What Drives Practice Value – Up or Down?

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KMG recently conducted an analysis of 200 of their most recent business valuations to determine what factors influence value, both up and down. You might be surprised at some of the results.

Recurring Revenue

The number one variable that drives value is the amount of revenue derived from "recurring revenue." This statistic shouldn't be a surprise. In 2018, the average value of more than 400 valuations conducted was 2.7 times recurring revenue plus 1 times transactional revenue (multiples applied to GDC after payout). While these are just the averages, you can see that recurring revenue is worth 2.7 times transactional revenue. This likely explains why most advisors have been moving to fee-based investment accounts. Buyers also like the consistent cash flow and income predictability. It is also interesting to note that the average ratio for recurring revenue has increased sharply over the past 3-4 years, increasing from around 78% to 86%.

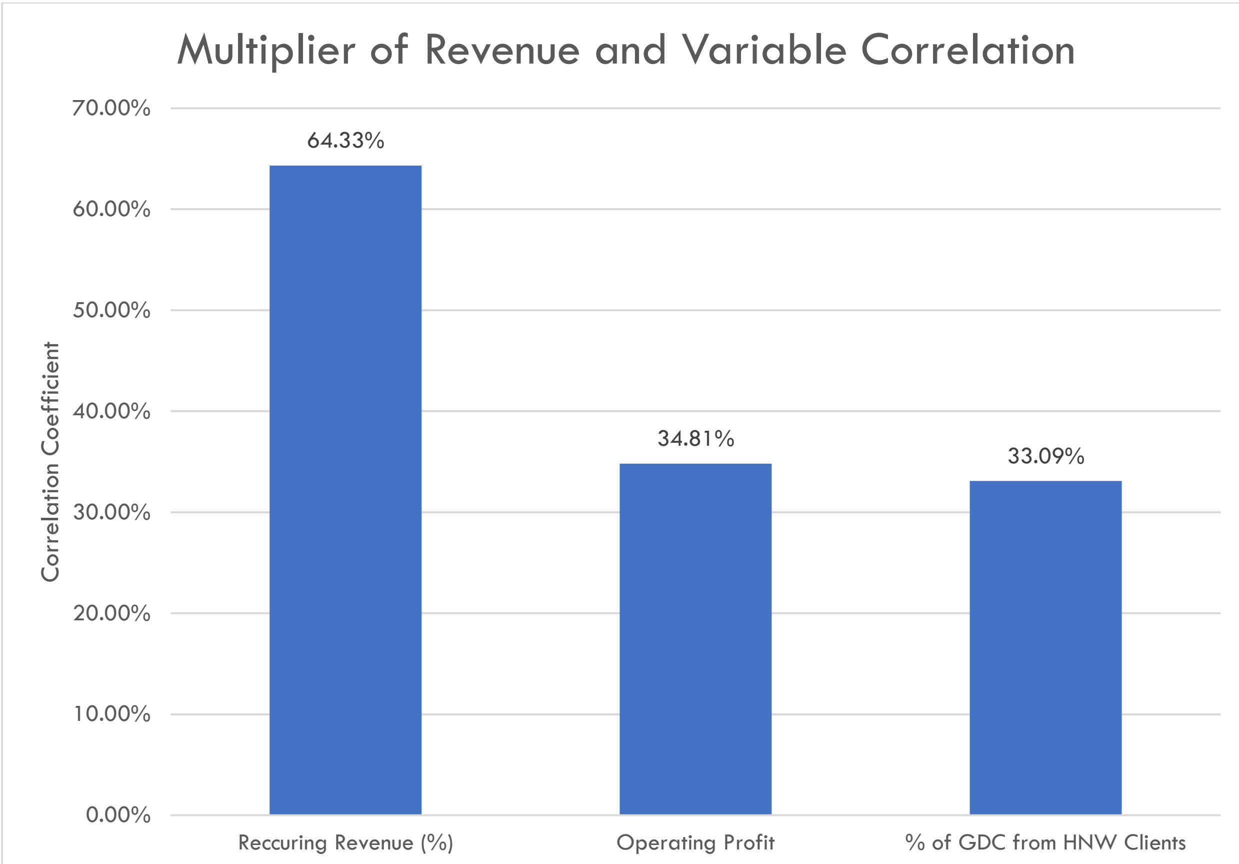
Operating Profit

The second driver causing increased value is the operating profit of the practice. Again, this should not be too much of a surprise. A buyer is willing to pay more for a practice that has high profitability. Inversely, if the practice maintains low margins, a buyer is likely to offer a lower price. An analysis of practice efficiency and the resulting profitability, or lack thereof, is known as "enterprise value" and is included in our valuation methodology. Larger practices generally have a lower profit margin and greater weighting of enterprise value in their valuations.

Client Segmentation

The third driver to increasing value is the ratio of high value and affluent clients (AUM more than $500K). Why is this important? Lower end clients (under $100K in AUM) constitute 43% of the clients of an average practice, while they produce only 7-9% of the revenue. This is a common inefficiency that we don't see in the most efficient/profitable practices, where lower end client ratios are generally around 25%. Because the advisor's time spent with High-Value and Affluent Clients is significantly more productive, managing these client ratios (client segmentation) is highly correlated to profitability and practice value.

So those are the top three drivers of value. Now let's look at the top three detractors.



Number of Low Value Clients

The largest detractor from value is the number of non-high value clients in the practice – a lot is not good. A practice laden with a large number of clients often requires more staff to support the needs of the clients. Generally, larger client bases have a substantial amount of "low value" clients and the time spent with these clients is simply not profitable. In addition, a buyer may need to hire additional support staff, thereby reducing their cash flow and profitability. In general, growing a practice through the number of clients results in lower profitability and practice value, while growing through quality (average AUM) leads to increased profitability and practice value.

Older Clients

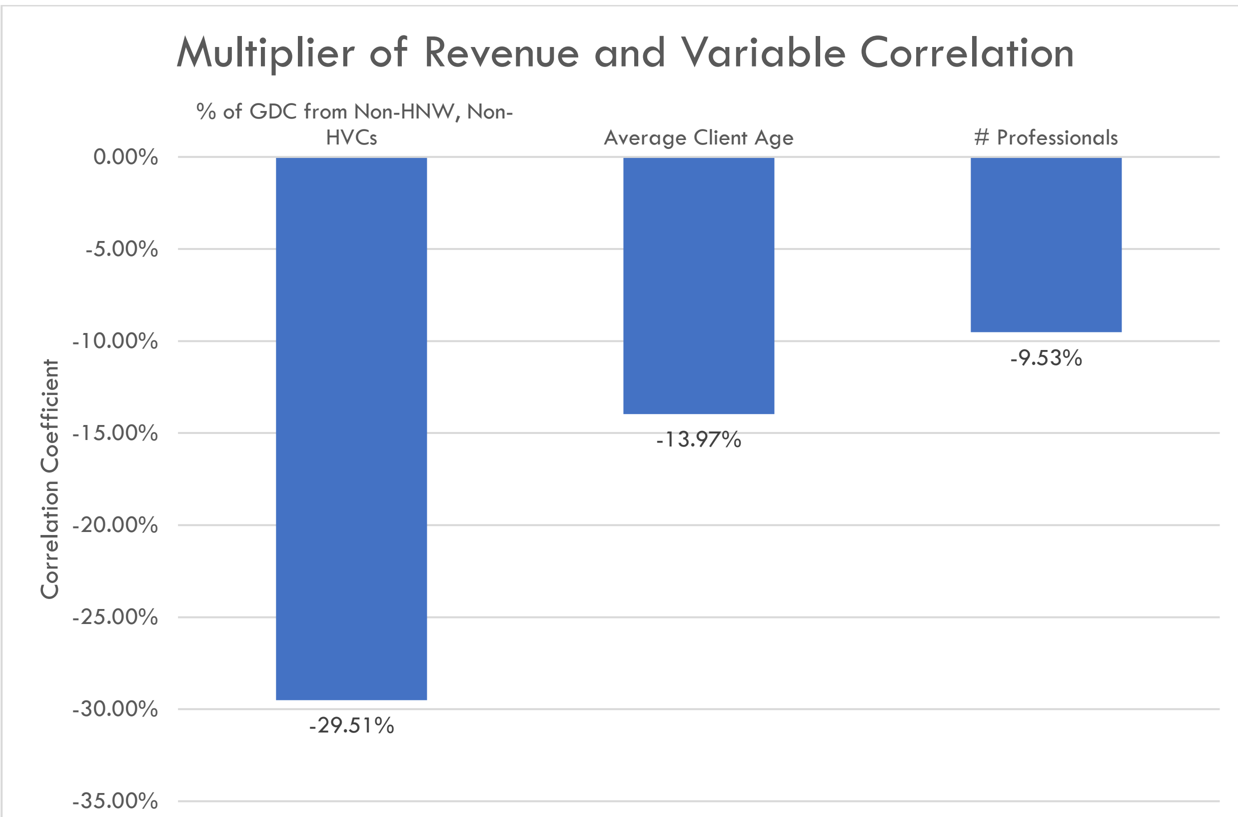
The next biggest detractor from value is the average client age – old is not good. Just like advisors in our industry, our clients are aging as well. Why does this matter? Because older clients are taking money out of their accounts to meet their lifestyle needs. In addition, more and more are dying each year and most of their money is not staying within the practice. This emphasizes the importance of generational planning. An overall client age average of 64 or higher (versus the benchmark of 61), or higher net worth clients with an average age at or near 70 years, can represent a "tipping point" in practice value as that client group will likely have a declining asset base.

Number of Professionals

The last detractor from value is the number of professionals in the practice – a lot is not good. To some extent, this relates to the paragraph above. If you have a lot of clients, you need a lot of professionals. The cost of employment is generally the largest expense a practice encounters. Licensed employees (sales reps) are generally the most expensive. One of the biggest mistakes we see is practice owners hiring additional professionals to serve the lower end of their client base. In other words, they apply their highest expense to their lowest revenue. That's not a good way to build a business.

So, what does this mean?

If you want to drive the value of your business, build it using a recurring revenue model, with mostly high value clients, served by a limited number of professionals.



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Methodology:
We compared the fair market value of the 200 practices assessed and determined each practice's value as a multiplier of revenue (MoR) based upon the latest 12-month revenue for the practice. Rather than ranking the value of the practice, the MoRs were ranked to determine "high value practices" and "low value practices" (higher MoR being high value, and lower MoR being low value). We then ran correlations between key variables of the practice and the MoR values. Higher correlation coefficients indicate that the variables are closely linked to a higher MoR (1.0 would be a perfect correlation, negative correlation coefficients indicate that as one number increases, the other decreases). The results of the highest correlated and lowest correlated variables are discussed in this article.