CLS Advisor IQ Series

BRIDGING THE INTERNAL SUCCESSION GAP

Strategies for Managing the Transition Between Selling Owners and Employee Buyers

advisor IQ
By CLS Investments

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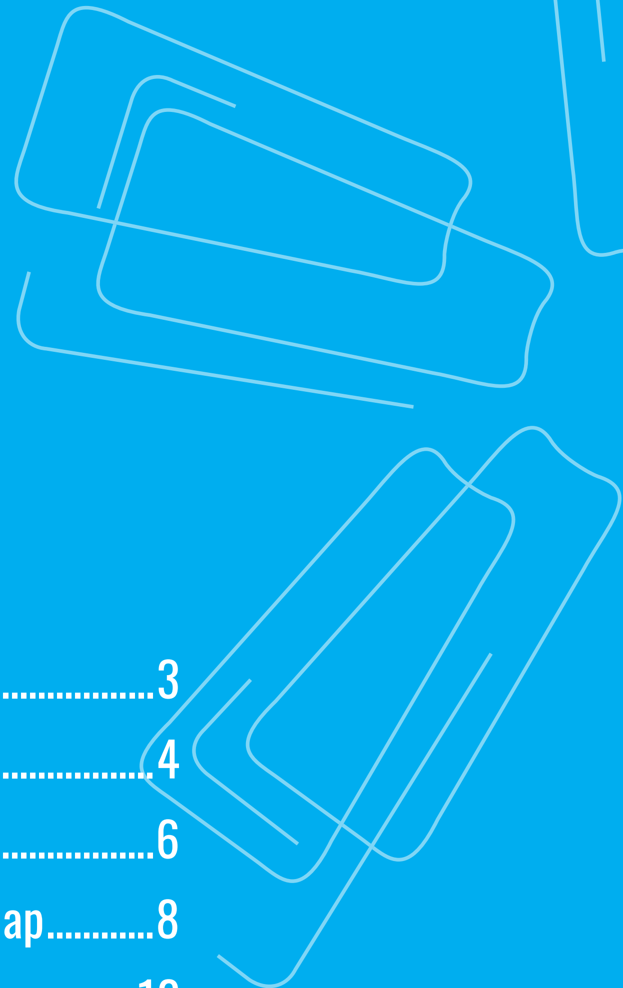

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Introduction

This paper is part of the CLS Advisor IQ series of industry content designed to help advisors succeed.

Building upon our previous succession planning white paper, “Reinvent Your Practice,” we are pleased to introduce the next chapter in our ongoing study of succession planning with this follow-up report.

Our first paper proposed the idea that instead of having to sell their businesses as the only option for succession planning, advisors can “reinvent” their practices to provide them with more options as part of their overall succession planning preparation.

This “reinvention” model described a process for gaining operating leverage to free up time for the founding principal(s) by making changes in their businesses. These changes allow advisors the ability to reduce their involvement in order to work less, begin pursuing outside interests, and provide flexibility to transition ownership according to their ideal schedule.

These “reinvention” strategies included approaches such as investing in technology to become more efficient, bringing in junior advisors to share the client workload, outsourcing investment and operational components to free up time, and other ideas to make the business less dependent on the founder(s). By reinventing their businesses, advisors can think about their futures differently and resist the siren being sounded by industry roll ups, aggregators, and private equity firms that the only option left is to “sell to us, now.”

By reinventing their practices, advisors have more control and options for the long-term transition of their businesses, ultimately leading to an eventual liquidity event and transfer of the business as part of their overall succession plan.

However, our research has shown that there are significant factors advisors need to consider when it comes to eventually selling an advisory firm, even when that sale is an internal transfer. These factors and considerations are complex and can lead to additional delays in implementing succession plans, further exacerbating an already pressing industry issue.

Accordingly, this white paper, developed in partnership with ECHELON Partners, a leading investment bank serving the wealth management industry, will continue our study of succession planning for advisors with a focus on the specific challenges of internal ownership transitions. We will suggest actionable strategies to address these unique challenges, while helping advisors develop a framework for the long-term continuity for founding owners, their chosen successor(s), and the firm’s clients.

The Succession Planning Challenge Continues

Despite high profile media attention given to advisor succession planning (and lack thereof), there is still a large gap in the preparedness of advisors, which is leading to challenges for the long-term health and sustainability of the industry.

According to ECHELON Partners, a leading wealth management investment bank, 20% of advisors industry-wide plan to retire or leave the industry within the next 10 years, yet 80% of all practice owners do not have a succession plan in place.

Moreover, advisors who are within two years of retiring have about the same low level of succession planning adoption as those who are a decade away from stepping down. Adding to this urgency is a misperception in the amount of time it will take to plan an orderly succession. Advisors believe that number is closer to 5 years, while industry experts, consultants and bankers all advise to plan for 10 years. The problem with waiting is real.

The longer advisors delay putting a plan in place, the more their business value erodes over time as their client base ages and moves into distribution mode, causing growth to slow and AUM to decline. When a firm's AUM shrinks, it becomes harder to attract new advisors and clients into a firm that has declining profitability resulting in client initiatives being cut, accelerating this "death spiral" until ultimately there is no value left in the firm to monetize.

Additionally, end-clients are becoming increasingly savvy and are now asking, "What happens to me if something happens to you?" further putting pressure on aging advisors to have a concrete plan in place so that they can communicate to keep current clients on board. Regulators are also beginning to examine this issue closely and are moving to create mandates that advisors have continuity plans in place as a regulatory requirement.

All of these factors are creating an urgency for advisors to get started today, yet the succession planning challenge persists.

So, what is holding advisors back from taking action? For many, it often comes down to the psychological issues of admitting that they are coming to the end of their careers, no longer being involved in their businesses, not having confidence in their staff, seeing their "baby" move on, and many other emotional ties to the firm they founded. These advisors continue to find reasons to delay the inevitable, instead of doing something about it, which can only hurt them in the long term.

For successful firms, on the other hand, succession can be a powerful strategy for growth, driving incremental financial rewards to founders, long-term career enrichment for their employees, and better outcomes for clients.

The good news is that industry experts expect a dramatic uptick in advisor succession planning over the next several years. This will be driven by some of the bigger industry challenges that are beginning to emerge, along with personal issues that are starting to catch up with aging advisors.

According to ECHELON Partners,

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of those advisors (for which such a plan is relevant) do not have a succession plan in place

of the advisors that have a plan in place, more than 50% of them have significant issues with the legal, human, valuation, and/or financial elements of their plans.

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For many advisors, after successful careers, they have hit their wealth targets and don't need to continue working. For others, they are simply nearing their later years and are getting tired of working. Their firms have grown in complexity and the new industry environment with changing compliance requirements, technology-enabled competition, and increasing client demands will be substantially more challenging to navigate. Others see an opportunity to take advantage of higher valuations as market cycles hit their peak, while others see a downturn in the markets around the corner and want to exit on top.

Regardless of the reason, once advisors do get in the succession mindset, research shows that nearly 60% are planning for an internal succession versus an outright sale to a third party to ensure business continuity for their clients and employees. This path resonates with most advisors, as it appears to be the least disruptive to the business and client relationships.

The next step, then, becomes identifying and grooming internal successor(s) to take over the business and provide the founders with the financial rewards of their sweat equity from many years of building the firm.

Though a seemingly simple step, when it actually comes time to have these internal conversations, founders are often surprised that their employees can have vastly different perceptions of what this means to them, and for many firms, there might not even be an internal candidate capable of taking over, further slowing down and complicating the process.

As noted, more and more advisors are looking to internal successors as the preferred route for their succession plan. This is because advisors perceive working with a known party as being less risky and more ideal. Advisors often believe that working with an unknown party will bring additional change, risk, questions, and more.

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TIM KOCHIS

is a famous advisor-founder who laid the seeds for the development of industry powerhouse Aspiriant, a $9 billion advisory firm. He did so by implementing a thoughtful succession planning approach to trigger the success and growth of his firm after he exited.

Now an industry consultant speaking on succession issues, Kochis recommends to advisors that the first step in planning is to, "pull yourself out of the business and imagine what you want it to be over time, and then develop a detailed plan to get you to that vision. No one, and no thing lasts forever."

The second step is to develop a transition model and fill in the blanks with the specific outcomes you want for such things as strategy, culture, client service, firm management, marketing, and equity transition. "You need to be very specific in terms of the outcomes you want, who is responsible and on what time frame. Ultimately if you have a plan in place, then you can be very opportunistic in how you implement it."

Internal Ownership Transition Challenges

On the surface, the risk perception for an internal deal is low. The counter parties and business model are known, the client base may be familiar to the successor, the work ethic of the future leaders is known, etc. Because of this familiarity, very few advisors do a thorough analysis of the pros and cons and jump into an internal deal mindset at the beginning of their thought process. However, there can be significant challenges to overcome that advisors are unaware of until they present themselves.

These challenges include orchestrating and managing the overall transition process, which can take quite a bit of time and effort, and can easily distract the owners from the day-to-day management of the firm. The many moving pieces involved can be a very complicated puzzle to put together, and sometimes take multiple years to accomplish.

The key to managing this process is to have clear communication and an understanding of each party's point of view on all facets...

If not thought through and communicated properly, there can be damage done to staff relationships as one person is identified as the firm heir, leaving others behind. This can create the potential for infighting and declining job satisfaction, leading to staff attrition.

In some cases, the selected successor may not even want to fill the role, or may lack the key skill set to be effective in the new position. For example, the successor may not have an entrepreneurial spirit, be able to bring in new business, or possess the key people skills necessary to be a leader. Successors may not even have enough faith in the future direction of the firm or see themselves in the long-term vision of the enterprise.

Additionally, because internal transactions often have lengthy, multi-year terms, keeping good relationships between buyer and seller is paramount to ensuring the success of the transition.

Therefore, the key to managing this process is to have clear communication and an understanding of each party's point of view on all facets. Ultimately, even one misperception can kill the deal and months, even years of hard work can go out the window, forcing advisors back to where they started.

Problems with the transition can easily arise when more complex issues from an ownership change come up, such as the legal, financial, tax, compensation, and firm governance and management. If the outcomes from these issues are not understood and embraced up front by both parties, it is very easy for negative feelings to arise and uncertainty to develop that can create delays and extend an already long process – all which can fester and become potential deal killers if left unmanaged.

THE NEXT GENERATION OF ADVISORS ARE READY

As senior advisors are considering their succession options, developing the next generation of advisors in their firm can be a powerful approach that can provide a smooth transition. However, for many senior owners, they may have doubts about the work ethic, experience, communication styles, values, perspectives, and skill levels of these younger advisors. Senior advisors may potentially use this as another excuse to delay transition planning.

Despite the sometimes negative stereotypes of the millennial generation propagated by media outlets, recent research shows that the next generation of advisors are not all that different from the generation that preceded them.

According to a survey by wealthmanagement.com of 349 advisors under the age of 45 across all channels of the industry, "it turns out that younger advisors are very much like older advisors. They are predominately white males with a bachelor's degree; they're largely satisfied with their respective firms, including its management, technology and support. They got into the business for the same reasons as their elders – job satisfaction, to work with people and to help clients make better financial choices."

Similar to the general advisor population, these next generation advisors are not inexperienced, "wet behind the ears" recruits coming into the profession right out of school. Nearly 70% of the survey respondents said that they came into the advisory business after working in another career capacity, with an average of over four years of experience out of college working somewhere else.

Additionally, nearly half of these younger advisors say they are included in some form of a succession plan, with two-thirds of those indicating that it will be an internal transition.

Strategies for Bridging the Internal Succession Gap

According to ECHELON Partners, there are 10 major management issues that need to be agreed upon by both sides in order to make a deal successful. These issues range from owner psychology, long-term vision, and firm growth, all the way to the legal documents and financial requirements.

While navigating these issues can be difficult and time consuming, presenting more of an uphill climb than advisors would like, they can be successfully managed by focusing on and implementing sound business and practice management principles.

The last thing advisors want in this process is to have surprises along the way that can delay and disrupt their plans. It is best to tee up each of these issues in a working dialogue up front, so all parties can gain alignment.

Often for both buyers and sellers, this is the first time they have ever gone through an ownership transition, so it is critical to seek outside advisors to help with the process. The stakes are too high to go at it alone.

STRATEGIC PLANNING

Without a clear vision among the owner(s) for the future direction of the firm, supported by a detailed plan for achieving those goals, successors will be unlikely to buy in. In order to solve this challenge, owners need to develop a quality planning process that has tangible goals tied to compensation, along with a track record of achieving and communicating those goals across the firm on a consistent basis.

GROWTH STRATEGY

Without future firm growth, there will be little interest in buying in, particularly when it comes to insiders who know the issues first hand. Accordingly, owners need to have a plan in place and a track record of success so that buyers will have confidence that the firm they are buying into will be an appreciating asset and something they can believe in.

FINANCIAL FORECAST

The finances of the firm need to be transparent, with reasonable assumptions embedded in them, not just top-line extrapolated growth. In order to communicate finances and make them transparent, owners need to develop a "bottom up" model that shows the new partners estimated profit distribution and share of business value over time.

EQUITY SHARING

Owners often make the mistake of assuming that every employee will be thrilled to obtain a piece of firm equity as part of grooming them to take over down the road. Unfortunately, rarely does everyone have the same interests in becoming an owner – they may not see their careers at the firm to be "for life." What happens if an employee does not want the equity – you cannot take the offer back. Will you have to make it up in increased cash compensation to keep harmony? In order to prepare successors for this step, industry experts recommend having preliminary conversations with potential successors to feel them out on these issues, gauge their interest prior to making these types of offers, or have more in-depth conversations.

VALUATION

There still remains a large amount of misinformation about valuation methods and approaches for advisory firms. Unfortunately, the industry has somehow coalesced around using a multiple of revenue, when a "theory of finance" method of valuing firms by using a multiple of earnings is preferred and a much more accurate approach. Additionally, there is a lack of understanding control and illiquidity discounts, along with other key factors that go into valuing an advisory firm. In order to overcome this valuation confusion and eliminate any doubt in determining a fair valuation, industry experts all recommend obtaining a firm valuation from a third party professional that uses a more robust approach and includes valuation multiples that can change as the firm grows over time.

FINANCIAL FEASIBILITY & FINANCING

For many internal transactions, buyers typically do not know how much cash flow they will receive down the road when considering their liabilities for the payment schedule, which creates uncertainty in their ability to ultimately afford the transaction. Additionally, with the historic lack of financing options, buyers have limited options (new programs through SBA loans and new entrants are alleviating some of this problem). Therefore, sellers need to illustrate future distributions, reinforcing the affordability of the buy-in over time, along with lining up financing, which is often sellerfinanced.

TAXATION

Because most advisors are structuring these internal transactions themselves and not consulting the right professionals, both buyers and sellers are unnecessarily leaving a large amount of money on the table for the tax authorities. There are multiple tax-efficient ways to distribute equity as well as save sellers large sums by creatively structuring the deals. Since so much is at stake in these transactions, it is critical for both parties to bring in outside professionals – the return on the investment is more than worth it.

MANAGEMENT & LEADERSHIP

When it comes to management of the firm, every advisory business is different. Some firms have too much management, while others do not have enough. Accordingly, both buyers and sellers need to come to an agreement on the organizational structure, roles, and responsibilities, as well as how to transition these functions over time. An effective time to address this is during annual strategic planning meetings. This enables future leaders of the firm to showcase their abilities in managing the various functions.

LEGAL ELEMENTS

This section should come with a warning label: of all areas, the legal aspects create the most opportunity for deals to fall apart because of the complexity, impersonal nature, and potential for conflict. Ideally, the necessary legal documents provide an "instruction manual" for how owners can leave the business based on a few scenarios, as well as their financial and client implications. In order to prepare buyers for this intimidating part of the process, advisors should provide an orientation to the key legal issues to be discussed upfront and not in the form of a "document dump." It is also critical to put in place protective covenants, such as non-solicitation agreements, as early in the process as possible.

GOVERNANCE & DECISION MAKING

As firm ownership transitions, the new leaders of the firm will begin to focus on making more and more decisions for the firm. How this decision making process is handed over is critical to the long-term success of the deal. It is important to begin sharing decision making among the new owners, as well as put together a process for how the bigger decisions will be made during the transition – majority, super-majority, unanimous, founders, etc. Additionally, a road map should be developed for the top 30 decisions that will be migrated over time and who/how those will be managed.

Succession Planning Timelines

According to industry experts, a good succession timeline starts about 10 years out from the desired time of the firm owner(s) exit. When considering the following timeline, keep in mind that succession is a process. It is not a single event. It is helpful to work toward the following milestones as part of that approach.

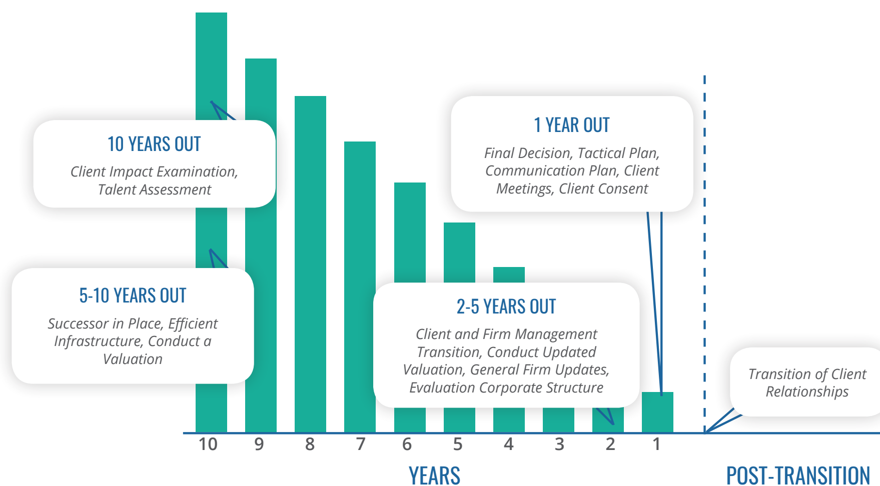
TEN YEARS OUT

- Client Impact Examination– Begin thinking about the big picture:
    1. What approach will best serve your clients?
    2. Depending on whether you are an owner/advisor or owner/manager, how will your clients react to having their relationship transitioned internally to junior partners or to a third party?
    3. Do you envision staying involved in the business during that time or are you planning a complete exit?

- Talent Assessment - If you are envisioning transitioning internally:
    1. Have you identified the person(s) who will be your successor?
    2. Do you need to begin looking to hire someone to fill the role?
    3. Do you have a career path identified to groom that future leader?

FIVE TO TEN YEARS OUT

- Successor in Place - For internal succession, the intended buyer should be on staff during this time frame and be given and increasing number of responsibilities for client and firm management. You may even want to have multiple potential successors in place to protect you if one of them does not work out, or if the firm is big enough that multiple successors will be necessary.
- Efficient Infrastructure – Re-examine all operational processes and technology. Upgrade and enhance your client service delivery and onboarding to create operational efficiencies and scale growth.
- Conduct a Valuation – Bring in third party professionals to complete a formal valuation of the firm and identify areas of improvement to increase valuation, such as new technology, client growth, marketing, bringing in younger advisors and clients, and more.



TWO TO FIVE YEARS OUT

- Client and Firm Management Transition – At this point, consider slowly transitioning client and firm management responsibilities in stages to see how that process works out. Begin to groom successors into firm leaders.
- Conduct Updated Valuation – Use an updated valuation to begin discussions with successors, ideally showing growth in the firm since the last valuation to demonstrate success and get buy-in from successors.
- General Firm Updates – Focus on expense management, employee contracts, non-solicitation agreements, and technology upgrades to prepare for a smooth transition.
- Evaluate Corporate Structure Evaluation – If necessary, update legal entity for the most efficient way to distribute equity (Partnership vs. LLC, etc).

ONE YEAR OUT

- Final Decision - Make final decisions on successor(s), agree on terms and conditions of sale, consulting agreements, earn-outs, etc.
- Tactical Plan - Identify steps for technology, operations, and staffing transition.
- Communication Plan – Determine how the new owner(s) will be communicated to the client base – letters, meetings, phone calls, updates to website, etc.
- Client Meetings – Introduce the new owner(s) during client meetings.
- Client Consent – Gain client consent via consent form.

POST TRANSITION

- Transition of Client Relationships – Departing owner(s) work part time, fulfill earn-out requirements and consulting agreements, and are available for meetings to ensure clients remain with the new ownership.

Conclusion

There is growing urgency for succession planning in wealth management. Particularly as the industry is unprepared, this becomes more complex and the majority of advisors will be reaching retirement age in the next 10 years.

Despite these industry challenges, there are concrete steps advisors can begin taking now to prepare their firms, staff, and clients for the orderly transition of their firms. Key to this approach is the need for advisors to educate themselves on the main factors that go into a smooth ownership transition. By managing these factors up front, planning in advance, and working closely with their chosen successors, owners will be in a much better position to transition on their terms and timelines. Advisors should seek outside help from industry experts and advisors to simplify and streamline the process – the stakes are too high for advisors to go at it alone and do it themselves.

While this process will take a good deal of time and effort, the rewards that come from it far outweigh the costs. But advisors should not wait – more value is eroded and fewer options will remain as the advisor delays. Advisors owe it to themselves, as well as their firms, employees, and clients to make succession a priority and take action today.

About CLS

CLS is an ETF strategist working with more than 2,500 financial advisors and 1,300 qualified plan sponsors to manage more than 35,000 investor portfolios. Since many financial advisors find their strengths lie in cultivating relationships and creating an overall financial strategy for their clients, they often choose to outsource portfolio management to CLS. CLS's partnership model gives advisors time to create meaningful relationships with their clients and learn important details about their financial standing, investing time horizon, and specific investment objectives. When the advisor passes this information on to CLS, we can accordingly make timely and active asset allocation decisions within the investor's portfolio. Through this mutually beneficial connection, CLS can enhance an advisor's service to investors.

With several billion in assets under management and as a part of NorthStar Financial Services Group, LLC, CLS has the investment experience to help advisors and individual investors achieve financial success.

About ECHELON Partners

Founded over 15 years ago, ECHELON Partners www.echelonpartners. com combines the high quality expected of a large investment bank with the high touch expected of a personal boutique. Unlike traditional investment bankers, ECHELON Partners brings together financial advisory, strategic consulting, and senior-level operational experience to each engagement. We believe the keys to successfully serving clients are a deep understanding of the wealth and investment management business, an extensive network of contacts, a powerful set of processes and databases, integrity, and trust. ECHELON Partners is committed to bringing all of these qualities to every client assignment. With a track record spanning hundreds of engagements and valuations, our team understands the unique needs of owners and executives.

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1033-CLS-8/15/2019