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Taking Steps to Help Maximize the Value of Your Firm

A resource to understanding factors that can influence the value of your RIA

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Overview

Understanding how a potential buyer may value your firm

Many small business owners share a similar dream: a potential big payday for all their hard work and investment. As the owner of a registered investment advisory firm (RIA), you may not be different, with dreams of one day selling your firm to an external party or through an internal transition.

Based upon feedback from industry contributors,[1] there isn't a shortage of buyers today, with increasing numbers of firms seeking to build scale, expand their service offerings through a merger or acquisition, or put capital to use in the form of a passive investment. What's more, it's expected that the number of sellers will increase due to an aging advisor population.

Making that big pay day a reality, however, may hinge on maximizing the value of your firm in the eyes of your suitors. As the number of potential buyers has increased, the methods of calculating firm value have become more sophisticated and precise.

With that in mind, it's important to understand how possible buyers may look at your firm. Today, it's important that every owner of an RIA firm:

- Know its value drivers: Understand what drives the business value of an organization today.
- Identify each "type" of buyer and transaction: A firm's valuation can be impacted by the type of buyer pursuing the RIA and the type of transaction sought by you or the buyer.
- Think like a buyer: Anticipate what action steps will be needed to push a sale forward.
- Uncover any gaps or liabilities: Identify and rectify anything that may scare off buyers.

With contributions from a number of industry participants interviewed,[1] we created this resource to help you better understand what you may want to consider when planning for a potential sale, as well as refining your business management practices, in order to help maximize the potential value of your firm. This resource is divided into the following five distinct topics:

1. Industry landscape. Learn how buyers have become more sophisticated in recent years and its impact on valuation.
2. Myths and realities of valuation. Understand why common rules of thumb may be misleading in placing a value on a firm.
3. Understanding the range of valuation drivers. Explore different value drivers and study which ones are some of the most important, regardless of buyer or transaction type.
4. How transaction types may impact firm valuation. Learn how counterparties in different types of transactions may place relative premiums or discounts on the value of an RIA.
5. Insights to consider. Take these action steps to maximize the potential value of a firm, even if you are not planning to sell it right away.

To aid you further, we've also included a list of Fidelity resources you can tap into today when considering how to maximize the value of your firm.

> "Sellers should do their homework to better understand what business elements might most impact the value of their firm, and how they can influence them. This can make for a much more productive discussion with a prospective buyer."
>
> —Waldemar Kohl, Vice President, Fidelity Practice Management & Consulting

[1]John Furey, principal of Advisor Growth Strategies, conducted interviews of executives of RIAs via telephone with the additional industry contributors listed at the beginning of this resource during the month of December 2013. John Furey and industry participants are referred to as "industry contributors" throughout this resource. Advisor Growth Strategies and the industry contributors are not affiliates of Fidelity, and the views or opinions of the industry contributors interviewed or quoted herein do not necessarily reflect those of Fidelity Investments.

1 Industry landscape

Our industry contributors tell us that your pool of suitors is widening. They believe that more and more firms are looking to build scale and grow offerings through acquisitions. At the same time, buyers are more sophisticated and better capitalized than ever. They emphasize that it's important for you to understand how the industry has evolved over recent years, who the key buyers are today, and how their growing sophistication may affect their perceptions of your firm.

"Today's climate for buying and selling RIA firms is as dynamic as ever, driven by a range of factors, including bigger, stronger buyers and an aging advisor population."

—Steven Levitt, Park Sutton Advisors

Evolution of business value in the independent RIA sector

Although the purchase and sale of RIAs has been occurring for decades, our industry contributors believe today's climate is much more dynamic. Among other things, they feel that it's a seller's market in that there are far more buyers, and firm valuations have the possibility to keep going up. They identified the following trends that have emerged over the past five years:

- Bigger, stronger buyers: Well-capitalized strategic and financial buyers have entered the industry as active players.
- Larger targets: Compared to three years ago, there are a greater number of large and regional firms, which typically are attractive targets for strategic buyers. Today, there are more than 500 firms with $1 billion in assets under management (AUM) in the industry—there were just 300 in 2010.[2]
- Larger market: An aging advisor population continues to increase the potential number of sellers.
- Validated value: Several high-profile transactions have occurred since 2009 to indicate that RIAs can have transferrable value.
- Better business practices: More and more RIAs are taking steps, such as hiring professional managers, to run their practice like a business and help make themselves more attractive to the market.

[2]Cerulli Quantitative Update—Advisor Metrics 2013.

Examples of high-profile deals since 2009

SELLER	BUYER	TRANSACTION TYPE	FIRM SIZE (AUM)	CASH/STOCK	VALUATION
Luminous Capital	First Republic	Bank Acquisition	$5.5B[1]	Cash	Cash
Atlantic Trust Private Wealth Management	CIBC	Bank Acquisition	$20B[2]	Cash	Cash: $210M
Bel Air Investment Advisors LLC	Fiera Capital Corp (TSX: FSZ)	RIA Acquisition	$7.3B[3]	Both	Total: $125M
Silver Bridge Advisors	Banyan Partners[6]	RIA Acquisition	$1.9B[4]	Not Public	Not Public
Argent Financial Group	Highland Capital Management	RIA Merger	$4.3B (Combined)[4]	Not Public	Not Public
Mintz Levin	Colony Group	RIA Merger	$2.5B (Combined)[5]	Not Public	Not Public

[1]Osterland, Andrew. "First Republic Bank buys Luminous Capital." InvestmentNews. N.p., 05 Nov 2012.
[2]Staff. "CIBC to acquire Atlantic Trust." Investment Executive. N.p., 11 Apr 2013.
[3]Fiera Capital Corporation, "Fiera Capital announces closing of acquisitions of Bel Air Investment Advisors and Wilkinson O'Grady & Co." CNW. N.p., 31 Oct 2013.
[4]June 3, 2013, Partners Buys Silver Bridge from WilmerHale, http://www.fa-mag.com/news/banyan-partners-buys-silver-br\fidge-from-wilmerhale-14469.html
[5]Coffey, Sarah. "The Colony Group to acquire Mintz Levin Financial Advisors in Boston wealth management merger." Boston Business Journal. N.p., 30 May 2012.
[6]Subsequently sold to Boston Private Bank in 2014.
Source: Advisor Growth Strategies, November 2014.

Valuation challenges come as no surprise

With more than 30,000 unique RIAs[3] in the U.S., each running their business a little differently, it's no surprise that placing a value on these firms can be challenging.

While most firms operate with similar business models, each RIA may apply a unique approach to managing the functional aspects of their organization, including sales, marketing, investments, client service, operations, technology, and compliance.

These differences can make it difficult for both buyers and sellers to adequately benchmark one firm to another and ultimately predict comparative future value.

"The structures of some deals can be a real mystery," says Rush Benton of CapTrust Advisors. "The lack of transparency with regard to overall deal structure, including specific terms and conditions, creates a real valuation challenge. Very often, a Form ADV is the only lens you have on a deal and it doesn't require advisors to provide details regarding the transaction structure."

[3]July 16, 2014, 2,280 New RIA Firms Were Started From May 2013 to May 2014, http://www.riainabox.com/blog/2280-new-ria-firms-were-started-from-may-2013-to-may-2014

Examples of today's buyers

With the market for independent RIAs becoming one of the fastest growing sectors in financial services,[4] a new set of buyers has emerged over the past five years. Our industry contributors provided the following examples of what today's buyers can include:

External buyers

- Private equity and venture capital firms. Usually, these firms are seeking economic interest versus control over day-to-day operations. They see value in the cash flow an independent RIA can generate and may seek liquidity through a future buy/sell event that could include an external sale, internal buy-back, or some variant.
- Strategic buyers. These buyers typically seek to drive scale, create value, or "roll up" firms. Often, strategic buyers offer an ongoing source of capital and have wide latitude in how they structure deals. Many of these buyers tend to seek critical mass and offer future liquidity events for their participants.
- Banks, insurance companies, or other financial service firms. Typically, these entities are seeking wealth management services for their clients. Instead of building the capabilities from scratch, they want to buy an RIA. Our industry contributors tell us that as capital markets have recovered over the past few years, some firms are finding that it's just faster to buy than to build an in-house advisory offering.
- Existing RIA with an exit plan. While this may feel similar to a business combination of two independent firms, this type of buyer has a defined exit plan for certain firm owners. Through the transaction, the eventual exit of an owner is defined within the terms of the sales agreement.

Internal buyers

- Succession. For owners who want to pass their firms to the next generation, thoughtful long-term planning is critical. According to Geoffrey Frazier of Global Financial Private Capital a 5 to 10- year horizon to transfer business value is common. He says, "For internal succession, buyers will usually weigh the long-term strength and longevity of the firm against their long-term prospects of remaining just an employee. They'll also consider any opportunities they may have or anticipate outside the firm. It's important to remember that many potential 'next generation' owners may lack the business acumen to own or operate an RIA."
- Internal "buy-in" or "earn-in" programs. Buy-in or earn-in programs allow participants to buy an interest in the firm. With an earn-in program, a participant earns equity in exchange for generating revenue. This latter type of structure is common for firms that are seeking to bring on additional advisors.
- Another RIA. Although this is not a true internal transaction, many in the industry consider a business combination or merger as a quasi-internal transaction given that a firm joins another, and most of both firms' participants remain in place. These types of transactions can potentially have a long courtship period and involve deep discussions to allow each party to get a strong sense of one another.

[4] Cerulli Quantitative Update—Advisor Metrics 2013

2 Myths and realities of valuation

Sure, "rule of thumb" calculations may save you time and help with broad, ballpark estimates of your firm's valuation. However, our industry contributors share that relying on such imprecise calculations can lead you to misjudge your value and, worse, leave money on the table in a sale. Whether you are a first-time buyer or a potential seller, learn some of the common pitfalls to avoid in trying to determine a firm's potential price tag, and see many of the things today's buyers are looking for.

"Any rule of thumb approach is fine for a bar napkin valuation, but precision matters if you're serious about growing your business equity."

—Bruce Cameron, Berkshire Capital

The dangers of relying on rules of thumb

For both new and inexperienced industry players, back-of-the-envelope rules of thumb have been perceived as a handy shortcut to a valuation number. Here are examples of a few common back-of-the-envelope approaches:

- Fee-revenue rule: All RIAs are worth 2 to 2.5 times fee revenue.
- Cash-flow rule: Firms usually are bought or sold for four to seven times cash flow. Larger firms can command higher multiples, up to 10 times their cash flow.
- Financing and "earnout" rules: Most sellers can expect a third of their sale price up front, with the remainder linked to an "earnout" or financing.
- Internal-discount rule: Most internal buy/sell transactions occur at a discount of 25% to 50% off fair market value (FMV).

Many of the industry contributors indicated that rules of thumb simply don't account for the variables of an actual deal. To help identify and assess the potential variables that could impact your firm's valuation, you may want to ask the following questions if you plan to sell your firm:

- Is this a cash or equity transaction?
- What type of financing is involved in the deal?
- What is the quality of my client list?
- How do I describe my firm's culture?
- What are the unique strengths and capabilities of my firm's human capital?
- How would I describe my firm's business management acumen and performance?

Strategic acquirers define value on their terms

Our industry contributors shared that many strategic players have a preestablished, systematic approach for buying, and even selling, firms.

"We look at 25 different drivers to determine the value of an advisor," says Rudy Adolf of Focus Financial Partners. "That includes quantitative and qualitative measurements—not simply a standard multiple of a firm's cash flow."

Yet, according to Adolf, "Culture trumps all criteria. If a potential advisor or firm does not seem to be in alignment with the Focus culture, client focus, collaboration, and entrepreneurship, we simply walk away from the deal."

A consistent, persuasive valuation method is needed

Our industry contributors agree there is no one single method of valuing an RIA. Valuation theory and application within the RIA space is still a work in progress. While the industry has come a long way, our industry contributors feel a consistent methodology does not exist for how firms are valued. Advisor Growth Strategies provided the following table, which offers an overview of some of the common industry valuation methods used today and their potential pros and cons:

VALUATION METHOD	MARKET USAGE	PROS	CONS
DCF (Discounted Cash Flow) Often viewed as a most accurate valuation method, a discounted cash flow analysis consists of forecasting free cash flows for a set period of time (usually 3–7 years). Beyond the last forecasted year, a terminal value is created using a capitalization rate.	• Emerging valuations method • Sophisticated buyers using more frequently	• Flexible in predicting future risk and economics • Alignment with public company valuation	• Hard to predict future cash flow • Highly sensitive to assumptions • Limited socialization in RIA community
EBOC (Earnings Before Owners Compensation) A measure of cash flow in advisory firms, EBOC considers all earnings before compensation is paid to the owner.	• Proxy for cash flow • Used by M&A firms as cash flow multiple	• Removes owner compensation • Focus on actual profits	• Does not forecast future cash flows • Does not incorporate future risk
EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) A widely used metric that indicates a company's operating profitability. EBITDA is used to gauge how a company is performing before deducting interest (financing) expense, tax expense and depreciation and amortization expense (non-cash).	• Proxy for cash flow • Used in M&A for cash flow multiples and cross-company comparisons	• Removes finance, tax, and non-cash expenses • Easy to compare across companies	• Does not forecast future cash flows • Does not incorporate future risk
EBIT (Earnings Before Interest and Taxes) Earnings before interest and taxes is a profitability metric that ignores interest and tax expenses. EBIT ignores a company's capital structure and current tax rate.	• Starting point for cash flow • Cross-company comparisons	• Easy to compare • Ignores finance and tax expenses	• Needs adjustments for proper usage
Revenue Multiple Using a revenue multiple consists of multiplying a firm's revenue by a set multiple (e.g., 2.3x) to determine enterprise value.	• Independent B/D • "Back-of-the-envelope" valuations	• Easy to understand • Easy to use for internal transfers	• Does not consider expense model • Assumes all revenue is created equal • Buyer risk
Market Comparables Market comparables are used to demonstrate the value of similar firms in the market. This approach provides perspective as to what value similar firms are commanding in recent transactions.		• Provides a multiple based on similar transactions • Alternative method to determining value	• Uses historical data and transactions • Does not account for future risks • Hard to find reliable data

Source: Advisor Growth Strategies, November 2014

"Anybody can say a firm is worth 2.3 times revenue, but the terms of the transaction can also make all the difference to a potential seller."

—Steven Levitt, Park Sutton Advisors

Deal terms can play a role

According to our industry participants, while valuation methodology is important, despite a lack of a consistent method used in the industry, deal terms can frequently drive how a firm's valuation is determined.

The hypothetical example below, provided by Advisor Growth Strategies, highlights the differences in valuation for two identical firms based on deal terms.

PRICE	HYPOTHETICAL TRANSACTION A	HYPOTHETICAL TRANSACTION B
Cash flow	$500,000	$500,000
Cash flow multiple	5	6
Initial purchase price	$2.5 million	$3.0 million

TERMS	HYPOTHETICAL TRANSACTION A	HYPOTHETICAL TRANSACTION B
Cash up front	$1.5 million	$750,000
Earnout	Three years for the final consideration of $1.0 million	Five years for the final consideration of $1.25 million
Promissory term note (seller financing)	n/a	5 years @ Prime + 2%: $1.0 million

Source: Advisor Growth Strategies, November 2014. This example and the information contained herein is hypothetical in nature and does not reflect data for a particular situation or any potential transaction.

In Hypothetical Transaction A, the seller receives $500,000 less in total consideration, but twice the amount of cash up front. The seller also receives the total consideration two years earlier than in Hypothetical Transaction B.

Hypothetical Transaction B also includes an element of seller financing, which could make the seller wonder if it's paying itself, given that future cash flow is being used to pay the promissory note.

Regardless of what valuation method is used, when managing business equity and considering future buy/sell transactions, do your homework on the potential terms and consider who bears certain risks. And, of course, consider the tax implications in any transaction, particularly any long-term plan to manage business equity.

Four reasons buyers may knock on your door

When it comes to valuation, it's easy to focus on the consideration a buyer is paying instead of what the buyer is hoping to gain from the purchase. Understanding what the potential buyer is seeking from the transaction can help the seller better assess a potential transaction's impact on valuation. Our industry contributors indicate that, in general, buyers tend to purchase an independent advisory firm for the following four main reasons:

1 Revenue or net profits

These buyers are simply seeking to buy the present and future revenue of a firm to achieve scale and growth. In essence, they are buying a "book of business." In these types of situations, the acquiring firm typically is not looking for "human capital" or capabilities, usually because they expect a firm to adopt their platform. Instead, these buyers look at professional acumen and key employees, as well as the quality of the revenue (e.g., the clients) they are buying. Although they are buying revenue, these buyers are likely seeking to understand how much profit their purchase will yield on a marginal basis.

Potential impact on valuation: In terms of valuation, David DeVoe, of DeVoe & Company, believes that this type of buyer usually does not care about current profitability, how costs are managed, or the current compensation system, since they expect you to adopt their cost structure.

"They're far more interested in your client base, ability to grow the business, and human capital," says DeVoe. "Therefore, your growth rate of clients, client demographics, and people will have the biggest impact on valuation."

2 Cash flow

Buyers seeking cash flow are typically financial buyers such as a private equity or venture firm, seeking to acquire a firm to deploy capital and achieve a desired investment return. These buyers typically want to understand not only revenue, but also the future cash flow they can tap. In most instances, these buyers leave the existing operating model of a firm intact. They might purchase a controlling or passive interest, since they are typically looking at long-term effectiveness to drive future cash flow.

Potential impact on valuation: These buyers may pay a premium for advisors that have a proven growth engine (e.g., rainmakers, a niche strategy, a strategic relationship for referrals) and client demographics, but they are also interested in a firm's acumen to grow the business as a stand-alone entity.

"Buyers focus on your track record of maintaining profitability and revenues in various markets, expecting that your existing model will remain intact," says Bruce Cameron of Berkshire Capital.

If a seller is not a good business manager, the buyer could apply deep discounts given the higher risk factor. These buyers may also feel that they are being forced to incur more costs (which can then drive down purchase price) if they feel they need to make incremental investments to drive longer-term success.

3 Capabilities

Certain strategic acquirers may want to purchase a firm to build a broader corporate capability or enter a new line of business. These buyers are usually in a related business and want to "buy instead of build." They may use cash flow as a buying method, but could put a relative premium on a valuation if your unique strength is valuable enough. This type of buyer often exclusively seek out top-tier RIAs that have scale, unique capabilities, and exceptional human capital.

Examples of some unique capabilities include:

- A sophisticated in-house research team
- A tax consulting desk that can perform work for ultra-high-net-worth clients
- A dedicated financial planning team, or other expertise such as trust services, that helps advisors gain scale

Potential impact on valuation: Buyers seeking specific capabilities are usually very selective and occasionally pay a premium, but probably won't apply much in terms of discounts either.

4 Geographic footprint

A buyer may consider a firm simply to enter a new market and leverage the firm's network and existing clients. This is another "buy versus build" strategy and can be an attractive point of entry for a buyer.

Potential impact on valuation: "If your location is ideal for whatever the buyer's 'concept' is, you may command a premium," says Marty Bicknell of Mariner Holdings.

Bicknell shares that there is also a hypothesis that location in the broadest terms can help drive firm value. For example, is a firm in southern California more valuable than a firm in the rural Midwest? Perhaps, but there are plenty of "successful firms" in small markets.

"Buyers want to understand the long-term growth prospects of a local market," according to Bicknell. "Locations with money centers essentially have that built-in, broadly addressable market."

When it comes to valuation, you may want to think about the reasons a buyer may be attracted to a firm and the subsequent implications for the "sale planning" process: the multi-year process to improve the value of a business in preparation to sell.

3 Understanding the range of valuation drivers

In an industry that includes more sophisticated buyers, and an increasing number of potential sellers resulting from an aging advisor population, you may want to become a savvier seller to make any deal work for you. That means knowing what specific attributes attract buyers and understanding how to work toward calculating a firm's value. Learn how to think like a buyer in order to take steps to help maximize your firm's value.

> "Growth rates are unpredictable in the RIA space, and discount rates are widely debatable. One essential thing you can do is understand what drives growth and risk, and then seek to maximize the former and minimize the latter."
>
> —Peter Raimondi, BP Wealth Management (formerly Banyan Partners)

Begin by trying to understand what's important to a potential buyer

When it comes to sale planning, if your goal is to maximize your firm's value in a sale or merger with another firm, our industry contributors say that most consultants, investment bankers, and transaction advisors will tell you to "think like a buyer."

That may mean understanding what your ideal buyer is looking for in order to improve your firm's potential value in their eyes. Gaining this understanding takes time and effort.

Hypothetical illustration: Ongoing due diligence to gain valuation intelligence

RIA Firm A is interested in selling at a future date and is seeking market intelligence to improve sale value. They believe a strategic or financial buyer would have a particularly strong interest.

Prudently, Firm A has made "managing firm equity" one of its main strategic planning objectives. Further, the firm owners proactively reach out to various strategic and financial buyers to understand what an ideal buyer might want. This outreach is yielding invaluable information they can use in important ways, such as:

- Making connections and building relationships
- Determining criteria future buyers may use to evaluate their firm
- Establishing metrics in their strategic plan to measure how well they are maximizing firm value

This thoughtful planning and ongoing effort may help the firm maximize their negotiating position when the time comes for a sale.

As mentioned earlier in Section 2: Myths and realities of valuation, using rules of thumb to value a firm may not always be the best approach. It may lead to increased expectations in terms of valuation and may hinder a buyer or seller from moving forward with a transaction, even if the price and terms are relatively attractive.

As Matthew Brinker of United Capital Financial Advisers cautions, "Firm owners must remember that valuation is directly related to the predictability of future revenue and cash flows, as well as the risk associated with those cash flows growing over time."

So is valuation simply an economic exercise related to revenue, growth rate, and the discount rate? Unfortunately, it may not be quite that simple. In fact, as shown on the next page, a range of drivers can play a role in firm valuation.

Understand the impact of valuation drivers

The valuation drivers covered in this resource are grouped into eight categories, presented in the table below. They are based on insights provided by our industry contributors. For purposes of this resource, some of these drivers are classified as "fundamental," meaning they may be important to all buyers. Others, which are labeled "variable," may influence firm valuation depending on the transaction type. These drivers are explained in the following pages, and Section 4 of this resource presents how our industry contributors believe the variable drivers may influence valuation based on transaction type. However, please keep in mind that you will always have to conduct your own analysis, review, and due diligence based on your own specific situation, and this information is not intended to be exhaustive.

Valuation drivers identified by our industry contributors

1 Firm size

Our industry contributors believe that the relative size of a firm is the number-one driver of value. Why? "Usually there is a direct correlation between the overall size of a firm's business and its capability for delivering wealth management with scale and without high people dependencies," says Brinker. He further explains that larger firms tend to have larger staffs and therefore more in-house human capital. Larger firms, in general, also have more clients and diversified client pools, which can help drive revenue and may in many instances lower certain risks to revenues if a client departs.

If managed well, larger firms can have the greatest opportunity to achieve operating leverage and scale. As firms grow capacity, they may invest resources to achieve greater size, which can potentially dampen profits in the short term. However, those that continue to grow in size (and achieve scale) will likely leverage their investment and deliver services to multiple new client relationships without additional fixed costs.

2 Revenue

- Growth. Almost as important as size is future growth potential. An easy trap for RIAs to fall into is extrapolating past growth rates as a proxy for future growth projections. While historical growth rates remain a critical measurement of success, our industry contributors feel that many buyers are seeking to purchase firms that have a transparent growth engine. Such firms are usually highly coveted and may have multiple suitors. Our industry contributors share the following forms a firm's growth engine can take:

  - People (rainmakers)
  - Processes (marketing acumen)
  - Capabilities (ability to increase revenue with new services)
  - Brand (recognition in a local market)

  According to our industry contributors, well-educated buyers and leading appraisal companies look at "net new" revenue growth, generally defined as net client asset deposits less withdrawals. Still, of course, overall market performance can have a very strong effect on revenue growth or losses.

  Common tactics to potentially grow revenue and ultimately help improve firm value include:

  - Pricing remediation or the ability to grow revenue through additional services
  - Expanding relationships with existing clients by managing more of their money
  - Liquidity events among existing clients (e.g., a small business owner sells his or her business)

- **Fee revenue versus commission revenue.** Many in the industry have broadly accepted that fee-based revenue is more valuable than commission-based revenue. This is a view shared by many simply because fees are recurring, while commission revenue must be earned year in and year out.

  The valuation premium for fee business may be significant. But should a firm eliminate commission revenue to maximize value? The answer is probably not, according to Geoffrey Frazier, Global Financial Private Capital.

  "Commission-based revenue could help diversify a firm's overall revenue mix," says Frazier. "It is a sound business practice to look at the value of the two revenue streams differently, realizing that one is more valued than the other."

- **Revenue diversification.** If you're a fee-only firm, should you consider charging for different services or expanding into additional business lines? The answer may depend on a firm's capability and long-term business plan.

  For example, a firm may provide services to retirement plans, or provide in-house tax consulting for larger clients and charge an annual, separate flat fee for this service. When markets go up or down, the price should remain consistent, outside of requests for incremental services or any cost-of-living increases. In this situation, it may make sense to charge separately for these services.

3 Organization

- **Quality of your team.** Because investors pay a firm for the quality of its advice, an important driver of value is a firm's people—especially those in client service and sales roles. Human capital is often perceived as one of the main drivers to retain and attract new revenue sources.

- **Culture.** Culture can connect a firm's clients, employees, owners, processes, and brand. A firm's culture can be more important than any quantitative measurement of value. Our industry contributors noted that they had seen many types of transactions, including mergers or acquisitions, fail due to culture.

  Because it can take years to find a good match, culture can be a pivotal valuation driver for owners seeking to sell their firm to an external buyer.

> "When transactions are completed without a cultural match, it is usually a recipe for disaster. There have been several high-profile independent entities that were sold to a large acquirer only to be spun off or repurchased by management because of a lack of cultural symmetry."
>
> —Bruce Cameron, Berkshire Capital

4 Leadership

Strong management teams provide the business acumen to build a strategic vision as well as effectively run firm operations. At the same time, a strong team should play a role in growing revenue. Larger firms may consider growing internal employees to help with management or looking for outside talent.

Strong management (along with some of the additional items in this section) may be particularly important for internal buyers considering "buying in." Internal buyers look at a firm's current management team to assess the firm's past financial performance and understand their long-term stability and willingness to grow.

5 Investment management and other capabilities

RIAs often have a very deep competency in managing client investment portfolios or delivering additional capabilities to round out an overall wealth management offering. All of these capabilities are critical for an independent firm to run, but a potential external buyer may not value them in a proposed transaction. Firms that have made material efforts in developing these competencies should find solace in the fact that those efforts helped their firm reach its current position.

6 Client experience/team structure

As firms grow and mature, their abilities to gain scale and operating leverage from their business models may depend on their ability to develop a compelling organizational structure that increases value to customers and removes the client dependency on an individual advisor.

For many advisors, the idea of separating themselves from the client relationship and making their clients less dependent on them is counterintuitive, but it may be crucial for creating business value.

"Firms of all shapes and sizes can take steps to formalize how they manage client relationships," says Joe Duran of United Capital Financial Advisers, "whether it's through the creation of functional teams, adding a junior advisor, having a client associate or service representative play a more meaningful role in the relationship, or adding an outsourced partner."

> "If the client relationship is completely linked to an individual, the business is far less transferable, since that advisor is involved in any proposed transaction."
>
> —Rush Benton, CapTrust Advisors

7 Cost structure and scale

Our industry contributors believe this is a key to understanding valuation in any proposed external transaction. External buyers almost universally create their valuation models based on what a firm looks like post-acquisition, not necessarily on the economics in the firm's current state. How does this happen? According to David DeVoe of Devoe & Company, "The buyer assumes the firm will adopt their cost structure and seeks to understand what value can be achieved if a transaction is closed."

He further explains that these types of buyers will make bids for firms at their valuation rate, without giving much consideration to your valuation model.

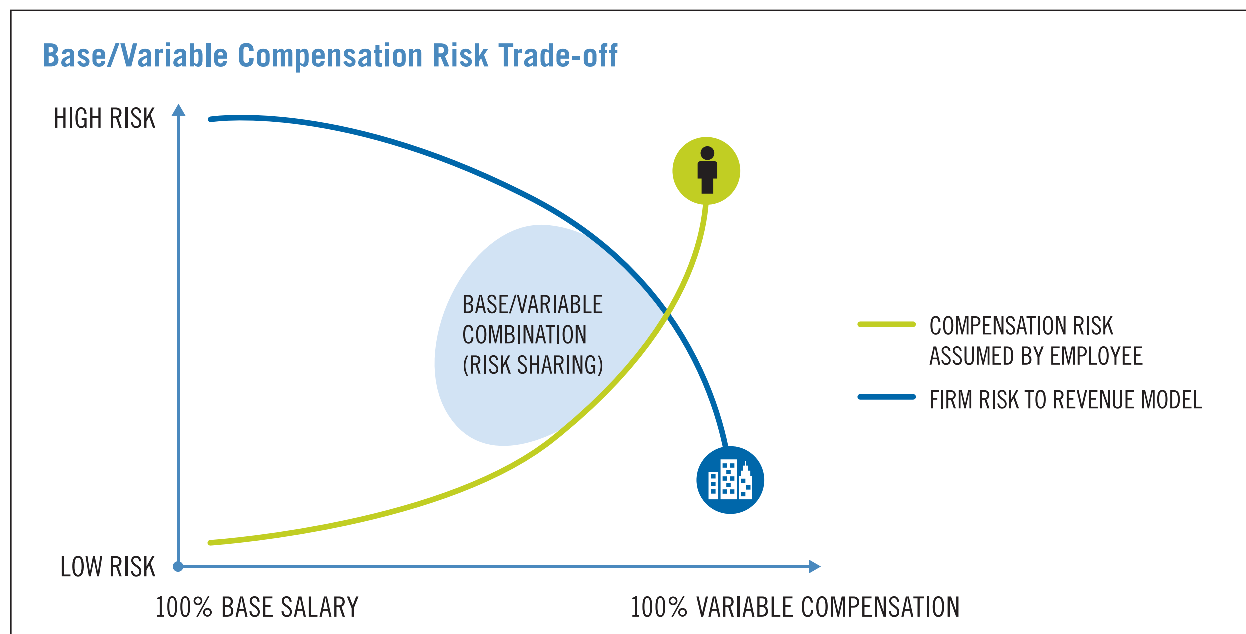
Savvy sellers may work to understand this. It's likely that they will press a potential buyer to share their valuation model and see if any accretive value can be gained through a transaction. If there is increased value, a question becomes who should retain that value.

Cost structure can also be critical with internal transactions. Internal buyers want to know the current cost structure, but may also seek a level of certainty about what the structure will be in the future so they can better predict the firm's cash flow.

- A compensation system, when viewed purely as an expense, is often perceived as the single largest driver of cost within a firm. Yet, outside of client pricing, the compensation system may be the single largest driver of value an RIA can control. It not only drives profit, but can be a lever to attract human capital, which drives value.

If compensation is so important, do certain types of compensation systems drive business value more than others? According to Peter Raimondi of BP Wealth Management (formerly Banyan Partners), "In general, firms that offer an equity award system will receive a relative premium because there is a positive correlation with client retention. Typically, higher levels of employee retention can help drive client retention, which in turn reduces risk to disrupting the revenue model in place. All of this can be accretive to firm value."

To pay professionals for their work, firms usually adopt a compensation system that includes a salary, plus some type of variable component linked to incentives. While there are no right or wrong answers regarding compensation, a key is to link the plan you put into place with your firm's overall long-term objectives that also shares risk.

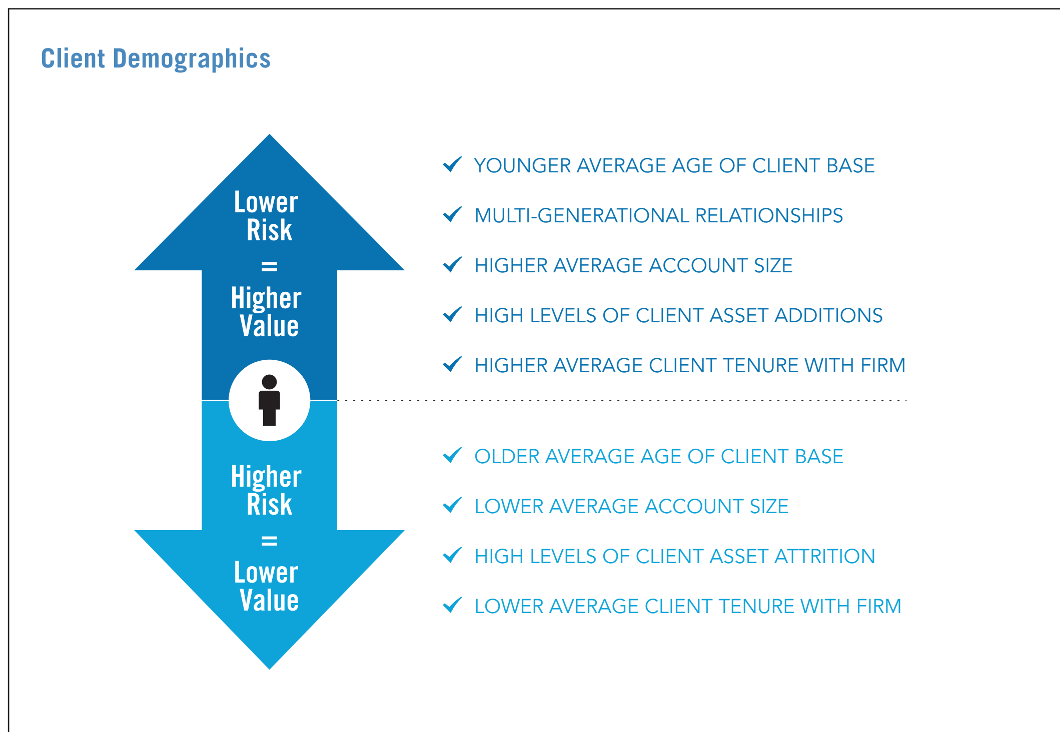


Source: Advisor Growth Strategies, November 2014

8 Client demographics

Client demographics can be an important indicator of future value. Information regarding clients informs the stability of a firm's revenue, a firm's ability to grow revenue, client loyalty, and how client accounts may grow or depreciate over time. Client demographics can contribute to or detract from firm value.

Some market participants may weight client demographics more heavily than others. Certain buyers have detailed and evolved models to predict how client accounts may grow or shrink over time based on assumptions driven by client demographics. Be prepared to share certain client data; however, consult with your counsel about putting non-disclosure agreements in place and other legal or compliance considerations before sharing any client data with a third party. Having aggregate client data organized and ready to deliver can be an indication of sound business management.



Source: Advisor Growth Strategies, November 2014

To maximize the potential value of your firm, you may wish to understand:

- How each of the above discussed drivers can affect your firm
- Your relative performance on each driver compared to other firms

Some of the ways you may wish to consider comparing your firm to others include leveraging industry benchmark, speaking to an industry expert with valuation experience, and obtaining an unbiased appraisal.

Case study 1: Selling to internal buyers

The following case study example, provided by DeVoe & Company, is intended to demonstrate how two principals came to financial terms for valuing the sale of a minority stake of the firm to two employees who would become junior partners. The information contained in this case study is hypothetical in nature and does not reflect data for a particular situation or any potential transaction.

About Grant Street Advisors

The two principals at Grant Street Advisors are in their early 60s and realize that they can no longer delay addressing succession issues, despite wanting to work in some capacity for another 10 years. In exploring their options, they decide that two current employees who have been with the firm for close to seven years are the right individuals to continue their legacy after they retire. Therefore, they decide to offer to sell 20% of the company to these two individuals and promote them to junior partners of the firm.

Grant Street Advisors Income Statement:

		2014
TOTAL COMPANY AUM		$258,463,573
TOTAL REVENUE		$1,997,781
DIRECT EXPENSES		$783,139
	% Revenue	*39.2%*
GROSS PROFIT		$1,214,642
	Gross Margin	*60.8%*
TOTAL INDIRECT EXPENSES		$716,316
	% of Revenue	*35.9%*
EBITDA		$498,326
	Margin	*24.9%*

Hypothetical example

Exploring the opportunity

For the future junior partners, the opportunity was a good one. However, they knew they needed to create a plan for long-term growth—and get a better understanding of the value of the company. As part of their analysis, they considered the following value drivers:

- Company growth (+): They realize the growth must occur for this investment to yield an appropriate return. The company's benchmarking report shows that the firm has been growing at a rate faster than its peer group, which is reinforced by their knowledge of the growth processes in place.
- Cost structure, particularly profitability (+): The company's solid margins and historical expense management are an important decision driver.
- Client demographics (–): The average age of the client is concerning to the buyers, as it is approaching 70 years old. They would like to see a more targeted strategy to make stronger inroads with the local technology firms.
- Leadership, particularly influence/control (–): As minority shareholders, the buyers are concerned about the influence they can have on the company.

The current owners valued the firm at $3.6 million, which felt like a seemingly high price to the future junior partners. In coming up with this value, the owners had placed a very high importance on the rationale that the margins would expand dramatically as they exit.

Conclusion: Getting to a deal

Recognizing that they wanted to sell a portion of the firm to the next generation already resident in their firm, the owners decided to make the deal more attractive. They did this by offering a 25% "minority discount" and negotiating attractive terms for internal financing for a 20% stake in the company for the future new junior partners.

Economics of the deal structure and amortization table

GRANT STREET ADVISORS DEAL STRUCTURE	
Company Valuation	$3,600,000
Stake to Be Acquired	20%
Valuation of Transacted Shares	$720,000
Discount	25%
Adjusted Valuation of Transacted Shares	$540,000
DEAL STRUCTURE	
Value of Shares Sold	$540,000
Down Payment	25%
Down Payment Amount	$135,000
Promissory Amount	$405,000
Interest Rate	5%
Term (in years)	5

BUYERS' PAYMENTS AND ECONOMICS	2015	2016	2017	2018	2019
Down Payment	$(135,000)				
Loan Amortization	$(93,545)	$(93,545)	$(93,545)	$(93,545)	$(93,545)
ANNUAL AMORTIZATION SUMMARY					
TOTAL BOY BALANCE	**$405,000**	**$331,705**	**$254,746**	**$173,938**	**$89,090**
Total Amortization	$(93,545)	$(93,545)	$(93,545)	$(93,545)	$(93,545)
Total Interest Payment	*$(20,250)*	*$(16,585)*	*$(12,737)*	*$(8,697)*	*$(4,455)*
Total Principal Payment	*$(73,295)*	*$(76,960)*	*$(80,808)*	*$(84,848)*	*$(89,090)*
TOTAL EOY BALANCE	**$331,705**	**$254,746**	**$173,938**	**$89,090**	**$0**

Source: DeVoe & Company, November 2014. The data and the information contained herein is hypothetical in nature and does not reflect data for a particular situation or any potential transaction.

Case study 2: Selling to external buyers

The following case study example, provided by DeVoe & Company, is intended to demonstrate how two potential buyers place two different values on the same acquisition candidate based on their unique needs and what they seek to achieve from a deal. The information contained in this case study is hypothetical in nature and does not reflect data for a particular situation or any potential transaction.

About the seller: Bancroft Advisors

The three principals at Bancroft Advisors are in final negotiations with two external buyers to sell the company.

The company has experienced above-average growth during the last several years, partly due to aggressive business development efforts of the firm's founder, and has an attractive ultra-high-net-worth client base. The three principals of the firm pride themselves on the comprehensive wealth management platform they have created. Financial planning is a core competency of the organization and they hired a full-time estate planner several years ago. The three partners share management responsibilities, but spend the bulk of their time managing relationships.

The company's founder and major shareholder, Jon, is 66 years old and has mixed feelings about retirement. He believes the company is in good hands and can run well without him, but enjoys the work and believes he adds value. He intends to sell his full 80% stake at the time of sale. As long as he is paid fairly, he is willing to work for another four to five years, or simply exit as soon as his clients are transitioned.

Bancroft Advisors Income Statement:

		2014
TOTAL COMPANY AUM		$364,322,421
TOTAL REVENUE		$2,730,063
DIRECT EXPENSES		$1,384,105
	% Revenue	*50.7%*
GROSS PROFIT		$1,345,958
	Gross Margin	*49.3%*
TOTAL INDIRECT EXPENSES		$960,891
EBITDA		$385,067
	Margin	*14.1%*

Hypothetical example

He has considered a deal structure within the context of his retirement goals and has clearly stated that any deal will require a $700K down payment up front, and is willing to finance the remainder over five years at a reasonable interest rate.

Potential Buyer 1: Zachary Investment Management, a $500 million money manager, is a five-minute drive from Bancroft Advisors. Zachary's principals see Bancroft as a strategic acquisition: the transaction would enable Zachary to accelerate their plans to expand beyond money management and offer comprehensive wealth management services.

The key value drivers for Zachary include:

- **Capabilities, particularly service expansion (+):** Bancroft would enable Zachary to offer financial planning and estate planning services.
- **Revenue, particularly growth prospects and pricing power (+):** While Zachary seeks to harness and learn from Bancroft's marketing expertise, especially as they re-brand their firm as a "wealth manager," they also see increased revenues from cross-selling the financial planning and estate planning services to their clients. As a result, they believe they will now have greater conviction to stop discounting their fees and also have greater success in their overall marketing.
- **Organization, particularly additional relationship management capacity (+):** Given their growth expectations, Zachary wants to maintain relationship management capacity. As they are running close to full utilization of their relationship managers/advisors (they currently have an average of 71 clients per advisor, just shy of their target of 75), they would request that Jon stay on for four (or more) years. In three years they plan to hire a new advisor to take over Jon's clients and provide additional capacity to the current advisors' base. They are pleased that they won't need to have that increased headcount for several years.

Based on their calculations, they determine Bancroft is worth $2.1 million. They are willing to pay a premium of $200,000, if needed, to accelerate their transition to "wealth management." They ultimately decide to offer $2.2 million under the terms that Jon requested.

Potential buyer #2: Golden Bear Capital Management is a $2 billion advisor located six blocks from Bancroft Advisors. The organization prides itself on running an efficient firm. As such, the following valuation drivers played a meaningful role in their valuation of Bancroft:

- **Organization, particularly high alignment of business models and culture (+):** The value propositions of the two firms are very similar. Like Bancroft, Golden Bear also provides both estate and financial planning services to their clients. The personalities of the firms are a great fit, too.
- **Client demographics, particularly larger clients (+):** Bancroft's average client is $5.2 million, versus their average of $3.4 million. Bancroft's lift in average age and track record of selling successfully to larger clients are perceived as a valuable asset.
- **Cost structure, which may result in margin expansion (+):** The company believes at least three cost reduction opportunities exist, which would make the deal accretive on an accelerated basis:
  - Cost Reduction 1: Golden Bear has determined that they could eliminate the employee who oversees estate planning, since they have an underleveraged resource in house. This could yield a $175,000 savings starting in Year 1.
  - Cost Reduction 2: They also see an opportunity to eliminate or reallocate an administrative/operations employee in Years 2 or 3, which could yield $60,000 in savings a few years out.
  - Cost Reduction 3: Golden Bear has determined that they could migrate Jon's 45 clients amongst their team of six advisors without compromising the client experience. They would like Jon to stay on board for 18 months through a transition period, after which his $250,000 compensation would drop to the bottom line.
- **Revenue growth rate (–):** Golden Bear appreciates Bancroft's growth rate, but doesn't consider it a key asset of the firm. They believe Jon is the primary rainmaker and his planned exit from the firm consequently discounts their growth potential. They contemplate offering him a role where he will be compensated for bringing in new clients, as an ancillary component of the deal.

Golden Bear has developed a discounted cash flow model that enables them to understand the impact of the cost reductions in each respective year. They calculate that the firm is worth $3.45MM, once it is combined with their organization. However, they believe much of this value is essentially created by the power and scalability of their firm and the seller shouldn't necessarily benefit from this. So, they decide to make a "generous offer" of $2.6MM with the terms that the seller requested.

POTENTIAL SALE OF BANCROFT ADVISORS		
	VALUATION	OFFER
Potential Buyer #1: Zachary Investment Management	$2.1 million	$2.2 million
Potential buyer #2: Golden Bear Capital Management	$3.45 million	$2.6 million
Difference	$1.35 million	$400,000

Conclusion: Making a choice

With two firms making vastly different offers for Bancroft based on their own valuations, the seller reviewed the pros and cons and specific deal terms from each and made a decision to sell to Zachary Investment Management. While price played a role in their choice, Bancroft felt that the high alignment of business models and culture was critical to helping ensure the long-term success of the combined entity.

Source: DeVoe & Company, November 2014.

4 How transaction types may influence firm valuation

Beauty, as they say, is in the eye of the beholder. Buyers often view valuation attributes differently, resulting in varied opinions on a firm's value. To help you maximize your potential sale price, our industry contributors provide additional insights to help you understand which of the variable value drivers introduced in Section 3 can be important in specific types of transactions.

> "Internal transactions tend to be executed with a discount to fair market value (FMV) and terms tend to be more friendly to the buyer than the owner."
>
> —Marty Bicknell, Mariner Holdings

The importance of valuation drivers based on transaction

Having read a summary of valuation drivers in the previous section, think through your ideal outcome for selling your firm. It's a crucial step in designing a framework that helps maximize a firm's potential value while also meeting your personal and professional goals.

The sales process is often the last, most important, stage in realizing those goals. By embarking on the process of understanding what's important to potential buyers both in terms of valuations and transactions, you can work toward shaping a better strategic plan for you and your firm.

The following table, provided by Advisor Growth Strategies, offers a summary of how certain hypothetical transaction types may impact valuation. While the fundamental valuation drivers play an important role in all transactions, our industry contributors show how the buyer in each type of transaction is different and will likely place varying levels of importance on the variable valuation drivers introduced in Section 3. As mentioned earlier, please keep in mind that you will always have to conduct your own analysis, review, and due diligence based on your own specific situation, and this information about certain valuation drivers is not intended to be exhaustive.

HYPOTHETICAL TRANSACTION TYPE	VARIABLE DRIVERS TO CONSIDER THAT MAY IMPACT FIRM VALUATION
Internal succession A structured plan to transition from existing majority shareholders to another non-owner or minority shareholder over time. **Internal buy-in or earn-in program** Opportunity for non-owners or majority owners to purchase equity or "earn-in" equity of a firm based on certain triggers that are usually linked to growing revenue.	• Leadership • Client experience/team structure • Cost structure and scale • Compensation system
Business combination with another independent Two firms make a strategic decision to join forces to create scale, drive leverage, or share capabilities. This can be a cashless transaction or include liquidity provisions for certain owners.	All variable drivers identified in Section 3
Sale to a large financial institution (e.g., bank) Firm decides to sell to an institution that is seeking a strategic capability or desires to grow a business line. Consideration can be cash or equity and owners usually need to stay with the buyer for a period of time.	• Investment management and other capabilities • Client experience/team structure • Cost structure and scale • Compensation system • Client demographics
Sale to a strategic acquirer Firm wants to sell to a purpose-driven firm that wants economic or strategic participation in the capability of the independent firm.	• All drivers if selling to a financial buyer • Wide disparity among remaining strategic buyers
Sale to existing RIA with an exit plan Firm makes a decision to sell to an existing independent entity. However, instead of a combination, the firm is sold and the owners have a predetermined existing plan that has a short duration.	• Investment management and other capabilities • Client experience/team structure • Client demographics

Source: Advisor Growth Strategies, November 2014.

5 Insights to consider

You may want to consider the action steps our industry contributors provide in the following pages. A deliberate process through each step may help you mitigate some of the challenges of selling your firm.

Five actions RIAs may want to consider

Commit to sale planning

Focus on client demographics

Nurture your growth engine

Hook in your top talent

Assign a dedicated resource to lead business management

1 Commit to sale planning

You can potentially set your firm apart from competitors by focusing on ways to improve your firm's value and marketability during your annual strategic planning process. "By definition, 'sale planning' is strategic in nature," says Bruce Cameron of Berkshire Capital. In all likelihood, your strategic planning process already takes into consideration several of the key tasks that Cameron identifies below:

- Think about sale planning at least five years before an eventual sale. Many RIAs have five-year or 10-year strategic plans, and many plan to exit their firms during that window. Nevertheless, numerous firms don't include sale valuation and optimization in their strategic planning processes. Be sure to consider sale planning as a regular, strategic event at least five years prior to your exit.
- Determine key performance indicators (KPIs) for managing the fundamentals of your business. This paper has explored some of the top drivers of value. Set goals and manage your firm to those goals.
- Develop work flows to improve your firm's sales value. This paper has provided examples of what can drive business value for RIAs. Determining areas that require improvement takes time. Implementing your changes may take years.
- Have a third party perform an appraisal at your next "trigger event." You can gain meaningful insights from an outside opinion on your firm's business value. Some firms seek an appraisal out of curiosity, and many choose to do so and should do so when a change in ownership (buy/sell event) occurs. Most third-party appraisers write an opinion letter that provides an independent perspective on the value drivers within a firm.

"Annual benchmarking can provide RIAs with a powerful means to set goals using Key Performance Indicators and monitor results over time."

—Waldemar Kohl, Vice President, Fidelity Practice Management & Consulting

2 Focus on client demographics

Client demographics can make a significant impact on a firm's value. For example, if a demographic assessment reveals that most of your clients are older than your ideal client, you may want to consider developing a strategy to build relationships with the children and other young family members of these clients, who may be inheriting assets.

You may want to consider creating a system to diagnose the strength of your client demographics and identify opportunities for improvement. Industry benchmarks or third-party consultants can also help in these efforts. As part of your strategy, you may want to establish a set of client demographic goals and a timetable for reaching them.

Once you better understand your client base, you can then take appropriate actions to make changes to help improve the value of your firm.

3 Nurture your growth engine

"The savviest buyers want a proven system, otherwise known as a growth engine," says Steven Levitt of Park Sutton Advisors.

According to Levitt, for most firms, a growth engine is related to the sales acumen of an owner or group of professionals. Other types of growth engines might be a niche strategy (e.g., focusing on planning for medical professionals) or a strategic relationship with an adjacent professional organization or center of influence (e.g., a law firm).

To help maximize the potential value of your firm, identify your organization's growth engine and work to strengthen it over time.

4 Hook in your top talent

It's top talent, in many cases, that may ultimately retain and attract client revenue. Implementing a compelling strategy to attract and retain top talent may help maximize your firm's value.

"In any transaction, a firm's top talent will almost certainly need to be part of the deal," says Marty Bicknell of Mariner Holdings. "Buyers will want to retain that talent for a period of time. So, building a system that provides for growth opportunities, including equity ownership, is extremely advantageous."

Bicknell offers the following considerations for retaining talent:

- Provide employees with opportunities to buy firm equity at a discount to fair market value (FMV). Many firms offer an equity discount of up to 50% and may also provide seller financing.
- Create a compensation system that links compensation growth to personal contribution and firm growth.
- Implement employment contracts that clearly outline roles and responsibilities as well as include restrictive covenants to protect the firm.

5 Assign a dedicated resource to lead business management

To work toward maximizing value, consider assigning a dedicated resource to the task of business management. This individual typically oversees three areas:

1. Strategic planning
2. Sale planning within or outside of the annual strategic planning process
3. Profit and loss of the firm

This professional may also take an active role in managing firm operations and can be designated the chief executive officer or chief operating officer of the firm. A formal, professional approach to business management can not only improve your bottom line, assigning a leadership-level resource to improving business efficiency, it can also signal to the market that a firm has prudent operating principles in place. To a prospective buyer, your firm may seem easier to evaluate, take ownership of, and even incorporate into the processes of a larger organization.

Sample Fidelity resources

We hope this inside look at many of the considerations for valuing your firm has provided you with ideas to leverage as you develop long-range plans for your firm. As you move forward, you may wish to use the sample Fidelity resources described on the next page. We hope you find these resources useful as you continue your efforts to maximize the potential value of your organization. As always, we invite you to contact your Fidelity Relationship Manager to learn more about these Fidelity resources.

Sample Fidelity resources

Realizing the Value in Your Firm: Succession Planning Toolkit

Comprehensive tools and solutions to help you determine your succession strategy.

Fidelity Succession Evaluator℠

An online tool designed to help advisors choose a transition path suited to their needs.

Developing a Plan to Transition Your Business to an Internal Successor

A planning guide that addresses the key considerations for firm owners seeking to pursue an internal succession.

Realizing the Power of Two: The Art and Science of a Successful Merger

A *Profiles of a Deal* white paper sharing case study examples and best practices of investment advisors who completed a merger.

Buyout Benefits: When an Offer is Too Good to Pass Up

A *Profiles of a Deal* white paper sharing case study examples and best practices of two wealth management firms undergoing an acquisition.

Exiting on Your Terms: How Team Building Can Lead to Sound Succession Planning

A *Profiles of a Deal* white paper sharing case study examples and best practices of two firms that embarked on an internal succession.

Expanding Your Practice—Are you Ready?

A mergers and acquisitions guide.

Your Guide to Expansion

A toolkit to help you prepare for growing your business through a merger, acquisition, or by adding an individual or team of advisors.

RIA Match

A third-party Web site that matches financial advisors with other financial advisors who want to buy, sell, merge, or join practices. The advisors can search for free and pay to connect anonymously and securely at www.riamatch.com.

Fidelity's Benchmarking Program

By participating in Fidelity's annual Benchmarking Study, you may gain new insights into your business and learn how your firm compares to its peers.

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