DEAL STRUCTURING

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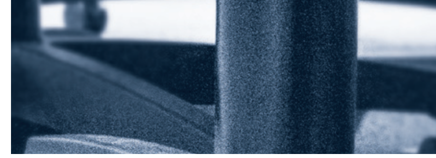


DEAL STRUCTURING

There are two critical and common mistakes that independent financial advisors make in the merger and acquisitions (M&A) space. One is to treat every sale or acquisition target the same way: applying one valuation approach, one documentation approach, and a common set of payment terms or financing elements, regardless of the size or structure of the opportunity. The second mistake is to equate exit planning with succession planning – the two concepts are completely different and you must understand the differences if you are to succeed in this arena and correctly structure your deal.

The purpose of this white paper is to help you understand how to sell what you've built to someone else, or successfully complete an acquisition if you're on the other side of the fence and want to become someone's exit strategy. Exit planning can result in a transaction with an external buyer or an internal buyer, but the commonality is that the deal is completed in one step - usually not suddenly, just completely. External buyers usually have a very similar practice model but are about twice the size and value of the seller, while an internal buyer is someone you hired, know and trust, but often without the financial resources of the external buyer (though bank financing can level this playing field quickly) - all important considerations in the deal structuring process.

A succession plan is very different; it is designed to build on top of an existing practice or business and to gradually and seamlessly transition ownership and leadership internally to the next generation of advisors. The founding owner in a succession plan is not a "seller" - they're a business partner, and long-term, sustainable growth powered by multiple generations of owners is the number one goal. This white paper is not about succession planning. If that topic is of interest to you, please consider reading our book: *Succession Planning for Financial Advisors: Building an Enduring Business*.

As part of exploring the various exit strategy options and how to structure those transactions, this paper will explain the different value and valuation techniques applicable to the different types of practice models, the use of an asset-based deal structure as opposed to a stock-based structure, the various financing methods such as a promissory note, performance-based notes, revenue-splitting or revenue-sharing arrangements, earn-outs and, of course, taxes. Taxes play a huge role in the deal structuring process and most advisors have far more control over this issue than they realize if they have a plan and good information to work with.

A SPECIAL NOTE FOR SELLERS:

Almost everything in this white paper applies to both buyers and sellers, but the math is pretty clear - for every would-be seller, there are 50 or more interested

buyers. And still, sellers tend to be at a distinct disadvantage in the process of buying and selling financial advisory practices. Oddly enough, this industry has a seller's market that is dominated by buyers. Many sellers are taken advantage of by predatory buyers, and their broker-dealers and custodians inadvertently help make this outcome not just a reality, but a probability.

The fundamental truth is this – buyers are more skilled in the transition process than sellers and their knowledge of the process is far more complete. Sellers have the advantage of scarcity, but buyers have the advantage of being able to repeat the acquisition process over and over until they get it right. You can buy or attempt to buy many times, but selling – well, that tends to happen just once in a career. It is hard to master a concept that you only get to do once, which is why experienced and professional consulting support is absolutely essential to level the playing field and complete a fair and balanced transaction.

As a prospective seller, you need to understand that, while in the "driver's seat", you are not in control unless and until you command the entire process from valuation, to listing, to documentation, to client approval of the transaction. Too often, sellers sit in the driver's seat full of confidence, but fail to understand that they're in a car sitting atop a car-carrier being driven by someone else who knows where they're going and what they're doing.

Being prepared means planning ahead and relying on accurate, occasionally blunt information and data sources; do not make the mistake of relying on stories told by advisors who have gone through the M&A process one time as a seller and come out relatively unscathed. Also be wary of your information source; your custodian or IBD almost certainly will have the best of intentions, but what's good for them may not be what's best for you. Learn the basic facts and decide for yourself - but gather the facts.

GETTING STARTED

Practice values have been slowly but steadily increasing over the past 15 years, fueled in part by a strong and stable sellers' market. As mentioned, the current buyer-to-seller ratio is about 50 to 1, but we've never seen this result in an auction or a bidding war. Instead, this strong ratio is used to ensure a very high quality match – the greater the field of applicants, the more likely a seller can find his or her perfect fit, the absolute key to success.

Having orchestrated 1,400+ successful transactions, the pattern for success is clear. In fact, it's as easy as one, two, three (ignore these basics at your peril):

1. Focus on the quality of the buyer. Sellers prefer to find buyers who are mirror images of themselves, at least in terms of client base, revenue streams, and investment philosophy, but larger in terms of cash flow and value. If possible, create a value-added opportunity for your clients by finding a buyer who is not only larger, but has a strong, proven business model and long-range succession plan.

2. Focus on the "geography" between buyer and seller. Sometimes this means selecting a buyer who is close by, and sometimes it doesn't. A seller who wants to keep his or her office open, the staff employed, and the same brick-and-mortar operation in place will often prefer a buyer who does not currently have a local presence. A seller with four months left on his or her lease and with no intentions of signing another lease will usually prefer a strong local buyer.

3. After resolving the first two issues, then focus on price and terms.

There is nothing wrong with selling to a friend or buying a practice from someone you know but keep the words and strategies on the pages that follow in mind. You might sell your home to a friend too, but would you forgo knowing what the fair market value actually is, give up the tax benefits of the sale, and take on all the risk because it seems so easy to do, or that's how others do it? Many financial advisors do exactly that at the end of their careers, thinking they have few better alternatives. Most of the time, they're wrong.

ASSET SALE vs. STOCK SALE

Determining whether to structure your deal as an asset-based transaction or a stock-based transaction really depends on what you've built and what your fact pattern dictates. If you're a sole proprietorship, you are limited to selling assets; if you're an S-Corporation or a Limited Liability Company, you have a choice to make.

The basic starting point for many buyers and sellers, at least in terms of deal structuring, is choosing between an asset sale and a stock sale. Most external transactions (between a seller and a third-party buyer) are structured as asset sales. Most internal transactions (between partners, between an employer and an employee, or between family members) are structured as stock sales or the equivalent in a Limited Liability Company.

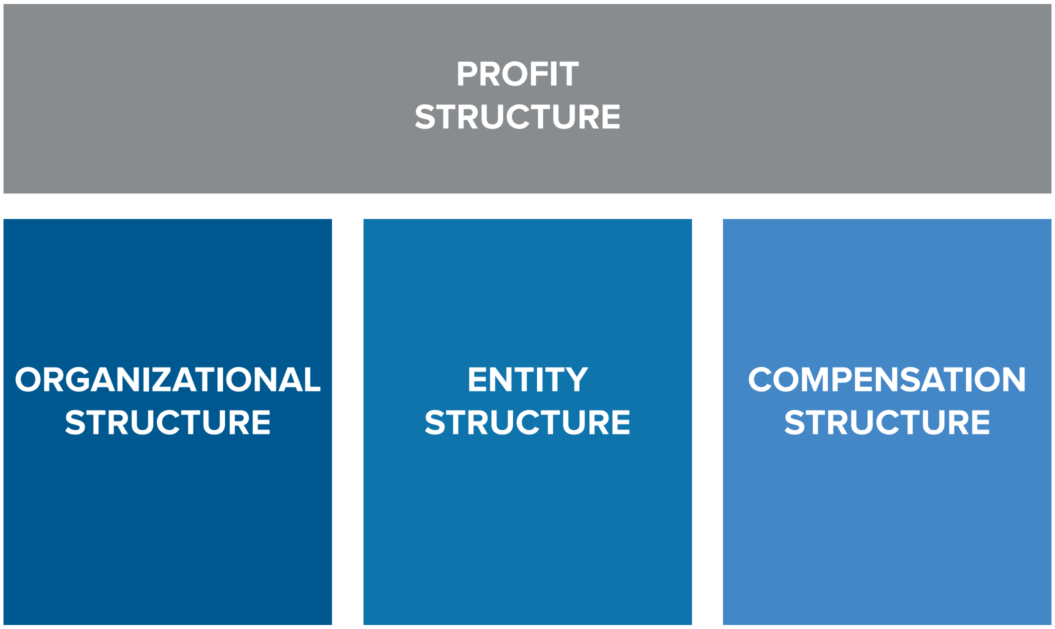
In an asset transaction, the assets to be acquired are specified in the contract. In most cases, the buyer usually purchases all of the practice's equipment, furniture, fixtures, inventory, trademarks, trade names, goodwill, the list of clients and associated revenue, and other intangible assets. The buyer may enter into employment agreements with the seller's key staff members as well, an important consideration in maximizing client and asset retention rates.

One of the benefits of an asset transaction is that it can, when properly structured, provide favorable tax consequences to both parties. Buyers typically are able to write off the entire purchase price over time rather than merely acquiring basis in their investment as with a stock purchase. The seller must pay taxes on the difference between his or her basis in the assets and the price paid by the buyer for the practice, but the sale of capital assets usually results in long term capital gains tax treatment for the majority of the purchase price. Achieving a favorable tax result isn't limited to larger practices or businesses - it is available to almost every seller and buyer if they have the right deal structure.

Buyers tend to prefer an asset-based transaction for liability reasons as well. By purchasing assets, the buyer greatly reduces the possibility of becoming entangled in any of the seller's undisclosed or unknown liabilities. Despite the tax and liability advantages of an asset-based transaction, sometimes stock deals are more expedient for both parties or solve various regulatory issues. Stock transactions can provide for improved continuity in relationships with clients and suppliers because the business often continues in the hands of the buyer. Stock sales are also preferred if the transition is intended to be incremental over many, many years - the incremental, internal transfer method is commonly used to support a long-range succession plan.

When a buyer acquires the assets of a seller, the seller's practice legally comes to an end, which illustrates the difference between an exit strategy and a succession plan. A stock purchase, at least when the buyers are the current partners or employees, means the business itself can endure.

WHAT ARE YOU SELLING OR BUYING?



WHAT ARE YOU SELLING OR BUYING?

There's a clever use of terms and concepts in this industry such as describing the organizational structures of independent financial practices as "silos" or "ensembles." The basic notion is that a silo is a single "book of business." The term "ensemble" is reserved for a business with multiple professionals who truly work together as a team, pooling their resources and cash flows, creating a bottom-line, and then distributing profits to the owners of that business.

This binary system of categorizing all financial advisors accurately reflects one critical element about this industry - the importance of organizational structure. How an advisory or services model is structured makes all the difference in how it is valued, sold or purchased, paid for, even how it expires (the term we'll use is "attrition"). In other words, the methods used to sell or acquire a practice often emulate how it was assembled and built.

But structural issues go well beyond just organization and must include the choice of entity (is it a partnership, a C-Corporation, an S-Corporation, or a Limited Liability Company?) and the compensation system, all of which directly affect growth rates and profitability.

The question is, "What have you built and are considering selling?" Or, "What is it that you want to acquire?" We suggest you consider the following terms for classifying the levels of independent ownership in the financial services industry which, in turn, dictate the deal structuring elements:

- A) A Job
- B) A Practice
- C) A Business
- D) A Firm

A job, often called a "**book,**" exists as long as the advisor or financial professional does it. Job or book owners are independent and "own" what they do, for the most part. W-2 or 1099, registered rep or investment advisor or insurance professional - it makes no difference - they can all fit equally well under this category. But when a job or book owner stops working and someone else starts, it's their job to do, and the cash flow attached to that job belongs in whole or in substantial part to the person doing the job. Of course it is about production; in fact, it is about nothing else. A job owner works under someone else's roof, owns none of the infrastructure, has no real obligations to the business other than to produce and get paid while taking care of the client base.

The "value" of a job is tied almost entirely to how much money the producer or advisor takes home every year. Think about gross revenues or GDC of less than $200,000 a year. In this industry, about 70% of advisors are owners of a job or a book. Jobs or books sell for the lowest value, the lowest price, and on the worst terms with the worst tax structure - at least when compared to practices, businesses or firms.

A practice is more than just a job, often involving support staff around the practitioner and the ownership of at least some basic infrastructure (phone system, computers, CRM system, desks and chairs, etc.) within an S-Corporation or an LLC. But like a job, a practice exists only as long as the practitioner can individually provide the services and expertise. Practices are limited to one generation of ownership, then someone else takes over - the practice is sold outright, sometimes and incorrectly transferred via a revenue-splitting arrangement, or the practice is dissolved and the clients find their way to another advisor on their own. Practices have one owner, but are often accompanied by one or more other producers with whom they share time, expenses and support. About 25% of the advisors in this industry fall into this category.

The focus for job or practice owners is entirely on revenue strength - there is little need for enterprise strength at these levels. The primary exit strategy for job and practice owners is attrition; the next most popular strategy is selling or transferring the cash flow to a third-party via a revenue-split whether as a result of the founder's retirement or his/her death or disability. There is little to no "bottom-line" or profitability at these levels and there doesn't need to be - no one invests in this model, at least in terms of becoming a formal shareholder. Earnings are paid out as compensation to the producers through some form of an eat-what-you-kill system. Still, the more valuable practices tend to sell using a formal documentation process that creates or supports long-term capital gains tax treatment for the seller and write-offs for the buyer. Practices are more valuable than jobs or books.

A business must have certain foundational elements in place - an entity structure, a proper equity-centric (or ensemble) organizational structure, and a compensation system that gives it the ability to attract and retain talent. That talent, in turn, enables this model to outlive its founder through a multi-generational ownership structure. A business is built to be enduring and transferable from one generation to the next. It operates from a bottom-line approach and earnings, for the first time, begin to reward ownership and investment in the business. The ownership-level compensation system (which typically includes most of the successful producers or advisors) shifts to a base salary plus profit distribution system. Continuity agreements are common and take

the form of a Shareholder Agreement or a Buy-Sell Agreement. A business gains it momentum and cash flow from revenue strength; its durability and staying power from its enterprise strength. Businesses are more valuable than practices. About 4% of independent advisors fall into this category.

A firm is an established, multi-generational business, and it got there through proper succession planning. It is built with a strong foundation of ownership and leadership by recruiting and retaining the very best people in the industry. It operates primarily from a bottom-line approach and earnings are the measure of success, at least as important as production and growth rates. Continuity agreements aren't just a safety measure; they are a means of internal growth and structure. Collaboration among owners and staff is the rule. In a firm, the goal isn't to have the best professionals, but rather to have the best firm. Firms are more valuable than businesses. About 1% of independent advisors are owners of a firm.

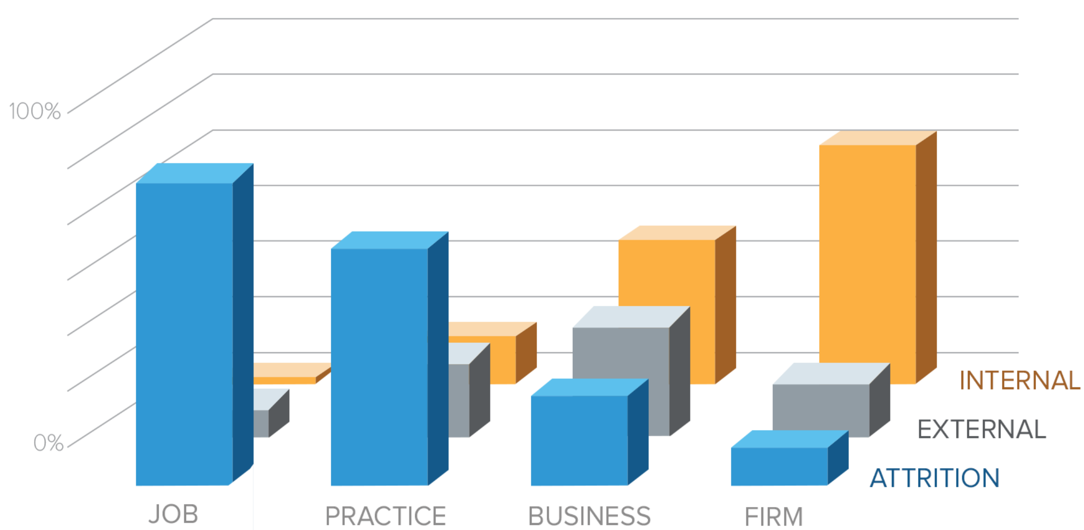
In this white paper, and in all of our writings, we use terms like "practice" or "business" very specifically and within the context of the preceding definitions. Depending on whether you are selling or buying a job, a practice, a business or a firm, your choice of valuation methodology, financing, deal structuring, transfer mechanism (assets or stock), and even the paperwork to complete the transaction is often tied to the seller's level of ownership and what they've built - even how they've built it. This conclusion is reflected in the graph below showing how advisors tend to leave or retire from each level of ownership.

That said, nothing in this graph should be taken as implying that there is a pre-ordained fate that awaits an advisor when it is time to sell (or buy). Armed with a good road-map and accurate information, the future belongs to you. In the following sections, we'll explain the common and proper deal structuring techniques applicable to each level of ownership.

SELLING OR ACQUIRING A "JOB" OR "BOOK"

If you own a job or have a book (less than $200,000 in gross revenue/GDC), or you're interested in acquiring at this level, here are the steps to setting up an appropriate deal structure.

The most common and expedient solution for selling or acquiring an advisor's or rep's "book of business" derives from the most commonly used compensation



structure — a revenue-sharing arrangement. Independent broker-dealers and custodians routinely hand out short-form contracts (two or three pages in length is typical) to their advisors at no charge. These agreements, often called something like an "Agreement for Assignment of Accounts," allow a seller and a buyer to agree on terms of sale in the event of an advisor's death, permanent disability, or retirement. This simple document is often used as a complete transfer device - it values, transfers, and (often unwittingly) establishes a tax structure for a job or a book of business.

JOB / BOOK

COMPENSATION SYSTEM:
"Eat what you kill," revenue splits, production-based compensation

VALUATION METHOD:
Multiples of Revenue

TRANSFER MECHANISM:
Revenue-Sharing or Commission-Splitting Arrangement / Earn-Outs

TAX TREATMENT (FOR SELLER):
Ordinary Income

Still, given the small size of the book, a relatively simplistic operational structure, and assuming a seller's limited expectations of value, it works. Revenue-sharing arrangements are simple, fast, and cheap. If there is a catch, it is this: there is little if any buyer risk. There is usually no down payment and no minimum amount to be paid by the buyer, which puts all of the risk on the seller. Buyers pay only for the clients they choose to work with and keep in the years to come and usually end up paying only 60 to 70 cents on the dollar when everything is said and done. It is not unusual to hear of single advisors who have acquired upwards of a dozen books this way, always within and on behalf of the same broker-dealer or custodial network. These agreements are primarily designed as a simple and effective way to ensure that the seller's clients and cash flow stay within the broker-dealer or custodial network after retirement, death or disability.

The typical structure of a revenue-sharing arrangement is for a buyer to agree to pay about 50% of every dollar they receive from any of the seller's clients. The payments often continue for two to four years depending on the estimated value, and payment is sent to the seller usually on a quarterly basis with a copy of the calculations either by the broker-dealer/custodian, or the buyer. Most of these revenue-sharing transactions result in ordinary income tax rates to the seller on the sale proceeds. Note that a revenue-sharing (or commission-splitting) arrangement is not the same thing as an earn-out. The two strategies have some important differences which are addressed in more detail below.

It is also important to note that this deal structuring technique and the related contracts stem from NASD Rule IM-2420-2, the **Continuing Commissions Policy**, now newly codified as FINRA Rule 2040. Under this policy/rule, continuing commissions must be paid according to a bona fide contract entered into by the buyer and seller at a time when the seller was still registered or licensed. Be certain to read ALL the requirements of this rule and consult with legal counsel and/or your compliance officer before implementing a transaction based on this rule.

The truth is that these revenue-sharing agreements mirror the way most jobs or books are assembled and built, so it is only natural to use a similar tool to take them apart and bring them to an end. For a one-owner book, or job, with less than about $200,000 in gross revenue at its peak, revenue-sharing arrangements may well be the best solution. They're simple, efficient, and good enough in most cases. But for every advisor above this level (owners of a practice or a business for example), or those who want more, you can and should do much better by using appropriate and sophisticated strategies that ensure a fair and balanced transaction with the best possible tax structure.

SELLING OR ACQUIRING A "PRACTICE"

This structure, for years, has been generically described as a silo-model, but that refers only to its organizational structure. The term "practice" as defined above more accurately addresses the common elements of its entity structure and compensation structure as well. If you own a practice, or you're interested in acquiring at this level, here are the steps to setting up a correct and professional deal structure.

Practices can have values that range from a low of $200,000 to as high as seven or eight million dollars or more - but value is not the defining attribute. Practices have an identifiable infrastructure that is almost always built around some form of a tax conduit such as an S-Corporation or an LLC. Most practices have just one owner or shareholder, but most have multiple producers or advisors operating under the same roof, often with separate, smaller books.

Practices represent an excellent acquisition opportunity and sellers are highly sought after if the price and terms are reasonable (this is the group the 50:1 buyer to seller ratio is primarily generated from). The biggest mistake that sellers of a practice make are to sell to a friend or peer using a revenue-sharing or commission-splitting arrangement - a proper tool, as previously illustrated, <u>but not at this level</u>.

The valuation method for a practice has progressed beyond the simplistic and limited gross revenue multiple to a more reliable market-based or "comparable" approach. **What do similar practices sell for, and on what terms?** Those are the questions FP Transitions answers over 100 times a month with it's Comprehensive Valuation. Practices typically do not warrant the cost or complexity of a more sophisticated valuation approach such as discounted cash flow (DCF). First, the DCF approach is considered too expensive for most practice owners to use and, secondly, most practices don't have the appropriate compensation system or cash flow model to generate any significant profits or earnings without significant or unrealistic modifications to their financial statements.

PRACTICE

COMPENSATION SYSTEM:
Salary and bonus strucutre based on profits and/or production

VALUATION METHOD:
Comparable Sales / Market-based Approach

TRANSFER MECHANISM:
Asset Sale to Larger, Strategic Buyer

TAX TREATMENT (FOR SELLER):
Long Term Capital Gains (Applies to majority of Sales Price)

Deals are commonly structured using an asset purchase agreement; ancillary documents include a post-closing consulting agreement, a non-compete/non-solicitation agreement, and usually a performance-based promissory note. Payment terms consist of a significant down payment (10% to 40%)

and either seller financing or bank financing of the balance – (for more information, see **Payment Terms** below). Sellers are typically tied to the transaction for up to one year, post-closing, to help the clients and staff members get to know each other in a comfortable and professional manner. Most sellers of practices do not stay on beyond the one year, post-closing transition period.

Because the compensation system commonly used at the practice level is almost always tied in some way to production, recent growth rates are not usually an issue unless the seller has held on to the practice for too long and the decline in growth and value is prompting the sale. Profitability or lack thereof in a one owner practice model also tends to be of minimal importance to a larger and stronger buyer who often seeks to acquire the assets of the seller and place those clients and related cash flows into their own infrastructure. For all these reasons, the common deal structure at the practice level centers on acquiring the seller's assets rather than the seller's stock.

Sellers at this level receive the majority of their sale proceeds at long term capital gains tax rates, while buyers enjoy the ability to write off or depreciate the entire purchase price. These tax benefits help support an aggressive group of informed buyers - hence the 50:1 buyer to seller ratio. The most likely buyer of a practice is a slightly larger practice owner or a much larger business with a similar client base and revenue structure. Practice owners should be wary of the quick and easy sale through a two page revenue sharing agreement, a structure and approach has led to application of an appropriate term that of "predatory buyer."

SELLING OR ACQUIRING A "BUSINESS"

Business owners often have a full array of choices when thinking about their own retirement. Many owners elect to create their own internal succession team and to very gradually transfer ownership and leadership to this group over a 10 to 20 year period as they literally retire on the job. Some business owners either don't have the staff to sell internally, or they start the planning and implementation process too late, necessitating consideration of a sale or merger to an outside third-party.

BUSINESS

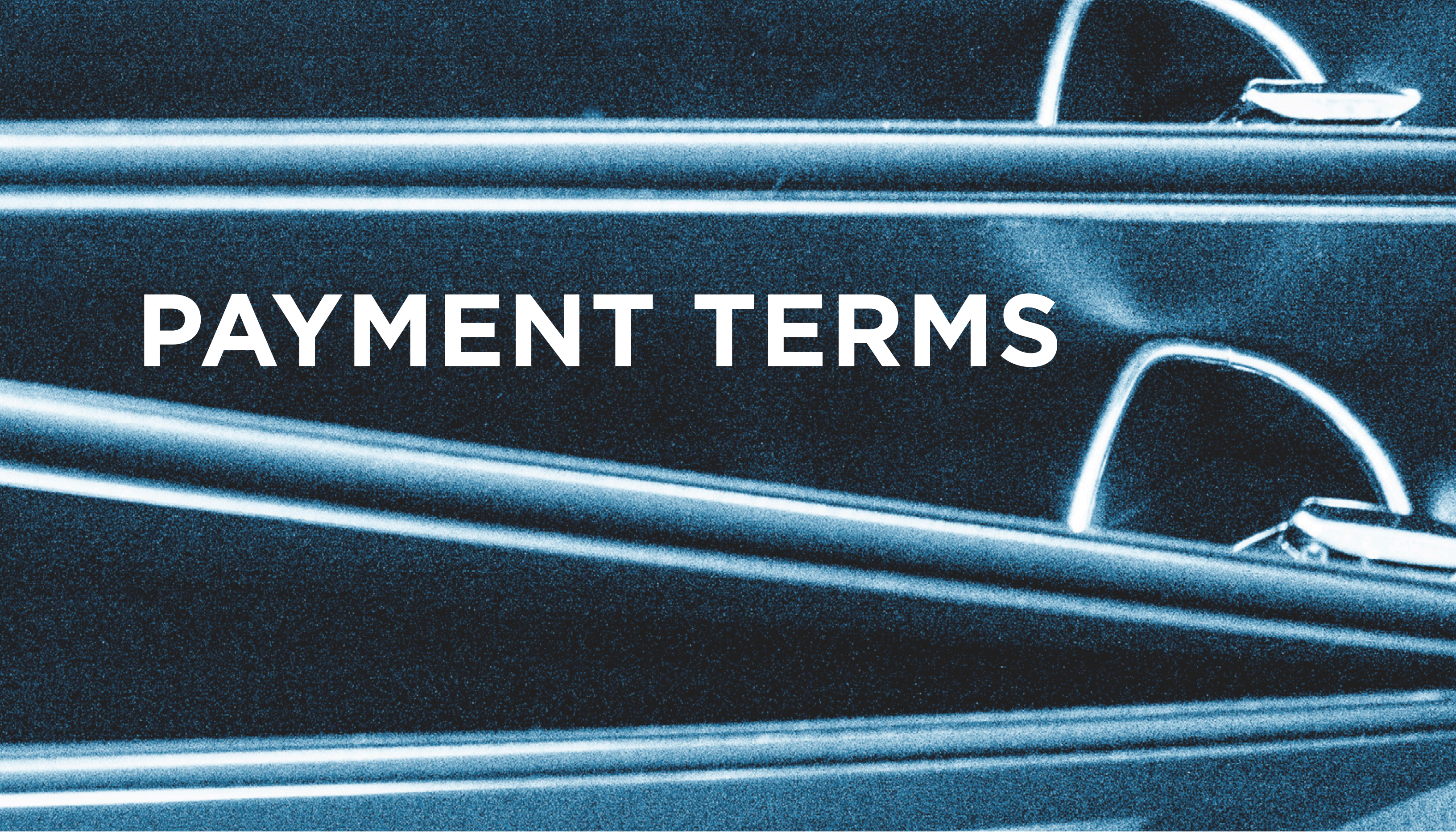
COMPENSATION SYSTEM:
Equity-centric compensation
(Salary + profit distributions + equity income)

VALUATION METHOD:
Earnings-Based / Discounted Cash Flow

TRANSFER MECHANISM:
Incremental Stock to internal Succession Team

TAX TREATMENT (FOR SELLER):
Multiple Options including Tax Deferment,
Long Term Capital Gains, Ord. Inc.

Selling or acquiring a business requires a more sophisticated approach than either of the two previous levels of ownership. This is the level where most investment bankers and business brokers become interested in the process because a business can be quite valuable and it is often capable of retaining clients and assets without the continuing involvement of its founding owner. Businesses are typically acquired by other businesses or by a firm - larger buys smaller. At this level, the use of bank financing is also a common deal structuring consideration.



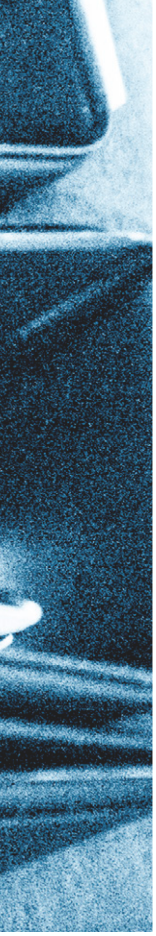
PAYMENT TERMS

The valuation techniques used to appraise an independent financial advisory or services business are very different from those used to value a job/book or a practice, and for good reason - businesses use a more sophisticated compensation system. As a result, profit distributions are the norm and are typically in the 20% to 35% range as a percentage of gross revenue. Accordingly, an earnings-based valuation or discounted cash flow approach should be used at this level to accurately determine fair market value. These valuation approaches are more expensive and time consuming, but they reflect the more sophisticated cash flow structures being used to create the stronger value proposition.

Sales of a business to a third-party are commonly structured using an asset purchase agreement with supporting documents that include a post-closing consulting agreement for the founder, employment agreements for the key staff members, a non-compete/non-solicitation agreement for the seller(s), and usually a performance-based promissory note unless bank financing is used instead. Payment terms include a significant down payment (20% to 50% is the range). Revenue sharing arrangements are almost never used at this level.

Internal sales to a son, daughter or key employee (more often than not, there is a group of internal buyers as opposed to just one person) are commonly structured using a stock purchase agreement or the equivalent for a Limited Liability Company. Financing terms are similar to those used by a third-party buyer with the exception of the down payment - most internal sales do not employ large down payments at the time of closing.

Sellers of businesses should receive all of their value at long term capital gains tax rates. Additional information on payment terms, tax allocation strategies and the documentation process can be found below.



PAYMENT TERMS

Up until about 3 years ago, all payment terms and financing arrangements in the M&A space (at least between practices and businesses) in this industry were strictly between the buyer and the seller - the applicable term is “seller financing”. Bank financing, in contrast, has generally been unavailable for the sale of a financial advisory practice or even a small business in this space. This dynamic is changing rapidly, but still, there are very few banks that handle this highly regulated space properly or efficiently.

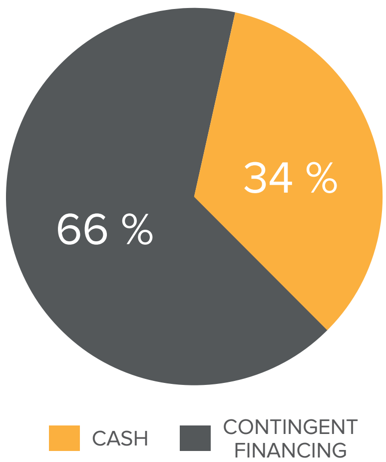
For the past 20 years, seller financing (and related payment terms) has been necessary because very few buyers write a check to the seller for the full purchase price at closing. This fact is less attributable to the sufficiency of a buyer’s cash reserves and more to basic deal structuring techniques that recognize the importance of keeping the seller motivated to help with post-closing client retention - critical in a relationship-based industry. Conversely, very few deals are struck with no cash down at closing – deals involving predatory buyers of practices and internal transitions at the business and firm levels being the exceptions.

The most common professional deal structure for the sale or acquisition of a financial services practice or business includes two distinct elements: (1) a nonrefundable cash down payment of about one-third of the value of the practice or business, and; (2) the balance seller-financed from three to five years, or bank financed for up to ten years. It is not unusual to employ bank financing and some seller financing in the same transaction. Typically, the more recurring revenue there is, the larger the down payment and the shorter the financing terms. Seller financing usually contains some type of contingency to make sure that the assets and cash flow actually transfer and can be retained for a period of time. Contingent financing is appropriate for most third-party transactions, but is not used for internal sales or formal succession plans.

Contingent financing for third-party transactions at the practice or business levels is often structured as a performance-based note, and more rarely these days as an earn-out arrangement. Revenue-sharing or fee-splitting arrangements are other forms of contingent financing, but are (or should be) limited to sales and acquisitions at the job or book level of ownership.

Performance-Based Promissory Notes: The most commonly used contingent financing method at the practice or business level is a performance-based promissory note (sometimes called an adjustable note). A properly constructed performance-based note usually includes a one-time “look-back” usually on the one year anniversary of closing. From the seller’s point of view, performance-based notes are predictable and carry a reasonable interest rate on the balance and “lock-in” at the end of the seller's post-closing consulting duties. From the buyer's point of view, downside protection is provided should the anticipated cash flow not materialize.

AVERAGE DEAL STRUCTURE 2015



Performance-based promissory notes can be structured in a variety of ways, but in most cases have a buffer built in that contemplates the effect of market fluctuations - losses of 5% to 7% of the cash flow post-closing may not be enough to trigger an adjustment to the note value, whereas the loss of 15% of the clients and/or assets, for whatever reason, would almost certainly cause an adjustment to the final value. This dynamic, explained below, tends to cause the seller to select the best possible match from the pool of buyer candidates - usually easy to do with a 50 to 1 buyer to seller ratio.

At the practice and business levels of ownership, a cash down payment and a performance-based note deal structure have become the norm. This common deal structure places a reasonable amount of risk on both parties (which benefits the client base) and is the favored technique for transitioning an independent financial services practice or business.

Earn-Out Arrangements: Earn-outs are used infrequently these days due to regulatory concerns and licensing issues primarily, and the unpredictability of the cash flow stream (from the seller's perspective) secondarily. An earn-out arrangement is a method of seller financing in which the buyer pays a percentage of future practice revenues from all of the acquired clients and assets to the seller for an agreed-upon period of time, or up to a set amount. The problem is that most broker-dealers require the seller to remain licensed for the duration of the financing - most sellers do not want to maintain licensure, E&O insurance and continuing education requirements for an additional 4+ years after retiring.

An earn-out arrangement is not the same thing as a revenue-sharing or fee-splitting agreement

it is different in at least two key respects: (1) earn-out arrangements are usually part of a formal asset purchase agreement and can result in the payments to the seller being taxed at long term capital gains rates, and; (2) an earn-out arrangement is usually preceded by a fairly significant down payment - in other words, earn-outs are a part of a complete and balanced financing package, not the entire payment and valuation plan.

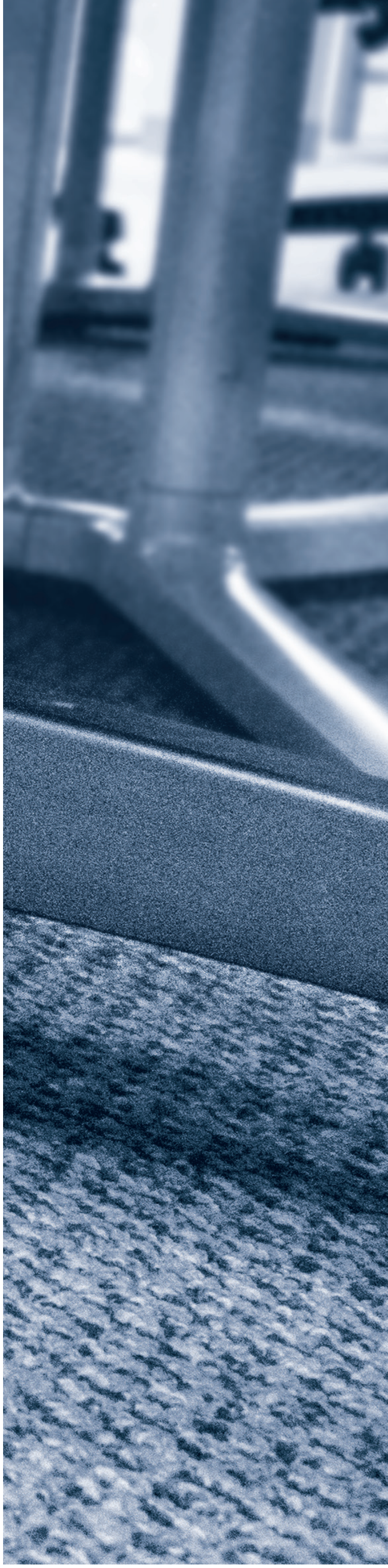
Earn-out arrangements typically do not carry interest on the unpaid balance, although for tax purposes, interest will be imputed. However, most earn-outs are not "capped" or limited in the amount to be paid unless the earn-out is specifically structured to pay the seller a set amount. If the gross revenues from the acquired client base grow rapidly in the buyer's hands, the earn-out payments will also increase at the same pace; the opposite is true as well.

Revenue-Sharing or Fee-Splitting Arrangements: This approach, often accomplished by having the buyer's and seller's broker-dealer or custodian split the revenue stream between the parties for an agreed upon number of years, is actually not considered a deal structuring technique. In fact, the short-form agreements are barely enough to constitute a purchase and sale document, but they work just fine for transferring a small group of clients and a minimal revenue stream (the *job* or *book* level, for example).

From a seller's perspective, a revenue-sharing arrangement not only bypasses the available long-term capital gains tax benefits of a properly structured transaction, it also overlooks the protective and motivational terms and deal structuring elements needed to consummate a professional transaction and protect the collateral. Worse, a revenue-sharing arrangement can create an unintentional legal partnership between the participants, subjecting each to liability for the other party's actions and obligations.

Shared-Risk / Shared-Reward Concept: The element of seller financing has had a very positive effect on practice transitions in this industry. By utilizing seller financing for the majority of the purchase price and a significant, non-refundable down payment from the buyer, most third-party transactions are created using a shared-risk, shared-reward format. This unique financing arrangement results in the parties focusing not only on the financial strength and stability of the buyer, but also the "best match" between the parties which usually results in very high client transition rates and long-term asset retention. Consider this aspect carefully in your own deal structure, especially if you elect to utilize some type of external or bank financing that substantially cashes out the seller at the time of closing.

Both buyer and seller typically seek a reasonable balance between price and terms so that the acquisition largely finances itself from the acquired cash flows (after the down payment) over time. This flexibility in seller financing and the "economic marriage" that often results has stabilized sales prices for exiting owners even in turbulent economies. It has never been about the highest bidder, and practice auctions do not occur as a rule - best match should always be the starting point for a successful transition at all levels - job, practice, business or firm.



DOCUMENTATION

The methods used to sell or transition a job, practice, or business often reflect the methods used to build each ownership level. The typical documentation package to sell or to acquire a **job** or a **book** is pretty simple:

- Basic revenue-sharing arrangement (as a general rule, not to exceed 5 years in length)
  - Valuation is "baked-in" (final value will be determined by adding up the payments)
  - Tax rates are typically ordinary income to the seller, expensed by the buyer

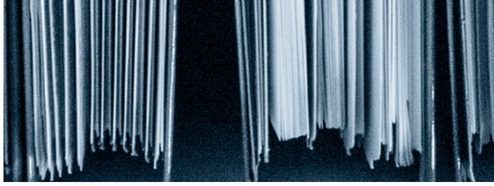
The typical documentation package to successfully sell or acquire a **practice** is a bit more involved and professional:

- Market-based valuation
- Confidentiality Agreement(s)
- Letter of Intent
- Asset Purchase Agreement
- Post-Closing Consulting Agreement
- Non-Competition / Non-Solicitation / No Service Agreements
- Performance-based Promissory Note
- Security and Collateralization
- Bill of Sale

The documentation package to support the sale or acquisition of a **business** includes all of the items listed under sale of a practice and these possible additions:

- Earnings-based valuation
- Stock Purchase Agreement(s)
- Bank Financing Agreements
- Employment Agreements for the seller's key staff members
- Post-closing Employment Agreement for the seller

At the practice and business levels, it is not uncommon to start the process with a Letter of Intent (LOI), often called a term sheet. An LOI helps to frame the main issues and creates a time frame for due diligence and the completion of the transaction. In a professionally structured transaction, it is not unusual for an earnest money deposit to be placed into an escrow account to ensure the buyer's commitment.



TAX STRUCTURING

Many advisors assume that they have little control or choice when it comes to paying taxes on what they ultimately realize in value from building and/or selling their job, practice, business or firm. Nothing could be further from the truth. If you take the time to lay out a plan and assemble your practice or business correctly, you should enjoy these results:

A) The sale of assets will predominantly be taxed at long term capital gains rates;

B) The acquisition of those assets will result in the buyer's ability to write off the entire purchase price over time.

Here is how this works. The tax consequences to the seller of an asset sale depend entirely upon the tax classification and treatment of the individual assets that comprise the practice or business, and the arms-length agreement of the parties to the transaction. Typically, the assets to be sold include as a part of every professional deal structure:

+ Seller's goodwill
+ Client files and associated revenues (recurring and non-recurring)
+ A personal agreement not to compete or solicit after closing
+ Furniture, fixtures and equipment
+ A personal services contract obligating the seller to assist the transition process post-closing

The amount paid for each of these assets varies and is negotiable, within reason - how that amount is paid, such as in cash, on a note or an earn-out is irrelevant (this statement does not apply to a revenue-sharing arrangement in most cases). In the typical transaction, the majority of the purchase price is paid to the seller at capital gains tax rates and the remainder of the purchase price is allocated across the remaining non-capital assets. The tax treatment may vary between two practices and should be carefully considered in the term sheet or LOI.

Many sellers blindly accept the revenue-sharing agreements handed out by their broker-dealers or custodians as appropriate for all levels of ownership. Understand that almost all of these simple forms result in ordinary income to the seller when long term capital gains could be a viable alternative.

For additional information, please review FP Transitions' **Tax Treatment of an Asset-Based Sale.**

CONCLUSION

Regardless of what you've built, or your acquisition goals, it makes sense to have a sound exit strategy that is based on accurate information applicable to your situation. Using an appropriate valuation strategy will help you better understand how to design that plan and, later, what to reasonably expect from it - whether upon retirement, or death or disability, or even attrition.

If you own a job or a book, using a multiple of gross revenue is a perfectly acceptable way to value what you've built. There is little need for sophisticated systems and processes at this level. But if you own anything more than a job or book, start with a formal valuation and learn enough to make informed decisions. Don't resort to simple multiples of revenue if you own a practice or a business, and don't fall back on three page agreements that purport to solve all of your problems quickly and easily - you'll pay for that decision in the long-run many times over.

To the independent broker-dealers and custodians, we offer this suggestion: learn and appreciate the differences in ownership levels, and respect your selling practice and business owners by giving them information appropriate for what they've built. Supporting a group of predatory buyers just to avoid losing a retiring advisor or rep is not the standard of professionalism this industry deserves - celebrate those who build real value and help these entrepreneurs realize what they've earned.

The ultimate judge and jury over our work, and yours, is your client base. They hired you and trusted you to make smart, well-informed decisions on their behalf. The end of your career should absolutely be held to the same standards. Use the current seller's market not just to obtain highest value, but also the very best match of skill sets and investment philosophies. Auditioning the pool of buyers for best fit and best geography isn't about greed; it is about doing your job and creating a value-added opportunity for your clients.

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FP TRANSITIONS®
4900 Meadows, Suite 300
Lake Oswego, OR 97035
www.fptransitions.com
800.934.3303 • 503.452.4203