FP CAPITAL

Facilitating Your Long-Term, Sustainable Business Independence

Transitional Capital: Bridging the Generations with Private Equity & Debt

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FP TRANSITIONS®

FP Capital, a division of FP Transitions, partnered with a leading global private equity firm, provides an integrated transitional solution to the critical challenges of succession and sustainability for independent fee-based advisors.

Introduction

In the independent financial services industry, a succession plan is best defined as a professional, documented plan designed to build on top of an existing practice and to seamlessly and gradually transition ownership and leadership internally to the next generation of advisors. The goal is sustainability, and it is best accomplished through a plan design and structural framework that carefully coordinates the shifting roles of the founder(s) and the successor team over many years.

In most cases, next-generation advisors have an incredible opportunity to build on top of an existing practice, enjoying the combined attributes of a steady paycheck, an established infrastructure, and the presence of a supportive team. Experience is gained daily in this environment and the talent of the next-generation advisors flourishes in time. What “next-gen” advisors universally lack is capital to invest in this opportunity, and this shortcoming affects everything from the plan length, to value and valuation, to the founding owner’s willingness to consider a succession plan at all. The issue almost always boils down to one question: “Where does the money come from?”

Most founding owners desire an *incremental* sale of their business to an internal team of successors (a process explained in more detail below), and for this reason, the financing question is often exacerbated. The incremental nature of the process does not align well with bank financing solutions and most of these transactions are simply too small for private equity. Over the past 10+ years, FP Transitions’ work in designing, building, and supporting succession plans for independent advisors has provided many important learning opportunities—from both successes and failures.

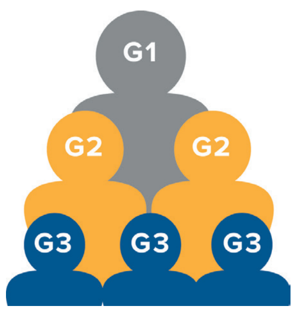
Succession planning has been driven primarily by the use of seller financing. Seller financing offers some important benefits, to be certain; it is very flexible, it is easy to set up and administer, and it is readily available to borrowers who may not yet have ideal credit profiles. But seller financing has also proven to have some significant drawbacks:

1. It is often a very slow process, requiring seven to ten years or more to pay off, per tranche.
2. It does not allow the selling owner to de-risk their ownership position.
3. It is not financially accretive to the selling owner.
4. It provides no liquidity to the selling owner.

The result has been that sellers are disinclined to sell more than 10% to 20% of their businesses to next-generation employees/advisors using only this financing tool, leaving too large of a valuation gap to cover even with a bank-financed, Small Business Administration (SBA) buy-out upon the founding owner's full retirement, death, or disability. In cases where conventional bank financing can be utilized, the founding owner who gradually sells his or her equity must personally guarantee the loan to his or her successors, often making it an impractical solution. The result of failing to overcome these challenges is that too many practices become the target of acquisition rather than the target of investment.

FP Transitions has been focused on finding a solution to these problems for several years. That solution is the subject of this white paper.

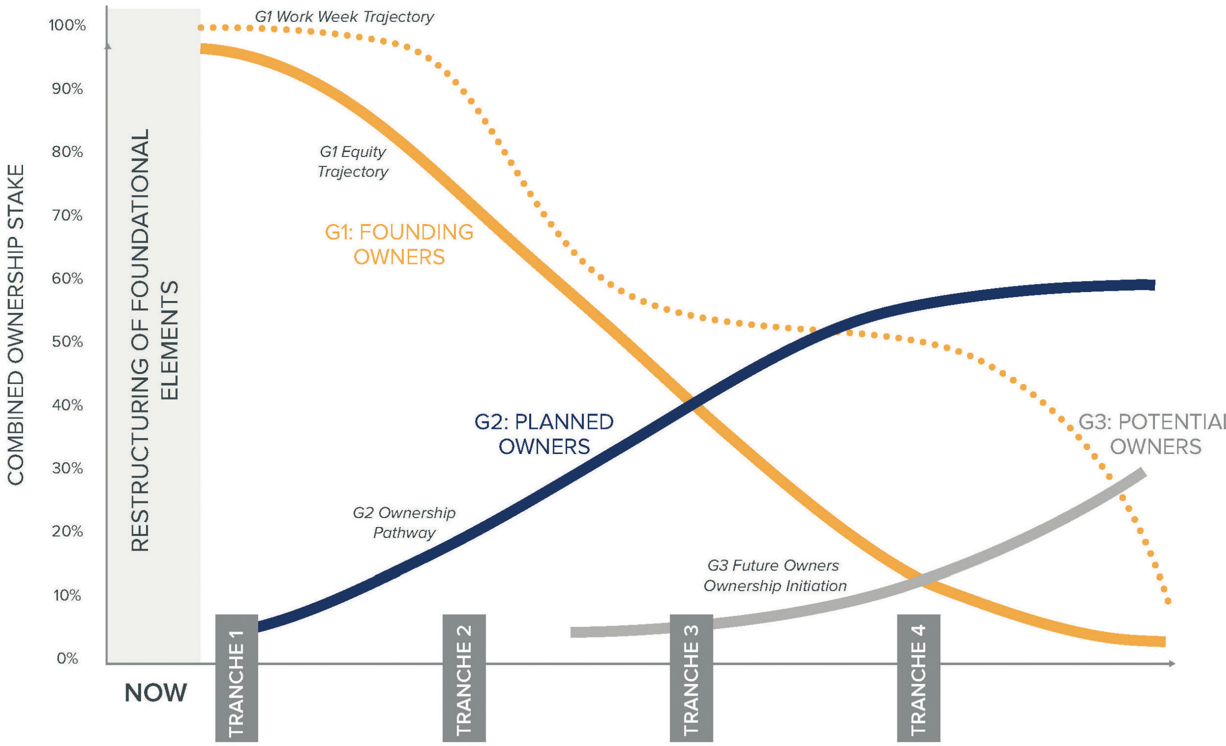
How a Succession Plan Works



The process of succession planning gradually transitions ownership internally to the next generation of advisors, referred to as the "successor team". This team is often comprised of two or more younger owners who collectively buy in to the ownership structure, starting with Generation Two or G2. G2s are about ten to fifteen years younger than G1s, on average. The accompanying illustration is not formulaic; the exact number of G2 and G3 owners depends on the goals and time frame of G1 and the value of the business.

The process begins when G1 sells some of his or her ownership (shares of stock in an S-Corporation or membership units in a Limited Liability Company), to the G2 level of ownership and later, perhaps, to the G3 level of ownership as well. Most succession plans start with a sale of 10% to 20% of the equity ownership to one or two G2s, cumulatively. Most plans tend to have one to four tranches (or steps), with each tranche lasting about seven to ten years, a time frame reflective of the financing process.

This staged succession solution often includes restructuring the foundational elements of the business to create an "investment worthy" enterprise. Every plan must carefully address issues such as share count, share price, growth rates,profitability levels, entity structure, time frames, compensation systems, and profit distributions. The natural decrease in the founding owner's time commitment to the business is also considered (see graph on page 3) and is matched to a staged series of equity sales to the successor team. It is expected that the successor team will continue to grow in number from tranche to tranche as next-gen advisors are recruited and retained by the growing business.



Tranche One is used, in part, to test or initiate the process. Accordingly, the first members of the successor team cumulatively acquire a minority interest in the business, usually through seller financing and the use of a *soft* or profit-based note with only a stock pledge as collateral; their willingness to take on debt and investment risk is key. G1, once convinced that the plan can work and that the successor team is up to the challenge of growing the business, is encouraged to move into Tranche Two as soon as the process allows, often before Tranche One has been fully paid for by G2.

Tranche Two includes not only the purchase of additional equity by G2 from G1, it tends to include a shift in financing methods from the soft or profit-based note to a more traditional *hard* or fixed-payment note structure, but again relying on seller financing requiring another seven- to ten-year repayment process. This is where the process often struggles and is prone to failure. As a result, it is not unusual that after Tranche One has been substantially completed, G1 simply elects to sell the business to a third party rather than work through additional tranches.

The point is that historically, some form of seller financing has been the primary methodology relied on for the early tranches of every succession plan. SBA-backed loans and lenders are generally not permitted to support a G2 buy-in of a 10% to

20% equity interest, for example. For G2 borrowers to qualify for such a loan, the G1 ownership level must bring their career to a close and sell ALL of their remaining ownership, and, for all practical purposes, relinquish all control, authority, and compensation with respect to the business they founded. Conventional bank loans, absent the SBA guarantee, require personal guarantees of all significant owners (i.e., those with an equity interest of 20% or more), *including G1*, which is rarely palatable to a founder gradually working less and less from one tranche to the next.

Succession Planning 3.0

Twenty years ago, FP Transitions launched the open-market concept for finding and matching the best of many interested and qualified buyers with one particular seller, and everything changed. Utilizing a shared-risk/shared-reward deal structuring process, the underlying client base quickly adjusted to the change of control and appreciated the continuing high-level of service provided by a larger, stronger buyer. Sellers, who had few choices other than to continue working, considered this to be their succession plan. Back in the day, Succession Planning 1.0 changed the industry, but it was clear that advisors needed and wanted something more.

About ten years ago, we pioneered the professional succession plans in use by this profession today, utilizing an entity structure, a modernized compensation system, and sophisticated cash flow modeling to empower next-gen advisors to become investors rather than competitors. Succession Planning 2.0 has worked very well and it has provided financial advisors with an important choice: sell all at once to a third party or sell gradually to a trusted team of key employees (perhaps even a son or daughter) and slowly retire on the job, mentoring the next generation.

Over the years, as advisory businesses grew in value, and the founding owners grew in age and often started the succession process a bit late, the shortcomings of seller financing became more apparent. Time after time, founding owners started their formal succession plans with optimism only to grow weary of the financing process and sell to a third party when the time for retirement grew closer and the need for liquidity became more pronounced. It became clear that a more sophisticated set of tools was necessary to address these challenges and to help bridge the gap between the generations of ownership. Welcome to Succession Planning 3.0!

The important elements to understand at the 3.0 level are these:

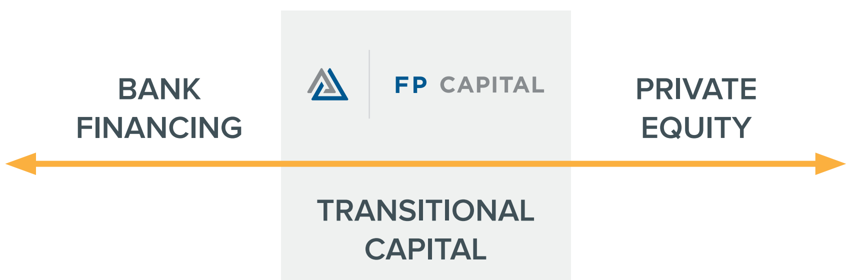
1. This solution-set utilizes transition capital, which means it is temporary in nature (five to ten years is common), and not a permanent buy-in as is the staple of consolidators and aggregators.

2. Transition capital marries ongoing business consulting with a combination of private equity and bank financing to support succession and sustainability goals.

3. Transition capital is designed for use by multi-generational partners working together to build an enterprise, not buyers and sellers in the M&A arena.

4. This process includes a credit augmentation function by FP Capital that effectively eliminates the need for G1 to guarantee the bank loans to the next-gen owners who are incrementally buying-in using conventional bank financing.

Transition capital has never been done before—this is a first for our profession. Functionally, FP Capital, supported by the FP Transitions team, becomes a minority owner of an advisory business, builds an equity bridge between the two generations of ownership from the inside, and then, when the work is complete, steps out of the picture, sells its stake to the successor team, and coordinates the financing of the final step. Along with the credit-augmentation function, this set of tools creates a seismic change in the way succession plans are designed and deployed.



Consider a situation where G1 and one or more G2 owners have already begun the first tranche of their plan. A couple of years later, with relatively little of the principal and interest paid off, G1 and G2 have several options as they consider the next steps in the succession process. Assuming G1 is not ready to fully retire and sell all of his or her remaining ownership, the current choices are to continue the slow, steady, seller financing pace, wait until G2 finishes paying off the first tranche before proceeding to sell any more stock, or resort to a conventional bank loan to pay off the first tranche and/or start a second tranche. Conventional bank loans typically require a personal guarantee from any owner with 20% or more ownership. This means that G1's risk is actually *increased* as the succession planning process unfolds—a non-starter for most founding owners.

> FP Capital works from within as a minority, non-controlling owner for up to ten years to bridge the gap between G1 and G2, financially and otherwise.

FP Capital offers a unique solution. By working with private equity and in coordination with a specialty lender, it is able to effectively provide the guarantee in the foregoing example, enabling G2 to obtain bank financing *without* requiring G1 to guarantee the loan(s). In addition, and as part of the entire FP Capital benefit package, conventional bank financing is provided at favorable lending rates that further support G2's buy-in efforts. As a result, G1 now has the ability to convert the balance of his or her seller financed Tranche One note to cash, and sell another round of stock in Tranche Two, also for cash, without having to sign a guarantee to the bank. This enables the succession plan to move much faster and, if desired, to shift the burden to G2 sooner, or as soon as desired without the pace of seller financing dictating the time frame.

The FP Capital solution-set is not a one-size-fits-all approach. Every transaction can be customized to work with the facts presented, and can be applied to virtually every step, or tranche, in the succession planning process. Every transaction will have its own timetable, ownership structure, transition plan, protection elements, and budget. FP Capital works from within as a minority, non-controlling owner for up to ten years to bridge the gap between G1 and G2, financially and otherwise. The ultimate goal is for G2 (and perhaps even G3 by that time) to gradually and completely buy out G1's position using a combination of private equity and bank financing with FP Capital's help. In the end, FP Capital is bought out too, leaving the locally-owned business in the hands of the next-generation successor team.

The Unsolved Phase of Succession Planning

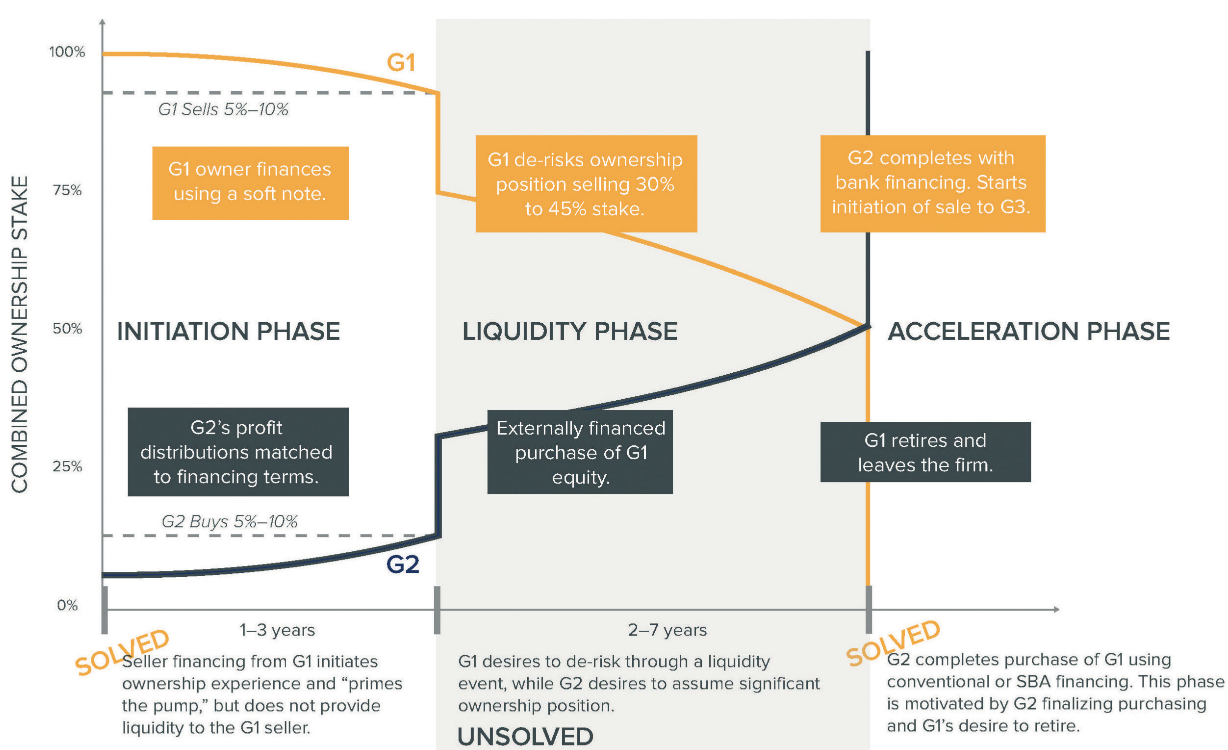
It is important to understand that regardless of business size, assets under management (AUM), number of founders, and number of next-generation advisors, most succession plans have three distinct phases to solve for:

- The initiation phase
- The liquidity phase
- The acceleration phase

As explained in the graph on page 7, the initiation phase is generally seller or owner financed. At this juncture, the G2 talent level is often ready to buy a significant stake in the business and is confident in their abilities, but they almost always lack the capital. Accordingly, the G2 debt-load is safely structured in Tranche One to match after-tax cash flow from the profit distributions of the commonly used tax conduit entity structures. However, since G1 is effectively funding their own buy-out in the early stages, often holding a promissory note with little to no down payment and a seven- to ten-year payout term (occasionally with a discounted valuation result to accomplish this goal as well as a low, fixed interest rate), G1's desire for liquidity and de-risking must be postponed until at least the second or third stages. This is not an anomaly; this is the norm for succession plans in this industry.

The third phase, acceleration, is often characterized by a complete buy-out of a retiring G1's position, usually in Tranche Three or Four. This phase also has a practical and tested solution. In most cases, this last phase is solved for through an SBA-backed loan, or even a conventional loan. SBA loans have become increasingly popular in the independent financial services industry, though not all advisors understand that such loans cannot be used in the early tranches for partial buy-ins.

The problem lies in between these two phases, and it is a significant and unsolved problem. FP Capital was created to address and resolve this critical issue—helping G1 de-risk their position (i.e., taking a significant part of their value home in the form of cash without having to guarantee G2's loans), maintain control, maintain a high-level of compensation, *and* support the development of the successor team. G1 owners are reluctant, and properly so, to provide significant seller financing beyond the initiation phase because it does not provide liquidity to them or de-risk their substantial



personal wealth position as an owner of the business. Finally, and frankly, waiting for up to two decades to be paid in full is just too long, aside from the fact that most seller financing is also minimally collateralized. For all of these reasons, FP Capital was created to build an equity bridge between the generations of ownership and resolve these and many other issues.

A Case Study (and a Solution)

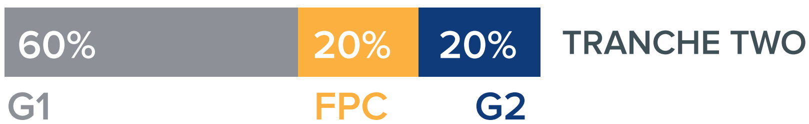
In this example, let's assume that in Tranche One, the goal is for ownership to move from this position:

to this position:

Let's also assume that the value of the independent advisory practice, ABC, LLC, has been appraised at $6 million. A 10% equity stake is worth, or costs G2, about $600,000 (not including interest on the seller financing, or any discounting because of the minority position). The G2 level of ownership includes two advisors, both working for the business on a W-2 basis, who buy in equally using a profit-based note which focuses on using profit distributions as the funding mechanism as opposed to W-2 compensation, with an anticipated amortization schedule of approximately nine years depending on the business's growth and profitability.

A little over two years into Tranche One, both G2 owners want more equity while G1 wants more liquidity. Transition capital can be used to accomplish both goals. At this point, the G2 owners still owe $500,000 on the Tranche One purchase (to put a number on it). Selling another 10% stake cumulatively to the G2 owners means that G1 effectively has to hold four notes that will be paid gradually over nine to ten years each. Bank financing in this situation is limited to conventional financing which will require G1 and the business to guarantee the new debt, with the previous debt either rolled up into the second purchase or subordinated to the lender financing the second purchase. Either way, G1 must remain very, very patient, fully active in the business, and be willing to take on additional risk in order to advance the succession plan.

In many cases, the better solution is to have FP Capital step into the succession plan in this example and allow it to acquire 20% of the equity in the business, backed by private equity. From this position, FP Capital will arrange bank financing for G2 to purchase another 10% of the equity at preferred rates, simultaneously refinancing any and all remaining debt from the initial equity purchase, without G1 acting as guarantor of G2's loans. In turn, G1 receives a check for $2.3 million (including the unpaid amounts from Tranche One), truly de-risking his or her position, moving ownership to this position:



Just to be clear, G1 remains in control as the majority owner and CEO, but in Tranche Two takes $2.3 million *off the table* at long-term capital gains tax rates. FP Capital comes on board not only as a financing partner but also as a minority equity partner in an advisory capacity, which enables it to solve the G1 guarantee issue on behalf of the entire successor team. FP Capital effectively builds an "equity bridge" between the generations. FP Capital's goal is to help ensure G2's overall success over the course of the transitional financing while supporting G1 as the majority owner and leader of the enterprise until G1 is ready to relinquish that role and/or fully retire. In most cases, similar solutions can be fashioned for almost any stage in the succession plan.

This case study is but one of many possible solution sets using the combined tools of transition capital, credit augmentation, and an internal, supportive equity partner in FP Capital, albeit on a temporary basis and in a non-control position. From the advisory client's perspective, the succession plan is a steady migration from one generation to the next with G1 still available and in the background as the relationships are gradually transferred to younger, invested professionals, just as law firms and CPA firms have been doing for many years. As G2 launches their own succession plan one day with G3 and G4 level owners, transition capital can also be used to "reset" the table and start anew.

Permanent Capital vs. Transitional Capital: The Funding Landscape

For younger advisors in the process of supporting a long-range succession plan, the goal in the financing operation is not acquisition, not a take-over or a buy-out, but rather the ability to participate in the process of transferring ownership, leadership, and production responsibilities from one generation to the next, gradually and professionally, even as the clients see the process unfolding—*especially* as the clients see the process unfolding. Next-gen advisors need help and support in this critical mission. What they don't need, and can't use, is a bank loan that effectively eliminates G1's involvement and support in the transition process, or a loan that requires G1 to underwrite all the risk. The goal in the succession planning process is to combine the talents of multiple generations and to blend their strengths to build a stronger business over time placing more of the burden on the shoulders of the successor team.

Current bank lending solutions are problematic, if not prohibitive, in the funding of minority equity positions for next-gen advisors. SBA lenders have strict rules to follow and gradual buy-ins of equity by G2 and next-gen advisors do not work in the early tranches of these plans. Conventional lenders have more flexibility but are usually unfamiliar with this highly-regulated industry and tend to find the lack of hard assets to collateralize the loan a non-starter; this also explains why SBA loans are favored by lenders.

Private equity has been used successfully in the financial advisory space but it is permanent capital and it impinges on the independence of the advisory business. Ironically, private equity is commonly preferred by G1 owners who cannot or will not sell internally to key staff members; it is the lack of a succession plan that precipitates the desire to bring in a permanent partner as lender and buyer. Private equity also is not designed for G2's use in a succession planning context, and the idea of selling the business to the lender in a roll-up operation is simply not palatable for most advisors if they have other options.

Source	Limitations
Seller Financing	• No liquidity • No risk transfer to buyers (away from G1)
SBA 7a	• Only available for complete purchase of equity (no partial sales) • Personal guarantee (G2) • Seller carryback • Standby provisions • Pure debt (low downside protection)
Conventional	• Unpredictable underwriting • Higher rates / Shorter term • Personally guaranteed by G1 (no de-risking of position) • G2 credit difficult to underwrite
Existing Private Equity	• Permanent investment • Change of control • Most firms in Sub $1B space are below target scale

All of these financing solutions result in a pure debt situation without the support of an equity-holding intermediary to participate in the strategic management decisions and to facilitate the transition plan alongside the successor team. Transition capital allows FP Capital to adjust the plan and debt-to-equity ratio to the realities of the business operation and its personnel *from the inside*. Transition capital is a new and totally unique tool for use in building a sustainable enterprise.

TRANSITIONAL CAPITAL

FP Capital Funding

- **Built for succession**
- **G1 de-risk**
- **Consulting/structuring create "investable" enterprise**
- **Equity vs. debt ratio flexible**
- **Not permanent, but transitional and regenerative financing**
- **Ongoing consulting support**

More Than a Retirement Plan for G1

One of the biggest challenges in a succession plan in this unique industry is an overdependence on the founding ownership level and its ability to almost single-handedly generate revenue and preserve client loyalty. This creates a problem should something happen to the primary advisor with no prepared back-up team in place to take over; in many cases, the one-owner practice model comes to a quick end or is sold to a third party. This is the challenge of continuity planning, very different from succession planning or exit planning.

The sudden death or disability (temporary or permanent) of the primary advisor is a real problem for an intangible, professional services model built around one person, and the slow-moving process of owner financing in Tranches One and Two. Transition capital can serve to develop a stronger, deeper, more invested successor team sooner by virtue of having the entire FP Transitions team available to guide and address issues that may arise during the course of the plan.

FP Transitions pioneered many of the early versions of continuity plans. A continuity plan, at least at this level, is a formal, written contract that assures a seamless transfer of control and responsibility in one single step. It is triggered in the event of a sudden departure from the practice or business of any of its owners, young or old, and whether by choice or through termination of employment, a partnership dispute, and certainly death or disability. The common terms applied to a continuity arrangement are a Shareholders Agreement (as with a corporation), a Buy-Sell Agreement, or even an Operating Agreement (for use in an LLC).

The process of succession planning is the single best solution for solving the continuity planning problem once the successor team is in place, substantially invested, and the clients look to them and respect them as owners and leaders. By the end of Tranche One, or certainly by the start of Tranche Two, even a minority equity interest has often become the single, largest most valuable asset G2 owns, and protecting that value against all threats becomes “job one” for the entire team.

FP Capital’s role as a transition capital source, equity partner, and credit augmentation facility eliminating G1’s guarantor role, also permits it to act as a stabilizing force for the advisory business depending on who is first to exit, why they exit, on how much notice, and the value of that individual’s equity interest. Having a capital source that is integral to the business and the industry, who cooperates with and coordinates the multiple generations of ownership, matters even more in times of crisis.

What if everything doesn’t go as planned?

Not every successor team achieves complete and total success. If the plan fails, or said more correctly, if the founder(s) and next-generation advisors are not successful in transitioning the entire business internally over time from one generation to the next, an external sale or merger remains a distinct possibility. Regardless, if the plan succeeds only in growing or stabilizing the business and providing continuity protection for temporary disabilities or interruptions in the founder’s ability to run the business day in and day out during the last five years of his or her career, some very important tasks can still be accomplished.

Growing a profitable, highly-regulated business while coordinating the roles of many contributors and shifting leadership from one generation to the next is difficult. How can a plan that *comes off the rails* be fixed? What if the G2 next-gen owners don’t stay on board for the entire duration, or in sufficient numbers? What if someone changes their mind? What if G1 has a health issue or some other problem and needs to accelerate the plan much sooner than originally anticipated? These are all possibilities that need to be addressed during the plan development and design stage and resolved quickly during the period of plan support and adjustment. In fact, these issues are all a part of the succession planning process.

In terms of specific solutions, FP Capital can mediate the differences and help the G1 and G2 owners work through the issues with the perspective and authority of a neutral, experienced third party and the motivation of an equity partner. Another possibility might be to find an outside buyer, a very similar firm, but two- to three-times the size of the business at issue. Another solution could be to merge the business with a similarly-sized business but with a younger ownership structure, or even to assist with the on-boarding of one or two key role players over time as part of a comprehensive plan to augment the current team of owners.

FP Capital, powered by the teams at FP Transitions and a leading private equity firm, has the unique ability to provide practice management support and M&A guidance which creates an almost exponential set of possible solutions over time. FP Capital has the unique ability to not only counsel on these “fixes,” but to implement them as well from within the business as both a debt and equity partner—in coordination with G1 and G2 level owners.

More Problems Solved

- One of the common problems that independent advisors face in building a sustainable business is that they are often starting the process too late. Most succession plans are designed to last for three tranches, with each tranche taking about seven to ten years to complete. Simple math suggests this is a 20- to 25-year process for most G1s. When G1 starts the process at age 63, for example, and wants to be able to fully retire, or at least have that choice within ten years, the succession planning process will likely need to be significantly accelerated. Transition capital can solve this problem by providing G2 owners the ability to substantially accelerate their buy-in once the foundational elements are in place.

- Independent advisors struggle with compensation more than any other issue. In a succession plan, compensation is often more about answering the question of “How?” rather than “How much?” Regardless, an incorrectly structured advisor compensation system (which is almost a given in this industry), significantly and negatively impacts both growth and profitability. As key employees become equity partners and as the G1 level of ownership begins to throttle back on their work-week trajectory, compensation issues require continual monitoring and adjustment.

  FP Capital, with support from the FP Transitions team, is perfectly situated to watch over the evolution of the ownership level compensation system, balancing the needs of G2 to make their house payments and student loan payments with G1’s goal of realizing value built over a lifetime. As an intermediary and technician, and as a debt and equity partner, FP Capital can help solve these problems early on and mediate the disparate positions as only a fellow owner can.

- Fee-based and fee-only practices are among the highest valued professional service models in America. This is good news for the founding owner, but it can be a real problem for next-gen advisors. Simply stated, the value of an RIA practice can outpace the ability of the next-gen advisors to purchase it, leaving founders to work forever or to sell to a third party at some point.

By creating an *equity bridge* between G1 and G2, FP Capital can effectively help the successor team catch up, utilizing private equity and supportive bank financing to overtake the growing value of the business they want to buy in to, and one day complete the buy-out of the founding owner or ownership team. Investment bankers prey on this dilemma and offer their services to find an outside buyer as the only available solution. FP Capital offers an alternative by working from within and coordinating the functions of seller financing, private equity, and bank financing to empower the internal succession route.

Conclusion

FP Capital, with support from the team at FP Transitions, a conventional and SBA-qualified bank, and a private equity firm, works from within an advisor's business structure as a motivated, experienced equity partner, coordinating the use of private equity with specialized bank financing in order to bridge the gap between the founding and succeeding generations of ownership and build a sustainable business. Once that goal has been achieved, FP Capital steps out and relinquishes its equity stake to the next generation of advisors and owners, again helping to facilitate and coordinate the third-party financing necessary for the task.

While the benefits to the founding level of ownership (G1) are obvious, this unique equity/debt structure allows FP Capital to champion the next generation of ownership and leadership in the financial services industry. Next-gen advisors need a very flexible capital partner to support their investment role. FP Capital, with the ability to be both an equity partner and a debt facilitator during the critical transition period, is best suited for this job. Transition capital can do things that permanent capital and lenders are simply not capable of, and which this profession needs to bridge the gap between the generations of ownership.

NOTES

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