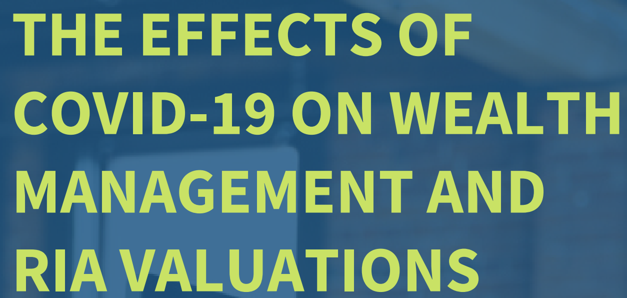

THE EFFECTS OF COVID-19 ON WEALTH MANAGEMENT AND RIA VALUATIONS

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April 16th, 2020

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Introduction

Unlike any time in our nation's history, the ongoing **COVID-19 outbreak has taken an incalculable toll on our prosperity and economic strength.** In the span of only two months, the US economy morphed from its strongest position since WWII to its weakest position since the Great Depression.

No business is more immersed in these recent events than wealth advisors, asset managers, broker-dealers, registered investment advisors and insurance agents. The asset and wealth management industry could in fact be considered a **bellwether for the overall economic environment**, given how closely revenues are tied to the capital markets.

Besides investing their blood, sweat and tears into the development and protection of their clients and portfolios, they must individually prepare for the inevitable storm which has arrived in full force during the month of March, 2020.

Even those business owners (financial advice or widget manufacturing) who have planned for cyclical downturns are being compelled to make **extremely difficult choices to survive the specific nuances of this unprecedented health and economic crisis.**

The General Case

The shock to our economy during the COVID-19 crisis has been like no other before it. Businesses have adapted in various ways including the dreaded "shut down" option. Despite the belief by many that the "corner has been turned", the reality is that **the degree of uncertainty which permeates our economic landscape remains in unchartered territory.**

Nonetheless, assuming that proper initial steps have been implemented involving the safety of personnel/premises, then:

> ….**steps can be taken NOW to mitigate the loss in business value which nearly every entrepreneur is presently assessing.**

It behooves business owners to understand valuation fundamentals as a means of protecting and enlarging the value of what is often their most substantial asset. Recognizing how business decisions impact going concern value over time is essential as:

> **Valuation is a <u>prophecy as to the future.</u>**
>
> **Business value is a function of the <u>expected future net cash flows</u> (quantity) accruing to the ownership AND the <u>risk profile</u> (quality) thereof.**
>
> **The "<u>size effect</u>" provides a double incentive to grow your business, i.e. higher cash flows increase value directly and indirectly.**

The business **owner who increases profits/cash flow** (through higher revenue or lower expenses) and/or **reduces the risk of future cash flows** (through sound business decisions) will increase business value.

Given the disparate impact across industries and even cities, there is **no uniform set of recommendations** to consider. Likewise, there will be **great differences between fully inactive companies and the "winners" stemming from the crisis** where it has been more like "business as usual" but with growth on steroids. The impact of CV-19 has been so severe on firms in certain industries that appraisers are rethinking **the application of the "going concern" premise** to value them today.

Some industries will suffer **"lost demand"** like restaurants and airlines hospitality while others will suffer **"delayed demand"** such as automobiles and clothing. Overall, the macro changes revolve largely around **consumer demand and supply chain challenges**. Some industries are faring better than others, but **no company is fully insulated** from the pandemic's impact.

Even if your business has been 100% shut down, much can be done to make the best out of a terrible situation. Among the more **important and often inter-dependent steps** to consider are:

1) First, **regularly convene your senior management team** via video conferencing. ST and LT decisions will be effective only with their commitment to "the new normal". Their insight will help immensely as you contemplate changing personnel leads and leadership succession. If you do not have an exit plan or a buy-sell agreement, get on this ASAP. Consider whether your supply chain is corrupted or overly dependent on any supplier and diversify where possible. Preparing to uniformly discuss your firm's CV-19 response with all stakeholders will be extremely important. For ongoing coverage of the pandemic pertaining to business owners, American City Business Journals is publishing daily the "The National Observer" which includes a link to "Federal Resources for Small Business". The daily publication is available at https://www.bizjournals.com/bizjournals/news/2020/04/14/the-national-observer-tuesday-april-14-2020.html

2) **Focus on CASH and CASH FLOW.** History shows that companies with strong balance sheets and adequate cash possess a real competitive advantage during slowdown AND during the upswing. Take advantage of existing credit but review your debt covenants and evaluate banking relationships. Consider payroll cuts or temporary wage concessions. Firms that maintain inventory can benefit by analyzing their cash conversion cycle. KPMG, Deloitte and other large accounting firms are publishing free advice including https://www2.deloitte.com/content/dam/Deloitte/global/Documents/About-Deloitte/gx-COVID-19-managing-cash-flow-in-crisis.pdf and https://www.growthforce.com/blog/7-strategies-for-surviving-a-cash-flow-crisis Regarding the cash conversion cycle, Dickinson Bransford created step-by-step instructions on how to perform this calculation.

3) Depending on your cash balance and cash flow position, **explore ALL opportunities for financial support** at the federal, state and local levels as well as throughout the private sector. Although access can be challenging, use your free time wisely by evaluating the wide variety of available resources. BizEquity in conjunction with American City Business Journals has compiled a complete and updated list of all such resources including many that are not "common knowledge" or widely advertised. https://info.bizequity.com/small-business-survival-guide-updates

4) Within the context of creating a formal **crisis contingency/business continuity plan**, visit with your insurance agent (or find the right one) to assist with the creation of a formal crisis contingency plan. Make sure your property insurance program includes both **business interruption and contingent business interruption coverage** protecting income losses

generated by inactive suppliers. This type of coverage can provide real peace of mind going forward in the post-CV 19 world. KPMG has published a variety of easy to read white papers including "Business Continuity in a COVID-19 World: Tips to Consider During the Pandemic" https://home.kpmg/xx/en/home/insights/2020/03/business-continuity-in-a-covid-19-world.html

5) **Think strategically to optimally account for the "new world order"** that has emerged. Brainstorm LT capital and operational spending requirements as well as key shareholders' personal financial goals. Major issues such as early retirement, an MBO or even ESOP, the ability to invest in growth channels and relevant technologies and even the sale of the firm need to be considered. This could also be the perfect time to make a strategic acquisition (to increase future cash flows or to reduce the risk of existing cash flows through diversification). Jennifer Clough and Robert Tull published the "Coronavirus Contingency Planning Checklist for the Middle Market" in Mergers & Acquisitions dated 3-11-20.
https://www.themiddlemarket.com/opinion/coronavirus-contingency-planning-checklist-for-the-middle-market?position=editorial_5&campaignname=M&A%20Daily%20Briefing-04032020&utm_source=newsletter&utm_medium=email&utm_campaign=M%26A_Daily_Daily_Paid%2B%27-%27%2B04032020&bt_ee=EKGgPX6M7zv5YIssAT%2Fl%2Fx1Tg4LsX49nntJZOFVB5jnFoz5MY3YiWY5wxPz1Mfi%2F&bt_ts=1585943474327

The Case of Wealth Advisors/RIA's/Broker-Dealers

There is little doubt that **most financial advisory firms will be suffering "financially"** during the crisis as falling portfolio values will depress management fee income. At the same time, clients are in need of more "hand holding" and client retention will suffer if it is not provided. In general, the "crisis" is bringing forth ***"the perfect storm" of declining revenues and potentially rising expenses in a period of dramatic uncertainty.***

The **impact on private practice values not crystal clear due to the slow-motion awareness of actual deals as they unfold during** the crisis. That said, the **combination of lower revenues, higher costs and elevated risk do not bode well for practice values – at least in the short run.**

Despite this terrible onslaught, the **Dow Jones has managed to recoup a large portion of the initial losses in value.** At the time of writing, the DJIA stood at 23,949 and was approaching the 24,000 plateau. **Based on the record high of 29,551 on February 12th, 2020, this important measure is around 23% below its peak just two months later.** As compared to the 2020 low of 18,592, the recent rally has added roughly 5,357 points or nearly 29%. The ***overall swing from high to low was more than 11,350 points or approximately 38%.***

Connecting these swings in value to private firms is generally ineffective due to the unique nuances of private firm valuation. Having said this, it is safe to say that the average business value in the private sector is markedly lower than it was just 3 months ago. In most cases, private firm values will be down due to lower revenues/profits/cash flows coupled with the uncertainty/risk which still persists at problematic levels. The ***most dramatic impact will stem from lower earnings/cash flows with a secondary impact from lower multiples*** (all other things equal).

There are a **variety of reasons why the owner of a wealth management or investment advisory firm would need or want to know what their enterprise is worth** on the open market. Besides the obvious **"event driven" need** stemming from divorce, partner buyout, estate taxes, etc., **learning how to manage and grow the value your business in a proactive manner may be the best reason of all** to take the time to understand the process of "enterprise value optimization". By learning the factors which drive the worth of your company, you can ***literally engineer growth*** in what is typically your most valuable retirement asset.

Similar to other types of businesses, there are a certain group of **key financial and operational attributes which will drive the value of a given wealth management firm.** The primary value determinants are summarized below:

Primary Value Determinants for RIA's/Wealth Advisors

- Top 3 producers' percent of total revenue?
- Total assets under management?
- Historical and expected top line growth rates - revenues and AUM?
- Is growth organic (better) or based on acquisitions (not as good)?
- Net new client rate (are new clients greater than lost clients?)
- Average management fee/%?
- Percent of transferable or recurring revenue (fees) versus variable revenues (commissions)?
- Total # of relationship managers and RIA's?
- Average years of investment advice experience?
- Relation between partner and overhead compensation?
- Contribution of primary owner to top and bottom line outcomes?
- Are producers subject to enforceable non-compete agreement?
- Percent of total revenue generated via institutional accounts?
- Concentration of client base or referral base?

- Broker-dealer license (the hybrid model)?
- Average client investment and net worth?
- Client demographics, e.g. age, diversification, prevalence of multiple generations of service and tenure, etc.?
- How "sticky" is clientele (how high are customer "switching costs" if leave?)
- Sophistication of internal processes and policies/procedures

In the most general sense, the value of a wealth management company or Registered Investment Advisor (RIA) will depend on **size, growth and profitability**. These three elements are inter-related as growth will increase size and may affect profit margins.

Additional Valuation Metrics

For another perspective, the firm **FP Transitions** published an article in January of 2018 titled **"The Top 10 Drivers of Business Value."**

Top 10 Drivers of Business Value

Their top 10 factors include:

- Predictable revenue and recurring revenue streams
- Client demographics
- Average client tenure
- Size of potential market
- Transition timing
- Client affluence and average client revenue
- Asset or revenue concentration
- Use and structure of referral fees
- Length of surrender period
- Profitability

Key Financial Metrics

Wealth advisors/registered investment advisors are generally aware of the **primary financial metrics** which drive the value of their companies. As usual, the "devil is in the detail" when seeking to assess the performance of a given firm relative to its peer group or industry cohort.

Chief among these key financial metrics are the following:

Key Financial Metrics for Evaluation of RIA/Wealth Advisory Firms

1) Total Assets Under Management (AUM) and Rate of Growth in AUM
2) Total Annual Revenues/Fees and Rate of Growth in Annual Revenues/Fees
3) Total Variable Revenues/Fees as Percent of Total Annual Revenues/Fees
4) Total Fixed or Recurring Revenues/Fees as Percent of Total Annual Revenues/Fees
5) Total Earnings Before Interest, Taxes and Depreciation (EBITDA)
6) Total Owner Compensation (salary, payroll taxes, benefits)
7) Total Discretionary Earnings (EBITDA plus primary owner compensation)
8) Total EBITDA and Total Discretionary Earnings as Percent of Total Annual Revenues/Fees

There are **also myriad non-financial factors (presented earlier)** which must be considered when valuing a typical wealth or registered investment advisor.

Analysis of Profitability and Cash Flow Generation

The final piece of the financial analysis of the subject pertains to its ability to generate profits, both in general and on behalf of the primary owner-operator. The most relevant **income-based metrics** for this type and size of firm are earnings before interest, taxes and depreciation and amortization expense **(EBITDA) and seller's discretionary earnings (SDE).**

EBITDA

In the past years there have been a number of articles criticizing EBITDA and a multiple thereof to determine a company's value. EBITDA is an acronym for:

"Earnings before interest, taxes, depreciation, and amortization."*

**Note: the word "before" can be read as "plus".*

It has been used extensively since the 1980's as a **quick measure of company's profitability and cash availability** by investment banks, commercial banks, investors, and mergers and acquisition companies. This metric is **easily calculated, easy to explain, and the information is readily available from basic financial statements**. The calculation and usage of the EBITDA

figure have always been criticized by business appraisers, but even banks and the Mergers & Acquisitions Industry recognize its shortcomings.

In determining the value of a company, **<u>EBITDA is lacking</u> some important elements that may lead to over/underpayment by a buyer or over/underpricing by a seller**. Some of these factors are:

What Are the Shortcomings of Using EBITDA for Business Valuation?

1. EBITDA is not cash flow
2. It does not show the actual cash available to service debt, pay owner salaries, etc.
3. It is not a good multiple in comparing companies as depreciation and amortization treatment can vary between companies
4. It does not include changes in long-term debt
5. It does not represent the amount of cash available to a hypothetical buyer interested in acquiring the subject business.

There are others, but the key finding is that it **does not truly reflect the availability of cash and the ability of the company to service debt and sustain its operations and growth potential. At BizEquity, we utilize a much more robust measure of cash flow** in the form of **<u>"discretionary earnings"</u>** and a **<u>modified "net cash flow"</u>** as well as an **<u>adjusted EBITDA</u>** to reach our conclusion of value.

Seller's Discretionary Earnings (SDE) and Asset Sale Value

"Discretionary earnings" or "seller's discretionary earnings" (SDE) or "adjusted cash flow" (ACF), etc. is a more powerful measure of cash flow as it accounts for the **tax-minimizing behavior of private firm owners** and revolves around a **"return on owner's labor" paradigm** rather than a "return on investment" paradigm. SDE or ACF is calculated as follows:

Discretionary Earnings

Normalized Pretax Profits (after eliminating non-recurring/non-operating items*)
+ Owner Compensation** (salary, payroll tax burden of around 7% plus perks or other "discretionary" outlays)
+ Non-Cash Charges (depreciation/amortization)
+ <u>Interest Expense</u>
Equals Discretionary Earnings***

**These "non-recurring" or non-operating cash flow adjustments are made to reflect the economic reality of the firm as inherited by a hypothetical buyer.*
***This amount should ALWAYS include the TOTAL ACTUAL COMPENSATION paid to the PRIMARY (single) OWNER-OPERATOR, whether it is a small amount or a large amount.*

****Also called "seller's discretionary earnings or SDE" or "adjusted cash flow" or "normalized earnings", etc.*

It is also important to recognize that **any estimate of value which is presented as a "multiple of discretionary earnings" will be an "asset sale value"** (inclusive of **inventory, FF&E plus all intangibles** such as tradename and customer base and goodwill). The average owner-operated business in the US sells for around 2.4 time's discretionary earnings, but the actual multiple for any given business will vary depending on industry, size of earnings, company risk factors, etc.

Accordingly, ***an* "asset sale value" does NOT incorporate cash and accounts receivables and other liquid financial assets NOR does it account for the liabilities** (both ST and LT). The **"equity value" DOES** incorporate and account for these other assets and liabilities, i.e.:

Equity Value = Asset Sale Value + Cash, A/R, etc. - Liabilities (short and long term)

In light of the charge to determine the firm's equity value, appropriate adjustments would be required if discretionary earnings multiples are utilized in this analysis.

DeVoe & Company Envisions Four Phases to the COVID-19 Crisis for RIA's

One source of publicly-available private firm RIA transaction values is published by **DeVoe & Company.** This particular edition (First Quarter 2020) is **exceptional in its clarity and vision** for the next couple of years in the RIA space.

Their **"RIA Deal Book"** results for the 1st Quarter of 2020 has been published and can be accessed at:
https://static1.squarespace.com/static/5410ec1be4b0b9bdbd0cc342/t/5e910c3bd520f342bac5f73f/1586564155753/DeVoe+Deal+Book+1Q20-F.pdf

The **headline for this report is accurate but might be considered unrealistic based on the dramatic changes in the US which unfolded during the final month of the quarter.** While the first two months were strong, there is no doubt that the ***final month was quite different and the 2nd quarter is likely to be very disappointing.*** January was a record month with 18 transactions with the full quarter generating 34 tracked transactions (annualizes to 136 deals). DeVoe maintains that the slowdown during the final month was not due to COVID-19, but it will have a profound effect on future activity. RIA businesses of all shapes and sizes will be directly

and indirectly affected by this evolving situation. M&A activity will be part of that broader dynamic.

DeVoe has **insightfully identified four phases which are unfolding** in this "required reading" on the part of RIA's operating in today's marketplace. There are **many important insights which should be considered by industry participants** as they work their way through the COVID-19 era.

Four Phases for RIA M&A Following the COVID-19 Crash

Phase One	Live Transactions Get Completed
Phase Two	A Lull in Activity
Phase Three	A Surge in Activity
Phase Four	Return to Normalcy

Their **analysis is rooted both in historical trends (the 2008 decline, in particular), as well as their assessment of the ever-changing dynamics of this particular crisis.** Although many deals will get done during **Phase One,** those in earlier stages of negotiation will likely stall. Specifically, transactions and strategies that had not progressed to signing a Letter of Intent are at greater risk of slowing.

Phase Two will be marked by a noticeable slowdown in M&A activities. Shifts in the psychology of advisors (such as fear and discomfort with ambiguity), as well as shifts in their activities (such as devoting all their time to taking care of clients and staff) have withered many early-stage M&A initiatives. Looking more broadly at the RIA space, there are quite literally thousands of advisory firms that need to do something about succession. Surveys clearly show that 70% of RIAs do not have a written succession plan, despite their best intentions to put one in place and COVID-19 has put a glaring spotlight on this shortcoming. During this decrease in signed deals, the actual activity – early- and mid-stage M&A activity — will be at heightened and intensive levels. Despite fewer announcements, plans are being executed, meetings are taking place, negotiations are occurring, and LOIs are being drafted. The seeds planted in the second phase are likely to be vast, and they will be setting the stage for a bumper crop of transactions.

Optimistically, DeVoe & Company believes that **Phase Three's** surge of activity will drive RIA M&A back to record highs. Delayed deals will come to market. Advisors who were shocked into action will have their deals signed. Advisors will also join enterprise level firms to both gain access to better capabilities, as well as have some potential shelter in an uncertain world. In

2010, M&A volume spiked 54%, following the lull in 2009. Although valuations will have likely compressed to some degree, deal structures will be more dynamic. The high down payments, which the industry saw rise through the 2010s, will give way to greater contingencies. This will enable buyers to mitigate risk and conserve cash. But, it will also enable sellers who might otherwise seek to 'wait until the market comes back' to get a deal done. Consolidators, serial acquirers, and private equity firms are expected to sustain their interest in the RIA space. The likely compression on valuations will also attract new entrants, both buyers and private equity. Overall, the marketplace will go through a period of heightened activity as the pent-up supply of sellers from Phase 2 converges with the demographic realities of the aging RIA owners.

The steep arcs of the lull and surge will eventually move back toward a degree of 'normalcy' during **Phase Four**. The structural underpinnings of the M&A trend remain. Any industry with 10,000 firms whose owner demographics skew toward retirement age should expect a steady march of sellers toward the exit.

Final DeVoe Commentary

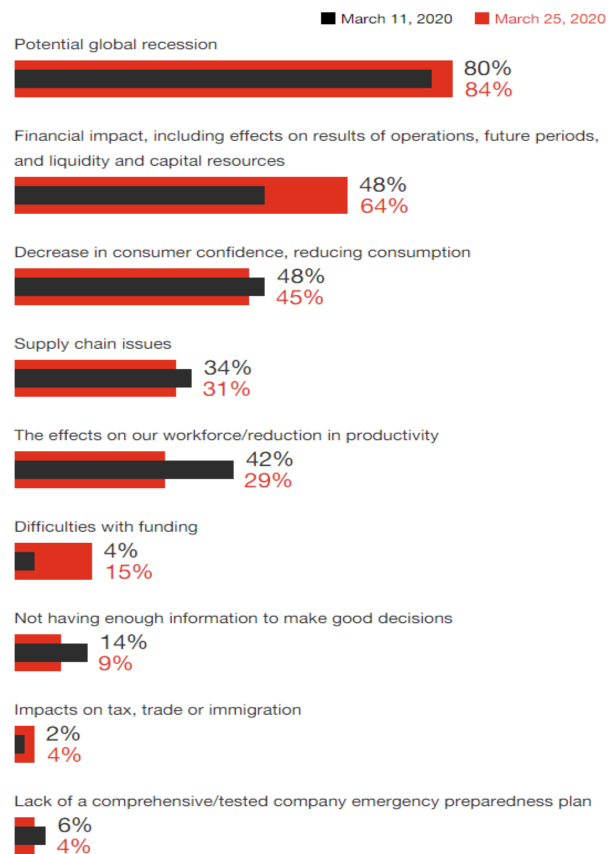
DeVoe & Company anticipates that following the first three phases, RIA M&A will eventually return toward the steady upward trajectory that the industry has seen for the last six years. And that this trend will continue for several years to come.

After many years of selling for immediate succession (quick sales), the interest in gaining the power of scale through selling to a bigger firm has eclipsed succession as the primary reason advisors are selling. For over two years now, advisors have improved their businesses and lives by carefully selecting larger firms that can help them better achieve their business – and personal – goals.

Hopefully, 2020 becomes the 'Year of Succession Planning' for the RIA industry. Perhaps COVID-19 is the wake-up call the industry needed. It's a common human reaction to reevaluate and reprioritize the most important things in life after a traumatic experience. This valuable evolutionary behavior helps us step back and reflect on our priorities. We all know the critical importance of succession planning. Proper transition planning benefits clients, staff and owners. It is time to take action. And put these plans in place. As Leonardo da Vinci wisely said, "Knowing is not enough; we must apply. Being willing is not enough; we must do."

PwC COVID-19 CFO Pulse Survey

To literally **take the pulse of the financial advisory industry,** PwC has executed an **inaugural survey** as of March 25th, 2020 comprised of 55 participants. The full survey called "COVID-19 CFO Pulse" can be accessed here: https://www.pwc.com/us/en/library/covid-19/coronavirus-asset-and-wealth-management.html.



Just 20 days later, it is highly likely that a new set of concerns would be at or near the top, but a global recession tends to sum up the magnitude of this pandemic. In terms of specific concerns which have arisen recently, the following were identified via this survey:

The remainder of the informative and enlightening survey covers the following areas:

- crisis management and response
- workforce,
- operations and supply chain
- finance and liquidity
- tax and trade
- strategy

Each of these sections include a discussion of the challenges faced by the asset management industry and then a list of potential steps to consider. **Typical contingency plans don't generally take into account the widespread quarantines, business and community disruptions, and added travel restrictions** of a global health emergency like this one. Constructing and following a contingency plan/business continuity plan/succession plan/exit plan can have a **dramatically positive impact on practice value.**

For those readers who are looking for **another financial advisory services-oriented crisis management strategy which reflects the unique attributes of the current environment**, **Michael Kitces*** (www.Kitces.com) posted an article written by Angie Herbers of Herbers &

Company (management and growth consultant for financial firms) which provides a six step crisis management strategy that is geared specifically towards the unique aspects of THIS crisis. The article can be reached via the following link: https://www.kitces.com/blog/hard-choices-financial-advisor-cut-expenses-stress-test-business-stability-culture/?utm_source=Nerd%E2%80%99s+Eye+View+%7C+Kitces.com&utm_campaign=0b1a9af2f7-NEV_MAILCHIMP_LIST&utm_medium=email&utm_term=0_4c81298299-0b1a9af2f7-57233637

As per Ms. Herbers:

> *……the truth is that even for experienced advisors who have been through market turmoil in the past, each crisis is different (posing unique challenges to firms at different stages in their growth), and in practice, the biggest risk to an effective crisis management response is one of "false equivalencies", in which an advisory firm owner makes the assumption that the current crisis can be dealt with in the same manner as the last.*

She further observes that advisory firms are avoiding asking themselves the hard questions that they need to consider when business planning in THIS specific crisis. In other words, they are not allowing themselves to think about questions like these:

- What if the markets turn south for a prolonged period of time?
- What if we experience declining revenues rather than growing ones for a prolonged period of time?
- What if one of our employees gets sick and dies?
- What if I get sick and die?

By not dealing with the hard questions during good times, you run the risk of making bad decisions in a crisis that can cost you substantially in the future. A link to this informative piece is found at the end of this document.

Conclusion

Despite the fantastic despair and unprecedented uncertainty that our country, businesses and people have faced in recent weeks, **we have no doubt that our economy will return to "normal" and much quicker than most had anticipated**.

In the short run, the impact on practice value is significant and concerning. As the crisis unfolds and enters the Phase Three and Four of the DeVoe scenario, fundamentals will evolve towards familiar levels and **we are hopeful that the RIA and financial advisory industries will**

once again prosper as they play their important role in helping others prepare for unforeseen future events similar to the COVID-19 outbreak.

This is **a time for patience and strategizing** to ensure that these "unforeseen future events" are mitigated to the strongest degree possible and **very few professionals are in a position to make such a positive impact on the millions of small business owners** across the country. BizEquity is proud to be a small part of this essential service and we look forward to much better days ahead for the wealth advisory industry and our entire nation.