The Value of Advice

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Background

The purpose of this paper is to provoke thought amongst management and valuators regarding the determination and tracking of value added from retail advice distribution channels. It has been written from a perspective of valuators and management of wealth management conglomerates who need to understand the value to their business from either owning or operating through advice based distribution channels.

Our paper advocates that a channel based approach to tracking and monitoring value over time provides an invaluable source of insight to the future management and strategic decision making of wealth management organisations. This is in contrast to the traditional approach of performing valuations from a "product" or "manufacturing" perspective. We further believe that moving to a channel centric view to valuing wealth manager conglomerates is a necessary evolution to ensure that the valuation techniques used by the valuators, such as actuaries and other professionals, remain relevant to the management of the conglomerates for whom future valuations are to be performed.

We believe this paper will be useful to practitioners responsible for valuing both wealth management conglomerates and the individual advice based businesses typically owned by such conglomerate entities. We provide a framework to assist in assessing the value of such advice based business.

The paper has drawn heavily from the experience of the two authors both working for and consulting to what has been a rapidly evolving wealth management industry over the last 10 years. Whilst the authors would like to recognise the input and expertise of their respective employers that has helped shape the thoughts in this paper, we nonetheless qualify this paper as being our own thoughts and not those of our respective employers. We would like to acknowledge the constructive comments of Andrew Gale, David Ward and Andrew Draney in the preparation of this paper.

1 The Role of Advice in Wealth Management

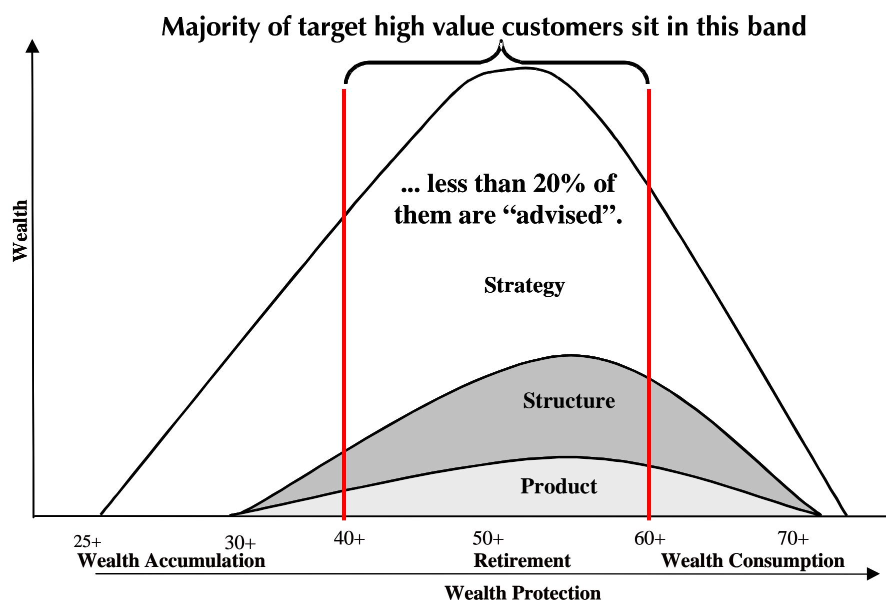
"…advice that is perceived as value added and objective is one of the few core demands that investors share worldwide." Cerulli, December 2002

1.1 Retail Advice

There has been, and will continue to be, a strong and growing industry in the delivery of individual financial advice. Demographic trends, the growing significance of individual wealth balances, a complex tax and social security regime, an increasing reliance on asset classes such as equities, a "compulsory" superannuation system that is increasingly self managed and a general increase in uncertainty have all been factors in the increased consumer demand for advice. Legislative changes such as the introduction of advice licensing (CLERP) and also a general evolution in industry behaviour has seen an ongoing improvement in the professionalism of the financial advice industry charged with meeting this demand.

Australian wealth management conglomerates continue to position their strategy around the tenant that consumers need quality financial advice. This is a distinct re positioning from the previous strategy of selling products – perhaps rather ungracefully known as "product flogging".

This re positioning by the industry has been strongly driven by the realisation that the provision of quality, holistic financial advice across an individuals life cycle (including product, structure but most importantly strategic advice) will play a critical role in ensuring that an appropriate level of wealth will be accumulated to fund their immediate lifestyle goals and eventual post retirement financial needs. Demographic trends have generated a large segment of highly profitable individual customers in the 40 to 60 age bracket who have accumulated wealth but are in pressing need of sound strategic financial advice.



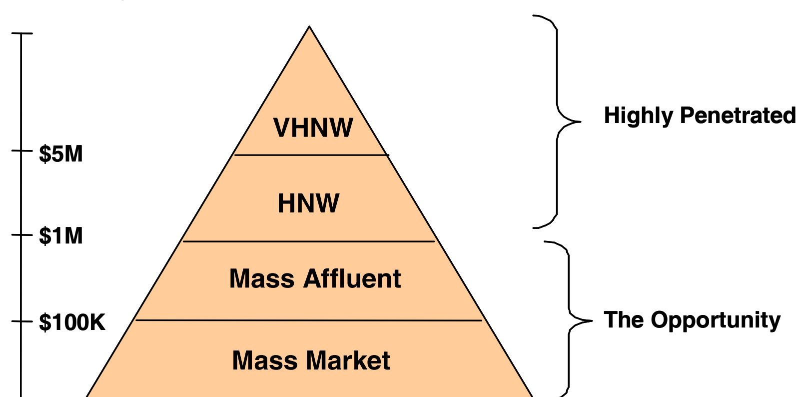
Source : National Wealth Management

Providers of this financial advice are seen to be the key relationship holder and access point to securing wealth management customers into the future. Indeed, the Australian wealth management market to date has been relatively untapped in terms of customer penetration for advice delivery and services (National Wealth Management recently estimated that less than 20% of potential customers in this high value 40 to 60 year demographic segment are currently advised). This low proportion represents both a major challenge and major opportunity to the Australian Wealth Management industry.

1.2 Wealth Management Advice Customer Segments

"High net worth" customers (HNW and VHNW in the diagram below) are the traditional customer segment that has been targeted for wealth management financial advice. These customers have been targeted given their significant need for quality financial advice. Their relatively high personal wealth demands customised strategic advice and management. They are often time poor and have both complex taxation and diverse investment structures which require specialist financial advice.

Wealth Management Penetration to Move into Mass Affluent



Source : Trowbridge Deloitte

A substantial market also exists in servicing both the mass affluent and mass market customer segments. This is an increasing focus of wealth management retail advice, especially through bank aligned wealth managers, who have the broad customer access points via their banking operations to enter such segments.

Corporate Super Master Trusts and other large corporate and industry super funds are also building capability to capture retail business, particularly in the broader mass affluent market. Business superannuation platforms are an increasingly important channel for wealth managers to target new individual customers. For larger wealth management conglomerates, the "end game" from participating in the growing Corporate Super industry is typically being seen as the longer term "downstream" opportunity through providing advice to fund members.

(Whilst this paper focuses on individual retail based advice, the principles discussed can be equally related to trends around the provision of advice to business customers.)

1.3 Evolution of the "Wealth Manager Conglomerate" Business Model

A fundamental shift began a number of years ago, and is still continuing, in the strategic positioning of many Australian wealth managers.

Traditionally, back ended capability such as product/service platforms, investment and underwriting processes were held out as a wealth managers core competency. Recent times has seen a shift in industry focus around capturing the growing need for quality financial advice and implementation thereof. The traditional notion of assessing product distribution capability is giving way to assessing the strength of positioning around advice and the advisers who provide it.

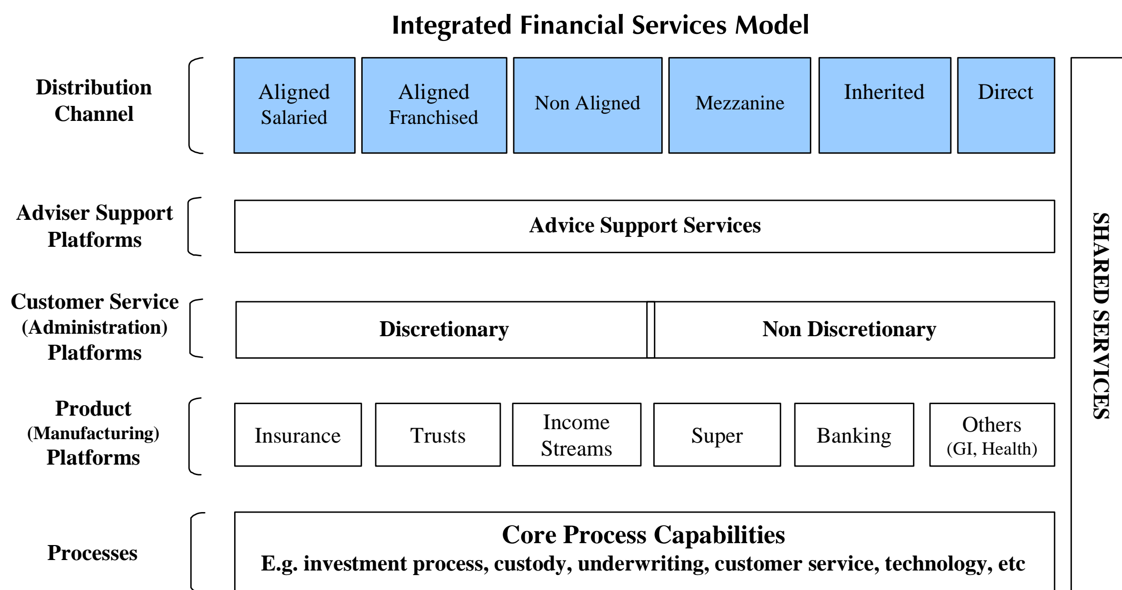
Financial planning advice is no longer seen as a "trojan horse" to sell financial service product but rather an inseparable component of a "holistic" package that integrates both the provision of advice and implementation of a long term customer solution. Once seen as a "means to an ends" for the product distributor, financial advice is now seen as core to the wealth management customer value proposition. Importantly, these businesses or adviser groups that provide the financial advice are now integral partners in the wealth management customer experience.

Product and service platforms are as much about satisfying the need of the adviser for a quality platform on which customers solutions can be implemented as it is about satisfying the ultimate customer need itself.

1.4 Integrated Financial Services Model

As a result of the above evolution, the modern wealth management business model is developing into a broad based "integrated financial service" model. This is demonstrated below.

Integrated Financial Services Model



Source : Gorst, Hickey

This model seeks to bring the infrastructure and scale to integrate the packaging of wealth management and banking solutions to retail advice demanding customers. Adviser support and customer service platforms support the adviser and other distribution channels in reaching and serving the customer. They also connect with the "back end" products to provide seamless delivery of the product to the adviser and customer. These are supported by back office processes provided by the wealth manager to ensure a holistic and integrated adviser and customer service solution.

The particular retail channels by which this model reaches the customer are defined as :

Aligned – salaried	Advisers are salaried and leverage off internal adviser support (dealer group) infrastructure and customer servicing / product platforms. Costs are typically funded by a combination of commission payments, financial planning fees and internal transfer pricing payments that allocate a share of revenue from any downstream sales made on internal product platforms through the salaried advice channel.
Aligned – franchise	Where customers are sourced through an advice business that has chosen to strategically align themselves to the wealth manager by operating under the brand and infrastructure of a dealer group owned by the wealth manager. Advice businesses will most often be self employed.
Non Aligned	Where customers are sourced through an advice business that has chosen to either remain independent, operate under a dealer group owned by another wealth manager or are salaried advisers with another wealth manager.
Mezzanine	Where a customers advice solution is implemented through a non owned service (administration) platform that offers customers access to the wealth managers product platforms. An example might be a non owned Mastertrust or Wrap service. "White labelling" of a wealth managers platforms to an external service provider might be another form of mezzanine new business to a wealth manager.
Inherited	Many wealth managers have a substantial pool of existing customer contracts from either older traditional style products or as members of business super schemes being managed by the wealth managers. Such customers are not able to be linked back to a particular advice business (or adviser) and in most cases are probably not receiving any professional financial advice. Such customer segments will require tailored strategies to strengthen the advice currently being provided to the customers and maximise the opportunity of further product cross sell.
Direct	Where customers are sourced through direct campaigns such as mail outs or internet based advertising rather than a personalised advice relationship.

Source : Gorst, Hickey

1.5 Corporate Strategic Positioning in the Retail Advice Market

Australian wealth management companies have adopted a range of strategic positions relative to the integrated financial solutions model shown above. These can be broadly considered as :

- **Wealth Management Conglomerate** – implementing most or all of the integrated financial services model. The big banks and other broad based financial services groups largely fall into this category. Combined with the existing customer base and distribution infrastructure that such conglomerates historically possess, they represent large, broad based organisations whose strategic opportunity is to leverage off both the size of their customer base and their overall scale advantage.

  Such conglomerates recognise the opportunity to integrate their financial services infrastructure to package both banking and wealth management solutions to their customers. This is driving their push into the mass affluent and mass market customer groups. Further, they appreciate the opportunities that can exist from having greater alignment between their adviser groups and other advice relating banking channels, such as mortgage broking.

- **Niche Adviser Business** – such groups fiercely maintain their independence and believe that this, together with their potentially more nimble operating model, can allow them to successfully survive against the adviser businesses that are owned and operated by the conglomerates. They exist at the advice distribution end of the integrated financial services model.

- **Niche Platform Provider** – these organisations consider their strategic strength lies in the ability to offer technologically advanced service delivery platform solutions to advice based businesses, be those owned by conglomerates or operating independently. With the generally significant capital expenditure required to support such servicing platforms, many of these providers are backed by large financial institutions that do not possess the desire or ability to implement a complete integrated financial services model. These institutions do, nonetheless, want to be active in the wealth management market without necessarily owning adviser businesses or possessing product manufacturing capability.

- **Specialist Product Manufacturers and Process Providers** – margins for product manufacturing services and their back end processes have generally been squeezed as a result of the emerging integrated financial services model. Investment managers, for example, have now realised that their strategic position may be best suited by providing specialist product services only and commanding prominent “shelf space” fees due to their size, specialty (ie. for boutique managers), and proven and expected performance. In effect they are able to achieve margins that are deemed “mezzanine” ie. lower than retail but higher than wholesale. By working through a platform they avoid retail distribution costs and can achieve larger volumes of funds invested.

There are many companies that exist somewhere between these four broad categories. These are the companies that will need to strategically review their business model and decide where they will operate – an unfocussed strategy is potentially dangerous.

1.6 Wider Applications : Mortgage Brokers

Mortgage brokers are an increasingly active and prominent component of the financial services landscape for banks and credit unions, and in particular for accessing the mass affluent and mass market customer segments. Many of the evolutionary steps that financial planners and financial advice groups went through in the wealth management context may be applicable for the emerging mortgage broking channel.

This introduces a powerful opportunity for both financial advisers and mortgage brokers to consider their holistic advice provision. Indeed, a model is beginning to emerge where financial adviser based businesses are working in conjunction with mortgage brokers to provide a broader range of customers with holistic financial services advice.

2 The Need to Value Advice

The evolving wealth management landscape and the prominent role that advice based channels play in this market requires particular attention to be paid to the value that is being generated through such channels. This is particularly so for those conglomerates who operate an integrated financial services model.

Three typical purposes for which valuations have been performed in relation to advice based businesses include :

i. Assessing and executing merger, acquisition and divestment opportunities
ii. Fair valuation of advice based businesses and wealth management conglomerates held as assets in financial statements
iii. To provide ongoing management insight and assistance with strategic decision making

2.1 Assessing and Executing on Merger, Acquisition and Divestment Opportunities

Advice will need to be valued as part of buying, selling or assessing an advice business but more typically an advice based dealer group. For the purpose of M&A work, a value based assessment of a stand alone advice business or dealer group can typically be made with a view to a:

- Passive acquisition – where a wealth management conglomerate seeks to preserve existing business and future sales (and associated business value) by “buying” more certainty over the stability of the business written through the advice group to the conglomerate.

- Active acquisition – where a wealth management conglomerate might seek to pay for the increase in value that can be engineered through having control over the advice based business. This covers a range of potential synergistic and strategic benefits such as control over an adviser force, access to customers, product penetration, integration, scale and intellectual property.

- Divestment – where the value of an advice based business is less to the current owner (due to limited operational scope which the current owner can provide the group) than to a potential acquirer who could achieve greater synergistic benefits. In this case it is as important to know when to sell as it is when to buy.

2.2 Fair Valuation of Assets in Financial Statements

With the M&A activity that has occurred, and the accounting treatment for such purchases when existing as assets in certain holding company balance sheets, there has developed a requirement for companies to place a “fair” market value on advice based businesses as well as on the wealth management conglomerates that own such advice based businesses.

This involves the owner having to come to an assessment of the underlying value of the advice based businesses and wealth management conglomerate. In doing so they generally rely upon a combination of both internal and independent external valuation opinion before considering a range of values which may be appropriate.

The process involved is not dissimilar from that required when assessing the value of such businesses in an M&A context (as per above). That is, considering the underlying value to the current owner and comparing to that which other owners may be able to extract and would be willing to pay for. Using external valuation advice, the directors then decide upon a point estimate of the value they will include for the advice based business in their balance sheet.

Assessment of fair value is not restricted to owned entities. The overall assessment of future new business value in assessing the "mark to market" value of a wealth manager for disclosure in its financial statements will require an estimate of the contribution to value from all advice businesses (whether they be owned or non owned) that have an economic relationship with the wealth manager.

2.3 To Provide Management Insight

The most beneficial purpose for valuing advice based businesses is to better equip management with the insights required to develop strategies that will enhance the value of the business.

This is particularly important considering that :

- substantial sums are often paid for such businesses, the rationale being that there is strong ability to generate future profits and strategic and synergy benefits; and

- such businesses are the front-end service delivery to the customer and will be critical to the success of the wealth management conglomerate in achieving product penetration

- extraction of integration and synergy benefits does take time and requires appropriate ongoing benchmarking and monitoring against what was originally paid for

It is the view of the authors that the provision of management insights as part of valuations of conglomerates, in particular in relation to the value of conglomerates as measured from an advice channel perspective, is an area where substantial improvement can be made.

3 Channel Based (Customer Delivery) View of Value

3.1 "Product" View of Value

It is common to find the value of wealth management conglomerates calculated and expressed along "product" lines. This traditional view of value, split across the operations of a wealth management conglomerate which owns and uses both retail advice based businesses and provides "back end" service, product and process capability, is:

Traditional Product (Manufacturing) View of Value

	Life Risk		Investment Management	
	Product A	Product B…	Offering A	Offering B…
Distribution & Support	< transfer pricing leaves little value in dealer groups>			
Servicing (Administration) Product (manufacturing) Investment Management	Majority of value passed to these operations			
TOTAL				

Source : Gorst, Hickey

Whilst producing a reasonable overall value, this view can be heavily distorted by transfer pricing mechanisms in place that shift value away from "front end" distribution entities. Distribution in the above normally only shows the value that is remaining in the advice based business after the margins are transferred to the product (manufacturing) operations and the remuneration is paid to advisers. Under most transfer pricing arrangements, and indeed due to the nature by which entities are operated, this margin remaining in the advice based business or distribution channel will be negligible, resulting in an artificially inflated view of the value of the product (manufacturing) operations of the company.

This "product" view of value can be of limited relevance for management of the wealth management conglomerates using advice channels as well as for the management of the advice based businesses themselves. The fundamental value of advice based businesses is the ability to generate and support platform and manufacturing services from the provider to the customer. In the wealth management industry, this value is significant. If it were not for the advice based channels, then service administration, product manufacturing and other margins would be substantially impaired. Lack of explicit recognition of this in the valuation can be misleading for management when deciding on where their key wealth management strategic opportunities and risks exist.

Furthermore, in complying with fair value reporting requirements, profit streams emerging outside of the "mark to market" environment (in particular banking business originated through advice channels) are often not considered in the "product" view of value.

A valuation approach which ascribes negligible value to front end advice entities, large values to back end product platforms and no value to customer solutions being implemented through non mark to market operations (such as banking) is arguably inconsistent with both

the significant market values being set for advice based businesses and the notion that value is increasingly migrating to the front end of the integrated financial services model.

3.2 Channel Based (Customer Delivery) View of Value

In order to remain relevant to the management and stakeholders for whom the valuation is performed, value needs to be considered consistently with the operating models which wealth management conglomerates are implementing ie. consistent with an integrated financial services model. In particular, a reflection of value from the top down – by the retail advice and other distribution channels which are used for customer delivery – is required.

An advice channel, or customer delivery, view of value places a valuation on all channels (and advice based businesses within these channels) that contribute customers to the conglomerates downstream service and product platforms.

Channel Based (Customer Delivery) View of Value

	Aligned (Owned)		Aligned (Franchise)		Non Aligned		Mezzanine		Inherited	Direct
	Group A	Group B….	Group A	Group B….	Group A	Group B….	Platform A	Platform B..		
Adviser (Support) Platform										
Service (Administration) Platform										
Insurance Products										
Product A										
Product B										
Investments Products										
Product A										
Product B										
Sub Total - PLATFORM VALUE *										
Synergy Value										
Strategic Leverage Opportunities										
Banking Products										
IFS										
Others										
ECONOMIC VALUE										
Market Adjustment										
MARKET VALUE										

* Value including net assets.

Source : Gorst, Hickey

This channel based view of value is far more informative for the user of the valuation. It provides a clear separation of not only the value across different "back end" operations (investment management processes, product platforms, service platforms, etc) but importantly shows the contribution of each significant channel and adviser based business to this value. The view remains relevant irrespective of whether the organisation chooses to own or not own advice based infrastructure.

A channel based view of value equips management with a value snapshot from the customer through to the product or service. Whilst providing management with the traditional insight provided by the product (manufacturing) view of value, it further enhances their strategic decision making ability in key areas such as:

- evaluating whether an advice business or channel is meeting its value expectations relative to historical shareholder capital invested into the business or channel
- assessing the relative value of the various channels (and significant adviser groups)
- developing strategies to enhance channel by channel value (including potential divestment)
- identifying the difference between market value and underlying economic value
- developing appropriate incentive and remuneration arrangements aligned to corporate value creation
- assessing the effectiveness of distribution spend across various group channels

Such a measurement framework is enhanced through explicit inclusion of potential synergy and strategic leverage opportunities, i.e. value that is not currently captured in the business. Explicitly identifying such components of value allows management to readily identify and focus on implementing strategies required to ensure the value from advice infrastructure, and overall wealth management operations, is enhanced into the future.

3.3 The Challenge To Valuers

Management will increasingly require channel centric "value based management" tools to assist in running their organisation. An ongoing process of viewing value by channel is arguably a far richer source of management insight than a "product" view of value that is often provided for delivering the majority of wealth management conglomerate fair valuations for financial statements.

Indeed, if the current accounting requirement for performing fair valuations of such wealth management conglomerates and advice based businesses was removed, valuers must ask themselves : "Would management still want our services?".

The answer to this will depend upon how much genuine strategic and management benefit is provided by the valuer, especially considering the integrated financial services model which such conglomerates are increasingly incorporating.

4 How to Value Advice

The volume and financial magnitude of advice based business transactions which have occurred over the past 5 years in the Australian wealth management marketplace has precipitated an evolution of methodologies to value such businesses. They have originated from both actuarial, corporate finance and accounting professions. The choice of method often varies significantly depending upon the purpose of the valuation, the availability of information and the professional training of the valuer.

Central to the ability to provide a channel centric view of value is the ability to appropriately understand and reflect the value being generated downstream from advice based business, and other distribution, channels.

This section provides a framework for performing such valuations of retail advice based businesses which can be used to either value such businesses in isolation or value wealth management conglomerates from an advice based business, or channel, perspective.

4.1 Definition of Value

Before proceeding further, it is necessary to consider the definition of value. The definition of value broadly depends upon the purpose and context of the valuation. In relation to wealth management conglomerates and advice based businesses, value is often considered as either "economic value" or "market value".

The "economic value" of an advice based businesses represents the value that the business brings to the current owner as an ongoing concern. In the case of non owned advice businesses, economic value will exist to a wealth manager to the extent that an existing book of business and / or future sales on the wealth managers support, service and product platforms are expected through the non owned advice channel.

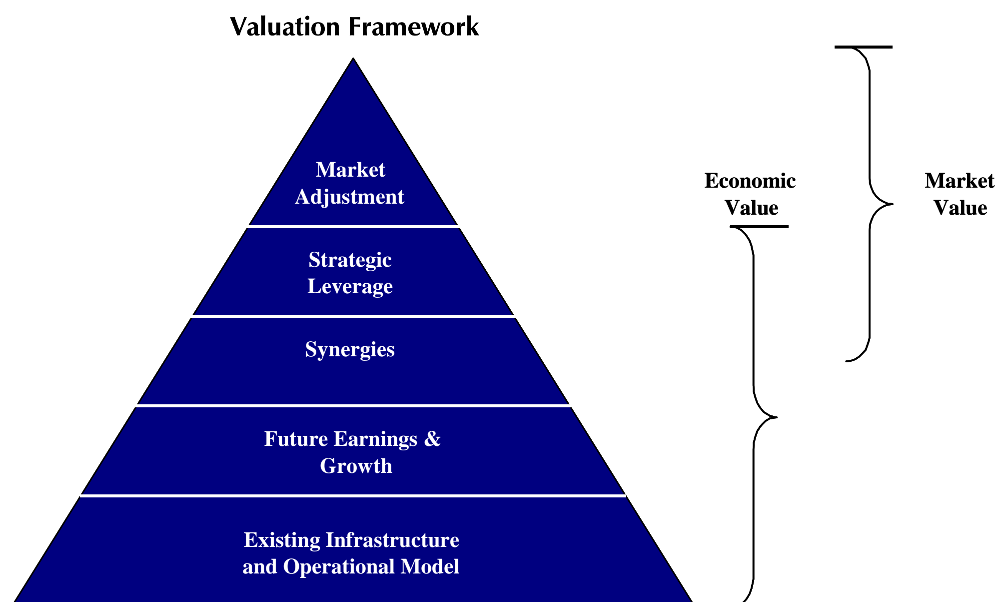
A "market value" is generally based upon this view of economic value with adjustments made where appropriate to reflect the different values (potentially both higher or lower) which willing parties may be prepared to pay to purchase the assets from the current owner, should they be a willing seller.

It is largely up to the recipient of the valuation results to guide the valuer as to their requirement – ie. economic or market value. For ongoing internal management and tracking of the value of advice based businesses, economic value and the change in economic value may be the most appropriate as it allows management to focus on strategic value add without the potential noise created from market adjustments. For external reporting of such values, and for testing potential disposal or transfer value, market values are often the most appropriate.

4.2 Valuation Framework

Valuing advice based businesses, both as stand alone entities and as strategic assets and distribution channels of wealth management conglomerates, requires specific consideration and practical knowledge. A value framework which will provide strategic and operational

insights for management is one that is based around the contribution to value from the following :



Source : Gorst, Hickey

The ability to understand advice based business value, and how this interacts with downstream product and service platform margins for the users of such advice businesses, is critical to being able to value a conglomerate from a channel perspective. The above framework allows the channel view of value to be obtained, including qualitative and quantitative assessment of the synergy and strategic leverage opportunities.

4.3 Existing Infrastructure and Operational Model

A core requirement in assessing the value from an advice based business is performing an assessment of the infrastructure and operating model.

Some aspects of the existing business operations to be assessed include:

Net Tangible Assets (NTA)	The size, quality and growth of this over the past period and the ability to access capital to support future growth. Have cashflows generated by the advice business drained or contributed to the balance sheet? (An advice business making stand alone cashflow profits can be an important validation of a sound underlying operating model)
Support Platforms and Operations	What platforms are available for planners and what is the quality of back office support? What are the product platforms that have historically been chosen by the planners and why?
Revenue Quality	Revenue drivers need to be understood, for instance ▪ What services and product sales are generating the revenue and how is this sourced across planners? ▪ How are advised assets split between direct vs. managed funds

	under management? ▪ How is the revenue split between up front vs recurring revenues? ▪ What are revenues split between fees and commissions? ▪ How are commissions diversified across risk, investment and banking business? ▪ To what extent is revenue being supported by transfer pricing (if owned by a larger wealth manager conglomerate) that provides a share of revenue on downstream service and product platforms? What has been the reliance upon key planners to generate this revenue? How is this key person risk being managed? What have been the trends around historical growth in, and retention of, advisers? What is the demographic and geographic segmentation of advisers? How are planners segmented across the spectrum of holistic advice providers through to traditional product sellers? How qualified are planners to provide advice? Quality advice businesses will generally have a more enduring revenue stream than a traditional product selling business.
Expense Mix	Many advice based entities are in growth phases and expenditure may be high in order to establish operations. How efficient has the business been in managing its expenses? Normalisation of operating levels, capitalisation and historical amortisation of expenses must be considered.
Size, Mix and Productivity of Planners	The number of planners are an important consideration in assessing an advice business. Further size related considerations might include: ▪ Full time vs. part time planners ▪ Experienced vs. inexperienced planners ▪ Para-planners ▪ Internal vs. aligned planners Key measures of productivity and planner effectiveness that might be considered include : ▪ Existing customers per planner ▪ Number of annual leads generated per planner ▪ Proportion of annual leads converted into plans ▪ Proportion of annual plans implemented ▪ Average sales volumes from implemented plans ▪ Average FUA / risk premium / debt per planner ▪ Customer profile (demographic, socioeconomic profile, etc) ▪ Customer retention multiple product ownership per customer per planner

Adviser and Third Party Contracts	Underpinning the financials and future growth are the remuneration incentives for the planners and senior management of the advice business. What are the nature of contracts between advisers and the advice business? What are the exit and retention arrangements for key advisers? Contracts (in particular remuneration arrangements) heavily influence the sustainability of business and behaviour of planners. What are the nature of any third party outsourcing contracts? It is important to understand what services have (and have not) been outsourced by the advice business. What are the terms and obligations to historical providers of financial capital? What licensing arrangements are in place?
Practice Management	What practice management functions are provided to planners to assist them in growing their business?

The above considerations will assist in performing the preliminary assessment required before forecasting the future earnings potential of the business being valued.

4.4 Future Earnings Streams and Growth

Once the key drivers of the business are understood, a discounted earnings model can be built to value the potential future distributable profits (and franking credits generated). Given the high growth nature of the wealth management market which advice based businesses serve, it will be no surprise to see substantial value arising from business yet to be written. This enforces the need to have a strong understanding of the business being valued, solid industry knowledge and insights to better understand the competitive potential that can be ascribed to the business.

Some particular considerations at this stage might include:

- Business plan review - the strategic direction and growth targets in the business plan must be critiqued against past experience, the existing structure of the business and the realism of the business's capability to grow at the rates anticipated in the business plan.

- Market growth – a strong understanding is required of the expected future market growth across the advice channel, the advisory services provided and the investment platforms used (and non-platform investments). Key drivers of this market growth will need to be considered against the current capabilities of the business.

- Downstream Products, Platforms and Services – from assessing the planner productivity and mix of sales, customers and cross-sell penetration, assessments can be made of manufacturing downstream business retention and sales. This links in the "product" perspective of value, but builds it up from an adviser centric analysis, rather than a product centric analysis.

- Margin shifts – there is continual pressure on margins throughout the wealth management market. It is important to understand where this squeeze is coming from and assess how exposed dealer groups, service and product platforms are to the squeeze. It is also necessary to appreciate that opportunities may exist to either increase margins or accept lower margins in trade-off for higher potential volumes.

  An increasing feature of advice based businesses is incentivised payment structures for planners, including margin sharing and equity participation. It is important to work through the dynamics of such arrangements. Although the dealer group may appear to receive lower fees as more is passed to the adviser, the actual outcome may be enhanced value through higher sales volumes and improved persistency.

- Capital expenditure – to sustain future growth (eg support operational upgrades, IT spend, etc) capital is inevitably required. This requirement often occurs in stages and must be considered in the forecast of value.

- Transfer pricing arrangements – it is important to have clear understanding of the flow of margins through the segments of the "value chain" ie. advisers, adviser support (dealer groups), service and product platforms and processes (e.g. investment management). There are often complex pricing structures established which can place greater margin in certain segments of the value chain. Such arrangements can severely distort the true value of advice based businesses.

  Typically, margins made from financial services products originated through either an owned dealer group or salaried advice channel are transferred from the dealer group and placed in "back end" service, product and process functions. This may give the recipient of the valuation an impression that the dealer group is of minimal economic value to the organisation. This is a critical element to understand when considering a channel view of value. It may be necessary to cut-through to the actual margins and associated expenses to appreciate where the real margin resides.

The above considerations, together with an analysis of the existing operational and business drivers, will provide the basis for an objective assessment of the potential future business flows and margins likely to emerge from the advice based business.

4.5 Synergy Benefits

A key determinant of the value of advice based businesses owned by larger wealth managers is the potential to extract synergies. This element of the valuation is particularly important when it is considered that the owners of such businesses are likely to have paid for a share of such synergies when they purchased the advice based business as a strategic investment. It will also be relevant in the case of a wealth manager that has invested considerable capital, not in acquiring an advice business, but rather aligning to a non owned third party advice or platform business.

A properly implemented valuation framework will allow the owner's management to understand the return on investment in an advice based business relative to that expected at purchase. This is critical to ensuring extraction of synergy value.

Some major potential synergy benefits to consider when valuing strategic investments in advice based businesses might include:

- Ownership / control leverage – this is the ability of the owner to have management influence over strategic decisions made by the controlled entity. This could allow the owners servicing and product platforms greater prominence in the sales of the advisers in the business. Additionally, the owners may get first option rights for providing new or updated services or platforms for the planners.

- Platform Cross-over – being able to roll out the owner's platforms across the advice based businesses. This will provide the owner with enhanced revenue as planners direct their customers to the owner's platform as well as greatly increase the "lock-in" of planners to the owner. The more integrated the customer service and product platforms rolled into the advice business or dealer group, the greater the product cross sell that can be achieved.

- Back Office Integration – consolidating back office adviser support platforms across the business. This can provide greater revenue for the owner from transfer fee arrangements, benefits from extra scale, as well as greater ease of communication and alignment.

- Overhead expense saving – by centralising certain corporate overhead functions expense savings can occur.

- Intellectual Property – the ability to understand the intricacies of how an advice based business and its planners operate and cross pollinate these ideas and intellectual capital across other owned groups.

Synergy benefit can be translated into a valuation outcome either through explicit calculation or through more favourable long term assumptions being used in the valuation of future earnings streams.

4.6 Strategic Leverage

There can exist substantial leverage potential within advice based businesses to expand their operations into broader fields in the wealth management marketplace. From an infrastructure of planners skilled in providing advice services to customers, information technology systems and intellectual property comes an ability for such businesses to expand operations in alike advice based fields, both in the wealth management and wider financial services market.

A primary role of the valuer is to assess how this potential leverage could be optimised. Strategic leverage opportunities might include :

- Anticipated industry developments – this could be based around customer behavioural change (eg demand for greater stability of investments leading to development of growth income assets) or adviser changes (eg the increased push for independence, badging and equity ownership models).

- "White space" opportunities – these are opportunities which it is foreseen by the management team may arise in the future. For example, greater integration of financial planning and mortgage broking operations and the need for advisers and platforms to service both.

- Growth segments / decline segments – it is important to assess whether there is strategic benefit in moving first into or out of specific segments of the market which may be about to undergo significant restructuring.

- Value chain shifts – understanding the industry dynamics around how customer fees are divided amongst advisers, platforms and investment managers within the traditional value chain can give insights into opportunities to maximise future success.

A qualitative assessment will need to be undertaken around the ability of the advice based business to take advantage of these and other potential strategic opportunities.

4.7 Market Adjustments

The outcome of the above will be a range, together with a central estimate, of the potential economic value of the advice based business. However, it will not necessarily be a fair market value. There are market factors to consider when adjusting from an economic value to a fair market value.

Market Comparables

The availability and willingness of informed potential buyers and sellers in the marketplace is fundamental to gauging a potential market sentiment for the value of the business. Recent transaction history, trading value information as well as general market sentiment are all important considerations when determining market comparables to assess against the economic value.

Such comparables which may be considered include :

- Price/earnings ratio
- Percentage of Funds Under Administration
- Multiple of NTA
- Multiple of recurring revenue

Past transaction history and current trading ranges, if considered in isolation and as the sole basis for determining value, can be misleading. This is because it is very difficult to find directly comparable businesses with the same level of potential strategic leverage and synergy benefits available to the purchaser.

Strategic Leverage and Synergy Benefits to Potential Acquirers

Whilst consideration against such market based parameters is an important indicator of potential market appetite, purchasing and selling companies will usually undertake more fundamental value analyses. The analyses will be based upon the drivers of the business value, such as current and potential earnings streams, ability to transfer funds to the owners

product platforms and other forms of strategic leverage, as described through our valuation framework.

The valuer can assist the company in determining whether the value which they could potentially extract from the business justifies the range of potential price which may be demanded in the market. It is critical to have a fundamental assessment of value and its sources performed to ensure that the ranges implied by current market sentiment is an appropriate and justifiable price range for the individual company (ie. its owners/shareholders) entering into the transaction.

The amount of and ability to extract strategic leverage and synergy benefit will be key when assessing the potential value acquirers may place on the business.

Example

Consider a current owner that does not offer investment management or product platform capability to the advice based group. This might represent, for example, a stand alone financial planning business owned by a small group of senior planners. Whilst the stand alone business is only generating future income relating to planning fees and commissions, a potential acquirer who has both investment management and platform service capability may see substantially more strategic leverage benefit than the current owner. Whilst the current owners may see potential "opportunity value" if they can build the necessary service and product platforms, it is more likely that the premium would be realised through eventual disposal of the business to a wealth manager conglomerate with the "back end" infrastructure ready built to unlock any synergy value paid for at acquisition.

Such a situation might give rise to an implied value that exceeds the underlying economic value of the advice business. In deriving a market value, this difference will likely be limited to the extent that any potential acquirer sees effort, cost and risk in actually extracting such benefits.

Such assessment can give rise to a considerable difference in estimated market values for advice businesses that may appear at face value to be similar in nature. Such differences will often need to be explained by the valuer to owners of advice businesses who have a vested interest in seeing their business valued at the upper end of any such valuation range. A robust framework for building up the components of market value, as recommended in this paper, is therefore essential to ensure that a recommended market valuation can be anchored around an objective bottom up assessment of the business.

Defensive Premium

To the extent that the advice based business is placing services (products, investment and platform offerings) to other providers who are not the current owner, such service providers may be willing to pay a "defensive premium" if given the opportunity to acquire the advice business to ensure that they retain the value being managed through the provision of such services. This can be a consideration in performing a market adjustment to an economic valuation.

Another aspect of the market value adjustment which needs to be considered is the potential loss in economic value if the business were owned by another party. Notably, divestment of an advice business will likely reduce, but not remove, the economic value that is being recognised by a wealth manager. Planners in the (now non owned) advice business may still continue to selectively direct customers to their old owners product platforms after divestment. In such a case, economic value will remain with the existing wealth manager even after divestment.

4.8 Implementing the Channel View of Value

A powerful way to represent the economic and market range of value to management is to show the results via the channel view of value (repeated below).

Channel Based (Customer Delivery) View of Value

	Aligned (Owned)		Aligned (Franchise)		Non Aligned		Mezzanine		Inherited	Direct
	Group A	Group B….	Group A	Group B….	Group A	Group B….	Platform A	Platform B..		
Adviser (Support) Platform										
Service (Administration) Platform										
Insurance Products										
Product A										
Product B										
Investments Products										
Product A										
Product B										
Sub Total - PLATFORM VALUE *										
Synergy Value										
Strategic Leverage Opportunities										
Banking Products										
IFS										
Others										
ECONOMIC VALUE										
Market Adjustment										
MARKET VALUE										

* Value including net assets.

Source : Gorst, Hickey

The valuation framework, being based from an assessment of the underlying advice business and its value from product and service downstream business support, is ideal for producing the channel view of value.

A transition from a product (manufacturing) view to a channel view of value can be reasonably smooth. The key requirements of such a transition will be :

- A clearly defined business model that identifies the various channels across which the valuation will be viewed.
- The ability to split data extracts across these channels in order to both analyse experience but also build prospective valuation models unique to each of these channels

Whilst it is recognised that such a process could involve a not immaterial increase in the amount of modelling required to complete the valuation, this can be mitigated by :

- Placing less focus on many models across individual products and more focus on fewer models across more generic consolidated product platform categories.
- Using sensitivity type factors to some of the more minor channels or to individual groups within each channel.
- Moving to an annual "fully modelled" valuation and estimating inter cycle (eg half year) valuations by strengthening sensitivity analysis around key value drivers being monitored and any inter period experience investigations being performed.

5 Tracking and Monitoring Value

Establishing or acquiring advice based businesses is a significant investment both strategically and financially. This is especially so when many of these operations may be at early stages of business growth with minimal operating profits emerging. In such cases, the value paid will largely depend upon the ability to generate future profitable earnings streams, extract synergies and implement strategic leverage. This ability is quantified by performing a business valuation.

The post acquisition tracking and monitoring of value is all too often frustrated by transfer pricing and valuation methodologies that create the impression that the value of the advice based business is negligible and that the "back end" service, product and process functions are where the value resides.

This can be misleading to management for a number of reasons.

- As evidenced by the large market based transactions of the last 10 years, substantial market value does actually reside in advice based entities.

- If it were not for such channels, then the service and product platforms would not have been able to achieve the scale which they currently have.

- Management need to be able to understand whether the value paid for (and/or capital invested in building) the advice based business has been maintained, enhanced or eroded. Substantial shareholder funds are often used for such strategic investments.

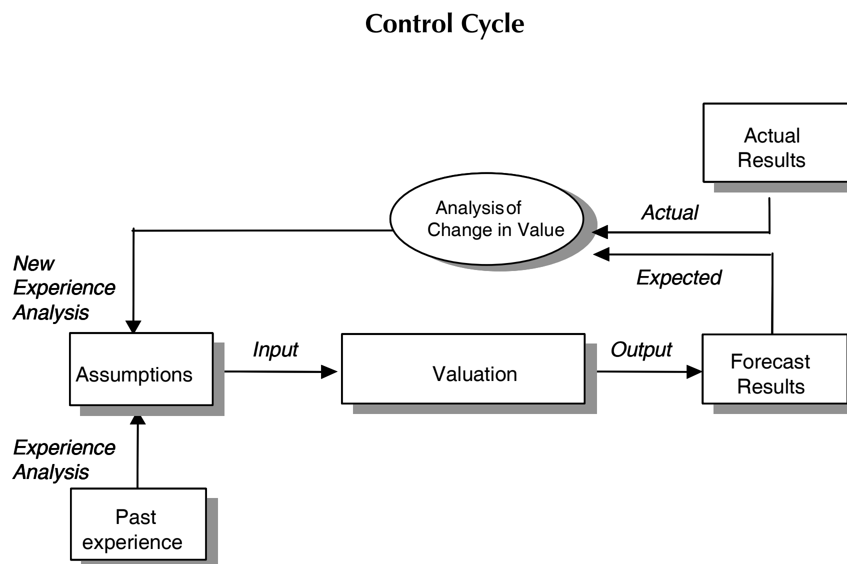
- Strategies at the "front end" advice channel level are equally as important as "back end" product platform strategies in terms of ultimate creation of value. Recognition between the correlation of channel value and holistic company value is critical.

The valuation framework in this paper provides the basis for performing regular tracking and monitoring of value from a channel perspective. A robust monitoring system is critical to providing greater insights to management to regularly assess the value of the business operations and to make informed strategic decisions.

5.1 A Control Cycle Approach

The conceptual "control cycle" for monitoring a valuation and providing management information is a simple yet powerful tool.

Control Cycle



This shows that a valuation is only one component of a regular reporting cycle. Experience must be monitored and the results compared to that which was expected. This will assist the valuer in understanding why, at future valuations, the emerging value across the channel may be different to what was expected. Revised assumptions and other bases may be incorporated for the next valuation, as well as management being informed of performance and providing them with the opportunity to implement strategic decision making in response.

5.2 Monitoring Key Value and Risk Levers

In changing the perspective of value to more fully incorporate that value residing in the "front end" of advice based businesses, it will be required to explicitly monitor those drivers that most impact value. This will both support the valuation and the relevant analyses to expectations as per the control cycle for tracking and monitoring value.

Under a product centric view of value, typical key performance indicators that might be tracked include:

- sales – volume and mix
- size of book – FUM or Annualised Premium (risk)
- redemptions
- expenses
- investment earnings

These are generally measured and analysed at the product level, with often some reference to broad channel.

To adequately measure value and track drivers under an "advice channel" view of business value, it is necessary to have more detailed and advice centric performance measurements. In particular, performance measures could be anchored around advice based value drivers such as :

- adviser numbers (including adviser attrition rates) by channel
- % of an advisers book (and sales) being managed on internal product/service platforms
- adviser productivity (% of leads and plans converted, products and volumes sold)
- customer retention by adviser
- cost of servicing advisers – servicing spend by wealth manager across adviser groups
- adviser revenue - fee split of advisers; up front versus ongoing commission streams
- internal expense splits within adviser business
- in-house platforms vs external placements
- etc

Under a properly constructed channel view of value, such drivers will form the key performance indicators with which the owner can benchmark the relative performance over time of their advice channels. They will be an output from the valuation and will be able to be tracked and compared against using the control cycle approach. It is important to know the relative impact which these items may have upon the value if actual experience is different from that expected. This allows management to track these on an interim cycle between actual valuations and will promote a more active management information process.

It will be critical to properly align these drivers with appropriate adviser incentive and remuneration structures. Both advisers and management will then share common goals linked to value and the interests of both will be aligned.

Ultimately management can only manage what they can measure. Disciplined performance measurement systems will enable the performance of advice based businesses to be monitored against key value drivers.

5.3 Reconciling Change in Value to Key Value and Risk Levers

Over time, the combination of :

- quantifying business value using the channel view; and
- analysing change in value by reference to value drivers

will provide senior management with the insight to understand the success or otherwise of their "front end" business strategy. In particular, it will provide an opportunity to quantify a channel by channel return on any shareholder capital historically employed to build advice based infrastructure.

A simplistic representation of the form this analysis could take is :

Analysis of Change in Value

	Channels	
	Owned – Group A	**Aligned – Group B…**
	$m	**$m**
Value at 31 December xx	100	…
Expected Value at 31 December xy	110	…
Net Capital transfers	-	
Actual variations over period		
- adviser number growth	(5)	
- adviser productivity	+15	
- adviser product cross-sell	(5)	
- customer retention	+5	
…….etc		
Assumption changes		
- adviser productivity	20	
- adviser product cross-sell	(10)	
…….etc		
Actual Value 31 December xy	130	

Source : Gorst, Hickey

The table above highlights that it is important to be able to clearly display the actual value compared to the previous value in terms of variations from expected outcomes by key value drivers. This allows management to assess performance relative to expectations and to, where appropriate, revise future expectations and/or implement initiatives to either continue positive actions or take remedial action against adverse emerging trends in key value drivers.

6 Enhancing Value From Advice Channels

The costs of acquiring advice can be considerable. Furthermore, the capital hungry nature of advice businesses can result in the initial cost of acquiring advice infrastructure quickly being overtaken by the ongoing capital contribution required to maintain and grow the business. Significant money can also be spent in building, servicing or aligning with ultimately non owned advice based infrastructure.

Value creation through an advice channel will occur to the extent that historical and future "end to end" profits on downstream service and product platforms together with adviser support revenue and ultimate divestment value is greater than the start up costs (such as acquisition) and ongoing servicing and commission costs required for the advice based business.

In order have the greatest possibility of optimising value from advice based businesses, the following general strategies can be effective :

i. Adopting a channel based view to monitor value
ii. Developing a robust valuation framework for assessing merger, acquisition and divestment opportunities
iii. Conducting ongoing portfolio review of advice based businesses
iv. Building integrated adviser support and customer service platforms
v. Focusing on practice management
vi. Strengthening key person relationships and business partnerships

6.1 Adopt a Channel Based View to Monitor Value

Enhancing value from advice based infrastructure is about developing strategies that positively influence value drivers. A critical precondition to enhancing value is to establish an ongoing cycle of channel centric value measurement and performance management. Such a system will support the need to assess benefit realisation over time against the key financial, operational, strategic and people targets required to be achieved in order to deliver an acceptable shareholder return on investment.

Understanding what the synergy drivers were at acquisition (eg leverage, lead generation, turnkey platform, workbench, re-engineer financial planner staff etc) and building a suitable ongoing reporting framework that measures performance against these drivers is important to ensuring that value paid for is actually tracked and implemented.

More generally, not losing sight of the hurdles required at time of investment into the advice based infrastructure avoids distorting the real return on capital that has been achieved on a particular strategy over time. By understanding the true return on capital of ongoing investment into advice based infrastructure, a business can learn historically where it has been best at creating shareholder value. Such knowledge assists management in more efficiently allocating capital over time.

6.2 Developing a Robust Valuation Framework for Assessing Merger, Acquisition and Divestment Opportunities

Control through acquisition (particularly of dealer groups) has been seen as a popular strategy to enhance value from previously non-owned advice based infrastructure. One strategy around acquiring an advice based business is the extent to which the cost of gaining control of a dealer group is exceeded by the extra ongoing profitability able to be realised through the advice based infrastructure. Value is created from such "active" acquisition to the extent synergy benefits and strategic leverage paid for can be achieved over time.

Another strategic ("passive") reason for acquiring previously non-owned advice businesses is to remove the risk that your own economic value might be eroded in the event that the business is acquired by another wealth manager.

Whichever reason, it is important to not pay too much for an advice based business.

Impatience to invest in positioning at the "front end" of the value chain can cause rational assessment of likely long term return on capital to be compromised by over exuberant assumption setting and business cases that, whilst strong on strategic positioning, ignore financial fundamentals. A thorough review of the contracts governing customer servicing rights is important to understand the extent to which customer value can be retained in an organisation in the event of advisers leaving. It is also important to understand the extent to which service functions have been outsourced. To what extent are you buying servicing infrastructure versus a series of outsourcing contracts? Large premiums have been paid to acquire advice based businesses in the last 10 years. The next 10 years will likely reveal the extent to which value has been created or destroyed by such acquisitions.

It is as important to know when to sell as it is when to buy. Whilst less popular amongst larger wealth managers, divestment of an owned advice business, dealer group or channel can be an important strategy in maximising shareholder value. The success of this strategy first requires having a buyer who thinks the business being divested is worth a lot more to them than it currently is to the vendor. More importantly, a clear strategy / opportunity is required to ensure that proceeds from divestment are suitably reinvested back into the business in a way that will enhance the longer term value of the business. The residual "post divestment" economic value that would continue to be captured in the wealth managers product and service platforms needs to also be considered. Such an assessment will be an important consideration in any ultimate decision to divest.

Understanding future capital requirements is another important requirement in the financially sound management of advice based infrastructure. Moreover, managing an advice business into a stand alone break even position where it is able to fund its own future operational and capital expenditure from ongoing cashflow profit should be an important financial goal in the management of an advice based business.

6.3 Conduct an Ongoing Portfolio Review of Advice Based Businesses

Like any portfolio of assets, a disciplined approach to the portfolio review of advice based infrastructure is required to re-balance and realign back to long term strategic objectives. A process of ongoing portfolio review will provide the opportunity to implement initiatives that leverage advice capability into broader fields in the financial services market place (e.g. mortgage broking) opening up partnerships and alliances that can enhance a wealth managers value.

Monitoring the segmentation of advice businesses, individual advisers and the customers they service is important in positioning, reviewing and efficiently executing an advice based strategy. One simple segmentation for advisers might be around average age. A wealth manager may own or be aligned to a well performing portfolio of advice based businesses, but if they are all looking to exit in the next 5 years, there will need to be focussed strategies put in place to ensure that customer value is not lost as advice businesses are transitioned to new owners. Understanding how advisers are segmented between the spectrum of "starting up" through to "seeking to exit" is crucial in developing longer term risk management strategies around the sustainability of advice based infrastructure and its ability to grow its long term revenue base. Start up advisers will generally be far more "capital hungry" than more mature businesses that have built up solid revenue flows and run on a cashflow positive basis.

6.4 Focus on Building Integrated Adviser Support and Customer Product/Service Platforms

Wealth managers can enhance value by providing quality support platforms for advisers to assist in freeing up an advice business to focus more on their core competency of providing quality financial advice. e.g. back office support, business management assistance, robust IT systems to handle adviser and customer needs, etc.

A wealth manager needs to have the quality and breadth of service and product platforms that both meet the needs of adviser's customers and represent the "platform of choice" to aligned and non aligned advisers. Value is created by advisers preferring a wealth managers internal service and product platforms to others in the market. When this choice is driven by platform quality (including price and customer features) the perception of independence to advice customers is not compromised.

The ability to package integrated customer solutions across various financial services product groupings will be an important strategy to enhance value from advice based businesses in the future. The emerging trend for quality advice businesses towards "holistic" financial planning across the full spectrum of investment, protection, debt and estate planning needs will challenge innovative wealth managers to develop and integrate the platforms required to meet this emerging advice proposition.

Management focus on positioning at the "front end" of the business model can't be at the expense of focus on maintaining operational efficiency and "best of breed" customer solutions**.** Owning aligned advice channels businesses should not be at the expense of operating unprofitably in other areas of the overall business model. The detrimental impact

on margins of both inefficient cost structures and advisers who would prefer to recommend to their clients platforms developed by competitor wealth managers in the market will be significant. Money spent in servicing and supporting advice channels must be seen to stand up to financial fundamentals that will ultimately result in value creation.

6.5 Focus on Practice Management

Whether the advice based business is owned by a wealth manger, or whether it is not owned but writes material business through a wealth managers platforms, it is in the interest of all stakeholders for the advice business to be run as a profitable, successful operation. Investment through assisting advice businesses to better manage their business is one of the most synergistic strategies that can be used to enhance value from advice based businesses.

A well run advice business will ultimately translate into an improvement in both the quantity and quality (i.e. profitability) of customers able to be bought onto and retained on a wealth managers product platforms. Initiatives such as providing back office support platforms, dedicated business development managers and offering ongoing training / education can all be used to assist in business development.

Assisting in business management helps foster a strategic alignment of interests between customers (who want good advice), advice providers (who want to run a successful business through providing quality financial advice) and the wealth manager (who want to create long term value for shareholders).

Initiatives that focus advisers away from “selling product” and more towards the provision of quality holistic advice will ultimately result in a higher proportion of quality (as distinct from value destroying) customers being managed on a wealth managers platforms.

Similarly, remuneration structures that reward ongoing retention of a client (through trail type commissions) and give less reward up front are better aligned with the powerful valuation driver of improved business retention. Whilst less common, fee for service type models are shaping up to be one of the distinguishing features of businesses dedicated to the provision of trusted, objective advice. Remuneration arrangements are an important driver of adviser behaviour and are able to be used to align adviser behaviour with long term value creation by the wealth manager.

Equity participation and ownership models for remuneration are also becoming more widespread. The aim of this is to financially align the interests of advisers and wealth managers by providing equity in the upside value of the business, platform services or products being written.

6.6 Nurture and Strengthen Key Person Relationships and Business Partnerships

Insensitive regard to cultural idiosyncrasies of adviser businesses will destroy value. A clash of personalities or corporate insensitivity can see an unresolvable breakdown in the partnership between a wealth manager and the senior management of either a dealer group or advice business.

Many wealth managers are now specialising in efficient portfolio transition (TurnKey) services for advisers and their customers. A breakdown in relationship with key person(s) in an advice business can see substantial amounts of customer value quickly up and leave to be transitioned to another wealth manager. Key person relationship management and an ongoing regard to preserving cultural fit between the wealth manager and advice channels is therefore essential to managing valuation risk with owned or aligned advice based businesses.

6.7 Other Value Enhancing Techniques

Some additional aspects that might characterise the business model of a wealth manager able to enhance value from their advice channels could include :

- Structures that give corporate accountability - recognising and rewarding decisions that enhance value from advice based infrastructure
- a culture that encourages the need for ongoing learning amongst advice channels
- a corporate culture that respects and values the independence of advisers and the customer demand for objective financial advice.
- suitable reward, recognition and remuneration strategies for retaining high performing advisers
- suitable mechanisms to first identify, then remove or retrain poor quality advisers
- encouraging long term adviser loyalty by suitable reward and recognition for advice businesses who choose to strategically align themselves with a wealth managers platforms, e.g. by underwriting an exit strategy for long serving advisers wishing to exit.

7 Conclusion

The Australian retail wealth management marketplace has undergone enormous change over the past 5 to 10 years, and is continuing to evolve at a rapid pace. Central to this evolution has been the need for quality financial advice to be provided to customers. Financial planners and associated advice based business groups have become the pivotal fulcrum in the retail wealth management value proposition.

It has become imperative for management of wealth management organisations that either own or use such advice based businesses to understand the value that is created in their organisation from such advice based business channels. Typically, perspectives of value have been performed from a "product centric" analysis of an organisation. This paper proposes that richer insights are possible from an analysis by "channel view", which links holistic customer service delivery from the advice channel through to downstream service, product and process platforms.

The ability to track and monitor key adviser value drivers, based upon a channel perspective of value, is paramount in being able to successfully operate a wealth management organisation's interaction with advice based businesses. Understanding the clear linkage between such drivers and their impact on value allows management to implement measures that will enhance and extract optimal value from their operations with such advice based businesses.

The techniques and approaches in this paper are not intended to be exhaustive. They are provided as a means to assisting valuers and management alike in considering value creation and associated strategic insights arising from advice based businesses. Providing greater management information on the role and value of advice in such evolutionary times should be an aim for all involved.

About the Authors

Tim Gorst (FIAA) *has around 10 years experience working in the wealth management industry, including 8 years with National Wealth Management across a variety of finance and business roles. He is currently working in a small team that assists senior management in gaining strategic insight from the business valuation process.*

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