

A scenic view of a beach and ocean framed by a large rock archway. The water is calm and blue, with a sandy beach in the foreground. In the distance, a large rock formation stands in the water under a cloudy sky.

GUIDE FOR SELLERS

Exiting your firm with integrity

VERTUS
CAPITAL



**Plan and execute
your succession**

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The subject of succession planning has been extensively covered in the press in recent years. Often these headlines focus on the price that individuals have sold their firms for. The focus always seems to be on the multiple obtained when in fact there are moving parts that can make the multiple a misleading number.

More importantly, the terms of these deals and the impact on clients and staff need to be considered. Complexity and jargon make it difficult to see these factors in the cold light of day and so they are seldom covered in any detail. At Vertus Capital we believe that there is more to deals than multiples and valuations. Succession planning starts with the needs and objectives of owners, clients and staff. In an effort to help you to make the right decisions for all parties, we have teamed up with Rob Stevenson of Kingmakers. Rob has significant experience in succession planning for financial advisers. I believe that as an independently minded adviser, your ultimate responsibility to your clients is a responsible exit. However, it is easier said than done. We are working to provide you with relevant content, to assist you in your decision making process. Buyer or seller, I hope you gain some useful insight from this guide and ultimately use it to put your clients first and exit with integrity.

By Matthew Marais of Vertus Capital

Where are we right now?

The World

As I write this, much of the mainstream global political landscape is almost unrecognisable from three years ago. The environment is seemingly clogged up with plastic, technology has taken much of societies attention hostage, social media enabled opinions are a substitute for sound journalism and the robots are coming to take all the jobs. Is it any wonder Elon Musk and Richard Branson are flat out, working to get themselves and whoever else can afford it, off this rock and onto another?

Our World

And in financial services it's not much better. The cost of regulation keeps on rising, the Senior Manager's regime is on the way, three years of pension freedom looks set to drive professional indemnity insurance premiums up further, the recruitment market is stagnant, your existing team demand complete autonomy in their working lives, understanding (let alone harnessing) digital marketing is a real struggle,

and a constant slew of consultants have the temerity to tell you your proposition, investment management solution and fee model are all wrong. Frankly, it's no wonder many advice firm owners are considering their options (30% of those surveyed at the 2018 New Model Adviser Retreat had firm plans to exit in the next five years). Those magic moments spent advising clients feel few and far between and there's always an email hitting your inbox with promises of great riches. Sometimes it feels like all you need to do is accept defeat, sell the firm and let the professionals take it from here.

The majority of IFA firms are modest in size, according to the FCA's FAMR baseline report of June 2017, 87% of financial advice firms have five or fewer advisers and only 1% of all firms have more than 50 advisers. With little need for capital, the majority of these firms are funded by the owner, who is also an adviser and manager. Given your firm size in relation to your corporate competitors and the external factors impacting your business, it's understandable that you might be planning your exit. It is also understandable that you could be feeling like you are stuck with a dilemma; sell to your colleagues and get less money or sell to a consolidator and subject your clients to a likely change in the advice proposition. Neither option feels right. The reality needn't be like that. With some basic knowledge and a little planning, you can achieve a satisfactory outcome for all parties. This guide has been created to help you do just that.

Why is succession such a tricky subject?

The primary succession challenge is to transfer ownership of the business in an effort to preserve your legacy, fulfil commitments made to clients and get paid for your years, if not decades of hard work. Balancing your needs and those of the other stakeholders (ie clients, staff etc) is hard enough. Doing so in an unfamiliar environment (few advisers also specialise in corporate finance) is almost impossible.

There are issues that compound this challenge. Many financial advisers work tirelessly to help their clients reach a position of financial independence. Yet they fail to extend themselves the same courtesy. As a result, there is often an underlying 'need' to realise a minimum amount from a business sale. Few owners wish to come to terms with that not being possible, particularly if a corporate buyer is telling you it is possible.

How much time do you have?

Your timeline is always important. How long you wish to continue working, what you want to do (hint, it's probably not management tasks), how much you need to earn and when you'd

like to be free from all responsibilities are all of huge importance. This timeline will determine the options available to you. Internal succession frequently involves having the right people in the right seats before you can manage your exit. In succession planning, time is the greatest driver of return on investment. The best way to increase the enterprise value is to reduce risk for the buyer. Equally, shortening the time for succession erodes value by increasing the risk of a disruptive handover. It is easy to see how options reduce dramatically as the timelines shorten.

Are you scared of change?

The fear of life-change is also an influencing factor. It rarely shows up as a consideration in a transaction, preferring to lurk in the subconscious until it's almost time to seal the deal. If you've owned a business for any period of time, it's likely become a part of you. It defines you as an individual and it shapes your daily routines and habits. For advisers in particular, helping successful people can provide a sense of personal validation. This is not to be underestimated.



Many IFA owners work tirelessly to help their clients reach a position of financial independence. Yet they fail to extend themselves the same courtesy.

Can you find a good fit for your clients?

All these issues and we haven't considered the most critical factor of all, fit for clients. You know your clients intimately. You have shaped your entire business around their needs. When you exit your business, you want to make sure your clients continue to receive the highest levels of care. The only guarantee in any transaction is that change will follow, as new owners adapt the business to their requirements and desires. Your job in planning your succession is to identify the best potential fit, enable a positive outcome for clients, and get paid for doing so. In most transactions money is paid to the seller over time. Those

deferred payments are typically adjusted to reflect performance in that period for factors like client retention. Therefore, the interests of you and your clients should be aligned when considering the right succession partner.

What about the others?

For firms owned by more than one person, the complexity in succession planning increases exponentially. Each individual's needs vary, and the range of variables may thwart any action whatsoever. Furthermore, the ability to do nothing, to delay indefinitely is an even greater issue. To delay without a plan erodes value and results in regret when the owners realise it's too late to change their position.

Establish your requirements

In planning your succession, you first need to consider your key requirements. The following is in no particular order, but all are equally important, so ensure you cover all areas.

What is your desired financial position?

Retirement may be an outdated ambition, but financial independence is not. There should come a time when you have sufficient capital to last the rest of your days. It is the point where you have more choices, because you don't have to work. Work out the variables and come up with a number. In building a succession plan, it will help you to know where you stand, even if a sale of your business cannot reasonably be expected to fill the gap entirely.

When do you want to be out?

You need to have a horizon in mind and this is determined by your personal ambitions, general state of health, current lifestyle, and proximity to your financial independence number. If you are close to what you need to achieve financial independence, then you can afford to change your decision-making criteria. Few are in this position, so the timeline may be determined by the need to continue work for several more years. If you've run out of energy, are in poor health, or simply lack the motivation to do the day job, then you might be forced to compromise your lifestyle ambitions.

What do you want to do all day?

If you no longer enjoy your work, you should plan to exit sooner or change your responsibilities to do what you enjoy. The stress from the status quo is likely to result in the timing of your departure being taken out of your hands. First, decide what you want to do all day and then determine what changes might be needed to allow that to happen. For example, if you want to advise clients all day and there's no obvious candidate to manage the firm, you could structure a role for yourself as an adviser in the purchaser's firm.

How much do you need to earn between now and your exit?


This is the final piece of the puzzle. Work out what you need to earn to save up sufficient funds separately, so that the sale of your business results in you reaching financial independence. It's worth noting that the owners of many advice firms pay themselves a salary through payroll and dividends. When planning your compensation requirements, it's prudent to calculate what the firm can pay as remuneration that still leaves sufficient profit left over to pay shareholders a reasonable dividend. You may see your compensation as an amorphous blob of money, but it is best to be clear about the level and structure of compensation associated with each level. Particularly if you plan to sell the firm to a third party (internally or externally).

What about the other owners?

If you have fellow shareholders, they all need to undertake these personal planning exercises and share their results. This can be tricky for a number of reasons, the main one being anchoring. As soon as an individual states their requirements and a capital number, the remaining shareholders state their own unique requirements, but with reference to the first number. This is understandable but not helpful and blocks the proper exploration of each individual's potential for compromise.

What you will learn from all this introspection?

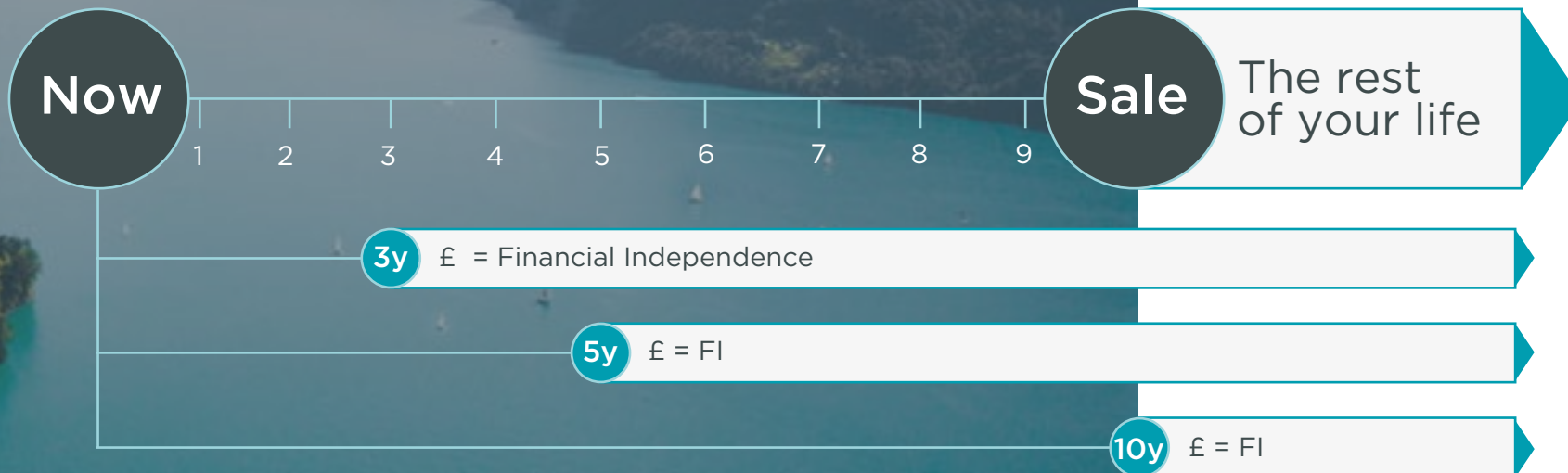
These exercises should lead to a situation where the owner(s) of the firm understand broadly: when to sell, what to do prior to exit, what you'll earn for doing so, and what you might do after the sale (including throughout any deferred consideration period). It will also give you an estimate of how much you want to sell for (and what each individual gets proportionally). Remember that the real driver of exit price will be a willing buyer in the future. All of this information is invaluable when considering succession options.



Retirement may be an outdated ambition, but financial independence is not.

Succession timeline

The timeline for exit is the defining factor when considering succession options, and there are no absolutes. The graphic below shows three different timelines. For the purposes of this exercise we assume the succession plan must be fully completed in the time allotted. The sections that follow explore the options that best suit each timeline.



Your options depend on the time horizon set to sell your business

I want out in less than three years

If you need to complete your exit in less than three years, the first thing to say is that your options are probably limited to a third-party sale. There are circumstances where a firm has advisers who are willing and able to buy out the founder (refer to the next section for a more detailed explanation), but this is the exception rather than the rule. Your ability to significantly increase the value of the firm is also constrained by time. Three years sounds like a long time but it's not if you consider that the entire preparation, implementation and handover needs to take place in twelve quarters. There's just not enough time.

I know a great firm...

You know that great firm that do things properly, treat their clients the same way you do and probably use similar suppliers for things like cashflow modelling software, platform,

investment managers and so on. They'd be a great fit for your clients but there's a problem. Until recently, these firms rarely had access to capital, so even if they wanted to buy your firm, they would have to structure a deal where you get paid out of your own income stream over an extended period. This situation has changed, with the advent of independent sources of capital, like Vertus Capital. Independent capital enables an increasing number of forward-thinking business owners to consider acquisitions as part of their growth plans. So whilst this was previously a difficult option, it is a definite possibility now.

I got an email offering me 20 x turnover...

Joking aside, consolidators might use interesting marketing tactics at times, but they can and do provide a viable option for some firms.

The trick is to fully understand their business model and what it might mean for you, your clients and staff. A few things to keep in mind. A consolidator, by definition, exists to consolidate something for someone. In the financial advice market, it is typically the client assets that are being consolidated to the benefit of professional investors. How do they benefit? By investing capital so that client assets can be purchased (i.e. advice firms) at one price and sold at a different, higher price (through a trade sale or listing), the delta becoming the return for the investor. All sounds very mechanical and therein lies the problem, it's not very flexible. It can't be by definition. Much time is wasted by people who convince themselves (and others) that flexibility exists, when it doesn't. If the consolidators proposition cuts across the commitments you've made to your clients, they will struggle to accept it, and so will you. Importantly, if you don't really understand the

realities of the post-deal proposition, you are unlikely to get paid the full consideration, as most consolidator acquisition models come with contingent deferred consideration as standard.

What about DFMs, they do something similar to us

There have been an increasing number of discretionary fund managers (DFM) purchasing advice firms throughout 2018. These transactions bolster the DFMs assets under management (AUM) and potentially expand their financial planning capability. Anecdotally, the primary driver is the acquisition of AUM and as such, your clients will likely experience discretionary fund management of some sort, post-acquisition. If you already use a DFM and they are in the market for advice firms, this option might be worth exploring.

In summary, the majority of viable options include selling the firm to a third party, as there is insufficient time to do much else. Consolidators can provide a viable option, provided your firm fits neatly into theirs. If you have a proposition that is not significantly scalable, chances are it will not fit well with a consolidator's proposition, which is specifically designed to do just that. Contingent deferred consideration is designed to increase alignment to the buyer's objectives. Think carefully about entering into such an arrangement if you fear you might not capture 100% of the overall transaction value.



Independent capital enables an increasing number of forward-thinking business owners to consider acquisitions as part of their growth plans.

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When the timeline is vague, so are the plans.

I want out somewhere between three and five years from now

When considering succession, the majority of business owners attach themselves to this timeline. While three years feels like an imminent departure, three to five years feels like sufficient time to properly consider the options, ignore all the spam emails, and maybe build some additional value into the business. In many situations, this timeline turns out to be an uncomfortable compromise. When the timeline is vague, so are the plans. In this situation, a three to five year timeline, is a three year timeline in two years' time. So, to benefit from the additional two years you are giving yourself, you need to plan carefully and make the execution a priority.

All 3 year options are on the table

For clarity, selling to a third party is still a viable option. A longer timeline gives you the opportunity to better understand business

models and to get to know a few potential suitors, see whether they put plans into action, how previous acquisitions turn out for them (and the sellers) and maybe start to build some relationships. It's far easier to negotiate with people you already know.

Merging then selling

This option is rarely explored but it is a good way to increase the number of buyers that might be interested in your firm. Acquirers take a risk (and do a ton of work) with every acquisition, so they will often minimise risk and workload by doing fewer, larger deals. Tax can also be an issue. Some acquirers are reluctant to purchase a legal entity below a certain firm size. A disproportionate amount of legal and due diligence cost is often cited as the reason for this. The alternative is an asset purchase and this will generally attract corporation tax at the

firm's prevailing rate, in the year the transaction happens. The firm can then be wound up and Entrepreneurs Relief claimed. The total tax paid on an asset sale will generally be significantly higher than that of a company disposal. Finding and merging with a similar size firm, where there are plenty of similarities, can attract acquirers that would not have considered the firms individually.

Management Buy-out

The first thing to say about a management buy-out (MBO) is that it is generally an 'adviser buy-out', as the succession solution inside advice firms frequently resides with those that control client relationships. So, if you have one or more credible advisers, the client transition aspect of the succession plan can generally be taken care of. You shouldn't assume no changes will be made to the proposition post sale. A business plan is not a guarantee, but it does help to flesh out the value proposition for clients, the buyer's intentions, and so on.

While it is tempting to focus on the client aspect (and granted, putting clients first is a great principle to adopt), your successor also needs to take on leadership, management and ownership responsibilities. If you have a great adviser in your firm, it's likely because of the focus they have given to their development as an adviser. There has likely been a lack of investment in manager training. So it is not common to find an experienced adviser who is also a good manager. You shouldn't be put off

by this, as you have time to address the issue, but don't ignore it. Your MBO will probably include payment over time, so the quality of business management will influence the total value you receive from the firm over time.

Careful and inclusive planning is critical to a successful MBO. A succession plan created by both the founder and the future owner(s), is an imperative as it will help create a shared understanding and enable preparation. You may want to help them prepare for their side of the deal, namely capital raising and creditworthiness. Understanding these key factors early will help with the capital raising process. Ideally, your potential successor should already be on the share register when it comes to doing your exit deal.

Finally, if an MBO goes wrong, it can result in a mass exodus from your firm. If these tricky negotiations break down, it's easy to understand why the potential internal buyer, might not want to stick around and be told what to do by a third-party buyer. Early and open discussions are so important here to enable you to do right by your clients and staff.

Careful and inclusive planning
is critical to a successful MBO.

I'm in it for the long haul

With more than five years to go, you can make strategic plans and implement long-term projects. That's precisely what's required when building an optimised succession plan. Indeed, the ideal succession plan allows you to focus on long-term growth strategies and install the next generation of owners.

Finding balance

Your priorities in building such a plan should be to create a culture of accountability and open up the ownership of the firm to key people. There are a range of schemes that can help facilitate the desired ownership model and advice should be taken in advance of adopting a particular course of action. There are however, a few important factors to consider; control of

the business (management, voting, etc.), how individuals acquire equity (paid for, earned via compensation sacrifice, received as a gift, etc.) and the tax implications of the scheme for the business and the individuals (on acquisition and disposal). Your goal is to find the right balance between value distribution and control to achieve optimum motivation and performance from key people.

As far as timing is concerned, a business that is well run and reasonably capitalised, should be able to facilitate changes in ownership on a regular basis (an annual window for internal equity transactions is often optimal). This means the organisation can cope with people wanting to leave the firm at different times, although majority owners exiting could still cause the firm to be sold to a third party.

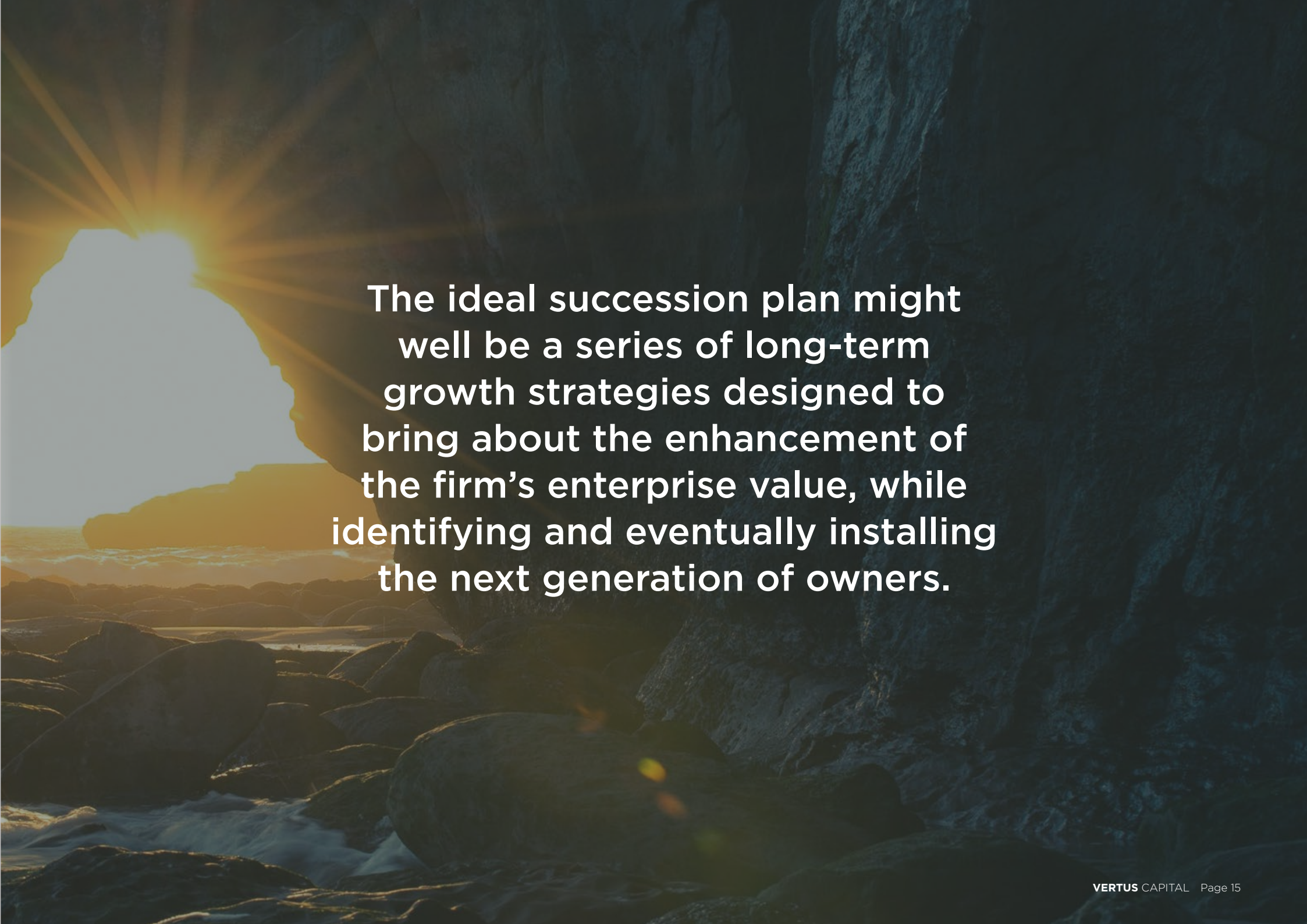
Employee Ownership Trusts (EOT)

While this is very similar to an internal succession plan, there are some key differences that are worth exploring. In simple terms, an EOT is very similar to an employee benefit trust. Creating one allows an owner to pass their controlling interest to a trust, which then owns the firm in perpetuity, on behalf of employees. There are tax benefits to doing so and for advice firms, it is being presented as another way to avoid a sale to a vertically integrated consolidation business. In order to successfully sell to an EOT you need to have depth of management, and the willingness

to sacrifice personally on price and control in order to enable the deal to happen. Typically the payout period is long as the deal is normally self-funded, and there may be a period of uncertainty for the seller as management step up to run the business. Management never own the business for themselves and so there is always an inherent risk that advisers leave to start their own firms where they can build significant capital value.

Transition

Early planning for your exit is crucial. You have worked hard to build your business and you should receive a commercial return when you sell. In preparing for your exit, you must transition your business from a lifestyle to an enterprise business. This will enable you to exit with integrity and for maximum value. Transitioning from a lifestyle business to a commercial business will enable the firm to scale beyond the owner's span of control. This transition requires a strategic approach, dedicated and competent management, marketing at the firm level (not the adviser level), systems and processes for all operations (not just risk management) and exceptional financial control. It is a significant undertaking, but necessary to facilitate scale and long-term growth. It will enable you to realise a meaningful value at exit and do right by your clients, staff, and legacy.

A dramatic landscape photograph featuring a bright sunburst emerging from a cave-like opening in a dark, rocky cliff. The sun's rays fan out across the sky, illuminating the scene. Below the cliff, a rocky coastline with waves is visible under the warm glow of the sun. The overall mood is one of hope and emergence.

The ideal succession plan might well be a series of long-term growth strategies designed to bring about the enhancement of the firm's enterprise value, while identifying and eventually installing the next generation of owners.



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