SETTING UP A PROSPEROUS BUSINESS STRUCTURE

#FP*INSIGHTS*

Your cash flow represents your revenue strength. This is the component of your business that supports your daily operations -- your rent, office expenses, support staff and your own income.

Too often advisor/owners focus on "revenue strength" as the sole measure of their success. However, creating and building "enterprise strength" delivers actual and enduring value capable of supporting a sophisticated succession planning strategy.

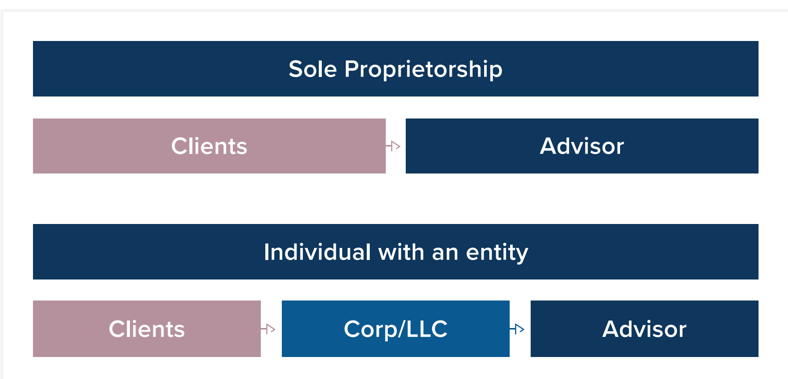
Enterprise strength is the combination of people, processes, procedures and agreements behind your revenue. It is the durability of your client relationships, the longevity of your cash flow and the documented corporate structure that will allow the next generation of advisors to invest in your firm and continue your business beyond your own career.

Key Points

1. Doubling the amount of cash flow in a silo practice model – which is the most common model in the industry – often results in little to no improvement in the value of the practice.
2. The most valuable and enduring business models in the independent financial services industry are structured as equity-centric ensembles.
3. Proper structuring provides enterprise strength capable of sustained growth rates and survivability even in the event of the founder's sudden death, or temporary or permanent disability.

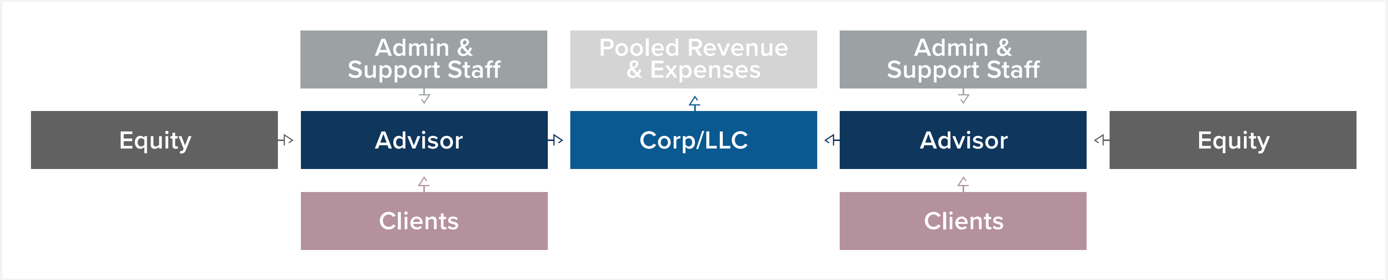
The compensation system most commonly used by registered reps and investment advisors is within a sole proprietorship with some form of revenue-sharing or commission-splitting (i.e., an eat-what-you-kill system). Revenue-splitting is an easy payment system to implement – certainly easier than hiring a bookkeeper or a payroll service to generate a W-2 wage and withholding system (Figure 1).

FIGURE 1. Eat-What-You-Kill Model



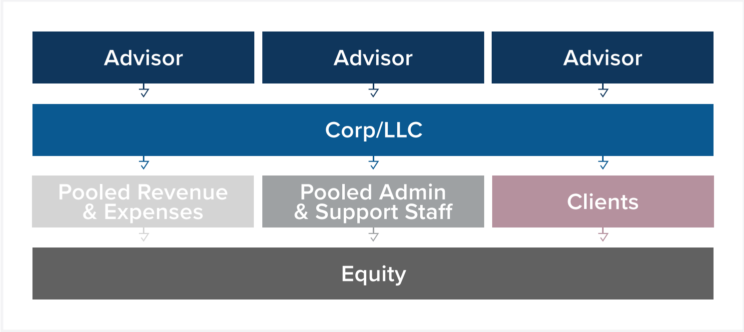
With revenue-splitting arrangements many "books of business" can be held under one roof. A group of advisors may create a corporation or LLC (Limited Liability Company) and present one common business name and structure to the advisors' clients and to the public (Figure 2). But this business model has little to no value because it is just managing expenses. The value, or equity, is actually split between the separate advisors, each an isolated "production unit" or "book of business." The ease and simplicity of setting up a revenue-splitting arrangement too often backfires when a formal valuation is completed, and the advisors discover that their business value is limited to the client base they individually serve. From a buyer's perspective, the business entity as a whole often has no value. Adding more and more advisors to this model may increase total cash flow, but it may not change the resulting value of the overall business.

FIGURE 2. Silo-Based Model



The most valuable and enduring business models in the independent financial services industry are structured like Figure 3. A properly constructed "Equity- Centric Ensemble Model" relies on a centralized entity structure (LLC or Corporation) regardless of the size of the practice or the number of financial advisors. The entity collects all revenue (assigned from the receiving producer/financial advisor), pays out compensation (wages and benefits) for work performed (including production), and pays operating expenses. The net result is a stronger business that generates higher quality and more predictable cash flow and profits. The resulting profit distributions, in turn, provide advisors/investors with two essential benefits: 1) a revenue stream and 2) capital appreciation as the value of the business increases.

FIGURE 3. Equity-Centric Ensemble Model



This powerful growth strategy uses both compensation and equity over the course of a career to obtain maximum value and growth. Note: Even though an entity cannot be paid securities revenues under FINRA rules, most independent broker-dealers permit an advisor to contribute their earned revenues into a corporate bank account that pays expenses, including salaries. All owners should be properly licensed in order to participate in these structures and to receive profit distributions.

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
    - Prevention of client attrition or loss when an advisor leaves the firm.

An entity with just one owner, will come to an end with the retirement, disability, or death of its owner. A corporation or LLC with multiple generations of ownership serving a multigenerational client base, on the other hand, has the ability with proper planning and staffing to last well beyond any one advisor's career or lifetime, and to create an enduring business with significant transferable value. This business value, in turn, can support a variety of sophisticated succession plans for the founding owner and key staff members for generations to come.

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