Making It Worth More

BY PETER VESSENS

There is no right valuation for a financial services practice. Valuation is what an independent professional third party believes the practice is worth. The sale price is what a buyer is willing to pay. Therefore it’s important to take steps to raise both the understanding and perception of value that has been built into a practice.

Seven Key Steps to Improve Valuation

I believe the following seven steps are key to improving the valuation of a practice:

1. Be team-based, not star-based.
2. Pay yourself a salary and reward yourself with dividends.
3. Move the practice fee-generated income to 50 percent or more.
4. Structure the eight disciplines of managing a practice so that you own only three of them.
5. Provide clear employee ownership of the other five disciplines.
6. Spend 90 percent of your time in client management.
7. Understand your true break-even point and build financial reports that reflect your performance against it.

Be Team-based, not Star-based

We all love being the star. Everyone who works for the star has only one purpose—to serve the star's needs. Unfortunately this approach to a practice has a poor impact on valuation. The reason? If the star leaves, who can replace him/her in the eyes of clients? A top producer at a very large broker-dealer loved his number-one position of the past 10 years but realized his practice was stuck at a production ceiling. The reason? His was a star-centered practice. A decision to restructure the back office and support teams helped him break through the barrier. He redefined job responsibilities to fulfill important elements in the services that clients received. Clients understood that it was the whole team that provided them exceptional service.

Over the next few years, revenues grew more than 300 percent. Everyone was pleased, especially the team. More years went by, bringing discouraging news: The practice had reverted to being star-based. The attraction of being “the star” had proved too great. Revenues still were high but not for long; the star encountered health troubles and production took a tumble. Most of the old team was gone, and the new team didn’t know what to do.

The moral? If your practice is star-based, save a significant percentage of what you earn, because when the star no longer can get on stage, the show is finished.

Pay Yourself a Salary, Reward Yourself with Dividends

Why pay yourself a salary? Isn’t every penny left in the checkbook at the end of the month yours? As tempting as this thought is, especially when a month of great production pays off, it is one of the worst things you can do to the value in your practice.

As good as your personal production might be, keep in mind that you own a business, you are not a stockbroker. The first question any buyer will ask is, “Can I match that production?” The next question a smart buyer will ask is, “How well did you leverage the assets of your practice?” If you were pocketing every leftover penny, the answer is, “Not very well.”

We all want larger incomes. We also want larger net worths. The key to making this happen with any closely held practice is to understand that larger income and net worth is born out of how well you leverage practice assets. To leverage assets more effectively, you first must understand the difference between expenses and costs.

Costs are bad and expenses are good. Costs mean you paid too much for something or incurred payments that you could have avoided. Expenses are something different. Expenses are the payments you make to create and/or leverage assets. Is the money you spend on a computer an expense or a cost? Unless you buy a supercomputer fast enough to solve the human genome, it’s an expense, because it plays an important role in serving your clients and helps generate your revenue. Expenses are assets, not costs.

What is your single largest asset? Your employees. What is their hard asset value? Is it the sum of the wages and other compensations that you provide them. If you do not realize that their compensation is an expense—and hence an asset—you will never leverage them for the value of your practice. Remember, costs are bad, expenses are good.

What does this have to do with paying yourself a salary? The fiscal management of your practice involves understanding three key elements of your bookkeeping: revenue, cost of sales-cost of goods (COS-COG), and general and administrative expenses (G&A).

We all understand revenue: More is better. What frequently gets ignored is how the other two ele-
ments work together to increase valuation. Cost of sales—cost of goods typically represents your marketing, promotion, and prospecting costs. These costs are typically variable; that is, as revenue increases or decreases, COS-COG also tends to go up or down. COS-COG is a variable asset targeted to increase revenue.

General and administrative expenses are all the other expenses of running the practice. They include the lease cost of your office, salaries and wages, taxes, office supplies, travel, technology, telephone, utilities, continuing education, and the entire host of whatever else gets paid to make the practice work. These expenses tend to be fixed; that is, they remain the same every month, whether you have a large production month or a small one.

Paying yourself whatever is left over at the end of the month makes it impossible to determine when the practice actually becomes profitable. It also skewers your ability to determine when an additional investment results in greater revenue and higher profitability. Be smart with your money: Pay yourself a reasonable salary and reward your profitability quarterly with dividend checks.

**Getting Fee-Generated Income to 50 Percent or More**

This is a simple concept. Fees transfer easily to the new owner. Commissions are no better than the next sale. Fees are sold at value. Commissions are sold at value. A highest-paid person in the practice, but many years of taking every penny out of the checkbook in wages each month left him clueless about what he needed to invest to break past seven years of a production ceiling.

What did the banker see that motivated his offer? He saw the financial reports to a bank and showed them how he had changed the fiscal management of the practice. Forty-eight hours later the bank offered a $1-million line of credit at 0.25 percent below prime on a signature. Four years later revenues had more than quadrupled and the line of credit never was used again.

What made the difference? Restructuring his chart of accounts, using an accounting package, and using a customized spreadsheet allowed him to assign a staff person to enter values. He also went on a salary plus quarterly dividend payments from profits.

Suddenly, he saw his true break-even and how modest amounts of growth produced large increases in profitability. A growth plan called for an investment of a six-figure amount. He did not have this amount in reserve capital. He took the financial reports to a bank and showed them how he had changed the fiscal management of the practice. Forty-eight hours later the bank offered a $1-million line of credit at 0.25 percent below prime on a signature. Four years later revenues had more than quadrupled and the line of credit never was used again.

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Continued

up upon your lifestyle through the dividends the practice earns for you.

The next concept requires that you throw out the traditional definition of break-even. This definition states that break-even is when

\[ \text{Expenses} + \text{Taxes} + \text{Depreciation} = \text{Revenue} \]

I would like you to adopt the following new definition of break-even:

\[ \text{Fixed Expenses} + \text{Variable Expenses} + \text{Taxes} + \text{Depreciation} + \text{Targeted Profit} = \text{Revenue} \]

Why is this an important change? Let’s start with why I separate fixed from variable expenses. In most financial services practices I have worked with, fixed expenses fall between 45 percent to 75 percent of break-even. What does this mean?

Let’s assume your practice’s fixed expenses are 50 percent of break-even. Variable expenses move up and down consistently with the rise and fall of revenue. Fixed expenses do not change with changes in revenue. In simple terms, this means that a $10,000 increase in revenue above break-even will result in 50 percent of $10,000 going to net pre-tax profits.

Understanding this simple principle allows you to plan and project how increases in variable expenses (e.g., a new marketing/prospecting campaign) can be underwritten to produce increases in revenue that can create dramatic increases in profitability.

What are targeted profits, and why are they an expense? The following are the only five ways that a company can use a profit:

1. Cash reserves
2. Investment in growth
3. Investment in risk
4. Employee incentives
5. Dividends

Unless your practice never has an off month, you should maintain some cash reserve to ensure stable cash flow.

Investment in growth is a critical element of any business. If you do not invest in growth, your business eventually may die.

Investment in risk is similar to investment in growth. The difference is that growth is expanding what you already do, while risk is expanding into something new. An example: An advisory firm decides to open a branch office on the opposite side of the metroplex to provide greater convenience for existing clients and expand opportunity for new clients. That is growth.

Another example: An advisory firm decides to partner with a law firm to offer trust and estate work to clients. That is risk—something they have not done before.

I label the monies set-aside for cash reserves, growth, and risk as targeted profit. It is the portion of this year’s profit reserved for next year’s business practice, and as such should be included as an expense for evaluating the fiscal management and strategies of your practice.

Now that you understand your true break-even and can reflect it in simple-to-read, easy-to-understand financial reports, buyers can see how you have been profitable and what they would adopt or change to sustain their own profitability. Good disciplines in financial management and reporting can increase the multiples of valuation.

Follow these seven steps in your practice and watch the value of your practice climb.

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