

## PE-STYLE INCENTIVES: THE BEST STRATEGY? MM&K Remuneration Dinner -9 June 2014

On 9 June 2014, MM&K hosted a dinner for Chairmen, Remuneration Committee Chairs and Chief Executives. The topic for discussion was the proposition that Private Equity (PE) style incentives might be the best remuneration strategy for key managers in UK listed companies.

### Summary

There were differing views at the dinner, but probably the majority of guests felt that the PE portfolio company model of remuneration is not really suitable for steady-state PLCs, although the principles behind it have much to inform better design of incentive plans in listed companies. There may be some helpful indicators for PLCs, eg in relation to performance/vesting periods and the selection of performance criteria. Much depends on the size and stage of development of a company. Immediately post-IPO is an important phase that requires some creative thinking.

There were some reservations expressed about the PE ownership model countered by opinions strongly in favour of the simplicity and focus it provides. The remuneration model came in for criticism in its particular focus on a small number of senior executives with their hands on the strategic levers – but most felt this was appropriate and necessary in the circumstances.

### Introduction by Nigel Mills

Nigel, who leads MM&K's work in the Private Equity area, began with an overview of the typical design features of an executive remuneration structure in a PE-backed portfolio company:

- Market-based salary and benefits, with a simple benefits package
- Annual bonuses for above target performance only, based on 2 or 3 KPIs – opportunity typically lower than in a comparable listed company
- Equity participation plan, involving a one-off award at the time the PE deal is done, which only vests and pays out on an exit by the PE investor. The key management team are effectively given a right to share in the upside
- Depending on the size of the deal, the team will be given a meaningful share of the value that they help to create – could be 5% to 20%
- The PE house will determine what level of (after tax) upside the team should benefit from if they achieve the expected returns. Could be £1m to £10m for the CEO
- Portfolio company management may be expected to invest their own money (nowadays not expected to be 'hurt' money). If individuals are prepared to put up sizeable amounts of their own money, their own equity participation opportunity is enhanced
- In summary, the key difference in the executive package between the listed company environment and the PE-backed environment is in the balance between short-term incentive and long-term incentive and in the structure of the long-term incentive.

The attraction of the PE model is that there is complete and demonstrable alignment between the interests of management and investors over the longer term. There is no debate about

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what constitutes good or bad long-term performance. It is all about absolute shareholder value creation. In listed companies, in contrast, Remuneration Committees struggle with long-term incentive performance criteria. Should they be relative TSR performance, EPS performance, ROCE, or some other measure? If you choose an absolute measure, what constitutes good, as opposed to exceptional, performance. And how do you factor in the economic environment which is bound to change over the long-term incentive cycle?

We are now seeing a few examples of companies implementing PE-style long-term incentive plans. In these types of plans, the management team (which sometimes is just the CEO and the CFO) are granted a one-off share based award which is intended to incentivise them over the next five years. This may be structured as a JSOP or for smaller companies that qualify, EMI Options, to provide capital gains tax treatment. PE-backed companies tend to structure their equity incentives as Growth Shares or 'sweet equity', which only realise value on specified events, such as an Exit for the PE investor.

Nigel said he was not suggesting that listed companies should have all their LTIPs for the key management team structured as only vesting on a sale of the company. But he was suggesting that consideration should be given to making one-off awards only, say, every three or five years and vesting them in tranches after three to five years. Vesting should only occur if a minimum or threshold IRR has been achieved by the shareholders over that period (say 8% pa). He was also suggesting that on vesting, the executives concerned should be required to retain a significant proportion of their vested shares for at least a further three years and, for some of their shares, until their eventual departure from the firm.

He asked why more companies don't replicate the PE Model. Those that do tend either to be small (often AIM) companies, which have good relationships with their long-term investors, or other companies which have gone through some difficult management changes and are looking to motivate a new key management team to deliver a strong share price performance over the next few years. The barrier seems to be a mixture of the nervousness of Remuneration Committee members, worried about their own reputations, and the 'tick box' mentality of large institutional investors who do not like large one-off and uncapped awards with vesting based solely on share price performance.

Nigel quoted the example of Aberdeen Asset Management but noted that Aberdeen had a 15% dissenting vote against its Remuneration Policy.

### A lively discussion followed:

#### *Contrasting the PE model and the PLC model*

- A participant with experience on the boards of three PE-owned companies identified three important remuneration features in PE-backed companies:

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- In the PE model, the participants buy-in at a significant discount and expect to see a 30-40 times return on their investment
  - Most of the PE investment is funded by debt – there is only a small proportion of sweet equity
  - All the senior team have to put money in. After exit (IPO or sale), the majority of gains are rolled over into new plans with a long tie-in.
- The PE portfolio company model really comprises salary plus long-term reward: the salary to pay the mortgage and school fees and long-term rewards for alignment, motivation and long-term commitment. Short-term bonuses are not really important to this model (although one guest did say he had not come across a PE-backed company that did not pay bonuses). In contrast, PLC pay is a “three-cornered beast”.

### *Trying to solve the problem in PLCs*

- One participant described a co-investment plan in one of the companies he works with. Senior executives can invest up to two times salary and get matching shares. This means participants are obtaining shares at half price and no-one would normally forgo this opportunity. Nigel was asked if he thought this was the same as the PE model and he responded by suggesting that this was a very different arrangement from the one he was talking about.
- Another diner said the company of which he was chairman had approached this problem from another direction. They were looking at a major acquisition which would lead to company transformation. The board did not want head-hunters poaching people and worked out the amount of money it thought would be necessary to keep people – and set up the plan accordingly. This sum was likely to be less than 5% of the gain in value through the transformation. He said throughout this they needed to balance the need to retain people with the need to reward super levels of performance.

### *The issue of limiting the incentive opportunity to a small top team*

- It was pointed out that the focus of these plans seems to be a small number of people at the top of a company. But success depends on engaging all staff and companies need to consider carefully the wider impact of introducing schemes of this sort.
- Size matters, said another participant, we are a small cap company with a small top team – but we have structured the business so it is ‘scalable’. We can grow without needing to increase the top team. This justifies high reward at the top.
- WWP is a large group which illustrates an exceptional opportunity for the very top team – Martin Sorrell was paid £28m last year – 3 times the earnings of No 2 in the group, and 8 times that of Number 3.
- But what happens further down, where managers do not participate in the equity plans at the top? Really it is their choice to leave the Group and go to work elsewhere or strive to become one of the executives in the equity plan.

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- Such plans need to be limited to the people with their hands on the levers. It may be two or three only; but in larger deals, typically 10-20 people are included.

### *Contrasting views of the benefits of Private Equity ownership of companies*

- PE is 'puff and stuff'. It's very artificial, whereas the PLC is a rolling model. This avoids the problem of individuals getting a large pay-out without the prospect of another one for several years – which can be the time to jump ship.
- There is a common illusion that PE firms are short term in their thinking and seek to make a profit by asset-stripping. That may once have been the case but now the opposite is true. They need to invest in order to have a living company to sell. PE companies want to invest - they look for growth in top line as well as bottom line and they want M&A opportunities.
- But another diner suggested that the PE model involves slashing capex and cutting costs; whereas generally PLCs try to support a long-term trajectory.
- The reason PE firms make a lot of money from the investments they manage is they are good at what they do. This is why they are able to charge 2% of funds under management in fees and 20% carry. This is in contrast to so-called active investors (who rarely beat the index) who make about 30-70 basis points only. What is more, there is evidence that ex PE-backed IPOs do better than other IPOs, further evidence that PE is a good model for managing and improving businesses.
- The executives in a PE-backed company can get on with managing the business. In a PLC you have to be out on the road all the time selling to the stock market – roadshows and corporate governance distractions.
- In contrast, another participant felt that managing in a PE-backed environment is rather one dimensional in expectations and restricts imagination.

### *Remuneration strategy post IPO*

- An area that needs a lot of careful thought is what remuneration strategy is appropriate for the portfolio company post IPO. Companies need to avoid automatic adoption of a 'standard box-ticking' PLC package.
- That's the time to introduce a post-IPO plan that encourages management to 'stay the ride' and not cash in and leave. At the moment, less thinking than should goes into the incentive plan post-IPO. It would be interesting to research how quickly PE firms sell down their remaining stakes following the IPO.

### *Problems of implementing a different model in a PLC*

- A PLC wanting to follow the PE model is going to have to stand up to the institutional investors
- The PE model only really works if an exit is achieved. There is then a logical end. In a PLC there is not an end. What is more, the shareholders are not there for the long term.

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They pretend they are, but in practice they will sell out when they want to. Boards and CEOs in contrast do, in the main, try to operate with a long-term view.

- Certainly any short-termism of the executives is offset by the NEDs who do think long-term.
- Doesn't the PE model effectively have the dynamics of share options – with just a price growth hurdle? This is basically true but institutional shareholders are opposed to such share options in PLCs. What is more, a PE firm is prepared to rebase the plan if it is underwater (having first dealt with under-performing managers) – this is another thing that institutional shareholders oppose.
- In PE, if you are a 'bad leaver', you have to sell back or forfeit your shares. The employment contract in a PLC is likely to restrict the employing company to a greater extent.

### *Tenure of directors*

- There was a discussion about the tenure of directors, with an average figure of 9 years for Chairmen being quoted and 2½ years for a CEO<sup>1</sup>. This was not felt to be long enough for a CEO – 5-7 years is needed to allow a proper impact. But 9 years is too long for a chairman.

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- <sup>1</sup> Note: following the dinner, MM&K checked the statistics in the Manifest/MM&K database and found the following: current (June 2014) average role tenure – All share chairmen 5.2 y; FTSE 100 chairmen 4.6y; all share CEOs 6.9 y; FTSE 100 CEOs 5.9 y.