AUM AND THE VALUATION PARADOX

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The RIA business is probably the only business extant where the provider charges clients based on the value the client brings rather than the value the provider delivers to the relationship. That observation came from Pershing Advisor Solutions CEO Mark Tibergien during a debate between him and ECHELON Partners CEO **Dan Seivert** at last month's Pershing Insite18 conference in Orlando.

This AUM compensation paradox has long vexed the RIA community, which borrowed the concept from the investment management world. Popular with advisors and many clients because it is clean and simple, others have questioned whether it accurately reflects the value advisors deliver for relationships that last decades.

But how many people would rely on a doctor who charged them based on their weight? The reality is that advisors often are forced to work extremely hard at the onset of an engagement and then can earn healthy fees for years, occasionally expending serious hours when clients reach turning points in their lives. Over the lifetime of a relationship, clients may receive fair value but there can be periods of stability and prosperity when they pay a lot for what they get.

Financial Advisor's RIA Survey on page 46 reveals that many RIAs are looking for sources of revenue beyond traditional AUM. These fees are charged by 97.3% of the firms in the survey, but 32.2% are now charging hourly fees while 43.4% charge flat-fee retainers.

The Pershing debate, entitled "What Matters Most When Considering An Acquisition," was structured to force **Seivert** and Tibergien to argue various positions whether or not they believed in the underlying premise. The first issue was whether a firm seeking to maximize its value should focus on boosting its profitability or its growth rate. Tibergien maintained that "organic growth is still king." What's most important to advisors when they evaluate an investment, what a company has done or what it will do, he asked.

Seivert argued profits "reign supreme." Not only does bottom-line cash flow reveal an RIA firm's cost management capabilities; it also demonstrates the quality of a firm's business model.

Acquirers want predictable recurring cash flow. That explains why most transactions involving significant RIA enterprises are based on multiples of EBITDA (Earnings Before Interest And Taxes Plus Depreciation And Amortization), not revenues, Seivert continued. This contrasts with the book of business valuation approach applied in the brokerage business, which produces far lower valuations and payouts.

Other factors come into play as well. Tibergien pointed out that as advisors get older, their client base tend to age as well and their businesses start "to look like a depleting oil well."

Ultimately, the decision of whether to stress top- or bottom-line growth should hinge on where a firm is in its life cycle. If an advisor is envisioning a liquidity event a decade down the road, focusing on growth for the six or seven years and then switching to profitability may be the optimal strategy, **Seivert** suggested.