2013 SURVEY

ROLLOVER AND INCENTIVE EQUITY TERMS IN MIDDLE MARKET PRIVATE EQUITY

GOODWIN PROCTER

TABLE OF CONTENTS

ABOUT THIS SURVEY

In any private equity transaction, the architecture of rollover equity and management incentive equity is critically important. While exhaustive studies exist on other matters such as transaction terms in the acquisition context or the contours of management equity in public companies, there is little publicly available data concerning rollovers and management incentive equity in private equity transactions.

How we did it

We sent our survey to our network of private equity clients and friends, principally in the middle market. Respondents were promised confidentiality as to both their identities and their specific responses. Our inquiry was limited to transactions involving acquisitions of a controlling interest. There was no focus on any particular industry segment or geography. We received completed responses from over 50 firms.

How it can be helpful

Being able to cite a study on a particular point rarely, if ever, wins a point for your side. However, the use of such studies can quickly and efficiently convince the other side that your position is not novel, nor unheard of, or the commonly used "not market." This study is intended to be a tool to help facilitate discussion of what terms are appropriate in the context of a particular transaction, and more broadly to provide insight into an important aspect of middle market transactions.

More significantly, getting rollover and management incentive equity terms right is one of the principal ways a financial sponsor can win over a founder or management team. From their perspective, rollover and incentive equity are among the most important economic aspects of a buy-out transaction. Knowing how to structure win-win solutions is therefore critical.

The future of this study

We intend to make this study a living document that will be updated and expanded periodically over time. We plan to capture the evolution of trends and, along the way, add areas of subject matter that will be of interest to the participants in and readers of this study. To that end, if you have not yet participated and would like to do so, if you were not on the original mailing list and would like to be, or if you have suggestions for additional questions or topics, please contact either **John LeClaire** (jleclaire@goodwinprocter.com) or **Jon Herzog** (jherzog@goodwinprocter.com).

EXECUTIVE SUMMARY OF FINDINGS

- Rollover interests ranged from approximately 8% to nearly 40% in our survey respondents' transactions.
- Rollover interests rank *pari passu* with sponsor equity more often than not.
- Sponsor securities in transactions involving rollovers are predominantly in the form of participating or straight preferred stock.
- Rollover securities are almost always subject to drag-along provisions, and sometimes are subject to call rights in favor of the company on departure of the holder or in other circumstances.
- Over 80% of sponsors surveyed require rollover investors to agree to non-compete/non-solicitation provisions.
- The average size of management equity pools offered by the sponsors responding to our survey is 12.57%.
- Management incentive pools most commonly involve a blend of performance vesting and time-based vesting.
- Return on invested capital is the most common performance vesting metric.
- Profit interests are used in lieu of options with increasing frequency.

1 SCOPE AND NATURE OF ROLLOVER INTERESTS

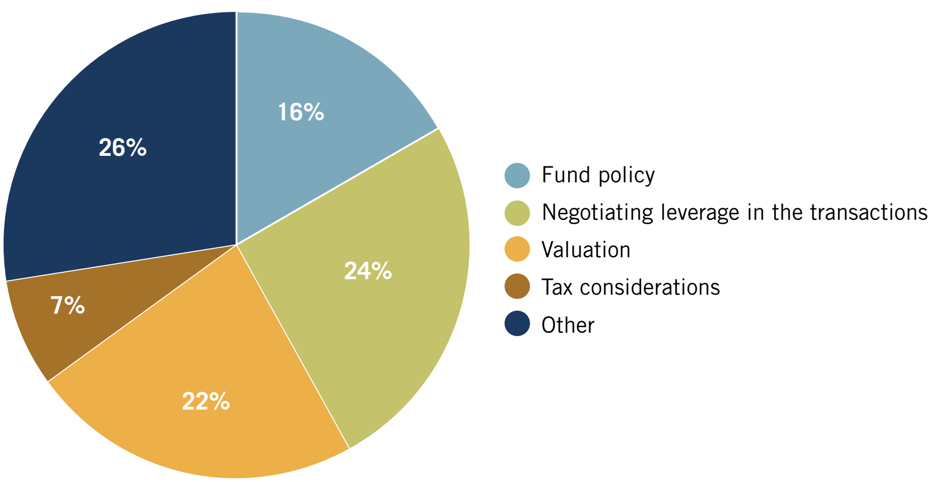
Percentage Range of Rollover

What is the typical percentage range of the rollover in your fund's majority transactions?

	Average
Min %	8.75%
Max %	39.20%

Drivers of Percentage Range of Rollover

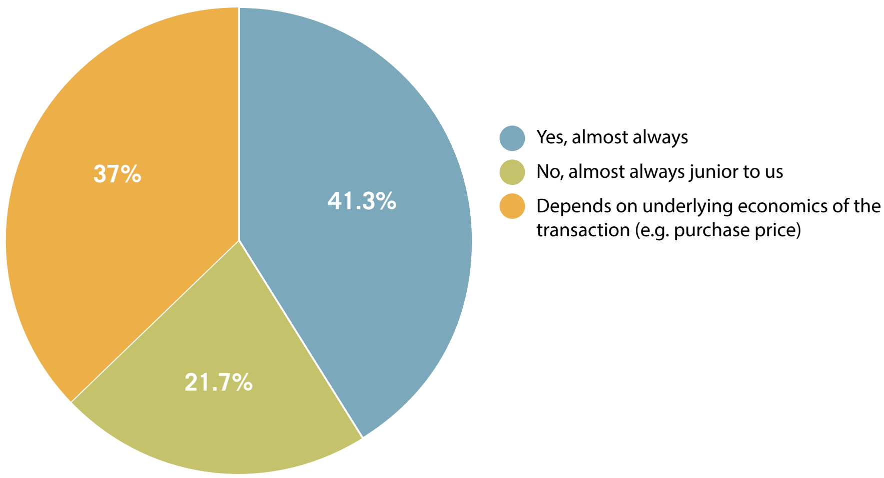
What drives the determination of percent range of the rollover in your fund's majority transactions?



Note: This question allowed participants to choose all answers that applied.

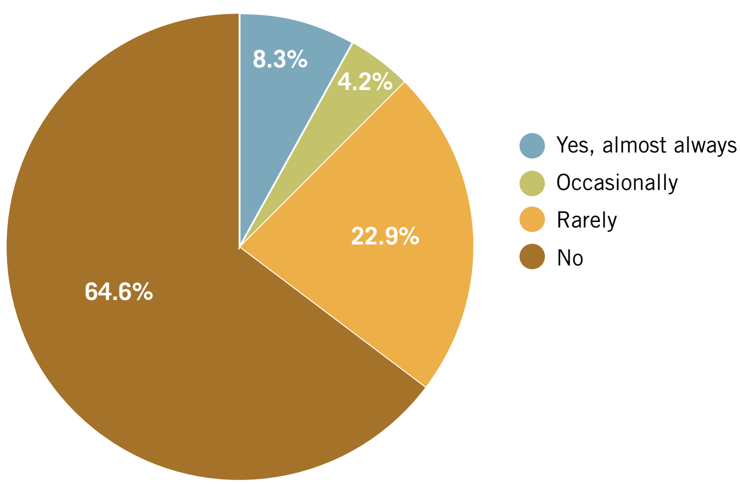
Is the Rollover Pari Passu?

Do Sellers' rollover securities rank pari passu with securities purchased by your fund?



Vesting Requirements

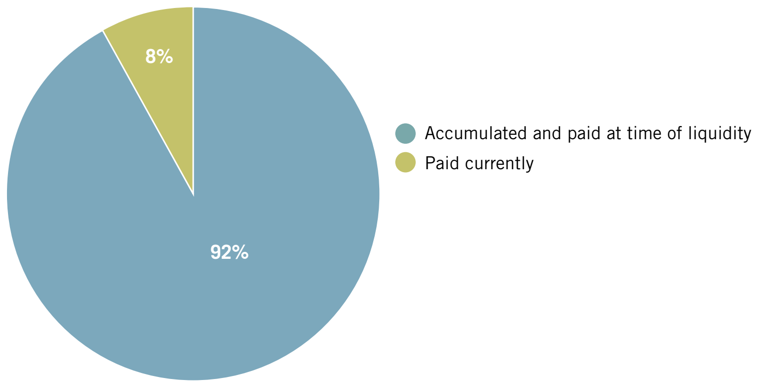
Are rollover securities typically subject to vesting requirements?



2 CHARACTERISTICS OF BUYER SECURITIES

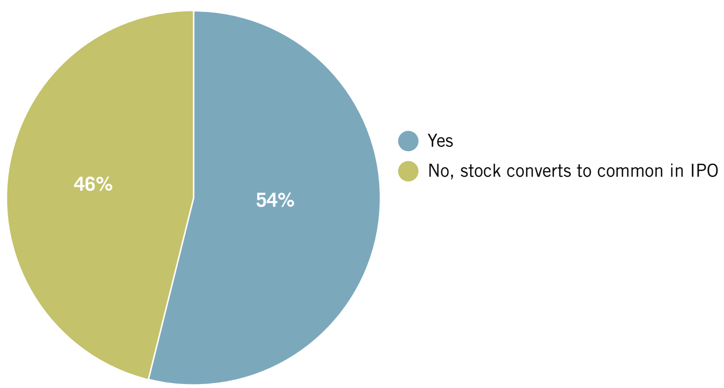
Timing of Dividend Payments

When are dividends paid? (subset of deals with accumulating dividends)



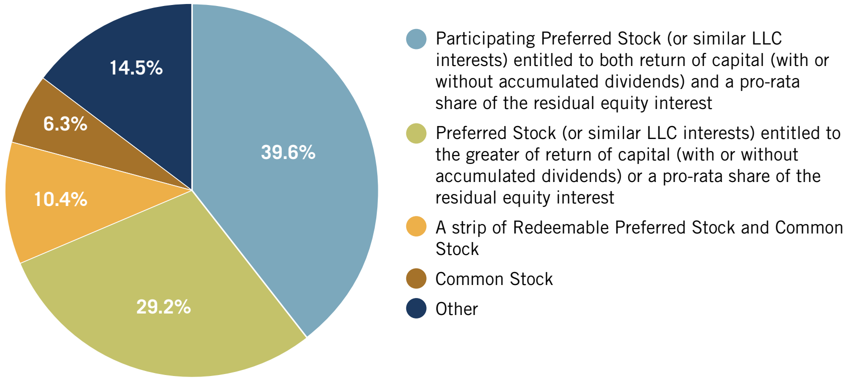
Return of Capital in an IPO

If your fund acquires a Participating Preferred Stock, do you get your preference/capital returned upon IPO?



Types of Securities

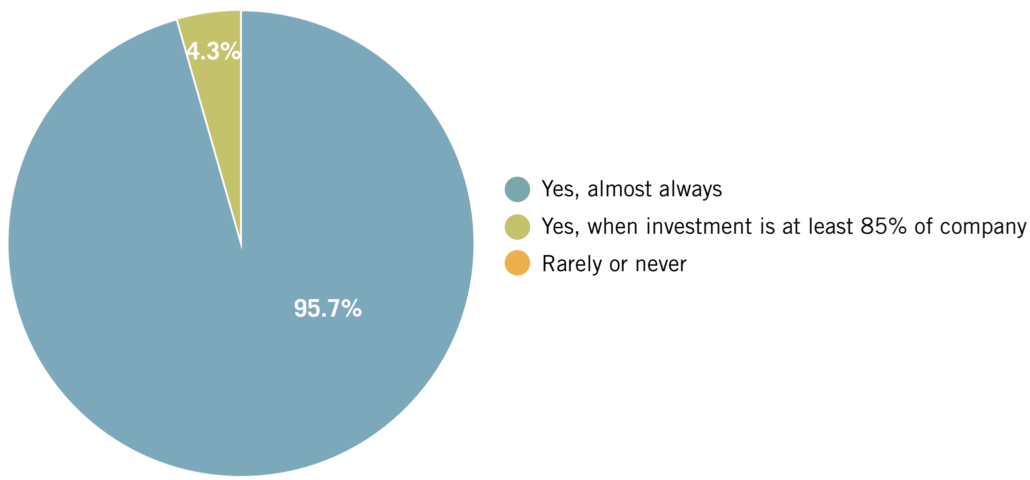
Typical Securities Purchased by Buyout Sponsors



3 TERMS OF SELLERS' ROLLOVER SECURITIES

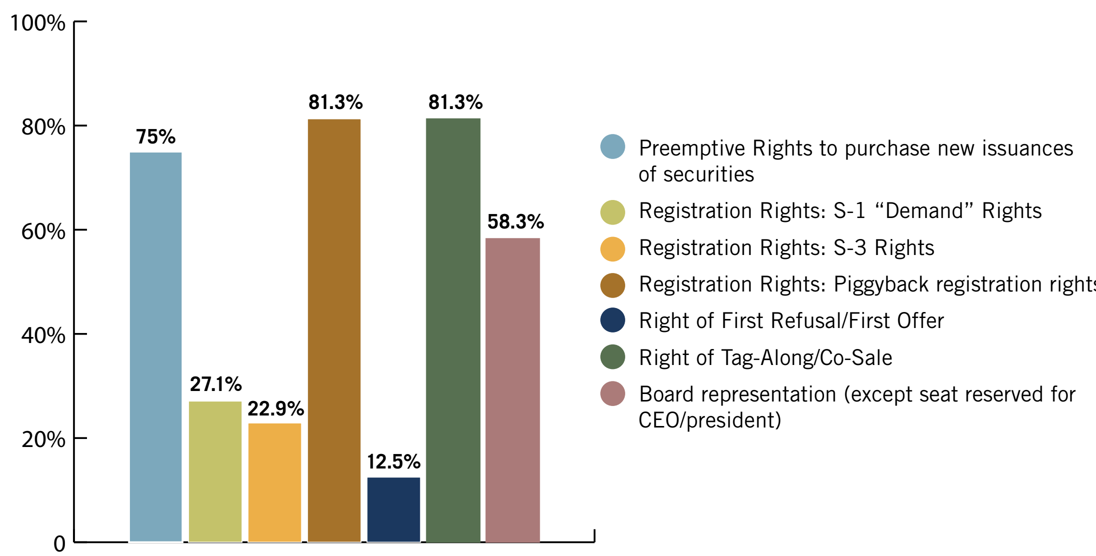
Restrictions and Limitations

Are rollover securities subject to drag-along/forced sale in favor of the fund's securities?



Rollover Rights

What rights do you typically offer holders of rollover securities?



Note: This question allowed participants to choose all answers that applied.

4 MANAGEMENT INCENTIVE EQUITY POOLS

Average Size

Average Size of Management Incentive Equity Pools

Average
12.57%

Note: This topic is particularly dependent on industry, locale and situation.

Average Pool Grant Size by Position

Average Equity Percentage Set Aside for Management

Management Level	Average
CEO	7.45%
CFO	2.97%
Other C-Levels	4.95%
Outside Directors	1.09%

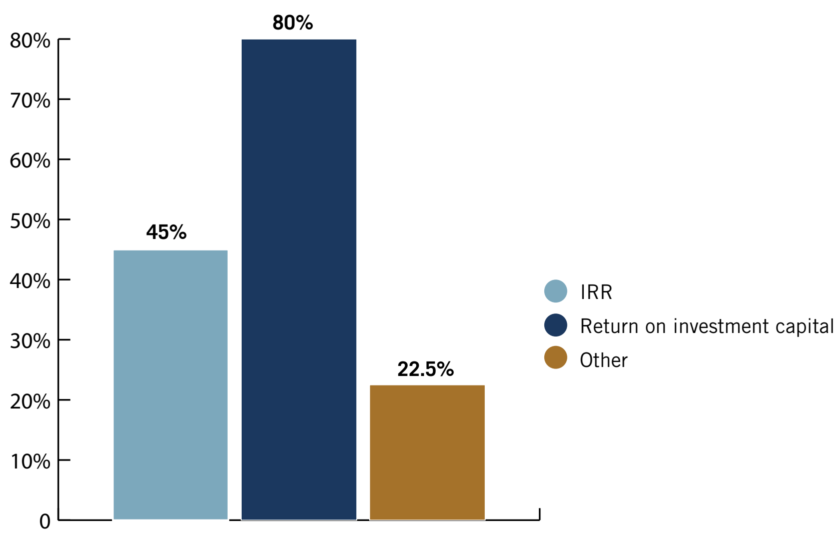
Average Vesting

Average Vesting Terms for the Management Incentive Equity Pools

Vesting Method	Average
Time-based vesting	55.1%
Performance-based vesting	44.9%

Performance Metrics

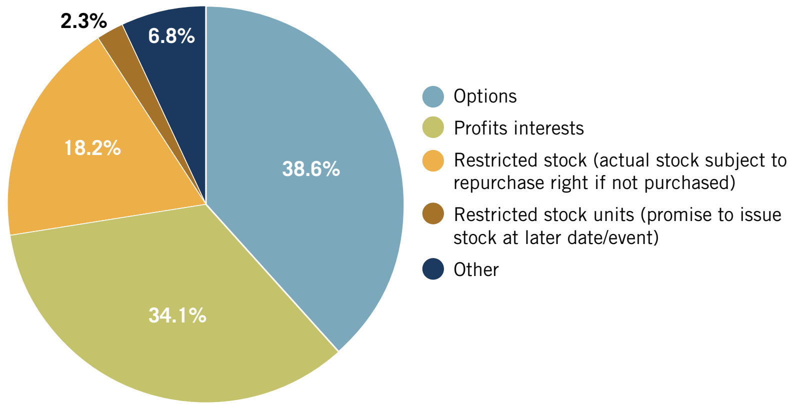
Performance-based vesting is based on:



Note: This question allowed participants to choose all answers that applied.

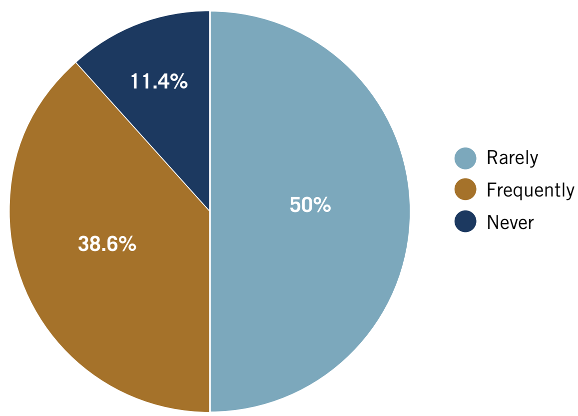
Options and Profits Interests

How is the management equity incentive pool structured?



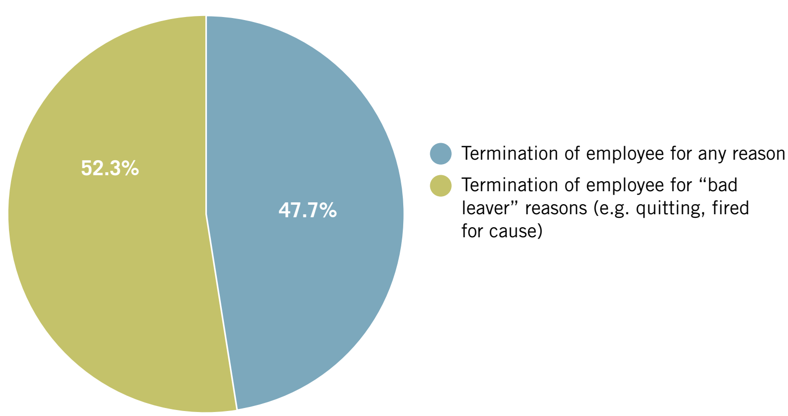
Profits Interests as an Equity Incentive Tool

Do you use profits interests as an equity incentive tool for management?



Repurchase of Vested Management Equity

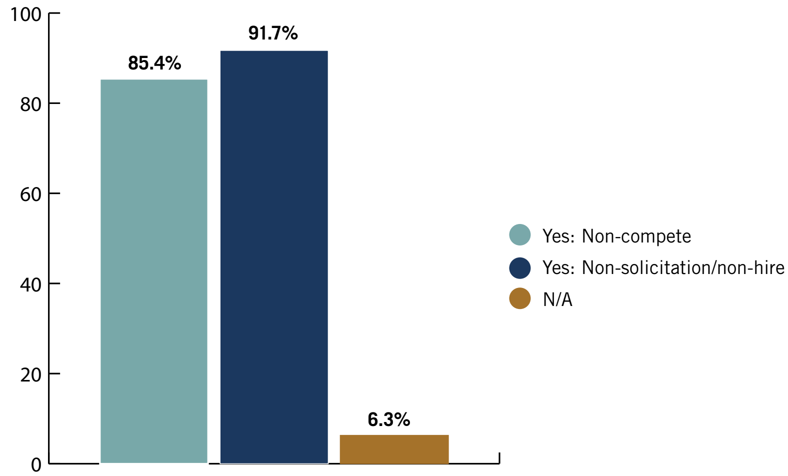
When can the company repurchase vested management incentive equity?



5 RESTRICTIONS ON SELLER CONDUCT

Types of Post-Closing Covenants

Do you seek post-closing non-compete or non-solicitation covenants?



Note: This question allowed participants to choose all answers that applied.

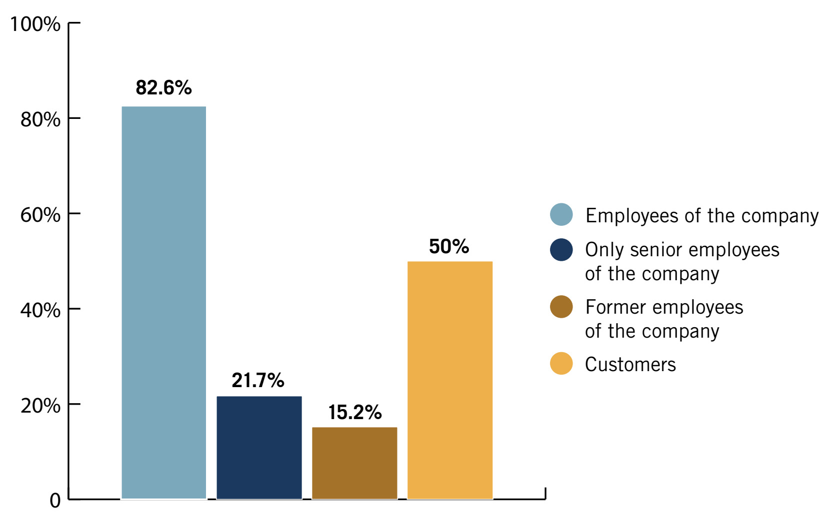
Length of Restrictions Placed on the Conduct of Rollover Security Holders

Non-competition agreements last how many years following the transaction?

	Average
Number of years	3.71

Coverage of Non-Solicitation

Non-solicitation agreements cover:

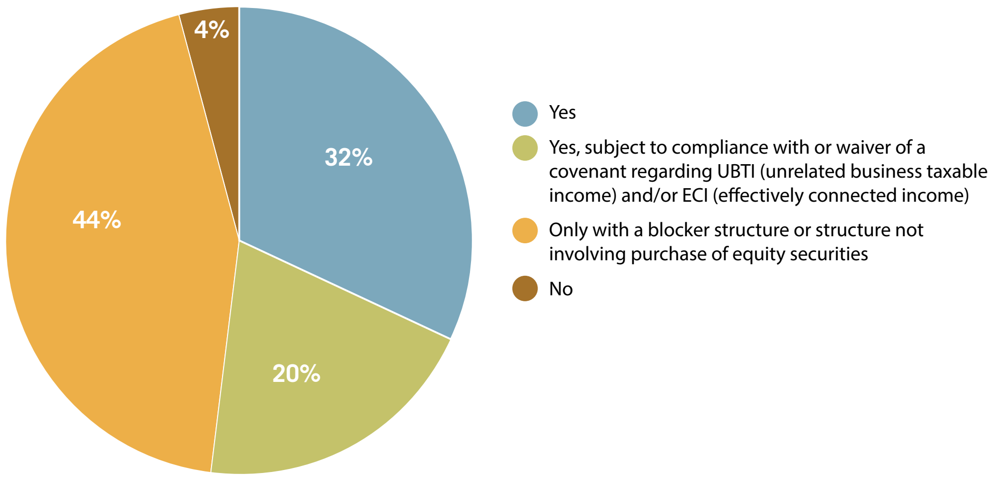


Note: This question allowed participants to choose all answers that applied.

6 MISCELLANEOUS: FUND CHARACTERISTICS

Limitations on Fund Investments

Is your fund permitted to invest directly into an LLC operating company?



OBSERVATIONS

Rollover Tax Issues

- Most rollover investors seek to roll over their equity interests on a tax-deferred basis.
- A tax-deferred rollover will reduce the value of any tax write-up of acquired assets in connection with an acquisition.
- Rollovers of more than 20% can raise tax issues for certain companies in transactions where a tax write-up is sought.
- Through the use of LLCs, equity-like interests in the form of options or "phantom" equity can be rolled over into true equity in the buyer on a tax-efficient basis, albeit with economic risk to the holder of equity value does not increase.
- Rollover equity is usually fully vested, although it is sometimes subject to repurchase or even forfeiture if specified adverse events occur, such as engaging in competitive activities. Put rights in favor of the holders of rollover equity are relatively rare, and are exceedingly rare in the case of management incentive equity.
- For both selling stockholders and sponsors seeking to woo them, attention to estate planning opportunities relating to rollover interests is a smart way to generate additional value.

Security Structuring Issues

- The data (and our view of what we most frequently observe in the current marketplace) suggest that *pari passu* treatment for rollovers has become fairly common. To some extent this reflects an evolution over time, from a period when rollover interests were more commonly subordinated to the sponsor's equity, presumably reflecting increased competition for transactions.
- Participating preferred stock enables a sponsor (and rollover investors to the extent they hold such a security) to enhance their returns in a sale or (in some cases) an IPO, with the economic effect borne by the management incentive equity pool. Historically, many sponsors' preferred stock structures, especially on the West Coast, provided for a return of capital plus a residual equity interest on a sale but not in an IPO. In more recent years, sponsor security structures tend to treat these events similarly, and sponsors look for underwriters who can deliver a return of their capital as a use of proceeds when selecting them for their IPO transactions.
- Preferred securities that return capital on an IPO can create tax issues that require structural attention.
- The increased use of LLCs in the past 15 years or so has fundamentally affected the structure of private equity deals. Many sponsors now have the flexibility to invest directly in LLCs, notwithstanding the UBTI/ECI effects, and many who cannot invest directly are allowed under their fund structures to create "alternative investment vehicles" to allow investors who wish to do so to invest directly while retaining a blocker structure for UBTI/ECI sensitive investors.

OBSERVATIONS (CONTINUED)

Management Incentive Equity

- Potential adverse and other tax effects resulting from the use of a blocker structure can be addressed through various measures, such as capitalizing the blocker partially with debt, requiring exits by sale of the blocker's stock and creative use of amortization inside the blocker.

- Principal instruments used for management incentive equity pools include options, restricted stock (sometimes acquired with the proceeds of loans from the company), profits interests and various forms of "phantom equity," sometimes in combination.

- Time vested equity in management incentive pools typically vests over three to five years, with matters such as the intervals for vesting (annual, quarterly or monthly, sometimes with initial "cliff" periods), treatment on sale (no acceleration, partial acceleration, so called "double trigger" acceleration, full acceleration), treatment of vested and unvested awards on termination of employment (loss of unvested shares, partial acceleration or full acceleration on a firing without cause or a resignation for good reason, and call provisions) all subjects of leverage in negotiations and the customary practices of the relevant sponsor. Treatment of incentive equity that is subject to performance vesting on termination of the relationship can also be a subject of negotiation, although attainment of the relevant performance hurdle(s) is a requirement that is always applicable.

- Many performance vesting arrangements are structured such that management enjoys successively higher equity stakes as the sponsor's return rises, e.g., 10% generally at a 2x return, 15% at a 3x return, etc.

- The details of waterfall provisions in performance vesting arrangements are important, e.g., a sponsor will not want to share equity based on 2x return if some of that return is held in escrow or subject to a contingency, or is in the form of illiquid securities that could decline in value. The details of waterfall provisions that relate to incentive equity are also important from management's perspective. For example, management typically seeks to assure that incentive equity pays out whenever the sponsor's benchmark return is crystalized, even if this occurs subsequent to a liquidity event, and seeks to assure that the full value of their shares will be paid from incremental proceeds once the sponsor's benchmark return is realized before sharing incremental value above the benchmark.

- Possible changes to tax laws relating to profits interests in connection with the larger national debate over budget and tax policy could fundamentally affect the structures of management incentive equity arrangements.

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We are consistently named among the nation's top law firms for buyouts, venture capital investment and fund formation by a variety of leading industry publications including *Private Equity Analyst, Buyouts Magazine, Mergermarket, Chambers USA, U.S. News-Best Lawyers* and *Legal 500.*

For more information about our Private Equity Practice, please visit **www.goodwinprocter.com/practices/private-equity.aspx.**

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