Michael Sirkin, Chairman & Managing Director of Jamieson USA, shares his views on equity grants in US private equity transactions

While annual compensation for executives of public and private equity portfolio companies are very similar, the equity arrangements are very different. Every executive joining or contemplating joining a private equity portfolio company needs to understand the differences in structure, potential reward and timing.

The public company equity structure is very much controlled by historic practice and the governance concepts of avoiding “poor pay practices”. Equity grants are usually made annually in amounts based on looking at compensation for peer levels at peer companies. At least 50% of each annual grant will be performance based over a 3 to 4 years measurement period, usually in the form of performance shares. The remaining portion will be a time based retention award vesting on a graduated basis over 3 to 4 years and in a combination of restricted stock units and options. Options are not considered performance based by the proxy advisory services and were strongly out of favor, although the usefulness of them are beginning to again be recognized as part of the equity package.

The first conceptual difference in the private equity owned world is that equity awards are not made annually. They are generally made at the time of the transaction or, if an executive joins the company later, at the time of joining. Then, there are no anticipated additional awards for at least 5 years. The result is that the initial grant is a front-loaded award by several multiples. It is intended to align the interests of management with that of the private equity firm. It also permits the value at exit to increase from the initial pricing of the acquisition rather than annually from the then value. When an executive joins the company several years after acquisition (e.g. a replacement chief executive officer), he or she will get a grant at that time that will be valued based on the then value of the company, the contemplated exit time and the appropriate award for that service period. As discussed below, that executive may have the same or different vesting criteria than those initially utilized depending on the status of the company and the then projections for value and exit.

The private equity firm creates a pool of shares to be used to award the executives of the portfolio company. The size of the pool will depend on a number of factors , including the size of the company, projected business plan, the number of executives to be covered, the price paid for the company versus the return the private equity house is seeking, the length of time expected before exit or other realization, contemplated roll up acquisitions, the strength of the management team and whether directors (and possibly advisors) will be included in the pool or treated separately

Once the pool size is established, a portion is carved out for contemplated hires either to fill vacant positions or as management of contemplated acquisitions. A small additional reserve is also usually carved out for promotions and more junior hires that are going to be given additional or new equity. The remaining portion of the pool is then allocated to the management team. Usually, the chief executive officer makes recommendations to the private equity firm as to relative value and suggested allocation. Together, the CEO and private equity firm decide on final allocation. Often,

the private equity firm has strong feelings on the amount to go to the chief executive officer. While there are exceptions depending on the depth of the pool and other factors, generally the chief executive officer will receive 20 to 40 percent of the pool and no one else will receive more than half of what the chief executive receives.

The equity in the pool will usually be either stock options or profits interests or some combination of the two. It is much less common to see restricted stock or restricted stock units, except perhaps when an offshore entity is involved. Profits interests can only be utilized if there is a pass through tax entity involved (e.g. a partnership or limited liability company). Because of the favorable tax result of being able to create capital gains with no initial tax, profits interests have become a common request of senior management and deals are often structured to create a new level of pass through ownership above the operating company to provide the ability to use profits interests. Even if the top couple executives receive profits interests, below that stock options are usually utilized to avoid the hinderance of them being initial partners in the entity. The effective use of profits interests generally only assist executives who are subject to taxes in the United States. If executives are not subject to US tax, the technique is likely not to avoid initial taxation and other structures need to be explored.

Just looking at the size and form of the grant is not sufficient. The key question is when and under what conditions that equity vests. In U.S. type deals, a portion of the grants, almost always 50% or less will be time based over 4 or 5 years. There is usually annual vesting, but sometimes after an initial one year period it is done on a quarterly or even monthly basis (especially in tech oriented companies). There is usually full vesting on either a change in control or termination within a period after a change in control without cause or good reason (effectively constructive discharge) and sometimes protection for a termination shortly before a change in control. One of the issues that need to be addressed on not fully vesting on the change in control is whether there will be liquidity on a later departure or lock in to the acquirors illiquid stock. Death and disability treatment varies greatly.

The remaining portion vests on one of three criteria or some combination of them. The three are amount of money received by the private equity firm over its investment (commonly referred to as either MOM (for money on money) or MOIC (for money on invested capital)), internal rate of return (IRR), and annual EBITDA or adjusted EBITDA.

More recently some private equity firms in the United States have utilized a hurdle before management starts to share in the growth in value of the portfolio company. This is both a reflection of the private equity firm potentially having their own hurdle with their investors prior to receiving their carry and the influence of the European model where all returns are subject to a hurdle concept. Management incentive would vest annually over 4-5 years and participate in value creation only above the hurdle rate. This often results in a larger pool being necessary to provide the same contemplated return to management.

MOM and IRR are based on exit realization by the private equity firm and usually cash exit realization. If an IPO is exit, it usually continues to be measured until the private equity firm heavily sells down. There are also issues to be addressed if property is received or a stub rollover interest remains. Treatment in these situations vary often depending on the private equity firm and the level of the executive involved.

If EBITDA is used there are issues of the setting of these amounts at the beginning of a 4 or 5 year period versus projections. Vesting in this case is often annual. The targets are often set based on management deal projections even though the private equity firm may use lower projections for its own analysis or financing analysis. They need to be subject to adjustment for acquisitions, divestures and market changes. They are often subject to annual catchups based on cumulative EBITDA or exit catchup based on MOM or IRR.

Two other issues often come up. Almost always the executive needs to be employed on the measurement date (subject to some “in contemplation” protection for senior people) for an MOM or

IRR measure performance criteria to vest or for an EBITDA catchup to apply. This raises issues as to whether there should be measurement dates after an IPO based on market price or, if employed at the time of the change in control, whether the executive should continue to be protected on future measurement dates even if no longer employed.

If stock options are utilized as the equity vehicle, they usually need to be exercised shortly after any departure. This often means that the executive is required to “come up” with the funds to exercise and also the funds to cover required tax withholding. Some firms will permit “netting” to cover exercise price by using the growth value of the stock; others will not commit that up front. Netting for withholding is less common because it means the portfolio company would need to pay the cash to the Internal Revenue Service. Profits interests do not have this issue because there is no action needed at the time of departure.

Unlike venture capital companies, which usually permit retention of equity subject to a right of first refusal, private equity companies almost always have a call on the incentive equity at the time of termination and, if they don’t exercise then, at any later date that a restrictive covenant is breached. The private company usually gives itself a period to exercise (e.g. a year) and the price is the fair market value of the stock at either termination or the call date. One key concern of management is that the determination of fair market value is based on full company value without discounts for minority interests or lack of marketability. The initial draft of agreements usually provides for the board to determine fair market value in either their sole discretion or good faith. Senior management often seeks an appraisal or other right to challenge the fixed prices. They also address the issue of an IPO or change in control relatively shortly after the buyout and whether there should be an adjustment. On a termination for cause fair market value is almost always the lower of fair market value and the price paid for the equity (if just granted it is zero; if a stock option was exercised, it is the stock option price). On a voluntary termination without good reason, some firms treat it the same as a cause termination, while others will call at fair market value at all times or at least after an initial service period.

The agreements will also provide that the call price can be paid with a note either in the discretion of the board or, more limitedly, if required by finance documents (they all usually limit stock buybacks in cash, but often will be waived). Some executives feel that, if they are going to be a creditor, they would rather remain an equity holder and seek a right to defer the call (with a new valuation) when cash can be paid.

It should be noted that management is often required to rollover equity or invest amounts they are receiving is the selling transaction or, if coming laterally, invest their own funds in the company so they have “skin in the game”. This equity is generally treated the same as the sponsor's investment, although, depending on the size of the investment and the attitude of the sponsor, it is usually subject to a call on termination of employment.

Private equity firms rarely give a put on a departure or other situation since they don’t want cash going out until they realize on their investment. Sometimes puts will be permitted in limited situations, especially if the private equity investment is intended to be a long term play and not the usual 5-7 year realization.

For the executive accustomed to the public company equity compensation arrangement, the private equity portfolio company arrangement can be somewhat disorienting. However, the potential upside on private equity compensation is usually significantly greater than the public company compensation over the same period because of the front-loading of the grants. This, of course, is offset by the generally added risk in the private equity situation.

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