Acquisitions & Mergers
Valuing a Financial Planning Practice

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I spend most of my time advising financial planning and accounting practices on how to re-position their businesses for increased profitability and growth. As a result of this I am often asked to assist with the purchase or sale of a financial planning business. It is interesting work because I see many different businesses and analyse their qualitative factors and advise my clients on purchase /sale negotiations and transitional issues.

Anecdotally I am finding that there is an increasing number of financial planning practices being offered for sale. Two years ago it was hard to find a business for sale. Today, acquisitions are becoming a common growth strategy for financial planners. The interesting aspect of this is that it is not the institutions that are buying these businesses. Most acquisitions today are financial planning practices buying other financial planning practices. These transactions are being financed by either private funds, institutional dealers, National Australia Bank or Macquarie Bank. The two banks offer cash flow lending which means that they will lend on the security of the business. Of the two, Macquarie appears to have the larger market share in the financial planning industry. I am often asked how do you place a value on a financial planning practice?

Financial planning businesses are 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.)

Where two businesses are looking at merging as opposed to one taking over the other, I have found that the most equitable way to value each business is to use a discounted cash flow analysis of expected future earnings of each business on the basis that they continue their present strategies without the merger.

I am finding that buyers are becoming more discerning when they are evaluating a business. Where two years ago almost no one questioned a value based on a multiple of recurrent income. Now buyers are looking for profitability and taking more notice of EBIT.

I have also found that the key factor in buying or selling is not price. This is generally the easiest part of an agreement. The art in a successful transaction is negotiating the transitional issues. There are many pitfalls and traps for the novice in what can happen after the sale agreement is signed and it will affect the investment of the buyer and the payment to the seller. I am often asked to negotiate on behalf of a buyer or seller after they have reached agreement on price. Buyers call me in because they want to ensure a successful transition and sellers call me in because they recognise that they need to remove themselves from the emotional investment they have in their business. They also want to protect their deferred payment.

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

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. 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.

Multiple of Recurring Income

In the financial planning industry, practices 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 2x to 3x.

As an indicator of value, and as a reflection of recent transactions, here is a guide to the value of a financial planning practice using a multiple of recurring income as the measure.

Value = 3x Recurring Income

- 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.

Value = 2.5x Recurring Income

- This will be an average business.
- 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 = 2.0x Recurring Income

- 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.
- Commission income.
- Client relationships tend to be with an individual and this makes transfer to a new owner difficult.

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