SRG
SUCCESSION RESOURCE GROUP

Your Guide to Increase the Value of Your Business

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Valuation Methodologies

There are three standard methodologies used to value financial services businesses. Each approach serves as a foundation for a group of different strategies, each used to determine the business value. It is important to understand and use the right methodology based on the circumstances.

Asset Based Approach

Net asset value is estimated by restating the value of assets and liabilities from historical cost to fair market value. Because most investment and financial advisory practices do not have much in the way of tangible assets, this method is typically not used.

Market Based Approach

This approach utilizes valuation ratios derived from market transactions involving companies that are similar to the subject business. Very few firms (Succession Resource Group being one) have a proprietary database of deals that allows them to provide a reliable market based value. Most experts rely on "rules of thumb," which, due to the dissimilar nature of investment advisory firms, lead to inaccurate valuations.

Income Based Approach

Expected future returns from an investment are discounted to present value at an appropriate rate of return for the investment.
Capitalization of Cash Flow: Capitalizing normalized cash flow amounts
Discounted Cash Flow: Forecasting based on historical cash flow amounts

Key Value Drivers

There are three standard methodologies used to value financial services businesses. Each approach serves as a foundation for a group of different strategies, each used to determine the business value. It is important to understand and use the right methodology based on the circumstances.

Growth Rate
The growth of an RIA is one of he key drivers of value under any valuation method. Look at the growth rate of: AUM, # of clients, and revenue.

Target Benchmark:

10.5% CAGR

Profitability
Focus on the bottom line - in the years leading up to a sale, manage your Profit & Loss Statement and keep expenses a buyer would need to retain to a minimum. This includes ensuring you don't overpay your staff

Target Benchmark:

Under $1,000,000 Revenue: 35%
$1,000,000 - $3,000,000: 45%
$3,000,000+: 55%

Client Service Mode
Your most valuable asset is the relationship you have with your clients. Focus on creating a great client service model, but that isn't labor intensive and consistent with industry norms

Target Benchmark:

90%+ meetings in office or virtual

Valuation Process

Using industry-specific data-gathering worksheets, Succession Resource Group (SRG) leverages its proprietary models and algorithms to evaluate your business relative to its comparable sales database. The database is one of a kind, containing the most robust information of RIA transactions in the industry.

These comparable sales provide two primary benefits to the analysis:

1. **Large volume of comparable sales** from a variety of sources that can be leveraged during the analysis to provide a micro-level of analysis and more direct comparable sales; and

2. **Unbiased industry data.** Comparable sales from a single source tend to show biases in the data. With a variety of data sources from around the financial services industry, the data relied upon for the comparative market analysis is less prone to such biases, providing a more accurate industry comparison

This guide contains our recommendations for building value in your practice based on current market conditions. It is designed to help you understand the four indexes used by SRG with recommendations under each of the four indexes evaluated: attrition index, financial quality index, client quality index and advisor demand index.

Attrition Index

The first step in determining the fair market value of a business is to determine the expected client retention after a sale has occurred. If the relationships are not transferable, there is little value associated with the business. Therefore, the first step is to analyze the business's Practice Risk and Client Relationship Risk relative to comparable sales to calculate the Attrition Index, which is used to estimate how much of the client base, AUM, and revenue is expected to be.

Branding

Change is hard – the fewer changes a client experiences during a transition, the better. Building a brand that is independent of the primary advisor creates greater continuity providing a smoother transition by reducing the number of changes, such as signage in the office, website, logos on statements, etc.

The long-term goal: When your clients are asked who their advisor is, they refer to your company and not you.

Understand the legacy you want to leave behind

Example: Joe Smith & Associates vs. ABC & Associates

Understand the impact of your brand on valuation & transition

Example: Joe Smith & Associates will likely result in name change, reduced continuity and lower value.

ABC Associates results in higher client name recognition and greater continuity, which leads to lower risk and higher value.

Business Value Assessment:

True	False	Statement
☐	☐	Your branding is tied to you/your name (website, business cards, etc.)
☐	☐	You are the primary "rain maker" bringing in business
☐	☐	Your clients primarily work with you
☐	☐	You make the investment recommendations for your clients
☐	☐	Your employees love working for you
☐	☐	You solve your client's and employee's problems

If you answered yes to 3 or more of these questions, its critical to make a concerted effort to create a business that is less tied to you.

Read the article to learn more about what this means:
Are YOU hurting the value of your business?
https://successionresource.com/blog/are-you-hurting-thevalue-of-your-business

Employees

Employees allow advisors to scale their business, but it is important to ask yourself the following questions for a variety of valuation related purposes. Employees are generally among the largest expenses, so make sure they are adding the value you expect from a buyer's perspective.

STAFFING

What are appropriate amounts of licensed and unlicensed stuff?

ROLES

What do they do for you/the company? Do you have defined roles and correct compensation?

PROTECT

Do you have employment agreements with your staff, and does it include restrictive covenants to protect the practice should an employee leave?

COMP

How are they paid? Is their total pay in line with the industry? Are they salaried or commission?

Financial Quality Index

After assessing the Attrition Index, the next step is to calculate the Financial Quality Index (FQ Index), which is an analysis of the revenue and other financial metrics used to begin making adjustments to the value of the projected retained revenue.

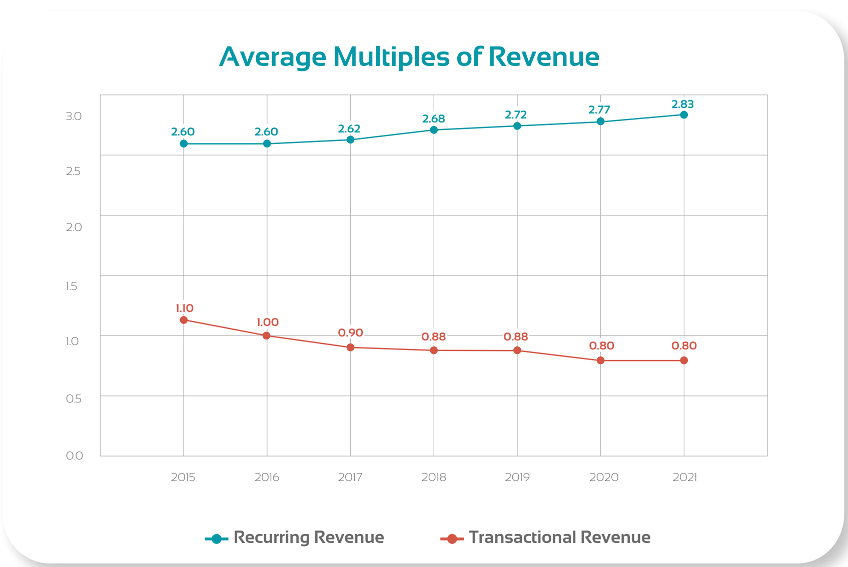
Revenue

Recurring Revenue

Recurring revenue (fees/trails/12b-1s/renewals) is one of the most valuable and influential factors in valuing an advisor's practice. Current recurring revenue rules-of-thumb are between 2.0 and 3.5 times an advisor's recurring revenue (see 2020 average below). The quality of the practice, combined with the type of recurring revenue, will determine where in the range your practice is. It is worth noting that not all recurring revenue is valued the same by buyers - 3rd-party managed assets often receive a slight premium due to the scalability for a buyer, as well as trails from A share mutual funds given the recurring nature and future opportunity to generate more revenue.

Predictability

Transactional or commission revenue is a one-time revenue event which holds very little value to buyers. Some transactional products are more consistent, such as individual stock and bond trading, REITs, and UITs, while others are less consistent/predictable, like life insurance and fixed annuities. Let's examine REITs as an example. You place your client's asset in a REIT. After a few years, the REIT matures, and the assets are invested in another REIT (or anything else in the client's best interest), generating another commission. If this cycle is maintained each year for a segment of your business, every year, REITs are maturing, providing a new revenue-generating opportunity for you or a buyer. In this example, you have turned your transactional revenue into a very predictable revenue stream for which a buyer would pay a premium. This same strategy can and is used in practices that focus on annuity sales, or individual stocks and bonds that are actively traded. There will still likely be changes from one year to the next, but if a buyer can see that your transactional revenue is with 10% +/- each year, you can now make a case for it being semi-recurring in nature and therefore having value.



Data Source: SRG Internal Data, January 2022

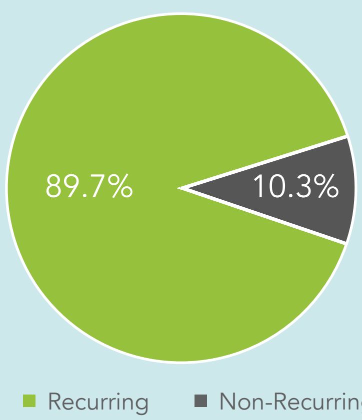
Financial Quality

Revenue (Cont'd)

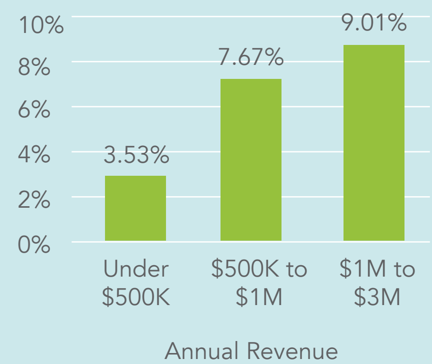
Diversity

Given the ever-changing regulatory environment and fluctuating markets, the stability of an advisor's revenue is critical to a buyer. Diversifying your book of business to include a variety of revenue sources can be a great way to ensure your business will retain its revenue and, therefore, value when the unexpected happens.

2021 Revenue
Recurring v.s. Non-Recurring



2020-2021
Revenue Growth Rate



EXPENSES

Three Major Takeaways

1. Keep fixed costs under 50% of revenue.
2. Avoid long-term payment structures (long-term leases or referral fees into perpetuity).
3. Work to eliminate any commission based compensation structures with employees, as this can greatly diminish the value of

Data Source:
SRG Internal Data, June 2020

Client Quality Index

The Client Quality Index (CQ Index) is used to adjust the post Attrition Index adjusted revenue and value based upon the overall quality of the client base being sold. This includes elements such as the age of clients, number of households, and size of client accounts.

Client Demographics

A.I.M

Age

Age is important, but advisors can't choose the age of their clients or make them younger. The key is knowing your book's demographics and identifying areas of concern. It is also key to understand which age group holds the assets and what is the perceived risk for a buyer.

Institutional Clients

Institutional clients such as retirement plans, municipalities, or endowments do not age, consistently add to accounts, and are usually "stickier" during a transition, reducing the risk for a buyer and therefore driving the value of the business up.

Multi-Generational Clients

You cannot build a multi-generational business in a day, but you can take simple steps to focus on multi-generational planning in an effort to reduce the risk for a buyer, such as focusing your multi-generational planning efforts on the top 5-10 older clients and making multi-generational planning part of the onboarding process.

Households

Concentration

Be aware of any significant concentration of assets with your top group of clients. Ensure these relationships are carefully maintained and transferable (client interacts with multiple points of contact at your firm, for example).

Number of Households

Track key performance indicators, such as # of households, revenue and assets per household, and households per advisor.

Pro Tip: The average number of households sold last year was 160. The fewer, higher net-worth clients, the better. If you have a large segment of clients with less than $100,000 in AUM, for example, be sure you are able to service this group profitably to maximize value.

Advisor Demand Index

The Advisor Demand Index (AD Index) is determined using comparable sales and SRG's expertise in representing selling advisors in a variety of markets. The calculation of the AD Index is based on the subject practice's state and metropolitan location, practice type, and a variety of other factors relative to the benchmark based on comparable sales.

Demand

Client Communication

Methods

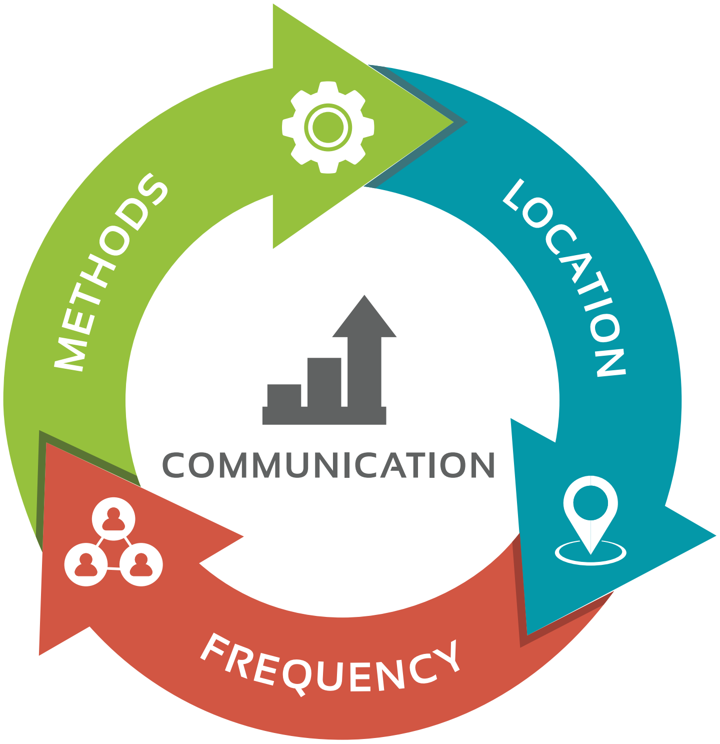
Communication is crucial to maintain advisor/client relationships. Face-to-face meetings, phone calls, emails, newsletters, client appreciation events, or birthday/holiday/ anniversary cards are just a few ways advisors communicate with clients. Working to streamline/ delegate/automate these methods will create more demand and therefore increase value.

Frequency

Face-to-face client meetings are important. However, to the extent possible, leverage more scalable methods of communication, such as telephone calls, emails, or video conferencing appointments to convey the same message while maintaining client relationships. This will create greater demand for the practice because the location of the buyer becomes less important.

Location

When face-to-face meetings are necessary, ensure these meetings occur in the office rather than clients' homes or other locations (restaurants, social events, etc.). The value is greatly diminished if a buyer will need to travel to each client, and the discount can be significant if there are a large number of clients. Focus on helping the buyer create scale, and your valuation will be higher.



Conclusion

1. Focus on maintaining your growth rate until you finally sell

2. The more recurring revenue you have, the greater value you will receive

3. Diversify your revenue sources to the extent it makes sense

4. Clean your P&L up years before selling, focus on driving profitability

5. HR - Update job descriptions and employment agreements with key employees and ensure you aren't overpaying

6. Do client segmentation regularly; transition smaller accounts away

7. Leverage technology - document and create systems/workflows to create a more transferable business

8. Communicate regularly and consistently with clients, but make it scalable

1. **Benchmark your business,** what's measured improves!
2. Use technologies and tools available to build a scalable practice

3. **Value** the business annually

4. Hire coaches to help provide strategic recommendations, hold you accountable, and help you increase your value.

5. Complete (bi-)annual **compensation research studies** for your employees

6. Start a **succession plan** to promote internal growth and staff retention

7. Stay compliant (DOL, FINRA, SEC)

***Items in bold are services offered by SRG**