TRANSFORMING YOUR PRACTICE INTO A BUSINESS

FP TRANSITIONS®

FP Transitions[1] is the nation's leading provider of enterprise development, 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.

The purpose of this white paper is to introduce advisors to the concepts and advantages of building a sustainable enterprise utilizing an entity structure and a professional compensation system to support growth and profitability. The following information, opinions and findings are based on the experience and research conducted by FP Transitions. Financial advisors must consult with their own counsel and tax professionals regarding how these concepts could apply to their individual situations.

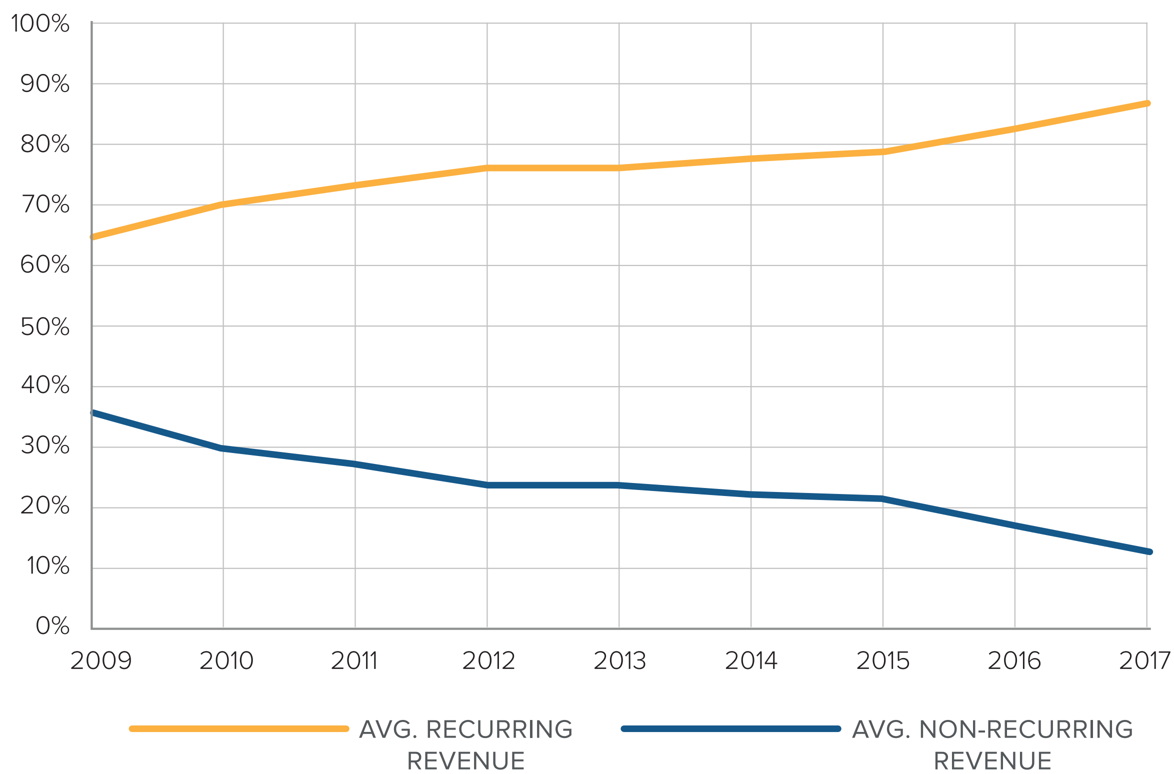
INTRODUCTION

It seems that the one constant in the financial services industry is change. Fortunately, entrepreneurs tend to be nimble and adaptable, constantly striving to improve what they do and how they do it. Over the past twenty years or so, even before the Department of Labor rules began to loom on the horizon, this industry has been gradually shifting away from product-based solutions to advice-based solutions. As a part of this trend, we have witnessed a change in the role of industry professionals from producers to advisors, a change in revenue structures from transactional to recurring, even a change at the organizational level from book builders to business owners.

Though such change can be difficult, there have been many benefits to financial advisors and to the clients they serve, which has greatly strengthened the position of independent financial advice over the same time. Recurring revenue is not only more valuable, dollar for dollar, its predictability, efficiency, and transferability helps to support the building of multi-owner, multi-generational businesses. For most financial advisors, the value of their practice is easily the largest, most valuable asset they own. Predictable income, high value, and the relatively low overhead of an advisory business can create strong profitability, all of which lead to the building of an investment worthy business. The next generation of financial advisors are taking notice, and this is good for founding owners and for the client base that is counting on receiving advice over the course of their lifetimes, and *especially* after they retire.

Advisory businesses are properly tasked with developing a sustainable business model to address the needs of their clients over their lifetimes, not the length of their advisor's career. Such businesses absolutely require the union of the founding generation ("G1" is the term we use for this group) and the succeeding generations ("G2" or "G3" accordingly). Instead of building one-generational, single-owner books, the goal has shifted to building strong, sustainable enterprises that help each generation of owners contribute to a single ongoing business, serving the next generation of clients and ensuring that each retiring generation of advisors realizes full value for the work they've done. The mission is changing – the tools and strategies used to build your business are changing too.

AVERAGE RECURRING VS. NON-RECURRING REVENUE 2009-2017



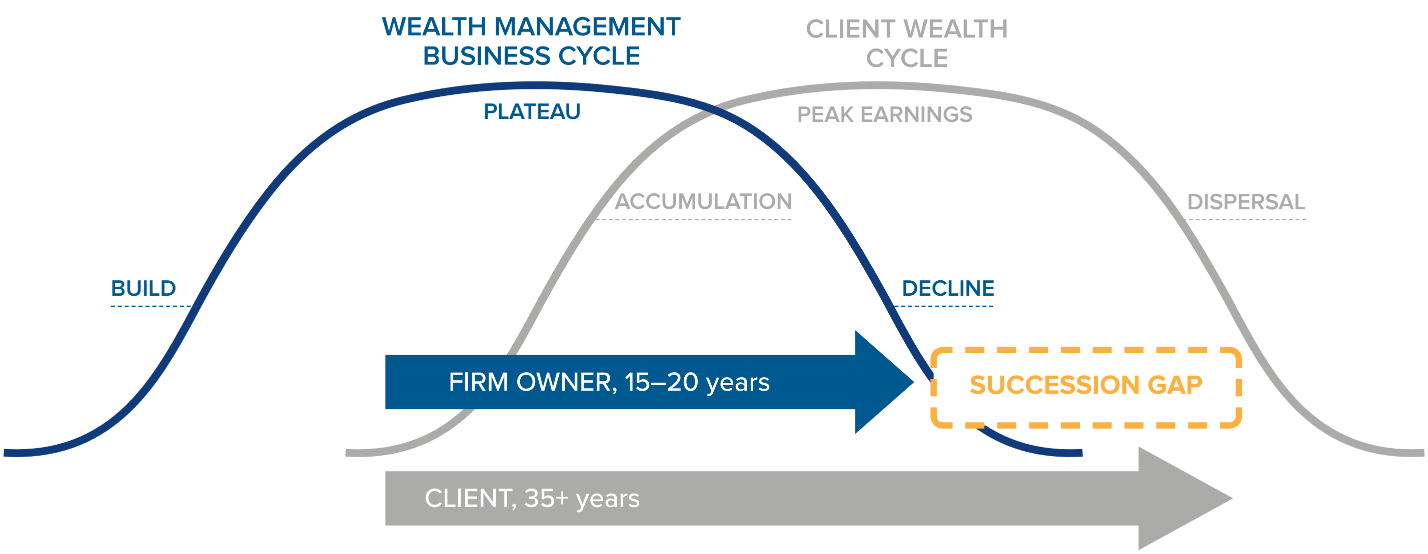
Source: FP Transitions, 2017

WHY DOES SUSTAINABILITY MATTER?

In many professions and in most businesses, sustainability is not a pressing issue. Most people don't need a multi-generational dentist office, for instance. Who really cares if the neighborhood hamburger-stand or your favorite restaurant is there to serve your grandchildren? But in the financial services and wealth management industry, it is different. Advisory clients have a clear expectation of receiving continuing advice and plan management tailored to the length of *their* lives. Being an independent financial advisor necessarily implies a commitment to a profession that surpasses a single career; the element of planning, or at least focusing on the future, implies that an advisor is starting something that will not and should not end with his or her own retirement. Sole proprietorships or single owner practices do not last – for the advisor or for the clients.

Consider the average successful financial advisor now in his or her mid-50's. This owner-advisor will likely continue to work full time, or thereabouts, for another 10 to 20 years even as time in the office gradually diminishes over the last half of that plan. The term "succession gap" refers to the time differences between a single advisor's career length and a client's wealth cycle.

Current demographic data suggests that as many as one-third of a financial advisor's client base will live to be over 90 years of age (husband or wife). Simply put, advisory clients are going to outlive their advisor's career length. If a client is of a similar age to their advisor, then the client is going to have to find a new advisor to finish the plan during the dispersal phase, arguably the most important part of the client's plan. This is not only a very poor result for the clients, it is also a very poor result for the advisory business in that it ignores another 15 to 20 years of management needs, responsibilities, and value to be earned and realized. This ongoing revenue stream and the attendant duties could be easily passed on (i.e., sold or transitioned) to the next generation of advisors if a plan is put in place earlier in the process. It only makes sense to design a *wealth management* cycle that addresses the *client life* cycle. Sustainable businesses are built to do exactly this.



DEFINING YOUR GOALS

It is important to have an industry-wide perspective as you develop your business plan, but it is equally important to build an enterprise that works for you and addresses your needs and those of your family. As you contemplate transforming your practice into a business, start with an eye on the horizon. What will your business look like 10 years from now?

If your goal is to continue to grow, it is likely that the size, value, and scope of your enterprise may very well double, or more, making it a very different business. If the goal is centered on such growth, your business will almost certainly provide significantly greater compensation and rewards, but it will also demand more time, capital, and personnel. As you think about the next ten years of your career, carefully consider your answers to these questions:

- What will you need the business to do for you?
- How many hours will you want to be working each week?
- What will your primary role be in the larger business – producer, leader, mentor?
- What will the business be worth? How will you realize that value?
- How will you attract, retain, and reward the key people it will take to build and operate such a business?
- Do you have the correct organizational, entity, and compensation structures to support such growth?

The answers to those questions will be different for every advisor, but building with a long-term plan and goals in mind will help you figure out what you need to accomplish on the journey. Building a sustainable enterprise requires more than a few important changes, but one that is an absolute *must have* is next generation talent. Younger advisors are needed who will invest in the business you're building – not just their time, but also their money and careers. They will need to see the value and the benefits of building on top of what you've started as opposed to just hanging out their own shingle and building a book on their own. Your goals need to translate into their goals; there has to be something for them to invest in. Your business will require a formal and legal structure to make it an investable asset, part of building a sustainable enterprise.

THE PROCESS OF BUILDING A SUSTAINABLE ENTERPRISE

There is no single method or static list of steps to take to transform a small practice into a dynamic, sustainable, multi-owner, multi-generational, profitable business. It takes time, a plan, and professional support, but there are some common building components. The exact and final process depends on an advisor's regulatory structure, revenue sources, growth rates, time frame, cash flow, staffing levels, and compensation methods. That said, the following general steps are common for most business builders, understanding that the process must be adapted to each advisor's specific goals:

1. Entity formation or modification
2. Compensation (re)structuring
3. Create equity opportunities to support growth and retention
4. Continuity planning to protect what you're building
5. Realization of value upon retirement

ENTITY FORMATION OR MODIFICATION

If you are going to build a sustainable business with more than one owner and more than one generation of ownership, you will need to set up an entity structure (a corporation or a Limited Liability Company, in most cases). There is no better way to do this part of the job. Think of the entity structure like the wood framing in the building of a home. The *2x4's* and *2x6's* provide rigidity and structure, and everything in one way or another is attached to or supported by this basic and essential framework.

Additional benefits from setting up and correctly operating a business through an entity structure can include:

- A more sophisticated ownership level compensation system that addresses top and bottom line goals
- An enhanced ability to recruit and retain next generation talent through use of both compensation and equity
- The ability to successfully compete against larger businesses for acquisitions and mergers
- Significantly improved continuity planning through a formal, internal buy-sell or shareholders agreement
- A clear and effective governance structure with officers, directors, shareholders, and employees

While a legal entity generally does not provide you with liability protection for negligent advice, a corporation or LLC does provide a layer of protection between your personal assets and the liabilities that result from business obligations. That is, the entity separates your personal affairs from those of your business, restricting the liabilities and obligations of the business *to the business*. A limited liability entity can shelter you from such things as contract disputes or disputes with vendors and suppliers, liability associated with an employee, and tort injuries of clients and others visiting your office.

In terms of selecting the right entity type, start with this basic premise: most advisors will benefit from a flow-through model, or tax conduit such as an S-Corporation or an LLC taxed as a disregarded entity, a partnership, or an S-Corporation. Why is this important? The short answer is profitability and the related payment of systematic profit distributions to those who take the risk of investing in the business, as explained in the following sections.

Another benefit of setting up or modifying an existing entity structure for the purposes addressed herein is "control." An entity structure can create various means of control and adjust to the founding owner's age, level of involvement, and percentage of ownership. For example, control might be held by the majority owner, but it might also be held by the corporation's director. On a day-to-day basis, authority might wielded by the CEO or the President, who might be one in the same, or have separate, specified powers and responsibilities. Properly structured corporate governance is part of building a durable business model.

If your entity of choice is a basic S-Corporation or an LLC taxed as such (both tax conduit structures) yet another advantage can be tax savings. It is possible, with guidance from your CPA, to split the business profits into FICA-taxable wages and FICA-exempt S-Corporation profit distributions. An S-Corporation only pays FICA taxes on salary compensation to its owners, and not on the remaining profits paid out as distributions. Set up and operated properly, the savings can be significant over time.

COMPENSATION (RE)STRUCTURING

Correctly structuring compensation at the ownership and production levels is a critical element to building a sustainable business. For such purposes, the question isn't always *how much* to pay an owner, but *how* an owner should be paid. The place to start is to think about the future, the long-term goals, and what ownership represents in that plan.

In order to create sustainability, an independent practice needs to be infused with next generation talent. To assemble this team, the founding owners must be able to attract young and talented advisors into the ownership circle and help them affirmatively answer several important questions. The first, and perhaps the most relevant is "What am I investing in, and why?," followed by "Where does the money come from to make this investment?" Proper modeling of the cash flows – of which the compensation methods are a main driver – are key to answering these questions and motivating next generation advisors to invest their money and careers in the business where they work. Profit distribution checks, issued regularly multiple times a year, serve as a practical answer to these questions and concerns. In most financial practices, compensation is the single largest expense item; as such, correct handling can make or break the long- term sustainability of the enterprise.

The compensation system most commonly utilized by advisors in this industry (both registered reps and investment advisors) is some form of revenue-sharing, often called an eat-what-you-kill approach. Revenue-sharing is an easy and seemingly low-risk payment system to implement, but one point should be made clear: while this compensation structure can increase revenue to the practice and producing advisor(s) in the near term, in most cases the relationship has no positive effect on business value. Revenue sharing arrangements effectively remove operational leverage, paying out the same rate on every dollar that flows into the business; the more the business and revenue grow, the bigger the problem becomes. The challenge in the process of (re)structuring compensation is to motivate producers to produce (or advisors to advise), while adjusting their compensation and simultaneously generating sufficient scale to also increase the profitability of the business.

Building a one-generational practice requires a focus on production or top-line growth. Building a sustainable business requires past and future leadership to make the connection between a growing cash flow

ENTITY FORMATION / MODIFICATION

COMPENSATION (RE)STRUCTURING

CREATING EQUITY OPPORTUNITIES

CONTINUITY PLANNING

REALIZE VALUE

stream and the costs of such growth. In other words, the most successful firms focus on the bottom line as well. In most cases, at one point or another, compensation systems must be transformed to accomplish these goals. The process of revising the compensation strategy is often best accomplished as part of a comprehensive plan that involves equity or equity-like arrangements (addressed below), or combined with a coherent bonus plan that rewards value-driving behaviors.

Rethinking the ownership level compensation strategy isn't about making things more complicated. In fact, the opposite is usually true. Creating a predictable and sophisticated compensation strategy for the ownership team reflects the philosophy that owners of small but growing businesses are not motivated simply by a pay check or a bonus on production, but by increasing the size and share of their profit distributions and growing equity value.

CREATE EQUITY OPPORTUNITIES

Independent financial service professionals have two primary methods to attract, retain, and reward talent, and to build the business:

1. Current income in the form of compensation
2. Equity

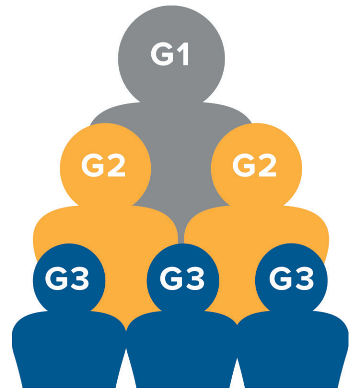
Equity is a powerful business building tool. Most advisors, however, never move past the basics of compensation from cash flows. In most cases this is all that is necessary in a one-generational, one owner practice. Building a sustainable business, on the other hand, requires that both resources be fully utilized and understood.

Equity is the value of the business cash flows that are distributed to its shareholders. Note that this approach is fundamentally different than the income that an employee (or owner-employee) would receive for services performed. Compensation is effectively wages for work, while profit distributions resulting from ownership or equity is a return on investment. Equity, in a tax conduit structure must result in profit distribution checks, especially once the compensation systems are properly aligned with a long-term growth strategy. In the case of equity ownership, the benefits are derived from growing the company and controlling the overhead costs, especially compensation, resulting in growth of the bottom line as well.

Cash flow is the part of a practice that founders are often willing to share with their employees, offering substantial payouts to producers and advisors to fuel fast growth and to survive in the near term. Equity is what individuals invest in. The goal of a sustainable business is to couple competitive levels of compensation with the substantial benefits of equity ownership in the business. A total compensation package for a business owner balances wages with profits, but having both tools to work with creates myriad opportunities to attract, retain, and reward key employees.

The benefits of equity in a growing and profitable business require a focus on profitability, incentivizing owners to think like long-term investors, and to manage the financial statements accordingly. These profits are shared with the equity partners pro rata, usually on a monthly or quarterly basis, which is then included in each owner's total income. As the business continues to grow, the equity value can literally pay for itself.

Creating equity ownership means G1 sells a portion of his or her stock in their corporation or LLC to one or two partners, possibly younger advisors (G2) who became minority owners. Together, G1 and G2 advisors own the business, execute a buy-sell agreement to protect each other's value, and work as a team to grow the business in an efficient and profitable manner. Along the way, additional talent will need to be recruited, and this is where offering fair compensation and an opportunity to one day become an equity partner really matters.



A small business with a history of growing value, regular and systematic profit distributions, and an internal continuity and succession plan is a great opportunity for an advisor, both for early- and late-career professionals.

CONTINUITY PLANNING

A continuity plan is usually a formal, written contract – an agreement, that assures a seamless transfer of control and responsibility in the event of a sudden departure from the practice or business by any of its owners, and whether by choice or through termination of employment, a partnership dispute, or death or disability. To be clear, the single biggest threat to an independent practice with one owner or one primary advisor is the lack of a plan to protect the clients, the owner's compensation (or cash flow) ,and equity value in the event of his or her sudden inability to come to work for a prolonged period of time.

The best continuity plan, in terms of protecting the founding owner's value, the clients' needs, and the staff's commitment and compensation, is an equity partner in the same business and entity structure. Absent a sustainable enterprise, the next best solution is to sell what you've built to the best qualified buyer usually in the same geographic area and with the same broker-dealer, custodian or insurance company. Building a sustainable business has many benefits, and a continuity plan is certainly one of them.

If you're building a multi-owner, multi-generational business, your continuity plan will derive from your formal succession plan; sustainability is achieved through an internal team of younger owners. An internal ownership track, once implemented, is the single best continuity plan available as clients' needs are addressed by other principals who are invested, and literally investing in the same business.

Independent financial practices are among the most valuable professional service models in America. But because those same practices are built primarily around the skill set and personality of an individual advisor, that same value proposition is quite fragile. Within a sustainable business that has two or more owners, the value proposition is much more durable. Establishing a continuity plan to protect that value, and the client's needs, is one of the most important and challenging aspects of being an independent advisor.

REALIZATION OF VALUE UPON RETIREMENT

There is currently about a 50:1 buyer to seller ratio for advisors who want to sell their practices to a third-party and call it a day. Mergers are also a very popular strategy, offering multiple solution sets for advisors who want to quickly change the shape, size, and trajectory of their businesses. For any practice owner who is well informed and serious about the task, realization of value is an achievable goal. Unfortunately, it's not quite that simple for most entrepreneurs, especially those in this valuable and highly regulated industry. Most advisors like what they do – they make a good living after twenty to thirty years of work, have good work-life balance, and feel valued by their clients and staff. Retiring on the job is a very common choice – if the business is strong enough to support that choice.

Transforming a practice into a business isn't just about building something that will last, or something that is more valuable or profitable. It is about having choices, the best choices, when the time comes. Sometimes, despite the best of intentions, small businesses don't last forever. What if your sustainability plans change, you want to move faster, or you'd prefer to monetize your life's work and just take a check home and turn the responsibilities over to the best qualified successor? What if your plans change along the way...? If you build a strong, sustainable business, you simply will have more choices as retirement comes into focus, and you're much more likely to retain the key personnel that helped you achieve a measure of success along the way.

CONCLUSION

There are three simple reasons why you need to transform your one-generational book or practice into a sustainable enterprise and why you need to start on it now: (1) it is the best way to protect and realize the value you've built; (2) it is the best way to recruit and retain the next generation talent to support your efforts over the years, and; (3) it is the best way to safeguard your clients and preserve the trust they've placed in you. Sustainable businesses are the future of the industry, destined to replace the one-generational practices and books of the past.

To be certain, transforming your practice into a business is about more than generating a bigger paycheck, increasing your practice's value, even taking care of your family's financial future. These are steps designed to help the best of the best get better and to finish the job they've started.

Change can be a very good thing.

Note: *Even though an entity cannot be licensed under FINRA rules, almost all independent broker-dealers and most insurance companies permit an advisor to assign their earned revenues into a corporate bank account, provided it is handled correctly. All owners should be properly licensed to participate in these structures and to receive profit distributions, depending on the regulatory structure involved. Professional guidance is a must.*

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