THE BASICS YOU NEED TO KNOW

*The following is an excerpt of Chapter 1 our book, **Buying, Selling, and Valuing Financial Practices–The FP Transitions M&A Guide**, by president and founder David Grau Sr., JD. Available now on Amazon.*

Avoiding the Critical Mistakes

There are two critical and common mistakes that independent financial advisors make in the mergers and acquisitions (M&A) space. One is to treat every sale or acquisition target the same way: applying the same valuation approach, the same set of documents, and a common set of payment terms or financing elements, regardless of the size or structure or sophistication of the opportunity. The second mistake is to equate exit planning with succession planning—the two concepts are completely different and advisors must understand the differences if they are to succeed in this arena and correctly structure a transaction, whether as seller or buyer.

The specific purpose of this book is to help advisors understand how to sell what they've built to someone else for maximum value and at optimum tax rates, and/or to successfully complete an acquisition and become someone's exit strategy, on the best possible terms, with minimum risk, writing off the entire purchase price over time. These are not disparate goals; they are connected in every way and part of a win-win-win strategy that must be the ultimate goal for the buyer and seller, the good of this industry, and the client base that serves as judge and jury over the outcome of the M&A process.

For most independent financial advisors, the worth of their practice or business is easily the largest and most valuable asset they own. Critical mistakes cannot be allowed to happen. The process of sorting out the issues, learning the basics, and then mastering the more complicated aspects starts right here, right now.

Exit planning results in a transaction with either an external buyer or an internal buyer, but the commonality is that the process is completed in one step—usually not suddenly, just completely. External buyers usually have a very similar practice model but are often much larger than the seller in terms of size and value, while an internal buyer is someone you've hired, know, and trust (maybe even a son or daughter), but who is often without the financial resources and the experience of the external buyer.

A succession plan is quite different; it is designed to build on top of an existing practice or business and to gradually and seamlessly transition ownership and leadership internally to the next generation of advisors. The founding owner in a succession plan is not a "seller"—they're a business partner or a shareholder, and long-term, sustainable growth powered by multiple generations of collaborative ownership is the number one goal. This book is not about succession planning. If that topic is of interest to you, please consider reading our first book, Succession Planning for Financial Advisors: Building an Enduring Business.

As a part of exploring the various exit strategy options and how to structure those transactions, this book will also explain the different value and valuation techniques and their applicability given various situations. You'll learn the difference between an asset-based deal structure and a stock-based deal structure, as well as how to employ various financing methods such as a promissory note, performance-based or adjustable notes, revenue-splitting or revenue-sharing arrangements, and earn-outs. The element of bank financing will also be carefully considered because this is a powerful tool when used correctly. We'll also evolve beyond the basic concept of silos versus ensembles in the process toward a more sophisticated and accurate classification process.

One of the fundamental tenets of this book is to not treat all advisors the same as though one approach to valuation, contracts, payment terms, and contingencies fits all situations, sizes, and revenue models across the spectrum. In fact, there is no one single method, one single view of this unique industry that works every time for every buyer or seller. It depends on what you've built and how you've built it. Using your specific vantage point, our goal is to explain what works and what doesn't work, and how to do the job right, whether you're a buyer or a seller. In the end, we all need the best buyer to prevail, not the first on the scene or the one with the most money.

If you approach all M&A opportunities in this unique industry with one set of tools, one set formula, and just one valuation approach or method to be applied in every instance—the way most writers, consultants, and practice management personnel recommend—your view of the world will always be partly right, but mostly wrong, not unlike the blind men and the elephant from the Indian folktale told in a poem by John Godfrey Saxe:

The Blind Men and the Elephant

It was six men of Indostan
To learning much inclined,
Who went to see the Elephant
(Though all of them were blind),
That each by observation
Might satisfy his mind.

The First approach'd the Elephant,
And happening to fall
Against his broad and sturdy side,
At once began to bawl:
"God bless me! but the Elephant
Is very like a wall!"

The Second, feeling of the tusk,
Cried, "Ho! What have we here
So very round and smooth and sharp?
To me 'tis mighty clear
This wonder of an Elephant
Is very like a spear!"

The Third approached the animal,
And happening to take
The squirming trunk within his hands,
Thus boldly up and spake:
"I see," quoth he, "the Elephant
Is very like a snake!"

The Fourth reached out his eager hand,
And felt about the knee.
"What most this wondrous beast is like
Is mighty plain," quoth he,
"'Tis clear enough the Elephant
Is very like a tree!"

The Fifth, who chanced to touch the ear,
Said: "E'en the blindest man
Can tell what this resembles most;
Deny the fact who can,
This marvel of an Elephant
Is very like a fan!"

The Sixth no sooner had begun
About the beast to grope,
Then, seizing on the swinging tail
That fell within his scope,
"I see," quoth he, "the Elephant
Is very like a rope!"

And so these men of Indostan
Disputed loud and long,
Each in his own opinion
Exceeding stiff and strong,
Though each was partly in the right,
And all were in the wrong!

Valuation: The Great Debate

There is a lot of debate in the financial services industry as to the best approach and method to apply when valuing a financial services practice. Some feel an income approach (focused on earnings or profitability as espoused by the discounted economic cash flow method) is best. Others prefer to use a direct market data method that relies on market "comps" or comparable transactions between buyers and sellers of similarly structured practices or businesses within the same industry. Some buyers prefer a much simpler valuation approach, applying basic revenue splitting, revenue sharing, or earn-out payment terms to measure actual success over a period of years—a wait-and-see approach. Some buyers insist on using a multiple of top-line revenue or adjusted bottom-line earnings.

Buyers tend to use the one method that they understand, or a method that has worked well for them in the past, regardless of the size and structure of the acquisition opportunity. Sellers are often embarking on the valuation trek for the first time and sometimes have only a limited understanding of this crucial topic. Practice management personnel at the various broker-dealers and custodians have their own agenda and weigh in on the valuation debate with their own preferences. Each party to the process has a goal, and the goal really isn't about finding the right answer; the goal too often is to find the answer each party needs to be true to advance their own cause. As a result, there is a lot of unnecessary and unjustified confusion about how to value a financial services practice or business for M&A purposes.

The goal of valuation, aligned with the proper approach and method, should be to bring the parties together, not to serve as a wedge and to bludgeon the other side with an argument about who is right or wrong and why one party's approach is superior to the other's. Valuation in the financial services industry has become the single most divisive issue in the M&A process. Valuation disputes stop most deals before they even start. Let's end the debate with the goal of completing more transactions and taking better care of the clients who have placed their trust in an independent advisor.

The place to start is to fundamentally understand that there is no right or wrong answer to the question, "What is my practice worth?" The answer will vary depending on what is being bought or sold (a book or a business, assets or stock, a minority interest or a controlling interest, etc.), who the buyer is, why the valuation is being performed, the motivations of the parties, and even who's performing it. When the time comes for you to sell your practice, the first question shouldn't focus on which approach to use to arrive at a proper value. The appropriate series of questions leading to a valuation solution should be:

- What am I selling and why am I valuing my practice?

If you're a buyer, the focus should be on this question:

- What am I buying and why am I buying it?

Purpose Informs Value

In other words, you need to know what you are trying to solve for before you attempt to answer the question as to how to solve it. No one single valuation approach and method solves every problem, every time. There are many tools in the valuation toolbox, and as a buyer or a seller, you need to know at least the basics of how to use them and when to apply them, or at the very least, when to call for help and what questions to ask.

Of course, selling a relationship-based practice or business isn't like selling a fast-food franchise in which you hand over the keys and a How-to-Run-It Manual. In this M&A space, the clients get a vote, and most sellers care about what their clients think of their final act—something that buyers need to understand as well. Best price and terms should always take a backseat to "best match," another consistent theme in this book.

So what does all this have to do with elephants and blind men? Last year, I sat on a four-person panel where we were asked to discuss the intricacies of value and valuation as applied to independent advisors who were interested in acquisition or selling. Two of the panelists were practice management specialists, one with a large independent broker-dealer (IBD) and the other from a custodian. The other panelist was an investment banker. The investment banker was adamant that the discounted cash flow method his firm produced and sold was the single best way to perform a valuation in this industry, every time—anything else was just silly and a wild guess. Another panelist opined that for most of the thousand-plus advisors in his IBD, what worked best on a daily basis was a simple rule-of-thumb, or a multiple of revenue or earnings. Over the length of his career, this method had proven to be practical, affordable, and good enough to do the job in most cases. The other panelist thought that it was simply a matter of "wait-and-see," paying value for what a buyer actually received using an earn-out arrangement or a basic revenue sharing approach; in his opinion, formal valuations or appraisals, even multiples of revenue, weren't even called for.

Each panelist was partly in the right, and all were in the wrong, but these points of view reflect what we hear and experience every day. There is no single valuation methodology adequately suited to the range of revenue streams and structural components now represented in this fast-growing and rapidly evolving industry. That is why buyers and sellers need to adjust and elevate their level of understanding and thinking about how to buy, sell, and value a financial services or advisory practice or business. On that note, another of our goals in this book is to help you understand not only how to determine value, but how to apply the payment terms so as to motivate a seller and to protect a buyer in order to ensure that the clients' best interests are never overlooked in the process of realizing or paying that value.

Overcoming Attrition: Public Enemy No. 1

Most independent advisors who consider retirement wonder if they should sell internally or externally. The truth of the matter is that, at least at the job/book and practice levels, neither result is going to occur in significant numbers—not yet, anyway. The number one exit strategy, as you've now learned, is attrition.

Attrition is the process of enjoying the cash flow provided by the work for as long as it will last once the single owner stops investing their full time, attention, energy, and funds. Eventually, the book or the practice just dies, but not before providing an extra 5 to 10 years of gradually decreasing income and cash flow to the founder. The attrition strategy centers on the advisor's needs, goals, and career length. That is a problem because a client's needs will almost certainly extend beyond the longevity of a founding owner's career. Not only does this leave the clients to fend for themselves, possibly at a time and an age where such a transition is very difficult, but it also leaves a lot of money or value on the table from the advisor's perspective. In years past, we accurately identified this issue, attrition, as the independent industry's Achilles' heel. Nothing has changed.

From the perspective of an independent broker-dealer, custodian, or insurance company, the fact that more than 80% of their advisors' books or practices won't be selling at career end, possibly to a competitor, is often treated as good news. It's not. The data is clear that those same books and practices will stop growing and will decline in production, cash flow, and value for about 10 years before the practice actually dies out. They will gradually shed their clients to other advisors, perhaps within other networks. Imagine what the clients of this industry think . . . and decide on their own along the way. This is the toll of attrition.

But the news is not all bad. Slowly but surely, advisors are beginning to create formal succession plans that are designed to build a multiowner/multigenerational structure sophisticated enough to last for many years to come, and to acquire every book and practice in their path. Currently, the independent financial services/advisory industry looks something like Figure 1.4.

Interestingly, many practice management consultants employed by the various independent broker-dealers, custodians, and insurance companies focus almost entirely on not losing the 10% who will sell. All available resources are spent to make sure this 10% sells within the same network. Almost nothing by comparison is spent on helping those who are building, or who could build, an enduring business. These businesses, in turn, tend to acquire many, many jobs, books, and practices. Growth by acquisition is the foundation for most businesses' marketing strategies, and such growth demands the recruitment of younger, next generation talent, that is, today's book builders.

We have been pressing the argument for some time now that the focus of the practice management personnel at the IBDs and custodians should be on the vast majority of independent advisors who do nothing but wither on the vine, who choose death by attrition, or who make no plans at all. The question(s) should be, How do we help these advisors and all the clients they serve? How do we get more advisors to sell to someone (preferably a business or a firm) who can serve their clients for more than one generation?

We don't think the answer, or the problem, centers on value or valuation, at least not in the sense that

FIGURE 1.4 End of Career Transition Strategies for Independent Advisors

a higher value or sales price will cause every book and practice owner to sell. Independent advisory books and practices already command a value of two to three times that of most other professional service models. We think the problem is twofold:

1. The abysmal payment terms that create a total disconnect between the valuation opinion and the actual realization of that value years later.
2. The failure to create a formal, written, executable plan (whether an exit plan or a succession plan) early enough to benefit from it.

Slowly but certainly, advisors have been coming to grips with the notion that their practices have value, above and beyond the cash flow generated every month and every year—in many cases, a great deal of value. Most advisors have a plan to realize the cash flow element for as long as they can work, but most advisors do not have a plan for how to realize their equity value and ensure that their clients are taken care of for the rest of their lives as opposed to the career length of their advisor.

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