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MANAGEMENT EQUITY PLANS

Myths and realities

What factors make a difference for managers in EU private equity deals?

1 MINUTE READ

Private equity investments are now being made in a rapidly expanding global market place with the quality of management equity plans (MEPs) being offered by private equity funds to managers needing to reflect the increasing globalisation and internationalisation of the industry.

France, it has been said, is an exception for private equity-backed leveraged buyout (LBO) transactions, with special benchmarks available for management equity plans (also called management packages).

There are old fashioned and inappropriate stereotypes. The UK is said to be a country where management is a 'commodity,' ie easily replacable, and therefore management equity plans are less important in ensuring the success of the company going forward. In Germany, managers do not want to be involved in private equity businesses, while Spain is just discovering private equity and Italy is a country where managers are not prepared. Therefore, MEPs are said to be less generous in these countries.

Of course there are differences in business culture in different countries around the world, but not in business objectives. Private equity funds invest in businesses across the world, for one purpose: be successful and achieve an attractive return on their investment.

There should be no such thing as local benchmarks (notwithstanding of course complete compliance with all local laws and regulations) and this is even more true today in our global economy and marketplace. Companies are becoming more international, have more global activities which are managed in more locations by more multicultural and multinational managers and management teams.

The thought that a manager or a management team should have different benchmarks or conditions from another manager or management team based on their nationality or the geographic location of the head office is inappropriate in today's market.

Difference of quality between management equity plans

What makes the real difference in the quality and content of management equity plans and importantly their outcome is the quality and success of the business being managed. A package will also depend on the experience and operational skills of its management team and the success they achieve in running the business and delivering results in a private equity backed financial structure.

For instance, the ability of the management to develop the group in line with the strategy agreed by the board or to provide all the adequate reporting information requested can also be taken into consideration when assessing the quality of the management. In the event that an initial public offering is identified as the preferred exit strategy, the management's experience in respect to listed company obligations or listings will also be taken into account.

Furthermore, in practice, the attractiveness of MEPs also depends on whether there is competition and interest around the acquisition of the company, as the proposed package could be different if for example there is only one potential acquirer, or a bidder has secured exclusivity compared to having several potential bidders having appetite in the deal.

National specificities

There are always a few national specificities in a transaction and a management equity deal. This is the case notably in terms of the structuring of the overall deal and in relation to the equity instruments used for the financial investor's and management's investment. This is also the case with respect to employment matters as well as personal tax aspects, which are specific to each country.

For example, ratchet instruments are seldom used in Germany and free share plans will benefit from a specific taxation regime in France whereas they will not be tax efficient in other countries. In Luxembourg the personal taxation rate will vary significantly depending on the shareholding percentage and period of holding. Also, when managers are required to invest through a dedicated management vehicle, this will have different consequences depending on the tax residency of the managers. The above elements make for technical rather than real qualitative differences.

Awareness of the private equity environment

What will also make a difference to the MEP (but also more generally and importantly to the company) is whether the management is able to understand and adjust to the very specific environment of private equity.

It is first of all about understanding the specificities of their financial shareholder. Private equity funds are shareholders that are different from institutional or industrial shareholders. They invest for a specific period of time (on average four to six years) whereas an institutional or industrial shareholder is not likely to sell the business again. Also, a private equity shareholder will acquire the group with a mixture of equity and debt which requires that the group closely manages its cashflows to reimburse the debt and respect the financial covenants. In terms of development of the group, there may be certain constraints depending on the strategy of its industrial shareholder whereas the independence implied by an LBO structure can provide more flexibility for the group.

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Managers must be aware of these differences and understand a fund's modus operandi, as well as its objectives, requirements and even constraints so as to meet their shareholder's expectations.

Consequently, it is about clearly identifying the advantages and risks of private equity for their company and business, and being able to adjust the business organisation, strategy and direction to this reality.

Finally, it is also about understanding the consequences of private equity for the management personally: they will not only be employees, but also shareholders, very often investing their own money in the business. As a result, it is key that managers are able to address the implications of this new status, in regard to legal, financial and tax matters.

Notably, it is key to properly identify and subsequently clarify what will be their rights and obligations, as well as the financial terms of their investment, and ensure that all key elements are discussed and where necessary negotiated in advance thus avoiding any potential misunderstandings going forwards.

Only when managers are clear about the specificities of private equity and its implications will they be able to discuss and then agree a MEP with appropriate conditions, fit for purpose focussed on making both the company successful and the result of the negotiated package lucrative.

Dedicated professional advice

Competent and experienced professional advice is key for management in private equity owned businesses.

Managers are experts in their operational field, but when it comes to discussing some private equity matters they are often the only party that is not an expert around the table. Furthermore, managers will be extremely busy, having to manage simultaneously the deal process, the business and their own personal situation. Every time we advise a management team they tell us that they did not realise that the process would be so time consuming and have such an impact on the operational aspects of the business.

Receiving strong and pertinent advice from an expert and dedicated professional on all matters will help them to remain focused on the business and the deal process, with the comforting knowledge that an experienced professional, truly representing their interests, is really taking care of their interests throughout the whole deal process and covering all important subjects of their MEP.

Furthermore, a good management advisor will not only advise management on the technical (legal, tax and financial) aspects of their deal, but will also share with them information about private equity funds, their expectations and track record and more generally educate them to the private equity environment.

One of the reasons why French managers have good MEP terms compared to some other countries is certainly that the vast majority are well informed, educated and advised on all PE matters early in a process.

Timing

Timing is absolutely critical for managers and management teams.

Firstly, it is far better for managers to discuss and negotiate the terms of the partnership in advance of a deal rather than after closing, both in terms of their ability to negotiate as well as all important structuring aspects.

With respect to the first aspect, once the buyer has moved forward in their discussions with the seller, management is less critical to secure the deal and therefore discussions around the MEP may be less easy. With respect to the second point, management may wish to require a certain level of financial headroom for new or existing business opportunities that can be more difficult to obtain if the acquisition financing has already been negotiated. As another example, the structure envisaged by the funds' advisors for the MEP – for instance the securities to be issued or the jurisdiction of the holding companies – might trigger negative tax consequences for the managers and it may be too late to obtain any modifications if the funds' structuring is already in place.

More generally and very importantly, unless a management team is already well versed in private equity practices, gaining awareness of this environment and adjusting to it takes time. It takes time psychologically but also in terms of business organisation and strategy. The sooner this awareness is gained and taken into account by the managers, the better it is for the business, the management team and their new private equity shareholder.

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Summary

Achieving a good outcome for management and their management packages will depend first and foremost on the quality of the business (and ultimately its results) and the skills of the management team. It will further depend on the appetite of bidders for the company.

Assistance of experienced and dedicated professional advisers will increase the opportunity for management teams to achieve the best results possible, irrespective of their nationality or geographic location. Ultimately, a well negotiated package and more importantly good and early preparation to the private equity environment will help to make the deal a success for the managers, their businesses and all other shareholders.

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