Want to make Partner? Now's the Time to Ask.

By Charles Paikert for Barron's

A growing talent shortage and the need to retain planning firms' best employees and attract new ones is one of the most pressing issues facing RIAs. Efforts to retain top wealth managers can be brutal, according to Charles Schwab's latest compensation report, with half of the country's RIAs planning to poach advisors and other staffers from competitors this year.

Not coincidentally, offering equity and laying out a path to partnership have become critical tools for advisory firms determined to attract and retain top-flight advisors, executives, and operations managers.

"Equity and partnership have to be part of the equation for advisory firms now, especially for younger advisors," says recruiter Louis Diamond, president of Diamond Consultants in Morristown, N.J. "If they're not incentivized to help the firm grow, it's harder to attract them and keep them."

"Equity is increasingly becoming part of overall compensation packages," agrees Brooks Hamner, vice president of Mercer Capital, a Memphis-based consulting and valuation firm. "It gives RIAs a competitive advantage over wirehouses and aligns the next generation with senior leadership. And junior employees are asking about a path to partnership more and more frequently."

Without that path to partnership, star employees are too easily tempted to accept an offer from a rival firm "and make more money right away," says J.D. Bruce, chief of innovation and a partner at Abacus Wealth Partners, a $3.7 billion RIA based in Santa Monica, Calif. In a market where noncompete clauses hold little sway, Abacus' partnership program "is about protection," Bruce says.

Key issues of sorting out equity. But navigating a path to RIA partnership may be more like hiking a rugged mountain trail than a stroll in the park. Parceling out equity with ownership stakes means advisory firms have to grapple with a variety of considerations, including criteria for admitting new partners, dilution, valuation, financing, and what to include in a buy/sell agreement.

Shares of the company should be made available to both revenue-producing advisors and employees on the operations side of the business, say RIA executives who offer partnership stakes.

Abacus' partner handbook states that partners are "expected to be ongoing contributors to the enterprise value of the firm." According to Willow Creek Wealth Management's "path to partnership" criteria, partners are expected to "represent the firm's core values, create new client leads, show leadership attributes, excitement about ongoing learning, and/or thought leadership on operational issues." Advisor candidates must have a "track record of acquiring new client revenue and maintaining an exceptional client retention level." Candidates who aren't advisors "should demonstrate that they have generated value to the firm through

prospective client leads, exceptional service to clients, and strategic relationships within the industry and the community."

Personality is also a consideration, says Kelly Noonan, managing partner and COO of Willow Creek, a $1.4 billion firm in Sebastopol, Calif. "The process can be like a co-op board interview," Noonan says. "You have to choose wisely. If there is someone you don't want to be in business with, or spend time with at a retreat, don't bring them in."

At RegentAtlantic, a $5 billion RIA in Morristown, N.J., that sells 4% of its equity annually to employees, new partners are selected based on qualities such as leadership and metrics, including business development and value creation. They also have to pass what partner and Chief Investment Officer Chris Cordaro call's the firm's "canoe" test: "The current partners have to be happy to spend a day in a canoe with them."

To dilute or not to dilute. RIAs considering partnerships also have to decide whether to dilute a firm's outstanding shares. Willow Creek chose not to dilute; the firm, which will have eight partners this year, wants to make sure ownership percentages remain in place. Accordingly, shares sold to new partners have to come from existing ones. The firm wants to make sure all shareholders are actively involved in the business, and thus all partners approaching retirement have to begin selling some of their shares, Noonan says.

By contrast, Abacus and RegentAtlantic, which have 24 and 19 partners, respectively, elected to increase the number of shares available for purchase, reducing ownership percentages. Bruce says the rationale for dilution is that, by adding new partners who can help grow the business, the firm will become more valuable over time. There's also a fairness principle to consider, he says: A partner who contributes significantly to a firm's growth should be allowed to have a higher ownership stake.

"I'd rather have a smaller percentage of a growing pie than a bigger percentage of a shrinking pie," RegentAtlantic's Cordaro says.

Soaring RIA valuations. No matter how many shares are sold, there's the issue of how much they will cost and how they will be paid for.

RIA valuations have soared in recent years, with the median adjusted EBITDA multiple increasing 21% from 2019 to 2020, according to Advisor Growth Strategies' latest RIA Deal Room report. Share prices for firms have increased commensurately, making purchases more expensive—and difficult to execute—for potential partners.

"Prices going crazy [pose] a real challenge to internal succession plans," Cordaro says. As a result, RegentAtlantic partners have agreed to take a discount to market value for their shares to maintain the feasibility of internal sales. At Abacus, internal share sales have a 25% discount off the firm's full market valuation, according to Bruce.

The high price of becoming a partner can be shocking for a candidate in his early or mid-30s. "When you realize the financial aspect is bigger than your house, you kind of go, 'Holy Cow, this is a little bit of a leap of faith,'" says Timothy Admire, who became CEO of Willow Creek this year at age 37, only four years after becoming a partner.

Admire bought his shares from Willow Creek's founder, Bruce Dzieza, who self-financed the transaction through a promissory note to Admire, who in turn paid back what he owed primarily through the distributions of the firm's profits he began receiving as a partner.

While many firms self-finance internal transactions, a growing number, including Willow Creek, are turning to specialized lenders such as Live Oak Bank and Oak Street Funding, which work closely with RIAs.

Potential partners also need to recognize the risks that come with buying shares in a firm whose revenue stream is impacted by market performance. "Market volatility," Hamner warns, "adds an extra layer of risk for transactions that are tied to debt financing."

Just in case. In arranging a partnership deal, once the price of the shares is set—which Hamner says can sometimes be contentious, with a "very wide" bid and ask spread—and financing is arranged, the new partners and the firm then finalize a buy/sell agreement. "It's critical," Noonan says. "You want to have everything in writing that can happen under any given circumstance, including death, disability, and divorce."

"A buy/sell agreement is like a prenup," Bruce adds. "You're defining the decisions you will make when you hate each other. Go to a whiteboard and write down every single thing that might go wrong."

The agreement should include a mechanism for defining how shares will be transacted in the future, Hamner says.

"The book value of a firm will be nowhere near as close in price to a firm's fair market value, for example," he says. "If you don't give the buy/sell agreement a lot of thought, there's a good chance someone will get screwed."