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Evaluating Executive Compensation for Potential Portfolio Companies

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PRINCIPAL

Private equity (PE) investors are grappling with challenges related to continued economic uncertainty and financial headwinds. These dynamics are marked by declining deal volume and increased emphasis on smaller deals and minority investments[1] —trends which underscore how critical it is that PE firms conduct exhaustive due diligence for new investments through every perspective possible, especially when it comes to executive and broader critical talent compensation.

> The facts uncovered by these analyses have implications for deal structure and planning, and in more severe cases, may constitute "deal-breakers."

A comprehensive understanding of a target company's executive compensation landscape with respect to potential investment includes:

- Competitive market benchmarking of current compensation programs;
- Understanding continuing obligations under existing employment agreements; and
- Evaluating cash and equity-based incentive plans to determine potential vesting and payout scenarios.

What is at stake for PE firms is significant. The facts uncovered by these analyses have implications for deal structure and planning, and in more severe cases, may constitute "deal-breakers."

Assuming a green light, some PE investors also consider the design and establishment of specialized annual and long-term incentive programs concurrent with the closing of deals as effective levers in achieving desired investment outcomes. And innovative PE firms are taking traditional deal evaluation further by focusing on future-state compensation design that can drive strategic goals and EBITDA growth by aligning executive financial interests with these goals. Also of note, major PE firms are spreading equity more broadly throughout the organization rather than staying with the historical practice of concentrating equity amongst a small executive population[2]. (PE funds should consider their approach to this trend and determine if it will result in increased cost due to the use of more equity or decreased levels of equity at the very top of the organization as equity is spread more broadly from the same pool.)

Executive Compensation Structures at Target Companies Before and After Investment

Base salary and annual incentives or bonuses are typical in private company executive compensation programs. But the compensation elements that arguably have the largest potential implications for PE company deals are long-term incentives (LTI). Long-term incentives in private companies can take many forms, including cash-based units, profit interests, or real equity. For publicly traded target companies, real equity will be the most common LTI vehicle.

Long-term incentive plans will frequently include immediate vesting provisions following takeover of a company by a PE firm. This leaves the PE firm vulnerable that key talent could exit as they achieve liquidity. This is a critical area that must be addressed with the establishment of new long-term incentives at deal close for talent that needs to be retained to make the investment successful.

In a common scenario, a private equity sponsor will establish an equity pool upon investment in a portfolio company. This pool may consist of around 10% of outstanding equity in the company, and the PE investor will either prescribe the allocation of the pool or allow input from the company to allocate the pool to its executives and/or other employees. However, there is no one-size-fits-all approach to initial equity allocation and concerns around whether the pool is spread too thin or is too concentrated among a specific group may arise.

An equity program that directly ties plan participants to the success of the organization—either through increases in value following a PE's investment via stock options or through full-value shares that vest upon certain performance conditions, or some combination of approaches—should be carefully designed with specific circumstances in mind. The pros and cons of any approach should also be carefully considered, as should any strategy that targets specific executives and key staff who need to be retained.

These calculations can be further complicated by the industry in which the potential portfolio company operates, for example in professional services, healthcare, or technology, the success of the company is largely dependent on the intellectual capital and people in leadership. Conversely, in a manufacturing or equipment company, retention of certain employee groups may be less critical. Put another way, outside of the executive suite, ask "How dependent on its people and their intellectual capital is the ongoing success of the company?"

Key Areas of Focus When Conducting Due Diligence and Compensation Design at Deal Close

Benchmarking Compensation

Understanding positioning of compensation relative to the market will help PE firms identify how potential portfolio companies' executives compare on both an individual and aggregate basis, which provides important decision-making context when entering into new compensation arrangements. Benchmarking compensation levels of executives and employees allows the PE investor to quantify the extent to which they may have to go to design-compelling levers to ensure retention.

However, market studies can also inform an investor as to how much the business is weighed down by "fixed costs" (i.e., base salary) versus performance-based compensation. Knowing if base salaries are higher than market, given that base salaries are very rarely decreased, is essential to understanding how much is going to be required to transition the portfolio company to a performance-based growth company through incentives.

Incentive Plan Review

The evaluation of annual incentive programs should include assessing performance metrics, historical award payouts, and the rigor of goal-setting under these programs (i.e., are goals being set too easy so that the annual incentive becomes effective deferred compensation, or conversely too aggressively so that plan participants do not see value in the program). Following close, PE firms tend to recalibrate the annual incentive plan to focus plan participants on near-term goals critical to growing the investment. However, understanding what metrics are prevalent within the industry and what is "exceptional" growth versus "market" growth will ensure incentives strike the right balance and better align management and investor expectations.

The evaluation of long-term incentive programs should include review of equity vesting schedules including acceleration triggers (specifically what accelerates, if anything, upon an investment from the PE), related performance measures, historical award payouts, and the rigor of the goal-setting process along the lines of the annual incentive plan. Once acceleration triggers are understood, PE firms will know how much of the equity value is required to "rollover," if any, and how much additional will need to be put in place. Most PE firms have an established "playbook" approach; however, there is a benefit in tailoring that percentage to a detailed understanding of the payout quantum and market norms.

One critical but often overlooked step is that PE investors should consider future LTI plan design at the time of a deal closing. Firms often issue a 50/50 split of time- and performance-vested equity at the time of investment in a portfolio company. This approach may be an effective incentive mechanism, but more efficient and less dilutive strategies may be overlooked. Consideration should be given to whether the LTI program is self-funded by achieving an EBITDA hurdle beyond which profits are shared between owners and management, and whether the current longer-hold and lower-multiple environment or the likely type of exit should have bearing on a potential plan design (i.e., potential liquidity before an exit event). How should up-and-coming leaders and critical talent who might represent the future of the company be treated differently than the legacy executives whose expertise is invaluable?

Existing Employment Agreements

Adding further complexity to the various elements of typical executive compensation programs at private companies is the use of employment agreements that may either be based on standardized company policies and templates, or completely unique and bespoke agreements that were negotiated and amended by the interested parties during different time periods and for varying reasons.

Employment agreements often include potentially costly terms like severance and change-in-control provisions, specialized and unique compensation arrangements, and various other restrictive covenants of which PE investors should be fully aware. The PE should model potential payouts under different scenarios and compare to a market-based perspective. The PE is likely to want to rework some of these agreements at transaction to ensure employment provisions have some consistency with other portfolio company investments and are aligned with the goals of the investment. Having a firm grounding in objective market data is critical to ensuring a smooth dialogue with the management team.

Implications for Deal Structure and Planning

The areas of focus outlined above, both together and separately, can equate to tens of millions of dollars and have meaningful impact on deal structure and planning. The structuring of new incentives following investment can equally have a material impact on the potential performance of the investment.

Regardless of how macroeconomic trends evolve, a comprehensive understanding of executive compensation programs at potential portfolio companies or investment targets can always serve to mitigate PE risk and align incentives between executives and the PE. Even when capital markets regain momentum and deal volume rebounds, this level of understanding with respect to executive compensation can pay dividends.

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[1] https://corpgov.law.harvard.edu/2024/01/13/private-equity-in-2023-a-year-not-to-remember/#:~:text=Private%20equity%20deal%20volume%20continued,smaller%20deals%20and%20minority%20investments

[2] https://www.bloomberg.com/news/articles/2024-05-21/blackstone-to-expand-equity-ownership-to-workers-in-future-deals

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About the Author

Peter Wertheimer is a principal at Pearl Meyer. In this role, he provides executive compensation and governance advisory services to boards and management teams across industries. Much of Peter's vast experience is in the tax-exempt healthcare space, but he has worked with non-profit as well as privately held and public for-profit organizations of all shapes and sizes. He specializes in executive pay benchmarking, incentive plan design, peer group development, nonqualified retirement plan design, and board compensation, among other areas.

About Pearl Meyer

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