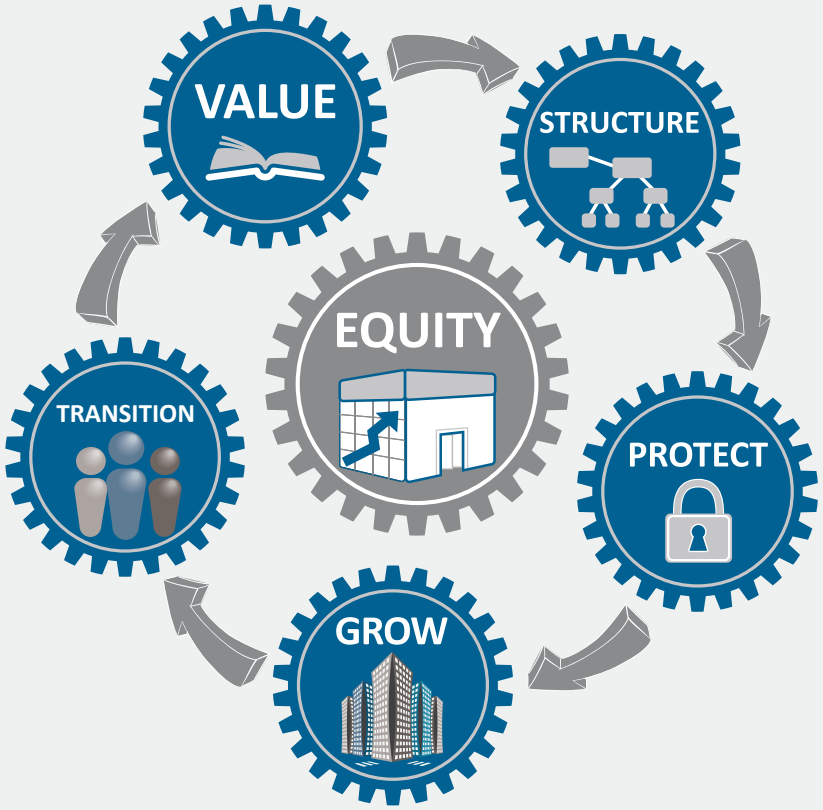
EQUITY MANAGEMENT

DETERMINING, PROTECTING AND OPTIMIZING PRACTICE VALUE

There comes a point in every practitioner's career when it becomes advantageous to shift from the role of an entrepreneur to that of a business owner. The process of building a financial services business that has enduring and transferable value means embracing and utilizing the benefits and rewards of practice equity, in addition to the compensation elements all advisors rely on during their careers.



Equity Management Lifecycle

Equity management is a concept focused on helping owners determine, protect, and optimize the value of their independent financial service practices. To accomplish these tasks, the process of managing practice equity necessarily includes building a business structure that can outlive the founding owner by integrating the next generation of advisory talent through hiring and advancement, practice acquisition, or merging.

Independently owned financial service practices are unique in several key aspects. First, they are among the most valuable of all professional service business models, often worth two to three times as much as a doctor's, lawyer's, architect's or CPA's practice. Second, they tend to be owned or operated by one person, or one primary advisor – contributing to a high value proposition that is, in turn, extremely fragile. Financial service practices also have the ability to generate recurring or predictable revenue within a supportive framework (including equity markets, mutual funds, broker-dealers or custodians). In other words, independent financial advisors work within a system designed to help them meet or exceed client expectations for a return on their investments, which in turn tends to fuel a strong and consistent rate of growth for individual practices.

In recent years, investment professionals have discovered one more important benefit of independent ownership – the equity, or value, built in their practices has steadily grown into the single, largest, most valuable asset they own. To be certain, it is also the one asset that an advisor exerts a significant measure of control over, and it is the one asset that will determine when and how an advisor will enjoy their retirement.

But for many investment professionals, the reward to be earned from a lifetime of work does not focus on a lump sum payment derived from selling the business and walking away. Instead, the reward often results from the benefits of being able to perpetuate the business and create an ongoing stream of income to the founding owner for 10 to 20 years past the typical retirement age. The realities of this type

of exit strategy demand new tools and long-term, ongoing support systems to effectively manage the business, retain the clients and their assets, and to realize the growing equity value.

A NEW VALUE PROPOSITION

Managing the equity of a financial services practice is a relatively simple process. Here is the basic formula, usually applied over the last 10 to 20 years of an advisor's career:

The weekly or monthly compensation an advisor takes out of the business as wages and distributions is the primary motivator for most business-building and growth decisions that advisors make early to mid-career. But compensation declines significantly as advisors age or comes to an end when an advisor stops working. Equity management brings to bear a second and potentially more lucrative element, that of "practice equity."

Equity is the value of the business separate and apart from an owner's ongoing work. Equity reflects the value of the practice's clients, cash flow stream, and infrastructure to a competitive, strategic buyer or successor. With a current buyer to seller ratio of about 50 to 1 for an open market listing of an independently owned financial services practice, equity value is very real, and it supports powerful and advantageous choices for those who plan well in advance.

It is important to acknowledge that investment professionals operate a unique business model in terms of measuring or assessing equity value. Unlike a manufacturing company or a wholesale supplier, the value of a financial services practice is not found in its fixed assets, inventory, or intellectual property—the value is primarily vested in the client relationships. The clients are, in fact, the "judge and jury" of every business continuity and succession plan.

In the end, doing what is right for the clients and best for the business are mutually dependent concepts. Taking the appropriate steps to build an equity-centric business model as opposed to an ego-centric model provides valuable rewards for all the stakeholders. The creation and maintenance of this framework is called an equity management system.

AN EQUITY MANAGEMENT SYSTEM

An equity management system must help investment professionals focus on and master five key areas:

Step One: Determining and Monitoring Practice Value

Investment professionals will attest that it is impossible to manage an asset unless they know its value, understand its future potential, and can monitor the changes in the value of that asset over time. For this reason, the entire equity management process begins, and ends, with determining the value of the investment professional's practice.

To make informed decisions over the course of a career, it is critical that the value of an advisor's practice be monitored over time (preferably on an annual basis). Having an accurate understanding of practice value each year allows the founder(s) to make full informed business and growth decisions and implement long-range plans that will affect the equity of the business and its various stakeholders.

Over the past few years, the financial services industry has seen a transformation in the methods by which practice values are assessed. The industry has gradually become more and more sophisticated, moving away from simplistic multiples or expensive CPA appraisals using publicly traded companies as comparables, to a more accurate and affordable market-based analysis.

The most widely used and most accurate valuation method being used today is a market value-based methodology that relies on comparable sales of similarly situated privately-held financial service practices and businesses. Regardless of the specific valuation methodology used, it is important that the solution is cost effective and that the expert performing the analysis understands the unique qualities of an advisory business.

There are many benefits to accurately and consistently tracking the value of an investment professional's practice. Specifically, understanding the value of practice equity is essential to supporting a death and disability plan and the use of life insurance, implementing equity compensation strategies (such as gifting or using stock grants), evaluating acquisition opportunities, and formulating long-range succession planning strategies.

Step Two: Building a Strong and Enduring Business Structure

Building a professional services practice that has enduring and transferable value requires a strong, properly constructed foundation – regardless of the size of the practice or the number of advisors/owners/producers. The process generally focuses on selecting the proper entity (corporation or LLC), capitalizing that entity correctly to support active and ongoing equity management, utilizing the entity correctly over the course of a career to obtain maximum functionality from the structure, and utilizing appropriate compensation models to support the growth and realization of equity value, rather than more simplistic "eat-what-you-kill" business models.

In stark contrast, a sole proprietorship comes to an end with the retirement, disability or death of its owner. A corporation or limited liability company, on the other hand, has the ability, with proper planning and staffing, to last beyond any one shareholder or partner's career – to create an enduring business model with transferable value.

One of the major advantages for owners who operate as an entity is the ability to transfer or sell small, incremental ownership interests (units or shares) creating two or more owners of one financial services business. For example, a founding owner can set up an internal ownership track and gradually sell 5%, 10% or 25% of the practice to one or more key employees over many years, while retaining control. This approach can support a range of equity management strategies including continuity planning, strategic growth plans, and succession planning.

The compensation structure that is utilized by advisory owners can significantly affect where the value, or equity, is centered – in the enterprise or entity itself, or in the individual producers.

In the latter case, often called a "silo model," all income (after expenses) or compensation from the provision of services to a client is retained by the clients' advisor, even within a larger organizational structure. An "ensemble model" typically relies on a strong, centralized entity structure which collects

all incoming revenue (assigned from the producers), pays out compensation (wages and benefits) for work performed (including production), pays operating expenses, and then pays distributions (profits) to its shareholders or owners.

In the independent financial services industry, many compensation models derive from the simple and straightforward sole proprietorship model – a system that works well for very small businesses and for younger owners capable of working harder to generate additional income. While this approach certainly has many positive attributes, it does not lend itself well to supporting an enduring business model. As practice owners grow older and their needs and goals change, an appropriate compensation structure should be considered alongside a strategy to optimize practice equity, one that rewards leadership and vision and mentorship as much, or more, than production.

A sound business structure provides additional, lucrative, long-term strategic planning opportunities, helping to retain and propel the next generation of advisory talent, which, in turn, can perpetuate a business beyond the founding owner's lifetime.

Step Three: Protecting Value with a Continuity Plan

The vast majority of financial service practices are largely dependent on the skills and personalities of one primary advisor, leaving the business, staff, and clients vulnerable should that advisor sustain a catastrophic injury or illness. This problem isn't restricted to just sole-practitioners, however, as multi-owner businesses which operate as individual silos are equally vulnerable. A heart attack, a car accident, or a stroke can erase years of built-up equity, and the clients' trust, in a heartbeat.

Continuity planning is a dynamic process. The best solutions are those which are applied as part of an overall equity management strategy.

A continuity plan is an emergency plan that assures ongoing management of the business and provides protection of practice value in the event of the sudden death or disability of an investment professional. Continuity planning seeks to address who will serve as advisor to the clients if their primary advisor is incapacitated for any reason.

For many owners, the goal of continuity planning is focused more in a monetary sense on protecting the compensation elements of the practice (i.e., continuation of an owner's salary and profits) rather than the equity value of the practice itself. In fact, a properly structured continuity plan must and can easily do both; otherwise it risks losing hundreds of thousands of dollars - sometimes millions of dollars of value built over the course of an investment professional's career.

The challenges and solutions in developing a continuity plan are often very different from those used to create or implement a succession or retirement plan. For some professionals, the first and only solution is to purchase a life insurance policy — a solution that completely ignores the value of the enterprise itself. Worse yet, life insurance serves to reduce the lifespan of a financial services practice to that of its owner, or even less upon that owner's disability.

The best practices for creating and supporting a practical continuity plan are:

- *Put the plan in writing and update it annually;*
- *Determine the fair market value of the advisory practice annually;*
- *Establish payment terms that reflect the practice's actual cash flow;*
- *Integrate the continuity plan into the practice's overall succession planning strategy;*
- *Tell the stakeholders about the plan.*

Creating a practical and reliable plan, and committing it to writing, is an important step for independent investment professionals. But advisors should never try to address continuity planning as though it were a single event tied to a single solution or contract form. Continuity planning is a dynamic process. The best solutions are those which are applied as a part of an overall equity management strategy.

Step Four: Developing a Strategic Growth Plan

Growing financial service practices provide more options and better strategies for their owners. Strong and sustained growth rates provide both internal succession planning options (in which transitions are highly dependent on a single cash flow stream) and higher values in an external or third-party transition or merger.

As recently as five to ten years ago, the commonly held view in this industry was that financial service practices had essentially no value. Value was seen as vested in the investment professional and not in the practice or business itself. As a result, owning a financial services practice has historically been viewed by many (especially those at the $500,000 GDC/gross revenue level and below) as a job with compensation as the primary reward and less, if at all, as a real business with separate equity value.

The new reality is that equity in an independent financial services business has grown into the single largest, most valuable asset most investment professionals own.

Today, as the Great Recession fades into history, the new reality is that equity in an independent financial services business has grown, or is growing, into the single, largest, most valuable asset most investment professionals own. The need to strategically build that value and create a foundation for its sustained growth has become essential. One of the key roles of an equity management system is to provide investment professionals with detailed information and comparative benchmarks from which to assess the strengths and weaknesses in a particular practice relevant to building greater value.

Financial service practice owners have a number of options to support long term growth initiatives including adding more clients, managing a larger share of assets from existing clients, acquiring other practices or merging, developing marketing niches, managing talent (hiring, retaining and rewarding key staff members), creating a multi-generational practice along with a multi-generational service delivery system, and even adjusting fees to the level of services and results being delivered.

The best approach typically requires a combination of strategies deployed over time. The specific strategy appropriate for a business depends on the circumstances and available resources, but should always be made with complete information, comparative data and benchmarks, and a long-range vision for the future of the business. The process of equity management provides for a continual flow of current information to support necessary, gradual and appropriate course corrections to this strategic growth plan over time.

Step Five: Implementing an Appropriate Succession Plan

Historically, financial advisors have equated the term “succession planning” with “selling their business.” Because of this, exit planning for the independent investment professional has been viewed as a singular event that is put off until the final moments of a career when an advisor trades in their compensation for the value of their client list. Done correctly, and as part of a broader equity management strategy, succession planning can perpetuate the business and maintain the level of compensation a founder is accustomed to, for a decade or longer, and still create opportunities to realize the full equity value.

Succession planning choices tend to fall into two broad categories. The first choice to consider is an internal sale to a partner or employee. The second choice, an external sale or merger, involves a third-party.

The equity management process supports the development and implementation of both strategies, provided the planning process begins early enough. Over time, the correct choice will become clear. The goal of starting the exit planning process early is the ability to cultivate multiple choices, all with positive outcomes so that as the business grows and evolves, and as priorities change, owners are left with acceptable options.

Internal ownership transitions are best constructed as gradual or incremental transfers of ownership over an extended period of time, usually ten years or more, allowing the founding owner to mentor

and evaluate the next generation of owners, while retaining control of the business. For those practice owners who do not begin the planning process early enough, who do not want to sell internally, or whose practice value is beyond the capitalization abilities of the internal buyers, the clear choice is to sell to a peer or other third-party (bank, consolidator, etc.).

Like the advice provided to an advisor's clients, the planning process is most effective when started early and continually adjusted over time. Monitoring practice value, benchmarking against the competition, and strategically building value over this extended period of time results in more and better choices as retirement draws near. Equity management provides powerful and dynamic tools with which to shape the future.

SUMMARY

Equity management is an ongoing process designed to help investment professionals determine, protect, and optimize the value of their life's work. The ability to realize the significant value of a financial services practice, under a variety of planned and unplanned transition events, is dependent on building a business structure that has enduring and transferable value.

The ability to combine the benefits of both compensation and equity over the course of a financial services career provides important building blocks when constructing an enduring business model. Together, these tools can be utilized to better manage and reward the next generation of talent, to retain key staff members, and to integrate their futures into the business to support strategic growth initiatives, and to provide continuity protection as well.

In the end, doing what is right for the clients and best for the business are compatible and mutually dependent steps – steps that every business owner should take. The best way to ensure that the value of a professional services practice will be fully realized by the founding owner is to provide for a seamless, gradual and professional transition to a well-qualified and prepared successor that meets or exceeds client expectations. Equity management provides the ongoing support system to accomplish these goals in a measured and determined fashion.

FP Transitions is the nation's leading provider of equity management, valuation and succession planning services for the financial services industry. Based in Portland, Oregon, FP Transitions operates the largest open market for buying and selling financial service practices in the U.S.

Since opening its doors in 1999, FP Transitions has completed more financial service transactions than any investment banker or business-broker in the country. FP Transitions' expertise also includes continuity planning, practice benchmarking, compensation studies, entity formation, mergers and acquisitions, and equity compensation strategies.

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