Key Value Drivers in Wealth Management Firms

By Patrice Radogna, ASA, CBA, CVA, CPA

Wealth management firms are brimming with talent, brain power, energy, and most importantly, revenue-generating capacity. These firms come in many shapes and sizes, and they vary widely in terms of the key components that drive value. As such, the valuations of wealth management firms present a number of special considerations.

Tangible assets are negligible among wealth management firms. The major driver of value is a two-legged asset that goes home every night—the human capital. Business typically is based on close personal contacts, mutual trust, and the collective reputation of the firm and its key professionals. The longevity and predictability of those assets are difficult to ascertain—and, in many cases, firms do not have legal rights to those assets except for those cases in which employment agreements have been signed.

Approaches to Valuation for Wealth Management Firms

Within the valuation industry, the three approaches to valuing a business are the asset approach, the income approach, and the market approach. The asset approach is typically best suited to value businesses rich in tangible assets or non-operating entities. Wealth management is a human capital-driven business, which is measured through the financial operating results of the business. Thus, the income and market approaches are best for valuing a wealth management firm. This article focuses on elements of the income approach and the market approach and their applicability in valuing wealth management firms.

Income Approach: Use of Historical Financial Information or Forecasts

The build-out of forecasts can be a daunting task. The two primary methodologies within the income approach are capitalization of cash flow (CapCF) and discounted cash flow (DCF). CapCF measures and determines value based on capitalizing a normalized cash flow amount that is viewed as representative of normalized financial performance. To the extent that the business is mature and the past is deemed to be a predictor of the future, a valuation professional may find CapCF the best method to employ. Oftentimes, however, the future direction of the firm is expected to vary from the historical results. This situation is best addressed through use of the DCF methodology.

Revenues of wealth management firms are a function of price and quantity. Price is usually stated in terms of basis points earned on assets under management (AUM) and quantity reflects the asset base, or AUM. Revenues for wealth management firms are not secured by long-term contracts and thus can provide challenges to building (or relying on) defensible forecasts beyond one year (much less two years). Current operating data may be relied upon when the level of client retention is high and when the fee structure is predictable. But revenue can shift due to unpredictable swings in market performance, cost drivers can change, or the business may not be mature; these conditions make the use of current operating data tenuous. In cases with a reliable track record or several likely scenarios on the horizon, our firm has worked successfully with clients to create sophisticated expected cash flow models based on various scenarios that consider all operating characteristics and pertinent drivers of value.

Because forecasts are subject to market expectations and are tied to shifting business dynamics, valuation professionals are dependent on management to prepare forecasts based on a soft set of assumptions. What if the valuation professional examines the financials and deems that client’s assumptions depart significantly from historical results with no supportable rationale? The valuation professional will lean on industry knowledge, the market-data trend, and drivers, coupled with the client’s input, to build defensible forecasts.

Forecast risk tends to be greater for smaller wealth management firms than for larger firms, due to smaller firms’ dependencies on key personnel and client concentration issues. The loss of either of these could significantly change the smaller firm’s projected path. This risk is mitigated in medium- to large-size firms because they have deeper benches of seasoned professionals with a larger pool of intellectual capital. Additionally, the intangible assets of a larger wealth management firm tend to be embodied in the collective knowledge of the firm’s culture, which is largely recognized as corporate branding. A wealth management firm that has built a reputation of consistently delivering a superior product that is backed by a strong track record and delivered by high-quality professionals has created distinctive branding, which enhances value.
In general, higher value, developed using the income approach, will be attributed to wealth management firms with the following characteristics: larger size, longevity, depth of personnel, increased brand awareness, diverse client base, and differentiation/sophistication of services. This translates into value to the extent that an investor would attribute lower company-specific risk (in the form of a “required rate of return” for investing in the company) when determining value via an income-based approach, or a higher multiple when determining value via a market approach. All other things held equal, holding the average AUM fee constant, the lower the risk attributes, the higher the firm value.

**Market Approach to Value Wealth Management Firms**

In addition to the income approach, the market approach is often applicable to valuing small- to medium-size closely held wealth management firms. A plethora of pricing data is available, and valuation professionals must guard against blindly applying the observed market data. There are two primary methods to employ the market approach—by developing valuation multiples implied by outright sales of similar businesses (the Transaction Multiple Method or TMM), or by obtaining the trading activity and valuation multiples in shares of publicly held companies (the Guideline Public Company Method or GPCM).

Publicly traded wealth management firms are large and diverse, and they are quite different from small privately held wealth management firms. Therefore, when dealing with small/medium-size firms, we tend to focus on TMM rather than GPCM. TMM provides data on more similar-sized, private companies, which may have a more-similar operating platform to our smaller/medium-sized wealth management firms. GPCM data (as compared to small/medium-size firms) are generally a poor fit because of significant differences in the size of the companies, the fact that public companies are subject to different influences on value, and that public companies may be significantly more diversified than closely held wealth management firms.

In the end, a valuation professional simply must recognize the strengths and weaknesses of each dataset—TMM or GPCM—when applying one of them in the market approach. Based on the quality and quantity of market data, the valuation professional may apply TMM or GPCM to determine value or to check results from the income approach, depending on the market data available. It is not uncommon for market data to call into question the credibility of client-driven forecasts, which form the basis of the income approach.

Another relevant point regarding market data: Small- to medium-size wealth management firms often contemplate implied value, as a multiple of revenue, in lieu of focusing on value as a multiple of earnings.1 The rationale is that the operating structure, practices, and expense structure may vary widely among firms, especially when it comes to partner compensation and employee bonuses. In addition, many smaller to mid-size wealth management firms are not encumbered with external third-party financing and therefore are not required to have audited financial statements. Thus, the financial statements often are not reviewed or audited by an accounting firm, increasing skepticism from acquiring firms about the expenses represented on the income statement. For these reasons, buyers often will focus on the firm’s revenue-generating capacity. They will determine value in relation to the level of expected continuing revenues, and they will institute their own practices and expense structures in generating revenue forecasts. The multiple considered applicable to a given company is determined largely by an analysis of many items discussed here.

Industry data from MergerStat and Capital IQ databases support the wide range of multiples applied to wealth management firms. Average revenue multiples based on a search for wealth management firms range from 0.25X up to 6.26X, with a median of 1.73X. Due to this wide range of multiples, a valuation professional needs to appreciate how the qualitative factors of the wealth management business come into play in determining if a reasonable multiple for a subject firm is on the low or high range of the stated revenue multiples.

**Key Drivers of Value**

The key data that a valuation professional should focus on are the following:

- Recurring client base, characterized by amount of repeat business
- Revenue growth, segregated into organic versus market growth
- Revenue source, commission-based or fee-based
- Size of the wealth management firm, because scale matters
- Client demographics, including client concentrations, client tenure, new-client ratio, client age
- Compensation and expenses of management
- Life stage of company—start-up, expansion, or mature
- Sophistication and quality; differentiated, sophisticated services command higher management fees and mean higher profitability
- Business model; is the firm offering integrated advice (i.e., financial planning, risk management) with higher margins in addition to traditional asset management services?
- New-business alliances; does the firm have an alliance with a broker–dealer that enables it to offer additional products but remain independent?
- Longevity—the longer the firm has been in business, the more stable the revenue base and stronger the corporate brand
- Employee demographics, including number of employees, tenure, relationships with clients; these factors provide insight to collective knowledge, reputation, and branding of a firm.

**Example: Two Wealth Management Firms**

We have valued many wealth management firms over the past several years. Below is a case study of two wealth management firms that operate similar business platforms but differ significantly in key characteristics. Table 1 illustrates the variety one can encounter when valuing two companies operating in the same industry:
Table 1: Comparison of Valuation Factors for Two Wealth Management Firms

<table>
<thead>
<tr>
<th>Factor</th>
<th>Wealth Management Firm #1</th>
<th>Wealth Management Firm #2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Longevity</td>
<td>In business for 25 years</td>
<td>A business division (of a larger firm) that commenced three years before valuation</td>
</tr>
<tr>
<td>Branding</td>
<td>Ranked as one of the top 25 wealth management firms in the United States</td>
<td>Reputation of the firm is closely aligned to the company’s founder</td>
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<tr>
<td>Size</td>
<td>Almost $250 billion AUM</td>
<td>Approximately $1 billion AUM</td>
</tr>
<tr>
<td>Historical Growth</td>
<td>Compound annual growth rate of 15 percent over the past 12 years</td>
<td>Growth from no meaningful revenue in 2011 to approximately $4 million in revenue in 2013</td>
</tr>
<tr>
<td>Revenue Model</td>
<td>Flat-fee revenue model, in response to client demand, accounts for more than 70 percent of revenues</td>
<td>Commission-based model</td>
</tr>
<tr>
<td>Profitability</td>
<td>Profit margins exceed industry norm</td>
<td>Profit margins below industry norm</td>
</tr>
<tr>
<td>Top Management</td>
<td>20 directors who manage the firm and bring in revenue</td>
<td>One director who is also the chief investment officer</td>
</tr>
<tr>
<td>Depth of Employee Base</td>
<td>Deep bench of employees</td>
<td>One credentialed employee in the investment division</td>
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<tr>
<td>Client Concentration Risk</td>
<td>Diverse client base with less than 10 percent of revenues coming from the aggregate of the firm's top 10 clients</td>
<td>Approximately 83 percent of revenues are derived from the top two clients; one of the two clients has been a client for approximately one year</td>
</tr>
<tr>
<td>Client Retention</td>
<td>Client loss ratio of less than 5 percent over the past 15 years</td>
<td>Client number one (first institutional client with a track record for this firm) has been a client for two years but relationship is in jeopardy because return is below client's established benchmark return</td>
</tr>
<tr>
<td>Industry (market sector) Risk</td>
<td>Diverse market sectors (attracts funds from different market sectors); no more than 28 percent of revenues come from any one market sector</td>
<td>Two top clients are both pension clients, which, to date, represent the only institutional money</td>
</tr>
</tbody>
</table>

Wealth Management Firm #1

**Purpose of the valuation:** Shareholder buy-ins and buy-outs. We completed annual valuations to set equity value for the purpose of buy-in/buy-out related to shareholder transactions.

**Primary valuation approach:** Income approach. Specifically, we performed a five-year discounted cash flow analysis with a relatively low discount rate due to perceived low forecast risk for this company. We also considered a significant sample size of transactions in the marketplace and used the market approach to compare how the implied market multiples, developed from the income approach, compared to market multiples from private transactions in the marketplace.

Wealth Management Firm #2

**Purpose of the valuation:** Stock equity compensation. Our firm was hired to determine the base price of the company in order to determine growth in value in subsequent years for the existing shareholder base.

**Primary valuation approach:** Income approach. Unlike Wealth Management Firm #1, we could not rely on a single-point DCF due to risk patterns shown in table 1 as well as myriad possible paths in the near future for Wealth Management Firm #2. With significant input from management, we prepared a probability-weighted cash flow scenario considering four different scenarios (including a 25-percent weight in a scenario that the company would be out of business in three years, consistent with fallout from potential loss of its founding and largest client). Preparation of each of these cash flow forecasts considered (1) compensation schemes, (2) changes in significant value drivers, (3) differing market expectations, and (4) risk characteristics.

Although both firms have talented personnel providing sophisticated services to their respective client bases, significant differences in the fact pattern exist between the two companies. It should be no surprise that the value results of Wealth Management Firm #2 were much lower in terms of a concluded value and implied valuation multiple than Wealth Management Firm #1.

**Concluding Thoughts**

Wealth management firms are sensitive to many assumptions that need to be contemplated carefully in the valuation process. If significant value-driving factors and potential risks for a company are not identified, or are mischaracterized, the results may be illogical in relation to the underlying fact pattern. A deep understanding of any wealth management firm, and analysis of meaningful documentation and facts in each case, could be the difference between a supportable value conclusion and one that can be challenged easily by a third party.

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**Endnote**

1. Note: The valuation of larger wealth management firms typically also will incorporate reliance on a multiple of adjusted earnings. This may be more applicable when reviewed/audited financials are available and when adjusted earnings can be computed.