Reviving Practice Valuations

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Because the value of most advisory practices is tied in varying degrees to cash flow, revenue and assets advised, most firms are probably worth less today than they were at their peak a year ago.

While no one knows when markets will rise and asset levels will return to their previous high-water marks, we should expect that valuations and deal structures likely will be different once they do. Until then, it's worth analyzing whether the decline in firm valuations has been greater than the decrease in assets. I believe that the valuation decline has been greater, for several reasons.

For one, being in the advisory business carries greater risk than it did a year ago. As a result, there now are fewer buyers than this time last year. While interest remains high, many strategic buyers are focused on higher priorities. All buyers have less confidence and gravitate much more to looking than acting. The credit crunch means that third-party financing went from tough to nearly impossible. This has put a great deal of pressure on sellers to hold notes. Finally, the diseconomies of lower scale carry with them lower margins and lower valuation multiples. Together, these elements put downward pressure on valuation multiples, which results in a decrease in valuation that is greater than a 1-to-1 decline in assets.

In an environment such as this, here are five steps an adviser can take to increase the value of his or her firm:

Resuscitate and rejuvenate clients and referral sources: Job One is taking care of existing clients. Make sure to revise their financial plans, re-balance their portfolios and increase their confidence that you are thinking of them and have made the appropriate adjustments to their portfolios. It is also important to spend time with key referral sources, communicating what you have done and rejuvenating their faith in you.

Employ a "supermodel": While independent fee-based businesses command far higher valuations than captive, commission-based ones, advisers shouldn't take that advantage for granted. They must constantly re-evaluate the products and services they offer, as well as pricing. Sometimes, products should be added; at other times, cut back. Similarly, some services now may make more sense with an additional fee, while others should be offered at no additional charge. There is more than one "supermodel" for an advisory business, but most share the characteristics of high productivity and marginal benefits that far exceed marginal costs.

Come together right now: One of the best ways to regain scale and develop a more attractive financial profile is to partner with another adviser or merge with another advisory firm. While a merger may be a powerful, permanent solution to current challenges, it also may be a transitional move that both parties put in place for a while before they agree to move on to another arrangement at a later date.

Rescue poorly serviced investors: Not all advisers do right by their clients in terms of diversification or manager selection. In fact, the definition of "adviser success" is in the process of change. For advisers who can offer a safe haven, there is an opportunity to widen one's competitive advantage and attract clients. Now is a great time to increase your visibility and revise your marketing pitch to address some of the common woes that dissatisfied investors may be feeling.

Stock the team: The largest expense in the advisory business is people, typically accounting for 50% to 70% of total expenses. Surmounting the challenge of lower revenue, coupled with relatively high fixed costs, requires either cutting back on the number of team members, cutting their work hours or reducing their compensation. Whatever the choice, it means employees will be working for less. To overcome that negative, find a way to increase equity sharing with those who drive value, and link it to doing just that, and ask the team to extend you, the owner, a small amount of credit which can be paid back when conditions improve.

If advisers successfully implement these recommendations, they likely will enjoy significant improvements in growth, scale and margins. To the extent a firm is a leader among peers in these factors, it will garner the high end of the prevailing valuation range for this phase in the business cycle, which is indeed a lower range overall. An added benefit will be that as markets recover, firms with greater financial and organizational fitness will enjoy even more attractive economics and higher valuations.

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