THE SHERIDAN ROAD MAP

The Best Route to Financial Success

July 2010 Volume 4 • Issue 7

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COPING WITH LONG-TERM HEALTH BLUES

Financial education is a multi-generational process

It's one of those "uh-oh" moments that financial advisors often have with clients who are at the cusp of retiring: figuring out how to pay for long-term health care without breaking the nest egg. When Joan Crane of Fort Lauderdale, FL, a wealth strategist for BNY Mellon Wealth Management, sits down with older investors, as part of her financial health checklist, she will raise the question of long-term-care costs. "Often times the answer is, 'Isn't Medicare going to pay for that?' They think that the Obama reform will pay for long-term care. I have to explain it to them," she says. "The biggest red flag is if they're just coming in and they're thinking it's going to be status quo. 'For the last year, I only spent this much on medical.' They're not even thinking about it."

Of course, Medicare only pays for up to 100 days of skilled nursing care. And there is no long-term care program in the new health care legislation that the president signed in March. The only government-run long-term health care program is Medicaid, which requires applicants to be virtually impoverished in order to qualify. If they are not impoverished, the government will require them to pay down their assets before they can qualify for Medicaid; when the investor dies, in some cases the government may place a lien on his or her house to recoup what was spent on nursing care. Medicare and Medicaid are hardly on the radar of high-net-worth investors who can easily cover the pricey premiums for long-term care insurance, or who may even pay the costs of nursing homes out of pocket. But for the rest of the investing public — more than 93% of American households last year had a net worth of less than $1 million, according to the Chicago-based consultancy, Spectrem Group — relying on Medicaid could easily become a necessity, which raises the question of how to protect assets when Uncle Sam comes knocking.

Health Care Blues Spell Opportunity

Indeed, preparing for end-of-life medical bills is a knotty problem that represents an opportunity for financial advisors who work with clients in this bracket, often called the mass affluent. "We're trying to get our clients to think about what they would do if they got sick and weren't going to get any better," says Bernard A. Krooks, founding partner of Littman Krooks LLP, a New York law firm.

The cost of nursing home care varies widely in the United States, from as little as $4,000 a month in places like Louisiana and Mississippi to about $200,000 a year in the New York metro area, he says. For people with chronic illnesses such as Parkinson's or Alzheimer's, nursing home stays of 10 or 15 years are possible. "The financial advisor who's attuned to these issues will develop better relations with their clients," Krooks says. "Their clients and family members will appreciate the fact that they're actually caring about an issue that might not necessarily result in a revenue-generating transaction for them, but will be a goodwill gesture for the family because it will help protect their assets."

There is no question that healthcare is a subject that is weighing heavily on Americans' minds. Over the past five years, U.S. workers have lost confidence in their ability to cover their long-term-care costs in retirement, according to a survey by the Employee Benefit Research Institute (EBRI) and Mathew Greenwald & Associates. The percentage of

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those polled who said they were "very" confident fell from 17% in 2005 to 10% this year; those who said they were "not at all" confident increased from 26% to 31%. The results were similar when investors were asked about their confidence in their ability to pay for medical expenses in general during retirement. Those "very" confident fell from 20% to 12%, while those "not at all confident" rose from 20% to 26%.

The recent financial collapse aside, the major reason for this loss of confidence is the sheer magnitude of wealth required to cover health costs in retirement these days. In March, Fidelity Investments' annual Retiree HealthCare Costs Estimate reported that a 65-year-old couple retiring this year will require $250,000 to cover medical expenses through retirement, a figure that excludes the cost of nursing home care. A study in February by the Center for Retirement Research at Boston College found that a typical household at age 65 has a 5% chance of seeing the present value of its lifetime health care costs exceed $311,000 — a figure that jumps to $570,000 if long-term care is included.

A Problem With A Solution

The ideal solution, many advisors agree, is long-term care insurance. Depending on such factors as the client's age and how extensive the coverage is, policies can run several thousand dollars a year. Some clients, however, may be uninsurable if they're very old or have medical conditions; nearly 43% of applications for LTC policies examined in 2003 and 2004 from people aged 70 to 79 were declined, according to the American Association for Long-Term Care Insurance. For applicants 80 and older, denials reached over 57%.

For mass affluent investors with less than $1 million in net worth, the possibility exists that post-retirement medical costs could deplete most if not all their assets. People in such circumstances would qualify for Medicaid, but at a steep price. One strategy estate attorneys use that can afford clients some protection is to place the investor's house or other assets into an irrevocable trust. The investor is entitled to draw income from the assets over the life of the trust, but, since the investor has removed his rights of ownership over the assets, the trust will not preclude the investor from qualifying for Medicaid. (Eligibility requirements vary by state.) The assets in the trust can then be left to the investor's children or other beneficiaries.

"It's hard to put a number on it. By and large this is not planning that we're doing for the ultra-wealthy, although it may have some applicability to people with seven-figure estates," Krooks says. "The most typical type of client who we do this planning for has a home in the Bronx or Westchester or Long Island or New York City, and a modest retirement account, either a 401(k) or an IRA that they've accumulated, plus several hundred thousand dollars in the bank. These are not wealthy people; these are lower-middle-class people who are stuck in a bind."

There are important rules to consider when using such a trust. Paramount is that it be created at least five years before an individual applies for Medicaid; the government "looks back" over that period for assets that may have been turned over to other family members, and may disqualify an application if it finds such transfers. "The kids' parents are getting to the point almost of having to go into the nursing home tomorrow, and the kids will suddenly realize, 'There go my assets. There goes my inheritance,'" Crain says. "I get quite a few calls from the 40-year-old professional who's worried, and there's really not a lot they can do at that point because there's the five-year look-back period."

Krooks recommends that investors who set up such trusts reserve what is called the power of appointment, which allows the investor to change who the beneficiaries of the trust will be. Reserving that power means that when assets are transferred into the trust, the IRS won't require that a gift tax be paid. (It's not considered a completed gift for tax purposes.)

Deciding how many assets to put in the trust and how many to leave out is a judgment call, says elder law attorney Harry S. Margolis in Framingham, MA. "It's probably better to err on leaving more out so you can lead a full life. You don't want to have this money sitting behind this wall," Margolis says. Timing is also key. "If someone is coming to me and they're 65 and in good health and have just retired, I don't think we're putting anything into an irrevocable trust at that point. Then, we're really looking at long-term care insurance as the best option. But if they're 10 years older, and certainly if they're 20 years older, then we're a lot more inclined to consider an irrevocable trust," he says.

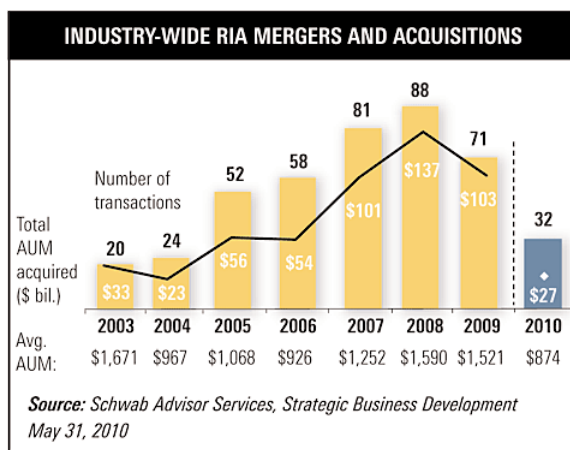
Medicaid trusts can help with estate planning, but at the end of the day the assistance they provide is limited because of the income and asset rules, Crain says. The government is no fan of letting investors preserve wealth while using the program, and has tightened policies over the years. The lookback period, for example, lasted just two years until it was extended to five in 2006. Crain says she often has to disappoint clients who wonder if there isn't some loophole that can be exploited. "Most of the time they want to know if there's some gimmick they've overlooked. Is there something new they can use to shelter assets? Frankly there's nothing new," she says. "Looking at the state of the (federal) budget, I can only assume it's going to get tighter, not easier, to qualify for Medicaid?"

By Jerry Gleeson • Registered Rep, July 2010

Succession Planning: Planning Your Future

No matter your age or goals, a succession plan can help you figure out where you want to end up—and how to get there

The economy may be on a slow track to recovery, but acquisitions of independent RIA practices are powering ahead. With the industry's continued growth and healthy profit margins, private-equity firms and consolidators are recognizing the value of this industry and making deals. Larger advisors are scooping up smaller firms to augment their existing teams and client rosters. It's clear that the sophistication of these buyers is increasing—providing greater choice, and in some cases, better offers, for the sellers. According to Schwab Advisor Services research, 2010 has been a big year for M&A activity in the investment-advisory business: through May 2010, there were 32 investment-advisory transactions, with $27 billion under management changing hands. Projecting ahead, these numbers could put 2010 on track to exceed 2008—a record year—which saw 88 transactions. We estimate as well, however, that the total AUM acquired will be lower than 2008's $137 billion due to market conditions (see chart).



With so many independent advisors nearing retirement age—on average, we estimate the average advisors as being 54 years old, with nearly 30% over age 60—one can expect that many will move into retirement through an external sale (data is from Schwab Advisor Services, Transition Planning: Valuation and Deal Structure MKT report, January 2010). The key point is this: whether you are 30 or 50—and regardless of whether your ultimate goal is to cash out, retire slowly, or help your internal successors evolve the firm you started—a carefully thought-out succession plan should be an integral part of your business strategy. Additionally, a robust succession plan is likely to increase your exit options and increase the value of your firm. It can serve as a roadmap for nearly every business decision you make for the rest of your career.

In the 2008 Moss Adams Financial Performance Study of Advisory Firms, only 25% of advisors surveyed thought they had adequately prepared their firm for their retirement. No matter what kind of exit you intend, you need time to put the pieces in place, like determining a fair valuation of your firm, finding or grooming the right successor, or identifying an appropriate firm with which to join forces. Like any business owner, you have accumulated a customer base and built a legacy, which you likely want to preserve. Creating a succession plan gives you enormous flexibility to: choose who will assume leadership of your business; negotiate selling terms, with either an internal or external candidate or acquirer; decide what role, if any, you will retain after the transition; and assure your clients that their assets will be guarded by someone familiar with and committed to your investment approach.

It's not easy to put time aside to consider your goals and dreams and then implement a strategy to make them reality. If you are still far from retirement, the idea of succession may seem abstract. But a solid plan can head off the sometimes-devastating impact of unforeseen events. I know of one $400 million wealth advisory firm whose managing principal suffered a stroke and died; within three months, the firm was gone. Another practitioner with no designated successor died of cancer and despite the best efforts of an internal manager, the firm lost 40% of its assets.

Let Your Future Role Be Your Guide. To create a succession plan, you should start by thinking about your goals. Some advisors will want their business philosophy and strategy to endure. Others will be content to let the new owner(s) take the firm in a different direction. You should ask yourself: How much of your firm, and what parts of your firm, do you want to survive you? Given your goals, what approach will optimize your firm's and your clients' welfare? Even if your primary goal is to have a healthy firm valuation, it is still important to figure out exactly how to continue to grow a client-focused firm while also maximizing its market value.

It's equally important to take time to consider which aspects of the business you enjoy—or haven't had the opportunity to pursue. If you stopped running your firm, is there another role you would like to play? Have you wished you could spend more time on client relationships than on day-to-day operations? Do you enjoy public speaking? Are you interested in mentoring? By considering your personal next steps, you will also be able to think about where a replacement will need to fill your shoes.

Consider Internal and External Successors. After you have thought about your goals, start thinking about your options for a successor. For many, the ideal person will come from inside your firm: a colleague will know, respect, and understand your approach, and your clients will trust this person. You will have the comfort of knowing that your legacy—your life's work, after all—will be preserved. And you will have the opportunity to groom your replacement over time.

If you decide to look within your company, remember that it can take five to 10 years or more to implement the transition to a successor. Why so long? The new leader must not only learn to run the business and grow into the role, but he must also have the time to accumulate a stake in the company.

Because the new leader is your employee, you know what terms are affordable based on their current compensation. For example, if your associate earns in the low six figures

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and can invest annually in the low five figures, calculate how long it would take to accumulate stock in a company worth seven figures. These calculations may be a little disconcerting. Beginning the purchase process early will give your successor an advantage in managing the expense of the investment. Conversely, you may conclude that the internal candidate simply cannot afford to buy into the firm. This can be especially problematic with larger and more valuable firms, because the process of buying in is simply too expensive for junior partners or other potential internal successors.

If you decide to look outside of your organization for a successor, it's just as important to plan ahead. Advisors often work with CEO/COO candidates on a trial basis, to make sure approaches and philosophies are aligned. A firm in Phoenix with two partners, both in their 60s, found out how important planning can be. One partner was ready to retire right away; the other in three years. It's been three years since they began the process; they have gone through two different COO candidates and are now looking for their third. Needless to say, both partners are still at the firm.

There are plenty of good outcomes as well. Kevin Hoyle and Joe Cohen, the founding partners at HoyleCohen, a San Diego advisory firm, knew they wanted a firm succession plan in place, with plenty of time for each of them to transition out at the appropriate time. When Hoyle, 58, and Cohen, 62, looked at their staff, however, they realized that no one had the right qualifications to run the firm or the resources to buy in. So they decided to try the external route, with much success.

Remember, Firm Value Is Driven by Profit. After determining how to locate a successor, you need to calculate —or at least estimate—the value of your firm.

Valuing your firm is especially important with the recent proliferation of acquirers. The process can help focus your attention on key drivers of profit and will help you identify ways to better manage your firm through business cycles. Ultimately this understanding will better enable you to build a resilient business that can command a premium when it comes time to sell and there are plenty of buyers out there.

When considering a partner, remember: Your assets under management may roughly equate to the comparable firm, but expenses may be wildly divergent.

When it comes to determining your firm's present or future value, you can use two approaches: A selling price based on comparable deals or an estimate of its value based on cashflow. (Although companies are often valued based on the book value of assets, the characteristics of advisory firms, i.e., few assets, yet high cashflow, preclude using this approach in our industry.)

Theoretically, it might seem easy and expedient to figure out the value of your firm by looking to a recent deal involving a firm of similar size. The problem is that since these deals happen in the private market, it's tough, if not impossible, to obtain the details of such deals.

It can also be deceptively difficult to compare your firm with another. Among private companies, transparency is rare. Even if you can access details of the other firm, you may find that the particulars make your firm significantly different. Your assets under management may roughly equate to the comparable firm, but expenses—especially salaries, which can account for up to 75% of expenses—may be wildly divergent.

Using the income method—discounted cash flow—can be the most accurate way of valuing your business. It allows you to capture an accurate, detailed picture of the current and future financial condition of your firm. Having this information at hand can give you an advantage when it comes to negotiating a selling price, especially if you are considering selling to an investor group.

Begin by estimating the growth of your firm in the following areas: assets under management, revenues and expenses. To project the growth of AUM, consider both the market growth and their expectations to add more client assets. You should try to estimate AUM growth for each year over the next five to seven years.

Revenue growth rates are likely to differ to a degree from AUM. For instance, if you plan to target a larger client moving forward (and have a tiered pricing structure) or make a change in your overall fee structure, then your revenue growth would not be in lock-step with your asset growth assumptions.

Expenses include salaries, office rent, software, and office equipment. If you're expecting the firm to grow, you may have to hire a new manager, expand your office space, or add an office manager—each in different years. Plotting these changes in each of the years that you expect them to come to fruition will help refine your future cash flow assumptions.

You will also need to estimate a terminal value for your firm —how much it will grow, and be worth, in perpetuity. This is where the process shifts from science to art. Your calculations could be based on factors such as the projected growth rate of your industry, of the market, the historical growth rate of your firm, and the future condition of the economy.

Most important is a discount rate that you, and then your potential buyer, will use to discount the cashflows back to present day. This number is essentially a calculation of what sort of return is appropriate for a buyer to take on the risks associated with your firm. The general consensus among investment bankers and private equity players is that the typical discount rate usually ranges from 20% to 30%.

Ultimately, the valuation you arrive at should be helpful in another way: it will pinpoint potential weaknesses in your business that you can begin to address, whether the transition you're planning is months or years away. As importantly, the model will help you identify key success drivers for your firm.

Once you have engaged with interested buyers, you will

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negotiate the purchase price. In addition to the valuation, the two parties must agree on the deal terms.

A common deal structure might comprise a 20% to 30% down payment, and a selling financing/earn-out period over the following three to seven years. Generally, the parties will agree on a target retention rate of client assets or revenues at 12 months after the deal closes, and will adjust the valuation based on performance.

The timing of this retention snapshot will vary based on a number of factors, including how long the exit partner plans to stay on, what role he or she will play in the future, and so on. A typical agreement requires the seller to stay on for a year, with a gradual decrease in weekly hours worked.

Stay Focused on the Details. Finally, you have to think about how you will implement the transition. Even if you sell to an external investor group, there are a number of details to consider.

Define roles and responsibilities. It is important to think through the responsibilities of each partner during this transaction and how these roles may transition over time. If, for instance, a senior partner is stepping down from the COO role but plans to stay with the firm as a relationship manager, this dynamic could create some confusion for the employees. Having clear communications on roles and responsibilities will help.

Write a timeframe for transition. It can take up to a year, or even longer, to move your successor into his or her new role. Ideally you have coached and developed your successor for this new role and they have a strong command of their new responsibilities. If not, you should be prepared to sequence the migration of responsibilities so that they are not overwhelmed. In either case, the role of leader will be new to the successor and you should think through how to transition this leadership in the most effective way.

It's a good idea to spell out the details of the transition timeframe in a written plan. You'll want to do this even if you have chosen a quick exit, since a smooth transition in leadership will affect client retention and, ultimately, the payout.

Carefully inform your clients. This is the most important part of the succession process, because your business is ultimately built on relationships. The acquisition price for your firm is usually based partly on the rate of client retention and future income growth. Mark Delfino at HoyleCohen notes that the original partners are focusing all of their energy on this as they begin to transition all but their largest client relationships to other advisors. "We embarked on a two- to three-year process and have transferred over 100 clients from the principals. We introduce the new advisors as part of the team in the first year and by the second year, they are in the lead. The clients understand and often feel better served because the new advisor is able to spend more time with them and the client still feels the principal is available if needed. Interestingly, this has reenergized the principals and resulted in more new client growth since they have more time for rainmaking."

As you begin thinking about your and your firm's future, I suggest you draw up a timeline of major milestones that must be achieved. Remember that succession planning is not just about future leadership, it is also about mitigating risks to you and your firm's future. For someone who is starting the process from scratch, there are three key outcomes that you focus on:

First, protect your family and your heirs. Buying insurance that protects your family from economic insecurity should something happen to you is something you can tackle tomorrow morning. If you have partners in your firm, you should also consider insurance policies that enable one partner to buy out the other's stake in similar situations.

Second, sign a buy-sell agreement with the right firm. A deeper level of protection will include some safeguards to ensure that your clients—and perhaps your staff—are in good hands should something happen to you. The goal is to create an agreement with a firm similar to yours that could take on your clients in these situations. Identify a firm with similar clients, investment philosophy, and client-service model, and have discussions about how you might structure this agreement. In many cases, there is a reciprocal agreement that if something happens to one of the owners, the other will pay his or her heirs a pre-negotiated amount and will migrate the clients to their platform. This should be someone who can quickly buy you out or take over should you become unable to fulfill your duties. You should do this no matter your age or how long you have owned your firm—and no matter how abstract this idea may seem right now.

Third, create a comprehensive succession plan. Now that you have strong protection in place for the worst-case scenario, you are in a more comfortable position to invest the time to create the right transition plan.

Don't be afraid to seek out information. Get advice from advisors who have already made the move—or from those who are trying to. Find out what lessons they have learned. Do your research. Remember, the more well-thought out your plan, the better the experience will be for you, your successor, your employees and your clients.

By David DeVoe • Investment Advisor,July 2010

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