Valuation, Economic Models & Equity Ownership
In Independent Advisory Firms

Independent financial advisory firms usually have similar origins. Typically, they were founded by one to five individuals who generated sufficient revenues to afford the costs associated with operating an independent firm. The backgrounds of firm founders vary and include traditional full-service advisory firms, financial planning firms, and insurance agencies. These backgrounds can impact the economic models adopted at inception.

Given the nature of their origins, most independent financial advisory firms focused in their early days on revenue generation and cost management – in short, survival. Little thought was given to economic models or equity ownership structure. Because the revenue generators were usually the founders, the economic model created was one in which employees earn a salary and the founders take distributions from profits as a monthly draw.

This model is generally the norm in smaller advisory firms, and there is nothing wrong with it as long as the founders remain the shareholders and continue to generate revenues proportional to their draws. Such may well be the case for years or even decades, but at some point in every independent firm, someone wants to retire. When that moment arrives, the complex issues attendant to retirement, such as compensation, ownership structure, equity value and succession planning, suddenly become urgent.

These same issues arise when a firm grows over time, especially if that growth is driven by hiring. If new or younger financial advisors begin to account for a meaningful percentage of revenues, they will likely want to be treated more like the founding shareholders than simply as employees.

Finally, these issues arise when an independent firm reaches a certain size, whether through organic growth or by acquisition. If growth is to continue, then the firm must build more infrastructure to support it. Firm size may require staffing in operations, compliance and information technology. It may also require investment in areas that support revenue generation and client acquisition, such as financial planning, investment research, portfolio management or family office services. Most importantly, the firm may require a real management team with clear responsibilities, usually on a part-time basis at first. Firms tend to reach this point when AUM grows to $500 million or more.

An exploration of these matters entails a thorough and comprehensive look at a firm's economic model. The definition of "economic model" encompasses the variable and fixed costs associated with revenue generation, which derive from the client service model employed. The simplest economic model is an independent firm with one financial advisor whose service model is limited to software-based financial planning and a "manage the manager" investment model. In such firms, the economic model is very simple. The advisor in this example may have one or two employees to handle clerical work and client support, including everything from order execution to interface with custodians to client reporting. Such firms almost always outsource compliance, IT and manager and securities research. Other fixed costs are occupancy, communications, information services and software. Because the service model is basic and because the

advisor makes extensive use of outsourcing, there is very little cost associated with an increase in revenue. The only variable cost is the compensation cost of an incremental dollar of revenue; however, firms such as this generally pay a draw against firm earnings instead of using a defined payout grid. Such models have the highest profit margins in the industry.

In firms that have a compensation system other than a shareholder draw, the incremental costs of revenue can be significant. Firms that have more complex service models incur higher fixed costs. Depending on client requirements, such costs may be worthwhile. Similarly, in firms that are large enough to require management infrastructure, the fixed costs are higher still. Again, these higher fixed costs may be well justified by a given firm's growth prospects or market opportunities.

All of these issues – compensation, client service model, firm economic model, ownership model – have an impact on firm value. So, too, do growth rate, succession planning, percentage of retirement accounts and ongoing competitiveness.

To understand fully, it is useful to review basics. First, independent advisory firms are enterprises. They are companies that generate revenues and profits on an ongoing basis. The value of any business relates directly to its ability to generate profits and cash flows. Without profits and cash flows, an enterprise has no value other than the liquidation value of its assets. While valuation techniques can be complex and varied, all of them ultimately hinge on a business' ability to generate cash flows on an ongoing basis for the foreseeable future. This point is critical for independent advisory firms.

In theory, the value of a business is the cash it would generate for a hypothetical independent investor, who has a cost of capital defined by the risks associated with the business. To calculate value, the investor discounts future cash flows at his cost of capital. Because future performance is fundamental to valuation, the key question is, "what are the risks to continuation of this firm's cash flows?"

Small independent firms with one financial advisor, as mentioned above, have the highest profit margins, but they also have the highest continuity risk. Should disability or death befall the sole financial advisor, the firm would quickly lose its revenues, its profits and, therefore, its enterprise value. A high average client age or a high percentage of retirement accounts are also risks to long-term cash flow stability. Other factors that may be viewed as risks include advisor age, succession status, account concentration and AUM turnover.

Larger firms are subject to the same questions in the valuation process, but some of the risks may be mitigated by firm size and the number of financial advisors.

Valuation methodology entails projection of financial results in the future, typically over five years. The cash flows generated by the business are discounted at a cost of capital, as mentioned above. Most models assume that cash flows in the last year of the forecast continue at that level indefinitely. In other words, the business is assumed to operate in perpetuity from that point forward. That assumption can add as much as 75% to the value calculation. In short, if a business is not likely to continue at its current success indefinitely, it is worth substantially less than similar firms that are.

Given the origins of most independent firms and their lack of focus on equity value, it is not surprising that many independent firms simply pay their founding shareholders a draw that, ultimately equates to 100% of firm profits. When founding shareholders approach retirement, and will no longer be receiving distributions as revenue generators, they might reasonably expect to sell their equity to the firm. Accordingly, equity value takes on heightened importance.

The example below illustrates two economic models, one with an advisor draw that equals profits and one with a compensation plan that pays advisors a fixed percentage of revenues. Each applies a multiple of 5.5x to profits to derive a simple firm valuation for comparative purposes.

	100% Shareholder Draw		50% Payout Ratio	
	Assumptions	Income Statement	Assumptions	Income Statement
Revenues	2,500,000	$ 2,500,000	2,500,000	$ 2,500,000
Advisor compensation	75.0%	1,875,000	50.0%	1,250,000
Staff compensation	5.0%	125,000	5.0%	125,000
Other costs	20.0%	500,000	20.0%	500,000
Profits		$ -		$ 625,000
Equity value at 5.5x	5.5x	$ -	5.5x	$ 3,437,500

This very basic example indicates the importance of a firm's economic model. It also shows the dynamic between compensation, taxable at current income rates, and equity value, taxed at capital gains rates when realized. Importantly, the profits in the second example could still be distributed to shareholders; it simply shifts dollars from revenue generators to shareholders.

While compensation is always the largest cost in a financial advisory firm, the other cost elements also matter to valuation. This means there will always be tension between incurring greater expense to expand the client service model and keeping costs at a minimum. The client service model can have direct impact on capturing new revenues and on maintaining fee levels, so such decisions require thoughtful analysis. Given that firm resources in this industry are human assets, compensation is critical. Should a firm decide to expand its client service model, it must also determine compensation models for the personnel needed to deliver those enhanced services, balancing market compensation requirements against targeted profit margins and valuation metrics. All of these decisions comprise the firm's economic model.

Compensation in a financial advisory firm can come from two elements, current compensation and equity compensation. Current compensation can and should be structured to incentivize desired behaviors in an individual's primary area of responsibility. Equity compensation is tied to the overall success and profitability of the firm. Properly structured, it can be a powerful driver of positive corporate culture and provide compelling long-term incentives.

There are many questions associated with structuring a plan for equity ownership.

- What are the criteria for ownership? Revenue generation? Meaningful support of revenue generation? Tenure?
- Should equity be granted, purchased or both?

- How often should people be allowed to purchase equity?
- How is the targeted amount of firm ownership set for each shareholder?
- How and when is valuation determined?
- What happens if a shareholder retires? Dies? Goes to work for a competitor?

In order for a financial advisory firm to prepare for shareholder retirements, employee equity incentives, capital infusions, or strategic opportunities, firms must embark upon a thoughtful exploration of their current and planned client service models, infrastructure needs, incentive compensation plans, growth prospects, all of which affect their economic models, forecasts and valuation. Addressing these matters now can enhance long-term value creation.