# The Stark Reality of Succession Planning

## Internal Succession: Part I of II

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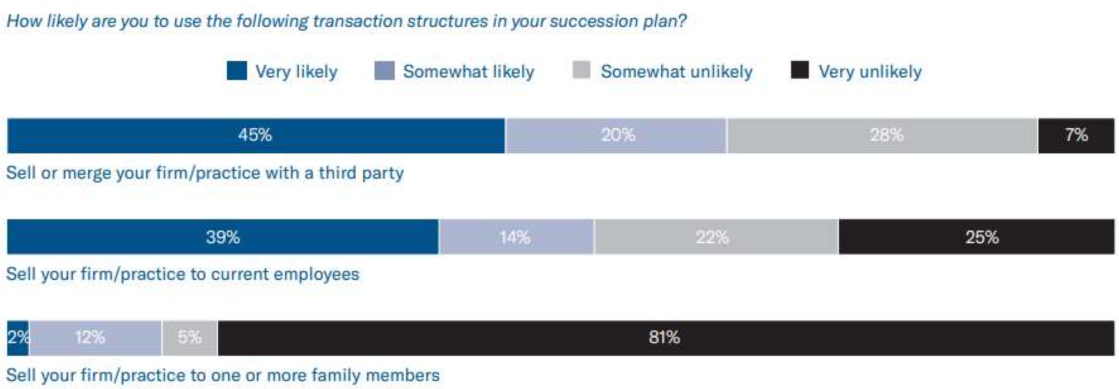
*10 MIN READ*

*This is a Part I of a 2-part RIA M&A advice series dedicated to succession planning. Part I assesses internal succession and financing options. Part II will address external succession.*

There has been a lot of talk about the looming succession plan crisis facing RIAs. Research shows that a majority of firms do not have a documented succession plan in place. When you consider that there are almost 15,000 SEC registered investment advisors, it paints a rather striking picture.

As for the minority of RIAs that reportedly have a succession plan, one has to wonder how viable many of those plans actually are. RIAs have become expensive due to rising valuations – and that is really the underlying quandary.

As a M&A Advisor to RIAs, I am often told that "we are planning an internal succession". That familiar response is supported by a recent Franklin Templeton survey which revealed that over half of respondents indicated that they were "very likely" or "somewhat likely" to sell their firm to current employees (as shown graph below).




Source: www.franklintempleton.com/articles-us/keys-to-successful-succession-planning-for-rias

On the surface, internal succession sounds great. Current employees certainly should be given the option to buy the firm if that is the desire of current ownership. In reality, though, it is not so simple.

### What are the internal succession plan options?

**NextGen**

The next generation (NextGen) is the most logical internal succession plan option – if you are fortunate enough to have one. Nunnally International typically works with firms in the $100 million to $1 billion range and a large percentage of those RIAs do not have a NextGen team. Given the well-documented talent shortage in the industry finding the right individual(s) can be daunting. It also takes time and resources to recruit, train and mentor your successor. Even then there are no guarantees they will stick around. Then what?

If your RIA does have a NextGen, the assumption is often that the team will take over the firm when the current partner(s) are ready to retire. As a current owner, you should not take anything for granted. Hope is not a strategy. You need to make sure that there is a definitive internal succession plan in place that spells-out how, when, and to whom shares transfer – and at what cost.

### Conflict and The Status Quo

Agreeing valuation and terms of sale internally can be tricky. It can also cause conflict. To avoid rocking the boat, the succession plan takes a back seat to other priorities. The status quo prevails…just like it did last year…and the year before… The intentions are good but there are still no tangible results.

Having worked with RIAs for nearly two decades in various capacities including M&A, I've found that firm principals generally have a hard time adhering to timetables. The primary reason for this is distractions, which is the result of running a business while wearing too many hats.

The day-to-day "usual" distractions are presently compounded by the need to manage market risks in a very challenging economic environment. The markets are undoubtedly a real concern. It is a complex and difficult time to manage money. But the fact is, it's always something.

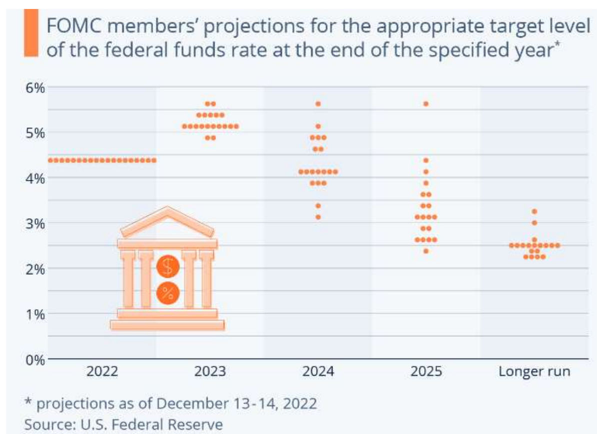
## The issue of risk and cost

### Risk Tolerance

To determine internal succession plan options and viability, you need to know whether the NextGen are *willing and able* buyers. Firstly, the NextGen have to be *willing* to assume the risk associated with purchasing the firm. Not everyone is comfortable taking risks. Subsequently, they may not want to take on the liabilities that come with debt. That is often the case with people in their 30s, 40s and 50s that have a steep mortgage and car loans hanging over their heads with kids in school and college to pay for. (I personally have 2 kids in college, one of which is freshman at Tufts. I get it, believe me).

### Capacity for Risk

The second part of the equation is the *ability* to buy the firm. Rising valuations is good news if you own an RIA. Not so much if you want to purchase one. To finance a buy-out takes funds. If you don't have the funds at your disposal, then you typically have to borrow them. In a today's interest rate environment, the cost of borrowing is high. Rates can come down, sure. But no one really knows when or by how much (as demonstrated in the graph to the right). Market timing does not work in investing nor is it advisable in succession planning.




## The most common financing options

**Banks**: If the lender happens to be a bank, then that adds another layer of complexity considering the collapse of SVB and the troubled sector as a whole. Banks are becoming more risk averse in addition to being notoriously self-serving. Not exactly the ideal capital partner under the best of circumstances. Besides that, banks want personal guarantees and collateral. Is the NextGen willing to put up their house?

**Private Equity and Venture Capital:** Private equity groups invest directly in a select few multi-billion-dollar RIAs that are then utilized as platforms to purchase smaller firms (i.e. aggregators, consolidators). PE firms typically do not entertain direct investments in RIAs that do not meet their revenue and EBITDA thresholds. Venture capital invests in start-ups, not mature businesses. Neither of these groups are viable succession plan financing options for the vast majority of firms.

**Minority Investors**: There are a handful of minority investors that will in some cases help fund a buy-out. Again, though, firms must meet minimum thresholds to even be considered. If you do not meet those minimums, then do not expect your enquiries to go very far. There used to be a handful of large RIAs that would make direct minority investments in smaller firms with the intent to purchase outright later. That model is evidently unsustainable and thus, the number of options is rapidly dwindling.

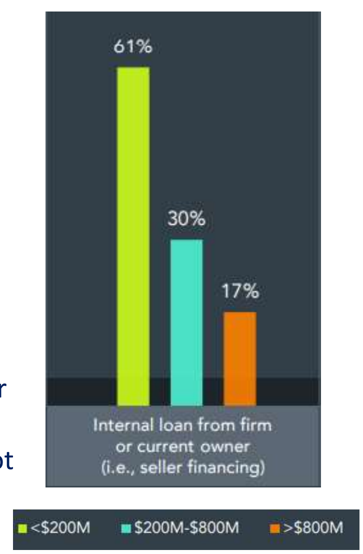
**Family and Friends:** This can be a very good option if the NextGen has wealthy family or friends with access to capital. That typically entails borrowing the funds and paying them back. Having family or friends make a direct investment in the purchase is a different story. Owners may not want to be beholden to the NextGen's aunt, uncle and grandparents. Appropriate deal structure, therefore, is crucial in such circumstances.

## If not lenders, then who?

**Owner Financing:** If none of the options above are viable or palatable, then the question becomes "what other option is there"? Firm principals will oftentimes finance the internal transaction themselves. This can be an excellent option if you are a NextGen member that wants to purchase the firm. Not so much if you are the seller – unless you are willing to assume essentially 100% of the risk. Most RIA owners took on all the risks when they initially founded their firms and are not particularly keen to do so now, especially if the proceeds are to be used to fund their own retirement.

A better solution is perhaps a hybrid approach that entails part owner financing and part external financing. It can be done, but it is rather complex. Adding to the complexity is valuation. First, of course, you have a agree a price and then work-out the details. Again, not quite as simple as it sounds. Building a consensus among the NexGen is not an easy proposition either.

**Do the Math:** Valuation is also a primary determinant in whether owner financing is a realistic option or not. If your RIA is worth $3 million, then that's one thing. If it is worth substantially more, then that's another. To substantiate the point, have a look at the results of a Dimensional 2023 Deals & Succession Planning survey to the right. The graph shows the correlation between AUM size and the percentage and internal successions that are owner financed.




As you can see, the number of owner-financed transactions falls dramatically as the size (value) of firms increase. For simplicity's sake, take a $500M RIA that is valued at $10 million. If you do the math on a 10-year note, the NextGen would need to come up with $1 million a year to pay off the loan. In my own experience reviewing numerous compensation schedules from multiple RIAs, I can safely say there are not too many NextGen employees that are making that kind of money (and if they are you're likely paying them too much).

This is not to say that internal succession plans cannot work. It is, however, increasingly difficult. Below are useful tips in successfully implementing a succession plan.

### KEYS TO SUCCESSFULLY IMPLEMENTING SUCCESSION PLAN

**1. Assign Responsibility**: The person driving the initiative should typically be a partner/owner that has the authority to make a final decision. The team should be given a voice in the process to ensure buy-in.

**2. Create a Plan**: Be transparent. Put the plan in writing and communicate it to the team. Take it step-by-step. Remember that it is a process; be methodical and disciplined.

**3. Explore the Options**: Evaluate differing scenarios, including both internal and external succession. Assess what options make sense in your firm's circumstances. Assign a probability of success to each.

**4. Set Deadlines**: Create a timetable and adhere to the deadlines. Resist the temptation to leave it to later or pause the process. Take decisive action now.

**5. Seek Assistance**: Succession planning can be overwhelming. Oftentimes, it takes a third-party facilitator or consultant to lead the process to a successful conclusion. Do not be afraid to seek assistance if you need help.

## Conclusion

There is a reason why so few RIAs have a documented succession plan. It is because things are complex and complicated. So much so, that it is easier to ignore it – despite the repercussions as a fiduciary of your clients, a boss, partner, leader, spouse, parent, grandparent, friend, benefactor…

It is our hope that the information provided in this advice series will give you the confidence to take decisive action. There are no right or wrong answers. Choosing the best succession plan option depends on your individual circumstances. To make the best-informed decision you need to consider all the available information. External succession plan options will be assessed in Part II of this advice series. Please do not hesitate to reach-out if we can be of assistance in the meantime.

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