How to Finance a Succession Plan

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by Greg Fink

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The demographics of the financial advisor population have given rise to a higher need for succession planning. For most advisors this is the most important financial decision they will make and it comes with a myriad of questions. What are the benefits of selling to a third party versus a junior advisor? How do you get the timing right?

I interviewed Steve Levitt of Park Sutton Advisors, an investment banking firm specialized in financial services firms, about what advisors need to know about the financial aspects of a succession planning deal.

How does an advisor know when it's better to find a successor themselves versus selling the firm to a national aggregator or roll-up firm? If you were to find a junior successor yourself, how do you recommend financing the deal?

My best advice is don't rush it. If you're considering an internal candidate, plan for it to take some time to see if they really can fill your shoes. It can take years to see if they really work out.

As for financing, typically once in a while the founder is prepared to seller-finance the deal over a long period of time, even five to 10 years depending on the age of the founder. More often they don't want to finance it for too long. They are looking for the junior to pay for the equity over time.

Depending on the size of the firm, this probably involves somewhere up to half down with the rest paid over time. In some cases, junior advisors need to borrow at a bank or consult with friends and family, or they can go to a lender such as Oak Street Funding or Live Oak Bank. Typically we see discount to fair market value in the context of what an advisor would pay for the business – about 25-50% off of fair market value. Some sellers are fine with that, but some are not.

What are some of the mistakes you see advisors making when they go about selling their firms?

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One reason why we are seeing and will continue to see a lot of RIA transactions is that these businesses are valuable and expensive and it's not easy to facilitate an internal transition.

Advisors shouldn't rush this decision; but some founders wait too long, sometimes to the point where they are at a bit of an advanced age and do not have much in the way of leverage with those next generation advisors. The older you are, the more limited your time horizon and you could be hurting your ability to achieve fair terms from your successor(s).

You should also consider that as time passes your AUM is subject to inevitable decline due to clients passing away or withdrawing for retirement income. Currently many folks expect market returns over the next decade to be lower than in prior decades, which could challenge clients' income requirements.

Timing also impacts the valuation. For example, the RIA market is very active right now. Assets are at a high level. It may not be this way in three years. In addition, an industry can be in or out-of-favor from an M&A perspective. Just as there are many buyers of RIAs right now, there are currently many buyers seeking to acquire real-assets managers. Back in 2002, many buyers sought to acquire hedge funds-of-funds but currently that M&A market is dead.

How does an advisor know when to go with a junior advisor versus go to market?

These can be very difficult discussions. Few of the businesses that want to transition internally to a junior advisor will actually see that ultimately play out. Most will go with a third party.

For many founders, this is their net worth and their retirement plan. For others, they may not need the business as an asset for their own retirement but want the assets as part of their estate to pass on to heirs as part of their legacy. They are not necessarily prepared to hand over the business for the price or terms that a junior advisor is willing or can afford to pay. Ultimately they need to go to market.

Conclusion

With the dizzying pace of advisor firms being acquired in recent years, the market is alive and active. However, as it is a seller's market, most founders are getting offers from multiple firms. Sellers should evaluate factors such as the potential for growth and margin improvement but should also consider the buyer's track record and be wary of firms that are new to acquisitions.

An experienced buyer is one who may or may not require financing, but has a track record of being able to procure such financing successfully if and when needed. You also want a buyer who has gone through the exercise of cultural assimilation, as this can become problematic if not handled correctly. Lastly, experienced buyers have an understanding of how to leverage resources such as third-party valuation experts, investment bankers and attorneys who may need to be called upon. All of this impacts valuation and makes for a smoother transition.

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