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Top 10 Drivers of Business Value

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The value of your practice is determined by many factors, some obvious, and some not so obvious. Even if the idea of exiting the business is far down the road, as an owner you need to consider the ten factors below as part of managing and growing the practice. Focusing on these areas can make a major difference in your book's sustainability and its eventual purchase price (when transition time arrives).

The purpose of this article is not to review the theoretical aspects valuation or create an exhaustive list of factors that influence your value. That would be a much longer, technical article–which can be viewed here. The point here is to highlight the drivers that can help give your value an extra boost in the right direction. These factors include:

1. **Predictable revenue and recurring revenue streams**
2. **Client demographics**
3. **Average client tenure**
4. **Size of potential market**
5. **Transition timing**
6. **Client affluence and average client revenue**
7. **Asset or revenue concentration**
8. **Use and structure of referral fees**

9. Length of surrender period
10. Profitability

As you look at your practice with an outsider's eye, you will see avenues that help grow the business and make it more robust.

1. Predictable Revenue

The most significant—and perhaps most obvious—value driver is revenue. Consider where your revenue is coming from and the predictability of each revenue stream. A thorough valuation will examine not only whether a revenue item is recurring, but will analyze the source itself. Look at historical returns and whether the products generate predictable revenue, year after year, or a periodic return that occurs every few years. Nothing will diminish value faster, especially at the end of a career, than taking upfront commissions that leave little opportunity for a future buyer. Think about it. Would you rather buy a business generating a constant, stable income stream, or one that has the majority of its assets locked up for 3-5 years?

2. Client Demographics

Client demographics are another important factor when it comes to the value of your business. For valuation purposes, demographics focus primarily on the ages of your clients, as a proxy for when clients tend to have the highest capacity for invested assets and personal income. Client demographics also paint a picture of the quality of the assets you manage, inferring client tenure as well as potential growth. Certain age groups statistically represent a larger accumulation of high value assets, in both the short and long-term. It's generally accepted that clients within the 50-70 year age bracket are at the peak of asset accumulation; their relationship adds significant value to your current book.

However, do not ignore other age groups. For instance, senior clients (71+ years) may have larger dispersals, but also tend to generate high fees in the near term. Senior clients can also add an element of sustainability to your practice by introducing you to their heirs. Younger or "next generation" clients (30-50 year range) may not add much current revenue to your practice, but they contain the seed of long-term growth. Be careful with "best" management practices that encourage you to only keep "A-Clients." Well-balanced client demographics enhance your practice's current and projected values.

3. Average Client Tenure

While it may not seem obvious, client tenure is directly related to post-transition client retention. Households who have recently joined an advisor may be less inclined to stick around through a transition. However, clients with a long-term relationship tend to stay with their trusted advisor's handpicked successor. The existence of loyal client relationships can play a big role in determining your deal structure, especially the balance of down payment to long-term financing.

4. Size of Potential Market

How you define the market for your business causes significant ripple effects down to your value. Your market controls your exposure to potential buyers, which affects the demand for your practice, which impacts the competition over your purchase price. There are many ways to define the market for your practice, such as by affiliation or geography. Any limitations on your market, for example related to regulatory structure or product focus, should be balanced by qualities that support retention—for example with a broker-dealer or insurance company who will facilitate the transition. Regardless of your restrictions, you need to look for buyers that you feel would be a good match for your clients.

5. Transition Timing

If you *are* preparing to sell your practice, consider any recent changes before talking with buyers and committing to a timeline. A recent acquisition, shift in BD network, conversion to RIA, or restructuring of fees and services could have an impact on the transition of your practice during a sale. Major modifications like these require a "curing" time to let the business and clients settle into the new situation. Jumping into a sale too soon after a large change could destabilize your post-sale client retention and elevate the transition risk. The key here is stabilizing the client relationship to preserve value.

6. Client Affluence and Average Client Revenue

While seeking high net worth clients may seem like an obvious growth strategy, it is worth exploring why this has a compounding effect on your overall operation. A client base composed of high net worth clients has a stronger fee profile and better long-term growth and stability. Businesses with high per-client revenues tend to have less demand for significant infrastructure, such as support staff or expansive office space, to maintain client relationships, and so have higher profitability. This translates to higher values. In contrast, practices with many smaller, less affluent clients often have higher overhead and higher expense drag.

7. Asset or Revenue Concentration

When courting HNW clients, be cautious of creating concentration risk. Revenue concentration risk occurs when an outsized percentage of your revenue is generated by a small number of clients. FP Transitions' valuation model calculates revenue from the top 10% of clients (ranked by number of households) compared to total revenue of the practice. If the concentration is abnormally high, market value dips.

8. Referral fees

New client growth bolsters value and offering referral fees to colleagues can be an effective tactic to grow your business in this area—if the fee structure makes sense. A common referral fee structure that works well is paying a percentage of revenue (if allowed) for a limited period of time, two years or less. For fixed fee referrals on larger accounts, it may be beneficial break up payments in order to normalize cash flow. However, paying referral fees into perpetuity creates a long-term obligation that must be assumed by a buyer. This arrangement can reduce practice value—prospective buyers don't generally want to take over a permanent expense they didn't agree to and can't control.

9. Length of Surrender Period

If you sell annuities and take up-front commissions—or take larger commissions and small trails—try to minimize the length of the surrender period. Most buyers will consider an acceptable surrender period to be 1-2 years, on average. Assets that are tied up well into the future, and that produce minimal current revenue, present little opportunity for a potential buyer. A long timeframe on surrender tends to diminish value.

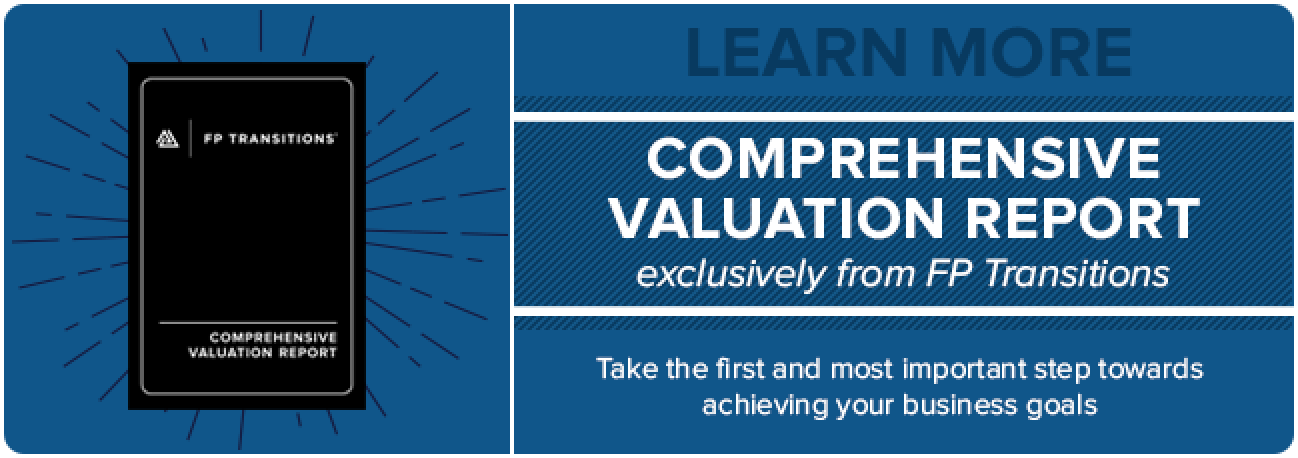
10. Profitability (for larger businesses/firms)

For many practices, market value is driven by top-line revenue—predictable, reliable income sources that can be transferred to another advisor. Expenses are only important when they are passed on to a buyer (as mentioned with perpetual referral fees, or items like a long-term lease) and, fortunately, most expenses can be eliminated in an arms-length transaction. However, as the business grows, pay attention to the bottom line.

Learn the distinction between compensation and profitability. Many advisors consider profit to be the same as compensation because, in a single-owner practice, they get to take all of the profits home at the end of the year. However, for owners looking to create a sustainable business, the focus needs to shift to bottom-line revenue as well—to net profit. A revenue sharing arrangement with an employee or office-mate may increase top-line revenue, but tracking the bottom line shows that the increased income is often offset by increases overhead—the compensation arrangement produces no net profit.

The initial impact will be academic—as a sole owner, you will continue to take it all home, just in different categories. The key is to show a history of profit. Eventually, the ability to generate revenue and control operational expenses will become a necessary metric to evaluate your key employees. Profit becomes especially important if you want to sell internally or recruit a successor to the business. Demonstrating a history of profitability is useful for incentivizing next generation owners, attracting outside investors, and securing financing for acquisition.

Remember, formal valuations are assessed in the context of its purpose, whether you're preparing to sell your business, litigating a partnership dissolution, transferring minority ownership stake, or simply tracking annual growth. Many advisors simply need a starting point. These factors can paint a comprehensive picture of your current position, which you can use as a benchmark for identifying and tracking your business goals.



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