Executive White Paper

Building a Profitable Practice
"An examination of practice structure and profitability"

By: Todd Doherty | July 2014

"The great source of both the misery and disorders of human life seems to arise from over-rating the difference between one permanent situation and another."

— Adam Smith, the Theory of Moral Sentiments

As I reflect on the supporting illustrations in this paper, I am reminded of Adam Smith's insights into the theory of "the grass is always greener on the other side". While I won't position the following illustrations as better or worse, I will attempt to point out the differences and how they may equate to a better "fit" for your vision. In fact, my goal is to communicate that the grass can be greener on either side by knowing which side you are on.

My work in business valuations and profitability analysis/ optimization for financial advisory practices has afforded me a unique view into profitability as it relates to practice structure. I am often amazed at how two seemingly similar practices can have meaningful differences in profitability. Over time (and for the sake of this illustration), I have come to see these differences resulting from two distinctly different structural/ operating models; I refer to these models as client quantity VS client quality. Simply put, the differences between a practice serving a relatively large number of high value clients (average AUM $250K) VS a practice serving a smaller number of high net-worth clients (average AUM $1m). While there is a lot of variation in the grey area between these two models, they serve our purpose well as distinctly different paths to growth, structure and resulting profitability. Each of these models requires very different skill sets of the senior advisor (founder) in their roles as CEO, COO and Human Resources Manager.

Let us now look at illustrations for these two models. While you are reviewing the illustrations, think about your own practice and your vision for it. Which of these two paths will your vision take you down? Which path is a better fit for your strengths and values? Are you creating a meaningful strategic plan that will lead you in one direction or the other; or are you simply following the path of immediate opportunity?

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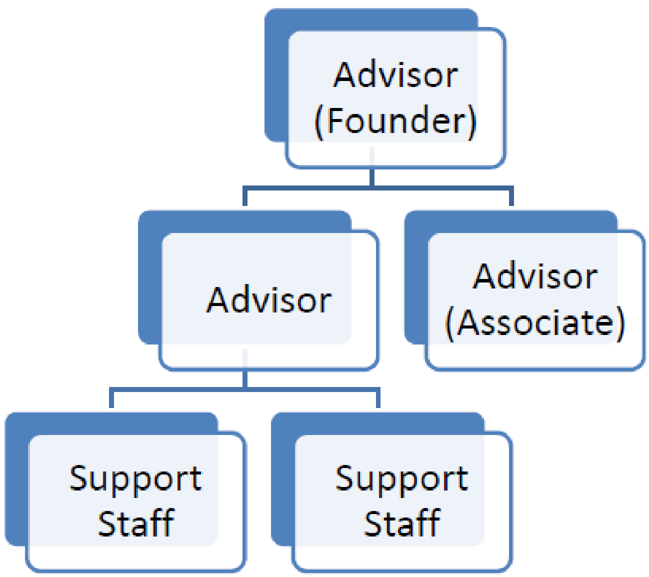
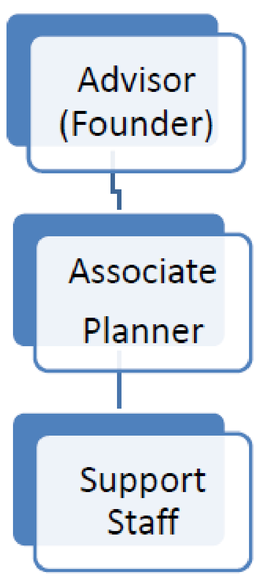
Client Quantity Model



- # of clients: 450
- Average AUM: $250,000
- Total AUM: $112,500,000
- Asset Velocity: .80
- Average GDC: $2,000
- Total GDC: $900,000

- Total Operating Expenses 49%: $441,000
- Net Operating Profit 51%: $459,000
- Hours Worked (Founder): 60 per week (3,120 total)
- Net Operating Profit per Hour Worked (Founder): **$147**

Client Quality Model



- # of clients: 100
- Average AUM: $1,000,000
- Total AUM: $100,000,000
- Asset Velocity: .80
- Average GDC: $8,000
- Total GDC: $800,000

- Total Operating Expenses 30%: $240,000
- Net Operating Profit 70%: $560,000
- Hours Worked (Founder): 40 per week (2,080 total)
- Net Operating Profit per Hour Worked (Founder): **$269**

Your immediate take-a-way from reviewing these two illustrations may have been the clear advantage in profitability of the Client Quality model; as well as its implications for that elusive "work-life-balance" that many of us aspire to. On the other side of the coin, the Client Quantity model may be less reliant on the founding advisor and therefor more transferable for succession; not an insignificant factor given the size of the asset. We can go on about the pros and cons but what does this mean for the majority of you who find yourselves operating closer to one or the other of the two models or somewhere in the area in between? Let me start by turning that question around – do you have a <u>meaningful</u> vision and supporting strategy for achieving one of these two models; or even a hybrid of the two? If we reflect honestly, the answer is frequently "no". **Herein lays the core issue and the underlying reason for variations in profitability**; you are not likely to optimize the operating efficiency of a structure you didn't intentionally pursue.

Consider the following:

- Practices with GDC between $500K and $999K have an average operating expense ratio of approximately **48%**
- Practices with GDC between $2m and $2.9m have an average operating expense ratio of approximately **61%**

These metrics indicate a diminishing margin on growth and an increased need for strategic planning around operating structure. Let's go a step deeper and look at the largest expense line items (people) for these two ranges.

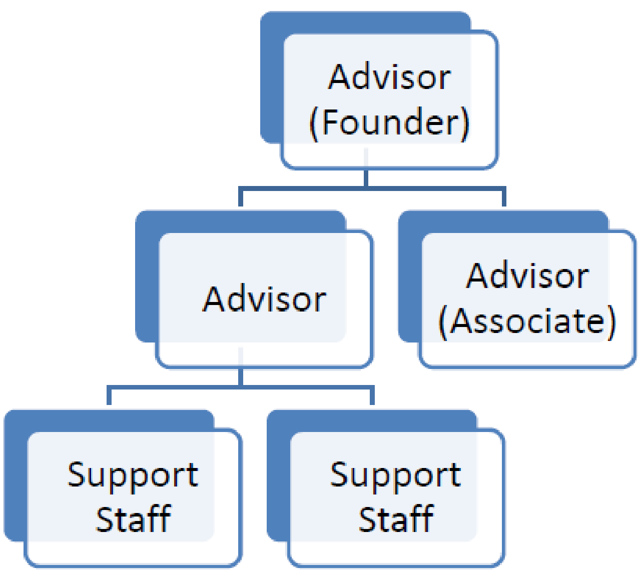
- Practices with GDC between $500K and $999K have an average operating expense ratio of approximately **48%**
    - Sales related (client facing staff) expenses: **13%**
    - Staff related (support staff) expenses: **18%**
- Practices with GDC between $2m and $2.9m have an average operating expense ratio of approximately **61%**
    - Sales related (client facing staff) expenses: **21%**
    - Staff related (support staff) expenses: **20%**

To be more specific still, you can see that the cost of sales (client and asset acquisition) is a more significant growth factor in increasing labor costs; indicating that your growth strategy should focus heavily on <u>how</u> you will create and support sales.

Optimizing profitability is about strategic planning and the resulting cumulative impact of expense VS revenue growth. To emphasize this point, let's take another look at the Client Quantity model with the following 3 changes outlined below:

- Decrease # of clients from 450 to 400 (total assets remain the same)
- Increase asset velocity from .80 to .90
- Reduce hours worked (founder) from 60 to 55 per week
    - The resulting difference is an **increase** of:
        - $108,000 in operating profit (+24%)
        - $51 net operating profit per hour worked (founder) (+35%)

Client Quantity Model (2)



- # of clients: 400
- Average AUM: $281,250
- Total AUM: $112,500,000
- Asset Velocity: .90
- Average GDC: $2,531
- Total GDC: $1,012,500

- Total Operating Expenses 44%: $441,000
- Net Operating Profit 56%: **$567,000 (VS $459,000)**
- Hours Worked (Founder): 55 per week (2,860 total)
- Net Operating Profit per Hour Worked (Founder): **$198 (VS $147)**

Just so we are not putting out unrealistic expectations for these changes, let's take a look at the reasonable action items behind them:

- Decrease # of clients from 450 to 400 (total assets remain the same)
    - Sold or gifted bottom end of book to a local associate advisor
    - Impact on GDC and AUM is negligible in most cases and quickly erased by advantages of more time spent on higher level clients

- Increase asset velocity from .80 to .90
    - Senior advisor (founder) is able to hand down 50 clients to advisor and associate advisor; allowing more time to focus on higher level clients
    - Additional clients are engaged in formal financial planning
- Reduce hours worked (founder) from 60 to 55 per week
    - Working with 50 fewer clients
    - Shift from reactionary growth to strategic planning; less time spent trying out every new marketing program

Take a step back now and consider our two models in their purest forms. Which one is better suited to your skills and values? Are you more comfortable as a leader or practitioner? Does the idea of running a large organization appeal to you or do you see yourself as a boutique practice? And again, have you intentionally moved in one of these two directions? Once this picture becomes clearer to you, **it is time to analyze your operating structure/ profitability and develop a strategic plan**. The challenge of having followed a path of immediate opportunity (reactionary management), as opposed to strategic planning, is undoing the resulting underperforming structure; in order to make meaningful changes to optimize the structure that you are now intentionally pursuing. Take action now as it is never too late to make the grass greener on your side!

*Definitions:

- ***Asset Velocity***: *The ratio of revenue to assets; also referred to as "Return on Assets" = (Total GDC/Assets under Management)*100*
- ***AUM***: *Assets under management*
- ***GDC***: *Gross Dealer Concession (practice revenue)*
- ***Operating Expenses***: *Overhead expenses of the practice; excluding: owner compensation; non-payroll taxes; amortization and depreciation*