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Retaining and Rewarding Talent Through Internal Equity Transactions

Catherine Williams: Hi, everyone, thanks for joining us today. We are going to talk about internal equity transactions. We know from our Dimensional Global Advisors study that top performing firms are more likely to have multiple equity holders. And they do so for a couple of key reasons. One, to keep and reward the great talent they have within their organization, but also to begin solving for the succession of their business. And so today, we're going to talk about what it means to pursue internal equity transactions, maybe some pitfalls to avoid, the best practices around that and how it can really be a powerful mechanism for your business.

Joining me for this discussion, it's my pleasure to introduce the founder and managing partner of Advisor Growth Strategies, John Furey. John, it's great to have you with us today.

John Furey: Great to be here, Catherine, thanks for having me.

Catherine Williams: So I think, as a place to start, when someone says internal equity or internal equity transaction, what does that mean? What comes to mind?

John Furey: Can mean a lot of things to participants out there, but internal equity, you know, other words used are next gen equity, also the ability to transition equity. And really from our perspective, it really means two things in the market. One, most independent advisory firms, RIAs, are founder led. So it's the distribution of ownership to maybe de-risk a firm. So, that's why you hear next generation equity out there is the opportunity for others to participate, which kind of de-risks key person risk with a founder. And then the other primary use of it is the opportunity to address and succeed at succession planning, which is obviously been talked about quite a bit in in our industry lately. And the good news now from our perspective is we're seeing maybe through the pandemic, founders taking the opportunity to really assess where they're at and maybe address their ultimate exit from the business.

Catherine Williams: So have you seen an uptick, if you will, in the interest in crafting some sort of program or process for equity within a lot of the businesses that you work with?

John Furey: Yeah, absolutely, I think there's a couple of triggers or drivers that's happening. So, number one, the M&A market is very hot right now. So everyone's, you know, sees that in the media and things like that. And then by viewing the M&A market and transactions getting done, it's also triggering internal discussions for firms that maybe don't want to find a partner and want to stay as an independent firm owned by their teams. So from our perspective, we're, as you know, a management consulting firm, we continue to see more requests and we're doing more work for the industry around internal equity. So now this year, I expect to do maybe 25-30 internal equity projects versus maybe even just two years ago where we did half that. So it's real.

Catherine Williams: Where do you start with a business, you know, we're likely to have some listeners here today that are wanting to begin expanding equity ownership in the organization, perhaps for those succession reasons we've been talking about. How do you get started and what do you look for in terms of the readiness of the business to take this particular step?

John Furey: I believe every firm, no matter what stage they are in their life cycle is, should consider internal equity. And why is that? So one is, our industry has a natural growth driver, which is the market. And wow, what a 10-year run, right? We all know this. So what happens over time, the equity value within an independent advisory firm, an RIA, just continues to grow. So some firms, you know maybe over the life cycle of it have just waited and then their equity value has increased. And then maybe, perhaps the affordability factor for a next generation owner or a key person goes down. What I would tell the listener is if you're going to embark on this journey, start with the end game in mind. Why are we taking the opportunity to build out internal equity? Most firms just work on the tactics. We have a key person. They've earned that. They deserved it. Let's get them some equity. But that's going from tactical, maybe without a strategic end game in mind. When you embark on internal equity, you should think in a five, maybe a 10-year horizon, where do we want to be? So, for example, if the firm says, hey, we want this to be contributor-led, team-led for the next 50 or 100 years, the sooner you start on internal equity, the better. Just because of the affordability factor I mentioned earlier, versus if a firm simply wants to grow, maybe find a partner, get liquidity from an external partner, meaning sell the firm. The program for the next generation people, the internal equity program might be far different because it's a different end game.

Catherine Williams: So I'd like to talk about that a little bit further. I think, you know, this idea that it's either or, right? You either are expanding equity within your organization, particularly if it is for purposes of succession or keeping the talent, or you do look for an outside partner. And I'm going to take lending out of that. And I'd love to talk about that in just a moment. But, you know, finding that external partner that, you know, certainly could bring a financial element to the table, but really help you think about how you grow the organization. They don't seem mutually exclusive any longer. It feels like I see more organizations thinking about who could they partner with that could really help to continue to grow the business, maybe pay off any of the debt that was that was created to make that equity transaction happening. Is that something you're seeing more of as well to?

John Furey: It's such a good point, Catherine, because you're right, it isn't so linear, it's not either or, one or the other. So and the beauty of the market now is there's so many options out there in terms of providers. So you can partner with an equity partner, maybe a minority stake, and they could assist with internal equity financing it, making it more approachable. There's debt providers in the market that can help finance internal equity. The purchases, if it's a buy-in program versus, you know, literally five or six years ago, a lot of internal buy-in programs had to be founder- or seller-financed, which, if you look at it from a founder perspective, is maybe less appealing. So, I think you're right. It doesn't have to be one or the other. And I would also make an argument, even if a firm says, hey, maybe long term, we want to find a partner, get liquidity from a partner, getting equity to key people, next gen people only makes a firm more attractive. So, I would argue that getting equity distributed to your team is a great strategy to make your firm more attractive to an external party, a partner.

Catherine Williams: I was absolutely going to ask you about that relative to if you do fancy yourself potentially selling or looking for an outside partner down the road, how attractive is it that, you know, how important is it that they see where equity is in play beyond just that single founder, single owner? It sounds like it definitely could help bring a premium to the conversation, at least.

John Furey: I think it's vital, so if it's not internal equity, it needs to be some sort of, whether it be deferred comp programs, something in a compensation agreement that keeps key people in their seats if there ever was a transaction. Because, one, sometimes we get so focused on valuation, what's the number? But when a buyer evaluates a firm, what are they really buying? They're not just buying revenue from a client list, which is, I think, where everyone rushes to. They're also looking at the talent within an organization. So the more committed the talent is, the more deep of a relationship they have with the firm. And equity is a great lever for that. The more stable the firm appears, which lowers the risk, which improves the value. So, I think it's critical.

Catherine Williams: Yeah, makes sense, I want to go back a little bit to you mentioned thinking about the strategy and what your ultimate end game is. Can you talk a little bit about the difference between being a, extending equity to others in the organization and what comes with that? Meaning, this is there are you seeing separation between you can be an equity holder, but you're not necessarily at the table for every decision that's made in the business. You know, the sort of separating what kind of, maybe not separating, but defining what it means to sort of be a partner versus an equity owner.

John Furey: Yeah, I think that's a great comment, Catherine, because there are distinctions, so equity, when you break it down, has really three components. One is the right to participate in annual profits within a firm. The second is the right to the sale value, the residual value. What is the valuation? What is the firm worth? And then the third is control. And that's having a say in how the firm's run. They don't have to be married together. You can, through an equity program, bifurcate economic participation versus control. So when we use this word, quote, partner, managing partner, that connotates you're in management in some way, have a vote, you know, share control within an organization versus equity, which could simply just be economic participation without necessarily a say on the firm direction having a vote. So I think the beauty of a small business, which RIAs are, is to kind of build it based on the business strategy and the direction of the firm.

Catherine Williams: An area that I often see that really come to the forefront or with organizations we work with is when they are conducting some sort of M&A activity, maybe making an acquisition or doing a tuck-in and thinking about do they need to have equity on the table on day one? If so, what does that mean? Certainly for firms that are looking to conduct multiple acquisitions, you know, you can sort of end up with you know, you can you could end up with a lot of a lot of partners, if you will, and that may not be a bad thing and maybe exactly what you're looking for. But any sense on maybe in the form of trends you're seeing when it comes to M&A activity and this process of do you, must you have equity on the table from day one and what that looks like for an organization?

John Furey: Yeah, that's a simple but complex question, so…

Catherine Williams: That's why I put it to you.

John Furey: Right, so the market, the M&A market is very dynamic. So for those of you out there, the word tuck-in that Catherine's using is usually the opportunity for, you know, an advisory firm, a registered investment advisory firm to find a new key person, a contributor, an advisor that can bring talent, bring their talent to a team, bring perhaps a client list to a team. And does it, do you have to have equity in that transaction to make it work? So just a starting point is if you're a registered investment advisor and you bring on another advisor that's bringing capabilities, if you have an equity component you're essentially creating a new partnership with that outside advisor. So I would think of it that way because it's essentially a business combination. And then what you can deliver if you're bringing on that advisor is again a platform to work on, one. The second piece could be cash, like, hey, well, essentially you're contributing your capability, your clients to our partnership. We can pay you in cash. We can pay you in equity. We can have contingent payments, thinking if things go well, you can get more. So I think that's the framework. And then the question, Catherine said, is like, well, on day one is equity required? And I would say, I don't think so. However, if equity is going to be on the table through that transaction of an advisor joining you, there must be certainty to how they can acquire the equity. You can't just say, hey, come on to the firm, bring your clients and we'll figure it out in a year or two. Like the market is just too sophisticated now. And if you look at these large buyers out there, they have, you know, their model. And it's hard maybe for the you know, the emerging buyer, an entrepreneurial firm that's not doing mergers and acquisitions all the time to compete. So I think if equity is going to be part of your a transaction to bring on a tuck-in or a new advisor, it has to be thought out, spelled out and the terms fully elaborated to get somebody to move.

Catherine Williams: I think that's an excellent point, so even if it's not something you're going to pull the trigger on, you need to account for it and really have it on the table, as you said. I think that's excellent advice for sure. On the so thinking about, you know, kind of maybe going back into the that internal equity transaction, what are some ways to think about structuring that, maybe even some best practices that you're seeing out there?

John Furey: Yeah, on the internal equity side, I would just break it out into really two ways to do it. The first one would be a buy-in program. So buying capital interests from a founder or an owner. And then the second would be a grant or an earn-in and that's usually some sort of phantom program or profits interest. So that's almost like a decision tree. Profits interests are usually taxless grants for future participation in a firm. So think a firm has a valuation of $10 million, maybe profits are a couple million dollars, whatever it is. If you grant equity, the value of the firm at 10 million is set in a threshold and then the participant has the opportunity to gain the future value of the firm. So think if you were granted five percent and the firm value went up to 20 million, you just do the simple math, 20 million minus 10 million is 10 million times five percent. The participant would have value of $500,000 without paying for it. Versus a buy-in structure, which is, maybe a little bit more straightforward. What everyone on the phone here is used to, if the firms worth five million you buy five percent. You essentially just stroke the check and that math for $250,000 or you have to find a financing mechanism for that. And that's where seller financing or debt financing comes into play.

Catherine Williams: Do you see where organizations may have both, maybe they have more the grant program for nonrevenue generating roles, if you will, in the organization, maybe like a COO or a long time, a long-tenured employee, and then you have more of the buy-in approach for those revenue or lead advisor, for example, positions. Do you see both, or is it, or do you have an opinion about whether it's good to have both in play?

John Furey: We do see both and we also see one or the other, so, and for me it goes again, well, what is the strategy of the firm and then work to the tactics of what's the appropriate vehicle? And Catherine's making a great point because we have structured equity programs where key contributors may be simply granted equity because they're longstanding contributors, great people, and maybe they can't afford the equity or just unwilling to get a loan to buy the equity. But they're still good people and maybe use a modest grant program for that. But ultimately, I think if someone is going to make, quote, full partner, be a partner in the firm, the only way you're going to get there is through a buy-in program. An interesting variant is something we were talking about earlier is an earn-in program. So if you're outside and you bring revenue or capability, you can get equity, right? True capital interests. But we have structured scenarios where let's say, Catherine worked at the firm for, you know, 10 years and brought a million dollars in revenue to the firm. She's granted capital interests, true equity without buying it. So that's another interesting variant where you can be, you know, think full capital interest holder by earning into the equity because you're such a longstanding contributor. Now, there's tax implications to that, which is probably too much to go into on this call. But I think to answer Catherine's original question, usually larger firms may have different types of equity programs serve different purposes.

Catherine Williams: And you make a really good point around the tax implications, your corporate structure, all these things can absolutely factor into what you do and what you can do and what you should do, if you will. And as you said, more than we can get into today, but that's where experts like you are such a valuable resource for our clients. It's lots of bits and pieces to consider around that.

John Furey: One more point on that, too, Catherine, I don't want to lose sight of is, once you start down the path of an equity program in any format, it'll trigger a look at your governance. So simply what I mean by that is your operating agreement, how decisions are made, how buy-sell transactions work. So it forces a level of professional maturity within advisors, which I think promotes business stability, business acumen, you know, essentially professionalizes the firm. So I think it's a good thing.

Catherine Williams: Do you see some best practices around those agreements, do you see some things, some areas perhaps that advisors tend to ignore or gloss over that they really should pay attention to?

John Furey: Within operating agreements, you're you know, or your governance structure, your articles of incorporation, whatever, whatever may be your entity set up, it's really critical to just think of three components. One is the buy-sell, what I mentioned before, because if somebody is buying equity, they're going to want to understand how they can get liquidity for their equity, even though most small businesses has you know, there's very little liquidity. Right. It's not an open market. You know, it's not publicly traded a small business, but it's the buy-sell. Then the other piece is how decisions are made. Think voting and how you set that up is that, you know, think a board framework or manager framework. How will decisions be made? How is a management team empowered? Think the contributors to make decisions. And then the third piece is really a protection framework, which is, says here is here is we're going to memorialize what happens if something goes wrong. So that would be you think like partner is a bad actor and harms the company. Someone overshoots the budget. How does that work? And having certainty of that up front. So when a new maybe a new owner, new equity holder comes in, they can look at the operating agreement and understand what they're getting themselves into.

Catherine Williams: You mentioned earlier sort of the value of businesses today, which I think, you know, we've seen even out in that traditional M&A landscape, the valuations are just incredibly higher than they were a year ago, two years ago. And so if you're thinking about an internal transaction, what we often hear from G2 or even G3 is, you know, I don't know if I can afford to write that check right now. And that's, of course, where maybe some lending or some financing can kick in. Any best practices you see with firms to begin introducing equity, making it accessible to the next generation, knowing that the business is highly valued? And that can be a really big check to write.

John Furey: Today's valuations in the external, in the M&A world, and we do we do M&A research at Advisor Growth and valuations are actually up 20 percent two years in a row in 2019, in 2020 and even higher this year. So what makes me worried is teams looking at external markets and maybe getting a full change of control valuation. Hey, if we sold the firm, we're worth a, you know, eight, nine, 10x multiple of our earnings, EBITDA or however you're measuring it, and then saying, OK, that's the market for an internal transaction. And why I worry about that is the affordability factor, right? I mean, even just doing a simple yields at a 10x multiple, you know, it's hard to make the math work maybe for an illiquid security. And plus, if it's a buy-in program, contributors have to buy with after tax dollars, obviously, usually. So to get the financing, if you did it a transaction, try to do a transaction on a 10x multiple. And you even if you went to the markets, got a 10-year term note to finance it, the math doesn't work without some serious growth.

So I would encourage all of our listeners here, don't extrapolate to these, you know, a large external values. If you want your team to be embedded into your company, you have to make the valuation a bit more approachable and I don’t even want to throw a number. But the math needs to work. And maybe I would encourage everyone to think of it within a framework of, hey, we have a great team here, we're going to give them the opportunity to buy in. And oh, by the way, we're going to make it more affordable because we want our team to stay. They've been loyal contributors. And it makes sense to maybe, if your business purpose is to perpetuate your firm, to not put folks over, you know, not the barrel, but have an expectation of a high valuation that's really from a buyer that would essentially gobble you up change of control and you become part of a larger group. So I think valuation right now is kind of a nerve wracking time for me, because when we're doing projects with our clients, you know, they ask about, hey, what's the M&A world valuation? Of course we have to tell them. And then all of a sudden the back of their mind, like, wow, OK, maybe that's how we should be doing internal deals. And I think that might be a little short sighted.

Catherine Williams: It's a great point, really great point, and I think it also reinforces what you said earlier around, you know, get started on this sooner than later because if you, you know, even for purposes of doing a series of smaller transactions versus that one big check, the more runway you create around that seems like that's going to serve both parties, if you will, all the more.

John Furey: I think that's such a great point. Buy-in programs or equity programs, at least the ones we're designing, are not one and done. Hey, let's do something in 2021 and that's it. It could be more installment in nature over time. You know, every year, every couple of years have the opportunity. So I think it's really important.

Catherine Williams: As we wrap up our conversation today, any lessons or just based on your incredible experience and expertise that immediately come to mind, maybe it's sort of those first couple of questions even that you might encourage a firm to ask themselves if they're thinking about pursuing an internal, other than picking up the phone and calling Advisor Growth Strategies, which they should definitely do as well. But anything that immediately comes to mind as a sort of a next step for organizations.

John Furey: I think step one is don't focus on the numbers right out of the gate. A lot of firms say, hey, OK, we can do internal equity, step one, get a valuation. I think that's a mistake. I think first is the strategy, starting with the end in mind, and then step two is how do people qualify for the equity, which we call equity criteria? What is your expectation for someone to be a partner and equity holder within the firm and being clear because it's a culture killer to have a perception of a popularity contest that makes little sense, and then figure out your structure and then do valuation. So don't start with the number, start with strategy, how are you going to align your team? And the numbers will be sorted. You know, any good valuation firm like ours or someone else in the market can help you with that if you need it. But don't start there. The numbers will work out. Get the alignment first.

Catherine Williams: John, thank you for joining us today. It's been a great conversation.

John Furey: Pleasure to be with you today, Catherine. Thanks for having me.

Catherine Williams: I want to let our listeners know that they can connect with John on LinkedIn or AdvisorGrowthLLC.com is their site. You can check them out there. And certainly if you are looking for more information about Dimensional and how we work with advisors and investment professionals, check us out at Dimensional.com and we'll see you next time.

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