DESTABILIZING VALUE WITH REVENUE SHARING

Instead of building businesses that evolve and improve from one generation to the next, advisors in the financial services industry build one-generational practices, and subsequently rebuild them from scratch with each new generation of owners largely because of eat-what-you-kill compensation systems. For that reason, jobs and practices that last for just one generation of ownership are plentiful; multigenerational businesses and firms are rare. The goal of a practice owner is one of production, and production equates more directly with cash flow that it does with equity.

In the independent sector, if your goal is to build a sustainable business, then your focus should be on a team of advisors working together, compensated for contributing to and supporting a single enterprise, rather than building individual books and subsequently leaving with the clients and related cash flow they generate when the time is right.

Revenue Sharing: Heads They Win, Tails You Lose

Let's examine the following situation. You hire a 32-year-old advisor (we'll call him Bob) with a newly minted Certified Financial Planner (CFP®) designation and a small book that may or may not follow him, but he is fully licensed (or registered as an IAR) and ready to go. You agree to a small base salary for one year, credited toward the payout structure, which is a 50/50 revenue-sharing arrangement. Bob turns out to be a complete failure. He couldn't sell a space heater to an Eskimo or create a financial plan that looks out past the end of the week. You let him go. You saved the costs and complexities of setting up a payroll, and you didn't pay for what you didn't get; but did you win? What exactly did you gain in this arrangement?

The best argument is that you cut your losses and on that point we'll concede. You definitely did that. But you lost a year or more in the effort, you're a little older and thinking about slowing down yourself, and now you have to start over with a new hire. Let's look at this from a different angle.

Bob instead turns out to be one of the best professionals you could have hoped for. He comes in early, he stays late, your clients love him, and most of his clients followed him. He produces $250,000 in gross revenue by the end of his second year, and all indications are that he'll double that by the time he has five years in with you. What exactly have you gained in this scenario?

Well, you get 50% of everything Bob produces, so that's $125,000 a year by the end of year two. That's a good thing. Bob takes the same amount of money home as his reward, a good payday for him as well. Of course, Bob hasn't had to spend any money on desks or chairs, a computer, or a customer relationship management (CRM) system, a phone system, the office space, or a computer network or the staff to make all these aspects of a business come to life, but you did. So, you take your half and you pay the rent, the staff, the electric bill, and other expenses, and then you take home what's left. You own half the cash flow, halved again after expenses, but what about the equity—the value of the book?

After year five, Bob does indeed reach his goal and now produces almost $500,000 in top-line revenue per year. About 70% of this revenue is recurring. You decide to make Bob a partner in your business and offer him the opportunity to buy in, but Bob astutely asks, "What about my book? Do you want to buy what I've built or exchange it for an equivalent amount of stock?" Those are really good questions, and we hear them almost every day. You own part of the cash flow, while Bob owns all the equity. Bob controls the assets, and those assets (the client relationships) are portable. They may not all follow Bob as he walks across the street and hangs out his own shingle, but they could, and therein lies the strength of Bob's negotiating position.

This example illustrates the concept that, as independent advisors, there are two kinds of value: cash flow and equity. This is a critical distinction that separates an independent practice from a captive or wirehouse practice.

The point is that setting up a revenue-sharing arrangement or any form of an eat-what-you-kill payment structure is a losing proposition for the founder or actual owner. If the next-generation advisor fails, you lose. If the next-generation advisor succeeds, you have to buy what he or she has built and pay for it with the stock or ownership interests of your own business, or risk creating a competitor, and you lose again. Is cash flow alone, after expenses, worth that cost?

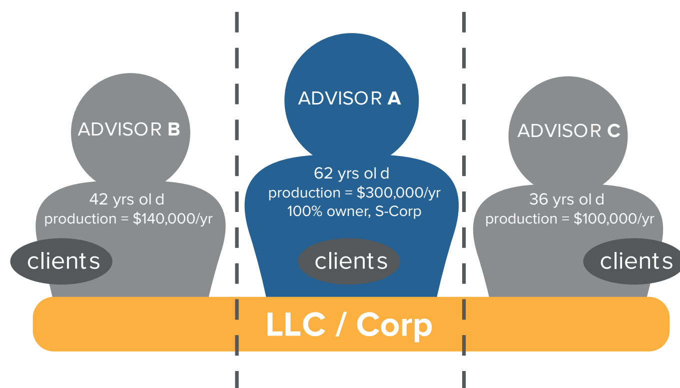
© 2019 FP Transitions

Think about this from the eyes of the next generation. When younger advisors are hired into a practice with no future of its own, a practice that is tied to the life or career of its single owner, the very natural tendency is for them to build their own practices or books. Said differently, if there is no single enterprise to invest in, they'll start building their own and this is exactly what is happening in this industry.

Fracture Lines

Revenue-sharing arrangements and other eat-what-you-kill compensation structures seriously undermine the effort to build a valuable and enduring business. Practices with more than one producer or advisor are being built with fracture lines from day one. Consider Figure 1. In this example, Advisor A, who is 62 years old, is the 100% owner of an S corporation. He hires and mentors Advisor B, who is 42 years old, and years later, Advisor C comes on board, who is 36 years old. Advisor A provides his younger associates the bottom half of his client base and all new client referrals that are below his minimums or who are just not a good personal fit. This fee-based practice has a value of just over $1,000,000.

FIGURE 1.



Four years later, when Advisor A is nearing retirement and is faced with a sudden and serious health condition, he decides to sell the business and turns to Advisor B. Advisor B is interested in being the buyer, but doesn't want to pay for his own book, and certainly won't pay anything for Advisor C's book. When Advisor A looks outside the firm, a third-party buyer materializes and offers $1.6 million for the practice, but there's a catch: Advisors B and C must sign noncompete, nonsolicitation, and no service agreements, along with formal employment agreements with restrictive covenants so that the buyer knows they won't interfere with or impede the buyer's ability to control and retain the acquired client base—except that Advisors B and C won't cooperate. And why would they?

All of a sudden, Advisors B and C's zero ownership positions are worth something—quite a lot, actually—as the junior advisors now have veto power over the value of their own books, cumulatively about $600,000 in value. The mistake most founders make is that they ask us to value the combined cash flows and think that they own and control 100% of the equity. How could they control 100% of the equity value when they or their practices don't control 100% of the asset base? This isn't one business; it is three separate practices. The fracture lines were built in from the first day Advisor A hired each junior advisor and paid him using the industry standard revenue-sharing arrangement.

This example is representative of a common problem where junior, non-shareholder advisors end up with total control over the assets (the client relationships) even though they haven't invested anything else into building the businesses—no lease of office space, no phone system or computer network, no employee payroll. All these things are provided through a revenue-sharing arrangement from an original advisor. This advisor was willing to accept cash flow in exchange for the control and value of the assets in each new advisor's book without realizing the full implications of the tradeoff.

The junior advisors, in turn, enjoy cash flow with minimal investment and risk. But what happens if any of these advisors gets hit by the proverbial bus as he or she steps off the curb at the end of a hard day? He or she owns nothing that is transferable. The family receives little to no value even with the typical revenue-sharing continuity agreement, and, with no infrastructure, the relationships he controls are gone in a heartbeat.

These built-in fracture lines take a single practice with multiple advisors and create multiple books that, cumulatively, are unsalable and therefore end up somewhere between worthless and worth less (than they should be). Creating a competitor is never the goal, but unfortunately creating an equity partner and investor, at least for 99% of advisors, hasn't been one of the goals, either. As an independent owner, you have the perfect tool for the job—equity.

Equity: A Powerful Business-Building Tool

Independent financial services professionals enjoy a distinct and important advantage over captive advisors: they have two kinds of value to work with to reward themselves, to build with, and to use to attract and retain next-generation talent:

1. Cash flow
2. Equity

Equity is key—it is what separates a one-generational job or practice from a more valuable and enduring business. Equity has always existed in the independent practice model, but it was more theoretical than practical up until the point where it could be accurately and affordably measured. Once measurable, equity required a proving ground, a place where the measurements could be tested and adjusted against a network of third-party buyers. Would buyers actually pay the values sought by sellers? The short answer was an emphatic, "Yes!" Currently, there is an average 50-to-1 buyer-to-seller ratio, which supports a strong value proposition.

Let's start with the most familiar form of value—cash flow. Independent owners pay themselves from the cash flow generated by the work they do, the products they sell, or the advice and guidance they provide. Owners know how much money they take home every month. By the end of the year, with help from their bookkeeper and/or CPA, owners know precisely how much money they made, and how (wages, bonuses, draws or distributions). And by comparing income statements, an owner knows how much more (or less) he or she made this year compared to years past.

The equity value of a business is similar in many respects to the benefits of the cash flow, and different in a few key aspects. Equity exists because of the competitive open marketplace that generates a 50-to-1 buyer-to-seller ratio. It's kind of like owning a house; if the demand is high, you have value; you don't have to sell your house to have value, and that is exactly how it is with financial services practices. Most advisors will never sell, but most have significant value, and that value is a powerful building tool when integrated into a long-range planning strategy, because equity is what next-generation owners actually invest in.

Just as cash flow has its measurement tools, so too does equity. Equity is determined by a formal and professional valuation (not a multiple of recurring revenue). Annual valuations, an essential part of the equity management process, provide a library of valuation results, creating a historical record that is of great interest to key staff members, new partners, or recruits being offered a current or future ownership opportunity in the practice.

Equity grows from year to year in most cases, certainly over a span of time if the business is growing. Equity has the ability to provide a regular income stream to the founder of a business with proper planning. Cash flow has the advantage of being immediate; in an established practice or a business with recurring revenue, it arrives predictably, and the overhead to generate it is more or less predictable as well. Cash flow is the part of a practice that founders are willing to share. However, equity is what next-generation advisors invest in and buy from an informed founding owner with a solid succession plan. Equity is what provides the return on investment advisors make, and it serves as the means for many of those investments as well.

A frequent mistake made by advisors is to equate cash flow with equity or practice value (or to link the two with a fixed multiple of something times the trailing 12 months revenue). To this end, doubling the amount of cash flow in an incorrectly but commonly structured practice model often results in little or no change or improvement in the value of the practice. In other words, if value is created and retained by individual advisors, it makes little difference whether you surround yourself with two, three, or 10 advisor/producers—you might make more money in the short term as cash flow, but you will build almost no business value in the long term and there will be nothing for next generation advisors to invest in. And when you stop working, by fate or by design, the cash flow stops, too, and with no transferable business value, the practice dies.

Measuring equity and using the value of the business as the primary determinant for growth is important because equity is not only a reflection of the cash flow and revenue generation capacity of a business, it also demands an assessment of the underlying foundation that supports the business's ability to grow and deliver services over time. Sustained equity growth directly impacts wages, benefits, profit distributions, and the ability of the business to maintain these functions from one generation to the next.

It is imperative to protect the value of your business by building a strong, collaborative team and focus on cultivating equity, as well as cash flow. The efforts to retain that team and create a sustainable and enduring business can best be achieved by creating clear equity pathways for the junior advisors to participate in the overall growth of the business, rather than the growth of their own books. This is best not only for the overall growth of the business, but for the long-term satisfaction and success of your clients as well.

Watch our webcast "Advanced Strategies for Growth and Profitability" at fptransitions.com/equity.

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.

4900 Meadows Road, Suite 300
Lake Oswego, OR 97035
800.934.3303
fptransitions.com

© 2019 FP Transitions