ADVISOR GROWTH STRATEGIES

Accelerating Business Excellence

Maximizing Independence:

Valuation Myths and Realities

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Executive Summary: Key Highlights

The wealth management M&A market continues to evolve rapidly, and it's important for advisors to know how they can take advantage of M&A trends, while not falling victim to the common myths and traps of book valuations.

Importantly, advisors should note that how they choose to affiliate with an RIA, broker-dealer, or any wealth management firm does not drastically impact business valuations. For example, those considering starting their own independent RIA may want to reconsider if a major reason is to increase the valuation of their business. A thorough study of recent transactions shows no meaningful valuation differences between sellers who own an independent RIA and those who are on their firm's Corporate RIA. This is one of several myths that Advisor Growth Strategies ("AGS") dispels ahead.

Another, is the myth that advisors should invest in and run their own compliance programs. In reality, most firms are better off relying on their RIA, broker-dealer, or wealth management firm's expertly managed programs. Other perceived valuation drivers that are dispelled include branding, technology, investment thesis, and operational process.

So what are the largest factors in determining a firm's value? According to research conducted by AGS, they are:

- **Profitability:** The firm's ability to drive profit margins.
- **Growth:** The firm's organic growth net of market performance. Net organic growth is the true test to see how the current infrastructure in place facilitates growth and drives scale.
- **Target Client Market:** The firm's geography and the market that is available for future growth opportunity. Does the firm have a unique niche to attract a client segment in the market?
- **Team:** Who is the next gen? How will the current governance and support structure create synergy in a transaction?

The bottom line: While understanding the M&A market is essential for advisors entering a transaction in the near future, it's also important that advisors at any stage of their business lifecycle leverage market intelligence to manage their enterprise value, participate in activities that generate value and opportunity, and build optionality for the future.

Introduction

Working to establish sustainable enterprise value is a critical element for the success of stakeholders in an independent financial advisory firm. The independent wealth management industry continues to evolve as more end investors seek fiduciary advice from objective advisors. Advisors outside of traditional brokerage firms have continued to gain market share in the wealth management industry by delivering a boutique and customizable approach.

2022 challenged financial advisors to evaluate existing infrastructure and efficiency. Historic interest rate increases, market volatility, and inflation created new challenges and heightened focus on core business management practices. 2022 also brought a record number of deals in the wealth management industry—229, up from 215 in 2021.

These economic influences put pressure on how independent advisors deliver a unique client experience, highlighting the importance of sustainable growth, talent acquisition and engagement, and service model expansion. The most successful independent advisors are building or partnering for efficiency and scale to maximize their competitive advantage. Done well, scale creates value for clients and owners. The motivations that propelled advisors to independence have evolved from operating autonomy and greater economics to building enterprise value, personal wealth, and a lasting improvement in a clients' experience.

The rapid change in the independent wealth space led Advisor Growth Strategies ("AGS") to re-examine the true drivers of value. This research was conducted to help independent advisors focus on the valuation metrics that matter and build the best practice possible. To accomplish this, AGS tested valuations across different business models to inform what is driving fair market value for independent advisors, and what is not. What follows is the most current breakdown of the robust marketplace for M&A within the wealth management space, valuation drivers and myths firms participating in the industry, and best practices for stakeholders seeking to manage their enterprise value.

Valuation Intelligence: What is driving the current M&A market?

While the wealth management industry has been historically dominated by large brokerage houses, typically attached to banks, in the past thirty years the industry has gone through a paradigm shift in terms of who delivers advice to end investors. The projected winners—independent advice. Cerulli Associates notes that independent models had a 38.8% share of advised wealth in 2021 and are projected to have 45.2% share by 2026[1]. The movement of advisors and investor households toward independence has led to increased attention from capital providers seeking to invest in an industry with favorable trends and a high upside for growth. Independence is highly flexible, advisors may choose to start an RIA with a separate ADV, or use a shared ADV with little impact to operational autonomy. Investment in the independent channel has significantly improved the Corporate RIA or shared ADV ecosystem, providing independent advisors with a leverage point to limit what activities advisors need to perform "in-house."

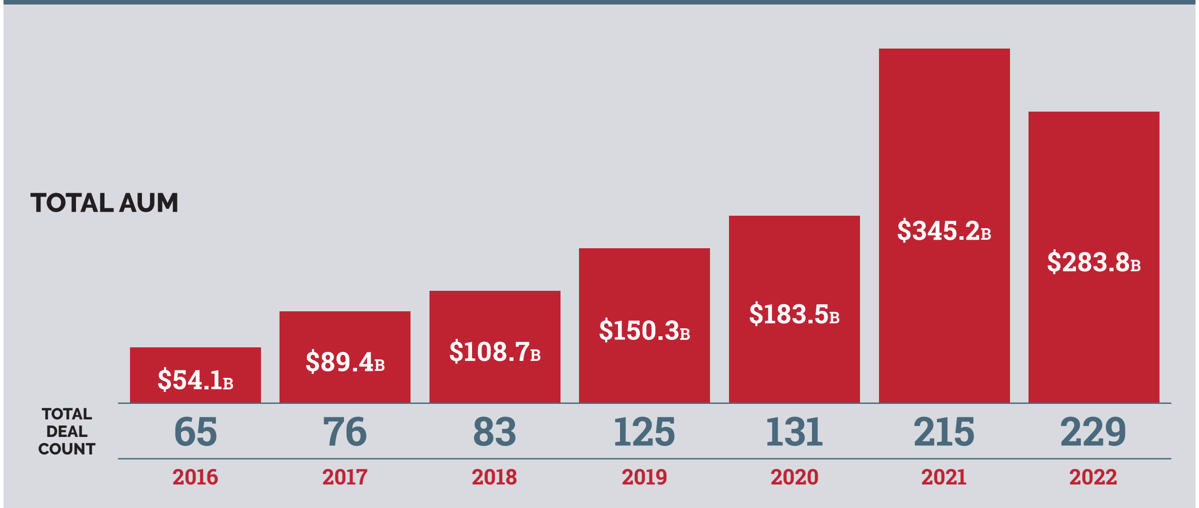
Strategic capital providers, including private equity and debt, banks, pensions, and family offices have made substantial wealth management investments. Between 2016 – 2021, capital providers have invested significant capital in wealth management firms leading to platforms that service in excess of $835.3B AUM[2] at the end of 2021. This investment trend has helped create a new competitive frontier of capable and scaled firms that challenges advisors to evolve their businesses and demonstrate added value to clients and prospects.

Professional management teams, substantial technology enhancements, process investments, and emerging marketing and sales tactics are all examples of trends enhanced by strategic capital partners with increased resources. Capital providers have also sought to invest in the support system around independent practices as evidenced by significant backing of advisory technology and advisor services businesses.

The attention from capital providers is also a catalyst for increased mergers and acquisitions (M&A) transactions in the independent space. Considering a deal is a viable possibility as advisors seek out more resources, access to services, and succession solutions. Outside capital has increased M&A demand, increasing reported transactions yearly since 2016[3]. This increased demand has also partially contributed to higher valuations over the last 3 – 5 years.[4] The trend has led to greater optionality for independent advisors with buyer types that include financial partners, partially integrated investors, and strategic buyers. The increase in buyer types has led to a more dynamic and diverse partner market with varying objectives.

1. Cerulli U.S. Intermediary Distribution Report, 2022.
2. Cerulli U.S. RIA Marketplace 2022 Report.
3. Fidelity Wealth Management Transaction Reports
4. Advisor Growth Strategies RIA Deal Room Reports

INCREASE IN BUYER TYPES 2016-2022



Financial Buyers: A small, but powerful, segment of the independent wealth management space is investors that invest equity capital and provide strategic support. These buyers typically buy a minority or small majority of a practice and tend to target larger independent firms ($1B+ AUM). Valuations can vary considerably based on a financial buyer's terms and participation.

Integrated Investors: Integrated investors differentiate their model by allowing for partial adoption of their platform and services while making a substantial investment in the RIA. This model has plenty of history as Corporate RIAs and participants from adjacent industries seek to have exposure to wealth management.

Strategic Buyers: The majority of transactions (>70% in a typical year) are completed by the strategic buyers. These firms are often fully integrated platforms that buy 100% of a practice. Strategic buyers also tend to pay the highest premium because they can drive accretive growth through integration. For the firms they buy, strategic buyers usually offer the opportunity to be an equity owner.

The majority of RIA firms (84%) manage less than $500M in AUM according to Cerulli Associates[5]. This large segment of independent firms are the emerging practices that comprise the majority of transactions each year and are the most likely to search for scale and succession solutions in the market. AGS constructed a valuation comparison between RIAs and independent practices leveraging a Corporate RIA affiliated with the same platform and found little difference in the average valuation since 2019, with Corporate RIA practices valued slightly higher than independent RIAs. This conclusion is important because it demonstrates that the factors influencing valuation are less about the practice's support structure, and more related to other core valuation drivers. This data comparison establishes that emerging independent advisory firms can realize high business valuation while leveraging the support structure that helps them operate optimally. Today's M&A market favors growth, efficiency, and talent over whether an independent firm does "everything in-house" or outsources certain functions to a platform provider.

5. Cerulli U.S. RIA Marketplace 2022 Report. Includes all RIAs and Hybrid RIAs managing less than $500M AUM.

COMPLETED TRANSACTIONS SHOW NO MEANINGFUL VALUATION DIFFERENCE DUE TO CORPORATE RIA OR OWN RIA STRUCTURE.

CORPORATE RIA SELLERS

Rev Multiple:
3.1x

EBITDA Multiple:
7.5x

INDEPENDENT RIA SELLERS

Rev Multiple:
2.9x

EBITDA Multiple:
7.2x

A Focus on the True Drivers of Value

As buyers evaluate potential firms they want to buy or partner with, they consider more than the headline metrics of AUM, gross revenue production, and client count. Two practices with similar metrics can have significantly different valuations due to differences in the true drivers of value. These factors fall into three main categories: financial, target market, and team.

ORGANIC GROWTH
PROFITABILITY
CLIENT DEMO

Financial: Financial factors are critical to valuation practices, and it is essential to isolate those with the greatest impact. The most significant driver in this category is organic growth. Organic growth (excluding market returns) counteracts client drawdown and market risk, while demonstrating a value proposition attractive to prospects. Buyers look for more than AUM aggregation and additionally focus on the potential to grow together post-transaction and realize increased returns. A practice that demonstrates organic growth is then measured on profitability. Profit margins are linked to pricing philosophy, expense management, productivity, and efficiency of the client service model. Buyers evaluate the historical financial success of a practice to understand the risk and opportunity. Organic growth and profit over the last three years will be either a positive or negative factor to the valuation of the practice.

GEOGRAPHY
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CAPABILITIES

Target Client Market: Buyers also consider factors beyond the pure financial metrics and evaluate the geographic location of the office and client base to understand growth potential and risk. Locations attractive to the buyer will be additive to valuation. Wealthy and growing locales provide opportunities for post-transaction growth and the long-term sustainability of the practice. Conversely, practices in declining markets, or in less attractive geographies, will decrease the relative valuation of the practice versus peers with similar metrics. Target client market factors also include the firm's unique capabilities that appeal to specific client segments or a niche. For example, firms specialized in working with dentists or families with special needs children have unique market positioning that would be attractive to a buyer. Market positioning increases valuation as it increases the opportunity for buyers to expand and grow with the addition of the target.

NEXT GEN
CAPACITY
BENCH STRENGTH

Team: Talent has become one of the most important valuation factors as buyers increasingly use M&A as a talent acquisition strategy. In the current tight labor market, acquiring a practice with talented next-generation professionals increases the value to the buyer. Practices made up of partner advisors and support staff only may leave succession as an open issue for the buyer to address post-transaction. Office management, the transition of the client relationships, and eventual partner exit require talented next-gen advisors—value for the seller is increased if they are already in place before the deal. The ownership structure also contributes to overall valuation of the practice. Governance, orderly financial participation, and partner roles create clarity for all parties, and demonstrate professionalism in the firm's operation. Team capabilities and structure can significantly enhance or limit value if the firm lacks structural clarity or non-partner professionals.

Each of these factors is exclusive of a practice's chosen support structure, demonstrating that the current valuation market favors factors that are difficult to scale. Firm culture, market positioning, client service model, and talent management strategy are all items in which buyer/seller similarities add synergy to a potential transaction, and drive valuation up.

Valuation Myths

There are many myths about valuation. Instead of focusing on the quantitative and qualitative factors that influence valuation, advisors can be lured into valuation traps that lead to unrealistic expectations or, at worst case, incorrect information that could result in poor business decision-making.

VALUE DRIVER MYTHS: ARES OF FOCUS WITH NO VALUATION IMPACT

- BRANDING
- TECHNOLOGY
- OPERATING INDEPENDENT RIA
- COMPLIANCE
- INVESTMENT THESIS
- OPERATIONAL PROCESS

Understanding valuation theory and its application in wealth management can be challenging depending on how close a participant is to quality data and transaction processes. The wide range of understanding and perspectives on valuation can lead to over- or under-emphasizing certain factors that are less important to valuation. As the industry has matured, factors have changed over time. For example, advisors once could increase valuation by building a unique investment process. However, today, being an "investment manager" often detracts from value. Most advisors can't scale investment processes and it is simply a more expensive way to run a smaller business, adding little value to clients.

Believing valuation myths can set the wrong expectations and lead to business owners making critical decisions in error. Common myths include:

Branding: It can be very easy for advisors to feel the branding/name recognition in a local market is critical to managing equity value. The current reality shows the opposite to be true. The buyer's brand prevails in most M&A transactions. Sellers adopt their partner's brand and, in most cases, client retention is north of 95%. Instead of focusing on the name of the firm and the positioning, advisors would be better served ensuring their clients know their team and the value proposition of working with that team, so clients become comfortable with any type of future transaction—internal or external.

Technology: Improving valuation by building sophisticated technology may improve value or have absolutely nothing to do with value. Smaller advisors often do not have the capital to build a custom/proprietary technology stack, so why would it make any sense to focus on building an "ideal tech stack"? Smaller advisors should focus on what is portable and drives efficiency versus building something that is unique for clients or delivers processes that are specialized for a firm.

Firms that have revenue models over $10M, and have a valid reason to develop technology, might be able to improve value if the goal is to keep the firm independent and the firm is solely looking for an investor or selling equity internally. This, of course, is only true if the technology drives incremental revenue or profit growth beyond what could be achieved without it. Without one of these dynamics, firms would be better leveraging technology from a platform or group of service providers.

Operating Independent RIA: Many advisors consider valuation when weighing the decision to utilize a Corporate RIA or operate their own RIA. AGS analyzed transactions conducted between comparable practices utilizing the same platform, 42 of which were Corporate RIA sellers, with the remaining 20 operating their own RIA, After analysis was complete, AGS found that while not meaningfully different, Corporate RIA practices achieved a higher sale valuation multiple than Independent RIAs (Corporate RIA average multiple was 3.1x revenue, 7.4x EBITDA. Independent RIA average was 2.9x revenue, 7.2x EBITDA); buyers will merge an acquired practice into their entity, and do not express a premium or discount for the RIA choice of the target.

Compliance: Developing compliance infrastructure helps maintain value, but certainly does little to drive value for most advisors. Large institutions such as custodians, broker/dealers, and other advisor support platforms with Corporate RIAs must have excellent compliance processes. However, advisors do not need to over-emphasize compliance. A buyer (internal or external) will not assign any premium if a firm passed an audit with flying colors or never had a regulatory complaint. Firm owners should simply be sure the compliance program is solid. Compliance can also detract from value because it is costly to hire people, build processes, and the cost of a misstep is high.

Smaller firms should consider an outsourced compliance program or adopt a platform. Why? It shifts the firm's focus away from a commodity (compliance management) and allows the firm to focus on the client side of the business which will hopefully drive future revenue and profit. Outsourcing shifts the administrative function of compliance and saves time, and a shared ADV structure saves time and shares risk. Either way, compliance is a necessary function versus a premium valuation attribute.

Investment Thesis: As stated earlier, managing investments is greatly overrated as it pertains to managing business equity. It is clear the wealth management industry is more focused on adding value through planning and wealth management versus investments. Of course, there is still "room" for investments to add to business valuation, but this is only the case if the advisory firm has a stated unique strength to add value over time. This can be showing a track record of alpha over time (very rare) or having a sleeve of investments uncorrelated to the markets – private placements.

It's hard for smaller advisors to differentiate and have an offering that a buyer would say is accretive. Advisors that overemphasize investments could be at a valuation disadvantage if a buyer expects a firm to adopt their way of doing business. For internal transactions, running investments can still be risky as the knowledge to run a portfolio is difficult to translate to next-gen contributors.

Operational Process: Building great internal processes is valuable as it can improve the client experience and increase profitability. Many advisors may feel that having fantastic processes actually increases value materially. However, this valuation lever is far less important than growth factors.

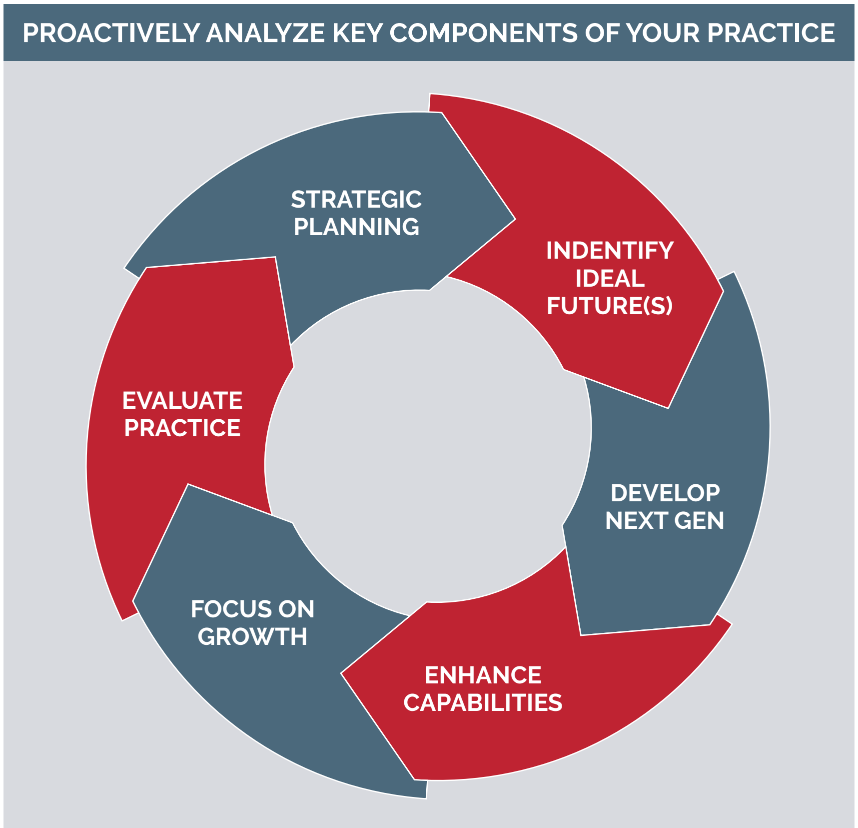
For example, let's say a buyer was offered two firms with $4M in revenue. One firm was growing at 20% and leveraged the processes of a platform, the other firm was growing at 5% but had fantastic internal processes that made it 10% more profitable than the other. Which firm is more valuable? Conceptually the faster-growing firm is more valuable because the growth outpaces the slower-growing firm over time (expectation for greater future profit). Now this example is not absolutely true, but is true in most cases.

The most important way to avoid being trapped by a valuation myth is for advisors to gain clarity around their firm's future. If the goal is to grow the business as fast as possible, then sell it, there is no reason to focus too much on technology, operational processes, and compliance. However, if the goal is to transition the business internally, then these areas are more important in order to earn the confidence of next-gen owners that the business is sustainable for the future.

Managing Business Equity

The factors that drive valuation often get associated with external (M&A) transactions, but those same factors are critical to the ongoing management of the practice. Independent practices have an opportunity to leverage the intelligence generated by the market to improve their overall business practices. Independent practices must leverage changing competitive dynamics to manage business equity to maximize internal and external options. The robust M&A market provides intelligence that will help business owners manage value and build options for the future.

The first step all owners should take is to get organized. Understand the business at a deeper level; financials, sources of growth, reasons for decline (client attrition, drawdown), and client demographics (age, size, tenure with practice). Whether a practice is considering the external market or is planning to remain independent, understanding the drivers of revenue, growth, and profitability allows for better decision-making, strategic planning, and optionality. Many practices don't go into this level of detail on their firm until they are considering a partnership in which the other entity is going "under the hood." Proactively analyzing your practice enables partners to manage their practices with an understanding of the strengths and opportunities.



The most important metric in today's valuation market is a practice's organic growth, net of market performance. This metric is not to be confused with overall growth and instead represents a practice's ability to add new client relationships and new assets from existing clients. The net new growth metric is also critical because it represents the infrastructure put into place by a practice that facilitates growth such as talented professionals and consistent processes. The net new growth metric also demonstrates a practice's ability to generate scale through internal and external partnerships. A focus on new client acquisition and winning wallet share from current clients will support the profitability and value of the practice; consistent net of market growth also insulates the practice from down markets, counteracting AUM decline, and enhances overall outcomes when the markets recover.

When considering future options for the practice, advisors should consider the ideal path for their clients, team, and themselves. This strategic planning exercise can uncover criteria for the optimal fit—remain independent or consider the wide range of buyers in the marketplace. Whether the practice plans to consider the M&A market or not, having an internal equity strategy supports the next iteration of the firm. Getting next-gen contributors involved in the ownership and operation of the firm is additive to sustainability and value, no matter the future path. Developing the human capital at the practice is a crucial component. Hiring talented team members expands the capacity and capabilities of the firm. In an external transaction, a talented team who know the clients is accretive to valuation. In an internal succession plan, where the team will be the ones taking on the practice and the relationships, developing them is imperative for the ongoing viability of the business.

Maximizing Value

Business owners have exciting opportunities ahead in the independent wealth management industry. Despite the new challenges, market changes, and economic pressures in the industry, independent financial advisors have an opportunity to capitalize on valuation fundamentals to improve long-term options and outcomes.

- **Understand the market:** Our research indicates that there is no significant difference between valuations for RIAs and Corporate RIA teams managing less than $500M AUM. This provides an extraordinary opportunity to focus on true value drivers.
- **Understand what drives valuation:** Growth, talent, and target client market are fundamentals that create premiums, or not. Focus on the aspects of the business that will drive the greatest outcomes and avoid valuation myths and traps.
- **Avoid valuation myths:** There are many fallacies such as operating model, compliance, technology, etc. that can lead to firms focusing on the wrong initiatives. Avoid these myths for clarity and precision.
- **Manage internal equity:** Engaging the next generation of talent and creating an incentive to drive value is critical in the years to come. Talent will play a significant role in valuation and business success—don't wait for someone else to solve this issue.

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