Remuneration Perspectives
1st Quarter – March 2006

Partner Pay:

"Who chooseth me shall get as much as he deserves" Shakespeare

Partner compensation is not only a sensitive topic, usually it is also extremely sophisticated and complex. Ultimately, it can also be unfair to high performers….

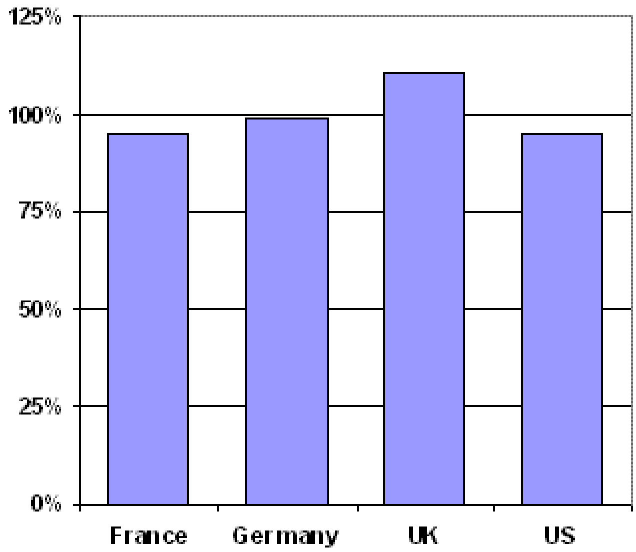
In the previous VenCon Perspectives (A World of Difference?), we examined how consultant pay-scales differed across economies as varied as India and the USA, but noted the extent to which earnings levels converged as we approached the Partner / VP level. This, we suggested, was a reflection of the global mobility of the most senior levels within top consulting firms, making them unlikely to accept extreme differentials in compensation.

For this quarter's *Perspectives*, we decided to look more closely at the issue of Partner Compensation in top consulting firms.

Hypothesis

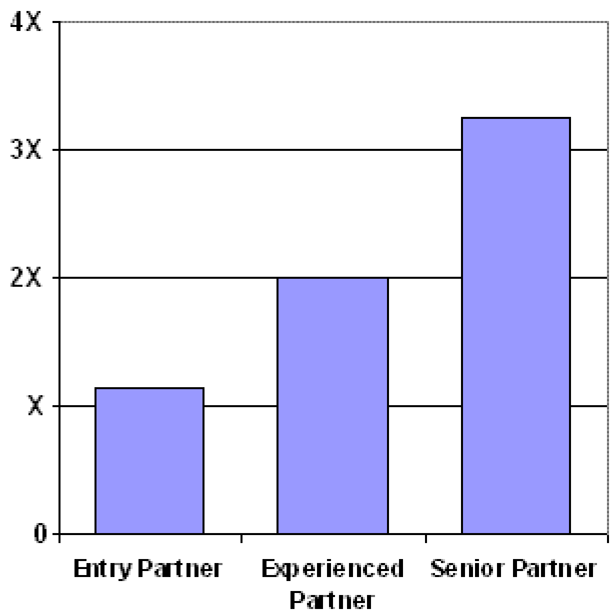
Building on our work for the Partner groups of a number of top consulting firms since 2000, we continue to present the hypothesis that Partner Compensation varies little by geography. To support this, we have taken data for the US, UK, France and Germany, which has enabled us to establish a consistent sample of international and global strategy firms and found that this hypothesis certainly holds true (Figure 1): Currently the difference in average Partner compensation between France and the US stands at less than 5%.

Figure 1. – Relative Compensation by Geography



For any given firm, such variation in pay as exists between the Partners' compensation across these four territories was, in part, certainly intentional, and was also attributable to each particular market's potential. Finally, one cannot ignore the dramatic impact of exchange rate movements: the last 5 years has seen the Euro-US Dollar rate vary by an incredible +/- 27%; even the Sterling-Dollar rate has flexed by +/- 20%, making this probably the most significant variable in the whole equation.

Figure 2. – Relative Compensation by Grade



For the purpose of structuring a meaningful comparison, we identified 3 generic levels of Partner: Entry, Experienced and Senior. Whilst the firms themselves may specify as few as 2 or more than 12 discrete Partner Grades, none had a problem working with these broad definitions, and for the purpose of this exercise, they are largely self-explanatory. Figure 2 illustrated the growth in average income between Entry and Senior partners as more than 3x's - significant by any standards.

Partner compensation, of course, is as much subject to market forces as anything else, so whilst we may see considerable parity across similar firms, it's no surprise that Partners in the larger global firms, exhibiting a bigger staffing and responsibility pyramid, often with larger client budgets and higher top-end performance goals, consequently have a higher top end to their partner compensation scales. Total compensation in excess of $1 million per annum may not be exactly commonplace, but it is certainly not an unrealistic expectation amongst the senior partner population.

However, in contrast to this relative homogeneity in average absolute compensation levels we saw very significant variations in the structure of the overall compensation package. Whilst we can adequately describe the compensation package of consulting's proletariat in terms of Base, Bonus and Benefits, the Partner / VP compensation structure is much more sophisticated, as are the targets and evaluation criteria by which their performance – and even continuance in office – is determined.

Determining and comparing Partner / VP compensation is therefore as much about understanding the firm's structure, drivers and targets as it is about the absolute numbers. Without knowing the underlying structure quoting projected total compensation for a Partner is as meaningless as giving a Sales Representative's 'On Target Earnings' without establishing sales targets, unit prices or market size.

Structure

Since 2000 VenCon has worked with a number of leading strategy firms on analysing and, where necessary, designing and implementing new Partner compensation structures. From the outset, we needed to establish a framework that would facilitate a meaningful comparison.

Figure 3. - The Partner Net-Worth Model

Current Income	Deferred Income
Base income: ▪ Paid-out monthly ▪ May be a fixed salary, a regular 'draw' against year-end income or a combination of both	**Equity growth:** ▪ Investment in stock, options and/or phantom derivatives of the firm or parent company ▪ Paid out upon retirement
Variable bonus income: ▪ Paid-out usually once per year ▪ Based on performance targets ▪ May be based on the profits of the company and/or country	**Pension contributions:** ▪ Firm's contribution to a company financed pension / retirement fund ▪ Paid out upon retirement
Other relevant income: ▪ Can include interest and dividends, equity units and equity derivatives ▪ Based on share ownership ▪ Paid-out of profits of the company	**Other external investments:** ▪ Investment in stock, options or derivatives of an external company ▪ Paid out after sale or realisation of the investment

Complicated and detailed modelling

The *Partner Net-Worth* model (Figure 3) identifies six components of Partner compensation, and so enables us to assess the overall package across several dimensions – fixed versus variable, current versus deferred, income versus equity. The evaluation of the actual numerics behind these dimensions, however, is significantly more complex:

Draw versus Salary: While some firms regard the Partners' regular monthly income as a salary payment, charged against overall personnel costs, others treat it as an advance or 'draw' against end-of-year profit distribution or bonus. Some firms operate a combination of both options, with a minimal salary supplemented by an optional draw up to a pre-agreed maximum. Adding to this complexity is the question of reimbursing excess draw if the firm, or the individual, has a poor year.

Current versus Deferred: Larger, more established firms have issues of continuity and retirement planning integrated into their compensation schemes, often with significant pension schemes and a track record of equity growth which together can represent over 25% of the total package value. Other (usually younger) firms, without a significant pension population (or a Senior Partner group growing increasingly concerned about such matters) may ignore deferred income totally – on the basis that pensions can be paid privately from the healthy current income pot.

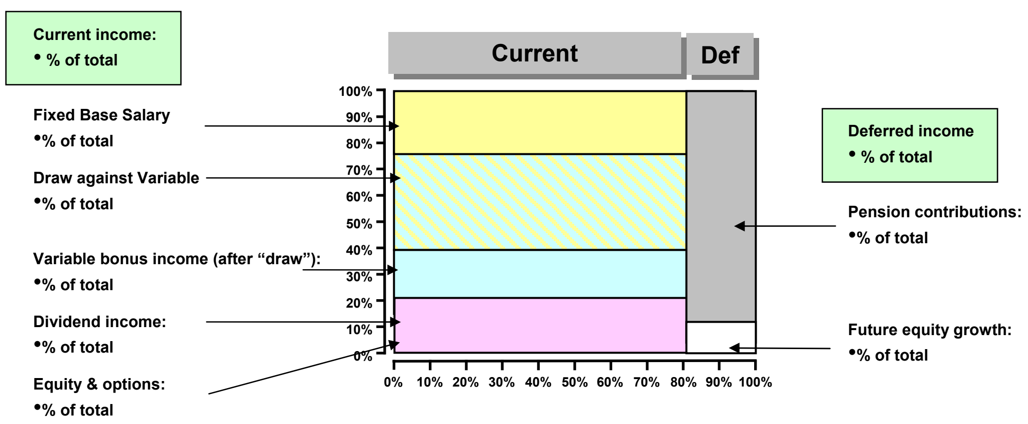
Other Income: Becoming a 'partner' usually requires the new partner to buy into the business – although if the firm is not a true partnership, but is either quoted or is a subsidiary of a quoted firm, it may result in the vesting of stock and options as part of the overall package. But however sophisticated the firm's forward revenue projection, NPV and Black-Scholes calculations may be, there is a considerable Act of Faith in building future investment values into the compensation package. The conservative option is to take any discount offered to current 'stock price' as an element within the current compensation. For deferred compensation, partnerships tend to have an agreed annual increment in the 'stock price', verified by independent audit, and usually extremely conservative.

Investment Programmes: Interestingly, *external* investment programmes have become much less common in the last couple of years - since the demise of Dot.Com Inc., in which so many firms had taken equity in exchange for fees!

Benefits: We have not, within this article, included any valuation of benefits, other than pension contributions. The most significant of these is the provision of cars, where the annualised value is of limited significance within the total compensation package, and tends to be consistent within most geographies.

From this complexity, we have established a model for total partner compensation, which might look like Figure 4 below.

Figure 4. – Typical Partner Compensation Model - Illustrative



In terms of the make-up of the 'average' Partner package we find most significant variations again come from the structural differences between individual firms.

Whilst we found commendable consistency in the total target value of the compensation package for each given partner level, we found remarkable differences once we started to examine remuneration against performance.

Performance

Within an 'average' strategy consulting firm we saw a typical staffing pyramid comprising 9 partners (of all grades), around 65 consulting staff and 26 support staff per 100 total staff. If we then take a typical strategy consulting 'revenue per professional' figures of $450k, we arrive at achieved revenues of almost exactly $30 million per hundred total staff, or an average of $3.3 million per partner,

Whilst this represented the average firm's structure, the individual firms in the study showed marked variance, with partner numbers ranging from as low as 5% to as high as 15% of the total. And this was where a critical anomaly arose.

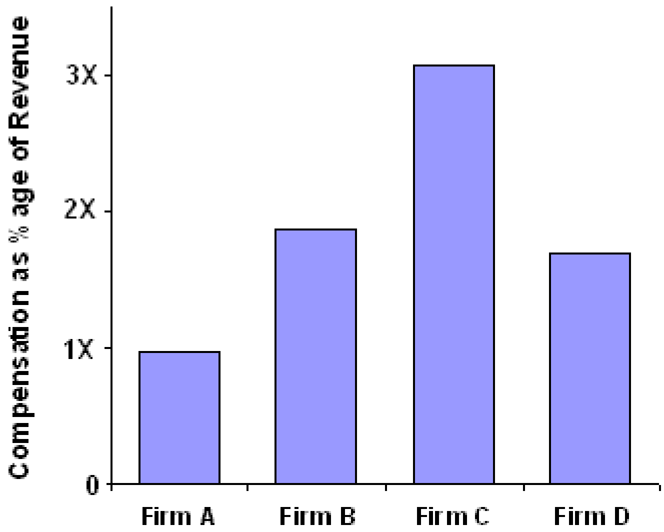
Fundamental economics dictate that in order to provide the revenues to *feed* the 91% or so of 'non-partners' in the business, all of whom are being paid at local 'market rates', the partner group in each firm must generate roughly the same revenue per 100 staff. So on a like-for-like basis those firms with only 5 partners per hundred must generate 3x's the revenue per partner as the firms with 15 partners per hundred. Whilst there is some mitigation in the exact mix of each partner group, this is generally what we see in practice.

Anomaly - I

What we don't see in practice, however, is a comparable variation in overall partner compensation – in fact, as we have already noted, total compensation is fairly consistent for a given partner level, even if the structure of that compensation package varies considerably.

To test this, we modelled the target compensation as a percentage of revenues of a number of firms, using their actual partner numbers and partner mix per 100 total staff, to see how different compensation structures reward partner performance.

Figure 5. – Partner Compensation as % of Revenue



The firms with the smallest number of partners per 100 staff – Firms A and D in this example – are tasked with the highest individual revenue targets. However, their reward, when expressed as a proportion of the revenue generated, is the lowest in the sample group.

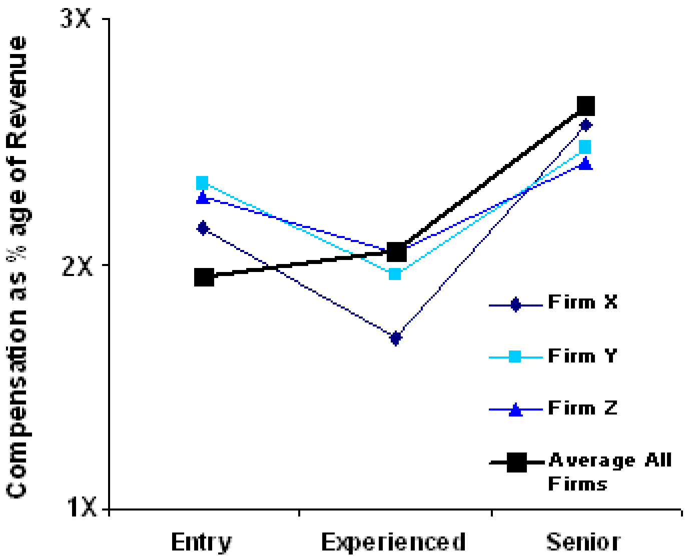
This, of course, is a structural issue – the firms in question may feel that they are operating in a finite market, and by having fewer partners they are simply facilitating higher revenue per partner, enabling every partner to be a successful rainmaker. As such, they may see no imperative to reward their partners disproportionately to the market.

Anomaly – II

This, however, leads us to another, more bizarre anomaly. If we now repeat this 'remuneration per unit revenue' exercise for the different partner grade levels within the same firm, we would expect to see a consistent trend: Naturally, revenue targets increase with seniority. As a result, each Partner should produce, in principle, more of the firm's total revenues as he / she grows through the ranks and Senior Partners should get a higher proportionate award, to reflect their higher performance goals and seniority.

For many firms in our study, we did see a consistent trend – generally, Senior Partners got a higher proportion of their achieved revenue than their more junior colleagues. But several of the firms in our study exhibited a curious 'hockey stick' curve, which when expressed in "Compensation per Million Revenue", demonstrated that Experienced Partners actually received a smaller proportion of the revenue generated than either Senior OR Entry Partners.

Figure 6. – Partner Compensation as % Revenue



By compounding the elements of a compensation structure such that the base, draw, profit share, interest, equity, options and dividends may each be geared to differing performance targets, the summation can sometimes create unexpected outcomes.

In each case in our study, although there was a progressive increase in total compensation at successive levels, it was not necessarily in direct proportion to the increased performance targets. The revenue targets between Entry : Experienced : Senior Partners were frequently set in inverse proportion to the number of partners within each grade. Consequently the step size in revenue targets actually decreased between the successive levels, whereas compensation increments between levels were more likely to be equal. The net effect was that, the Experienced Partner was, to some extent, penalised.

Conclusion

Partner compensation schemes have usually evolved over time, are periodically 'tweaked' to address a specific market or internal issue, and generally calibrated to achieve a 'felt fair' balance across the board. Inevitably, each change creates more anomalies in its wake.

Working with our clients on these analyses we inevitably must face issues such as:

- Is the 'hockey stick' compensation curve a natural consequence of 'Up or out'?
- How and to what extent can Senior Partners benefit from their greater value to the firm?
- Would partners in a firm with low partner numbers be better off in a high partner firm?

Of course, in total compensation terms, no-one on a Partner package should feel deprived. But without looking at the whole picture - internal and external relativities, measurement metrics, business drivers and total compensation value – and periodically reviewing these against a consistent framework of what the firm aims to achieve, some bizarre outcomes will result.