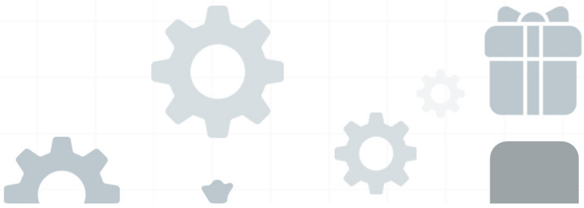
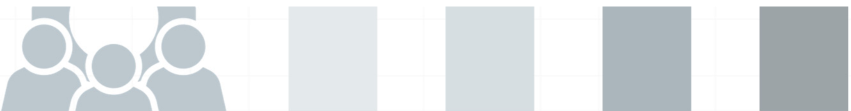
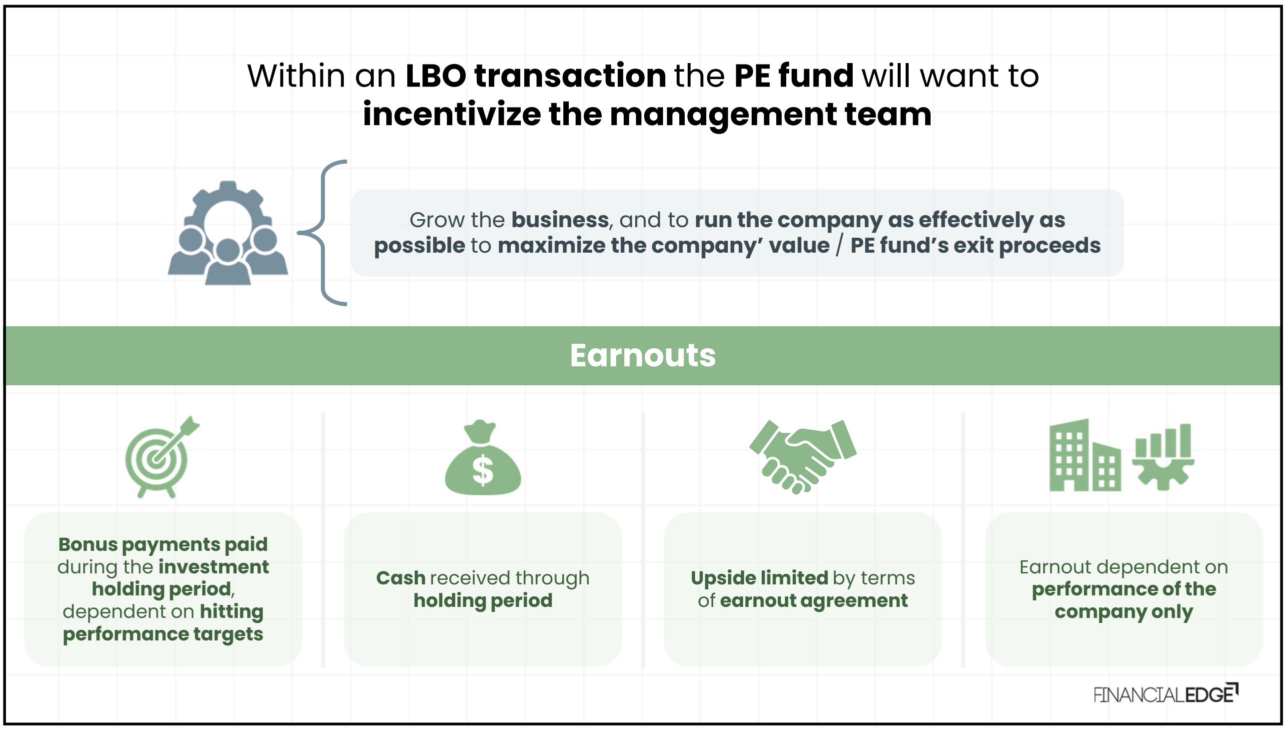
LBO Management Incentives



Management Rollover and Options




Within an **LBO transaction** the **PE fund** will want to **incentivize the management team**
Grow the **business**, and to **run the company as effectively as possible** to **maximize the company' value** / **PE fund's exit proceeds**
Earnouts
Bonus payments paid during the **investment holding period**, dependent on **hitting performance targets**
Cash received through **holding period**
Upside limited by terms of **earnout agreement**
Earnout dependent on **performance of the company only**
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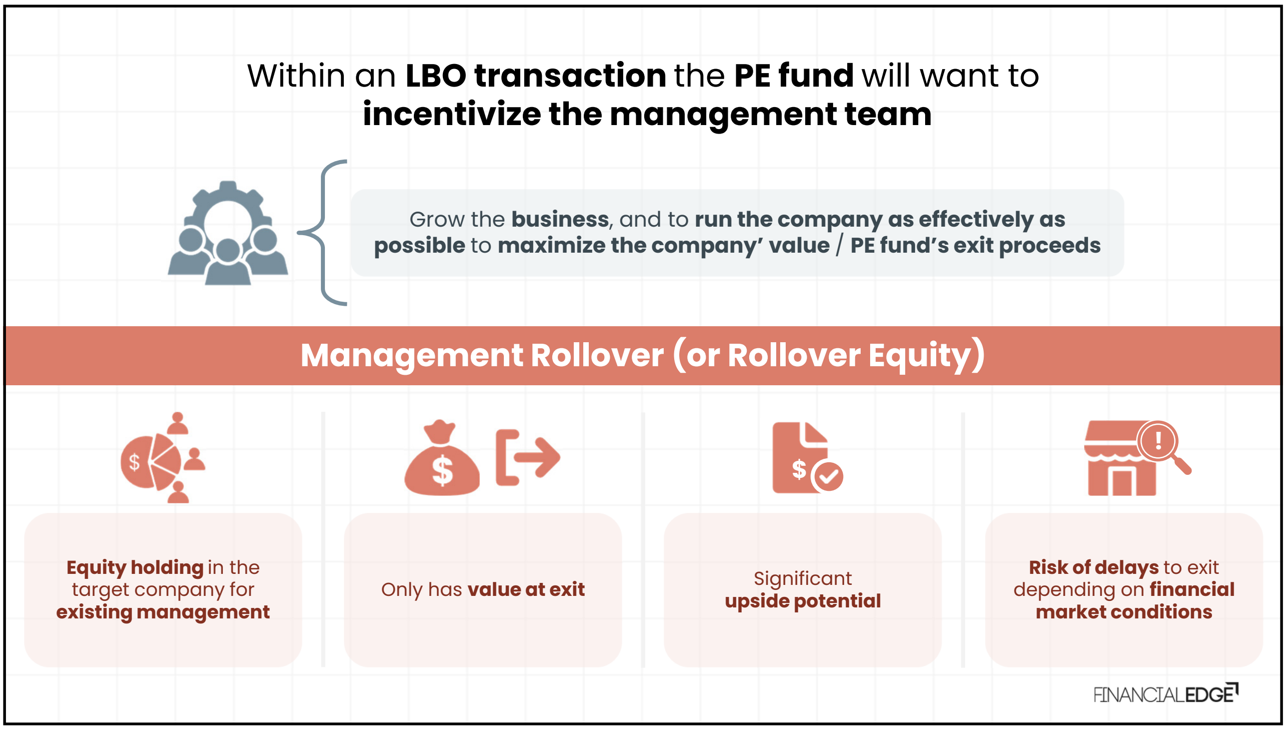
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Grow the **business**, and to **run the company as effectively as possible** to **maximize the company' value** / **PE fund's exit proceeds**
Management Rollover (or Rollover Equity)
Equity holding in the target company for **existing management**
Only has **value at exit**
Significant **upside potential**
Risk of delays to exit depending on **financial market conditions**
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Management Rollover

1 — **Management** must **remain** with the company until **exit to benefit,** and they must **contribute their own capital**

2 — Aligns the **interests of the PE fund** with those of **the management team**

3 — **Managers** can receive **favorable tax treatment** by **postponing the capital gains** on selling their shares

4 — **Equity** for the management team may either **rank equally** or be **subordinated** to the **PE fund equity holding,** meaning the PE fund may get paid out before the management team get their share

5 — **Management stake** in the deal can **increase over time** due to **incentive compensation plans**

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Management Rollover

Additional management % ownership dependent on **MOIC** (multiple on invested capital) **on exit**

- **If MOIC > 1.5x => extra 2%**
- **If MOIC > 2.0x => extra 4%**
- **If MOIC > 3.0x => extra 6%**

Incentivized towards selling the company for a **high price on exit,** achieving the **higher multiple,** and **earning the additional % ownership**

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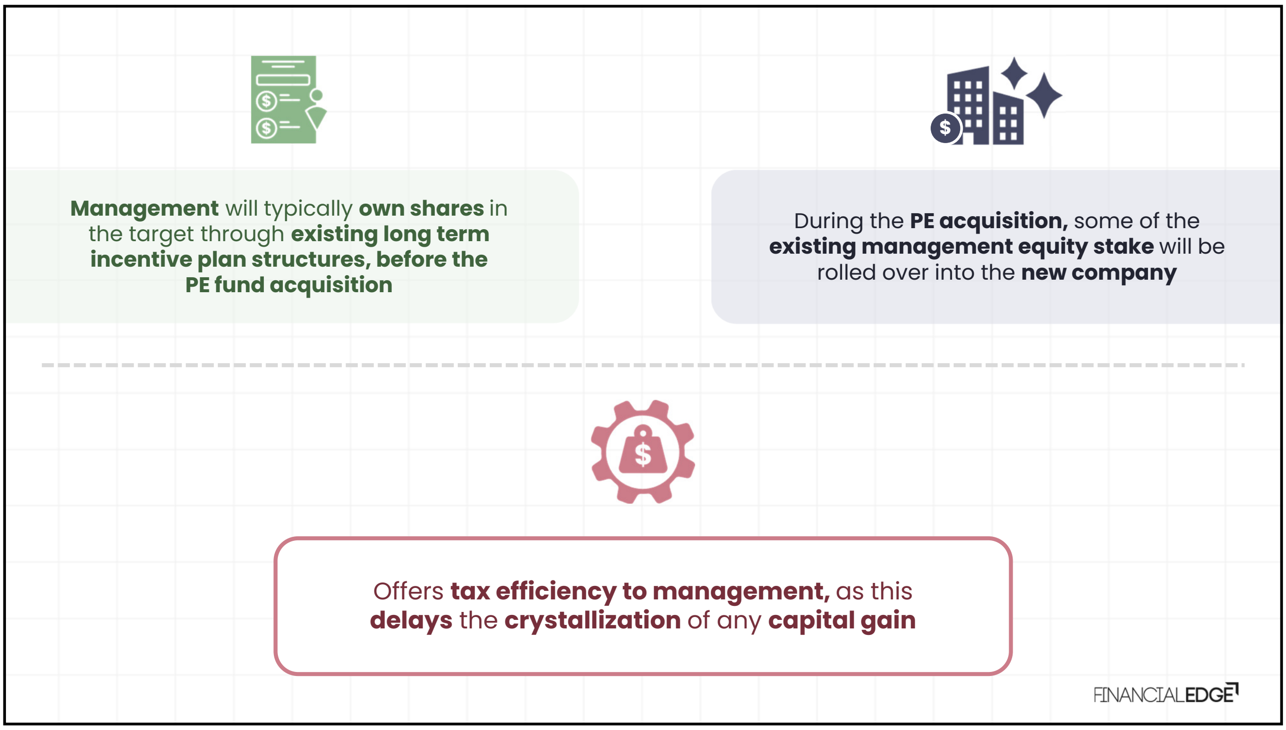
Management Rollover Terms and Risks

Management will typically **own shares** in the target through **existing long term incentive plan structures, before the PE fund acquisition**

During the **PE acquisition,** some of the **existing management equity stake** will be rolled over into the **new company**

Typically **8% – 40% of compensation** owed to management happens through the **acquisition**


Management will typically own shares in the target through existing long term incentive plan structures, before the PE fund acquisition
During the PE acquisition, some of the existing management equity stake will be rolled over into the new company
Offers tax efficiency to management, as this delays the crystallization of any capital gain
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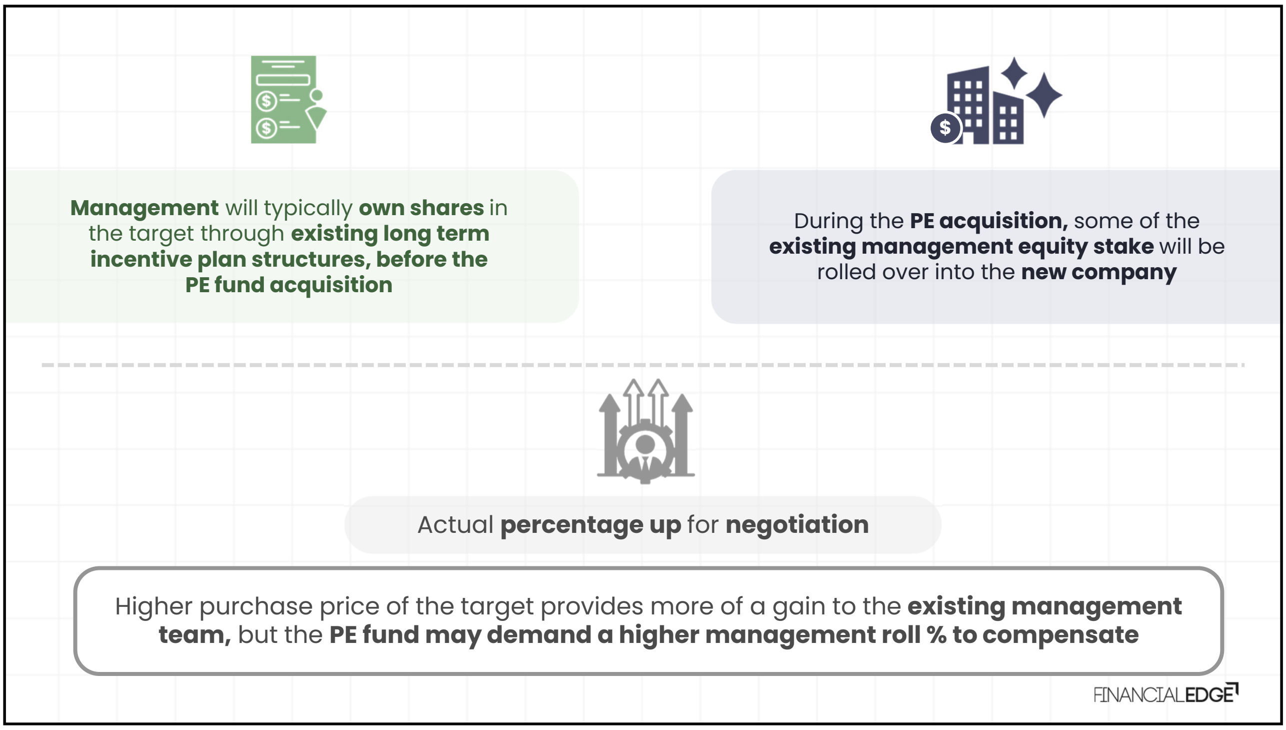
Management will typically own shares in the target through existing long term incentive plan structures, before the PE fund acquisition
During the PE acquisition, some of the existing management equity stake will be rolled over into the new company
Actual percentage up for negotiation
Higher purchase price of the target provides more of a gain to the existing management team, but the PE fund may demand a higher management roll % to compensate
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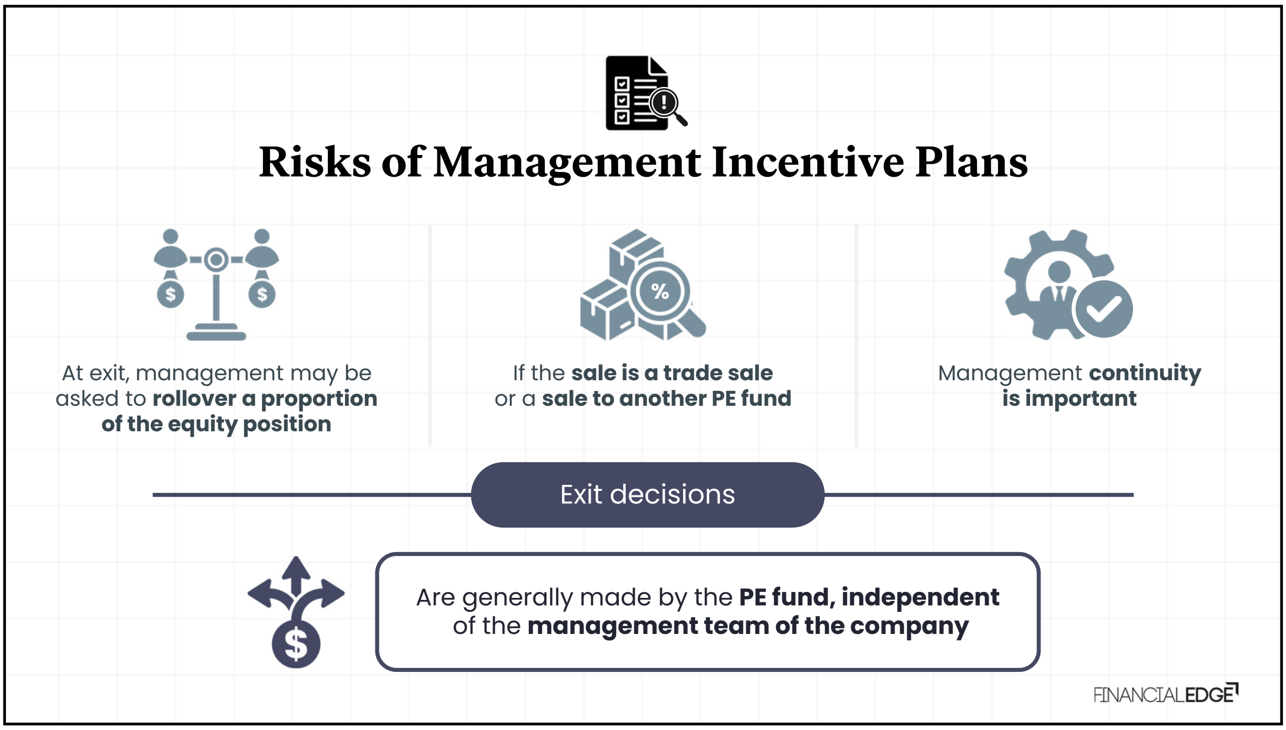
Risks of Management Incentive Plans
At exit, management may be asked to **rollover a proportion of the equity position**
If the **sale is a trade sale** or a **sale to another PE fund**
Management **continuity is important**
Exit decisions
Are generally made by the **PE fund, independent** of the **management team of the company**
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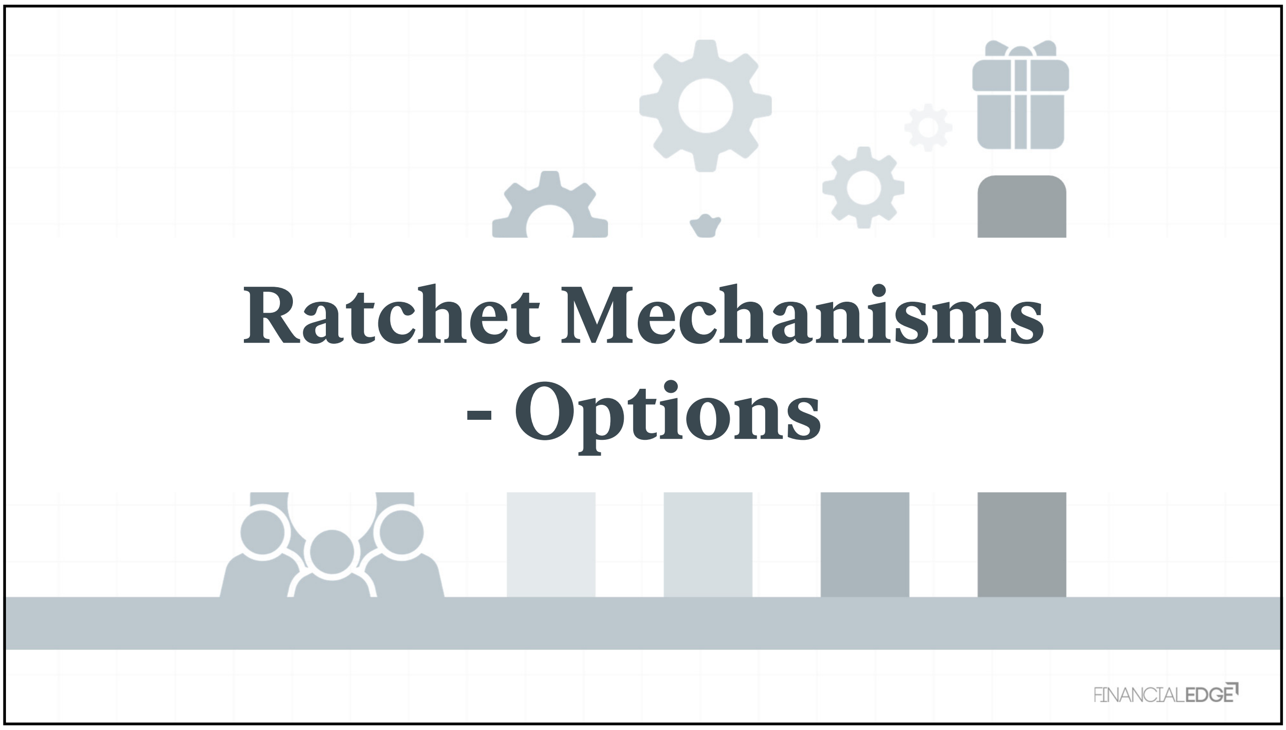
Ratchet Mechanisms - Options
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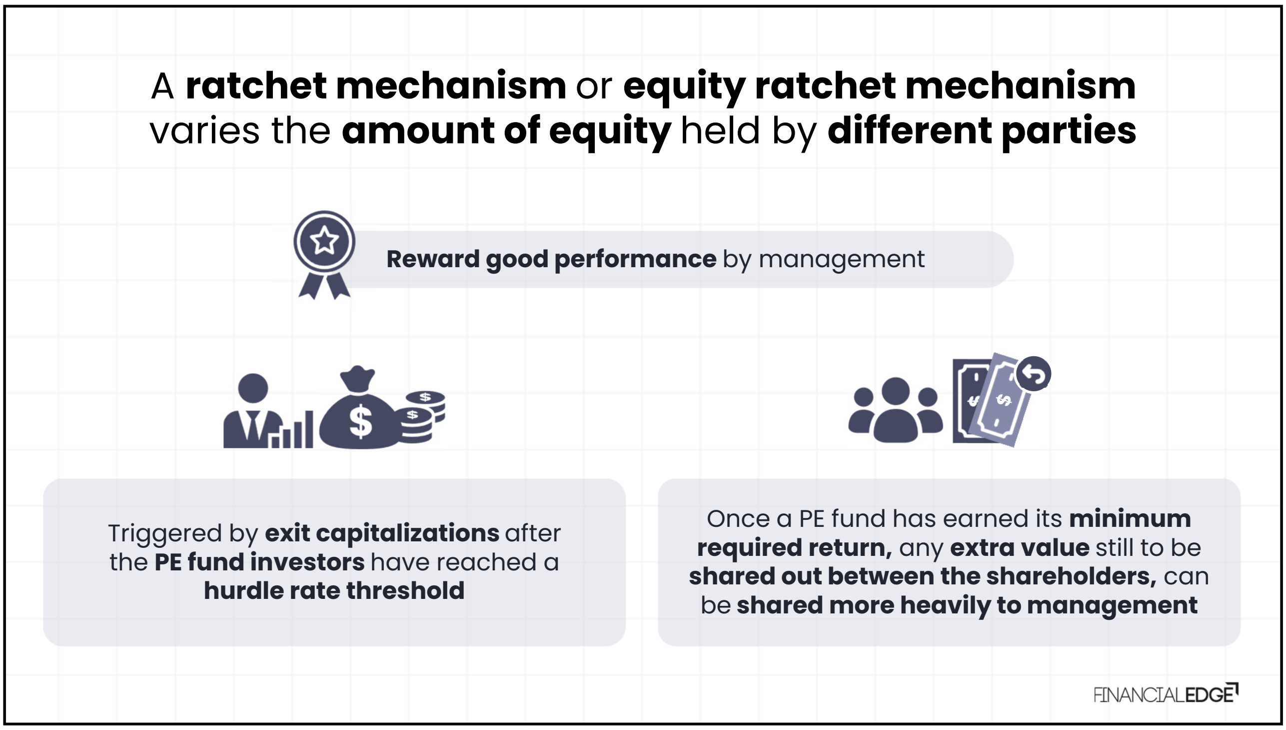
A ratchet mechanism or equity ratchet mechanism varies the amount of equity held by different parties
Reward good performance by management
Triggered by exit capitalizations after the PE fund investors have reached a hurdle rate threshold
Once a PE fund has earned its minimum required return, any extra value still to be shared out between the shareholders, can be shared more heavily to management
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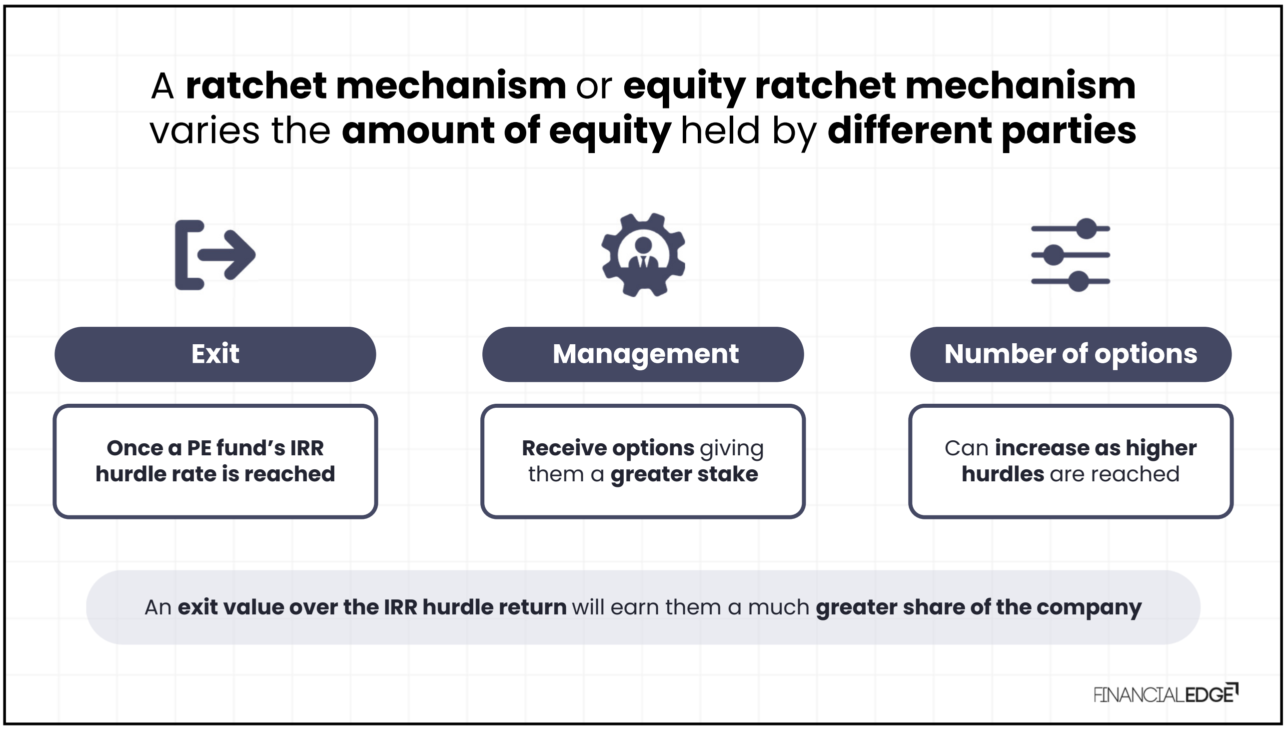
A ratchet mechanism or equity ratchet mechanism varies the amount of equity held by different parties
Exit
Once a PE fund's IRR hurdle rate is reached
Management
Receive options giving them a greater stake
Number of options
Can increase as higher hurdles are reached
An exit value over the IRR hurdle return will earn them a much greater share of the company
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Ratchet Mechanisms - Profit Share

Ratchet Mechanism

Varies the amount of equity held by different parties

Giving options to **one party** to increase their **ownership stake** is an example

At exit, once a **PE fund's IRR hurdle rate is reached,** the extra proceeds still to be shared out are shared equally

Management **receives HALF of the extra proceeds**, rather than the **20%** that they might technically deserve

A deal that has a threshold IRR of 25%

PE fund wants a minimum return of 25%

Ratchet Mechanism

Shares return **50:50 between management** and the **PE fund**

Ratchet mechanism 50:50 *	
Threshold IRR	25%
Current PE fund ownership	80%
PE fund Investment	80
Management investment	20
Exit: equity value of 350 after 4 years	
PE fund threshold value = 80 x (1+25%)^4	195
Management threshold value = 195 / 80% x 20%	49
Value pre-ratchet = 195 + 49	244
Proceeds for ratchet = 350 – 244	106
Ratchet 50:50 above threshold IRR	
PE fund post ratchet = 195 + 106 x 50%	248
Management post ratchet = 49 + 106 x 50%	102

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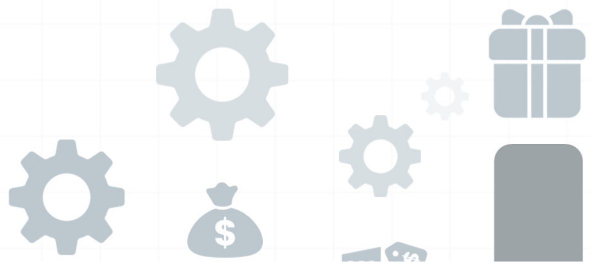
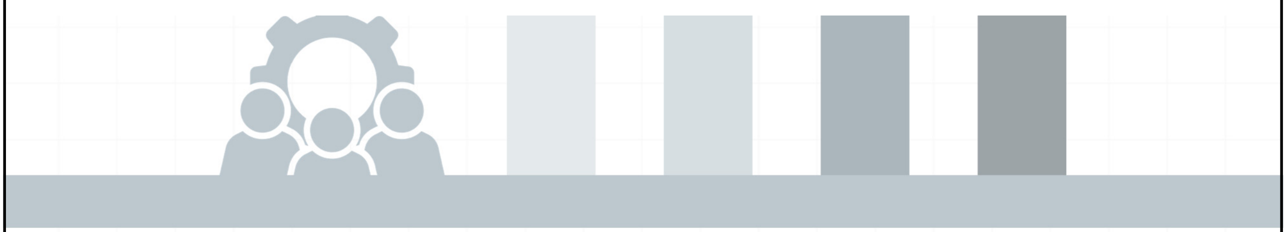


Role of Preference Shares



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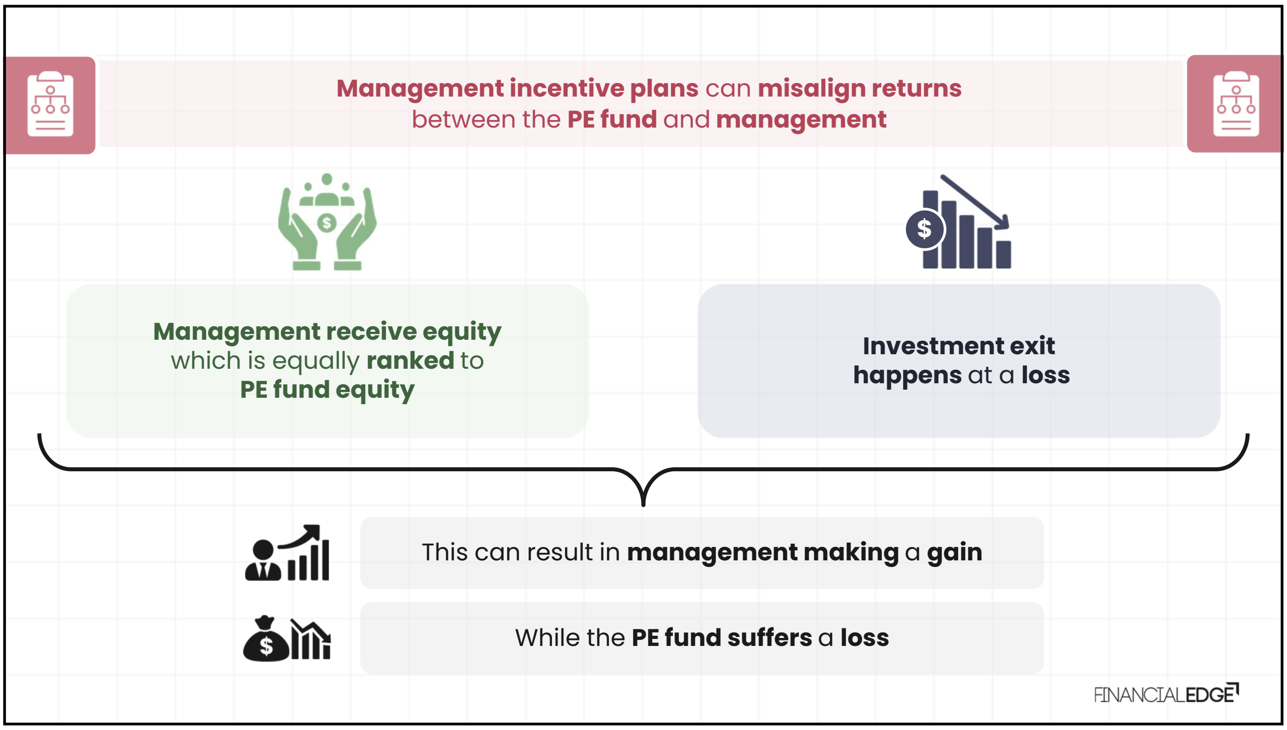
Management incentive plans can misalign returns between the PE fund and management
Management receive equity which is equally ranked to PE fund equity
Investment exit happens at a loss
This can result in management making a gain
While the PE fund suffers a loss
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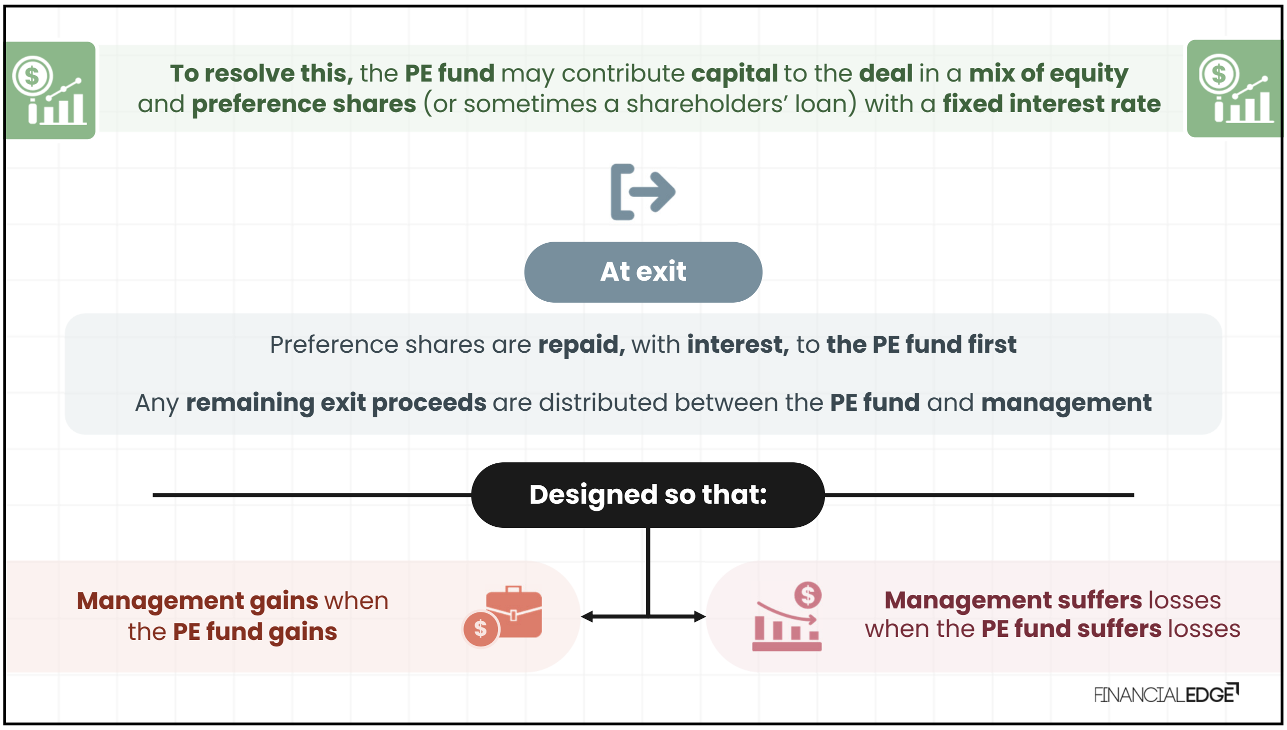
To resolve this, the PE fund may contribute capital to the deal in a mix of equity and preference shares (or sometimes a shareholders' loan) with a fixed interest rate
At exit
Preference shares are repaid, with interest, to the PE fund first
Any remaining exit proceeds are distributed between the PE fund and management
Designed so that:
Management gains when the PE fund gains
Management suffers losses when the PE fund suffers losses
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