Financing succession – funding your equity stake

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Malcolm Arnold has worked in the finance sector for over 15 years in management and senior management roles covering corporate and business banking, retail banking and training and skills development. Malcolm holds a Masters in Applied Finance as well as a Bachelor of Economics. For over three years Malcolm has been providing specialist banking services to the financial planning industry, having been involved in more than 100 transactions across Australia. These transactions have included acquisitions and divestments of practices/dealer groups, succession planning strategies and purchase of business premises. Malcolm currently leads the National Australia Bank's Financial Planning Banking team. He is responsible for the development of new business and implementation of NAB's strategy for providing specialist banking services and solutions to owners of financial planning businesses.

Whether you're a Generation X or Y financial planner or a current financial planning business owner, a great deal of planning is required in order to be successful in your succession strategy.

As a specialist provider of banking services to the financial planning industry we've provided business finance to over 500 financial planning practices around Australia across a wide range of licensees.

Over the past 5 years we have seen an increase in the number of financial planning business owners looking to secure their own retirement and the future of the businesses they have spent considerable time building. Traditionally, the vast majority (over 70 per cent) of transactions presented to specialist financiers were all about business owners looking to grow their existing practice. But in more recent times at least 50 per cent of transactions revolve around succession planning needs, often involving the direct financing of new and young equity partners into the business.

A number of key factors have driven this market growth. An ageing population has meant that the average age of the business principal in the financial planning industry is on the increase. And the shortage of talent has meant business owners are using equity to motivate and retain their key people for the long term benefit of the business.

The increasing average age of business principals within the industry has motivated more of these business owners to focus attention on managing their own succession plans. And a significant number of business owners will be looking to either transact a trade sale or transfer equity to a new owner in the coming few years. The latest research from industry consultant Bob Neill, who manages succession at MLC, reveals that more than half of financial planning business owners are over 50 year of age.

MLC research also indicates that some 88 per cent of business owners have indicated a need to raise finance for their business.

In the past, financial planners looking to purchase equity in an existing practice had limited options. Many either sought to borrow informally from family or friends or negotiate vendor finance terms with the business owner from whom they were purchasing. The only other option was bank finance leveraging personal assets. However many younger advisers don't have sufficient equity in personal assets (such as property) to make this a viable option.

More recently the banks have started recognising the increasing opportunities within the financial planning industry. Many of the leading financiers already offer some sort of funding solution against business assets, which enables young advisers to finance an equity purchase in a financial planning practice.

It has become well-recognised as an effective solution for both parties with the more prudent financiers offering the following:

- Cost effective pricing when compared with more traditional property-based lending;
- The ability to finance up to 100 per cent of your equity purchase;
- Up to 10 years debt payback;
- The flexibility of interest only options;
- The ability to package both business and personal borrowing needs, allowing tailoring of your debt repayment program to most appropriately suit your individual circumstances.

While leveraging against the business provides a neat finance solution for the asset-poor young planner, it does carry some complications and requires a good working relationship between buyer and seller.

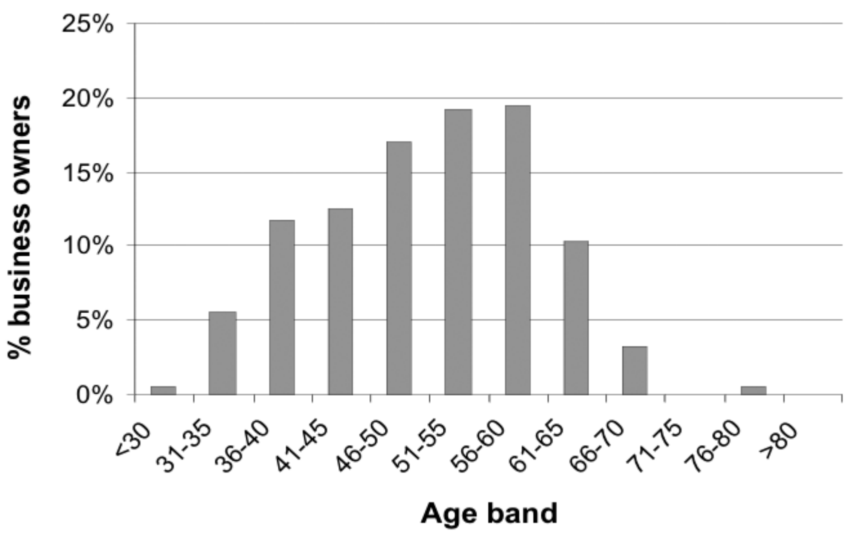
The standard security taken by the banks for this sort of lending is a fixed and floating charge (or mortgage) over the business. This poses a problem for an adviser buying an equity stake but not the entire business. The bank requires a mortgage over the whole business, even though the buyer may only be purchasing a minority stake. Just like buying a house, you can't raise finance by mortgaging the front bedroom alone.

This means the seller who retains the majority stake must agree to a charge over their business. While of course the bank only has claim to the value of the loan, in a worst-case scenario the bank can require a sale of the business if default occurs. So in effect the majority owner is taking on some risk in order to facilitate the sale. This can lead to tensions down the track and it is important to document all agreements at the outset.

There are a number of organisations taking advantage of this current market growth and offering financial solutions. However, there are some important factors to consider when choosing the right financier:

- Some, but not all, financiers offer specialist bankers with industry knowledge and experience in managing the type of transactions financial planners will be seeking to undertake. Your ability to locate a specialist financial planner banker is likely to make your experience with your bank a lot more pleasant and lead to significant ease in doing business with them. They are most suited to provide you with best practice solutions and ongoing business support.
- Minimum loan amounts apply with some financiers who seek to participate only in the larger and more profitable transactions in the marketplace.
- Valuation methods vary with some banks leveraging against recurring income while others leverage against profit. In all cases a standard leverage ratio of at least 50 per cent of market value should be attainable.
- Some financiers will seek an independent external valuation or due diligence report on the business, often at considerable expense to either you or the business owner. Ask your financier upfront if this can be done internally at no additional cost.
- Some financiers will require a tripartite deed (between the business, dealer group and bank). This gives the bank the ability to liaise with your dealer group if problems occur and, if required, seek direct access to your revenue stream.

Figure 1. Financial planning business owners age profile



In assessing your application a financier will be reviewing and assessing the same fundamentals that you as a potential equity holder should be examining:

- The historical performance of the business;
- Evidence of a clear business plan or strategy;
- A certain level of business forecasting and an understanding of the associated implications;
- Analysis of the existing client base serviced by the business, including client demographics, the level of client segmentation;
- The ultimate potential of the business to grow the client base;
- The key people within the business and how the current owners are motivating and working to retain their employees;
- The likely impact on performance from the introduction of a new equity partner;
- The employment history and qualifications of the current and proposed owners;
- The individual financial position of the new equity partner and their ability to service all debts from proposed cashflows;
- The longer term transition plan for any exiting owners.

Financiers looking to finance your equity purchase are themselves making an investment in that same business. So they need to be confident that the business will be successful. It's important for the potential purchaser and the current business owner to provide all required financial information to the financier.

It's also important to be across current industry regulations. If you're looking to buy into a business and thinking of financing your equity purchase using the business itself as security, you need to be aware of potential complication with Corporations Law (section 260B) and the need to address financial assistance issues. These regulations also apply to the business owner. In simple terms there are certain restrictions around the ability of a borrower to raise finance to buy shares in a company when that same company is being offered to the Bank as security for the borrowings. Financial planners need to seek guidance from their own legal advisers in such circumstances and ensure they comply with the various requirements to prevent a Corporations Law breach.

For an aspiring or new business owner, the following tips should help get you on the right track for success:

- When buying into a business ensure you have clear objectives and know what it is you plan to achieve;
- Take a structured and long-term approach to your investment. Plan five to 10 years ahead;
- Ensure your are well organised and that you seek external support where required (accountants, solicitors, industry consultants, business coaches);
- Seek advice from business owners within the industry and make the most of networking opportunities and industry organisations;
- Start planning early as a successful strategy will likely take years to implement;
- Put everything in writing and ensure you have appropriate contracts and agreements in place to cover both you and the existing business owner;
- Engage your financier early in the process to ensure you understand what they require from you and that they fully understand the transaction. This will allow for greater flexibility and a solution fits your particular needs.

Ultimately almost all finance sought by financial planning business owners will impact the succession strategy. Even where finance is sought to expand the business, ultimately this will affect the value of the business and make the practice more saleable in the longer term.

Figure 2. Financial planning loan structures