Are you about to see your practice value halved?

The abolition of commission and volume bonuses will affect the value of many financial planning practices. Wayne Marsh explains

Over the past decade-and-a-half, financial advice practices that provide investment and superannuation solutions have had a successful relationship with institutionally-owned product administration platforms.

The platforms have delivered some client management efficiency and a highly effective means for advice practices to collect asset-based fees by way of trail commissions and/or dial-up advice fees.

In addition, revenue has been enhanced when licensees (and boutique practices with their own AFSL) have negotiated volume-based rebates or bonuses with platform providers. For some larger licensees the rebate represents more than 50 per cent of total revenue.

This symbiotic revenue relationship with platforms has allowed many practice owners to build highly reliable cashflow and recurrent revenue for their businesses. This annuity stream remains the envy of other professional services businesses, such as accounting practices.

In an open market, where demand for quality practices far exceeds the supply, sales of advice practices have been negotiated at a multiple of 3 to 3.5 times the annual recurrent revenue, compared to accounting firms at 0.8 to 1.2 times annual revenue.

The relatively premium prices paid for financial planning practices are also a function of:

- The double-digit growth inherent in wealth management;
- The baseline provided by institutional buyer-of-last-resort (BOLR) pricing facilities (these cover 40 to 45 per cent of the practices in the industry);
- The relatively low working capital requirements (an accounting firm needs 25 per cent of its annual billings as working capital); and
- The certainty of income provided by asset-based trail and service commissions.

For larger financial planning practices, with annual recurrent revenues greater than $1.5 million, the market has valued the practices at an earnings before interest and tax (EBIT) multiple of 5 to 8 times - double the price typically paid for small businesses in other industries.

However, we know that the financial planning industry agenda has been set around:

- The removal of upfront or trail commissions from investment platform or product solutions; and
- An advice regime that may require clients to opt into advice fees.

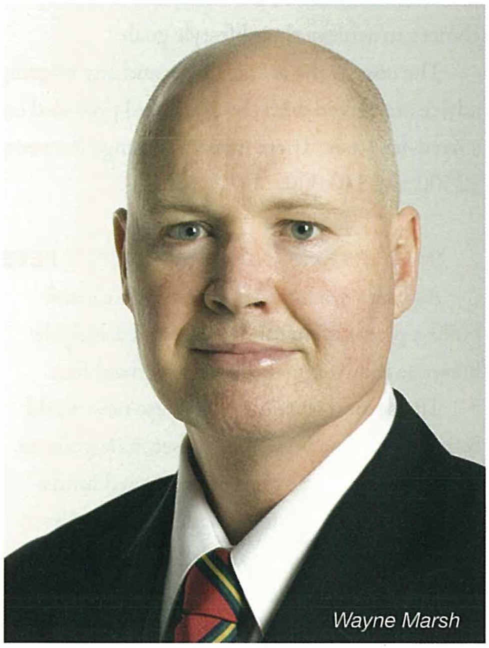
In the short term, the loss of the certainty of annual recurrent income will see practice values decline, perhaps to a level between that paid for other professional services, and the current level of pricing.

For all practice owners, the key concern and business focus has to be on how to replace the quantum and the certainty of annual recurrent income, once trail commissions and advice fees are removed, and clients have to opt into advice fees on a yearly basis.

A NEW-WORLD BUSINESS MODEL

In the same way technology allowed platforms to become entrenched in advice business models, is present-day technology about to provide a new age solution?

From a business model perspective, the most effective response we have seen to the loss of certainty of income is from practice owners looking to migrate away from the reliance on a master trust or wrap platform, to take more active management of each component of the client relationship.


Wayne Marsh

These "new world" practices have migrated to a business model that acknowledges that there are at least three, and in some cases four, opportunities in the relationship with a client, where it is possible to add value, and to charge a combination of fixed and asset-based fees for that value.

ADVICE FEES

The first opportunity is in the initial advice provided to a prospective client. In this step, "new world" practices go beyond interpreting the complexity of the superannuation regime or making recommendations on the various client tax structures, and have implemented a values- or an objectives-based lifestyle financial planning process.

The offer is a client engagement process that starts with documenting lifestyle aspirations, reconciles this with a client's current circumstances, then leads the client through decisions around the risk/return trade-offs they have to make, strategies they can consider, and lifestyle choices they need to accept or forgo. The client decision-making is supported by interactive software.

On an annual basis, depending upon their financial circumstances, clients go through an abridged version of this process to monitor where they are at, and make the necessary choices to achieve their lifestyle goals.

The cost of the initial advice and any ongoing advice are agreed with the client and provided on a fixed-fee basis. These initial fees range between $2500 and $10,000.

INVESTMENT AND MANAGEMENT FEES

As every practitioner knows, you cannot build a premium business asset and a scalable business model if you charge only fixed fees.

The second client offer in these new world business models is in-house asset management. Rather than using externally managed funds, these financial planning practices favour direct investment, with active asset allocation and securities selection being the building blocks of a personal portfolio management service.

Using the services of research providers, they perform investment decision-making functions previously outsourced to institutional or boutique funds management groups. In some cases the practices buy in wholesale model portfolio services and set their own prices to clients.

In the direct investment model, an adviser is afforded many opportunities to talk directly to clients about their investments or their portfolios - a conversation that was more difficult and less relevant in a business model that outsourced investment decision-making and implemented strategies via managed funds.

The business and investment model is particularly effective with medium- to higher-net-worth clients, and valuable for self-managed super fund (SMSF) clients.

In effect, the investment model is the private wealth management equivalent of an institutional fund manager, and captures all the investment fee income from assets under management. The fee scale varies by asset class, but the practice can collect 1 to 1.25 per cent of assets under management

This migration to in-house investment management is the most significant step practice owners are taking to produce an appreciating, fee-certain, scalable and highly valuable annuity income, to protect and ultimately grow the value of their business.

COMPARISON OF INCOME STREAMS

Traditional financial planning model	"New world" private wealth management business model
Initial advice fee: $2500 to $10,000	Initial advice fee: $2500 to $10,000 Ongoing Advice: $Variable
Trail commission: 0.25 to 0.5 per cent Dial-up fee: 0.5 to 1 per cent	Investment Fees: 1 to 1.25 per cent Administration fees: 0.3 to 0.6 per cent
Licensee rebate: 0.2 per cent	Licensee rebate: Nil
Recurrent practice revenue: 1.2 per cent (approx)	Recurrent practice revenue: 1.5 to 2 per cent
EBIT (after owners' drawings): 10 to 20 per cent of revenue	EBIT (after owners' drawings): 40 per cent-plus of revenue
	Revenue uplift (net of expenses): 40 to 50 per cent
Cost to client (incl. platform fees): 2.5 to 3 per cent	Cost to client: 1.5 to 2 per cent

'The loss of the certainty of annual recurrent income will see practice values decline'

ADMINISTRATION FEES

The third step is administration and client reporting - the traditional domain of master trusts and wraps. You may recall the initial impact that platforms had on the industry. At first, they were considered to be a technology solution for a business problem: administering and reporting on client assets. Their improved functionality and web enablement has made them an integral part of many traditional financial planning businesses.

In the "new world" solution, practices are buying-in a desktop administrative solution. This solution has full web-based practice and client reporting and, where required, integration with specialist accounting software, at a fixed cost per client.

Practices then on-sell the service to clients, at an asset-based fee. This administration fee is the second source of asset-based fee income at 0.3 to 0.5 per cent of assets under administration.

COMPLIANCE FEES

In models that specialise in or provide an SMSF service, the preparation of financial statements and the management of a relationship with an external auditor are the fourth source of practice income, via a fixed fee. If the investment funds are discretionary savings, then often there is a tax service at this point.

This new world model is completely compli-
nt with the Cooper Review's recommendations nd intent. There are no commissions; advice es are fixed-dollar and only need to be dis-ussed with the client when advice is provided. ivestment management and administrative es remain asset-based, and in this new world iodel, all fee income is captured inside the ractice.

The offer is particularly attractive to SMSFs, iedium- and high-net-worth clients. The clients ke:

- The transparency of pricing and illustra-on of value added by the adviser at each step in ie relationship;
- The opportunity to choose which of the our services (advice, investment management, sset administration, tax) they want. They want, nd inevitably choose, all four; and
- The pricing, which can be 50 to 100 basis oints less than a traditional financial planning elationship.

From a practice perspective, migration to this private wealth management model has seen well-run practices achieve a 40 per cent (net of expenses) improvement in annual revenue, and replaces the uncertainty of trail and dial-up income with income certainty from investment and administration fees.

> 'For some larger licensees the rebate represents more than 50 per cent of total revenue'

The key reasons for the premium prices being paid for financial planning businesses include demand, industry growth, BOLR valuation conventions, low working capital requirements and certainty of income.

In the private wealth management model, the variable over which a practice owner re-asserts control is the certainty of annual recurrent income and its asset basis. The practice does not need, or receive, a volume-based rebate to improve financial viability or return to shareholders.

When a practice designs its business processes to support its client engagement model, then the business is capable of delivering EBIT twice that achieved by practice owners using traditional platforms, and at a minimum, a preservation of the current value of the practice.

If EBIT valuations become the norm, then these businesses are well positioned to command a premium price. ■

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