MERCER CAPITAL

BUSINESS VALUATION &
FINANCIAL ADVISORY SERVICES

How to Value a Wealth Management Firm

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INTRODUCTION

Because valuation is a relative concept (one asset is only "worth" something when compared to the worth of other assets), the value of a wealth management firm is very much about context. The particular transactional purpose of a valuation is a context. The firm being valued is a context. The state of the wealth management industry is a context. Each context provides a perspective on the expected returns of an investment in a wealth management firm. This whitepaper is intended to give a brief overview of relevant considerations of these perspectives on the value of wealth management firms. It is not intended to be an exhaustive presentation of every consideration, but as the industry has grown up, so has the understanding of most participants that simply saying firms are worth "2% of AUM" is not enough. As professional valuation practitioners, we always viewed such rules of thumb with disdain, and welcome the attitudes of those who take the financial analysis of their own firms as seriously as they do the analysis of the securities they manage for their clients.

Is the Wealth Management Industry Mature?

The business of wealth management is characterized by some as mature, and others as dynamic, but in many ways it is surely both. This sometimes conflicting narrative is a consequence of industry history, which can be traced through eras of regulatory reform that have occurred since the depression.

Wealth management as we know it today took root shortly after World War II, when wealthy men (they were all men) who prospered by trading securities for depository institutions were forced to take their practices outside by a series of securities regulations enacted to avoid another economic depression. Investment advisory businesses could exist then, but broker-dealers were the preferred model, as the significant capital requirements of BDs reduced risk to regulators and, theoretically, clients. Wealth management grew significantly in the post war era as retail brokers acted as commissioned missionaries for investing in securities to generations of Americans still scarred by the depression.

Typically compensated on a commission basis, the broker was as incentivized to churn client assets as he was to grow them, because pay was tied to transactions rather than performance – at least directly. The result was often a gradual transfer of wealth from the customer to the broker, whose interests ran counter to most investors.

RIAs were an afterthought, and might still be, were it not for the advent of ERISA in the 1970s. Bad market conditions kept the lid on RIA growth for a decade or so, but by the 1980s registered reps were leaving wirehouse firms and young trust officers were leaving banks to set up registered investment advisors, usually offering a very wide variety of services priced under the then new fee-based concept, instead of commissions. The barrier to entry for setting up an RIA was more expertise-based than capital-based, and credentialing bodies like the Institute of Chartered Financial Analysts (now the CFA Institute) and the CFP Board grew rapidly. The growth of the RIA industry was fueled by a new bull market in domestic equities, as well as growing cynicism over the motivations of commissioned brokers.

Over the past couple of decades, the count of RIAs, the number of professionals who work for RIAs, and the dollar volume of assets managed by RIAs, has exploded. Competition has led to the need for differentiation, and that need has led to specialization. Although some firms still offer both “asset management” and “wealth management” services, these models are increasingly seen as different as manufacturing and distribution, with wealth management being essentially a distribution model. There is a regulatory impetus for this change as well, as the call for a sanctioned fiduciary standard becomes lodged in the mindset of retail clients, institutional investment committees, family offices, and consultants—whether or not there is ever governmental action on the matter.

A Better Model

Wealth management firms represent a critical link between asset management firms (who develop investment products using centralized strategies) and the highly fragmented retail client channel. At the moment, there is ample reason to believe that the wealth management side of the investment management business is healthier than asset management. Consider the following dynamics that are prevalent today.

Fee Pressure

Active versus passive may still be an intellectual debate, but there's no debate that trillions of dollars are managed passively today at much lower fees than would have been the case even five years ago. The transition has clobbered the revenue streams of asset management firms, especially if you could imagine what those management fees would be today but for the rise of index and ETF investing. Wealth management has largely side-stepped fee pressure thus far, and we don't hear many instances of wealth management firms bending their stated pricing schedules as a consequence of client pushback. Some industry observers think that day is coming, but we're not sure. Unlike asset managers, who have to justify their fees by beating a given benchmark, the "alpha" that wealth managers deliver is the professional discipline of financial planning and protecting clients from their own bad investing habits. There's a lot of upside for clients of good wealth managers, and a lot of reasons to believe that 1% of AUM will be a sticky fee-for-service level for years to come. The ability to keep this up will likely depend on their capacity to continue servicing clients while connecting with their next generation.

There is ample reason to believe that the wealth management side of the investment management business is healthier than asset management.

Technology

We've seen technology used increasingly by all investment management firms to backstop and rationalize administrative infrastructure. But whereas tech threatens to commoditize asset management from several angles, it mostly frees wealth managers to pursue new client relationships and to strengthen existing ones. The big threat of technology to wealth management was going to be the rise of the robo-advisor, but so far robos aren't very satisfying to clients of significant means, and have served mostly to augment the core asset of a wealth management business: the client/advisor relationship.

Demographics

The base of wealth management clients continues to grow as the baby boomers reach retirement age. Most wealth management clients become clients as they approach retirement. Increased longevity, especially for wealthier Americans, nonetheless assures that many of these will be long lasting client relationships, with at least an opportunity to continue the relationship with heirs thereafter. These demographic trends indirectly help asset managers as well, but to a lesser extent.

Scale

One area where the asset management model beats wealth management is scalability. You can build a bigger wealth management firm, but it usually requires a corresponding increase in advisors, planners, support staff, and compliance. Asset management firms often exhibit enormous financial leverage in their models, although we've seen that work both ways.

Ironically, despite how comparatively difficult it is to grow margins in wealth management, there is much more consolidation activity in wealth management than asset management (Affiliated Managers Group and BlackRock being two noteworthy exceptions). We think it's still debatable whether these consolidation efforts can produce enough efficiency and enhanced growth at the subsidiary RIA level to overcome the margin drag of parent company overhead, but with hundreds of smart people at Focus Financial, Hightower, CI Financial, CapTrust, and others working on the problem, we'll at least see some good attempts at a solution.

One area both asset management and wealth management firms are facing head-on is the issue of succession.

Succession

One area both asset management and wealth management firms are facing head-on is the issue of succession. Moving from the founding to second generation ownership and leadership is never easy, but the skill sets of leading a wealth management firm are generally in greater supply than those to head an asset management shop. Why? Asset management is usually built around the particular investment picking skills of a founder. Many asset management firms seek to create an investing discipline that is replicable and teachable, but oftentimes there is a creative aspect to security selection that leaves when the individual retires. Wealth management does not rely on idiosyncratic talent and is, therefore, easier to mimic; brokerage firms have been doing it for decades.

The Anatomy of a Wealth Management Firm

From Broker to Advisor

The industry, as a whole, has come a long way since the *Wolf of Wall Street* days. Evolving client expectations, increased transparency, and stronger fiduciary standards have expedited the broker-to-advisor conversion in recent years. This evolution has had some obvious benefits for advisors as well. Client attrition rates have plummeted since the broker days as customers are far more likely to stick around when their advisor's interests are aligned with their own. High retention rates make it easier to retain the employees who service these accounts, enabling partners to build an actual business rather than a collection of brokers that switches firms every few years.

Recurring revenue from asset-based fees is also more predictable than commission income. A wealth management firm's ongoing or run-rate revenue is simply the product of its current AUM balance and effective realized fee percentage. This predictability makes it easier to forecast hiring needs and project future levels of profitability. These apparent financial advantages, combined with the fact that the fee-based model is more appealing to clients, explains why the number of broker-dealer firms has declined over the last decade while the number of RIAs has grown year over year. Asset flows also demonstrate the apparent advantages of the fee-based, fiduciary model; RIAs as a group are growing AUM at a faster rate than other distribution channels and manage a growing share of total AUM. Look for these trends to continue as investors become more educated on fee structures while regulators crack down on conflicts of interest and suitability concerns.

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Characteristics of Today's Wealth Management Firm

According to *ThinkAdvisor* and a report from Investment Advisor Association (IAA), the typical (i.e. average) SEC-registered investment advisor has the following characteristics:

- Works with a team of eight employees;
- Has $341 million in regulatory assets under management;
- Manages 141 client accounts;
- Exercises discretionary authority over most accounts;
- Does not have actual physical custody of client assets or securities; and
- Is organized as a U.S.-based limited liability company headquartered in California, Connecticut, Florida, Illinois, Massachusetts, New Jersey, New York, Ohio, Pennsylvania, or Texas.

Even though some of the firms included in the report outlined above are not specifically wealth managers, they are generally representative of the wealth management industry since 95% of their clients are individuals rather than institutions. The report also states that over 95% of RIAs are compensated as a percentage of AUM while approximately 3% charge commissions, so it doesn't include many broker-dealers or RIA/BD hybrids. Perhaps also in contrast to the Wall Street era, 87% of RIAs reported no disciplinary history at all.

RIAs with over $100 billion in AUM grew at a faster pace than smaller advisors.

The IAA report also states that 57% of RIAs are "small businesses," employing ten or fewer non-clerical employees, with 88% employing fewer than 50 people. While, the majority of assets are still managed by a small group of large advisors, both smaller firms (with under $1 billion of assets) and larger firms (with over $100 billion in AUM) saw increases both in terms of the number of firms and also AUM. However, RIAs with between $25 million and $100 million experienced a decline in the number of advisors.

How Does Your Wealth Management Firm Measure Up?

According to RIA in a Box's annual survey, the average advisory fee in 2019 was 0.96%, flat from the prior year. A little math (0.96% x $341 million) implies average annual revenue of $3.3 million. According to the InvestmentNews Advisor Compensation & Staffing Study, the average operating margin for an RIA was 22.8% in 2017, so here's how the "typical" advisory firm P&L breaks out:

Average RIA Metrics	
Assets Under Management	$341,000,000
x Average Realized Fees	0.96%
= Revenue	$3,273,600
x Average Operating Margin	22.80%
= Average Operating Income	$746,381

Realized fees for the asset management industry have been on the skid for quite some time. Recent declines in AUM and revenue combined with generally higher costs associated with rising compensation expenses means margins have compressed. The silver lining for wealth management firms is that their generally more adhesive customer base won't jump ship after a few quarters of poor returns.

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

RIA Valuation Insights Blog

Mercer Capital's blog, *RIA Valuation Insights*, presents weekly updates on issues important to the investment management industry. To visit the blog or to subscribe, visit **mer.cr/RIAInsights**.

Value Focus: Investment Management Newsletter

The team also produces a complimentary quarterly newsletter which contains an industry market overview, a review of recent transactions, and tracks multiples by industry sector. To view the current issue and the archives or to subscribe, visit **mer.cr/RIA-nl**.

When You Need a Valuation

If you've never had your wealth management firm valued, you will, eventually, need to do so. That need may arise because of a circumstance you intended, or it may be because of a circumstance that was forced upon you. Whether voluntary or involuntary, the situation giving rise to the need for a valuation will probably be one of the most important of your life as a business owner.

The Business Transfer Matrix	PARTIAL SALE/TRANSFER	TOTAL SALE/TRANSFER
THINGS YOU MAKE HAPPEN	ESOP Outside Investor(s) Sale to Insiders/Family Combination Merger/Cash Out Going Public	Sale of Business Stock-for-Stock Exchange w/ Public Co. Stock Cash Sale to Public Co. Installment Sale to Insiders/Family ESOP/Management Buyout
THINGS THAT HAPPEN TO YOU	Death Divorce Forced Restructuring Shareholder Disputes	Death Divorce Forced Restructuring Bankruptcy

In our practice, wealth management firms usually need valuations for one of three reasons: shareholder agreements, transactions, and litigation.

Shareholder Agreements

Simply put, a buy-sell agreement establishes the manner in which shares of a private company transact under particular scenarios. Ideally, it defines the conditions under which it operates, describes the mechanism whereby the shares to be transacted are priced, addresses the funding of the transaction, and satisfies all applicable laws and/or regulations.

These agreements aren't necessarily static. In investment management firms, buy-sell agreements may evolve over time with changes in the scale of the business and breadth of ownership. When firms are new and more "practice" than "business," these agreements may serve more to decide who gets what if the partners decide to go separate ways. As the business becomes more institutionalized, and thus more valuable, a buy-sell agreement—properly rendered—is a key document to protect the shareholders and the business (not to mention the firm's clients) in the event of an ownership dispute or other unexpected change in ownership. Ideally, the agreement also serves to provide for more orderly ownership succession, not to mention a degree of certainty for owners that allows them to focus on serving clients and running the business instead of worrying about who gets what benefit of ownership.

Transactions

We are witnessing significant M&A activity in the industry as one generation of business owners prepares for retirement with and without having planned for a successful ownership transition from one generation of business leaders to the next.

Valuations and financial analysis for transactions encompass a refined and scenario-specific framework. The valuation process should enhance a buyer's understanding of the cash flows and corresponding returns that result from purchasing or investing in a wealth management firm. For sellers or prospective sellers, valuations and exit scenarios can be modeled to assist in the decision to sell now or later and to assess the adequacy of deal consideration. Setting expectations and/or defining deal limitations are critical to good transaction discipline.

Are you managing your business in a way that increases value?

Even those not currently contemplating a transaction in their business have a reason to consider a business valuation because knowing the value of your business can be a tremendously effective management tool.

Ultimately, you will get two returns from your business—"interim cash flows" and "terminal cash flows." Interim cash flows include your salary, your benefits, and your dividends. You know what these are and what you can do to influence them. However, your greatest cash flow may be the terminal cash flow (i.e., the value when you sell your business). Therefore, it is important to ask — **are you managing your business in a way that increases value or not?**

Disputes

Unlike most closely-held businesses which are owned by members of the same family, most wealth managers are owned by unrelated parties. A greater than normal proportion of RIAs are very valuable, such that there is more at stake in ownership than most closely held businesses. Consequently, when disputes arise over the value of ownership in a wealth management firm, there is usually more than enough cash flow to fund the animosity, and what might be a five figure settlement in some industries is a seven figure trial for an RIA. The need for a valuation may arise out of deficiencies in your buy sell agreement, the divorce of one of your primary shareholders, or in the case that the business has been damaged as a result of a "bad actor". In litigious circumstances, the rules and the standards for due diligence and work product are subject to a high level of scrutiny, and the skillset required of the appraiser is equally high.

Beware that many valuations (most in our experience) performed by industry advisors and some inexperienced business appraisers do not meet the requirements of the business valuation standards of many professional appraisal societies.

Who Should Value Your Wealth Management Firm?

Aren't partners in wealth management firms equipped to value their own business? RIAs (unlike many other closely held businesses) have ownership groups with ample training in relevant areas of finance that enable them to understand financial statement analysis, cash flow forecasting, and market pricing data. What they lack is the arms' length perspective to use their technical skills to determine an unbiased result.

Many business owners suffer from familiarity bias and the so-called "endowment effect" of ascribing more value to their business than what it is actually worth simply because it is well-known to them or because it is worth more to them simply because it is already in their possession. On the opposite end of the spectrum, some owners prone to forecast extreme mean reversion such that they discount the outperformance of their business and anticipate only the worst. Partners with a strong grounding in securities analysis and portfolio management have a bias to seeing their business from the perspective of intrinsic value, which can limit their acceptance of certain market realities necessary to price the business at a given time.

In any event, just as physicians are cautioned not to self-medicate, and attorneys not to represent themselves, so too should professional investment advisors avoid trying to be their own appraiser.

"Rules of Thumb" Don't Work

Many owners of wealth management firms consider the value of their practice using broad-brush metrics referred to as "rules-of-thumb." Such measures admittedly exist for a reason, but cannot begin to address the issues specific to a given firm.

Understanding why such rules-of-thumb exist is a good way to avoid being blindly dependent on them. Observed market multiples are often condensed into "rules of thumb", or general principals about what an investment firm is or should be worth. These rules provide a simple, back-of-the-envelope way of quickly computing an indicated value of a wealth management firm. However, rules of thumb are not one-size-fits-all.

As an example of this, industry participants might consider wealth managers as being worth some percentage of assets under management. At one time, wealth managers valuations were thought to gravitate toward about 2% of AUM. The example below demonstrates the problematic nature of this particular rule of thumb for two wealth managers of similar size, but widely divergent fee structures and profit margins.

At one time, wealth managers valuations were thought to gravitate toward about 2% of AUM.

	Firm A	Firm B
Assets Under Management (AUM)	$1,000,000,000	$1,000,000,000
x Realized Average Fee	**1.00%**	**0.40%**
= Revenue	$10,000,000	$4,000,000
x EBITDA Margin	**25.00%**	**10.00%**
= EBITDA	$2,500,000	$400,000
Implied Value at 2% of AUM	$20,000,000	$20,000,000
Effective Multiple of EBITDA	**8.0x**	**50.0x**

Both Firm A and Firm B have the same AUM. However, Firm A has a higher realized fee than Firm B (100 bps vs 40 bps) and also operates more efficiently (25% EBITDA margin vs 10% EBITDA margin). The result is that Firm A generates $2.5 million in EBITDA versus Firm B's $400 thousand despite both firms having the same AUM. The "2% of AUM" rule of thumb implies an EBITDA multiple of 8.0x for Firm A—a multiple that may or may not be reasonable for Firm A given current market conditions and Firm A's risk and growth profile, but which is nevertheless within the historical range of what might be considered reasonable. The same "2% of AUM" rule of thumb applied to Firm B implies an EBITDA multiple of 50.0x—a multiple which is unlikely to be considered reasonable in any market conditions.

We've seen rules of thumb like the one above appear in buy/sell agreements and operating agreements as methods for determining the price for future transactions among shareholders or between shareholders and the company. The issue, of course, is that rules of thumb—even if they made perfect sense at the time the document was drafted—do not have a long shelf life. If value is a function of company performance and market pricing, then both of those factors have to remain static for any rule-of-thumb to remain appropriate. This circumstance, obviously, is highly unlikely.

Choosing an Independent Expert

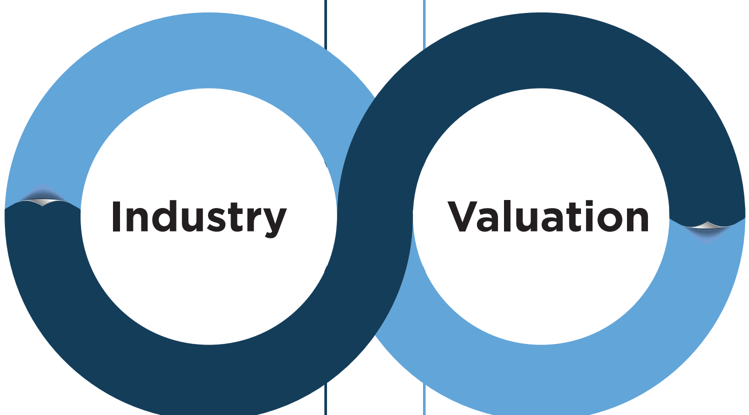
Once you decide to engage a professional to value your firm, you'll need reasonable criteria to decide whom to work with.

Choosing someone to perform a valuation of your wealth management firm can be daunting in and of itself. Over time, we have reviewed a wide variety of work product from different types of service providers—but have generally observed that there are two types of experts available to the ownership of wealth management firms: Valuation Experts and Industry Experts. These two types of experts are often seen as mutually exclusive, but you're better off not hiring one to the exclusion of the other.

There are plenty of valuation experts who have the appropriate training and professional designations, understand the valuation standards and concepts, and see the market in a hypothetical buyer-seller framework. And there are a number of industry experts who are long-time observers and analysts of the industry, who understand industry trends, and have experience providing advisory services to wealth managers. However, business valuation practitioners are often guilty of shoehorning wealth managers into their generic business valuation templates, resulting in flawed valuation conclusions that don't square with market realities. By contrast, industry experts are frequently guilty of a lack of awareness concerning the use and verification of unreported market data, for the misapplication of valuation models, and for not understanding the reporting requirements of valuation practice.

Industry Experts

- Long-time observers and analysts of the industry
- Understands industry concepts and terminology
- Writes/speaks about industry trends
- Transactions experience
- Regularly provide advisory services to BDs / RIAs / Trustcos
- See the market as typical buyers and sellers of interests in Investment Management Firms



Valuation Experts

- Appropriate training and professional designations
- Understanding of valuation standards and concepts
- Sees the market as hypothetical buyers and sellers
- Regularly values minority interests
- Advises on buy-sell agreements
- Defends work in litigated matters
- Handles recurring tax and/or valuation work for other clients

At Mercer Capital, we think it is most beneficial to be both industry specialists and valuation specialists.

The valuation profession is still, for the most part, populated with generalists. But as the profession matures, an increasing number of analysts are realizing that it isn't possible to be good at everything, and that they can do better work for clients if they specialize in a type of valuation or a particular industry. Because our firm has had a specialty in valuing financials since they day we opened for business in 1982, it was easy to pursue this to its logical conclusion.

How Your Appraiser Will "Scope" Valuing Your Firm

Before covering specific approaches to valuation, there are a few basic valuation concepts that must be explored. Some business owners may be surprised to learn that their business does not have a single value, but rather, that its valuation is determined by numerous factors. Tax, legal, and other elements play important roles in defining value based upon the transfer circumstances. While there are significant nuances to each of the following topics, our purpose is to help you combine the economics of valuation within the relevant framework.

The Valuation Date

Every valuation has an "as of" date, which is the date on which the analysis is focused. The date may be set by legal requirements related to a death or divorce, or it may be implicit, such as the closing date of a transaction. In many circumstances, a valuation must consider only what was "known or reasonably knowable" at the valuation date.

Using the proper standard of value is crucial in obtaining an accurate determination of value for the intended purpose.

Purpose

The purpose of the valuation is linked to the transfer event at hand (such as a sale, estate planning, or buy-sell agreement trigger). A valuation prepared for one purpose is not necessarily useful or applicable for another.

Standard of Value

The standard of value is an important concept that must be addressed in every valuation assignment, as it influences the selection of valuation methods as well as the level of value. "Fair market value," most commonly used in tax matters, is the most familiar standard of value. Other important standards of value include "investment value" (purchase and sale transactions), "fair value" (financial reporting purposes under GAAP), "statutory fair value" (corporate reorganizations), and "intrinsic value" (public securities analysis). Using the proper standard of value is crucial in obtaining an accurate determination of value for the intended purpose.

Fair Market Value

Fair market value is defined as follows:

> *The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market when neither is under compulsion to buy*

> *or sell and when both have reasonable knowledge of the relevant facts. (American Society of Appraisers Business Valuation Standards)*

The willing seller and the willing buyer are hypothetical parties. Each is assumed to be well informed about the subject interest and the market context in which it might be transacted.

Fair market value is the most common standard of value used in business appraisals. With respect to the wealth management industry and business valuation, the development and communication of "fair market value" requires an awareness of the market conditions under which wealth managers typically transact and the general conditions that transfers of ownership interests are subject to.

Investment Value (Strategic Value)

Investment value is defined as follows:

> *The value to a specific investor based on their particular investment requirements and opportunities. The value produced would reflect the knowledge, expectations, synergies, and economies of scale of the particular investor. (American Society of Appraisers Business Valuation Standards)*

Investment value, also referred to as "strategic value" or "value to the owner," is often used when valuation or investment banking professionals are advising their clients on the merits of executing a specific transaction such as buying or selling a specific business or asset. Investment value answers the question—what is a wealth management firm worth to a specific party based on investor-specific considerations?

Strategic value is usually higher than fair market value. Consider the following.

In the context of a hypothetical buyer and hypothetical seller framework, the value of a wealth management firm is likely based on the present value of expected future cash flows generated by the business with some consideration for market pricing. The value may consider foreseeable strategic initiatives such as increased spending on technology aimed to improve customer experience and create more sticky relationships. However, the value of the business is generally thought to be the same to any financial investor in the business.

Compare this situation to the circumstance of one wealth management firm buying another wealth management firm in order to expand its geographic presence, reduce overhead, and combat margin compression. This buyer may pay more for every $1 under management at the target wealth manager with the expectation that it can reduce the company's current expense base and earn higher margins. The strategic value in this case could be much higher than fair market value, based on selling the business to another wealth manager who is motivated beyond the objectives and purely financial motivations of a hypothetical investor.

> Strategic value is usually higher than fair market value.

The wealth management industry is consolidating, and it may be reasonable to assume that an eventual strategic exit value could be available to any owner with the capacity and patience to wait for it.

That is not to say that when a strategic exit is planned (or reasonable to expect) that the two values will converge. If such an exit is five, ten, or more years in the future, there can be a meaningful difference between fair market value and investment/strategic value. The complexity of these considerations may be compounded when valuing minority interest positions in a business versus a controlling interest.

Fair Value in Legal Matters

In legal matters, fair value is a statutory standard of value (inclusive of any relevant judicial guidance) applicable to cases involving dissenting or oppressed shareholders and/or with respect to corporate reorganizations or recapitalizations. Fair value may also have a specific and differentiated meaning under state laws. In litigation proceedings, case venue and jurisdiction dictate.

Fair value frameworks will typically reconcile to a single or hybrid definition of value under the standard of fair market value or investment value. Legal counsel determines the value-defining elements as part of the engagement agreement with the valuation expert.

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Fair Value for Financial Reporting Purposes

The Financial Accounting Standards Board (FASB) functionally introduced the discipline of fair value measurement for accounting purposes with a series of pronouncements in the early 2000s. The changes were intended to impart greater financial transparency and consistency in an accounting universe steeped in historical cost disciplines and to enhance the accuracy and timeliness of information provided to users of financial statements whether they be lending institutions, investors in publicly traded securities, or individual owners of closely held businesses.

We will not delve into the details; however, it's important for wealth managers to understand how fair value is applied upon the closing of a transaction and during annual goodwill impairment tests.

When the acquisition of a wealth manager occurs, the aggregate value paid for the company's assets is required to be allocated to the various assets purchased. For companies that develop their financial statements under GAAP, this specific exercise (called a purchase price allocation or "PPA") is required to allocate the total enterprise value to the acquired assets, both tangible and intangible. For wealth managers who have very few tangible assets, a purchase price allocation is even more important so that the balance of intangible assets can be allocated to amortizable intangibles such as the value of the customer relationships and non-amortizable assets such as goodwill.

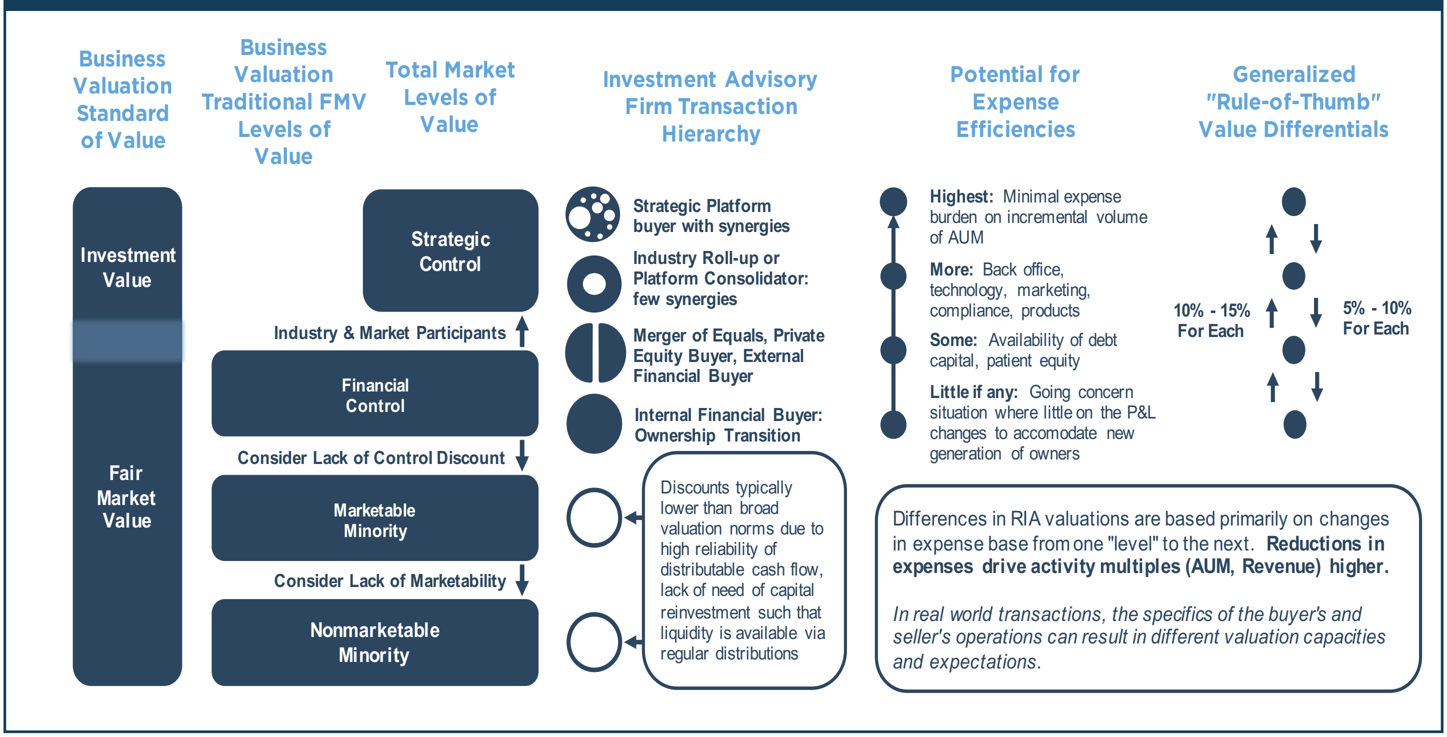
Not only are PPAs vital to the process of purchase accounting, so too is the annual or periodic test for impairment. If your financial statements include a significant intangible asset balance and there is an unfavorable change in the market value for such assets, your accountant may require an impairment test. An impairment test includes an analysis to determine if a previously recorded asset value is impaired. If impairment is indicated, an additional analysis quantifies the adjusted value and the corresponding impairment charge required to restate the value of the asset.

Levels of Value

When business owners think about the value of their business, they usually neglect to consider the levels of value concept. From this perspective, the value of a single share is the value of the whole divided by the number of outstanding shares. In the world of valuation, however, this approach may not be appropriate if the aggregate block of stock does not have control of the enterprise; in many cases, the value of a single share will be less than its pro rata share of the enterprise.

The determination of whether the valuation should be on a controlling interest or minority interest basis can be a complex process, but it is also essential. A minority interest value often includes discounts for a lack of control and marketability; therefore, it is quite possible for a share of stock valued as a minority interest to be worth far less than a share valued as part of a control block. Grasping the basic knowledge related to these issues can help you understand the context from which the value of a business interest is developed.

Valuation Framework: You Are (Somewhere) Here



FREQUENTLY ASKED QUESTION

What is involved in your valuation process?

Every project is different, but most progress from information gathering to research, analysis, and then reporting. The timeline is typically 6-8 weeks.

Engagement Phase

- **Initial call**
  When you call us, we discuss (1) your firm, (2) your situation, and (3) your needs. During our discussions, we determine the type and scope of services that your project will entail.
- **Provide engagement letter (immediately)**
  The engagement letter provides a descriptive project overview and sets forth the timetable and fee arrangement. At this point or shortly thereafter, we also send you a preliminary information request.

Valuation Phase

- **Initial research**
  We conduct a preliminary analysis of your company, including research and review of industry data and information you provide.
- **Leadership interview (after initial research)**
  We visit with appropriate members of management to review your company's background, financial position, and outlook, and respond to your questions.
- **Analysis and report preparation**
  Following the management interview, the analysis is completed and the valuation report is prepared to explain and support our analysis.

Report Phase

- **Draft provided for client review**
  Your review of the draft report is an important element in the process. We discuss the draft report with you to assure factual correctness and to clarify questions you have about the report.
- **Final report & discuss next steps**
  Upon final review, the final report is issued. Any follow-up consulting, if needed, is begun.

Valuation Methodology

There are three general approaches to determining the value of a business: the asset-based approach, the income approach, and the market approach. The three approaches refer to different bases upon which value may be measured, each of which may be relevant to determining the final value. Ultimately, the concluded valuation will reflect consideration of one or more of these approaches (and perhaps several underlying methods) based on those most indicative of value for the subject interest. The depiction below summarizes the methods typically used to value wealth management firms under each valuation approach.

Asset-Based Approach	Income Approach	Market Approach
Not applicable because wealth management firms are not (internally) capital intensive businesses	Discounted cash flow analysis to evaluate business plan and industry trends	Pricing metrics from public companies and transactions relative to company performance characteristics

Asset Approach

The net asset value method is, in simple terms, a balance sheet approach to value. Book value (or adjusted book value, sometimes called net asset value) is a primary benchmark of value in many asset intensive companies but provides little insight into the value of a wealth manager, which usually doesn't have much of a balance sheet or capital base.

Market Approach

The market approach is a general way of determining the value of a business which utilizes observed market multiples applied to the subject company's performance metrics to determine an indication of value. The "market" in market approach can refer to either public or private markets, and in some cases the market for the subject company's own stock if there have been prior arm's length transactions. The idea behind the market approach is simple: similar assets should trade at similar multiples (the caveat being that determining what is similar is often not so simple). The market approach is often informative when determining the value of a wealth management firm.

There are generally three methods that fall under the market approach.

1. Guideline Public Company Method
2. Guideline Transaction Method
3. Internal Transaction Method

All three methods under the market approach involve compiling multiples observed from either publicly traded guideline companies, comparable transactions in private companies, or prior transactions in the company's own stock and applying the selected (and possibly adjusted) market multiples to the company's performance measures.

Multiple Multiples

The most common multiples used when valuing wealth management firms are enterprise value (EV) to EBITDA[1], EV to AUM, and EV to revenue multiples. The multiples used are generally categorized as either "activity" multiples or "profitability" multiples. Activity multiples are multiples of AUM and revenue; whereas, profitability multiples are multiples of earnings metrics (e.g. EBITDA).

Both profitability and activity multiples have their advantages and disadvantages. Activity multiples can provide indications of value for a subject wealth management firm that are only a function of the chosen activity metric—typically AUM or revenue. Such an indication is not a function of the profitability of the firm, which can be an issue because the underlying profitability of a firm is the ultimate source of value, not revenue or AUM. The benefit of activity metrics, however, is that they can be used without explicitly making normalizing adjustments to a wealth management firm's profitability. The caveat, however, is that applying market-based AUM and revenue multiples to the subject wealth management firm's activity metrics is essentially transposing the realized fee structures and EBITDA margins of the guideline companies onto the subject firm—an implicit assumption about normalized profitability and realized fees which may or may not be reasonable depending on the specific circumstances.

Both profitability and activity multiples have their advantages and disadvantages.

If a particular asset manager doesn't enjoy industry margins (whether because of pricing issues or costs of operations), value may be lower than the typical multiple of revenue or AUM. In the alternative case, some companies achieve sustainably higher-than-normal margins, which justify correspondingly higher valuations. However, the higher levels of profitability must be evaluated relative to the risk that these margins may not be sustainable. Whatever the particulars, our experience indicates that valuation is primarily a function of expected profitability and is only indirectly related to level of business activity.

[1] Wealth management firms tend to have little "DA", so EBITDA is typically approximately equal to EBIT and operating income.

Profitability multiples, on the other hand, explicitly take into account the subject firm's profitability, which on its face is a good thing. Profitability metrics are not without their drawbacks, however. Differences in risk or growth characteristics will, all else equal, result in different EBITDA multiples. If the risk or growth prospects of the subject company differ from the guideline companies that informed the selected EBITDA multiple, then the appropriate multiple for the subject company will likely differ from the observed market multiple.

Subject Company Performance Measures

Once a market-based profitability multiple is obtained which reflects the risk and growth prospects of the subject firm, the next question is often: which EBITDA (or other profitability metric) is the multiple applied to? Reported EBITDA? Management adjusted EBITDA? Analyst adjusted EBITDA? Wealth management firms frequently require significant income statement adjustments—the largest of which is typically related to normalizing compensation—and so the answer to the question of which EBITDA to apply the multiple to have a significant impact on the indicated value.

It's often said that "value equals earnings times a multiple." While there is some truth to be had there, the simplicity of the statement belies the reality that the question of the appropriate multiple and the appropriate measure of earnings is rarely straightforward, and buyers and sellers may have very different opinions on the answer.

Guideline Public Company Method

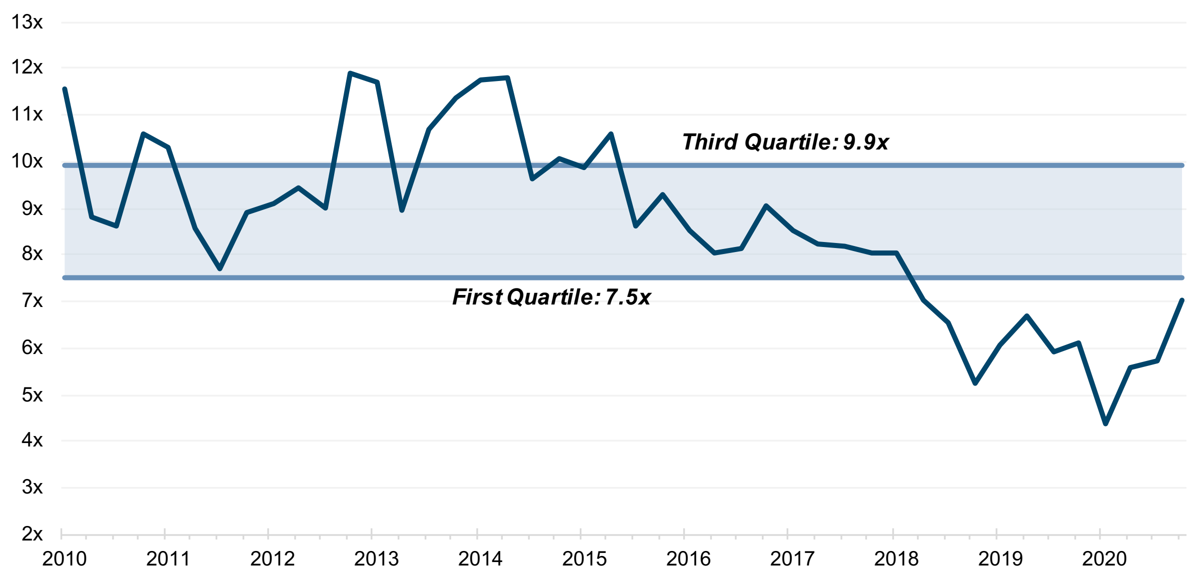
The guideline public company method uses multiples obtained from publicly traded businesses to inform the value of a subject company. For wealth managers, the universe of publicly traded firms is relatively small.

The chart at the top of page 20 shows historical EV / LTM EBITDA multiples for publicly traded RIAs with less than $100 billion in AUM (the size range which most of our clients fall in). As can be seen, the public companies have generally traded in a band of 7.5-10x LTM EBITDA. Pricing for these public companies fell to a historically low multiple of just over 5 times at year-end 2018.

Since 2018, EBITDA multiples for smaller publicly traded asset/wealth managers have remained below historical norms. This downturn reflects adverse trends like pricing pressure and asset outflows that have impacted this group of public companies (which consists predominately of asset managers). Many sectors of closely-held RIAs, particularly wealth managers, as well as larger public asset/wealth managers have been less impacted by these trends and have seen more resilient multiples as a result.

> The lack of available information on deal terms can make it difficult to determine the actual value of the consideration paid.

EV / EBITDA Multiples for Publicly Traded RIAs under $100B AUM (Last 10 Years)



When valuing small, privately held wealth management firms, the use of multiples from publicly traded companies—even the smallest of which is still quite large compared to most privately held RIAs—naturally brings up questions of comparability. How comparable is a wealth management firm with, say, $1-10 billion in AUM and a few dozen employees to BlackRock, which manages approximately $8 trillion? The answer is probably not very.

The comparison of the small, privately held RIA to BlackRock is obviously extreme, but it illustrates the issues of comparability that are frequently present when using publicly traded businesses to value privately held wealth management firms. In our experience, the issues of comparability between small, privately held companies and publicly traded companies are frequently driven by key person risk/lack of management depth, smaller scale, and less product and client diversification. These differences point towards greater risk for privately held RIAs versus the publicly traded companies, which, all else equal, suggests that the privately held RIAs should trade at a lower multiple to that observed in the public markets.

The growth prospects for privately held RIAs can differ from publicly traded companies as well. Because small, privately held RIAs tend to be focused on a single niche, the growth prospects tend to be more extreme, either positive or negative, compared to publicly traded guideline companies. A subject company's singular niche may be growing quickly or shrinking, whereas the diversified product offerings of publicly traded companies are likely to have some segments that are growing and some that are shrinking, resulting in a moderated overall growth outlook. The growth prospects, of course, impact the multiple at which the subject company should trade. In some cases, we've seen RIAs much smaller than the guideline public companies transact at a premium to the then-prevailing observed public company multiples because of the RIA's attractive growth prospects. More often, however, the higher risk of the privately held RIA dominates, and the justified multiple is lower than the guideline public company multiples. As a general rule, a smaller RIA means a smaller multiple.

Despite the less-than-perfect comparability between publicly traded companies and most privately held RIAs, publicly traded companies provide a useful indication of investor sentiment for the asset class, and thus, should be given at least some consideration. However, due to differences in risk and growth characteristics, adjustments to the multiples observed in the guideline companies may need to be made.

Guideline Transactions Method

Guideline transactions of private companies in the wealth management space provide additional perspective on current market pricing of RIAs. The guideline transactions method uses these multiples to derive an indication of value for a subject firm.

The transaction data is appealing because the issues of comparability are generally less pronounced than with the guideline public companies. There are caveats to the guideline transactions method, however. One unique consideration for the use of the guideline transactions method in the wealth management industry is that deals in the industry almost always include some form of (often substantial) contingent consideration (earn-out). The structure of such contingent consideration will be tailored to each deal based on the specific concerns and negotiations of the buyers and sellers. In any event, the details of the earn-out payments are often not publicly available. The lack of available information on deal terms can make it difficult to determine the actual value of the consideration paid, which translates into uncertainty in the guideline transaction multiples.

Transaction data is appealing because the issues of comparability are generally less pronounced than with the guideline public companies.

Another important consideration is that deals in the industry occur for unique reasons and often involve unique synergies. It's not always reported what these are, and the specific factors that motivated a particular guideline transaction may not be relevant for the subject company. The type of buyer in a guideline transaction is another consideration. Private equity (financial buyers) will have different motivations, and will be willing to pay a different multiple, than strategic buyers.

Despite an uptick in sector deal activity over the last several years, there are still relatively few reported transactions that have enough disclosed detail to provide useful guideline transactions multiples. Looking at older transactions increases sample size, but it also adds transactions that occurred under different market conditions, corporate tax environments, and the like. Stale transaction data may not be relevant in today's market.

Internal Transaction Method

The internal transactions method is a market approach that develops an indication of value based upon consideration of actual transactions in the stock of a subject company. Transactions are reviewed to determine if they have occurred at arm's length, with a reasonable degree of frequency, and within a reasonable period of time relative to the valuation date. Inferences about current value can sometimes be drawn, even if there is only a limited market for the shares and relatively few transactions occur.

However, even arm's length transactions in the subject company stock occur for unique reasons and often involve unique synergies, which means even these implied multiples are not always a clean indicator of value.

The Income Approach

The income approach is a general way of determining the value of a business by converting anticipated economic benefits into a present single amount. Simply put, the value of a business is directly related to the present value of all future cash flows that the business is reasonably expected to produce. The income approach requires estimates of future cash flows and an appropriate discount rate with which to determine the present value of future cash flows.

Methods under the income approach are varied but typically fall into one of two categories:

1. Single period capitalization of free cash flow
2. Discounted future cash flow model (DCF)

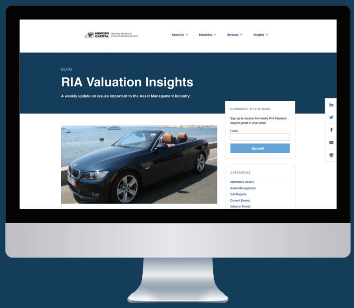
Single Period Capitalization Model

The simplest method used under the income approach is a single period capitalization model. Ultimately, this method is an algebraic simplification of its more detailed DCF counterpart. As opposed to a detailed projection of future cash flow, a base level of annual net cash flow and a sustainable growth rate are determined.

$$\text{Value of a Business} = \frac{CF_0(1+g)^1}{(1+r)^1} + \frac{CF_0(1+g)^2}{(1+r)^2} + \ldots + \frac{CF_0(1+g)^\infty}{(1+r)^\infty} = \frac{CF_0(1+g)}{(r-g)}$$

The denominator of the expression on the right ($r - g$) is referred to as the "capitalization rate", and its reciprocal is the familiar "multiple" that is applicable to next year's expected cash flow. The multiple (and thus the firm's value) is negatively correlated to risk and positively correlated to expected growth.

There are two primary methods for determining an appropriate capitalization rate a public guideline company analysis or a "build-up" analysis. The first, most familiar method applies the P/E ratio from a guideline public company analysis. A build-up analysis can be based up on the Capital Asset Pricing Model (CAPM) or Adjusted CAPM (ACAPM). Both the P/E ratio and the built-up capitalization factor articulate the risk and growth factors that investors believe underlie earnings measures.



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Discounted Cash Flow Model

Wealth management firms are frequently valued using the DCF method because this method allows for detailed modeling of revenue and expense items over the discrete projection period. A discrete projection period of three to five years is typically employed so that AUM trends, fee levels, and operating expenses can be modeled with reasonable certainty based on the current trends and business model. Beyond the discrete projection period, it is assumed that the business will grow at a constant rate into perpetuity. In circumstances where no changes in the business model or capital structure are expected, a single period capitalization method may suffice.

The discounted cash flow methodology requires three basic elements:

1. Forecast of expected future cash flows
2. Determination of terminal value
3. Selection of an appropriate discount rate

Client assets (AUM) may correlate to a great extent with the market, but client relationships do not.

Forecast of Expected Future Cash Flows

Both the single period capitalization model and DCF model require a base level of cash flows to either (1) capitalize with the appropriate multiple, or (2) use as starting point to model future growth and profitability.

The base rate of profitability is determined by a wealth manager's current revenue and cost structure, with possible adjustments made. It is often said that wealth managers generate revenue while they sleep, as revenue is a function of assets under management and is typically not performance or commission based. The fee-based revenue model used by most wealth management firms allows us to determine an ongoing (run rate) level of revenue by multiplying assets under management at any given day by the business' average realized fee structure.

The base rate of expenses for wealth management firms is typically based on reported expenses over the most recent annual period, with adjustments made for various items (the most significant of which typically relates to normalizing compensation).

Projected Cash Flow

We typically view the discounted cash flow method as superior to the single period capitalization approach as it is more dynamic and allows for the discrete forecasting of cash flows. Projections of future cash flows rely on many assumptions as explained below and summarized in the table on page 25.

Assets Under Management

Projected AUM growth should consider both growth in new business and expected market returns based on overall asset allocation. When determining growth in AUM it is important to ask what has historically

Projected Distributable Cash Flow	
Average AUM	Revenue Mix, Capture & Loss Rate, Marketing Effectiveness
x Realized Fees	Fees schedule trends in light of competitive pressure
= Revenue	Include any non fee-based sources of revenue
- Owner Compensation	Salary, bonus, & benefits
- Staff Compensation	Appropriate staffing for business plan; wage pressure for key relationship managers
- Non-Personnel Costs	Non-labor cost trends; can be source of operating leverage
= Pre-Tax Profitability	Evaluate in light of industry norms and trends
+/- Noise (CapEx, Depreciation, Investment in Working Capital)	Rarely significant
- Taxes	State or federal taxes or tax pass-through
= Distributable Cash Flow	Source of incentive compensation or real profitability?

driven growth and if it is reasonable to assume that this trend will continue. For example, has a firm's historical AUM growth been driven by market movement or by new client generation? Markets will have good years and bad years, but strong client relationships (and the ability to generate new ones) result in a continual source of new assets to manage. **Client assets (AUM) do correlate to a great extent with the market, but client relationships do not.** Without proper relationship management, assets leave and revenue suffers.

Further complicating new AUM generation, many wealth managers have aging customer bases and are struggling to attract younger clients who are more likely to choose passive alternatives. As managers struggle to gain new clients in light of the competitive environment, effective marketing has become increasingly important.

Realized Fees

Projected realized fees are typically evaluated in light of historical levels. However, fee compression has plagued the industry in recent years, and in light of increasing fee consciousness among clients, some wealth managers are tempering fees in order stem outflows.

Compensation

Wealth management is a relationship business, and relationships require the time and energy of a dedicated staff. The majority of a typical wealth management firm's expenses are personnel expenses, which include salaries, bonuses, and other benefits for employees and officers. Compensation generally tracks revenue fairly closely, making operating leverage more pronounced with overhead costs than compensation related expenses.

Compensation programs tend to evolve in wealth management firms and over time take on a life of their own. Inevitably, compensation programs tend to be intertwined with business model and ownership. The valuation process typically includes an analysis of the compensation program to formulate a normalized margin that can be used to value the firm.

The compensation structure for owners is often affected by the tax environment. The corporate structure of a firm (C corp vs S corp or other pass-through entity) as well as the current federal and state tax environment frequently determines whether firms pay out profit as bonuses or distributions. For example, in states with high corporate tax rates but no personal income tax, income is more likely to be paid out in the form of bonus compensation rather than distributions in order to reduce taxable income at the corporate level.

Non-Compensation Operating Expenses

Marketing expenditures have increased as wealth managers seek to attract new, often younger, clients. We have seen an increased focus on branding as wealth managers seek to connect with clients on a more personal level. Additionally, spending on technology has increased as wealth managers update their platforms to increase transparency and cater to younger clients who prefer to manage their accounts online. This increased reliance on technology has allowed some wealth mangers to reduce overhead combatting margin compression.

With some exceptions, wealth managers' non-compensation operating expenses are generally fixed in nature, which allows wealth managers to take advantage of operating leverage over time.

Terminal Value & Discount Rate

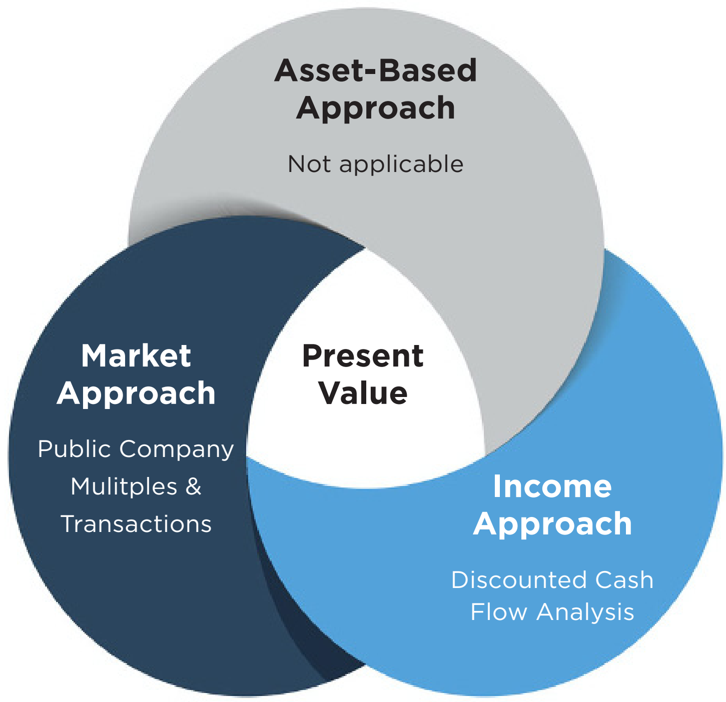
Once it is assumed that the business will achieve a constant level of performance, the remaining cash flows are capitalized and represented by a terminal value. An appropriate discount rate is used to discount the forecasted cash flows and the terminal value to the present.

The sum of the present values of all the forecasted cash flows (both the discretely forecasted periods and the terminal value) is the indication of value for a specific set of forecast assumptions.

Reconciling Indicated Values

Your firm's valuation should clearly articulate the observations, assumptions, adjustments, and empirical data upon which methods are based. If your valuation provider cannot develop and report their analyses in a manner that you sufficiently understand, get clarification or a new appraiser. You may not agree 100% with the conclusion, but you should understand the methods used and recognize your wealth management firm in the report.

Additionally, your firm's valuation should make sense in light of industry trends and valuations observed within the public and private markets.



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

The asset approach is generally not considered 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.

Value indications from the market approach can be reasonably volatile, since the market for investment 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 investment management firms. Nonetheless, using multiple valuation approaches serves to generate tests of reasonableness against which the different indications can be evaluated.

Putting It All Together

Although some view the wealth management industry as mature, the industry has changed significantly over the last decade. The average client today looks different than the average client did ten years ago, which means the average wealth management firm has changed as well. The interests of wealth managers and their clients are better aligned today than they were during the height of commission based, broker-dealer firms. Additionally, the fee based approach provides a more predictable source of income for wealth management firms. More time is being spent addressing the actual needs of clients, as technological advancements have freed up time and improved service offerings. This new model benefits both the client and the advisor which is evidenced by the increase in dollars under managed and the number of firms in the space.

Amidst this, the industry is consolidating as some owners look to increase scale and improve operating leverage, and others look for a retirement plan or exit. Understanding value today, as well as planning for tomorrow's value driven events is essential in this changing landscape. As we said before, the value of a wealth management firm is very much about context. We hope this white paper has increased your understanding and broadened your considerations of value of wealth management firms.

FREQUENTLY ASKED QUESTION

What sectors of the industry do you serve and what services do you provide?

Sectors Served

- Wealth Management Firms
- Registered Investment Advisors
- Asset Management Firms
- Mutual Fund Companies
- Independent Trust Companies
- Investment Consultants
- Hedge Fund Managers
- Real Estate Investment Companies & REITs
- Private Equity & Venture Capital Firms
- Bank Trust Departments
- Broker/Dealers

Services Provided

- Corporate Valuation
- Fairness Opinions
- M&A Representation & Consulting
- Buy-Sell Agreement Valuation & Consulting
- Financial Reporting Valuation
- Tax Compliance Valuation
- Litigation & Dispute Resolution Consulting/Testimony
- ERISA Valuation

About Mercer Capital

Mercer Capital provides investment managers, wealth managers, independent trust companies, and financial institutions with business valuation and financial advisory services related to corporate disputes, litigated matters, and financial reporting requirements. Mercer Capital also provides transaction advisory and consulting-related services.

Mercer Capital provides a comprehensive suite of valuation and financial advisory services to meet your needs. Experience includes:

- Assisting RIAs and other asset managers with annual valuations, fairness opinions, and appraisals for gift and estate tax compliance
- Valuing start up managers with as little as $50 million in assets under management to established industry leaders managing over $400 billion
- Negotiating transactions involving asset managers from sell-side, buy-side, and mutually retained perspectives
- Providing expert witness testimony for purposes of shareholder disputes, commercial litigation, and marital dissolution
- Providing financial statement reporting services related to purchase price allocation and goodwill impairment testing

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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