

## Valuing Your Financial Planning Business

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### 1. Observations on the Present Market for Financial Planning Businesses

In the past few years I have helped quite a few people sell their financial planning businesses and I have advised others on purchases. I have also spent a lot of time valuing businesses and I am constantly surprised at the naïve view that business owners have about value.

It is so common to hear the financial planner say that he wants three times recurrent income for his business. This completely ignores the cost of producing that income. Most financial planning businesses are small enterprises but they are generally offered for sale as a going concern. In this case, the purchaser is going to look at the return he will make by investing his money in the business. In simple terms, what will be my net profit after I have paid the business expenses and after I have been paid a salary? The purchaser will then make a judgement as to whether this is a good investment.

The multiple of recurring income method places a value on the recurring income stream with no regard for the cost of producing it. This is only valid if a business is going to buy the client base and merge it into their own cost structure. Then there is a case for ignoring the seller's cost structure. However, the true value of an income stream must account for the cost of producing it and therefore capitalising EBIT (net profit) provides a valuation of the whole business. (In reality a purchaser is buying the future earnings of the business and therefore a valuation should be based on capitalisation of future maintainable earnings.)

The problem that most sellers have is that their businesses are often not well managed and little thought has gone into positioning them for sale. Consequently many small financial planning businesses are not very profitable. Because of this I can understand why the owners want to value according to recurrent income. When I point out that their valuation methodology is flawed, their response is usually that practices are selling for three times recurrent income and therefore that is market value. Are they? Client bases might sell at that level but businesses generally don't. The next response is that I can get more than that on my Licensee's buyer of last resort provisions. Can you? I recommend that they take it.

With all of that aside, we are in an interesting part of the evolution of the financial planning industry. Most financial planning businesses have reached a stage of maturity where their growth has plateaued. The business owners are generally around 50 years old, and they have built the business from scratch. They are also generally good financial planners and marketers but not good managers. So these businesses are often not managed to their potential. To take them to their next level of growth and value, the businesses need to become efficient and profitable. The skills needed to do this are different from the entrepreneurial skills needed to start the business and get it to this point. This is why practice management expertise has become a focus in recent times. Most large Licensees are now offering practice management advice as part of their value proposition and we have also seen a proliferation of business coaches emerge. This is all a reflection of the need for efficient management of these small businesses.

Why are the business owners accepting the need for better management? They know that by investing in management, they will grow their businesses and in three to five years from now, they can sell at a higher capital value. This is an interesting observation in the context of today's market for financial planning businesses. Every week people who want to buy a business contact me. However, there are few businesses for sale. This is a seller's market. Demand exceeds supply. This is a good time to sell. I think that the equation will change in the future as a lot of small businesses come on the market. This is likely to happen because the demographic of business owners suggests that they will be thinking about retiring and I know that very few of them have a realistic succession plan.

I have been talking about the small end of the market, the financial planning practices. Looking at the big end of town is also interesting. Why do institutions buy financial planning businesses? The mantra is that they are buying distribution. But are they? The culture of financial planners is that they see themselves as independent and representing the best interest of their clients. Consequently their common reaction when an institution buys their licensee is to be very wary of using the owner's product lest their clients and peers see them as biased. In 2004 Challenger had to acknowledge that Associated Planners would be independent in their choice of product. Therefore Challenger did not buy distribution.

Generally large financial planning businesses are not very profitable. Most are losing money or are marginally profitable. The profit centres in financial planning are the margin on product and the financial planners who earn a good income and build a small business of value. In between you have the distribution business, the Licensee. So why would you buy a Licensee if it is not very profitable and there is no guarantee of distribution into your product?

One of the characteristics of the financial planning businesses that have been bought by institutions is that they consist of a head office licensee and a number of independently owned small financial planning practices operating under the licence. When the institution has bought the business, they have no equity in the individual planning businesses associated with it. These independently owned businesses produce the cash flow. A smart new owner will contract the associated financial planning businesses for a defined period of time. This does not always happen and the new owner can be very disappointed to see some of the funds under management that they purchased, transferred elsewhere if the independently owned businesses leave. This raises the interesting question of how you value a financial planning business when the cash flow producers are independently owned.

It seems as though the decision-makers in these large corporations don't understand the financial planning business. They don't understand that it is not about numbers, it is about relationships. I think that the banks are learning that a banking relationship with a client is transactional but a financial planning relationship is influential. A financial planner can influence the distribution of a client's financial resources. This is a valuable relationship. The large corporations need to understand that when they buy a financial planning business, they are not acquiring the client relationships. These exist between the individual financial planner and the client, not between the Licensee and the client.

The corporations can achieve their objectives but they need new thinking.

## **2. Valuing a Financial Planning Business**

Financial planning businesses are typically valued according to one of two methods. The most common method is to apply a multiple to the recurring income of the business. The other is to apply a multiple to earnings before interest and tax (EBIT). The multiple of recurring income places a value on the recurring income stream with no regard for the cost of producing it. This method is only valid if a business is going to buy the client base and merge it into their cost structure. Then there is a case for ignoring the seller's cost structure. However, the true value of an income stream must account for the cost of producing it and therefore capitalising EBIT (net profit) provides a valuation of the whole business. (In reality a purchaser is buying the future earnings of the business and therefore a valuation should be based on capitalisation of future maintainable earnings.)

The real issue is what multiple to apply to either EBIT or the recurrent income.

### **2.1 Multiple of EBIT**

Surveys have shown that the expectation of the operators of financial services businesses is that they will earn 20% net profit (EBIT) on gross earnings. This will be a well organised, efficient

business with good systems and processes. So you would value this business on a multiple of 5x EBIT. However recent sales history over the past two years has shown that businesses have sold on an average EBIT multiple of 6x.<sup>1</sup> In my opinion, this multiple reflects a premium due to the shortage of supply. When I am valuing a business I will apply a discount or premium according to qualitative issues within the business.

Care must be taken when you look at the profit and loss statement provided by a business owner. It is common for small businesses to include private or non-commercial expenses in the business. I generally have to adjust the profit and loss to calculate a commercial arms length EBIT.

## **2.2 Multiple of Recurring Income**

In the financial planning industry, client bases often sell on a multiple of recurrent income. This reflects the fact that the purchaser is actually buying the rights to the income generated by the client base.

Recurrent income is the amount of income received by the business in the previous twelve months where that income is of a recurring nature. This includes asset commission, life insurance servicing commission and recurring fees for service. Recurrent income excludes fees or commissions received for once only events. Therefore recurrent income excludes plan preparation fees and implementation fees and commissions.

The qualitative judgement is what multiple to apply to recurrent income. In my experience practices have typically sold on multiples in a range from 2.5x to 3.5x. However recent sales history over the past year has shown that businesses have sold on an average multiple of 3.3x.<sup>2</sup>

## **2.3 Indicators of Value**

As an indicator of value, and as a reflection of recent transactions, here is a guide to the value of a financial planning practice. The following descriptors give a rule of thumb value for the sale of a client base based on a multiple of recurring income method and the sale of a business based on a capitalisation of earnings method.

### **Value = 3.5x Recurring Income or 7x EBIT**

- This will be a premium business.
- Database will be segmented and well organised in electronic format.
- Services will be defined, priced, and relative to segments.
- There will be a systematic and organised process for delivery of service.
- There will be a systematic and organised process for client reporting and review.
- Client agreements will be in place where clients have agreed to a defined service and price.
- Business uses management information systems as a management tool.
- Business controls its income and margins and has the ability to replace asset commission with fees.
- There will be no problem in transferring client relationships to a new owner. This will reflect the fact that the client understands that they are being serviced by the firm, not an individual.

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<sup>1</sup> Source: Stephen Prendeville of Kenyon Prendeville, 18th August 2006

<sup>2</sup> Source: Stephen Prendeville of Kenyon Prendeville, 18th August 2006

### **Value = 3.0x Recurring Income or 5x EBIT**

- This will be a business that is slightly less than the average.
- Database may not be segmented but review clients will be identified.
- Services are not defined for all clients.
- Larger clients are reviewed and charged, smaller clients are dealt with on an ad hoc basis.
- Business has processes in place for reviews and other services but these may not be clearly defined.
- Review clients may have signed client agreements, others have not.
- No management information systems.
- Mixture of fees and commission.
- Generally speaking, review clients may be transferred but others are unknown.

### **Value = 2.5x Recurring Income or 4x EBIT**

- This will be a less organised business.
- Database will not be segmented and may not be up to date.
- Many clients will receive no service at all.
- Service will be largely ad hoc although best clients will be reviewed.
- No client agreements.
- Processes are informal meaning that they are known by staff but not documented.
- No management information systems.
- Largely commission income.
- Client relationships tend to be with an individual and this makes transfer to a new owner difficult.

## **3. Positioning Your Financial Planning Business for Sale**

You should always manage your business as though it is for sale. Understand the factors that add value to your business and focus on them in your day to day management. Adding clients does not create value in itself. You need to deliver consistent service and value to your clients to create strong relationships with your business. This adds value. Here are some value issues that I have observed with many financial planning businesses.

### **3.1 Service and Pricing**

The most common flaw I see in financial planning businesses is that they have not addressed service and pricing. This is fundamental to the value of your business because it impacts on the amount and quality of recurrent income.

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| Step 1 | You need to segment your client base according to the income delivered to your business by each client. |
| Step 2 | You need to define the service that you will deliver to each segment.                                   |
| Step 3 | You need to calculate the cost of delivering the defined service.                                       |
| Step 4 | You can then determine what pricing you should adopt for each segment.                                  |

It is essential that you deliver consistent service to each segment and that this is valued by your clients. This will create quality relationships and strong recurrent income streams.

### **3.2 Make Yourself Dispensable**

The value of your business ultimately depends on your ability to transfer client relationships to a new owner. If the maintenance of client relationships is dependent on you, then you have not only placed a limit on the income of the business, you have also increased the risk of not being able to transfer the relationships to a new owner. You need to ensure that the clients have a relationship with a team of your staff that delivers service. Then the client will perceive that they have a relationship with the firm, not an individual. It will be easier to transition to a new owner of the firm.

### **3.3 Run your Business Profitably**

A profitable business is more valuable than a marginal business. It is also a measure of business efficiency. The purpose of running your business is to make a profit and you should show a purchaser that your business achieves its goals. I see many businesses that are grossing \$1-2 million with EBITs of 5% of gross income. The most common problem, apart from service and pricing, is that they are often over-staffed. The most common response to this observation is that they are positioned for growth. However, when I look at them in a year's time, they are still over-staffed.

### **3.4 Management Information Systems**

Keep good financial records. Produce monthly financial statements measuring actual performance against budgets. Monitor key ratios and graph trends so that you can see if you need to take corrective action. Being able to produce good financial and management information for a prospective purchaser makes a big difference in the qualitative view of your business. Make sure that all processes in your business are documented.

## **4. Transitional Issues**

As I am talking about the sale of businesses it is worth a comment on the transition from one owner to the next. Quite a number of people have used me as an adviser in their negotiations to sell and purchase businesses. Reaching agreement on price is the easy part. The art in a successful transaction lies in negotiating the transition of the business. These transactions normally include a deferred payment that will be adjusted to reduce payment for clients that did not make the transition to the new owner. After all, the purchaser does not want to pay for a client who did not stay. At issue is how do you define when a client has transferred to the new owner? How do you transfer client relationships without disturbing the client? There are a host of other matters to be agreed between the parties before the transaction can take place.