MERGERS 2.0

A FOCUS ON THE M IN M&A

FP TRANSITIONS®

CONTENTS

This white paper breaks down the key merger topics that FP Transitions' team of professionals consults on every day in the areas of valuation and financial analysis, compensation, organizational structure, and legal.

If you've ever stood on the warm sands of a seashore on a clear day underneath sunny, cloudless blue skies, it seems like you can look out to the horizon and see forever. Using your imagination, you can, and it is magical. But when you apply logic and basic mathematics, things change and become very real.

The Earth curves about 8 inches per mile. Standing on a flat surface with your eyes 5 feet or so off the ground, the farthest edge of the ocean that you can actually see is about 3 miles away. If you stand on the second-floor balcony of your home or a hotel that you're visiting, you can quickly and easily double, even triple, how far you can see. By climbing a few flights of stairs, the change of perspective opens up new horizons.

Mergers are like that. The idea is often sparked by meeting another like-minded advisor. The initial view is incredibly exciting and the possibilities seem endless. Details of how to make it happen or what that new business will look like are still out of sight and over the horizon. As you move your way up through the floors of learning about each other and imagining your future together, in detail, the picture changes. How will you handle cultural shifts? Who will be in charge and how will decisions and voting work? What are the tax consequences?

Let's enjoy that view of the ocean for a while longer before getting into the actual details of mergers, a term we use broadly in this white paper to encompass the combination of two or more businesses into one through a wide variety of transactional forms. In the following section, we'll take a conceptual look at how the merger process is commonly utilized in the independent financial services profession, and why it can seem a bit complicated and even over the horizon for many. In the end, you'll likely find that mergers are indeed a viable option and well within your reach as a practice owner, even a sole proprietor, who wants to leap forward and own a business – one built in a fraction of the time it would take through organic growth.

A PARABLE: UNDERSTANDING THE MERGER PROCESS

Picture a bright orange life-raft floating on a dark blue, storm-tossed ocean. In this durable, well-built, Coast Guard approved 10 ft. craft sits a single, individual, independent financial advisor. That financial advisor might well be you. But let's be clear, you're not powerless – entrepreneurs never are. You have a paddle for propulsion, the means by which to move the raft to safer or more prosperous waters. You also have a compass for navigation to guide forward progress along your chosen route. In addition, your life-raft has a small treasure chest tied down safely – that treasure is your AUM, client relationships, and annual cash flow, which creates value in your current book or practice.

Over time, though the sea is vast, there are many independent financial advisors and you'll undoubtedly encounter other life-rafts, crewed by peers or even direct competitors. Most of the time, you'll just pass by and co-exist, easily and effortlessly competing for the same food supplies without much thought or concern. However, in time, when the skies grow dark and the seas inevitably become more challenging and treacherous (i.e., the occasional recession or economic headwinds), behaviors tend to change. Instead of passing by each other, groups of advisors in their bright orange life-rafts may come together and form a group. Under the right circumstances, they'll lash their rafts together with yours for safety and support and form a consortium of two, three, maybe four advisors or more, each advisor sitting in their separate crafts, inextricably linked together for the duration of the event.

During this time together, the group can explore various opportunities. Synergies may develop. Resources may be shared. The paddle might be placed in the hands of the strongest advisor whose task it will be to propel the group to safety or more prosperous waters. The advisor best qualified to lead and navigate will take the *helm* and direct the group with a single vision and set of coordinated actions. And the advisors best suited to "hunting and gathering" will be charged with collecting water and food in order to sustain the efforts of the group – each person doing what they do best, contributing to the success of the group. This structure is commonly known as an "ensemble" arrangement.

In this common configuration, often organized through a written agreement, each independent advisor continues to function as a separate unit, each "eating what they kill", each keeping a close eye on their own treasure chest and the value they've built with their own efforts and continuing level of production. Each advisor commonly, legally reserves the right to cut the ropes and paddle off at any time and in a direction of their own choosing; the epitome of independent ownership and being an entrepreneur. From a distance, through the eyes of a client, this small group purposefully looks like a single vessel.

For some, this is the end of the story; some advisors want to go no further. Sharing resources is enough. But if you're considering a merger opportunity, this is just the beginning. As you sit in your flotilla, or ensemble, cast your eyes back to that horizon we recently explored. If you look far enough you'll see four or five bright, white lights – those are the ships and they're under power with a captain on the bridge and a supporting crew in place. These ships are built to last and can do things in this merger space that other professions cannot – independent financial advisors have a built in advantage as explained below. These ships are being built today in record numbers and for good reason.

Your book or practice could be your ticket onto one of those ships, analogous to an enduring, valuable, equity-centric business. These are vessels designed and built for strength, growth, durability, and long-term success. Mergers in this profession are a very common method of achieving this important set of goals. Many of today's most successful businesses were built from the combined talents of several books and practices.

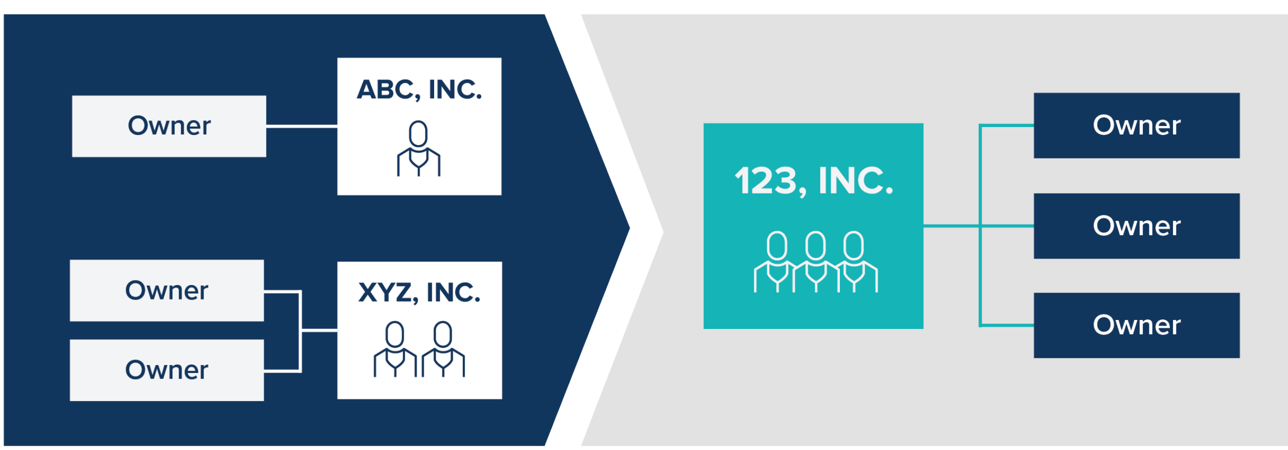
For advisors who have already built a ship, mergers or "onboarding", as explained below, is an excellent way to add next generation talent to your organization to support sustainable growth and long-term succession planning.

HOW MERGERS WORK

Mergers are often spoken of in terms of synergies, the notion that 1 + 1 could indeed add up to 3. One of the key points of this white paper is to explain how, and why, in this unique profession, the merger process is often about how 1 + 1 + 1 = 5. Three books (AUM, cash flow, goodwill, plus the combined experiences, talents, and marketing abilities) combined to create a valuable, dynamic, and enduring business. These books, or practices, become businesses with greater value and talent and more diversification almost instantly, accomplishing together and in less than a year what most advisors are unable to do alone over the course of an entire career.

A merger occurs when two or more companies legally combine to become one. Usually, most of the principals and staff join together post-merger to pool their respective strengths and eliminate or reduce pre-merger weaknesses or inefficiencies. Most commonly, a merger occurs when Company “A” uses a certain amount of its own stock in exchange for the stock of Company “B.” The former shareholders of Company “B” become shareholders (usually minority) in Company “A.” Their basis in their original Company “B” shares carry over to their new Company “A” shares and no tax is due. This is just one of the many different forms of mergers available depending on the circumstances and goals of the parties.

An acquisition can result in a similar combination of two companies into one but is typically an asset-based transaction instead of stock based. It is often used when the selling owner is ready to retire after a post-closing transition period. Stock, cash or debt can be the acquisition currencies. Acquisitions are usually taxable to the seller, but there are exceptions.



The merger process, as explained in this white paper, primarily focuses on advisors who aren't ready to cash out, but who want to strengthen their operation and build something more valuable than they could ever do alone and create improved options for the future, including a safety net against their own death or disability. Mergers and acquisitions are both important steps forward.

The basic numbers and dollar figures do matter, of course. A merger of three sole proprietorships each grossing around $750,000 annually, of which about 75% is recurring (fees, trails, residuals), suddenly could generate partners in a business worth more than $5,000,000 with an instantaneous continuity plan to protect their investment. For most advisors, though, the numbers aren't the driving force. Mergers are usually more about combining attributes and differences to create a stronger growing business. Some examples of strategic combinations include:

- Older + younger
- Smaller + larger
- Experience + energy
- Marketing skills + planning skills + leadership
- Commission-based + fee-based + insurance-based

Unlike acquisitions, mergers bring these talents together as equity partners within a single ongoing business for, ideally, the rest of the participants' careers.

Statutory mergers, as well as consolidations and reorganizations, are conducted under the rules of the Internal Revenue Code (IRC), Section 368, as well as applicable state statutes. The statutory merger process is often complicated, time-consuming, expensive, and...sometimes the only way to get things done. Statutory mergers can be used to create a tax efficient combination of books and practices into a single business but are neither simple nor inexpensive to execute.

The good news is that this is not how most business combinations tend to be completed in the independent financial services and advisory profession. Because of the way books and practices are regulated and generally operated, the IRC actually supports a simpler, faster, and far less complicated way to help independent advisors join forces and combine their books and practices into a single, strong, durable business. It's called a tax-neutral exchange.

LATERAL MERGER

When two or more books or practices come together that were not previously competitors.

HORIZONTAL MERGER

When the merged firms are in direct competition in the same markets or provide the same services, but now elect to join forces.

VERTICAL MERGER

When a company and one of its suppliers or distribution channel partners join together.

MARKET-EXTENSION MERGER

When two businesses that sell the same services but in different markets come together.

THE TAX-NEUTRAL EXCHANGE PROCESS

The most common type of merger between independent financial professionals is a tax-neutral exchange conducted under partnership law. Assets (clients and goodwill) can be contributed to a partnership in exchange for a partnership interest without incurring current tax liability under IRC §721.

Similarly, if the receiving entity is an S-Corporation or C-Corporation, IRC §721 allows property to be contributed to the corporation in exchange for stock in certain circumstances. This works both when forming a new company, or so long as owners of at least 80% of the outstanding shares materially participate in the contribution plan. Just like within a partnership, no tax bill is generated when properly executed.

Merging through a tax-neutral exchange of assets for equity (either a partnership interest or stock), is simpler and less expensive than a statutory merger in most cases and complements the functionality and regulatory structure of this profession. Let's revisit and continue that parable:

In order to complete a merger, these life raft owners will each need to consider taking an important step. Each advisor will be tasked with leaving his or her life raft behind, taking with them only their respective treasures. Once aboard their new ship, even as it is being assembled around them, each advisor must legally contribute all right, title, and interest in their client relationships, cash flow, AUM and goodwill, to the ship, or entity structure, in exchange for equity in the vessel. Each person will have to give something up in exchange for the opportunity to be a part of something bigger, faster, and stronger.

Consider three independent advisors who all work under the same independent broker-dealer ("IBD"), in the same building, in the same town, all around age 40. They get along well and have worked together in one way or another for several years. These advisors currently work as sole proprietorships each filing one or more Schedule C's with their personal tax returns to report their income as registered reps ("RR's), investment advisory reps ("IAR's"), and as licensed insurance professionals ("INS"). In this merger process, the three come together (referred to as 3:1, or 3 into 1) and agree that each will contribute all right, title and interest in their "books" to a newly organized entity structure ("Newco, LLC") in exchange for their respective pro rata shares of equity. A special valuation process is used to determine the value of each contribution and to establish initial equity ratios as explained below.

Over the course of the next six months, as the process unfolds and due diligence is completed, the three merge into a single new, valuable, sustainable business. Ownership between the three might be, for example, 43%, 37%, and 20%, with each owner agreeing that, in terms of governance and decision-making, this could be set up as a manager-managed LLC (similar to having directors in a corporation) with each owner receiving one vote on key issues regardless of how much equity he or she owns. To make the most important business decisions post-merger, the three will have to reach a consensus. In years to come, the three owners agree to seriously consider an “equity-equalization event”, bringing ownership to 33%/33%/33% each, through a series of equity sales and purchases, when the owners and the business are ready for that step.

This is the process known as a tax-neutral exchange. It is an internal documentation and reorganization process. A tax-neutral exchange is the most common route in this industry for good reason – the ownership and control of the client relationships and their underlying cash flow and AUM usually reside with the individual producer, not his or her entity or trade name. In many cases, even when an individual producer has set up an entity such as an S-Corporation or an LLC taxed as a DE (i.e., a disregarded entity), partnership, or corporation, the goodwill and the ability to receive revenue is “owned” by the individually licensed professional. This often allows for the set-up and formal contributions of assets to a new, specially designed and plan-specific entity structure years, sometimes even decades into an advisor’s career.

Consider the application of the tax-neutral exchange/merger process when solving for continuity and succession planning issues – a particularly difficult challenge for a book or single-owner practice. Let’s reset the preceding fact pattern to involve four independent advisors, or 4:1, each organized as a force of one, whether a sole proprietorship or with a basic entity structure used to pay expenses, be it an LLC or S-Corporation. In this reset, the advisors ages are 62, 54, 38 and 33.

In the flotilla model, or ensemble arrangement, each of these four owners relies on a contractual arrangement to address what happens next in the event of any one advisor’s death, disability, or as is more common, their exit from the profession for some other reason. Remember that in an ensemble model each owner maintains control and possession of his/her own treasure or AUM, client relationships, and cash flow. It often appears, and is designed to appear to the client base, as a single business with one trade name and a leased office space, while behind the scenes it is a contractually organized group of separate book owners – this is the norm in this profession across all the regulatory bodies.

Effectively, this means that the 62 year-old advisor can sell all of his or her practice to any one of his ensemble partners, or he/she can sell it to someone outside this group – it is usually the owner's individual choice because he/she has no fellow shareholders. Selling to all three ensemble "partners" simultaneously is problematic. For starters, the value that is being sold revolves around the client relationships; in fact, clients are the medium being valued, transferred, and paid for in this instance, not equity or stock. If our selling advisor has 270 client relationships, those relationships can be sold and transferred, in groups of 90 each, for example, to the three ensemble partners perhaps based on skills, ages, sex, investment specialties, geography, or other metrics. This works well only in theory.

Compare and contrast what happens when the ensemble partners choose to implement a tax-neutral exchange merger process and together build an equity-centric business. For starters, the medium that is valued is the stock of the entity – which now "owns" all of the client relationships. Value shifts from the individual book owners and their clients to an entity structure with shareholders. Protecting the business is simpler, cleaner, and clearer because it is accomplished with a single contract, often called a shareholder or partnership agreement, that transfers all underlying value through equity. This Agreement needs to be professionally drafted to address how an exiting owner's equity will be valued, paid for, financed (including the use of life insurance, if any), and who will purchase the equity.

This common merger device is how most mergers between book owners (often sole proprietorships), practice owners (single-owner LLC's or S-Corporations in many instances), and businesses are actually designed and constructed. FP Transitions consults, models, and documents this type of merger for hundreds of independent advisors every year.

STATUTORY MERGERS

When two or more larger, established, and more successful practices or businesses come together and contemplate a merger, sometimes the only way to get the job done is through a formal, statutory merger under IRC §368. In such instances, a tax-neutral exchange is not an option because the planned transactions either do not meet the requirements set forth in IRC §721 or do not qualify for the exceptions set forth in IRC §351, often because one or more of the business entities involved in the transaction is taxed as a C-Corporation or an S-Corporation.

The most common type of statutory merger we see at FP Transitions is the Type A Reorganization. A Type A Reorganization is a transaction in which one practice's entity (the "dissolving entity") merges all of its assets, liabilities, and operations into another practice's entity (the "surviving entity") in order to create a stronger, more valuable single business.

Rather than using cash or debt to fund the transaction, the surviving entity will use its own equity ("shares") to purchase the assets of the dissolving entity. Then, on the date of the merger, the dissolving entity will distribute those shares to the dissolving entity's shareholders. In the end, the dissolving entity no longer exists, the surviving entity assumes all of the dissolving entity's assets and liabilities, and the shareholders of the dissolving entity become shareholders of the surviving entity. Although a merger will dilute each shareholder's interest in the business, ideally their interests will be as or more valuable than they were before the merger because of the increase in the overall value of the surviving entity.

Learn more about the details and structure of different mergers in our companion article: ***Statutory Mergers, Combinations, and Reorganizations.***

To download visit
fptransitions.com/mergercompanion

Every merger situation is unique and complex in its own way. (Re)structuring elements required for each business to be able to combine will range from simple to difficult, but rarely impossible.

When done correctly, a statutory merger that meets the following criteria set forth in IRC §368(a)(1)(A) is a tax-free (or at least tax-deferred) event for all parties involved:

1. **IRS-recognized entities:** The participants in a statutory merger must be entities that are recognized by the IRS, such as corporations or LLC's that are taxed either as a C-Corporation or an S-Corporation. LLC's that are taxed as a partnership for federal income tax purposes are not recognized by the IRS for purposes of a statutory merger.

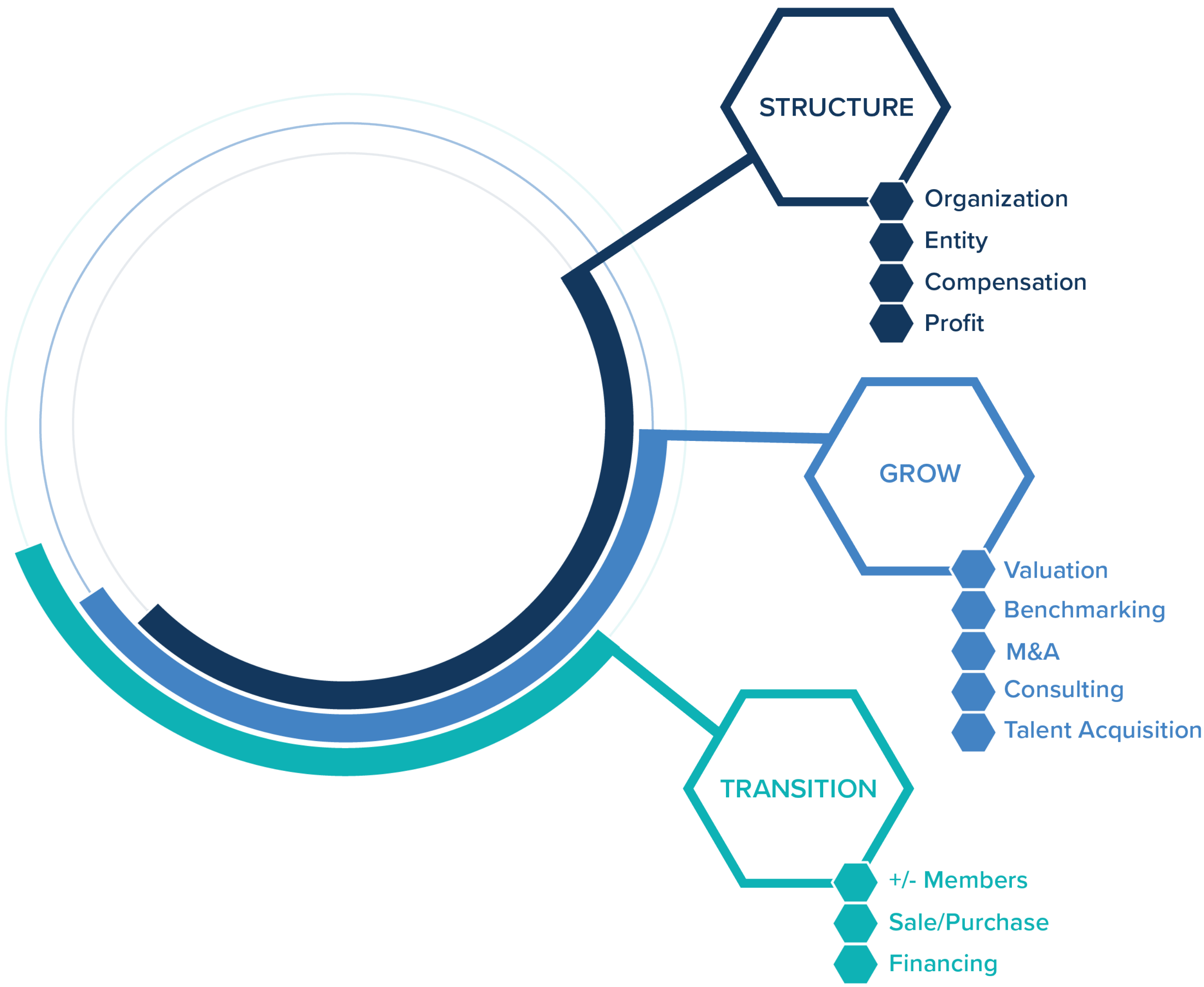
2. **Continuity of ownership interest:** As long as at least 50% of the consideration paid by the surviving entity to the dissolving entity is shares of the surviving entity, then the merger meets the continuity of ownership interest test. The shares may be common or preferred, voting or non-voting. For the mergers we construct, shares of the surviving entity are commonly 100% of the consideration for the merger, so this condition is usually met.

3. **Continuity of business enterprise:** The surviving entity must either continue the dissolving entity's historical business or use a significant portion of the dissolving entity's assets in an existing business post-merger. If two or more financial advisory firms are merging and continue to operate a financial advisory firm after the merger, then this condition should be met, but the IRS may look at all of the facts and circumstances including continuity of employees, location, clients and even suppliers to determine compliance.

4. **Valid business purpose and step-transaction doctrine:** The transaction must serve a valid business purpose beyond tax avoidance. In other words, the transaction cannot be part of a larger plan that, taken in its entirety, would constitute a taxable transaction.

To effect a statutory merger, each entity must file with the appropriate Secretary of State (in the state where the entity is registered) Articles of Merger and, typically, a Plan of Merger that describes all of the terms and conditions of the merger. In addition, all of the individuals who will be equity owners of the surviving entity must work together to develop the governance documents for the surviving entity. These governance documents will address all of the management and

TRANSFORMING YOUR PRACTICE **INTO A BUSINESS**



decision-making processes for the business and will contain the terms for onboarding new equity owners and buy-outs upon the occurrence of certain triggering events such as retirement, death, or disability. The time, cost, complexity, personnel issues and regulatory hurdles to complete a merger are not insignificant, but the potential rewards make the effort worthwhile when the right merger partner(s) comes along.

WINNING THE BATTLE FOR TALENT ACQUISITION (AND RETENTION)

One of the greatest benefits of using the tax-neutral exchange approach may be in acquiring and retaining next generation advisory talent. In a business with a properly organized and compliant underlying entity structure, the process of "onboarding" talent changes everything when it comes to hiring advisors who "think like owners." Returning to our parable once more, here is a useful analogy before getting into the details of the process and why it should matter to most advisors:

Once our vessel is built and is afloat, it is usually only a matter of time before it comes across a life raft or two (in a profession replete with life rafts and book owners) with an owner who is tired or frustrated with the role of being a force of one. In this instance, a ship has the ability to onboard the book owner into the business, put that book owner on the payroll and, when both sides are ready, execute a tax-neutral exchange. Effectively, the business acquires the book owner's clients, AUM, cash flow, and goodwill in exchange for equity in the business – an equity for assets transaction. A growing, profitable business can offer substantial benefits to a younger book owner and, in exchange, can onboard younger talent who might well become part of the successor team in the future.

In effect, this singular, relatively small transaction is a merger, perhaps one of dozens over the years to come for this business; it is becoming common practice for businesses in search of experienced and motivated next generation talent. In an industry with far more book-builders than business-builders, this consolidation tactic is how many independent advisors and businesses are winning the battle for talent – they use equity!

A growing, profitable business can offer substantial benefits to a younger book owner and, in exchange, can onboard younger talent who might well become part of the successor team in the future.

The onboarding of a smaller book or practice owner into a larger business with a strong, sustainable rate of growth and consistently strong profit distributions to the equity partners is an enticing proposition. It is the perfect answer to why an independent advisor might give up the going it alone route to become part of a team. It is also an answer to the question many clients ask of their single financial advisor: What happens to me if something happens to you?

For this process to consistently work, however, the underlying foundations of a sustainable, profitable business must first be put in place, often years in advance – this means strong top-line growth rates and a consistent record of bottom-line profitability and profit distributions within a tax-conduit or flow-through entity structure, among other things. The equity-centric business model can do things that a sole proprietorship or a practice cannot.

One of the goals of this white paper is to convey the notion that mergers are not a once-in-a-career event. Using the more streamlined tax-neutral exchange, mergers become a tool for rebuilding, reshaping, and strengthening a business on an annual basis. An advisor who masters this tool set can build a legacy.

THE VALUATION ELEMENT: DETERMINING INITIAL EQUITY RATIOS

Many advisors who seriously consider a merger are doing so for the first time. One of the first challenges that they run into, like hitting an iceberg in the dark of night, is trying to figure out initial equity ratios. In other words, as you explore a merger of 2:1, 3:1, or even 4:1, how do you determine how much equity each partner will own in the new company?

In a 3:1 merger, where three book owners decide to form a single, stronger, equity-centric business, a determination needs to be made as to who will own how much of the post-merger business. This is a critical step in the merger decision making process because equity ownership dictates each advisor's share of the profits, voting rights, and stock appreciation for many years to come. Indirectly, initial equity interests often impact, or influence, variable elements such as owners' compensation and governance provisions.

Assume that the three advisors in this case decide to set up Newco, LLC, to be taxed as a partnership with a single-class of equity. The merger process needs a method by which it fairly and defensively (as to the IRS in the event of an audit) determines who is receiving what in exchange for the property contributed. Remember the parable:

Once aboard their new ship, even as it is being assembled around them, each advisor must legally contribute all right, title, and interest in their client relationships, cash flow, AUM, and goodwill to the ship, or entity structure, in exchange for equity in the vessel. Each person will have to give something up in exchange for the opportunity to be a part of something bigger, faster, and stronger.

How does an advisor contribute such assets? Legally, a contract called a "Contribution Agreement" is prepared that recites the specific assets that each advisor is contributing, and the approximate value of those assets – and therein lies the challenge.

FP Transitions has developed and refined a methodology for solving this problem. In our merger work, this step is called Financial Analysis – and it is a key step in the merger process. Initially, an experienced analyst evaluates each individual advisor's book of business and provides a written recommendation for the initial division of ownership between the merging parties. In performing this analysis, each advisor's existing book or practice is reviewed in terms of overall revenue, type of revenue, growth rate, number of households, client demographics, concentration risk, expenses, compensation, profitability and other factors. Each advisor's cash flow is examined in its current state with expenses normalized to reflect industry norms for the operation of a similar book or practice. Profit and loss statements, balance sheets, and other supporting financial records are also examined.

Based on a thorough evaluation, this Financial Analysis step results in a specific written recommendation to guide the parties' final decision as to an equitable and reasonable division of ownership based on the contributions from each stakeholder. The analyst then uses these results to develop a long-range forecast to bring these initial equity ratios into context, with the focus then shifting to owners' compensation. As the spreadsheet models evolve, and with input from FP Transitions' multi-disciplinary team, the numbers, and the answers, become clear.

Initial Equity Ratios are individual to each situation and typically vary depending on AUM, experience, reputation and entity structure.

The Financial Analysis work also includes an equity-based valuation of the business so that each owner can track the value of their equity interest with a higher level of certainty and better understand the value drivers of the newly merged business. Working through this valuation process is important because many businesses will want or need, at some point in the future, a line of credit, funding for an acquisition, or perhaps a subsequent equity sale to equalize the ownership between the merger parties, or perhaps a sale of equity to one or more key employees, or even an onboarding opportunity; such activities almost always require a professional appraisal.

CONCLUSION

Mergers are a powerful and indispensable business building tool that every independent advisor needs to be aware of and take advantage of at some point in a career. It is about growth. It is about strength. Most of all, it is about building a durable business that can serve not just your current clientele, but their children and grandchildren as well. This is about building a business where generations of advisors and support staff will want to work and make a difference with their efforts.

Your choice is to build that business organically and trust that you can figure it out, that you can hire and retain the necessary talent to support your goals, and that you'll have the time to complete all the work. Another choice is to grow bigger and stronger using both organic means and the tools offered through the merger process – why not avail yourself of both pathways? Your competition will!

GET STARTED

FP Transitions' Merger Program is built to help independent advisors with all facets of the merger process. To learn more call **800.934.3303** or visit **www.fptransitions.com.**

ABOUT FP TRANSITIONS

FP Transitions, based in the beautiful community of Lake Oswego, Oregon, just south of Portland, has a team of over 60 people that specialize in building financial service businesses of enduring and transferable value. This kind of work takes a talented group of people who aren't afraid to pioneer the concepts needed to help you succeed, and to evolve time-honored approaches to meet the demands of a new century of rules, regulations, and taxes.

In addition to working directly with individual financial advisors, FP Transitions also works directly with broker-dealers, custodians, and insurance companies to develop and implement business transition systems and procedures for field use. This coordinated approach helps us evolve solutions that are practical and that meet specific needs of all the stakeholders.

As a part of the planning and M&A processes, FP Transitions provides expert guidance in areas that include:

- Practice valuation, benchmarking and "equity management"
- Development and design of customized succession planning structures
- Execution of exit plans designed to find the best third-party buyer for advisors interested in selling
- Merging two or more practices into one strong, sustainable business
- Restructuring ownership compensation to support internal ownership tracks
- Establishing organization structures that support an equity-centric ensemble
- Creating or modifying entity structures to work for generations of owners
- Modeling cash flow outcomes for a variety of continuity and succession planning solutions

If the building process isn't for you, or your plans change, FP Transitions also created and operates the largest open market for buying, selling, and merging financial practices. Either way, we are the experts at helping you manage the equity you've built over a lifetime of work in this industry. Our goal is to help you plan for your future, and to be ready when it gets here.

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FP TRANSITIONS®

www.fptransitions.com
4900 Meadows, Suite 300
Lake Oswego, OR 97035
800.934.3303 | 503.452.4203