The Case for Succession Planning

Of the 467,000 registered reps, 176,000 are independent and 41% are over fifty.

The inherent beauty of the financial planning profession lies in its applicability to all people. Conceptually, it transcends cultural, social, and wealth boundaries. A confluence of factors, including our nation's economic plight and our aging population, makes financial planning a more relevant and opportune career discipline. As industry leaders, we steward the evolving nature of our profession and educate our retiring group of legacy financial advisors. The financial dreams, goals, and needs of America depend upon our profession addressing succession planning.

Effective succession planning is emotionally complicated and deeply personal. The decision by a financial advisor to consciously evaluate how to retire or transition is perhaps the most difficult one they will encounter. We hope this white paper will accomplish the following:

- Engage financial advisors and convey the risks associated with not having a succession plan.
- Raise awareness among the national advisory community that not having an exit strategy is a ubiquitous, national phenomenon.
- Provide our audience with pertinent information and, ultimately, a more expansive decision-making framework when personally addressing this industrywide quandary.

Background

The age demographics in the United States have changed rapidly over the past several decades. The number of Americans age 65 and older is expected to more than double, from roughly 40 million people today to 89 million people, by 2050. As this shift in age structure plays out, addressing the social and economic consequences, particularly as they relate to retirement, Social Security, health coverage, living arrangements, and kinship networks, will require focus from both the public and private sectors. 10,000 U.S. residents will retire daily over the next 17 years. With only 5% of the existing 316,000 U.S. financial advisors under age 30 and 10% over age 60, a colossal challenge exists on the wealth management succession-planning frontier. The average age of an advisor now exceeds 50. Several trillion dollars of hard-earned investment and retirement capital will move from retiring advisors to their successors. Perhaps more significantly, most advisors do not have a succession or contingency plan, nor are aging wealth managers formulating a solution as retirement age comes into focus. Additionally, the war for talent, which describes the established industry practice of aggressively recruiting the competition's seasoned advisors, has resulted in a substantial shortage of young advisors, further compounded by the fact that the profession is expected to expand by 32% over the next decade, according to the Bureau of Labor Statistics.

Recognize the Risk

By definition, a financial advisor's job is to guide their clients and best position them for achieving their desired lifestyle and retirement vision. Ironically, these same advisors devote very little time to protecting their own business equity: generally fewer than 30% of all advisors have undergone the process of formalizing an optimal exit strategy or succession plan. A total of 4 out of every 10 financial advisors will retire in the next 10 years, and 42% of these advisors lack a succession plan.

Many advisors have neglected to address, or even understand, how their decisions impact their clients and their heirs, especially in the event of an untimely death.

While the likelihood of being struck by the proverbial bus is something most people would rather not think about, life and disability insurance and an adequate succession plan are two necessities advisors routinely recommend to clients but neglect to implement for themselves. From a risk perspective, advisors may not realize that the Financial Industry Regulatory Authority (FINRA) forbids commissions and advisory fees to pass through to a nonregistered spouse in the event of death or disability, making a succession plan critical for realizing the true value of a life's work. Protecting heirs and addressing personal and professional interests with a well-structured succession plan is beneficial on several levels. Advisors are surprised to learn that succession plans, which provide clarity, positively correlate with growth in enterprise value.

A lack of standardized options, varying degrees of competency, product innovation, technological disruption, and a fragmented industry all perpetuate ambiguity and confusion when attempting to formulate a succession plan. Business owners may leave involuntarily as a result of incapacity or death or the loss of the key person, which can devastate an advisory practice and force liquidation at an inopportune time. Additionally, the difference between a written plan and a mental plan is seismic. Advisors will often mentally formulate a plan but fail to include defined dates, intentions, and people, resulting in marginal or unrealized outcomes.

"Advisors who don't make an exit plan early enough slowly lose their clients to death or desertion and may be forced to sell or shutter their practice abruptly at the cost of leaving potential on the table. This does not have to be; options exist for advisors."

-Mary Ann Buchanan, RIA Match founder

Figure 1. Independence Demographics
(As a percent of registered reps)

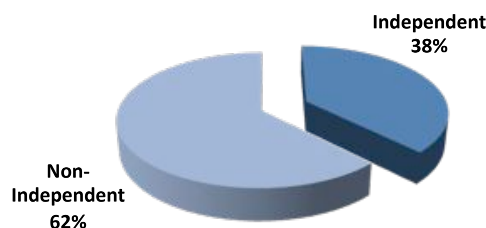
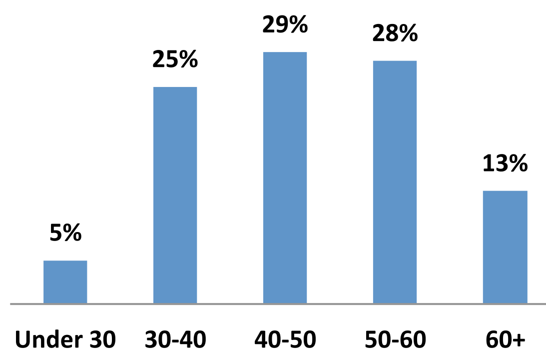


Figure 2. Industry Age Demographics
(As a percent of registered reps)



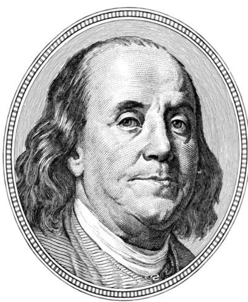
Source: Meridian IQ March 2013

Exit Strategy Inevitability

Exit strategies and succession planning are predicated on a series of proactive decisions. A comprehensive exit plan encompasses issues beyond the obvious monetary ones, including control—ensuring that an entity or financial asset remains with a family—providing care for valued employees, and establishing a legacy. Financial planners often follow the trend of many small businesses in the United States: they ultimately hand over the reins of their practices to a successor too late, failing to protect their legacy or realize their intended vision of succession.

As Benjamin Franklin said, "Failing to plan is planning to fail." Advisors who, for whatever reason, continue to neglect their inevitable transition are subject to an array of risks, including an adverse impact on their families, loss of realized practice

value, orphaned clients, slower growth potential, and legacy erosion. Given the magnitude of these issues, it would seem logical that every advisor would be proactive in mitigating these risks. However, 54% of advisors lack a succession plan and do not know the value of their practice. Financial advisors can be also be disadvantaged because they may lack a support structure, resources, guidance, and options. As with many businesses, regardless of the industry, there is a strong emotional attachment that complicates transitioning a planning practice. Clients that were once strangers are now friends and extended family. Clients have entrusted the advisor with their most intimate information, which leads to the development of strong bonds and a different trust wavelength. A wealth manager's identity is embodied in these relationships, which may now constitute some, or even all, of the advisor's closest friends.



"Failing to plan is planning to fail."

-Benjamin Franklin [1706-1790]

Succession Planning Barriers

There are many reasons that financial advisors fail to plan for their retirement and business succession. The lifestyle, daily personal gratification, a sense of immortality, ego, lack of trust in a potential successor, the desire to retain control, or even fear of retirement boredom are all contributing emotional factors. Advisors must also acknowledge that the way they entered the business may not be the most prudent way for their successor to enter the business. In many of the major brokerage firms, clients are reassigned immediately after an advisor gives their resignation notice. The ruthlessness and ferocity of this unofficial, but standardized, practice intimidates advisors. Legacy advisors resent and fear having to fight their former colleagues for their clients, one account at a time. This process further compounds the succession-planning dilemma, so much so that many advisors simply "turn out the lights" and retire from their practices without monetizing the equity in their businesses.

CFP BOARD

"Advisors take the personal delivery of financial planning and the relationships with their clients so seriously that they are reluctant to delegate to the next generation."

-Kevin R. Keller, CFP Board CEO

Advisors care about their clients, and some, understandably, dread the day they will no longer be the center of their clients' lives. The process is time-intensive, and the stress of so many moving parts can be difficult to manage. Most retiring legacy financial advisors have spent several decades building a successful practice. They now face the reality of transitioning at least some aspect of their responsibilities in order to enjoy their own retirement. Advisors overlook discussing their dreams and having the retirement conversation with their families.

This phase of life is well earned and well deserved, but addressing succession has proven to be a prodigious obstacle for the entire industry. Advisors need a partner firm that understands that this process involves more than transitioning an existing book of clients to a larger, more established one. Furthermore, legacy advisors that have worked with the same people are often averse to moving their clients.

The transition process for financial advisors frequently lacks continuity. Advisors who sell their practices, instead of forming a legacy partnership with a specializing firm, usually find that their transition resulted in low client retention. According to the 2012 NFP Advisor Group Research report, one in four advisors retain fewer than 50% of their clients. NFP also found that client retention was the single greatest obstacle to integrating and realizing value in an advisory purchase transaction. The work associated with transitioning one's practice is substantial and can be rather intimidating to the retiring advisor. This process includes the need to articulate the expected

transition to each client, employee, and center of affluence. The process of researching and obtaining guidance about regulatory and legal requirements, systems and technology consolidation, investment allocation changes, and modification of client agreements is intense and daunting.

Options Today

The time required to create a roadmap for each exit strategy—transitioning to part-time work, phasing out operations, or exiting altogether—varies, but it is important for the advisor to know that their menu of choices narrows as they approach decision time. Advisors have one of several distinct succession plan models. The fragmented market helps reinforce the challenge of finding the right match. Advisors who proactively evaluate their options and commit to a succession plan often begin by having an objective in mind. Mergers & acquisitions (M&A) consultants advise preparing 10 years in advance of a succession, but most advisors take a reactive approach to this preparation Consequently, they may not realize full value and peace of mind when implementing an exit strategy. Disciplined and diligent practice management may improve valuations because weaknesses can be identified and remedied with human capital, technology, and targeted growth upgrades. Wealth managers will ultimately realize a better risk and return tradeoff by spending more time on succession planning.

It is important for practicing advisors to understand how to gain leverage and develop a logical decision tree as they begin the succession planning thought process. When choosing a succession strategy, an advisor should consider the following points, both internally and externally:

- Does he or she want to simply hand over the practice to a family member or junior colleague?
- Does he or she prefer to monetize their practice over the short or long term?
- Is the successor firm or individual a known entity (family or friend)?
- Does the advisor want to retain a legacy relationship with clients, or is full departure the priority?
- Would the advisor entertain a firm and agreement that offers more control over staying involved?

"In any moment of decision, the best thing you can do is this right thing, the next best thing you can do is the wrong thing, and the worst thing you can do is nothing."

-Theodore Roosevelt [1858-1919]

Transaction Valuation

If the goal of the advisor is to sell the business rather than create a retirement partnership, then maximizing practice value is usually of primary importance. Advisors may put their practice up for sale and market it through their CPA, attorney, broker-dealer, or local business broker. An open courtship and matching process, which may continue over an extended period of time, attempts to match buyer with seller. Practice valuation focuses on the tangible metrics of an advisor's book of business. These variables include assets under management (AUM), business longevity, revenue mix, specialization of services, client composition, client age, location, infrastructure, intellectual capital, earnings before owner compensation (EBOC), and trailing 12-month revenue. Given the metric-obsessive industry of financial advising, many are well aware of these factors, but these same advisors do not know their valuation range.

Revenue originating from investments that pay a recurring stream of income is preferred to commission revenue, at least from a valuation perspective. A strong growth trajectory will attract the most attention from a buyer, who may want to incentivize the retiring advisor during the client transition period. Higher levels of production are naturally correlated with larger valuations. The conventional wisdom of a buying firm puts a premium on growth statistics from the preceding 3 to 5 years. It is not uncommon for practice that generates $350K per year to be entirely

consumed by expenses with no reinvestment component. This puts the selling advisor in a somewhat precarious position because it may signal to the marketplace that the practice is not mature. Agreeing upon a valuation in a transaction-based sale might be next to impossible. The subsequent discount applied may be disadvantageous to the retiring advisor, who simply focused on retention rather than growth.

Understanding the composition of an advisory firm with respect to average client size and revenue, client age, relationship with the next-generation, turnover, outliers, and geographic dispersion all factor into an astute buyer's assessment, especially when determining whether the practice warrants a discount or premium.

Some of the key metrics and drivers of valuation for an advisor's practice are annuitized revenue stream, growth profile, book size, and client demographics. Fee-based revenue is considered "sticky", and is preferred because of its recurring nature. Geographic considerations, such as whether a large percentage of an advisor's book is concentrated in an area where wealthy clients migrate to or where wealth is created, merit consideration.

A typical buy/sell agreement will include the parties and entities involved, valuation methodology, and payment schedule. Other terms may include non-compete clauses, key-person insurance, and protections for the advisor's estate. A nonbinding letter of intent can be signed to commit to a plan. For advisors seeking complete separation from their practice, but who are not amenable to a transaction succession plan, an earn-out provision that will pay based upon retention expectations over several years may be required by the buyer.

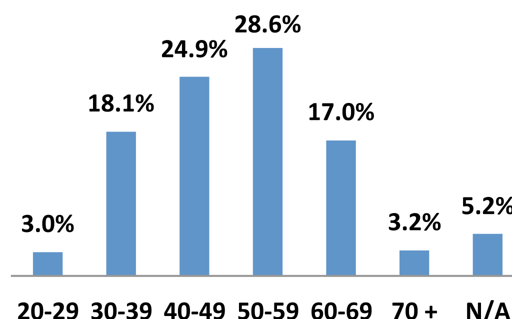
Financial advisor practices over the last several decades have typically seen average AUM growth rates of between 7% and 12%. The unpredictable financial markets, the pain of the 2008 financial crisis, and the proliferation of exchange-traded funds (ETFs) and self-directed brokerage are several factors that may explain less ambitious growth rates moving forward. Practices with scale, the ability to significantly grow in size after reaching a specific asset threshold, while still maintaining growth and expense control, are considered the most attractive from a transaction-only perspective. Advisory practices under $250 million have seen their multiples deteriorate in the five-and-below multiple range, while practices above the $750 million threshold command premium valuations.

Exit planning options are almost entirely focused on quantitative metrics related to valuation, and this transaction-orientated mentality has, unfortunately, marginalized qualitative factors and human empathy, which can be, to some, of more importance. Minimal attention is given to the intangible value the practice may have to the advisor, who may be attached to his or her clients and the role. Transactional suitors may lack empathy or an understanding of the sacred relationships an advisor has with his or her core clients because they focus on the numbers. In practical terms, it is crucial for the suitor to understand the degree to which the advisor hopes to remain active in the lives of their closest clients or families. No matter what angle one takes, for many advisors approaching retirement, a book of business is more than just a recurring revenue stream; it is a life's work.

"Tangibly, it's your bread and butter. Intangibly, it's your baby."

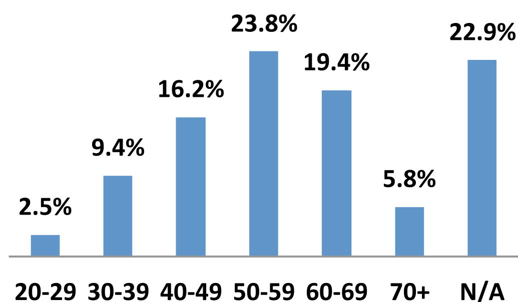
-Janet Stanzak, CFP®, 2013 FPA President-Elect

Figure 3. CFP Board Age Demographics
(As a percent of membership)



Source: CFP Board February 2013

Figure 4. FPA Age Demographics
(As a percent of membership)



Source: FPA March 2013

Organic Succession

Some advisors prefer to first hand off a share of their client base internally, while continuing to service and even grow their key relationships. Internal succession, an option many advisors consider, involves mentoring and fostering the development of a successor. Such a path allows the advisor to gain comfort with the junior advisor, while continuing to service clients and grow their practice. However, advisors may abandon this plan because either their successor fails to reach their level of expectations or the junior advisor's skills gravitate to a support role. Thus, the younger professional fails to develop the confidence, technical capability, and charisma of the senior planner. Further compounding the issue, the new advisor is somewhat numb to the demands of running a successful practice and may have their own system, or at least a mental model, for balancing the core areas of the business: portfolio management, client service, and prospecting new business.

The limited pool from which to choose a successor has further disadvantaged the aging advisor.

For the past 15 years, major firm resources have been allocated to recruiting or cannibalizing top-producing advisors from competing firms. They have not committed to programs that help young advisors build the critical skill and acquire the knowledge needed to attract the increasingly sophisticated affluent client. The economic downturn beginning in 2008 exacerbated this supply/demand imbalance, as financial services firms concentrated a disproportionate amount of time on cost cutting and the bottom line. New and younger advisors fell victim to this industry wide contraction, and, on the whole, the profession is not making a conscious effort to solve this quandary.

Partnership

Once an advisor identifies the desired succession plan and anoints a successor firm, several steps must then be implemented from a legal and business perspective in order to realize the plan in the preferred time frame. Of primary importance is the due diligence that must be done by the seller. With such varying degrees of competence, integrity, and ambition within the wealth management industry, an advisor must ensure that their needs and intentions are, first, understood, and, second, realized. Seller's remorse can be mitigated by engaging a firm that embodies a similar philosophy or has the capacity and wherewithal to customize the relationship experience for the transitioning advisor's clients. The industry has shifted to a fee-based model, and advisors must understand the successor firm's investment process, fee structure, and capacity when finding the best suitor. Sellers need to determine whether the partnering advisory firm or advisor has an opportunistic and active, yet malleable, philosophy that embraces technology and a client-first mentality.

Innovation and new solutions are required in order to raise the industry profile and provide a mainstream path for advisors to retire on their own terms:

- Each advisor's situation is unique, and advisors place value and emphasis in different areas.
- Industry associations such as the Financial Planning Association (FPA) and reputable industry organizations such as the CFP Board facilitate education and true networking with potential suitors and provide the very best business partners to support financial advisors in forming a practice management and exit strategy.
- Financial advisors often lack strong training, coaching, development, and practice support options to facilitate a controlled transition.

Transactions may involve an earn-out and cash, and may not result in the desired win-win experience for the advisor and the successor. Advisors need to partner with a consultative team and firm that will steward the transition of their practice in terms of ownership and responsibility. While the process of succession planning requires a serious time investment, finding the right successor or succession firm has proven to be an arduous task. Each advisor's

situation is unique, in that value and importance are perceived independently. Priorities with succession vary considerably, even among retiring colleagues at the same office and who are part of the same brokerage firm. The industry has not adequately invested in the next generation of sage financial advisors. As a result, advisors looking to exit often find a lack of exemplary talent or intellectual capital. There exists only a limited talent pool of emotionally intelligent and technically competent leaders to engage. It is quite possible, given the size of the United States and the fragmented state of our industry, that a suitable advisor that simply meets—let alone exceeds—one's expectations is not within commutable distance. Compounding this talent shortage is a lack of partnership platforms where an advisor can control the phase-out process, especially in terms of time, responsibility, and revenue sharing.

Practice owners often cite finding the right succession fit as the top reason for not committing to a transition plan. Other primary concerns include finding the right financial terms, identifying a successor firm with the same core values, transition/implementation logistics, and migrating assets to a new custodian. Indecision can result when advisors are torn between slowly phasing out the business and maximizing the value of selling their practice.

"Intelligent people make bad decisions based on opportunity costs."

-Charles Munger

Client Retention

The most significant risk of a transactional transition is retention. The vast majority of practices that are purchased fail the ultimate test metric of how many clients actually remain with the new advisor after the transition. Buyer firms, many of whom have not successfully mitigated client-retention risk, usually fall short of their return-on-equity goals. This causes them to devalue the succession planning opportunity. They may choose not to acquire another practice, or, more often than not, they choose to only buy a practice on their own terms, complete with protection clauses and addendums that disadvantage the seller. A practice that yields low client retention will likely see value deteriorate, and may result in the buyer mandating a lower purchase price retroactively. Selling advisors who fail to be thoughtful and strategic in how and when they introduce their partner firm may realize average and below-average retention rates. It is the duty of the succession firm to understand everything about how the advisor has built and sustained their business, including, but not limited to, how meetings are conducted, the client service process, and overall client-specific relationship management.

A well-orchestrated succession plan should expect 90% client retention, and enhanced productivity. Advisors who share long and deep relationships with their clients may want to consider a proactive approach to educating their clients about their plan for taking care of them, knowing that the advisor will not be around forever. Even highlighting the importance and merit of a contingency plan in the event of the advisor's sudden death is well received. Clients may secretly worry and discuss their own plan for their advisor's sudden departure, and wealth managers can take advantage of this obvious, but potentially disastrous, concern by ensuring that their clients will always receive the very best advice.

A written succession plan must include perceived risks in order of estimated liability, and a strategy for mitigating each of these risks. An advisor may want to consider a trial period with phases when partnering with a successor. This will also help mitigate risk and allow clients to become familiar with the new firm over time, while still maintaining close relations with their legacy advisor. Planning several years in advance of one's desired retirement transition can considerably enhance the overall effectiveness of an exit strategy.

"The sale needs to be made from the perspective of the client. Think about it. The profit center is the client. The client only stays if they love the deal."

-Vern Hayden, CFP®, Hayden Wealth Management

Innovative Solutions

Advisors who value legacy and seek the most flexibility in detailing terms of their succession plan may want to consider organizations that have a comprehensive understanding of succession issues, as opposed to the plethora of opportunistic advisory practices that seek to simply "grow their book" through acquisition. Some wealth managers who have never been approached about the subject of scaling back their engagement in their practice are eager to explore partnership opportunities on their own terms. These same advisors are pleasantly surprised to learn that they can still have their name on client statements, share in revenue, and assume a new role of working part-time with a select group of clients. Some consider educating their peers about the proverbial blue ocean of partnership opportunities that exist.

Conventional industry practices that focus on advisor transitions are overwhelmingly committed first to simplifying a retiring advisor to a price and, second, to negotiating and finalizing a predetermined list of parameters to get a signature. Since many of our legacy advisors have achieved a degree of financial independence, perhaps a greater emphasis needs to be placed on flexibility and customization of exactly how much or how little the advisor wants to remain involved with their clients. Furthermore, buyers routinely have the desire to finalize an end game with the seller and rarely explore unconventional options, such as allowing the advisor to remain engaged to a group of their most treasured clients or allowing the seller to receive a portion of their annuitized income through retirement. Advisors retiring in the immediate future may realize more value and stability through an annuitized payout. Some firms are willing to pay out a percentage of the revenue generated from a client's book through retirement without any cap in years.

Some successful exit strategies apply the merits of having the selling advisor remain onboard as an ambassador. The proverbial emotional bank account, which has been built over the course of decades with their longstanding client base, is in many cases irreplaceable. Flexible successor organizations may facilitate annual or biannual client appreciation engagements, designed to give the legacy planner a forum to continue to see their best clients and to improve long-term retention. With respect to phasing out the legacy advisor workload, an advisor may prefer to work part-time, perhaps 20 hours a week, for several years, before assuming an ambassador-type role.

Legacy is about sharing what you have learned, not just what you have earned. When you make a meaningful contribution to your clients, family, and community by serving a cause greater than you own. Experienced advisors are needed to cement and carry legacies forward. The selling advisor should consider a partner with an intergenerational focus. This will help improve the advisor's legacy in the minds of their clients, who are often of retiring age. This will also put clients at ease with respect to their own passing and create mutually beneficial financial-planning education opportunities.

Once terms have been finalized, the selling advisor may or may not take upon much of the responsibility for transitioning clients, which can take as long as three years. While some exit strategies are short-term in nature, some may last for years, where the senior advisor becomes an employee of the buyer party. Choosing a firm that allows the transitioning advisor to dictate terms may offer more opportunity.

Focusing on his or her clients' need to have a plan that effectively follows their goals and financial needs is of utmost importance to the advisor, but often he or she does not apply the same urgency to his or her own financial situation. Linking one's business plan to a succession plan can have tangible and intangible benefits. We recommend that advisors ask themselves a series of difficult but important questions annually when planning for the following year:

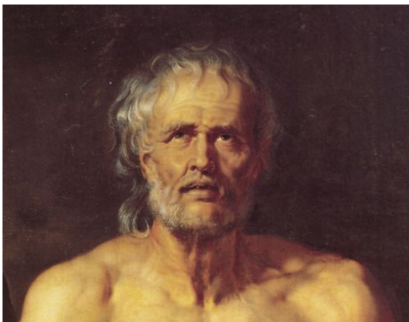
- For how many more years would I like to continue providing full service to my clients, and would I consider a part-time arrangement with the right organization?
- What are the principles and core beliefs I need present in order to consider trusting another advisor to service my clients?
- Am I concerned about telling my clients about my succession plan, or have they been hinting at their desire for me to have one?
- What is my vision for retirement, and what interests and hobbies will I devote myself to?

Leveraging network and resources of national and local industry forums, such as CFP Board and FPA, help differentiate the best advisors in a crowded field. A buyer must be aware of the marketplace, where agreements may contain terms that unfairly favor the buyer, leaving the seller in a disadvantaged position after transferring equity.

Conclusion

- We are facing a major inflection point, and a confluence of factors make the financial advisor exit strategy an ever-more relevant and opportune area of discussion.
- Current solutions and red ocean M&A tactics are not meeting the inherent demand of the industry.
- The best advisors listen to their clients, and the best succession practices and options need to listen to their clients (the advisor).
- Solving the succession plan quandary will make advisors more valuable to their clients by openly addressing who will give the same advice and support to these clients in the event that their long-trusted advisor passes suddenly.
- Not only does solving the succession plan quandary benefit the pioneers of our profession, it develops future leaders who will continue on their legacy.

Advisors who do not plan early enough, much like a family that does not plan appropriately for retirement, risk putting a successful practice transition in jeopardy. Advisors need a partner firm that recognizes succession transcends simply rolling over an existing book of clients into a larger, more established one. The complicated nature of practice valuation does not allow for a one-size-fits-all formula because qualitative factors can have a multiplicative impact on final valuation. As a result, advisors may receive several differing opinions when appraising their practice. Furthermore, one can agree on financial terms while overlooking a misalignment in culture and philosophy. There are many benefits to beginning this process early and identifying a solution that customizes the retirement experience based upon each financial advisor's unique needs. The fragmented nature of the advisor succession industry further exacerbates and complicates transition planning. Overcoming this obstacle and recognizing the need to plan early are the first steps to developing a successful exit strategy.



"You ask what is the proper limit to a person's wealth? First, having what is essential, and second, having what is enough."

-Lucius Annaeus Seneca [4BC – 65AD]

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