Realizing the Value of Your Life's Work

Building a Sustainable Succession Plan

Our partner in developing this guidebook:

ADVISOR GROWTH STRATEGIES

Pershing Advisor Solutions®

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Introduction

Now more than ever, designing and implementing a succession plan is a critical element of every successful advisory firm. How will clients be served, and who will propel your firm to the next level, when the current generation of ownership leaves? A well-crafted plan helps firm owners achieve alignment between their personal and professional goals, the goals of all partners, and can serve as a powerful tool for improving a registered investment advisor's (RIA's) business model and firm value.

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

- What is a succession plan?
- Why the need for succession planning will continue to be important and the advantages of having a succession plan.
- Education on how to chart your firm's future succession planning course.

Indeed, the choices for succession have never been greater. A rush of new market entrants now seeks to buy or partner with independent advisory practices, offering a variety of economic models, degrees of control and exit timing scenarios for owners. For example, intermediaries and large RIAs now offer custom succession plans that allow the owner to choose when to implement succession. These offers provide various degrees of flexibility that were not available a mere ten years ago. Keep in mind that regulatory changes may force advisors to implement succession. Owners may choose to plan for an internal succession, merge with another firm, sell their business, or a combination of all three.

There is good news for current owners. Not only have the choices for succession increased, but the support for independent firms that are looking to develop and implement a succession solution has also increased dramatically this decade. RIA custodians, existing independent firms, consulting practices and investment banks, and strategic acquirers have all built support models to help independent practices develop a succession solution. Current owners are encouraged to understand what resources are available. Specific resources are provided at the end of this paper.

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

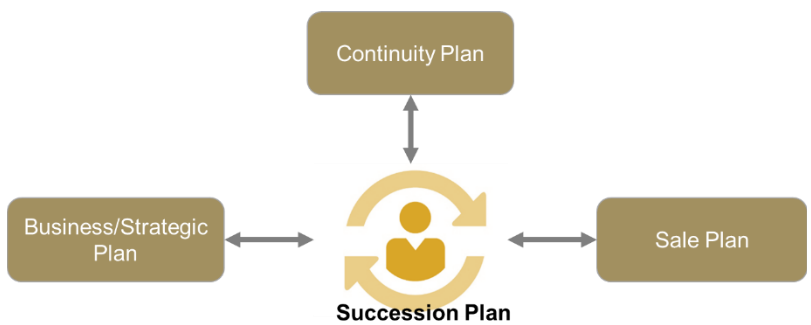
What Is Succession Planning?

First, let's take a look at the definition of succession and how it is different from business, continuity and sale planning. Succession planning is the intentional process of transferring the ownership and goodwill of an advisory firm from one generation to the next or from one entity to another. Succession planning is unique because it is not a stand-alone event. It is linked to multiple areas of a business plan and evolves over time. For example, owners of an advisory firm may at first want to develop an external succession plan, but ultimately discover suitable personnel internally. We often see that the original option for succession is not the option that is fully implemented in the end.

Succession planning is not the same as business, continuity, or sale planning. Succession planning bundles elements of each into one cohesive process. It is helpful to have a clear understanding of what makes succession planning unique compared to the other forms of planning in an advisory business.

1. **Succession planning:** This is the process of transferring ownership of a firm from one generation to the next. This may be an internal transfer (to heirs or employees) or an external transfer to another entity. Succession is generally focused on limiting disruption to clients, employees and owners.

2. **Business planning**: This outlines a firm's purpose, vision, strategy and tactics. Business planning helps firm's reach specific goals over time. A firm needs to develop a strategic planning process to perpetuate the firm over time. Therefore, succession planning is integral to a firm's strategic plan. Succession planning should be incorporated into a firm's strategic plan as it will consist of many elements of the firm's strategic process. However, the process requires a clear vision of the desired outcome and dedication to execution.



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

3. **Continuity planning:** This is planning for an unforeseen event. Continuity planning is often considered a form of disaster planning. A continuity plan will outline how a firm operates in the event of a catastrophic event (such as death or disability of an owner or a loss of key contributor).

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

State of the RIA Industry: Why Does Succession Planning Continue to Be De-emphasized?

The RIA channel continues to be one of the fastest growing segments in financial services. According to Cerulli Associates, the RIA channel is expected to grow from 23.3% market share of advisor-managed assets in 2015 to 28.1% market share in 2020.[1] However, RIAs are disadvantaged versus larger institutions as there is no defined model when an advisor needs to retire. Many RIA owners have no clear answer to the client question, "Who will be my trusted advisor when you are gone?"

Currently, we are seeing larger RIAs being formed by seasoned sales professionals that are exiting large institutions. We will continue to see more sophisticated and larger RIAs vying for talent and the next new client. This trend may lead to greater consolidation within our industry. Here are some notable recent transactions:

Notable recent RIA and Breakaway transactions

	M&A Transaction	Breakaway Transaction
Summit Trail Advisors		Left Barclays Capital in 2015 to form a multi-billion dollar RIA.
Summit Trail Advisors	Immediately completed successful integrations of two former Barclays advisors adding an estimated $1B in assets.	
Omnia Family Wealth		$1.4B Multi-family office formed in 2015 after a long history with Merrill Lynch and UBS.
Pathstone Federal Street	Began with a merger of Pathstone and Federal Street in 2015. The merged entity then acquired Convergent Wealth Advisors, creating a national multi-family office.	
Columbia Pacific Wealth Management (CPWM)	Acquired Kibble & Prentice Private Investment Advisory Group in 2015 resulting in a multi-billion dollar combined firm.	

Source: Advisor Growth Stategies.

Larger firms can get greater productivity and scale advantages through more specialized expertise, high-touch service, robust infrastructure, brand recognition and exclusive products. For example, a typical firm considered an elite RIA generates more than six times the revenue of non-elite RIAs [2] as defined by *InvestmentNews* Elite RIA study. Comparatively, elite RIAs only employed four times more employees than non-elite RIAs. For more information, refer to Pershing's "What Wealth Wants: Refining Your Firm's Approach to the High-Net-Worth Market".

Top firms are focused on growth and scale, but ownership structures are evolving at a very slow pace in the industry. The majority of firms (79%) reported no change in ownership in the previous year, and only 6% reported transferring ownership from an outgoing to an incoming partner, according to *InvestmentNews* 2014 Financial Performance Study of Advisory Firms[3].

Flexibility is the motivation for many advisors to pursue the independent RIA model. Owners have endless options when it comes to running their business, planning for succession and building business value. Flexibility comes with responsibility as owners must define and

[1] Cerulli, U.S. RIA Marketplace 2016
[2] 2016 Elite RIA Study. *InvestmentNews.*
[3] "The 2014 Financial Performance Study of Advisory Firms". *InvestmentNews* . Note: Respondents were able to select multiple answers.

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

Making Succession Inevitable

	Why have educated professionals not made succession planning inevitable?	Getting Started
Establishing a Fair Valuation	36% of respondents were very concerned about valuing the firm fairly and accurately.	Consider hiring a valuation expert to give an objective opinion of value. Valuation experts will provide candid feedback on the drivers of value and help establish a fair methodology.
Transitioning Clients	29% were concerned with the emotional aspects of transferring clients to a new advisor.	Start by transitioning a small number of clients. Test client acceptance of a firm-wide approach and begin to change overall expectations. Consider speaking with other firms that have successfully transitioned clients to help reduce fear and avoid pitfalls.
Investing Time and Capital	Succession planning takes investment in time and money to execute and advisors will have to perform research and speak with experts to get educated.	Start early and imagine you are giving succession advice to one of your clients. How would you advise a client in your same position? Putting yourself in your clients' position can help clarify the importance of investing time and money into succession.
Transitioning a Firm	Advisory firm owners grabble with emotions in transitioning a firm.	Lean on your custodian and third-party experts to give an objective point-of-view. Prioritize what is important to you and use it as a framework to help manage your emotions.
Realizing the Need	Owners may not be motivated because there isn't a pressing need to design a succession plan.	Challenge your status quo. If something happened to you today, what would happen to your clients, employees and family? You will find that deferring is a risky option.
Overcoming Fear	There may be an overall fear of the succession planning process.	Use the planning process to define a "change" versus the "end." Consider using your custodian and third-party experts to help. Collaborate with others that have gone through the process to identify how life has (and has not) changed.

Regulatory changes will intensify the succession discussion moving forward and may force many firms to execute a succession and continuity plan in the future. The industry has long speculated when the SEC might step in and require transition and continuity plans for RIAs. As of the writing of this guidebook, the SEC has proposed a rule that will force firms to have a documented continuity and succession plan.[4] The proposed regulatory change will require firms to have an actionable plan that addresses transition in the face of disaster or an advisor leaving the business. The final rule is likely to be nuanced after adjustments, but many industry experts expect the rule to make succession planning a requirement versus an option.

[4] Securities and Exchange Commission. Release No. IA-4439; File No. S&-13-16. www.sec.gov/rules/proposed/2016/ia-4439.pdf

The Planning Process Addresses the Key Areas of Risk

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

1. **Client attrition risk**: Clients, especially those with high net worth, value continuity and stability, may decide to move to another firm. To overcome this risk, advisors are analyzing the following elements of their business model and communicate them to clients throughout the business development cycle and beyond.

    a. **Business continuity plan**: This plan details how clients will receive service in the event of a disaster or unforeseen event. This is directly related to the firm's succession plan (see Succession Plan Options for Owners, page 17). Telling your clients what will happen to their account if their individual advisor is no longer with the firm or is unable to provide service is usually done verbally. Advisory practices may choose to adopt a team-based approach to client service delivery to lower client attrition risk.

    b. **Privacy policy**: This policy outlines how clients' confidential data will be protected by the firm. Every firm should prepare a written statement on its privacy policy and distribute it to clients.

    c. **Financial stability and asset protection**: This communication may be delivered via a letter or newsletter and shares key metrics around the company's financial stability and track record, such as years in service, total clients and assets under management. Talk to your asset custodians. The Relationship Managers and Practice Management Consultants at Pershing can help provide perspective.

2. **Opportunity cost and lower growth trajectory**: Firms lacking a business and succession plan are challenged in defining success and charting a course to get there. Without defined annual metrics, firms can go fiscal quarters, if not years, without meeting objectives. A business plan must also define roles and assign accountability. Advisory firms should commit to business objectives in the plan and create individual job descriptions and evaluation processes to track success. Discipline in business and succession planning will mitigate the risk that a firm's growth stalls or declines as current owners wind down their professional contributions near retirement.

3. **Increased risk of low employee commitment and high turnover:** A business plan is critical to defining an employee's role within the advisory firm's organization. Job descriptions should be directly linked to stated objectives in the business plan. Advising the group of the succession plan is important, especially if key employees may take on an ownership role or play a part in the plan at some point in the future. Involving the next generation professional in succession and business planning will create a sense of commitment and promote a long-term tie to the firm.

4. **Loss of enterprise value:** Most RIAs are valued based on discounted cash flows or multiples of free cash flows with discounts and premiums taken based on elements such as revenue growth, client demographics, employee tenure and stability, and quality of management. Lacking a plan may negatively impact a firm's attractiveness to potential buyers. Firms can leverage business and succession planning as a blueprint for driving growth, retaining clients and top talent, and mitigating perceived business risks. There is

never a guarantee when it comes to value, but firms can positively influence value drivers through the planning process.

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

Succession Planning Goals

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

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

A succession plan should be aligned with the personal goals and time horizon of an individual or team. Start by defining the goals and objectives and documenting a written plan. Plans that are documented have a higher probability of execution. The documentation should include actionable steps toward the optimal succession. The option selected impacts the firm's legal structure, the resulting business plan, and its clients and employees. The chart below describes the options available to advisors along with the economic considerations, pros and cons, and impact on employees and clients.

Succession Plan Options

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

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

As a firm continues to grow, so will its value. Present and next generation owners should consider the implications of increasing fair value as a succession plan is developed. Many firms will take the opportunity to forecast future growth, increase firm value and plan how to sequence transitioning equity in tranches periodically over time. Timing is important. For example, if a firm wants to execute an internal transition, it could potentially take five to 10 years. The simple economics of the transaction and probable need for next generation financing should tilt firms into action sooner rather than later.

Financing

Example Wealth Management: Cost to Become an Owner

	Example Wealth Management
Revenue	$5,000,000
Direct Expenses	
Owners Compensation	$750,000
Non-Owner Professional Compensation	$1,000,000
Gross Profit	$3,250,000
Overhead Expenses	$2,000,000
Operating Income	$1,250,000

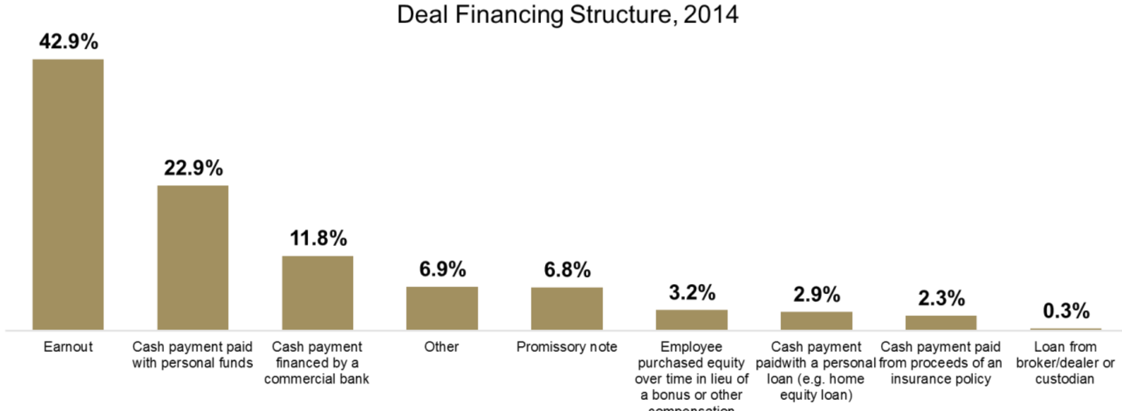
	100% Ownership	10% Ownership
Current Valuation	$7,500,000	**$750,000**
10% Discount	$6,750,000	**$675,000**
25% Discount	$5,625,000	**$562,500**

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

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

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

Deal Financing Structure, 2014



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

Required Steps in Building a Succession Plan

Common Succession Pitfalls	
Procrastination	Firms that wait too long to address succession often find their options to be limited. Not allowing enough time to properly plan succession may exclude internal successors and/or force firms to accept a less than optimal deal from a third-party. The lesson is to start early, and allow time to be nimble with succession planning.
Prioritization	Prioritization within the context of business and succession planning can be a pitfall for some firms. If succession is not linked to an end-goal, the firm risks losing sight over what it is seeking to accomplish. The lesson is to prioritize what is important: create a legacy, maximize financial outcome, or some variant. Prioritization will help departing owners understand what is negotiable, and what is not.
Emotional Hazard	Succession planning can bring unexpected emotions from both current and future owners. Topics that seem small can derail the entire succession process. Be prepared to manage emotional decisions along the way. In some cases, outside perspective may be needed to manage the process and work through emotional roadblocks.
Execution	Succession planning is a valuable exercise, but falls short without execution. Firms that go through the process of documenting a succession plan should be sure to create accountability to execution. Sharing the plan broadly and creating key milestones will help mitigate this pitfall. The lesson is to create urgency and be the best at execution.

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

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

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

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

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

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

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

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

4. **Identify the time horizon**: Owners must pinpoint the time of their exit from the firm. This knowledge informs the timing of seeking a potential successor; finding the right external buyer could take up to three years and grooming an internal successor could take more.
5. **Perform due diligence to identify a potential buyer or successor**: Start an informed search for the right person or entity to take over. Creating a list of potential suitors is fairly straightforward but evaluating successors, especially outside buyers, is a far more complicated. Owners should identify what is important to them and build an evaluation scorecard to list the strengths, weaknesses, opportunities and threats of each choice.
6. **Select a model and structure the deal**: Once the due diligence process is complete, owners still face plenty of work. Negotiations must take place between the owner (seller) and the successor (buyer) to complete the transaction or set terms. Owners may decide to hire a consulting firm or investment bank to negotiate on their behalf. In fact, these firms may be brought on far earlier to help owners build their plan and perform their search.
7. **Implement the plan**: Implementing the succession stretches far beyond the legal aspects and potential economic transaction. There are communication requirements with clients, employees and vendors. There could be a significant organizational impact for firm employees. For external sales, owners must plan for post-merger integration work.

Consideration: External Succession

Some firms will come to the conclusion that an external successor will be the best way to execute on succession. For firms taking this approach, it is important to identify key additional steps that must be taken to ensure the best fit.

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

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

Succession planning and execution is critical. It can set the stage for growth and mitigate many risks. As we look toward the future of advisory services, clients will continue to monitor the safety and security of their assets and will expect a detailed plan from their firm. A well-crafted succession plan can be used as a competitive advantage to attract new business, retain clients and increase employee engagement and retention.

Spotlight: Massey Quick Creates a Succession Strategy

Massey Quick is the featured RIA. The complete case study, including firm profile, can be found in the Appendix.

Succession and business continuity is critical to Massey Quick and to its clients. But the firm did not have a good answer when clients asked, *"What happens to my family after the founders leave?"* So in 2013, the firm developed a plan that would allow Massey Quick to operate *perpetually*. This meant the firm's lifespan would extend beyond that of the founders.

To accomplish this goal, Massey Quick needed to identify potential successors soon as the founders were all in their late 50s and early 60s. Joseph A. Belfatto, Managing Partner, noted, *"The three partners felt that Mark DeLotto and Chris Moore were the best choices. They had showed interest in helping advance the firm strategically and from a revenue perspective."*

Both Mark and Chris were invited to join the firm's management committee. The leadership encouraged Mark and Chris to challenge the firm's strategic direction and business strategy—which they did. The results were amazing. *"Mark and Chris think about the future differently. They are less wedded to our past successes and are more interested in driving the firm forward. We have benefited greatly from their insights into sales, technology and client service."*

After a year, Mark and Chris became partners. They each bought 6% equity ownership, which was financed by a third party. The installment payments backstopped by the company. Mark and Chris also became permanent members of the management team. The two new partners exhibited strengths such as cultural fit and leadership ability. They had a track record of driving revenue and earning the respect of clients and employees. Once Mark and Chris were in place, Massey Quick realized that the next step was to institutionalize its succession planning process.

Improving and Realizing Firm Value

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

 **Growth**	Sophisticated buyers look for a consistent history of AUM, revenue, and earnings growth. Consistency in this category results in higher confidence in the buyer and more favorable projections of future economics. Firms can improve this category by clearly defining their sales, marketing, and client experience infrastructure.
 **Scale**	Discipline in managing the cost of developing and servicing client relationships is impactful to a firm's earnings. Valuations will be influenced by a firms discipline in controlling costs and driving more return. Firms can improve this category by better leveraging technology, human capital, and a well-crafted client acquisition strategy.
 **Risk**	Managing common business risks such as continuity, succession, employment agreements, and corporate governance will give potential buyers confidence. Risk factors lower valuations and expected return, but can be mitigated through owner effort. Outside consultants or legal counsel can provide intelligence and create a roadmap for improvement.
 **Cash Flow**	Cash flow is the most important metric for most sophisticated buyers. Demonstrating consistent growth in cash flow (or EBITDA) will greatly improve a firm's valuation. Firms can take several steps to improve cash flow including: revisiting compensation plans, installing technology, and implementing financial controls.

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

1. **Assets under management (AUM) growth:** AUM is required to generate fees for an advisory business. AUM growth is a positive indicator for a firm's value as the base to charge fees is increasing.

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

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

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

Growth is a strong story to tell to a potential buyer. However, it is important to consider the risks associated with buying or selling a financial advisory firm. There is always some element of risk with an ongoing business concern. However, risk can be mitigated to improve the valuation of a firm over time. Common risks can be grouped into three categories:

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

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

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

Addressing the drivers of value

Growth	Scale
> Why it matters: Growth creates confidence in earnings expansion and mitigates rising expense concerns. > Consider: Diversifying the growth engine, defining a niche, implementing sales training and process.	> Why it matters: Scale signals that performance is predictable. > Consider: Automated work flows, career path development, consistent compensation and benefits plan.
Risk	**Cash Flow**
> Why it matters: Risk creates uncertainty in future performance that is priced into a firm's valuation. > Consider: Refining corporate governance, implementing succession/continuity, balancing client demographics.	> Why it matters: Cash flow creates the expected yield for any buyer and is critical in the valuation process. > Consider: Implementing formal financial P&L discipline, budgeting, and forecasting.

Valuation Methods

Understanding what drives value in an advisory firm helps to translate commonly used valuation methodologies in the industry. Valuation methodology is discussed at length in the industry, but is important knowledge for succession planning. The chosen methodology will be impacted by the value drivers listed above in varying ways. The chart below shows commonly used valuation methodologies and the considerations of each.

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

Understanding the methods for valuing a financial advisory business will help inform business and succession planning. The growth and risk characteristics of a firm can be influenced over time to improve valuations and attractiveness to internal and external buyers. Choosing a consistent methodology that incorporates the unique characteristics of a firm will lead to more certainty and a better outcome for owners. Firms should be careful with general methodologies such as revenue multiples as they do not consider the expense and cash flow characteristics of the firm.

Example Wealth Management: Valuation Methodologies

	Example Wealth Management
Revenue	$5,000,000
Direct Expenses	
Owners Compensation	$750,000
Non-Owner Professional Compensation	$1,000,000
Gross Profit	$3,250,000
Overhead Expenses	$2,000,000
Operating Income	$1,250,000
EBITDA	$1,250,000
EBOC	$2,000,000

	Multiple Range	Low Value	High Value
Revenue	2 – 2.5x	**$10,000,000**	**$12,500,000**
EBITDA	6 – 6.5x	**$7,500,000**	**$8,125,000**
EBOC	4 – 4.5x	**$8,000,000**	**$9,000,000**
Variance (max/min)		**$2,500,000**	**$4,375,000**

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

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

Mitigating Risk and Protecting Owner's Equity

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

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

How do advisory firm owners mitigate risk to their succession plan? We will exclude processes and procedures associated with business risk, such as trading, compliance, client experience, retention and sales growth that are tackled on a daily basis by owners and their staff.

Key Succession Planning Questions

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

Beyond business risk, legal and insurance provisions to protect ownership equity can mitigate many of the risks faced by firms today.

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

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

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

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

Spotlight: Massey Quick Institutionalizes Succession

The firm needed outside perspective to enhance its succession planning design and develop a way to transition equity from the founders to the next generation. So the firm hired Echelon Partners, an investment banking firm that serves the financial services community. Joe noted: *"After we completed the first phase of our succession planning, we needed an outside voice that could provide industry perspective/best practices and help the management team work through issues. As you can imagine, ownership can be an emotionally charged subject!"*

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

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

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

Consideration: Negotiating the Right Deal Terms

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

1. **Purchase price**. Determine what tradeoffs are reasonable when it comes to purchase price. This may include discounting for internal purchases or adjusting purchase price based on events for external.
2. **Payment timing**. Define an acceptable period of time to receive full consideration in a succession transaction. The longer time it takes to receive payment, the higher the risk to the seller. However, stretching out payments may make a higher purchase price more feasible for internal or external buyers.
3. **Buyer protections**. Establish how much you are willing to protect a buyer in any transaction. Outside consultants and legal counsel can help inform commonly used protections and what they mean for a buyer/seller.
4. **Seller protections**. Sellers should define must-haves when it comes to protections. This may include protections for financial outcomes, employees, brand/logos, etc. Outside consultants and legal counsel can help inform commonly used protections and what they mean for a buyer/seller.

Legal and Tax Implications

After owners come to agreement on the business side of their succession plan, a significant amount of time and care must be devoted to legal and tax impacts. Even if an agreement to sell an ownership stake is not imminent, it is still prudent to understand the legal and tax implications of these decisions. The chosen legal structure of a business will impact the tax treatment of yearly economics as well as an eventual sale. Industry data shows that the use of pass-through entities is most popular among financial advisory firms. In the 2014 Financial Performance Study, 45% of respondents indicated using a limited liability company. In a close second, 39% of firms are using an S corporation. The results decline from there with only 8% using a C corporation or sole proprietorship, and 2% using a partnership structure.[5]

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

Low — Administrative Complexity — High

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

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

[5] 2014 *InvestmentNews* Financial Performance Study of Advisory Firms

Resources Available to Advisors

Developing a well-thought-out business and succession plan entails a significant time investment for advisory practices. Guidebooks such as this can provide a framework for advisors and they can also tap external resources for help in developing and executing their plans. Options include:

1. **Create a business and succession plan in-house:** Firm owners and management team work together to craft their strategic plans internally. Advisory firms only use required third parties such as legal counsel to implement their plan.
2. **Third-party support:** Subject matter experts can help develop a process, timeline and accountability mechanism to ensure agreed upon deliverables and timelines are met. They can also work through the key decision points of business and succession planning. Firms that implement this approach value industry insight or require a third party to guide them through sensitive issues or mediate an impasse.
3. **Custodian support:** Pershing Advisor Solutions provides RIAs with the resources they need to drive growth, optimize human capital, maximize operational efficiency and manage risk. By collaborating with Pershing Advisor Solutions, you have the advantage of our practice management resources to help you handle the complexities related to business and succession planning. Some examples of the resources available are:
    a. Independent studies and guidebooks such as those available through our thought-leadership library.
    b. Thought leadership and tools such as the *InvestmentNews* Compensation study, to help attract, retain and develop top performers. This is a critical component in the development and implementation of your business and succession plan.
    c. Events and workshops such as INSITE and regional events that provide you with a comprehensive overview of technology and product options that you can incorporate into your ongoing business planning.

Third-Party Resources

Advisory firms usually leverage some or all of the following industry providers.

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

Conclusion

Succession planning plays a large role in the success of an advisory firm. The failure to execute a plan creates significant risk for an owner and partners, the owner's estate, employees and clients. Although succession planning may make sound business sense, the single biggest barriers are emotions and unwillingness by owners to work through the process.

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

Pershing Advisor Solutions works with best-of-breed providers of insurance solutions through our ValueAlliance program. To learn more about providers you gain access to by working with us, visit pershingadvisorsolutions.com.

Appendix

Case Study #1

Massey Quick and Co., LLC: Building the Foundation for Generational Transfer

Massy Quick is one of the rare firms in the industry that is not only thinking about succession planning for founding partners, but is building a firm for generations to come. Founded in 2004, the firm has grown to over $2.4 billion in assets, 24 employees and five partners. The firm's clients include ultra-high-net-worth families, endowments and foundations.

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

Massey Quick: Task Forces

- Hiring
- Next Generation
- Woman's Initiative
- Technology

In addition, Massey Quick created task forces that drive the future direction of the firm. This allows contributors of all levels to participate, improving commitment. The task forces interact with the management team to set investment priorities and drive enhancements to the client experience. Massey Quick is proud of its diversity which includes half of the team being under 30. The firm has made a deep investment to find and grow the next generation of talent and ownership within the firm.

1. Given the nature of the firm's clients, succession and business continuity were critical to clients. The firm did not have a good answer when clients asked, "What happens to my family after the founders leave?" In 2013, the firm developed a plan that would allow Massey Quick to be perpetual.

Evolution of Massey Quick Succession

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

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

Key Findings from Massey Quick

1. Be open minded
2. Higher a third party to broaden your perspective
3. Nail your valuation methodology
4. Project growth into the future
5. Start early

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

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

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

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

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

Risks associated with not having a plan:

Advisory firms that do not address succession planning may introduce unnecessary economic and systemic risk into their practices. (define economic and systemic risk). For a single-owner firm, an unforeseen event can impact employees and clients. A larger firm that lacks a succession plan risks its corporate governance, internal operating processes, future revenue and client retention.

What is an effective succession plan?

An effective succession plan directs a company's operating agreement, including buy/sell provisions, and strengthens a firm's corporate governance.