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Welcome to the first issue of 'Market Matters' in 2010, a quarterly-newsletter providing a range of valuable insights for Practice owners considering succession, sale, merger or acquisition.

This month reflects on the Year that Was 2009, some observations for Practice Owners to consider, and a summary of activity and valuations.

If we can clarify any of the comments or observations in ‘Market Matters’ for you, then contact us on 1300 766 156.

Best regards
Chris Wrightson & Wayne Marsh, Directors

That was the Year that Was

2009, from a Mergers and Acquisitions perspective, was literally a year of two halves.

January to June 09, was charactorised by a significant fall in the new business and annual recurrent revenues of Practices, due to the GFC impact on asset values and investment markets.

The fall in Practice revenue was particularly acute in investment only planning Practices, where revenue declines of between 20 - 40% were common.

As a result, the number of Practice sales in the industry declined, as Vendors of Practices were concerned about a fall in the value of their business, buyers became nervous about pricing in future potential growth and the impact of client dissatisfaction, and financiers either withdrew facilities or sought additional security.

Transactions conducted by Centurion during this period were structured to recognise the desire of the seller to capture future improvements in investment revenue.

A transaction we completed in this period was of a large Practice at over 7x EBIT, with a significant 3 year upside performance incentive for the Vendor, to share in the future value of market returns and new business.

Throughout the first half of 2009, Centurion received alot of enquiry from financially distressed Practices that were looking to refinance, and from small to medium size practices seeking scale by merging with a complementary Practice. For several Practices we sourced equity investors,

which allowed the Practice to retire its debt.

One of the mergers we conducted was between two different size Practices, one growing quickly with good lead sources, the other an established Practice sourcing its new business from existing clients.

One of the 2 partners in the larger Practice was retiring and a merger was the preferred solution. To recognise that small/mid –size fast growing businesses are valued differently to large mature businesses, the valuation methodology on this transaction was a mix of recurring revenue, EBIT and NPAT.

During the second half of 2009, confidence started to return to the Mergers and Acquisitions arena. The supply of sellers improved as Practice revenues and business valuations recovered and the demand from funded buyers grew.
The age demographic of owners of financial planning business means retirements deferred during the GFC, are now being reconsidered.
The reform recommendations from Ripoll are also proving to be catalyst, with sellers expressing concern for the business impact of a ban on product and platform payments, regulatory uncertainty, the increasing cost of professional indemnity and more onerous competency standards.

Risk businesses remain in high demand. A recent transaction we completed, achieved a head line sale price in excess of 3.8x annual recurrent revenue.

Observations from 2009

The first observation would be that delivering financial planning advice requires a business model with scale. We would suggest that if Practices have annual recurrent revenue of less than $300k, they seek a similar sized merger partner, and jointly implement sustainable ways of reducing operating costs. For example, in times of investment market declines, it is apparent Advisers spend as much (sometimes more) time servicing low value clients, as they do servicing clients who are far more profitable to the business.

A key part of cost management is to define the advice and service models for clients, on-selling clients whose needs, profile and expectations do not fit the Practices new offer.
The second observation is the importance of alternative revenue sources and of revenue management.

On revenue sources, risk books remain a robust and countercyclical way of supporting Practice revenue. Most specialist risk Practices grew by 20% during the financial crisis, while broad based financial planning practices were able to redirect their marketing activities to generate new risk business from existing clients.

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On revenue management, with Ripoll tabled, our suggestion is that if Practices have not started the migration away from a dependence on commissions on investment products and platforms, then do it would be prudent to start.

A recent survey by Centurion indicates that over 50% of practices are now fee based. The definition of fee based varies, the common theme is that fee based Practices draw the bulk of their revenue from explicit advice and service fees that are agreed with the client. In parallel, the Practices' client value proposition is not about investment performance, it is about strategic advice, values or objectives based lifestyle financial planning – with a consistently applied end to end client engagement model.

In the majority of cases a transition to an advice proposition with an explicit fee schedule has placed fee pressure on platform providers, generated more income to the Practice(without growing costs), and improved value to the client.

Sale Prices and Valuation Methodologies

Pricing methodologies and valuations remain unchanged to this point.

For Practices with annual recurrent revenue of less than $1 - $1.5m the dominant method of valuation remains a revenue multiple, typically 3 to 3.5x the annual recurrent revenue. Quality Risk Practices are at the higher end, or slightly above this valuation.

For larger financial planning Practices, where annual recurrent revenue is greater than $1.5m, there are very few private buyers, and more institutional buyers.
These institutional buyers tend to use EBIT based multiples, in the 5-8x range.

Centurion believes that in time there will be valuation declines in investment commission based Practices, if superannuation commission arrangements are restricted or grandfathered.

The big question is whether Practice valuations ultimately fall in line with other professional services businesses such as accounting firms (0.8 to 1.2x fees).
Centurions view is that this unlikely. The embedded growth in wealth management, asset based fees (while under some pressure) will continue to provide a high value annuity income and are unlikely (in the immediate term) to be replaced by an Accounting style time based fee.

What is more likely from a valuation perspective is that the various buyer of (first) last resort facilities that are prevalent in institutional Licencees, will be reviewed - down.

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This is significant at an industry level for all Practice owners, in that the BOLR has long provided a floor price for Practice sales and transactions across the industry.

What are the key messages to take into 2010?

- **Become an advice business** – don’t lead with an investment guru proposition –its not sustainable.
- **Scale** - If you’re a small practice, then look for a merger partner. The cost of insurance, compliance and customer service will mean scale in Practices is a necessity.
- Look at your **end to end client offer** (including the platform administration) and compare it with the overall value clients receive. Ensure the parts of the client experience you deliver (advice and ongoing service) are valued so that as pricing pressure increases, it's not your business that feels it.
- **Diversify your Practice income -** look for ways to build an alternative revenue stream- consider the benefits of introducing insurance (life or general), mortgages or acquiring an accounting service.
- If you’re hanging onto the commission model – **transition to a fee for service** or get out – regulation prohibiting payments from product or platform providers is a distinct possibility.