BNY MELLON | PERSHING

Realizing the Value of Your Life's Work:

Building a Sustainable Succession Plan

In collaboration with

ADVISOR GROWTH STRATEGIES

Introduction

Now more than ever, designing and implementing a succession plan is a critical and foundational element of every successful advisory firm. How will clients be served, and who will continue to lead your firm when the current generation of ownership leaves? A well-crafted succession plan helps firm owners achieve alignment between their personal and professional goals and can serve as a powerful tool for improving firm value.

In this paper, we will explore:

What is succession planning?

The benefits of succession planning for owners, teams, and clients

How to build a high-impact succession plan

The need for succession planning has never been greater. The volume and breadth of M&A activity has increased the pressure on business owners to invest in internal succession plans. The median RIA valuation increased more than 20% from 2019 to 2020 according to AGS' M&A research, *The 2021 RIA Deal Room*. A variety of well capitalized partners, as well as growth-oriented RIA platforms and investors that are seeking to buy or partner with independent advisory practices, offering an assortment of economic models, degrees of control and exit timing scenarios.

There is good news for current owners: not only have the choices for exiting the business increased, but the support for independent firms that are looking to develop and implement a succession solution has also increased. The industry has developed a new cohort of talent that provides founders with more options to transition their business to the next generation as an alternative to outside partnership.

What is Succession Planning?

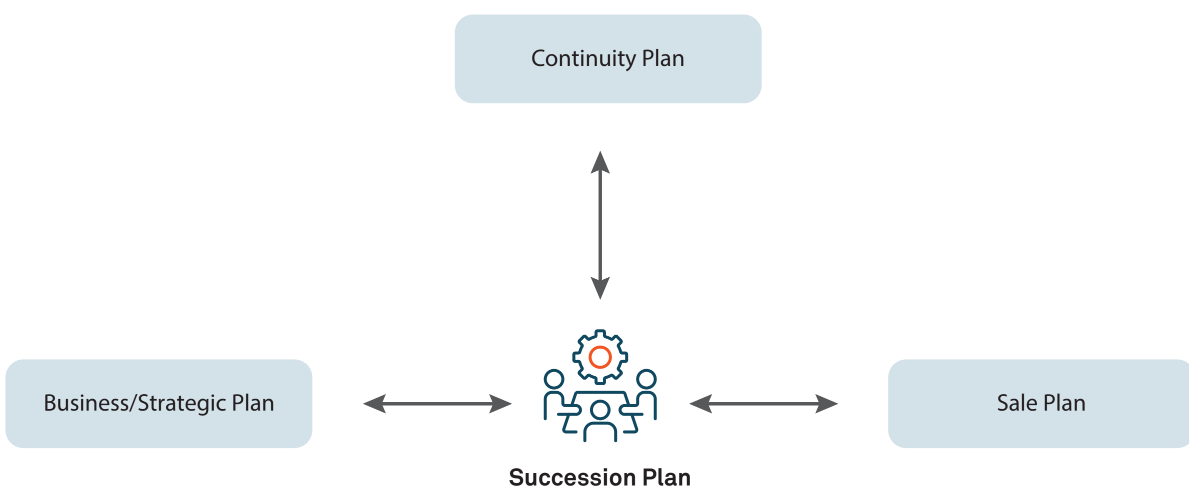
Succession planning is the intentional process of transferring the management, ownership, and goodwill of an advisory firm from one generation to the next or from one entity to another. Transitioning a business is not a stand-alone event; it is linked to multiple areas of a strategic plan and is executed over time.

Succession planning is not the same as strategic, continuity or sale planning. Succession planning bundles elements of each into one cohesive process.

1. **Strategic planning.** The process of outlining a firm's purpose, vision, mission, and values—along with a tactical plan to bring that vision to life. Business planning is designed to help firms reach specific goals over time. A firm needs to develop a strategic planning process if the intent is to be an enduring firm.

2. **Continuity planning.** The process of 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). The continuity planning phase is critical to ensure the business has simple steps in place to create options if this business is forced to implement succession sooner than expected.

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



Succession planning impacts and interacts with all other forms of planning

SPOTLIGHT: SENDERO WEALTH MANAGEMENT

What got you here, won't get you there.

Sendero Wealth Management is a progressive firm that has taken steps to form a dedicated executive team and address succession. Founded in 2008, the firm has grown to nearly $4 billion in assets, 30 employees, including six partners. Sendero's team chose to institutionalize the business in 2017 after realizing, "What got us here, won't get us there."

Sendero is a firm that values independence and views succession as an opportunity to create a multi-generational firm that focuses on clients' financial life cycle. Elizabeth Crawford, Chief Executive Officer, notes, "Succession planning helped the firm evolve quickly. We put dedicated management in place and installed a Board structure to create better accountability. Our next generation of talent sees the firm being run professionally and has responded well." Learn more.

The Benefits of Succession Planning for Owners, Teams, and Clients

The RIA market is getting more complex as the ecosystem grows and competition increases. RIAs have an appealing and flexible model but the industry has no defined model or consistent approach for when an advisor needs to retire or exit the business. Many RIA owners have no clear answer to the client question, "Who will be my trusted advisor when you are gone?"

RIAs have seen more sophisticated and larger RIAs vying for talent and the next new client, and facing greater pressure to prove their value. Cerulli and Associates estimates that 6.4% of RIAs controlled 68% of the channel's AUM in 2019, and some of these large RIAs are building structural advantages through increased resources and reach. To complicate matters further, these large RIAs are also developing sophisticated acquisition strategies by leveraging their platforms and access to capital. The rapidly changing landscape will force more RIAs to clearly articulate their long-term strategies to retain talent and remain independent.

Top firms are focused on growth and scale, but ownership structures are evolving at a very slow pace. Most firms (69%) reported no change in ownership in the previous year according to the *InvestmentNews* 2019 Adviser Compensation & Staffing Study. Flexibility is the motivation for many advisors to pursue the Independent RIA model, and flexibility comes with responsibility as owners must define and implement their own succession plan.

Succession planning provides strategic benefits for and addresses several areas of risk, such as:

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

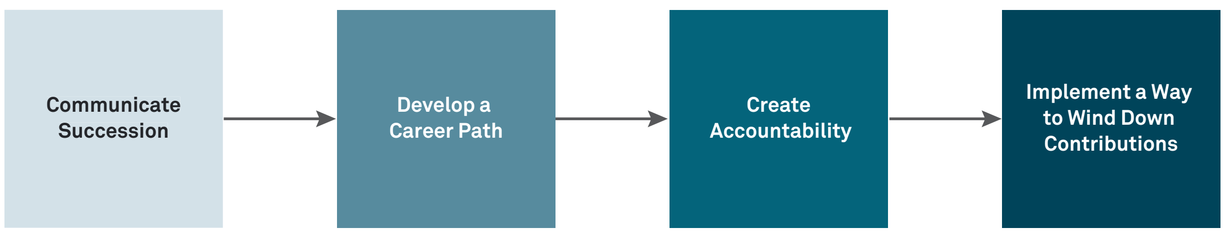
    a. **Privacy Policy.** This policy outlines how clients' confidential data will be protected by the firm. Every firm should prepare a written statement on their privacy policy and distribute it to clients.

    b. **Financial Stability.** 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.

    c. **Safety and Security of Their Assets.** A quarterly statement is made available by your custodian which shows the measures taken to protect their investments.

2. **Growth Risk.** 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. By investing in the next generation, firms can mitigate future growth risk by equipping and empowering future owners to grow the business.

3. **Staff Attrition Risk.** Job descriptions should be directly linked to stated objectives in the business plan. 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. **Enterprise Value Risk.** RIA valuations are based on either 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 valuation and attractiveness to potential buyers. There is never a guarantee when it comes to value, but firms can positively influence value drivers through the planning process.

5. **Optionality Risk.** A lack of a defined plan, or waiting too long to create one, will reduce the options available to owners. According to Advisor Growth Strategies research, internal succession can take five to ten years to execute, and an external sale event can take upwards of 2 years to execute.

SPOTLIGHT: COMPASS ASSET MANAGEMENT

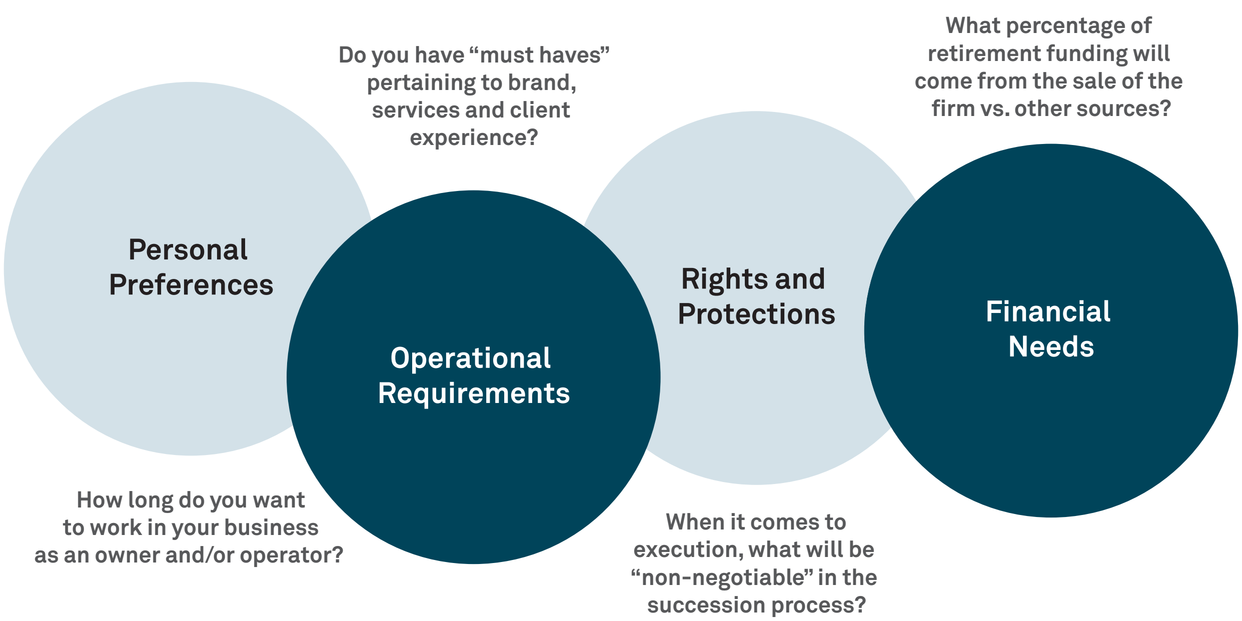
Building trust between founder and next gen delivers win-win-win

Compass Asset Management is an example of succession planning done thoughtfully between a founder and a next generation successor. Founded in 1997, the firm was able to execute a successful succession agreement in 2020 between the firm's founders and a talented next generation professional.

William and Carolyn Matthes built an asset management firm to serve the communities around their office in Guilford, Connecticut.

William and Carolyn had deep experience in the asset management world, founding the company after a long history working in asset management departments of some of the more successful large institutions in the U.S. The firm built a successful investment track record by "insourcing" asset management versus outsourcing asset management as many RIAs in the U.S. have moved to in recent years. This boutique approach is still in place today. Learn more.

Determining the Appropriate Succession Plan Requires a Thoughtful Process



Selecting the appropriate succession plan option, or combination of options, requires owners to identify goals. A succession plan should be aligned with the personal goals and time horizon of the owners and team. The plan should include actionable steps towards succession that will help a firm realize the best outcome. The option selected may impact the firm's legal structure, business plan, clients and employees. The chart in the appendix describes the options available to advisors along with the economic considerations, pros and cons, and impact on employees and clients.

Even with the right plan selected, owners of advisory firms still face execution challenges. For example, advisors that are seeking an internal succession plan may not be able to find next generation talent that can effectively manage and grow the firm. If the right talent is identified internally, high levels of equity concentration can make financing difficult, and employees may not have the ability 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. For firms that want to execute an internal transition, a succession plan could potentially take five to ten years. The simple economics of the transaction and probable need for next generation financing alone should tilt firms into action sooner rather than later.

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 between $562,500 and $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. Furthermore, the external market will continue evolving and could create a substantial gap between internal and external valuations.

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	$7500,000	$750,000
10% Discount	$6,750,000	$675,000
25% Discount	$5,625,000	$562,500

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 financing cannot be achieved, a flood of new market entrants has bought independent practices, including acquirers, 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.

How to Build a High-Impact Succession Plan

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. In this step, owners should define if they are seeking to build a legacy, maximize a financial outcome, or a combination of both.

2. **Identify viable succession plan options.** 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 the 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 (EBITDA, 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.

   d. **The buying party (internal succession) and funding source.** One of the 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.

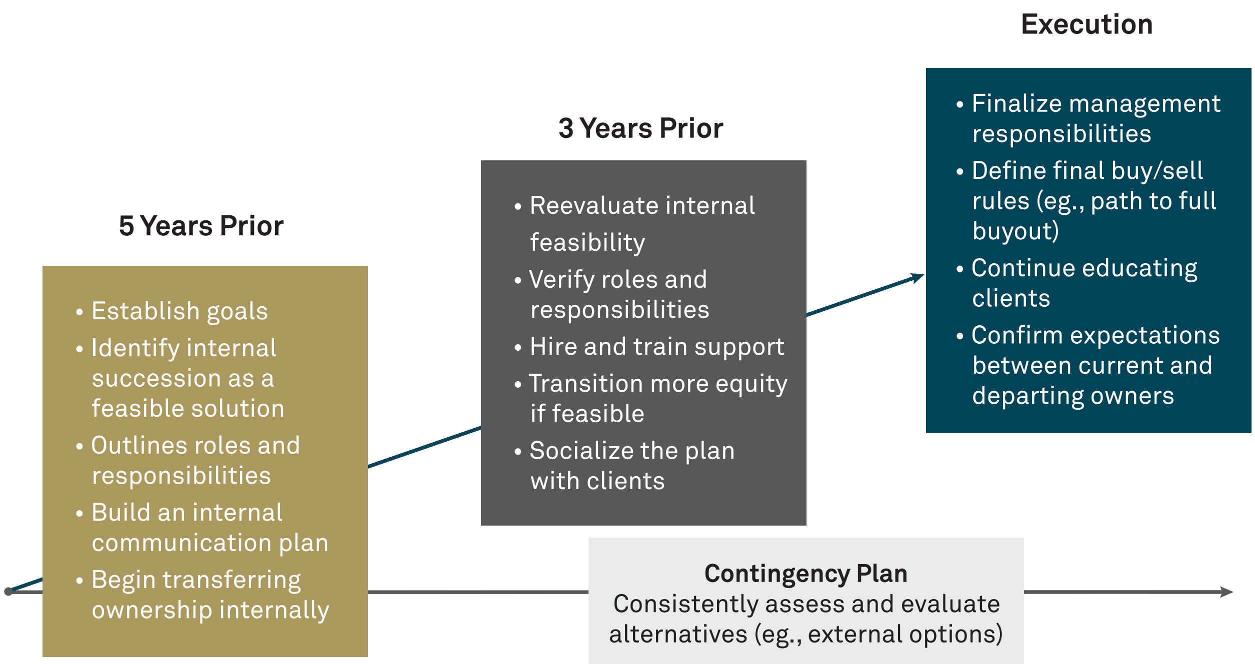
4. **Identify the time horizon.** Owners must pinpoint the time horizon of their exit from the firm. This knowledge informs the timing of seeking a potential successor. Finding the right external buyer could take up to two years and grooming an internal successor could take more.

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 straightforward but evaluating successors, especially outside buyers, is a far more complicated and time-consuming process. 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.** Negotiations must take place between the owner (seller) and the successor (buyer) to complete the transaction or set terms for the future. Owners may decide to hire a consulting firm or investment bank to negotiate on their behalf.

7. **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.

Building a Flexible Succession Plan



8. **Implement the plan.** Implementation includes communication requirements with clients, employees and vendors. There could be a significant organizational impact for firm employees.

The execution of a succession plan is critical. As we look towards 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 advisory 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: VENTURA WEALTH MANAGEMENT

Business planning drives next gen commitment and succession

When Nick Ventura started Ventura Wealth Management in 1999, he had a stated commitment to find and develop young industry professionals. "I knew from day one that I was only as good as my team, so I made a day-one commitment to providing opportunities and transparency to my team," Nick said. This event has yielded fruit as Ventura has seen high team member retention with contributors staying with the firm for over 25 years.

In terms of succession planning, Nick began the process of transitioning equity once he turned 60 years of age. To start, Ventura leveraged the services of a third-party valuation company to provide an objective view of firm value. Dan McElwee was the first professional on the team to buy equity. Dan developed credibility with clients and the community by leading the firm's retirement plan business and being a leader in the industry by writing newsletters and being quoted by various industry trade publications. Dan's personal development has paid dividends with Ventura currently managing over $300M in AUM, with Dan playing a meaningful role in growing revenue. Learn more.

Conclusion

There is no better time than the present to create or review your business and succession plan(s). Executing on succession and business planning now will create more options and greater flexibility in the future. Those firms that have spent the time to prepare will have greater control over the process of executing a succession plan, and therefore the future outcome. Advisory firm owners now have access to a broad array of business consultants and legal and tax advisors to help them chart a course. Now is the time to define what is important to you, document a plan, and execute on the future. **Contact your Pershing Relationship Manager to learn more.**

Appendix - Chart References

	Why have educated professionals not made succession planning inevitable?	Getting started: Making succession inevitable
Establishing a Fair Valuation	Valuation is part art and part science and establishing a consensus is difficult.	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	A primary driver of value is client relationships or goodwill. Many professionals are concerned about clients' reaction to transitioning to another 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.

	Internal Succession	Combine with Another RIA	Sell a Minority Stake	Sell to a Strategic Acquirer
Description	Existing owners transfer equity to existing 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	Owners sell all of their equity to their buyer. Buyers are usually well capitalized and include: banks, trusts or larger RIA firms
Economic Considerations	Cash transaction. Buyers may have to be financed through earnout 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. Buyers usually sells a portion of future cashflow	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 events 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

	Internal Succession	Combine with Another RIA	Sell a Minority Stake	Sell to a Strategic Acquirer
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 a strategic partner may not be valued by all sellers	May be highly desruptive to clients and employees. Seller may loose brand and identity through the transaction
Client Impact	Low	Medium	Low	High
Employee Impact	Medium	Medium-to-High	Low-to-Medium	High

	Why have educated professionals not made succession planning inevitable?	Getting started: Making succession inevitable
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? In many cases 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 in the process. Collaborate with others that have gone through the process to identify how life has (and has not) changed.

CONSIDERATION: NEGOTIATING THE RIGHT DEAL TERMS

Price and terms of a transaction are important considerations, 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 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.

CONSIDERATION: LOOKING EXTERNALLY FOR SUCCESSION

Some firms will come to the conclusion that an M&A transaction is the best succession solution. 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 is non-negotiable for any partner. This may include everything from culture fit to investment process and will help narrow the candidate list when you begin your search.
2. **Build a plan with your team.** Get your next generation involved in the process. Build a plan that creates the best outcome for your clients, team, and owners.
3. **Seek out and interview external firms.** Leverage your criteria to find external partner candidates. The M&A market for RIAs has matured considerably and more options exist than ever before. Leverage resources such as your custodian, consultants, or investment bankers to help profile and interview potential partners.
4. **Think like a buyer.** When creating your business and succession plan, think about what the "ideal" buyer is looking to purchase. Industry partners and interviews with outside parties will help inform this process.

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