Business services deal making: five critical partner compensation questions to consider

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Deal negotiating is a complex and sometimes contentious undertaking with many financial and operational aspects for private equity firms and strategic buyers to consider. One important consideration, especially related to potential business and professional services industry acquisitions, is the target company's partner or owner compensation structure. When acquiring a business services firm, buyers are essentially purchasing human capital. People are the primary assets of a business services company and as such, there are many variables to consider, especially when it pertains to compensation, which is typically the largest expense on a business services company's income statement. Potential buyers must consider how every part of the historical partner or owner compensation plan impacts revenue, profitability and overall value of the business and, inevitably, how it influences a future profitability post-sale. This may be particularly difficult for a private equity firm that has not historically invested in this industry.

A thorough due diligence process is recommended to uncover the many nuances of a partner compensation plan to ensure an accurate negotiating platform and relatively surprise-free deal. To help launch an effective due diligence strategy around partner compensation, private equity firms strategic buyers should consider five critical questions. The following white paper provides further discussion around each essential question.

1. What is the size of the firm and partnership structure?

The size of the firm and number of partners in the organization can dictate a variety of compensation issues. For instance, for small firms, it is not uncommon to see partners focus on business growth, as opposed to maximizing their compensation.

Conversely, larger or more mature firms with an established business growth platform may have partners more focused on the growth of their own compensation. In this instance, plans can be elaborate and multilevel with compensation not originating through the formal payroll process. **This may make compensation expense less visible, causing confusion on how the compensation is reported within the historical income statements.** In addition, attempts to normalize recurring partner compensation can be difficult to accomplish, especially as firms look to maximize their valuation when going to market. The schedule below illustrates select financial variables between small and large firms.

SMALL VS. LARGE FIRM EXAMPLE

U.S. $ in thousands	FY10	FY11	FY12
Small firm (growth-oriented)			
Revenue	$ 12,000	$ 24,000	$ 36,000
EBITDA	2,160	4,320	6,480
Partner compensation (10 partners)			
Payroll expense per partner	100	100	100
Equity distribution per partner	200	400	600
Subtotal, payroll + distribution	$ 300	$ 500	$ 700
Large firm (mature and stable)			
Revenue	$ 115,000	$ 116,000	$ 117,000
EBITDA	17,250	17,400	17,550
Partner compensation (50 partners)			
Payroll expense per partner	500	500	500
Equity distribution per partner	300	300	300
Subtotal, payroll + distribution	$ 800	$ 800	$ 800

In addition, partnership structures should be considered as they can have a significant impact on the overall compensation plan. For instance, a simple partnership is usually clear cut regarding payouts. However, a partnership with multiple classes of partners could mean multilevel bonuses with varying distribution rights (see below). **This more elaborate compensation plan may not be part of the organization's traditional payroll reporting; therefore, an accurate account of compensation could be skewed or hidden.**

MULTIPLE PARTNER CLASSES

U.S. $ in thousands	FY10		FY11		FY12	
Class A: Senior Partner						
Salary	$	300	$	300	$	300
Bonus		–		–		–
Distribution		1,000		1,000		1,000
Subtotal	$	1,300	$	1,300	$	1,300
Class B: Junior Partner						
Salary	$	300	$	300	$	300
Bonus		100		100		100
Distribution		300		300		300
Subtotal	$	700	$	700	$	700
Class C: Non-equity Partner						
Salary	$	100	$	100	$	100
Bonus		300		300		300
Distribution		–		–		–
Subtotal	$	400	$	400	$	400

2. What type of existing compensation plan is currently in place?

As size and structure can influence a partner compensation plan, the actual type requires special consideration as well. In business services organizations, partners are paid in a variety of ways, which typically include:

1. Base compensation (usually a set annual amount)—Depending on the type of legal entity, these amounts could be expensed or taken as non-expense distributions through equity.
2. Distributions—For smaller firms, distributions are often aimed to cover partners' tax liabilities. For larger firms, all earnings of the company may be distributed to partners at year-end. In partnerships, compensation is generally paid as a distribution. Distributions are not expensed and do not burden EBITDA.
3. Set *guaranteed* bonuses (quarterly or annual)—These are common in companies with few partners. Again, depending on the entity type, these amounts may be expensed or taken as distributions.
4. Variable bonuses based on performance—These bonus programs often vary in design and complexity, and performance bonus compensation generally varies from year to year.

An all-encompassing approach to reviewing and analyzing partner compensation, including the various aspects noted above, should be considered in each due diligence process.

3. What are the post-closing partner compensation expectations?

Another extremely critical factor to consider is what are the existing partners of the business services firm expecting in the way of compensation after the deal is complete? **Many partners often expect similar compensation levels post-close, even after a significant reduction in equity.** The buyer must consider how this will impact future business profitability. In addition, questions like how will existing partners accept the new compensation structure after they, as owners, were accustomed to a more lucrative compensation that was tied to business performance and entrepreneurial in nature?

Regarding partner distributions through equity, a buyer must remember the ownership and return on equity component of the pre-closing financial statements. The buyer should consider how to structure a lucrative enough compensation structure post-closing, after the partners transition from business owners to employees that properly aligns firm and individual growth goals and maintains key motivating factors each organization requires to be successful. This may be resolved by management rollover equity or bonuses tied to business performance or profitability. **This will be an important consideration to ensure future partner motivation and performance.**

Other things to consider include, will partners expect a bonus structure tied to the whole company's performance, a business unit's performance, or a mix, similar to what they had received prior to the deal close? And, if it changes, how might the new incentives impact partner motivations and performance? See next page for pre- and post-close compensation examples.

POST-CLOSE COMPARISON

U.S. $ in thousands	Pre	Post	
Revenue	$ 30,000	$ 30,000	A
EBITDA	6,000	6,000	
Partner compensation			
Payroll expense per partner	200	600	
Total partner equity distribution	1,000	–	
Subtotal, payroll + distribution	1,200	600	B
EBITDA, after partner compensation	5,800	5,400	
EBITDA multiple assumed	7	7	C
Valuation	40,600	37,800	
Difference		(2,800)	

A - Assumed consistent revenue for comparability purposes

B - Partners will receive half of the compensation post-close

C - For illustration purposes only

4. How will EBITDA be impacted under the new compensation structure?

It is essential that a buyer obtain an accurate understanding of how much compensation was expensed and included in EBITDA, and how much compensation is reported outside of EBITDA, i.e., through equity distribution. Consider an entity with five owners each making $200,000 per year. In this case, EBITDA could vary by $1 million depending on whether the compensation was expensed or paid as distributions. A due diligence team is well-positioned to perform this analysis. Another example relates to incremental benefits the partners may have received during the historical periods. This may include, but is not limited to, car payments, excess retirement plan contributions, personal expenses, among other items. **If personal expenses are recorded through the business, extra attention should be paid from a financial and tax due diligence perspective to ensure a normalized earning profile is achieved.**

One thing is certain post-closing of the potential transaction: EBITDA will be impacted, but to what degree? In order to anticipate accurately, pre-close expense levels must be compared to post-close expectations. Is post-close compensation structured with a ceiling, either through salary or set bonus? Is a percentage of EBITDA and gross profit considered? Should a buyer consider open-ended bonuses with no ceiling and based on performance?

Furthermore, in looking at the target company on a historical basis, how is gross profit defined? There are many potential definitions in a business services firm. For instance, the deal definition may vary from the audit definition. This should be defined in the purchase agreement, and all parties should agree so as to prevent disputes later. **If the post-close bonus plan is structured with a profitability target, the buyer should consider how the definition of gross profit could dictate potential bonus payouts.** Without knowing the amount and type of partner compensation, metrics for gross profit or EBITDA cannot be forecasted.

5. What potential tax issues should be considered?

As is the case with any deal, the potential buyer should also consider possible tax issues related to owner compensation. The tax treatment of the owner compensation depends on the legal entity structure of the business. While most of the professional services firms are typically structured as partnerships for tax purposes, it is not uncommon see such businesses set up in corporate form.

For the businesses set up as partnerships for tax purposes (and that would include limited liability companies), partners are generally not treated as W-2 employees and any compensation they receive is typically in the form of guaranteed payments, which are not subject to payroll tax withholding. Partners report this income on their 1040 and pay income and self-employment tax. Payouts treated as distributions are not taxable to the recipient unless the distribution exceeds the partner's basis in his or her partnership interest, whereby they are taxed at lower capital gains rates. **The buyer should consider how the seller's changing personal tax structure may motivate compensation negotiations.**

Distributions are usually governed by the partnership agreement, and in many cases, require a distribution that at least equals the partners' estimated tax liability on the income derived from the partnership.

For the businesses that are set up in corporate form, the owner compensation is typically deductible while calculating the taxable income of the business. Further, such compensation is typically subject to payroll tax withholding requirements as it would be for non-owner employees. Reasonable compensation requirements may apply to ensure that owners are not unreasonably reducing their compensation to avoid payroll taxes.

At closing, the buyer likely will have the flexibility available to negotiate different compensation levels between the former owners. If the business is a partnership, the partnership agreement (or equivalent) would typically need to be modified to reflect the new compensation arrangements. In other cases, new employment letters may need to be issued. **For cases in which the owners were compensated equally in the past, the buyer needs to consider how varied salaries between former owners could impact motivation and workplace dynamics after the deal is completed.**

Summary

While a buyer completes their own due diligence early in the overall transaction process, a formalized due diligence strategy is needed, frequently through an outside consultant, to fully realize all the critical intricacies of a partner compensation plan, pre- and post-closing the potential transaction. Due diligence consultants can delve into the details and act as objective facilitators when sensitive information is uncovered, partnering with the buyer on how to approach delicate topics around compensation negotiation with the seller. Additionally, in larger firm environments, owners often prefer to keep compensation information confidential among partners. Partners are often more willing to share this information with the third-party due diligence team that may have signed a confidentiality agreement.

Consultants typically review a history of the seller's partner compensation activity up to five years, determining everything from whether the compensation was expensed or not, to detecting whether a seller, in anticipation of a sale, changed compensation or expense levels recently. Failure to complete thorough due diligence, especially around partner compensation, could translate into contending with ill-timed surprises during deal negotiation, achieving substandard return on the investment in the newly purchased business, low productivity in the newly acquired entity, loss of critical leadership, or worst of all, losing the deal entirely.

As private equity groups and strategic buyers continue to increase the number of investments in business services firms, due diligence around salaries and compensation will play a key role in deal making. Hopefully, the high-level examples and situations presented in this paper illustrate the importance of a thorough due diligence strategy, which could potentially illuminate key risk areas and help to assure a successful transaction.

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