How to make an RIA attractive to buyers

by Charles Paikert in FinancialPlanning

CHICAGO - Two advisory firms can have nearly identical revenue and assets under management. Yet if one structures its business in specific, strategic ways, it can command more than twice the valuation of a lifestyle-oriented practice — even if the other firm is larger.

"Characteristics drive value, not size," said John Furey, principal of Advisor Growth Strategies, at Charles Schwab's annual Impact conference.

Furey, who spoke to advisors about how RIAs are valued, together with Todd Thomson, chairman of Dynasty Financial Partners, stressed the importance of advisory principals running their business as if they were trying to sell it.

Firms that focus on areas they can control, such as investment practices, client relations and technology, can potentially achieve a 9 to 11 multiple of free cash flow, Furey and Thomson maintained.

WHY NET MARGIN MATTERS
Net margin and earnings growth are two of the most important characteristics potential buyers will evaluate, the men said.

Even if firms have similar earnings, a larger net margin can have "a significant impact on valuation," Thomson said. "It's a multiplier effect.

Dynasty's Todd Thomson (left)and consultant John Furey discuss RIA valuations at Schwab's IMPACT conference. Image: Charles Paikert
Earnings expansion is also critical, he pointed out. "Buyers want free cash flow to be sustainable," Thomson said. "They are going to ask sellers 'How are you growing exactly?'"

WHOM DOES THE CLIENT ASK FOR?
Lifestyle practices tend to have clients directly tied to the firm's principal, Thomson said, while professionalized firms institutionalize client relations. The former will result in a discounted valuation, according to Thomson.

"If more clients are directly tied to the principal, the buyer is only going to pay the owner when the clients actually transition over," Thomson said. "Institutionalized firms don't have to worry about that."

Lifestyle firms also have to worry about having too many older clients and advisors. "Buyers want younger clients and advisors," Furey said. "If they're older, it's considered a declining asset and buyers pay a lot less."

ASSET MANAGEMENT MODELS
Firms that institutionalize asset management with standardized investment models that are scalable tend to be more highly valued than firms that spend more time and money on customized investment solutions, Thomson asserted.

"Buyers want less risk," Furey said, "and a scalable model is considered more sustainable."

Valuations are highly dependent on what buyers are looking for. Furey and Thomson noted that buyers can often be characterized as financial, strategic or peer-to-peer.

Financial buyers, for example, are looking for growth, and are unlikely to buy a practice from a principal who is retiring. Strategic acquirerers may be more interested in larger firms, while an RIA who is a peer-to-peer buyer may be less concerned about an owner retiring if the seller is a local firm that is a good cultural fit.

And Furey warned sellers they should not to read too much into news stories about firms selling for a high price or multiple. "The main impediment to the sale of RIAs, "Thomson added, "is unrealistic expectations on the part of the seller."