

BUYOUTS

INSIDE THE DEAL

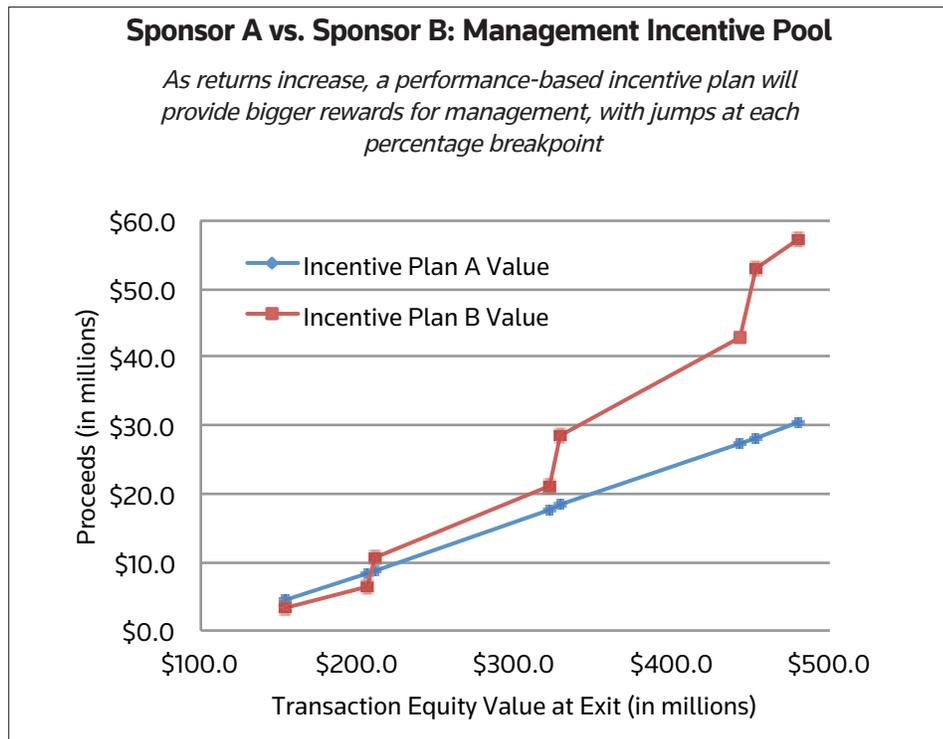
Slicing up the pie: the role of incentive equity in winning deals

By John LeClaire, Mike Kendall and Chris Nugent, Goodwin Procter LLP

Among the most important terms in any private equity transaction are the size and structure of the management equity incentive plan. Offering an attractive incentive plan can help a sponsor convince a CEO or founder to choose its proposal over competing bids and create incentives that catalyze growth.

For thoughtful management teams and the sponsors who wish to partner with them, incentive plans can be created to allocate increases in equity value in a way that correlates with the amount of value created.

Such incentive plans utilize “performance vesting” and (like preferred stock with variable ownership based on company performance or exit value) are increasingly common in growth buyouts and investments, particularly in the middle market. For example, a 10 percent incentive plan might include a tranche of equity awards that vests based on the passage of time (e.g., 5 percent), with a right to additional ownership if and when the sponsor realizes specified returns (e.g., an additional 2.5 percent at each of 2x and 3x). Within this framework, some management teams evaluate incentive plan terms by considering the allocation of incremental equity value they will



enjoy at various levels of exit value in relation to the value captured by the sponsor and its general partners.

To illustrate, assume that two sponsors are bidding to acquire a company, which we’ll call “Hotco.” Sponsor A offers a basic, time-vesting incentive plan that entitles the management team to 8 percent of any increase in the equity value of Hotco over Sponsor A’s investment amount.

Sponsor B offers an incentive plan that entitles the management team to 6 percent of increases in equity value under time-based vesting, plus an additional 3.5 percent, 3.0 percent and 2.5 percent if and when the sponsor realizes cash-on-cash returns of 2x, 3x and 4x, respectively. Each sponsor proposes to invest \$100 million of equity and no sub debt. Each has a 20 percent carried interest arrangement with its



INSIDE THE DEAL

limited partners. Neither sponsor’s capital carries a preferential return, and Sponsor B’s incentive plan has a “catch up” feature (via the waterfall or option vesting terms) back to initial equity value each time Sponsor B’s cash-on-cash return attains a benchmark. Assume that debt remains constant, there is no rollover, Sponsor A and B have similar intangible credentials, and both proposals have the same tax characteristics.

The accompanying charts illustrate the financial results of the competing proposals in a sale of Hotco at various exit values. If you were Hotco’s CEO, which would you favor?

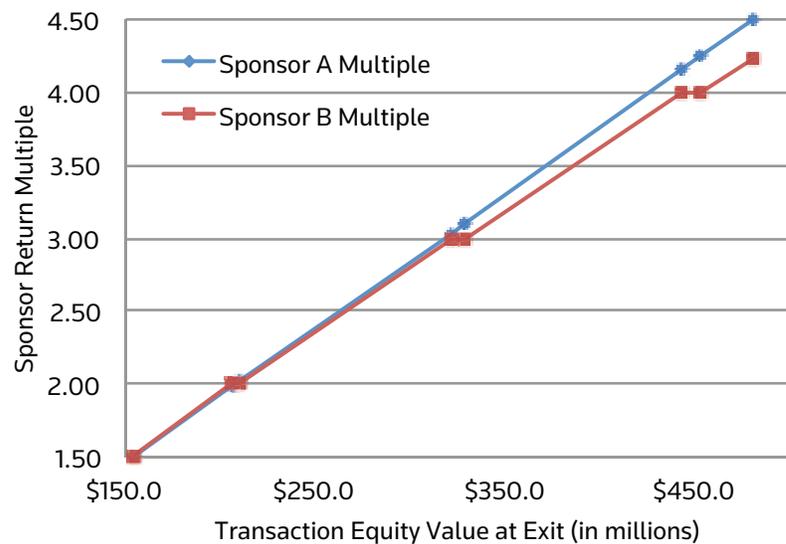
There is, of course, no “correct” answer to this question, just as there is no limit on the variations of performance-based incentive plans (although in buyouts many tend to utilize a blend of performance-based grants and time-based grants and to target performance benchmarks at or near the 2x and 3x levels). Other benchmarks/terms that are not uncommon include IRR, EBITDA, less “cliffy” return multiples, and time to exit, alone or in combination. The relative ubiquity of cash-on-cash return as a benchmark reflects the fact that cash return is a direct measure of investment success and not merely an achievement that is predictive of investment success, such as meeting an EBITDA goal.

The Hotco example shows that a management team that executes its plan is very likely to make more money with Sponsor B. It also shows that the cost to Sponsor B of increasing the management team’s stake as equity value grows—thereby flattening its return curve a bit relative to Sponsor A’s—is modest in terms of the incremental amount of equity value at exit needed to deliver significant incremental rewards to management.

For example, the aggregate equity value needed to generate a 3x return for Sponsor A is \$317.4 million. In comparison, Sponsor B will realize a 3x return (after funding the incentive plan at the 12.5 percent level) at an equity value of \$328.6 million, \$11.2 million higher. At the equity value at which Sponsor B achieves a 3x return

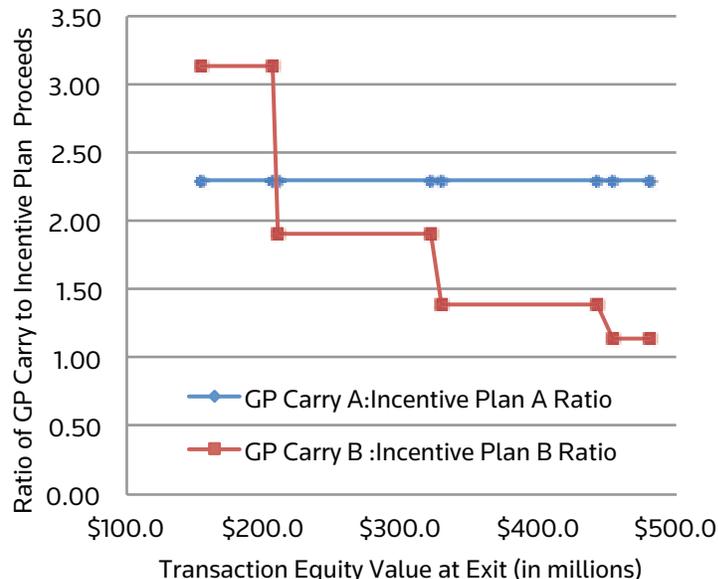
Sponsor A vs. Sponsor B: Sponsor Returns

Sponsor B’s returns are slightly higher at lower exit values. At an exit equity value of \$207.5 mln the two return curves cross



Sponsor A vs. Sponsor B: Ratio of GP Carry to Management Incentive Pool

An incentive equity plan with a single fixed percentage for management will always have a flat GP carry to incentive pool ratio



INSIDE THE DEAL

(\$328.6 million), Sponsor B gives up 0.1x in additional return multiple and 0.84 percent in terms of IRR (assuming a five-year investment period with no interim distributions) compared to Sponsor A's return at that level, while the management team realizes an additional \$10.3 million, or 56 percent more than Sponsor A's incentive plan provides in an exit at the same equity value.

The performance-based incentive plan proposed by Sponsor B will result in a narrowing (in steps) of the ratio between the returns to management and the sponsor and its partners as exit values rise. In Sponsor A's proposal, by contrast, the ratio of general partner carried interest proceeds to incentive plan proceeds is constant at 2.3 to 1 at all levels of exit value; a smaller fixed percentage incentive plan would have a wider but similarly constant ratio. An incentive plan in which the sponsor and its partners have a constantly higher share than the management team

at all levels of exit value may reflect the fact that the sponsor is expected to drive a substantial amount of value creation, for example by providing valuable services such as M&A execution, operational guidance and references for new business. If the ratio narrows as equity value increases, it may signal that the management team is expected to be principally responsible for increasing equity value. In any case, sharing the rewards of a superior outcome more liberally as investment returns increase may be attractive for a sponsor, especially if the trade-off is a lower share for management in a disappointing or so-so exit scenario. This may be particularly true if the carried interest percentage of the sponsor's general partners increases as fund returns increase.

Apart from the key issues of the incentive plan's size and basic structure, a number of other issues are important. Among these are the nature and (critically) tax

status of the incentive plan awards (i.e., options, restricted stock, profits interests, etc.), capital and dividend preferences, vesting terms, intricacies related to determination of performance, allocation of awards, and dilution, call, put and "conversion" terms, if any.

Regardless of how these issues are resolved, it is critical to keep in mind that there can only be 100 points of equity to allocate in any entrepreneurial situation. How these precious points are allocated, and the degree to which the allocation creates a management-investor partnership in which interests are aligned, are important factors in winning bids and facilitating investment success. ❖

John LeClaire is co-founder and co-chair of the private equity group at Goodwin Procter LLP; Mike Kendall is a partner in the firm's private equity and technologies groups; Chris Nugent is partner in the private equity group; Adam Small, a Goodwin Procter associate, also contributed to this piece.