White Paper
Practice Management

Succession, Scale, Capabilities, or a Combination?

Evaluating Succession Opportunities

Brie Williams
Head of Practice Management

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Executive Summary

Advisors spend their career cultivating client relationships. It's no surprise, then, that many express apprehension about retiring and transferring ownership to someone else. A misalignment in successor personality, method or outlook can cause friction between buyers and sellers. This underscores the need to develop and proactively manage a succession plan. With a clear perspective, advisory owners can be more strategic and increase the likelihood of a successful transition.

As financial advisors approach retirement, a substantial portion of assets is poised for transition in the coming decade. Nearly 40% of advisors anticipate retiring within the next ten years, placing over $11 trillion in assets under management in motion. Advisors retiring in five or fewer years represent $2.4 trillion, accounting for 9% of industry assets. Yet, one in four advisors planning to retire or take a major step back from day-to-day operations within ten years remain uncertain of their succession plan.[1] While many advisors are aware of the need for succession planning, evaluating options and prioritizing the scope of this task poses a significant challenge. This presents both an opportunity to win dislodged assets and a major concern for attrition within the industry.

Succession planning, however, is not a standalone event. It is an essential part of the firm's business plan — vision, strategy and tactics — and elements of the process are likely to evolve over time. The staff of the Securities and Exchange Commission has stated in guidance that investment advisers should establish business continuity plans because an adviser's fiduciary obligation to its clients includes taking steps to protect the clients' interests from risks resulting from the adviser's inability to provide advisory services.[2]

Evaluating Business Transition Models

Simply stated, a succession plan outlines the process of transferring ownership, clients, and management of a firm from one generation to the next. Advisory owners may choose to plan for internal succession, merge with another firm, sell their business or develop a plan that combines elements of all three.

Today's market offers advisors many choices for transitioning a practice — a variety of economic models offering varying degrees of control (Figure 1). When evaluating transition models, advisors should take an intentional approach supported by a flexible process with a long-term view.

Figure 1
Business Transition Models

	Description	Considerations
Internal Succession		
• Organic growth • Business continuity	A transition of equity to an individual within the advisory owner's organization: another partner, a junior advisor or other employee or a family member	+ High degree of continuity for clients and staff + Advisory owner can retire from the job and maintain a limited role if desired ∨ Best leader for the business may not exist internally; hiring (and training) may be required ∨ Internal buyers often lack capital; longer-term financing or earn-out proviso structure
Merger with or Acquisition of Another Practice		
• Inorganic growth • Strategic partnership for business growth and succession	Expansion of business designed to more quickly increase market share and scale; a partnership — sharing of revenue and resources	+ Medium to high degree of continuity for clients and staff + Offers opportunities to access new markets, expand practice expertise and realize economies of scale — Composition of payments tends to vary and include cash payments, exchange of equity and/or bank loan ∨ Finding the right advisory firm match can be challenging ∨ Integration may be more complex
Merger	Combination of two previously separate firms into a single economic entity. Allows some portion of monetization, while allowing the advisory owner to stay involved over an agreed-upon period with select business and/or client relationship responsibilities remaining in place	+ May provide a route for strengthening both firms and set the stage for a de facto acquisition when founders and/or other leaders move on
Acquisition	Buy/sell agreement structure where the acquirer purchases a stake in the practice while receiving a contractual right to become the eventual successor when the advisory owner exits	+ Option offers the possibility of merging the founding generation with the next generation
Direct Sale		
• Divestment of the practice	Sale of all equity to a buyer and transition of client relationships after the deal has closed. Buyers can include practice aggregator firms, banks or trust companies	+ Provides a more immediate liquidity event and performance/retention criteria may be part of the agreement — Common deal terms involve up to a 40% cash down payment[3] with balance of the sale financed ∨ High potential of disruption for clients and staff

Source: State Street Global Advisors Practice Management.

Risk Mitigation: Protecting the Business You've Worked So Hard to Build

A business continuity plan is part of the succession planning process. The continuity plan accounts for how a firm will continue to operate during an unplanned disruptive incident. This includes the protocol to address the sustainability and viability of the business, uphold the firm to their fiduciary obligations, and minimize any potential harm to clients due to any service interruptions.

- **From a fiduciary perspective** Financial stability and asset protection is essential. Advisors are obligated to ensure that clients best interests are being safeguarded.

- **From a business perspective** Success is not achieved by chance. Owners who delay planning may lose enterprise value — and may place the practice itself at risk, including jeopardizing client relationships and staff retention.

- **From the client perspective** Clients value continuity. Advisors should be able to provide confirmation that a client will not be adversely impacted by an unforeseen event or upon the retirement of an individual.

Clarity and discipline in business continuity and succession planning will help an advisory owner consider opportunity costs, guiding them to more profitable decision-making. Without a well-defined commitment to complete the plan, outside influences and short-term setbacks can become distractions. That can lead to added business risks for the practice and negatively impact several important stakeholders, including clients of the firm, practice employees and equity business partners, or advisory owners and their families. There are several common and critical gaps that should be addressed to adequately prepare for a range of sudden changes and unexpected disruptions (Figure 2).

Figure 2
Risk Mitigation: Address Critical Gaps to Improve Business Stability

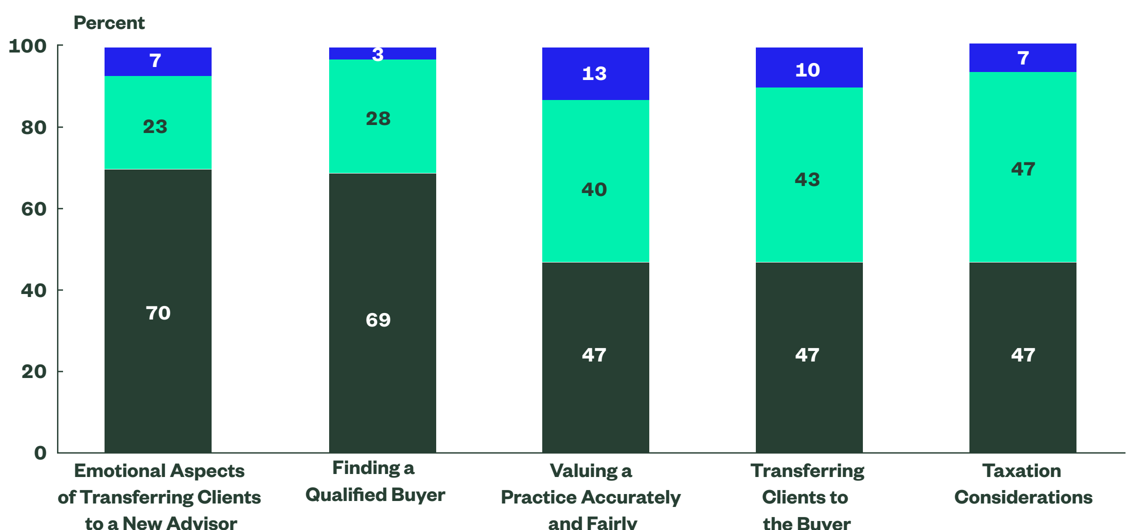
Change	Strategic plans for temporary or permanent change in the executive leadership team to support both investment advisory services and business operations
Control	• How control and responsibilities are transferred when change is necessary • Identification of any material financial resources available to the advisor • Regular review of the plan including governance structure and applicable transition-related economics to ensure sustainability over time
Client Service	• Process for investment management of client portfolios during a change of leadership • Outline how data is secured, how client assets and information are protected, and the process for clients to follow • Establish policies and procedures intended to safeguard, transfer and/or distribute client assets for short- and long-term scenarios
Communication	• How continuity is communicated, both internally and externally, including third parties involved in serving clients • Formalize practice privacy policy (written statement distributed and available to all clients)
Consistency	• How to compensate key professionals and follow through on equity sharing programs • Structural maintenance of critical operations and systems, and the protection, backup, and recovery of data
Covenants	How to ensure the team stays together, debt requirements don't take the firm down, and required transactions are clear or are appropriately restructured

Source: Echelon Partners, "Continuity Planning Solutions for Wealth Managers," 2018. Common challenges advisors struggle with. State Street Global Advisors Practice Management.

Laying the Groundwork for a Successful Transition

Whether an advisory owner is actively looking to transition the business through a merger or just starting to explore the possibility of retirement, there is value in starting to do the groundwork now. Advisory owners must contend with a series of decisions that call for introspection and potential tradeoffs (Figure 3) — and many often struggle to let go of their business, career, and clients. However, having a plan in place is simply smart business. Creating such a blueprint requires the advisory owner to think through and develop systems and processes for the business to ultimately run without them.

Figure 3
Top Five Succession Preparation Challenges



Source: Cerulli Associates, U.S. Advisor Metrics, 2023. Responses are from practice management professionals.

A good place to start is with the end in mind.

- What should happen as the practice continues to develop?
- How do you want your career to progress?
- How do you plan to exit the business?

Conducting a candid self-assessment of the business' current state and your future aspirations will help identify steps for the next chapter.

Vision: What do you want to accomplish with the business transition plan?

- Do you want to disengage entirely from the business or stay on in a different role? How does this align with the goals you have for the practice — and for your retirement?
- If you stay on with the practice as part of the transition plan, what will your role be? Mentoring new advisors? Serving as a board member? Transitioning key clients?

Leadership: Who should lead the business and who will serve clients well?

- Will you be comfortable giving up control of your practice to new leadership? If the succession plan includes human capital, can you build ownership and compensation incentives to attract and retain next-generation advisors and valued support staff?
- Is the right talent within the firm today? Perhaps a defined M&A strategy has the potential to realign the trajectory of the business — or does an external sale seem to be a better fit?

Strategy: What will implementation look like?

- How best to manage expectations — yours, current team members, future leadership, and clients? Is optimizing the business structure foundational to the plan?
- What key milestone can be used to guide — and course correct — the strategic plan? How can you use time to your advantage when addressing both short- (unplanned events, death or disability) and long-term considerations (planned scenario, exiting and retirement)?

These questions can help inform an appropriate future state, but it's important to realize that the answers may evolve over time. Furthermore, current advisory owner leadership and transparency behind the process will be key to the success of the chosen strategy. Succession preparation is about much more than the transaction itself. It's also about growth and continuity. Evaluating options includes a thorough assessment, and the goal-setting process can help keep the focus on achievement — not just activity — to accomplish the objective.

Five Guidelines for Shaping a Comprehensive Succession Strategy

The choices an advisory owner makes during the succession planning process do much more than clarify how leadership is transitioned. A comprehensive plan demonstrates to clients and team members that not only is the business capable of facing any unforeseen environment headwinds (such as the coronavirus pandemic), but that current firm leadership is able to help steer them through to a more secure future.

1

Budget Ample Time for a Transition

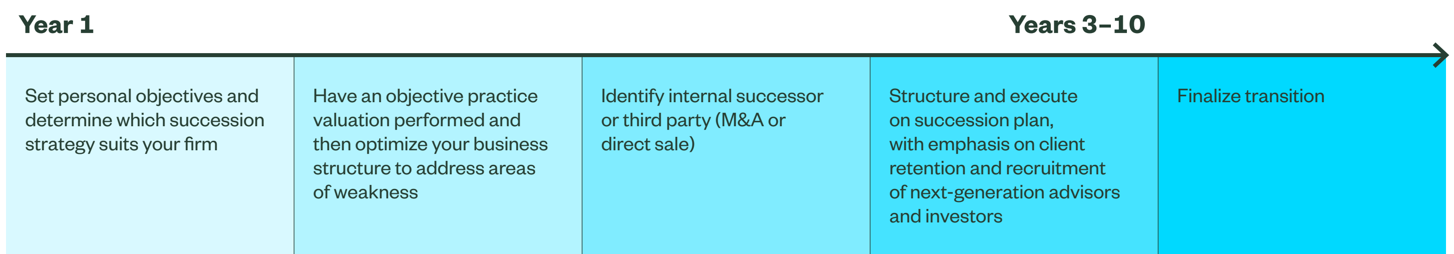
It is never too early to begin discussions related to succession planning (Figure 4) and knowing what the priorities are is a key component. Identifying your time horizon informs the timing of seeking a potential successor. Certainly, it is possible to plan your succession with a one-year horizon, however a shorter timeline imposes risks and constraints that a longer timeline wouldn't.

- For an internal succession, plan for a minimum of five years:
    - The talent required to take over and grow the practice may not exist in-house. Hiring externally can be time consuming and the first hire may not be the right choice.
    - Few individuals can raise the capital required to buy an advisory business, so the purchase must typically be financed by the owner over an extended period.

> "Not only does internal succession require a longer runway, it requires that owners create more than one viable option. Putting all your eggs in one basket by assuming one key individual will be the answer to your succession plan carries high risk. Identifying successors that demonstrate the character, values, skills and financial wherewithal takes time, so the more time to plan, the better."
>
> — Eliza De Pardo, Founder and Director, De Pardo Consulting

- For a merger or direct sale, plan for a minimum of two years, but recognize that while there are firms that have become quite adept at managing the integration process, integrating firms can be complex and time-consuming:
    - — Conduct an independent valuation before getting underway with a search. This leaves time to optimize business value if there are areas where the practice may fall short.
    - — Lead time is required to source and perform due diligence on the right partner or buyer, build relationships, and adequately negotiate the structure of the agreement.

Figure 4
An Effective Succession Plan Can Take Several Years to Execute



Source: State Street Global Advisors Practice Management.

2

Understand the Drivers of Practice Valuation and Address Weaknesses

Advisors frequently use a multiple of revenue to value their practice (Figure 5). However, practice management professionals recommend securing a valuation from a third party to ensure a fair, objective assessment that considers the nuances of one's business.

Figure 5
Methods for Practice Valuation

	Practice Management Professionals: Frequency of Valuation Methods Used by Advisors			Always (%)	Practice Management Professionals: Suggested Methods (%)
Valuation Method	Never (%)	Sometimes (%)	Frequently (%)		
Multiple of EBOC, EBITDA, or Another Financial Metric	3	31	48	17	63
Valuation by a Third Party	0	41	48	10	63
Multiple of Revenue	0	3	41	55	50
Discounted Cash Flow Based on Financial Projections	3	52	34	10	43
Percent of AUM	10	34	38	17	20

Source: Cerulli Associates, U.S. Advisor Metrics, 2023.

> "Valuation professionals understand two things. First, value is a function of the future. Second, the key drivers of value are free cash flow, risk and growth, not gross revenue. An advisory firm may be generating a high level of gross revenue, but underperforming in terms of cash flow or net profits, have a high degree of risk and uncertainty, such as overdependency on the founder, or a poor organic growth rate. A third-party valuation professional will take these factors into account. Revenue multiples are often used in postmortems or cocktail conversations but are not always helpful when buyers are making an investment decision."
>
> — Mark Tibergien, Independent Director, Pathstone

Sellers often have unrealistic expectations for their practice's valuation while buyers are evaluating the practice's future revenue potential — and an aging client base diminishes that prospect. Divergent expectations can break a deal so aligning interests is critical.

Valuation concerns are undoubtedly top of mind. Many well-established methods for valuing an advisory practice exist, but they all involve some degree of complexity and subjectivity — and both buyers and sellers need to be prepared. In assessing a practice, the revenue multiple can be a starting point with adjustments then made (up or down) to reflect the following individual characteristics of the business:

- Assets under management
- Client age and tenure
- Revenue mix
- Product mix
- Operations and technology platforms
- Financial terms of the deal
- Business location

3

Focus on Key Decision Factors

When the opportunity for growth shifts to the need to add a financial advisor partner — build a larger combined business — both parties should be mindful of sourcing complementary skill sets rather than identical or matching ones. This aspect of inorganic growth is about developing the infrastructure necessary to navigate this growth phase.

Practice management specialists note that far too often, advisors approach acquisition targets trusting that transitions will simply run smoothly instead of taking the time to assess whether the acquisition is truly a good fit for the practice. Advisors often fail to have extensive, upfront conversations about how they will integrate incoming clients into the client service model or what the future growth plans for the combined entity may look like.

During the due diligence phase, buyers and sellers are frequently exceedingly focused on value and overlook key factors for future success, such as adoption of new technologies, pricing strategies and pathways to realize anticipated benefits, including economies of scale. Fit and compatibility should be assessed across the full business model, including client demographics and human capital philosophy.

Cultural considerations are particularly important, given that a cultural misfit can derail an acquisition and substantially disrupt the client experience. As explained by Andrew Blake, Associate Director of Wealth Management at Cerulli, firms must adhere to company culture when exploring M&A. “Establishing clear expectations for integration processes, timing, and post-deal roles and responsibilities is essential to ensuring a successful transition,” Mr. Blake notes. “Strategic partners can help advisors understand how to integrate on all levels to create successful M&A outcomes.”

4

Build Your Human Capital

Historically, wealth transfers from one generation to the next have resulted in more than 70% of heirs changing advisors[4] — an eye-popping number for a retiring advisor unprepared to mitigate the risk. An overconcentration of assets with one client segment can have a negative impact on the value of the business.

While serving the older demographic remains essential due to their substantial wealth holdings, it’s imperative to begin cultivating relationships with the next generation as they represent a viable demographic for portfolio growth.

With Americans collectively possessing approximately $156 trillion in assets, baby boomers hold half of that wealth at $78.1 trillion.[5]

Generation X — in or approaching their prime wealth accumulation years — controls $46 trillion, nearly 30% of the nation’s wealth, while Millennials currently possess $13.3 trillion, constituting 8.5% of the total.[6]

Projections indicate that Gen X and Millennials are expected to inherit $58 trillion by 2045.[7]

Affluent investors among the younger generation are seeking more investment advice than in the past — a jump from 34% in 2018 to 44% as of 2023 — as geopolitical events and market volatility drive concerns.[8] Generation X in particular is an investor segment requiring service as they show signs of distress, trying to save for retirement, while needing to spend to take care of children and aging parents. More than a third of this cohort are not optimistic about their financial outlook, and over 60% continue to have inflationary concerns and the impact that will have on sufficiently funding their retirement years.[9]

In conversations with Mr. Blake at Cerulli, multiple advisors express shock at lower-than-expected valuations proposed by potential acquirers, often driven by the majority of an advisor's book of business being in the decumulation phase with no concrete growth plan. In many cases, firms serving predominately older client bases are positioned to be more profitable than those serving a younger clientele; however, firms with a younger client base are able to generate higher growth rates. With more proactive efforts to diversify the client base, this trade-off between growth and profit can be avoided.

A teams-based approach can promote continuity of relationships even as senior advisors retire. Sharing stewardship over client relationships and leveraging the collective talent of a team fosters growth. Associate advisors can bring fresh perspective on serving clients and are more likely to engage younger investors who established practices typically overlook. Furthermore, by laddering ages of advisory talent in the practice — from Boomers to Gen X to Millennials — the firm is in a better position to address the different concerns of clients across the generations. Advisory owners who invest in the career of younger financial advisors not only create potential internal succession options but also help the business drive future growth.

> “Every time I interact with someone who really impresses me, particularly younger professionals, I put their name on a list. When I want to hire new team members, I send the job description to everyone on the list. If the people on my list are not interested themselves, they might know someone who could be ideal for the role. This is a simple strategy to quickly get the word out to a large number of prospective candidates.”
>
> — Advisor, Morgan Stanley

Case Study: Sourcing, Developing, and Mentoring Young Advisors

One of the most common questions posed by financial advisors to Sterling Shea, Head of Practice Strategy for Morgan Stanley Wealth Management, is how to source, develop, and mentor young advisor talent to become potential successors.

“These are among the most important, albeit challenging activities for any financial advisor,” says Shea. “Too often, I see advisors spend decades building an outstanding business, only to begin the succession planning process too late and end up not finding a suitable match to whom they can transition ownership and leadership of the team.” As a result, the practice owner is forced into a defensive position — or even left desperately seeking an answer for the future — which can create negative ramifications for their business and team culture.

For those teams who get it right, what is their secret to success? “In my experience, the secret is to dedicate time, energy, and resources to business continuity. The succession plan should be developing, evolving, and actively executed all the time, as opposed to receiving attention periodically or a few years before retirement,” notes Shea.

The process begins with talent acquisition. “Successful talent acquisition strategies mirror many fundamentals of a new business acquisition strategy: Building and maintaining a strong professional network, having a clear and visible team brand, and keeping an active and relevant digital footprint,” describes Shea. “Networking and brand building internally and across a variety of external sources will attract top talent — both seasoned and green.”

Lastly, Shea encourages advisors to consider how they are training and mentoring talented team members. “Is your process for their development strategic and intentional? Are you making the right introductions to clients and centers of influence? Are you building their skill set for long-term success? Are you considering your team members’ career goals?” asks Shea. “In short, the key to success in talent sourcing — and ultimately, in succession planning — is the same as it is for any function of the business: It requires strategy, intent, and accountability.”

5

Be Proactive with Clients

An advisor's ability to prioritize clients' best interests (93%), establish strong chemistry with current clients (87%), and demonstrate a compatible personality (80%) are all crucial factors in successor evaluation.[10] Retiring advisors have typically spent decades cultivating relationships with their clients and express apprehension about handing them over. They want to choose a successor who will similarly care for their clients and nurture their business.

Practice transition deals frequently incorporate an earn-out component, which results in the price being reduced if client retention rates are less than expected. Furthermore, a misalignment in personality, style, or expectations can cause friction between buyers and sellers. This underscores the importance of the initial due diligence process, thorough vetting of potential successors, and extensive conversations regarding the succession process.

Transparency is important and key to a successful transition. It's important that clients understand, during a planned transition — or an unplanned disruption — that they are in good hands and their assets are protected. Clients are already thinking about the day their primary advisor will retire so a proactive approach is best.

For both internal and external successions:

- Include the eventual successor in client relationships far in advance of an expected retirement.
- Collaborate with the new successor to ensure that clients have continuity in the areas of service levels as well as investment management and product selection.
- Pair associate advisors with senior advisors together in client meetings to build rapport, earn trust, and ease the transition experience for clients.

Succession Planning is About More Than Retirement

A succession plan can serve as a powerful tool for maximizing the value of an advisory firm. And when care is taken to plan ahead, the advisor-client bond will only strengthen.

But advisory owners who wait too long to develop a plan will likely fail to attain full value for their businesses. Furthermore, a lack of a robust continuity and succession plan can result in a next-generation client retention challenge.

The time to act is now — protect and enhance the future of your business.

Endnotes

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