Buyouts

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INSIGHT

When the journey is not over: performance vesting beyond an IPO

Two trends are becoming increasingly relevant for mid- to large-cap private equity buyouts: performance-based vesting and the increasing frequency of companies choosing an exit involving the public securities markets.

In private equity deal making, emerging trends frequently converge and impact one another. In the current climate, two such trends are becoming increasingly relevant for mid- to large-cap private equity buyouts: (i) the surge in use of performance-based vesting for incentive equity awards in sponsor-backed companies as a complement to time-based vesting, and (ii) the increasing frequency of companies choosing (or actively considering) an exit involving the public securities markets in recent periods.

Performance vesting – A Babel of approaches

Performance-based vesting, or the use of distinct classes of growth shares in a European context, can be based on a number of economic metrics, and generally involve sequential and ascending hurdles which ratchet up management returns once achieved. Most commonly, the performance thresholds are based on the sponsor's multiple of invested capital ("MOIC") and/or internal rate of return on invested capital ("IRR"). Such structures aim to more closely align the interests of entrepreneurial management teams and sponsors and better assure employee retention. Their underlying principle is that a sponsor will be willing to share an increasingly large percentage of equity ownership with management as overall equity value grows, but only if the sponsor's superior returns are realized.

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The specific terms and operational details of performance vesting arrangements tend to vary widely. However, in many performance vesting arrangements that exist today, the possibility of an IPO is not addressed. Rather, terms in such arrangements have often simply provided that, upon a sale, the number of performance-based awards that vest will be measured and "crystallized" based on the company's equity value established in the sale.

Alternatively, performance vesting terms in some US deals and most European deals envision an IPO as a possibility but view it as terminal calling for "exit event" crystallization of the arrangement. Here, the company's equity value is marked-to-market based on the IPO price, and performance vesting awards are settled in accordance with the waterfall, typically by way of distribution of public company stock. Any unvested performance awards drop away at this point unless the board decides to accelerate or replace them with public company incentive awards such as options or RSUs.

Actual examples of pre-IPO performance-based awards designed to stay "live" following an IPO are not ubiquitous, and examples of those that actually stay alive post IPO are rarer. For example, in the recent US IPO of KinderCare, the MOIC-based incentive equity awards granted at the time of the original buyout provided for continued vesting following an IPO but were vested at the discretion of the Board at IPO.

In another recent IPO by a sponsor-backed company, Sovos Brands, pre-IPO restricted share awards with a performance vesting component count post-IPO realizations by the sponsor. Performance-based restricted shares that are forfeited are effectively recycled to the sponsor and other investors through special distributions. Alternative approaches exist, but no common standard has yet emerged.

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Should vesting last beyond IPO?

Management and sponsors alike may have an interest in keeping vesting of performance awards alive following an IPO.

In the most elemental level, from management's perspective, allowing pre-IPO incentive equity awards to continue to vest post-IPO creates the possibility of reaching high-end hurdles and thus making more money. In this regard, unvested pre-IPO awards are highly advantageous because they are typically deeply in the money and structured to achieve long-term capital gains tax treatment of proceeds. By contrast, if lapsed awards are replaced by public company incentive equity awards, the tax and economic consequences will be less favorable.

From the sponsor's perspective (and management's), having management remain on board to focus on post-IPO stock price appreciation can maximize the sponsor's investment. This is particularly true if the purpose of the IPO is to raise capital rather than to facilitate a partial sponsor exit. Few handcuffs are more golden than a deeply in-the-money tranche of incentive equity awards having challenging but attainable hurdles that will ultimately deliver tax-advantaged returns.

Keeping performance vesting terms of pre-IPO awards alive beyond an IPO can be complex and lacks a large body of precedent. Doing so is best suited for situations where the original vision of the management/capital partnership includes at least a realistic possibility of going public and increasing the sponsor's return (while creating value for public investors as well) through post-IPO appreciation. In that circumstance, the management team's task doesn't end when the IPO occurs.

Art is in the execution

What are the relevant issues and questions that should be considered in implementing an incentive equity program that includes performance vesting that extends past an IPO? They may include: Are awards sufficiently in the money and attainable? Who will bear the dilution that results from the vesting of pre-IPO performance-based awards? Will there be any accommodation for the fact that attainment of performance hurdles can become harder as the shared capital base shrinks due to serial sponsor monetization events? Post-IPO performance-based arrangements can be especially tricky, particularly for structures that extend across multiple geographies and jurisdictions, with a range of inherent tax, securities, structural and market practices issues.

Future developments and evolution of the market will hold the answers to these questions.

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