Equity Incentives at Publicly Traded vs. Private Equity Owned Companies: Is There a Difference?

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Equity compensation for senior management of private equity owned companies is very different than that of publicly traded companies. While both types of companies share a common principle of rewarding management based on an increase in shareholder value, fundamental differences in the investors and their potential holding periods drive divergent equity compensation practices. This article refers to the different equity compensation models as the "Private Equity Model" (for example, concentrated financial driven owners with a generally approximately five year time horizon) and the "Publicly Traded Model" (for example, broad and diverse owners driven by financial gain over an indefinite time horizon) in explaining their differences.

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- Type of shareholders (concentrated financial vs. diverse institutional) which dictate investor approach; and,
- Return timetable (generally approximately five years vs. an indefinite time horizon).

This article refers to the different equity compensation models as the "Private Equity Model" (for example, concentrated financial driven owners with a generally approximately five year time horizon) and the "Publicly Traded Model" (for example, broad and diverse owners driven by financial gain over an indefinite time horizon). Please note that in some cases, the private equity owned company could be publicly traded in a limited manner.

Publicly Traded Model: In a public company, the largest shareholders are usually institutional investors—often mu-

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tual funds. These type of investors review the company on a frequent basis (sometimes daily), and on each review dynamically adjust their investment outlook. Even if the large investors are not mutual funds (they might be pension funds or other types of institutional investors), a good portion of these large investors will be making short-term investment decisions, resulting in focus on quarterly earnings and other such short-term factors.

Private Equity Model: In a private equity owned (or sponsored) company, there are a very limited number of investors and they expect to be in the investment on a multi-year basis. One of the primary concepts of private equity investors is that they are not particularly concerned about quarterly or other short-term results, but instead are focused on the long-term growth of the company.

This difference in investor approach impacts the type and style of equity compensation for executives of the company.

IMPACT ON MANAGEMENT COMPENSATION

Publicly Traded Model: Management equity grants are generally made annually. They usually consist of a performance-oriented grant with a three-year performance period (at most four years) or a series of one-year performance periods (which are frowned on by proxy advisory services and institutional investors). The value of the performance grant is generally 50%, or more, of the total long-term incentive grant value for each year. The remaining portion of the grant is generally a time-based award, vesting on a graduated annual basis over three or four years. The award is usually made in the form of stock options, restricted stock units (or restricted stock) or some combination thereof.

The performance vesting criteria for the Publicly Traded Model is often total shareholder return (TSR) on a relative basis, although sometimes earnings, revenues or some combination are used to measure performance. The concept of using TSR is to align the management compensation with the return to the shareholders during the same period. The use of relative or comparative TSR is to reward the executives for specific (industry-based) stock market growth. Using TSR also helps avert the need to project revenues and earnings for three or four years, which is a difficult task, given a variety of factors and assumptions that change over time.

The alignment of management and shareholders is reinforced by awarding annual grants to reflect the changing population of shareholders. If management terminates employment as a "good leaver" (without cause or for good reason, death and disability), they will usually receive their vested equity perhaps on a prorated basis for open performance periods with determination at the end of the performance period. In a for cause or voluntary termination, all unvested equity is generally forfeited but vested equity is not usually subject to claw back (except for situations where there is a claw back for improper accounting or other issues or, in some cases, violations of restrictive covenants).

Public companies usually grant equity-based awards on a comparison to peer companies so that executives' total annual compensation is comparable to a percentile of the value of executives of similar levels in those peer companies. The 50th percentile is very common, although for experienced executives it is often closer to the 75th percentile and for less experienced executives it may be below the 50th percentile. The peer comparison is based on dollar value, although there is sensitivity to economic value transferred and size of the pool transferred.

The company has a pool approved under an equity plan that is utilized over several years and then the shareholders are asked to refurbish the pool. Investors are concerned about the size of the pool and the overhang of outstanding grants that can dilute shareholder value.

Private Equity Model: The Private Equity Model takes a different approach to equity. The concept in a private equity company is that management should be rewarded when the investors are rewarded. They generally enter the company at the same time and the equity vesting is geared to exiting the company together. Of course, sometimes executives join or leave the company during the course of private equity ownership. The executive who leaves early generally receives a lesser (or suppressed) amount depending on the termination type. The executive joining is inserted into the existing plan but typically with some variations.

The Private Equity Model consists of a front-loaded grant that is supposed to cover approximately five years of annual grants (as compared with public peer group companies). This gives the executive the benefit of the initial company value and not grants at increasing values (of course, if value in a public company goes down, future grants are at lower levels). Moreover, this approach directly aligns the executives with the private equity investor since everyone is starting from, and exiting at, the same value.

The Private Equity Model provides flexibility by use of partnerships and limited liability companies to make stock option grant like an award structured as a "profits interests" for senior executives, which basically provide the executive with a capital gains opportunity on the value above the initial value of the company (commonly known as the "waterfall" or the "threshold").

The Private Equity Model uses the concept of profits interests, which are much like stock options without the need to exercise the option and pay ordinary income tax on the spread at the time of exercise. To use the profits interests concept, a pass-through tax entity, such as a partnership or limited liability company, is necessary. This makes the executive a partner in the pass-through entity with potential state liabilities and tax return filing requirements as well as entitlements to certain information on the partnership. Therefore, profits interest grants are often limited to the more senior executives. Restricted stock is rarely used in the Private Equity Model since the concept is to share in future growth and not to share in the initial value. Restricted stock is occasionally used as makeup for lost equity on a lateral hire.

The equity pool size can vary greatly. Generally, the larger the initial equity value, the smaller the pool percentage size since the absolute dollars become more important. However, the plan structure can also impact the size of the pool. Plans with hurdles (return on equity before management starts to share) will have larger pools because of the hurdle requirement.

Plans with hurdles tend to be more common in the United Kingdom and Europe than in the United States because executives in the United Kingdom and Europe do not have the benefit of the use of profits interests. In the United States, profits interests are treated as having zero value if the waterfall is the value of the equity on grant, since on liquidation immediately after grant, the executive would not receive any value. This is pursuant to United States tax rules. In the United Kingdom and Europe they use sweet equity and/or growth equity. In both cases, a lot of the initial equity value (hence, the tax cost) is structured as a loan note or preferred stock with a fixed compounded rate of return (a hurdle) (together defined as Preferred Equity) thereby creating a "thin" ordinary share value. This, in turn, lowers the value of the sweet equity or growth equity share sufficiently to make it affordable to managers when they subscribe for the shares. The growth in future equity value is then taxed as capital gain assuming certain tax elections are made.

An equity pool in the United States is likely to be in the 8% to 12% range of total equity, although as noted it can be larger or smaller. Of that pool, the chief executive officer would likely receive 20% to 40% of the pool with the second executive receiving one third to one half of what the chief executive officer receives and down from there with each management layer. The relative percentages will depend on the size of the pool, how many executives are to be covered by the pool and their relative strengths, and the philosophy of the private equity firm and the chief executive.

Some private equity investors believe that only the top executives should share in the equity and other executives should be compensated with cash-based plans because they do not have a significant impact on the company's growth and would prefer cash (vs. equity). Others believe that equity should be spread widely. It should also be noted that private equity reward is considered more risky than a public company reward (partially because of the front-loading and the inability to have liquidity in the public market) and, therefore, total potential equity reward in private equity portfolio companies will be higher than in public companies.

Most private equity pools are divided into two parts. There is a time-based vesting portion that will generally be 50% or less of the pool with the remainder being performance based. The time-based portion typically vest over four or five years, usually annually although sometimes quarterly (or at least quarterly for good leavers). If an executive's employment terminates, treatment will vary depending on the basis of the termination. If it is good leaver (death, disability, without cause or good reason) the executive generally retains what is vested and, on occasion, gets some additional vesting. In the case of cause, all incentive-equity is forfeited. In the case of voluntary termination without good reason, treatment will vary from forfeiture to retaining what is vested. This depends on such things as the level of the executive and the philosophy of the private equity house. In many cases, for the senior executives, the treatment may vary before and after two or three years of service. There is often an acceleration of the time based equity on a change in control and senior executives will seek protection for good leaver termination in contemplation of a change in control.

The performance-based portion of the pool will vest upon a cash realization of proceeds by the private equity firm. Vesting is usually measured by return of proceeds over investment (commonly referred to as MOIC or MOM) or investment return rate (commonly referred to as IRR) or some combination of the two. Obviously, a MOIC measurement is preferable for a long hold and an IRR measurement for a short hold. Occasionally, there is annual vesting based on annual and cumulative earnings before interest, tax, depreciation and amortization (EBITDA) projections with perhaps a MOIC or IRR catch-up upon realization of the investment. Rarely is there measurement of the return and vesting before realization (except if annual EBITDA is used), but in the event the company has an initial public offering (IPO), there is sometimes a measurement at the IPO and/or some date thereafter before the private equity firm sells down.

In most cases, if an employment termination occurs, the portfolio company and/or the private equity firm will have a call on the executive's interests in the company. This generally applies to both the incentive interest and the investment, although in the case of large investments and in certain other cases, the executive seeks to be treated like a true investor. The call is usually at fair market value at the time of call, although in the case of a cause termination and sometimes in the case of voluntary termination it is at the lower of fair market value and cost (if any). The fair market value determination is usually made without regard to discounts for minority interest or marketability, but not in all cases. The private equity firms prefers to determine the fair market value in their discretion or good faith discretion, but senior executives often have an appraisal right. The executives prefer payment in cash on a call (or delay until cash can be paid), but the private equity firm often seeks the ability to use a note (especially if cash could violate financing covenants).

In a public company the senior executives will need to accrue an ownership position of a multiple of their annual salary. They are usually given five years to do so and it is usually accomplished by not selling the equity grants they receive from the company. In a private equity portfolio company situation, the equity commitment is up-front at the time of the acquisition. If it is a portfolio-to-portfolio transaction or a public-to-private transaction where equity will vest or there is a sales bonus, the equity commitment requested (subject, of course, to negotiation) is usually a percentage of the net after-tax amount being received by the executive in connection with the transaction. If the executive is receiving limited amounts, the private equity firm is likely to ask them to invest their personal assets and often provides them with a loan (initially paid from a percentage of annual bonuses) to cover the investment. "Skin in the game" is even more important to private equity portfolio companies than it is to public companies.

The models for equity incentives are different in many ways, but the overall concept is the same. That concept is to support overall organizational wellbeing by rewarding the executive if, and only if, the investors are rewarded.