Key Considerations for Private Equity Sponsored Long Term Incentive Plans

By Boluwaji Apanpa and Busola Farinmade of KPMG Nigeria

Investors entrust their funds to Private Equity (PE) firms with the primary aim of increasing the value of their investment. As Fund Managers, PE firms are saddled with the responsibility of investing in profitable portfolio companies, ensuring safety of investors' funds and surpassing expected rates of return. To achieve their objectives, PE firms typically leverage Long Term Incentive Plans (LTIPs) that provide management and other key employees the opportunity to share in the success and value that they help to create. This serves to inspire commitment and performance.

LTIPs are pay plans used to reward performance over a period longer than one (1) financial year, usually three (3) to five (5) years. There is an increasing trend of PE-sponsored LTIPs in portfolio companies, as PE firms continue to emphasise the need for alignment of interest of key employees to investors' objectives. For most LTIPs, eligibility is usually restricted to Senior and Executive Management employees, and, in some cases, high performing / critical roles on lower levels. LTIP benefits are tied to achievement of predetermined Key Performance Indicators (KPIs), usually linked to the investors' objectives. Examples are increase in Equity Value / Share Price of the portfolio company and profitability measures such as Earnings Before Interest Tax, Depreciation & Amortisation (EBITDA), Profit Before Tax, Return on Equity, et cetera.

There are various types of LTIPs available to PE firms for motivating and retaining management and other talent that will help achieve their growth agenda. The type and structure of the LTIP adopted is a function of many parameters, which we have examined below:

- **Equity Vs Cash-Settled LTIPs:** PE firms can choose one or a combination of the following:
  - ✓ **Equity-Settled LTIPs:** This type of LTIPs allow eligible employees to become shareholders, by granting them company shares at no cost or at a predetermined price. Equity-settled schemes are easier to implement, where there is a ready market for the underlying shares such as in publicly-quoted companies. The quantum of equity awarded will vary based on the available share pool, employee's role and achievement of predetermined corporate and individual KPIs. Examples of such schemes include Share Awards and Share Option Schemes.
  - ✓ **Cash-Settled LTIPs:** In some cases, payout/ proceeds from LTIPs are settled in cash. This option is desirable when there are no shares available or to mitigate share dilution. Other times, a cash-settled LTIP is adopted when regulatory requirements for equity-settled benefits are cumbersome or expensive to comply with. It is important to note that the value of cash payout is usually tied to the underlying shares/equity to ensure alignment of interest. Examples are Deferred Bonus Plans, Profit Sharing Plans, Performance Share Units / Phantom Share Plans, et cetera. In private companies, phantom units and other cash-settled schemes are easier to implement, where shares are not tradable in an active market.
- **Strategic Objectives of the PE Sponsors/ Investors:** Generally, LTIP payouts are tied to vesting conditions, such as tenure and predetermined KPIs. For PE-sponsored LTIPs, there is an alignment between the KPIs and the investor's objectives. Therefore, the quantum of payout that will crystallize depends on how well the investors' objectives have been achieved. This may result in a payout that is below and above a target amount, but also, usually subject to a cap to prevent unintended windfall and excessive risk taking.
- **Lifespan / Period of Investment:** The investment lifespan plays a critical role in determining the vesting period, vesting schedule and grant cycle of a PE-sponsored LTIP. Vesting or exercise is usually aligned with the investment period or a liquidity event. This ensures alignment of interest and helps the PE firm determine whether it has achieved its overall objective for that portfolio company.

  Investors may implement varied vesting schedules, such that a larger quantum of payout vests at the end of the vesting period, compared to equal percentages annually. Accelerated vesting may occur in the case of an early exit i.e. before the end of the target investment period. Also, one-off grants are common where the Investor anticipates eventual exit from the company compared to multiple grants for longer investment periods.
- **Instituting the LTIP:** A PE-sponsored LTIP may be instituted in the PE firm or in the portfolio

company (in this case, the portfolio company will be responsible for the LTIP, while the PE firm funds the LTIP benefits and cost). The decision on where the LTIP will be instituted is driven by regulatory, tax and accounting considerations, as discussed below.

- **The Memorandum and Article of Association (MEMART):** In Nigeria, the MEMART must contain a provision that empowers the company to engage in share-based payments. A company contemplating such arrangements must, therefore, check that such provision is in place or put one in place. A resolution is required to amend the MEMART and must then be filed with the Corporate Affairs Commission.

- **Sustainability:** Although PE Investors may exit a portfolio company, if the new investor perceives sustainability, this can enhance the sale / exit value. PE firms, therefore, also seek to use LTIPs to drive a sustainability mentality in management. To do this, a portion of the LTIP proceeds due at exit may be deferred for a period of one (1) to two (2) years. The deferral can promote retention as well as aid implementation of clawback provisions, in case of misconduct or misstatement in the underlying financials. Also, a mandatory holding requirement, which requires employees to hold shares or units for a period of time before disposal, may be incorporated. Another way of ensuring sustainability is to include non-financial KPIs as part of the vesting conditions. Where the scheme sits at the portfolio company, it is easier for the new investor to administer the deferred component or enforce clawback.

- **Tax Implication and Efficiency:** LTIPs have tax implications for the company and employees. It is important to review the tax implications in deciding on the type and structure of LTIP to adopt. Participating employees need to understand the tax implications of the scheme and the role they have to play. For example, in Nigeria, LTIP payout qualifies for personal income tax, while dividends are considered franked investment income and subject to 10% Withholding Tax. Also, tax is not triggered until employees receive LTIP benefits. Therefore, employees can be allowed to sell a portion of their vested shares / units to offset tax liabilities, at the time of tax-trigger. From the company's perspective, LTIP payout and the scheme running cost qualify for corporate tax deductibility under the caption of staff cost. However, this depends on whether the LTIP is instituted in the PE firm or with the portfolio company. If instituted at the PE firm, which does not have a taxable presence in Nigeria, the corporate tax benefit will be lost.

- **Accounting Considerations:** The International Financial Reporting Standard (IFRS) 2 (Share-Based Payments) provides guidelines for recognizing and accounting for LTIPs that are linked to company shares. An increase in expenses (in the income statement) and a corresponding increase in liability or equity is recognised for employee share-based payments in a company's annual report. The Standard stipulates that fair value of the equity instrument should be recognised at the time of grant. The company's share price is often a key component of this valuation. For publicly quoted companies, the market price is readily available, while for private companies, a valuation is required to determine the share price. The valuation of the equity instrument is dependent on how it is structured. The professional valuing the arrangement must have a thorough understanding of the scheme structure and all the key parameters.

In line with global practices, disclosure of LTIPs are required. Therefore, auditors also need to ascertain that the transaction has been properly valued and accounted for.

- **Impact on Social Security Contributions:** It is important to check whether payout via cash or shares may form the basis of computing social security contributions such as pension, health insurance for the employer and employee. If this is the case, this may imply an increase in social security liability for both the company and/or employees. In Nigeria, payouts from LTIPs are not included in computing employer and employee contribution towards pension. In countries like South Africa, gains from LTIPs form part of employee remuneration for the purpose of computing employer and employee contribution to social security schemes like the Unemployment Insurance Fund, a scheme that gives short-term relief to workers when they become unemployed or are unable to work because of maternity, adoption leave, or illness, and the Skills Development Levy, imposed to encourage learning and development and determined by an employer's salary bill.
- **Other Regulatory Considerations-** Other regulatory provisions may impact the LTIP and should be carefully assessed to mitigate any penalties that may arise from regulatory infractions. Globally, there are various regulations guiding implementation of LTIPs, including use of shares for compensation and related costs such as stamp duties. Various Codes of Corporate Governance provide guidance on Executive Compensation practices, as shown below:
  - ✓ **The United Kingdom** Corporate Governance Code encourages the implementation of share-based remuneration, including holding requirements for Executives. In addition, full disclosure and shareholder's "say-on-pay" are required.
  - ✓ **In Nigeria,** the following apply, amongst others:
    - Central Bank of Nigeria's (CBN) Code of Corporate Governance encourages the use of LTIPs for Executive Compensation.
    - The draft Financial Reporting Council of Nigeria's Code of Corporate Governance also encourages LTIPs for Executives.
    - The Companies and Allied Matters Act requires a company to disclose any substantial ownership of its shares by any shareholder (at least 10% of unrestricted voting rights).
    - In addition, the Investments and Securities Act empowers the Securities and Exchange Commission to regulate investments and securities business in Nigeria, including share ownership and options.

The following are critical for implementing a LTIP:

- **Board Approval and/or Board Resolution:** Where the LTIP is instituted in the portfolio company, the company's Board of Directors would give the mandate and approve the scheme structure and implementation framework. The remuneration committee is typically responsible for making recommendations to the Board on LTIPs and other matters.
- **LTIP Implementation Documentations:** This is a very critical aspect of the LTIP implementation. There should be a scheme rules / policy document that clearly articulates the following, amongst others:
  - ✓ Objectives of the LTIP
  - ✓ Eligibility - to specify employees that can participate in the LTIP
  - ✓ Performance / vesting conditions – to articulate the requirements for vesting of LTIP benefits
  - ✓ Share pool / grant size – to define the size of the benefits to be awarded
  - ✓ Treatment of exits and new joiners to the LTIP
  - ✓ Clawback provisions – to create a mechanism for recouping excess LTIP payout due to a misstatement in the underlying financials.
  - ✓ Tax implications

  The LTIP Rules / Policy is necessary to provide clarity on the LTIP's objective and engender employees' trust and buy-in. The LTIP Rules / Policy should be communicated and made available to the eligible employees. Depending on the type of LTIP, the other scheme documents to put in place are Offer/Grant Letter, Vesting Letter, Exercise Letter, and Trust Deed.
- **Scheme Administration:** LTIPs may be managed by the Human Resources (HR) team, where the required skills and competencies exist internally. Some of the areas where HR can assist include:
  - ✓ Issuance of grant letters and scheme rules to the eligible employees
  - ✓ Collation of individual acceptance letters
  - ✓ Periodic tracking of any new joiners and exits from the LTIP
  - ✓ Documentation of promotions and any role changes that may impact LTIP grant
  - ✓ Tracking performance scores/ratings and its impact on LTIP awards
  - ✓ Pay review decisions that may impact LTIP
  - ✓ Review of payout computations
  - ✓ Notification to employees of payout
  - ✓ Review of tax computations on LTIP payout.

  An organisation may outsource the above functions to an independent rewards consultant or a Trust Fund Manager. For equity-based schemes, the company may require a Trust to administer the LTIP, while for cash-settled schemes, the company can choose to leverage internal resources for the LTIP administration with the relevant support from a rewards consultant. A Trust Deed is required to spell out the role of the Trustee and the company in managing the LTIP.

Human Resource Professionals are critical change agents in implementing PE-sponsored LTIPs. As strategic partners, HR professionals need to have a holistic view of the LTIP and partake in the conceptualization, design and administration of the LTIP, especially, where instituted at the portfolio company. Also, all employee-related information and HR policies should be organized and collated in an information system that is easily accessible. Aside LTIP implementation, the goal is to ensure that HR professionals are positioned to supply information for due diligence activities and perform critical change management roles that come with, Mergers & Acquisitions and entry of new PE Investors.

The success of any PE-sponsored LTIP is hinged on its ability to align employees' interest with Investors' objectives. Therefore, the LTIP structure, performance levels / parameters must be aligned to the Investors' objectives and should be predetermined and communicated. However, it is very critical that an independent rewards consultant is engaged from the onset to ensure that the desired objectives are achieved and unintended consequences avoided.

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