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Voices The flawed economics of admitting new partners

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Does this scenario sound familiar? You need to admit a new partner. You feel like a 10 percent stake makes sense. And between the capital contribution required and selling a 10 percent interest in the intangible value of your $3 million firm based on your agreement's valuation multiple, the cost would be $400,000.

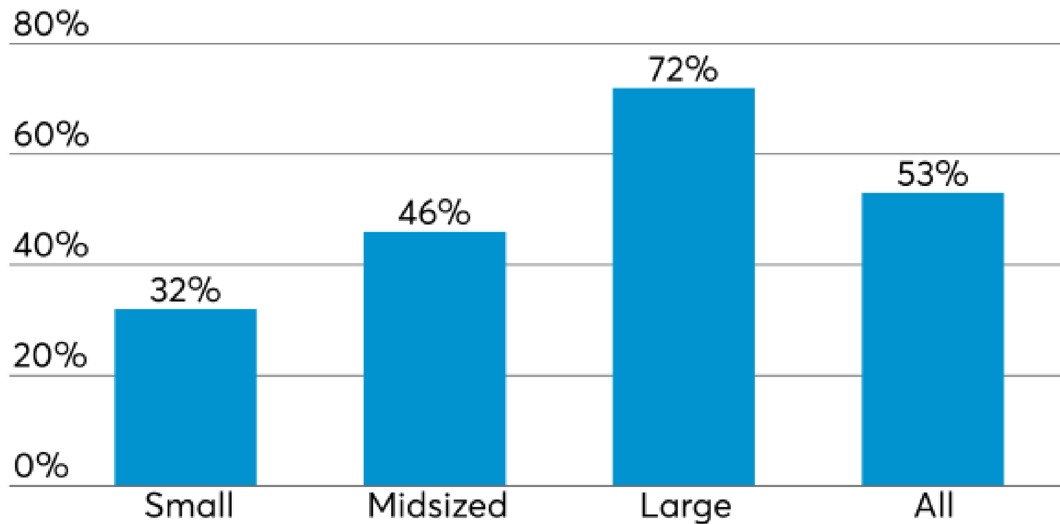
You know the new partner can't afford that, so you raise their compensation by $50,000 per year to pay for it. You're wondering why they're suddenly worth that and ask yourself what are you really accomplishing? Aren't you paying for your own partial buyout? And the new partner wonders how long their compensation will be capped at that new level. They appreciate a $50,000 raise, but they won't see any of it for eight years.

If you have ever bought a practice off the street, you know you can't keep paying the seller their historical level of full-time compensation and pay for the practice purchase at the same time. Yet many internal purchase arrangements are set up under the same flawed economics.

So maybe you'll limit the equity acquired to a nominal 2 percent or 3 percent, so the problem isn't so large. Then, 10 years later, you realize you just kicked the can down the road and now your 2 percent partner is anything but a 2 percent partner. But how do you ask a partner 10 years later to write a check to acquire more equity in the firm they helped grow?

What is missing from the above scenarios is any recognition of sweat equity. If you are a founding partner in your firm, it's likely a huge part of the value you own is due to your contribution of sweat equity over the years. You've helped the firm grow and you may have helped buy out retiring partners. You may have never written a check to acquire your ownership. So how do you use that strategy when admitting new partners in a mature firm?

This problem is inherent in the equity method of allocating value in your firm. The equity method calculates a hypothetical value for the full firm and allocates it to the owners based on their assigned ownership percentage. Often, those percentages only change when a partner leaves, creating accretion for the remaining partners, or when a partner literally buys ownership from another partner.



Two alternative methods for allocating value are the compensation multiple method, and the AAV or unit method.

The compensation method essentially allocates the intangible value of the firm based on relative compensation. The theory is that compensation is usually a better reflection of the current contribution that partners are making to the financial success of the firm, and therefore a better reflection of the firm's value that they should be allocated.

Compensation in most firms is dynamic, and over time has more flexibility than equity allocations. Typical multiples of compensation are 2.5 to 3 times for determining overall buyout or retirement allocations to a partner. If your partner compensation as a percent of revenues is 33 percent, 3 times compensation yields the same overall value as one times revenue in the equity method.

In most compensation-based systems, the new partner's investment is limited to a capital contribution - often based on accrual basis book value. Then, tenure and age-based vesting in the owner agreement is used to create sweat equity through a long-term commitment to the firm. Ongoing increases in compensation due to increasing levels of performance result in further recognition of sweat equity.

The AAV or unit method more closely resembles the equity method but has distinct advantages. Units are established that align with fee volume, often one unit per dollar of volume. The difference is that allocations are based on units, instead of static equity allocations. That allows for much more flexibility in the distribution of intangible value to partners. If a partner is allocated 750,000 units and the valuation multiple is $1 per unit, the buyout or retirement value for that partner is $750,000.

Normally, accrual basis capital is added to obtain the full buyout package. As the firm grows, partners are allocated the incremental units based on algorithms such as relative compensation or performance evaluations. As retiring partners are bought out, the units acquired from those partners are allocated to the remaining partners on a similar basis. Younger partners are acquiring value by participating in the firm's ongoing success without writing checks. Newly admitted partners aren't asked to pay for intangible value upfront. They earn it over time. Senior partners aren't giving anything away that they owned at the time the new partners are admitted. Usually, newly admitted partners make a capital contribution upfront just like they would under the compensation multiple method.

Most firms feel like it's important for a new partner to have some "skin in the game" coming in. Based on profession averages, the upfront investment, a.k.a. capital contribution, that newly admitted partners are asked to make ranges between $50,000 and $200,000, depending on the size of the firm under both compensation multiple and unit methods.

If you are struggling with how to structure the buy-in for newly admitted partners and have it make sense to all the parties, the problem might be in the underlying structure of your owner agreement.

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