What’s My RIA Worth?

Assessing the Value of an Investment Management Firm

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Topics for Today's Presentation

How RIAs are NOT valued

Key parameters governing RIA valuation

Measuring the profitability of an investment manager

Projecting performance

The cost of capital for an RIA

What transactions data tells us, and what it doesn't

Market driven context for valuation

Common Truths

What we can, generally, say about RIAs

RIAs are often very valuable

Worth so much no one can afford to buy them

RIAs are typically owned by unrelated parties

Most private companies are family businesses

RIAs typically tie equity participation to employment

Passive ownership is difficult absent substantial scale

Common Myths

Firms aren't always worth 2% of AUM

Rules of Thumb

RIAs are worth 2% of Assets under Management

RIAs are worth 2x revenue

Rules of Thumb are only accurate by coincidence

Rules of Thumb Are Not Reliable

Don't RIAs "typically" sell for 2% of AUM?

	Firm A	Firm B
Assets Under Management	$1,000,000,000	$1,000,000,000
x Realized Fees	**0.65%**	**0.30%**
Revenue / Management Fees	6,500,000	3,000,000
x EBITDA Margin	**40%**	**15%**
= EBITDA	2,600,000	450,000
Implied Value at 2% of AUM	$20,000,000	$20,000,000
Effective Multiple of EBITDA	**7.7x**	**44.4x**

Valuation Framework

Standard of Value sets the perspective of the analysis

Fair Market Value according to Revenue Ruling 59-60

The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property

This is in contrast to the definition of **Investment Value**

The value to a particular investor based on individual investment requirements and expectations

Valuation Framework

For many reasons, there is no one “value”

Business Valuation Standard of Value

- Investment Value
- Fair Market Value

Business Valuation Traditional FMV Levels of Value

Total Market Levels of Value

- Strategic Control
- Industry & Market Participants ↑
- Financial Control
- Consider Lack of Control Discount ↓
- Marketable Minority
- Consider Lack of Marketability Discount ↓
- Nonmarketable Minority

Asset Management / Investment Advisory Firm Transaction Hierarchy

- Strategic Platform buyer with synergies
- Industry Roll-up or Platform Consolidator: few synergies
- Merger of Equals, Private Equity Buyer, External Financial Buyer
- Internal Financial Buyer: Ownership Transition

Potential for Expense Efficiencies

- **Highest:** Minimal expense burden on incremental volume of AUM
- **More:** Back office, technology, marketing, compliance, products
- **Some:** Availability of debt capital, patient equity
- **Little if any:** Going concern situation where little on the P&L changes to accomodate new generation of owners

Generalized "Rule-of-Thumb" Value Differentials

- 10% - 15% For Each Step Up
- 5% - 10% For Each Step Down

Discounts typically lower than broad valuation norms due to high reliability of distributable cash flow, lack of need of reinvestment of capital such that liquidity is available via regular distributions

Differences in RIA valuations are based primarily on changes in expense base from one "level" to the next. **Reductions in expenses drive activity multiples (AUM, Revenue) higher.**

In real world transactions, the specifics of the buyer's and seller's operations can result in different valuation capacities and expectations.

So, How Are RIAs Valued?

Asset-Based Approach

Not applicable because RIAs are not (internally) capital intensive businesses

Income Approach

Discounted cash flow analysis to evaluate business plan and industry trends

Market Approach

Pricing metrics from public companies and transactions relative to company performance characteristics

What Really Matters?

Value is a function of cash flow, risk, and growth

$$V_0 = \frac{CF_1}{r - g}$$

Income Approach: DCF

Projected Cash Flow

Project likely revenue mix

- AUM trends (capture and loss rate, marketing effectiveness)
- Fee schedule and trends in light of competitive pressures
- Performance fees
- Consider ceiling on revenue from product mix, capacity

Project expense base

- Non-labor cost trends
- Staffing for business plan
- Evaluated in light of industry norms and trends
- Potential for operating leverage in mature firm

WACC

Cost of equity

- CAPM (considered in light of WACC of comparable public companies)
- Revenue tied to market conditions with operating leverage compounding the effect on earnings
- Non-systemic (company specific) risk considered (client demographics, sector focus, management dependence, etc.)
- Often higher for higher risk revenue streams (performance fees)

Cost of debt

- Usually irrelevant: little use of debt in RIAs

Capital structure

- Typically assume 100% equity

Indicated Value

Indicated value

- Expressed on a total capital basis
- Before consideration of capital structure implications
- Evaluated against available market pricing metrics for reasonableness

Cash Flow

The key to value is ultimately distributable cash flow

Average AUM	Product Mix, Capacity, Trends
x Realized Fee	Fees as stated or negotiated, pressure from passives
= Revenue	Charged in advance or in arrears
- Owner Compensation	Salary, Bonus, Benefits; return to labor or equity
- Staff Compensation	Source of operating leverage or wage pressure for key folks
- Non-Personnel Costs	Usually a source of operating leverage, but difficult to reduce
= Pre-Tax Profitability	EBIT or EBITDA usually favored
+/- Noise (CapX, Deprec, WC)	Rarely significant but some working capital growth helps
- Taxes	State or Federal Taxes or Tax Pass-Through
= Distributable Cash Flow	Source of incentive compensation or real profitability?

Cash Flow

When do good numbers mask growing pressures

	Year 5	Year 4	Year 3	Year 2	Year 1
Average AUM (000s)	$1,200,000	$1,175,000	$1,000,000	$1,050,000	$800,000
x Realized Fee	0.75%	0.77%	0.77%	0.80%	0.81%
= Revenue	$9,000	$9,048	$7,700	$8,400	$6,480
- Owner Compensation	(500)	(500)	(500)	(500)	(500)
- Staff Compensation	(4,500)	(4,000)	(3,750)	(3,250)	(2,500)
- Non-Personnel Costs	(1,000)	(975)	(950)	(925)	(900)
= Pre-Tax Profitability	$3,000	$3,573	$2,500	$3,725	$2,580
+/- Noise (CapX, Deprec, WC)	(100)	(100)	(100)	(100)	(100)
- Taxes	0	0	0	0	0
= Distributable Cash Flow	$2,900	$3,473	$2,400	$3,625	$2,480
Margin	*32.2%*	*38.4%*	*31.2%*	*43.2%*	*38.3%*

Cash Flow

Tradeoff and balance between returns to labor and returns to equity

Returns to Labor (Compensation)

Too little:

Can't replace in the event of turnover

Margins are artificial

Valuation inflated

Too much:

No incentive for ownership

Margins won't withstand bear markets

Valuation biased to the downside

Returns to Equity (Distributions)

Too little:

No incentive for ownership

Hard to finance transitions

Valuation deflated

Too much:

No $ to reinvest in talent pool

Second gen can't afford to become partners

Valuation inflated

Pricing Cash Flow Is All About Risk

RIAs benefit from recurring revenue, suffer from concentration risks

Risk-Free Rate		**2.75%**
Equity Risk Premium	5.50%	
Systematic Risk (Beta)	1.00	
Beta Adjusted Common Stock Premium		**5.50%**
Size Premium		**3.50%**
Non-systematic or Idiosyncratic Risk (Alpha)		
Dependence on key management	2.00%	
Dependence on key clients	1.00%	
Ownership transition plan	1.00%	
Net Specific Company Risk Premium		**4.00%**
Equity Discount Rate (Required Rate of Return)		**15.75%**

Expected Equity Returns for independent RIAs usually fall in the low teens to high teens for established firms with industry-normal levels of risk. Often higher for startups or distressed firms

The weighted average cost of capital, or WACC, is usually at or close to the cost of equity because leverage is rarely employed to a material extent

Market WACCs for RIAs

Publics are typically priced at a high single to low double digit return

	Ticker	(1) Treasury	(2) ERP	(3) 2 Yr Beta	(4) (2x3) Beta Adj. ERP	(5) Size Premium	(6) (1+4+5) Eq. Disc. Rate	(7) % Equity	(8) % Debt	(9) After Tax Cost of Debt	(6x7) + (8x9) Implied WACC
AUM Under $100 Billion											
Diamond Hill Investment Group Inc	DHIL	2.76%	5.50%	0.82x	4.50%	2.04%	9.30%	100%	0%	2.78%	9.30%
Westwood Holdings Group Inc	WHG	2.76%	5.50%	1.15x	6.34%	2.04%	11.14%	100%	0%	2.78%	11.14%
Silvercrest Asset Management Group Inc	SAMG	2.76%	5.50%	0.83x	4.58%	5.60%	12.94%	99%	1%	2.78%	12.79%
Hennessy Advisors Inc	HNNA	2.76%	5.50%	0.61x	3.37%	5.60%	11.73%	74%	26%	2.78%	9.45%
GAMCO Investors Inc	GBL	2.76%	5.50%	1.01x	5.58%	1.62%	9.96%	79%	21%	2.78%	8.44%
Virtus Investment Partners Inc	VRTS	2.76%	5.50%	1.22x	6.70%	2.04%	11.50%	63%	37%	2.78%	8.31%
Cohen & Steers Inc	CNS	2.76%	5.50%	1.10x	6.05%	1.63%	10.44%	100%	0%	2.78%	10.44%
AVERAGE (AUM under $100B)				0.96x			11.00%				9.98%
MEDIAN (AUM under $100B)				1.01x			11.14%				9.45%

Pricing Cash Flow Is All About Risk

And risk is relative to the industry

Client Demographics

Concentrations

Age

Longevity

Generational Connectedness

Turnover

Staff Dependence

Star System

Succession

Client teams

Age

Longevity

Turnover

Competitive Position

Industry capacity

Industry Trends

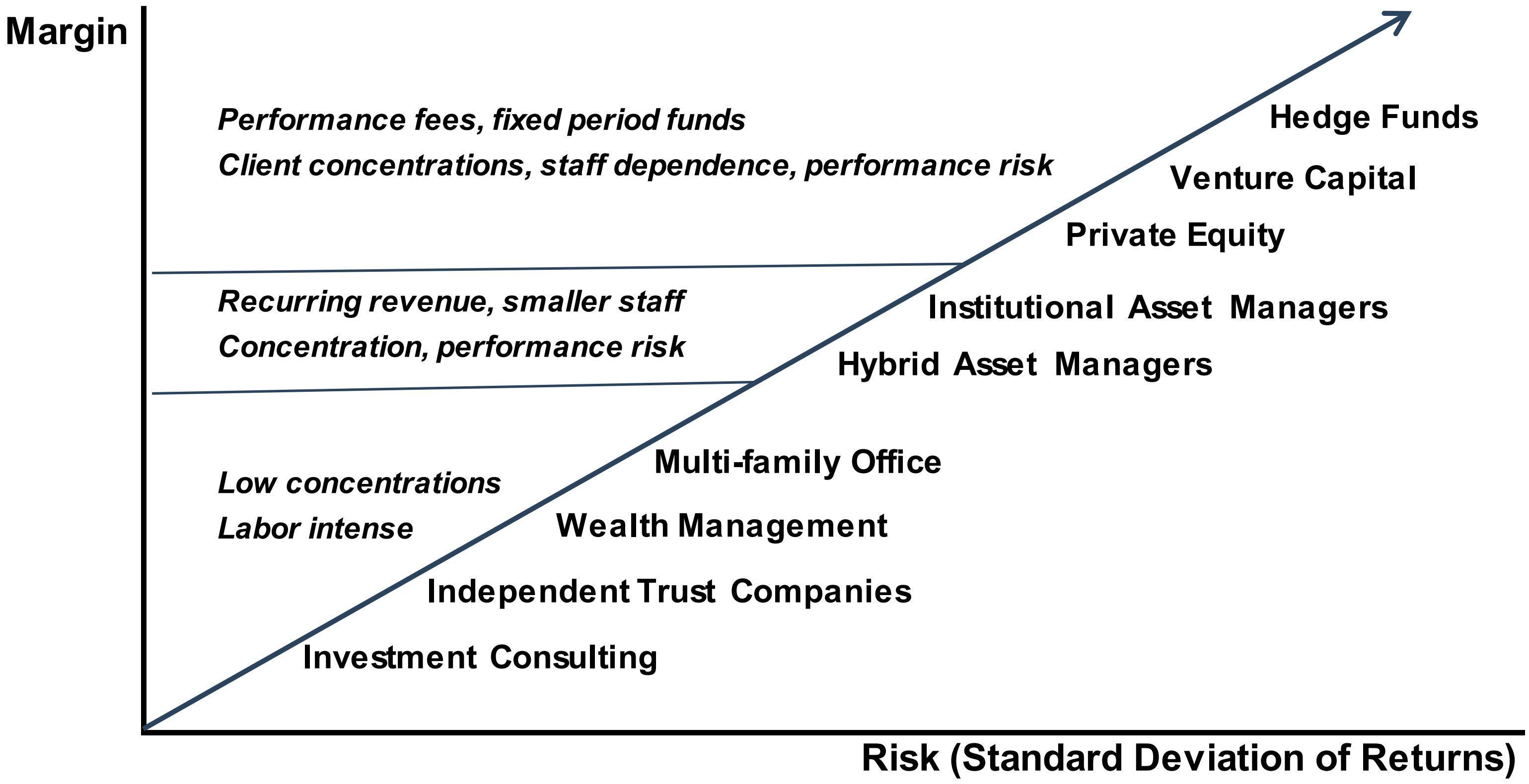
Differentiation

Fees relative to market

Investment performance

Value Tradeoff between Margin and Risk? Yes!

Easy come, easy go



Value Tradeoff between Margin and Risk? No!

Margin is safety in bear markets

High Margin RIA	Year 1	Year 2	Year 3	Year 4	Year 5
AUM	$100,000	$110,000	$70,000	$80,000	$90,000
Realized Fee	0.90%	0.90%	0.90%	0.90%	0.90%
Revenue	$900	$990	$630	$720	$810
Expenses	(500)	(500)	(500)	(500)	(500)
Profit	$400	$490	$130	$220	$310
Margin	*44.4%*	*49.5%*	*20.6%*	*30.6%*	*38.3%*

Low Margin RIA	Year 1	Year 2	Year 3	Year 4	Year 5
AUM	$100,000	$110,000	$70,000	$80,000	$90,000
Realized Fee	0.90%	0.90%	0.90%	0.90%	0.90%
Revenue	$900	$990	$630	$720	$810
Expenses	(750)	(750)	(750)	(750)	(750)
Profit	$150	$240	($120)	($30)	$60
Margin	*16.7%*	*24.2%*	*-19.0%*	*-4.2%*	*7.4%*

But Remember – Sometimes Failures of Marketing Are Masked by the Market …

	Year 1	Year 2	Year 3	Year 4	Year 5	Cumulative
Starting Assets Under Management	**600,000,000**	**685,000,000**	**715,000,000**	**875,000,000**	**985,000,000**	
New Business	5,000,000	0	10,000,000	15,000,000	5,000,000	**35,000,000**
Client Contributions (Withdrawals)	10,000,000	20,000,000	10,000,000	(5,000,000)	(15,000,000)	**20,000,000**
Terminations	(30,000,000)	(60,000,000)	(40,000,000)	(80,000,000)	(45,000,000)	**(255,000,000)**
Net Business Gained / Lost	**(15,000,000)**	**(40,000,000)**	**(20,000,000)**	**(70,000,000)**	**(55,000,000)**	**(200,000,000)**
Change in Market Value	**100,000,000**	**70,000,000**	**180,000,000**	**180,000,000**	**204,000,000**	**734,000,000**
Ending AUM (Starting AUM + Net Flows + Δ in MV)	**685,000,000**	**715,000,000**	**875,000,000**	**985,000,000**	**1,134,000,000**	
Management Fee Revenue	3,705,000	4,047,750	4,480,000	4,929,000	5,673,000	
Average Assets Under Management	570,000,000	642,500,000	700,000,000	795,000,000	930,000,000	
Implied Realized Fee	0.65%	0.63%	0.64%	0.62%	0.61%	

Assessing Growth

New assets often come in at lower fees but still accretive to margins due to operating leverage

	Year 1	Year 2	Year 3	Year 4	Year 5
Average AUM (000s)	$1,000,000	$1,100,000	$1,200,000	$1,300,000	$1,400,000
x Realized Fee	0.65%	0.64%	0.63%	0.62%	0.61%
= Revenue	$6,500	$7,040	$7,560	$8,060	$8,540
- Owner Compensation	(500)	(530)	(560)	(580)	(600)
- Staff Compensation	(3,000)	(3,200)	(3,400)	(3,600)	(3,800)
- Non-Personnel Costs	(1,000)	(1,030)	(1,060)	(1,090)	(1,120)
= Pre-Tax Profitability	$2,000	$2,280	$2,540	$2,790	$3,020
Margin	*30.8%*	*32.4%*	*33.6%*	*34.6%*	*35.4%*

Assessing Growth

Capacity and product extensions

For Wealth Managers

Market penetration and geographic reach can always improve

Infinite capacity

Product is mostly homogenous

Costs (labor) scale with revenue

With scale, management needs grow

Some research, compliance efficiencies

Fewer challenges with client concentrations

For Asset Managers

Growth through different distribution channels

Capacity Constraints

Some product migration available

Style over different asset classes

Operating leverage

Talent costs rise per unit with growth

Managing client concentrations challenging

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Market Approach Considerations

Ongoing Performance

Baseline revenue

- Current AUM
- Realized fee schedule
- Risk adjusted consideration of performance fees

Baseline expenses

- Run-rate labor costs evaluated in light of market data as available
- Differentiation between base and bonus consideration as appropriate
- Most non-labor costs slated at run-rate as of valuation date

Nonrecurring items of income and expense adjusted out as appropriate

Market Pricing

Publicly traded asset managers

- Evaluated for comparability
- EBITDA most meaningful, but look at EV to AUM, revenue, and earnings multiples for context
- Multiples potentially adjusted for size and non-systemic risk factors

Transactions data

- Data is thin and idiosyncratic
- Deals occur for specific reasons which may be irrelevant
- Trends in deal pricing offer bands of reasonableness

Indicated Value

Indicated value

- Expressed on a total capital basis
- Before consideration of capital structure implications
- Evaluated against discounted cash flow analysis for reasonableness (consideration of business plan and cost of capital relative to market)

Market Data

Transactions data is more “data” than “information”

		AUM			Initial	Earnout	Total Deal	Deal Value (Excl. Earn-out) ÷			Revenue	EBITDA	EBITDA
Buyer	**Seller**	**($M)**	**Announced**	**Closed**	**Pmt ($)**	**(max)**	**Val ($M)**	**EBITDA**	**AUM (%)**	**Rev**	**($M)**	**($M)**	**Margin**
TriState Capital Holdings Inc.	The Killen Group, Inc.*	2,500	12/16/2015	4/29/16	15.0	5.0	20.0	5.00x	0.60%	1.05x	14.3	3.0	21.0%
Hellman & Friedman	Edelman Financial**	15,000	10/12/2015	12/23/15	800.0	NA	800.0	10.15x	5.33%	3.56x	225.0	78.8	35.0%
Simmons First National Corp.	Ozark Trust & Investment Company	1,029	4/29/2015	10/30/2015	20.7	NA	20.7	10.35x	2.01%	3.51x	5.9	2.0	33.9%
Boston Private Financial	Banyan Partners LLC	4,581	7/16/2014	10/2/2014	65.0	15.0	80.0	9.29x	1.42%	2.60x	25.0	7.0	28.0%
Legg Mason Inc.	Martin Currie (Holdings) Ltd.	9,800	7/24/2014	10/1/2014	NA	NA	427.8	NA	4.37%	NA	NA	NA	NA
Henderson Group	Geneva Capital Mgmt Ltd.	6,300	6/30/2014	10/1/2014	130.0	70.0	200.0	NA	2.06%	NA	NA	NA	NA
Affiliated Managers Group Inc.	SouthernSun Asset Mgmt LLC	5,317	12/19/2013	3/31/2014	NA	NA	109.9	NA	2.07%	NA	NA	NA	NA
TriState Capital Holdings Inc.	Chartwell Investment Partners	7,500	1/7/2014	3/5/2014	45.0	15.0	60.0	7.50x	0.60%	1.74x	25.9	6.0	23.2%
KKR & Co. L.P.	Avoca Capital Holdings	8,000	10/18/2013	2/19/2014	NA	NA	102.3	NA	1.28%	NA	NA	NA	NA
AXA	W.P. Stewart & Co. Ltd.	2,000	8/15/2013	12/12/2013	NA	NA	78.4	NA	3.92%	NA	NA	NA	NA
Fiera Capital Corp.	Bel Air	5,975	9/3/2013	10/31/2013	115.0	10.0	125.0	9.62x	1.92%	NA	NA	12.0	NA
Fiera Capital Corp.	Wilkinson O'Grady & Co.	2,086	9/3/2013	10/31/2013	29.7	1.6	31.3	12.04x	1.42%	NA	NA	2.5	NA
Standard Life Plc	Newton's private client bus.	3,000	2/27/2013	9/27/2013	NA	NA	126.4	NA	4.21%	NA	NA	NA	NA
Legg Mason Inc.	Fauchier Partners Mgmt Ltd.	5,400	12/13/2012	3/13/2013	80.0	56.0	136.0	NA	1.48%	NA	NA	NA	NA
First Republic Bank	Luminous Capital Holdings LLC	5,891	11/2/2012	12/28/2012	NA	NA	125.0	NA	2.12%	NA	NA	NA	NA
Tamco Holdings, LLC	Titanium Asset Mgmt Corp.	8,713	12/18/2012	12/18/2012	NA	NA	36.0	NA	0.41%	1.62x	22.3	NA	NA
Charles Schwab Corp.	ThomasPartners Inc.	2,200	10/15/2012	12/14/2012	NA	NA	85.0	NA	3.86%	NA	NA	NA	NA
Hennessy Advisors Inc.	FBR Fund Advisers Inc.	2,200	6/6/2012	10/26/2012	19.7	9.1	28.8	NA	0.90%	NA	NA	NA	NA
City National Corp.	Acebes D'Alessandro & Assoc.	4,890	4/25/2012	7/2/2012	NA	NA	100.0	NA	2.04%	NA	NA	NA	NA
Principal Financial Group Inc.	Origin Asset Management LLP	2,600	7/7/2011	10/3/2011	NA	NA	66.0	NA	2.54%	NA	NA	NA	NA
Wintrust Financial Corp.	Great Lakes Advisors Inc.	2,400	5/4/2011	7/1/2011	NA	NA	20.2	NA	0.84%	NA	NA	NA	NA
MEDIAN		**4,890**			**55.0**	**12.5**	**85.0**	**9.62x**	**2.01%**	**2.17x**	**23.7**	**6.0**	**28.0%**
AVERAGE		**5,113**			**132.0**	**22.7**	**132.3**	**9.14x**	**2.16%**	**2.34x**	**53.1**	**15.9**	**28.4%**

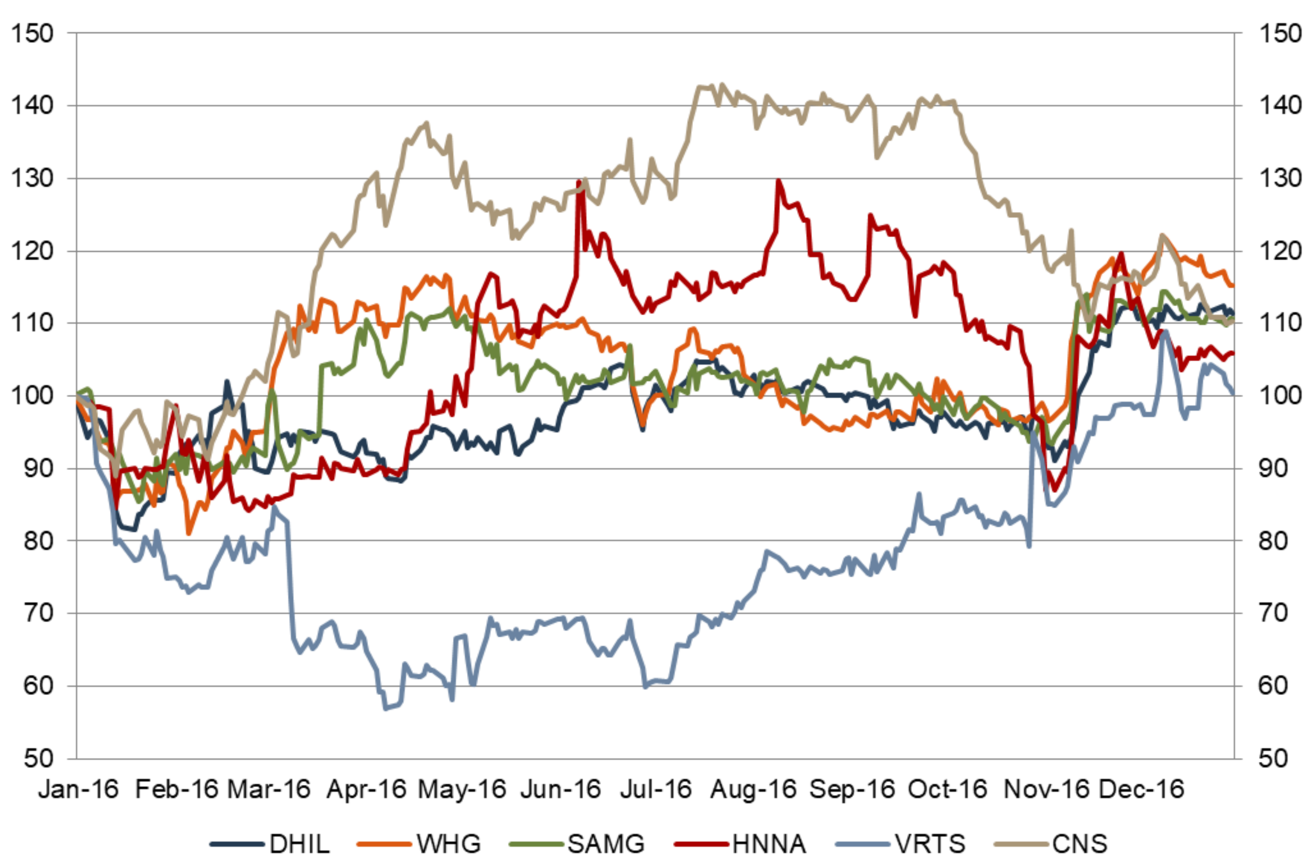
Limits of Market Data: Example

Example: Acme buys Smith for $25 million including contingent payments

Known	Unknown	Not knowable
ADV says prior year-end AUM was $2 billion, and an advisory fee schedule with a sliding scale from 1.25% to 0.5% depending on account size Implied Price/AUM is 1.25%	Actual AUM at transaction date, realized fee, margins, trends, synergies, product integration, terms of earn-out Consequently, no performance metrics disclosed other than stale AUM measure	Post-transaction client conversion, retention, performance, margin So, earn-out payment schedule isn't known and, if not fully earned, would reduce total consideration for transaction, along with the measure of performance

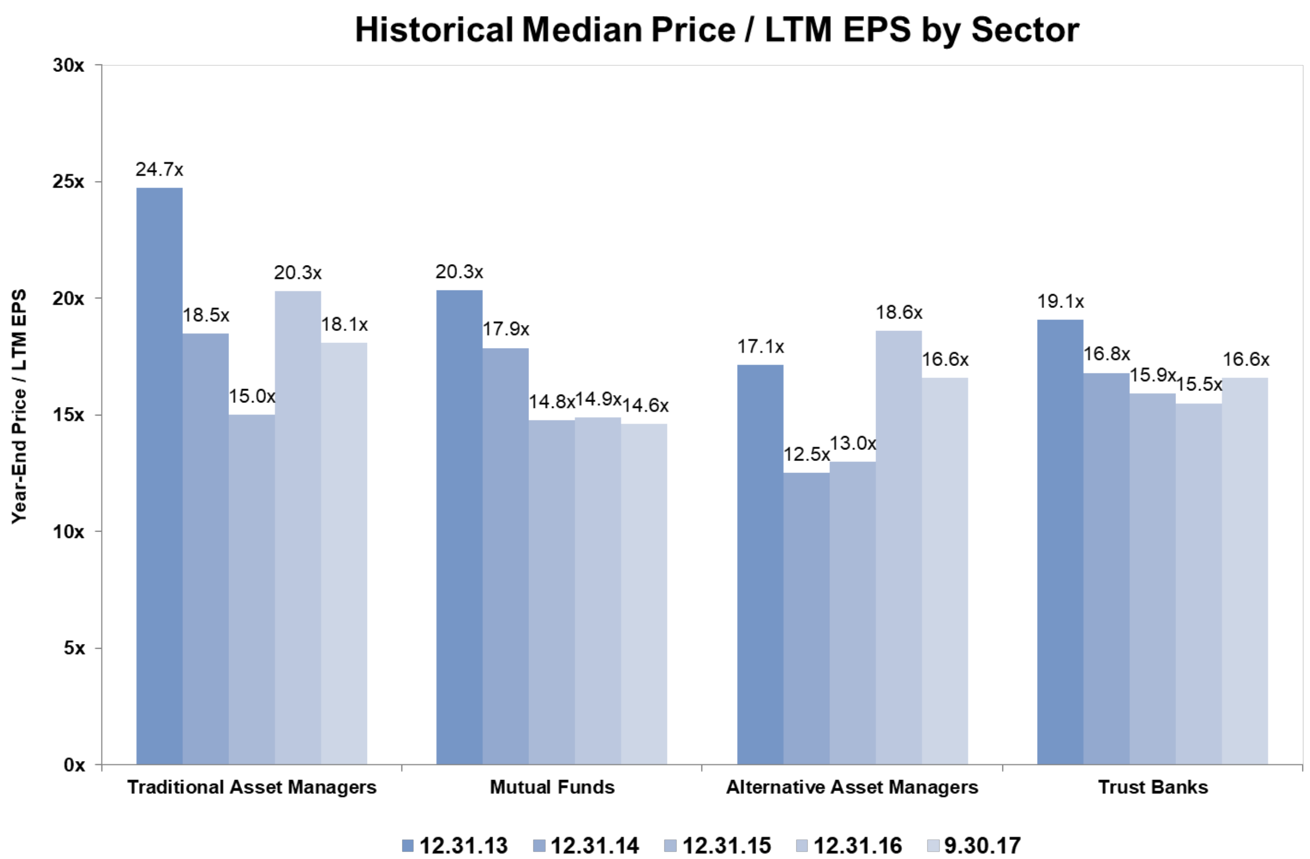
Market Data Can Be Difficult to Interpret

Sometimes public company pricing takes the scenic route



Market Data

Multiples have trended lower for most classes of asset managers since 2013



Reconciling Indicated Values

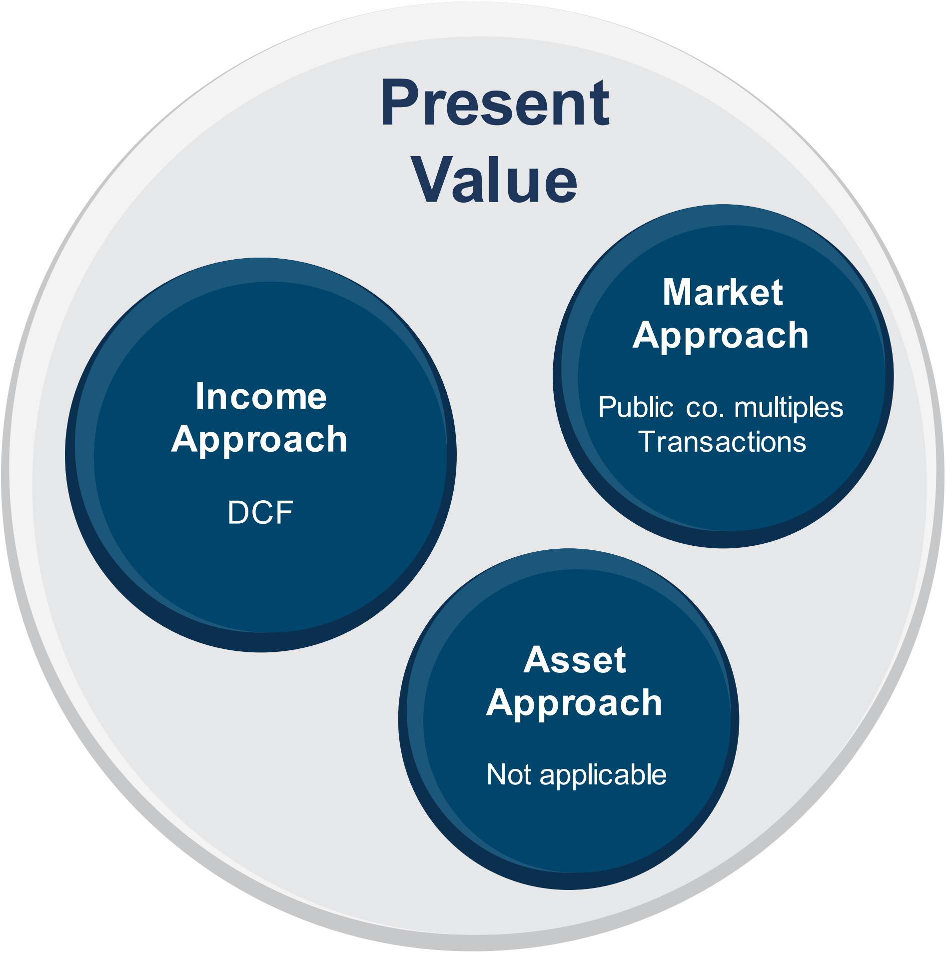
It would be unusual for the indicated values from the various income and market methods to align perfectly.

Value indications from the market approach can be reasonably volatile, since the market for public asset managers is leveraged to the performance of the market in general. Because valuation for fair market value purposes is more of a descriptive exercise than a prescriptive one, this is a perspective we consider.

In our experience, though, investors in private companies think longer term. The more enduring indications of value from income approaches such as DCF models are often more representative of the actual behavior of real-world buyers and sellers of interests in asset management firms.

Nonetheless, using multiple valuation approaches serves to generate tests of reasonableness against which the different indications can be evaluated.

Note: we usually don't consider the asset approach to be relevant to the valuation of RIAs. However, the balance sheet can be remarkable in situations where there are excess or non-operating assets or contingent liabilities that need to be considered apart from the value of the firm's ongoing operations.



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Matt is active in valuations related to asset management firms and also has broad industry experience accumulated by working with hundreds of client companies during his more than 20 year tenure at Mercer Capital. Along with Brooks Hamner, Matt publishes research related to the asset management industry.

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Circumstances giving rise to the engagements Brooks is involved with include corporate planning, employee stock ownership plans, and estate and gift tax planning and other compliance matters. In addition, he actively participates in projects in a litigated context.

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