Dispelling the valuation myths

March 2016

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1. Introduction

The way IFA companies are being valued has changed significantly.

The Beaufort Group, the national financial advisory and discretionary fund management firm, with assistance from corporate finance firm Asgard Partners and accountancy firm Taylorcocks, has researched and written this report on the real basis of valuation of IFA businesses in the UK.

In dialogue with many advice firms, there appears to be a disconnect between the expectations of how firms are valued and the reality of what is offered. Valuing a business in this sector is complex and company-specific and the expectations of both vendor and acquirer vary considerably. The report examines the reasons behind these differences and suggests how vendors should structure their businesses to realise their true potential.

The Beaufort Group
Established in 2012, the Beaufort Group has been created to address an increasing need for the provision of retail financial services advice and solutions:- the 'network' that isn't a network. The founding directors have devised a brand new model; a partnership of national or nationwide firms in which each partner has a stake in the group. The partnership is made up of 9 appointed representative firms, including an employee benefits specialist and a DFM business, which has some £490m under direct management in its range of model portfolios.
Website: **www.thebeaufortgroup.co.uk**

Asgard Partners
Asgard Partners is a corporate finance firm authorised by the FCA that specialises in the financial services sector. The firm is active in the IFA and wealth management market and has completed 26 transactions since inception in 2006, including both purchases and sales of IFA businesses and raising equity finance for them.
Website: **www.asgardpartners.co.uk**

Taylorcocks
Taylorcocks was established in 1996 and has maintained an impressive growth rate to become an Accountancy Age "Top 100" full service firm with 8 partners, 13 portfolio managers, 120 staff and 9 offices across central southern England. The firm provides a comprehensive range of accountancy, audit, taxation and business advisory services to over 2,500 corporate and private clients. The majority of clients are owner-managed SMEs plus some large multinational companies. Taylorcocks is the founding member firm of TGS Global, a "Top 20" (IAB/AA) international accountancy network.
Website: **www.taylorcocks.co.uk**

2. Executive Summary

The key findings of the report, which involved an analysis of recent deals (shown in Appendices i and ii), and the views of leading practitioners, showed that:

- Profits were considered more important than recurring revenue as a valuation basis
- Tempting but highly conditional offers may well leave vendors disappointed in the end
- Vendors continue to care greatly about the ability of acquirers to service their clients properly post transaction
- Limiting acquired advice risk remains a key concern for acquirers
- The ability to prove rigorous controls, advice processes and compliance greatly enhances value
- Value lies in a strong brand rather than a collection of adviser silos

The main methods of valuing an IFA business are multiples of profits, normally measured as EBITDA since that excludes the amortisation of goodwill, and of recurring revenue. In setting appropriate multiples, acquirers will factor in revenue and cost synergies over and above the intrinsic value of the business. High recurring revenue multiples remain justified only when:

- There Is a likelihood that client fees can be increased or funds moved to an in-house proposition
- An acquirer can realise substantial cost synergies, for example where premises can be closed and staff numbers can be reduced

Most IFAs have now increased their fees post RDR, so the original basis for valuing companies on high multiples of recurring revenue in the expectation of being able to increase on-going fees has disappeared.

3. How a business is valued

Detailed valuation usually involves building a model of future free cash flows. This incorporates expectations of savings in costs and increases in revenues that an acquirer might make. This free cash flow is discounted to a present value at an appropriate discount rate to reflect transaction risk (such discount rates appear to have increased recently). Provided an acquirer pays less than this figure, the transaction will be worthwhile.

Such models involve making many detailed assumptions. Changes in these assumptions can have dramatic effects on the end value and parameters can often only be determined after in-depth due diligence. Other approaches to valuation are therefore also examined, in particular considering appropriate multiples of a target's key financial results to value its goodwill and adding tangible net asset value.

There are 4 main valuation 'metrics' which we will explore in more detail. IFA businesses are typically valued on a multiple of:

- Recurring revenue
- EBITDA or other profit measure e.g. PBT or earnings
- Total revenue / turnover
- AuM

3a. Recurring Revenue

Typically, a 3x recurring revenue multiple was expected within a range of 2 to 4x depending on the quality of the business. This was usually predicated on moving pre-RDR 0.5% trail to newer charging models at up to 1% p.a.

Post RDR, high recurring revenue multiples only work for acquirers where:

(i) there remains scope to uplift fees (unless the acquired business is making substantial profits, such that the underlying profit multiple is also reasonable);
or
(ii) where significant other revenue or cost synergies are available.

This valuation metric suits the businesses of retiring IFAs, who are happy to hand over their clients to the acquirer that can then apply its own charging structure and operating model.

The consideration is usually paid on a partly deferred basis, typically 1/3 to 1/2 upfront with the remainder paid out in stages over two years or sometimes longer.

Issues with recurring revenue metrics

Crucially, the recurring revenue on which the multiple is paid is usually the amount retained at the end of the retention period, typically two years. The acquirer, reasonably, wishes to ensure that clients and associated revenues will stay post sale. However, there can be problems:

- If clients are asked to transfer to a new charging structure, the sellers will wish to ensure that this structure is reasonable and that the new investment and product selection methodology remains suitable for their clients.
- If there is leakage on transfer, e.g. clients prefer to take their business elsewhere because they may dislike the acquirer's methodology, the actual consideration received will be depressed.
- Recurring revenue offers may be predicated on the successful transfer of clients to an acquirers' investment process. Of course, if clients do not transfer then the offer price related to those clients may be nil!
- Acquirers may demand a move to a restricted proposition which may not be suitable for all clients and value will then be lost.
- Future remuneration arrangements for IFAs that remain are also important – poor terms will lead to defections.
- Acquirers may not pay cash - some offers may even be 100% in shares with uncertain value.

Is actually achieving 3x recurring revenues as total consideration still possible?

We believe achieving 3x recurring revenue is now largely a myth and that vendors are becoming accustomed to the change from a "3x recurring revenue" model – as we have said, this only works for a very strong opportunity where the acquirer can leverage more value post-deal. Gone are the days of heady multiples!

Even if such a multiple is agreed upfront, actually achieving it is unlikely as there will be leakage of clients and advisers over the earn-out period, and business and asset deals that are common but which require novation will cause fallout. Deal incentives that require the transfer of AuM may fall foul of inducement rules.

3b. EBITDA / Profit

Profit-related valuations are usual for most M&A transactions. Value can be attributed to existing profits, rather than expected future profits from a change in the business model.

It can be hard to establish a "normal" EBITDA multiple as most IFA transactions are private and the terms are not disclosed. There are a few listed IFAs (e.g. AFH Financial) but multiples are high based on expected future growth rather than actual current EBITDA, and there is usually a limited free float (i.e. freely tradeable equity), so these are not necessarily representative.

A normal range for transactions could be set at 12-14x EBITDA, based on precedent transactions which can be analysed and other data (such as the 2015 typical multiple from Thomsons for all disclosed 2015 UK transactions across all sectors of 13.3x). However, a significant discount could be expected for small transactions reflecting lack of liquidity compared with large companies. (Please see Appendices i and ii).

BDO publishes a quarterly market average exit value based on private company transactions and, for Q4 2015, the value was 10.9x (almost a 20% discount to the wider market value, reflecting the liquidity discount – 20-30% discounts are normal). Therefore, 10x EBITDA may be assumed as an average exit multiple for a 100% sale, with a range expected based on the quality of the underlying business. The EBITDA should be reduced if necessary to include an allowance for directors' pay in lieu of dividends post deal. The calculation results in an enterprise value (EV), being the sum of the equity value belonging to the shareholders plus long-term debt less cash (in excess of that required for working capital).

Issues with EBITDA/profit metrics

Whilst EBITDA/profit multiples are more concrete, problems can arise:

- If existing profits are low, offers may require an uplift in profits over an earn-out period for the full value to emerge, leading to issues regarding the suitability and possible client acceptance of such changes and the achievability of forecasts.
- Acquirers may not pay wholly in cash. Some share-based consideration may be suitable, but the sellers will wish to know when and how shares of the acquirer can be cashed in, and at what value. Share-based consideration is more attractive when the sellers can see concrete future value above accepting cash – otherwise, it is just a mechanism for the acquirer to avoid having to pay out cash and value may be illusory or at least disappoint compared with the headline consideration figure.

3c. Total Revenue/Turnover

In the absence of known profit or recurring revenue on which to price the business, total revenue may be used as a valuation measure. Valuation is often focussed solely on recurring revenue, but there is value in new business. Otherwise a firm with no new business and 100% recurring revenue would be worth the same as one with the same recurring revenue but producing substantial new business - a sign of a healthy business.

The metric is also useful as a valuation measure since data can frequently be obtained via company accounts unlike recurring revenue figures.

Multiples of EV to revenue for listed companies are of the order of 2.5x, with similar values for completed deals (although there is a wide range). If you assume that IFAs typically have about 90% recurring revenue, the implied recurring revenue multiple is then 2.8x.

Issues with total revenue metrics

Whilst revenue is one measure, it shouldn't be relied on without detailed thought:

- Potential over-valuation can occur if the business is not profitable (a business should be worth the discounted value of its future free cash flows).
- Prospective acquirers will be naturally cautious about purchasing on a total revenue basis alone, without substantial cost synergies to increase the underlying profit.

3d. AuM

IFAs are primarily advice businesses rather than asset managers. However, some have introduced a centralised investment process and gained discretionary permissions. This means that the asset management element of the company can be valued like a separate business and it is appropriate to consider common metrics used to value such companies, typically 2-3% of AuM.

The multiples of EV derived from the Appendices to this report (see pages 15 and 16), give 2.1-2.4% of AuM as representative. But higher quality businesses can attract premium multiples of over 3%. This assumes discretionary permissions rather than the common advisory ones (or even AuI where the IFA has no input to the management of the funds).

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4. Some offers are not what they seem

Whilst acquirers tend to publish a high headline price, what is actually received is often watered down as the deal develops. Final consideration is linked to recurring revenue at the end of the earn-out period, but this is uncertain as staff and clients may move on, particularly if the operating model is changed significantly.

The devil is often in the detail, or better still the proof of the pudding is in the eating – and digestion of the acquired business!

- Many offers are structured as 'business and assets' deals to avoid the acquirer taking on liability for past advice. This means that entrepreneurs' relief is unlikely to be available.
- Final consideration is normally linked to retained recurring revenue at the end of the earn-out period. This poses a risk as the sellers may not have much control over the retention of recurring revenue, as the new company will be in charge by then. Retention of client-facing staff is also key.
- Payment of consideration may be linked to the transfer of assets to the acquirer's DFM offering, or advice fee structure, or both, which may cause fallout in retained revenue. Due to issues with inducement rules, movement of AuM may only be possible under a restricted regime. However, there are models that exist that are not just focused on AuM, and have set very clear KPIs as to how consideration can be achieved, whilst retaining independence.
- Consideration may be payable in shares (of uncertain value) and may even be linked to some uncertain future event (such as the acquirer successfully completing an IPO to raise the monies to pay for the deal).
- Restrictive covenants may lock in advisers on punitive terms. Consideration can be diverted from the vendors to a bonus or retention scheme for the advisers.
- There may be a move to a restricted advice model, but this may not properly serve all the clients.
- There will be due diligence on all of the metrics of an acquired business. In general, whatever metrics are agreed to be measured in respect of an earn-out, performance is likely to be lower than expected post deal.
- Fundamentally, does the acquirer have the credibility to finance the deal?

The upshot is that a headline figure is only one parameter in considering a deal and vendors should not be blinded by that, if the offer is highly conditional.

5. The shift away from recurring revenue multiples

Vendors are still fixed on recurring revenue as the prime valuation metric, as it typically produces a high exit multiple as compared with, say, a more traditional EBITDA or profit-based metric.

A deal based on recurring revenue may work in the case of the retiring IFA, or a relatively small deal where the business is folded in. For bigger and more complex deals, where the purchase is dependent on retaining advisers and clients whilst saving on back office and admin costs, there is a shift away from recurring revenue deals.

In particular, for retiring IFAs, the recurring revenue metric can work provided there are meaningful synergies for the acquirer, typically subsuming the acquired firm wholly so that both premises costs and salary/dividend costs of the principals are lost. The acquiring firm will also seek revenue synergies such as increasing fee scales and gaining DFM revenues from acquired AuM/AuI and probably reducing head count.

For larger deals, recurring revenue deals are rare as it becomes harder to achieve the level of synergies required and the execution risk increases with scale.

With larger businesses, the acquirer will typically wish to retain all the IFAs (aside from the retiring sellers/principals). This introduces another dynamic as some incentive may need to be paid to those IFAs they wish to keep on to ensure their loyalty, an incentive that will reduce the consideration available to the vendors.

Therefore, larger deals are more usually priced using EBITDA or profit-related multiples.

6. Discretionary management, not AuI

For many IFAs, their main source of fees is from recurring revenue linked to the assets of their underlying clients. There are various types of AuM/AuI:

- Assets under discretionary management (either in-house or outsourced)
- Assets under advisory management (where discretionary permissions have not been obtained)
- Assets advised on, but not directly under the IFA's control e.g. funds with life companies or locked into particular products for tax purposes and held elsewhere – Assets under Influence

Many IFAs do not track AuI as it is the associated revenue that is important to them, and such assets may be "locked in" i.e. not transferable to in-house investment solutions without detriment to the client.

The highest quality assets are those under discretionary management i.e. the client has ceded control of those assets to the IFA (or an external manager). Regarding valuation, clearly a higher weight should be given to such assets, particularly those managed in-house where the IFA has a solid stream of high-quality recurring revenue.

Valuation ranges are typically 1% - 3% dependent on quality and composition of assets. How they are managed and the robustness of the process itself will also play a factor in the deal.

Discretionary	Vs	Advisory
True DFM		Higher cost = lower valuation
Sticky clients		Loyal client bank?
Periodic rebalancing easy		Onerous process

Assets under Influence are managed by external parties so the value does not accrue in the main to the IFA. They are often tricky to value as even accurate quantification can be hard as AuI might not be recorded on underlying systems.

7. The value of repeatable processes and structured management

The financial statements of a business only give so much information. The quality of a business is also in the underlying **processes** and the quality of **management**, which are more intangible but equally important and will affect the business value greatly.

- Most large, well-structured businesses will support the implementation of proper segregation of duties and a dedicated management group, as opposed to a small business where the principals typically run the business whilst being primarily responsible for revenue generation, and who may pick their CEO for sales rather than overall management capability.

- The quality of the advice process is defined by the underlying processes and checks which support and underpin it. This includes the quality of IT such as CRM software.

- The depth of investment management expertise is also key. Platforms have allowed many IFAs to run 'best-of-breed' fund-based portfolios for their clients with the help of tools or outside support for asset allocation and fund selection. Some smaller IFA businesses without a coherent overall framework may run a significant risk of inappropriate customer outcomes as a result.

8. Building value in the brand, not the individual adviser

Building a brand and building value into the brand is very important. A business with a well-known name, respected reputation or a top position within its competitive arena will add value to the potential business sale.

For small owner-operators, the individual advisers are the brand – there is often little or no distinction between the advisers and the business. But, as it grows, all too often advisers seek to control the client relationship, for reasons of self-preservation, a natural reaction perhaps. If the adviser leaves with a book of clients pre- or post-sale, even if restrictive covenants are in place, the brand suffers. This is particularly the case with self-employed advisers who use the infrastructure of the firms but can effectively run their own underlying book of business within it.

Building value in the brand involves:

- Ensuring various points of contact with a client so the adviser is not their only connection. Firms must ensure that the adviser doesn't "hoard" clients and that relationships are formed between the clients, paraplanners, administration, support staff and so on (within regulatory constraints). The latter should be in the position to manage the day-to-day running of the advice process.

- Forming a repeatable and structured advice process involving competent and professional paraplanners and other support staff so that advice is provided as part of a firm-wide system rather than an individual.

- Building a structured investment proposition so that, again, a repeatable process is put in place where the adviser introduces the clients rather than manages the money. Without this, costs become disproportionate.

- Good use of technology to capture details about client circumstances and client interactions and the reasoning behind advice decisions. This also allows an easy transfer of responsibilities if an adviser moves on and is imperative in the regular review process and as part of a strong compliance culture. IT and CRM systems need to be of a high standard so that the administration can run smoothly and be easily evaluated.

9. Summary

For the vendor

Selling a business requires serious consideration of the type of partner that vendors are happy to sell to, mainly for the sake of the clients and continuing advisers. The vendors want to be able to continue to look their clients in the eye.

- Headline price is of course vital, but the terms and conditions are equally important and should be examined carefully as part of any assessment of an offer. Highly conditional offers are unlikely to meet vendor aspirations.
- A deal that allows entrepreneurs' relief on qualifying assets is an important consideration (i.e. paying tax at 10% on capital gains rather than the normal rate of 18% or 28%).
- Some are 'mirage' offerings predicated on future IPOs or trade exits.
- Deals are now being priced more commonly using EBITDA or profit-related metrics.
- Recurring income isn't the only driver - new business levels, AuM and overall growth potential are just as important.
- Can a business clearly demonstrate its 'levers and buttons'/unique selling point?
- Soft factors such as depth of management, quality of processes and infrastructure, and whether the value lies in individual advisers or the brand, are critical in assessing the value of a business, as well as the actual financial results.

For the purchaser, it is important that, as well as considering the financial position of the business:

- There should be a depth of management and support staff.
- Infrastructure, processes and systems should be robust and support repeatable results.
- The value should lie with the brand, not the individual adviser.
- Advice risk should either be factored into the price or taken out of the equation.

And finally, *what does the vendor achieve or realise? What are the 'new world' realistic end prices for businesses post any earn-out?* Based on companies up to £5m valuation, here are our conclusions:

	LOW	MEDIUM	HIGH
Multiple of EV to EBITDA	5x	9x	14x
Multiple of recurring income	1x	1.8x	3.1x
Assets under management (Discretionary)	0.9%	2.1%	3.1%
Assets under influence	0.2%	0.5%	1%

Appendix i

Comparable company valuation

£m	EV	EV /Rev	EV /EBITDA	EV /PBT	P/E 2014 A	P/E 2015 E	P/E 2016E	EV /AUM
AFH Financial	41	1.9x	15.6x	n/m	n/m	23.6x	12.1x	2.3%
Brewin Dolphin	629	2.2x	9.0x	10.3x	15.9x	15.2x	14.9x	1.9%
Brooks Macdonald	223	2.9x	14.1x	19.5x	20.0x	18.8x	17.3x	2.8%
Charles Stanley	113	0.8x	6.1x	17.0x	18.8x	22.4x	14.1x	1.0%
European Wealth	20	2.7x	n/m	n/m	n/m	n/m	10.7x	1.7%
Frenkel Topping	40	n/m	26.5x	26.8x	24.7x	31.3x	25.5x	n/m
Mattioli Woods	139	3.7x	18.6x	25.7x	22.7x	22.3x	20.3x	2.1%
Rathbone Brothers	1,044	5.1x	n/a	13.5x	21.2x	18.6x	17.0x	3.6%
St James's Place	4,748	n/a	17.2x	16.5x	25.7x	31.3x	23.8x	n/a
Tavistock Investments	11	0.6x	n/m	n/m	n/m	n/m	22.7x	n/m
	Mean	**2.5x**	**15.3x**	**18.5x**	**21.3x**	**22.9x**	**17.8x**	**2.2%**
	Median	**2.5x**	**15.6x**	**17.0x**	**21.2x**	**22.3x**	**17.2x**	**2.1%**

Note:
EPS estimates have been converted to a calendar year-end where necessary
Data as at 3 February 2016

Appendix ii

Precedent transaction valuation

Target	Acquirer	Ann. Date	EV (£'m)	EV/Rev (x)	EV/EBITDA (x)	P/E	EV/AuM
Rowan Dartington	St. James's Place	Jul-15	33	4.3	n/m		3.3%
7IM	Caledonia	Jun-15	98	2.3	11.3	14.9	n/m
Ashcourt Rowan	Towry	Mar-15	110	2.7	21.5	21.5	4.6%
Barker Poland Asset Man.	Walker Crips	Mar-15	4	2.6			1.8%
Quilter Cheviot	Old Mutual	Oct-14	517	4.2	23.9	27.0	3.2%
IFG Financial Services	Ascot Lloyd	Aug-14	8	1.9			n/m
DPZ Capital	Brooks Macdonald	Apr-14	12				2.7%
Jupiter private clients	Rathbone Brothers	Apr-14	43	3.6			2.1%
Tilney London	Rathbone Brothers	Apr-14	14	0.0			2.0%
JO Hambro Inv. Man.	Somers/Management	Mar-13	50	2.0	7.3		1.4%
Cazenove Capital Man.	Schroders	Mar-13	311	2.8	8.7		1.8%
Newton private clients	Standard Life	Feb-13	84	4.2			2.3%
Spearpoint	Brooks Macdonald	Nov-12	27	2.4			2.5%
Taylor Young	Rathbone Brothers	Nov-12	9	3.4			2.7%
Cheviot LLP	Quilter	Oct-12	85	3.0	n/m		2.1%
Quilter	Bridgepoint Capital	Jan-12	150	1.9	14.1	13.2	2.0%
Cavanagh	Close Brothers	Apr-11	24	1.8	n/m		1.7%
			Mean	**2.7**	**14.5**	**19.2**	**2.4%**
			Median	**2.6**	**12.7**	**18.2**	**2.1%**

Glossary of terms

AUI	Assets under influence
AUM	Assets under management
CEO	Chief Executive Officer
CRM	Client / Customer relationship management
DFM	Discretionary fund manager
EBITDA	Earnings before interest, taxes, depreciation and amortization
EV	Enterprise Value
FCA	Financial Conduct Authority
IFA	Independent Financial Adviser
IPO	Initial Public Offering
M&A	Mergers and Acquisitions
PBT	Profit before tax
RDR	Retail Distribution Review
SME	Small or Medium-Sized Enterprise

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