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# Understanding the Value of Your Business

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# Understanding the Value of Your Practice

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## Introduction

Practice valuation is the starting point for owners who want to effectively manage their equity and build a business of enduring and transferable value. Sellers, and prospective buyers, need to accurately assess the value of a financial services practice, understand what drives that value, and learn how it can be increased and improved–all in an unbiased manner.

The independent side of the industry has witnessed an evolution in valuation approaches, moving away from simple rule of thumb gross revenue and earnings multiples towards a more comprehensive approach that considers many of the complexities in valuing a privately held, independent, financial services practice.

With so much to consider, performing a professional valuation of your business can feel like a monumental task, but it does not need to be. A professional and thorough assessment of value should be supported by a comprehensive system designed to provide you an analysis and value that is tailored to your specific purpose. The first step is to establish a clear understanding of the valuation purpose and the intended use. This will inform many of the steps that follow. Secondly, the level of value needs to be established. This, along with the purpose will establish whether the book of business or profitability/rights or a combination of the two need to be considered.

From there, the appraiser can accurately determine which valuation approaches to use and the content that must be included in the report. Whether a market approach or an income approach is used, the business is analyzed on a broad range of key performance indicators, separated into three indexes: Market-Demand, Transition Risk, Cash Flow Quality. These key indicators are used to determine a value based on the unique risks and opportunities present in the subject practice.

## Purpose

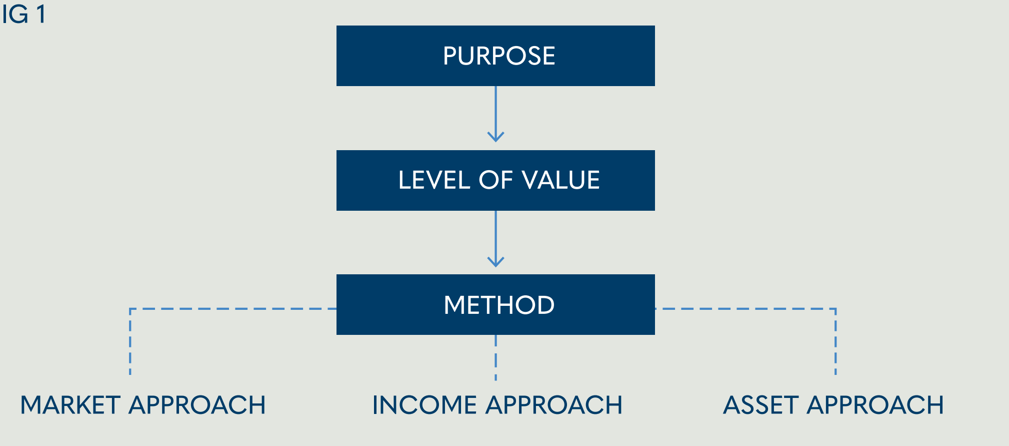
The need for a professional third-party's opinion of the value can be driven by various factors. The most common motivations are:

1. **General Knowledge** For strategic planning, performance monitoring, and continuity planning
2. **Reasonability Assessments** To determine whether an ask or offer price is reasonable
3. **Bank Loans** To assess the value of the collateral in order to securing a loan
4. **Tax Related Matters** For estate planning and charitable contributions
5. **Disputed Matters** For divorce, breach of contract, or partnership dissolutions

While the list above is not exhaustive, it covers the most common requests. What is important to understand is that each purpose above has unique factors that need to be considered to provide a value for that specific circumstance. In other words, there is not a single value solution that can be uniformly applied to all purposes.

Once the purpose has been identified, the type of sale needs to be determined. The type of sale can be broken into two categories: asset value or equity value.

FIG 1



**Asset values** represent the value of the practice on a debt free basis. Almost all transfers of a controlling interest from seller to buyer will be structured as an asset sale and the value should be presented as such. Asset values for financial service practices typically do not include the value of tangible assets as they are often minimal or not transferred. The value is based on the intangible assets–such as goodwill– which represent the majority–if not all–the value in most financial services businesses.

An **equity value** differs from an asset value in that it accounts for the practice's invested capital debt. Invested capital debt is debt that is incurred to support the growth and operations of the practice. If the practice does not have invested capital debt, then both the asset and equity values for a controlling interest will be the same. When selling a fractional ownership interest, an equity value needs to be determined. An owner of fractional interest is buying rights to future cash flows and capital appreciation, which are both impacted by debt.

A simple analogy for understanding asset versus equity value is valuing a home. A home appraisal will provide an asset value for the property. The seller mortgage(s) on the property is not a factor since the buyer will not take on the responsibility of servicing the seller's debt. The equity to the seller is the price paid for the asset less the amount that needs to be paid to the mortgage lender.

## Level of Value

After determining the type of sale, the next step is to determine the level of value–synergistic, controlling, or a minority interest. In the financial services industry, both control and synergistic levels of value will utilize the same type of analysis and value, an asset value.

A **synergistic value** is used for most scenarios where a controlling interest is expected to be transferred to buyer that is in the same line of business as the subject practice being and as a result of the purchase: (1) the buyer is able to acquire a group of households for less then what it would cost to acquire the same amount of households through marketing activities; (2) the buyer can absorb the households into their expense and capital structure and service the households for less than the seller, and/or; (3) receive an increased payout from their broker-dealer (if applicable).

A **control value** represents the sale of a practice to a non-synergistic buyer–such as an arm's length transaction to a buyer that does not have their own separate distinct practice–that will have the ability to market and sell the practice at any time and will be afforded the prerogatives of control.

When assessing equity value, the level of value can be variable on the spectrum of controlling interest. The level of controlling interest determines the decision-making power, impact, and marketability of the ownership being sold. The sale of 100% controlling interest comes with commensurate discretion and would be valued higher than a 50/50 interest subject to shared control, or a **minority interest** with a lower impact on business decisions. For this reason, the level of value in a stock sale is a key component of equity value.

Understanding the level of value will inform the appraiser about the types of adjustments that need to be considered when reviewing and recasting financial statements for the subject practice. These adjustments measure the true economic performance of the company and provide a basis for projecting future cash flows. There are two specific types of adjustments that can be made, normalizing and control.

**Normalizing Adjustments** remove non-operating and non-recurring assets, liabilities, revenues, and expenses. The financial statements are adjusted to reflect the company's regular ongoing financial position and operating performance. The capital structure may be modified to incorporate a different use of financial leverage. Working capital may be adjusted as necessary to support anticipated needs. An example of this can be seen in Figure 2. Normalizing adjustments are appropriate when valuing either controlling or non-controlling ownership interests.

FIG 2

| | NORMALIZED NET INCOME | | NORMALIZED NET INCOME |
|---|---|---|---|
| + | Depreciation & Amortization | + | Depreciation & Amortization |
| +/− | Changes in Working Capital | +/− | Changes in Working Capital |
| − | Anticipated Capital Expenditures | − | Anticipated Capital Expenditures |
| + | After Tax Interest | + | After Tax Interest |
| | | +/− | Changes in Long-Term Debt |
| = | NET CASH FLOW TO INVESTED CAPITAL | = | NET CASH FLOW EQUITY |

**Control Adjustments** are appropriate when valuing controlling ownership interests where the ownership level has the authority and ability to execute the changes. These adjustments may be applied when valuing minority interests if the minority shareholder should expect the controlling owner to act prudently and make such changes. Control Adjustments primarily relate to discretionary expenses that are solely at the discretion of the owners. These expenses adjustments are typically applied to the following:

1. Unnecessary employees
2. Owner/management salaries
3. Entertainment expenses
4. Rent expenses (if not an arm's length lease)
5. Salaries paid to family members
6. Personal assets, liabilities, and related income and expenses from these assets

## Approach

One of the most highly debated topics is: Which valuation approach is best to value a practice? The correct answer is: *it depends*.

First, this is not the starting point of the value conversation—purpose is. There is no "one-size fits all" valuation approach for all practices, all purposes and all levels of value.

The appraisal discipline has three generally accepted approaches to value: asset, income, and market approaches. These approaches are broad categories for various ways to value a business. Under each of these approaches are commonly used and accepted methods of valuation. Without an understanding of the purpose and level of value, the correct application of these approaches is limited to a best guess.

Of the three valuation approaches, the easiest to understand, and the most commonly used for synergistic and control values, is the market approach. The income approach is easily one of the most complex approaches and is used for measuring profitability and rights to future cash flows. The asset approach is the least relevant and is rarely used in this industry due to the lack of physical capital assets needed to produce revenue. Therefore, we will limit our discussion to the market and income approach.

The **market approach** is well suited for valuing a book of business or practice when the operations of the practice are expected to be dissolved and absorbed into the acquiring firm (synergistic, controlling value). If adequate transaction data is available, and the practices within that dataset are comparable to the practice/ownership interest being appraised, then a market approach can and should be used. Also, this approach can be used as a reasonability check when using an income approach.

The proper application of the market approach requires a professional appraiser to analyze the characteristics of the transactions then make appropriate adjustments to the market multiple to reflect the unique risks and opportunities present in the subject practice.

The **income approach**, specifically the discounted benefit stream method (benefit stream can be earnings or cash flow), is based on the concept that the value of a practice is a function of the future economic benefits that will flow to the buyer/investor. The value of the forecasted economic benefit stream is discounted to a present value. Similar to the use and adjustments to multiples in the market approach, the discount rate should be adjusted to reflect the unique risks and opportunities present in the subject as well.

The income approach is well suited for valuing a going-concern where the net operating profits of the practice should be considered AND the future earnings are expected to increase or decrease in the future. The income approach is typically not the best fit for books of business or small practices (generally less than $250M AUM). Granted there are some unique scenarios where the income approach needs to be used for smaller practices, but those scenarios are very limited.

## Key Performance Indicators

The biggest value drivers for any financial service practice are size, reliability, scalability, and transferability of gross revenues. Gross revenue and AUM, in many cases, provide a clear and straightforward ways of comparing one practice to another. A comprehensive valuation assessment considers the strength and durability of the practice's revenue as well as other critical factors related to assessing growth opportunities and risks present in the practice and its cash flows. These key performance indicators (KPI) are critical for the determination, monitoring, and growth of value for a business.

A complete assessment of value should look at the practice from every angle and consider an exhaustive list of details. The FP Transitions Comprehensive Valuation System evaluates these KPIs in the context of three main indices to provide a full and accurate picture of value: Transition Risk, Cash Flow Quality, and Market Demand.

**Transition Risk** refers to the likelihood that the households of the practice will transfer to the buyer or successor of the business and be retained in the years immediately following the sale. The gross revenue and cash flows of a practice are only as good as what can be transferred and retained. Transition Risk, which takes into account more than 20 factors, is applicable even in an internal sale as well, whether it applies to controlling or non-controlling interest. This index is intended to measure a practice's engagement with its clients and strength of both professional and enterprise goodwill. If the households are not strongly attached to the practice and the selling practitioner, then the buyer may or may not receive the full revenue, and cash flow will be negatively impacted. By looking at key factors affecting the Transition Risk of a given practice and selling situation, a professional and comprehensive valuation can be adjusted to offset the risk.

The next step is assessing the **Cash Flow Quality.** This assessment is based on more than 30 data points, but the three main factors that influence this index are size, the repeatability and predictability of revenues and cash flows, and sources of growth (Figure 3). The growth component of the index is a major contributor and accounts for market growth, additional deposits from existing clients, new client assets, retirement plan rollovers, cash value conversion rates, and death benefits among others. A proper Cash Flow Quality assessment also takes into account the details of the managed households including: age demographics,

FIG 3

| RECURRING REVENUE | | NON-RECURRING REVENUE | |
|---|---|---|---|
| Fees on Managed Assets | Accounting/Taxes for Clients | Securities-Based Trials | Securities Commissions |
| Third-Party Managed Assets | Consulting | Insurance Renewal | Insurance Commissions |

← DEGREE OF PREDICTABILITY →

HIGH — LOW

asset and revenue concentrations, surrender periods, asset growth or decline, multi-generational planning, and expenses associated with servicing existing clients and attracting new ones.

By taking all these factors into account, the market multiple and discount rate can appropriately be adjusted for the unique risks and opportunities present in the subject practice. The Cash Flow Quality index of the business should also be benchmarked against the central tendency of the marketplace based on an extensive database of advisory firms and transactions, giving the advisor an accurate point of reference to compare their practice against other successful practices.

The last category of key performance indicators is **Market Demand.** Market Demand accounts for discoveries made in assessing Cash Flow Quality and Transition Risk as well as other factors. A subject practice with strong Cash Flow Qualities and low Transition Risk would be expected to have higher demand. The geographic location of the practice and its proximity to a large, growing metropolitan region as well as the number of potential buyers in a given area are all factors considered in the Market Demand Index.

## Value ≠ Price

Business valuations may serve many purposes to the end user, but they are designed with one primary objective: to provide an unbiased opinion or calculation of value for a specific purpose. Value opinions are intended to be informative, not declarative.

FIG 4

VALUATION MATRIX

| DEAL STRUCTURE | YEARS: 1 | YEARS: 4-6 | YEARS: 7-9 |
|---|---|---|---|
| All Cash | $877,000 | | |
| Average Structure | | $958,000 | $1,042,000 |
| All Contingent | | $1,015,000 | $1,121,000 |

Impact of Deal Terms on Practice Value

For asset sales, an FP Transitions Comprehensive Valuation System assessment provides a cash value for the subject practice as well a matrix of prices based on different financing scenarios to demonstrate how deal terms may influence the purchase price. The matrix serves as a guide to illustrate the variability of price and provide a baseline for determining an asking price for the business and to guide transaction discussions, as seen Figure 4 example.

For sales of stock where equity is being valued, the value presented in the report will also be a cash value. As variance in prices paid for stock vary widely, further assessment of transition specifics and business circumstances are required to determine an accurate adjusted value and fair price for the sale.

Deal terms play a major role in determining price. However, negotiations are the basis for determining the actual price. Value and price may be similar concepts, but they are not inextricably linked. The value of a practice is based on a comprehensive set of factors and considerations for each individual business. In contrast, price is the value of that practice adjusted for seller's demand and the terms of the transaction.

The value expressed in the valuation report is an opinion and should be used as a starting place for further negotiations. Ultimately, successful transactions–whether external or internal–require cooperation between the buyer and seller and are not wholly dependent on the expressed opinion of value.

## Conclusion

Determining accurate value is the starting point for any path for your business, whether it's selling (internally or externally), acquisition, creating enhanced structures and systems, or building a powerful team. It allows you to plot a way forward to realize your vision for the business.

The industry and individual expectations of business performance and operations have increased. A complete, unbiased assessment of practice value should meet that level of sophistication. Assessing a business on a variety of factors based on purpose rather than just applying a simple rule of thumb across the board is an important evolution indicative of the impact of the financial services profession.

## Determining Value and the FP Transitions Comprehensive Valuation System

The FP Transitions' Comprehensive Valuation System provides financial practice owners simplicity and clarity to the task of effectively understanding value and managing their equity to build a business of enduring and transferable value. By providing a clear explanation of the transaction or situation requiring your practice to be valued, FP Transitions' team of Certified Valuation Analysts can help you understand what needs to be analyzed, the appropriate adjustments given the level of value, and how various key performance indicators influences the valuation results. By understanding what drives value, owners will gain insight into how to manage it for the future.

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