Taking Control: Exploring Independence | Part Four

Transitioning Your Practice the Way You Want

How independence enables customized business succession for advisors and facilitates inorganic growth opportunities

June 2022

Summary

Advisor demographics dictate that a relatively steady stream of advisors enter retirement each year. The business transitions that occur as a result represent a critical stage in the lifecycle of a financial advisor, which impacts them monetarily and the legacy of the practices that they have worked hard to build and grow. These transitions also create significant opportunities for the next generation of advisors, who have the potential to take on a book of business through an internal succession, as well as for third parties for whom acquisitions of the practices of retiring advisors represent an opportunity for inorganic growth.

While captive employee advisors and those who purchase their books of business upon retirement often benefit from robust transition programs sponsored by their broker/dealer (B/D), they often must make certain concessions in terms of control and other restrictions. Alternatively, sellers and acquirers of independent practices have great flexibility in terms of how they can structure a transaction, but they often have a less formalized framework to follow. For independent advisors, in particular, it is extremely important that they seek partners that can assist them with the various aspects of business succession planning, design, and implementation, while those independent firms that are looking to acquire other practices also stand to benefit from partners that can assist them with the various aspects of sourcing and executing deals.

Methodology

Commonwealth Financial Network® engaged Cerulli Associates to help understand advisor best practices in working with the firms they affiliate with*. In January and February 2022, Cerulli conducted qualitative research interviews with successful financial advisors across employee and independent channels. These interviews addressed a broad range of topics, including consideration or experience with moving to an independent channel, business development, client service models, succession planning, portfolio construction, and their overall relationships with the firms they have chosen to affiliate with. Research participants were required to have a minimum of five years of experience as an advisor and $50 million in client assets under management (AUM).

*This study was paid for by Commonwealth Financial Network®. Commonwealth Financial Network® and Cerulli Associates are separate and unaffiliated entities.

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"Our succession planning approach combines proactive matchmaking with all the mechanics needed to get the deal done, and then the liquidity to capitalize on it. [Our advisors know] that when the time comes, we will be a partner to help them find a successor and/or provide growth capital to drive acquisitions."

Senior Commonwealth Financial Network® Executive

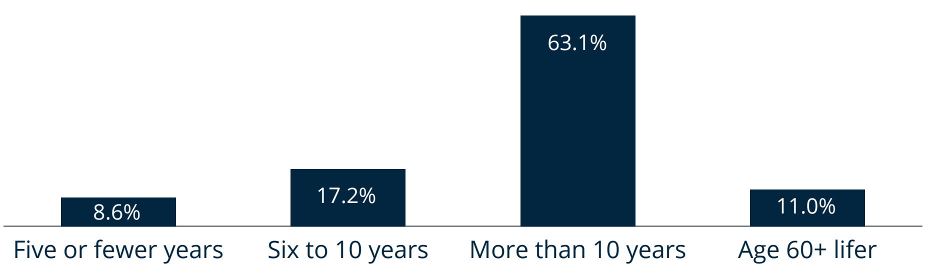
How Succession Planning Is Fueling Opportunities for Growth

The financial advice industry has traditionally comprised a more tenured workforce than many other industries; the average advisor is 51 years old with nearly 20 years of experience. Furthermore, trends show that the average age of a financial advisor has been slowly increasing over time, making succession planning an increasingly important consideration for many advisors while creating a steady stream of opportunities for inorganic growth. According to Cerulli data, within the next 10 years, 37% of financial advisors, collectively controlling $10.4 trillion, or 40% of total industry assets, are expected to retire.

Advisor retirements represent a significant ongoing opportunity for the next generation of advisor talent, who may be in a position to acquire a book of business from a retiring advisor within their practice or through some other internal succession mechanism, and for external firms that are inclined, and in a position to pursue, inorganic growth. Cerulli estimates that nearly half of the advisors retiring within the next 10 years operate within a solo practice and one in four are unsure of their succession plans. Some of these solo advisors are likely to think soon about teaming up with another advisor who can take over the business when the time comes, or will represent opportunities for external acquirers upon retirement. However, with 49% of advisors identifying as being open to or actively searching for practices to acquire, competition for the acquisition of these practices is strong, resulting in higher multiples and other advantageous deal terms for many sellers.

Advisors in Transition, 2020

Anticipated Retirement Timeframe: All Industry Advisors



Succession Plan for All Industry Advisors Transitioning within 10 Years

Sources: Cerulli Associates, Investment Company Institute, Insured Retirement Institute, VARDS, Strategic Insight/SIMFUND, Investment News, Judy Diamond, Department of Labor, PLANSPONSOR, S&P Capital IQ MMD, Financial Planning, Financial Advisor Magazine, Investment Advisor Magazine, and Cerulli Associates, in partnership with the Investments & Wealth Institute, WealthManagement.com, and the Financial Planning Association® (FPA®) | **Analyst Note:** Advisors were asked for the number of years until they expect to retire. The "Age 60+ lifer category" represents advisors who are over age 60 and indicate an expected retirement date of 10 or more years. The data exhibited here is a result of Cerulli Associates' surveying of approximately 1,500 advisors each year.

Key Figures

47% of industry assets are managed by advisors over age 55

49% of advisors retiring within the next 10 years are solo practitioners

73% of practice management professionals identify the emotional aspects of transferring clients to a new advisor as a major challenge for succession planning preparation

COMMONWEALTH VOICES

"The first thing that an advisor needs is expert [succession planning] guidance. One of the ways in which we add value is just helping them to understand the options, the pros and cons, and the mechanics. One of the advantages of being a home-office partner is that you can be a partner to [an advisor] early on in their thinking on succession, and can help them find the path that makes the most sense for them."

Senior Commonwealth Financial Network® Executive

The Business Succession and Transition Landscape

Advisors have a diverse range of objectives that they would like to achieve through their succession plans. These can include maximizing their monetization of the practices that they have built, ensuring the continued delivery of high-quality advice to their clients by those who acquire their business, and furthering the interests of other members of their team. According to practice management professionals that take part in an annual Cerulli study, the personality of the acquiring advisor (88%), likelihood to put the client's interests first (85%), and the regulatory/compliance record (85%) are the most important factors for advisors when evaluating potential successors.

In order to achieve the objectives that advisors have for their practices upon retirement, it is essential that they define those objectives, and determine the best path to achieve them, far in advance of their transition. According to one Commonwealth advisor, "[Developing a successor takes time]; it takes about five to seven years to train somebody to take over a position like this. They have to get through a full business cycle and market cycle." Despite this, one in four advisors who are expected to transition their business within the next 10 years identify as being unsure of their succession plan.

The approaches that advisors take toward transitioning their practice, and the structure of the transition, are numerous and are heavily influenced by the range of options available to them, depending upon whether they are employees of a captive B/D or independently affiliated. Independently affiliated advisors typically have greater flexibility than their employee counterparts to customize their transition plan to align with the objectives they have for their succession. For example, independent advisors typically have greater opportunity to pursue a sale of their practice to a third party (external sale) and also have a greater ability to build larger, multi-partner organizations with a path to equity ownership over time, creating sustainable legacy organizations (internal succession). The latter approach typically provides an advisor with greater flexibility regarding the timing of their transition and how they monetize their interest in the practice, among other factors.

Commonwealth Advisors Speak

"We're looking at building an ensemble team and I have a desire to mentor and pass on some of the stuff that we've done here; that's my number one goal. Somebody passed the baton to me 30 years ago; now, I'm going to do the same. And then I want to [stay on] to take care of my older existing clients who have always been here."

"We were able to structure the sale how we wanted. [My retiring partner] wanted some upfront money and Commonwealth was able to do that. They were very good about it, and pretty flexible for us. They even went above their norm on the amount they gave us as an upfront, which I paid back over five years."

Key Characteristics of Transitions for Independent vs. Employee Advisors

Independent Advisors	Sale often qualifies for capital gain tax treatment resulting in higher net after-tax proceeds to the seller.	Significant flexibility regarding how the advisor exits, such as gradually reducing involvement or monetizing and staying indefinitely.	May provide greater control over choice of successor.	High operating leverage can provide greater economics for buyer, resulting in potentially greater valuations.
Employee Advisors	Rookie recruitment and corporate transition programs can provide a relatively simple, "easy-button" transition for retiring advisors.	Financing may be easier to attain and more comprehensive.	Terms associated with the transition of clients may create material restrictions for the buyer, the seller, or both.	Often involves a more limited opportunity set of potential buyers and may involve certain restrictions on deal terms.

Successfully Navigating the Sale/Acquisition of an Independent Practice

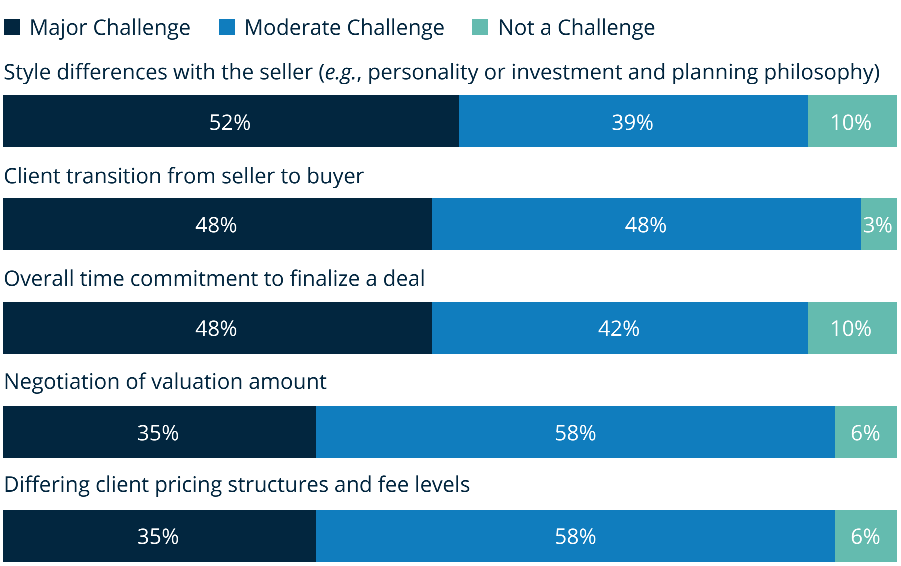
The process for transitioning the ownership of an independent advisory practice differs significantly between those who are pursuing an internal succession plan and those pursuing a sale to a third party. While the sale of an independent practice to a third party can occur with comparatively little lead time, creating a multi-owner enterprise with a clear internal path to succession takes significantly more.

It is important that practices pursuing internal succession are transparent and embrace the concept of shared equity ownership as part of their culture. Communication with the next generation of advisors is essential to retention, and it is important to recognize that talented advisors will only wait so long for ownership opportunities to come to fruition. To facilitate the sale of equity ownership, it may be helpful for firms to secure financing mechanisms to assist the next generation of owners with acquiring their equity interests, as many may not have the resources to pay out of pocket. Sources of financing tend to be diverse in nature and can be seller-financed or involve loans from platform partners such as independent broker/dealers (IBDs), custodians, banks, and private equity firms.

When selling a practice to an external third party, it is essential that there is a strong alignment between firms in order to maximize staff and client retention. Alignment should exist in terms of core values, service delivery, and investment philosophy. Retaining the principals of the selling firm to provide overlap to transition client relationships is also a critical aspect of success, with many deal terms requiring the selling principals to remain employed with the new firm for a specified length of time.

Regardless of whether a business transition is done through sale to a third party or through internal succession, it is highly advisable to have strategic partners that can advise firms through the various elements of a succession plan. These partners can assist with key elements of the transition, including strategic advice, financing, valuation, legal guidance, sourcing prospective candidates, and more.

Acquisition Challenges, 2021



Sources: Cerulli Associates, in partnership with the Investments & Wealth Institute and the Financial Planning Association® (FPA®) | **Analyst Note:** Responses are from practice management professionals. The data exhibited here is a result of Cerulli Associates' surveying of approximately 1,500 advisors each year.

Key Aspects of Selling/Acquiring an Independent Advisory Practice

Sourcing

Identifying prospective sellers or prospective buyers of an advisory practice, including fundamental practice characteristics to identify alignment.

Valuation

Determining the value of the business based on agreed-upon criteria and valuation metric(s). Often performed by a certified valuation specialist.

Structure

The specific terms of the transaction, including the agreed-upon sale price, the form of consideration, and the timing of payments.

Financing/Capital

The way in which the transaction will be funded. This can include loans from financial institutions, seller-financed loans, and earnouts, among other approaches.

Operations

New account set-up, account transfers, and data transfers required as a result of a change in ownership and systems.

Source: Cerulli Associates

About Cerulli Associates

For over 30 years, Cerulli has provided global asset and wealth management firms with unmatched, actionable insights. Headquartered in Boston with offices in London and Singapore, Cerulli Associates is a global research and consulting firm that provides financial institutions with guidance in strategic positioning and new business development. Our analysts blend industry knowledge, original research, and data analysis to bring perspective to current market conditions and forecasts for future developments. Learn more about Cerulli Associates by visiting www.cerulli.com.

About Commonwealth Financial Network®

Commonwealth Financial Network, Member FINRA/SIPC, a Registered Investment Adviser, provides a suite of business solutions that empowers more than 2,000 independent financial advisors nationwide. Privately held since 1979, the firm has headquarters in Waltham, Massachusetts, and San Diego, California. Learn more about Commonwealth by visiting www.commonwealth.com.

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