Crafting a Robust Succession Plan for your Practice: An Advisors' Guide

Canadian Securities Institute
A Moody's Analytics Company

Presenters

MARSHALL BEYER

Host/Presenter

Senior Director

CSI & Moody's Analytics

MELANIE RUSSELL
CPA, CA, CBV, CIM, CFE, CFF, ABV

Panelist

Director

Kalex Valuations Inc.

PHILLIP ACKERS
CPA, CGA, MBA

Panelist

Principal

Lakeshore Performance Limited

Agenda

1. Introduction
2. Elements of a Succession Plan
3. Getting Ready
4. Maximizing your Value
5. The Process
6. Client Ownership
7. Lesson's Learned

1 Introduction

Introduction

Current State

- The average age of advisors continues to increase – now 52[1]
- 56% of advisors are over the age of 50 while only 5% are under 30[2]

But the demand for advisory relationships continues to increase

And yet, almost 63% of advisors confirm that they don't have a succession plan in place[3]

1 Investment Executive Dealer Report card 2020
2 https://brandongaille.com/29-financial-advisor-industry-statistics-and-trends/
3. Investment Executive Dealer Report card 20211

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The Importance of a Succession Plan

The Importance of an Effective Succession Plan

- Transitions should be seamless to a client with close to 100% retention
- Done wrong, it can cause both the client and incoming advisor(s) considerable disruption and heartache leading to higher levels of client attrition
- The need is not only for advisor succession planning but also to provide for true business continuity
- An effective plan:
  - allows for a seamless transition for your clients
  - maximizes its value to both you and the purchaser
  - drives future opportunity, consistency of revenues and growth

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The Components of a Succession Plan

Getting Ready

- Write your "story" – to educate potential purchasers
- Your business vision and mission and how important it is to continue
- Looking at the true strengths and weaknesses of your business – be realistic
- Address staffing / HR impacts and plans
- Solve current compliance issues
- Document operational aspects (e.g., IT, key processes & systems)
- Consider client and staff personalities
- Clean up financials
- Understand current key business metrics and trends such as:
    - Overall assets under management
    - Allocation of assets
    - Sources of revenue, i.e. fee, trailer, transactional (recurring vs non-recurring)
    - Revenue, expenses and key business ratios
    - Overall profitability of the practice
    - Client assets / average assets per client
    - Historical attrition

Components of a Succession Plan

A true succession plan is more than a simple buy sell agreement or key person insurance

- What will you do post retirement? What are your goals personally, financially and professionally
- Consider it as part of the annual business planning process
- Vision & metrics for you and the firm 5, 10 years out
  - Realistic timetable for succession
- When will you realistically be able to "let go of the baby"?
- Staffing considerations, strengths, weaknesses
- Business and client profitability / revenue metrics and trends
- Assessment of the factors that increase business value
- Client needs / makeup / profitability (past and future)
- Long term contracts / obligations
- Evaluate succession strategies: internal / external, bringing a successor into a team / acquisition, outright sale
  - Full vs partial sale? Stay on as employee vs partner?
  - Consider $s related to each strategy
  - Consider alternative ways of financing sale
- Shareholder / partner agreements and the impact of succession
- Buy / Sell agreements

4 Maximizing Value

Factors Impacting Valuation

Recurrence of Revenue

RECURRING REVENUE ←→ NON – RECURRING REVENUE		
Fees on managed assets / fee-based accounts	Insurance renewals	Securities commissions
Trailers on mutual funds	‘Level’ insurance commissions	‘Heaped’ Insurance commissions
HIGH ←→	DEGREE OF PREDICTABILITY	LOW

Factors Impacting Valuation

- Size of the book – larger books drive larger valuations, but supply and demand drives the multiples of smaller ones
  - Market conditions - # of potential purchasers
- Composition of the book
- Type of revenue
- Nature, age, relationship, etc. of clients
- Location of Practice
- Profitability – cashflow and revenue
  - Historical & potential
- Terms of the deal
- Shared vision and philosophy
- Effective processes and compliance protocols
- Method of transition
  - Sale of assets, shares, merger

Earn Outs

- Ultimately, price is a function of supply & demand, as well as risk & reward
- Conceptually, the vendor brings the client relationships/goodwill & encourages clients to give the new owner a chance (loyalty & good faith support)
- The vendor assists with client retention but the majority of the responsibility of this is with the purchaser
- i.e., the purchaser has the highest degree of control over client service (or non-service) after closing & therefore, a high degree of influence over whether client stay
- 100% cash is preferred by vendor (assuming purchase price is the same with or without)
- Earnouts may (or may not) increase purchase price

Earn Outs (cont'd)

- Earnouts shift some of practice risk to vendor – addresses purchaser's perceived risk of clients transferring to purchaser
  - What if purchaser incapable of handling clients or staff?
  - What if purchaser dies, gets sick, etc. before the end of the earnout period & can't service the clients?
  - What if purchaser decides not to pay for invalid reason?
  - Have to commence lawsuit against purchaser?
  - What if purchaser not interested in certain clients or services of the acquired practice (i.e., "cherry picking")?

Earn Outs (cont'd)

- Other issues with earnouts:
    - They motivate vendors to stay around for longer than necessary & delay a successful handoff of the relationship; no clean break for either purchaser or vendor
        - IF the earnout is not significant
- In theory, much of the risk should be captured if proper diligence undertaken
- In my experience, the risk of loss of clients is overstated
- Generally, purchasers think of/are focused on only downside risk, but don't factor in the upside risk properly
- Higher possibility of disputes between vendor & purchaser

Earn Outs (cont'd)

- The shorter the better
- Can be complex formulae
  - Individual or cumulative multi-year thresholds?
  - Measurement base?
  - On cash/collection or accrual/billed basis?
  - Interest-bearing or not?
- Security needed? Life & disability insurance on purchaser?
- Definitional issues frequently arise
  - Meaning of "recurring"/"repetitive"?
  - Costly to get defined properly & "papered"
- Maybe commission base for new files after sale

Retention Clauses

- Alternative to earn-out – but similar
  - Hold back a portion of the purchase price subject to transition of highest value clients

- Or some other target/measure
  - Encourages the vendor staying on for transition

Other Considerations

- Negative Growth
- Poor record keeping
- Concentration of clients
- Long term leases / expenses
- Owners who wish to retain clients or continue on in the business
- Professionally marketing deals
- Practice focused on a specific niche / market
- Transition time
- Existing staff – retain?
- Alignment of technology

Value of Practices – Revenue Basis ROT

Revenue Multiples range:

0.0 (e.g., non-recurring / one-time) to 1.5

Multiple reflects the required rate of return & considers factors such as:

- expected payback period
- alternative rates of returns
- competitive factors for the practice/supply-demand equilibrium / market conditions
- nature of the practice for sale
- structure of the purchase price
- E.g., earn-outs transfer risk to vendor so multiple will be higher
    - Financing ability of the purchaser
    - Other factors specific to the purchaser

But what is "revenue"?

Value of Practices – Cash Flow Basis

Normalized EBITDA or Cash Flow to Owner:

3.0 to 5.0+

- Recognizes that what is important for purchasers is discretionary cash flow, not just the top line.

Subjective adjustments:

- Discretionary/personal expenditures
- Non-recurring expenses
- Economic adjustments

5 The Process

The Process

- Start (thinking/planning) today!
  - You want to transition before you are forced to do so – for your benefit as well as staff and clients
- Begin with the end in mind
  - Visualize your life after sale
- Define what you want life to look like ‘post succession’
- A compliant approach is key
- Taking a transactional approach to succession is a mistake
- Many consider a team approach
- Obtain a valuation /valuation assistance
- Evaluate your exit strategy
- Assess team capabilities
- Create a contingency plan

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What About the Client?

Impact of Client Ownership

- Many organizations ‘own the clients’, therefore they typically may a say in what happens regarding the transition
- Work with your firm to identify the strategy that will provide the best outcome
- Be upfront and communicate your intentions well in advance
- Impacts your ability to ‘sell your practice’.

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Lessons Learned

Lessons Learned

- Consider joining the purchasing team for transition
- Option to build from within – generational approach
  - Internal transition is usually easier
  - But it may generate lower proceeds
- Recurring revenue is paramount
- A good transition plan should eliminate risk of loss of clients
- Start now
  - Recognize this is going to take time, commitment and $ (whether out of pocket or opportunity costs)
  - But benefit will outweigh the costs
- Ensure that you have a contingency plan – regardless of your plans for succession
- Communication is critical
- Don't be afraid to use professionals, pay some fees
- Find the right professionals to assist

Thank You!

MARSHALL BEYER

Host/Presenter

Senior Director

CSI & Moody's Analytics

MELANIE RUSSELL

CPA, CA, CBV, CIM, CFE, CFF, ABV

Panelist

Director, Kalex Valuations Inc.

Tel: (416) 488-9590x225

Cell: (416) 710-8099

melanie@kalexvaluations.com
linkedin.com/in/melanie-russell-1241b73

PHILLIP ACKERS

CPA, CGA, MBA

Panelist

Principal, Lakeshore Performance Limited

Tel: (416) 471-7324

Text (416) 471-7324

Phillip.ackers@lakeshoreperformance.com

linkedin.com/in/phillipackers

Thank you