VALUE AND VALUATION FUNDAMENTALS

EXCERPT FROM "BUYING, SELLING, & VALUING FINANCIAL PRACTICES"

AN OVERVIEW

Most independent advisors have some idea of what their practice is worth. Whatever the method used, the concept of value represents one the largest, if not the largest and most valuable assets an advisor owns. Guessing at value is okay, right up until the time decisions and plans need to be made. There comes a time when plus or minus a hundred thousand dollars or so doesn't cut it. Engaging in any form of M&A activity is one of those times.

There is a lot of information in this chapter and the following chapter on value and valuation, some of it technical, some of it academic, and much of it practical. The goal of most advisors when the subject of valuation arises is to get to the right answer as quickly and inexpensively as possible and with the least amount of hassle. That goal is achievable, though the truth of the matter is that if you own anything larger and more complex than a book, you will likely need some help with the valuation process.

Valuations are performed for a variety of reasons. In addition to acquisitions, advisors might have a valuation performed for gift and estate purposes, for marital, partnership, or corporate dissolutions, for a sale of a minority interest in their corporation or limited liability company to a son, daughter, or a group of next-generation employees. Because of the differing objectives and standards of value for each of these situations, the valuation approach and methodology for each purpose can differ. Purpose drives value!

It is quite possible, even likely, that different standards of value and different valuation approaches and methods will produce different values when looking at the same target. That is okay and is how it is supposed to work. There is no one right approach, method, or standard that applies to every situation or that considers every possible circumstance. A valuation for the purposes of buying or selling an intangible asset such as a financial services or advisory practice will almost certainly provide a different answer, perhaps substantially different, than a valuation conducted for purposes of a divorce, a gift tax filing, or a shareholder dispute or some type of IRS-related filing. A firm that is acquiring the assets of a small practice, for example, and that insists on using a discounted cash flow method under the income approach to value the acquisition opportunity because that is the method it uses and has become comfortable with when selling equity internally, is likely making a mistake. In such an instance, the firm may be applying the wrong standard, approach, and method, as explained in more detail in the pages that follow.

This chapter is written to help advisors understand how the valuation process works from an analyst's or appraiser's perspective. The fundamentals, including standards of value, traditional valuation approaches, and the methods applied under each approach that are most applicable to independent financial service and advisory models are a key component. Other key concepts include which valuation approach and method works best when buying or selling stock or a minority interest in a going concern, as opposed to executing an asset sale or absorbing a seller's practice into a buyer's

business. We also will discuss how and when a rule of thumb approach (such as multiple of revenue or earnings) makes sense, and when it does not. Finally, advisors should become familiar with the credentials or designations that qualified analysts and appraisers earn so that qualifications can be quickly assessed. These value and valuation fundamentals will help every advisor in the M&A space understand what questions to ask, how things work, and why, in most cases, *you can't do this at home.*

Our goal here is not to teach advisors how to perform a valuation or even how to arrive at the specific value they might be willing to sell for, or buy for. The goal also is not to intimidate the average reader, though some of the information might do just that. Certain aspects of the valuation process are complicated, far more than most advisors know, and include a lot of assumptions and opinions—more than just the final number. The pages that follow are intended to provide insight into the actual valuation process. The end goal is to help prospective buyers and sellers of an independent model understand the basic but essential information needed to make decisions, create realistic plans, and to know what questions to ask.

Building on this information, Chapter 3 subsequently explains exactly how to value the assets of a book, practice, or business for the express purposes of buying it or selling it, as part of an advisor's exit plan. If you just want to know the right standard of value, the best valuation approach, and the best method to get the right answer for M&A purposes as a practice or business owner, skip to Chapter 3. And if you want to know the typical deal structures, payment terms, and the like that support this valuation method, Chapter 7 has the details. Consider this as a "fast map" to the specific answers some advisors want.

Principles of valuation have been constant for many years, but the independent financial services and advisory industry is changing rapidly all around us. This chapter and the next are aimed at bridging the gap between accepted tradition and practical solutions anchored by the reality of an active and efficient marketplace. The M&A space is still evolving, but it is much better organized than at any point in its history. Today, there is a proper way to value an advisory practice to determine its selling price and to quickly resolve the issue of valuation so that the parties can focus on the other critical attributes of a transaction and get the job done right the first time.

WHAT CREATES VALUE?

At its most basic level, the value of an independent financial services or advisory model lies in its client relationships. From this starting point, the discussion logically progresses to the revenue derived from those client relationships and, of course, the transferability of those relationships and that revenue. If, for some reason, the clients cannot or will not be transferred to another advisor, there is no inherent value from the buyer's perspective. These things are important, but fairly obvious.

So what *really* creates value? Why do 50 buyers line up for every book or practice to try to convince the seller that they're the right one? What is it that so many prospective buyers see when looking at a practice that another independent advisor has chosen to sell and walk away from? The answers to these questions suggest that "value" may include much more than a list of clients and the related trailing 12 months of revenue. The starting point is to look at the M&A process, certainly the valuation process, from the eyes of a buyer.

This industry is different from other professional service models. Independent advisory practices generally have predictable, recurring revenue, which creates predictable, recurring overhead. Sustainable growth rates tend to be in the neighborhood of 7% to 15% annually, sometimes higher. Overhead is not only predictable, it tends to be lower than most professional service models. Value, or selling price, is typically two to three times as much as in a similarly sized CPA, doctor, dentist,

attorney, or architectural practice. Clients, especially when tied to a specific advisor and affiliated with an independent broker-dealer or custodian, are transferable, in a measurable and reliable way. These things add up.

As Senator Everett Dirksen (1896–1969) once famously never said, "A billion here, a billion there; pretty soon it begins to add up to real money." (Apparently, the senator once attributed the statement to having been misquoted, but thought it sounded so good he never bothered to deny it!) My father repeated the statement at the dinner table so often and so fervently that I knew it must be true. The point is, all these things do add up, and for an independent advisor, it adds up to a lot. But the advisor we're talking about isn't the seller, it is those who want to be buyers.

Look at the average financial advisory practice as a business owner does, relying on the specific definitions from Chapter 1 in the process. By the time most practice owners sell, their revenue streams have often become stagnant. Real profitability is an afterthought since every dollar ultimately ends up passing through to the owner anyway. Clients, standing on a bedrock of trust, are loyal to the end. These same clients, however, often stop referring new business and investing additional assets as they see their sole advisor grow a little older and a little grayer. Practice growth tapers off, income soon follows, and when the markets become more turbulent than memory can recall, it becomes time to sell. So how does one measure the value of a practice that isn't growing, or may even be in decline?

One common way is to look to the recent revenue history, take a snapshot of the last quarter or the last year, and project that into the future. Common tools include a multiple of revenue or even a more basic revenue sharing arrangement. Another common tactic is to significantly discount the seller's value and penalize him or her for not building a business of enduring value, or for not selling on the way up.

Most smart, successful buyers don't approach value and valuation this way. We have the benefit of observing the interactions between buyers and sellers on a national, open-market platform, and every year we watch an increasingly large group of experienced buyers acquire one or two practices or businesses a year—basically, whenever they want to. These buyers know how to "buy value." Here's an example:

One buyer in particular acquires a practice through FP Transitions about once a year, usually a practice that has stopped growing, or may even be in decline. Within one or two years, they have it growing at 20% to 25% annually, every single time. Following the acquisition, the buyer's team meets with all of the professional advisors to the largest of the newly acquired clients and coordinates duties and roles with the clients' estate planning attorney, CPA or tax preparer, business or corporate attorney, insurance agent, and so on. In addition, the buyer's business creates a clear "value add" by providing a choice of advisors to work with, and a larger staff and array of services than the smaller practice owner could ever have achieved. Having purchased the seller's assets, the seller's cost structure is eliminated in favor of the buyer's. In this example, the buyer recognizes that the cost of client acquisition justifies the price of purchasing a practice, even one headed for stagnation.

Experienced buyers also provide one more important lesson: don't attempt to underprice the market or consistently offer substandard payment terms in an effort to find the best opportunities. In a competitive market full of smart and experienced buyers, sellers are quick to learn that when they receive a poor offer, there's another qualified buyer, or two, in line. Factor that into the process as the discussion moves to the technical aspects of value and valuation.

STANDARDS OF VALUE

Every appraisal report or valuation engagement should specifically identify and define the applicable "standard of value." The term "value," however, is relative to the circumstances and is not, as a single word or concept, considered to be specific enough when it comes to a formal valuation process.

When you decide to sell your car, for example, the standards of value that you need to consider include trade-in value, suggested retail value, private party value, and certified preowned value, among others: one car, but at least four different values, depending on the purpose. Given the specific purpose, all four answers as to value are correct, even though all the answers may be different.

A valuation expert will need to determine the level, or standard of value, that a buyer or seller is seeking in order to properly consider the relevant facts and circumstances and to deploy the right set of tools (valuation approaches and methods) for the job. In the independent financial services industry, there are four common standards of value. The following list, while not exhaustive, is what most valuation analysts encounter on a daily basis when talking to independent financial advisors.

Most Probable Selling Price

MPSP is the standard applicable to the majority of the valuation work FP Transitions is hired to perform. This standard of value is defined by the International Business Brokers Association as, "The price for the assets intended for sale which represents the total consideration most likely to be established between a seller and a buyer considering compulsion on the part of either buyer or seller, and potential financial, strategic, or nonfinancial benefits to the seller and probable buyers."[1]

This standard of value reflects the reality of the marketplace and is the standard or type of value applicable to books, practices, or businesses that might sell to a third-party buyer. This is the standard used in FP Transitions' Comprehensive Valuation Report, explained in detail in Chapter 3.

Fair Market Value

FMV is a standard of value set forth in IRS Revenue Ruling 59-60, and is defined as, "The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."[2]

Revenue Ruling 59-60 represents the 60th revenue ruling from 1959, which means that this ruling has been around for a long time. The relevance of this ruling is found in its clear and authoritative guidance on how to properly value privately held businesses. Revenue Rulings are public administrative rulings by the IRS that are deemed applicable to particular factual situations. There are several important revenue rulings that relate to the valuation of business interests, but none are more insightful or widely cited and utilized by the valuation profession than Revenue Ruling 59-60. Even though this Revenue Ruling is now well over 50 years old, it is still authoritative as to the methods and factors to be considered in valuing the stock of privately held practices. Although initially presented for use in estate and gift tax calculations, its usage has spread and it is now relied upon in the valuation of privately held businesses.

However, it is worth noting that this standard of value is more of an academic standard than the reality of what an advisor could expect to receive if they actually sold their practice or business to a third party. The goal isn't to find the highest or most probable selling price; it is usually to find a middle ground, a compromise of sorts. In fact, most buyers and sellers who are participating in an open marketplace are under some level of compulsion to buy or sell. If compulsion were not present, it stands to reason that a seller would never accept anything less than absolutely favorable deal terms at the highest value from his or her point of view. The inverse of this argument is applicable to buyers. Secondly, having knowledge of all reasonable facts is relative.

1. *IBBA University, a division of International Business Brokers Association, Inc., Introduction to Pricing Small Businesses. Course 220 V2.1 2006.*
2. *Revenue Ruling 59-60, 1959-1 C.B. 237.*

Investment Value

Investment value is value from the perspective of a particular buyer or investor, and may include both the value of the selling standalone entity as well as the value created by the strategic buyer through synergies and other means. A strategic buyer is typically willing to pay the investment value for the business because, as a result of the acquisition, the cost of goods may decrease for both firms with the value of the acquiring firm thereby increased.

Investment value is closely related to the MPSP and is used when valuing a practice for mergers or acquisitions and in some states for divorce or other litigious purposes. The primary difference that sets investment value and MPSP apart is that investment value is built on the chassis of fair market value.

Fair Value

Fair value is a rational and unbiased estimate of the potential market price of a good, service, or asset for which a market price cannot be readily determined, often because there is no established market for the asset. This standard is typically a function of state law and is often applied to cases involving divorce, partnership, or shareholder disputes. This approach considers objective factors such as supply versus demand, replacement costs, and acquisition costs, as well as subjective factors such as cost of and return on capital, risk characteristics, and individually perceived utility. Commonly, there is a willing buyer but not a willing seller.

Fair value is the standard of value used by the Financial Accounting Standards Board (FASB) in its pronouncements pertaining to business valuation. For financial reporting consistency, FASB states, “Fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”[3] Fair value is a market-based measurement, rather than an entity-specific measurement, and is determined using assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. As a result, an entity’s intention to hold an asset or to settle or otherwise fulfill a liability is not relevant in measuring fair value.

Advisors tend to think that “value” literally means “one value” and sometimes become frustrated with valuation analysts when things become a little more complicated and questions are asked about standards, approaches, and methods. Valuation, like financial planning and wealth management, is a professional, respected, and learned vocation; there’s a right way to do it and a wrong way. People can now easily obtain free financial plans online, and sometimes they don’t even need to talk to a human being to do so. This doesn’t mean they obtain the right answers, just that they have some kind of answers that make them feel better. In sum, advisors would be wise to follow their own advice and admonitions, especially during one of the most important times of their career.

VALUATION APPROACHES AND METHODS

Traditionally, there are three broad valuation approaches used to determine value. These approaches include the income approach, the market approach, and the asset approach. Within each approach there are various methods for calculating value as explained further on. Each method brings with it specific assumptions, benefits, and limitations. Depending on the purpose of the valuation, an analyst or appraiser may utilize more than one approach and provide each result with a weighting in order to arrive at a final conclusion.

That said, let’s review the traditional approaches first, and then the common methods applied under each approach second, keeping in mind the specific scope of this book—M&A activity between independent advisors.

3. Financial Accounting Standards Boards, “Statement of Financial Accounting Standards No. 157.”

Income Approach

The income approach is commonly recommended for valuing a financial services business or firm. This approach seeks to identify the future economic benefits to be generated by an entity and to discount those benefits due to the risk that those benefits might not be received when expected or at all. The income approach is founded on the concept that future economic benefit streams, namely net cash flows, can be forecasted and then discounted back to a present value by applying a rate of return reflecting the uncertainty or risk associated with the projections.

From the income approach, an appraiser will then typically employ either a capitalization of earnings/ cash flow method or the discounted earning/cash flow method to determine value. Each of these income methods is designed for specific purposes. Since net cash flow is the economic benefit most sought by investors, it is the preferred level of earnings used to value a business in the financial services industry. Accordingly, for the remainder of this particular section, we will refer to each method on a cash flow basis.

The point of explaining these two methods in greater detail is to help advisors understand the actual valuation process and the number of assumptions and subjective judgments that are involved. In talking to independent advisors, large and small, all across the country, there seems to be a feeling that this valuation process is like a black box. Buyers or sellers know what information they put into it, and they can see the number that comes out of it, but in between is a complete mystery. The part that is clear is that someone smart is in charge of the black box , the process is complicated, the algorithms beyond comprehension, and buyers or sellers charge thousands and thousands of dollars to complete the analysis. The assumption advisors make is that the process is sophisticated and reliable and must provide "the right answer." Advisors, whether buying or selling, need to know what is happening and understand that a certain level of subjectivity is involved.

Capitalization of Cash Flows The capitalization of cash flows method is typically used when the business has attained maturity or is expected to grow at a uniform rate in the future. This method assumes that the non-income related contributions to cash flow such as working capital, capital expenditures, and debt repayment will also grow at the same long-term rate proportionately to revenues. This method is not used as frequently as the discounted cash flow method to value businesses in this industry because the assumption that all financial factors of the business will grow uniformly is simply not true in most cases.

Discounted Cash Flow Method The most commonly used method from the income approach in the financial services industry is the discounted cash flow method, or DCF. The theory supporting the DCF method is that an entity's value is equal to its expected future cash flows, discounted at an appropriate rate (to accommodate the risks to receiving that cash flow, and including an appropriate return). The result is the present cash value of the business or firm. This method is used primarily when the valuator can estimate the known or expected future changes that are not uniform, may terminate or change after a period of time for specific elements of either income, receipts or expenditures of the business. Said more succinctly, the short-term growth in net cash flow is not expected to grow uniformly at a single rate.

The steps for calculating value of nonmarketable equity using this method are summarized as follows:

1. Review, compare, and make normalizing adjustments to financial statements.
2. Calculate adjusted net cash flow to invested capital (NCFIC).
3. Develop a risk-adjusted discount rate.
4. Determine the forecast period for growth to stabilize.

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5. NCFIC is then calculated for the forecasted growth.
6. Discount forecasted NCFIC to its present value using a weighted average cost of capital (WACC).
7. Determine an applicable terminal value by capitalizing the NCFIC after the forecasted growth above using the terminal growth rate and the WACC.
8. Discount terminal NCIFC using a WACC.
9. Sum the present values of the discounted forecasted cash flows and discounted terminal value.
10. To this value, the present value of the deferred tax benefits of amortized goodwill needs to be added.
11. The resulting value is the present value of future net cash flows to invested capital on a marketable basis.
12. If the source of the discount rate is from the return on publicly traded stocks, the value needs to be discounted to account for the fact that this is a privately held company.
13. Subtract interest-bearing debt.

Each of the methods from the income approach generally rely on federal income tax rates applicable to publicly traded C corporations. As a result, a value that uses these methods may be artificially reduced. If an advisor's entity structure is anything other than a C corporation (i.e., a passthrough tax conduit of any type), an adjustment needs to be made in order to recognize the benefits of a pass-through tax entity. Furthermore, to arrive at a value that best represents the value of a privately held practice that is not as liquid as a publicly traded company, an additional private company discount may be justified. These two concepts are very important and are often overlooked by consultants or IBDs trying to apply this method.

The income approach to valuation is a thorough and robust analysis. It takes time and an expert to do the job right, and it costs more than the approaches and methods explained further on, but there are times when this is exactly what is needed. Common examples include selling equity to one or more employees of a business or a firm, preparing for an arbitration hearing, or a courtroom setting that involves a question of value such as for a marital or partnership divorce.

Market Approach

The market approach is one of the most commonly used approaches to value a financial services book, practice, even a business sometimes, because it is a relatively easy concept for the end user to understand and apply, it is inexpensive, and it is reasonably accurate if there is private company data to support the conclusions. The concept is that value can be determined by comparing one company to other similar companies that have previously sold.

The market approach to business valuation is rooted in the economic principle of a fair and orderly market: that in a free market buyers will not pay more for a business, and sellers will not accept less, than the price of a comparable enterprise. This approach is similar in many respects to the "comparable sales" method that is commonly used in a real estate appraisal that, though a very different transaction, is an experience most independent advisors have experience with, while selling an advisory practice is typically a one-time, end-of-career event.

The market approach relies on reported transaction data from public companies or private companies, or both, depending on the valuation method and assignment and available, relevant data. There are

several commonly applied methods under the market approach that can be used to value a financial services book, practice, or business as listed next.

Guideline Transaction Method Under the GTM, transaction databases are used to identify sales of businesses or assets that are similar to the business being valued. The presumption is that these transactions reflect valuation multiples or market multiples that can provide an indication of the value of the subject company. When the current common stock prices of freely traded public companies are used, the method is known as the “guideline publicly traded company method.” When the method uses specific transactions of sales of all or at least a controlling interest in a privately held company, it is known as the “merger and acquisition method.” In both methods, the prices used are only from a few (seldom more than eight) similar and relevant public companies or private companies. For determining the value of a closely-held or family-controlled business, there can be many adjustments needed to match the data to the ownership interest being bought or sold. As applied by most valuation analysts, the GTM uses both publicly traded companies and privately held businesses in its analysis, if both levels of data provide relevant and useful comparisons.

The steps for calculating value using this method are summarized here:

1. Review, compare, and make normalizing adjustments to financial statements.
2. If available, obtain transaction data of relevant comparable publicly traded companies from available databases.
3. If available obtain transaction data of relevant comparable privately held companies from available databases.
4. Make appropriate adjustments to the comparable transaction data to ensure the subject company data is being compared on a similar basis.
5. Develop a multiple of revenue or earnings, or a range of such multiples, from market data that will be applied to the company being valued.

The accuracy and reliability of the GTM depends on the thoroughness of the comparative data being reviewed (i.e., how detailed is it and how accurately it was reported?) and the number of businesses available that are similar, or very similar, to the subject of the valuation. Transaction databases that appraisers have access to provide a mixture of both asset-based sales as well as stock sales, and there are no consistent delivery requirements placed on the submission of data by private parties, often business brokers, or intermediaries. As a result, the prices and ratios reported from these transactions can vary and are often not fully disclosed. This can make it quite difficult for an appraiser to make an apples-to-apples comparison. Said in a more positive manner, the market-based approaches are only as good as the underlying database of information.

Direct Market Data Method The DMDM method is similar in many respects to the GTM, except that it relies entirely on transaction data of similar, privately held practices and businesses. The direct market data method involves the use of actual industry sales transactions. This market based method tends to result in the most reliable conclusion when the comparable transactions were structured similarly to the anticipated transaction expected by the buyer or seller and if there is sufficient information available from the supporting database, which helps to explain why relatively few valuators use this approach.

The market approach and the DMDM method is used by FP Transitions in its valuation work in support of M&A activity between buyers and sellers who are trying to understand the market prices agreed to by others in similarly structured deals. With a large and complete database of private transactions between independent advisors, the DMDM is accurate and reliable in that it reflects actual and recent market activity. The database allows FP Transitions’ valuation analysts to group transactions by size, location, revenue type, regulatory structure, payment terms, tax structures, and even the standard of value with a high degree of accuracy.

Asset Approach or Asset-Based Valuation Approach

This valuation approach focuses on a company's net asset value, or the fair market value of its total assets minus its total liabilities. The asset-based approach basically asks what it would cost to reproduce the physical business. There is some room for interpretation in the asset approach in terms of deciding which of the company's assets and liabilities to include in the valuation, and how to measure the worth of each. This valuation approach consists of multiple methods, but the two most commonly used methods include book value and adjusted net asset value.

Book Value Technically, this is an accounting concept and refers to the sum of the asset accounts, net of depreciation and amortization, less the liability accounts, as shown on a balance sheet.

Adjusted Net Asset Value Method The adjusted net asset value method removes all of the business's assets and liabilities not being used to support operations from the balance sheet and the remaining assets and liabilities are restated to their fair market value. This method is applicable when estimating the value of a nonoperating business (e.g., holding or investment companies) that has a significant amount of capital invested in its assets or a company that will not continue operations into the future and will be liquidating its assets. The limitation to this approach is that it does not account for operating earnings, making it inappropriate to use when valuing intangible assets such as goodwill. Since the client list is the primary asset of a financial services or advisory practice, this method isn't of much use in this industry.

Methods from the asset approach are often appropriate in the following situations:

- *The business is considering liquidating, or going out of business.*
- *The business has no earnings history.*
- *The business's earnings cannot be reliably estimated.*
- *The business depends heavily on competitive contracts and there is no consistent, predictable customer base (e.g., construction companies).*
- *The business derives little or no value from labor or intangible assets.*
- *A significant portion of the business's assets are composed of liquid assets or other investments (e.g., marketable securities, real estate, mineral rights).*

For the reasons stated here, the methods from the asset approach are not often called for when valuing a financial services or advisory practice or business in the M&A space.

It is interesting to note that both the income and the market approaches look to a marketplace for data from which to make a valuation decision. If a valuation expert has a detailed and deep database of independent books, practices, and businesses from one particular industry, why would they look to publicly traded companies and then discount or adjust back to find value? Why not just look to the direct market data? The problem is, there is only one such database of sufficient depth and detail in this industry and FP Transitions owns it, and continues to build on it. In the end, both approaches require qualified analysts and good data—but one source of data is much closer to home than the other.

Consider Table 2.1 to help you understand the application of the various valuation standards, approaches and methods, and the degree of analysis applicable to each level. Covered in this table, from left to right, is the CVR or Comprehensive Valuation Report, a valuation for SBA loan purposes, a valuation of a 100% equity interest, a valuation of a minority ownership stake for use in FP Transitions' succession management program (SMP), a valuation for IRS tax purposes, a valuation for IRS tax purposes as a minority interest, a valuation of a disputed interest, and a valuation for a disputed minority interest. Under each of these headings is the type of valuation report that is produced, the level of certification needed to produce and sign off on the valuation report, and the estimated number of hours to prepare the valuation, among other things.

TABLE 2.1 : Application of Various Valuation Standards and Methods

CHARACTERISTICS / PURPOSE	CVR	SBA LOAN	100% EQUITY	SMP MINORITY	TAX FILING 100%	TAX FILING MINORITY	DISPUTED 100%	DISPUTED MINORITY
Type of Report	Calculation	Appraisal	Restricted	Restricted	Restricted	Appraisal	Appraisal	Appraisal
Level of Certification	CVA	CVA, ASA	CVA, ASA	CVA, ASA	CVA, ASA	CVA, ASA	CVA, ASA	CVA, ASA
Hours to prepare / report	5	10	20	30	40	60	50+	60+
Client	Owner	Lender	Owner	Owner	Owner	Owner	Owner	Owner
Other Intended Readers(s)	Owner	SBA-buyer		G2s	IRS	IRS	Court	Court
Transfer anticipated	Y		N	Y	Y	Y	Y	Y
Asset	Y	Y		N	N	N	N	N
Shares		N		Y	Y	Y	Y	Y
Excluded & Assets								
Cash & Equivalents	Y	Y	N	N	N	N	N	N
Non Operating Assets	Y	Y	N	Y	Y	Y	Y	Y
Acct Receivable	Y	Y	N	N	N	N	N	N
Acct Payable	Y	Y	N	N	N	N	N	N
Included Assets								
Non-Compete	Y	Y	?	Y	?	?	?	?
Non-solicit	Y	Y	?	Y	?	?	?	?
Consulting	Y	Y	?	?	?	?	?	?
Employment				?	?	?	?	?
Debt Assumptions								
Seller note % sale price	70%	N	N	N	N	N	N	N
Seller note term	5	N	N	N	N	N	N	N
Interest rate	6%	N	N	N	N	N	N	N
Economic Conditions								
National		Y	Y	Y	Y	Y	Y	Y
Regional		Y	Y	Y	Y	Y	Y	Y
Local				Y	Y	Y	Y	Y
Industry Factors								
RMA data comparisons								
IBIS World / First Research		Y	Y	Y	Y	Y	Y	Y
Bloomberg			Y	Y	Y	Y	Y	Y
FINANCIAL ANALYSIS								
Adjusted P&L		Y	Y	Y	Y	Y	Y	Y
Adjusted balance sheet			Y	Y	Y	Y	Y	Y
Net Cash Flow Historical			Y	Y	Y	Y	Y	Y
Forecasted P&L			Y	Y	Y	Y	Y	Y
Forecasted Balance Sheets			Y	Y	Y	Y	Y	Y
Forecasted Net Cash Flow			Y	Y	Y	Y	Y	Y
Comparison to Industry			Limited	Limited	Detail	Detail	Detail	Detail
Market Debt / TC			Y	Y	Y	Y	Y	Y
Working Capital			Limited	Limited	Detail	Detail	Detail	Detail
Capital Expenditures			Limited	Limited	Detail	Detail	Detail	Detail
METHODOLOGIES								
FP Transitions DMDM - (CVR)	Y	Y	Y	Y	Y	Y	Y	Y
Single Period Capitalization		Y						
WACC		Y	Y	Y	Y	Y	Y	Y
Discounted Cash Flow		Y	Y	Y	Y	Y	Y	Y
Private Entity Discount			Y	Y	Y	Y	Y	Y
Tax Pass Through Premium			Y	Y	Y	Y	Y	Y
DLOM (Liquidity)				Y		Y		Y
DLOC (Control)				Y		Y		Y
Non FMV Factors in CVR			Y	Y	Y	Y	Y	Y

THE RULE OF THUMB METHOD OF VALUATION

A rule of thumb. A multiple of revenue. A multiple of earnings. A multiple of AUM. So many variations, and so many opinions. Are they reliable? Is one method more accurate than the others? Should they even be used at all?

Professionally, at least from the vantage point of a certified valuation analyst (CVA) or an appraiser, a multiple of revenue deserves little to no weight as a reliable and accurate valuation method. Let's start with the positive aspects of this valuation method and figure out if it can work for you— there are limited circumstances where it does make sense.

The best thing about using a rule of thumb approach is that it is simple. It is easy to apply and easy to understand. In the financial services or advisory industry, the most commonly applied rule of thumb is the gross revenue multiple, or GRM. Practically, this is a market-based valuation method and is assumed by many advisors to be reasonably accurate. A multiple of AUM is no longer a useful method for this industry because of the variations in fee structures currently in use. A multiple of earnings such as EBIT or EBITDA (earnings before interest, taxes, depreciation, and amortization) or EBOC (earnings before owner's compensation) really doesn't make sense at the job/book level because these one-owner models don't aspire toward profitability. It all goes home, one way or the other. The margin of error is simply too great at the practice, business, or firm levels of ownership for this or any other rule of thumb approach.

The multiple of revenue can work well for, and should be limited to, job or book owners who are buying or selling less than $50,000 to $75,000 of recurring gross revenue or maybe twice that amount of transactional revenue out of a sole proprietorship model. At these levels, the margin of error when coupled with reasonable payment terms is acceptable to most buyers and sellers. If an advisor is selling, or buying, a job or a book that has no entity structure and no profits to speak of, primarily using a simple payment arrangement such as an earn-out or a revenue-splitting mechanism (more on this later) with little or no down payment, then a multiple of gross revenue is close enough and can be the right tool for the job, no pun intended.

Over the past five years, the GRM paid by buyers to sellers for every dollar of recurring revenue in an independent financial services book (fees and trails) ranged from a low of 1.40 to a high of 3.0 times trailing 12 months recurring revenue (TTMRR), after any applicable broker-dealer override (TTMRR-BD). (See Figure 2.1.) The multiple paid by third-party buyers for every dollar of nonrecurring revenue ranged from a low of 0.00 to a high of 1.60 X TTMR-BD. That means that for the average fee-based book in this industry, the range of multiples is from 0.00 to 3.00 X TTMR-BD. The recent average GRM for recurring revenue is about 2.36 X TTMRR-BD, but it changes or drifts from year to year and reflects the current sentiment of "the crowd" or, more appropriately, the open market and leans heavily toward recurring, fee-based revenue supported by standard deal terms. In other words, sellers don't get to realistically make up, or guess at, the multiple, and the payment terms, and the tax structure. Unfortunately, the way it usually works in the field is that the seller guesses at his or her value using a multiple,

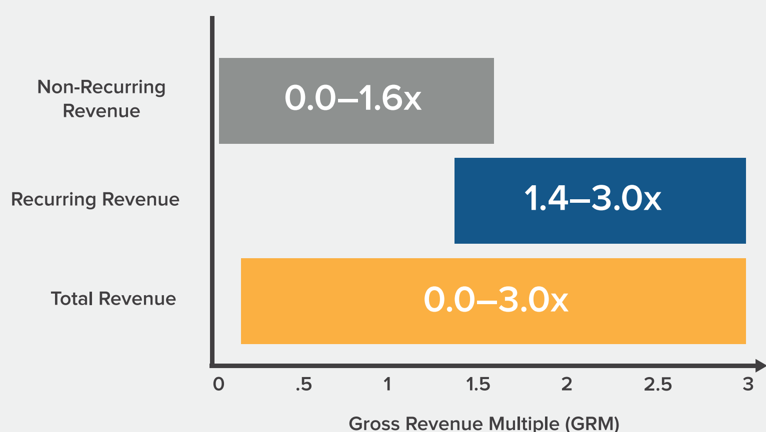

FIGURE 2.1 : Gross Revenue Multiple by Revenue Type

the buyer guesses at the payment terms and tax structure based on what he or she needs, and the result is considered an acceptable compromise. Playing a guessing game around $100,000 of value or more doesn't usually turn out very well.

Rules of thumb have some other significant drawbacks that make them inapplicable to practices, businesses, and firms. The various rules of thumb do not factor in risks that can materially impact value such as capital structure, regulatory issues, liabilities, profitability, growth rates, client demographics, and infrastructure, to name just a few. This method also does not consider the differences in cash flow quality or transition risk that might affect one book versus another. In other words, a rule of thumb treats every book as being equal to any other book except for the amount of revenue generated.

Rules of thumb are not empirical and have not been examined or tested to determine their validity. Rules of thumb, practically speaking, are often misstatements taken out of context and often applied incorrectly. Here are some specific examples: a multiple of 3.0 X TTMR is a great result at first glance, but not if the buyer insists on paying nothing down, and the entire balance on a fully contingent, earn-out basis over five years, which generates ordinary income tax rates to the seller; or perhaps a multiple of 2.25 X TTMR with 35% cash down, nonrefundable, and the balance seller-financed over just 24 months with one look-back provision (i.e., a performance-based promissory note) and all monies taxed to the seller at long-term capital gains rates. Which is the better deal? What about an offer of 1.35 X TTMR all cash and at preferential tax rates? Is the seller who sold at a GRM of 3.0 actually better off than the seller who sold at a GRM of 2.25, or even 1.35? Without all the underlying facts, and without knowing the final results years later, it is impossible to know.

When you hear about such multiples from a "successful" seller, or read about them in a trade publication, consider how much information is known and unknown. Even at the job or book level, the best advice is this: do not focus on the multiple without considering all the underlying deal terms, tax structures, and legal obligations, to support it. A simple multiple supported by simple paperwork often creates simply a mess.

For everyone else, specifically those advisors who own and have built a practice or a business or who seek to acquire such a model, a GRM is, at most, a starting point. Use a GRM to provide a safety check to the reasonability of a more formal and sophisticated calculation of value or appraisal, or a basic test to see if a more formal valuation is worth the time and expense. A GRM, for most practice and business owners, can be a decent place to start; it's just not a very good place to end. To be clear, practice and business owners should always progress to a more formal and thorough analysis on the issue of value.

APPLICATION OF STANDARDS AND APPROACHES

In this section, we compare the valuation results of two practices to illustrate the different levels of value that similar practices can have. The two practices used in the following illustration were valued for different purposes, utilized different standards of value, and employed different valuation approaches.

The purpose of this illustration is not to demonstrate which approach is right or wrong or yields the highest or "best" level of value, depending on a buyer or seller's perspective. Rather, it is to highlight value and valuation fundamentals: (a) that purpose informs value; and (b) randomly selecting valuation standards, approaches and methods to value a practice, or being sold a one-size-fits-all valuation solution without entirely understanding the process, can produce a value that is irrelevant.

Both practices in this illustration are Registered Investment Advisors (RIAs) with an independent broker-dealer (IBD) affiliation. They both are single-owner S corporations with relatively flat and stable growth rates and similar amounts of recurring and nonrecurring revenue. Both are located in

TABLE 2.2 :
A Comparison of Two Practices

	PRACTICE A	PRACTICE B
Entity Structure	S-Corp	S-Corp
Ownership	One Shareholder	One Shareholder
Organizational Structure	Silo (one producer only)	Silo (one producer only)
Regulatory Structure	RIA/RR	RIA/RR
Annual Recurring Gross Revenue	$400,000	$365,000
Annual Nonrecurring Gross Revenue	$130,000	$112,000
Total Annual Gross Revenue	$530,000	$477,000
Annual Revenue Growth Rate	Flat (0% to 3%)	Flat (0% to 3%)

or near a major metropolitan area. Table 2.2 provides a brief comparison of the two practices side by side.

Practice A is actually an example extracted from the previous, bestselling M&A book in this industry. Approximately 10 years ago, the authors of this book devoted an entire chapter to expertly explaining and working through a sample valuation process using both an income and market approach. While the purpose for the example wasn't made entirely clear (the subject matter was M&A activity), it was stated that the valuation results of $567,000 are what a prudent investor would pay for Practice A's expected future income stream given the practice's specific risks. The authors placed an 80% weighting on the income approach and split the remaining 20% between two market methods, the guideline public company method and the merger and acquisition analysis method , which they said reflected recent merger and acquisition prices for reasonably comparable companies, noting that reliability of the underlying data was questionable, thus the reduced weighting. The resulting value was stated as the fair market value of a 100% interest in the common stock of the practice.

Practice B is an actual advisor who listed and sold on the open market in 2011. FP Transitions was hired for the purpose of performing a valuation to determine what a buyer would pay for the practice if it was listed for sale on the open market, assuming normal market conditions, a reasonable marketing period, and standard payment terms upon sale or acquisition, an example of the most probable selling price standard of value. Using a market approach and the direct market data method, relying on a database of over 1,000 transactions at that time, the value was estimated to be $1,009,000 (we will discuss the specific methodology in more detail in the following chapter).At the seller's request, the practice was listed for sale at $1.1 million and received 72 formal inquiries from interested buyers and three written offers. Within four weeks, the practice sold for $1 million with terms of 35% down, the balance seller-financed over four years using a performance-based promissory note. The buyer also maintained the seller's office lease and retained key staff members. One year later, a post-closing transition rate of 96% was reported (based on gross revenues received by the buyer). Note that Practice B was also about 10% smaller than Practice A in terms of gross revenue.

Table 2.3 contains a summary of the valuation results side by side. The valuation results of Practice A may very well have been accurate given the choice of standard of value, valuation approach, and valuation method. It would also be uncommon for a buyer to acquire the stock of Practice A given its relatively small size and specific regulatory structure; it is far more likely to have been an asset sale. But that is comparing academics to the reality of the marketplace. In fact, if the same standard

TABLE 2.3 : A Summary of Valuation Results

	PRACTICE A	PRACTICE B
Purpose	What would an investor pay for stock?	Sale to a third party
Standard of Value	Fair Market Value	Most Probable Selling Price
Approach	80% Income – Capitalization of Earnings 10% Market – Public Company 10% – Public Comapny M&A	100% Market – Direct Market Data Method
Valuation Results	$567,000	$1,009,000

of value, method, and approach were applied to Practice B, the seller would have lost more than $400,000 in value. This isn't an isolated example, and it isn't "merely academic" when the wrong approach is used on the largest, most valuable asset most advisors own.

The takeaway is this: the applicability of each standard of value, valuation approach, and underlying methodology is based on the purpose and circumstances of the practice to be valued, as well as the appraiser's understanding of all the relevant facts at hand. In most cases, one standard and approach is better suited for the job than the others, but no single standard applies in every instance. The process of valuing a dynamic, fluid, and personality-based practice or business like those in this industry is a more complex task than most advisors, buyers or sellers, realize. It is one thing to hire a valuation professional; it is another thing to let him or her take charge of one of the most important decisions of your financial life.

MAKING SENSE OF IT ALL

In summing up the valuation fundamentals covered in this chapter, suffice it to say that independent advisors have choices to make. Valuing a highly regulated, relationship-based practice or business is challenging work, but it isn't that hard, or expensive in most cases, to do the job right. Simple approaches and quick answers may be appealing, but they are rarely accurate and such inaccuracy tends to cost many times what a formal valuation or appraisal actually costs, to one party or the other.

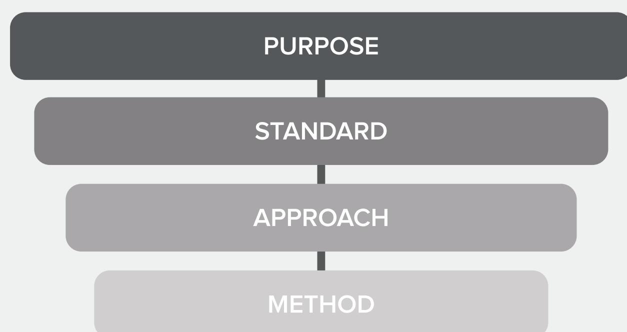

FIGURE 2.2 : Valuation Considerations

The starting place for most advisors in the M&A space is the simple mantra: purpose, standard, approach, and method (Figure 2.2.). These are the key choices that need to be made. Work with a qualified analyst or appraiser to determine the best choices at each level for your particular circumstances. As an advisor interested in buying or selling, you don't need to know how to perform a valuation. In fact, a disinterested third party is a must, but you do need to help your chosen valuation analyst make the correct decisions as to the purpose, standard, approach, and method in order to obtain a reliable and accurate valuation result. There is no one set answer that applies to all situations.

For advisors who follow the general structuring techniques of an asset-based purchase or sale, with a meaningful down payment and common payment terms, the standard of most probable selling price is the best choice. If the other party in your transaction insists on a different standard, ask for their justification and consider the consequences. Remember that, while qualified analysts will not allow an advisor to buy a specific valuation result, choosing a less applicable or incorrect standard, approach, or method can have the same effect.

In a nutshell, the least appropriate of the traditional valuation approaches is the asset-based approach. Think of this as the value of the "bricks and mortar." This method is generally not applicable to financial services or advisory work at any ownership level because there are relatively few valuable tangible assets (computers, copiers, and file cabinets notwithstanding). In contrast, the real value of a financial services or advisory model lies in the strength of its client relationships, the quality of the cash flow generated by those relationships, and their transferability.

At the other end of the spectrum, the income approach analyzes the earnings of a given book, practice, business, or firm. Think of this approach as the value of the income stream that could be derived from the bricks and mortar. Earnings-based appraisals (think bottom-line looking up) using the discounted cash flow (DCF) or the capitalized-earnings method work best and should also be the primary method for businesses and firms in support of an internal ownership track where advisors purchase a minority interest of stock in a profitable and ongoing model. Recall that this group comprises just 5% to 8% of the industry at this time.

The income approach should also be used for any courtroom-based valuation activity such as a partnership dissolution or marital dissolution, and certainly for an arbitration-related issue. FP Transitions provides valuations using the income approach to advisors every day, but not for most of the basic, straightforward M&A activity that applies to prospective buyers and sellers.

Understand that when performed correctly, this approach requires an in-depth analysis of a business's or firm's financial performance and financial reports. This isn't a process that can be performed online or for free, if it is done right. The income approach requires a qualified, competent, disinterested professional to perform the analysis required to generate a reliable valuation result.

The market approach compares the practice being valued to other, similar practices that have recently been sold under similar, if not identical, circumstances. If an advisor is going to participate in the open market, as either buyer or seller, knowing what similar practices sold for as of yesterday is a fair, accurate, and relatively inexpensive way to determine the value of what you're selling today. If you're going to participate in the market, or seek to benefit from the market that supports valuation data, why not listen to the market data?

This approach is typically a "top-line, looking down" view that reflects the way most of this industry's ownership structures are operated on a day-to-day basis. The market approach is applicable to books, practices, and those businesses that sell externally to a third-party buyer. It has many positive attributes. It is accurate, inexpensive, and easily understandable, but requires one critical component to make it all work: supporting data. Without privately held transactional data in sufficient quantity and of sufficient quality, it's like comparing apples to lemons. This is the point of Chapter 3, "Solving Valuation."

Rules of thumb also deserve some attention here. Simply put, if an advisor does not understand how valuation works or doesn't see the need of paying someone else for the answer, they'll just multiply recurring revenue by a factor of two (or maybe a little higher) and trust that it's close enough and that the other party will not have, or insist on, a better answer.

A multiple of revenue might work for the smallest and lowest-valued ownership level (jobs or books) because, even though it is really just a best guess , usually without any underlying factual basis, it isn't wrong enough to warrant spending the time and money on a better answer.

In the end, choosing the correct path from a standard approach and method isn't a matter of which is better or, more accurate, or more expensive or less expensive, it is solely a function of addressing the specific purpose of the valuation.

WHO IS QUALIFIED? (TO OFFER AN OPINION OF VALUE)

If you are in need of a formal valuation, be sure to work with a qualified individual. Refer back to Table 2.1 for a detailed, quick checklist of the different valuation approaches and methods, and the competency standards for each level. The field of valuation, like financial services and advisory functions, has its own professional designations and governing bodies. These regulatory bodies include the American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), the National Association of Certified Valuators and Analysts (NACVA), and the American Institute of Certified Public Accountants (AICPA). These regulatory bodies issue the respected valuation credentials, or designations, set forth in Figure 2.3.

Whoever you choose to value or appraise what you've built or seek to acquire, rely only on valuation analysts or appraisers that are certified and have earned the necessary and proper designations. If the person or company offering you an opinion has not earned one of these designations, you have an unqualified person telling you what they think about one of the most valuable assets you own, or will acquire. While everyone seems to have an opinion nowadays, this one matters.

To this end, it is highly likely that the practice management personnel at a broker-dealer or custodian have no special valuation training or qualifications or market transaction data upon which to base their opinions; answering hundreds of questions the same way does not equal qualification or certification. In addition, as well intentioned as they may be, these folks have a stake in the outcome. That is why most IBDs and custodians smartly do not wade into the value and valuation space. If one side of a transaction, either buyer or seller, relies on an unqualified opinion from an interested third party, he or she should be called out. We're being hard on this issue. The point is, credentials and expertise and experience matter.

If you are going to have a valuation performed, for any purpose, make sure the analyst or appraiser holds at least one of the following designations:

- *Certified Valuation Analyst (CVA)*
- *Accredited Senior Appraiser (ASA)*
- *Accredited in Busienss Appraisal Review (ABAR)*
- *Master Certified Busienss Appraiser (MCBA or CBA)*
- *Accredited in Business Valuation (ABV)*
- *Master Analyst in Financial Forensics (MAFF)*

In some instances this list might also include a Certified Vinancial Analyst (CFA). A CPA, even with a PFS, is not usually qualified unless one or more of the above designations have been earned. The same holds true for an MBA without one or more of the designations above.

In addition, some knowledge of this industry's regulatory or compliance aspects is helpful in the valuation process

FIGURE 2.3 : Valuation Credentials

VALUATIONS FOR BANK FINANCING

As you'll read later, more and more advisors are now able to utilize bank financing in their transactions to help implement an exit plan or to accelerate their succession plans. Reasonable and appropriate bank financing for acquisition purposes is a relatively recent and major step forward for independent advisors in the M&A space. While most independent advisors do not need a formal appraisal for their M&A activity, it is a distinct possibility that a specific type of valuation will be needed if or when bank financing is utilized to complete the transaction.

Since the financial crisis of 2008, bank lending standards have become noticeably more stringent. This is easily observed by visiting the Small Business Administration website and reviewing the ongoing changes made to their lending and processing standard operating procedures (SOPs),

SOP 50 10 5, specifically. This SOP states the conditions that must be met by both the borrower and lender to secure and provide, respectively, an SBA 7(a) or 504 loan. (Bank financing is addressed in detail in Chapter 7.)

Since 2009, SOP 50 10 5 has been updated annually with each iteration containing substantial changes. For example, in 2012, the entire Change of Ownership section for this SOP was rewritten, and in 2013, the SOP no longer allowed lenders to accept appraisals from certified public accountants (CPAs) without further valuation accreditation. According to the SBA, appraisals for a change of ownership must be completed by a "qualified source," which is defined as an individual who regularly receives compensation for business appraisals and is accredited by one of the following recognized organizations:

- *American Society of Appraisers*
- *Institute of Business Appraisers*
- *American Institute of Certified Public Accountants*
- *National Association of Certified Valuators and Analysts*
- *International Society of Business Analysts*

In addition to being accredited, appraisers must be independent and have no financial or other interest in the property being appraised or the loan transaction; be capable of rendering an unbiased opinion; be hired and paid by the lender, not the borrower or the seller of the property or business; and, be state-certified or licensed in accordance with the Uniform Standards of Professional Appraisal Practice.

In addition to the standards set forth by organizations such as the Institute of Business Appraisers (IBA) and American Society of Appraisers (ASA), qualified business appraisers must follow the Uniform Standards of Professional Appraisal Practice (USPAP), recognized as the official source of appraisal standards in North America

Read more in our book **Buying, Selling & Valuing Financial Practices – The FP Transitions M&A Guide** written by FP Transitions president David Grau Sr., JD. Available now on Amazon.

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.

Since opening its doors in 1999, FP Transitions has completed more financial service transactions than any investment banker or business-broker in the country. FP Transitions' expertise also includes continuity planning, practice benchmarking, compensation studies, entity formation, mergers and acquisitions, and equity compensation strategies.

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