

So, What Are You Worth?

For sellers it's back to the future, but for buyers, it's here and now.

Glenn Kautt, CFP, EA

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The other day my 18 year-old daughter strolled in and started a conversation with: “Dearest Father of mine....” I knew I was about to be hit up for some quick cash. A large part of my value to her at that moment depended on a) what I had in my pocket and b) my inclination to part with it. As a result of that conversation, I was worth at least \$20. A few days later, as a result of a stern conversation about some promises not kept by her I’m sure she felt my value was less than zero. Even so, she paid attention, so I’m presuming she considered the positive value in maintaining a good family relationship because of the expectation of vast amounts of future cash flows for college.... It’s interesting how an individual’s perception of value in someone or something hinges on both immediate returns and future expectations. That’s the subject of this column.

I attended a conference put on by a well-known firm in our industry to learn if I was worth anything. Well, actually, I went to find out if the firm where I’m working is worth anything. The meeting was an eye-opener. It was not your average financial planning gathering—there were experts on valuation, legal and tax issues of merger/acquisitions, and business practices. Frankly, a lot of what you read in the press about transactions doesn’t tell the whole story, and the message of the conference was: be very careful how you analyze value. That meeting made me look in a new way at my value to my firm, and how it relates to developing an exit strategy.

Soon after, I attended a breakfast meeting with a colleague of mine who owns a large firm. I asked him a simple question: “In terms of your exit strategy, what do you think you’re worth?” He thought for a while but couldn’t come up with a quick answer. In my mind, the answer was simple: he isn’t worth anything. This wasn’t a trick question, but it does expose what many practitioners fail to realize. You aren’t worth a dime to the firm

after you're gone. Yes Virginia, there is a Santa Claus, but he isn't going to pay you for sticking around after you've sold him the firm.... So, if you're wondering how to *create* value, review the past two years of John Bowen's excellent columns in this magazine. On the other hand, if you're wondering how to *measure and predict* value for the company you're running, read on.

Show Me The Cash Flow!

The most appropriate analytical method to measure the value of an investment advisory business is the discounted cash flow ("DCF") model. You may think some multiple of revenues, earnings or assets under management is better. Sorry, it isn't. It's easier, but not as accurate. Accept the fact everyone valuing your firm will use a DCF analysis in combination with a subjective review. DCF analysis measures expected future returns in the form of future cash flows, discounting them to a present value. The appropriate discount rate is developed using the risk free return, market returns and adjustments for uncertainty of the future returns.

Developing a DCF model gives you a good picture of the key drivers of value: expected growth in operating earnings, operating efficiency, cost of capital and expected duration of growth. An added bonus is a DCF analysis is less likely to be manipulated by aggressive growth estimates, as they are plainly visible in the analysis. DCF takes into account changes in growth, whereas revenue multiple models assume constant growth, which is unlikely.

Spreadsheet or Crystal Ball?

To see how this works, calculate this year's net cash flow, which is profit after all expenses including a reasonable salary for you (somewhere between \$50-250 thousand, depending on the size of your firm and gross revenue) before paying interest or taxes. Finance types call that number "Earnings Before Interest, Taxes, Depreciation and Amortization" ("EBITDA"). If you don't have any EBITDA at this point, your firm isn't worth anything to an outside buyer. Remember, value is based on a return *on* investment—without working *in* the investment.

Some of you are squirming in your seats right now because you *just know* there's value in a firm even if it doesn't show any EBITDA. If so, you're assuming future value based on the development of EBITDA through some combination of increase in revenues and decrease in costs. Since there will be future value, it can be discounted back to some positive present value, and *volia!* you've created value.

Well, here's the rub. For this flat-liner, you only create value in the future by investing your energy and time when you jump right in, hit the ground running and whip that puppy into shape. However, since the inertia of most flat-lined firms will not carry them to great new heights even with a new general manager, they aren't worth much if EBITDA is not currently present. You've just valued yourself, or more accurately, your investment of effort. A buyer taking over the firm can't—and won't—do that. Remember, in terms of your exit, you're worth nothing.

When projected revenues and earnings for the next three years, you face the same dilemma other business owners face each year: trying to project the future. Because it gets a hazy after a couple of years, valuation experts estimate future EBITDA three years for analyses, or at best five years for the most mature and stable companies.

To complete the DCF analysis, you need a discount factor. Mathematically, this is the rate of return which, when applied to a series of equal future cash flows from an initial investment, yields a net present value of zero. Put another way, it's the expected return on a zero growth asset. Based on many years of education, research and work in this area, as near as I can tell, developing the proper discount factor for a growing small firm is part art, part science and part voodoo economics. For our industry, the range for most small firms is about 14% to 27%, based on size, stability, margins and growth rate.

In other words, investors expect to make no less than 14% to 27% from the investment based on several factors. The larger the size, the greater the stability, the higher the margins and greater the growth, the smaller the appropriate discount rate. This makes

sense. As the uncertainty of future returns diminishes (think bonds) the acceptable rate of return diminishes. For firms with EBITDA of \$3 million and up, discount rates might hover in the 10% range. Strategic buyers are willing to pay more, with discount factors as low as 6-7% for very large firms. They assume synergies of combining business will result in well above average growth, yielding returns much more than the discount rate.

I haven't mentioned some multiple of gross revenues, assets under management, number of clients, types of clients, fees vs. commissions, margins or anything else in this calculation. That's because the way you do business and these things all contribute to EBITDA. Buyers look first at your EBITDA, then what you're doing to generate it and your prospects for improving it in the future.

Up Your P/E!

By now, you might have figured out 1 divided by the discount factor equals the P/E for a public firm. Remember, investors only see "E" as dividends, but if you are a "pass-thru" entity (LLC or S Corp.) then "E" becomes EBITDA for the purposes of our calculation. So, in this article, we'll refer to P/E for public firms and P/EBITDA for pass through entities. Several years ago I realized two things: I had to concentrate on things to increase our value and EBITDA, and figure out how to get the whole thing running without me, since I'm worthless, anyway. Remember, value is improved by higher margins, greater stability and size, and rate of growth. I wondered what the impact of growth would be on value, so I ran the DCF analysis on our firm using historical and projected data.

For our firm, historical annual growth in revenues has averaged slightly over 27%. For the interesting 1999-2004 period annual growth averaged nearly 17%, and I estimate we can continue to grow at 20% annually for at least seven more years. Margins have remained essentially constant at 46%; thus relative EBITDA does not have to be adjusted for increasing revenue growth. Because of the organization and size of our firm, our discount rate is 12.7%.

Using these assumptions, when we forecast zero growth, our P/E works out to 7.36. Forecasting growth at 9%, P/E jumps to 10.98. (I don't have room for the math here but note this is not a simple division calculation. It is a discounting of future growth for a period, combined with a zero growth model thereafter.) Growing at 12% means the P/E goes to 12.68. Growing at 20% annually yields a P/E of 18.69. By way of comparison, Russell's new Micro-Cap Index with companies with market capitalization from \$50 to \$500 million has a P/EBITDA of 21. This means investors are expecting growth in the 25% per year range. I increased the discount factor to 17% to see what happens if we assume more risk or earnings volatility in the forecast. At zero growth, our P/E is 5.54. At the other end of the forecast, growing at 20% yields a P/E of 12.07.

The P/EBITDA sale range for medium-size, well run investment management today is 6-7. For smaller firms it is 4-5. This means they aren't paying much, if anything, for future growth. This should be a wake up call for financial advisors who are looking to cash out at some point in the future. It was for me. Since prospective investors are like my daughter, both whom have expectations of future cash flows, I better get working growing the firm for when I'm put out to pasture, worthless.

Glenn G. Kautt, CFPTM, EA is president of The Monitor Group, Inc., a wealth management firm in McLean, VA. To read more of this thoughts, visit www.themonitorgroup.com.