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Navigating Internal Equity Transition in Asset & Wealth Management

A Roadmap for Long-Term, Employee-Owned Sustainability

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Recently Rosemont covered the topic of internal equity transition on our year-end episode of the [Rosemont Roundtable](#) podcast.

It is a topic critically relevant to Rosemont partner companies, whose primary goal is to sustain themselves as majority or materially employee-owned firms. Internal equity transition has been and remains an underserved business consideration, often taking a back seat throughout the industry to headline-generating transactions and valuations.

As we discussed on the podcast, there is no blueprint or optimal formula for moving equity internally through generations of employee owners in the asset and wealth management industry. Moreover, it has proven extremely challenging to accomplish. Examples of multi-generational transition in majority-owned firms are quite rare.

WHAT ARE YOU TRYING TO ACCOMPLISH?

In our decades of working with firms on this topic, it always comes back to a single key starting point: *what is the company trying to accomplish?* Typically, the answer falls into one or more of the following five buckets:

1. Cycle out external investors or retired partners
2. Obtain liquidity for current owners
3. Retain key employees and align incentives
4. Augment standard compensation
5. Appeal to clients/prospects

Any internal equity discussion has to start with acknowledging—meaning understanding and agreeing upon—the reasons to even have the discussion. With that in mind, let’s take a closer look at each of the core motivations:

Cycling out equity holders

At varying points in a firm’s lifecycle, there will always be equity holders whose value to the organization diminishes. This could include less-active retired founders or partners, or outside investors that continue to extract economics without making any meaningful contribution. It might also include outside investors that seek to exit for their own reasons, as their horizon has been reached (private equity) or their priorities have changed. It can be incredibly helpful to reclaim and repurpose the equity (and economics), perhaps for new value-creating employees, for a more aligned and strategic outside partner or to consolidate control.

Liquidity for current owners

Internal equity programs can be helpful to provide liquidity for current owners without selling some or all of the equity outside the organization. This can be very effective if executed properly. Often, however, owners are anchored to external valuations and expect internal buyers to pony up, often with an argument that keeping the equity in the company is better for everyone. Many prioritize immediate or near-term paydays over longer term control and internally driven growth. This price maximizing objective makes internal equity transition almost impossible, particularly over short periods of time. Owners need to be honest and transparent about their desire to maximize liquidity and understand that the feasibility and consequences will vary based on actions taken.

Long-term retention and alignment

Equity programs can be effective tools for attracting and retaining talent, and when structured properly can be very aligning. Instilling an ownership mentality for current and future leaders is an excellent way to ensure sustainability. Deciding how new employees may integrate into an equity plan is important as well. Choreographing an equity plan internally with buyer and seller objectives and means is challenging but achievable with compromise.

Compensation supplement and/or proxy

Often firms look at equity as a way to augment compensation and drive a meritocracy of value sharing. Some firms lump salary, bonuses and distributions into a compensation bucket, proportionally gauging the total of each owner’s W-2. They may also decide it’s not worth the effort, complexity, tax consequences or risk of making key insiders actual equity partners and use ownership proxies such as profits interests. And often these are granted rather than purchased. Profits interests can be useful, but are not the same as equity and likely viewed as another form of compensation by the recipient. Future outcomes won’t be quite as aligning.

Market appeal

A meaningful portion of the institutional asset allocator community favors “independent” employee-owned boutiques, believing in the purity of the model to deliver alignment and better investment performance. There is a certain cachet to being employee owned. And while the lines have blurred a bit—you’d be hard pressed to find an investment firm that calls themselves “captive” instead of “independent”, and it’s hard to know the shape of the indifference curve between 100% employee ownership and some employee ownership—the ability to claim being employee owned is clearly a motivating factor for some.

In the wealth community, independence and employee ownership are often viewed as significant differentiators to the financial institution or corporate owned model. Even the aggregator model comes with orientations and decisions which serve the overall company, and not necessarily those of the clients of any affiliate wealth management firm, especially when they are traded as currency in successive transactions.

There are other reasons, for sure, but these buckets capture the preponderance. The motivations for equity transition should determine the approach. As potential equity partners and, perhaps more importantly, long-time students of the topic, we are often approached to engage in discussions with firms looking to move some equity. The motivations are typically based on the mode of introduction; investment banking processes tend to be driven foremost by price seeking, while network introductions and industry referrals tend to prioritize the company’s future above the sellers’ fortunes. And given that the ways to solve for equity transition are innumerable, we usually start each conversation drilling down to find the true “why”.

BEST PRACTICES STEM FROM THE “WHY”

Once the “why” is established—and if a form of internal transition is indeed the right or combined path to accomplish said objective—we can turn to the “how”. For starters, there is no universally applicable formula or blueprint. There are so many factors at play, both static and dynamic, that there is just no silver bullet solution. However, there are a number of best practices that increase the probability of success in setting up and executing a successful transition program.

Start by considering the relationship between equity and comp

How will your internal equity program mesh with your bonus and incentive structure? Is equity expected to be a proxy for compensation? Or completely distinct? A well-designed equity program becomes an extension of base-and-bonus comp, with a particular emphasis on collective outcomes (both in terms of risk and reward). Standard comp for given roles will more or less level off over time, but distributions tied to equity (and capital value) can grow indefinitely alongside firm value.

There’s also the question of how equity is obtained. Are checks being written? Are bonuses being used—whether by obligation or voluntarily—to purchase equity? Seller or bank financing? Straight-up grants? How do entitlement instincts compete with entrepreneurial? It’s important to consider how an employee’s

take-home pay will be affected, as well as the absolute risk he or she is taking on. Relativity matters. For example, what's the ratio of "at-risk" distributions to more assured bonus dollars or fairly certain base comp?

Our sandbox as partners to employee-owned firms spans companies in the sub-\$100 million EBITDA world, and more typically \$5-50 million. There are very few firms with multiple hundreds of millions (or more) of dollars of EBITDA that have or can create meaningful employee ownership. For these larger firms, equity is solely an incentive tool. And this is where "employee ownership" can become something of a farce. When an employee is immaterial to the cap table, there is no sense of impact and thus no real meaning to ownership. All that matters is the economics, and they only matter if material in relation to the compensation package.

Start early

If internal transition is the goal, it is imperative to move equity early and often. It preserves optionality and may be the only way to reasonably execute such a plan. Many firms wait too long to develop and initiate their internal equity programs, and then find themselves with one or a few key owners holding the majority of the equity late into their careers. This typically takes significant internal equity transition off the table and requires a sale, unless the current owners are willing to dilute/grant much of their stock through long-term incentive programs. Develop a program that gets equity moving and prevents large blocks of stock from developing inertia.

Use a valuation methodology that makes sense

Absent a third-party offer, what are the key elements of a valuation? Companies specializing in investment and wealth management valuations often weight relevant private transactions, public company comparables and/or a discounted cash flow (DCF) valuation in some proportion. These may or may not be appropriate inputs. Private transaction data is often not available or particularly relevant to the case in point, particularly given deferred and earn-out components. Public company data is usually wildly irrelevant in terms of the size, scale and business type to which a firm is being compared. DCF valuations are often irrationally exuberant or flawed given the straight-line assumptions. The only thing certain is that the projections will be wrong. Balancing these components realistically and applying a discount for illiquid securities and/or minority positions is challenging but necessary.

Valuing a firm is further challenging when EBITDA is nonexistent or unreliable. It is possible to normalize a P&L (for commercial compensation and margin assumptions), as long as those that do that math are unbiased. How often is normalized run-rate EBITDA lower than actual? How often is a seller given credit for unlanded prospects or M&A? And EBITDA is not EBOC. Owners' compensation is often a material variable; replacement of any management owner is not without fixed cost.

The key is to understand where the firm is in its lifecycle and to pick a structure that reflects that reality. But also acknowledge the appropriate structure may well change over time as circumstances change.

Compromise on valuation

When price seeking is the driver for an equity transaction, going to market is clearly the best answer. Focused processes quickly distill highly competitive valuations, providing sellers with a short list of compelling (i.e., high) bids and allowing the seller to choose the best partner among these bids.

On the other hand, when other priorities are paramount there is likely to be a price tradeoff. Nowhere is this more pronounced than with an internal transition; sellers should not expect internal buyers to pay a commercial rate, let alone the most competitive market rate. For internal purchasers, valuation discounts have typically ranged over time from 20-50%. That range obviously means material sacrifice for the seller and thus all of the sellers' considerations need to be carefully weighed. Even so, valuations at these levels may be a significant stretch for the buyer(s) as well.

One issue that comes up from time to time, and is particularly relevant in wealth management right now given elevated third-party multiples, is whether internal multiples should be floating or fixed. We've seen internal programs pegged to fixed multiples (where the discount percentage flexes as the market changes), and we've seen some pegged to fixed discounts (where the valuation multiple floats as the market changes). Each has its merits and drawbacks. In our experience, the most important consideration here is the feasibility test. How much equity can be reasonably moved internally, even at the very modest end of the pricing range? The sheer number of dollars required may significantly burden the buyers or be flat out untenable. For example, moving 30% of a business with \$10 million in EBITDA at a 7x multiple would require \$21 million (sizeable absolute dollars). If that 7x represented a 30% discount to a 10x market multiple and the market multiple grew to 15x, the new internal multiple would be 10.5x and the buyers would need \$31.5 million. Is that realistic under any reasonable structured outcome?

For internal transition, the optimal valuation is one that makes everyone a little uncomfortable. Balance the pricing and structure of that equity between some discount to fair market value and the feasibility of your would-be owners' ability to purchase it over time.

Treat performance fees/carry distinct from management fee EBITDA

The topic is further colored by firms whose economics are often dominated by significant performance fees or carry. Typically, such businesses focus more on sharing this upside with deserving employees than buying and selling their equity. For valuation purposes, carry and performance fees are almost always valued at a steep discount to management fee earnings, and even that component can tremendously whipsaw the valuation of any investment business.

Be realistic about financing

Unless the equity transition is done by pure grant, it may be hard for buyers to afford up front or in lump sum. Writing material checks might not be feasible. Financing can be done either internally through the company, its principals, or through the specialty group of banks and lenders which make business lines in

cash flow finance. This is a necessary tool for many firms where check writing alone is not nearly capable of moving the desired stock.

Also consider the payback model; is it likely max 7-8 years or less under realistic assumptions? What if the shares don't cash flow net of debt or payments made for 10 years or more? Should the terms of internal equity programs be recalibrated if the equity/options are out of the money for a long period of time—when does the buyers' perspective sour?

Consider a waterfall, not unlike a PE fund, upon a capital event that appropriately balances different share classes and value creation. Compare unvested/gifted shares with those purchased, and contrast long term inactive owners (5-10+ years) with the recently retired or departed. An outcome that should be avoided with thoughtful planning is that in which retired/inactive partners or entities own significant equity, often 50% or more of the business. It's clearly a demotivating factor to up and coming partners driving more of the current and future value, but maybe a lesser of evils outcome if there is a lack of a significant appetite, unwillingness to take net worth risk, or a strong desire to maintain the known at the expense of the unknown. These are not pejoratively negative connotations; they are practical attributes of many work forces that may be strong functionally but not appropriate for sustained material employee ownership. And internal buyers' appetites to take on debt will be an important factor in the ability to move equity.

Be clear about what equity represents

Don't conflate ownership with control. Ownership should focus on sharing value, while day-to-day governance should be its own dedicated function which puts the best interests of the company above any one individual or group. Equity should never be viewed as a right; it should be viewed as a privilege which an incoming owner demonstrably values and deserves. And ownership is not binary. Becoming an owner does not flip a switch and make someone an insider or management. It is a step in that direction, perhaps, but there are other more important factors that determine the degree to which an owner has influence and makes decisions.

Consider equity alternatives

Alternatives to actual equity may be effective solutions. Phantom shares offer tax advantages for buyers while allowing for participation in profits and capital value creation. An LTIP (long-term incentive plan) can be an aligning retention tool that doesn't require a transaction or change to the cap table.

Multiple share classes or equity incentives can be appropriate especially when owners cycle through very different stages of a company's life or a firm has a parent company. How relevant is an affiliate contribution to the parent's P&L, and how to ensure alignment in a one security business with multiple revenue drivers? Ownership and sharing of team revenue streams is more relevant to the team members, but the parent company stock represents an amalgam of all the P&L's. And beware excessive and unnecessary complexity; it will be difficult to untangle later.

Conduct a pre-mortem

Look at the horizon and consider potential points of failure. What assumptions are being made, and what would happen if they prove false? One thing we've learned over many years of doing this is that over time things will happen that were not anticipated. Maybe a critical value driver leaves or dies, or performance fees dry up, or someone shows up with a large pot of money. Thinking ahead to where the plan might be unprepared is important. To that end, solicit input from current and future stakeholders to understand how their views might vary from your assumptions. For example, G1 shouldn't make assumptions about G2 behavior should things go awry.

Fortify the operating agreement

Think about economic waterfalls and shareholder rights—what happens under different scenarios. For example, all good operating agreements have careful language around purchasing departed owners' shares—whether good leaver or bad; retirement, death or disability—and payout schedules and guardrails that don't put a company's economic condition in jeopardy in the event economics substantially rise or fall within the payout timeline. It becomes a judgment for many firms in these circumstances as to how much of their prospective bonus pool and distribution dollars should be spent buying back shares relative to compensation needs and reinvestment interests, but having clear provisions can prevent unnecessary disputes, align outcomes, and keep the company out of harm's way due to large, unexpected financial obligations.

In 40 years of working with asset and wealth managers on this topic, it has become clear that employee-owned investment businesses very rarely sustain themselves into a second generation. It's almost unheard of to make it to a third. Dodge & Cox, Wellington, GMO and a handful of others have done it, but only by long ago developing internal equity transition programs which incrementally move the stock each year over decades, at valuation methodologies more representative of professional service firms, not asset and wealth management. Very few firms have followed the lead of these venerable companies, as M&A proved to be an increasingly lucrative outcome. Far more owners are likely to seek paydays with new equity plans and incentives, versus taking the internal equity transition route. The explosive growth of private equity capital both in dollar terms and number of competitors provides a solution that most of the founders of long-tenured businesses never had and with which individual buyers can't compete.

For those contemplating what to do and how, seeking advice can be tremendously valuable. Keep in mind, however, that anyone with a vested interest in any particular outcome will be inherently biased. Seek the counsel of those with no vested self-interest. Other firms and peers who have chosen differing paths often make the best sounding boards. Because so many firms wait too long to develop and initiate their internal equity programs, many firms find themselves with one or a few key owners holding the majority of the equity late into their careers. This typically takes significant internal equity transition off the table and requires a sale, unless the current owners are willing to dilute/grant much of their stock through long-term incentive programs.

Some employee-owned firms view very broad-based employee ownership as a badge of honor and point of distinction. Be wary of that goal in and of itself, as well as focusing on options to play to client/prospect preferences. Rather, think through the desired behavioral aspects and the optionality that employee-ownership provides. Make sure the plan aligns with the “why” and then work on the “how”. Getting that right can provide the best shot at a meritocracy that treats ownership accordingly and puts the firm ahead of the person. And in our experience, that creates a distinctive investment organization that owners, employees and clients can rally around for a long time to come.

Have other thoughts or ideas? Drop us a line.

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