DEAL STRUCTURING FOR THIRD-PARTY TRANSACTIONS

Over the last decade, deal structuring for acquisitions of an independent advisory business has evolved and matured. The result is a set of financing mechanisms that recognize business value, promote a successful transition, and provide tax advantages to both parties. This white paper provides a high-level overview of how to begin the negotiation—and deals to avoid.

KEY COMPONENTS:

- *Balance financial risk between buyer and seller*
- *Understand and limit tax consequesnces to both parties*
- *Recognize full value of the people, processes and structure of the business–not just revenue*
- *Allow one-time price adjustment for attrition due to transition of ownership*

ASSET SALE

In arms-length transactions, asset sales are the norm. In an asset sale, the acquirer purchases the seller's goodwill (i.e., client relationships), post-transaction consulting support, and the seller non-compete agreement. The acquirer does not purchase any of the liabilities of the seller.

PRICE & TERMS

Most negotiations begin with a third-party valuation of the business being sold. FP Transitions' market-based valuation is considered the industry standard for assessing business value, and analyzes the business using the three major valuation indexes: cash flow quality, transition risk, and marketplace demand. The Comprehensive Valuation Report also includes an assumption of average deal terms used in the market. The actual terms of the transaction can change the ultimate purchase price. As of the publication of this article, the typical deal is structured with the following elements:

- *Seller financing on 98% of deals*
- *31% of purchase price paid at closing (cash down payment)*
- *69% of purchase price financed on a contingent promissory note carried by the seller*
  - *12 month look-back to adjust promissory note for attrition or drop in market*
  - *4 year financing term, on average*

SHARED RISK, SHARED REWARD

The various components of an asset sale serve to balance the risk between the buyer and seller. By making a substantial down payment, the buyer establishes their commitment to ensure all clients are served; the seller's reliance on long-term, contingent financing emphasizes their obligation to see the business transferred in its entirety. It is important that both parties can work together after the sale to transfer the client relationships and realize value to both buyer and seller post-closing.

ANTIQUATED TACTICS

As recently as 2010, revenue sharing and earn-out arrangements were a common element in arms-length transactions. However, they have quickly fallen out of use. Depending on the specifics of the transaction, common drawbacks to production-based payment structures include:

- *seller may be required to remain licensed through the entire earn-out period, at added expense*
- *payments to seller may be taxed at ordinary income tax rates, rather than long term capital gains*
- *purchase price paid to the seller will be controlled by the buyer's production ability*
- *buyer has a disincentive to serve smaller clients*

For further information on FP Transitions' valuation methodology, deal structuring, and transaction support, contact FP Transitions at (800) 934-3303.

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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