Succession Planning

Lead Time Is Crucial to a Successful Effort

By Nick Platt

As America, led by the signature baby boom generation, ages, so do the financial advisors who serve them and the rest of the population. The graying of America’s advisors—it is estimated that one in 10 practitioners is over the age of 60—raises a number of critical issues for both advisors and clients alike; as the trend accelerates, these issues will become increasingly pertinent.

For advisors, the major question is, simply, what to do? More specifically, who do I sell to? An internal party? An external party? And when? At what valuation? What does this mean for my own retirement? What does this mean for my partners, staff, and clients?

For clients, a key question is: Am I prepared for a transition? Am I comfortable with the exit of my advisor and with the chosen successor or successors? Does internal or external ownership impact my decision to stay?

Although the focus in this article is principally on the advisor, client consideration is paramount. There is the obvious moral and fiduciary obligation to the well-being of the client; from a standpoint of pure economics, an unhappy client represents risk and the potential for lost assets and ultimately a negative impact on valuation.

As will be discussed in further detail, the financial advisor approaching or even contemplating retirement would be well-advised to consider the following:

Succession. It is never too early to think about succession. In fact, the more lead time one has, the better the chances are to attain maximum valuation for a franchise while ensuring the relative satisfaction of key interlocutors, namely partners, staff, and clients.

Valuation. When considering valuation, there are some key valuation parameters but no hard and fast rules. It is best to take a flexible and open-minded approach regarding the multiple inputs that drive ultimate valuation.

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Industry research appears to confirm the succession trend and underscores the need for the advisor community to sit up and take notice.

Earlier in 2012, the AITE Group, under the aegis of NFP Advisor Services, conducted a study of 228 financial advisor practice owners. Here are some of the salient conclusions:

- 40 percent of advisors want to transition their practices in the next 10 years
- Nearly two-thirds of practice owners do not have a succession plan in place
- A majority of advisors without a succession plan have no sense of their practice value
- 40 percent of all financial advisor practices will have ownership changes in the next 10 years

These numbers point to big changes coming soon for the industry. That said, only a minority of advisors appears prepared, or even aware that they need to be prepared. Perhaps the most critical factor here is time. Although no one knows for sure how much time it takes to adequately prepare for succession, some in the industry say 10 years or more lead time is necessary to put the right program in place. If we are to accept that yardstick, then the AITE/NFP findings are eye-opening: The research showed that only 6 percent of advisors were aware that they need a decade to transition a practice.

Also of interest in the AITE/NFP report was an indication that the vast majority of advisors wish an internal (i.e., selling to insiders) versus an external (i.e., selling to a roll-up or the like) succession. This overwhelming preference has been confirmed by other studies, such as the 2011 RIA Benchmarking study by Charles Schwab & Co.

Internal vs. External Succession

The preference for an internal versus an external succession makes sense. These businesses are fundamentally practices; their value does not depend on the production of widgets but on intangible things such as personal relationships, judgment, and trust. Such value-driving inputs are delicate and more likely to be protected by seasoned and knowledgeable insiders.

On the internal sale, generally two routes can be pursued. If the firm’s bench is deep enough, then an advisor can organize a phased sale to existing insiders. Without an adequate internal successor, or perhaps if current insiders need further seasoning, then a sale can be organized to a designated firm or outside individual who has the requisite experience and qualities.

The internal versus external sale presents a quandary for the practice owner. Simply put, an external buyer is likely to offer a greater premium than an inside buyer if for no other reason than more potential buyers means greater price competition. Additional problems with insider buyers include access to financing and potentially longer buy-out periods. These issues get more complicated if the practice has scale, say, assets of $500 million or more. In this case, an external buyer may be willing to pay a higher premium.
to capture these efficiencies. The same dynamic applies if the practice’s revenue mix features, for instance, a higher proportion of recurring revenue, which is deemed attractive by outside firms.

An insider may lack the means to pay more, and besides, an insider has very little incentive to pay more because he is, in effect, the only buyer. A 2012 Schwab MKT report: “Transition Planning: A Guide to Understanding Valuation and Deal Structure,” said owners can expect to receive up to 20 percent less with an internal transaction than with an external transaction.7

Still, for all this talk of higher premiums, the practice owner who chooses to pursue an outsider sale faces a host of risks. Client retention is a recurrent problem in sales of advisor businesses. The owner who negotiates a large nominal valuation may see a chunk of it frittered away on a lower than expected back-end payout as clients, unhappy at the prospect of being cast into unfamiliar arms, head for the exits.

A third exit strategy—being carried out of one’s practice feet-first—is a potentially lucrative option few responsible advisors would consider. It is unfair to partners and staff and ultimately clients, who would be left with no transition to speak of.

Time is to be carefully considered in all these options. Most advisors prefer the notion of internal succession, but it carries the longest and potentially riskiest (for the owner) timeline—anywhere between five and 10 years. The transition time is a function of the time the under-resourced insiders need to pay off their commitment. Selling or merging is by definition a shorter process with a timeline of two years at most.

All of which underscores the assertion that significant lead time is required to sort out these knotty succession issues.

Practice Valuation
As advisors consider their options, they need to think equally hard about practice valuation. A factor in delayed or botched successions can be unrealistic expectations of valuation. The naïve practice owner can, for example, expect an out-of-the-industry-norm premium and payments tilted toward the front-end.

The reality is that practice owners can expect to receive a minority—perhaps up to 30 percent—of their proceeds upfront in the form of cash or equity, with the remainder coming via a staged three-to-five-year earn-out delivering cash or equity. In some cases partial payment may come in the form of a note. Owners can expect consulting or employment contracts to further bolster retention.

Just what kind of premium a buyer will attach to the practice is a function of a number of factors including the quality (i.e., predictability) and relative size of cash flows (the bigger the better); the perception of dependable growth prospects that are a function of the franchise as opposed to, say, a single individual; and the perception of relative risk in things such as client concentration or the ability to hold on to clients or key employees. Other factors affecting valuation include corporate structure and the attendant tax consequences of that structure.

As the Schwab MKT report on transition planning points out, traditional approaches to valuation methodology such as book value don’t apply because advisor franchises lack hard assets. Similarly, trying to use market-based comparisons is tricky because many transactions are private and there is little public data. Not surprisingly, the preferred method of valuation is cash flow-based with acquiring firms looking to predict future income and pay accordingly. The general range is four to six times earnings before interest, taxes, depreciation, and amortization (EBITDA), but it can be below or above the low and high ranges depending on circumstances. The revenue multiple rule of thumb is one to two times, but a revenue multiple is a less-refined form of measurement than the EBITDA multiple.

When using EBITDA multiples, be careful to ensure that the earnings presented adequately reflect the earnings power of the firm. EBITDA can be distorted by owners who, for tax or lifestyle reasons, remove all the excess cash from the business on an annual basis, as the Schwab MKT report notes. So earnings before owner compensation (EBOC) might be a more accurate yardstick. Simply put, this is EBITDA with owner compensation removed.

Advisor succession will become an increasingly high-profile issue in coming years. Advisors, even those still some years from transition, would be well-advised to start thinking about the problem and taking steps to provide themselves with an appropriate price for their practices while continuing to protect the interests of internal stakeholders and clients.

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Endnotes

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