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Practice Sale Multiples
Separating Fact From Fiction

By Todd Doherty, Vice President of M&A

A New Era of Speculation

The misuse of multiples by various groups in the financial advisor industry have created a frenzy fueled by sellers with unrealistic expectations and buyers struggling to make deals.

The best use case for multiples is as a means of comparing the results from practice sales or practice valuations across the industry. Beyond that, they become an unreliable metric for deal making.

Why It Matters: The misuse and application of multiples as a metric greatly impacts the viability of M&A deals, leading to stalled negotiations or unsound terms that have a ripple effect across the industry. Here's how they are being misused:

- **Using Them To Assign Value or Define Sales Price:** Multiples ignore important qualitative data that truly depict the quality of the client base and of practice operations/performance.
- **Exaggeration of Actual Results:** Many of the claims of excessive multiples are hearsay and unsubstantiated. Practices that receive multiples above 3.5x are rare outliers.
- **Create Unreasonable Expectations:** The exaggerated numbers lead advisors to set unrealistic expectations.
- **Mistaken As Industry Level Data:** Practice sales results are not compiled at the industry level and are often self reported. Many M&A firms provide data which is representative only of the lanes in which they work.

Our data clearly demonstrates that the main driver of determining the true value and ultimate sales price of a practice lies in cash flow.

Multiples Defined

The most commonly accepted definition is "a sale price multiple of a total gross trailing 12-month (T-12) revenue or GDC."

Example:
A practice with T-12 gross revenue of $1,000,000 that sells for $2,300,000 has a multiple of 2.3.

Other acceptable definitions include:

- Multiples of net revenue (after Broker Dealer payout)
- Multiples of recurring revenue (gross or net)
- Multiples of EBITDA (earnings before interest, taxes, depreciation and amortization)

Why Use Cash Flow Instead

Demonstrates ROI: Cash flow demonstrates whether the investment made by the buyer provides the proper return relative to risk and opportunity cost.

Determines Financing: It also determines whether a deal can be financed and the debt obligation adequately cash flowed by the business.

Cash flow scenarios that can garner 3.5x and higher are difficult to achieve and rare.

How To Show Cash Flow

Buyers should develop an earnings model or pro forma for the practice that includes:

1. Practice revenue with annual growth rate assumption
2. Operating expenses with annual growth rate
3. Debt service for the acquisition

Net revenue after practice operating expenses and debt service should exceed a hurdle rate.*

Hurdle Rate

Also known as the "minimum acceptable rate of return (MARR)" is the target rate of return investors expect to make. The hurdle rate is determined by assessing the cost of capital, risks involved, current opportunities for business expansion, rates of return for similar investments, and other factors that directly affect the investment.

Cash Flow Is King

Buyers Need To See A Return On Investment

Cash Flow & Hurdle Rate Illustration

Key Assumptions With Cash Flow

Most deals assume that pre-tax cash flow will be positive from year 1 and will exceed the hurdle rate by year 3. Lender financing for most of the sales price with 10-year terms allow deals to exceed these expectations.

Acquisition Earnings Model					Acquisition Debt Service		Owner Retained Earnings		Investment Metrics	
Year	Revenue	Growth	Expenses	Growth	Lender Financed Debt Service #1	Seller Financed Debt Service #2	Net to Buyer	% of Revenue	Hurdle Rate	Weighted ROI
0	$1,137,000		$568,500							
1	$1,216,590	7.00%	$579,870	2.00%	$380,204	0	$256,516	21.08%	18.00%	3.08%
2	$1,301,751	7.00%	$591,467	2.00%	$380,204	$156,370	$173,710	13.34%	18.00%	-4.66%
3	$1,392,874	7.00%	$603,297	2.00%	$380,204	$156,370	$253,003	18.16%	18.00%	0.16%
4	$1,490,375	7.00%	$615,363	2.00%	$380,204	$156,370	$338,438	22.71%	18.00%	4.71%
5	$1,594,701	7.00%	$627,670	2.00%	$380,204	$156,370	$430,457	26.99%	18.00%	8.99%
6	$1,706,330	7.00%	$640,223	2.00%	$380,204	$156,370	$529,533	31.03%	18.00%	13.03%
7	$1,825,774	7.00%	$653,028	2.00%	$380,204	0	$792,542	43.41%	18.00%	25.41%
8	$1,953,578	7.00%	$666,088	2.00%	$380,204	0	$907,285	46.44%	18.00%	28.44%
9	$2,090,328	7.00%	$679,410	2.00%	$380,204	0	$1,030,714	49.31%	18.00%	31.31%
10	$2,236,651	7.00%	$692,998	2.00%	$380,204	0	$1,163,449	52.02%	18.00%	34.02%
			TOTALS:		$3,802,042	$781,849	$5,875,647			

The buyer's risk tolerance determines their willingness to accept certain ranges of cash flow results

Cash Flow Exceptions

Exceptions Are Responsible For Multiples Outliers

There are three scenarios that typically influence whether higher multiples are achieved:

1. A buyer who is willing to inject cash into the deal. Most lenders prefer that the buyer maintain a healthy reserve of cash.

2. Trading a portion of the seller's equity for a stake in the buyer's practice. This is most common in RIA space. Equity is traded on a future valuation assumption of significant growth for the buyer's practice.

3. Creative or highly contingent terms resulting in greater risk to the seller in exchange for potential monetization, such as through earn outs.

The Data

Earnings Models Do Not Support Claims Of High Multiples

Our team developed 36 earnings models to stress test the likelihood of multiples above 3.5x passing the cash flow test and hurdle rate for the investment.

The earnings models were based on the following assumptions:

- Revenue growth of 5%, 7% and 10%
- Expense ratios of 30%, 40%, and 50% (do not include owner's comp)
- Typical financing structure of:
  - 80% lender financed at 7% over 10 years
  - 20% seller financed for 5.5% over 5 years, with a 12-month delayed start

The Results

The data clearly shows that multiples of 4x and higher are hard to support, even when taking into account aggressive growth and moderate expenses.

	Multiples	X2			X3			X4			X5		
Revenue	Growth Rates	5%	7%	10%	5%	7%	10%	5%	7%	10%	5%	7%	10%
Expense Ratios	30%	3	3	3	3	3	3	2	2	3	1	1	1
	40%	3	3	3	3	3	3	1	1	2	1	1	1
	50%	3	3	3	1	2	3	1	1	1	1	1	1

1	Below Hurdle
2	Marginal
3	Exceeding Hurdle

**Revenue and expense growth rates are typical of the practices with whom we*

Actual Sales Data

What We're Seeing

How The Deal Is Done Matters

Besides cash flow, the other factor that impacts multiples is the way that the practice is sold. In general, there are four types of practice sales: closed, closed professional, Nextgen (internal), and open market (defined below).

Practice Sales Types

CLOSED	This is the most common deal type, wherein the buyer and seller find each other and negotiate terms on their own.
CLOSED PROFESSIONAL	When buyer and seller find each other and leverage professional support for negotiating, legal, and transitions.
NEXTGEN	Internal transaction passing the business to an associate advisor within the practice, usually completed with professional support.
OPEN MARKET	Characterized by multiple buyer candidates competing for the sale. Almost exclusively managed by a third-party firm utilizing a listing platform and managed process

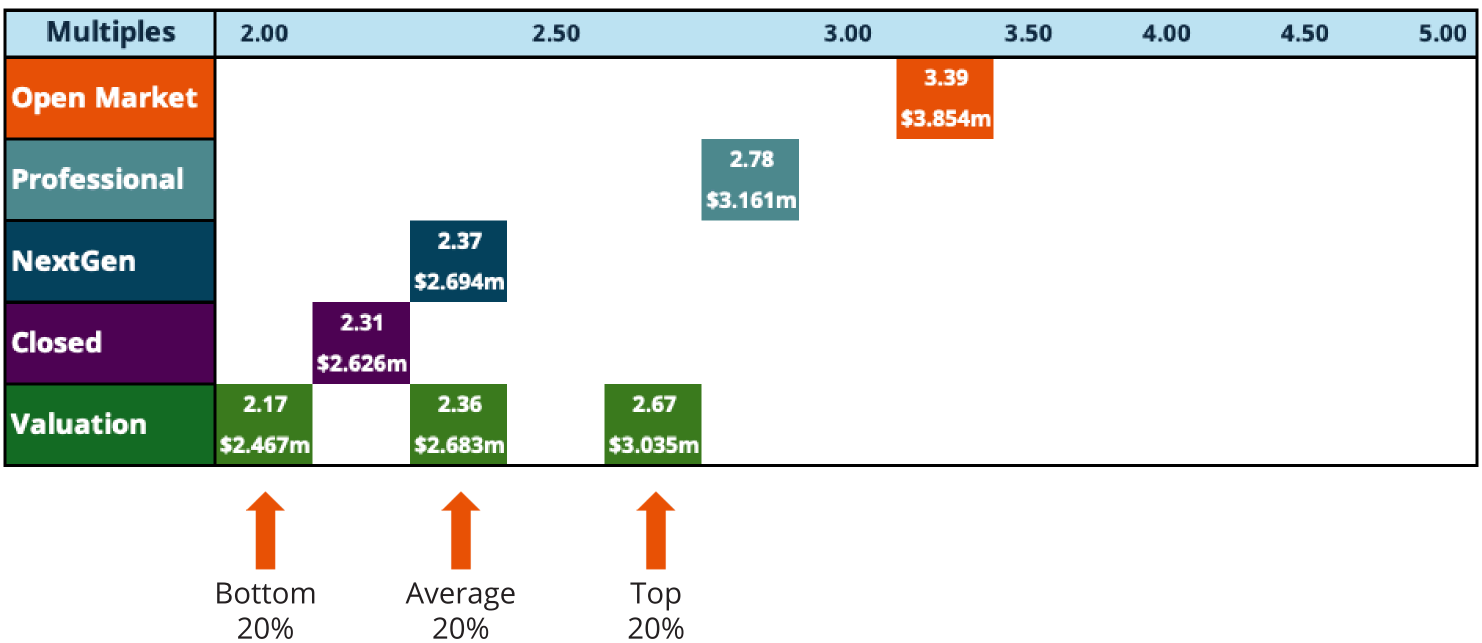
Multiples By Sale Type

Three Year Average

Competition among multiple buyers naturally drives up multiples for open market sales. On the other hand, closed and Nextgen deals garner multiples at the lower end of the spectrum. This is typically due to the fact that the seller will often give concessions to their chosen successor for closed and Nextgen deals by way of a lower price or other terms. Nextgen deals are also often sold in tranches, with the value of the practice generally increasing between the first and final tranche sale.

To demonstrate the difference in sales price and multiples for different types of practice sales, we compiled data on practice sales for the last three years. We also generated typical valuations data for an average practice with:

- Gross T-12 Revenue - $1,137,071
- Recurring Revenue – 90%
- AUM - $157,204,518



Three years of practice sales and valuations data shows that multiples are falling between 2-3.5x of revenue, not 4-5x.

2x-3.5x

Doing Deals

A Better Approach That's Fair To Both Parties

Setting Realistic Expectations Based On Facts

Both parties need to base negotiations on a sound earnings model and a professional valuation conducted by a qualified third-party. The valuation should include both a market and income approach and not rely on "rule of thumb" calculations. It should also be no more than 6 months old at the time the deal is finalized.

Any deal must pass due diligence by a lender, which means it must comfortably cash flow for both the worst and best case growth scenarios. It must also provide a return to the buyer and pass the hurdle rate by year 3 in order for the buyer to justify the investment.

Monetization is Still Healthy

Although sellers can't realistically expect to achieve multiples of 4-5x, most are achieving a purchase price of 2-3.5x of revenue. Sellers who work with a succession consultant consistently achieve the higher end of that spectrum, generally leading to an average premium range of 20% to 46% versus doing a closed deal on their own.

In all types of deals, buyers and sellers alike greatly benefit from the help of a qualified M&A consultant. They can advise on reasonable terms, identify potential risks, and ensure that the deal makes it all the way to the finish line.

"Sellers who use a third-party succession consultant generally secure premiums of 20% to 46% more on the value of their practice versus selling on their own."

Next Steps - Get Help

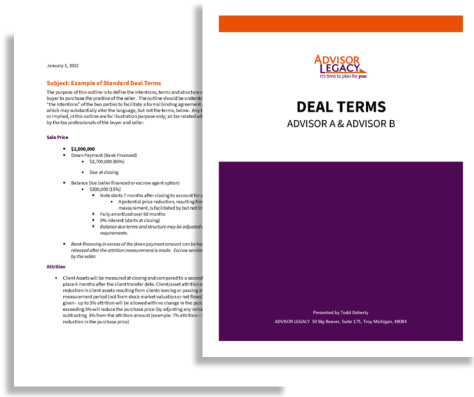
Whether you're looking to buy or sell, we have a suite of services designed to help you get the best deal possible.

Practice Valuation

Our award-winning practice valuation is used both as a basis for negotiating a deal and for securing bank financing.

Turnkey Deal Support

Three different options for completing closed deals and Nextgen successions. All three include legal agreements and term sheets, along with various levels of M&A coaching and support.



Advisor Legacy Sales Marketplace

A quality platform for buyers and sellers to find each other. Designed for open market deals both within and outside of a specific Broker Dealers. Keep it in the family, or cast a wide net across the industry.

"Having never gone through this process before, the knowledge and professionalism Advisor Legacy displayed was invaluable. They helped us really understand the process and the value drivers of the practice so we could design a deal that worked for everyone. We wouldn't have been able to figure this out on our own. They were always responsive and gave us undivided attention during meetings. They even helped us with finding lenders for financing and legal support."

- Internal Succession, Ameriprise

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About The Author

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MAXIMIZE THE SALE OF YOUR PRACTICE!

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Todd Doherty serves as Vice President for Advisor Legacy, where he helps advisors navigate the entire M&A process from start to finish. With over 15 years of senior leadership experience in financial advisor firms, Todd knows first-hand what it takes to grow a successful practice and stays at the forefront of critical trends impacting the financial advisor industry.

His specialties include growing practice value, succession and acquisition strategy and planning, business valuation analysis, and operations. Todd works closely with his team of executive coaches and analysts to help advisors make smart decisions and successfully execute practice sales and acquisitions.

Among his many accomplishments, Todd was the driving force behind the development of our valuation methodology and practice sales process. As the market has evolved, Todd has continued to enhance our services to match the needs of the industry. This includes the development of our MaxVal Predictor™ tool and our revamped Turnkey Deal Support and NextGen Deal Support services. Todd also publishes a growing body of thought leadership on equity management and M&A through Advisor Legacy and noted industry publications including *Wealth Management* and *Advisor Perspectives*.

"My experience going through your evaluation process versus the other company was night and day. This is also true for format and clarity of the deliverable. I can't believe the differences in the amount of my time required and the level of my frustration between the two processes. Thanks again for your help!"

-Randy Kreinbrink, CFP®

No matter what stage of your career you're in, we help you build, live, and leave a legacy you can be proud of.

BUSINESS VALUATIONS

CONTINUITY PLANNING

LENDING & LEGAL SUPPORT

DEAL SUPPORT

PRACTICE SALES

SUCCESSION PLANNING

Your future is our only priority.

You wouldn't leave your client's legacy to chance. Why leave yours?

It's time to plan for *you.*

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