Alliance for Registered Investment Advisors

# Creating value and certainty within your independent advisory firm

## Part I: The evolution of value creation

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# Forward

The independent financial advisor industry has been flooded with insight about succession planning, growing your firm via non-organic growth and maximizing a vague term known as "enterprise value" – the perceived value of an independent advisory entity. Most of this commentary has been written by entities or individuals who are sound in their thinking, are rational in their point of view and provide significant value to the industry as a whole.

However, our industry has been somewhat underserved, given that much of the information provided to advisors has been slanted to serve the needs of either the individual writing the content or an expert that has great subject matter expertise, but may not completely understand the needs and nuances of the independent advisory owner.

## Why should advisors read this white paper?

Business-planning challenges such as succession planning, gaining scale and maintaining growth may not be acute today; however, if advisors choose not to plan for their future, they may fall into the land of unintended consequences, including degradation of firm value, limited growth, an aging client base and limited choices/control about the future of their business. Left unaddressed, the result could dramatically affect how advisors can exit the business effectively (if at all) and balance the interests of their key constituencies – owners and their estates, employees and clients.

This white paper aims to provide objective and unbiased views around key business management issues owners of independent advisory firms face, with a specific focus on business management, building scale and providing certainty/business continuity for advisors. This white paper will describe the difference between an advisor harvesting their practice for cash flow in support of the advisor's lifestyle versus managing the business equity that can be unlocked to create real value. The emotional pressure to maintain an advisor's lifestyle instead of building a sustainable business can be intense, but the status quo may limit choices in the future.

aRIA is an organization formed by advisors to create thought leadership for the benefit of all advisors. Our sole focus is to arm advisors with a solid foundation around the key elements in building a strong and growing advisory business. Our objective in writing this white paper is to provide real-life perspective to help you answer some of the most serious questions facing an advisor's business today:

- How is the market changing, and what does it mean to a firm's long-term viability?
- What options are available to provide continuity for clients, employees and owners?
- What is my firm really worth, and how can I maximize its value?
- Why will scale become critical in the future, and would I be better off building scale in-house or finding the right partner to accelerate that process?

At minimum, we hope you find some of the concepts to be thought-provoking. At best, we hope you leverage this white paper as a tool to perhaps chart the next chapter of your firm's growth and future. Two things are certain in our industry: change is constant, and opportunity will

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be available for those with a focus and business model to take advantage.

Structurally, aRIA decided to develop this white paper in a series. The rationale around creating a series was to provide content as we create it and provide a completed white paper for advisors who would like to read the full version versus a modular format. After all, who doesn't like flexibility? The four-part series includes:

- Part I: The evolution of value creation
- Part II: Taking control of your future: scale, value and certainty
- Part III: Myth vs. reality: What is your independent advisory firm really worth?
- Part IV: Navigating your path forward and achieving your ideal model

This installment is meant to provide advisors with a point of view of how the industry is changing and what some of the largest and most successful firms are doing to position their businesses for the future. The remaining parts of the white paper will be more technical in nature and provide advisors with more practical information about the drivers of value, how to create scale and choosing the right path forward.

The writer is fortunate enough to have six leading advisory firms to partner with. All six firms have achieved varying levels of size and scale, operate their businesses in diverse markets, have unique value propositions and have creative concepts to grow their businesses both organically and non-organically.

aRIA members' common bond is their achievement of reaching critical mass in terms of scale, their passion around growth, their fiduciary focus when serving clients and their desire to be transparent with their keys to success. The reader should take stock in the fact that the white paper has somewhat of an embedded conflict, given that each member of aRIA is trying to grow through building a partnership or alliance with other advisors.

On behalf of aRIA, we hope you find this paper to be useful and informative. We realize not every participant in the industry will agree with our point of view. We welcome the debate and feedback – positive and constructive. Please contact us! **www.allianceforrias.com**


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# Executive summary

The independent advisor industry has experienced significant growth over the past decade. The 130,000+[1] advisors that belong to the independent channel agree it is a platform that presents the greatest amount of opportunity in the future. As the popularity of the independent advisor industry has hit ever-increasing new heights, new opportunities and threats have surfaced.

In years past, independent advisors had the luxury of growing by attracting client assets from captive and more conflicted channels, such as wirehouses, banks and referral networks constructed by asset custodians. This provided significant growth at the expense of captive channels as RIAs, Hybrids and independent contractors (that work with an independent broker/dealer) grew at a compound annual growth rate (CAGR) of ~7%, while their captive wirehouse and bank counterparts lost ~5% market share during the same period.[2]

This success has helped the independent advisor channel to go mainstream, with increased consumer and advisor awareness of the benefits of being in the channel. Clearly this growth has made all boats rise, and both advisors and investors have benefited. In addition, new forms of capital and providers entered the market and delivered best technology, innovative investment platforms, world-class business management support and practical ideas to grow their business. The industry has evolved from what many would describe as a cottage industry to an ecosystem of choices that aRIA refers to as open architecture.

Advisors can clearly build their business their way, but what does the future hold? Independent advisors will face several strategic issues over the next decade, including:

- Increasing competition from regional and national independent advisory firms in their local markets
- New and upcoming providers such as online RIAs that will likely compete on price and deliver value-added technology that smaller advisors may not possess
- Financial providers from other verticals looking to enter the wealth management space
- Margin compression if economies of scale are not realized
- Business continuity and succession planning
- Difficulty in realizing the equity value of their business
- Uncertainty around future compliance and regulatory construct

The myriad of challenges and uncertainty may put advisory firms in a difficult position. Do they want to continue to focus on each of the key elements in running their business – sales and relationship, wealth management and investments, and business management? As advisors and their top clients continue to age, how should key elements such as business continuity and wealth transfer be facilitated?

Once an advisor reaches the top of the mountain, there is only one way to go. How can advisors avoid reaching the top of the mountain and hitting a plateau where they stop growing – or even worse, decline? Are advisors better off trying to simply manage their business as an

1. Cerulli Quantitative Update, 2011. Total number of Independent Broker Dealer representatives, RIAs, and Hybrids

2. Cerulli Quantitative Update, 2011. Assets by channel 2007 – 2010

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annuity? Should they make material investments in their business to spur the next iteration of growth? Or would they be better served by finding the right strategic partner to help them achieve their long-term priorities? The answer is there is no right answer. Advisors must first understand what changes lie ahead in the future and build a sound plan that meets those dynamics head on and likewise meets their personal and professional preferences.

The good news: The amount of choices advisory firms have in terms of building a scalable business that meets the needs of their clients and matches their personal preferences has never been greater. As advisors look toward the future and where they want to take their advisory business, it is critical to understand all the options available to them and the pros and cons of each. Jack Welch of GE once said, “Failing to plan is planning to fail.” Advisors that choose not to build a game plan for the future are putting their advisory business at risk.

# Chapter I: The evolving industry landscape is fraught with opportunity and risk

“Even when opportunity knocks, you still have to get up off your seat and open the door.”

Anonymous

## State of the independent advisor industry

The independent advisor industry has enjoyed tremendous success. From a market return perspective, the first decade of the 21st century may have been lost, but the independent advisory channel has been the clear winner in terms of investor and advisor market share gains. Although there is much for independents to celebrate, there are still tremendous opportunities for growth.

Looking toward the future of the industry in terms of advisor affiliation models and support options available to advisors, one can only assume the pace of change will accelerate. What is different now and in the future versus 10 years ago is the introduction of greater choice for independent advisors. Ten years ago, being independent meant advisors generally had the following affiliation choices:

- Registered Investment Advisors (RIAs): Purchased services from an asset custodian, technology and other support advisors (RIAs) and had the responsibility of building their platform
- Independent Broker/Dealer representatives: Become a contractor with a broker/dealer for greater support services and infrastructure, with varying abilities to customize their platform or “sell away” to gain access to investments for their clients

The “build it your way” mentality has served independent advisors well for many years. Advisors were able to build their own unique client experiences, construct their advisory platform in their own image, hire staff to manage client relationships, manage the office and still capture a decent amount of cash flow in the process.

In the early 2000s, the independent advisory channel caught notoriety from captive advisors and brokers within wirehouses and regional systems. In addition, new market entrants popped up, including entrepreneurs, business leaders and entities with significant pools of capital such as private equity, venture capital and banks. And who

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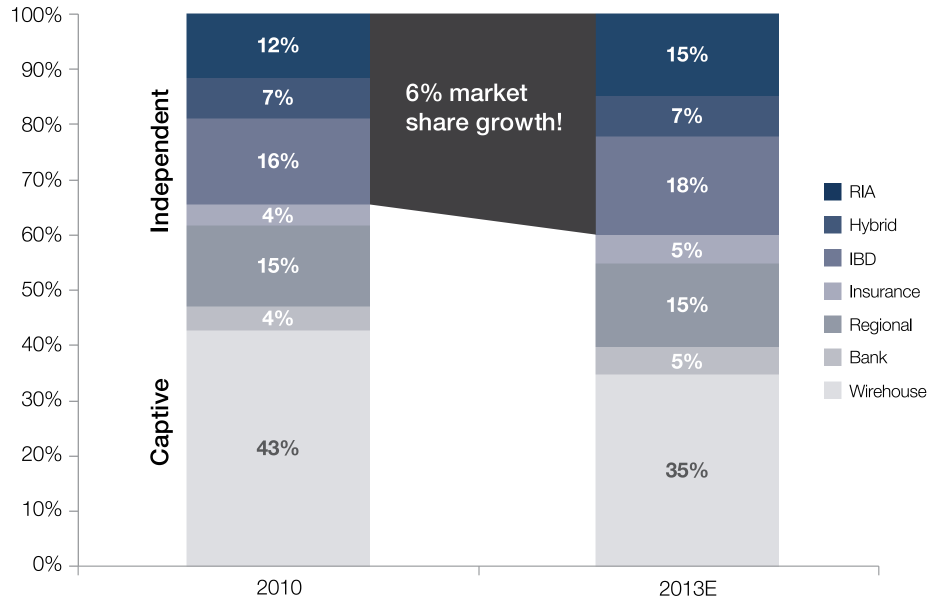
## Independent Advisors Expected to Gain Share




Source: Cerulli Quantitative Update, 2011

Figure 1

could blame them? Owning an independent advisory firm is a terrific business model and dream scenario in any line of business. Owning an independent advisory business offers the following primary benefits:

- Annuitized revenue
- Revenue model that is sticky
- Ability to bill a client in advance of delivering service
- Control over revenue and expenses
- Open architecture
- The ability to grow revenue organically
- A natural ascending revenue model (due to long-term market trends)

At the first aRIA meeting, Neal Simon from Highline Wealth Management, who ran three businesses outside the Wealth Management industry prior to founding his firm, mused, "What other line of business can you be on your clients' side of the table and feel good about the fee you charge for sound advice?" He's right – all independent advisors rejoice in the beauty of the business they have nurtured over the years. Independent advisory firms are also blessed in that they do not have to deal with inventory, receivables, supply chains and other complexities outside of the financial services industry.

Looking ahead, independent advisors are expected to continue to gain market share. By 2013, independent advisors are expected to manage ~40% of all U.S. household net worth that is serviced by intermediaries (see Figure 1). This growth is expected to be primarily at the expense of the wirehouses that are expected to lose 8% market share in the same period.

In the future, we may begin to see lines blur over traditional "channel" definition. For example, what if a larger RIA builds significant infrastructure, brand and support capability for advisors and pays

The challenge is the aging of our nation's wealth and the advisors that serve them.

advisors based on a revenue split or a payout grid? Isn't that a similar model of a large employer firm (e.g. a wirehouse), just in a different and potentially preferred channel? As the market evolves, it may become harder to distinguish one channel from another.

The key trends that will drive future advisor moves to independent channels include:

- Improvement to advisory support models
- Industry consolidation and scale
- Continuation of breakaway advisor movement
- Increased sophistication of advisors
- Tarnished brands of national firms
- Friction within private wealth divisions of large banks

These trends will continue to create significant tailwinds for existing independent advisors. But the key question is what independent advisors are doing to take advantage of the trends.

Not only do advisors need to think about what trends will drive business to the independent channel, but also what developments may impact an advisory firm's competitiveness in the future. The sections below will address many of the key trends that aRIA sees and is proactively and systematically developing their business models to take advantage of these changes. But first, they will address a few macro trends of how the market is evolving and the impact they will have on an advisory firm's business.

## The aging of U.S. wealth and wealth advisors

Looking forward to the future, quantitative research shows that there is an inevitable storm coming to independent advisors. In some ways, it is almost a perfect storm of opportunity and uncertainty. Not enough advisors in the industry are being proactive in addressing these key dynamics and positioning their firms for success. This is validated by the fact that the rate of client growth within the independent channels is outpacing the rate of advisors joining the channel.

The challenge is the aging of our nation's wealth and the advisors that serve them. The Baby Boomer generation is currently experiencing the greatest wealth transfer in the nation's history. As the independent advisor is well positioned to take advantage of the opportunity, the challenge is that the independent advisory firm owner is also aging. It is widely known that the average age of the independent owner is 55 years of age[3] and growing (see Figure 2 on page 8). As advisors mature and reach retirement age, there is a direct correlation with the aging of the majority of high-net-worth and ultra-high-net-worth individuals.

Future parts of this white paper will go into the details of what drives the value of an advisory firm. To summarize, the importance of client age within a book of business can't be understated. Would an advisor rather have a book of clients with a concentration of younger clients that are adding wealth or a book of clients about to draw down their investments due to their retirement years (see Figure 3 on page 8)? Given the preferences of younger investors, would they hire their parents' advisor, seek out a different advisor or choose to hire a different kind of partner altogether?

3. 2011 Moss Adams LLP

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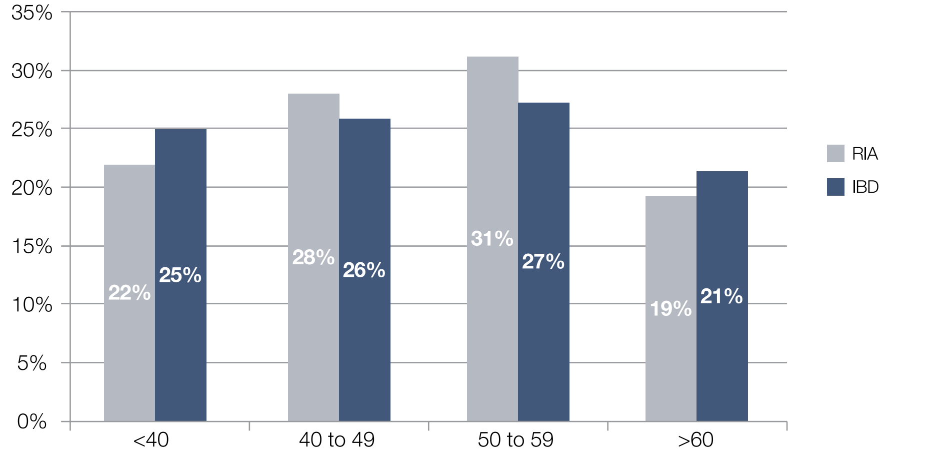
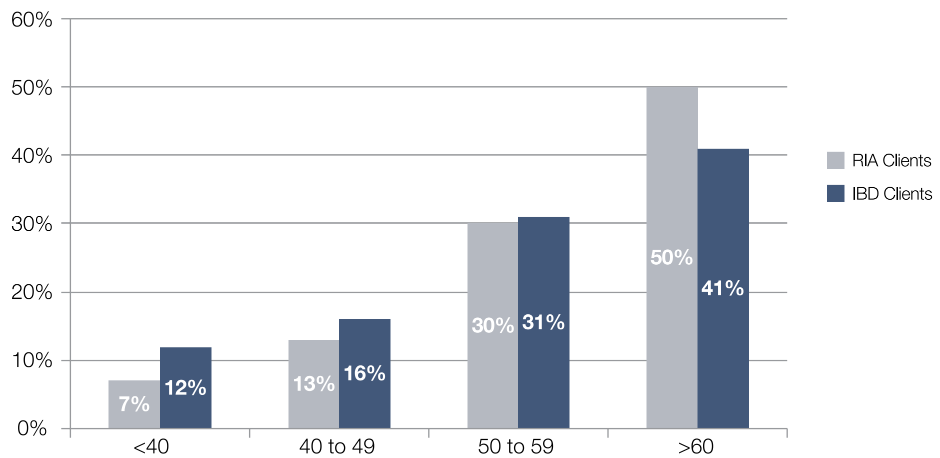
## Independent Advisor Age Demographics




Source: Cerulli Quantitative Update, 2011

Figure 2

## Independent Advisor Client Age Demographics




Source: Cerulli Quantitative Update, 2011

Figure 3

When aRIA thinks about building enterprise value, a key element is providing stability and certainty of profits and cash flow. If an advisory firm's owners and/or key contributors are aging or if an advisor's book of business is aging, significant business risk is around the corner. If there is uncertainty over what will happen to a client's assets upon their demise or if the advisor's clients will stay upon the departure of the advisor from the business, it will have a direct negative impact not only to firm value, but to the confidence of an advisory firm's employees and clients, as well. Not a compelling story!

Advisors must take the opportunity to understand the age dynamics going on within their business and take appropriate actions to create a sustainable future.


Figure 4

## Is solving the succession planning problem the *real* problem?

Beginning in 2010, there has been a wave of industry research reports, guidebooks, practice management programs and an endless array of industry experts all opining on the topic of succession planning. It is true that the single biggest asset an independent advisor has is the future revenue and profit potential of the clients he or she has spent a career developing and nurturing.

As mentioned earlier, client age demographics do not lie, and most advisor surveys note that 2/3 of independent advisors do not have a strategic succession plan or even a business continuity plan for their business. Clearly, this is an issue that all firms need to address, but aRIA challenges the industry to think more broadly about the opportunities and threats that persist.

Although succession planning is a critical planning feature in terms of business continuity and how ownership will be transferred in the future, it may not address key structural issues an advisor is facing today. Succession planning does not account for the opportunity cost of continuing to operate as usual versus evaluating strategic opportunities to either grow, scale or create new capabilities. In addition, succession planning may be related, but is not equal to planning to *sell*. Succession planning relates to how to provide continuity when the advisor exits the business; a strategy to sell the business is more closely related to a growth strategy or the maximization of an independent advisory firm's enterprise value. Defining and knowing the difference is a key element in long-term business planning.

Advisors will face new competition from a variety of providers, and the function of leading, managing and operating an independent advisory firm is becoming increasingly complex. As competitive forces continue to grow, advisors will be required to raise the bar and build deep competency in the key facets of owning and operating an independent advisory business (see Figure 4).

1. **Wealth management and investment management:**
   The ability for advisory firms to develop capabilities to serve the needs of clients. This includes traditional investment management services, but also includes wealth management services such as financial planning, tax planning, estate planning and cash management, among others.

2. **Sales and client experience:**
   Building a value proposition that will help drive the firm's growth trajectory. The ability for the advisory firm to deliver client service and support, drive client satisfaction and referrals, and deliver desired outcomes for clients. The sales process and the subsequent client experience will likely become the single largest differentiator in the industry as functions such as investment management and planning become increasingly commoditized.

3. **Business and practice management:**
   Many advisory firms are composed of great advisory professionals, but not all are great business managers, as well. In fact, many advisors learned the competency over time. aRIA member Ron Carson of Carson Wealth Management noted, "When I first started out, I was

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laser-focused on gaining clients. My attitude was if I continued to bring in more revenue, the rest will take care of itself. Fast forward to today and you would discover Carson Wealth has a formal management team analyzing the business and building future strategy in addition to our great professionals that are delivering on our promise to our clients." Business and practice management includes key functions such as strategic planning, financial management, human capital, office management, legal, compliance and elements of operations.

A key question advisors should ask is "Can I build deep competency in all facets of my business, or would I be better served finding a strategic partner to help?" The reality may be most advisory firms do not have the willingness or the ability to build, maintain and evolve all areas of their business. In many cases, the advisory firm will plateau and will be stuck trying to find new ways to grow.

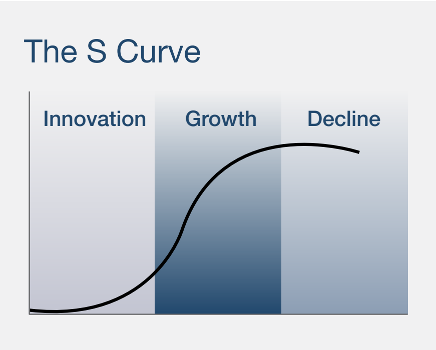


Figure 5

Any MBA will tell you that any growing and sustainable business is constantly innovating to avoid the dreaded S curve. The S curve essentially shows that once growth from innovation is complete, other entities within a certain industry vertical will replicate and commoditize the once-value-added service that the innovative provider created. This ultimately leads to growth stagnating and potentially declining (see Figure 5).

To get to the next stage of innovation, advisors may be better served to have a like-minded strategic partner help pull them up the mountain versus trying to climb the mountain by themselves. This white paper will delve into options that are available to advisors and their potential ability to help grow enterprise value and scale. The exciting development for this industry is that advisors have choice.

## The maturing of the independent advisor channel

### The new RIA and IBD ecosystem

Advisors have never had more choice in building their businesses. Over the past decade, the RIA and IBD channels have experienced explosive growth from new market entrants that brought unique technology and services to the market and breakaway advisors from captive channels seeking to reap the benefits of the independent channel. Additionally, service bureaus and strategic acquirers have entered the market seeking to provide liquidity or the promise of future growth and/or tangible benefits to an owner.

Each of these providers in one form or another is building what it positions as a value-added resource to help advisors with one or more of the key three advisory functions mentioned above. The benefit for advisors is that most of these models provide either scale, liquidity or partnership in their business or capabilities that a small to midsized advisory firm can't build on its own. Advisors know most of these providers.

On the following page is a very brief summary. Please note, there are many variants and overlap in each of these categories, and many of these firms' leaders are passionate about not being categorized.

1. **Turnkey Asset Management Programs (TAMPs).**
   TAMPs provide advisors with outsourced research, modeled portfolios, investment

allocation and rebalancing. In addition, these firms may help automate advisors with functions such as proposal generation, CRM, billing, reporting and portfolio accounting. Examples include Envestnet, Genworth Financial Management and Fortigent.

2. **Platform service bureaus.**
   These entities seek to improve functionality to help an advisory firm scale, automate or add a new capability to their office. Normally, these firms combine and integrate functions, allowing the advisor to work on a more unified platform. These firms also provide integration between an advisor's custodian and broker/dealer. The value these firms may offer the industry are emerging and in many cases still unproven. (Unproven given it remains to be seen if they can deliver scale and value for a sustained period.) Examples include Dynasty and Orion Advisor Services.

3. **Consolidators.**
   Commonly referred to as "roll ups" or "financial buyers," these firms seek to purchase or combine with existing independent advisory firms. Usually there is an economic consideration where the consolidator purchases some or all of the advisory firm for cash, stock in the consolidator, or a combination of cash and stock up front and earnout. Many consolidators offer value-added services beyond just a financial model. Many also offer material business management support, collaboration amongst advisor affiliates and scale through the centralization of support resources and/or advisor functions. Examples include Focus Financial, HighTower, Fiduciary Network and United Capital.

   Advisors considering a relationship with a consolidator should weigh the benefits of these firms with the potential challenges and risks these firms may present. Consolidators may have complex financial structures and provisions that may increase risk to the advisor and may leave partner firms with unfulfilled expectations. Just like any business relationship, advisors must perform due diligence to weigh the benefits versus any potential risk.

4. **Regional and national RIAs.**
   There are RIAs who believe that economies of scale are important and that there will be an evolution of several $10 billion+ RIAs with integrated research, reporting, operations, compliance, etc. They have lifted out advisors from other firms and acquired and merged with other RIAs. They believe that the only way to achieve true scale is to integrate their companies to form larger ones. Examples include Aspiriant, Mariner and TCI Advisors.

5. **Independent advisor platforms.**
   Independent advisors, including certain aRIA firms, are also in the game of providing support services to advisors. The level and type of support could range from leveraging the back office of an advisor, leveraging investment capabilities (e.g. a sub-advisory model) or providing a 401(k) platform to an equity arrangement. Examples include Concert Wealth Management and Spire Investment Partners.

6. **Niche providers.**
   The growing RIA market has also attracted functional specialists to assist independent advisors with key issues that face their businesses. This could include business management, succession planning, human capital (including recruiting), investment banking and the broad term "practice management." Advisors continue to benefit as these firms' capabilities continue to evolve. Examples include ActiFi, MarketCounsel and Advice Dynamics Partners, among others.

New market entrants are applying pressure to traditional value-added providers.

## Pioneers of disintermediation

As the new RIA ecosystem evolves, new market entrants are applying pressure to traditional value-added providers such as asset managers, custodians and technology companies. Many traditional players are choosing to reinvent themselves through acquisition, by building new capabilities or by finding new ways to partner with providers who offer a value-added overlay to their services. The reason behind this is they don't want to have an S curve happen to their own model, and they will fight to maintain growth and retain their position in the marketplace.

There are multiple examples of this trend, including:

- Schwab's Intelligent Integration, Pershing's NetX360, TD Ameritrade's VEO API interface and Fidelity's Wealth Central to integrate disparate technology platforms
- Tamarac's integration of CRM and portfolio management and subsequent acquisition by Envestnet
- Advent's purchase of Black Diamond to expand their reach into the wealth management space

In addition to acquisition and solution expansion, there are independent entities finding ways to create symbiotic relationships that benefit advisors. An example is Stratos Wealth Partners' relationship with Linsco Private Ledger (LPL). At its inception, Stratos sought to build a model with LPL at the core and Stratos providing services that advisors didn't want to do or felt they could not scale to drive value. Stratos services include turnkey advisor support functions such as accounting, compliance, marketing, billing and virtually all other functions outside the core advisor functions. Stratos wins because they are providing services advisors want, and LPL wins because Stratos advisors hold most of their assets at LPL. Advisors affiliated with Stratos also have the ability to custody assets where they choose, given Stratos is open architecture.

In addition, the market is starting to see a greater amount of convergence around products and services a provider seeks to deliver. As traditional provider functions such as custody, portfolio management and client relationship management systems become increasingly homogenous in the eyes of the advisor, providers have shifted their value add to areas above and beyond their core competency. For example, advisors are now being engaged by asset management companies regarding their practice management issues, not just how the asset manager can deliver the best investment solution for the advisors' clients.

This change has provided advisors with benefits, but also has forced service providers, including custodians, technology companies and a cadre of additional advisors, to rethink their strategies.

## The rise of the national RIA

Given the fractured nature of this industry, one would suspect that it is ripe for consolidation. Nothing has been further from the truth. In fact, over the past several years, the number of independent advisor entities has continued to grow, while advisors in other channels continue to drop (see Figure 6 on page 13). Why is this? Is it because consolidation models are not compelling enough, or it is simply a fact that

## Advisor Market Share by Channel

| Channel | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 3-Year CAGR |
|---|---|---|---|---|---|---|---|---|
| RIA | 15,786 | 16,498 | 16,527 | 16,983 | 19,322 | 20,534 | 20,605 | 6.7% |
| Dually registered | 4,744 | 6,967 | 9,340 | 10,378 | 12,066 | 11,591 | 12,773 | 7.2% |
| IBD | 102,689 | 104,282 | 97,761 | 99,461 | 98,142 | 98,848 | 97,792 | -0.6% |
| Insurance B/D | 98,416 | 93,593 | 88,196 | 92,963 | 96,004 | 95,404 | 89,121 | -1.4% |
| Wirehouse | 60,960 | 64,058 | 59,696 | 56,901 | 54,865 | 50,204 | 50,742 | -3.7% |
| Regional B/D | 36,691 | 33,581 | 32,814 | 33,029 | 34,598 | 38,249 | 34,359 | 1.3% |
| Bank B/D | 15,634 | 16,220 | 16,042 | 16,528 | 16,815 | 15,919 | 14,986 | -3.2% |
| Total | 334,919 | 335,200 | 320,376 | 326,243 | 331,811 | 330,748 | 320,378 | -0.6% |

Source: Cerulli Quantitative Update, 2011

Figure 6

market participants (advisors) just are not interested?

Will this trend of lack of consolidation remain the same? Nobody can predict the future with any certainty, but a trend that is growing is the rise of larger and far more sophisticated firms. These firms have a desire to build a regional or national footprint. These firms have all achieved a certain level of scale and usually want to grow non-organically by recruiting, providing affiliation or acquiring other independent advisors.

aRIA member Matt Cooper from Beacon Pointe says, "Firms need to provide a leverage point for advisors. What is different is we provide what we feel is the best of what we offer with the benefit of being an owner in the larger enterprise. They can partner with us by joining platforms, which frees them up to do what they do best, serve clients and grow their business." aRIA member Brent Brodeski from Savant Capital, LLC adds, "We have made significant investments in our platform over the years – many millions of capital. We would love to find advisors that want to partner with us, leverage our investments and grow together."

Outside of aRIA, there are numerous large players beginning to sprout up. These firms are prime examples of scale-driven operations, managed by business leaders who are seeking to provide value to all constituencies – investors, advisors, employees and the owners of their firms. This growth is evident in the sheer size of independent entities. In 2005, there were fewer than 50 firms with more than $1 billion in client assets. As of 2011, there were 334 firms with $1 billion in client assets.[4] The implication for advisors is these large firms have the revenue to support investments back into their businesses to increase functionality and drive scale.

### The future competition is not the wirehouses

Within two years, independent advisors will likely have a greater market share than wirehouses in terms of assets under management. Consumer and advisor preferences may not change in the

4. Cerulli Quantitative Update, 2011

immediate future, and one can expect independent advisors to continue to gain share as a channel. But will advisors be able to compete?

As was mentioned earlier, large RIAs, holding companies and advisors leveraging service bureaus will continue to develop compelling brands, services and offerings that pose a threat to an existing advisor's business. Will going it alone be enough? Can advisors rely on traditional referral services to grow their businesses? Are advisors increasingly vulnerable to clients being poached by another independent advisor who has built superior capabilities? If advisory firm owners are not answering these questions, they could find themselves with lost opportunity at best or a declining business at worst.

A final broader and larger unknown is the current emergence of bleeding-edge-type platforms and solutions that are unproven, but could cause meaningful disruption to traditional business models:

- Schwab's construction of a national franchise system to differentiate channels and gain share through owner/operator advisors
- Advisor-assisted online service providers such as Motif
- Technology providers that see opportunity to enter the self-serve and assisted financial advisor space, such as Quicken

Advisory firm owners will face a myriad of competitive forces in the future that will force a relentless focus on building value for clients, scale for their businesses, and flexible systems and processes.

# Chapter II: Myths and realities of enterprise value

"Reality leaves a lot to the imagination."
John Lennon

## What do advisors really own? An annuity or a business?

Many advisors in this industry either lack awareness of what type of business they truly own or choose to systematically ignore the underpinnings of the differences between owning an annuity-type advisory practice and a self-sustaining business (see Figure 7). Many industry experts and consultants refer to this as the difference between running a lifestyle practice and building an enterprise. First, advisors must realize there is *nothing wrong* with one model versus another.

| Advisory Practices | | Sustainable Businesses |
|---|---|---|
| Lifestyle practice | → | Firm-level brand and focus |
| Harvest business | → | Reinvestment in business |
| High professional comp | → | Cash flow focus |
| Investment focus | → | Sales and service focus |
| Owner in value prop | → | Firm-wide value prop |
| Near-term focus | → | Long-term business planning |

Figure 7

Advisors must consider not only their business goals, but also their personal goals in developing and nurturing their businesses. As many advisors can appreciate, their business goals may change based on their current personal situation. For instance, there are many advisors who want to get back to "growth" mode after their children go off to college.

aRIA's goal is to open advisors' eyes to current or future blind spots in their business-planning process so advisors can limit unintended consequences from not addressing future challenges today.

## What is an advisory business really worth?

Independent advisors take pride in the fact that they have built a business over the years, with many advisors generating significant income for their families. In aRIA member firms' direct experience, many advisors are conflicted about the present value of the business (the annuitized cash flow of their business in present terms) versus the future value of their business if they were no longer with their firm.

Any business entity is valued by the entity's ability to generate future cash flow for owners. Based on this simple concept, what is a business really worth? Even more importantly, what would a buyer be willing to pay based on the expected future earnings of that business? In many respects, this industry has done many advisors an extreme disservice by sensationalizing transactions with high multiples and incredible outcomes for the owners of the selling firms.

Unfortunately, these transactions are more myth than reality. A major challenge the industry faces is the lack of transparency and a lack of standardization in firm valuation methods and transaction terms.

Advisory firms that lack scale, have client relationships tied to owners or a small group of professionals, or lack business acumen are unlikely to generate any real business or enterprise value from an external buyer's perspective. These types of firms have more of a *cash flow* or *annuity* focus and reap the value of their business year in and year out. The blind spot these firms have is when they reach the end of the road, they may realize they have already harvested the value of their business over the years of owning it.

If an owner of an advisory firm felt it was important to enhance their advisory firm value, wouldn't it be prudent to understand the levers they can pull to increase value? Very few advisory firms have shown the ability to unlock the value of their firms even though the drivers of value are static. As noted earlier, the value of any advisory firm is based on the future value of the cash flows. Current value is simply a proxy for the expected future value of the cash flows.

## Climbing the mountain and avoiding falling off

aRIA member firms are constantly striving to increase the value of the firms by pulling the levers in their businesses that they can control. Part III of this white paper will delve deeply into the drivers of valuation and what advisors can do to manage their equity.

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**Value Drivers of an Independent Advisory Business**

$$V = \frac{CF}{R-G}$$

Figure 8

Here is a brief summary of the main drivers of value (see Figure 8).

1. **Cash flow (CF)**
   Cash flow represents the profitability of an advisory firm. Cash flow is usually measured by earnings before owner's compensation (EBOC), earnings before interest, taxes, depreciation, and amortization (EBITDA), or a variant of this. Advisors who want to maximize value seek to grow cash flow at a high annual rate, maximize operating leverage and provide consistent returns to owners.

2. **Growth (G)**
   Growth represents the rate of organic growth with an advisor's business. Usually the best proxy for growth is net new revenue – client additions less client attrition. In the past, market growth was able to mask potential deficiencies in growth, but that may not be the case in the present and the future. Growth from mergers and acquisitions may or may not be included as a growth driver.

3. **Risk (R)**
   Risk represents the potential for future cash flow to be derogated. This is usually the most vague and unfamiliar ground for advisors who are trying to maximize their value. Risk includes factors such as client and employee demographics, operating model, stability of ownership team, revenue risk from potential key employee departures, ability to maintain margin and concentration risk of revenue.

   Independent advisory firms that are privately held, by nature, have a higher risk premium to an informed buyer. The buyer must secure substantially higher returns than what they can receive passively through capital markets to compensate them for the substantial risks related to the capital and the human resource investment to monitor that investment. Owners of advisory firms must grasp how susceptible their firms are to capital markets and the risk premiums buyers will demand related to the nature of their businesses.

## The value of each revenue dollar

Are all revenue dollars created equal? aRIA argues each revenue dollar to an independent advisory firm is not. Here is an example. For simplicity, assume each advisory firm is in the same market and has the same number of clients and average client size is the same. Advisor A has $500,000 in fee-based revenue linked to his broker/dealer's corporate RIA. Advisor B has $500,000 linked to a mutual fund class C and receives an annuity trail that is faithfully paid each quarter by his broker/dealer. Advisor C has $500,000 in fee revenue related to planning and investment advisory fees charged via their own independent RIA. Which revenue would a buyer be more willing to pay for?

On the surface, it would be natural to pick Advisor C, given the fee is not linked to a product and is directly linked to the advisory entity. But what if a buyer were told that Advisor A's clients had an average age of 55, Advisor B's clients had an average age of 45 and Advisor C's clients' average age was 65. In addition, what if Advisor A was near retirement age and had not grown the business, Advisor B was young with a high growth trajectory and Advisor C had an investment focus that would be an accretive capability to the buyer's business? As you can see, the waters get murky pretty quickly.

The point is not all revenue dollars are equal. As mentioned earlier, the most highly valued dollar is the one that has the highest residual *future value*. In this example, one could argue that even though Advisor B was operating in a captive environment and the revenue was most likely linked to an investment product, that revenue is the most valuable as it will likely have the highest future residual value.

In general, most advisors are aware that fee-based dollars are more valuable than commission-based dollars. But what about the shades of gray within each type of model? Assuming all other things are equal, here is a ranking of advisory firm revenue dollars from most valuable to least valuable:

1. Recurring fee revenue derived from advisor-owned RIA
2. Recurring fee revenue derived from a broker/dealer-owned corporate RIA
3. Recurring commission trailers linked to variable annuities or mutual funds
4. Non-recurring planning fees or value-added service fees from advisor-owned RIA
5. Non-recurring commissions from product sales

## The importance of pricing clients

Pricing strategy is one of the most underrated opportunities an independent investment advisory has. As the wealth management industry has evolved, advisors are continually adding more value to clients, yet pricing schedules have remained fairly constant for a decade or more. The majority of advisors reading this paper have a fee-based advisory schedule that starts at 100 to 125 basis points and ladders down to 40 or 50 basis points based on asset size. Will this model serve advisors well into the future?

A recent study showed that the average fee-based advisor (not advisory firm) leaves more than $20,000 of fee-based revenue on the table annually.[5] Most of the shortage is directly attributed to an advisor's willingness to negotiate pricing off their schedule or provide special consideration for friends and family or legacy accounts. The biggest trap an advisor commonly feels is that all revenue is accretive to their business.

## The virtues of diversification in your advisory business

Advisors seek diversification in their clients' investment portfolios to mitigate risk – not only diversification in investment class, but also revenue diversification in the underlying companies their portfolios are invested in. So wouldn't it seem reasonable that advisory firms would want to do the same with their own practice?

What the last two down markets should have taught advisors is that their revenue models are vulnerable in periods of market decline if the only source of revenue is the fee-based revenue that is tied to the advice they give.

Several advisors in our industry shun the notion of charging for services in any other format than fees based on assets under management. Very few advisors consider bifurcating fees charged for managing investments versus the fees charged for wealth management, family office or investment planning services. What about the consideration for additional value-added services for tax returns, one-time strategic planning or

5. 2011, PriceMetrix

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Scale is defined as the ability for an advisory firm to create operating leverage by lowering the marginal cost of each new revenue dollar their firm earns.

"one team" services that advisors seem so eager to simply embed in the recurring fee-based model?

There are no right or wrong answers, but advisory firms that have the ability to diversify business lines, services and revenue sources have the ability to better stabilize their cash flow and decrease their revenue risk, two of the key drivers to increasing value. aRIA member John Burns of Exencial Wealth Advisors is currently working through an expansion of wealth management services.

John noted, "We recently completed an acquisition of a firm in Dallas, Texas. We soon realized there was opportunity to cross-pollinate services from the firm we bought and vice versa. We now have the ability to deliver advanced planning services for ultra-high-net-worth families and deliver sophisticated tax planning and return services to our best clients. Not only is this a new source of revenue, but it forced us to think differently about our client segmentation and service delivery model. We are achieving the next level of scale."

## Achieving *true* scale

Scale is a common term thrown around in this industry. Advisors hear the "We help you grow by helping you scale your business" quote all the time. What does scale really mean? Why is scale even important? Or, asked differentially, are there any real long-term benefits from advisors supporting 30,000+ independent entities with 30,000+ research departments, 30,000+ trading departments, 30,000+ operations departments and 30,000+ brands? An argument can be made that an independent advisor's ability to build their firm based on client need and their value proposition is what helped our industry to grow so quickly. A counter argument is competition may force advisors into thinking differentially, as the luxury of building 30,000+ unique platforms may not be viable in the future.

aRIA feels scale is defined as the ability for an advisory firm to create operating leverage by lowering the marginal cost of each new revenue dollar their firm earns. This can be achieved by people, process and technology. In general, scale is achieved within an independent advisory firm the following ways:

1. **Developing functional departments.**
   Larger advisory firm entities are almost always advantaged in terms of creating scale. Once an advisory firm is able to achieve critical mass via revenue expansion, it allows for the building of functional expertise in various functions versus having employees wear multiple hats. Deeper functional expertise allows people to take on additional clients and revenue without having to hire more people.

2. **Developing more efficient operational processes.**
   Firms can develop deep competencies within their operational functions to take on additional volume without having to hire additional staff. This is usually referred to as "workflow optimization" and is a process-driven function.

3. **Fixed-cost leverage.**
   Larger firms continue to create scale by their ability to leverage fixed costs within their model. For example, if an advisory firm has two advisors, those advisors leverage the brand related to the firm. This cost is static and required. However, larger firms gain operating leverage and scale by continuing to leverage off the existing functions and capabilities of the

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| Benefits of sharing equity | Risks of sharing equity |
|---|---|
| Aligns key employees | Expanded corporate governance |
| Helps drive future growth | Inability to contribute to management |
| Next generation of ownership | "Giveaway" if not structured correctly |
| Distributes ownership risk | Tax implications for buyer and seller |
| May increase firm value | |

Figure 9

firm. This is where benefits of scale truly kick in. Key leverage points include:

- Investment management functions and research
- Marketing and PR
- Technology licensing
- Operations
- Dedicated wealth management functions such as planning teams, tax teams and family office functions

When advisors think about business and financial management, scale will become increasingly important in the future. Many industry observers feel that pricing will continue to come under scrutiny as advisors structure to differentiate their offerings and compete on value. In the absence of creating scale, advisor cost models will be under pressure as costs they can't control, such as taxes, insurance, health coverage and employees' salaries, continue to rise.

The key question an advisor should ask is "Do I want to achieve scale to increase the value of business?" If the answer is yes, the next question is "Would I be better off investing in-house or would I be better off finding a strategic partner?" Given the dynamics and market trends mentioned earlier in this paper, only a subset of advisory firms will have the capital, capability, commitment and human capital to effectively differentiate their offerings and build competency in all areas of their business.

## Ownership structure – is full control a good thing?

aRIA is a diverse group of advisors with unique platforms, ideal clients and value propositions. In addition, each firm has unique corporate governance and ownership structure. However, each firm also has an internal system to either grant or sell equity ownership to key people based on rigorous predetermined criteria.

Why is this so important? For advisory firms that want to build a business with true enterprise value, you must attract top talent and provide incentive for that talent to stay. As we have all learned from the breakaway advisor trend and advisors that transition more broadly, top talent will leave an organization if opportunities dry up or if there is limited opportunity to grow.

Is an advisory firm better off by concentrating ownership to a single

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owner (who started the businesses) or the original partner group?

aRIA suggests advisors think toward their *future goals* in growing the business and the eventual transfer of the firm.

Once that is identified, it will be become much clearer which ownership structure is best for the firm (see Figure 9 on page 19).

# Case Studies


Figure 10

> "Building a practice that's all substance is good from the standpoint that it's what your clients need and expect of you. The bad news is, without sizzle, you may not attract any assets because nobody will have heard of you."
>
> Ron Carson

## Carson Institutional Advisory: Substance and sizzle

Ron Carson has built one of the larger independent advisory practices in the U.S. Advising on more than $3 billion in client assets, 396 clients and 40+ employees, Carson Wealth Management has achieved scale through people, process and innovation. The firm has received widespread industry recognition for its sales acumen, thought leadership and Ron's willingness to be transparent via the firm's sister company, Peak Advisor Alliance, which provides best practices and coaching services to independent advisors.

When you ask Ron to reflect on how he built such a large and successful business, he reflects on a few key moments in his more than 20-year career in the business. Famously, Ron began his career cold calling out of his dorm room at the University of Nebraska, and he found material success in the early years by being an extraordinary salesman. "I remember working many long hours, and I was always trying to scale by hiring operational-type individuals to watch the office while I went out selling."

Ron started to build his business in a material way beginning in the early 2000s. "I didn't have an epiphany moment, but a mentor of mine told me to hire the brightest people you can find and get out of the way." This changed the way Ron viewed his staff and human capital in general. "People are not an expense – they drive value via their ability to generate new ideas, create revenue opportunities and ultimately, profit." Carson Wealth has built true functional teams, optimized processes and constructed a technology platform that is part customized and part best of breed in the industry. How Ron delivers a turnkey wealth management business is captured in Ron's new book, "Tested in the Trenches: A 9-Step Plan for Success as a New-Era Advisor."

In 2012, Carson Wealth launched a new line of business that allows advisors to leverage the scale Carson Wealth has attained and be substantial in any market. "All advisors want scale, but when you drill in deep, they really want the scale without a massive internal commitment or making long-term commitments that make them captive or limit their choices." Carson Institutional Advisory (CIA) was built to provide advisors with substance (a time-tested investment and sales platform) and sizzle (the ability to provide a differentiating story to clients).

CIA provides independent advisors with Carson Wealth's time-tested and

Stratos Wealth Partners
Elevating Financial Strategies

"Our ideal advisor is an existing independent representative that wants a more value added provider or the advisor from the wirehouse that wants a turnkey solution."
Jeff Concepcion

battle-proven processes without the "captive" hooks that come with many other platforms. Ron likes to describe the offering as a "value-added outsourcing model" for investments, sales, marketing and technology (see Figure 10 on page 20). There are no long-term agreements or commitments and that's the way Ron wants it. "We want advisors to want to do business with CIA because they view our platform as the best way to scale their business. We have a passion around building a model that we have to deliver day in and day out to our advisor clients." The CIA Alliance program offers the following key elements:

1. Access to Carson Wealth Management investment strategies
2. Transparency and access to Carson Wealth Management investment processes and tools
3. Marketing and PR resources and support
4. Business development support and access to CIA wealth management function resources
5. Opportunity for a succession solution

CIA represents the next iteration of scale for Carson Wealth and provides the company with greater revenue diversification and risk reduction. Ron feels CIA will represent a huge part of the firm's growth engine. "We feel this is a triple-leverage play. Not only can an advisor become substantial virtually overnight, but they also get best-in-class resources that would take them years to build, and ultimately their clients will see an uptick in their client experience and outcomes."

## Stratos Wealth Partners: Independence without isolation

Stratos Wealth Partners has experienced a near-meteoric rise in size since the firm's inception in 2009. With more than $4 billion in client assets, 130 advisors and more than 100 employees in a support role, Stratos has seen material growth that is virtually incomparable to any firm within the industry.

Jeff Concepcion, founder and CEO, had roots within the insurance industry and sought to start a firm that was the antithesis of everything wrong within "captive" insurance and wirehouse platforms. Jeff felt the market was being underserved and felt that advisors wanted all the benefits of independence, but wanted a strategic partner that could take on responsibility for the non-client-facing functions such as HR, technology, reporting, real estate, compliance and coaching. Jeff commented, "We refer to it as independence without isolation. Not only are we providing value-added services to our advisors, but we are also building camaraderie within our team. We are building forums for advisors to collaborate and share ideas."

The Stratos model is unique, given the fact it provides common shared services to affiliated advisors, while the advisor retains complete control over the areas that are most important to them:

- Control over their legal entity, while leveraging the Stratos RIA and their relationship with Linsco Private Ledger (LPL) for commission business.
- Complete control over investments and wealth management functions.
- The ability to control expenses related to their local office. Stratos

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also offers a turnkey model for advisors that want to outsource office setup and maintenance to Stratos.

- The ability to work with like-minded advisors. Stratos notes that advisors enjoy being able to work with shared affiliates.
- A regional network manager to help with practice management, business management and sales.
- A strong bench of talented research, insurance, marketing and wealth management specialists to help Stratos affiliates deliver services to clients.

One of the top benefits for advisors is the ability to own their business and have the ability to be an owner of Stratos, as well. This two-tier model is somewhat unique. "We are the exact opposite of a roll-up model," Jeff noted. "Instead of taking an equity interest in the advisor's business, they take an equity stake in our business. It's a powerful alignment tool. Our advisors are interested in our growth and now they are starting to reap the rewards of their investment." Stratos also provides a built-in succession plan option for advisors nearing retirement, and they also try to match affiliated advisors that are seeking to buy or sell their practice.

Stratos doesn't expect the pace to slow down anytime soon. Jeff notes, "Our advisors have told us our pricing is extremely competitive and we are delivering the tools they need to grow and be successful." Given Stratos went from zero assets under management to more than $4 billion in three years, it is difficult to argue his point.

# Acknowledgements

The formation of the industry group aRIA and this subsequent white paper is a watershed event for our study group. Our goal is to share our experiences of how each member firm evolved from the more humble roots of a lifestyle practice or large corporation into sophisticated regional or national businesses. Our hope is that advisors can leverage the findings to help construct a roadmap to grow and scale an advisory business.

aRIA has established a mantra of checking our egos at the door, which has allowed us to interact in a way that creates knowledge-sharing, best practices and collaboration that improves the way each of us manages our respective businesses. Along the way, each of us has received help and guidance from a variety of industry participants and professionals who have helped shape our points of view and challenged our assumptions.

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Wishing you all future success,
John

## About aRIA

aRIA, the alliance for RIAs, is a think tank study group composed of six elite RIA firms that collectively manage more than $20 billion in client assets, and Advisor Growth Strategies, a leading consulting firm serving the wealth management industry. The group offers insight for advisors considering ways to enhance their firms' enterprise value. Members include Brent Brodeski, CEO of Savant Capital; John Burns, Principal at Exencial Wealth Advisors; Ron Carson, CEO of Carson Wealth Management Group; Jeff Concepcion, CEO of Stratos Wealth Partners; Matt Cooper, President of Beacon Pointe Advisors; Neal Simon, CEO of Highline Wealth Management; and John Furey, Principal of Advisor Growth Strategies, LLC. The group meets regularly, releasing thought leadership pieces of interest to both independent and wirehouse advisors interested in exploring long-term growth strategies. On the Web at: **www.allianceforrias.com**

## About Advisor Growth Strategies

Advisor Growth Strategies, LLC (AGS) is a leading consulting firm serving the wealth management industry. AGS provides customized business management solutions for independent firms seeking to aggressively grow their business and for financial advisors in transition. Our services include strategic planning, recruiting and acquisition programming; compensation design; and succession planning. We serve established independent advisors, large breakaway advisor teams and institutional-level corporations. On the Web at: **www.advisorgrowthllc.com**

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## About Weitz Funds

Wallace R. Weitz & Company was started in 1983 with about $11 million under management. Over the years, the firm has followed a common-sense formula: own a group of strong businesses with deeply discounted stock prices. By staying true to this philosophy – and sticking to industries it understands – Weitz Funds has been able to pursue solid returns for investors. Today the firm, a registered investment advisor, manages approximately $4.4 billion for the Weitz Funds, individuals, corporations, pension plans, foundations and endowments. Learn more about Weitz Funds at **www.weitzfunds.com**

This white paper was sponsored by Weitz Funds.

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