FP TRANSITIONS®

RESEARCH & PUBLICATIONS

SOLVING VALUATION

The following is an excerpt of Chapter 3 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.*

The Blue Book Standard

In 1918, Les Kelley parked three Model T Fords on a lot, put them up for sale, and thus started the Kelley Kar Company. It was to become one of the largest used car dealerships in the world. But in order to succeed, a method was needed for placing easily determined *and accurate* values on the vehicles. Solving valuation was the key step in the process.

In those days, new car dealerships didn't sell used cars, so Kelley bought vehicles that new car dealers took in trade. Sometimes the line of cars waiting to be appraised would wind around the block. During the Depression, there were times when the Kelley Kar Company bought the entire inventory of dealers who went out of business. As a frequent buyer and seller of cars, Mr. Kelley was tied into the open market on a daily basis, and his experience and opinions as to value began to hold increasing sway with others in the automotive industry, from individuals to banks to car companies. In 1926, Kelley published his first *Blue Book of Motor Car Values*, which quickly became a standard.

The title "Blue Book" was borrowed from the Social Register, a directory of names and addresses of prominent American families who formed the social elite, because, to Kelley, it implied that one could find valuable information inside. That was important, because this was a new concept, a new valuation tool. And not coincidentally, Emily Post had recently published her first book on how to do certain things properly, titled *Etiquette: The Blue Book of Social Usage*.

The *Kelley Blue Book* as it came to be known, became the authoritative source for car values. It was certainly not an appraisal, and it was not intended to be. The *Blue Book* was not the approach that you would use if ascertaining the value of your 1962 Ferrari 250 LM, and it didn't try to be that. It was something else, something more. Of course, valuing a priceless Ferrari isn't the issue, or the challenge, that most people have. For the task at hand, buying and selling cars on a daily basis, the Blue Book did the job better, and more accurately, than any other method ever invented.

In the previous two chapters, the point was made that valuation is often a divisive issue. Buyers, sellers, and their IBD or custodian-supplied practice management support teams, sometimes think that paying more for a valuation, or using a more complicated method, will allow them to dial in the result they're looking for. Somehow, somewhere, the right number is waiting to be found and proven. But what if the best source of information has nothing to do with spending $10,000 on an appraisal or obtaining a valuation report that weighs 2.5 pounds? Consider what the marketplace has to say.

Recurring vs. NonRecurring Revenue

From a buyer's perspective, nothing may be more important than the amount of recurring, predictable revenue. Fee-based income is what buyers covet. It is what they primarily value. Buyers almost always want more fee-based income and the clients that generate it. The 50:1 aforementioned buyer-to-seller ratio reflects seller listings in the open market in which the majority of the revenue stream is recurring, fee-based revenue.

Standards of value and most valuation approaches treat every dollar of revenue pretty much the same, but in this industry, there is a big difference. At the business and firm levels, the value of recurring revenue is heightened. Recurring revenue tends to generate predictable, recurring overhead. With skillful leadership and steady growth, such overhead can be controlled and minimized, which leads to higher profits and improved return on investment (ROI) for the

founder and the next-generation owners who choose to build on top of the existing model. For businesses and firms, acquiring recurring revenue is a matter of building durability and long-term value. For book builders and practice owners, recurring revenue is a matter of convenience and predictability. Many times, for these two ownership levels, acquiring another book actually substitutes for a formal marketing plan.

Recurring revenue in the financial services industry is generally earned by applying a charge to assets under management (AUM), or trails derived through the sale of annuities, mutual funds, or insurance products. Transactional-based or nonrecurring revenue is generally earned from onetime transactions or a commission payment. From a valuation perspective and within the Comprehensive Valuation Report, these revenue categories form an important starting point for determining value. Regulatory changes may serve to further underscore the differences in revenue streams and their value to prospective buyers.

Since value is largely based on the assumption of a continuing stream of revenue into the future, it is important that the valuation analysis takes into account what proportion of the revenue is recurring versus transaction-based. Simply stated, recurring revenue is one of the single most important determinants of value of a financial services or advisory model. While the assessments used in the CVR are applied to both recurring and nonrecurring revenue, significantly more weight is usually placed on the recurring revenue component.

Transactional revenue is more elusive and difficult to predict, and while it may be *worth less* rarely is it *worthless*. Transactional revenue can have value to a buyer, but it is essential to be able to show the propensity for additional revenue. In other words, if not recurring revenue, at least predictable revenue. Factors like the practice's historical revenue growth, length of surrender periods, and quality and depth of the relationships are instrumental in assessing the potential from transactional revenue. Insurance-based books and practices are assessed differently from a fee-based model for exactly these reasons.

The takeaway is this: If you want to maximize value, focus on generating recurring revenue. Every dollar of recurring revenue is worth approximately two to three times as much as every dollar of nonrecurring revenue. If your income model falls somewhere in between, predictability and reliability is valuable if you can demonstrate it over time and deliver it to a new owner. If you own a book, a practice, or a business, think like a buyer and evaluate what you are building based on the three indexes of value: *transition risk, cash flow quality,* and *marketplace demand*. How do you measure up?

Assessing Transition Risk

Transition risk reflects the issue of transferability and retention of the client base post-closing. This is what keeps buyers and sellers up at night. Are the clients and the associated revenue stream transferable?

FP Transitions' Comprehensive Valuation Report assesses transition risk separately from cash flow quality. Transition risk is defined as the risk associated with transferring the clients, and hence the revenue stream, to a new owner or successor. Assessments are made based on actual experience as reflected in our comparable transaction database. Based on a given fact pattern and ownership level, it is now possible to estimate the risk in transferring a given set of client relationships.

To be fair, the issue of transition risk can be accounted for in the income approach/discounted cash flow method, but most advisors never see this issue in terms of the specific assessments or a specific adjustment. The CVR allows an advisor to understand the logic and adjustments for assessing transition risk, the transferability of the client base, in plain English. Advisors need to know.

A number of factors, in addition to those listed earlier, are involved in accurately assessing transition risk, including:

- *The tenure of the book, practice, or business*
- *The willingness/ability of the departing advisor to offer post-closing assistance*
- *The use of noncompete/nonsolicitation agreements for nonowner advisors*
- *Continuation with the same broker-dealer/ custodian post-closing*
- *Client affluence level*
- *Client demographics*
- *Branding (personal versus corporate)*

On average, experience dictates that in a well-structured, well-documented transaction at the

practice level of ownership, the level of transition risk is around 5% to 10%, meaning that 90% to 95% of the clients and revenue should make the transition to the new owner and remain in place at least one year post-closing. Transition risk is typically higher for a book, and lower for a business, using practices as the measuring point.

In general, the longer the client has been with a given independent practice or business, the less likely it is that the client will leave following an ownership transition without significant cause. Long-term clients are much more likely to stay through an ownership transition (whether to a third party or internally to other partners, managers, or employees). This is particularly true if the assistance of the departing owner has been structured into the transaction or is part of an internal succession plan. This is a case of inertia working to the advantage of the transition.

A corollary factor for determining transition risk is the tenure of the financial advisory practice or business itself. The longer and better established the enterprise, the less likely the clients are to leave in the event of an ownership transition. A number of reasons may be attributed to this observation. In longer-tenured models, the clients may associate the services more with the practice or business and less with any one individual, thereby making a change in ownership easier and more natural. Longer-tenured firms also have acquired a marketplace reputation and position (often referred to as "goodwill") that carries through in the event of a well-structured and professionally executed transaction.

The degree that technology is used and maintained in the office also factors into transition risk, one important reason why this element is carefully tracked in our benchmarking studies. In models where there is a high technology level, and where owners have invested the time, money, and resources into this component, the common result is that client contacts and tracking are more automated and in many cases more systematic as well. In these models, the transfer of ownership often experiences less disruption than when the contact, processing, and systems are not as highly automated. To the extent that technology produces a paperless or very efficient office structure, value is also positively impacted, reflected in part by much higher buyer demand.

Other factors that contribute to the transition risk assessment include the owner's willingness to grant noncompetition / nonsolicitation / no-service agreements upon their retirement or exit, and having similar restrictive covenants in place with licensed employees. Consider this issue carefully, especially if you are a potential seller and have surrounded yourself with "book builders" or independent contractors paid on a revenue-sharing arrangement.

Measuring Cash Flow Quality

The factors used to assess the cash flow quality index focus on the strength and durability of the revenue stream and include:

- *Client demographics*
- *Asset concentration*
- *Revenue growth, separate and apart from new client growth*
- *Expenses*
- *Referral channels/referral fees*
- *Business niche*

In assessing client demographics, it is statistically desirable from a value or equity standpoint to have the largest proportion of the client base in the 50 to 70 years of age bracket, while at the same time not having a large percentage of clients in the above-70 years or older age group. This is a recurring trait that we observe in the largest and most valuable businesses and firms. The 50-to-70 years of age demographic is desirable because this group, in general, is not only at the top of their earning cycle, but also is at the top of the saving cycle as well. "Event drawdowns," such as purchasing a home, paying for college tuition, or making business investments, are less frequent in this age group, while the urgency of saving as retirement approaches becomes more salient.

The demographics of those clients in the 30 to 50 years of age bracket are also important, contributing to a developing revenue base. In our benchmarking studies, this age group does not represent the majority or largest group of clients, at least in the most valuable models. The demographic group represented by those clients 70 years of age and older is often the wealthiest segment in a financial services practice or business. This group, however, is a less stable and less predictable source of long-term revenue because they are subject to event drawdowns for trust disbursements, gifting, living expenses, health issues, and, of course, mortality. In practices where the majority of the clients fall into the 70-plus age group, the result would be a lower cash

flow quality rating, and, depending on other related factors, usually a lower value. Understanding these value drivers and knowing where you stand years ahead of time, is important and another reason for using a formal valuation as a management tool on a regular basis.

Asset concentration is another consideration in calculating the cash flow quality rating; it is measured by assessing the total percentage of assets under management owned by the largest top 10% of a practice's clients (ranked in order of fees paid). Most practices and businesses have at least some level of asset concentration.

Revenue growth and *net new client growth* are significant contributing factors to cash flow quality as well and are measured separately. In FP Transitions's analysis, average annual revenue growth over the 2005–2014 period was 12% (measured in at least five-five-year increments), with the middle 50% of the distribution curve growing by between 5% and 16% annually. The rate of revenue growth, however, is strongly influenced by market performance and therefore, by itself, is not a reliable indicator of the long-term strength of the cash flow. Net *new client growth* on the other hand, provides an excellent proxy for determining the future growth potential of the practice, as well as helping to determine the quality and strength of the referral channels and the client development systems that the practice has in place.

In the end, it is cash flow quality that captures a buyer's interest. As such, this should be the starting point for every prospective seller thinking about an exit plan, a succession plan, and/or a continuity plan. Advisors often think about having a formal valuation performed and wonder why they need to know their "exact" value. In fact, most advisors don't need to know their value at first—they need to know what drives and detracts from their value while there is still time to implement changes and improvements.

The Profitability Issue

There is an argument that pervades the M&A process in this industry that profitability is what defines "real value." The idea is that actual profits, or "normalized earnings" is the starting point from which value is, or should be, professionally determined. Even in the most simplistic sense, buyers attempt to use a multiple of earnings, arguing that a multiple of revenue is somehow unsophisticated in comparison. This brings us to the profitability issue, something yet again unique to the independent financial services industry and the valuation process, at least in terms of how the issue is created and resolved.

Most independent advisors make a good living, often a very good living. But there is a difference between cash flow and profitability, even if the former is $500,000 a year. Profitability, as first explored early in Chapter One, is a key issue in discerning who owns what, and helps to explain why only about 5% of independent advisors own a sustainable business or firm. Actual profits matter—just ask your investors, or the lack thereof.

Every year, we have the opportunity to examine more than a thousand jobs/books, practices, businesses, and firms, collectively, from a financial statement perspective. Nine out of 10 are not profitable—literally, nothing, or next to nothing, makes it to the actual bottom line. However, most of these owners are indeed prosperous at least in terms of the money they take home as their reward every month. Their practice models certainly could be profitable, but they have set up an organization and compensation structure (sometimes an entity structure as well in the case of a C corporation) that is simply not focused on generating profits. Frankly, in a one-owner model where everything not spent on overhead gets taken home anyway, what does it matter?

In the typical one-owner S corporations or LLCs, as well as the sole proprietorships, profits are almost an afterthought regardless of how many additional advisors are in the office. The singular focus is on top-line cash flow, anchored by lofty production goals. The logic is that the best way to get every producer or advisor to think like an owner (without making them an equity partner) is to treat them like one. Said another way, the path to achieving double-digit growth rates year after year is to tie every advisor's compensation directly to their production, easily achieved with a revenue sharing arrangement or very large bonuses tied to production. This is part of the legacy of 50+ years of wirehouse compensation models.

Businesses have a compensation system that supports not only top-line revenue growth, but also bottom line profitability. Balancing the two aspects is challenging, but it is necessary if the goal is to build sustainability because next-generation advisors can't invest in compensation. Younger advisors typically do not need to buy stock in the S corporation (or LLC)

where they work to obtain a bigger paycheck. The point of investing money, energy, and a career into ownership, or equity, is to obtain the benefits of being an equity partner. If there are no profits, such as in the case of a C corporation that pays no dividends to avoid double taxation or an S corporation that "distributes" everything through a revenue sharing compensation structure, then what is the point of taking on the risk of ownership, especially at a minority level? Why invest if there is no ROI?

Profits, or profitability, is a game changer if you're building a business or want to take on equity partners. If there are no profits, there will be no next generation advisor/investors. And profits need to be real, as in actual profit distribution checks issued several times a year to each equity partner, not an accountant's or valuation expert's attempts to normalize the income stream to create "profits" on paper. Fictitious profits equate to a fictitious business.

So, a lack of profits also hurts value, right? No, not in all cases. Most buyers, at least of books or practices, are willing to focus on top-line revenue, not bottom-line profits. This reality is reflected in the Comprehensive Valuation Report, which reflects actual marketplace activity. Most buyers don't really care whether the seller they are chasing is "profitable." The acquisition of a book or practice is tantamount to a marketing plan or more aptly, a substitute for a marketing plan. They view the book purchase as a client acquisition opportunity. ROI? That's an academic issue for the appraisers and sometimes a negotiation ploy by experienced buyers.

Let's put this in perspective. The lack of physical profit distributions or dividends does not necessarily hurt the value or the demand for most books and practices. Actual profits do matter if you're selling internally, or setting up a succession plan that involves next-generation equity partners. Lack of profitability is also an early warning sign in almost every instance, and demands a closer look at the compensation system in use. It is very possible that the lack of real profits points to a book-building mentality rather than a single strong practice or business, and buyers should carefully consider this issue during due diligence.

The point is, profits can affect value but not in exactly the same way as other components of value. Failure to separate salaries and distributions or dividends on the profit and loss statement is not necessarily a red flag. In this industry, it is normal because of the use of compensation systems designed entirely around the goal of revenue production rather than the generation of profits. These books, practices, and businesses can still be excellent acquisition opportunities and are, as evidenced by the high buyer-to-seller ratio almost every time one is listed for sale.

FP Transitions is the nation's leading provider of equity management, valuation, and succession planning services for the financial services industry. Based in Portland, Oregon, FP Transitions operates the largest open market for buying and selling financial service practices in the U.S.

4900 Meadows Road, Suite 300
Lake Oswego, OR 97035
800.934.3303
fptransitions.com