The Valuation Conundrum

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With more motivated sellers than qualified buyers, how much is your advisory firm really worth?

People often remark that advisory firms are now worth so much that nobody can afford them. This ironic observation reminds me of Yogi Berra's memorable quote, "Nobody goes there anymore. It's too crowded."

Estimating the value of an advisory firm begins with the development of assumptions. In the simplest calculation, divide cash flow by risk minus growth: V=CF÷(R-G). On average, advisory firms have grown in size. The numerators are getting larger, boosting valuations.

Further, many firms are making strides to mitigate risk by focusing on three areas: managing client selection and retention, improving compliance and reducing dependency on a few key people. In addition, even though the rate of growth has slowed considerably and the cost of doing business continues to rise, many firms are experiencing absolute growth in revenue and profit. Yet how accurately do these factors predict firm value?

When appraising a business for a gift, an estate tax or divorce, where the standard is fair market value, the hypothetical price assumes "a willing buyer and willing seller, both parties being fully informed of all the facts, and neither party being under any compulsion." (IRS Revenue Ruling 59-60) As a practical matter, however, these conditions rarely exist in a real-life sale. If the asset or entity is not transferrable for whatever reason, it does not have much value.

The seller's dilemma

A comparison may be drawn between this dynamic and the valuation of restricted stock. How does the marketplace treat a security that cannot be sold freely relative to securities in the same company that are liquid? Further, how does the market treat an investment opportunity when the supply exceeds the demand? In both cases, lower prices are the consequence.

Firm leaders seeking to sell must consider this reality. First, they face an important decision:

1. Should I ensure the continuity of my business by transferring ownership to key employees who have helped me to build value? or

2. Should I try to get as much as I can by selling to a strategic or financial buyer who is willing to pay a premium for my business?

An internal transaction involving successors requires the seller to determine if key employees possess the financial ability and risk tolerance to buy him out.

A qualified strategic buyer has the unique ability to use creative financing and to pay for synergies that an internal buyer cannot. As a result, strategic buyers may be inclined to pay more.

In the first case, the seller will optimize value and in the second they will maximize value.

An advisory firm owner making a purely economic decision would lean toward the highest valuation. However, many realize that they are selling not just a financial asset, but a human capital asset as well. It is important to note that without terms and incentives handcuffing key employees to the business for a period after the sale, the drivers of value could literally walk out the door once the deal is done

Often, owners feel that they are doing their employees or partners a favor by cutting a deal with them. Not only does this insult the successors, it fails to recognize the important contributions these individuals made to build value in the business.

Remember, employees who manage clients free up the founder to focus on where he or she makes the greatest impact. Their good work aids in the retention of clients and contributes to cash flow and the business brand. Often these employees brought in the top clients in the first place. While the initial risk the founders took to create the business entitles them to some return, without the help of others they would not have created a transferrable asset.

Preserving a legacy

I do not mean to imply that selling to an internal buyer is the "right" thing to do. Owners of advisory firms must define their goal before proceeding with their liquidity plan. Clearly, one's legacy has a greater chance of surviving intact if the business is transferred to those who helped create it, rather than to an outside buyer who views the business as a mere financial asset.

However, there are advantages to an outside buyer.

• A strategic buyer — like Pathstone Federal Street, Edge Capital, Aspiriant or HighTower — would bring a brand, a process and a way of managing the business that should help those who remain with the firm.

• An investor — such as Fiduciary Network or AMG Wealth Advisors — would bring capital and expertise to help the business grow. They could also facilitate internal transactions to ensure that key people remain with the firm and contribute going forward.

• A large consolidator or financial buyer would bring the potential for a possible future liquidity event; companies in the portfolio would get a real lift on the multiple of earnings at which it is sold. They could also receive equity in the new firm which potentially would enable them to grow their net worth through business ownership more quickly.

Internal buyers often lack the advantages of these professional buyers. They do not have the same access to debt or equity capital; consequently, they cannot make material improvements in the business that would generate more cash flow to enhance their financial return. Internal buyers often require at least some portion of seller financing — though some good funding sources exist for the advisory market, most prominent among them Live Oak Bank.

-- A record number of RIA M&A deals closed last year. ***ECHELON Partners*** *identified five trends driving that activity --*

Firm leaders should recognize that the buyer and the sources of capital tapped to finance the purchase will weigh many factors:

• Value is a function of the future, not the past. If you use historical numbers as the foundation for valuation, be sure to explore whether any of those revenues or earnings are at risk of discontinuing. Loss of assets or clients, or dissatisfaction with the experience by existing clients, could impact future earnings of the business.

• The sale of a business can feel somewhere between giving up one's daughter for adoption and giving away her hand in marriage. Sellers can be emotional and even irrational, while buyers tend to resist any pressure to appease the seller. Outside professional help may be necessary to facilitate successful negotiations.

• Terms are more important than price. Assuming that seller and buyer come to an agreement on what factors influenced the valuation, the next step is to resolve how the deal will be structured. Will it include seller financing, bank financing, performance and retention incentives or other factors? What will be the duration of the buy-out period? Will a non-compete or another restrictive covenant exist? Will the seller have a continuing role in the business and how will he or she be compensated?

Selling an advisory firm in today's market requires careful examination of many moving parts. Regardless of whether the sale is to a strategic buyer, a financial buyer, an investor or a successor, establish exactly what is being transferred to the new owner and what it is worth to them. Enlisting professional help with your sale will ensure that your asset is transferrable and that you are making a solid transaction. These experienced professionals can guide and support you in the complex process of making a deal, mitigating the angst of all parties involved.

The Takeaway

- Recognize that value depends on what is transferrable
- Value is based on what the business is expected to do, not what it has done
- sellers and buyers should always seek professional help to ensure a more informed transaction