PwC Academy M&A

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Dealing with underwater management equity arrangements

19 November 2009

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PRICEWATERHOUSECOOPERS

Management Equity Arrangements

“How to keep the management of private equity backed companies motivated in (after) the financial and economic downturn”

Agenda

Pay practices within PE Backed Companies

Sweet Equity

Underwater equity

Resetting underwater equity incentives

Tax treatment of resetting methods

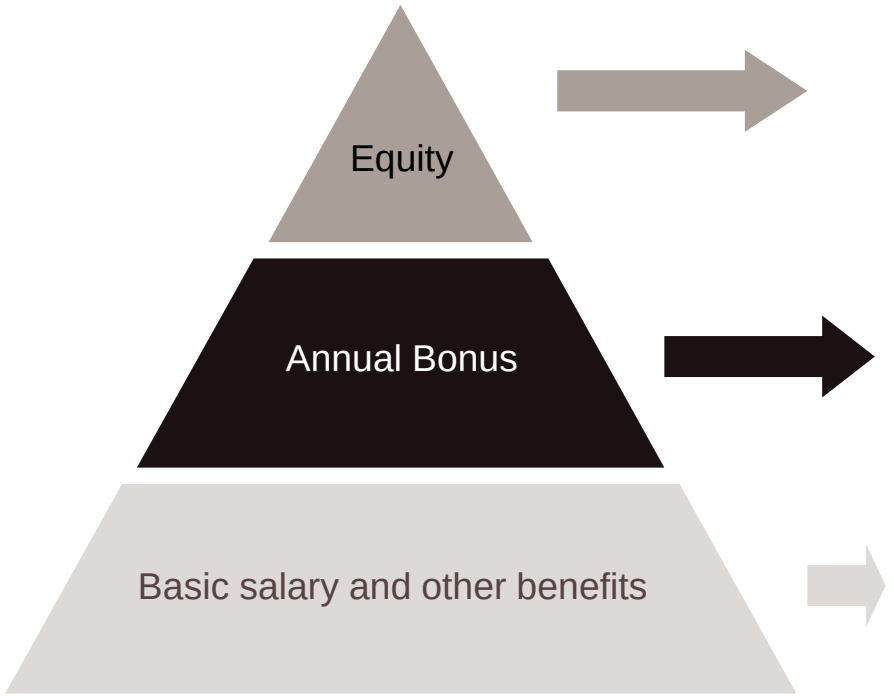
Valid alternatives : Options & bonus

Managing Capital Gains Tax

Conclusion

Pay practices within PE Backed Companies

Objective : incentivise, retain and attract talented individuals to execute the business strategy over the medium to long term



Key component of remuneration structure with value predicated on exit event

Alignment with shareholders' financial interests

Bonus levels reduced in favour of capital growth. Competitive levels of bonus for exceptional performance which are commonly self-financing and linked to key profitability fundamentals

Minimize impact on EBITDA

Conservative levels of salary and other benefits emphasizing value from equity component.

In compliance with a pay-for-performance culture

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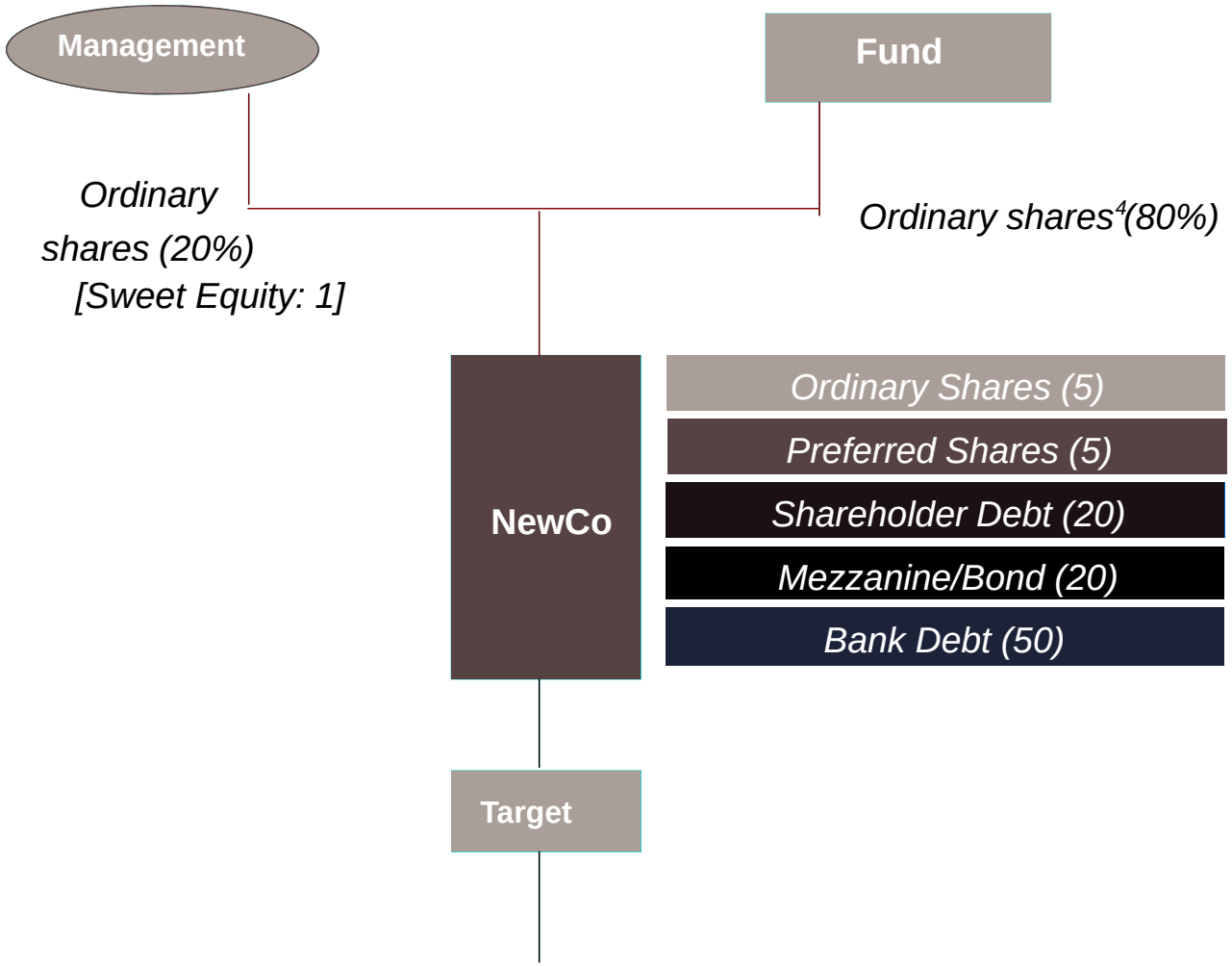
Sweet Equity



Sweet Equity

- ‘Skin in the game’ to ensure retention and alignment with shareholders’ interests

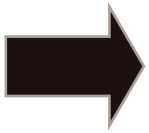
  - Approx. 1 – 2 times gross base salary
  - Roll-over of pay outs (secondary buy outs)
  - Investment of completion bonuses
  - Bad leaver and good leaver conditions

- Incentivise the management

  - Take advantage of leverage but hurdle rates apply
  - Envy ratio (“once in a lifetime opportunity”)

$$\frac{\text{PE house total investment / Percentage of company equity held by the Private Equity house}}{\text{Management total investment / Percentage of company equity held by Management}}$$

  - Ratchet arrangements



Sweet Equity is the key component of the remuneration structure

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Underwater Equity – Example

Source of financing of Newco (purchase price of Target is 100)

Senior Debt	50
Mezzanine/ Bond	20
Shareholder loans	20
Preferred shares	5
Ordinary shares	5
Total	100

Allocation of shareholder loan and equity

	Fund	*Management*	*Total*
Shareholder loan	20	0	20
Preferred shares	5	0	5
Ordinary shares	4	1	5

Financial returns

Senior Debt	5,00%
Mezzanine/ Bond	6,00%
Shareholder loans	7,00%
Preferred shares	8,00%

Exit value of financing at exit (after 7 years)

	T	*T + 7*
Senior Debt	50,00	70,4
Mezzanine/ Bond	20,00	30,1
Shareholder loans	20,00	32,1
Preferred shares	5,00	8,6

Underwater Equity – Exit value is anticipated to be lower than expected

Allocation of exit proceeds after 7 years (Mios €)

Exit proceeds	**110**	**120**	130	**140**	**150**	**160**	170	**180**	**190**	**200**
Senior Debt	70,4	70,4	70,4	70,4	70,4	70,4	70,4	70,4		
Mezzanine/ Bond	30,1	30,1	30,1	30,1	30,1	30,1	30,1	30,1	30,1	30,1
Shareholder loans	9,6	19,6	29,6	32,1	32,1	32,1	32,1	32,1	32,1	32,1
Preferred shares	0,0	0,0	0,0	7,5	8,6	8,6	8,6	8,6	8,6	8,6
Ordinary shares	***0,0***	***0,0***	***0,0***	***0,0***	***8,9***	***18,9***	***28,9***	***38,9***	***48,9***	***58,9***
Fund	0,0	0,0	0,0	0,0	7,1	15,1	23,1	31,1	39,1	47,1
Management	0,0	0,0	0	0,0	1,8	3,8	5,8	7,8	9,8	11,8
Total	**110**	**120**	**130**	**140**	**150**	**160**	**170**	**180**	**190**	**200**

In 2009, the PE house assumes an exit value of the business in 2012 to be 130

In 2005, the PE house assumed an exit value of the business in 2012 to be 170

Depressed Share Value

Underwater Equity – Exit is deferred (+ 3 years)

Allocation of exit proceeds after 10 years (Mios €)

Exit proceeds	**110**	**120**	**130**	**140**	**150**	**160**	170	**180**	**190**	**200**
Senior Debt	81,4	81,4	81,4	81,4	81,4	81,4	81,4	81,4	81,4	81,4
Mezzanine/ Bond	28,6	35,8	35,8	35,8	35,8	35,8	35,8	35,8	35,8	35,8
Shareholder loans	0,0	2,7	12,7	22,7	32,7	39,3	39,3	39,3	39,3	39,3
Preferred shares	0,0	0,0	0,0	0,0	0,0	3,4	10,8	10,8	10,8	10,8
Ordinary shares	***0,0***	***0,0***	***0,0***	***0,0***	***0,0***	***0,0***	***2,6***	***12,6***	***22,6***	***32,6***
Fund	0,0	0,0	0,0	0,0	0,0	0,0	2,1	10,1	18,1	26,1
Management	0,0	0,0	0,0	0,0	0,0	0,0	0,5	2,5	4,5	6,5
Total	**110**	**120**	**130**	**140**	**150**	**160**	**170**	**180**	**190**	**200**

Emphasising the Increasing Effects of Institutional Return Depressed Share Value

Underwater Equity

Value of Sweet Equity is far below the stake invested by the management

Management may not recover its stake at exit

Key component of the management pay is missing

Management is not incentivised anymore

Management is de-motivated and candidate to leave

Underwater management equity is a significant issue affecting the PE Industry

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Resetting Underwater Equity

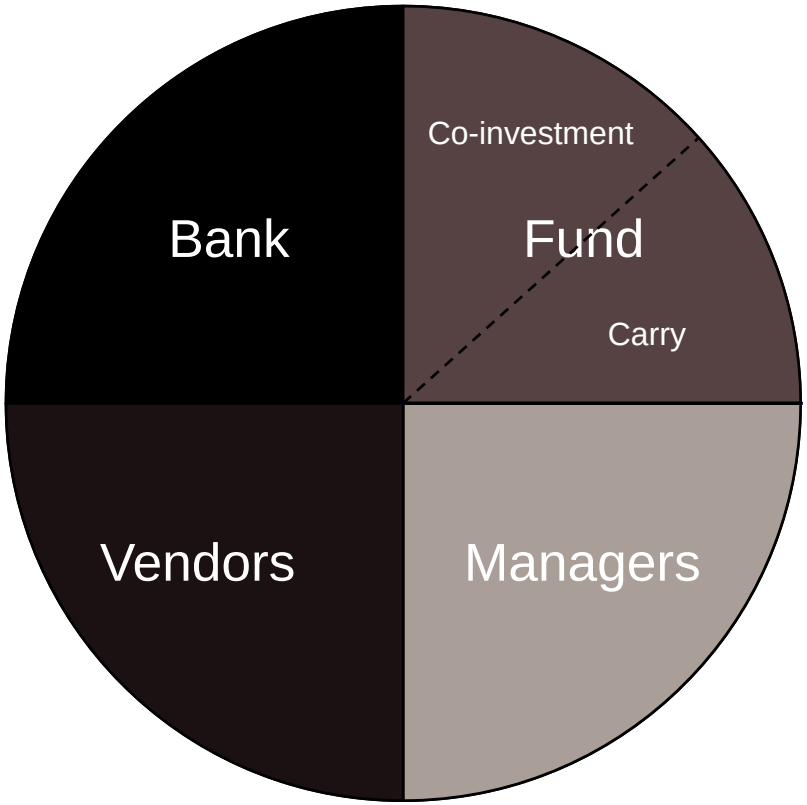
Stakeholders

Identifying management expectations is key

Possible resetting methods

- Waiving debt
- Reducing the coupon
- Convert Debt to Equity

Resetting Underwater equity incentives - Stakeholders



Resetting Underwater Equity

Stakeholders

Identifying management expectations is key

Some possible resetting methods

- Waiving debt
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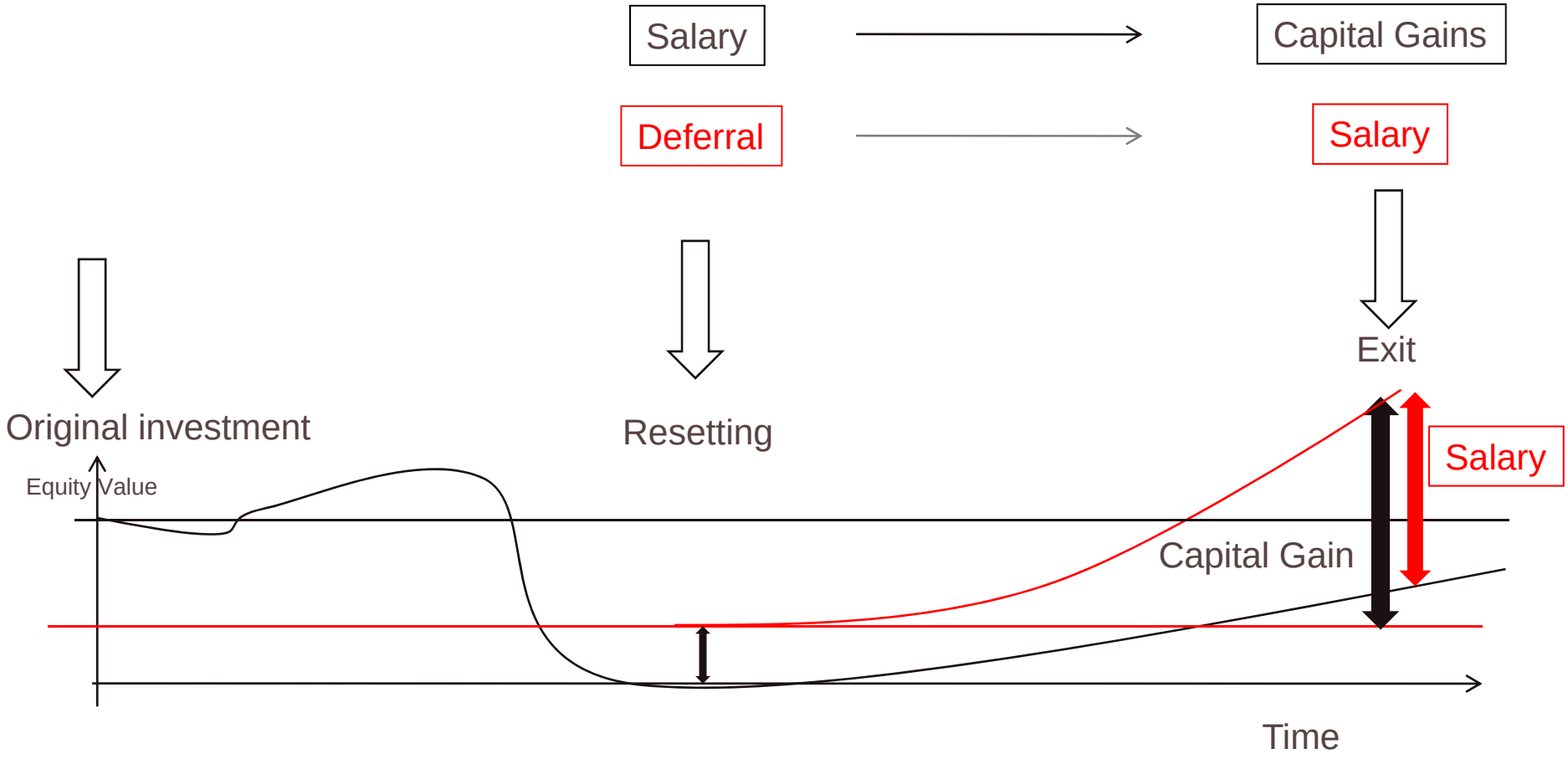
Resetting underwater equity incentives

Identifying the management expectations is key

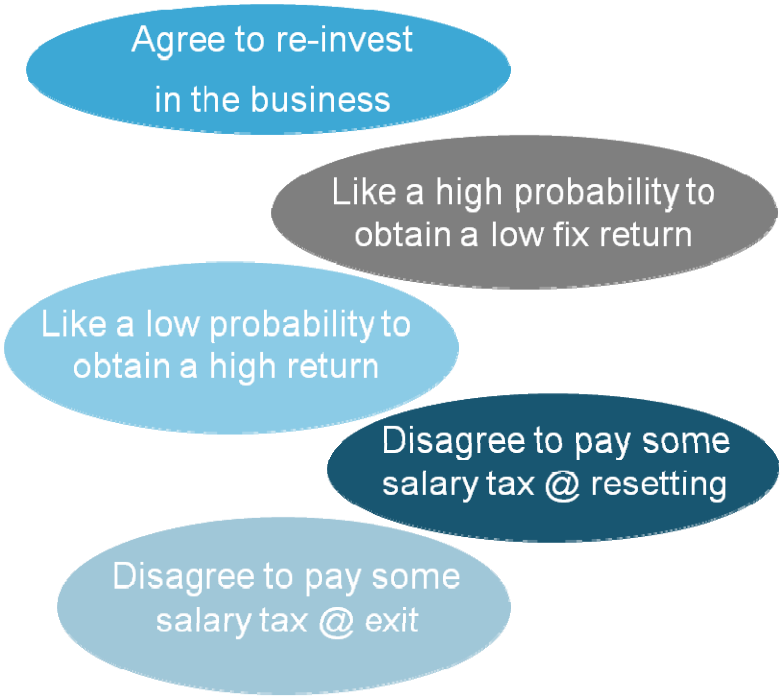


Resetting underwater equity incentives

Identifying the management expectations is key

Resetting underwater equity incentives

Identifying the management expectations is key



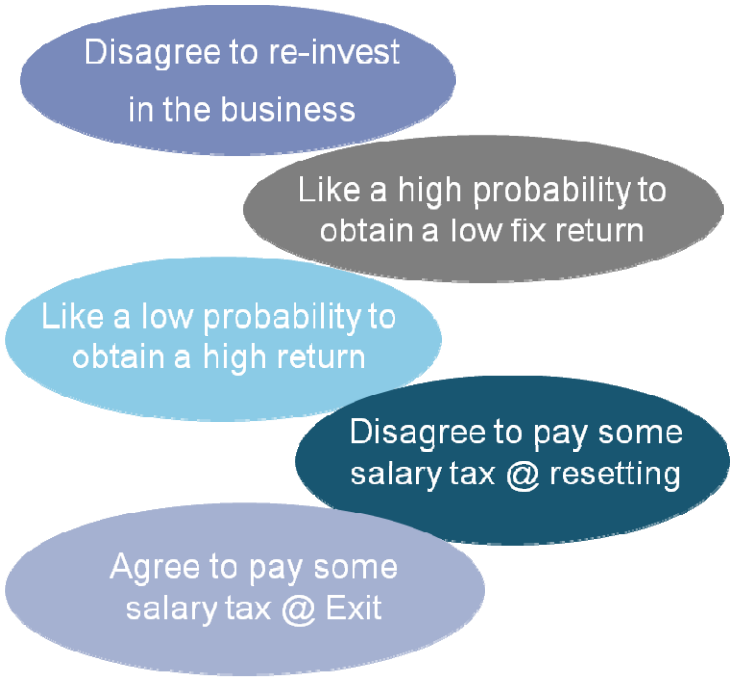
Management reinvest in instruments in line with their risk-appetite

If the re-investment occurs @ FMV, the management will not be recognized a taxable salary at resetting

Usual tax and legal structuring may be needed to avoid a possible risk of taxation of exit proceeds @ 33% (+ local tax)

Resetting underwater equity incentives

Identifying the management expectations is key



Resetting of the management equity incentive through a debt waiving, reduction of coupon, bonus….. in line with his/her risk appetite

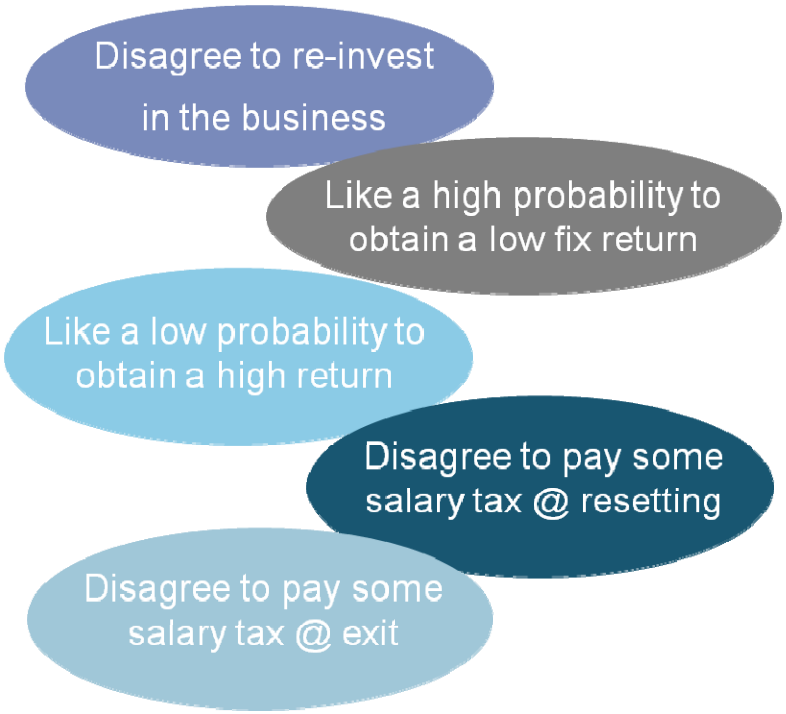
Secure a deferral of taxation of the resetting

That part of the exit proceeds arising from the equity incentive resetting is taxed @ exit as salary income

Usual tax and legal structuring may be needed to avoid a possible risk of taxation of that part of the exit proceeds not subject to salary tax as sundry income @ 33% (+ local tax)

Resetting underwater equity incentives

Identifying the management expectations is key

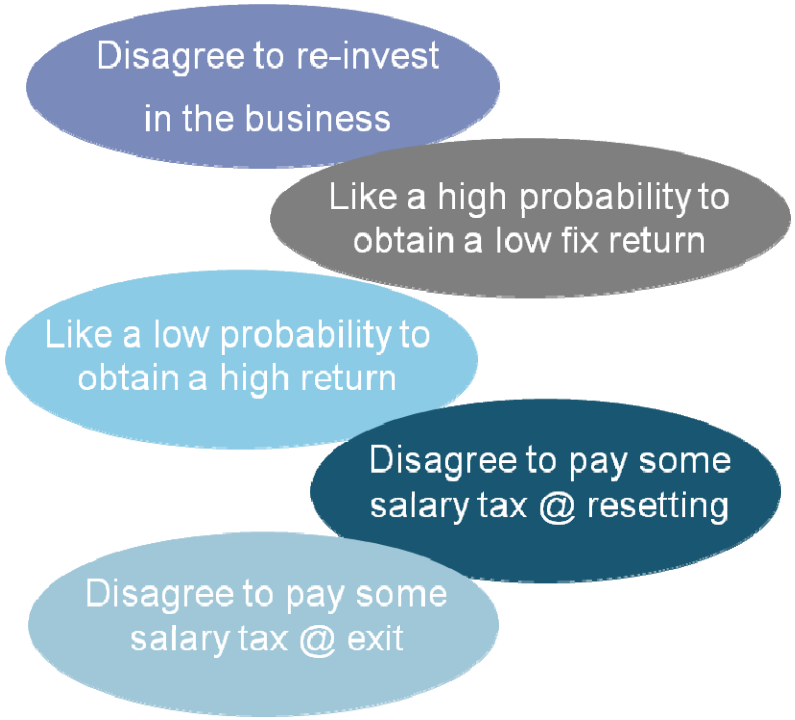


PE house grants financial instruments free of charge to the management and satisfy the **salary tax due** @ **resetting** on behalf of the management

Usual tax and legal structuring may be needed to avoid a risk of taxation of exit proceeds @ 33% (+ local tax)

Resetting underwater equity incentives

Identifying the management expectations is key



PE house grants a loan (possibly non-recourse loan) to the management to acquire the instruments

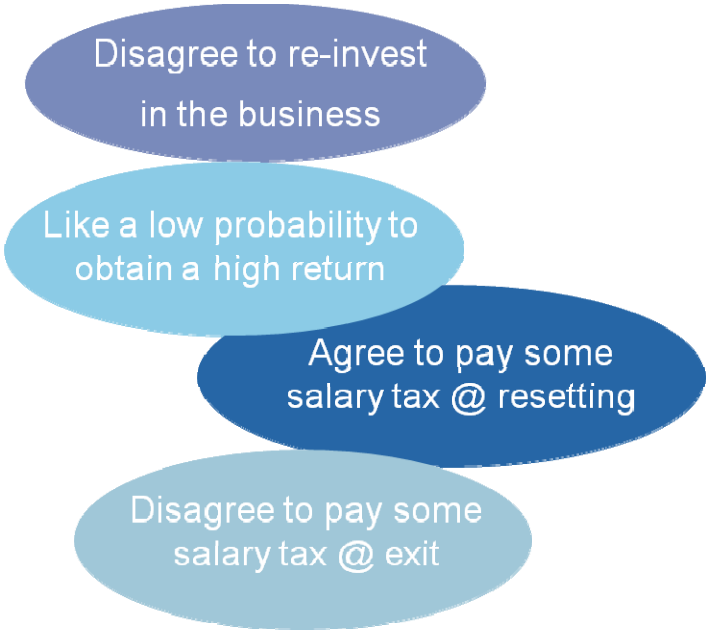
Management reinvest in instruments @ FMV

At exit, part of the exit proceeds are dedicated to the loan reimbursement

Usual tax and legal structuring may be needed to avoid a risk of taxation of the balance of the exit proceeds @ 33% (+ local tax)

Resetting underwater equity incentives

Identifying the management expectations is key



Resetting through Share Options

Options are taxed immediately

Tax is a small percentage of the equity ..

If equity value is low….tax is low

No taxation on the exit proceeds

Resetting Underwater Equity

Stakeholders

Identifying management expectations is key

Some possible resetting methods

- Waiving debt
- Reducing the coupon
- Convert Debt to Equity

Possible resetting methods- Waiving Debt

Allocation of exit proceeds after 7 years (Mios €)

	T	*T + 7*
Senior Debt	50,00	70,4
Mezzanine/ Bond	20,00	30,1
Shareholder loans	20,00	32,1
Preferred shares	5,00	8,6

Exit proceeds	**110**	**120**	130	**140**	**150**	**160**	**170**	**180**	**190**	**200**
Senior Debt	70,4	70,4	[illegible]	70,4	70,4	70,4	70,4	70,4	70,4	70,4
Mezzanine/ Bond	30,1	30,1	30,1	30,1	30,1	30,1	30,1	30,1	30,1	30,1
Shareholder loans	9,6	19,6	29,6	32,1	32,1	32,1	32,1	32,1	32,1	32,1
Preferred shares	0,0	0,0	0,0	7,5	8,6	8,6	8,6	8,6	8,6	8,6
Ordinary shares	***0,0***	***0,0***	***0,0***	***0,0***	***8,9***	***18,9***	***28,9***	***38,9***	***48,9***	***58,9***
Fund	0,0	0,0	0,0	0,0	7,1	15,1	23,1	31,1	39,1	47,1
Management	0,0	0,0	[illegible]	0,0	1,8	3,8	5,8	7,8	9,8	11,8
Total	**110**	**120**	0	**140**	**150**	**160**	**170**	**180**	**190**	**200**

In 2009, the PE house assumes an exit value of the business in 2012 to be 130

Possible resetting methods- Waiving Debt

Allocation of exit proceeds after 7 years (Mios €)

	T	T + 7
Senior Debt	40,00	56,3
Mezzanine/ Bond	16,00	24,1
Shareholder loans	16,00	25,7
Preferred shares	5,00	8,6

All debts and related interest (accrued or not) are waived by 20%

- Money multiple for management is increased to reach 3.1
- Slightly more complex
- Need to integrate all parameters : corporate tax aspects,…

Exit proceeds	**110**	**120**	130	**140**	**150**	**160**	**170**	**180**	**190**	**200**
Senior Debt	56,3	56,3	56,3	56,3	56,3	56,3	56,3	56,3	56,3	24,1
Mezzanine/ Bond	24,1	24,1	24,1	24,1	24,1	24,1	24,1	24,1	24,1	24,1
Shareholder loans	25,7	25,7	25,7	25,7	25,7	25,7	25,7	25,7	25,7	25,7
Preferred shares	4,0	8,6	8,6	8,6	8,6	8,6	8,6	8,6	8,6	8,6
Ordinary shares	***0,0***	***5,4***	***15,4***	***25,4***	***35,4***	***45,4***	***55,4***	***65,4***	***75,4***	***85,4***
Fund	0,0	4,3	**3.1**	20,3	28,3	36,3	44,3	52,3	60,3	68,3
Management	0,0	1,1		5,1	7,1	9,1	11,1	13,1	15,1	17,1
Total	**110**	**120**	**130**	**140**	**150**	**160**	**170**	**180**	**190**	**200**

Value of the ordinary shares is reset

Possible resetting methods- Reducing the coupon on the debt

Allocation of exit proceeds after 10 years (Mios €)

Financial returns

Senior Debt	5,00%
Mezzanine/ Bond	6,00%
Shareholder loans	7,00%
Preferred shares	8,00%

Exit value of financing at exit (after 10 years)

	T	*T + 10*
Senior Debt	50,00	81,4
Mezzanine/ Bond	20,00	35,8
Shareholder loans	20,00	39,3
Preferred shares	5,00	10,8

Exit proceeds	**110**	**120**	**130**	**140**	**150**	**160**	170	**180**	**190**	**200**
Senior Debt	81,4	81,4	81,4	81,4	81,4	81,4		81,4	81,4	81,4
Mezzanine/ Bond	28,6	35,8	35,8	35,8	35,8	35,8	35,8	35,8	35,8	35,8
Shareholder loans	0,0	2,7	12,7	22,7	32,7	39,3	39,3	39,3	39,3	39,3
Preferred shares	0,0	0,0	0,0	0,0	0,0	3,4	10,8	10,8	10,8	10,8
Ordinary shares	***0,0***	***0,0***	***0,0***	***0,0***	***0,0***	***0,0***	***2,6***	***12,6***	***22,6***	***32,6***
Fund	0,0	0,0	0,0	0,0	0,0	0,0	2,1	10,1	18,1	26,1
Management	0,0	0,0	0,0	0,0	0,0	0,0	0,5	2,5	4,5	6,5
Total	**110**	**120**	**130**	**140**	**150**	**160**		**180**	**190**	**200**

Exit is anticipated to be deferred by 3 years

Possible Resetting Methods- Reducing the coupon on the debt

Financial returns

Senior Debt	5,00%
Mezzanine/ Bond	6,00%
Shareholder loans	4,90%
Preferred shares	5,60%

Exit value of financing at exit (after 10 years)

	T	*T + 10*
Senior Debt	50,00	81,4
Mezzanine/ Bond	20,00	35,8
Shareholder loans	20,00	32,3
Preferred shares	5,00	8,6

Coupon on the shareholder debt and preferred shares is reduced by 30%

- Money multiple for management is increased to reach 2.4
- Slightly more complex
- Need to integrate all parameters : corporate tax aspects,…

Value of the ordinary shares is reset

Exit proceeds	**110**	**120**	**130**	**140**	**150**	**160**	**170**	**180**	**190**	**200**
Senior Debt	81,4	81,4	81,4	81,4	81,4	81,4	81,4	81,4	81,4	81,4
Mezzanine/ Bond	28,6	35,8	35,8	35,8	35,8	35,8	35,8	35,8	35,8	35,8
Shareholder loans	0,0	2,7	12,7	22,7	32,3	32,3	32,3	32,3	32,3	32,3
Preferred shares	0,0	0,0	0,0	0,0	0,5	8,6	8,6	8,6	8,6	8,6
Ordinary shares	***0,0***	***0,0***	***0,0***	***0,0***	***0,0***	***1,8***	***11,8***	***21,8***	***31,8***	***41,8***
Fund	0,0	0,0	0,0	0,0	0,0	1,5	10,0	20,0	25,5	33,5
Management	0,0	0,0	0,0	0,0	0,0	0,4	1,8	1,8	6,4	8,4
Total	**110**	**120**	**130**	**140**	**150**	**160**	**170**	**180**	**190**	**200**

Possible Resetting Methods - Convert Debt to Equity

Financial returns

Senior Debt	5,00%
Mezzanine/ Bond	6,00%
Shareholder loans	7,00%
Preferred shares	8,00%

Exit value of financing at exit (after 10 years)

	T	*T + 10*
Senior Debt	50,00	81,4
Mezzanine/ Bond	20,00	35,8
Shareholder loans	20,00	39,3
Preferred shares	5,00	10,8

Equity value is deemed to be 10% of nominal value

Fair market value of preferred shares is say 20% of nominal value

Fair market value of the shareholder loan is say 60% of nominal value on the date the debt is contributed

- Value of ordinary shares: 0.5 million EUR
- Value of preferred shares : 1 million EUR
- Value of shareholder loan: 12 million EUR

Exit proceeds	**110**	**120**	**130**	**140**	**150**	**160**	**170**	**180**	**190**	**200**
Senior Debt	81,4	81,4	81,4	81,4	81,4	81,4	81,4	81,4	81,4	81,4
Mezzanine/ Bond	28,6	35,8	35,8	35,8	35,8	35,8	35,8	35,8	35,8	35,8
Shareholder loans	0,0	2,7	12,7	22,7	32,7	39,3	39,3	39,3	39,3	39,3
Preferred shares	0,0	0,0	0,0	0,0	0,0	3,4	10,8	10,8	10,8	10,8
Ordinary shares	***0,0***	***0,0***	***0,0***	***0,0***	***0,0***	***0,0***	***2,6***	***12,6***	***22,6***	***32,6***
Fund	0,0	0,0	0,0	0,0	0,0	0,0	2,1	10,1	18,1	26,1
Management	0,0	0,0	0,0	0,0	0,0	0,0	0,5	2,5	4,5	6,5
Total	**110**	**120**	**130**	**140**	**150**	**160**	**170**	**180**	**190**	**200**

170

0,5

Possible Resetting Methods - Convert Debt to Equity

Financial returns

Senior Debt	5,00%
Mezzanine/ Bond	6,00%
Shareholder loans	6,00%
Preferred shares	7,00%

Exit value of financing at exit (after 10 years)

	T	*T + 10*
Senior Debt	50,00	81,4
Mezzanine/ Bond	20,00	35,8
Shareholder loans	0,00	0,0
Preferred shares	0,00	0,0

Exit proceeds	**110**	**120**	**130**	**140**	**150**	**1**	**170**	**30**	**190**	**200**
Senior Debt	81,4	81,4	81,4	81,4	81,4	81,4		81,4	81,4	81,4
Mezzanine/ Bond	28,6	35,8	35,8	35,8	35,8	35,8	35,8	35,8	35,8	35,8
Shareholder loans	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Preferred shares	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Ordinary shares	***0,0***	***2,7***	***12,7***	***22,7***	***32,7***	***42,7***	***52,7***	***62,7***	***72,7***	***82,7***
Fund	0,0	2,7	12,6	22,6	32,5	42,4	52,3	62,3	72,2	82,1
Management	0,0	0,0	0,1	0,2	0,2	0,3	0,4	0,5	0,5	0,6
Total	**110**	**120**	**130**	**140**	**150**	**1**	**180**	**190**	**200**	

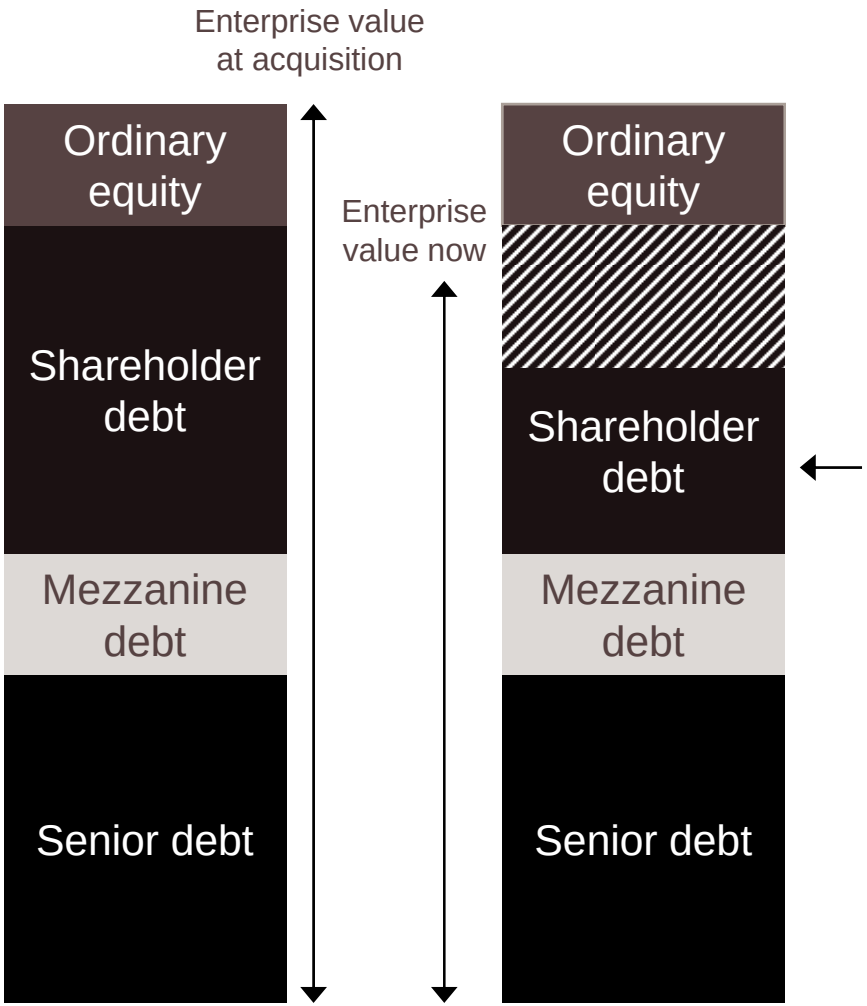
Conversion of Preferred Shares and Shareholder Loan into ordinary shares

- Managers holds 0,1 / (0,5 + 13) = 0,74% of Equity
- PE holds 99,26% of equity

Management is worse-off as a result of the dilution

Solution: Management purchases additional ordinary shares from the PE house

Tax consequences associated to a resetting of underwater equity



- Value flows into equity
- Value of the shares held by the management is increased accordingly
- Is this taxable income?

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Pay practices within PE Backed Companies

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Valid alternatives : Options & bonus

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Tax consequences associated to a resetting of underwater equity

Salary income

The value flows into equity arising from a waiving of debt, debt coupon reduction ….are likely to be regarded as compensation income to the extent the management is not paying for the resetting

Article 30 of BITC

> All benefit received by reason or at the occasion of the professional activity which ever the debtor

Taxed @ 50% (+ local taxes)

Potentially subject to social security contributions

Timing for taxation: date of resetting versus exit date

Tax consequences associated to a resetting of underwater equity

Timing for taxation

- Date of attribution: date on which the beneficiary can dispose of the benefit (likely exit)
- Case-by-case basis
- Possibility to secure a taxation of the value flows into the equity @ the resetting date

1. Management transfers its shares to the PE house prior to the resetting
2. PE house commits to transfer - after the resetting - an agreed number of shares newly created in replacement of the shares surrendered by the management

Management is taxed on the excess of the post-resetting value of the new shares over the value of the surrendered shares on the exchange date

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Valid alternatives: Options & bonus

Think about…. share options when appropriate

- Take advantage from the low value of Equity
- Taxable benefit in kind arising from the grant of share options is a percentage of the equity value underlying the options (like 10%)
- Equity value is close to nil =>Taxable advantage arising from an option grant is close to nil while the spread value @ exercise is tax free
- Grant of option on a huge percentage of shares
  - Newcomers
  - Not sure will be welcome by the existing management which might more likely be inclined to recover their stake and +

Valid alternatives: Options & bonus

Think about…. a bonus….to incentivize the management

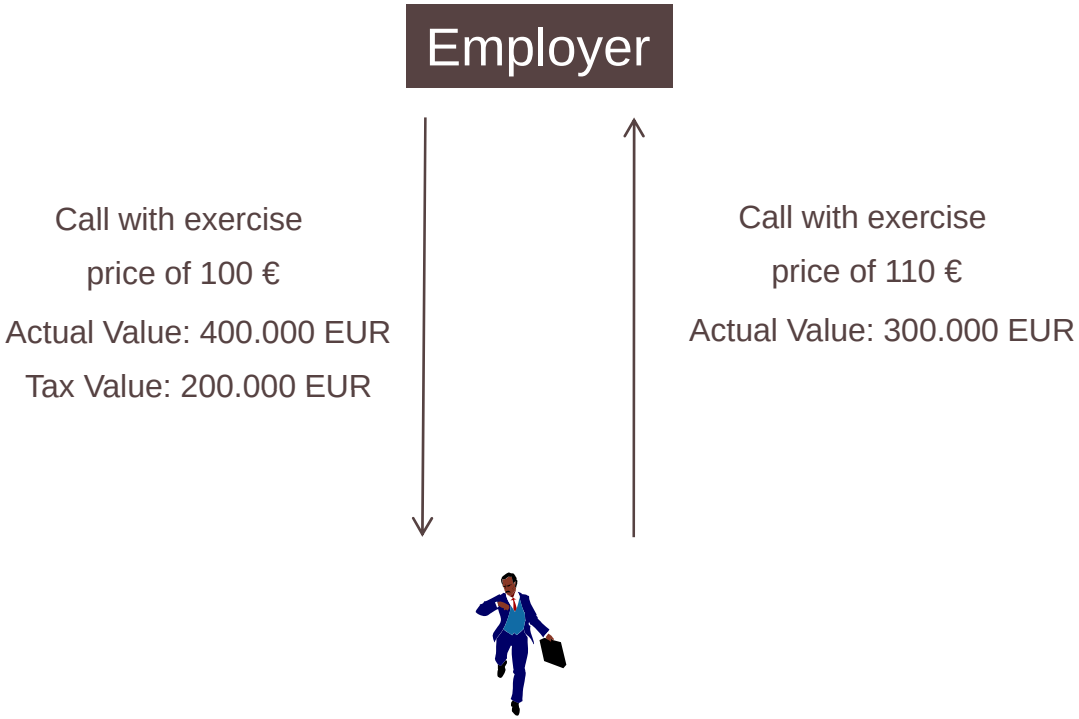
- Simplicity
- Not tax effective
- Possible tax planning may be available
  - Over the counter options (OTC)
  - “Tunnel” call options
    - Call option transferred to a manager with a given strike price
    - Call option issued by a manager with a higher strike price
      - Taxable value of the option transferred to the manager is offset by the financial value of the call option issued by the manager
      - Tax value = lump-sum value of call received minus actual financial value of call issued
      - Way open for tax free bonuses?

Valid alternatives: Options & bonus

Example

- Exchange of 10.000 call options with a strike price of 100 EUR against 10.000 call options with a strike price of 110 EUR (10 years)
- 0 EUR < Bonus < 100.000 EUR
- Tax value of the call options received by the manager: 20% x 10.000 x 100 EUR = 200.000 EUR (actual financial value: say 400.000 EUR)
- Financial value of the call options issued by the manager as per Black & Scholes = say 300.000 EUR
- Taxable amount = 200.000 EUR – 300.000 EUR = 0
- => no tax??

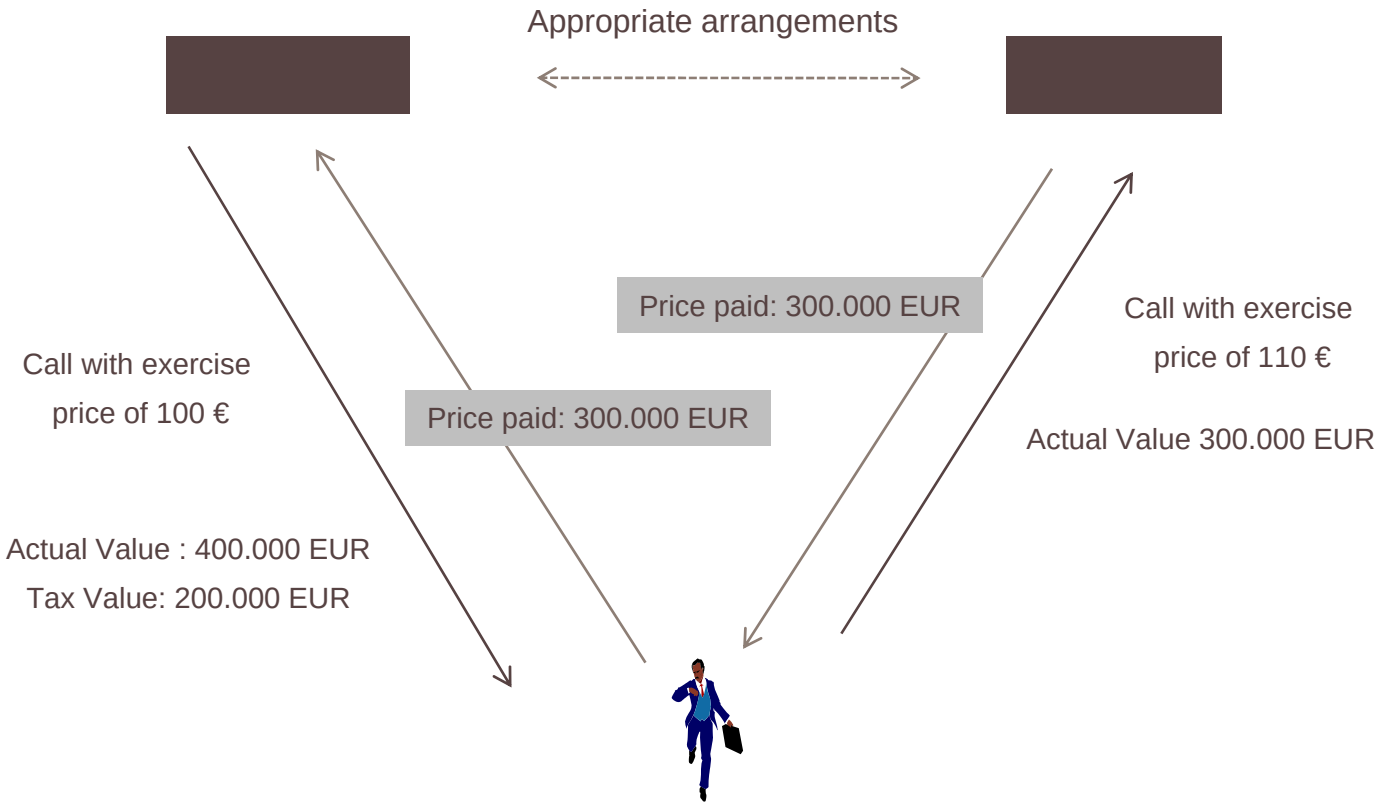
Valid alternatives: Options & bonus



May be challenged by the tax authorities

Valid alternatives: Options & bonus

Sale of the option to the manager



More difficult for the tax authorities to challenge

Agenda

Pay practices within PE Backed Companies

Sweet Equity

Underwater equity

Resetting underwater equity incentives

Tax treatment of resetting methods

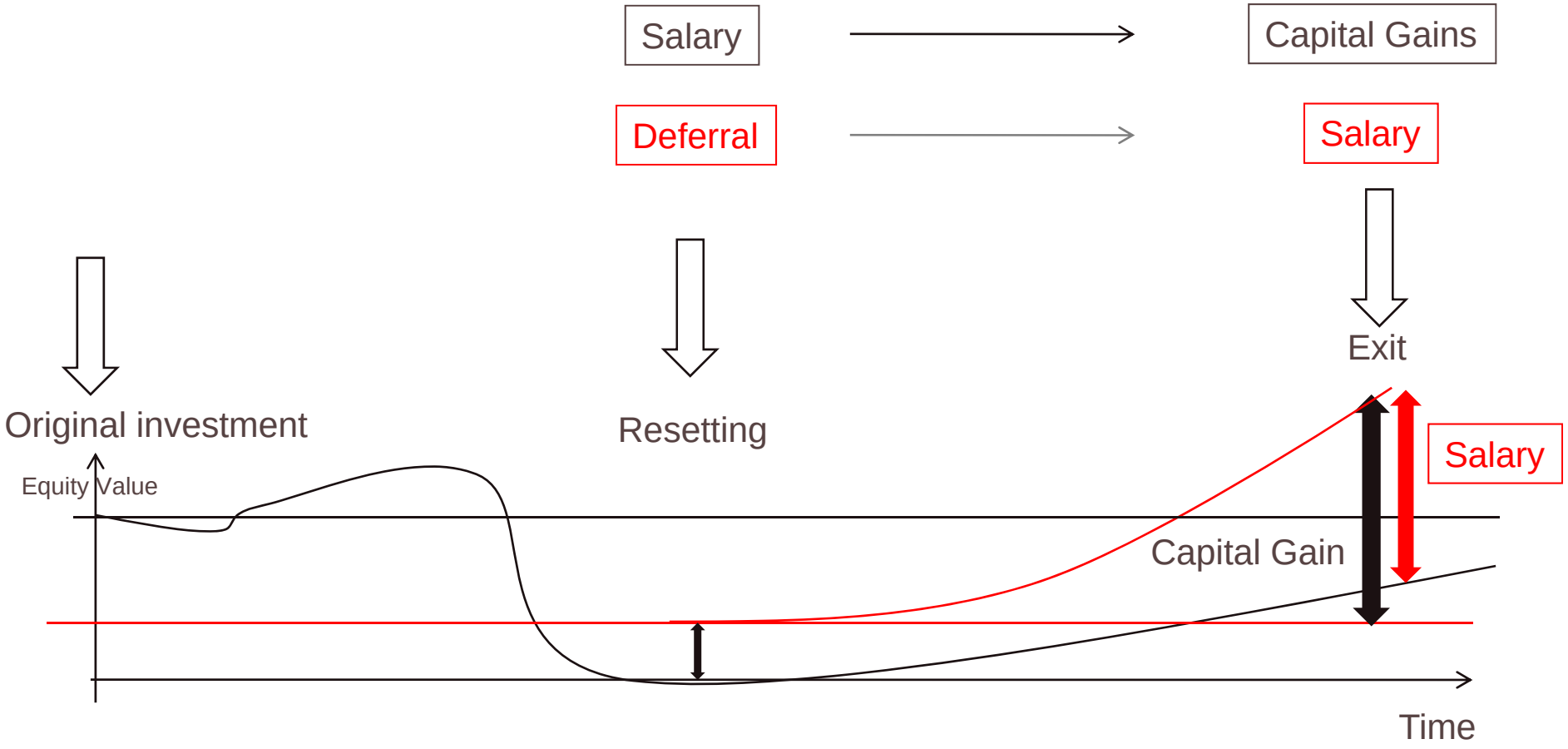
Bonus and options

Managing Capital Gains Tax

Conclusion

Managing Capital Gains Tax

Identifying the management expectations is key



Managing Capital Gains Tax

Risk of taxation of the capital gains @ exit @ 33% (+local taxes)

- High exit multiple
- Investment in the structure may be important to the manager (risky)
- The circumstances of the sale are defined and determined from the outset
- Connectivity with the professional activity

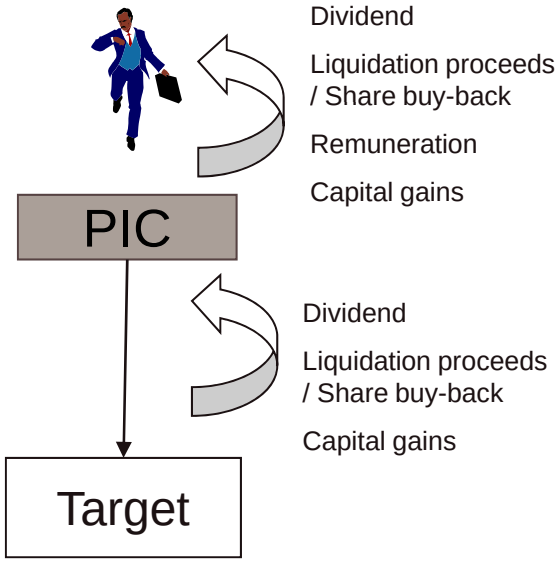
Effective Tax Structuring of Management Participation

- Personal Investment Company
- Deeply Discounted Options

Managing Capital Gain Tax

Personal Investment Company

- Description **:**
  - To avoid the risk of taxation of the exit proceeds as speculative income (33% + local taxes), the Belgian resident managers could consider structuring the investment through a Belgian resident PIC
  - The manager invests in PIC while the PIC invests in Target
- Consequences :
  - At exit, PIC sells its shareholding in Target (exemption of capital gain on shares in the hands of PIC)
  - Managers can liquidate PIC and pay 10% withholding tax on the liquidation proceeds (ignoring possible foreign taxes)
  - Remark: thresholds of € 1.2 m or 10% of the share capital of the Target + 12 months holding



Managing Capital Gain Tax

Deeply Discounted Options

Option with an exercise price being far below the FMV of the underlying share

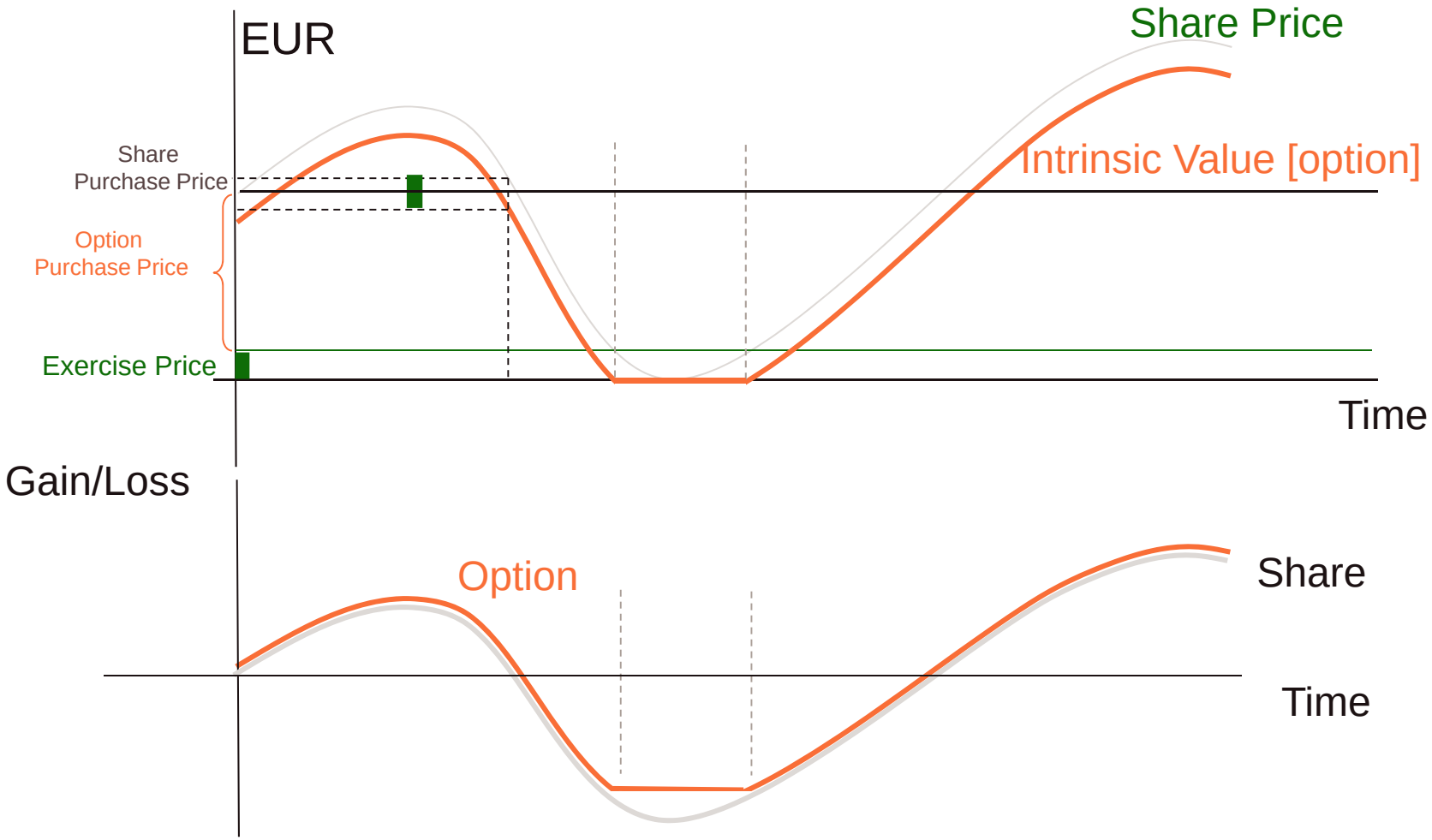
The purpose of the Belgian manager investing in DDO (rather than in ordinary/ junior preferred shares) is to avoid the risk of taxation of the exit proceeds as speculative income (33% + local taxes).

DDO are purchased at their intrinsic value, which is fixed at say 90% of share value (strike price is then 10% of the shares value).

From a financial perspective, an investment in DDO is very much equivalent (but not identical) to a direct investment in shares.

Managing Capital Gain Tax

Deeply Discounted Options vs shares



Effective Tax Structuring of Management Participation

Deeply Discounted Options

Managers will be recognized a taxable benefit in kind equal to 10% of the value of the shares underlying the DDO (assumptions 10 years, option not exercisable before the expiration of the 3rd calendar year following their offer, not transferable except by reason of death).

Effective Tax Structuring of Management Participation

Deeply Discounted Options

Manager buys an option over the shares in NewCo having a market value of €100,000 and allowing him to acquire the shares for €10,000 (strike price) in 10 years (max)

	Year 1	*Year 5*	*Gain*	*Tax*	*Net Gain*
Equity investments					
Tax exempt income ???	**100,000**	**800,000**	**700,000**	**0**	**700,000**
Speculative income (35.3 %)	**100,000**	**800,000**	**700,000**	**<247,170>**	**452,830**
DDO's					
Purchase price option	**90,000**	**800,000**	**700,000**		**694,500**
Exercise price		**10,000**			
Tax at grant				**<5,500>**	

Agenda

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Underwater equity is a main concern for private equity houses

There are solutions

Identify the expectations of the management is key

Value flows into equity arising from a resetting are likely taxable as compensation income (structuring for appropriate timing to pay tax)

Take advantage of a favourable tax treatment of options where appropriate

Optimize bonuses

Manage capital gains tax on exit proceeds

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