



EPISODE TRANSCRIPT

Financing Independence: A Lender's Perspective on Breakaway Transitions, M&A, and Succession

A conversation with Louis Diamond and James Hughes, SVP, Head of Investment Advisory Lending at Live Oak Bank.

Mindy Diamond:

Welcome to the latest episode of our Podcast Series for Financial Advisors. Today's episode is Financing Independence: A Lender's Perspective on Breakaway Transitions, M&A, and Succession. It's a conversation with James Hughes, SVP and head of investment advisory lending at Live Oak Bank. I'm Mindy Diamond, and this is Mindy Diamond on Independence.

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Whether you are a prospective breakaway advisor looking for liquidity to de-risk a leap to independence or pay off a note balance, or a business owner seeking funds for acquisitions or succession planning, you have an important decision to make around accessing capital. Because as the wealth management industry landscape has evolved, advisors became the beneficiaries of a few pathways to consider. In several other episodes of this series, links to which you can find on this episode's page on our website, we've looked at options to sell a portion of the business, that is, equity to any one of the many minority investors or private equity firms in this space. It's an option that's fueled a super hot M&A market over recent years.

Additionally, we've looked at independent broker dealers and many supported versions of independents that offer forgivable loans to help fund the transition. But what about direct financing options? That is, taking on debt as a way to fund the next phase of success for your business? In this episode, we explore that path with James Hughes, the SVP, and head of investment advisory lending at Live Oak Bank as the number one SBA, or small business association lender in the country, the bank started lending to advisory practices back when James came on board in 2013, at a time when there were few other options available in this space. So, in this episode with my partner Louis Diamond, James talks about the benefit of taking on debt versus selling equity. He shares the many reasons advisors opt to work with the bank and how Live Oak stands out, not only amongst others in the space, but equity partners as well. James discusses key use cases and what advisors and business owners need to have prepared before taking on debt, and much more. It's an important episode for both prospective and current business owners. So, let's get to it.

Louis Diamond:

James, thank you for joining us today.



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James Hughes:

Louis, thanks for having me.

Louis Diamond:

Very good. Why don't you tell us about yourself and how you found your way to Live Oak Bank as head of investment advisory lending?

James Hughes:

Sure. I grew up in New Jersey, went to school in Pennsylvania, moved to Manhattan right out of school, started working for Morgan Stanley, spent about eight, nine years there. Then I also just got tired of the city and I met my now wife. She's from North Carolina. And her sister was working for Live Oak. And Live Oak is based in Wilmington, North Carolina, this beach town in North Carolina. When we were living in New York City, the beach sounded good. So, I interviewed for a couple different roles at the bank, and eventually got a job in 2013, and we moved down. We moved from Brooklyn to Wilmington, North Carolina. It was definitely a big change.

My first role at the bank was actually in our secondary market selling our loans to the secondary market. I had my Series 7, and I think that's sort of where they needed help, they needed a sales trader there. As I spent more time with the bank, I really fell in love with the small business aspect of what we do and the stories of our customers. I would go to credit committee on Fridays, where we get together as a bank and we discuss all the different credits that we're approving that week.

Just hearing the loan officers talk about the individual stories was really inspiring and something I didn't have in my previous roles at Morgan Stanley or my current role at Live Oak. So, I went to my boss and I said, "Listen, I want to get out of this securitization business and into lending. I want to do small business." They said, "Okay, well, I think that'll be a good fit, but you got to start at the bottom." So, I went into our servicing group, which is traditionally where we start training people on how to lend money, and you service the existing portfolio and you work with existing customers.

I sat in the veterinarian group, which is actually the oldest portfolio at the bank, and I have the Northeast portfolio. I was there for about a year, and then I moved into underwriting, and that was actually inside the investment advisory team. That's ultimately where I think the bank saw me long-term is in that role or in that industry, because of my background obviously at Morgan Stanley. I was in underwriting for another year, two years, and then moved into sales, eventually into business development. Then two and a half years ago, I took over the team. Now, I lead the investment advisory team.

Louis Diamond:



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Very interesting. I don't disagree with you. The beach from New York doesn't sound bad. Sounds like a pretty good trade. And starting off with veterinary practices to RIAs. Can you just share with us briefly about who Live Oak is and what the various lines of business are? It's obviously not a household name like Bank of America or Wells Fargo. Just for perspective, it'd be great to just learn more about the institution.

James Hughes:

Sure. Live Oak is a bank, we're FDIC insured. We're everything that a bank traditionally is, the deposits and lending. Live Oak is unique in a lot of ways. The first one is we're in Wilmington, North Carolina, that's our headquarters, but we lend nationwide. We have loans in Alaska, Puerto Rico, Hawaii, our biggest portfolio is in California, but again, we're located in Wilmington, North Carolina. The biggest unique thing is most banks will open up in a market and then their customers will be in that market. We sort of flip the banking model on its head and opened up in Wilmington. But then our market is nationwide. We also have a focus on small businesses. So, we do not have any mortgages, credit cards, none of that stuff. We are solely focused on small businesses. So, we have aspirations to be the nation's small business bank.

As I mentioned, I started in the veterinarian group on the banking side, and that was our first industry that we got into. When we started the bank, that's what we wanted to lend into. We actually hired veterinarians on staff. Our lenders had to lend into that industry, had to service that industry, and we really took that foundation and then grew the bank from there. Now, we lend into 35 different industries nationwide, and we have an M&A team that lends to any small business nationwide. We also have a middle market lending team and an E&I team, energy and infrastructure. They do a lot of solar lending, bioenergy. The bank has grown a tremendous amount since the time I've been here. We're just under \$10 billion in assets and we're the largest SBA lender in the country. We also do a lot of USDA lending and conventional lending. Just to sum it up, I'd say, who is Live Oak Bank? We are the nation's small business bank.

Louis Diamond:

When you say SBA, can you explain briefly what that stands for and why that matters?

James Hughes:

Sure. If you're a business and you go to a bank and you want to get a loan for your business, you might hear the terminology SBA, Small Business Administration, it is a government-guaranteed program where a bank can use an SBA loan to lend you money and the government will guarantee a portion of that. There are a lot of benefits to use the SBA program, both for the bank and the customer, and it's just a type of loan. Again, if you're a business going to a bank and you want a million dollar loan, it might



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either be a USDA loan or an SBA loan or a conventional loan. At the end of the day, you're going to get your million dollars and have to pay the bank back that million dollars.

Louis Diamond:

Got it. And Live Oak as the largest SBA lender, is that because you're mostly supporting small businesses or, strategically, is there a benefit to the customer to Live Oak to make an SBA loan versus a conventional loan?

James Hughes:

Yeah, there is a tremendous interest on our part to do SBA loans, because of that government guarantee, it makes our balance sheet that much more secure. That's why we target SBA lending. It's also an extremely capital-efficient product. When you're a small bank, you can do a lot of loans with a little bit of capital using the SBA program. That's why we focus on it. I'd say the way that we got to number one in this space is just really understanding the rules. I'd say, generally, the banking industry does not do SBA lending well. When people hear the words SBA, they often sort of just shutter. They think about a lot of paperwork and the rules and it's just being very difficult. The average banker doesn't do a lot of SBA lending. They might do one loan a year or one loan every couple years.

So, they don't really understand the rules, versus a lot of our teams here at Live Oak just do SBA lending. Because of that, they have a tremendous expertise in the SBA space and we can guide our customers accurately through all the rules and regulations. That's how we've been able to create a name for ourselves and set ourselves apart from the Wells and the Bank of America and all these other larger banks that you would think would lend more dollars than us, just given that our size. We're still very small from a banking standpoint.

Louis Diamond:

Very interesting. I would agree. Better have your specialty to stand out. I actually really remember Live Oak coming into the RIA world, I think it was back in 2013, 2014, so not a ton of time, but for the lifespan, I guess, where the RIA channel is today versus where it was in 2013. Very, very different. Can you explain what Live Oak saw in creating a registered investment advisory vertical back in 2013?

James Hughes:

Yeah. It's a pretty funny story. Chip Mahan, our CEO and our founder, was on CNBC talking about small businesses in the United States, and I don't know who it was, but there was somebody in our industry that was on before him or on after him. They were in the green room and they said, "Hey, Chip, you're really missing the boat." Because at this time we were probably only lending to veterinarians, maybe dentists and pharmacists at the time. He said, "You're really missing the boat. You need to be looking at the registered investment advisory space, independent advisors, it is a very cash flow-heavy business,



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but there's no collateral, so banks don't want to lend." Chip left that meeting and called his team and said, "We got to get into this space, let's do some research."

We ended up hiring, gentleman's name is Jason Carroll, out of Charles Schwab, and was either alongside that or before that that we actually hired David DeVoe to write a white paper for our board. Anyway, it ended up getting approved. We got Jason in house to start the team, and we took off from there. You're absolutely right that the industry has changed a lot and our team has changed a lot over the years to answer the bell to what advisors are looking for in today's environment.

When we started, we did some breakaway financings. We were moving people out of wirehouses, forgivable note refis, working capital, start your business. Then we did some acquisitions, some succession, we did some commercial real estate, and almost all of that was SBA. Now you cut to today and it's a much more sophisticated offering. We still offer all of that stuff. So, we will help you start your business if you're moving out of a wire, help you refinance that forgivable. Once you're independent, we'll do acquisition financing, succession financing.

But actually we've made a shift inside of our group, where we're actually lending a lot more conventional dollars than SBA dollars. Last year it was 85% of what we did was conventional versus 15% was SBA. The reason for that is the deal structures have gotten a lot more complex. We're doing a lot more internal succession transactions. Think of an employee buying equity for the first time or a minority partner maybe buying a little bit more interest. Then we were lending just larger dollar amounts. As the bank has gotten, we've gotten more comfortable with taking more risk.

So, we're doing larger facilities that the SBA can't handle. Last year we did our largest loan ever at \$82.5 million dollars. It was an acquisition facility, which that alone is really unique to the market, and we think is helping us stand out right now. Basically, we're approving people for a set dollar amount and it works like a line of credit, sort of. We get approved for \$5, \$10, \$20 million and then you can go out and use that line to acquire businesses. It's really unique and, like I said, it's sort of helping us stand out. But to go back to your original question, I mean, where we were in 2013, mainly doing SBA lending, to where we are today is quite different. The last thing I'll just say is, we've built a portfolio of \$1.2 billion since 2013 and we feel really confident in the industry. Our portfolio has performed phenomenally. We're very excited about continuing to be in the industry as a long-term partner to all of our customers.

Louis Diamond:

Yeah. Congratulations on that success. Curious, back in 2013, if you can recall, what were the options, the debt options or the bank options for an advisor or business owner who typically now would be a customer for you? So, let's say they were looking to acquire or looking to finance a forgivable note or some other capital need, what would they do?

James Hughes:



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Yes. When we started, there was very few options for advisors. Some broker dealers were lending, but no real local banks were lending to investment advisors. It was something they just did not touch. For an acquisition, there was a lot of earnouts being done or seller financing being done, very minimal down payments in acquisitions. Any sort of internal succession or partner purchase was mainly done through seller financing. So, there weren't a ton of options and that's how we were able to come into the space and be successful. That's really how we've gotten into all these industries is we found industries that have had niches at the very least that no one else is really banking and we've really inserted ourselves there. To answer your question, very little options.

Louis Diamond:

Yeah, I would agree with you. One of the major enablers of the growth of the independent channel I think has been banks and capital providers like Live Oak that have provided amazing exit opportunities for founders, so that deal structures are more compelling and advisors can think longer term, and forgo a lucrative short-term deal, because now there's many options for them to monetize their equity in the future. I think it's a testament to all the work your group did, which paved the way for, unfortunately, competitors for you, but also just help professionalize the RIA channel, which we've talked about a lot on the show.

James Hughes:

Yeah, definitely. I completely agree. I don't shy away from competition, I think competition is good. We know a lot of our competition, we go to all the same trade shows and we're friendly and we'll have dinner and drinks and we know each other. I think it's good to have competition. It means that we're providing, hey, you got to have to raise your game, you got to sharpen your pencil, you got to provide better products to the customer. I think when you get more competition in the space, the customer wins. The advisor today seeking financing has a lot more options than the advisor back in 2013.

Louis Diamond:

You mentioned that conventional banks, they shied away or maybe they still shy away from financing acquisitions and for advisors breaking away. How come that is? I mean, RIAs are very profitable, they have predictable cash flow. Seemingly, they'd be really good customers for the bank. So, why has it happened that way?

James Hughes:

Yeah, generally banks want physical collateral that they can use in the event of default. You think about a car loan or a house loan, you pledge your car or you pledge your house, and if you default on that loan, then they take your car, they take your house. That's really what banks want is that physical collateral in the event of default. In 2013, when you looked at a financial advisor, to this day, I mean, there's no collateral. The only collateral is the client list, and you can't really force Mr. Smith or Mr.



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Jones to do business with any particular financial advisor. So, there is no collateral in these deals and that's ultimately why banks shied away from it.

I think now, we've seen the industry professionalize, as you put, so much over the last 10 years, that banks are more willing to enter the space. We have seen banks enter and banks leave the space. That's often what we tell people is, "Listen, we've been here for 10 years, we've got a really large portfolio, we understand the industry, we're not going anywhere. We'll be here in 10 years lending to investment advisors." I don't know if you can say the same about the mom-and-pop bank in your local town that would've never touched this deal five years ago, but now it's in vogue that they're doing it. I think that when you're choosing a capital partner, you need to think about who they are and is this someone you want to hook up with for the long-term? That's certainly how we think about our customers, it's a long-term partnership.

Louis Diamond:

Yeah. It sounds like it's your unique understanding of the industry that enables your credit teams to get comfortable with underwriting and helps you compete because a local bank isn't going to understand the makeup of a business and why it actually is a compelling business, even if there isn't physical plant that they could secure in the event of a default.

James Hughes:

That's absolutely right.

Louis Diamond:

Very good. Let's hit on, and I think we'll probably spend the rest of the interview, let's talk about the specific use cases for capital that advisors come to Live Oak for. In my view, and please correct me if I'm wrong, there is lending for succession planning. For that internal succession plan, there's lending for acquiring, so for M&A, and then lending for breaking away or for working capital. Did I miss any major buckets of categories?

James Hughes:

Yeah, the two major buckets are really internal succession and acquisition. But I'll just name a few other ones because I want to talk about breaking away and working capital, because I do think that's a significant bucket. The other ones would be debt refinance, so if you have just debt that you want to refi, commercial real estate, recruiting, and then lines of credit as well.

Louis Diamond:

Perfect. Let's dive into some of the major ones. Let's start it off with succession. I would assume what you mean by this is you have a non-owner advisor that's looking to buy out, someone who is looking to



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retire, or someone who is looking to distribute equity to the firm. And instead of just using the cash flow of the firm to finance the transaction, or someone I would assume selling their home or having deep pockets themselves, they come to Live Oak for a loan. Let's talk a little bit about succession and how you guys come in and assist your clients with internal succession planning.

James Hughes:

Yeah. This has been a product that certainly we're very proud of and we've tried to build over the years and it's gotten to a point now where we feel like it is very executable, very marketable. The majority of our loans here are 10 years. The individual doing the buying is our borrower and then the founder does not need to personally guarantee and, basically, will have the RIA provide some sort of provision where in the event of default, that they'll buy the shares back from us, because that's our collateral on the deal. So, it is a very good product in that we don't need to have the founder personally guarantee. So, if they're the ones doing the selling, they can have a liquidity event without having the liability. So, it really is an arm's-length transaction, where they're not tied into the deal, it's solely the buyer that's tied in.

Louis Diamond:

Before Live Oak or before debt financing was in vogue for RIAs, how would someone looking to settle their next generation handle such a problem?

James Hughes:

Seller financing. And that was really the only game in town there.

Louis Diamond:

Meaning selling the business for X and I'm going to get paid from the cash flow of the business over the next five years and that was how it would get paid?

James Hughes:

Absolutely, yep.

Louis Diamond:

Definitely seems better to get paid upfront, but also more like a sale rather than just putting money from one pocket into the other.

James Hughes:

Absolutely. From the seller's standpoint, it's definitely a much different transaction. If you're selling 10% of your company to an employee. When you do that, all you really have is a piece of paper where the distributions that would go to that person, are they going to come back to you over a period of five to seven years, and then they're going to end up owning 10% of your company. That doesn't feel very



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good. Versus if you sell 10% of your company and you get a one million dollar check or whatever it is, it feels more like a sale than how it probably felt beforehand.

Louis Diamond:

Right. I would agree. On their website, it says that Live Oak helps to enable a move toward more sustainable firms. I think that makes sense, but what do you mean by this?

James Hughes:

Yeah, when the concept of a sustainable firm, and I don't know that we really coined that, I want to say that probably came from FP Transitions. We've done a lot of work with them over the years. And it's this concept where if you're a financial advisor, you start an independent RIA and you grow that business, you got \$250 million in assets, and like everyone will, we will age. Let's say you're 75 years old and you still own 100% of the equity, well, that firm is probably not going to survive you, if something happens to you, you end up passing away, hopefully, you have some sort of contingency plan in effect where maybe a local RIA will end up buying the clients from your estate and those customers will get taken care of.

But that's not a very sustainable firm versus if you are a sole owner RIA and you are building out a team, you have some employees, you get equity in their hands and now you're starting to transition as you start to age. And when you're ready to retire, they buy out your equity and then that would be the G2 that bought you out. Then there might even be G3 that is starting to buy equity as well. That's what we would consider to be a sustainable firm, one that is meant to last in perpetuity, if you want it to, as an independent business. That's something that we can help firms achieve through financing.

Louis Diamond:

Right, because without financing then the business either winds down as the founder looks to exit or the business is sold on the open market.

James Hughes:

That's right.

Louis Diamond:

Makes sense. Let's talk a little bit more about internal succession. It might seem obvious, but what's the benefit of an internal succession plan rather than selling to an external buyer?

James Hughes:

It's a loaded question. It is a difficult one for me to answer. I don't own an RIA, so probably someone that is an owner-operator could answer that better than I could, and everyone has their own mission, what makes them tick. We have a long-term customer that's been with us since 2013 that is currently



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going through an internal succession and they were having a difficult time with it, because they had been approached, like a lot of firms of his size, he's got 450 million and he's an independent RIA, and he was getting two phone calls a week saying, "I'll buy your business for incredible numbers." And when we talked about the internal succession and how that would work, it's not quite as incredible. So, he was really having to spend some time with that and think about whether or not he wanted to sell internally or if he wanted to sell externally.

I'd say the benefits are probably the ability for your business to live on independently, legacy, something that's bigger than you and can sort of live on. Also, empowering your employees. A lot of these employees are family. I mean, it's people that you spend every day with for years and years and years. By getting them equity, you give them the ability to have wealth creation, you're going to improve their lives by giving them equity and hopefully growing the business and then eventually they can sell their equity down the road. Those are probably the two benefits that come to mind for me. It is an incredibly difficult thing though, and whenever I'm having a conversation with a majority owner thinking about this, we can help finance the internal succession, but we certainly can't make that decision for them. It's a difficult one that I know a lot of people are struggling with because of the economics.

Louis Diamond:

Right. Talking about the economics, I know every deal's different, the fun part of owning an independent business is you get to set the price that you look to sell the business for and there's millions of different variations of deal structures. But for a typical or standard deal structure for an internal sale, what does that structure look like? Obviously, valuation differs, but what percent of the purchase price is the lender financing in debt through Live Oak? And then how long does it normally take for the proceeds to be paid? How does that work?

James Hughes:

Yeah, our payback is over 10 years. It's either seven to 10 years. The majority of ours are over 10, though. Then, we will finance up to 100% of the purchase price. Let's say someone's going to buy 5% of the company for \$500,000, then we will lend up to \$500,000. The reason for us, and people have different opinions about us lending up to 100%. Some founders will say, "Well, I want my buyer to come up with some cash." That's great, we would love to have our buyers bring in cash and certainly will accept that. When we stood up the program originally we wanted 10% cash into every single deal. But what we found was that a lot of the buyers were early 30s, had a young family, historically been W-2, they didn't have the ability to build a huge amount of liquidity on their personal balance sheet.

So, we were not able to do some transactions because we were requiring that. Since eliminating that requirement, it's just given us more flexibility and we've been able to do more deals and help more people and do business with great firms. So, that's the general structure. Then a question I get a lot is like, "What multiple could you finance?" Ultimately, what we're looking for is that the buyer's income



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can cover the debt payment. The buyer is going to be an employee of the firm and their income is going to be their salary plus their distribution. The easiest thing is going to be if the distribution covers the debt payment, well, that certainly makes sense, but then there's this other component of their salary. It's like anything, if you're living within your means, then you're going to be more bankable. If you're not living within your means, you're living above your means, then it's going to be hard to get financing.

Each individual deal, like you said, is different. That's even true for these individual buyers. Each individual buyer might be more or less qualified to buy equity in one given business. But I would say that if I had to put a number on it, I'd say typical multiple is somewhere in the six to nine times maybe of EBITDA. Generally, we are seeing discounts. I just posted a deal of the week where we talked about that, or actually it hasn't come out yet, but I have a deal of the week coming out where we talked about a discount, I think there was a 15% discount on that particular deal. So, we are seeing a good amount of what's on these deals.

Louis Diamond:

Is that normal? Because I would put that in the potential negative for an internal succession plan is typically we see that an internal deal is done at either a express discount, the fair market value, or simply because a market isn't developed and there's not an auction process for a business, that an internal deal will naturally be at a lower multiple or a lower valuation than an external deal. So, is it normally 15% discount, you'd say? Or I don't know, you have a ballpark or just a hunch on how much of a discount an internal deal is to the market?

James Hughes:

Yeah. Every deal is different. We've seen zero discount applied, we've seen a premium asked for, and we've seen steep discounts. Think it, the internal succession, you are right, there isn't an open market for minority stake in a business. Although, I'm sure some of the M&A brokers might argue that point. If we went to one of these investment banks and said, "Hey, we need to sell 10% of this RIA, could they find a buyer?" I think that's one reason for providing the discount. The other one I think is really these people being offered equity have provided significant amount of value for the business over the years and have helped grow it to where it is today. I think it's almost a little bit of incentive compensation when they give a discount on the purchase, or at least that's the way I think about it. Oftentimes, we see the initial buy-in maybe come at a discount and then future buys not coming at a discount.

Louis Diamond:

I think it sounds reasonable, too, if you're going to be rewarding your employees, part of the purchase price was already paid for in sweat equity, if you will. That sounds right to me. Let's talk about M&A. That was the second use case for your services or for your capital. This would be a firm using you for a



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loan to buy a business, to buy more of this external acquisition. Can you talk a little bit about that and maybe how you help a buyer and a seller in this segment of your business?

James Hughes:

Yeah. Start from the beginning part of the process. We get a lot of phone calls about people wanting to buy businesses, spend a lot of time on the phone, "I'm interested in acquiring, how do I acquire?" We go through a lot of those conversations prepping people for the acquisition market. We do pre-qualification, so we will pre-qualify a lot of people. Then once there is a seller involved, we will help with the structuring conversation, so that when an LOI is sent out, it's actually a bankable deal. We do spend some time around. Then they're struggling with negotiation or purchase price or any of that sort of stuff. We certainly will recommend that they reach out to a consultant or a valuation firm to try and get more centered in an agreeable dollar amount. Then, ultimately, we provide the financing.

So, we will provide typically the down payment financing. Think of a \$2 million deal, it's a million upfront and then a million dollar promissory note over seven years. We'll provide the million dollars upfront. The majority of our terms are over 10 years, sometimes with the deals structured with two payments, one this year and then one the next year. We can actually finance both of them using an escrow account. With acquisition financing, we can also go up to 100% financing. As always, we like our buyers come with some cash and the seller to hold some of the deal either through a promissory note or earnout. But we do have the ability to go up to 100%.

The majority of our transactions are one-off. So, someone's buying it, doing a one-off acquisition, and we'll finance that particular deal. It'll be a term loan, they'll pay us back, and then the next time we do business, we'll be their next acquisition. But as I mentioned on the front of this interview, we do have this acquisition line, we call it a delayed draw term loan. It's not a very good name. But, as I mentioned before, we'll approve someone for a larger dollar amount and then they can go out and acquire businesses over the next year or so using that line. Then ultimately, it will term out to a 10-year payback.

Louis Diamond:

Interesting. Two more questions for you on M&A. One, from your vantage point, you see a lot of deals, you're involved in the process, you see valuation, et cetera. What do you think makes a firm valuable other than just the profits? What's going to cause a firm to get a higher valuation or cause Live Oak to be more comfortable with financing a deal if you saw certain characteristics or attributes about a seller?

James Hughes:

Standout one is going to be organic growth. I think that's what everyone would answer there. As you already mentioned, the EBITDA of the business is going to be our focus and be the focus of the valuation firm, it's going to be the focus of the buyer. Really optimizing your P&L, really getting as much as you can to the bottom line. That's going to be increasing your value. Organic growth is going to be big. Then



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other things are going to be client concentration. If one client accounted for 30% of your revenue, that would be somewhat of a concern. Management of the business, if you are the one selling and you meet with every single client and you do all the investment management, well, that's going to be a really difficult transition. So, having a team in place that is going to remain is certainly going to help in valuing the business.

Then, along those same lines, I'd say just transferability, how easy it is to transfer the business? I think a lot of advisors get into this, they have a lot of intellectual property themselves, they want to build investment models and they want to create an option strategy overlay and all this sort of internal stuff, which is phenomenal. Maybe that's a better candidate for an internal succession, because if you want to sell then externally, it's going to be really difficult to pick that model up and move it to another firm, versus if it was 100% third-party managed money, it would be a lot easier to transfer that. Transferability would be the other one I'd highlight.

Louis Diamond:

That's helpful. How about your thoughts on, this is probably more related to a seller, but the thought of financing, whether it's a capital need or an acquisition strategy or growth strategy, be it debt versus selling a portion of the business, so selling a minority segment of the business to fund the same sorts of projects. What's your thoughts on deploying debt versus selling equity?

James Hughes:

Yeah, I mean, equity is more expensive. I think that's just traditionally what... You believe that the business will grow in value, then equity will be more expensive. At the same time, equity will allow you to grow faster. So, different people want different things. When people come to me and they have a fairly young business and they want to borrow a lot of money, I'll often say, "Listen, this is where we're going to cap out debt-wise. If you want to keep going, you're going to need an equity partner." For me, it is fairly simple. If it was me, I would prefer to take debt out, run that as far as I could. If, again, I'm thinking about a roll-up strategy, I would run with debt as long as I could to keep all the equity myself and drive up the valuation and then ultimately bring on an equity partner when debt just wasn't enough.

Louis Diamond:

Right. You said with equity, it can grow faster. You mean that an equity investor might be willing to deploy more capital, which gives you a larger facility to do deals, is that what you're talking about?

James Hughes:

Yeah, that's right. I mean, we're a bank, so we sit inside the construct of the FDIC, and we have regulators that regulate how much we can lend to one firm. Generally, we're lending no more than



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three times EBITDA. That alone is a constraint. Versus if you have an equity partner that's willing to put cash in and will continue to put cash in, they might be taking more and more equity in the business. But debts, like I said, will only take you so far and then when you put cash in, it'll allow you to continue to grow.

Louis Diamond:

Got it. Thank you for the clarification. Then let's talk about breakaway financing. So a lot of our listeners are either employed by a captive firm considering breaking away or might have some sort of capital need that isn't related to mergers and acquisitions. Let's talk a little bit about that. First off, I know from experience that it is relatively hard for breakaway to tap the debt markets, many solutions for forgivable notes, a number of buyers would buy equity, but very few banks would lend to the space. In large part, I think it's because of what you talked about, just not understanding the space, not having physical property to secure in event of a default. But specifics to the breakaway, why do you think it's hard for these folks to access capital? And how come Live Oak is comfortable with it?

James Hughes:

No, no, we are, I mean, we love that piece of our portfolio. We've probably lend \$120 million to startup breakaway firms. It is difficult. I think, over the years, we've relied on you, on Louis, and Mindy, to help us understand where these individuals are breaking away from, what the contracts say, and are they inside a protocol, outside a protocol, what does that look like when they move? Do you have experience moving people outside of that type of firm before? Just really getting comfortable with the move. Then it comes down to the advisor. So, talking to the advisor, who are your clients? How long have you known your clients? What do you think about making the move? How many people will move? We'll have them do a three-year projection on their P&L, and then we will be pretty conservative on that. We'll say they'll probably bring 80% of what they think they're going to bring.

That portfolio has been tremendously successful. I think the only place where we've ever seen hiccups has been where we've moved some advisors with a lot of institutional business, schools, hospitals, endowments, those sorts of things, where instead of, the individual can just move by one signature, some of these institutions might only be able to move if they go out for RFP. That's something that, for a breakaway, we really pay attention to. So, who are your clients? And really trying to understand how easily they will move.

My last point would be experience is ultimately where we've found comfort. Over the years, we've moved people out of Merrill, Goldman, Morgan Stanley, JP Morgan, Truist, I'm sure I'm missing a few. As we move them out of those firms, now we have a real comfort with moving people out of that firm. So, the next time we get a phone call from that group, we'll feel more confident in doing so.

Louis Diamond:



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How come it's difficult for a breakaway to just go to Chase or go to XYZ community bank? Well, what's the blocking factor for them being able to work with the small business department of a bank versus Live Oak?

James Hughes:

Yeah, they probably just don't understand it. We are so embedded in the industry that we understand the nuances of wirehouse to independence, and all the things that need to transpire, and ACATing. So, I think you really need to be in the industry to understand that nuance. I think it is the riskiest transaction that we do, if you think about it. We would never lend an advisor with \$0 in assets under management anything, but every time we do a breakaway, that's exactly what we do. We'll lend sometimes millions of dollars to an advisor that has no assets. So, when you just say that out loud, it sounds pretty wild, but we know the industry well enough and we understand the mechanics that we can get comfortable with breakaway financing.

Louis Diamond:

Yeah, I would assume a normal bank would ask for tax returns and they won't understand that. You're saying that you make this, but you don't have EBITDA, and that you don't really know what's going to come over, and is it 80% that's coming or is it 100%? It doesn't make sense. You have to have a deep understanding and appreciation of the space to really underwrite the risk.

James Hughes:

Yeah, I mean, I wouldn't credit you guys for helping us understand that, too. I mean, you guys have been along the way with us and helping us understand that market, and obviously not just breakaway, but recruiting, and M&A, and all this stuff. So, you've been a good partner of us and helping us educate our team. So we appreciate you guys.

Louis Diamond:

Terrific. Glad we could help. Last question for this kind of segment, what are the use cases of capital that advisors come to you? It's an advisor who's breaking away, why would they tap Live Oak?

James Hughes:

The biggest one is going to be the forgivable note, oftentimes is the biggest dollar amount. Then the other one would just be startup capital. When you're going independent, you might have a leasable deposit, you're going to have to buy computers, software is expensive. Then there might be a period of time where you have employees, but you don't have any revenue coming in. There's going to be a breakeven point where your expenses are X and your revenue hasn't caught up yet. We will basically finance your breakeven point, plus all of your one-time startup costs, that being the leasable deposit, furniture, carpet, artwork, all sorts of stuff to get the business off the ground. Then we put that all into a



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general package. Sometimes it's relatively small, \$200, \$300,000, but we've put together some pretty large breakaway packages in the past.

Louis Diamond:

Last question, we ask everyone this, any parting thoughts or words of advice for advisors considering change?

James Hughes:

I would just say reach out to people like myself and Louis. There's no harm in having a conversation, I think, speak for myself, but I want to be a resource to the industry. I know, Louis, you feel the same way. We want to have conversations with people out there. So, if you're thinking about a change or you're just interested, you want to talk about the M&A market, or what it would be like to be independent, understanding how these things work, reach out to us. Give us a call. We'd be happy to set up time with you, so that you better understand your options.

Louis Diamond:

Very good. James, this has been very interesting, and learning about the different ways you interface with the market is really, it's a primer for M&A, for internal succession, for breaking away. Thank you for sharing your story, your insights and perspectives on the industry, and certainly I'm sure you'd be happy to speak with anyone who's interested in your services. Thanks, again.

James Hughes:

Absolutely. Thank you, Louis, I appreciate it.

Mindy Diamond:

Taking on debt versus selling equity is a business decision not to be taken lightly. As James shared, getting familiar with the options and having conversations with not only potential partners, but with peers as well, will make the decision an educated one.

I thank you for listening and I encourage you to visit our website diamond-consultants.com and click on the tools and resources link for valuable content. You'll also find a link to subscribe for regular updates to the series. And if you're not a recipient of our weekly email, Perspectives for Advisors, click on the articles link to browse recent topics. These written pieces are an ideal way of staying informed about what's going on in the wealth management space without expending the energy that full-on exploration requires.

You can feel free to email or call me if you have specific questions. I can be reached at 973-476-8578, which is my cell, or by email mdiamond@diamond-consultants.com. Please note that all requests are handled with complete discretion and confidentiality. Keep in mind that our services are available



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