The Stark Reality of Succession Planning

External Succession: Part II of II

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10 MIN READ

This is a Part II of a 2-part RIA M&A advice series dedicated to succession planning. Part I assessed internal succession and financing options. Part II addresses external succession and key considerations.

Part I of this 2-part RIA M&A Advice outlined a number of internal succession options along with some of the complexities involved in each. One of the main complications is cost. There are currently significantly more buyers than there are sellers in the market. The ratio is somewhere around 30:1.

The imbalance between supply and demand has resulted in fierce competition for deals. That has driven up valuations to YOY record highs. Consequently, NextGen successors are being priced out of the market. As a result, internal succession is no longer a viable option for many firms.

This conundrum has forced RIA owners to explore alternative succession options. Owners without successors face similar circumstances. A logical choice is an external sale given the number of RIAs that looking to acquire or merge. As readers can attest, you do not have to look far – they will find you.

With so many prospective M&A opportunities, the problem is not finding a buyer – it is choosing the right one. The best fit will be willing and able to meet your goals and needs. In this second part of the analysis will explore the external succession options available. We will start with an overview of the key considerations first. The term "sale" relates to both acquisitions and mergers.

Formulating a M&A Framework

If you have read or watched our video presentations before then you will recall that developing a strategy is a lot like goal-based financial planning. Start with the most basic questions first when formulating your framework:

1. What is your goal?
2. What are your needs?
3. What is the time horizon?

Defining Goals and Time Horizon

A primary goal in succession planning is to determine who is going to run the business after you and/or your partners step away. That is where establishing a time horizon is of the utmost importance. Having a longer runway provides flexibility along with the ability to adapt to changing circumstances.

It takes years of advance planning, but plenty of firms have successfully implemented internal succession plans. If selling the firm outright is not a realistic expectation, you can still set-up a plan that provides an opportunity for NextGen equity participation as minority owners. Ownership helps align incentives and reduces the risk of attrition prior to an eventual external sale. Talent is hard to come by these days and losing key team members will likely reduce the sale price.

If that ship has already sailed due to time constraints, then it is important to consider alternative approaches – like partnering with a group that will provide equity to the NextGen as part of the transaction or that offer equity through a stock option plan. Some acquirers will and others won't.

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If equity participation is a goal, it is important to know the answer to that question before getting deep into discussions. Time and resources are of the essence in M&A.

Another goal should be to find a good home for your entire staff. Look for groups that will provide career advancement, peer networking opportunities, continuing education, etc. Above all else, make sure you have a good cultural match.

Smoothing the Way

Gaining buy-in from the NextGen and other key members of staff during the M&A process is vital. Everyone likes to feel that their views matter. Giving the team a voice in the process helps alleviate friction. The extent of involvement is ultimately up to you, but the team should know who has the final say. Part of the role of a M&A Advisor is to act as a mediator between the parties and to help build consensus. That is not always easy, and things can get messy without mediation.

Another goal should be to provide a better client experience. That could be superior customer service through technology enhancements, more investment options, or a deeper range of services. A better experience is a good way to position the ensuing change of ownership to clients. It also a good way to make sure clients stick after the transaction – which is where needs come in.

Needs and Negotiation

Needs center on what you want to get out of the transaction. It could mean dialing back the number of hours you currently work, or offloading compliance and investment management. Needs also relate to financial aspects of the deal, including:

- Valuation expectations
- Cash, equity, or a mix
- Upfront payment percentage
- Earnout terms
- Claw back provisions
- Employment agreements
- Ongoing compensation

All the details above are typically open to negotiation. The negotiations are more involved if there are multiple owners and can take-on added complexity if the parties have divergent needs. Time horizon is a key factor, if say, one partner is nearing retirement while others have a longer runway with no immediate plans to retire. The former will typically want more cash at close to fund retirement needs while the NextGen may want to roll their equity into the acquirer. Again, circumstances differ. The best fit will structure a deal accordingly.

An indispensable role of a M&A Advisor is to facilitate the deal by working out the most suitable arrangement. That means to make sure the acquirer accommodates the needs of each individual. It also involves negotiating the best possible terms at highest possible valuation (i.e., “show me the money!”). This often entails complex deliberations that require exemplary negotiation skills.

External succession options

Once you have formulated a M&A framework it is time to evaluate available external succession options. There are a lot of good options given the number of RIAs that are looking to acquire. Many of those options involve private equity (PE), which is one of the primary reasons we see valuations at record levels.

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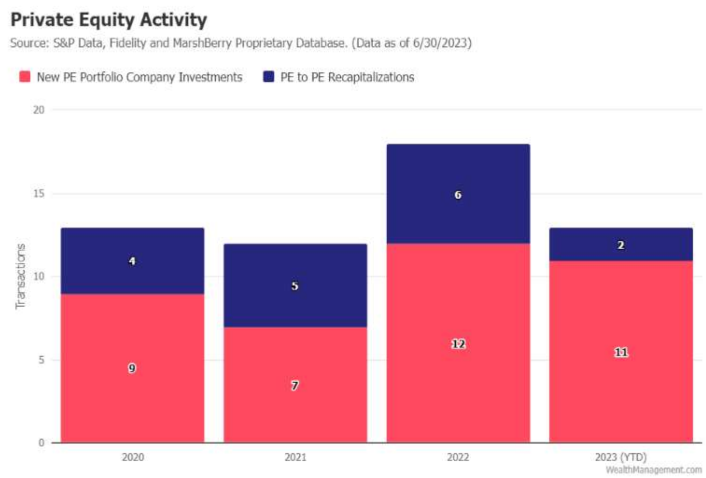
According to a recent Fidelity report, PE was behind 76% of M&A transactions in the first half of 2023. That was mainly through RIA platforms (aka aggregators, consolidators, strategic acquirers). Expect that trend to continue. More PE firms are entering the RIA M&A market through direct investment in portfolio companies (RIA platforms). As the graph to the right shows, there have been 11 new PE portfolio company investments in the first half of 2023 alone. There were 12 in the whole of 2022 and only 7 in 2021.



Source: WealthManagement.com

Types of Acquirers

Below is an overview of various available external succession options:

PE Owned: There are a multitude of PE owned RIAs consolidators. One of the biggest advantages to these groups is that they have readily available cash to make acquisitions. There can be drawbacks as well. Like RIAs, not all PE firms are the same.

Minority PE Backed: There are also several RIAs that are backed by PE minority investments. This can give management more control over the direction of the firm versus those that are wholly owned by PE firms. How much control ultimately depends on deal terms and operating agreements.

Long-Term Capital: Long-term capital backed RIA consolidators are differentiated from PE firms in that the sell mandate is typically longer. They will often hold on to RIA investments for around a decade before exploring exit options. Funding can come from UHNW, insurers or institutional investors.

Large Employee-Owned: Several large employee-owned RIAs are very active in M&A. If the end game for both parties is to remain independent and employee-owned, then this is a win-win for both sides. Some firms fund acquisitions from their balance sheet or have a debt facility available from a lender.

Small Acquirers: There is a plethora of smaller RIAs (< $1 billion) that want to do deals with other small RIAs or buy books from retiring advisors. Funding acquisitions can be an issue, particularly in the current interest rate environment. That said, there are plenty that are successful at it. Experience helps.

Conclusion

Succession planning is complex and challenging which explains why the majority of firms lack a formal plan. Finding the right path forward takes considerable time and effort. What works for other firms may not work for yours. To make the best-informed decision, you need to understand all the moving parts.

It is our hope that the information provided in this advice series will give you the confidence to take decisive action. If you need assistance, Nunnally International is here to help. We will introduce your firm to compatible RIAs, help you avoid costly mistakes and negotiate the best deal on your behalf.

We invite you to learn more by visiting our website at www.nunnallyinternational.com

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About Nunnally International, Inc.

Nunnally International, Inc. provides strategic M&A services to RIA firms that are looking to buy, sell or merge their business.

The company was founded by Tyler D. Nunnally in 2020. Prior to entering M&A, Tyler served as a strategist to leading advisor technology providers – including FinaMetrica, which was acquired by Morningstar. He began his wealth management career in England as an executive at Oxford Risk, a spin-off of Oxford University that specializes in behavioral finance.

Tyler has consulted hundreds of RIAs on matters of risk as a frequent speaker at industry conferences, host of countless webinars and proficient author of journal articles. He has been a key relationship manager to strategic partners including Schwab, Fidelity, Redtail, Orion, eMoney, Fi360, MoneyGuidePro and SEI.

As an industry thought-leader, Tyler has been interviewed extensively by The Wall Street Journal, Bloomberg, CNBC, Smart Money, Kiplinger and InvestmentNews. He holds a B.A. from the University of Georgia and a Master's in International Business with Distinction from the University of St Andrews in Scotland.

How We Work with Clients

Nunnally International, Inc. works with RIAs in the following ways. You can choose whichever option best suits your unique circumstances.

Option A – Seller Representation

RIA firms that want to sell or merge engage Nunnally International, Inc. through a Sale and Fee Agreement. We lead the M&A process all the way from initial introductions to close. Our fees consist of a success fee based on the closing price. We guide you through the M&A process by:

- Help define your strategic objectives.
- Identify shortlist of prospective M&A partners.
- Market your firm to prospective acquirers.
- Coordinate calls and meeting.
- Facilitate conversations and information flow.
- Solicit initial offers.
- Negotiate terms of sale and maximize valuation.
- Assist in preparation of necessary documentation.
- Conduct due diligence on prospective acquirers.
- Successfully close sale

Option B – Referral Partner Network

Nunnally International, Inc. can introduce your firm to prospective buyers through our referral partner network. Our referral partners pay our fees, so there is no cost to you. We work with around 22 referral partners that are all differentiated in terms of what they bring to the table.

We employ our expertise in investor profiling to find the best fit based on your strategic objectives, partnership criteria and firm culture. Naturally, this is done in consultation with you. If you decide that you would like to pursue a conversation with a group that we recommend, then we make the initial introduction and help facilitate talks.

For more information call us at 404.492.2152 or send an email to tnunnally@NunnallyInternational.com

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