

The Technology Impact on Business Valuation

Optimizing and monetizing your life's work



THOUGHT LEADERSHIP FROM A TECHNOLOGY LEADER

Change is a constant in the wealth management industry, yet the pace seems to be accelerating these days, with a number of macro trends picking up steam and converging at once.

60%

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The M&A wave in wealth management

With the unstoppable passage of time, the wealth management industry has been characterized as "aging advisors serving aging clients." Not only is the baby boom generation well into retirement age, but the average principal of an advisory firm is nearing 60. Nipping at the heels of these mature firms are new, technology-powered competitors. Robo-advisors may no longer be leading news, but now we're also seeing discount brokers and big asset managers unbundling TAMP services, adding online CFPs and driving investment management fees to zero. This is one of many factors aggravating pricing pressures—according to Fidelity's 2017 RIA Benchmarking Report, 60% of advisors are regularly discounting fees.

Technology is having an impact on client expectations as well. Call it the "Amazon effect"—more and more people across all demographic segments expect to get whatever they want, whenever they want it with the click, swipe or tap of a finger. Wealth managers are facing pressure to deliver on the digital experience clients expect and increasingly demand.

Other forces at work are beyond the managers' control. Whether the Department of Labor fiduciary rule is truly dead or simply stalled remains to be seen, but regulatory change is constantly requiring more disclosure, transparency and documentation of processes. Meanwhile, prognosticators are saying that the long-running bull market is running out of steam, and recent volatility has made "buy and hold" investors understandably nervous. And just as advisors are struggling to attract new

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— Dan Seivert, CEO of Echelon Partners

clients, they are also competing fiercely for talent. Fewer advisors are entering the industry, and those that are pretty much have their pick of places to work.

It's enough to make even the most durable wealth managers dizzy. And it explains, in large part, the wave of consolidation rippling through the industry, as retirement-age advisors decide its time to hang it up and seek to exit the business in a position of strength.

In this more complex and competitive environment, economies of scale make merger and acquisition opportunities quite compelling. With compliance requirements driving up operating costs, smaller firms are feeling pressure to become part of larger firms. More established firms, in turn, are looking for ways to acquire experienced talent and absorb more assets into their existing infrastructures.

As a result, M&A activity in the industry is at peak levels. Fueling this trend is an influx of new alternative financing sources like Succession Lending (a specialist in RIA deals) and Live Oak Bank (with its focus on small business owners), as well as a variety of private equity and debt firms.

All of this is creating opportunity for both buyers and sellers. For buyers, it's a chance to leverage their back-office efficiency and

gain scale without a significant increase in operational overhead. For sellers, it's an opportunity to optimize the value of their life's work. With an estimated 10 buying firms for every seller, it's widely viewed as a seller's market for the foreseeable future.

So what can sellers do to ensure they make the most of this once-in-a-lifetime monetization opportunity? This white paper identifies key business valuation drivers that advisory firms can deploy to enhance their business value.

Business valuation drivers

Strategic M&A advisors use a variety of methods for valuing RIA businesses. For instance, Echelon Partners, a Manhattan Beach, CA-based investment banking firm focused on M&A in the investment industry, bases valuations on a multiple of earnings before interest, taxes, depreciation and amortization, or EBITDA. Other firms may use multiples of cash flow or net income. Regardless of the method, advisors to potential buyers or sellers are looking to arrive at a fair indicator of future earnings that the buyer is likely to accrue.

Multiples can range from 3x to 12x earnings or cash flow. Echelon arrives at its multiples by scoring target firms on several key value drivers.

The cumulative score on all these factors determines the multiple:

- Financial performance
- Clients and client service
- Human capital
- Business process and operations
- Portfolio management
- Sales and marketing
- Legal and governance

For firms interested in selling, that raises an important question: what can you do to increase your cash flow and, by extension, your multiple?

Leveraging technology to optimize value

Dan Seivert, CEO of Echelon Partners, agrees that technology is one key lever firms can employ to positively influence their valuation. "Technology can produce savings by reducing the amount of time spent on repetitive tasks," he notes, "but it also frees up capacity to spend more time on marketing and client service. So technology has a dual benefit, not only cutting costs but also helping drive revenue growth."

Figure 1: Leveraging technology to increase profitability and value

	Industry Benchmark	\$1 Billion AUM Example	After Technology	\$1 Billion AUM Example
Revenues	100%	\$7,000,000	100%	\$7,000,000
Direct Expenses	40%	\$2,800,000	40%	\$2,800,000
Gross Profit	60%	\$4,200,000	60%	\$4,200,000
Overhead Expenses	40%	\$2,800,000	30%	\$2,100,000
Operating Profit (Cash Flow)	20%	\$1,400,000	30%	\$2,100,000

Of course, this assumes a firm has a strong technology platform and efficient processes built around it. An integrated technology stack, in which core applications communicate and share data seamlessly, further enhances efficiency by streamlining workflows, eliminating manual workarounds and reducing operational risk. Cloud deployment also helps contain costs by reducing the internal IT footprint and the corresponding need for in-house support.

Having a robust client portal can also help reduce overhead by enabling a high level of self-service for clients and reducing the time staff spends handling routine client inquiries and requests. Online reporting cuts servicing cost further by eliminating the mailing of statements. And with account aggregation capabilities that enable firms to report on each client’s complete wealth picture, advisors stand to garner a larger share of the assets of existing clients without incurring prospecting costs.

Finally, firms that have well documented, institutionalized processes that can be easily transferred to a new owner will have an advantage in the M&A market. Moreover, having a proven, widely used and well-known technology platform at the core of your business, backed by a reputable provider with a track record of investing in continuous improvement, can add incremental points in your favor.

The power of technology leverage

It stands to reason that a more efficient operation is likely to be more profitable and hence more attractive to buyers. But what does that translate to in valuation?

For all RIA firms, profit and loss consists of two line items: direct expense, meaning the cost of advisors, and overhead, meaning the back office, administrative staff, compliance, and everyday operating expenses such as rent. What’s left is the profitability or cash flow of the firm.

Given the competition for talent, cutting advisor salaries is not an option. Any effort to reduce expenses has to focus on the back office. As noted earlier, experts agree that firms can and should leverage technology to drive greater profitability and cash flow, by increasing both back office efficiency and front office productivity.

Let’s look at a hypothetical firm with \$1 billion AUM, \$7 million in revenue and, based on industry standard expense benchmarks, \$1.4 million in operating profit (see figure 1). Based on the cumulative score on its key value drivers, it has been assigned a 7x multiple, for a valuation of \$9.8 million.

Let’s further assume that a state-of-the-art, integrated wealth management technology platform could reduce overhead expenses by 10%, effectively raising profitability to \$2.1 million. That only reflects expense reduction and does not take into account the opportunity to grow revenue created by the new technology. However, the improved

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profitability and process efficiency elevate the firm's multiple to 7.5x. Now, the valuation is \$15,750,000—or \$5,950,000 higher than it would be without the implementation of advanced technology.

Of course, there may be other variables in this scenario, such as the time it takes for cost reductions to hit the bottom line. The point remains, however, that an investment in a better technology platform can produce returns in the millions when it comes time to sell. That is the power of leverage that technology has the potential to produce.

Get the most value for your life's work

The time to think about ways to maximize the value of the business you've built is well before you start putting feelers out in the market. Some of the variables that affect valuation are out of the firm owner's control, but one is very much within your control: your technology investment. The right technology can lower expenses, increase scale, power growth, improve client retention and streamline the business—all the factors that ultimately improve cash flow, as revenues rise while expenses stay flat or even decline. Even in a seller's market, firms that have invested wisely to keep their technology up to date are bound to stand out.

About the Black Diamond® Wealth Platform

With the Black Diamond® Wealth Platform as the hub of your advisory business, your firm will be better positioned to maximize its value in the marketplace. Black Diamond delivers the operational efficiencies and productivity gains that have a direct impact on increasing cash flow. In addition to performance reporting, rebalancing and client billing functionality, the platform encompasses daily reconciliation services, and features an award-winning client portal with mobile access and self-service capabilities.

Black Diamond also has integration partnerships with a growing ecosystem of complementary solutions, including financial planning, portfolio analytics, risk profiling and CRM software, as well as access to traditional and alternative managed account platforms.

For more information

If you have questions about this paper, or would like to learn how the Black Diamond Wealth Platform can support your business, call **1-800-727-0605** or email **info@advent.com**. You can also visit **blackdiamond.advent.com**.