Monetizing the Value of
Independent Financial Advisory Firms

The proliferation of independent financial advisory firms over the past 20 years has resulted in great value creation for the shareholders of such firms. With that value creation comes a challenge. How can shareholders unlock that value and monetize it when appropriate?

It is important here to define “monetization”. Monetization is simply the ability of a shareholder to receive cash in exchange for stock in a privately held business. The valuation ascribed to such stock ownership is a separate question that we will set aside for now.

Given that time is an irresistible force, retirement of shareholders at some point is a given. Retiring shareholders typically expect to realize value for their shares, so it follows that monetization will become a challenge for every independent firm at some point. Prudence suggests it should be addressed in a timely and thoughtful fashion. Because most financial advisors lack experience or expertise in monetization transactions, they often default to the “do nothing” option. Unfortunately, a decision to do nothing is, in fact, a decision, and it simply pushes the question further into the future.

Exploring a monetization transaction is not a herculean task, merely a process that requires discipline and execution of simple, consecutive steps. In fact, it is analogous to doing a financial plan for a client and crafting an investment solution that achieves the client’s goals.

As with a client financial plan, the monetization process begins with developing a clear understanding of personal and financial goals, except in this case the “clients” are the shareholders of the independent firm.

Age is often a key driver of an advisor’s personal and professional objectives. The *Financial Times* reported in 2017 that the average financial advisor was 50 years old and that 27% of advisors intended to retire within 10 years. These statistics imply that financial advisors have differing goals as to when they want to retire. Another driver is net worth; once a given advisor achieves a certain level of wealth, he or she may opt for other pursuits. Financial advisors within the same firm may have widely differing personal and professional goals. Accordingly, it is important that shareholders in such firms discuss their goals in order to anticipate and plan for retirements and other organizational changes. Once the shareholders have ascertained one another’s goals for retirement, they can develop a schedule with the percentages of the ownership that will require monetization in the years ahead.

The second step in the process is to get a valuation of the firm’s equity from an independent valuation firm. Because there may be internal stock sales as well as sales upon retirements, an annual update of the valuation is highly recommended. Depending on the size and complexity of the independent firm and the uses of the valuation analysis, the cost for the initial valuation can be as little as $5,000 with subsequent annual updates being done for half the initial amount.

It is important to note that this valuation type is that of a business as a going concern, and, therefore, it is appropriate for use in transactions that do not involve a change of control. The analogy here is to the public equity markets, in which market prices reported are for buy and sell transactions that do not represent significant ownership percentages. A going concern valuation would not contemplate sale of control of the company, which one presumes would be at a premium, as in the public equity markets.

The third step in the monetization process is to combine the first two steps to ascertain the dollar magnitude of future retirements. For example, if a shareholder who owns 25% of the firm intends to retire in two years and the valuation shows that the firm is worth $2,000,000, the firm must come up with $500,000 in two years to monetize that shareholder's equity. Attendant to this question is one of payment structure – will selling shareholders be paid one lump sum or in staged payments over several years? Gauging the dollar requirements on a year by year basis allows the shareholders to consider transaction options.

The fourth step is to determine the best type of prospective investor and whether they have the financial wherewithal to meet the needs defined in the previous step. There are four categories of prospective investors: other shareholders and employees of the independent firm, individual or family office investors who are not affiliated with the firm, strategic investors and financial investors.

The first group, other shareholders or employees, can be attractive prospects for obvious reasons. However, this group may lack sufficient personal wealth to absorb the dollar supply of shares coming on the market as calculated in step three. The second set of prospective investors, individual or family office investors, may have the financial wherewithal to provide the needed funds. It is important that they have a sufficient understanding of the financial advisory business to be patient and passive long-term shareholders. Depending on their knowledge and investment objectives, individual or family office investors may be optimal prospects for monetization in independent advisory firms. In general, these first two groups of prospective investors are candidates for minority investment transactions in which less than 50% of the ownership is being sold.

The third category, strategic investors, is comprised typically other firms already in financial services. This group includes other financial advisory firms, banks, trust companies, and insurance companies. Strategic investors are control investors who prefer to own 100% of any company in which they invest. Their objective in such investments is generally to add a new line of business to their other financial services or to increase market share of an existing line of business. In general, strategic investors are the most likely to have personnel and infrastructure in place that will allow them to realize cost savings in such an investment. The higher the potential cost savings, the more the strategic investor can afford to pay.

Financial investors, the fourth category, are also generally control investors, although some are willing to purchase minority interests. Financial investors seek opportunities with attractive growth prospects, whether the growth is organic or through acquisitions. Financial investors targeting the financial advisory industry do so because they see an attractive opportunity to grow by consolidating independent firms.

Evaluating these four investor categories in the context of the firm's needs allows the shareholders to determine which might be the best fit. Nonetheless, the decision cannot be finalized except in concert with the fifth step in the monetization process. The fifth step is for the shareholders to define what would comprise for them a successful transaction.

There is a temptation when one is selling stock to define success as achieving the highest possible price. To do so in the context of monetizing an independent financial advisory firm would be short-sighted, as there are other important considerations to be addressed. Specifically, the shareholders must ponder the effect of a monetization transaction on three constituencies: the firm's clients, its non-shareholder employees, and its shareholders. Clients may have concerns regarding the breadth of investment access, technological capabilities and advisor resources. Non-shareholder employees may have concerns about continued employment, compensation, benefits, and expense practices. Considerations that affect all employees include the culture and day-to-day operation of the firm. Finally, questions of control, self-governance, branding, succession planning, and support must be considered. Any change in ownership, even simply an internal shift among shareholders, can trigger concern about these topics. It is essential that the shareholders of independent firms discuss all of these matters and define what they would regard as an optimal transaction or transactions. Unless the shareholders debate and agree on deal parameters and objectives, it will be difficult to negotiate successfully, regardless of the investor type. The nature of investment negotiations is such that there can only be one or two lead negotiators. Those negotiators must have a clear understanding of how the shareholders define success in order to represent them to their best advantage.

As part of this step, the shareholders of an independent firm must also contemplate risks. Avoiding negative conditions and outcomes is as important as securing positive ones. Risks will vary depending on the target investor group and must be evaluated accordingly, but some risks apply to all four categories. Such risks might include investment time frame, strategic expectations, corporate cultural norms, desired level of involvement or control, and capacity for further investment, among others.

The sixth step in the monetization process is exactly like the fifth, except that the shareholders must consider the definition of a successful transaction and the risks involved from the standpoint of the investor group. What are the investor's objectives? What does the investor hope to achieve? How do our strengths help the investor reach his goals for this investment? Do our weaknesses jeopardize those goals? What are the risks to the investor? How are we addressing those risks? Understanding the investors' perspectives is essential to the success of a monetization transaction.

The seventh step is to determine what outside advisors might be helpful to achieving monetization. Lawyers will certainly be involved in any investment transaction, so it makes sense to select legal counsel, if one is not in place, and to apprise them of the shareholders' views from steps one through five. Experienced legal counsel can be very helpful to the shareholders. In addition, it may make sense to hire a financial professional with transactional experience, such as an investment banker. This can be especially helpful in crafting proposals and in assessing offers. Finally, advice from an accounting firm on the potential tax consequences of different deal structures is essential to making the right decision.

The target investor group and the transaction type will determine the level of outside help required, as follows. The simplest form of monetization transaction is one in which other shareholders and employees invest the capital needed to redeem the ownership of a retiring shareholder. This requires a third-party valuation, as noted above, which eliminates the need for colleagues to negotiate the share price. It also requires some work from legal counsel to ensure that the procedures and paperwork are properly done. A transaction with individual or family office investors that are not affiliated with the firm requires substantial outside assistance. In such a transaction, it is incumbent on the firm to structure and value an offering of securities to such investors. The offering could be the same as the securities being sold by the selling shareholders, or it might be something different, depending on steps five and six. This requires significant legal advice, as the offering must comply with securities laws. Additionally, it may make sense to involve an investment banker, depending on the scope of the offering.

Pursuing monetization with either the third group, strategic investors, or the fourth group, financial investors, may be sufficiently complex as to require both lawyers and investment bankers. These two groups tend to be control investors, meaning that the transaction and attendant documentation will be complex by definition.

The eighth step is to assemble and package information on the firm that investors, regardless of type, would want to see as part of their due diligence. At a minimum this would include historical financial results, a listing of financial advisory teams and their revenues, and a narrative description of the firm, its history and its customer service model. Data such as historical growth in AUM, the mix of investment products used, and the percentage of retirement accounts can provide knowledgeable investors with additional insights into the firm's performance.

Step nine is to contact investors in whichever category the shareholders deem appropriate. This is best handled by one or two individuals, at most. A successful effort will attract the interest of several investors and lead to due diligence meetings and negotiations. This step varies considerably based on the desired transaction and the target investor group. Minority investments by existing shareholders and employees would be the shortest, while a control investment will likely be the longest.

Step ten is to evaluate any proposals received. Again, for minority transactions, this is generally just a question of valuation and deal structure. Change of control transactions can be multi-faceted, and it is sometimes difficult to compare proposals on an "apples to apples" basis. This is best illustrated by example.

Let's assume a hypothetical independent firm called "SmallCo" is seeking a monetization event. SmallCo has $1 million in trailing revenues and is led by one senior financial advisor who founded the firm and owns 100% of the firm's stock. SmallCo has good support personnel but no junior advisors. The financial advisor would like to retire in five years. An internal transaction is not an option and the advisor has decided not to seek individual investors. Thus, SmallCo has opted to consider a change of control transaction with either a strategic or financial buyer.

After following all the steps above, SmallCo receives three offers, one from a bank and two from independent firms backed by financial investors.

Bank has offered $1.7 million to purchase SmallCo. Independent Firm A has offered $1.7 million as well. Independent Firm B has offered $2.8 million. Each offer is structured as a purchase of SmallCo's assets and will be taxed at capital gains rates. The net amounts, after capital gains taxes, assuming a 20% rate, are $1.36 million, $1.36 million, and $2.24 million, respectively. Independent Firm B has the best offer, right?

Maybe, maybe not. The purchase of SmallCo is just one part of the deal. The financial advisor plans to stay for five years, so the next question is payout. Bank is offering him an industry payout of roughly 48%, and Independent A is offering 50%. However, Independent B is only offering a fixed salary of $200,000. Assuming flat revenues over the five years and a marginal income tax rate of 35%, the five-year after-tax income for the three offers is $1.56 million, $1.625 million, and $650,000, respectively.

Totaling the after-tax amounts for the purchase of the firm and the five-year compensation yields $2,920,000 for Bank, $2,985,000 for Independent A, and $2,890,000 for Independent B. What initially appeared to be widely varying offers are, in fact, separated by less than $100,000.

Independent A has another component to its offer that is not in the other two offers. Independent A will allow the financial advisor to do an internal sale of his book to an internal successor advisor or advisors whenever he decides to retire. For simplicity, we will assume that value to be 1.0x revenue, or $1,000,000. This would be treated as current income for tax purposes, and the after-tax amount would be $650,000.

The final tally, after-tax, including each element of the offers that puts money in the hands of SmallCo's owner and sole financial advisor, is this:

	Bank	Independent A	Independent B
Purchase price	1,360,000	1,360,000	2,240,000
Advisor payout over 5 yrs.	1,560,000	1,625,000	650,000
sub-total	$ 2,920,000	$ 2,985,000	$ 2,890,000
Sale of client book	-	650,000	-
Total	$ 2,920,000	$ 3,635,000	$ 2,890,000

Seen in such a table, Independent A's offer is clearly the highest. The challenge in comparing and evaluating offers is that shareholders of independent firms and their advisors must break them down in detail to understand the after-tax value of each component of the offering. Offer letters are designed to present proposals in the most favorable light, not to make them easy for comparative analysis.

While Independent A has made the highest offer in the example above, it has not necessarily made the best offer. Dollars are important and can be determinative, but every offer should be evaluated qualitatively as well as quantitatively. If a proposal does not substantially meet the definition of success laid out by the independent firm shareholders in advance, they should negotiate it further or decline it.

The example of SmallCo is the simplest possible. As it has but one shareholder who is also the sole revenue generator, there are no differences of opinion regarding, personal and professional goals, timing or definition of a successful transaction. The larger the firm, the greater the complexity of any transaction. The only path to success entails discipline, thoughtfulness and timely execution.

To recap, here are the ten steps in a well-managed monetization process.

The Monetization Process

1. Develop an understanding of shareholder personal and professional goals, especially the timing of retirements.

2. Hire a qualified firm to conduct an annual valuation of the firm on a going concern basis.

3. Develop a timetable of probable retirements and the dollars required for monetization of retiring shareholders.

4. Define categories of possible investors and determine which ones best meet the financial needs of the shareholders.

5. Define a successful transaction for the shareholders, especially regarding corporate culture, advisor flexibility and client support, and discuss the risks to be avoided.

6. Define a successful transaction for the investors, anticipating their concerns and perceived risks in such an investment.

7. Determine what outside advisors and support resources are necessary and helpful to a successful transaction.

8. Assemble information on the firm that prospective investors will need to see as part of their due diligence.

9. Contact investors in the appropriate category or categories.

10. Evaluate and compare proposals quantitatively and qualitatively.

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