M&A REPORT

TRENDS IN TRANSACTIONS & VALUATION STUDY

FP TRANSITIONS®

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Introduction

We are pleased to bring you our 2019 Trends in Transactions & Valuation Study. Over the past 20 years, FP Transitions has been privileged to occupy a unique vantage point in the market. We have been much more than a spectator to the emergence of independent wealth advisors; we have participated in many of the dramatic changes in this industry by helping to create and define new ways of viewing and modeling a wealth advisory practice. In our early days, our toughest mission was to convince advisors that their practices even had a value. A short 20 years later, the advisory world has changed dramatically.

As the leader in mergers and acquisitions, we have helped guide many of the transactions that form part of the current landscape. Our databases include analytics from over 1,500 external sale and merger transactions as well as over 11,000 business valuations from the last two decades. From our years of experience and collected data, we are able to examine some of the major trends currently affecting owners of independent financial advisory businesses and provide context for our data within the evolving industry.

The shift from product-driven sales to advice-driven service has changed not only the way we value advisory firms, but also how they are structured and how they are sold. The need for enduring firms that provide advice over their clients' lifetimes—not the career tenure of an individual advisor—has led to the emergence of multi-owner enterprises capable of serving clients as they continue to grow beyond the founder's involvement. A new breed of emerging enterprises, often headed by younger advisors, are forging new ways to compete in the market and are, in many ways, matching the services and offerings of much larger competitors.

FP Transitions has been on the forefront of these developments, not only helping pioneer the use of bank financing in advisor transactions, but also helping create enterprises with enduring value, many of which have gone on to become some of the most successful acquirers in the marketplace. We have watched the evolution of the advisory business first-hand. As the trusted authority on valuing and transitioning Registered Investment Advisors, Registered Representatives, and independent insurance businesses, our team is constantly asking "What is happening in the market now?" and "Where is it going?" This report focuses on these questions.

Throughout this study, you'll read about the evolution of business structure to meet current demands. The need for talent, infrastructure, and systems is leading to the development of new enterprises that are replacing solo advisors as well as old practice models. This evolution has fueled the increase in acquisitions, leading some to speculate that the industry is destined for consolidation, as has happened in other financial industries such as commercial insurance. The article "The Impact of Consolidation" addresses this topic and provides valuable perspective for both small and mid-size firms who want to compete with the big-name acquirers.

The sheer growth of wealth in the last ten years, coupled with the acceleration in the number of high earning/high saving families, has outstripped the number of newly licensed advisors entering the market. While automated and online services have met some of this need, advisory firms with robust offerings continue to experience growth rates (measured in both assets under management as well as revenue) in excess of 10% per year. But this growth has not been shared equally across financial advisory businesses. In "Business Factors Supporting Growth & Resilience," we delve into our valuation database to analyze five-year growth rates, comparing businesses by size and structure to highlight advantages and weaknesses of each model.

As these firms have grown, there is no longer any doubt that they are valuable, but many questions persist around how to determine value and its application as a strategic tool. What drives value? How is value connected to price? Our Valuation Team illuminates the current trends in the articles "Drivers of Growth" and "Technology & Value," and provides insight for both buyers and sellers in the piece "Price, Not Value, Is the Product of Negotiation." Our colleagues at Live Oak Bank, the largest lender to independent financial practices, weigh in on the connection between valuation, purchase price, and lender approvals in the article "Value, Price, & Lender Approvals."

In addition to in-depth discussions of business growth and value factors, our Mergers & Acquisitions Specialists provide expert insight into the past year's transactional data in articles "Components of a Deal" and "Buyers in the Marketplace."

One thing is certain: this is not an industry where the status quo is a safe place to be. For advisor-owners to thrive and grow, they will need to be willing to change and adjust their models as well as be nimble and creative acquirers and business developers. Successful acquirers may have the opportunity to hone their craft over time, but an advisor aiming to sell his or her business gets one chance to do it right. As you review the data, please take the opportunity to find yourself within the broader picture, see where you fit in, and determine where you would like to be.

Brad Bueermann, CEO

The Impact of Consolidation

There has been a fair amount of talk over the past decades about consolidation in the financial services industry. Most of the white papers and articles addressing this concept have presented it in a negative light as though it signals the end of the lifestyle practices that dot the landscape in this profession. Industry regulation, growth, technology, fee compression, competition, and aging advisors forced smaller practices to consolidate just to survive—at least that was the working theory.

As the original organizers of the open marketplace for independent advisors seeking to sell or to acquire, we have a slightly different perspective on consolidation; we view it in a very positive light. Consolidation looks very different than what the prognosticators laid out decades ago. From our vantage point of working with businesses below $2 billion in AUM, we've observed the industry is indeed experiencing some consolidation, but not only due to acquisitions or roll-ups by companies like Focus Financial, United Capital, or Dynasty. The consolidation that we see every day is owners of stronger, sustainable enterprises acquiring smaller, one-generational books and practices.

Viewed in this light, how better to look after 250 clients or households when a single-owner advisory practice nears retirement than to find a very similarly structured business that can step in, take over, and provide for the staff members as well? This process works for the buyers, the sellers, and, most importantly, the clients.

As the financial advisory profession matures, practice owners have been compelled to grow and improve—a very natural part of facing competition head on. But eventually, time and energy begin to wane. As retirement, or even simply slowing down, begins to appear on the horizon for single-owner books and practices, advisors are faced with three choices:

- Maintain the practice as long as possible while gradually working fewer hours and thereby winding it down;
- Invest the time, money, and resources to grow and strengthen the business and transition to an internal successor team; or
- Sell to or merge with a third party.

Many advisors tell us that they don't want to sell to a third party—ever. The problem is that these same advisors haven't built a sustainable enterprise of their own, which leaves them with few options, including attrition. Letting a practice wind down slowly as the founding advisor retires on the job, stops taking on new clients, and stops serving the small ones is an attractive option for many advisors, as it preserves the cash flow and practice for an additional five to perhaps ten years. If there is a health event during that time frame, the business is not particularly salable since the owner has been scaling back. In time, there is nothing left to sell. Building a sustainable business, however, is the best option if the founding owner starts soon enough (at least ten years prior to retirement) and has the energy and acumen to turn his or her one-generational book or practice into an enterprise.

In our work, we see some very natural divisions in the construction and ownership of independent financial professionals—divisions that help to explain the choices that advisors have as they consider their transition options. The ownership structures utilized by independent financial advisors or service providers fall into three distinct categories: book, practice, and enterprise.

BOOK

A book is the traditional ownership structure, best described as a single advisor, usually in a sole proprietorship arrangement. While there may be multiple advisors sharing an office and splitting the revenue to cover expenses and to pay for office space, phones, support staff, and basic services, each advisor is a single book owner. A book is all about production. About 70% of advisors own a book.

PRACTICE

A practice is not only larger and stronger than a book, but its owner will have invested in office space, at least a small support staff, and basic infrastructure. Practice owners also have set up a formal entity structure, either an LLC or a corporation, even though there is only one owner. Practices are larger than books in terms of cash flow and value. About 20% to 25% of advisors own a practice. Note that books and practices are, by definition, one-generational.

ENTERPRISE

An enterprise is not only larger and stronger than a practice, but it is more sophisticated in that it will utilize a professional compensation system that supports a strong bottom line. Profitability is key to differentiating this level. Profit distributions are used to augment the compensation system and to reward and empower next-generation advisors who invest in ownership and create an internal successor team. Sustainability is the main idea here. Enterprises have already—or are actively working to—established a multi-owner, multi-generational structure. Less than 10% of independent advisors own an enterprise.

The key differences between financial advisory businesses do not center on size or the amount of AUM, or even value. The differences lie in the structural elements of organization, entity, compensation, and profitability. Book owners simply don't have the same choices that enterprise owners enjoy.

One clear trend in transactions that we've seen over the years is that larger buys smaller; stronger acquires weaker. Consolidation is the natural maturation of an industry whose entire value is derived from professional abilities and personal relationships. If an advisor doesn't choose to—or isn't able to—build a strong, sustainable enterprise, then he or she can join someone who has already done so. The result is that an advisor who still wants to work for only three to five more years can still ensure his or her clients and staff members are taken care of beyond that time. Selling to a third-party buyer who is a mirror image of the seller's practice, but operates a larger, stronger business that can take on 100% of the seller's clients and staff, looks like a much more palatable alternative.

We often use the term "micro-consolidation" to describe smaller, sustainable enterprises acquiring small books and practices. Sellers in this case are looking for buyers no more than double their size. For example, a business with $150 million in AUM would likely be looking for a buyer with $250 million to $300 million in AUM. When we see these matches it is often because similar deals with larger consolidators and banks look good on paper and are tempting, but the cultural differences and the expectations placed on the seller post-closing are often a bridge too far. As a result of these "micro-consolidation" matches, the interactions between new advisors and the acquired clients are not drastically different from what the clients are used to. Micro-consolidation allows smaller but sustainable businesses to provide a compelling value proposition to a seller in terms of both their financial needs and client concerns. The acquisition success of smaller enterprises illustrates that the opportunity is growing for buyers and sellers across the market.

Along with the trend of micro-consolidation, we are also seeing more diversity in size between buyers and sellers. Regional enterprises are making competitive offers to onboard both the clients and the advising talent of small and mid-size practices. Larger boutique firms are pursuing smaller books that fall within their niche. The defining feature for many successful acquirers (of any size) is an enduring structure and a strong match for the seller's clients. Consolidation is not a homogeneous trend and it signifies a maturing industry. The value, scale, and efficiency consolidation creates can be a good thing for both practitioners and clients.

If you fall into the general definition of a book or practice owner, consider your options and decide at least ten years before your estimated retirement date (or goal date) which path you want to be on when that time comes. Are you poised to be acquired or to be the acquirer? Are you in a position to develop and invest resources in an internal succession team? Does attrition make sense after carefully analyzing the other options?

As a book or practice owner, start your planning process by doing one thing—a formal, third-party valuation of what you've built. Through that process, you'll learn a lot more than just what an appraiser thinks your value is. You'll also learn what drives value and what you can focus on to make the most improvement. You'll also likely come to discover what most of our valuation clients have learned: your business is the largest, most valuable asset you own.

David Grau Sr., JD

Trends in Transactions

Since assisting our first independent financial advisor with his practice, a lot has changed. Whether you read this report as an experienced or prospective buyer, a potential merger partner, or as an owner thinking about retirement, it is important to know what is happening on the mergers and acquisitions (M&A) front in this unique industry.

For starters, today's sellers are better prepared than ever before, having access to market-based valuations, benchmarking trends, and sage advice on when and how best to proceed. Every year we assist between 125 to 200 sellers or merger prospects in their quest to find a suitable buyer or merger partner. The good news is that most transactions are successfully completed. The bad news is there still aren't enough sellers to satisfy buyer demand. This strong seller's market, however, means that advisors who are looking to exit sometime in the next year or two will be well positioned to achieve their goals.

Our Mergers & Acquisitions Team reports on the following continuing trends in transactions between sellers and their third-party buyers or merger partners:

- A strong seller's market continues to exist. The current average buyer-to-seller ratio is 85:1.
- In our open-market system, the use of market-based valuations has effectively taken practice value off the negotiating table and shifted the focus to the deal terms.

OPEN MARKET TRANSACTION *AVERAGES*

28 WEEKS
ON THE MARKET

$2,400,000
TRANSACTION SIZE

61 YEARS
SELLER AGE

- Most sellers or merger prospects seek buyers or merger partners who have larger and stronger businesses—buyers are usually about two to three times the size and value of the seller.

- The average age of a selling advisor is 61; the average age of a merger prospect is about 56.

These trends have remained steady for many years, since before and through The Great Recession. Strong buyer interest tends to generate three or four full-priced offers in most cases with varying deal terms. The important advantage of having a large group of potential buyers auditioning to buy a practice is that it helps the seller to find a great buyer that fits in terms of personality, regulatory structure, geography, business approach, and certainly price and payment terms. Tilting the playing field in the seller's direction tends to provide the seller's underlying client base with the best possible succeeding advisor.

As you read through these transaction trends, understand that FP Transitions works with independent advisors who generate between $250,000 to about $15 million in annual GDC or gross revenue. Most sellers are fee-only or have over 75% in recurring fee revenue.

Though certain aspects of the M&A process have remained steady for many years, this is an industry of change. Guided by a strong entrepreneurial spirit, independent advisors have evolved and adapted in an effort to succeed in a highly-regulated industry facing increased competition and the occasional economic headwind. On the seller's side of the aisle, here are the changes that are most apparent:

$440K–11M
TRANSACTION RANGE

2.65
RECURRING REVENUE MULTIPLE

85
INQUIRIES PER LISTING

- Beginning in 2018, we experienced a surge of larger, fee-based sellers with valuations in the range of $4 million to $7 million.

- Another prominent group of sellers (almost 33%) fell into a general category we refer to as the Sell & Stay® model; these sellers were looking for a liquidity event, but also wanted to stay on and work for another three to five years under a formal employment agreement before retiring.

- Seller size did not impact the marketability or desirability of a financial advisory practice listed for sale. The market is full of buyers that seek to acquire assets from a financial planner operating out of his or her home office in Seattle or from a large multi-partner firm operating out of Class A+ space in Atlanta, and just about every size in between.

There is a lot of competition to acquire well-run financial advisory practices. Prospective buyers have had to evolve and adapt as well, and they have. Stronger, larger advisory businesses can offer sellers and their clients and staff some great choices that go far beyond a mere acquisition of assets at market value. From the buyer's side of the aisle, here are the most notable and relatively recent trends we have observed first-hand:

- Larger, more sophisticated and seasoned buyers are interested in acquiring practices of any size, whereas in the past most of the larger firms (e.g., $4 billion plus in AUM) had expressed little desire to acquire practices with less than $200 to $300 million in AUM.

- There has been a significant increase in the quality, experience, and preparedness of the enterprises that are acquiring practices and books. This results not only in better offers, but a much higher closing rate.

- Buyers are more flexible on deal terms and are willing to work with sellers to provide satisfactory, customized terms that help a seller meet his or her specific goals. Recent examples include flexibility with respect to the tax allocation (i.e., the amount of the purchase price allocated to capital assets vs. post-closing consulting services vs. restrictive covenants), retaining key employees, taking over an office lease or space, increasing the amount of the non-refundable down payment, shortening the length of seller financing, and providing more favorable promissory note adjustment mechanisms.

- Buyers have shown a willingness to pay a premium for a niche practice or a practice that is in a unique geographic area where the buyer has a desire to expand.

- There has been a demonstrated interest in acquiring not only the typical fee-only or hybrid RIA, but also IARs, RRs, and practices that may have a complementary insurance or tax/accounting component. Given recent discussions around fee compression, many enterprises are looking to acquire practices that have complementary services that they can scale and provide to all of their clients.

While the buyer-to-seller ratio has continued to climb over the past 20 years, competition for high-quality clients and AUM has also become fierce. Buyers have stepped up their level of commitment and are fully embracing inorganic growth as a key strategy. Recent buyers not only see acquisitions as a tool to grow revenue and

AUM, but also as an excellent method to acquire talent in the form of next-generation advisors and other key staff members. The presence and transition of such talent is not looked upon as an expense, but rather as a resource that enhances the value of the acquisition or merger.

One trend that continues to change the M&A landscape is bank financing, through both conventional loans and loans backed by the Small Business Association (SBA). Bank financing changes everything; it also requires a skilled hand in completing the documentation process, security and collateral considerations, subordination agreements, client transition, and post-closing support. Bank financing often significantly improves cash flow for the buyer post-closing and can substantially de-risk a seller's position as they no longer must provide four or five years of contingent seller financing to get a deal done. Bank financing permits smaller, younger advisors to compete with larger, more seasoned acquirers, and this bodes well for continuing strong demand for practices listed for sale.

One of the hallmarks of our work in creating and supporting the open-market system is to provide every seller with the opportunity to audition many buyer prospects to find the best match, the best location, and the best cultural fit. Then, and only then, should a seller focus on the best price and terms. This works quite well in a seller's market. When a seller can select from the best two or three buyers from a large pool of prospects, it almost goes without saying that the clients will be left in very good hands. But for sellers who aren't quite ready to retire or who need superlative deal terms to make it work, there is still time to plan and take advantage of the seller's market.

David Grau Sr., JD
James Fisher, JD

Valuation Methodology: Market Approach

Valuation within the sphere of financial services is often over-simplified for most business owners. For many, it's a paragraph or two within their Buy-Sell Agreement or a general multiple of revenue ascertained through the industry grapevine. Most owners of larger financial services businesses understand that the concept of valuation is important, but when dealing with the nuances of value, having only a basic understanding can negatively impact their business if misapplied.

Opinions from industry pundits tend to vary on the appropriate valuation methodology that should be applied to a financial services business. Ironically, they are all correct and simultaneously all wrong. This article serves as a cursory overview of generally accepted valuation methodologies within the financial services industry and the appraisal community at large, including the considerations of the commonly utilized methods and considerations for the application of each method. The goal here is that all stakeholders in a sale appreciate how value can fluctuate, that it may not be a single, easily determined number, and that there is give and take in understanding the overall process.

PURPOSE & STANDARD OF VALUE

Before considering what method is most appropriate for a singular valuation, an analyst or consultant must first consider the purpose at hand of the valuation to be performed. Just as a building rests on its foundation, the framework of valuation is grounded on its purpose. Situations vary, but by and large the purposes for a valuation are generally categorized as either tax or non-tax reasons. Both are applicable for the investment advisory industry. For instance, a business owner may need to value the entirety of his or her business for an external sale in the marketplace (a non-tax application) or may need to value a fractional interest in his or her business in conjunction with a tax filing resulting from the gifting of shares to an employee or family member (a tax application).

After purpose has been established, a standard of value must then be selected. "Standard of Value" deals with the perspective of value. In other words, the selection of a standard of value answers the question of "value to whom?" In an article published in the Journal of Financial Planning, Ryan T. Grau, CVA, CBA, outlines how the standard of value affects the valuation of a financial services business and points out that the two most common valuation standards in the financial services industry are Fair Market Value (FMV) and Most Probable Selling Price (MPSP).[1] FMV represents value on a cash or cash equivalent basis to a hypothetical buyer where neither the seller nor the buyer are under any compulsion to buy or sell. MPSP, however, can consider compulsion on the part of both the buyer and seller and can represent a value that includes

[1] Grau, R. (2017, November 01). What Is My Practice Worth? What You Need to Know About Value and Valuation. Retrieved from https://www.onefpa.org/journal/Pages/NOV17-What-Is-My-Practice-Worth-What-You-Need-to-Know-About-Value-and-Valuation.aspx

additional service contracts commonly included in the sale of a business, such as a post-closing consulting agreement.

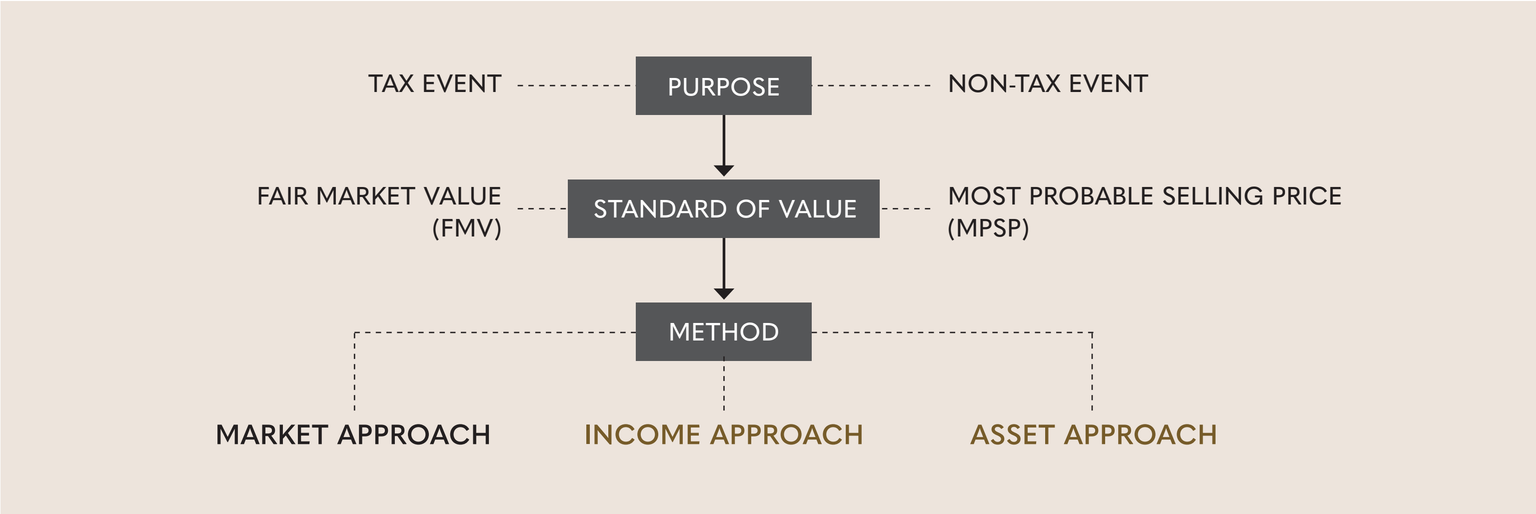
With the purpose and standard of value defined, the valuator can select and apply the appropriate valuation approach. Any valuation conclusion that does not first take into account the purpose and standard of value should be questioned.

There are three generally accepted approaches to valuation: the Market Approach, the Income Approach, and the Asset Approach. Under each approach, there are multiple methods for measuring and calculating value. The Asset Approach, however, is not commonly used to value financial services businesses as the ability to produce revenue is not dependent upon costly equipment and other tangible assets. Rather, the largest asset in a financial services business is an intangible asset; it is the goodwill established between the advisor and his or her clients. To determine the value of the intangible assets, an appraiser must first rely on the Income Approach and/or the Market Approach. What this means is that the majority, if not all, of the value calculated under the Asset Approach is reliant on the calculations of value using some other method. As such, this report will not be going into detail about the Asset Approach, but it will discuss the Market and Income Approaches and the various methods categorized under each approach.

VALUATION METHOD: MARKET APPROACH

The general theory behind the Market Approach is that in a group of transactions involving similarly structured businesses, the central tendency of the value ratios represents the value as determined by a free and open market. This method is dependent on the statistical relevance or variability within the transactions data to the value relationships being estimated. As represented by the Direct Market Data Method (DMDM), value is based on the sale of ownership interests in companies that are in the same or similar lines of business. The sale of ownership interests within this industry are typically characterized by the

Figure 3.1 Valuation Methodology Flow



sale of a 100% interest in the assets of a business. Once comparable transactions are found, the data is analyzed and evaluated for its dependability and then applied to the appropriate benefit stream of the subject business.

Database sources for comparable transactions, such as Institute of Business Appraisers, Bizcomps, and Pratt's Stats, are available on a subscription basis, but often lack sufficient detail about the operating characteristics of businesses within the financial services industry. The lack of detail is significant enough to erode the credibility of the valuation results and an appraiser's ability to apply the Market Approach. For example, these databases do not provide information about the revenue composition of the comparable transactions, e.g., what portion of the business's revenue comes from advisory fees versus annuity sales. Additionally, gross revenue is commonly referred to as "net sales" and is not distinguished as being either revenue paid to the broker-dealer—known as gross dealer concession—or gross revenue paid to the advisor after the broker-dealer charges its fees. In contrast, the FP Transitions databases include detailed information on operational characteristics, revenue compensation, and gross revenue productions to the advisor collected from over 1,500 transactions and over 11,000 business valuations in the last 20 years.

In the context of the financial services industry, our transaction data indicates that the most common type of sale of a financial services business is the sale of a 100% interest in the business's operating assets to a third party, or external buyer, on the open market in an arm's length transaction. These transactions are highly synergistic in nature; the average buyer is typically twice the average seller's size, is usually engaged in a similar line of business within the financial service industry, and already has components of the seller's infrastructure in place. These synergies give buyers the ability to eliminate redundancies in overhead expenses between the two businesses, thereby reducing the total cost to maintain the combined client base post-closing while still maintaining the capacity to service the breadth of the combined client base and leverage their existing business model to grow the combined revenue stream. This is the essential reason why an appraiser using the Market Approach will select gross revenue as the appropriate benefit stream as opposed to any other measure of earnings or cash flow. Using gross revenue removes the subjective process of estimating and forecasting earnings when the buyer is unknown to the seller, which is typically the case when a seller takes his or her business to market or when a business owner is establishing his or her value relative to the market as a benchmarking exercise. Our transactions data also indicates that historically there is a very high statistical correlation between the gross revenue of a business and the final sales price at which the business is transacted.

MARKET APPROACH: MARKET MULTIPLES

While gross revenue multiples are a widely used metric of marketplace value throughout the industry, there are other market multiples that come into play depending on the circumstances of a sale. The general assumption when determining a gross revenue multiple in the context of the financial services industry is that the buyer will acquire 100% ownership of the assets from the seller. Beyond a 12–18 month consulting period, there is generally no additional consideration within this multiple for the seller's continued involvement in the business. A gross revenue multiple also assumes that the buyer has existing operational infrastructure under which the clients will be serviced.

Applying a multiple against different types of earnings produces a market valuation that carries with it a much more varied set of assumptions. For example, a price/Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) multiple assumes that the business is sold with all of its operational infrastructure intact, including the reasonable salary attributable to an owner. EBITDA multiples are useful when a buyer is acquiring the business as a passive owner, in that the buyer will either retain the seller or replace the seller with a servicing advisor and has included in the sales price the consideration of compensation for the individual who will actively run the business. For this reason, EBITDA multiples are commonly used by both regional and national "roll-up" firms and private equity groups who are looking for acquisition opportunities to add to their portfolios.

Below is a brief chart summarizing different market multiples used in the financial services industry and the built-in assumptions inherent in their use. It is imperative when using market multiples that the selected multiple is only used in tandem with the benefit stream from which it was derived.

MARKET APPROACH CONSIDERATIONS: STRUCTURE AND PROFITABILITY

When discussing approaches to valuation within the financial services industry, it is important to keep in mind the general structure of the businesses that are being transacted in the market place. David Grau Sr., JD, goes into detail about these different business structures (classified as book, practice, or enterprise) in his article "The Impact of Consolidation," on page 7 of this report.

The various structures within the financial services industry dictate how each of these businesses will be sold and how they are subsequently valued. Typically, the only exit

Table 3.2 Application of Market Multiples

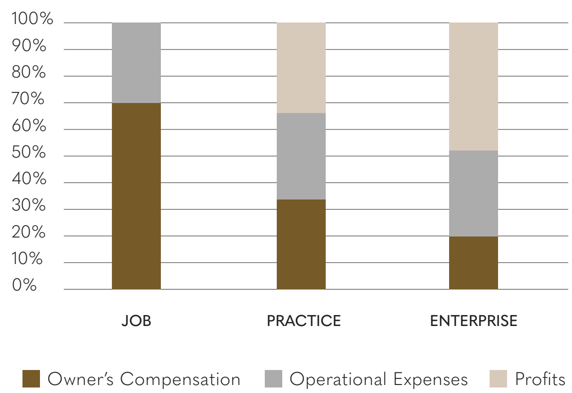
MULTIPLE	BENEFIT STREAM	ASSUMPTIONS
Price/Gross Revenue	Gross Revenue/GDC	Buyer has operational infrastructure in place and requires 100% of seller's assets.
Price/EBITDA	Earnings Before Interest, Taxes, Depreciation, and Amortization	Buyer is acquiring assets and maintaining seller's operational infrastructure. Seller or servicing advisors will remain to service practice.
Price/EBOC (SDE)	Earnings Before Owner's Compensation (Seller's Discretionary Earnings)	Buyer is acquiring assets and maintaining seller's operational infrastructure. Buyer will be the primary service advisor.
Price/Assets	Total Assets (AUM)	Buyer has operational infrastructure in place and acquires 100% of seller's assets.

strategy, other than attrition, for book owners or practice owners is an external sale on the open market.

Our data shows that sales of these businesses are almost exclusively transacted as asset sales to a third party where the owner remains with the business for approximately 12–18 months post-closing to assist in the transition of client relationships. From a pricing standpoint, the Direct Market Data Method under the Market Approach is an appropriate method of valuation, as it caters to the common exit strategy of an advisor who owns a book or practice. The gross revenue multiple is also a common tool used under this Market Approach methodology, as the majority of books are purchased by practices that have existing infrastructure, and the majority of practices are purchased by other practices or enterprises that are, generally speaking, about twice the size of the acquired practice by gross production. Because they need to acquire little to no operational infrastructure, external buyers are primarily concerned with the gross revenue they can add to their top line, which caters to the use of a gross revenue multiple.

The story is not the same with the sale of enterprises. The organizational and compensation structures of an enterprise—as opposed to that of a book or a practice—gives owners additional options for their exit strategy. If enterprises are sold externally, they are rarely acquired by a smaller enterprise, let alone a practice or a book. In many cases, enterprises tend to view an external sale as a last resort, instead pursuing internal succession as a preferred and more beneficial exit strategy. In this instance, the Market Approach isn't necessarily the best indication of value and the use of a gross revenue multiple becomes less relevant. Whereas the buyer of a practice may have top-line production in the form of gross revenue as its target, an investor in an enterprise is looking for a "bottom-line" revenue stream—the enterprise's profits—as a return on his or her investment.

Figure 3.3 Benefit Streams by Business Structure



While the Market Approach is very useful to determine the value of books and practices, the value of enterprises that are generating profits at levels illustrated in Figure 3.3 is less in the revenue-generating capacity of the enterprise (although still important) and lies more in the company's ability to generate profits. The Market Approach can still provide a good proxy for the value of an enterprise in an external transaction. However, enterprises are built to transition ownership internally and more often leverage this option rather than selling externally. Therefore, most valuations of businesses at this level more appropriately use the Income Method discussed further on page 48.

As a financial business grows its market footprint and evolves its organizational structure, its value will change in accordance with its size and sophistication.

Aaron Wells, CVA, CBI
Julia Sullivan

Drivers of Growth

The key drivers of economic value for small- and medium-sized businesses are size, growth, leverage, profitability, turnover, and liquidity. To the extent that the economic value of a business is based on its comparison to other businesses, for which a market value of invested capital is known, it must be determined whether the key value drivers are in fact similar between the two. Focusing on these drivers and developing implementation strategies will increase the market value of a business.

SIZE

Size is an elusive concept. Roger Grabowski in the Risk Premium Report considers seven measures of size other than dollars of market capitalization, a.k.a. market value of equity.[1] They are:

1. Book value of equity
2. Five-year average net income
3. Market value of invested capital
4. Total assets
5. Five-year average Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA)
6. Annual sales
7. Number of employees

Each of these metrics will change the hierarchy of companies by size. Taken together, these measures of size clearly indicate that the largest 4% of companies have a cost of capital that is 1/3 to 1/2 of that of the smallest 4% of companies.[2] However, within the financial services sector, the correlations of annual sales and EBITDA to market value are the more reliable metrics. Still, as the value of equity and invested capital increases, so does a business's relative value. Strong balance sheets still tend to add more value than the simple difference in the net assets. Larger companies are generally perceived by investors to have a greater capacity to withstand disruption than their smaller counterparts with the same exposure.

GROWTH

Growth, and the expectations of it, are extremely powerful factors in value. Growth likely to produce future increases in profitability can have a very large impact on value. The observed and reported average growth of annual revenues of all investment advisors in the US between 2010 and 2017 is 7% per year.[3] To the extent that a business has experienced growth different than this in annual revenue, applying a multiple to trailing 12-month revenues to estimate value may be misleading. A small difference, say between 5–7%, in average growth rate could represent an error over 4% in the market value.

Growth in revenues that do not result in equal or greater growth in earnings can be a distractor from value. There are multiple strategies for growth. It can be "organic" or through acquisition. It can come from changes in product mix or fee schedules. It can come from opening new market areas or product lines, or from increased market shares in existing markets. It may come from changes in the value of the clients' investments. An advisor needs to understand the specifics of the strategies he or she is choosing to employ, including the demands they make on capital and

[1] Duff & Phelps, "Risk Premium Report" in *2017 Valuation Handbook – U.S. Industry Cost of Capital* (Hoboken, NJ: John Wiley & Sons, 2017).
[2] *Ibid.*
[3] Victor Adeleke, "Financial Planning & Advice Industry in the US," *Ibis World.* (December 2018): 30.

the lead times to achieve meaningful results. While this may seem obvious, some business owners perceive that merely embarking on one course is sufficient to demand increased value. The key here is to determine what impact that change has on overall growth and what impact it has on earnings.

LEVERAGE

Businesses that have the ability to raise capital in the debt market are more highly prized than those that must depend solely upon equity investors. It is the ability to borrow, not the presence of debt, that increases the perception of value. The amount of debt in the business is not an indication of its market value. It is for this very reason that knowledgeable investors are much more interested in the returns on enterprise value than returns on equity. Seldom are the costs of capital of the buyer and of the seller equal in a transaction. Those investors that choose to be debt free may sleep better, but they usually do not earn more. In 2018, the median and average cost of debt to the 29 publicly traded investment advisory businesses was 4.1%. Those same 29 companies had an average cost of equity of 13.9%. For the typical sale of an investment advisory company under-$10 million both the cost of debt and the cost of equity are higher, but both sets have a cost of debt to cost of equity ratio of approximately 30%.[4]

In addition to the ability to repay a loan, many subjective factors about the borrower's business can give lenders comfort, such as good books and records, relative stable growth in earnings, depth of management, reputation, positive brand images, tangible assets, and lack of concentration in customers and products.

PROFITABILITY

There are many different measures of financial performance: Net Income, Gross Cash Flow, Net Cash Flow, Earnings Before Owners Compensation (EBOC), Discretionary Earnings (DE), Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA), Earnings Before Tax (EBT), and others. These metrics may also be measured as a percentage of a number of different balance sheet values such as total assets, net tangible assets, equity, invested capital, and others. To further complicate these numbers games, these ratios may be based on values from either the beginning or the end of the earnings period.

Those companies that can consistently produce the highest returns for the least amount of risk enjoy relatively higher market prices than those that are either inconsistent or just not getting the job done. The easier it is for an outsider to understand the profitability of the business, the greater that person's confidence will be in the decision to purchase or invest in the business.

TURNOVER

Similar to profitability, turnover measures how efficiently the company employs its various assets. Using less to make more is perceived as successful, and permits an investor to expand and diversify. This metric has more relevance in industries that have physical inventories or capacities limited by fixed assets. Nonetheless, as a

[4] Duff & Phelps, "Cost of Capital Navigator," accessed September 2018, https://costofcapital.duffandphelps.com (subscription required).

practice's technology needs advance, it can be an additional measure whether the practice has the right physical "assets" and uses them to their full advantage.

LIQUIDITY

The company that has lots of cash will be preferred over the one that has much of its assets tied up in long-term investments with little ability to adapt to change. Fee advisors benefit from this metric in that they typically receive payment at the beginning of the quarter based on the value of assets covered by their fee agreement. Alternatively, when fees and or commissions are collected after the delivery of services, the expenses necessary to support the services reduce the liquidity of the company.

When considering the value of a financial advisory firm, questioning a value offered by someone else, or looking for opportunities to increase the market value of a business enterprise, it is important to keep these key drivers in mind. Remember that size, growth, and leverage are the most powerful in the investment advisory market. If the characteristics of the subject are materially different from those of the target and not addressed, then the comparison may be seriously flawed.

Warren Burkholder, ASA, MCBA, CBI

Estimating Value Based on Recurring Revenue

Recurring revenue is one of the most important single determinants of value. Revenue produced through management fees, trails, or renewals is ongoing and reasonably predictable. Transactional revenue is more elusive and difficult to predict. While this isn't cutting edge news, it is important to understand that recurring revenue is more predictable and presents less risk of future earnings when compared to transactional revenue. As such, when a portion of revenue is generated from transactional revenue, buyers will require a higher rate of return (discount) when compared to other market alternatives that provide more certainty.

It is important to understand the difference between an adjusted pricing multiple based on the specific characteristics of the business being valued versus a "rule of thumb." A rule of thumb for the financial services industry is that businesses sell for two-times gross recurring revenue and one-times non-recurring revenue, or that they are worth five-times Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA). Often sellers approach us asking if the offer they have received based on a rule of thumb is sufficient or fair. This question cannot reasonably be answered without understanding the revenue characteristics of the practice.

Rules of thumb are not based on empirical evidence and have not been examined or tested to determine their validity. A rule of thumb is merely a means of estimating value based on a rough and ready practical rule, not based on science or exact measurement. Other definitions include "[a] theoretical market-derived unit [ ] of comparison"[1] and "a mathematical formula developed from the relationship between price and certain variables based on experience, observation, hearsay or a combination of these; usually industry specific."[2] A rule of thumb is therefore used as a reasonability check for other valuation methods that are not tied directly to observed market transactions. It should never be used as a stand-alone method for valuing a business.

An adjusted pricing multiple is the result of a professional appraiser's many hours of market research and analysis of the subject practice as it compares to observed prices in the market. Arriving at an adjusted pricing multiple requires an understanding of how buyers in the marketplace perceive value and what those key value drivers are. For financial services practices, this key value driver is recurring revenue. It is the difference between a practice selling for 0.27 times annual gross revenue and 2.84 times annual gross revenue.

[1] "Commonly Used Methods of Valuation," in *Business Valuation Fundamentals, Techniques & Theory,* (National Association of Certified Valuators and Analysts (NACVA), 2015), 27-28.
[2] Shannon P. Pratt and Roger J. Grabowski, "International Glossary of Business Valuation Terms," in *Cost of Capital in Litigation: Applications and Examples*, (Hoboken, NJ: John Wiley & Sons. 2011).

Our observed range of annual gross revenue pricing multiples ranges from a low of 0.27 to a high of 2.84 with the central tendency being 1.85. This is quite a broad spread between high and low. Without understanding the primary value driver of these businesses, simply using a rule of thumb or average pricing metric as opposed to an adjusted pricing multiple may lead to a significant error in valuing the subject practice. Valuation errors can result in the deal being skewed toward one party as opposed to creating a fair and equitable deal for both parties, or worse, a transaction that never closes or results in one party who feels taken advantage of.

Figure 5.1 Common Sources of Compensation

Revenue streams, even recurring revenue streams, are seen differently depending on their degree of perceived predictability. Figure 5.1 shows the most common sources of compensation financial advisors receive for their services and the market's sentiment regarding the predictability of each source of revenue.

Market demand for recurring revenue remains high and values for fee-only business types are strong. Not all fee sources are valued equally, however. Further complicating questions of value, most businesses include a combination of revenue sources with varying degrees of predictability. Determining an appropriate value for a specific business in a specific situation merits a deeper assessment than simply estimating value on a multiple of recurring revenue.

Practices in this industry are commonly categorized as fee-only, commission-based, or transactional, depending on how their advisors are compensated for their services. It's important to remember that many people, especially those outside the advisory industry, often use the terms fee-only and commission-based interchangeably. They are indeed different and have a different impact on recurring revenue. Fee-only advisors receive all compensation in the form of either performance-based fees or a fixed, flat, hourly percentage. These fees are typically based on the amount of assets the advisor is managing and the complexity and financial needs of the individual clients. Commission-based advisors can receive compensation from charging fees similar to a fee-only practice, but they also receive compensation based on transactions involving a product or service. This includes insurance renewals, securities-based trails, surrender charges, and contingent deferred sales charges. Commission-based practices generally receive a mix of both recurring and non-recurring forms of compensation. Transactional practices are those that receive compensation-based revenue on transactions involving a product or service, but the compensation is primarily non-recurring.

The graph in Figure 5.2 illustrates how recurring revenue influences the perceived value of a business by examining recent transactions (2016–2018) and the modeled relationship between the multiple that each practice sold for as compared to each practice's reported amount of compensation that is recurring and predictable. It is important to note that the transactions used in this model were not sorted by deal terms, which can influence the final purchase price. We can see here that the market places more value on recurring, predictable forms of compensation.

Figure 5.2 Gross Revenue Multiple-Based Price Relationship to Recurring Revenue

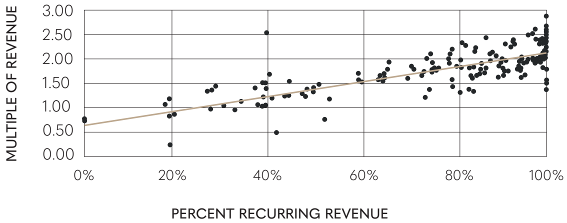
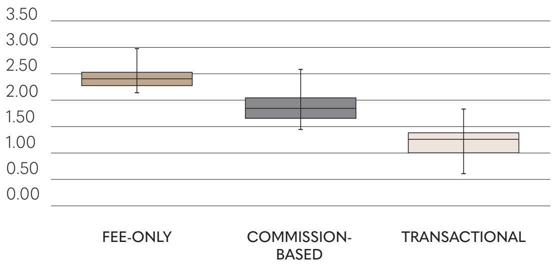


Figure 5.3 Gross Revenue Multiple Range by Practice Type



Another notable observation is that there are relatively few transactions involving practices that generated less than 20% of their revenue from recurring forms of compensation. Typically, businesses that fall below this 20% threshold don't engage in a typical asset sale as other practices do. In other words, most practices generating less than 20% recurring revenue typically transition their business and receive their value by sharing revenue with the new advisor servicing the clients if there is any future revenue generated from those clients.

There is a clear pricing differential based on the practice type (fee-only, commission-based, or transactional) as shown in Figure 5.3. Fee-only practices typically sell within the range of 2.28–2.53 times gross annual revenues with the central tendency being 2.44. The median sale prices for these practices have been trending upward over the last three years.

Commission-based practices sell within a much larger range than fee-only practices. When valuing these types of practices, it is important to understand the forms of compensation the advisor receives and what restrictions there are regarding future compensation. Typically, these types of practices will sell within the multiple range of 1.66–2.05 with the central tendency being 1.85. The market for these types of practices has remained fairly level over time. In 2016, 2017, and 2018, as with fee-only practices, the median values have also trended up from the past three years, albeit at lower absolute numbers.

Lastly, transactional practices typically sell within a multiple range of 1.01–1.37 with the central tendency being 1.25. As illustrated in Figure 5.3, the central tendency for these types of businesses is toward the higher end of the range. This is a result of the transactional pricing multiples for these practices not being evenly distributed within the range of 1.01–1.37. In other words, more practices receiving transactional compensation have sold for less than a 1.25 multiple of gross revenue, but a few have sold for substantially higher. This is a result of the mixed perceptions of value for these types of practices due to their varying ability to generate future revenues.

Estimating the value of a financial services business requires reliance on the amount of recurring revenue as well as its sources and level of predictability. It is important to understand that recurring revenue presents less risk of future earnings when compared to transactional revenue and provides a relatively clearer forecast of future value.

Ryan Grau, CVA, CBA

Technology & Value

Advisors constantly seek an answer to the questions "How can I grow faster?" and "How can I increase the value of my practice?" Generally, their focus is on acquisition. However, growth and value are not singular concepts. In other words, achieving a rapid pace of growth needs to be tackled through multiple facets, and ultimately, growth will be a driver of value. However, many practices are not adequately equipped to grow at the rates they are striving for. Technology provides many of these opportunities. Investing in technology has a demonstrated relationship to higher growth, more affluent clients, increased profits, and increased value.

The rapid pace of technological advancement has provided financial advisors more opportunities to reach a broader client base and manage client relationships more effectively and efficiently. By implementing and effectively utilizing web-based advertising, digital conference rooms, client relationship management (CRM) systems, and billing and portfolio management software, advisory practices of all sizes are able to more closely track their performance and focus their efforts on the market segments they wish to target.

Investments in technology in and of itself will not add to the value of the firm. Use of technology requires investments of time and money to strategize how the technology can be most effectively utilized in the course of business. Technology is a means to an end where, as the data to the right suggests, an increased online presence, coupled with a non-proprietary CRM system and billing and portfolio software tend to result in higher revenue growth rates, better client management, and, ultimately, higher values.

	PRACTICE ATTRIBUTES
LOW-TECH	• No website • No digital meetings and conferences • Little, if any, online presence (use of social media, forums, etc.) • No use of CRM/proprietary CRM • No systematized client contact campaigns • No billing or portfolio software • Rudimentary client documentation tracking system • Minimal, if any, digital document storage and retrieval systems • No IT staff or outsourced IT support • Little, if any, investments in hardware and software
MEDIUM-TECH	• Website • No digital meetings or conferences • Some online presence (use of social media, forums, etc.) • Proprietary CRM • No systematized client contact campaigns • No billing or portfolio software • Some paper records, mostly paperless • Minimal, if any, digital document storage and retrieval systems • No IT staff or outsourced IT support • Investments in hardware and software when needed
HIGH-TECH	• Website • Digital meetings and conferences • Strong online presence (use of social media, forums, etc.) • Proprietary CRM • Systematized client contact campaigns • Billing or portfolio software • Paperless records • Digital document storage and retrieval systems • Use of IT manage or staff or outsourced IT support • Regular investments in hardware and software

Table 6.1 Technology Level by Performance

TECH LEVEL	PREMIUM/ DISCOUNT*	REVENUE GROWTH RATE	MEDIAN REVENUE PER CLIENT	MEDIAN ASSETS PER CLIENT	PAYROLL (AS A % OF REVENUE)
Low	-5%	8.4%	$4,143	$474,667	18.0%
Medium	0%	7.6%	$4,594	$638,250	16.9%
High	10%	10.5%	$5,704	$722,147	13.6%

**Premiums or discounts are based on the observed gross revenue pricing multiple.*

Our data suggests that low-tech practices, on average, sell for less as compared to high-tech businesses. The value delta between these types of practices has been observed to be as high as 15%. One reason for this is that low-tech practices often struggle to gather basic information about their practice and client base.

Interestingly, higher-tech practices consistently report servicing fewer, but more affluent, clients when compared to similarly sized low-tech practices. While somewhat counterintuitive, effective use of CRMs and other client servicing technology allows for businesses to actively manage their client base and focus their time and resources on more profitable clients.

Servicing fewer, more affluent clients allows other efficiencies to be gained, including the ability to increase profitability. The largest expense for most, if not all, advisory businesses is payroll. By successfully incorporating technology into an advisory business and utilizing a CRM to track and monitor client contact and systematize certain other forms of communication, practices are able to strategically grow their bottom line. On average, high-tech practices, report lower payroll expenses, as a percentage of their total revenue when compared to low-tech practices.

Regular investments of time and money in technology can pay off in the long run. Having an online presence and embracing digital meetings and conferences can increase a practice's market share and assist in servicing clients in other states and regions. Use of a CRM can help advisors stay on top of important tasks, provide reminders to follow up with specific clients at specific times, and offers a central location to store notes about each client. Cumulatively, strategically and effectively utilized technology can unlock a practice's growth potential and profitability.

Jeremy Seicianu, CVA
Ryan Grau, CVA, CBA

Buyers in the Marketplace

Understanding the basic concepts of value requires an understanding of the buyers in the marketplace. Just as beauty is in the eye of beholder, value, including future benefits, is in the eye of the buyer. As such, in scenarios where the future benefits—namely future cash flow—is high, as is the case when creating economies of scale, the value perceived by the buyer is high. When these cash flows are minimal as a result of greater expenses, the perceived value is reduced.

The differences in buyers classify them to two categories: financial buyers and strategic buyers. “Financial buyers” are considered to be those that are not able to create economies of scale, such as a successor buying into a business or acquiring a practice, without gaining any synergies from the acquisition. In this scenario, the primary interest is the cash flow from the business, and there are minimal—if any—operational synergies created. On the other hand, “strategic buyers” have a specific interest in acquiring practices that can create synergies by combining acquired operations with their own. Recognizing this difference between buyers will help provide clarity regarding differing opinions of value.

A financial buyer’s focus is on the returns generated from the current operations of the business and his or her ability to modify the bottom line. A business that focuses on growth and increasing profits for its owners while paying reasonable and competitive compensation will be perceived by financial buyers as being more valuable than a business with greater operational costs and higher levels of owner compensation. In other words, if all the revenue flowing into a practice is consumed by compensation, a financial buyer’s return is diminished and his or her perception of value is eroded.

Strategic buyers are less concerned with the operational expenses of the existing ownership. They are motivated by the efficiencies that can be created by acquiring clients in bulk and the ability to amalgamate various expenses such as compensation, rent, utilities, office expenses, and travel. These buyers are often willing to pay a premium as a result of creating economies of scale when compared to financial buyers.

Table 7.1 is an example of a strategic buyer’s acquisition.

Table 7.1 Example of a Strategic Buyer’s Acquisition

INCOME	COMPANY A	%	COMPANY B	%	COMPANY B*	%
Total Revenue	$1,000,000	100	$2,000,000	100	$3,000,000	100
Operational Expenses	$600,000	60	$800,000	40	$1,000,000	21
Expense Percentage	60%		40%		33%	
Operational Profit	$400,000	40	$1,200,000	60	$2,000,000	67

**After acquisition of Company A. Assumed 33% of total operational expenses transfer from Company A to Company B.*

The strategic buyer in Table 7.1 is able to acquire the clients and generate the same level of revenue as was generated pre-acquisition. The benefit to the buyer, which leads to an increased perception of value, is the ability to significantly reduce the amount of overhead necessary to operate the business. Instead of two separate operations generating a combined profit of $1.2 million, Company B, having its own operational structure, will acquire Company A and assume about 33% of its overhead. As a result of this synergy, Company B's revenue increases to $3 million and expenses increase to $1 million, which increases the profit margin after operations from 60% to 67% (or $2 million). In this scenario, which represents a majority of the acquisitions that occur in the investment advisory industry, a seller's operational inefficiencies are less important to a strategic buyer.

A sale involving a financial buyer, however, paints a somewhat different picture. A financial buyer may be a key employee being offered the opportunity to "buy in" to the practice, and as such rightfully has concerns regarding cost structure, operational efficiencies, return on investment, growth, and financially stability of the company. All of these factors need to be enticing enough to make buying equity financially feasible and worth a buyer's investment. This scenario also plays out with small-book acquisitions as well as mergers between similarly sized practices.

Financial buyers are looking for different benefits in a purchase than are strategic buyers. Oftentimes this difference is due to the way the buyer is gaining ownership—through an internal buy-in or an external acquisition. Understanding the differences in these circumstances as well as the buyer's focus can be helpful for an owner in identifying his or her buyer, as well as where to position the business to realize the greatest value.

Jeremy Seicianu, CVA

Price, Not Value, Is a Product of Negotiation

Price is usually the most difficult hurdle for buyers and sellers to overcome. The value of a business is different for each party participating in a transaction and is based on opinion and the specific set of circumstances for each individual. Price, on the other hand, is the number at which the transaction is executed. Yes, value informs price, but it is not the only influencer. Price is also the result of good faith negotiations between buyer and seller. While negotiation does not necessarily impact each party's perception of value, it allows for dialogue so that both sides arrive at a price where the value for each individual overlaps and a mutually beneficial deal can be struck.

HOW MUCH IS MY BUSINESS WORTH?

The answer is: It depends. What are the circumstances of the valuation? Experienced and certified appraisers can provide guidance, insight, and consultation to help inform buyers and sellers regarding the buyer's perceived value of specific types of property. However, in order to answer the question of value and to produce a relevant report, the appraiser needs to understand why the valuation is being performed.

Ultimately, valuation is a function of purpose. For example, the sale of a practice on the open market versus a valuation on the same practice for another purpose, such as tax reporting or disputed matters, may result in widely different values. IRS Revenue Ruling 59-60 requires Fair Market Value (FMV) as the standard of value to be expressed in terms of cash or cash equivalents. This all-cash value basically assumes that a check is written at the time of the transaction for the full price.

However, in an open-market sale, buyers rarely take the risk of paying 100% cash at closing to acquire an intangible, personal, services-based practice. Deals are typically structured with terms that include a portion of the price paid up front with the balance financed on a performance-based promissory note. The deal structure plays a crucial role in determining price, not value. Payments over time should account for the time value of money, the risk the seller takes on of potentially not receiving future payments, and the recourses associated with a buyer defaulting on payments. These are important considerations and generally buyers and sellers agree to a premium over a cash value. The takeaway here is that it is important to identify and understand the intentions and needs of both buyer and seller.

HOW DO I REALIZE THE GREATEST VALUE FOR MY PRACTICE?

As discussed above, deal terms play a major role in determining the most probable selling 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 business is the buyer's perception of whether the monetary worth of the business is equal to its net present value of future expected cash flow. In contrast, price is the value of that business adjusted for the terms of the transaction. In essence, value is the business's worth in relation to an individual's perspective, whereas price is the negotiated value considering all relevant factors of the deal. If the value is not adjusted for the negotiated terms of the deal, the value of the practice may be materially increased or reduced.

Consider the following example: Advisor X sells his practice for $1.5 million, is paid cash at closing, and 100% of the price is allocated to capital assets resulting in long-term capital gains tax treatment. Advisor Y sells his practice for $1.5 million for 30% down at closing and finances the balance over five years with 80% of the price allocated to capital assets resulting in long-term capital gains tax treatment. The buyers in both scenarios paid the same price for the practice, but as a result of the deal terms, the value each seller received is different. Ultimately, value is a stepping stone for a buyer and seller to arrive at an agreed-upon price.

The agreed-upon price does not need to equal the value or, if deal terms are included, the price expressed in a valuation report. The value or price expressed in the valuation report is an opinion and should be used as a starting place for further negotiations.

Sellers that realize the highest prices effectively communicate and demonstrate historically reliable, predictable, growing cash flow, as well as cost savings and synergies to be created as a result of the acquisition.

Successful transactions require cooperation between the buyer and seller and are not wholly dependent on the valuation result. This is often difficult for practice owners to absorb. After all, in financial services most numbers are absolute and do not vary. However, when it comes to the value and price of an advisory practice, there can be, and often is, a range of value. The deals with the highest success rates result from both buyer and seller understanding that value can vary and that deal terms play a major factor on the final price. Effective communication in the negotiation process is equally critical.

Jeremy Seicianu, CVA

Components of a Deal

Whether you are buying or selling, it is important to understand what is being bought and sold and what expectations both the buyer and seller have of each other. Absent these details, it is difficult, if not impossible, to determine if an offer is fair. After all, "fair" is a relative term. The question of fairness would be easy to answer if all deals were done the same way, but the reality is they are not. Nonetheless, there are still common attributes to most deals that can shed light and aid in understanding the underlying terms. This in turn helps both buyer and seller assess the reasonability of an offer.

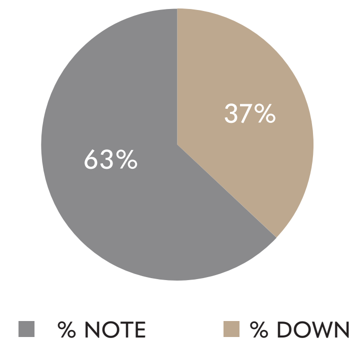
WHAT IS BEING BOUGHT AND SOLD

The sale of many, if not most, financial service businesses are completed as asset sales as opposed to stock sales, where all ownership rights are transferred to a third party. In an asset-based sale, both buyer and seller receive more favorable tax treatment when compared to a stock sale. Since financial services businesses are primarily relationship-based, providing mostly intangible services, what is being sold in an asset sale is rights to a future benefit stream—namely, revenues. However, given the intangible nature of the assets, there is no certainty that a buyer will receive the same amount of revenue from the clients as the seller did. This is why the ability to leverage the seller's goodwill (the primary asset being bought and sold) to establish proper deal terms that create a shared risk, shared reward scenario become important.

DEAL STRUCTURE: SELLER FINANCING

The most common payment structure for the sale or acquisition of a financial services business typically includes two elements: a cash down payment of about one-third of the agreed upon purchase price, and a seller-financed promissory note for the balance, paid on average over five years at a 5% interest rate. Over the past 20 years, FP Transitions has observed thousands of buyers and sellers use this type of deal structure (Figure 9.1) to create a shared risk, shared reward model.

Figure 9.1 2018 Average Deal Structure



The basic premise of this deal structure is that if the seller successfully transitions a majority of the client accounts to the buyer, then he or she should receive the full agreed-upon price. However, if the seller fails to deliver a significant portion of the client accounts, the price should be adjusted to reflect what actually transferred to the buyer. The most effective way to account for this uncertainty is through a properly structured performance-based note, as opposed to an arbitrary discount to the value. Combining a discounted purchase price along with a performance-based note may amplify the buyer's discount, shifting more risk to the seller.

To mitigate risk from the buyer's perspective, buyers prefer to use an adjustable, performance-based promissory note. Typically these notes include a one-time "look-back" tied to the expiration date of the seller's consulting agreement to provide post-closing transition assistance. From the seller's point of view, performance-based notes are predictable and carry a reasonable interest rate on the balance with a "lock-in" at the end of the seller's consulting duties. From the buyer's point of view, downside protection is provided should the anticipated cash flow not materialize.

Performance-based promissory notes can be structured in a variety of ways but in most cases have a buffer built in that contemplates the effect of market fluctuations—losses of 5–7% of the cash flow post-closing—that may not be enough to trigger an adjustment to the note value. Whereas, a loss of 15% of the clients assets, for whatever reason, would almost certainly cause an adjustment to the final value.

To mitigate risk from the seller's perspective, when the deal allows for a performance-based adjustment post-closing, it is imperative that the seller perform due diligence on the buyer. Due diligence is more than a background or credit check; it also involves interviews to determine if the buyer's personality and office culture are going to be a good fit for the clients and if the clients are likely to stay on with the new advisor. If the seller isn't comfortable with the buyer for whatever reason, the likelihood that the deal will close is reduced and the risk of a downward purchase price adjustment is increased.

Once the seller has determined there is a good personality and culture fit, well-prepared documents can help further mitigate risk. Proper documentation will create binding obligations for the buyer, and will clearly state the penalties if the obligations are not upheld. For example, FP Transitions suggests that, in deals with potential downward adjustments, the contracts impose certain restrictions on the buyer until the end of the adjustment measurement period. These restrictions often include changing broker-dealer or custodian affiliation, increasing fees or commissions, and office relocation.

DEAL STRUCTURE: BANK FINANCING

Up until about three years ago, financing arrangements in the financial services mergers and acquisitions (M&A) space were strictly between the buyer and the seller. Slowly, bank financing has become a more readily available option for buyers. When bank financing entered the market, we began to see some changes in the marketplace; more buyers inquired about practices and sellers received larger down payments at closing. Interestingly, even with larger down payments, we have not observed a significant change in pricing multiples.

Before bank financing was available to buyers in this industry, seller financing was previously born out of necessity and created an "economic marriage" between the buyer and seller. It created an incentive for the seller to ensure successful transition of the majority of the client accounts and protected the buyer in the event the accounts did not transfer or in the event of significant change in the market that was beyond their control. As lenders, sellers were allowing the buyer to spread payments over a five-year period on average, charging approximately 5% interest. Comparatively, banks were offering buyers the ability to stretch payments over ten years at a rate slightly higher than what sellers were charging. As such, we have observed an increase in buyers electing to use bank financing over seller financing.

However, buyers understand the importance of creating an incentive for the seller to successfully transition the clients and the goodwill. To this end, even when a buyer finances the deal through the bank, we rarely observe true, 100% non-refundable cash payments being made at closing. Typically, buyers are willing to pay up to 75% cash at closing and will have the seller carry a subordinated note on the balance. Alternatively, they will pay 100% of the purchase price at closing, but a portion of the purchase price—25% or more—is held in an escrow account until the seller's post-closing consulting contract has been fulfilled or the majority of the assets have transferred to the buyer.

While there are benefits and drawbacks to both bank and seller financing, both deal structures contain several core components:

1. The seller's agreement to provide post-closing consulting to help transfer the assets;
2. The seller's agreement to not compete or solicit the clients subject to the purchase agreement;
3. A financial incentive for the seller to successfully transition the clients and their goodwill; and
4. A financial benefit to the buyer allowing them to make payments over time.

We have not seen a significant difference in purchase price when comparing seller- and bank-financed deals. However, for true cash deals, where 100% of the purchase is paid as a non-refundable cash payment at closing, we usually observe discounts in the range of 15–35%. The increased discount here is typically because these types of transactions only include two of the four aforementioned elements:

1. The seller's agreement to provide post-closing consulting to help transfer the assets; and
2. The seller's agreement to not compete or solicit the clients subject to the purchase agreement.

Absent the seller's financial incentive and ability to finance the purchase price, a buyer will generally expect a discount when paying cash at closing since the buyer has assumed all of the risk.

DEAL STRUCTURE: TAX TREATMENT

In an asset-based sale, there are three common classes of assets: (1) the book of business itself; (2) the seller's consulting agreement—i.e., agreement to help transition the clients to the buyer; and (3) the seller's agreement to not compete with the buyer. The tax allocation of the purchase price with respect to these types of assets adds to the shared reward for both buyers and sellers.

The sale of assets—on average 85% of the purchase price—is predominantly taxed at long-term capital gains rates for the seller and is considered an intangible asset to the buyer that can be amortized over 15 years. The remaining 15% is typically allocated between the seller's consulting agreement to provide post-closing transition assistance (on average 10% of the purchase price) and the seller's agreement to not compete or solicit the clients subject to transition (on average 5% of the purchase price). Table 9.2

Table 9.2 Tax Treatment of Assets in a Sale

TYPE OF ASSET	TAX TREATMENT FOR SELLER	TAX TREATMENT FOR BUYER	REPORT ON BUYER'S:
Client Accounts	Capital Gain	15-Year Amortization	Balance Sheet
Seller's Name & Goodwill	Capital Gain	15-Year Amortization	Balance Sheet
Non-Competition Agreement	Ordinary Income*	15-Year Amortization	Balance Sheet
Seller Post-Closing Consulting	Ordinary Income: FICA	Expensed as Paid	Profit & Loss Statement

**Not subject to FICA withholding*

outlines how the four common classes of assets are reported for tax purposes and the benefit of such treatment from both the buyer's and seller's perspective.

One of most commonly ignored benefits of the tax treatment of the purchase price is the fee for the seller's post-closing consulting. This is a service provided by the seller, and as such the consulting fee is expensed by the buyer in the year that it is paid. This means that if a buyer pays one-third of the purchase price at closing, he or she can offset a portion of the down payment by expensing the following:

1. The portion of the purchase price allocated to the seller's post-closing assistance, paid to seller in advance of the performance of the seller's consulting duties; and
2. The pro-rated amount of 1/15th of the client accounts and seller's goodwill.

Though every deal is different, it is important that both buyer and seller understand each other's expectations in addition to the common components, tax considerations, and financing options for structuring the sale of a financial services business.

Ryan Grau, CVA, CBA

Is Mediation a Good Investment?

Acquisition strategies are varied and diverse; how an advisor or a firm pursues acquisitions will depend on their business model and philosophy. While the approach to acquisition should be personalized, it is a mistake to do it alone. In addition to the successful transactions presented in this report, FP Transitions works with many advisors who have endured failed sales or stalled deals. The story of a failed transaction often begins with one or both parties hesitating to hire a mediator, the perception being that their deal is "simple," and buyer and seller can save money if they do it themselves. The information we gather from these clients about their failed sales gives our consultants broader perspective on what works and what doesn't in an evolving marketplace. These are indeed important data points. When we combine this information with the data gathered from successful deals, it is clear that investing in a mediator improves results for both buyers and sellers in terms of success rate, speed, and value.

One misconception advisors often share with us is the belief that one-on-one negotiations are easier and brokers will just get in the way of a personal connection between buyer and seller. This perception is understandable, as it is essential that buyer and seller have a mutual affinity and have aligned interests in order to transfer and retain client relationships after the deal is done. However, mutual affinity is not sufficient to get buyer and seller over basic negotiating factors, such as valuation, deal structuring, and tax allocation of the purchase price. These are complex topics where a mediator can provide expertise and perspective to both sides and advance the deal forward. Financial services is such a regulated industry, with the added complexity of requiring a long transition, that it is common to have a sale get bogged down in "paperwork." So while each party does need representation, there also needs to be a knowledgeable mediator who can be responsible for keeping everyone on track, offers solutions, and has data to show why one side's objection is or is not valid.

In a related fallacy, advisors often perceive that a consultant will add unnecessary expense to the deal; buyers in particular may be cautious of hiring a consultant, believing instead that they can get a better price by negotiating directly. To be sure, attorneys and banks have a reputation of complicating negotiations and accruing expensive fees, but hiring a consultant can be a useful litmus test of either party's genuine commitment to the sale. What's more, an impartial mediator will actually return value to both parties by enhancing alignment and providing guidance as to the contracts to reduce the need for endless revisions.

When we look at what makes transactions succeed or fail, we can see that unmediated deals are fraught with challenges. Advisors relate that they commit four to five years to their acquisition strategy before turning to an expert for help. Considering that successful acquirers can purchase a new practice each year, five years amounts to a substantial investment and a significant wasted opportunity. Even sales that are completed may be deemed unsuccessful in hindsight: a 2014 study of acquisitions across the industry disclosed that one in three advisors were "dissatisfied" with their purchase, some swearing off future acquisitions altogether.[1] This was a surprising statistic within our offices, as most advisors who complete purchases with our consultants report strong client retention—typically greater than 95%—and continued, even heightened, interest in acquiring.

A third-party mediator provides benefits that makes acquisitions more successful. Mediators uphold accountability and momentum: in the 2018 FPA/Janus Henderson survey on succession planning, three out of four advisors had no transition plan, but nearly 60% of advisors who had a documented plan had used an outside consultant.[2] A review of all transactions brought to FP Transitions shows that 85% of mergers and acquisitions that were initiated reached closing. For most deals, the timeline from start to finish was within 14 weeks (longer timelines are often based on year-end tax considerations). For the transactions that did not close, the reasons are telling: buyer or seller did not pass due diligence, the broker-dealer prevented the sale, the parties could not agree on terms, the seller decided to postpone retirement, or the seller demanded a higher price. In situations where the seller is not committed or has outlandish expectations of value, a mediator will help a buyer have confidence when they leave the negotiating table.

When advisors use FP Transitions' Open Market listing service to find their ideal buyer and mediate the sale, sellers receive 15% higher value than compared to one-on-one negotiations involving sellers with a similar business model and AUM. As consultants to the sale, our aim is to keep the sellers focused on the match over the price. The reality of the open market is that competition will influence the purchase price; buyers can protect their investment with balanced deal terms and vetted contracts that support the successful transition of clients and assets to their business.

Whether you are a buyer or seller, the data supports investing in a mediator to get the deal done. Mergers and acquisitions have a reputation for being highly adversarial as both sides fight tooth and nail for the best terms. Within a relationship business like financial services, a successful transaction will balance the interests of buyer and seller so that both are satisfied with the outcome. An experienced mediator will help maintain momentum and alignment so that both sides are enthusiastic about the outcome. In a delicate process like acquisition, where the impact and investment are substantial, a good mediator will pay back their value indisputably.

Christine Sjölin

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[1] "Alpha Acquisition: Maximizing the Return on Your Practice Investment," *AITE* (July 2014), https://www.aitegroup.com (subscription required).
[2] "The Succession Challenge 2018," Janus Henderson Investors & Financial Planning Association, https://www.onefpa.org/business-success/Documents/FPA-Succession-Planning-Report-0418FINAL.pdf.

Business Factors Supporting Growth & Resilience

In the late nineties, not everyone believed that financial practices had transferable value. Financial planning as a profession separate from traditional brokerage was still finding itself and, while the trade was well established, the concept of selling an independent advisory practice was novel and untested. By and large, the brokers and advisors who founded the independent advisory sector had not engaged in serious retirement activities themselves, and a repeatable transition model had not yet been developed.

Shortly after we launched the FP Transitions Open Market listing service in 1999, we experienced our first economic downturn, tied to the dot-com burst. As an internet-based company in the financial services industry, we, too, were vulnerable to a recession; however, the slump in the markets motivated more advisors to participate in our new venture and the industry itself provided a proving ground for the new marketplace. These early sellers seized the opportunity to capture their business value and enjoy life after advising. The planners who remained in the profession were captivated by the growth opportunity that a viable acquisition marketplace had created. When the next bear market started in 2009, we had a new opportunity to see how owners would behave in an uncertain economy and how that uncertainty would affect buyers' and sellers' confidence. A recovery and a bull market later, we not only have the advantage of hindsight but also have substantial practice data to help us understand the underlying characteristics that can influence revenue growth and which ultimately affect long-term value.

What kinds of businesses are best suited to be resilient and to produce sustained growth through variable economic times? As we enter our twentieth year as dealmakers and valuers in the independent financial services industry, it is possible to look at the data gathered over the last two decades to see which business factors transcend market conditions and contribute to sustained growth and higher values.

OVERALL GROWTH RATES ENDING IN 2018

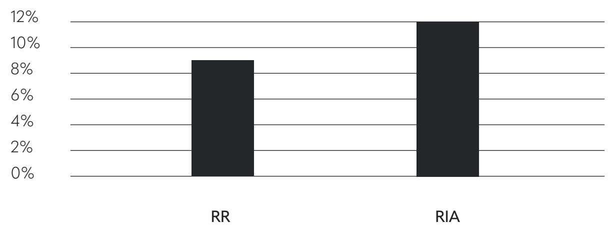
This article is a review of growth rates as reported by practices of various sizes and with different regulatory and ownership structures. The focus is on gross revenue as the best metric for an apples-to-apples comparison of firms across the independent spectrum. The purpose is to understand which businesses had the capacity not only to endure, but to grow through the recession and into the stronger market. Data for this report was gathered from our valuation database, which includes over 11,000 unique valuation records; for our purposes, this report only relies on those records which include a full five years of revenue history covering the period from 2013–2018.

To set a baseline of expectations for this analysis, we started with the macroeconomic factors during the same time period. With the five-year rate of return on 20-year treasury bills averaging roughly 3% and the S&P 500 rate of return for the same period averaging roughly 16%, we anticipated that advisor growth should fall close to the average within this range, or roughly 10%. Given that financial advisory businesses should see not only macroeconomic growth effects on current client assets, but also the acquisition of assets and revenue from new clients and greater share of wallet, the expectation would be to see average growth rates beyond 10%. The results from the data suggest there are factors that can have significant slowing effects on advisor firm growth. Intuitively, growth is a significant driver of equity, and there is an obvious corollary between revenue growth and higher business values. But inconsistent growth doesn't have the same impact as sustained growth, and practices with weak growth may be fatally vulnerable to market fluctuations.

GROWTH BY SIZE & REGULATORY STRUCTURE

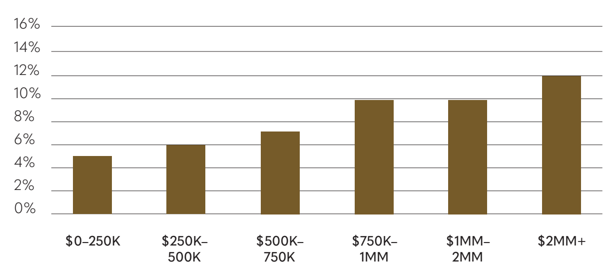
Based on advisor-reported revenue in our valuation database, median compound annual revenue growth for the five-year period ending in 2018 was just above 8%. We have already noted that a strong economy in the short term has created favorable conditions for advisors to operate their practices. The data shows considerable variation in performance, especially when we segment the data by regulatory structure and contrast firms operating as Registered Representatives (RRs) with Registered Investment Advisors (RIAs). Fee-only RIA firms consistently reported 3% higher growth when compared to their RR counterparts over this same period. Our observed five-year growth rate for RIAs was 12% compared to RRs, which grew at only 9% (Figure 11.1). This difference in growth potential could be one of the factors influencing business owners to gravitate toward the RIA model: if advisory firms can grow faster as a whole—which our data indicates is true—then there is a strong incentive to operate under that business model.

Figure 11.1 2018 Average Compound Annual Growth Rate (CAGR) by Practice Type



In general, fee-only RIAs tend to be larger than RRs in terms of gross income (Figure 11.2), and this dissimilarity in revenue has implications for growth—our data from both the 2013 and 2018 studies clearly show that growth rates vary substantially according to the size of the firm. Larger firms with over $2 million in revenue grew faster than smaller ones (12% over the period), producing more than twice the growth rate when compared to books with less than $250,000 in revenue (5% compound annual growth rate). While it may seem intuitive—larger grows faster—in this case it may also be an illustration that smaller practices are either: 1) lifestyle practices with more limited resources, or 2) still in their building phase and looking for growth opportunities.

Figure 11.2 2018 Average Growth Rates by Gross Revenue

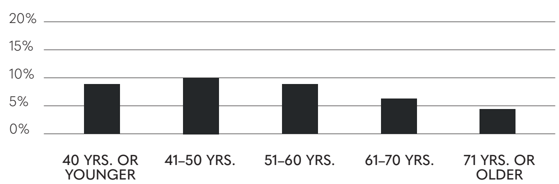


OWNERSHIP STRUCTURE & ADVISOR AGE

When we look at revenue growth through the lens of an owner's age, or the average of owners' ages in multi-owner practices, the results were intriguing. While we expected to see a link between experience and growth rates, the data presented a more nuanced picture.

Focusing on single-owner practices, the data shows solo advisors aged 41–50 produce the strongest revenue growth. Here, the assumption may hold true that a 40-something sole practitioner has the benefit of experience (likely a decade or more) and momentum to grow the practice at peak rates with his or her own efforts. Trailing closely behind the 41–50 age group in terms of revenue growth rates are advisors under 40 (Figure 11.3), who present slightly higher growth rates than solo advisors aged 51–60, who have crested the peak. The trend for the most senior business owners could be a warning sign, as owners between 61–70 report annual growth below 7% and owners that are older than 71 report annual growth rates below 5%—approximately half that of the top-performing groups.

Figure 11.3 2018 Single-Owner Growth Rates by Owner Age

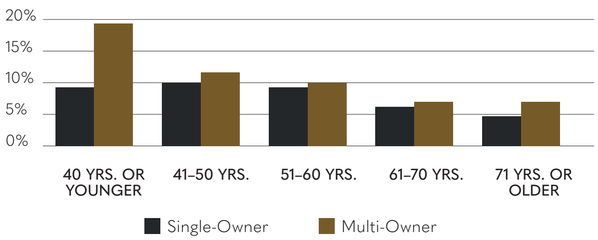


To be sure, each owner needs to review their individual results and goals. Dwindling revenue is a symptom of attrition, which we have previously identified as part of the succession problem. The failure of single-owner practices to pursue succession planning can create a poor situation for the clients. This analysis makes it clear that retiring through attrition creates a poor outcome for the advisor as well: from 2013–2018, practices with advisors over 70 at the helm produced meaningfully lower revenue growth rates than other age classes, and, perhaps most importantly, did not keep pace with the climbing market. As clients disappear and revenue diminishes, business value will ultimately decline, causing significant impact to the advisor's personal wealth.

MULTIPLE OWNERS & CROSS-GENERATIONAL BUSINESSES

Compared to single-owner practices, multi-owner businesses generate stronger growth rates across all age groups. This trend may be related to multiple factors such as expanded personal networks, diversification of services, and operational efficiencies derived from advisors working together in a common business. If single-owner practices generate the strongest growth in the owner's 40s, then when advisors combine the efforts of two or more owners in this age group, the growth rate (somewhat predictably) increases from 10 to more than 12%. The enhanced growth within teams may appear as the predictable result of teamwork, yet for advisors interested in rapid growth, a compelling trend emerges when we review the growth data for multi-owner firms according to the average of the owners' ages: the impact of younger owners in a multi-owner practice. Businesses owned by two or more advisors whose ages average less than 40 demonstrate the strongest growth rates compared to all other groups: 19% for teams whose ages average less than 40 versus 12% for the slightly older owner group averaging 41–50 years old (Figure 11.4).

Figure 11.4 2018 Growth Rates by Owner's Age in Single- and Multi-Owner Practices



Consider what is at play in these businesses. These teams certainly share the benefits of other multi-owner firms (greater service capacity, larger network, opportunity for diversification), but something unique is accelerating their growth. When we look behind the data, we see that the owners of these businesses are not peers, i.e., not a team of 30-somethings. After all, the 30-year-old advisors working on their own do not outperform their elder sole practitioners. Instead, these businesses have a cross-generational ownership structure: a 50-year-old advisor and a 30-year-old junior partner, or a 60-something founder with multiple minority owners at various stages in their careers and young enough to draw the average age below 40. It isn't just the grouping of like ages; the business is also being driven by the different perspectives that each age group brings to the practice. Contrast this with teams whose ages average 60 or above, which are much more likely to be directed by peers. The combined effect of experienced advisors working in alignment with younger, highly motivated professionals has significant measurable impact on year-over-year growth.

While much has been written about the need to build cross-generational businesses, recruiting and retaining young professionals remains a challenge for many business owners. Finding suitable next-generation talent can be difficult. Some advisors neglect recruiting because they are wary of the responsibilities that come with managing a growing team. Creating alignment between founders and successors often requires restructuring the entity and compensation systems from their solo-advisor form, while processes and communication need to be organized to provide for efficient service from a multi-advisor team. Others see hiring as a distraction from what really drives their business value—acquiring and serving more clients. However, as Figure 11.4 shows, investing resources in finding and keeping the right next-generation leaders will pay dividends in your firm's potential to grow.

CLIENT DEMOGRAPHICS

Focusing on client acquisition is not a misguided strategy for growth-oriented advisors. Certainly, the most valuable asset in a financial advisory practice is the goodwill (and cash flow) derived from its client relationships. Client demographics are always part of best practices seminars and articles, however much of what has been presented is conventional wisdom. Within our data, we've been able to parse out the breakdown of client age with some interesting insights.

Clients between the ages of 51–70 are often considered "prime" clients as they are commonly believed to be at the peak of their earning capacity while not yet drawing down their savings as they transition into retirement. The combination of income and savings suggest that these clients have the highest potential to add new assets to the business. Advisors typically pursue these clients most aggressively, attributing most value to acquiring these relationships, whether organically or by purchasing them.

When we drill down into client ages to determine which clients have the greatest indication of future revenue growth, the result is somewhat unexpected. Clients in the "prime" age group make up roughly the same percentage of assets under management across all businesses (between 48–50%) (Table 11.5). However, businesses with the highest year-over-year growth rate as compared to other businesses with a higher average age also have the highest concentration of assets from investors in the 31–50 age group (Table 11.5), suggesting that this demographic may be a leading indicator of future growth. Indeed, cultivating a relationship and securing early investments from younger clientele positions the business to capture additional assets during future wealth events, such as a career advancement, 401(k) rollover, or inheritance. Businesses with the weakest growth have the least amount of assets from investors under 50 and the most assets from clients over 70.

Another piece of conventional wisdom is that advisors and their clients come from a similar age group pool (+/- ten years from the advisor), and this is, in fact, observed among the oldest advisors. This could be interpreted as a "red flag" regarding practice growth, as businesses managed by the oldest practitioners report the least client diversity—and, not coincidentally, the poorest growth rate. This points to a potential fatal flaw for senior advisors: failure to nurture cross-generational relationships could be crippling as the advisor is unlikely to retain the assets transferred to their clients' heirs. Septuagenarians who intend to remain in the business (and advisors who want to work into their 70s) would do well to pursue younger investors, but the data shows that a more effective strategy would be to partner with a skilled, qualified next-generation owner (or two).

The cross-section of trends by owner's age, client demographics, and total revenue paint a clear picture for lifestyle practice owners. Solo advisors have a limited period of time to escalate their business to the peak of their abilities before it becomes more difficult to grow the business on their own. This is not a value judgment that these owners are less active or less invested, but the data suggests that, for whatever reason, revenue growth is more challenging for solo advisors as they age, and smaller solo practices are in double trouble. Sole practitioners should be mindful of where they are in this growth curve in order to create a specific plan for

Table 11.5 2018 Client Demographics by Owner's Average Age in a Single Business (Single- & Multi-Owner)

	OWNER'S AGE RANGE				
	40 Yrs. or Younger	41–50 Yrs.	51–60 Yrs.	61–70 Yrs.	71 Yrs. or Older
CLIENT GROUP AGE RANGE					
Under 30 Yrs.	4%	5%	4%	4%	3%
31–50 Yrs.	28%	21%	18%	16%	15%
51–70 Yrs.	48%	48%	50%	51%	50%
Over 70 Yrs.	19%	22%	24%	26%	30%
Corporate/Institutional	2%	4%	3%	3%	2%

the future of their business. If the preference is to maintain a lifestyle practice, they should acknowledge the limits of their individual efforts and plan accordingly. However, if the owner prefers to continue expanding the business, the data suggests that partnering with another advisor, particularly a younger professional, will provide stronger revenue and greater resources to continue growing the business into the next decade of operation.

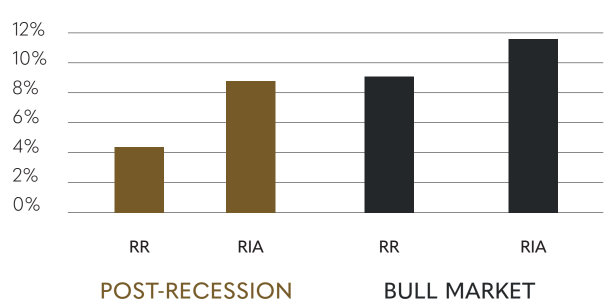
2013 VS. 2018 (A STORY OF RESILIENCE AND RECOVERY)

In the period from 2013–2018, wealth managers had the benefit of the strongest bull market since World War II. The five years prior, from 2008–2013, include the largest market decline since the Great Depression. When we review data from these two periods, we can contrast information from the recession and recovery with data from the stronger economy. This lets us see which practices were more resilient during the weaker economy and stronger when the recovery began.

If we break down the data using the same groupings as we've discussed above, we can uncover evidence as to which firms are more resilient when markets are rough. When we divide the data by the regulatory structure and compare RIAs to RRs, we see that RIAs grew about 50% faster than RRs in the five years leading to 2018, but grew at double the rate of RR practices in the five years leading to 2013 (i.e. RIAs came out of the recession faster) (Figure 11.6). This trend suggests that RIAs are more robust and sustainable during volatile markets than RR-only businesses and are better positioned to grow once the markets improve. In a similar vein, firms with younger owners (as indicated by average owner age) grew faster than firms led by older advisors; not only did they grow faster, but the spread between their revenue growth was wider coming out of the recession than it was during the more favorable economy between 2013–2018.

Our data comes from advisors who persevered through the downturn, and therefore does not include information from advisors who retired, sold, or simply left the industry during this period. It does, however, include the younger and multi-owner practices who acquired or merged with the senior professionals as part of their succession plan during the same period of time (to be sure, market turmoil often triggers a retirement conversation for many advisors). The spread between growth rates based on average owner age suggest that older advisors are more susceptible to headwinds during tough economies. Owners of lifestyle practices who do not make a proactive decision to retire may already be experiencing retirement through attrition, which a down market accelerates. Our experience with sole practitioners who choose to persist through the headwinds reveals their focus is often on maintaining stability for their existing clients with less energy invested in building the business. While this is not an incorrect approach, it does not position an advisor for growth when the market improves.

Figure 11.6 Average Compound Annual Growth Rates (CAGR) by Type (2013 vs. 2018)



FINAL THOUGHTS

As a business owner reviewing growth data, it's important to evaluate your firm's position within the industry and consider how your business is performing compared to others in your situation. Advisors should also be forward-thinking with regard to what they want their businesses to look like in the next five to ten years. If your business is growing apace with the trends, what can be done to ensure that you avoid the constriction observed in your peer group as you age? Do you want to continue building and investing in the next generation, or do you want to stay on top of the market and make a move to monetize your value while it is strong? Today's financial professionals have substantially more options than they did 20 years ago and better resources to help them determine the path that is right for them. Many owners have energy to keep running their business but admit to us that it's still not enough energy to actively build and recruit. And that's perfectly fine. The important take-away is to recognize where your practice lies within the trends of the marketplace and to plan accordingly.

Christine Sjölin
Ryan Grau, CVA, CBA

Valuation, Price, & Lender Approvals

There are several ways to analyze the financial health of an investment advisory business and get to a purchase price that is amenable to the buyer, seller, and any other stakeholders in the transaction. For instance, a valuation company is going to analyze the business in a different manner than a financial institution funding the transaction. Each stakeholder conducts their own unique, interdependent due diligence, and it is important to understand what each stakeholder is looking for when they complete their valuation.

When looking to assess the financial health of your business, or if a buyer and seller are looking to start negotiations, the best place to begin is often to get a business valuation. Because advisory businesses are service-oriented and do not have many tangible assets on the balance sheet, investors or buyers are often looking at the earnings, and ultimately the cash flow, of the business to render a value. This notion can be confusing for potential dealmakers because conversations around market value often start with a revenue multiple. While that may be one point of interest in initial negotiations, this frequently leaves out discussions around profit margin, efficiency ratios, earnings growth, and other data points that are important when valuing a business.

When analyzing and valuing a business based on cash flow, there are several ways that stakeholders will make decisions around value and the ability to provide capital. For instance, valuation companies alone have multiple methods to determine value—depending on the circumstances, they may use market value based on comps, multiples of earnings, or a discounted cash flow analysis to name a few. The ultimate valuation figure is commonly a number based on an average transaction structure.

A valuation gives you a good idea of enterprise value; however, it is rare that the purchase price of the business is simply equivalent to the valuation, as the terms of the deal will affect the purchase price. Some valuation firms will provide potential deal structures and guidance on how those structures should warrant a premium or discount to the price. This assessment is based partially on risk. With an all-cash offer, the buyer is taking on all the risk and the seller's involvement post-closing may be limited, so the buyer might get a discount on the price. On the other hand, a transaction that is highly contingent on performance with a smaller down payment will shift much risk to the seller and will usually result in a premium. Bank-financed sales often require seller covenant even when a down payment is high, which also tends to balance the risk.

The structure of the transaction will affect the analysis done by lenders or other providers of capital. Lenders look at the repayment ability of the business in addition to the value of the firm. This can be called a debt service coverage ratio, which, simply stated, measures whether there is enough cash flow to cover the annual principal and interest payments of the note with a buffer (annual cash flow or annual debt service). This can be calculated on a historical basis, but lenders will also consider projections to see what the firm's revenues will look like the future. Also, there will be a focus on revenue and earnings growth and on whether acquisitions will bring economies of scale to the business.

The deal structure, like the valuation or purchase price, will influence the lender's analysis, specifically as it relates to the denominator in the debt service coverage ratio mentioned above. The denominator in that equation is the annual debt service, which is a combination of lender debt and any seller note that the buyer is responsible for. If the term of the seller debt is a typical three to five years, the annual debt service will be higher for that portion of the purchase price than for a typical ten-year lender note. It is the lender's job to assist in creating a structure that contemplates the risk between buyer and seller, in addition to making sure the debt service coverage ratio meets bank guidelines.

As you can see in Table 12.1, Example 2 has less total annual debt service because of the discount given to the purchase price and the larger portion of the debt (75%) put over a ten-year term instead of a five-year term. These examples do not contemplate whether Example 2 is too risky for a buyer, but offers some insight into how lenders are looking at the transactions. As mentioned earlier, the lender's job is to balance the buyer's ability to pay and the structure that will lead to loan approval.

Although cash flow lenders and other providers of capital look to a borrower's earnings as the primary source of repayment for a loan, they also examine the borrower's balance sheet. If companies keep cash on hand and invest retained earnings back in the business instead of distributing the net income to the owners, they will provide additional strength to anyone making an investment or a loan to the business.

Figure 12.1 The Effect of Deal Structure on Financing

	EXAMPLE 1	EXAMPLE 2
Purchase Price	$1,000,000	$900,000*
Bank Note (10-yr. term, 7%)	$500,000	$675,000
Annual Debt Service	**$69,665**	**$94,048**
Seller Note (5-yr. term, 7%)	$500,000	$225,000
Annual Debt Service	$118,807	$53,463
Total Annual Debt Service	$188,472	$147,511

**Discount due to increased down payment*

It is critical to understand how stakeholders assign worth to advisory businesses in order to increase the value of your firm, obtain capital for growth, and have the ability to sell your firm when the time is right. The good news is valuation firms that are industry-focused will be able to provide this type of consultative support and help you increase the value of your firm.

Mike McGinley, Live Oak Bank

Live Oak Bank is a digitally focused, FDIC-insured bank serving customers across the country. Live Oak brings efficiency and excellence to the banking process, without branches, by using a focused approach to technology and innovation.

Valuation Methodology: Income Approach

As discussed earlier in this study, the value in a larger, profitable business is an owner's ability to receive profits and experience the increase in value of his or her respective share of the business as growth continues, also known as capital appreciation. In this instance, the Income Approach to valuation, which measures the value of the internal benefit stream received by a business's owner is an appropriate approach to determining value.

The Income Approach is based on the concept that a business's value lies in the future economic benefits that will flow to the owner of that business. In all variants of the Income Approach, the value of the forecasted economic benefits is adjusted for risk and the time value of money using either a capitalization rate or discounting process. There are two commonly used methods of valuation under the Income Approach: Capitalization of Future Benefits Method or the Discounted Future Benefits Method. In the context of valuing financial services businesses, "future benefits" most commonly refers to projected revenue, earnings, and/or cash flow.

CASH FLOW VS. EARNINGS BENEFIT STREAMS

Economic benefit streams are typically a measure of earnings or a measure of cash flow. Most business owners are familiar with levels of earnings, such as Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA), Earnings Before Interest and Taxes (EBIT), Discretionary

Figure 13.1 Valuation Methodology Flow

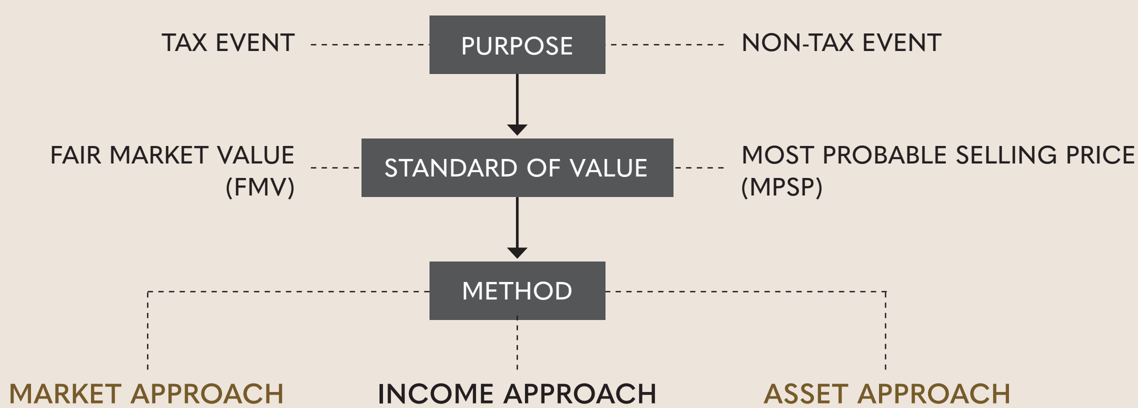


Table 13.2 Business Cash Flow Calculations

	NORMALIZED NET INCOME		NORMALIZED NET INCOME
+	Depreciation & Amortization	+	Depreciation & Amortization
+/–	Changes in Working Capital	+/–	Changes in Working Capital
–	Anticipated Capital Expenditures	–	Anticipated Capital Expenditures
+	After Tax Interest	+	After Tax Interest
		+/–	Changes in Long-Term Debt
=	NET CASH FLOW TO INVESTED CAPITAL	=	NET CASH FLOW TO EQUITY

Earnings/Earnings Before Owner Compensation (EBOC), and Gross Revenues. These specific benefit streams are more commonly applied in the context of the Market Approach, as they are typically capitalized using pricing multiples derived from transaction data from comparable businesses (as described earlier in the study). Cash flow is a more commonly used benefit stream in the context of an Income Approach. As opposed to an earnings benefit stream, which measures various levels of profitability within a business, cash flow measures the flow of a dollar from the top line of the business down to the various stakeholders in the business, which can include both debtors and investors. In *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses,* Gary R. Trugman compares cash flow to a measure of earnings as follows:

> *A valuation analyst will frequently find that using cash flow is a better measure of the company's earning capacity. This is particularly true when a more realistic picture is being sought of the amount of money that will be available to pay to the owners of the business as a return on their investment. Many profitable companies go out of business, but it is rare that we see a business with solid cash flow go under.*[1]

There are two common measures of cash flow in a business: 1) net cash flow to equity, and 2) net cash flow to invested capital. Net cash flow to invested capital is a measure of the cash available to debt and equity holders in a business after all operational expenses have been paid. Net cash flow to equity (sometimes called free cash flows to equity) is a measure of the cash available to equity holders in the business after all long-term, interest-bearing debt has been serviced. Table 13.2 is a basic calculation of both benefit streams for comparison.

The main difference between the two benefit streams is the service of long-term debt. Net cash flow to invested capital as a general rule best represents the economic benefit to all of the providers of capital.[2] Therefore, it is the most commonly utilized measure of cash flow as a benefit stream. However, in instances where a company has a substantial amount of long-term debt on the books and the intended user of the report is a potential equity partner, net cash flows to equity provides a more accurate representation. Again, the purpose and use of

[1] Trugman, Gary R., *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses*, 4th Edition. (Durham, NC: AICPA, 2012).

[2] Pratt, Shannon P., Grabowski, Roger J., and Brealey, Richard A., *Cost of Capital: Applications and Examples*, 5th Edition. (Hoboken, NJ: John Wiley & Sons, 2014), 16.

the valuation report will inform what benefit stream should be selected.

The selection of an appropriate discount rate or capitalization rate goes hand-in-hand with the selection of a benefit stream, be it earnings or cash flow. Both discount rates and capitalization rates are intended to express the rate of return required by investors in the marketplace to attract investment in businesses similar to the business being valued.

CAPITALIZATION OF FUTURE BENEFITS

The Capitalization of Future Benefits Method is the simpler of the two methods under the income approach in form and function. The formula below illustrates the components of this method and their function:

$$V=B/R$$

In the formula above, "B" represents a defined benefit stream (i.e. gross revenue, earnings, cash flow); "R" represents the required rate of return on the benefit stream, which is represented by the capitalization rate chosen by the appraiser; and "V" represents the resulting value.

There are a few assumptions made here. First, all of the tangible and intangible assets are indistinguishable parts of the business and no attempt is made to separate their values. Second, and most importantly, the capitalization process assumes that the selected benefit stream will grow in perpetuity at a consistent rate. When growth is expected to be uniform, the selected benefit stream "B" is the first forecasted year (current year plus one year of growth).

While the basic calculation under the Capitalization of Future Benefits Method is relatively simplistic, the calculation of the benefit stream and the selection of the long-term growth rate must be made with care. Any mistake in these inputs can result in an unrealistic valuation. For example, if a long-term sustainable growth rate is unsupportable based on the history and the knowable facts about the business, the appraiser will overvalue the benefit stream. Likewise, incorrect assumptions could cause a business to be significantly undervalued.

DISCOUNTED BENEFIT STREAM

Unlike the Capitalization of Future Benefits Method, the Discounted Benefit Stream Method, often referred to as the Discounted Cash Flow Method, assumes that the benefit stream being analyzed will continue to grow in a non-linear pattern for a period of time until it stabilizes and then continues to grow (or decline) at a consistent rate. This method assumes that the value of the business is equal to the future cash flows or earnings of the business discounted back to present value, plus the terminal value of the business. Using this valuation method allows the appraiser to select varying growth rates for the business over the forecasted period using input from management, projections for the growth of the industry, and forecasted growth of the economy as a whole.

Similar to the Capitalization of Future Benefits Method, the Discounted Future Benefits Method requires selecting a benefit stream and a corresponding rate of return, which is represented by a discount rate, not a capitalization rate.

The key distinction between the use of a discount rate and a capitalization rate is that there is no growth assumption built in to a discount rate. Rather, the relationship between the discount rate and capitalization rate can be illustrated by the following formula:

Discount Rate = Capitalization Rate + Long-Term Sustainable Growth Rate

A crucial part of any valuation analysis made by a certified appraiser is selecting an appropriate discount rate or capitalization rate that aligns with the benefit stream being valued.

CAVEATS TO DISCOUNT RATES AND BENEFIT STREAMS

In both the Capitalization of Future Benefits and Discounted Future Benefits Methods, the selection of an appropriate benefit stream and discount rate are essential. These two elements are not selected in isolation, and both are affected by the purpose of the valuation.

In *Understanding Business Valuation,* Trugman points out some factors that warrant special consideration:

1. *The nature of the business and its capital structure;*
2. *The purpose and function of the appraisal; and*
3. *The particular subject of the valuation (for example, whether or not the valuation involves a controlling interest or a minority interest).*[3]

If a business is highly leveraged, not taking into account the continued debt service may not be appropriate given the business's capital structure. Additionally, if the purpose of the appraisal is to determine the fair market value of the business's operating assets (which for the financial services industry indicates the goodwill established with an advisor's clients) in an M&A scenario, then using an after-tax benefit stream to value the company wouldn't necessarily make sense; i.e., what the seller pays in taxes is irrelevant to the transfer of the benefit stream. Finally, valuing a minority interest with no power to enact changes in a company's capital structure, using a benefit stream in which several control-level adjustments have been made in the normalization process may not be appropriate.

Table 13.3 Pre-Tax vs. Post-Tax Capitalization Rates

COMPANY A: CAPITALIZATION RATES		
EBITDA: $500,000		
Effective Tax Rate=40%		
	Pre-Tax	Post-Tax
Capitalization Rate	20%	33%
Value	$2,500,000	$1,500,000
$ Difference from Proper Application	$0	($1,000,000)
% Difference from Proper Application	0%	-40%

Table 13.4 Application of Pricing Multiples

COMPANY A: PRICING MULTIPLES			
EBITDA: $500,000			
	Gross Revenue	EBITDA	EBOC
Multiple	2.5	5	3.5
Value	$1,250,000	$2,500,000	$1,750,000
$ Difference from Proper Application	($1,250,000)	$0	($750,000)
% Difference from Proper Application	-50%	0%	-30%

CAPITALIZATION RATES AND MARKET MULTIPLES

As we mentioned in our discussion of the Market Approach on page 14, the selected market multiple must align to the benefit stream from which it is derived. The same is true of capitalization rates. A pre-tax capitalization

[3] Trugman, Gary R., *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses*, 4th Edition. (Durham, NC: AICPA, 2012).

rate shouldn't be applied to a post-tax or tax effected benefit stream. Similarly, a multiple derived from the relationship between a business's EBITDA and the sales price shouldn't be applied to that business's gross revenue. A brief illustration of this concept and its impacts is included in Tables 13.3 and 13.4.

Under the "Company A: Capitalization Rates" header, a pre-tax and post-tax capitalization rate has been applied to a pre-tax benefit stream (EBITDA) using our formula from earlier: V=B/R. When tax is considered, the capitalization rate yields a value on the pre-tax benefit stream that is 40% lower than the correct application of the pre-tax capitalization rate to that same benefit stream. Said another way, applying the improper post-tax capitalization rate to a pre-tax benefit stream will cause Company A to be undervalued by 40%.

There is a similar risk with using pricing multiple approaches. Under the "Company A: Pricing Multiples" header, three separate market-based pricing multiples are applied to one benefit stream. If an analyst were to apply the Gross Revenue or EBOC pricing multiple to the business's EBITDA under the Market Approach, the result would be a business that is severely undervalued.

While the numbers and calculations in Table 13.3 have been simplified, they illustrate a critical point when applying any type of capitalization rate, pricing multiple, or discount rate. Regardless of the method selected for valuation, the applied capitalization rate, discount rate, or pricing multiple must be applied to its correlating benefit stream.

CONCLUSION

Understanding the minutia of the Income Approach to valuation can feel daunting, but the simple truth remains: all else being equal, the more profitable a business becomes, the more value the owners of that business can and should realize. Placed in the hands of a qualified appraiser or analyst, the Income Approach is a great tool that can enable entrepreneurs to establish the value of what they have grown and turn their profits into a payout when the time comes to transition ownership within the company.

Aaron Wells, CVA, CBI
Julia Sullivan

Final Thoughts: The Future of Independent Financial Ownership

If there is one overriding observation from this data and analysis that I could offer as a last thought, it would be this: The evolution of this profession lies in building strong, sustainable enterprises.

Enterprises prosper. Enterprises are successful buyers. Enterprises recruit and retain top talent. Enterprises are capable of executing growth plans through multiple avenues—organically, by merger, or by acquisition. Enterprises are built to thrive for many generations.

But enterprises are not always defined by size or AUM. We see larger wealth advisors who have not built sustainable enterprises; instead, they've built support organizations for a handful of superstar advisors. The value of these organizations lies in the producing advisors, not in the businesses themselves, and the value can walk across the street at any time. The result is an inability to recruit and retain next-generation advisory talent as shareholders, rather than book builders. As we look back on the past couple of decades, we've seen many energetic and well-intentioned owners spend too much time working "in" their businesses rather than "on" their businesses. Success in the future—in this profession—will require both.

In our work helping advisors create successful and sustainable businesses, we've discovered that increased value, profitability, acquisition viability, and succession are all by-products of building a strong, sustainable enterprise. Our consulting work recognizes that reality and is focused on supporting enterprise transformation for advisors as they continue to grow and prepare for the future.

How do you build a strong, sustainable enterprise? Hard work and a clear path are good starting points, but it takes a bit more. We approach this with a step-by-step process: First, we assess the practice to determine where it is, how it got there, and where the owner(s) want to go. Next, once we determine its current position, we help practice owner(s) create an actionable plan centered on the key elements of advisor compensation, entity structure, and other organizational elements to create an investable business. Finally, we help our clients use the equity value they have created to recruit, reward, and retain the best of the next generation of advisory talent.

Our mission at FP Transitions has always been to provide valuable insight and resources to the financial services industry. We continue to focus on developing the most successful and most trusted strategies for building strong, valuable, financial *enterprises*—ones that can support continued growth and sustainability for generations to come. That is good for our profession and for all the clients who depend on the work that you do.

Brad Bueermann, CEO

FP Transitions Enterprise Consulting is an integrated, end-to-end solution with expert support and a targeted plan tailored to your unique business and goals.

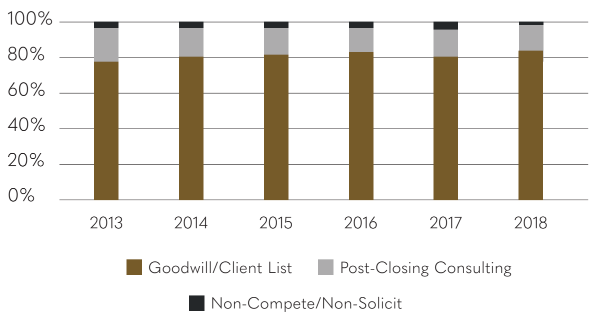
Visit **fptransitions.com/enterprise2019** to take the first step toward creating a sustainable enterprise ready for optimized value and explosive growth.

Appendix A: Historical Transactional Data 2013–2018

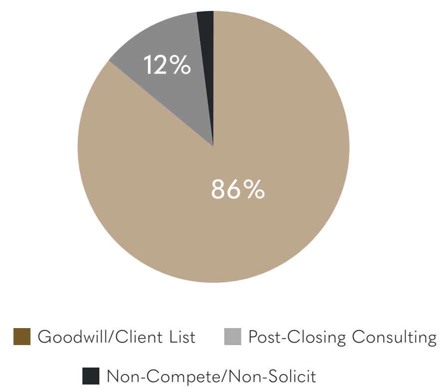
AVERAGE DEAL STRUCTURE MULTIPLES	2013	2014	2015	2016	2017	2018
REGISTERED REPRESENTATIVES (RRs) Gross Revenue Multiples						
High	2.39	2.31	2.53	2.30	2.17	2.40
Median	1.89	1.81	1.72	1.70	1.89	1.84
Average	1.89	1.78	1.66	1.71	1.75	1.87
Low	1.25	1.32	0.90	1.01	0.83	0.98
Average Time on Market (Weeks)	30	11	9	13	13	21
Average Age of Seller	64	62	64	64	67	64
FPT Certified Valuation Report Value vs. Selling Price	105%	101%	103%	98%	98%	94%
REGISTERED INVESTMENT ADVISORS (RIAs) Gross Revenue Multiples						
High	2.55	2.43	3.45	2.84	2.53	2.68
Median	2.54	2.31	2.44	2.39	2.46	2.49
Average	2.54	2.31	2.64	2.47	2.46	2.47
Low	2.52	2.20	2.04	2.31	2.38	2.18
Average Time on Market (Weeks)	15	12	6	14	13	51
Average Age of Seller	61	61	63	60	67	61
FPT Certified Valuation Report Value vs. Selling Price	107%	96%	96%	100%	107%	101%
TAX STRUCTURE						
Goodwill/Client List	78%	81%	82%	83%	81%	86%
Post-Closing Consulting	17%	14%	14%	13%	14%	12%
Non-Compete/Non-Solicit	5%	5%	4%	4%	5%	2%
DEAL STRUCTURE						
% Down (of Purchase Price)	31%	29%	27%	32%	36%	37%
% Note (of Purchase Price)	69%	71%	73%	67%	64%	63%
Length of Note (Years)	4	5	4	5	5	5
Interest Rate	4.2%	3.9%	4.1%	3.8%	4.4%	4.0%

PURCHASE PRICE & TAX ALLOCATION

Historical Purchase Price Allocation

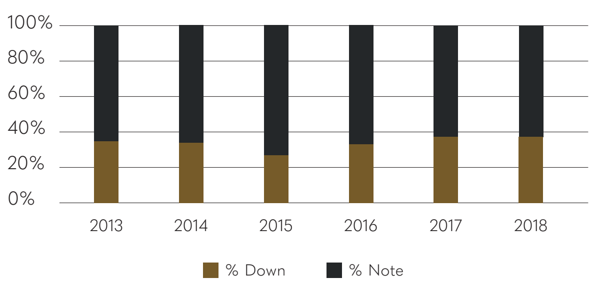


2018 Tax Allocation of Purchase Price

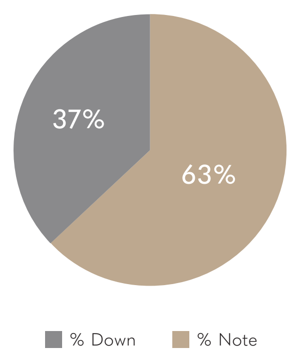


AVERAGE DEAL STRUCTURE

Average Deal Structure 2013–2018

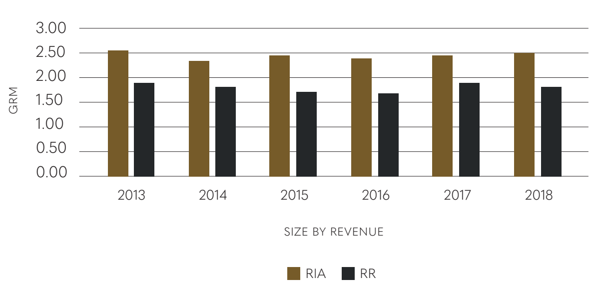


Average Deal Structure 2018



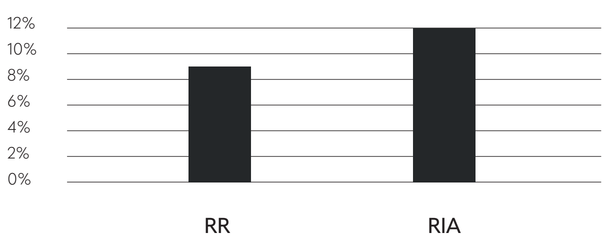
MEDIAN GROSS REVENUE MULTIPLE

Historical Median Gross Revenue Multiple by Practice Type

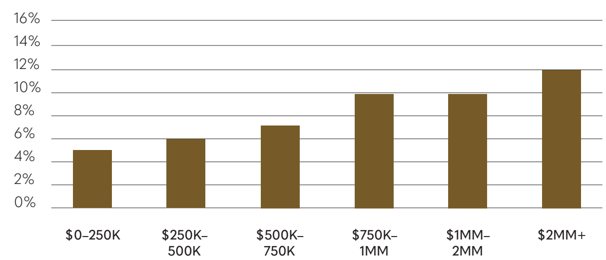


Appendix B: 2018 Advisory Business Growth & Performance Data

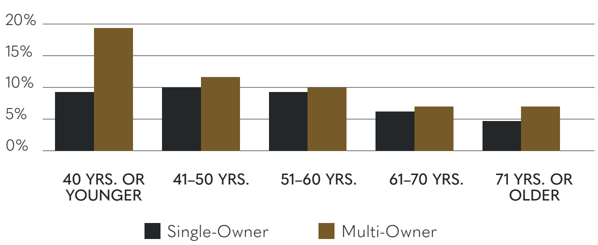
Average Growth Rates by Practice Type



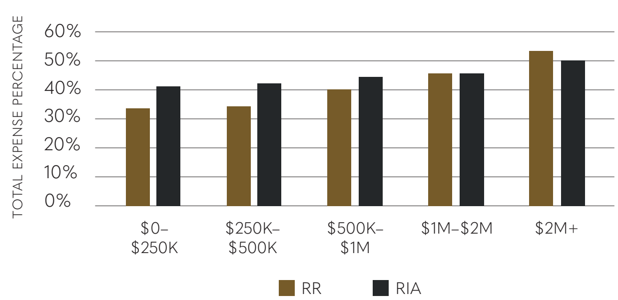
Average Growth Rates by Gross Revenue



Average Growth Rates by Combined Owners' Age: Single- vs. Multi-Owner Practices



*Average Business Expenses by Gross Revenue and Practice Type**



**Includes BD overrides, other BD fees, and firm overhead*

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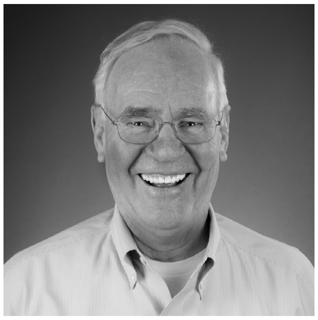

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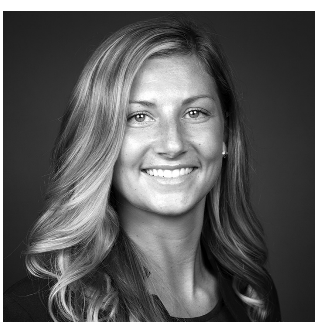

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FP Transitions is the nation's leading provider of equity management, valuation, enterprise consulting, and succession planning services for the financial services industry. Based in Portland, Oregon, FP Transitions operates the largest open market for buying and selling financial service practices in the U.S. FP Transitions' team of 40 professionals provides integrated expertise in a wide range of practice management areas, including exit and continuity planning, practice benchmarking, compensation studies, entity formation, mergers and acquisitions, and equity compensation strategies.

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