

Valuation, Economic Models & Equity Ownership In Independent RIAs

Introduction

Valuation in independent registered investment advisory (“RIAs”) firms has become a major concern, given the increasing volume of acquisition activity in the industry. There is quite a bit of confusion regarding valuation methodology, partly because of oversimplified terminology.

All too often, the value of an advisory business is quoted in terms of revenue multiples. This is simplistic, but useful for comparison purposes, just as price/earnings ratios are simplistic and useful for comparing the relative values of publicly-traded companies. Revenue multiples and P/E ratios are static, and neither is sufficient basis for a rational investor to make a buy or sell decision.

The value of any business is based solely on the ability of that business to generate current and future cash flow for an independent investor, who has a required rate of return. The investor’s required rate of return, or cost of capital, is defined by the investor’s assessment of the risks associated with the business. The cost of capital may vary from investor to investor, based on each one’s assessment of the probability of future cash flows.

To value a company, one must project financial results in the future, then discount the cash flows generated by the business at the required rate of return.

Risks

The risks in the financial advisor industry are straightforward. The major risk categories are historical risk, health risk, retention risk, performance risk, and client attrition risk.

Historical risk includes the legal and regulatory liability associated with actions taken by the principals or employees of an RIA. Because such liability in the financial advisory industry can be great and because there is a long statute of limitations on misfeasance or malfeasance related to client accounts, this can be an unknown and unquantifiable risk. Insurance can mitigate the financial risk associated with regulatory violations, but it cannot cover reputational risk and any resulting loss of business.

Health risk encompasses the possibility of death or disability of advisors and the attendant loss of their revenues. Health risk can be addressed through life and disability insurance. Retention risk relates to the continued affiliation of the advisor or advisors with the RIA. Performance risk simply means that the advisor or advisors in an RIA fail to achieve their historical level of success, whatever the reason.

Finally, client attrition risk must be considered in any valuation of an RIA. Historically, the industry has enjoyed a high level of client loyalty, and most client attrition relates to demographics. Simply put, clients of a certain age are subject to required minimum distributions from retirement accounts and to higher mortality risk. If a firm’s client base has an average age in the 70s, those client assets are more likely to decline than to increase over time.

All of these risks must be considered in evaluating any RIA, as they may impact the firm’s future financial results, and, in turn, the rate of return that an independent investor would require for assuming those risks.

Segmentation of RIAs

RIAs not simply “advisory practices”, they are companies comprised of advisory practices that generate revenues and profits on an ongoing basis. Properly managed, they will continue to generate those revenues and profits, even as advisors retire and transition their practices to successor advisors. There are different tiers of RIAs and therefore, different structures, economic models, and levels of complexity.

The Charles Schwab Corporation, the largest provider of clearing and custody services to RIAs, publishes an annual RIA benchmarking study, based on surveys of its client RIA firms. Schwab defines the RIA market by organizational model and by size, as shown below.

Firm Organizational Models			
Model	Definition	Assets Under Management	
		<\$250MM	>\$250MM
Solo	One advisor, possibly administrative support	27.2%	3.1%
Silo	Two or more advisors. Advisors paid for own revenues, share expenses.	12.6%	7.2%
Ensemble	Multiple advisors. Clients belong to firm. Relationship management orientation.	58.5%	74.5%
Enterprise	Large firm, multiple locations. Clients belong to firm. Well-defined functional teams. Layers of leadership.	1.7%	15.2%
		<u>100%</u>	<u>100%</u>

Source: Schwab 2020 RIA Benchmarking Study

The RIA types defined by Schwab, Solo, Silo, Ensemble, and Enterprise have differing service models, target clients, compensation plans, and cost structures. However, there is also wide variability in those attributes within each category.

The Key Drivers of Value

Since value is determined by the cash generated from any given business, one driver of value is a firm’s ability to manage expenses. The impact of cost structure is easily illustrated by the example below. RIA 1 and RIA 2 each have revenues of \$1,000,000. Each has an advisor payout ratio of 50%. However, RIA 2 has higher operating expenses, due to a greater spend on marketing.

		Trailing 12 Months' Results	
		RIA 1	RIA 2
Advisory fee revenue		\$ 1,000,000	\$1,000,000
Advisory payout	50%	500,000	500,000
Other personnel		100,000	100,000
Operating expenses		<u>150,000</u>	<u>200,000</u>
Total expenses		750,000	800,000
Operating profit		<u>\$ 250,000</u>	<u>\$ 200,000</u>

This illustrates why a revenue multiple is inadequate as a valuation tool. While their revenues are the same, a rational investor would choose RIA 1 and its higher cash flows.

However, a snapshot of profitability is only slightly better than a revenue multiple approach, because it does not consider the second key driver of value, revenue growth rates. A look at a five-year forecast illustrates this. RIA 1 has a forecast growth rate of 4% per year, the approximate industry average excluding the impact of market increases and declines. RIA 2, because of its higher marketing spend, has a forecast annual growth rate of 12%. Expenses for each grow 2% annually.

		RIA 1				
		Year 1	Year 2	Year 3	Year 4	Year 5
Advisory fee revenue		\$ 1,040,000	\$ 1,081,600	\$ 1,124,864	\$ 1,169,859	\$ 1,216,653
Advisory payout	50%	520,000	540,800	562,432	584,929	608,326
Other personnel		102,000	104,040	106,121	108,243	110,408
Operating expenses		<u>153,000</u>	<u>156,060</u>	<u>159,181</u>	<u>162,365</u>	<u>165,612</u>
Total expenses		775,000	800,900	827,734	855,537	884,347
Operating profit		<u>\$ 265,000</u>	<u>\$ 280,700</u>	<u>\$ 297,130</u>	<u>\$ 314,321</u>	<u>\$ 332,306</u>
		RIA 2				
		Year 1	Year 2	Year 3	Year 4	Year 5
Advisory fee revenue		\$ 1,120,000	\$ 1,254,400	\$ 1,404,928	\$ 1,573,519	\$ 1,762,342
Advisory payout	50%	560,000	627,200	702,464	786,760	881,171
Other personnel		102,000	104,040	106,121	108,243	110,408
Operating expenses		<u>204,000</u>	<u>208,080</u>	<u>212,242</u>	<u>216,486</u>	<u>220,816</u>
Total expenses		866,000	939,320	1,020,826	1,111,489	1,212,395
Operating profit		<u>\$ 254,000</u>	<u>\$ 315,080</u>	<u>\$ 384,102</u>	<u>\$ 462,030</u>	<u>\$ 549,947</u>

RIA 1 generates total operating profit over the forecast period of \$1.5 million, but RIA 2 generates total operating profit of almost \$2.0 million for the same forecast period. Given this information, a rational investor would value RIA 2 more highly.

Applying different costs of capital to these forecasts and assuming the Year 5 results continue indefinitely results in the values shown in the table below. For illustration purposes, each value is also shown as a multiple of the trailing 12 months' revenues and operating profits.

RIA 1			
		Multiple of Trailing 12	
Cost of Capital	Value	Revenues	Profit
20.0%	\$1,540,575	1.5x	6.2x
17.5%	\$1,773,113	1.8x	7.1x
15.0%	\$2,084,414	2.1x	8.3x

RIA 2			
		Multiple of Trailing 12	
Cost of Capital	Value	Revenues	Profit
20.0%	\$1,869,705	1.9x	9.3x
17.5%	\$2,180,978	2.2x	10.9x
15.0%	\$2,600,826	2.6x	13.0x

These two examples illustrate that value in an RIA, or any enterprise, is a function of profitability and growth rate. The challenge for advisors and for managers is to balance the costs associated with the firm's client service model and staffing needs with profitability and growth considerations.

Potential Issues in Valuing Smaller RIAs

The valuation approach outlined above works very well with firms in which the personnel and operating expenses are clear and consistent. It is especially important that the largest single component of expenses in any RIA, advisor compensation, is clear and easy to forecast. That is always the case in what Schwab defines as Ensemble or Enterprise RIAs, which are large enough to have defined compensation policies in place.

In smaller firms, those Schwab describes as Solo or Silo firms, operating expenses can vary more widely, and advisor compensation is not always separated from owner compensation.

Given the nature of their origins, most Solo and Silo 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 draw. This comingling of compensation streams becomes a problem if the founders decide to add more advisors or seek an outside investor or if they cease to generate revenues proportional to their draws.

Take for example a firm with three founders with equal ownership of the RIA. Each advisor generates \$500,000 in revenues, and the firm has total expenses of \$375,000, 25% of revenues, before advisor compensation. Each advisor receives one-third of the firm profits in distributions.

	Total	Advisor 1	Advisor 2	Advisor 3
Advisory fee revenue	\$ 1,500,000	\$ 500,000	\$ 500,000	\$ 500,000
Total expenses	375,000			
Operating profit	<u>\$ 1,125,000</u>			
Profit distribution		\$ 375,000	\$ 375,000	\$ 375,000
Percentage of revenues		33.3%	33.3%	33.3%
Percentage of compensation		33.3%	33.3%	33.3%

However, if Advisor 1's revenues increase and Advisor 2's revenues decline, it creates an imbalance as shown below.

	Total	Advisor 1	Advisor 2	Advisor 3
Advisory fee revenue	\$ 1,500,000	\$ 600,000	\$ 400,000	\$ 500,000
Total expenses	375,000			
Operating profit	<u>\$ 1,125,000</u>			
Profit distribution		\$ 375,000	\$ 375,000	\$ 375,000
Percentage of revenues		40.0%	26.7%	33.3%
Percentage of compensation		33.3%	33.3%	33.3%

In this example, Advisor 1's revenues have grown to \$600,000 while Advisor 2's revenues have declined to \$400,000. Advisor 1 generates 40% of the firm's revenues but is paid only 33.3% of the profits. Meanwhile, Advisor 2 also receives one-third of the profits, despite contributing only 26.7% of the revenues. Because advisor compensation and owner compensation are co-mingled, Advisor 1 is penalized, and Advisor 2 is supplemented.

The simplest solution would be to implement an advisor payout ratio, thereby ensuring that each advisor was fairly compensated for his revenues, as shown below.

		Total	Advisor 1	Advisor 2	Advisor 3
Advisory fee revenue		\$ 1,500,000	\$ 600,000	\$ 400,000	\$ 500,000
Advisor payout	50%	750,000	300,000	200,000	250,000
Total expenses		1,125,000			
Operating profit		<u>\$ 375,000</u>			
Advisor payout		750,000	300,000	200,000	250,000
Profit distribution		375,000	125,000	125,000	125,000
Total		<u>\$ 1,125,000</u>	<u>\$ 425,000</u>	<u>\$ 325,000</u>	<u>\$ 375,000</u>
Percentage of revenues		100.0%	40.0%	26.7%	33.3%
Percentage of compensation		100.0%	37.8%	28.9%	33.3%

A more complex resolution entails valuing the incremental payments to Advisor 2 over time and having him pay Advisor 1 for that cash stream.

Comingling advisor payout and profit distributions also creates a problem for bringing in a new investor. If the business has no profits, it has no value to the new investor. Again, separating advisor compensation from ownership compensation is the simplest solution.

Going Concern Value v. Change of Control Value

The valuation methodology outlined above works well for valuing an RIA as a “going concern” and for valuing an RIA in a potential sale transaction.

Going concern value should matter to every equity owner in an RIA, as that value should be growing as the firm grows. Going concern value is also important because of the inevitability in every firm that someone will eventually want 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 new or younger financial advisors begin to account for a meaningful percentage of revenues. They will likely want to become shareholders with equity upside.

The methodology for calculating value in a potential change of control is identical to that of a going concern valuation, with one addition. A buyer may be able to reduce or eliminate certain staffing or operating costs. A second, *pro forma* version of the financial forecast that assumes those reduced costs and increased profits will indicate what the buyer could pay and still meet its required rate of return. Whether the buyer pays that higher value is a matter of negotiation.

Conclusion

The valuation of any business is based solely on its ability to generate cash in the future. It entails thorough analysis of the risks associated with those cash flows to determine the required rate of return. Profitability and growth rates drive value over time.