From Success to Significance, Part II

Identify and Manage Business Risk to Maximize Value
In Your Wealth Management Firm

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Introduction

Beacon Pointe Wealth Advisors defines successful firms as strong businesses that provide a great lifestyle for founding owners. Successful firms tend to have the vast majority of ownership held within a single generation of owners, are founder-centric to the market, and generally rely on the collective power of founding owners as their sole growth engine. These firms typically manage at least $500M in assets under management (AUM) and have company revenues of at least $4M. The owners of these firms have robust income year-over-year, and assuming nothing changes, have built a very stable company for clients and employees.

Although many independent advisory firms are successful, only a small percentage of firms are significant. BPWA defines significant firms as those that have assets of at least $1B in AUM and demonstrate $8M or more in company revenue. However, not only revenue and AUM define the difference between successful and significant firms; this was discussed more deeply in Success to Significance, Part I.

The difference between success and significance is analogous to an affluent versus a wealthy client. Affluent clients move a good deal of money working through their checking account on a monthly basis, while wealthy clients tend to own assets and have significant net worth. Significant firms are focused on creating a legacy for themselves, their clients, their employees and their community.

Significance is a natural extension of the fiduciary promise made to clients and the moral obligation to employees. Significant firms shift the focus from the founding owners to supporting future generations via the firm's strategic direction. This is a desirable state that requires material reinvestment of time, capital and emotion. The outcome might be a multi-generational firm that more closely resembles what many founding owners initially envisioned when they chose independence.

Why is significance such a desirable state? It allows a firm to have a multi-generational focus with lasting business value. Significant firms are able to remain nimble in turbulent markets, leverage people and infrastructure, provide certainty for clients and employees, and better deliver on the fiduciary promise. The financial and emotional investments needed to build a significant firm can be viewed as a rebellion against linear thinking.

For example, a common linear thinking pitfall that successful owners face can be in direct conflict with their most cited disclaimer, "*Past performance is not an indication of future results*." Linear thinking is a trap that leads founding owners to assume the status quo in how they manage their independent firm, based on the assumption that maintaining the status quo will provide similar results in the future. This logic makes success a risk in itself and provides a dangerous justification to ignore other potential threats, and more importantly, future opportunities.

What if the markets suddenly turn for a prolonged period? What if the talent inside a successful firm becomes disengaged with the founder's vision and seeks an alternative path? What if increased capabilities and value propositions of competitors cause client preferences to change, and clients begin to look for a firm with a better offering, brand, client experience, or perceived future stability? And, what if an unexpected compliance "black swan" or legal issue avails itself at the most inopportune time?

This paper will explore risks in greater detail and offer solutions to manage them while building firm value.

The perfect storm: T-minus five years until retirement + business disruption

Imagine you are a founding owner of a very successful firm that is five years away from retirement. You have effectively created a strong business that has grown materially over time and consistently provided a great income. You believe there is an operational staff in place that is able to successfully run the firm when you exit. Two key professionals have been groomed as successors and will begin buying a portion of your firm this year. The stage has been set for you to capture the value of your life's work as you enjoy more time away from the office and, ultimately, your firm's healthy longevity continues beyond you.

Now, imagine you wake up tomorrow and all this has changed. In the middle of turbulent markets, your human capital has begun to break down, with one of your main successors opting to leave the firm and taking a key member of your operations staff. That advisor was not happy with the equity transaction offered to him/her and felt he would be better off taking the risk of "going it alone". That advisor was overseeing and developing relationships with some of your best clients and is now intent on taking those clients with him. During this moment, you now have to deal with compliance and operations that were previously handled by the key operations person who just left! During the chaos and volatility of the markets and disruption to your operations team, a number of trading errors occur. Finally, you discover that an advisor has made incredible errors in judgment with clients, and has thus created a compliance "black swan." You are now staring at the prospect of losing revenue and having to work much longer than five years.

This is an example of the perfect storm. Unfortunately, this scenario, or a similar combination of events, is a real possibility in our business, especially as markets become more volatile and clients and lawyers become more litigious. This breakdown in human capital, succession planning, compliance and clients can happen to founding owners that think in a linear way. This should be every founder's worst nightmare, and if advisors are honest with themselves, this scenario is not so farfetched in today's environment. Are today's founding owners aware of the risks that can result in this type of a perfect storm? Some of these risks are obvious, while others are more subtle, but they all can have a meaningful impact on a firm's value and the financial outcomes of founding owners.

Human capital risk: finding (and keeping) the next generation of talent

Human capital is one of the largest expenses an advisory firm will incur year-over-year. The investment in people is critical to a firm's growth and future success. This investment will give firm owners more control over their time and provide gainful employment for the community. It also poses a unique, long-term risk because growth is contingent upon founding owners investing in talent, delegating both authority and client relationships, and empowering the next generation.

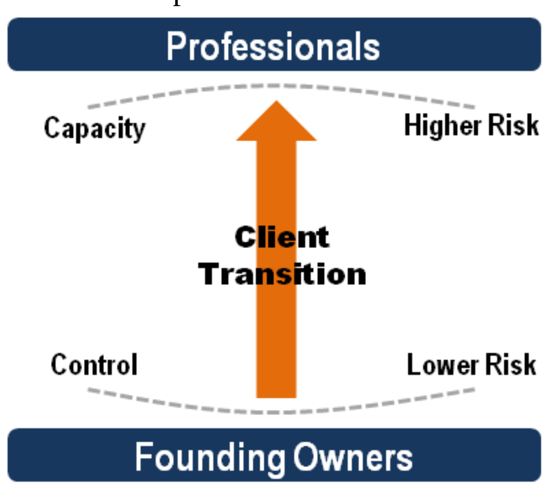
Depending on the size and evolution of an advisory firm, owners might need to add personnel to advance toward significance. Adding headcount to a firm requires an investment by current ownership.

From professional to support staff, compensation costs are recurring in nature and, in the advisory business, essential to running a firm. This is a function of time, as founders will eventually reach capacity and the firm's growth will stagnate. Additionally, many advisors who start to reach the later years of their professional lives may choose to start decreasing their hours worked, which, in turn, further exacerbates the need for human capital. It is important to consider, however, that the investment in people comes without guarantee of return.

Investing in people is built on one assumption: that you can actually find them! There is no secret that a talent shortage exists in the advisory industry. A damaged reputation by the Great Recession and lack of awareness among young talent has made finding human capital particularly challenging in today's market.

Advisory firms will first need to actively address finding talent before they can begin to plan for meaningful growth. Once talent is courted and hired, they usually will need to be trained and developed. Time must be given to allow new talent to learn the unique culture and allow them to grow up in a firm. This process can span from several weeks to several months, even to years. Additionally, during this time of training and growth, there is a real risk that the owners or new employees will come to the conclusion that it just is not working out. The result can be wasted time and money on human capital that did little to advance the firm's future.

Assuming new staff makes it through training and has sufficient time to grow into their roles, there is a better chance that they will contribute to the firm's growth. This is a desired outcome, as founders can begin to create leverage with their human capital. However, a new risk is presented: will the new staff stay with the firm? Loyalty is a risk that is inherent in any business, and can have a material impact on advisory firms.



This is no more apparent than with the hiring of professionals (advisors). Founders need other professionals to grow in their roles and take over client relationships. This creates capacity, adds growth levers, and sets the stage for building business value. This transition of shifting responsibilities to professionals also carries the risk of professionals building strong relationships with clients (perhaps even stronger than those you have built), and then leaving. This represents the "*professional conundrum*".

Founding owners need professionals to grow through delegation, but founding owners also experience a loss of control if the transition is not structured properly.

Often the lack of loyalty with human capital stems from an incongruence of the professional's career goals with the founder's long-term vision. This might be as simple as the lack of attractive compensation or fundamental elements such as lack of shared values. This disengagement creates a risk in all areas of human capital. Operations, administrative, professional, and even management can become disengaged along the way and seek other opportunities. Real risks are presented along the human capital lifecycle, and it is best to begin mitigating these risks early in the process.

The following best practices in mitigating human capital risk should be considered:

- ***Hire the best and brightest.*** Determine the ideal qualities of a potential employee and the "non-negotiable" qualities. The search might take longer, but the reward will likely be much higher than a below-average replacement.
- ***Ladder employee ages.*** Strive to create a healthy balance of tenured employees and bright young employees. This will give the firm an element of cross-pollination between those with experience and those hungry for knowledge.
- ***Communicate your vision early.*** Being upfront with the company's vision will weed out prospective employees who are not good fits. Do not wait until they have become fixtures in your firm to see if there is alignment.
- ***Install protections.*** This is a critical step for all advisory firms. Non-solicit/compete agreements and intellectual property agreements are effective ways to protect against employees harming the firm upon exit. The best protection may be creating a mutually beneficial environment where the company and employees can grow in a positive culture.
- **Partner with outside resources.** Partnering with a larger firm or service provider can provide the benefit of existing support staff and infrastructure. Rather than taking on the risk of building a team, some firms opt to utilize another firm's existing resources.

Your best client is another firm's best prospect

Continuing to have a concentrated ownership position in a successful firm will increase the chances of facing risks with clients. Deep relationships have been built with clients that have trusted you with their financial lives. This is a very difficult connection to replicate, and should never be taken for granted. It is wise to consider that your best client is another firm's best prospect!

One key way to assess this risk is to first look at whether the relationship with clients is firm-centric or founder-centric. The difference might seem subtle, but it is crucial to a firm's ability to retain the best clients. Clients of founder-centric firms will experience abrupt changes as the firm adds new advisors and processes. Clients are used to having personalized attention from one person, rather than a firm. Clients who experience a firm-centric relationship have become comfortable with dealing with different employees within the firm. This makes them less likely to become skittish when the firm experiences changes in operations. The founders should still play a pivotal role in the firm's brand, but there is significant risk if client retention is tied to the personal relationship with one person.

Clients that have been with a firm for a number of years may have grown accustomed to a certain level and type of experience. Tenured clients might have been part of an advisor's client list early in the process and might have received consistent, personalized attention. As a firm grows, some level of standardization must take place in order to scale up the service model. This may have a negative impact on some clients' experiences as they undergo the growth pains that firm is experiencing. While the firm is scaling up, there is a real risk that firms with a boutique platform, or those with institutionalized processes, will be able to make a strong pitch for these clients. Significant firms may grow at the expense of smaller successful firms as they lead with more holistic client experiences, and offer more cost-effective solutions.

Clients will also seek different qualities from a firm as their preferences and wealth management needs change. Successful firms have, no doubt, built strong personal relationships with clients in the past. The client of the future may not see the relationship as enough. Successful firms might lose clients if they perceive risk in the firm's management, brand, or expertise. This can become especially true if clients become concerned with security and continuity, or they determine that the once best-in-class client service experience is no longer adequate. There is no certainty in how client preferences towards your firm will change, but the following steps will help manage a number of potential changes, and help transition to a firm-centric client experience:

- ***Form a strong client communication process.*** Constant communications with clients will reinforce the firm's vision and make clients feel part of the process. These are not market commentaries, nor updates on investment strategy. Effective communications should inform clients about the changes in your business and how they are for their benefit.
- ***Consider investing in your firm's capabilities.*** Significant firms usually have deeper functional expertise than successful firms. In the future, being a great planning firm and delivering solid investment returns may not be enough to keep "ideal" clients.
- ***Create a client experience with multiple touch points.*** This seems easy to conceptualize, but is more difficult to execute. Spend time identifying the ideal structure, and then see if you have the staff to fill or grow into the roles. This is a way to take stock in current human capital and identify if additional resources to mitigate risk are needed.
- ***Form a client advisory council/committee.*** This can open up a firm to brutal feedback, but also valuable intelligence. Consumers of your service are unlikely to approach you when things are going poorly. A client advisory structure provides a safe and dedicated venue for communication. This can help to emotionally invest the clients to strengthen firm success.
- ***Focus on young advisors***. Young advisors should be integrated into your firm and be supported on a defined path to building their careers. Young advisors will bring fresh perspective and give reassurances to clients that the future is being addressed. They can also enhance your clients' experience by identifying new technologies or practices that were previously untapped.

Owner risk: personal and professional events

The founders of independent advisory firms have embarked on every entrepreneur's desired path by dedicating time and effort to build a strong business. For successful firms that have concentrated ownership, the value created could be put at considerable risk. Why? Owners may not be confronting risk that is specific to them, or even worse, realizing the risk exists!

If the future of a successful firm is held at a status quo, there is a real probability that success will not fully insulate when "life happens". This refers to the personal and professional events that can happen to firm owners over the course of their careers. The following events impact an owner individually, but can potentially create a damaging ripple effect inside and outside of the firm:

- ***Disability or major health event.*** Every person runs the risk of having health issues during his/her career. Founders of successful firms risk having such issues impact business operations.
- ***Major family event.*** A major disruption in a founder's family such as illness, death, etc., can force a founder away from the business, leaving the business to run without him/her.
- ***Personal burnout.*** A founder might run out of motivation or passion for the business. This is a real risk for an aging founder who is forced to be a pivotal part of day-to-day firm operations.
- ***Professional growth.*** Founders will be forced to move from the role of advisor to one of business manager over time. Some founders enjoy the advisory and relationship side of the business, yet fail to adapt to being business managers.
- ***Inability to adapt.*** As founding owners' age, they become more and more attached to "the way things are done." This poses a risk as firms are forced to adapt to new technologies and communication avenues.

Owners of successful firms will find themselves addressing one or more of these risks during their careers. This is often overlooked, as very few people are comfortable with facing their own mortality or vulnerability (validation of the "linear thinking" concept referenced earlier). Owners should take tangible steps within their firms to address these risks and protect the value they have built by taking the following steps:

- ***Build a continuity plan***. This should be done *as soon as possible*. Continuity plans help protect firm operations in the case of death or disability, but also create a liquidity event for heirs. A continuity plan is a prudent business practice that addresses the Fiduciary Promise[1] for clients and extracts value for an owner's estate.
- ***Empower the next generation.*** This is simply a function of time and stress. The next generation of advisors and employees will remove owners as a focal point of business operations and prevent burnout. Ideally, they will also allow founders to pay attention to their health and well-being.
- ***Consider professional management.*** Owners/advisors that are not comfortable moving into a management role can consider hiring professional management. These experts come at a price, but can be valuable in the operation of a growing business.

[1] The Fiduciary Promise is described in "Success to Significance Part I"

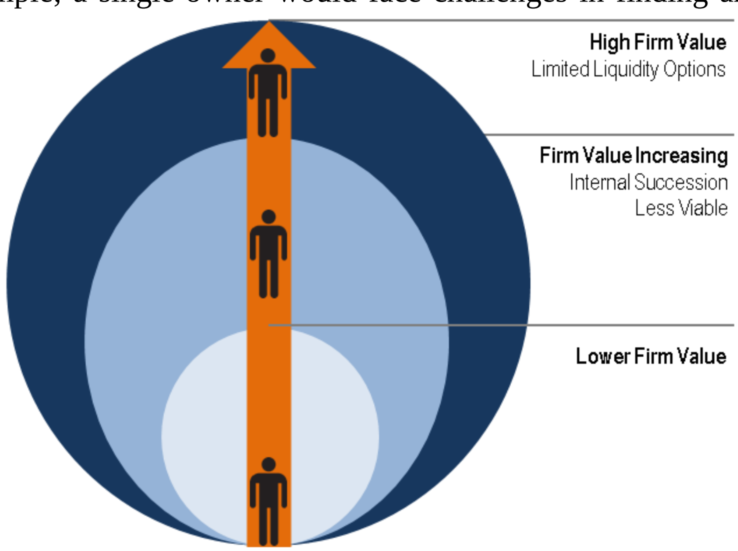
- ***Appoint a younger employee to head technology and communications***. This will open up new ideas about technology and communication channels that were previously not considered. This will also keep the firm close to the cutting-edge in the industry.

A privately held asset: liquidity risk

Today's founding owners have generally succeeded in building entities that produce strong income and potential value. The potential value can be great and, in some cases, can range into $10M or more. Over time, successful firms will continue to produce a great lifestyle for founding owners. A key concern uncovered in our first paper is the challenge created when trying to monetize business value, either today or upon exit. This is due to the fact that business value for the majority of successful firm owners is tied up in a concentrated, privately held, and illiquid asset.

A key issue in successful firms is concentration risk. For example, if a successful firm has grown to produce $5M or more in revenue, the implied value of that firm can be material, depending on the underlying economics and company structure. For many founders this will represent a significant portion of their net worth and create concentration risk to their personal estate. The question that founders should ask is, "Would I advise my client to stay concentrated, or diversify and take chips off the table?" *Founding owners face the dilemma of continuing to bet entirely on themselves, or sharing risk with other parties.*

Founders will also face a risk in the very thing they strive for: growth. As a firm grows, exit planning can become more difficult. This is a result of the correlation between size and business value. A single partner has the greatest concentration risk, as there will be limited options for monetizing value of this size. Using the $5M revenue firm as an example, a single-owner would face challenges in finding an internal successor capable of a purchase and securing outside capital if financing is necessary. Multiple partners can share some of the risk in this example, but they would likely be averse to buying another partner's position if they share the same exit timeline. The risk of a growing firm becomes more and more evident as time passes.



Single Owner Concentration Risk

The correlation between size and value also sets the foundation for the challenges faced in internal succession. Internal successors may need outside financing to complete a transaction; will it be available? More and more industry dedicated financing options are available, but there is no guarantee that they will be able to completely solve this problem. This is one of the key reasons that internal transactions must happen at a discount to fair market value. Outside of the financing, there is an issue with what is being bought and sold. For example, if an internal successor is also a rainmaker, that person may feel they own the revenue they created. Why should they buy it back from a founding owner? Why not just set up their own firm and take the revenue (clients) with them? The cost is lower, the terms are generally much better, and the "would be" successor is in complete control.

Founders will need to place emphasis on mitigating the risk of concentrated ownership in an illiquid asset. There is risk in not having an early framework for liquidity planning. Founders should ask themselves, "Will I yield a higher risk-adjusted return over the next ten years in the current state versus a liquidity event?" The prudent framework is to think through this question and devise an optimal path forward. Do you want liquidity in cash or equity? Do you want to maintain complete control or share? To help with this framework, Beacon Pointe Wealth Advisors has created a model[2] that compares maintaining a concentrated ownership position and going alone, versus taking some risk off the table in the form of a full or partial liquidity event. This model should encourage founders to think about and assess their desired future path and consider the following tactics for mitigating illiquidity risk:

- ***Explore external financing***. As previously mentioned, more options are available today. Exploring these can be a good way to secure financing and transfer ownership well in advance of exit.
- ***Explore an external sale.*** This can be an abrupt option, but will also provide desired liquidity. Many external buyers will require founders to stay on with the company to protect the investment, so those close to retirement can consider this as a viable option.
- ***Partner with a large RIA***. These firms have infrastructure, capital, and often provide a flexible structure. Large RIAs can take considerable risk off the table and let founders phase out over time to focus on their most enjoyable parts of the business. These firms often employ the concept of "selling in" versus "selling out." Meaning, firms are treated as a partner in a larger vision versus purely an acquisition target.

Maximizing value today and in the future

Dedicating time and effort to both the obvious and subtle risks in running an advisory firm can pay off in future years. Successful firms, whether looking to grow or remain at the status quo, will need to prepare for these risks, as they are inevitable and in many cases, already exist within the firm. Successful firms will still be well positioned to continue to capture income and provide the desired lifestyle for founding owners. However, significant firms are more likely to be prepared to address these risks because of their size, infrastructure, and scale.

The good news is that there are many paths forward for successful firm owners. No single solution will fit every founder's vision. The key decision point in thinking about the future is considering whether to address these risks alone or to utilize a partner. The following paths will help founding owners think critically about their firm's future and how risk can be decreased while maximizing future value:

- ***Strategically plan to mitigate risks internally.*** Owners may choose to handle these by utilizing some of the risk mitigation tactics described. This path will be most desirable to younger founders that have many years to address human capital, client experience, infrastructure, and liquidity.

[2] Available upon request from BPWA

- ***Engage third-party experts***. Experts such as consultants, coaches, and asset custodians can help deliver solutions that founding owners will eventually administer. There is a cost associated with hiring outside experts to address these issues, but the payoff can be high if owners are willing to administer the solution, and revisit it periodically.
- ***Sell or merge your firm.*** Some founding owners may be too close to retirement and unwilling to address all the risks described. For those select few, a sale or merger might be viable. This needs to be addressed quickly, as it can take several years to find an ideal acquirer and/or complete a transaction.
- ***Partner with a large RIA***. Some large RIAs have capital, infrastructure, and are willing to take some risk off the table for founding owners. These RIAs allow owners to phase out over time while offering the needed support to mitigate risks. For owners unwilling to address the described risks, but not wanting to make an abrupt exit, this is a viable option.

The risks, and the paths forward, should inspire founding owners to think critically about their desired future state and what it will take to get there. The future can be great, but the risks are real, and founding owners need to consider what the payoff will be if they burden these risks alone.

About Beacon Pointe Wealth Advisors

Beacon Pointe Wealth Advisors (BPWA) is a client focused partnership between Beacon Pointe and successful wealth managers across the country to collectively move from success to significance and create certainty for yourself, your clients and your team. BPWA is a private partnership focused on creating synergies and value, while also providing a private market for your equity when you would like liquidity at fair market value.

BPWA is not being built to be sold, publicly or privately. We are a long-term operating company working with our partners, sharing best practices, creating and leveraging scale and resources to the benefit of our clients, our teams and ourselves.

Our goal is to help all partners move to significance and have absolute certainty to succession, create a legacy and empower the next generation within the business.

For more information or if you have questions, please contact:

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