Realizing the Value of Your Life's Work

Building a Sustainable Succession Plan

In collaboration with:

Advisor Solutions

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Introduction

Now more than ever, designing and implementing a succession plan is a critical element of every successful Registered Investment Advisor (RIA) firm. Who will propel the firm to the next level when the current generation of ownership leaves? How will clients be served? How can the firm be sustainable for generations to come? A well-crafted succession plan helps firm owners align their personal goals with their professional goals as well as align with the goals of the other partners. It can also improve a firm's business model and valuation.

Although the benefits of a succession plan are obvious, few firms take the opportunity to design and proactively manage one. In this paper, we will explore the:

- Material elements of succession
- Advantages of having a succession plan (and the risks of not having one)
- Considerations and process to implement succession

Indeed, the choices for succession have never been greater. There are a variety of economic models, degrees of control and exit timing scenarios for owners. For example, intermediaries and large RIAs now offer custom succession plans that allow the firm owner(s) to choose when to implement succession. These plans provide various degrees of flexibility that were not available a mere ten years ago. Keep in mind that regulatory changes may force firms to implement succession. Owners may choose to plan for an internal succession, merge with another firm, sell their business or develop a plan that combines elements of all three.

There is good news for current owners. RIA custodians, existing independent firms, consulting practices, investment banks and strategic acquirers have all built a range of support models to help independent firms develop and implement a succession plan. Current owners are encouraged to understand what resources are available. Specific resources are provided at the end of this paper.

This guidebook, commissioned by BNY Mellon's Pershing Advisor Solutions and developed by Advisor Growth Strategies, provides owners of RIA firms with an overview of the material elements of a succession plan to be incorporated into the firms overall strategic plan. Firm owners should examine the options and set a course that marries their personal goals with the strategic goals of their business. This paper also includes a case study which highlights a firm that has taken the opportunity to proactively manage its succession plan to help meet the objective of creating a multi-generational firm (see page 24).

Overview of Succession

First, let's take a look at the definition of succession and how it is different from business (strategic) planning, continuity planning and sale planning—but also how all are integral to one another.

Succession planning impacts and interacts with all other forms of planning.

1. **Succession:** Outlines the process of transferring ownership of a firm from one generation to the next. This may be an internal transfer (to heirs or employees) or an external transfer to another entity. Succession is generally focused on limiting disruption to clients, employees and owners. It is unique because it is not a stand-alone event but linked to multiple areas of a business plan and evolves over time. For example, owners of an advisory firm may at first want to develop an external succession plan, but ultimately discover suitable personnel internally. Often, the original option for succession is not the option that is fully implemented in the end.

   Succession bundles elements of business, continuity and sale planning into one cohesive process.

2. **Business planning:** Outlines a firm's purpose, vision, strategy and tactics. Also referred to as "strategic planning," business planning helps firms reach specific goals over time and charts a path for firm longevity. Therefore, succession is integral to a firm's business planning process. It requires a clear vision of the desired outcome and dedication to execution.

3. **Continuity planning:** Accounts for how the firm plans for unforeseen events. Continuity planning is often considered a form of disaster planning, and it outlines how a firm operates in the event of a catastrophic event (including the death or disability of an owner or the loss of a key contributor, which forces succession to occur).

4. **Sale planning:** Prepares a firm for sale to a third party. Sale planning is geared toward maximizing the firm's position with potential buyers. This usually differs from succession planning as it is geared toward a one-time event. Firms may have a succession plan in place and then proceed with sale planning, which coincidentally addresses succession.

Making Succession Inevitable

The independent RIA channel continues to be one of the fastest growing segments in financial services. According to Cerulli Associates, the channel is expected to grow from 14.7% market share of advisor-managed assets in 2017 to 16.8% market share in 2022.[1] However, RIAs are disadvantaged versus larger institutions as there is no defined point in time when an advisor needs to retire. Many RIA owners have no clear answer to the client question, “Who will be my trusted advisor when you are gone?”

Top firms are focused on growth and scale, but ownership structures are evolving at a very slow pace in the industry. The majority of firms (76%) reported no change in ownership in the previous year, and only 5% reported transferring ownership from an outgoing to an incoming partner, according to the *InvestmentNews* 2016 Financial Performance Study of advisory firms.[2]

Flexibility is the motivation for many advisors to pursue the independent RIA model. But flexibility comes with responsibility as owners must define and implement their own succession plan. This responsibility will become even more apparent as RIAs grow in size and complexity, and become more adept at competing against larger institutions for talent and clients.

A passive approach to succession planning has often been driven by fear and perceived roadblocks. Succession education has evolved over the last five years, and owners can take advantage of support that was not available a short time ago. Making succession inevitable is dependent on addressing these fears through calculated steps and leveraging resources.

Regulatory changes will intensify the succession discussion moving forward, and may force many firms to execute a succession and continuity plan in the future. The industry has long speculated when the SEC might step in and require transition and continuity plans for RIAs. As of the writing of this guidebook, the SEC has proposed a rule that will force firms to have a documented continuity and succession plan.[3] The proposed regulatory change will require firms to have an actionable plan that addresses transition in the face of disaster or an advisor leaving the business. The final rule is likely to be nuanced after adjustments, but many industry experts expect the rule to make succession a requirement versus an option.

[1] The Cerulli Report-U.S. RIA Marketplace 2018

[2] Note: Respondents were able to select multiple answers.

[3] Securities and Exchange Commission. Release No. IA-4439; File No. S7-13. www.sec.gov/rules/proposed/2016/ia-4439.pdf

Advisor Concerns Around Succession

	The Challenge	Getting Started
Establishing a Fair Valuation	The lack of certainty on how to value the firm fairly and accurately	Consider hiring a valuation expert to give an objective opinion on value. Valuation experts will provide candid feedback on the drivers of value and help establish a fair methodology.
Transitioning Clients	The emotional aspects of transferring clients to a new advisor	Start by transitioning a small number of clients. Test client acceptance for a firm-wide approach and begin to change overall expectations. Consider speaking with other firms that have successfully transitioned clients to help reduce fear and avoid pitfalls.
Investing Time and Capital	The amount of investment needed in both time and money to thoroughly research and execute	Start early and imagine you are giving succession advice to one of your clients. How would you advise a client in your same position? Putting yourself in your clients' position can help clarify the importance of investing time and money into succession.
Transitioning a Firm	The emotional aspects of transitioning a firm to new owners	Lean on your custodian and third-party experts to give an objective point-of-view. Prioritize what is important to you, and use it as a framework to help manage your emotions.
Realizing the Immediate Need	The lack of motivation because of a perceived lack of urgency to design a succession plan	Challenge your status quo. If something happened to you today, what would happen to your clients, employees and family? You will find that deferring is a risky option.
Overcoming Fear	The overall fear of how succession signifies the resulting changes in one's personal and professional life	Use the planning process to define a "change" versus an "exit." Consider using your custodian and third-party experts to help. Collaborate with others that have gone through the process to identify how life has (and has not) changed.

Succession and Risk Mitigation

The business and economic risks of not having a plan are real. The following are key areas of risk that firms can actively address through the succession and business-planning process:

1. **Client attrition risk:** Clients, especially high-net-worth ones, value continuity and stability with respect to their relationship with a firm and may decide to go elsewhere if they notice a lack of planning in that regard. To overcome this risk, firm owners should analyze and address the following elements of their business model and communicate them to clients throughout the business-development cycle and beyond:
   a. **Business continuity plan:** This plan details how clients will receive service in the event of a disaster or unforeseen event, and it is directly related to the firm's succession plan (see Succession Options, page 9). Telling clients what will happen if their individual advisor is no longer able to provide service to their account is usually done verbally. Firms may choose to adopt a team-based approach to client service delivery to lower client attrition risk.
   b. **Privacy policy:** This policy outlines how clients' confidential data will be protected by the firm. Every firm should prepare a written statement on its privacy policy and distribute it to clients.
   c. **Financial stability and asset protection:** This communication may be delivered via a letter or newsletter and shares key metrics around the company's financial stability and track record, such as years in service, total clients and assets under management. Firms can also reach out to their custodians (such as Pershing) for assistance, particularly for data around the safe and secure measures in place to protect client assets.
2. **Opportunity cost and lower growth trajectory:** Firms lacking both a business and succession plan are challenged in defining success and charting a course to get there. Without defined annual metrics, firms can go quarters, if not years, without meeting objectives. A business plan must define roles and assign accountability. Firms should commit to business objectives in the plan and create individual job descriptions and evaluation processes to track success. Discipline in both business and succession planning will mitigate the risk that a firm's growth stalls or declines as current owners wind down their professional contributions near retirement.
3. **Increased risk of low employee commitment and high turnover:** A business plan is critical to defining an employee's role within the firm's organization. Job descriptions should be directly linked to stated objectives in the business plan. Advising the group of the succession plan is important, especially if key employees may take on an ownership role or play a part in the plan at some point in the future. Involving the next generation, professionals in both succession and business planning will create a sense of commitment and promote a long-term bond with the firm.
4. **Loss of enterprise value:** Most firms are valued based on discounted cash flows or multiples of free cash flows with discounts and premiums taken into account based on elements such as revenue growth, client demographics, employee tenure and stability and quality of management. Lacking a plan may negatively impact a firm's attractiveness to potential buyers. Firms can leverage succession

and business planning as a blueprint for driving growth, retaining clients and top talent and mitigating perceived business risks. There is never a guarantee when it comes to value, but firms can positively influence value drivers through the planning process.

5. Impact to owner's personal estate: A lack of a defined plan may impact the family and heirs of a firm's owners. In the event of an unforeseen event, *owners can lose significant enterprise value*. Firms must establish a plan to transfer ownership and client relationships internally within a firm or to a defined buyer to prevent the loss of equity built over a lifetime. Succession and business planning will provide confidence for all parties that there is certainty upon owner exit or an unforeseen event.

Succession Goals

Selecting the appropriate succession plan option, or combination of options, requires owners to identify goals. Goals are defined by asking key questions that establish a critical path to succession. Owners should answer the following questions:

- How long do you want to work in your business as an owner or operator?
- How long do you want to contribute to your firm as a professional (e.g., advisory, business development, investments, etc.)?
- When do you want to be completely out of the business (e.g., retired)?
- What is your vision for your firm post-succession? What are the must-haves as they pertain to brand, services and client experience?
- What are acceptable tradeoffs in the succession process? Based on your post-transition vision, where are you willing to compromise?
- What requirements do you have for employees post-succession? What protections, if any, are needed before you will agree to a full transition?
- What aspirations do you have in retirement? Will succession facilitate those aspirations (or not)?
- How much money do you need in retirement? What percentage of retirement funding will come from the sale of the firm versus other sources?
- How do you want to be associated with the firm in retirement?
- What will be non-negotiable in the succession process? What could shut down the process completely from your point of view?

A succession plan should be aligned with the personal goals and time horizon of an individual or team. It is important to start by defining the goals and objectives, and then documenting them in a written plan. Documented plans have a higher probability of execution. The documentation should include actionable steps toward the optimal succession. The option selected impacts the firm's legal structure, resulting business plan, its clients and its employees. The following chart describes the various succession options available to firms along with the economic considerations, pros and cons, and the impact on employees and clients.

Succession Options

	Internal Succession	Merge with Another RIA	Affiliate With a Strategic Partner	Full Divestiture or Sale
Description	Owners transfer equity to employees or family heirs through an internal sale	Owners merge with a like-minded independent advisor	Owners sell a portion of their firm to join a larger ensemble or platform provider. May be an equity or partnership transaction	Owners sell all equity to a buyer. Buyers are usually well capitalized and include: banks, trust companies or larger RIA firms
Economic Considerations	Cash transaction. Buyer may have to be financed through earn-out provisions or funding from a third party	May be a stock or a combination of cash and stock. Generally comes with defined exit terms for departing owners	Cash, stock or a combination of both. Buyer usually sells a portion of future cash flow	Cash, stock or a combination of both. Seller is usually held to performance criteria that may impact the ultimate economic considerations
Pros	Continuity for clients and employees. Builds a sustainable business	Provides scale, continuity for clients and could increase enterprise value. Certainty of liquidity event for owners	Provides liquidity event and takes risk off the table. May provide increased operating leverage and higher valuation multiples	Usually maximizes the financial return for the seller as enterprise value is bid up by multiple buyers
Cons	May be “force fitting” internal employees to take owner responsibility; buyer(s) may lack capital. Transaction may be below market rates	Time consuming to find the right partner and eventually integrate the firms. Some risk to clients and employees	Finding the right fit and potential reduction of being in control. Resources provided by the strategic partner may not be valued by all sellers	May be highly disruptive to clients and employees. Seller may lose brand and identity through the transaction
Client Impact	Low	Medium	Low	High
Employee Impact	Medium	Medium-to-High	Low-to-Medium	High

Even with the most appropriate option selected, firm owners still face challenges in plan execution. For example, advisors who are seeking an internal succession plan may not find the "next generation" of talent that can continue to effectively manage and grow the firm that the original owners have built. Even if the right talent is identified internally, high levels of equity concentration can make financing difficult. Employees may not be able to raise the capital required to buy a stake in the business.

As a firm continues to grow, so will its value. Present and next generation owners should consider the implications of increasing fair value as a succession plan is developed. Many firms will take the opportunity to forecast future growth, increase firm value and plan how to sequence transitioning equity in tranches periodically over time. Timing is important. For example, if a firm wants to execute an internal transition, it could potentially take five to ten years. The simple economics of the transaction and probable need for next generation financing should tilt firms into action sooner rather than later.

Financing

Wealth Management Example: Cost to Become an Owner

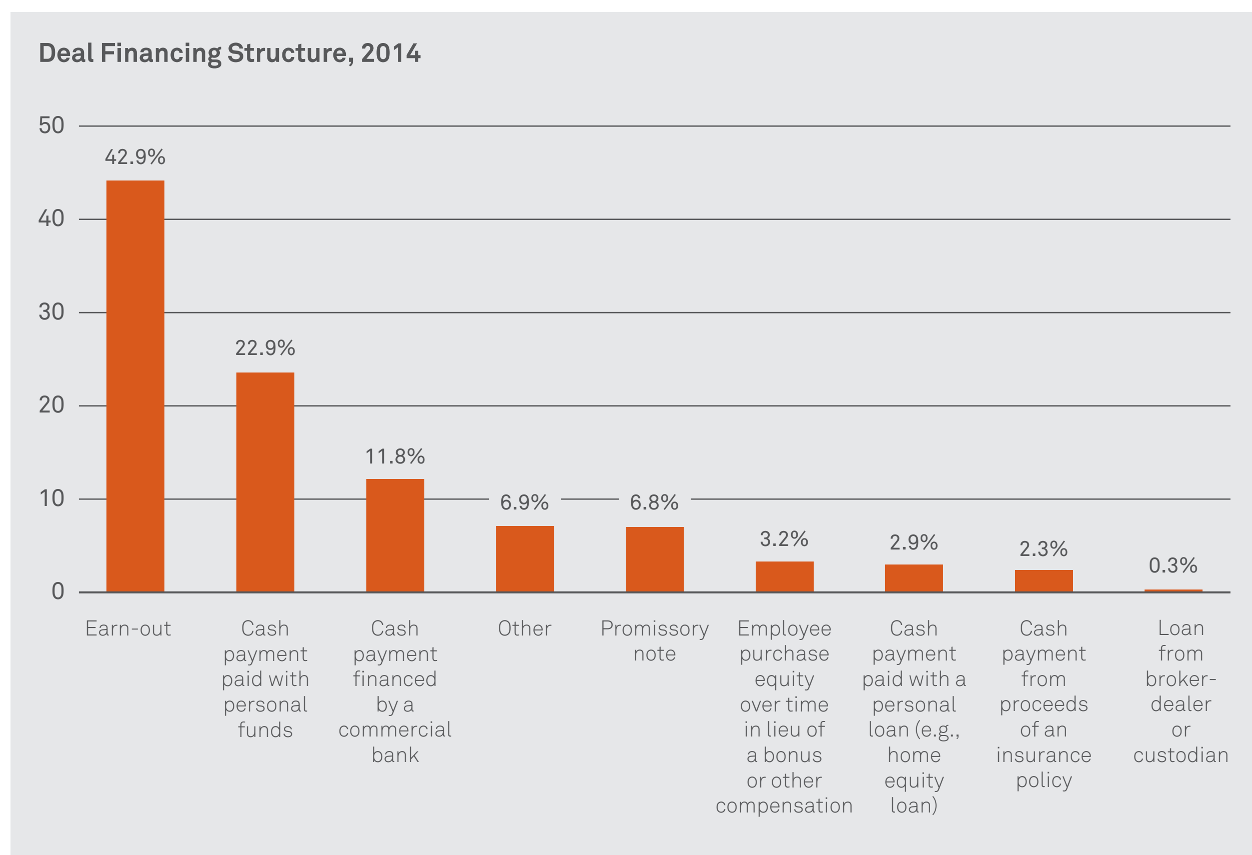
Revenue	$5,000,000
Direct Expenses	
Owners Compensation	$875,000
Non-Owner Professional Compensation	$1,125,000
Gross Profit	$3,000,000
Overhead Expenses	$1,050,000
Operating Income	$1,950,000

	100% Ownership	10% Ownership
Current Valuation	$7,500,000	**$750,000**
10% Discount	$6,750,000	**$675,000**
25% Discount	$5,625,000	**$562,500**

For example, if a firm with $5 million in annual revenue is valued at $7.5 million, an employee seeking to buy a 10% interest in the company needs $750,000 to buy in at market value. Even if the firm's current ownership elects to discount the equity value (discount rates typically range from 10–40%), the employee would still need $562,500–$675,000 to purchase a 10% interest in the company. The risk for current owners seeking to execute internal succession is waiting too long to start the transfer process. As evidenced by this example, the cost to purchase equity can become onerous to the next generation with limited capital.

The trend in the industry is to have some form of financing for a next generation professional to purchase equity. Financing may come from the firm directly, personal funds or from an outside source such as a bank. If that financing cannot be achieved, a flood of new market entrants has bought independent practices, including rollup companies, RIA firms in acquisition mode, private equity and publicly traded companies. Custodians such as Pershing Advisor Solutions and other industry valuation experts can educate firm owners on their options and help them navigate this process.

Owners must plan early, narrow their options, and perform due diligence on potential alternatives and select the right option for their firm. According to Cerulli, a deal's financing structure should balance risk and reward between the buyer and the seller. As evidenced below, earn-outs will usually comprise the largest component of the financing structure. However, the firms that master growth will understand the complexities of valuation and use multiple techniques to assess a firm's enterprise value in relation to its opportunity and risk factors.



Source: The Cerulli Edge-Advisor Edition, 4Q 2014.

Required Steps to Build a Succession Plan

Succession Plan Steps

At a minimum, owners should consider the following steps in building their plans:

1. **Set personal goals and objectives:** Owners should align their personal objectives with the objectives of the business. For firms with multiple owners, goals should be communicated and agreed to by all parties. In this step, owners should define if they are seeking to build a legacy, maximize a financial outcome or do a combination of both.

2. **Select a viable succession plan option:** Personal and business needs should guide owners in selecting the right succession option. Avoid the crucial mistake of entertaining offers from potential suitors without truly understanding your firm's objectives.

3. **Build succession plan features and requirements:** Advisors should define the following with help from the firm's legal counsel:

   a. **Establish voting rights process for potential internal and external buyers:** A key consideration within any succession plan is the timing of the economic event versus the timing of transferring control or voting power from the seller to buyer. Owners can issue non-voting shares that are convertible at some point in the future or sell a portion of the firm's cash flow to a third party without losing voting control.

   b. **Identify event(s) to trigger succession plan execution:** Normally included as a contingency within a succession plan, these events typically include death, disability and perhaps age, and defined growth metrics such as revenue, profit or number of clients.

   c. **Determine the valuation methodology (for internal succession):** How will the firm be valued to transfer shares from buyer to seller? Will an objective third party complete the valuation? Typical valuation methods include average revenue over a two- to five-year period, cash flow (EBITDA, EBOC or net income) or a blend of cash flow over a period of time. Owners may also consider a hurdle rate for external sales or buyouts. For example, a succession plan could be triggered if a buyer offers a certain level of cash flow multiple or absolute dollar amount.

   d. **Identify the buying party (internal succession) and funding source:** One of the biggest challenges facing the independent advisor industry concerns the funding of internal buyouts. Firms can build earn-out provisions linked to a successor's compensation plan or build provisions for the successor to set aside funds in escrow to complete the succession.

4. **Identify the time horizon:** Owners must pinpoint when they plan to exit the firm. This knowledge informs the timing of seeking a potential successor. Finding the right external buyer could take up to three years and grooming an internal successor could take more.

5. **Perform due diligence to identify a potential buyer or successor:** Start an informed search for the right person or entity to take over the firm. Creating a list of potential suitors is fairly straightforward but evaluating successors, especially outside buyers, is far more complicated. Owners should identify what is important and build an evaluation scorecard to list the strengths, weaknesses, opportunities and threats of each choice.

6. Select a model and structure the deal: Once the due diligence process is complete, owners still face plenty of work. Negotiations must take place between the owner (seller) and the successor (buyer) to complete the transaction or set terms. Owners may decide to hire a consulting firm or investment bank to negotiate on their behalf. In fact, these firms may be brought on even earlier to help owners build their plan and perform their search.

7. Implement the plan: Implementing succession stretches far beyond the legal aspects and potential economic transaction. There are communication requirements with clients, employees and vendors. There could be a significant organizational impact for firm employees. For external sales, owners must plan for post-merger/acquisition integration work.

8. Evaluate the plan periodically: Succession plans generally have a long time horizon and will require updates as conditions change. Stay diligent about reviewing your succession plan, at least annually, to ensure it is still applicable. This also presents an opportunity to evaluate the chosen succession path and determine if a change is required.

Succession is critical. Clients will continue to be concerned about the safety and security of their assets, and will expect a seamless service experience that eliminates any unnecessary risks. A well-crafted succession plan can be used as a competitive advantage to attract new business, retain clients and increase employee engagement and retention.

Succession is a challenge for many firms for a number of reasons referenced earlier. Common succession pitfalls include:

1. Procrastination: Firms that wait too long to address succession often find their options to be limited. Not allowing enough time to properly plan succession may exclude internal successors or force firms to accept a less than optimal deal from a third party. The lesson is to start early, and allow time to be nimble with succession planning.

2. Prioritization: Failing to prioritize succession within the context of business planning can be a pitfall for some firms. If succession is not linked to an end-goal, the firm risks losing sight of what it is seeking to accomplish. The lesson is to prioritize what is important: create a legacy, maximize financial outcome, or some variant. Prioritization will help departing owners understand what is negotiable, and what is not.

3. Emotions: Succession planning can bring unexpected emotions from both current and future owners. Topics that seem small can derail the entire succession process. Be prepared to manage emotional decisions along the way. In some cases, outside perspective may be needed to manage the process and work through emotional roadblocks.

4. Execution: Succession is a valuable exercise, but falls short without proper execution. Firms that go through the process of documenting a succession plan should be sure to create accountability to execution. Sharing the plan broadly and creating key milestones will help mitigate this pitfall. The lesson is to create urgency and be thorough in execution.

Additional Steps for External Succession

For firms taking this approach, it is important to identify key additional steps that must be taken to ensure the best fit.

1. **Build a list of key criteria:** Create criteria that are non-negotiable for any external partner. This may include anything from a cultural fit to investment philosophy and process. Your must-haves will help narrow the candidate list when you begin your search.
2. **Seek out and interview transition partners:** Look to the local market for firms that are a good fit. Start by having casual conversations and stating your desired succession solution.
3. **Think like a buyer:** When creating your succession plan, think about what your "ideal" buyer would want to purchase. Interviews with local firms will help inform this process.
4. **Collaborate on a proactive plan:** Once you select a local firm, collaborate on a proactive plan for succession. The joint effort will build confidence and help improve the process for existing owners.

Improving and Realizing Firm Value

As firms go through the succession planning process, a key question is "What is my firm worth?" Establishing a firm's value is important as it informs the eventual financial consideration an owner will receive, but also establishes key areas of improvement. Driving value in a financial advisory firm is based on four factors: growth, scale, risk and cash flow. Scale (sustainably growing revenues faster than expenses) is important for firms that seek to improve the other three categories as they lower the cost of service and facilitate growth. Scale is created through the use of technology, financial discipline and human capital development. Managing elements of all four is the key to establishing and improving a firm's valuation over time.

Factors in Firm Value:	
Growth	Sophisticated buyers look for a consistent history of assets under management (AUM), revenue and earnings growth. Consistency in this category results in higher confidence in the buyer and more favorable projections of future economics. Firms can improve this factor by clearly defining their sales, marketing and client experience infrastructure.
Scale	Discipline in managing the cost of developing and servicing client relationships is impactful to a firm's earnings. Valuations will be influenced by a firm's discipline in controlling costs and driving more return. Firms can improve this factor by leveraging available technology, employee talent, and also by employing a well-crafted client acquisition strategy.

Risk	Managing common business risks such as continuity, succession, employment agreements and corporate governance will give potential buyers confidence. Risk factors lower valuations and expected returns, but can be mitigated through owner effort. Outside consultants or legal counsel can provide intelligence and create a roadmap for improvement.
Cash Flow	Cash flow is a very important metric for most sophisticated buyers. Demonstrating consistent growth in cash flow (or EBITDA) will greatly improve a firm's valuation. Firms can take several steps to improve cash flow including revisiting compensation plans, installing technology and implementing financial controls.

Size and growth are popular metrics measured in the valuation process. Larger firms often command a premium in the industry because the economics are generally favorable to smaller firms and represent a lower perceived risk to a buyer. Size is measured both on revenue and AUM. Growth is linked to size as it speaks to a firm's ability to continue to grow larger and improve long-term economics. Some common growth measures used in firm valuation are as follows:

1. Assets under management (AUM) growth: AUM is, of course, required to generate fees. AUM growth is a positive indicator for a firm's value as the base to charge fees increases.

2. Revenue growth: Revenue growth is correlated to AUM. However, revenue is a more important measurement as it demonstrates how effectively firms are charging clients and improving economics.

3. Fixed expense growth: Fixed expense growth is important to measure as it indicates how well a firm is managing investments. The difference between revenue and fixed expenses is a positive (or negative) sign that a firm is creating scale.

4. Earnings growth: Earnings growth is the result of AUM, revenue and expense growth over time. However, cash flow is the most important driver of earnings growth as it demonstrates the expected return for any buyer (internal or external). Demonstrated momentum in growing earnings will greatly improve a firm's valuation.

Growth is a strong story to tell to a potential buyer. At the same time, it is important to consider the risks associated with buying or selling a financial advisory firm. Risk can be mitigated to improve the valuation of a firm over time, and it can be grouped into three categories:

1. Business risk: The risks associated with structural inefficiencies in an advisory firm. This can be lack of a continuity or succession plan, corporate governance or infrastructure. Furthermore, business risk may be present in key-man risk or a captive relationship with a vendor.

2. Client risk: Client attributes can be a source of risk to a potential buyer. Client age, tenure, concentration and experience can impact a firm's perceived value. In particular, client attributes can inform the future economic prospects of the firm if clients are accumulating or withdrawing assets.

3. Employee risk: Employees can pose a risk if the proper protections are not in place. Employment agreements that contain protections for the firm are ways to mitigate the risk of employees leaving and soliciting clients or distributing intellectual capital.

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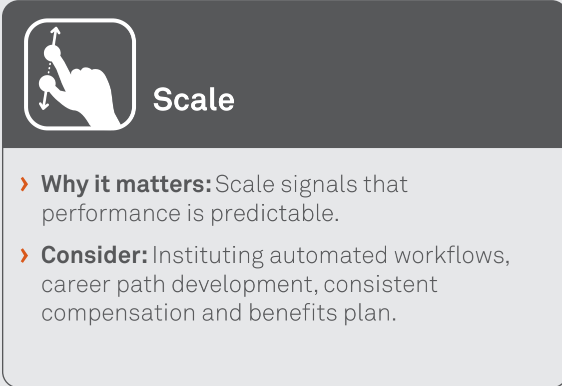
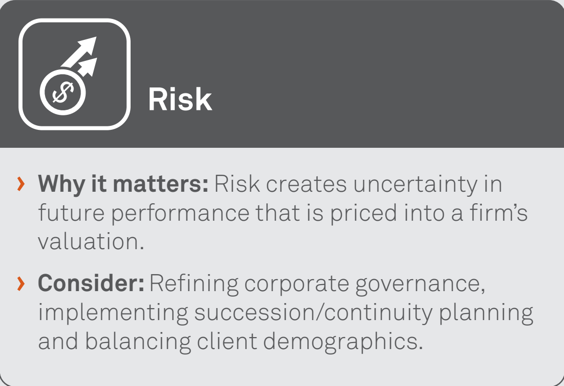
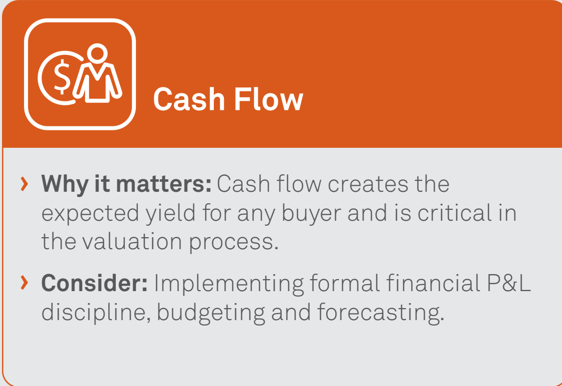
Addressing the drivers of firm value







Valuation Methods

Understanding what drives value in an advisory firm helps to translate commonly used valuation methodologies in the industry. Valuation methodology is discussed at length in the industry, and it's important knowledge for succession planning. The chosen methodology will be impacted by the four factors listed previously in varying ways.

	Revenue Multiple	EBITDA Multiple	Discounted Cash Flow (DCF)	Hybrid
Definition	Multiple of firm's most recent or blended revenue result	Multiple of earnings before interest, taxes, depreciation/ amortization. For advisory firms, this is generally a proxy for cash flow	A calculation of future cash flows discounted to today's value using a selected rate	A unique approach such as Earnings Before Owners Compensation (EBOC) or a blend of approaches
Pros	Easy to calculate and communicate to potential buyers. Comparable transactions can inform the result	Easy to communicate and calculate year-over-year. Provides alignment between price and expected return	Viewed by some as the most accurate valuation method. Full consideration of size, growth and risk	Can be tailored to a firm's unique characteristics. May provide validation to the enterprise value calculation
Cons	Does not take into consideration the unique attributes of a firm. Ignores expense and cash flow characteristics	Difficult to agree on what should be included in EBITDA. One party may argue that certain expenses will not persist post-transaction	Difficult to calculate and explain. Point of contention is often on cash flow forecast and discount rate	May be difficult to find industry data to support the findings. May also create confusion for a counterparty

Understanding the methods for valuing a financial advisory business will help inform succession. The growth and risk characteristics of a firm can be influenced over time to improve valuations and attractiveness to internal and external buyers. Choosing a consistent methodology that incorporates

the unique characteristics of a firm will lead to more certainty and a better outcome for owners. Firms should be careful with general methodologies such as revenue multiples as they do not consider the expense and cash flow characteristics of the firm.

Wealth Management Example: Valuation Methodologies

Revenue	$5,000,000
Direct Expenses	
Owners Compensation	$875,000
Non-Owner Professional Compensation	$1,125,000
Gross Profit	$3,000,000
Overhead Expenses	$1,050,000
Operating Income	$1,950,000
EBITDA	$1,950,000
EBOC	$2,825,000

	Multiple Range	Low Value	High Value
Revenue	**2–2.5x**	**$10,000,000**	**$12,500,000**
EBITDA	**6–6.5x**	**$11,700,000**	**$12,675,000**
EBOC	**4–4.5x**	**$11,300,000**	**$12,712,500**
Variance (max/min)		**$2,500,000**	**$975,000**

Note: Multiple ranges are hypothetical and for illustration purpose only. Please consult with a qualified valuation expert for a more precise value for your firm.

Consider the firm with $5 million in annual revenues. What happens when you change the valuation methodology? Each valuation methodology can result in a large variance and impact the ultimate financial consideration for departing owners. This can also have a significant impact on incoming internal owners or negotiations with a third-party partner. The lesson for advisory firms is to be objective when selecting a valuation methodology. When it comes to realizing the value that has been built, it is often helpful to incorporate outside valuation experts to inform the process.

Mitigating Risk and Protecting Owner's Equity

While many firm owners may see succession simply as a future liquidity event or a way to transfer equity to a buyer at some point, they should understand the risks from the present time until execution of the plan. Real risks exist and there can be significant detours down the road.

The willingness to accept risk drives profits and enterprise value. Reinvesting time and capital into a firm can create future upside when linked to succession and business planning steps outlined here. Advisors should not let risks paralyze their ability to manage and grow their businesses, but rather plan for the desired outcome while systematically reducing risk through the best practices listed below.

How do advisory firm owners mitigate risk to succession? We will exclude processes and procedures associated with business risk, such as trading, compliance, client experience, retention and sales growth that are tackled daily by owners and their staff. Beyond business risk, legal and insurance provisions to protect ownership equity can mitigate many of the risks faced by firms today.

Answering Questions That Help Mitigate Risk

- What happens to my ownership interest in the event of death or disability?
- Who will manage my client relationships if an unforeseen event occurs?
- Is there an individual that can lead the firm if the owner can no longer perform?
- What happens to the legal structure of the firm if an owner abandons their responsibilities?
- What if a key employee or owner commits a criminal act or materially damages the firm's reputation?
- Is there an alternate succession plan if the original does not pan out?

Key-man insurance: A successor may take a life insurance policy on an owner during the period from the drafting of the succession plan to its actual execution. This is usually structured as term insurance, and it allows a successor to buy out an owner's stake in case of an unforeseen event.

Disability insurance: As in most industries, owners may take out disability insurance in case they become unable to perform their ownership and advisory duties. There is not much value in terms of protecting equity, but this does protect the owner from lost annual compensation.

Errors & Omissions (E&O) insurance: Essential for advisory firms, this insures against errors in the trading and rebalancing process. Required by most advisory firms, this protects advisors in case of a severe market error by somebody within the firm.

Buy/sell provisions: This is a critical element of risk mitigation for small and large firms. Usually built within the firm's operating agreement, buy/sell provisions identify what will happen between owners (or with a single owner) should a variety of events occur. For example, if a single owner advisory firm is unable to manage the business, a buy/sell with a successor advisory firm may trigger. The successor then buys the practice under the construct of clearly defined economic and legal provisions.

Buy/sell provisions are structured between the owners and dictate how ownership changes when a variety of events occur, from death of an owner, to outside business activities, to potential abandonment of the business. Consultants or legal counsel can help owners think through these trigger events and structure a buy/sell agreement to meet the needs of all parties, including the owner's estate. Risk-adverse owners may also consider adding a successor or strategic equity partner in the near term. A near-term liquidity event can protect the owner from down market cycles, provide a more certain economic outcome and reduce exposure to externalities. Owners may also want to be opportunistic with their approach and time the market. The market for buyers is dynamic and based on market conditions; at certain times, higher multiples may be achievable.

Consideration: Negotiating the Right Deal Terms

Price and terms of a transaction are important to consider as they can have long-term implications for departing owners. Start by using the list below to determine what tradeoffs are acceptable. The outcome should be a list of non-negotiables as it pertains to succession.

1. Purchase price: Determine what tradeoffs are reasonable when it comes to purchase price. This may include discounting for internal purchases or adjusting purchase price based on events for external purchases.
2. Payment timing: Define an acceptable period of time to receive full consideration in a succession transaction. The longer time it takes to receive payment, the higher the risk to the seller. However, stretching out payments may make a higher purchase price more feasible for internal or external buyers.
3. Buyer protections: When creating your succession plan, think about what your "ideal" buyer would want to purchase. Interviews with local firms will help inform this process.
4. Seller protections: Sellers should define must-haves when it comes to protections. This may include protections for financial outcomes, employees, brand/logos, etc. Outside consultants and legal counsel can help inform commonly used protections and what they mean for a buyer/seller.

Legal and Tax Implications

After owners come to agreement on the business side of their succession plan, a significant amount of time and care must be devoted to legal and tax impacts. Even if an agreement to sell an ownership stake is not imminent, it is still prudent to understand the legal and tax implications of these decisions. The chosen legal structure of a business will impact the tax treatment of yearly economics as well as an eventual sale. Industry data shows that the use of pass-through entities is most popular among financial advisory firms. In the *InvestmentNews* 2016 Financial Performance Study of Advisory Firms, 42% of respondents indicated using a limited liability company, 39% are using an S corporation, 16% are using a C corporation or sole proprietorship, and 3% are using a partnership structure.

Business Structure Types

	LLC	S Corporation	C Corporation
Advantages	Limited liability pass-through entity with flexibility in tax treatment (partnership, S Corporation etc.). The LLC also provides significant flexibility in equity design and corporate governance and less paperwork	Limited liability pass-through corporation with limited flexibility in tax treatment and corporate governance. S Corporations generally seek to minimize W2 income (within reason) and maximize distributions	Limited liability entity with the ability to add unlimited shareholders. C Corporations can also provide advantages in accumulating earnings and attracting outside financing (public or venture)
Disadvantages	Increased flexibility can lead to complexity of administration. Tax advantages of flow-through income/ loss may not be as advantageous as other structures	Limited flexibility in equity design and corporate governance. S Corporations have restrictions on number and type of shareholders. S Corporations may result in more paperwork and administration	The potential for double-taxation and increased reporting requirements. C Corporations can also result in increased complexity if ever sold to a third-party

Note: Legal and tax considerations can be complex. Please consult with your tax and legal advisor for details.

Legal and tax considerations should not drive business decisions. Once the right model is selected, legal and tax processes should commence. It is much more efficient for owners to provide succession plan requirements to a law firm and tax advisor than to work through the issues on the fly. Most legal counselors and tax advisors provide questionnaires to help structure the legal documents and advise owners on the relevant tax implications of any event.

Resources Available to Advisors

Developing a well-thought-out business and succession plan entails a significant time investment for advisory firms. Owners and the management team often work together to craft their strategic plans internally, along with legal counsel to implement their plan.

Guidebooks such as this can provide a framework for firms. They can also remind you of other external resources for help in developing and executing plans, including:

1. **Third-party support:** Subject matter experts can help develop a process, timeline and accountability mechanism to ensure agreed upon deliverables and timelines are met. They can also work through the key decision points of succession and business planning. Firms that implement this approach value industry insight or require a third party to guide them through sensitive issues or mediate an impasse.
2. **Custodian support:** Custodians such as Pershing provide RIAs with the resources they need to drive growth, optimize human capital, maximize operational efficiency and manage risk. Its practice management resources can help firms handle the complexities related to business and succession planning. Some examples of the resources available from Pershing include:
   - Independent studies and guidebooks such as those available through its website, pershing.com.
   - Benchmarking research such as the 2018 *InvestmentNews* Adviser Staffing & Compensation and Pricing & Profitability studies, to help firms evaluate and reposition themselves to better attract, retain and develop top performers. This is a critical component in the development and implementation of a business and succession plan.
   - Events such as INSITE, the Elite Advisor Summit, regional events and local practice management workshops that provide a comprehensive overview of technology and financial solutions options to incorporate into ongoing business planning efforts.
   - Consultation conversations and engagement touchpoints, which are the ongoing standard of care that Pershing Advisor Solutions Relationship Managers and Practice Management Consultants give to clients.

Third-Party Support Providers

1. **Strategic partners:** Independent business management consultants or those offered through the RIA's custodian. Strategic partners help firms think through their corporate strategy and drive consensus within an ownership team.
2. **Legal counsel:** Attorneys provide critical aid in the development and execution of a succession plan. A completed succession plan requires the creation and modification of a firm's operating and other legal agreements.
3. **Investment bankers:** Investment bankers have experience in M&A and other ownership changes. Advisors may seek out investment bankers to provide turnkey transaction support.
4. **Accountant/Tax advisor:** Tax specialists provide advice on any tax ramifications to a firm and its owner from a transaction or other material change in business structure.

Conclusion

Succession is essential to the long-term success of an advisory firm. The failure to execute a plan creates significant risk for owners, partners, their family members, employees and clients. Although succession may make sound business sense, the biggest barriers are emotions and unwillingness by owners to work through the process.

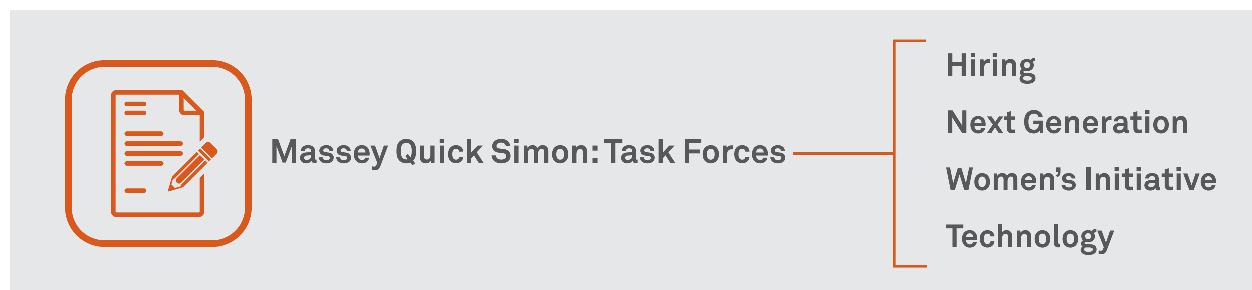
Despite the challenges, there is no better time than the present to create a business and succession plan. Execution of succession and business planning now will provide owners with more options and greater flexibility in the future. Those firms that are the best at execution will have greater control over process and a future outcome. Advisory firm owners now have access to an array of business consultants and legal and tax advisors to help them chart a course. Even more compelling, the RIA industry itself has matured, providing firm owners with various succession plan options to realize the wealth they have created in their business. Now is the time to define what is important to you, document a plan and execute on the future.

Case Study

Massey Quick Simon and Co., LLC: Building the foundation for generational transfer

Massey Quick Simon (MQS) is one of the rare firms in the industry that is not only thinking about succession for founding partners, but has built a firm for generations to come. Founded in 2004, the firm has grown to over $4 billion in assets under advisement with 54 employees and six partners. (Assets under advisement consists of assets under management by MQS and assets which MQS advises and consults on, but does not have any management, execution or trading authority.) The firm's clients include ultra-high-net-worth families, endowments and foundations.

Massey Quick Simon has an advanced business planning posture. Managing Partner Joe Belfatto notes, "We created a management committee that meets every Monday to discuss all aspects of the firm. We have four strategic off-sites each year. We have developed partner functions within the firm, including a COO, that keep us on track."



In addition, Massey Quick Simon created task forces that drive the future direction of the firm. This allows contributors of all levels to participate, ensuring best ideas to make the firm better. The task forces interact with the management team to set investment priorities and drive enhancements to the client experience. MQS is proud of its diversity, with women making up half of all employees, and a third of all employees under the age of 30. The firm has made a deep investment to find and grow the next generation of talent and ownership within the firm.

1. Given the nature of their clients, Massey Quick Simon knew that succession and business continuity were critical to the level of confidence that their clients would have in working with them. The firm did not have a good answer when clients asked, "What happens to my family after the founders leave?" In 2013, the firm developed a plan designed to keep MQS perpetual.

To accomplish this goal, Massey Quick Simon would need to identify potential successors as the founders were all in their late 50s and early 60s. Joe noted, "The three partners felt that Mark DeLotto and Chris Moore demonstrated leadership in helping advance the firm strategically and from a revenue perspective."

Both Mark and Chris joined the firm's management committee and quickly challenged the firm's strategic direction and business strategy. Joe noted this helped make amazing advancements within the firm. "Mark and Chris think about the future differently and are keenly focused on driving the firm forward. We have benefited from their insights into sales and client service."

2. After a year, the three founders felt Mark and Chris should become partners. They bought in for 6% of the firm, financed by a third party, and with the installment payments backstopped by the company.

   Mark and Chris became permanent members of the management team. Joe noted that the firm did not have specific criteria for ownership. The two new partners exhibited strengths such as cultural fit and leadership ability. They also drove operational efficiencies, helped recruit and retain talent and earned the respect of clients and employees. Once the transaction was completed in 2014, Massey Quick Simon realized that to create a sustainable business, it needed to institutionalize its succession planning process.

3. Last year, the firm pursued outside perspective to enhance its succession and develop a way to transition equity from the founders to the next generation of owners. To this end, the firm hired Echelon Partners, an investment banking firm that serves the financial services community. Joe noted, "After we completed the first phase of our succession plan, we needed an outside voice that could provide industry perspective and help the management team work through issues. As you know, ownership can be an emotionally charged subject!"

Key Findings From Massey Quick Simon

- **Be open minded**
- **Hire a third party to broaden your perspective**
- **Nail your valuation methodology**
- **Project growth into the future**
- **Start early**

The firm is enhancing the way it thinks about valuation. It uses an EBITDA multiple versus the EBOC multiple it used in the past. A critical change was moving toward a market-based compensation system for partners as it pertains to the valuation. It also helped predict the FMV of the firm. "Outside perspective showed us how critical it is to start transitioning equity sooner than later. The forecast tells you the hard facts of transitioning equity to the next generation from an economic perspective. We know we need to execute the next step of our plan right away."

Massey Quick Simon expects to develop more formal criteria for equity ownership within the next year. Then it will do a formal rollout to the team. Its goal is to add as many partners as makes sense and transition ownership consistent with the strategic plan that was developed in 2013. "We know we still have a long way to go. But our team is confident we have the pieces in place that will serve our clients and team for years to come," Joe concluded.

Notes

Notes

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