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Compensation Structures for Investment Management Firms

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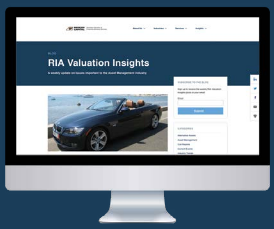

RIA Valuation Insights Blog

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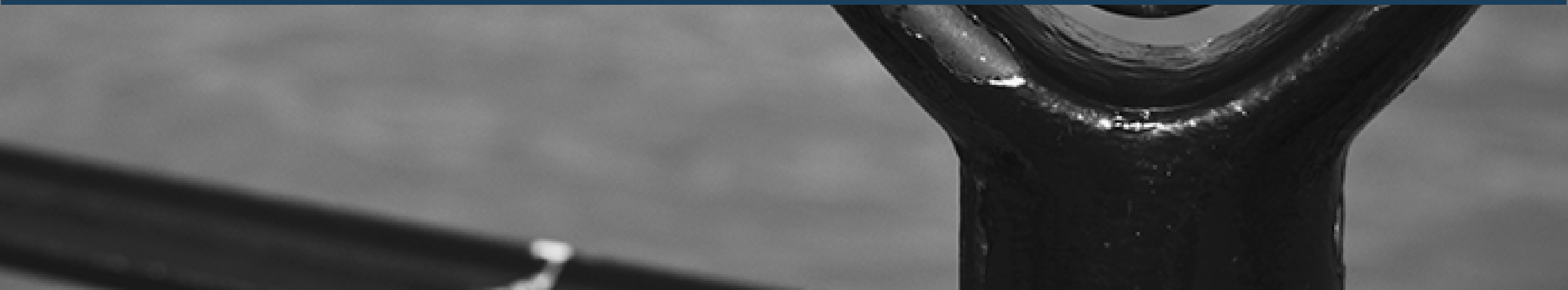


Introduction

In the golden age of asset intensive businesses, companies made giant capital expenditures on fixed assets and research & development to fuel long term growth strategies. In those days, economies had similar opportunities. The U.S. system of interstates, launched by President Eisenhower, is a prime example of major spending in support of long-term opportunities.

As our economy has evolved to feature more service-based, asset-light businesses, so too has the need to rethink what infrastructure means and what investing in long term growth looks like. Even businesses like investment management have a type of infrastructure, and their long-term growth opportunities require investment in that infrastructure.

One common feature of RIA financial statements is the simplicity of their balance sheet. We not infrequently work with clients whose asset base consists of little more than a token amount of cash, receivables, and leasehold improvements. On the right hand side of the balance sheet, we commonly see nothing but a few payables and equity.

But as the old saw goes, an investment management firm's assets get on the elevator and go home each night, such that the real infrastructure of an RIA is its staff – sometimes referred to in the valuation profession as the "assembled workforce" – an intangible asset that is more-or-less measurable using a replacement cost methodology (oftentimes achieving a result that is more precise than it is accurate).

Compensation models are the subject of a significant amount of handwringing for RIA principals, and for good reason. Out of all the decisions RIA principals need to make, compensation programs often have the single biggest impact on an RIA's P&L and the financial lives of its employees and shareholders.

The effects of an RIA's compensation model are far-reaching, determining not only how compensation is allocated amongst employees, but also how a firm's earnings are split between shareholders and employees, what financial incentives employees have to grow the business, and what financial incentives are available to attract new employees and retain existing employees.

Compensation models at RIAs tend to be idiosyncratic, reflecting each firm's business model, ownership, and culture. In an ideal world, these compensation programs evolve purposefully over time in response to changes in the firm's size, profitability, labor market conditions, and various other factors. However, inertia is a powerful force: we often encounter compensation programs that made sense in the past but haven't adapted to serve the firm's changing needs as the business has grown in scale and complexity.

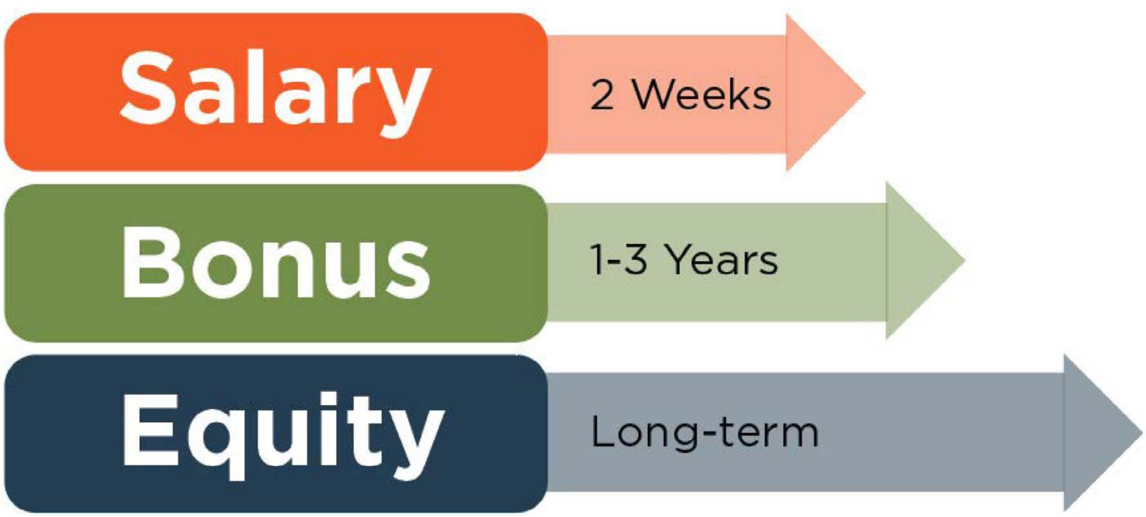
Effective compensation programs need to change with the times, and the times have certainly changed. The RIA industry has seen tremendous growth over the last decade. As a result, firms today face increasingly complex compensation decisions that affect a growing list of stakeholders: outside shareholders, multiple generations of management, retiring partners, new partners, possible minority investors, and so on. On top of that, a persistent bull market and the accompanying earnings growth over the preceding decade have made it relatively easy to appease both shareholders and employees. Now, financial market conditions and the state of the labor market have led many RIAs to scrutinize their compensation models more than ever before.

Introduction to RIA Compensation Models

At the outset, it's important to note what compensation models do and don't do. Compensation models determine how the firm's earnings are allocated; they don't (directly) determine the amount of earnings to be allocated. When it comes to determining who gets what, it's a fixed sum game. The objective of an effective compensation policy is to allocate returns in such a way as to increase this sum over time.

Compensation for RIAs is broken down into three basic components, each of which serves different functions with respect to incentivizing, attracting, and retaining employees:

- **Base salary / Benefits.** This is what an employee receives every two weeks or so. It's fixed in nature and is paid regardless of firm or employee performance over the short term. On its own, base salary provides little incentive for employees to grow the value of the business over time.
- **Variable Compensation / Bonus.** In theory, variable compensation can be tied to any metric the firm chooses. The amount of variable compensation paid to employees varies as a function of the chosen metric(s). Variable compensation is also called at-risk compensation because all or part of it can be forfeited if target thresholds are not met. Variable compensation is most often paid out on an annual basis.
- **Equity compensation.** Equity incentives serve an important function by aligning the interests of employees with that of the company and its shareholders. While base salary and annual variable compensation serve as shorter-term incentives, equity incentives serve to motivate employees to grow the value of the business over a longer time period and play an important role in increasing an employee's ties to the firm and promoting retention.



Variable Compensation

Variable compensation plays an important role in incentivizing employees over the relatively short term (1-3 years). The evidence suggests that such incentives work, too: According to Schwab's 2022 RIA Compensation Report, firms using performance-based incentive pay saw 28% greater AUM growth, 31% greater client growth, and 34% greater net asset flows over a five-year period than firms without performance-based incentives.

What Do You Want to Incentivize?

As the name suggests, variable compensation changes as a function of some selected metric, typically revenue, profitability, or some other firm-level metric or individual-level metric, depending on the specific aspects that management intends to incentivize.

In our experience, variable compensation pools tied to firm profitability and allocated amongst employees based on a combination of individual responsibilities and performance provide the most effective incentives for most firms to grow the value of the business over time. Such structures tend to work well because linking variable comp to profitability creates a durable compensation mechanism that scales with the business and aligns shareholders' and management's financial and risk management objectives. Variable comp linked to profitability also promotes a cohesive team, rather than the individual silos that can arise out of revenue-based variable comp, which further helps to build the value of the enterprise.

In markets like today's, where RIA margins face the dual threat of rising costs and declining AUM, compensation mechanisms that directly link employee pay to firm profitability have the additional benefit of helping to blunt the impact of market conditions on firm profitability. Consider the example below, which shows the impact of a 10% AUM increase and a 10% AUM decrease for a hypothetical firm under two comp programs, one in which all compensation is fixed and the other in which there is a variable bonus pool equal to 20% of pre-bonus profitability.

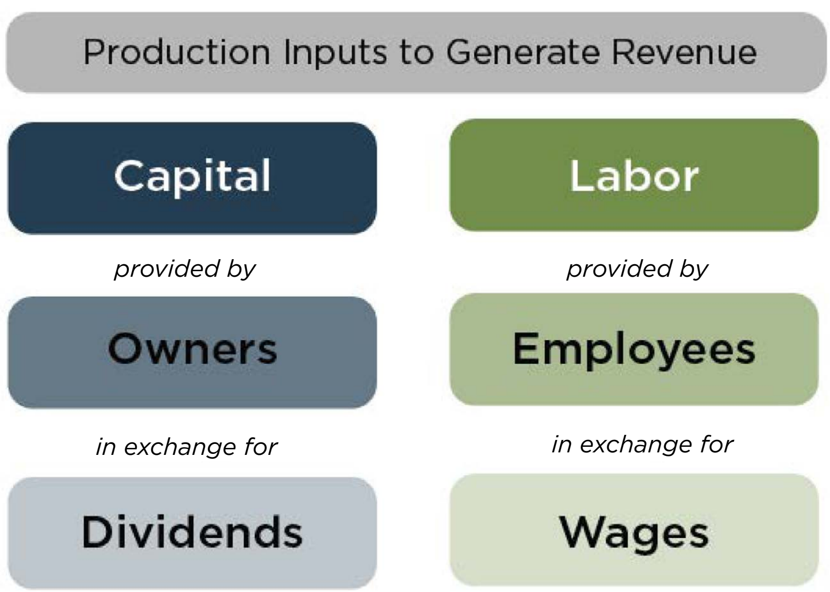
	Fixed Comp			Variable Comp (20% of Pre-Bonus Profitability)		
	AUM -10%	Base Case	AUM +10%	AUM -10%	Base Case	AUM +10%
AUM	$2,250,000,000	$2,500,000,000	$2,750,000,000	$2,250,000,000	$2,500,000,000	$2,750,000,000
Effective Realized Fee	0.65%	0.65%	0.65%	0.65%	0.65%	0.65%
Revenue	$14,625,000	$16,250,000	$17,875,000	$14,625,000	$16,250,000	$17,875,000
Cash Operating Expenses	$3,250,000	$3,250,000	$3,250,000	$3,250,000	$3,250,000	$3,250,000
Fixed Compensation Expense	9,000,000	9,000,000	9,000,000	8,000,000	8,000,000	8,000,000
Variable Compensation Expense	0	0	0	675,000	1,000,000	1,325,000
EBITDA	$2,375,000	$4,000,000	$5,625,000	$2,700,000	$4,000,000	$5,300,000
EBITDA - % Change vs Base Case	-40.6%	na	40.6%	-32.5%	na	32.5%
Total Comp - % Change vs Base Case	0.0%	na	0.0%	-3.6%	na	3.6%
EBITDA Margin	16.2%	24.6%	31.5%	18.5%	24.6%	29.7%
Bonus as % of Base Compensation				8.4%	12.5%	16.6%

In the example on the previous page, both compensation programs result in $4 million in EBITDA and an EBITDA margin of 24.6% in the base case scenario. In the downside scenario, however, the fixed comp structure leads to a high degree of operating leverage. As a result, a 10% drop in AUM leads to a decline in EBITDA of over 40% and a decline in the EBITDA margin to 16.2%. Under the variable comp structure, the variable bonus pool helps to mute the impact of declining AUM. In this example, a 10% decline in AUM results in a 32.5% decrease in EBITDA and a decline in the EBITDA margin to 18.5% under the variable comp program. In the upside scenario, the increase in EBITDA is greater under the fixed comp structure than under the variable comp structure (an increase of 40.6% vs. 32.5%).

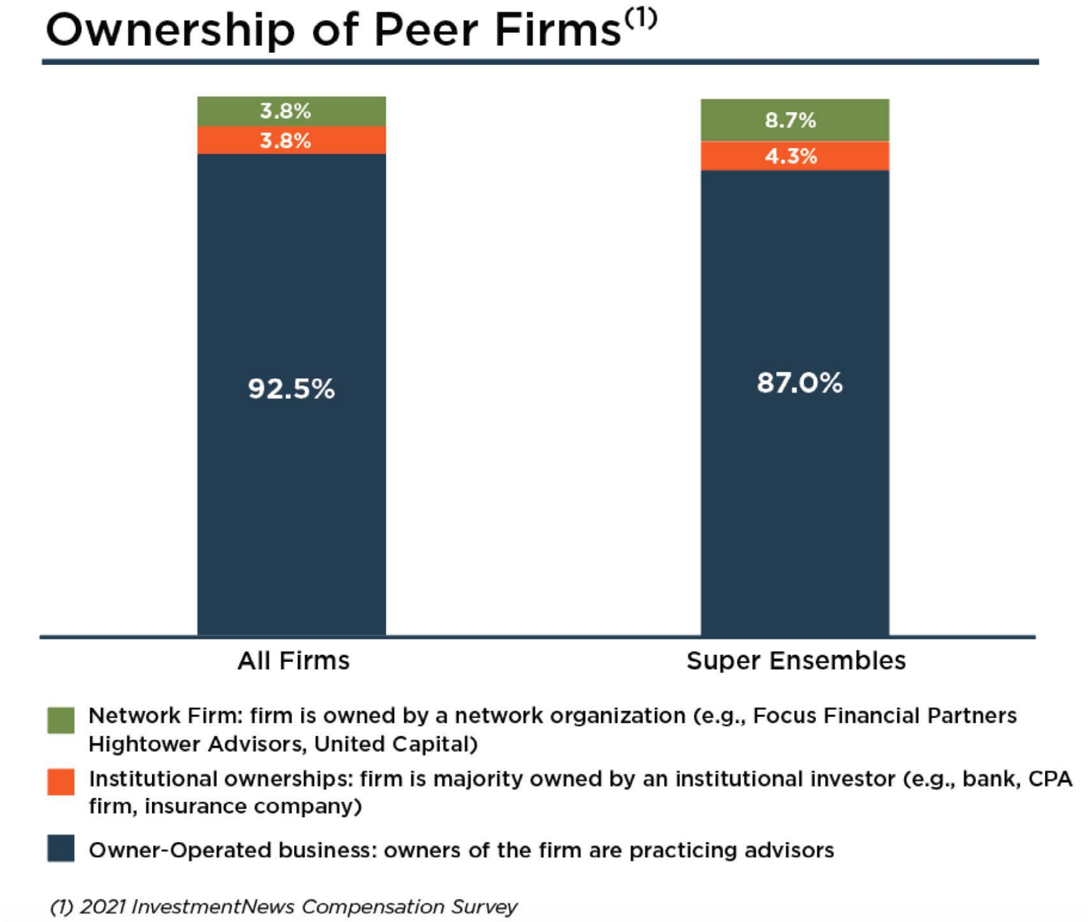
From a shareholder perspective, a variable compensation program such as the one described above effectively transfers some of the risk borne by equity holders to the firm's employees. In downside scenarios, some of the declines in profitability that would otherwise accrue to shareholders is absorbed by employees. Similarly, some of the increase in profitability is allocated to employees in upside scenarios. The logic of such a compensation program is that employees are incentivized to grow and protect the same metric that shareholders care about—the firm's profitability.

Equity Compensation

If the other forms of compensation are meant to attract (salary) and retain (bonus) qualified talent, RIA equity is intended to align shareholder and employee interests while rewarding long-term contributions to firm growth and value. This structure inherently blends returns to labor (employee comp) with returns on investment (shareholder distributions) by its very design. It is typically the most complicated and misunderstood component of RIA compensation but can be highly effective when implemented correctly. We often use the following depiction to simplify the distinction between these sources of return:



Unfortunately, this distinction between returns to capital and labor becomes blurred when the business is owner-operated like most investment advisory firms:



As a result, most investment management firms offer their key employees some form of equity compensation to align their interests with shareholders and incentivize them to continue growing the business. Equity comp can also be a differentiator that allows some RIAs to recruit top talent from other investment management firms that don't offer any sort of stock consideration to their employees. Equity comp has become more common during the Great Resignation and is part of the reason we're seeing so much turnover in the industry now.

Common Equity-Incentive Plans

While implementing an equity incentive plan will typically have a dilutive impact on existing shareholders, a properly structured plan will facilitate attracting and retaining the right talent and motivating participating employees to grow the value of the business over time. In that sense, a well-structured equity incentive plan is accretive to existing shareholders, not dilutive.

Some of the more common equity-incentive plans are discussed below:

1. **Direct Equity Ownership:** For most investment management firms, equity is held by senior management. As these executives retire or leave the business, equity is transferred to the firm's next-generation management. In these cases, the internal market for the company's shares serves the function of an equity incentive plan by placing equity ownership in the hands of the individuals with the greatest influence on the performance of the company. Direct equity incentive plans are typically the most straightforward way of transferring equity to the next generation but may not be the most practical if the current principals are unable or unwilling to relinquish ownership or control of the business, or if next-generation management is unable or unwilling to purchase equity.

2. **Stock Option Grants:** Stock option grants give employees the right, but not the obligation, to purchase equity in the company for a specified period of time at a specified exercise price. Typically, the exercise price is equal to the fair market value of the company's shares as of the grant date, which allows employees receiving the option grants to participate in any appreciation in value over the value at the grant date. Stock option grants may be subject to vesting periods in order to promote employee retention.

3. **Synthetic Equity Plans:** Under synthetic equity plans, employees receive something that mimics equity ownership from an economic perspective, but typically without the non-economic rights (such as management and voting rights) that accompany direct ownership. Examples of such plans include phantom equity and stock appreciation rights (SARs). Under these plans, a select group of employees (usually senior management) receive payments tied to the company's stock value at a certain date or dates. In the case of phantom equity plans, the payments can be based on the value of the stock at a certain date (a full value plan) or only the appreciation in value relative to the grant date value (an appreciation only plan). These plans can be highly customizable with respect to dividend participation, vesting schedule, and triggering events for redemption/forfeiture.

4. **Profits Interests:** RIAs structured as LLCs can issue profits interests, which represent an interest in the future profits or appreciation in value of the firm. Profit interests offer potential tax advantages in that they should not result in taxable income for the recipient when they are granted, and the appreciation in value may be taxed as capital gains rather than ordinary income.

Ultimately, for each dollar of revenue that an RIA brings in, the process of deriving profitability is largely a function of setting up a compensation structure. The portion of revenue devoted to expenditures other than staff and ownership is comparatively small (and less discretionary in nature). The balancing act between returns to capital and returns to labor is also a balance between current return and long-term growth.

But spending on staff isn't simply a tradeoff with profitability, it is also a tradeoff with growth. Most growth opportunities in the RIA space involve staffing – whether it's for new initiatives, succession, or further development of the existing business model. Staffing requires spending that may not be immediately accretive to earnings.

To the extent that spending on staff is front-loading the costs of opportunities for growth, the margin tradeoff can be rightly characterized as infrastructure spending – building the workforce needed to support more growth and profitability in the years ahead.

Most understand the tradeoff, but little has been written about what sort of tradeoff is appropriate. In our experience, the best way to analyze this trade-off is through a variation of a concept know as "The Rule of 40" used in other industries but still largely applicable to the RIA business.

The Rule of 40

Elsewhere in the business community, this issue of the tradeoff between growth and margin has been explored thoroughly. In the subscription software industry (SaaS), there is a well-known concept called the Rule of 40. The Rule of 40, or R40, holds that venture investors like to invest in businesses in which the profit margin plus the growth rate adds up to at least 40%.

So, if a growing SaaS company shows a profit margin of 30% and a growth rate of 15%, the total margin and growth (30% + 15%) is 45%, exceeding the R40 expectation. Companies with combined growth and margin rates of 50% are top performers and get lots of attention.

The R40 function is a shorthand way of determining the strength of a business model, in measuring the degree to which growth requires a tradeoff with profitability (whether through price concessions, higher compensation expenses, or customer acquisition costs). If growth plus margin equals more than 40, it indicates a business that can maintain profitability and still expand at better than average levels. Imagine a unique development stage business in a market with lots of upside and little competition – the sort of environment that promotes high growth with the pricing power to maintain substantial margins. On the contrary, a measure below 40 indicates a mature business with few expansion opportunities and increasing competitive threats.

Now, which profit margin are we speaking of, and is it unit growth, top-line growth, or profit growth that matters? As with everything, the devil is in the details. But the concept, measuring the aggregate return of growth and margin, has merit in a "growth and income" business like investment management.

Is R40 Applicable to RIAs?

The most attractive feature of investing in the RIA space is that it generates lots of distributable cash flow and has the market tailwind (recent quarters notwithstanding) to provide growth. But more margin and more growth is always a better thing. As with SaaS businesses, RIAs that produce more margin and more growth are going to be worth more – ceteris paribus – than those which produce less margin and less growth. Investment management firms are therefore tasked with determining an appropriate compensation structure to maximize its "R" score since investing in staff generally promotes firm growth but reduces profit margins in the short run.

What's a reasonable expectation of "R" for investment management? This is definitely a topic worth further study, but for the time being, let's venture out to offer a few thoughts on using this type of economic thinking to evaluate an RIA's performance. Established wealth managers commonly produce EBITDA margins in the range of 20% to 30%. So, any measure of the efficacy of an RIA's business model – including evaluating whether it is investing for the long term – should develop an "R" that is in excess of that level. That "excess" metric is growth – but to what extent?

Growth from market performance is always welcome, but as we've said many times in this blog, organic growth is the key to long term performance. Years like 2022 are a cruel reminder that the market doesn't always fuel AUM growth, and that a growth minded RIA needs a demonstrable and repeatable strategy to capture new assets. Without real organic growth, clients eventually spend off their assets, pass away, or take their business elsewhere.

So, we would look at organic growth. That's new client assets and additions to existing accounts, net of client terminations and withdrawals. The net growth of AUM, absent any market activity. Organic growth is a question of how quickly one can envision doubling an RIA's business. 15% organic growth would imply doubling the business every five years. 5% is closer to 15 years. What organic growth rate will your model sustain?

R35?

If organic growth in the 5% to 15% range can be supported by a 20% to 30% normalized EBITDA margin, the combination of these ranges, or about 35% at the midpoint, suggests that something on the order of R35 is a decent norm to observe – at least in the wealth management space. Totals that far exceed 35% would indicate a more effective business model. RIAs that produce growth plus margin much lower than 25% suggest a comparatively weak model.

The Rule of 40 – extended to the RIA space – works pretty well. The higher the "R" (percentage growth plus percentage margin), the better performing the business model – showing less of a tradeoff between margin and growth.

We need to develop this idea further, but it's promising as a diagnostic. R40 works in the SaaS world because the VC community investing in these companies has a cost of capital around 25%. R40 produces approximately the same present value of interim cash flows regardless of the tradeoff between margin and growth, provided they total about 40%. In the RIA space, where WACCs are more in the mid-teens, R35 appears to accomplish a similar parameter.

The New GARP

Growth at a reasonable price (margin) is an old concept in investment management, but it bears extending to practice management as well. RIAs are fortunate not to have to spend billions on factories, only to grieve them as "money furnaces". But that doesn't mean RIAs don't have the same imperative to invest in the people who compose their businesses. If your firm's R-score is significantly lower than 35 that likely means you're not optimizing your compensation structure. An RIA with above average margins and little or no growth is likely not investing enough in its staff or incentivizing key employees properly. Conversely, an above average growth rate with minimal profit margin indicates excess headcount or above market compensation levels relative to industry norms. Obviously, there are other factors, but since compensation costs are typically 75% of an RIA's expense base, the most likely path to optimizing your firm's R-score is determining the appropriate mix of salaries, performance pay, and equity incentives to grow the business as efficiently as possible.

Conclusion

As professional services firms, RIAs generally don't have to manage a balance sheet, and most of their revenue gets paid to employees and owners through compensation and distributions. Determining the appropriate allocation between returns to labor (compensation costs to employees) and returns on investment (income distributions to owners who are usually also employees) is one of the most challenging and important decisions facing any RIA principal today. A well-reasoned compensation structure will attract qualified talent, retain key staffers, and incentivize management to run the business in a way that maximizes its R score and value in the marketplace. We hope this whitepaper has provided some context on key compensation considerations and what structure makes the most sense for your firm.

About Mercer Capital

Mercer Capital provides investment managers, wealth managers, independent trust companies, and financial institutions with business valuation and financial advisory services related to corporate disputes, litigated matters, and financial reporting requirements. Mercer Capital also provides transaction advisory and consulting-related services.

Mercer Capital provides a comprehensive suite of valuation and financial advisory services to meet your needs. Experience includes:

- Valuing start up managers with as little as $50 million in assets under management to established industry leaders managing over $400 billion
- Negotiating transactions involving investment managers from sell-side, buy-side, and mutually retained perspectives
- Providing financial statement reporting services related to purchase price allocation and goodwill impairment testing
- Providing expert witness testimony for purposes of marital dissolution and shareholder disputes
- Assisting RIAs and other asset managers with annual ESOP valuations, fairness opinions, and appraisals for gift and estate tax compliance

Mercer Capital's Investment Management industry group publishes research on the industry via its quarterly newsletter, *Value Focus: The Investment Management Industry*. The Group also writes about issues important to the industry on the *RIA Valuation Insights* blog.

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