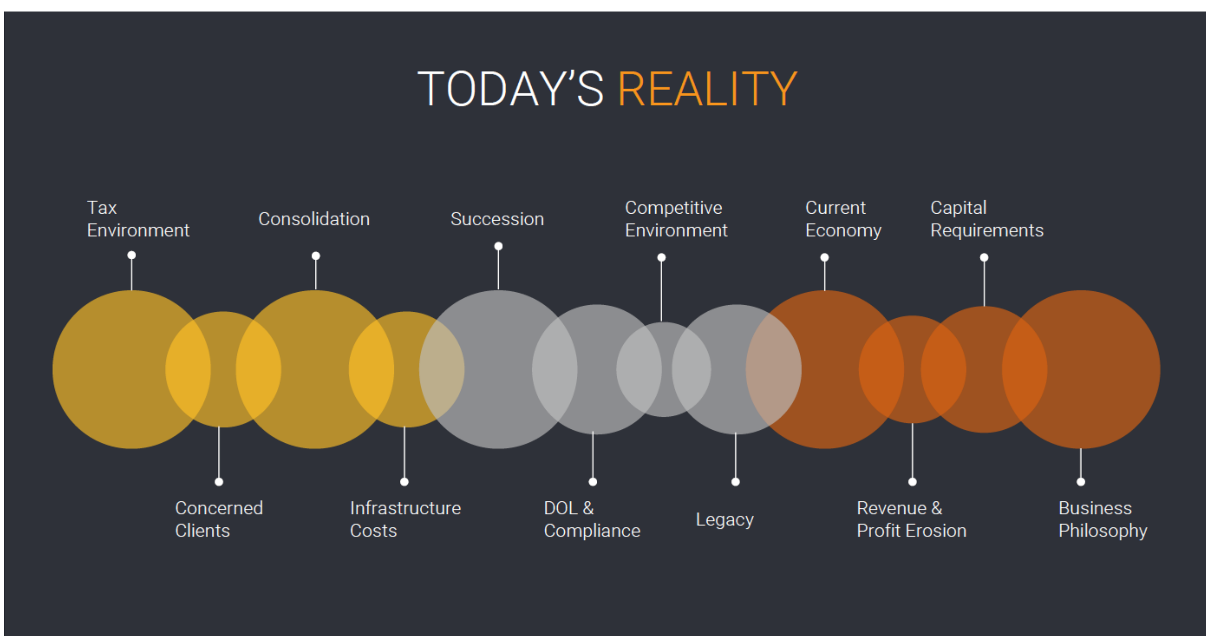
Valuation: Myths & Realities

When it comes to valuation, there are, unfortunately, many misperceptions in the industry. More often than not, Advisors have an unrealistic valuation expectation for their business, but do not have a clear understanding of how value is actually derived. The reality is that our industry is ever-changing and Advisors are facing a host of challenges that are impacting their businesses and how they're being viewed for valuation purposes. This article is going to address some of the major points of confusion, as well as explain the reality behind each myth.

The Challenges Facing the Financial Services Industry



Myth #1: There are industry accepted standard multiples.
Reality: There are no standard multiples, just "rules of thumb".

While there are "rules of thumb" when calculating a baseline valuation for a Firm (i.e., a Firm with $100-$250 million in AUM will *typically* carry a 3-4 times multiple on EBITDA[1] or EBOC[2]), the multiples you're accustomed to are a moot point when it comes to getting a deal done. In fact, no two businesses are alike and no two Firms are alike – by extension, no one "standard" multiple can exist as a fair assessment of value.

Buyers will ALWAYS back into a "multiple" to make the Seller more comfortable with the deal. So, where does this number come from? A sophisticated Buyer will use a calculation on the expected Return on Investment (ROI). Since the Seller isn't concerned with the Buyer's return, the Buyer will translate the value into a number the Seller can more easily

identify with. For example, most Buyers want a 15-18% return on their investment. Once the purchase price is calculated, they'll translate that number into a multiple of 'x' (perhaps revenue, EBITDA, or EBOC).

Myth #2: My Firm's value is based upon its financial attributes.
Reality: A Firm's value is based upon not only the financial attributes, but also its non-financial and even intangible attributes as well.

While historical financials are certainly important, they're not the only component when determining value. Factors affecting valuation include:

- Strength and depth of management team
- Capability/intention of next generation
- Growth (historical and projected) of cash flow and AUM
- Reputation and brand equity
- Firm size (AUM, geographic footprint, staff)
- Client base compensation (age, tenure, relationship)
- Transferability of revenue stream
- Continuity plans for the Firm
- Capacity vs. scale
- Corporate tax status/structure
- Organizational and operational issues
- Client service model
- Broker Dealer affiliation

Keep in mind too that Buyers will have certain objectives they're hoping to accomplish. Everything from product line to talent to technology will establish whether a permium or discount will be applied.

Objective + Financials + Intangibles = Premiums or Discounts

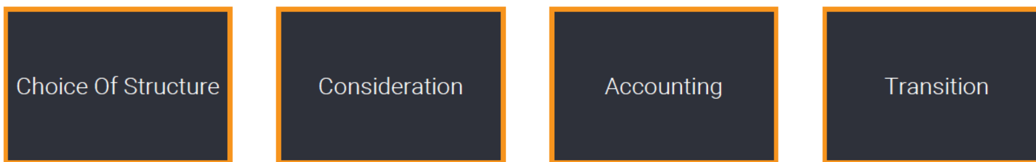
Discounts & Premiums Can Be Highly Impactful

Myth #3: Maximum value is the number in the valuation.
Reality: In transactions or sales, you cannot separate value from structure.

Purchase price is only part of the deal; structure is equally as important and can raise or lower what the Seller ultimately nets. Deal structure typically consists of some combination of a down payment, promissory note (adjustable or fixed), and earnout. Additionally, a "clawback" provision can be added to protect the Buyer in the event of Client attrition. All

of these can potentially impact the final "value" a Seller receives. Don't forget the accounting aspect either! Whether deal components are treated as capital gains or ordinary income have an impact on both the Buyer and Seller.

Maximum Value = Financials + Intangibles + Deal Structures



Myth #4: Valuation is based upon a specific point in time.
Reality: Valuation takes the past, present, and future into consideration.

A Buyer is not purchasing your Firm based on what it has done historically or at any given point in the past, but rather ***what it can do going forward***. Again, a Firm's history (both financial and non-financial) is important, as it tells a story – but it is only a small piece of determining value. Buyers buy the viability, stability, and predictability of future profit.

Myth #5: Using a multiple of revenue approach is the most commonly accepted valuation method.
Reality: The multiple of revenue approach is the least accurate and accepted method.

As a business owner, you know that every dollar of revenue has an expense tied to it. The net number (or profit) is what really matters. For this simple reason, the multiple of revenue approach is the least accurate method and what Buyers care the least about. Remember that Buyers want a Firm for what it can do going forward. That's why the discounted cash flow methology is usually the most widely used and accepted. The DCF model projects future cash flow and discounts it back to present day value (see the examples at the end of this article).

Myth #6: The valuation that I have done is the value my Firm is worth.
Reality: A valuation, whether formal or informal, is only a baseline and not a true indicator of a sale price.

The ultimate value of a Firm is what a willing Buyer and a willing Seller are willing to agree upon. Periodic valuations provide a check and balance for any offer a Seller might receive, but a valuation is merely a starting point. (**Hint:** If you're a Seller, ***never*** present a prospective Buyer with a valuation you've had performed on your business – allow the Buyer to complete their own.) And don't forget deal structure!

Value + Structure = Purchase Price

Myth #7: I will be able to sell or transition my Firm for a value that will allow me to fund my retirement.
Reality: The market does not care about your retirement.

Advisors often hold a concentrated stock position in their businesses, failing to diversify their personal wealth – ***and*** expect to receive maximum value at a moment's notice, at timing that is most convenient for them. Unfortunately, life just doesn't work this way. Your value is your value, regardless of when or what you need to comfortably retire.

Myth #8: Having good revenue and low expenses equals strong cash flow and greater value.
Reality: Low expenses can sometimes mean I have not reinvested in my business.

While it's true that strong cash flow is an attribute, falsely inflated cash flow can be a detriment. A well-run business is one that wisely invests in itself on a regular basis – after all, investments are a calculated business risk. Failing to make the proper investments in your business though (for example, in technology), will typically lead to a lower valuation, as a Buyer will need to discount the value to "fix" what is lacking. Be careful about being penny wise and dollar foolish.

Myth #9: If something happens to me the Firm will be sold at fair value.
Reality: Upon an unforeseen event, many Firms will experience immediate value erosion.

Statistics show that revenues drop 60% when an Owner dies[3]. As a relationship business, if the Advisor/Owner is the primary Client contact, it's easy to understand how value drops significantly should the unexpected occur. Even in instances where there is an interim/emergency or long-term succession plan in place, Client attrition is nearly inevitable. That means more risk to the Buyer…. and thus, a lower value.

Myth #10: My compensation is considered an add back to profit.
Reality: Not necessarily, especially if you are taking a majority of your compensation based upon the performance of the Firm or haven't built in management replacement costs.

EBOC can be a tricky calculation to understand. Think of it this way – if you sell your business and someone is needed to replace what you do (i.e., an Advisor being paid a salary to manage/service your Clients), that salary is subtracted from the cash flow of the business. Similarly, any K1-type distributions are not added back. What you can do is normalize your compensation (for instance, say you take $400,000 as comp, but could be replaced at $125,000 – you'll addback the difference) and addback any "perks" that you run through as an expense (i.e., automobiles, cell phones, etc.). It's always best to work with a valuation expert to gain clarity around a true EBOC calculation.

Earnings Before Owner's Comp – Replacement Cost = True EBOC

Conclusion: This article has hopefully left you with the knowledge that perception is not reality. Valuation is actually part art, part science – and there are many considerations to take into account than you may have originally recognized. Most important, ***transferable*** value is the ultimate value.

[1] Earnings before interest, tax, depreciation, and amortization
[2] Earnings before owner's comp
[3] *Many Firms Don't Survive After Owners Die*, Forbes, February 26, 2013

Valuation Examples

(for illustrative purposes only)

<u>Firm #1 Profile:</u>

$75mm AUM
Revenue = $750,000
60% recurring revenue
Expenses = 36%
Owner age = 50
Average Client age = 55
LLC business entity
Future expected YOY growth rate = 10%

Firm #1 is run like a business (it's even set-up as an LLC). The owner is 50 and is still growing the business.

Revenue Valuation *(2x recurring; 1x non-recurring)* =	DCF Valuation *(31.9% DCF rate)* =
$1,200,000	**$1,632,626**

<u>Firm #2 Profile:</u>

$75mm AUM
Revenue = $750,000
60% recurring revenue
Expenses = 36%
Owner age = 65
Average Client age = 69
Sole proprietorship
Future expected YOY growth rate = 0% (*additionally, offset by estimated Client withdraws, based on avg. age*)

Firm #2 is NOT run like a business. The owner is 65 and is no longer trying to grow the business. Notice, the only differences from Firm #1 are Owner and Client age, corporate structure, and future growth rate.

Revenue Valuation *(2x recurring; 1x non-recurring)* =	DCF Valuation *(35.0% DCF rate)* =
$1,200,000	**$1,067,981**

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