



Remuneration in Private Equity portfolio companies

September 2018



Introduction

The private equity ('PE') landscape is of significant importance to the UK economy, with PE investment in the UK exceeding €27 billion in 2017, nearly double the figure we saw deployed in 2016¹.

Consistent feedback from investors, as evidenced by the successes and failures of recent years is that the strength of the management team behind a business is key to what a portfolio company actually achieves.

So how do you attract and motivate a management team in a private equity portfolio company? We regularly see headlines about executive pay in listed companies, and there is readily accessible information in PLC remuneration reports, but less information and less disclosure is available in the context of privately owned and private equity backed businesses.

In response to this, KPMG have undertaken a survey of both PE investors and management teams to ask them some of the questions we thought you would like to know about the role of reward in a PE portfolio company. Our findings and insights coming from them are contained in this report.

Unsurprisingly, the role of equity to incentivise management teams is still critical, but it is evident that as the stakes get higher for both parties, the different drivers and expectations of each side can come more sharply into focus. This can be exaggerated with the focus moving to a more 'patient capital' approach, compared to the shorter hold periods which people have long since associated with private equity in the past.

More complex businesses can also mean that a wider group of employees need to be incentivised to achieve results. International expansion can also add further complexities.

We spoke with over 70 PE investors and management teams for their views and would like to thank those who participated and for taking the time to help us in preparing this report. We hope that you find this report insightful and would welcome feedback on what we feel is an important and under-researched subject matter. You can contact the KPMG team responsible for preparing the report with the contact details overleaf.

Chris Barnes
Partner, KPMG

Sources:

¹ Centre for Management Buyout Research, Imperial College Business School)

Highlights

2/3

of Investors thought that Management were paid above 'market-rate' (taking into account the value of equity).

Only 30%

of Management agreed.



Management's ability to

invest

is a key factor when determining the size of their Investment.

2/3

of respondents said they would negotiate a different package if the deal was done today.

Just under 50%

negotiate base pay at the time of the deal.

Management are most motivated by the

value

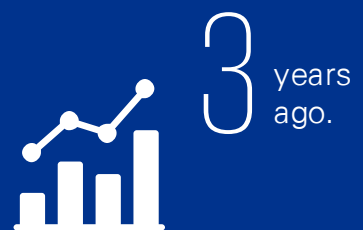
of their equity.



Half

of equity resets take place where the business is outperforming or meeting forecasts.

Motivational value increases where the deal was more than



3 years ago.

Over 2/3

of Investors use ratchets. Value Creation mechanisms are typical.

Typically at least 10%

of share capital is set aside for 'sweet equity'.

Corporate Finance advisors are increasingly a part of Management's advisory team.



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What really drives Management?

Investors seek to ensure that Management are motivated throughout the deal lifecycle. We were curious to know whether Management were motivated entirely by Equity and if this ever changed. Are Management less motivated by Equity when their business isn't performing as well?

And what impact does a longer exit horizon have?

"Where Equity is given in exchange for lower salary, Management Equity should be somewhat secure as it is effectively deferred compensation."

[Management]

Equity is king when it comes to PE portfolio businesses with 65% of Management reporting that Equity motivates them most. Management see it as the optimum way to realise personal wealth. For Investors it is seen as the best way of aligning the interests of the Management with their own.

What motivates Management the most?



"Equity is extremely risky but has a huge upside. We did well and the market did well, a great outcome where we were able to double our initial investment"

[Management]

Whilst the above is not surprising, we found that the motivating value of Equity appears higher:

- Immediately after a deal, reflecting the newly found sense of ownership and enthusiasm.
- Three years after a deal, perhaps suggesting the anticipation of an exit.

The expectation would be that where the business is under-performing, base pay would provide more of a motivation than where the business is doing well. Interestingly however, we found this not to be the case and Management remained most motivated by their Equity. A careful balance between cash and equity needs to be maintained to avoid Management feeling that they are taking too much risk.

Do bonuses have a role?

In a PE context, bonus schemes are often considered a drain on cash and can also be a source of friction between Management and Investors. The problem is that Management will always welcome a bonus, whereas Investors are more focused on the long term return. Whilst the majority of Management respondents receive an annual bonus with the terms set at the time of the deal, feedback suggested that they were less important than base pay which covers the cost of Management's 'cost of living' and equity which could potentially deliver significant financial returns.

Deal time: Who negotiates what?

Negotiations between Management teams and Investors play a key role in how remuneration packages are put together and is often one of the first major tests of the relationship.

But what do we mean by remuneration in this context - is equity effectively deferred remuneration or is it an investment (or both)? And how does Management's perception drive negotiations?

At the time of the deal, the majority of Management negotiate the terms of their equity and just under 50% negotiate base pay. Management are much less likely to be satisfied by the Investor's proposals in respect of equity allocation.

What is negotiated at the time of the deal?

Base pay



Bonus



Equity



- No, did not negotiate because no flexibility permitted
- No, did not negotiate because of acceptable proposal
- Yes, negotiated at the time of the deal

"A basis for annual salary increases should be agreed at the time of the deal. Regular benchmarking should also be agreed."

[Management]

Hindsight is a wonderful thing

Whilst more experienced Management teams come into negotiations prepared, on a primary deal Management are more likely to experience buyers' remorse with 72% wishing they had negotiated a different package. This compares to only 30% of Management going through a secondary deal who would like to renegotiate.

Many of those who would renegotiate Equity would look for a larger share (unsurprisingly). Ratchets for over-performance were also top of Management's wish list, so there does appear to be an acknowledgement that any request for more should be linked to higher levels of performance.

In the heat of the moment, the more traditional elements of remuneration are sometimes overlooked. With all of the focus being on maximising the enterprise value and negotiating potentially significant financial returns, little attention is given to employee benefits. This can lead to frustration further down the track. Where benefits can be implemented tax efficiently, this can be a 'win/win'.

"Fringe benefits like car, pension and health coverage shouldn't be disregarded. They're not high enough and not aligned to the market."

[Management]

Let's get down to business ... how much to invest?

We're often asked how much Management should be required to co-invest. Like most things in life, the answer isn't straight-forward but the key factor is the deal type. For newer Management teams, the prospect of investing meaningful amounts can be a daunting prospect. Whilst for more seasoned Management teams on a secondary deal, the question is more likely to be 'how much can we invest'.

We were keen to find out in broad terms, how much of their base pay Management typically invested in a primary deal (sometimes referred to as the 'Investor Strip'). And how much is rolled-over on a secondary deal?

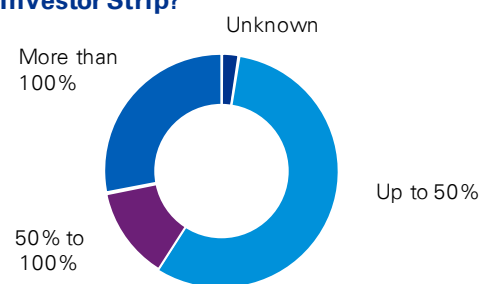
"Affordability of equity impacted the meaningfulness of my stake. Any upside will be from future investment."

[Management]

How much of base pay is invested in the Investor Strip?

On a typical primary deal, Management are required to invest up to 50% of their base pay in Equity. This is lower than we've seen historically and perhaps an acknowledgement that this can be a risky investment. Many PE houses will welcome investment in excess of their 'core' level of investment.

More senior members of the Management team will generally be asked to invest a higher percentage of base pay.



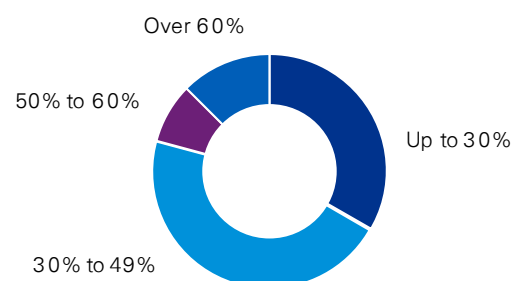
"There was limited ability to negotiate, I'd push harder for another 1%."

[Management]

How much of net roll-over proceeds are re-invested in the Investor Strip?

On a typical secondary deal, Management are required to re-invest between 30% and 49% of their net proceeds.

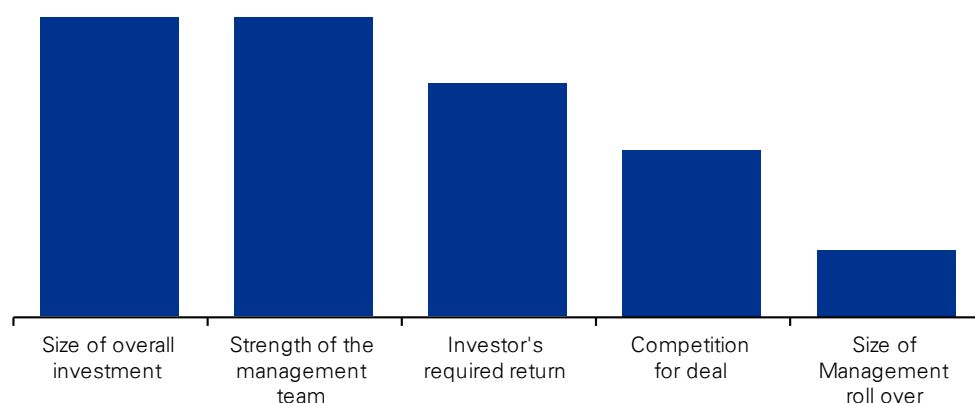
Management's reinvestment is typically a combination of ordinary shares, loan notes and/or preference shares.



And how much to give up?

Whilst Management may be thinking about how much they need to co-invest, Investors are thinking about how much they are willing to give up. A PE portfolio business without a motivated Management team is unlikely to deliver the investment case, but is that the only focus for Investors?

What is the most important factor when deciding the size of Management's investment?



"Management need to invest a substantial amount of their wealth."

[Investor]

Surprisingly, when determining how much should be set aside for Management, Investors did not rank their expected return as the most important factor.

Competition for the deal isn't as important as it once was. In the midst of the Private Equity boom it was common for multiple Investors to be competing in a deal. Whilst this may still hold good today, its lesser impact on Management's investment may suggest more conformity across the market. We are also seeing more 'competition' from secondary deals, at which point Management's focus is often different, Management are more likely to be focused on realising a cash payment at the point of the deal rather than necessarily solely focusing on a future exit potential. In this regard, it is increasingly common to see Management being asked to roll a minimum amount but being given the opportunity to roll more.

The strength of the Management team was one of the most important factors for Investors, really showing that in the context of PE investments the relative power of each party shapes the deal.

The softer side

Our survey revealed a paternalistic side to Investors which is not often seen when it comes to the topic of Management's personal financial position and their investment in a deal.

Management's 'personal balance-sheet' and their ability to invest was identified as a key consideration with a number of Investors commenting that they will consider the financial position of each member of the Management team separately.

'Taking care' of Management is in the Investor's interests, a deal is typically at least three years long and it's in everyone's interests for the Management team to be stable throughout. By showing some understanding of the worries that may face Management when co-investing, it's more likely Management will stick around for the longer term and feel more willing to take decisions for the benefit of all shareholders rather than adopting a lower risk growth strategy.

"The net wealth of the individual manager is key especially where they have 'rolled over'. Their investment needs to matter but not be so great they can't sleep at night."

[Investor]

Sweetening the deal

The Investor Strip is generally regarded as Management's investment, rather than a motivational tool. So what drives Management to out-perform? The answer to that is a pot of Sweet Equity. We asked how big this pot usually is and whether special terms apply.

"Ratchets should apply for over-performance both to Sweet Equity and bonus payments."

[Investor]

"An early cash-out by investors kills the value of Management's Sweet Equity. There should be some provision to recompense Management for lost opportunity value."

[Management]

Investor's reported that they typically set aside at least 10% of their portfolio company's share capital for Sweet Equity, with a third allocating more than 15%. Our experience indicates that the larger the deal, the smaller the Sweet Equity allocation.

Return of the ratchet

For a number of years, ratchets were unpopular and only featured in a minority of deals. Where used, ratchets were generally 'investor led', with terms being set and controlled by the Investor.

Our research suggests a resurgence in the use of ratchets, with two thirds of Investors confirming that they appear in deals. Notably, ratchets are now often put forward by Management in their own 'term sheet', a common feature of many deals where Management are advised.

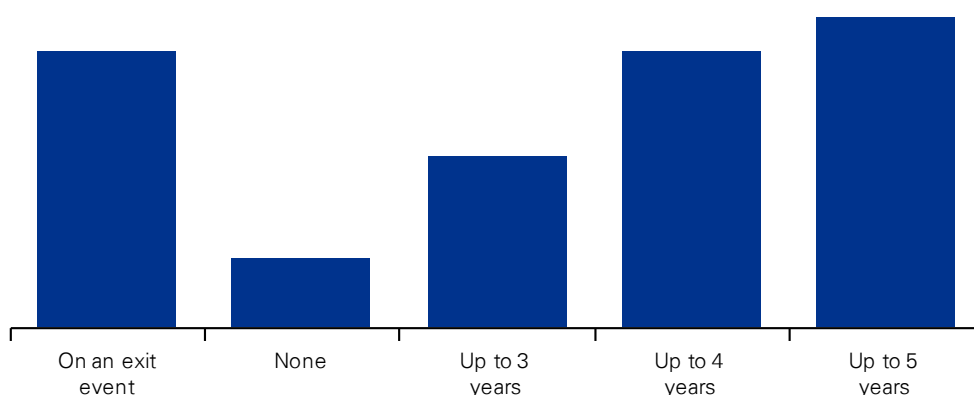
Where ratchets are included, 'value creation' measures are typical. Investors prefer:

- 'Money multiple';
- IRR; and
- EBITDA.

What vesting provisions apply to Sweet Equity?

If Management leave the company before a certain date, they will normally forfeit their Sweet Equity. Good and Bad Leaver provisions are typical, with preferential terms applying to individuals who leave for a 'good' reason. Generally this includes employees who leave due to illness, death, disability and retirement.

So what is a typical vesting period? Four or five years, or otherwise on exit are by far the most common periods.



Typically we would expect to see full vesting on an exit, such that if an exit event takes place earlier than anticipated then everyone benefits, although this wasn't a question respondents were asked.

Alignment of Management and Investors on the timing of an exit is crucial. Where Investors seek to exit early, there is often little value in Management's sweet equity which can damage an otherwise good relationship. Management are increasingly looking to secure certainty regarding exit timing – but what can be done where an exit takes place out of this time frame? One option is that Management are compensated for the lost 'opportunity', but this is unlikely to be favored by Investors.

Resetting: When, why and how?

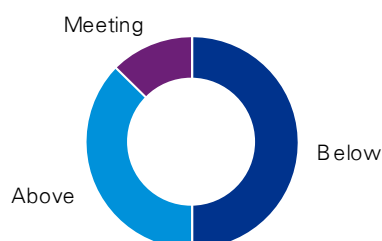
PE portfolio companies will often revisit the terms of Management's investment part way through the life of a deal where performance is not as anticipated or where the expected deal lifecycle has changed.

A revision (or 'reset') can be critical to Management's continued motivation, and can be a valuable opportunity to re-establish how much and when both Management and Investors can expect to realise on a future deal.

We're often asked to help a company revisit its debt/equity position, particularly where Management's equity is underwater, perhaps because of a market event or extended investment period rather than under-performance of the business (or Management themselves).

We wondered whether our expectation of resets taking place mostly where the business was underperforming against original expectations would be borne out by the results.

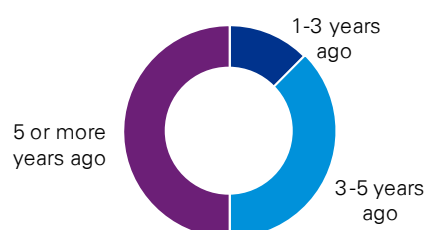
Resets: Business performance



We asked, where resets took place, how was the business performing compared to forecasts made at the time of the deal.

Interestingly, we found that there are as many resets where the business is outperforming and meeting forecasts as where the business is underperforming.

Resets: Time since the deal



Changes in the expected deal lifecycle also play a key role in when a reset takes place.

The majority of equity resets take place where the deal was more than five years ago.

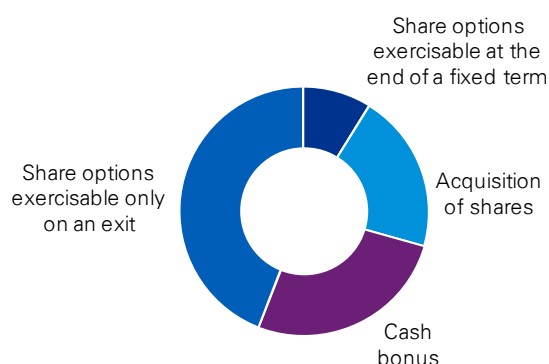
Who has the upper hand at the time of a reset? This will depend very much on a range of factors including Management's commitment to the business, economic conditions and the extent to which Investor's return has been achieved.

Sharing the success

Investors are bought into the idea of using equity as a motivational tool for the most senior members of Management. But what about the next Management tier, often regarded as vitally important to the every-day running of the business?

Equity participation can take the form of share options, exercisable on a certain event, or a direct acquisition of shares, typically subject to restrictions including vesting provisions. We asked Investors which they prefer to use for extending equity participation to this Management tier.

Preferred mechanism



Unsurprisingly, share options exercisable only on an exit were the preferred mechanism. Whilst this can help control the number of minority shareholders, because of the manner in which PE Investors hold their investments, it can mean the loss of valuable tax reliefs associated with direct equity ownership and a significant employer's NIC cost. As an alternative, nominee arrangements can be used to effectively aggregate the holdings.

The true cost of cash

Just over a quarter of Investors expressed a preference for cash bonuses as a means of extending participation. Whilst cash is arguably the simplest mechanism for rewarding employees, the impact of paying bonuses on the EBITDA and hence the value of the business can be significant.

Unallocated equity: unexpected consequences

It is common for PE portfolio businesses to retain an unallocated pot of equity for new recruits and promotions. Whilst this may be simple in theory, there may be unintended consequences particularly where the Equity has grown in value. This can often lead to equity being allocated immediately before exit, often without consideration of the tax impacts. The timing of post-deal shares acquisitions by Management should be carefully considered.



Tax: It's complicated

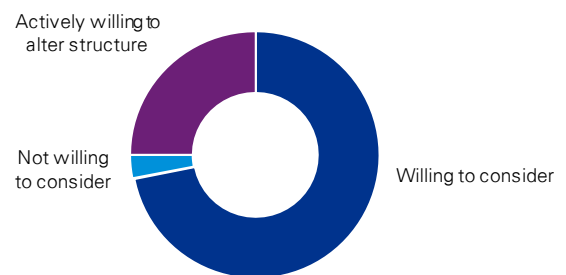
"Tax is a moving target, and varies widely across jurisdictions. We try to cut our deals on a gross basis, helping with structuring as practical."

[Investor]

With such a difference between capital and income tax rates, there is no wonder that tax can occupy a prominent position when it comes to structuring Management's investment. The increasing complexity and ever changing nature of tax legislation means that a boilerplate approach won't be acceptable to either side.

At the outset, Management will be keen to understand their tax position and the impact of paying insufficient attention to structuring Management's investment will be magnified on an exit. But how willing are Investors to accommodate Management's tax position?

Are Investors willing to consider Management's tax position?



A very small minority of Investors are not willing to consider Management's tax position at all and consider Management's tax position as their personal concern.

The above is also reflective of Management's anxiety around their tax position with over 65% of Management respondents saying tax was 'very important' to them.

Entrepreneurs' relief

HMRC's rules on entrepreneurs' relief provides an effective tax rate on qualifying disposals of 10%. Management teams are naturally very keen to ensure that this relief is available where appropriate and Investors recognise the importance of this.

Allocations of equity, loan notes and other instruments throughout the deal lifecycle can have unexpected consequences on the availability of this relief. It's often not until an exit however that any problems with the structuring of Management's investment come to light.

Global tax considerations

The structure of Management's investment and the associated tax position often go hand in hand with Management's location. Whilst the commercial desire may be for all Management to invest on the same terms, the tax implications where Management are located overseas may prove a hurdle to achieving parity.

Timing, valuation and rates vary dramatically in different jurisdictions and understanding the consequences of any Equity allocation is critical.

Advice when you need it most

There is clearly a lot to consider from both Management's and the Investor's perspective when starting deal discussions. But where to start? Advisors can help guide the way.

Investors will often encourage Management teams to use experienced advisors in order to ensure the deal remains on track and give Management comfort that they have been properly advised.

What type of advice are Management seeking?

The overwhelming majority of Management respondents stated that they received legal and/or tax advice at the time of the deal. Whilst legal advice has always been critical, tax advice is becoming more commonplace underlining a greater focus by Management on their tax position.

We are also increasingly noticing the appointment of separate corporate finance advisors by Management teams, particularly on secondary and tertiary deals. This could point towards greater confidence on the part of Management in securing the best possible deal, or perhaps reflects the growing complexity of deal structures.

But, why is advice so important?

The waterfall on a deal can be complex and can become more so as a result of acquisitions, complex working capital positions and longer than expected life cycles.

When questioned 80% of Management reported they are 'very clear' on when their Equity will become valuable. The remaining 20% are unclear, suggesting Management have lost sight of what needs to be delivered to Investors.

Worryingly, 5% of Management have 'no understanding' of the return required by the Investor in order for their Equity to become valuable. Where Management don't understand the terms of their equity investment, it will provide little if any motivational value and it is unlikely Management will be focused on achieving the necessary business outcomes. It is in both Management's and the Investor's interests to ensure that the terms of Management's Equity investment are well understood. Receiving the correct advice can be invaluable in the context of the success of a deal.

The value of advice

Independent objective advice at the time of the deal:

- Increases alignment of the Investor and Management interests;
- Allows for the focus of both sides to be on forward looking business performance rather than 'deal distraction' issues;
- Reduces the risk of Management regrets following completion of the deal.



KPMG can help

“An advisor who specialises in equity structures is a necessity. The deal structure was really complicated and it wasn't clear how much our equity was actually worth.”

[Management]

KPMG's Reward practice is a dedicated national team operating from five main locations across the UK. Our team combines detailed technical knowledge with extensive practical global experience and commercial 'know-how'.

One of our key areas of expertise is around Private Equity working both with Management and Investors on exits, reinvestment and new reward arrangements both in the UK and overseas.

Reward matters frequently overlap with other business issues at the time of a transaction and will often have an international dimension. We regularly advise on executive remuneration matters and taxation covering structuring, incentive design, remuneration structure, benchmarking and benefits provision.

We have a multi-disciplinary team, able to advise on the tax, legal, regulatory, accounting, design, market practice and corporate governance aspects of UK and global incentive plans.

Base pay

- Benchmarking
- Design/banding
- Job families
- Levelling

Short-term incentives

- Annual cash bonus
- Incentive schemes

Long-term incentives

- LTIP design
- Equity schemes
- RSU/Phantom scheme

Benefits

- Medical
- Insurance
- Car/cash allowance
- Elected benefits

KPMG can assist with all aspects of a transaction assisting both Investors and Management with the entire deal process and providing ongoing advice and support throughout the transaction lifecycle.

Contact us

London

Chris Barnes

020 7694 2738
chris.barnes@kpmg.co.uk

North

Joanne Brien

0161 246 4553
joanne.brien@kpmg.co.uk

Midlands

Richard Burston

0121 232 3925
richard.burston@kpmg.co.uk

South

Lorna Jordan

0118 373 1422
lorna.jordan@kpmg.co.uk

Scotland

Edward Norrie

0131 527 6724
edward.norrie@kpmg.co.uk

Editors

Andrew Johnson

0113 231 3670
andrew.johnson@kpmg.co.uk

Corin McGinley

0121 232 3160
corin.mcginley@kpmg.co.uk

kpmg.com/uk/PE-survey

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