What is your Financial Planning Practice really worth and why should you care?

Succession planning related to financial advisors is a current hot topic given that the vast majority of planner’s are 55 or older and openly admit to NOT being prepared for succession. The articles may have prompted you to think about selling your own firm and wondering what price you would get. As both a business consultant and a former acquirer of Financial Planning practices I can tell you, your practice is very likely worth less than you think it is. It is important that you understand this because if you want your succession to get implemented, you are going to need to adjust your expectations. The challenge is in finding a capable buyer and offering him/her a deal that can be funded.

This is a pretty broad statement with far reaching implications, but it’s true. Valuation models change with the environment they apply to, and our environment has changed. The commonly cited multiples of 1.1x non-recurring revenues and 2.2x recurring revenues, is not an appropriate basis for valuation but many of us cling to this expectation. Revenues have dropped but expenses have not; clients have more choices and competition is greater; none of us has intellectual property that excludes others from our market place; and the best projection of a market trajectory for the coming 10 years is no better than the last 10 - Flat.

Assume a practice with $500k GDC and 85% payout from the BD, with a 60/40 split on Recurring v Non recurring revenues. Using the expected norms, it would be valued at $750,000.

This valuation ignores the “Quality” of the revenues being generated and the free cash flow after ALL expenses are allocated. If the practice has a 30% gross margin, its annual “Profit from Operations” would be $128,000. Debt on the purchase price, assuming a 5-year straight term deal, would be $150,000 a year. This is overly simplified but it can be seen that the deal is negative coming out of the gate. It can be argued that this does not take into account the future potential of the acquired assets or the cost savings of the existing owner leaving the practice. The unfortunate reality is that most owners do not leave immediately. Instead, they stay on to provide “continuity” and continue to draw a salary or fees for some period. Their productivity in the transition period seldom meets expectations.

The effective attrition rates for assets being moved within the same Broker Dealer are low and the transition can be expected to be uneventful. However a change from one BD to another demands intensive client involvement and the attrition rates can be as high as 20% of clients and/or AUM.

Many of us have attended webinars or read reports that suggest that a debt-funded sale is quite simple and the benefits significant. What these seminars fail to point out is the risk of something going wrong. When it does go wrong, it goes quickly and sometimes catastrophically.

Another trap is reading and believing “Industry Averages” that include many internal transactions. These are real succession events executed with little client disruption. However, they mask the higher rates of attrition that commonly affect transactions involving two BD’s. Buyers need to be aware of this when assessing their position. “Plan for the worst and hope for the best”, is a sound approach when considering an acquisition.
Err on the side of caution when reviewing cash-flow to debt coverage and cash flow interruption during the transition.

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<th>Pre-Sale</th>
<th>Post Sale 90% Retention</th>
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<tr>
<td>GDC</td>
<td>$500,000</td>
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<td>Override %</td>
<td>15%</td>
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<td>Override $</td>
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<tr>
<td>Gross Income</td>
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<tr>
<td>Gross Expenses</td>
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<tr>
<td>Expenses $</td>
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<td>Cashflow</td>
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Pre-sale the firm operates with $500k GDC and 30% margins after expenses. This results in a positive cash-flow of $127.5k.

After a sale the firm suffers 10% attrition of assets and has GDC of $450k – there has been NO change to the expenses. The 10% loss of GDC translates into a 33% loss of income.

So let’s go back to our model and assume the seller wants to stay on for a year and the transition results in 90% retention. The effect is a reduction in profit by 33% and increased expenses for the cost of retaining the seller as an employee or consultant. The available free cash flow to handle the debt is now at or close to zero and interruption to cash flows through the transition period draws on the reserves you have to manage the process.

The tangible issues that present themselves at this juncture are obvious, there are equally important and difficult intangible issues relating to morale, organizational stability and service models that compound the situation a buyer may find themselves in. All the while the seller looks on with a single expectation – to be paid on time.

So what’s the real value of a Financial Planning firm? The clients have no obligation to the seller or the buyer; market volatility and returns on portfolios are unpredictable; regulation is restrictive; costs to capture share of mind continue to rise; there is no intellectual property that limits others from playing in your park; and there are few, if any, hard assets to count on. Well it’s the same as any other business that has a capacity to generate a profit from its underlying value proposition – in this case, skilled advice and investment services. Its value is directly correlated to its cash flow, past and future. The past cash flows establish a historic average, median, and trajectory for the firm.

A firm’s financial history enables projections to be generated. Knowing the margins and understanding the potential for expense savings enables creation of a credible cash flow model, NPV of future cash flows, and an IRR. Future cash is the single benefit you are offering to a buyer. Skills, people, equipment etc. may also be considered but only as points of negotiation, as their impact on the fundamental valuation is minor.

In the example of a practice with $500k GDC and 85% payout from the BD, assuming 6% compound growth and a modest discount rate of 20% [and this is modest] over a 10 year period with a terminal valuation, the firm would be worth approximately $620,000.
The impact of creating a realistic valuation is to increase the potential IRR for the buyer by close to 50% [in the model above a reduction in the asking price $750k to $620 pushes the IRR to 11% from 7% or the difference between making it attractive and not.] The buyer has other ways to make 7% on his money.

Why is this reassessment important to you and our industry as a whole? Well it’s important because more of us are approaching retirement and we believe we are worth a lot of money, and have established expectations accordingly. But consider the structure of a debt financed acquisition – it’s leveraged and uses the target firm’s cash flow to pay down the debt. If the debt cannot be paid because, in so doing the firm bankrupts itself, the outcome benefits neither the seller nor the buyer, the employees nor the clients. It is far better to value a practice on its predictable cash flow, and add a shared benefit bonus structure that the seller can enjoy if the firm does well under new management.

I can hear many of you saying “But there are 50 buyers to every seller”. If this were true, the value of every practice in the USA would be ramping exponentially. The fact is that there are many more interested buyers than sellers but the buyers are kicking tires. They do the math and recognize they cannot buy a practice that is priced above the point where they can be confident that cash flow will service the new debt.

Buying practices and assets is a proven method of developing a financial services firm; it serves the industry as much as it does the practice founder in providing a succession mechanism. However, with a less than robust global economy, tight capital markets and having a business that carries a significant transition risk, being realistic about the value of our practices rather than optimistic ultimately benefits all parties involved in the transaction. Transitions create disruption – the last thing clients want is to be involved with a firm where the senior parties are in court! Our environment has changed and today we have to recognize that our valuation models should be based on the tangible benefits of realize-able cash flow, not simply notional historical multiples.

About the Author

Allen Duck is a business executive with a career covering manufacturing, sales, marketing and most recently financial services. A resident of Colorado but born in the UK, he has worked in USA, Europe and Asia. He is the author of “Get Out Alive!” and “Successful Financial Planners”. As a result of acquiring a number of financial planning practices and advising on other financial services acquisitions he has first-hand knowledge in the finer points of acquisitions, divestitures, valuation and transaction structure which determine the success or failure of a deal.

Allen founded Eighty20 Advisors LLC to offer consulting and brokerage services providing a bridge between buyer and seller. Both parties benefit from an agent dedicated to the success of the succession transaction, including completion of the transition and any earn-out component in the terms of sale.