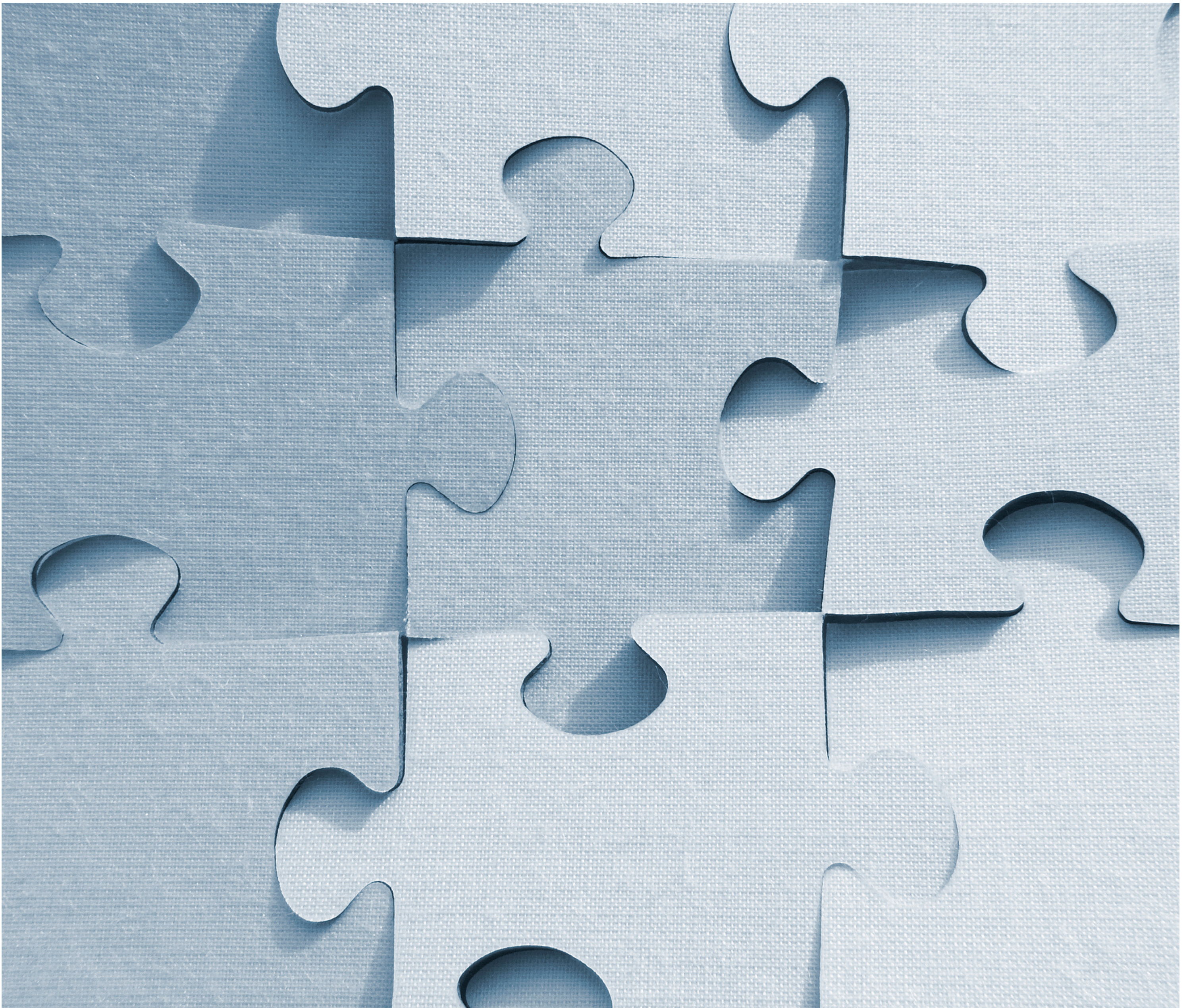
Succession planning: Protecting and enhancing the future of your business



FOCUS® FINANCIAL PARTNERS

J.P.Morgan Asset Management

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What about you?

You've worked hard to build a successful business; if you're like most advisors, it's your most valuable asset. Despite one of the worst economic downturns in recent memory, your business has grown, your client base has expanded and profits have improved steadily. You make a living helping clients build and implement transition plans, but what about your own plan? When will you start creating a continuity plan for yourself and your practice? Have you given any thought to what your practice is worth? Or what your options are? You're not alone.

Like most professional service businesses, advisor practices are not built to survive beyond their owners. One industry observer suggests that 99% of the independent financial services practices in the country will not survive their founder's retirement.[1] Despite dire warnings, only a small percentage of advisors are ready for the transition to retirement. Recent research[2] shows that only about one-quarter of all advisors have a formal succession plan today. The number increases slightly to 31% for advisors aged 60-64. At age 65+, only 41% of advisors have a succession plan. But without one, firms expose their businesses – especially their clients – to unnecessary risk.

In this paper, we explore the subject of succession planning and the related trends and challenges facing advisors in 2016 and beyond. In addition to primary and secondary research, we offer insights on succession planning strategies, including case studies from Focus Financial Partners, to help you shape a future for your firm.

[1] Succession Planning for Financial Advisors, by David Grau Sr., p. 1
[2] The Importance of Succession Planning for Financial Advisors, ADP (Summer 2015)

Why is succession planning a necessity today?

Aging advisors: The average age of more than 300,000 financial advisors is 51 years.[3] Just two years ago, Cerulli & Associates estimated that principal owners of 5,084 RIAs and 2,948 dually registered advisors were approaching retirement, representing $320B and $187B in assets, respectively.[4]

Over the next 10 years, 12,000 to 16,000 financial advisors are expected to retire every year. Commentator Michael Kitces has written often about the subject of advisor industry demographics. He calls the problem a slow-motion train wreck and says "the number of advisors available to hire who have capacity for new clients continues to dwindle."[5] To keep up with the demand for advice, the industry will need to contend with a shortage of more than 200,000 new financial professionals.[6]

More than half of all RIAs (60%) have at least 15 years of experience,[7] with numbers skewing slightly higher for larger firms that manage in excess of $100 million in client assets.

Aging clients: Advisors aren't the only ones who are getting on in years; their clients are aging, too. Today, the median age of full-service investors is 61 years[8] — and the age factor steps up a whole year every nine months as more Baby Boomers reach retirement age.

Among RIAs, research finds that more than two-thirds (68%) of RIA clients have reached age 50, while 44% are over the age of 60. Across all AUM tiers, RIA clients under age 40 make up just 13% of all clientele.[9]

Average client age range by firm AUM, 2015

Client age	<$25m	$25m to <$100m	$100m to <$500m	≥$500m	All RIAs
Under age 40	15%	12%	11%	16%	13%
Ages 40 to 49	17%	21%	16%	20%	19%
Ages 50 to 59	25%	27%	25%	22%	25%
Ages 60 to 69	27%	23%	29%	24%	26%
Ages 70 to 79	11%	12%	14%	14%	13%
Ages 80 and older	5%	5%	5%	4%	5%

Source: Cerulli Associates, in partnership with the Investment Management Consultants Association, WealthManagement.com, the Financial Planning Association and OnWallStreet

Number of years in which advisors plan to retire or leave the industry by channel, 2014

Only 4% of advisors plan to exit the industry in the next four years. However, nearly one-quarter (21%) plan to retire in a 5- to 10-year time frame.

Years	Bank	Wirehouse	Regional	Insurance	IBD	Dually registered	RIA	All advisors
<5	1%	5%	3%	4%	3%	1%	3%	4%
5-10	13%	30%	17%	15%	22%	23%	27%	21%
11-15	37%	21%	22%	17%	23%	16%	22%	21%
16-20	23%	20%	22%	26%	24%	21%	30%	24%
21-25	11%	7%	11%	5%	10%	21%	6%	9%
>25	14%	16%	26%	33%	17%	18%	13%	22%

Sources: Cerulli Associates, in partnership with the Investment Management Consultants Association, WealthManagement.com, Peak Advisor Alliance and Impact Communications

[3] Cerulli Report, RIA Marketplace 2015, p. 72
[4] Cerulli Advisor Edge Q3 2012
[5] Michael Kitces Blog, *Nerd's Eye View,* January 6th, 2014
[6] Touryalai, Halah (2014-02-19). *The New Wealth Doctors, Wall Street's Hottest Career* (Kindle Locations 243-244). Forbes Media. Kindle Edition.
[7] Cerulli Report, RIA Marketplace 2015, p. 73
[8] http://www.jdpower.com/press-releases/2015-us-full-service-investor-satisfaction-study#sthash.GOujtitk.dpuf
[9] Cerulli Report, RIA Marketplace 2015, p. 98

Lack of a robust continuity and succession plan can result in a next-generation retention challenge: Lack of a robust continuity and succession plan makes retaining the next generation of clients that much more difficult. As older investors begin to spend down their portfolios, advisors seeking to grow their practices will need to find new ways to replace those fee-bearing assets. Without a succession plan, some advisors may lose those retirement-ready clients who worry that their aging advisors may not be able to serve their future needs. They may also lose prospective new clients who would much rather work with an advisor likely to be around longer than them.

Another concern is losing the opportunity to retain assets of a deceased client. More than one-third of American workers today are Millennials (adults ages 18 to 34 in 2015), surpassing the number of Baby Boomers in 2014 and the Generation X cohort during the first quarter of 2015.[11] In addition to the wealth this generation is poised to build on its own, it also stands to inherit some $59 trillion in personal wealth over the next several years.[12]

The problem for most RIAs is that they have not yet developed a business strategy to attract these younger investors. Nor have they focused on recruiting younger talent to target this increasingly important market segment. Research commissioned by Scivantage, an information-enabled software company serving the financial services industry, and produced by Aite Group affirms that "financial advisors are not prepared to deliver the digital experience younger generations expect, and they have little experience working with investors under the age of 40."[13] Aite research finds that, unlike their Baby Boomer parents, Generation X and Millennial investors, including those who work with a financial advisor, are looking for better technology with which to manage their financial lives.

Of greater concern to RIAs is the fact that "the children of clients often view their parents' advisors as out of touch with their own needs. Over 40% of next-generation investors prefer to work with someone within 10 years of their own age."[14]

A recent *Time* magazine writer warned consumers that they could end up being part of a bidding war as rival firms vie for their advisor's book of business, or they may be handed to an inexperienced financial advisor who inherits the account at their old firm.

THE GENERATIONS DEFINED

THE MILLENNIAL GENERATION*
Born: 1981 to 1997
Age of adults in 2015: 18 to 34

GENERATION X
Born: 1965 to 1980
Age in 2015: 35 to 50

THE BABY BOOM GENERATION
Born: 1946 to 1964
Age in 2015: 51 to 69

THE SILENT GENERATION
Born: 1928 to 1945
Age in 2015: 70 to 87

THE GREATEST GENERATION
Born: before 1928
Age in 2015: 88 to 100+

*The youngest Millennials are in their teens. No chronological end point has been set for this group. For the purpose of following a clearly defined group, Millennials are defined as those age 18 to 34 in 2015.

Source: Pew Research Center

RIA years of experience, 2015

	Channel		Firm AUM				
Experience Range	**Independent RIA**	**Dually Registered**	**<$25m**	**$25m to <$100m**	**$100m to <$500m**	**≥$500m**	**All RIAs**
<5 years	6.2%	1.8%	8.0%	3.2%	1.1%	6.6%	4.2%
5 to 9 years	16.8%	15.0%	25.7%	11.3%	9.1%	19.5%	16.0%
10 to 14 years	18.7%	21.5%	23.0%	25.9%	15.7%	10.6%	20.0%
15 to 19 years	16.8%	19.5%	10.3%	21.7%	21.6%	16.2%	18.1%
20 or more years	41.5%	42.1%	33.1%	37.9%	52.6%	47.0%	41.8%

Source: Cerulli Associates, in partnership with the Investment Management Consultants Association, WealthManagement.com, the Financial Planning Association and OnWallStreet

[11] Pew Research Center analysis of U.S. Census Bureau data, http://www.pewresearch.org/fact-tank/2015/05/11/millennials-surpass-gen-xers-as-the-largest-generation-in-u-s-labor-force/

[12] https://www.bc.edu/content/dam/files/research_sites/cwp/pdf/A%20Golden%20Age%20of%20Philanthropy%20Still%20Bekons.pdf

[13] The Race to Easy: Reevaluating the Wealth Management Technology Strategy, March 2015; Research commissioned by Scivantage and published by Aite Group p. 4

[14] Touryalai, Halah (Kindle Location 295)

Demand for independent financial advisors is growing, yet lack of succession planning can derail this increasing opportunity: As the modern era of the RIA industry approaches its third decade, the tide is shifting for maturing businesses. Many of the characteristics that have contributed to RIAs' success to date — transparent fee arrangements, a fiduciary standard and independence — are the very factors that are expected to propel the industry forward. In many ways, the industry has never been more vibrant.

IBD advisors: Reasons for preferring the RIA channel, 2015

	IBD
Flexibility regarding fee levels and structure	37%
Appeal of independent model to clients	34%
100% payout	34%
Greater marketing flexibility	34%
Flexibility to select technology systems	33%
Regulatory oversight is less burdensome for RIAs	32%
Operate exclusively as a fiduciary	30%
Current B/D not adding enough value in relation to cost	28%
Increases financial value of practice	26%
Paying for unused services offered by current B/D	25%
Ability to take discretion over client accounts	25%
Ability to build custom model portfolios	21%
Increased opportunity to acquire other RIAs	19%

Sources: Cerulli Associates, in partnership with the Investment Management Consultants Association, WealthManagement.com, the Financial Planning Association and OnWallStreet

Schwab's 2015 RIA Benchmarking Study — one of the industry's most comprehensive — reports that, in addition to record revenue and profitability, RIA firms have achieved "an effective combination of growth and improved operating margins as they increasingly institutionalize operations and make strategic decisions around talent."[15] Several trends are taking shape that will frame the future of the financial advice industry — and RIAs, in particular.

The Department of Labor's Bureau of Labor Statistics predicts that personal financial advisor jobs will be among the fastest growing in the nation over the next 10 years at a rate of 27%. That compares to an 11% growth rate for all U.S. occupations over the same period.[16]

Similarly, Cerulli & Associates projects the RIA/Dually Registered market share to increase to 27% of the retail advisor marketplace by 2018, up from 20% in 2013.[17] Several factors are contributing to the rosy outlook:

The allure of independence: The hybrid model enables traditional broker/dealer affiliated advisors to transition from commissionable to fee-based services. Hybrid RIAs can reposition themselves and their businesses while leveraging the broker/dealer's compliance and technology infrastructure. The move to complete independence is a logical next step for many hybrid RIAs. In addition to the economic incentives — chiefly the opportunity to build equity in and realize the value of the firm they join or build — they embrace the notion of entrepreneurship. Business ownership affords them ultimate control of their business and the differentiated client service they seek to provide. They are able to offer a broader or more specialized range of products and services, can choose to work with preferred trust and custodian service providers, and increasingly are able to assume direct control of technology and ownership decisions. Economically, complete independence is also the most rewarding in most cases: considering long-term firm viability, the independent fee-only model based on recurring advisory revenue generally garners the highest valuation multiples.

- Independent broker/dealer (IBD) advisors prefer the RIA channel primarily for its flexibility regarding fee levels and structure.
- Other equally attractive factors include the independent model's appeal to clients, 100% control over economics, greater marketing flexibility and, most importantly, ownership benefits and legacy.[18]

Investor choice: Another factor supporting industry growth is affluent consumers' preference for doing business with boutique, high-touch RIA practitioners.[19] The fact that many RIA firms are independent — and not employees or agents of large organizations — is an attractive advantage for high net worth investors as well as younger investors. The independent fee-based model also appeals to consumers concerned about conflicts of interest. To be sure, investors are far more discriminating in the post-Madoff era about who they entrust with their assets. Again, citing research by Cerulli Associates, a significant share of recent asset inflows — 47% for RIAs and 44% for dual-registered advisors — originates from new clients with new money.[19]

[15] http://pressroom.aboutschwab.com/print/node/1122
[16] http://www.bls.gov/ooh/business-and-financial/personal-financial-advisors.htm
[17] Cerulli Report, Intermediary Distribution 2014, p. 18
[18] Cerulli Report, RIA Marketplace 2015, p. 59
[19] Cerulli Report, Intermediary Distribution 2014, p. 38

Increased regulatory scrutiny: On the heels of the Great Recession, the Securities and Exchange Commission published a study in 2011, as mandated by the Dodd-Frank Act, which concluded — among other things — that all financial advisors operate under "a uniform fiduciary standard." Most experts agree that the future will hold greater scrutiny and oversight of RIAs. Many believe that RIAs will need to invest more in their compliance and training infrastructures — weighing down the economic advantage they currently enjoy. In addition, pressure is mounting from both state and federal regulators who expect advisors to have a business continuity and succession plan in place. On this front, such pressure from regulatory authorities may be the impetus to get RIA owners thinking more about the future of their firms. Yet only one in 10 advisors (13%) is expecting this request from regulators and few (18%) have shared their plan with their clients.[20]

In December 2014, Mary Jo White, Chairwoman of the Securities and Exchange Commission, cited the agency's focus on enhancing risk monitoring, including minimizing the impact on investors when an advisor is no longer able to serve his or her clients.

...The staff is therefore developing a recommendation to require investment advisors to create transition plans to prepare for a major disruption in their business. The process of creating such a plan in advance of an actual severe disruption in the advisor's operations could better prepare advisors and their clients to deal with a transition and its attendant risks if one were required.

In December 2015, at the ICI 2015 Securities Law Development Conference, David Grim, Director, Division of Investment Management, U.S. Securities and Exchange Commission, reinforced this:[21]

...The Division is considering a recommendation to the Commission to require registered investment advisers to create and maintain transition plans in the event of a major disruption in their business. The staff's recommendation regarding transition plans will be informed by current requirements for registered investment advisors, and designed to complement existing compliance programs.

The North American Securities Administrators Association, Inc. (NASAA) went a step further; it adopted the Model Rule on Business Continuity and Succession Planning, Model Rule 203(a)-1A or 2002 Rule 411(c)-1A in April 2015. The rule outlines five core provisions that would be required in any business continuity and succession plan:[22]

1. The protection, backup and recovery of books and records.
2. Alternate means of communications with customers, key personnel, employees, vendors, service providers (including third-party custodians) and regulators, including, but not limited to, *providing notice of a significant business interruption or the death or unavailability of key personnel or other disruptions or cessation of business activities.*
3. Office relocation in the event of temporary or permanent loss of a principal place of business.
4. Assignment of duties to qualified responsible persons in the event of the death or unavailability of key personnel.
5. Otherwise minimizing service disruptions and client harm that could result from a sudden significant business interruption.

This rule requires every advisor to establish, implement and maintain written procedures for business continuity and succession planning. And while this rule still needs to be adopted at the state level, all established precedents point to NASAA rules being adopted by state regulators by the end of 2017.

[20] J.P. Morgan Asset Management / Focus Financial Research Study, December 2015
[21] David W. Grim, Director, Division on Investment Management. Testimony on oversight of the SEC's Division on Investment Management, October 23, 2015
[22] NASAA Model Rule of Business Continuity and Succession Planning (Model Rule 203(a)-1A or 2002 Rule 411(c)-1A), April 13, 2015

The push for the formal rule that NASAA is urging states to adopt came in response to reports from examiners that many of the practices they visited had no formal procedures in place to keep the business going in the event of an unexpected disruption. "Part of this was driven by what our examiners were finding in the field over the last several years," says Patricia Struck, the Wisconsin securities administrator who led the development of the model rule recently approved by NASAA. "They're not necessarily common occurrences, but they happen, and they're things that people are reporting," Struck adds, explaining that the model rule is intended to create a uniform standard for advisors regardless of which state they operate in.[23]

Struck says that the next phase of her work on the business continuity and succession proposal will be reaching out to states to promote the model rule. That effort, she says, will aim to "make sure that states are adopting it with the objective that it will be the same rule in every state, so that an advisor who's doing business across state lines really doesn't have to worry that they're having to deal with different requirements in different states."[23]

However, Struck notes that advisors shouldn't wait for their state to adopt the regulation before developing their own plans for keeping the business going and communicating with clients in the event of a natural disaster or the death or incapacitation of a principal at the firm. "This is the kind of discussion ... that we would bring up when we do exams," Struck says. "And we would expect, even though the law hasn't been adopted as a rule in Wisconsin, for advisors to take into account all of the succession planning and business continuity plans generally. And we'd expect them to be conversant in these concepts. *Although it's not an enforcement issue it's simply a compliance issue at this point."*

She argues that advisors acting under their fiduciary responsibilities to their clients should already have a contingency plan in place, and cautions that examiners will ask about it when they visit a practice. **"Be ready to talk about it, because that is something that... *we're going to be looking at, and if you don't have it and you haven't thought about it, then that is something that we're going to be noting in an exam report,"* she says. "You should have thought about it."**

MOST RIAs DO NOT HAVE A ROBUST CONTINUITY PLAN

- Of financial advisors targeting a transition within three to 10 years, 50% do not have a succession plan in place.[24]
- Less than 25% of firms have a real succession plan in place, while nearly three-quarters (72%) report they are planning to create a succession plan or need to refine their current plan.[25]
- Nearly half of advisors (49%) have identified next-generation leaders, but only about one-third of those advisors (37%) believe their successor is ready for leadership.[26]
- A quarter of advisors (26%) say they are comfortable with their succession plan.[27]

[23] "Don't Wait for New Rules to Get a Succession Plan," *Financial Planning,* May 3, 2015
[24] Aite Group, The Efficient Frontier of Succession: Maximizing Practice Value, p. 7
[25] 2012 IN Adviser Solutions Succession Planning Study, Succession Planning – Biggest Industry Challenge
[26] Ibid p. 6
[27] J.P. Morgan Asset Management / Focus Financial Research Study, December 2015

Why is succession/ continuity planning a challenge for advisors?

Denial of their own mortality: As with most humans, advisors fear their own mortality. They do not want to accept that they could be gone one day and will need to plan for it. As is often said, "a cobbler's son has no shoes." Most advisors help their clients plan for their future but procrastinate on their own future because it reminds them that at some point the business will not be theirs. Most advisors also love what they do, so it becomes very difficult for them to accept the fact that they need to plan for alternate, possible calamitous scenarios.

- *"I love what I do and planning for when I am not there means thinking of other ways to spend my time."*
- *"My clients depend on me and the thought of not being able to service them is morbid, so I avoid thinking about that."*

Lack of time: Advisors start planning for succession far too late because they do not like being reminded of their mortality; 15% say they lack the knowledge and 13% lack the time to successfully implement a plan.[28] Almost 70% of practice owners indicate that it will take five years or less from the time they decide on a succession strategy to the time they can leave the practice. M&A consultants suggest starting to prepare for an internal succession at least 10 years before the planned transition — only 6% of practice owners realize this much time is required.[29]

- *"It takes a lot of effort to articulate then put into motion; kind of like giving yourself shots."*
- *"Deciding the right time frame is a big decision."*
- *"With day-to-day business to attend to, time to think through issues and plan for different scenarios is scarce."*

Absence of training, talent recruitment and development tools/expertise: While talent management is gaining more attention, most firms have not invested in the training and development resources that can facilitate succession planning. **Research shows that the #1 succession challenge is finding the right successor — skill set, client fit and the advisor having the financial means to assume responsibility for the firm.**[28] Less than a third of advisors (31%) are confident they have a capable group of next-generation advisors.[28] Only a quarter of advisors (26%) are confident of their own skills in grooming the next generation of advisors.[28] As a general rule, the RIA market segment lacks the deep resources and large-scale training programs commonly found within the traditional broker/dealer channels. As older advisors begin retiring and competition intensifies for the best and brightest, many firms will be challenged to keep pace. Firms will need to attract the right kind of talent to ensure viability of their businesses and create a true continuity solution for their clients. Older advisors also need to be willing to relinquish control of their firms if they truly want to develop talent into next-generation owners of the business.

- *"Identifying a successor with the appropriate training and desire, as well as credentials acceptable to our client base, is critical."*
- *"There are not enough people with the right expertise."*
- *"Finding someone to continue with the same philosophies for my clients is tough."*
- *"Making sure that all the right people are in place to have a seamless transition is important."*
- *"The inability to hire people who could maintain and grow the business is slowing down the planning process."*
- *"I simply assumed that many firms do the kind of work we've done for the last 25 years, i.e., analyze securities for potential profit opportunities. Lo and behold, very few do — 'asset allocation' is the preference with little concern for underlying businesses. Finding a firm or a person who does what we do turned out to be highly challenging."*

[28] J.P. Morgan Asset Management / Focus Financial Research Study, December 2015
[29] Aite Group, p. 10

Access to capital: Research shows that smaller firms need more help than larger firms in creating and executing succession plans.[30] And, across all practice owners, one in three does not know the value of his or her practice.[31] Maximizing practice value is/will be an important part of the plan for one-third of advisors, especially for those with less than five years to retirement.[28] And even if they know it, finding an internal buyer who has the capital to buy them out is very difficult. Only one in 10 advisors say the next generation can afford to buy them out.[28] This is where external buyers add value.

- *"Finding someone who understands that building a business requires capital and that you can't have a big salary AND get ownership in the firm is almost impossible."*
- *"The deal structure and making an internal succession plan both tax efficient and able to be financed affordably with external lenders for younger advisors is tough."*
- *"Younger advisors do not have the resources to afford the significant purchase of a large, established RIA."*
- *"The next gen has no capital to purchase my shares."*
- *"I struggle with this question every day — how to transition ownership in a way that the receiving owners feel that they are getting value and the selling owners are able to receive cash."*

Inability to give up control: Most advisors started their businesses from scratch years ago. They scrambled, bootstrapped, asked for referrals and gradually built up their RIAs as true entrepreneurs. When you have put your blood, sweat and tears into building something that you love doing, it is very difficult to digest the concept of handing it over to someone else to manage. This is a big stumbling block for a lot of advisors. As decision makers, they have shaped their business so far and do not want to give that up. They realize they need to plan and do something, but they are unwilling to give up control. This clouds their judgment and makes the planning process a lot more difficult and challenging for them.

- *"I built this business putting all that I had at stake — it is such an integral part of my life and who I am. The thought of giving it up is painful."*
- *"I am happy to bring in a successor, but I want to keep making decisions while I'm still around."*

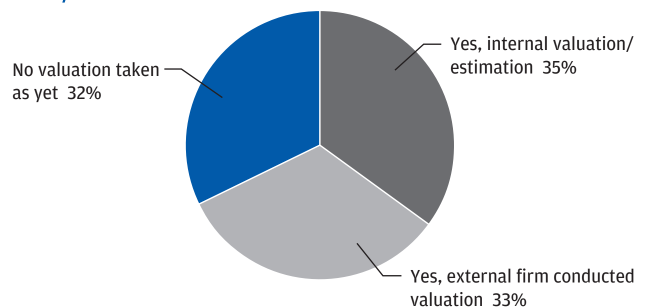
Internal issues: Research has also found that internal issues are challenging for advisors. Two of the toughest concerns facing advisors are the negotiation process (especially for firms with over $250M in AUM) and the business owner's desire to be equitable (particularly to those who are family members).[32]

- *"Getting compromise from participants was critical."*
- *"It was difficult to get the partners/founders to agree on terms that were acceptable to all parties."*
- *"Divergent financial interests of majority equity holders need to be considered."*
- *"Conflict between (1) wanting to have an immediately implementable plan in place now, vs. (2) desiring to maintain flexibility to bring owner/founder's children into the firm in future years and adjust the succession plan to include them later has prevented us from doing anything."*
- *"One of my three children will take over my business. He is a CFA. I struggle with how to be fair to the other children in terms of inheritance as well as being fair to two key employees."*

Lack of clarity on valuation: The industry is clearly divided into three equal groups regarding valuations — those having conducted an internal valuation (35%), those using an external firm to conduct the valuation (33%) and those that have not conducted a valuation for their firm (32%).[32] Of those with valuations, nine out of 10 advisors (87%) had performed valuations as part of the succession planning process.[32] Valuation issues are the most pressing concerns for one in 10 advisors (13%).[32]

- *"It's been challenging working with the CPA firm."*
- *"Figuring out how to value ownership is difficult."*

Firms that have conducted a valuation study within the last two years

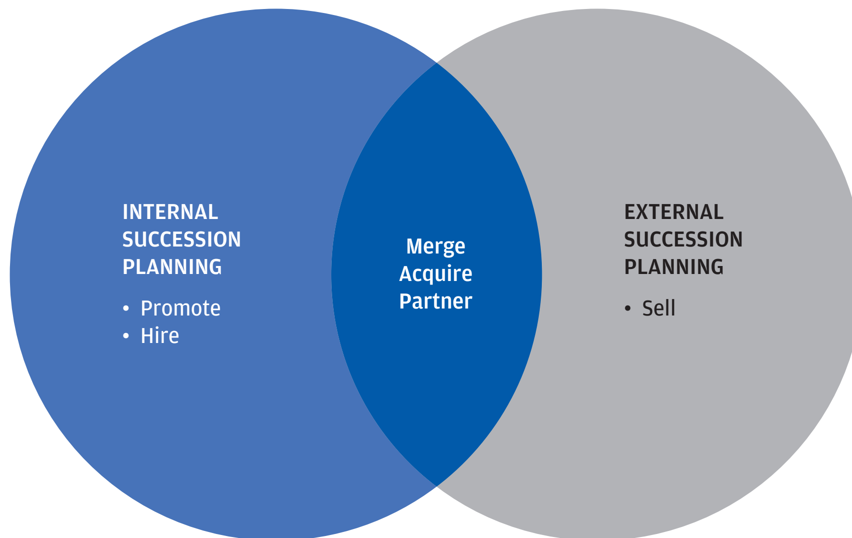


[30] 2012 IN Advisor Solutions Succession Planning Study, Succession Planning — Biggest Industry Challenge, p. 4
[31] Aite Group, The Efficient Frontier of Succession: Maximizing Practice Value, p. 14
[32] J.P. Morgan Asset Management / Focus Financial Research Study, December 2015

What are viable succession/continuity planning choices for advisors?

When developing a succession plan, you should start with the end in mind. Envisioning the outcome that you want will help you know what steps to take first and enable you to better control your destiny.

Consider what you want for yourself, your family, your clients and your team. Do you want to stay engaged; do you want to sell 100% and retire; do you want to implement an internal transfer of the business to a family member, a junior advisor or an existing partner?



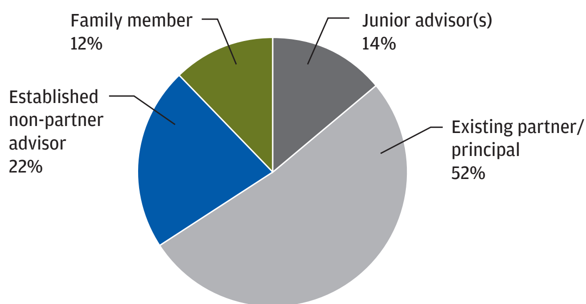
In today's advisor market, there are three possible solutions that advisors may consider: an internal succession plan, an external solution, or a combination. Each has its merits and is worth exploring.

Internal succession planning solutions

Promote: Looking inside the company for a potential successor is a logical place to start. The idea of identifying and grooming an existing employee or family member to assume the leadership role of an established practice is one option many advisor-owners consider, especially if the firm has multiple employees. The successor can be a strong manager who currently runs the operation or a solid producer with a book of business. This may be a delicate situation.

Hire: Another path worth exploring is the idea of hiring an individual from the outside to ultimately take over your business. One model popular among small firms today is to attract a younger, career-minded professional seeking an ownership opportunity.

Who will be your internal successor?



Of those who plan to select an internal successor, more than half of survey participants (52%) expect an existing partner to take over the practice.[32]

OBSERVATIONS AND PRIORITIES

- A one-time transfer of 100% ownership in a lump sum to an internal advisor or key employee (other than a family member) is rare.
- Quality people are becoming more valuable, more difficult to source and more expensive to train.
- Younger advisors as well as clients are essential to the sustainability of most independent firms.
- Potential internal "partners" must be trained and developed over time so they eventually and effectively transition to a leadership role. Figure out the criteria for evaluating them and decide the skill sets you'll need to help them develop. A variety of third-party mentorship and executive training programs tailored to the RIA business are available to support your efforts.
- It's never too early to identify candidates who may be able to lead your business one day. The sooner you identify and begin coaching the internal or newly hired resource, the greater the likelihood of success.

Financial structures for an internal transfer of ownership

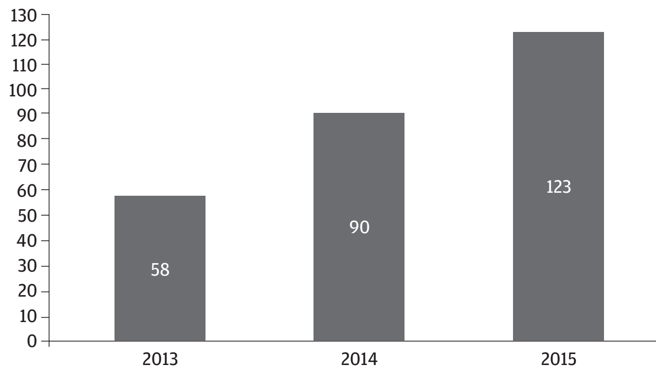
Determining whether to structure your deal as an asset-based transaction or a stock-based transaction depends on your organizational structure. If you're a sole proprietorship, you are limited to selling assets; if you're an S-Corporation or a Limited Liability Company, you have a choice to make.

[32] J.P. Morgan Asset Management / Focus Financial Research Study, December 2015

External succession planning solutions

Sell: Best described as an “exit strategy” as it entails the sale of the practice. Planning and executing an external sale of your entire business may be the fastest exit strategy, but it is also the most rare.

Total RIA acquisitions: 2013-2015



Source: DeVoe & Company, *RIA Deal Book Annual Review*

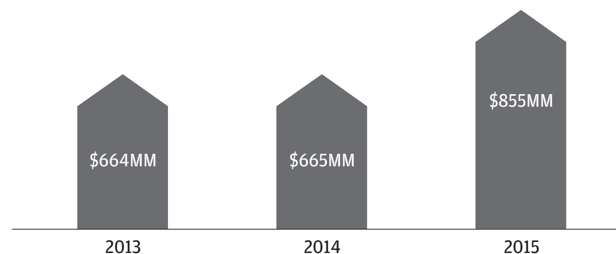
> ***In 2015, mergers and acquisitions activity in the RIA industry hit an all-time record of 123 transactions in a single year. This new high water mark is a 37% increase above 2014’s previous record of 90 transactions, and more than double the 58 transactions executed in 2013.***
>
> ***A number of external factors, ranging from the economy and the stock market, to the future success of “robo-advisors,” to supply/demand ratio of selling advisors, can and will affect the future RIA M&A market.***
>
> *DeVoe & Company*
> *RIA Deal Book Annual Review*

OBSERVATIONS AND PRIORITIES

- Practice values have been slowly but steadily increasing over the past 15 years, fueled in part by a strong and stable sellers’ market. For more than two decades, seller financing (and related payment terms) was necessary because very few buyers write a check for the full purchase price at closing. New financing alternatives are changing external succession planning.
- More than half of RIA respondents indicate that they expect to receive a multiple of revenue if they are acquired. Increasingly, however, firms are valued based on EBOC (Earnings before Owners Compensation) and EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization) though other factors are also taken into consideration, including fee models and average client age/wealth.[33]
- To maximize earn outs, sellers want a buyer who will retain the majority of clients after the deal closes. The most attractive buyers offer an established infrastructure and staff support, a multi-professional team with enough excess advisory capacity to take on new clients, adequate capital to comfortably finance the deal, and a shared investment and planning philosophy that is congruent with that of the seller’s.

Financial structures for an external transfer of ownership

AVERAGE AUM OF ESTABLISHED RIA SELLER



Source: DeVoe & Company, *RIA Deal Book Annual Review*

[33] DeVoe & Company, *RIA Deal Book 2015, Annual Review*

Combined internal/external succession planning solutions

Merge: Entails merging your practice with another practice to get economies of scale, talent, learning and expertise. This can be a great way to gain market share, develop complementary skill sets, get access to unique client niches and acquire talent.

Acquire: Entails acquiring a smaller practice and absorbing it within yours. This is a great way to buy an attractive book of clients but sometimes also comes with capable next-generation leaders who had no future in the smaller practice and could not afford to buy out their founders.

Partner: You could also share resources with a similar business, be it by merging investment committees or sharing a COO/back office structure, and have a partnership model. This is a baby step toward a full merger, but can provide a lot of benefits.

> ***"I work so hard and wear so many hats in the business; I did not have the capacity to grow the business anymore. Multitasking is difficult and I had difficulty finding qualified, experienced people to add to staffing. Merging with another firm that was the 'right fit' for my clients helped me resolve the two most important issues I had — relieve me of some of my responsibilities and add talent to the firm — and in the process, created capacity for further growth. The fact that they were able to pay me cash to buy out some of my ownership in the firm was the 'icing on the cake.'"***

OBSERVATIONS AND PRIORITIES

- A merger is a true combination of internal and external succession solutions because you are selling a portion of your firm in order to acquire a book of business and internal talent that you can groom.
- It is much easier to groom talent that has worked in a similar environment building a similar business than trying to start from scratch; hence, mergers are true talent acquisition tools.
- Mergers can also help you build scale as you gain tremendous revenue synergies by virtue of complementary client niches, geographies or even service models.
- Mergers and partnerships are most difficult to value because there are multiple forms of currency involved. And when you incorporate client transition and retention earn-outs and growth earn-outs, it adds an additional layer of complexity. A third party with expertise in structuring these deals would help you tremendously.
- Also remember capital is a very important consideration, and having an external partner or investor might strengthen your discussions.

Financial structures for a combined internal/external transition

Determining whether you want to pay in cash or in equity of the combined company is an important consideration. Sometimes, if you have an external investor, an additional form of currency in the investor's stock can also be very valuable and attractive for a potential merger partner. If the founder is exiting the business, you want to pay all cash. If it is a true merger, equity can be a great talent retention tool.

How do advisors currently feel about these choices?

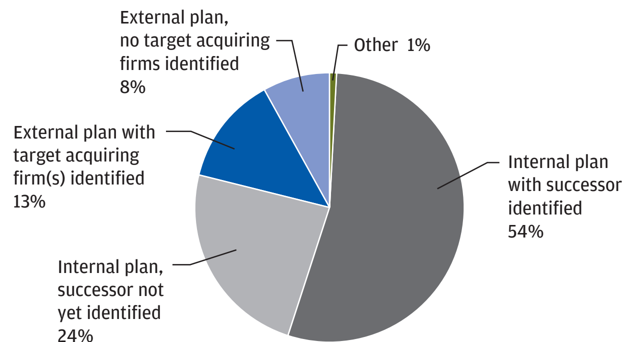
RIA industry-wide anticipated successor by affiliation model, 2015

Anticipated successor	Independent RIA	Dually registered	All RIAs
I am unsure	34.6%	29.9%	32.5%
Existing partner or principal	15.4%	15.0%	15.2%
Established non-partner advisor at my firm	5.4%	13.4%	9.1%
External buyer (not yet identified)	10.0%	7.9%	9.0%
Junior advisor	6.9%	10.2%	8.4%
Family member	6.2%	7.1%	6.6%
Other	9.2%	2.4%	6.1%
External buyer (already identified)	6.9%	2.4%	4.8%
My firm will reassign clients and I will receive compensation	1.5%	7.9%	4.4%
My firm will reassign clients and I will not receive compensation	3.8%	3.9%	3.9%

According to Cerulli, one-third of firms with more than $500 million have not yet identified a successor plan. Given the size of these firms, the impact of an internal succession and the resultant transfer of the business from a principal to a group of senior managers is complex.[34]

- Nearly one-third of all RIAs (32.5%) are unsure who their practice successor will be.[35]
- Among all RIAs, 15.2% expect an existing partner to be the most likely acquirer of their practices.[35]
- More so than advisors in other AUM tiers, 12.1% of smaller RIAs with $25 million to $100 million AUM have already identified an external buyer.[35]
- Of those intending to go the internal successor route, almost one-third of advisors (30%) have not yet identified a successor.[35]
- Our survey found that more advisors (24%) expect to sell to an external firm, though less than one-third of them (29%) have yet to identify a target acquiring firm.[35]

Succession plan choices from J.P. Morgan/Focus Financial Partners research study



Most advisors (78%) who participated in our survey reveal that they will implement an internal plan, while 20% plan to implement an external plan — whether or not they have a target firm selected.[35]

[34] Cerulli Report, RIA Marketplace 2015, p. 67
[35] J.P. Morgan Asset Management / Focus Financial Research Study, December 2015

How have other advisors tackled this issue of succession/continuity planning?

Percent of advisors who acquired a practice in past year, 2015

	Segment	% of advisors who acquired a practice
Channel	Independent RIA	5.7%
	Dually registered	13.3%
First AUM	<$25m	7.5%
	$25m to <$100m	5.9%
	$100m to <$500m	10.5%
	≥$500m	19.9%
	All RIAs	**9.2%**

Source: Cerulli Associates, in partnership with the Investment Management Consultants Association, WealthManagement.com, the Financial Planning Association and OnWallStreet

- With total AUM staying relatively consistent since 2013, it appears that the size of the deals has increased.[37]
- The market for practice acquisitions remains opportunistic.
- An imbalanced marketplace with significantly more prospective buyers has inflated sellers' expectations for practice valuations.
- Overall, only 9.2% of all advisors acquired a practice in the past year, compared to one-fifth of RIAs at large advisory practices.[38]
- Larger advisory practices (>$500m) were far more likely to have done an acquisition, and Cerulli only expects this to continue as smaller firm principals retire and seek to sell their practices.

[37] Ibid, p. 65
[38] Cerulli Report, RIA Marketplace 2015

How should you be looking at valuing an RIA?

Be it an internal succession plan, an external succession plan or a combination of the two, valuation is an important piece of the puzzle. It is also the piece that advisors are least familiar with.

There are various approaches to valuation. The "market comparable multiple" approach is the most common but because most RIA transactions are private, the lack of transparency in multiples can make this difficult. The "discounted cash flow" approach can also be helpful, but it requires many assumptions that could lead to false precision.

What should advisors not do?

- A lot of consultants propound the theory of using revenue multiples, which is the biggest misconception prevalent in the industry. A business is ONLY as valuable as the free cash flow it generates for its owners. Revenue can be high, but unless it translates into profits, it does not make the business more valuable.
- Given that RIAs are usually entrepreneurial businesses, firm owners can choose to pay themselves in many different ways — salary, bonus, distribution, benefits, profit-sharing plan, country club memberships, company car benefits and the like. Hence, EBITDA is a difficult comparable number to calculate across RIAs since EBITDA margins can vary greatly. Using an EBITDA multiple can be misleading under these circumstances.

What is the appropriate metric to look at?

A multiple of the free cash flow that can be monetized by owners (referred to as EBPC or "Earnings Before Partners' Compensation") after accounting for replacement costs for someone of their caliber to perform their duties.

100% of cash flow can never be monetized, unless an advisor/owner can find someone who can absorb their book of business without any additional expenses. So for most RIAs, their value will be a multiple of their EBPC less any replacement advisor/owner compensation.

What other factors influence valuation?

There are various other factors that go into determining the appropriate value for a firm. The factors listed below are likely to command higher valuations:

- Higher historical revenue and profitability growth rates
- Larger firms with strong infrastructures
- Higher EBPC margins sustained over time
- An increased percentage of high net worth retail clients and a less concentrated client base
- Younger client base in accumulation mode and higher client retention percentages
- RIAs with multiple partners/owners that mitigate "key man risk"
- Strong operational systems, processes and a robust compliance culture relative to peers
- Higher growth potential in specific client niches, specific geographies or otherwise

At the end of the day, valuation is an art and not a science. It will depend on what the buyer intends to do with the seller's business and the potential that the seller's business presents for the buyer.

Case studies

This section of our paper presents several case studies that illustrate a variety of common scenarios that many advisors face. While these cases are based on actual experiences, the names and locations of individuals have been changed to protect their identity. These demonstrate instances where advisors have used a combination of choices to realize their continuity vision.

Situation	AUM profile	Objective
Multi-billion dollar firm	$5 billion	Grappling with internal succession issues
Large firm	$4 billion+	Looking to provide liquidity to founder who is no longer in the business
Mid-sized firm	$400 million	One partner looking to exit while the other does not want to continue running the firm himself
Solo advisor at a wirehouse	$50 million	Looking for a career path, a backup plan and opportunity to be the successor for other advisors
Mid-sized firm	$500 million	Firm with few employees looking for a platform
Mid-sized firm	$500 million	One partner looking to buy out his passive partners and give his next generation a career path
Solo young practitioner	$400 million	Seeking backup plan for his clients
Small sole proprietor	$150 million	Looking to retire and transition clients

CASE STUDY

Multi-billion dollar successful firm

GRAPPLING WITH INTERNAL SUCCESSION ISSUES

Situation

In 2006, partners Mike, Bill, Heather and Charles sat down to put together the strategic plan for their wealth management firm for the next five years. They had built a successful firm in the Midwest with over $5 billion in assets under management and were very proud of what they had built from scratch. They also had attracted high quality talent to the organization who could take over when the time came.

The business was very profitable, generating in excess of 50% in profit margins to partners, and had about 35 employees. Their comprehensive client service model translated to a loyal and sticky client base. The organization was run very efficiently, had robust systems and processes in place and had scalable infrastructure to support steady growth.

Challenges and objectives

The partners were starting to feel like victims of their own success. The business was growing at 15% a year, attracting the right talent and making a lot of money. That also meant the business was very valuable. As they talked about the plan to gradually transition equity to potential next-generation talent, they were faced with one big issue: valuation.

At the high margins the business was generating, the fair market value of the equity was so high that, in order to buy in, younger associates would have to take on significant debt. The next generation — in their 30s and early 40s — did not have significant savings and most had mortgages and children's college educations to finance. Paying fair value for the equity would put them in dire financial straits.

The shareholders could sell their equity at a discount to the fair value in order to continue the legacy of the firm, but that didn't feel fair either. Their dilemma: They wanted to continue the legacy of the firm but also wanted a fair price for the equity they created. They had a few options available to them.

"It's so rewarding to see the next generation take the reins of our successful business and know that they have the resources to build on what we started. It's really a win-win situation for us, our employees and our clients."

— *Mike*

Options

- Stick around for longer than they wanted to and then sell the equity at a discount to the next generation
- Personally guarantee loans so the next generation could buy into the equity
- Finance the buy-in with a seller note
- Set aside a pool of funds from the firm's profits to enable the next generation to buy in
- Seek an external investor

Valuation methodology used

- Multiple of EBPC (earning before partners' compensation) monetized (monetized portion less than 60%)

Resolution and results

Mike, Bill, Heather and Charles agreed that the first four options were less than ideal and overly generous on their part. They wanted to be involved in the business but also wanted to create an equity transition path.

The partners had started talking to an external investor around the same time. This external group would buy a significant portion of their business at a very attractive multiple, which would allow the current partners to transition the remaining part of the business to the next generation at a palatable valuation. This option enabled them to reduce their involvement in the business by allowing the next generation to take over, while creating ongoing meaningful roles for themselves. The external investor also brought growth expertise and capital that would help support the growth of the firm by the next generation.

A year after they started reviewing their strategic plan, they partnered with this strategic investor, brought in next-generation employees as owners and started transitioning responsibilities, achieving the following:

- Partial monetization of equity at an attractive valuation
- Creation of an ongoing firm legacy
- Ability to step back from the business and give the next generation the opportunity to manage and grow the business

CASE STUDY

Large firm

LOOKING TO PROVIDE LIQUIDITY TO FOUNDER WHO IS NO LONGER IN THE BUSINESS

Situation

In 2009, Susan started a conversation with Greg, the firm's founder, to talk about his transition plan. Greg had transitioned out of the day-to-day operations but still owned 60% of the business, and there was no economically viable plan to buy him out. Susan and her partners did not have the resources to buy him out and he was not willing to take anything less than a fair value. That meant that 60% of the profits of a firm generating in excess of $10 million in revenues was going to a non-contributing partner.

Susan had been brought in to manage the firm and had succeeded in both enhancing its level of professionalism and positioning it for accelerated growth. She had plans to grow the firm through acquisition, but this required an operational and technology overhaul as well as capital. The arrangement with the founder definitely limited the resources available to bring ideas to life.

Susan had already identified a few firms and had initiated conversations, but given their constraints, she could not come up with the right transaction structure nor the capital.

Challenges and objectives

As Susan and her partners looked at the future trajectory of the business, they realized that they needed to buy out Greg, to avoid "founder overhang" on the organization and take it to a new level. They wanted to preserve their independence and create a new governance structure that would enable them to achieve growth faster. So they began looking for sources of capital.

"Going into it, I had my doubts, as these situations can be very complicated emotionally. Assessing the 'fair value' of a founder's share of the business is not all black and white. But our patience and diligence finally paid off. Access to external capital enabled us to satisfy Greg's needs and gave us the framework we needed to raise the firm's profile and service model to a whole new level."

— *Susan*

Options

- Get a loan from a bank to finance the buyout of the founder
- Merge with another RIA
- Sell to an RIA platform aggregator, but they would lose their brand, their unique sense of identity and, most likely, clients in the process
- Join forces with a strategic non-controlling partner who would provide the capital to buy out the founder

Valuation methodology used

- Multiple of Greg's portion of EBPC (Earnings Before Partners' Compensation)

Resolution and results

Susan and her partners evaluated all the options. After talking to a bank, they realized that none of the partners had the financial strength to take on the significant loan that a buyout required, and the founder was not willing to guarantee the loans. They also spoke to other RIAs and platform aggregators, but were not keen on forfeiting their brand, independence or sense of identity. They were business leaders and didn't believe that any of the firms they talked to could add further value or make them better.

Susan and her partners sought out strategic investors and one piqued their interest. This group would allow them to remain independent, control their business and monetize a portion of their business, primarily the founder's share. In addition, this partner would bring M&A expertise and additional capital to the table to enable inorganic growth. They selected the fourth option, and three years into the partnership, the firm's expansion record is staggering:

- Increased billable assets over 300%
- More than doubled the number of clients and grew revenue over 150%
- Increased profitability over 200%
- Tripled the number of locations through acquisitions and mergers
- Expanded the suite of client services as a result of strategic mergers
- Implemented a professional governance structure with a large, cross-sectional executive committee that serves as the primary decision-making body; multiple strong leaders fully empowered, with the founder completely out of the business

CASE STUDY

Mid-sized firm

ONE PARTNER LOOKING TO EXIT, THE OTHER DOES NOT WANT TO RUN THE FIRM HIMSELF

Situation

In 2010, Eric sat down with his partner Scott to discuss his plans. With $400 million in assets under management, they had grown steadily over the years and had a very loyal clientele who had been with them for an average of 10 years or more. But there was a big issue. Eric was 80 years old, and Scott was 53 years old. Eric had been in the business for much longer than anyone expected, but he was ready to retire and enjoy his life.

Scott, on the other hand, had been happy playing second fiddle to Eric and had no interest in running the business on his own. He had some clients of his own, but most had been brought in by Eric. Scott enjoyed the client service but was not particularly excited about the prospect of running, managing and growing a firm.

Challenges and objectives

Scott and Eric thought through the challenges they were facing:

- Eric needed to have a smooth transition out of the business
- Scott needed support in running the firm

> "There's a lot of noise in the marketplace right now about RIA mergers and acquisitions. You have to find a deal that works for all the parties – and the right fit is essential. In our case, our small scale and inadequate technology were inhibiting our growth. We were fortunate to find the right partner at the right time, and our combined assets have dramatically improved our market position and our staying power."
>
> – *Scott*

Options

- Promote someone internally to help Scott
- Hire someone to help Scott
- Sell to another local RIA that can run the business
- Sell the entire business and both Eric and Scott walk away from it
- Merge/partner with another RIA

Valuation methodology used

- Multiple of EBPC (Earnings Before Partners' Compensation), less Scott's ongoing compensation

Resolution and results

Eric and Scott were not 100% satisfied with any of the first four options. Scott had kids in college and wanted to work for another 10 years. They decided that partnering with another RIA might be the best option, despite the loss of complete autonomy.

They were approached shortly thereafter by an RIA in the region that wanted to establish a presence in their city. The new firm had a similar client base, service model and investment philosophy. Most importantly, the RIA was larger and had an established management team effectively running the business. The founder, Don, was well respected and looking to grow the business.

This was a great solution for Scott, who could independently run his office while getting back-end and infrastructure support from the main office. Eric could retire and Scott would become a partner in the larger combined RIA. They pursued this option and three years into the partnership, the merger has been a resounding success:

- Eric was able to retire and get full liquidity for his equity at a fair value. Eric exited the ownership of the business but retained limited client service responsibility and was able to create a permanent legacy for his clients. Unfortunately, he passed away suddenly one year after the transaction, underscoring the timeliness of the transaction for his clients and his family.
- Scott was able to continue running the small office with the support of Don and his team.
- Scott was able to contribute strategically to the growth of a larger combined firm.
- Scott was also able to create a glide path to retirement for himself, since the larger combined firm had a good group of next-generation leaders who could take over from him when needed.
- Scott was able to attract better talent now that he could create meaningful paths to partnership for next-generation advisors in the new combined firm, as compared to those in his smaller one-location firm.

CASE STUDY

Solo advisor at a wirehouse

NEEDED A BACKUP PLAN, BUT ALSO WANTED TO BE THE SUCCESSOR FOR OTHER ADVISORS

Situation

In 2012, 26-year-old Lisa, an advisor at a major wirehouse firm, was looking at her production numbers for the quarter. She had been doing very well and bringing in new clients. With $200,000 in annual production, she would take home about $60,000. But without a team to support her efforts, there was little opportunity to aggressively grow her book of business. Her mother had been in and out of the hospital and she worried that others would appropriate her client relationships if she had to take a sudden leave of absence.

Lisa decided to look at options available to her. She could move to another wirehouse but that would not address her problem. Lisa also had been following developments in the independent space for a while, and looked up a team that had left and formed an independent RIA with the help of an external expert in her area. This larger firm had over $2 billion in assets under management and had been steadily expanding its presence since leaving the wirehouse space two years ago. They had also retained more than 95% of their clients through the 'transition to independence' process. The larger firm was looking for a new advisor to join the team who potentially could take over clients from the older founder over time.

Lisa decided to talk to them. She was excited about being part of a team and possibly being the succession solution for an aging advisor. She also decided to talk to other wirehouses to make sure she considered all her options.

Challenges and objectives

As Lisa thought about the challenges she was facing, she realized her goals were two-pronged:

- She wanted a career path and ownership options
- She wanted to be part of a cohesive team where fellow members could rely on each other and act as a backup for each other if necessary

> "I was really in a dead-end situation, and I couldn't see my way out of it. What a difference a couple of years has made on my attitude and my production. When you can envision being a part of the future of a thriving organization, it unleashes a new sense of purpose. Now I have a clearly defined career path and, just as important, I am confident that I made the right decision for my clients."
>
> — *Lisa*

Options

- Join a different team at her current wirehouse firm
- Join a team at another national firm
- Start her own RIA
- Join an existing RIA

Valuation methodology used

- Percentage of revenue transitioned (since there were no significant additional expenses to Lisa joining the RIA), less her compensation payout

Resolution and results

Lisa was convinced that the independent world was the way to go, and she decided that joining another RIA was the right path for her. She could learn from a team that shared similar roots; she could have a career path with ownership options; and she would be doing the right thing for her clients. The RIA's external partner had industry expertise and capital to help structure her deal and assist her in the transition process.

Two years into her decision, Lisa could not have been happier. She transitioned to the RIA in 2013 with about $50 million in assets. She transitioned most of her book of business and also implemented a fee increase while still saving her clients money. By year end 2014, she was billing more than $300,000 and taking home $80,000 in salary. In addition, she was introduced to new clients sourced by the partners at the RIA, and made an additional $50,000 on the revenue-sharing of the shared business.

She has gradually been introduced to older partners' clients and has taken on more responsibility for those accounts. The RIA benefited from hiring Lisa as well. They not only found a young advisor with a book of business who was hungry to grow, but also someone they could see as a next-generation leader. Lisa will be the potential successor for the clients of older partners who increasingly would step back from the business.

CASE STUDY

Mid-sized firm

FEW EMPLOYEES LOOKING FOR A PLATFORM

Situation

In 2015, 72-year-old Derek was invited to attend a study group meeting of some of the elite RIAs in his region. Derek had spent 15 years building a firm that employed 5 qualified individuals and managed $500 million in assets for high-net-worth clients. Derek had always considered himself a successful entrepreneur, but a shake-up at his firm in 2015 left him questioning this belief. He had not experienced much employee turnover since he had started the firm, and in 2013 he had hired two young bright advisors, Ryan and Sid, who were doing a great job bringing in new business and helping him with investments. But both of them suddenly left in 2015 without warning, and in the process, ended up taking clients with a total of $50 million in assets under management. This was a rude awakening for Derek, who decided to use this as an opportunity for introspection. The study group's discussion topic of continuity planning could not have been better timed.

Challenges and objectives

Derek realized that he had always treated his firm like a hobby, where he could do what he loved most – investing money. He had failed to build a firm culture, had not developed his team or put in established systems or processes. Ryan and Sid could not see a future for themselves at the small firm, and left to start their own.

Derek knew that his passion lay in investing, but to provide his clients with better service – and his employees with better career opportunities – he needed to make a change. He began looking for other RIAs he could merge with. His criteria were specific – the RIA firm would need to have a culture of client service, operations and compliance that Derek's firm could leverage. He also sought a firm that had expertise in financial planning that would complement the investment advisory services he offered his clients. Lastly, he wanted to be able to continue offering the same investment advisory solutions for his clients.

> "I had done a poor job as a leader, which ultimately led to Ryan and Sid leaving the firm. After joining a new firm and transitioning to their model of client service systems and processes, I am convinced that this is the better solution for my clients in the long run. They will be taken care of with a much higher standard now and into the future. And my employees now have a bright future at a growing firm and something to look forward to."
>
> – *Derek*

Options

- Join an established RIA in his region that he had identified as a great complement to his and his team's skill sets
- Become the local branch office of a larger asset manager based in another part of the country
- Hire someone internally who could implement the culture that he wanted

Valuation methodology used

- Multiple of EBPC plus any platform synergies, less Derek's ongoing compensation

Resolution and results

Derek realized that hiring someone was out of question. He was 72; clients were already asking him about his continuity plan and he did not have the luxury of time.

The asset management firm option was appealing to him since it valued his portfolio management skills, but it would not resolve any of his concerns.

A local firm in his region was the best option for him. After speaking with several viable firms, Derek chose a local RIA firm that met all of his criteria. He joined the firm and a year after the merger, he was elated that his plan had actually worked and helped him achieve the following:

- He was able to focus most of his time on portfolio management while other advisors at the firm worked with clients.
- His employees and clients were put on the other firm's strong operational systems and processes, which greatly improved efficiency.
- He could now be totally distanced from business management issues like compliance, HR and payroll, which previously had been cumbersome.
- He had tremendous flexibility, allowing him to focus on what he loved while mentoring some of the younger investment specialists at the new firm.

CASE STUDY

Mid-sized firm

ONE PARTNER LOOKING TO BUY OUT HIS PASSIVE PARTNERS AND GIVE HIS NEXT GENERATION A CAREER PATH

Situation

In 2015, Bob met with his eight partners in the wealth management firm to discuss the future of the business. He had started the firm with an accounting background, and his accounting partners had invested in the business as partners instead of becoming solicitors. The relationship had been a very fruitful one, and they grew to $500 million in assets under management.

However, while Bob was running the firm, most of the business growth was coming from client referrals and work done by his next-generation advisors, and his partners did not have a steady stream of referrals to send their way. They were splitting profits, but the time had come for Bob to discuss the future of the firm with his partners.

Bob wanted to buy them out, so he could offer next-generation advisors equity in the company and plan for his own succession. He was almost 60 years old and even though he had no intention of retiring soon, he wanted to step down from his day-to-day responsibility as a CEO. He could not do that without incentivizing his younger advisors to become owners. But he also did not have the capital to buy his partners out, nor did his younger advisors. And his partners wanted a fair value for their investment — a common problem in the industry.

> "You get to a point when you realize that if you want the firm you've built to continue to grow in the future, you have to plan for it. Sometimes the solution is better than you ever imagined. In our case, the planning process set in motion a direction for the company that not only compensated the original partners, but gave the next generation an opportunity to participate in the future of a larger, growing enterprise."
>
> — *Bob*

Challenges and objectives

As Bob thought through the challenges he was facing, he realized they were three-fold:

- He needed to buy out his partners who were passive investors in the business
- He needed to find a way to incentivize his next-generation advisors
- He needed to find a way to gradually decrease his day-to-day responsibilities

Options

- Get a loan from a bank
- Get another external investor
- Merge with another RIA that can run the business and provide the capital to buy out his partners

Valuation methodology used

- Multiple of EBPC (Earnings Before Partners' Compensation), less Bob's ongoing compensation

Resolution and results

Bob went to the local banks and inquired about a loan. The interest rates and personal guarantees required made it extremely unattractive for him and his younger advisors. He spoke to external investors but his younger advisors were not in favor of bringing another passive investor into the company unless they could add value.

Bob was discussing the issue with Mark, one of his longtime acquaintances in the business, when Mark mentioned casually that their firms could fit together. Mark had just added an advisor in the region to his team and was looking to expand. Their firms came from similar roots in the accounting world and had very similar practices. Bob was excited about the option, but wondered where Mark would get the capital.

Mark had partnered with a value-added investor who helped him with consulting, expertise and capital for organic and inorganic growth, and capital was not an issue. Given that Bob knew Mark's firm well, the only remaining issue was the path forward for his younger advisors.

Bob decided to partner with Mark, despite the loss of 100% autonomy. And his next-generation employees were thrilled to be part of a larger, faster growing firm where the career and development opportunities were attractive. More importantly, Mark had a full-time CFO, COO and CCO, and Bob could step back from his day-to-day responsibilities and focus on client service and new business development. He had finally managed to put in place a robust succession plan for himself and his passive partners — one that was the right solution for his clients and his employees.

CASE STUDY

Solo young practitioner

SEEKING A BACKUP PLAN FOR HIS CLIENTS

Situation

Jason, a 36-year-old financial advisor, owns an RIA firm with about $400 million in assets under management. One evening in 2014, he was crossing the quiet street near his home when a car suddenly backed out of a driveway and almost hit him. He fell down and sustained a few scratches and bruises but nothing more. It was his neighbor's teenage daughter who was learning to drive and he let it go.

But as he was getting his bruises checked at the hospital, he began thinking – "What if?" What if the car had hit him and he had died? What if he had been permanently disabled? His life insurance policy would protect his family, but what about his clients?

Jason had read about an advisor who died unexpectedly in Wyoming, leaving his clients to scramble to form an advisory board to sell the firm. Jason couldn't see his clients doing that; if something happened to him, they would be at a loss. Some of his clients had been with him since he started 10 years ago; they wouldn't know who to turn to or how to find another financial advisor. To do right by his clients, he needed a plan to activate in case something ever happened to him.

Challenges and objectives

As Jason thought through his objectives, he had one goal in mind: to find a firm that would give his clients the same level of service that he did, a firm that would take care of them like he did and give them a similar or better experience.

Jason wanted to find a firm that shared his evidence-based investment philosophy. With clients based across the country, location was less of a concern than what he called a "cultural fit" for his clients.

"Beyond just meeting a regulatory requirement, I have to admit that the peace of mind that comes with having a bona fide contingency plan for my business is empowering. I now have a solid backup plan in writing that will protect my family and my clients in the event I am unable to provide for them. And it hasn't gone unnoticed with clients and prospects. In fact, I'm using it as a business development tool."

– *Jason*

Options

- Join a broker/dealer platform, so another firm on the platform could be his successor, if needed.
- Find a firm that fit his service model and philosophy, and try to draft documents showing what a contingency agreement could look like (would involve legal fees and issues he was not intimately aware of).
- Find an existing succession planning program that would satisfy his requirements.

Valuation methodology used

- Percentage of client revenue that transitions over to the successor RIA paid over a period of five years

Resolution and results

Jason set about trying to find a good fit in circles he knew. He asked his custodial RMs, he asked around in his study groups, and serendipitously, around the same time, he got a call from an investor in the industry about a newly launched program intended to solve RIA succession planning issues. He took the call and agreed to an introductory meeting with a firm that could be a potential backup.

The firm managed $2 billion in assets and was located in the next state over. He was amazed by their similarities in the first conversation and decided to visit them. The visit and conversations with members of the firm convinced him that this was the right option for his clients. He could not believe his luck; he thought the process would take a year or two; it had taken him two months.

- He engaged in a program that offered all the relevant documents to address his regulatory concerns over business continuity planning and protecting his family's economic interest in the business. He signed the documents and over the next several months got to know the firm better.
- The "aha" moment came when he realized that existing and potential clients who were worried about doing business with a one-person firm were far more willing to sign on knowing their accounts would be handled in the event he was unable to manage them.
- Jason not only secured a robust business continuity solution for his clients, family and regulators; he was able to leverage it for business development. Most importantly, he was satisfied that he had done right by his clients and planned for the security of their financial future.

CASE STUDY

Small sole proprietor

LOOKING TO RETIRE AND TRANSITION CLIENTS

Situation

In 2013, John, the sole proprietor of a $150 million AUM firm based in a small town in New Jersey, set out to define the future of his business. He was 65 years old and offered comprehensive financial planning, investment management and tax consulting services to about 70 clients in New Jersey and Florida, most of whom had been with him for more than 20 years.

John had one employee who had been with him for 30 years and provided administrative, operations and client service support. He had a very profitable business but over the last few years it had become a lifestyle business for him — he loved what he did but had not actively grown his business.

Challenges and objectives

- John knew he couldn't take on new clients without hiring additional staff or sacrificing his work-life balance. More importantly, he wanted to retire in three to five years and had no one in mind who could take over his clients or business. Internal succession could have been an option if he had started planning 10 years ago. A true fiduciary, he needed to create a robust continuity plan for his clients, and he realized he had to look externally for a solution.
- He wanted to find a good firm for his clients, an advisor who his clients would be comfortable with and a monetary package that would enable him to retire comfortably in Florida.

> "I couldn't hope for a better outcome. After 30 years, I am finally in a position where I can transition to retirement knowing my clients will be taken care of properly."
>
> — *John*

Options

- Join forces with a similar-sized firm and create something bigger
- Join a larger firm where he could become an employee and find a way to transition clients to another advisor
- Do nothing
- Explore a unique succession planning program that enables advisors to provide continuity of service to their clients should they wish to retire or in the event of an unplanned life circumstance. This “living will” for his business would give him full control, as well as a robust continuity plan for transitioning clients to a firm that shared his service philosophy. More importantly, this agreement was free and non-binding. There was really no downside.

Valuation methodology used

- Multiple of EBPC (Earnings Before Partners’ Compensation), less a portion of John’s compensation (since he has a fixed retirement date in three years and his book will be absorbed by a junior advisor, ongoing compensation to service his book will be lower than his compensation in the first three years).

Resolution and results

John signed the succession agreement with the larger firm and the actual “dating” started. He got to know the “successor” firm’s principals and advisors better. He learned about their business model in detail and met the entire team without the pressure of having to reach a deal right away. The more he learned, the better he felt about making a decision, knowing his clients would be well taken care of.

Eight months after he signed the initial succession agreement, John decided to merge with the firm and defined a retirement path for himself in three years. He achieved his objectives by securing a seamless transition plan for his clients and an attractive value for his business.

A year after the merger, John has assimilated into the firm, has started the process of transitioning his clients to another advisor thereby reducing his workload and is very happy with what he was able to achieve:

- Seamless transition and continuity plan for his clients
- Continuation of high level of service for clients
- Gradual retirement plan for himself having fulfilled his fiduciary obligations
- Full liquidity for his business at an attractive valuation

What should your succession planning timeline look like?

When	What
10 years from retirement	• Begin thinking about your succession plan, envisioning at least the broad outlines of your exit strategy and what is important to you. • Seek guidance from a third party. • Develop a contingency plan.
5 years from retirement	• Identify potential successors. • Assess your “salability” — including growth plans, client retention strategies, technology to improve operating margins and efficiency. • Consider an acquisition or merger — an effective strategy that enables you to quickly increase market share and scale. An expanded business may be more valuable, making it easier to attract new talent and access capital when you need it. You may also benefit from the skills and expertise of added staff members. • Develop a contingency plan.
3 years from retirement	• Communicate your intentions and develop a plan to mentor your successor. • Simultaneously, scour the market for firms that look and feel like you. Start detailed conversations, because your successor could fail and you need a robust backup. • Focus on the fit more than the valuation — but pick a firm with a good track record of completing successful transactions and the requisite capital. • Develop a contingency plan.
1 year from retirement	• Reach out to a third party immediately. There is no time to groom an internal successor. You need to find a firm that your clients will like and that can pay you the appropriate value for your business. You need to be around for six to 18 months after to help transition your clients to the firm as well. This should be your contingency plan.

Implementation/next steps

1. **Educate yourself**
2. **Engage stakeholders**
3. **Prepare yourself emotionally**

Talk to associates you respect who implemented a successful transition plan; ask your service providers about firms they know and trust. And talk to your accountant to ensure that you've considered all the issues.

It may help to seek guidance from a specialized firm that understands the wealth management business, has experience working with firms similar to yours and has a proven track record with transactions for mergers, acquisitions and succession planning. A third-party professional can help you ask the right questions and make better decisions.

Involve your family from the beginning. When the time is right, talk to your employees about your succession plan. And communicate the message to your clients. But most importantly, communicate with yourself.

You have a fiduciary duty to your clients and you need to be prepared to do what is right for them. ALWAYS!

Following are a variety of resources that may help you shape your firm's succession plan and future:

Resource	Content
Focus Financial Partners®	Focus has been offering the Focus Successions® solution since 2013 — we see it as an integral part of being a successful advisor to your clients. As of the end of 2015, more than 70 independent RIAs have signed succession agreements with a Focus Partner Firm. Learn more at http://focusfinancialpartners.com/business/succession
Michael Kitces *Nerd's Eye View* Blog	A variety of blog posts on the subject of succession planning, including https://www.kitces.com/blog/why-profit-margins-should-matter-to-any-financial-planning-firm/
Success and Succession: Unlocking Value, Power, and Potential in the Professional Services and Advisory Space	Written by Eric Hehman, Jay Hummel and Tim Kochis, and released September 2015 by Wiley Publishers, *Success and Succession,* examines the leadership transition process from the successor's point of view and outlines the considerations and strategies that lead to a better future for the business. http://www.amazon.com/Success-Succession-Unlocking-Potential-Professional/dp/111905852X

Next steps

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Authors

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Rajini Kodialam is a Co-Founder of Focus Financial Partners, the leading international partnership of independent, fiduciary wealth management firms. Focus provides unrivaled access to best practices, resources, and continuity planning for its partner firms who serve individuals, families, employers and institutions with wealth management, benefit and investment consulting services. Focus partner firms maintain their operational independence, while they benefit from the synergies, scale, economics and best practices of the market leader to achieve their business objectives.

Prior to founding Focus, Rajini was a Vice President at American Express in New York where she managed the overall online experience for the U.S. Consumer Card and Travel businesses. Rajini also worked in the Strategy and Business Development Group at AMEX where she helped launch new online brokerage and banking services. Prior to joining AMEX, Rajini was at McKinsey & Company in New York, working primarily on strategic initiatives for consumer financial services firms.

Rajini holds an MBA from Columbia Business School, New York, a PGDM from the Indian Institute of Management, Ahmedabad and a BA from Delhi University, India.

She is a member of the Young Presidents Organization™ and is part of the Executive Committees for both the Financial Services Network and WYN, YPO's™ Women's Network.

Rajini lives on the Jersey shore and is an avid gardener who enjoys experimenting in the kitchen for her husband and two sons.

Steve Lundquist, CIMA®

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Steve Lundquist is the head of the Institutional Advisor Division of J.P. Morgan Asset Management. An employee since 2001, Steve is responsible for the division's business strategy as well as managing the team of client advisors and national account executives that represent the firm's mutual funds, separately managed accounts, hedge funds and structured notes. The team is dedicated to partnering with registered investment advisors, custodial platforms, family offices, turnkey asset managers and bank trust and independent trust firms across the country. Starting his career in 1989, Steve previously worked with Fortis Financial Group and Fidelity Investments. Steve earned a BA from Gustavus Adolphus College and an MBA from the University of St. Thomas and holds the Certified Investment Management Analyst (CIMA®) designation.

Tom McKean, CFA

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Tom is a Client Advisor for the Southwestern territory of J.P. Morgan's Institutional Advisor business, based in Los Angeles. He has 20 years of experience in investment management. Prior to joining J.P. Morgan Asset Management, Tom served as Senior Portfolio Advisor with Kayne Anderson Rudnick, a small-cap boutique, where he reported to the CIO and managed the Western business with brokers, institutions and private clients. Earlier, Tom was Vice President and Western Regional Director with Schwab Funds/Laudus Funds, building a new business with independent Registered Investment Advisors. He also held positions in business development within the institutional channel, initially with SSR Realty Advisors (now BlackRock Realty), then with Barclays Global Investors. Tom has a BA in architecture from Yale University, an MBA in real estate from the University of California at Davis and is a CFA charterholder.

Anita Venkiteswaran

Vice President, Focus Financial Partners

Anita is responsible for business development, relationship management and acquisition activities at Focus. She also manages the Focus Successions® program which provides advisors with a viable business continuity plan for the future.

Prior to joining Focus, Anita worked at CI Capital Partners, a middle market-focused private equity firm based in New York City. At CI Capital, Anita was responsible for sourcing, evaluating, and structuring transactions, coordinating and conducting due diligence, and monitoring the investments post-acquisition.

Prior to joining CI Capital Partners, Anita worked at Audax Private Equity in Boston where as part of the investment team, she analyzed new investment opportunities and worked on improving existing portfolio companies. Anita started her professional career at McKinsey & Company where she helped clients across industries devise and implement strategic and operational initiatives.

Anita received her MBA from Harvard Business School and her B. Tech in Biotechnology & Biochemical Engineering with honors from I.I.T. Kharagpur, India.

She lives in New York City and enjoys traveling, playing tennis and scuba diving. She is also on the board of Dance Films Association, a non-profit organization based in New York City.

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Focus Financial Partners, LLC, is the leading international partnership of independent, fiduciary wealth management firms. Focus provides unrivaled access to best practices, resources, and continuity planning for its partner firms who serve individuals, families, employers and institutions with wealth management, benefit and investment consulting services. Focus partner firms maintain their operational independence, while they benefit from the synergies, scale, economics and best practices of the market leader to achieve their business objectives. For more information about Focus Financial Partners, please visit www.focusfinancialpartners.com.

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