



The Value of Financial Planning Practices Post Bowen

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Following the release of the Bowen Report in respect to the “Future of Financial Advice” in April 2010 and various other government enquiries many Financial Advisers are reviewing their Financial Planning proposition to ensure that they can maintain profitable financial planning practices (FPPs).

Some financial advisers are also considering the implications of staying in the industry or alternatively maintaining the profitability of their FPP. Other Financial Advisers are looking at merger or acquisitions of FPPs or the purchase or sale of a Client Register.

What follows is an overview of the value Financial Planning Practices post Bowen in respect to mergers and acquisitions.

Financial Planning Practices – A Business or an Asset

A business consists of both tangible and intangible assets. Tangible assets could include a Client Register and the resulting income generated from the client whether through upfront or recurring income. Other assets include the possible purchase of work in progress, site location of premises (assignment of a Lease) or the possible purchase of premises. Such assets are tangible, easily identifiable and the benefits flowing from such assets are more easily measured than their intangible counterpart.

An intangible asset may include goodwill or the “Brand” of an FPP. Such “assets” could be the product of the efforts, skills and expertise of the human capital of the business (whether Principal or Employee). However measuring the value of human capital and other forms of intangible assets may be difficult in practice particularly in relation to the contribution to profits and cash flows. Furthermore intangible assets can easily be “lost”.

Current Consideration

In practice very little distinction in relation to FPPs is made between a business or asset acquisition, sale or merger. Nevertheless the distinction is critical in order to understand the benefits of the structure and price paid for a “deal”, to either acquire, sell or merge a FPP.

In the majority of situations many Principals of FPPs look no further than the Client Register (Assets) and seek to obtain a value for the Assets based on the reoccurring income of the Client Register. The “due diligence” (if any) other than for finance purposes is based on assessing client files for purpose of compliance risk in respect to regulatory or negligent advice.

But post Bowen query whether such simplistic assessment will be acceptable.

As a rule of thumb the less a prospective acquirer understands about the nature of the FPP as a business or as an asset that they are purchasing the less chance they have of acquiring and merging the assets or business for sustainable future value – whether in the form of future income entitlements or capital value on sale.

Merger or Acquisition

A merger occurs when there is mutual agreement on the part of the management of two businesses. An acquisition, or takeover, occurs when the management of one business makes a direct offer to the principal of the other and is willing to pay a higher price for their interest than the prevailing market value. In practice, a clear distinction is not always possible.

There comes a time when many successful FPPs consider further expansion to exploit potential economies of scale and scope and to make use of additional opportunities that a larger scale operation can often deliver. The essence of the strategy is to create a market



value that is greater than the sum of the businesses involved.

Horizontal Mergers and Acquisitions

Horizontal mergers occur when FPPs combine at the same stage of service - for example a single advisory practice merger with another advising with similar clients and expertise. There are a number of specific reasons why FPPs choose to merge. A horizontal merger may grant a firm a larger market share or the removal of a close rival in a similar geographic proximity. Either outcome may increase the resulting firm's ability to increase profits through shared knowledge, and cost efficiencies without having to worry about a risky change in direction.

A common argument in favour of horizontal mergers is that the combined size of the two firms leads to economies of scale. Since efficiency gains can be achieved through a firm's own internal expansion, only merger-specific gains are relevant here. These involve the integration of specific, hard-to-trade assets owned by the merging firms. These gains are referred to as synergies. One example involves the coordination of joint operation: two firms linked by the joint management resources thus reducing inefficiency. A merger might lead to a reduction in such inefficiencies. Another example involves the sharing of complementary skills, where, for example, one firm may enjoy superior process skills in providing advice solutions, while the other party is better at sourcing clients. Or perhaps one firm's strategic position can be fully and quickly exploited using the resources of a second firm.

Vertical Mergers and Acquisitions

Vertical mergers occur when two FPPs combine at different stages of a service offering or different service offering — for example acquired an aged client base of superannuation contributors for a retirement specialist to exploit. Reasons for such a merger

tend to focus on the following issues: the technological advantages of linking successive stages of the service offering to a larger client base enabling the adviser to concentrate on a core market and thus enhance their skills.

The incentive to integrate vertically will exist where the market fails to work well (proves costly). In such cases the FPP internalises that particular market transaction by, for example, acquiring a financial planning practice specialising in managed investments to record risk solutions. It substitutes internal organisation for external market exchange. The firm benefits from internal organisation in three ways: incentives, controls and inherent structural advantages. Incentives cover the advantages of being able to avoid costly and time-consuming bargaining to find new clients. Controls imply that the firm can benefit from exerting more power over intrafirm activity as opposed to interfirm activity. Structural advantages may increase the economies of communication exchange. Therefore, staff within the organisation share common training, experiences and codes of practice, which ensures cost effectiveness.

Summary

Whilst the above factors in many instances appear obvious in practice rarely do merger and acquisitions occur without significant initial problems. In the main problems occur due to the acquirer or vendor focusing on price based on the "Rule of Thumb" of a Client Register rather than fit and planned outcome to merge the acquisition correctly. In many instances such problems could be avoided by careful review of the FPP purchase as either a business or an asset in the first instance.

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