Business and Legal Considerations in Succession and Continuity Planning

Scott Matasar
Mark Jacobs

Northeast Ohio Financial Planning Association
April 20, 2017

A. Buy/Sell Agreements
B. Practice Transition Agreements
C. Business Continuity Plans

A. Some Statistics

- 12,000-16,000 advisors retiring per year through 2025
- As few as 29% of advisors have a succession plan
- Even for advisors with basic succession plan, 59% of those retiring within five years have not determined purchaser
- 1/3 of acquiring advisors report client retention rate of <50%
- 22% retained <75%
- 36% retained 75-99%

- Clients will leave if they think they'll be handed off to a stranger
- Clients will not accept successor unless persuaded they are equipped to address financial concerns
- Sellers see the value of practices erode by delaying succession planning
- Buyers face client retention & ROI challenges

10 years out

- Determine what exit strategy is best for you and clients
  - Especially important if clients see you as practice owner and primary source of investment guidance
- Decide on internal or external succession strategy
  - Immediately monetize or transition to junior advisor?
  - Stay involved after sale or full departure?
  - Preferred successor known or lateral hire needed?
- Establish detailed succession plan
  - Identify known risks that need addressing

5-10 years before transition

- Install potential successor and define trial period length
- Consider using several potential successors simultaneously
- Calculate practice valuation and determine weaknesses
  - Potential upgrades to tech platform
  - Focus on growing profitable relationships

2-5 years before transition

- Phased transition of lesser clients to successor(s)
- If external succession, initiate buyer search
- Obtain valid practice valuation
- Tighten operations
  - Improve expense management
  - Ensure all employees have good contracts
  - Lock up key employees with incentives to stay/restrictive covenants
- Align corporate structure with exit strategy
  - S-corps make it hard to distribute equity
  - LLCs usually preferred

Timeline

1 year before transition

- Final determination on successor
- Agree on practice acquisition terms
- Develop external communications plan
  - Clients
  - Employees
  - Vendors
  - Custodians
  - Broker/Dealer
- Develop systematic introduction strategy
  - 3 meetings with each top client
    - Solo to describe process & timing
    - With successor led by seller
    - With successor led by successor

Post-transition

- How long should you stay to facilitate transition?
- What role will seller play post-transition?
- Determine definitive end date? Or stay as a part-time ambassador?
- Structure deal with earn-out to incentivize client retention efforts

- Disruptive for firms—loss of client assets & profitability
- Disruptive for clients
- Loss of retirement income for unprepared advisors
- When implemented properly, both advisor and client stickiness increased
  - Advisors less likely to sell to external successor
  - Clients more likely to stay with firm after advisor's retirement
- Ensuring buyers get what they pay for

Challenges for Buyers

- Client retention
- Finding suitable practice
- Implementing transition
- Agreeing on valuation
- Financing down payment

Challenges for Retiring Owners

- Finding suitable successor
- Obtaining appropriate offer
- Locating successor with financing power
- Implementing transition
- Client retention
- Agreeing on future vision for practice
- Repapering/technology integration
- Uncertainty over book ownership during transition

- According to FP Transitions, typical deal terms:
  - 1/3 non-refundable down payment
  - Balance is seller-financed over 3-6 years
    - Bank financing is increasingly available
  - Higher recurring revenue=larger down payment and shorter financing term

Key Elements of Retirement Models

A. Quantitative
- Price
- Forms
- Taxes
- Timeline

B. Qualitative
- Culture
- Practice philosophy
- Client base capability

Retirement Models

A. Sell & Move On
- Internal sales/external sales
- Potentially disruptive or costly

B. External Merger & Stay Involved
- Disrupts client service

C. Internal Succession Plan
- Least disruptive
- Could slow client acquisition process

Do you want an <u>exit strategy</u> or a <u>succession plan</u>?

- How do you perpetuate your business and generate an income stream for yourself for years into retirement?

MATASAR JACOBS LLC

A. Traditional Sale

- Advisor sells book in single transaction
- Short overlap period (6-18 months)
- Valuation factors
  - Length of tenure of clients
  - Average client age
  - AUM
  - Recurring/non-recurring revenue mix
  - Firm growth rate
- Typical valuations: 1 x - 3.5 x trailing 12
  - 15-40% downpayment depending on riskiness of book
  - Balance of price bank or seller financed
  - Promissory note
  - 3-5 year earn-out

B. **Gradual/Partial Book Sale**

- Buyer/seller must be part of the same B/D network
- Seller monetizes portion of existing book
- Overlap period: 3-5 years
- Delayed transfer of "A" clients to buyer
- Common way to transfer practice to junior colleague

C. **Sell and Stay (Merger Acquisition)**

- Structured as practice merger—sale of entire practice
- Advisor sells book but continues working as buyer's employee with a contract
- Downpayment at deal close (20-50%)
- Guaranteed employment for collaboration period (1-5 years)
- Promissory note for purchase balance with interest

D. Internal Succession

- Gradual sale to partner or family member
- Increases odds of intergenerational continuity
- Increases odds of long-term revenue stream for retiring seller
- Long collaboration period
- Small downpayment
- Seller or bank financing for up to 10 years
- Ongoing payments in retirement
    - Seller can finance on series of successive notes each 5-7 years long (paid by buyer from practice profits/compensation)
    - Can provide seller fixed stream of income for 10-20 years

Key Deal Terms

- Specification of exact parties involved
- Valuation methodology
- Payment schedule
  - Downpayment
  - Commencement of remaining payments
  - Schedule/length of remaining payments
  - Earn-out provision
  - Tax allocations
- Non-compete for seller
- Key man insurance for buyer
- Protections for seller's estate

Valuation Variables

- AUM and GDC are obviously important drivers
- But other aspects influence practice value and sale price
  - Cash flow
  - Business longevity
  - Revenue mix
  - Client tenure
  - Average client age
  - Products offered
  - Technology

Valuation Variables

- Practice growth rate (typical range 7-12%)
- Scale of practice (under $250mm AUM ~5x normalized earnings)
- Age & tenure of client base
  - Has practice connected with the next generation?
- Recurring/commission revenue mix
- Quality of technology & operating infrastructure
- Actual client retention
  - Structure with staged payments:
    - Downpayment up front
    - Interest-bearing note paid over time
    - Earn out adjustment formula to reflect actual

Valuation Variables

- Advisors look at revenue and AUM
- Buyers look at expense management and normalized earnings
- Sellers should aim for 90% retention rate and price sale accordingly
  - Buyers often seek to apply lower client retention assumptions
  - Don’t buy into such assumptions
  - Instead, structure contract to stipulate initial practice valuation will be adjusted down if client retention rate falls below set rate (85-90%) and upwards if buyer sees revenue increase

- Multiples of revenue are simplest—but not the most accurate
- Sophisticated consultants assess normalized earnings
  - Free cash flow
  - X net income
  - Earnings before owner compensation (EBOC)
  - EBITDA
- These ensure both income and expenses are reflected in calculation

Valuation Methods

- Multiples of gross revenue (rather than earnings)
  - More relevant where buyer implementing purchased book into existing practice
  - Seller’s overhead and profitability not relevant
- Multiples of earnings or discounted cash flow
  - More relevant in sale to internal successor
  - Buyer who plans to maintain seller’s current infrastructure
- Recurring/non-recurring revenue
  - Recurring multiples: 2-3.5x
  - Non-recurring: .5-1.2x
- Internal successions have higher overall multiples at longer payoff periods

MJ

One possible approach:

Component	Description
Production	Trailing 12 months of income generated by the practice when. If buyer are only interested in acquiring fee business, any commission revenue might be excluded from the valuation.
- Compensation expenses	All salary and salary-related costs like benefits and insurance—aside from any staff working for the practice. The salary paid to the practice owner must also be included in this component. Compensation should not represent more than 75% of total expenses.
- Non-compensation expenses	All costs not related to salaries are included here. These include technology costs, operating costs (e.g., custody, reconciliation), office rent, marketing fees and sales materials, consultant fees, travel expenses, etc.
= Normalized earnings	Normalized earnings should be 30% or higher of total production. This earnings measure is taken as the basis for calculating the price valuation.
x Valuation multiplier	The practice value is determined as a multiple of normalized earnings. The typical multiplier is between five and nine times normal is to earnings depending on qualitative factors such as the growth rate of practice, average tenure, and age of clients. The bulk of practices would be valued with around 6 ½ to 7 times normalized earnings.
= Practice value	

Legal Requirements

- FINRA Rule 2040(b): Payments to Retiring Representatives
  - Retiring advisors <u>may</u> continue to receive commission income if:
    - Bona fide contract providing for continuing payments
    - Done while advisor was still registered
    - Contract bars retiring advisors from servicing, opening, soliciting
  - Must actually be retiring from securities industry and surrender licenses
- SEC Rule 206(4)-4
  - Proposed June 2016
  - Would require all RIAs to adopt written continuity plans
    - Procedure for winding down business or inability to continue
    - Handling of clients during any transition
      - Natural disaster
      - Cyberattack
      - Technology failure
      - Personnel departure from firm
      - Advisor or personnel death/incapacity
      - Winding down of business

Legal Requirements

- RIAs: Advisors Act requires firms to obtain client consent to handoff

- NASAA Model Rule on Business Continuity and Succession Planning (Model Rule 203(a)-1A)
  - Would require advisors have formal plans for business interruption
  - Also requires advisors to institute succession plans designating takeover of core responsibilities if key personnel incapacitated

- Triggered only under specific circumstances
- Living Will for your practice
- Ensures clients served by advisor of your choosing
- FINRA rules <u>bar</u> spouses from receiving ongoing commissions or advisory fees in the event of death or disability
- Secures the value capture of your practice for your family
- Practice is one of your most valuable assets—act like it

Scott Matasar

Mark Jacobs

Matasar Jacobs LLC

1111 Superior Avenue, Suite 1355

Cleveland, OH 44114

Thank You