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HyperValue

NAVIGATING THE FUTURE OF YOUR BUSINESS

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Introduction

Since the production of HyperCompetition Part I and II, we have been besieged with requests to present our findings on the outlook for the financial planning industry. This industry demand in times of great uncertainty, combined with the vast quantity of copies of HyperCompetition that have now been published demonstrates the keen interest from all industry participants in determining what shape the industry will take in the years ahead. Many readers, who have studied these, have responded to several of the thoughts and suggestions to begin the re-modelling of their financial planning proprietorships into businesses.

Throughout the past few years we have enjoyed sharing our research and views with the financial planning industry, and gained useful feedback from those who have read the paper and heard us speak.

Several have noted that many of the industry commentators fail to offer any significant solutions in preparing a financial planning entity for the inevitable changes ahead.

It is the intention of this third installment in the HyperCompetition series to provide the tools required in implementing those changes that have been suggested in the previous papers. We hope that by reading through the contributions from those who have successfully implemented their own strategies, you will gain an insight into converting from a financial planning proprietorship to a financial planning business.

Many industry experts have contributed their knowledge towards producing this installment of the HyperCompetition trilogy. We encourage you to review their contributions and contact them direct for any additional areas of assistance that they may be able to offer your business. Full contact details of each contributor are contained at the end of this paper.

Finally we trust that the HyperValue paper adds value to your business through providing practical solutions to assist you in navigating the industry challenges that lie ahead.

Brian Thomas **Clayton Coplestone**

SECTION 1

Welcome to Hyper Value

"Should I Stay or Should I Go"… The Clash

If you never got to read either of the HyperCompetition papers we would encourage you to download these from www.csam.com/au. Alternatively the next few pages are intended to summarise the key points from both papers.

The now highly regarded paper, **"HyperCompetition – The Dynamic Future of Financial Planning in Australia"(HyperCompetition I)** was written in November 2001 by Brian Thomas and Clayton Coplestone, providing a then groundbreaking overview of trends in the financial planning industry overseas, and an insight of where Thomas and Coplestone saw the Australian industry heading.

This paper overviewed a maturing industry, which having sprung up during a period of economic prosperity, was now becoming increasingly subject to the forces of competition. These forces, clouded somewhat in Australia by a legislative regime that ensured confused consumers almost mandatorily sought advice, and a favourable business environment where fees were never questioned too harshly, were initially regarded as a distant threat by many. However, as the tech wreck unfolded, and those same consumers became increasingly disenchanted with the failure of their financial plans to deliver the returns they had expected, many of the competitive forces highlighted in HyperCompetition I started to unfold with startling accuracy.

Whilst most now agree that a new "hyper competitive" age is dawning, how many are improving their financial planning businesses to cope with a future of increased competition? It is this complacency, and perhaps the belief that the industry is merely suffering from the bear market, which will sneak up on many industry participants and envelop their business at a point where it is difficult and perhaps impossible for them to adapt.

Beyond its comprehensive review and analysis of the historical and geographic influences on the industry, HyperCompetition I delivered **4 key insights** and identified the **4 key trends** that are shaping the current and future competitive landscape.

As the paper's relevance gained momentum, Thomas and Coplestone realised that a second paper was required, focusing on the financial planning industry from the consumer viewpoint. Hence **"HyperCompetition II – Survivor"** was launched in May 2002, highlighting some concerning gaps between what the financial planning industry felt it was offering clients, and what clients felt they were getting. The paper highlighted the major **issues** facing the industry, analysed the **attitudes** of its customer base and explored a number of the **myths** of successful practice management to which the industry clings.

Again, the paper was early in forecasting issues that would need changing, but was quickly joined by perhaps less objective reports in the media over the remainder of 2002, that built a constant barrage of criticism.

Indeed, the release of the latest Shadow Shopper Report on the industry by the ACA and ASIC, showed a high level of discontent from participants with the advice received, indicating that many financial planners may face the outcomes of HyperCompetition sooner than they anticipated. With most financial services businesses having achieved business growth in excess of 20%pa over the past decade, with relatively little skill, there has been little necessity to address a change in business and fee models. However the response is somewhat different when the question is asked of the consumer – who has become more sensitive and discerning about the value that is being added to their wealth and risk management after fees are taken into consideration.

As these negative forces arrive at a time when the maturing industry highlighted in HyperCompetition I, sees an increasing number of mature players wanting to exit the industry, as touched on in HyperCompetition 2, Thomas and Coplestone felt a final paper discussing the sale of practices going forward, was appropriate. And thus **HyperCompetition 3 – HyperValue**, has been born.

Note: A complimentary copy of HyperCompetition I & HyperCompetition II can be downloaded from our Internet site www.csam.com/au

Recap: HyperCompetition I - Insights & Trends

The Four Insights

Insight 1
'HyperCompetition' is the incredible boom coming to the competitive landscape of financial planning that will change the industry dramatically. This is at the same time as many of the early successful planners are looking to exit their businesses in the next few years.

- Increasing number of planners
- Increasingly skilled planners
- Large/global institutions marketing aggressively
- Encroachment of other professionals into planning activities
- Resulting pressure on margins

Insight 2
Given the high margins available, current ease of new client acquisition and the expected growth in this industry, the time is ripe for a new competitor to enter the market and take a dramatic market share: "Platform Plus"

"Platform Plus" can be simply defined as the new competitor who will manage to find the profitable balance between technology and relationship. We forecasted that technology would serve primarily as a catalyst for many of the changes brought on by competition. Rather than replace the role of the advisor (as many "Internet gurus" had predicted), we argued that technology would increasingly become an integral part of advisory businesses. It would serve as a key tool in making advisory businesses more efficient, leveraging the time of professionals. Advisory firms that embraced technology would be far more capable of withstanding the inevitable margin compression that would accompany a more competitive environment. This is likely to be offered by a non-traditional industry participant who is not weighed down with any legacy structures or systems. HyperCompetition II further expanded on this concept, outlining some of the technological, client service and cost issues that should be addressed by Platform Plus. It is interesting to note on this front some of the new players in this space have utilised a rolled up unit price structure as their response to the issue of fee transparency, rather than make significant changes to the status quo.

Over time, as advisory businesses need to operate more efficiently to offset the effects of margin compression resulting from competition, the use of technology platforms will play a larger role in maintaining profitability. It will be a key source of operating leverage for advisory firm owners and professionals.

Insight 3
Most of the literature on the planning industry is flawed in that most commentators are usually only focused on one or perhaps two models of financial planning whereas the industry has a multi model approach. Understanding the multi-layered relationships between the business owners, dealers and planners is crucial.

Perhaps the most important insight from HyperCompetition Part I was the simple observation that the Australian financial planning industry is a multi-dimensional industry without any single "correct" approach. This tends to contradict the popular concept of institutionalising the provision of financial advice into one of a few standard models. There are too many variables differentiating the myriad of participants and their clients in the industry. When this is translated to fee structures, we can see where some of the future pressures arising out of reports such as the ACA Shadow Shopper report, will continue to focus.

Insight 4
Competitive advantage in client relationship management is more complex than merely "high-touch" versus "high-tech". Planners often overemphasise the strength of their client relationships.

This last insight on the nature of the client relationship motivated an independent consumer survey and the HyperCompetition II paper.

The danger that lies ahead for many in the industry will come through the misinterpretation of what a "true" relationship is between the financial adviser and their client. In addition, the paper found a number of anomalies in client perceptions on fees and value for money, which is now beginning to be uncovered by the consumer.

The majority of advisory businesses, however, would remain relatively generic providers of financial advice. While many, if not most, of these organisations would survive, they would suffer the most from the two forces reshaping the industry. Their operating margins would be crushed, their owners would have to work harder for less money and they would have little or no enterprise value.

The key issue for advisory firms was to decide which group they hoped that their firm would eventually wind up in and to take the necessary actions to ensure this outcome. However, it would be very difficult to reposition an advisory firm after the combined effects of competition and technology were felt. Hence, the actions taken by owners over the next couple of years would largely decide the long-term destinies of their organisations.

The Four Key Trends

Trend 1: The Death of the Transactor
The Internet has a 'disintermediating' effect (cutting out the middle man), providing low-cost transacting to mass markets and a commoditising effect, automating a range of planning processes. Planners need to be able to provide demonstrable added value to justify their fees.

Most industry participants have recognised that there is no longer a sustainable business in facilitating transactions. Consumers are only prepared to pay premiums for advice, with cheaper and easier alternatives available for the placement and monitoring of their finances. Nevertheless there are other aspects of the financial planning process, which are also becoming commoditised and yet are being promoted as key value-add components by financial advisers.

Which part of that process are you still charging clients for? More importantly, what do clients think they are paying you for? If it's something they can find free then this will erode the proposition.

Trend 2: The Capitalised Client Value Effect
With the outlook for intermediary distribution continuing to play a significant role in the distribution of financial services globally, groups (particularly product manufacturers) are now debating the 'buy' versus organic growth strategies and look closely at the acquisitions of distributors that have been made in the past. NAB and CBA have both written down the value of their wealth management divisions significantly in recent times.

Despite this, large, well branded financial services businesses have continued to be sold for high multiples of earnings (witness Rothschild's and BT's sale to Westpac). However the aggregators, consolidators and smaller players have not realised the market values envisaged a few years earlier with the collapse of Stockford Group. Despite these excessive valuations beginning to be questioned, there remain many organisations that are desperate to pay high premiums for distribution, thereby continuing to push up the valuations to unrealistic levels. This raises a broader series of issues for the industry to consider, including how to develop a value-add program that retains existing clients, and how to develop succession plans that work for all stakeholders. Both of these concepts, together with corporatising a "cottage industry" are discussed further in the HyperCompetition II.

Trend 3: The Bandwagon Effect

A global phenomenon that has accelerated with the introduction of technology throughout the past decade has been the rapid consolidation of old, and the birth of new industries. A notable recipient of this has been the attraction of many new participants to the comparatively easy start-up industry of financial planning. Many of these new entrants have been able to easily adopt the standard business methods used by existing parties to derive a reasonably good income, contributing little by way of innovation or new techniques.

This exposes the industry to a new dynamic (which we have dubbed "Platform Plus"), which will have the effect of exploiting the profitable blend between technology and relationship in the provision of financial planning. If these predictions are correct, then this raises some interesting questions; about which business models will survive the new environment of higher competition and in particular a "platform plus" type of model? How will consumers respond to the increased media attention that is being focused on returns after fees and after tax and the increased portability and choice in relocating their portfolios?

The ultimate question that is now being considered relates to whether consumer's expectations from the industry and existing business models are being met, as competition will accelerate the provision of available alternatives. Indeed, HyperCompetition II raises the issue of advisers being so reliant on product suppliers for revenue, and the problems this will entail.

Since releasing the findings from HyperCompetition Parts I & II, many participants have been made aware of the new revenue models appropriate in supporting financial advisory businesses in the future. Existing models suggest that consumers be charged a fee that relates directly to their funds under advice. This sounds logical until you look at this from a consumer viewpoint. Rather, the success of many financial advisers will depend upon their ability to develop a clearly defined value-add or unique selling proposition. The strategies and direction of larger organisations will adequately cater for the masses by providing a homogenous and relatively inexpensive approach to financial planning. Failure to consider these quandaries will cause failure in meeting the consumer's awakening expectations.

Trend 4: The Industry Maturation Effect

With the combined characteristics of high profitability, high growth, changing product/ service offerings, and the effects of technological, legislative and demographic changes, it is clear that the financial planning industry will evolve and change dramatically as it matures.

Pointers to the direction of the industry can be found in other maturing consumer and professional services industries as diverse as fast food, banking and medical services, which share to varying degrees the drive towards low costs, low margins, high volumes and high quality control and well as an unending focus on what customers value.

Recap: HyperCompetition II - Issues, Attitudes and Myths

The Big Issues that face the Financial Planning Industry

In framing a review of the Australian financial planning industry from the perspective of the consumer, HyperCompetition II assessed a number of matters that impact on the consumers' experience.

Fees versus Commission

In an increasingly fee-sensitive market compensation arrangements will continue to draw increasing attention. As competition grows, clients who do not receive transparent value for money will be targeted by competitors with more flexible fee models.

Competition and Fee Pressure

However fees are recouped, an effect of increased competition will be competitive offers on both service and price.

Specialising versus Generalising

With the proliferation of specialist practices, the increasing participation of large institutions and the increased professional standards of the industry it will be increasingly difficult for small practices to be all things to all clients. Such practices will face strategic decisions whether to specialise, to collectivise into "multidisciplinary practices" or to manage some other form of alliance to provide diversity of advice to clients.

Balancing Technology and Relationships

The growing sophistication of online and technological planning tools has commoditised many traditional planning functions, and is changing the nature of the service customers seek from their planner. Financial advisers need to find the appropriate balance between technology and relationship.

New Investment Products

The industry will come under demand for more open architecture as it continues to be deluged with more products and information. As clients become more able to discreetly unbundle advice costs they become less tolerant of perceived bias in proprietary products.

New Performance Benchmarks

As scrutiny increases on both performance and price, new benchmarks will appear for consumers to measure their financial advisers and financial products against.

Attitudes – From the Outside Looking In

To illuminate the consumer perspective on the financial planning industry Business Owner Research was commissioned to conduct an independent survey with high-income households. Although the consumers surveyed were more satisfied with their adviser than may have been expected, there were some worrying anomalies around client expectations and understanding. For example, the survey revealed that while most clients felt at the time their adviser was charging them an appropriate amount, around a quarter didn't know if the adviser is receiving trail, while a third believe that the adviser was not receiving a trail. This indicates a profound misunderstanding of what is being charged, and provided for the charges.

Myths – Building the Perfect Practice

Prefacing the theme of HyperCompetition III – HyperValue, HyperCompetition II outlined some of the steps and pitfalls of building the "perfect practice". In particular, the paper identified **five myths** of conventional thinking about industry success.

Myth #1: I need more clients to grow

The number of clients does not boost practice value, however the right type of clients will. The wrong type of clients, or the wrong service model for low value clients can actually destroy value.

Myth #2: My success is based upon the length of time spent in the industry

Whilst length of tenure may have contributed to the growth in a financial planning practice over the previous boom-decade there is no correlation to demonstrate that it will continue in the future. With the rise of competitive factors identified, a continuation of "business as usual" may be an increasing competitive disadvantage.

Myth #3: I will grow my financial planning business through providing advice to all those who are prepared to pay

Aspiring to be expert in all needs of all clients will be increasingly unrealistic in the future, and increasingly unprofitable as clients continue to demand more for less.

Myth #4: My heart is no longer tied to the business, as I earn a good income and no longer need it to grow. Besides, I'm out in the next few years.

With many senior advisers now receiving substantial revenues from established client bases some now lack the very passion for their business that will be required to adapt to the hypercompetitive forces that they will encounter.

Myth #5: I am the distributor, and require a revenue share from product suppliers to compensate me for the client relationship.

With the overall cost of the financial planning value chain being unsustainable in a lower return environment, all financial industry participants will need to demonstrate their value-add. Planners will need to justify their own revenue generation, not expect third party sponsorship.

SECTION 2

Converting to a Business – Meeting the Challenges and Changes of HyperCompetition

Central to the task of responding to "the challenges and changes of HyperCompetition" is the "corporatisation" of financial planning practices.

We encourage the proprietors of planning practices to shift from working "in the business" to working "on the business", creating a business that is an independent viable entity. In so doing they will both "future-proof" and maximise the value of their business.

In this section we explore some of the challenges and issues of creating the long-term success of a planning practice.

The first paper of this section, by *Business Health Ltd*[1] demonstrates how to target two key indicators of a successful business:

- A truly client focused value proposition
- A reduced dependency on one or two key personnel.

The second paper of this section, prepared by *Shirlaws Pty Ltd*, describes how to use a Capacity Planning approach to designing business strategy. The paper will show how business challenges vary through the cycles of growth, requiring management focus to shift between "Platform Strategies" to improve efficiency and "Growth Strategies" to increase the capacity of the business.

This section's third paper, from *Wes McMaster*, provides a summary of the components of practice management that should be undertaken by a planning practice that seeks to establish a sound foundation for an efficient conversion from a practice to a business.

[1] Contact details for all contributors can be found in the Acknowledgments section at the end of this paper

Converting an Advisory Proprietorship to a Business

Business Health Limited[2]

To build a successful business in the future, advisers must do two things above all else:

- Put their client firmly at the centre of their business & develop a truly ***client*** focused value proposition
- Reduce the dependency of the business on one or two key people

The Client Value Proposition

Successful advisers in the future will have a client value proposition that is compelling to their target markets. The successful adviser of the future must provide to their clients a different (or better) service that delivers unique value in a particular set of uses, for a particular set of customers.

While the client value proposition for each practice must be unique, there are a number of key themes common to developing a value proposition for all professional advisory firms:

- The client value proposition should be the answer an adviser wants their clients to give when a friend or colleague asks them about their firm
- It should focus on the outcome to their clients, not the detail, or the process
- It is the main area of comparison with competitors
- If the client value proposition is about providing services at the lowest cost, it will affect nearly all other decisions in their business
- In developing their unique value proposition, advisers should ask themselves the question – "what do I want to be famous for?" The answers to this question will be reflected in the value proposition they offer their clients.

By definition, the client value proposition puts the 'client' at the very centre of the business. It must provide a service that clients will need/want and pay for.

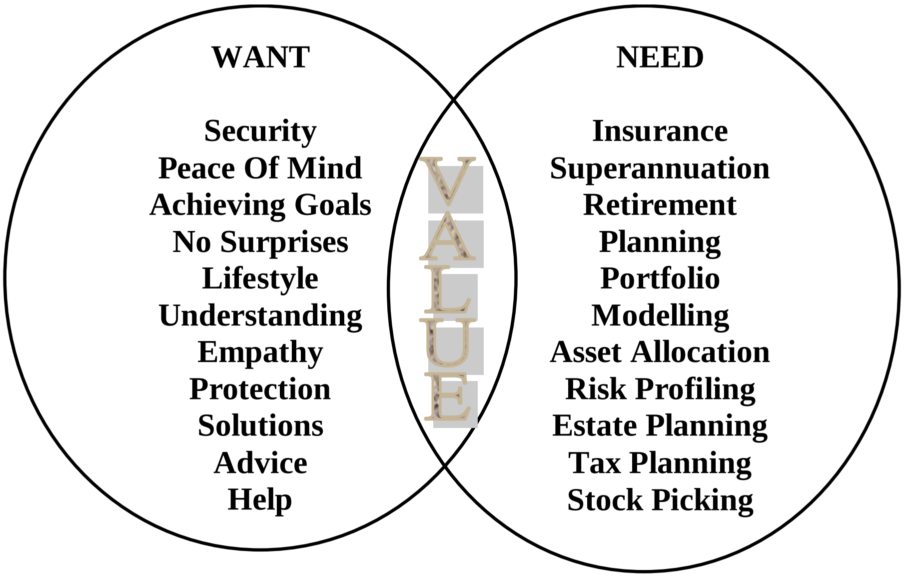
What Do Clients Want & Need?

The question of the need for financial services cannot be questioned. However, it is what the client wants (not the process) that is most important.

As the chart 3e illustrates, the client *wants* things like security, trust, peace of mind, to achieve their goals and to create and protect their lifestyle. They *need* financial products and services to deliver these outcomes.

[2] Contact details for all contributors can be found in the Acknowledgments section at the end of this paper

Chart 3e



The services advisers deliver will be based on outcomes to the client, not the process. This means that the commoditising of product will continue and the sale of a product will have little value. Successful advisory firms of the future will be interested in finding, defining and achieving their client's needs and objectives over the long term - not just in short term investment performance.

The practice will not necessarily directly provide all these services. They could be facilitated through strategic alliances/partnerships with other professionals (eg: accountants, lawyers, insurance and mortgage brokers etc). However "facilitation" will mean controlling the entire process and taking responsibility for ensuring the strategies and recommendations of the strategic partners are implemented. It does not mean simply "outsourcing" the client through an introduction to an alliance partner with no responsibility for implementation.

What Will Clients Pay For?

The combination of increasingly educated consumers and vigilant (and aggressive) regulators suggest that the move to complete fee transparency will continue. In this environment, advisers will need to address two key pricing issues with their clients:

The level of fee

The client is the only person that can decide if the service they are paying for is of value. Different clients, with different needs and wants (and different financial situations) will view value differently – the successful adviser of tomorrow will satisfy their target clients by pricing their services at a level that represents real value to the client.

This means there must be full disclosure of all income. While the actual method of disclosure can take many forms (currently adviser remuneration is disclosed via a mix of a percentage of funds invested/managed and flat dollar amounts) the underlying principle going forward remains clear – clients will understand precisely what they are receiving in return for the fees they are paying. They (and only they) will then decide if this represents *value* to them.

The vehicle used to recoup the fee

Similarly, the “right” method of remuneration is a question only the client can answer. With education and choice, the client will understand that the fund managers or administration platform can provide incentives for the adviser. They will also understand invoices can be issued and cheques can be written.

This does not mean all advisers will necessarily move to an “hourly fee” pricing model. Provided the services they deliver are clearly understood and the cost of those services are fully disclosed, a number of remuneration vehicles will remain available.

While fee for service, job costs and success fees may well become more common, the client will ultimately decide what is right for them.

This also begs the question that the latest push to “outlaw” all commissions could actually be doing consumers a disservice. In many cases commissions may represent the only way consumers can afford to pay the fees to get the service – fees they are more than willing to pay but are unable to because of the lack of surplus cash in their financial situation.

The move to complete disclosure and value based adviser remuneration will also put pressure on both the value and valuation basis of financial planning practices. At the moment a multiple of ongoing revenue is the norm, depending on the state of the business. To a large extent this ongoing revenue is paid by the administration provider or fund manager with little regard however for the value the client may be getting.

The business that will have more value in the future will have systems and processes in place that ensure they consistently deliver on their client value proposition and that all contractual obligations contained in their ongoing service contracts are met. If that service can be delivered irrespective of the principal’s involvement, then the business will be far more valuable.

How to deliver what clients need, want and will pay for

<u>The Client Experience</u>

While the successful advisory businesses of the future (and it could be argued even of today) will have the client at the centre of everything they do, the practice will be driven by a documented set of business systems and processes that ensure the client experience is delivered seamlessly and consistently.

The client experience is quite simply what happens to a client every time they “deal” with a company. It must be stressed that it is what the client sees – not what the advisers’ thinks they see (or would like them to see). -(If you do not include the list, then this sentence must be deleted). All advisers who are committed to building their businesses into the future should “map” the experience their clients receive for each key element of their service offer.

<u>Client Management</u>

To help control and deliver the client experience, advisers need a robust and comprehensive client management system. The delivery is underpinned by access to the relevant client information at the appropriate time. The better a practice knows and understands their clients, the better they can deliver a tailored service offer.

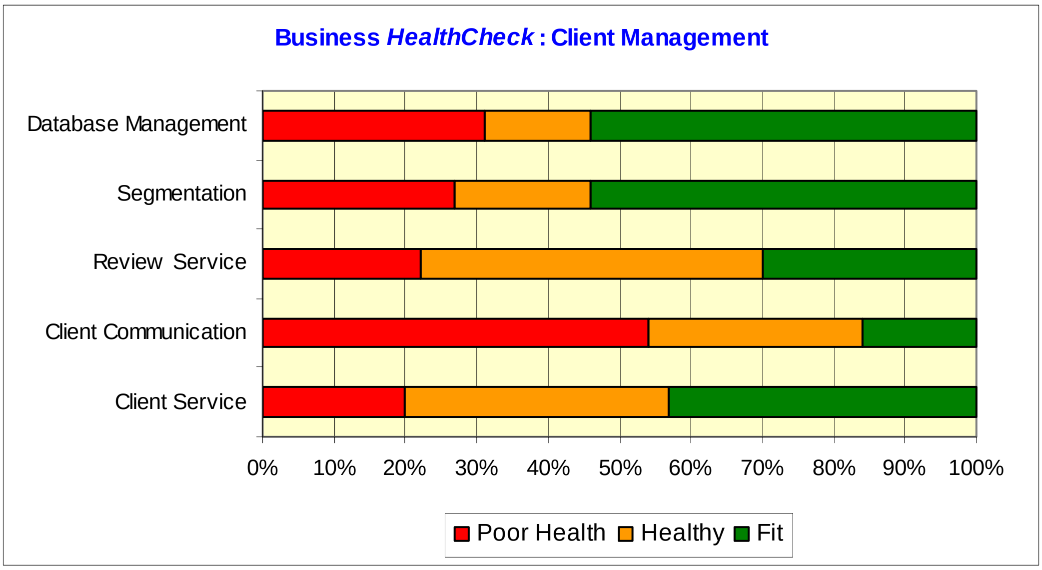


Chart 3f illustrates the results of the client management section from the recent analysis conducted by Business Health Pty Ltd of the top 500 Australian advisory practices that have completed the Business Health *HealthCheck* diagnostic report.

While 88% used some form of client management software, 24% update the client information held on their system on an irregular or ad-hoc basis. The value of any client management system is totally dependent upon the quality of information it holds and one in four Australian advisory practices are potentially operating with incorrect or out of date client data.

Surprisingly, almost one in three of the top 500 practices (31%) did not store the details of their "prospects" on their client management system. This makes efficient marketing to these targets quite difficult and lessens the return on the practice marketing and advertising initiatives.

Business Health also found that 28% of the practices kept less than half the desired client information. As stated before, the truly client centric firms intimately know and understand their clients.

They also appreciate that they can not possibly be all things to all people. While every client must be treated with respect and every client must be treated fairly, not all clients can be treated equally.

To do this, there must be an agreed and documented segmentation model within the business. Each client segment must have a service/solution offer tailored specifically for their needs and wants. The "value" of the client to the business must also be a consideration here.

Whilst it was pleasing to see that 76% of the top 500 practices undergoing the *HealthCheck* clearly segmented their client base, 11% of them did not then offer a different or unique service to each segment! Obviously it is not enough to simply categorize each client – the point of segmentation is to then to align a tailored and appealing service offering to each segment.

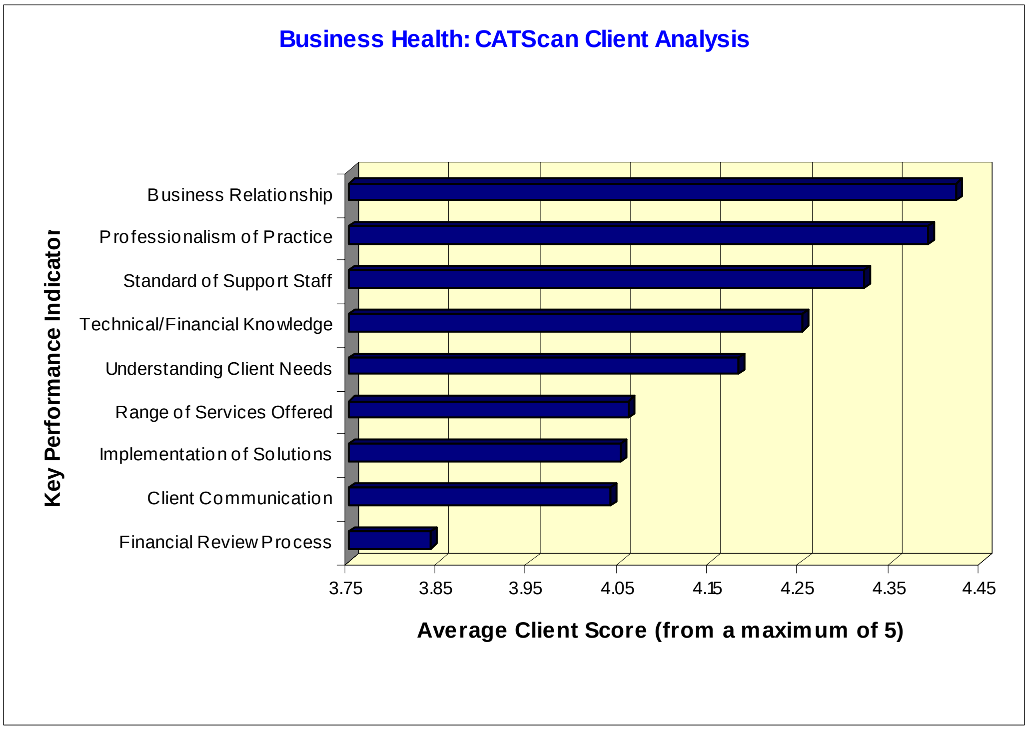
What makes up this service/solution offering is dependent upon the wants and needs of those clients – it must represent value to them.

Successful businesses do not think or assume they know what represents value to their clients – they continually ask. The highly successful firms then take this one step further – they actually act on the feedback they get. 71% of the practices analysed by Business Health had no structured approach to seeking client feedback.

Only one in three practices (32%) contacted or "touched" their very best clients more than 10 times a year – the majority (45%) had between five and ten client contacts and 23% contacted their very best clients less than five times a year.

It has been proven that those practices that regularly contact their best clients benefit enormously – they have higher client retention rates, higher client satisfaction rates and they receive a greater share of the clients "wallet".

The Business Health *CATScan* results from over 10,000 individual client surveys also identifies communication as a real issue for practices to address.



As shown in the table above, client communication is rated the second poorest of the nine key performance indicators rated.

The CATScan results also tell us that of the 10,000+ clients surveyed, over 65% of them now have access to email. This makes email an effective and efficient communication vehicle for communicating with clients. Again, to gain the maximum value from any client communication (be it electronic, hard copy or face to face) it must be both relevant and timely – the business must understand what the clients' value and tailor their communications around this. An integrated and comprehensive client management system is critical here.

One of the key business benefits of getting this right can also be found in the CATScan findings. Almost 90% of the 10,000+ individual clients surveyed indicated they would refer their adviser to someone they knew – however, only 62% had!

Interestingly, the poorest performing CATScan function is the financial review process – however 78% of the practices *HealthChecked* indicated they have a regular and documented review process for their business!

Obviously there is a disconnect here – while the review service is just one component (albeit, a very important part) of the broader service package offered to clients, not enough advisers know what their clients really think of their reviews.

How often do they review each client's portfolio? What do they actually review – are the reviews goal focused or return focused? How much time is spent discussing investment returns and market performance versus the client's personal lifestyle goals and aspirations and the changes in their lives? What supporting review reports are required and in what format?

These are all variables the client should have input into – after all, it is their opinion that matters most and the *CATScan* clearly tells us the industry has yet to get it right.

Finally, the agreed review process (whatever it may look like) must be systematised and clearly documented. It also needs to be communicated, understood and "owned" by all the staff in the practice. Only then will it be a valuable business commodity that will attract a premium at sale time.

Reducing Principal Dependence
Business Health's *CATScan* client satisfaction survey of 10,000+ individual clients reveals that more than two out of every three clients would leave their existing practice if their current adviser were to change!

The ongoing value and viability of these practices must be called into question. How to reduce principal dependency must be the second greatest challenge facing most (if not all) advisers today.

To achieve this there are four key areas that must be addressed

- Business Planning
- Risk Management
- Staffing – Performance Management
- Succession Planning

Business Planning
The Australian Bureau of Statistics tells us over 80% of new businesses fail in the first five years. Interestingly enough, statistics also show that around 80% of all small businesses don't have a business plan!

Not surprisingly, the one business trait common to all finalists in the IFA Magazine *Practice of the Year Competition*, was that they all had a clearly documented, regularly reviewed and actioned plan for their business.

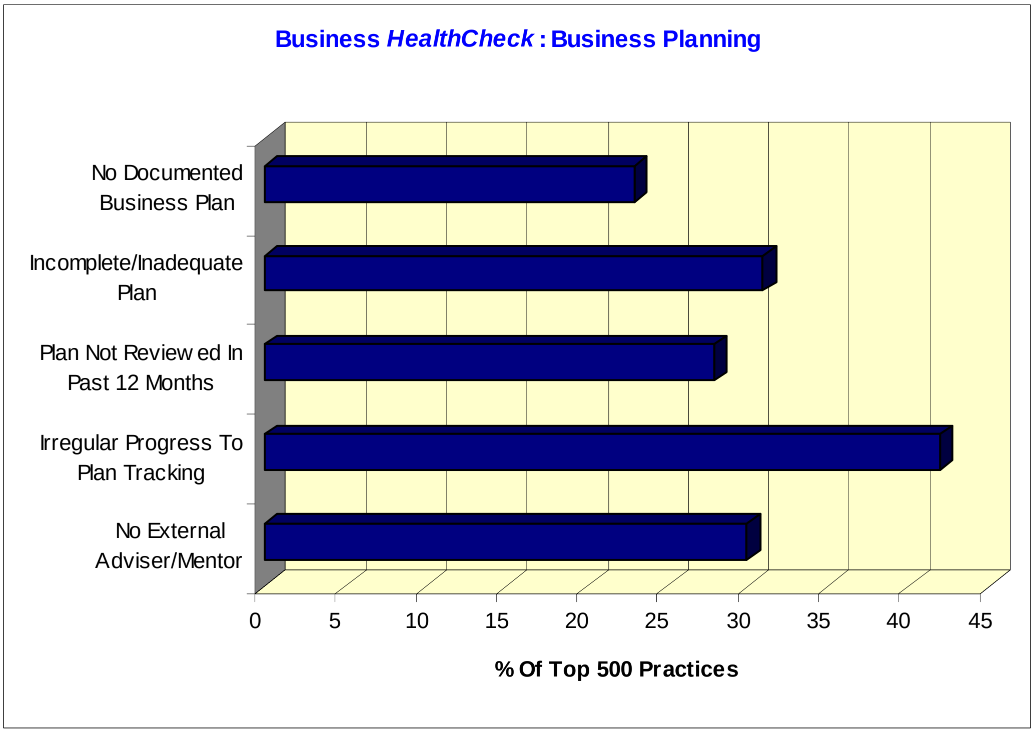
Of course, before an adviser can complete a plan for his or her business, they need to truly understand their business – why they are in business, what they want to achieve, what they want their business to look like, what their strengths and weaknesses are, and as discussed earlier, what types of clients they want to deal with and what they will offer them.

Importantly, the plan must also include their personal goals and hopes - not just for the business but also for their family and lifestyle.

Also remember, while there are many different formats a business plan can take, the measure of a successful business plan lies in its implementation. Having a beautifully scripted and bound 60+ page business plan document means nothing if the objectives are not met, the strategies are not implemented or the action plans are not put into place.

Even if the plan is just a few pages long and only addresses one or two vital issues, it still needs to be written down. This is better than a detailed plan that only sees the light of day at end of year "planning" sessions.

The following table shows the business planning results from the recent Business Health top 500 analysis.



While 77% of the practices surveyed had documented business plans, 28% of these plans had not been reviewed in the past 12 months and only 58% were regularly tracking their progress to plan. The point to note here is that the business plan is not a static document, but one that changes and evolves over time.

These changes may be brought about by external factors such as economic issues or regulatory constraints, staff changes, by unexpected business results, or by strategies that are not creating the desired outcomes. Of course, personal aspirations and family goals will also change over time. It is crucial these "non-business" aspects are included as part of the plan reviews.

By tracking the 'progress to plan' regularly, the practice will know at all times how well it is travelling - it is no use "shutting the gate after the horse has bolted." If changes need to be made, then those responsible for the business need to know as soon as possible.

It can however be quite difficult to develop and document, and then regularly review a business plan in isolation. In today's business world (and even more so into the future), the role of an external adviser or coach continues to grow in importance. Everyone (whether they are a sports person, politician or business person) needs someone they can refer to for objective advice.
Interestingly, just over half (56%) of the top 500 practices surveyed by Business Health utilized the services of an external adviser who they met with on a regular basis.

While there are no hard and fast prerequisites for choosing an external adviser (it could be a respected Business Development Manager, a successful client, an accountant or a professional business coach), the following tips may help an external "mentor" deliver real value to an adviser's business

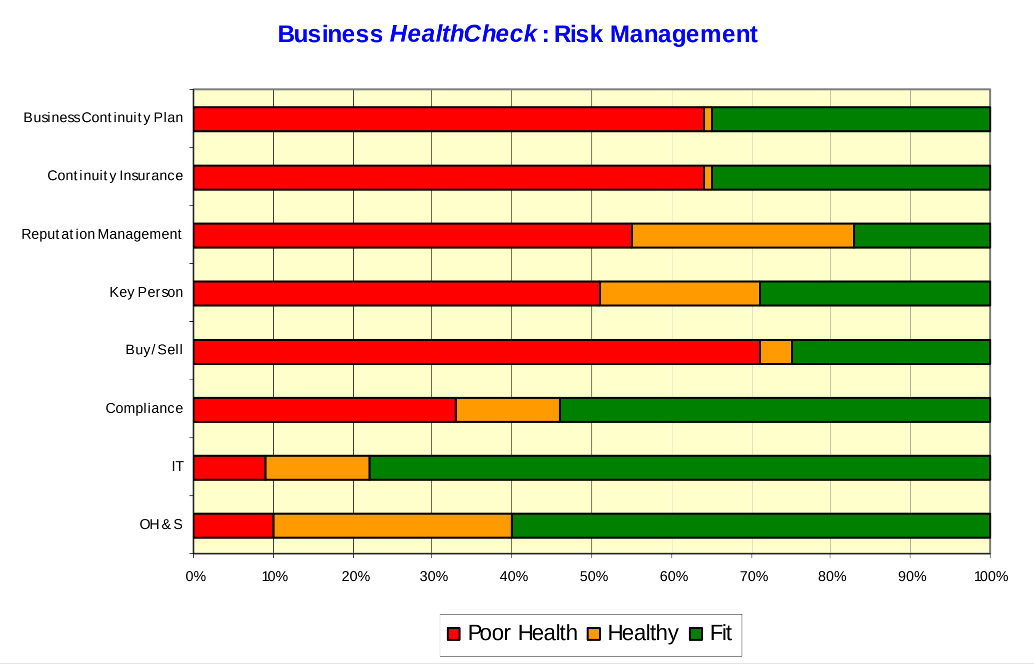
- Everyone must clearly understand what is trying to be achieved and the role each will play.
- The principal must also be able to work with the adviser on a professional level – a close personal friend may not be able to provide the objective, business advice needed.
- The adviser must possess a skill set and attitude that complements the principal – the last thing a business owner needs is someone who will simply tell them what they want to hear. They need someone to productively challenge their thinking.
- Ideally, the adviser will also bring experience and knowledge gained from outside the practice.
- The principal must also be willing to be held accountable to the adviser.
- The progress to plan meetings must be structured and held regularly.

Risk Management

Of course, to convert a proprietorship into a true business, there are a number of other "back office" issues that must also be addressed.

If an adviser is running their practice as a business, then they must ensure that all risks associated with running the business are being managed. Most importantly, disaster recovery, continuity insurance, reputation management, key person insurance, buy/sell agreements, operational compliance, information technology and occupational health and safety.

As shown in the table below, 64% of practices surveyed by Business Health did not have a clearly documented business continuity or disaster recovery plan.



Pleasingly, where a plan did exist, almost all of them had been regularly reviewed. A business continuity/disaster recovery plan that restores processes and applications that are no longer used in the business, or calls on people who have left the practice is of no use.

Linked to this was the fact that almost a third of the top 500 practices surveyed (30%), were also not satisfied they had an adequate amount of business continuity insurance cover.

Almost half the practices surveyed (44%) had a documented reputation management plan to proactively communicate with their clients when bad news is reported about the markets or their firm. Where plans did exist, they were not widely communicated or understood – in only 17% of the practices surveyed, were all staff aware of the media/reputation management plan.

50% of the top 500 practices *HealthChecked* by Business Health had no key person plan in place to ensure their business had ready access to the required funds to continue operations if one of the key employees or principals were unable to work.

Unfortunately, less than 30% of the key person plans that were in place had been reviewed within the last two years.

Only 32% of Business Health's top 500 practices had a documented buy/sell agreement in place to deal with the critical business issues of purchase and sale in the light of the death, disablement or retirement of one of the partners.

These agreements are integral to the ongoing operation of the business, which could otherwise find itself in difficulty if a partner suddenly died.

Firms also need to be wary of the "one size fits all" or all encompassing "template" type solutions. All businesses are unique and need a tailored agreement. Drafting formal buy/sell agreements can be quite complex – there are a number of legal, taxation and legislative issues to be considered and the cost of getting it wrong can be substantial. Given the speed and magnitude of change in the financial services industry, all agreements need to be reviewed annually.

Of course, this is a specialised area and advisers should seek professional help in documenting and reviewing their agreements.

As employers, professional financial planning practices also need to be fully aware of their workplace obligations. 40% of the practices Business Health surveyed rated their understanding of, and attention to, Occupational Health and Safety issues within their office as “Average” or worse.

As the practice is responsible for all staff, clients and partners entering the premises, workplace safety is a business issue that must be addressed. While the actual OH&S legislation varies from state to state, any matter that can affect the health, safety and welfare of people at work can be see as a duty of care issue. This extends to issues not typically seen as OH&S matters such as bullying, personal safety (eg: aggression from clients, working alone at night) and appropriate use of the internet and email.

Given the crucial role information technology plays in running an efficient and profitable practice, IT systems and procedures are another key risk management area that professional firms must address. Given a great deal of focus and money has been spent on this area in recent times, it was very pleasing to see that real progress has been made - 78% of the practices *HealthChecked* rated “Fit” or above. However, as the following table shows there is still room for improvement in some areas.

Information Technology	**% Practices**
How many computers do you have in your business?	
Less than one per person	20%
More than one per person	80%
What is the average age of your computers?	
Less than 1.5 years	40%
More than 1.5 years	60%
How easy is it to share and access the information within the business?	
Fully networked	85%
Partial/No networking	25%
Is your company data backed up regularly and a copy stored off-site?	
Yes	86%
Yes – but no off-site storage	6%
No	8%
Do you use anti-virus software to protect your company data and systems?	
Yes which includes live/automatic updates for new viruses	94%
Yes but a stand alone program	1%
No	5%
Do you send out regular client e-mails or letters through an automated process?	
Yes – personalized	27%
Yes – no personalization	23%
How often is your web site updated?	
Monthly	11%
Six monthly	15%
Greater than six monthly or no web presence	74%
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Having clearly documented (and regularly reviewed) plans, processes and systems remains the key to any successful risk management program. To position a practice as a business, unforeseen events that impact on the business must be prepared and planned for and then communicated to all the key stakeholders. In the event of an emergency, there will be no time to prepare. It is crucial everyone involved in the business is aware of exactly what is required – a plan kept only in the principal’s head has limited chances of success.

It is also imperative that these businesses are run not so much as planning/advice practices, but as true businesses – the decisions that are taken must be informed business decisions, based on business reality.

This means having ready access to accurate and timely management information. Of the top 500 practices analysed by Business Health, less than a third were able to base their input to the Client section of the survey on hard data extracted from their client management system. Most relied on a mixture of intuition, educated guesses and limited hard data.

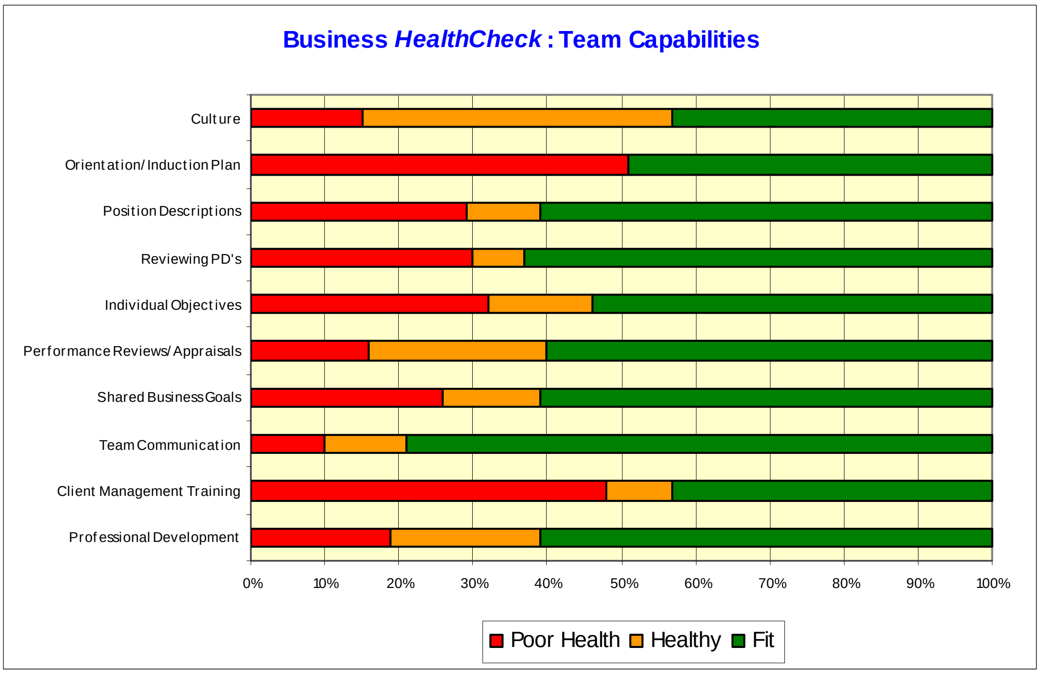
Similarly, a third of the practices surveyed could not extract all the relevant Key Performance Indicators from their financial/business management systems.

Staffing – Performance Management

As we mentioned earlier, 65% of the 10,000+ clients surveyed by Business Health's *CATScan* would leave their existing practice if their current adviser changed. To consistently deliver on their Client Value Proposition (CVP), professional financial advisory firms must be underpinned by robust, sustainable and transparent systems that are not reliant on the principal.

To achieve this, practices must invest in their support staff. The ongoing success of any client centric business will be directly linked to the quality of the overall team. To attract and retain the calibre of staff required, practices must adopt a more structured and rigorous approach to people management.

While the Business Health analysis found that almost half of the top 500 practices rated "Fit" in the Team Capabilities section, as can be seen from the following table, there were several areas that need to be addressed if these practices are to consistently deliver on their client value proposition.



Less than one in two practices (49%) had an orientation plan for introducing new team members into the business. While this area is often overlooked, it should be the first step of a continuum, leading to an understanding of the business, its structure, principles and plans.

In over a third of the practices (39%), the majority of staff did not have a clearly written job description.

No matter what size the business is, every role must have a documented position description. While the format and content of the actual position description will vary from business to business (and position to position), it should be written in brief, clear sentences and at least address the accountabilities and responsibilities of the role, the functions involved in performing the role and the reporting lines – upwards, downwards and sideways.

It is also essential that every position description accurately reflects the current role and operating environment in the business – Business Health found that in 37% of practices, the position descriptions had not been reviewed in the last 12 months.

Reviewing the roles and responsibilities within the practice can also be an excellent way to receive ideas and feedback from your staff. Quite often there is no-one better placed to review the position description than the current incumbent – while the principal will have an understanding of what they want the role to achieve, the team member will know what tasks they actually do perform.

Once the role has been clearly defined and documented, it is essential that all staff have an agreed set of individual performance objectives and understand how these will be measured. In 54% of the top 500 practices Business Health analysed, the majority of staff did not have agreed objectives for the coming 12 months.

For optimal performance, people also need regular feedback. While most practices were regularly reviewing performance with their staff, 40% had not conducted a “formal” appraisal in the past six months.

It is also critical that the entire team understands the broader practice/business goals and how their performance contributes to the success of the practice as a whole. In 39% of the practices participating in the Business Health analysis, the principals had not shared their business goals for the coming 12 months with the majority of their staff.

Open and regular communication is crucial in every business. Without regular and frequent meetings involving all of the staff, the chances of developing a well informed, satisfied, team of people with aligned objectives is remote. It was pleasing to note that 79% of the top 500 practices were conducting regular team meeting with most, if not all their staff.

In an ever competitive marketplace demand for key staff will be intense. Once a practice has the “right” people on board, they then need to invest considerable management time, focus and money on keeping them.

Ongoing professional development and career progression can be as important to key members of the team as their remuneration package. A worrying statistic to emerge from the Business Health analysis was that staff from 48% of the top 500 practices had not attended a client management/professional services course in the last two years. Only 43% of practices reported that the majority of their staff had attended any professional development program during the last 12 months.

Going forward it will also become far more common for key "service" staff to hold an equity stake in the business. No longer will ownership of the firm be limited to just advisers. Given it has been estimated to cost as much as 1.5 times the annual salary and benefits to replace an employee, new and innovative ways of attracting and retaining the people needed to survive and thrive in the future will have to be considered.

There is no doubt there is a competitive advantage to be gained from investing in the ongoing development of a practice team. Clients perceive a wider range of capabilities when staff have skills and abilities that complement those of the principals.

Succession Planning

Of course, it is not only clients that are attracted to a well run and supported business. Potential buyers will also pay a premium for a true business over a limited proprietorship.

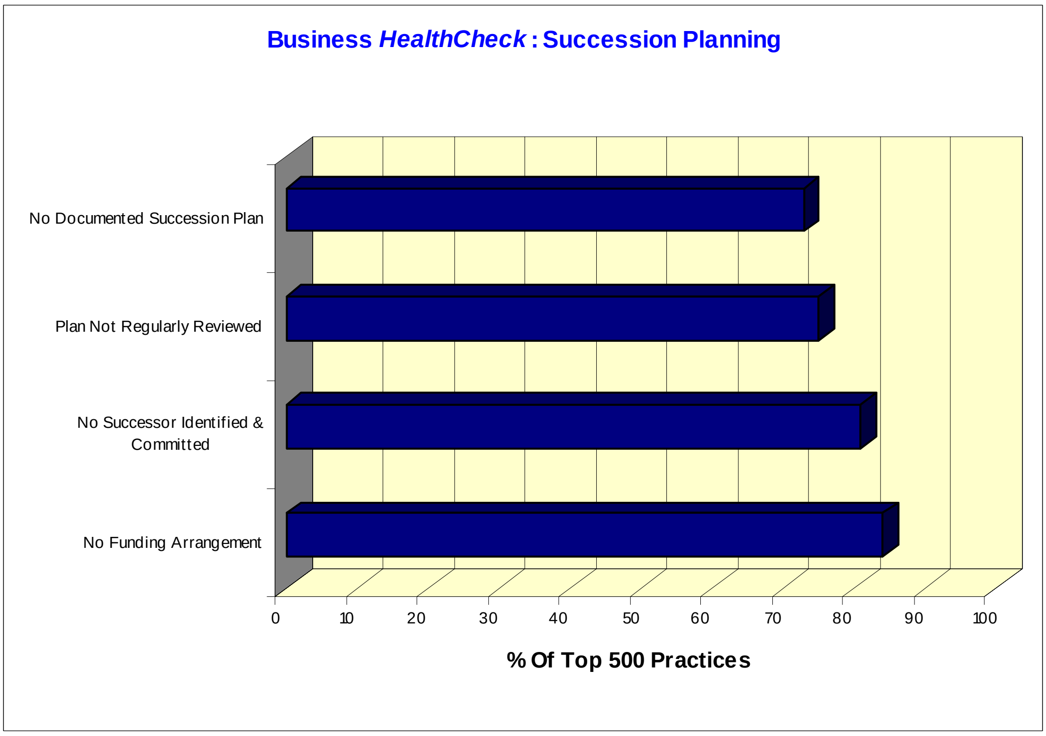
Consider that the vast majority of today's advisers are very much part of the "baby boomer" demographic and are fast approaching retirement. Advisers are far from immune from the "greying" we are seeing in the broader Australian community.

As more and more of these practices come onto the market, purchasers will become more discerning. The price paid for a practice will be determined by the strength of the underlying business principles – profitability, sustainability, scalability, etc. Valuations based on nothing more than a simple multiple of recurring income will become a thing of the past.

The businesses that attract top end valuations will be just that – well run businesses. They will have addressed the issues we have discussed earlier and have carefully planned for the orderly transfer of ownership.

Regardless of when and how an adviser intends to exit their business, they need to start planning for it now. Of course, the closer they are to exiting the business, the more detailed their succession plan needs to be.

While most advisers agree with this, it is somewhat surprising to see the results of the Succession Planning section of Business Health's HealthCheck analysis.



Some 73% of the top 500 practices do not have a clearly documented succession planand only 19% had identified a successor who had agreed to the plan.

Similarly, only 16% of the practices surveyed had a structured funding arrangement in place to support their succession plan.

Acknowledgments
In putting this paper together we have been fortunate enough to receive many offerings from leading organisations and individuals within the Australian Financial Services industry. As it is often difficult to convey all of the information in a drafted contribution, we would strongly urge you to contact the following providers for additional information on how they can assist your business.

Capacity Planning Within Small to Medium Sized Financial Planning Entities

Shirlaws Pty Ltd[3]

Capacity Planning was created as an alternative to current market practice in designing business strategies for small to medium sized financial planning entities. Traditionally, small financial planning proprietorships developed a business plan, which more often than not, management and staff never adhered to during the financial year. The purpose of capacity planning is to implement a strategic plan that is attainable. The success of Capacity Planning stems from the integration of all members of the business, both CEO and staff, in the planning process.

The Traditional Approach

Experience has shown the financial planning community are dependent on a traditional approach to strategic planning that normally encompasses any one of more of the following factors:

- Goal Setting
- Mission Statements
- Business Planning
- Vision Statements
- SWOT Analysis.

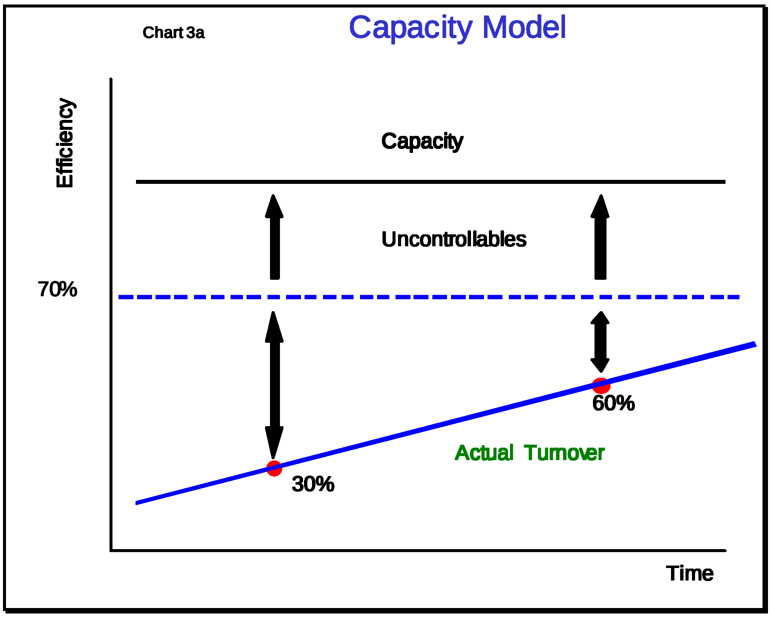
What has become apparent is that the traditional approach to business strategy is flawed. The cause can be linked to the source for strategic decision-making that is often based on historical outcomes that culminate into future hurdle rates. This includes the previous year's profit and loss figures, sales budgets and revenue levels. This market practice eventuates in a bias in growing turnover. Management focus on turnover alone only introduces further stresses in the business due to the inability to sustain a strategy of continuous growth.

Moreover businesses heavily weighted towards growth in turnover never attain best practice. What is apparent is a diminishing rate of return, as the business remains fixated on increasing actual turnover. Few businesses are aware of their maximum capacity or the uncontrollables that exist within the business.

Small business is often focused on a strategy of growth with little regard for the capability of the business. The common fallacy is that an increased turnover and economies of scale will yield efficiencies. Whether the business is at 30% or 60% efficiency (chart 3a), the business has the capability to attain a higher running rate without actually altering the size of the resource mix.

As illustrated in chart 3a, experience tells us that no business ever achieves 100% of its optimum capacity due to 'uncontrollable' factors within a business such as sickness, holidays, and exogenous shocks (who would have ever guessed the magnitude of the securities markets collapse over the past 3 years?). The best-managed businesses achieve approximately 70% to 80% capacity. It is important to note that turnover does not determine efficiency. What is imperative is that business minds need to be aware of the capacity and efficiency of the business, which then determine the strategic planning of the business.

[3] Contact details for all contributors can be found in the Acknowledgments section at the end of this paper



Why should you use Capacity?

Business practices within the financial planning market have a tendency to focus their success based on revenue and profitability. The consequence of such business thinking is a management that is always immersed in detail. For example, the traditional business plan tends to be content driven, which in turn imposes an internal business culture that is unable to envisage the broader direction of the business. There is a need for the business to attain a contextual perspective when developing and implementing its business strategy.

What is not considered in strategic thinking is the capacity of the business. Essentially capacity within a financial planning business is ***the maximum revenue that can be achieved given the current resource mix.*** Capacity planning provides a contextual framework by prioritising the business issues within the business, such as staff, motivation, sales, product and management. This is effective as it enables management to review its current resources and inefficiencies.

Capacity Planning would look at the following factors:

- Running Rate – efficiency level that corresponds to the current turnover
- Current Turnover – sales revenue for the current financial year.

The capacity of a business can be determined by the following simple formula:

$$\text{Capacity} = \frac{\text{Current Turnover}}{\text{Running Rate}}$$

It is important to note that the running rate is determined by the position of the business on the Stages of Development Model.

The Capacity Model

The Capacity Model is an aid to the development of strategy in a business. The model identifies the need to focus on either platform issues and/or growth issues.

Platform Issues

The gap between where a business is operating and capacity is termed the "Platform issues" (inefficiencies). Addressing these issues within a business maximises the current capacity. Platform issues include those functions and tasks that do not increase the capacity of the business, but raise the efficiency of the business (see Stage 1 and Stage 3 – Chart 3b). The common platform issues tend to be focused within the following areas of a financial planning business.

- Business support functions such as IT, Legal, Human Resources and Compliance
- Business operation functions such as Sales, Marketing, Training and Output.

Growth Issues

Growth issues include those functions and tasks that increase the capacity of the business (see Stage 2 and Stage 4 – Chart 3b). The common growth issues of a business are:

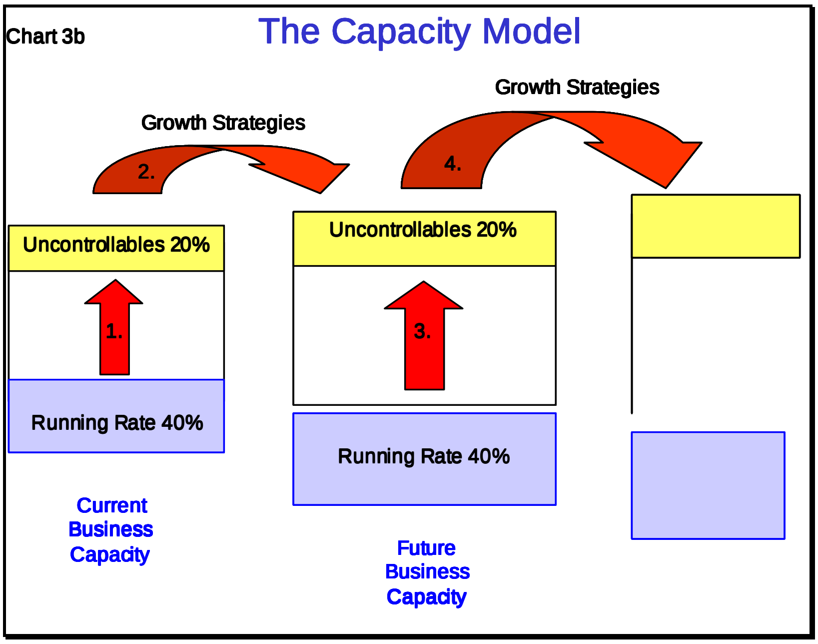
- Business management functions and tasks such as distribution, positioning, client management systems
- Business operation functions and tasks such as new products or services and pricing

Once the platform and growth issues have been identified an implementation schedule (known as the capacity plan) is prepared specific to each business.

The most common implementation program would be an alternating strategy of platform and growth over an 18 – 24 month period. An example of this strategy has been outlined in the table below.

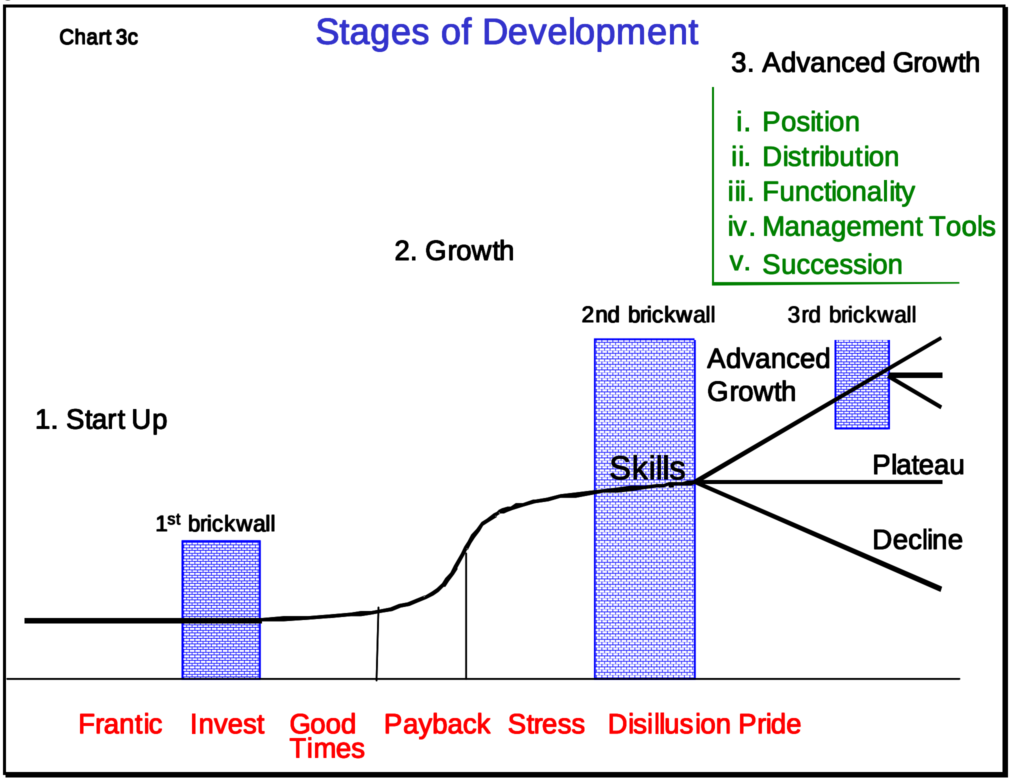
Stage 1 Platform Strategies:	Raise the Running Rate (efficiency within the business) from 40% to 70% by implementing Platform strategies.
Stage 2 Growth Strategies:	Increase the Capacity of the business by employing Growth strategies
Stage 3 Platform Strategies:	Just like pouring water from a wine glass that is 70% full into a decanter, the water level is again approximately 40%. This analogy represents the impact of Growth Strategies on a business in that the water level represents the Running Rate. Again, raise the Running Rate (efficiency within the business) from 40% to 70% by implementing Platform strategies.
Stage 4 Growth Strategies:	Again, increase the Capacity of the business by employing Growth Strategies

It is important to note that there are no specifics on how large the capacity of a business can be increased or how quickly the running rate can be raised. The determining factor here is the capability of the resource mix to undertake a sustainable rate of growth within the business.



Links to the Stages of Development Model

The evolution of all financial planning businesses can be portrayed on the Stages of Development model in Chart 3c. This model outlines the journey of a business from start up to achieving advanced growth. Each stage of development is characterised by the emotional state of the business (highlighted in red below) typically experienced during each stage (highlighted in black below). By identifying the emotional state, management can then determine the current stage of the business and how close they are to achieving advanced growth.



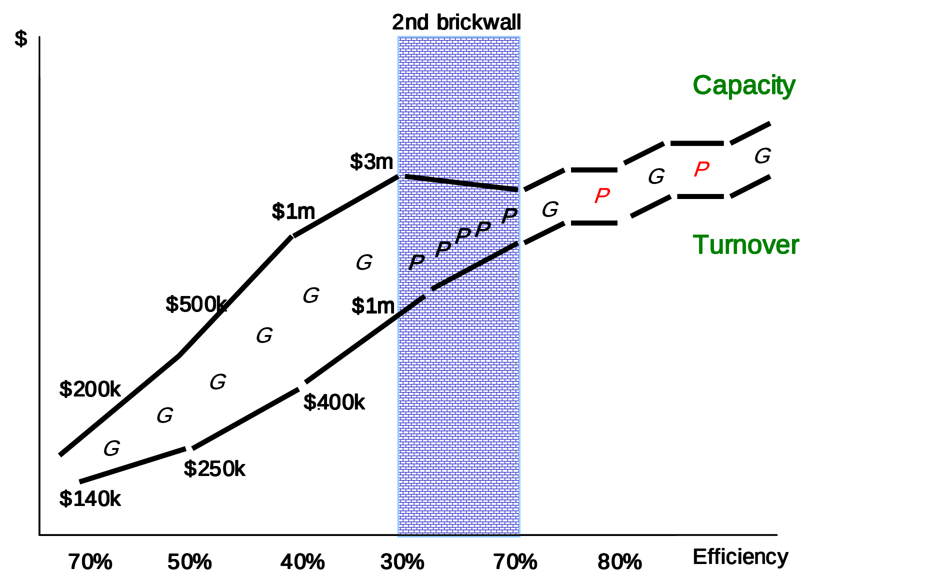
Once the emotional state is determined the appropriate mix of growth and/or platform strategies are implemented to drive the business towards a state of advanced growth. The key objective of all capacity planning is to reduce the duration of the 2nd Brick Wall and hence determine the future direction of the business, whether it is:

- Advanced – whereby the business will make a choice to re-energise the business
- Plateau – whereby the business makes a choice to maintain the current level of operation and not to move into advanced growth
- Decline – whereby the business will make a choice not to move to advanced growth or plateau, and move into decline in either staff or turnover.

To achieve advanced growth a business needs to have five key characteristics, being:

- An efficient functional structure
- Strong market position
- Established distribution relationships
- Implementation of a succession plan
- Established management systems

Chart 3d **The Optimal Mix of Platform & Growth Strategies**



A critical assumption of the capacity plan is that a negative correlation exists between the capacity of a business and efficiency (or the running rate). As noted above, a business in start up more commonly has a high running rate, which corresponds to small gap between capacity and turnover. However this gap widens as the business undertakes a strategy of growth until stresses appear within the business usually characterised by low levels of efficiency at the commencement of the 2nd brick wall.

The 2nd brick wall refers to the time in a business where the impact of the issues that were not dealt with during the accelerated growth period comes to a head. When a decision has been made to invest in addressing the issues, namely the lack of skill, the business tends to become re-energised.

The capacity plan will incorporate a mix of platform or growth strategies depending on the position on the Stages Model and issues identified in the business. Some of the more common strategies that make up the capacity plan are described in the next table.

Platform	**Growth**
Functionality Client Service Sales Process Human Resources	Positioning Pricing & Packaging Distribution Joint Ventures

As a general guide, businesses with a running rate of:

- **Less than 50% -** will incorporate a capacity plan heavily weighted with platform strategies. These businesses are typically in the 2nd brick wall (Stages Model – Chart 3c)
- **More than 65% -** will incorporate a capacity plan heavily weighted with growth strategies. These businesses are typically in good times (Stages Model – Chart 3c)
- **Between 50% to 65% -** will incorporate a capacity plan with an alternating mix of platform and growth strategies. These businesses are typically in advanced growth (Stages Model – chart 3c).

Most small to medium financial planning businesses focus on their turnover rather than their capacity. Analysis of turnover alone gives neither little insight into current management practices nor the current capability of the resources within the business. Small business has a tendency to impose a strategy that is biased to continuous growth in turnover, which is the common theme within most strategic decision-making like business planning. On most occasions this reduces the efficiency of the business in the long term, due to internal stresses on both proprietors and staff alike.

Capacity planning provides a contextual framework that incorporates the efficiency of the business. Business owners can ascertain the capacity given the current resource mix and implement the appropriate strategic plan. Lastly, it is imperative to locate the business on the Stages Model in order to deploy and time the appropriate mix of platform and growth strategies.

Practice Management In a Model Financial Planning Practice

Wes McMaster[4]

Background

Most financial planning practices were started ten or more years ago and have grown through the entrepreneurial and marketing skills of the operators. They have reached a stage in their development where they require management skills to operate efficiently, capitalise on the client base and position themselves for the next stage in their growth. Typically the owners that created the business are good at building the business and being financial planners but they are not good at managing the business forward.

Positioning the Business

Prepare a Strategic Plan

The first step is to review your business from top to bottom and prepare a Strategic Plan. This document should cover the following areas.

A review of the business as it is today, covering;

- Organisational structure
- Client base
- Pricing
- Service levels
- Processes
- Systems
- People
- Financials
- Marketing

The review should make recommendations for change and document an implementation path and the expected impact.

The Strategic Plan is the blueprint for taking the business towards an efficient model. Following are some of the principles that can be considered for a modern financial planning practice.

Organisational Structure

It is common to see financial planning practices where the financial planner deals with a discreet group of clients. This encourages territorial behavior and limits the income of the firm. It also means that the client relationship depends on an individual and therefore is less easily transferred. If you wish to build a financial planning business that has enduring value, then you must build a business where clients deal with the firm and the custom of the clients is not dependent upon a particular adviser. If a business is to develop intrinsic value it must be able to be transferred.

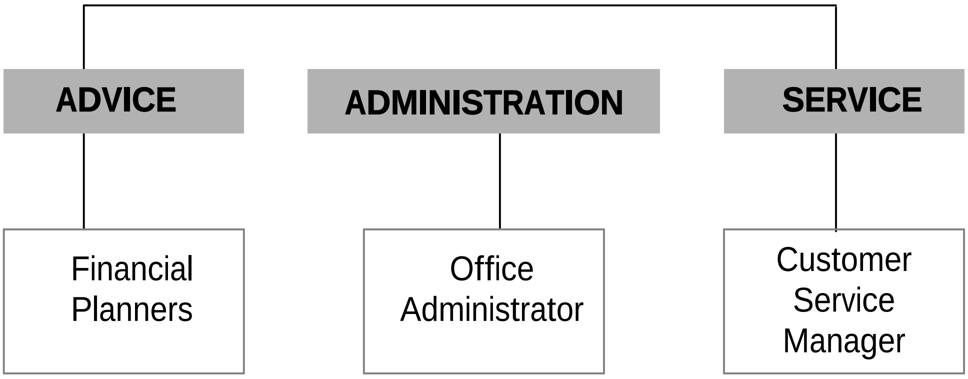
The preferred process is one where the financial planner and a para planner attend the initial interview with a client. The role of the planner is to conduct the interview and the role of the para planner is to record client information and ask questions of clarification. At this point the client has met two people in the firm who will service their needs. At a subsequent interview, the client will meet the Administration or Customer Service Manager (CSM) and

[4] Contact details for all contributors can be found in the Acknowledgments section at the end of this paper

they will now have a relationship with three people in the team that will deliver service. The client will be comfortable talking with the para planner about technical or the CSM about administrative issues. If one member of the team leaves, the client relationship stays with the firm.

In a mature practice, it is not essential for financial planners to service every client. Planners and para planners dedicated to delivering ongoing service can conduct client reviews. Here is an example of an organisational chart that separates service from advice.

Sample Organisation Chart



Pricing and Service
Financial planning practices earn income from three distinct activities.

- **Initial advice** This is one of the most valuable activities because you are re-positioning the client to use their financial resources efficiently into the future. This is a time-based activity and should be charged a time-based fee.
- **Implementation** This is an administrative task and does not add value. Choices a nominal flat fee or a time-based fee to simply recover the cost of time spent. Most planners charge a percentage fee.
- **Continuing Service** Most planners charge a percentage of assets under management, or if that is not appropriate, an annual service fee.

For illustrative purposes, let's assume that your pricing for continuing service is a percentage based asset fee.

Your client database is the most valuable asset of your business. Businesses generally segment their client base into several categories according to the value of the client to the business. This is measured in the annual income contributed to the business by the client. Here is a suggested way to segment your client base and it is matched with a typical pricing scale to give you an indication of what you can do.

Clients by $ invested	Fee % of assets	Segment	Minimum $pa to Business
$1 million +	0.25	A	5,000
$500,000 - $1 million	0.50	B	3,750
$100,000 - $500,000	0.75	C	1,000
$50,000 < $100,000	1.00	D	500

So you can see that there are four client segments and now that we know the minimum income to the business we can design service levels for each segment. However, first we must understand what it costs to deliver service.

There are five fundamental services that you will deliver to your clients on an ongoing basis.

- Review of asset allocation in investment portfolios
- Quarterly portfolio statements
- Annual financial planning review
- Responding to client requests as the result of an event
- Initiating client activity

Let's try and quantify what this might cost you.

Ongoing Service	Estimated time (hours pa/client)	Est. cost ($) @ $200/hr
Review of asset allocation in investment portfolios	0.5	100
Quarterly portfolio statements	0.5	100
Annual financial planning review	6.0	1,200
Minimum ongoing service	7.0	1,400
Responding to client requests as a result of an event	2.0	400
Initiating client activity	?	?

Now, here is an example of how you can design your service levels to suit your different client segments.

Client Segment	**Annual FP Review**	**Quarterly P/F Statements**	**Quarterly Asset Allocation Review**	**Client Briefings**	**Additional Client Meetings**	**Additional Client work**	**Newsletter**
A	6 monthly	Yes	Yes	2 + special dinner	Yes	Yes	Yes
B	Yes	Yes	Yes	2	Yes	Hourly rate	Yes
C	Yes	Yes	Yes	2	Hourly rate	Hourly rate	Yes
D	Hourly rate	Yes	Yes	2	Hourly rate	Hourly rate	Yes

Where the response is "Yes" then the service is provided at no extra cost to the client. Where the response is "Hourly rate" then the service is only provided to the client if they agree to pay an hourly rate for the time involved.

You can see how the service offering is adjusted to the different segments to reflect their income contribution to the business and the need for you to operate at a commercial level.

Managing the Business

Practice management is a particular skill and you need to approach managing your business as a professional management exercise.

Create a Model of your Business

The first thing to do in a business is create a model of it. You can do this with spreadsheets. The model is based on the following elements (it is not described in much detail as it is the principle we wish to demonstrate).

Pricing of each client segment.

- Number of existing clients in each segment, average portfolio value and risk premium.

- Assumption on the number a new clients that will be acquired in each segment by planner.
- Assumption on future investment growth (or loss) rates.

We now have a forecast income. We have also set activity targets for each planner.

- Forecast non-payroll expenses.
- Payroll expenses by employee.
- Forecast capital expenses.
- Work in progress.
- Assumptions on time delays in cash receipts.
- Opening balance sheet figures.
- We can now project future profit and loss, cash flows, balance sheet and capital value of the business.
- Time spent on direct client activity by each employee
- Expenses that are directly related to client acquisition and client servicing.

We can now calculate client profitability by segment. We can also view future staff utilisation and see when we need to employ new staff or to delegate tasks to staff. This is important because it allows you to budget for a new staff member in the future as the client base and servicing needs grow.

The model is projected over five years. The first year has monthly details, the second quarterly, and years three, four and five are annual figures. Once you have your model of your business, you can use it to look at the effect different strategies such as pricing, acquisition, or market change will have on your business. The model will show you the future effect on cash flow, profitability, capital value and staffing needs. In this way you can make decisions about your business from an informed position where you know the expected outcome. It is recommend that you update the model quarterly and take into consideration where you are taking your business in the future.

Create Your Business Plan

Now that you have a five-year model of your business going forward, you can use this as the basis of your business plan. Your business plan will document the strategies that you have built into your model. Because you are going to update your model and re-visit your strategies quarterly, it is simple to update your business plan quarterly.

Define and Automate your Business Processes

It is possible to define processes used in financial planning businesses and then automate them within the business. Here is how it works.

Using workflow software you can define each process used in your business. Here are some typical processes that you can document.

- Client acquisition
- Initial Advice
- Plan preparation
- Implementation
- Portfolio review
- Client review
- Administrative processes

Each part of a process will have tasks that need to be completed. Each task will be allocated to a particular person in the business and will be dependent on a preceding task or decision. Once a process is being followed, the software will send the tasks to the desktop computer of the allocated person in the business at the appropriate time in the process. So each morning when people log on to their computer, they will have a list of tasks to complete within a given time and this will appear next to their diary. When they look at the task, there might be a document attached to it. For example, if the task is to send a letter to a client, then by selecting the attachment to the task, they will reveal a template of a standard letter that will be already populated with the client's name, address and greeting. They simply need to print it out and send it.

The benefits of automating workflow processes are significant and can be summarised as follows.

- By building your business and compliance rules into the processes, you will ensure compliance and reduce liability.
- Each client will receive a consistent experience.
- Nothing in a process can be misplaced or forgotten.
- Staff will require less supervision.
- More junior staff can handle tasks.
- Each employee can complete more transactions.
- You can record key performance indicators based on any task.
- You can design management reports on any activity.
- You have a record of work in progress.
- You can examine the activity of any employee.

Key Performance Indicators

One of the benefits of automating your workflow processes is that you can measure the time that it takes to complete each task and the number of times that each task is completed by each employee. This allows you to automatically produce Key Performance Indicator (KPI) reports tailored to your business. Here are some examples of KPI's that you might use.

You can design your KPI's for the whole business, an individual or a team of employees within the business.

- Income produced versus targets.
- The number of first appointments, second appointments, implementations and $ income. This will allow you to measure the client conversion rate of planners and over time you will build statistical information that will measure the average income to the business that will flow from each first appointment for each planner.
- The number of referrals to each planner. If some planners are receiving referrals and others are not, this identifies an issue.
- The number of referrals from each client. This will allow you to identify that particular clients should receive special support.
- The number of overdue tasks per employee. This might allow you to identify that an employee needs assistance.
- The time taken to complete tasks by employee.
- The time spent by each employee working on an individual client. Provides you with a record of how much work is done for each client. This can be used for time-based billing or simply to support a justification for your annual fee.

KPI's for each employee are typically used to provide an incentive bonus. Because you can measure the activity of each employee (or a team of employees), you can provide them with activity-based targets and base their bonus on achievement of those targets.

Management Reports

Another by-product of your model and automating workflow processes is that you can produce management reports that measure key elements of your business versus targets.

For example, you would want a cash flow statement. You might measure production by planner and this might lead you to examine a particular planner's activity to understand why it stands out. There are potentially about 500 different elements that you can measure.

Summary

Some of the issues that you need to address in positioning your business towards an efficient model have been identified. Additionally a system can be used to efficiently manage a financial planning practice has been detailed. Establishing these management systems is not an expensive exercise and is an investment that will deliver an improvement in profitability and capital value. If you are serious about your business, then you have to be serious about managing it.

SECTION 3

Converting Sweat into Reward – The Drivers of Value of a Financial Planning Practice

Perhaps the most effective way for a practitioner to attain full value for his/her planning business is to adopt a long-term view of succession planning. Succession planning is beyond the direct scope of this paper. More immediately, planners need to ensure that their practice is run like a business; that it follows a business model and client value proposition that potential buyers will value. Section 1 offered some insights into the disciplines of converting a practice into a business.

Regardless of how a planning business has been run historically, it is apparent that the processes of preparing the business for sale and of negotiating and completing the sale can make an enormous difference, not only to sale prices, but to "fit" and the long term satisfaction of clients as well as the buyer and seller.

In this section we consider the factors that drive the value of financial planning practices and the success of transactions involving those practices.

The first paper by Stephen Bingham of *bingham|martin*[5] describes the drivers of superior value of financial planning practices in terms of the structure of the business for sale, the intrinsic nature of the business and the conduct of the sale process.

The next paper by *Kenyon Prendeville* offers further insights into the sale process, identifying the key factors in the success or failure of the sale of planning businesses, with case studies illustrating the mechanics of both successful and unsuccessful transactions.

The next paper in the section by Robert Bain of *Money Values Pty Ltd* identifies the client base as the core asset of a planning business and describes the use of client modelling software to understand and communicate the financial, circumstantial and personal dimensions of those clients to maximise the value of the a planning business for sale.

The final paper by Richard Rasker applies the principles of managing for value and succession planning to General Insurance brokerages.

[5] Contact details for all contributors can be found in the Acknowledgments section at the end of this paper

Drivers of Value for Financial Planning Businesses

Stephen Bingham[6]

Introduction

The confluence of competitive threats and opportunities explored in HyperCompetition parts I and II have contributed to a steady escalation in the number of sales and mergers of planning practices. Sale prices, although down from the peak of recent years, remain high by comparison to international and Australian historical norms and are widely tipped to fall in relative terms.

Although the financial planning profession is part of a wider industry that in part justifies its existence by its superior ability to judge value and investment strategy, valuation techniques and sales strategies often appear surprisingly unsophisticated (e.g., relying on 'rule of thumb' multiples). Nonetheless, it can be observed that the prices paid for planning practices with broadly similar characteristics have covered a wide range of values (from approximately 1.25 to 4 times trail fees, for example) indicating that buyers will recognise and reward other drivers of value than recurring income, even if this is simply expressed as a higher or lower 'multiple' of a single valuation factor.

It is our observation that lower multiples (and, more particularly, deferred and conditional payments, 'retention sums' and the like) are often effectively a <u>discount for uncertainty</u>. That is, although financial performance is generally well documented and verifiable, if a seller is unable to satisfy a buyer in relation to the many other drivers of business value, the buyer will inevitably adopt conservative or negative assumptions about those drivers, and reduce the business valuation accordingly.

We advise vendor clients to:

- recognise that the sale of their practice is a significant project,
- put considerable effort into anticipating and understanding the drivers of business value that will influence a buyer,
- prepare both their business, and their information memoranda for the sale of the business, in a way that provides maximum transparency and comfort to the buyer so as to minimise or eliminate this uncertainty discount.

This paper will describe a number of drivers of financial planning business value, and describe how data on these drivers can be presented in sales documentation and negotiations.

What is for sale? Sale of Contractual 'rights'?

It is an axiom of the planning industry that "nobody owns the client". Even so, planners who are members of a dealer group generally assume that they have the unfettered right to sell the servicing and brokerage rights of their business, or to take it with them when they leave the group. Their capacity to do so may depend upon the contract with the dealer group, or more practically the policy and practice of the dealer group with regard to sales of member practices.

As an initial step the vendor should review the contract with their dealer principal to clarify the obligations and conditions on a transfer of clients, and database information to another

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[6] Contact details for all contributors can be found in the Acknowledgments section at the end of this paper

dealer. Often, however, the contract will be silent or non-specific about these matters. As a further step, we advise clients to share information about their intentions with their dealer group, and obtain a "letter of comfort" from the dealer group stating that they are aware of the proposed sale, and will assist in its completion.

What is for sale: the company, the "business" or a "book of business'?

There are significantly different implications for both the vendor and the buyer as to whether the sale is of the shares of a company, the defined rights and obligations of a 'business', or the 'servicing rights' with respect to certain clients (sometimes called a 'book of business'). The optimal structure will depend upon individual circumstances, and upon the answer to questions such as:

- Exactly what is intended to be sold/ bought (not just rights and assets, but obligations and liabilities)?
- What legal and tax implications flow from different sale mechanisms?

These issues are well beyond the scope of this paper, and would require appropriate legal advice, but some of the principal considerations will include:

- GST. Subdivision 38-J of the GST Act provides that, if certain conditions are satisfied, a `supply of a going concern' is GST-free. The conditions include that 'the supplier supplies to the recipient all of the things that are necessary for the continued operation of an enterprise' (from the perspective of the supplier), creating the technical possibility that anything less than a 'lock, stock and barrel' sale will lose the GST exemption.
- Capital Gains Tax. If the company was established before September 1985 it may be preferable to sell the company, rather than the assets (many of which are likely to have been acquired post-1985).
- Due diligence issues. As a generalisation, acquisition of a company requires a more complex due diligence process by a buyer, with investigation of corporate constitution and filings, asset ownership, corporate shareholdings, debts, encumbrances, shareholder loans and contractual commitments including premises and employees. A buyer may prefer the purchase of a 'clean' set of assets or book of business.

Who are the Clients? (How many engineers?)

If "no-one owns the client", the Buyer is being asked to part with significant funds for the privilege of hopefully continuing a number of relationships. Helping a buyer to know the clients may be the most valuable qualitative data that a buyer can provide. Which clients are 'high maintenance'? Which clients demand a lot of information ('How many engineers?' asked one potential buyer during due diligence) and which prefer a disengaged approach? Who shows high anxiety about their financial affairs and who demands constant demonstration of performance?

This type of information is notoriously difficult to collate and present, and resides 'in the head' of the vendor. However, mechanisms are available for collecting, analysing and presenting this 'soft' data. A vendor client had collected "Money Values"[7] client profile data for his entire practice, and was able to provide profile data of client attitudes and beliefs in relation to investment at both individual and business aggregated level. The buyer was able to obtain an understanding of each client's beliefs and 'hot buttons' in relation to money and

[7] See separate paper on Money Values herein.

investment prior initial interview, and thus gained a head start in establishing rapport and confidence.

Other valued client profile data will include financial (FUM, client incomes, revenue per client, investment types etc) and demographic (residence, age, gender, duration etc.).

Systems and Procedures

Buyers of planning practices can exhibit two distinct acquisition strategies. Some might seek opportunistic acquisitions of 'distressed' or poorly run businesses, and add value by introducing their own proven business systems.

Others will look for 'quality', well run practices that can be continued or integrated with a minimum of disruption and management effort and the minimum potential for subsequent loss of business.

Clearly, for a vendor, maximising value requires attracting the latter type of buyer. An intending vendor should allocate a large part of the sale project plan to ensuring that systems and processes are up to date and 'clean' - client files, client databases, client reports, brokerage payments, regulatory filings etc.

Thorough preparation of sales documentation and due diligence materials (data files and the like) will demonstrate to potential buyers that business data is accessible and complete.

Business Plan or Strategy (and Pareto's Law)

Many planning practices have grown, to varying degrees, opportunistically. Planners are often reluctant to reject new business, however small, whether from new clients or new product/service offerings. As a result, many planning practices exhibit a number of low value clients, and various partially developed business opportunities (e.g. a handful of mortgage broking or DIY super clients). Experience shows that a disproportionate amount of management time will be consumed by the 'bits' of the business that were not added pursuant to an articulated plan for profitable growth.

Expressed differently, we can thank the Italian economist, Vilfredo Pareto for Pareto's Law that has been generalised and simplified into what we commonly refer to as the 80/20 rule. Typically in planning practices (as in most businesses) 20% of the clients provide about 80% of the revenues. Moreover, when profitability in a typical planning practice is analysed on a fully costed (or economic profit) basis this profile deteriorates further. Research by the Boston Consulting Group in the wealth management industry found that typically 20% of clients drive 120% of profit, and 20% or more of clients actually destroy value[8]. As a vendor, how much can you expect a buyer to pay for clients that cost more to serve than they earn? As a bidder stated in a recent offer document; "*there are only 40% of clients that are profitable. We have defined profitable to mean… (We) do not value the other 60%"*.

Accordingly, particularly where there are a number of smaller clients, it may be useful to provide some analysis of customer profitability and cost to serve. For example, we recently advised a client whose small practice included about 200 clients each with less than $100,000 FUM and low revenue contribution. However, three quarters of these were corporate superannuation clients, managed through employer contacts, and the planner could demonstrate that the aggregate revenue of these clients was highly attractive relative to the cost to serve.

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[8] *The Boston Consulting Group, Inc.* **Hidden Treasure: Finding the Keys to Profitability in Wealth Management** *2002*

In other circumstances it may be desirable to show a differentiated client service model. If a practice uses a one-size-fits-all client servicing model two problems occur. Firstly, some clients will actually represent a drain on profitability, as described. Secondly, and potentially more damagingly, the highest value clients will have been implicitly subsidising the lowest value. These clients will be most vulnerable to an attractive competing offer (lower costs or higher service) from another firm that has a more flexible service offering. And the time when these clients will be the most likely to reassess their advisor is during the uncertainty of the sale of their advisor's practice.

Thus a more highly valued practice will be one that can demonstrate that clients have been assessed and serviced in a way that ensures both that smaller clients remain profitable, and that larger clients feel spoilt and loyal.

Moreover, a vendor needs to be able to demonstrate the strategic roadmap by which business has been grown, and can be grown further from its current base. Smaller practices in particular cannot hope to maintain expertise in every area of financial advice. Rather than suggest that the business offers all things to all comers, the vendor should show where the business has established a defensible niche, based upon an assessment of its best capabilities, possibly supported by mutually beneficial alliances. If an intending buyer brings expertise in new areas, this will represent an opportunity to provide increased services for the acquired client base.

Client Satisfaction

One of the greatest risks to a buyer is that a proportion of clients who have been only marginally satisfied with the performance of the vendor planner will treat the sale of the planning business as a trigger to reassess their position and will seek other advice or investments.

A vendor should highlight if annual client turnover is low compared to the generally accepted norm of 4 to 5% per annum, and should ideally be able to show a healthy proportion of clients of long duration.

A strong professional reputation of the vendor will support an expectation of well served and satisfied clients, provided the business has not been built in reliance upon the particular qualities or relationships of the vendor that a buyer cannot hope to match.

Revenue Consistency and Growth

An attractive planning business will be able to show a stable history of (recurrent) revenues, steady growth in those revenues, and a favourable pattern in costs relative to revenues. Conventionally sales valuations are struck on trail (recurrent) brokerage with a low or nil value placed on upfront (non-recurrent) brokerage. However, we encourage vendors with a strong history of funds inflows (perhaps evidenced by historically high upfront payments) to highlight this fact. As with valuation of any financial asset, it is the discounted present value of all future cash flows that determines value, and a high, steady inflow of funds from existing clients (from, for example, regular investment plans) must support a higher valuation than if the same FUM are held by a relatively inactive client base.

Vendor's Intentions, Restraint of Trade

A vendor's motive for sale will generally be retirement, a change in personal circumstances, or a new professional opportunity. Whichever is the case, it will clearly be preferable to present the sale as the outcome of a succession planning process, rather than a forced sale resulting from an inability to properly continue the business.

A buyer will have two legitimate concerns with the intentions of the vendor after completion of the sale. Firstly, a buyer will require, at the minimum, an appropriate handover period, probably including a series of joint introductory meetings with clients. (It is very much in the interests of a vendor to facilitate handover meetings, because it assists with the shifting of advisory risk to the buyer.)

Following handover, most buyers will want to know further that the vendor is at least available on some agreed basis to assist with problem resolution, client reassurance and the like. The vendor's deeper ongoing involvement beyond this will be a matter of negotiation subject to the preferences of the parties. In the case of a succession of ownership by a younger employee, for example (and the most successful transactions tend to occur within the business), the ongoing presence and mentoring of the vendor is likely to be highly valued by the buyer (and clients). For a purchase/ merger into a larger established practice, by comparison, the buyer may wish to establish a new and distinct identity more quickly.

Aside from the question of the vendor's ongoing involvement with the business, a buyer will generally require a contractual restraint of trade. At the minimum this will involve a commitment not to actively approach ('poach') former clients of the business, or possibly not to accept work from former clients for a period of time. The most restrictive 'non-compete' clauses demand that the vendor not work in financial planning, or related industries, anywhere, ever. We advise against agreeing to these ambit clauses (they are probably unenforceable at law anyway), but it is generally possible for the vendor to meet the reasonable needs of the buyer without tying their hands so completely.

Purchase price structure – When is a dollar not a dollar?

A payment that is contingent upon an uncertain event, or that is deferred into the future (or both) is worth less than a fixed sum today. Despite the widespread convention for selling planning practices upon such terms (for example 50% upfront, 25% in 12 months, 25% in 24 months, the latter payments conditional upon the retention of certain levels of business) we strongly advise vendors against accepting such terms.

When demanding such terms, a buyer is seeking to ensure that they have paid for no more than they bargained for (both quantitatively and qualitatively), and that the vendor meets post-sale obligations. They aim to shift the risks of the transaction from themselves to the vendor. As such, as noted above, it is generally a manifestation of the uncertainty of the deal, much of which can be managed.

We advise vendors to do all that is possible to anticipate and address the various sources of uncertainty, through the presentation of sale offer documentation, through the conduct of the due diligence process and through the contract negotiation. They should not, however, underwrite the ability of the buyer to adequately service and retain clients for as long as some years into the future. If the sale is properly conducted, the vendor should be able to well demonstrate what he has done in the past, and what is offered for sale. What will happen in the future is under the direct influence of the buyer. These arguments are additional to the complexities of purchaser's guarantees, business audits, dispute resolution etc.

Where, however, a potential buyer insists (as many do) upon some deferred and/or conditional component, this may be in the interests of the vendor if the terms are sufficiently favourable. This means firstly that the total consideration needs to reflect the fact that deferred settlement is a form of vendor finance, so a 'time cost of money' component (perhaps bank bill +3%) is appropriate.

Secondly, just as the buyer is seeking to pay less if retained business is less than expected, the vendor should seek an 'uplift' or 'escalation' payment if the retained business (or additional business from transferred clients) exceeds expectations.

In this regard it should be remembered that in negotiation theory (if not in finance theory) different expectations can create value for the deal. For example, suppose a buyer's experience and fears tell her that 25% of the FUM she is proposing to buy will walk out within 2 years. However, the vendor's experience and knowledge of the clients tells him that 95% of the clients will stick, and they'll tip in more funds, so that FUM will grow by at least 25%. They will unsurprisingly come to very different valuations of the business. However, based on their widely different expectations, the parties could strike a deal with a large bonus or uplift component that satisfies each of them. If the buyer thinks she is, say, only 5% likely to make a $100,000 bonus payment, the expected value/cost to her of this is (10% x $100k) $5000. If the vendor, by comparison, is 90% sure that he will collect, the expected value to him is (90% x $100k) $90,000. $85,000 of (expected) value is created, which may be enough to close the deal.

Reverse Due Diligence

As a simple matter of ethics the vendor will want to assure him/herself that the clients are going to a practice that can serve them at least as well as previously. More pragmatically, however, if there is any part of the purchase consideration that is contingent on client retention or ongoing business performance the vendor will need to be satisfied that the buyer has the resources, expertise and service style that will be satisfactory to the clients transferred.

Accordingly, vendors should be prepared to take a broader view than selling to the highest bidder. A part of the sale process will involve undertaking some of the same investigations of the buyer as the buyer has made of the vendor: what is the client management process-planning, reviews, communication?, what is the fee basis?, what range of services is offered? and so on.

Conclusions

Lawyers, doctors, architects and financial planners tend not to do their best work when they are their own clients. Planners whose life work has been in achieving superior financial and lifestyle results for their clients sometimes short-change themselves when it comes to managing for, and realising, the value of the business that might be their largest asset. In an application of the old adage about working on rather than working in the business, many vendors are disappointed not to be able to achieve 'full value' for a business they have worked hard in for a number of years. But buyers are dispassionate, and increasingly cynical. They know what drives value, and what dilutes it. And while they don't like to buy problems, they hate to not know what they are buying. A clean, well-run and transparent practice, followed by a clean, well-run and transparent sale process is the best way to achieve full and fair value.

Where to From Here?

Kenyon Prendeville[9]

The Current Climate

Acquisitions - Growth - Enhancement - Realisations

Much has been spoken and written about the future of the financial services industry in recent times.

A great deal of the discussion has been focused on prices paid for businesses, business valuations, methodologies used, and what constitutes a 'good business'. Additionally the price one might expect to pay or receive can be dependant on the varying degrees of systemisation and sophistication adopted within a business (see Appendix 1).

The conference and seminar circuit provides no shortage of experts prepared to espouse what the "perfect business" looks and feels like. When added to the very active promotion of platforms, benchmarking, health checks, coaching and practice management is it any wonder financial planners are bewildered and wanting plain talking and practical solutions?

Fund manager to fund manager and financial planner to financial planner business sales have perpetuated and reinforced false and flawed valuations. These bear no relevance to the valuations applicable in the commercial world outside this industry. Whilst many of the institutions over 2003 wrote down considerable sums for their wealth management purchases, their appetite which was once so voracious, was sated. This demand shift impacts pricing, supply and demand and may further change leading into a post FSR regime.

2003 saw a background of several years of negative investment returns, consumer disenchantment with the erosion of their nest eggs, industry practices under scrutiny and pressure on margins culminated in record low funds inflows.

In that environment the desire by fund managers to reverse the trend and try to achieve ambitious growth targets by providing funds for acquisition purposes to their advisers. However this strategy was largely unsuccessful as vendors looked to "value propositions above cheque book".

In a "Sellers Market", which exists today, sellers have the luxury of picking and choosing who they sell to. This is likely to be individuals like themselves – advisers with demonstrable experience and success who share a common value system. Vendors seek confidence that their clients and staff will be well cared for. They want to know with some certainty that their business is in good hands and will grow going forward.

Currently, fund manager/dealer groups supported by institutions, are still undertaking to assist their financial planning businesses grow by promoting ready access to finance to acquire other financial planning businesses. But they have now learnt to be more selective in who they provide this assistance to. In 2003 there was than absence of organic growth, and whilst this has reversed in 2004, growth by acquisition is still the fastest growth strategy.

Some transactions were disastrous (these were often intra dealer transactions), whereby two good businesses brought together ultimately disappointed and suffered significant value loss.

[9] Contact details for all contributors can be found in the Acknowledgments section at the end of this paper

The key learnings were that only businesses that had sufficient systems to achieve scale efficiencies, staff, support and skills should be encouraged to enter into acquisitions.

Our experience shows that at the present time (September 2004) there are still many more buyers than sellers. However over the past 24 months, many negotiations having stalled and failed and many acquisitions have not delivered the expected outcomes.

To change the trend we firmly believe industry discussions need to be elevated above price, best practice and internal industry issues.

Critical success or failure revolves around the human elements; people, business culture, egos, background and experience. The impact of these issues tend to be overlooked and can only be appreciated when examining why deals have fallen over.

Financing is generally available at two times the recurring revenue of the existing practice, plus two times the recurring revenue of the practice to be purchased. To acquire an average sized practice, financial planners could be committing to debt of between $700,000 to $1.5M.

Many businesses are small principal driven financial planning practices. Yet, many of these principals have limited skills or experience in managing or negotiating the sale or purchase of a business. There is little understanding of the preparation required, the journey ahead or how to negotiate and manage the integration successfully.

Why Do Deals Fail?

Ego: It needs to be remembered that both parties have something to sell. It is often a mistaken belief that the buyer holds the leverage - the chequebook YES, the business NO. If mutual respect is not evident the deal will falter.

Cultural Misalignment: A recent and high profile example was witnessed within Stockford, where a corporate model was enforced on entrepreneurial business builders. For a transaction to occur, the Buyer must exhibit a “value proposition above cheque book” to entice a Seller. The point of differentiation will be the relationship, the trust and confidence the Seller has that the Buyer will protect the business and all its stakeholders.

Unrealistic $ Expectations: Many business owners are of the mistaken belief that the Buyer of Last Resort (BOLR) agreement provides a floor to their business valuation. The reality is that BOLR is now a very attractive ceiling. However many Dealer Groups reserve the right to buy but are not compelled to do so. Many contracts are highly conditional and thus can be voided.

The growing trend is to value businesses on EBIT multiples (the average is 4 times), this disparity between BOLR and 4 times EBIT, is deferring many exit strategies.

Other methods of valuations include Capitalisation or other maintainable earnings. Buyers can often be working under the misconception that there is a perfect business out there just waiting for them. The “perfect business” is one of low risk, high returns, is easy to operate, has few if any problems, offers great products and services and is in high demand at all times. Guess what? It doesn’t exist, and if it did, most couldn’t afford it. <u>The reality is to try to buy a good business, and make it great.</u>

Lack of Preparation: Many buyers and sellers under estimate the amount of work and preparation required to complete a transaction. Due diligence, strategic planning and risk sensitivities must be conducted and insufficient consideration is given to what the "big picture" objective is. Many are of the mistaken belief that changes will only be within the acquired business, and not within their own.

Lack of Objectivity: Being objective is difficult when your business is being critically analysed or is valued less than you deem worthy. Often during negotiations there will be different points of view and overly emotive or inflexible positions guarantee failure.

Owner Negotiation: Most business owners will only sell their business once. No matter how effective a communicator one may be, the right counsel and representation will maximise outcomes. The invaluable role of a Business Adviser is to deliver any bad news and endeavour to preserve the Buyer and Seller relationship, someone to provide reality checks, and strategic input, often to both parties.

Intimidation: Many transactions do not proceed because the selling party is intimidated. As a business owner, to be dealing with an M&A team whose whole objective is to reduce the purchase price can be daunting. Dealing with many individuals on separate issues such as legal, compliance, IT, due diligence, financials and negotiations is overwhelming for many.

Timeframes: Anecdotally, there have been many cases of transactions taking up to 12 months to complete, or even fail to complete after an extended time. Most transactions should be facilitated within 6 to 12 weeks. If like-minded parties desire a fair and equitable outcome, then it should be achieved within a workable timeframe.

Unsure of Journey: Given the lack of experience most parties have in these circumstances, they are unsure of the journey and can often walk away at the first sign of an obstacle. Acceptance that each deal will have a number of issues that cannot be anticipated is realistic. An experienced Business Adviser will be able to prepare the parties as to the likely obstacles and factor these into the timeframes. Every business is different, every deal is different and processes if adhered to allow the journey to follow a predictable path (see Appendix 2 – Process).

Poor Communication: The degree of success or failure will eventually come down to effective communication. Communication strategies for all stakeholders delivered at the "right" time will assist in staying on track. Strict adherence to confidentiality must be observed.

Professional Help: Legal assistance is essential at the right time, however being aware that lawyers can become "deal breakers" not "deal makers" is very important. Lawyers should be briefed to draw up agreements, which accurately reflect what the parties have agreed. Business Advisers should ensure that the right parties are at the table, that there is cultural alignment and the appropriate preparation has been undertaken. They should be effective negotiators and communicators and an ally to consult and strategise with. This will provide the best environment to successfully complete a transaction within a reasonable timeframe.

The following two case studies give a brief insight into why these recent deals failed to consummate.

CASE STUDY 1

Owner Aged	54
Staff	5
F.U.M	$140m
Platform	$110m
Recurring Revenue	$915k
Gross Revenue	$1.3m
EBIT*	$260k
Client Service Offer	7/10

* Earnings Before Interest and Tax. Consists of revenue less direct expenses (essentially the cost of obtaining that revenue). Excludes the effect of borrowings, tax benefits and adjustments.

<u>Objective</u>

- To Sell the Business and Continue Working for 3 – 5 years.

Asking Terms

- A multiple of recurring revenue of 3.5 times = an asking price of $3.202m. 70% up front, balance in 12 months.
- Continue to work in business, salary of $150k pa plus bonuses
- Plus 25% of any increased recurring revenue over the base recurring revenue.
- Sell the company including clients.

<u>Best Offer</u>

- A multiple of recurring revenue of 2.85 times = an offer price of $2.607m
- A payment of 60% up-front, balance 12 months adjusted by client retention and a 10% rise and fall adjustment
- Principal to work for 6 months on client transition included in price.
- Extensive warranties required re: tax effective investments sold
- Non compete
- Purchase assets, not company

<u>Why It Did Not Proceed</u>

- Price Difference of over $60,000 plus the other terms
- Owner undertook his own negotiations and was distracted, a lack of productivity created anxiety and the deal didn't proceed.
- Realistic expectations and sensible negotiations could have seen a "win win" outcome.

CASE STUDY 2

Two equal partners, one aged 43 (technical) and the other 56 (sales/market).

Staff	4
F.U.M	$140m
Platform	$70m
Recurring Revenue	$735k
Gross Revenue	$850k
EBIT	$124k
Service Offer	5/10

<u>Objectives</u>

- 56 yr old partner wanted to sell his 50% share
- 25% to be sold to existing partner and 25% to a new partner
- Exiting partner wanted to stay on for 12 months (paid)
- New partner needed to bring clients and attract new business
- Valuation 3 times gross revenue averaged over past year present year and future year (3 yrs). Their valuation $2.430M
- 75% of price to be paid up-front by new partner, balance over 12 months
- Existing partner to purchase 25% on 3 yr terms

<u>Why It Did Not Proceed</u>

- Partner selling generated most new business
- Price comprised a gross future earnings component with no guarantees.
- Valuation methodology flawed.
- No one wanted a 25% share without an option to increase their equity over time.
- Remaining partner and major shareholder would service most of the clients
- Service offer not robust, not equitable, no control or influence for the minor partner.

Understanding that most financial planning practices are small/family businesses assists to gain an insight as to the psyche of the owners.

Most of these principal financial planners are excellent at what they do, they love their work and their clients trust and respect them. Many don't have the acumen, or the desire to acquire the business or management skills necessary to build, grow or run a bigger business. Many will reject a business plan that might suggest they recruit a highly paid business manager. Their role would be to grow, develop and run the business, allowing the principal to keep doing what he/she does best – financial planning.

Today there are few financial planning firms that are officially and publicly 'for sale'. There are however, many principals/partners in financial planning firms who are in a serious state of flux. Not only are they wrestling with the day to day business issues, they are trying to decide what the future holds and what strategies should be implemented. Not surprisingly, less than 5% of all financial planning practices have active succession plans – a disaster in the making.

These owner practitioners desperately need high quality strategic assistance to work through their issues, exploring all possible options and developing and deciding the way forward. We contend the availability and quality of this high level strategic assistance, with all due respect to our industry colleagues, is less than optimal.

KEY SUCCESS FACTORS

In preparing to buy or sell a business the key success factors as we see then are as follows:

Develop a strategy: Whether buying or selling one must develop a game plan; determine what they want, when they want it, and for how much. They must consider how they are going to go to market, what assistance is required and what is their strategic position.

Preparation: There is a significant amount of work required for a Seller and the creation of a "virtual data room" is necessary containing:

3 years financials, client segmentation, client service matrix, organisational charts with job descriptions and C.V's, full client list to facilitate compliance client file selection. Past and current compliance reports, complaints register, F.U.M analysis, business plans, office manual, licence/s and lease details.

A software summary, marketing material, lists of referral sources and a new business activity summary.

The Buyer needs to have explored, if not sourced, finance and considered the ramifications of an acquisition. Assembling compliance, accounting and negotiation personnel and clearly being able to articulate the "value proposition above cheque book" is essential.

Realistic Expectations: The Seller needs to have sought an independent valuation of the business. This should provide a range of prices, employing several methodologies to establish a realistic range.

As well as the Seller, the Buyer also needs to have seriously considered the duration of transition period post sale and whether he or she will stay on 3 months, 1 year or seek ongoing part time employment. Understanding that there will be obstacles and disappointments, one must be committed to moving positively ahead, staying focused on the "big picture".

Business as usual: Both parties need support to ensure business continuity. Personal discipline is required to ensure that the focus is not diverted too much from normal business operations.

Too many sellers "emotionally retire" at the signing of contracts when significant outstanding payments are determined by performance after 12 months. The Seller may work as an employee, yet is still required to inspire staff and clients as to the businesses future.
The Seller must be an advocate of the Buyer and vice versa. This underpins the need to establish, from the earliest possible point, cultural alignment and mutual respect.

Communication strategies need to be developed for both pre and post transaction by both parties.

Effective and timely staff communication is vital and requires "emotional intelligence". There will be change; thus there will be fear and uncertainty. Leadership and the ability to articulate a clear vision for the future is essential from the Buyer and Seller.

Flexibility: For any deal to be successful flexibility is required. Often a Buyer can feel they paid more than they should, the Seller may feel he/she has sold for less than true value. Price is but one factor, flexibility on a wider range of issues such as timing, transition, continuity of staff and ongoing roles all contribute to a satisfying deal.

Risk analysis: Confidentiality Agreements need to be signed at the earliest possible stage. Due diligence across financial, commercial and legal issues should be carried out early in proceedings.

It is the future entitlement to the ongoing revenue of the business that is usually being bought or sold, thus there must be a high degree of integrity and confidence attached to the financials.

Any risk to the continuity of income will be assessed.

A significant risk is "business interruption". If a Buyer proposes to integrate the acquired business within their own, the following issues will need to be considered:

Data migration financial and client, technology selection and best practice implementation. Staff selection to ensure there is no knowledge or skill gap. A new business plan including marketing and cash flow management must be developed to further reduce risks.

Negotiable/ Non Negotiable items: To avoid deals falling over because the "Goal Posts " are moved during negotiations, work with your Business Adviser in an open and frank manner to establish what the bottom line really is.

Deal breakers can be around issues such as personnel, timing, future roles and price. To avoid conflict, create an inventory of Non Negotiable items. This will ensure you would not enter negotiations with the wrong party.

Timeframes: A purchase or sale should be managed like any other important project. Timeframes should be created and monitored. All parties should agree to the timeframes and commit to them to ensure the process gets to a "Go" or "No Go" expeditiously.

The more protracted the negotiations, the less likely a transaction will be satisfactorily concluded. We contend for the average business, a duration of 6 to 12 weeks from search to completion is very realistic.

Legal Advice at the Conclusion: Legal advice is essential, however we strongly recommend this should not be sought until negotiations have been largely concluded - lawyers can become "deal breakers" instead of "deal makers".

Lawyers are there to draft documents that reflect what has been agreed, ensuring their legitimacy and strength if ever tested.

Allowing the lawyers to influence the intent or "the spirit" of an agreement will significantly increase the chance of failure.

Future Vision: Most sellers will experience "seller remorse" given the significant changes envisaged.

This can be a subconscious hurdle to overcome, which is understandable given the business is about to be handed over (to a virtual stranger) usually after many years of sole control.

"Seller remorse" can be overcome when there is confidence in the purchaser and in the seller's own future. If the Seller is to retire, significant lifestyle planning needs to have been undertaken. The seller needs to be aware of issues such as their own ego and personal worth, which are often attached to employment status.

The seller must be able to positively look to the future of the business without them at the helm and to the next phase of their personal life journey. The buyer must plan for the future and must accept the fact that this will be one of the greatest challenges of their career.

Project Management: Being faced with anxieties of how much needs to be done, can be intimidating, however this can be offset by a project management approach.

Whilst it is important to have and maintain the "big picture" it is equally important to break the project down to digestible pieces. Effective communication and time management is essential, as well as having the appropriate resources.

Seek Professional Advice: Use of an experienced Business Adviser will enable a transaction to be negotiated smoothly. A Business Adviser should have extensive networks and specialise in their field. Their skills should enable outcomes to be successfully negotiated in order to protect the interests of all stakeholders.

The adviser must be able to work in harmony with staff, dealer group, due diligence teams and other professional advisers. The contracting of a Business Adviser should substantially increase the likelihood of success within workable timeframes. They need to have the required experience and reputation, and be able to demonstrate they act only for one party in the transaction. Thus avoiding any potential conflict of interest.

Fees, references, processes employed and timeframes should also be discussed prior to an appointment.

The following case studies demonstrate two successful outcomes primarily due to planning, preparation and effective communication.

CASE STUDY 3

	SELLER	BUYER
F.U.M	$50m	$45m
Platform	ASGARD	MLC
License	Own	Own
Recurring Revenue	$415,000	$400,000
Age of Business	15 yrs	12 yrs
Staff	4	4
Key Issues	▪ Early Retirement ▪ Health ▪ Daughter's future as a Financial Planner ▪ Client Welfare	▪ Growth ▪ Funding ▪ Synergy

<u>Outcomes</u>

- 6 weeks from start to finish
- Purchase Price 2.65 times recurring revenue = purchase price of $1.1M. EBIT times 4.25.
- 40% Up-front, balance (60%) 12-months, subject to revenue retention including a 5% rise and fall adjustment.
- Daughter - offered long term employment contract and mentored
- All Staff : Retained for 3-months and one is now general manager for whole business
- Client Transition: No fall off, Cross selling occurring and Increased Revenue

CASE STUDY 4

Financial Planner	Aged 30
F.U.M	$25m
Recurring Revenue	$200k
Clients	135

<u>Objective</u>
To buy a business with $30M of FUM.

<u>Funds Available</u>

2 times current Recurring Revenue	= $400k
2 times Recurring Revenue of new business	
Say $30m @ .5 = $150k recurring revenue x 2	= $300k
Total Loan Available	**$700K**
Interest Payment @ 9% = $63k pa.	

<u>Unable to Proceed</u>
Didn't Have

- 5 years in industry
- 3 years acceptable financials
- EBIT to gross income > 20% last 3yrs
- Gearing < 70% business and personal

<u>Solution</u>

- Negotiated an **Active Succession**
- Clients business, FUM and Recurring Revenue equated to equity of 20% of a larger business
- The parties agreed to acquire 20% pa. over further 4 years
- Client was mentored, gained experience
- Worked in and understand the business
- Funding was a combination of debt, performance bonuses and personal contribution – much easier to manage.

Simple Tips on Buying or Selling

- Commit sufficient time to explore an acquisition or realisation until it's a go or no go (Most transactions should take no longer than 6 – 12 weeks)
- Get professional help early, develop a strategy and accept advice
- Remember both buyer and seller are selling something
- Establish what is and isn't negotiable
- Be flexible – there are many ways to achieve a successful outcome for both parties
- Communicate with all stakeholders effectively and in a timely manner
- In most deals, price is not THE most important issue
- Leave the lawyers until the deal is agreed
- Plan to make a good business great
- Assess the past, evaluate the present but plan the future

The Future
Over the next two to three years, we will see most of the action at the smaller end of the market, given the appetite of the institutions would appear to be sated.

At this stage there appears little interest from international players in acquiring large distribution networks in Australia. Therefore, the supply and demand pendulum may well stay in excess demand for the next few years.

We could see prices for financial planning businesses move down from 2.5 - 3.5 times recurring revenue to around 1.8 – 2.5 times recurring revenue. More buyers will want to negotiate on profit multiples such as EBIT, probably in the vicinity of 3 to 5 times or NPAT (Net Profit After Tax) 5 to 6 times.

The US example, if we were to follow it, is 1.3 times recurring or 1.6 times recurring professional fees paid over a four year period on average. The gap between the US and Australian valuations is significant and unlikely to overlap or replicate. However it does beg the question as to which is closer to true value?

With the large write-downs in the wealth management arena also comes a reluctance for additional investment in institutional supported dealer groups. This will further disillusion experienced advisers who have substantial and sustainable FUM. The challenge for dealer groups, as always, will be to show clear value propositions. Failure to deliver on BOLR expectations has increased tensions within the various groups.

The movement towards the creation of boutiques will be accelerated, but lessons need to be learnt here too. Groups who previously splintered from large dealerships are now facing issues around growth, scale and liquidity. Whilst the ideology of independence is compelling, the reality is how do you facilitate succession? What price is another like minded individual - not institution/or institution supported individual - prepared to pay?

Innovative solutions, other than listing, need to be explored and it is our contention that we will see 'Independent Boutiques' form alliances with institutions to try and address the issues of firstly liquidity, then scale and growth.

The merging of smaller financial planning firms, whilst more difficult to negotiate, will develop at an increasing rate. This will mean huge opportunities for those planners who have vision, can put their egos to one side and understand that if sensibly constructed, huge benefits can be gained by all parties, such as economies of scale, maintenance of independence, autonomy and synergetic growth.

"Active succession" and "value proposition above cheque book" will become the buzzwords given the age of most principles and the talent pool coming through the universities. The ability to pay is only one consideration and client and staff welfare is paramount. Interest rates will rise, organic growth will continue with market performance and the number of buyers will likely reduce.

FSRA is having immediate and lasting impacts. Planners and especially Boutiques may become disillusioned with stringent processes, legislative requirements and the increased compliance cost, this may accelerate some exit strategies.

We see emerging market opportunities for arbitrage, and cross selling opportunities within accounting practices, which are very differently priced. What will bring businesses together however will be ideology and geography.

The Supply and Demand Equilibrium - In Summary

Supply Shift

- Age demographics
- Creation of boutiques, pods/cells
- No succession – must go to market
- FSRA too much – accreditation too difficult

Demand Shift

- Fund Manager – sated/write-downs
- No apparent international distribution demand
- Activity of Aggregators ceased
- New planners – well qualified – poorly financed – cannot buy 100% in 12 months
- Buyers focus on EBIT

Outcomes

- Prices may decrease
- EBIT x multiple applied
- Solutions re Boutique liquidity/scale
- More strategic alliances
- BOLR disappointments continue
- Innovation – pods/cells/co-op's

The future holds many challenges, however the difficulties being experienced now shape a stronger and more focused industry going forward.

Maximizing Sale of Business Value – a Model

Money Values Pty Ltd[10]

Introduction

The process for buying a financial planning business can be influenced by many factors. A key to a successful sale is that the 'value' of the business is linked to the confidence generated in the mind of the buyer by the nature of the information presented.

Whether you are presenting the initial Information Memorandum or subsequent formal presentation of the business, the time you spend up front documenting, reconciling and presenting the information to facilitate the due diligence process is well worth it.

Many factors will influence a buyer's confidence level including their own personality and business experience, external market conditions, supply and competition for the purchase. The value of your business will become most apparent by ensuring you take the following steps:

- Provide deep data into the core assets of the business, demonstrating key motivators and expectations of the client base and a clear view of how they can be retained;
- Organise information in a format that makes it easy for buyers to identify the components of value that align with the buyer's objectives
- Demonstrate how full business value has been and can be realised
- Deliver data early and prior to negotiation to best represent value

This paper outlines a series of key activities that facilitates a simpler risk analysis and due diligence process for the buyer.

The real key to documenting the client base and scope of the core assets is to include personal dimension data rather than just financial and demographic data. The personal data is difficult to assess, quantify and record without a specific customer relationship management system inherent in solutions such as "Money Values"[11]

Defining the Client Asset Base

Demographics, Financial and Personal

Prior to purchase, buyers are seeking an understanding of the quantum and value of clients by various 'types'. A purchaser of a financial planning business would generally expect to find clients' financial and circumstantial information on record. No doubt every business on offer will have basic client profile information that should be compiled and summarised to describe the nature of the client base.

Information about the make up of the client base will generally be available to the buyer prior to purchase, through anecdotal expressions and samples offered by the seller. Post purchase, additional information will generally be available by reviewing client files, file notes and the assistance of an adviser briefing on each client, commonly requested in the form of a 'one pager'.

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[10] Contact details for all contributors can be found in the Acknowledgments section at the end of this paper

[11] Deriving from the client profiling process, Money Values is a client and practice management system that provides rich client data and segmentation by key (financial related) attitudinal traits along with demographic and financial attributes. For information go to: http://www.moneyvalues.com.au/

There are a number of limitations for both seller and buyer with this form and sequence of disclosure. Due to privacy restrictions, time constraints and the sensitivities in sales negotiations, much of the information that could articulate the nature and make up of the client base will only be available to the buyer after a negotiated sale or at best during due diligence when assessments of value by buyers have already largely been formed.

This means that, in the absence of deeper information into the make up of the client base, the buyer's assessment of the value can only take place in a climate of uncertainty. Uncertainty means risk, and a corresponding discount to business valuation, offers and terms of purchase.

For the seller, the ability to provide segmentation and insight into the make up of the various client types demonstrating the substance of the offer, means increased buyer confidence of retention and a higher value proposition, leading to higher perceived business value.

<u>Measuring the make up</u>
The following three-dimensional model illustrates broadly the information necessary for effectively profiling an individual financial planning client. This information in aggregate represents the defining information of an effective 'client base profile'.

The model has proved an effective tool in organising and presenting substantial amounts of client and practice management information. The benefit of the model format for the buyer is that they quickly identify:

The nature of the client base in terms that are familiar to the planning process;

Where 'preferred' and 'other parts' of the client base value proposition lie;
The completeness or wholeness of the available data set.

Understanding the client means knowing what clients value, how they think, feel, decide and act regarding money and money management including but not limited to, an assessment of a client's inclination (or aversion) to financial risk. These attributes describe the 'personal' dimension of the client base profile.

This area is commonly the most difficult area to articulate and record, but provides the real keys to developing rapport, maintaining continuity and return on investment (ROI) for the buyer.

<u>Continuity and Retention means ROI</u>
Achieving a buyer's expected level of client retention (or better) is critical to realising or enhancing the buyer's expected return on investment.

Buyers are aware that some clients may leave upon the transfer of a planning business if they perceive that the personal understanding, relationship and rapport they have built with their planner has been lost. As a buyer, the ability to minimise this effect and maintain the business value will largely be a function of how quickly they can demonstrate understanding and replace a relationship of trust and rapport. Information that assists in the process of rapport building and relationship development is then valued highly.

Commonly, the seller only finally provides a deeper appreciation of the client base to the buyer at the point of handover and transition. The shortcoming of this approach for the seller is that the exchange takes place at a time when it is likely to provide additional value for the buyer, but little chance to enhance the value for the seller, as purchase price and terms are likely to have been agreed.

The inability to provide the data early in the process means that this information, (which is generally well known to the seller) is unlikely to be utilised in a substantial way to add value for the seller. At best, in the case of deferred payment arrangements based on retention rates, the strategic value of the information is limited to defending rather than enhancing the business value for the seller.

Enhanced value for the seller is in the opportunity to present this valuable information in an appropriate form, at an early enough stage in the business sale to enhance the buyer's confidence in client value, retention and consequently their perception of business value.

Identifying Additional Value

A thorough segmentation of the client asset base provides opportunity to extend the buyer's initial preferences and perception of value. Detailed segmentation reports give the purchaser a valuable understanding of the various dimensions of the clients and how to relate to them 'systematically'. For example:

A buyer, through experience, may initially consider that clients with less than a certain level of funds under management are less attractive or even unprofitable. This may not necessarily be true for the seller and need not be so for the buyer if the seller is able to demonstrate how the clients are related by common factors and therefore able to be efficiently serviced.

Segmenting clients by services provided may demonstrate how business potential has not been fully realised and opportunity exists to target segments for particular services. Segmentation by attitudinal types provides opportunity for costs savings and increased conversion rates for new product offerings and client service packaging.

Managing Relationships

Quickly identifying key client values and expectations may be critical even if retention is not a major problem. A buyer, during transition of client servicing, will generally be at pains to identify key relationships and expectations and demonstrate that the advisory relationship and service levels may be maintained or improved.

Key relationships can include clients, their referral chains and relationships with professional sources such as accountants or lawyers (whether referred or not). Appropriate definition of client relationships will provide the tools for the buyer and seller to plan a transition and succession plan in clusters of like clients with common expectations and values, leading to efficiencies for both buyer and seller during handover.

Systemising the process

Stemming from the initial data collection stage of the client relationship and updated for review processes (which all financial planning practices must undertake in some form), Money Values (www.moneyvalues.com.au) provides a system for documenting and aggregating the key descriptors of the seller's client asset base. It provides the information otherwise notoriously difficult to collate and present. Information which generally, resides 'in the head' of the vendor, key client support staff or exists in the form of prosaic margin and file notes.

Providing a client base segmentation with the ability to drill down as far as individual client records means that ‘managing client expectations’ moves from a ‘catch cry’ to a ‘business process’.

Defining the Business Model

Resources, Results and Style

Interested buyers quickly broaden their enquiries from simple bottom line descriptors to a broader characterisation of the business. This means that they form for themselves a model of the factors that influence business outcomes and results. In summary they will seek to assess:

- the business ‘circumstances’ in the form of history and life cycle, positioning of the business, maturity and resources employed;
- management and attitudinal style, motivations and values of the business including motivation to sell;
- the apparent effectiveness of the business in extracting value from its resources to date and the prospects for increased effectiveness and return.

Naturally, some level of business reporting and information should be compiled and summarised to describe the key characteristics and circumstances of the business. How well that information is prepared, presented and accessible to address enquiries is a matter of choice.

Packaging the package

Buyers will be seeking to determine how effectively the business results follow from and relate to the ‘client base asset’ that they are seeking to purchase. By presenting the information defining the business as an extension of the three dimensional model used to define the ‘client asset base’ the model supports transparency and provides a short route to identifying the value in the business offered for sale.

Dimension	To include:	Measures
Circumstantial	Location and history of the business, affiliations, structure, licensees, employees, advisers/ support staff ratios, age, longevity of employment, education level of principal and advisory staff, relevant computer hardware and software systems, etc	Referral rates Client conversion ratios Client retention/ longevity
Financial	Assets Under Management by type, by platform, retail vs. wholesale Average Servicing revenue yield History and consistency of revenue (growth or shrinking) and prospects Profitability, etc	Type and source of revenue Yield per client Servicing costs per client Client conversion ratios
Attitudinal	Business style/philosophy Values and motivations Attitudes to Industry issues Fee for service vs. brokerage Personal priorities, etc	Client satisfaction Staff morale

The information and priority given to each element will vary according to strengths, weaknesses and priorities of various business offerings, however, care should be taken with assumptions about what is too much or too tedious to prepare or include in an Information

Memorandum (IM). Buyers themselves come in many forms and personality types and no doubt have differing priorities and values for information.

Incomplete preparation or unreconciled data predisposes a seller to “knee-jerk” reactions to requests for information, demands or perceived concerns of the buyer undertaking due diligence and prevents the seller from being entrepreneurial or opportunity seeking in presenting the value on the business.

Defining Key Business Processes

<u>Client and Business Interactions</u>
A business is more than a collection of assets. To varying degrees a business is a collection of processes and systems for creating revenues, profits and other business objectives. The extent to which business processes need to be addressed in an offer to sell will depend largely on what is for sale.

Whilst a company’s physical and financial assets may be relevant in some business transfer arrangements, generally, where the ‘book of business’ or ‘client asset base’ is for sale, then critical processes are those defining the interactions between the client and business and the formulation and delivery of services. Since, in the event of a sale taking place, clients’ expectations are likely to be transferred to the buyer, a critical need of the buyer is an assessment of the clients’ experience of the business.

In an attempt to develop an impression of the ‘client experience’ a buyer is likely to enquire about the nature of various business systems and methods which, in essence, define the ways the business and clients interact. At the minimum the buyer will be seeking to develop a view of past and present processes to determine:

- What business processes have been applied and how do they rate against benchmarks?
- What systems have been implemented? Are they reproducible or replaceable?
- Are the processes and systems dependent on an individual person, item or system?

Important processes include marketing, client sourcing, construction of advice, software, research, client servicing models and contracts, relevant personnel management and processes that articulate the character and unique value proposition of the business. These might be described simply by reference to recognised business tools and software systems, philosophical styles, defined standards or providing samples of documented company procedures addressing:

- Initial Client Process & Service Offering
- Business Approach to:
    - Strategic Advice
    - Portfolio Construction & Investment
    - Insurances
    - Taxation & Accounting
    - Finance & Other Services
    - Legal & Estate Planning
    - Ongoing Client Servicing Process & Contract
    - Compliance
    - Research and Education
    - Record keeping and accounting

The effectiveness of a sellers' demonstration of business processes will significantly impact on a buyer's confidence as the buyer seeks surety on various matters including whether:

- Client relationships are stable, improving or diminishing, can be maintained or improved, are dependent on the seller in person, other key personnel or on the use of particular or proprietary systems;
  - Service levels have been satisfactory, may be maintained or represent opportunities for improvement with the application of the buyers systems;
  - Compliance standards have been maintained appropriately or whether problems are lurking in client files.

Adoption or Replacement
In some cases buyers may be on the lookout for ideas and improvements to their own systems or to inherit whole business systems as part of the asset purchase. Other buyers will clearly intend to add value to the purchase with the application of their own business systems.

For the buyer intent on purchasing and adopting existing business systems, documentation provides tangibility of process, confidence and hence business value.

Alternatively, for buyers seeking to add value with the implementation of alternative systems, documenting and presenting existing systems effectively demonstrates where and how the buyer is able to add value, providing surety and confidence in extracting value from the purchase.

Either way, preparation and documentation of systems builds buyer confidence and provides the seller the opportunity to be entrepreneurial and value adding when presenting the value of the business offer.

Clearly, other factors will influence a buyers 'confidence' level such as the buyer's own personality and business experience, external market conditions, supply and competition for the purchase. This paper has concentrated on the best presentation of the value inherent in the business.

Even in a practice with extensive record keeping, information and practice management systems it is the author's own experience that the compilation and reconciliation of the information represents a substantial managerial effort. The process is well worth it in terms of clarity, surety of the business value on offer, surety of process and time savings during due diligence with multiple potential buyers seeking reconciliations at different times over differing periods.

The question arises about whether the greater value is realised by treating the preparation for sale of business as a project prior to sale or transition, or implementing the processes early in the life and development of a practice with a view to adding value. It's never too early to start creating value in your business.

How to Secede in Business - Business Succession Planning Strategies for GI Brokers

Richard Rasker

There are two important sides to Succession Planning:

1. Planning for the managed exit of a principal, at some point in the future, with the goal of the plan being to ensure the receipt of maximum value.

2. Planning for the unplanned exit of a principal (e.g. death), with the goal of the plan being to minimise the negative impact of this exit on the business and the family / estate.

This article will focus on planning for a managed exit and outline some important business and operational strategies, which will assist you to maximise the value of your business.

There are three key issues to consider in planning for a successful business succession:

Who will buy the business? (Or from another angle - How will you sell it?)

There are really only four options for appropriately exiting the business:

- Sell or pass on to your children or other family members
- Partial or total management buy out (as above, but to non family heir apparent)
- Sell to an independent company
- Capital raising - float or join a consolidator

In developing your business succession strategy, you need to consider the four options and set a path as to your preferred course of exit. A number of issues should be evaluated:

- Are the next generation capable or interested?
- How would the next generation or internal management fund the purchase?
- How quickly do you wish to exit and do you want a clean 100% exit or would you prefer a transitional exit, perhaps exiting the day to day management but remaining on a Board of Directors. This will also help you determine the extent you may wish to "vendor finance" the incoming ownership team.
- Is your business strategically attractive to another business or to a consolidator? If so, who?
- Is your business large enough to float and will it be attractive to arms length investors?

Once these and other related issues are resolved, you can begin establishing an action plan for targeting potential new owners (either internal or external), together with plans for your preferred exit methodology and timing. Once this strategic direction is established, you can then consider the valuation issues, such as how to actually value the business and the implementation of strategies to maximise the value, enabling you to establish and ultimately achieve goals for funding the next phase of your life.

How do you value the business?

Most independent valuations of businesses will use the term "fair market value", being "the price that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller, acting at arms length".

In terms of valuing financial services businesses, while many still talk about "multiple of recurrent revenue", especially in relation to communicating Buyer of Last Resort offerings, this remains a crude valuation method, not reflective of the recurring costs required to generate the revenue. Of more importance is "maintainable future profits" and any business valuation should include consideration of common valuation methodologies such as "multiple of after tax profits" or "discounted cash flow". In other words, while recurrent revenue (your ongoing fees and commissions) is important, of greater importance is your profitability or business "earnings" (i.e. what is left of your overall revenue once you have paid for all salaries and business expenses).

While the past is a good indication of the future, a buyer is purchasing future earnings / cash flow, not past revenue and as such their valuation will be calculated based on the cash flow they expect to be generated in the future.

A good way to approach the valuation of your business is to create a range of valuations based on the commonly used valuation methodologies (e.g. multiple of recurrent revenue, multiple of after tax profits and discounted cash flow). Once this range is determined, you should then assess the business on its performance in a number of key qualitative and quantitative attributes / indicators, such as:

- Financial results against industry benchmarks
- Reliance on key customers
- Reliance of the business on the principal – extent of systemisation
- Quality of customer records / information
- Brand image – strong, positive, consistent

Where the business performs well in these indicators, valuations at the higher end of the range will be appropriate, however where the business does not perform so well, a valuation at the lower end of the range is more likely.

As an example, let's say a business is valued as follows using the three common valuation methodologies

- Multiple of Recurrent Revenue - $900,000
- Multiple of After Tax Profits - $ 800,000
- Discounted Cash Flow - $700,000

The range of values is between $700,000 and $900,000. Looking at the attributes / indicators, if the business performs well, it may be valued above $800,000 and approaching $900,000. If it does not perform so well, a valuation below $800,000 and perhaps as low as $700,000 is more appropriate. Logic, reasoned consideration and commercial reality should always support any valuation – in other words, there should always be a fundamental basis of why there is a certain value.

How do you maximise the value of your business?

There are a number of logical performance indicators / evaluation criteria that a buyer will use to develop a view on the value of your business, as discussed above. Given this and that most initial valuation estimates will be based around business profitability, it makes sense that you should implement business planning strategies to maximise profitability and your performance on the qualitative and quantitative attributes listed.

Whether you wish to sell your business this year, next year or in ten years, you should be planning to maximise profits and your performance on the valuation attributes as a matter of course – in other words, planning and driving your business today with the end in mind. Some planning strategies you could consider include:

- Financial results against industry benchmarks
- Focus on cash flow – “cash is king!” Most valuation calculations will include a calculation of “maintainable future profits”. So you may need to implement strategies that increase profitability such as reducing overhead expenses, ensuring your staffing structure and allocation of responsibilities is appropriate and building revenue through referrals, thus ensuring you are attracting profitable clients for your business.
- Demonstrate that your business is performing at a higher level than others in the industry by participating in industry benchmarking programs and then implementing strategies that improve your performance relative to the industry average. Important benchmarks include:
- Revenue per staff member
- Profitability per principal
- Overheads as a % of revenue
- Salary costs as a % of revenue

<u>Reliance on key customers</u>

- Is your revenue diversified and spread evenly over your customer base or is your business reliant on a limited number of customers? (e.g. 5-10 customers representing 30-50% of your business). Do most of your key customers come from one or two centres of influence?

- The more reliant your business on key accounts or a few centres of influence, the riskier it is for a purchaser, and therefore the less they will be prepared to pay. It may be important therefore for you to implement strategies to expand and diversify your customer base. Make sure you define your “ideal” client and, through a pro-active referral program or through the targeting of industry associations, which your “ideal” client may be a member of, seek to add new, large and most importantly profitable customers to your existing base.

<u>Reliance of the business on the principal – extent of systemisation</u>

- Are the needs of your customers met by a business following solid systems and processes or is the servicing of customers reliant on the principal? Do you have good and well-maintained operations manuals?

- The more reliant your business is on you to get things done, the riskier it is for a purchaser (will the business thrive without you?) and therefore the less they will be prepared to pay – so implement processes and systems that do not rely on you. For example, do you deal with all new customer inquiries or does your business have a process to screen and set up a new customer?

Quality of customer records / information

- Are your customer files and records well maintained, complete and compliant? Can the purchaser be confident that historical customer revenue information is accurate?

- Implement strategies to ensure the quality of your customer information is of a high order, to enable purchasers to effectively analyse what they are buying and evaluate opportunities for target marketing and growth into the future. Good customer records should also enable you to improve the ongoing profitability and performance of your business anyway.

Brand image – strong, positive, consistent

- What does your office look like when someone walks in? Does it look professional, organised and efficient? What would you pay more for – a business that looks like a disorganised mess or a well-run organisation?
- How do your marketing material and other branded items look? Do they look tired, old and all over the place or do they reflect a strong, positive and consistent brand, sending a message of an organisation with a good reputation? Implement strategies to develop and enhance a positive and consistent image. For example, make sure your office looks neat, tidy and professional and that the visible logo and other branded elements are consistent with the logo and other branded elements provided to customers on letters, reports and other marketing material. Get some professional advice to ensure your "look" sends the strong, positive message you wish to convey about your business.

Whether you are planning to sell now or in ten years, the important thing is to start planning today to maximise the value of one of your most important assets – your business. To succeed in Succession Planning you will need to consider numerous issues as outlined in this article and seek to ensure your business performs well on the criteria that buyers will use to determine their view of value.

Put simply, you should implement strategies that maximise profits and minimise risk. Higher profit means higher maintainable future earnings, which means a higher valuation calculation. Less risk means reducing the reliance on the principals or a few key accounts by implementing appropriate processes and systems for your business and working to diversify your customer base. Start today and you will "secede" in business!

SECTION 4

Valuation Methodology

It was noted in Section 2 that a number of valuation methodologies are used in transactions involving financial planning practices, and a number of factors can influence a higher value or the prospects of a sale proceeding successfully.

Nonetheless, whether one is a potential buyer or seller, and notwithstanding the factors upon which one subjectively places a greater or lesser value, anyone involved in a business sale transaction needs to understand both the "science" component of valuation methodology, and the climate and practices of the current market.

In this section we offer some more insights into the mechanics of valuing a financial planning practice; when is it appropriate to use a revenue multiple, a historic earnings multiple or discounted (future) cash flow? What value will businesses of different qualities deliver?

The first paper by Stephen Bingham of bingham|martin summarises the methodology and application of traditional valuation techniques, describing why "pure" valuation methods might not be practical for businesses such as planning practices. The paper describes the use and usefulness of a range of alternative valuation methods.

The following paper by Robert Neill & Jeff Long of MGI Meyrick Webster further describes the process and methodology of business valuation, and explains the practical limitations in systems and financial data that businesses frequently face.

The final paper by Wes McMaster describes the use of different valuation methods, and details the characteristics of businesses that will drive differing valuations in today's market.

(Real World) Valuation Techniques for Financial Planning Businesses.

Stephen Bingham[12]

> How can I tell you what is in my heart?
> How can I measure each and every part?
> How can I tell you how much I love you?
> How can I measure just how much I do?
>
> How Deep Is The Ocean (How High Is The Sky).

So wrote the legendary big band musician, Irving Berlin, in 1932.

Measurement and valuation has always been such a vexed and *romantic* topic. In terms of finance theory, we can make a start with an even more venerable Irving, the late economist Irving Fisher. As long ago as 1906 Fisher wrote:

> "Capital, in the sense of capital value, is simply future income discounted or, in other words, capitalised. The value of any property, or rights to wealth, is its value as a source of income and is found by discounting that expected income….
> The present worth of any article is what buyers are willing to give for it and sellers are ready to take for it. In order that each may logically decide what he is willing to give or take, he must have (1) some idea of the value of future benefits…(2) some idea of the rate of interest by which these future values may be translated into present values by discounting."
>
> Irving Fisher, The Theory of Interest, 1906

These concepts have since been universally adopted and refined in finance theory to form the basis of modern security analysis and business valuation.

Today, many erudite texts on business valuation can demonstrate how one business valuation technique – referred to variously as Net Present Value (NPV), discounted cash flow (DCF) or capitalisation of forecast future earnings – is "the purest form of valuation", "superior", "more sophisticated" "more reliable" and "leads to better investment decisions" than other commonly used techniques such as multiples of earnings or revenue.

As we noted in the paper "Drivers of Value", valuation methods on the sale of financial planning businesses often appear quite unsophisticated, while nonetheless taking account of a wide variety of financial and non-financial information.

If pure DCF methodology is a clearly superior technique, why is it not universally applied? As the 'bad' sergeant said in the movie 'Platoon':

> "There's the way things oughta be, and there's the way things are."

In practice, DCF and related processes suffer from a number of significant limitations, calculation difficulties and issues as to real world validity. These issues are greatest when dealing with valuations of small, private businesses such as the majority of financial planning practices.

This paper will explain why pure DCF analysis might not be a practical valuation methodology, and will describe some alternative techniques that, used individually or in combination, may prove more useful in estimating the realisable value of a planning practice.

Different Concepts of Value

When reviewing various valuation techniques it is worth bearing in mind that different concepts of 'value' are employed in finance literature. The validity of each concept will depend on the context of its use.

1. Intrinsic Value

Intrinsic value, closest to the concept of fair or true value, is defined as the value that would be placed on an investment opportunity if full information regarding the investment's prospects for future cash flows and discount rate were available to all potential buyers and sellers. This definition does not suppose a supernatural knowledge of the future, which is always uncertain, only that all relevant, available facts are known.

Intrinsic value is sometimes referred to as underlying equilibrium value. Because buyers and sellers do not have perfect information, market prices (discussed below) can differ from intrinsic values. As more/ better information becomes available, market prices trend towards the notional 'true' value. With sufficient information market prices will closely match intrinsic values and can be said to be in "equilibrium".

2. Personal Value

In the purchase of businesses, as with other financial assets, each potential buyer attempts to estimate future cash flows and risks. Although each are endeavouring to objectively estimate these factors it is not surprising that in the face of uncertainty these estimates can vary considerably from one buyer to another.

Moreover, because small businesses such as financial planning practices are often owner-managed, estimates of their value are also subject to some more subjective personal considerations such as the "value" of being self-employed or of building a family asset.

Thus both objectively and subjectively differing assessments can lead to differing valuations between potential buyers.

3. Asset based Valuation

An asset based valuation approach presumes that a "base-line" value of a business can be derived by examining the value of the assets that it holds, estimated either by:

- (modified) book value,
- replacement value or
- liquidation value

Asset based approaches do not recognise "goodwill" and do not attempt to value the business as a "going concern". As such, these approaches are generally considered inferior to other valuation methods. This is particularly true for the valuation of financial planning practices, for which virtually all of the value is intangible goodwill; some in contractual rights, most in relationships.

We advise clients selling their planning practices to treat asset values as entirely distinct from, and additional to, the core value of the business to which they are attached.

4. Market Value

4.1 Market Price

With publicly traded financial assets such as shares and bonds there is a transparent market price available to all buyers and sellers. The market price represents the consensus value of all buyers and sellers at any point in time.

The Nobel Laureate Paul Samuelson showed that "efficient" markets assemble and evaluate information so effectively that the price of a stock is usually the best estimate of its intrinsic value. (Proof That Properly Anticipated Prices Fluctuate Randomly, Industrial Management Review, Spring 1965) (See also Eugene F. Fama, "Random Walks in Stock Market Prices," Financial Analysts Journal, September/October 1965 (reprinted January-February 1995)).

However, the "market" for sale of businesses does not meet the definition of an "efficient" market. Each business has unique characteristics, so that past sales can only offer indirect inferences of the value of other businesses. In each business sale, perfect information of all relevant facts is available to neither buyer nor seller. In these circumstances, when one speaks of the "market value" of a type of business, one is actually referring to the estimates that can be inferred from "market comparables".

4.2 Market Comparables

For both buyers and sellers valuable information about the achievable value of a business can be gleaned from the observed market value of comparable businesses. This comment sounds almost trite, but it assumes a considerable amount. "Observed" values are different from rumoured values. The planning industry is rife with rumours (that generally cannot be authenticated) of stratospheric values paid for some practices.

"Comparable" businesses are those that can be meaningfully compared not only on financial metrics, but also on a range of other factors such as described in the companion paper: "Drivers of Value". Comparison of "earnings" means more than top line revenues or commission fees, but also costs and free cash flows.

The difficulty of making valid comparisons with other market transactions emphasises the benefit of obtaining objective expert advice before applying apparent "industry norms". In advising on the sale of planning practices we have encountered both practitioners who undervalue and (who'd have guessed?) significantly overvalue their business, generally on the basis of imperfectly understood market comparisons.

Discounted Cash Flow Valuation Revisited

As noted in the introduction, the elements of valuation are well established and straightforward:

- estimate the *timing* and *magnitude* of "future benefits", being future (ungeared, after tax) <u>cash flows</u> plus any residual capital value,
- understand and apply the appropriate <u>discount rate</u>, recognising the rewards for *time* and for *risk*.

As simple as this might sound, "the devil is in the detail". Although it is beyond the scope of this paper to fully describe DCF processes, the essential steps are as follows.

Build a Financial Model

- Forecast not just profits, but "free cash flow" (essentially EBITDA – tax - increases in working capital - investments in fixed assets)

- Beyond the forecast period, estimate "continuing" or "residual" value (including assumptions about growth rates, if earnings based)
- Note that most valuation errors result from mis-estimations (usually exaggerations) of forward cash flows. Issues include:
    - Assumptions as to growth
    - Failure to recognise changes in competition and profit margins over time (as described throughout the HyperValue papers)
    - Failure to adequately account for working capital and investment requirements

Estimate the Discount Rate (Cost of Capital)

- Weighted average cost of capital (**WACC**) includes cost of capital from all sources: debt and equity.
- Note that the cost of equity is an economic concept, not an expense. It is the opportunity cost of invested capital.

$$\text{WACC}=[\text{Cost of Equity}]\left[\frac{\text{equity value}}{\text{firm value}}\right]+[\text{Cost of Debt}]\left[\frac{\text{debt value}}{\text{firm value}}\right][1\text{-tax rate}]$$

- Cost of debt is higher for small businesses
- Estimate the cost of equity
    - There are various methods for estimating cost of equity. ***The Capital Asset Pricing Model (CAPM)*** is the most commonly used, but also suffers practical limitations.

<u>CAPM</u>: $$\begin{matrix}\text{Cost of}\\ \text{equity}\end{matrix} = \begin{matrix}\text{risk - free}\\ \text{rate}\end{matrix} + \begin{pmatrix}\text{company}\\ \text{beta}\end{pmatrix}\begin{pmatrix}\text{market}\\ \text{risk premium}\end{pmatrix}$$

- CAPM in turn requires an assessment of the "<u>beta</u>" of the investment: its expected volatility of relative to the investment market as a whole. Estimates of beta, in turn, will be influenced by assessments of <u>risk</u>:
    - Business (operating) risk
    - Financial (capital structure) risk
    - Interest rate risk

"Crunch" the numbers (net present value [NPV] calculation)

$$\text{NPV} = \text{Present value}\begin{pmatrix}\text{Planning Period}\\ \text{Cash Flows}\end{pmatrix} + \text{Present value}\begin{pmatrix}\text{Residual}\\ \text{Value}\end{pmatrix}$$

$$\text{NPV Planning Period} = \sum_{t=1}^{T}\frac{FCF_t}{(1+k)^t}$$

- Calculate NPV of both the forecast or planning period and the continuing or residual value. There are various techniques and assumptions for estimating continuing or residual value.

- Perform some sensitivity analysis and reality checks.
- To fine-tune the valuation, use option pricing techniques (Black-Scholes or other) to estimate any uncaptured value of options/ opportunities (e.g. to defer or bring forward investment, or to assess other strategic options/ directions for the business).

Use of DCF in the Real World

The above summary only touches on some of the complexities of DCF analysis. There are numerous good texts that detail the issues and methodologies more fully. Plainly, in its application, DCF valuation can be a complex process.

Ask a well-paid colleague who works in investment banking whether his/her firm undertakes this process in valuation or M&A work (*really?).* At, say, 9:00am Monday you'll be told "Sure, all the time!" There are many good examples in prospectuses, Part B Statements and the like.

Asked the same question after three beers on Friday night the same investment banker may tell you how they and their clients are not overly reliant on such methodologies, and how a surprising number of high profile and high value transactions are completed with much less analysis (of intrinsic value) and on the basis of "what the buyer will pay/ seller will take".

Using such a methodology to value a financial planning business is likely to be laborious at best. At worst, given the layers of assumptions that in practice would be required, it can give rise to "spurious accuracy"; the misplaced sense that because the calculation was "scientific" or complex, it must be highly accurate. It can only be an estimate, and the result may be significantly at odds with other estimation techniques and with market comparables.

This is not to suggest that it is not appropriate to employ (at least parts of) DCF methodology. Often the best approach is to "triangulate"; to compare the results of a number of methods, rather than relying on the "best" method to give the "right" result.

In these circumstances it is not surprising that a number of other, simpler tools and rules are employed in the valuation of planning businesses.

Alternatives to DCF Analysis.

<u>Capitalisation of Earnings</u>
Perhaps the most common and reliable alternative to full DCF analysis is capitalisation of earnings. With this technique current, "normalised" earnings are used as a proxy for future earnings, and a capitalisation rate (or earnings multiple) is used in lieu of a discount rate. The capitalisation rate or earnings multiple is usually based on a recognised "rule of thumb" adjusted for the characteristics of the business being valued.

As such, capitalisation of earnings makes some implicit assumptions about future earnings (i.e. that current earnings can serve as a reliable indicator of future earnings) and about business risk (increased risk implies a lower multiple).

There are a number of alternate capitalisation methods.

<u>What is the 'Earnings' to be Capitalised?</u>
Caution needs to be applied when discussing the concept of capitalised earnings. The earnings being capitalised might variously be net income, EBIT, EBTDA or some version of

cash income or cash flow. We have known it to be strenuously and insistently asserted that a business was worth “five times earnings” by someone who was unable to say quite what he meant by “earnings”.

Equally important, where past earnings are being capitalised, is to come to a view of what represents <u>normalised</u> earnings. As past earnings are to be used as a proxy for forecast earnings it is important to adjust for any factors that are not representative of future sustainable earnings. These are likely to be of two types.

Firstly, one should adjust for extraordinary items: items of revenue or expense that are not representative of ongoing business activity and are unlikely to be repeated.

Secondly, it may be necessary to make adjustments to more accurately reflect the management and staffing costs of the business. These may be significantly understated if the vendor/principal has been taking his remuneration only as dividends, or overstated if the principal has been loading his/her superannuation, employing and overpaying spouse and family, and expensing annual conferences in Aspen (as vital as they are). Sometimes the recorded accounts of small businesses are quite … idiosyncratic.

<u>Capitalisation of Revenues</u>
Often the acquisition of a planning practice is essentially the purchase of a “book of business”, whereby it is hoped that the revenues of the acquired business can be merged into an existing business with little or no impact on exiting cost structure.

While this might not be an accurate reflection of the true cost impact of the acquisition (including management time, bringing forward of capacity constraints etc) it is sometimes thought more meaningful to understand and value revenues, rather than the profits of the existing business structure.

<u>Capitalisation of ‘Recurring’ Revenues</u>
The most common “shorthand” valuation method in transactions involving planning businesses is to apply a multiple not to gross revenues, but to “recurring” revenue, i.e., to trailing brokerage or commission and recurrent fees for service.

Excluded are fees such as “upfront” commissions and non-recurrent service fees such as plan preparation fees (and of course inflows from asset sales).

Payback
Payback is simply the period within which an investment cost is recovered from its earnings. Of the various methods commonly used to value, assess and compare investments, ‘payback’ is the most criticised in finance theory. Payback ignores or misrepresents some of the most important components of value. The payback method treats all cash flows within the payback period as of equal value, and ignores cash flows after the payback period. It also takes no account of comparative risk of investments.

Despite these limitations, payback period is often referred to, and used as a benchmark comparison in the purchase of financial planning businesses. When considering the circumstances in which these businesses are bought, this is perhaps not surprising. The acquisition of a planning business might be the largest investment that a planner makes. It may be financed with the help of a mortgage over his/her other biggest investment: the family home. This significant step might be motivated in part by non-financial personal goals such as the independence of self-employment.

In these circumstances it is not surprising that a “front of mind” question for the buyer is “How long before I own this business outright, without the bank over my shoulder?” This may have more decision-making weight than, say, finessing the assessment of growth rates three or more years into the future.

Average Return on Investment

As another simple benchmark, some investors will calculate a simple or average return on investment, which is simply average forecasted profits (NOPAT) divided by the cost of the investment. This is then compared to an estimated or recognised industry norm.

Average ROI is a poor investment decision tool. It is based on accounting profits, not cash flows, it ignores the opportunity cost of capital, and it does not properly account for the timing and amount of income or cash flows.

Other

Not discussed here, principally because they suffer from same computation difficulties as DCF, without significant benefit, are other competitors to DCF methodology including:

<u>Internal (or DCF) Rate of Return (IRR)</u>
The IRR is the discount rate that makes the NPV of an investment equal to zero. It is the estimate of the long-term rate of return of the investment. An investment should be undertaken if the IRR exceeds the cost of capital.

<u>Profitability Index (or Benefit-Cost Ratio)</u>
The profitability index is the net present value of the investment divided by the cost of the investment. An investment should be undertaken if the index exceeds one.

Valuation in Other Contexts

This paper has been written about valuation principally in the context of the negotiated, arms-length purchase and sale of financial planning businesses. There are a number of other circumstances in which a formal valuation will be required. For requirements such as tax or probate of course an independent, formal valuation will be required, and it is important to obtain appropriate professional advice.

Another important context in which value will need to be understood and fairly assessed is in **partnership agreements** providing for the “earning in” or “cashing out” of partner equity and **succession plans** providing for the acquisition over time (or at an agreed future time) of equity or ownership.

These agreements often require that some aspect of valuation be performed in the future, or from time to time. For this to work, and be seen to work, fairly, it is essential that the process be transparent (understandable), consistent and not subject to surprises.

In these circumstances, and bearing in mind the complexities of valuation that we have described, we would generally not recommend an agreement that provides for equity to be transferred “at valuation”. Rather, we would recommend a well-documented process for agreeing value based on a matrix of factors, in the nature of a “balanced scorecard”, with defined objectives and measures of financial, business process, customer service and change/growth/improvement factors. The “Hillross approach” described in a later paper is an excellent example of this type of method.

Conclusions

DO	DON'T
Understand the drivers of value	Fixate on simple multiples Rely on BOLR as a benchmark
Consider a range of valuation methods Use market comparisons as a reality check	Sweat the details of DCF analysis (Approximately right beats exactly wrong)
Critically assess • sustainability and quality of earnings • growth rates	Treat all revenue components in the same way Assume that competitive factors will not change
Consider synergies and cost/ revenue impacts of merging an acquisition	Forget to account for the costs of management
Take professional advice	Believe everything you've heard about sale prices!

A better understanding of valuation helps planners not only when they are buying or selling. It will also assist with assessing business and growth strategies, with reviewing business performance, with managing shareholder and succession planning issues and with designing staff incentives. Planners can become more empowered business managers when they better understand how to create and measure value.

Valuation: Art or Science?

MGI Meyrick Webster[13]

Value like beauty is in the eye of the beholder. Something may well have many different values dependant on who is assessing it or at what point of time it is being assessed.

The process of valuation is a combination of Science and Art. The science is quite simply all of the factual elements that surround the process such as the numbers and ratios whilst the Art relates to the subjective judgments applied to the elements around the process.

Parties to the process can generally come to agreement on the factual elements of a valuation by a procedure of reviewing and verifying the information. Where disagreement tends to arise is in the application of the judgment to those respective facts in determining what the end result should be.

In this paper we will explore the issues that we need to resolve to reach a view as to the value of a business and how participants seeking to maximise the position of their business should apply that information.

What is Value?

It is our view that value is quite simply the economic price someone is willing to pay to obtain all of the future benefits of owning or, controlling and benefiting from the use of, an Item. By its inherent nature Value is a personal judgment. All prospective acquirers will have a view as to the value the item delivers to them and all prospective disposers will have a view of the value to them of continued ownership.

It is also our view that there are different values to different acquirers. A concept that we describe as inherent vs. synergistic value. Inherent value is often described as the price a "willing but not anxious buyer will pay for an item from a willing but not anxious seller". This refers to the conceptual view that the acquirer is making an investment choice compared to other similar choices e.g.: They are comparing the purchase of a Financial Planning business with the purchase of a Milk Bar or a Rental property. This decision is based upon what the business in its current form can deliver to them as a stand-alone investment.

Synergistic value on the other hand embraces the view that a business will deliver an enhanced return beyond what it is currently capable of if it was integrated into the acquirer's existing circumstances. In these instances the acquirer will be willing to pay an economic price in excess of what an investor looking to inherent value will consider reasonable. The most obvious examples of this is where the business can be merged into an existing staffing structure and consequently reduce labour and overhead costs or alternatively create additional revenue opportunities from the enhanced circumstances.

It is important to recognise that value is not a stagnant concept. The relative worth of alternate investments change on an ongoing basis as external factors such as economic conditions alter the environment in which we operate. Alterations to the way in which a business conducts its affairs also has an impact on its worth and it is this factor that prospective disposers have the most capacity to influence.

[13] Contact details for all contributors can be found in the Acknowledgments section at the end of this paper

Why understand Value?

The reasons people seek to understand the value of their business are varied. Some are obvious, others less so. At the forefront of a business owner's mind when they commence the thought process of selling their business is: what is it worth? It is exactly the same question that someone looking to acquire a business is asking.

There are many other circumstances in which the value of a business is required. In situations where partners, in whatever guise, look to come to arrangements to deal with each other's equity in a sale or retirement, planned or unplanned a fundamental element to the agreement is how the value of the equity is to be determined. Where a business seeks a capital partner in return for the granting of equity it needs to have a basis for offering that equity that is soundly based. Any contemplation of mergers between businesses requires both parties to come to a conclusion on how the respective interests are to be valued as a part of the agreement.

A less understood reason for understanding the value of the business is to measure the Return on Investment that is being achieved. This is an important business management tool that more business owners should take regard of. Even where the business has been started from scratch and accordingly there has been no financial investment in the business there is still a tangible worth to the business. If a business owner does not understand what the value of the business is, then they have no way of measuring what the profit should be based on expectations of relative return from alternate uses of the money "tied up" in the business.

The Process of Valuation

The process of conducting a valuation is predicated on determining two factors.

1. The level of anticipated future returns from the business and
2. The likelihood of the anticipated returns being achieved

The first factor involves the collection and review of a range of financial information. Typically included in the information reviewed are the following:

- Financial statements for the preceding three financial years
- Management accounts for the current financial year
- Budgets and Cashflow projections for the next 2 – 3 years
- Proprietorial remuneration details
- Related party transaction details
- Non-commercial dealings details
- External financial markets information
- Comparative transactions occurring in the market place

The purpose behind the collation of the data is to form a view as to what represents the "normalised earning" position of the business. In addition it is also imperative that external factors influencing the maintainability of those earnings are understood and taken into account. Amongst those external factors are any that impinge on the economic environment in which the business operates even though the impact on the business is indirect.

The second factor involves forming a judgment around the risk factors that will influence the businesses capacity to maintain the earnings profile established by the financial review. There are many elements that enter into consideration in this aspect. The most significant factor is the existence of integrated business systems that allow for a consistent application of the business model. The importance of this cannot be overemphasized. The documentation and implementation of robust systematic procedures allows the business to transcend any individuals influence to ensure that the business can exist in its own right following the departure of a key Principal. The other effect of systems is that the efficiency of the business is enhanced and the resultant profit increment improves value.

Other factors influencing risk are outlined hereunder

- Geographic location
- Demographics of client base
- Nature of revenue sources
- Quantum of Funds under influence
- Compliance management regime
- Staff qualifications and experience
- Business brand recognition
- Business development processes

It is common for businesses to be managing some of the risks identified effectively but it is rare that businesses that are operating in the current environment have adequately addressed all of them. The consequence of this is that those businesses are not maximising the value that should be attributed to them given the level of revenues being generated.

Upon arriving at a conclusion as to what the maintainable benefits of a business are and having assessed the likelihood of achieving them a valuer is armed with the basic data with which to form a view as to the value of the business being reviewed.

Methodology

Whilst there are several different methods of valuation the most common use is made of two options:

1. Capitalisation of Maintainable Earnings or
2. Discounted Cash Flow

Both of these are most suited to businesses that are “going concerns”. That is, a business that a prospective buyer is looking to continue to operate and accrue the future benefits from rather than to liquidate and sell off the assets.

Whilst both methods are utilising the same broad approach of determining revenues and applying a risk factor to those revenues there is a significant difference. The capitalisation method relies on historical financial performance as the basis of predicting what is likely to be the future performance. In this approach much is made of the certainty of known results and the assumption that it is reflective of what is likely to be repeated.

The Discounted Cash Flow method relies on budgets and cashflow projections for the business into the future; it is normal that at least 3-year and preferably 5-year projections are available if this method is to be adopted. The integrity of the approach is greatly influenced by the accuracy of the projections and the assumptions upon which they are based.

In an Industry that is experiencing rapid growth or changes in earnings profiles the preferred method is the Discounted Cash Flow basis, simply because it represents a more reasonable prediction of what is likely to occur than to rely on historical performance in a changing environment.

The issues surrounding the assessment of risk are similar in both methods and the result is either the “Capitalisation Rate” or the “Discount Factor” that is applied to convert the earnings stream to a value. One extra risk factor that is experienced in the application of the

Discounted Cash Flow basis is the level of certainty surrounding the assumptions that have been utilised in building the Budget and Cashflow model.

In practical terms most businesses do not prepare sufficiently sound forward projections to enable a robust valuation process using a Discounted Cash Flow method. As previously stated if the business or the environment is in a growth phase this will result in a valuation that is lower than would be achieved if proper projections incorporating the anticipated growth were factored in. It is in the best interests of business owners to be aware of what the market is saying about businesses that are operating in their environment as a base for forming their view of where their own business is heading.

Our Experience

Over the past three years or so we have valued many businesses for a range of different purposes ranging from raising debt financing to disposing of the business. As a consequence of this exposure we have had the opportunity to look at and appraise a large number of different business operations. This has resulted in us acquiring a great deal of knowledge of what factors are driving value and what factors are raising the risk of some businesses to the extent that it has a significantly detrimental effect on value.

We believe it would be useful to outline some of the conclusions we are drawing from that experience.

Systems

Very few of the business operations that we have looked at over the period have had better than adequate systems. There is a notable absence of well-documented procedures that are implemented and monitored. This area extends to matters such as Procedures manuals, Role and job descriptions for staff, Workflow management, Client database management, Business plans, Marketing plans, IT processes, Standardised documentation including Investment Plans and Management planning.

The exposure this creates is that the business operations are reliant for consistency on individuals being aware either from experience or existing knowledge of the manner in which business is conducted. This makes it difficult to transition a business without the active participation of all of those individuals. This exposure is generally exacerbated because it is common that the Client relationship and Business development responsibilities are assumed by a key Individual who becomes integral to the ongoing success of the business. This is typically the case where the business has been established and developed by an “entrepreneurial” type of practitioner that has not moved the business beyond the individual relationship status.

Our description of these types is that they do not have a business but rather a series of relationships. It is very difficult to convince a prospective buyer that there is not significant risk associated with this type of acquisition and accordingly the price they are willing to pay is lowered.

In terms of weighting of risk factors we place far and away the most emphasis on this area, in fact it makes up around 50% of our risk assessment.

Financial Information

The most glaring weakness in this category is without doubt the absence of properly constructed forward projections. At best most businesses will have a view of what the revenue expectations are for one year ahead. It is a part of prudent business planning to prepare Profit and Loss budgets for at least the next year on a monthly basis and generally for the two succeeding years on an annualised basis.

It would be expected as part of the process of preparing the projections that a Cashflow analysis would be prepared together with forward Balance Sheets to identify funding capability. The absence of this documentation does place some concerns around the Management planning aspects of the business

Another misunderstood component of the financial process is the separation of Remuneration and Return. Put quite simply it is essential that in arriving at the true profitability of a business regard has to be taken of the level of remuneration being paid to employed proprietors. An investor or buyer will take a view that the market value remuneration of the employee proprietor is a cost of the business and accordingly will reduce the profit contribution of the business by the amount it will cost to replace the employee proprietor.

A number of businesses that we have looked at have been providing the owner a market value remuneration only, and in this instance it is our view that the only buyers of this type of business would be those looking to "acquire a job".

It is important to also have regard to the structure of return in the form of Tax Planning endeavours undertaken. Many of the businesses reviewed have reported lower than achievable profits due to the availability of income splitting or Tax Effective measures taken on board. We are careful to assess earnings at an EBIT (Earnings Before Interest and Tax) level to ensure individual tax planning and funding choices do not distort comparative values Expectations.

Most principals when entering the process of valuation have pre-determined expectations of their businesses worth. This has usually been predicated on some information obtained by word of mouth or through the press and not specific to their business.

It must be understood that the valuation process is not an emotional process but rather one of detached observation, although most business owners have a significant personal stake in the business they have built or fashioned, it is of little consequence to an acquirer.

An acceptance of realistic third party appraisal of the qualities, and flaws of the business is essential to the successful transaction.

<u>Compliance</u>

It is our view that the stringent compliance regime that our industry operates in imposes a higher level of risk to the business within it. This risk is clearly that a business that is not strictly complying with regulations, is exposed to potential litigation and a requirement to cease operating.

Good business systems will inevitably encompass a strong regime of governance including compliance as part of the operating environment.

Most businesses we review require some attention to this area and it is a critical factor that potential acquirers are checking the due diligence process.

Case Study - The Application

Perhaps the best way to bring together the elements is to review how the issues we have touched on are applied in a transaction situation.

The Case study outlined briefly relates to a client process that led to a successful result for all stakeholders.

The Client approached our organisation to conduct a valuation. At that stage the business was like many others, with a large number of clients all receiving a level of service on an ad hoc basis. Our valuation was a figure around the $400,000 mark.

Over the ensuing two to two and a half year period, the business was re engineered with a very clearly defined service offering. The number of clients was reduced and the business more strictly systemised.

The business was re evaluated after this process and the resultant value was closer to $2000000. At this stage the proprietors undertook to dispose of the business and we were engaged as advisors on the project.

At this stage a view was formed as to the most suitable synergistic buyers and preliminary information was provided.

After a process of negotiation an agreement was reached for the sale and acquisition at a price around 20 to 25% above valuation. It is important to understand that the premium was paid due to the synergistic value accruing to the acquirer, which enabled the disposer to extract the best possible deal. It should be noted that the deal went beyond simply the cash consideration but rather covered a number of non-financial aspects that were equally as important to the vendor.

The Case Study highlighted the benefits of understanding the key factors driving value they can be summarised as:

- Have the business “Sale ready”
- Have demonstrable systemisation
- Have a clear focus on what is required from the process
- Identify the most synergistic acquirer
- Negotiate a fair deal to all stakeholders
- Ensure the documentation reflects the deal
- Finalise the transaction

The total costs of a valuation and sale process does vary but with valuation, corporate finance and legal requirements it will generally be in the range of 2.5% to 4.5% of the sale proceeds.

Summary

The valuation process is complex but it is worth the effort to do it properly. It equips a business owner with valuable information about the state of their business and provides guidance on the areas that should be concentrated upon to improve the position. All business owners should endeavour to understand the value of the asset they control and be in a position to measure how effectively they are managing the investment of the stakeholders’ interest albeit that they may be one and the same person.

Buying & Selling Businesses

Wes McMaster[14]

Introduction

It has been rewarding to be part of the evolution of financial planning businesses from their emergence in the 1980s to the entrepreneurial growth period of the 1990s and now to be advising businesses on how to manage their maturity in the 2000s. The institutional realisation of the influence and long-term nature of financial planning relationships with clients has naturally led to the consolidation that we have seen over the past two years. These acquisitions combined with the fact that the owners of most financial planning businesses are in or near their 50s, has focused people on the values of these businesses and how to extract that value. Many people that I talk with have thought about an exit strategy but few have positioned their business or actually done anything about it.

Australian Survey Research

The Investor's Advisor magazine conducted a survey of its readers during March to measure Australian Financial Planning Practice Transitions. The buying, selling and transitioning of financial planning practices is a matter that, while of great importance to most practitioners, receives scant attention. The survey covered demand for practices, prices, the process itself, reasons for, and impediments to, buying and selling practices. There were 121 responses and here is a synopsis of the key findings.

50% of respondents said that they had considered selling their practice in the last three years. Of this group, 10% had actually sold their business and 35% had, or are in discussions, with a potential purchaser. So 45% of these people have actively pursued selling their business and the principal reason they were motivated to consider selling was because of succession and retirement issues. When asked about the greatest challenge in selling their businesses, 38% said obtaining a fair price and 28% said transferring clients to the new owner.

I am often asked by people to value their business because they are interested in selling. It is common for me to look at the business and advise them to re-position it by adopting strategies to make it more valuable. 76% of respondents to the survey said that they were positioning their business for sale. 58% of these people said that they are re-organising their database and processes and 37% said that they are changing their pricing.

It is interesting to see that 39% of respondents have been approached within the last three years to sell their business. This is a high figure if we extrapolate it to the whole community and it fits with my anecdotal evidence that this is a sellers market for financial planning businesses. Dealers approached 31% of this group and 47% were approached by other practitioners. It also seems that it might remain a sellers market for a few more years because 83% of those surveyed said that are not planning to retire until sometime after 5 years.

It is also interesting to look at how people might approach the task of selling their business. 73% of respondents indicated that they did not have a good knowledge of how to go about selling their business. 39% said they would seek the advice of an industry specific broker (pretty hard to find one, though) and 32% said they would go to their Dealer.

[14] Contact details for all contributors can be found in the Acknowledgments section at the end of this paper

Survey Results on Business Valuation

Business valuation is always a topical issue. 74% of our respondents value their business as a multiple of recurrent income and 26% use a multiple of earnings before interest and tax (net profit) as a measure of value. The multiple of recurring income places a value on the sustainable income stream with no regard for the cost of producing it. This method is only valid if a business is going to buy the client base and merge it into their cost structure. There is a case for ignoring the seller's cost structure. However, the true value of an income stream must account for the cost of producing it and therefore capitalising EBIT (net profit) makes sense.

When we asked what they thought is a fair price for their business, 34% said 2-2.5x and 40% said 2.5-3x recurring income. My experience is that 2.5x is good and 3x is premium.

So far we have been talking about selling a financial planning business but what about buying one? 55% of our respondents have considered buying a practice in the past three years. Of these, 32% actually bought one. Anecdotally I am not sure that this would reflect the degree of turnover in the wider financial planning community. I don't think that it is this high but perhaps we need to look at it as a pointer to change.

77% of respondents think that buying another business is a good growth strategy. 28% would finance a purchase with a bank and 25% would source finance from a Dealer or Institution. 42% would ask advice from an industry specific broker and 27% would ask another financial planner to help them.

This is the first survey of its type in Australia and Investor's Advisor has said that it will be conducted annually so that we can benchmark these issues and identify trends.

Valuation Methodology

Financial planning businesses are valued according to one of two methods. The most common method is to apply a multiple to the recurring income of the business. The other is to apply a multiple to earnings before interest and tax (EBIT). The multiple of recurring income places a value on the recurring income stream with no regard for the cost of producing it. This method is only valid if a business is going to buy the client base and merge it into their cost structure. Then there is a case for ignoring the seller's cost structure. However, the true value of an income stream must account for the cost of producing it and therefore capitalising EBIT (net profit) provides a valuation of the whole business. In reality a purchaser is buying the future earnings of the business and therefore a valuation should be based on capitalisation of future maintainable earnings.

Where two businesses are looking at merging as opposed to one taking over the other, I have found that the most equitable way to value each business is to use a discounted cash flow analysis of expected future earnings of each business on the basis that they continue their present strategies without the merger.

I am finding that buyers are becoming more discerning when they are evaluating a business. Two years ago almost no one questioned a value based on a multiple of recurrent income. Now buyers are looking for profitability and taking more notice of EBIT.

I have also found that the key factor in buying or selling is not price. This is generally the easiest part of an agreement. The art in a successful transaction is negotiating the transitional issues. There are many pitfalls and traps for the novice in what can happen after the sale agreement is signed and it will affect the investment of the buyer and the payment to the seller. I am often asked to negotiate on behalf of a buyer or seller after they have reached agreement on price. Buyers call me in because they want to ensure a successful transition and sellers call me in because they recognise that they need to remove themselves from the emotional investment they have in their business. They also want to protect their deferred payment.

The real issue is what multiple to apply to either EBIT or the recurrent income.

Multiple of EBIT
Surveys have shown that the expectation of the operators of financial services businesses is that they will earn 20% net profit (EBIT) on gross earnings. This will be a well-organised, efficient business with good systems and processes. So you would value this business on a multiple of 5x EBIT. When I am valuing a business I will apply a discount or premium according to qualitative issues within the business.

Care must be taken when you look at the profit and loss statement provided by a business owner. It is common for small businesses to include private or non-commercial expenses in the business. I generally have to adjust the profit and loss to calculate a commercial arms length EBIT.

Multiple of Recurring Income
In the financial planning industry, practices often sell on a multiple of recurrent income. This reflects the fact that the purchaser is actually buying the rights to the income generated by the client base.

Recurrent income is the amount of income received by the business in the previous twelve months where that income is of a recurring nature. This includes asset commission, life insurance servicing commission and recurring fees for service. Recurrent income excludes fees or commissions received for once only events. Therefore recurrent income excludes plan preparation fees, implementation fees and commissions.

The qualitative judgment is what multiple to apply to recurrent income. In my experience practices have typically sold on multiples in a range from 2x to 3x.

As an indicator of value, and as a reflection of recent transactions, here is a guide to the value of a financial planning practice using a multiple of recurring income as the measure.

Value = 3x Recurring Income

- This will be a premium business.
- Database will be segmented and well organised in electronic format.
- Services will be defined, priced, and relative to segments.
- There will be a systematic and organised process for delivery of service.
- There will be a systematic and organised process for client reporting and review.
- Client agreements will be in place where clients have agreed to a defined service and price.
- Business uses management information systems as a management tool.
- Business controls its income and margins and has the ability to replace asset commission with fees.
- There will be no problem in transferring client relationships to a new owner. This will reflect the fact that the client understands that they are being serviced by the firm, not an individual.

Value = 2.5x Recurring Income

- This will be an average business.
- Database may not be segmented but review clients will be identified.
- Services are not defined for all clients.
- Larger clients are reviewed and charged, smaller clients are dealt with on an ad hoc basis.
- Business has processes in place for reviews and other services but these may not be clearly defined.
- Review clients may have signed client agreements, where others have not.
- No management information systems.
- Mixture of fees and commission.
- Generally speaking, review clients may be transferred but others are unknown.

Value = 2.0x Recurring Income

- This will be a less organised business.
- Database will not be segmented and may not be up to date.
- Many clients will receive no service at all.
- Service will be largely ad hoc although best clients will be reviewed.
- No client agreements.
- Processes are informal meaning that they are known by staff but not documented.
- No management information systems.
- Commission income.
- Client relationships tend to be with an individual and this makes transfer to a new owner difficult.

SECTION 5

Buyer of Last Resort (BOLR)

The Fallacy of BOLR

Many dealer groups incentivise their distribution through the provision of a guaranteed buy-back arrangement known as the Buyer of Last Resort (BOLR). They are commonly applicable where a dealership enters into a written agreement that includes a provision for a financial planner wanting to leave the industry, and can be a superficial 'way out' for those who are unable (or unwilling) to sell their entity on the open market. But beware, as many dealer groups reserve the right to buy without being compelled to do so. The term "Last Resort" is a particularly apt description of these facilities with most dealer groups typically unwilling to have BOLR provisions exercised against them. There is currently an example in the Australian financial services industry, where the allocated BOLR reserves of a major dealer group are substantially less than the compensation requests by financial planners. The 'piggy bank' is nearly empty, with the dealer group preferring to invoke highly conditional contracts to avoid ownership of financial planning practices.

From a financial planner's perspective BOLR has set in place an unrealistic expectation of what their financial planning entity is actually worth, which now underpins the unrealistic valuations that currently preside in the industry. The growing trend is to value true financial planning businesses on EBIT multiples, with any disparity between BOLR and EBIT deferring many exit strategies. BOLR remains a broad valuation method, not reflective of the recurring costs required to generate the revenue, as opposed to net profits. The price is the same for a planner's practice that generates $100,000 of trail commission from 100 or 1,000 clients. Yet the former would be a far more profitable business. If a dealer group culture espouses certain values, but rewards other values, the latter will prevail. In this example the BOLR facility does not reward superior quality service by paying a higher price.

The challenge for the dealer group is that using a valuation method that does not reward the provision of quality service, raises challenges for the long-term positioning of a business, the satisfaction of its client base and the impact on referrals. Most BOLR offers value the business from the point of view of the buyer who prefers to protect the business volume that has been attracted to their proprietary platform. This is simply valuing funds under management in a "product" – not valuing a business. The BOLR offer to the financial planner is the same whether their clients are well or badly serviced, which is not as relevant to the profitability of the fund / platform manager.

In short BOLR enables an unprofitable business to be sold for the same price as a profitable business, which will be very attractive to those financial planning entities with low average recurrent earnings per client… and less appealing to those with actual financial planning businesses to sell.

Who Wins With BOLR?

With all of these negative predictions surrounding BOLR, why have fund managers & dealer groups (particularly those with proprietary platforms which the financial planning entity has been feeding into for the past few years) been prepared to pay inflated multiples in the past? It's important to remember that the fund manager / master trust manager may be collecting recurrent revenue of up to 2 per cent per annum from the funds under management that have been captured within their proprietary platform. From this amount, only 0.5 per cent per annum is paid to the financial planning entity in trail. If they offer to buy the financial planner's business at four-times trail, they are really only paying one-times their earnings. If the offer is conditional on, say, five years of previous service, the economics for the buyer become even better. The institution will have investors from which it earned two per cent per annum for at least five years, at the end of which it makes a payment of two per cent (that is, four by 0.5 per cent). This can be a profitable acquisition. Not a bad deal if you believe that platform margins will remain at their current levels.

Of course the future profitability of this purchase will be affected by any cost for a new financial planner to service the acquired clients. The financial planner who is assigned will be at the discretion of the dealer group / funds manager that now owns the client. Those financial planners who are concerned about quality of service to their clients (once they have left) will need to assess their confidence in the institution's commitment to high quality financial planning services. Will the new owner of the financial planning entity delegate the clients to a financial planner of the same quality, or will it try to reduce its servicing costs? While the need for strategic purchases will be present, buyers will need to be more selective about their targets. While the profitable financial planning business will continue to attract pleasing prices, the days of being able to obtain an inflated BOLR (or market) price for an average financial planning entity will quickly fade.

Beware of the Hidden Traps Within BOLR

In the desperate rush for the "Buyer of Last Resort Backstop", many new financial planning entities are now not being invited to qualify for BOLR until they have been with the dealer group for 5 years or more. This begs the question: what will the Australian financial services landscape look like in 5 years time, and are you prepared to gamble on the outcome? It is worth remembering that dealer groups are reporting lower margins, fund managers are reporting lower margins and financial planners are being protected to some degree by the desire to maintain market spread and distribution. At some future time – possibly within the next 5 years - margins for funds managers and dealers will have to be restored to ensure their survivorship. This can either occur through a prolonged market recovery or they will be forced to cut costs. The later scenario would result in financial planners' trail commissions (and other financial incentives) coming under increasing pressure, together with the ever-prevalent soft-dollar commissions being paid to platforms. In the case of funds managers, they will quickly become commoditised with their offering being subject to alpha, price and product gateways.

Buyer of Last Resort contracts in recent times have often been for 3 or more times the recurring component to be the buy-back price. Whilst many of these contracts are still in practice, the issue as to what constitutes recurring income is becoming an increasingly strenuously tested subject. Some contracts exclude clients for which plans are not up-to-date, for which contact records have not been maintained, for clients who have only recently become users of some services, from the recurring calculations. The effect has been that the effective BOLR values are beginning to come under intense pressure.

Other Industry Buyer of Last Resort Conditions

If the branch is eligible to participate, payment shall be based on the purchase price based on the net revenue for every representative who has belonged to the branch for at least two years.

The purchase price shall be calculated based over two-year period immediately preceding the contract date as follows:

- A multiple of 3.5 times the sum of net revenue from Platform

A multiple of 2.75 times the sum of net revenue:

- For Term and Trauma, Annuities (excluding Short Term), Income Protection, Etc
- For Unit Trusts Etc
- For Discretionary Master Funds

- In the event a product may fall into multiple categories referred to in then the multiple applied shall be the higher multiple possible

The multiples mentioned may be reduced by up to 10% in the event that:

- the branch is unable to produce an accurate computer data base of client information; and/or,
- there has been a reduction of at least 15% in the Branch's funds under management in the last twelve (12) month period

The purchase price shall be paid as follows:

- 33.33% per cent on transfer of the clients conditional on:
- the Branch's Representatives maintaining a relationship for a period of 12 months to assist, as directed, in the on-sale of the client base; or
- in the event the branch's representatives are totally and permanently disabled or deceased, no further conditions apply
- the balance is payable of 33.3% in equal installments over the next two anniversaries of the first payment being made

The honeymoon for BOLR is coming to an end. So what is the alternative for a financial planning entity that has relied upon their friendly dealer group to buy them out in the next few years? If you have time-on-your-side then start by asking the following questions:

Can you afford to retire from the financial planning entity?

- Have you built a profitable, appealing entity that someone would want to acquire? What's the quality of the client base? Are they satisfying clients to deal with?
- Have you prepared your financial planning entity for someone else to assume your management and ownership responsibilities?
- Can the buyer make a living from the entity and still pay you a fair purchase price?
- If the book of business is the biggest asset that you own, then what that is worth?
- The luxury of time permits financial planning entities to explore alternative exit strategies – including succession planning which was touched on briefly in "Converting a Financial Planning Proprietorship To a Business" in Section 2.

Aside from BOLR other options to exit the financial planning industry include:

<u>Pursuing aggregators</u>
These professional buyers were popular in the 'roaring nineties', as they acquired numerous financial planning entities with scrip with the aim to take them public. Not many of these have made it into the 'naughties' with almost all of them having been failures. The key issues were the inability to produce cost synergies, revenue synergies or the multiple list cobbling together practices and selling them for a higher price that they originally claimed. In retrospect, financial planning entities don't have many costs aside from employee salaries, so there is no significant avenue for cost savings.

<u>Identifying strategic buyers</u>
The Australian financial services scene contains a number of known strategic buyers who are looking to gain business efficiencies through acquisition. The logic of merging is that they sink money into branding and centralized resources that can be standardised. Strategic buyers typically pay good money for entities in return for the ability to dramatically change the business to reflect their own models. This includes business name changes, location changes and pricing differences.

Selling to a local competitor

This option provides an easy transition for your clients. However local acquirers generally don’t pay as much as strategic buyers, as the latter tends to need your business more. The other issue to consider is what happens if the sale doesn’t proceed. During the due diligence process, your competitor will discover proprietary information about your pricing, your clients, and your business.

Closing the business and referring clients to your industry friend

Whilst this may sound like a last resort it can often be too much of a common occurrence. As many financial planning entities are run as small businesses they are usually sole practitioners or two- or three-partner entities, which have limited scope to attract realistic valuations.

Succession Planning: An Alternative Strategy

Succession planning is concerned with keeping control of the entity within a collection of existing related stakeholders. This requires the proprietor / major stakeholder to effectively disengage and extricate themselves from the financial planning entity, and walk away with cash or cash equivalents that represent the present value of a fair return on their time, talents, and capital. The effective implementation of this strategy takes approximately three to five years – and even then there is no assurance of a successful transition.

Essentially there are three major issues to focus on with succession planning: client succession, management succession and ownership succession. Once the first two have been successfully addressed, it becomes easier to sell the shareholding in the financial planning entity. Client continuity is an issue, because if the clients don't successfully transfer, then with most financial planning entities there is nothing to transfer.

There are three factors that drive any succession strategy: time, control and money. If control is important then selling to a partner or an existing employee is an easier exiting strategy, as it involves little or no change for the clients and employees. A key issue is whether the employee has any money or financing ability to be able to purchase the entity.

The Hillross Approach

Whilst proving support for each stage of a financial planner’s lifecycle, Hillross Financial Services have initiated a Practice Scorecard, which measures the financial planner’s business on a variety of criteria. These range from Adviser Education to percentage of Funds under Administration within their proprietary platform (PortfolioCare), to the location and presentation of their premises.

Hillross Financial Services		
Measurement	Items	Maximum Points
Adviser Education	CFP Principal	3
	Continuing Education	3
	Attendance at Hillross	3
	Current Product Accreditation	1
	Maximum	**10**
FUA within	<20% of FUM	2
	20% to 39%	5
	40% to 59%	8
	60% to 79%	11
	80% to 100%	15
	Maximum (non	**15**
Practice Premises	Accessible premises in commercial area	4
	Formal Lease agreement	2
	Professional appearance - fixtures / fittings	4
	Maximum	**10**
Practice Management	Audited or 'arms length' prepared financial statements	3
	Acceptable business plan	4
	Computerised customer base	3
	Acceptable office procedures and service standards	5
	Maximum	**15**
Human Resources Policy	Position descriptions, cross trained	5
	Staff performance management	3
	OH & S: EEO in place	2
	Maximum	**10**
Sales & Marketing Processes	Clear HR branding - office & promotional material	2
	Clients segmented (A, B, C, D)	5
	Use of approved marketing material & templates	3
	Sustainable pricing & service	5
	Maximum	**15**
Practice Sussion Processes	Succession plan in place for principals	6
	Succession plan in place for key staff	3
	Risk management process	6
	Maximum	**15**
Compliance Processes	Annual field risk audit results	4
	No breach notices against the AR	3
	No valid complaints against the	2
	Continual meeting of PS146	1
	Maximum	**10**
Maximum Possible Score		**100**

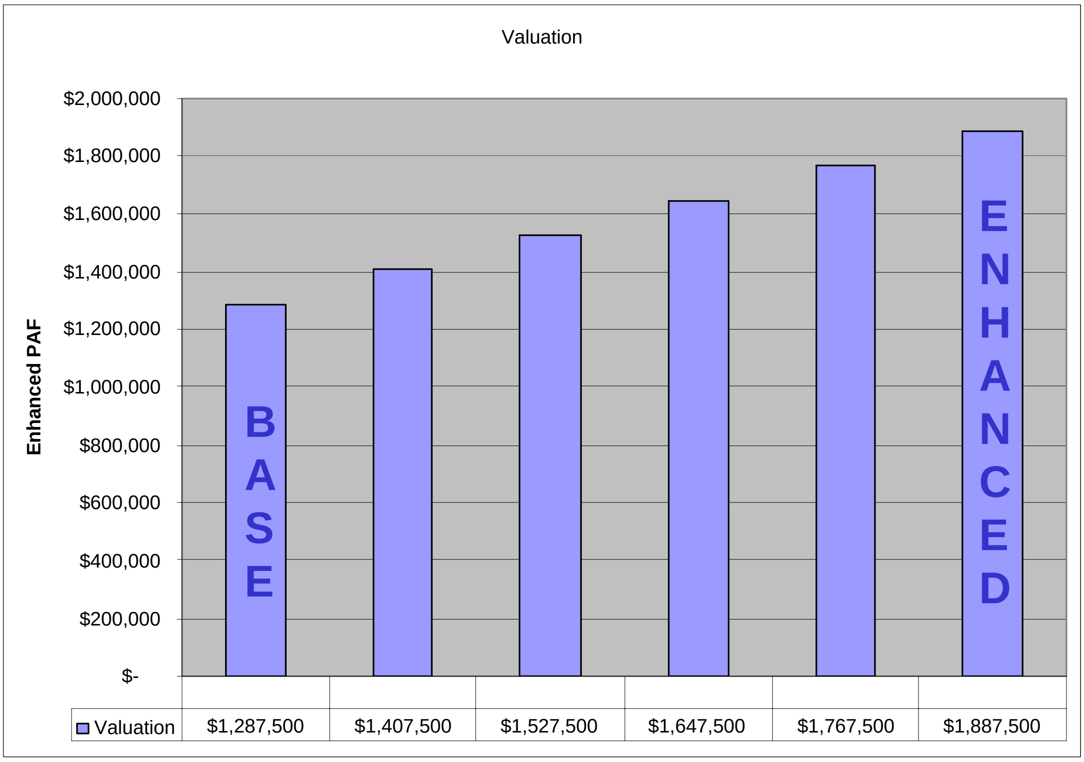
This data provides the financial planner and Hillross with a scorecard based valuation process, which can assist in either selling the practice, or securing favourable financing packages. Hillross also provide assistance with financing practice purchases (Practice Acquisition Facility up to 80% of the base valuation or 100% of the practice purchase price), or practice development (50% of the base valuation or 100% cost of genuine practice development).

PAF Base Calculation				
Type	FUM	Trail	Multiple	Amount
Corporate Superannuation	N/A	$ 25,000	2.5	$ 62,500
General Insurance	N/A	$ 1,250	1.0	$ 1,250
Retail	N/A	$ 25,000	2.0	$ 50,000
Hillross Profit Share		$ 92,000	3.0	$ 276,000
PortfolioCare (Max ASR 0.5%)	$50,000,000	49,486	3.0	$ 148,457
Practice Acquistion Facility				$ 538,207
Less ADL				$ -
Less Other Loans				$ -
Net Realisable Value				$ 538,207

Hillross PAF Base Finance		
Practice Purchase	80%	$ 430,566
Practice Development	50%	$ 269,104

PAF Enhanced Calculation				
Type	FUM	Trail	Multiple	Amount
Corporate Superannuation	N/A	$ 25,000	2.5	$ 62,500
General Insurance	N/A	$ 1,250	1.5	$ 1,875
Retail	N/A	$ 25,000	2.5	$ 62,500
Hillross Profit Share		$ 92,000	3.5	$ 322,000
PortfolioCare (Max ASR 0.75%)	$50,000,000	$ 49,486	3.5	$ 173,200
Practice Acquistion Facility				$ 622,075
Less ADL				$ -
Less Other Loans				$ -
Net Realisable Value				$ 622,075

The Buyer of Last Resort offering in this example is more an incentive for practice development - or failing that, enables a valuation to be determined, whilst clearly identifying the avenues that are available for improvement. Those financial planners who are unwilling or unable to improve upon their practice essentially open up the opportunities for the prospective purchaser to capitalise on the enhancements made.



Other offerings are less sophisticated than the Hillross example. Usual statements within other dealer groups include the requirement by the financial planner to provide twelve months notice if there is an intention for Buyer of Last Resort. At this point the financial planner's practice is only eligible to participate in the Buyer of Last Resort if:

- They have been associated for a lengthy period of time (usually more than three (3) continuous years)
- Have made reasonable efforts to sell their client base at a price equal to the dealer group's buyer of last resort multiple
- Have not split or attempted to split the client base
- Have signed an undertaking, that they will not work for, assist, or advise, any entity in competition with the dealer group for a period of three years

SECTION 6

Summary

The Australian financial planning industry has travelled through an unprecedented history of bull markets and prosperity. Coupled with a more intense regulatory framework, the complacency of the industry has begun to give way to a more ‘business-like’ approach.

In recent times the emotional and economic grind of running a financial planning entity during a more challenging environment has begun to take its toll on less seasoned financial planners who are without the secure income of a mature business to rely on. Many of these have begun to opt for seemingly simpler solutions as they prepare their plans to exit the financial planning industry.

Like many other professions, financial planning tends to be a local business, which requires the matching of willing and able local buyers with sellers. The traditional short cuts involving aggregators, buyer of last resort and equity participation arrangements in platforms have a legacy of grief for many who have relied upon them. There is no replacement for converting a financial planning entity that has enjoyed the luxury of the environment without the necessity for planning, into a business that happens to be involved in the financial planning industry.

We hope that many of the contributions and observations contained in this paper prove useful in preparing readers for the challenges ahead that await the Australian financial planning industry.

SECTION 7

Acknowledgments

In putting this paper together we have been fortunate enough to receive many offerings from leading organisations & individuals within the Australian Financial Services industry. As it is often difficult to convey all of the information in a drafted contribution, we would strongly urge you to contact the following providers for additional information on how they can assist your business.

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APPENDICES

Appendix 1 – Kenyon Prendeville

Realisation Process

Stage	Information Memorandum / Business Profile	Sourcing Potential Purchaser/s	Negotiations	Sale	Post Transaction
Week	1 2 3	4 5 6 7	8 9 10	11 12	13 +
Overview of Activities	• develop strategy • collection of data • establish key features: - pricing - not negotiable issues - marketing strategy	• data base search • network search • adv. campaign • evaluate potential buyers • recommendations	• enter negotiations • make recommendations • act as intermediaries on due diligence issues • negotiate terms sheet	• complete o/s items • final negotiations • finalise contracts • execution of sale • settlement • post sale report	• communication to all stakeholders • develop a transition plan • QA review
Principal/Dealer Involvement	■ □ ■	□ □ □ □	■ □ ■	■ ■	■
3rd Party Involvement	■ ■ ■	□ □ □ □	□ □ □	■ ■	□
Indicative Fees	Please Note: Fees will be tailored for each individual client project. Progression to each successive stage is at client discretion.				

Appendix 2 – Kenyon Prendeville

Fair market Value Assessment (FMVA)

A core competency of Kenyon Prendeville is the production of Fair Market Value Assessment of businesses.

The methodologies we employ are varied and dependant on each individual business, however the constant is the identification of risk.

Within financial planning businesses we believe the risks can be identified best, by conducting a diagnostic on the businesses with particular focus on the practice management sophistication. The greater the existence of processes, corporatised service and the lesser the reliance on individuals, leads to a corresponding reduction of risk to maintainable earnings.

Kenyon Prendeville in conjunction with The Encore Group has devised a process which provides a business diagnostic with a maximum score out of 100 points which is then translated into what risk adjustment or factor is used in all FMVA methodologies.

Our preference is to use several methodologies:

1. A multiple of recurring revenue
2. A multiple of earnings before interest and tax (EBIT)
3. Net profit after tax (NPAT)
4. Capitalisation methodology (maintainable earnings)
5. Discounted Cash Flow

In some instances; when there is an absence of profit or strong EBIT only one methodology can be adopted. This is often a multiple of recurring revenue. Whilst we prefer profit driven assessments we can provide an additional level of comfort by using known last trade sales.

Our FMVA's are structured to provide a price range and to be conservative and can represent a discount to actual market transactions. This is done in the belief that the present market represents a premium given the imbalance in the supply / demand equilibrium.

It is currently a 'sellers' market, however FMVA's are designed to have a currency of at least 12 months. Therefore the need for some conservatism.

The reality is the value of a business is highly subjective, what constitutes risk and the degree that perceived risk is considered is often arbitory. It is often not possible to put an accurate price on a commercial enterprise.

We believe our processes and emphasis on business fundamentals combined with an overlay of current market activities is preferable to an assessment based purely on profit and loss statements.

Business Overview

Commercial				
Structured Board				
CEO / CFO / GM				
Outsourced Advice				
Strategic Direction & Drivers				
Licensing				
Business Premises				
Financial Performance				
- Total Income				
- Net Profit				
- Net Profit Per Person				
Financial Reporting				
Business Plan				
Cash flow Projections				
Management Reporting				
DEBT / Financing				
Reliance On Brokerage				
Marketing				
Target Market Definition				
Branding / Positioning				
Segmented Client base				
Segmented Service				
Segmented Pricing				
Multiple COI's				
Retention Communication				
Promotion Marketing Activity				
Marketing Management				
Client Referrals				
- Numbers per Annum				
- Average New FUM per Annum				
- Number of New Clients per Year				
- New Business				
- New FUM per Year				
Clients per Revenue Producer				
% of Active Clients				
% of Clients Over Age 65				
Allocated Pension % to Total FUM				
Client Surveys				
Marketing Plan				
No Referral Reliance Greater than 20%				

	Not Evident / Poor	Average	Good	
Operations				
Business Processes / Workflow				
Business Systems				
Data Management				
Data & System Security				
Business Documentation				
Risk Management				
Own WRAP / Whitelabel				
Corportised Advice				
Product Risk				
Research				
Intellectual property				
Implementation of FSRA				
Annual Audit				
Compliance Audit				
Complaint History & Current Actions				
Own Licence / Independence				
People				
Organisational Structure / Staffing				
% of Fixed Costs to Gross Revenue				
Corportised Service / Not Principle Dependent				
Role Clarity & Job Descriptions				
Salaried Advisers				
Remuneration, Incentives, Rewards				
Active Succession				
Education				
Performance Management				
Training & Development				
Culture				
Communication				
Tenure / Retention				