ADVISOR RESEARCH COLLABORATIVE

CERULLI ASSOCIATES

March 2023

The Impending Succession Cliff

Implications and Insights for Advisors

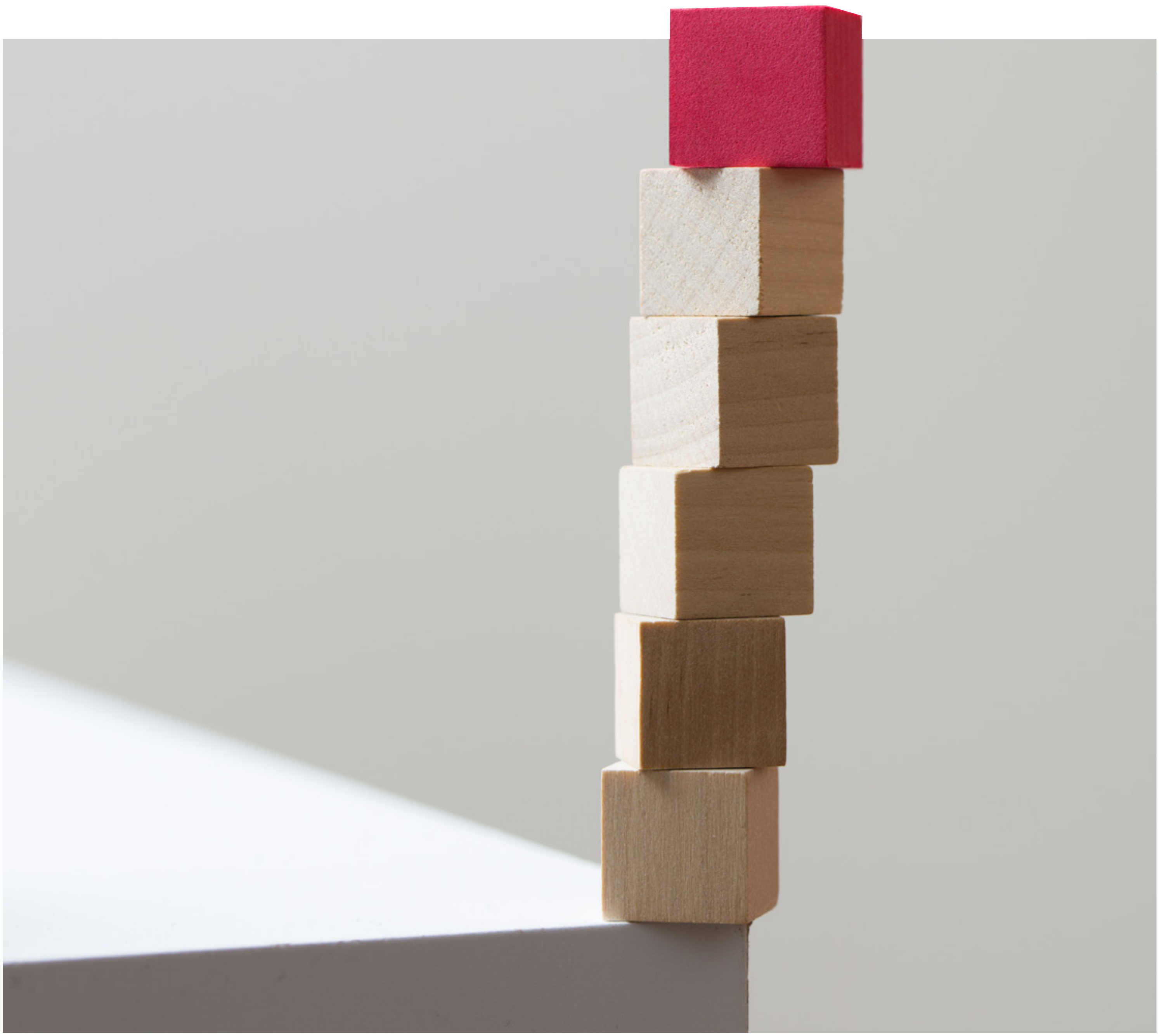

TABLE OF CONTENTS

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The Impending Succession Cliff

The financial advice industry continues to grapple with an impending succession cliff, created by an aging, retiring advisorforce and scarcity of new advisors. Although advisor headcount has remained steady, it is poised to decline because the industry is failing to generate enough new talent to replace experienced advisors as they transition into retirement.

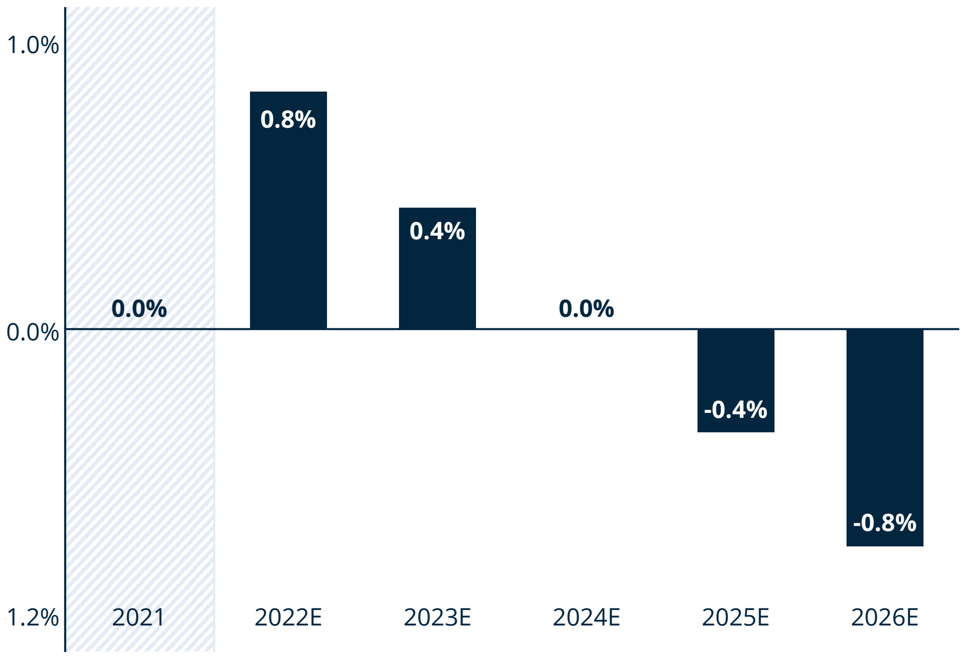
Bracing for a Retirement Wave

Among advisors retiring in the next 10 years, 26%—or 27,922 advisors—have no succession plan. These advisors account for $2.4 trillion in assets and may potentially put significant money in motion, presenting both an opportunity to win dislodged assets and a major attrition concern. In recognition of this impending succession crisis, firms are rolling out succession programs aimed at helping retiring advisors transition their practices to the next generation.

While many advisors are aware of the need for succession planning, evaluating options—internal vs. external sale—poses the greater hurdle. Practices must contend with a series of decisions that call for introspection and potential tradeoffs.

A succession crisis and talent shortage loom as advisor retirements accelerate

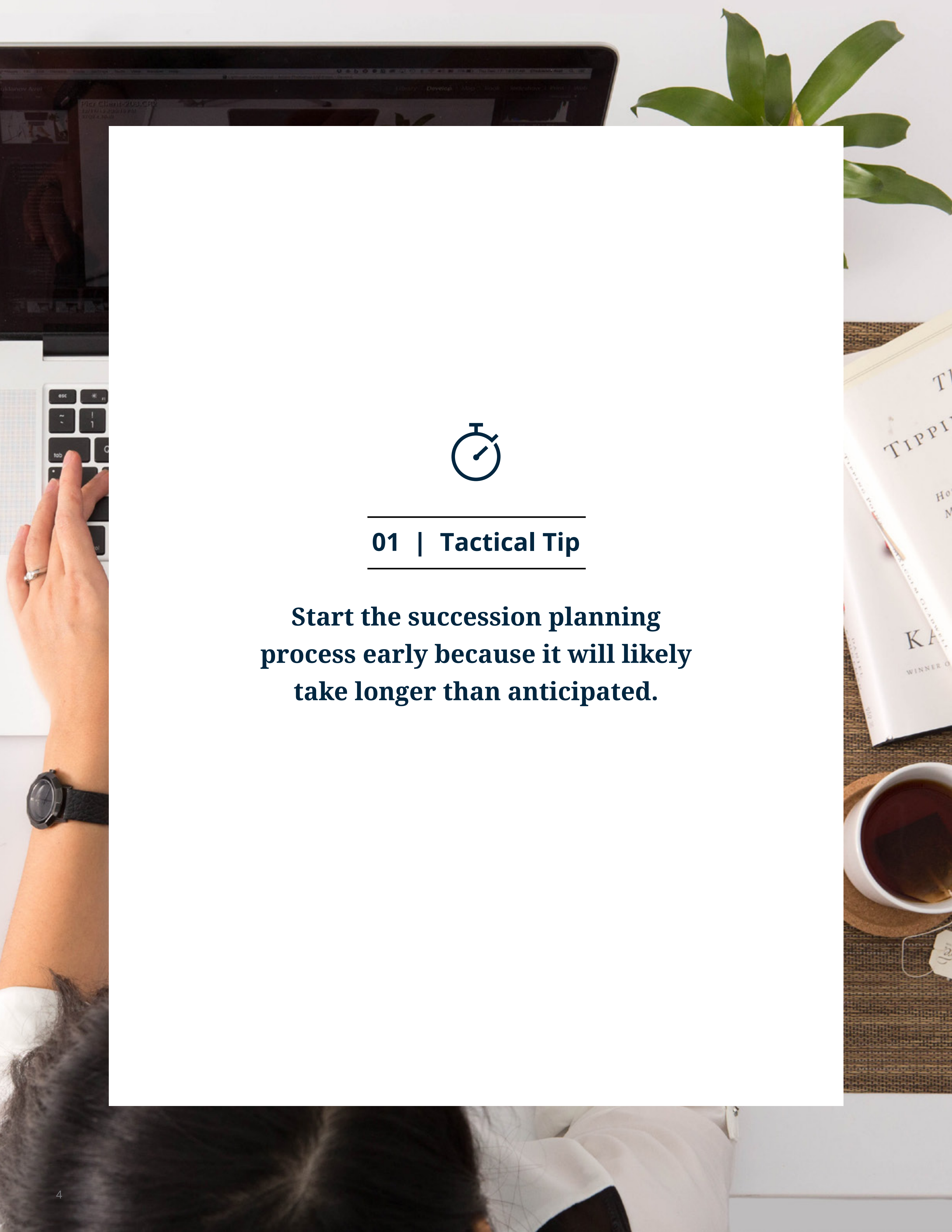
Projected Change in Advisor Headcount, 2021-2026E



Sources: Cerulli Associates, Investment Company Institute, Insured Retirement Institute, VARDS, Strategic Insight/SIMFUND, Investment News, Judy Diamond, Department of Labor, PLANSPONSOR, S&P Capital IQ MMD, Financial Planning, Financial Advisor Magazine, and Investment Advisor Magazine

Key Findings

- After several years of flat growth, Cerulli projects that advisor headcount will decline beginning in 2025.
- Cerulli estimates that 106,264 advisors will retire in the next decade, representing nearly 37% of industry advisor headcount.
- Among advisors planning to retire in the next 10 years, 26% are unsure of their succession plan.
- Close to half (45%) of advisors are preparing for an internal transition to an existing advisor in their practice, a junior advisor, or a family member.



01 | Tactical Tip

Start the succession planning process early because it will likely take longer than anticipated.

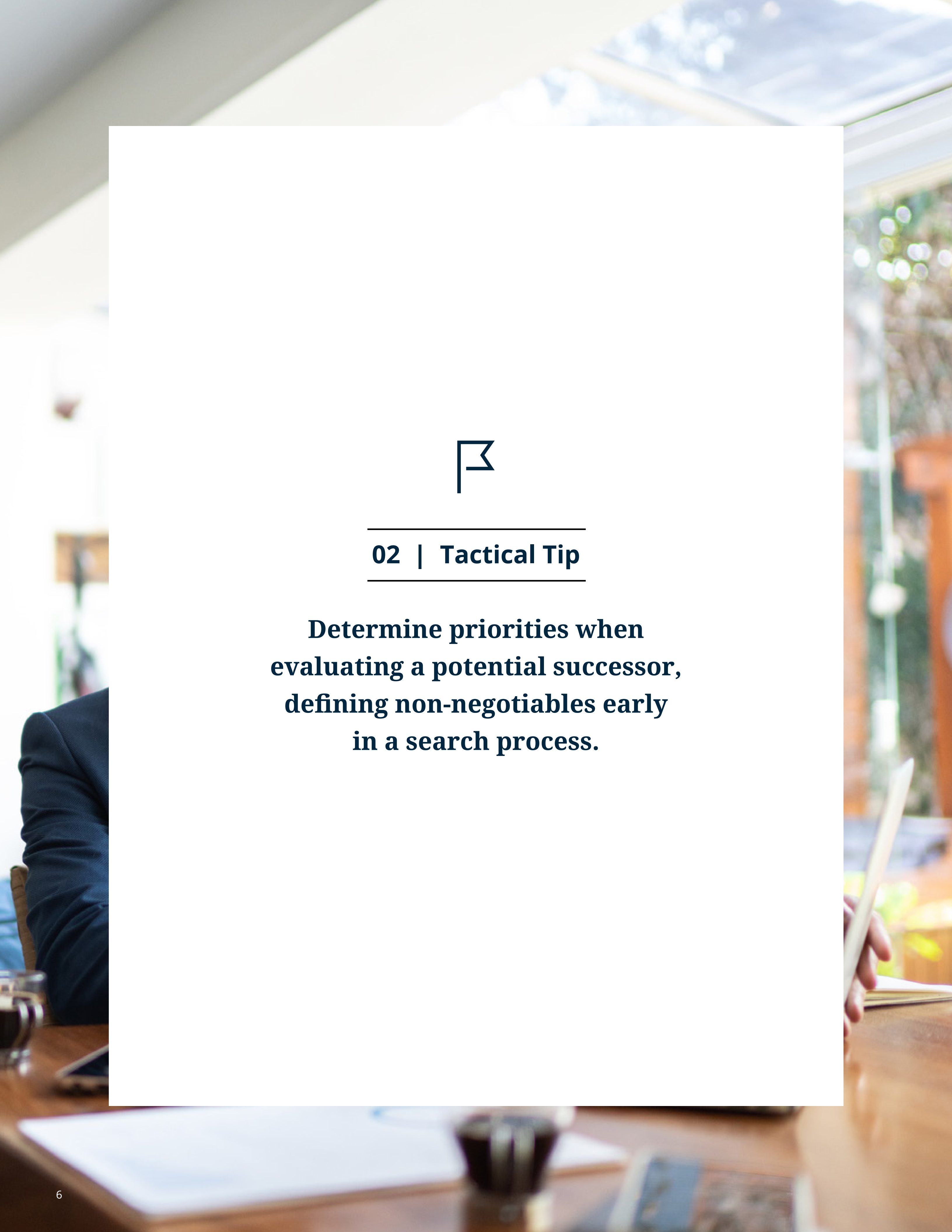
The majority of advisors expect to retire not long after age 65. However, as that anticipated retirement date approaches, the selling advisor may find it harder to walk away from a practice than they initially expected, prolonging their career and lengthening the transition process. This can be especially frustrating for internal successors—junior advisors or family members—who are awaiting their chance to assume leadership of the practice. Communication about the status of succession plans between senior and junior advisors is important, especially because timetables can shift.

Delaying retirement also has the potential to erode the practice's valuation if principals/owners are not continually growing the client base. As advisors' clients age, they retire and enter the decumulation phase, which subsequently decreases assets under management (AUM). Advisors should work to ensure that the practice isn't overweighted with retiring clients and has a sufficient future revenue stream to bolster their valuation.

Many retiring advisors do not currently have a succession plan

Retiring Advisors: Current Succession Plan, 2022

Sources: Cerulli Associates, Investment Company Institute, Insured Retirement Institute, VARDS, Strategic Insight/SIMFUND, Investment News, Judy Diamond, Department of Labor, PLANSPONSOR, S&P Capital IQ MMD, Financial Planning, Financial Advisor Magazine, and Investment Advisor Magazine



02 | Tactical Tip

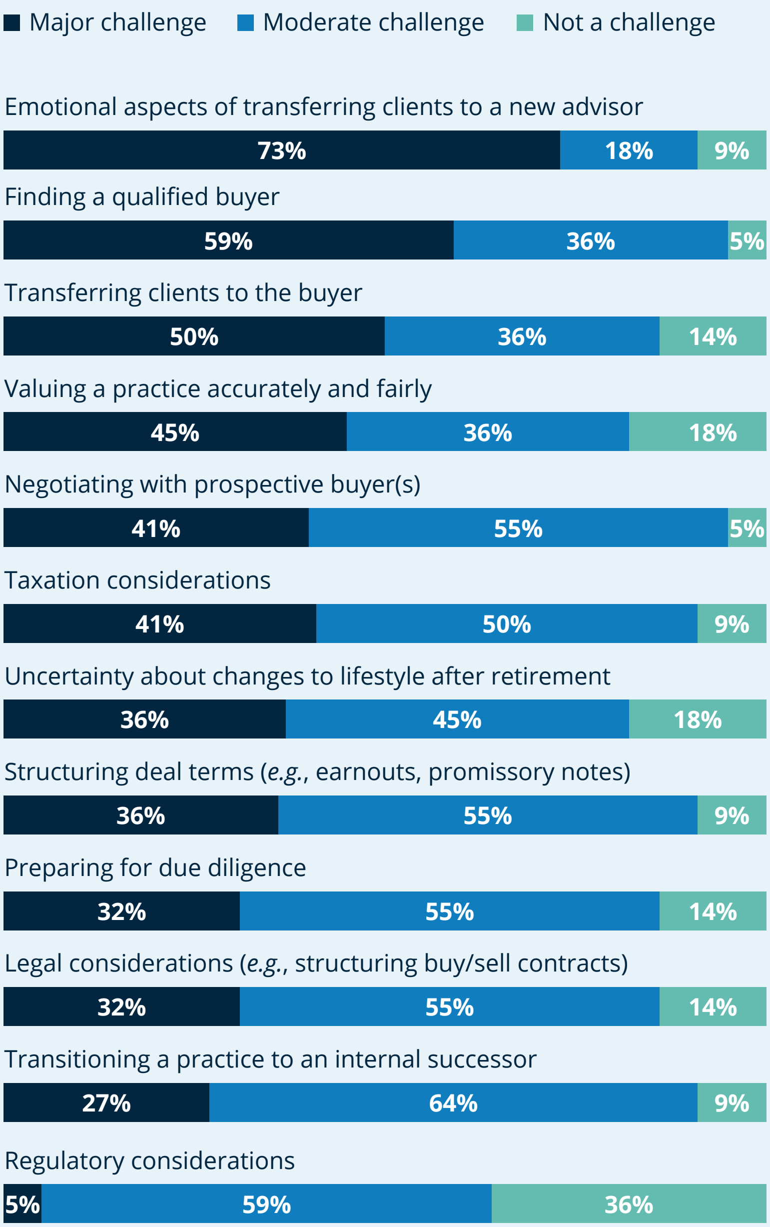
Determine priorities when evaluating a potential successor, defining non-negotiables early in a search process.

Positioning for Success

Advisors often encounter challenges throughout the succession planning process, including difficulty finding a qualified buyer, accurately valuing their practice, and transferring clients. While some of these issues may be unavoidable, advisors who are aware of potential roadblocks are typically better prepared to address them.

The emotional aspects of a transition are oftentimes the greatest hurdle

Succession Preparation Challenges, 2022



Source: Cerulli Associates
Analyst Note: Responses are from practice management professionals.

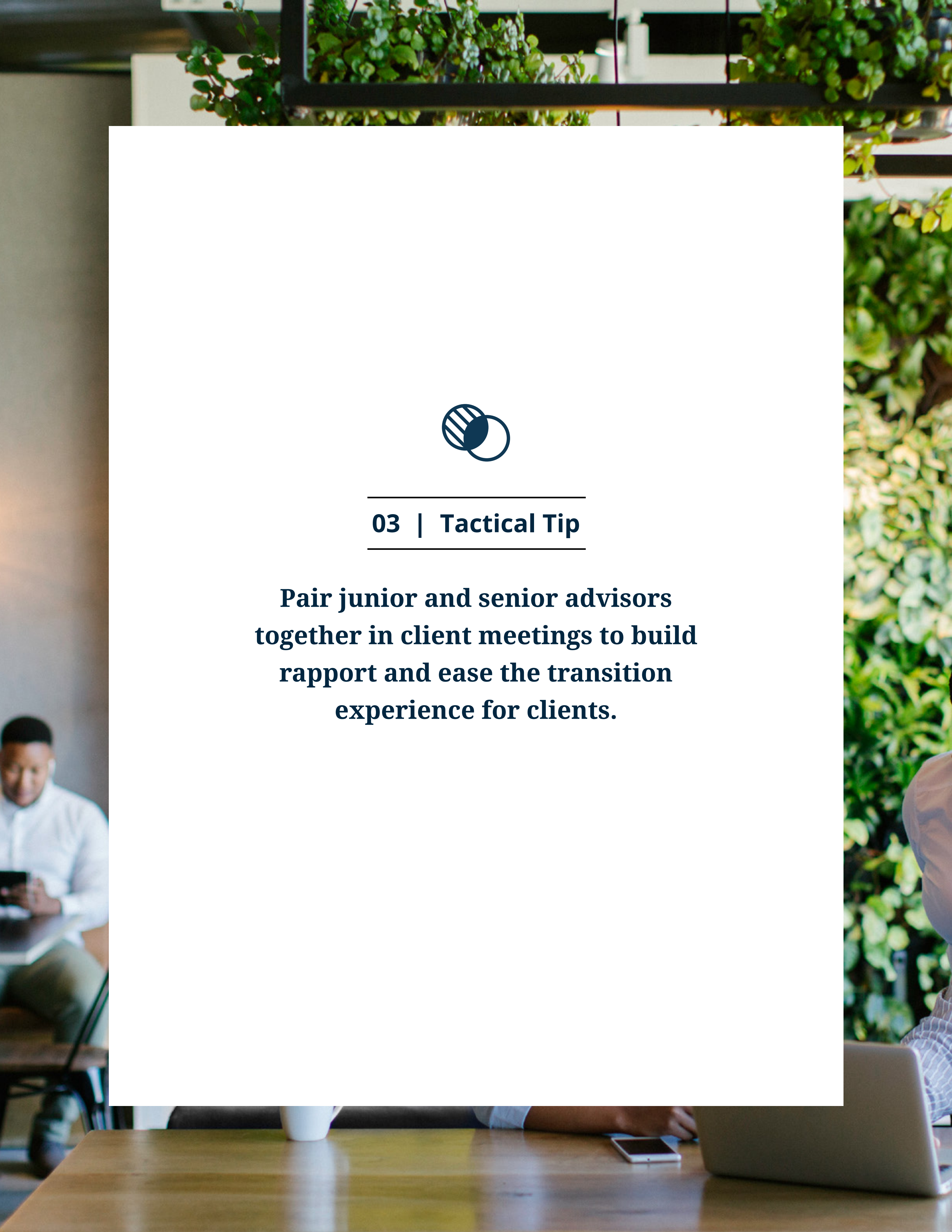
Over-emphasis on the deal terms: Addressing the emotional challenges of a client transition underscores the reality that financial advice is a relationship business at its core. Retiring advisors have typically spent decades cultivating relationships with their clients and express apprehension about handing them over. They want to be mindful of choosing a successor who will similarly care for their clients and nurture their business. Potential acquirers who are acutely focused on deal terms, valuation, or other mechanics can easily alienate a seller and jeopardize the deal.

Misalignment in personality, style, or expectations: Substantial misalignment can cause friction between buyers and sellers. These differences are disruptive to the client experience, complicate the integration process, and may even derail the deal.

Negotiation of terms and assessment of practice value: While sellers often have unrealistic expectations for their practice's valuation, buyers are evaluating the practice's future revenue potential and an aging client base diminishes that prospect. Divergent expectations can break the deal and aligning interests is critical.

Lack of clear post-deal roles and responsibilities: Advisors often fail to have extensive, upfront conversations on how they will integrate incoming clients into the client service model or what future plans for the combined entity may look like. Establishing clear expectations on integration processes, timing, and post-deal roles/responsibilities is essential to ensuring a successful deal.

Insufficient due diligence on the practice: Too often, advisors trust transitions to run smoothly by chance instead of taking the time to assess whether there is truly a good fit. This underscores the importance of the initial due diligence, thorough vetting of potential successors, and extensive conversations regarding the succession process.



03 | Tactical Tip

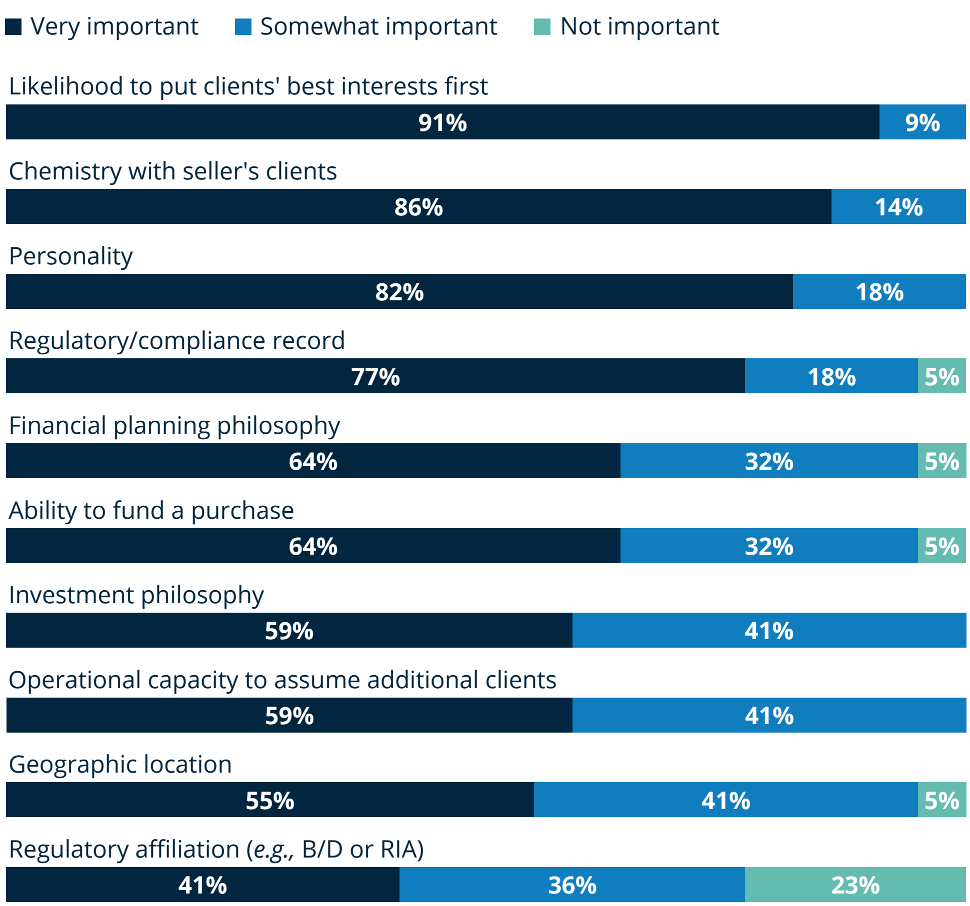
Pair junior and senior advisors together in client meetings to build rapport and ease the transition experience for clients.

Potential Succession Plan Pitfalls

- Differences in planning or investment philosophy
- Mismatched approach to fee levels and pricing structure
- Negotiation of terms and assessment of practice value
- Lack of clear post-deal roles and responsibilities
- Insufficient due diligence on the practice
- Legal process and associated costs
- Misalignment in personality, style, or expectations
- Post-deal transition and integration timeframe

Ensuring fit upfront increases the likelihood of a successful transition

Seller Evaluation of Potential Successors, 2022



Source: Cerulli Associates

Key Findings

- Practice management professionals cite the emotional aspect of transferring clients (73%) and finding qualified buyers (59%) as the most common major challenges in succession plan preparation.
- More than 90% of practice management professionals consider the likelihood to put clients' best interests first very important when evaluating potential successors.
- Less than one-fifth (16%) of advisors are actively searching for acquisitions and 39% are open to acquisition opportunities.
- On average, advisors anticipate retiring at 68. Almost one-third (32%) of advisors plan to retire between ages 65 and 70.

04 | Tactical Tip

Remain actively engaged in the process. Training a successor is an ongoing, daily commitment.

Assessing Practice Value

Advisors most commonly use a multiple of revenue to value their practice. However, practice management professionals suggest that advisors receive a valuation from a third party to ensure that it is fair, objective, and takes into account the nuances of their business. Advisors are most likely to use a multiple of revenue because it's simple and fast. The downside is that the method provides limited insight into a business' growth opportunity or underlying risk factors. An aging client base, an excessive concentration of assets with a just a few clients, or high exposure to certain investment products could all impact the level of risk for a buyer, yet the multiple-of-revenue method treats all practices as having the same risk profile.

Seasoned advisors tend to work with a greater number of older clients than rookies—a natural outcome of pursuing the demographics with the highest concentrations of wealth. However, as advisors approach their own retirement, this can have unintended consequences. In conversations with Cerulli, multiple advisors express shock at lower-than-expected valuations proposed by potential acquirers, often driven by the majority of an advisor's book of business being in the decumulation phase with no concrete growth plan.

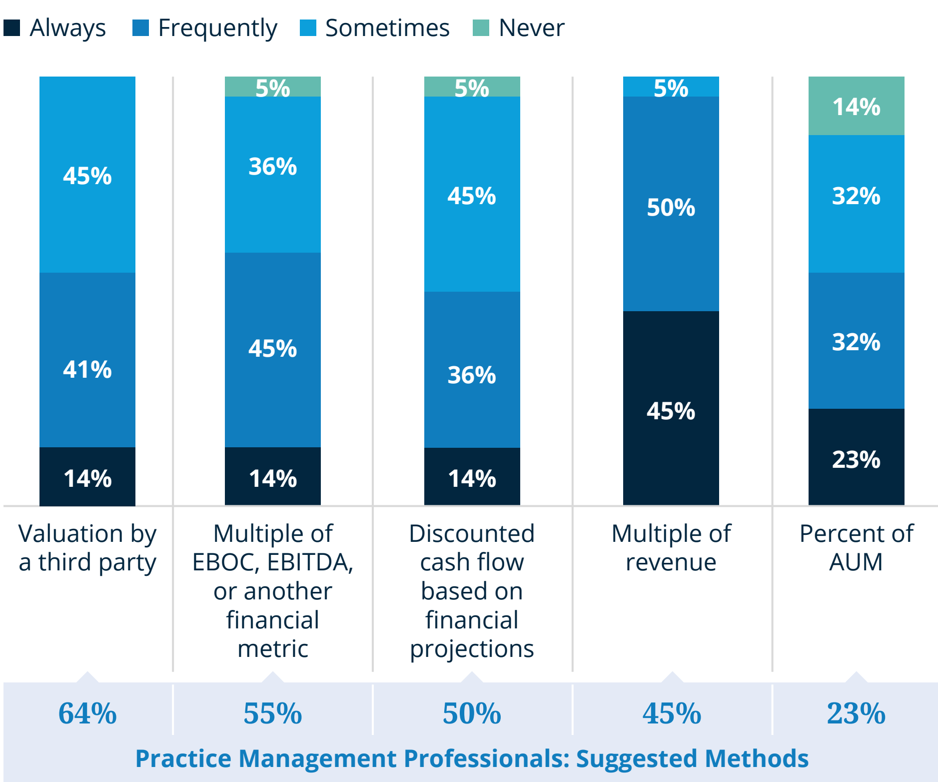
Buyers are becoming increasingly sophisticated when it comes to valuation and deal terms and may forecast revenue streams to calculate a discounted cash flow. Others may choose to hire a third-party, such as FP Transitions, to obtain a valuation from an independent, objective source. Likewise, broker/dealers (B/Ds) can help navigate advisors through the process, provide valuations, and fund transitions.

Key Findings

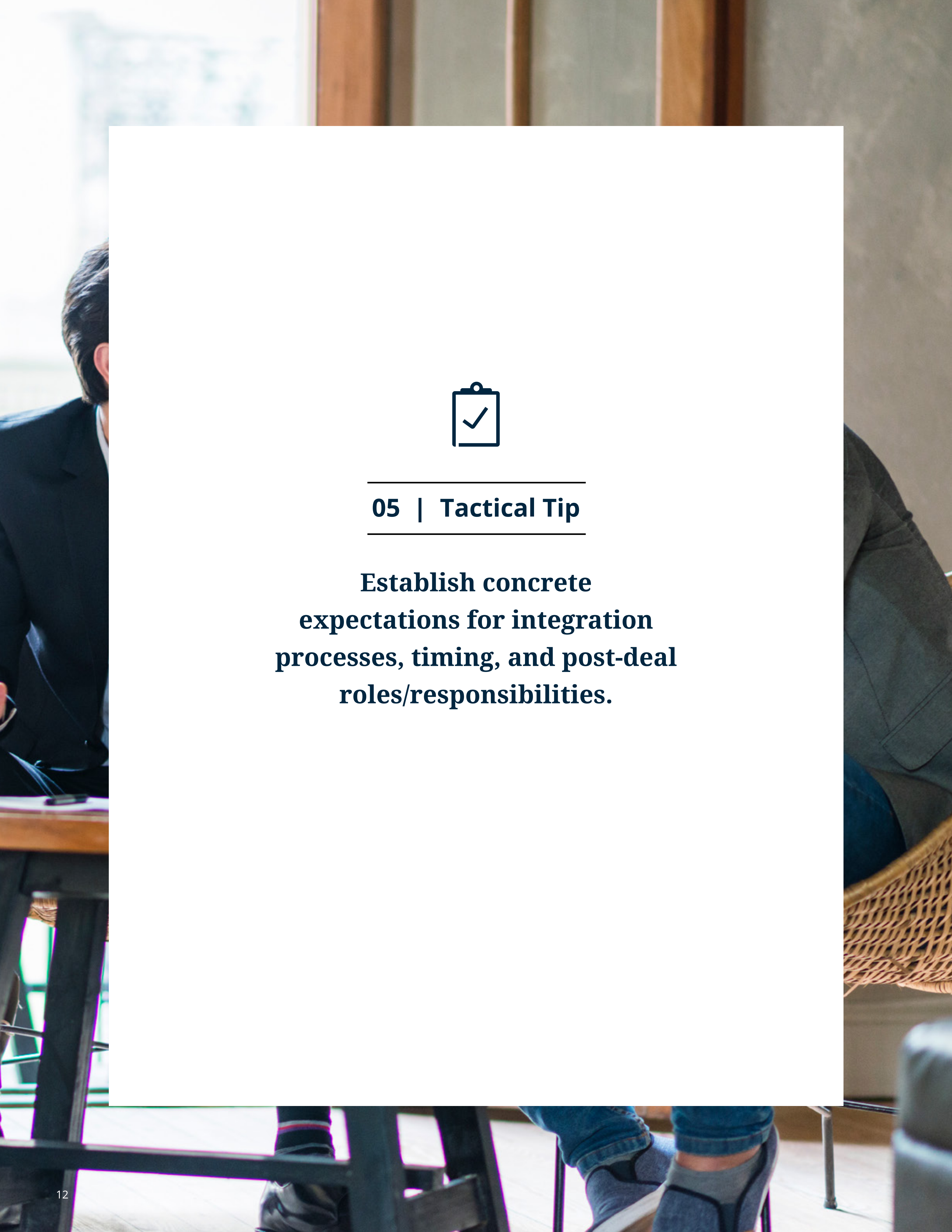
- The most popular valuation method among advisors is a multiple of revenue.
- Close to two-thirds (64%) of practice management professionals recommend that advisors obtain a practice valuation by a third party; however, only 55% report that advisors use that valuation method frequently or always.
- On average, 38% of rookie advisors' clients are age 60 or older, whereas this cohort represents 50% of experienced advisors' clients.

A third-party valuation ensures a fair, objective perspective

Methods for Practice Valuation, 2022



Source: Cerulli Associates | Analyst Note: Responses are from practice management professionals.



05 | Tactical Tip

Establish concrete expectations for integration processes, timing, and post-deal roles/responsibilities.

Shaping a Successor

The advisor population is aging, and a shortage of advisors is imminent. Young advisors can become a future succession option that allows an owner-advisor to preserve their legacy after exiting the business. Advisory teams offer fertile training ground for next-generation talent to develop, but rookies must be properly positioned for success.

Advisors need to be strategic about bringing junior advisors into the fold. As successful practices grow, many hit an inflection point at $75 million to $100 million in assets under management, in which the size of their client base becomes untenable to manage and service delivery often becomes reactive. These advisors have limited time for business development activities, which can stunt the practice's future growth. Hiring a junior advisor can free up the senior advisor's time to focus on ideal clients and revenue-generating activities. The junior advisor can focus on smaller, nonideal clients, rather than being expected to build a client base right out of the gates.

Building a structured career path for junior advisors to grow into an advisory role slowly over time is key. Juniors can start in an operational capacity, assisting with client service inquiries. As they build industry knowledge and develop relationship skills with clients, they can then shift to a paraplanner or investment analyst position, gaining exposure to advisory activities. Shadowing senior advisors in client meetings, contributing to the financial planning process, presenting on specialty topics during client meetings, and pitching in with nonideal clients are all part of this next step. As senior advisors delegate more responsibilities, juniors can eventually become associate advisors, alleviating some of the pressure on seniors by fully managing small- to medium-sized clients, and helping the operations staff answer questions related to investments and financial planning. If the associate advisor desires, they can eventually transition to a business development position.

In addition to providing mentorship on business development, senior advisors have the opportunity to lay the groundwork for a successful transition if the trainee is a potential successor. Having rookies help service the practice's existing client base can foster the trust and familiarity necessary to ensure that clients feel that they will eventually be left in good hands.

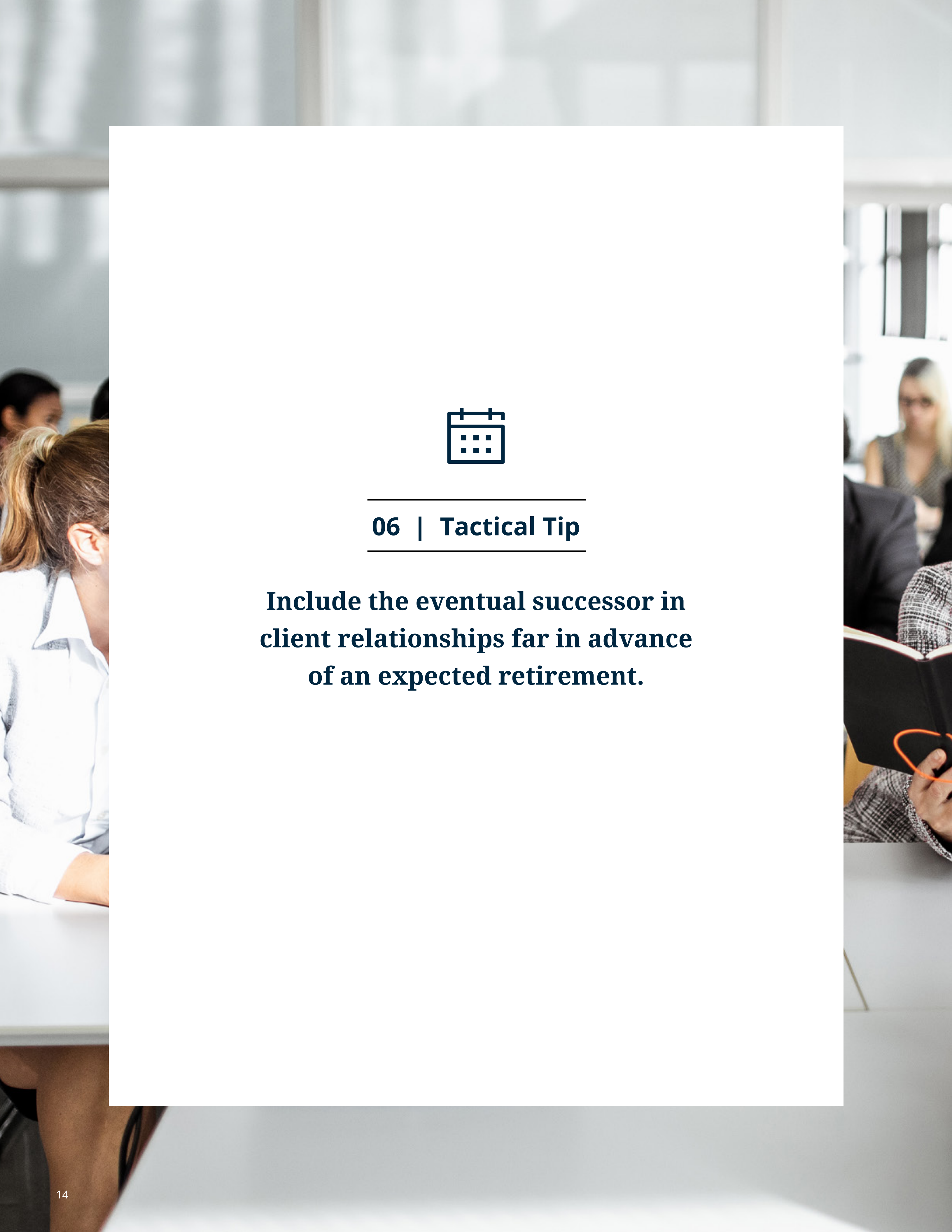
Key Findings

- Practice management professionals consider five years to be the ideal training period before transitioning clients from an established advisor to a rookie.
- Rookie advisors underestimate the value of mentorship from an established advisor with just 60% considering it very important to success, compared to 73% of practice management professionals.
- According to 71% of rookie advisors, training on financial planning topics is a very important factor for success.

A structured career path for new advisors provides adequate time for training

Ideal Training Timeframe, 2022

Source: Cerulli Associates | Analyst Note: Responses are from practice management professionals, who were asked, "On average, how long do you believe a rookie should work in an advisory role before a senior advisor transitions a practice to him or her?" Rookie advisors are defined as financial advisors with three years or less of experience in an advisory role.



06 | Tactical Tip

Include the eventual successor in client relationships far in advance of an expected retirement.

TACTICAL TIPS

- **Start the succession planning process early because it will likely take longer than anticipated.**
- **Include the eventual successor in client relationships far in advance of an expected retirement.**
- **Determine priorities when evaluating a potential successor, defining non-negotiables early in a search process.**
- **Evaluate the buyer's operational capacity to assume additional clients.**
- **Establish concrete expectations on integration processes, timing, and post-deal roles/responsibilities.**
- **Engage an expert. Advisors most commonly use multiples of revenue as a valuation method, but practice management professionals recommend a third-party valuation.**
- **Remain actively engaged in the process. Training a successor is an ongoing, daily commitment.**
- **Pair junior and senior advisors together in client meetings to build rapport and ease the transition process for clients.**

ARC

Advisor Research Collaborative

Cerulli's Advisor Research Collaborative (ARC) is the largest financial advisor research network in the U.S. For over 30 years, it has served as the foundation for Cerulli's strategic intelligence on the U.S. wealth management marketplace. More than 1,500 financial advisors regularly participate in the Collaborative to benefit from shared insights and recommendations.

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United States
699 Boylston St.
Boston, MA 02116
+1 617-841-1011

Europe
Valiant House
4-10 Heneage Lane
London EC3A 5DQ
United Kingdom
+44 (0)20 7645 9040

Asia
10 Anson Road, #24-15
Singapore, 079903
+65 6327 4045

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