

White Paper

Ideas Without LimitsSM

Contents

Overview	1
A New Value Proposition	2
The Long and Short of Equity Management.....	3
The Equity Management Process.....	3
Summary	10

Our partner in developing this white paper...



Equity Management: Determining, Protecting, and Maximizing Practice Value

Overview

Equity management is a concept focused on helping practice owners monitor, protect, and realize the value of their life’s work while providing for the long-term care and retention of the clients they serve. Most importantly, equity management transforms how investment professionals—and their broker-dealers view a practice—shifting from an employee mentality to a business ownership mentality.

Throughout an investment professional’s life cycle, equity management encourages growth and acquisition, in addition to retention of clients and assets—placing the idea of “practice equity” at the forefront of every business decision. When fully adopted, equity management improves the quality and length of service provided to clients, increases value for practice owners, and boosts the bottom line for their broker-dealers.

Reward

- > Equity realized at retirement

Valuation

- > Equity valuation
- > Practice benchmarking

Equity Management

Growth

- > Targeted strategies
- > Acquisition
- > Re-evaluation

Succession Planning

- > Continuity planning
- > Succession planning

Pershing[®]

AN AFFILIATE OF THE BANK OF NEW YORK MELLON

While management of the equity value of a business is hardly a foreign concept to investment professionals, the advent of a robust market for practices has forced investment professionals to look at their own businesses in a new way. The marketplace, in turn, has provided a stream of comparable sales data to support a new market-based valuation approach—along with industry-specific methods to monitor and track the value of practices from one year to the next.

Independent investment professionals who are recently retired or nearing retirement are the first to confront the complexities and challenges of realizing the value of their businesses while carefully transferring their client relationships to the next generation. Many of these retirees started the planning process too late and failed to understand the equity value in the client relationships they built. However, this is changing with the next generation of investment professionals, who are pioneering the concept of equity management—monitoring, growing, and realizing the value of their businesses—with a level of sophistication never before seen in this industry.

This new ownership philosophy has implications not only for how practices will be structured and developed, but also for how these practices will be best served by their broker-dealers. Equity management requires broker-dealers to focus their efforts and resources on providing the tools and support that their investment professionals need to manage and grow their practices.

A New Value Proposition

Accurately valuing a financial services practice requires a specialized approach.

As recently as 10 to 15 years ago, the predominant view in the industry was that value was vested in the individual investment professional and not in the practice. As a result, owning a practice was viewed more as a job and less, if at all, as a real business. However, the environment has changed since the advent of the open market in 2000. The current competitive acquisition landscape reflects the next generation's recognition of the value of what their predecessors had built and ultimately undervalued.

Investment professionals operate within a unique business model. Unlike a manufacturing company or a wholesale supplier, the value is not in the business' fixed assets, inventory, or intellectual property—the value is solely vested in the client relationships. This creates challenges in devising strategies to maximize the value to the owner while balancing how those relationships will be transitioned to the appointed successor.

Doing what is right for clients and protecting the equity in the business are mutually dependent upon each other. The only way to ensure that the value of a practice based on intangible assets (such as client relationships) ends up in the hands of the practice owner is to provide for a seamless transition to a successor who has a clear understanding of the future needs of the clients, their families, and their assets.

The Long and Short of Equity Management

Equity management follows the life cycle of an investment professional—from the point of entry, through the planning and growth phases, to the eventual exit and reward—and begins again with the successor. “Managing for the end game” becomes an ongoing process as the practice is passed from one generation to another.

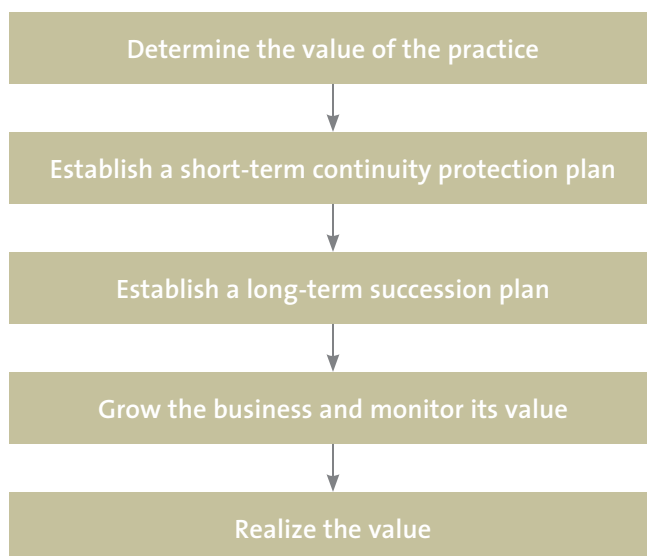
The general term “succession planning” has often been used in the financial services industry to describe a practice owner’s departure from the business, whether the exit is planned or unexpected, permanent or temporary. It may focus on an internal succession involving employees or family members, or it may involve a merger or sale to a third party. The sheer breadth of the topic is one reason why broker-dealers find the planning process so difficult to discuss with their investment professionals.

Under the equity management concept, the planning process is broken into two components—short-term planning and long-term planning. Short-term continuity planning involves a written plan to address an investment professional’s sudden death or disability—whether temporary or permanent. Whereas long-term succession planning involves a well-defined exit strategy designed to maximize the equity in a practice upon retirement. Together, continuity planning and succession planning are part of an ongoing process that encompasses a broad range of challenges and solutions, set against a background of changing tax laws and securities regulations. The process is made easier, and the efforts are far more successful, by the support and aid of the broker-dealer.

Equity management helps every practice owner achieve the satisfaction and rewards of building the value and legacy in his or her business.

The Equity Management Process

Equity management can be condensed into five basic steps that create stability, predictability, and retention of clients and assets for the broker-dealer while maximizing the value of the underlying business for the individual investment professional:



While there are many ways to determine value, the challenge lies in finding an affordable method that delivers a consistent, accurate, and easily understandable result.

Step 1: Determine the Value of the Practice

Investment professionals will attest that you cannot manage an asset unless you know its value and understand its future potential. For that reason, the entire equity management process begins with determining the underlying value of the investment professional's practice. Over the past few years, the industry has seen a transformation in the methods by which practice values are assessed, moving away from the use of both simplistic gross revenue multiples and expensive, theoretical appraisals using publicly traded companies as comparables.

Gross revenue multiples, the industry's "rules of thumb," oversimplified the complexity and diversity of practice models—thereby overvaluing some practices while grossly undervaluing others. Professional appraisals using traditional valuation methods, such as income and asset approaches, ignore many of the subtleties involved in evaluating a practice, such as the transition risk or the demographic qualities of the client base being transferred. The new approach to practice valuation changes the way equity is quantified by using a market value-based methodology that relies on a strong and growing list of comparable mergers and acquisitions data, together with industry-specific valuation measurements.

Gross Dealer Concession (GDC) serves as the foundation for most market-based valuations. This top-line revenue figure is adjusted based on a series of metrics related to the practice's transition risk, cash flow quality, and marketplace demand. The actual deal terms, duration of financing, and broker-dealer overrides are also taken into consideration to produce a final, realistic, market-generated value. Buyers and sellers almost always structure their deals as asset sales, relying on the buyer's existing infrastructure rather than the seller's overhead and liability structure. Therefore, using adjusted GDC is the best proxy for regulating cash flow while providing reliable, comparable data.

The market-based approach values an investment professional's practice with the following primary assumptions:

- **Transition Risk Index:** This measures the likelihood that clients will transfer to the successor and be retained in the years immediately following the sale. In other words, the GDC of a practice is only as good as the assets that can be transferred and kept on the platform. If the client base is not strongly attached to the practice and the selling practitioner, then the buyer may not realize the full revenue being negotiated. This risk can be predicted now that sufficient data exists. FP Transitions' post-closing data indicates that transition rates run from 85% of clients transferred to the high 90% range for well-structured transactions with low transition risk. The difference in value received by the purchaser could amount to several hundred thousand dollars a year for many larger practices.

> **Cash Flow Quality Index:** This focuses on the revenue stream to be acquired, assessing the demographic qualities, asset concentrations, and wealth index of the client base, as well as the expenses associated with serving the clients. The Cash Flow Quality Index also looks at the critical growth components of a practice, including the strength of the referral base, past client acquisition rates, and whether the practice has a niche. As an added benefit, analyzing the Cash Flow Quality Index provides investment professionals with a benchmark against which to measure their practices and manage them for maximum value.

A durable cash flow stream from a strong and well-established client base is a key factor when determining equity value.

Client Analysis	Practice Analysis
Client demographics	Technology capabilities
Asset concentration risk	Established referral channels
Client growth rate	Revenue mix and growth rate
Fee revenue generated per client	Projected growth of fee-based income
Average client affluence	Expense structure

> **Marketplace Demand Index:** This applies a market-driven capitalization rate to the adjusted GDC that is connected to the type, size, and geographic location of the practice, among other factors. Linking the practice valuation to these factors and the corresponding demand in the marketplace sets this methodology apart from both the generalized “one-multiplier-fits-all” approach and the theoretical methodology that capitalizes the revenue stream regardless of whether or not there are buyers in that particular market or niche.

It should be noted that none of the individual assessment factors of transition risk, cash flow quality, or marketplace demand has a large, singular impact on value; rather, these factors collectively make incremental adjustments to the value and produce results that closely mirror the reality of the marketplace.

Marketplace demand is assessed by comparing the geographic location and type of practice to the current levels of buyer activity.

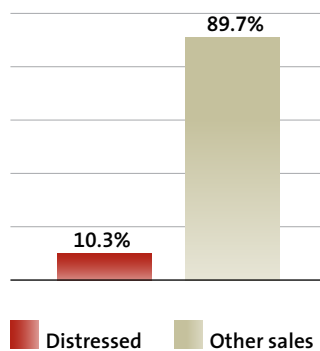
Continuity planning lays the groundwork for a complete, long-term succession plan.

Short-term continuity planning creates an excellent opportunity to partner with the next generation of investment professionals.

Step 2: Establish a Short-Term Continuity Plan

The second step in the equity management process is to create an emergency plan that can retain the market value of a practice and ensure that clients continue to be served in the event that an investment professional is suddenly unable to work. Safeguarding practice value in the event of an owner's death, disability, or premature retirement requires having agreements in place that assure the continued operation of the practice under a licensed professional.

Percentage of Distressed Deals in 2007



Source: FP Transitions

Unlike long-term succession planning, disaster planning often involves the need for a temporary solution. The challenge in continuity planning is twofold: (1) finding the right continuity planning “partner” and (2) structuring a plan that allows for a smooth, effective, and efficient transition to a designated successor. A continuity plan is most successful when entered into with another investment professional who is with the same broker-dealer and on the same platform—a benefit that calls for guidance and resources by the broker-dealer. Taking the lead on the continuity planning process can be advantageous for broker-dealers, as it allows them to highlight the mutual benefits of establishing an intra-broker-dealer plan with their investment professional base.

Investment professionals benefit from the time savings and regulatory advantages of creating an intra-broker-dealer plan, while the broker-dealer is able to retain the client assets on its platform—a win-win for all parties involved.

Fortunately, there has been significant progress in developing and evolving the turnkey solutions that broker-dealers can provide to their investment professionals, including the following:

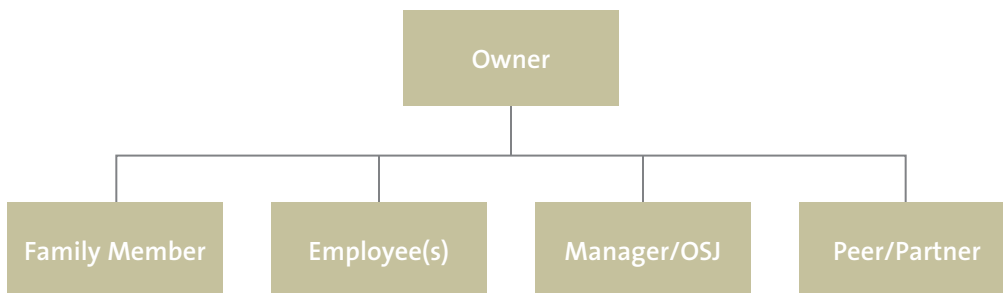
- › **Internal Stock Ownership Plans (ISOPs)** provide minority ownership to employees, which is an incentive for them to continue to run the practice until the ultimate successor can be found
- › **Cross-Purchase Agreements** are reciprocal, binding agreements between two or more practices that ensures the sale of the practice in the case of a death or permanent disability
- › **Guardian Agreements** put another licensed investment professional in place who may purchase the practice or act as its guardian until it can be sold
- › **Buy-Sell Agreements** are internal purchase agreements between practice partners

Continuity planning not only meets a critical need to protect an investment professional's clients and the business' employees, but it also lays the groundwork for developing a complete, long-term succession plan to maximize and realize the equity of the business. It is a basic and essential step in protecting business equity and the trust each client places in the investment professional and the broker-dealer.

Step 3: Establish a Long-Term Succession Plan

The third step of the equity management process focuses on preparing for retirement and realizing the value of a lifetime of hard work. In the past, many exit strategies focused on liquidation of the business and its assets. As recently as the mid-1990s, investment professionals in the independent channel provided clients with a list of two or three investment professionals and said “good-bye” when it was time to retire. Even worse, some owners simply decreased the number of hours they worked and the level of services they provided, opting for an attrition-based exit strategy. Others turned to a broker-dealer–supplied “revenue-sharing agreement,” which transferred capital assets at ordinary income tax rates but did not create an incentive or strategy for the buyer to retain clients.

Today, with a strong seller’s market and the value and transferability of even the smallest financial service business model well proven, the goal of realizing and maximizing the return on investment is within reach. The question then becomes where to look for the best possible successor based on the size and type of practice. The succession plan may focus on an internal route, choosing an employee, partner, or family member as a successor, or it may involve a merger or sale to a third party or an Office of Supervisory Jurisdiction (OSJ). In fact, most third-party transactions take place between buyers and sellers who know each other. They are peers or relatives, oftentimes within the same geographical area or within the same broker-dealer or organization.



As with continuity planning, broker-dealers who invest in the future of their current investment professionals by educating them and assisting them with the implementation of an intra-broker-dealer transition plan greatly increase the probability of retaining clients and their assets. In addition, the future opportunities afforded by linking together two generations of professionals through the equity management process are tremendous. Tying the current group of practice owners to the energy and talents of the next generation will help broker-dealers retain the growing assets from one generation of investment professionals to the next. By establishing a well-developed plan, a practice owner can groom the next generation through training and mentoring, allowing time for clients to become comfortable with the successor and providing a legacy for the business that lasts beyond the investment professional’s lifetime. Offering even minimal support at this juncture will pay huge dividends for a broker-dealer into the future.

Succession planning requires an investment professional to take steps well in advance of retirement to secure a strong, skilled, and well-prepared successor.

Long-term planning provides the next generation of investment professionals with time to prepare and acquire the skills necessary to operate the business they are taking over.

Step 4: Grow the Business and Monitor Its Value

The valuation tools available today allow investment professionals to track their equity values on an annual basis.

The fourth step in the equity management process involves creating and implementing a plan to grow the equity value of an investment professional's business and regularly monitoring this value. With the aging of practice owners, the opportunity to grow through acquisition has never been greater, as the growth that results from buying a single practice can equal years of prospecting for new clients.

One of the best ways to acquire a practice is through the continuity planning process. An investment professional looking to grow his or her business can act as the "continuity partner" for a number of practices and, upon succession, can acquire these practices without having to compete on the open market. Furthermore, establishing relationships with the client base far in advance of the transfer of clients and assets creates an advantage for the successor, as it affords the opportunity to cultivate relationships and trust with the client base, ensuring a high rate of retention. As a result, many broker-dealers are shifting their growth initiatives inward by developing programs that help existing investment professionals build their businesses through acquisition while grooming the next generation.

Another common but often underused targeted growth strategy is to retain the services of a coach. The financial services industry has many well-established and well-known coaches who can help practice owners identify drivers of growth and ways to maximize operational efficiencies, as well as develop and implement plans to address these opportunities. Commonly used growth strategies include changing or improving branding and marketing, or converting from commission-based to fee-based revenue.

Finally, practice valuations can be used to benchmark a firm over time. The continual use of practice valuations can help practice owners monitor the equity built or lost from one year to the next. In fact, obtaining an annual valuation and reviewing this data with a coach is one of the most beneficial strategies of growing a business, as it encourages investment professionals to keep equity management in mind with every business decision.

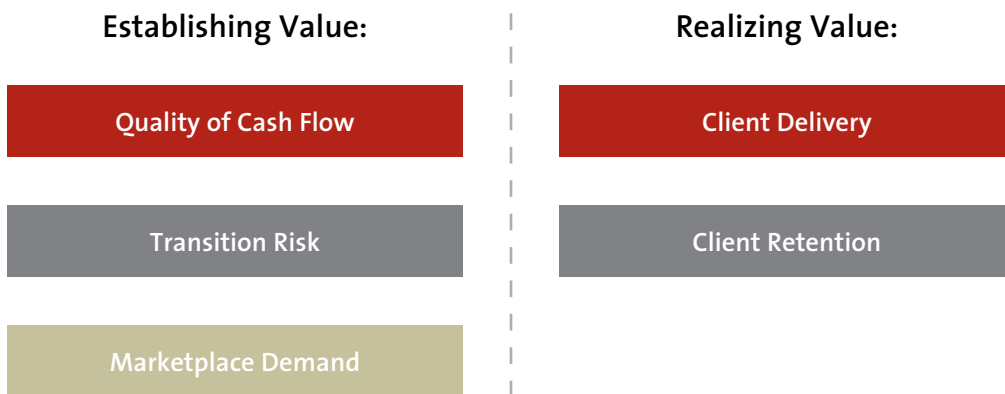
Step 5: Realize the Value

The final step in the equity management process is the realization of value. This may come from an internal sale to a partner, employee, or family member, or it may come from a third party or an OSJ. Equity management does not favor one approach over another; every owner is tasked with laying out the appropriate plan while having a full understanding of the value of the business and the needs of the clients.

Realizing value at the end of a career frequently involves an internal succession between a practice owner and an employee or a relative. This approach requires the most advance planning and informational support due to the lack of capitalization inherent in such transactions, but it almost always creates a great opportunity for a broker-dealer to retain the cash flow and assets under management from one generation to the next. Broker-dealers can assist the efforts of their investment professionals by providing information, guidance, and affordable acquisition financing. Working as a team, starting the process about 10 years prior to retirement, a practice owner and a broker-dealer can create a seamless short-term continuity plan and long-term succession plan by means of an internal transaction.

For those practice owners who do not begin the planning process early enough or whose practice value is beyond the capitalization abilities of a family or staff member, successors often come in the form of a peer or other third party. Today, investment professionals can list a practice for sale on a variety of listing platforms, including many “closed” markets (intra-broker-dealer only), as well as national open-market listing systems. With a 30-to-1 buyer-to-seller ratio, finding a talented successor is no longer a major impediment when exiting the business.

There is increasing demand for broker-dealers to help their network of investment professionals monitor, protect, and realize the value of their practices.



Summary

Equity management is a concept focused on helping investment professionals monitor, protect, and realize the value of their practices while providing for the long-term care and retention of clients. The equity management process includes knowing and monitoring the value of an investment professional's business regardless of the size or age of the practice, and protecting that value by implementing a short-term continuity plan and a long-term succession plan. Above all, equity management focuses on running a practice as a professional business. This concept tasks practice owners with monitoring and growing that value over the course of their careers.

Practice owners have a fiduciary responsibility to ensure the continuity of their practices by establishing a formal plan to address their personal retirement objectives, as well as life's contingencies. Regardless of when or why an exit occurs, owners need to be prepared to put their clients' financial futures in the hands of a qualified, well-trained, and trusted successor. The good news is that investment professionals do not have to do this alone. Broker-dealers now have many tools to address the increasing demand for assistance in building businesses with measurable value and both short- and long-term plans. These plans allow investment professionals to realize equity when exiting the business and create a more mature and stable business model for the broker-dealer.

Ideas Without LimitsSM

This white paper is part of Pershing's thought leadership program, Ideas Without Limits. Ideas Without Limits provides financial services firms and their investment professionals with strategic insights, ideas, and best practices delivered through independent studies and white papers. It is a component of our unique practice management program designed to help firms drive growth, optimize human capital, and maximize operational efficiency—going beyond high-level guidance to offer actionable information, personalized consulting, and ready-to-execute solutions.

About Us

Pershing LLC (member FINRA, NYSE, SIPC) is a leading global provider of financial business solutions to more than 1,150 institutional and retail financial organizations and independent registered investment advisors who collectively represent over five million active investors. Financial organizations, investment professionals, and independent registered investment advisors depend on Pershing's depth of experience and consultative approach to provide them with forward-thinking solutions that help them to grow their businesses. Located in 19 offices worldwide, Pershing is committed to delivering dependable operational support, robust trading services, flexible technology, an expansive array of investment solutions, practice management support, and service excellence. Pershing is a member of every major U.S. securities exchange and its international affiliates are members of the Deutsche Börse, the Irish Stock Exchange, and the London Stock Exchange. Pershing LLC is a subsidiary of The Bank of New York Mellon Corporation. Additional information is available at www.pershing.com.

About FP Transitions

FP Transitions provides valuation, consulting, listing, continuity planning, and succession planning services to the financial services industry. FP Transitions created the open-marketplace concept for buying and selling practices and offers the industry's only Comprehensive Valuation Report using open-market data from the sales of independent financial service practices.

FP Transitions is the industry leader for internal transactions between employers and employees, and between parents and sons or daughters in family-run businesses, having pioneered the Internal Succession Planning Program and the Internal Stock Ownership Plan (ISOP) ownership track. To learn more about the services provided by FP Transitions, contact David Grau, Jr. at (800) 934-3303. Additional information is available at <http://tcreources.fptransitions.com>.

Pershing[®]

AN AFFILIATE OF THE BANK OF NEW YORK MELLON

One Pershing Plaza, Jersey City, NJ 07399

www.pershing.com

Pershing LLC, member FINRA, NYSE, SIPC.