Management Incentives Roundtable

Setting up well-considered incentive plans for management teams has become a crucial lever for value creation and winning deals for private equity firms. A panel of experts sit down to discuss how to do it right and what options buyout firms have available to them.

At the table:
Andy Goodman, *BDO*
Gabbi Stopp, *Proshare*
Jennifer Campbell, *Deloitte*
Sophie Black, *Mercers*
Chris Fallon, *Tapestry*
Jeremy Edwards, *Baker McKenzie*
Chris Prout, *EY*
Gordon Purvis, *Aztec Group*
Geraldine O'Rourke, *Aztec Group*

Moderator:
Nicholas Neveling, Real Deals

At the table (clockwise, from top left):
Jennifer Campbell, *Deloitte*
Sophie Black, *Mercers*
Gabbi Stopp, *Proshare*
Andy Goodman, *BDO*

To set the scene I wanted to ask the panel what the actual objectives of management team incentive plans are? Are private equity firms using incentives to lock in key people and spur earnings growth, or are plans a tool to get a deal over the line by dangling a carrot?

Gabbi Stopp:
The key objective is defined by the audience that you're targeting, because you're going to need to motivate the top team rather differently to people down the hierarchy.
It is important to align sight over the objectives. If you target the senior team as the key people who will drive value, then they have to know what they have to do to influence the outcome. Poorly designed targets and poorly designed incentives create really, really poor outcomes, which don't do individuals or businesses any good.
Think about your audience first of all and the behaviour you want to see from them. That's the key thing. That starts the decision tree over what structure you choose and the tax treatment you ultimately want to get for the individual at the end.

Jeremy Edwards:
It is not just a case of dangling a carrot. We often have a deal-focus in the work we do for private equity and the elements of getting the deal over the line, incentivisation and retention commingle. Investors want to ensure that incentives are ambitious but realistic enough for management to achieve in the future. The incentivisation for the management team to reach and exceed the hurdle is probably the key thing to get right and forms the basis of whether a plan is effective or not. You can't get away with incentives that have no real chance of future realisation.

Chris Prout:
In the private equity industry there is an expectation that a percentage of the equity will be ring-fenced for senior management. In my experience there is an expectation that certain senior people will get a percentage of the sweet equity cut. A private equity house that can't deliver that, or doesn't want to deliver that, will be at a competitive disadvantage. This is a competitive market and prices are high, so the sweet equity packages are pretty rich. I think that has been stoked by the competitive deal processes we have seen.

Geraldine O'Rourke:
We see our private equity clients setting up management incentive plans for a variety of reasons and the structure they use will tie in with their objectives. For many it is about aligning the senior team with the investors.

Sophie Black:
I've been in this business for more years than I'd care to admit, and I definitely see a difference in the private equity approach to incentives. We do a lot of benchmarking at Mercer and if I go back 10 years there was very little attention given to remuneration. All the focus was on the equity structures. Now I see private equity firms wanting to understand all the elements of the package and how to structure it, because when the equity incentive starts to stretch out beyond four and five years it becomes less and less effective. Hold periods are increasing and the equity incentive can feel like more of a lottery rather than a real thing that is going to happen.

Jennifer Campbell:
That is a crucial point. Management teams will go in and look at a three-to-five-year time frame, which isn't actually that long. But if the hold period keeps extending and you start to reach eight, nine and ten years then people do lose interest. Something needs to be done to reinvigorate the situation. In the listed environment, with the annual plans, that is in place. It is more difficult for private companies to set up, but it is something they will have to think about in the long term.

Andy Goodman:
That is a key point. Private equity can set up the annual plans on the way in, but that doesn't change the position on the way out. In the listed environment you will have two companies with long-term incentive plans (LTIPs) that are trying to achieve very different things. For private equity-backed companies, the overriding word is alignment. It is about aligning the management team with the private equity house and the investors. The issue for private equity is that if you give management liquidity at an earlier point, they're not aligned with the investors.

Black:
I still think it comes down to the time horizon. When you are looking at three to four years, it's all about alignment. I like working in private equity in these situations, because it's very simple and there is no politics. You get people aligned and that's it. But if a firm looks at it from a longer-term perspective and wants to build a business over time then it isn't just about reaching a hurdle. I have certainly seen private equity portfolio companies putting a mixture of milestone plans in place alongside the sweet equity.

Chris Fallon:
Infrastructure does this in an interesting way. The hold period is 10 to 20 years in infrastructure and we have talked to firms and advised that if the plan is to hold for 10 to 15 years then it is not really reasonable to lock in management over that time. Instead, you need to build in some kind of liquidity event before then.

Is putting these milestones in place something relatively new? Or is this something that private equity has been doing for a long time?

Black:
This is still relatively new in private equity. I think the first one I saw was about 10 years ago. But now I see it more. Firms will look at things like getting the IT systems sorted in a business, which has to happen to have any chance of exiting. The private equity firm will give management a long-term incentive related to doing a strategic thing like this.

Campbell:
That is interesting because in my experience the priority is still alignment towards an exit. You will see different approaches in areas like infrastructure, as Chris mentioned, but for your mainstream private equity deals, dealmakers are still working towards a three-to-five-year time frame. It's the "in together, out together" mentality. Where we may see some kind of milestone come in is when the business plan is moving slower than anticipated and the exit horizon has moved back.

In a situation where something has gone a bit off-kilter and you need to put a milestone in place, is that quite a complicated thing to deliver? How do firms approach that? Are you tearing everything up and starting from scratch?

Fallon:
Not necessarily. I would agree that at the outset the package is focused on the exit and that's the endgame. But in my limited experience of where things haven't necessarily panned out as well as people thought, where there's been recapitalisation or there's been reorganisation of the group, and a longer timetable becomes a reality then yes, that's where the milestones are brought in. You need to be inventive at this point because the values are different, and interests are different. The people may be different too. You need to be clever about the rights that people are going to receive and the way they will participate in value going forward.

I wanted to move on and ask if there are any trends with regards to how incentive plans are structured? What level of employee is typically included and to what extent is each package bespoke?

Goodman:
If we accept that there is relative commonality around the aims of the plan, then you get back to, "Okay, so how are we

At the table (from top):
Chris Fallon, *Tapestry*
Geraldine O'Rourke, *Aztec Group*

going to structure this?" Tax then becomes the overriding driver of what you do. The private equity partners will want an attractive tax position and the management teams will want alignment with that. Typically, the preference will be to look for capital gains tax, and that does drive you towards getting equity into people's hands. If we need to use growth shares, because that's the stage we're at, then we will do that, and we will look at joint share ownership plans (JSOPs) too. Those types of structures have been fairly common for a fairly long time. So, I think we're in a stable place in that regard, to be honest.

Gordon Purvis:
What drives the choice between an employee benefit trust (EBT) structure or a straight share ownership structure?

Goodman:
The main driver towards an EBT structure is if you want to have a warehouse for your equity. If people need to receive value along the way it is an option, but the downside is that everyone can get preoccupied about capital gains tax. You can end up at a point where a deal happens with some equity parts in the EBT and those come out with an income tax charge. People spend quite a lot of time trying to work out how to do a warehouse without actually having a warehouse! I don't really see that changing. When people get comfortable with the idea of an EBT I don't see many of them regretting it but, getting comfortable with it in the first place is quite a challenge.

Campbell:
The nominee structure can be a neat way to get shares into the hands of a number of employees, but strip back control so that staff can have shares and capital gains tax without the business having 20 additional shareholders. The nominee structure is simple from a tax angle and it works. That is how I see EBTs being used.

O'Rourke:
That's certainly how we're seeing many plans being structured. The trust is there to warehouse shares which can then be used to make further awards. With the nominee arrangement the employee owns the shares, but with a structure around the shareholding that is effective, especially on the sale of the investment.

Prout:
If the transaction plan is to park whatever percentages the management has, then there are two ways of dealing with the unallocated piece. You can leave the house with the unallocated piece and the house would have the benefit of that. But some management teams will say, "Well, hold on a minute. We've agreed a dilution of 15 per cent." So, there is a ring fence for management. An easier way is to park all of it into an EBT, the beneficiaries of which are all employees. So, it's a sort of ring fence for those people.

Edwards:
We're seeing some more nominee arrangements coming up at the side. We are seeing investors being quite imaginative about ways of keeping people interested when horizons stretch out using real equity. But we do also have other companies, that are trying to put in place phantom plans [cash-based plans that mirror the value of equity coming out] in place for a wider population, because they just can't bear to have to amend the main investment agreements. This can be expensive tax wise, except in low tax jurisdictions, but it is easier to implement and leads to less securities laws in different places.

O'Rourke:
Do you think people get that same feeling of ownership from a phantom plan? We have clients who set up phantom plans and these can be very effective if there is good communication.

Edwards:
I think you're right. I think phantom plans do have limitations, but if you're dealing with a tight share structure or a fairly disparate group of management across different jurisdictions, sometimes it's just an easier way to proceed. In an ideal world, you would want everyone to go for equity. Indeed, in some jurisdictions that could be very beneficial tax wise. However, sometimes it's just not worth the hassle.

Purvis:
In some jurisdictions, it's almost impossible given the costs involved.

Stopp:
Phantom plans solve problems, but they are for the pragmatists rather than the purists.

Does that feeling in company really change that much when equity is issued to management and staff anyway?

Purvis:
At Aztec, we have a share ownership arrangement that has come into place. The Group is privately owned by a small number of founders. So for us, as the management team, to get involved in that makes a huge difference. Everyone was already very engaged, but now I would say we are super-engaged. It has been transformative for our business, which has been very successful year on year. Everyone is focused and motivated.

Stopp:
We have seen various pieces of research conducted over the years, which have established a correlation, not a causation, but

At the table (clockwise, from above):
Chris Prout, *EY*
Gordon Purvis, *Aztec Group*
Jeremy Edwards, *Baker McKenzie*

a correlational link between broad-based employee share ownership and increased productivity, which feeds through to the bottom line. A few years ago, HMRC commissioned research which found a boost in productivity of between 2.5 per cent and 5 per cent for the firms with share ownership that they looked at. Employee-share ownership works, and it suits all stakeholders, whether you are at the top of the tree or whether you are at the bottom.

Whatever structure you choose, what is actually involved in the execution of a plan?

O'Rourke:
As the administrator, our role is to make sure that we fully understand the needs of the private equity house as well as the tax and legal advice. We look to understand all the steps required. Some plans are complex and it is essential that they are fully understood and properly communicated. Our role is very much looking at it from a practical point of view! It is important that reporting, accounting, administration and communication with employees are fully considered. We work with the advisors to create a plan to ensure we meet the deadlines.

There are so many cases where management teams are quite happy with their package going in, but unhappy with it halfway through. What happens when things aren't going well, and the financial sponsor feels that it needs to change management team – what happens then?

Prout:
It can be harsh, but given that the rewards on offer are great, that comes with the territory. Private equity firms will take a very detailed review of the management team, and if they feel they need to change horses then they will, and the plans will be rebased.

O'Rourke
Aligning the risk and reward for the individual and the private equity house is always really interesting.

Goodman:
How would the private equity house look at it? "We're putting our equity in and you guys are not. There's just upside for you". If I'm a really quality individual, then I will make a decision as to whether I go and work in a listed company with a higher base or go to a private equity and back myself.

Black:
It is interesting. I have seen private equity houses being very brutal with management, but I was in New York last year working with one firm with a very tough reputation and they were moving on a chief executive but weren't brutal at all. The person was moved on and wouldn't participate in the equity plan, but they were looking for other options to place the individual. I didn't expect that, but sometimes firms will move someone sideways rather than go head-to-head, especially if a deal is approaching.

To close, what is the current political mood towards incentive plans? Executive pay seems to be in the headlines incessantly, for all the wrong reasons, but at the same time, there appears to be significant political support for employer ownership?

Stopp:
There is clearly something about the employee ownership concept that really grabs people's imagination. There are 2.5 million people who participate in some kind of ownership in the UK, but there are many more people who don't have that opportunity. The concept of ownership interests them, and I find that a very positive thing. How you make it work in a non-listed company is another matter entirely, but the interest is there and it's about understanding how to make it work in practice. I feel very encouraged that ownership and employee ownership is so high up the agenda for politicians, but SMEs need help to understand it and implement it. If you are leading a small business and wearing many hats, there are more pressing issues higher up your to-do list, so that is a challenge.

Fallon:
On the executive remuneration point, there is increasing shareholder scrutiny of undue pay for unearned gains. On the drafting side, we are seeing share plans incorporating this. The clauses added to plans can be as simple as a discretion to amend and reduce pay outs in certain circumstances. Shareholders are aware and alive to the issue. It's increasingly at the forefront of negotiations when execs are getting awards and its part of everything that we're dealing with now from a corporate governance perspective.

Edwards:
As private company regulation of remuneration grows, you'll start to see the same factors that we're seeing in the listed company environments. But I think we're just starting that process at the moment. I don't think it's overwhelming but there could be various leverage points that could make it a bigger issue for private equity-backed companies. Gender pay could be one area, especially for larger private equity investments.

Black:
Private equity firms probably haven't been that focused on it, but there is a social agenda change. In the listed environment the focus is on the quantum, whereas five years ago it was all about peer-to-peer benchmarking. I think this really becomes pertinent for private equity firms investing in the B2C space. If you are dealing with a brand that is where the headlines come from when an executive receives a big pay out.

Prout:
If there is one thing that makes private equity a little different, it is that it is so success driven. If you are a chief executive of a private equity-owned business and you're getting half the sweet equity that equates to a lot of money, but you only see that reward when the whole of the shareholder base has been hugely successful. I don't think you have that (at least to that degree) in the listed world, where senior executives can get higher pay and a higher bonus, but the company performance has gone down. That's all taken off the table in the private equity setting. I think it is inevitable that scrutiny of private equity portfolio company pay will percolate up over time, but I don't think we are there yet.

Real Deals would like to thank Aztec Group for making this roundtable possible.