Business Factors Supporting Growth & Resilience

In the late nineties, not everyone believed that financial practices had transferable value. Financial planning as a profession separate from traditional brokerage was still finding itself and, while the trade was well established, the concept of selling an independent advisory practice was novel and untested. By and large, the brokers and advisors who founded the independent advisory sector had not engaged in serious retirement activities themselves, and a repeatable transition model had not yet been developed.

Shortly after we launched the FP Transitions Open Market listing service in 1999, we experienced our first economic downturn, tied to the dot-com burst. As an internet-based company in the financial services industry, we, too, were vulnerable to a recession; however, the slump in the markets motivated more advisors to participate in our new venture and the industry itself provided a proving ground for the new marketplace. These early sellers seized the opportunity to capture their business value and enjoy life after advising. The planners who remained in the profession were captivated by the growth opportunity that a viable acquisition marketplace had created. When the next bear market started in 2009, we had a new opportunity to see how owners would behave in an uncertain economy and how that uncertainty would affect buyers' and sellers' confidence. A recovery and a bull market later, we not only have the advantage of hindsight but also have substantial practice data to help us understand the underlying characteristics that can influence revenue growth and which ultimately affect long-term value.

What kinds of businesses are best suited to be resilient and to produce sustained growth through variable economic times? As we enter our twentieth year as dealmakers and valuers in the independent financial services industry, it is possible to look at the data gathered over the last two decades to see which business factors transcend market conditions and contribute to sustained growth and higher values.

OVERALL GROWTH RATES ENDING IN 2018

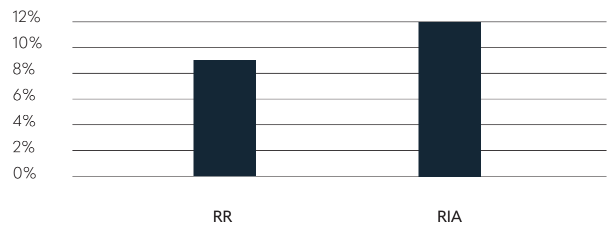
This article is a review of growth rates as reported by practices of various sizes and with different regulatory and ownership structures. The focus is on gross revenue as the best metric for an apples-to-apples comparison of firms across the independent spectrum. The purpose is to understand which businesses had the capacity not only to endure, but to grow through the recession and into the stronger market. Data for this report was gathered from our valuation database, which includes over 11,000 unique valuation records; for our purposes, this report only relies on those records which include a full five years of revenue history covering the period from 2013–2018.

To set a baseline of expectations for this analysis, we started with the macroeconomic factors during the same time period. With the five-year rate of return on 20-year treasury bills averaging roughly 3% and the S&P 500 rate of return for the same period averaging roughly 16%, we anticipated that advisor growth should fall close to the average within this range, or roughly 10%. Given that financial advisory businesses should see not only macroeconomic growth effects on current client assets, but also the acquisition of assets and revenue from new clients and greater share of wallet, the expectation would be to see average growth rates beyond 10%. The results from the data suggest there are factors that can have significant slowing effects on advisor firm growth. Intuitively, growth is a significant driver of equity, and there is an obvious corollary between revenue growth and higher business values. But inconsistent growth doesn't have the same impact as sustained growth, and practices with weak growth may be fatally vulnerable to market fluctuations.

GROWTH BY SIZE & REGULATORY STRUCTURE

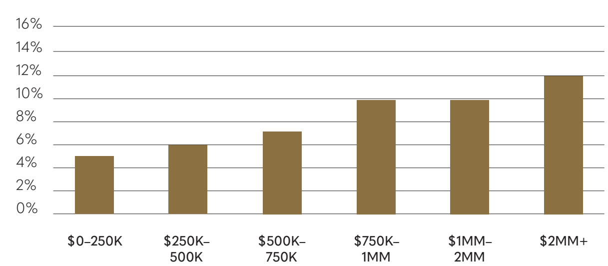
Based on advisor-reported revenue in our valuation database, median compound annual revenue growth for the five-year period ending in 2018 was just above 8%. We have already noted that a strong economy in the short term has created favorable conditions for advisors to operate their practices. The data shows considerable variation in performance, especially when we segment the data by regulatory structure and contrast firms operating as Registered Representatives (RRs) with Registered Investment Advisors (RIAs). Fee-only RIA firms consistently reported 3% higher growth when compared to their RR counterparts over this same period. Our observed five-year growth rate for RIAs was 12% compared to RRs, which grew at only 9% (Figure 11.1). This difference in growth potential could be one of the factors influencing business owners to gravitate toward the RIA model: if advisory firms can grow faster as a whole—which our data indicates is true—then there is a strong incentive to operate under that business model.

Figure 11.1 2018 Average Compound Annual Growth Rate (CAGR) by Practice Type



In general, fee-only RIAs tend to be larger than RRs in terms of gross income (Figure 11.2), and this dissimilarity in revenue has implications for growth—our data from both the 2013 and 2018 studies clearly show that growth rates vary substantially according to the size of the firm. Larger firms with over $2 million in revenue grew faster than smaller ones (12% over the period), producing more than twice the growth rate when compared to books with less than $250,000 in revenue (5% compound annual growth rate). While it may seem intuitive—larger grows faster—in this case it may also be an illustration that smaller practices are either: 1) lifestyle practices with more limited resources, or 2) still in their building phase and looking for growth opportunities.

Figure 11.2 2018 Average Growth Rates by Gross Revenue

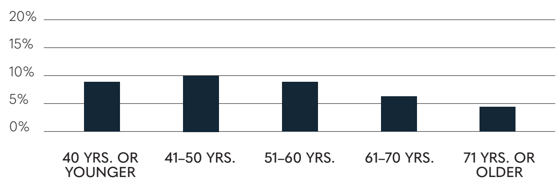


OWNERSHIP STRUCTURE & ADVISOR AGE

When we look at revenue growth through the lens of an owner's age, or the average of owners' ages in multi-owner practices, the results were intriguing. While we expected to see a link between experience and growth rates, the data presented a more nuanced picture.

Focusing on single-owner practices, the data shows solo advisors aged 41–50 produce the strongest revenue growth. Here, the assumption may hold true that a 40-something sole practitioner has the benefit of experience (likely a decade or more) and momentum to grow the practice at peak rates with his or her own efforts. Trailing closely behind the 41–50 age group in terms of revenue growth rates are advisors under 40 (Figure 11.3), who present slightly higher growth rates than solo advisors aged 51–60, who have crested the peak. The trend for the most senior business owners could be a warning sign, as owners between 61–70 report annual growth below 7% and owners that are older than 71 report annual growth rates below 5%—approximately half that of the top-performing groups.

Figure 11.3 2018 Single-Owner Growth Rates by Owner Age

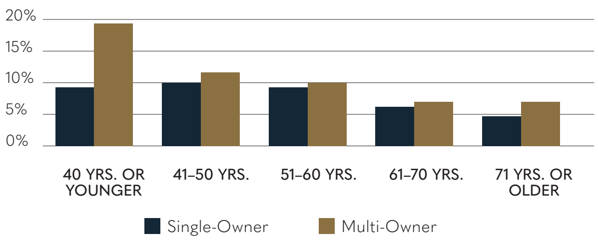


To be sure, each owner needs to review their individual results and goals. Dwindling revenue is a symptom of attrition, which we have previously identified as part of the succession problem. The failure of single-owner practices to pursue succession planning can create a poor situation for the clients. This analysis makes it clear that retiring through attrition creates a poor outcome for the advisor as well: from 2013–2018, practices with advisors over 70 at the helm produced meaningfully lower revenue growth rates than other age classes, and, perhaps most importantly, did not keep pace with the climbing market. As clients disappear and revenue diminishes, business value will ultimately decline, causing significant impact to the advisor's personal wealth.

MULTIPLE OWNERS & CROSS-GENERATIONAL BUSINESSES

Compared to single-owner practices, multi-owner businesses generate stronger growth rates across all age groups. This trend may be related to multiple factors such as expanded personal networks, diversification of services, and operational efficiencies derived from advisors working together in a common business. If single-owner practices generate the strongest growth in the owner's 40s, then when advisors combine the efforts of two or more owners in this age group, the growth rate (somewhat predictably) increases from 10 to more than 12%. The enhanced growth within teams may appear as the predictable result of teamwork, yet for advisors interested in rapid growth, a compelling trend emerges when we review the growth data for multi-owner firms according to the average of the owners' ages: the impact of younger owners in a multi-owner practice. Businesses owned by two or more advisors whose ages average less than 40 demonstrate the strongest growth rates compared to all other groups: 19% for teams whose ages average less than 40 versus 12% for the slightly older owner group averaging 41–50 years old (Figure 11.4).

Figure 11.4 2018 Growth Rates by Owner's Age in Single- and Multi-Owner Practices



Consider what is at play in these businesses. These teams certainly share the benefits of other multi-owner firms (greater service capacity, larger network, opportunity for diversification), but something unique is accelerating their growth. When we look behind the data, we see that the owners of these businesses are not peers, i.e., not a team of 30-somethings. After all, the 30-year-old advisors working on their own do not outperform their elder sole practitioners. Instead, these businesses have a cross-generational ownership structure: a 50-year-old advisor and a 30-year-old junior partner, or a 60-something founder with multiple minority owners at various stages in their careers and young enough to draw the average age below 40. It isn't just the grouping of like ages; the business is also being driven by the different perspectives that each age group brings to the practice. Contrast this with teams whose ages average 60 or above, which are much more likely to be directed by peers. The combined effect of experienced advisors working in alignment with younger, highly motivated professionals has significant measurable impact on year-over-year growth.

While much has been written about the need to build cross-generational businesses, recruiting and retaining young professionals remains a challenge for many business owners. Finding suitable next-generation talent can be difficult. Some advisors neglect recruiting because they are wary of the responsibilities that come with managing a growing team. Creating alignment between founders and successors often requires restructuring the entity and compensation systems from their solo-advisor form, while processes and communication need to be organized to provide for efficient service from a multi-advisor team. Others see hiring as a distraction from what really drives their business value—acquiring and serving more clients. However, as Figure 11.4 shows, investing resources in finding and keeping the right next-generation leaders will pay dividends in your firm's potential to grow.

CLIENT DEMOGRAPHICS

Focusing on client acquisition is not a misguided strategy for growth-oriented advisors. Certainly, the most valuable asset in a financial advisory practice is the goodwill (and cash flow) derived from its client relationships. Client demographics are always part of best practices seminars and articles, however much of what has been presented is conventional wisdom. Within our data, we've been able to parse out the breakdown of client age with some interesting insights.

Clients between the ages of 51–70 are often considered "prime" clients as they are commonly believed to be at the peak of their earning capacity while not yet drawing down their savings as they transition into retirement. The combination of income and savings suggest that these clients have the highest potential to add new assets to the business. Advisors typically pursue these clients most aggressively, attributing most value to acquiring these relationships, whether organically or by purchasing them.

When we drill down into client ages to determine which clients have the greatest indication of future revenue growth, the result is somewhat unexpected. Clients in the "prime" age group make up roughly the same percentage of assets under management across all businesses (between 48–50%) (Table 11.5). However, businesses with the highest year-over-year growth rate as compared to other businesses with a higher average age also have the highest concentration of assets from investors in the 31–50 age group (Table 11.5), suggesting that this demographic may be a leading indicator of future growth. Indeed, cultivating a relationship and securing early investments from younger clientele positions the business to capture additional assets during future wealth events, such as a career advancement, 401(k) rollover, or inheritance. Businesses with the weakest growth have the least amount of assets from investors under 50 and the most assets from clients over 70.

Another piece of conventional wisdom is that advisors and their clients come from a similar age group pool (+/- ten years from the advisor), and this is, in fact, observed among the oldest advisors. This could be interpreted as a “red flag” regarding practice growth, as businesses managed by the oldest practitioners report the least client diversity—and, not coincidentally, the poorest growth rate. This points to a potential fatal flaw for senior advisors: failure to nurture cross-generational relationships could be crippling as the advisor is unlikely to retain the assets transferred to their clients’ heirs. Septuagenarians who intend to remain in the business (and advisors who want to work into their 70s) would do well to pursue younger investors, but the data shows that a more effective strategy would be to partner with a skilled, qualified next-generation owner (or two).

The cross-section of trends by owner’s age, client demographics, and total revenue paint a clear picture for lifestyle practice owners. Solo advisors have a limited period of time to escalate their business to the peak of their abilities before it becomes more difficult to grow the business on their own. This is not a value judgment that these owners are less active or less invested, but the data suggests that, for whatever reason, revenue growth is more challenging for solo advisors as they age, and smaller solo practices are in double trouble. Sole practitioners should be mindful of where they are in this growth curve in order to create a specific plan for

Table 11.5 2018 Client Demographics by Owner’s Average Age in a Single Business (Single- & Multi-Owner)

	OWNER’S AGE RANGE				
	40 Yrs. or Younger	41–50 Yrs.	51–60 Yrs.	61–70 Yrs.	71 Yrs. or Older
CLIENT GROUP AGE RANGE					
Under 30 Yrs.	4%	5%	4%	4%	3%
31–50 Yrs.	28%	21%	18%	16%	15%
51–70 Yrs.	48%	48%	50%	51%	50%
Over 70 Yrs.	19%	22%	24%	26%	30%
Corporate/Institutional	2%	4%	3%	3%	2%

the future of their business. If the preference is to maintain a lifestyle practice, they should acknowledge the limits of their individual efforts and plan accordingly. However, if the owner prefers to continue expanding the business, the data suggests that partnering with another advisor, particularly a younger professional, will provide stronger revenue and greater resources to continue growing the business into the next decade of operation.

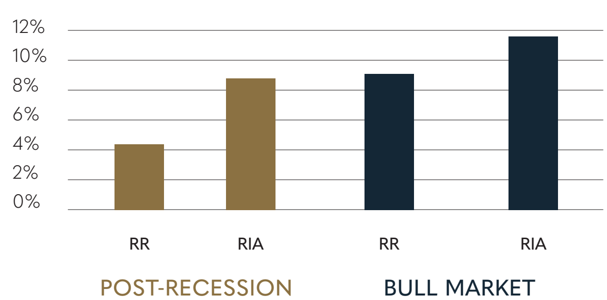
2013 VS. 2018 (A STORY OF RESILIENCE AND RECOVERY)

In the period from 2013–2018, wealth managers have had the benefit of the strongest bull market since World War II. The five years prior, from 2008–2013, include the largest market decline since the Great Depression. When we review data from these two periods, we can contrast information from the recession and recovery with data from the stronger economy. This lets us see which practices were more resilient during the weaker economy and stronger when the recovery began.

If we break down the data using the same groupings as we've discussed above, we can uncover evidence as to which firms are more resilient when markets are rough. When we divide the data by the regulatory structure and compare RIAs to RRs, we see that RIAs grew about 50% faster than RRs in the five years leading to 2018, but grew at double the rate of RR practices in the five years leading to 2013 (i.e. RIAs came out of the recession faster) (Figure 11.6). This trend suggests that RIAs are more robust and sustainable during volatile markets than RR-only businesses and are better positioned to grow once the markets improve. In a similar vein, firms with younger owners (as indicated by average owner age) grew faster than firms led by older advisors; not only did they grow faster, but the spread between their revenue growth was wider coming out of the recession than it was during the more favorable economy between 2013–2018.

Our data comes from advisors who persevered through the downturn, and therefore does not include information from advisors who retired, sold, or simply left the industry during this period. It does, however, include the younger and multi-owner practices who acquired or merged with the senior professionals as part of their succession plan during the same period of time (to be sure, market turmoil often triggers a retirement conversation for many advisors). The spread between growth rates based on average owner age suggest that older advisors are more susceptible to headwinds during tough economies. Owners of lifestyle practices who do not make a proactive decision to retire may already be experiencing retirement through attrition, which a down market accelerates. Our experience with sole practitioners who choose to persist through the headwinds reveals their focus is often on maintaining stability for their existing clients with less energy invested in building the business. While this is not an incorrect approach, it does not position an advisor for growth when the market improves.

Figure 11.6 Average Compound Annual Growth Rates (CAGR) by Type (2013 vs. 2018)



FINAL THOUGHTS

As a business owner reviewing growth data, it's important to evaluate your firm's position within the industry and consider how your business is performing compared to others in your situation. Advisors should also be forward-thinking with regard to what they want their businesses to look like in the next five to ten years. If your business is growing apace with the trends, what can be done to ensure that you avoid the constriction observed in your peer group as you age? Do you want to continue building and investing in the next generation, or do you want to stay on top of the market and make a move to monetize your value while it is strong? Today's financial professionals have substantially more options than they did 20 years ago and better resources to help them determine the path that is right for them. Many owners have energy to keep running their business but admit to us that it's still not enough energy to actively build and recruit. And that's perfectly fine. The important take-away is to recognize where your practice lies within the trends of the marketplace and to plan accordingly.

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