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New Rules for Firm Valuations

BY CHARLES PAIKERT

Putting a price tag on advisory firms isn't what it used to be.

The traditional "two times revenue" metric is being increasingly eclipsed, say industry experts, by the use of cash flow multiples and such factors as demographics (of both advisors and clients), growth rates and depth of in-house talent.

"Most advisors don't know that each situation demands a different valuation technique and firm value," says Dan Seivert, chief executive of Echelon Partners, which is exploring valuation issues in its Deals and Deal Makers Summit in New York Thursday.

"RIAs are getting more sophisticated about buying and valuation, and there are more RIA buyers, who are now getting access to financing and have capital," says industry consultant **John Furey**, principal of Phoenix-based **Advisor Growth Strategies**. "Two times revenue has become irrelevant. People are looking at multiples of cash flow and more subjective criteria -- like a firm's ability to grow and how much of that growth is tied to a particular rainmaker or team."

The value of advisory firms is now being driven by growth, cash flow and risks, says David DeVoe, whose namesake San Francisco firm provides investment banking and consulting services.
A typical RIA with assets of at least $100 million is normally valued at four to six times annual cash flow, according to DeVoe. Larger firms get higher cash flow multiples, he says: five to seven times cash flow for firms with roughly $500 million to $1 billion, and six to nine times for large RIAs with $1 billion or more.

For the few independent firms with over $2 billion in assets, valuations are even higher, according to Elizabeth Nesvold, managing partner of the New York-based investment banking firm Silver Lane Advisors. "There's a 'scarcity of value' dynamic at play," Nesvold says. "You're going to pay a premium because there are not that many firms over $2 billion, and even less with assets over $3 billion or $4 billion."

BOOMER BUST?

One issue is a surprisingly limited supply. Although forecasters predicted a wave of baby boomer sellers, the seller's market has failed to materialize, in what has been one of the more curious developments affecting advisory firm valuations.

"I haven't seen any evidence of large numbers of baby boomer sellers, and I don't expect to see it for a while," says **Furey**. "People's horizons are changing; they're healthier and living longer. And most advisors like what they do and are staying with their firms longer, even though by not selling earlier they're going to receive less value when they finally do."
In fact, FP Transitions, a valuation firm in Lake Oswego, Ore., estimates that less than 10% of boomer advisors are likely to sell their firms at the end of their careers.

"Many of the smaller advisors are married to the lifestyle," says David Grau Sr., president of the firm and author of the forthcoming book *Succession Planning for Financial Advisors*. "They're supported by the income; they're the boss and they don't see a compelling reason except if there is a health issue or an emergency," Grau explains.

Blame boomers' emotional attachment to their firms, says Matt Cooper, president of Newport Beach, Calif.-based Beacon Pointe Wealth Advisors, which has nearly $7 billion in assets under management and has acquired three firms in the past two years.

"Virtually all of [the reason boomers aren't selling] is emotional," Cooper says. "There are plenty of buyers out there. It's not a supply and demand issue. Emotions are causing the gap. Sellers are not motivated to share risks, and they can't agree on earn-out deal terms based on future performance. Buyers see all the risks in a business, but sellers don't see it because they're living it every day."

Advisors see an advantage to sticking around rather than selling, argues Jeff Crosby, chief executive of 3XEquity, an online valuation firm that offers independent advisors free software in return for data and a chance to either finance deals or play matchmaker.

"A lot of [advisors] are realizing they can work three more years and make the same amount as they could if they sold their firm today," says Crosby, who also owns an Ameriprise-affiliated RIA in Kirkland, Wash.

Indeed, most advisors "should never sell their practice," he adds. Ideally, he says, they should find a good next generation successor, give them a stake in the business and keep on doing what they enjoy doing "unless they just want to unplug."

INTERNAL OPTION

An increasing number of advisors who are considering selling their firms are wrestling with the difficult decision of whether to sell internally or externally, say industry observers.

"Internal successions are growing dramatically," says DeVoe. "But the sooner advisors put them in place, the better.

"If they start an internal succession eight or nine years before they want to leave the firm, they will have more options; if they start 12 months before, they will have less," he adds. "And the earlier they start, the greater the valuation will be."

The difference between sales to internal buyers and to external buyers will be one of the key issues covered at the Deal Makers Summit, Seivert says. "Most advisors believe they can get more by selling to external parties, and often the opposite is true."

But Cooper -- who is, admittedly, an external buyer -- argues that there are also caveats that come with selling internally. "Owners always end up buying themselves out at a discount to fair market value with their own money," he maintains.

Selling to an external buyer, however, means an owner loses control of his business and potentially disenfranchises the firms' next-generation advisors, Cooper acknowledges.

PLAN FOR VALUATION

As advisors set a horizon for a sale, they should also use a realistic valuation as a guideline for internal operations, experts say.

"Advisors should incorporate their valuation in their strategic planning process," says **Furey**. "They need to understand what drives value. If their clients are too old, for example, the firm is less valuable, and they can do something about it.

"One owner of an RIA told me he tries to run his business like he's on a roadshow with an investment banker," **Furey** adds. "He's not going to sell his firm any time soon, but he tries to manage it like he will."

Valuations can help drive practice management strategy, agrees Grau, who says his firm has done over 5,000 valuations in the past 16 years.

"The valuation process injects a dose of reality into the owners' business," he says. "It shows them how the business is trending, if it's growing and where there's attrition. It forces owners to take a hard look at where they're spending and where they're making money. It's just a good exercise to go through."

GETTING THE DEAL DONE

For those advisors who are ready to sell and about to sign off on a transaction, cultural alignment with the buyer is often the biggest hurdle to clear.

"The numbers usually are worked out, but cultural and values and how the two firms go about their day-to-day operations probably trumps everything in the end," says Furey. "The owners became RIAs for a reason, because they wanted to run things their way."

According to Nesvold -- a veteran dealmaker who worked on the Luminous Capital-First Republic and Bel Air Investment Advisors-Fiera Capital transactions -- buyers and sellers in successful transactions need to have chemistry together, a shared sense of what's important and a strategic rationale for the deal.

"They have to agree on why they're doing it and why it makes sense for the clients and the employees," she says.

While the structure of the deal -- and pricing -- can be complex, Nesvold says if the first three elements are in place, it's rare a transaction will be derailed by pricing and deal terms. Firms should, however, be wary of what she calls "deal euphoria," where expectations may exceed reality in the heat of the moment. "Sometimes," Nesvold cautions, "they get carried away with what the new company could be versus what actually exists today."