on the control characteristics of the value being transacted. The level of controlling interest determines the decision-making power, impact, and marketability of the ownership being sold. The sale of 100% controlling interest comes with commensurate discretion and would be valued higher than a 50/50 interest subject to shared control, or a minority interest that has a lower impact on business decisions. For this reason, the level of value in a stock sale is a key component of equity value.

Understanding the level of value will inform the appraiser about the types of adjustments that need to be considered when reviewing and recasting financial statements for the subject practice. These adjustments measure the true economic performance of the company and provide a basis for projecting future cash flows. There are two specific types of adjustments that can be made, normalizing and control.

Normalizing Adjustments remove non-operating and non-recurring assets, liabilities, revenues, and expenses. The financial statements are adjusted to reflect the company's regular ongoing financial position and operating performance. The capital structure may be modified to incorporate a different use of financial leverage. Working capital may be adjusted as necessary to support anticipated needs. An example of this can be seen in Figure 2. Normalizing adjustments are appropriate when valuing either controlling or non-controlling ownership interests.

FIGURE 2.



Control Adjustments are appropriate when valuing controlling ownership interests where the ownership level has the authority and ability to execute the changes. These adjustments may be applied when valuing minority interests if the minority shareholder should expect the controlling owner to act prudently and make such changes. Control Adjustments primarily relate to discretionary expenses that are solely at the discretion of the owners. These expenses adjustments are typically applied to the following:

1. Unnecessary employees
2. Owner/management salaries
3. Entertainment expenses
4. Rent expenses (if not an arm's length lease)
5. Salaries paid to family members
6. Personal assets, liabilities, and related income and expenses from these assets

APPROACH

One of the most highly debated topics is: Which valuation approach is best to value a practice? The correct answer is: it depends. As we've established, the purpose, not the approach is the first step in a valuation analysis. Attempting to select a valuation approach without first establishing the "why" is like a doctor diagnosing a patient without having a conversation with the patient to understand the symptoms. There is no "one-size fits all" valuation approach for all practices, all purposes and all levels of value.

The appraisal discipline generally recognizes three approaches to value: asset, income, and market approaches. These approaches are broad categories for various ways to value a business. Under each of these approaches are commonly used and accepted methods of valuation. Without an understanding of the purpose and level of value, the correct application of these approaches is limited to a best guess. Of the three valuation approaches, the easiest to understand, and the most commonly used for synergistic values, is the market approach. The income approach is easily one of the most complex approaches and is used for measuring profitability and rights to future cash flows. The asset approach is the least relevant and is rarely used in this industry due to the lack of physical capital assets needed to produce revenue. Therefore, we will limit our discussion to the market and income approach.

The **market approach** is well suited for valuing a book of business or practice when the operations of the practice are expected to be dissolved and absorbed into the acquiring firm (strategic value). If adequate transaction data is available, and the practices within that dataset are comparable to the practice/ownership interest being appraised, then a market approach can and should be used. Also, this approach can be used as a reasonability check when using an income approach.

The proper application of the market approach requires a professional appraiser to analyze the characteristics of the transactions then make appropriate adjustments to the market multiple to reflect the unique risks and opportunities present in the subject practice.

The **income approach**, specifically the discounted benefit stream method (benefit stream can be earnings or cash flow), is based on the concept that the value of a practice is a function of the future economic benefits that will flow to the buyer/investor. The value of the forecasted economic benefit stream is discounted to a present value. Similar to the use and adjustments to multiples in the market approach, the discount rate should be adjusted to reflect the unique risks and opportunities present in the subject as well.

The income approach is well suited for valuing a going-concern where the net operating profits of the practice should be considered AND the future earnings are expected to increase or decrease in the future. The income approach is typically not the best fit for books of business or small practices (generally less than $100M AUM). There are some unique scenarios where the income approach needs to be used for smaller practices, but those scenarios are relatively limited.

KEY PERFORMANCE INDICATORS

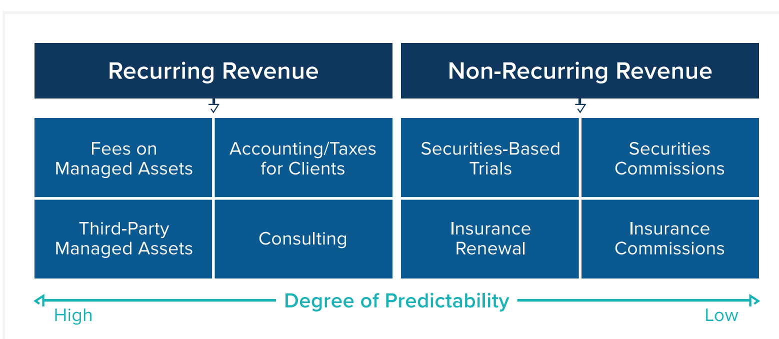
The key value drivers for any financial service practice are size, reliability, scalability, and transferability of the benefit stream enjoyed by the practice's owner(s). Gross revenue, AUM, and earnings, in many cases, provide a means of comparing one practice to another. A comprehensive comparative analysis of a seller's practice to its peers considers the strength and durability of the practice's revenues and/or earnings, as well as other critical factors related to assessing growth opportunities and risks present in the practice. These key performance indicators (KPI) are critical for the determination, monitoring, and growth of value for a business.

A complete assessment of value should look at the practice from every angle and consider an exhaustive list of details. FP Transitions evaluates these KPIs in the context of three main indices to provide a full picture of value: Transition Risk, Cash Flow Quality, and Market Demand.

Transition Risk refers to the likelihood that the households of the practice will transfer to the buyer or successor of the business and be retained in the years immediately following the sale. The gross revenue and cash flows of a practice are only as good as what can be transferred and retained. Transition Risk, which takes into account more than 20 factors, is applicable even in an internal sale as well, whether it applies to controlling or non-controlling interest. This index is intended to measure a practice's engagement with its clients and strength of both professional and enterprise goodwill. If the households are not strongly attached to the practice and the selling practitioner, then the buyer may or may not receive the full revenue, and cash flow will be negatively impacted. By looking at key factors affecting the Transition Risk of a given practice and selling situation, a professional and comprehensive valuation can be adjusted to offset the risk.

The next step is assessing the **Cash Flow Quality**. This assessment is based on more than 30 data points, but the three main factors that influence this index are the impact of the underlying household demographics, the size and repeatability of the revenues, and the efficiency of the underlying operational structure and sustainability of the practice's profits. Growth is a large component of this index and accounts for market growth, additional deposits from existing clients, new client assets, retirement plan rollovers, cash value conversion rates, and death benefits among others. This assessment emphasizes the details of the managed households including: age demographics, asset and revenue concentrations, surrender periods, asset growth or decline, multi-generational planning, and expenses associated with servicing existing clients and attracting new ones.

FIGURE 3.



By taking all these factors into account, the market multiple and discount rate can appropriately be adjusted for the unique risks and opportunities present in the subject practice. The Cash Flow Quality index of the business should also be benchmarked against the central tendency of the marketplace based on an extensive database of advisory firms and transactions, giving the advisor a relevant point of comparison to other successful practices.

The last category of key performance indicators is Market Demand. Market Demand accounts for discoveries made in assessing Cash Flow Quality and Transition Risk as well as other factors. A subject practice with strong Cash Flow Qualities and low Transition Risk would be expected to have higher demand. The geographic location of the practice and its proximity to a large, growing metropolitan region as well as the number of potential buyers in a given area are all factors considered in the Market Demand Index.

VALUE ≠ PRICE

Business valuations may serve many purposes to the end user, but they are designed with one primary objective: to provide an unbiased opinion or calculation of value for a specific purpose. Value opinions are intended to be informative, not declarative.

FIGURE 4.

Valuation Matrix

Deal Structure	Year: 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

Impact of Deal Terms on Practice Value

For asset sales, an FP Transitions market value assessment provides a cash value for the subject practice as well a matrix of prices based on different financing scenarios to demonstrate how deal terms may influence the purchase price. The matrix serves as a guide to illustrate the variability of price and provide a baseline for determining an asking price for the business and to guide transaction discussions, as seen Figure 4 example.

For sales of stock where equity is being valued, the value presented in the report will also be a cash value. As prices paid for stock vary widely, further assessment of transition specifics and business circumstances are required to determine an applicable adjusted value and price for the sale.
Deal terms play a major role in determining price. However, negotiations are the basis for determining the actual price. Value and price may be similar concepts, but they are not inextricably linked. The value of a practice is based on a comprehensive set of factors and considerations for each individual business. In contrast, price is the value of that practice adjusted for seller's demand and the terms of the transaction.

The value expressed in the valuation report is an opinion and should be used as a starting place for further negotiations. Ultimately, successful transactions– whether external or internal–require cooperation between the buyer and seller and are not wholly dependent on the expressed opinion of value.

CONCLUSION

Determining accurate value is the starting point for any path for your business, whether it's selling (internally or externally), acquisition, creating enhanced structures and systems, or building a powerful team. It allows you to plot a way forward to realize your vision for the business.

The industry and individual expectations of business performance and operations have increased. A complete, unbiased assessment of practice value should meet that level of sophistication. Assessing a business on a variety of factors based on purpose rather than just applying a simple rule of thumb across the board is an important evolution indicative of the impact of the financial services profession.

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