PRIVATE EQUITY NEWS

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Reincentivising management teams holding underwater equity

Guest comment

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The equity in many private equity-backed portfolio companies is currently underwater. Given that private equity is about aligning the interests of the management team with those of the private equity house, the consequence is that management teams may not be incentivised to create shareholder value for all and the retentive effect of their equity may have been lost.

Until the last quarter, the prevailing view among private equity houses has been to do nothing about this for a number of reasons. Some see little point resetting underwater equity in management's favour if an exit is not imminent. Others take the view that this is all par for the course: investments go down as well as up.

There has, however, been a big change in sentiment since the summer, probably because a number of private equity houses have reshuffled their management teams and, in so doing, recognised they can incentivise new joiners only with equity that is at least at par. The imminent rise in the UK's higher income tax rate reinforces how important the equity incentive is. Firms have also learnt it must keep management teams onside when a senior lender is looking to call an event of default.

The simplest way to deal with this question is to agree to pay management a cash bonus on an exit based on the exit price or the private equity house's return on investment, or even non-financial metrics such as customer satisfaction. The advantages of such an arrangement are that it is simple and has no cost to the portfolio company or the private equity house unless the performance criteria are satisfied. The disadvantage is that any payment on exit will be taxed as employment income and may not be deductible for corporation tax purposes.

The payment of a cash bonus, however, does not improve the balance sheet of the portfolio company. The best way of doing that is to release or capitalise a portion of the existing debt. A release of the obligation to repay a loan may seem counterintuitive to the holder of the loan receivable but the effect could be twofold.

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First, it eases the burden of interest payments and therefore increases the likelihood the portfolio company will not fail.

Second, it will either bring the equity into the money immediately or more quickly if valuations rise, and so help to incentivise management. The key issue is to ensure the debt release is done in such a way that the portfolio company does not suffer a tax hit. The Treasury has just put a stop to one structure that sought to achieve this, involving a Newco connected with the borrower being established to acquire the debt. Consideration also needs to be given to whether the management team will suffer an income tax and national insurance charge if the debt release/capitalisation results in an increase in share value.

Other solutions are to push management's instruments further up the waterfall by amending the terms of their instruments or exchanging them for others, typically institutional strip held by the private equity house. Again, to the extent that such a change increases the value of management's equity, this may give rise to a tax and NI charge.

One solution gaining currency is the idea of putting the institutional strip into a partnership and then giving the management team an interest in the partnership. In this way, management can receive a new incentive on virtually any terms, without the need to adjust any of the underlying instruments.

There are many reasons to realign the interests of the management team with the private equity house now and there are many ways of doing it.

Editor's comment: Highlights from penews.com

What HgCapital's fundraising means for others

James Mawson, January 14

HgCapital raising its sixth mid-market buyout fund above target is excellent news for it signifies the lifeblood of the industry, commitments to long-term funds, can continue to flow even during times of relative fear and contraction.

The garnering of about £1.85bn (€2.1bn/$3bn) is only, at current exchange rates, $500m more than the $2.5bn US venture capital firm New Enterprise Associates raised for its 13th fund last week.

It is, nonetheless, a substantial sum and provides one of Europe's most successful buyout firms with the firepower to buy companies worth about a total of $6bn over the next five years. The responsibility to deliver will be intense.

One large limited partner who declined to back HgCapital said he was surprised it had beaten its target as its fifth fund had been invested quite quickly at the peak of the previous credit boom. He added: "I am surprised the market is as forgiving as it appears to be. Even very reputable names