What is your RIA Worth? A Framework for Understanding Valuations

by Norb Vonnegut 3/17/2017 The Wall Street Journal

If you own a stake in a registered investment adviser, you probably spend time estimating what your shop is worth. With good reason.

Fees are coming down. Which puts pressure on annual compensation. Which makes equity stakes increasingly important to your personal wealth. Which means your retirement activities, whether you flip burgers in a greasy spoon or nurse fruity drinks on a Caribbean beach, depend on answers to three questions:

1. Is your RIA generating $10 million in revenues?

2. How good are your negotiating skills?

3. Do you have the right stuff to retain younger family members as clients?

Todd Thomson, chairman of Dynasty Financial Partners, says size, margins, growth potential and sustainability determine the value of your business.

“Small practices that are dependent upon the principal itself and therefore not sustainable” aren't valuable to buyers, says Mr. Thomson, whose firm provides investment and technology services to RIAs as well as capital to make acquisitions.

The little shops have what he calls “lifestyle margins,” which means an owner might make a decent living but can't afford to pay someone to run the business.

Mr. Thomson contrasts lifestyle RIAs with larger, professionally run practices that are characterized by decent margins and business-development strategies that generate growth without relying on one person. These companies have incredible value in today's world, he says.

$10 Million and Other Hurdles

Size appears to be the No. 1 determinant of the multiples paid on earnings before interest and taxes, or EBIT, says John Furey, founder of aRIA. His firm—whose acronym stands for the Alliance of Registered Investment Advisors—is an industry consultant and association of seven RIAs that manage $30 billion in total assets.

To attract interest from top strategic or private-equity buyers, Mr. Furey finds that RIAs must have "revenue north of $10 million, margins north of $3 million to $4 million," and "the people, processes and technology which will enable the firm to continue to grow."

Every transaction has distinct considerations. But for RIAs with $10 million or more in revenue, the multiples on EBIT are about 8 to 10 times, he says. For firms generating less revenue, the multiples range from 4 to 7 times.

So let's assume an RIA manages $588 million in total assets, generates $3.6 million in annual revenue, and delivers an operating margin of $979,200 or 27.2%. (I base my numbers on the median from Schwab's 2016 RIA Benchmarking Study of 1,128 different RIAs.) At 5x, the firm is worth $4.9 million.

Too bad for the owners. In an RIA with over $10 million in revenue and similar profitability, the same $979,200 is worth about double given the higher multiples awarded for size.

Unfortunately, lower transaction multiples are more likely to be the norm than the exception. Mr. Furey estimates that 4,183 RIAs of the roughly 12,000 registered advisers with the Securities and Exchange Commission, which includes hedge funds and other kinds of money-management businesses, are wealth managers. Of this subset, only 527 have $1 billion or more in assets under management, which is my proxy for companies within reach of $10 million in annual revenue.

Margins, Growth and Sustainability

The $10 million hurdle for higher multiples troubles me. To paraphrase Mark Twain, it's not the size of the RIA in the fight, it's the size of the fight in the RIA. And when measured by margins and growth, the largest firms show few discernible advantages.

Schwab's 2016 Benchmarking Study indicates the median operating margin for RIAs with over $2.5 billion in AUM IS 27.0%, slightly below the industry as a whole at 27.2%. The difference in five-year growth figures for AUM is more pronounced. The overall industry median is 9.2%, well ahead of the big dogs at 8.4%.

So given these performance comparisons, why do larger RIAs deserve bigger multiples?

Here, Mr. Thomson makes the sobering observation that nearly 70% of all RIAs close their doors once the founder leaves the business. The issue is sustainability, Mr. Thomson's fourth factor, and the numbers say size is perhaps the biggest determinant.

In Schwab's study, the median number of clients for RIAs with $2.5 billion or more in assets is 1,089. For firms with $100 million to $250 million in AUM, the median is 165 clients. Who do you think is more likely to survive client departures or the vicissitudes of sharp economic downturns?

Shirl Penney, Dynasty's CEO, sums it up best: Size is the difference between a practice and a firm.

Why Negotiating Skills Matter

The annual compensation of RIA principals is another factor affecting valuations, says John Straus, the CEO of FallLine Securities LLC. His firm provides transition and platform services to RIAs and breakaway advisers.

"In order to keep the former owner involved, the acquirer pays the former owner a salary. When that salary is subtracted from the earnings it reduces the profit," he says. And lower EBITs mean lower enterprise values, leading to inherent tension over the right number for annual compensation.

Buyers prefer to pay exiting seller-advisers a market rate, say, 35% of revenue. At 5x, this line item reduces the sales price by $6.3 million, assuming two seller-advisers generate $3.6 million in revenue and earn $1.26 million annually.

Sellers, conversely, prefer lower annual comp and higher sale prices. One primary reason is that this structure shifts taxation from ordinary income rates to capital-gains treatment. And Mr. Straus says that in today's market "the owner comp used in these calculations is typically $500,000" per seller-adviser.

At a multiple of 5x, this line item reduces the sales price by $2.5 million per person. But two seller-advisers are still better off by $1.3 million than in my previous example when their annual compensation was calculated at 35% of revenue.

This $1.3 million is a big difference. Why wouldn't you negotiate the lowest annual comp possible?

The Double-Whammy of Demographics

That said, timing is everything. If you're planning to sell your shop when you retire, the demographics of an aging population might be a double-whammy your valuation.

For one, there are likely to be lots of RIA owners exiting at the same time. According to a white paper published by Focus Financial Partners and JPMorgan Asset Management, 30% of all RIA advisers plan to retire during the next 10 years.

Now layer on the impact of wealth transfers. In a 2015 study, Wealth-X reported that ultra-high-net investors in North America will transfer 15% of their wealth to the next generation over the next 10 years and as much as 39% over the next 20 years.

These percentages are probably a good indication of the wealth transfers that RIA clients will make. According to the Focus Financial/JPMorgan white paper, 44% of RIA clients are 60 or older. According to the separate study by Wealth-X, 44% of the world's UHNW population is 60 or older.

The problem is that investment professionals aren't especially good at hanging on to AUM during generational shifts. I've seen various industry estimates say they lose anywhere from 66% to 98% of the assets that move to the next generation. Forget about 10x. You're lucky to get 2x with these kind of retention rates.

Uh-oh.

My two cents: Rather than wait to throw a Hail Mary when you retire, think about merging with like-minded competitors and building scale for a sale down the road. Or sell a piece of your business now, keeping some upside in future growth. And whatever you do, pay attention to those millennials.

If you have a great business to sell, Mr. Thomson says, "there's no better time than right now."

—Norb Vonnegut built his wealth-management career in New York and now writes thrillers about financial malfeasance. Email him at norbert.vonnegut@dowjones.com. Twitter: @NorbVonnegut