BUILDING A SUSTAINABLE BUSINESS FOR LONG-TERM VALUE GROWTH

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To effectively help clients implement a wealth plan that spans decades, if not generations, a financial advisor must build a business that lasts well beyond the length of their own career. However, the majority of financial advisors are solo practitioners with no one to take over the responsibility for oversight on their clients plans when they retire.

Even with a single owner, financial services businesses are among the most valuable professional service models in America, featuring recurring revenue and high growth rates. In addition, or as a result, this profession offers even greater benefits to those owners who have the foresight to create an enduring business structure that supports sustainability and increased profitability. Through a multi-generational business, advisors can best serve their current clients and make sure their successors are well cared for long after their retirement.

THERE ARE MANY BENEFITS OF BUILDING A VALUABLE, MULTI-GENERATIONAL BUSINESS

First and foremost, there is no better way to protect what is likely the most valuable asset an advisor owns than to have talented, next-generation advisors invest their time, money, and effort into the business. Secondly, under a multi-generational structure, founders and majority owners, commonly referred to as G1's here at FP, can benefit from greater control over their own business and their own retirement plans well past any traditional retirement age as they effectively build and implement their own glidepath to retirement, gradually shifting from chief revenue producer to CEO to mentor. Finally, building a multi-generational business provides structure to support generations of clients and their assets beyond the length of any one single advisor's career.

REDEFINING VALUE: SALES-CENTRIC VS. EQUITY-CENTRIC

The process of building a sustainable business often starts with changing how an advisor views the value of their business. Typically, owners tend to define value based on what the business is worth to a third-party buyer. Creating a sustainable business that outlasts any one advisor's career requires a shift in the definition to include what the business is worth to the next-generation of owners, G2's in the FP vernacular, who are investing their time, money, and careers in the business through a buy-in.

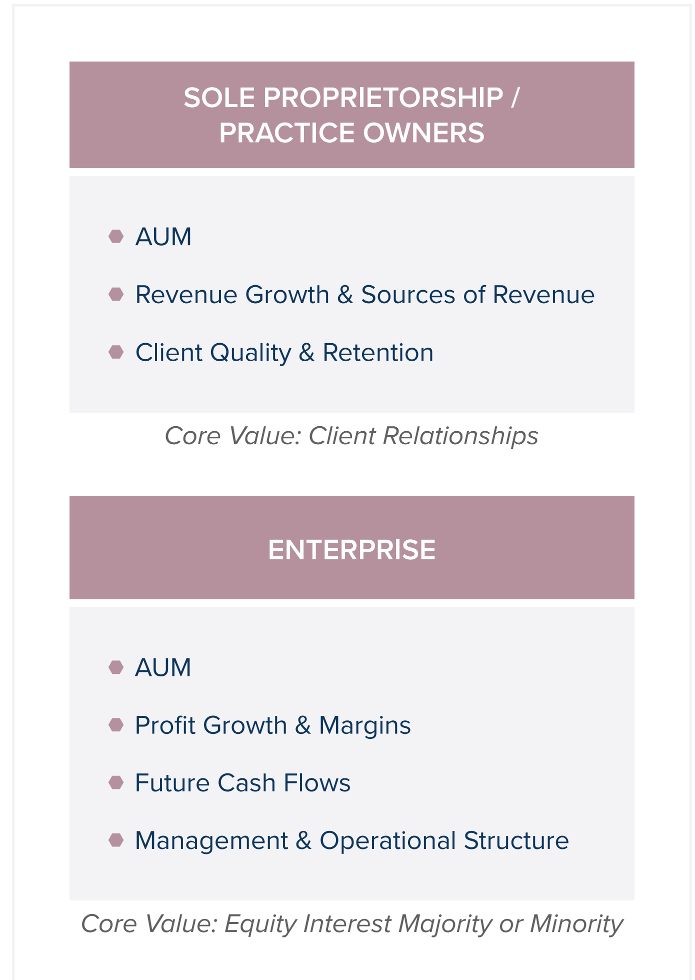
The value of a sustainable business encompasses more than simply clients, AUM, and revenue. It relies on long-term vision and the business's ability to perpetuate growth. This investable, equity value is rooted in how the entity is structured, how revenue flows through the centralized business structure, and the profitability it creates.

Naturally, most sole practitioners – or practice owners – focus on client relationships as the main driver of value and income. At career end, that's where the value lies: in the sale. A single owner book or practice sells a list of clients, along with the cash flow and AUM supported by those clients and walks away with the price paid. However, an equity-centric business poised for sustainability and long-term growth takes a different path.

An equity-centric businesses centralizes assets, revenue, expenses, and, most importantly, available profits. These profits are used to reinvest in business growth and attract next-generation talent to create a multi-generational ownership structure. This allows the business to derive further value from the streamlined cash flow and greater efficiencies. Equity-centric businesses are stronger, more secure, and have a foundation from which to perpetuate sustainability.

Multi-generational, sustainable businesses view value from the perspective of an investor rather than a third-party buyer. This "investor" is the next-generation of owners. Value is more than just top-line revenue and AUM. It relies on the strength and sustainability of the business, its projected growth over time, and the profits it generates.

FIGURE 1. TOP VALUE DRIVERS

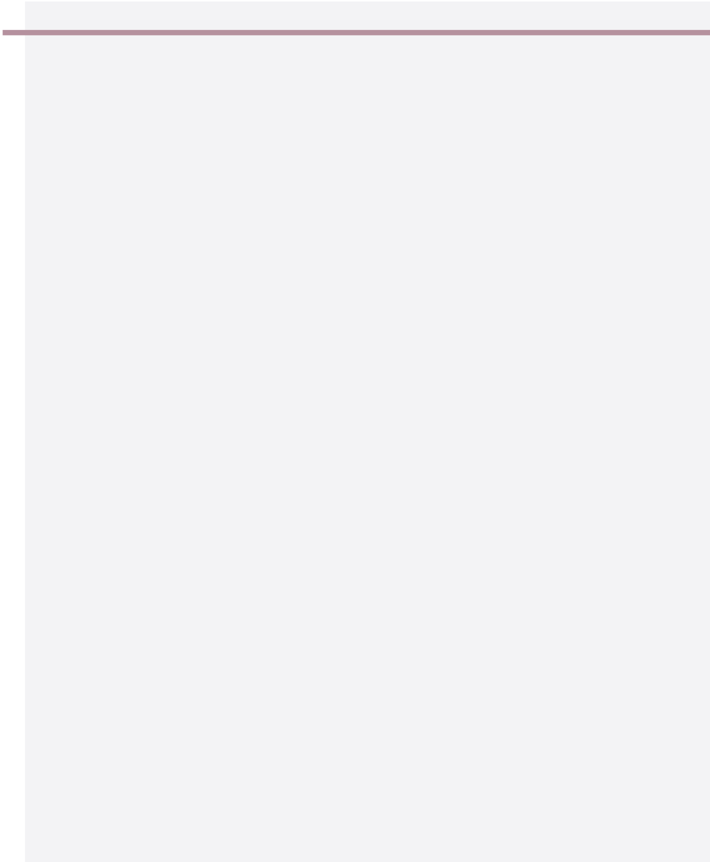


HOW IT'S DONE

The value of a business, when divided by the number of outstanding shares/units of investable equity, provides next-generation advisors with the ability to invest incrementally. This is where the next-generation of advisors comes in to create internal succession. Next-generation advisors, often key employees already on staff, are able

to purchase minority interests in the business– usually 5% to 10% at a time – backed by seller financing or a conventional bank loan and paid for using their expected profit distributions over the first few years. This, in turn, allows the founding owner to gradually de-risk his or her own position and to monetize this valuable asset gradually over the remaining years of their career.

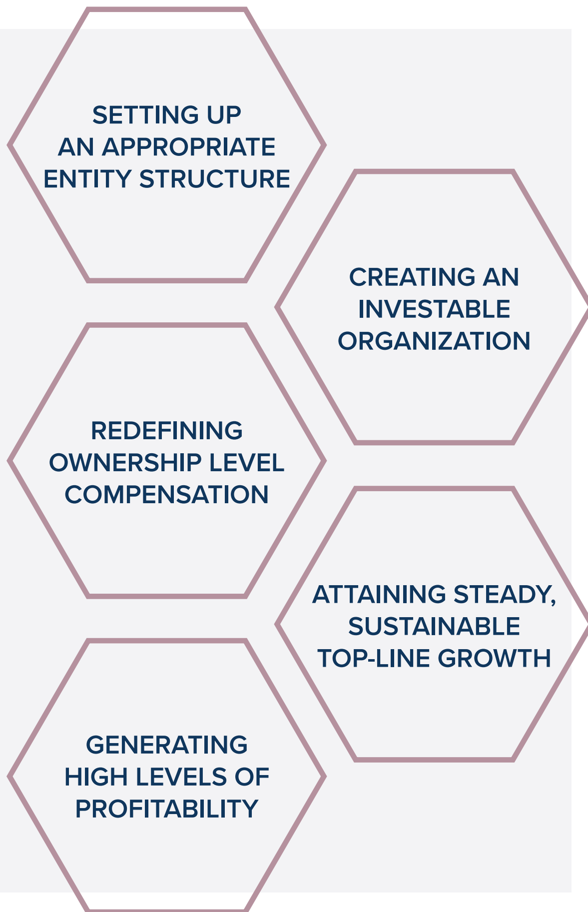
Rather than selling at the highest possible value to a third-party buyer and retiring, what if you build from within and sell your equity gradually as it increases in value while remaining on the payroll? What if you enjoy both a pro rata share of profit distributions and equity appreciation, all while reducing your workload gradually on a defined glidepath and maintaining current income well past that traditional retirement age? What if selling your business to a third-party becomes Plan "B" and you focus on building a sustainable, multi-generational business as your Plan "A"?



The answers to these questions belong to each individual owner. The goal here is to provide a full perspective of the possible and to help the next-generation advisors understand that there might be a better way to monetize the equity in your business and provide continuity to your clients by building a business that will continue to grow, thrive, and serve for generations to come.

THE BUILDING BLOCKS OF SUSTAINABILITY

Today's financial professionals, whether functioning as an RIA and/or IAR, an RR under an IBD, an insurance professional, or all of the above, have the tools to build a sustainable business or become part of one. In fact, the building blocks are essentially a part of their businesses from day one. The only element that is lacking is the understanding of how to structure and nurture these building blocks to support a multi-generational ownership team as well as long-term growth and sustainability.



To create a multi-generational ownership team, you need next-generation advisors to invest in the business you're building – not just their time and energy, but also their money and careers. In order to do so, they will need to see the value and the benefits of being a contributor to something bigger than themselves rather than hanging up their own shingle and building their own book. The goals of the founder needs to translate into the goals of the next generation as investors and producers.

There is no single method or a static list of steps to take that will transform a single-owner practice into a dynamic, sustainable business; the exact process depends on an advisor's commitment to building such a business, in addition to the advisor's regulatory structure, revenue sources, growth rates, time frame, cash flow, staffing levels, and compensation structure.

The most impactful areas of focus are:

1. Setting up an appropriate entity structure
2. Creating an investable organization
3. Redefining ownership level compensation
4. Attaining steady, sustainable top-line growth
5. Generating high levels of profitability

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1. Setting Up An Appropriate Entity Structure

An entity structure is akin to frame of a home. It provides a back bone, and everything is attached to or supported by this basic and essential framework even though it is not visible to the occupants. Sometimes a single S-corporation or LLC will suffice, but in this highly regulated and often complex industry, more sophisticated structures may better support long-term goals and create an investable business. In most cases, there are two or more good, workable entity choices – and one great choice – depending on the journey.

As mentioned previously, once you have an entity in place that owns the client accounts, revenue, and other business assets, value shifts from the single advisor to the entity. As such, the owners of the business, or the entity itself, may sell equity interests of the entity to next-generation advisors. Depending on your plan, owners may sell portions of their equity to the next-generation advisors over one or more sale transactions (often referred to as "tranches"). It is common for founders to start by selling smaller tranches, such as 5% or 10%, but as they get closer to their desired retirement date, they will often start to sell larger percentages.

The entity type and tax election determine, in part, applicable tax structures and how revenue flows through the entity. A key component in establishing a multi-generational business and attracting and retaining next-generation owners is choosing an entity and a tax election that will be efficient for each of the owners, no matter their age or ownership percentage. Independent financial advisory businesses are capable of producing high levels of profitability that flow down to the owners pro rata. This helps to alleviate some of the concerns a potential next-generation owner may have when they're considering buying into a closely-held professional services business.

Additional benefits of strategic entity selection include:

- A clear and effective governance structure supported by officers, directors, managers, owners, and employees
- The ability to onboard or merge smaller books into the entity via a tax neutral exchange process
- Limited liability in certain situations

If you choose to make an S election for your corporation or LLC, yet another advantage may be tax savings. With guidance from your CPA, you may be able to structure your owners' compensation so that each owner receives a set, reasonable salary paid in the form of W-2 wages, plus periodic pro rata profit distributions. Set up and operated properly, the savings can be significant over time in a highly profitable business.

Finally, there is no better way to protect the value of an independent professional services business than building a safety net in the form of a Buy-Sell Agreement among the owners. Every equity-centric business should have such an agreement in place that establishes onboarding a new owner or buying out an existing owner, whether due to retirement, death, disability, or any other reason.

2. Creating An Investable Organization

It is not uncommon for an independent financial business to be comprised of two or more individual advisors who own their own books, share certain expenses, and operate under a single trade name or DBA. They present to the public a single identity; however, their structure is quite different from, and does not experience the same benefits as, an equity-centric business.

Book builders are each focused on their own revenue production and take-home pay. For example, four book builders may operate under a single DBA and support each other and the joint operations of in general, but retain ownership of their individual client relationships, cash flow, AUM, and goodwill. In effect, this is a group of four sole advisors who support each other and create synergies up to a certain point, but each advisor is still free to walk away with their own book at any time and do as they please. Under this structure, valuation is a function of simply adding up the individual book values as there is no single, investable business to assess.

In contrast, owners of an equity-centric business are focused on building overall value for the business and, consequently, the owners. This relatively simple but sophisticated concept can be expressed by the following formula:

Wages + Profit Distributions +
Equity Income + Equity Appreciation

In a sense, an equity-centric model is an all-for-one and one-for-all business model that is designed to outlive the individual owners that rely on a strong, central organizational structure.

Centralized cash flow prioritizes shared revenue and shared expenses to create efficiency, maximize capital for future growth, create and pay out profit distributions, and build business value.

To be certain, this is a seismic shift from the traditional revenue-sharing or *eat-what-you-kill* model. Under that model, even if multiple advisors share a DBA and certain operating expenses, the advisors maintain ownership of their own books, retain the revenue from their books, and keep their growth separate, which destabilizes the ability to grow or realize the value of a single, sustainable business.

3. Redefining Ownership-Level Compensation

Correctly structuring compensation at the ownership and production levels is a critical element of building a sustainable business. In addition to providing the ability to recruit and retain talented professionals to help grow the business, an equity-centric compensation system creates predictability around this single largest business expense, allowing the business to streamline cash flow, make better strategic decisions, and support a strong bottom line. The entity structure provides a framework for supporting sophisticated ownership-level compensation, including regular profit distributions, tax benefits, and equity appreciation, each of which augments an owner's base salary.

The basics of an ownership level compensation system rely on the proper allocation of a wage/salary for work performed, bonuses for achieved performance goals, profit distributions as a return on investment, and the benefits of equity appreciation as the business grows. Profits are shared with the equity partners pro rata, usually on a monthly or quarterly basis, which makes it an important part of each owner's total compensation package. Profit distributions, a key component of an equity-centric business, are the mechanism that help attract, reward, and retain next-generation owners; making earnings the measure of success each year and driving maximum business value.

To assemble a multi-generational ownership team, a founding owner must first be able to attract young and talented advisors to the business as employees, and then into the ownership circle as buyers/investors.

To succeed, a founder must be able to answer these important questions on behalf of the next-generation investor:

- "What am I investing in, and why?"
- "Where does the money come from to make this investment?"
- "What are the long-term opportunities and obligations?"

For most businesses with multiple owners, compensation is the largest expense item; as such, correctly handling this element over time can greatly affect the profitability and long-term sustainability of the business. Specifically, as an equity-centric business doubles in size over a five to ten-year period, salaries at the ownership level should not necessarily also double in size. Instead, increasing the owners' salaries at a slower rate will help create business scale, which will increase the value and investibility of the business. Although an owner's salary may not double when the value of the business doubles, the value of the owner's equity interest in the business and the owner's profit distributions will increase accordingly.

4. Attaining Steady, Sustainable Top-Line Growth

Multiple generations of owners working together are capable of generating greater growth rates over a longer period of time than a single, experienced – but aging – founder. Although the concept may be simple, its execution can be complex.

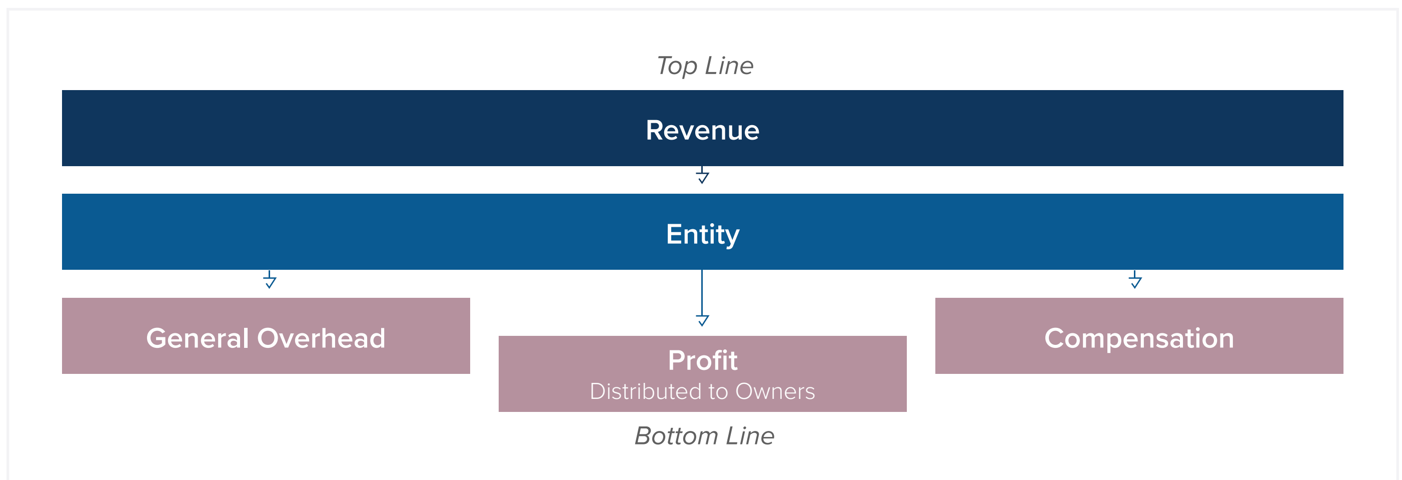
Top-line growth rates that depend on a single, primary advisor who attempts to serve as the head of marketing and sales, HR, financial planning, client services, and operations will run out of gas at some point, it is inevitable. Building an equity-centric business supports a gradual shift from the *force-of-one* model to a more complete and integrated team, assembled one person at a time, over a period of time.

There is a common misperception by book builders that a top-line growth rate of 15%, for example, is unsustainable as the business grows larger and larger. In our experience, quite the opposite is true, as a business grows larger and stronger with a deeper bench, sustaining high growth rates is more attainable. As the business grows, it has the ability to invest more specifically in targeted, non-production areas of the business, such as marketing and sales functions.

As a business grows, it will have a larger budget with which to hire staff members that focus more on the operations and growth of the business, such as marketing, sales, and acquisitions staff. Armed with an adequate budget and specific annual goals, a larger business is, in our experience, better positioned to consistently grow at higher levels for longer periods of time.

In the end, growth is what next-generation advisors depend on to fuel their purchase and service the debt of making an equity investment in the business. Top-line growth translated to bottom-line profitability increases the value of each owner's interest in the business over time, perhaps doubling that value several times over in the course of a generation. Those same profits are also the source of funds to service the debt. But the top-line revenues have to grow and the responsibility for such growth must be shared by – and gradually transferred from – the founding owner to the next-generation team.

FIGURE 2. CENTRALIZED CASH FLOW



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5. Generating High Levels of Profitability

From an appraiser's point of view, the bottom line of an equity-centric business's Profit & Loss Statement is the starting point for building a valuable enterprise. Profits are what an appraiser looks to when determining business value; profits are what a bank looks to when considering a conventional or SBA loan for next-generation advisors who are buying in to ownership; and profits are a key consideration for next-generation advisors making the decision to invest in the business.

As we've discussed, the entity structure's function is to collect all incoming revenue, settle operating expenses, pay out compensation, and then make additional investments to support future growth. What flows through from there to the bottom line are the profits of the business which provide equity partners with a return on their investment.

Conceptually, it helps to think about your incoming gross annual revenue flowing into three buckets, each of which serves a critical role in the business. The revenue that flows into Bucket #1 is used to pay overhead expenses; Bucket #2 is used to pay owners' compensation; and Bucket #3 is used for profit distributions. Overhead expenses are best described as all of the expenses of the operations of the business, including payroll and benefits for employees, but not including owners' compensation. Owners' compensation is the combined, annual base salaries paid to the equity owners. Profits are what remain after all overhead expenses and owners' compensation is paid. Profits flow to the bottom line and are distributed pro rata to the owners of the business. Ideally, the expenses paid with the revenue in Buckets #1 and #2 do not exceed 60% of the gross annual revenue of the business, so at least 40% drops to the bottom line. With a good plan, fee-based businesses, or businesses with a higher percentage of recurring revenue, are more capable of generating this level of profitability over time.

This restructured flow of shared revenue and profits encourages the formation of a team of colleagues rather than a group of competitors who rely on a diverse set of coordinated and applied individual strengths to service a collective client base, building value in a single business that is designed to last for generations to come.

By shifting how you define value and understanding how these building blocks affect your value, you can begin to focus on leveraging them to create a sustainable, multi-generational enterprise.

DEFINING YOUR GOALS & MAKING A PLAN

The ROI on building a sustainable, multi-generational business can be enormous. Building such a business requires a plan and the time and energy to see it through.

The first step is to gather more information, starting with a candid assessment of what you've built and how you've built it. From there you can identify priorities and map out your plan for growth, including when and how you will restructure different elements of your current structure as well as when and how to add new owners.

It's important to create an open dialogue with prospective, next-generation owners to articulate your vision and expectations for the firm. One of the ultimate tests of executing a sustainable growth plan is the ability to share it and sell it to next-generation investors (your succession team). And the best way to do this is to work up a detailed proforma spreadsheet model fueled by growth, profitability, investment, and time. Done well, this financial analysis sells itself to next-generation advisors looking for a career track and a worthwhile investment opportunity.

As you think about the possibilities, look out to the horizon and think about what you'd like your business to look like five years from now, or even better, ten years from now – assume that your business will double in size at least once. What could that business do for you if built on a sustainable foundation aimed at maximizing business value without increasing the amount of work and production required of you?

Answering this question will help you develop a long-term plan and connect the dots from where you're at to where you want to go and what you want your business to become. FP Transitions' has been helping independent advisors do exactly that for the past 25 years. Our integrated team of experienced and credentialed consultants, analysts, appraisers, lawyers, and M&A specialists are here to help you plan and build a sustainable, multi-generational business. **Let's get started.**

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