Firm Valuation

This course is designed to provide advisors with practical guidance on the principal techniques used to value advisor businesses, an understanding of the key drivers impacting valuation, and a renewed appreciation for the circumstances in which an updated assessment is important.

By the end of the course, you will have an actionable roadmap to discover the current value of your firm and to systematically enhance that value over time.

Overview:

It's normal for a business to represent 80% or more of an owner's net worth. It stands to reason, then, that a realistic, metric-driven business valuation would be the kind of thing most owners would want to have in hand – yesterday.

An understanding of the specific levers that drive value, a scorecard indicating the firm's "grade" for each lever, and a detailed plan to systematically improve the areas in which the business is underperforming would naturally follow.

But this is often not the case, even for advisors who make a career of helping others establish goals and drive toward their achievement. Without a strategy to fully realize the wealth potential that lies latent within their firms, how do business owners and their colleagues receive just rewards for decades of hard work and sacrifice?

The topic of valuation rises to the surface when a transition is looming. And certainly, this is a time for principals and mediators on both sides of the transaction to align on value, as well as come to agreement on terms, deal structure, and the impact those factors have on price.

For advisors interested in acquiring other firms, an understanding of meaningful valuation techniques is critical in accurately assessing the opportunities at hand and having confidence that you are making a fair offer rather than overspending.

Valuation is not only a critical first step in positioning a firm to be sold with the most favorable price and terms, it's also an essential first step in these important areas:

- Ongoing management of profit gap: the difference between best-in-class cash flow and the cash flow from your business
- Ongoing management of value gap: the difference between best-in-class valuation and the value at which your firm is assessed
- Planning for distribution of firm ownership to team members
- Business continuation planning for death, disability, divorce, or partnership dissolution

- Exit planning

Depending on the ultimate purpose, some advisors will choose to perform their own valuation analysis and some will engage an outside professional. If you are preparing to sell your most significant asset or purchase someone else's, we strongly recommend working with an experienced industry expert who grapples with these issues every day. Business valuation is a specialized skill with significant financial consequences, and much like you would bring an attorney, accountant, or insurance expert into a client relationship for their specialized knowledge and experience, using a consultant to ensure you are getting or receiving the best price and the right terms is beyond prudent.

The high-level steps are:

- **Step 1:** Understand the most common techniques for deriving business valuation.
- **Step 2:** Understand the specific metrics that drive value for advisory firms.
- **Step 3:** Have a valuation assessment performed on your business by a qualified valuation consultant who understands our industry, ensuring that you are able to identify the areas in which your firm scores highly (adds to value) and poorly (subtracts from value).
- **Step 4:** Develop and execute a plan to systematically address the valuation drivers for which your firm is underperforming.

Like the cobbler and his shoes, many advisors -- who devote their professional lives to helping clients plan for every contingency -- have not sufficiently focused that lens on their own circumstances.

We encourage you to take an active role in managing your firm's value.

Rather than allowing a question mark and a head scratch to hang over your most substantial asset, request a formal appraisal by a recognized industry expert. Then, adopt a project management approach to address the areas of opportunity that have been highlighted. This enables you, your family, team members, and business partners to receive the appropriate reward for the hard work, time, and creative energy devoted to building the business.

Particularly if you are purchasing or selling a business, engage an experienced valuation consultant who has in-depth knowledge of advisory firms. In this way you can have confidence that the terms and deal structure appropriately reflect the unique circumstances of your transaction.

Step 1: Understand the most common techniques for deriving business valuation.

Among financial advisors it is widely believed that their business is worth two and a half to three times the revenue. These back-of-the-napkin calculations are based on common assumptions that don't necessarily map to what a potential buyer may be willing to pay.

Rather than top-line revenue, a selective buyer is far more likely to emphasize profitability, cash flow, and the stickiness and assumed duration of your specific revenue streams.

Creating a sober assessment of these attributes now affords you time to implement corrective measures if the valuation assessment does not line up with your expectations. Waiting until you are six months out from your target transition date is simply shortsighted – an interesting choice for those whose profession includes helping others identify goals and take steps to achieve them.

We know that not all revenue is treated equally. This is the fundamental flaw in the 2.5X revenue guesstimate. As an example, it's widely recognized that transactional revenue is deeply discounted relative to recurring revenue. And it's logical that a firm posting $2M in revenue with a 55% margin would command a very different price than a $2M firm with an 18% margin.

So, if revenue multiples are not the best approach to determine what your firm is worth, what is?

Outlined below are the techniques most commonly used by M&A specialists, large financial institutions, and strategic acquirers. Industry professionals will have their favorites, and it can be argued that different methods may be best used in particular situations. We don't want to go too far down the rabbit hole, and this is by no means an exhaustive discussion of the topic, so what follows is an overview of the most popular methods. The method you ultimately select will likely be heavily influenced by the consultant who performs your valuation.

Multiple of EBITDA

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) represents true operating performance or profitability. The word "before" indicates that certain items are excluded from the calculation. This is true because they represent discretionary, non-operating decisions rather than indicators of current operating performance:

- Interest – depends on financing and capital structure
- Taxes – can depend on geography
- Depreciation and Amortization – depends on historical investment decisions the company has made

Because this formulation removes the impact of non-operating factors such as interest expenses, tax rates, and significant intangible assets, it focuses squarely on the financial outcome of operating decisions. Hence, it's popular with valuation professionals and those directly involved in buying or selling businesses.

The EBITDA will often be further modified to create re-casted EBITDA – also referred to as adjusted or normalized EBITDA. This excludes items that may not continue when the new buyer takes over. It accounts for non-operating income or expenses, non-recurring income, owner's discretionary items, and perks. Some examples include:

- Higher than normal compensation
- Cars and vacation homes
- Income from the sale of an asset
- Losses due to fires or other events

A quick Internet search will provide a list of articles and videos that provide more detail and specific examples if you want more information. Your valuation consultant would also be a resource.

Once the EBITDA number is calculated, an industry-specific multiple is applied to it. This multiple is driven by various market forces including the level of activity in that industry. As an example, if your EBITDA calculation is $750,000 and the relevant industry multiple is six, the resulting valuation is $4.5M ($750,000 x 6). The average multiple in the advisory business varies widely and is heavily influenced by size – the amount of assets managed.

Other measurements sometimes used are essentially derivations on this theme: EBOC (Earnings Before Owners Comp) and EBIT (Earnings Before Interest and Taxes). Valuation experts will likely favor one over the others. When engaging a valuation consultant, be sure you understand what method they use and why.

Discounted Cash Flow

The Discounted Cash Flow (DCF) technique applies the time value of money: the sooner you get it, the more it's worth; or, a dollar today is worth more than a dollar five years from now due to inflation and opportunity cost. DCF reduces, or discounts, the annual cash flows – income minus all expenses, over a period of years (typically five) back to the equivalent of today's money. For the wonks out there, the formula used to discount each cash flow is $1/(1+r)^n$ where r is the interest rate and n is the number of periods.

Here's an example. Imagine that Acme Advisors generates $1M in annual income after all expenses have been paid. Let's assume that an interest rate of 6% is appropriate in this circumstance and that we want to look at five years' worth of cash flows. Applying the first year's formula, $1/(1+.06)^1$, against the $1M cash flow returns $943K. For the next year, $1/(1+.06)^2$ evaluates to $890K. For the remaining periods, years three, four and five, the calculated values are $839, $792, and $747 respectively. The total of these discounted values is $4.2M.

But what about the revenue streams beyond year five? For many industries it becomes increasingly difficult to accurately forecast revenue beyond the short term, so it is common to use a terminal value to account for the period of time past the fifth year. Your valuation consultant can explain this more fully if the DCF model is chosen for your valuation.

Check Your Understanding:

- Why is multiple of revenue a dubious method for determining value?

- Who generally takes the lead on determining a formal firm valuation?
- Why is a formal assessment of the value of your business important? How would a business owner typically use this information?

Step 2: Understand the specific metrics that drive value for advisory firms.

One of the deliverables you should expect from your valuation project is a report that identifies the attributes that enhance or diminish value, and how your firm performs on each. Only when armed with this information can you most effectively address performance challenges – those areas where your valuation is being "penalized."

As you begin to energize and create space for this important undertaking, recognize that at the highest level, these value drivers generally fall within three overarching groups: 1) historical performance, 2) the current state, and 3) readiness to evolve and scale effectively into the future.

Within these three divisions you can imagine the following categories: the team, firm leadership, clients, infrastructure, and growth. Outlined below are examples of important metrics with each category.

The Team

- Tenure with the firm
- Strengths
- Ability to expand skill sets and value to the firm
- Connection with clients
- AUM per advisor
- Households per advisor

Firm Leadership

- Clients connected with team members who will remain after the owner exits rather than attached solely to the owner
- Defined role in the firm that is well understood by both the clients and the team
- Duration of involvement with the firm post transition

Clients

- Revenue concentration
- Average client age
- Percent of revenue attributable to each age bracket (70s, 80, 90s, etc.)
- Amount of systematic distributions
- Client tenure

- Percent of AUM with a next-generation relationship
- Segmentation and alignment of service model with fees
- Percentage of unprofitable relationships

Infrastructure

- An organized, systematized and, where appropriate, automated approach to the firm's key business functions, particularly those that drive revenue and control the client experience such as prospecting, new client onboarding, the service model for existing clients, asset transfers, and rebalancing.
- The degree to which the firm leverages technology to enhance client engagement and heighten operational efficiency: workflows in the CRM, client adoption of firm portals, effective utilization of the financial planning tool, video-based client meetings, etc.
- Business model and fee structure that emphasize recurring revenue

Growth

- Number of new top tier clients
- Referral history
- Recent trends in both AUM growth and asset flows
- Defined and well executed growth strategies
- Growth initiatives successfully implemented by "Next Generation" advisors (often referred to in the industry as "G2" – Generation Two – advisors. So called because they are earlier in their careers than most.)

Use these data points and others that are important to you to begin framing up in your mind the type of performance indicators you want to master. Have a conversation with your valuation consultant about the key metrics that are important to you and how they align with the approach they intend to implement.

Check Your Understanding:

What rating would you give your firm on the points mentioned in this lesson? How compelling do you believe your "report card" would be compared to other firms that a buyer evaluates? Are the results likely to elicit an offer that fairly reflects what you and your team have created over the years? Would an offer based on current circumstances reward other firm stakeholders fairly?

Step 3: Have a valuation assessment performed on your business by a qualified valuation consultant who understands our industry, ensuring that you are able to identify and act upon the areas in which your firm scores highly (adds to value) and poorly (subtracts from value).

For the reasons mentioned in other parts of this course, revenue alone is a shaky foundation upon which to derive enterprise value. EBITDA, EBOC and discounted cash flow are formulas typically employed by buyers, sellers and M&A (Mergers and Acquisitions) professionals.

As mentioned in a previous lesson, firm valuation is a specialized skill with significant financial consequences, and we recommend engaging the services of a valuation consultant experienced in assessing advisory firms.

Once armed with this information, your Carson coach can help you formulate and implement strategies to address poor grades and elevate your valuation number to the lofty heights where it belongs.

When you feel ready to hire an expert, note that Advisor Growth Strategies, DeVoe & Company, and FP Transitions enjoy a significant presence as valuation consultants in our industry. Check with your custodian, broker-dealer, or other vendors and strategic partners to see if they offer discounts to these or other service providers.

Step 4: Develop and execute a plan to systematically address the valuation drivers for which your firm is underperforming.

Knowing where your firm is out of alignment opens the door to making the required adjustments.

Think of it as an organizational chiropractic session! How good will it feel getting the kinks out – assertively pursuing the areas that need attention and confidently taking the right steps to maximize the value of the firm on which you and your team have worked so hard?

We encourage you to take an active role in managing your firm's value.

Rather than allowing a question mark and a head scratch to hang over your most substantial asset, request a formal appraisal by a recognized expert. Then, adopt a project management approach to address the areas of opportunity that have been highlighted. Steps are:

1. Identify the implementation specialist on your team – the person who exhibits skill at process, detail, prioritization and accountability, and who is most accomplished at getting things done. (Hint: In our experience, the person best suited is not the advisor).
2. Choose an online project management tool to coordinate the action plan. Carson Coaching can help you here as well.
3. In partnership with your implementation specialist, lead a strategy session with your team to document actions steps – the specific remedies for the challenges or gaps that are exerting downward pressure on your valuation.
4. Break down the steps above into their underlying executable activities – think tasks and subtasks: the 20,000-foot vision, 10,000-foot tasks and street-level subtasks.
5. For each task and subtask, designate an assignee and a due date.

6. As part of your weekly team meeting, the implementation specialist should gather status updates from the team and lead the team in completing overdue tasks.

Check Your Understanding:

- What's the most effective way to implement the changes suggested in your valuation report?
- Which team member is best qualified to lead this effort?

Summary:

Advisors can get stuck in the weeds helping the people who have entrusted them with financial success, and with the networking and prospecting activities that enable them to help even more families. Don't let these two worthy callings, no matter their impact, prevent you from keeping the oil changed, the spark plugs clean, and the timing belt tight in your own vehicle.

With this knowledge and through these steps you can align the external assessment of your firm's value with what you feel in your heart and know in your mind is its true worth. You deserve it!

FAQs:

- **Advisor often mention that their firm being worth a certain multiple of revenue. That sure is easy to calculate, but is it the best way to fairly assess the value of a business, particularly if I'm considering several opportunities?**
  - No. Fundamentally, not all revenue streams are of equal value to a prospective buyer. Most valuation professionals would argue that what's more illuminating of the business' true value is cash flow – profitability. The discounted cash flow method (DCF) and a multiple of EBITDA are common formulations used to establish price.
- **What factors have the biggest impact on valuation?**
  - Many attributes are evaluated during a comprehensive valuation assessment. See the section in this course titled *Understand the Specific Metrics that Drive Value for Advisory Firms* for a detailed discussion. Generally speaking, key metrics in the following categories are important: team, leadership, clients, infrastructure and growth.
- **I'm planning on selling my firm to G2 advisors that have been with me for a while. Is a formal valuation still important in this more casual transaction?**
  - If your retirement plan does not rely on income from the sale of the business, and your heirs and business partners are in agreement, then the value of your business can be whatever all the interested parties agree to. However, for most advisors whose business is their largest single asset, maximizing its value over time and selling it at a fair price are important considerations where a valuation is in order.

Resources:

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Learn more and download the resources referenced in this document from the ***Firm Valuation*** course in Carson Coaching Online.