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, Tax, 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.

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