



FP TRANSITIONS[®]
RESEARCH & PUBLICATIONS

Building a Business of Enduring & Transferable Value

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Most independent financial practices are designed around an ego-centric model capable of providing a good living and consistent cash flow as long as the founder can work . . . and then these practices die. There is another choice; there is a better way.

THE VALUE PROPOSITION

The foundation of this discussion, as in any valuable and well-constructed business, is equity. Equity is the underlying value of a financial services or advisory practice, separate and apart from the money taken home every month in exchange for the work performed. Equity exists in virtually every independently owned financial services practice to varying degrees because of a strong and organized marketplace. Equity reflects the value and quality of the practice's clients, cash flow stream, and infrastructure to a competitive, strategic buyer or internal successor. But many small business owners confuse, or fail to understand and appreciate, the differences between equity (business value) and cash flow.

Cash flow is no less important than equity and, in the short-term, is arguably more important – cash flow pays the bills to run the business and support an advisor's lifestyle. Cash flow pays the mortgage, buys the groceries and puts the kids through school. But cash flow has real limitations that equity doesn't have. Cash flow in the independent financial services industry is "active" rather than "passive"; in other words, you have to go to work to make the cash flow. Most of this revenue is also realized at ordinary income tax rates, making it a challenging long-term wealth building tool.

A frequent mistake made by advisors in the independent financial services industry is to equate cash flow with equity or practice value (or to link the two with a fixed multiple of something like $2.0 \times T12$). However, doubling the amount of cash flow in an "ego-centric" practice model – which is the most common model in the industry today – often results in little to no improvement in the value of the practice. For example, if value is created and retained by individual advisors, it makes little difference whether you surround yourself with 2, 3, or 10 advisor/producers – you might make more money in the short term from cash flow, but you may build little or no business value or equity in the long term. When you stop working, by fate or by design, the cash flow stops, and with no enduring or transferable business value, the practice will die.

Accordingly, valuing a financial services practice is about much more than merely addressing an owner's curiosity as to "the number" placed on their body of work to date. Remembering that 90% of independent advisors are practice owners who are in an active building mode (vs. ready to sell and walk away), makes formally valuing a practice support a very different end-game strategy than most financial advisors initially recognize. Valuation is the sum total of what you've done right – and what you've done wrong. It's important to understand the former while

there is time to address the latter. Valuation data also can be relied on to provide accurate, relevant and equity-based benchmarks to guide strategic growth plans from year to year.

The revenue generated from a financial advisory practice (even a very small practice) is valued at the highest levels of all professional service practice models (often two to three times as much as a lawyer's, doctor's, dentist's, architect's, or CPA's practice). Financial advisory practices tend to have very low overhead, high profitability, and high client retention if built correctly. This means that even the simplest and smallest advisory practice can, with a sound plan and annual course adjustments, easily develop into a business worth several million dollars during the course of an advisor's career. However, what's lacking in most cases - the one thing that stops most advisors - is a clear picture and a set of detailed instructions on exactly how to build a strong and equity-centric business model.

SETTING UP THE PROPER BUSINESS STRUCTURE

In order to build a financial advisory practice or business that has enduring and transferable value, the advisor must begin with a properly constructed foundation, regardless of the size of the practice or the number of financial advisors, owners or producers. Cash flow and value are directly linked through a practice's organizational and compensation structure. Correctly assembling and coordinating these functions can result in the business's ability to perpetuate itself and provide a steady income to its founder for a lifetime – for most, the creation of a practical succession plan.

The compensation system most commonly utilized by advisors (registered reps and investment advisors) is that of revenue-sharing or commission-splitting (an eat-what-you-kill system). This approach can have a seriously detrimental effect on where the value, or equity, is centered – either in the enterprise or business itself (which can endure), or in the individual producer or advisor (which cannot survive beyond the advisor's career). Revenue-splitting is an easy payment system to implement – certainly easier than hiring a bookkeeper and payroll service to generate a W-2 wage and withholding system. But the risk of a revenue-splitting arrangement becomes increasingly apparent the more successful the new advisor becomes.

The end result of revenue-splitting arrangements and other forms of eat-what-you-kill payment systems is the creation of many small, perishable “books of business” under the hiring advisor's own roof, rather than the growth of one strong and enduring business model. Equity, or business value, is often exchanged for cash flow, but that cash flow is under the

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control of a separate advisor. The ease and simplicity of setting up a revenue-splitting arrangement too often backfires when a formal valuation is completed and the founding advisor discovers that his or her business value is limited to the client base they individually serve.

A PARABLE

The most valuable and enduring business models now emerging in the independent financial services industry are structured as equity-centric ensembles.

The concept of an equity-centric business model can be hard to grasp for those unfamiliar with this approach. Consider this parable to better understand the problem most independent financial advisors face when trying to progress from a job to a practice, and ultimately to a business of enduring value over the course of a career:

Picture a bright orange life-raft floating on a dark blue, storm-tossed ocean. In this durable, well-built small craft sits an independent financial advisor. Our advisor has a paddle for propulsion – the means by which to move the raft to safer or more prosperous waters. Our advisor has the means to collect and store rain water for drinking, and fishing tackle to bring in food for survival – the craft literally is floating on a sea of food and fuel to sustain and propel its lone occupant. Our advisor also has a compass for navigation to guide forward progress along a chosen route.

Over time, though the sea is vast, there are many financial advisors and our advisor encounters other life-rafts and other peers. Most of the time, they just pass by and co-exist, easily and effortlessly competing for the same food supplies without much thought or concern. But in time, when the skies grow dark and the seas inevitably become more challenging and dangerous, behaviors tend to change. Instead of passing by each other, advisors come together and form a group. Under the right circumstances, they'll lash their life-rafts together for safety and support and form a flotilla of three or four, each sitting in a separate craft, but inextricably linked together for the duration of the event.

During this time together, our financial advisors can explore various opportunities. Synergies may develop from the group as the paddles are placed in the hands of the strongest advisors, whose task it will be to propel the group to safety. The advisor best qualified to lead and navigate will take the compass and direct the group with a single vision and set of actions. And the advisor best suited for “hunting and gathering” will be in charge of collecting water and catching fish to sustain the efforts of his or her crewmates – each doing what they do best, contributing to the success of the group. But it is just as likely that each

independent advisor continues to function as a separate unit, each “eating what they kill” and each reserving the right to cut the ropes and paddle off at any time and in a direction of their own choosing.

One of the biggest mistakes that financial advisors continue to make is to view this group of life-rafts as the pinnacle of business growth and organization, or even as the goal. The mistake is to think of this loose assembly of individuals and producers as a “ship” when in fact it is nothing more than a flotilla, quick and easy to assemble, and equally quick and easy to disassemble. The old wirehouse model or the traditional OSJ models are poor blueprints for building a valuable and enduring advisory business. Even RIAs are susceptible to these assembly errors.

In terms of organizational structure, the common starting point for most financial advisors is a sole proprietorship model – a single advisor compensated on the basis of some form of revenue split or eat-what-you-kill system (Fig. 1).

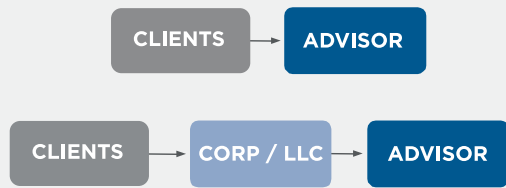
To its credit, this basic production-based or advisor-driven model is extremely adaptable and simple to establish and operate. Unfortunately, this starting point is often mistaken as a building block for larger, more sustainable business models, resulting in a very common, still predominant, business structure in the independent financial services industry.

Another structure, generically described as a “silo-based model,” (Fig. 2) does present one common business name and structure to the advisor’s clients and to the public, but the nucleus of the business model, the corporation or LLC, has little to no value because only expenses are paid through its bank account. The value, or equity, is actually split between two or more separate advisors, each a separate “production unit” or “book of business” capable of taking their clients with them at any time. From a buyer’s perspective, the business as a whole has no value. Adding more and more advisors to this model does not change the resulting value of the founder’s overall practice.

The most valuable and enduring business models now emerging in the independent financial services industry are structured like Figure 3.

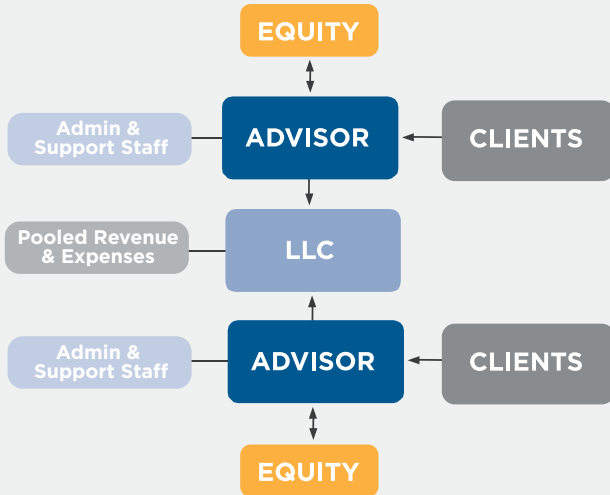
A properly constructed “Equity-Centric Ensemble Model” relies on a strong, centralized entity structure (LLC or Corporation) which collects all incoming revenue (assigned from the receiving producer/financial advisors), pays out compensation (wages and benefits) for work performed (including production), and pays operating expenses. The net result is a stronger business that generates a higher quality and more predictable cash flow. This fuels profit distributions – (does not increase salaries) and these profits, in turn, provide advisor/investors with two essential results:

FIGURE 1 | Eat-What-You-Kill Model (LIFE RAFT)



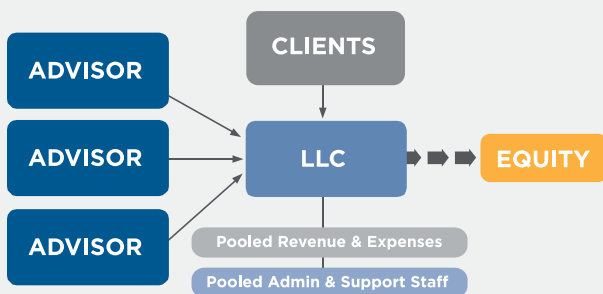
sole proprietorship or sole proprietorship with entity

FIGURE 2 | Silo-Based Model (FLOTILLA)



multiple sole proprietorships linked together through a corporation or LLC

FIGURE 3 | Equity-Centric Ensemble Model (SHIP)



a centralized LLC or corporation collects incoming revenue and pays out operating expenses and compensation

1) a return on their investment, and; 2) the means by which to pay for that continuing investment.

One of the most powerful growth strategies available to independent financial professionals is to use a combination of compensation elements (e.g., wages or paychecks for work performed) and equity value (i.e., an internal ownership track) throughout a business's lifetime. Adding an ongoing equity component to a firm's compensation structure allows the business to create a shared-risk/shared-reward relationship between employers and employees – a connection between the generations, providing both the means and the rewards of ownership. This is often accomplished by assembling a team organized around a formal entity structure such as an LLC or a corporation.

The Entity Structure: The process generally begins with selecting the proper entity (usually a corporation or LLC (Limited Liability Company), though the differences can be significant), capitalizing that entity correctly to support ongoing equity management, and utilizing both compensation and equity over the course of a career to obtain maximum value and growth. Note: Even though an entity cannot be licensed under FINRA rules, most independent broker-dealers permit an advisor to assign their earned revenues into a "corporate bank account." All owners should be properly licensed in order to participate in these structures and to receive profit distributions.

A sole proprietorship, or a corporation or LLC with just one owner, will come to an end with the retirement, disability or death of its owner; it is built to die. A corporation or LLC with multiple generations of ownership serving multi-generational client bases, on the other hand, has the ability with proper planning and staffing to last well beyond any one advisor's career or lifetime, and create an enduring business with significant, transferable value. This business value, in turn, can support an income perpetuation strategy for the founder even as he or she retires on the job, as many entrepreneurs tend to do.

The benefits of proper entity structuring reach far beyond liability and tax issues. Establishing an entity structure and using it correctly can provide excellent continuity solutions as well as additional long-term strategic planning opportunities. Utilizing the entity structure along with ongoing valuations to measure equity can also help retain and propel the next generation of advisory talent, which in turn can perpetuate a business beyond the founding owner's lifetime.

One of the major advantages for owners who operate as an entity is the ability to transfer or sell small, incremental ownership interests to next-generation staff members, and create two or more owners of one financial services business. Incremental sales to employee-partners often become the foundation of a succession plan.

Staffing: It is impossible to perpetuate a business without the help and support of next generation talent. That much is obvious. The more challenging aspects are often summed up in these questions:

- a) *How do I hire and retain employees with an entrepreneurial mind set?*
- b) *How do I sell or gradually transfer the business to employees who have no extra money to invest?*
- c) *What if my internal ownership plan doesn't work out?*

Many founding owners struggle with these issues, but their real concern may be better stated as “How do I find people who will work as hard and care as much about this business as I do?” Too often, however, these questions are framed to generate nearly impossible answers in support of a self-fulfilling prophecy. As the founder, there is only one of you; there will never be another.

But the better and more exciting news may be this – creating and supporting an internal ownership track isn't about replacing you as the founder. Rather, the process is about taking the best of your talents and experiences and using them to build a business of enduring value, something that can outlive you and serve your clients for generations to come. That's powerful, and that's exactly what an independent financial services practice should do. This business building step, supported with proper staffing, organization structure, and direction, can also be quite lucrative (see FP Transitions' white paper, *The Lifestyle Succession Plan*).

It isn't that most advisors hire the wrong people. The issue is that the founders (FP Transitions' programs use the term “G-1 level advisors” for first generation or founding advisors) look for younger versions of themselves, specifically, entrepreneurs. In most cases, this is the wrong approach, or, said differently, these are the wrong attributes to focus on.

“How do I find people who will work as hard and care as much about this business as I do?”

A sole proprietorship, or a corporation or LLC with just one owner, will come to an end with the retirement, disability or death of its owner; it is built to die.

Building on top of a million dollar business requires a very different skill set than starting a business from scratch. An established business can present an excellent investment opportunity for G-2 and G-3 level advisors (succeeding generations of advisors), but one that requires a broader group of talent – a team of successors, not any one individual buyer.

Successful plans developed, designed, and implemented by FP Transitions rely on a three-tiered, multiple-tranche strategy that can be adjusted to create a long-term, flexible approach that results in a gradual and significant reduction of the G-1 level advisor's time spent in the business as the reins of leadership are gradually handed off. The process begins with the acquisition of stock by the G-2 level advisor(s) on a tranche basis (the number of tranches or steps are designed to fit the circumstances of the business and its owners, but three to five tranches are the norm). In other words, the acquisition proceeds in stages, such as 10% to 25% of the G-1 level advisor's equity interest at a time to the succeeding levels of advisors. G-2 and even G-3 level advisors are literally auditioned on the job in terms of their capability and determination – as investors in your business.

One of the biggest challenges to implementing this strategy centers on compensation. It is essential that the founder pay at least competitive wages in order to attract and retain exceptional talent for the long term, but it is a mistake to overpay by a significant amount, thereby making an investment in ownership unnecessary by the employee – why invest and take a risk when the profits come with the paycheck? This is almost always the issue when an advisor uses a revenue-sharing or commission-splitting arrangement and is numerically obvious when benchmarking between practices and businesses on the payroll expense line.

START THE PLANNING PROCESS EARLY AND WITH THE CORRECT END GAME STRATEGY

FP Transitions has valued or consulted with thousands of business owners and even next generation family and staff members and it is clear that financial advisors of all sizes are starting the planning process too late. Selling to a third-party doesn't take a great deal of advanced planning, but retooling a practice to fulfill the tasks most financial advisors need a business to do, for their own families and finances, takes time—and just as you tell your clients, the more time you allow, the better the results. For the best results, advisors should begin to establish a formal written succession plan by their early 50's.

In addition to starting too late, most financial advisors have the wrong end-game strategy. This is easier to understand when considering that the most common exit strategy used today across the spectrum of jobs,

practices, and businesses in this industry focuses on income perpetuation via a sale to an outside party. To be certain, selling and walking away is an option that should never be too far out of reach, as this may very well be the most lucrative short-term, and even emergency, exit strategy. But for most financial advisors, selling the practice and living off of the proceeds is simply not a realistic goal.

Start the planning process by understanding the predominant succession planning strategies in use today and the timelines for their successful implementation:

- 1) Sell and walk away (3rd party buyer) - Planning time: 3 years or less*
- 2) GlidePath strategy* (3rd party buyer) - Planning time: 3 to 5 years*
- 3) An internal exit strategy - Planning time: 5 to 10 years*
- 4) An income perpetuation strategy - Planning time: 10 years or more*
- 5) Building a legacy/firm - Planning time: 20 years or more*

What is the reward for planning ahead and managing your practice equity in a professional manner? To put it simply: control over your future and your income, while you're working and afterwards. In addition, the effective value you'll receive can be upwards of six times your gross revenue based on the starting point of the plan – a fair return on your investment of time and leadership, with an even greater reward from having professionally transitioned your work and your clients' care to a new generation. You will have built a ship of your own.

** A GlidePath strategy typically includes the sale of assets in full and a substantial "down payment" at closing. But rather than the seller walking away after introducing the clients, the seller continues to work for the buyer for a period of 3 to 5 years, after which time the balance of the purchase price is paid on a fixed promissory note, often with an adjustment to reflect the success of the gradual transition.*

GET STARTED

To learn more about setting your business up to sustain growth for generations to come, pick up a copy of our book, *Succession Planning for Financial Advisors: Building an Enduring Business*. The book takes an in depth look into the lack of succession in the industry and what that means for growing practices. It delves into the nuts and bolts of a strong succession plan, along with how to prepare the business to support your plan and one day work for you.

FP Transitions' Succession Management Program is designed to help independent advisors with practice values above \$1 million address the issues covered in both this white paper and our book.

For more resources, visit fptransitions.com or call us at 800.934.3303.

ABOUT FP TRANSITIONS

FP Transitions is the nation's leading provider of equity management, valuation and succession planning services for the financial services industry. Based in Portland, Oregon, FP Transitions operates the largest open market for buying and selling financial service practices in the U.S.

Since opening its doors in 1999, FP Transitions has completed more financial service transactions than any investment banker or business-broker in the country. FP Transitions' expertise also includes continuity planning, practice benchmarking, compensation studies, entity formation, mergers and acquisitions, and equity compensation strategies.

In just over a decade of work, FP Transitions and its team of innovators have forever changed the independent financial services landscape, and quite possibly the value of every advisor's practice or business. FP Transitions has pioneered and re-engineered the way financial practices are valued, bought and sold, protected and transitioned from one generation to the next. The development of the "equity management" concept by the FP Transitions team gives today's investment professionals the ability to build stronger, enduring business models that can deliver the well-earned rewards of a lifetime of work, and the satisfaction of doing what is best for the clients they serve.

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