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Sustainability and Succession: Foundation of a Powerful Enterprise

By David Grau, Sr., JD



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Sustainability and Succession

FOUNDATION OF A POWERFUL ENTERPRISE

By David Grau, Sr., JD

It's July 2021. Walter Smith is 66 years young and is gradually throttling back on his time in the office—even while the business he founded is growing in a strong, sustainable manner with a team of younger advisors and leaders stepping up, thinking and acting like owners. Everything about the business seems different, but better, and necessary.

Walter has found that he really enjoys being a mentor to his younger advisors, a group that includes his son and daughter. He sits in on meetings with the larger, more complex clients, and even some of the new client prospects just for fun—he likes telling them about how things were when he first started the business. Other than that, Walter likes leaving the operational details to his younger partners. That's not his job anymore, and he's OK with that.

As a result of careful planning that began many years earlier, Smith Financial Partners now has five owners, including Walter (at 35 percent). The little practice that Walter founded has grown into a true enterprise with an appraised value of just more than \$9.4 million. Revenue and assets under management (AUM) growth is strong and steady and is now the primary responsibility of the entire team.

Several times a year now, Walter steps away completely. His goal is to take his grandchildren to every Major League Baseball park in the United States. He wants to spend time with each and every

one of them without the pressures of running a business constantly in the back of his mind. Walter still has the baseball card collection that he started as a 12-year-old boy, and he has a yarn to go with each legendary player; all he needs is an audience and the time to share the memories, and now he has both. Life is good.

That's where the story is now, but here's how the story began:

It's April 2014, and Walter is a 59-year-old advisor, the founder of an independent financial planning practice located just north of Denver.

At this time, Walter is FINRA-regulated and the single owner of an S corporation into which he deposits or assigns most of what he earns. Walter's gross annual revenues are a tad under \$1.9 million with total AUM of \$185 million and five full-time employees, including his son and daughter. Walter is the primary revenue generator; clients come to see him and he participates in most client meetings. If things don't go right, the buck stops on Walter's desk, and he wouldn't have it any other way—most days.

Like many financial advisors, Walter is starting to wonder: "What's next? How does this story end? How do I retain and motivate my key employees in this process? How do I best serve my clients as I get older and my own retirement comes into focus?" The answer to these questions, and many others, lies in how the story unfolds.

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Walter founded his practice in 1995 after spending the previous seven years learning the ropes as an employee of a large, well-known broker-dealer. Over time, Walter took and passed the Series 6, 7, 24, 63, and 65 examinations, earned his CFP® and ChFC credentials, and added life, health, and disability insurance lines to his service offerings. There were many long days and lots of hours invested in the process of building the practice. In terms of regulatory structure, Walter found an independent broker-dealer (IBD) with a registered investment advisor firm to work under, which provided him with a strong support system. By 2014, Smith Financial Partners had a diversified revenue stream that included third-party managed assets, mutual fund trails, annuity trails, and non-recurring revenue from limited partnerships and real estate trusts, among other things.

Walter is married and has four children. The two middle children, Eric and Elizabeth, are full-time employees at Smith Financial Partners. In 2014, Eric

is age 27 and Elizabeth is age 24. Eric is fully licensed and still working on his CFP® designation; Elizabeth has not yet taken the first of the necessary Series examinations. Walter wants to ensure a place for his son and daughter in the business with a goal to build a family-like business. Walter is also sure about one more important thing—he doesn't ever want to fully retire.

Walter took the next step and reached out for help in exploring the process of setting up an internal succession plan. But before starting his succession planning journey, Walter had a few important questions—questions that many owners in Walter's situation ask.

THE PROCESS

When should I start this process?

How long does it take?

In general, the best time to start a succession plan is around age 50, understanding that a succession plan doesn't focus on selling your equity or helping you retire sooner. Succession planning is about building a sustainable enterprise and a stronger, investable business structure. Effectively, then, it's never too soon to start overhauling systems and processes to add strength, value, and resiliency to your own practice. Even at age 59, like Walter—provided you don't want to retire in less than five years—you'd be wise to start the process as soon as possible.

The initial stages of the succession plan usually take about four to six months to organize, model, discuss with all the stakeholders, finance, and document. Most succession plans are designed to last for three steps or tranches, with each tranche taking roughly seven to 10 years to complete (a time frame reflective of the financing process). Even with some overlap of the tranches, this is a 20-year process for most founding owners.

Why should this matter to me?

You should transform your single-generation book or practice into a sustainable enterprise with an internal

succession plan for three simple reasons: (1) It is the best way to protect and realize the value you've built while maintaining control; (2) it is the best way to recruit and retain the next-generation (next-gen) talent to support your efforts in the years to come; and (3) it is the best way to safeguard your clients and their financial plans, preserving the trust they've placed in you.

Practices commonly represent the single largest, most valuable asset advisors own. Protecting that asset should be a high priority for any business owner. By building a multi-owner, multi-generational enterprise, you create continuity of ownership that stems from your formal internal succession plan.

Powered by recurring revenue that can support strong, sustained growth and a high level of profitability, a financial services practice presents a unique opportunity for founders and next-gen advisors alike. In a profession where one of the greatest challenges is attracting, retaining, and properly rewarding next-gen talent, putting your business to work for you, and them, and bringing equity into the conversation is an absolute must. This is an opportunity to build something that is the target of investment rather than the target of acquisition. And, in Walter's case, there was also the opportunity to create a business his children could carry on.

Finally, designing and implementing an internal succession plan provides you with more choices as to how your story ends. You can retire on-the-job at a time and in a manner of your own choosing, you can still sell to a third party in what is currently a strong sellers' market, you can engage in a merger, or you can enjoy one of many other exit paths.

WHERE DO I START?

The best place to start is to become familiar with how an internal succession plan works. Though every plan is unique and customized to fit your needs and goals, knowing the basic structure helps.

In the independent financial services industry, an internal succession plan is best defined as a written plan designed to gradually transition ownership, leadership, and production responsibilities to the next generation of advisors. This transition is the outcome of a professionally organized and sustainable enterprise. It requires an entity structure, a steady top line, scalable growth, and a well-organized team.

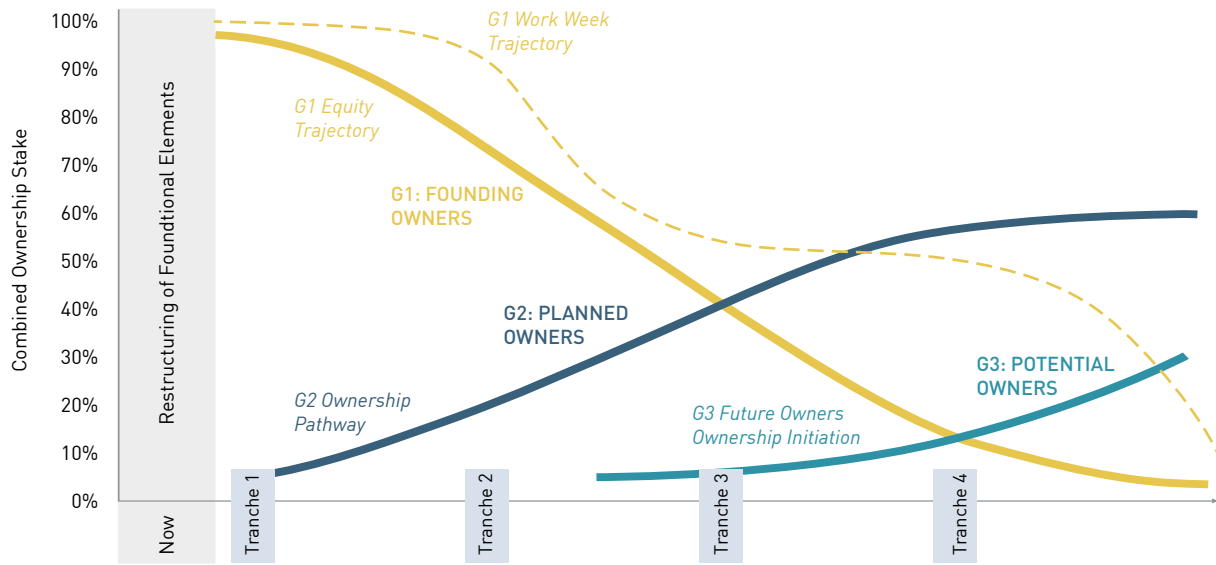
This process gradually transitions ownership internally to the next generation of advisors, referred to as the successor team. This team often comprises two or more younger owners who collectively buy in to the ownership structure as Generation Two (G2). G2s are about 10 to 15 years younger than the founders (G1), on average. The exact number of G2 and G3 owners depends on the goals and time frame of G1 and the value of the business, but most internal succession plans have more than one next-gen buyer.

In Walter's case, the initial plan indicated that two advisors on staff, Stuart and Rachel, were ready for this opportunity, having been employed at Smith Financial Partners for seven and four years, respectively. Although the long-term succession planning priorities included Walter's son and daughter, Eric and Elizabeth, in the ownership circle, at this point they were not quite ready. Eric was newer to the practice and the decision was made to postpone his buy-in for one year. Elizabeth was not yet licensed and her planned equity purchase was instead planned for in a future tranche.

The internal succession process begins when G1 sells some ownership (shares of stock in an S corporation or membership units in a limited liability company or LLC) to the G2 level of ownership and later, perhaps, to the G3 level of ownership as well. Most succession plans start with a sale of 10 percent to 20 percent of the equity ownership to one or two G2s. Plans tend to have one to three tranches.

Figure
1

SUCCESSION PLANNING SCHEMATIC



Tranche One (T1), is used, in part, to test or initiate the process; it is the most difficult stage. The first members of the successor team cumulatively acquire a minority interest in the business, usually through seller financing and the use of a soft or profit-based note with only a stock pledge as collateral. The G2's willingness to take on debt and investment risk is key—and why stock grants are not recommended. Ownership should be reserved for those individuals who can make a meaningful difference in terms of sustainable growth and profitability.

G1, once convinced that the plan can work and that the successor team is up to the challenge of growing the business, is encouraged to move into Tranche Two (T2) as soon as the process allows. This often happens well before T1 has been fully paid for by G2. Conversely, if G1 is not satisfied with the results of T1, the work ethic G2 displays, or G2's ability to generate revenue growth, the ability to sell to a third party is always retained. The measure of success of every succession plan is this: Can the business continue to grow in a scalable manner, even as G1 begins to cut back?

This staged succession solution, as illustrated in figure 1, often includes

restructuring the foundational elements of the business, including organizational, entity, compensation, and growth and profit structures, to create an investment-worthy enterprise. The natural decrease in the founding owner's time commitment to the business is also considered and is ideally matched to a staged series of equity sales to the successor team. It is expected that the successor team will grow in number from tranche to tranche as next-gen advisors are recruited, retained, and rewarded for the growing business.

Do I need a formal valuation on my practice to help determine my next-gen buy-in rate?

In most cases, yes. It is important for both parties—the seller of equity and your key employees who are buying that equity—to have an objective opinion of value in an equity transaction.

It is also important to understand that an internal succession plan is valuing the business from a different perspective than that taken by a third-party buyer or private equity. Next-gen employees who are considering this investment in their careers and in the business where they work are buying the bottom line and all the expenses

that go into supporting the business, along with any debts or liabilities on the balance sheet. The appraisal results will be used to inform the selling price of a share of stock, but they do not necessarily set that price. Price and value are different concepts, and reconciling the different perspectives can be achieved through consideration of the business's succession priorities and with thorough cash-flow modeling.

What needs to be done to ready my current business model to support a multi-owner, multigenerational ownership team?

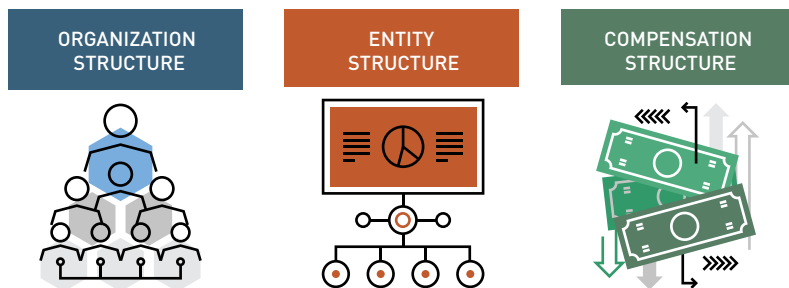
In most cases, the process of building a sustainable enterprise, which is the foundation for a succession plan, will require some significant restructuring of the existing practice. The pillars of sustainability (see figure 2) almost always need to be rebuilt or significantly reinforced as part of the process. These pillars—organization, entity, and compensation structure—support your business's ability to grow in a profitable and sustainable manner.

ORGANIZATIONAL STRUCTURE

Building a book or a practice requires a focus on production. Building an enterprise requires past and future leadership

Figure 2

FOUNDATIONAL STRUCTURES OF A SUSTAINABLE BUSINESS



of the receiving producers/financial advisors), pays out compensation for work performed (including production), and then pays operating expenses. Controlling all income and overhead items results in a bottom-line or profit distribution. Profits, in turn, provide each equity partner with two essential results: (1) a substantial return on investment, and (2) the means by which to pay for that continuing investment. These results are why and how next-gen advisors invest in a more valuable business rather than building their own individual books.

To underscore an earlier point, growth means that you will need more talented and younger advisors and support staff to help you build and run the business. Setting up an entity structure allows you to create an equity opportunity—to offer and sell some of your own stock, allowing next-gen advisors to invest in a career rather than just work at a job. The proper organizational structure helps to ensure that your new hires aspire to grow assets and goodwill for the business as part of a team, rather than the siloed approach of individual book building.

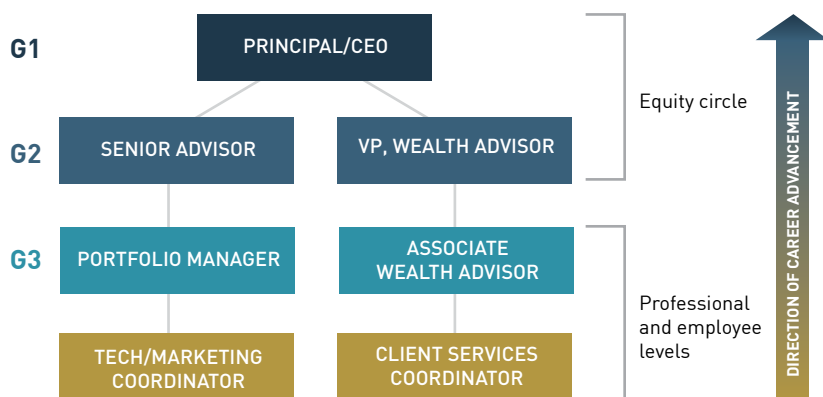
ENTITY FORMATION OR MODIFICATION

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. In most cases, this is a corporation or an LLC. Think of the entity structure like the wood framing in the building of a home. Everything in one way or another is attached to or supported by this basic and essential framework. Additional benefits from setting up and properly operating a business through an entity structure can include the following:

- Sustainability for the business where shareholders can be more easily added or subtracted
- Enhanced ability to recruit and retain next-gen talent through use of both compensation and equity

Figure 3

PATHS OF LEADERSHIP, ACCOUNTABILITY, AND ADVANCEMENT



Titles are examples and not recommendations

to make the connection between a growing cash-flow stream and the costs of such growth—in other words, a focus on the bottom line. In addition, the reliance on individual production is gradually lessened in favor of building a team to provide the future leadership and to create a professional sales and marketing process to grow the business.

In many cases, the first order of business is to shift out of the book-building mindset and into a professional organization with diversifying roles and responsibilities. This gradually creates paths of leadership, accountability, and advancement. An example of this optimization is illustrated in figure 3. With sustained strong profitability as a fundamental objective, expenses and re-investment of capital come under additional scrutiny. Ultimately, it comes down to this: Let leaders lead; let advisors advise; let

marketing market; let sales sell. Enterprises that move in this direction aren't just bigger—they are stronger.

This approach touches everyone and everything, and most fee-based practice owners (which includes IBD and insurance-based advisors) find a ready and willing group of next-gen advisors when equity is introduced into the conversation. Unlike the “force of one” book or practice approach in which a single entrepreneur takes the lead on production, service, marketing, training, vision, etc., a talented group of motivated owners can divide up the duties based on their skills and their interests to better accomplish the business's needs and goals.

Proper organization relies on a strong, centralized entity structure that collects all incoming revenue (assigned from all

- A sophisticated ownership-level compensation system that addresses top- and bottom-line goals
- Significantly improved continuity planning through an internal buy-sell or shareholders agreement
- A clear and effective governance structure with officers, directors, shareholders, and employees

Although 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 may result from business obligations. The entity separates your personal affairs from those of your business, restricting the liabilities and obligations of the business to the business itself. A limited liability entity can shelter you from such things as contract disputes or disputes with vendors and suppliers, among other things.

Another of the multiple benefits of setting up or modifying an existing entity structure centers on the idea of 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 also might be held by the corporation's director. On a day-to-day basis, authority might be wielded by the chief executive officer 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.

Note: Even though an entity cannot be licensed under Financial Industry Regulatory Authority (FINRA) rules, almost all independent broker-dealers and most insurance companies permit an advisor to assign earned revenues to 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.

COMPENSATION (RE)ENGINEERING

Properly structuring compensation at the ownership and production levels is a critical element to building a sustainable business. For such purposes, the question isn't how much an owner should be paid, but how. The place to start is to think about the future long-term business goals and what ownership represents in that plan. From there you can balance your compensation tools in a way that aligns with your business priorities.

Your compensation toolbox includes: wages and salary paid for an individual's role and work performed; bonuses as a reward for performance (usually for achieving a predetermined metric of production or growth); and profit distributions based on equity ownership. Profit distributions should be accessible only to those in the equity circle as a return on their investment. Equity is the most powerful tool for recruiting and retaining top talent to your team.

In order to create sustainability, an independent practice needs to be infused with next-gen talent. To assemble the successor team, the founding owner(s) 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 the main driver—are key to answering these questions and motivating next-gen 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.

The process of rethinking the ownership-level compensation strategy isn't about making things more complicated. In

fact, the opposite is almost always 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 solely by a paycheck or a bonus. They are motivated by increasing the size and share of their profit distributions and the appreciating value of their stock.

WHAT DOES MY SPECIFIC PLAN LOOK LIKE?

After a thorough strategic assessment of what Walter built, how he built it, and the people and structure he had in place, our firm's consulting, analytics, and compensation teams designed and modeled several evolving plans. Walter's T1 plan, which was ultimately documented and put into place by our legal team, looked like this:

- Effective January 1, 2015, Walter sells a 15-percent equity interest to Stuart (a G2 advisor, 36 years old)
- Effective January 1, 2015, Walter sells a 10-percent equity interest to Rachel (a G2 advisor, 33 years old)
- Effective January 1, 2016, Walter sells a 5-percent equity interest to his son, Eric (29 years old)

The modeling process also included a second, substantial tranche in five years that would take Walter below 51-percent ownership and likely add two more owners to the equity circle. Walter's new governance structure allowed him to retain control over key decisions as chairman of the board of the S corporation while yielding control over the day-to-day operations. The modeling process also anticipated that Walter would reduce his hours worked and days in the office to just three full days per week by 2020.

Walter agreed to seller financing for Tranche One and conventional bank financing for Tranche Two. A formal appraisal was used to guide the process,

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SUSTAINABILITY AND SUCCESSION

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but a discount of 25 percent was built into T1 to ensure a reasonable amortization period for the investing next-gen buyers. Going forward, all owners would be subject to a restructured compensation system augmented with profit distributions and other benefits.

THE END?

By understanding his long-term individual and business priorities and the process he could use to achieve them, Walter was able to shape his business and his life into what he had always envisioned. But the story doesn't end there, and maybe that's the whole point.

It's 2021. Walter has retained a minority share of ownership in the enterprise and has reduced both his time in the office and his day-to-day responsibilities. He has the freedom to work—and play—as much as he wants and still reap the rewards of the business he built from the ground up. All the while, the business itself is growing in a sustainable manner with new leaders stepping up, leaders who are committed to its continued success and who are excited to put their own stamp on the future of the business.

Creating an enduring and sustainable business isn't just about the work and

the income. It's about writing the story of your own life, building your future, and enjoying the adventures along the way.

What's your story? ●

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