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A Case for Rigor in the Glow of the Pipeline

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2010 was a bounce back year for many Investment Banking firms focused on M&A, particularly smaller "boutique" shops. After painful years in 2008 and 2009, with low deal volume, scrambles to assemble restructuring teams, and speculation about the merits of countercyclical products and services, firms are bullish on the M&A pipeline and focusing on expansion. If the anticipated deal volume comes to fruition, this will likely be a prosperous year for the vast majority of firms in this space. There will be a small set of firms that will make the most of this opportunity and some that will simply ride the wave up and then slide back down.

In the scramble to staff out across sectors and geographies and harvest as much opportunity as possible, firms may lose track of appropriately managing the single factor that has the greatest influence on the long-term success of the business: compensation.

Compensation in the M&A space for boutiques is the largest cost of doing business - larger than all the other costs combined. This is a space where there is typically no capital committed and little delivered in the way of commoditized products offered to clients. Thus, at the end of the day firms are selling intellectual capital and sorting out how to most effectively divide up the proceeds from these sales. While it sounds relatively simple, many questions hang on the back of this:

1. How should the equity / ownership of these organizations best be structured?
2. What percentage of the proceeds should be distributed to the equity holders vs. the revenue producers?
3. What is the appropriate funding rate for the business, based on its unique set of challenges / opportunities / level of maturity?
4. Once the firm wide bonus pool is funded, how is it best divided up between teams or divisions?
5. How can the pool distribution be optimized?
6. Does the overall cost structure of the organization (non-compensation costs) support the business without creating an undue drain on compensation?
7. Is the support or infrastructure area of the organization appropriately calibrated to the size and needs of the banker population?
8. Are the right bankers on board? Are they productive?

While this is a fairly long list of concerns, many of them speak to each other. In attempting to position a firm to maximize the benefits of a robust pipeline, it is critical to benchmark and assess the firm's performance relative to the competitive market. When

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done properly, this assessment should quickly reveal where to find the greatest opportunity for improvement:

- Is there a "revenue problem"? (too many unproductive bankers or not enough productive ones - firm unable to generate enough revenue to reward talent)
- Is there a "cost problem"? (too undisciplined with controlling cost - in spite of good production, there is a hole in the bottom of the bucket)
- Is there a "scaling problem"? (oversized support staff is a drain on banker production)

The results of this diagnostic process, coupled with the existing, defined business plan create a clear lens through which to view the set of eight compensation related questions listed above. These questions cannot be answered generically - the answers need to conform to the business plan and the competitive benchmarking. Surprisingly, in spite of a generally optimistic market view, there may be significantly different strategies appropriate for different firms in this space - consider these hypothetical scenarios:

Firm A

- Would benefit from actually shrinking in size - pruning out unproductive bankers, narrowing focus on fewer sectors with deeper coverage
- The comp cost reduction due to increased discipline around staffing would free up dollars to hire top talent only and over the course of time would result in a leaner organization with upgraded capabilities

Firm B

- Has disproportionately large support staff - has capacity to grow banker population significantly without adding incremental support heads or needs to scale back infrastructure compensation spend

Firm C

- Is owned by partners who only account for a fraction of revenue production - connection needs to be established between producers and ownership stake and returns

Firm D

- Has ambitions to add significant amount of staff, but is concerned about new bankers being focused purely on current year comp payouts vs. building franchise - need to build link to long-term view

All things considered, most firms advising clients on M&A transactions will have a strong year in 2011. Some number of these firms will make a decision to use this as a transformational year. They will not only enjoy the short-term spoils of a hot market but also make structural changes that will leave them poised for continued success throughout the business cycle. ■

ABOUT THE AUTHOR

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