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TRACK:	<i>PRACTICE MANAGEMENT & TECHNOLOGY</i>
SESSION: 979045	THE BEST FRIEND AND WORST ENEMY – CREATING SUCCESSFUL PARTNERSHIPS
	MONDAY, OCTOBER 12, 2009
	10:00 AM -11:45 AM
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Philip Palaveev is the President of Fusion Advisor Network – a \$50 million in revenue franchise network of independent advisors that provides business management and collective bargaining services to its members. As president, Palaveev is responsible for the strategy of the firm and leads the practice management development for Fusion, focusing on helping the 200 advisors grow their businesses. Prior to joining Fusion, Palaveev was a principal of Moss Adams LLP and led the market research for the firm as well as consulted with broker-dealers and registered financial advisors on issues of strategy, competitive positioning, and financial performance. As head of research, Palaveev developed the content of a series of reports with high impact on the advisory industry, including the Moss Adams Financial Performance and Compensation Surveys of Financial Advisors, Financial Services Institute Broker-Dealer Compensation and Financial Performance Studies and industry reports such as “Real Deals: Definitive Information on M&A of Advisory firms,” “The Future of Operations” and “Dually Registered Firms.” His consulting clients included many of the largest custodians, clearing firms, broker-dealers, banks and CPA firms as well as over 100 advisory firms that he has worked with. Mr. Palaveev holds an MBA from the Charles H. Lundquist School of Business at the University of Oregon and a Bachelor of Arts in Economics.

	<h2>Best Friend and Worst Enemy</h2> <p>Creating Successful Partnerships</p>
	

What is a Good Partnership	
	<ul style="list-style-type: none">▶ A firm that has more strategic options, better quality of client service, more resources and improved economics▶ A collegiate atmosphere that fosters sharing of ideas and knowledge▶ A strong culture that helps attract and retain people▶ Shared management responsibilities that enhance the ability to run the business▶ Larger footprint in the local market▶ Enhanced financial security and continuity
	

The Foundations of a Good Partnership	
	<ul style="list-style-type: none">▶ Clear understanding of roles and responsibility▶ A structured process for making business decisions▶ A mechanism for transparency and feedback into each others area of practice▶ A well thought out compensation method▶ A mechanism for changing equity ownership over time
	

What is a Bad Partnership

- ▶ Lack of shared vision for the firm
- ▶ Lack of respect between the partners – professional or personal
- ▶ Unclear responsibilities resulting in confusion and resentment
- ▶ Poor communication
- ▶ Fractured decision-making
- ▶ No decision-making discipline
- ▶ No accountability to each other



Why Advisors Come Together

- ▶ Advisors join offices typically for one or more of the following reasons:
 - Obtain critical mass
 - To create certain resources necessary for the wealth management business simply require a larger office than each of the practices can afford
 - Create economies of scale
 - Staff leverage
 - Efficient space use
 - Certain technologies
 - Payouts
 - Appear larger
 - Market as a larger entity
 - Assuage continuity concerns among clients
 - Provide back up
 - Share expertise
 - Technical specialization in specific areas
 - Knowledge of specific markets
 - Pursue strategy as a firm
 - Transfer the "brand" to the firm and away from the individuals
 - Pool intellectual and financial capital



Types of Partnership Deals

- | | |
|---|---|
| <ul style="list-style-type: none">▶ Internal Promotion<ul style="list-style-type: none">■ An employee buys into the firm and becomes a partner■ Often the second partner/owner in the firm■ Often part of a succession plan | <ul style="list-style-type: none">▶ Merger<ul style="list-style-type: none">■ Two or more established practices combine■ A surviving firm is formed■ Shared equity and profits■ A common brand and presence in the marketplace |
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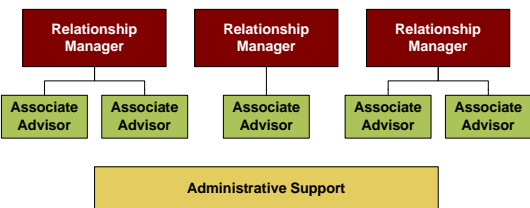


Two Possibilities – One often is a Step Towards the Other

- ▶ Roommates
 - Share office
 - Share staff
 - May have buy-sell and back-up agreements
 - May share firm name
 - May agree on shared technology platform
 - Separate economics
 - Separate equity
 - Separate client base
 - Somewhat different methods of service
- ▶ Partners
 - Share strategy
 - Share economics
 - One client base
 - One pool of equity
 - Joint marketing
 - Joint sources of referral



The Silo Model




Expectations

- ▶ Be clear what you expect from each other? Leave the dollars and cents out of the discussion for now:
 - Space – how much, what kind, be specific
 - Staff time – whose, how much, how often, at what times, what priority will you have, what will be the joint staff
 - Responsibilities – what staff will be responsible for what, what will be the role of key employees
 - Office equipment – how much, when, priority, commitment to maintain
 - Mentorship – on what issues, how will it make an impact
 - Client help – who will help who, when, how
 - Back up – who, when, under what circumstances
 - Joint marketing – is it too early to discuss, who will you market to, how, who will spend how much time
 - Joint strategy – do you have the same understanding of “wealth management,” service methods, investment philosophy



Partner Compensation


- Partners are employees - there has to be compensation for responsibilities as an employee of the firm
 - Base salary
 - Draw
- There has to be a performance component that rewards contribution
- Share of the profits



Economics of the Firm


Revenue	100%	All commissions and fees paid by client
Professional Compensation	40%	Including partner base or draw
Gross Margin	60%	
Overhead	35%	All other expenses
Operating Profit	25%	Available to equity

For illustrative purposes only. Individual results may vary.



Contribution vs. Equity

<p>▶ Contribution</p> <ul style="list-style-type: none"> Current revenue generation Current client responsibilities Favored by younger – rising stars Favors growth In danger of creating silos 	<p>▶ Equity</p> <ul style="list-style-type: none"> Historical contribution Reputation Risk taking Capital at risk Favors stability and longevity In danger of creating a stale and overly conservative firm
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The Roommate Model

- ▶ Generally two models for "roommate":
 - Cost specific model
 - Real estate by the square foot
 - Staff by percent of FTE (what about pay raises?)
 - Other consumables and bills on a per capita basis
 - Very specific and exact method
 - Some parameters are not easy to define
 - May result in some penny pinching
 - Payout model
 - A percent of on of the advisors revenue – usually around 15% +/-
 - The logic is that revenue drives cost
 - The logic is not very strong in all expense categories – people and clients tend to be a driver too
 - The percent is not scientifically established – just a guess
 - Friction as Paul's practice grows



Structuring Ownership

- ▶ Participation in management
- ▶ Participation in firm policy making
- ▶ Voting mechanisms
- ▶ Ownership of specific assets (e.g., a client base)
- ▶ Right to block specific decisions
- ▶ Buy-sell agreements
- ▶ Rights of first refusal
- ▶ Requirement to sell on exit




Internal Transactions – Buy-Sells

- ▶ Becomes effective upon the death or disability of one of the parties
 - It should be specific about the circumstances when it becomes effective
 - It should be clear in it's definitions
- ▶ Sometimes covers voluntary retirement
- ▶ The surviving partner is obligated to acquire the business
- ▶ Payments are made to the estate
- ▶ The valuation is based usually on a formula or a mutually agreed third party expert valuation




Merger Structure

- ▶ Valuations are irrelevant since there is no payment
- ▶ Relative valuation is key how much one firm is worth relative to the other
- ▶ Example – Firm A has \$2 million in revenue, Firm B has \$1 million in revenue
 - If we use a 10 X revenue multiple – Firm A has \$20 million in value and B has \$10 million in value. A gets 66.6% of the surviving firm and B gets 33%.
 - If we use a 1 X revenue multiple – Firm A has \$2 million in value and B has \$1 million in value. A gets 66.6% of the surviving firm and B gets 33%
- ▶ Often revenue is used to determine the percentage ownership but the real criteria is profit
 - Are the two revenue streams similar?




When Partnerships Don't Work

- ▶ Lack of trust between the partners
- ▶ Lack of respect
- ▶ "My practice is better..."
- ▶ Uncompensated contributions are part of a partnership
- ▶ Unwillingness to manage the business
- ▶ Side businesses – legacy clients or outside businesses
- ▶ Unwillingness to surrender control
- ▶ A tangle of personal and business expenses confusing the economics



Can You Add Partners Now?

- ▶ Successful firms lay solid foundation and continue to invest in their business
- ▶ Talented people will always be hard to find
- ▶ Your decisions in difficult time have a magnified effect on your firm culture
- ▶ The firms that benefit most from the recovery are the firms that have created productive capacity
- ▶ It is invaluable to have a partner in tough times

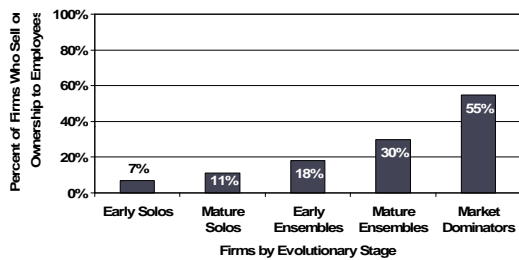


Who Are The Firms Who Capture The Rebound

- ▶ Have the people in place to devote significant amount of their attention to business development
- ▶ Have clients who are satisfied with the advisor and willing to refer
- ▶ Have a well organized office workflow that does not struggle if client load is increased
- ▶ Take decisive action when the opportunities present themselves



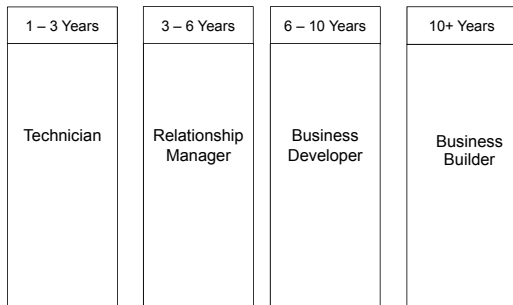
Opportunity to Obtain Ownership



Moss Adams LLP, 2007 Moss Adams Compensation and Staffing Study of Advisory Firms. Sponsored by JPMorgan Asset Management and SEI Advisor Network. Seattle: Moss Adams LLP, 2007



The Career Path



The Key Questions

1. What are the criteria for making partner in your firm?
 - Financial contribution
 - Skills and abilities
 - Character
2. When do we expect the candidate to meet these criteria?
3. What is his compensation before he makes partner?
4. What is his compensation after making partner?
5. How will he become partner?
 - Stock purchase
 - Stock options
 - Profits Interest
 - Phantom Stock
6. How do we finance the purchase?



Who Should be a Partner?

- ▶ Contribution to the firm
 - Revenue
 - Retention and growth of existing clients
 - Intellectual
- ▶ Maturity
 - Decision-making
 - Employee management
 - Community presence and representation
- ▶ Ability to bear risk
 - Financial
 - Professional liability
- ▶ Character



Partner or Employee?

	Partner	Employee
Responsibilities	<ul style="list-style-type: none"> • Authority and expectations to make independent decisions • Manages a defined practice or department • Makes a vital contribution to the business – sales, intellectual capital or other 	<ul style="list-style-type: none"> • Authority to make decisions within the firm policies and workflow • Manages projects or clients • Contributes, time and skill that are important inputs but can also be found in the open market
Financial Stake	<ul style="list-style-type: none"> • Profitability • Job compensation • Value created 	<ul style="list-style-type: none"> • Job compensation • Incentive compensation • Profit sharing or other long-term incentives



What Are The Criteria (Example)

1. Become a complete financial advisor
 - Service a client without any help
 - Competence, experience and judgment
2. Business judgment and acumen
 - Train his replacements completely
 - Demonstrate he can manage the department (operations)
 - Continue representing the firm in the community
3. The business reaching \$3 M in Revenue
 - Candidate will show ability to generate revenue from existing clients and referrals for new prospects
 - He has to be relationship manager for at least 50% of the households and/or 20% of the revenue



The First One is the Toughest

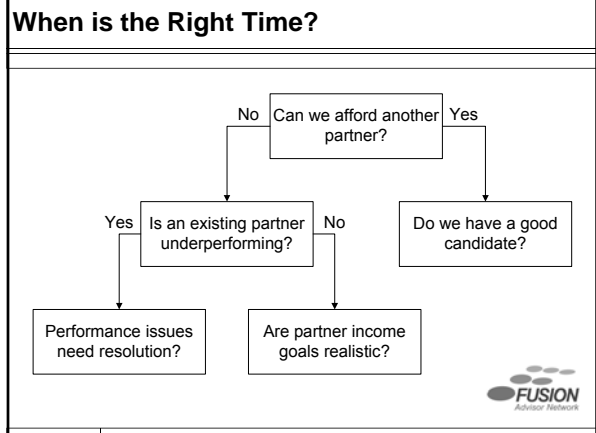
- ▶ When can you share equity without diluting income:
 - Choose your baseline goal for income – discretionary
 - Determine your personal compensation
 - \$250,000 to \$400,000
 - Determine candidate compensation
 - Establish salary and bonus plan
 - Establish your normal profitability
 - Should be 20% to 25%
 - Determine percent equity to be shared
 - 5% to 10% for first candidate
 - How much revenue do you need in order to get to that level of profit
 - $(\text{Your base profit} + 5\% \text{ to } 10\%) / \text{Normal profit}$



Example

- Choose your baseline goal for income – \$500,000
- Determine your personal compensation
 - \$300,000 base salary
 - \$200,000 target profit
- Determine candidate compensation
 - \$100,000 in salary updated yearly based on industry surveys
 - 10% of revenue managed by the employee-advisor
- Establish your normal profitability
 - Should be 25%
- Determine percent equity to be shared
 - 5% initially with another 5% to be made available after first buyout is complete
- How much revenue do you need in order to get to that level of profit
 - $(\$200,000 + 5\%) / 25\% = \$210,526 / 25\% = \$842,000$





- ### What are the Other Options
- ▶ The features of ownership:
 - Right to share of profit of the firm
 - Right to share of sale proceeds if the firm is sold
 - Right to vote
 - ▶ Phantom stock or SARs – share of sale proceeds or equity appreciation but no profit claim and no voting rights
 - ▶ Preferred stock – can be customized for voting rights, profit distributions and equity value
 - ▶ Income partnership – share of profits but no voting or equity
 - ▶ Stock options – lock a price, defer the real equity effect
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How?

	Options	Stock	Profit Interest
Pros for Owner	-Can be used repeatedly with many employees	-Cashing out	-Encourages growth -Preserve the existing level of profits and value
Cons for Owner	-Not enough "skin in the game" until buying the stock -No cash out to owner	-Immediate sharing of control and profits	-Not attractive in slow growth scenarios

How?

	Options	Stock	Profit Interest
Pros for Candidate	-No immediate cash outlay -No downside -Can be offered early -Can be offered to many employees	-Immediate participation in profits and voting -Real ownership -Access to cash income	-No cash needed -No taxable event -Participates in the upside -No downside
Cons for Candidate	-No participation in profits -No decision making	-Requires cash investment -Can decline in value -Exposes the candidate to legal liabilities of the business	-Not attractive in slow growth scenarios -Zero basis



Some Notes

- ▶ What should be my baseline income?
 - No science here – start with last year
 - How sustainable/realistic is that number
- ▶ What should be my baseline income:
 - How do you pay employees – what do you value?
 - What is your compensation logic/philosophy?
 - How would it apply to you?
 - What do surveys say?
- ▶ What percent to share?
 - First time – firms under \$3M – 5% to 10%
 - Secondary purchases – 1% to 5%
 - Large firms – 1% to 5%
 - How many candidates are pending in the next 5 years?




Why Firms Merge

- ▶ To create a larger pool of resources and capabilities
- ▶ To create synergies between practices
- ▶ To unite similar practices under a common brand
- ▶ To tackle succession issues in the future
- ▶ To gain higher multiple from an acquirer



Financing

- ▶ Loan from owner(s)
- ▶ Loan from the business
- ▶ Loan from the bank
 - Likely guaranteed by the other owners or the business
- ▶ Loans from third-party private equity
 - Large firms
- ▶ Sale of minority interest to a third-party
 - Large firms



Valuations

- ▶ Issues to consider:
 - Internal deals are almost always for lower valuation than the external ones
 - Internal buyers are buying a minority interest but the seller is often selling a majority interest
 - External deals are almost always for controlling interest rather than minority interest
 - The terms of external deals contain many contingencies and payments over time
 - Rules of thumb are dangerous if the profitability of the firm is behind the "standard"

