fa insight

TD Ameritrade Institutional Benchmarking

White Paper

Succession Planning: Beyond Ownership Transition, It's a Smart Human Capital Strategy

TD Ameritrade Institutional

About the Survey

The objective of this research was to understand how financial advisory firms are approaching succession planning.

The research was completed in December 2017 through an online survey with 322 independent RIAs, followed by interviews and focus groups. This white paper also references data from *The 2017 FA Insight Study of Advisory Firms: People and Pay* to draw conclusions about trends and provide context.

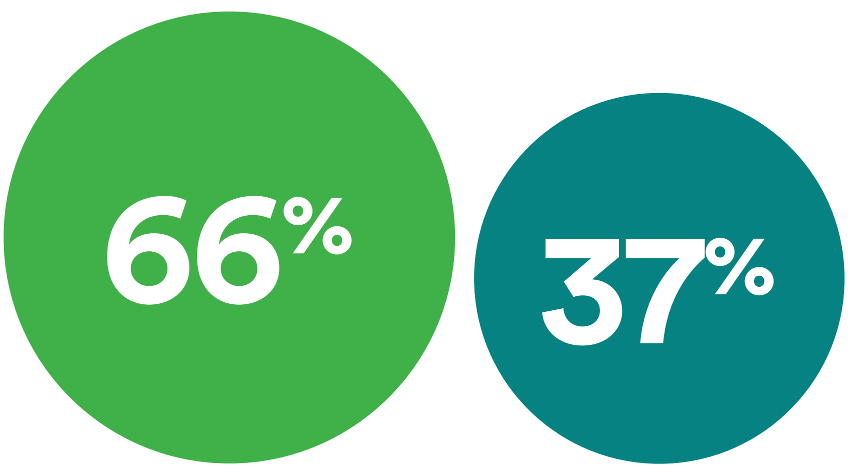
All survey respondents have been in business for at least one year, generate a minimum of $150,000 in annual gross revenue and serve individuals or households as primary clients.

Executive Summary

It's not news that the majority of advisors would prefer to develop an internal succession plan in comparison to other opportunities open to them. Given this preference, there are still a startling number of advisory firms that have a less-than-ideal plan in place or are yet to start the succession planning process. Lack of an adequate succession plan can present a business continuity risk in the short term and limit a firm's ability to create sustainable growth and equity value over the long term.

The question is why? Why isn't there more urgency among advisors around succession planning? The short answer is it's hard. This research examines why firm owners have not made more progress on succession and offers guidance for overcoming challenges, focusing in particular on the potential for human capital development to unlock succession solutions.

In 2017, as part of *The FA Insight Study of Advisory Firms: People and Pay*, 66% of firms reported that they have a succession plan in place—which on the surface appears encouraging. However, only 37% of all firms indicated that they have an adequate plan in place. Dating back to 2011, FA Insight study findings show the share of all firms with an adequate succession plan has fluctuated from 32% to 43%, indicating that firms continue to be challenged in developing a plan and/or making plan development a priority.



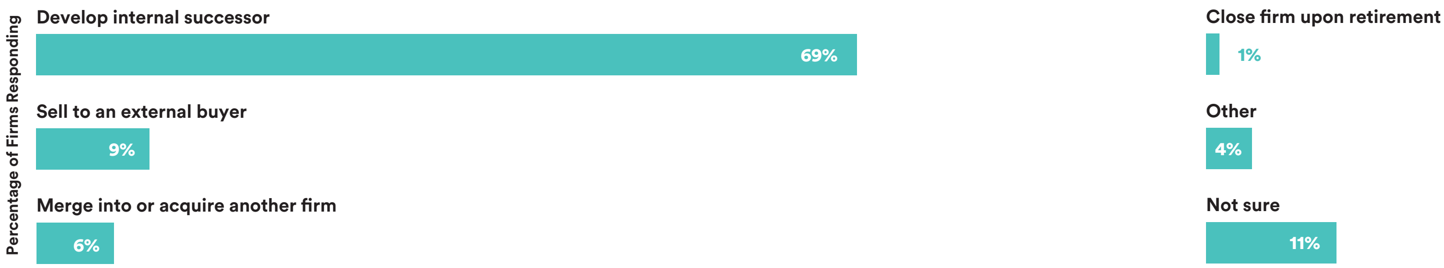
66% of firms reported that they have a **succession plan** in place. However, only **37%** of all firms indicated that they have an **adequate plan** in place.

Internal Succession Is Preferred, but Challenging

The majority of advisors (69%) indicate that an internal succession solution is preferred over a potential merger or acquisition, outright sale to an external buyer or closing upon retirement. If we look at firms with a succession plan already in place, this preference increases to 80%.[1]

Figure 1

Anticipated Succession Solution



Source: *The 2017 FA Insight Study of Advisory Firms: People and Pay.*

Advisors cite a number of reasons as to why they have not put more priority on developing an adequate succession plan, from both a short- and long-term perspective. To further complicate matters, many advisors indicate that there are a combination of obstacles, not just one, that they need to overcome in order to be successful in this endeavor. When you take into account the ownership transition, financing and leadership transition process in conjunction with the emotional barriers often encountered, it is understandable why more advisors are not in a better position.

Figure 2

What's Holding RIAs Back from Planning?

Source: *The 2017 FA Insight Succession Planning Survey.*

[1] *The 2017 FA Insight Study of Advisory Firms: People and Pay.*

Who's Most at Risk?

All firms, regardless of development stage, are at risk if they do not have an adequate succession solution in place. However, Operator firms, those that generate between $150,000 and $500,000 in annual revenue, are most at risk. Only roughly one in five small firms are prepared from a succession perspective, in contrast to 100% of the largest firms surveyed. Operators are most at risk primarily because they have not yet progressed to the point of having a team. As such, there are no obvious successor candidates within the firm, whereas larger firms have someone who can step in at least in the short term. For firms that have not yet made that first hire, it can be a big step. Smaller firms need to determine if they are ready to form a team and thus begin the process of mentoring a possible successor or consider other external options.

19% of Operator firms ($150K–$500K) have adequate succession plans

100% of Pacesetter firms ($8M+) have adequate succession plans

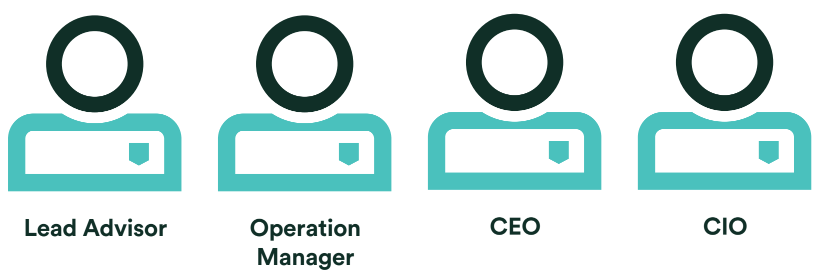
Source: *The 2017 FA Insight Succession Planning Survey.*

The Succession Blind Spot

The traditional focus of succession planning tends to be on the firm founder or principal. However, there are other business critical roles within an advisory firm that, if left vacant for a period of time, could have a negative impact on a firm's ability to operate, generate revenue and deliver a quality client experience.

What would you do if your operations manager went on a prolonged medical leave or your portfolio manager left for another opportunity? Do you have someone who can step in to fill the role immediately, or will you have a gap until you are able to hire? How might the vacancy impact your business? Advisors need to expand their definition of succession planning to plan for vacancies in the short and long term for all business critical roles.

Advisory firm roles most difficult to replace



Succession as a Human Capital Strategy

Advisor participants in both our online survey and focus groups indicated that multiple attempts are often required to get succession right. It's not easy, and even when you do have a plan in place, it may fall through over time for one reason or another. Those who are most prepared for succession from a business continuity and long-term perspective have built succession into their human capital strategy. By adopting this approach, advisors can grow a pool of viable candidates within their firms, have "understudies" waiting in the wings to fill business critical roles and position themselves to better attract and retain high-performing talent while minimizing business risk. By broadening their perspective, they eliminate the need to focus on succession as a stand-alone exercise; it becomes a natural outcome of human capital best practices.

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Defining Succession

The concept of succession can have different meanings for different advisors. Put simply, however, succession involves a process through which owners exit their firms. The solution may be internal, external or a combination of both. As simple as the definition may be, preparing for succession is often anything but simple, which may explain why more advisors are not further along in the process.

The first foray into succession planning is often focused on identifying a single successor candidate. Finding "the one" individual to whom you feel comfortable turning over ownership of your firm can be likened to finding your soul mate or finding a needle in a haystack. The reality is that over time as your firm evolves, so, too, will your plan, and it may grow to include multiple owners and succession strategies.

Why Succession Matters

While advisors are often challenged to make succession planning a priority, getting started on a sound plan is clearly in the best interest of the firm's owners, its employees and its clients. The benefits can be far reaching, including:

- Risk mitigation. A good succession plan reduces unhealthy dependencies on key team members, which in turn lessens the risks of business disruptions.
- Compliance. While final rules are yet to be released, regulators highly recommend that firms include succession as part of business continuity plans.
- Client retention. Clients want the assurance of continued quality of care. The lack of a succession plan can create client concern and potentially impact the firm's ability to sustain a quality client experience in the event that succession becomes necessary.
- Employee retention. Outlining career path progression is an important aspect of a comprehensive succession plan. A defined path for progressing to new levels of responsibility, including ownership, provides a strong incentive for valued employees to remain committed to the firm.
- Legacy. Succession planning gives the advisor greater control for shaping the legacy of the firm.
- Options. A good succession plan, prepared well in advance of need, preserves flexibility and widens options for how an owner will transition out of the business.
- Performance. Succession plans can facilitate broader distribution of ownership, which in turn correlates with a better-performing firm.
- Value. All the above benefits, in combination, help build greater value in the firm—perhaps the most important byproduct of succession planning. In a sense, an effective succession plan sets off a virtuous cycle: The various iterations of the plan help to enhance firm value, and the more valuable firm attracts a wider range of interested buyers, with potential succession options increasing as a result.

By emphasizing the eventual exit of the firm owner, advisors are leaving opportunities on the table to better mitigate short- and long-term risk in terms of contingency planning, attracting and retaining future leaders and diversifying their succession options. Adopting a broader perspective of succession planning as part of a firm's human capital strategy can help advisors to solve for succession over time, build firm value and be better positioned to minimize disruption caused by the unexpected departure of a key individual.

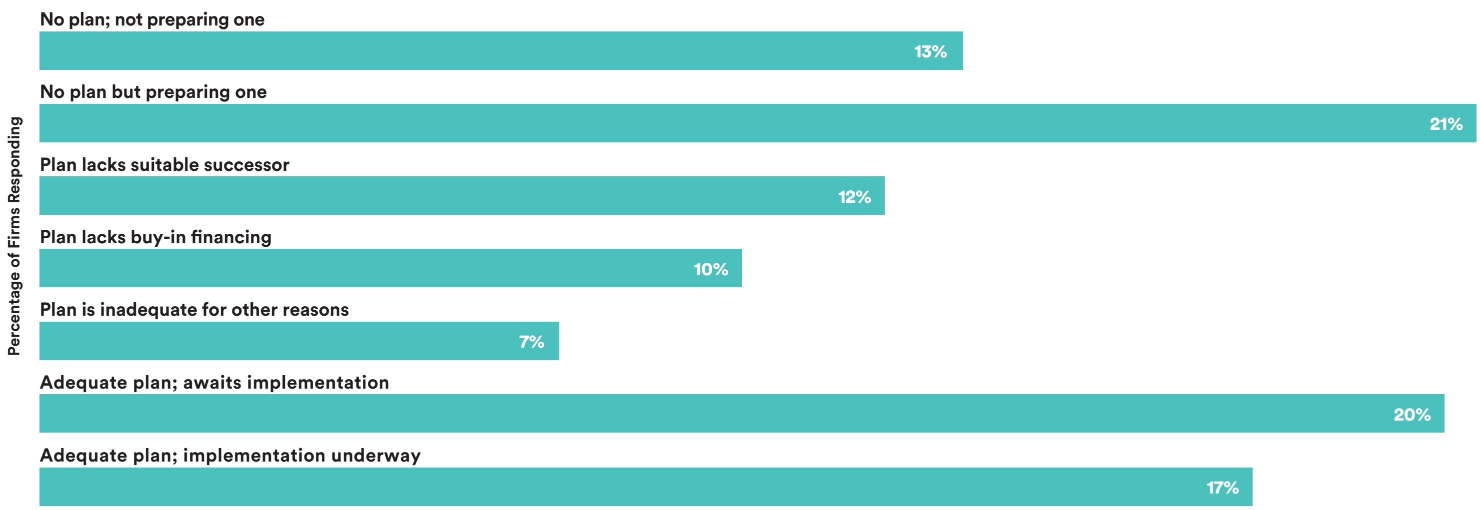
The State of the State

Despite the tremendous potential that succession planning can have for sustaining firm growth and building value, most advisory firms do not have adequate plans in place. One of the primary objectives of this research is to better understand why advisors have not made more progress in planning for succession and offer insights from those who have successfully traveled the path and overcome common obstacles.

Survey participants cite the need to prioritize and dedicate time as leading obstacles to successful planning. This makes sense given that until you have begun the process, you are unlikely to come up against other types of obstacles until you are further into the journey. These obstacles include the more technical aspects of structuring a plan such as valuing firm shares and financing buy-in for a new owner. In addition, there are intangible obstacles encountered related to the exiting owner's readiness and comfort level that the firm will be left in good hands.

Figure 3

Succession Planning Readiness



Source: *The 2017 FA Insight Study of Advisory Firms: People and Pay.*

Ironically, this industry is one that specializes in preparing its clients for major transitions, yet advisors aren't following their own advice. In our focus groups, we learned that advisors are in many cases aware of the benefits of succession planning but, for a variety of reasons, can't spring into action.

> "Every day we talk to clients about navigating the same thing—about retiring, or letting go of the thing that they used to do every day that gave them so much pleasure. We can tell them what to do, and yet we have a hard time taking our own medicine."
>
> —Evelyn Zohlen, Inspired Financial

Historically, our FA Insight study findings indicate that succession plan preparedness has hovered at similar levels over the years, which is corroborated by a variety of other industry research on this topic.

37%
of firms reported an adequate succession plan in place

Figure 4

Share of Firms with Adequate Succession Plan, 2011–2017

	2011	2013	2015	2017
Adequate plan	34%	32%	43%	37%

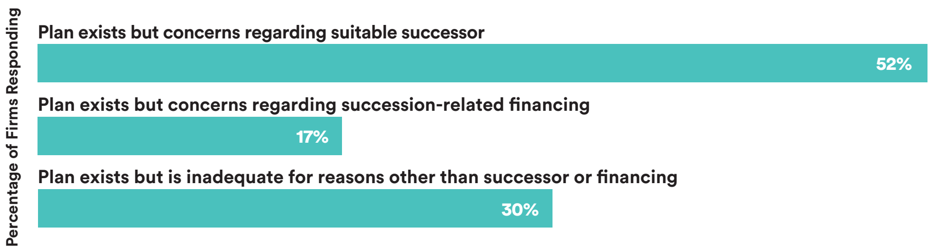
Source: *The FA Insight Study of Advisory Firms (2011–2017).*

An Inadequate Plan Isn't Really a Plan

Of the 29% of all firms that reported inadequate plans in 2017, the majority lacked a suitable successor or had concerns about transition financing. While having a plan may appear better than having no plan at all, an unsuitable successor, for example, could jeopardize the future of a firm if a succession is triggered unexpectedly.

Figure 5

Top Reasons Why a Succession Plan May Be Less Than Ideal



Source: *The 2017 FA Insight Study of Advisory Firms: People and Pay.*

An inadequate plan will not achieve the primary objectives of succession, which are to ensure an exit plan for an owner, ensure clients are taken care of and secure the firm's future.

Perspective and Challenges Change as Firms Mature

Across each stage, firms will experience unique challenges and certain advantages with the various aspects of succession planning. In addition to having difficulty prioritizing succession planning, advisors cite the following as the most difficult to solve as they progress on this journey.

The challenge of succession is particularly acute for small Operator firms.

Top Items Most Difficult to Solve

1. Prioritizing succession planning over other business issues
2. Putting a team in place that can sustain the firm after the current owner departs
3. Dedicating time to work on succession planning
4. Identifying or developing a suitable successor

Source: *The 2017 FA Insight Succession Planning Survey.*

When we look at the planning challenges by stage of development, it is clear that the challenge of succession is particularly acute for small or Operator firms (those firms generating $150,000 to $500,000 in annual revenue). Less than one in five (19%) of Operator firms in our 2017 survey had an adequate plan, with owners of small firms much likelier to be unsure of what their ideal solution might be. For smaller firms, either succession is not a priority, there are no clear successor candidates as they may have not yet begun to form a team, or there is difficulty in finding a partner to execute an M&A solution.

For the largest firms, the chief concern is having a team in place that can work independently of current owners. Indicating their planning is likely further along, larger firms also tend to be more concerned with deal terms and deal financing.

Succession Wins and Challenges by Firm Stage*

		Challenges	Advantages
Operators $150K–$500K	Revenue: $300K AUM: $35M FTE: 2 Owners: 1 % of owners retiring within 7 years: 34%	• Finding the time • Not sure where to start • Firm ownership concentrated with one individual • No likely successor candidate	• Younger owners • More time to plan
Cultivators $500K–$1.5M	Revenue: $894K AUM: $110M FTE: 5 Owners: 1 % of owners retiring within 7 years: 39%	• Many owners close to retirement • Planning time underestimated • Worried about client experience	• Greater awareness and priority • Viable internal candidates emerging
Accelerators $1.5M–$4M	Revenue: $2.4M AUM: $368M FTE: 9 Owners: 2 % of owners retiring within 7 years: 32%	• Assembling right team • Owner uncertainty about realizing full firm value	• Likely added new owner • Reduced dependency on principal
Innovators $4M–$8M	Revenue: $5.6M AUM: $795M FTE: 18 Owners: 5 % of owners retiring within 7 years: 37%	• Low % share of owners • Many close to retirement • Assembling team to sustain firm • Lack of suitable successor • Agreeing on deal terms	• Likely have a plan in place • Broad pool of candidates
Pacesetters >$8M	Revenue: $13.5M AUM: $2B FTE: 45 Owners: 9 % of owners retiring within 7 years: 20%	• Multiple failed attempts • Financing challenges due to high firm value • Owners' reluctance to "let go" • Require extensive leadership and management abilities	• Likely have adequate plan in place • Retirement not imminent for majority of owners • Large pool of candidates • Fewer personal obstacles for owners

Sources: *The 2017 FA Insight Succession Planning Survey* and *The 2017 FA Insight Study of Advisory Firms: People and Pay.*
*Note: All numbers are medians with the exception of % of owners retiring. % of owners retiring represents an average across all owners at each stage.

Larger Firms Are Challenged with Increasingly Concentrated Ownership Levels

While any time is a good time for prioritizing succession, the need becomes more pressing as firms increase in size and firm owners get older. Across all firms, one in five team members was an advisory firm owner in 2017. For Pacesetters, the industry's largest firms with $8 million or more in annual revenue, this share falls to 13%, or about one in 10 team members. As firm size increases, employees are added at a faster rate than new owners, resulting in increasingly concentrated ownership.

In addition, a larger firm is often a more valuable entity in terms of share price per revenue dollar. The combined effect of more costly shares held in greater concentration presents a challenge for the large firm, making it more difficult for the next generation to be able to afford buy-in. In short, while the need for broader distribution increases, firm shares are increasingly less affordable for potential successors.

Succession Risk Beyond the Owner

The traditional view of succession planning focuses on an exit strategy for a firm owner. Succession in a broader context should cover contingency plans for the unexpected vacancy of any business critical role with the firm, including team members who are not owners. Such planning will help minimize the short-term business disruption often experienced with an unforeseen departure.

Business critical roles include any position that heavily influences firm success. If a key employee unexpectedly left tomorrow, is there someone who can step into their shoes with minimal impact? Their departure, in the short term, could result in increased firm expenses, reduced income or decreased productivity. From a longer-term perspective, identifying and developing successors for business critical roles is a human capital best practice and can be helpful in establishing career paths.

Succession is not **JUST FOR OWNERS.** There are many **BUSINESS CRITICAL ROLES** that if **VACANT** can negatively impact your business.

Firms with a Plan in Place by Role

58%	39%	39%
Firm principals/ partners	Revenue-generating personnel	Operational support personnel

Source: *Advisor participants in the TD Ameritrade Institutional Securing Your Firm's Future 2017 Fall Workshop Series.*

Despite the advantages of extending succession plans to non-owners, only a minority of firms go this far. Of participants in a recent TD Ameritrade workshop series, just 39% reported that they had contingency plans in place for replacing revenue-generating or operational support employees. This compares with 58% of participants with plans for firm owners.

The Successor Pipeline—Why Isn't It Bigger?

It's challenging enough for firms to prioritize succession over other business demands. However, once ready, the next challenge often faced is the lack of millennial or career-changer talent to fill the role of successor.

The millennial generation is projected to overtake the baby boomer population as the largest generation, with approximately 76 million strong. So why aren't there enough young people to succeed the current financial advisory workforce? A few, but challenging reasons to overcome include:

1. The majority (62%) of millennials don't even know what a financial advisor does.[2]
2. Many lack the high risk tolerance required for owning a business.
3. Firms are looking for successor candidates who can "think like an owner."
4. Millennials are looking for something different out of their career than previous generations.
5. Successors are attracted to a strong investment proposition—how strong is your value proposition for a potential investor?

As an industry, financial advisory firms need to work collaboratively to raise awareness and develop a compelling employee and successor value proposition to become part of the consideration set for millennials and career changers.

[1] GenHQ, *Will Millennials Be Able to Retire?*, September 2015.

Planning for Ownership Succession

Multiple options exist for how working owners will eventually exit their firms. Choices range from an outright firm sale or merger, to grooming a successor from within, to simply shutting the firm down upon retirement. Depending upon the firm, not every choice is viable or even desirable; some firms may incorporate a combination of solutions to implement a long-term succession.

Determining which options are best suited for a firm and owner depends on the personal preferences of the owner and the opportunity set that is realistically available to the firm. Personal goals that extend beyond potential monetary reward, including a future vision for the business and how it will continue to care for its team members and clients, will likely shape the owner's preferences. The length of time the owner wishes to remain with the firm is another key determinant from a personal perspective. Current ownership composition, firm size, client makeup, business mix, pricing, marketing methods, operational infrastructure and human capital are some of the primary firm-related factors that shape the breadth of succession options specific to the firm.

Internal Succession Is the Preferred Choice

Across all firms sizes, grooming a successor from within the firm is the leading choice. Compared with other options, owners are nearly four times more likely to prefer an internal succession.

> "I'd like to see it internally. I believe it is best if financial planning firms are majority owned by the people who are actually doing the financial planning."

—Steve Lear, Affiance Financial

> "We are in a relationship-based business, and so much of the work that we do is very personal. To be able to cultivate somebody to hand off that relationship over time is a value. We're not in a build-it-to-sell-it type of model."

—Focus Group Participant

Smaller firms, however, do have a lesser tendency to favor an internal succession, likely due to having a smaller pool of internal candidates to draw from.

The allure of an internal succession centers on the greater degree of influence that the selling owner can have on the outcome of the transition. Relative to a sale or merger with an external party, the seller has greater control over the following:

- Overall legacy of the firm, including preservation of its culture and values
- Continued ability of the firm to deliver quality care for clients
- Continuance of the firm as an employer of choice for team members
- Terms for the succeeding owner's role and tenure following the ownership transition

Successfully implementing an internal succession, however, is not without challenges. This is evident in the many firms that are yet to put a plan in place. In addition to the typical obstacles cited, other hurdles center on the owner's mindset and the potential that their fears will be realized.

> "While grooming a successor would be the most desirable, one of my concerns is that you think you have the right person, you spend years mentoring them and get to the point where you want to retire, and they leave."
>
> —Kathy Guerin, Envision Wealth Advisors, LLC

4x

Advisors are four times more likely to choose internal succession over other options

Source: *The 2017 FA Insight Succession Planning Survey.*

It's Not an Event—It's a Journey

Successfully implementing an internal plan is more like a long-term journey than a one-time transaction, complete with unexpected turns that force the traveler to adapt and evolve along the way. It requires time, patience and flexibility. In most cases, multiple attempts will be required before you reach your ideal state—then the process repeats. Each new successor will need their own successor, making this a continuous cycle for firms looking to stand the test of time.

Where Do You Want to Go?

As with preparations for any trip, good planning begins with an understanding of where it is you want to go. What are you looking to achieve through your succession plan? Define your succession-related goals in terms of personal, client, employee and firm level objectives. Your vision can provide a foundation for profiling the ideal successor candidate that is best equipped to take your firm into the future.

> "The fear of the unknown can be paralyzing. There are so many options to consider when it comes to succession—it's the largest transaction I will ever go through and the most emotionally involved."
>
> —Kathy Guerin, Envision Wealth Advisors, LLC

Facing the Reality of Succession

Imagining your preferred succession outcome is often the easy part. Preparing yourself for the changes ahead can be far more complicated. For owners, this reality can be an unsettling, uncomfortable and far more of an emotional experience than anticipated.

A range of factors influences the rate at which firm founders actively plan their exit. For many who participated in our research, the procrastination is personal. Personal pride and the self-worth experienced in founding and growing a successful business play a dominant role in stalling progress.

One in six survey participants felt that the "fear of letting go" was among the succession-planning factors most difficult to solve for. Nearly one-third (31%) felt that being "not ready to retire" limited their ability to implement a succession solution.

> "I had an epiphany in attempting to deal with a business-owner client struggling to hand over the reins to a successor. I said, 'Look, nobody cares that you walked uphill both ways in the snow to school. Nobody cares that you mortgaged your house.' His inability to move forward stemmed from pride of ownership and being the founder and having run everything your way for 25 years—all emotional factors. When I got home that night, I looked at myself in the mirror and realized that I have that same problem."
>
> —Kirk Francis, Financial Life Advisors

For succession to succeed, exiting owners must be ready to relinquish control and embrace a new life outside of the firm. An honest and personal evaluation of your beliefs and your outlook can be a useful tool. The following self-assessment might be a helpful starting point for consideration.

Firm Control and Decision-Making Authority

- ☐ Are you prepared for the day you no longer hold a controlling interest in the firm that you founded? How will you feel relinquishing control to incoming owners?
- ☐ Would you be comfortable working in the business when you are no longer the majority owner? If not, why?
- ☐ Are you ready for younger, less experienced partners to determine the direction of the firm and to make the most significant decisions on behalf of the firm?

Changes to Your Day-to-Day Role and Your Personal Routine

- ☐ Are you prepared for your role in the business to change and to become more limited while others take on more responsibility? Do you feel you are the only one who has the experience to do your work, and if so, how will that affect your willingness to make the changes?
- ☐ Are you ready to transition some or all of your long-term client relationships to younger advisors to ensure the sustainability of these relationships beyond your exit?
- ☐ How will you feel when you are no longer the lead advisor to your clients and are no longer required in meetings with clients you have worked with for decades?
- ☐ How will you feel working reduced hours and being required in the office only a few days a week?
- ☐ Have you considered how you will spend your time outside of work once your role in the business reduces or comes to an end? Do you have a retirement transition plan that you are excited to pursue?
- ☐ Are you considering pursuing other interests that you are enthusiastic about such as a new business initiative, hobbies or personal development endeavors?

Take time to explore what might be holding you back from planning your business succession in order to best prepare yourself for what lies ahead.

Set a Time Frame

It is no secret that succession planning takes time. Unfortunately, firm owners often underestimate the amount of time required.

> "I didn't feel any urgency for succession planning because retirement was decades away. Now, decades later, I realize I may have let it go for too long. Time has slipped away."
>
> —Evelyn Zohlen, Inspired Financial

Our survey asked firm owners to report the minimum amount of time needed to achieve a successful succession, from beginning a plan to exiting out of the business. Of those survey participants with an adequate succession plan in place, more than half (54%) indicated needing at least four years. Executing an internal succession can be an especially lengthy process. The sooner you can overcome the barriers to getting started, the more potential solutions you will have to choose from.

In setting a realistic succession time frame, owners may need to make concessions in terms of how much longer they are willing to work at the firm versus the actual time needed for achieving other desired succession outcomes. A planning and implementation time frame must also account for the possibility that multiple attempts may be needed before the right option works out.

54%

54% of firms with an adequate succession plan in place indicate you need at least four years to implement a plan.

Source: *The 2017 FA Insight Succession Planning Survey.*

Be Flexible

Succession rarely unfolds according to plan. The first attempt is unlikely to be successful. Candidates may not be as qualified as originally hoped for, a buyer or seller may have last-minute regrets or deal negotiations may fall through at the final hour.

46% of firms were successful on their first attempt

54% of firms had to try at least twice

Source: *The 2017 FA Insight Succession Planning Survey.*

More than half of succession-prepared firms participating in our survey (54%) pursued multiple options before finding a working succession solution. As a result, selling owners should expect the unexpected and be ready to develop or pursue a backup plan.

> "A piece of a plan is better than no plan. If you can only agree on what happens from a contingency plan perspective, then execute it and work on the long-term plan later. Go in pieces, and don't be afraid to change it. I think the stumbling block is that you think you have to get it all done in one shot."
>
> —Lee DeLorenzo, United Asset Strategies

The succession planning and implementation process is an inherently dynamic one—not a static stand-alone exercise. To be effective, the process is embedded within the fabric of the firm in terms of initiatives and behaviors that consistently expand succession-related options and increase the probability for reaching an ideal succession solution.

Get Your House in Order

Before you can move full steam ahead in pursuing your chosen succession pathway, you will need to do a bit of prep work in terms of getting your house in order. Regardless of the preferred solution, a key to success will be your ability to focus on building lasting firm value, which will better position your firm to attract not only the next generation of talent but the next generation of owners.

By focusing on those key drivers of firm value, your firm will naturally begin to develop a strong value proposition for prospective buyers, including successor candidates. Over time, your firm may be able to grow a pool of successor candidates, providing your firm with expanded choice and flexibility for crafting a succession solution.

> "First attempt didn't really fail. I selected to alter my direction when a better solution presented itself."
>
> 2017 FA Insight Succession Planning Survey Participant

Key areas of focus for building value:

- **Strategic vision.** A clear vision defining how the firm will grow lays the foundation for building value. The strategic vision outlines who the firm will serve and how the firm will differentiate itself in the marketplace. It includes specific initiatives or targets and a time frame for achieving them, empowers your employees and assigns who will be accountable.
- **Management structure.** The establishment of a management structure with specific accountabilities aligned with a firm's strategic vision can help to distinguish a "practice" from a "business" and can greatly enhance a firm's ability to sustain profitable growth.
- **Human capital development plan.** An effective human capital strategy starts with an organizational blueprint that defines the various roles in the firm and how they will relate to one another and evolve as the firm grows. Further, it allows for a focus on professional development and the creation of career paths and employee retention strategies.
- **Efficient operations.** Defined workflow processes, in combination with the thoughtful application and integration of technology promote service efficiency, consistency and quality—all important contributors of firm value.
- **Client growth.** A sustainable client growth rate over the long term is a key driver of firm value. Your firm's approach to bringing on new profitable client relationships as well as continuing to deepen your existing relationships needs to be proactive, process-driven and repeatable across different individuals. Reliance on passive referrals or the business development efforts of a single team member, for example, can be viewed as a risk factor long term.
- **Legal structure.** Certain business entity types or legal structures may restrict an owner's ability to transfer equity. Firm owners should consult with their attorney or accountant to confirm whether they might benefit from a different legal structure.
- **Business continuity plan.** Do you have thoughtful, tested contingency plans in place to ensure your firm is able to operate with minimal business disruption should an unforeseen event occur (e.g., prolonged medical leave of firm principal, natural disaster)?

Moving Forward

Once your house is in order, you need to determine how you will source a potential successor candidate. If you have an established team in place, you may already have someone in mind. If you are a sole proprietor, you may need to begin an external search. Regardless of where you look to identify a successor from, you want to have a clear idea of what you are looking for and a thorough vetting process to make sure you make the best decision you can with the information available. This is not a decision to make lightly and will require more than just a few interviews to know if you have a viable candidate worth investing your time with.

Defining Successor Criteria

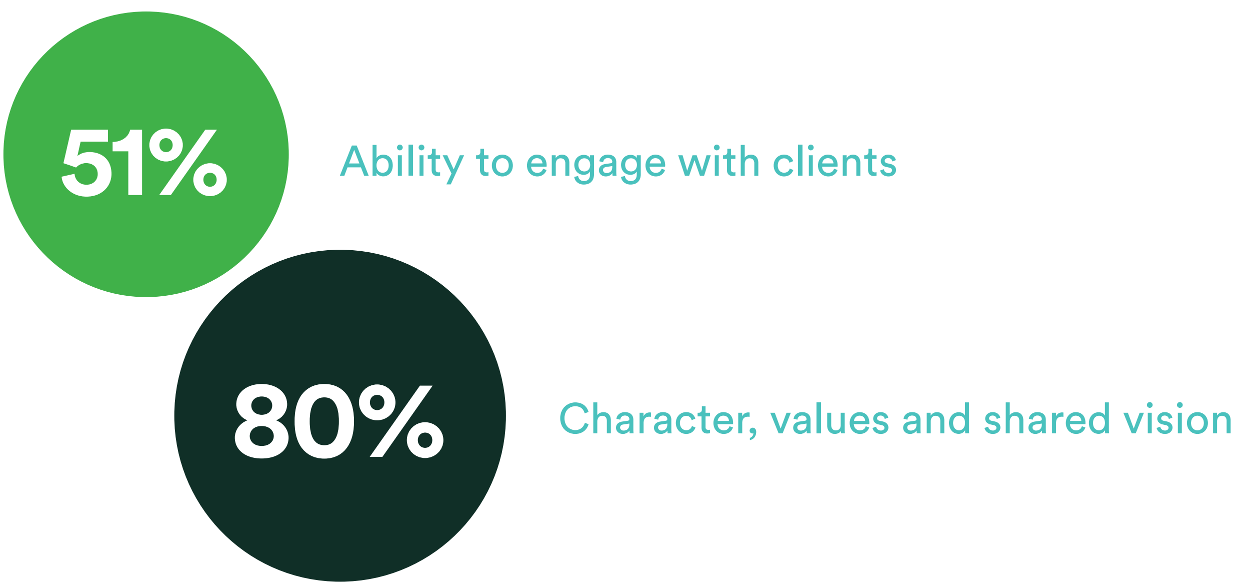
What kind of successor candidate will be best suited to achieve your vision for the future? In much the same way a firm might profile a target client, an owner can apply a profile to more effectively recruit and vet successor candidates. The candidate profile serves as a useful reference point to focus the selection process and avoid reactive decision-making. Survey findings provide helpful background in terms of the most important attributes that owners are looking for in a successor.

Successor Candidate Sample Criteria

What's your ideal list of experience, character traits and skill sets for your successor? Which items on your list are negotiable and which are must-haves?

- ☐ Shared values
- ☐ Shared vision
- ☐ Ability to lead and influence
- ☐ Management expertise
- ☐ Business development acumen
- ☐ Financial capital or financing
- ☐ Ability to empathize and engage with clients
- ☐ High risk tolerance
- ☐ Ability and desire to mentor and develop others
- ☐ Other? ______________________

Figure 5
Most Important Evaluation Criteria for Ownership



Source: *The 2017 FA Insight Succession Planning Survey.*

Far and away the most prevalent criteria to apply in evaluating a new candidate for ownership are character and values (including a shared vision on firm culture), favored by 80% of owners surveyed. The second most popular attribute selected by just over half of survey participants (51%) is the ability to effectively engage with prospects and clients. Leadership or management ability and professional maturity followed.

> "They must have the ability to effectively bring something to the business that creates value, whether it's the ability to bring in new relationships, be extraordinary in terms of service or indispensable in managing day-to-day operations."
>
> —Ben Gurwitz, Financial Life Advisors

Ownership criteria vary according to firm stage. The ability of the candidate to engage with clients is more important for owners of smaller firms. Leadership and management ability is more important for larger firms.

Assessing a Candidate's Propensity to Tolerate Risk

Character and values along with specific business capabilities create a solid framework for determining suitability for ownership. One character trait that is often overlooked but critically important is the candidate's propensity for risk. Current owners have experienced the sacrifices that come with ownership over the course of time through bull and bear markets. The burden of risk is not for everyone, and the ability to bear risk should be a key component of your successor evaluation process.

For example:

- Is the succession candidate capable of funding significant debt to acquire equity? Are they able to manage their existing personal debt such as a home mortgage along with this new commitment?
- Is the succession candidate comfortable with the responsibility of meeting payroll and other critical business expenses? If business revenue drops 20% in a given year, are they prepared to take a reduced salary (or no salary) for a period of time to ensure that business critical expenses are covered?
- All businesses go through periods of reinvestment to support future growth. In some years, profits will not be distributed. Does your succession candidate understand and accept that annual profit distributions are not guaranteed?
- Does the candidate have the resilience to navigate stressful events—for example, working with legal counsel and other professionals to resolve an issue such as a client suing the firm?

Despite an individual's character and skill set, this elevated level of accountability is one of the ways that you can begin to understand a candidate's ability to think like an owner and weather the ups and downs of ownership relative to those who will flourish as employees.

Develop a Successor Value Proposition

Successful firms have a well-defined value proposition that speaks to target clients. Similarly, as a firm owner seeking a successor, you will need to craft a value proposition that resonates with the target successor profile.

Naturally, the value proposition would highlight the firm as an attractive long-term investment opportunity, but other aspects of the opportunity deserve attention as well. These might include the potential for career growth, opportunity to receive coaching, and greater job satisfaction in addition to potential personal or lifestyle rewards and, eventually, ownership.

Sourcing Candidates

Finding a successor is often a primary stumbling block for firms. For half of firms with inadequate succession plans, lack of a suitable successor is the reason for the plan's inadequacy.

Owners have three levers at their disposal to broaden their pool of potential successors. Utilizing all three can maximize options available:

- **Improve firm value.** As noted, more valuable firms will naturally attract greater interest from a wider cross-section of potential buyers.
- **Develop from within.** "Growing your own" involves a long-term investment in people and a proactive approach to human capital development. The payoff is significant, however, in terms of a more reliable pool of successor candidates as well as a better-performing firm. The most successful firms, rather than focusing on a select few individuals, adopt a culture of progressing people across their teams, encouraging every team member to aspire to ownership. An infrastructure is in place to support this culture, including defined career paths, training opportunities, mentoring and performance management programs.
- **Market externally.** Looking outside the firm is especially critical if the firm's existing team is small, no natural succession candidates exist or the selling owner's time frame is limited. Several avenues exist for promoting the firm and potential opportunities for ownership. Participating in professional associations such as FPA or NAPFA, speaking at industry events or serving on community boards are all examples of how to increase exposure and attract interest. Two of our focus group participants formed a successor relationship after getting to know each other while serving on an FPA board. Custodians and industry vendors have broad contacts across the industry and can be good sources for identifying potential successors at other firms. A growing number of matchmaking services for advisory firm buyers and sellers is another marketing option.

Testing the Waters

Successfully identifying successor candidates is only the beginning. For some advisors, a potential successor comes to their notice years before any serious discussions begin or deal terms are finalized. There is a reason for this. It takes time to observe a candidate's capabilities as a leader, visionary, growth driver and business manager. In addition to determining their ability to step in and run a business, you also need to assess whether there is a cultural match from a values perspective and overall business philosophy.

CASE STUDY

Health Crisis Forces the Issue of Succession

In October 2016, David Koshinski, President and CEO at the time of IPI Wealth Management, went in for a routine colonoscopy, following which he was diagnosed with Stage 3 colon cancer and was advised to undergo surgery as soon as possible. David was faced with the reality of being unable to work for the foreseeable future, with no identified successor to step up and lead the firm. In addition, he was left with little to no time to formulate a plan for how the business would run without him. Learn how strong values and a unified mission helped David and his team weather a prolonged medical leave and put the question of succession at the top of the priority list.

To download the full case study, visit education.tdainstitutional.com/risk.

If your successor meets all of your ideal candidate criteria and you are ready to transition, you will need to initiate the more technical aspects of succession planning, including valuation, deal terms, financing and transition timeline. It is more likely, however, that your successor candidate will need time to acclimate to your firm's culture and develop their skills as a business leader and potential owner. In this scenario, your ability to mentor and monitor their progress is critical to determining if they are, after all, the right individual to succeed you. While the development time depends on the individual, a time will come when you need to decide whether they can be a successor and move on to more serious discussions or explain that ownership is not in their future and allow for a graceful exit from the firm or transition into an employee-only capacity.

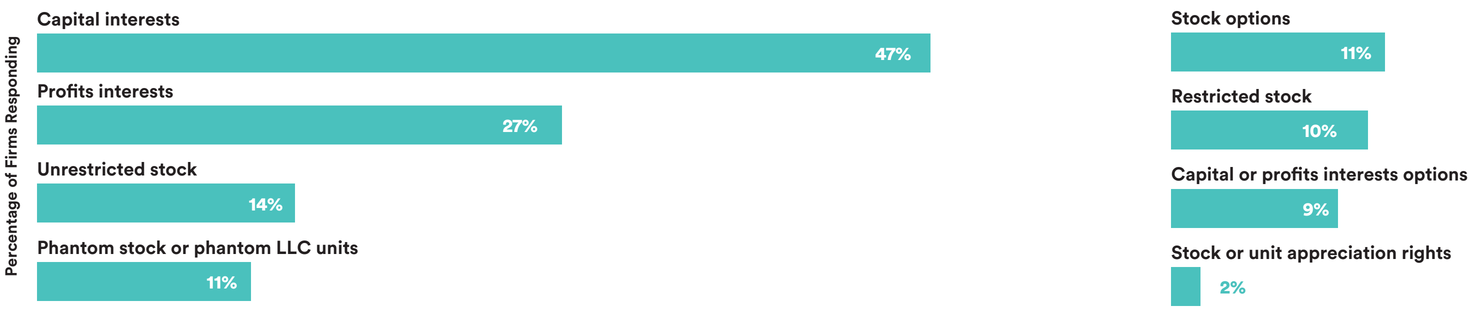
> "I recently announced the addition of three new employee partners in the firm at our annual team meeting. These individuals each bring a unique ability to drive business value over the long term. Between our ESOP and these people, I have the team in place to take over the company."
>
> —Lee DeLorenzo, United Asset Strategies

A lesson learned frequently cited by both exiting owners and successors is to avoid having an open-ended time frame. Such a time frame can be frustrating for the potential successor, who is eager to take on ownership, and a potentially poor investment of your time if the candidate fails to meet expectations.

Valuation and Share Distribution Methods

The decision to move forward with transitioning shares to a successor indicates to the successor that you believe in their ability to lead the firm and are ready to begin the transition. You can transition shares in a number of ways—the offering of capital and profit interests being the most popular methods. There are key considerations associated with all of the distribution methods, and you should consult with your legal and tax professionals to determine the best fit for your firm.

Figure 6
Ownership Offered in a Variety of Forms



Source: *The 2017 FA Insight Study of Advisory Firms: People and Pay.*

Shares are typically valued based on a firm's current valuation with a discount rate applied. The discount rate reflects the riskiness of future cash flows, and it discounts them back to their present value. Firms that have stock distribution programs or are anticipating a transfer of ownership as part of a succession plan or compensation strategy will need to have a formal valuation conducted by an objective third party.

42% of shares are offered at a discount ranging from 11–25% less than the estimated market value.

50% Half of all shares are purchased at market rate.

Source: *The 2017 FA Insight Study of Advisory Firms: People and Pay.*

Tip:

While it might be tempting to simplify calculations by using a rule of thumb such as a multiple of revenue or a multiple of cash flow, these methods are not sufficient. They do not take into account the uniqueness of the business and the transaction, and they do not account for expectations of future cash flow, growth potential and risk.

Deal Structure

Each transaction will be unique based on factors such as the firm valuation, transition timeline, the role of the exiting owner over time, the speed with which the successor assumes the reins, and financial performance of the firm throughout the transition.

In addition, focus group participants repeatedly pointed out the importance of recognizing that the successor will enter negotiations from a very different perspective than the exiting owner. Be upfront about what you want and need to come together in order to proceed with the transaction. Both sides will need to make compromises to achieve a satisfactory outcome for the firm and parties involved.

The following are standard considerations for the majority of transactions:

- Agreement on firm valuation methodology
- Tax considerations
- Earn-out provisions
- Employment contracts and non-solicitation agreements
- Protective provisions in the event that the deal does not work out over the long term

Note:

While there are third-party providers that offer "out of the box" templates to assist with the above, it is not recommended that you leverage these types of resources without customizing them to your specific circumstances and seeking professional counsel.

CASE STUDY

Ambitious Entrepreneur Becomes Firm's Desired Successor

After numerous attempts to bring on a viable successor, Kirk Francis of Financial Life Advisors shares his story of how he almost passed over "the one" and why all the factors that initially made the candidate the wrong one ended up being the very reasons that made him the right one. This case study also presents the succession journey through the eyes of Ben Gurwitz, the successor. Ben offers unique insight into his search for a firm to join and why he ultimately decided determined FLA was the right choice.

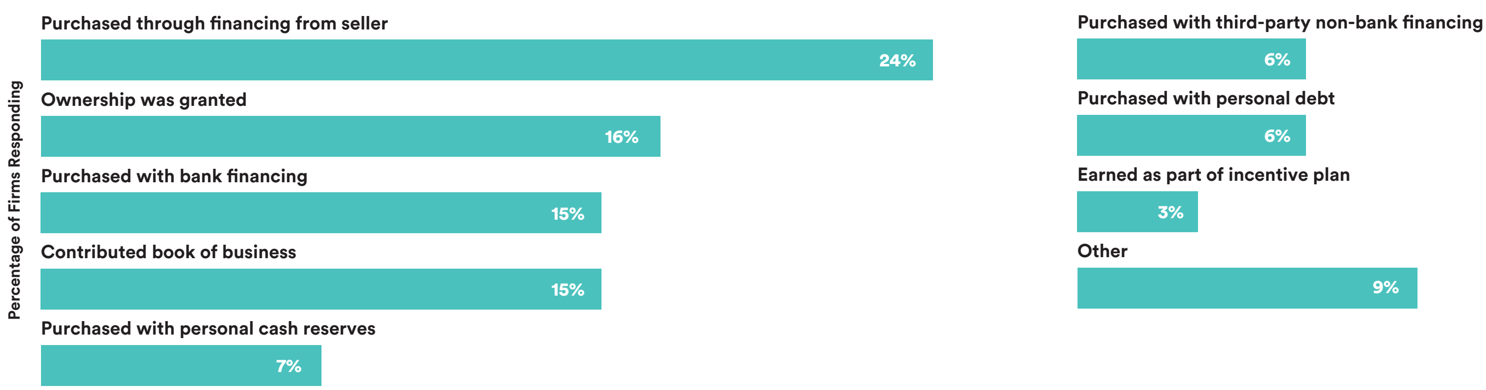
To download the full case study, visit education.tdainstitutional.com/risk.

Financing

Most successor candidates lack personal capital to purchase ownership or even provide a substantial down payment. Discounting firm valuation, financing assistance, including stretching out the payback period, can help make a successor buy-in more affordable. Despite these options, about one-quarter of successor buy-ins were seller-financed.

Figure 7

Primary Payment for Ownership



Source: *The 2017 FA Insight Study of Advisory Firms: People and Pay.*

While still a challenge, access to commercial lending is improving. Bank financing was utilized by 15% of transitions. A growing number of specialty lenders are helping to increase the supply of available capital. Other funding options include the successor paying for shares out of job compensation or profits from purchased shares.

The Transition Period

Successful transitions have some common elements, including a predefined length of time with associated milestones that must be achieved before the parties can move on to the next step. The length of time needs to be long enough to ensure the transfer of leadership responsibilities, including client relationships and staff management. However, if the transition period goes on for too long, it can strain relationships and cause confusion. It can raise questions as to who is the ultimate leader and decision-maker and cause frustration for the successor who is ready to assume their new role.

Ongoing and frequent communications to clients and staff and between the exiting owner and successor are also critical to a successful transition period. As the balance of power moves from one individual to the next, it becomes imperative that the existing owner support the successor in their new role. Over time, the owner should relinquish their decision-making authority in favor of assuming the role of behind-the-scenes mentor until the transition is complete.

If at First You Don't Succeed…

Developing and implementing a succession plan is a journey and not a one-time event. Even if a successor does not work out over the longer term, you will emerge from the experience better prepared to try again. Take the time to self-reflect and examine the reasons why it may not have worked out. Assess how you may be able to avoid these obstacles in the future or, at the very least, be better able to identify a red flag before traveling too far down the road. Leverage the experience for understanding, and determine how to increase the chances of success with the next attempt. In the event of a failed attempt, it is important that you have a contingency plan—that is, other candidates waiting in the wings who can be considered—rather than beginning again with an initial search. Succession planning takes time, and as an owner nears retirement, new options may need to be considered if a successor is not found in time.

Succession for Key Roles Beyond Firm Principals

Beyond the firm principals, advisory firms have roles that, if left vacant for a period of time, can impact a firm's ability to make progress on strategic goals, serve clients and help team members maintain a satisfactory work life balance. How can you minimize what, for many firms, is often missed as a potential business risk? First, identify the business critical roles within your firm.

Which Roles Require a Succession Plan?

Is the role needed to execute your firm's strategic plan?

If the role is vacant, will it impede your ability to operate?

Does the role have key decision-making responsibilities?

If the answer is yes to any of the above three questions for a role within your firm, you need to have a succession plan in place. The plan can help you mitigate the risk related to a sudden departure of a key employee for business continuity purposes, as well as for the long-term sustainability of your firm. While making it through without a specific individual role may seem like a short-term challenge, the true long-term impact may not be measurable for some time.

We asked survey participants to identify the most critical roles within their firms as well as the anticipated amount of time it would take to replace these roles. The results are as follows:

Roles Most Difficult to Replace

	Lead Advisor	Operations Manager	CEO	CIO
% of firms reporting it would take more than 6 months to fill role	65%	43%	66%	52%
% of firms reporting it would take more than 12 months to fill role	31%	7%	32%	18%

Source: *The 2017 FA Insight Succession Planning Survey.*

Benefits to a Broader Approach to Succession Planning

In addition to helping ensure a firm is covered from a business continuity perspective, broadening your definition of succession offers a range of benefits for your firm over the long term, including the ability to:

- Improve competency levels across the firm
- Create overlaps in skills and responsibilities
- Leverage development opportunities to strengthen employee engagement and retention
- Reduce the impact of losing a business critical role
- Groom a new generation of firm leaders

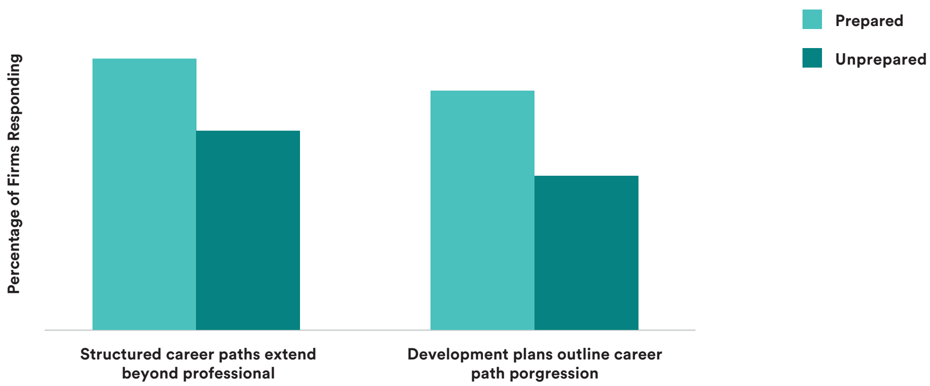
Rather than solely focus on the development of a single successor, firms best prepared for ownership succession work across their entire teams to ensure the firm has the capacity to meet future growth needs and the appropriate level of overlapping expertise to limit unhealthy dependencies on key individuals. Key individuals include not just firm owners but any role deemed business critical.

Planning for Succession Creates Natural Career Paths

Human capital development is tightly integrated into the most effective succession plans. FA Insight research finds strong correlations between succession preparedness and good human capital practices such as the availability of training opportunities and career paths.

Figure 8

Career Paths Broaden Succession Choices



Source: *The 2017 FA Insight Study of Advisory Firms: People and Pay.*

Structured career paths are important elements for facilitating the development of team members for succeeding into business critical roles. Both revenue-generating and non-generating roles will require career path definition.

Career paths can outline a road map for team members in terms of their potential progression to higher levels of responsibility within the firm. Job descriptions depict roles along the career path (existing or to be added) and the core responsibilities, skills and requirements expected of each role. To further set expectations for progression, career path detail includes the competency or performance standards expected of each role and what differentiates outstanding performance.

Succession as Part of Your Human Capital Strategy

Planning for succession should be a component of your overall human capital strategy. It begins with assessing the talent you have, determining each individual's potential for advancement, identifying skill set gaps that need to be filled, creating a development plan and, finally, managing performance. Mentoring team members is essential to their ability to progress and grow as individuals, as is providing opportunities for them to access formal and on-the-job training opportunities. Firm owners and senior leaders are often well-suited for mentoring and coaching, an interest validated during our focus group research.

"Mentoring is very appealing to me because it's a continuation of the growth process, wanting to see someone else learn from you. You can learn from a younger person too—it can go both ways."

—Kathy Guerin, Envision Wealth Advisors, LLC

Once you have a sense of who you have and where they stand from a performance and potential perspective, you can develop an action plan on how you will motivate your top performers and drive continued engagement among your loyal longtime employees, with the aim of minimizing the possibility of losing a key employee.

Succession Planning for Business Critical Roles

	Key Role 1	Key Role 2	Key Role 3
Title of role	Ops manager		
Who is currently in role?	Jane Doe		
Retention risk/expected departure	Medium		
Potential candidates	Sam Jackson		
Retention risk	Low		
Readiness rating	Medium		
Performance/potential level			
Top development needs			
How long would it take them to be ready for role?	3 years		
Needed to execute your firm's strategic plan			
Is the role key to decision-making?			
Will a vacant role halt business?			

Note to the Sole Proprietor:

If you do not have a team, you will need to begin with sourcing talent. If approached thoughtfully, an ongoing focus on developing, motivating and competitively compensating your people can yield a wider pool of succession candidates for continuity purposes and for securing the future of your firm over the long term.

Conclusion— A Never-Ending Journey

The best succession plans prepare the firm for sustaining business growth beyond the tenure of the firm's current generation. Progressive firms recognize that succession is a never-ending cycle. In the broadest sense, succession extends far beyond replacing a single owner and includes contingency plans for the loss of any business critical role within the firm. This more comprehensive approach recognizes that the firm's entire stable of human capital must continually renew to sustain the firm over time. Development and succession plans for key roles help build a more valuable firm in addition to increasing options for transitioning ownership. When firms are continually able to progress team members to higher levels of responsibility, reliance on any key person (owner or non-owner) is reduced and better ensures capacity will be on line to accommodate future business growth.

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