Valuation of Investment Management (“IM”) Firms

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Agenda

- Part I: Operating Trends
  - Death (and Rebirth) of Equities
  - Pressure on Profitability
  - Is the Industry Becoming Commoditized?

- Part II: Valuation Considerations
  - Concepts of Value
  - Valuation Approaches
  - Other Valuation Considerations
  - The Valuation Gap

- Part III: The Art of the Deal
  - The Decision to Sell
  - Deal Types & Typical Structures
PART 1:
Operating Trends
Death of Equities?

✦ “The Cult of Equity Is Dying.” Bill Gross

✦ Is the above statement true? Data through the end of 2012 supports the notion that investors are falling out of love with equities.

✦ In 2012, equity mutual fund flows were negative for the fifth straight year, while inflows to bond funds remained robust (Details on next slide).

✦ Returns on bonds have experienced an unprecedented run in the past twenty years.

✦ Since bond funds have lower fees, this has directly impacted the profitability (and ultimately the value) of asset managers.
### Operating Trends (II)

**Death of Equities?**

Investment Company Institute ("ICI") Data Supports the Decline in Equities through 2012, BUT...

<table>
<thead>
<tr>
<th>Year/Quarter</th>
<th>Mutual Fund Flows ($B)</th>
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<tbody>
<tr>
<td></td>
<td>Equity</td>
</tr>
<tr>
<td>2008</td>
<td>$(234)</td>
</tr>
<tr>
<td>2009</td>
<td>$(9)</td>
</tr>
<tr>
<td>2010</td>
<td>$(37)</td>
</tr>
<tr>
<td>2011</td>
<td>$(98)</td>
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<tr>
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<td>2Q 2012</td>
<td>$(18)</td>
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<tr>
<td>3Q 2012</td>
<td>$(52)</td>
</tr>
<tr>
<td>4Q 2012</td>
<td>$(70)</td>
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Rebirth of Equities?

ICI Data show that flows to equity funds totaled $38 billion in January 2013. This was the largest monthly net inflow post-financial crisis.

Equity fund inflows outpaced bond fund inflows for the first time since January 2011.

Virtually all equity indices have posted positive returns YTD through March 15, with the S&P 500 and Dow Jones Industrial Average trading near all-time highs.

Key Takeaways?
Operating Trends (IV)

Profitability Is Under Pressure

- A recent study by Booz & Company has outlined several areas that impact the profitability of wealth management firms (*U.S Wealth Management Survey: Trends and Emerging Business Models*).

- Areas negatively impacting profitability include pressure on management fees, preference for less risky products, more simple mandates, and increasing regulation.

- Areas positively impacting profitability include offering integrated advice with higher margins, i.e., financial planning, risk management.

- In response to the profitability challenges, Booz has outlined the following priorities for wealth management firms: (1) right-size the cost basis; (2) upgrade organic growth capabilities; and (3) explore new sales formats and business models, i.e., the hybrid model.

- In the hybrid model, an RIA forms an alliance with a broker-dealer. This enables the owner of the RIA to offer additional services while still remaining independent.
### Operating Trends (V)

<table>
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<tr>
<th>Profitability Driver</th>
<th>Trends</th>
<th>Impact on Profitability</th>
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</table>
| Pricing              | • Greater price sensitivity in low return environment  
                        • Pressure on management fees  | Down |
| Assets               | • Lower asset values have decreased earnings  
                        • Preference for simple, less risky, and transparent products  | Down |
| Mandates             | • Simplicity and transparency reduce clients' willingness to delegate wealth management (fewer discretionary mandates)  | Down |
| Holistic Advice      | • Offering integrated advisory services (e.g., insurance, financial planning, risk management) with higher margins  | Up   |
| Tailored Offerings   | • Can be addressed via modular product architecture  
                        • Complex products will return, but with lower margins  | Up   |
| Regulation           | • Increasing requirements regarding operations, IT, reporting, data security, regulation, etc.  | Down |

**Priorities**

1. Right-size the cost base
2. Upgrade organic growth capabilities
3. Explore new sales formats and business models

Source: Booz & Company
Is the Industry Becoming Commoditized?

- Execution of trades has become commoditized, driven by technology and the rise of online brokers like E-Trade and Charles Schwab.

- Index investing has become commoditized with the acceleration of ETFs. Similarly, active management has more recently become commoditized through the rise of actively managed and alternative ETFs.

- The above factors have undoubtedly impacted the industry. Nonetheless, the industry has shown resilience by focusing on the unique needs and complex circumstances of the client. Additionally, since outcomes (returns) can vary greatly, it appears that commoditization will continue to be a nagging threat, rather than a fatal one.

- These factors affect IM firms’ operating risk and competitive advantage period, which are key elements of valuation.
PART 2: Valuation Considerations
Valuation Considerations (I)

Value Drivers for IM Companies

- **Size** (reaching scale is important)
- **Revenue Growth** (organic growth or market growth)
- **Revenue Source** (commission-based or fee based)
- **Client Demographics** (client concentration, client tenure, new client ratio, client age)
- **Relationship of Revenue to Owner of Firm**
- **Compensation and Expense Management**
- **Employee Demographics** (number of employees, tenure, relationship with clients)

These are factors that should all be considered by the valuator and directly impact company-specific risk (as well relative valuation multiples).
Valuation Considerations (II)

Concepts of Value

- **Valuation Date**: Usually determined by a specific event.

- **Purpose** (gifting, financial reporting, transaction): Valuations performed for one purpose are not necessarily transferable to another purpose.

- **Standard of Value**: A legal concept which influences the selection of methods and level of value. Most common include fair value and fair market value.

- **Level of Value**: Value can be different depending on the level of value under consideration. Levels of value range from non-marketable minority positions to strategic control positions. The chart on the next slide highlights the attributes of the different levels.
Valuation Considerations (III)

Levels of Value Chart (source: Mercer Capital website)
Valuation Considerations (IV)

Valuation Approaches Employed in the IM space

- **Income Approach**
  - Capitalization
  - Discounted Cash Flow

- **Market Approach**
  - Guideline Company Method
  - Guideline Transaction Method

- **What About Rules of Thumb?**
  - Application
  - Example
Valuation Considerations (V)

Capitalization of Income Method

I. Derive Income Base

- The goal is to arrive at a normalized level of earnings (usually cash flow), which can be capitalized to derive a value.
- Non-recurring items should be adjusted out (examples include, gains and losses, extraordinary fees/expenses)
- Normalizing adjustments should be made (officers’ compensation restated to market, i.e, replacement value).
- Question: Is normalizing officers’ salary appropriate for valuations of minority interests?
Valuation Considerations (VI)

Capitalization of Income Method

II. Determine Discount Rate

♦ Equity Cash Flows—Discount Using Cost of Equity
  ➢ Components include: (1) the risk-free rate; (2) equity risk premium; (3) size premium; and (4) company-specific risk premium.
  ➢ Two common methods for estimating the cost of equity include the Capital Asset Pricing Model ("CAPM") and the Build-up (Beta-adjusted or Plain).
  ➢ Cost of equity for investment management firms typically ranges between 10% and 20% (varies depending on size and risk profile of the subject).

♦ Debt Free (Invested Capital) Cash Flows—Discount Using Weighted Average Cost of Capital (WACC)
  ➢ The required rate of return on all invested capital is the WACC, which is developed by: (1) separately estimating the costs of equity (as discussed above) and debt; and (2) weighting these costs based on an assumed capital structure (using market participants as a guide).
Valuation Considerations (VII)

Capitalization of Income Method

III. Estimate Growth Rate

Considerations:

- Should represent cash flow growth rate.
- General Economic Considerations (i.e., GDP growth).
- Industry-related Considerations.
- Company-specific Considerations, i.e., previously discussed value drivers).
- High-growth companies (due to sustainable competitive advantages) can be valued with a multi-stage growth model.
- Long-term growth rate is typically in-line with GDP growth, i.e., 3% to 4%
Valuation Considerations (VIII)

DCF Method

- Process is similar to the Capitalization Method
  - Derive cash flow,
  - Determine discount rate
  - Select growth rate

- Since this method is predicated on the use of a forecast, the accuracy of which is unknown at the time of valuation, it is important to benchmark the assumptions utilized in a DCF analysis against a peer group.
  - Benchmarking typically occurs in the form a ratio analysis.
  - By analyzing ratios, the valuator must determine whether the subject’s projections are overly aggressive or conservative relative to the comparison companies.
  - When variances occur, their causes must be identified and addressed appropriately in the valuation, i.e., adjust the cash flows or discount rate as deemed appropriate.
Valuation Considerations (IX)

Guideline Company Method
I. Identifying Guideline Companies

- Primary Considerations
  - Size
  - Business Mix
  - Operating and Financial Metrics (margins, growth rates, capital structure, capital spending requirements)

- Secondary Considerations
  - Geographic Location
  - Geographic Diversity
Valuation Considerations (X)

Guideline Company Method (Continued)

II. Selecting Multiples

- Price/Net Income or Cash Flow-Useful when there is a similarity in capital intensity, depreciation methods, and tax rates.

- Price/Sales-Useful when there is a uniform profit margin in the industry or when there is a strong correlation between Price/Sales and return on sales. Risk: does not account for firm’s expense model.

- Price/AUM – Useful when there is a similarity in effective management fee, i.e., revenue/AUM and profit levels per dollar of AUM, i.e., net income/AUM.
  - More useful for pure play asset managers
  - Not so applicable to trust companies or other business with significant amounts of assets under administration (“AUA”).

- Enterprise Value (“EV”) Multiples can be utilized instead of equity (price) multiples for each of the above in certain situations, i.e., to mitigate differences in capital intensity, capital structure, and tax rates.
Valuation Considerations (XI)

Guideline Company Method (Continued)

III. Applying Multiples

- Identify key differences between the subject and the guideline company group.

- Discover if any single guideline public company or subset of guideline public companies is more comparable to the subject;

- Select a multiple to apply to the subject based on qualitative and quantitative comparisons to the peer group.

- Must be able to support the selection of each multiple, whether it is a mean, median, or something other than a central tendency measurement.

- Result is a marketable minority interest value
Valuation Considerations (XII)

Guideline Transaction Method

- Process is similar to the Guideline Company Method
  - Identify relevant transactions
  - Determine which multiples to utilize
  - Perform qualitative and quantitative comparisons to sample companies
  - Apply multiples based on above analysis

- Pay attention to level of value (if valuing a controlling position, make sure the comparable transactions were for control positions)

- Challenges with this method
  - Limited number of transactions
  - “Staleness” of transactions
  - Data quality issues
Valuation Considerations (XIII)

What About Rules-of-Thumb?

- Rules-of-Thumb are a short-cut way to arrive at a value, i.e., the “average” firm in the industry is valued at two times revenues or 5 times cash flow.

- Rules-of-Thumb fail to take into account (among other items):
  1. Differences in effective management fees
  2. Profitability
  3. Differences in growth rates
  4. Quality of AUM, clients

- As a result of the above, firms of above average quality can be under valued, while firms of below average quality can be over valued.

- Takeaway: Use with Discretion
Valuation Considerations (XIV)

Other Valuation Considerations

- Tax Status of Entity Being Valued
- Non-operating Assets
- Premiums and Discounts
  - Control Premium
  - Discount for Lack of Control
  - Discount for Non-voting Shares
  - Discount for Lack of Marketability
The Valuation Gap (diverging perception of value between sellers and buyers)

- Some Causes for the Valuation Gap
  - Poor Quality AUM/AUA, i.e., low margin
  - Reliance on the skills and contacts of a limited number of individuals
  - High compensation-related expenses
  - Aging client base (draws on accounts leads to declining AUM)

- Ways to Bridge the Valuation Gap
  - Reduce reliance on the principal (take your name off the door)
  - Invest in the business (take reasonable compensation and leave the excess cash in the business for reinvestment)
  - Train employees to be business generators and relationship managers
  - Grow AUM through new products, markets, client demographic, etc.
NOW WHAT?

What types of transactions take place in the industry and how are deals structured?
PART 3:

The Art of the Deal
The Art of the Deal (I)

Reasons to Sell
- Grow Assets
- Increase Marketing/Distribution
- Cost Reduction
- Diversify Risk

Reasons to Postpone Selling
- Temporarily Depressed Profitability
- Partnership Dissent Issues
- Extraneous Market Conditions (stage in economic cycle, investor perceptions, etc.)
The Art of the Deal (II)

Deal Types & Typical Structures

I. External Transactions

❖ External Sale

➢ Appropriate when internal candidates to purchase the business have not been identified.
➢ Since an external sale is usually strategic, it often will yield the highest price to the seller.

❖ Typical Structure

➢ Buyer pays seller a cash amount at closing.
➢ The balance is paid via earn-out, typically over three to five years.
➢ Earn-out payments are collateralized by the cash flows of the business.
➢ Sellers often receive a transition consulting contract if they plan to leave within the first couple of years.
Deal Types & Typical Structures

I. External Transactions (Continued)

- **External Merger**
  - Usually done when the benefit of merging two firms outweighs the costs of doing so (benefits accrue to the merged firm in the form of higher margins).
  - A selling firm might choose this option if some or all of the partners wish to stay with the merged firm.

- **Typical Structure**
  - Often a cashless transaction
  - The merged firms have their firms valued prior to the transaction and the merge their equity into a new organization.
  - Ownership is divided on a pro-rata basis based on a host of factors, but primarily includes the pre-deal valuation and expected growth rates.
  - Often there will be a valuation reset after a couple of years if adjustments are necessary, i.e., one of the firms is under-performing.
II. Internal Transactions

◆ Hire or Acquire Successor

➢ Usually assumes that there are no partners or junior advisors internally who would represent good candidates to assume control of the business.

◆ Typical Structure

➢ The successor typically purchases shares in stages. This is done as a hedge in case the new advisor is not compatible with the remaining employees or if he/she is unproven.

➢ Since the founder usually stays for a while, the deal structure will usually include a base salary plus commission.

➢ When ready to exit completely, there is usually a buyout formula in place to purchase the founders’ remaining equity after they depart.
Sale to Internal Successor

- Can preserve the firms’ legacy, allow owners to gradually transfer control, and often means less change for the firm and its clients during transition.
- Transitioning ownership to an internal successor can take several years (5 to 10) to completely take place.

Considerations

- Selling internally reduces the addressable market for the shares. This can result in lower selling prices and higher valuation discounts.
- Internal successors may have less access to capital relative to outside buyers.
### The Art of the Deal: (Appendix)

Source of Chart: *Transition Planning*, Charles Schwab Advisory Services

<table>
<thead>
<tr>
<th>SELLING</th>
<th>POTENTIAL BENEFITS</th>
<th>CAVEATS</th>
</tr>
</thead>
</table>
| 1–2 years | • Allows for efficient exit from the business  
         | • Creates liquidity for departing founders | • Control transfers quickly to the buyer.  
         | 25% OF OWNERS CONSIDERING* | | • Seller earnout payments are revenue dependent. |
| Merging with another firm | • Creates scale and efficiencies (costs and revenue)  
                          | • Brings new skills and capabilities  
                          | • Creates market for founder equity  
                          | • Enables founders to let go of day-to-day operations | • Deals are mostly done in equity.  
                          | 1–2 years | | • Strategic fit is key (for example, shared vision and values, common investment philosophy, processes, etc.).  
                          | TYPICAL TIMELINE | | • Partners from both firms must be able to share control. |
| Recruiting an external successor | • Allows owners to retain control during transition  
                                  | • Enables owners to handpick successor  
                                  | • Provides continuity (personnel, processes, client service quality) | • Honeyymoon period is required to make sure it’s the right fit.  
                                  | 3–5 years | | • Deal terms should specify process for unwinding (should it become necessary).  
                                  | TYPICAL TIMELINE | | • Deals are often completed using phantom stock and/or options. |
| Internal succession | • Allows owners to retain control during transition  
                      | • Enables owners to handpick successor  
                      | • Provides continuity (personnel, processes, client service quality)  
                      | • Enables firms to provide better service | • This option has a long time horizon.  
                      | 5–10+ years | | • Valuation may be subject to a reduction of up to 20% compared with external mergers. Proper long-term succession planning, including structuring the transfer of equity, can have a long-term positive effect on valuation.  
                      | TYPICAL TIMELINE | | • Most owners are unprepared: lacking a plan, an identified successor, and the time necessary to implement.  
                      | 80% OF OWNERS CONSIDERING* | | • Internal successors rarely have the capital to buy out founders.  
                      | | | • Banks are hesitant to lend money to finance buyouts. |

*Schwab 2011 RIA Benchmarking Study*
Questions?