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BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Assessing Earnings Quality in the Investment Management Industry

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Quality Of Earnings For Investment Managers

Earnings are a crucial reference point in determining transaction prices negotiated by buyers and sellers of RIA firms. However, reported earnings, even when audited and presented in accordance with Generally Accepted Accounting Principles (GAAP), have limitations. GAAP earnings are backward-looking, reflecting how a business has performed under specific rules in the past. While these historical earnings have their uses, buyers in the RIA industry focus more on the future—what's visible through the windshield, not the rearview mirror.

INTRODUCTION

Any future perspective of an investment management firm's earnings must be grounded in reliable historical information. A Quality of Earnings ("QofE") analysis goes beyond the scope of a financial statement audit. While audited results provide a snapshot of past performance under GAAP, they don't necessarily offer a reliable basis for projecting future profitability. A QofE report adjusts historical earnings to provide a more accurate measure of a firm's ongoing earning potential. As depicted in Exhibit 1, a QofE report is neither an audit nor a projection of future results for the subject company but instead serves as a bridge between the two.

Exhibit 1 :: Audit, QofE Report, and Projections

Audit	QofE Report	Projections
Present historical results according to generally accepted accounting principles (GAAP)	"Translate" GAAP earnings into reliable base for projections / valuation	Expected future financial performance built off of reliable base earnings, reflecting forecasts for economy, industry, market share, etc.

For RIA buyers, commissioning a QofE report on a target firm is an essential element of the due diligence process. A QofE analysis allows buyers to assess how the business of an acquisition target compares to the business described in the target's information memorandum. A QofE report assists buyers in:

- Avoiding overpaying for earnings that aren't sustainable.
- Identifying opportunities for cost savings in the target's expense base.
- Finding revenue synergies with the existing business.
- Clarifying and quantifying any working capital needs of the target.
- Assessing capital expenditures or other investment needs at the target.

For sellers, commissioning a QofE report on themselves enhances the credibility of the seller's value narrative. A QofE report assists sellers in:

- Avoiding unpleasant surprises in due diligence.
- Identifying opportunities for cost savings in the expense base.
- Highlighting underlying trends in revenue components that may be masked in the reported P&L.
- Clarifying prospective capital investment needs.
- Protecting transaction proceeds.

The objective of a QofE report is to translate historical financial information into a relevant picture of earnings and cash flows useful for developing future projections. In the RIA industry, specific adjustments and considerations are necessary to tailor historical earnings to a measure of pro forma run-rate earnings.

Exhibit 2 :: QofE Adjustment Categories

1. **Discretionary expenses**
2. **Unusual and nonrecurring items of revenue and expense**
3. **Timing / accounting policy adjustments**
4. **Major customer wins and losses**
5. **M&A run-rate adjustments**

QUALITY OF EARNINGS ADJUSTMENTS FOR RIAS

This section serves to illustrate common adjustments made during a QofE analysis in the RIA industry.

Discretionary Expenses

RIAs occasionally incur discretionary expenses that are tied to personal preference rather than operational necessity. These can include premium office locations, high-end technology, extravagant client entertainment, or above-market compensation to owners of the business. For example, RIAs might report significant expenses related to having a prestigious office location or substantial spending on business development. While these items may enhance the firm's image in the view of current ownership, a third-party buyer may find these expenses excessive and would expect to reduce these costs if they were to acquire the business.

Exhibit 3: Adjusting For Discretionary Expense

Assets Under Management	As Reported	Discretionary Expenses	Adjusted for Discretionary Expenses
Approximate Average AUM	$787,500,000		$787,500,000
Effective Realized Management Fee	0.50%		0.50%
Investment Management Fees	$3,937,500		$3,937,500
Income Statement			
Investment Management Fees	$3,937,500	$0	$3,937,500
Other Revenue	500,000	0	500,000
Total Revenue	**$4,437,500**	**$0**	**$4,437,500**
Fixed Operating Expenses	$754,375	($50,000)	$704,375
Salaries & Benefits	1,553,125	0	1,553,125
Bonuses	1,331,250	0	1,331,250
Depreciation & Amortization	44,375	0	44,375
Other Non-Interest (Income)/Expense	250,000	0	250,000
Total Operating Expense	**$3,933,125**	**($50,000)**	**$3,883,125**
Operating Income / EBIT	$504,375	$50,000	$554,375
Depreciation & Amortization	44,375	0	44,375
EBITDA	**$548,750**	**$50,000**	**$598,750**
EBITDA Margin	*12.4%*	nm	*13.5%*

Unusual or Non-Recurring Income or Expense

Like all businesses, RIAs can experience “one-off” items of income and expense that are not expected to continue in the future. Business interruptions, revenue windfalls, casualty losses, and the like influence historical earnings but do not affect the company’s core ongoing earnings power. Historical financials need to be adjusted for these items as they do not reflect the ongoing earnings capacity of the business. For example, if an RIA had to make severance payments to an advisor that left the firm, this would represent a one-time expense that is not expected to continue in the future.

Exhibit 4: Non-Recurring Income/Expense

Assets Under Management	Adjusted for Discretionary Expenses	Non-Recurring Income/ Expenses	Adjusted for Non-recurring Income/Exp
Approximate Average AUM	$787,500,000		$787,500,000
Effective Realized Management Fee	0.50%		0.50%
Investment Management Fees	$3,937,500		$3,937,500
Income Statement			
Investment Management Fees	$3,937,500	$0	$3,937,500
Other Revenue	500,000	(220,000)	280,000
Total Revenue	**$4,437,500**	**($220,000)**	**$4,217,500**
Fixed Operating Expenses	$704,375	$0	$704,375
Salaries & Benefits	1,553,125	0	1,553,125
Bonuses	1,331,250	0	1,331,250
Depreciation & Amortization	44,375	0	44,375
Other Non-Interest (Income)/Expense	250,000	(150,000)	100,000
Total Operating Expense	**$3,883,125**	**($150,000)**	**$3,733,125**
Operating Income / EBIT	$554,375	($70,000)	$484,375
Depreciation & Amortization	44,375	0	44,375
EBITDA	**$598,750**	**($70,000)**	**$528,750**
EBITDA Margin	*13.5%*	nm	*12.5%*

Gain or Loss of Major Client

If a firm gains or loses a client that constitutes a significant portion of its AUM during the year, adjustments must be made to the run-rate revenue to reflect the impact of this change. For example, if an RIA lost a large institutional client that made up 10% of AUM towards the end of the year, an adjustment would need to be made to AUM. As a consequence, run-rate-revenue would also be adjusted to reflect this loss going forward. Conversely, if a new client with a significant amount of AUM was acquired during the year, revenue should be adjusted upward to reflect a full year of management fees from this client and its contribution to future earnings.

Exhibit 5: Gain or Loss of Major Client

Assets Under Management	Adjusted for Non-recurring Income/Exp	Gain of Major Customers	Adjusted for Gain of Major Customer
Reported AUM (Year-End)	$825,000,000		$825,000,000
Approximate Average AUM	$787,500,000	$50,000,000	$837,500,000
Effective Realized Management Fee	0.50%	0.50%	0.50%
Investment Management Fees	$3,937,500	$250,000	$4,187,500
Income Statement			
Investment Management Fees	$3,937,500	$250,000	$4,187,500
Other Revenue	280,000	0	280,000
Total Revenue	**$4,217,500**	**$250,000**	**$4,467,500**
Fixed Operating Expenses	$704,375	$0	$704,375
Salaries & Benefits	1,553,125	0	1,553,125
Bonuses	1,331,250	9,000	1,340,250
Depreciation & Amortization	44,375	0	44,375
Other Non-Interest (Income)/Expense	100,000	0	100,000
Total Operating Expense	**$3,733,125**	**$9,000**	**$3,742,125**
Operating Income / EBIT	$484,375	$241,000	$725,375
Depreciation & Amortization	44,375	0	44,375
EBITDA	**$528,750**	**$241,000**	**$769,750**
EBITDA Margin	*12.5%*	nm	*17.2%*

M&A Run-Rate Adjustment

If an RIA has been involved in mergers and acquisitions, the GAAP financial results for the year of the acquisition will only reflect the earnings of the acquired entity following the acquisition date. Similarly, if an RIA divests a portion of its business during the year, its earnings will still include the profits from the divested business prior to the closing date of the transaction. As a result, financial results for the year of acquisition or divestiture would need to be adjusted to reflect the true run-rate performance of the business.

Exhibit 6: Adjusting for Mid-Year Acquisitions/Divestitures

Assets Under Management	Customer	Adjustment	Acquistion
Approximate Average AUM	$837,500,000		$837,500,000
Effective Realized Management Fee	0.50%		0.62%
Investment Management Fees	$4,187,500	$1,000,000	$5,187,500
Income Statement			
Investment Management Fees	$4,187,500	$1,000,000	$5,187,500
Other Revenue	280,000	0	280,000
Total Revenue	**$4,467,500**	**$1,000,000**	**$5,467,500**
Fixed Operating Expenses	$704,375	$150,000	$854,375
Salaries & Benefits	1,553,125	250,000	1,803,125
Bonuses	1,340,250	330,000	1,670,250
Depreciation & Amortization	44,375	10,000	54,375
Other Non-Interest (Income)/Expense	100,000	0	100,000
Total Operating Expense	**$3,742,125**	**$740,000**	**$4,482,125**
Operating Income / EBIT	$725,375	$260,000	$985,375
Depreciation & Amortization	44,375	10,000	54,375
EBITDA	**$769,750**	**$270,000**	**$1,039,750**
EBITDA Margin	*17.2%*	nm	*19.0%*

Run-Rate Adjustment

An RIA's historical revenue (on an annual basis) is reflective of the average level of AUM during the relevant twelve month period, whereas forward-looking revenue is more reliably estimated from AUM at a moment in time. For example, imagine two firms (Firm A and Firm B). Both have identical fee schedules and cost structures, but Firm A started the year at $1.0 billion in AUM and grew steadily to $1.5 billion at year-end, while Firm B saw the reverse trajectory, starting the year at $1.5 billion AUM and declining steadily to $1.0 billion by year-end. Both firms had average AUM of $1.25 billion during the year, and generated similar levels of revenue and profitability. However, it's clear that Firm A has a more favorable outlook for future revenue because of its more favorable trajectory during the year. A run-rate adjustment is intended to capture these considerations by adjusting an RIA's historical revenue and expenses to a run-rate level based on the RIA's current level of AUM and effective fee levels (to the extent not captured by previous adjustments). This adjustment provides a clearer insight into an RIA's prospective revenue and earning power.

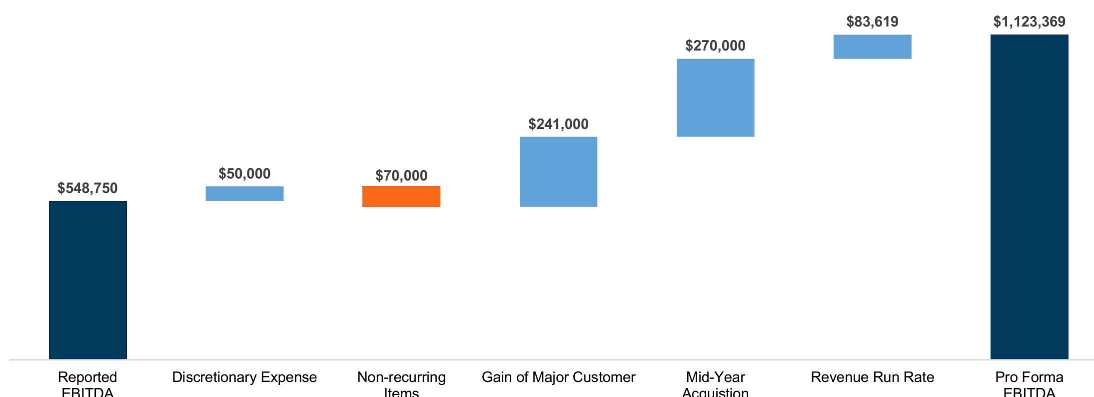
Exhibit 7: Adjusting for Run-rate Revenue

Assets Under Management	Adjusted for Mid-Year Acquistion	Revenue Run Rate Adjustment	Adjusted for Revenue Run Rate
Reported AUM (Beginning of Year)	$787,500,000		
Reported AUM (End of Year)	$887,500,000		
Approximate Average AUM	$837,500,000		$887,500,000
Effective Realized Management Fee	0.62%		0.62%
Investment Management Fees	$5,187,500		$5,497,201
Income Statement			
Investment Management Fees	$5,187,500	$309,701	$5,497,201
Other Revenue	280,000	0	280,000
Total Revenue	**$5,467,500**	**$309,701**	**$5,777,201**
Fixed Operating Expenses	$854,375	$46,455	$900,830
Salaries & Benefits	1,803,125	77,425	1,880,550
Bonuses	1,670,250	102,201	1,772,451
Depreciation & Amortization	54,375	3,097	57,472
Other Non-Interest (Income)/Expense	100,000	0	100,000
Total Operating Expense	**$4,482,125**	**$229,179**	**$4,711,304**
Operating Income / EBIT	$985,375	$80,522	$1,065,897
Depreciation & Amortization	54,375	3,097	57,472
EBITDA	**$1,039,750**	**$83,619**	**$1,123,369**
EBITDA Margin	*19.0%*	nm	*19.4%*

Net Effects of QofE Adjustments

Having identified relevant (and material) adjustments of each type, it is instructive to step back and assess the overall direction and magnitude of the adjustments made. A "bridge" chart like that shown in Exhibit 8 summarizes the adjustments made in deriving pro forma run-rate EBITDA.

Exhibit 8: Net Effect of QoE Adjustments



From reported EBITDA of $549 thousand, the QofE adjustments for discretionary expenses, unusual or non-recurring income/expense, adjustments from the gain of a major customer resulted in a net upward adjustment of $221 thousand, bringing EBITDA to $770 thousand. Including the full-year of earnings for the company acquired in the middle of the year and the revenue run-rate adjustment brings pro forma run-rate EBITDA to just over $1.1 million.

While in compliance with GAAP, the reported EBITDA of $549 thousand is not an appropriate base from which to derive valuation indications (using guideline or single-period capitalization methods) or build an earnings forecast. For sellers, QofE analysis is an essential step in achieving transaction outcomes that reflect the true earnings potential of the business they have built. Likewise, a proper QofE analysis helps buyers maintain discipline by identifying the truly durable components of earning power for the target company.

REVENUE ANALYSIS

The revenues of an RIA are relatively straight forward to compute, as they are the product of AUM and the company's effective management fees. However, this does not provide insight into how this revenue was generated, its sustainability, and the prospect of future revenue growth. A QofE analysis looks beyond the level of AUM and effective management fees, considering the following:

1. **Nature of Assets Under Management (AUM):** An analysis of the types of assets managed by an RIA is crucial to understanding revenue sustainability. RIAs that manage a diversified asset base are better suited to handle a downturn in the market when compared to RIAs with assets concentrated in more volatile sectors.

2. **AUM History**: An understanding of how the current level of AUM was achieved is key to a QofE analysis of an RIA. An RIA that has achieved recent growth in AUM through organic growth (new client acquisition) rather than market appreciation, would indicate a higher likelihood of a company sustaining and building on its growth in revenue.

3. **Client base:** Understanding the makeup of an RIA's client base can lead to great insights into the firm's ongoing earnings. Firms with a high concentration of AUM from a few key clients are more susceptible to a decline in AUM/revenue if these key clients were to leave when compared to firms with a more diversified client base. Not only is it important to understand whether an RIA has continued to bring in new clients, but it may be even more important to understand if the firm is able to retain these customers over time. An analysis of an RIA's client attrition can provide further insight into the sustainability of the company's earnings. A high level of client attrition might be indicative of a firm that is not providing quality service to its clients and may indicate that AUM could decline in the future.

4. **Fee Structure and History:** An RIA's fee schedules relative to the market can reveal much about its competitive position and pricing power. Above-market fees might suggest strong brand equity, while below-market fees could indicate efficiency or potential pricing pressure. Below market fees may also represent an opportunity to improve profitability or possibly market competitiveness, but the specific meaning of relative fee levels is usually found in conjunction with other key operational aspects of the firm. Additionally, an analysis of an RIA's realized fees

compared to its fee schedule can provide insight into the sustainability of revenue. If the RIA sticks to its fee schedule, it may underscore its pricing power within the industry or indicate a rigidity that impedes growth. Fee negotiations are more normal within some sectors of money management than others and are usually a barometer of competitive pressures that speak to revenue sustainability.

COST STRUCTURE

Quality of earnings doesn't just depend on revenue dynamics. The expense base of an RIA is ideally designed to attract and develop revenue streams at a reasonable margin. The primary expense for any RIA is compensation. Compensation structures for RIAs can vary widely in structure:

1. **Compensation Model:** Compensation schemes for RIAs are as varied as the businesses themselves. Some are heavy on salary; some are heavy on incentives. Some incentive compensation is tied to firm performance, and some is tied to individual performance. Some compensation schemes offer the firm flexibility with different market circumstances, and some lean heavily on profitability to support compensation in challenging times.

2. **Relative Compensation Levels:** Compensation doesn't operate in a vacuum. A firm with seemingly appropriate compensation expense relative to revenue could be far off-market if the fee schedule that forms the revenue base is also off-market. For example, if compensation expense is reported at, say, 65% of revenue, but realized fees are 20% above market, then compensation expense is 80% of normalized revenue — probably not a sustainable level.

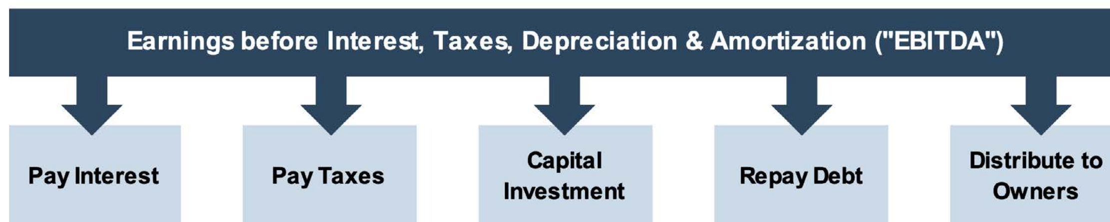
The impact compensation has on quality of earnings revolves around how the compensation plan supports the business model over time, how it is stressed and supported by different market circumstances, and how it has responded to bull and bear markets in the past.

EBITDA AND CASH FLOWS

The principal earnings measure analyzed in QofE reports is EBITDA. Why do buyers and sellers focus on EBITDA?

First, EBITDA is the broadest measure of earnings and cash flow for the firm. As depicted in Exhibit 9, EBITDA is a proxy for cash flow available for a variety of purposes.

Exhibit 9 :: Potential Uses of EBITDA



Second, referencing EBITDA promotes comparability across firms. Working up from the bottom of the income statement, EBITDA provides the most consistent measure of relative operating performance across companies by "normalizing" for how different companies are organized, financed, and assembled.

- **Income taxes.** Many RIAs are organized as tax pass-through entities and therefore report no income tax expense on the income statement. Since EBITDA is calculated without regard to income taxes, C corporations, S corporations, and LLCs are on equal footing.
- **Interest expense.** The decision to finance operations with debt rather than equity does not directly affect the operating performance of the business. Since EBITDA is calculated without regard to interest expense, the operating performance of highly leveraged companies can be readily compared to that of companies with no debt.
- **Depreciation.** Depreciation is a non-cash charge that depends on various accounting estimates and fundamental business decisions, such as whether to own or lease productive assets. Nonetheless, while it is true that depreciation does not represent a cash flow in the current period, it does arise from a real cash outflow in a prior period, and one that will need to be repeated as fixed assets wear out.
- **Amortization.** Acquisitive RIAs recognize acquired intangible assets on their balance sheets that are subsequently written off through amortization charges on the income statement. Companies that grow organically do not incur amortization charges. EBITDA is unaffected by amortization charges, thereby putting companies that grow organically and those growing by acquisition on an equal footing. Unlike depreciable fixed assets, amortizable intangible assets generally do not need to be replaced through subsequent cash outflows.

Since these four uses are a function of choices made by the buyer, they do not affect what a given dollar of EBITDA is worth. Capital investment, on the other hand, does influence the value of EBITDA since capital-hungry businesses with significant capital investment obligations to sustain operations generate less cash flow per dollar of EBITDA than their capital-light peers.

Capital investment consists of two components: capital expenditures and incremental working capital. A comprehensive QofE report should analyze each.

Capital Expenditures and Investments in Working Capital

While RIAs are generally less capital-intensive than other industries, capital expenditures (CapEx) and investments in working capital are still relevant for a comprehensive QofE analysis.

Capital Expenditures

- **Maintenance vs. Growth**: Distinguishing between maintenance CapEx (to sustain current operations) and growth CapEx (to expand capacity) is essential. In RIAs, this might include investments in technology, office expansions, or other infrastructure.
- **Efficiency Analysis:** Evaluating historical CapEx in relation to revenue and growth provides insights into how efficiently the firm is using its capital to generate returns.

Working Capital

- **Components and Cyclicality:** RIAs typically have lower working capital needs, but fluctuations in receivables, payables, and other current assets/liabilities can still impact cash flow.
- **Seasonal and Cyclical Factors:** Analyzing working capital on a monthly or quarterly basis helps identify seasonal trends and cyclical factors that could affect liquidity.
- **Impact on Transactions:** During M&A activities, understanding the working capital requirements can influence negotiations around closing balance requirements and ultimately affect net proceeds from the transaction.

CONCLUSION

A thorough QofE analysis plays an important role in evaluating the performance of RIAs. It transcends traditional financial assessments, providing a view of a company's sustainable earning power by adjusting for nonrecurring items and discretionary expenses and analyzing revenue and cost structures.

For buyers, a QofE report is an essential component in the due diligence process. A QofE report will help offer a clear picture of the sustainable earning potential of the target company, aiding informed decision-making and appropriate valuation.

For sellers, a QofE analysis helps position the firm attractively, potentially securing a premium price. Commissioning a QofE analysis in anticipation of future transactions will assist the seller in presenting a compelling narrative regarding the true underlying earning power of the business.

Unlike audit work, QofE is not governed, per se, by the Financial Accounting Standards Board or any regulatory body. The concept has evolved over time, and the benefit of a QofE depends in part on the experience level of the professionals doing the work.

In essence, a well-executed QofE analysis not only reveals why a firm is profitable but also assesses the likelihood of maintaining and enhancing that profitability after the transaction. This comprehensive approach ensures that both buyers and sellers make well-informed, strategic decisions in the RIA industry.

Stay Updated on How Current Events Are Affecting the Value of Your RIA

Value Focus: Investment Management Newsletter

Mercer Capital's investment management industry team produces a complimentary quarterly newsletter. Each quarter has a different sector focus and contains an industry market overview, a review of recent transactions, and tracks multiples by industry sector. Click the button below to view the current issue and the archives or to subscribe to receive the quarterly newsletter.

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- Negotiating transactions involving investment managers from sell-side, buy-side, and mutually retained perspectives
- Providing financial statement reporting services related to purchase price allocation and goodwill impairment testing
- Providing expert witness testimony for purposes of marital dissolution and shareholder disputes
- Assisting RIAs and other asset managers with annual ESOP valuations, fairness opinions, and appraisals for gift and estate tax compliance

Mercer Capital's Investment Management industry group publishes research on the industry via its quarterly newsletter, *Value Focus: The Investment Management Industry*. The Group also writes about issues important to the industry on the *RIA Valuation Insights* blog.

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