

# Developing a Sustainable Business and Succession Plan

AN INDEPENDENT ADVISOR'S GUIDE

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# Contents

Introduction .....	5
State of the RIA Industry: Lack of Business and Succession Planning Persists .....	6
Business Planning: Charting your Firm’s Future Course .....	9
Sample Business Plan Outline.....	14
Succession Plan Options for Owners.....	17
Illustrative Profit and Loss Statement.....	17
Enterprise Value Calculation .....	17
Succession Plan Matrix.....	18
Mitigating Risk and Protecting Owner’s Equity.....	20
Legal and Tax Implications.....	21
Resources Available To Advisors .....	21
Conclusion .....	22
Appendix .....	23
Business Plan Table of Contents .....	23
XYZ Capital Management: P&L .....	24
XYZ Capital Management: Key Performance Indicators.....	26
Case Study #1: Leonetti and Associates: Finding the Right Strategic Partner .....	27
Case Study #2: Kistler Tiffany Advisors: Accelerating Growth While Providing Flexibility to Owners.....	28



## Introduction

Business and succession plans are critical strategic elements of every successful advisory practice. A well-crafted plan helps firm owners achieve alignment between their personal and professional goals, and can serve as a powerful tool for improving a registered investment advisor's (RIA's) business model and practice value.

Although the benefits of a business and succession plan are clear, very few advisors have implemented them. These two critical plans are linked; you cannot form an exit plan without a strategic framework that outlines steps to get there. The need for business and succession planning will continue as the RIA market grows and as a large percentage of the advisor community reaches retirement age. In the last five years alone, the number of RIA firms increased from 13,314 to 16,541<sup>1</sup>.

Advisory firms that choose not to address business and succession planning may introduce unnecessary economic and systemic risk into their practices. For a single-owner firm, an unforeseen event can impact employees and clients as well as the owner's personal estate. A larger firm that lacks a business and succession plan risks their corporate governance, internal operating processes, future revenue and client retention. An effective succession plan informs a company's operating agreement, including buy/sell provisions, and strengthens a firm's corporate governance.

Today's advisors have the opportunity to take hold of their future. Support for independent firms has grown alongside the burgeoning RIA industry. RIA custodians, independent consulting practices, advisor coaches and strategic acquirers have all built capabilities and support models to help independent practices manage key issues. A strategic partner can help many firms design, document and execute successful business and succession plans.

The choices for succession have never been greater. A rush of new market entrants now seeks to buy or partner with independent advisory practices, offering a variety of economic models, degrees of control and exit timing scenarios for owners. Owners may also choose to plan for an internal succession, to merge with another firm, sell their business or roll their business into an existing business. This decision will be based on the strategic direction of their practice.

This guidebook, commissioned by Pershing Advisor Solutions and developed by Advisor Growth Strategies, is intended to provide owners of RIA firms with an overview of the material elements of a business and succession plan. Firm owners should examine the options and set a course that marries their personal goals with the strategic goals of their business and the various constituencies associated with it.

<sup>1</sup>Cerrulli Quantitative Update, 2010

## State of the RIA Industry: Lack of Business and Succession Planning Persists

Over the past decade, the RIA channel has been one of the fastest growing segments in financial services. At the end of 2010, independent RIAs managed \$1.8 trillion in client assets, representing 17% of total U.S. advisor managed assets.<sup>2</sup> RIAs can offer significant benefits over their more fully affiliated advisor peers in wirehouses and banks, including open architecture product access, a more defined fiduciary standard and the independence of true business ownership.

Despite the growth in the RIA channel, the lack of succession planning persists. RIAs are disadvantaged versus larger institutions as there is no defined model or consistency when an advisor needs to retire. Many RIA owners have no clear answer to the client question, “Who will be my trusted advisor when you are gone?” Only 28.7% of all advisors surveyed in a recent Moss Adams study<sup>3</sup> had either defined or implemented a succession plan. Even with industry education around the topic, the needle has barely moved from 2007 to 2009.



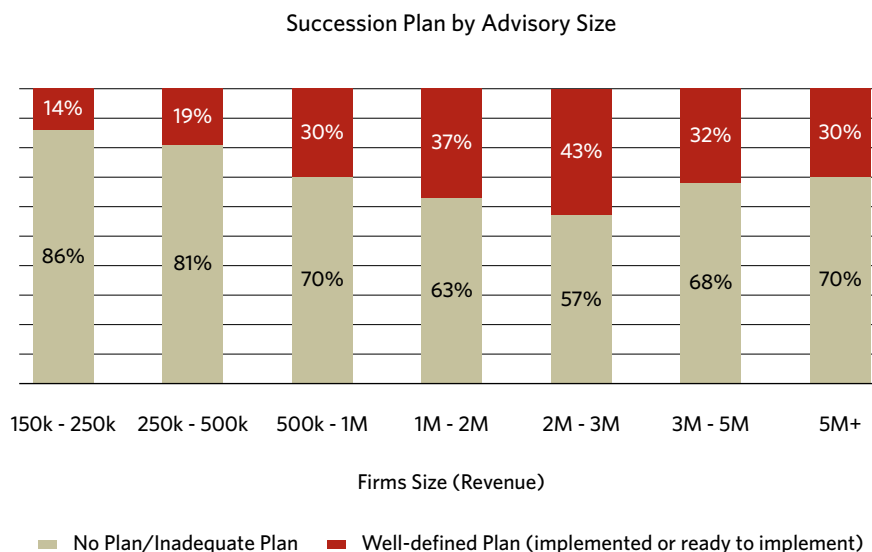
*Source: Moss Adams/InvestmentNews 2010 Financial Performance Study of Advisory Firms*

While it would be logical to assume that smaller advisory firms and solo practices lack the time to invest in succession planning, statistics reveal that this trend persists across RIA firms of all sizes and levels of sophistication. More than two thirds of advisors with over \$3 million in client revenue do not have a defined plan or characterized their plan as inadequate.<sup>4</sup>

<sup>2</sup> Cerrulli Quantitative Update, 2010

<sup>3,4</sup> Moss Adams/InvestmentNews 2010 Financial Performance Study of Advisory Firms

While most advisors agree that having a well-thought-out business and succession plan has real benefits, the business and economic risks of not having such a plan should be understood:



*Source: Moss Adams/InvestmentNews 2010 Financial Performance Study of Advisory Firms*

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. **Business continuity plan:** This plan details how clients will receive service in the event of a disaster or unforeseen event. This is directly related to the firm’s succession plan (see Succession Plan Options for Owners, page 17). Telling your clients what will happen to their account in the event that their individual advisor is no longer with the firm or is unable to provide service is usually done verbally. Advisory practices may choose to adopt a team-based approach to client service delivery to lower client attrition risk.
  - b. **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.
  - c. **Financial stability and asset protection:** 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. Asset custodians such as Pershing can help lend credibility to your firm.

Michael Leonetti from Leonetti & Associates, LLC noted, “Our financial partner is a publically traded company with a well-thought-out continuity plan. If something was to happen to me or a key member of the team, our clients know there is still a team member who knows them. Advisors without this type of relationship could be disadvantaged.”

**2. Opportunity cost and lower growth trajectory:** Firms lacking a business and succession plan are challenged in defining success and charting a course to get there. Without defined annual metrics, firms can go fiscal quarters, if not years, without meeting objectives. A business plan must also define roles and assign accountability. Advisory firms should commit to business objectives in the plan and create individual job descriptions and evaluation processes to track success.

Andy Reder from Kistler Tiffany Advisor noted, "We built a five-year strategic plan three years ago with the help of an outside consultant. We review our plan annually and build action plans to achieve our objectives. My partners and I have clear and accountable goals we're all expected to achieve. Our firm is growing faster and our lifestyles have improved because of it."

**3. Increased risk of low employee commitment and high turnover:** A business plan is critical to defining an employee's role within the advisory firm's organization. Job descriptions should be directly linked to stated objectives in the business plan. Sharing the firm's business plan with all employees helps them understand the bigger picture and allows them to contribute their skills and capabilities in working with clients, developing new clients and increasing firm productivity. Advising the group of the succession plan is important, especially if key employees may take on an ownership role or play a part in the plan at some point in the future.

**4. Loss of enterprise value:** Most RIA firms are valued based on 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. Management must be able to articulate the firm's operating model and growth priorities.

**5. Impact to owner's personal estate:** Specific to succession planning, a lack of a defined plan may impact an advisory firm owner's family and heirs. In the event of an unforeseen event, owners can lose significant enterprise value. Firms must establish a plan to transfer ownership and client relationships internally within a firm or to a defined buyer in order to prevent the loss of equity built over a lifetime.

## Business Planning: Charting your Firm's Future Course

One of the first things a student learns in Entrepreneurship 101 is how a business plan with forecasted financials helps an owner think through the risks and opportunities of any endeavor. While many advisory firms may have a business plan that was created at the inception of their business, how many firms treat their business plan as a living, breathing document that can guide the firm's future?

Business and Succession Planning Lifecycle



A business plan should be aligned with the owner's personal goals and monitored and revised on a consistent schedule. Firms with multiple owners must understand each other's personal goals and objectives and work together to meet them where possible.

Michael Leonetti noted, "Advisors should focus on their personal vision—what do you want to happen with your life—and build their business priorities around that. Matching the two will make you more effective personally and professionally."

How does an advisory firm's business plan intersect with a succession plan? A business plan helps an advisory firm focus on what is important and drives results. But within the construct of a succession plan, it can provide firm owners with a roadmap to their ultimate exit from the industry.

Andy Reder commented, "When we built our business plan, we built it with our succession plan in the back of our mind. We have a flexible structure to allow partners the option to be bought out by another partner while positioning Kistler Tiffany for a larger liquidity event down the road."

Depending on the advisory firm owner's time horizon, it may be prudent to build a succession plan prior to revising or building a business plan. Why? The priorities set in a succession plan may have a direct impact on the business plan, requiring a recalibration of the economic model and distinct strategic priorities and initiatives. First, owners should identify their time horizon and type of succession. The options include:

- > **Grow and sell the business to a strategic acquirer:** In this model, the owners want to grow the firm aggressively, manage firm profitability and build a business that is sustainable and transferrable when they depart.
- > **Build a legacy-based business and transfer internally:** Many advisory firms are not looking to sell at all. Instead, they want to build a business that will continue well beyond their retirement years. In this multi-generational model, advisory firm owners need to identify and nurture the next generation of owners.
- > **Transfer business to owner's heirs:** Linked to a legacy-based plan, owners want to keep the business within the family and groom their children or other family members to take control of it. This may also be an effective way to transfer wealth within the construct of a broader personal estate plan for the owner.
- > **Scale the business with a strategic partner:** Owners who grew their business aggressively and now seek to take some risk off the table through a liquidity event may wish to partner with another firm that will take an equity stake in the business. Owner benefits include "diversifying" some of the equity the firm has built, obtaining a higher valuation for the remaining equity held, achieving operational scale and working within a more collaborative team environment.

These options are not mutually exclusive. Owners may select multiple options or build a business and succession plan that could lead to multiple outcomes.

Writing a business plan should serve a purpose, whether it is a roadmap to a succession plan, a way to drive new firm priorities or a vehicle to communicate the firm's commitment to employees, clients and firm partners. Whatever the purpose, every advisory firm business plan has four major elements: Company Overview, Market Analysis, Strategic Plan and Financial Plan.

## Key Elements of an Advisory Firm's Business Plan



The chart above provides an overview of plan elements. Many of these key components have a direct relationship to a firm's succession plan. In fact, some firms choose to include their succession plan within their overall business plan.

- > **Firm vision:** This allows owners to link their personal vision with their vision for the firm. The vision or mission statement should be a clear message that articulates the firm's values and where it plans to go in the future. Kistler Tiffany proudly posts their firm's mission directly on the company website, shares it during client visits and includes it in firm marketing materials.
- > **Ideal client or design target:** The firm must have a well-defined profile for each target client. Firms may choose to have multiple targets. For example, an advisory firm may have a desire to grow organically by adopting a specialized strategy with medical professionals while at the same time exploring the possibility of partnering with another advisor.
- > **Unique value proposition:** This is a critical element to every business plan, defining what sets the firm apart from other advisory practices in their market. This value is what makes clients stay with the firm and helps the firm sell its services to new clients. Having a well-thought-out value proposition increases confidence, and potentially firm valuation.
- > **Sales and marketing plan:** Firms seeking to reach a certain economic milestone to trigger a succession plan or liquidity event need an effective sales plan. Firms may choose time horizons of five or even 10 years, with defined sales and marketing plans in the short, intermediate and long terms. Clearly defined roles, a compelling compensation model and accountability are key to success.

- > **Management and operating model:** Each financial advisory firm in the independent wealth management space has a unique operating model. For firms with multiple professionals and operational functions, management roles and responsibilities must be clearly defined. The operating model takes the strategic vision and executes it. Firms may choose to reevaluate strategic partners such as technology providers or decide to outsource advisory functions versus build a competency in house.
- > **Legal structure and corporate governance:** The firm's entity structure and other elements of the firm's operating agreement should be stated in the plan, including ownership percentage, any functional role owners have and how owners are held accountable. Andy Reder noted, "When we build out a plan, we build clear roles for partners around core functional areas such as finance, sales, compliance and operations."
- > **Financial plan and forecast:** Probably the most obvious element, a financial plan should include a five-year P&L, balance sheet, statement of cash flows and key provisions of the firm's compensation model. Larger advisory firms may choose to build separate or "program" P&Ls for key priorities. For example, a firm may build a P&L to measure the impact of a new recruit or new partner on a firm's free cash. These measurements can also impact future buy/sell provisions in a succession plan.

Once a business plan is drafted, owners should gain outside perspective from trusted partners. A simple scorecard can help owners and outside parties evaluate the plan against the plan's defined objectives. This "readiness assessment" helps identify gaps in the plan and risks to personal, business and financial objectives.

Questions should include:

- Is the firm's vision clearly articulated?
- Who is the firm's ideal client or clients? Will the value proposition resonate with this client? What are the gaps?
- Has the firm completed a comprehensive market analysis? Do local market and industry trends provide evidence the firm can be successful?
- Has the company defined a "client experience" determining how it will interact with clients? Are specific client segments defined? Is the service delivery model differentiated for each segment?
- Has the firm's product offering been defined (investment management, wealth management, tax, insurance, etc.)?
- Is pricing consistent with the perceived value of the product offering? How does your pricing relate to industry standards? Does it put the firm at a competitive advantage or disadvantage?
- How does the firm work with other financial professionals such as trust attorneys, lenders and tax professionals to deliver integrated advice to clients?
- Does the firm have clearly stated short, intermediate and long-term objectives? Are owners attached to each objective along with an action plan to achieve the objective within a defined period?
- Has the firm's value proposition been clearly defined? Are strengths, weaknesses, opportunities and threats adequately addressed?
- Who are the firm's main competitors? Is there client attrition risk? Has the business plan defined how the firm sets itself apart?

- Is there a sales and marketing plan in place to attract new clients? Is it well defined and achievable? Are new client and revenue sources expected to come from multiple channels? Is there a sales forecast?
- Have clear financial goals been set?
- Are the firm's stated financial goals in line with industry benchmarks and practices?
- Is a compensation and incentive plan in place for owners and employees? Does it align with the interests and objectives stated in the plan?
- Is a corporate governance structure in place? How are management and owners held accountable?
- Does the firm have sufficient resources to execute against defined objectives? Is the right management and leadership team in place?
- Are the firm's growth plans achievable? Have the risks to growth been identified?
- Are there plans to retain key clients and staff?
- Has the firm built contingency plans to account for unforeseen events? Is there a plan to provide continuous service to clients?
- Is there a defined succession plan for the firm?

Even when these questions have been answered and the plan is in place, the process of “business planning” continues. Advisory firms must continuously manage and monitor business activity. Taking the time to build a plan is not worthwhile if the plan collects dust or is tucked in a file folder on a corporate server. Many advisory firms have annual or quarterly meetings to review and refine their plans while holding each other accountable to success or failure.

Advisors also need to build the right team to effectively execute the plan. Human capital will continue to be one of the most challenging issues facing the independent advisor and wealth management community for the next several decades. The plan should identify the roles needed to execute the work. Analyzing the business plan may cause an advisory firm to rethink their operating model and organizational structure. For example, a firm may decide one of the owners should focus solely on business development rather than relationship management, triggering the firm to hire or redeploy a resource.

Every independent advisory firm should revisit their business plan on an annual basis within the construct of a goal-setting process. Doing so helps firm owners achieve their goals, whether related to organic growth, client satisfaction, employee satisfaction or succession planning.

## Sample Business Plan Outline

We have discussed the elements of a successful business plan. Now translate your vision into a working document. Some firms prefer a broad strategic document with a project plan, while others create a very comprehensive written document that is suitable for investment bankers.

All business plans have key elements from strategic to financial. This example should help flesh out some of the details necessary to design and execute your vision and strategy. See pages 23-25 in the Appendix for an actual Business Plan Template and examples of a P&L.

### 1. Executive Summary

- **Company Overview:** Thumbnail of the firm’s history, market and key metrics such as year founded, place of business, number of clients and employees, and revenue. This may also include the purpose of the plan, such as accelerating growth, optimizing operational functions or planning for succession.
- **Company Ownership and Legal Structure:** Simply an overview of the firm’s ownership structure, legal entity and state of incorporation.
- **Mission and Vision:** The articulation of where the firm is today and where it would like to be in the future. The firm’s mission and vision can form the value-based framework for all business and financial decisions. The mission can be refined over time.
- **Objectives and Milestones:** A brief statement of the key milestones for the firm in the near, intermediate and longer term. Firms may adopt horizon planning to organize goals. For example, the first horizon could be the current year, with the second horizon as the second and third years.

### 2. Products and Services

- **Advisory Services:** The articulation of all the services a firm offers to clients. This usually starts with defining the advisor by type: family office, wealth advisory firm, investment management firm, etc. Describe the individual products and services to clients and how the firm delivers those services. For example, many firms offer financial and intergenerational planning.
- **Complementary Offerings:** Instead of building financial services and products for direct delivery to clients, a firm may work with strategic third parties to round out their offering. For example, instead of building a tax preparation and consulting capability, an advisory firm may use a CPA firm but still position the services to clients.
- **Pricing Strategy:** Outlines how the firm earns revenue for services offered. This could range from very simple to very intricate depending on the firm’s size, clients, delivery model and market.

### 3. Market Analysis

- **Competitive Environment:** This section describes an advisory firm’s position within their sector of wealth management. Many firms outline the offerings of key competitors relative to their own and include how they will retain clients.
- **Unique Value Proposition:** Here the advisory firm answers the question, “Why should a potential client hire our firm versus all other alternatives?” This section outlines the advisory firm’s differentiators versus their competition and how it will leverage that distinction for competitive advantage.

- **Ideal Client and Target Market:** Statement of the firm’s “sweet spot” and what type of client will value the firm’s capabilities. Firms may have more than one ideal client, such as private wealth, endowments and benefit plan consulting. The firm’s target market describes the demographics of the ideal client.

#### 4.Strategy and Sales

- **SWOT Analysis:** The classic strengths, weaknesses, opportunities and threats analysis is intended to help advisors think through their position in the marketplace. This exercise reveals any hurdles in executing the firm’s mission and may spur future projects or investments in the business.
- **Unique Strengths:** Particular focus on any competitive advantages the advisory firm feels it possesses within their market.
- **Marketing Plan Overview:** Summarizes the firm’s brand and how it intends to communicate the firm’s value proposition to the marketplace. Marketing plans range from simple to sophisticated integrated plans. At minimum, this section should outline the firm’s brand identity, the message platform that will communicate the value proposition and the marketing tactics the firm will deploy.
- **Business Development Strategy:** The playbook on how the firm intends to grow their business.
- **Sales Forecast:** Goals for organic and non-organic growth. The sales forecast is folded into the firm’s broader financials.

#### 5.Management Summary

- **Corporate Governance and Advisory Board:** Outlines the firm’s management relationship with ownership. Provides accountability to owners (or a board) to review and interact with management. Some advisory firms create an advisory board to act as a counseling and accountability mechanism in lieu of a board.
- **Management Roles and Responsibilities:** Describes the role management will play in executing the firm’s strategy.
- **Succession Plan:** Provides a summary of the firm’s exit strategy (see Succession Plan Options for Owners, page 17).

#### 6.Operating Model

- **Legal Structure and Affiliation Model:** Delineates the firm’s structure and type of advisory model, such as contractor, RIA or hybrid. Firms may include their operating agreement within the business plan.
- **Functional Overview:** Describes all advisory functions in the front office and middle office and what the firm will be responsible for versus a strategic partner. The front office includes all client-facing tasks such as sales and investment management. The middle office includes reporting, operations and compliance. Firms may outsource some of these functions.
- **Technology and Systems:** Includes a statement of all technology used by the firm and firm providers. A firm may articulate a strategic vision to scale up as it grows.
- **Organizational Structure and Human Capital:** Includes the firm’s organizational chart and brief descriptions of roles and their functions. Employee bios would be included in this section.
- **Compensation Plan:** The firm’s compensation philosophy and plan for owners, professionals and support staff. This is usually conceptual, with actual compensation plans kept under separate cover.

- **Client Experience (Service Model):** A critical section in the business plan, this describes the client service experience. For firms that segment, a unique experience is outlined for each segment, including letters, website or e-mail communications, personal meetings and phone conversations. Client experience goals are often linked to individual professional goals and performance.

## 7. Financial Plan

- **Profit and Loss:** The pro-forma forecast of revenues, expenses and profit. Usually advisory firms plan in three- to five-year horizons. Larger firms may include sensitivity analyses with base case, best case and worst case scenarios.
- **Statement of Cash Flows:** An optional section, this can help firms understand the timing of cash running through their profit and loss. This may be critical for start-up advisory firms or firms that bill once a quarter.
- **Balance Sheet:** Standard in all business plans, the balance sheet represents the assets and liabilities of the firm. Book value has little correlation to firm enterprise value as advisory firms are usually measured by revenue multiple, cash flow multiple or discounted cash flows.
- **Key Business Indicators and Benchmarking:** Financial performance within the independent wealth management space can be measured with several financial ratios and measurements versus a benchmark. Custodians such as Pershing Advisor Solutions provide a valuable service for advisors through benchmarking surveys. This type of diagnostic can inform managers and owners of red flags and exceptional performance within their company.

### Key benchmark measurements:

- Gross profit margin
- Operating profit margin
- Pre-tax income per owner
- Active clients per professional and staff
- Revenue per professional and staff
- Assets under management for professional and staff
- Assets under management and revenue per active client
- Revenue on client assets (ROCA)
- Operating profit per client

## Succession Plan Options for Owners

As the RIA industry continues to mature, succession plan options will also increase. The enterprise value generated by annuitized revenue and the profit margins generated by well-managed firms have proven very attractive to buyers. Over the past decade, a flood of new market entrants have bought independent practices, including roll-up companies, RIA firms in acquisition mode, private equity and publically 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.

A succession plan should be linked to the personal objectives and time horizon of an individual or team. The option selected impacts the firm's legal structure, the resulting business plan, and its clients and employees. The chart below 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 challenges in plan execution. For advisors that are seeking an internal succession plan, there may not be a "next generation" of talent that can effectively manage and grow the firm that the original owners have built. Even if the right talent is identified internally, few employees lack the ability to raise the capital required to buy a stake in the business. For example, if a firm with \$2 million in annual revenue is valued at \$3.6 million, an employee seeking to buy a 10% interest in the company needs \$360,000 to buy in.

### Illustrative Profit and Loss Statement

Revenue	\$2,000,000	100%
Professional Salaries	\$700,000	35%
Gross Income	\$1,300,000	65%
Overhead	\$720,000	36%
Net Income	\$580,000	29%

### Enterprise Value Calculation

EBITA*	\$600,000	30%
Cash Flow Multiple	6	
Enterprise Value	\$3,600,000	
10% Interest	\$360,000	

\*EBITA: Earnings Before Interest, Taxes and Amortization. Example is for illustration only; individual results may vary. When computing this example of EBITA, we assumed \$20,000 in interest, taxes and amortization.

## Succession Plan Matrix

	Internal Succession	Transfer to heir	Merger or sale with peer	Affiliate with a strategic partner	Full divesture or sale
<b>Description</b>	Existing owners transfer equity to existing employees through an internal sale	One or more of the owners transfers ownership to family heir, usually over a definite period	Owners sell or merge with a like minded independent advisor	Owners sell a portion of their firm to join larger ensemble of practices. Could be an equity or partnership transaction	Owners sell all of their equity to a buyer, usually a bank, trust company or wealth management firm
<b>Economic Consideration</b>	Cash transaction. Buyer may have to be financed through earn out provisions or funding from a third party	Cash or cashless transaction. This plan could be used to transfer wealth and may be tax advantaged	Could be stock or a combination of cash and stock. Usually there is a stated provision to buy out owners	Cash, stock or a combination of both. Buyer usually sells a portion of their free cash flow	Cash, stock or a combination of both. Seller is usually held to provisions surrounding revenue and profitability
<b>Pros</b>	Continuity for clients and employees. Builds a sustainable business	Provides a legacy for existing owners and confidence for employees and clients	Provides continuity to clients and could increase enterprise value. Certainty of liquidity event for owners	Provides liquidity event and tasks risk off the table. May provide operating leverage and higher valuation multiples	Usually maximizes enterprise value as multiple suitors are sought. May create synergies with buyer
<b>Cons</b>	Finding the right individuals to take owner responsibility. Buyer may lack capital. Transaction may be below market rates	Achieving alignment between owner, heir and partners. May limit other partners liquidity flexibility	Time consuming integration between the firms. Challenge to find the right suitor. Client and employee risk	Finding the right fit. May not value all the resources a firm can provide	Could be highly distributive to clients. Firm may lose brand and identity
<b>Client Impact</b>	Low	Low to Medium	Medium	Low	High
<b>Employee Impact</b>	Medium	Low	Medium to high	Low to Medium	High

Owners must narrow their options, perform due diligence on potential alternatives and select the right option for their firm. Andy Reder opined, “We never really thought about selling a portion of Kistler Tiffany to a ‘holding company’ or a bank. But after learning about their models and their economics, we started thinking differently about enterprise value and how we should run the business to maximize our worth. We may never do a deal, but we feel we are stronger because we went through this exercise.”

Each succession option has variations. For example, aligning your business with a strategic partner can take various forms. Some strategic partner firms buy a portion of a firm’s free cash flow in exchange for cash, stock or a combination. Other firms are organized with more of a partnership model, where an advisory firm’s equity is added to another firm’s within the partnership. Usually these types of firms provide shared services, such as technology, operational support and marketing and sales to their affiliates. Advisors considering this type of succession plan need to perform significant due diligence on these firms to determine a financial, cultural, operating model and end client fit.

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. For firms with multiple owners, goals should be communicated and agreed to by all parties.

2. **Select a viable succession plan option:** 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:
  - **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 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.
  - **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.
  - **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 (EBITA, EBOC<sup>5</sup> or net income) or a blend of cash over a period of time. Owners may also consider a hurdle rate for external sales or buyouts. For example, a succession plan could be triggered if a buyer offers a certain level of cash flow multiple or absolute dollar amount.
  - **The buying party (internal succession) and funding source.** One of 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 three 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 fairly 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:** Once the due diligence process is complete, owners still face plenty of work. 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. In fact, these firms may be brought on far earlier in the process to help owners build their plan and perform their search.
7. **Implement the plan:** Implementing the succession stretches far beyond the legal aspects and potential economic transaction. There are communication requirements with clients, employees and vendors. There could be a significant organizational impact for firm employees. For external sales, owners must plan for post-merger integration work.

Challenges can arise in each plan option. For example, advisors desiring an internal succession may not have a "next generation" of talent to effectively manage and grow the firm. Even if the right talent is identified internally,

<sup>5</sup> EBOC: Earnings Before Owner's Compensation.

few employees have the capital required to buy a stake in the business; a firm with \$2 million in annual revenue is valued at \$3.6 million, requiring an employee to put up \$360,000 for a 10% interest in the company.\*

Succession planning and execution is critical; it can set the stage for growth and mitigate many risks. 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 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.

## Mitigating Risk and Protecting Owner's Equity

While many advisors may see a succession plan simply as a future liquidity event or a way to transfer equity to a buyer at some point, they should understand the risks from the present time until execution of the plan. Real risks exist and there can be significant detours down the road. Consider these questions:

- > What happens to my ownership interest in the event of death or disability?
- > Who will manage my client relationships if an unforeseen event occurs?
- > Are there buy/sell provisions if a partner decides to leave ahead of our agreed-upon succession plan?
- > For single owners, is there an individual who can lead the firm if the owner can no longer do so? Is funding available to purchase the existing owner's equity stake?
- > What happens to the legal structure of the firm if an owner abandons the firm?
- > What if a key employee or owner commits a criminal act or materially damages the firm's reputation?
- > What if market disruption severely impacts firm economics? Is there a plan for reacting to protect ownership equity?
- > Is there an alternate succession plan if the original plan does not pan out?

The willingness to accept risk drives profits and enterprise value. Advisors should not let risks paralyze their ability to manage and grow their businesses, but rather plan for the desired outcome while surgically limiting risk.

How do advisory firm owners mitigate risk to their succession plan? We will exclude processes and procedures associated with business risk, such as trading, compliance, client experience, retention and sales growth that are tackled on a daily basis by owners and their staff. Beyond business risk, legal and insurance provisions to protect ownership equity can mitigate many of the risks above.

- > **Key-man insurance:** A successor may take a life insurance policy on an owner during the period from the drafting of the succession plan to its actual execution. This is usually structured as term insurance, and it allows a successor to buy out an owner's stake in case of an unforeseen event.
- > **Disability insurance:** As in most industries, owners may take out disability insurance in case they become unable to perform their ownership and advisory duties. There is not much value in terms of protecting equity, but this does protect the owner from lost annual compensation.
- > **Errors & Omissions (E&O) insurance:** Essential for advisory firms, this insures against errors in the trading and rebalancing process. Required by most advisory firms, this protects advisors in case of a severe market error by somebody within the firm.

\* Example is for illustration only; individual results may vary.

> **Buy/sell provisions:** This is a critical element of risk mitigation for small and large firms. Usually built within the firm's operating agreement, buy/sell provisions identify what will happen between owners (or with a single owner) should a variety of events occur. For example, if a single owner advisory firm is unable to manage the business, a buy/sell with a successor advisory firm may trigger; the successor then buys the practice under the construct of clearly defined economic and legal provisions.

For larger advisor firms, buy/sell provisions are structured between the owners and dictate how ownership changes when a variety of events occur, from death of an owner, to outside business activities, to potential abandonment of the business. Consultants and/or legal counsel can help owners think through these trigger events and structure a buy/sell agreement to meet the needs of all parties, including the owner's estate.

Pershing Advisor Solutions partners with best of breed providers of insurance solutions through our ValueAlliance Program. To learn more about providers you gain access to by working with us, visit [www.pershingadvisorsolutions.com](http://www.pershingadvisorsolutions.com).

Risk adverse owners may also consider adding a successor or strategic equity partner in the near term. A near-term liquidity event can protect the owner from down market cycles, provide a more certain economic outcome and reduce exposure to externalities. Owners may also want to be opportunistic with their approach and time the market. The market for buyers is dynamic and based on market conditions; at certain times, higher multiples may be achievable.

## Legal and Tax Implications

After owners come to agreement on the business side of their succession plan, a significant amount of time and care must be devoted to legal and tax impacts. Even if an agreement to sell an ownership stake is not imminent, it is still prudent to understand the legal and tax implications of these decisions.

Legal and tax considerations should not drive business decisions. Once the right model is selected, legal and tax processes should commence; it is much more efficient for owners to provide succession plan requirements to a law firm and tax advisor than to work through the issues on the fly. Most legal counselors and tax advisors provide questionnaires to help structure the legal documents and advise owners on the relevant tax implications of any event.

## Resources Available To Advisors

Developing a well-thought-out business and succession plan entails a significant time investment for advisory practices. Guidebooks such as this can provide a framework for advisors and they can also tap external resources for help in developing and executing their plans. Options include:

1. **Create business and succession plan in-house:** Firm owners and management team work together to craft their strategic plans internally. Advisory firms only use required third parties such as legal counsel to implement their plan.

2. **Third-party support:** Subject matter experts can help develop a process, timeline and accountability mechanism to ensure agreed upon deliverables and timelines are met. They can also work through the key decision points of business and succession planning. Firms that implement this approach value industry insight or require a third party to guide them through sensitive issues or mediate an impasse.
3. **Custodian support:** Pershing Advisor Solutions provides RIAs with the resources they need to drive growth, optimize human capital, maximize operational efficiency and manage risk. By collaborating with Pershing Advisor Solutions, you have the advantage of our practice management resources to help you handle the complexities related to business and succession planning. Some examples of the resources available are:
  - Independent studies and guidebooks such as *Pricing Strategies to Create Growth: An Independent Advisor’s Guide*, which provides best practices to drive profitability while improving the value provided to your clients.
  - Programs and tools such as TalentConnect®, designed to help attract, retain and develop top performers—a critical component in the development and implementation of your business and succession plan.
  - Events and workshops such as INSITE, Pershing’s Financial Solutions Conference, which provides you with a comprehensive overview of technology and product options that you can incorporate into your ongoing business planning.

Advisory firms usually leverage some or all of the following industry practitioners:

- > **Strategic Partners:** Independent practice management consultants, or those offered through the RIA’s custodian, help advisors think through their corporate strategy and drive consensus within a management or ownership team. The consultants can help advisory firms forecast growth and firm economics and hold owners accountable to agreed upon goals. They may play a role in executing elements of the business and succession plan. Some industry consultants also assist advisors through buy or sell transactions.
- > **Legal counsel:** Attorneys provide critical aid in the development and execution of a succession plan. A completed succession plan requires the creation or modification of a firm’s operating agreement and other additional legal documents. Counsel can educate firm owners on the legal benefits and risks of any changes.
- > **Investment bankers:** Investment bankers have expertise in acquisition, divesture and other changes in ownership. For advisors seeking turnkey and expert advice on building a growth strategy or M&A representation on the buy or sell side, investment bankers can be a valuable resource. Several investment banks specialize in the RIA space and have practice management capabilities beyond banking.
- > **Accountant or tax advisor:** Tax specialists provide advice on any tax ramifications to a firm and its owner from a transaction or other material change to the firm’s legal structure.

## Conclusion

Business and succession planning play a large role in the success of an advisory firm. The failure to execute a plan creates significant risk for an owner and partners, the owner’s estate, employees and clients.

There is no better time than the present to create a business and succession plan. Advisory firm owners now have access to an array of business consultants and legal and tax advisors to help them chart a course. Even more compelling, the RIA industry itself has matured, providing firm owners with various succession plan options to realize the wealth they have created in their practice.

# Appendix

## Business Plan Table of Contents

1. Executive Summary
  - 1.1 Company Overview
  - 1.2 Company Ownership and Legal Structure
  - 1.3 Mission and Vision
  - 1.4 Objectives and Milestones
2. Products and Services
  - 2.1 Advisory Services
  - 2.2 Complimentary Offerings
  - 2.3 Pricing Strategy
3. Market Analysis
  - 3.1 Competitive Environment
  - 3.2 Unique Value Proposition
  - 3.3 Ideal Client and Target Market
4. Strategy and Sales
  - 4.1 SWOT Analysis
  - 4.2 Unique Strengths
  - 4.3 Marketing Plan Overview
  - 4.4 Sales and New Client Acquisition Strategy
  - 4.5 Sales Forecast
5. Management Summary
  - 5.1 Corporate Governance and Advisory Board
  - 5.2 Management Roles and Responsibilities
  - 5.3 Succession Plan
6. Operating Model
  - 6.1 Legal Structure and Affiliation Model
  - 6.2 Functional Overview: In-House vs. Outsource
  - 6.3 Technology and Systems
  - 6.4 Organizational Structure and Human Capital
  - 6.5 Compensation Plan
  - 6.6 Client Experience (Service Model)
7. Financial Plan
  - 7.1 Profit and Loss
  - 7.2 Statement of Cash Flows
  - 7.3 Balance Sheet
  - 7.4 Key Business Indicators

## XYZ Capital Management: P&L

REVENUE	XYZ Capital Management		\$1M - \$2M Revenue	
Asset Management Fees	\$1,650,000	95.7%	\$1,088,175	80.0%
Planning and Consulting Fees				
<i>Project/Hourly Fees</i>	74,223	4.3%	25,608	1.9%
<i>Retainers</i>	0	0.0%	150,494	11.1%
Securities Commissions	0	0.0%	25,423	1.9%
Securities Trails	0	0.0%	28,264	2.1%
Insurance Commissions - New or First Year	0	0.0%	19,070	1.4%
Insurance Renewals	0	0.0%	3,443	0.3%
Other Fees	0	0.0%	19,710	1.4%
<b>Total Revenue</b>	<b>\$1,724,223</b>	<b>100.0%</b>	<b>\$1,360,187</b>	<b>100.0%</b>
DIRECT EXPENSE				
Professional Salaries				
<i>Owners</i>	420,500	24.4%	365,979	26.9%
<i>Non-Owners</i>	120,344	7.0%	173,945	12.8%
Professional Bonuses/Incentive Comp				
<i>Owners</i>	26,500	1.5%	38,395	2.8%
<i>Non-Owners</i>	33,270	1.9%	12,841	0.9%
Referral fees	0	0.0%	20,746	1.5%
<b>Total Direct Expense</b>	<b>\$600,614</b>	<b>34.8%</b>	<b>\$611,905</b>	<b>45.0%</b>
<b>GROSS PROFIT</b>	<b>\$1,123,609</b>	<b>65.2%</b>	<b>\$748,282</b>	<b>55.0%</b>
1. Moss Adams/InvestmentNews 2010 Financial Performance Study of Advisory Firms				

OVERHEAD EXPENSE				
Auto Expenses	6,520	0.4%	5,790	0.4%
Business Development and Marketing	40,600	2.4%	25,086	1.8%
Depreciation/Amortization	9,200	0.5%	8,225	0.6%
Equipment Leases, Purchases and Maintenance	10,100	0.6%	8,165	0.6%
Health and Other Employee Insurance Benefits	45,230	2.6%	34,338	2.5%
Information Technology (Hardware, Software & Outsourcing)	50,100	2.9%	38,359	2.8%
Insurance, Business-Related (P&C, E&O, etc.)	12,250	0.7%	14,248	1.0%
Office Expenses	20,160	1.2%	18,103	1.3%
Office Rent, Repairs and Maintenance	60,520	3.5%	71,972	5.3%
Outsourcing Services Excluding IT	35,240	2.0%	7,095	0.5%
Payroll Taxes	50,200	2.9%	39,530	2.9%
Professional Services	9,640	0.6%	21,000	1.5%
Retirement Benefits	55,740	3.2%	37,521	2.8%
Salaries, Administrative & Support (Technical) Staff	207,365	12.0%	187,660	13.8%
Taxes and Licenses Excluding Payroll Taxes	10,250	0.6%	11,460	0.8%
Training, Education, Professional Dues and Licensing	14,720	0.9%	8,689	0.6%
Travel & Entertainment	27,325	1.6%	8,461	0.6%
Utilities/Phone/Fax/Online Service	14,370	0.8%	12,078	0.9%
All Other Expenses	41,835	2.4%	34,437	2.5%
<b>Total Overhead Expenses</b>	<b>\$721,365</b>	<b>41.8%</b>	<b>\$592,217</b>	<b>43.5%</b>
<b>OPERATING INCOME</b>	<b>\$402,244</b>	<b>25.1%</b>	<b>\$156,065</b>	<b>11.5%</b>
<b>OTHER INCOME/(EXPENSES)</b>				
Other Income	6,420	0.4%	3,761	0.3%
Other Expense (-)	-5,520	-0.3%	-4,306	-0.3%
<b>Total Other Income/(Expense)</b>	<b>\$900</b>	<b>0.1%</b>	<b>-\$544</b>	<b>0.0%</b>
<b>PROFIT BEFORE TAX</b>	<b>\$403,144</b>	<b>25.7%</b>	<b>\$155,520</b>	<b>11.4%</b>
1. Moss Adams/InvestmentNews 2010 Financial Performance Study of Advisory Firms				

## XYZ Capital Management: Key Performance Indicators

	XYZ Capital Management	\$1M - \$2M Revenue
Assets Under Management	\$220,000,000	\$168,237,000
Total Revenue	\$1,724,223	\$1,360,187
Active Clients	280	270
Gross Profit Margin	65.2%	55.0%
Earnings Before Owners Comp (EBOC)	49.2%	42.8%
Operating Profit Margin	25.1%	11.5%
Pre-Tax Income per Owner (2 partners)	\$424,622	\$280,219
Staff Headcount:		
Professionals	3.0	2.5
Support or Technical Staff	2.0	1.9
Administrative Staff	1.0	1.0
Total Headcount	6.0	5.4
Active Clients per Professional	93	108
Active Clients per Staff (Total Headcount)	47	50
Revenue per Professional	\$574,741	\$544,075
Revenue per Staff (Total Headcount)	\$287,371	\$251,887
AUM per Professional	\$73,333,333	\$67,294,800
AUM per Staff (Total Headcount)	\$36,666,667	\$31,155,000
Revenue per Active Client	\$6,158	\$5,038
AUM per Active Client	\$785,714	\$623,100
Operating Profit per Active Client	\$1,437	\$578

## Case Study #1:

### Leonetti and Associates: Finding the Right Strategic Partner

Michael Leonetti built a successful independent practice before even considering business and succession planning. Based in the Chicago area, Leonetti and Associates was founded in 1982 and currently manages almost \$450 million in client assets, providing portfolio management and financial planning services. From modest beginnings, the firm now employs 17 people.

About three years ago, Leonetti sold 50% ownership in the company to The Edelman Financial Group Inc., a publically traded company that purchases a passive equity interest in independent practices. Michael noted, “In 2007, I was approached by multiple companies seeking to buy my business. As the sole owner with a long time horizon to retirement, I never really thought much about selling an interest of the company to a third party. The opportunity presented by Edelman Financial caused me to think about where I wanted to be in a different way.”

Prior to the sale to Edelman Financial, Michael was the sole owner of Leonetti and Associates. When the opportunity from Edelman Financial arose, he discovered real benefits in the offer and noticed a great fit with his personal objectives, including:

- > An opportunity to receive a liquidity event and take equity off the table
- > Providing help for the team’s sales process with a public company backing the firm
- > The promise of operational scale and vendor discounts
- > A well-thought-out “end game” to address the last 50% of equity he still owns

Three years later Michael is happy with his financial and business partner. “Edelman Financial helped free us by providing scale. Now we can focus on growth. They respect our autonomy.” For advisory firms without a business and succession plan, Michael recommends the following steps:

- > Determine the personal and professional vision and goals of each partner.
- > Document the team’s long term professional goals and succession plan.
- > Make sure the right people are in place to get the firm to where it needs to be.
- > Have annual offsite meetings to recalibrate what is important to owners.

## Case Study #2:

### Kistler Tiffany Advisors: Accelerating Growth While Providing Flexibility to Owners

Kistler Tiffany Advisors (KTA) has evolved into a successful wealth management firm in the Philadelphia metropolitan area. With four managing partners, nine additional advisors and \$4 million in revenue, this hybrid advisor has a game plan to drive growth and opportunity for each of the firm's partners.

Andy Reder, Managing Partner, commented, "We are seeking to aggressively grow KTA to increase the firm's enterprise value while providing flexibility to each partner, understanding that each of us has different time horizons." All the partners of KTA are pleased with the strategic direction of the firm.

KTA was not always this organized about their business. The four partners bought KTA from a retiring owner in 2003. The business had an advisory component, with a significant estate planning focus. Andy noted, "We were financial planners focusing on several areas, but wanted to shift our focus to becoming fiduciary advisors." KTA hired an outside consultant to help them with their business plan.

The planning exercise took several days, but had transformational outcomes. One of the first implementation items was to establish a KTA independent RIA and move away from leveraging a corporate RIA. Andy said, "We knew we wanted greater control over our economics and having our own RIA helped us gain the traction to start setting goals for the broader team." KTA built a five-year plan with clearly defined economic goals and roles and responsibilities for each Managing Partner.

The partners built accountability through monthly partner meetings and annual offsite retreats. "We are in year three in executing our vision to become a \$1 billion asset under management advisory firm. We haven't hit every goal, but we would never be this far without the focus our business plan has brought us."

In terms of the firm's succession plan, KTA has formalized a buy/sell agreement and they perform annual valuations of the firm's enterprise value. KTA's succession plan was built under the notion of flexibility. Andy noted, "Perhaps one day down the line, we'll get to a point where we want to liquefy some of our ownership interest, pursue other ownership opportunities or even have our children join the business. We're not there yet, but we get quite a few calls from acquirers looking to buy a stake in KTA."

KTA has defined a path for long term success and a clear succession for partners. The team is much more confident in their approach and KTA is growing rapidly. For firms without a plan Andy warned, "It is almost irresponsible not to address business and succession planning. Advisory firm owners have family, clients and staff to think about and they have a stake in what decisions are made. Uncertainty creates risk for all."

This guidebook is part of a program designed to help registered investment advisors and financial services firms identify trends, enhance operations and grow revenue. It represents Pershing Advisor Solutions' unique approach to practice management support—going beyond high-level guidance to offer actionable information, personalized consulting and ready-to-execute programs.

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