ENDGAME PLANNING

MAXIMIZING YOUR FIRM'S VALUE FOR A SUCCESSFUL EXIT

THE GREAT TRANSFER OF ASSETS IS UNDERWAY – not just for clients of wealth advisors, but for wealth advisors themselves, as an increasing percentage of financial planners, brokers, and independent advisors reach retirement age. Two years ago, Cerulli Associates found that the average age of financial advisors had already topped 50 years, and 43% were over 55. In a business where identifying successors, transitioning clients, and arranging financing for the transfer of equity can take a decade, more than a third of financial advisors have entered the traditional pre-retirement age of 55 to 64.

Financial advisors nearing retirement can take steps right now to maximize the value of their practice in a hot market where wealth planning firms focused on fee-based business command attractive multiples. Finding the right people to take on leadership, institutionalizing the processes, and forging long-term relationships that support growth, especially through multi-generational structures like trusts, can significantly increase your payout when it comes time to move on.

The perils of not planning

Relatively few advisors have made solid workable plans for transferring their business. David Grau Sr., a founder and president of FP Transitions, says that only about 7% of independent advisers work hard at developing and implementing a succession plan, and another 4-5% will sell or merge their practice with another firm. That leaves nearly 90% ill-prepared for retirement or, worse, sudden death or disability, which are genuine risks for advisors who put off planning into their 60s and 70s.

"Advisors are generally not as prepared as their clients for succession," says Elizabeth Nesvold, founder and managing partner of Silver Lane Advisors, an investment banking boutique focused on the financial services sector. "They do extensive financial planning, trust and estate oriented work for their clients, but they are invariably the shoemakers' wives when it comes to their own planning."

Many advisors genuinely enjoy the work they do and hesitate to start preparing for the end of a career that has become such a large part of their lives. Yet, there are risks in putting off succession planning. Carolyn Armitage, a managing director at ECHELON Partners, says that waiting too long may undermine the value of the practice. "As an advisor ages — and especially in the very good, robust markets for wealth managers that we've seen over the last several years — proactivity or growth tends to slow down," she explains. "So as the growth number slows down for a firm, the valuation does decrease. It may not be as robust as it would be for another firm of like size that is growing rapidly."

"Even worse, the unexpected could happen, either death or disability, and if they don't have the documented succession plan in place, then you may need to go into a buyer/sale scenario, where you're forced to sell at a deeply discounted rate," Armitage adds. "It becomes a stressful situation for the employees, the clients, the heirs, and the advisors if they're disabled. It's a very stressful situation. So, waiting to put in place a succession plan is very problematic for our industry."

And finally, given that so many advisors are nearing retirement age — and that there are far fewer Gen X and Millennial advisors in the pipeline — advisors who wait may have fewer options. Armitage points out the imbalance, "Given that up to a third of the advisors will be retiring and looking for a successor over the next five to ten years, that's over 100,000 financial advisors that are looking for this good strategic fit. It's not going to be easy because the advisors have such individualized businesses."

A rush of capital and transactions

Wealth managers seeking exit financing have enjoyed a robust market over the last several years, as financial buyers, private equity firms, banks, and rival firms have spent freely on acquisitions. Last year set a record pace with 138 transactions in the wealth management industry, up 10% over 2015 activity which set the previous record, according to the Echelon RIA M&A Report. For 2017, Echelon expects approximately 160 deals, which would set another high-water mark.

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FOUR WAYS TO EXIT THE BUSINESS

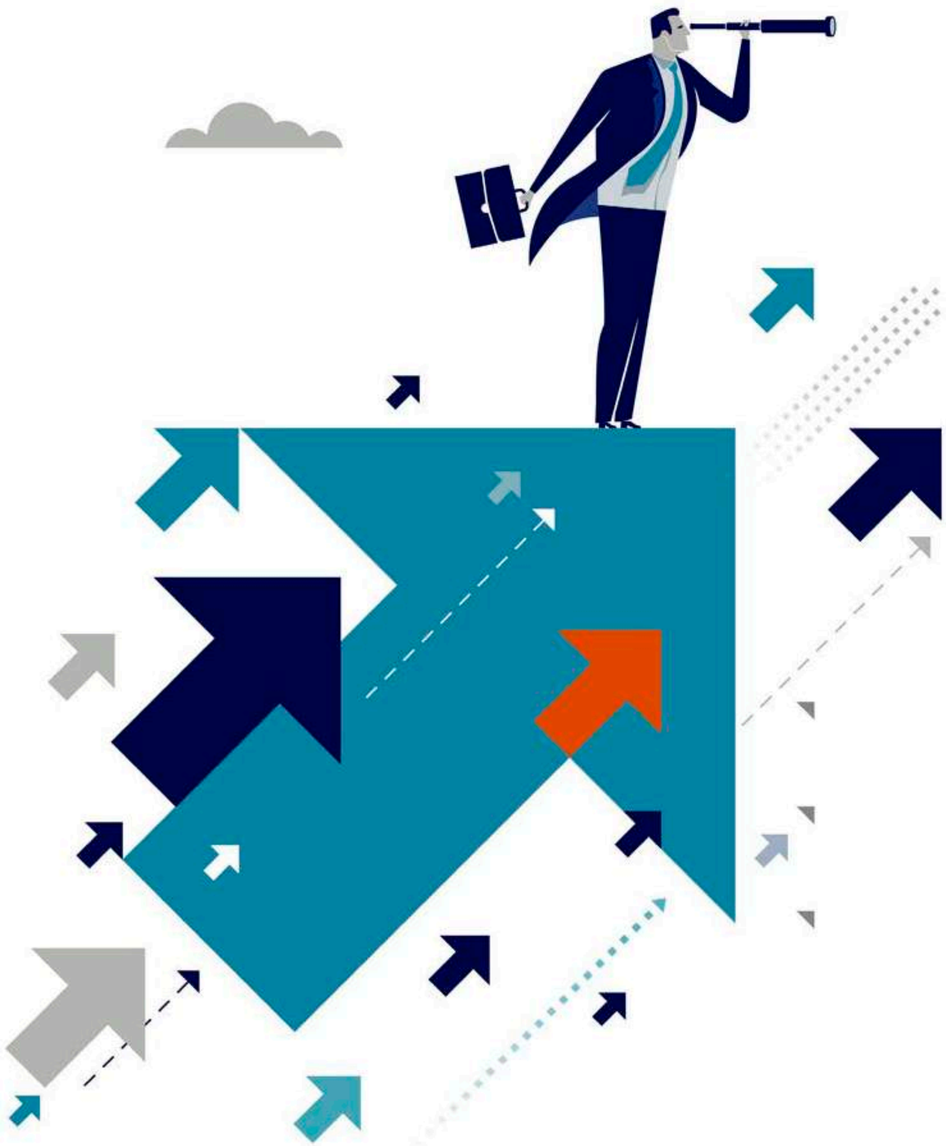
Financial advisors have four basic ways to achieve an ownership transition.

- They can sell their business outright. Banks, private equity firms, and competing advisory firms have been voracious buyers lately of fee-based investment advice practices, particularly larger entities with $500 million or more under management.

- They can develop a succession plan that structures a gradual, incremental sale of the business to the next generation of leaders within the firm. This approach typically requires five to ten years and may necessitate hiring new talent if there is no successor candidate already in the business.

- They can develop an emergency "continuity plan," where they nominate someone to take on ownership and responsibility for the firm in the event of death or disability.

- They can merge their firm with another similar firm.



Ben Harrison, head of business development & relationship management at Pershing Advisor Solutions, says that the market's hunger for wealth management firms reflects a long-term shift towards a fiduciary standard. "The movement toward the fee-only fiduciary side of the market is really driven by clients. Clients really want to be served by a fiduciary that has their best interests in mind and is not a product sales person but really a buy side individual that has their best interests in mind whenever they are planning for the future," he explains. "Whether it's wealth management or investment management. So, we've seen this shift from product sales to really the ability for an advisor to deliver solutions sitting on the same side of the table as a client, and transparency in terms of fees and knowing each element of how a firm, an advisor, a product is compensated in a wealth advisory chain. Clients are much more sophisticated and recognize that. "

"People are interested in this business because there's significant growth. If you look at the advisory business versus the brokerage business or what's going on at the wire houses where there's a decline in assets. In the advisory channel, there is a year over year double digit growth in term of assets and opportunity coming into this space. So obviously it's a great business from a growth perspective, and that's where all the trends are pointing," he adds.

Echelon's Armitage says that buyers are paying a premium for wealth managers versus asset managers. "The asset management side of the business has become more commoditized than it was in the past. So, you'll see valuations being driven up on the wealth management side. There are many more strategic and financial buyers coming into the market on the wealth management side than on the asset management side," she explains. That has driven valuations for wealth management practices up to multiples of between four and nine times EBITDA, with the larger firms (those with more than $1 billion in assets under management) commanding multiples of six to nine times. "Occasionally there may be deals done at even higher multiples, but that would be because of other strategic factors, getting certain key personnel, infrastructure or technology that a firm has," says Armitage.

Armitage says that the $1 billion plus sector has been particularly hot because these firms have spent money on recruiting, technology, and infrastructure that make them sustainable institutions, even after the founders retire. "Definitely the $1 billion plus AUM firms are attractive because they have good economies of scale. They usually have good growth records over the last few years. However, there's not as many of them in the marketplace. So, the valuations are a little bit higher because folks are going after them," she explains.

With competition fierce, buyers are beginning to look at firms just below the $1 billion mark, which are still in the process of building out their infrastructure. "There's quite a bit of opportunity in the middle market. Call it the $100 million to $500 million, even $750 million in assets under management," says Armitage. "At about $500 million, we'll typically see an advisory firm purchasing additional infrastructure investments and sometimes their EBITDA or their revenue can drop down a bit in that $500 million to $750 million range, they might see a drop in their net earnings. So that's where that's not always such an attractive time for the sellers to sell. They want to wait until that infrastructure has been absorbed and you've got the growth."

Institutionalizing value

Armitage's focus on mid-size and larger firms that have begun to build out infrastructure highlights one of the key drivers of value for wealth advisory firms; how far they have gone in institutionalizing their practices. For owners of wealth planning firms, the challenge is to take what they have personally built, the processes and relationships that they have created, the culture they have fostered, and turn it into an entity that will last beyond them.

"It's a personality driven business, and it is a predominantly intangible asset that we represent on a regular basis," says Nesvold. "It's really developing the culture of the firm, attracting the right people who embody the culture and defining the characteristics of the business. That's the first challenge or mission."

Defining and understanding a firm's culture can pay off when it's time to look for a partner, she adds, since it will be easier to find the right match. A firm focused on relationships and holistic planning, for instance, would know right away to shy from a deal with a buyer primarily interested in expanding distribution for its products. A practice committed to actively managing stock and bond portfolios would not pursue a buyer that emphasizes passive solutions.

Beyond defining culture, though, comes the challenge of communicating and instilling it in the next generation of leaders. In some cases, the right successors may already work for the business; in others, they will have to be sought out and hired from the outside. The right

incentives need to be put in place to keep these new hires at the company, and they need to gradually be introduced to clients so that they can take over relationships for the owner. Business owners with five to ten years left before retirement "should be thinking about next generation succession, meaning identifying the eventual leader or leaders of the business," says Nesvold. "Do the clients see those people as leaders of the business? Have they begun to transition any key relationships that they have so that others in the firm are touching those relationships. You want it to be a relationship with the firm. That is a way to institutionalize that relationship."

"It's really about building a business that's built to last for the future," says Harrison. "In terms of the ability to maximize the amount of multiple or the end price that you would get for a merger or acquisition, it's really about how sustainable the revenue and the cash flow is over time. It's really important that as buyers are evaluating the marketplace that they're not only taking a look at how a business has performed in the past and what that revenue is, but it's really about how sustainable that business is. You know, what the growth has looked like and the future potential for the business to grow."

Harrison notes that practices that rely on a handful of large relationships are less marketable than those with a broader base of customers. Those that hire teams from multiple generations who are diverse by gender and ethnicity are also more attractive than one or two-person firms. "Having senior advisors and junior advisors and analysts and cultivating that next generation is important. A good mix of clients is going to diversify the business over time. Businesses that are growing are going to be more valuable than stagnant businesses that have clients that are only in their distribution years rather than growth years," he says.

Adding younger staff members, Harrison says, can significantly improve long-term growth prospects. "Having multiple generations in your firm is really important," says Harrison. "You really need to think in terms of replenishing clients. Continuing to onboard new clients is critical to the longevity of a business and the ability to maintain cash flow and revenue. As the baby boomers and older generations begin to retire or move in, you need to make sure there's a pipeline of Gen X and Millennial clientele that can continue to build the pipeline." He adds, "So in order to attract clients of multiple generations, we have observed that firms that approach it from a team orientation perspective and have more of an ensemble approach are growing faster than firms that operate as sole advisors."

Finally, owners need to think about financing their transition – providing younger partners with the capital to eventually buy them out of the business. This can take time — Nesvold recommends at least five and ideally ten years to make a successful transfer of equity that's financed internally — and often owners are reluctant to give up ownership in time. Delay can result in a forced sale to a third party, even if the founder would have preferred his or her firm to remain independent. "The problem is that if I know I have ten more years and I see that each year we make the business more valuable, I'm hard pressed to want to give up any of my equity. That's really a big part of the challenge," she says.

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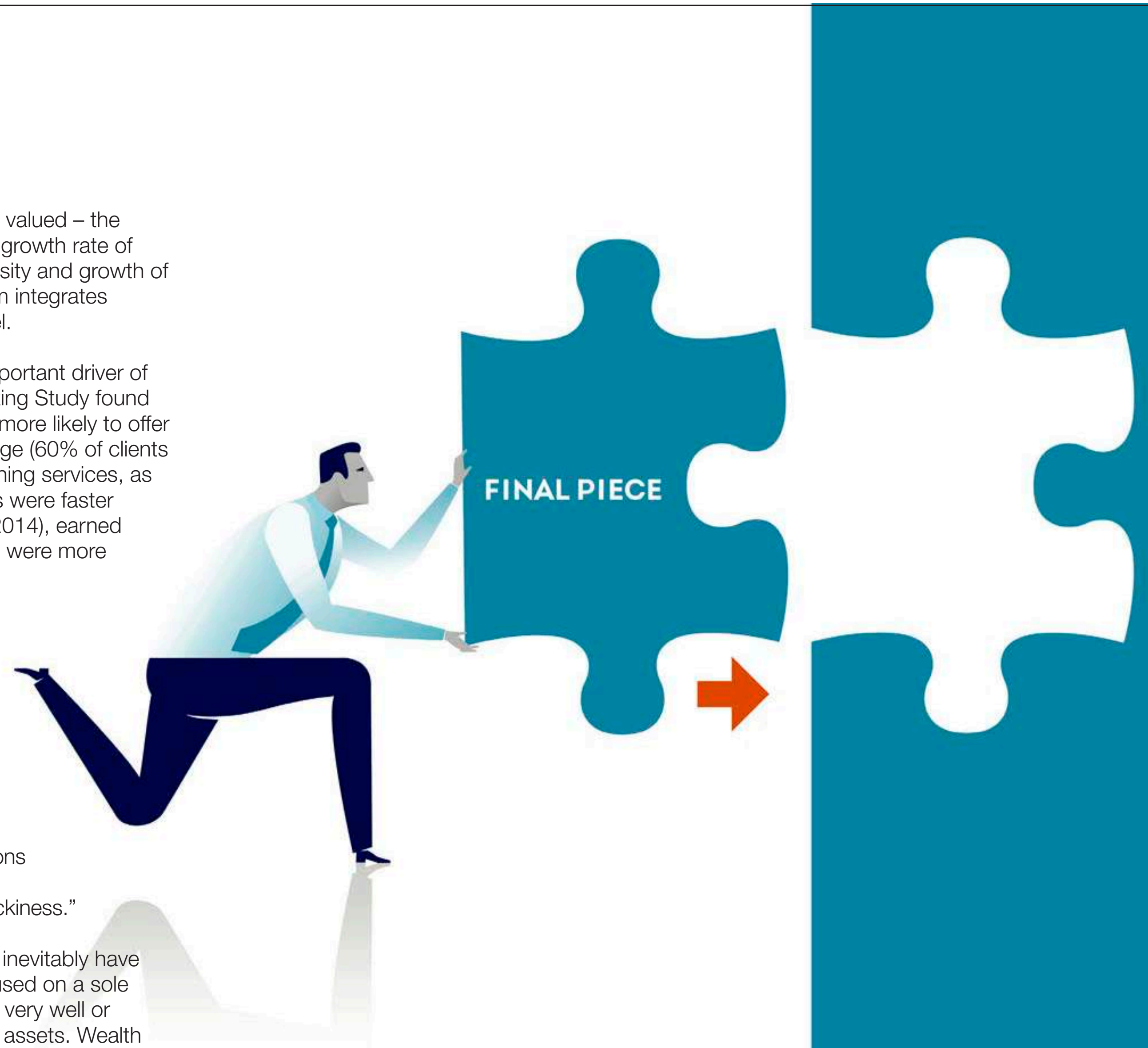
The trust advantage

Many factors play into the way a wealth advisory practice is valued – the amount of assets under management, the historic size and growth rate of revenues and profits, the strength of the team and the diversity and growth of the client base – yet one overlooked factor is how well a firm integrates complex planning vehicles like trusts into its business model.

This is partly because comprehensive capabilities are an important driver of business success. The recent 2015 Fidelity RIA Benchmarking Study found that high performing wealth management firms were much more likely to offer trust and estate planning services to their clients than average (60% of clients at high performing wealth advisory firms received trust planning services, as compared to only 40% overall). These high performing firms were faster growing (18.1% versus 12.5% growth rate per year, 2011-2014), earned higher revenues per advisor ($1,055,182 vs. $626,357) and were more profitable than average.



Offering trust services also connects advisors to the next generation of clients. "Multi-generational planning is a big plus because invariably you have more stickiness from generation to generation," says Nesvold. "If I know the Smiths but I don't know the Smiths' children, the Smiths' children may not want to do business with somebody who's perceived as their parents' advisor. They may want to have their own advisor when the assets pass through, if the trusts are bust and released at the time they inherit. I think the planning aspect between multiple generations and having means for connecting with the beneficiaries is an important piece of the equation in terms of continuity and stickiness."

Ben Harrison says that firms that can provide trust services inevitably have more diverse revenues. "Investment managers that are focused on a sole equity strategy or a fixed income strategy, they may do that very well or very effectively, but they only have one sleeve of the clients' assets. Wealth managers typically would look after the entire client relationship," he explains. "They have more of an opportunity to provide additional services, whether it's planning or comprehensive analysis around closely held businesses or tax advice or next gen planning and the implementation of trusts. They have more of a diverse ability to earn revenues, so that would imply that there could be a premium that could get paid for those types of firms."

Yet the way that advisors offer trusts may affect valuation as much as the fact that they do. Says Nesvold, "You have to look at the nature of the corporate trustee in place and the ability for the advisor who may not have a trust company to continue to manage that beyond the life of the person who put the trust in place." She adds that some strategic buyers put a high premium on wealth advisory firms with trust capabilities, while others shy away because of additional regulatory requirements.

Armitage adds that having lots of trust relationships with a particular trust company can limit the pool of buyers. "When a firm comes to us and they're looking to sell, if they're working with a particular clearing firm, we will typically try to keep the client or the new buyer within the same clearing firm, so as not to disrupt the client's relationship with that firm and keeping the assets in place. The same would hold true of a trust company. If you're with a certain trust company, you would need to find an advisor that does work with them and has the ability to work with them. So, it's both good and bad. It depends on the pool of the advisors within that trust company and how robust that is," she says.