THE COSTS OF IMPROPERLY VALUING THE FIRM

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Assets under management are a poor indicator of advisory firms' true worth.

Financial advisers' incorrect assumptions about what adds value to their practices can cost them dearly when it comes time to sell.

"In most cases, it's hundreds of thousands of dollars, but a lot of times it's millions" advisers unnecessarily lose out on in a sale, says Dan Seivert, founder and managing partner of Echelon Partners in Los Angeles. Echelon is an investment bank and consultancy that works with wealth and investment managers.

"You hear caveat emptor"--let the buyer beware--but "in this case: it's seller beware," he says.

But there are steps advisers can take to increase the value of their practices long before they consider selling. Taking measures to increase the firm's assets systematically rather than hoping for referrals, presenting a buyer with evidence of client satisfaction or turning away individuals who may need lots of hand-holding will make an advisory business more attractive to a prospective buyer.

"I call it the perfect blind spot," says Mr. Seivert. Managers "get a little bit lulled into this notion that because they know wealth management, they know valuation, so they're easy prey," he adds.

The most important drivers of an advisory business's valuation are its scale and projected growth, Mr. Seivert says.

Advisers often overrate the importance of growth in assets under management. But assets are a poor indicator of the true economics of a business, he says, because a lot of assets don't generate full fees. One client may have $20 million sitting in a single stock, for example, for which the adviser charges very little.

What really matters to buyers is the growth of the firm's bottom line--its revenue minus its expenses, excluding interest, taxes, depreciation and amortization. Firms should target compound annual growth in earnings before interest, taxes, depreciation and amortization of more than 25%, Mr. Seivert says.

Businesses that increase assets systematically are viewed much more favorably by buyers than those that grow assets due to strong markets or luck. For example, a firm at which a few new clients join and existing clients add a bit more money each year will be viewed more negatively than one which conducts seminars that brings in 50 new clients each year, Mr. Seivert says.

Another misconception: Revenue is the most important indicator of a firm's financial health--but it's actually a poor gauge in many situations.

"You can have a firm with $2 million in revenue and $1 million in profits and one with $2 million in revenue and no profits," Mr. Seivert says. While revenue is applicable and relevant in some situations, "it's not the metric of choice," he adds.

Brad Bueermann, chief executive at FP Transitions, a Lake Oswego, Ore., firm specializing in valuation and analysis of financial-services practices, says advisers often believe all of a firm's value is attributable to revenue or to assets under management.

"How those revenues are created or how those assets are held is incredibly important," he says.

The robustness and durability of a firm's cash flow is key, Mr. Bueermann says. Among the concerns is whether a firm has a shrinking or growing group of clients, which usually relates to the quality of its service, as well as client demographics.

There's a big difference, he says, in a group of clients in the accumulation phase--say, between 40 and 70 years of age--and one made up of clients in the disbursement stage. "If the majority of assets are held by people in the disbursement phase, we would expect that over time, that book will diminish in value," he says.

Buyers will also consider the concentration of the assets. "Oftentimes, we will see a firm where a handful of clients make up better than 50% of a firm's total assets under management," Mr. Bueermann says. "That obviously presents a risk to a buyer."

Other indicators prospective buyers like to see include non-compensation expenses of less than 20% of revenue and compensation expenses of less than 50% of revenue, Mr. Seivert says: "It's really the leading firms that are able to generate 30% profit margins; certainly, some go as high as 50%."

Many advisers believe their practice will be worth more if they offer more than wealth-management services, such as accounting, insurance, trust and estate planning. But such services often generate less revenue than pure wealth management, Mr. Seivert says.

"It's really only the investment-management business that in combination with wealth management adds value at all, and 50% of the time, it's probably a value detractor," he says.

In addition, advisers often overemphasize winning clients with very large accounts. While some investors with $10 million to $20 million in assets make great clients, many are high maintenance with complex needs that can add to a firm's expenses, Mr. Seivert says.

In addition, clients with more than $20 million often employ an intermediary, such as a personal chief financial officer or attorney, between themselves and their adviser. As a result, advisers may face "an occasional bake-off" with another new adviser under consideration, he says, adding that many prospective buyers prize practices with an average client size of $2 million to $10 million.

Buyers will also want to know if clients are satisfied and unlikely to defect after a sale. But citing client retention figures is a poor measure of satisfaction because most people are reluctant to switch advisers even when they're not totally happy, Mr. Seivert notes. Producing empirical evidence of client satisfaction for a buyer in the form of a strong client survey is much more powerful, he says.

Mr. Bueermann of FP Transitions says it's important that the clients' accounts are easily transferable to another adviser, which generally relates to how frequently those clients are contacted.

"If you bought a financial advisory practice with 250 clients and after the deal closes, they go somewhere else, you would have purchased a bag full of feathers," he says.

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